OPERATION OF MONETARY POLICY

The Hong Kong dollar came under strong speculative attack in August. There were signs of some hedge funds deploying a double market play to engineer extreme conditions in the money market so as to gain from their short positions in the stock and futures markets. To frustrate the double market play and restore market order, the HKMA operated in the stock and futures markets and successfully fended off the speculators. In early September, a package of seven technical measures to strengthen the currency board arrangements were introduced to follow through the earlier market operations. The combination of market operations and the reform measures helped stabilize the foreign exchange and money markets conditions.

Monetary Conditions Prior to August

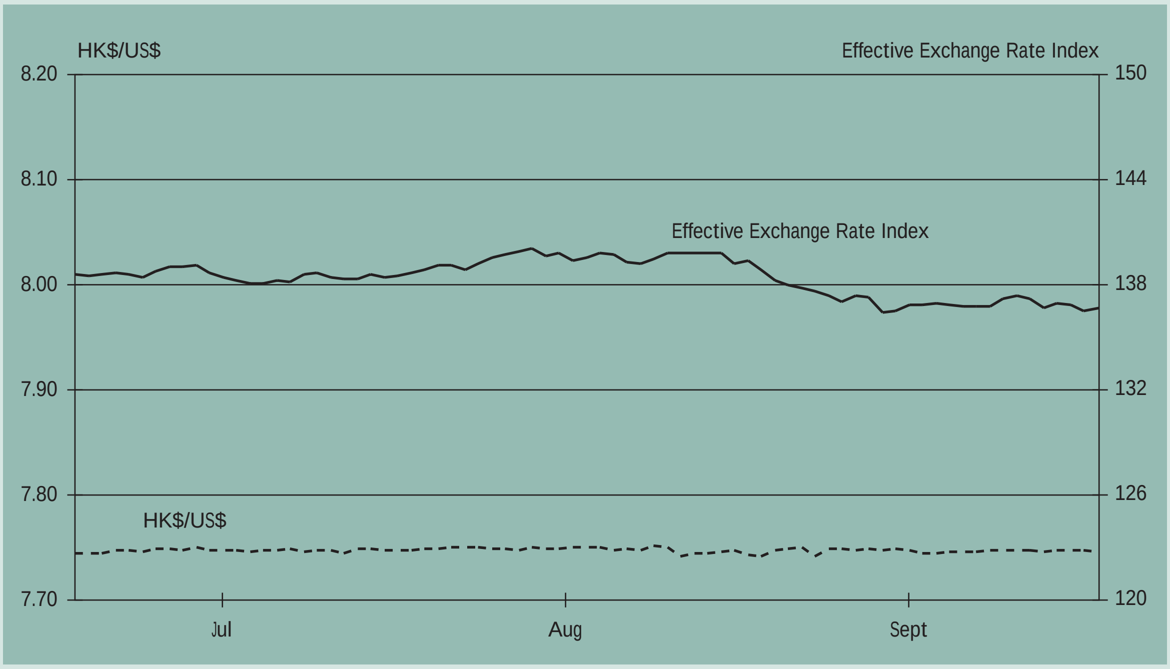
As the June round of currency attack against the Hong Kong dollar subsided, monetary conditions in Hong Kong stabilized in July. The Hong Kong dollar exchange rate traded within the range of around 7.743 to 7.750 for most part of July (Chart 1). In late July, market uncertainty over the prospects of economic recovery in Japan led to a depreciation in Japanese yen. This triggered renewed selling pressure on the Asian currencies. Nevertheless, the Hong Kong dollar was largely unaffected.

Events in August

In early August, external and domestic conditions further deteriorated. Dow Jones corrected sharply by 300 points (or 3.5%) on a single day on 5 August and the yen weakened to an eight-year low of 147 on 11 August. There was growing instability in Russia and the Latin America countries. Domestically, the downward revision of the GDP for the first quarter of 1998 from -2% to -2.8%, coupled with the worse than expected half year financial results of some major banks, weighed

Chart 1

HK Dollar Exchange Rate (July - September 1998)



on the stock markets. On the back of unfounded rumours of an imminent RMB devaluation and the abandonment of the linked exchange rate system in Hong Kong, selling pressure in Hong Kong dollar intensified in early August.

Against the monetary pressure in the domestic and external environments and taking advantage of the automatic adjustment in the monetary base to the fund flows under the Currency Board discipline, some hedge funds had sought to create extreme conditions in the money market in order to benefit from their huge short positions in the stock and futures market. Market feedback suggested that those speculators had pre-funded their Hong Kong dollar positions by swapping US dollars for Hong Kong dollars, through intermediaries, with multilateral agencies which had been actively issuing Hong Kong dollar debt instruments since the beginning of the year (over HK$30 bn of one to two year debt paper were raised by such multilateral agencies in the first eight months of 1998). On the securities market front, while the turnover in the stock market fell substantially as the Asian turmoil in the region intensified, the stock index futures market grew sharply and disproportionately. Gross Open Interests in spot Hang Seng Index futures rose from 70,000 contracts in June to some 92,000 contracts in early August. The strategy of the hedge fund was to undermine the stability of the exchange value of the Hong Kong dollar so as to produce sharply higher interest rates. As they had prefunded themselves, an interest rate hike would not increase their funding cost. They would gain from both deposits and short positions in stock and Hang Seng Index futures.

