The last quarter of 1995 saw a very stable Hong Kong dollar amidst turbulence in the international financial markets. These included, for example, the Daiwa incident and the re-emergence of the Mexican financial problems. Following announcement of the US Fed funds rate cut in December, retail deposit and best lending rates in Hong Kong were reduced accordingly. The inaugural issue of 7-year Exchange Fund Notes was launched in November. The Central Moneymarkets Unit Service successfully introduced its end-of-day delivery against payment facility in December.

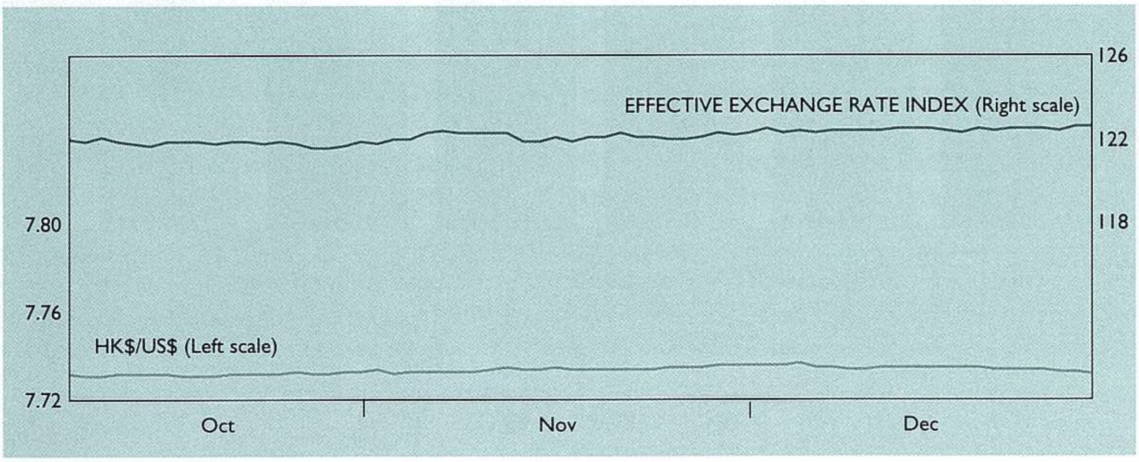
HK dollar exchange rate

The exchange rate of the HK dollar remained very stable against the US dollar in the last quarter of 1995, moving within a narrow range of 7.731 and 7.737. In the first half of the quarter, the exchange rate stayed around 7.731 and 7.733. The resurfacing of Mexican economic tensions in October and November did not exert any pressure on the HK dollar, or on other Asian currencies. The HK dollar exchange rate eased marginally to a level of 7.735-7.737 in mid-December. Upon a slight tightening of interbank liquidity, the exchange rate gradually strengthened and closed the year at 7.732.

In the international foreign exchange markets, the US dollar strengthened against the Yen but it remained largely stable against the Deutschemark (DM). In early October, in anticipation of concerted support for a strong US dollar in the G-7 meeting, buying interest in the US dollar increased. Triggered by the Daiwa incident, the US dollar further strengthened against the Yen. On 2 November, when the US Fed announced the suspension of Daiwa s operation in the US, the exchange rate of the US dollar against the Japanese yen firmed to 104.1. The prolonged debate over the federal budget between the Clinton Administration and the Republican Party left the US dollar exchange rate largely unaffected. By end December, the US dollar rose to 103.4 Yen and 1.437 DM, representing a rise of 3.0% and 0.7% respectively as compared to the beginning of the quarter.

Notwithstanding the slight strengthening of the US dollar in the international foreign exchange markets, and a fairly stable RMB which traded within the narrow range of 8.314 and 8.319 against the US dollar, the trade-weighted Effective Exchange Rate Index (EERI) of the HK dollar was fairly stable and stood at around 122 throughout the quarter. (Chart 1)

Chart 1
HK Dollar Exchange Rate (Oct – Dec 95)



