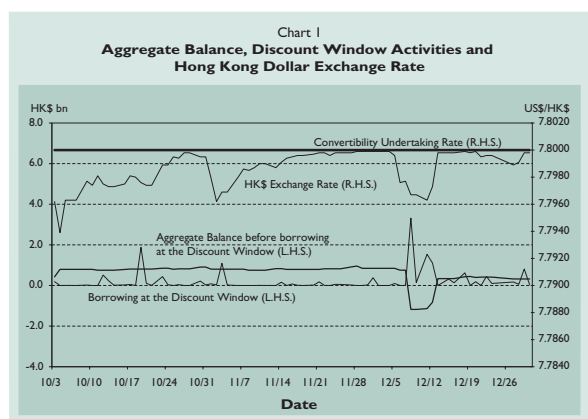


OPERATION OF MONETARY POLICY

The Hong Kong dollar exchange rate remained generally steady in the last quarter of 2000, staying within the 7.7980-7.8000 range most of the time, but spiking up briefly on three occasions as a result of equity-related demand for the local currency. The Convertibility Undertaking was triggered in early December, sending the Aggregate Balance to negative HK\$1,178mn for a few days before the rise in short-term Hong Kong dollar interest rates reversed the outflows. Hong Kong dollar forward points eased by over 100 pips during the quarter, but closed the quarter only slightly lower with tighter Hong Kong dollar interest rates. Signs of slow down in the US economy led the market to expect interest rate cuts in the US in early 2001; long-term Hong Kong dollar interest rates fell in tandem with their US dollar counterparts, with little change in the “Hong Kong premium”.

Convertibility Undertaking and Aggregate Balance

Activities involving the Currency Board Accounts subsided noticeably in the fourth quarter of 2000, reflecting a stable financial environment. The Hong Kong dollar exchange rate stayed within the narrow range between 7.7980 and 7.8000 for most of the quarter, except on three occasions when it strengthened briefly due to equity related demand for the local currency. The Hong Kong dollar reached a high of 7.7935 on 4 October (Chart 1) apparently due to keen overseas buying interest associated with the initial public offering of MTRC shares. Against this capital inflow, the HKMA bought some US dollars through the currency board, raising the Aggregate Balance from HK\$427 mn to HK\$794 mn on 4 October.



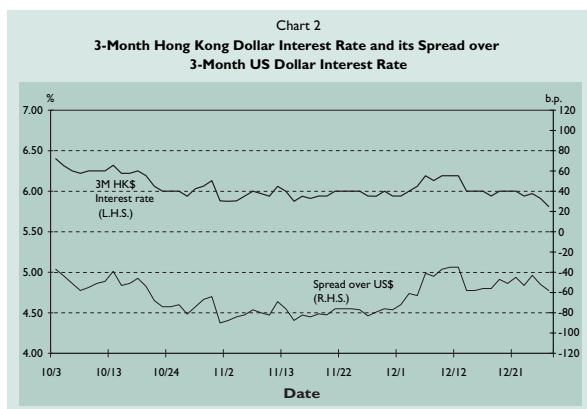
Demand for Hong Kong dollars emerged again in early November, associated in part with the share placement exercise of China Mobile (Hong Kong) Limited. The exchange rate touched 7.7960 on 2 November but drifted back to 7.8000 later in the month. In early December, Hong Kong dollar arbitrage activity occurred due to soft Hong Kong dollar interest rates. Together with a large corporate order to sell Hong Kong dollar raised in a recent equity exercise, this caused the CU to be triggered on 6 December. The Aggregate Balance declined to negative HK\$1,178 mn on 8 December. The resultant firming of short-term interest rates saw the currency strengthen to 7.7963 on 11 December. The exchange rate closed at 7.7998 at the end of December, compared to 7.7972 at the end of September. The Aggregate Balance edged up to negative HK\$826 mn on 12 December, and was restored to positive HK\$338 mn on 13 December before settling at HK\$321 mn at the end of the quarter.

Short Term Hong Kong Dollar Interest Rates

With infrequent movements involving the currency board accounts, short-term Hong Kong dollar interest rates were quite stable during the quarter. The overnight Hong Kong dollar interest rates stayed below its US dollar counterpart in early October, dipping to a low of 3.00% on

24 October. With the Aggregate Balance falling to negative HK\$1,178 mn on 8 December, the overnight rate spiked up to 9.00% on the same day. However, as soon as the deficit in the Aggregate Balance was replenished on 13 December, the overnight rate eased back to 5.38%. The usual year-end demand for Hong Kong dollar funding sent the overnight rate to 6.00% level before closing at 6.88% on 31 December, as compared to 6.25% at end-September.

