

During the September quarter of 1994 the HK dollar traded in a narrow range close to the linked rate and depreciated slightly in trade-weighted terms. Rises in US interest rates were followed by rises in local rates. The first batch of Exchange Fund notes to mature after the change of sovereignty in 1997 were favourably received.

Monetary Policy Objective

The overriding monetary policy objective in Hong Kong is stability in the external value of the HK dollar. This is defined as a stable exchange rate between the HK dollar and the US dollar at around HK\$7.80 to US\$1 under the linked exchange rate system.

The core feature of the system is a fixed exchange rate of HK\$7.80 to US\$1 for the issue and redemption of Certificates of Indebtedness, which note-issuing banks are required to hold as cover for banknotes issued in Hong Kong. Should there be any significant deviation from the linked rate, the HKMA will undertake foreign exchange market intervention and money market operations as appropriate to ensure exchange rate stability.

Exchange rate

The exchange rate of the HK dollar moved within a narrow range of HK\$7.725 - 7.730 to US\$1 during the period under review. The maximum deviation from the linked rate was less than 1%.

From a level of around 7.729 in late June, the exchange rate of the HK dollar slightly strengthened to 7.725 in mid-July. It then moved around a level of 7.725/7.727 for most of August and September. The modest rebound in the stock market during the September quarter was probably associated with some inflows of funds. Further, there were signs that some depositors had switched from non-US dollar foreign currency deposits to HK dollar deposits to take profits against the weak US dollar. The respective growth rates of HK dollar deposits and non-US dollar foreign currency deposits during the September quarter of this year were 5.11% and 1.86%.

The overall exchange value of the HK dollar, as measured by the effective (trade-weighted) exchange rate index, is influenced by the exchange

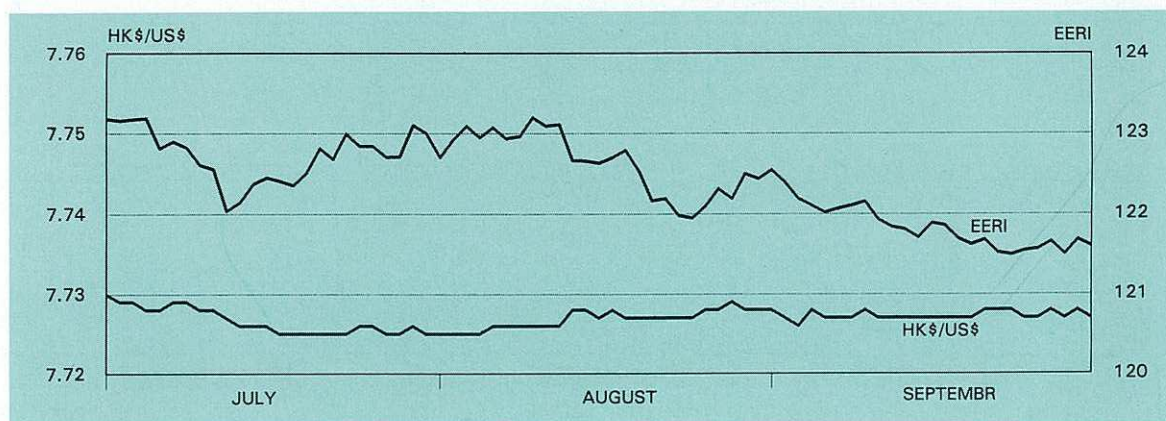
rate of the US dollar against the currencies of Hong Kong's major trading partners. Renminbi, which has a high weight of 27% in the index, strengthened marginally by about 1% against the US dollar during the September quarter. Following a sharp appreciation in June, the Japanese yen stabilised somewhat against the US dollar in the September quarter, although some volatility in the dollar/yen rate still occurred as a result of changing sentiment towards the US-Japan trade agreement. As the Japanese yen had already achieved a strong gain in June, trading interest started to shift to the Deutschemerk, the exchange rate of which was supported by market expectations that German interest rates had bottomed out. Pound sterling also appreciated against the US dollar in the September quarter, underpinned by the rising UK interest rates which maintained the interest rate differential in favour of pound sterling. Reflecting these exchange rate movements, the effective exchange rate index dropped slightly from 123.1 at end-June to 121.6 at end-September (Chart 1).

