

Operation of monetary policy

by the Monetary Management and Infrastructure Department

The Hong Kong dollar exchange rate strengthened during the fourth quarter of 2004 amid an optimistic outlook for the Hong Kong economy. Improvements in external trade and private consumption were the main driving forces for the strong economic growth. The broad-based weakness of the US dollar and speculations on the revaluation of the renminbi attracted fund flows to the Asian region, including Hong Kong. To alleviate the pressure on the strong side of the currency peg, the HKMA purchased US dollars and the Aggregate Balance increased to HK\$15,789 million. Meanwhile, the US Federal Reserve raised the federal funds target rate by a total of 50 basis points in November and December. Due to the abundant liquidity in the interbank market, the Hong Kong dollar short-term interest rates did not follow their US counterparts during the period, except during a temporary spike in early December when Hong Kong dollar liquidity dried up as a result of the Link REIT IPO. For the same reason, yields of long-term Exchange Fund Notes declined modestly, divergent to the movement in the yields of corresponding US Treasuries.

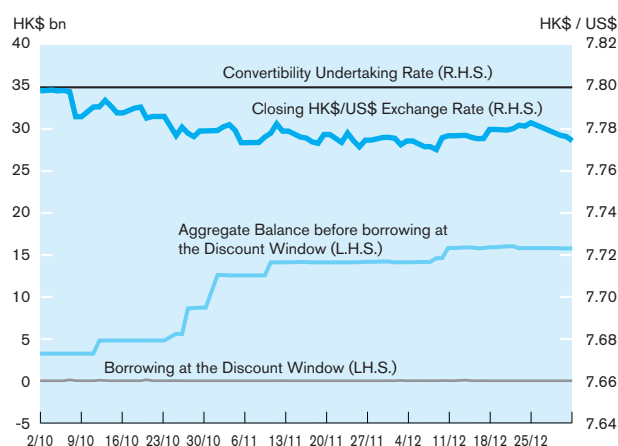
Convertibility Undertaking and Aggregate Balance

The Hong Kong dollar strengthened gradually in October amid an optimistic outlook for the local economy. The domestic economy continued to recover, led by strong private consumption and external trade. With strong consumer confidence, both the local stock market and property market were buoyant. Worries over the unsustainable US current account deficit triggered a broad-based sell-off of the US dollar, which attracted inflows into the Asian currencies, including the Hong Kong dollar. Inflows continued in early November due to the speculation of a possible revaluation of the renminbi. In order to avoid excessive fluctuations in the exchange rate, the HKMA purchased US dollar during the quarter. This resulted in an increase in the Aggregate Balance, which stood at HK\$15,789 million on 31 December, compared with HK\$3,234 million on 30 September.

The Hong Kong dollar exchange rate ended stronger at 7.7745 on 31 December, compared with 7.7983 on 30 September (Chart 1).

CHART 1

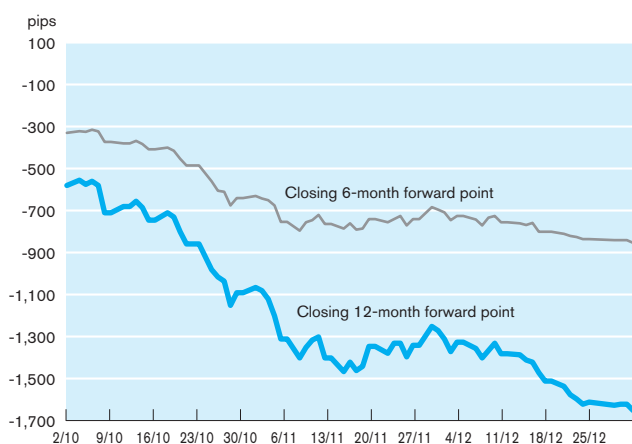
Aggregate Balance, Discount Window activity and Hong Kong dollar exchange rate



The forward discount in the Hong Kong dollar exchange rate also widened, amid the positive sentiment on Hong Kong and speculations for renminbi appreciation. Forward points began to decline in early October as US officials repeatedly exerted pressure on the Chinese authorities about adopting a more flexible exchange rate regime for the renminbi. The six-month and 12-month Hong Kong dollar forward points closed at -853 pips and -1,650 pips respectively on 31 December, compared with -330 pips and -580 pips at the end of September (Chart 2).

