REGULAR ARTICLE

Operation of Monetary Policy

by the Monetary Management and Infrastructure Department

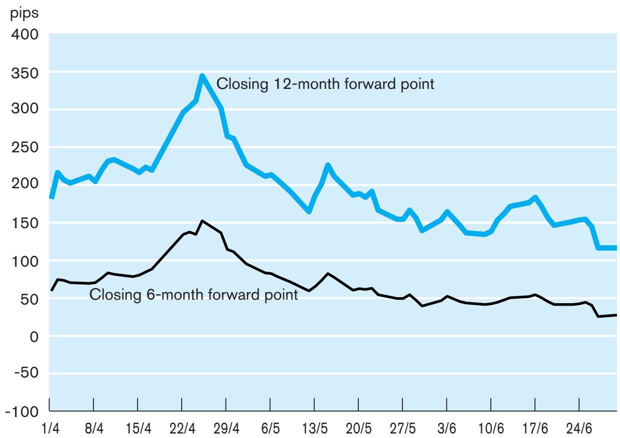
Sentiment in the Hong Kong dollar market deteriorated initially during the second quarter of 2003 as the outbreak of severe acute respiratory syndrome (SARS) began to take its toll on the Hong Kong economy. Against a background of unfavourable assessments of the impact of SARS on the economy, Hong Kong dollar forward points rose noticeably. However, as the epidemic gradually receded, market sentiment improved and the forward points began to drop in late April. Despite the volatility, the spot Hong Kong dollar exchange rate remained stable during the quarter. Meanwhile, the US Federal Reserve confirmed the deflation risk bias of its monetary policy stance and lowered the Fed funds target rate to a 45-year low. Hong Kong dollar interest rates initially moved higher with the rising forward points, but then eased with their US dollar counterparts on intensifying expectations of an aggressive US rate cut. Tracking US Treasuries, the yields on Exchange Fund Notes fell generally before correcting slightly upwards by the end of the quarter.

Convertibility Undertaking and Aggregate Balance

Overshadowed by worries about the impact of SARS on the pace of economic recovery and hence the Government's fiscal position, the Hong Kong dollar forward points picked up early in the second quarter. The forward points rose as a number of financial institutions, credit rating agencies and research institutes slashed their growth forecasts for the economy. The 12-month forward points breached +300 pips on 23 April following the Government's announcement of a HK$11.8 billion SARS relief package, which exacerbated concerns about a deteriorating fiscal position. As international credit rating agency Fitch lowered the outlook of Hong Kong's foreign currency and local currency ratings from stable to negative on 24 April, the 12-month forward points reached a high of +343 pips on 25 April. Nevertheless, as the number of confirmed SARS cases began to level off towards end-April, the forward points eased and maintained a soft tone, except for spiking briefly in mid-June on renewed rumours of renminbi revaluation. This triggered concerns about the currency peg in Hong Kong. After the World Health Organisation's removal of Hong Kong from its list of areas with local transmission of SARS in late June, the forward points fell further. The 6-month and 12-month forward points ended the quarter at +26 pips and +115 pips respectively on 30 June, compared with +46 pips and +140 pips at end-March (Chart 1).

CHART 1

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



Despite the volatility in the forward points, the spot Hong Kong dollar exchange rate was stable in the first two months of the quarter, trading mostly in the range 7.7990-7.7995. The exchange rate then strengthened from late May on reported commercial buying interest and unwinding of short Hong Kong dollar positions amidst improving market sentiment. The exchange rate strengthened to 7.7979 Hong Kong dollars per US dollar on 27 June before ending the quarter at 7.7983, compared with 7.7993 on 31 March. The Convertibility Undertaking was not triggered during the quarter and the level of the Aggregate Balance stayed largely within the range HK$500-600 million. The Aggregate Balance closed at HK$517 million on 30 June, compared with HK$535 million at end-March (Chart 2).

After confirming the deflation risk bias of its monetary policy stance at the Federal Open Market Committee (FOMC) meeting on 6 May, the Federal Reserve, at the conclusion of its subsequent two-day meeting on 24 and 25 June, cut the Fed funds target rate by 25 basis points to 1%, the lowest level in 45 years. In its statement accompanying the decision, the Fed expected economic growth to strengthen in the near future, but was still worried about a dangerous "substantial fall" in already-low inflation, signalling that further room for easing would be rather limited. Nevertheless, the Fed would maintain its accommodative monetary policy for an extended period of time. The US economic indicators released towards the end of the quarter showed an improvement in consumer confidence and signs of recovery in the US economy following the end of the war in Iraq. In Hong Kong, while the Base Rate was lowered to 2.50% on 26 June after the US rate cut, major banks left their savings rates unchanged at 0.01%.

Short-term Hong Kong Dollar Interest Rates

The Hong Kong dollar overnight interest rate firmed initially, moving largely within the range 1.24%-1.50% but then moved lower in early May to the range 0.88%-1.41% on heightened expectation of an interest rate cut in the US. The overnight rate finally ended the quarter at 1.31%, compared with 1.44% on 31 March (Chart 3).

