

# Operation of monetary policy

by the Monetary Management and Infrastructure Department

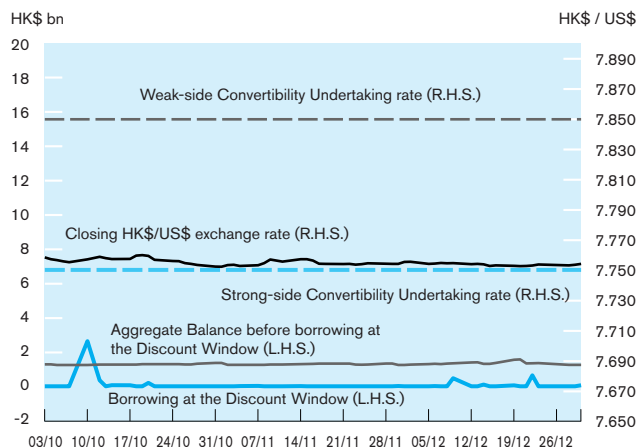
The Hong Kong dollar exchange rate held firmly near the strong-side Convertibility Undertaking rate during the fourth quarter of 2005. The strong demand for Hong Kong dollar funding related to some large initial public offerings (IPOs), for example the IPO of China Construction Bank in October and Link REIT in November, and speculations about further renminbi revaluation had underpinned the strength of the Hong Kong dollar. Nevertheless, the Convertibility Undertakings were not triggered and the Aggregate Balance was steady at around HK\$1.3 billion. The Base Rate was raised to 5.50% in November and 5.75% in December, matching the increases in the Fed funds target rate. Meanwhile, domestic interest rates tracked closely the movement of their US counterparts.

## Convertibility Undertakings and Aggregate Balance

The inflow of funds, particularly those associated with IPO activities, remained a dominant driving factor in the Hong Kong dollar money and exchange markets. This coupled with the renewed talks of further renminbi revaluation supported the Hong Kong dollar in the fourth quarter of 2005. The Hong Kong dollar exchange rate was close to the strong-side Convertibility Undertaking rate (HK\$7.75 to one US dollar) during the quarter (Chart 1). Both the strong-side and weak-side Convertibility Undertakings were not triggered and no monetary operation within the Convertibility Zone was conducted by the HKMA. Throughout the period, the Aggregate Balance was stable at around HK\$1.3 billion.

CHART 1

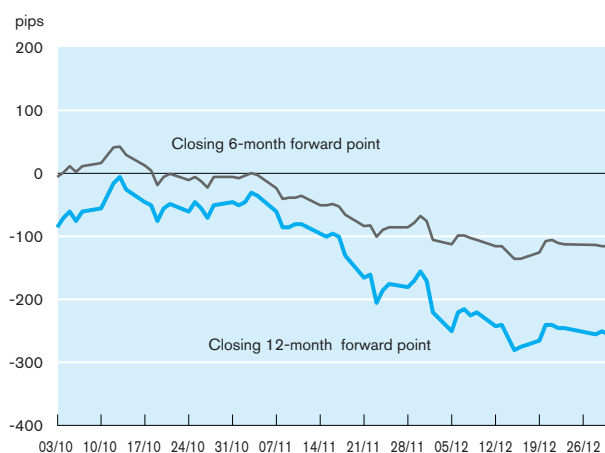
Aggregate Balance, Discount Window activity and Hong Kong dollar exchange rate



Amid strong equity-related demand for Hong Kong dollars and speculations about further renminbi appreciation towards late 2005, the forward discount in the Hong Kong dollar exchange rate widened. The six-month and 12-month Hong Kong dollar forward points closed lower at -115 pips and -255 pips respectively on 30 December 2005, compared with -5 pips and -85 pips at the beginning of the quarter (Chart 2).

CHART 2

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



The Federal Reserve maintained its measured pace of monetary policy tightening and raised the Fed funds target rate by 25 basis points each at the Federal Open Market Committee meetings in November and December 2005. Following the rate increases, the HKMA raised the Base Rate to 5.50% on 2 November, and subsequently to 5.75% on 14 December.

