

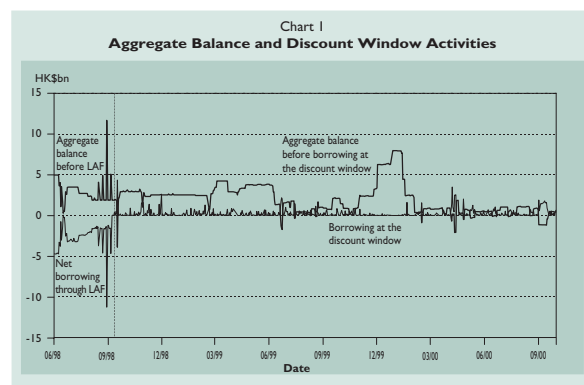
## OPERATION OF MONETARY POLICY

The rate of the Convertibility Undertaking (CU) reached 7.8000 on 12 August and remained there. As this had been clearly explained and publicised well in advance, there was no significant market reaction. This smooth convergence and the announcement that the HKMA would not introduce an explicit CU on the strong side for the Hong Kong dollar bolstered confidence, leading to a substantial easing in the Hong Kong dollar forward points in August. Changes in the Aggregate Balance were less frequent in the third quarter than in the second, largely because the banks were more willing to sell US dollars at or near to the CU rate when the Hong Kong dollar was relatively weak, reflecting their further confidence in the currency board arrangements as the CU rate converged with the link exchange rate on 12 August. The level of the Aggregate Balance fluctuated within the range of about negative 1 billion to positive 1 billion, but shifts from positive to negative, or vice versa, were less frequent than in the second quarter. Overnight Hong Kong dollar interest rates, as a result, tended to stay below or above the corresponding US dollar interest rate for a longer period of time. Moving broadly in line with the forward points, longer term money market rates eased initially but picked up in September after the Aggregate Balance stayed in a deficit position in excess of 1 billion for 2 weeks. Yields on Exchange Fund notes tracked closely those of US Treasuries, easing in July and August as the US inflation fears faded but correcting upwards in September on concerns arising from escalating oil prices.

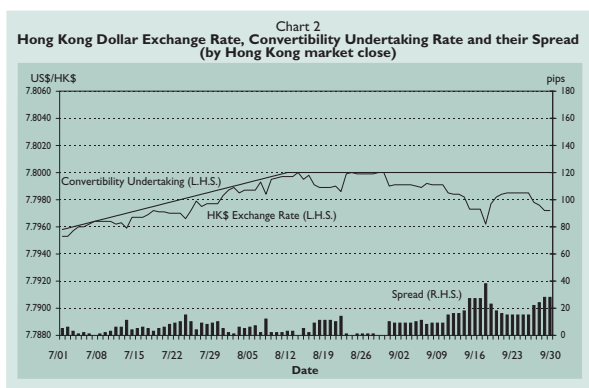
### Convertibility Undertaking and Aggregate Balance

The Convertibility Undertaking (CU) was triggered only a few times during the third quarter. In early July, renewed jitters in Asian currency markets, arising in particular from weakness of the Indonesian Rupiah, triggered some selling of the Hong Kong dollar, as a result of which the Aggregate Balance declined to negative HK\$140 mn on 11 July, but this was soon reversed with the level restored to positive HK\$319 mn on 17 July and further to HK\$1,048 mn on 26 July. It remained close to HK\$1 bn until near the end of August, except for a few days in mid-August when it dipped below zero on a flurry of corporate buying interest in the US dollar. The CU was again triggered on 30 August, causing the Aggregate Balance to fall to negative HK\$1,148 mn on

1 September. This deficit persisted until 15 September when the firming short term Hong Kong dollar interest rates induced inflows which brought the Balance back in stages to positive HK\$493 mn on 19 September. It ended September at HK\$427 mn, as compared to HK\$1,025 mn at end-June (Chart 1).



Tracking closely the one pip a day movement of the rate of the CU, the market exchange rate for the Hong Kong dollar eased initially in the third quarter. As the convergence of the CU rate to 7.8000 on 12 August had been explained and publicised well in advance, the event itself passed calmly, with no noticeable reactions in the exchange market. The exchange rate touched 7.8000 on 14 August and then stayed within a narrow range on the strong side of 7.8000 for the rest of the month. In the first half of September, higher short term Hong Kong dollar interest rates associated with the sizeable deficit in the Aggregate Balance attracted inflows and caused the exchange rate to strengthen again. It reached 7.7957 on 18 September before easing slightly as short term Hong Kong dollar interest rates softened when the Aggregate Balance resumed positive (Chart 2).

