

The HK dollar remained steady against the US dollar for most of the June quarter, notwithstanding a brief easing around mid-June. Money market conditions were relatively soft except for a temporary tightening on a couple of occasions due to share subscriptions and mid-year and financial year settlement by some banks and companies. Amidst market expectation of a rise in US interest rates, the entire yield curve of the Exchange Fund Bills and Notes, alongside the US yield curve, shifted upwards.

HK Dollar Exchange Rate

The HK dollar exchange rate was stable during the June quarter, trading for most of the time within a narrow range of 7.734 to 7.740. The prolonged trade dispute between China and the US, however, aroused some uncertainty in the market in the second half of the quarter. On 14 June, which was the last trading day before the deadline for a settlement of the dispute, the HK dollar eased to 7.745 but quickly rebounded to 7.740 on the subsequent trading day upon news of the trade agreement reached between China and the US. Thereafter, the HK dollar exchange rate remained stable at around 7.740 until the end of the June quarter.

In the international foreign exchange markets, the US dollar strengthened amidst market expectation of a rise in US interest rates. For instance, the yen exchange rate eased from 107.60 at the beginning of April to 109.73 at end of June, a record low since the beginning of the year. Deutschemark also showed signs of weakening in the June quarter, moving along a downward trend

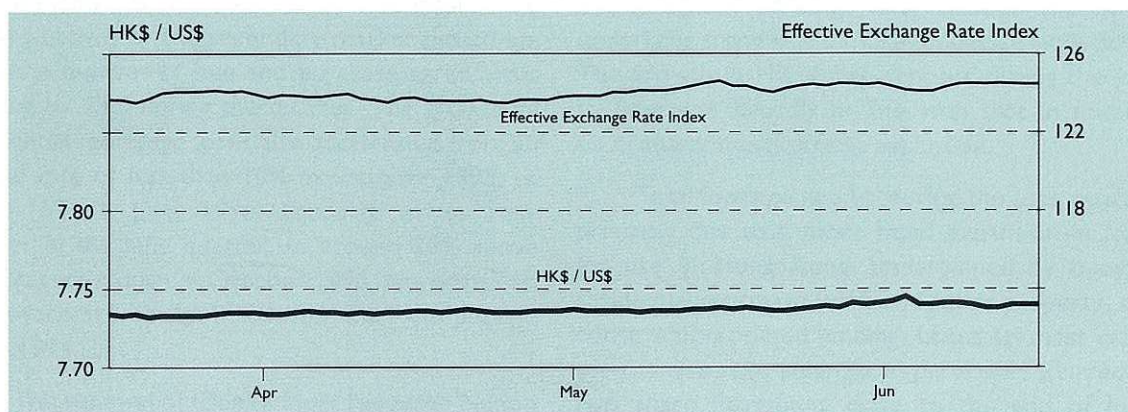
against the US dollar from 1.48 at the beginning of April to 1.54 in early June before strengthening slightly to 1.52 at the end of the month. RMB, on the other hand, continued to remain stable against the US dollar, trading between 8.32 and 8.33.

Reflecting mainly these currency movements in the international foreign exchange markets, the trade weighted Effective Exchange Rate Index of the HK dollar appreciated from 123.67 to the quarter high of 124.60 on 29 May before easing marginally to 124.45 in the month of June (Chart 1).

Management of Interbank Liquidity

To maintain exchange rate stability, the HKMA undertook money market operations on a few occasions to adjust the level of interbank liquidity to influence short term interbank interest rates. In the light of a softening of the interbank market, as reflected in the easing of the HIBOR towards the LAF bid rate, liquidity was withdrawn from the interbank market in late April and early May. Accordingly, the Balance (before LAF) kept by the

Chart 1
HK Dollar Exchange Rate (Apr – Jun 96)



Hongkong Bank with the Exchange Fund, which represented the interbank market liquidity, fell during this period. It remained low at around \$2.0 bn through May and June except at the very end of the quarter when a large injection of liquidity to relieve temporary tightness in the interbank market raised its level to more than \$5 bn (Chart 2).

When the overnight HIBOR softened to 4.81% on 23 April, the HKMA withdrew in three consecutive days a total of \$371 mn from the interbank market to narrow the gap between the HK and US interest rates which might otherwise exert pressure on the HK dollar exchange rate. As a result, the overnight HIBOR rebounded to over 5% and remained stable for some time before softening again to around 4.80% in the second week of May. In response, the HKMA again tightened the level of interbank liquidity by continually withdrawing liquidity from the interbank market. A total of \$442 mn was taken out from the interbank market during 8 to 16 May. When share subscription activities led to a sudden tightening of the interbank liquidity on 17 May, pushing the intraday overnight HIBOR to 6%, the HKMA promptly recycled some \$199 mn back to the market to alleviate the pressure on the interest rate. Residual demand for funds was met through the LAF which lent some \$1.3 bn to the banks on the same day. When market conditions eased on the following Monday, the liquidity was withdrawn. Between 21 May and 27 June, the market conditions remained stable and no market operation on a significant scale was carried out.

