*While the Hong Kong dollar exchange rate remained very stable throughout the December quarter, monetary operations were undertaken on a number of occasions to ease temporary tightening that arose from month-end and year-end settlements and share subscription activities, and to ensure the smooth introduction of the RTGS system. Reflecting strong confidence in the stability of the Hong Kong dollar, the long-term Hong Kong dollar interest rates came down relative to the US interest rates.*

## Hong Kong Dollar Exchange Rate

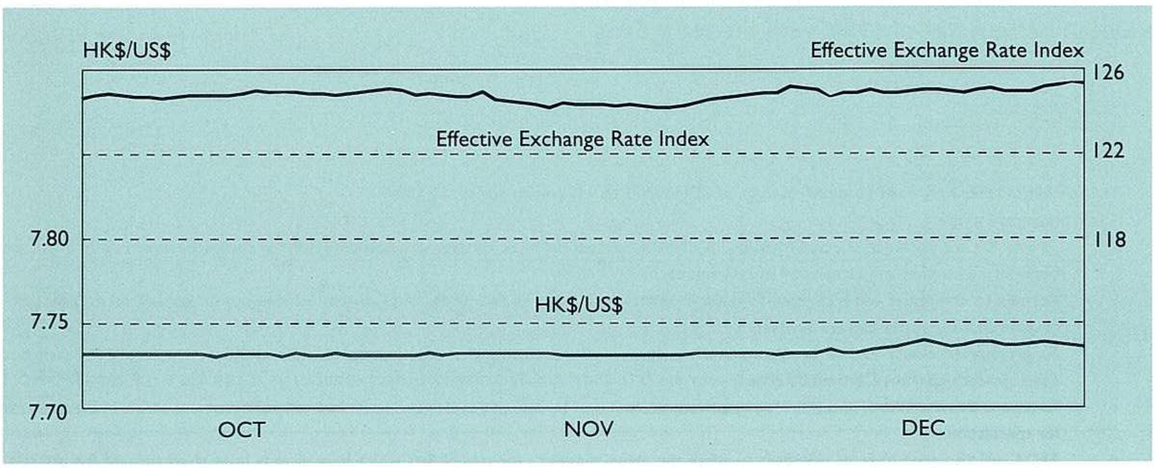
The Hong Kong dollar exchange rate remained very stable against the US dollar during the fourth quarter of 1996, moving within a narrow range of HK$7.732 – 7.739.

In the international foreign exchange markets, the US dollar strengthened against most major currencies. Steady, non-inflationary economic growth and the stock market rally in the US compared favourably with the sluggish economic performance and falling stock prices in Japan. Furthermore, with a more convincing time table for replacing individual European currencies by EMU and the perceived adverse impact on major European currencies, some investors had apparently shifted from Deutschemark to the US dollar. Reflecting these factors, the Yen/US$ exchange rate appreciated from 111.1 in early October to around 116.0 by the end of December. The DM/US$ exchange rate also strengthened, from around 1.53 at the beginning of October to 1.574 in early December, but then eased slightly on profit-taking activities. The RMB exchange rate remained stable against the US dollar throughout the December quarter, moving between 829.5 – 830.2. Reflecting these currency movements, the Effective Exchange Rate Index of the Hong Kong dollar appreciated from 124.6 at the beginning of October to 125.3 at end-December (Chart 1).

## Management of Interbank Liquidity

Month-end and year-end settlements, initial public offering (IPO) activities as well as the introduction of the Real Time Gross Settlement (RTGS) interbank payment system influenced the management of interbank liquidity during the December quarter. In late October and early November, month-end demand for funds coupled with a number of IPOs led to a tightening in the money market with the overnight HIBOR edging up to the LAF Offer Rate of 6.0%. In response, the HKMA injected a total of HK$633 million into the interbank market between 24 October and 1 November, bringing the Balance before LAF to around HK$3 billion.