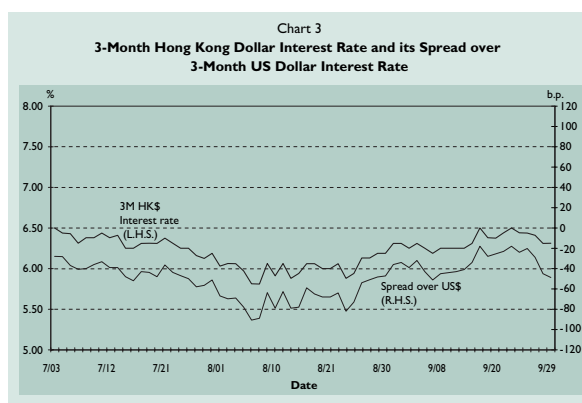


The Hong Kong dollar/US dollar rate ended September at 7.7972, or 28 pips below the rate of the CU, as compared to 7.7953 at end-June, which was 4 pips below the then applicable rate of the CU.

### Short Term Hong Kong Dollar Interest Rates

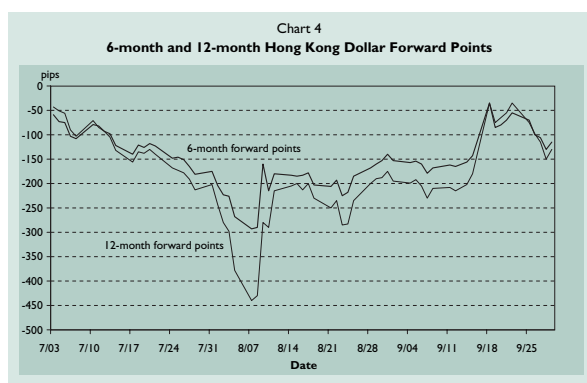
Overnight Hong Kong dollar interest rates adjusted to reflect changes in the Aggregate Balance. But changes in the Aggregate Balance were less frequent in the third quarter than in the second, largely because the banks were more willing to sell US dollars at or near to the CU rate when the Hong Kong dollar was relatively weak, reflecting their further confidence in the currency board arrangements as the CU rate converged with the link exchange rate on

12 August. As the level of the Aggregate Balance moved from positive to negative, or vice versa, less often, the overnight interest rate generally stayed above or below the corresponding US dollar interest rate for a longer period of time. The overnight rate dipped to a low of 2.00% on 15 August after the Aggregate Balance had stayed over HK\$1 bn for almost three weeks. On the other hand, the deficit of more than HK\$1 bn in the Aggregate Balance in early September, pushed the overnight rate to a high of 8.25% on 5 September. But the market remained calm and the overnight rate then eased slightly as the market became accustomed to the situation, in the knowledge that overnight liquidity was assured from the Discount Window. The overnight rate ended the month at 6.25%, as compared to 6.88% at end-June. Longer term money market rates moved in tandem with the forward points, easing initially in July and August but picking up moderately in September. The 3-month Hong Kong dollar interbank rate fell from 6.50% at the beginning of third quarter to a low of 5.81% on 7 August. It then hovered around 6.00% before rising to 6.50% on 18 September as the firmness in the overnight rate as a result of the prolonged period of sizeable deficit in the Aggregate Balance eventually spilled over to the longer term rates. The 3-month rate ended September at 6.31%, or 49 b.p. below its US dollar counterpart (Chart 3).



Following the easing trend seen in the second quarter, Hong Kong dollar forward points eased further initially on continued position liquidations as the CU rate moved uneventfully towards 7.8000. The meeting minutes of the Exchange Fund Advisory Committee's Sub-committee on Currency Board Operations released in early August disclosed

that the HKMA would not introduce an explicit CU on the strong side for the Hong Kong dollar; this led some market players to believe that the Hong Kong dollar could strengthen beyond their previous expectations. The position liquidation activities intensified on this announcement and pushed the forward points down to record levels -6-month and 12-month to -293 pips and -440 pips respectively on 7 August before correcting gradually to about -150 pips and -200 pips by mid September. However, as the effect of higher short term interest rates in the first 2 weeks of September began to filter through, the forward points rose briefly before easing back again. 6-month and 12-month forward points both peaked at -35 pips on 18 September before widening to -115 pips and -130 pips respectively at end-September, as compared to -59 pips and -43 pips at end-June (Chart 4).

