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**Deepening and Fine-tuning Hong Kong's Linked Exchange Rate System: An Insightful Analysis.**

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**Abstract**

This research thoroughly examines how Hong Kong can improve and reform its Linked Exchange Rate System (LERS), a fixed peg that ties the Hong Kong dollar (HKD) to the US dollar (USD) within a narrow band of HK\$7.75 to HK\$7.85. Since its establishment in 1983, the LERS has been crucial in maintaining the region's monetary stability and financial credibility. However, the changing macroeconomic environment marked by increasing financial instability, rising volatility in capital flows, and occasional external stress events raises important questions about how to protect the exchange rate link system. The study aims to enhance the system's effectiveness, resilience, and flexibility amidst evolving global monetary conditions. It considers both short-term corrective actions and long-term structural reforms, taking into account global monetary policy trends, exchange rate regime theories, and the views of key local and international financial stakeholders. The goal is to contribute to the discussion on optimal currency peg arrangements within the context of a rapidly globalizing economy.

**Keywords:** Hong Kong's linked exchange rate system, LERS, fixed peg, fine-tuning

**Introduction:**

Hong Kong's Linked Exchange Rate System (LERS) is widely regarded as a cornerstone of the territory's macroeconomic stability and monetary credibility. However, abrupt structural adjustments or shifts in global financial conditions can threaten its sustained viability, posing significant challenges to the monetary authorities. Proponents argue that the peg offers a credible commitment to exchange rate stability, thus fostering investor confidence, minimizing currency volatility, and reinforcing Hong Kong's status as an international financial hub with deepened offshore financial services and capital markets. Conversely, detractors contend that the peg increasingly diverges from the evolving macroeconomic fundamentals of Hong Kong, especially considering the asymmetric economic cycles. This misalignment can exacerbate macroeconomic imbalances, elevate the risk of entrenched monetary volatility pressures, and expose the system to speculative attacks or sudden capital outflows, thereby illuminating vulnerabilities inherent in a fixed exchange rate regime that may constrain flexible monetary policy responses during times of economic stress.

**Methodology:**

We will extensively utilize the report published by the Hong Kong Monetary Authority (HKMA) covering the period from 2022 to 2025, along with the comprehensive literature review presented by Genberg, Hans and Hui, Cho-hoi (2009), which critically examines the structural challenges inherent in the Hong Kong dollar–US dollar link exchange rate system. Building upon these authoritative sources, our approach involves synthesizing the Hong Kong link exchange rate problem to develop a nuanced understanding of the underlying issues. We will then present original perspectives and conduct a rigorous, in-depth analysis of the macroeconomic implications, market dynamics, and insights related to the exchange rate regime. Additionally, our analysis will include proposing targeted policy recommendations aimed at strengthening the resilience and stability of Hong Kong's monetary and exchange rate framework.

**Literature review:**

The review article Genberg, Hans and Hui, Cho-hoi (2009) describes Hong Kong's linked exchange rate system as a long-standing benchmark for currency stability and monetary credibility, maintained for a few decades with substantial reserves and a transparent operational framework. Currently, the system faces pressures from capital flow imbalances and market structural shifts linked to Mainland China's growing influence. These challenges threaten its sustainability, requiring careful policy adjustments to maintain its role in ensuring monetary and financial stability in a complex global environment (HKMA, 2025). Some analyses (Chen, 2025) recommend that strengthening the LERS's resilience could involve expanding policy tools to better manage capital flow volatility and diversifying the market to include more long-term, varied capital. Improving credibility may also involve reducing discretionary interventions, increasing transparency, and reinforcing market mechanisms. Despite these issues, the system's core strengths, credibility, stability, and confidence support its continued use, although it must keep adapting to evolving global and local economic conditions.

**Discussion:**

Recently, the Hong Kong Monetary Authority (HKMA) is experiencing escalating regulatory and economic pressures attributable to a confluence of macroeconomic challenges, heightened geopolitical risks, and evolving financial market dynamics. These factors have prompted the HKMA to adopt a more rigorous oversight posture, implement strategic monetary policy measures, and enhance its macroprudential frameworks to safeguard financial stability amid heightened uncertainty.[1]

Due to the significantly higher interest rates in the United States compared to Hong Kong dollar (HKD) rates [2], there exists a substantial interest rate differential. This differential exerts considerable upward pressure on capital outflows, as investors seek to capitalize on higher yields domestically. Consequently, this scenario fosters increased financial market volatility and persistent arbitrage opportunities, particularly in the context of interest rate parity conditions

and cross-border capital mobility. Such dynamics can impact exchange rate stability and influence monetary policy considerations in both jurisdictions.

