

# Operation of monetary policy

by the Monetary Management Department

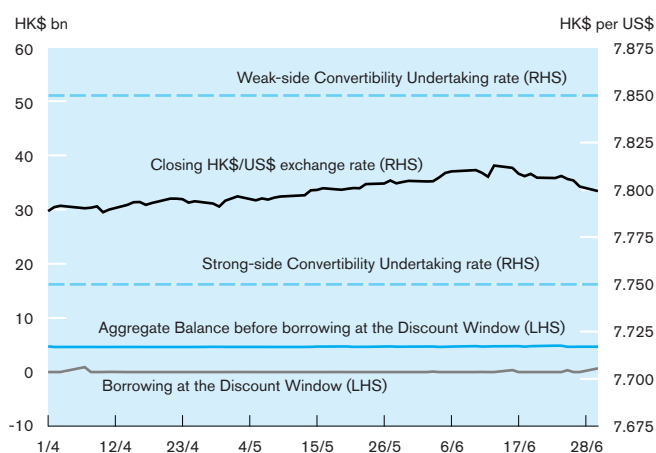
The Hong Kong-dollar exchange rate stayed close to the Linked Rate of HK\$7.8 to US\$1 during the reporting period. In the early part of the quarter, the Hong Kong dollar was kept soft mainly by a broad-based weakening of most other Asian currencies and interest carry trades amid widened negative HIBOR-LIBOR spreads. However, approaching the middle of the year, the demand for interbank funding increased and the negative interest spreads narrowed, triggering the unwinding of some interest carry trades. As a result, the Hong Kong dollar strengthened slightly in the latter part of the quarter. During the reporting period, the HKMA did not conduct any market operations and the Aggregate Balance remained steady at around HK\$4.7 billion. In line with the US Fed funds target rate, the HKMA base rate was reduced by 25 basis points to 3.5% during the quarter.

## Convertibility Undertaking and Aggregate Balance

In the early part of the quarter, the Hong Kong dollar weakened under pressures associated in part with a broad-based weakening of most Asian currencies and interest carry trades amid widened negative HIBOR-LIBOR spreads. However, nearing the middle of the year, the demand for interbank funding increased, causing the negative HIBOR-LIBOR spreads to narrow. As a result, the Hong Kong dollar strengthened somewhat on the back of the unwinding of interest carry trades amid a narrowing of spreads. During the reporting period, the HKMA did not conduct any market operations and the Aggregate Balance remained steady at HK\$4.7 billion (Chart 1). In line with the US Fed funds target rate, the HKMA base rate was reduced during the quarter by 25 basis points to 3.5%.

CHART 1

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

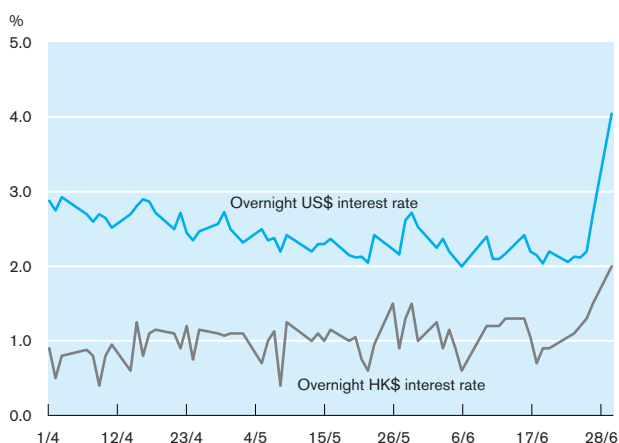


## Short-term Hong Kong-dollar interest rates

Short-term interest rates moved higher. The overnight interbank interest rate climbed from 0.9% at the beginning of the quarter to 2.0% by the end of quarter. The rise was more significant in the latter part of the quarter and largely attributable to the increased funding demand approaching the end of the first half. The overnight rate hovered within the range of 0.4-1.5% throughout the reporting period, before ending the quarter at 2.0% (Chart 2).

CHART 2

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



While Hong Kong-dollar interest rates tracked closely their US counterparts to move higher during the quarter, the Hong Kong-dollar rates rose at a faster pace amid increased funding demand before the end of the first half of 2008. As a result, 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

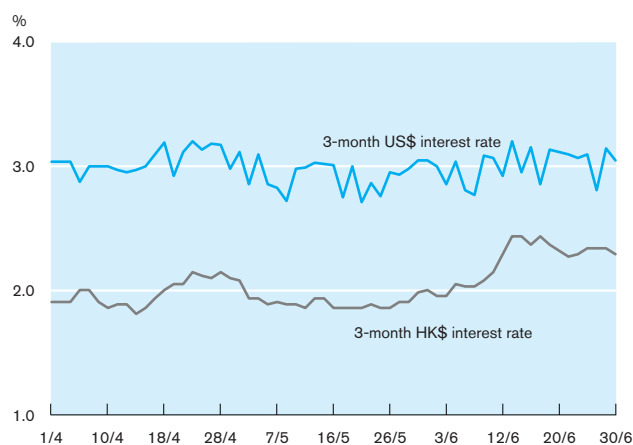
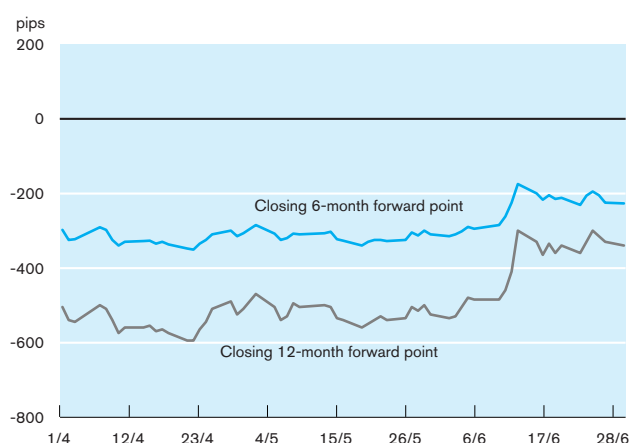


CHART 4

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

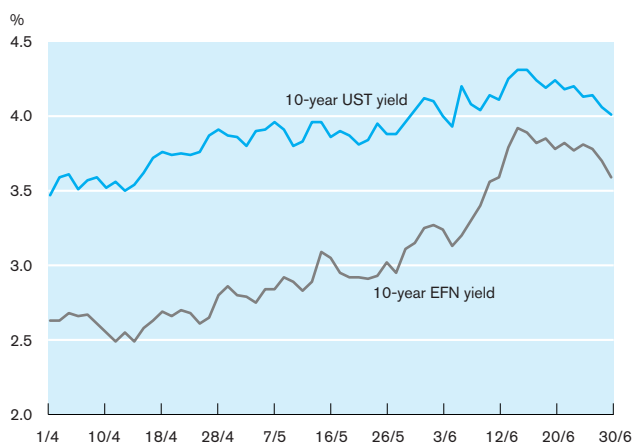


## Long-term Hong Kong-dollar interest rates

Long-term yields on the Hong Kong dollar and the US dollar both increased during the quarter. However, the long-term Hong Kong-dollar yields rose more significantly after early June. The yield spreads between the 10-year US Treasuries and the 10-year Exchange Fund Notes narrowed to -42 basis points compared with -84 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 85.2 on 30 June, compared with 85.6 on 1 April (Chart 6). The lower NEERI reflected 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

