Record of Discussion of the Exchange Fund Advisory Committee Currency Board Sub-Committee held on 25 May 2007

(Approved for Issue by the Exchange Fund Advisory Committee on 31 May 2007)

Report on Currency Board Operations (30 March – 10 May 2007)

The Sub-Committee noted that the Hong Kong dollar exchange rate had weakened moderately during the reporting period. Interbank interest rates had risen, while their negative spreads against US dollar interest rates had narrowed. The Monetary Base had declined from HK$298.48 billion to HK$296.79 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 the **Annex**.

Monitoring of Risks and Vulnerabilities

The Sub-Committee noted that global financial markets had rallied to new highs during the reporting period amid strong corporate earnings, merger-and-acquisition activities, and easing oil prices, although nervousness was growing among investors as to how sustainable the rally might be, given that the policy of the US Federal Reserve remained uncertain.

Despite a slowdown in the US, the world economy was continuing to expand robustly, led by strong growth in the euro area and renewed strength in China. The US slowdown was the result of a double-digit decline in residential investment and a larger trade deficit, although private consumption had continued to hold up. The euro area had continued to expand robustly in the first quarter, despite the euro strengthening against the dollar and the yen. With solid growth in domestic demand and aided by the weak yen, the Japanese economy had also continued to expand. The newly industrialised economies in East Asia saw exports rebound, mostly because of increased demand from Mainland China. Emerging economies in the region saw a fall in exports. Overall, regional growth (excluding Japan and China) had moderated.

The Mainland economy had accelerated again in the first quarter propelled by strong net exports and a rebound of fixed-asset investment. Increased risks of economic overheating, elevated asset prices, and worsening external imbalances might lead to more and stronger economic tightening measures.

The Hong Kong economy had continued to expand moderately in the first quarter, following two consecutive quarters of rapid growth. The expansion had been underpinned by robust growth in private consumption, while growth in business spending and exports had moderated. Financial markets had remained resilient, despite increased volatility. Following the strong rally in April, the Hang Seng Index had reached a record high, partly driven by strong corporate earnings and US market rallies. The negative spreads between Hong Kong dollar and US dollar interest rates had narrowed further, while the Hong Kong dollar exchange rate had weakened against the US dollar in April and the first half of May, but remained comfortably within the Convertibility Zone.

The Sub-Committee noted that fears of the sub-prime mortgage problems spilling over to broader segments of the US economy and posing systemic risks had increased. The HKMA's analysis indicated that, as the credit problems were largely confined to the high-credit-risk segment of the mortgage market, the overall impact on the broader economy should be small. The resilience of the US economy suggested that an outright recession was unlikely. Nevertheless, the risks had increased, and extended period of moderate growth was possible.

The Sub-Committee also noted an analysis of the Mainland A-share market, which suggested that the risk of an asset-price bubble was increasing but that experience of other economies showed that the top of the cycle was likely to be difficult to predict.

The "Three Refinements" Two Years on

The Sub-Committee noted a study of the effects of the three refinements to the Linked Exchange Rate system (LERS) introduced in May 2005, which concluded that the decoupling of the Hong Kong dollar exchange rate from that of the renminbi demonstrated that the refinements had succeeded in meeting their objectives without the need for the HKMA to intervene in the foreign exchange market.

The study noted that, in a fully credible exchange rate target-zone regime, the spot exchange rate normally stayed inside the band but did not have a natural tendency to converge toward the centre of the zone. While a certain level of interest-rate differential between the Hong Kong dollar and the US dollar might persist, it should not grow significantly larger than what was implied by the width of the Convertibility Zone. Judged against this framework, the developments in the money and foreign exchange markets since May 2005 pointed to increased credibility of the refined LERS.

Is the Hong Kong Dollar Exchange Rate "Bounded" in the Convertibility Zone

The Sub-Committee considered a study which concluded, based on empirical results, that after the introduction of the three refinements, the Hong Kong dollar had followed a bounded process consistent with a fully credible exchange rate band. The study suggested that the bounded process would limit the movements of the exchange rate close to the strong and weak-side limits because its variance vanished at the Convertibility Undertakings (CUs). The Hong Kong dollar had not shown any tendency to move towards the centre of the Convertibility Zone in the absence of interventions in the foreign exchange market since May 2005. There appeared to be few forces or incentives for market participants to drive the exchange rate towards 7.80 to the US dollar.

How Big is the Mainland Dividend: A Quantitative Assessment

The Sub-Committee noted an analysis using a global macroeconomic model to gauge the impact on Hong Kong of favourable developments on the Mainland over the medium term. The study assessed three scenarios: sustained robust growth on the Mainland, a faster gain in the global market share of Mainland products, and a further rise in tourist spending by Mainland visitors in Hong Kong. The study suggested that Hong Kong is well positioned to gain from the upside potential of the Mainland economy.