During episodes of heightened market volatility and moments of arbitrage opportunity, frequently stemming from disparities in US-HK interest rate differentials, capital flows can undergo sudden and adverse reversals. Such reversals exert depreciation pressure on the Hong Kong dollar, compelling the Hong Kong Monetary Authority (HKMA) to intervene by deploying its foreign exchange reserves to uphold the currency peg. For example, in June 2025, the HKMA was compelled to intervene both at the upper and lower bounds of the currency band within a single month, underscoring significant systemic stress and the limits of its liquidity reserves, thereby reflecting the fragility of the currency stabilization framework under intensified external shocks. [1][2]

In addition, Mainland capital inflows, predominantly driven by southbound investments through mechanisms such as the Stock Connect and Bond Connect programs, have intermittently exerted pressure on the Hong Kong dollar (HKD), occasionally approaching the bound limit of its managed exchange rate band. In response, the Hong Kong Monetary Authority (HKMA) has undertaken interventions, including liquidity-providing operations such as currency market interventions and open market operations, to uphold the peg and maintain exchange rate stability [3][4]. These episodes reflect the capital account dynamics and the sensitivity of the HKD to cross-border capital movements influenced by other-side economic signals, monetary policy, stock market movement, and investor sentiment.[5][6]

While, increasing financial and geo-location pressures, the independent leadership of the Hong Kong Monetary Authority (HKMA) and prominent geo-location pressure have consistently reaffirmed their dedication to the Linked Exchange Rate System (LERS) [7]. The sustainable drawdown of reserves may cause a serious impact on the link exchange rate system, hindering Hong Kong's economies [8]. Although, the HKMA emphasizes that strong foreign exchange reserves, solid macroeconomic fundamentals, and ongoing international confidence are essential pillars supporting the peg. But the consistent of potential capital outflow, may show resistant in positioning the leadership staircase situation, this spectacular highlights the link exchange rate have weakness, and co-exit of confidence crisis, prolong with the economies in stability, due to the citizen capital outflow, mainly cause by the mainlander. [9]

If this scenario materializes, it could trigger a substantial capital exodus driven by a profound confidence crisis. This crisis may not necessarily stem from immediate political instability but could originate from speculative pressures and fundamental concerns regarding the sustainability of the fixed exchange rate regime. As market participants' confidence diminishes progressively, the credibility of the link exchange rate system could deteriorate to a point where it becomes unsustainable, potentially leading to a hyperinflationary spiral or speculative attack. Ultimately, this erosion of trust might precipitate a sudden and irrevocable collapse of the peg, forcing a transition to a different monetary regime or a devaluation process.

### **Synchronized cycles**

In addition, Hong Kong's economy is now facing a different business cycle, meaning the pegged system sometimes worsens Hong Kong's macroeconomic performance, increasingly exhibiting synchronization with different economic cycles, as opposed to the more distinct and independent fluctuations observed in the different economic trajectory. This heightened correlation is significantly influenced by the region's currency peg system, which constrains monetary policy. Consequently, during periods of divergent policy stances such as differing interest rate decisions or fiscal interventions, the pegged exchange rate mechanism can exacerbate domestic economic distortions. Specifically, it may impede Hong Kong's ability to implement countercyclical measures effectively, thereby amplifying local economic volatility and undermining the stabilization objectives typically associated with autonomous monetary policy differences.

Also, Hong Kong's economic cycle is increasingly different in geo-locational conditions. Meanwhile, the Hong Kong dollar remains linked to US interest rates and cycles. This creates interest rate differences, as HKD rates decline while US rates stay higher, encouraging arbitrage and boosting capital flows into USD assets. The peg of HKD to a strong USD, combined with low local inflation, has worsened Hong Kong's economic stagnation and could lead to a "strong-money, weak-economy" narrative.

Moreover, the predominance of mainland Chinese capital within Hong Kong's financial markets has begun to exert significant influence on the structural stability of the market [7][8]. This influx of external capital sources has introduced a range of systemic risks, as the concentration of financial assets and decision-making power among mainland entities can lead to distortions in market dynamics. Such imbalances may reduce market resilience, making the financial system more susceptible to shocks. Consequently, regulatory authorities have been compelled to implement more frequent interventions to maintain market order and stability, which in turn contributes to heightened volatility. This scenario reflects a transfer of risk and oversight from local to centralized mainland financial institutions, fostering concerns about the long-term implications for Hong Kong's role as an independent financial hub and the overall health of its market recycling system. [7][8]

Insight:

Zero-sum game spearhead operation

Capital inflows from the mainland—particularly southbound investments—have periodically pushed the Hong Kong dollar (HKD) to the limit of its trading band, prompting the Hong Kong Monetary Authority (HKMA) to intervene through liquidity injections. Due to the substantial influx of mainland capital, the savings deposit in the mainland has already reached 1000 billion RMB. This significant capital inflow poses a threat to the stability of the HKD, as it may lead to currency outflows and a depletion of USD reserves within the Hong Kong banking and monetary system. Such developments could result in further depreciation of the HKD. When

mainland currency deposits are increased and HKD redemptions occur, there is a potential risk that the Hong Kong government may exhaust its USD reserves, thereby causing monetary instability that could impact currency stability.

