

OPERATION OF MONETARY POLICY

The exchange rate of the Hong Kong dollar and the local money markets remained stable in the first quarter of 1999, despite the sharp depreciation of the Brazilian Real, the liquidation of the Guangdong International Trust and Investment Corporation, and the seasonal purchase of US dollars by the Note Issuing Banks ahead of the Chinese New Year holidays. The seven technical measures to strengthen the Currency Board system introduced in September 1998 provided a useful anchor in facilitating an orderly adjustment of interest rates to the outflow of funds. As the money markets returned to more normal conditions, there was an apparent reduction in the “Hong Kong premium” towards the end of the quarter.

Detailed monthly reports on Currency Board operations for the period 4 January to 26 March 1999 may be found with the Records of Discussions of the Exchange Fund Advisory Committee Sub-Committee on Currency Board Operations on pages 93 to 112.

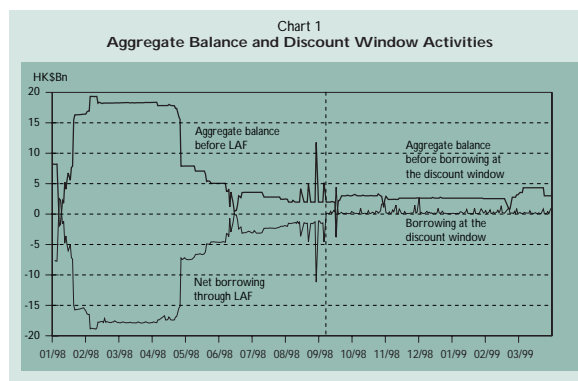
Convertibility Undertaking and Aggregate Balance

While the foreign exchange and money markets generally moved back to normality in the first quarter, the Convertibility Undertaking arrangement was triggered several times due to a combination of external and internal factors. Reflecting increased confidence in the HK dollar and the effectiveness of the seven technical measures introduced in September 1998 to strengthen the Currency Board system, the amounts of the outflows were substantially smaller than those witnessed in 1998 and interest rate adjustment was orderly and less volatile.

The HK dollar was under some pressure in mid-January due to concerns about the deepening financial crisis in Brazil and the liquidation of the Guangdong International Trust and Investment Corporation (GITIC). The substantial capital outflows from Brazil and the sharp depreciation of the Real rekindled concerns about possible contagion to other emerging markets, in particular the other Latin American countries and China. The liquidation of GITIC cast doubts on the financial positions of other state-owned conglomerates in Mainland China and possible adverse impact on banks in Hong Kong which have significant

exposure to these companies. However, the market reacted calmly and only a very modest amount of outflow was recorded. On 25 January, amidst the rumours about RMB devaluation, the HKMA sold US\$10 mn for HK\$77.5 mn under the Convertibility Undertaking, causing the forecast Aggregate Balance on 27 January to decline slightly to HK\$2.44 bn (Chart 1).

The Convertibility Undertaking was triggered again in mid-February due to the seasonal purchase of US dollar by the Note Issuing Banks to provide backing for additional banknote issuance to meet



public demand ahead of the Chinese New Year holidays. The HKMA bought a total of HK\$3.41 bn for US\$440 mn under the Convertibility Undertaking. The Aggregate Balance shrank correspondingly and was at one point forecasted to drop to a negative level of HK\$0.97 bn on 22 February. The situation was however quickly reversed after the Chinese New Year holidays, with the HKMA selling HK\$3.64 bn for US\$ on 19 February. As a result, the Aggregate Balance rose to HK\$2.68 billion on 22 February.

The HK dollar exchange rate strengthened slightly in early March on the back of equity-related inflows as some portfolio capital re-entered the Asian markets. The HKMA sold some HK dollars for US dollars in response to offers by a few banks. This increased the Aggregate Balance, which in turn led to easing in interbank interest rates. However, the exchange rate weakened briefly to the convertibility rate of 7.75 in mid March as some market players sold HK dollars hoping to take advantage of the implementation of HKMA's plan to move the rate of the Convertibility Undertaking gradually to 7.80 at a speed of one pip per day starting 1 April 1999. Interbank liquidity tightened briefly as the HKMA bought HK dollars under the Convertibility Undertaking, after which the exchange rate strengthened to 7.7490 and stayed around that level until the end of the quarter.

