

Monetary Stability

Despite the lingering uncertainties surrounding the COVID-19 pandemic and increased concerns about the pace of US monetary tightening, the Hong Kong dollar exchange and money markets continued to trade in a smooth and orderly manner. As the cornerstone of Hong Kong's monetary and financial stability since it was implemented in 1983, the Linked Exchange Rate System has shown its strength and resilience to external shocks.



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OBJECTIVES

The overriding objective of Hong Kong's monetary policy is currency stability. This is defined as a stable external exchange value of Hong Kong's currency, in terms of its exchange rate in the foreign-exchange market against the US dollar, within a band of HK\$7.75–7.85 to US\$1. The structure of the monetary system is characterised by Currency Board arrangements, requiring the Monetary Base to be at least 100% backed by US dollar reserves held in the Exchange Fund, and changes in the Monetary Base to be 100% matched by corresponding changes in US dollar reserves.

The Monetary Base (Table 1) comprises:

- ◆ Certificates of Indebtedness, which provide full backing to the banknotes issued by the three note-issuing banks;
- ◆ Government-issued currency notes and coins in circulation;
- ◆ the Aggregate Balance, which is the sum of clearing account balances kept with the HKMA; and
- ◆ Exchange Fund Bills and Notes (EFBNs) issued by the HKMA on behalf of the Government.

Table 1 **Monetary Base**

HK\$ million	31 December 2021	31 December 2020
Certificates of Indebtedness ^a	592,645	559,515
Government-issued currency notes and coins in circulation ^a	13,132	12,920
Balance of the banking system ^b	377,516	457,466
EFBNs issued ^c	1,148,769	1,069,180
TOTAL	2,132,062	2,099,081

- a. The Certificates of Indebtedness and the Government-issued currency notes and coins in circulation shown here are stated at Hong Kong dollar face values. The corresponding items shown in the balance sheet of the Exchange Fund in this *Annual Report* are in Hong Kong dollars equivalent to the US dollar amounts required for their redemption at the prevailing exchange rates on the reporting date. This arrangement is in accordance with the accounting principles generally accepted in Hong Kong.
- b. Balance of the banking system shown here is the carrying value before the amount advanced to the banks under the Discount Window Operations. In accordance with the accounting principles generally accepted in Hong Kong, the corresponding item shown in the balance sheet of the Exchange Fund in this *Annual Report* includes the amount of these advances.
- c. The amount of EFBNs shown here refers to their fair value. In accordance with the accounting principles generally accepted in Hong Kong, the EFBNs held by the HKMA on behalf of the Exchange Fund in relation to its trading of the EFBNs in the secondary market are offset against the EFBNs issued, and the net amount is recorded in the balance sheet. The EFBNs allotted on tender dates but not yet settled are included in the balance sheet but excluded from the Monetary Base. Therefore, the amount of EFBNs shown here is different from that in the balance sheet of the Exchange Fund in this *Annual Report*.

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism and the firm commitment by the HKMA to honour the Convertibility Undertakings (CUs). With the HKMA standing ready to sell (or buy) Hong Kong dollars to (or from) banks in exchange for US dollars upon request at

7.75 (or 7.85) per US dollar, when the strong-side (or weak-side) CU is triggered, the Aggregate Balance will expand (or contract) to push down (or up) Hong Kong dollar interest rates that would help move the Hong Kong dollar back to within the Convertibility Zone of 7.75 to 7.85.

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REVIEW OF 2021

Exchange rate stability

Driven by equity-related demand arising from fundraising activities and the southbound Stock Connects¹, the Hong Kong dollar traded close to the strong-side CU at the beginning of the year. Thereafter, the Hong Kong dollar weakened amid stock market correction and repatriation of initial public offering (IPO) proceeds by some newly listed

firms before rebounding slightly in the second quarter due to corporates' dividend payment needs and net inflows from the southbound Stock Connects. Stepping into the second half of the year, while the Hong Kong dollar drifted lower amid softened equity market sentiment, it stayed mostly at the strong side of the Convertibility Zone and continued to trade in a smooth and orderly manner (Chart 1). Overall, the Hong Kong dollar exchange market functioned normally throughout 2021.

Chart 1 Market exchange rate in 2021



¹ Including Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect.

