OPERATION OF MONETARY POLICY

Despite turbulence in the Asian foreign exchange markets in the wake of the Thai Baht turmoil, the Hong Kong dollar exchange rate remained remarkably stable and moved within a narrow range of 7.736 to 7.750 during the June quarter. Money market conditions were generally stable though some large-scale IPO activities had led to occasional market tightening. With the release of the latest US economic statistics which suggested an easing in the inflationary pressure, the Hong Kong dollar long-term interest rates, along with the US rates, have come down slightly.

Hong Kong Dollar Exchange Rate

The Hong Kong dollar exchange rate remained stable in the second quarter of 1997, moving within a narrow range of 7.736 to 7.750. In part reflecting an inflow of funds into the local stock market (with HSI registering a gain of 25.9% during the quarter), the Hong Kong dollar strengthened from 7.750 in early April to around 7.736 in mid-May. Since then, the Hong Kong dollar exchange rate moved between 7.738 to 7.748 during the rest of the quarter. The currency turmoil in Thailand and the turbulence in other Asian currency markets had little impact on the Hong Kong dollar exchange rate.

In the international foreign exchange markets, stable, non-inflationary growth in the US economy, coupled with unfavourable market sentiment towards the European currencies in the face of the Economic and Monetary Union, led to a strengthening of the US dollar against the Deutschmark from 1.67 at the beginning of April to 1.74 towards the end of June. The Yen/US dollar exchange rate appreciated from 121.8 to 127.8 during the first two weeks of April. However, supported by market expectation of improved economic conditions in Japan and an anticipated rise in the Japanese long term interest rate, the Yen rebounded to 114.6 at the end of the quarter. During the quarter, the RMB remained stable against the US dollar, moving between 829.1 to 829.7. Reflecting the mixed currency movements, the trade weighted Effective Exchange Rate Index of the Hong Kong dollar appreciated slightly from 127.9 on 1 April to 129.0 around end-April, before easing to 127.0 towards the end of June (Chart 1).

Chart 1
HK Dollar Exchange Rate (Apr-Jun 1997)

