

# Monetary Stability

The linked exchange rate system serves as an anchor for Hong Kong's monetary and financial stability. This stability plays an important part in supporting Hong Kong's role as a trading and financial centre. During 2000, the link continued to function smoothly to deliver a stable and predictable monetary environment, which facilitated a robust recovery in economic activity.

## Objectives

The HKMA's predominant monetary policy objective is currency stability, defined in terms of a stable external value of the Hong Kong dollar against the US dollar under the linked exchange rate system. The system, in operation since 17 October 1983, is in essence a currency board system, which is characterised by two distinctive 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 monetary base (comprising Certificates of Indebtedness (CIs) and coins issued, the sum of the balances on the clearing accounts maintained by licensed banks with the HKMA (the Aggregate Balance), 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 corresponding changes in the foreign currency reserves backing the monetary base. In respect of the convertibility between the monetary base and the reserve currency, CIs and coins are issued and redeemed against US dollars at the rate of \$7.80 to one US dollar. The HKMA has also provided an undertaking to all licensed banks to convert their Hong Kong dollar clearing balances into US dollars at the linked rate of \$7.80.

Under the currency board arrangements, interest rates adjust to changes in the demand for Hong Kong dollars, while the exchange rate remains stable. Specifically, when there is a decrease in the demand for Hong Kong dollar assets, and the exchange rate weakens to the linked exchange rate of \$7.80 to one US dollar, the HKMA stands ready to purchase Hong Kong dollars from banks (provided they have sufficient clearing balances to settle the

transactions). The Aggregate Balance (as part of the monetary base) will fall. Interest rates then rise, creating the monetary conditions conducive to inflows of funds 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 Aggregate Balance correspondingly expands, exerting downward pressure on interest rates and so discouraging continued inflows.

### A review of 2000

While the external environment has been much less turbulent since the subsidence of the Asian financial crisis, increased volatility was seen in some regional financial markets in 2000 owing to their domestic political and economic problems. Global stock markets corrected, spearheaded by a pronounced shift in sentiment against the high technology sector. Notwithstanding these developments, our foreign exchange and money markets remained stable under the linked exchange rate system. This stability has provided a sound foundation for a full economic recovery.

There were nevertheless occasional periods of market pressure against the Hong Kong dollar during the year, arising from events such as the heightened tension across the Taiwan Straits, sharp corrections in the local and US stock markets, volatility in global oil prices, and renewed

jitters in some Asian financial markets. There were also occasions when the exchange rate came under strengthening pressure on the back of equity related inflows, partly underpinned by market perceptions of Hong Kong as a safe haven amid regional volatility. On some of these occasions, exchange rate movements triggered the purchase or sale of Hong Kong dollars against US dollars by the HKMA. For the year as a whole, the HKMA sold US dollars for Hong Kong dollars under the Convertibility Undertaking on 22 occasions. In the opposite direction, the HKMA purchased US dollars for Hong Kong dollars on 22 occasions in response to bank offers. In the interests of transparency, the HKMA continued to publicise the details of its operations through the electronic news media directly after each event. Market participants can immediately assess the implications of the movements in the currency board accounts for the local foreign exchange and money markets. This transparency may help to explain why volatility in the Hong Kong dollar market remained subdued in 2000.

Reflecting improved market confidence, the risk premium on the Hong Kong dollar was substantially reduced in 2000. Interbank interest rates eased at the beginning of the year on the back of ample interbank liquidity arranged by banks in preparation for the year 2000 transition. They then followed an up-trend along with rising US dollar interest rates, but softened from the middle of May onwards, as the US economy began to show signs of slowing



