

OPERATION OF MONETARY POLICY

The Hong Kong dollar exchange rate remained stable under the linked exchange rate system notwithstanding the Asian currency turmoil. There was, however, some firming up in interest rates since mid-August. The Hong Kong dollar yield curve at the end of the quarter had become flatter due to the firming up of the yields of short-term Exchange Fund Bills and Notes along with the money market rates.

Hong Kong Dollar Exchange Rate

Amidst the turbulence in Asian currency markets, the Hong Kong dollar exchange rate remained stable during the third quarter of 1997, moving within a narrow range of 7.735 to 7.750. The exchange rate temporarily softened to 7.750 on 18 July and 15 August as a result of concerns over sharp falls in Asian currencies. But on both occasions, the exchange rate quickly rebounded to around 7.740. The Hong Kong dollar stayed around the 7.745 level during the latter part of August and throughout September.

In the international foreign exchange market, stable, non-inflationary growth in the US economy coupled with uncertainties in the European currencies in face of European Monetary Union led to a strengthening of the US dollar against the Deutschemark from 1.747 at the beginning of July to 1.882 in early August. However, volatility in the Dow Jones Industrial Average in early August, followed by subsequent announcements by the Bundesbank of a possible interest rate hike,

hindered the rise of the US dollar. The Deutschemark rebounded to 1.761 in mid-September, supported by statements of German officials pledging intervention if the US dollar/D-Mark breached 1.90. At the end of the quarter, the Deutschemark closed at 1.763. Yen depreciated from 115.0 at the beginning of July to 120.9 at the end of September, attributable partly to the volatility in Asian stock and currency markets and partly to concerns over the slow economic growth in Japan. During the quarter, the RMB remained stable against the US dollar, moving between 828.5 to 829.2. Reflecting these currency movements, the trade weighted Effective Exchange Rate Index of the Hong Kong dollar appreciated from 127.5 at the beginning of July to 130.5 at end-September (Chart 1).

Management of Interbank Liquidity

Money market conditions were affected by IPO activities and the regional currency instability during the quarter. Money market conditions

Chart 1
HK Dollar Exchange Rate (JUL-SEP 97)

