Monetary Stability

Despite a turbulent macro-financial environment, the Hong Kong dollar exchange rate remained stable against the US dollar. Activities in Hong Kong's money market were orderly, with a slight upward adjustment in the interest rates. The Hong Kong Government is fully committed to maintaining the Linked Exchange Rate system.

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, within a band of HK$7.75 – 7.85 to US$1. The structure of the monetary system is characterised by Currency Board arrangements, requiring the Monetary Base to be at least 100% backed by US dollar reserves held in the Exchange Fund, and changes in the Monetary Base to be 100% matched by corresponding changes in US dollar reserves.

The Monetary Base (Table 1) 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.

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism and the firm commitment by the HKMA to honour the Convertibility Undertakings (CUs). When the demand for the Hong Kong dollar is greater than the supply and the market exchange rate strengthens to the strong-side CU of HK$7.75 to the US dollar, the HKMA stands ready to sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will then expand to push down Hong Kong dollar interest rates, creating monetary conditions that move the Hong Kong dollar away from the strong-side limit to within the Convertibility Zone of 7.75 to 7.85. Conversely, if the supply of the Hong Kong dollar is greater than demand and the market exchange rate weakens to the weak-side CU of HK$7.85 to the US dollar, the HKMA will buy Hong Kong dollars from banks. The Aggregate Balance will then contract to drive Hong Kong dollar interest rates up, pushing the Hong Kong dollar away from the weak-side limit to stay within the Convertibility Zone.

Table 1 Monetary Base

$ million	**31 December 2011**	31 December 2010
Certificates of Indebtedness[1]	**259,815**	226,705
Government-issued currency notes and coins in circulation[1]	**9,930**	8,929
Balance of the banking system	**148,684**	148,702
Exchange Fund Bills and Notes (EFBN) issued[2]	**658,748**	655,220
Total	**1,077,177**	1,039,556

[1] The Certificates of Indebtedness and the government-issued notes and coins in circulation shown here are stated at Hong Kong dollar face values. The corresponding items shown in the balance sheet of the Exchange Fund in this Annual Report are in Hong Kong dollars equivalent to the US dollar amounts required for their redemption at the prevailing exchange rates on the balance sheet date. This arrangement is in accordance with the accounting principles generally accepted in Hong Kong.

[2] The amount of EFBN shown here is different from that in the balance sheet of the Exchange Fund in this Annual Report. In accordance with the accounting principles generally accepted in Hong Kong, the EFBN held by the HKMA on behalf of the Exchange Fund in relation to its trading of the EFBN in the secondary market are offset against the EFBN issued, and the net amount is recorded in the balance sheet.

REVIEW OF 2011

Exchange-rate stability

Currency stability in Hong Kong was sustained during the year (Chart 1). Between January and March, the market exchange rate softened slightly from around 7.77 to 7.80, partly reflecting the repatriation of funds raised in the equity market. With the US dollar depreciating against other major currencies, the Hong Kong dollar exchange rate strengthened somewhat against the US dollar in April. From May to July the bilateral exchange rate weakened again as growing worries about the European sovereign debt problems weighed on market sentiment. In the five months to December, the exchange rate largely mirrored the swings in the US dollar against other major currencies, either strengthening amid a weaker US dollar or weakening alongside a stronger US dollar. Overall, the market exchange rate traded within a narrow range between 7.7671 and 7.8097 during the year.

Activities in the local foreign exchange market were orderly throughout the year. The convertibility rates were not triggered and the HKMA did not carry out any discretionary foreign exchange operations. Notably, the foreign exchange market continued to function smoothly despite a series of external turbulences, including the political unrest in the Middle East and North Africa, the natural disasters and nuclear crisis in Japan, the downgrade of the US sovereign credit rating by the Standard & Poor's, the escalation of the European sovereign debt crisis and increased volatility in global equity markets.

Chart 1 Market exchange rate in 2011

Money market

After being largely stable at low levels in the first half of the year, Hong Kong dollar interbank interest rates increased slightly in the second half, tracking the upward movements in their US dollar counterparts (Chart 2). The upticks in HIBORs also reflected increased demand for year-end Hong Kong dollar liquidity and occasional funding needs arising from initial public offerings in the equity market. Despite the modest rises, most short-term interbank rates stayed well below the Base Rate of the Discount Window.

