

Record of Discussion of the Exchange Fund Advisory Committee Currency Board Sub-Committee on 6 January 2006

(Approved for Issue by the Exchange Fund Advisory Committee on 26 January 2006)

Report on Currency Board Operations (30 November – 20 December 2005)

The Sub-Committee noted that the Hong Kong dollar exchange rate had strengthened modestly during the reporting period and that interbank interest rates had eased. The Monetary Base had risen from HK\$277.09 billion to HK\$280.06 billion, largely due to increases in Certificates of Indebtedness. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

The report on Currency Board operations for the period under review is at [Annex](#).

Monitoring of Risks and Vulnerabilities

The Sub-Committee noted that economic growth in the US had remained solid with leading indicators continuing to point to robust, albeit slower, growth ahead. Economic recovery in Europe and Japan was gathering momentum and economic activity in Mainland China remained strong. CPI inflation rates in major economies had softened as energy prices eased.

In Hong Kong, recent data suggested that the economy had continued to expand in the fourth quarter of 2005. Headline inflation had edged up in recent months. The rise in interest rates had had some dampening effect on the property market.

A significant tightening of global financial conditions continued to be the main risk to the near-term growth outlook.

The Sub-Committee also noted an analysis of the revision of Mainland China's 2004 GDP announced by the National Bureau of Statistics. The revision suggested that growth on the Mainland was less imbalanced and more sustainable than previously thought. For Hong Kong, risks arising from vulnerabilities on the Mainland should be smaller than previously believed.

A Review of the Hong Kong Dollar Effective Exchange Rate

The Sub-Committee noted a review of the framework for measuring the Hong Kong dollar effective exchange rate. A revised Monetary Conditions Index, modified to include service trade but excluding re-exports in determining currency weights, and incorporating a measure of the renminbi real effective exchange rate, suggested that the depreciation of the Hong Kong dollar and renminbi real effective exchange rates had contributed to a marked easing of monetary conditions in Hong Kong in recent years.

An Empirical Framework of Hong Kong's Best Lending Rate

The Sub-Committee noted a proposed empirical framework for predicting changes in the domestic Best Lending Rate (BLR). The model was able to predict past divergences of the BLR from the US federal funds target rate. The Hong Kong dollar risk premium and the balance-sheet positions of banks were found to have contributed to such divergences.