

Monetary Stability

Notwithstanding the difficult external environment and ongoing economic adjustment in Hong Kong in 2002, the Linked Exchange Rate system continued to function smoothly. This provided a steady monetary environment, which is critical for maintaining financial and economic stability in Hong Kong.



OBJECTIVES

The primary objective of monetary policy is currency stability, which is 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, which was adopted on 17 October 1983, is essentially a Currency Board system with 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.

Hong Kong's Monetary Base consists of four components:

- Certificates of Indebtedness (CIs), which are used for backing the banknotes issued by the three note-issuing banks
- Government-issued currency notes and coins in circulation
- the sum of the balances on the clearing accounts maintained by licensed banks with the HKMA (known as the Aggregate Balance)
- Exchange Fund Bills and Notes, which are issued by the HKMA on behalf of the Government.

The Monetary Base is fully backed by foreign reserves, and any change in its size must be fully matched by a corresponding change in foreign reserves in the backing portfolio. CIs and Government-issued currency notes and coins are issued and redeemed 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 into US dollars at the linked rate of HK\$7.80.

Under the Currency Board arrangement, the Hong Kong dollar exchange rate remains fixed against the US dollar, while interest rates adjust to changes in the demand for Hong Kong dollars. Specifically, when there is a decrease in the demand for Hong Kong dollars, and the exchange rate weakens to the convertibility rate of HK\$7.80 per 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 to maintain exchange rate stability. Conversely, if there is an increase in the demand for Hong Kong dollars, leading to a strengthening of the exchange rate, the HKMA may sell Hong Kong dollars for US dollars. The Aggregate Balance will accordingly expand, exerting downward pressure on interest rates and thus discouraging continued inflows.

A REVIEW OF 2002

The external environment was difficult in 2002. Global stock market corrections continued in the light of accounting scandals and weak corporate earnings. Growth momentum in the major industrial economies was moderate and their economic prospects were further clouded by rising geopolitical risks. In the emerging markets, Argentina abandoned its currency board system in January, and the Brazilian real depreciated substantially in the second quarter owing to political uncertainties.

Nevertheless, the exchange and money markets in Hong Kong were largely stable. The Hong Kong dollar exchange rate stayed close to the convertibility rate, within a narrow range of 7.7980 - 7.8000 (Chart 1). During the year the HKMA sold US dollars for Hong Kong dollars under the Convertibility Undertaking once and purchased US dollars for Hong Kong dollars twice in response to banks' offers.

The Hong Kong dollar forward market experienced occasional periods of pressure during the year (Chart 2). The rises in the

forward premium were most notable in March and October, and were largely attributable to concerns about the widened budget deficit and renewed public concerns about the Link. The forward premium, in terms of 12-month money, reached a high of 368 pips in mid-October before easing to 170 pips at the end of 2002.

Hong Kong dollar interest rates decreased modestly in 2002 together with US dollar interest rates (Chart 3). In terms of one-month money, Hong Kong Interbank Offered Rate (HIBOR) eased from 2% to 1.4% during the year.