Chart 1
**HK Dollar Exchange Rate (Oct-Dec 1996)**



Similar month-end and IPO effects occurred in late November. For instance, subscription monies involved in the flotation of Nam Fong International Holding Limited amounted to as much as HK$32.7 billion. Reflecting the tight conditions in the interbank market, overnight HIBOR briefly breached the LAF Offer Rate, to around 6.4% on 29 November. To ease the tightness in the interbank market, the HKMA made an injection of HK$2.6 billion on the same day. This was partially reversed the following Monday as the market pressure subsided. Nevertheless, in preparation of the implementation of the RTGS system on 9 December, banks generally increased their precautionary demand for liquidity. Accordingly, the HKMA made further injections into the interbank market in early December, bringing the Balance before LAF to around HK$6.5 billion.

Under the new interbank payment system, all licensed banks directly maintain a Settlement Account with the HKMA. The Hongkong and Shanghai Banking Corporation Limited ceased to be the Management Bank of the Clearing House of the Hong Kong Association of Banks, and the Accounting Arrangements were therefore terminated[1]. The total supply of interbank liquidity is now represented by the Aggregate Balance in the Settlement Accounts maintained by banks with the HKMA.

In the first two weeks following the implementation of the new system, a number of monetary operations were undertaken to accommodate the payment flows (Chart 2). They were effective in stabilising the overnight interbank interest rates within the LAF corridor. The Aggregate Balance before LAF was maintained at a level of around HK$8 – 10 billion for most of the time. As banks have more timely information on their liquidity position under the RTGS system, much of the excess liquidity was returned to the HKMA at the end of the day through the LAF deposit facility. Towards the latter part of December, banks became more familiar with the new interbank payment system. Demand for liquidity became less volatile, and the HKMA operated less frequently in the money market.

Under the new interbank payment system, banks can obtain interest free intraday liquidity from the HKMA through intraday Repos involving Exchange Fund Bills and Notes. In addition, a Liquidity Adjustment Window (LAW) was put in place as a contingent liquidity facility to help settle the time-critical bulk clearing obligations such as net settlement for stock market transactions, low value bulk electronic payment items, and cheques. Under the LAW, banks can use LAF-eligible securities other than the Exchange Fund Bills and Notes to obtain intraday liquidity from the HKMA at a cost (For details, see the article on "Hong Kong's Real Time Gross Settlement System" on page 30).

## HK Dollar Interest Rates

The LAF bid and offer rates remained unchanged at 4% and 6% respectively during the December quarter of 1996. Except on a few occasions due to IPO activities and month-end effects, the overnight HIBOR generally stayed within the LAF corridor. Three-month HIBOR also remained stable during the December quarter and tracked closely its counterpart in the Euro-dollar market.

Long term Hong Kong dollar interest rates eased considerably during the December quarter. For instance, the yield on 5-year Exchange Fund Notes fell from 7.21% at the beginning of October to 6.7% at end-December; that on the 10-year Exchange Fund Notes dropped from 7.6% in late October to 7.27% at end-December. Apart from the favourable inflation outlook in the United States, strong confidence in the long-term stability of the Hong Kong dollar has also contributed to the easing in the long-term interest rates. The latter factor was reflected in a narrowing of the spread between the yields on the Exchange Fund Bills and Notes and those on the US Treasuries. In respect of the 10-year paper, the yield spread narrowed from 94 bp in late October to 89 bp at end-December.

1 The Accounting Arrangements, introduced in 1988, were arrangements between the Hongkong and Shanghai Banking Corporation Limited (HSBC) as the management bank of the Clearing House of the Hong Kong Association of Banks, and the Exchange Fund. Under the arrangements, the HSBC was required to maintain an interest free account with the Exchange Fund, and to manage the net clearing balances of other banks at a level not exceeding the Balance in its account with the Exchange Fund. The arrangements allowed the Exchange Fund to directly influence the level of interbank liquidity by altering the level of the Balance.

