6 Currency System and Money Supply

In recent years there has been a growing interest in money supply both as an analytical concept and a policy variable. It is well known that in comparative static analysis, changes in money stock generate multiplier effects on nominal income, though the size of this may vary considerably according to the behavioural assumptions of the underlying model.¹ In the long run money, whether treated as a factor input or consumer good, may produce non-neutral effects on the equilibrium growth path of the economy.² Quite apart from the contemporary revival of the Quantity Theory, therefore, money supply is of great importance whether viewed from cyclical stabilisation or from secular growth. While the purely theoretical aspects of money supply cannot be treated here, it will evidently be of interest to analyse the determination of money supply in Hong Kong, its special characteristics and the role of the banking system in this process of determination. The present chapter is concerned with these problems.

Early discussions on money supply in Hong Kong were understandably sketchy owing to the lack of relevant data. In recent years, particularly as a result of the enactment of the Banking Ordinance and the establishment of the Banking Commissioner’s Office, statistical coverage of bank deposits has greatly improved. Depending on the commencing dates of availability it is now possible to construct continuous (1) annual series of money supply from 1954; (2) quarterly series from 1962; and (3) monthly series from mid-1965.

ALTERNATIVE DEFINITIONS OF MONEY SUPPLY
Even if there were adequate data for a historically long period, one thorny problem would still remain: what is the precise
definition of ‘money’? Monetary economics is outstandingly rich in controversies and there can be no better example of this than the fact that, more than a century after the celebrated debate between the Currency School and Banking School in England, contemporary economists still cannot agree on what they mean by ‘money’. At one end of the continuum, economists who stress the medium of exchange function tend to argue that money supply equals currency outside banks plus adjusted demand deposits and perhaps trade credit. The rationale for this approach is that only these instruments perform the medium of exchange at minimum costs. At the other end, those who emphasise the ‘asset’ or ‘store of value’ function tend to argue that various liquid assets possess different degrees of ‘moneyness’, and consequently it is pointless to single out any particular set of assets as money.

Intermediate between these extremes is an important school of thought, represented chiefly by Friedman and his associates, who argue that money supply should also include other liabilities of the commercial banks, notably time deposits, but exclude the liabilities of non-bank financial intermediaries. The rationale for this approach is that demand deposits cannot be meaningfully separated from other deposit liabilities of the commercial banking system. Moreover, they also think the definition of money is an empirical question that cannot be settled on a priori grounds alone.

For the computation of Hong Kong’s money supply, Friedman’s approach appears to us to be more appropriate for several reasons. First, institutional arrangements and banking practices here are such that substitutability between demand, savings and time deposits is very high. Unlike elsewhere, savings deposits in Hong Kong are not subject to notice (or written instructions) and may be withdrawn at any moment without restrictions on the number and amount of withdrawal, and also without any service charge. The only difference between demand and savings deposits is that while the former can be withdrawn by cheque, the latter can only be withdrawn by debit entry on the depositor’s pass-book on presentation.* Similarly, with many Chinese banks notice requirement on time deposits can often be revoked

* As noted in Chapter III, for some banks even the presentation of a pass-book is unnecessary.