



Monetary Stability



Despite the turbulent external environment in 2001, Hong Kong's Linked Exchange Rate system continued to function smoothly and effectively to deliver a stable and predictable monetary environment.

Monetary policy

The primary monetary policy objective of the HKMA is currency stability, which is defined in terms of a stable external value of the Hong Kong dollar against the US dollar under the Linked Exchange Rate system. This system, which has been in place since 17 October 1983, is in essence a currency board system. It is characterised by two distinctive features: the full backing of the Monetary Base by the reserve currency, and convertibility between the Monetary Base and the reserve currency at a fixed exchange rate.

Hong Kong's Monetary Base comprises the following four elements:

- Certificates of Indebtedness (CIs) which back the banknotes issued by the three note-issuing banks
- coins in circulation
- the sum of the balances on the clearing accounts maintained by licensed banks with the HKMA (known as the Aggregate Balance)
- Exchange Fund Bills and Notes, issued by the HKMA on behalf of the Government.

The Monetary Base is fully backed by foreign reserves, and any change in its size must be fully matched by corresponding changes in the foreign currency reserves in the backing portfolio. CIs and coins are issued and redeemed against the US dollar at the rate of \$7.80 to one US dollar. The HKMA has also provided an undertaking to all licensed banks to convert their Hong Kong dollar clearing balances at the linked rate of \$7.80.

Under the currency board arrangements, the exchange rate remains stable, while interest rates adjust to changes in the demand for Hong Kong dollars. Specifically, when there is a decrease in the demand for Hong Kong dollar assets, and the market exchange rate weakens, the HKMA stands ready to purchase Hong Kong dollars from banks at \$7.80 (provided they have sufficient clearing balances to settle the transactions). The Aggregate Balance (as part of the Monetary Base) will fall. Interest rates then rise, creating the monetary conditions conducive to inflows of funds to maintain exchange rate stability. Conversely, if there is an increase in the demand for Hong Kong dollars, leading to a strengthening of the exchange rate, the HKMA may sell

Hong Kong dollars for US dollars. The Aggregate Balance correspondingly expands, exerting downward pressure on interest rates and so discouraging continued inflows.

A review of 2001

With the onset of a global economic downturn and corrections in the stock markets, the external environment became increasingly difficult in 2001. Nevertheless, Hong Kong's foreign exchange and money markets remained stable. The market exchange rate remained within a narrow range of 7.7972 – 7.8000 during the year, close to the Convertibility Undertaking rate (Chart 1). During the year, the HKMA sold US dollars for Hong Kong dollars under the Convertibility Undertaking on three occasions. In the opposite direction, the HKMA purchased US dollars for Hong Kong dollars on four occasions in response to bank offers.

The Hong Kong dollar forward market experienced occasional periods of pressure during the year (Chart 2). During March and

April, in the face of political tension between the US and China, a weakening yen and increased pressure in Argentinian financial markets, Hong Kong dollar forward points rose appreciably, reaching +470 pips at one point, in terms of 12-month money in early April. They subsided thereafter, before a moderate pick-up from mid-October onwards, corresponding to the deepening Argentinian crisis, and renewed concerns about the weakness of the yen and its pressure on other Asian currencies. The 12-month forward points closed at +240 pips at the end of 2001.

Hong Kong dollar interest rates declined in 2001, in line with the reduction in US dollar rates (Chart 3). In terms of one-month money, Hong Kong dollar interbank interest rates (HIBOR) eased from 6.1% to 2.0% during the year. For most of the year, short-term rates, of six months and below, stayed below their US dollar counterparts (Chart 4). The interbank market liquidity was generally stable during most of the year. Following a decline in the early part of the year, the Aggregate Balance stayed within the