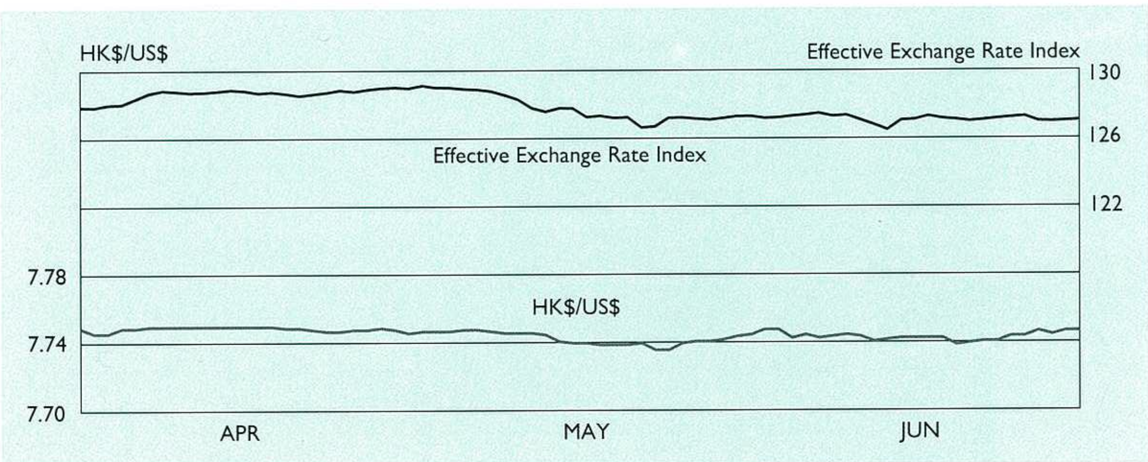
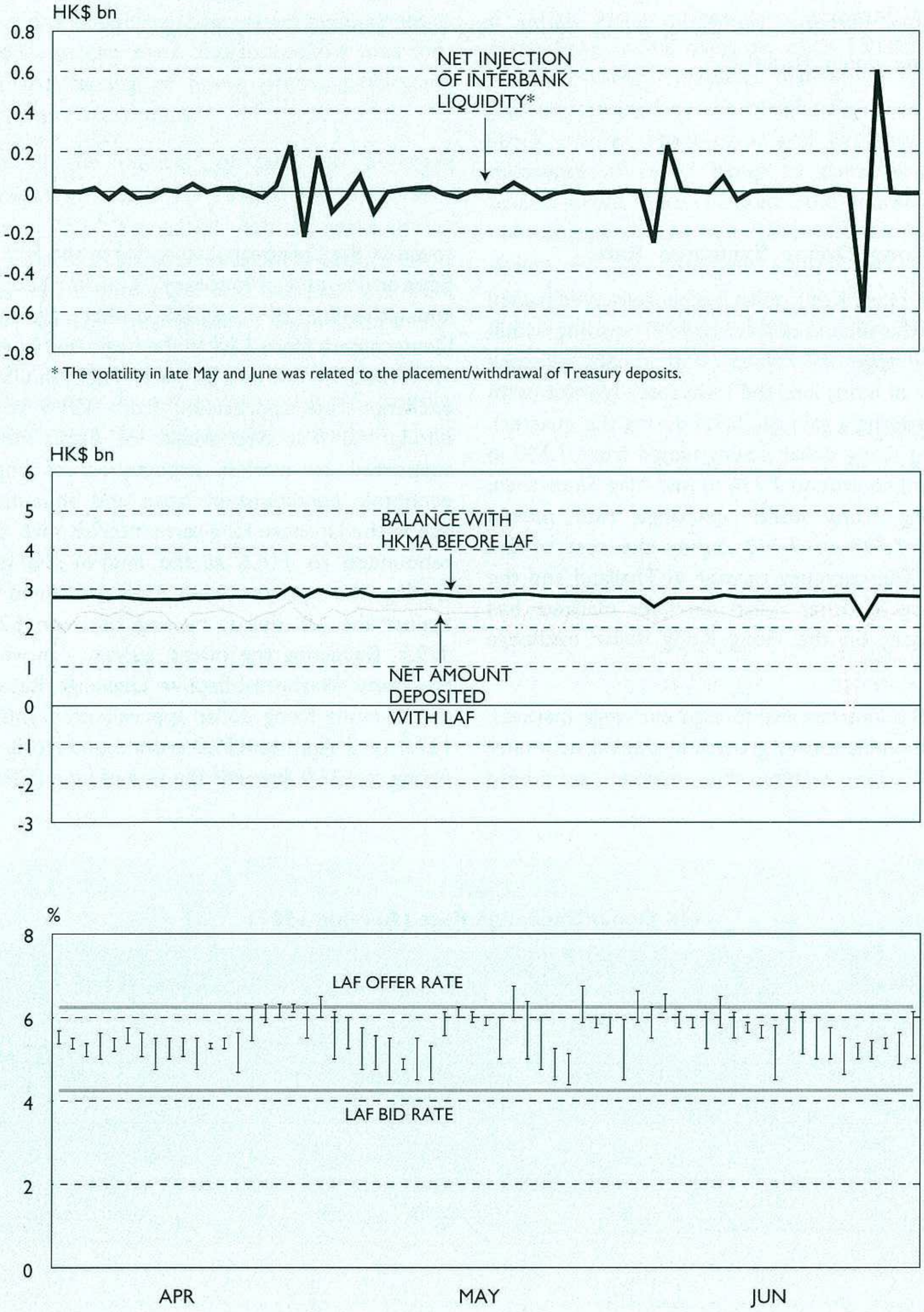


Chart 2

Money Market Operations and Movement of Overnight Interbank Interest Rate (Apr-Jun 1997)



Management of Interbank Liquidity

Money market conditions were affected by a series of IPO activities during the quarter. Demand for liquidity rose in the latter half of April due to the closing of a number of IPOs, which attracted subscription monies amounting to HK$11 bn to HK$52 bn. The tightening effect persisted until the end of April, with overnight HIBOR firming up to 6%. Occasionally, it breached the LAF offer rate of 6.25%. To relieve market tightness, the HKMA injected on 24 April and 28 April $228 mn and $177 mn respectively. When market conditions returned to normal, the excess liquidity was withdrawn.