On 28 June which was the last Friday of the June quarter, the money market again experienced a sudden shortage of funds. Due to mid-year and financial year settlement of some banks and companies as well as share subscription activities, there was a sharp rise in demand for interbank liquidity. As a result of intense bidding for liquidity by banks, the overnight HIBOR firmed up in the late afternoon to 6.63%, exceeding the 6% LAF offer rate. To relieve market tightness, the HKMA injected some \$400 mn before the market closed, thus raising the Balance before the opening of the LAF to \$2.4 bn. Additional liquidity of \$5.15 bn was provided to banks through the LAF, bringing the closing Balance to \$7.5 bn. This represented the largest amount that had ever been injected into the interbank market by the Exchange Fund through the LAF since its inception in 1992. With some

\$2.2 bn returned to the LAF during the following Saturday morning, the Balance was still above \$5 bn before the operation of the LAF on that day. The Balance (before LAF) returned to the normal level of \$2.0 bn on Monday, 1 July.

HK Dollar Interest Rate

Despite widespread anticipation of a rise in US interest rates in the financial markets, the FOMC decided in its meeting held on 21 May to maintain the current level of discount rate and the target Fed funds rate. As a result, the LAF bid and offer rates and most retail deposit rates were left unchanged during the June quarter.

Nevertheless, changing interest rate expectations during the quarter brought volatility in the bond market. The release of a stronger than expected first quarter GDP growth in the US on 2 May triggered off market expectations of an imminent rate increase by the Fed to contain inflationary pressures. As a result, the yield of 7-year US Treasuries rose from some 6.71% at end of April to 6.92% on 3 May. It then fell to a range of 6.6% to 6.8% starting from the second week of May upon the publication of a mild increase in US producer prices. Following a greater-than-expected increase in May non-farm payrolls, however, the yield of 7-year US Treasuries rose to a high of 7.02% on 12 June before easing gradually to 6.65% by the end of the June quarter. Similar to the US interest rate movement, the yield of the 7-year Exchange Fund Notes rose from 7.06% on 1 April to the quarter high of 7.96% on 13 June and then eased to 7.75% at the end of the quarter. Compared with end-March, the entire HK dollar yield curve at end-June shifted upwards. With relatively larger increases in short term rates, however, the yield curve flattened slightly. (Chart 3).

Exchange Fund Bills and Notes Programme

Regular issues of the Exchange Fund Bills and Notes continued to be well received by the market. The 5-year Notes and 7-year Notes launched on 11 June and 28 May, respectively, were oversubscribed by 2.66 and 2.33 times. As at end of the June quarter, the total outstanding amount of the Exchange Fund Bills and Notes stood at \$62.3 bn.

Chart 2
**Money Market Operations and Movement of Overnight Interbank Interest Rate
 (Apr – Jun 1996)**

