

OPERATION OF MONETARY POLICY

The HK dollar exchange rate remained stable amidst volatility in the international foreign exchange markets and occasional rumours about the health of Mr. Deng Xiaoping. Amidst these rumours, there was a brief tightening of money market conditions in late April. But such tightness quickly dissipated by early May. Reflecting market expectations that US dollar interest rates had peaked, the full spectrum of HK dollar interest rates had been easing since May.

HK dollar exchange rate

Throughout the period under review, the HK dollar traded within a narrow range of 7.731 to 7.742 at the strong side of the linked rate (Chart 1). Rumours of the demise of Mr. Deng Xiaoping triggered a fall in stock prices during the last week of April and early May. The HK dollar exchange rate briefly touched 7.742 on 29 April but quickly returned to around 7.735 in the following week. On another occasion, unfounded rumours of riots in Tibet on 15 June sent the Hang Seng Index down by 103 points. But the HK dollar exchange rate was basically unaffected. The stability of the HK dollar exchange rate reflected strong confidence in the linked exchange rate system, which has been reinforced by the effective monetary action taken by the Monetary Authority to fend off currency speculation in January this year.

In the international foreign exchange markets, overshadowed by the lack of progress in the US-

Japan trade talks and the absence of concerted action on the part of the US Federal Reserve to raise interest rates, the cut in discount rate of 50 bp by the Bundesbank on 30 March and 75 bp by the Bank of Japan in mid April gave little support to the US dollar. After touching a record low of 79.70 against the Yen and 1.345 against the D-mark on 19 April, the US dollar experienced a short rebound around mid-May, supported by a brief rally in the US stock market and bond market. However, selling pressure on the US dollar soon reemerged following the release of a series of weak economic data that pointed to a slowing economy. The slide in the US dollar was nevertheless arrested by concerted foreign exchange intervention by central banks in late May and the announcement of a balanced-budget plan by the Clinton administration in mid June. In the latter half of June, the US dollar softened somewhat as the G7 summit did not reach any concrete plan for currency stabilisation.

Chart 1
HK Dollar Exchange Rate
(Apr – Jun 95)

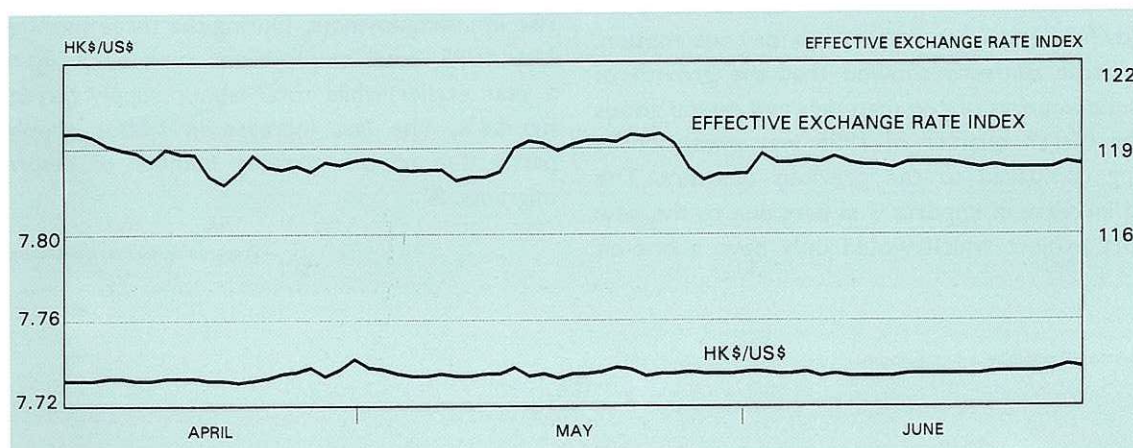


Chart 2
Net Injection of Interbank Liquidity
(Apr – Jun 95)

