

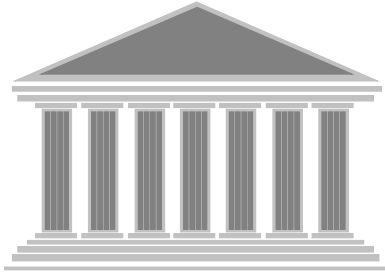


香港金融管理局

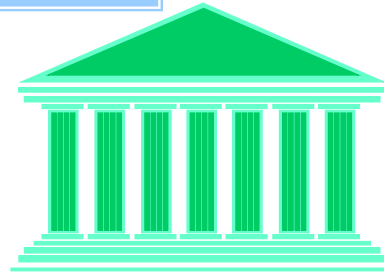
HONG KONG MONETARY AUTHORITY

The Linked Exchange Rate system of Hong Kong

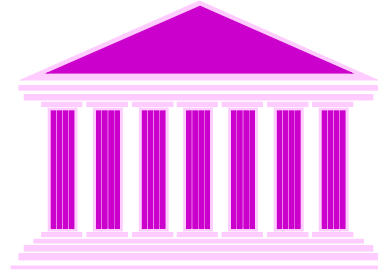
1 April 1993



**Exchange Fund
Office**



**Banking
Commissioner
Office**



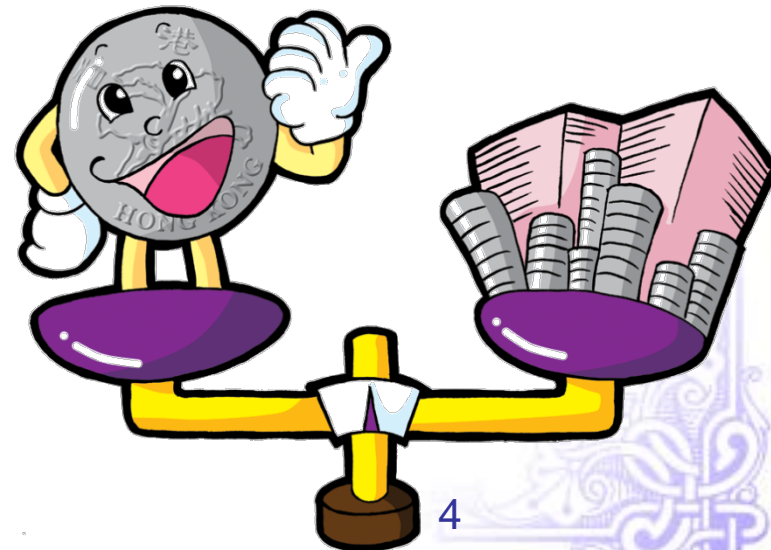
**Hong Kong Monetary
Authority**

Main Functions

- ❖ **Maintaining currency stability within the framework of the Linked Exchange Rate system**
- ❖ **Promoting the stability and integrity of the financial system, including the banking system**
- ❖ **Helping to maintain Hong Kong's status as an international financial centre, including the maintenance and development of Hong Kong's financial infrastructure**
- ❖ **Managing the Exchange Fund**

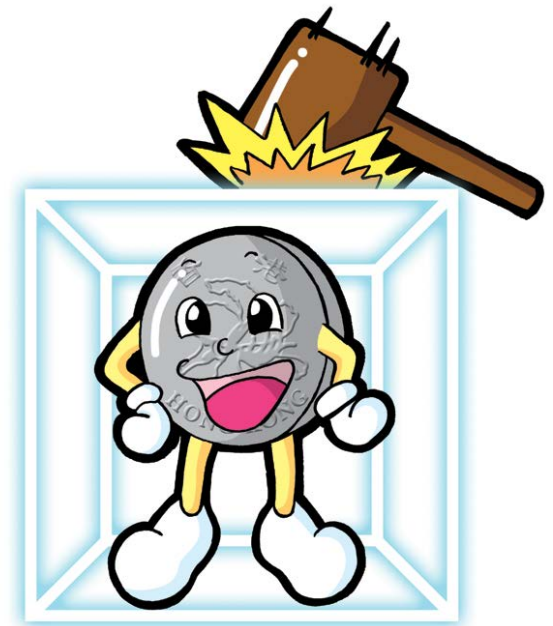
Monetary Policy Objective

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.



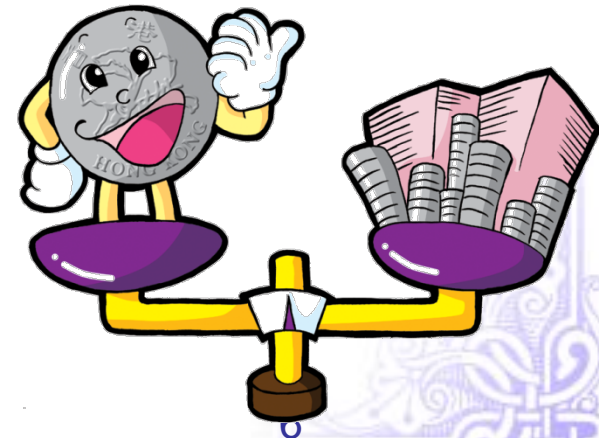
US Dollar as the Anchor Currency

- ❖ The US dollar is the most commonly used currency for international trade and financial transactions
- ❖ Financial markets with transactions settled and denominated in the US dollar rank first in the world in terms of depth, breadth and liquidity
- ❖ Hong Kong's business cycle fluctuations are still influenced more by the US



Historical Background

- ❖ In 1982-83, Sino-British talk on the resumption of Hong Kong's sovereignty after 1997 triggered a confidence crisis, leading to sharp depreciation of the Hong Kong dollar
- ❖ In response, the HK Government established the Linked Exchange Rate system on 17 October 1983
- ❖ A currency board system



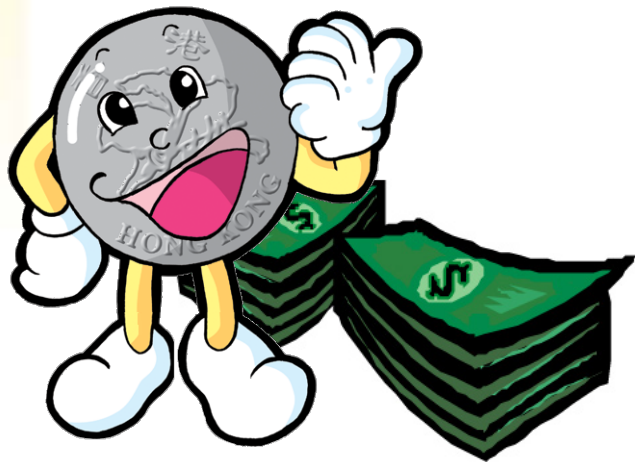
Currency Board system

- ❖ Monetary Base fully backed by foreign exchange reserves, and changes in Monetary Base matched by corresponding changes in reserves
- ❖ Components of Monetary Base :
 - ❖ Currency in circulation
 - ❖ Aggregate Balance
 - ❖ Exchange Fund Bills and Notes



Currency in circulation

HKD banknotes issued by the three note-issuing banks are fully backed by USD reserves



