

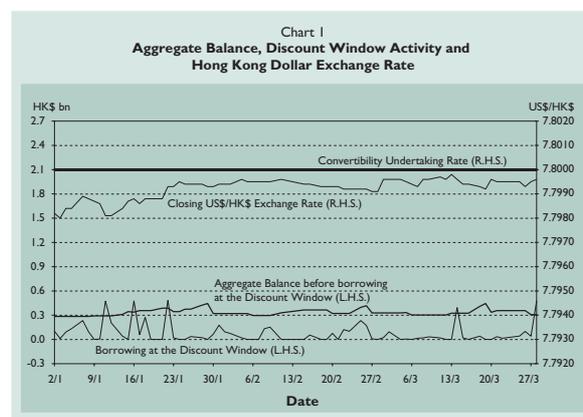
OPERATION OF MONETARY POLICY¹

The Hong Kong dollar exchange rate remained stable during the first quarter of 2002, notwithstanding the dismantling of the Argentine currency board system, the volatility in the Japanese yen's exchange rate and the seasonal increase in bank notes issuance and redemption activities straddling the Chinese New Year holidays. The Convertibility Undertaking was not triggered and the level of the Aggregate Balance remained unchanged, save for minor movements associated with interest payments on Exchange Fund paper. The favourable US economic data released during the quarter helped to solidify hopes of a near-term US economic recovery. Meanwhile, the US Federal Reserve shifted its monetary policy stance from easing to neutral while holding the Fed funds target rate steady. In line with their US dollar counterparts, Hong Kong dollar interest rates eased initially but picked up towards the end of the quarter. Except for spiking briefly in early March amidst renewed rumours about the currency peg, the Hong Kong dollar forward points were generally stable. Yields on long-term Exchange Fund Notes bottomed out with those on US Treasuries amidst expectations that the rate easing cycle had come to an end and the tightening cycle would soon commence.

Convertibility Undertaking and Aggregate Balance

The Hong Kong dollar exchange rate started the quarter on an easing trend as the usual year-end funding demand subsided. The exchange rate then hovered in the range 7.7990-7.7999 for the rest of the quarter (Chart 1). The sustained weakness of the Japanese yen, despite a brief rebound in early March, and the collapse of the Argentine currency board system had no apparent impact on the Hong Kong dollar exchange rate. As usual, the exchange rate eased slightly when note-issuing banks bought US dollar in anticipation of increased note issuance for the Chinese New Year holidays in mid-February but firmed afterwards on redemption of the Certificates of Indebtedness.

The Convertibility Undertaking (CU) was not triggered during the quarter and the level of the

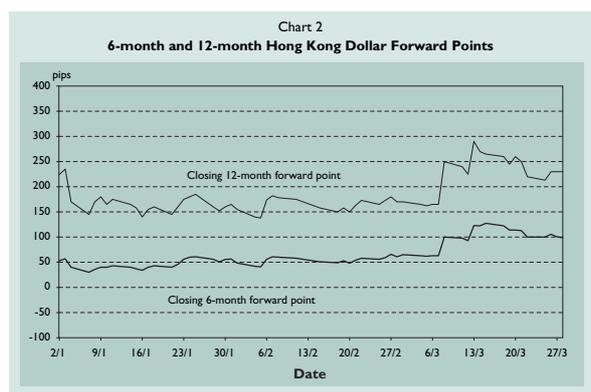


Aggregate Balance remained stable at around HK\$300 mn, save for intra-week fluctuations when interest on outstanding issues of Exchange Fund paper was disbursed and before additional Exchange Fund Bills were issued to sterilise those payments. The exchange rate closed at 7.7996 on 28 March 2002, as compared to 7.7978 at end-December

¹ Starting from this issue, the domestic credit and money supply conditions will be covered in the article 'Domestic and External Environment'.

2001, while the Aggregate Balance ended the quarter at HK\$307 mn, compared to HK\$296 mn at end-December 2001.

Hong Kong dollar forward points remained steady until early March when rumours that the Hong Kong SAR Government might review the currency peg to revive the economy triggered some Hong Kong dollar selling interest in the forward market. As a result, the 12-month forward points picked up from +165 pips on 7 March 2002 to as high as +290 pips on 13 March 2002 before profit-taking activities emerged and brought the forward points lower gradually. 6-month and 12-month Hong Kong dollar forward points closed at +99 pips and +230 pips respectively on 28 March 2002, as compared to +53 pips and +240 pips at end-December 2001 (Chart 2).

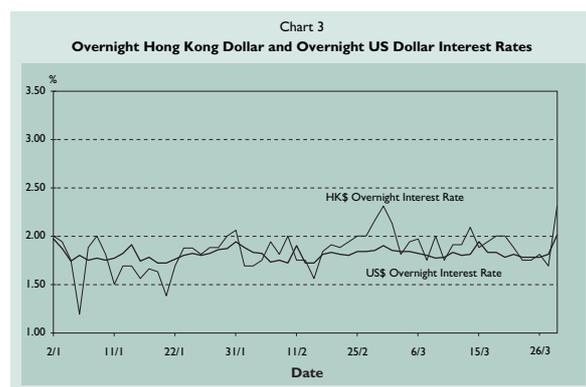


A spate of better-than-expected US economic data and the upbeat assessment of the US economy by Federal Reserve's officials, including Chairman Alan Greenspan, fuelled optimism of a swift recovery of the US economy. The Federal Reserve left the Fed funds target rate unchanged at 1.75% at the two Federal Open Market Committee meetings held during the quarter, on 30 January and 19 March 2002, but shifted its monetary policy bias from "weakness" to "neutral" at the second meeting, signalling the end of the rate easing cycle

and the possible commencement of the tightening cycle later this year. In Hong Kong, the HKMA Base Rate stayed at 3.25% while the savings rates quoted by major banks stood at 0.125% throughout the first quarter.

