

OPERATION OF MONETARY POLICY

During the December quarter of 1994, the HK dollar exchange rate remained very stable at around 7.727 to 7.740 against the US dollar. The HKMA progressively reduced the Balance of HSBC's account maintained with the Exchange Fund in response to the liquid money market conditions observed since end-October. Since mid-November, there were a few occasions when substantial liquidity was injected into the market to ease temporary tightness. HK dollar interest rates rose in line with US dollar interest rates.

In spite of some speculative selling pressure in the second week of January 1995, the HK dollar exchange rate fluctuated by less than 0.4%. The monetary policy actions taken by the HKMA were effective in maintaining exchange rate stability.

The monetary policy objective in Hong Kong is to maintain exchange rate stability within the framework of the linked exchange rate system¹. This being a currency board system, any significant deviation between the market rate and the linked rate should be self-adjusting. Nevertheless, the HKMA is also in a position to undertake foreign exchange market intervention and money market operations as appropriate to ensure exchange rate stability.

HK dollar exchange rate

Throughout the quarter ending December 1994, the market exchange rate of the HK dollar remained stable at around 7.727 - 7.740 level against the US dollar. It eased slightly during the last two months of 1994 and closed the year at 7.7375².

With the US interest rates on an increasing trend affecting stock market performance, there was some alleged outflow of funds from the HK dollar. But this did not really have any significant effect on the HK dollar exchange rate, which only softened slightly to around 7.7410 in mid-December.

During the early part of the December quarter, the US dollar continued to weaken against the major currencies and reached a low of 1.4911 against the D-mark, 96.83 against the Yen, and 1.2420 against the Swiss Franc on 26 October. It was then supported by news reports of market intervention by the Federal Reserve and statements

of the US Treasury in favour of a strong dollar. The US dollar then rebounded, prompted by the electoral victory of the Republicans, which the market interpreted to mean a tighter fiscal policy, as well as the subsequent rise in US interest rates in November. However, by the last week of the year, the US dollar weakened amid market concerns about the possible impact of the currency crisis in Mexico. Against other currencies, the HK dollar moved in line with the movements of the US dollar.

The Renminbi continued to appreciate slightly against the US dollar and HK dollar, by about 1% in the last three months of 1994, attributable mainly to China's balance of payments surplus. Given the close China-HK trade relations, Renminbi has a 27% weighting in Hong Kong's effective (trade-weighted) exchange rate index.

Reflecting these exchange rates developments, the effective exchange rate index rose slightly from a low of 120.4 on 2 November to a high of 122.0 in early December before closing the year at 121.4 (Chart 1).

Following the Mexican currency crisis, the HK dollar, along with the currencies of a number of "emerging markets" in Asia, came under some speculative selling pressure in the second week of January 1995. The speculators were presumably unable to draw a distinction between the economic fundamentals of Hong Kong and Mexico, nor between the currency board type linked exchange

¹ The core feature of the linked exchange rate system is a fixed exchange rate of HK\$7.80 to US\$1 for the issue and redemption of Certificate of Indebtedness, which note-issuing banks are required to hold as cover for banknotes issued in Hong Kong.

² Exchange rates quoted in the text are closing middle T/T rates unless otherwise specified.

Chart 1
HK Dollar Exchange Rate (Oct 94 – Jan 95)

