

OPERATION OF MONETARY POLICY

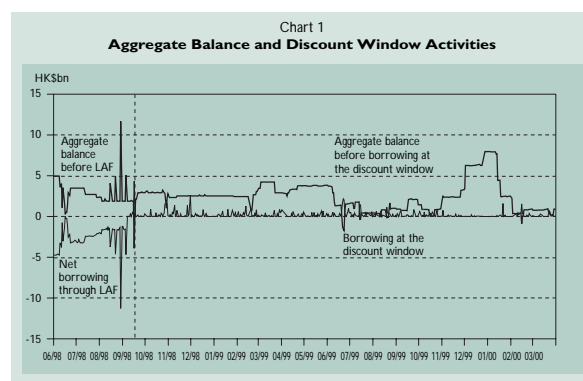
The Hong Kong dollar exchange rate tracked closely the rate of the Convertibility Undertaking in the first quarter of 2000. The size of the Aggregate Balance shrank in general, as demand for liquidity reduced after the smooth changeover of the millennium. In mid-February, the Aggregate Balance briefly dropped to below zero when the Hong Kong dollar exchange rate eased and the Convertibility Undertaking Arrangement was triggered. Hong Kong dollar interest rates remained steady during the reporting period despite the tightening of US monetary policy on 2 February and 21 March, each time by 25 b.p. As the interest rate gap between US dollar and Hong Kong dollar narrowed in general, the forward points softened during the quarter. The yields of Exchange Fund Notes eased in tandem with the yields of corresponding US Treasuries.

Convertibility Undertaking and Aggregate Balance

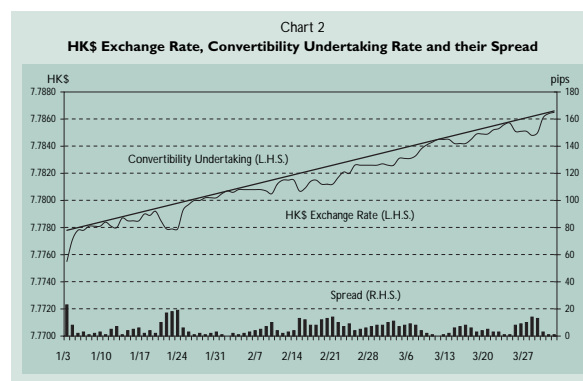
The HK\$ exchange rate remained steady and stayed very close to the rate of the Convertibility Undertaking throughout the first quarter of 2000. In early January, banks that held on to excess HK\$ liquidity ahead of the millennium changeover began to convert the excess HK\$ balances in their settlement accounts into US\$. Towards the end of January, the notes issuing banks bought US\$ to pay for Certificates of Indebtedness in order to issue new HK\$ notes to satisfy the usual increases in demand before the Chinese New Year. As a result, the Convertibility Undertaking was triggered a few times and the Aggregate Balance was reduced from HK\$7,960 mn on 30 December 1999 to HK\$2,461 mn on 18 January 2000, and further to HK\$359 mn on 3 February 2000.

A dip in the local stock market immediately after the Chinese New Year holidays put pressure on the HK\$ exchange rate and the Convertibility Undertaking was triggered again. The Aggregate Balance fell to negative HK\$902 mn on 15 February 2000, but soon returned to positive territory as the resultant firming of short-term interest rates induced some inflows. The Hong Kong stock market recovered strongly between late February and the end of March. However, no significant inflows were recorded and the Aggregate Balance remained very stable, hovering around HK\$1 bn before closing at HK\$909 mn on 31 March 2000. Towards the end of the reporting

period, it appeared that banks in Hong Kong were showing an interest to switch their excess HK\$ balances into US\$ to enjoy a higher return



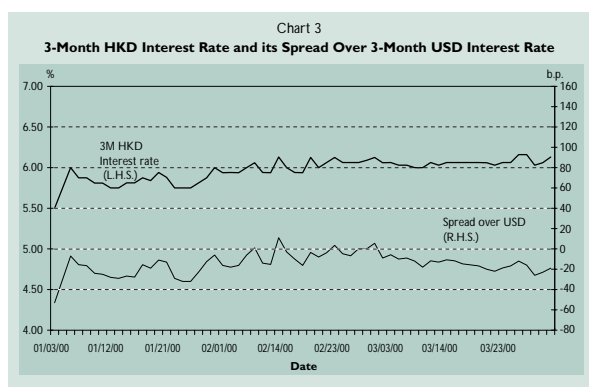
(Chart 1). Small outflows were recorded every time the overnight HK\$ interest rate dipped significantly below its US\$ counterpart, but the flows were reversed as soon as HK\$ interest rate began to climb. As a result, the HK\$ exchange rate tracked very closely the rate of Convertibility Undertaking in late March (Chart 2).



HK\$/US\$ eased from 7.7734 on 30 December 1999 to 7.7865 on 31 March 2000, 1 pip below the rate of the Convertibility Undertaking, as compared to a gap of 40 pips at the end of last year.

Short-term Hong Kong Dollar Interest Rates

As excess liquidity in the interbank money market gradually reduced after the millennium changeover, short term interest rates began to move up. The overnight interest rate picked up from a low of 0.13% on 4 January to around 5.5%, almost at par with the overnight US\$ rate, in early February. With the Aggregate Balance dipping into the negative territory, the overnight rate reached 7% on 15 February, but quickly retreat to 1% on 21 February when a positive balance was restored. Small outflows and the resulting reductions in the Aggregate Balance in the latter half of March again dragged up the overnight rate to 7.25% before settling at 5.69% on 31 March. The 3-month rate followed a similar pattern, rising steadily from a low of 5.50% on 3 January to 6.13% on 31 March (Chart 3). The level of the Aggregate Balance was generally lower during the reporting period than in



the previous quarter. This phenomenon alone, however, did not appear to have caused the level of short-term HK\$ interest rates to move up significantly.