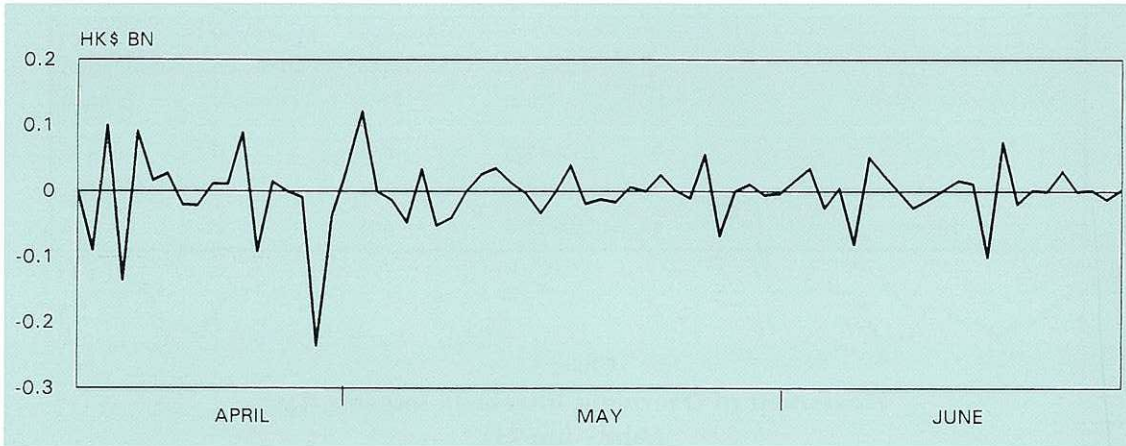


Chart 3
HSBC's Balance (Before LAF) with the Exchange Fund
(Apr – Jun 95)

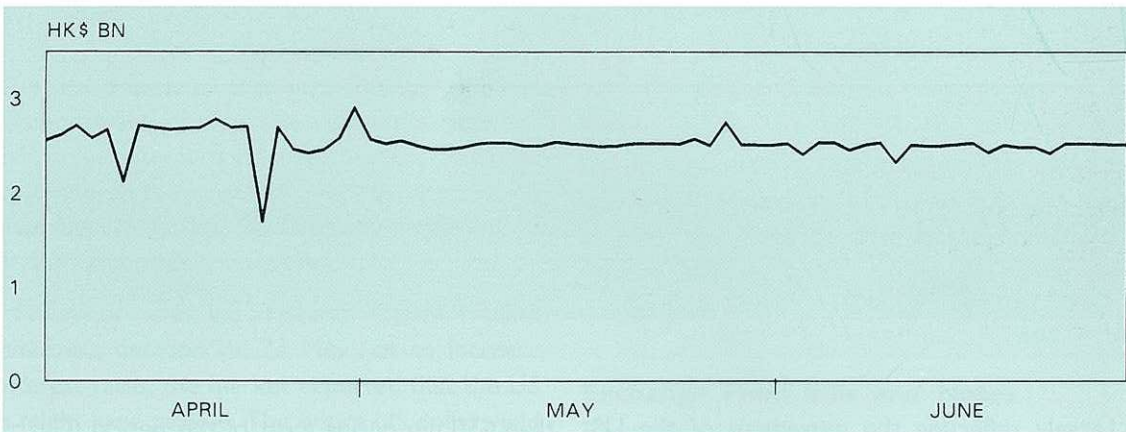


Chart 4
Net Amount Deposited with LAF
(Apr – Jun 95)

