



恒生銀行

HANG SENG BANK

# Press Release

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## HONG KONG INTEREST RATES ON THEIR WAY UP AFTER CURRENCY BOARD ENHANCEMENTS

Enhancements to the operation of the Linked Exchange Rate System have given the Hong Kong Monetary Authority (HKMA) a stronger role in directing Hong Kong interest rates to follow US interest rates more closely, which should be on their way up for the rest of the year, according to the latest issue of the *Hang Seng Economic Monthly*.

Under Hong Kong's currency board system, interest rates in Hong Kong should passively follow the movement of US interest rates. However, such a relationship did not hold in the past 18 months when the Hong Kong market was awash with liquidity as a result of the inflow of funds.

The persistent low interest rates and their inability to rise along with US rates hide the fact that credit growth returned in 2004 and the banking sector's balance sheet expanded again.

The report points out that loan demand is improving along with the growing economy. Loans for use in Hong Kong rose 6.3% in 2004, while total loans outstanding for the banking sector recorded a 5.9% year-on-year increase.

Lending in almost all major economic sectors showed different degrees of growth, indicating that the revival in loan demand has been broad-based across the whole economy.

However, the report notes that the loan expansion is only at a very early stage and is not strong enough to absorb the huge liquidity in the money market.

The strong inflow of funds since 2003 has resulted in the rapid expansion of money supply. Total customer deposits and negotiable certificates of deposit recorded an increase of HKD601 billion, or a rise of 17.4%, between December 2002 and December 2004.

Apart from driving customer deposit growth, the inflow of funds has also reversed the shrinking trend of the banking sector's balance sheet between 1998 and 2002.

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## **Hong Kong Interest Rates On Their Way Up After Currency Board Enhancements / 2**

According to the report, total assets/liabilities of the banking sector fell from HKD7,485 billion in December 1997 to a low of HKD5,525 billion in December 2002, a contraction of 26%. Since then, it has rebounded by 16% to HKD6,411 billion in March 2005, boosted by rising customer deposits as well as placement of funds from overseas financial institutions.

An examination of Hong Kong's balance of payment (BoP) statistics for 2004 shows that a substantial portion of the HKD25.5 billion BoP surplus was recorded under "other investment", which was mainly fund inflows from overseas banks to the local banking sector. This lent further support to the belief that the increase in money supply in the past two years was partly associated with fund inflows related to market speculation in regard to the renminbi.

The reports states that the Hong Kong dollar loan-to-deposit ratio hit bottom in 2003 and rebounded from 81.5% at the end of 2003 to 84.8% in March 2005. But despite the recovering loan demand, Hong Kong interest rates did not move along with US rates until recently.

It was against such a backdrop that the HKMA on 18 May 2005 introduced three new measures to enhance the operation of the Linked Exchange Rate System.

In essence, the HKMA has created a 'convertibility zone' of 7.75-7.85 for the Hong Kong dollar and is now empowered to buy or sell the Hong Kong dollar versus the US dollar at any level within that zone consistent with currency board principles.

Although the new measures cannot eliminate Hong Kong dollar speculation from the market, the convertibility zone provides the HKMA with greater flexibility to correct interest rate differentials not consistent with the currency peg.

The report concludes that under the new arrangement, the HKMA has become more influential in affecting short-term interest rates. Only time will tell how the market will react to the changes and the trading patterns of the HKMA.

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