Tighter Hong Kong dollar liquidity towards the end of the year was also evident in the forward market. Following some widening in August, the Hong Kong dollar forward discounts broadly narrowed between September and December and the three-month forward point even momentarily turned from discounts to small premiums in December (Chart 3).[1] Some market participants might have tapped into collateralised term funding by swapping US dollars for Hong Kong dollars, leading to the contraction in forward discounts, especially during the last two months of the year. From January to July the forward discounts were generally stable, consistent with the roughly stable HIBOR-LIBOR spreads.

Chart 2 Hong Kong dollar interest rates in 2011

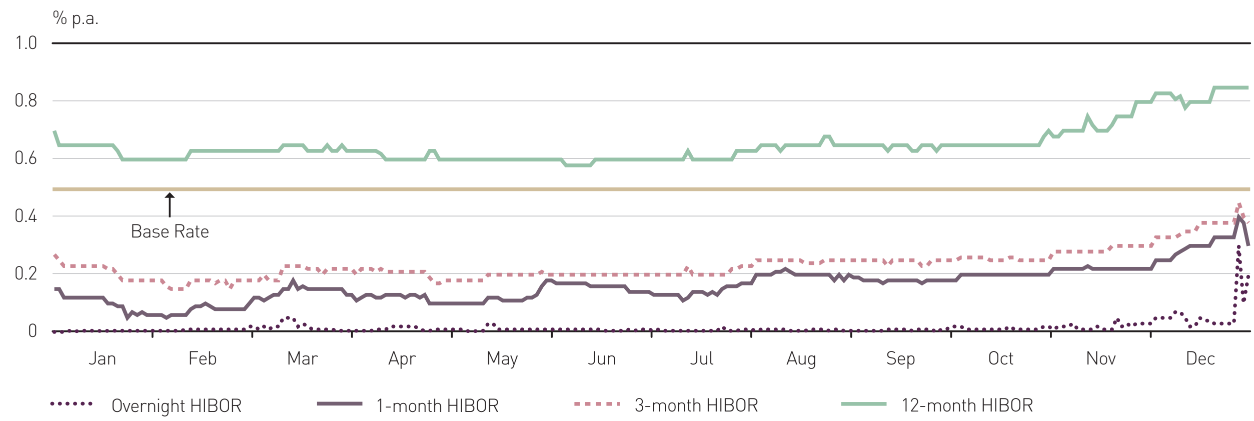


Chart 3 Hong Kong dollar forward points in 2011

[1] The widening forward discounts in August were reportedly driven by precautionary demand for US dollar liquidity amid concerns about the spill-over effect of euro area bank funding pressures.

Monetary Stability

The Linked Exchange Rate system

Against the backdrop of rising inflationary pressures and the downgrade of the US sovereign credit rating, there was renewed discussion among commentators in mid year about the appropriateness of the Linked Exchange Rate system (LERS). The Hong Kong Special Administrative Region Government has reiterated its full commitment to the LERS.[2] In its annual Article IV consultation with Hong Kong, the International Monetary Fund also gave a strong endorsement of the LERS and our policy framework for safeguarding monetary and financial stability.

While short-term HIBORs, by design of the Currency Board system, follow the short-term US dollar LIBORs very closely, longer-term and retail interest rates in Hong Kong may differ to various degrees from their US dollar counterparts, depending on domestic supply and demand factors. In fact, Hong Kong banks gradually tightened their mortgage interest rates for newly approved loans despite the stable HIBORs in the first half of the year, and raised Hong Kong dollar deposit interest rates to attract new deposits. As such, the HKMA has reminded the public to manage the risk of higher interest rates carefully, and has promoted continued prudent risk management by banks so that Hong Kong will be able to cope well with any adverse shocks. In this context, the HKMA has introduced multiple rounds of prudential measures on residential mortgage loans (with the latest one on 10 June) and has continued to be vigilant against excessive credit growth.

Over the years, the operating framework of the LERS has become stronger and more transparent. To improve the transparency of the Currency Board Account, a specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998. The Backing Ratio (defined as the Backing Assets divided by the Monetary Base) moved around 108 - 109% during the year and closed at 108.92% on 31 December (Chart 4). Under the LERS, while specific Exchange Fund assets have been designated for the Backing Portfolio, all Exchange Fund assets are available to support the Hong Kong dollar exchange rate. The large amount of financial resources under the Exchange Fund will provide a powerful backstop in the event of a crisis, protecting Hong Kong's monetary and financial stability.

