

MONETARY STABILITY

Refinements to the operation of the Linked Exchange Rate system introduced in May 2005 removed the uncertainty about the strong-side potential of the Hong Kong dollar and made the interest rate adjustment mechanism more efficient.

OBJECTIVES

The primary monetary policy objective of Hong Kong is currency stability. This is defined as a stable external exchange value of Hong Kong's currency, 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 a Currency Board arrangement, requiring the Hong Kong dollar Monetary Base to be at least 100 per cent backed by, and changes in it to be 100 per cent 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.

The Monetary Base has four components:

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

 > [Monetary Base](#)

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism. When there is a decrease in the demand for Hong Kong dollars and the market exchange rate weakens to the weak-side convertibility rate of HK\$7.85 per US dollar, the HKMA stands ready to purchase Hong Kong dollars from banks. The Aggregate Balance (as part of the Monetary Base) will decrease, pushing up Hong Kong dollar interest rates to induce capital inflows to restore exchange rate stability. Conversely, if there is an increase in the demand for Hong Kong dollars and the market exchange rate strengthens to the strong-side convertibility rate of HK\$7.75 per US dollar, the HKMA will sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will expand, exerting downward pressure on Hong Kong dollar interest rates to restrain inflows.

 > [Monetary Stability](#) > [Currency Board System](#)

REVIEW OF 2005

The exchange and money markets were largely stable during the year. As appreciation pressures built up in late 2004 abated, the Hong Kong dollar exchange rate gradually weakened towards the Linked Rate of 7.8 in January 2005 (Chart 1). Thereafter, the Hong Kong dollar exchange rate stayed near the Linked Rate between February and April. The weak-side Convertibility Undertaking of 7.8 was triggered intermittently during this period, with the HKMA buying a total of \$12.0 billion

worth of Hong Kong dollars. The Hong Kong dollar exchange rate began to strengthen again in late April, due to speculation about a change in the renminbi exchange rate regime.

On May 18, the HKMA announced three refinements to the operation of the Linked Exchange Rate system to make interest rate and exchange rate adjustments more effective:

- (1) A strong-side Convertibility Undertaking was established, under which the HKMA undertakes to buy US dollars from licensed banks at 7.75.
- (2) The weak-side Convertibility Undertaking was gradually moved from 7.80 to 7.85 (by 100 pips per week from 23 May to 20 June) to create a symmetric Convertibility Zone around 7.80.
- (3) The HKMA may conduct market operations consistent with Currency Board principles within the Convertibility Zone.

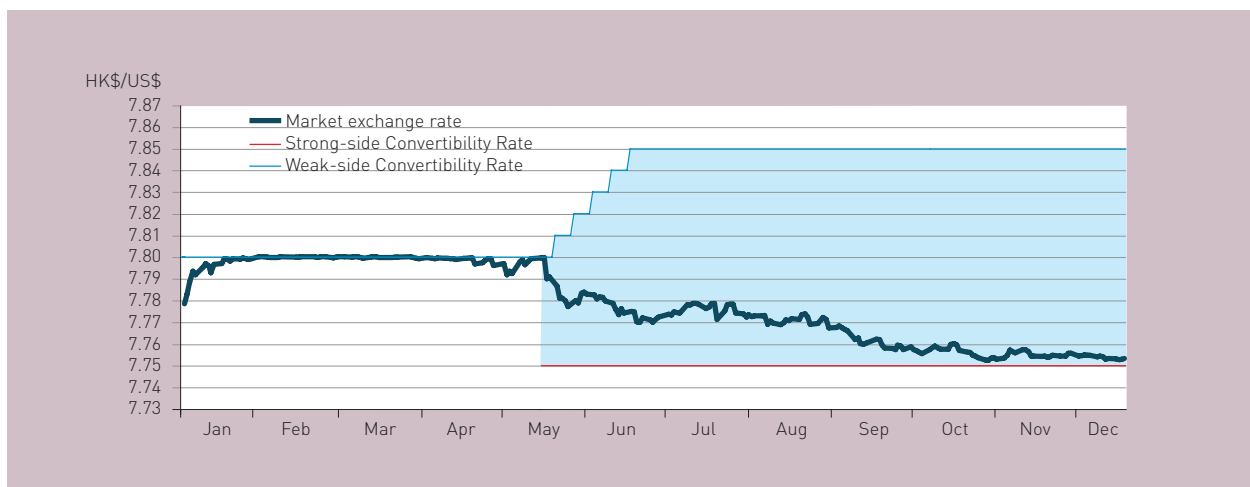
The refinements are aimed at removing uncertainty about the strong-side potential of the Hong Kong dollar. By anchoring exchange rate expectations on the strong