The sale of the Hong Kong dollars had not led to a contraction in the monetary base, however. The months of June to October are the usual "deficit" season for the Treasury in which there will be sizable net drawdown from the Exchange Fund by the Treasury to pay for government expenses. To fund the actual and anticipated drawdown by the Treasury, the HKMA had switched some of its foreign currency reserves into Hong Kong dollars. This counteracted some of the selling pressure on the Hong Kong dollar, leaving the Aggregate Balance of the banking system unchanged[1]. Interbank interest rates only firmed slightly in early August with overnight and 1-month HIBOR moving around 6 - 7% and 10 - 11% respectively.

Shortly before the long weekend in mid August, rumours of a devaluation of the RMB and the abandoning of the Hong Kong dollar's link with the US dollar intensified. To frustrate the double market play, the Government decided to operate in the stock and futures market to counteract market manipulation and restore market order. When the Hang Seng Index futures contracts for the month of August settled on 28 August, there was substantial selling pressure in the stock market and daily turnover reached the record high of HK$79 bn. Interbank interest rates surged across the board. Overnight HIBOR rose to an intraday high of 24% during the day. 1-month and 3-month HIBOR firmed to a high of 22% and 18% before easing to close at 19% and 15.25% at end-August (Chart 2).

Follow through actions in September

The HKMA followed through the operations in the stock and futures markets with a package of seven technical measures to further strengthen the currency board arrangements and make them less susceptible to manipulation[2]. Two major themes that underscore the technical measures are the provision of Convertibility Undertaking and the modification to the Discount Window facility. Under the former measure, the HKMA provides a clear undertaking to all licensed banks in Hong Kong to convert Hong Kong dollars in their clearing accounts into US dollars at the fixed exchange rate of HK$7.75 to US$1. This explicit

[1] In all activities conducted by the HKMA which may have the effect of varying the clearing balance of the banking system (other than those carried out under exceptional circumstances e.g. in times of Initial Public Offerings), the HKMA ensures that such effect is neutralized as the case may be, by recycling or sterilizing Hong Kong dollar liquidity. For example, a transfer of fiscal surpluses from the Government held in commercial bank accounts to the HKMA for the account of the Exchange Fund will be recycled to ensure that there is no effect on the clearing balance of the banking system. This will be done either through the purchase of foreign assets when market conditions permit or through lending Hong Kong dollar in the interbank market. Similarly a drawdown of fiscal reserves by the Government will be sterilized to ensure that there is no effect on the clearing balance of the banking system. This will be done either through the sale of foreign assets when market conditions permit or thorough borrowing Hong Kong dollars in the interbank market.