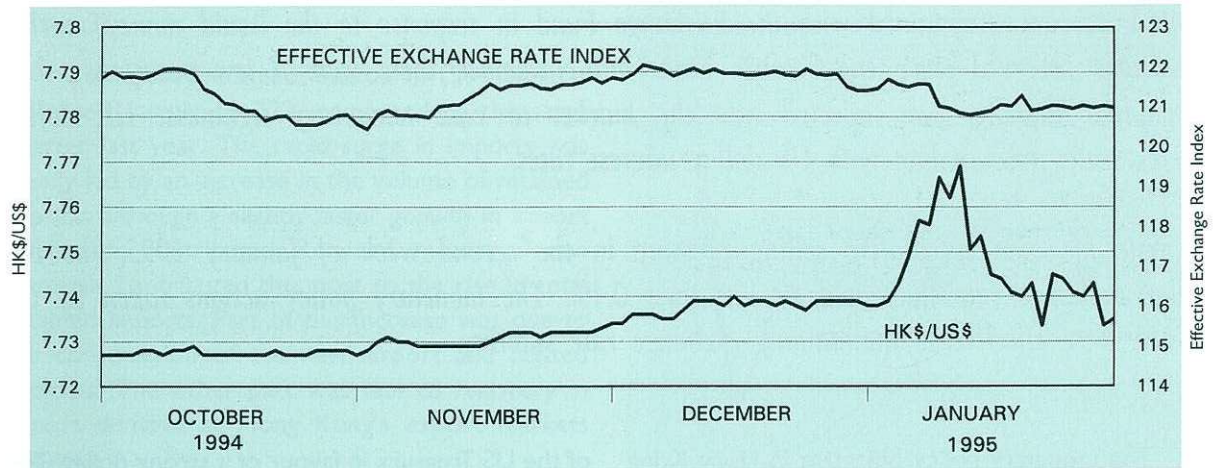
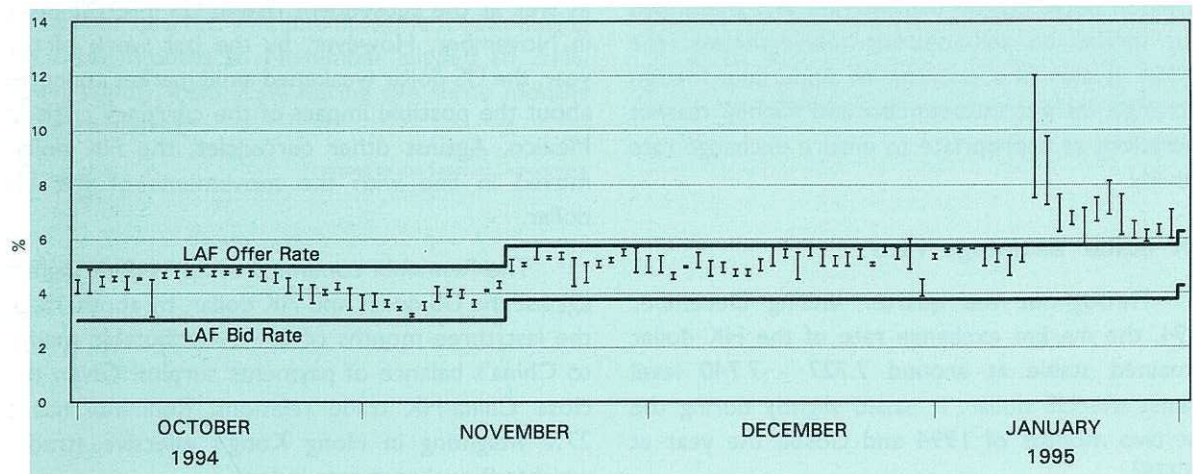


Chart 2
Movement of Overnight Interbank Interest Rate (Oct 94 – Jan 95)



rate system of Hong Kong and a currency peg. The HK dollar softened against the US dollar from 7.7375 at the beginning of 1995 to touch a low of 7.7225 during 12 January. The HKMA intervened in the foreign exchange market and tightened interbank liquidity to prevent the HK dollar from weakening too sharply. The actions were successful. The HK dollar exchange rate rebounded and stabilised around 7.73 by 20 January.

In the week ending 13 January, the HK dollar fared better than other southeast Asian currencies. It fluctuated less than 0.4%, compared with 0.9% for Malaysian Ringgit, 1.4% for Indonesian Rupiah, 1.6% for the Singapore dollar, 2.7% for the Philippines Peso and 3.6% for the Thai Baht.

Monetary Management

Quarter ending December 1994

During the December quarter, overnight HIBOR stayed within the range set by the Liquidity Adjustment Facility (LAF) bid and offer rates for almost all of the time (Chart 2).