**HKD
Banknotes**



**fixed
exchange rate**

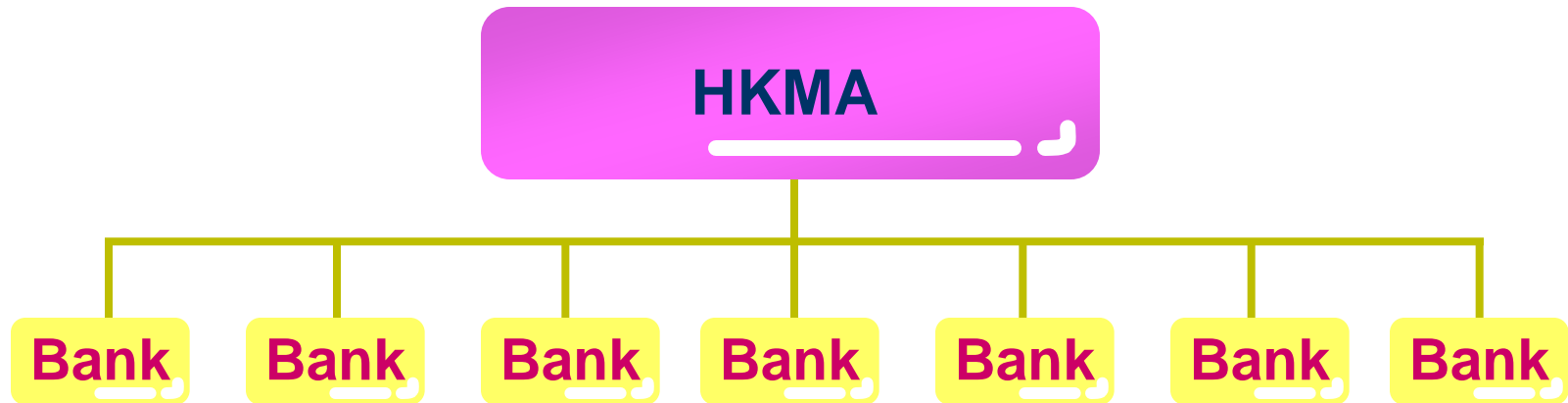


HK\$7.8=US\$1



USD

Aggregate Balance



**Sum of clearing accounts maintained by
banks with the HKMA
= interbank liquidity condition**

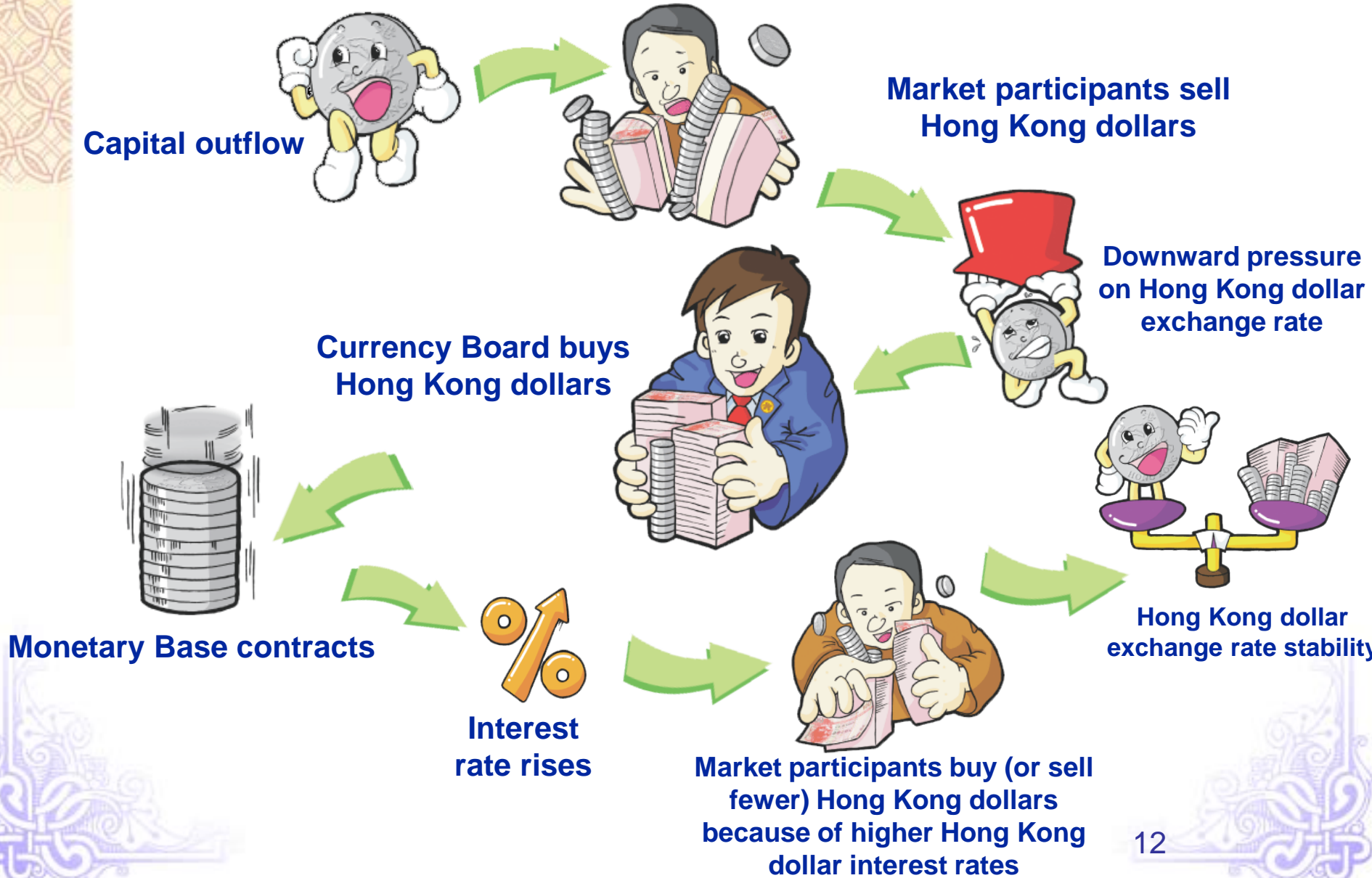
Exchange Fund Bills and Notes

- ❖ **Introduced in March 1990**
- ❖ **Hong Kong dollar debt securities issued by the HKMA**
- ❖ **To facilitate banks' liquidity management and to help develop the Hong Kong dollar debt market**
- ❖ **Additional issuance to absorb interest payments or when there are inflows**

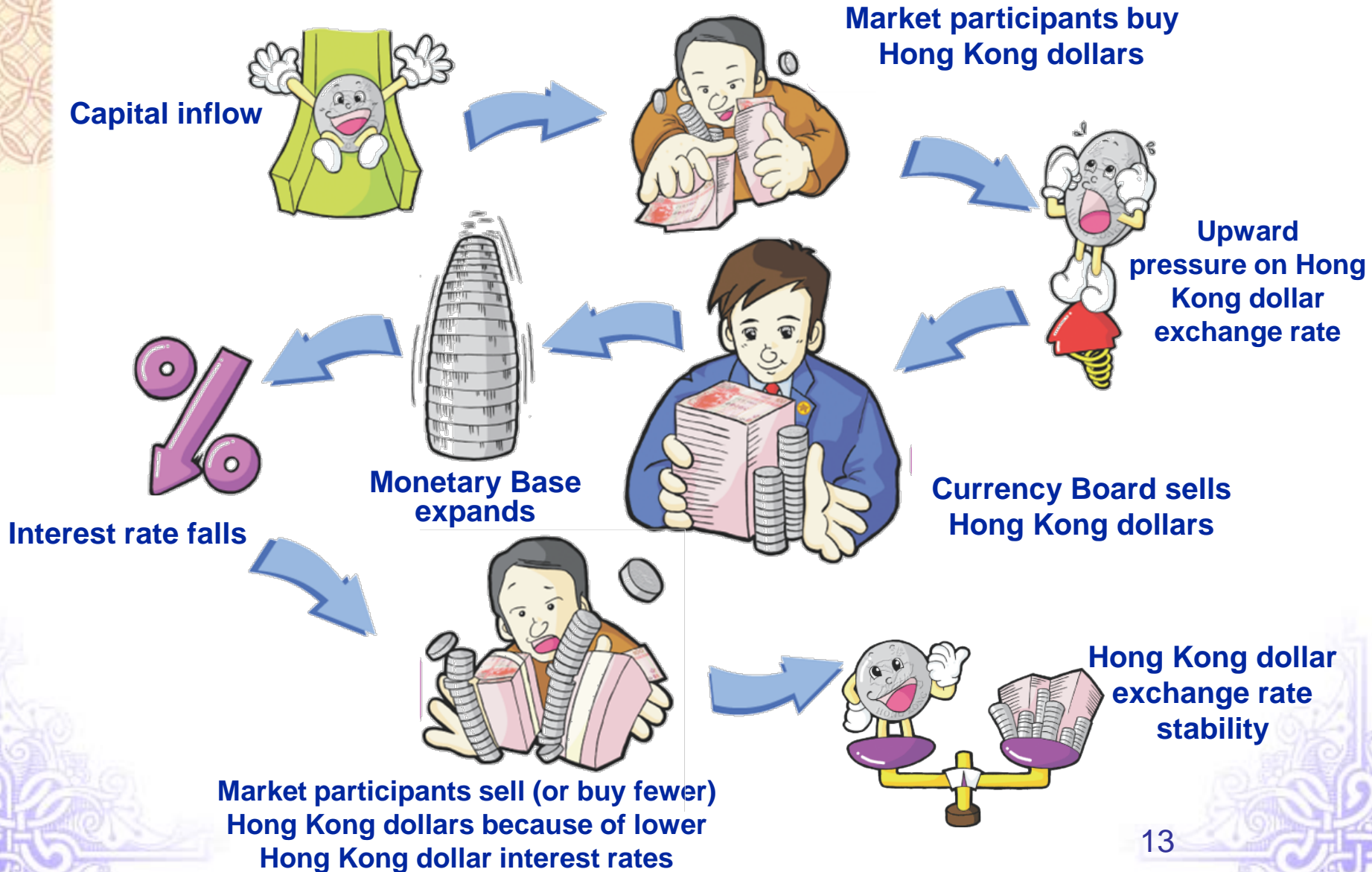
How does the Linked Exchange Rate system operate?