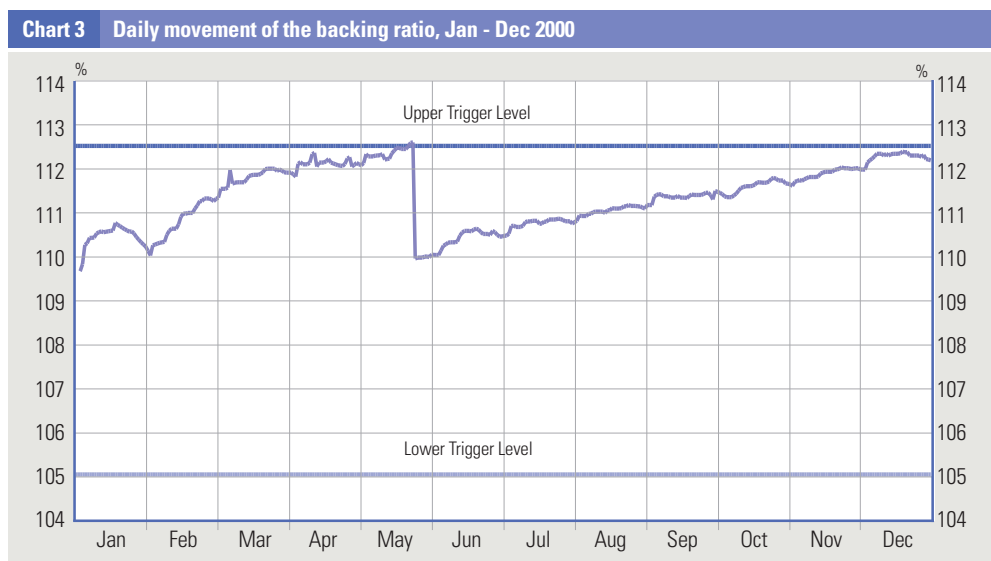


down (Chart 1). Reflecting strong demand for Hong Kong dollar assets, Hong Kong dollar interest rates with a term of 12 months or below stayed below their US dollar counterparts for most of the year (Chart 2).

The Aggregate Balance declined notably in the early part of the year along with a drop in banks' liquidity demand following the smooth transition into 2000. It then moved between positive and negative \$1 billion during most of the year. Interest rate volatility remained low, partly reflecting stable monetary conditions, and partly the smooth operation of the Discount Window facility in absorbing occasional liquidity shocks. Overnight interbank interest rate rarely surpassed the Base Rate for the Discount Window. For the one-month interbank interest rate, daily interest rate volatility (measured in terms of standard deviation) fell from 0.49 percentage points in 1999 to 0.45 percentage points in 2000, compared to 3.34 and 2.84 percentage points in 1997 and 1998 respectively, which included the crisis period.

During the year, the EFAC Sub-Committee on Currency Board Operations continued its extensive review of the currency board arrangements, covering a wide range of areas, including: strong side operation strategy, currency board arrangements in Argentina and their relevance for Hong Kong, the settlement of foreign exchange transactions conducted by the HKMA, and the pros and cons of reserve requirements as a liquidity buffer.

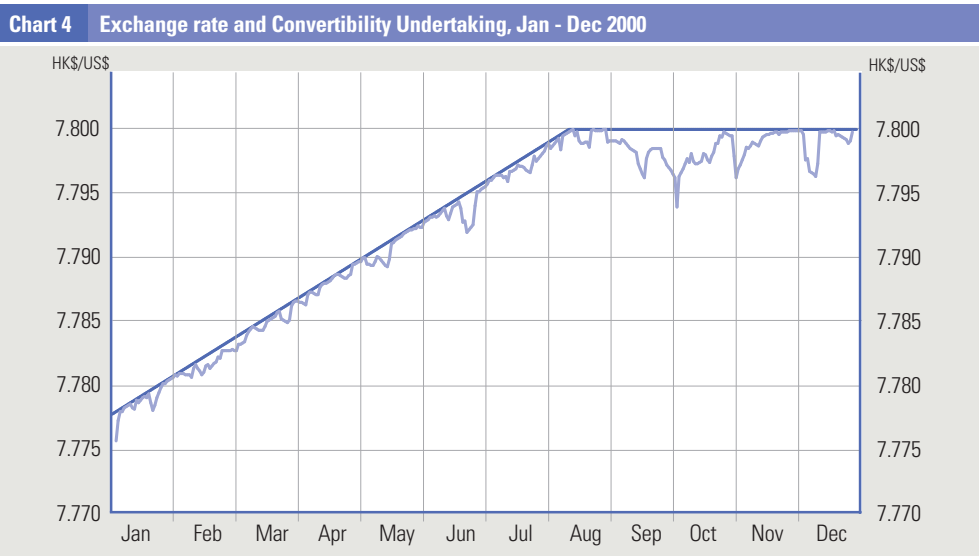
During 2000, the HKMA, following the advice of the EFAC Sub-Committee on Currency Board Operations, introduced the following measures in its continuing efforts to improve the currency board arrangements in Hong Kong:



