

The HKMA's Convertibility Undertaking is Not an Insurance Instrument

Tsang Shu-ki

Department of Economics

Hong Kong Baptist University

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Interesting questions, puzzling answers, and switch-off options

Is the one-way convertibility undertaking offered by the HKMA from 7 September 1998 onwards an insurance instrument, like a put option that Chan et al. (1997) and Chan and Chen (1999) proposed? To what extent is the “one pip a day” programme started on 1 April 1999 with the intention of moving the convertibility rate from 7.75 to 7.80 by 12 August 2000 “analytically equivalent” to a legally binding guarantee with a definite time horizon?

My answers to both questions are negative.

However, on the basis of their recent writings, including online articles, some of my good friends at the HKUST and the City University seem to be saying yes to these two questions (e.g. Kwan, Lui and Cheng, 1999). More informally, Leonard Cheng of the HKUST reiterated an affirmative answer to the first question in the 9 October workshop we just organized (I presume I might quote Leonard here: my apology otherwise). This baffles me. I fail to understand why A is actually B when A only looks like B in some aspects.

If this interpretation of mine about what is going on is wrong, please neglect what follows. Otherwise, I should start with a declaration of interests: in my view the convertibility undertaking of the HKMA looks more like my proposal of the “AEL model” of Argentina, Estonia and Lithuania (Tsang, 1998) under which the central bank “guarantees” the convertibility of all its financial liabilities, including banks’ balances with it. In Hong Kong’s case, the latter means the famous “aggregate balance” in lieu of deposit reserve requirements. In any case, the guarantee or undertaking is not an insurance instrument like a put option.

Of course, I did not invent the AEL model. All I was saying was that the HKMA should do what most other major currency board regimes (CBRs) were doing, instead of clinging on to its idiosyncratic and ineffectual arrangements to defend the link in a time of crisis.

Readers who think that this is simply a quarrel among grudging academics eager to claim credit for what has happened should switch off immediately here. There is no need to read on. However, before you do so, I have to say that both sides of the argument are much more civilized and sophisticated than you might think.

Thanks for staying: credibility versus (political or monetary) liability

For those who are still with me, I wish to say that my intention here is to conduct discussion about an important issue in plain language, but with logical rigour. Hopefully, the result of the argument is useful for a correct understanding of the evolving CBR in Hong Kong and serves to clarify things for commentators who are not experts in the field. It may even provide insights on how the system should be improved in the future.

If my dear colleagues at the HKUST and the City University are keen about establishing insurance for Hong Kong's CBR, my opinion is quite straight-forward: their objective has not yet been achieved. To pursue it to the end, I have a very simple but concrete proposal that I would humbly submit to them later on in this short piece.

A guarantee may take many forms, generating different degrees of **credibility** as well as **liability**. If a CBR legislates the convertibility undertaking, like what Argentina, Bosnia-Herzegovina, and Bulgaria have done in various manners (Tsang, 1999), the credibility of the undertaking should be enhanced. But even such legalization never spells out any liability provisions.

In so far as there is liability, it is **political**, not **monetary** in nature. If the currency board reneges and devalues the currency through the legal route by changing the law or the regulation, or simply by exercising its discretionary power under either, who can claim what from whom? Nobody and nothing! Yes, one can pour abuses on the already embarrassed monetary officials, and the government might even be brought down democratically or otherwise. But no bureaucratic institutions are going to pay one any money for putting faith in the previous ill-fated peg.

An insurance instrument, on the other hand, is a legal contract that clearly specifies, amongst other features, a monetary liability. Its credibility is based on both its legality and the spelt-out “compensation” in terms of dollars. A put option writes all these and other provisions into the contract: the size of commitment, the maturity period, the strike price, etc. You know exactly how you are hedged and what you will get if market conditions turn different ways. In case of default, you can sue the party who issues the option.

As far as I know, no CBRs have issued any instruments that have legal features resembling these. Certainly not Hong Kong up to now. Of course, it does not mean that these instruments are necessarily infeasible or undesirable in a CBR. But feasibility and desirability are separate issues. We are now only talking about whether such instruments exist in Hong Kong or not. I don't think they do.

Hong Kong's “loosest” CBR: you can sue nobody

In Tsang (1999), I looked at the legal frameworks of six major currency board regimes (CBRs), and found Hong Kong's CBR having the “loosest” foundation in laws. There is no law on the currency board system; nor an ordinance governing the HKMA. Article 111 of the Basic Law stipulates that “(t)he issue of Hong Kong currency must be backed by a 100 per cent reserve fund”, without specifying the reserve asset or the exchange rate. Then there is Section 4(1) of the Exchange Fund Ordinance, which calls for full backing for Hong Kong dollar bank notes issued under the CI mechanism, again without pointing to the US dollar or any exchange rate.