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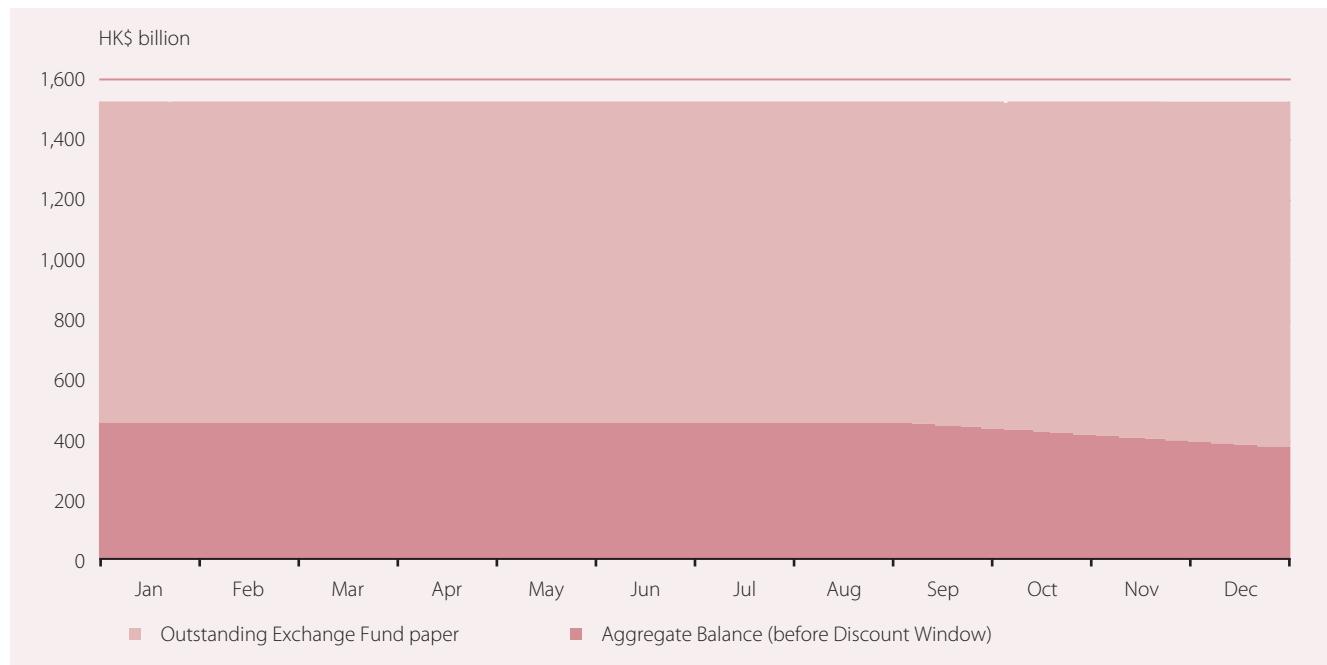
As the CUs were not triggered, the total of the Aggregate Balance and outstanding EFBNs remained virtually unchanged at around HK\$1,526.3 billion in 2021 (Chart 2). During the year, the HKMA issued a total of HK\$80 billion additional Exchange Fund Bills to meet the ongoing demand for Exchange Fund paper by banks amid the abundance of liquidity in the banking system, which led to a contraction of the Aggregate Balance from HK\$457.5 billion at the end of 2020 to HK\$377.5 billion at the end of 2021².

HK\$1,526.3 billion

Total Aggregate Balance and outstanding EFBNs

Reflecting the additional issuance of Exchange Fund Bills and the issuance of EFBNs to absorb EFBNs' interest payments according to the established practice, the outstanding EFBNs increased from HK\$1,069.2 billion to HK\$1,148.8 billion during the year. The Monetary Base as a whole remained fully backed by foreign exchange reserves.

Chart 2 Aggregate Balance (before Discount Window) and outstanding Exchange Fund papers in 2021



² The HKMA increased the issuance size of 91-day Exchange Fund Bills by HK\$5 billion in each of the 16 regular tenders on 7, 14, 21 and 28 September, 5, 12, 19 and 26 October, 2, 9, 16, 23 and 30 November and 7, 14 and 21 December 2021. The issuance of the Bills was increased by HK\$80 billion in total and the Aggregate Balance decreased by the same amount. The issuance of additional Exchange Fund Bills simply represents a change in the composition of the Monetary Base, with a shift from the Aggregate Balance to the outstanding EFBNs. As the Monetary Base remains fully backed by US dollars, such operations are consistent with the Currency Board principles.

