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The Hong Kong Foreign Exchange Market

Yin-Wong Cheung

Hong Kong has one of the largest foreign exchange (FX) markets in the world. According to the most recent survey conducted by the Bank for International Settlements (1996) [1] , Hong Kong has overtaken Switzerland to become the fifth-largest FX market in the world. In April 1995 Hong Kong's average daily trading volume was over 90 billion U.S. dollars. The prominent FX market puts Hong Kong in a good position to be recognized as one of the major international financial centers (IFCs).

The importance of the financial sector to the Hong Kong economy is well understood by both Hong Kong and China officials. In fact, the Basic Law states that Hong Kong should maintain its IFC status after returning to Chinese rule. Given Hong Kong's significant position in the global FX market, a strong FX market has the ability to strengthen and extend the role of Hong Kong as a renowned IFC. In addition, the fact that Hong Kong enjoys IFC status means that a healthy climate exists in which to develop the FX market.

A questionnaire survey was conducted in 1995 and 1996 to study the current status of the FX market in Hong Kong and its future prospects. The survey's target group was that of practitioners in the interbank market. Through their responses to the survey, these practitioners offered some interesting and useful insights into the FX market. The remainder of this article summarizes some of the survey results. [2]

Most market practitioners surveyed believed that the Hong Kong economy had most of the essential features of a successful FX market (see Table 1). Specifically, more than one half of the respondents considered "political stability," the "absence of capital and FX controls," a "free and friendly business environment," "excellent infrastructure," "well-trained financial professionals," and "the role as an IFC" to be important factors contributing to the success of the Hong Kong FX market. On the other hand, slightly less than half of the respondents viewed "trade and financial ties with China" as crucial to FX business. The survey shows that Hong Kong's biggest disadvantage in terms of its FX market is operation cost. This result reflects the adverse effects that high real estate prices and labor costs have had on economic activity in Hong Kong.

Table 1: Characteristics That Contribute to the Success of the Hong Kong FX Market*

	Now	5 years from now
Political stability	55.9%	53.7%
Absence of capital and FX controls	69.6%	49.8%
Free and friendly business environment	61.2%	41.1%
Excellent infrastructure	64.3%	52.0%
Well-trained financial professional	68.3%	59.5%
Low operation costs	28.6%	39.7%
International financial centre	71.4%	54.2%
Trade and financial ties with China	49.8%	59.0%

*The chart gives the percentages of respondents selecting each characteristic.
The total number of respondents is 227.

Respondents were slightly less hopeful that Hong Kong would be able to maintain the factors that make her a renowned FX center in five years. An "absence of capital and FX controls" and a "free and friendly business environment" were the two categories in which respondents were the least positive. Now that Hong Kong is under Chinese rule, Hong Kong's ability to maintain the conditions necessary to its continued IFC status depends on China's policies and actions. So far, the situation has been quite encouraging. Hong Kong has retained a high degree of autonomy, and China has been reassuring in terms of Hong Kong's IFC status. More respondents anticipated that "trade and financial ties with China" would contribute a larger amount to Hong Kong FX business in five years.

Market practitioners saw Hong Kong's role as an IFC as the most important source of FX business growth (see Table 2). The other potential sources of growth had a response rate substantially below 50 percent. This reinforces the Hong Kong Monetary Authority (HKMA)'s emphasis on the need to provide an appropriate environment to maintain and foster Hong Kong's leading position as an IFC. Thus, the role of Hong Kong as an IFC is of primary importance to the economy in general and to the FX market in particular.

Table 2: Sources of the FX Market Growth

International financial centre	70.0%
International and regional trade	36.1%
Speculative trading	17.6%
Derivative products	17.6%

In terms of developing the Hong Kong FX market, the survey reveals some interesting and useful opinions on policies. In the short term, practitioners had a relatively low opinion of the policies listed in Table 3. Even the most popular choice, "tax incentives and strength regulations," received only 37 percent of the respondents' votes.

