



Highways Department staff work at night against tight deadlines to ensure that Hong Kong's roads are smooth and safe.

MONETARY STABILITY

The Linked Exchange Rate system continued to function smoothly throughout 2003 despite a marked shift in market sentiment from extreme pessimism during the SARS outbreak to optimism in the later part of the year. The Linked Exchange Rate system provides a stable monetary environment that is crucial to maintaining financial and economic stability in Hong Kong.

OBJECTIVES

The primary monetary policy objective of Hong Kong is currency stability, defined as a stable exchange value of the currency of Hong Kong, in terms of its exchange rate in the foreign exchange market against the US dollar, at around HK\$7.80 to US\$1. The structure of the monetary system is characterised by currency board arrangements, which require the Hong Kong dollar Monetary Base to be at least fully backed by, and changes in it to be fully matched by corresponding changes in, US dollar reserves held in the Exchange Fund at the fixed exchange rate of HK\$7.80 to US\$1.

Hong Kong's Monetary Base consists of four components:

- Certificates of Indebtedness (CIs), which are used to back 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 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 stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism. 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. 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 2003

The exchange and money markets were largely stable during the year, despite a marked shift in market sentiment from extreme pessimism during the SARS outbreak to optimism in the later part of the year. The Hong Kong dollar exchange rate stayed close to the convertibility rate of 7.80 in the first eight months of 2003. However, it appreciated markedly in late September, triggered by US dollar weakness and increased pressures for a renminbi

appreciation, reaching a high of 7.70 at one point (during London hours on 22 September) (Chart 1). The movement in the exchange rate was probably exacerbated by an unwinding of substantial short positions in the Hong Kong dollar that had been accumulated earlier. The strength of the Hong Kong dollar persisted in the fourth quarter, reflecting an improvement in the economic fundamentals of Hong Kong, and portfolio re-allocations arising in part from Hong Kong's large current account surpluses and large international investment position. Economic prospects brightened following the introduction of

a number of policy measures designed to deepen economic integration between Hong Kong and the Mainland: these included relaxations of travel restrictions on Mainland visitors to Hong Kong, the conclusion of CEPA, and the agreement between Hong Kong and the Mainland to launch a personal renminbi business scheme in Hong Kong.

The Hong Kong dollar forward points shifted from a premium to a significant discount during the year. The 12-month forward points rose during April, largely because of concerns about the adverse effect of SARS (Chart 2). As SARS was brought

CHART 1 Market exchange rate and convertibility rate, January – December 2003

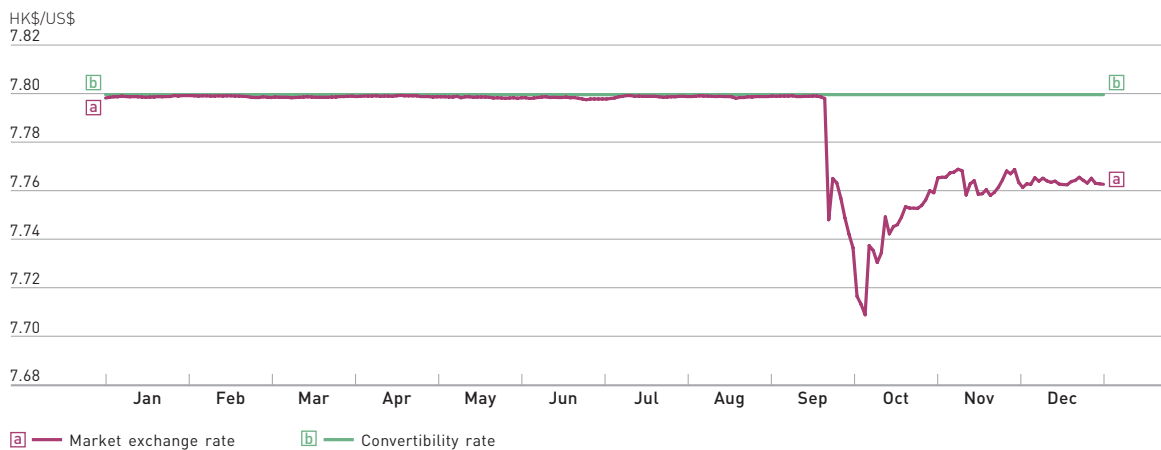
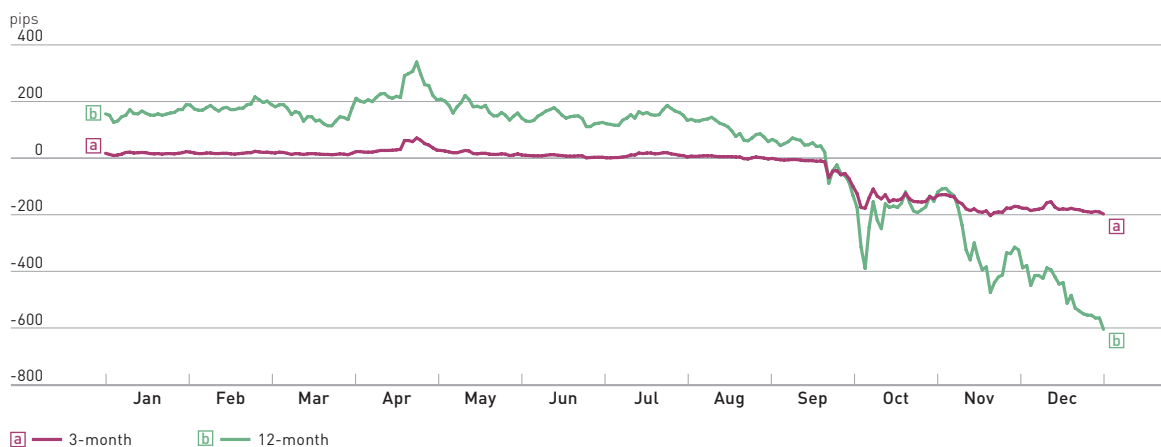


