The Hong Kong dollar exchange rate moved within a narrow range of 7.735 to 7.750 during the quarter. The money market remained stable except on a few occasions when IPO activities and month-end and quarter-end effects caused temporary tightening in the market. In line with the 25bp increase in the US Fed Funds Target Rate announced on 25 March, the Hong Kong dollar interest rates rose towards the end of the quarter. At the longer end of the interest rate spectrum, the spreads between the Hong Kong dollar interest rates and their US counterparts continued to narrow.

Hong Kong Dollar Exchange Rate

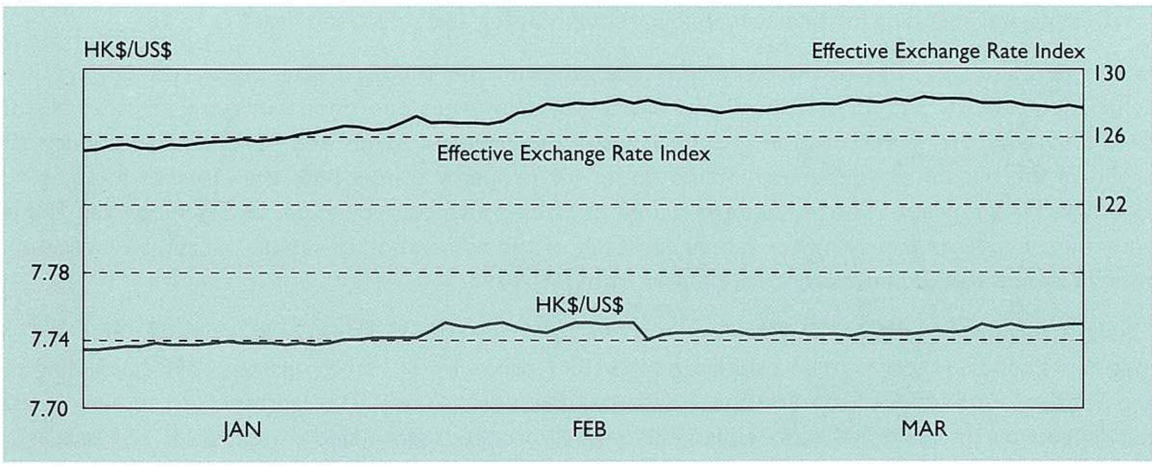
The Hong Kong dollar exchange rate remained stable during the first quarter of 1997, moving within a narrow range of 7.735 to 7.750. The exchange rate eased slightly from around 7.735 at the beginning of the year to the 7.750 level towards the end of January, partly due to the purchase of US dollar by the note-issuing banks to acquire Certificate of Indebtedness to meet the seasonal demand for new bank notes ahead of the Chinese New Year holidays. As the seasonal effect subsided, the Hong Kong dollar started to strengthen since mid-February. Reflecting the confidence in the linked exchange rate system, the foreign exchange market reacted calmly to the death of Mr. Deng Xiao-ping on 20 February. The exchange rate stayed around the 7.740 level in the latter part of February before easing to 7.750 in March along with the correction in the stock market.

In the international foreign exchange market, steady US economic growth and statements of US officials in support of a strong US dollar underpinned a continued strengthening of the US dollar against other major currencies. The D-Mark/US dollar exchange rate appreciated from 1.544 at the beginning of the year to 1.716 in early March. The Yen/US dollar exchange rate also appreciated, from 115.7 in early January to 123.8 in late March. During the first quarter, the RMB remained stable against the US dollar, moving between 829.2 and 829.8. Reflecting these currency movements, the trade weighted Effective Exchange Rate Index of the Hong Kong dollar appreciated from 125.2 at the beginning of the year to around 127.9 in March (Chart 1).