CHART 1 Market exchange rate and convertibility rate, January-December 2002

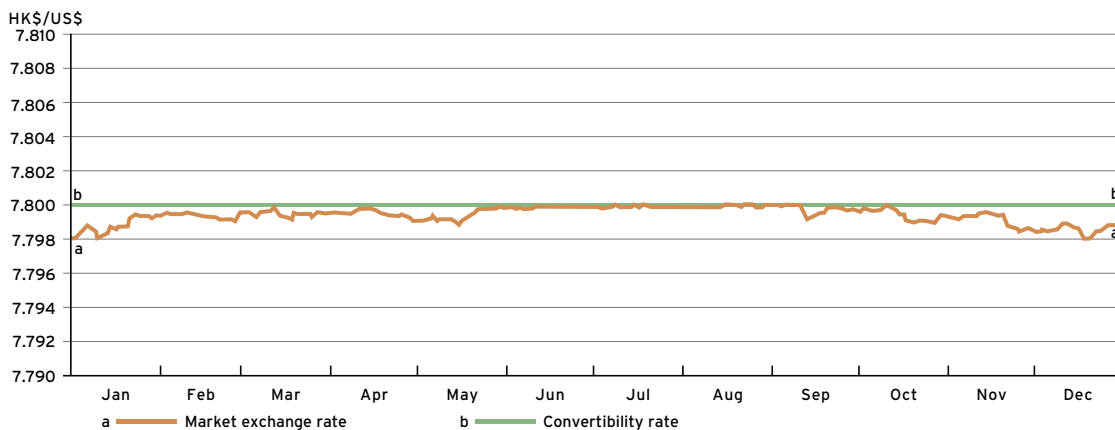
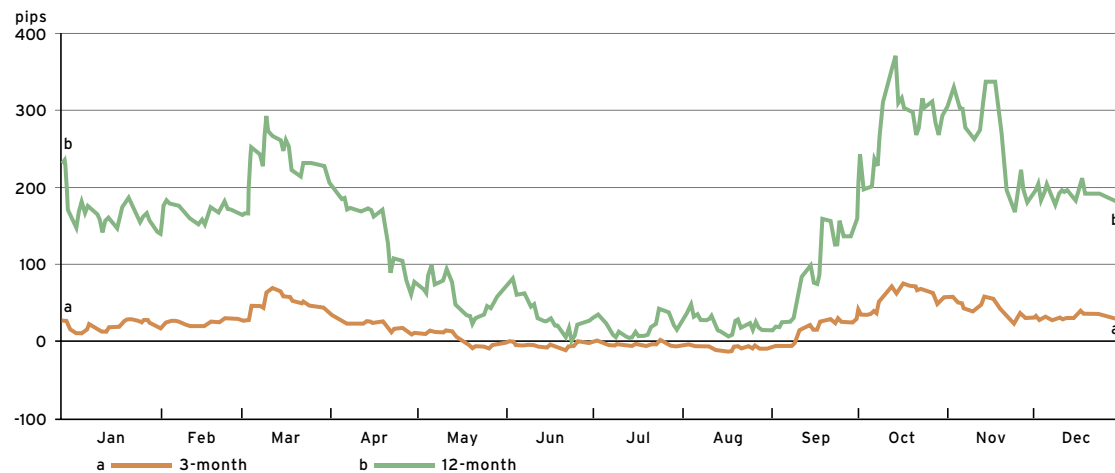


CHART 2 Hong Kong dollar forward points, January-December 2002



Except for the third quarter when the interbank liquidity was relatively abundant, local interest rates generally maintained a small positive differential against their US dollar counterparts (Chart 4). The Aggregate Balance stayed within a narrow range of \$0.25-0.45 billion until late May, when the HKMA sold Hong Kong dollars in response to banks' bids. The Aggregate Balance then expanded to around \$1.1 billion. In

September, the Convertibility Undertaking was triggered, leading to a reduction in the Aggregate Balance to \$0.3 billion. Nevertheless, subsequent to a sale of Hong Kong dollars by the HKMA in response to banks' bids in late October, the Aggregate Balance increased and stayed at around \$0.6 billion in the rest of the year (Chart 5).