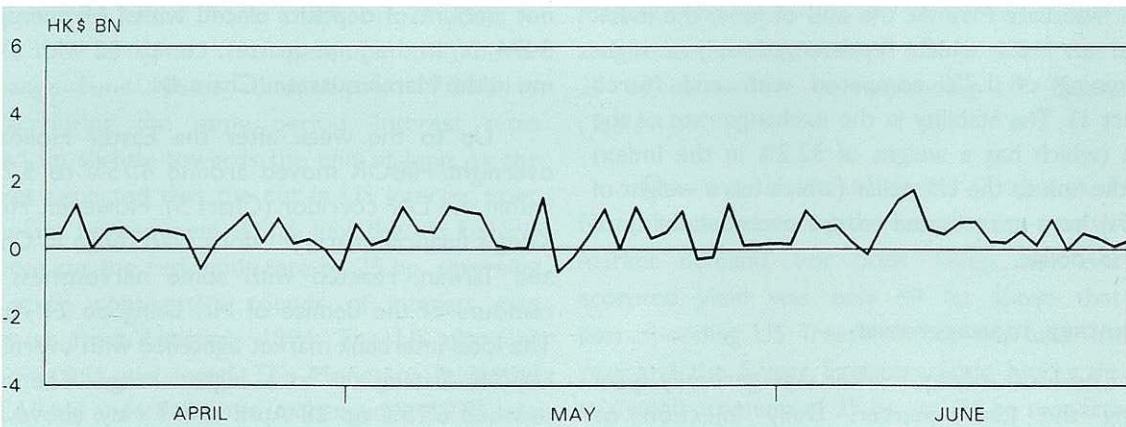
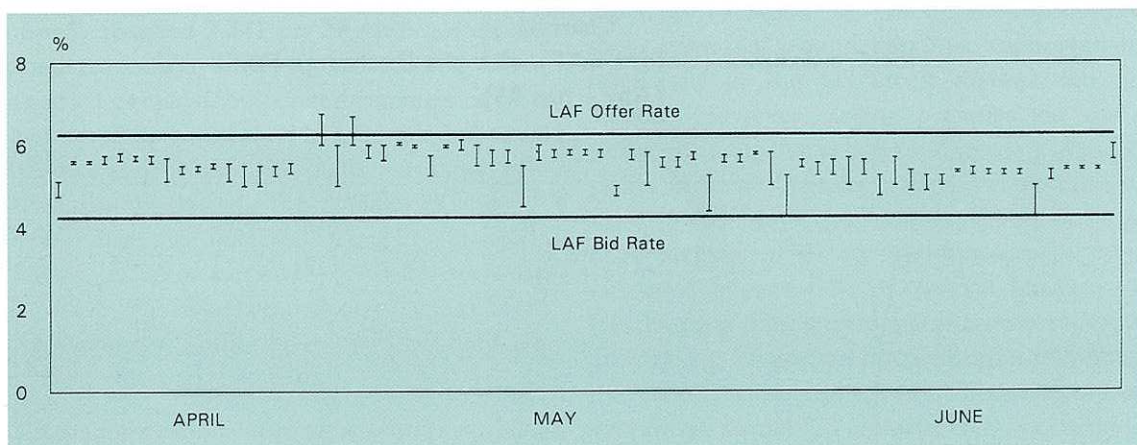


Table 1:
3-year and 5-year Exchange Fund Notes issued
during the June quarter of 1995

Exchange Fund Notes	Issue No.	Maturity Date	Average accepted yield (%)	Basis Point above US Treasuries	Over-subscription (times)
3-year	7	27.04.1998	6.96	27	4.70
5-year	3	21.03.2000	7.75	68	1.62
5-year	4	13.06.2000	6.95	68	3.06

Chart 5
Movement of Overnight Interbank Interest Rate
(Apr – Jun 95)



Largely reflecting the movement of the US dollar against other currencies, the trade-weighted Effective Exchange Rate Index of the HK dollar fell from 120.2 at end March to 117.7 on 19 April. It then edged up slightly to around 119.5 but fell again from late May. At the end of June, the index stood at 118.1 which represented only a slight weakening of 1.7% compared with end March (Chart 1). The stability in the exchange rate of the RMB (which has a weight of 32.2% in the Index) and the link to the US dollar (which has a weight of 17.6%) have contributed to the overall stability of the HK dollar.

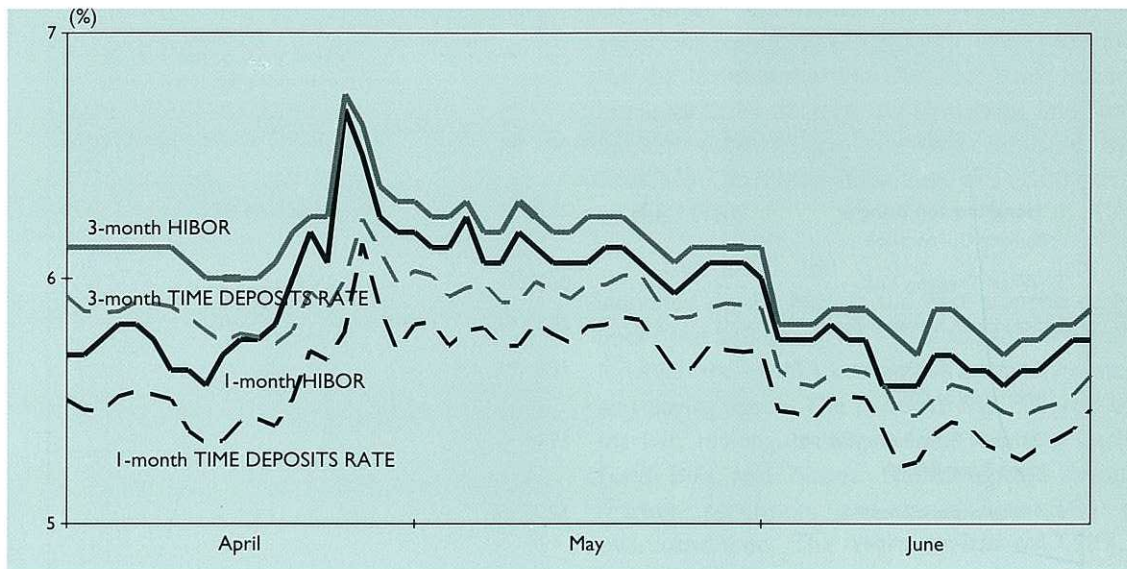
Monetary management

The local money market was generally quiet during the June quarter. Daily injection or withdrawal of interbank liquidity amounted to less

