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**Fifth Issue  
(July 2004)**

This is the fifth issue of  
the Hong Kong Institute  
for Monetary Research  
(the Institute)  
Newsletter.

The Institute was  
established by the Hong  
Kong Monetary  
Authority (HKMA) in  
August 1999 to conduct  
and support research on  
issues in monetary  
policy, banking and  
finance that are of  
strategic importance to  
Hong Kong and the  
Asian region.

#### **Highlights of this issue:**

New Web Site.

Recent Activities.

Paul McNelis – visiting  
Research Fellow at the  
Institute.

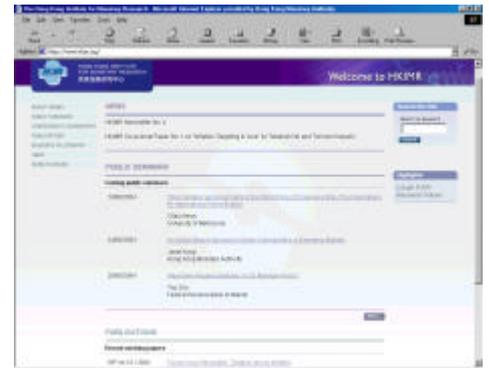
Workshop: Advanced  
Modelling for Monetary  
Policy.

Recent publications and  
upcoming activities of the  
Institute.

## Hong Kong Institute for Monetary Research -- *Newsletter*

### New Look for Web Site

The web site of the Institute has a new layout!  
Information can be easily found by one or two  
mouse clicks, and new functions include  
seminar registration and a publication search  
engine. Any views or suggestions on the  
revamped web site are most welcome.



### Recent Activities

#### **Joint BIS/HKIMR Seminar**

The Institute co-organised a seminar entitled "**Monetary Policy Operating Procedures in the Three Major Economies: Main Features and Current Issues**" with the Asian Office of the Bank for International Settlements on 29 April 2004. Claudio Borio (BIS) discussed the conceptual framework behind the choice of operating procedure, while the other three speakers, Spence Hilton (Federal Reserve Bank of New York), Paul Mercier (European Central Bank) and Hiroshi Nakaso (Bank of Japan) presented their banks' own operating procedures. The seminar was attended by more than forty participants.



*Joseph Yam delivered  
introductory remarks*



*Speakers: Claudio Borio, Spence  
Hilton, Paul Mercier and Hiroshi  
Nakaso (From left to right)*

#### **Financial Derivatives Course**

Prof. Salih Neftci conducted a course on "**Calibration Methods, Industry Applications and Software Examples**" at the Institute from 13 to 16 April 2004. Prof. Neftci of the City University of New York is well known for his book *An Introduction to the Mathematics of Financial Derivatives* – a popular textbook on financial derivatives. The course was tailor-made for market practitioners, risk managers and banking regulators. More than thirty participants from the private and public sectors, and local universities attended the course.



*Salih Neftci*

## Visiting Fellow – Paul McNelis



*Prof. Paul McNelis from Georgetown University visited the Institute on two separate occasions (July to August 2003 and January 2004) to undertake a research project entitled “Deflation Dynamics in Hong Kong”.*

My visit to the HKIMR took place in two stages, the first in July 2003 and the second in January 2004. Research centred on the Hong Kong experiences of inflation and deflation since the inception of the currency board system.

As an economist interested in the adjustment problems of small highly open economies to internal and external change, I cannot help but find Hong Kong a fascinating place. Currency boards or complete dollarisation are being put forward as options for many countries (most recently East Timor adopted the US dollar as its currency), so we cannot learn too much about how currency boards work. Similarly deflation is an ever present threat to many countries, so the lessons from Hong Kong offer clues about the causes and consequences of deflation.

Hong Kong is both a highly globalised economy, well integrated into the world trading and financial systems, as well as a Special Administrative Region of the Peoples’ Republic of China. It is thus integrated politically into the largest country in the world, and the economic consequences of this political integration will continue to unfold in the coming years and decades. Hong Kong is thus a “resource” where political scientists and economists can learn how political transitions interact with economics in the formation of expectations.

What stands out about Hong Kong more than anything else is that it is a rule-based economic system. A currency board first and foremost is a “hard” monetary rule: domestic money supply changes are linked

to increases or decreases in US dollar reserves. What we are learning from the global economic and political system in the post-Cold War era is the need for a set of rules. Global trade will falter with hidden protection and subsidies, currency crises will do damage not just at home but can have negative spillover effects to neighbouring countries. Hong Kong is an example of “good behaviour” for small open economies in the global system. It is an economy which has adopted one “rule”, the Currency Board System, and has stood by this rule for more than two decades. While Hong Kong has had downturns (particularly during the past five years), as an economy it has prospered quite a bit with this rule.

Coupled with the Currency Board “rule”, Hong Kong has a sound banking system. Research comparing Hong Kong with Japan has shown that the bank lending channel is an independent and major factor driving the prolonged recession and deflation in Japan, whereas in Hong Kong, bank lending is a dependent variable, falling with the collapse of property prices, as we would expect. The banking sector is not a major “actor” in the Hong Kong drama of deflation and recession, as it is in Japan. The “soundness” of the banking sector is not in doubt. This soundness is another good example from Hong Kong for open economies (or economies in the processes of becoming open), that wish to catch the “globalisation train” to sustained growth and prosperity.