side, the measures should make the interest rate adjustment mechanism more effective and efficient. The initial reaction from the foreign exchange and money markets suggested that the refinements were effective. Immediately following the announcement, market expectations of an appreciation of the Hong Kong dollar diminished and the weak-side Convertibility Undertaking of 7.8 was triggered, prompting the HKMA to buy \$3.12 billion Hong Kong dollars from banks.

On 21 July, the People's Bank of China announced reforms to the renminbi exchange rate system by moving to a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The Hong Kong dollar exchange rate responded calmly to the announcement, suggesting that the three refinements are effective in anchoring exchange rate expectations on the strong side.

Under the Currency Board arrangements, foreign exchange operations of the HKMA lead to corresponding changes in the Aggregate Balance. The weak-side Convertibility Undertaking of 7.8 was occasionally activated between January and April 2005, decreasing the Aggregate Balance from \$15.8 billion to \$3.9 billion

Chart 1. Market exchange rate, January – December 2005



(Chart 2). Following the introduction of the refinements to the Linked Exchange Rate system, the weak-side Convertibility Undertaking was triggered and the Aggregate Balance shrank to \$714 million on 20 May. Subsequently, to address a rising demand for Hong Kong dollars in anticipation of a number of equity initial public offerings, the HKMA conducted market operations within the Convertibility Zone on 25 May, selling \$544 million Hong Kong dollars to banks. As a result, the Aggregate Balance increased to \$1.32 billion on 27 May. The HKMA did not conduct any further market operations and the Aggregate Balance remained stable at around \$1.3 billion for the remainder of the year, with small fluctuations due to interest payments on Exchange Fund paper.

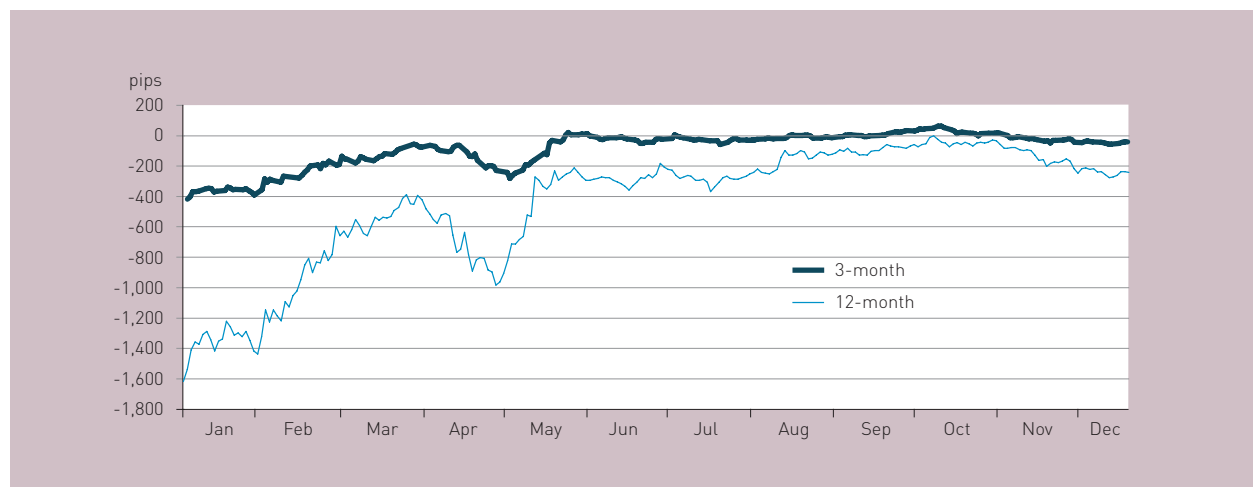
The Hong Kong dollar forward discount narrowed markedly during the year (Chart 3). The 12-month forward discount fluctuated between 400 and 1,600 pips (each pip equivalent to HK\$0.0001) before the introduction of the Linked Exchange Rate refinements, but narrowed markedly afterwards to around 250 pips at the end of the year. This reflected dissipated market expectations of appreciation of the Hong Kong dollar after the introduction of the three refinements.