Open Market Operations

The US Federal Reserve initiated the fifth round of interest rate increase on 16 August, adjusting the Fed funds rate and the discount rate upward by 50 basis points, to 4.75% and 4% respectively. The HKMA immediately followed suit and raised the Liquidity Adjustment Facility (LAF) Bid and Offer Rates by the same magnitude to 3% and 5% respectively on 17 August. This was the third time the LAF rates were revised since the Facility was introduced in June 1992. The previous two revisions were in July 1992 and May 1994, also in response to changes in the US discount rate.

With a view to improving money market conditions, a revised mode of money market operations was introduced in March this year, whereby the HKMA uses interbank interest rates

Chart I
HK Dollar Exchange Rate (July – Sept 94)



Source: HKMA

rather than the level of interbank liquidity as its operational target¹. In practice, the HKMA injects liquidity into the system when overnight HIBOR firms up to the Offer Rate and drains liquidity from the system when the overnight HIBOR eases to the Bid Rate.

During the period under review, the local money market was occasionally affected by the seasonal fluctuation in the demand for interbank liquidity. Towards the end of June, money market conditions tightened as a result of the mid-year accounting factor. The HKMA injected substantial liquidity into the interbank market in late June to prevent overnight HIBOR from going above the LAF Offer Rate. The excess liquidity was withdrawn in early July when market conditions began to ease, as reflected by the decline in short-term HK dollar interest rates. Volatility in the demand for interbank liquidity, though of a smaller scale, was also observed towards the end of July and the end of August. The HKMA adjusted the supply of interbank liquidity to reduce the impact of the volatile demand on overnight HIBOR. For instance, it injected additional liquidity amounting to \$2,150 mn on 29 July to relieve a temporary tightness in the interbank market. Similar action was taken on 30 August and 2 September when money market conditions suddenly tightened and overnight HIBOR

hit the LAF Offer Rate of 5%. On these two days, the injections amounted to \$1,500 mn and \$2,690 mn respectively. These operations proved to be timely and helpful in forestalling sharp movements in the interest rate, which may have some effects on the exchange rate. The additional liquidity was withdrawn shortly afterwards as the interbank market began to ease. During the September quarter of 1994, the average level of interbank liquidity was \$2,254 mn, compared with \$3,483 mn and \$2,443 mn in the March and the June quarter respectively (Chart 2 and 3).

