Record of Discussion of the Exchange Fund Advisory Committee Currency Board Sub-Committee on 23 November 2006

(Approved for Issue by the Exchange Fund Advisory Committee on 30 November 2006)

Report on Currency Board Operations (28 September – 9 November 2006)

The Sub-Committee noted that the Hong Kong dollar exchange rate had strengthened slightly during the reporting period. Interbank interest rates had declined and their negative spreads against the US dollar rates had widened. The Monetary Base had risen from HK$289.91 billion to HK$291.87 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, economic growth in the US had moderated further in the third quarter, mainly reflecting cooling residential investment and widened trade deficits. However, the slowdown had not translated into slower exports in the rest of the world. Asian economies (excluding China and Japan) continued to record impressive growth, and robust external demand in Japan partly offset declining consumption. The euro area registered solid economic growth resulting from strong domestic demand. Inflationary pressures generally eased, partly because of declining oil prices. China's trade surplus continued to rise despite an economic slowdown in the third quarter. In addition to conducting open market operations, the People's Bank of China had raised the reserve requirement ratio by half a percentage point on 9 November to control liquidity expansion in the banking system.

The Sub-Committee noted that recent data for the Hong Kong economy suggested that solid growth had resumed in the third quarter after a temporary slowdown in the second, boosted by renewed strength in external trade and robust domestic demand. Headline inflation had remained benign in recent months. Property prices had remained stable and share prices had risen, underpinned by supportive monetary conditions. Because of ample liquidity in the interbank market, banks had cut their best lending rates and savings deposit rates despite a stable policy interest rate in the US.

Outward Portfolio Investment from Mainland China: How much do we Expect and how Large a Share can Hong Kong Expect to Capture?

The Sub-Committee noted a paper estimating the potential volume of outward portfolio investment from the Mainland and the share Hong Kong could capture if the Mainland's capital account were as open as those of developed economies. Based on a counterfactual scenario for 2005, total outward portfolio investment from the Mainland was estimated to increase from 5% to 15% of GDP, if its capital account were as liberalised as in a typical OECD country. Assumptions based on the study's projections suggested that the amount might reach 23% to 54% of the Mainland's GDP when the Mainland's level of income is considerably higher. Hong Kong might capture around 10% of such investment. The study's findings suggested that, while Hong Kong's comparative advantage lay in its proximity to and cultural affinity with the Mainland, the most important determinant of bilateral portfolio investment is the domestic share of world stock market capitalisation. If the size of Hong Kong's stock market were to increase to that of Japan's, the share of Mainland outward portfolio investment it might capture might almost double. The increase in Mainland portfolio investment would benefit Hong Kong's financial services industry.