Monetary Stability

Despite a volatile global financial environment and concerns about the US Federal Reserve's plan to reduce asset purchases, the Hong Kong dollar exchange rate remained stable in 2013, while the money market operated smoothly with abundant liquidity. The Linked Exchange Rate system continued to serve as the anchor for Hong Kong's monetary and financial stability and proved highly resilient in a series of regional and global financial crises.

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 Hong Kong dollars 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 Hong Kong dollars 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 2013**	31 December 2012
Certificates of Indebtedness[1]	**329,325**	291,675
Government-issued currency notes and coins in circulation[1]	**10,638**	9,997
Balance of the banking system	**164,093**	255,851
Exchange Fund Bills and Notes (EFBN) issued [2]	**751,850**	661,396
TOTAL	**1,255,906**	1,218,919

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. The EFBN issued on tender dates but not yet settled are included in the balance sheet but excluded from the Monetary Base.

Monetary Stability

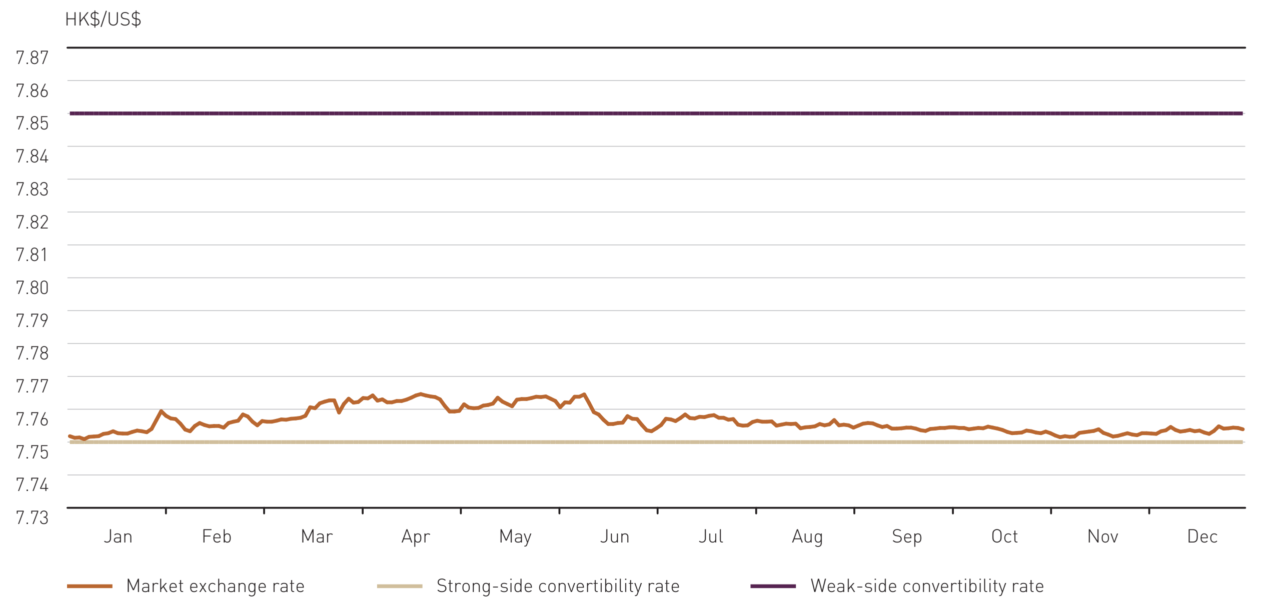
REVIEW OF 2013

Exchange rate stability

The Hong Kong dollar exchange rate traded within a tight range between 7.7509 and 7.7646 against the US dollar (Chart 1). After strengthening close to the strong-side CU in late 2012, the Hong Kong dollar exchange rate eased back slightly in the first half of 2013 amid weaker equity-related demand on market concerns about the reduction of asset purchases by the US Federal Reserve and a slowdown in Mainland China's economy. But from mid-June onwards, despite a confluence of concerns about the US Federal Reserve reducing asset purchases, a liquidity squeeze on the Mainland and sell-offs in emerging market currencies, there were mild fund flows into the Hong Kong dollar, resulting in a slight strengthening in the Hong Kong dollar exchange rate. Following the December announcement by the US Federal Open Market Committee of its decision to reduce asset purchases, there was no significant weakening in the Hong Kong dollar exchange rate which continued to stay close to the strong-side CU.