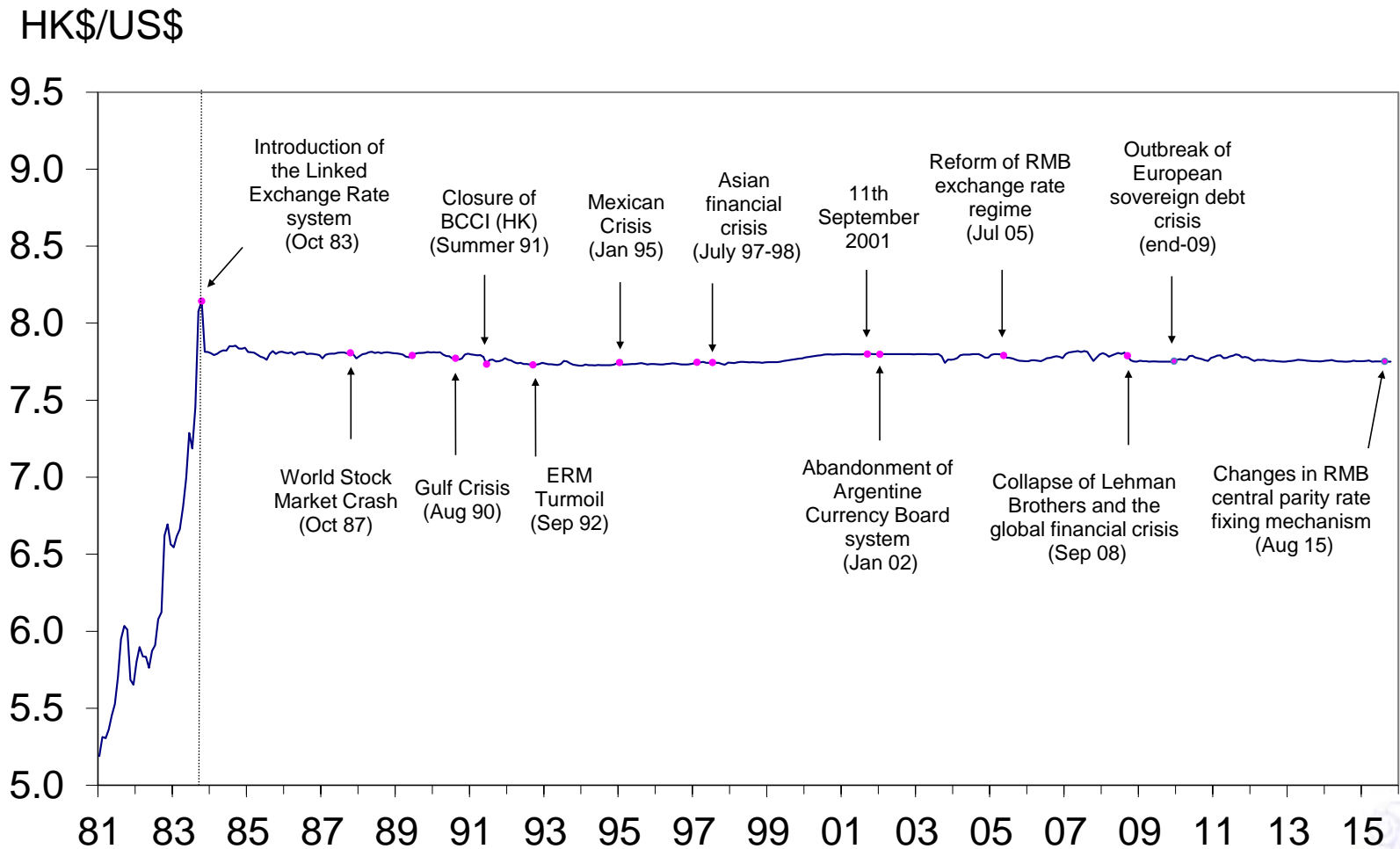
Automatic adjustment mechanism (1)



Automatic adjustment mechanism (2)



Resilience Against External Shocks



Reform measures

- ❖ **September 1998**
(seven measures)
- ❖ **May 2005**
(three refinements)



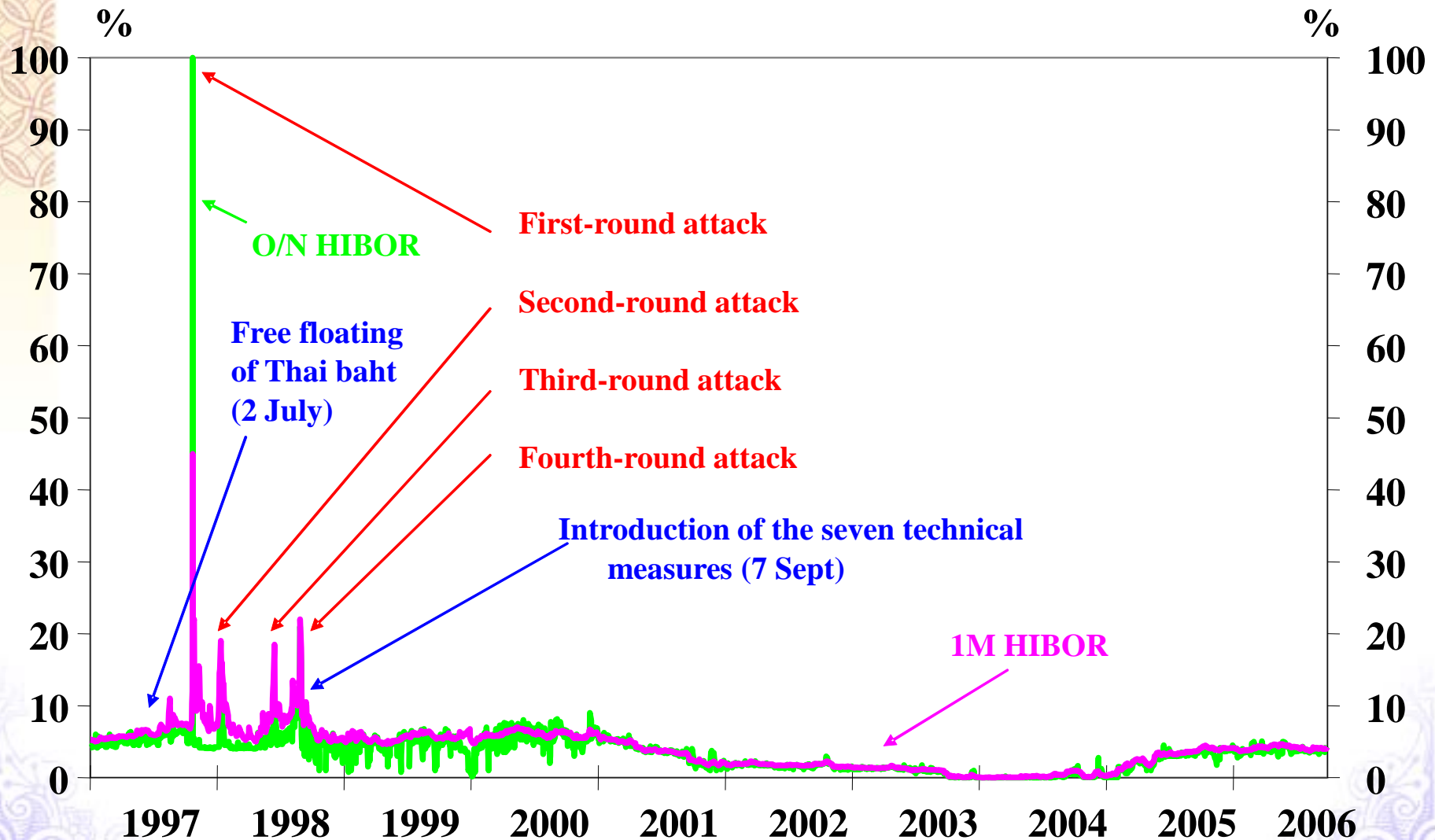
Background on seven technical measures in 1998