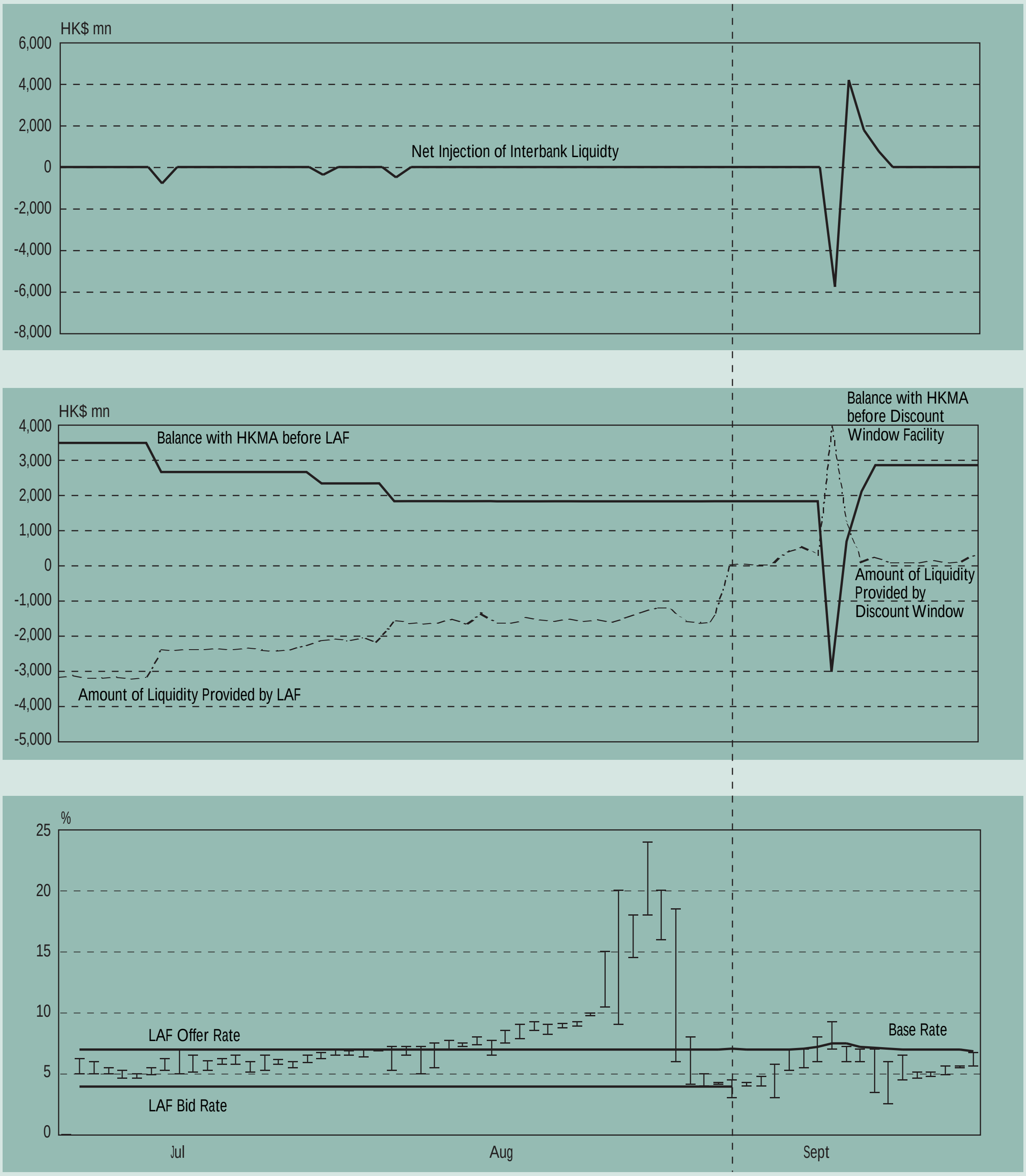
[2] See 'Strengthening of Currency Board Arrangements in Hong Kong' on page 7 of this bulletin.

Convertibility Undertaking is a clear demonstration of the Government's commitment to the linked exchange rate system. It is also the intention of the HKMA to move the rate of the Convertibility Undertaking to 7.80 when market circumstances permit. The second plank of the technical measures is the replacement of the then Liquidity Adjustment Facility (LAF) by a Discount Window with the Base Rate (formerly known as the LAF Offer Rate) to be determined from time to time

Chart 2

Money Market Operations and Movement of Overnight Interbank Interest Rate

(July - September 1998)



* Since the introduction of the seven technical measures on 7 September 1998, the LAF Bid Rate has been removed. LAF was then replaced by Discount Window under which overnight liquidity assistance is provided with reference to the Base Rate.

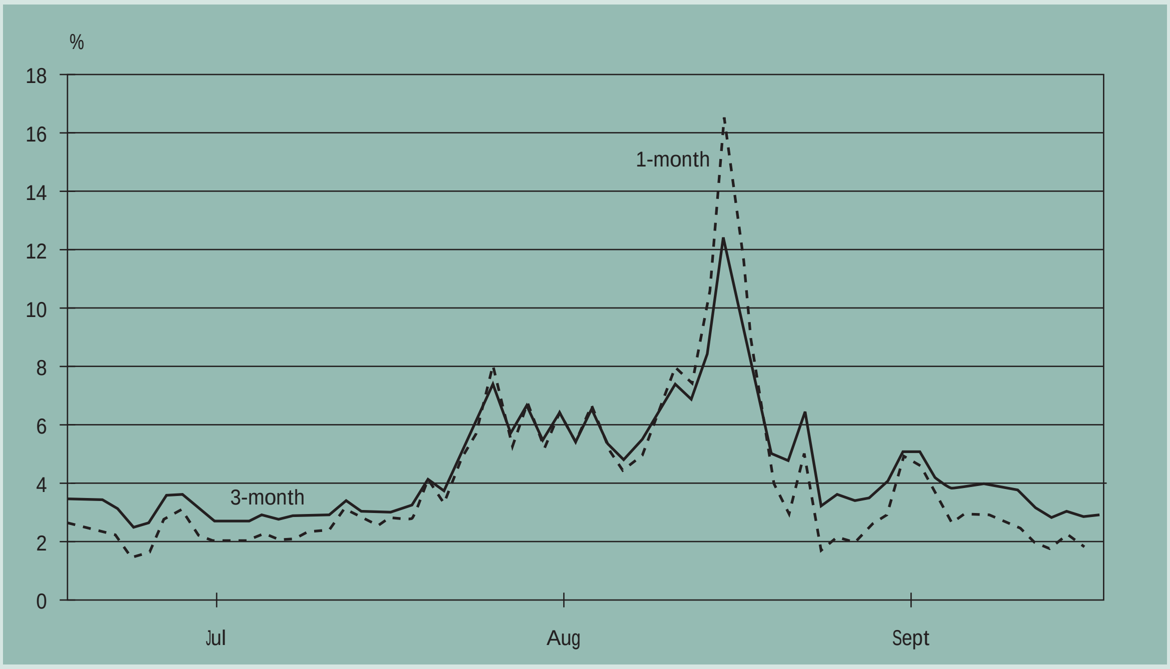
by the HKMA. Banks are allowed unrestricted access to the Discount Window in respect of repo transactions involving Exchange Fund Bills and Notes. This provides a bigger cushion of interbank liquidity and helps to reduce excessive volatility in interest rate due to the small Aggregate Balance of the banking system. In determining the Base Rate, the HKMA will ensure that interest rates are adequately responsive to capital flows while allowing excessive and destabilizing interest rate volatility to be dampened.

