

## Worksheet 6: The Importance of the Linked Exchange Rate System to Hong Kong

Book	Chapter	Related concepts
5 National Income and Price Level	5	Changes in equilibrium output level
6 Money and Trade	8	Functions of the Hong Kong Monetary Authority

### Source A: Changes in the exchange rates of selected currencies against the US dollar

The global foreign exchange market was volatile in 2024, with many currencies experiencing a significant decline in their exchange rates against the US dollar. For example, the Australian dollar fell by 9%, the Korean won by 12%, the Mexican peso by over 20%, and the Japanese yen by more than 9%. Meanwhile, the exchange rate between the Hong Kong dollar and the US dollar remained stable.

*Source: Hong Kong Monetary Authority*

### Source B: Operation of the Linked Exchange Rate System

The Linked Exchange Rate System in Hong Kong operates under the currency board system. Under this system,

- The monetary base is fully backed by US dollar assets, and all changes in the monetary base are fully matched by corresponding changes in US dollar assets at a fixed exchange rate.
- The Hong Kong Monetary Authority (HKMA) provides Convertibility Undertakings (CUs) (兌換保證), under which the HKMA commits to sell Hong Kong dollars upon request by banks at the strong-side CU of HK\$7.75 per US dollar, and to buy Hong Kong dollars upon request by banks at the weak-side CU of HK\$7.85 per US dollar.

Hong Kong has sizable foreign currency reserves of over US\$420 billion, which is equivalent to about 1.7 times of the monetary base, ensuring the smooth functioning of the Linked Exchange Rate System.

*Source: Hong Kong Monetary Authority*

### Source C: Difficulty in maintaining the Linked Exchange Rate System

In order to maintain the Linked Exchange Rate, Hong Kong's foreign currency reserves dropped in 2024 by 15% from their highest level in 2021. Many hedge funds (對沖基金) believed that the Linked Exchange Rate System is coming to an end and claimed that they would attack the Hong Kong dollar.

*Source: Summary of news report*

## Discussion

1. With reference to Source A and your own knowledge of Economics, explain the impact on Hong Kong's economy if there were no Linked Exchange Rate System in Hong Kong.
2. With reference to Source B and your own knowledge of Economics, determine which of the following statements about how the HKMA maintains the Linked Exchange Rate is/are correct. Put a tick (✓) in the appropriate box(es).
  - a. When Hong Kong dollars become strong, the HKMA will purchase US dollars from note-issuing banks. ☐
  - b. When Hong Kong dollars become strong, the HKMA will purchase Hong Kong dollars from note-issuing banks. ☐
  - c. When Hong Kong dollars become weak, the HKMA will purchase US dollars from note-issuing banks. ☐
  - d. When Hong Kong dollars become weak, the HKMA will purchase Hong Kong dollars from the public. ☐
  - e. Hong Kong must keep a large amount of foreign currency reserves so as to sell US dollars to banks when Hong Kong dollars become weak. ☐
3. With reference to Source C and your own knowledge of Economics, explain the difficulty the HKMA may encounter when maintaining the Linked Exchange Rate System in the following two aspects.

Size of foreign currency reserves held	External factors

4. If international speculators successfully attack the Hong Kong dollar and Hong Kong can no longer maintain the Linked Exchange Rate, what will be the immediate impact on you and your family?

**Answers:**

1. If there were no Linked Exchange Rate System in Hong Kong, the Hong Kong dollar might greatly depreciate against the US dollar during market fluctuations. As more Hong Kong dollars would be required in exchange for the same amount of foreign currency, firms in Hong Kong may suffer a loss in international transactions. This will increase the exchange rate risk, lowering the willingness to conduct business or invest in Hong Kong, and leading to a decrease in investment. As a result, aggregate demand decreases and hence aggregate output decreases.

2. a, e

3.

<b>Size of foreign currency reserves held</b>	<b>External factors</b>
The HKMA must keep a large amount of foreign currency reserves to maintain the Linked Exchange Rate System. However, the size of these assets has been decreasing in recent years.	Facing an attack by speculators, the HKMA needs to maintain the Linked Exchange Rate System by selling US dollars, resulting in a further drop in foreign currency reserves.

4. Free answer.

For example, Hong Kong relies heavily on imported goods. If Hong Kong can no longer maintain the Linked Exchange Rate System, the exchange rate may fluctuate from time to time. This may cause the price of daily necessities to fluctuate significantly. Volatility in the exchange rate will also lower the incentive to invest. As a result, many families will lose their jobs, threatening their livelihood.