Monetary Management

The quarter-end tightness in the money market that emerged towards the end of September continued in early October. Overnight HIBOR surged to around 6% in the first few days of October. When the seasonal demand for funds was over, the market quietened and the rate eased to a level of around 5.6%. During the flotation exercise of Ng Fung Hong Ltd. in mid-October, the IPO subscription funds amounting to $20.5 bn were efficiently recycled in the interbank market, with no noticeable volatility being observed in the interbank interest rates. Given the stability in the HK dollar exchange rate and the fairly stable interbank market conditions, the HKMA rarely intervened in the money markets in the first three weeks of October. The Balance before LAF was maintained at slightly above $3 bn, the prevailing level as at end September. Excess liquidity of the banking sector was returned to the Exchange Fund through the LAF deposit facility. (Chart 2)

Towards the end of October, when overnight interbank interest rates eased to a level of around 5.2%, the HKMA gradually withdrew excess liquidity in the money market. $300 mn each was drained on 25 and 27 October respectively, thus bringing down the Balance before LAF from $3 bn to around $2.5 bn. In the third week of November, overnight HIBOR eased again to around 5.06%. In response, the HKMA initiated a series of liquidity withdrawals, and the Balance before LAF was reduced to $1.2 bn in the latter part of November. Overnight HIBOR stayed at around 5.5%-6.0% towards the end of the month.

The tightness in the interbank market was maintained in early December, in view of a marginal easing of the HK dollar exchange rate from 7.734 to 7.736. The level of Balance before LAF was maintained at a level of $1.2 – $1.4 bn and overnight HIBOR moved to around 5.9%-6.0%. A few banks acquired overnight liquidity assistance through the LAF.

Towards the last week of December, the HK dollar exchange rate firmed up to 7.734-7.735 level. In the money market, there was a strong demand for liquidity due to year-end settlement needs. To relieve market tightness, the HKMA injected a total of $878 mn on 21 and 22 December. The Balance before LAF was thus increased, closing the year at $1.9 bn. Overnight HIBOR eased slightly to 5.8% before closing the year at 6.0%.

For the December quarter as a whole, the net amount of deposits placed with the Exchange Fund through LAF (i.e. deposits through the LAF minus borrowing through LAF) was around $190 mn, slightly more than the $169 mn recorded in the September quarter.

The Federal Open Market Committee (FOMC) meeting held on 19 December announced a 25 bps cut in the Fed funds rate. As the US discount rate was not changed and the Fed funds rate was within the LAF bid and offer rates, the LAF rates were left unchanged at 4.25% and 6.25%. As regards the retail deposits rate, the Hong Kong Association of Banks decided at its meeting on 23 December to follow the US rate cut by reducing the savings rate and the interest rate on deposits fixed for less than 7 days by 25 bps. Most banks also cut their best lending rate by 25 bps. This was the first cut since July 1992 in the retail interest rates governed by the Interest Rate Rules of the Hong Kong Association of Banks. The third phase of the interest rate deregulation at the beginning of November removed interest rate caps on time deposits fixed for 7 days. Less than 1% of HK dollar time deposits are now subject to the Interest Rate Rules.

Following the US rate cut, the entire yield curve of the EF Bills and Notes shifted downwards together with the US Treasuries during the December quarter. Reflecting the tightness in the interbank market in mid-November, the short term interest rates firmed up, resulting in a flattening of the yield curve in the overnight to 1-month area (Chart 3).

Exchange Fund Bills and Notes Programme

With a view to facilitating the development of the longer end of the local debt market, the inaugural issue of the 7-year Exchange Fund Notes was launched on 28 November to extend further the benchmark yield curve of HK dollar debt. The issue was well received by investors with an oversubscription rate of 6.64 times. Average accepted yield was just 106 bps above the corresponding US Treasuries, reflecting investor

Chart 2

Money Market Operations and Movement of Overnight Interbank Interest Rate (Oct – Dec 1995)