Hong Kong dollar interbank interest rates rose significantly during the year. This reflected tightened interbank liquidity following repeated triggering of the weak-side Convertibility Undertaking in the early part of 2005, the introduction of the three refinements to the

Chart 2. Aggregate Balance, January – December 2005



Chart 3. Hong Kong dollar forward points, January – December 2005



Linked Exchange Rate system, and increases in the US federal funds target rate throughout the year (Chart 4). The first two factors also led to a rapid catch-up of Hong Kong dollar interbank rates with their US dollar counterparts, substantially narrowing the negative interest rate spreads (Chart 5). For the year as a whole, short-term interest rates rose by about 390 basis points, exceeding the increase of 200 basis points in the US federal funds target rate.

Interest rate volatility, measured by the standard deviation of daily changes in the one-month interbank rate, remained at low levels during the year. The Discount Window functioned smoothly to accommodate liquidity

shocks and overnight interbank interest rates rarely exceeded the Base Rate of the Discount Window.

A specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998 to improve the transparency of the Currency Board Account. The Backing Ratio, defined as the ratio of Backing Assets to the Monetary Base, rose from 111.05% at the beginning of 2005 to a high of 112.52% on 15 March, surpassing the Upper Trigger Level of 112.5% (Chart 6). This largely reflected the contraction in the Aggregate Balance as a result of the triggering of the weak-side Convertibility Undertaking in the early part of the year.¹ Under the arrangements approved by the

Chart 4. HIBORs, January – December 2005

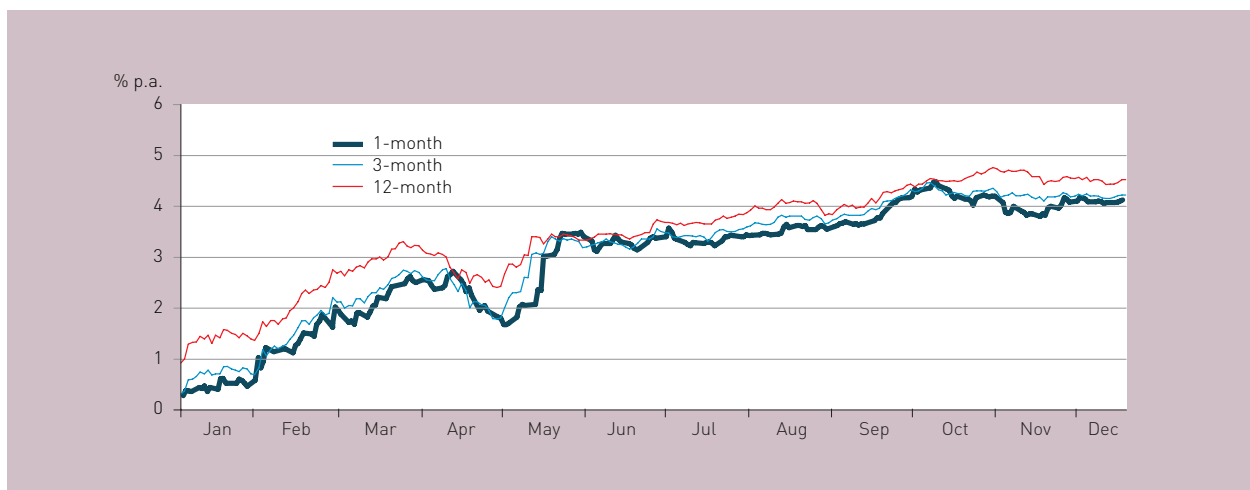
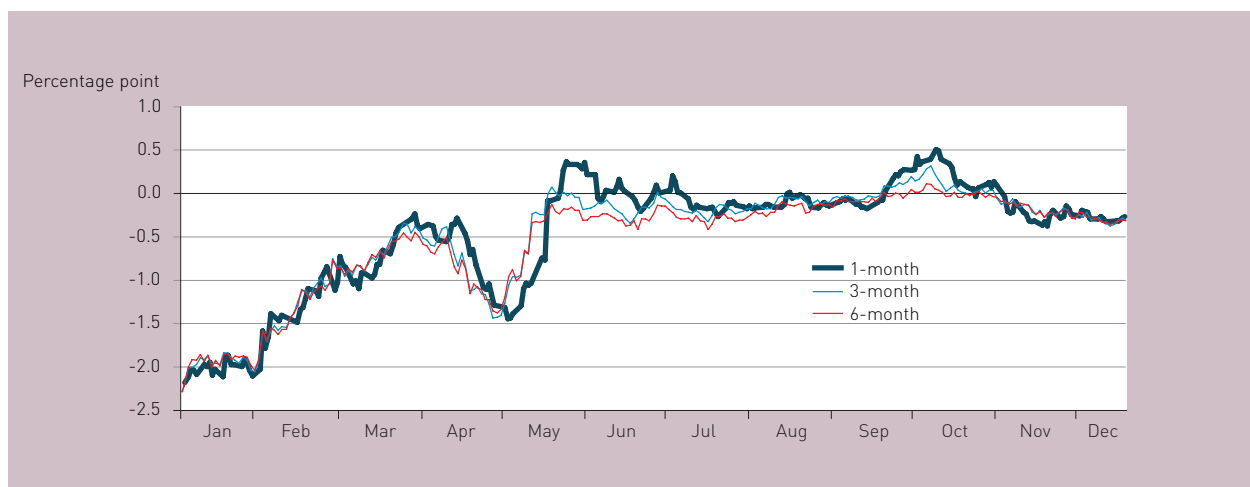


