

## OPERATION OF MONETARY POLICY

The Hong Kong dollar exchange rate remained stable throughout the September quarter. The money market was stable although, on occasion, month-end settlements and share subscription activities drove up the demand for liquidity and short-term interest rates. Reflecting confidence in the Hong Kong dollar, the yield curve of the Exchange Fund Bills and Notes moved downward relative to that of the US Treasuries.

### Hong Kong Dollar Exchange Rate

The HK dollar exchange rate remained stable during the September quarter, moving within a narrow range of 7.732 to 7.741. From around 7.740 in early July, the exchange rate strengthened marginally to 7.734 towards the end of the month. It strengthened further to a level around 7.732-7.733 in the second half of August and September, reflecting continued inflow of funds and the rally of the stock market that started at end-July.

In the international foreign exchange markets, when the US FOMC decided to leave the official interest rate unchanged at its July meeting, the US dollar weakened gradually against Yen and Deutsche Mark in the first half of the quarter. The Yen/US dollar exchange rate depreciated from an average level of 110.4 in the first two weeks of July to the quarter low of 106.5 on 5 August. Meanwhile, the D-Mark/US dollar exchange rate weakened from

around 1.52 in the first half of July to a low of 1.465 on 31 July. However, following the release of stronger than expected economic statistics and hence the increased likelihood of an interest rate move by the Fed in August, the US dollar exchange rate strengthened against major currencies. The upward movement of the US dollar was further underpinned by the supportive statement on a strong US dollar at the G-7 meeting in early September. By end-September, the US dollar strengthened to 111.4 against Yen and 1.525 against Deutsche Mark.

The RMB exchange rate remained stable and traded within a narrow range of 8.302-8.322 against the US dollar throughout the quarter. Reflecting these currency movements, the Effective Exchange Rate Index of the Hong Kong dollar depreciated from a high of 124.66 on 8 July to the quarter low of 123.64 on 5 August before rebounding to 124.72 by the end of September (Chart 1).

Chart 1  
HK Dollar Exchange Rate (Jul – Sep 96)

