



HONG KONG MONETARY AUTHORITY

**Refinements to the Operation of the
Linked Exchange Rate System**

4 July 2005



REVIEW OF MONETARY CONDITIONS (I)

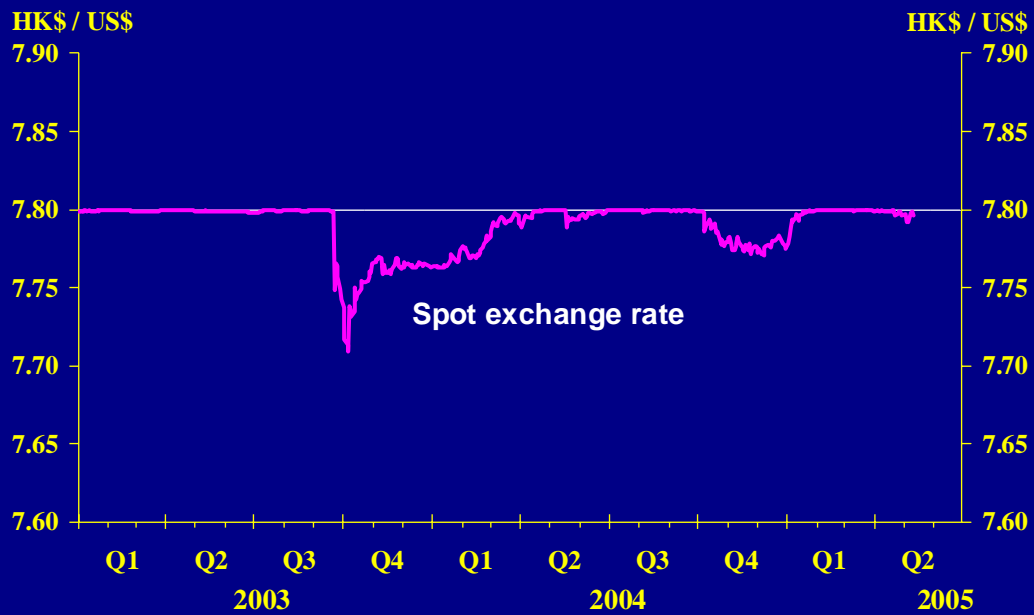


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- 12-month Hong Kong dollar forwards tracking closely the movement of 12-month renminbi non-deliverable forwards (NDF). Increasing use of the Hong Kong dollar as a vehicle for speculation on the revaluation of the renminbi.
- Pressures on revaluation of renminbi intensified as reflected in the widening of the discount of 12-month renminbi NDF to -5000 pips.
- Inflows into Hong Kong are likely to get stronger and more persistent should there be any change to the renminbi exchange rate regime.



REVIEW OF MONETARY CONDITIONS (II)

