Monetary Management

The capability of the Monetary Authority to deliver exchange rate stability has been greatly enhanced with the implementation of various monetary reform measures in the past few years. Monetary management was further strengthened in 1994 with the adoption of the revised mode of money market operations, the broadening of the scope of eligible Repo securities for discounting under LAF as well as a progressive expansion of the Exchange Fund Bills and Notes Programme.

Monetary policy objective

The monetary policy objective in Hong Kong is to maintain exchange rate stability within the framework of the linked exchange rate system through sound management of the Exchange Fund, monetary policy operations and other means deemed necessary. The core feature of the linked exchange rate system is a fixed exchange rate of HK$7.80 to US$1 for the issue and redemption of Certificates of Indebtedness, which note-issuing banks are required to hold as cover for banknotes issued in Hong Kong.

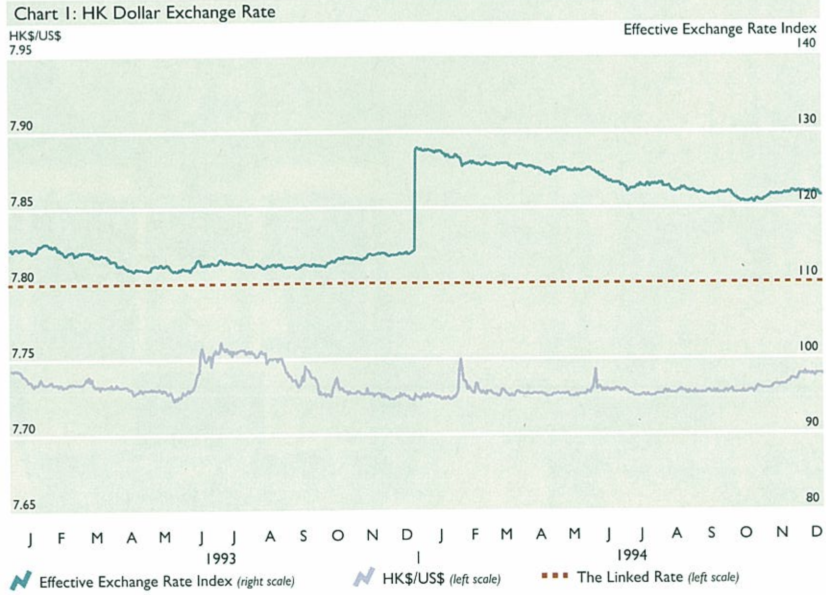
Should there be any significant deviation between the market rate and the linked rate, the Monetary Authority may undertake foreign exchange market intervention and money market operations as appropriate to maintain exchange rate stability. In its pursuit of exchange rate stability, the Monetary Authority has put in place a number of monetary reform measures which enable it to have effective control over the level of interbank liquidity, and hence short-term interbank interest rates. These included the Accounting Arrangements with the Management Bank of the Clearing House introduced in 1988, the Exchange Fund Bills and Notes Programme introduced in 1990 and the LAF, Hong Kong's version of the discount window, in 1992.

The linked exchange rate has served as an effective monetary anchor around which other economic variables, including money supply and prices, adjust to the changing internal and external environment. The system has proven to be resilient against a number of external shocks experienced in the past eleven years, and has contributed to the overall monetary and financial stability in Hong Kong.

The HK dollar exchange rate

Throughout 1994, the exchange rate of the HK dollar remained very stable against the US dollar and stayed very close to the linked rate at a level slightly on the stronger side of 7.8 (Chart 1).

Chart 1: HK Dollar Exchange Rate



The HK dollar exchange rate traded on the stronger side of the link at around 7.73 for most of the time during the year. In the last two months of the year, there had been some outflows of funds from the stock market as it went through some corrections, triggered by the continuing rise in US dollar interest rates. But this did not have any significant effect on the exchange rate, which closed the year at 7.7375.

There were occasional blips in the exchange rate during the year. The first incident occurred on 4 February when US Fed funds rate went up for the first time in many years. In subsequent days, many currencies weakened against the US dollar and some quite sharply. But the exchange rate of the HK dollar eased only briefly to the 7.7525 level and soon recovered to the previous levels. The second occasion occurred on 10 June due to unfounded rumours about changes in Chinese leadership. The HK dollar exchange rate weakened slightly to an intraday low of 7.7460 but quickly recovered the following day.