CHART 2 Hong Kong dollar forward points, January – December 2003



under control and signs of economic recovery emerged, the Hong Kong dollar forward points decreased gradually. The 12-month forward points declined to a discount in September, and reached a level of -600 pips at the end of the year.

Hong Kong dollar interest rates eased during the year, mainly reflecting an increase in inflows of funds in the fourth quarter (Chart 3). Domestic interest rates dropped significantly below US rates in September (Chart 4). The Aggregate Balance rose from less than \$1 billion in early September to

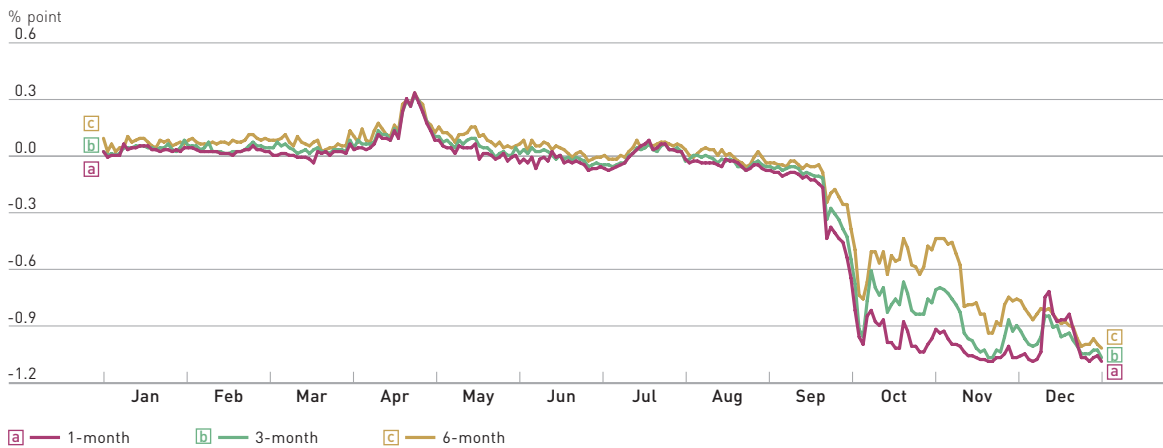
\$28.3 billion at the end of 2003, as the HKMA sold Hong Kong dollars to banks in response to the increase in demand for Hong Kong dollar assets (Chart 5).

Interest rate volatility, as measured by the standard deviation of daily changes in the one-month interbank rate, remained at low levels throughout the year. This reflected the smooth operations of the Discount Window in absorbing liquidity shocks. Overnight interbank interest rate rarely rose above the Base Rate of the Discount Window.

CHART 3 HIBORs, January – December 2003



CHART 4 Hong Kong dollar – US dollar interest rate differentials, January – December 2003



Specific assets of the Exchange Fund have been earmarked to back the Monetary Base since October 1998 to increase the transparency of the Currency Board Account. The Backing Ratio, defined as the ratio of Backing Assets to the Monetary Base, decreased from 112.0% to 110.1% in 2003 (Chart 6). A large part of the decrease occurred in the fourth quarter, owing to a revaluation loss on the Backing Assets associated with an appreciation of the Hong Kong dollar against the US dollar. The expansion of the Aggregate Balance also exerted a downward

influence on the ratio: while the Backing Assets increased by the same magnitude as the Monetary Base, the fractional increase was smaller in the former because of its larger size.