During the year, the CU was not triggered and the HKMA did not conduct any foreign exchange operations within the Convertibility Zone, leaving the total Aggregate Balance and outstanding Exchange Fund Bills and Notes virtually unchanged at around $916.0 billion. In response to market demand, the HKMA issued a total of $92.0 billion in additional Exchange Fund Bills in the first half of 2013. The Aggregate Balance contracted accordingly to $163.9 billion in early June and stabilised at around this level for the remainder of the year (Chart 2). As the additional issuance of Exchange Fund paper represented a change in the composition of the Monetary Base, these operations were consistent with Currency Board principles, with the Monetary Base fully backed by the foreign exchange reserves.

Chart 1 **Market exchange rate in 2013**



Money market

Interbank liquidity remained abundant despite a volatile global financial environment and concerns about the US Federal Reserve reducing its asset purchases. The Hong Kong dollar interbank interest rates remained at very low levels during 2013, although they edged modestly higher over the course of the year with occasional fluctuations stemming from banks' funding demand for quarter-end liquidity management and intense equity fund-raising activities (Chart 3). For the whole year, the short-dated interbank rates continued to hover below the Base Rate of 0.5%. Discount Window borrowing was not active and amounted to only $5.1 billion in 2013. The Hong Kong dollar forward market also operated orderly and smoothly, with the Hong Kong dollar forward points closely following the movements in the HIBOR-LIBOR spreads.

Chart 2 Aggregate Balance and outstanding Exchange Fund paper in 2013

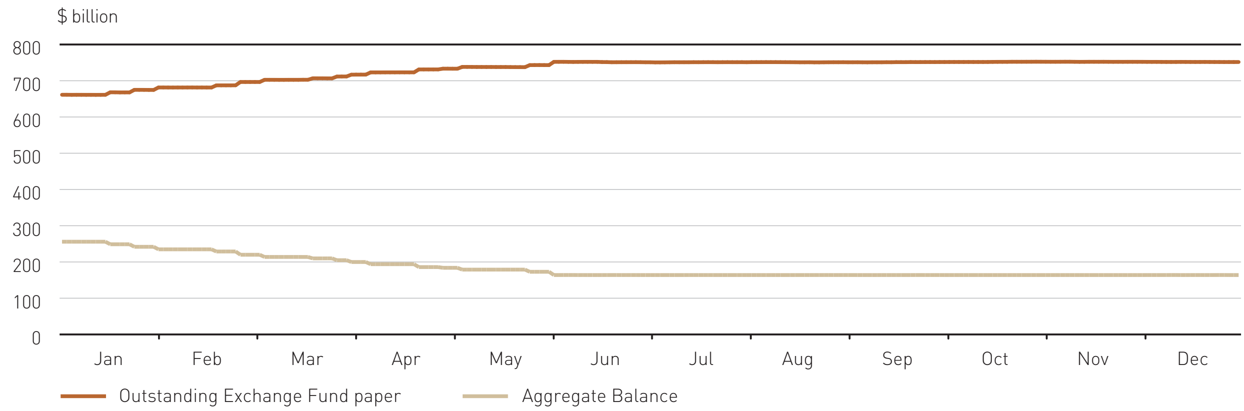
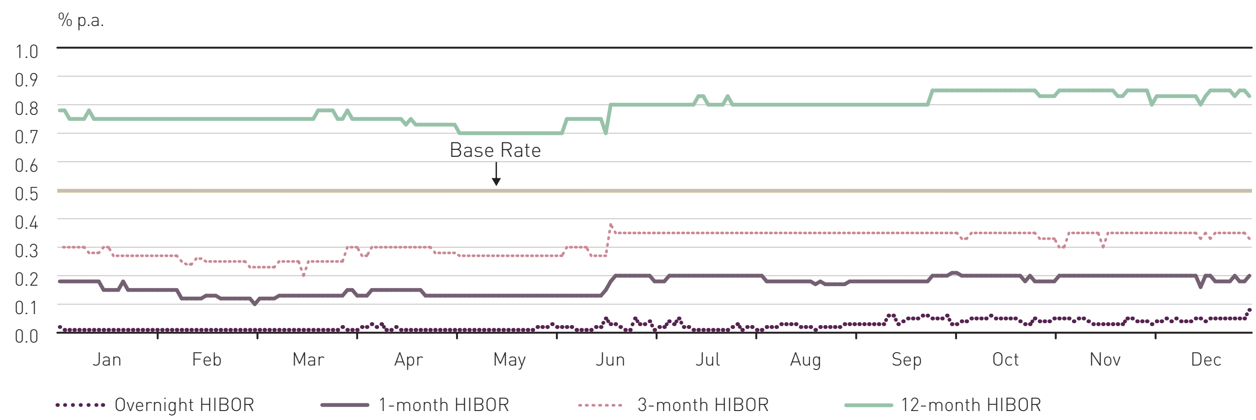