Management of Interbank Liquidity

The interbank market remained stable in the first quarter, except on a few occasions when IPO

Chart 1
HK Dollar Exchange Rate (Jan-Mar 1997)



activities caused a temporary tightening in the market. On 24 January, owing to the flotation of GZI Transport Limited which attracted $54 bn of subscription moneys, overnight HIBOR briefly surged to 6.25% during the day. To relieve market tightness, the HKMA injected a total of $7.3 bn into the market. In response, the overnight HIBOR eased and closed the day at 5.75%. The excess liquidity was withdrawn in the following week when market conditions returned to normal. Signs of tightness re-emerged towards the end of January due to the month-end settlement effect. Overnight HIBOR firmed to around 5.75% – 6% on 30 and 31 January. The market tightness was eased following injection of around $3.4 bn by the HKMA on these two days.

In late February, the flotation of Shum Yip Investment Limited, coupled with month-end settlement, caused another brief tightening in the money market. Similar month-end settlement effects were observed in late March. On both occasions, overnight HIBOR edged close to the LAF offer rate, but market conditions soon returned to normal. The HKMA did not have to intervene in the money market.

In the early stage of the implementation of the Real Time Gross Settlement (RTGS) system, the HKMA injected a substantial amount of liquidity in the interbank market to meet the precautionary demand for liquidity by banks and to smooth the payment flows. The Aggregate Balance before LAF was around $6 - 8 bn for most of the time in December 1996. As banks have become more familiar with the new interbank payment system, the HKMA gradually withdrew excess liquidity from the market. The Aggregate Balance before LAF has returned to the normal level of around $2 to $3 bn since mid-February.

As banks have more timely and accurate information on their liquidity conditions under the RTGS system, most of the banks' surplus funds in the Aggregate Balance were deposited with the HKMA through the LAF at the end of each trading day (Chart 2).

Hong Kong Dollar Interest Rates

Following a 25 bp increase in the Fed Funds Target Rate on 25 March, the LAF Bid and Offer rates were raised by the same magnitude on the following day, to 4.25% and 6.25% respectively. The savings deposit rate and the best lending rate quoted by major banks also increased by the same extent.

Except on a few occasions due to IPO activities and month-end effects, the overnight HIBOR moved within the range set by the LAF Bid and Offer rates. The 3-month HIBOR tracked closely the 3-month Euro dollar deposit rate and moved on an upward trend from 5.44% at the beginning of Jaunary to 5.75% at end-March. The average differential between the two rates was only about 10 bp.

At the longer end of the interest rate spectrum, the yields of the Exchange Fund Notes have largely followed the movements in the US Treasuries. The yield of 5-year bonds softened from 6.29% at the beginning of the year to around 6% in mid-February as inflation remained moderate. In late February, Alan Greenspan, Chairman of the US Federal Reserve, hinted in his 'Humphrey Hawkins' testimony that preemptive measures might be taken to curb inflationary pressure. This led to renewed concerns of near-term monetary tightening, with the 5-year bond yield edging up to 6.56% before the FOMC meeting on 25 March. After the announcement of the 25 bp interest rate increase, the bond yield rose further to 6.78% at end-March.

In line with the movement of the US yield curve, yields of the Exchange Fund Notes moved gently on a downward trend in the first half of the quarter. The yield of the 5-year Exchange Fund Notes fell from 6.82% in early 1997 to 6.30% on 11 February. Thereafter, heightened expectation of an interest rate hike drove the yield up to close the quarter at 6.97%. The yield of the 10-year Notes followed similar movements, edging down from 7.41% at the beginning to a low of 6.78% on 12 February but firmed up to 7.38% by end March. Reflecting strong investor confidence in the Hong Kong dollar, the spread of the Exchange Fund Notes over the US Treasuries continued to narrow during the first quarter of 1997. For instance, the yield spread of the 10-year Notes stood at 50 bp at end-March, compared to 89 bp at end-December 1996 (Chart 3).