The new measures were put to a test in mid-September when market anxiety over a reportedly imminent move of the exchange rate under the Convertibility Undertaking from 7.75 to 7.80 triggered an outflow of funds. As a result of an outflow of around US$1.2 bn, the forecast announced on 14 September showed that the Aggregate Balance would shrink to a negative HK$7.5 bn on 16 September. Interbank interest rates edged up moderately. Overnight HIBOR rose to a high of 9.25% on 16 September while 1-month HIBOR firmed up to a high of 12.25% on 14 September. The moderate increase in interest rates and the shortage of liquidity induced some banks to sell US dollars on a "value today" or "value tomorrow" basis to obtain Hong Kong dollars to meet their settlement needs. As a result, the Aggregate Balance improved to a negative of HK$3.9 bn on 16 September and returned to a positive HK$322 mn on the following day. On the back of some capital inflows, the Aggregate Balance rose further to about HK$2.9 bn on 21 September. Overnight HIBOR eased and closed at 3.5% on that day. 1-month and 3-month HIBOR also fell to 8.5% and 9.4% respectively. The interbank interest rates then remained stable for the rest of September. Following the 25 bp cut in the US Fed Funds Target Rate on 28 September, the whole spectrum of Hong Kong dollar interest rates showed signs of easing towards the end of the September quarter.

Mainly due to the significant selling pressure on the Hong Kong dollar during August, the differential between the 1-month and 3-month Hong Kong dollar interbank interest rates and their US dollar counterparts averaged about 400 and 445 basis points respectively during the September quarter (Chart 3), compared with 214 and 246 basis points respectively in the June quarter. Notwithstanding the fluctuations in the interbank interest rates and the 25 bp cut in the US official

Chart 3

Differentials between Hong Kong Dollar and US Dollar Interest Rates (July - September 1998)



interest rate, 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 unchanged at 5.25% and 10% respectively throughout the September quarter.

During the September quarter, the Hong Kong dollar exchange rate moved within a narrow range of HK$7.741 to 7.751 to US$1. The overall exchange value of Hong Kong dollar, as measured by the trade weighted Effective Exchange Rate Index (EERI), is affected by the exchange rate of the US dollar vis-á-vis other currencies. The EERI moved on a rising trend from 138.5 at the beginning of the quarter to peak at 140.0 in mid-August on the back of a weakening Japanese Yen. Following the sharp correction in Dow Jones Industrial Index at end-August, the Japanese Yen and Deutschemark rebounded against the US dollars and hence the EERI fell to 137 towards the end of September.

Exchange Fund Bills and Notes

As part of the technical measures to further strengthen the Currency Board arrangement , the HKMA has undertaken that new Exchange Fund paper not for the purpose of rolling over existing issues will only be issued when there is an inflow of funds. This ensures that all new Exchange Fund paper will be fully backed by foreign currency reserves. In September, no additional Exchange Fund paper was issued, but 13 maturing issues were rolled over. For the September quarter as a whole, 35 issues of Exchange Fund Bills and 4 issues of Exchange Fund Notes have been launched. They have continued to be well received by the market. The total outstanding amount of Exchange Fund papers stood at around HK$97.45 bn by the end of the September quarter.

Reflecting the improved market sentiment, yield spreads between the Exchange Fund Notes and the US Treasuries narrowed during the month. In terms of the 7-year and 10-year paper, the yield spread narrowed from 474 bp and 481 bp respectively at the beginning of July to 398 bp and 392 bp respectively at the end of September (Chart 4).

- Prepared by the Research Department

Chart 4
HK$ and US$ Yield Curves