

The macro monetary policy objective in Hong Kong is currency stability in terms of the external value of the HK dollar, in other words, the maintenance of exchange rate stability. This is entirely appropriate in view of Hong Kong's circumstances, being a highly externally oriented economy undergoing

economic and political transition. Stability in the external value of the currency has special significance for Hong Kong, in terms of the nature of the businesses carried out in Hong Kong and in terms of general confidence.

THE EXCHANGE RATE

Hong Kong operates what is called the linked exchange rate system, which was established in October 1983. This is basically a currency board system where bank notes are issued and redeemed against a foreign currency at a fixed exchange rate. In the case of Hong Kong, where bank notes are issued by commercial banks, this takes the form of a requirement on the note issuing banks to submit US dollars to the Monetary Authority in return for Certificates of Indebtedness required by law as backing for the bank notes issued by them. The US dollars are for the account of the Exchange Fund and the exchange rate determined by the Financial Secretary is HK\$7.80 to one US dollar. HK dollar bank notes are therefore backed by US dollars held in the Exchange Fund. The note issuing banks have their own arrangements for bank note transactions with other licensed banks.

To assist in the maintenance of exchange rate stability within the framework of the linked exchange rate system, the Monetary Authority does have the traditional mechanism available to other monetary authorities to influence the availability and the price of

money, or more precisely the level of interbank liquidity and the level of interbank interest rates. This mechanism is used only occasionally, when the exchange rate is subject to abrupt movements significantly away from 7.80, and with the clear objective of achieving stability in the exchange rate.

In 1993, the HK dollar exchange rate stayed on the strong side of, but close to, 7.80, influenced significantly by the inflow of funds for investment in the buoyant stock market and IPOs. The rate opened the year at 7.742 and gradually strengthened to 7.732 by the end of the first quarter. It remained strong in the second quarter but suddenly softened on 25 June to touch 7.78 due to market rumours of a repatriation of funds, including HK dollars, by mainland enterprises to China. The exchange rate quickly rebounded to the 7.75 level shortly after the adoption of new macro-economic stabilisation measures by the Chinese Government in early July.

The exchange rate remained at this level until September when it again strengthened on further capital inflows. In October, coinciding with the sharp rise in the Hang Seng Index to pass the 8,000 mark on 6 October, the rate strengthened to 7.726. The capital inflow was particularly strong in the fourth quarter, as the Hang Seng Index reached 11,888 by the year end. The exchange rate closed the year at 7.726.

Under the link, the overall exchange value of the HK dollar is influenced predominantly by the movement of the US dollar against other major currencies. The US dollar showed a mixed performance during 1993. The narrowing of the interest rate differential between the US dollar and European currencies, and the volatility in the exchange rates of some of the currencies in the EMS resulted in an appreciation of the US dollar against the European currencies. On the other hand, the persistent trade surplus of Japan led to a depreciation of the US dollar against the Japanese yen during the first three quarters of the year. This trend was however partly reversed during the fourth quarter in view of the improved performance of the US economy.

Reflecting these developments, the effective (trade-weighted) exchange rate index of the HK dollar firmed up from 114.2 (24-28 October 1983 =

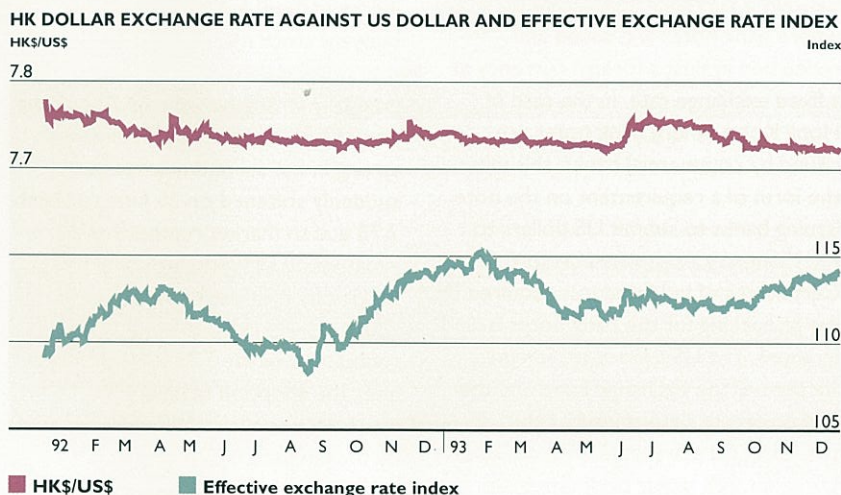
points, to around 128, due to the unification of the renminbi exchange rate on 1 January 1994. Previously the index was based on the renminbi official exchange rate, which stood at RMB 5.8 to one US dollar on 31 December 1993. The unified exchange rate, which was based on the swap market exchange rate, remained stable at around RMB 8.7 to one US dollar in early 1994. But the shift from the previous official exchange rate to the unified exchange rate raised the effective exchange rate index sharply, because of the high trade weight of China in the overall Hong Kong trade weighted index.

