Monetary Stability

The Hong Kong dollar exchange rate remained stable against the US dollar despite strong inflows of funds and large swings in the US dollar exchange rate against other currencies. Hong Kong's money market largely returned to normal and the withdrawal of the temporary liquidity measures introduced in 2008 went smoothly.

OBJECTIVES

The overriding objective of Hong Kong's monetary policy is currency stability. This is defined as a stable external exchange value of Hong Kong's currency, in terms of its exchange rate in the foreign-exchange market against the US dollar, within a band of HK$7.75 – 7.85 to US$1. The structure of the monetary system is characterised by Currency Board arrangements, requiring the Monetary Base to be at least 100% backed by US dollar reserves held in the Exchange Fund, and changes in the Monetary Base to be 100% matched by corresponding changes in US dollar reserves.

The Monetary Base (Table 1) comprises

- Certificates of Indebtedness, which provide full backing to the banknotes issued by the three note-issuing banks
- Government-issued notes and coins in circulation
- the Aggregate Balance, which is the sum of clearing account balances of banks kept with the HKMA
- Exchange Fund Bills and Notes issued by the HKMA on behalf of the Government.

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism and the firm commitment by the HKMA to honour the Convertibility Undertakings (CUs). When the demand for Hong Kong dollars is greater than the supply and the market exchange rate strengthens to the strong-side CU of HK$7.75 to the US dollar, the HKMA stands ready to sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will then expand to push down Hong Kong dollar interest rates, creating monetary conditions that move the Hong Kong dollar away from the strong-side limit to within the Convertibility Zone of 7.75 to 7.85. Conversely, if the supply of Hong Kong dollars is greater than the demand and the market exchange rate weakens to the weak-side CU of HK$7.85 to the US dollar, the HKMA will buy Hong Kong dollars from banks. The Aggregate Balance will then contract to drive Hong Kong dollar interest rates up, pushing the Hong Kong dollar away from the weak-side limit to stay within the Convertibility Zone.

Table 1 **Monetary Base**

$ million	31 Dec 2009	31 Dec 2008
Certificates of Indebtedness[1]	**200,185**	177,225
Government-issued currency notes and coins in circulation[1]	**8,477**	8,319
Balance of the banking system	**264,567**	158,038
Exchange Fund Bills and Notes issued[2]	**537,429**	163,554
TOTAL	**1,010,658**	507,136

[1] The Certificates of Indebtedness and the government-issued notes and coins in circulation shown here are stated at Hong Kong dollar face values. The corresponding items shown in the balance sheet of the Exchange Fund in this Annual Report are in Hong Kong dollars equivalent to the US dollar amounts required for their redemption at the prevailing exchange rates on the balance sheet date. This arrangement is in accordance with the accounting principles generally accepted in Hong Kong.

[2] The amount of Exchange Fund Bills and Notes (EFBN) shown here is different from that in the balance sheet of the Exchange Fund in this Annual Report. In accordance with the accounting principles generally accepted in Hong Kong, the EFBN held by the HKMA on behalf of the Exchange Fund in relation to its trading of the EFBN in the secondary market are offset against the EFBN issued, and the net amount is recorded in the balance sheet. The EFBN issued on tender dates, but not yet settled, are included in the balance sheet but excluded from the Monetary Base.

REVIEW OF 2009

Exchange-rate stability

Having withstood the global financial crisis in 2008, the effective functioning of the Linked Exchange Rate system continued to keep the Hong Kong dollar stable in 2009. Despite large swings in the US dollar, activities in the local foreign-exchange market were generally orderly. The Hong Kong dollar market exchange rate stayed close to the strong-side CU for most of the time and moved within a narrow range between 7.7500 and 7.7594 (Chart 1).

Between 20 March and 4 December, the strong-side CU was triggered repeatedly and the HKMA purchased a total of US$59.8 billion in response to banks' offers, creating HK$463.4 billion. The inflows into the Hong Kong dollar were reflected in a rise in the Aggregate Balance and the increased issuance of Exchange Fund Bills consistent with the Currency Board system. The Aggregate Balance rose to $264.6 billion on 31 December from $162.7 billion on 2 January 2009 (Chart 2).