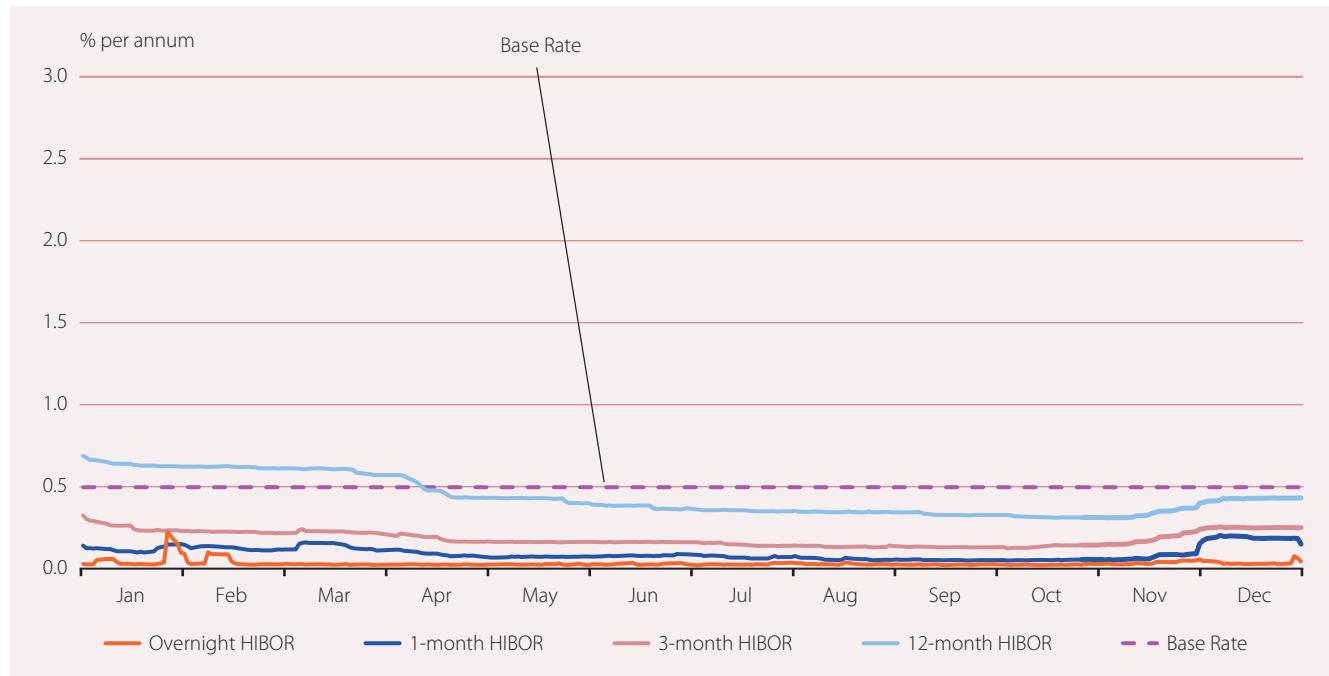
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Money market

With the sizeable Aggregate Balance, the Hong Kong dollar interbank interest rates remained largely stable at low levels throughout the year (Chart 3). While the demand for the Hong Kong dollar increased along with the IPO activities during the first quarter, Hong Kong Interbank Offered Rates (HIBORs) of various tenors saw little fluctuations. Thereafter, HIBORs remained largely stable despite concerns about the

pace of US monetary tightening. Towards the end of 2021, HIBORs witnessed mild pick-ups, partly reflecting anticipated funding needs towards the year end. On the retail front, banks kept their Best Lending Rates unchanged. Overall, Hong Kong's money markets continued to function normally. Discount Window borrowing decreased to HK\$6.8 billion in 2021 from HK\$9.1 billion in 2020.

Chart 3 Hong Kong dollar interbank interest rates in 2021



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The Linked Exchange Rate System



The Linked Exchange Rate System (LERS) has been a strong anchor of Hong Kong's financial system for more than three decades and has shown its strength and resilience to challenges. Despite lingering uncertainties surrounding global economic recovery, the Hong Kong dollar exchange and money markets continued to function in an orderly manner, reflecting the robustness of the LERS. The Government is firmly committed to the LERS. In its *2021 External Sector Report*, the International Monetary Fund once again reiterated that the credibility of the LERS has been assured by a transparent set of rules, ample fiscal and foreign reserves, strong financial regulation and supervision, a flexible economy and a prudent fiscal framework.