MANAGEMENT OF INTERBANK LIQUIDITY

To ensure stable conditions in the interbank market, which would under normal circumstances also contribute to exchange rate stability, the Monetary Authority monitors closely the level of interbank liquidity and the level of interbank interest rates. When considered appropriate, the Monetary Authority takes action to influence either or both of these levels.

This is done through the so-called Accounting Arrangements, introduced in 1988, which in effect enable the Monetary Authority to vary the level of interbank liquidity, in other words, the net amount of liquidity held in the clearing accounts of all licensed banks, as measured by the amount in the account which the Management Bank of the Clearing House maintains with the Exchange Fund. Alternatively, the Monetary Authority can vary the bid and offer rates of the LAF, Hong Kong's version of a discount window introduced in June 1992. This would have the desired effect on the short-term interbank interest rates.

During the year, market liquidity was affected by a record level of IPOs, which attracted significant over-subscriptions. On 10 February, the Denway issue was over 600 times over-subscribed, and HK\$240bn of subscription monies had to be recycled



100) at end-1992 to 115.3 in early February. It then moved around 112 in the second and third quarters before edging up during the fourth quarter to close the year at 114.3. The overall exchange value of the HK dollar was quite stable, with the index fluctuating within a 3.4% band between 111.5 and 115.3.

In early January 1994, the effective exchange rate index jumped by 13

through the interbank market. Overnight HIBOR reached 4.5%, which exceeded the 4% offer rate under the LAF. In order to ease the tightness in the interbank market, the Monetary Authority increased the level of interbank liquidity from HK\$1,500mn to HK\$2,150mn. This eased market conditions and the interbank market was more stable compared with the Cathay Pacific IPO in 1986 and the Oriental Press Group IPO in 1987, when HIBOR rose by 12.75pp and 6pp respectively.

On 31 May, in anticipation of the Shangri-La Asia IPO, the Monetary Authority injected another HK\$650mn into the banking system, bringing the Balance to HK\$2,800mn. On 20 July, as interbank conditions eased, the Balance was reduced to HK\$2,000mn to firm up interest rates in the face of a weakening in the exchange rate.

Thereafter, the Balance was changed twice. On 13 October, the Monetary Authority increased the Balance by HK\$1,000mn to HK\$3,000mn to ease domestic interest rates in order to relieve pressure on the HK dollar as a result of heavy capital inflows. Again, on 7 December, a further HK\$1,000mn was added to the Balance to relieve interbank liquidity due to the heavy over-subscription of the Dao Heng Bank IPO, which resulted in the Monetary Authority taking through the LAF HK\$18bn in surplus funds and lending out HK\$14bn. Overnight

HIBOR touched 5% during the day as there was heavy bidding of funds by some of the smaller banks.

INTEREST RATES

The term structure of interest rates in Hong Kong followed closely US dollar interest rates, varying slightly due to local market conditions, such as IPO activity. The LAF bid and offer rates have remained unchanged at 2% and 4% respectively since July 1992. Overnight HIBOR stayed, by and large, within the LAF band throughout most of the year, averaging 2.96% in the first quarter and edging up to 3.19% in the last quarter due to extensive IPO activity. Three-month HIBOR stayed at a level of around 3.4% for most of the year. Occasionally, under the influence of a large flotation exercise, three-month HIBOR rose, for example to 3.88% in late June, 63bp higher than the corresponding Euro-dollar deposit rate. In late September and October, three-month HIBOR eased slightly, to a level marginally below the Euro-dollar deposit rate. The interest rate gap briefly widened to about 25bp following the injection of interbank liquidity in mid-October.