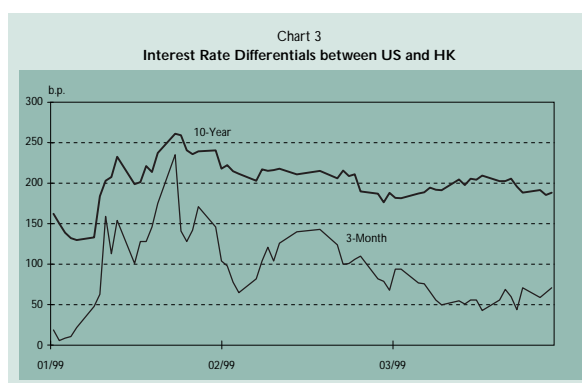
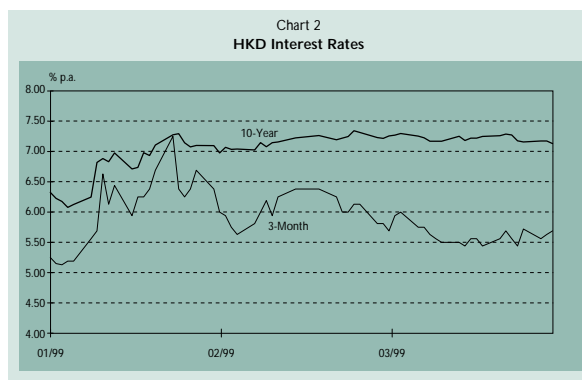
3-Month Hong Kong Dollar Interest Rate

Despite the fairly eventful first quarter, short-term HK dollar interest rates remained stable throughout the period. 3-month HK dollar interest rate (closing level) peaked at 7.25% on 25 January amidst concerns about the Brazilian crisis and the rumour of an imminent RMB devaluation. The rate stayed within a tight range of 5.44% - 6.38% from February onwards (Chart 2). Even when the Aggregate Balance was forecast to drop to negative territory on 22 February, the 3-month interbank rate rose only to 6.38%. The mild and orderly adjustment in interest rates indicated that the seven technical measures and the improved transparency on the currency board operations have contributed to steadier conditions in the money market.

¹ Including loans for trade financing.

Long Term HK\$ Interest Rate and the Hong Kong Premium

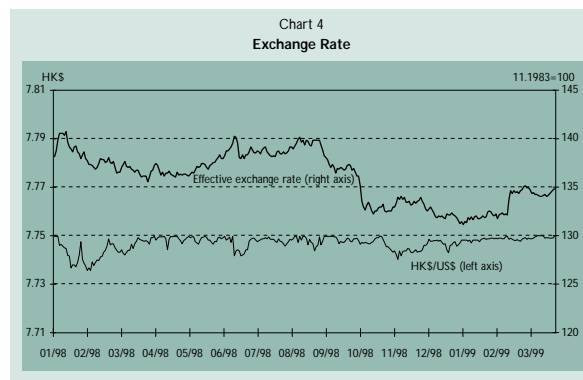
At the height of the Brazilian crisis and the RMB devaluation rumour, the yield of the 10-year Exchange Fund Notes (EFN) rose by 121 basis points to 7.29% on 26 January. Thereafter, the yield of the 10-year EFN stayed within the range 6.98% - 7.34%. From 25 January onwards, the yield spread of 10-year EFN over the corresponding US Treasuries showed a clear narrowing trend, from 259 basis points to 188 basis points at the end of the quarter (Chart 3), implying a reduction in the risk premium on Hong Kong dollar denominated paper.



Base Rate and HK\$ Effective Exchange Rate

The Base Rate is set at the higher of the US Fed Fund Target Rate plus 150 basis points, and the simple average of the 5-day moving averages of the overnight and 1-month HIBORs for the previous five trading days. Since the US Fed Fund Target Rate remained unchanged at 4.75% throughout the period, and the moving averages of the relevant HK dollar interest rates were relatively stable, the Base Rate was maintained at 6.25% throughout the first quarter.


The overall exchange value of the HK dollar, as measured by the trade weighted Effective Exchange Rate Index (ERRI), tracked closely the movements of the exchange rate of the US dollar vis-à-vis other major currencies. On the back of a weaker Japanese yen and a weaker Euro, the ERRI appreciated by 2.35%, from 131.7 to 134.8, during the first quarter (Chart 4).



- Prepared by the Monetary Policy and Markets Department

Domestic Credit and Money Supply

Domestic credit² decreased by 2.6% in the first quarter of 1999, the sixth decline in a row. Loans to most economic sectors contracted as banks remained cautious and credit demand stayed weak. The liquidation of GITIC and insolvency of several other Mainland-linked companies prompted banks to become more cautious in their lending. Nevertheless, there was little evidence of an across-the-board liquidity crunch. Loans to utilities companies, stockbrokers and residential property buyers were the only sectors that registered positive growth in the first quarter of 1999, the latter two reflecting in part improved investor appetite in the stock and property markets.

Narrow money supply (HK\$M1) increased by 2.0% during the first quarter, sustaining the positive growth started in the December quarter after five consecutive quarters of decline. However, partly reflecting subdued credit expansion, the growth of broad money slowed. HK\$M3 grew 0.4% in the first quarter, following an increase of 2.4% in the previous quarter. Compared with a year ago, HK\$M1 was down by 2.0% in March 1999, while HK\$M3 was up by 8.2%. 

² Including loans for trade financing.