

# Operation of Monetary Policy

by the Monetary Management and Infrastructure Department

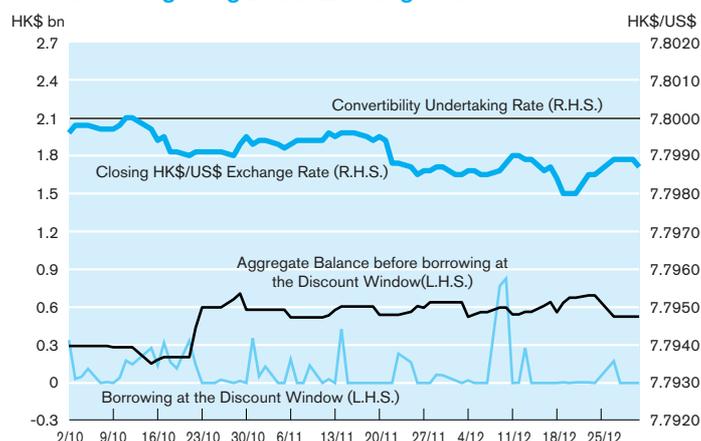
The Hong Kong dollar exchange rate strengthened initially as short-term interest rates stayed firm due to the small Aggregate Balance during the early part of the fourth quarter of 2002. The Aggregate Balance went up after the HKMA accepted an offer of US dollars under the Currency Board Account on 22 October, leading to a slight easing in the exchange rate. Approaching the year-end, the exchange rate firmed again due to seasonal funding demand. Hong Kong dollar forward points climbed at the beginning of the quarter on lingering concerns about the fiscal deficits. The forward points, however, came down noticeably following Premier Zhu's positive comments about Hong Kong in mid-November. The US Federal Reserve lowered the Fed funds target rate by 50 basis points and shifted its monetary policy bias from "weakness" to "neutral" on 6 November, signifying that the Fed would keep rates unchanged for the time being. Tracking their US dollar counterparts, Hong Kong dollar interest rates picked up initially but softened after early November. The yields on Exchange Fund Notes were largely stable during the quarter.

## Convertibility Undertaking and Aggregate Balance

The Hong Kong dollar exchange rate strengthened during the early part of the fourth quarter of 2002 and touched 7.7986 on 22 October, as short-term interest rates remained firm against the small Aggregate Balance. In view of the tight liquidity conditions, the HKMA accepted offer of US dollars from a bank on 22 October, inflating the Aggregate Balance from HK\$204 million to HK\$438 million. Following the expansion of the Aggregate Balance, the exchange rate eased and hovered mostly in the range 7.7990-7.7995. The exchange rate firmed again since late November on reported commercial buying interest in Hong Kong dollars and strengthened further to 7.7977 on 19 December as short-term interest rates tightened due to the usual year-end demand for funds and some market players squared their short Hong Kong dollar positions. The exchange rate finally ended at 7.7987 on 31 December, as compared to 7.7998 on 30 September, while the Aggregate Balance ended the quarter at HK\$525 million, as compared to HK\$328 million at end-September (Chart 1).

The Hong Kong dollar forward points firmed at the beginning of the quarter on looming concerns about the sustainability of the currency peg amidst the ballooning fiscal deficits. After peaking at +368 pips on 15 October, the 12-month forward points eased briefly but rose again on S&P's announcement in late October to downgrade Hong Kong's local currency rating outlook from stable to negative and on worries about the impact of suspension of land sales on the

**CHART 1**  
Aggregate Balance, Discount Window Activity and Hong Kong Dollar Exchange Rate



fiscal deficits. The forward points then hovered around +300 pips but eased noticeably and maintained a soft tone subsequent to Premier Zhu's comments on 19 November that China would use her resources to support the Hong Kong SAR. 6-month and 12-month forward points closed at +65 pips and +170 pips respectively on 31 December, as compared to +53 pips and +135 pips at end-September (Chart 2).