Chart 4 Daily movement of the Backing Ratio in 2011

[2] The Financial Secretary stated in his blog on 14 August that the LERS continued to be the most appropriate exchange rate arrangement for Hong Kong. See also the *inSight* article of 15 August by the Chief Executive of the HKMA on the LERS.

Macro-prudential surveillance

In December 2011 the Financial Stability Surveillance Division was established under the Monetary Management Department to strengthen the HKMA's oversight of global financial issues. The new Division brings together staff of the Banking Policy Department and the Monetary Operations Division previously engaged in macro-prudential surveillance work. Their analyses will form the basis for deliberations by the Macro Surveillance Committee, which was set up in the second quarter of the year to facilitate regular monitoring of risks and vulnerabilities to Hong Kong's monetary and financial system. The Committee is chaired by the Chief Executive of the HKMA and includes the three Deputy Chief Executives and other senior executives. The functions of the Committee are to:

- identify potential risks and threats to the monetary and financial system in Hong Kong and discuss possible measures to address such risks
- review existing measures for managing risks in the monetary and financial system to identify possible gaps and ensure the adequacy of these measures
- encourage cross-department sharing of relevant information on macro surveillance with a view to enhancing macro surveillance capability of the HKMA.

In 2011 the Committee examined a number of major risks, including the rapid pace of credit growth among authorized institutions and the development of the European sovereign debt crisis.

Other activities

The EFAC Currency Board Sub-Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. In 2011, the Sub-Committee considered issues including the effects of the loan-to-deposit ratio of the Hong Kong banking sector on domestic interest rates; chances of a hard landing of the Mainland economy and interaction between onshore and offshore Eurodollar markets. Records of the Sub-Committee's discussions on these issues and the reports on Currency Board operations submitted to the Sub-Committee are published on the HKMA website.

The Hong Kong Institute for Monetary Research continued to sponsor research in the fields of monetary policy, banking and finance. In 2011, the Institute hosted 22 research fellows and one post-doctoral fellow. It also published 41 working papers and two occasional papers.

The Institute organised eight international conferences and workshops, including the following main ones. In January, the Institute held its Second Annual International Conference on the Chinese Economy with the theme "Macroeconomic Management in China: Monetary and Financial Stability Issues". This conference covered a wide range of issues such as China's inflation, implementation of monetary policy, rising wages, housing market conditions, export growth and Asian business cycle synchronisation. In October, the Institute, together with the Asia and Pacific Department of the International Monetary Fund, held the "Monetary and Financial Stability in the Asia-Pacific amid an Uneven Global Recovery" conference, which dealt with a number of empirical and policy issues related to the monetary and financial stability in the region. The Institute also organised its Ninth Annual Summer Workshop on "US Monetary Policy and Asset Bubbles in Hong Kong", and its Ninth Conference on the Mainland economy with the theme "Money and Bond Market Developments in Mainland China". These conferences and workshops were attended by participants from academia, the financial services industry and central banks around the world. In addition, the Institute organised 36 public seminars during the year covering a broad range of economic and monetary issues.

Notes and coins

At the end of 2011, the total value of banknotes in circulation was $259.8 billion, an increase of 14.6% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to $9.7 billion, up 11.5% (Charts 8 and 9). The value of $10 notes in circulation issued by the Government (both paper and polymer notes) reached $3.7 billion, an increase of 24.9% from 2010.

