Monetary Stability

Hong Kong's foreign exchange and money markets were stable in 2006, with ample interbank liquidity, Hong Kong dollar interbank interest rates stayed below their US dollar counterparts throughout the year. The benign conditions meant that the Convertibility Undertakings were not triggered and the HKMA did not carry out any discretionary monetary operations. The market remained calm even when the renminbi appreciated beyond the Hong Kong dollar weak-side Convertibility Undertaking.

OBJECTIVES

The overriding objective of Hong Kong's monetary policy 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 Currency Board arrangements, requiring the Hong Kong dollar Monetary Base to be at least 100 per cent backed by US dollar reserves held in the Exchange Fund, and changes in the Monetary Base to be 100 per cent matched by corresponding changes in the US dollar reserves.

The Monetary Base comprises

- Certificates of Indebtedness, which provide full backing to the banknotes issued by the three note-issuing banks
- Government-issued notes and coins in circulation
- the Aggregate Balance, which is the sum of clearing account balances of banks kept with the HKMA
- 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 the demand for Hong Kong dollars decreases 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 will then contract, driving up Hong Kong dollar interest rates to induce capital inflows to restore exchange-rate stability. On the other hand, 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 to push down Hong Kong dollar interest rates, creating monetary conditions that counteract the original inflows.

› Monetary Stability › Currency Board System

REVIEW OF 2006

Hong Kong's foreign exchange and money markets were stable in 2006. Since the introduction of the three refinements to the Linked Exchange Rate system in May 2005, the Hong Kong dollar spot exchange rate has fluctuated between the central parity rate of 7.8 and the strong-side Convertibility Undertaking of 7.75, reflecting buoyant stock market activities, which raised equity-related demand for Hong Kong dollars (Chart 1).[1]

The Hong Kong dollar spot exchange rate moved within a narrow range of 7.7510–7.7622 from January to April. Driven by interest carry trade taking advantage of the widening negative gaps between Hong Kong dollar interest rates and their US dollar counterparts, the Hong Kong dollar exchange rate weakened gradually from 7.7514 in May to 7.7946 in early October. Thereafter, the exchange rate strengthened towards the end of the year to close at 7.7763 on 29 December, mainly because of equity-related inflows. The market remained calm when the renminbi spot rate appreciated beyond the Hong

[1] In 2006 a record $525 billion was raised on the stock market, including a series of H-share IPOs amounting to $292 billion.

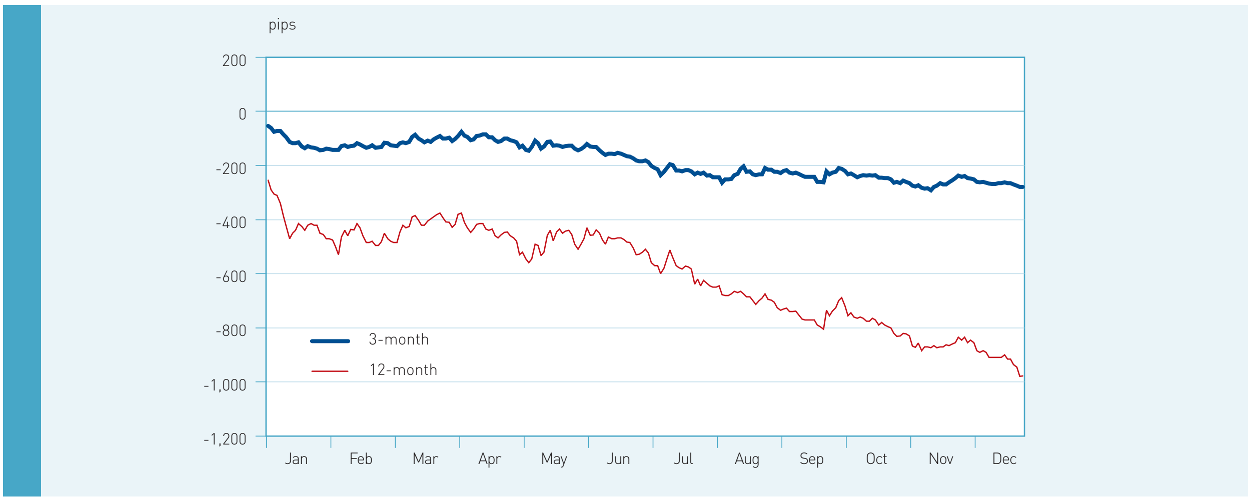
Kong dollar weak-side Convertibility Undertaking of 7.85. This was the first indication of an apparent decoupling of the Hong Kong dollar spot exchange rate and the renminbi spot rate.