Chart 1 **Market exchange rate, January - December 2009**

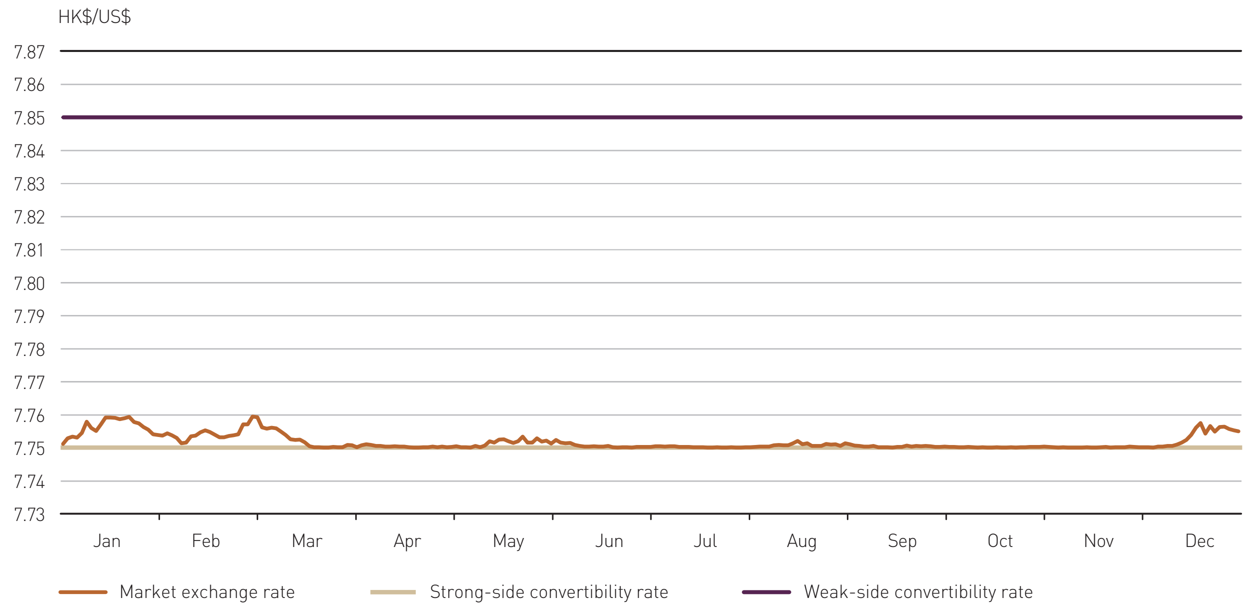
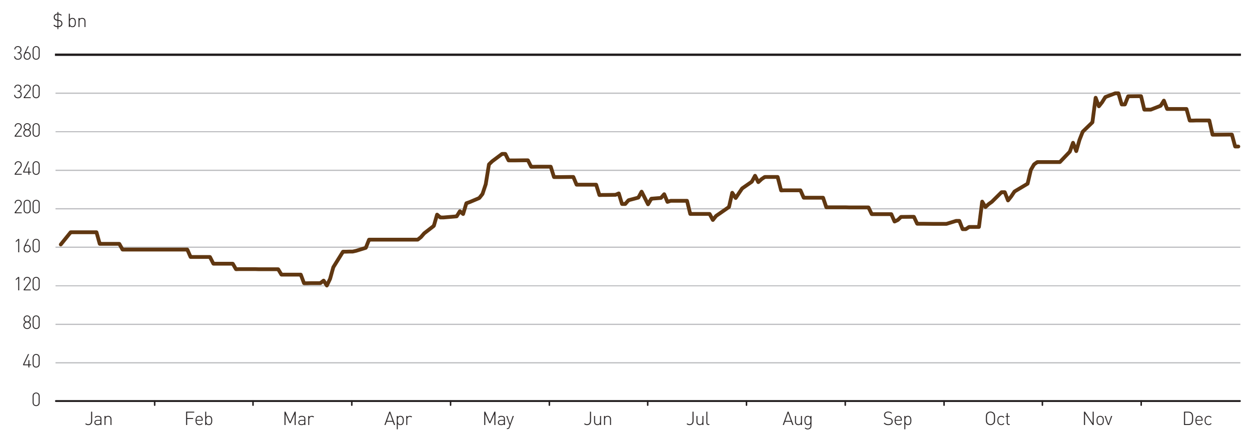