A robust banking system is crucial to the normal functioning of the LERS. Hong Kong's banking sector continued to operate smoothly with liquidity positions and capitalisation

faring very well by international standards. To ensure resilience of the banking sector, the HKMA has been closely monitoring banks' management of credit, liquidity and interest rate risks and stress-test results, and has maintained its supervisory efforts on bank lending.

To improve transparency of the Currency Board Account, a specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998. The Backing Ratio (defined as the Backing Assets divided by the Monetary Base) moved within a range of 109.8–110.5% during 2021, without touching the Upper or the Lower Trigger Level. The ratio closed at 110.2% on 31 December (Chart 4). Under the LERS, while specific Exchange Fund assets have been designated for the Backing Portfolio, all Exchange Fund assets are available to support the Hong Kong dollar exchange rate. The ample financial resources of the Exchange Fund, together with the sound banking system, provide a powerful backstop to Hong Kong's monetary and financial stability.

Chart 4 Daily movement of the Backing Ratio in 2021



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Currency Board Sub-Committee

The Currency Board Sub-Committee (CBC) of the Exchange Fund Advisory Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. In 2021, the CBC considered issues, including an assessment of inflation in the US, implications of the US dollar depreciation on Hong Kong, assessment of the taper tantrum risk and its impact on Hong Kong, and understanding the influence of Mainland-related fund flows on monetary conditions in Hong Kong. Records of the CBC's discussions on these issues and reports on the Currency Board operations submitted to the CBC are published on the HKMA website.

Notes and coins



At the end of 2021, the total value of banknotes issued by note-issuing banks in circulation was HK\$592.6 billion, an increase of 5.9% from a year earlier (Charts 5, 6 and 7).

The total value of Government-issued notes and coins in circulation amounted to HK\$12.9 billion at the end of 2021, up 1.7% year on year (Charts 8 and 9).

