

Quamnet Research Series contains 5-7 daily commentaries on Hong Kong equity market outlook and specific stock analysis by Quam Research team. This is only one of the articles dated on 28 Dec 2010 for reference.

For details, please refer to <http://subscription.quamnet.com>
Subscription Hotline : (852) 2217 2705 / email support@hk.quamnet.com

Monetary policy of Hong Kong

Monetary and fiscal policies are the two major government economic policies. In general, monetary policy is formulated and implemented by central banks to meet the targets such as stabilizing prices and economy by adjusting interest rates and money supply. In 1970's and 1980's, lingering inflation for reasons like oil crisis was a headache for many countries around the world. Price stability is the main target of various central banks. In 1990's prices were stable in Europe and US, and the world was on the verge of deflation and recession for the Asian financial crisis, the aim of monetary policy was thus shifted to deter recession and promote economic growth.

Taking US, the biggest economy in the world, as an example, the monetary policy of US aims "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.". Therefore, the aim of the current US quantitative easing is to stimulate the weak economy resulted from financial tsunami.

Since the peg system implemented in 1983, the monetary policy aims at "currency stability". Currency board operations were taken as the monetary system. The Financial Secretary is responsible for formulating the monetary policy objectives and monetary system, while the Hong Kong Monetary Authority (HKMA) has to achieve the monetary policy objectives on its own, including determining related strategies, tools and means of implementation, to ensure the stability and integrity of the currency system of Hong Kong.

However, there's actually no monetary policy in Hong Kong under the peg system.

Generally speaking, monetary policy is formulated by central banks and implemented by interest adjustment and money supply. However, under the peg, the autonomy of interest is lost for HK interest must be moving in sync with US interest. The passive interest movement not only fails to stabilize prices or economy duly, but adds unnecessary economic volatility. For example, in early 1990's, Hong Kong maintained an actual growth of over 5% for a few consecutive years, and double-digit inflation rate in the same period, interest rate should be hiked to cool down the economy and curb the inflation. But Hong Kong was forced to follow US to lower interest, the nominal interest rate kept falling, resulting in negative interest in Hong Kong. Negative interest had prompted deposit to flow into property and stock markets. It was one of the reasons behind the asset bubble.

Another way to conduct monetary policy would be to impose control over monetary supply through open market operation, a method often adopted by central banks to achieve the monetary objective. Take the Federal Reserve as an example, the New York branch of the Fed conducts bond market operations in every trading day's mornings in order to micro-adjust money supply, an action in line with the monetary policy established by the Federal Open Market Committee. As a result, the Federal Fund Rate could be maintained at a certain target level, which in turn serves the function of regulating the economy. Recently, the US has been attempting to stimulate the local economy by increasing monetary supply. Despite the fact that the action might end up leading to a bubble, the power of free monetary policy is beyond doubt.

The fact that Hong Kong is carrying out a pegged exchange rate system does not only mean that it has surrendered its power to adjust the exchange rate of HKD, but also that the HKMA does not have a say in regulating monetary supply. It is because according to the currency board system, monetary supply is determined by market demand, while market demand solely hinges on the flow of capital. By definition, the inflow or outflow of capital would lead to a change in the interest rate instead of the exchange rate. For example when there exists an inflow of capital into the economy, the currency base would be increased. The case is reversed for an outflow of capital. Under the pegged exchange rate system, the HKMA can neither adjust the interest rate freely nor change the exchange rate, giving up the freedom to conduct monetary policies. Certainly the current system makes sure the authority could not print as many bank notes as it wishes, thus reducing the probability of inflation. The debate over the pros and cons of the pegged exchange rate system seems to be everlasting.

Disclaimer: The above views are the personal opinions of the author and do not represent the views of Quamnet.