In 2006 the Hong Kong dollar forward discount stabilised from January to May, but widened towards the end of the year (Chart 2). For 12-month contracts, the Hong Kong dollar forward points widened to -977 pips on 29 December, after fluctuating around -440 pips in the first five months of the year, consistent with the interest rate differentials.

Movements in the Hong Kong dollar interbank interest rates largely tracked their US dollar counterparts (Chart 3). The Hong Kong Interbank Offered Rates (HIBORs) rose in the first half of the year, in line with increases in the US federal funds target rate. With the pause in interest-rate increases by the Fed from August, Hong Kong dollar interest rates eased and stayed steady, moving between four and five per cent. However, there were small short-term fluctuations, partly induced by equity initial public offerings (IPOs). On 29 December, the one-month and three-month HIBORs were 3.90% and 3.88% respectively.

Chart 1. Market exchange rate, January-December 2006

Chart 2. Hong Kong dollar forward points, January-December 2006



The ample interbank liquidity caused Hong Kong dollar interbank interest rates to stay below their US dollar counterparts throughout 2006. The negative interest rate differentials, starting from around 30 basis points, rose to around 140 basis points at the end of the year (Chart 4). The negative interest rate spreads in 2006 were not large compared with substantial capital inflows in the past. From a macroeconomic perspective, monetary conditions in the past year were broadly neutral. However, the risk of a sudden increase in local interest rates still exists.

The Convertibility Undertakings were not triggered and the HKMA did not carry out any discretionary monetary operations in 2006. As a result, the Aggregate Balance remained stable at around $1.3 billion throughout the year (Chart 5). The interbank market worked smoothly even when some large and highly over-subscribed equity IPOs caused a surge in demand for interbank funds. There were small fluctuations in the Aggregate Balance because of time lags between the payment of interest on Exchange Fund paper and the issuance of additional Exchange Fund paper to absorb these payments.

Chart 3. HIBORs and LIBORs, January-December 2006

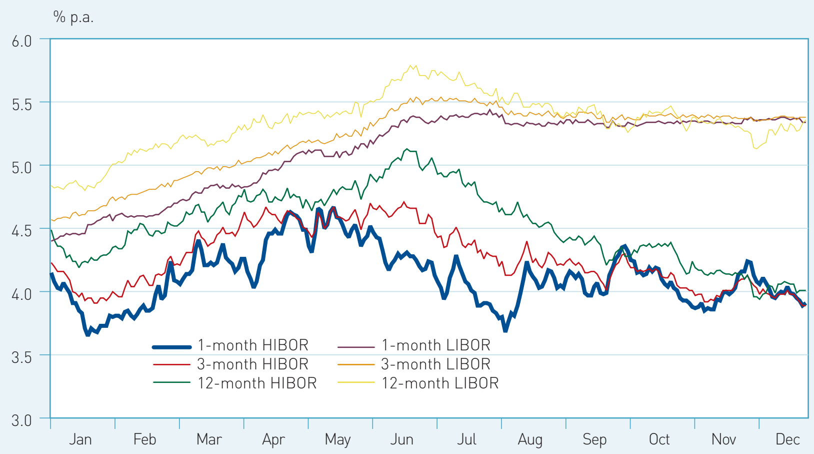
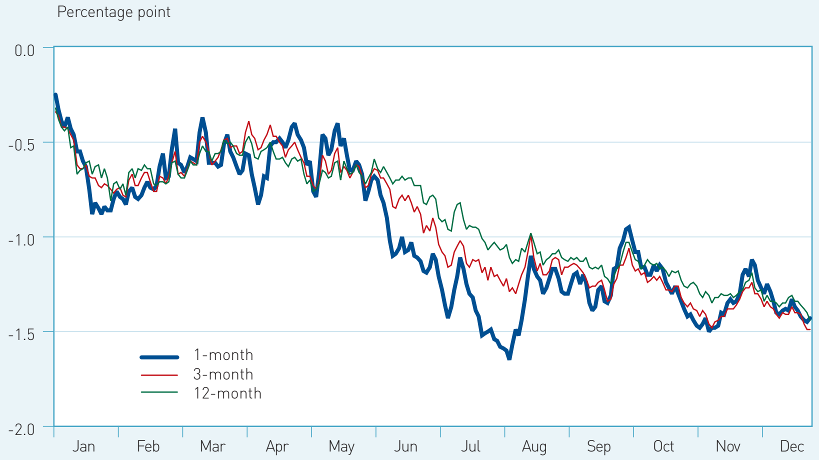