Chart 2

**Money Market Operations and Movement of Overnight Interbank Interest Rate (Oct-Dec 1996)**

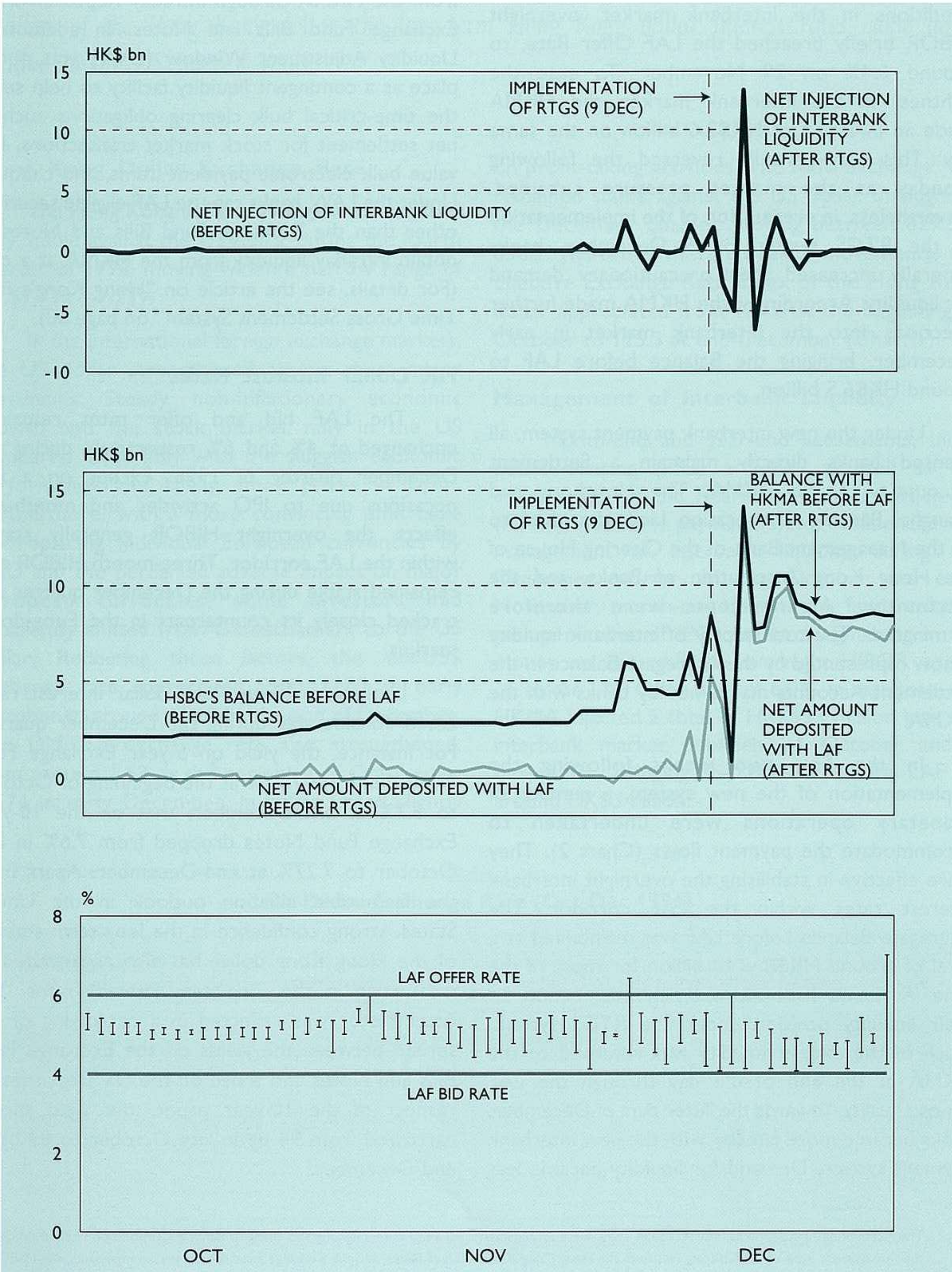
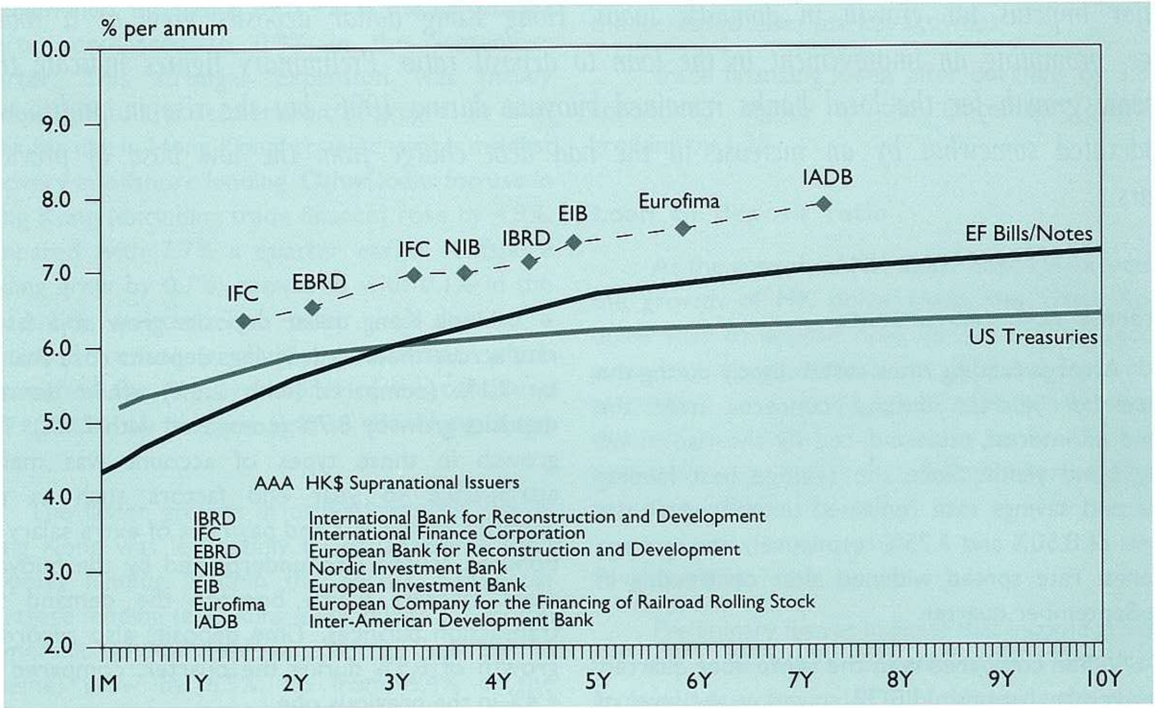


