

# Operation of monetary policy

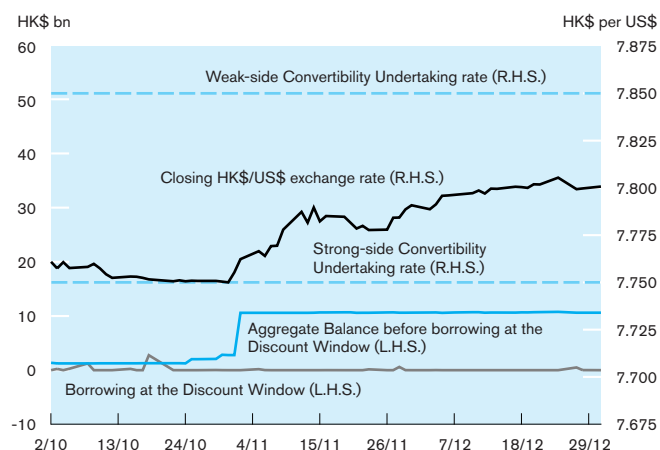
by the Monetary Management and Infrastructure Department

The Hong Kong dollar rose to levels near the strong-side Convertibility Undertaking in late October, prompting the HKMA to conduct market operations under the currency board system. A total of HK\$9.4 billion was sold to banks, resulting in the Aggregate Balance expanding to HK\$10.6 billion. With an expanded Aggregate Balance, monetary conditions loosened and the Hong Kong-dollar exchange rate eased to levels around 7.80 in the latter part of the quarter. In line with the US Fed funds target rate, the HKMA Base Rate was reduced twice by a total of 50 basis points to 5.75% during the quarter.

## Convertibility Undertaking and Aggregate Balance

In the early part of the quarter, the Hong Kong-dollar exchange rate strengthened, supported in part by the unwinding of carry trades as investors became more risk averse in the face of the US sub-prime crisis, and in part by the equity-related demand for Hong Kong dollars against the backdrop of a buoyant stock market (Chart 1). In response to the appreciation of the Hong Kong dollar near the strong-side Convertibility Undertaking (CU), the HKMA conducted market operations, including an active operation on 23 October and the triggering of the strong-side CU on 26 and 31 October. Through these operations, the HKMA sold HK\$9.4 billion to banks, leading the Aggregate Balance to expand to HK\$10.6 billion. With the increase in the Aggregate Balance and the resultant decline in interest rates, the Hong Kong-dollar exchange rate eased to levels around 7.80 in the latter part of the quarter. In line with the US Fed funds target rate, the HKMA Base Rate was reduced twice during the quarter by a total of 50 basis points to 5.75%.

**CHART 1**  
Aggregate Balance, Discount Window activity and Hong Kong-dollar exchange rate

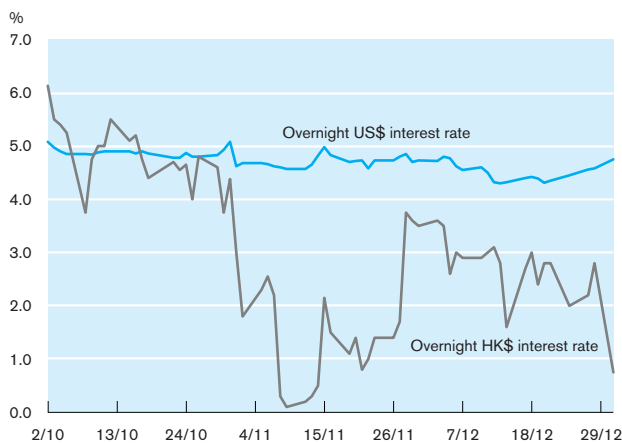


## Short-term Hong Kong-dollar interest rates

Short-term interest rates eased. The overnight inter-bank interest rate dropped from 6.15% at the beginning of the quarter to slightly below 1% by the end of quarter. The fall was largely attributable to the expansion in the Aggregate Balance arising from the market operations in late October. The overnight rate fell to a low of 0.1% on 9 November, but later rebounded to the range of 1.50-3.50% on initial public offering activities, before ending the quarter at 0.75% (Chart 2).