CHART 3 HIBORs, January-December 2002

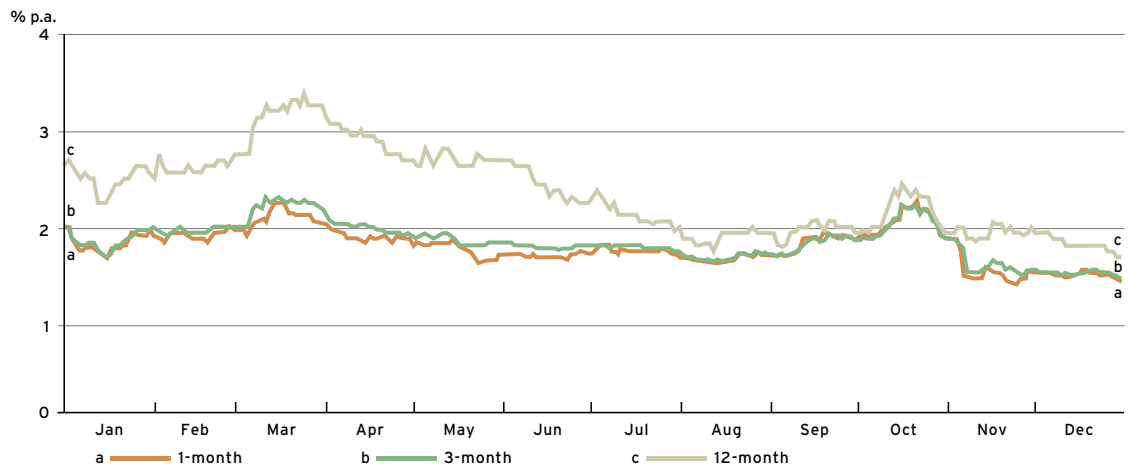
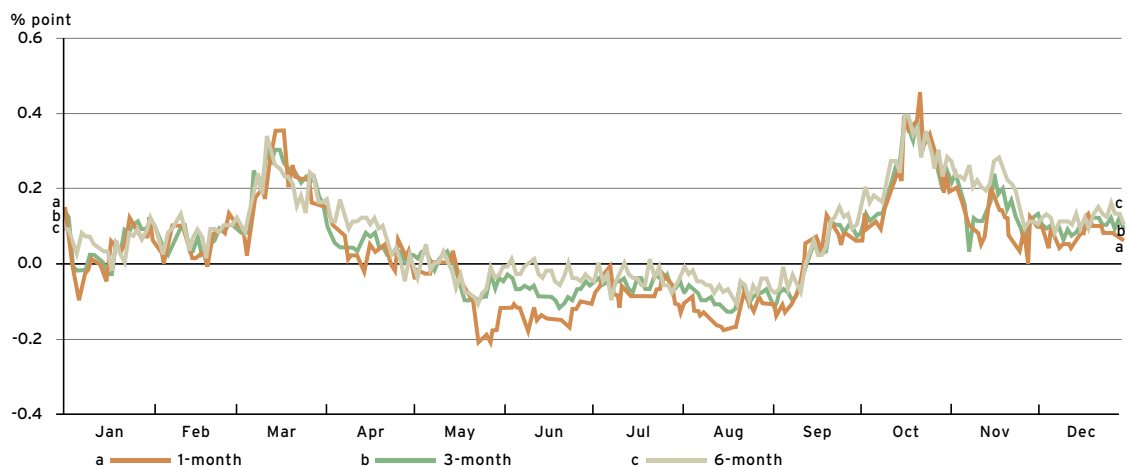


CHART 4 Hong Kong dollar - US dollar interest rate differentials, January-December 2002



Interest rate volatility remained low in 2002, reflecting stable monetary conditions and the smooth operation of the Discount Window in absorbing occasional liquidity shocks. Overnight interbank interest rates rarely surpassed the Base Rate of the Discount Window. Interest rate volatility, as measured by the standard deviation of the daily changes of the one-month interbank rates relative to the yearly average rate, was 0.02 in 2002, about the same level as in 2001, compared with 0.38 and 0.15 in 1997 and 1998 respectively.

Specific assets of the Exchange Fund have been earmarked to back the Monetary Base since October 1998, in order to provide transparency to the Currency Board Account. The backing ratio, defined as the ratio of backing assets to the Monetary Base, was about 112.1% at the end of 2002 (Chart 6).

Activities at the HKMA

The Exchange Fund Advisory Committee (EFAC) Sub-Committee on Currency Board Operations was established in August 1998 to oversee the