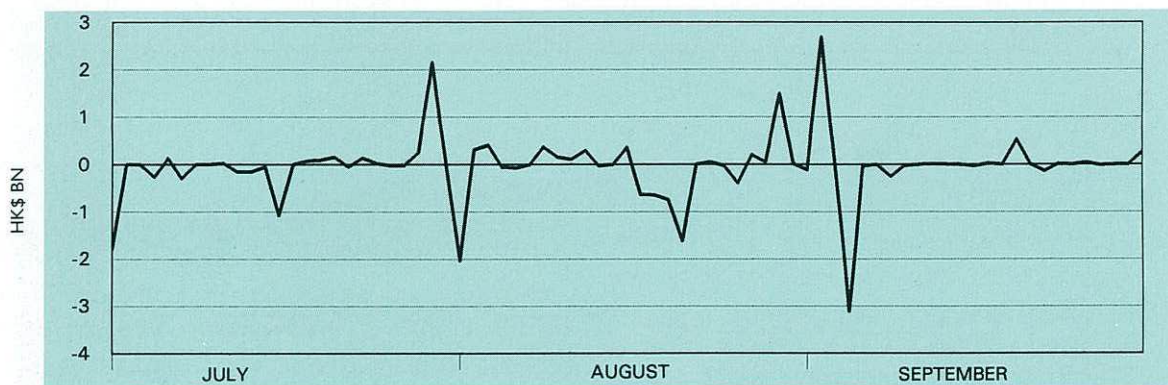
HK dollar interest rates

In part reflecting the effectiveness of the revised mode of money market operations, overnight HIBOR stayed within the range set by the LAF Bid and Offer Rates during the period under review. In terms of the movement within the range, overnight HIBOR (using the noon rate) softened from 4.5% at the end of June to around 3.875% in mid-August. It then firmed to around 4.25% to 4.50% in late August and September, along with the upward adjustment in the LAF Bid and Offer Rates (Chart 4).

The three-month HIBOR stayed close to the corresponding Euro dollar deposit rate during the reporting period. Following the rise in the US

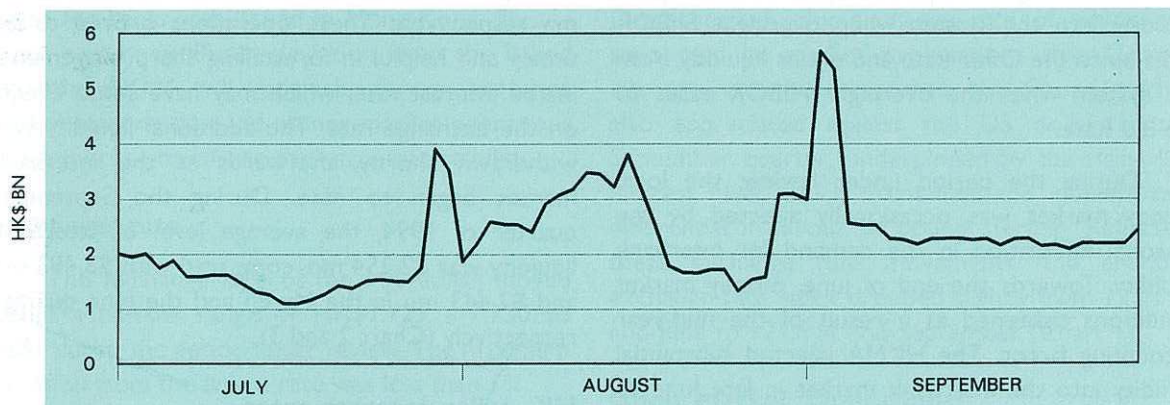
¹ Details are given in "Management of Interbank Liquidity", in this issue of the *Quarterly Bulletin* (p.1-7)

Chart 2
Net Injection of Interbank Liquidity (July – Sept. 94)



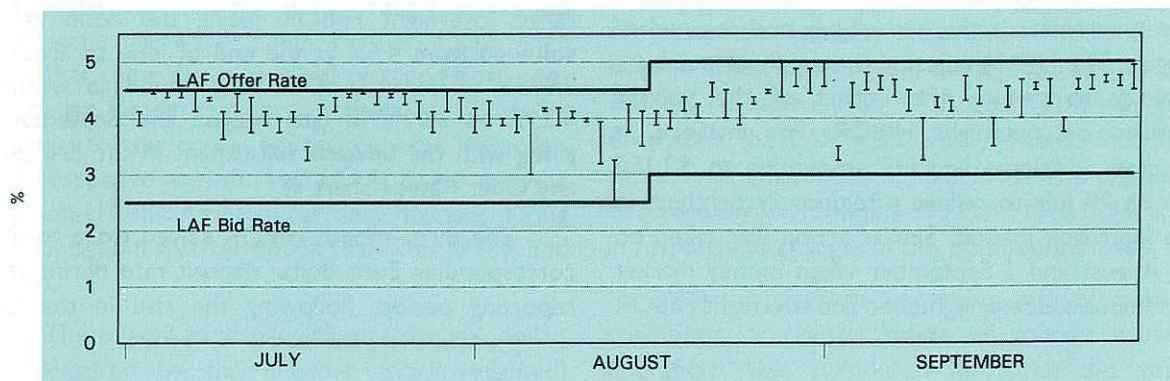
Source: HKMA

Chart 3
HSBC'S Balance with the Exchange Fund (July – Sept. 94)