Market concerns :

- ❖ Asian financial crisis
- ❖ Rumours of renminbi devaluation, market scepticism on the commitment to the Link
- ❖ A lot of Hong Kong dollar short-selling activities, tight interbank liquidity and high interest rate volatility

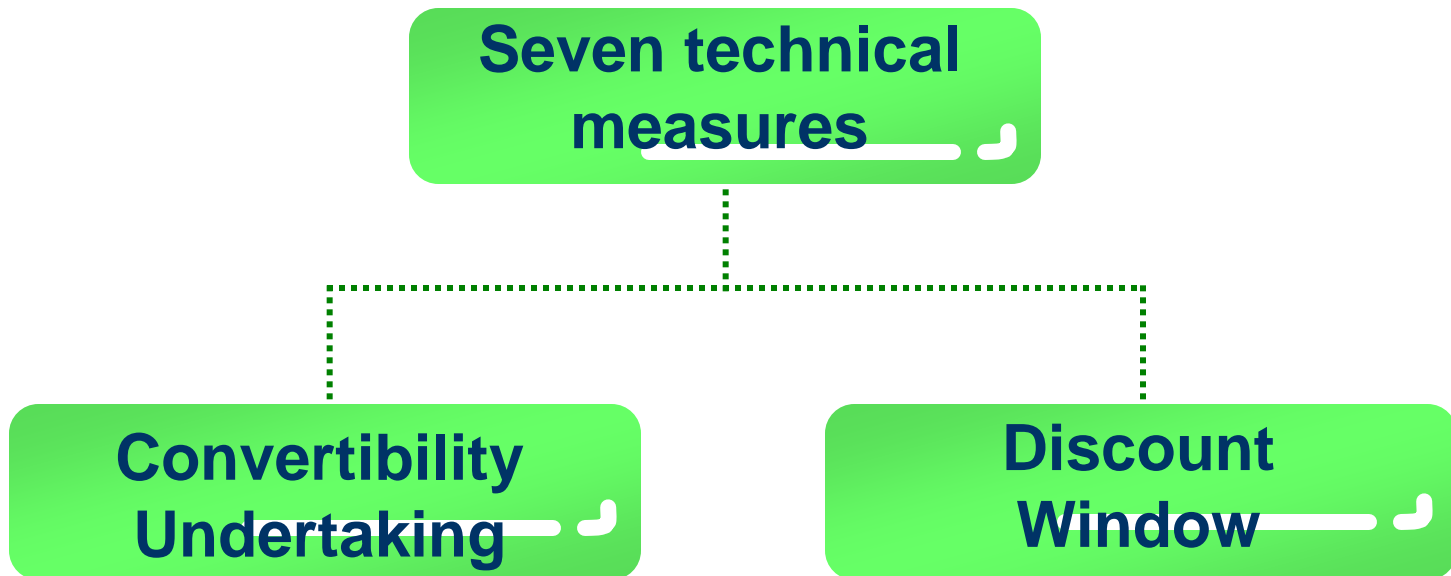


Interest rates movement during the Asian Financial Crisis



Seven technical measures

Introduced in September 1998 to strengthen the Currency Board arrangement

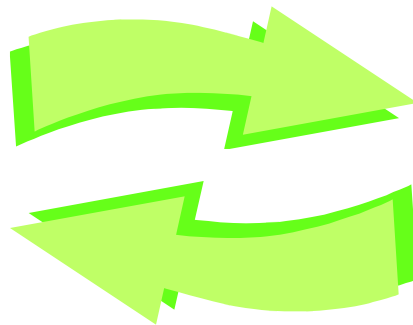


Weak-side Convertibility Undertaking

HKMA



US dollar



Hong Kong dollar

Bank



US\$1 = HK\$ 7.80

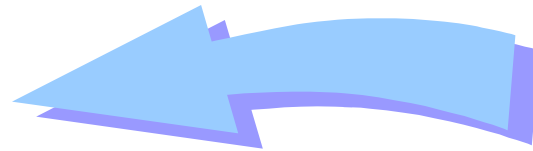
Clarify commitment to the Linked Exchange Rate system

Discount Window

Bank



HKMA



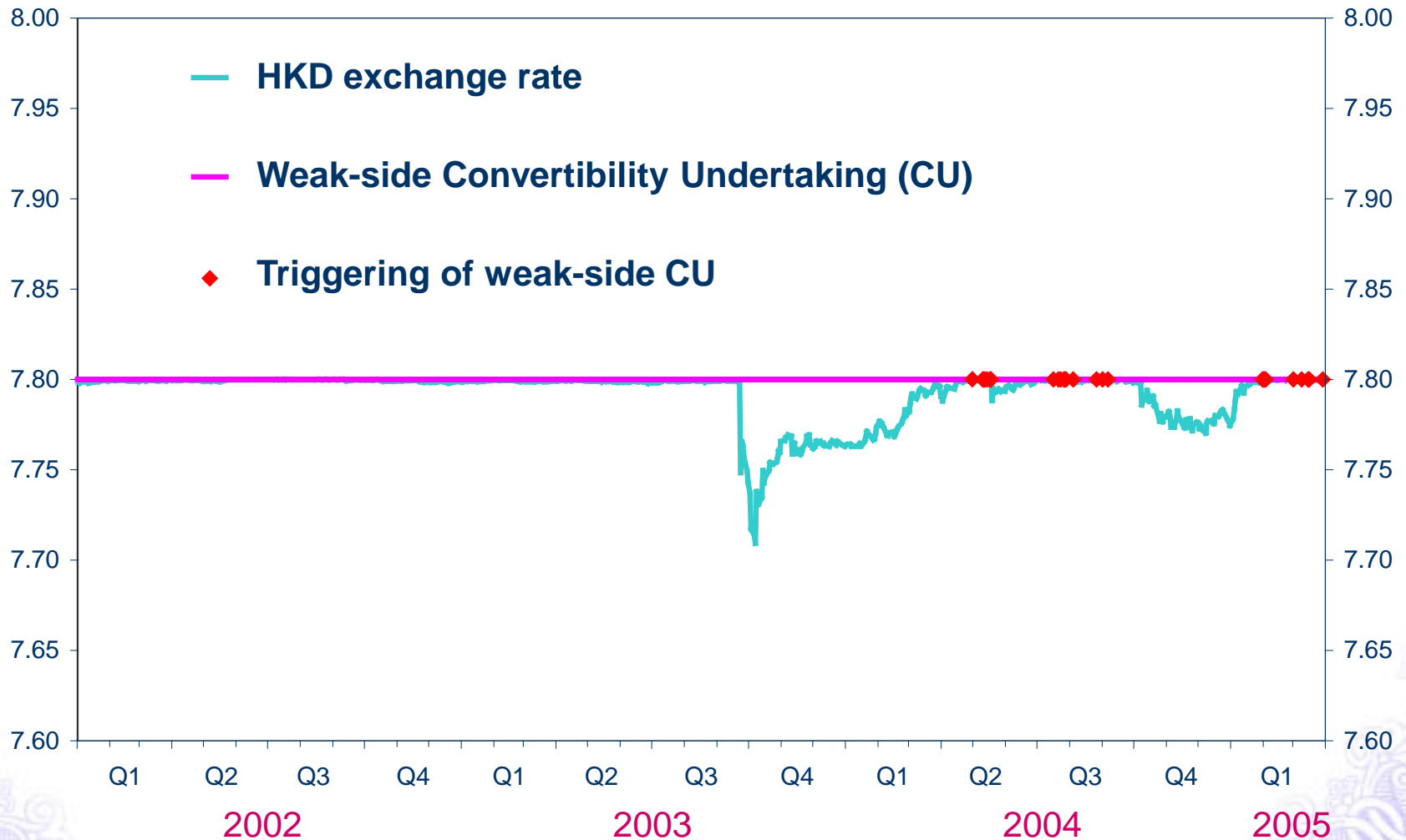
Banks can use Exchange Fund paper as collateral to arrange repo agreement with the HKMA for liquidity management (4:30 p.m. daily)