Chart 3 Hong Kong dollar interbank interest rates in 2013



The Linked Exchange Rate system

Over the past three decades, the Linked Exchange Rate system has served as the anchor for Hong Kong's monetary and financial stability and has proved highly resilient in a series of regional and global financial crises. The LERS was also strongly endorsed by the International Monetary Fund (IMF) in its annual Article IV consultation with Hong Kong as a simple, credible, transparent and widely understood exchange rate system that has contributed immensely to the maintenance of Hong Kong's monetary and financial stability. To mark the system's 30th anniversary in 2013, the Hong Kong SAR Government reiterated its full commitment to the LERS, with the HKMA reaffirming the merits of the system in an inSight article and publishing a set of Frequently Asked Questions to help the public develop a better understanding of the LERS.[1] The HKMA also illustrated that there continued to be very strong public confidence in the Hong Kong dollar as a means of payment and storage of value, with no signs or evidence of the currency being "marginalised" by the rise of the renminbi.[2]

A sound banking system is crucial to the normal functioning of the LERS. During 2013, the HKMA continued to monitor closely banks' management of credit and liquidity risks, property-related lending and stress-testing to ensure the resilience of the banking sector.

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 within a tight range of 107-108% during 2013, without touching the Upper or Lower Trigger Level. The ratio closed at 107.4% 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 Fund provides a powerful backstop in protecting Hong Kong's monetary and financial stability.

Chart 4 Daily movement of the Backing Ratio in 2013

[1] Chan, Norman T.L. "The Linked Exchange Rate System – 30 Years On", *inSight*, 14 October 2013, http://www.hkma.gov.hk/eng/key-information/insight/20131014.shtml.

[2] Chan, Norman T.L. "Foreign exchange turnover involving the Hong Kong dollar and Hong Kong dollar marginalisation", *inSight*, 13 September 2013, http://www.hkma.gov.hk/eng/key-information/insight/20130913.shtml.

Other activities

The EFAC Currency Board Sub-Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. In 2013, the Sub-Committee considered issues including the liquidity and depth of the Hong Kong dollar exchange market, the risk in the US bond market and likely contagion impact on Hong Kong, the influence of the renminbi on Asian currencies, and the dynamics of the Hong Kong dollar-US dollar interest rate differentials and fund flows. Records of the Sub-Committee's discussions on these issues and the reports on Currency Board operations submitted to the Sub-Committee were published on the HKMA website.