Chart 4. HK dollar - US dollar interest rate differentials, January-December 2006



Reflecting the smooth functioning of the Discount Window and the Linked Exchange Rate system, interest rate volatility, measured by the standard deviation of daily changes in one-month interbank interest rates (relative to the annual average), remained low. The overnight interbank interest rate, which is probably the most volatile among different tenors, did not exceed the Base Rate of the Discount Window in 2006.

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. On 27 January 2006, the Backing Ratio, specified as the Backing Assets over the Monetary Base, declined to 110.76% due to increases in Certificates of Indebtedness ahead of the Chinese New Year holidays (Chart 6). Following this, and underpinned by decreases in the Monetary Base, the Backing Ratio gradually rose to the Upper Trigger Level of 112.5%. Under the arrangements approved by the Financial Secretary in 2000, a portion of the Backing Assets was re-allocated to the Investment Portfolio, restoring the Backing Ratio to around 110% on 14 July. Thereafter, the Backing Ratio moved steadily upwards as revaluation gains more than

Chart 5. Aggregate Balance, January-December 2006

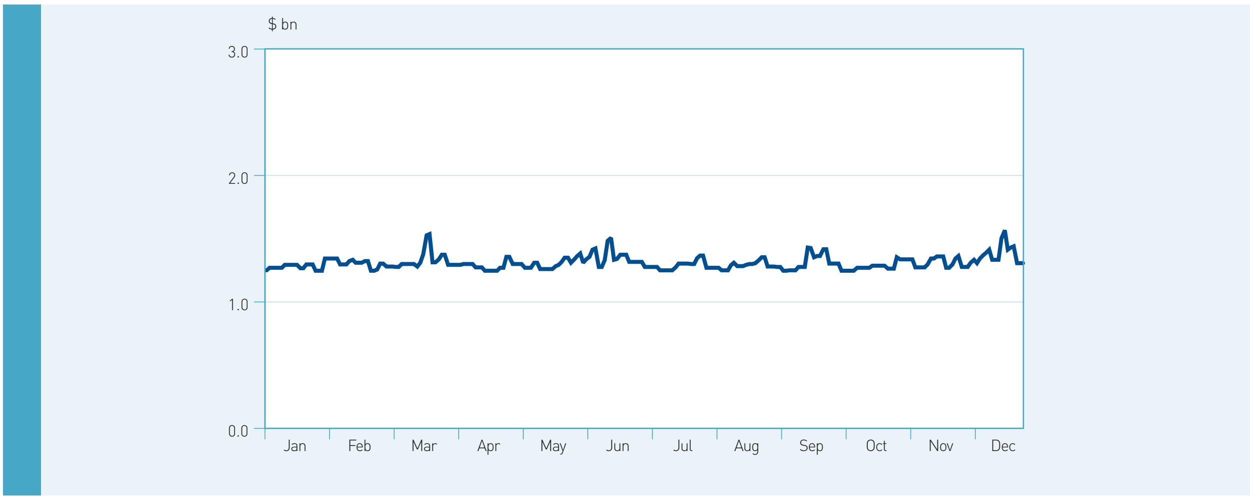
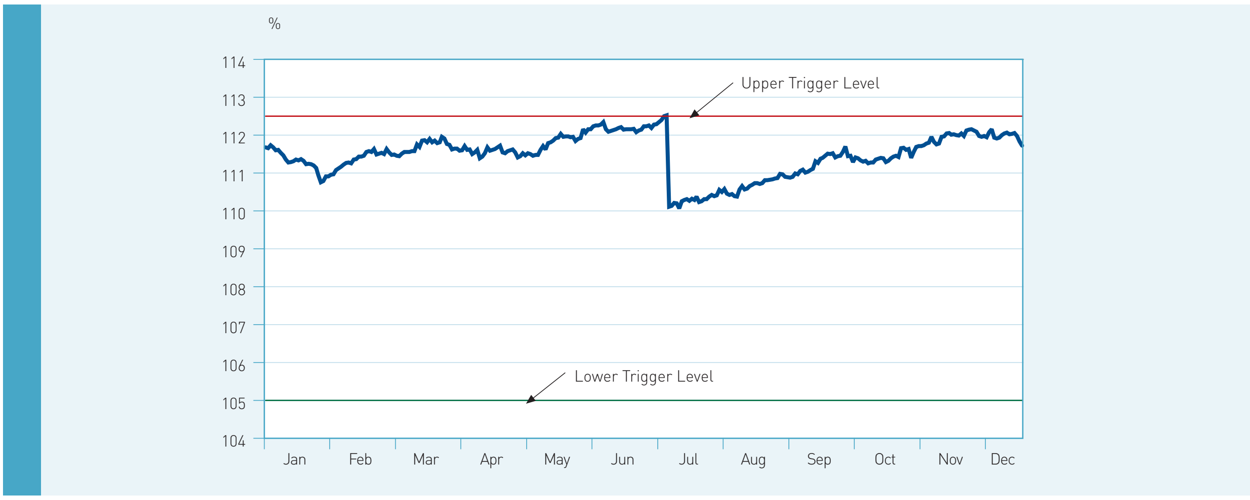