HK\$592.6 billion, +5.9%

Total value of banknotes
issued by note-issuing banks

HK\$12.9 billion, +1.7%

Total value of notes and coins
issued by Government

Chart 5

Banknotes in circulation by note-issuing banks at the end of 2021



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Chart 6

Distribution of banknotes in circulation at the end of 2021

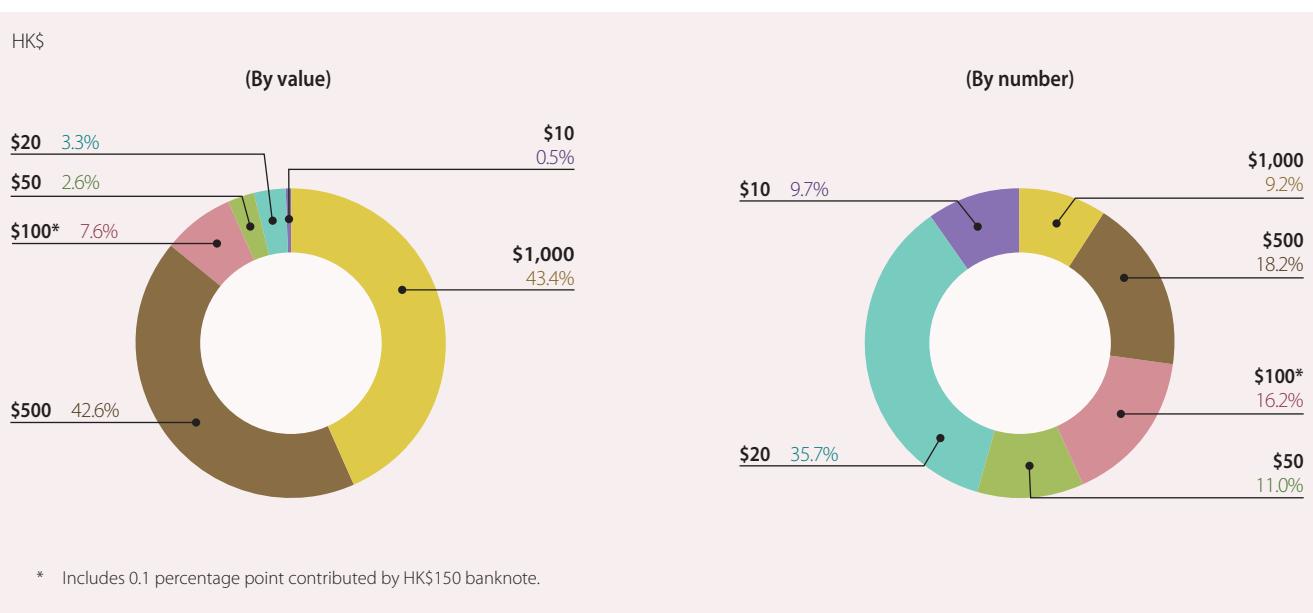


Chart 7

Banknotes in circulation at the end of 2021

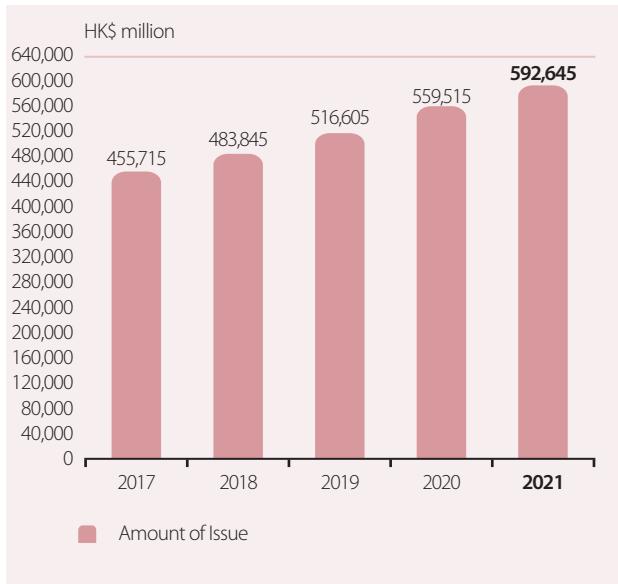
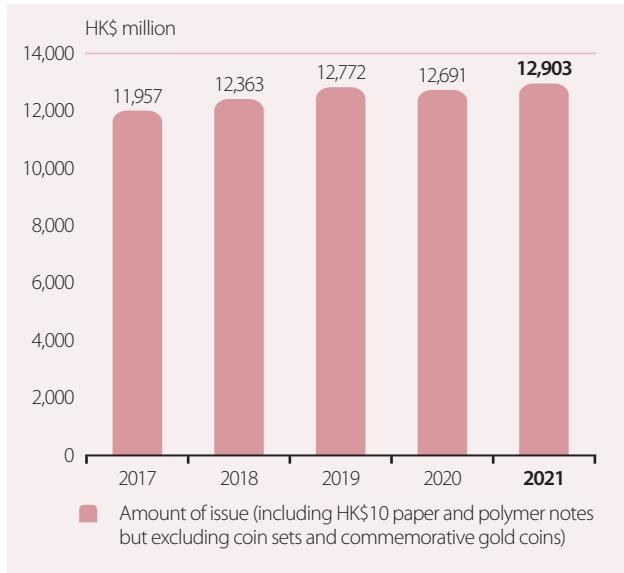


Chart 8

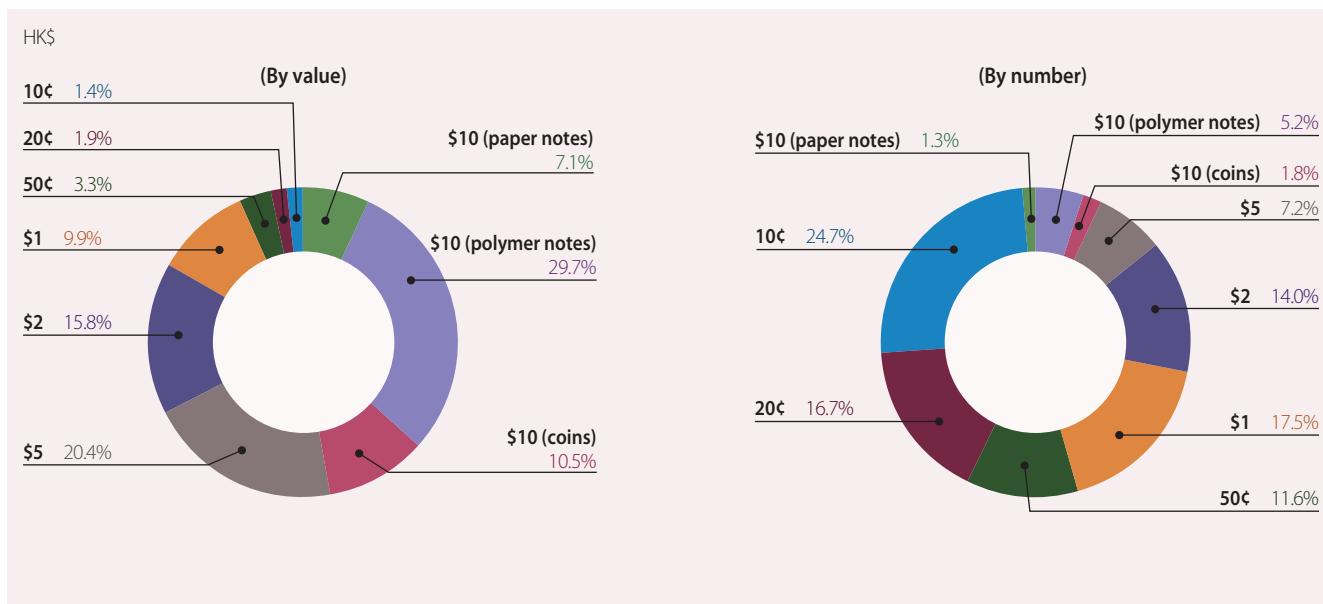
Government-issued currency notes and coins in circulation at the end of 2021