From the beginning of October to mid-November, the US and HK markets were still uncertain about the timing and extent of the next move of US interest rates as the US Federal Reserve did not announce any interest rate rise in its FOMC meeting on 27 September. At that time, the HK dollar interbank market turned soft against the quiet asset markets, affected by investor

hesitation in acquiring interest in HK dollar assets amidst the uncertainties. Interbank liquidity had been in a mildly surplus condition such that overnight HIBOR moved progressively downwards from 4.75%³ around mid-October to 3.375% on 8 November, approaching the floor of the LAF corridor. During the last week of October, the 'Balance'⁴ before LAF reached a high of \$4,280 mn. Surplus liquidity was then frequently placed with the HKMA through the LAF deposit facility; lending to banks through the LAF discount window had been sparingly used (Chart 3 and Chart 4). In the three weeks from 24 October to 12 November,

gross overnight deposits with the LAF averaged \$913 mn per day which was over twelve times the average of \$75 mn in the September quarter.

In view of the softening interbank market, the HKMA progressively reduced the level of interbank liquidity, with the exception of occasional injections as mentioned below, with a view to bringing HK dollar interest rates in line with the rising trend of the US dollar counterparts. The average level of the 'Balance' before LAF was reduced from \$3,017 mn in October to \$2,469 mn and \$2,000 mn in November and December respectively.

Chart 3
HSBC's Balance (before LAF) with the Exchange Fund (Oct - Dec 94)

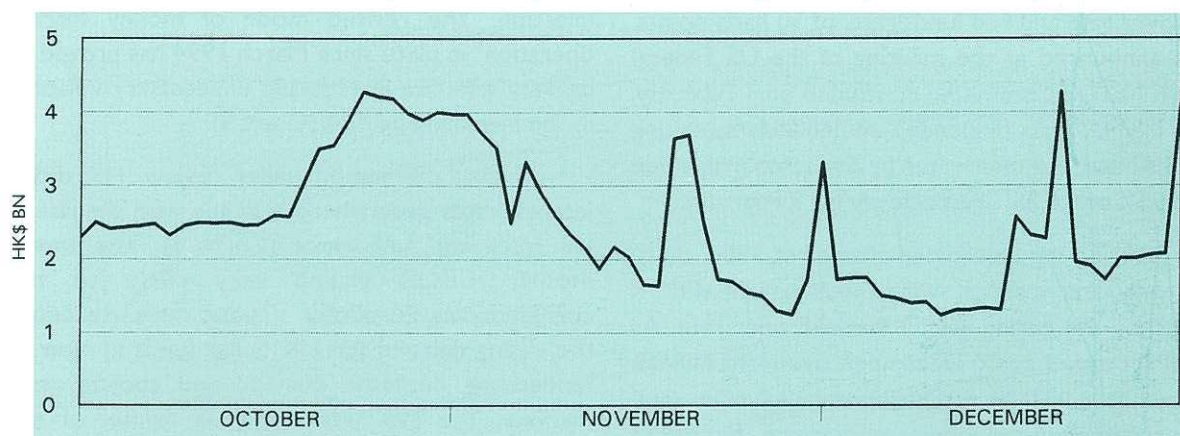
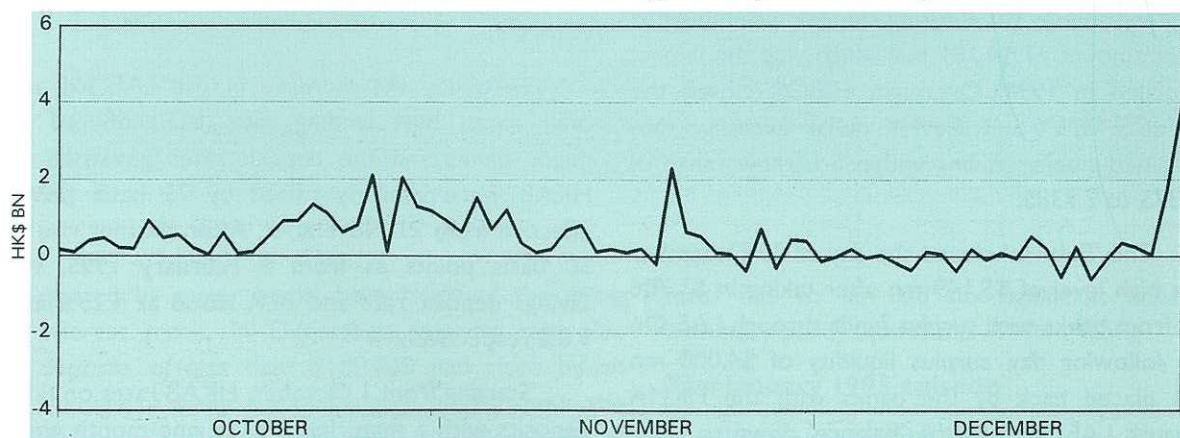