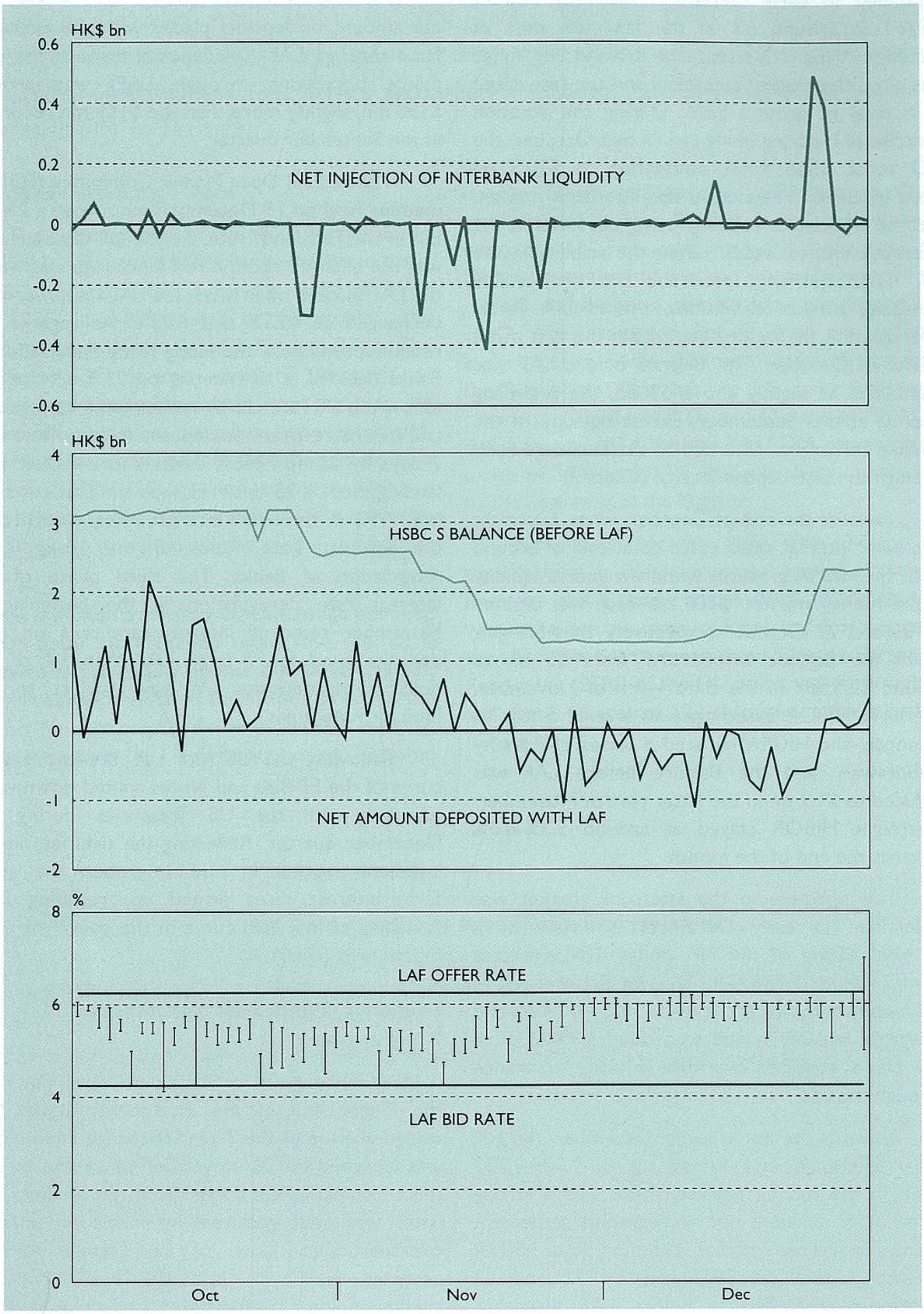
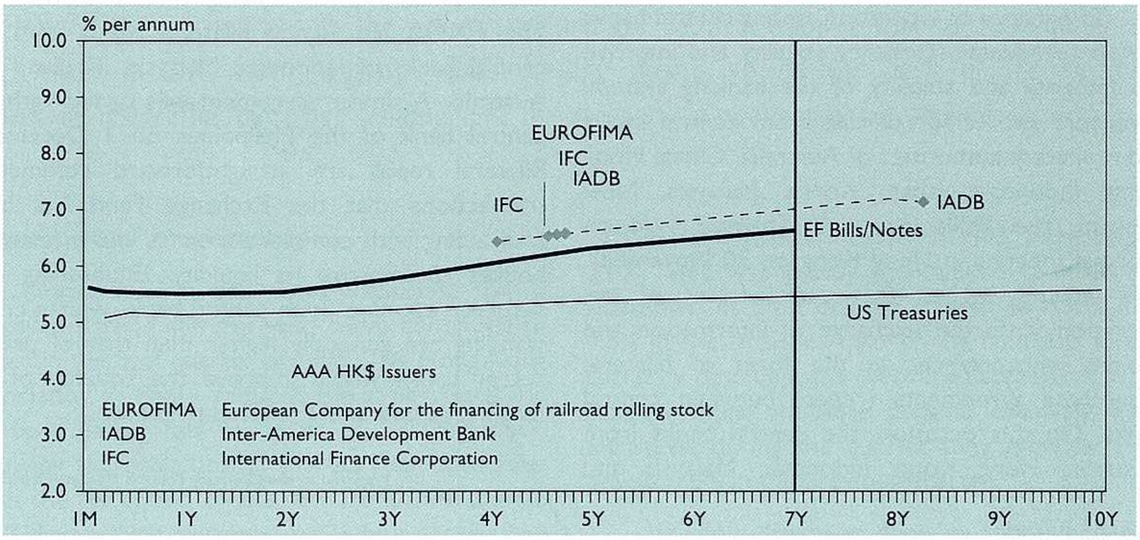