than \$50 mn during most of this period (Chart 2). The Balance (before LAF) remained stable at between \$2 bn to \$3 bn (Chart 3). The average level, at \$2.53 bn, was about the same as the level of \$2.43 bn recorded in the previous quarter. The net amount of deposits placed with LAF averaged \$474 mn in the June quarter, compared with \$494 mn in the March quarter (Chart 4).

Up to the week after the Easter Holidays, overnight HIBOR moved around 4.75% to 5.75% within the LAF corridor (Chart 5). However, Hong Kong's financial markets, along with those in China and Taiwan, reacted with some nervousness to rumours of the demise of Mr. Deng on 24 April. The local interbank market tightened with overnight HIBOR firming up to a higher range. The rate touched 6.75% on 28 April and 1 May, above the LAF offer rate of 6.25%. Thereafter, overnight

Chart 6
Movement of HK dollar Interest Rate



HIBOR eased back to around 5.25% to 6.12% in the second week of May. The differential between the HK dollar interbank interest rate and US dollar interest rate, in terms of the 3-month rates, which rose as high as 62 bp on 25 April, narrowed to fewer than 25 bp since early May.

Following the US Federal Open Market Committee's decision on 23 May not to increase US interest rates, the market expected that the US rates might have peaked. The entire US dollar yield curve shifted downwards and the yield curve in the 3 months to 1 year area became inverted since early June. The HK dollar yield curve also shifted downwards from late May. The 3-month HIBOR, for example, eased from 6.12% on 24 May to 5.56% on 23 June. The yield on the 5-year Exchange Fund Notes softened from 7.20% to 6.68% during the same period. Interest rates firmed up slightly towards the end of June, as the market expected that the cut in US interest rates might not be imminent. On 6 July, the US Federal Reserve cut the Fed funds rate by 25 bp, reversing the seven consecutive rounds of interest rate increases from February 1994. The US discount rate was left unchanged. The Monetary Authority left LAF bid and offer rates unchanged at 4.25% and 6.25% respectively.

The de-regulated retail deposit interest rates moved in line with HIBOR. For example, the 1-month time deposit rate progressively eased from 6.14% at the beginning of May to 5.75% at the end of June; the 3-month time deposit rate also fell from 6.24% to 5.88% during the same period (Chart 6).

Exchange Fund Bills and Notes Programme

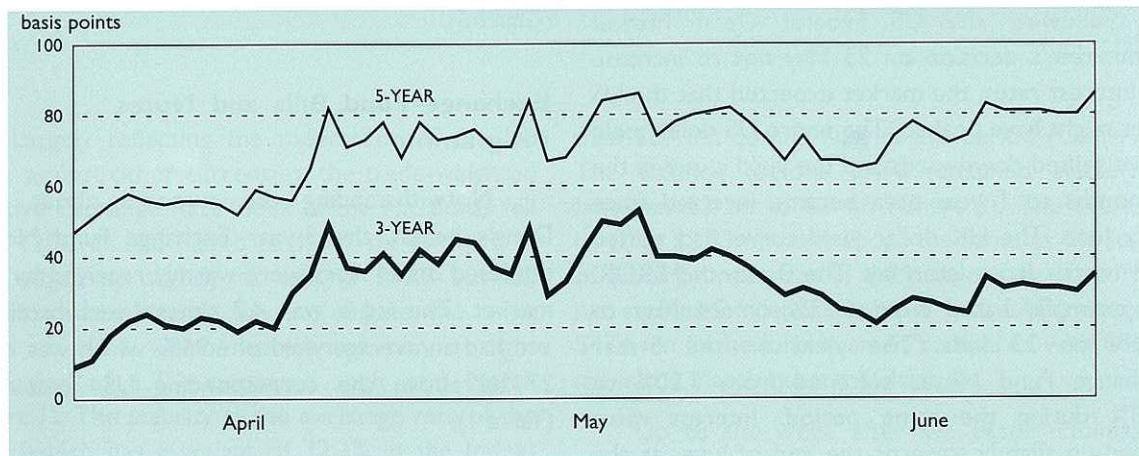
Notwithstanding the rumours about Mr. Deng's health, the 3-year Exchange Fund Notes tendered on 24 April were warmly received by the market. The issue was 4.7 times oversubscribed and had an average yield of 6.96%, which was only 27 bp above the corresponding US Treasuries (Table 1).