The situation resembles an ant relocating a home. As is well known, stringent restrictions exist in the mainland's capital that hinder the transfer of money abroad. Consequently, substantial amounts of illicit funds are transferred to Hong Kong via underground channels. These channels may control significant funds from the mainland, purchasing properties and establishing deposit accounts in Hong Kong banks to deposit RMB. When appropriate, they convert RMB into HKD and subsequently exchange HKD for USD before withdrawing the funds. Such activities have the potential to deplete the financial reserves of the Hong Kong government and monetary authorities. Although initially modest, akin to an ant moving a home, the cumulative effect can become sufficiently large to threaten the stability of the entire exchange rate system.

This converting strategy is somewhat like a zero-sum game, where the saver deposits RMB money in the bank at the first stage and then withdraws it once and for all, or gradually cashes out in HKD to USD. These strategies aim to empty the HKMA's reserve cash, with the opposite strategy being the initial withdrawal of money from the banking system during the buying phase. In the mountainous communities and maritime regions, the liquidation of the excess USD reserves held by the Hong Kong Monetary Authority (HKMA) may be dissipate.

This spearhead operation, strategically, will challenge the Hong Kong banking system and destabilize the HKMA foundation. Therefore, when the RMB savings increase gradually, the risk of de-pegging or re-pegging will significantly heighten (crowd out the USD reserve), based on zero-sum game theory principles within competitive economic resource allocation and strategic interdependence among market participants.

So, considering the potential risks associated with capital outflow (flight) and the implications of anti-speculative interventions, we suggested that the Hong Kong Monetary Authority (HKMA) [4] compelled to adopt a comprehensive resilience policy. This policy aims to enhance the robustness and stability of the currency peg mechanism, potentially involving fine-tuning and refinements to the existing linked exchange rate system. The primary focus is on reinforcing market confidence and fortifying the financial system's resilience against external shocks, thereby ensuring the sustainability of monetary stability and the integrity of the currency linking framework.

So, we come out the suggestion, in order to tackle the above issue.

**Suggestion:**

There are few suggestions to promote the resilience of the linked exchange rate system in Hong Kong, in order to boost confidence and facilitate the modification of the linked exchange system. It includes the following:

- 1.) Harmonizing the frameworks governing currency issuance alongside the aggregate balance sheet and optimizing operational efficiency within financial markets. This alignment can facilitate a more streamlined implementation of monetary policy, while also enhancing the transparency of central bank interventions. This, in turn, fosters overall macroeconomic stability by promoting a coherent approach to liquidity management and monetary sovereignty.
- 2.) Moving towards the development of a more adaptable corridor, an exchange rate regime or operating within a carefully managed currency band would enhance monetary policy flexibility. This method allows for a responsive adjustment of exchange rate movements within set boundaries, supporting macroeconomic stability and creating a buffer against external shocks while enabling gradual policy normalization. Such mechanisms balance exchange rate stability with the operational flexibility needed for effective monetary policy in a dynamic global economy.
- 3.) Remitting international currency settlements and financial assets helps strengthen the integration of Hong Kong dollar operations within financial markets. This process supports the development of a smoother and more efficient cross-border capital flow infrastructure, thereby reducing currency mismatch risks caused by differences in currency denominations and foreign exchange exposures. By encouraging currency interoperability, this approach improves transaction efficiency and aligns with the broader goals of financial market liberalization. Ultimately, it deepens financial markets, increases the resilience of cross-border payment systems, and reinforces Hong Kong's role as an international financial hub connected to its economy.
- 4.) Transparent management practices and clear, well-communicated forward guidance from monetary and fiscal authorities are essential for maintaining market confidence, stabilizing expectations, and enabling effective policy transmission. Such transparency helps reduce uncertainty, aligns stakeholder expectations, and boosts the credibility of policy measures, ultimately supporting macroeconomic stability and growth.

**Conclusion:**

Reforming Hong Kong's linked exchange rate system involves carefully balancing innovation, stability, and market confidence. Practical improvements include deepening market reforms and increasing integration with international market to enhance resilience gradually, avoiding sudden shocks. Major changes like changing or abandoning the peg require careful planning, wide consultation, and strong crisis management. Currently, focusing on operational improvements and deepening capital markets is the most practical way to strengthen the Linked Exchange Rate System amid evolving global and regional conditions.

The Linked Exchange Rate System is a credible and resilient exchange rate framework. It effectively sustains monetary stability by anchoring the local currency to a foreign anchor, which helps to mitigate exchange rate volatility. This system serves as a buffer against external

economic shocks, thereby reducing instability pressures and supporting the region's overall financial stability. Despite the complexities of the international economic environment, the Linked Exchange Rate System provides a robust monetary policy framework that promotes predictable inflation rates, enhances investor confidence, and fosters economic resilience by maintaining exchange rate discipline and financial sector stability. So, we'd better preserve it, not to abandon it.

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