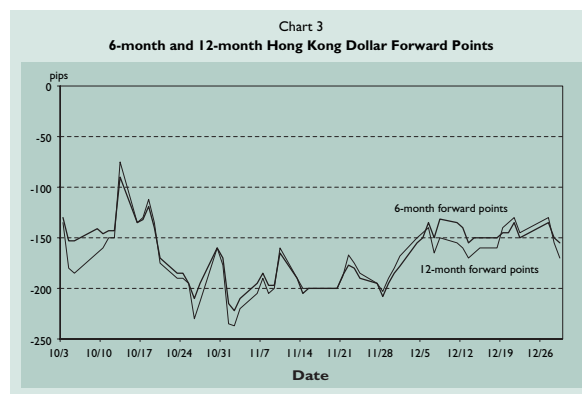
The release of a series of weaker-than-expected US economic data during the quarter eroded the bullish sentiment in the US economy. One-month to six-month Hong Kong dollar money market rates eased in tandem with their US dollar counterparts on expectation that the US authorities might lower rates in early 2001 to prevent a hard-landing of the US economy. The Federal Reserve changed its policy bias from ‘tightening’ to ‘easing’ at the US Federal Open Market Committee (FOMC) meeting on 19 December. The three-month Hong Kong dollar interbank rate fell from 6.40% at the beginning of the quarter to 5.81% at the quarter end, 58 b.p. below its US dollar counterpart (Chart 2).



During the fourth quarter, the US Federal Reserve left the Fed funds target rate (FFTR) unchanged at 6.50%. The Hong Kong Association of Banks in turn left the savings rate unchanged at 4.75%.

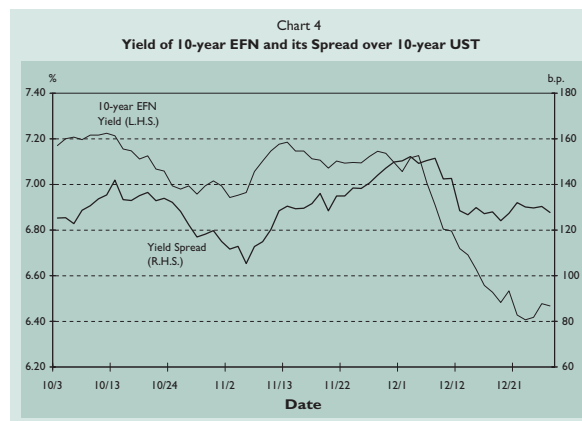
Hong Kong dollar forward points eased during the quarter from -115 pips (6-month rate) and -130 pips (12-month rate) at end-September to -230 pips and -245 pips respectively on 2 November. They then hovered around -200 pips

in November before picking up slightly to close at -155 pips and -170 pips respectively at the end of December (Chart 3).



Longer Term Hong Kong Dollar Interest Rates and the Hong Kong Premium

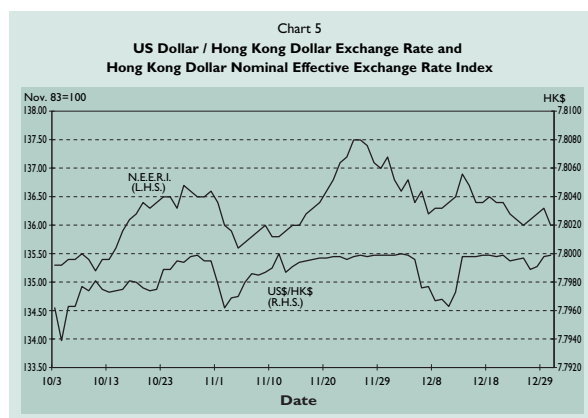
Following the sharp decline in the yields of US Treasuries in December, the long end of the Hong Kong dollar yield curve dipped noticeably. While the yields on Exchange Fund Notes (EFN) remained generally steady in October and November, 10-year EFN yield dropped from a high of 7.23 % on 5 October to a low of 6.39% on 22 December, before ending the year at 6.46%, significantly below the 7.21% recorded at end-September. Since the EFN yields generally tracked those of UST, the yield spread of 10-year EFN over the corresponding UST, often referred to as the ‘‘Hong Kong premium’’, moved only within a narrow range - from a minimum of 105 b.p. on 6 November to a maximum of 152 b.p. on 4 December before closing at 127 b.p. at end-December, as compared to 130 b.p. at end-September (Chart 4).



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 five trading days, stayed unchanged at 8.00% during the fourth quarter.


The Hong Kong dollar 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 136.0 on 30 December, as against 134.9 at the end of the third quarter. The effect of the weakening of US dollar against Euro was more than offset by that of the strengthening of US dollar against Japanese Yen (Chart 5).



Domestic Credit and Money Supply

Domestic loans¹ contracted slightly by 1.8% on a quarter-on-quarter basis in the fourth quarter of 2000, following a notable rise related to a large corporate acquisition in the third quarter. Nevertheless, domestic loans have shown mild positive year-on-year growth since August 2000, though they have continued to lag behind the pick-up in economic activity. The slow pace of lending has not been caused by any lack of liquidity in the banking sector. Rather, it appears to be related to a number of demand-side factors, including declines

in property values, and a diversification of fund-raising channels.

Narrow money supply (HK\$M1) rose by 5% on a quarter-on-quarter basis in the fourth quarter of 2000, reflecting active fund raising activity². However, because of the inflated level of cash holdings in December 1999 relating to the Y2K factor, HK\$M1 recorded a 0.7% decline in the year to December 2000. The growth of broad money (HK\$M3) moderated to 1.7% in the fourth quarter, driven mainly by increases in time deposits. Compared with a year ago, HK\$M3 was up by 4%, broadly in line with nominal GDP growth. 

- Prepared by the Monetary Policy and Markets Department

¹ Including loans for trade financing.

² A total of HK\$290 bn funds were raised in the equity market in the fourth quarter of 2000, compared with HK\$19 bn in the third quarter.