

Record of Discussion of the Exchange Fund Advisory Committee Currency Board Sub-Committee on 1 September 2006

(Approved for Issue by the Exchange Fund Advisory Committee on 28 September 2006)

Report on Currency Board Operations (27 July – 17 August 2006)

The Sub-Committee noted that the Hong Kong dollar exchange rate had weakened slightly during the reporting period. The patterns of interbank interest rates and their negative spreads against the US dollar rates had been mixed. The Monetary Base had risen from HK\$285.91 billion to HK\$286.94 billion, reflecting increases in Certificates of Indebtedness and Exchange Fund Bills and Notes.

The Committee noted that, 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, despite a significant slowdown in the US in the second quarter, recent data suggested that economic growth outside the US had been more resilient. The euro area had grown at its fastest pace in six years, while domestic demand was becoming a more important growth driver in Japan. In Mainland China, the growth momentum, while remaining strong, had moderated somewhat as macroeconomic tightening policies had begun to take effect. Oil prices had continued to be affected by geopolitical uncertainties.

The Sub-Committee noted that the Hong Kong economy had moderated markedly in the second quarter, reflecting weaker external demand. Recent data had pointed to a continued slowdown in July but business sentiment remained generally optimistic. Consumer price inflation had edged up moderately. While external risks had increased, the short-term outlook for the economy remained generally positive: domestic demand was expected to hold up well in the second half because of favourable monetary conditions resulting from the pause in US interest rate increases. Improving labour market conditions would also continue to support domestic demand.

Hong Kong's Business Cycle Synchronisation with Mainland China and the US

The Sub-Committee noted a paper analysing the effects of increased integration of Hong Kong's real economy with that of the Mainland and the synchronisation of business cycles among the Hong Kong, Mainland and US economies. The analysis concluded that, while co-movements of the business cycles of the Hong Kong and Mainland economies had increased, this was largely a result of the common influence of economic conditions in the United States on both economies.

Relaxing the Three-Year Tenor Issuance Restriction on Multilateral Development Banks: Implications for Monetary Stability and Market Development Potential

The Sub-Committee agreed to withdraw a request, made in 1998, that Multilateral Development Banks should issue Hong Kong dollar bonds with a tenor of at least three years. Members noted that the risks for monetary stability were small and that there would be benefits for the development of the local bond market.

Structural Determinants of Hong Kong's Current Account Surplus

The Sub-Committee noted a paper analysing the structural determinants of Hong Kong's current account surplus. The analysis showed that terms of trade and volatility of the output gap were predominant among the structural variables. The paper concluded that Hong Kong, as a small and open economy, was specialised and subject to high income volatility and business cycle fluctuations with relatively concentrated and limited domestic investment opportunities. As a result, Hong Kong residents had run current account surpluses in order to accumulate substantial net foreign assets to smooth income and diversify risk.