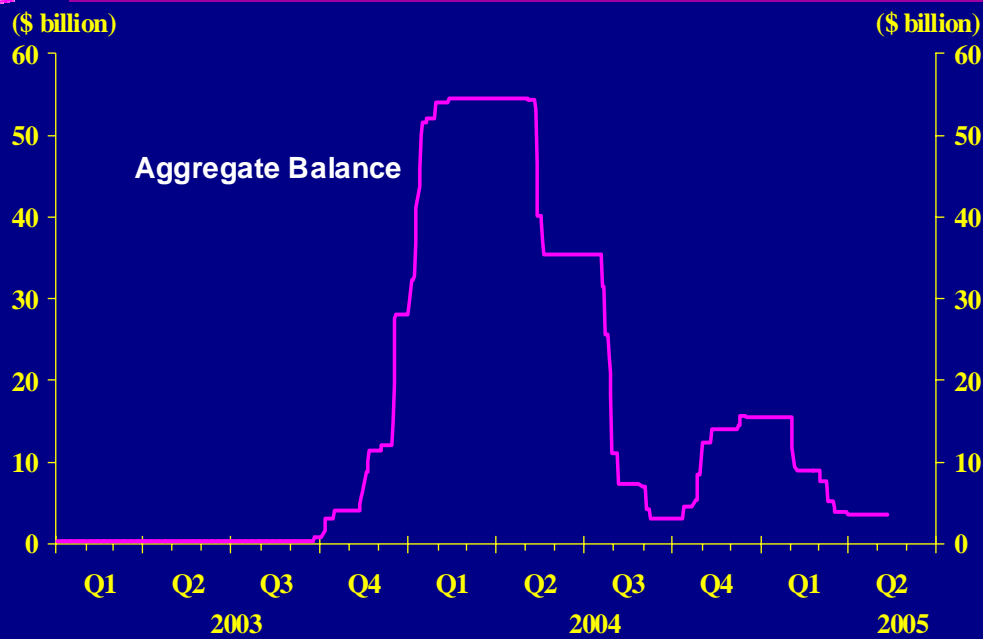


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- The effects of the repeated episodes of capital inflow and pressure for the Hong Kong dollar to strengthen, which started in 2003 Q3, lingered on as market attention on renminbi grew.
- The Currency Board system functioned reasonably well, with the interest rate differential in time reversing the capital inflows and triggering the weak-side Convertibility Undertaking (CU). The situation had not, however, returned entirely to normal, and relatively easy monetary conditions continued to prevail.



REVIEW OF MONETARY CONDITIONS (III)

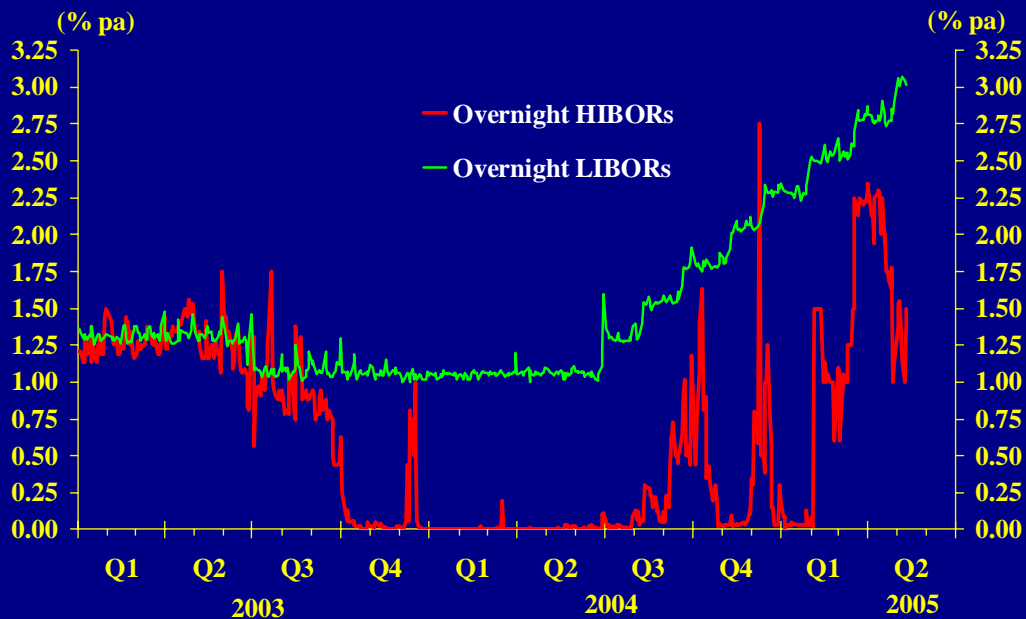


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- Easy monetary conditions had already prevailed for over 18 months. Although the Aggregate Balance declined to \$3.8 billion on 20 April as a result of some arbitrage activities in 2005 Q1, this was still in multiples of the normal level required for the smooth payment and settlement among banks.
- Persistent market expectation on renminbi revaluation and the complex market dynamics in the foreign exchange market had prevented the Aggregate Balance from returning to normal.



