

The strengthening of the Hong Kong dollar: A few observations

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The recent strengthening of the market exchange rate of the Hong Kong dollar has caught many people by surprise. Here I have a few observations.

The first factor is no doubt the unwinding after the G7 meeting of speculative short positions (which some market participants knew had been accumulating since mid-summer). Apparently squeezing by other traders has helped to push the rate to levels unseen in a number of years.

Under Hong Kong's one-way convertibility undertaking (CU), there is no explicit “intervention” point on the strong side, and hence, unlike on the weak side, no effective arbitrage mechanism. Indeed, the HKMA is supposed to “continue to respond to offers (of US dollars) from banks according to prevailing market conditions”. The reasons for not adopting two-way CU were spelt out in [the record of discussion of the EFAC Subcommittee in October 1999](#).

Technically, I have different opinions about the asymmetry in our currency board system, as I argued in an earlier piece posted on my homepage: www.hkbu.edu.hk/~sktsang/Tsang021201.pdf.

In any case, there is I think no presumption about strong side “defence”. Market participants liked to think about 20, 30 to a few dozen pips. But now it is a few hundred; and still no further (announced) “intervention” has taken place.

The Government is apparently not worried about the strengthening, not to say not wanting to help those who sold short. A lengthened period of “pain” might serve as a better “lesson”.

In my view, a second factor is the persistent inflow of capital into Hong Kong, which perhaps explains the more recent stage of non-convergence. Investors may have become more optimistic about Hong Kong because of CEPA, and the just announced “Capital Investment Entrant Scheme” (details of which were widely “expected”). As a small open economy with a fixed exchange rate, one possible way for Hong Kong to get out of deflation is through balance of payments (capital account) surplus. China's experience could be of reference value here, although whether the inflow will persist

and how it will eventually impact on the local economy are controversial questions.

For the moment, the Government may not want to dampen investors' enthusiasm in putting their money into the SAR. In face of significant interest in the Hong Kong dollar, "intervention" would not be very effective anyway. And the inflow could itself dry up after a period. So why hurry to achieve convergence again? If the strengthening threatens the credibility of the currency board system, it will be another story.

These personal views of mine may or may not be correct interpretations of the events.