



The camphor tree, *Cinnamomum camphora*, is often planted as a fung shui tree in village groves, and as a shade tree in parks and gardens. Camphor is obtained from the tree for medicinal and other uses, and the wood of the tree is prized for its insect-repelling properties.

# MONETARY STABILITY

The Linked Exchange Rate system operated smoothly in 2004 despite the depreciation of the US dollar, market speculation about revaluation of the renminbi, and interest rate increases in the US.

## OBJECTIVES

The primary monetary policy objective of Hong Kong is currency stability, defined as a stable external exchange value of the currency of Hong Kong, in terms of its exchange rate in the foreign exchange market against the US dollar, at around HK\$7.80 to US\$1. The structure of the monetary system is characterised by Currency Board arrangements, requiring the Hong Kong dollar Monetary Base to be at least 100 per cent backed by US dollar reserves held in the Exchange Fund at the fixed exchange rate of HK\$7.80 to US\$1. Any changes in the Monetary Base must be matched by corresponding changes in the US dollar reserves.

The Monetary Base has four components:

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

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The Hong Kong dollar exchange rate is stabilised around the Linked Rate through an automatic interest rate adjustment mechanism. When the demand for Hong Kong dollars decreases and the market exchange rate weakens to the Convertibility Rate of HK\$7.80 per US dollar, the HKMA stands ready to purchase Hong Kong dollars from banks. The Aggregate Balance (as part of the Monetary Base) will then fall, driving up Hong Kong dollar interest rates. An increase in Hong Kong dollar interest rates against their US dollar counterparts will induce capital inflows, thereby restoring exchange rate stability. Conversely, if the demand for Hong Kong dollars increases and the market exchange rate strengthens, the HKMA may sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will then increase, placing downward pressure on Hong Kong dollar interest rates to restrain inflows.

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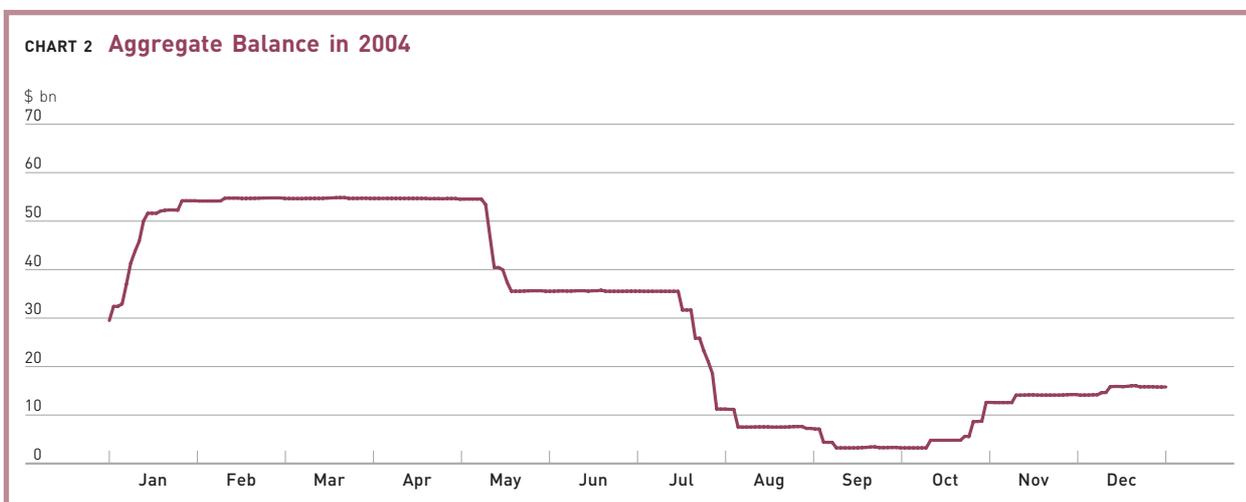
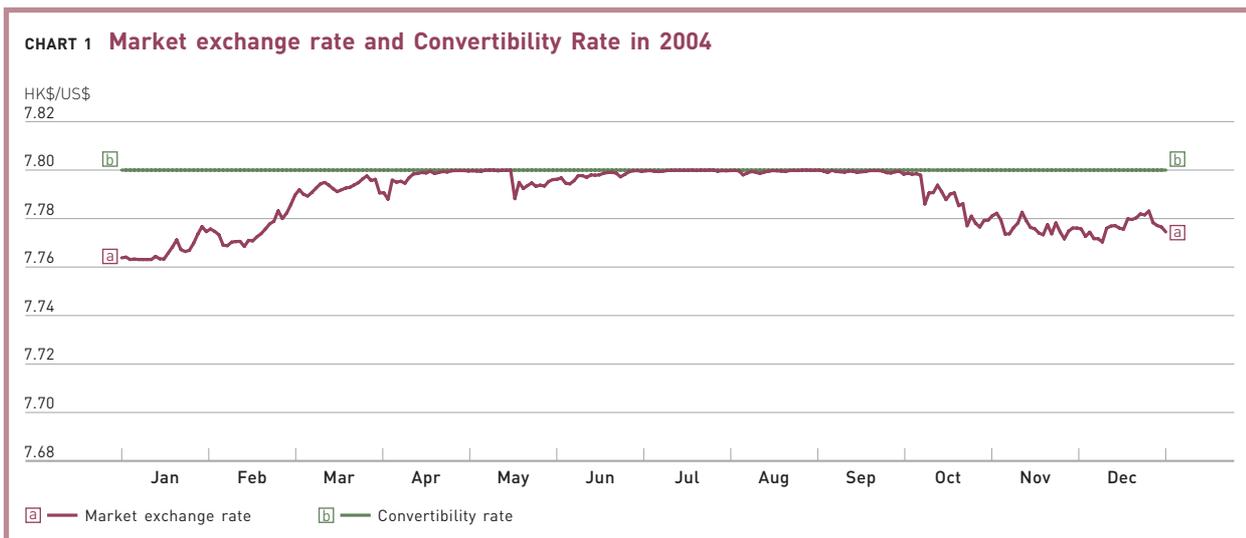
## REVIEW OF 2004