Chart 4
Net Amount Borrowed through LAF (Oct - Dec 94)



3 HIBOR figures quoted in the text are closing middle rates unless otherwise specified.

4 The 'Balance' refers to the balance of the account of HSBC (the Management Bank of the Clearing House of the HK Association of Banks) opened with the Exchange Fund which can only be altered by the HKMA.

On 15 November, the Fed funds rate and the US discount rate were raised by 75 basis points to 5.25% and 4.75% respectively. This round of interest rate increase was somewhat higher than that generally anticipated and successfully brought relief to fears of further rises in the near term and to concerns over longer term inflation by the US bond markets.

The HKMA immediately followed suit and raised the LAF bid and offer rates by the same magnitude to 3.75% and 5.75% respectively on the following day. This rise of LAF rates was the third one in 1994. Along with the rise in LAF rates, overnight HIBOR firmed to around 4.56% to 5.75% in the latter half of November and throughout December.

Stepping into 1995, another rise in the US discount rate and Fed funds rate, of 50 basis points, was announced at the meeting of the US Federal Open Market Committee concluded on 1 February. The HKMA again responded immediately by raising the LAF bid and offer rates by the same magnitude to 4.25% and 6.25% respectively on 2 February.

During the December quarter of 1994, there was only one occasion when the overnight HIBOR breached the ceiling set by the LAF offer rate. As trading opened on 30 December, overnight HIBOR surged to 6.0375%, surpassing the LAF offer rate. The tightness in the money market was due to the huge demand for interbank funds to meet year-end settlements and also to the effect of a long weekend. In response, the HKMA injected liquidity on a continuous basis during the day, amounting to a net amount of \$4,781 mn which was the largest recorded in 1994. Overnight HIBOR closed the day at 5.4375% and the HK dollar exchange rate remained stable, trading within a narrow range of 7.7375 to 7.7385.

The 'Balance' closed the day of 30 December at a high level of \$5,149 mn after taking in \$1,706 mn from banks with surplus funds through LAF. On the following day, surplus liquidity of \$4,000 mn was placed back by the banks with the HKMA through LAF, bringing the 'Balance' down to close the year at \$2,207 mn.

Since mid-November, there had been four other occasions of temporary tightness when overnight HIBOR hit the LAF offer rate of 5.75%. The HKMA injected liquidity amounting to \$2.1 bn and \$1.9 bn in response to two heavily oversubscribed IPOs. The first happened on 18 November when the application monies for Golden Harvest Entertainment were refunded. The second occurred on 30 November when the IPO of Guangnon Holdings was closed for subscription. In the other two occasions during mid-December, substantial amounts of funds tied up by some banks in their clearing accounts had caused a temporary shortage in interbank liquidity. Timely injections of liquidity were again made to forestall sharp movements in overnight interest rates. Excess liquidity was subsequently placed with LAF or withdrawn from the market a day or two after injection. The revised mode of money market operation⁵ in place since March 1994 has proved to be very effective in reducing unnecessary volatility in the interbank market (Chart 5).

During the period under review, HK dollar interest rates generally rose in line with the rise in US rates and LAF rates (Chart 6). The three-month HIBOR stayed very close to the corresponding Eurodollar deposit rates. Reflecting the easing demand for HK dollar funds in view of moderating domestic demand and cooling asset markets, the gap was mildly in favour of the Eurodollar rates during the December quarter. Notwithstanding a slight widening of the gap from mid-October to mid-November, the maximum deviation was contained within 25 basis points (Chart 7).

