

Operation of monetary policy

by the Monetary Management and Infrastructure Department

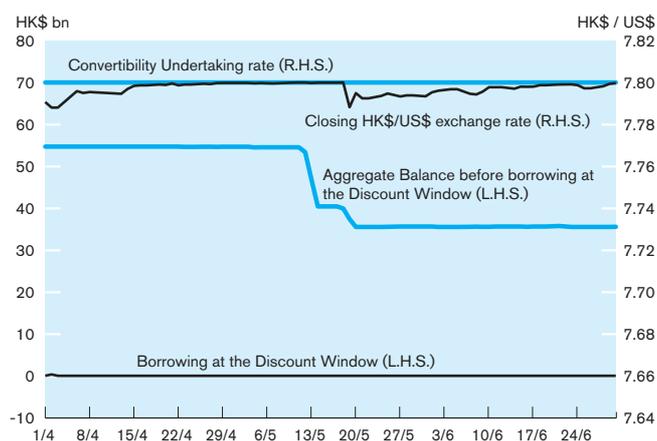
The exchange rate stayed close to 7.8 during the quarter as worries over a more aggressive pace of tightening by the Fed, high oil price and a slowdown in the Chinese economy prompted significant outflows from the Hong Kong dollar. The Convertibility Undertaking was triggered on seven days during the early part of May. The HKMA purchased over \$19 billion Hong Kong dollars from banks, reducing the Aggregate Balance to HK\$36 billion. The Hong Kong dollar forward points rose, tracking the weakness in the spot exchange rate. The Hong Kong dollar term rates moved higher across the board, reflecting the outflow of funds. Nevertheless, short-term interest rates remained very low, as the Aggregate Balance was still phenomenally large. Meanwhile, the US Federal Reserve raised the Fed funds target rate by 25 basis points at the FOMC meeting on 29-30 June and reassured that the policy accommodation could be removed at a pace that was likely to be measured. Yields on long-term Exchange Fund Notes moved up, in parallel with movements in the yields on US Treasuries.

Convertibility Undertaking and Aggregate Balance

Equity-related outflows emerged in mid-April, exerting selling pressure on the Hong Kong dollar. There was a sharp correction in the local stock market, triggered by the change in market expectations that the US Federal Reserve would start raising rates soon after the release of a series of better-than-expected US economic data. Rising oil price and the tightening measures announced by the Mainland authorities to curb excessive growth in investment and credit also weighed heavily on sentiments. The Hong Kong dollar exchange rate hovered around 7.8000 for most of the time during the quarter, and ended at 7.7997 on 30 June as compared with 7.7906 on 31 March. The Convertibility Undertaking was triggered on seven working days during early to mid-May, with the HKMA purchasing over \$19 billion Hong Kong dollars from banks. The Aggregate Balance ended at HK\$35,544 million on 30 June, compared with HK\$54,682 million on 31 March (Chart 1).

CHART 1

Aggregate Balance, Discount Window activity and Hong Kong dollar exchange rate



The forward discount in the Hong Kong dollar exchange rate narrowed since mid-April as the Hong Kong dollar exchange rate eased towards the 7.8000 level. 12-month forward points rose from around -600 pips in early April to -245 pips in mid-May. Nevertheless, as the level of Aggregate Balance stabilised thereafter and the Mainland economy

showed signs of an initial success in the tightening measures, 12-month forwards dropped significantly and stayed in the range between -450 and -700 pips. The 6-month and 12-month forward points closed at -405 pips and -635 pips respectively on 30 June, as compared with -350 pips and -575 pips at the end of March (Chart 2).

CHART 2

6-month and 12-month Hong Kong dollar forward points



The Federal Reserve embarked on a tightening cycle by raising the Fed funds target rate by a quarter of a percentage point to 1.25% at the Federal Open Market Committee (FOMC) meeting on 29-30 June. In the FOMC meeting statement, while the Federal Reserve acknowledged the improvement in the labour market, it maintained that the policy accommodation could be removed at a pace that was likely to be measured. The dovish tone of Fed's statement relieved market concerns about the pace and aggressiveness of further rate-hikes arising from the favourable economic developments and accelerating consumer price inflation in the US. In Hong Kong, the Base Rate was adjusted upward by 25 basis points to 2.75% on 2 July following the US rate-hike on 30 June. Meanwhile, the savings rates quoted by major banks stayed unchanged at 0.01%.

