

The convertibility zone and operations to remove market anomalies

[Tsang Shu-ki](#)

Department of Economics

Hong Kong Baptist University

6 June 2005

To implement two-way convertibility in Hong Kong's currency board system, there were basically two options: (1) a narrow band between the weak-side and strong-side undertakings (dozens instead of hundreds of pips) plus a liquidity buffer such as deposit reserves with averaging and rolling provisions; or (2) a wider zone with no additional liquidity cushion.

My past writings presented an analysis of the first option on the basis of a number of theoretical assumptions and practical observations.¹ The actual choice taken is now history.

In lieu of any reserves requirement, the Aggregate Balance (AB) would remain very small under normal circumstances. Given a significant exogenous shock, some variables need to serve as absorption buffers. With a convertibility zone of 500 pips on either side of 7.80, the spot exchange rate is one of them (along with interbank interest rates).

The zone is regarded as very wide by some commentators but as vulnerable to speculation because of its narrowness by others. In my article "Liquidity management, two-way CU",² I discussed the possibility of a powerful speculating party "pushing the exchange rate up and down in the corridor" of 50 pips.

¹ See two pieces of mine: "Liquidity management, two-way CU and deposit reserves with averaging provisions: A technical note", 2/12/2001 (www.hkbu.edu.hk/~sktsang/Tsang021201.pdf); and "Buffers for the link: A graphical note", 15/10/2003 (www.hkbu.edu.hk/~sktsang/Buffers_for_the_link.pdf). For deposit reserves requirements in the U.S., Japan, the euro area, and a range of developing economies, including arrangements covering the maintenance periods and averaging and carry-over provisions, see Denis Blenck, Harri Hasko, Spence Hilton and Kazuhiro Masaki, "The main features of the monetary policy frameworks of the Bank of Japan, the Federal Reserve and the Eurosystem", in Monetary and Economic Department, "Comparing monetary policy operating procedures across the United States, Japan and the euro area", *BIS Papers*, No.9b, December 2001 (www.bis.org/publ/bispap09b.pdf); and Jozef van 't dack, "Implementing monetary policy in emerging market economies: an overview of issues", in "Monetary policy operating procedures in emerging market economies", *BIS Policy Papers*, No.5b, March 1999 (<http://www.bis.org/publ/plcy05b.pdf>).

² Cited in footnote 1.

How should that kind of destabilising behaviour be discouraged? I followed up immediately in the article by saying: “From this perspective, a two-way CU with no spread would kill its fun.” Yet the rigid guarantee itself leads to new problems. The foreign exchange market in HKD/USD will be displaced, leading to layoffs.³ Moreover, imagine a two-way CU with no spread plus a near-zero AB in an international financial centre. I can’t honestly recommend such a setup as a “solution” and I didn’t, especially in the light of Hong Kong’s post-1998 economic and monetary developments.

What is the alternative? Interestingly, we have to travel some distance to find it. A convertibility zone of hundreds of pips would mean that any speculating party, even one with market manipulating capabilities, faces a relatively “spacious corridor” and the risk and cost of its actions are increased.

I remember long time ago I used to play one-a-side (plastic) football games with my younger brother in the narrow corridor of our old home. The “goals” were simply conceived to exist at either end of it, but “long-range” shooting was forbidden. Being physically stronger, albeit not by much, I always resorted to the ploy of kicking the ball to one side and then speeding past my brother on the other to collect it back after its rebound from the wall. The rest of the task was peanut.

What if the corridor had been considerably wider than it was? The ball rebounding from the wall, on whether the left or the right, would have taken longer to reach me. So my little opponent would have had time to turn around and chase it at a less disadvantage. I would not have had the easy job of guiding it towards a defenceless “goal”, as was often the situation.

Readers may complain that I didn’t use my own footwork skill (like a Ronaldino, or a Pele, to be more truthful to our bygone era). But we are not talking about a genuine football field, are we?

In my personal view, a convertibility zone for Hong Kong’s currency board system represents a trade-off between stability as well as credibility on the one hand, and liquidity and flexibility on the other.

³ Some may argue, though, that it is a matter of temporarily sacrificing private interests for the sake of the public good as the unfortunate traders can find new jobs later.

Anyhow, an important point is that it would be highly unrealistic to expect the monetary authority to do nothing proactive within the zone, and just receptively react to market offers to buy/sell at either border (7.75 or 7.85). If that passivity were the single rule, then a powerful speculator might play the other trick of trying to block the move of the exchange rate towards those two triggers, with a view to delaying adjustments in the market (including interest rate arbitrage) for the benefit of his own betting positions or profit-seeking manoeuvres.

Under the past setup with only one-way (weak-side) CU, the HKMA reserved some discretion in its “strong-side operation strategy”.⁴ I called the complex problem one of “multiple equilibria”.⁵ I find it quite normal that discretion is needed for market operations within the new convertibility zone to remove anomalies which could emerge from time to time. Any smoothing action should certainly be carried out in a transparent and accountable manner.

⁴ See the Record of Discussion of the Meeting of the Exchange Fund Advisory Committee Sub-Committee on Currency Board Operations held on 31 August 2000.

⁵ Tsang Shu-ki, “A quick note on multiple equilibria under a currency board regime”, 26 May 2005 (www.hkbu.edu.hk/~sktsang/Multiple%20equilibria.pdf).