

Operation of monetary policy

by the Monetary Management and Infrastructure Department

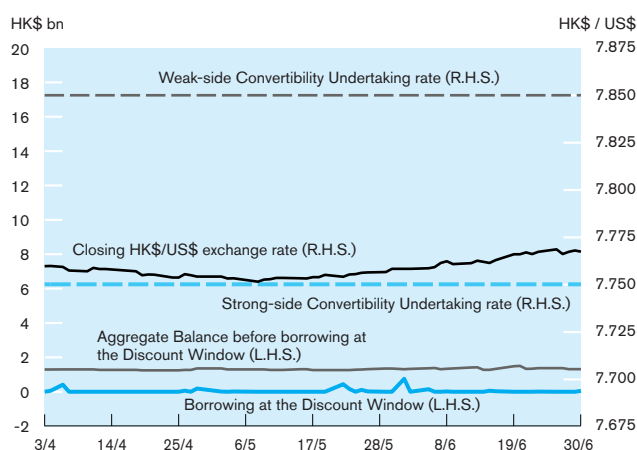
Capital inflow continued and the Hong Kong dollar exchange rate stayed near the strong-side Convertibility Undertaking during the early part of the quarter, against the backdrop of a number of large initial public offerings (IPOs), a buoyant local stock market and speculations about further renminbi revaluation. However, the Hong Kong dollar started to weaken somewhat towards the end of the quarter, partly associated with interest rate arbitrage activities relating to the slightly widened HIBOR-LIBOR spreads. The Convertibility Undertakings were not triggered and the Aggregate Balance remained steady at around HK\$1.3 billion. The Base Rate was raised to 6.50% in May and further to 6.75% in June, matching the increases in the Fed funds target rate. Given that the loan-to-deposit ratio remained low, major banks left their best lending rates unchanged during the quarter, despite the hikes in US interest rates. The interest rate differentials between the Hong Kong dollar and the US dollar widened slightly at the short end.

Convertibility Undertaking and Aggregate Balance

In the early part of the quarter, the Hong Kong dollar exchange rate stayed close to the strong-side Convertibility Undertaking, amid strong equity-related demand for Hong Kong dollars. However, it started to weaken in the later part of the quarter, moving to around 7.76. This was partly associated with the correction in the equity market and the repatriation of funds raised at the recent large IPOs, and partly with the interest rate arbitrage activities resulting from the slightly widened HIBOR-LIBOR spreads (Chart 1). None of the strong-side and weak-side Convertibility Undertaking were triggered and no monetary operation within the Convertibility Zone was conducted by the HKMA during the quarter, and the Aggregate Balance was stable at around HK\$1.3 billion.

CHART 1

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



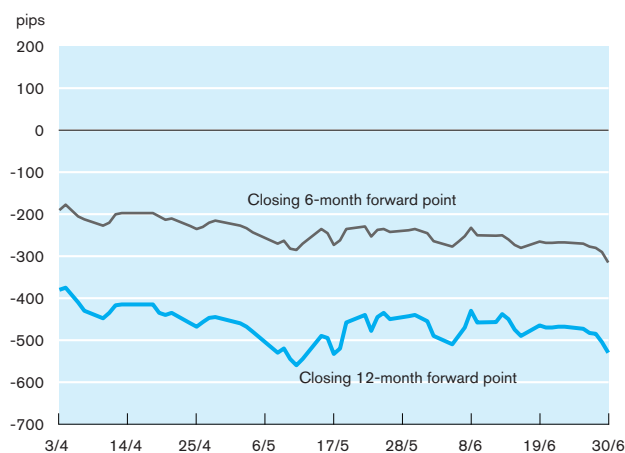
The US Federal Reserve continued to tighten monetary policy gradually and raised the Fed funds target rate by 25 basis points at the Federal Open Market Committee (FOMC) meetings in both May and June. Following the rate increases, the HKMA raised the Base Rate to 6.50% on 11 May, and to 6.75% on 30 June.

