

# Operation of monetary policy

by the Monetary Management and Infrastructure Department

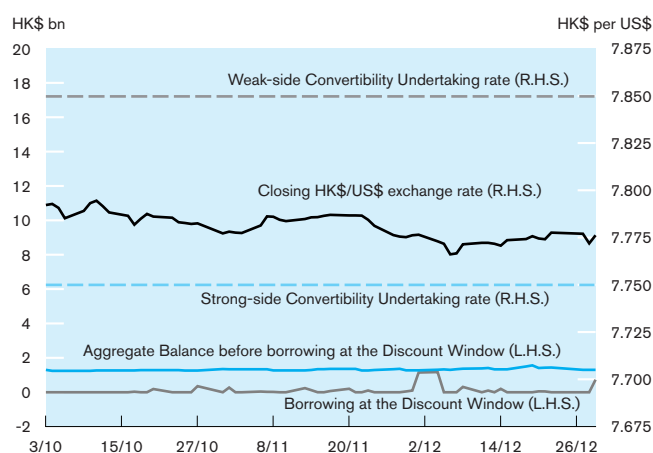
The Hong Kong dollar exchange rate strengthened during the quarter against the backdrop of a number of large Initial Public Offerings (IPOs), a more active local stock market and speculation about further renminbi appreciation. Its gains were nevertheless checked by the conversion of funds raised from IPOs into US dollars and interest carry trades. As the Convertibility Undertakings were not triggered, the Aggregate Balance remained steady at around HK\$1.3 billion. The US Fed funds target rate and the HKMA base rate were unchanged during the quarter.

## Convertibility Undertaking and Aggregate Balance

During the fourth quarter, the Hong Kong dollar exchange rate was underpinned by equity-related inflows but its advance was contained by conversion of IPO proceeds out of Hong Kong dollars and interest carry trades. In the early part of the quarter, the exchange rate once eased to a low of 7.7950 upon some selling of Hong Kong dollars by Chinese entities to convert IPO proceeds into US dollars and also interest carry trades to take advantage of a higher US dollar interest rate. However, towards the end of the year, the Hong Kong dollar strengthened, moving to around 7.7700 amid strong equity-related inflows on the back of a buoyant local stock market and a number of large IPOs (Chart 1). The accelerated pace of renminbi appreciation might have also boosted the Hong Kong dollar. The Convertibility Undertakings were not triggered and no monetary operation within the Convertibility Zone was conducted by the HKMA during the quarter. The Aggregate Balance was stable at around HK\$1.3 billion. The US Fed funds target rate and the HKMA base rate were unchanged during the quarter.

CHART 1

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

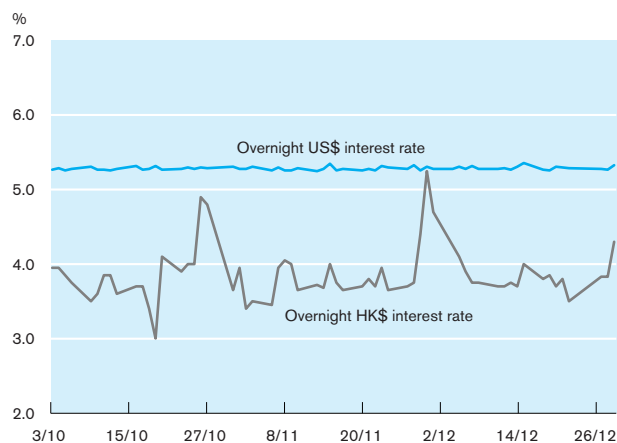


## Short-term Hong Kong dollar interest rates

Short-term interest rates were generally stable during the period except for some brief rises during large-scale IPOs. The overnight rate mostly stayed between 3.75 and 4%, although it dropped to 3% on 19 October as banks were flooded with liquidity before the IPO of Industrial and Commercial Bank of China. The overnight rate rose to 4.90% on 26 October and 5.25% in late November in the face of large-scale IPOs (Chart 2).