CHART 1

Exchange rate and Convertibility Undertaking, January – December 2001

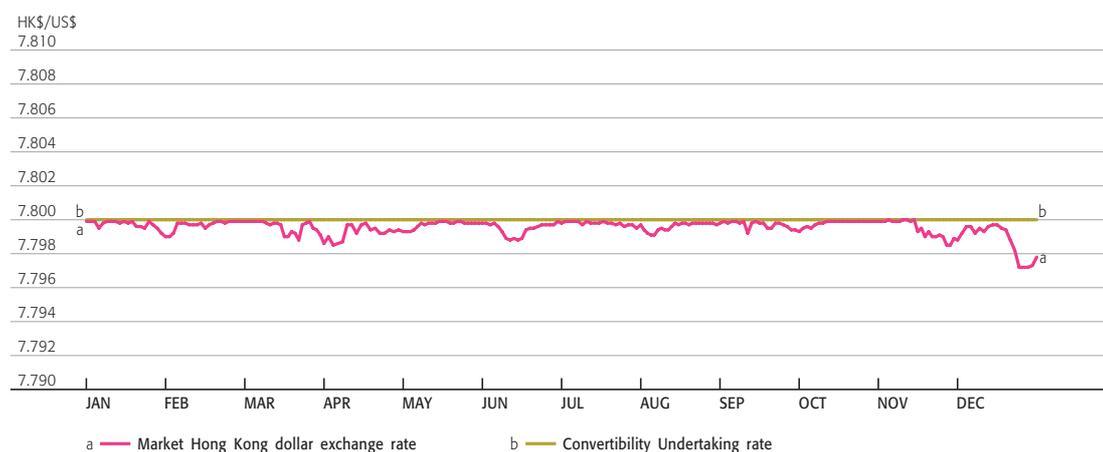


CHART 2

Hong Kong dollar forward points, January – December 2001



CHART 3

HIBORs, January – December 2001

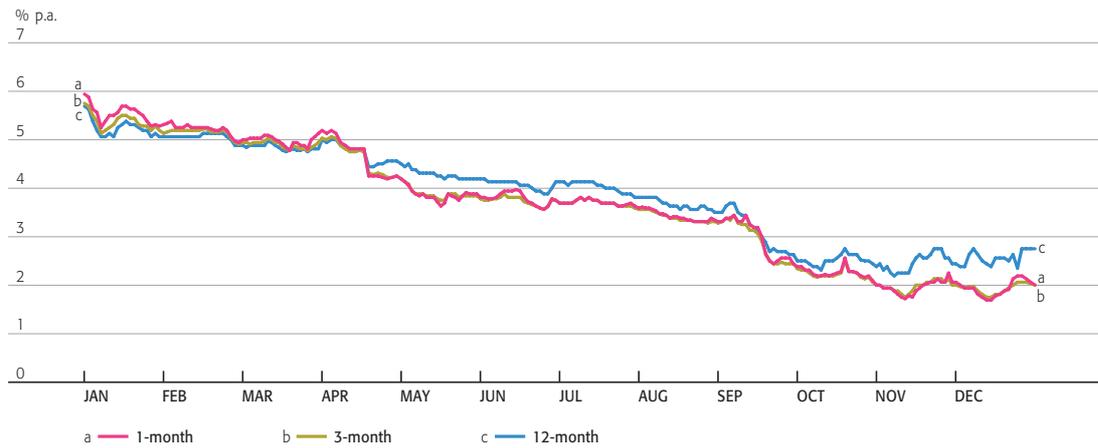
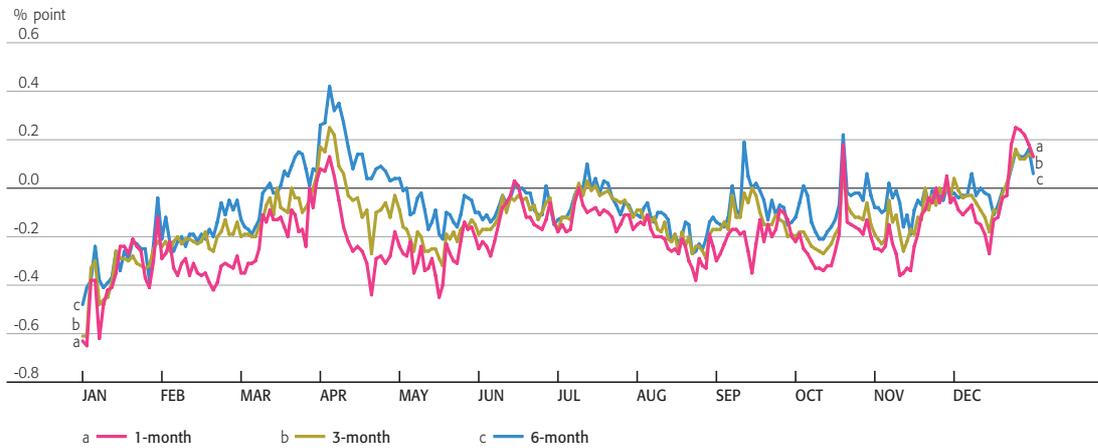