CHART 2

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



While Hong Kong-dollar interest rates followed those of the US dollar to edge lower during the quarter, the Hong Kong-dollar rates declined at a faster pace amid increased liquidity supply after the monetary operations in late October. As a result, the negative interest rate differential against the US dollar and forward points widened (Chart 3 and Chart 4).

CHART 3

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

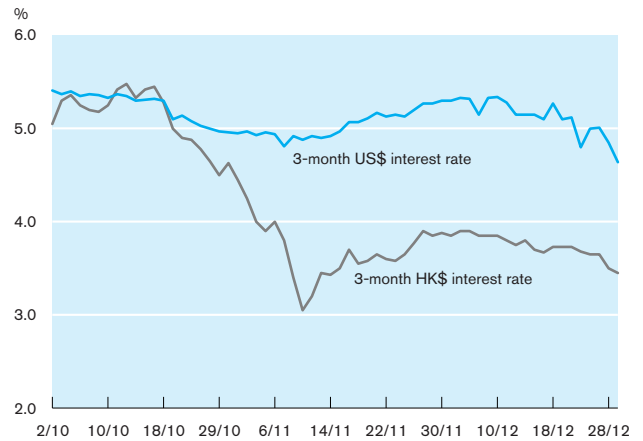
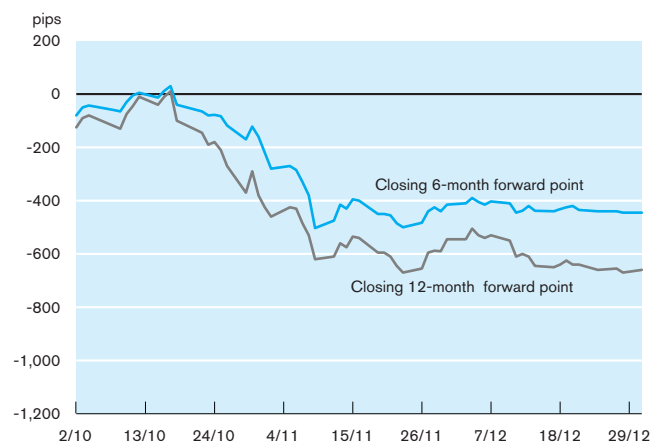


CHART 4

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

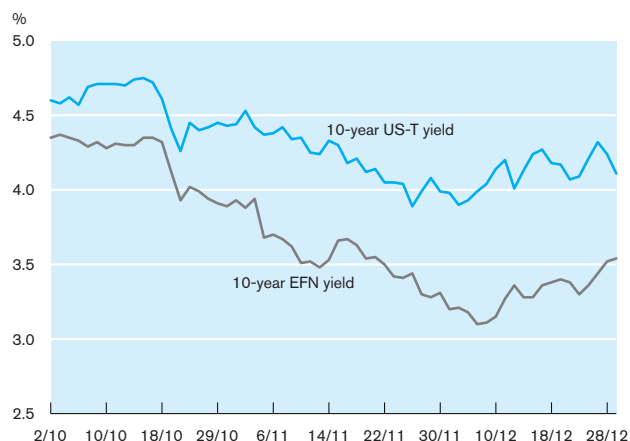


## Long-term Hong Kong-dollar interest rates

Long-term yields on the Hong Kong dollar and the US dollar both dropped during the quarter. However, the long-term Hong Kong-dollar yields fell more significantly than their US counterparts after mid-October. The negative yield spreads between the 10-year US Treasuries and the 10-year Exchange Fund Notes increased to -57 basis points compared with -25 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 major trading partners, closed slightly lower at 88.6 on 31 December, compared with 91.0 on 2 October (Chart 6). The lower NEERI reflects the weakening of the US dollar, particularly 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

