

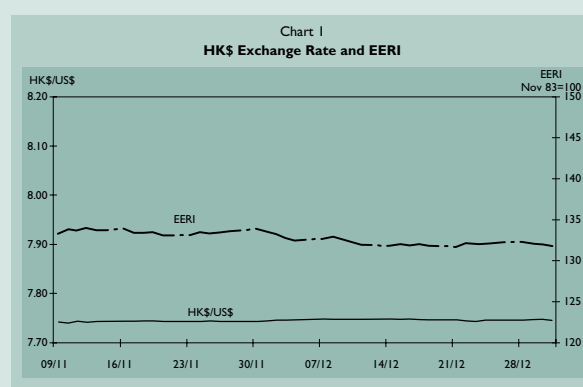
REPORT OF THE CURRENCY BOARD OPERATIONS

This report covers the period from 9 November to 31 December 1998. During the reporting period, changes in the size of the Monetary Base were fully matched by corresponding changes in the Foreign Reserves in accordance with the Monetary Rule of the Currency Board arrangements.

Hong Kong Dollar Exchange Rate and Interest Rate Movements

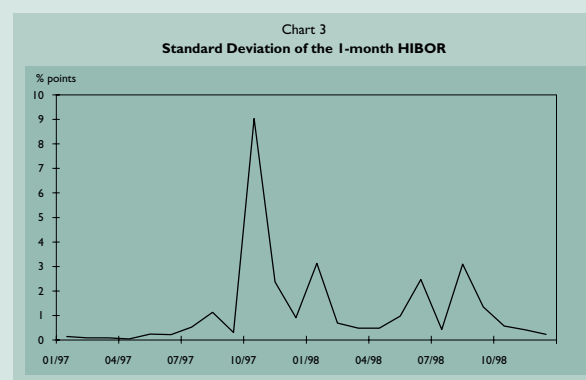
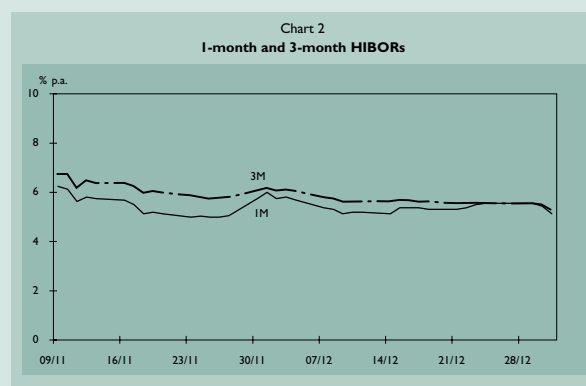
Hong Kong dollar exchange rate

1. **The Hong Kong dollar exchange rate remained stable** during the reporting period, trading between 7.740 and 7.748. Probably driven by improved sentiment in local financial markets, there was some inflow of funds in early November. The HK\$ strengthened to a high of 7.740 on 10 November. On the same day, the HKMA sold HK\$193.4 mn for US dollar. The exchange rate then eased back to around 7.744. Thereafter, the HK\$ exchange rate remained stable at around 7.743 to 7.748 (Chart 1).



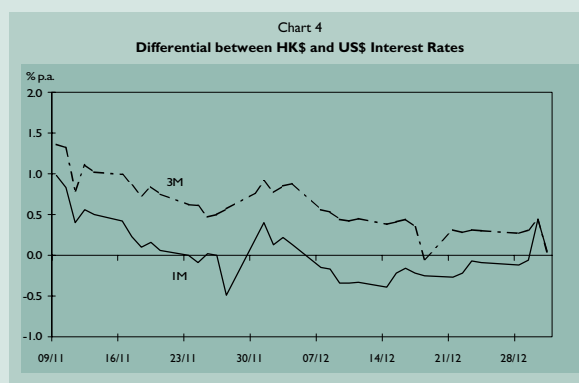
Interest rate

2. **Interest rates in Hong Kong continued to fall** in November along with the decline in US interest rates. The US Fed Funds Target Rate was further lowered by 25 basis points (bps) on 17 November, following two successive cuts in September and October. In response, HK dollar interest rates fell across the board. 1-month and 3-month HIBORs declined markedly from 6.25% and 6.75% respectively on 9 November to 5.00% and 5.75% on 26 November (Chart 2). Overnight HIBOR briefly firmed to an intraday high of 6.13% on 30 November due to month-end effects. But the seasonal tightening quickly subsided. Overnight HIBOR softened to 4.0% in early December, while 1-month HIBOR eased to around 5.4% and remained stable until the end of the reporting period.
3. **Interest rate volatility has declined significantly** since August this year (Chart 3). The standard deviation of 1-month HIBOR (as a measure of interest rate volatility) fell from