My stay at the HKIMR was my first experience of Hong Kong for more than a few days. It was a very pleasant surprise on the personal level. While I have been in

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*“...the quality of service and the ease of doing business are impressive. From health clubs to restaurants to taxi service to arriving and departing at the airport, the atmosphere was always one of respect and courtesy.”*




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## Workshop: Advanced Modelling for Monetary Policy

*The Institute co-organised a one-week workshop on “Advanced Modelling for Monetary Policy in the Asian Pacific Region” with the Centre for Central Banking Studies (CCBS) of the Bank of England from 10 to 14 May 2004.*

This workshop followed the previous advanced modelling workshop jointly organised by the two organisations in 2002. It was similar in structure but with a focus on some recent specialised topics.

The workshop highlighted estimation methods that could be programmed in EViews, together with the use of Winsolve to analyse the resulting models. It covered similar topics to the previous workshop with additional materials on robust estimation methods

for rational expectations models, stochastic simulation for policy analyses and dynamic stochastic general equilibrium modelling.

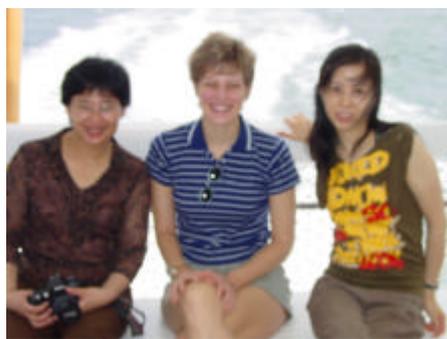
The course was led by Andrew Blake and Ibrahim Stevens, who conducted the lectures. After the workshop, the Institute organised an outdoor activity for the directors and participants on the following Saturday. A boat trip to Lamma Island, with a seafood lunch, was followed by a tour around Victoria Harbour.



*Workshop Directors: Ibrahim and Andrew*



*Hiking on Lamma Island*



*From left to right, Mei, Petra and Emily*



*Workshop participants*

## Visiting Fellow – Paul McNelis

*...continued from last page*

other Asian countries and braced myself for the “large numbers” of people, the quality of service and the ease of doing business are impressive. From health clubs to restaurants to taxi service to arriving and departing at the airport, the atmosphere was always one of respect and courtesy. People in business know the “rules of engagement” for successful transactions. Again, this is an important lesson for small economies in transition.

Is the Hong Kong experience pure luck? Hong Kong was

hit hard by SARS in 2003, and in 1997 was affected by the Asian Financial Crisis. While luck plays a part in development success stories, more important is economic resilience. All countries are hit by crises in one form or another, but how they respond to the crisis makes all the difference. In 2003 and 2004, it is obvious that Hong Kong has recovered from the SARS crisis with renewed optimism. Hong Kong teaches us that success is not simply based on luck or an accident of history, but comes from understanding and playing by the rules of the international economic game.

## Coming Activities

The Institute is planning to rerun a course in financial derivatives with Prof. Salih Neftci in the fall or winter. The course will again be geared towards market practitioners, risk managers and banking regulators, and based on his latest book *Principles of Financial Engineering*.

The Institute will co-organise a one-day conference on "*Managing Procyclicality of the Financial System: Experiences in Asia and Policy Options*" with the International Monetary Fund in Hong Kong on 22 November 2004. More information will be posted on our web site later.

## HKIMR Occasional Paper Series

The HKIMR's first Occasional Paper entitled "*Inflation Targeting in Asia*" by Takatoshi Ito and Tomoko Hayashi has been published.

The aim of the Occasional Paper series is to publish policy-relevant papers by prominent economists. The papers are non-technical and avoid formal models or econometric work. The paper by Ito and Hayashi provides the first comprehensive survey and assessment of inflation targeting in Asia, and considers the challenge of implementing such a framework in emerging economies that are small and open to capital movements. The full text and the summary of this paper are available on our web site.

### Recent and Coming Seminars:

**9 June 2004** *Two-Sided Learning and Optimal Open-Economy Monetary Policy Design*, Timothy Kam (University of Western Australia)

**18 June 2004** *Time Variation and Asymmetry in the World Price of Covariance Risk: The Implications for International Diversification*, Ólan Henry (University of Melbourne)

**28 June 2004** *Were there Regime Switches in US Monetary Policy?*, Tao Zha (Federal Reserve Bank of Atlanta)

**12 July 2004** *An Option-Based Approach to Bank Vulnerabilities in Emerging Markets*, Janet Kong (Hong Kong Monetary Authority)

**21 July 2004** *Order-Imbalance and the Pricing of Index Futures*, Joseph Fung (Hong Kong Baptist University)

**12 August 2004** *Measuring Provisions for Collateralised Retail Lending*, Chohoi Hui (Hong Kong Monetary Authority)

## Recently Published HKIMR Working Papers

**No.12/2004** *"The Suitability of A Greater China Currency Union"* by Yin-wong Cheung and Jude Yuen

**No.11/2004** *"On the Relationship between Pass-through and Sticky Nominal Prices"* by Charles Engel

**No.10/2004** *"Fiscal Crisis Resolution: Taxation versus Inflation"* by Michael Kumhof

**No.9/2004** *"Tunneling, Propping and Expropriation: Evidence from Connected Party Transactions in Hong Kong"* by Yan-leung Cheung, P. Raghavendra Rau and Aris Stouraitis

**No.8/2004** *"Good Housekeeping? Reputation, Fixed Exchange Rates, and the 'Original Sin' Problem"* by Prasanna Gai and Kang-yong Tan

**No.7/2004** *"The Magic of the Exchange Rate: Optimal Escape from a Liquidity Trap in Small and Large Open Economies"* by Lars Svensson

**No.6/2004** *"Swap Curve Dynamics in Hong Kong: An Interpretation"* by Salih N. Neftci

**No.5/2004** *"Testing for Output Convergence: A Re-Examination"* by Yin-wong Cheung and Antonio Garcia-Pascual

and more ..... please visit our web site.

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