Triggered by another round of IPO activities from early May to mid-June, money market conditions tightened again with overnight HIBOR trading for most of the time above 5.5%. On 16 May and 23 May, overnight HIBOR touched the intraday high of 6.75% due to the closing of IPOs of Chu Kong Shipping Development Co. Ltd. and Beijing Enterprises Holdings Ltd., which attracted subscription monies of around $96 bn and $215 bn respectively. In the latter case, the shares were oversubscribed by a record high of over 1,000 times. To relieve the pressure on money market conditions and the interbank payment system, the HKMA met with the receiving banks to alert them to the need for efficient liquidity management taking into account the large volume of payment flows during the share subscription period. In the money market, market tightness quickly subsided after the IPO activities. The HKMA did not need to carry out money market operations on any significant scale (Chart 2).

Hong Kong Dollar Interest Rates

As the US Fed Funds Target Rate was left unchanged during the second quarter, the LAF Bid and Offer rates stayed at 4.25% and 6.25% respectively throughout the quarter. Similarly, the savings deposit rate governed by the Interest Rate Rules of the Hong Kong Association of Banks and the best lending rate quoted by major banks remained at 4% and 8.75% respectively.

Overnight HIBOR in the interbank market generally moved within the range set by the LAF Bid and Offer Rates, except on occasions when the market tightened due to IPO activities. In part reflecting some hedging activities in the forward foreign exchange market, there was an increase in swap points in May and early June. Along with this, the 3-month HIBOR rose from 5.75% at the beginning of April to 6.56% in mid-June, but softened to 6.13% by the end of the quarter. The average differential between the 3-month HIBOR and 3-month Euro dollar deposit rate widened from 10 bp in early April to over 80 bp in early June but narrowed to around 40 bp towards the quarter end (Chart 3).