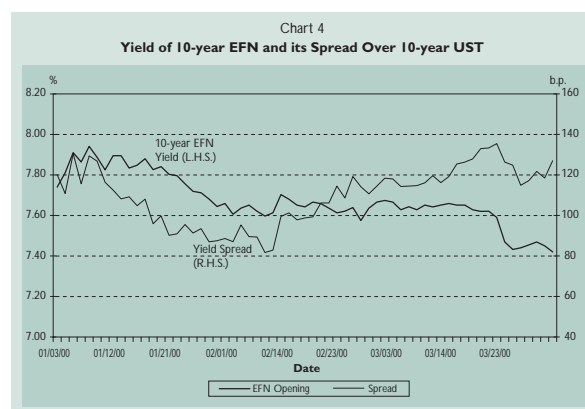
The US Federal Reserve Bank tightened its monetary stance twice during the first quarter of 2000, by 25 b.p. each time on 2 February and 21 March, raising the Fed funds target rate from 5.50% to 6.00%. Correspondingly, the Hong Kong Association of Banks also raised the savings rate

twice on 14 February and 27 March, to reach 4.25%. However, since short-term market HK\$ interest rates moved up by less than their US counterparts during the same period, the interest rate gap between the two currencies narrowed, causing the swap points to soften.

Neither of the two Y2K contingency measures arranged for the money market by the HKMA¹ — the term repo facility and the enlarged discount window — was activated at any time and the facilities expired, as scheduled, on 31 January.

Long Term Hong Kong Dollar Interest Rate and the Hong Kong Premium

The yield on 10-year Exchange Fund Notes (EFN) eased gradually from 7.71% on 30 December 1999 to 7.42% on 31 March 2000, following the general trend of the US Treasuries. Apparently, a shift in US investor interest from equities into the fixed income market and the expected reduction in the supply of long-term US sovereign debts provided strong support to the Treasuries market. The HK\$ EFN market out-performed the US Treasuries market during the early part of the first quarter. The more positive economic outlook for Hong Kong presented by the Financial Secretary in his Budget Speech helped to renew confidence in the resilience of Hong Kong's fixed exchange rate. The yield spread of 10-year EFN over the corresponding US Treasuries, often referred to as



the "Hong Kong premium", narrowed from 122 b.p. on 30 December 1999 (Chart 4) to a low of 82 b.p. in early February. Towards the end of

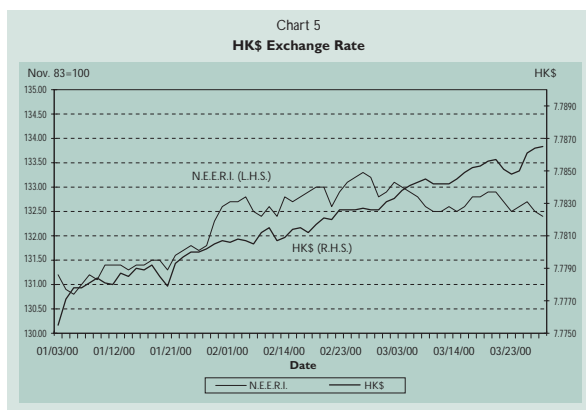
¹ Please refer to the "Liquidity Arrangements for the Money Market in the Year 2000 Context" in the November 99 issue of Quarterly Bulletin

the quarter, the yield on US Treasuries declined further on rumours of a more aggressive debt buyback programme. The yield spread rose and ended at 126 b.p. on 31 March 2000.

Base Rate and the Hong Kong Dollar Effective Exchange Rate

The Base Rate, which is defined 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 7.00% in January. Following the successive increases in the Fed funds target rate on 2 February and 21 March, the Base Rate was adjusted upward from 7.00% to 7.25% on 3 February and to 7.50% on 22 March.


The HK\$ trade-weighted nominal effective exchange rate index (NEERI), which measures the nominal exchange rate of the Hong Kong dollar vis-à-vis currencies of major trading partners, closed at 132.40 on 31 March, up from 131.20 at the beginning of the quarter. This reflected mainly the strengthening of the US\$ against the other major currencies, in particular, the euro, during the first quarter of 2000 (Chart 5).



Domestic Credit and Money Supply

The decline in domestic credit² has moderated on a quarter-on-quarter basis. Following a decline of 1.2% in the fourth quarter of 1999, domestic loans remained stable in the first quarter of 2000. Analysed by economic use, loans for residential mortgages, transport and transport equipment,

building, construction, property development and investment, stockbrokers, and credit card advances registered positive quarter-on-quarter growth, while loans for other sectors declined. On a year-on-year basis, domestic credit dropped by 5.9% in March, compared with a decline of 8.3% in December 1999.

Narrow money supply (HK\$M1) dropped by 2.9% in the first quarter of 2000, following a rise of 10.0% in the fourth quarter of 1999. The decline was in part attributable to a high base of comparison in December 1999, when demand for cash was boosted by seasonal and Year 2000 factors. Meanwhile, broad money supply (HK\$M3) decreased by 1.0% in the first quarter. Compared with a year ago, HK\$M1 rose by 9.7% in March, while HK\$M3 was up by 3.8%. 

- Prepared by the Monetary Policy and Markets Department

² Including loans for trade financing.