The exchange and money markets were generally stable during the year. As appreciation pressures in late 2003 subsided, the Hong Kong dollar exchange rate gradually depreciated towards the Convertibility Rate of 7.8 during the first four months of 2004 (Chart 1). The return of the exchange rate towards the Convertibility Rate was facilitated by strong-side operations of the Currency Board, under which the HKMA sold a total of \$22.3 billion worth of Hong Kong dollars in response to banks' bids during the first two months of the year. Thereafter, the Hong Kong

dollar exchange rate stayed close to the Convertibility Rate between April and September. The Convertibility Undertaking was repeatedly triggered during this period, with the HKMA purchasing a total of \$51.5 billion worth of Hong Kong dollars. The Hong Kong dollar exchange rate started to strengthen again in October, reaching 7.7703 on 8 December. The renewed strength in the Hong Kong dollar reflected several factors, including weaker sentiment towards the US dollar, upward pressure on the renminbi, and stronger growth in the Hong Kong economy. In response, the HKMA conducted a number of strong-side

operations in the fourth quarter, selling a total of \$12.6 billion of Hong Kong dollars. The Hong Kong dollar exchange rate finally closed at 7.7745 at the end of the year.

Under the Currency Board arrangements, foreign exchange operations by the HKMA lead to corresponding changes in the Aggregate Balance. As appreciation pressure subsided and the Convertibility Undertaking was repeatedly triggered, the Aggregate Balance declined from over \$50 billion in early 2004 to \$3.2 billion in late September (Chart 2). Inflows of funds resumed in



the fourth quarter. The HKMA conducted a number of strong-side operations. The Aggregate Balance rebounded to close at \$15.8 billion at the end of the year.

The Hong Kong dollar forward discount further widened during the year (Chart 3). The 12-month forward discount fluctuated between 200 and 800 pips during the first nine months of the year, but increased in the fourth quarter to close at 1,650 pips at the end of the year. This reflected weakness