Chart 5 Banknotes in circulation by note-issuing banks at the end of 2011

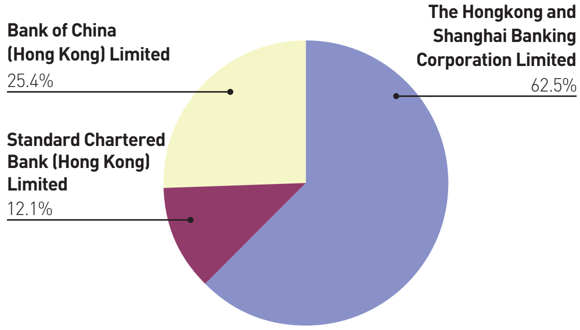
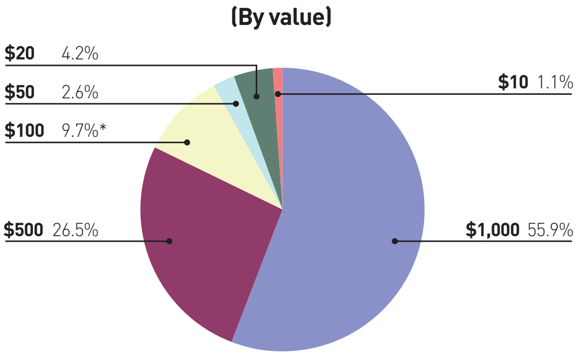
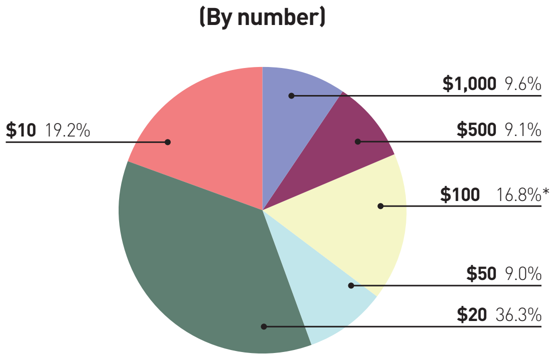


Chart 6 Distribution of banknotes in circulation at the end of 2011





* Includes 0.1 percentage points contributed by $150 banknote.

Chart 7 Banknotes in circulation at the end of 2011

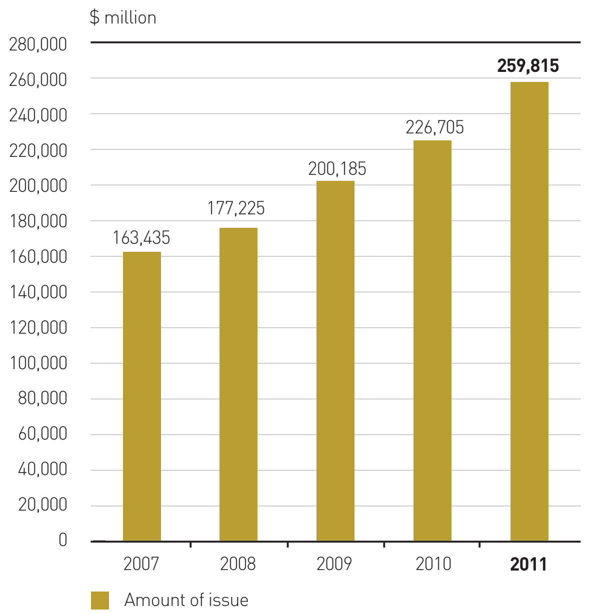


Chart 8 Government-issued notes and coins in circulation at the end of 2011

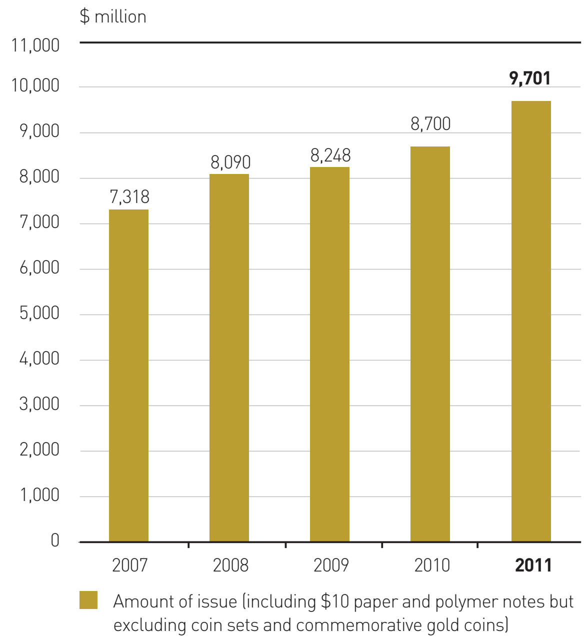
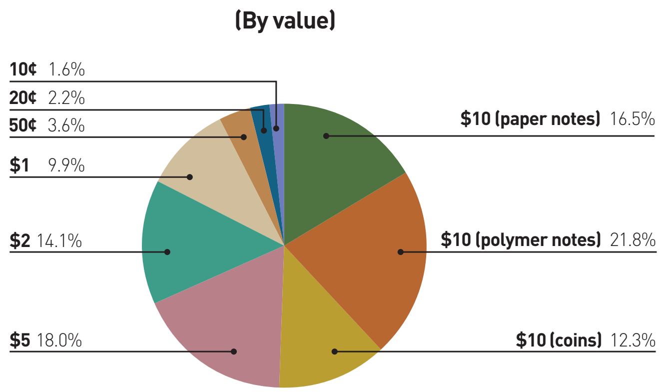
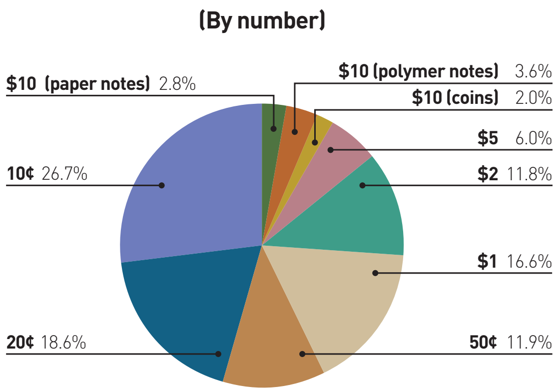


