

Record of Discussion of the Exchange Fund Advisory Committee Currency Board Sub-Committee on 2 May 2006

(Approved for Issue by the Exchange Fund Advisory Committee on 2 June 2006)

Report on Currency Board Operations (30 March - 18 April 2006)

The Sub-Committee noted that the Hong Kong dollar exchange rate had strengthened moderately during the reporting period. Interbank interest rates had risen. The Monetary Base had increased from HK\$285.93 billion to HK\$288.52 billion, largely because of expansion in Certificates of Indebtedness. In accordance with Currency Board principles, changes in the Monetary Base had been 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 the global upswing was strengthening. In the US, a significant recovery in economic activity was expected in the first quarter of 2006, and business confidence continued to rise in the euro area. In Japan, robust growth in consumption was supported by corporate-sector recovery and improvements in labour-market conditions. While inflation had so far remained contained in most of the major economies, demand pressures and tight labour-market conditions continued to point to risks of increasing inflation. The International Monetary Fund had recently warned that the US dollar would have to depreciate “significantly” over the medium term if global economic imbalances were to be resolved in an orderly fashion.

The Sub-Committee noted that recent data suggested that the Hong Kong economy had continued to expand in the first quarter of 2006, reflecting robust external trade and strong capital goods investment. Headline inflation had edged up in recent months, in part because of the pass-through of higher residential rents to the CPI. Property prices had shown signs of stabilisation while share prices had risen markedly.

The Sub-Committee noted that, while the spreads between HIBORs and LIBORs had turned negative again recently, overall risks to macroeconomic stability from fluctuations in monetary conditions appeared limited for now.

The Sub-Committee noted that the Grassley-Baucus Bill had recently been proposed in the US Senate to commission the US Treasury to identify countries whose currencies were in fundamental misalignment. Under the provisions of the Bill, if such misalignment adversely affected the US economy, the US Treasury would take action to address the situation. The risk that US authorities would apply the Bill (if it were to be passed) to Hong Kong appeared low, given Hong Kong's small share of US trade and the fact that Hong Kong did not impose tariffs or other forms of trade distortions.

Estimating Demand for Narrow Money and Broad Money

The Sub-Committee noted a paper providing an updated analysis of the determinants of the demand for Hong Kong dollar M1 and M3 with the aims of better understanding and interpreting the behaviour of key monetary aggregates; especially their recent movements; and making use of information contained in the monetary aggregates to explain inflation and output.

Forecasting the Non-rental Component of Hong Kong's CCPI Inflation - an Indicator Approach

The Sub-Committee noted a paper that discussed a bivariate and a multivariate indicator model, using a large group of high-frequency economic indicators to forecast Hong Kong's non-rental component inflation. Although at an early stage of development, the performance of these models suggested that they were promising tools for improving the accuracy of inflation forecasting.