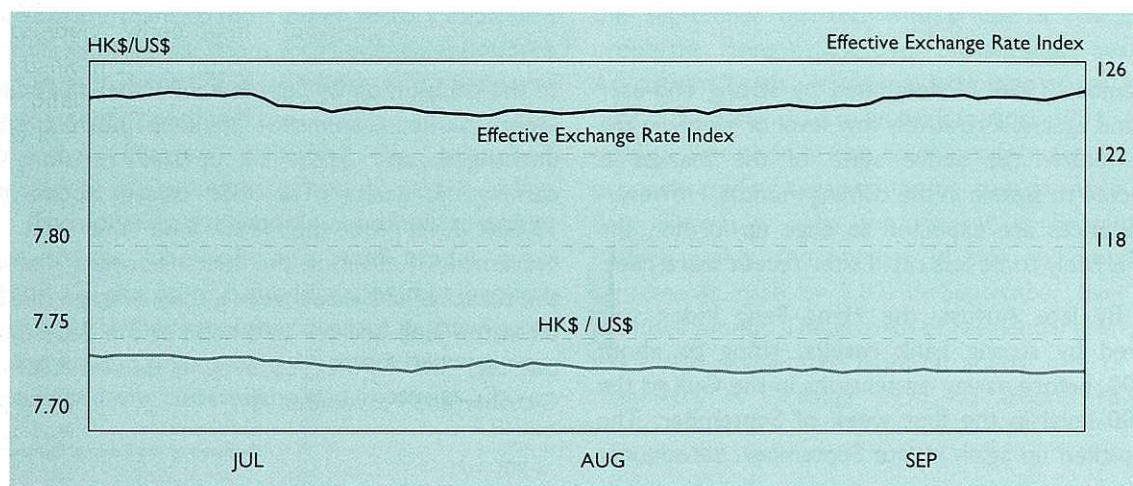
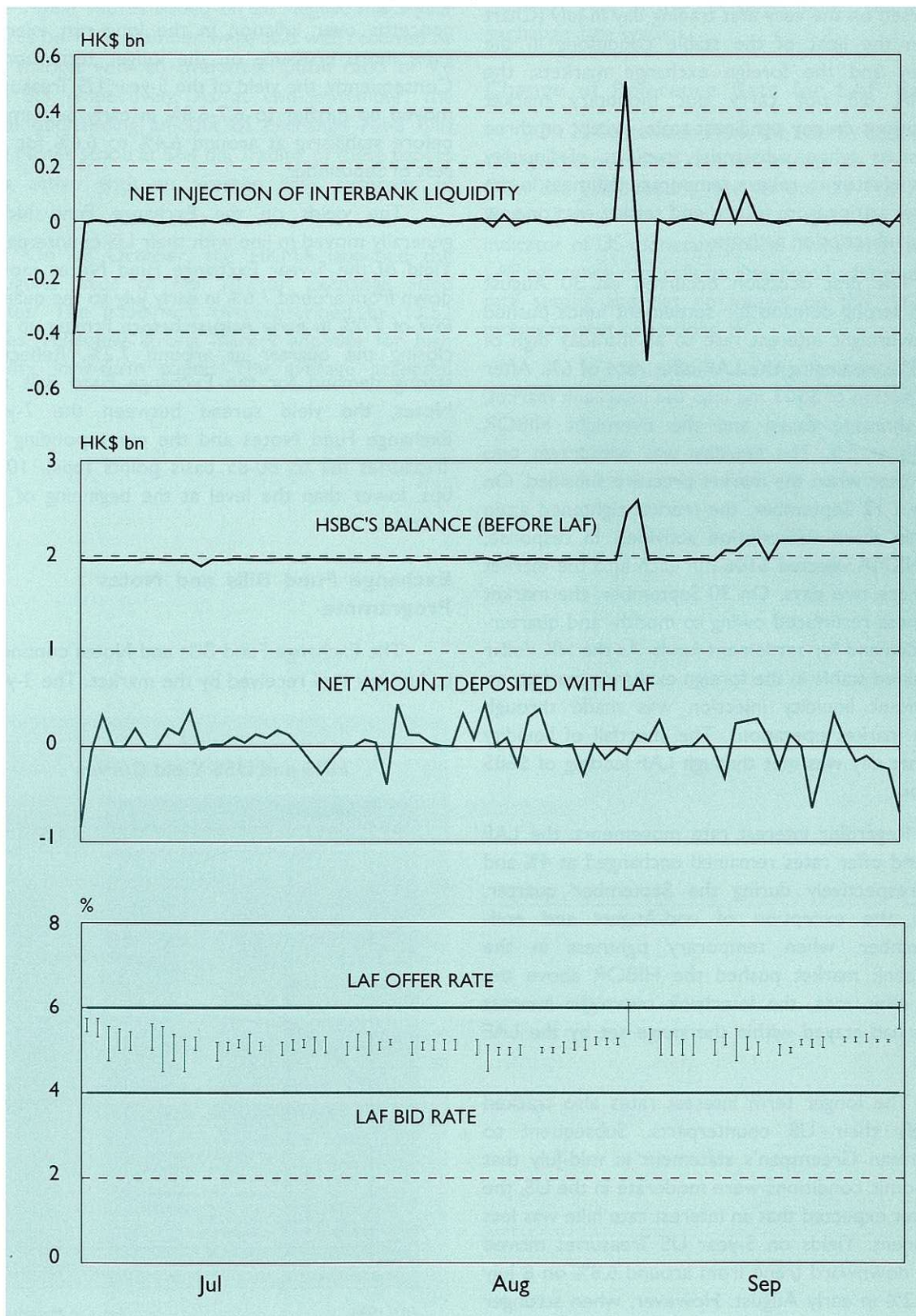




Chart 2  
**Money Market Operations and Movement of Overnight Interbank Interest Rate**  
 (Jul – Sep 1996)





## Monetary Management

As the mid-year demand for interbank liquidity was over, the liquidity injected at end-June was reversed on the very first trading day in July (Chart 2). In the light of the stable conditions in the money and the foreign exchange markets, the HKMA did not carry out monetary market operations on any significant scale, except on three occasions when substantial amounts of liquidity were injected to relieve temporary tightness in the market arising from month-end settlements or new share subscription activities.

The first occasion occurred on 30 August when strong demand for settlement funds pushed the overnight interest rate to an intraday high of 6.125%, exceeding the LAF offer rate of 6%. After an injection of \$503 mn into the interbank market, the shortage eased and the overnight HIBOR closed at 5%. The liquidity was withdrawn two days later when the market pressure subsided. On 10 and 12 September, the market tightened again due to share subscription activities. In response, the HKMA injected \$106 mn each into the market on these two days. On 30 September, the market tightness resurfaced owing to month- and quarter-end demand for settlement funds. As the HK dollar remained stable in the foreign exchange market, no significant liquidity injection was made through open market operations. The shortfall of liquidity on that day was met through LAF lending of \$685 million.