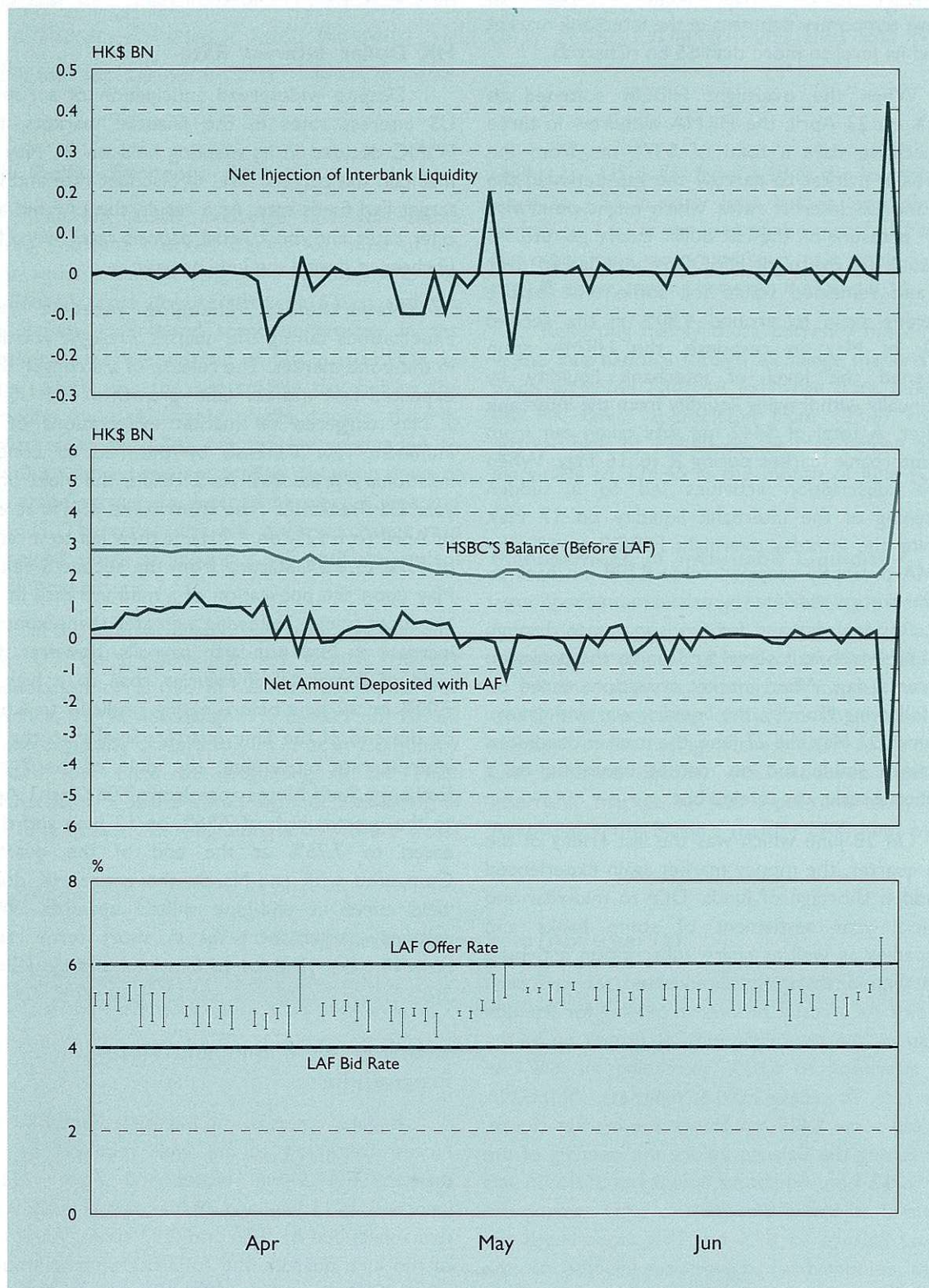
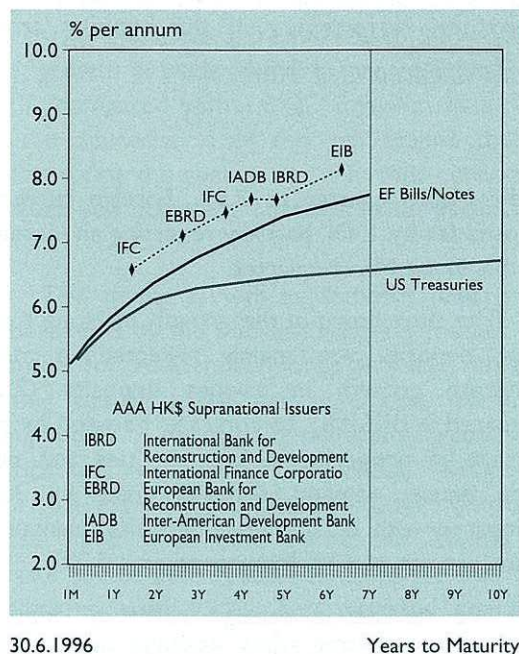


Chart 3
HK\$ and US\$ Yield Curves



Securities eligible for discounting under LAF

To be eligible as Repo securities for discounting under the LAF, a private sector debt issue must meet, amongst other criteria, a minimum credit rating requirement specified by the HKMA. Previously, only the ratings of the S&P's and Moody's were recognized for LAF purpose. On 17 May 1996, the HKMA announced that the ratings of IBCA and the Japan Bond Research Institute (JBRI) would also be recognized by the HKMA in assessing the eligibility of HK dollar denominated debt issues for LAF discounting. For debt instruments issued by banks, the minimum rating requirement is A- from IBCA or A+ from JBRI. For non-bank issues, the minimum rating requirement is A from IBCA or AA- from JBRI.

During the quarter, six issues totalling \$10.5 bn were accepted as eligible securities for discounting under the LAF. By the end of the June quarter, a total of 23 issues with an outstanding issue size of \$42.3 bn had been accepted as LAF eligible securities. ☉