

Monetary Stability

The linked exchange rate system serves as an anchor for Hong Kong's highly externally oriented economy and as a cornerstone of its monetary and financial stability. During 1999 we continued our extensive review of the currency board arrangements and introduced a number of refinements to meet the challenges of a rapidly changing financial environment.

Objectives

The main monetary policy objective of the HKMA is to maintain currency stability under the linked exchange rate system. This is defined in terms of a stable external value of the Hong Kong dollar against the US dollar. The linked exchange rate system is, in essence, a currency board arrangement, which is characterised by two distinct features: the full backing of the monetary base by the reserve currency, and convertibility between the monetary base and the reserve currency at a fixed exchange rate.

In the case of Hong Kong, the entire monetary base (comprising Certificates of Indebtedness (CIs) and coins issued, the sum of balances on the clearing accounts maintained by licensed banks with the HKMA, and all the Exchange Fund Bills and Notes outstanding) is fully backed by foreign reserves. Any change in the size of the monetary base has to be fully



matched by a corresponding change in the foreign currency reserves backing the monetary base. In respect of the convertibility between the monetary base and the reserve currency, at present CIs and coins are issued and redeemed against the US dollar at the rate of HK\$7.80 to US\$1. The HKMA has also provided an undertaking to all licensed banks to convert their Hong Kong dollar clearing balances at the prescribed exchange rate, which has been moving by 1 pip (0.0001) each day from 7.7500 since 1 April 1999 for a 500-day period to 7.8000, where it will converge with the convertibility rate for CIs.

An automatic interest rate adjustment mechanism functions under the currency board system to maintain exchange rate stability. When there is a decrease in demand for Hong Kong dollar assets and the Hong Kong dollar exchange rate weakens to the convertibility rate, the HKMA stands ready to purchase Hong Kong dollars from banks, leading to a contraction of the monetary base. Interest rates then rise, creating the monetary conditions conducive to capital inflows so as to maintain exchange rate stability. Conversely, if there is an increase in the demand for Hong Kong dollar assets, leading to a strengthening of the exchange rate, the HKMA may sell Hong Kong dollars for US dollars. The monetary base correspondingly expands, exerting downward pressure on interest rates and so discouraging continued inflows.

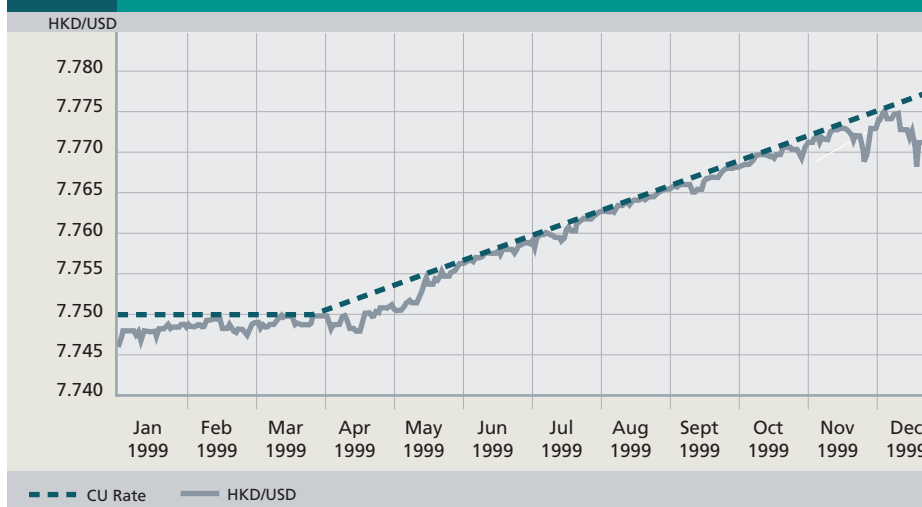
Achievements

Having ridden out the market turbulence in 1998, the currency board system in Hong Kong, strengthened by the technical measures introduced in September 1998, functioned smoothly and effectively to deliver a stable Hong Kong dollar in 1999. Helped also by a less turbulent external environment, local interest rates came down in 1999, and interest rate volatility was significantly reduced, providing a sound foundation for recovery in the real economy.