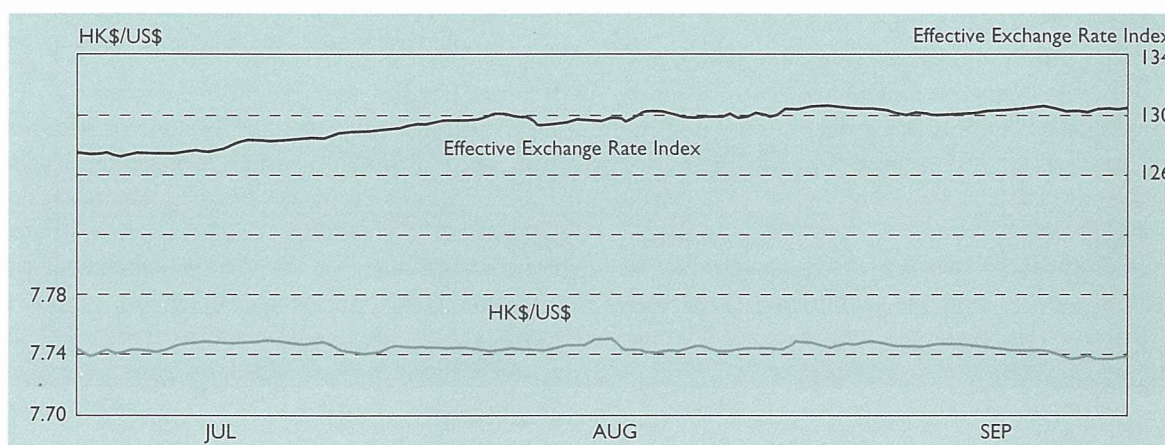
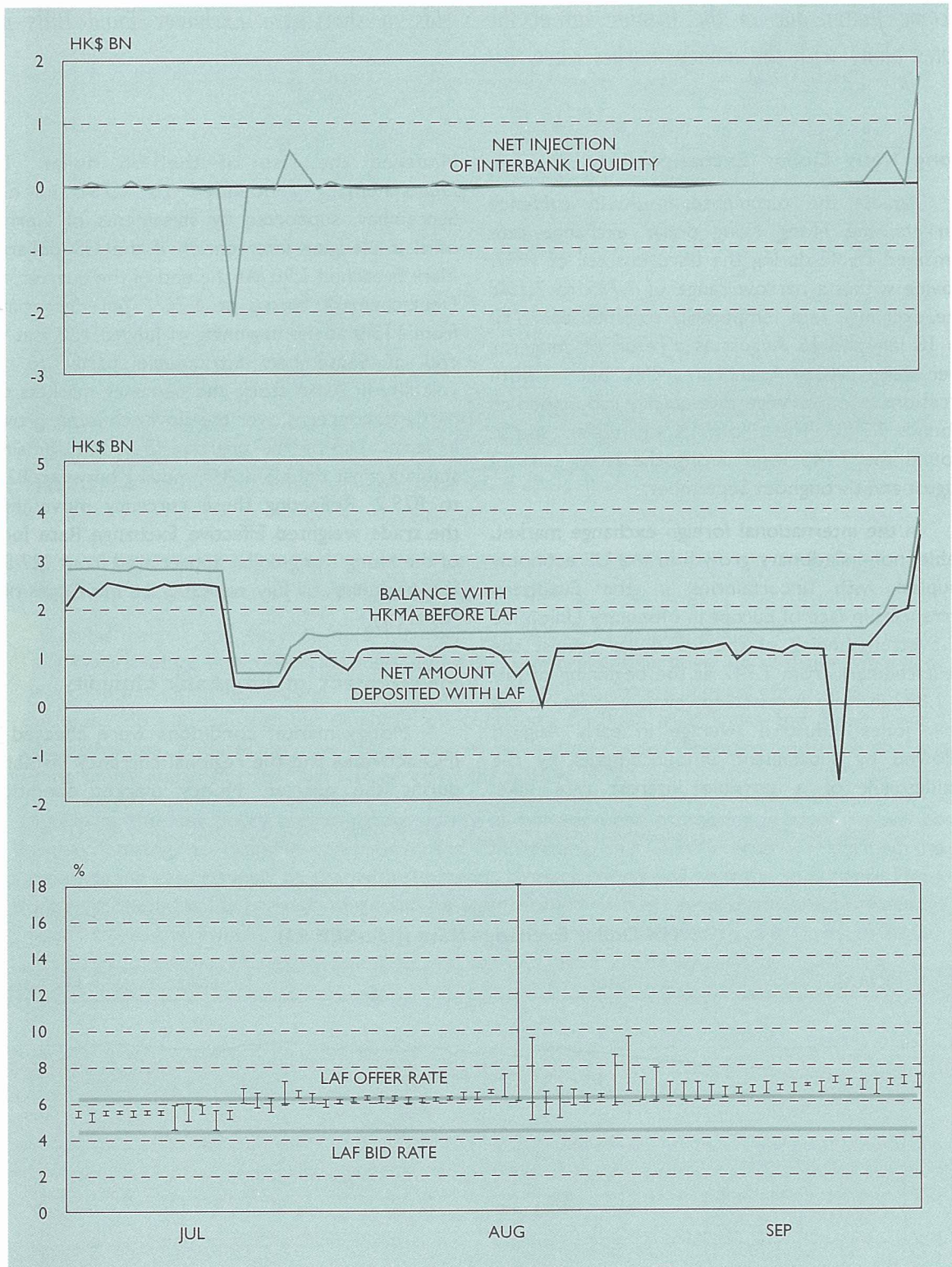


Chart 2
**Money Market Operations and Movement of Overnight Interbank Interest Rate
 (JUL-SEP 97)**



were tightened on 21 July on signs of some speculative pressure on the exchange rate. As the exchange rate of Hong Kong dollar quickly stabilised to close at 7.740 level on 25 July, liquidity was recycled back into the market and overnight HIBOR eased to around 6.13% - 6.25% at the end of July.

In late August, owing to the flotation of South East Asia Wood Industries Holdings Limited which attracted HK\$9 bn of subscriptions moneys and month-end settlement, overnight HIBOR reached a high of 9.50% but then eased gradually to close at 6.75%. On 22 September, the flotation of CATIC Shenzhen Holdings Limited, which attracted around HK\$37.6 bn of subscription caused another brief tightening in the money market. HIBOR touched 7.18% in the morning before easing to 6.88%. In both occasions, market tightness quickly subsided after the IPO activities. The HKMA did not need to carry out money market operations on any significant scale to relieve pressures on the money market. Signs of tightening re-emerged towards the end of September due to a number of flotation activities and month-end settlement. Overnight HIBOR firmed up to 7.31% on 30 September. The market tightness eased following injection of around HK\$1.7 bn by the HKMA and overnight HIBOR closed at 6.63% (Chart 2).