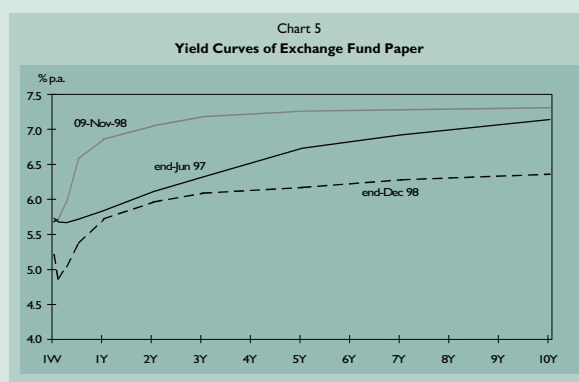


the peak of 9.0 percentage points in October 1997 to only 0.2 percentage points in December 1998, close to pre-crisis levels in 1997.

4. Reflecting improved confidence in the HK dollar, **the HK\$ and US\$ interest rate spreads narrowed significantly** during the review period. The differential in terms of the 1-month interbank rate fell from a positive 98bps on 9 November to 7bps on 31 December. The gap in the 3-month rate also narrowed from 136bps to 19bps during the same period (Chart 4).



5. **Longer term interest rates, represented by yields on Exchange Fund paper, fell significantly** during the review period. The entire yield curve has shifted downwards since early November. Yields of 5-year and 10-year Exchange Fund paper fell by 109bps and 95bps to 6.17% and 6.36% respectively. These were lower than the pre-crisis levels at end June 1997 (Chart 5).



6. As yields on Exchange Fund paper fell more than those on US Treasuries, **yield spreads narrowed for all maturity**. On the longer end of the yield curve, the yield differential between 5-year and 10-year paper decreased significantly from 259bps and 229bps to 156bps and 163bps respectively during the period covered by this report (Table 1).

7. In the retail market, **the HKAB lowered the savings rate under the Interest Rate Rules three times by a total of 75bps** during the review period. Along with the easing of interbank interest rates, the weighted average deposit rates offered by 44 major authorised institutions for 1-month time deposits (which are outside the Interest Rate Rules) dropped by 29bps from early November to 6.47% on 24 December 1998. In recent months, there has been a notable shift from HK\$ time deposits to demand and savings deposits. HK\$ demand and savings deposits increased by 5.5% and 9.9% respectively during November, while time deposits fell by 3.2%. It has been roughly estimated that the effective deposit rate

Table 1

Yield Spreads between Exchange Fund Paper and US Treasuries (basis points)

	27-Jun-97	09-Nov-98	31-Dec-98
3-month	56	116	54
1-year	21	211	122
3-year	3	242	139
5-year	27	259	156
10-year	54	229	163

(measured as the average of deposit rates weighted by type and maturity of deposits) has fallen from 7.24% in August 1998 to 5.90% in November 1998 (Chart 6). The best lending rate offered by major banks also fell by 75bps from 9.75% to 9.0% in the review period.

8. Real interest rates measured in terms of best lending rate and 1-month HIBOR decreased by 75bps and 112bps to 9.70% and 5.83% respectively in the review period, largely due to the decline in nominal interest rates (Table 2). However, real interest rates were still significantly higher than pre-crisis levels.

Base Rate

9. **The Base Rate was lowered on 18 November from 6.5% to 6.25%** following the 25bps cut in the US Fed Funds Target Rate (Chart 7). On 26 November, the HKMA announced the formula for determining the Base Rate. Under this formula, the Base Rate is set at either 150bps above the prevailing US Fed Funds Target Rate or the average of the 5-day moving averages of the overnight and 1-month HIBORs for the last 5 trading days, whichever is higher. Since then, the Base Rate has remained at 6.25% (i.e. the US Fed Funds Target Rate + 150bps). Experience so far suggests that the Base Rate has not constrained downward movements of the overnight interbank interest rate.

Monetary Base

10. **The Monetary Base**, comprising the outstanding amount of Certificates of Indebtedness, coins in circulation, the Aggregate Balance, and the outstanding amount of Exchange Fund Bills and Notes, **increased from HK\$188.73 bn on 9 November to HK\$192.47 bn on 31 December** (Table 3). Movements of individual components are discussed below.

