

# Operation of monetary policy

by the Monetary Management and Infrastructure Department

Against the backdrop of interest carry trades and the conversion of proceeds from equity initial public offerings (IPO) out of the Hong Kong dollar by Mainland companies, the Hong Kong dollar exchange rate softened in the second quarter of 2007 and hovered mostly within the range 7.800-7.825. As the Convertibility Undertakings were not triggered, the Aggregate Balance remained steady at around HK\$1.3 billion. The HKMA base rate was kept unchanged during the quarter.

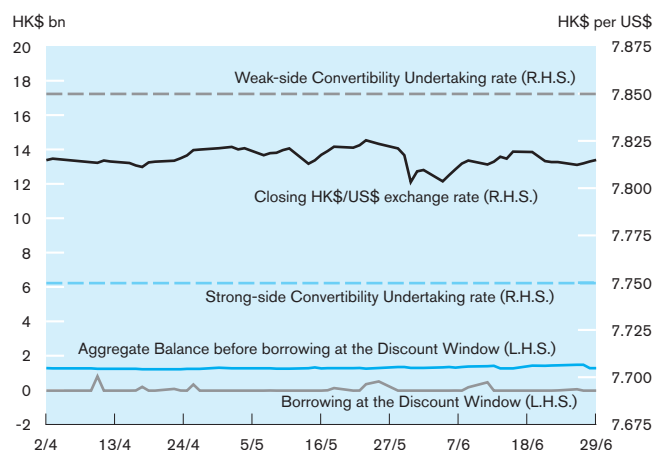
## Convertibility Undertaking and Aggregate Balance

The Hong Kong dollar remained soft during most of the second quarter owing to interest carry trades and conversion of IPO proceeds into US dollars (Chart 1). Nevertheless, the Hong Kong dollar once strengthened to near 7.80 in late May owing to some unwinding of carry trades linked to an increase in Hong Kong dollar interest rates as demand for funding associated with equity IPOs increased. 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 HKMA base rate was kept unchanged during the quarter, as the US Fed funds target rate stayed the same.

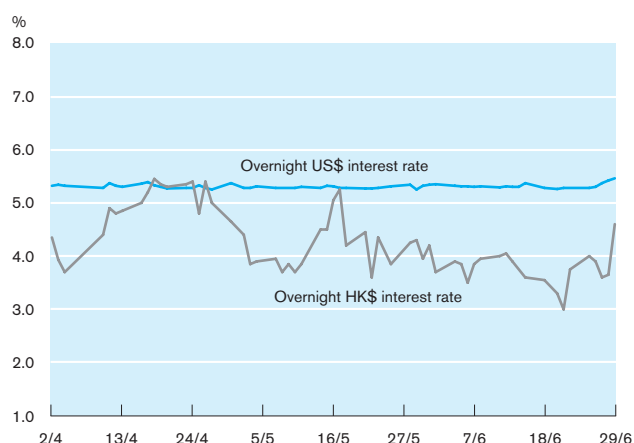
## Short-term Hong Kong dollar interest rates

During the quarter, short-term interest rates were generally stable except for a few brief increases during some large-scale IPOs in the middle of both April and May. The overnight rate stayed within the range 3.50% – 4.50% during most of the quarter, but rose to 4.60% on 29 June in the face of another large-scale IPO straddling late June to early July (Chart 2).

**CHART 1**  
Aggregate Balance, Discount Window Activity and Hong Kong Dollar Exchange Rate

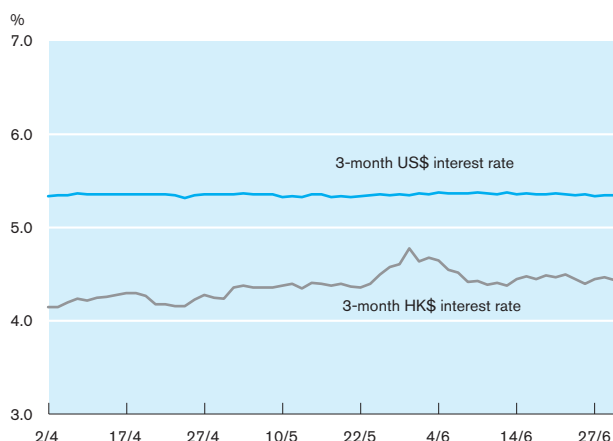


**CHART 2**  
Overnight Hong Kong Dollar and US Dollar Interest Rates

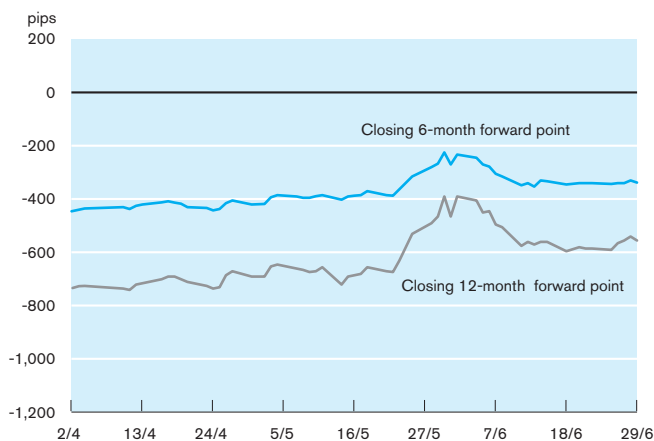


While US interest rates remained stable during the quarter, Hong Kong dollar rates increased slightly amid increased liquidity demand. As a result, both the negative interest rate differential against the US dollar and forward points narrowed (Chart 3 and Chart 4).

**CHART 3**  
3-month Hong Kong dollar and US dollar interest rates



**CHART 4**  
6-month and 12-month Hong Kong dollar forward points

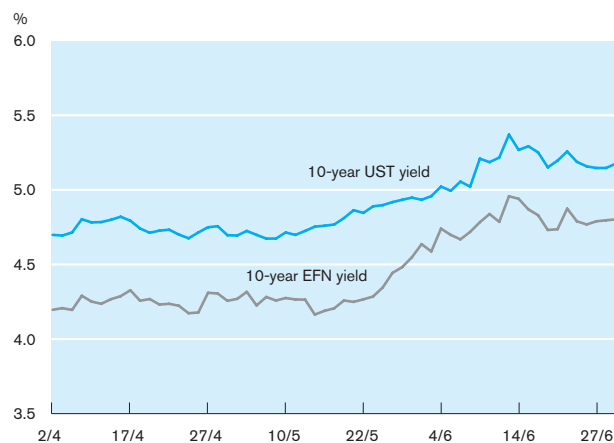


### Long-term Hong Kong dollar interest rates

During the second quarter, long-term yields on the Hong Kong dollar moved largely in line with their US counterparts, except for some narrowing of yield spreads in June. The yield spreads between the 10-year US Treasuries and the 10-year Exchange

Fund Notes reduced to -37 basis points from -50 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 the currencies of its major trading partners, closed slightly lower at 92.5 on 29 June, compared with 93.0 on 2 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