Avoid excessive interest rate volatility and allows orderly adjustment

FX market development in 2002-05

HK\$/US\$

HK\$/US\$



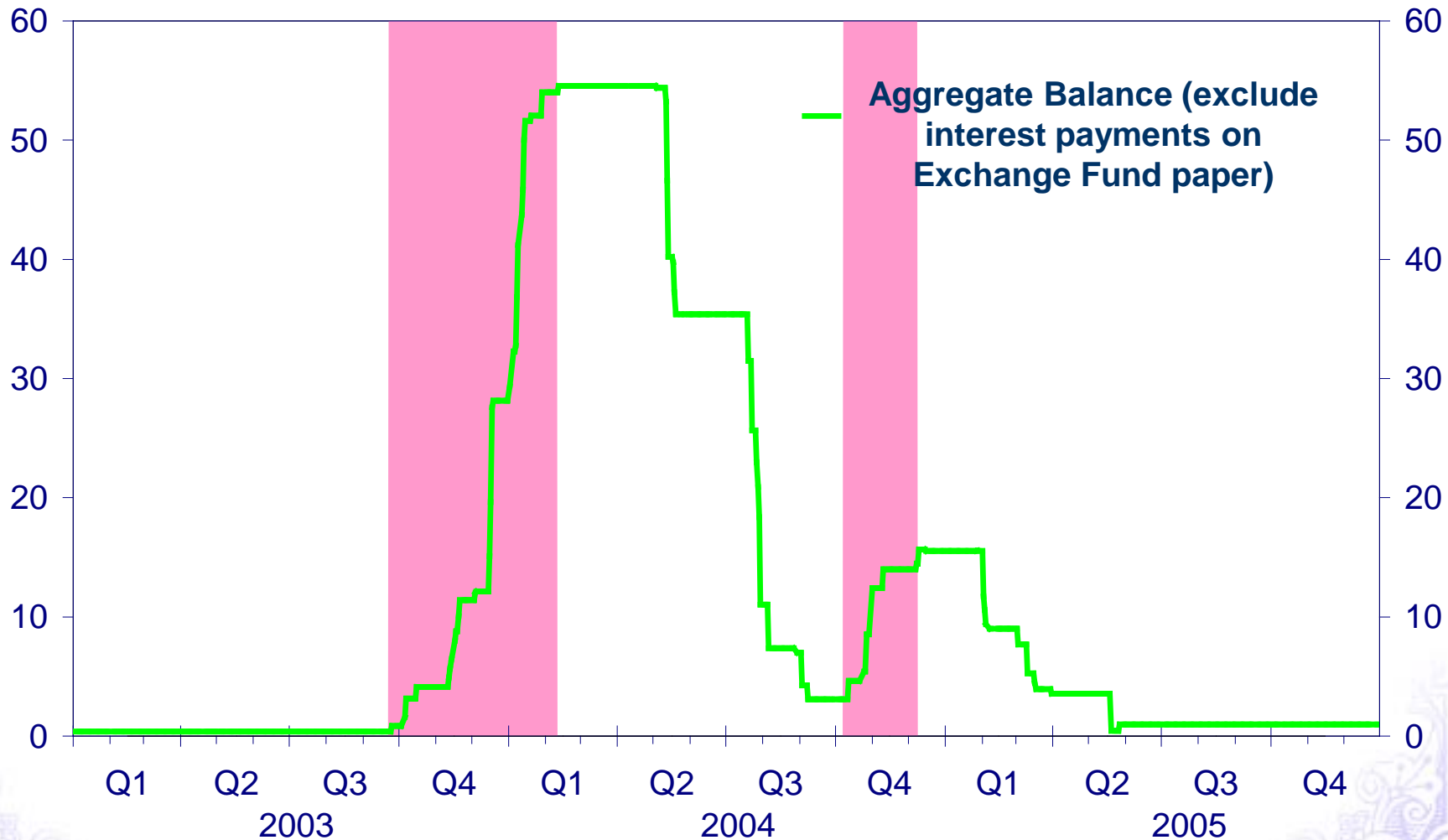
Background on three refinements in 2005

- ❖ **Expectations on renminbi appreciation**
- ❖ **Hong Kong's economic recovery**
- ❖ **Depreciation of the US dollar**