Chart 3
**HK$ and US$ Yield Curves**




31. 12. 1996

Years to Maturity

## Exchange Fund Bills and Notes

There were a couple of notable developments in the Exchange Fund Bills and Notes Programme during the December quarter. First, the inaugural issue of the 10-year Exchange Fund Notes was launched on 29 October. It was very well received by the market, with an oversubscription ratio of 13.5 times. Secondly, to prepare for the implementation of the RTGS system, banks increased their purchase of Exchange Fund Bills and Notes (which can be used as Repo securities for obtaining interest-free intraday Repos from the HKMA). As a result, the yields on 1-week and 1-month Exchange Fund papers fell to around 160 bp and 150 bp below the corresponding HIBOR. At the request of the licensed banks, the HKMA tendered 4 tap issues of 28-day Bills in November and December. The first 2 issues, totalling HK$10 billion, were oversubscribed by 2.7 and 2.2 times respectively. The enthusiasm for the last two issues waned somewhat as banks became more familiar with the RTGS system and had accumulated adequate short-term Bills for payment purposes.

The regular issues of Exchange Fund Bills and Notes continued to be well received by the market. The 3-year Exchange Fund Notes issued on 15 October and the 2-year Notes issued on 12 November were oversubscribed by 13.5 and 4.2 times respectively. The 5-year and 7-year Notes issued on 17 December and 26 November were oversubscribed by 4.5 and 8.3 times respectively.

The total amount of Exchange Fund Bills and Notes outstanding as at end-December 1996 stood at HK$91.85 billion. Trading in the Exchange Fund paper continued to be active, with an average daily turnover of HK$14.4 billion during the December quarter.

## Bilateral Repo Agreement

Bilateral repurchase agreements were signed between the Hong Kong Monetary Authority and the Monetary Authority of Singapore and the Bank of Japan in the fourth quarter. Altogether, eight bilateral repurchase agreements have been signed by the HKMA with central banks in the Asia-Pacific region since November 1995.

– Prepared by the Monetary Policy & Markets Department