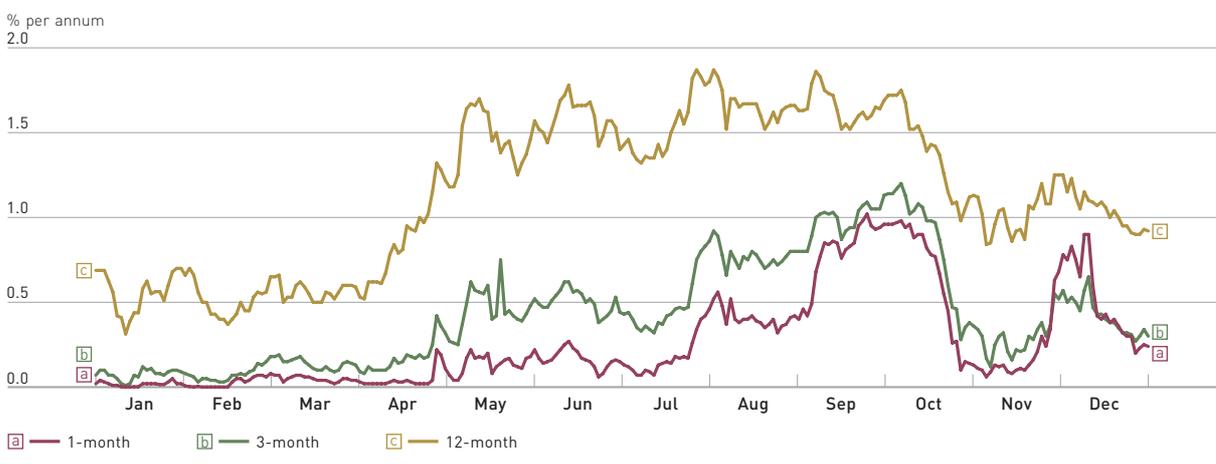
in the US dollar and renewed speculation about the exchange rate policy of the Mainland authorities.

With a cumulative increase of 125 basis points in the US federal funds target rate during the year, Hong Kong dollar interbank interest rates rose between April and September (Chart 4). However, interest rates started to ease in October because of increased liquidity in the face of capital inflows. This led to an increase in the negative spread between Hong Kong dollar interest rates and their

**CHART 3 Hong Kong dollar forward points in 2004**



**CHART 4 HIBORs in 2004**

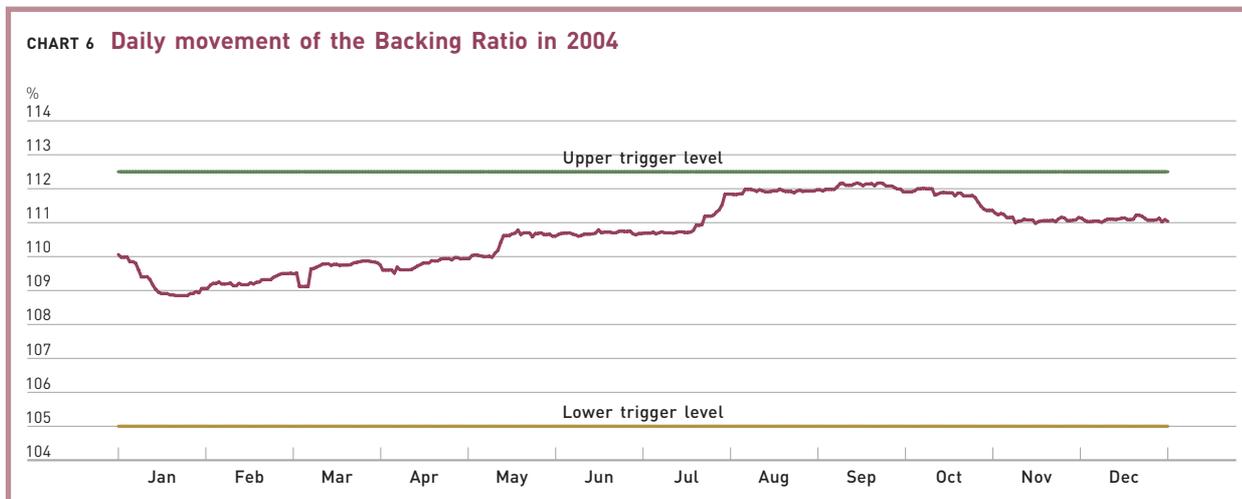
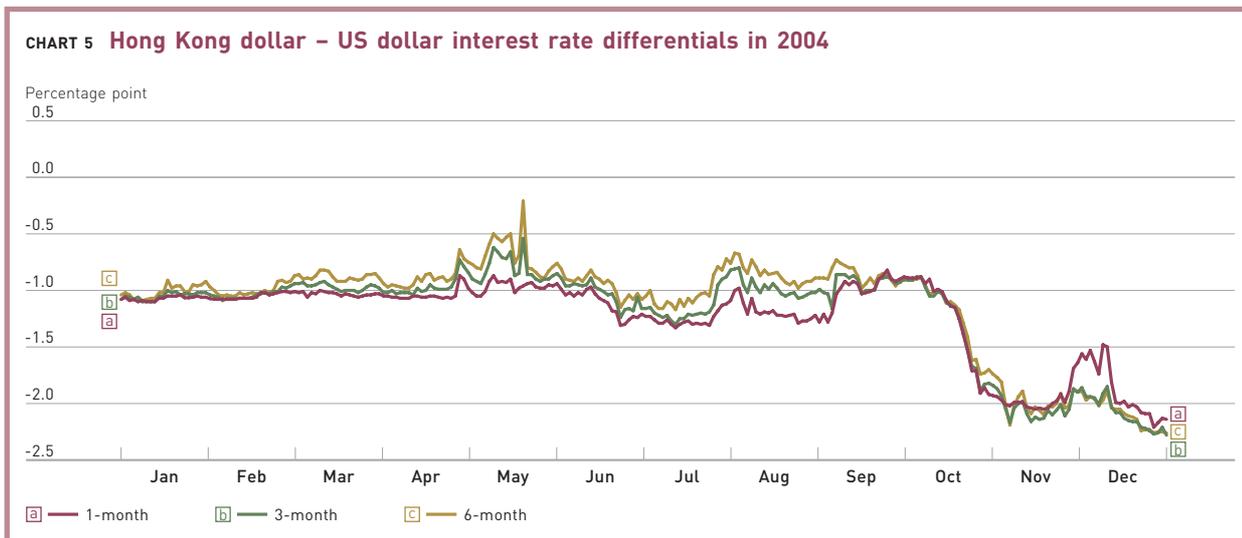


