

## **New Seven Ways to Reduce Speculative Pressure on Hong Kong's Linked Exchange Rate System**

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### **ABSTRACT**

*Hong Kong's Linked Exchange Rate System (LERS) remains one of the most durable currency board arrangements in the international monetary system. Introduced in October 1983, the regime anchors the Hong Kong dollar within a convertibility zone of HK\$7.75 to HK\$7.85 per US dollar through a rules-based and fully backed monetary framework [1][3]. In 2025, renewed capital inflows pushed the Hong Kong dollar to the strong-side Convertibility Undertaking, prompting the Hong Kong Monetary Authority (HKMA) to sell Hong Kong dollars and expand the Aggregate Balance in accordance with the design of the system [5][7]. These developments revived debate over whether speculative flows, particularly short-horizon capital movements associated with hedge funds and other financial institutions, could amplify asset-price volatility and complicate macro-financial management in a highly open economy without capital controls [1][2][3]. This research paper argues that the central vulnerability of the LERS is not the absence of a formal defense mechanism, because the system already contains explicit strong-side and weak-side convertibility commitments, but rather the possibility that volatile cross-border capital flows could interact with interest-rate adjustments, leverage, and asset-market sentiment in destabilizing ways [1][2][3][4]. Building on this argument, the paper proposes seven policy directions: strengthening operational transparency, improving surveillance of concentrated positions, recalibrating market-based prudential tools, reinforcing fiscal credibility, refining liquidity-management incentives, deepening two-way stabilizing arbitrage, and developing contingency planning for longer-run monetary evolution. These proposals are designed not to replace the LERS, but to enhance its resilience, credibility, and deterrent capacity under conditions of recurrent global financial volatility [1-8].*

**Keywords:** Hong Kong dollar, Linked Exchange Rate System, currency board, speculative capital, hot money, monetary stability, foreign exchange intervention, financial regulation

## **Introduction**

Hong Kong's monetary arrangement is built on a clear institutional objective: preserving exchange-rate stability in a small, externally oriented, and highly open economy. The HKMA states that the LERS operates through a rigorous currency board in which the Monetary Base is fully backed by US dollar assets [1], while the Convertibility Undertakings (CUs) commit the authority to sell Hong Kong dollars at HK\$7.75 and buy Hong Kong dollars at HK\$7.85 against the US dollar [1][2][3]. This mechanism matters because Hong Kong does not employ foreign exchange controls, and its role as an international financial center depends heavily on confidence in convertibility, balance-sheet stability, and the predictability of the exchange-rate regime [1][2][3][4].

Recent market conditions have again tested public understanding of the system. In early 2025, equity-related demand and regional currency appreciation pushed the Hong Kong dollar to the strong-side CU, leading the HKMA to inject Hong Kong dollar liquidity by selling HKD in exchange for USD; by mid-2025 the weak-side CU was also triggered as flows reversed, reducing the Aggregate Balance [5][7][8]. These episodes do not, by themselves, indicate regime fragility; rather, they illustrate the normal operation of an automatic adjustment mechanism in which capital inflows and outflows are absorbed through changes in the Monetary Base and interbank liquidity conditions [1][2][3][4]. Even so, the speed of modern foreign exchange markets and the scale of financial turnover suggest that authorities cannot rely solely on legal commitment and reserve backing; they must also cultivate institutional credibility, transparent communication, and market structures that make speculative attack strategies more expensive and less effective [1][2][3][4][5].

The broader international context reinforces this concern. According to the (BIS) [9], global foreign exchange turnover reached US\$6.6 trillion per day in April 2019, with 55% of turnover involving "other financial institutions," including hedge funds and proprietary trading firms [2][10]. FX swaps alone accounted for 49% of total turnover, while spot trading represented only 30%, indicating that global currency markets are dominated not merely by trade settlement but by funding, hedging, leverage, and portfolio-adjustment activities [2][9][10]. For Hong Kong, this means that exchange-rate pressure can arise not only from current-account transactions, but also from capital-market reallocations and leveraged position-taking. The policy question, therefore, is not whether the LERS should be abandoned, but how its institutional architecture can be refined to reduce the scope for destabilizing speculation while preserving openness and rule-based credibility.