Following the increase in the LAF bid and offer rates, best lending rate (BLR) offered by major banks and the deposit rates governed by HKAB were similarly raised by 75 basis points effective from 21 November. After another rise of 50 basis points as from 6 February 1995, the savings deposit rate and BLR stood at 4.25% and 9.0% respectively.

Starting from 1 October, HKAB rates on time deposits with a maturity of over one month were deregulated. Since deregulation, the market rates

5 Details of the revised mode of money market operations are given in "Management of Interbank Liquidity" in the November 1994 issue of the Quarterly Bulletin (pp.1-7).

Chart 5
Net Injection of Interbank Liquidity (Oct – Dec 94)

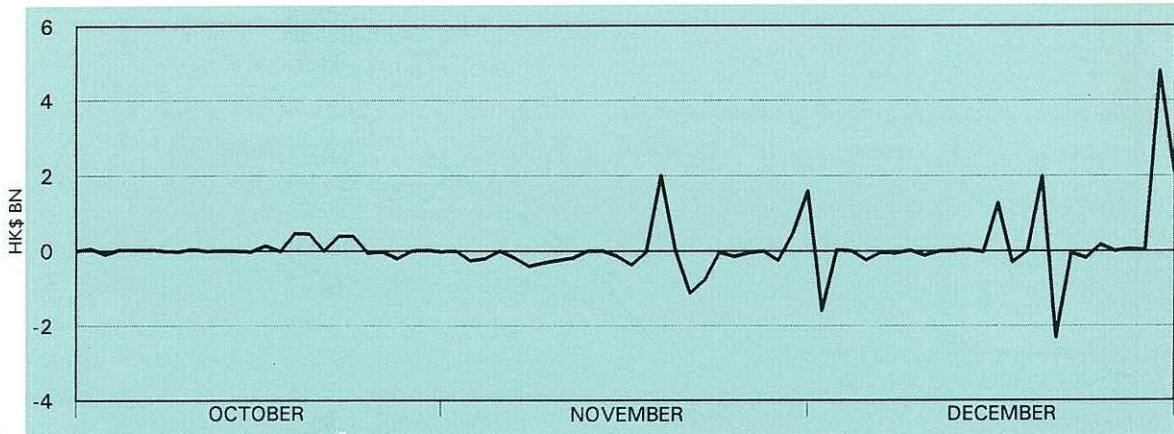
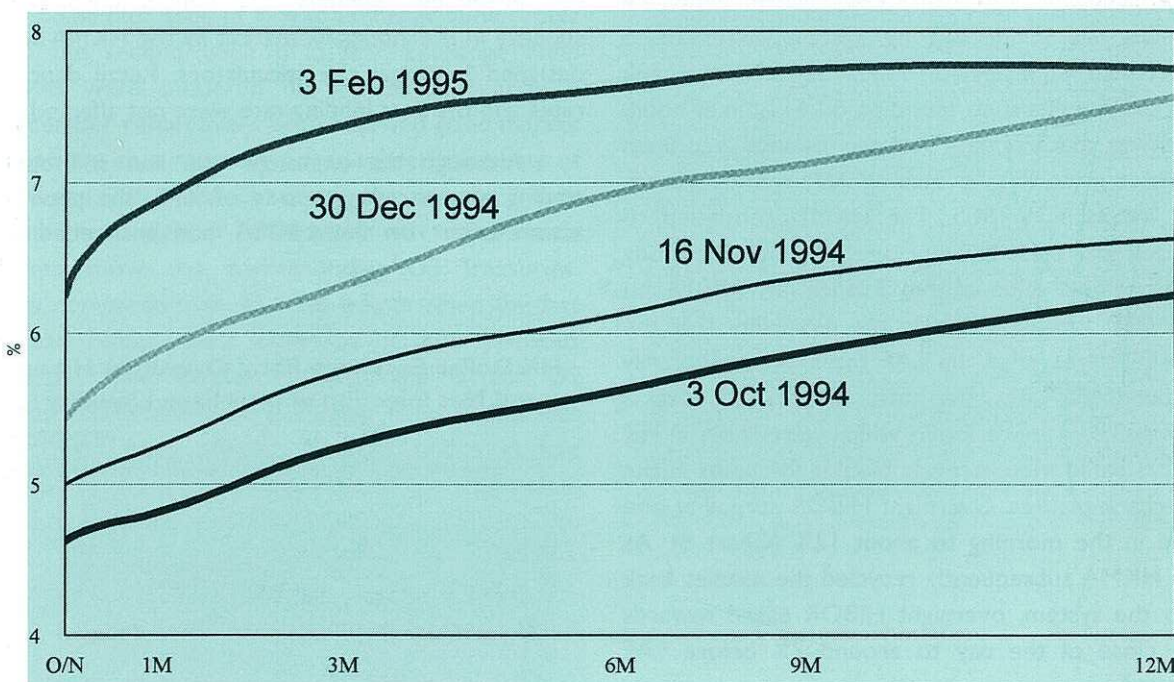