Hong Kong dollar term deposit rates were dragged higher by the rising forward points at the beginning of the quarter, but then eased in tandem with their US dollar counterparts since late May. The 3-month Hong Kong dollar money market rate dipped to a low of 0.98% on 25 June on speculation of an aggressive US rate cut at the US FOMC meeting on 24 and 25 June, but rebounded as the smaller-than-expected

CHART 2

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

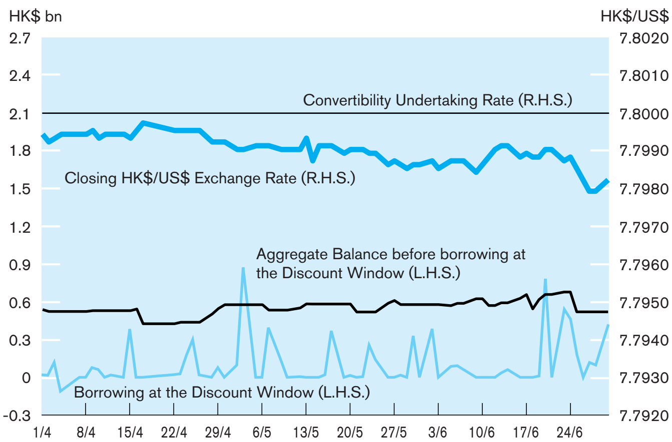
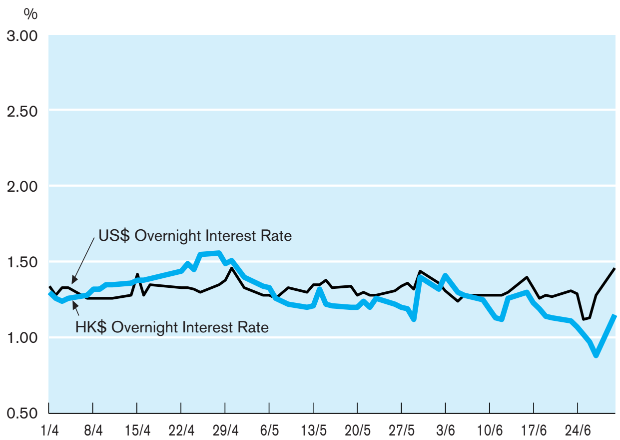


CHART 3

Overnight Hong Kong Dollar and Overnight US Dollar Interest Rates



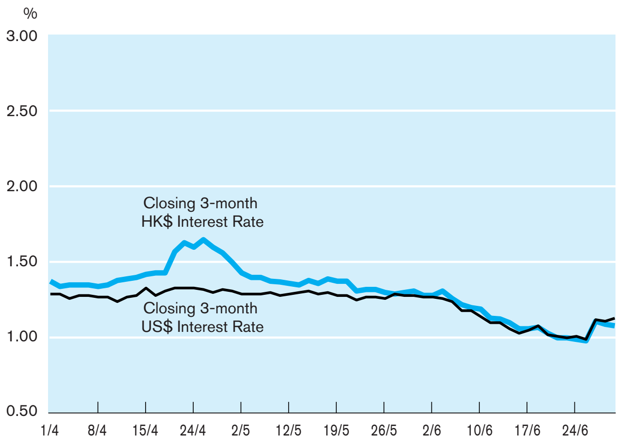
25 basis points rate cut at the meeting dashed hopes of further easing. The spreads between Hong Kong dollar and US dollar interest rates widened initially, but narrowed in the second half of the quarter. The 3-month HIBOR closed at 1.08% on 30 June, five basis points below its US dollar counterpart, compared with 1.33% at end-March, three basis points above the corresponding US dollar rate (Chart 4).

Long-term Hong Kong Dollar Interest Rates

US Treasuries extended gains from the previous quarter as the initially poor economic data reinforced hopes of an aggressive rate cut at the June FOMC meeting. Nevertheless, the US Treasuries prices began to fall in late June as investors switched their money into the stock market and the subsiding war jitters lessened investors' appetite for bonds. Mirroring the movements of their US counterparts, the yields on Exchange Fund Notes (EFN) fell initially, but bottomed out in mid-June. The 10-year EFN yield rose gradually from a low of 3.61% on 17 June to close higher at 3.94% on 30 June, compared with 4.44% on 31 March. As the EFN yield rose at a slower pace than that of US Treasuries, the yield spread of the 10-year EFN over US Treasuries narrowed to 37 basis points on 30 June compared with 59 basis points at end-March (Chart 5).

CHART 4

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



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 the Hong Kong dollar against currencies of major trading partners, closed lower at 100.80 on 30 June, compared with 101.90 at end-March (Chart 6). The lower NEERI reflected the weakening of the US dollar against other major currencies, in particular the euro.

CHART 5

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

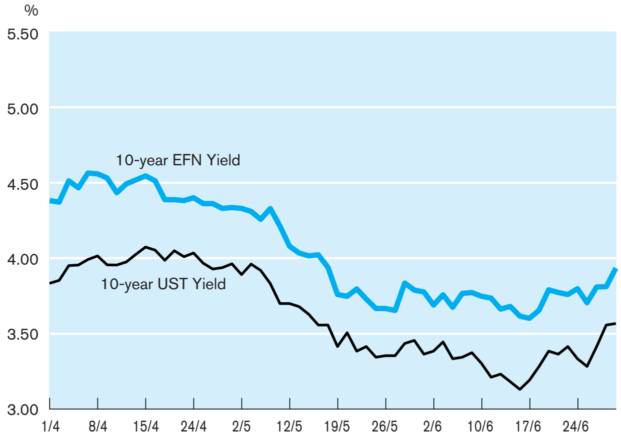


CHART 6

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