Under the linked exchange rate system, the overall exchange value of the HK dollar, as measured by the trade-weighted EERI, is influenced predominantly by the movements of the US dollar against other major currencies. The EERI jumped by 13.2 points on 3 January 1994, reflecting a change in calculation of the index that uses the RMB exchange rate at the swap centre (at around 8.7 yuan to US$1) instead of the prevailing official rate (at 5.8 yuan to US$1). This change followed the unification of the official exchange rate for RMB and the swap rate from 1 January. Up to mid-October, the US dollar continued to weaken against the Yen and major European currencies because of prolonged US-Japan trade disputes, the narrowing of interest differential with European currencies and the slump in the US bond market. Correspondingly, the EERI moved successively downward to reach a low of 120.5 in the last week of October (Chart 1).

Having touched a new low on 26 October, the US dollar exchange rate rebounded, supported by news of foreign exchange market intervention by the US Fed and US Treasury's statements in favour of a strong US dollar. Reflecting this, the EERI firmed up and closed the year at 121.4.

While the fixed rate of HK$7.8 to US$1 continued to apply in the issue

Table 1: Chronology of HK Dollar and US Dollar Interest Rates Adjustments in 1994

bp Month	Effective date	US official interest rates Discount	Fed funds	HK LAF rates Bid	Offer	HKAB Time deposits*	Savings deposits	Best Lending Rate
Feb	4	–	+25	–	–	–	–	–
March	22	–	+25	–	–	–	–	–
	28	–	–	–	–	+75	+50	+25
April	18	–	+25	–	–	–	–	–
May	17	+50	+50	–	–	–	–	–
	18	–	–	+50	+50	–	–	–
	23	–	–	–	–	+75	+50	+50
Aug	16	+50	+50	+50	+50	–	–	–
	22	–	–	–	–	+50	+50	+50
Nov	16	+75	+75	+75	+75	–	–	–
	21	–	–	–	–	–	+75	+75
Total		+175	+250	+175	+175	+200	+225	+200

* *Since 1 October 1994, interest rates on time deposits of over 1 month which were previously governed under the IRR of the HKAB have been deregulated.*

and redemption of Certificates of Indebtedness, a new banknote transactions arrangement among banks was introduced in January 1994. Previously, banknote transactions between note-issuing banks and other banks was for US dollar value at the fixed rate of HK$7.80 to US$1. Thus, when the exchange rate was on the strong side of the link, banks receiving banknotes from customers and redeeming them with note-issuing banks would incur an exchange rate loss. In response, banks imposed banknotes handling charges on customers to recoup such losses. These charges were unpopular with customers.

The matter was resolved satisfactorily on 24 January when the note-issuing banks, following consultations with the Monetary Authority, agreed that all banknote transactions between themselves and other licensed banks would henceforth be for HK dollar value. As from that date, licensed banks agreed to stop charging banknote handling fees. The new arrangement for banknote transactions had no impact on the maintenance of exchange rate stability in Hong Kong.

Monetary management

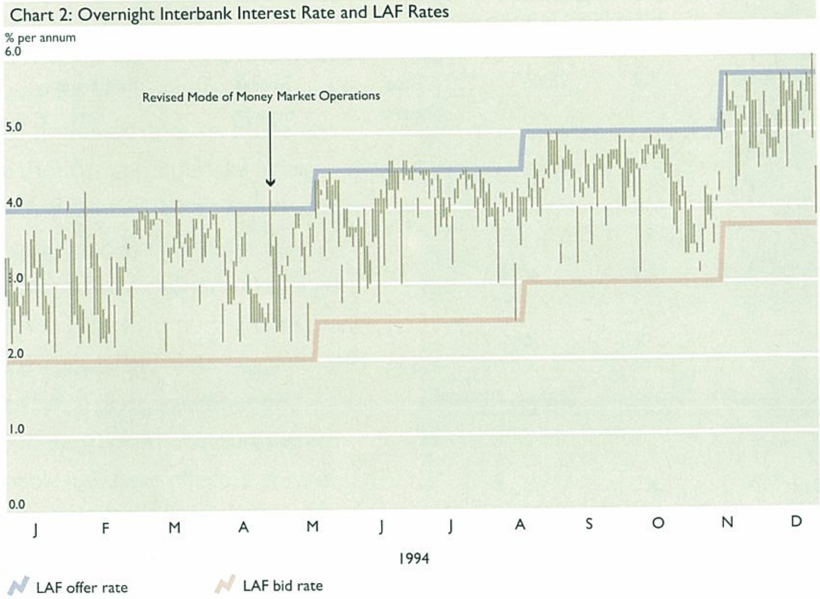
In 1994, HK dollar interest rates moved closely in line with the US dollar counterparts (Table 1). During the year, the US Fed initiated six rounds of interest rate rises including three upward adjustments of the US discount rate. In line with the rise in US rates, the Monetary Authority raised the LAF bid and offer rates in three successive steps by a total of 175 bp to 3.75% and 5.75% respectively at the end of the year.