The Hong Kong Institute for Monetary Research (HKIMR) continued to sponsor research in the fields of monetary policy, banking and finance. During the year, it hosted 22 research fellows and published 25 working papers. The Institute also organised seven international conferences and workshops. The main ones included:

- The Fourth Annual International Conference on the Chinese Economy in January with the theme "The Role of Financial System Reforms in Rebalancing the Chinese Economy". The conference covered a wide range of issues, such as China's economic growth, the lending behaviour of state-owned banks, financial system reforms and China's monetary policy, renminbi internationalisation, and the impact of labour market development on wages

- The HKMA Symposium on Financial Stability in May, which dealt with issues related to financial stability, including the interactions between micro- and macro-prudential policies, the role of rule and discretion in financial stability policy-making, the efficient and effective governance arrangements for financial stability policies, and the pros and cons of different institutional arrangements

- The "HKMA 20th Anniversary Research Workshop" in June, designed to celebrate the HKMA's 20th anniversary and featured research papers on the Hong Kong economy by HKMA staff. Major economic issues covered included the recent performance of the Hong Kong dollar foreign exchange market, the current account balance of Hong Kong, the Mainland exposure of Hong Kong banks, the demand and supply of mortgage loans and the role of loan-to-value ratio policy, and the development of the renminbi market in Hong Kong

- The 36th Pacific Trade and Development Conference in December with the theme "Financial Development and Co-operation in Asia and the Pacific". The conference examined issues affecting these economies, including financial reform and liberalisation, monetary policy frameworks, capital market developments, financial developments in Mainland China and their implication for the global economy, and prudential regulation and supervision in the region.

The Institute co-hosted a conference on macroeconomics and international finance with the Hong Kong University of Science and Technology and the Eleventh HKIMR Summer Workshop on property markets with the Chinese University of Hong Kong. Moreover, it held the eleventh HKIMR conference on the Mainland economy focusing on the offshore renminbi market. The conferences and workshops were attended by participants from academia, the financial services industry and global central banks. In addition, the Institute held 35 public seminars on a broad range of economic and monetary issues.

Notes and coins

At the end of 2013, the total value of banknotes in circulation was $329.3 billion, an increase of 12.9% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to $10.4 billion, up 6.6% (Charts 8 and 9). The value of $10 notes issued by the Government in circulation reached $3.8 billion, of which 68% were polymer notes.

Chart 5 Banknotes in circulation by note-issuing banks at the end of 2013

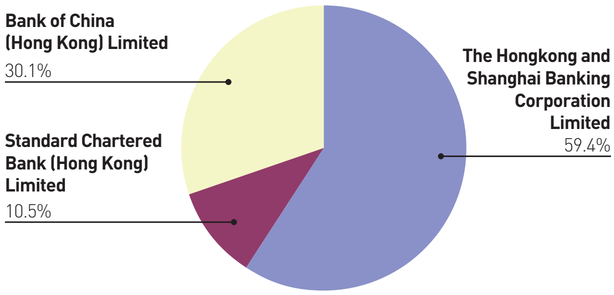
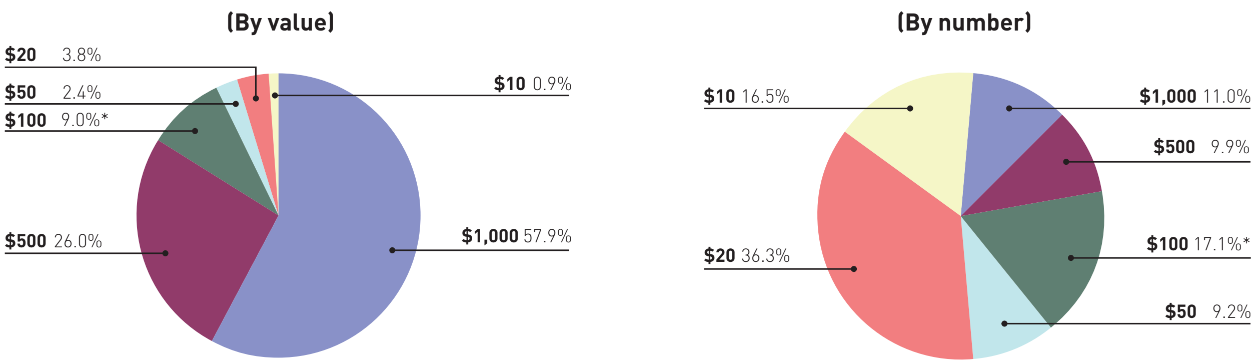


Chart 6 Distribution of banknotes in circulation at the end of 2013



* Includes 0.1 percentage point contributed by $150 banknotes.