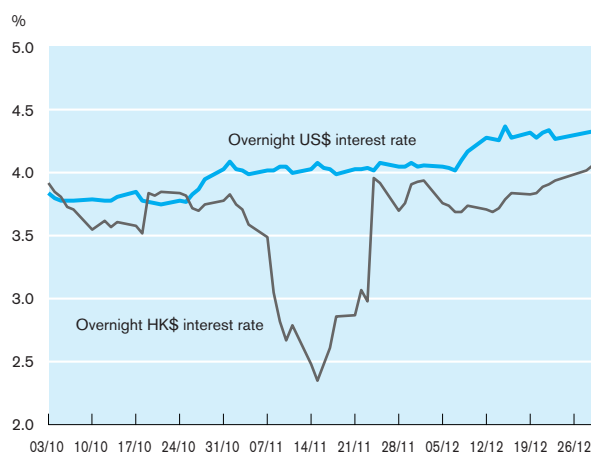
### Short-term Hong Kong dollar interest rates

The Hong Kong dollar interest rates continued to track closely their US dollar counterparts except for a brief period in mid-November when banks unloaded some excessive liquidity. Many banks had anticipated an overwhelming response to the Link REIT IPO. When these banks rushed to unload their excessive liquidity, the overnight Hong Kong dollar interest rate fell significantly, touching 1.50% briefly in mid-November. The rate climbed afterward and

finally closed at 4.32% at the end of the year, compared with 3.92% on 3 October (Chart 3).

CHART 3

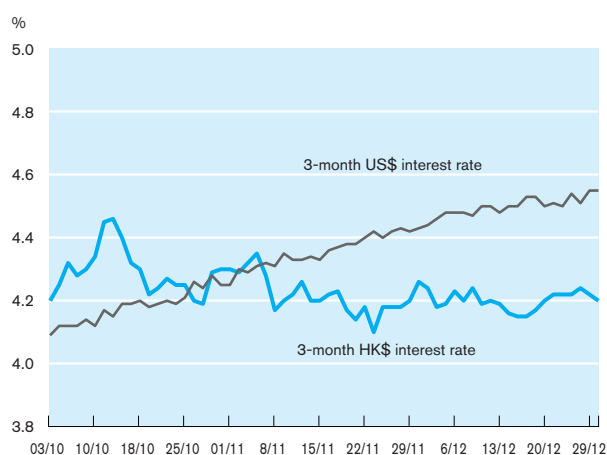
### Overnight Hong Kong dollar and US dollar interest rates



Reflecting the funding demand ahead of the IPO activities, Hong Kong dollar term rates picked up slightly at the start of the quarter, but soon eased back to slightly below US dollar interest rates. In fact, the negative interest rate differential against the US dollar widened during the quarter alongside the lower forward points (Chart 4).

CHART 4

### 3-Month Hong Kong dollar and US dollar interest rates

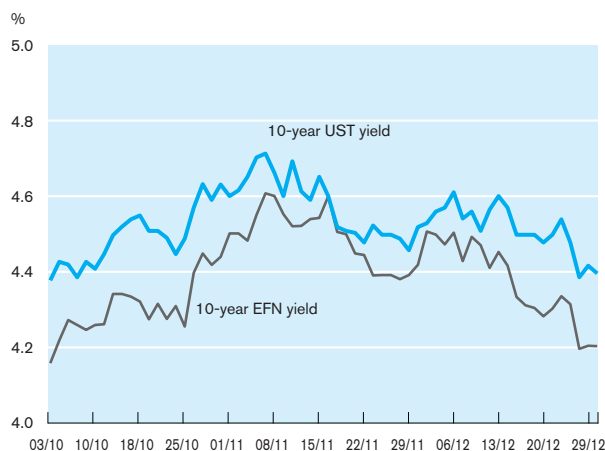


## Long-term Hong Kong dollar interest rates

During the fourth quarter, long term yields on the Hong Kong dollar moved in line with their US counterparts. In the first half of the quarter, the US Treasury yields moved upward in anticipation of further interest rate increases by the Federal Reserve in 2006. However, market sentiment changed in mid-November as there were signs that the Federal Reserve might end its monetary tightening sooner. As a result, the 10-year US Treasury yield decreased in the latter part of the quarter. While tracking closely the movements of its US counterparts, the yield of 10-year Exchange Fund Notes remained slightly lower than that of the 10-year US Treasury yield (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, which measures the nominal exchange value of the Hong Kong dollar against currencies of major trading partners, closed slightly stronger at 98.4 on 30 December 2005, compared with 98.2 on 3 October (Chart 6). The higher index reflects the strengthening 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