Chart 3
HK$ and US$ Yield Curves



30.12.1995 Years to Maturity

confidence in the long term stability of the HK dollar.

Other issues of Exchange Fund papers continued to be well received by the investors. The ninth issue of 3-year Notes tendered on 23 October and the eleventh issue of 2-year Notes on 13 November were oversubscribed by 4.42 and 3.64 times respectively. The sixth issue of the 5-year Notes tendered on 18 December was 1.82 times oversubscribed. Average accepted yield was only 77 bps above the comparable US Treasuries.

Eligible repo securities

During the December quarter, three more private sector debt issues were accepted as eligible securities for repurchase agreement (repo) under LAF. They were the Hongkong and Shanghai Banking Corporation Limited's $2 bn floating rate CD issue, ABN AMRO Bank's $1 bn floating rate CD and the Korea Exchange Bank's $1.1 bn floating rate note issue. By end December 1995, a total of 14 private sector debt issues, involving a total amount of $26.3 bn, have become eligible for discounting under the LAF.

The second tranche of the MTRC $10 bn Note Issuance Programme, which involved an issue amount of $500 mn and a maturity of 5 years, was successfully launched on 8 November. Similar to the last tranche launched in May, HKMA acted as the agent and custodian of this issue. The average accepted yield was 7.31%, 58 bps above the 5-year Exchange Fund Notes.

The Central Moneymarkets Unit (CMU) Service has been further enhanced by the introduction of end-of-day delivery versus payment (DvP) function for the clearing of private sector debt securities on 18 December. This function helps to minimise the settlement risk in debt securities trading. More than 30 active market participants, accounting for about 70% of the daily turnover in CMU instruments, have signed up as DvP users by end December. Starting from 15 January 1996, the CMU will also accept foreign currency debt instruments for clearing. The expanded scope of CMU operation will help promote the liquidity of the debt market in Hong Kong.

Bilateral repurchase agreement between central banks

To enhance co-operation among central banks in Asia to maintain currency stability and improve the integrity and stability of the banking system, governors and senior officials from central banks and monetary authorities of Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines and Thailand held an informal meeting in Hong Kong on 20 November. The meeting agreed that useful forms of co-operation were the exchange of information and liquidity enhancement in the form of bilateral repurchase agreements (repos) between central banks. On this occasion, the central banks from Australia, Hong Kong, Indonesia, Malaysia and Thailand signed bilateral memoranda of understanding on the repo of US dollar government securities to provide liquidity on a bilateral basis. The HKMA has signed bilateral repos with the central banks of Indonesia, Malaysia, Thailand and Australia. A similar agreement was signed with the central bank of the Philippines on 1 December. Bilateral repos are straightforward commercial transactions that the Exchange Fund has been transacting with commercial banks and investment houses to improve its liquidity. Establishing well secured repo lines with central banks whose credit standing are generally higher than that of private sector banks would improve the liquidity of the Exchange Fund under minimum risk.

– Prepared by the Monetary Policy & Markets Department