Chart 7 Banknotes in circulation at the end of 2013

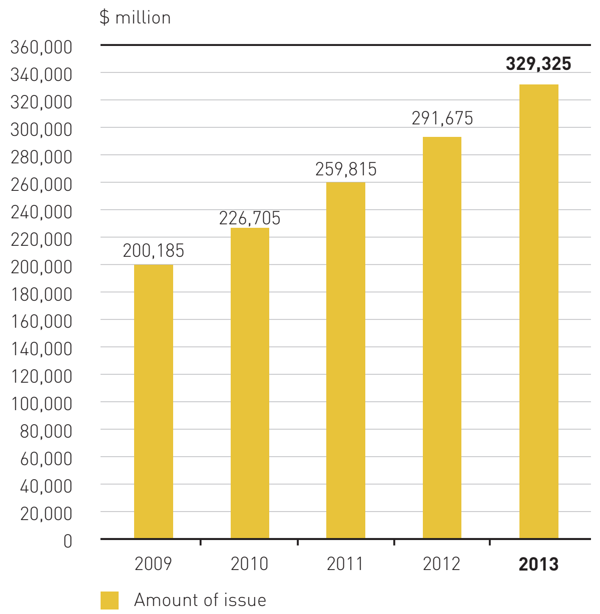


Chart 8 Government-issued notes and coins in circulation at the end of 2013

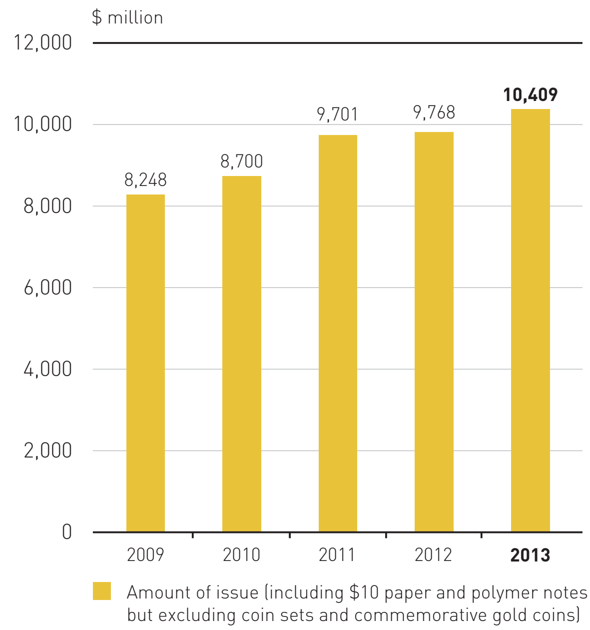
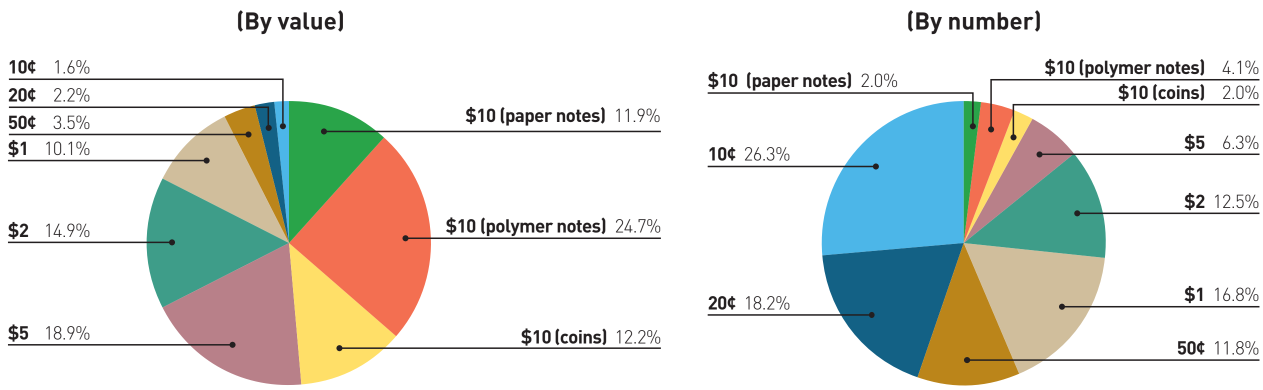


Chart 9 Government-issued notes and coins in circulation at the end of 2013



Hong Kong banknotes

The latest series of banknotes, issued in 2010 by the three note-issuing banks, is incorporated with advanced security features to stay ahead of counterfeiters. Public education programmes to promote awareness of the designs and security features of Hong Kong banknotes continued to be well-received.

