

A RECORD OF DISCUSSION OF THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE ON CURRENCY BOARD OPERATIONS ON 8 JANUARY 1999¹

(Approved for Issue by the Exchange Fund Advisory Committee on 28 January 1999)

Operations of the Currency Board Arrangements

The Sub-Committee noted that during the period from 9 November to 31 December 1998, the changes in the size of the Monetary Base were fully matched by corresponding changes in the Foreign Reserves in accordance with the Monetary Rule of the Currency Board arrangements. It was agreed that, further to enhancing the transparency of currency board operations, it would be desirable for the report presented to the Sub-Committee on this matter (copy at Annex A) to be published together with the meeting record. This would be recommended to the Exchange Fund Advisory Committee for approval.

The Sub-Committee noted that in response to some capital inflow in early November, the HKMA purchased US dollars at a rate of around 7.74 leading to a small increase in the Aggregate Balance. This was fully consistent with the Currency Board arrangements, although there is no pre-announced rate for purchases of US dollars, as there is for sales under the Convertibility Undertaking in respect of the Aggregate Balance.

Backing Arrangements of Coins in Circulation

The Sub-Committee discussed the proposal to provide an explicit and transparent mechanism for backing coins in circulation. At present, the issuance and withdrawal of coins are settled in HK\$. The proceeds from coin issuance have over a period of time been switched into Foreign Reserves but no automatic backing arrangement is in place. This practice is different from that applicable to HK\$ banknote issuance. To ensure that coins are also backed in a manner consistent with the Monetary Rule, it was proposed that the issue and withdrawal of coins should be settled

against US\$ at the fixed exchange rate of US\$1 to HK\$7.80.

The Sub-Committee considered the alternatives of introducing an internal rule for switching HK\$ proceeds arising from future coin issuance into foreign currencies or for coins to be settled against the Aggregate Balance, but considered that these were less desirable options. The Sub-Committee considered that the proposal being put forward would achieve a higher degree of transparency and similarity with the banknote-issuing process. It therefore agreed to recommend the proposal to the Exchange Fund Advisory Committee for approval. In the meantime, the HKMA would consult its agent bank for storing and distributing coins on the operational procedures involved.

Interest Payments on Exchange Fund Bills and Notes

The Sub-Committee reviewed the procedure for interest payments on Exchange Fund paper. Currently, interest is credited to the clearing accounts of the banks concerned and the HKMA seeks to neutralize the effect on the Monetary Base through its subsequent HK\$ operations. The amount of interest payments involved is roughly HK\$6 bn per year. The Sub-Committee noted that there were good reasons for allowing interest payments on Exchange Fund paper to expand the Monetary Base in an orderly manner. Firstly, interest payments on Exchange Fund paper were backed by interest earned on the US\$ assets portfolio earmarked to back the Monetary Base. Thus, allowing such interest payments to expand the Monetary Base would be consistent with the Monetary Rule which required any change in the Monetary Base to be fully matched by a corresponding change in Foreign Reserves. To ensure the full automatic backing of the monetary

¹ The establishment of the Exchange Fund Advisory Committee Sub-Committee on Currency Board Operations and its terms of reference were explained in the November 1998 Quarterly Bulletin (page 10). There have since been three changes in the composition of the Sub-Committee. The present membership is - Joseph Yam (Chief Executive, HKMA) (Chairman), Liang Xiaoting (Bank of China), Marvin Cheung (KPMG), David Li (Bank of East Asia), John Greenwood (INVESCO Asia Limited), Tsang Shu-ki (Hong Kong Baptist University), Richard Wong (University of Hong Kong), David Carse (Deputy Chief Executive, HKMA), Norman Chan (Deputy Chief Executive, HKMA) and Tony Latter (Deputy Chief Executive, HKMA). The main Exchange Fund Advisory Committee has agreed that the record of the Sub-Committee's discussion at each regular meeting should be made public, along with the factual Report of Currency Board Operations that is tabled for each meeting. These documents are now being released to the press within a few days of the meeting. It has also been decided to include them in the Quarterly Bulletin.

base, increases in the monetary base via this mechanism would be limited to the interest income on the backing US\$ assets in the event that this amount was less than the interest paid on Exchange Fund paper. Secondly, allowing interest rate payments on Exchange Fund paper to be included in the Monetary Base would provide a mechanism for gradual expansion of the Monetary Base in order to accommodate secular growth of liquidity in line with overall growth in economic and financial activity.

The Sub-Committee also noted that, instead of necessarily allowing the Aggregate Balance to build up over time, as a result of the interest payments, it might be appropriate from time to time to issue new Exchange Fund paper to absorb the increase. The mechanism for the issue of additional Exchange Fund paper should be a transparent one.

The Sub-Committee agreed that the matter should be discussed with academics and market participants before a recommendation could be formulated by the Sub-Committee and put to the Exchange Fund Advisory Committee.

Transferability between the Aggregate Balance and Exchange Fund Bills and Notes

The Sub-Committee noted that transferability within the Monetary Base in the direction from Exchange Fund Bills and Notes to the Aggregate Balance was possible at present through the Discount Window. There was a question of whether transferability in the reverse direction should be allowed and, if so, how this would be achieved.

The Committee noted that, while it was desirable to allow the transferability between different components of the Monetary Base, this specific issue was complex and would have significant implications that had to be studied carefully. It was agreed that the views of academics and market participants should be sought on the matter. (2)