

Record of Discussion of the Meeting of the Exchange Fund Advisory Committee Currency Board Sub-Committee held on 7 September 2007

(Approved for Issue by the Exchange Fund Advisory Committee on 19 September 2007)

Report on Currency Board Operations (7 August – 24 August 2007)

The Sub-Committee noted that the Hong Kong dollar exchange rate had strengthened during the reporting period. Interbank interest rates had risen, while their negative spreads against US dollar interest rates had narrowed. The Monetary Base had declined from HK\$297.80 billion to HK\$296.46 billion.

The Sub-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 concerns about the US sub-prime mortgage problems had triggered turbulence in global financial markets. The resulting increased risk aversion had led to increased credit spreads, unwinding of yen carry trade and major sell-offs in global equity markets. In response, a number of major central banks had injected emergency liquidity into their financial systems and the Federal Reserve had cut its discount rate by 50 basis points on 17 August. These moves had calmed markets to some extent towards the end of the review period.

While economic activities in the US, the UK and East Asian economies had picked up in the second quarter, growth in the euro area and Japan had moderated. The volatility in equity and credit markets had increased the risk to the global economic outlook, in particular the risk that turbulence in the financial markets might worsen the declines in the US and European housing markets, affecting investment and consumer spending, which could, in turn, affect export-dependent East Asian economies.

The Mainland economy had softened somewhat in July despite a sizable trade surplus. Headline CPI inflation had reached a ten-year high of 5.6%. The People's Bank of China had raised the benchmark deposit and lending rates by 27 and 18 basis points respectively on 21 August to rein in loan growth, anchor inflationary expectation and alleviate overheating pressures.

On 20 August the State Administration of Foreign Exchange had announced a pilot scheme for Mainland residents to invest directly in securities listed on the Hong Kong Stock Exchange to help fulfil the Mainland's policy objective of allowing an orderly outflow of funds and alleviate overheating pressures in the Mainland's asset markets.

The Hong Kong economy had registered solid growth in the second quarter underpinned by increased private consumption and business spending, while the trade balance had recorded a deficit as imports rose faster than exports. CCPI inflation (after adjusting for one-off relief measures) had risen to 3.4% three months on three months (annualised) in July. The local equity market had been exceptionally volatile affected by the turbulence in global financial markets. However, activities in the local foreign-exchange and money markets had been smooth and orderly.

Sources of Employment Growth in Hong Kong

The Sub-Committee noted a paper analysing the sources of employment growth and assessing the contribution of demand from the Mainland to job creation in Hong Kong. The study found that the import/export sector had been the major contributor to employment growth, with real estate and business services second, and finance and insurance third. Growing service demand from China is likely to continue to boost demand in areas such as trade and financial services. The study suggests that about one quarter of employment growth between 2001 and 2005 may be attributable to demand from the Mainland. Near-term employment prospects remain favourable.

How Do Macroeconomic Developments in Mainland China Affect Hong Kong's Short-term Interest Rates?

The Sub-Committee noted a paper studying the significance of Mainland macroeconomic variables for Hong Kong's interest rates after controlling for the influences of US variables. The study concluded that, while HIBOR is not expected to diverge significantly from LIBOR, the influence of Mainland macroeconomic developments has increased in determining the unexpected movements in the HIBOR-LIBOR differential.

Impact of the Renminbi Exchange Rate on Asian Currencies

The Sub-Committee noted a paper investigating whether movements in the renminbi exchange rate have had an increasing effect on the movements of other Asian currencies in recent years, as is widely believed. The study concluded that movements of the renminbi independent of the US dollar have indeed begun to affect Asian currencies but that the renminbi's influence is constrained by its own limited fluctuations against the US dollar. The study suggests that the renminbi exchange rate has taken on an international dimension and is likely to become more important in the region.