Chart 6
Term Structure of Interbank Interest Rates



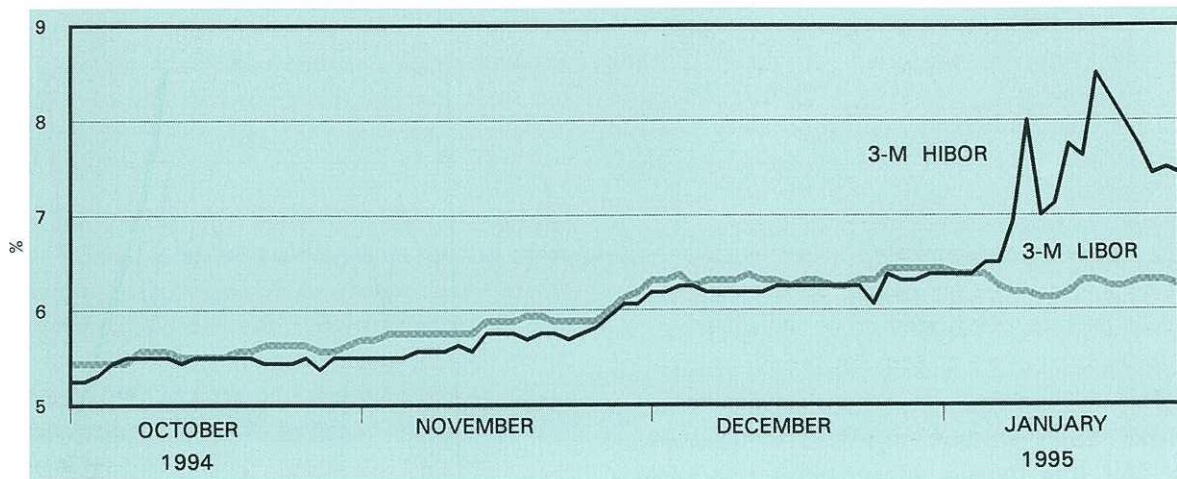
quoted by major banks have followed the rising interest trend. In December, interest rates for deposits of less than \$100,000 had risen by an average of about 1.5 percentage points above the average September level. The second phase of deregulation began on 3 January 1995. Since then, interest rates on time deposits with a maturity of over one week are not governed by the Interest Rate Rules. Deregulation of time deposit interest

rates has so far had no significant impact on monetary policy operations in Hong Kong

The January 1995 episode

In response to the selling pressure on the HK dollar during the second week of January 1995, the HKMA tightened the interbank market and intervened directly in the foreign exchange market. On 12 January when the speculative activity

Chart 7
3-Month HIBOR and LIBOR (Oct 94 – Jan 95)



became more significant, the HKMA withdrew liquidity from the banking system to create a substantial shortage of funds in the interbank market. The 'Balance' stood at -\$4,613 mn at noon. This was the first time that the 'Balance' had been negative since the Accounting Arrangements were put in place in 1988. The HKMA continued to tighten interbank liquidity on 13 January, resulting in a negative value of the 'Balance' at -\$3,011 mn by 10:00 a.m. Considering the possibility that the HKMA might raise the LAF rates, or temporarily suspend the LAF offer rate, thereby imposing a high penalty rate on banks which were short in HK dollar, banks were actively bidding for funds in the interbank market. Overnight HIBOR surged at one time in the morning to about 12% (Chart 8). As the HKMA subsequently recycled the monies back into the system, overnight HIBOR eased towards the close of the day to around 7% before LAF opened.