The two issues of 5-year Exchange Fund Notes tendered during the quarter also met strong market demand. For both issues, the average accepted yield was only 68 bp above that of corresponding US Treasuries. At end June, the 3-year and the 5-year Exchange Fund Notes traded at a small premium of 35 bp and 86 bp respectively over the US Treasuries (Charts 7 and 8).

Table 2:
Securities eligible for discounting under LAF (as at end June)

Private Issues			Instruments under the market-making arrangements	
Issuer	Value outstanding (\$ bn)	Issue date	Instruments	Value outstanding (\$ bn)
1. Hongkong and Shanghai Banking Corporation	3.2	23.09.94	Exchange Fund Bills	44.3
2. Wharf Treasury Ltd.	2.3	06.12.94	Exchange Fund Notes	10.8
3. Standard Chartered Bank	2.5	09.12.94	MTRC Notes (1st tranche)	0.5
4. Sun Hung Kai Property International Ltd.	3	10.01.95		
5. Bangkok Bank Public Co. Ltd., Hong Kong Branch	1	19.04.95		
6. Hongkong and Shanghai Banking Corporation	2	12.05.95		
7. Standard Chartered Bank	1.5	21.06.95		
Total	15.5		Total	55.6

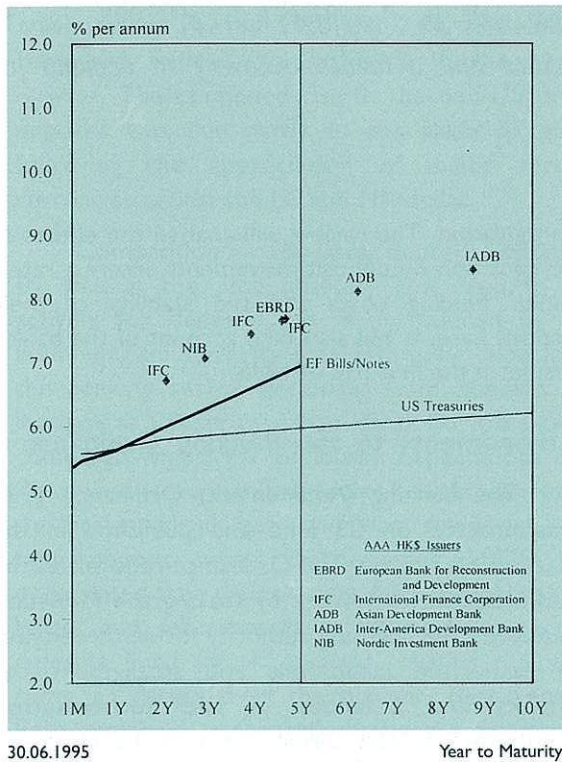
Chart 7
Movement of Yield Differential Between EF Papers and US Treasuries* (Apr – Jun 1995)



DATA UP TO 30 JUNE

* Opening yield of EF paper relative to previous night's New York close of treasuries

Chart 8
HK\$ and US\$ Yield Curves



Eligible repo securities

In the June quarter of 1995, four additional HK dollar debt issues were accepted as eligible securities for discounting under LAF. They include the \$1 bn issue by the Bangkok Bank Public Co. Ltd., the \$2 bn issue by the Hongkong and Shanghai Banking Corporation, the \$1.5 bn issue by the Standard Chartered Bank, and the \$500 mn issue by the MTRC.

The \$500 mn 5-year MTRC debt issue, launched on 19 May, is the first tranche of Notes under the \$10 bn MTRC Note Issuance Programme, in which the HKMA acts as the arranger, custodian, and paying agent. The paper is also covered by the market making arrangements for the Exchange Fund Bills and Notes. Reflecting the favourable market reception, the issue was 2.86 times oversubscribed. The average yield at 7.98%, was only 23 bp above that of AAA-rated and tax-exempted supranational issues of the same maturity. Ⓢ

– Prepared by the Monetary Policy and Markets Department