Short-term Hong Kong dollar interest rates

During the reporting period, short-term Hong Kong dollar interest rates were somewhat volatile, as a number of large IPOs brought about fluctuations in the demand for interbank liquidity. In particular, the overnight Hong Kong dollar interest rate dipped to 2.9% on 10 May, as some banks offered overnight money in the interbank market to earn a return for their excessive funds accumulated in advance of the upcoming IPO of Bank of China. The overnight rate then rose sharply to 5.0% on 23 May, as a part of the interbank liquidity was held up by the Bank of China's IPO. With the effect of large IPOs dissipated, the overnight Hong Kong dollar interest rate closed at 4.1% on 30 June, compared with 3.9% at the beginning of the quarter (Chart 2).

CHART 2

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



While US interest rates edged higher during the quarter, Hong Kong dollar rates remained stable, given ample liquidity in the interbank market. As a result, the negative interest rate differential against the US dollar widened alongside the lower forward points (Chart 3 and Chart 4).

CHART 3

Overnight Hong Kong dollar and US dollar interest rates

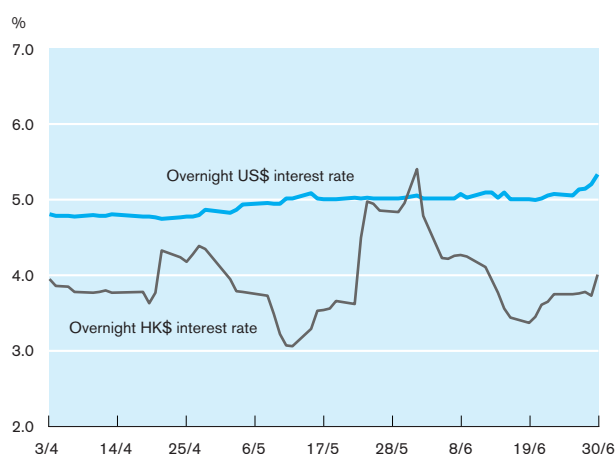
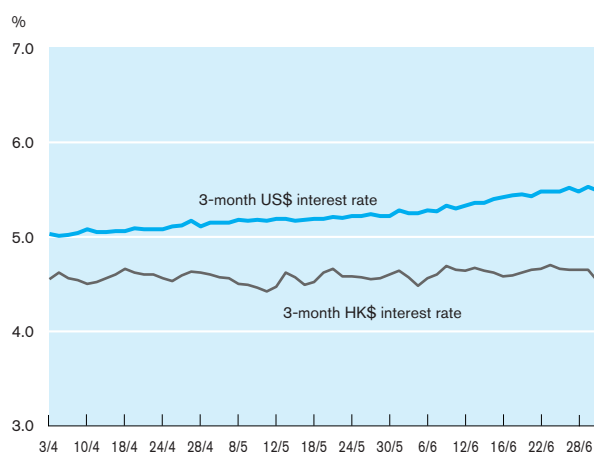


CHART 4

3-Month Hong Kong dollar and US dollar interest rates

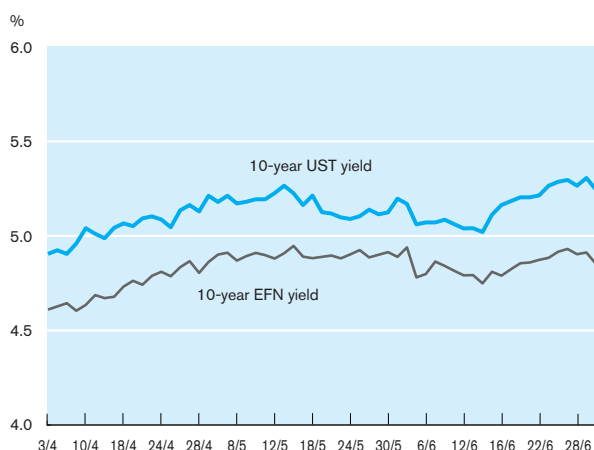


Long-term Hong Kong dollar interest rates

During the second quarter, long term yields on the Hong Kong dollar moved in line with their US counterparts. The US Treasury yields continued to rise along with the increase in short-term rates. The 10-year US Treasury yield edged up during the quarter. While tracking closely the movements of its US counterparts, the yield of 10-year Exchange Fund Notes remained 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 (NEERI), which measures the nominal exchange value of the Hong Kong dollar against currencies of major trading partners, closed slightly lower at 96.1 on 30 June, compared with 97.6 on 3 April (Chart 6). The lower NEERI reflects the weakening 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

