



## Chief Executive's Report



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The monetary policy objective in Hong Kong is to maintain exchange rate stability within the framework of the linked exchange rate system. The Monetary Authority is responsible for achieving this objective. I am happy to report that throughout 1994 the exchange rate of the Hong Kong dollar against the US dollar remained very stable, slightly on the stronger side but very close to the linked rate of 7.80. Further demonstrating stability in the exchange rate, Hong Kong dollar interest rates from the short end to well beyond 1997 stayed close to those for the US dollar. On the exchange rate front, therefore, the year 1994 was comfortably uneventful, which is good for the stability and prosperity of Hong Kong.

The main instruments for ensuring a stable exchange rate are Hong Kong's robust monetary arrangements centred around the linked exchange rate system - a currency board system requiring Certificates of Indebtedness (which give authority to the note-issuing banks to issue bank notes) to be issued and redeemed against the US dollar at the fixed rate of 7.80. The currency board mechanism and strong economic fundamentals such as the very high level of foreign reserves, and fiscal discipline have combined to provide a firm anchor for the exchange rate not available in "pegged" exchange rate systems practised in other economies. These aspects are sometimes overlooked, in particular by some of those who were encouraged by the Mexican crisis to speculate against the Hong Kong dollar in January 1995. Such speculation was notably unsuccessful, and the Hong Kong dollar maintained impressive stability during the episode, falling at most by 0.5%.

Within the stable macro monetary environment, the basic economic fundamentals of Hong Kong remained sound in 1994, with healthy economic growth, low unemployment, a fiscal surplus and a balance of payments surplus. Although overall consumer price inflation was still uncomfortably high, under the influence of continued strong demand for services arising from the rapid reform and liberalisation of China, it was clearly easing during the year. With a stable exchange rate, inflation in the traded goods sector remained subdued.

There was, however, a distinct change of mood in financial markets worldwide in 1994. In Hong Kong, as interest rates rose continuously, along with the trend in US dollar interest rates, the prices of financial assets fell; so did property prices, affected additionally by the Government's measures to curb property speculation.

The corrections in asset prices inevitably followed the sustained boom period in the early 90s. This was anticipated by the banking community who have positioned themselves well in the management of the risks concerned. Working closely with the banking community, the Monetary Authority addressed a number of supervisory issues during 1994. New liquidity requirements for authorised institutions were introduced. A new loan classification system was also adopted. Guidance was given on exposure to property and on the management of risks arising from involvement in derivatives. The importance of the latter was underscored by the events with Barings that point to a serious failure of risk management systems and internal controls.

Actions on the banking front have not all been preventive or defensive. Measures which have significant implications for enhancing the competitiveness of Hong Kong's banking system were also introduced in 1994. Again, working closely with the banking community, a programme for the liberalisation in the determination of interest rates for retail time deposits was worked out. The banking community also took important steps towards greater disclosure, in accordance with a best practice guide issued by the Monetary Authority. The "one building" restriction applicable to foreign banks licensed in or after 1978 was conditionally relaxed.

Also, in light of the adverse market conditions, the Monetary Authority, under the guidance of the Exchange Fund Advisory Committee chaired by the Financial Secretary, adopted a prudently defensive strategy in the management of the Exchange Fund in 1994. The year has now been recognised by participants in world financial markets as the worst for well over 30 years. The prices of bonds and equities fell sharply during the year in all major markets. But I am happy to report that the defensive strategy has worked well for the Exchange Fund. The accumulated surplus of the Exchange Fund weathered the storm unscathed, and even managed to show a small increase for the year as a whole, while the Fund itself continued to grow substantially.

In 1994 the Monetary Authority was also able to make considerable progress on the development of the financial infrastructure of Hong Kong. This is necessary to ensure the continued development of Hong Kong as an international financial centre. The services of the Central Moneymarkets Unit (CMU) was extended to private sector debt instruments and those instruments of acceptable credit quality were given eligibility for tapping funds under the Liquidity Adjustment Facility operated by the Monetary Authority. The CMU was also linked up with Euroclear and Cedel. The benchmark yield curve for Hong Kong dollar debt was further extended to beyond 1997 through the issue of 3-year and subsequently 5-year Exchange Fund notes.

An important decision was taken jointly by the Monetary Authority and the Hong Kong Association of Banks (HKAB) to introduce Real Time Gross Settlement (RTGS) for interbank payments. This was for the purpose of eliminating settlement risks - a subject that has been occupying the minds of central banks for some

time. In Hong Kong, we made a good start in this work in 1994 and the project is expected to be completed by end-1996. The Monetary Authority also explored with the central banks in China and the United States possible linkages with their payment systems. This would facilitate the safe and prompt settlement of financial transactions involving the Hong Kong dollar on the one hand and the two most important foreign currencies for Hong Kong on the other.

On currency matters, there were also notable events. The Bank of China started issuing bank notes in May, the new \$10 dollar coin was introduced, and the replacement of bank notes and coins bearing references which will in 1997 become inappropriate to the status of Hong Kong as a Special Administrative Region of China continued smoothly. The authority for the minting of Hong Kong coins has also been brought into Hong Kong with the Hong Kong Coinage Ordinance coming into operation.

The work relating to the review of other monetary and banking legislation continued expeditiously. The Exchange Fund Ordinance has been reviewed and suitable amendments introduced. Under consideration are the Bank Notes Issue Ordinance and the Hong Kong Association of Banks Ordinance, the latter specifically to allow the Bank of China, one of the three continuing members of the Committee of HKAB, to rotate with the other two as Chairman of the Committee. A new Banking (Amendment) Bill has also been prepared and introduced into the Legislative Council in early 1995.

The year 1994 had thus been fruitful for the Monetary Authority. There was valuable support in Hong Kong from the people of Hong Kong, from the banking sector, from the Legislature and from the Administration. Outside Hong Kong, there was helpful cooperation from the international financial community and the central banking fraternity, in particular from the Bank of England and the People's Bank of China. Staff of the Monetary Authority are most encouraged by this wide support. There is much work ahead for the Monetary Authority in pursuing its objectives. This will continue to be carried out with enthusiasm and professionalism, and in a manner that commands the confidence of the people of Hong Kong and the international financial community.



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