Record of Discussion of the Exchange Fund Advisory Committee Currency Board Sub-Committee on 2 March 2007

(Approved for Issue by the Exchange Fund Advisory Committee on 22 March 2007)

Report on Currency Board Operations (30 January – 14 February 2007)

The Sub-Committee noted that the Hong Kong dollar exchange rate had been generally stable during the reporting period. Interbank interest rates had risen, while their negative spreads against US dollar interest rates had narrowed. The Monetary Base had increased from HK$299.06 billion to HK$314.14 billion.

The Sub-Committee noted that, in accordance with Currency Board Principles, changes in the Monetary Base had been fully matched by corresponding changes in foreign reserves.

The report on Currency Board operations for the period under review is at **Annex**.

Monitoring of Risks and Vulnerabilities

The Sub-Committee noted that the US, Japan and euro area economies had registered solid GDP growth in the fourth quarter of 2006. However, the GDP expansion in developed economies had not translated into stronger export growth for the Asian (ex-Japan and China) region. The slowdown in Asians exports had also affected industrial production. Solid growth in domestic demand had partly cushioned the slowdown in exports in some Asian economies, rendering fourth-quarter GDP growth mixed across the Asian region.

While growth momentum had remained strong in Mainland China, the trade surplus had remained large, putting pressure on liquidity expansion in the banking system. Portfolio shift by depositors had caused outflows of deposits to the stock market, raising concerns for the authorities. The People's Bank of China had announced that it was raising the reserve requirement ratio by another 0.5 percentage points to 10% from 25 February 2007.

Solid growth, favourable labour market conditions and benign inflationary pressure had continued to characterise the Hong Kong economy. Financial market conditions had been stable. The negative spreads of domestic interest rates against their US counterparts had narrowed, the Hong Kong dollar spot exchange rate had weakened and the equity market had eased after the strong rally over the past few months. There had been signs of revival in property market activity. The recent divergence in the spot exchange rates of the Hong Kong dollar and the renminbi and the calm reaction in the Hong Kong dollar exchange rate when the renminbi had breached psychological levels, suggested that the efforts to manage market expectation and decouple the psychological relationship between the exchange rates of the two currencies had been quite successful.

The Sub-Committee noted that the recent appreciation of the renminbi beyond parity with the Hong Kong dollar had reportedly caused some shops in Shenzhen to stop accepting Hong Kong dollars, raising concerns about the potential monetary impact on Hong Kong should demand for Hong Kong dollars in China shrink markedly. However, HKMA analysis suggested that the potential impact was likely to be small for several reasons: demand for Hong Kong dollar banknotes in China arising from visits by Hong Kong residents to southern China only accounted for about 4% of banknotes in circulation; external demand for Hong Kong dollars from the Mainland was related to the convenience of the large denomination of Hong Kong dollar banknotes and the free convertibility and lack of capital controls of the Hong Kong dollar; and possible repatriation of Hong Kong dollar banknotes from the Mainland was unlikely to affect the Hong Kong dollar market exchange rate and interest rates, since Certificates of Indebtedness (which affect the redemption of Hong Kong dollar banknotes) and the Aggregate Balance (which affects Hong Kong dollar market interest rates and exchange rates) are not transferable.

A Model of Best Lending Rate Adjustment Decisions of Hong Kong Banks

The Sub-Committee noted a paper describing a model to examine factors which determine banks' best lending rate (BLR), and assess likely decisions by banks on rate adjustments following meetings of the US Federal Open Market Committee (FOMC). The empirical analysis of data from five selected banks suggested that BLR adjustments are largely determined by Fed funds target rate (FFTR) adjustments; changes in liquidity conditions; the BLR-based liability-to-asset (LA) ratio of individual banks; and the level of disequilibrium among BLR, FFTR and the risk premium of the Hong Kong dollar relative to the US dollar. The analysis also suggested that even when there was no change in the FFTR, individual banks might adjust their BLRs based on their own balance sheet positions and prevailing liquidity conditions. The estimation results found that banks with an LA ratio greater than one tended to be less responsive to FFTR changes than banks with an LA ratio less than one during the tightening phase of US interest rates. When the FOMC decided not to change the FFTR, there was still a stronger tendency for banks with an LA ratio of less than one to have a higher BLR than banks with a ratio of greater than one.

Hong Kong's Trade Patterns and Trade Elasticities

The Sub-Committee considered a paper discussing whether the Marshall-Lerner condition holds for Hong Kong given its role as an entrepot for the Mainland and the complex nature of re-exports. The paper applied an econometric model to examine Hong Kong's long-run price and income elasticities and short-run dynamics. Empirical estimates indicated that the sum of the absolute values of the estimated price elasticities of Hong Kong's direct imports and exports was greater than one, implying that the Marshall-Lerner condition does hold. Changes in re-export volumes and re-export earnings were also found to be sensitive to changes in the real effective exchange rate of the renminbi and income growth of the Mainland's trading partners. In view of the importance of Hong Kong as an entrepot for the Mainland, the real effective exchange rate of the renminbi is also important to Hong Kong's overall trade performance.