CHART 2

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



The Federal Reserve tightened monetary policy by raising the federal funds target rate by a total of 50 basis points at the Federal Open Market Committee (FOMC) meetings in November and December. In the press statements, the FOMC stated that the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters would be roughly equal. With underlying inflation expected to be relatively low, it believed that policy accommodation can be removed at a pace that is likely to be measured. It is widely expected

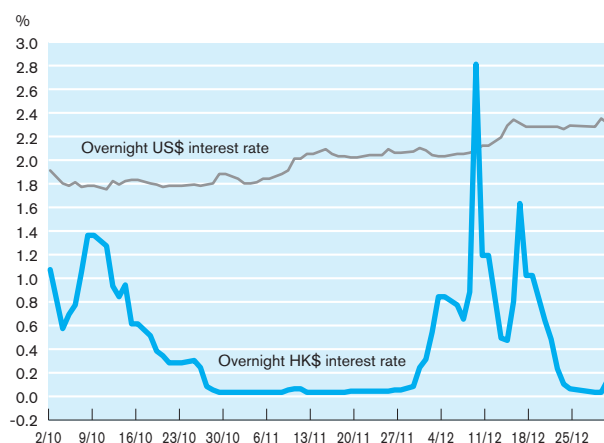
that the Federal Reserve would continue its tightening in 2005. The HKMA Base Rate was adjusted upward to 3.50% on 11 November and to 3.75% on 15 December following the rate increase by the Federal Reserve. However, due to the abundant liquidity in the interbank market, the savings rates quoted by major banks remained low at 0.01%.

Short-term Hong Kong dollar interest rates

The large inflow of funds resulted in an increase in the Aggregate Balance, and the ample liquidity in the interbank market helped push down short-term Hong Kong dollar interest rates. Overnight interest rate declined from about 1% in September to around 0.03% in November. It stayed at that level for most of the time in the fourth quarter of 2004, except for a brief jump to 2.8% in early December as a result of the liquidity demand for the Link REIT IPO (Chart 3).

CHART 3

Overnight Hong Kong dollar and US dollar interest rates

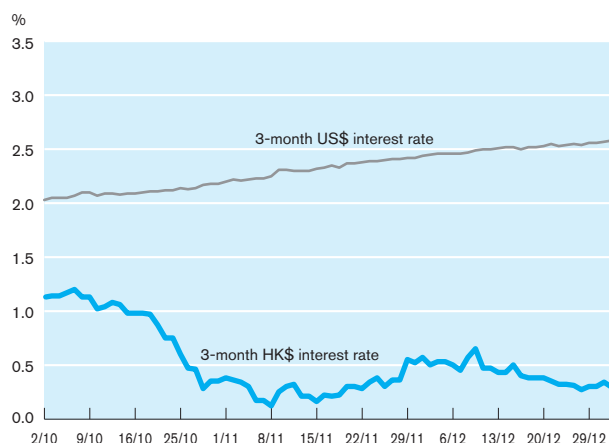


Hong Kong dollar term rates dropped since October, reflecting the ample liquidity in the market. With US dollar interest rates drifting steadily higher, the negative interest rate differential between the Hong Kong dollar and US dollar widened. The three-month Hong Kong dollar money market rate closed at

0.30% on 31 December, 228 basis points below its US dollar counterpart, compared with 1.13% or 90 basis points below the corresponding US dollar rate at the end of September (Chart 4).

CHART 4

3-Month Hong Kong dollar and US dollar interest rates

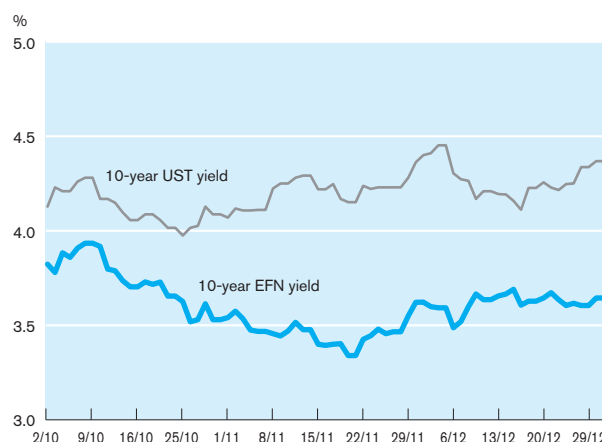


Long-term Hong Kong dollar interest rates

Despite repeated warning from Fed officials that the US tightening might accelerate should there be a serious inflationary threat, the Fed had in fact only effected two rounds of 25-basis-point rate hike in the last quarter of 2004. There was a general consensus that the Fed would continue its “measured” pace of tightening in 2005. Yields of US Treasuries went up mildly during the quarter as a result. Meanwhile, the soft Hong Kong dollar interbank rates dragged the yields of Exchange Fund Notes (EFN) lower. The 10-year EFN yield fell from 3.83% in late-September to 3.34% in mid-November, before rebounding to 3.66% on 31 December. The yield spread of the 10-year EFN over US Treasuries widened, closing at -64 basis points at the end of December, compared with -30 basis points at the end of September (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 weaker at 96.0 on 31 December, compared with 98.6 at the end of September (Chart 6). The lower NEERI reflects the broad-based weakness of the US dollar, in particular against the euro and the Japanese yen.

CHART 6

Hong Kong dollar/ US dollar exchange rate and Hong Kong dollar nominal effective exchange rate index