Chart 3
Movement of 3-month HIBOR and Euro-dollar rate

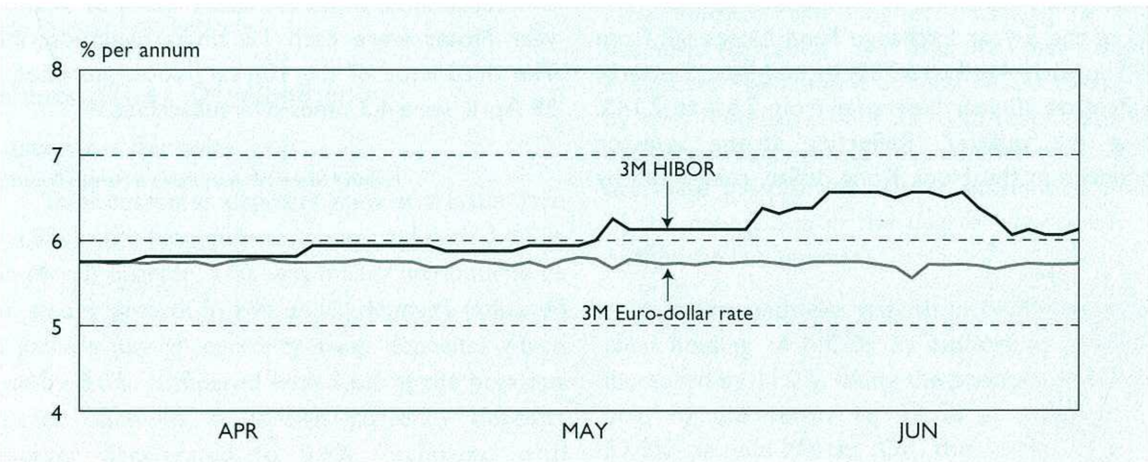
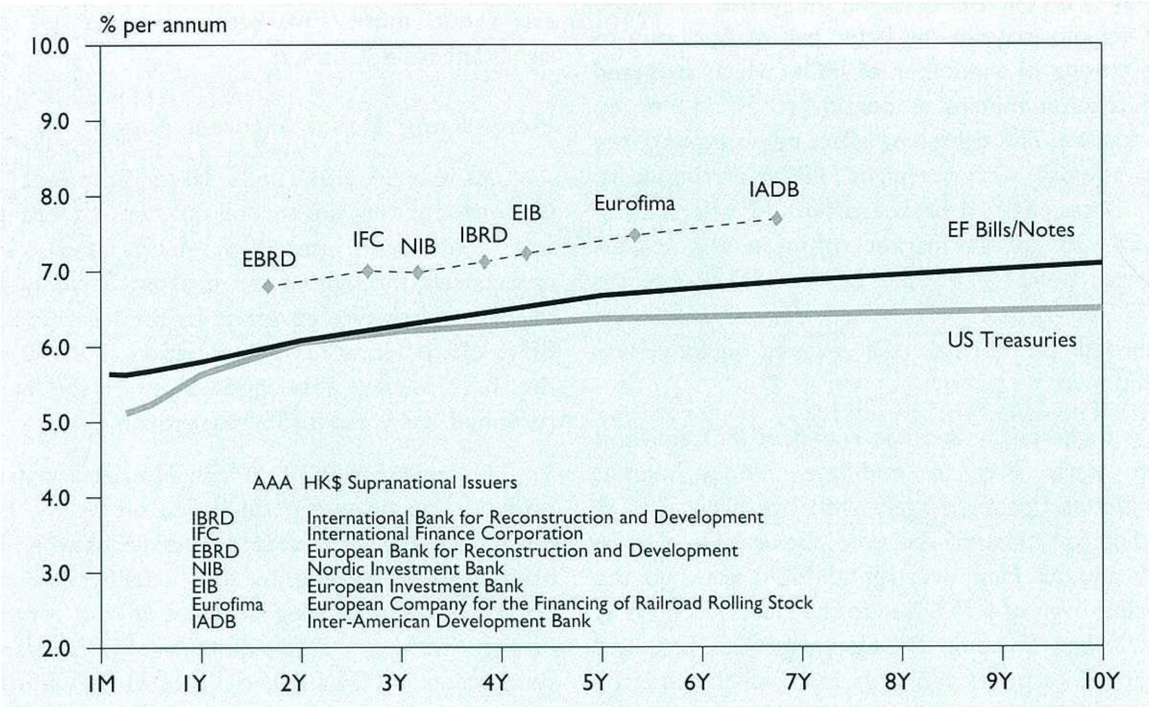


Chart 4
HK$ and US$ Yield Curves



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Years to Maturity

At the longer end of the interest rate spectrum, the yield of the Exchange Fund Notes generally followed the movements in the US Treasuries. As inflationary pressure in the US economy remained subdued, the yield on US Treasuries eased during the second quarter. The yield on 10-year Treasury Bond, for instance, fell from 6.88% in early April to 6.50% by end-June.

Moving in line with the US interest rates, the longer term Hong Kong dollar interest rates moved gently downwards during the quarter. The yield of the 5-year Exchange Fund Notes fell from 7.09% in early April to 6.73% by end-June. Similarly, the yield on 10-year Notes fell from 7.5% to 7.14% during the quarter. Reflecting strong investor confidence in the Hong Kong dollar, reinforced by the upgrading of the Hong Kong's credit ratings by S&P's, the yield spread of the 10-year Exchange Fund Notes over the US Treasuries was very narrow, at around 50-75 bp (Chart 4).

Exchange Fund Bills and Notes Programme

The Exchange Fund Bills and Notes continued to be well received by the market. The latest issues of 2- and 3-year Notes were 7.9 and 1.4 times oversubscribed, while the latest issues of 5- and 7-year Notes were each 1.6 times oversubscribed. The third issue of the 10-year Notes launched on 29 April were 4.3 times oversubscribed.

- Prepared by the Monetary Policy & Markets Department