How the Link works

Hong Kong's Linked Exchange Rate system is a currency board system, which requires both the stock and flow of the monetary base to be fully backed by foreign reserves. This means that any change in the monetary base is fully matched by a corresponding change in foreign reserves at a fixed exchange rate. In Hong Kong, the Monetary Base comprises:

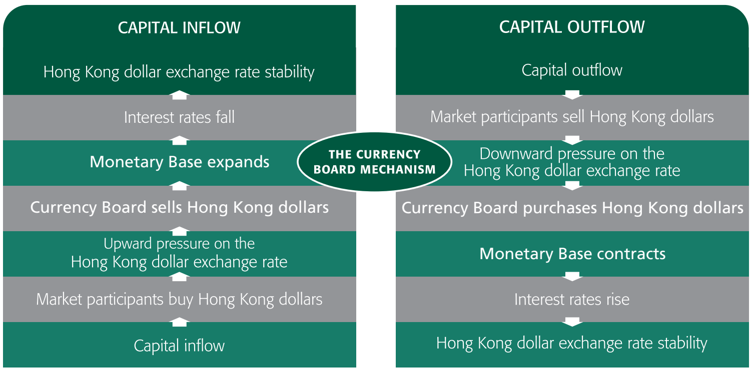
- **Certificates of Indebtedness**, which exactly back the banknotes issued by the note-issuing banks
- **Government-issued notes and coins in circulation**
- **Aggregate Balance**, which is the sum of the balances of the clearing accounts of banks kept with the HKMA
- **Exchange Fund Bills and Notes**, which are issued by the HKMA on behalf of the Government.

Most banknotes in Hong Kong are issued by three note-issuing banks. When the note-issuing banks issue banknotes, they are required by law to purchase Certificates of Indebtedness, which serve as backing for the banknotes issued, by submitting an equivalent amount of US dollars at the rate of HK$7.80 to one US dollar to the HKMA for the account of the Exchange Fund. The Hong Kong dollar banknotes are therefore fully backed by US dollars held by the Exchange Fund. Conversely, when Hong Kong dollar banknotes are withdrawn from circulation, Certificates of Indebtedness are redeemed and the note-issuing banks receive an equivalent amount of US dollars from the Exchange Fund. In the case of notes and coins issued by the Government through the HKMA, transactions between the HKMA and the agent bank responsible for storing and distributing the notes and coins to the public are also settled against US dollars at the rate of HK$7.80 to one US dollar.

Operating under the Currency Board system, the only normal circumstance in which the Aggregate Balance varies is when the HKMA responds to the flow of funds into or out of the Hong Kong dollar.

On 18 May 2005 the HKMA introduced a strong-side Convertibility Undertaking to buy US dollars from licensed banks at HK$7.75 to one US dollar, and announced the shifting of the existing weak-side Convertibility Undertaking from HK$7.80 to HK$7.85, so as to achieve symmetry around the Linked Rate of HK$7.80. Within the Convertibility Zone defined by the levels of the Convertibility Undertakings, the HKMA may choose to conduct market operations consistent with Currency Board principles with the aim of promoting the smooth functioning of the money and foreign exchange markets. The strong-side Convertibility Undertaking to buy US dollars removes the uncertainty about the extent to which the exchange rate may strengthen. This increases the sensitivity of the flow of funds into and out of the Hong Kong dollar to the interest rate differential between the Hong Kong dollar and the US dollar.

Under the Currency Board system, it is interest rates rather than the exchange rate which adjust to inflows or outflows of funds. The Monetary Base increases when the foreign currency (in Hong Kong's case, the US dollar) to which the domestic currency is linked, is sold to the Currency Board for the domestic currency (capital inflow). It contracts when the foreign currency is bought from the Currency Board (capital outflow). The expansion or contraction in the Monetary Base causes interest rates for the domestic currency to fall or rise respectively, creating the monetary conditions that automatically counteract the original capital movement, while the exchange rate remains stable. This process is very much an automatic mechanism.



To reduce excessive interest rate volatility, a cushion of liquidity is provided by the Discount Window facility, through which banks can obtain overnight liquidity from the HKMA by arranging repurchase agreements using Exchange Fund paper and other eligible securities as collateral. The Base Rate of the Discount Window, which is the interest rate forming the foundation upon which the Discount Rates for repo transactions are computed, is set according to a pre-announced formula that takes into account the US Fed funds target rate and Hong Kong Interbank Offered Rates.[3] The practice of backing Exchange Fund paper by foreign exchange reserves ensures that Hong Kong dollar liquidity created by this process is also automatically backed by foreign exchange reserves in accordance with Currency Board principles.

[3] Technical details on the operation of the Discount Window are contained in the article "Strengthening of Currency Board Arrangements in Hong Kong", *Hong Kong Monetary Authority Quarterly Bulletin*, November 1998. A soft copy of the publication is available on the HKMA website (www.hkma.gov.hk).

Hong Kong's Currency Board system is overseen by the Currency Board Sub-Committee of the Exchange Fund Advisory Committee, which meets regularly to monitor the operation of the system and to consider ways of improving it. The Sub-Committee is composed of expert academics, market professionals and senior officials from the HKMA. In keeping with the HKMA's policy of transparency, the records of the Sub-Committee's meetings are published, and a large proportion of the papers considered by it are reproduced in the HKMA's *Quarterly Bulletin*. The Currency Board Accounts have, since March 1999, been published every month.