## **Discussion**

A professional assessment of speculative pressure must begin by correcting a common misunderstanding. Hong Kong already has a two-sided convertibility framework: the HKMA stands ready to sell Hong Kong dollars at the strong-side CU of 7.75 and to buy Hong Kong dollars at the weak-side CU of 7.85 [3]. The issue is therefore not the absence of a formal strong-side mechanism, but the macro-financial consequences of repeated inflow and outflow cycles. When the strong-side CU is triggered, the Aggregate Balance expands and Hong Kong dollar interest rates tend to decline, easing domestic liquidity conditions [3][5]. This may support credit creation and improve sentiment in equity and property markets, but it can also encourage procyclical leverage if market participants interpret liquidity accommodation as a one-way policy buffer [1][2][3][4][5].

In a small open economy, speculative capital inflows can generate a misleading appearance of strength. A surge in Hong Kong dollar demand may reflect not long-term commitment to productive investment, but tactical positioning linked to equity issuance, carry trades, derivative structures, or expectations of future asset-price appreciation [2]. The BIS data show that trading with hedge funds and proprietary trading firms amounted to US\$593 billion per day in April 2019, while prime-brokered turnover rose sharply relative to the previous survey [2]. These figures do not imply that all capital inflows are destabilizing, but they do show that globally mobile financial actors possess the scale and flexibility to reprice risk rapidly. In Hong Kong, where financial markets are deep but the domestic economy is comparatively small, abrupt reversals can transmit quickly into exchange, interest-rate, equity, and property channels.

The discount window and Base Rate framework should also be interpreted carefully. The HKMA's Base Rate is set at the lower end of the prevailing US federal funds target range or the average of the five-day moving averages of overnight and one-month HIBOR, whichever is higher [6]. This rule helps preserve the interest-rate adjustment channel that is central to currency board discipline [2][3][4][5][6]. Yet the availability of liquidity facilities for banks can alter the short-run transmission of stress in money markets. In normal times this supports orderly market functioning, but during periods of concentrated speculative positioning it may also soften the funding squeeze that would otherwise penalize aggressive one-sided bets. The policy challenge is not to withdraw liquidity support indiscriminately, but to ensure that backstop facilities do not unintentionally subsidize destabilizing short-term strategies.

Another concern relates to the interaction between exchange-rate expectations and other asset classes. Historical experience in many emerging and open financial centres shows that speculative strategies are often cross-market in nature: currency positions can be paired with equity index futures, interest-rate expectations, or property-related exposures. The BIS notes that

five centres, including Hong Kong SAR, facilitated 79% of all FX trading in 2019, underscoring Hong Kong's systemic importance as both a local market and a regional intermediation hub [2]. In such an environment, speculative pressure need not begin with a direct attempt to "break" the peg. Instead, it may involve exploiting predictable policy reactions, such as lower local rates after strong-side inflows or tighter liquidity after weak-side pressures, in order to profit from correlated market movements.

At the same time, arguments for dismantling the LERS remain unpersuasive on the evidence available. The HKMA has emphasized that Hong Kong held more than US\$420 billion in foreign reserves in early 2025, equivalent to about 1.7 times the Monetary Base, and that the system is highly transparent, rules-based, and disciplined [1]. The authority also reiterated that it sees no need to alter the regime, which has weathered multiple crises since 1983 [1]. This position is institutionally credible because a currency board is judged not by eliminating volatility in all asset markets, but by maintaining firm exchange-rate convertibility under stress. The more practical policy objective, therefore, is to harden the surrounding institutional environment so that speculative inflows and outflows are less likely to distort domestic financial conditions.

### **Suggestions**

Seven reforms can improve resilience without abandoning the linked exchange rate. First, the HKMA should deepen operational transparency rather than alter the core convertibility band. The current HK\$7.75-HK\$7.85 zone and automatic adjustment mechanism should be established by market mechanism rather than solely by government intervention [1][2][3]. Frequent, rule-consistent communication on Aggregate Balance movements, capital-flow drivers, and the interaction between the CUs and interbank liquidity would reduce information asymmetry and weaken rumor-driven speculation [1][2][3][4].

