

Press Release

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Record of Discussion of the Meeting of the Exchange Fund Advisory Committee Currency Board Sub-Committee held on May 13 2005

(Approved for Issue by the Exchange Fund Advisory Committee on
May 26 2005)

Report on Currency Board Operations (April 1– April 28 2005)

The Sub-Committee noted that the Hong Kong dollar had strengthened briefly in late April. Part of the explanation for this could be increased expectations of a change in Mainland China's exchange rate arrangements in the near future. Interbank interest rates had eased, and the Monetary Base had declined from HK\$287.31 billion to HK\$284.74 billion during the reporting period, largely as a result of a decline in the outstanding amount of Certificates of indebtedness. Members noted that the Backing Ratio had hit the Upper Trigger Level of 112.5% in mid-March, when, in accordance with the triggering arrangements, assets had been transferred out of the Backing Portfolio to the Investment Portfolio in order to reduce the Backing Ratio to 110%.

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 during the reporting period.

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

Monitoring of Risks and Vulnerabilities

Members noted that growth in the region continued to be solid, but that there has been a slowing of growth in the US. Domestic demand and inbound tourism had continued to show expansion in Hong Kong. Members also considered a special analysis examining recent developments in the property market, making use of the graphical framework developed by the HKMA. The indicators suggested that the risk of another residential property bubble continued to be low for the time being. However, the increase in “confirmor” transactions pointed to a rise in the speculative demand for housing, and easy monetary conditions and their subsequent reversal might lead to sharp fluctuations in asset prices.

Convertibility Arrangements for the Aggregate Balance

The Sub-Committee considered a paper re-examining the convertibility arrangements for the Aggregate Balance. Members

noted that the Hong Kong dollar had been under strong-side pressures since late 2003 and that these pressures were likely to persist as the Hong Kong dollar continued to be used as a vehicle for speculation on a revaluation of the renminbi. Members considered what refinements might be introduced to remove the uncertainty about the extent to which the exchange rate might strengthen under the Linked Exchange Rate system and to promote the smooth functioning of the money and foreign exchange markets in accordance with Currency Board arrangements, in particular by helping to ensure that Hong Kong dollar interest rates tracked more closely their US dollar counterparts.

Taking into account the recent experience with strong-side operations, the Sub-Committee considered that there was room for strengthening the operations on the strong side of the Linked Exchange Rate and advised that, in the light of changed market conditions, there was now a case for introducing a strong-side convertibility undertaking for the Aggregate Balance in addition to the existing weak-side Convertibility Undertaking. The Sub-Committee advised that, taking into account the monetary policy objective of achieving a stable external exchange value of the Hong Kong dollar at around HK\$7.80 to US\$1, the two Convertibility Undertakings should be symmetrically positioned around the Linked Rate of 7.80. Members noted that this would involve shifting the existing weak-side Convertibility Undertaking above 7.80 and advised that, in order to address possible market concerns, the shift could be carried out in a gradual manner.

Members considered that the actual width between the two Convertibility Undertakings should be set having regard to the desire, on the one hand, to avoid excessive exchange rate volatility by imposing too great a width, and, on the other hand, to avoid displacing foreign exchange business involving the Hong Kong dollar by imposing too small a width. Members advised that, within the Convertibility Zone bounded by the two Convertibility Undertakings, it would be appropriate for the HKMA to conduct market operations aimed at promoting the smooth functioning of the Linked Exchange Rate system, for example, by removing any market anomalies that might arise from time to time. Members advised that these operations should be conducted in strict conformity with Currency Board principles: both the stock and changes in the Monetary Base would be fully backed by foreign exchange reserves at the level of the Linked Exchange Rate; and the impact on the Aggregate Balance arising from any market operations would be announced immediately, with the relevant information included in the monthly Reports on Currency Board Operations to the Sub-Committee, which were subsequently published on the HKMA website and in the HKMA's Quarterly Bulletin.

Members further considered the question of whether there should be transferability between the Certificates of Indebtedness, issued under the Exchange Fund Ordinance as cover for the banknotes issued by the note-issuing banks, and the Aggregate Balance.

Members advised that this question should be further researched into by the HKMA, in consultation with the three note-issuing banks, with

a view to producing practical proposals for the Sub-Committee's consideration.

The Relationship between commodity and Consumer Prices in Mainland China and Hong Kong

The Sub-Committee considered a paper presenting the empirical results of a study of whether changes in commodity prices were a leading indicator of future Consumer Price Index (CPI) inflation in Mainland China and Hong Kong. The results suggested that changes in non-oil commodity prices had significant predictive power for headline CPI inflation, while changes in oil prices were not significant. The impact of a 1% rise in non-oil commodity prices was associated with a larger increase in future CPI inflation in Hong Kong and Mainland China than was typically found in other economies such as the US. There were several explanations for this. First, these economies were highly open (especially Hong Kong), and so the domestic business cycle was highly synchronised with the global business cycle. Consequently, one might expect a close correlation between measures of domestic and global inflation. Secondly, food prices accounted for a larger share of the CPI basket in Hong Kong and Mainland China than in the US, so that global food price shocks tended to have a larger effect on CPI inflation, other things being equal. Thirdly, production processes in Mainland China were commodity-intensive.

For further enquiries, please contact:

Jasmin Fung, Manager (Press), at 2878 8246 or

Hing-Fung Wong, Resource Co-ordinator, at 2878 1802

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