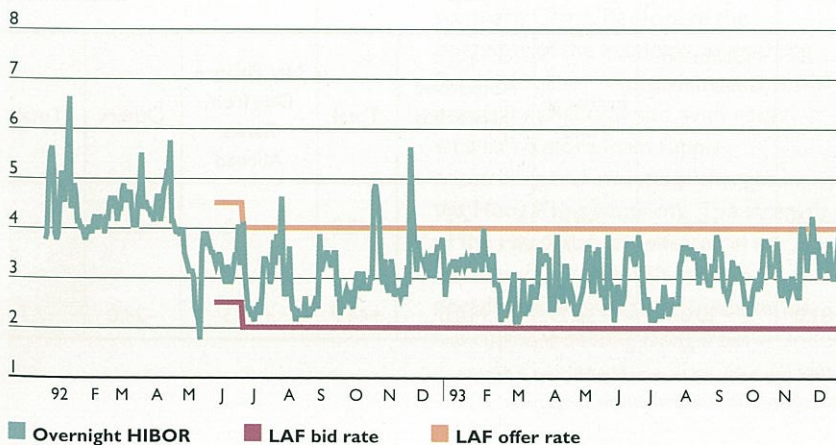
The bunching of share subscription activities, coupled with the usual year-end tightness, led to a slight firming up of HIBOR in late November and December. At the end of the year, three-month HIBOR stood at 3.63%, 31bp above the corresponding Euro-dollar deposit rate, while 12-month HIBOR was 25bp higher.

Deposit interest rates governed by HKAB and BLR of the note issuing banks were left unchanged in 1993. The differential between HKAB deposit rates and HIBOR averaged 100bp in terms of the one-month rate and 64bp in terms of the three-month rate. The differentials narrowed to 57bp and 28bp for six-month and 12-month deposits respectively.

Traditionally, the interest rate yield curve has risen more sharply than comparable US interest rates. With the

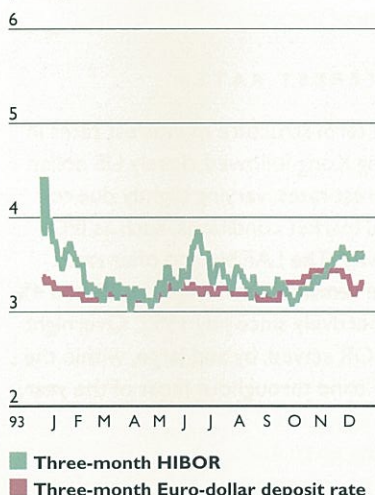
OVERNIGHT HIBOR AND LAF RATE

percent per annum



THREE-MONTH HIBOR AND EURO-DOLLAR DEPOSIT RATE

percent per annum



introduction of Exchange Fund Bills and Notes, however, the differential in longer term interest rates has narrowed.

At end-1993, three-year Exchange Fund Notes, which were introduced in October, were trading at a yield at par with US Treasury Notes. The spread between World Bank HK dollar Bonds (with remaining maturity of around three years) and US Treasury Notes of a corresponding maturity narrowed sharply from around 160bp to 110bp following the introduction of three-year Exchange Fund Notes. It is the intention of the Monetary Authority to extend the maturity profile of Exchange Fund Notes in order to set a benchmark yield curve for HK dollar debt instruments.

MONEY SUPPLY

HK dollar currency held by the public increased by 21.4% in 1993, marginally slower than the growth of 22.4% in the previous year. The narrow definition of money, HK\$M1, rose by 20.8% in 1993, compared with the 24.8% growth in 1992.

The broad definition of money supply, HK\$M3, adjusted to include foreign currency swap deposits, reflected a similar pattern of growth to HK\$M1

during the year. For the year as a whole, HK\$M3 grew by 25.2%, faster than the increase in nominal GDP of 13.7%. Throughout most of the year, HK\$M3 followed closely nominal GDP growth after discounting for seasonal factors, but in the fourth quarter it accelerated due to the inflow of funds into Hong Kong.

The importance of net inflow of funds in increasing money supply can be seen against historical trends. The table below rearranges the combined balance sheet of the Exchange Fund and authorised institutions to show the counterparts to changes in money supply. Over the past decade, 1983-92, the principal determinants of HK\$M3 growth have been net credit to the private sector (+109%) and net foreign currency assets of the banking system (i.e. the Exchange Fund and all authorised institutions) (+42%), the latter being a reflection of net inflow of funds into the HK dollar. Public sector surplus, on the other hand, has helped to hold back monetary growth (-15%). Net other influences have had a negative contribution to growth in money supply (-36%). This was largely attributable to an increase in bank capital and net liabilities to banks abroad.