Second, the authorities should strengthen surveillance of concentrated foreign exchange and cross-asset positions. Because a substantial share of global turnover comes from other financial institutions, including hedge funds and proprietary trading firms, macro-surveillance should track not only spot flows but also forwards, swaps, options, and prime-brokered structures that can magnify short-term pressure [2]. The objective is not capital control, which would contradict Hong Kong's institutional framework, but earlier detection of correlated positions capable of destabilizing money, equity, and derivatives markets [2].

Third, prudential frictions in derivatives and leveraged markets should be adjusted countercyclically. Higher margin requirements, tighter collateral positioning, and enhanced stress-testing of brokers and counterparties during episodes of unusually one-sided positioning

would raise the cost of speculative leverage [2]. Such measures are more defensible than discretionary exchange-rate activism because they target balance-sheet amplification rather than the exchange-rate anchor itself. Properly designed, they would preserve market functioning while reducing the convex payoff structure that often attracts speculative attacks.

Fourth, fiscal credibility should be treated as a component of exchange-rate defense. The exchange-rate regime is more robust when investors perceive the sovereign balance sheet, policy coordination, and medium-term budget management as coherent and predictable [1]. Reducing persistent fiscal uncertainty would not mechanically eliminate speculative flows, but it would compress the risk premia that speculators often exploit during periods of weak sentiment. In this sense, fiscal discipline serves as a complementary credibility anchor alongside foreign reserve adequacy and monetary rule consistency.

Fifth, the banking system's liquidity incentives should be refined to discourage excessive one-directional accumulation of Hong Kong dollar balances that are not clearly linked to productive intermediation. When liquidity surges, banks may face incentives to warehouse balances passively rather than recycle them efficiently into diversified foreign assets or real-sector financing. A calibrated review of reserve management incentives, internal transfer pricing, and supervisory guidance could reduce the extent to which surplus liquidity mechanically enlarges the burden of later stabilization operations [5][9].

Sixth, the authorities should cultivate stronger market-based stabilizers. The HKMA should establish an automatic interest-rate adjustment mechanism under the LERS [3]. That principle can be reinforced by encouraging deeper two-way arbitrage capacity, in the lower quadrant of  $7.75+0.0025$  (7.7525) to the upper quadrant of  $7.8-0.0025$  (7.7975), broader market-making participation, and stronger expectations that deviations toward either side of the band will be met by private stabilizing flows before official operations become large. A resilient system is one in which market participants perceive speculation as expected value because private arbitrage and official rules jointly provide profitable windows.

Seventh, Hong Kong should maintain long-horizon contingency planning for monetary evolution without signaling any imminent regime shift. The HKMA has clearly stated that it has no intention or need to change the LERS [1]. That stance should remain intact. However, prudent reserve managers and monetary authorities routinely examine tail-risk scenarios, institutional contingencies, and regional currency developments. Analytical work on future options involving deeper renminbi integration or alternative reserve arrangements can proceed quietly as strategic planning, not as an invitation to speculative reinterpretation of current policy commitments.

## **Conclusion**

The appropriate policy response to speculative pressure is institutional strengthening, not abandonment of the linked exchange rate. The evidence indicates that the LERS remains a credible, rules-based, and well-reserved currency board whose two-sided convertibility structure functioned as designed during the inflow and outflow episodes of 2025. The real policy challenge lies in limiting the extent to which volatile capital movements propagate into domestic leverage cycles, asset-price overshooting, and strategic speculation across multiple markets.

A professional reform agenda should therefore focus on transparency, surveillance, prudential design, fiscal credibility, liquidity incentives, and market-based stabilization. These measures would not eliminate speculation, because no open financial centre can do so entirely, but they would increase the cost of destabilizing strategies and improve the capacity of the HKMA and the wider policy apparatus to manage shocks credibly. In that sense, the best defense of Hong Kong's exchange-rate system is not ad hoc intervention, but a coherent macro-financial architecture that makes the linked rate both operationally robust and strategically difficult to challenge. Hope this research can contribute to the citizens and humanities.

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