There were occasional periods of market pressure against the Hong Kong dollar in the first ten months of 1999, triggered by external events such as the Brazilian crisis in January, news of mounting pressure on the Argentina currency board system in May, and escalating tensions across the Taiwan Straits and rumours of an impending devaluation of the renminbi in July and August. In each case, the pressures were temporary and of a much smaller magnitude than during 1997 and 1998. In the last two months of 1999 there was a significant increase in demand for Hong Kong dollar assets, supported by positive news, including the conclusion of the Sino-US World Trade Organisation agreement and a further pick-up in economic growth in the third quarter, as well as market perceptions of Hong Kong as a Year 2000 safe haven.



Chart 1 Exchange rate and Convertibility Undertaking, Jan - Dec 1999



Notwithstanding these shifts in demand, the Hong Kong dollar remained remarkably stable during the year, moving in tandem with the convertibility rate in respect of the Aggregate Balance (Chart 1). For the year as a whole, the Convertibility Undertaking was triggered on 34 occasions. In the opposite direction, the HKMA purchased US dollars on 41 occasions in response to bank offers. In value terms, there was a net purchase of US dollars by the HKMA of US\$0.69 bn for the currency board account.

The effectiveness of the technical measures introduced in September 1998 has helped to underpin investor confidence. Reflecting a reduction in the risk premium, Hong Kong dollar interest rates moved on a gentle downtrend from the last quarter of 1998 notwithstanding a rise in US rates. One-month and three-month HIBOR stood at 5.50% and 5.81% on 30 December 1999, compared with their peak levels of over 10% in August 1998. The interest rate differential between Hong Kong dollar rates and their

US dollar counterparts, in terms of one-month money, fell into negative territory during the last quarter of 1999 (Chart 2). Measured in terms of the standard deviation of one-month HIBOR, daily interest rate volatility fell from 2.8 percentage points in 1998 to 0.5 percentage points in 1999, which was similar to pre-crisis levels.

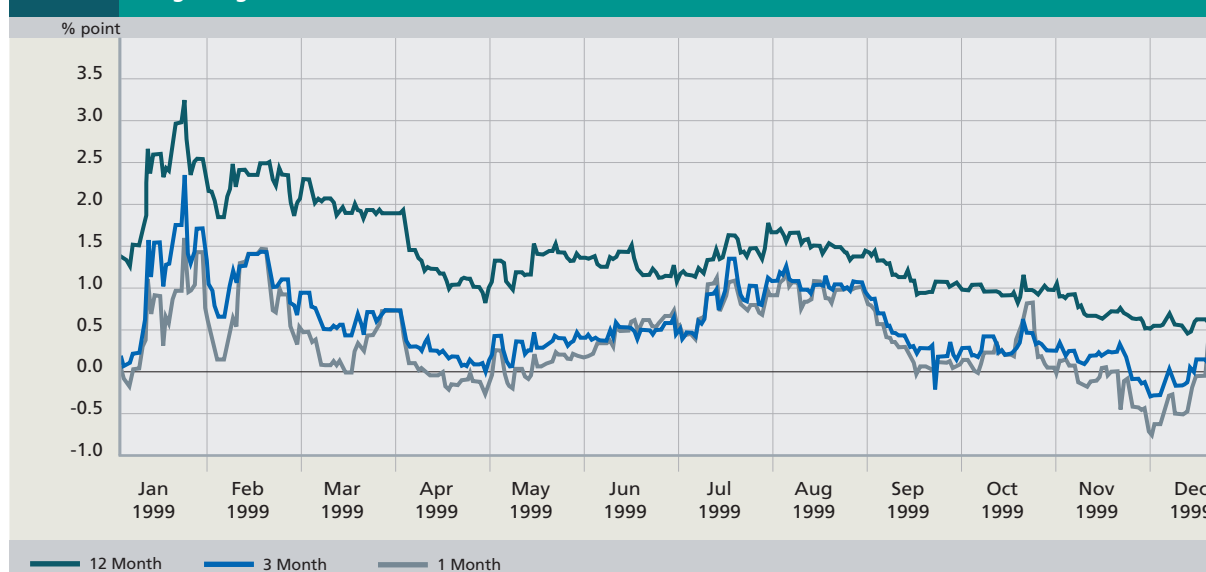
During the year the HKMA continued to review the currency board operations in Hong Kong and to introduce measures to increase the robustness of the system and ensure adherence to currency board discipline. To this end, several reforms were implemented in 1999:

Enhancing the transparency of currency board operations

To enhance transparency and promote better understanding of currency board operations in Hong Kong, the Currency Board Account has been published since March 1999. This Account shows the



Chart 2 Hong Kong dollar-US dollar interest rate differential, Jan-Dec 1999



monetary base on its liabilities side, and the backing assets on its assets side. The monthly publication of the Currency Board Account demonstrates the HKMA's adherence to currency board principles, which require any change in the monetary base to be fully matched by a corresponding change in foreign reserves. At 31 December 1999, the monetary base stood at \$234.4 billion, while the backing assets totaled \$257.0 billion, implying a backing ratio of 109.6% (Table 1).

