

OPERATION OF MONETARY POLICY

The Hong Kong dollar exchange rate and local money market remained generally stable in the fourth quarter of 1999. The exchange rate eased somewhat in early October on account of equity related outflows. A flurry of positive news, including the Government's decision to build a Disney theme park, the successful launch of the Tracker Fund, and the signing of the Sino-American agreement on China's entry into WTO, reversed the capital flows from late October. The inflows further intensified towards the year-end, supported by market perceptions of Hong Kong as a Y2K safe haven. Abundant liquidity in the interbank market, together with the Y2K liquidity arrangements made available by the HKMA (in the event not drawn upon), kept short-term HK\$ interest rates soft and stable during the millennium change-over period. The yield of 10-year EF Notes, however, rose during the latter half of December, in tandem with the rising yields on US Treasuries.

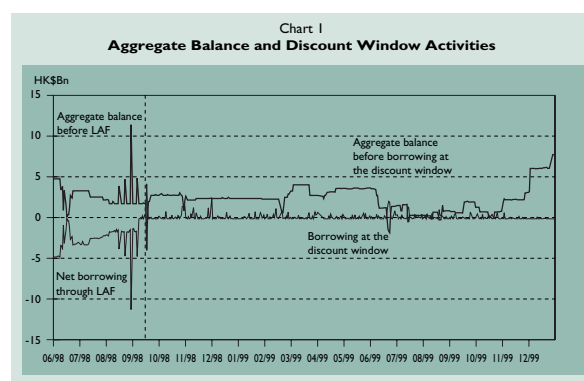
Convertibility Undertaking and Aggregate Balance

Movements of the Aggregate Balance and interest rates were mainly influenced by equity related fund flows during the fourth quarter of 1999. In early October, a correction of the stock market, due to the downward adjustment of weighting assigned to the Hong Kong market by some equity fund managers and the uncertainty prior to the launch of the Tracker Fund, resulted in some capital outflows. The Convertibility Undertaking was triggered several times in mid October. Consequently, the Aggregate Balance shrank to HK\$28 mn on 19 October. The resultant tightening of interbank liquidity then reversed the flow of funds and the Aggregate Balance was restored to HK\$840 mn on 22 October.

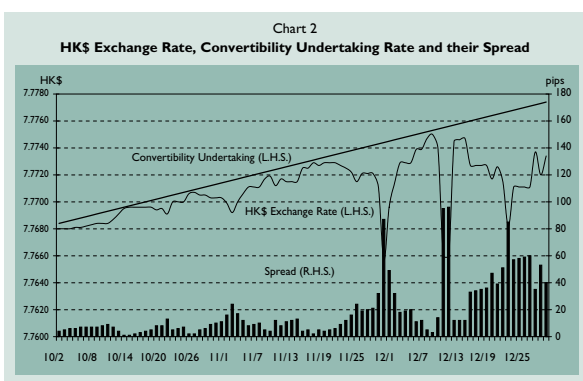
Market sentiment started to turn in late October following the Government's announcement of the planned construction of a Disney theme park in Hong Kong. Subsequently, a flurry of positive news, including the successful launch of the Tracker Fund on 12 November and the signing of the Sino-American agreement on China's entry into the World Trade Organisation in mid-November, further reinforced market optimism. The subsequent announcement of a strong 4.5% year-on-year growth in Hong Kong's real GDP in the third quarter

prompted many equity fund managers to replenish their under-weighted Hong Kong stock portfolios. Significant equity related inflows were seen during 26-30 November. The HKMA purchased US dollar passively and the Aggregate Balance increased to HK\$6,258 mn on 2 December.

Foreign investors' confidence in Hong Kong was further boosted by Standard & Poor's announcement in early December to upgrade Hong Kong's rating outlook from "negative" to "stable". The perception that Hong Kong was one of the best prepared major financial centres in dealing with potential Y2K problems also attracted some last minute flight-to-quality inflows. The Aggregate Balance further increased to HK\$7,968 mn on 28 December, the highest level since the introduction of the seven technical measures in September 1998 (Chart 1).

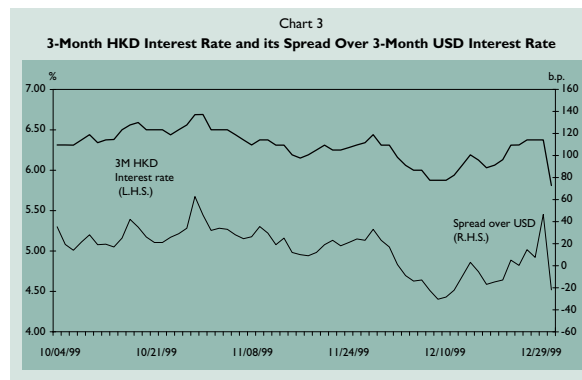


While the exchange rate stayed very close to the rate of the Convertibility Undertaking in October and early November, the significant inflows in late November and December led to a strengthening of the HK\$. HK\$/US\$ reached 7.7657 on 30 November, 87 pips below (i.e. stronger than) the prevailing rate of Convertibility Undertaking. At the end of December, HK\$ was trading at 7.7734, 40 pips below the rate of Convertibility Undertaking, as compared to a gap of about 3 pips in late September (Chart 2).