Chart 2 **Aggregate Balance, January - December 2009**



These strong inflows partly reflected better prospects for recovery in the Hong Kong and Mainland economies than elsewhere. Amid ample liquidity worldwide and capital inflows into the region, the demand for Hong Kong dollar assets also increased alongside a rebound in the regional asset markets. However, the inflows into the Hong Kong dollar did not appear to be related to exchange-rate speculation. During 2009 the Hong Kong dollar forward discounts traded within a narrow range, with the 12-month forward discount fluctuating between 40 and 265 pips (a pip is equivalent to $0.0001).

Money market

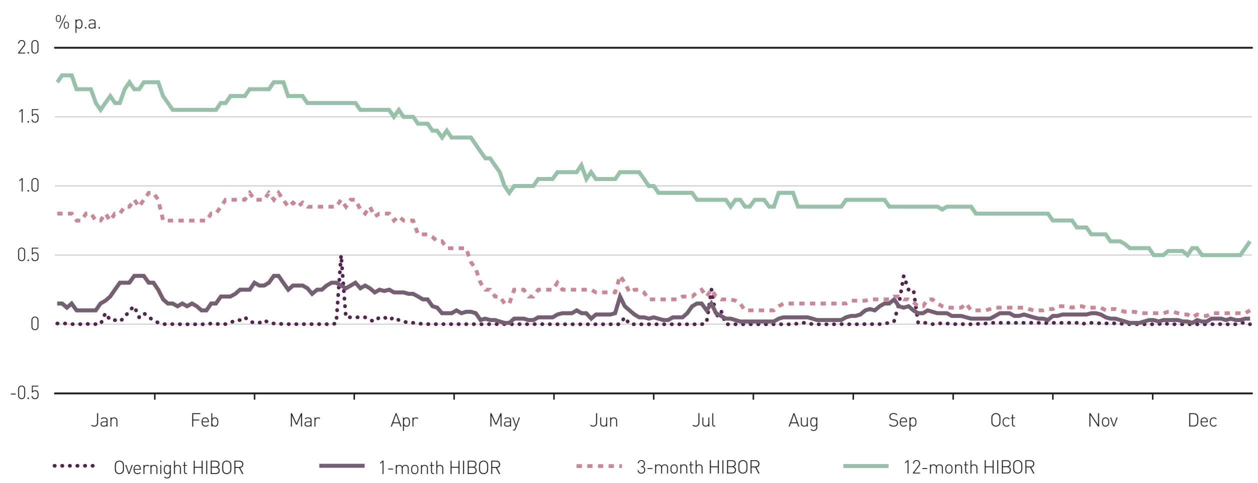
After stabilising towards the end of 2008, the Hong Kong interbank money market largely returned to normal in 2009. The various financial measures taken by the Financial Secretary and the HKMA in 2008 were effective. Liquidity concerns eased significantly and confidence in the local banking system greatly strengthened. Term HIBORs declined to very low levels during the year, reflecting the larger Aggregate Balance and the downward movements in the corresponding US dollar interest rates (Chart 3). The overnight HIBOR also stayed near zero, with occasional increases due to IPO-related funding demand.

While the Hong Kong dollar interbank market largely returned to normal, the demand for high-quality, liquid money-market instruments (a form of local-currency liquidity) remained strong, as shown by activities in the Exchange Fund Bills market. In view of the strong market demand, the HKMA issued additional Exchange Fund Bills amounting to $374.4 billion in 2009. Following the additional issues, the Aggregate Balance contracted accordingly. These market operations were consistent with Currency Board principles and had little impact on the exchange rate and interest rates partly because of the large Aggregate Balance.

