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Press Release

Issues in Monetary Policy: Speech by Mr Joseph Yam

In a speech entitled “Issues in Monetary Policy” delivered at a luncheon today (19 January) organised jointly by the Hong Kong University Foundation for Educational Development and Research and the Hong Kong University Faculty of Business Economics, Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority (HKMA), said that the HKMA had no concerns about the recent strengthening of the Hong Kong dollar or about the size of the Aggregate Balance. “Whatever the reason for the recent strong tone of the Hong Kong dollar, I consider it a much more pleasant problem to deal with than a currency exhibiting a tendency to weaken,” Mr Yam said.

Mr Yam said that, on the strong side, Hong Kong’s Currency Board arrangements translated currency strength arising from capital inflow into an expansion of the Monetary Base, more foreign reserves and lower domestic interest rates. As US dollars were sold to the Exchange Fund, the Aggregate Balance of the Hong Kong dollar clearing accounts of banks correspondingly increased and interest rates in the interbank market fell.

Mr Yam said that there was no limit to the amount of domestic money that could be created if the demand existed. As long as banks wanted to sell US dollars to the HKMA, for the Currency Board account of the Exchange Fund, at the exchange rate determined by the HKMA, the HKMA had to create those Hong Kong dollars. “There is no limit to the size of the Aggregate Balance. Nor is there any concern on our part about its size. We take no view on what its size should be,” said Mr Yam.

Mr Yam outlined two possible scenarios under which the current episode of Hong Kong dollar strength would play out. The first was for the Aggregate Balance, which earned no interest for the banks, to increase to a size in which the total opportunity cost for holding on to it became too significant for the banking system as a whole. The alternative was for banks to switch out of Hong Kong dollars into foreign assets earning some return, although this carried with it the risk of a sudden appreciation of the Hong Kong dollar.

The second scenario was to increase the risk-adjusted opportunity cost. Mr Yam said that the HKMA had the powers to introduce charges on large balances maintained by banks in their clearing accounts held with the HKMA, so that the interest rate differential between holding Hong Kong dollars and holding US dollars became a lot higher than the current one. Outflow from the Hong Kong dollar would then be generated, the exchange rate would weaken, US dollars would be sold at 7.80 and the Aggregate Balance would return to a more normal level. Hong Kong dollar interest rates would also be more in line with those for the US dollar.

Mr Yam said that whether banks would pass on such charges, which amounted to the imposition of negative interest rates, to the small depositors or not was a commercial decision for each bank to take. However, there seemed to him no reason why they should. “The customer deposit base of a bank is far greater than the clearing balance. There is scope for banks to arrange matters in a way that would not affect ordinary depositors, for example, by passing the charges on only to very large depositors,” said Mr Yam.

He added that the HKMA was not currently contemplating taking action that would lead to this second scenario developing. Low interest rates were helpful to economic recovery, and there did not seem to be any sign of excessive credit creation.

However, Mr Yam added that there was a variation of the first scenario. The HKMA could take the exceptional step of mopping up the large pool of Hong Kong dollars in the Aggregate Balance, or part of it, through the issue of more Exchange Fund paper. Since the paper that would replace the Aggregate Balance in this manner would be fully backed by US dollar reserves and would still be part of the Monetary Base, the Currency Board rules would continue to be observed. This would in effect be a mechanism for preventing or mitigating the emergence of extreme monetary conditions on the strong side, and one that would be symmetrical to the cushion afforded on the weak side by the same pool of Exchange Fund paper eligible for accessing the Discount Window. Mr Yam said that the HKMA kept an open mind on this possibility.

Mr Yam also addressed the question of whether a more formal convertibility undertaking on the strong side of the Link was desirable. He said that there were pros and cons for retaining some discretion in the determination of the intervention level on the strong side. On the one hand, the constructive ambiguity inherent in discretion inhibited speculative shorting of the Hong Kong dollar by making it difficult to calculate the downside risk involved. On the other hand, the total absence of discretion could enhance further the credibility of the system, although it would also limit the downside risks of currency speculation. He noted that these subjects had been reviewed periodically by the Currency Board Sub-Committee of the Exchange Fund Advisory Committee.

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