The counterfeit banknotes incident at the end of 2013 further demonstrated the importance for the HKMA to be able to act promptly and effectively on matters that could potentially affect Hong Kong's monetary stability. The HKMA responded swiftly to the surfacing in December of two good quality counterfeit notes of the 2003 series $1,000 banknote. It issued clear advice to the public on how to identify the counterfeit notes with the aid of press releases and a joint press conference with the Police. Detailed information on the characteristics of the counterfeit notes, including videos, were posted on the HKMA website, attracting over 500,000 views. Within the space of one month, the HKMA also held 33 seminars on banknote security features for more than 7,000 participants from the banking sector and major retailers. After the training sessions, the participants indicated they were much more confident of identifying the counterfeit notes.

The HKMA requested the banks to speed up the withdrawal of the 2003 series $1,000 banknotes, and reassured the public that all notes dispensed by tellers over the counter or through automated teller machines were duly authenticated and genuine. The HKMA also worked closely with the Police and the banking sector to enhance the capability of the banks' cash deposit machines to detect counterfeit notes.

Exchange Fund Bills and Notes

A total of $92 billion worth of additional Exchange Fund Bills were issued in 2013, alongside an increase in demand for these papers after repeated triggering of the strong-side CU in the final quarter of 2012 led to an expansion in the Aggregate Balance. The additional issuance covered the two benchmark tenors of 91 and 182 days. Outstanding Exchange Fund Bills increased to $683 billion. In addition, the HKMA maintained the regular issuance programme for the Exchange Fund Notes. At the end of 2013, the amount of outstanding Exchange Fund Bills and Notes stood at $751 billion (Table 2).

Table 2 Outstanding issues of Exchange Fund Bills and Notes

$ million	**2013**	2012
Exchange Fund Bills (by original maturity)		
28 days	**0**	600
91 days	**399,851**	350,884
182 days	**241,000**	195,000
364 days	**42,200**	42,200
Sub-total	**683,051**	588,684
Exchange Fund Notes (by remaining tenor)		
1 year or below	**15,800**	17,000
Over 1 year and up to 3 years	**25,300**	25,900
Over 3 years and up to 5 years	**11,200**	11,200
Over 5 years and up to 10 years	**9,800**	8,600
Over 10 years	**6,000**	6,000
Sub-total	**68,100**	68,700
Total	**751,151**	657,384

PLANS FOR 2014 AND BEYOND

While the advanced economies have shown signs of continued recovery, the global financial environment is expected to be challenging in 2014. In particular, the US Federal Reserve's decision to begin reducing its monthly asset purchases from January 2014, together with the still-uncertain pace of asset purchases reduction and interest rate normalisation ahead, could increase the volatility in fund flows and the risk of fund flow reversals for Hong Kong. For example, a faster-than-expected normalisation process could lead to global re-pricing of market risks and shifts in asset allocation. This could cause significant outflow pressure on Hong Kong and a contraction in banks' liquidity, thereby weighing on domestic asset prices and the domestic economic outlook. On the other hand, any undue delays in the Federal Reserve's exit that included keeping the ultra-loose monetary conditions for much longer could well support market sentiment and pose further risks to asset price inflation and the macro-financial stability of Hong Kong.

The HKMA will continue to closely monitor risks and vulnerabilities in the domestic and external environment and stand ready to deploy appropriate measures, where necessary, to maintain monetary and financial stability in Hong Kong. Research programmes for the coming year will study issues affecting the Hong Kong economy and assess their potential risks. 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.