Exit strategies

The strong inflows of funds, very low interbank interest rates, and the measures introduced in the global financial crisis helped create an accommodative monetary environment locally. Given the depth of the recession in the Hong Kong economy in early 2009, the easy monetary conditions were appropriate. However, there were risks that, if the policy responses to the crisis were kept in place longer than necessary, they might lead to inflation and excessive fluctuations in asset prices. The measures might also cause distortions to the economy, fostering undesirable household and corporate behaviour. It was therefore important for the HKMA to prepare exit strategies to maintain monetary and financial stability in Hong Kong.

Chart 3 Hong Kong dollar interest rates, January - December 2009



Monetary Stability

Following the introduction of the five temporary liquidity-assistance measures in late September 2008, the local interbank money market stabilised and utilisation was mainly confined to the fourth and fifth measures – foreign-exchange swaps and term repurchase agreements with the HKMA. Against this background, and taking into account market views, the HKMA announced on 26 March 2009 that it would incorporate forex swaps and term repos (against securities of acceptable quality to the HKMA) into its framework for market operations after the five temporary measures expired at the end of March 2009. This provided an assurance to individual banks which might need liquidity that it would be available. The HKMA also decided to resume the previous arrangements for the Discount Window (using only Exchange Fund paper for overnight repos) to safeguard exchange-rate stability under the Currency Board system. Following these decisions, the exit from the five temporary liquidity measures in late March 2009 went smoothly and Hong Kong's money market remained calm.

Another arrangement for providing liquidity assistance to banks was the adjustment to the Base Rate formula on 8 October 2008. After a review of the modified Base Rate formula, the HKMA announced on 26 March 2009 that the narrower 50-basis point spread over the US Federal Funds Target Rate would be retained in place of the previous spread of 150 basis points. The HIBOR leg would also be re-instated in the calculation of the Base Rate to facilitate interest rate adjustment under the Currency Board system and encourage banks to prudently manage their day-to-day liquidity. Throughout 2009, the HKMA Base Rate remained unchanged at 0.5% (50 basis points above the lower boundary of the target range of the Federal Funds Target Rate) according to the new formula.

During the year the HKMA also prepared the ground for exiting from the contingent capital facility for banks and the temporary 100% deposit guarantee, although these measures had not had to be used since the local banking sector remained stable. Subject to legislative approval, the Deposit Protection Board proposed to raise the maximum protection limit of the existing Deposit Protection Scheme to $500,000. Under the proposed scheme, about 90% of all depositors will be unaffected by the removal of the deposit guarantee at the end of 2010. In July the HKMA, Bank Negara Malaysia and the Monetary Authority of Singapore established a tripartite working group to facilitate the scheduled exit from the full deposit guarantees by the end of 2010 in their respective jurisdictions.

At the macro level, the exit from the easy monetary environment is largely market-driven. Such an exit might be triggered by a reversal of fund flows due, for example, to a normalisation of US monetary policy. However, the increased foreign reserves built up under the Currency Board arrangements as a result of the original fund inflows would allow the HKMA to sell US dollar assets back to the market, in a manner consistent with the Currency Board principles and the three refinements introduced in 2005. The automatic interest rate adjustment under the Currency Board arrangements would also act as a cushion against downward pressure on the exchange rate. Where appropriate, the HKMA could undertake foreign-exchange operations within the Convertibility Zone to support orderly interest rate adjustments that would maintain exchange-rate stability.

Financial stability and the functioning of the Linked Exchange Rate system

After 26 years of operation, the Linked Exchange Rate system continues to serve as an anchor for Hong Kong's highly externally oriented economy and as a cornerstone of its monetary and financial stability. The recent financial crisis has demonstrated that monetary frameworks that do not take sufficient account of financial stability are seriously flawed. Hong Kong's experience during the crisis shows that the HKMA's approach to monetary and financial stability is serving Hong Kong well.

A sound banking system is a crucial condition for the normal functioning of the Linked Exchange Rate system. On 20 January the HKMA signed a currency swap agreement with the People's Bank of China, providing liquidity support of up to RMB200 billion or HK$227 billion for a period of three years. The bilateral swap agreement will enable both sides to meet the contingent short-term liquidity needs of its own banks in the other jurisdiction, thereby enhancing Hong Kong's banking and financial stability. The HKMA also reviewed and strengthened the Lender of Last Resort framework for individual banks under liquidity stress by expanding the types of assets and facilities eligible for obtaining Hong Kong dollar liquidity through the framework.