Movement of the exchange rate under the Convertibility Undertaking

The HKMA announced in November 1998 a plan to move the convertibility rate in respect of the Aggregate Balance from 7.7500 to 7.8000 over a 500-day period. This arrangement, which started on 1 April 1999, ensures a convergence of the convertibility rate with the exchange rate of 7.80 applicable to the issue and redemption of the Certificates of Indebtedness, with minimum

disruptions to the foreign exchange and money markets. Except for the months of November and December, when the Hong Kong dollar strengthened on the back of increased demand, the market exchange rate broadly tracked the movement of the convertibility rate.

Table 1 Exchange Fund Currency Board Account as at 31 December 1999
(Expressed in millions of Hong Kong dollars)

	31 December 1999 (Market Value)
Monetary base	
Certificates of Indebtedness	118,195
Coins in circulation	5,777
Exchange Fund Bills and Notes issued	101,828
Interest payable on Exchange Fund Notes	626
Balance of the banking system	7,960
Net accounts (receivable)/payable	0
Total	234,386 (b)
Backing assets	
Investment in designated US dollar assets	255,720
Interest receivable on investments	1,267
Net accounts receivable/(payable)	0
Total	256,987 (a)
Backing ratio [(a) / (b)] x 100%	109.64%



Backing arrangements for coins in circulation

Starting on 1 April 1999, the issue and withdrawal of coins in circulation have been settled against US dollar value at the fixed exchange rate of HK\$7.80 to US\$1, in line with the arrangements for Certificates of Indebtedness.

Treatment of interest payments on Exchange Fund Bills and Notes

Also starting from 1 April 1999, the impact of interest payments on Exchange Fund Bills and Notes on the monetary base has no longer been neutralised. Instead, additional Exchange Fund paper has been issued to absorb the increase in the Aggregate Balance due to such interest payments. This arrangement allows the Exchange Fund Bills and Notes programme to grow in a non-discretionary manner.



The Inaugural Conference of the HKIMR on "Currency Arrangements in Asia: Post-Crisis Issues" held in Hong Kong on 17 December 1999.

Establishment of the Hong Kong Institute for Monetary Research

The Hong Kong Institute for Monetary Research was established in August 1999 with the objective of conducting research studies in the fields of monetary policy, banking and finance that are of strategic importance to Hong Kong and the Asian region. The Institute held its inaugural conference on "Currency Arrangements in Asia: Post-Crisis Issues" in December 1999. The conference was well attended by the financial and academic communities.



One of the discussants at the inaugural conference of the HKIMR: Mr Eisuke Sakakibara (right), former Vice-minister of Finance in Japan.

Opening of the London Representative Office

Following the establishment of the New York Office in 1996, the HKMA's London Representative Office was officially opened on 28 September 1999.

The setting up of the London Representative Office allows the HKMA to honour its unconditional convertibility undertaking on a round-the-clock basis. It also enables the HKMA to have continuous twenty-four-hour coverage of the latest developments in foreign exchange and other financial markets around the world.



Challenges

In addition to considering the above fine-tuning measures described above, the EFAC Sub-Committee on Currency Board Operations, which was set up in the summer of 1998 to oversee the operations of the currency board arrangements in Hong Kong, examined a number of important issues, such as the extension of the scope of the convertibility undertaking, the transferability among components of the monetary base, the desirability and feasibility of dollarisation, the use of currency options under the currency board system, and the monetary implications of the development of electronic payment systems. Looking to the future, the HKMA will continue to keep abreast of the latest financial developments and changing market conditions and, where appropriate, introduce measures so as to further strengthen the effectiveness of the currency board system in coping with the challenges of the modern-day financial environment.



Chief Executive Mr Joseph Yam officiates at the opening ceremony of the HKMA's London Representative Office on 28 September 1999.