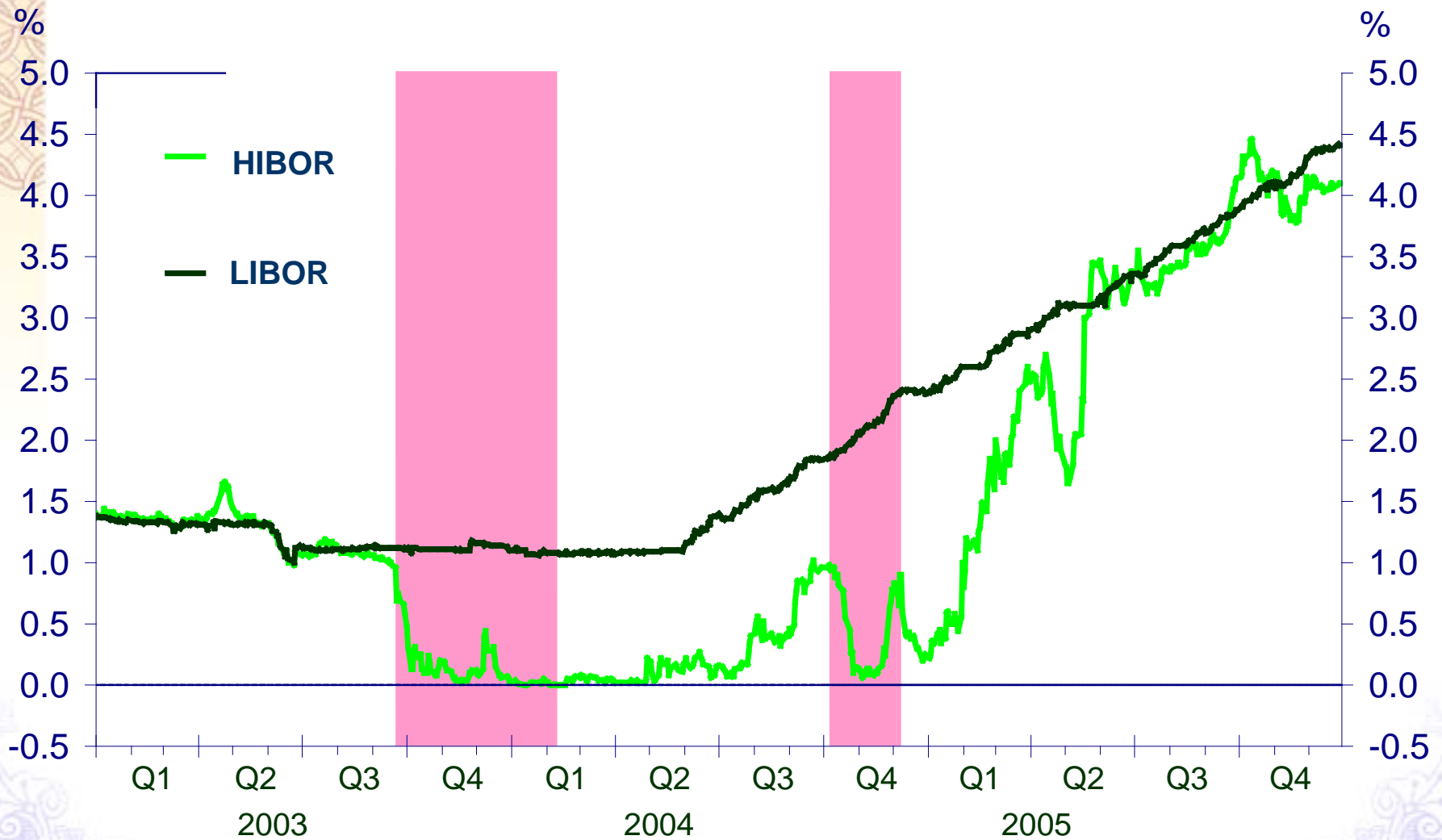
Aggregate Balance

HK\$ billion

HK\$ billion



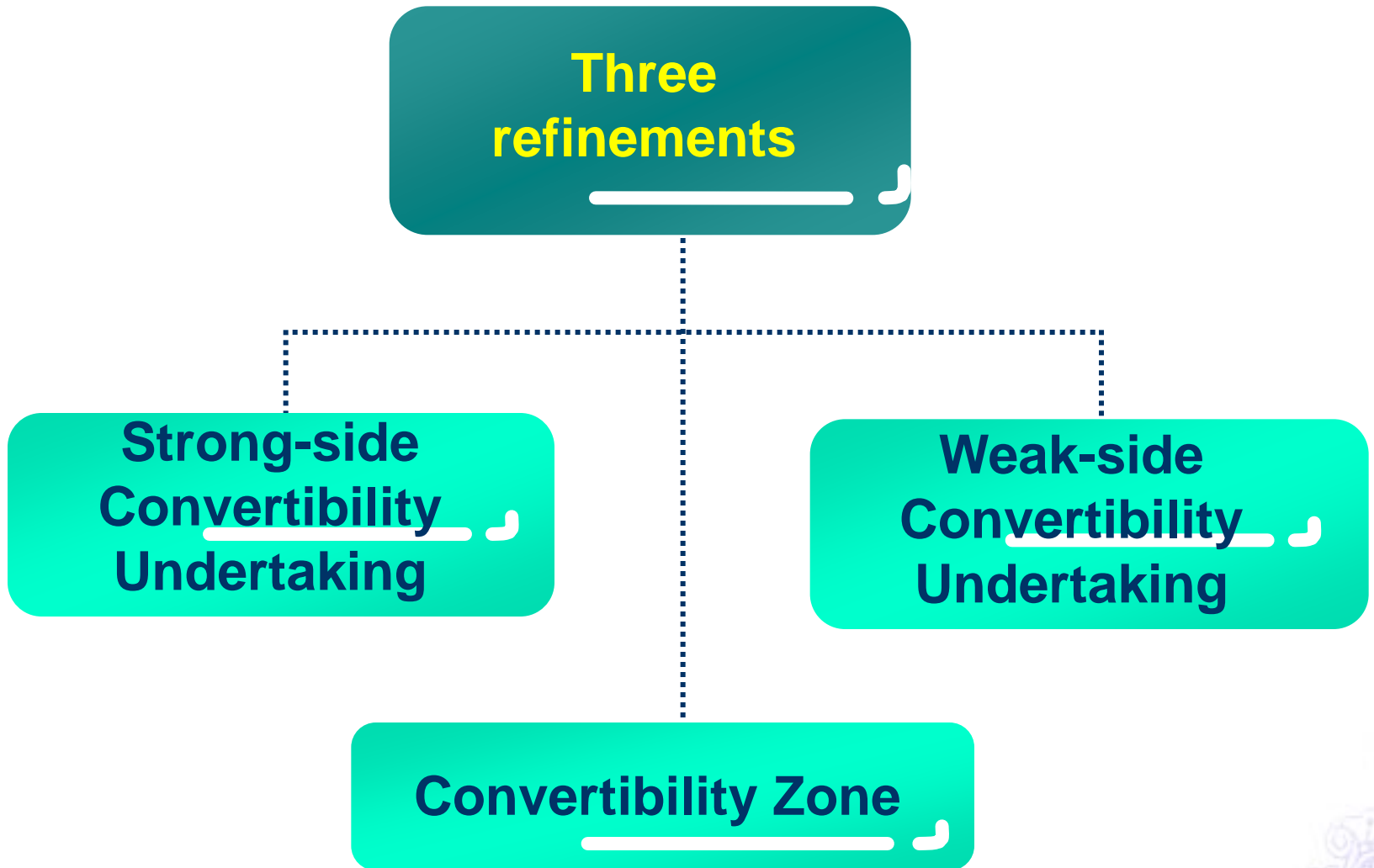
HKD & USD interest rates



Impact of easy monetary conditions

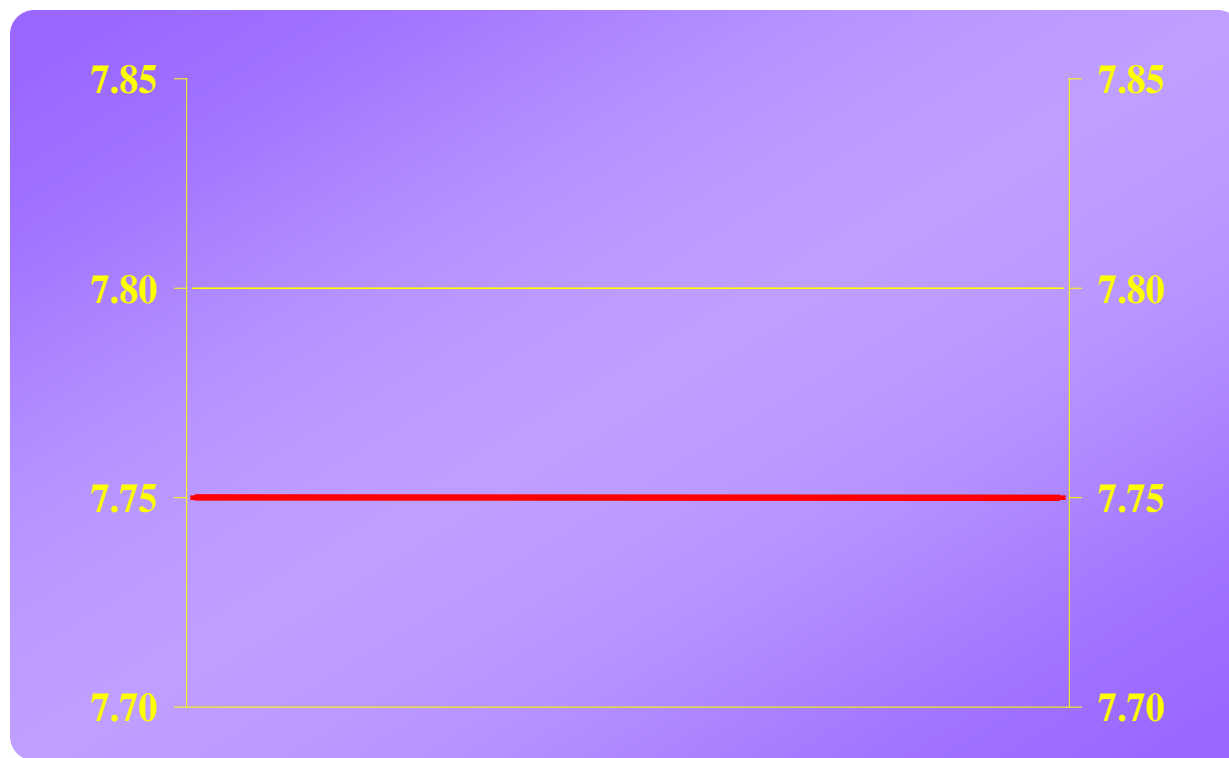
- ❖ **Risk of inflation and formation of asset bubble**
- ❖ **Destabilising effect associated with realignment of HKD interest rates with USD rates**