In fact, the linked exchange rate of HK\$7.80/US\$ does not appear in any statutory document in Hong Kong.

I should hasten to add that “legalization” is not a panacea to enhance credibility of a CBR. As I analyzed in Tsang (1999), credibility of a CBR depends on three things: (1) the commitment of the monetary authority; (2) the effectiveness of the mechanism of defending the fixed exchange rate; and (3) the perceived appropriateness of the fixed exchange rate. Legalization only adds directly to “commitment”, but not necessarily to “effectiveness” and “appropriateness”.

And top Hong Kong officials have been using non-legal channels to repeat their

commitment to the linked rate of HK\$7.80/US\$, including in one case that the Financial Secretary said he would resign if the link were abandoned. So far, this approach seems to work.

Convertibility undertaking: just words of the HKMA

What is the legal status of the one-way convertibility undertaking of the HKMA? Well, very simply, it is not legal at all. The HKMA makes dozens of pronouncements and “policy statements” over the years, many of which are declarations of intent, or more bluntly, only “believe it or not” in nature.

Take the LAF as an example. Its transformation into a discount window on 7 September 1998 required no approval from the Legislative Council because no statutory changes were involved. The HKMA can modify the rules of the discount window any time it deems fit. It is the same for the one-way convertibility undertaking and the 500-day sliding shift of the convertibility rate. If the HKMA changes its mind and goes against your way, you can't sue it. Frankly, where is the legal contract, verbal or in black and white, which you, as a commercial banker involved in the discount window and the aggregate balance, can show to your lawyer to claim any specific damage from the HKMA in the (unlikely) event of a devaluation or the floating of the Hong Kong dollar?

Of course, all indications are that the HKMA is a very responsible institution that will not change its mind erratically. But remember why the 500-day programme was necessary. It was because the HKMA could not make up its mind in the turbulent month of September 1998. The convertibility rate was initially set at 7.75 instead of 7.80, as the HKMA fell victim to its use of 7.75 as a line of defence or an instrument of "constructive ambiguity" in the past. Then the HKMA threatened that the convertibility rate would be moved to 7.80 very soon, generating a brief period of chaos in the market. In response, the HKMA made a U-turn and pledged not to change the rate for six months; and it consulted academics and practitioners on how to move the rate back to 7.80 in a smooth manner. Colleagues from the Chinese University of Hong Kong, in particular Dr. Chong Tai-Leung (Chong, 1999), were the first to suggest a sliding programme of five pips a day, but the HKMA settled on one pip a day because the interest rate effect would be minimal. My only "contribution" then was to suggest to the HKMA that instead of business days, it should use calendar days for calculation.

It is obvious that the “intertemporal guarantee” of 500 calendar days arose from a series

of accidents and changes of mind, rather than from a calculated plan. Who dare say that accidents and changes of mind won't happen in the future? Again, even if those unlikely events do emerge, you can't sue the HKMA and claim any damage.

What will happen after 12 August 2000?

Moreover, the 500-day programme will end on 12 August 2000 when the convertibility rate will arrive at 7.8000. So the "intertemporal currency board" (Chan and Chen, 1999), if it does exist, will become "static" again. Supporters of put options and structured notes should perhaps plan for the demise of "insurance".

What is to be done? Very simply: just ask the HKMA to issue genuine put options and structured notes, like what many financial institutions are doing all the time, unless one argues that the illusive, and in my view erroneous, "analytical equivalence" is good enough. This is not convincing to academics, not to say practitioners and the general public. Are the words of the HKMA and top government officials, undoubtedly committed morally, as good as legal contracts?

Of course, I am assuming above that issuing legally binding insurance instruments is a desirable thing for the HKMA to do. Actually I doubt it as well. I don't think it is a necessary or a sufficient condition for exchange rate and monetary stability in Hong Kong under the present circumstances. But that is another story.

References

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Epilogue (3 December 1999): In its meeting on 5 November 1999, the Exchange Fund Advisory Committee Sub-Committee on Currency Board Operations discussed the feasibility and desirability of using currency options to assist in the defence of the currency board system in Hong Kong. The Sub-Committee concluded that "the writing of options was not necessary in current conditions". Hence, at least from the perspective of the Sub-Committee, official put options covering the link do not exist in Hong Kong now. See the Record of Discussion of the Meeting posted on the HKMA website (<http://www.info.gov.hk/hkma/eng/press/latest/991201e3.htm>).