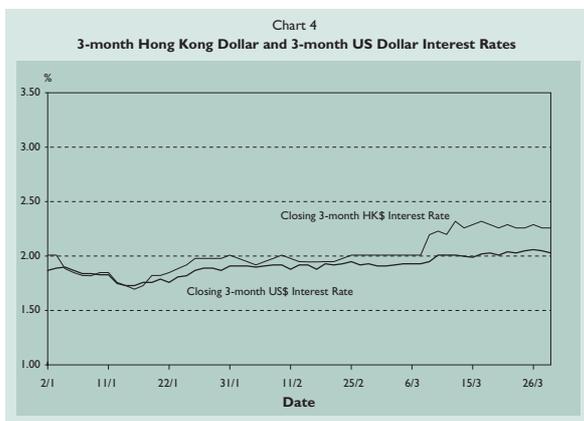
Short-term Hong Kong Dollar Interest Rates

As the CU was not triggered during the quarter, the steady market liquidity level helped to foster a very stable interest rate environment. Except for brief periods of tightening ahead of month-ends due to the usually higher funding demands, the overnight rate stayed close to its US counterpart and moved in the 1.56-2.00% range for most of the quarter before ending at 2.31% on 28 March 2002, as compared to 1.38% at end-December 2001 (Chart 3).



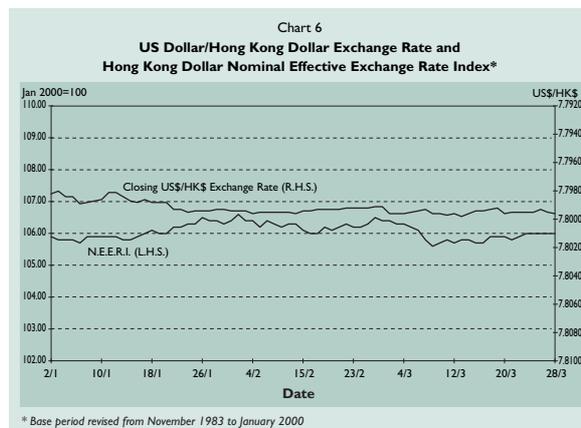
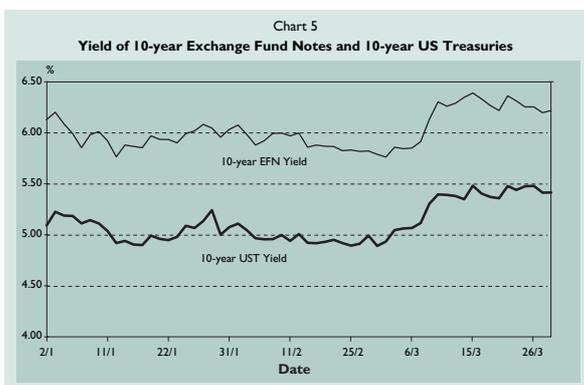
Hong Kong dollar term deposit rates also tracked closely the movements in their US dollar counterparts. After easing slightly at the beginning of the quarter, the term deposit rates edged up gradually on looming rate hike expectations but shot up with the rising forward points in early March on rumours that the Government might review the peg, resulting in a widening of the positive interest spreads between Hong Kong dollar and US dollar interest rates. 3-month Hong Kong

dollar money market rate rose from 2.00% at end-December 2001 to 2.25% by end-March 2002, 23 b.p. above its US dollar counterpart (Chart 4).



Long-term Hong Kong Dollar Interest Rates

The yields on US Treasuries remained flat at the beginning of the quarter as investors stayed on the sidelines, awaiting more clues on the future interest rate trend. Nevertheless, the yields on US Treasuries picked up noticeably since early March as it was increasingly evident that the US economic recovery was on the way, reinforcing investor expectation that the Fed might tighten later this year. The yields on Exchange Fund Notes (EFN) went up generally with the US Treasuries yields, albeit at a slower pace. The 10-year EFN yield peaked at 6.39% on 15 March 2002 before ending at 6.22% on 28 March 2002, as compared to 6.13% at the beginning of the quarter. The yield spread of the 10-year EFN over US Treasuries narrowed from 104 b.p. to 80 b.p. over the quarter (Chart 5).



Hong Kong Dollar Effective Exchange Rate

The Hong Kong dollar trade-weighted nominal effective exchange rate index (NEERI), which measures the nominal exchange rate of Hong Kong dollar against currencies of major trading partners, closed marginally stronger at 106.00 on 28 March 2002, as compared to 105.90 at the beginning of the quarter (Chart 6).

- Prepared by the Monetary Policy and Markets Department