After announcing a larger-than-expected 50 basis points rate reduction and switching its monetary policy bias from "weakness" to "neutral" at the Federal Open Market Committee (FOMC) meeting held on 6 November, the Federal Reserve left the Fed funds target rate unchanged at 1.25% and retained the "neutral" bias at the FOMC meeting on 10 December. Meanwhile, the pace of US economic recovery remained doubtful as the economic figures released during the quarter were mixed and market sentiment was undermined by the threat of US military action against Iraq. In Hong Kong, after the 50 basis points cut in the Fed funds target rate, the Base Rate was lowered to 2.75% on 7 November. Major banks also trimmed their savings rates from 0.125% to 0.01% on the same day.

CHART 2

### 6-month and 12-month Hong Kong Dollar Forward Points



## Short-term Hong Kong Dollar Interest Rates

The Hong Kong dollar overnight interest rate moved upwards from the beginning of October and reached a high of 2.57% on 22 October due to tight interbank liquidity. Nevertheless, after the replenishment of the Aggregate Balance on 22 October, the overnight rate eased significantly to between 1.70% and 2.03% until early November when the Fed rate cut sent the rate to a lower range between 1.19% and 1.41%. The overnight rate ended slightly higher at 1.59% on 31 December, as compared to 1.94% on 30 September (Chart 3).

Hong Kong dollar term deposit rates picked up initially with the US dollar rates but softened after the Fed rate cut in early November. In line with the movements of the forward points, the term rates climbed and then fell, albeit at a faster pace than their US dollar counterparts. As a result, the spreads between Hong Kong dollar and US dollar interest rates widened initially and narrowed towards the end of the quarter. 3-month Hong Kong dollar money

CHART 3

### Overnight Hong Kong Dollar and Overnight US Dollar Interest Rates



market rate ended the quarter at 1.47%, 9 basis points above its US dollar counterpart, as compared to 1.86% at end-September, 7 basis points above the corresponding US dollar rate (Chart 4).

## Long-term Hong Kong Dollar Interest Rates

The yields on Exchange Fund Notes (EFN) remained stable and tracked the US Treasuries yields closely. 10-year EFN yield moved higher initially, touching 4.79% on 18 October before retreating with its US counterpart on growing expectation of a US rate cut at the FOMC meeting on 6 November. Following the

CHART 4

### 3-Month Hong Kong Dollar and 3-Month US Dollar Interest Rates

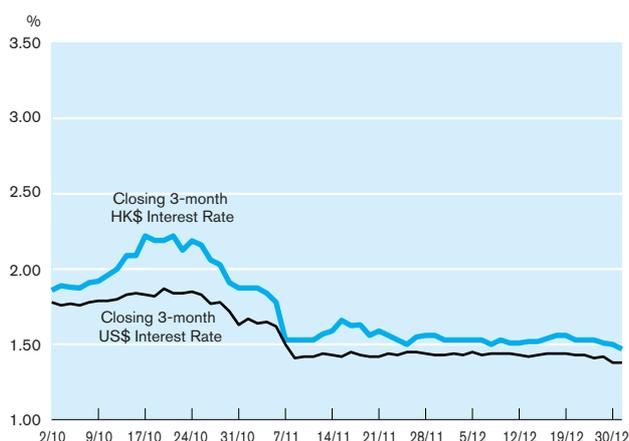


CHART 5

### Yield of 10-year Exchange Fund Notes and 10-year US Treasuries



Fed's announcement on 6 November to cut rates and revert the monetary policy stance to "neutral", the yield rebounded, touching 4.74% in early December before coming down again amidst looming concerns about a possible US-Iraq war. The yield finally closed at 4.27% on 31 December, as compared to 4.14% on 30 September. The yield spread of 10-year EFN over the US Treasuries also remained steady, closing at 44 basis points on 31 December as compared to 47 basis points on 30 September (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 weaker at 102.00 on 31 December, as compared to 103.20 at end-September (Chart 6). The lower NEERI reflected the weakening of the US dollar against other major currencies, in particular the euro and the Japanese yen.

CHART 6

### Hong Kong Dollar / US Dollar Exchange Rate and Hong Kong Dollar Nominal Effective Exchange Rate Index