### Transfer of backing assets

Since October 1998, specific assets of the Exchange Fund have been earmarked to back the monetary base. Initially set at 105%, the backing ratio had steadily increased as a result of the accumulation of net investment income. A framework was established in January 2000 for a transfer of assets between the backing portfolio and the investment portfolio of the Exchange Fund, which would ensure adequate, liquid assets in the backing portfolio, while allowing assets which are clearly surplus to the narrow needs of that portfolio to be managed more flexibly in the investment portfolio. The arrangements are symmetrical: on the high side of the backing ratio, the trigger point is set at 112.5%; normally, when the backing ratio reaches this point, assets should be moved out of the backing portfolio sufficient to reduce the ratio to 110%. On the other side, 105% is set as the trigger

point at which, normally, assets would be transferred into the backing portfolio sufficient to restore the ratio to 107.5%. On 23 May 2000, the ratio hit the upper trigger point of 112.5%, and a transfer of assets from the backing portfolio to the investment portfolio was effected, reducing the ratio to 110% (Chart 3).



**Convergence of exchange rates under convertibility undertakings**

When the convertibility undertaking rate in respect of the Aggregate Balance was introduced in September 1998, the convertibility rate was set at 7.7500, which was the prevailing market exchange rate at that time. To bring the convertibility rate in line with that for the issuance and redemption of Certificates of Indebtedness at 7.8000, a 500-day transition period began on 1 April 1999, during which the rate moved by one pip per day. The transition was completed smoothly on 12 August 2000 with no disruptions to the markets (Chart 4).

On the strong side of the linked exchange rate, the HKMA continued to manage the foreign exchange operations by responding to offers from banks according to the prevailing market conditions. This system has been functioning smoothly, and is also well accepted by the market. It has provided the HKMA with some flexibility in responding to bank offers, while obliging the HKMA to be fully accountable by immediately publicising any currency board operations.

**Hong Kong Institute for Monetary Research**

The Hong Kong Institute for Monetary Research, established in August 1999 to conduct research studies in the fields of monetary policy, banking and finance, had a productive year in 2000. Eleven research fellows visited the Institute and completed their research projects. Eleven working papers were published: these are available on the Institute’s website ([www.hkimr.org](http://www.hkimr.org)).



Participants in the workshop on “Design and Use of Economic Models in Implementing Monetary Policy” organised by the Hong Kong Institute for Monetary Research.

As part of the efforts to promote central bank co-operation in research activities, a workshop on "Design and Use of Economic Models in Implementing Monetary Policy" was organised in December 2000. Fifteen representatives from 11 regional central banks attended the workshop, together with three resource persons from Bank of Canada, Bank of England and Bank for International Settlements.

In addition, the Institute organised a total of 15 seminars in 2000 on a broad range of economic and monetary issues. It also sponsored the plenary session of the Hong Kong Economic Association Conference in December, in which Professors Robert Mundell and Joseph Stiglitz were invited as keynote speakers.

## | Future plans |

In coping with challenges presented by the increasingly globalised international financial environment, the EFAC Sub-Committee on Currency Board Operations will continue its review of the currency board arrangements, and where appropriate, introduce measures to further strengthen the effectiveness of the currency board arrangements in Hong Kong.

The HKMA will continue to keep abreast of latest developments in financial markets, and closely monitor risks and vulnerabilities in the domestic and external environment which may impact on Hong Kong's financial stability. Topical issues of particular relevance to our economy will be studied in greater depth, such as the implications of deceleration of global economic growth, interest rate spreads between Hong Kong dollar and US dollar, as well as other developments in the monetary and banking sector.