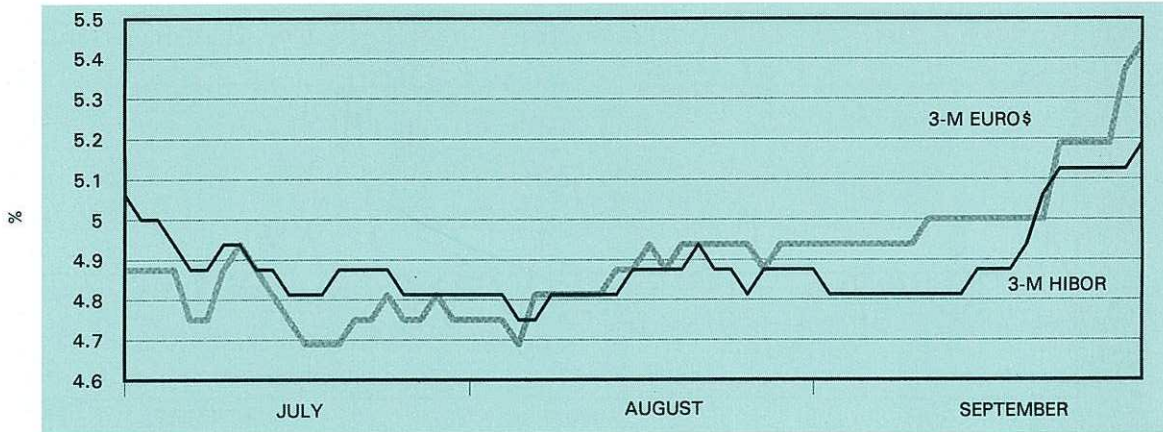
Source: HKMA

Chart 4
Movement of Overnight Interbank Interest Rate (July – Sept. 94)



Source: HKMA

Chart 5
3-Month HIBOR and EURO\$ Deposit Rate (July – Sept. 94)



Source: HKMA

dollar interest rate, the three-month HIBOR rose from 4.9375% at the end of June to 5.1875% at the end of September (Chart 5).

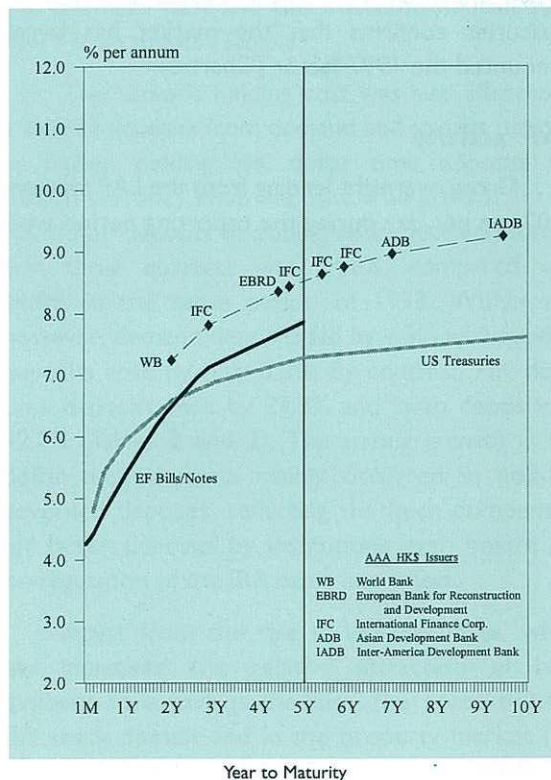
In line with the increase in the LAF Bid and Offer rates and the interbank interest rates, the HKAB deposit rates were adjusted upwards by 50 basis points across the board on 17 August. This marked the third round of increase in HKAB deposit rates this year. Starting from 1 October, HKAB rates on time deposits with a maturity of over one-month were de-regulated. A number of banks have raised these time deposit rates to a level comparable to the interest rates offered on swap deposits.

