LCQ14: Ensuring stability of financial system

Following is a question by the Hon Yim Kong and a written reply by the Secretary for Financial Services and the Treasury, Mr Christopher Hui, in the Legislative Council today (June 14):

Question:

It is learnt that a large amount of funds flowed out of the Hong Kong dollar (HKD) system in the past year or so. From May last year, the exchange rate of HKD against the US dollar (USD) repeatedly triggered the weak-side Convertibility Undertaking and the Hong Kong Monetary Authority (HKMA) therefore needed to buy HKD and sell USD, resulting in an outflow of funds of nearly HK$300 billion from the HKD system. On the 15th of May this year, the aggregate balance of the banking system dropped to about HK$44.7 billion. At the same time, HKD interest rates were on an upward trend and HKMA raised the base rate to 5.5 per cent on the 4th of May. At a stage when Hong Kong has just emerged from the plight of the epidemic and its economy is beginning to recover, some members of the public are worried that the outflow of funds from the HKD system and the rise in the relevant interest rates will seriously hinder the progress of economic development. In this connection, will the Government inform this Council:

(1) whether it has assessed the impacts of the recent outflow of funds from the HKD system and the rising trend of the base rate on the economy and finance of Hong Kong; if so, of the conclusion;

(2) whether it has assessed what level to which the aggregate balance of the banking system is reduced will affect the smooth operation and settlement among banks, and what new measures the Government has put in place to release liquidity to the banking system at any time when necessary; and

(3) as there are views that the correlation between the economic cycles of Hong Kong and the Mainland has become increasingly strong, while the correlation between the economic cycles of Hong Kong and the United States has become relatively weak, whether the Government will study afresh how the monetary policy stance for Hong Kong should be adjusted to adapt to such a changing trend?

Reply:

President,

Hong Kong is an international financial and trade centre with free flow of capital into and out of the city. The Linked Exchange Rate System (LERS) is an important anchor to the financial and monetary stability in Hong Kong. With the LERS operating effectively, the market having developed sufficient understanding and operational experience of the LERS continues to have strong confidence in the system. There is no need and no intention for Hong Kong to change the LERS.

Regarding the various parts of the Hon Yim Kong's question, my reply, in consultation with the Hong Kong Monetary Authority (HKMA), is as follows:

(1) In response to the US entering a rate hike cycle, it is a normal market phenomenon for some funds flowing out of the Hong Kong dollar system, which is in line with the design and expectation of the LERS. Similar situation occurred during the previous US rate hike cycle between 2015 and 2018. These market activities will not affect the financial and monetary stability of Hong Kong. The HKMA will continue its market surveillance and so far has not found any signs of anomalies.

Funds flowing out of the Hong Kong dollar system have, in many instances, been converted into other currencies (such as US dollars) and continued to remain in Hong Kong's financial system. In fact, total deposits in the Hong Kong banking system have remained largely stable. The deposit amounts grew by 1.1 per cent from end-March last year to end-March this year, and total loans and advances for use in Hong Kong of the banking system grew by 0.8 per cent during the same period.

Under the LERS, the Base Rate is set by the HKMA according to a pre-set formula and forms the foundation upon which the Discount Rates for repurchase transactions through the Discount Window are computed. Since banks generally handle their funding needs through other channels (including interbank lending) instead of the Discount Window based on the Base Rate, the interest rates of the Hong Kong dollar market are generally impacted by their US dollar counterparts and by the supply and demand of Hong Kong dollar funding in the local market instead of the Base Rate.

(2) The Aggregate Balance (AB) is the sum of balances of banks' clearing accounts kept with the HKMA, which is primarily used by banks for payment and settlement purposes with the HKMA and other banks in Hong Kong. The account balance of each bank represents only a small portion of its total assets and banks can transfer their funds to their clearing accounts at any time. The AB level will not affect the normal and smooth operation of the interbank market.

In terms of liquidity, the Monetary Base of Hong Kong exceeded HK$1.8 trillion, of which Exchange Fund Bills and Notes (EFBNs) held by banks amounted to over HK$1.1 trillion, providing ample buffer for interbank liquidity. Banks can use EFBNs as collateral to obtain Hong Kong dollar liquidity through the Intraday Repo and Discount Window operated by the HKMA when necessary. These standing liquidity facilities help banks fulfil their settlement obligations and ensure the smooth functioning of the interbank payment system. According to HKMA's continued monitoring, banks have been able to properly manage their liquidity to ensure orderly and efficient movements of funds.

(3) There is no need and no intention for Hong Kong to change the LERS. The stability of the monetary system is a crucial foundation for Hong Kong as an

international financial and trade centre with a small and open economy, handling large volumes of international trading activities, cross-border direct investments, and financial activities. The LERS has been operating effectively for four decades since its establishment in 1983, weathering many economic and interest rate cycles, as well as multiple global and regional economic and financial crises.

In the Staff Report published by the International Monetary Fund after completion of the 2023 Article IV Consultation with Hong Kong in May this year, it is affirmed that the LERS remains the appropriate arrangement for Hong Kong as an anchor for macroeconomic and financial stability. A number of factors, including the mechanism's transparency, ample foreign reserves, a prudent fiscal policy framework, robust financial regulation and supervision, and the economy's flexibility, ensure the credibility of the LERS.