Three refinements



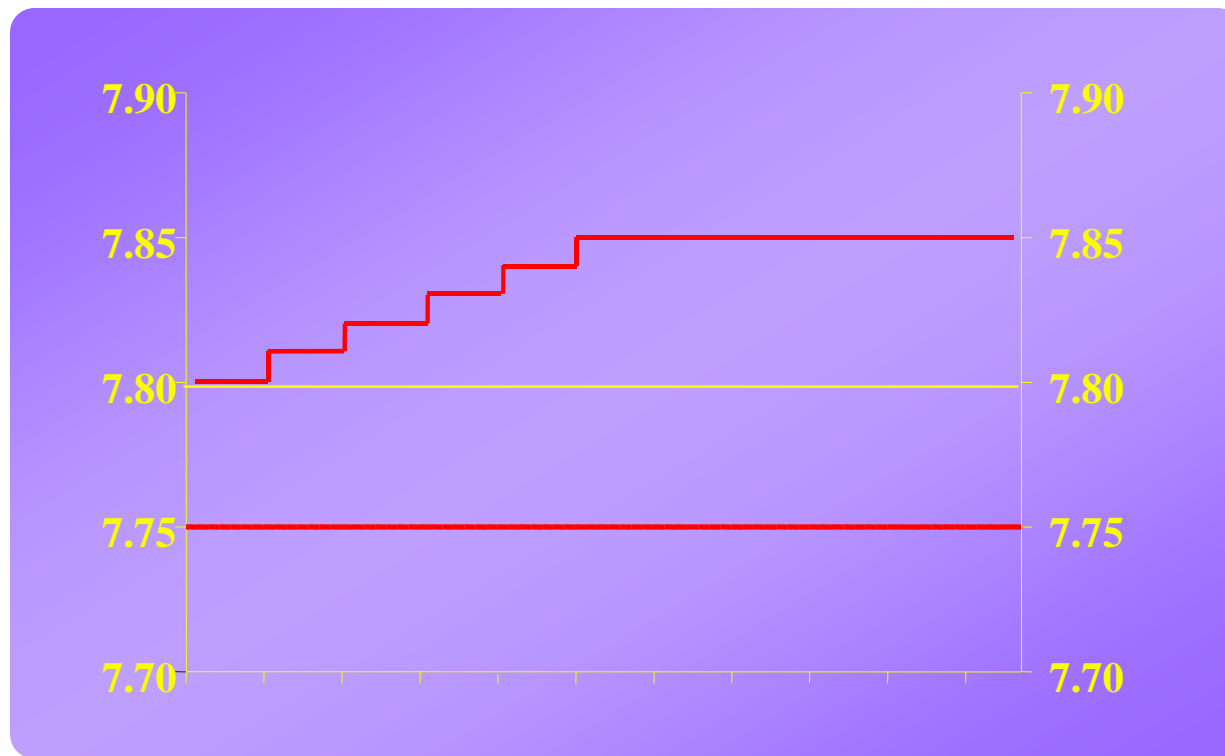
Three refinements (1)

The HKMA undertakes to buy US dollar from banks at HK\$7.75/US\$1



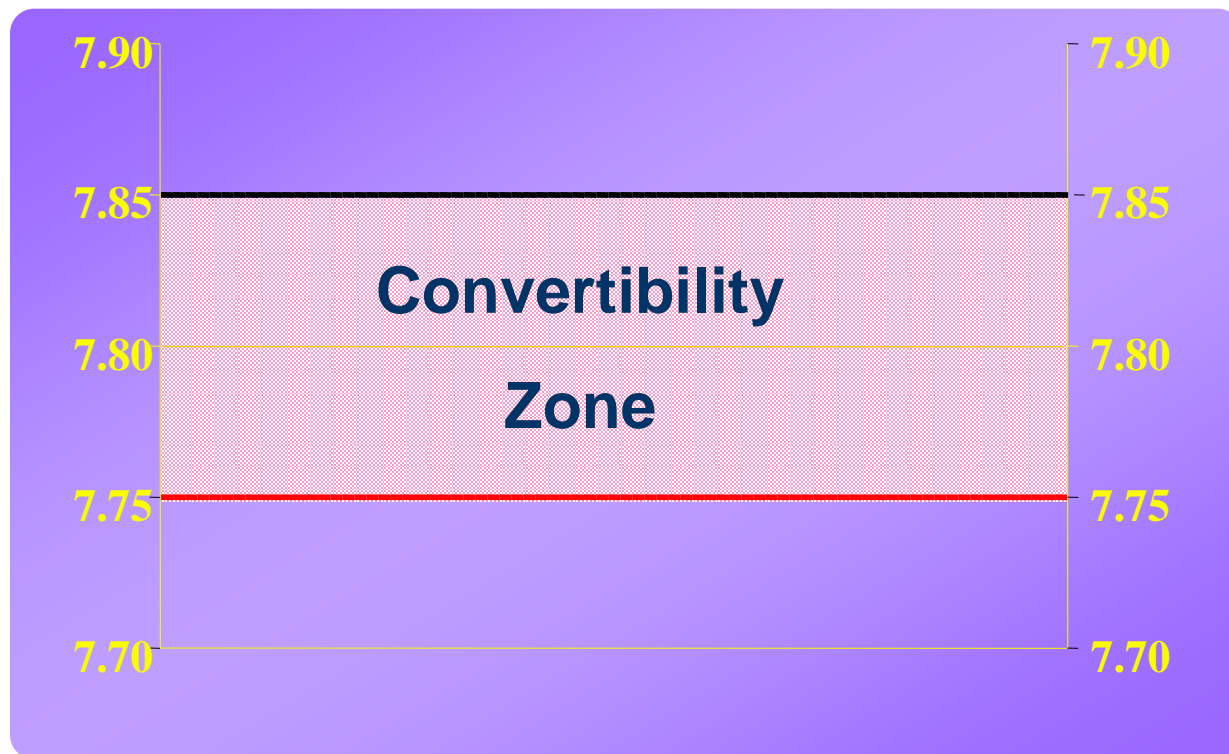
Three refinements (2)

Gradually move the weak-side Convertibility Undertaking from 7.80 to 7.85



Three refinements (3)

Establish a Convertibility Zone, within which the HKMA can conduct discretionary monetary operations