HK dollar yield curve

Two significant developments in the HK dollar benchmark yield curve occurred during the September quarter this year. First, on 25 July, the fourth issue of the three-year Exchange Fund Notes, the first to mature after 1 July 1997, was put on tender. The average accepted yield was 6.9%, which was only 35 basis points above the corresponding US Treasuries. As at end-September, the differential in yields between the fourth issue and the third issue (a difference of three months in maturity) was 16 basis points, the same as the differential between the third and the second issue. This clearly indicates that the market does not

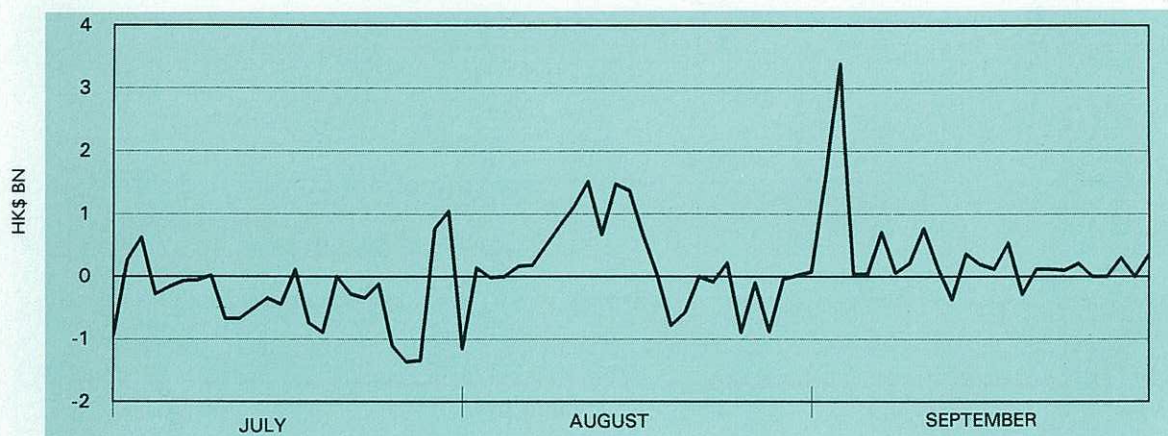
demand any additional premium on the change of sovereignty on 1 July 1997. Secondly, on 26 September, the first issue of 5-year Exchange Fund

Chart 6
HK\$ and US\$ Yield Curves (as at 30 Sept.)



Source: HKMA

Chart 7
Net Amount Borrowed by LAF (July – Sept. 94)



Source: HKMA

Notes was launched, pushing the benchmark yield curve further to the five-year area. The yield on the Notes, at 7.68%, was only 37 basis points above the corresponding US Treasuries, and was 90 basis points below some HK dollar bond issues issued by triple-A multilateral agencies. The narrow spread between the 5-year Notes and the US Treasuries confirms that the market has largely discounted the 1997 factor (Chart 6).

LAF activity

Gross overnight lending from the LAF averaged \$207 mn per day during the reporting period while

gross overnight deposits with the LAF averaged \$281 mn. In net terms, there were on average net deposits of \$75 mn (Chart 7). Reflecting a greater demand for interbank liquidity during month-ends, banks made increasing use of the LAF discount facility in these periods. Gross overnight loans of around \$1 bn were extended to banks on a few days in late July and late August. In mid-August, money market conditions appeared to have eased. The surplus liquidity was returned to the HKMA through the LAF deposit facility. On several days, gross deposits of over \$1 bn were recorded. ☺

– Prepared by the Monetary Management Department