Certificates of Indebtedness

11. **The outstanding amount of Certificates of Indebtedness (CI) picked up in late**

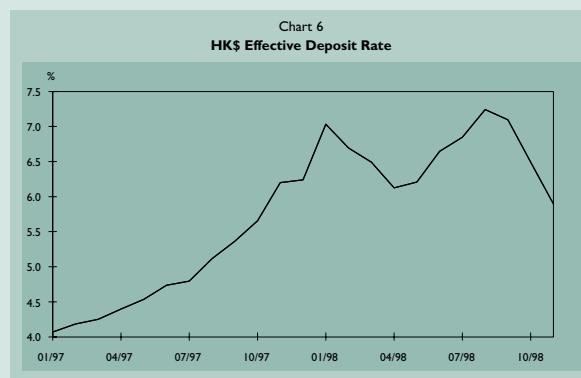


Table 2
Real Interest Rates (%)

	27-Jun-97	09-Nov-98	31-Dec-98
Best lending rate	3.15	10.45	9.70
1M HIBOR	0.46	6.95	5.83
1M deposit rate	-0.11	5.73	5.44

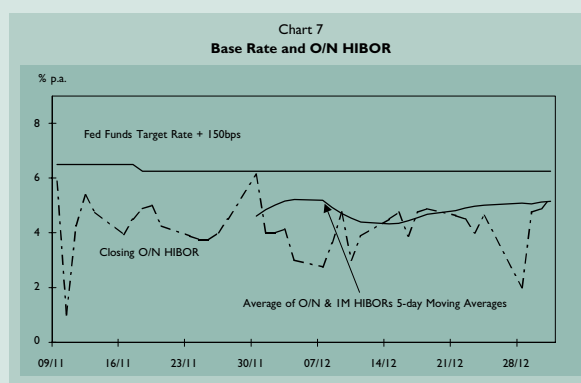
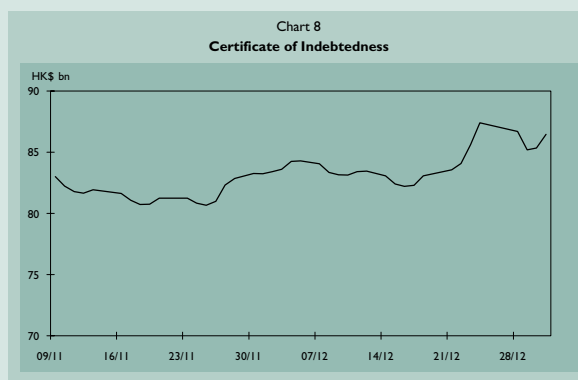


Table 3
The Monetary Base

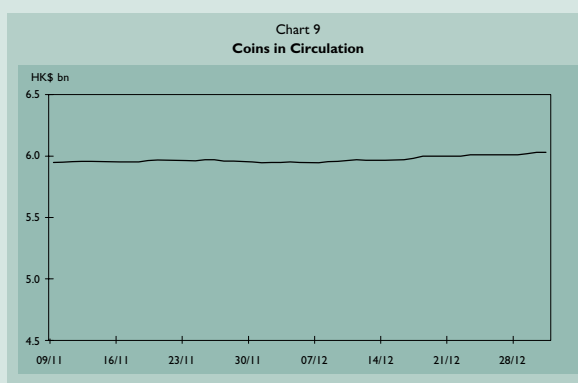
(HK\$ bn)	09-Nov	31-Dec
CI	83.01	86.47
Coins in Circulation	5.95	6.03
Aggregate Balance	2.33	2.52
Outstanding EFBNs	97.45	97.45
Monetary Base	188.73	192.47

November, largely due to month-end effects (Chart 8). During 26 November to 7 December, the three note-issuing banks submitted to the Exchange Fund a total of US\$394 mn in exchange for an increase in the CI (from around HK\$80.99 bn on 26 November to HK\$84.06 bn). Ahead of Christmas and New Year holidays, the three banks further submitted US\$494 mn during 21-24 December in return for HK\$3.85 bn worth of additional CI.



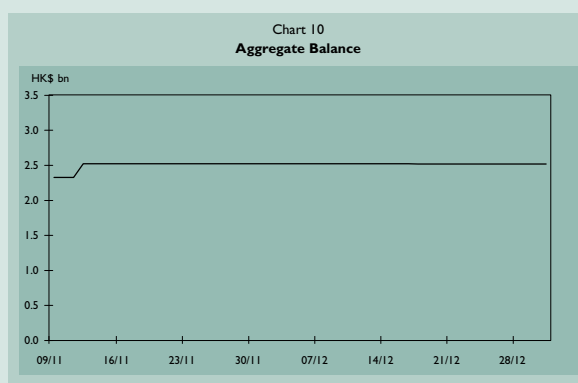
Coins

- The total amount of coins in circulation (adjusted for the face value of commemorative gold coins issued in 1997) **remained stable** at HK\$ 6.03bn as at 31 December (Chart 9).