REVIEW OF MONETARY CONDITIONS (IV)



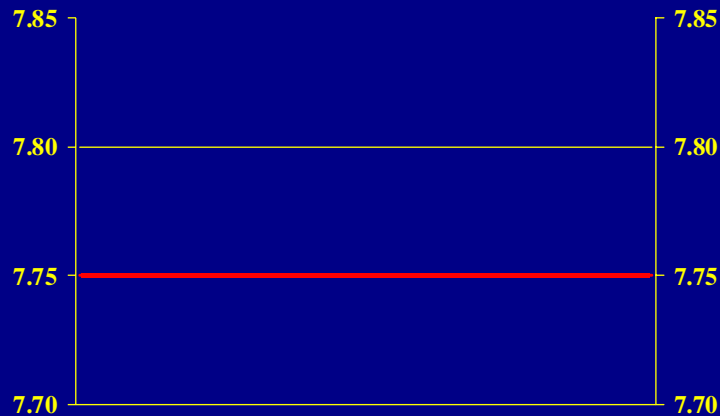
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- Hong Kong dollar interbank interest rates (HIBOR) persistently stayed below their US dollar counterparts throughout the period since 2003 Q3.
- Despite some narrowing of the interest rate differential between Hong Kong and the US as a result of the triggering of the weak-side CU in 2005 Q1, a significant gap still existed between Hong Kong and US dollar interest rates in early May 2005.
- Under the Linked Exchange Rate system, it is possible that domestic monetary condition may deviate from that of the anchor currency if there are market expectations of revaluation or devaluation. This is part of the normal adjustment through the real side of the economy under the Currency Board arrangements.
- But we are concerned that there could be structural factors in the system or the market that might frustrate the effective functioning of the adjustments under the Currency Board arrangements.
- Market conditions at that time pointed to one such structural factor: the lack of a clear anchor on exchange rate expectation on the strong side, given that there was no explicit CU on the strong side. This had discouraged the interest rate arbitrage activities which helped the adjustments in the money and foreign exchange markets under the Currency Board arrangements because gains on interest rate arbitrage could be quickly wiped out by losses from the strengthening of the Hong Kong dollar. This concern was further aggravated by persistent market expectations of an appreciation of the renminbi.
- There is therefore a need to consider whether refinements to the Currency Board arrangements are needed to ensure that they could facilitate adjustments in the money and foreign exchange markets in the most efficient manner.



THREE REFINEMENTS TO THE OPERATION OF THE LINKED EXCHANGE RATE SYSTEM (I)

- **A strong-side Convertibility Undertaking by the HKMA to buy US dollars from licensed banks at 7.75**



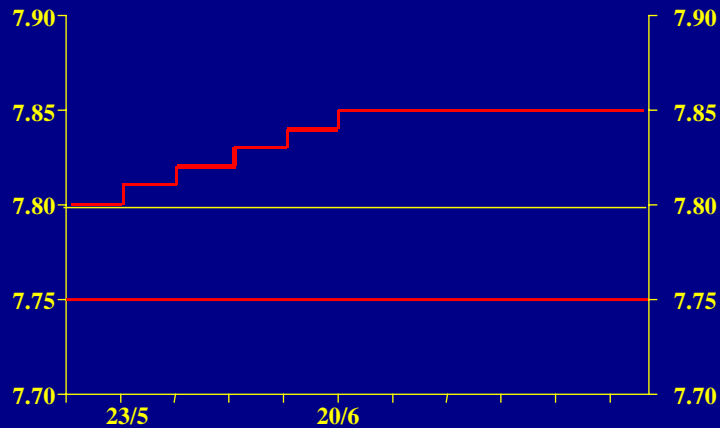
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- The HKMA announced on 18 May 2005 the introduction, with the agreement of the Financial Secretary following consultation with the Exchange Fund Advisory Committee, of three refinements to the operation of the Linked Exchange Rate system.
- The refinements are aimed at removing uncertainties about the extent to which the exchange rate may strengthen under the Linked Exchange Rate system and promoting the smooth functioning of the money and foreign exchange markets in accordance with Currency Board arrangements.
- The first refinement is the introduction with immediate effect of a strong-side CU by the HKMA to buy US dollars from licensed banks at 7.75.