CHART 5 Aggregate balance, January-December 2002

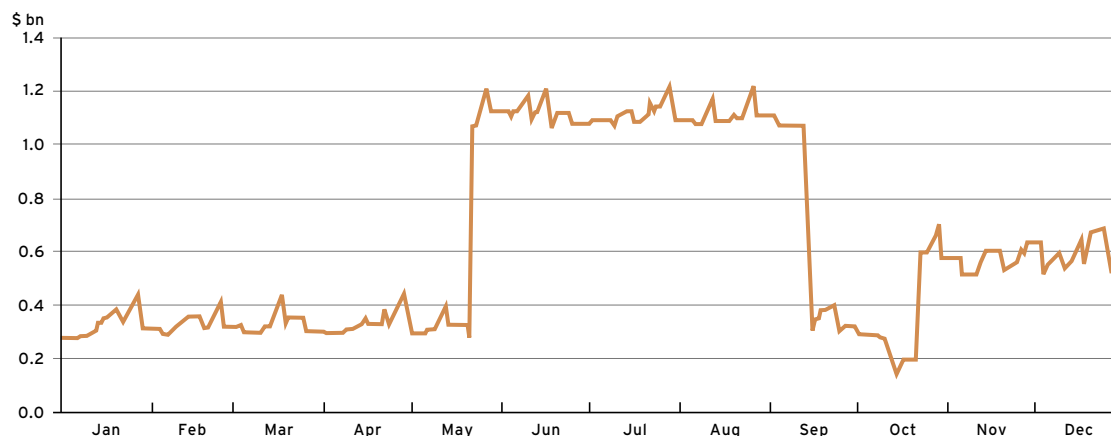
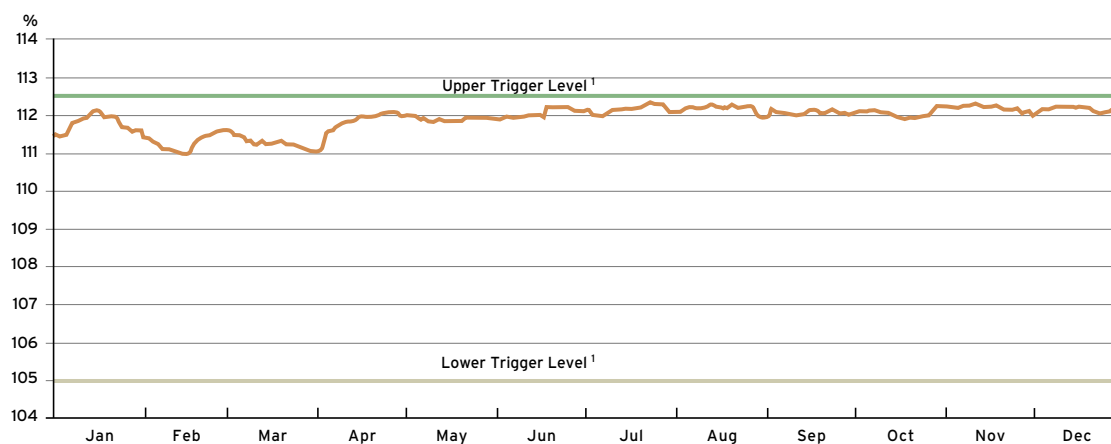


CHART 6 Daily movement of the backing ratio, January-December 2002



¹ Under the arrangements for transferring assets between the backing portfolio and the investment portfolio of the Exchange Fund, when the backing ratio reaches 112.5% (the upper trigger point), sufficient assets will be transferred from the backing portfolio to the investment portfolio to reduce the ratio to 110%. Should the backing ratio drop to 105% (the lower trigger point), sufficient assets will be transferred from the investment portfolio to the backing portfolio to restore the ratio to 107.5%.

operations of the Currency Board system in Hong Kong. The Sub-Committee continued to monitor the Currency Board arrangements in 2002 and to examine issues that might have an impact on monetary and financial stability in Hong Kong. These issues included the definition of money supply and the information content of monetary aggregates; external circulation of Hong Kong dollar currency; the flexibility of the Argentine and Hong Kong economies and their compatibility with the maintenance of a fixed exchange rate; Lithuania's re-pegging from the US dollar to the euro; monitoring US dollar interest rate expectations from derivative prices; the relationship between bank lending and property prices in Hong Kong; and price convergence between Hong Kong and the Mainland.

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The Hong Kong Institute for Monetary Research, established in August 1999, continued to sponsor research in the fields of monetary policy, banking and finance. The level of activity at the Institute increased as it became more established and widely known. Twenty fellows visited the Institute to undertake research during the year and 23 working papers were published. To facilitate central bank co-operation in research activities and contribute to policy analysis of strategic issues affecting monetary and financial development in Asia, the Institute co-organised with the Centre for Central Banking Studies of the Bank of England a one-week workshop on "Building Models for Monetary Policy in the Asian Pacific Region" in July. In addition, 40 public seminars were organised during the year on a broad range of economic and monetary issues.

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PLANS FOR 2003 AND BEYOND

The global economic environment has become increasingly uncertain, especially in the light of rising geopolitical risks and increased volatility in the financial markets. Locally, the economy is confronted with the challenges of addressing fiscal imbalances, deflation, and integration with the Mainland. We will continue to study issues pertinent to the local economy in our research programme for the coming year. The EFAC Sub-Committee on Currency Board Operations will closely monitor risks and vulnerabilities in the domestic and external environment that may affect Hong Kong's financial stability.

The Sub-Committee will keep the technical aspects of the Currency Board arrangements under review, and where appropriate, recommend measures to strengthen them further.