MONETARY SURVEY

% CONTRIBUTION TO CHANGE IN HK\$M3

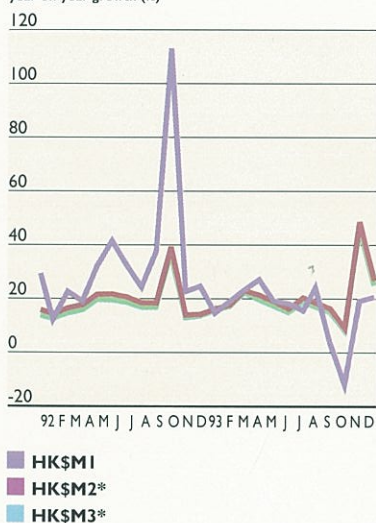
| | HK\$M3 (a) | Domestic Credits | | | | Net Foreign Currency Assets | | | Net Other Items | | |
|-------------|------------|--------------------------|----------------------------|--------|----------------------|-----------------------------|-----------------------------|-------|-----------------------------------|--------|-------|
| | | Claims on Private Sector | | | Claims on Government | Exchange Fund | Authorised Institutions (c) | Total | Net Balance Due from Banks Abroad | Others | Total |
| | | Loans | Debts Instruments Held (b) | Total | | | | | | | |
| 1983 - 1992 | 100.0 | +107.4 | +1.5 | +108.8 | -14.8 | +39.8 | +2.4 | +42.2 | -11.2 | -25.0 | -36.2 |
| 1993 | 100.0 | +83.4 | -0.4 | +83.0 | -20.0 | +34.7 | +10.0 | +44.7 | +16.3 | -24.0 | -7.7 |

(a) Adjusted to include foreign currency swap deposits (from 1984 onwards) and to exclude public sector deposits.

(b) Debt instruments issued by the non-bank private sector and held by authorised institutions.

(c) Adjusted for swap deposits.

HONG KONG DOLLAR MONEY SUPPLY
year-on-year growth (%)



* Adjusted for foreign currency swap deposits

In 1993, however, the contribution to monetary growth from net private sector credit declined (+83%), but the contribution from foreign inflow of funds increased (+45%). The public sector surplus continued to have a restraining influence (-20%) while net other influences was relatively small. The reduced contribution from net private sector credit to monetary growth, which has been helpful in constraining inflationary pressures, reflected fundamentally the prudent behaviour of the banking system, which held private sector credit growth at 17.6%, broadly in line with the growth of nominal GDP. In contrast, inflows of funds maintained a proportionately high weight in helping to push monetary growth, particularly during the fourth quarter. The restraining impact of net other influences was considerably reduced due to a decline in net liabilities to banks abroad. So far, the fiscal surpluses of the Government have helped to constrain monetary growth and consequently inflationary pressures.

The historical relationship between monetary growth and inflation in Hong Kong has not been a stable one, due to structural changes in the real economy and rapid financial innovation. In the decade 1983-92, narrow money (HK\$M1) grew at an average of 18.3% pa, compared with a slightly slower growth of broad money (HK\$M3) of 17.5% pa and nominal GDP growth of 14.9% pa. Growth in narrow money has been slightly faster due to the increasing level of HK dollars circulating in southern China. Because of the openness of the economy, and strong fiscal discipline, inflation has not been a monetary phenomenon, with roots emanating more from supply constraints and structural changes in the Hong Kong economy. The strength of the HK dollar, as reflected in an increase of roughly 13% over the decade in trade weighted index terms, has cushioned Hong Kong from

externally generated inflation. Import prices have increased at 2.9% pa over the past decade and only about 1.5% pa in the past five years, compared with 7.7% pa and 9.9% pa respectively in the consumer price index during the corresponding periods.

BANK NOTE HANDLING CHARGES

At the time the linked exchange rate system was introduced in 1983, the note issuing banks, which issue or redeem bank notes against Certificates of Indebtedness with the Exchange Fund at the fixed rate of HK\$7.80 to one US dollar, were concerned that they might have to acquire US dollars at a rate more expensive than 7.80, thus incurring an exchange loss. The note issuing banks therefore decided to pass on the 7.80 rate to other banks, so that any such losses would be shared with the non-note issuing banks.

Over the past ten years, however, the exchange rate has more often been on the strong side of 7.80 than the weak side. Consequently, banks imposed bank note handling charges for their customers returning cash to the banks, to compensate themselves for the exchange loss resulting from obtaining US dollar value from the note issuing banks on cash redemption at slightly lower Hong Kong value than 7.80, when the HK dollar remains on the strong side of the link. These charges were unpopular with non-bank customers.

The matter was resolved satisfactorily on 24 January 1994, when the three note issuing banks, following consultations with the Monetary Authority, agreed that all bank note transactions between themselves and other licensed banks would henceforth be for HK dollar value. As from that date, licensed banks agreed to stop charging bank note handling fees. The new arrangement had no impact on the maintenance of exchange rate stability in Hong Kong.