Chart 6. Daily movement of the Backing Ratio , January-December 2006



offset the effect of an increase in the Monetary Base. The Backing Ratio stood at 111.72% on 29 December 2006.

Activities at the HKMA

The EFAC Currency Board Sub-Committee, established in August 1998, monitors and reviews issues essential to monetary and financial stability. In 2006, these included an empirical framework of Hong Kong's best lending rates, the demand for narrow money and broad money, an indicator approach to forecasting the non-rental component of the Composite CPI in Hong Kong, relaxation of the three-year-tenor restriction on multilateral development banks' issuance of debt securities, Hong Kong's business cycle synchronisation with the US and Mainland China, structural determinants of Hong Kong's current account surplus, and the potential size and impact of outward portfolio investment from the Mainland.

› Press Releases › Monetary Policy

The Hong Kong Institute for Monetary Research has continued to sponsor research in the fields of monetary policy, banking and finance. During the year, the Institute hosted 16 full-time and three part-time research fellows. It also published 19 working papers, one occasional paper, and one book in conjunction with the International Monetary Fund.

The Institute co-organised two international conferences. The first, held in July with the International Journal of Finance and Economics, looked at different aspects of international financial markets and the macro-economy; the second, in December with the Bank for International Settlements' Representative Office for Asia and the Pacific, reviewed the development of bond markets in Asia, Europe and Latin America. In April, the Institute sponsored a three-day workshop on building and solving macro-econometric models by Professor Richard Pierse from Surrey University with participants from six central banks in the region. Other programmes included the Fourth Summer Workshop and a two-day workshop on issues related to the Mainland's rapid urbanisation. The Institute also organised 37 public seminars on a broad range of economic and monetary issues.

› Links › HKMA-related Organisations › Hong Kong Institute for Monetary Research (HKIMR)

› Research Memorandums

PLANS FOR 2007 AND BEYOND

The HKMA continually monitors risks and vulnerabilities in the domestic and external environment. Two sources of risk and vulnerability warrant special attention in 2007. First, ample liquidity in the local money market has led to persistent negative spreads of domestic interest rates relative to the corresponding US interest rates. In a currency board arrangement such spreads are expected to narrow over time. While the narrowing of spreads is likely to be smooth, it is not impossible that a sudden reversal of fund flows might lead to an abrupt increase in local interest rates and consequentially rapid adjustments in other local asset prices. Secondly, despite the decoupling of the Hong Kong dollar and renminbi spot exchange rates in 2006, further appreciation of the renminbi may have a more significant impact on local financial markets than has been the case so far if it begins to influence flows of funds into and out of the Asian region. The EFAC Currency Board Sub-Committee will continue to study issues relevant to Hong Kong's monetary and financial stability, including the role of Hong Kong as an international financial centre and Hong Kong's economic integration with the Mainland, keep the technical aspects of the Currency Board arrangements under review and, where appropriate, recommend measures to strengthen them.