

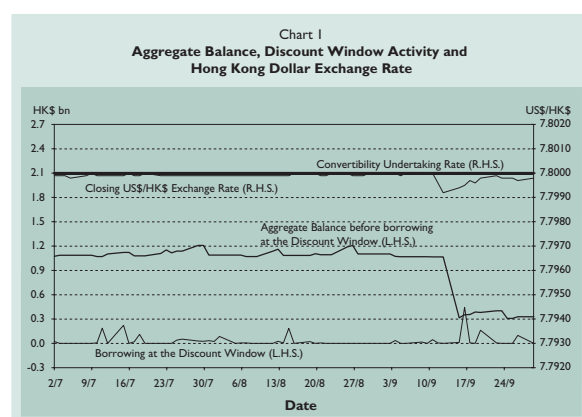
## OPERATION OF MONETARY POLICY

*The Hong Kong dollar exchange rate stayed close to the Convertibility Undertaking (CU) rate for most of the third quarter. Soft short-term Hong Kong dollar interest rates induced some switching into US dollars during the first two months of the quarter. Selling pressure on the Hong Kong dollar intensified in mid-September following further speculation in the press about the future of the peg. This triggered the CU and caused a reduction in the Aggregate Balance to HK\$315 million on 16 September. The exchange rate then firmed briefly, but eased again on further news stories reporting concerns about the sustainability of the Linked Exchange Rate system, which also sent the Hong Kong dollar forward points higher. The US Federal Reserve shifted its monetary policy bias from “neutral” to “weakness” while leaving the Fed funds target rate unchanged. Hong Kong dollar interest rates softened initially with their US dollar counterparts but were dragged higher by the rising forward points towards the end of the quarter.*

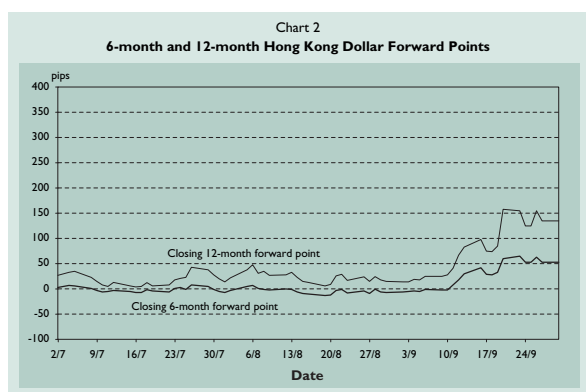
### Convertibility Undertaking and Aggregate Balance

Influenced by abundant interbank liquidity and soft short-term Hong Kong dollar interest rates, the Hong Kong dollar exchange rate stayed close to the CU rate of 7.8000 early in the quarter as market players switched into US dollars to enjoy higher yields. Selling pressure on the Hong Kong dollar intensified on 11 September following reports of a research note issued by a brokerage house commenting that the Hong Kong dollar's peg to the US dollar was hindering local economic recovery and should be abandoned sooner or later. The heightened Hong Kong dollar selling interest triggered the CU on 12 September, causing the Aggregate Balance to drop from HK\$1,067 million to HK\$315 million on 16 September. Thereafter the exchange rate strengthened briefly to 7.7991 on 13 September but soon eased towards 7.8000 on 20 September when selling pressure emerged again on reports that the Legislative Council Panel

on Financial Affairs proposed to initiate a study on the future of the Currency Board and that several financial institutions had issued research reports advising their clients to reduce Hong Kong dollar exposure. The exchange rate finally ended at 7.7998 on 30 September, as compared to 7.7999 on 28 June, while the Aggregate Balance ended the quarter at HK\$328 million, as compared to HK\$1,075 million at end-June (Chart 1).



The Hong Kong dollar forward points maintained a soft tone amidst the initial strength of the Japanese yen and other Asian currencies against the US dollar during the quarter but firmed up around mid-September when the brokerage report dampened market sentiment. The 12-month forward points traded at a small premium before picking up to +98 pips on 16 September, reaching +158 pips on 20 September and ending the month at +135 pips (Chart 2).