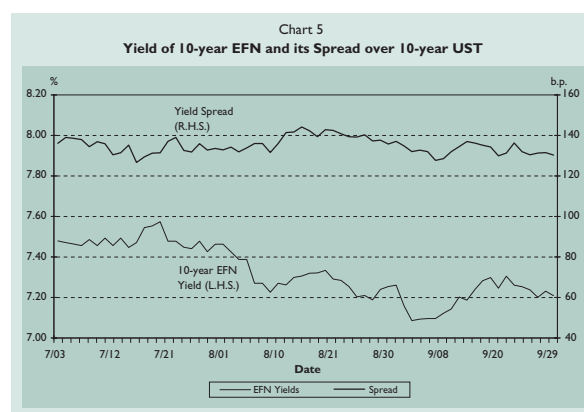


As expected, the US Federal Reserve decided to leave the Fed funds target rate (FFTR) unchanged at 6.50% at the US Federal Open Market Committee (FOMC) meeting on 22 August. The Hong Kong Association of Banks also left the savings rate unchanged at 4.75% during the third quarter.

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

The longer end of the Hong Kong dollar yield curve remained very stable during the third quarter. The yields on Exchange Fund Notes (EFN) moved in close proximity to the yields of US Treasuries (UST) of matching maturity. 10-year EFN yield eased steadily from a high of 7.57% on

20 July to a low of 7.09% on 4 September. Meanwhile, US economic figures continued to hint at a benign US inflation outlook, which was further confirmed by the US Federal Reserve's decision to keep the FFTR unchanged at the US FOMC meeting on 22 August. However, the yields on EFN then picked up briefly as renewed inflation concerns, sparked by escalating oil prices, began to weigh on the UST in early September. The 10-year EFN yield edged up to 7.31% on 21 September before ending the month at 7.21%, as compared to 7.48% on 30 June. The UST and EFN yield curves moved largely in parallel so that the yield spread of 10-year EFN over the corresponding UST, often referred to as the "Hong Kong premium", remained generally stable. It ranged from a high of 144 b.p. on 15 August to a low of 127 b.p. on 17 July, and closed at 130 b.p. on 29 September, as compared to 134 b.p. on 30 June (Chart 5).

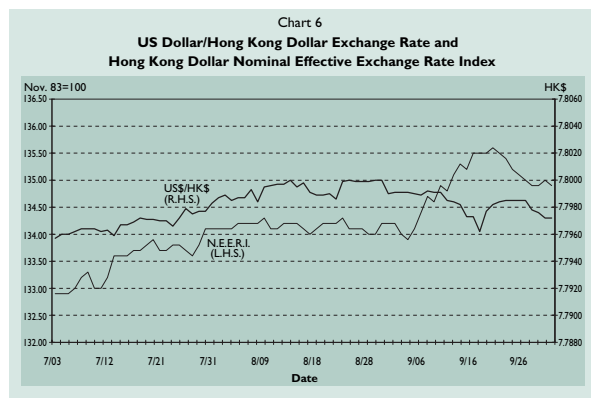


### Base Rate and Hong Kong Dollar Effective Exchange Rate

The Base Rate, which is defined as the higher of the US FFTR plus 150 b.p., and the simple average of the 5-day moving averages of overnight and 1-month HIBOR for the previous 5 trading days, stayed at 8.00% during the third quarter.

The HK\$ trade-weighted nominal effective exchange rate index (NEERI), which measures the nominal exchange rate of Hong Kong dollar vis-à-vis currencies of major trading partners, closed at 134.90 on 30 September, as against 132.70 level at the end of the second quarter. The higher NEERI


reflected a stronger US\$ against the other major currencies, particularly against the Euro (Chart 6).



### Domestic Credit and Money Supply

With continuing economic recovery, the decline in domestic loans<sup>1</sup> had come to a halt in the first half of 2000 and they then rose quite significantly, by 3.8%, in the third quarter, to a level 2.4% higher than a year earlier. However, a large part of this increase was accounted for by loans for a large corporation acquisition.

Analysed by economic use, loans for electricity, gas, and telecommunications saw the largest quarter-on-quarter rise (148%) in the third quarter of 2000 as a result of corporate acquisition loans, but their share in total loans remained small at 3.5%. Loans for stockbrokers also rose notably by 69%, amid buoyant equity market activity. Nevertheless, loans for wholesale and retail trade declined by 5.2%, reflecting a consolidation in retail sales, while loans for building, construction, property development and investment, and trade financing decreased moderately by 1.3% and 0.8% respectively.

Narrow money supply (HK\$M1) rose by 0.6% in the third quarter of 2000, reflecting an increase in transaction demand for money amid robust economic activity and increased activity in the equity market. Meanwhile, broad money supply (HK\$M3) increased by 1.6% in the third quarter, driven mainly by increases in time deposits. Compared with a year ago, HK\$M1 rose by 4.1% in September, while HK\$M3 was up by 5.2%. 

- Prepared by the Monetary Policy and Markets Department

<sup>1</sup> Including loans for trade financing.