Chart 5. HK dollar – US dollar interest rate differentials, January – December 2005



¹ While the Backing Assets decreased by the same magnitude as the Monetary Base, the fractional decrease was smaller in the former because of its larger size, thus increasing the Backing Ratio.

Financial Secretary in January 2000, assets were transferred out of the Backing Portfolio to reduce the Backing Ratio to around 110% on 16 March. Thereafter, the Backing Ratio rose steadily to close at 111.67% at the end of the year.

Activities at the HKMA

The EFAC Currency Board Sub-Committee continued to review issues crucial to monetary and financial stability in Hong Kong. These issues included convertibility arrangements for the Aggregate Balance, implications of the new renminbi exchange rate regime for Hong Kong, external demand for Hong Kong dollar currency, money and inflation in Mainland China, and a monetary conditions index for the Mainland.

 > [Press Releases](#) > [Monetary Policy](#)

The Hong Kong Institute for Monetary Research, established in August 1999, has continued to sponsor research in the fields of monetary policy, banking and finance. In 2005, the Institute hosted 18 full-time and two part-time research fellows. It also published 22 working papers and one occasional paper.

 > [Research Memorandums](#)

The Institute co-hosted a roundtable meeting in October with the Representative Office for Asia and the Pacific of the Bank for International Settlements. The meeting reviewed the long-term prospects for regional monetary co-operation in Asia following the changes in the

renminbi and Malaysian ringgit exchange rate regimes. Another function the Institute co-organised with the Representative Office was the *Monetary Policy Approaches and Implementation in Asia* conference in November with the participation of the region's central banks, academics, and officials from international financial institutions. In December, the Institute, together with the Centre for Central Banking Studies of the Bank of England, arranged a four-day workshop on financial stability and fragility with participants from seven central banks in the region. Other Institute programmes included a two-day workshop on the Mainland's property market and macro-economy in July and the Third Summer Workshop in September. In addition to conferences and workshops, 40 public seminars were organised during the year on a broad range of economic and monetary issues.

 > [Links](#) > [HKMA-related Organisations](#) > [Hong Kong Institute for Monetary Research](#)

PLANS FOR 2006 AND BEYOND

The HKMA will continue to examine various economic issues in its research programme for the coming year. The EFAC Currency Board Sub-Committee will closely monitor risks and vulnerabilities in the domestic and external environments that may affect Hong Kong's monetary and financial stability. The Sub-Committee will also keep the technical aspects of the Currency Board arrangements under review and, where appropriate, recommend measures to strengthen them further.

Chart 6. Backing Ratio, January – December 2005