THREE REFINEMENTS TO THE OPERATION OF THE LINKED EXCHANGE RATE SYSTEM (II)

- **Shifting the weak-side Convertibility Undertaking by the HKMA to sell US dollar to licensed banks from 7.80 to 7.85 in a gradual manner (100 pips per week from 23 May 2005 to 20 June 2005)**



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- The second refinement is the shifting of the existing weak-side CU by the HKMA to sell US dollars to licensed banks from 7.80 to 7.85, so as to achieve symmetry around the Linked Rate of 7.80. This shift had been completed smoothly over five weeks by moving the exchange rate of the weak-side CU by 100 pips on every Monday starting with 7.81 on 23 May 2005 until it reached 7.85 on 20 June 2005.



THREE REFINEMENTS TO THE OPERATION OF THE LINKED EXCHANGE RATE SYSTEM (III)

- **Introduction of a Convertibility Zone within which market operations may be conducted consistent with Currency Board principles**

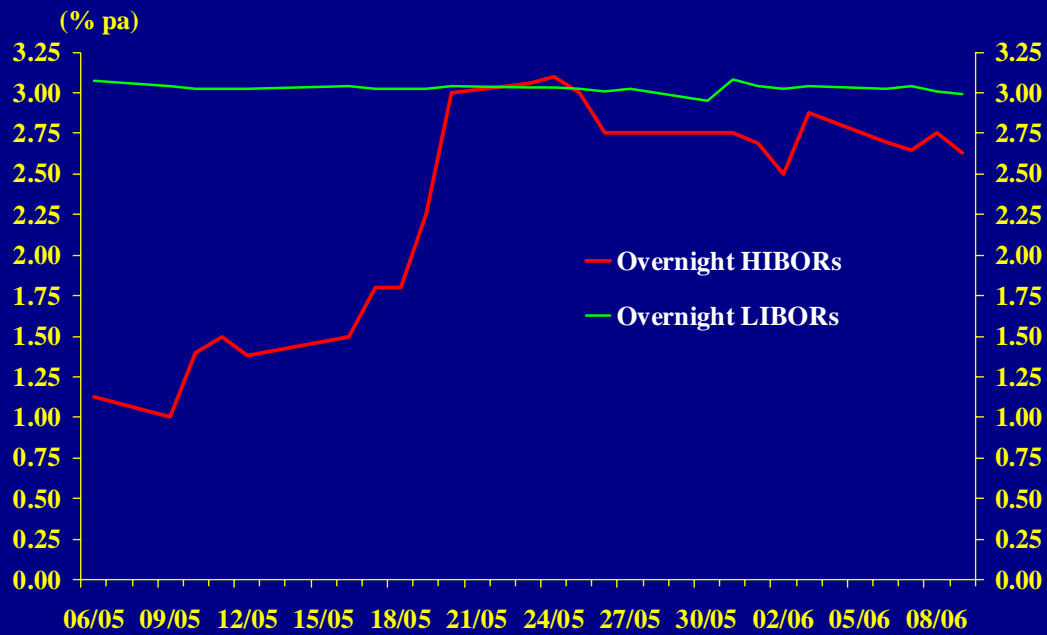


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- The third refinement is that within the zone defined by the levels of the CUs (the Convertibility Zone), the HKMA may choose to conduct market operations consistent with Currency Board principles. These market operations shall be aimed at promoting the smooth functioning of the Linked Exchange Rate system, for example, by removing any market anomalies that may arise from time to time.



THE LATEST MONETARY CONDITIONS



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- After the introduction of the three refinements, the exchange rate has remained stable. The Aggregate Balance declined quickly. Hong Kong dollar interest rates have risen to levels close to US dollar rates.