Regarding interest rate movements, the LAF bid and offer rates remained unchanged at 4% and 6% respectively during the September quarter. With the exception of end-August and end-September, when temporary tightness in the interbank market pushed the HIBOR above the LAF offer rate, the interbank overnight interest rates had stayed within the range set by the LAF rates.

The longer term interest rates also tracked closely their US counterparts. Subsequent to Chairman Greenspan's statement in mid-July that economic conditions were moderate in the US, the market expected that an interest rate hike was less imminent. Yields on 5-year US Treasuries moved on a downward trend from around 6.8% on 8 July to 6.2% in early August. However, when stronger than expected economic indicators were released

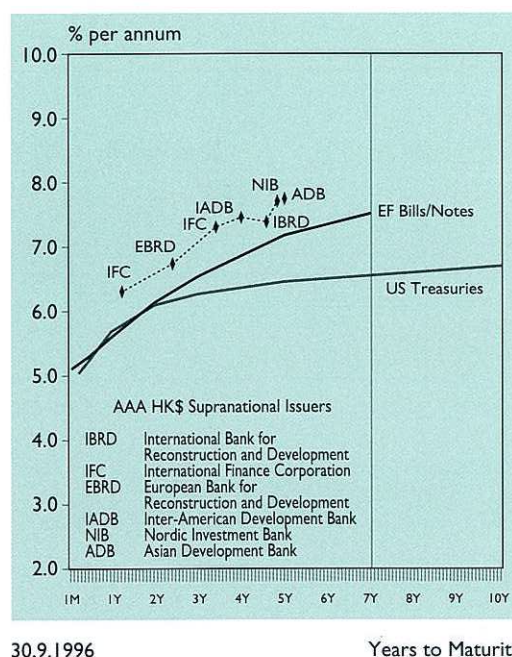
in early August, expectations of an early interest rate rise resumed. As a result, the yield on 5-year Treasuries edged up. When the August FOMC meeting decided not to raise the interest rate, concerns over inflation in the long run exerted even more pressure on the longer term bonds. Consequently, the yield of the 5-year US Treasuries moved up further to 6.7-6.8% in early September before stabilising at around 6.4% to 6.6% for the rest of September.

The yields on the Exchange Fund Notes generally moved in line with their US counterparts. Yield of the 5-year Exchange Fund Notes moved down from around 7.6% in early July to the quarter low of 7.0% in early August before firming up and closing the quarter at around 7.2%. Reflecting strong demand for the Exchange Fund Bills and Notes, the yield spread between the 7-year Exchange Fund Notes and the corresponding US Treasuries fell to 80-85 basis points (bps), 10-15 bps. lower than the level at the beginning of the quarter.

## Exchange Fund Bills and Notes Programme

The Exchange Fund Bills and Notes continued to be very well received by the market. The 3-year

Chart 3  
HK\$ and US\$ Yield Curves



Exchange Fund Notes issued on 23 July and the 2-year Notes issued on 13 August were oversubscribed by 12.3 and 8.4 times respectively. The 7-year Notes issued on 20 August and 5-year Notes on 17 September were also well received by the market with an oversubscription ratio of 4.6 and 3.5 respectively. As at end-September, the total outstanding amount of Exchange Fund Bills and Notes stood at \$64 bn. Trading of these papers was active with an average daily turnover of \$12 bn.

On 28 October, the HKMA launched the inaugural issue of the 10-year Exchange Fund Notes. The issue was oversubscribed by 13.52 times, reflecting strong market appetite for high quality, long-term paper. The average accepted

yield, at 7.57%, was only 92 bps. above the corresponding US Treasuries, demonstrating strong market confidence in the long-term stability of the exchange rate of the HK dollar under the linked exchange rate system.

### Change of Reference Rate for LAF Rates

On 25 September 1996, the HKMA decided to change the reference rate for setting the LAF rates from the US discount rate to the US Fed Funds Target Rate which is a more relevant and timely indicator of US monetary policy.<sup>1</sup> The change in the LAF reference rate reflects a technical adjustment in rate setting and has no impact on the HKMA's money market operations. ☎

– Prepared by Monetary Policy & Markets Department

<sup>1</sup> For details on the change in the LAF reference rate, please refer to another article "Reference Rate for LAF Rates" in this *Quarterly Bulletin*.