Hong Kong Dollar Interest Rates

As the US Fed Funds Target Rate was left unchanged during the third 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 (IRR) 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 generally moved within the range set by the LAF Bid and Offer Rates until mid-August when the money market became more volatile amidst growing concerns over instability in other Asian currencies. Following a tightening of the interbank liquidity as a result of the selling pressure on the Hong Kong dollar, overnight HIBOR rose briefly to 6.75% on 21 July. On 19 August, overnight HIBOR surged briefly to a high

of 18%¹. Since then, overnight HIBOR continued to stay above the LAF Offer Rate of 6.25% for most of the time. Owing to renewed concerns of the contagion effect of sharp falls in the regional currency and stock markets and the effect of IPO activities, the market tightened again in late August, with overnight HIBOR reaching 9.50% on 29 August. As the market stabilised, overnight HIBOR softened to around 6.63% to 7.31% on 30 September. Along with the movement of overnight HIBOR, the 3-month HIBOR rose from 6.06% at the beginning of July to a high of 12.50%¹ on 19 August before easing to 7.38% on 30 September. The average differential between the 3-month HIBOR and 3-month Euro dollar deposit rate widened from 41 bp in early July to over 342 bp in mid-August but narrowed to around 167 bp at the end of September (Chart 3).

At the longer end of the interest rate spectrum, the yield of the Exchange Fund Notes followed the movements in the US Treasuries during the first half of the quarter. In late July, the statement by Alan Greenspan that US economic growth was slowing and inflation environment was benign sent the bond market into a rally. The 10-year bond yield reached a low of 6.09% on 1 August. The movement was then reversed upon release of stronger US economic figures. Despite FOMC's decision on 19 August to leave US interest rates unchanged, the yield went up moderately to 6.50% before easing to 6.10% at the end of September.

Moving in line with the US interest rates, the long term Hong Kong dollar interest rates moved downwards in July. During the month, the yields of the 7-year and 10-year Notes fell from 6.85% and 7.06% to 6.54% and 6.67% respectively. The yields of the Exchange Fund Notes then went up with the short-term interest rates, with both the yields of 7-year and 10-year Notes reaching a high of 7.84% on 19 August, which were 155 bp and 154 bp over that of the US Treasuries. The yields then eased gradually as the money market stabilised, with the 7-year and 10-year Notes traded at 6.77% and 6.91% respectively at the end of September. The yield spread of the 7-year and 10-year Exchange Fund Notes over the US Treasuries were 57 bp and 70 bp respectively at the end of the third

¹ The rate was derived from the corresponding forward swap points as no direct market quotes were available.

Chart 3
Movement of 3-month HIBOR and Euro-dollar Rate
(JUL-SEP 97)