CHART 2

### Overnight Hong Kong Dollar and US Dollar Interest Rates



While US interest rates remained stable during the quarter, Hong Kong dollar rates declined slightly, amid ample liquidity in the banking sector. As a result, the negative interest rate differential against the US dollar widened and forward points fell further (Chart 3 and Chart 4). In early November, banks in Hong Kong cut their Best Lending Rates by 25 basis points, there continued to be two Best Lending Rates at 7.75% and 8.00%.

CHART 3

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

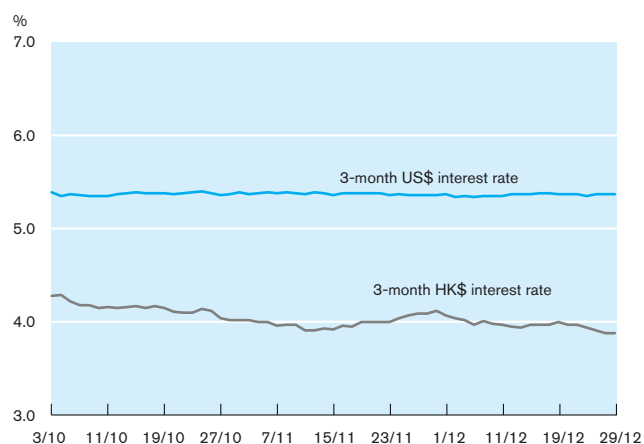
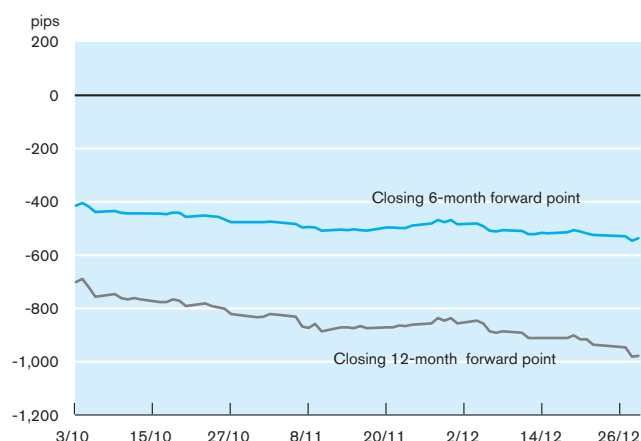


CHART 4

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

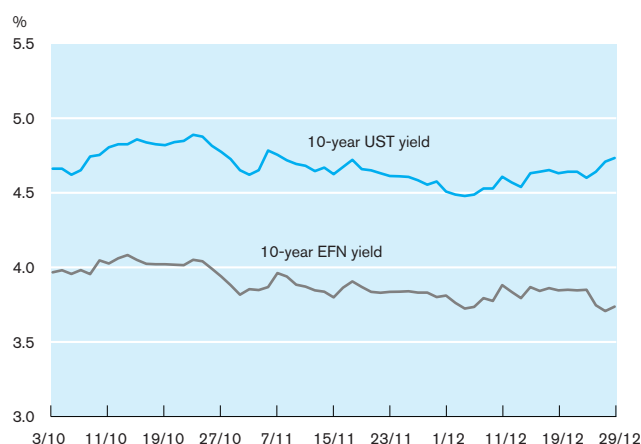


## Long-term Hong Kong dollar interest rates

During the fourth quarter, long-term yields on the Hong Kong dollar moved largely in line with their US counterparts, except for some widening of yield spreads towards the end of the year. The yield spreads between the 10-year US Treasuries and the 10-year Exchange Fund Notes increased to -100 basis points compared with -70 basis points at the beginning of the quarter (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 94.3 on 29 December, compared with 95.5 on 3 October (Chart 6). The lower NEERI reflects a weakening 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