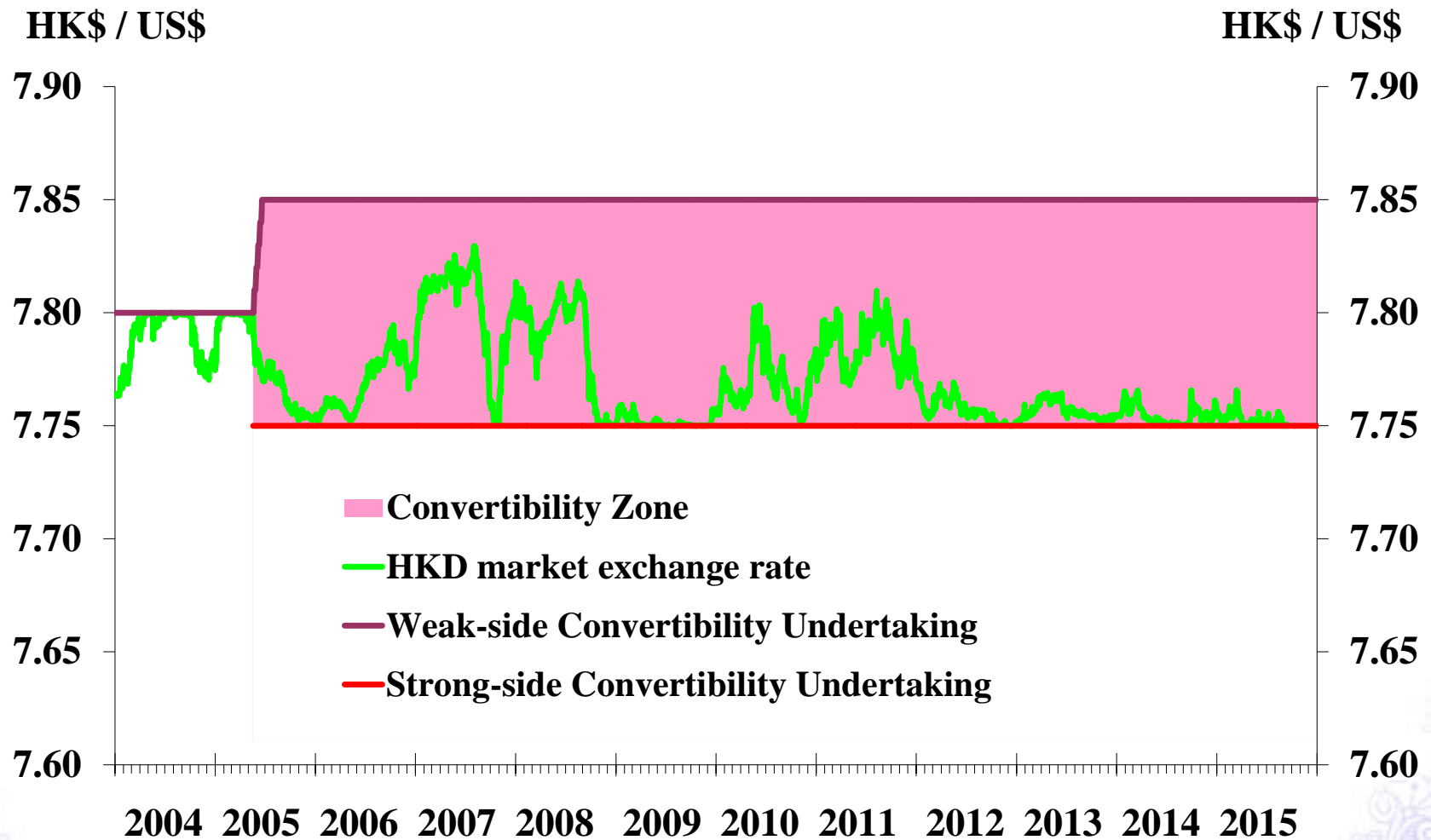


Effects of the three refinements

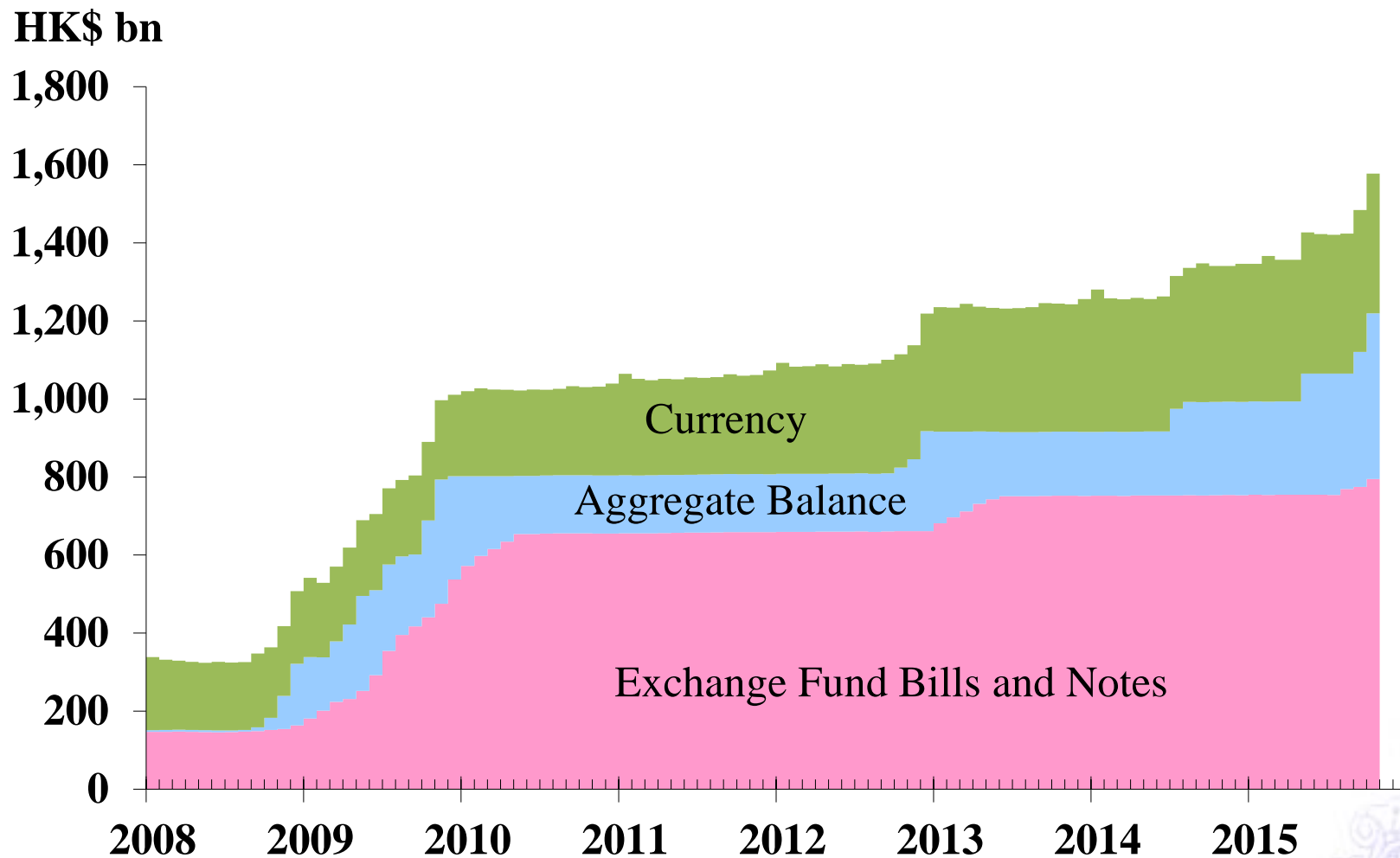
- ❖ Remove uncertainty about appreciation potential of the Hong Kong dollar
- ❖ HKD interest rates closer to USD rates
- ❖ Strengthen the operation of the Linked Exchange Rate system



Hong Kong dollar exchange rate



Monetary Base



Conclusion

- ❖ The Linked Exchange Rate system is a cornerstone for maintaining economic stability

- ❖ Economic underpinnings

- ❖ Ample forex reserves

- ❖ Flexible economic structure

- ❖ Prudent fiscal policy stance

- ❖ Sound banking system