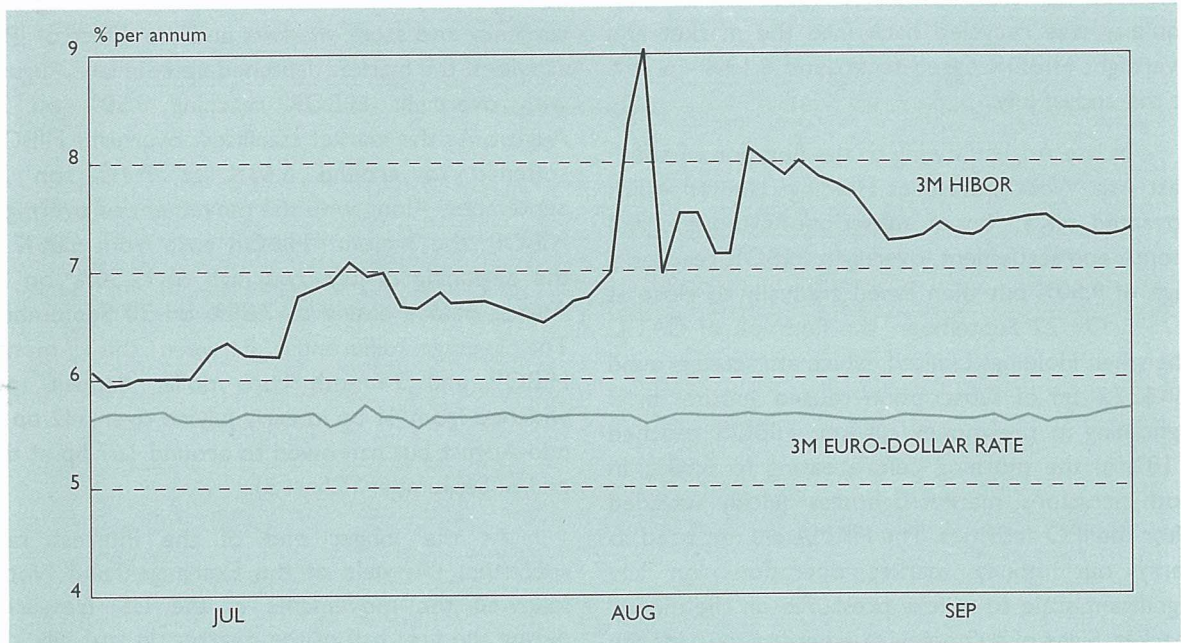
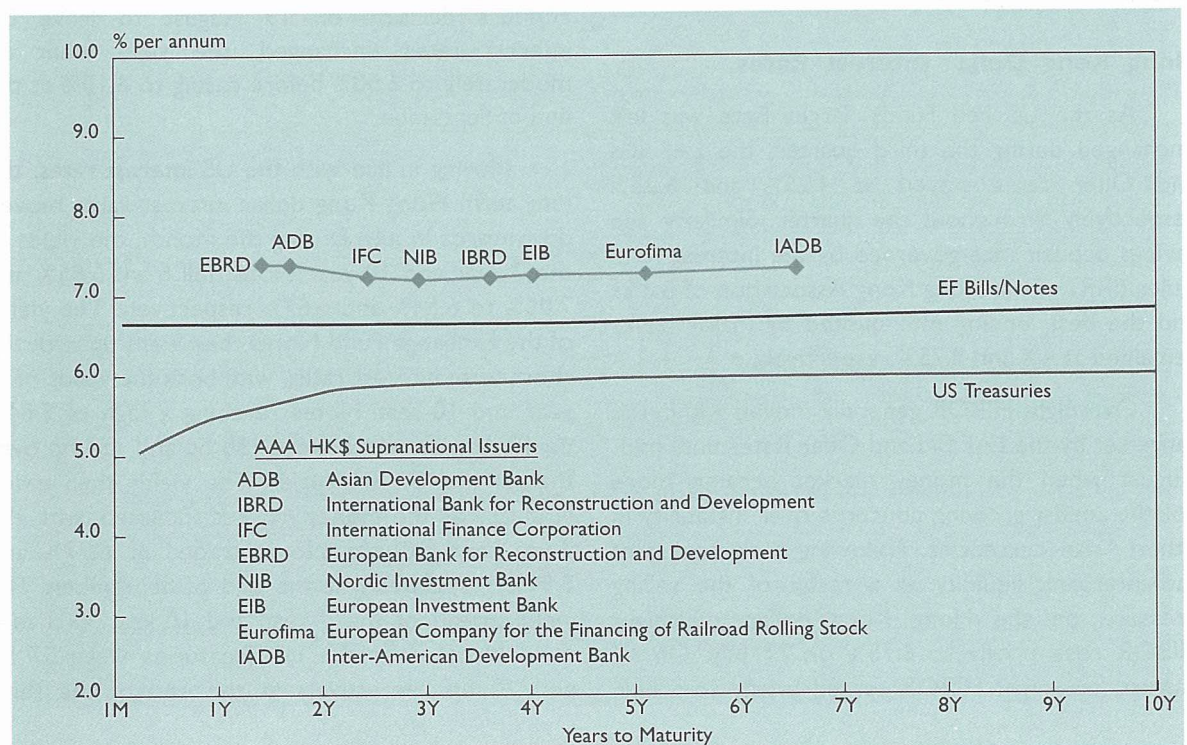


Chart 4
HK\$ and US\$ Yield Curves



quarter. Amidst the Asian currency turmoil, the yields of short-term Exchange Fund Bills and Notes also firmed up with the money market rates, resulting in a flatter Hong Kong dollar yield curve (Chart 4).

Exchange Fund Bills and Notes Programme

The Exchange Fund Bills and Notes continued to be well received by the market. All the issues launched during the third quarter were oversubscribed. As at end-September 1997, the total outstanding amount of Exchange Fund Bills and Notes stood at HK\$99.9 bn.

Securities eligible for discounting under LAF

To be eligible as Repo securities for discounting under the LAF, a private sector debt issue must meet, among other criteria, a minimum credit rating requirement specified by the HKMA. Previously, only the ratings of the Moody's, S&P's, IBCA and the Japan Bond Research Institute (JBRI) were recognised for LAF purpose. On 15 September, the HKMA announced that the ratings of Thomson BankWatch (TBW) would also be recognised by the HKMA in assessing the eligibility of HK dollar denominated debt issues for LAF discounting. The minimum requirements in respect of the debt ratings assigned by TBW for LAF purpose are A+ for bank issues and AA- for non-bank issues. ☎

– Prepared by the Monetary Policy & Markets Department