Table 3: Policy Recommendations

	Short-term policies	Long-term policies
Training programs for FX professional	32.2%	61.7%
Market-maker system	26.4%	27.3%
Currency futures and options markets	27.8%	60.4%
Tax incentives and regulations	37.0%	60.4%
Let the FX market take care of itself	31.7%	40.5%
Renmenbi offshore trading	25.1%	68.3%

In the long term, however, the listed policies drew considerable attention from market practitioners. Over 60 percent of the respondents believed that policies on "renmenbi offshore trading," "training programs for FX professionals," "currency futures and options markets," and "tax incentives and regulations" should be considered to promote FX business. The HKMA (1995) also identifies "training programs for FX professionals" and "tax incentives and regulations" as strategies by which to maintain the status of Hong Kong as an IFC.

The respondents were not enthusiastic about the laissez-faire policy of letting the market take care of itself over both the short and the long term. However, this may not imply a genuine desire for active government intervention. Given the proactive polices being pursued by neighbor countries to develop their FX markets, the responses may reflect the need for a level playing field upon which to compete with other established and emerging financial centers in the region.

About 50 percent of the respondents suggested that the linked exchange rate system was beneficial to Hong Kong, and 40 percent of them voiced the opposite opinion. Since its establishment in October 1983, the linked exchange rate system has been shown to be a viable regime for maintaining a stable Hong Kong dollar. Indeed, exchange rate stability is viewed as an important barometer of Hong Kong's economic and political conditions. On the theoretical level, there are pros and cons for sustaining a pegged exchange rate. However, given Hong Kong's special circumstances, the linked exchange rate arrangement secures considerable support from practitioners.

An overwhelming 84 percent of the respondents believed that renmenbi convertibility would have a favorable impact on the Hong Kong FX market. The renmenbi market is a very lucrative one given the enormous size of the China economy. Hong Kong's prime location and excellent FX trading network provide it with a good opportunity to fully exploit this tremendous opportunity. Successful interbank renmenbi trading will surely give the FX business in Hong Kong a big push.

The survey reflects several interesting aspects of the Hong Kong FX market. While practitioners were quite positive about the present situation, they were somewhat concerned about Hong Kong's ability to maintain its status as a major FX center. It was suggested that some long-term policies be pursued to enhance Hong Kong's position in the global FX market. However, to implement these policies would require a more thorough analysis. For instance, the implications of a tax incentive program on economic efficiency and fairness should be carefully examined before being put into effect. The development of a renmenbi market could also be complicated. It would depend on the convertibility of renmenbi and would require China's endorsement and cooperation.

Table 4: Impacts of Abolishing the Linked Exchange Rate System and Renmenbi Convertibility

Table 4.a: Abolishing the Linked Exchange Rate System		**Table 4.b: Renmenbi Convertibility**	
Favorable	40.4%	Favourable	83.6%
Unfavorable	50.2%	Unfavorable	11.1%
No effect	9.4%	No effect	5.3%

Note:

[1] Bank for International Settlements, 1996, Central Bank Survey of Foreign Exchange and Derivatives Market Activity, Basle.

[2] The survey was conducted by the author and Dr. Clement Yuk-Pang Wong of the City University of Hong Kong. The major results are reported in two manuscripts by the authors, Foreign Exchange Markets of Hong Kong, Singapore, and Tokyo: Current Status and Future Prospects (1998) and A Survey of Market Practitioners Views on Exchange Rate Dynamics (1997).

Dr. Yin-Wong Cheung is associate professor in the Department of Economics, University of California at Santa Cruz.

| Index | Research Projects | HKCER Letters |
| Speaker Program / Conference | Index of Economic Freedom |

The Hong Kong Centre for Economic Research
School of Economics and Finance
The University of Hong Kong
Phone: (852) 2547-8313 Fax: (852) 2548-6319
email: hkcer@econ.hku.hk