Aggregate Balance

- In compliance with the Monetary Rule of the currency board system, the Aggregate Balance of the banking system varies in accordance with the flows of funds into and out of the Hong Kong dollar. **In response to some inflow of funds, the HKMA sold HK\$193.4 mn for US dollar on 10 November.** As a result, the Aggregate Balance increased from HK\$2.33 bn on 11 November to HK\$2.52 bn on 12 November and remained at that level for the rest of the reporting period (Chart 10).
- The HKMA announced on 26 November the plan to move the exchange rate under the Convertibility Undertaking in respect of the Aggregate Balance from the present level 7.75 to 7.80. As from 1 April 1999, the exchange rate under the Convertibility Undertaking in respect of the Aggregate Balance will move by 1 pip (i.e. HK\$ 0.0001) each calendar day. It will then take 500 calendar days to complete the move to 7.80. The announcement had no impact on money and currency markets.



Outstanding Exchange Fund Bills and Notes

- Adhering to the Currency Board discipline, the HKMA has undertaken to issue additional Exchange Fund paper only when there is

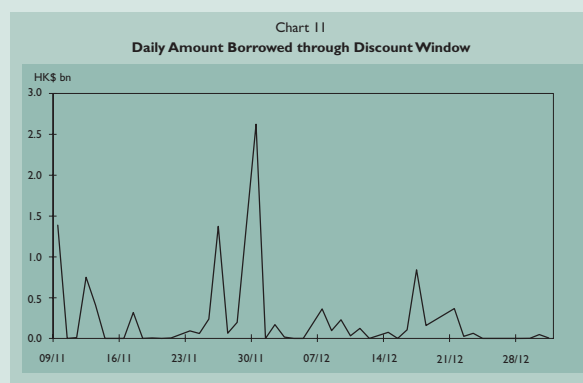
persistent inflow of funds, enabling the additional paper to be fully backed by the Foreign Reserves. During the period under review, **no additional issue of Exchange Fund paper was launched.** The total outstanding amount of the Exchange Fund paper remained at HK\$97.45 bn. During the period under review, 20 maturing issues of Exchange Fund Bills and 1 issue of Exchange Fund Notes were rolled over. These issues were well received by the market (Table 4). The banking sector has continued to increase their holding of Exchange Fund paper, from HK\$ 78.36bn (80.4% of the total outstanding amount) on 9 November to HK\$ 81.03bn on 31 December (83.2%).

Table 4
Tender Results of EF paper
(9 Nov 98 – 31 Dec 98)

	No. of issues launched	Over-subscription ratio
1-month EFB	6	1.15-2.82
3-month EFB	8	0.51-2.02
6-month EFB	4	1.25-2.58
1-year EFB	2	3.43-3.98
2-year EFN	1	1.41
Total	21	-

Discount Window Activities

16. **Banks borrowed a total of around HK\$10.22 bn** from the HKMA through the Discount Window from 9 November to 31 December. The usual daily amount involved was less than HK\$500 mn. When money market conditions tightened on 30 November due to month-end settlement, banks borrowed some HK\$2.6 bn through the Discount Window (Chart 11).



17. An overwhelming majority (HK\$9.69 bn or 94.8% of total) of the borrowings made during the period were collateralized against Exchange Fund Bills and Notes. On 4 occasions (HK\$89 mn), the amount which banks borrowed exceeded 50% of their holdings of Exchange Fund paper. Hence, these banks were charged at the Base Rate plus 5%.

18. During the reporting period, a total of 32 banks borrowed overnight liquidity through the Discount Window and only 2 of them borrowed for more than 4 times (Table 5).

Table 5
Frequency of Individual Banks
Access to Discount Window

Frequency of using Discount Window (9/11–31/12)	No. of banks
1	25
2	3
3	2
4	0
>4	2
Total	32

Backing Portfolio

19. Starting from 1 October 1998, specific US dollar assets of the Exchange Fund have been designated to back the Monetary Base. During the period under review, **the increase in the Monetary Base was fully matched by a corresponding increase of US dollar assets in the backing portfolio.** (2)