Chart 9 Government-issued notes and coins in circulation at the end of 2011





2010 series Hong Kong banknotes

Following the circulation of the 2010 series new $1,000 and $500 banknotes, the HKMA and the three note-issuing banks unveiled the designs of the remaining $100, $50 and $20 banknotes in July 2011. These new banknotes incorporate the same state-of-the-art security features as the new $1,000 and $500 banknotes. They also carry the same special features to help the visually impaired differentiate the denominations. All five denominations of the 2010 series banknotes have been put into circulation since January 2012.

The HKMA has launched an extensive educational campaign to promote public awareness of the new banknotes. A total of 37 seminars were conducted during the year for over 6,000 participants, including bank tellers, retailers, teachers and students, and roving exhibitions were held in six districts to introduce the new banknotes to the public.

The public visits a roving exhibition on the new banknotes.

$10 polymer note

About 211 million polymer notes were in circulation at the end of 2011, representing 57% of the $10 notes issued by the Government.

Coin replacement programme

The withdrawal of coins bearing the Queen's Head design continued, with 12 million coins removed from circulation in 2011.

Exchange Fund Bills and Notes

In June the HKMA enhanced the market-making arrangements by refining the selection criteria for Eligible Market Makers of EFBN to include a broader range of quantitative indicators, such as turnover by reference to the outstanding EFBN, market-making activities through the electronic trading platform, aggregate positions in EFBN and bid-ask spreads in quotations. At the same time, the HKMA ceased publishing the League Tables on turnover of EFBN.

By the end of 2011, the amount of outstanding Exchange Fund paper stood at $655 billion (Table 2). During the year, the HKMA continued to fine-tune the maturity mix of the EFBN with increased issuance of 10- and 15-year Exchange Fund Notes.

PLANS FOR 2012 AND BEYOND

The external macro-financial environment is likely to remain highly challenging in 2012. The European sovereign debt crisis remains unresolved and risks to global financial stability have increased substantially. The uncertain economic outlook and increased volatility in local financial markets will pose risks to Hong Kong's monetary and financial stability. The HKMA will remain vigilant and prudent and stand ready to deploy appropriate measures as necessary to protect monetary and financial stability in Hong Kong. Research programme for the coming year will continue to study issues affecting the economy and assess potential risks to Hong Kong's monetary and financial stability. The EFAC Currency Board Sub-Committee will continue to examine issues relevant to Hong Kong's monetary and financial stability, review the technical aspects of the Currency Board arrangements and, where appropriate, recommend measures to strengthen them.

Table 2 Outstanding issues of Exchange Fund Bills and Notes

$ million	2011	2010
Exchange Fund Bills (by original maturity)		
28 days	**600**	0
91 days	**348,313**	346,038
182 days	**195,000**	195,000
364 days	**42,200**	42,200
Sub-total	**586,113**	583,238
Exchange Fund Notes (by remaining tenor)		
1 year or below	**17,000**	17,000
Over 1 year and up to 3 years	**28,000**	29,200
Over 3 years and up to 5 years	**10,900**	11,500
Over 5 years and up to 10 years	**8,000**	8,000
Over 10 years	**5,400**	4,200
Sub-total	**69,300**	69,900
Total	**655,413**	653,138