The exposure of the banking system to asset markets and the volatility of asset prices were closely monitored during the year. The HKMA took prudential measures to reduce banks' mortgage lending risks to ensure banking stability. It issued a circular to authorized institutions on 23 October requiring them to lower the maximum loan-to-value ratio for properties with a value of $20 million or more to 60%, and to maintain the 70% loan-to-value ratio for properties valued at below $20 million but cap the maximum loan amount at $12 million.

To improve the transparency of the Currency Board Account, a specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998. With the marked expansion in the Monetary Base, the Backing Ratio declined to 105% on 13 November, touching the Lower Trigger Level (Chart 4).[1] This was the first time the Lower Trigger point was reached. Under the arrangements approved by the Financial Secretary in January 2000, US dollar assets were transferred from the Investment Portfolio to the Backing Portfolio of the Exchange Fund to restore the Ratio to 107.5%. The Backing Ratio closed at 107.03% on 31 December.

Other activities

The EFAC Currency Board Sub-Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. During the year such issues included dislocation in the foreign-exchange and money markets in Hong Kong; the framework for monitoring capital flows; the effects on Hong Kong's financial markets of the markets in the US and China during the current crisis; and exchange rate regimes and the management of asset price bubbles. Records of discussion of the Sub-Committee on these issues and the reports on Currency Board operations submitted to the Sub-Committee are published on the HKMA website.

The Hong Kong Institute for Monetary Research (HKIMR) continued to sponsor research in the fields of monetary policy, banking and finance. In 2009 the Institute hosted 24 research fellows and seven post-doctoral fellows. It also published 38 working papers.

Chart 4 Daily movement of the Backing Ratio, January – December 2009

[1] The expansion in the Monetary Base exerted a downward influence on the Backing Ratio because while the Backing Assets rose by the same amount as the Monetary Base (as required under the Currency Board arrangements), the proportional increase was smaller in the former due to its larger size.

The Institute co-organised four international conferences. The first, held on 12 - 13 January with the Bank for International Settlements' Representative Office for Asia and the Pacific, focused on the relationship between real estate markets and financial markets. The second, (19 - 20 January) with the Asian Development Bank, examined the costs and benefits of regional economic integration in Asia. The third, (11 - 12 May) with Columbia University and Lingnan University, dealt with issues surrounding the global financial turmoil and Asia's evolving financial interdependence. The fourth, (26 - 27 June) with The Hong Kong University of Science and Technology, the National Bureau of Economic Research and other Asian research institutions, studied issues of commodity prices and financial markets. Other programmes included the seventh HKIMR workshop on the Mainland's economy, entitled "Macroeconomic Statistics and Surveillance in Mainland China" in November, the Seventh Annual Summer Workshop in August and the Tsinghua – Columbia Workshop in International Economics 2009 sponsored by the Institute in June. In addition, 46 public seminars were organised during the year on a broad range of economic and monetary issues.

PLANS FOR 2010 AND BEYOND

The external environment remains highly uncertain despite signs of recovery from the global financial crisis. The key issues facing monetary policymakers around the world include when to start tightening, and how to unwind large central bank balance sheets. In the foreign-exchange market, movements in the US dollar remain volatile and a possible resurgence of carry trades, or their sudden unwinding, could affect monetary and financial stability in Hong Kong. Indeed, any sharp reversal in fund flows might lead to market volatility given the considerable gains in asset prices in 2009.

The HKMA will continue to monitor risks and vulnerabilities in the domestic and external environment. In the event of destabilising capital outflows, the HKMA can, if necessary, conduct foreign-exchange operations within the Convertibility Zone, to ensure adjustments are orderly, as long as exchange-rate stability is not affected. Prudential supervision of lending by authorized institutions can also be stepped up to mitigate potential risks to banking stability. The EFAC Currency Board Sub-Committee will continue to examine issues relevant to Hong Kong's monetary and financial stability, review the technical aspects of the Currency Board arrangements and, where appropriate, recommend measures to strengthen them.