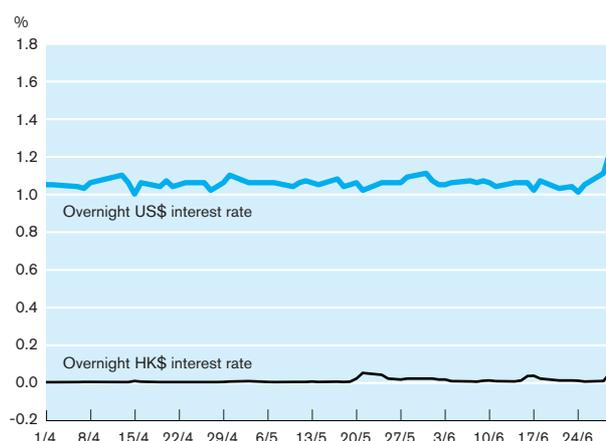
Short-term Hong Kong dollar interest rates

Despite the reduction in the Aggregate Balance, interbank liquidity remained abundant. The Aggregate Balance hovering at the level around

HK\$36 billion was still higher than normal, thus keeping the short-term Hong Kong dollar interest rates close to zero. The overnight rate had stayed below 0.01% until the end of June when the high funding demands at the end of first half year pushed it up to close at 0.12% on 30 June (Chart 3).

CHART 3

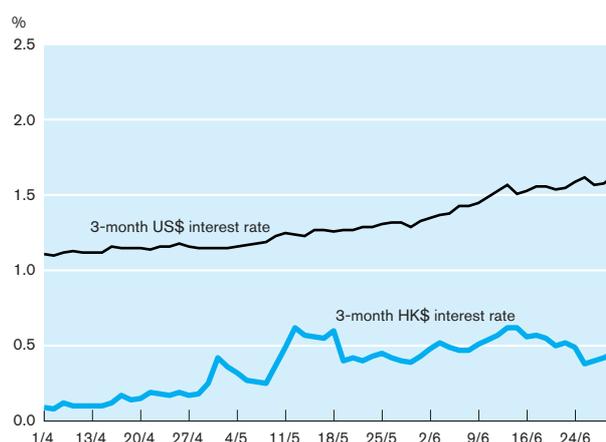
Overnight Hong Kong dollar and US dollar interest rates



Hong Kong dollar term rates rose initially, reflecting the outflow of funds. However, mirroring the softer forward points, the negative interest differential between Hong Kong dollar and US dollar widened towards the end of the quarter. Three-month Hong Kong dollar money market rate ended at 0.45% on 30 June, 118 basis points below its US dollar counterpart, as compared with 0.13% or 98 basis points below the corresponding US dollar rate at the end of March (Chart 4).

CHART 4

3-Month Hong Kong dollar and US dollar interest rates



Long-term Hong Kong dollar interest rates

Yields on US Treasuries moved up in general, owing to the heightened expectations of interest rate rises. Nevertheless, the rising trend came to a pause in mid-May as the Federal Reserve hinted at a gradual removal of monetary policy accommodation. Yields on Exchange Fund Notes (EFN) moved in tandem with their US counterparts. The 10-year EFN yield peaked at 4.95% on 11 May 2004 before easing gradually to 4.59% on 30 June, as compared with 3.75% at the beginning of the quarter. The yield spread of the 10-year EFN over US Treasuries remained largely steady, closing at -14 b.p. at the end of June. (Chart 5).

CHART 5

Yield of 10-year Exchange Fund Notes and US Treasuries



Hong Kong dollar effective exchange rate

The Hong Kong dollar trade-weighted nominal effective exchange rate index (NEERI), which measures the nominal exchange value of Hong Kong dollar against currencies of major trading partners, closed stronger at 98.7 on 30 June, as compared with 97.9 at the end of March (Chart 6). The higher NEERI reflects the strengthening of the US dollar against the 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