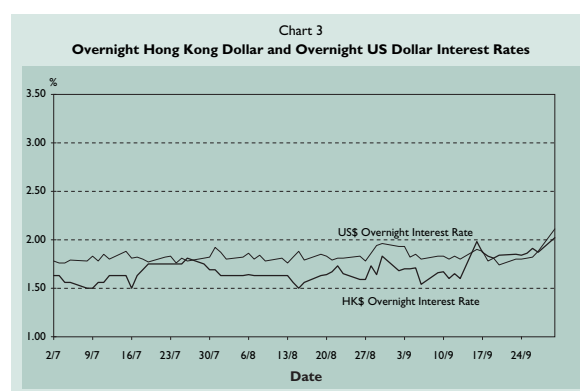


As widely expected, the Federal Reserve kept the Fed funds target rate unchanged at 1.75% at the Federal Open Market Committee meetings held on 13 August and 24 September, but shifted its monetary policy bias from “neutral” to “weakness” at the first meeting. Meanwhile, worries about the sustainability of the US economic recovery intensified with falling stock prices, looming concerns about the negative economic impact of a possible war with Iraq and recurring signs of weakness in the manufacturing sector, consumer confidence and labour market. The gloomy outlook resulted in a scaling down of interest rate expectations. In Hong Kong, the HKMA Base Rate remained unchanged at 3.25% while the savings rates quoted by major banks stayed at 0.125% throughout the third quarter.

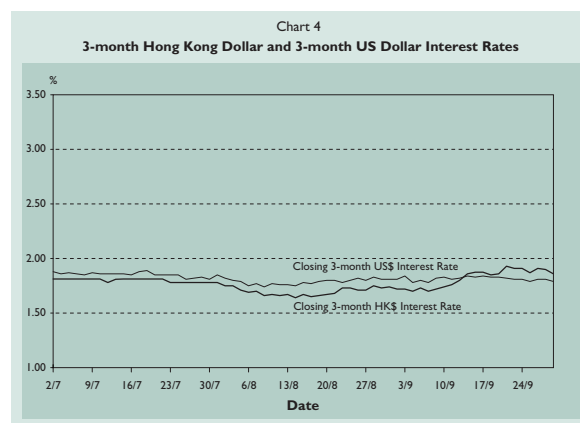
### Short-term Hong Kong Dollar Interest Rates

The Hong Kong dollar overnight interest rate remained generally soft during the quarter, staying below its US dollar counterpart. This mainly reflected abundant liquidity. The rate edged up

marginally straddling the initial public offering periods of a couple of new shares in July and hovered within the range 1.13-1.88% until 16 September when the rate spiked up to 2.06% in response to the shrinkage in the Aggregate Balance. It then moved between 1.63% and 2.09% before ending at 1.94% on 30 September, as compared to 1.81% at end June (Chart 3).

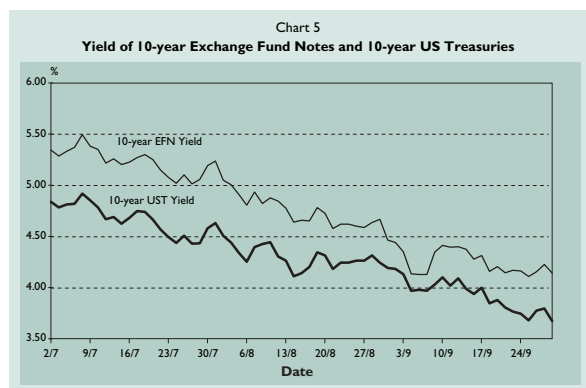


Hong Kong dollar term deposit rates eased initially in tandem with their US dollar counterparts on growing market consensus that the Fed would lower rates before the end of this year. However, driven by the rising forward points from mid-September, term deposit rates stopped easing and moved upwards. As a result, the spreads between Hong Kong dollar and US dollar interest rates moved from negative to positive. 3-month Hong Kong dollar money market rate ended the quarter at 1.86%, 7 b.p. above its US dollar counterpart, as compared to 1.81% at end-June, 7 b.p. below the corresponding US dollar rate (Chart 4).



## Long-term Hong Kong Dollar Interest Rates

US Treasuries posted solid gains on safe-haven buying amidst plummeting US stocks, the tame interest rate outlook and worries about military action on Iraq. The yields on Exchange Fund Notes (EFN) dropped significantly in tandem, with the 10-year yield falling from a high of 5.50% on 8 July to a low of 4.11% on 25 September before ending at 4.14% on 30 September, as compared to 5.44% at end-June (Chart 5). The EFN yields dropped at a faster speed than their US counterparts initially on reportedly keen investment interest from local banks and growing market expectations of a flattening of the Hong Kong dollar yield curve. The yield spread of 10-year EFN over US Treasuries once narrowed to 15 b.p. on 5 September before picking up gradually to end at 47 b.p. on 30 September, as compared to 56 b.p. on 28 June.



## 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 at 103.20 on 30 September, as compared to 102.60 at end-June (Chart 6). The higher NEERI reflected the strengthening of the US dollar against other major currencies, including the euro and the Japanese yen. 🇺🇸

- Prepared by the Monetary Policy and Markets Department

