A quick note on multiple equilibria under a currency board regime

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Hong Kong is the only existing currency board system, which is also an international financial centre with no capital controls of any kind. It is therefore susceptible to various exogenous shocks of significant magnitudes. Add to that mix a market structure that does not quite match the textbook model of perfect competition, and one should see why volatility or instability sometimes arises.

Any shock can be transmitted to the aggregate balance, interest rates, and the exchange rate in different proportions and combinations.[1] To use a technical jargon, the case is possibly one of “multiple equilibria”. Trying to trace a simplistic relationship between any two variables, say HIBOR-LIBOR differential and the spot exchange rate, would in many cases not be fruitful.

In the past regime of one-way (weak-side) convertibility undertaking, strong-side exchange rate deviations found no explicit reference point and interest rate arbitrage could be risky for market participants. The problems of identifiability and determinacy became a headache to researchers. Now with the two-way CU providing a firmer symmetrical anchor in the foreign exchange market, hopefully more tractable multiple equilibria are emerging.

[1] Readers may like to refer to paragraphs 3 and 4 of the Record of Discussion of the Meeting of the Exchange Fund Advisory Committee Sub-Committee on Currency Board Operations held on 31 August 2000.