CHART 4

Hong Kong dollar – US dollar interest rate differentials, January – December 2001



range of \$0.4 – 0.6 billion during most of the period between April and late November. Thereafter, the Aggregate Balance declined slightly to close at \$0.3 billion at the end of December 2001 (Chart 5). The modest overall decline in the Aggregate Balance probably reflected more effective liquidity management, partly as a result of consolidation within the banking sector.

Interest rate volatility remained low in 2001, reflecting stable monetary conditions and the smooth operations of the Discount Window facility in absorbing occasional liquidity shocks. Overnight interbank interest rates rarely surpassed the Base Rate of the Discount Window. Interest rate volatility, measured by the standard deviation of daily changes in 1-month interbank interest rates relative to the yearly average rate, was 0.02 in 2001, about the same as the level in 2000: this compares with 0.38 and 0.15 in 1997 and 1998 respectively.

Specific assets of the Exchange Fund have been earmarked to back the Monetary Base since October 1998, in order to provide transparency to the currency board arrangements. To yield a higher return for the surplus assets while maintaining sufficient liquid assets in the backing portfolio, a framework was formally established in January 2000 for a transfer of assets between the backing portfolio and the investment portfolio of the Exchange Fund. Under this arrangement, when the backing ratio reaches 112.5% (the upper trigger point), sufficient assets are transferred from the backing portfolio to the investment portfolio to reduce the ratio to 110%. Should the backing ratio drop to 105% (the lower trigger point), sufficient assets will be transferred from the investment portfolio to the backing portfolio to restore the ratio to 107.5%. Assets were transferred out of the backing portfolio to the investment portfolio on one occasion in 2001 – on 20 February – when the backing ratio hit 112.5% (Chart 6).