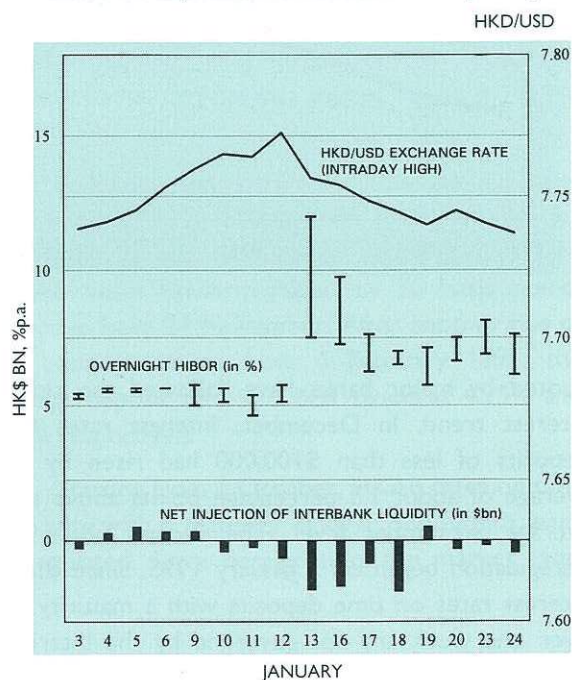
The HKMA continued to have the interbank market tight in the following few trading days when the overnight HIBOR stayed firm at around 6% to 7% (Chart 8). Meanwhile, the HK dollar exchange rate gradually strengthened to a level around 7.734 by 20 January 1994. As a result of the tight liquidity condition, the 3-month HIBOR rate exceeded that on Eurodollar deposits from 10 January (Chart 7).

The sharp rise in interbank rates had been costly to those speculators who were shorting the

HK dollar to purchase US dollars. The brief squeeze in the interbank market by the HKMA was designed to target the speculators. Retail deposit rates and the best lending rate were not affected.

Although the exchange rate had still been trading at the stronger side of 7.80, the prompt action taken by the HKMA had succeeded in

Chart 8
HK Dollar Exchange Rate, Overnight HIBOR and Net Injection of Interbank Liquidity



preventing sharp movements in the HK dollar exchange rate as a result of the speculative activities in the market.

On 21 January, the HKMA convened a meeting with senior officials from the central banks or monetary authorities of Indonesia, Malaysia, the Philippines, Singapore, and Thailand to exchange information concerning the speculative activities, the type of currency speculators, how they operate and how they fund themselves. The central banks also exchanged views on the appropriate responses on their part, covering operational and supervisory measures. It was also agreed that the central banks should keep closely in touch and share relevant information on this subject matter.

Exchange Fund Bills and Notes Programme

The fifth issue of 3-Year Exchange Fund Notes and the second issue of 5-Year Exchange Fund Notes were tendered on 24 October and 19 December respectively. Both received good market support with a respective over-subscription rate of 4.28 and 6.20 times. On the tender day, the 3-Year Notes had a yield of 7.52% which was only 35 basis points above the corresponding US Treasuries. This compared with 45 basis points when the last 3-Year Notes were tendered in the previous quarter. The spread between the 5-Year US Treasuries and 5-Year Exchange Fund Notes has narrowed from around 70 basis points in late October to a stable level of below 60 basis points in the remaining part of the quarter (Chart 9). The

narrowing of spreads reflected continued market confidence in the Notes.

As at end-December, the total amount of Bills and Notes outstanding was \$52.34 bn. The secondary market remained highly active with an average daily turnover of \$23.80 bn during the December quarter, up by 5.8% from a year ago. ^(*)

— Prepared by the Monetary Management Department

Chart 9
HK\$ and US\$ Yield Curves