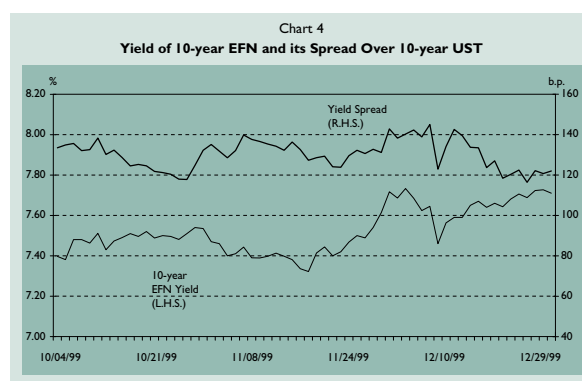
Short-term Hong Kong Dollar Interest Rate

The substantial inflows and abundant interbank liquidity, together with the enlarged discount window and term repo facilities introduced by the HKMA as contingency measures to relieve possible tightening in the money market during the millennium change-over period, kept the short-term HK\$ interest rates soft in the latter half of the fourth quarter. Overnight HK\$ deposit rates stayed below 3% for most of December and eased further to 0.25% on the last day of the year, in contrast to the firming of interest rates typical at previous year-ends. The soft overnight rates also spilt over to term deposit rates. 3-month HK\$ interbank rate was very steady in the early part of the quarter, but softened significantly towards the end of the year, reaching a low of 5.81% on 30 December. The decision of the Federal Reserve Bank to raise the Fed Funds Target Rate by 25 b.p. to 5.5% in mid-November did not present any upward pressure on HK\$ interbank rates, and the Hong Kong Association of Banks decided to leave the Savings Rate unchanged at 3.75% (Chart 3).



Long Term HK\$ Interest Rate and the Hong Kong Premium

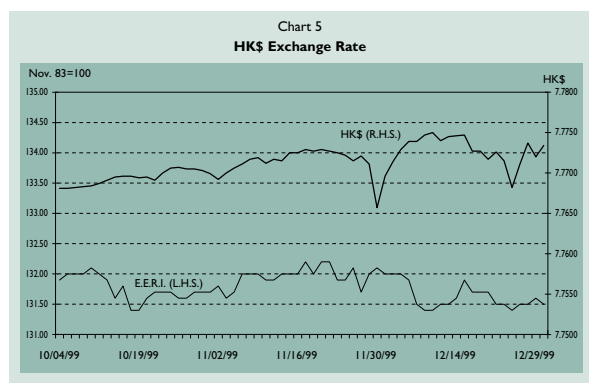
The abundant liquidity in the interbank market did not, however, have a significant impact at the long end of the HK\$ yield curve. Yield of 10-year Exchange Fund Notes (EFN) stayed between 7.32% and 7.61% in October and November. Yields of US Treasuries picked up substantially in the latter half of the fourth quarter as the market began to price in the possibility of aggressive monetary tightening by the US Federal Reserve in early 2000. The yield of 10-year EFN moved up in tandem and reached a peak of 7.73% on 29 December. Nevertheless, the yield spread of 10-year EFN over the corresponding US Treasury Notes, often referred to as the “Hong Kong premium”, remained steady. The spread hovered within a range of 116 b.p. to 145 b.p. during the quarter and ended at 122 b.p. on 30 December (Chart 4).



Base Rate and the HK\$ Effective Exchange Rate

The Base Rate, which is set as the higher of the US Fed Funds Target Rate plus 150 basis points, and the simple average of the 5-day moving averages of overnight and 1-month HIBOR for the previous 5 trading days, stayed at 6.75% in October and early November. Following the 25 b.p. rise in the Fed Funds Target Rate on 16 November, the Base Rate was adjusted upward to 7.00%.

The HK\$ trade weighted Effective Exchange Rate Index (EERI), which measures the nominal exchange rate of the Hong Kong dollar vis-à-vis currencies of major trading partners, closed at 131.5 on 30 December, down marginally from 131.9 level at the beginning of the quarter. This reflected mainly the weakening of the US\$ against the other major currencies during the fourth quarter, albeit marginally. The HK\$/US\$ exchange rate, however, tracked the gradual movements in the Convertibility Undertaking rate, easing to 7.7734 on 30 December, compared to 7.7681 on 4 October (Chart 5).



Domestic Credit and Money Supply

Domestic credit¹ continued to decline, by 1.0% in the fourth quarter of 1999. Nevertheless, the rate of decline moderated in comparison with previous quarters. The decline in lending appeared to have been driven mainly by banks' concerns over credit risk and subdued loan demand rather than by liquidity concerns. Analysed by economic use, loans for transport and transport equipment,

¹ Including loans for trade financing

building, construction, property development and investment, stockbrokers, and credit card advances registered positive quarter-on-quarter growth, while a decline was felt in other sectors. For the year as a whole, domestic credit fell by 8.2%.

Narrow money supply (HK\$M1) saw a notable rise of 10.0% in the fourth quarter of 1999, following an increase of 2.5% in the preceding quarter. The rise was mainly attributable to an increase in cash withdrawals amid seasonal demand and the Y2K factor around the turn of the millennium. Currency held by the non-bank public rose by HK\$12.1 bn (or 13.8%) during the month of December. Following an increase of 0.6% in the preceding quarter, broad money supply (HK\$M3) increased further by 2.9% in the fourth quarter. At end-1999, HK\$M1 was 15.2% higher than a year earlier while HK\$M3 was up by 5.3%.

- Prepared by the Monetary Policy and Markets Department