CHART 5

Aggregate Balance, January – December 2001

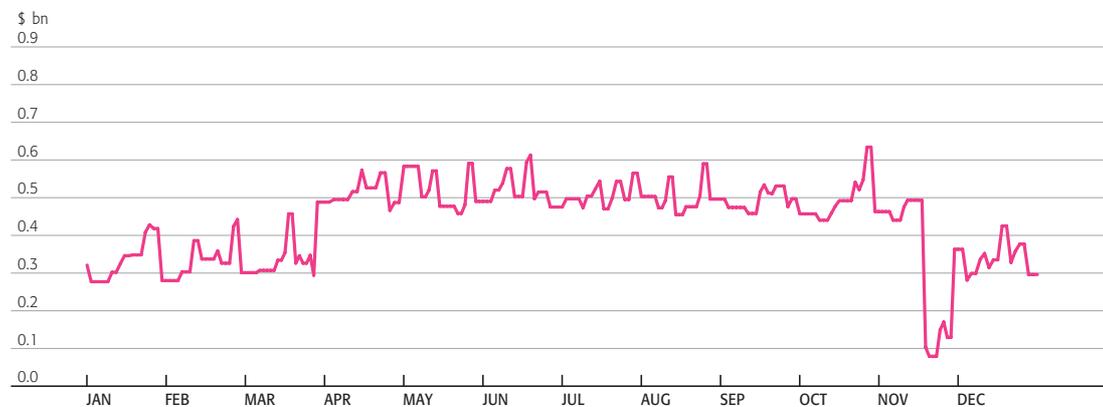
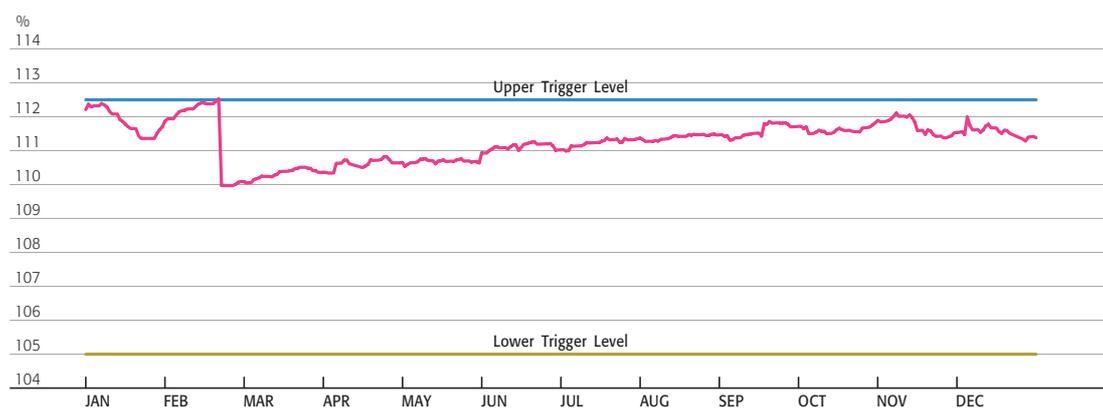


CHART 6

Daily movement of the backing ratio, January – December 2001



The Exchange Fund Advisory Committee (EFAC) Sub-Committee on Currency Board Operations continued to monitor and review the currency board arrangements in 2001. Specifically, the Sub-Committee examined the desirability and feasibility of determining the optimal level of foreign exchange reserves, the impact of fiscal transfers on money and exchange rate markets, the relationship between monetary and financial stability under a fixed exchange rate system, the exchange rate arrangements in Argentina and their relevance for Hong Kong, and the use of option prices to monitor market sentiment regarding the Hong Kong dollar.

Hong Kong Institute for Monetary Research

The Hong Kong Institute for Monetary Research, established in August 1999, continued to sponsor research in the fields of monetary policy, banking and finance that are relevant to Hong Kong and the Asian region. Fourteen fellows visited the Institute to undertake research in 2001. Fifteen working papers were published during the year.

To promote interaction between the public and the academic and research circles, the Institute co-hosted with the City University of Hong Kong a conference on "Monetary and Financial Issues in Asia" in December. In addition, a total of 30 seminars were organised during the year on a broad range of economic and monetary issues.

Plans for 2002 and beyond

The beginning of 2002 was marked by great uncertainties in the external environment, particular regarding the economic prospects for the US and Japan. At the same time, Hong Kong faces the challenges and opportunities of deepening integration with Mainland China, along with China's entry into the World Trade Organisation (WTO). The HKMA will continue to study issues of importance for the local economy in its research programme for the coming year. These include: the interaction between fiscal and monetary policies, wage flexibility, the influence of macroeconomic developments on banks, volatility in financial markets in Hong Kong and their relationship with financial markets abroad, the implications of China's entry into the WTO on our financial sector, and price differentials and convergence between Hong Kong and southern China.

The EFAC Sub-Committee on Currency Board Operations will continue to monitor the currency board operations and the risks and vulnerabilities in the domestic and external environment that may have an impact on Hong Kong's financial stability. The Sub-Committee will also keep technical aspects of the currency board arrangements under review, and where appropriate, recommend measures to strengthen them further.



■ Conference on "Monetary and Financial Issues in Asia" co-hosted by the Hong Kong Institute for Monetary Research and the City University of Hong Kong.