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Chart 9

Breakdown of Government-issued currency notes and coins in circulation at the end of 2021



Hong Kong banknotes

During the year, the HKMA arranged 14 seminars for more than 4,000 participants, including professionals in the banking and retail industries as well as students, to help enhance their knowledge and skills in differentiating between authentic and counterfeit banknotes. These public education programmes on the design and security features of Hong Kong banknotes are well received.

Coin Collection Programme

The Coin Collection Programme continued to be well received by the public. More information about the Programme can be found in the *Sustainability* chapter on page 198.

Exchange Fund Bills and Notes

The EFBN Programme continued to operate smoothly. To meet the ongoing demand for Exchange Fund paper by banks amid the abundance of liquidity in the banking system, the HKMA issued a total of HK\$80 billion additional Exchange Fund Bills in the second half of 2021. The additional issuance resulted in a corresponding reduction of the Aggregate Balance. At the end of 2021, the nominal amount of outstanding Exchange Fund papers stood at HK\$1,148.6 billion (Table 2).

Table 2

Outstanding issues of Exchange Fund Bills and Notes

HK\$ million	2021	2020
Exchange Fund Bills (by original maturity)		
28 days	800	0
91 days	710,917	630,430
182 days	361,800	361,000
364 days	51,700	51,700
Subtotal	1,125,217	1,043,130
Exchange Fund Notes (by remaining tenor)		
1 year or below	7,000	6,400
Over 1 year and up to 3 years	10,400	9,800
Over 3 years and up to 5 years	2,400	4,000
Over 5 years and up to 10 years	3,600	4,800
Subtotal	23,400	25,000
Total	1,148,617	1,068,130

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Monetary research

The Hong Kong Institute for Monetary and Financial Research (HKIMR)³ maintained a steady research output in 2021 despite the ongoing pandemic. During the year, the HKIMR released 30 working papers and held nine webinars, which encompassed a wide range of topics including monetary policy, banking stability, market microstructure and financial technology (fintech) development. The HKIMR also organised an international conference and a webinar in hybrid format.

- ◆ The webinar⁴, titled *RMB Exchange Rate Formation Mechanism and Exchange Rate Outlook*, was co-organised with the Hong Kong Academy of Finance on 17 August. It was live-streamed on a number of online platforms and attracted a total of over 1.16 million real-time views.

- ◆ The 11th Annual International Conference on the Chinese Economy, titled *On the Path to Common Prosperity: China's Economic Development in Dual Circulation*, was held on 11 November. The conference discussed recent policy developments related to common prosperity, dual circulation, anti-monopoly regulations, property market, Cross-boundary Wealth Management Connect and financial developments in the Greater Bay Area⁵. Expert speakers also presented in-depth analyses on the impact of population ageing and the sustainability of social security funds, as well as China's contribution to global financial stability and world economy. The six different sessions of the conference attracted over 3,200 online and on-site viewers, totaling 5,900 views.



³ The HKIMR is a subsidiary of the Hong Kong Academy of Finance.

⁴ Speakers included Dr Guan Tao, Global Chief Economist of the Bank of China International (China) Co., Ltd. and Professor Huang Yiping, Sinar Mas Chair Professor of Finance and Deputy Dean of the National School of Development of Peking University.

⁵ Mr Long Guoqiang, Vice President of the Development Research Center of the State Council, delivered a keynote speech at the conference.