Buffers for the link: A graphical note

聯匯之緩衝：圖象註釋

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Twenty years ago, the link of 7.80, a product of political and economic distress, was announced. Ironically, the Hong dollar has been under strong-side pressure lately.

With the existing one-way convertibility undertaking (CU), "constructive ambiguity" serves to deter speculative short positions. Nevertheless, should the credibility of the currency board system be under threat in the future (and while the link is still deemed useful), it can be enhanced by the institution of a strong-side CU; but a very efficient system like Hong Kong's (with RTGS) may imply undue liquidity volatility for a two-way pricing arrangement without spread. Outside disturbance will be transmitted to the financial sector more quickly and strongly through the settlement mechanism if the exchange rate is "cast in stone" and the "aggregate balance" is by design near zero.

Buffers can in my view be created against "portfolio shocks" (e.g. exogenous capital inflows or outflows) by having a spread between the strong-side and the weak-side undertakings and a deposit reserves requirement with averaging provisions. External pressure will then be spread out over variables and over time.

This short piece can be regarded as a graphical illustration for my earlier article "Liquidity management, two-way CU and deposit reserves with averaging provisions: A technical note" (www.hkbu.edu.hk/~sktsang/Tsang021201.pdf). The graph was drawn during my recent interview by an international journalist. I hope that it is intelligible even though I do not have time to turn it into something tidier.

reform: deposit reserve system with averaging provision

4% of depo monthly average

2% 6%

the law of large no.

banks liquidity even out

liquidity buffer

~ 0

HKMA depo reserves > 0

Interbank liquidity system

financial tax

T+2

HKMA

RTGS

Agg. balance

banks

Discount window

help solve

portfolio shocks

exogenous capital inflow / outflow

liquidity management

problems with 2-way CU 7.80 with no spread

all banks ⟷ HKMA bilateral →

liquidity r ↕ volatility

if exchange rate can move a bit ✓

→ absorbs the pressure