US dollar counterparts (Chart 5). Short-term interest rates rose for a brief period between mid-November and early December, attributable to liquidity demand associated with a number of equity IPOs. For the year as a whole, short-term interest rates rose only by about 20 basis points, considerably less than the increase of 125 basis points in the US rates.

Interest rate volatility, as measured by the standard deviation of daily changes in the one-month interbank rate, remained low during the

year. The Discount Window functioned smoothly to absorb liquidity shocks, and the overnight interbank interest rate rarely exceeded the Base Rate of the Discount Window.

To improve the transparency of the Currency Board Account, specific Exchange Fund assets have been set aside to back the Monetary Base since October 1998. The Backing Ratio, defined as the ratio of Backing Assets to the Monetary Base, rose from 110.06% at the beginning of the year to a high of 112.17% in mid-September (Chart 6). A large part



of the increase was due to the reduction in the Aggregate Balance as a result of the triggering of the Convertibility Undertaking during the period.<sup>1</sup> Thereafter, as the HKMA conducted strong-side operations and the Aggregate Balance expanded in the fourth quarter, the Backing Ratio declined, and closed at 111.04% at the end of the year.

### Activities at the HKMA

The EFAC Currency Board Sub-Committee continued to examine issues having a bearing on monetary and financial stability in Hong Kong. These issues included the possible issuance of Exchange Fund papers to reduce the Aggregate Balance, movements in the Backing Ratio, the adequacy of international reserve holdings, macroeconomic conditions in Mainland China, the use of the federal funds futures rate to extract information on market expectation of US monetary policy, and a review of HKMA operations in the foreign exchange market.

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The Hong Kong Institute for Monetary Research, established in August 1999, continued to sponsor research in the fields of monetary policy, banking and finance. In 2004 the Institute hosted 16 full-time and two part-time research fellows. It also published 24 working papers and one occasional paper during the year.

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The Institute co-organised with the International Monetary Fund a conference entitled *Managing Procyclicality of the Financial System: Experiences in Asia and Policy Options* on 22 November 2004 with the participation of senior policy makers of the region's central banks, academics, and officials from international financial institutions. In May 2004 the Institute co-organised with the Centre for Central Banking Studies of the Bank of England a one-week workshop on *Advanced Modelling for Monetary Policy in the Asian-Pacific Region*. The Institute organised two workshops on *Research on the Mainland Economy* in July and December. In addition to conferences and workshops, 38 public seminars were organised during the year on a broad range of economic and monetary issues.

 > [About the HKMA](#) > [Links](#) > [HKMA-related Organisations](#) > [Hong Kong Institute for Monetary Research](#)

### PLANS FOR 2005 AND BEYOND

The HKMA will continue to study issues affecting the economy in its research programme for the coming year. The EFAC Currency Board Sub-Committee will closely monitor risks and vulnerabilities in the domestic and external environment that may affect Hong Kong's financial stability. The Sub-Committee will keep the technical aspects of the Currency Board arrangements under review and, where appropriate, recommend measures to strengthen them further.

<sup>1</sup> While the Backing Assets decreased by the same magnitude as the Monetary Base, the fractional decrease was smaller in the former because of its larger size, thus increasing the Backing Ratio.