Activities at the HKMA

Established in August 1998, the Exchange Fund Advisory Committee Sub-Committee on Currency Board Operations is responsible for supervising the operations of the Currency Board system in Hong Kong. The Sub-Committee continued to monitor the Currency Board arrangements and to examine

CHART 5 Aggregate Balance, January – December 2003

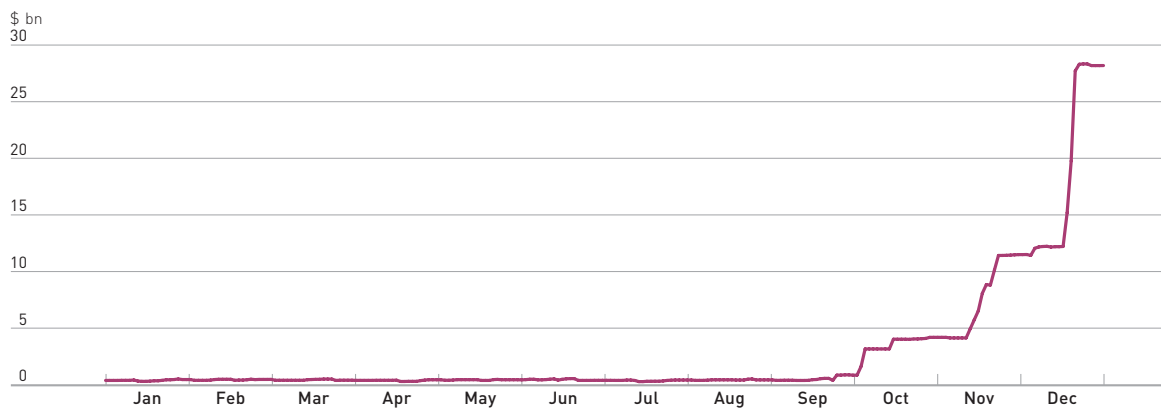
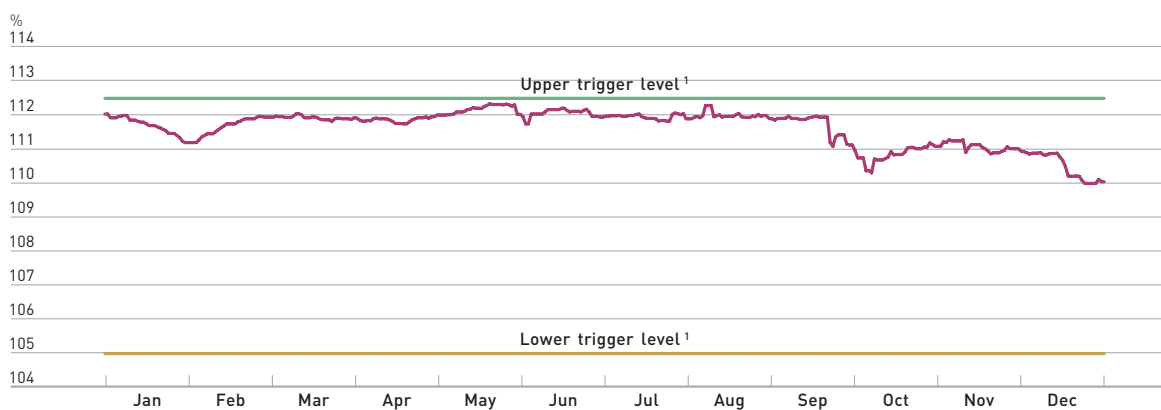


CHART 6 Daily movement of the backing ratio, January – December 2003



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%.

issues that may affect monetary and financial stability in Hong Kong in 2003. These issues included the economic impact of SARS on Asian economies, prospects for a re-emergence of inflation in Hong Kong, the macroeconomic effects arising from maintaining the Linked Exchange Rate system, the determinants of banking performance in Hong Kong, and an analysis of the balance of payments in 2002.

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The Hong Kong Institute for Monetary Research, established in August 1999, has sponsored research in the fields of monetary policy, banking and finance. In 2003 the Institute hosted 18 full-time and three part-time research fellows, and published 24 working papers. The research agenda and projects were determined and approved by the Institute's Council of Advisers which comprise internationally prominent academics and analysts from Hong Kong and overseas.

The Institute hosted the eighth Annual Australasian Macroeconomics Workshop in Hong Kong in September. Thirty-three papers were presented from participants from various universities and central banks. In addition, the Institute co-organised a two-day conference entitled "Deflation, Pegs and Capital Flows" in December with the Hong Kong Institute of Economics and Business Strategy of the University of Hong Kong and the Centre for Economic Policy Research of the United Kingdom. In addition, 33 public seminars were organised during the year covering a broad range of economic and monetary issues.

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