Chart 2

Money Market Operations and Movement of Overnight Interbank Interest Rate (Jan-Mar 1997)

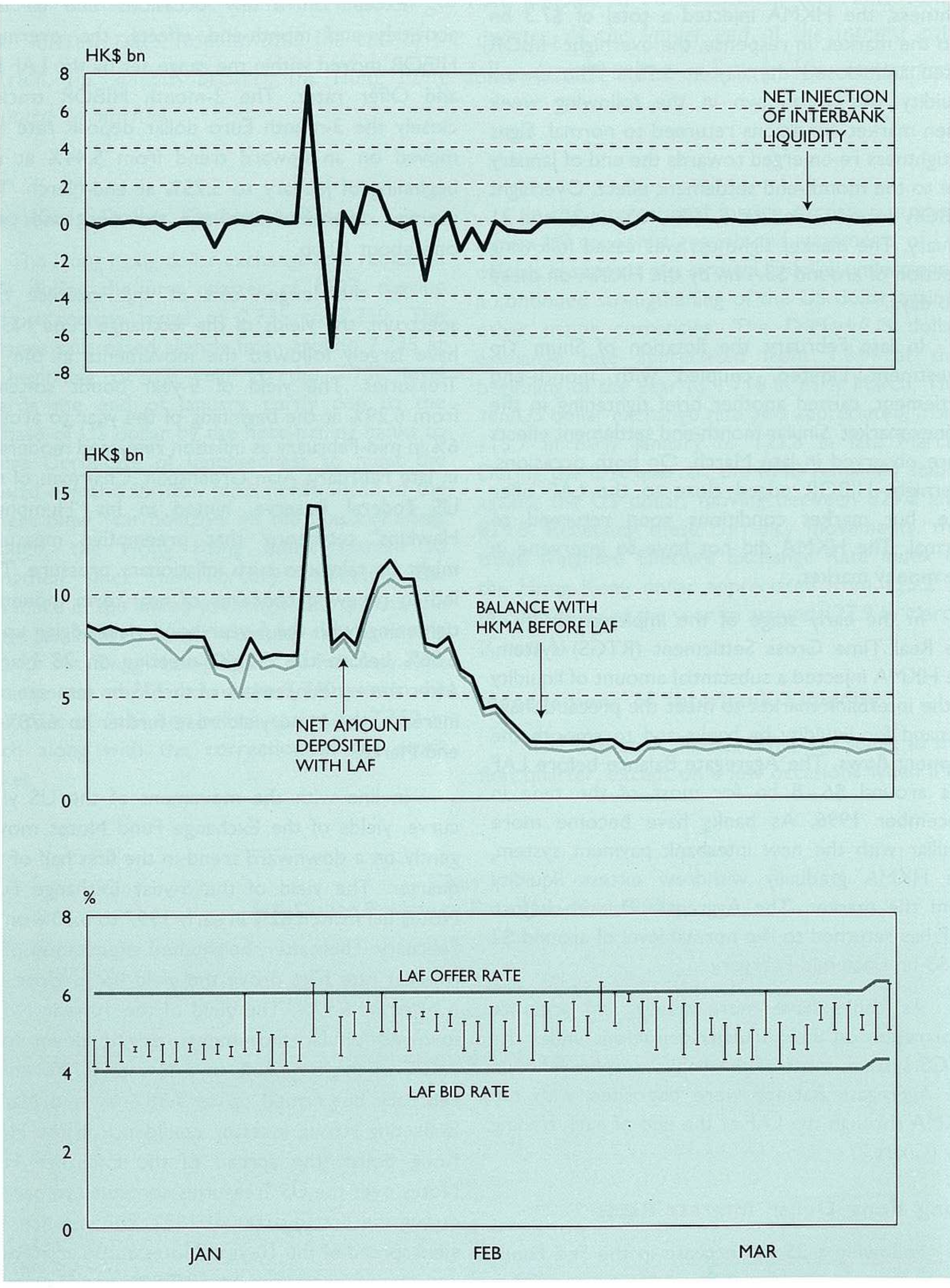
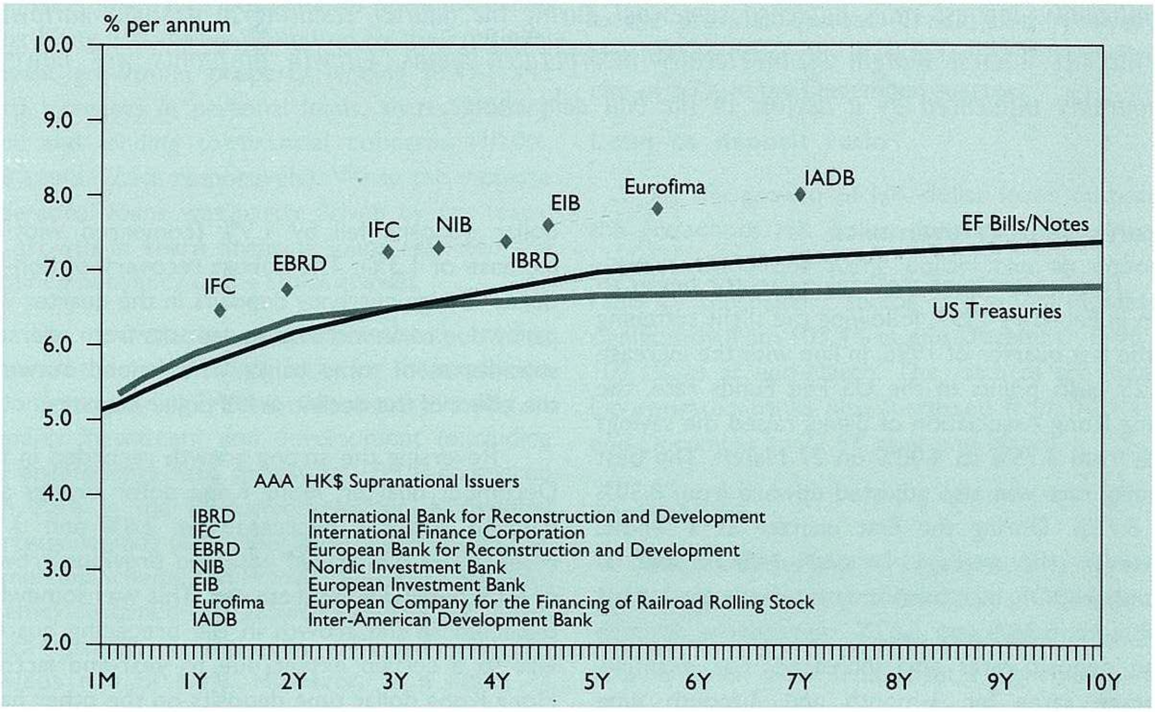


Chart 3
HK$ and US$ Yield Curves



27. 3. 1997

Years to Maturity

Exchange Fund Bills and Notes Programme

The tap issues of 28-day Exchange Fund Bills, introduced to facilitate liquidity management of banks under the RTGS system, were roll-overed in response to continued demand. In the secondary market, the average daily turnover of the Exchange Fund Bills increased markedly from $11.3 bn in the fourth quarter of 1996 to $18.8 bn in the first quarter of 1997, in part relating to the strong demand for such papers by banks for liquidity management purpose. Exchange Fund Notes continued to be well received by the market. All the issues launched during the first quarter were oversubscribed. As at end-March 1997, the total outstanding amount of Exchange Fund Bills and Notes stood at $95.2 bn.

Bilateral Repo Agreement

Two repo agreements were concluded during the first quarter, one with the Bank of Korea and the other with the Reserve Bank of New Zealand. Altogether, ten bilateral repo agreements have been signed by the HKMA with other central banks/monetary authorities in the Asia-Pacific region since October 1995.

– Prepared by the Monetary Policy & Markets Department