Following the upward adjustments of the LAF rates, the full spectrum of domestic interest rates rose accordingly. Along a general rising trend, movements of the overnight HIBOR were largely kept within the corridor set by LAF rates (Chart 2). The success of monetary operations in reducing the volatility of the overnight HIBOR contributed to the stability of the HK dollar exchange rate. Throughout 1994, HIBOR stayed generally close to its Eurodollar counterparts. The average differential between 3-month HIBOR and the corresponding Eurodollar deposits rate in 1994 was merely 16.1 bp.

As to retail rates, the transmission from wholesale money market rates to banks' deposit and lending rates was immediate. After four rounds of upward revisions by the HKAB, the savings deposits rate and time deposits rate governed by the IRR were 225 bp and 200 bp higher than the respective rates a year ago. The BLR offered by major banks was also up by 200 bp to 8.5% at year-end.

As from 1 October, deposits rates under IRR were deregulated in phases, starting with time deposits of over one month. The deregulated deposits rates moved broadly in line with the general uptrend in interbank interest rates. The deregulation in the retail deposits rates in 1994 had no impact on monetary management.

Chart 2: Overnight Interbank Interest Rate and LAF Rates

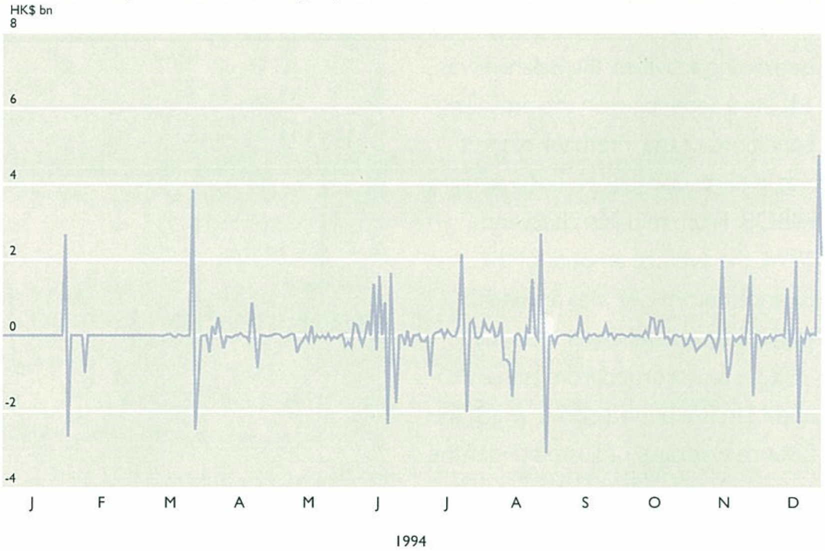


With a view to enhancing its liquidity management capability, the Monetary Authority adopted a revised mode of money market operations in March 1994. Under the new approach, money market operations targeted the overnight interbank interest rate instead of the level of interbank liquidity. Experience in the past revealed that short term interbank interest rates had a more stable and direct relationship with the exchange rate.

Interbank liquidity refers to the net amount of liquidity held in the clearing accounts of all licensed banks. The Monetary Authority varies the level of interbank liquidity by influencing the Balance, which is the amount in the account that the Management Bank of the Clearing House maintains with the Exchange Fund. Prior to the change, the Balance was adjusted only infrequently. Under the revised mode of money market operations, the Balance is flexibly adjusted in a way pertinent to stabilising short term interbank interest rate within the corridor set by the LAF bid and offer rates.

To tie in with the change in the mode of monetary operations, the Monetary Authority also revised the screen format on Reuters for announcing the money market operations to enhance the transparency of market operations. Beginning on 14 March, the new screen format has provided a time track of the cumulative changes in liquidity injections or withdrawals.

Chart 3: Net Injection of Interbank Liquidity



Brief surges in the Balance occurred during month ends and quarter ends as liquidity was injected into the interbank market to meet higher seasonal demand for funds. The largest single injection took place on 30 December when overnight HIBOR briefly touched an intraday high of 6.0375%, above the LAF rate of 5.75%, as a result of an upsurge in demand for funds towards the close of the year. Following a HK$4.8 bn injection into the banking system (Chart 3), overnight HIBOR promptly softened. The injection brought the Balance to a relatively high closing level of HK$6.2 bn at end-year.

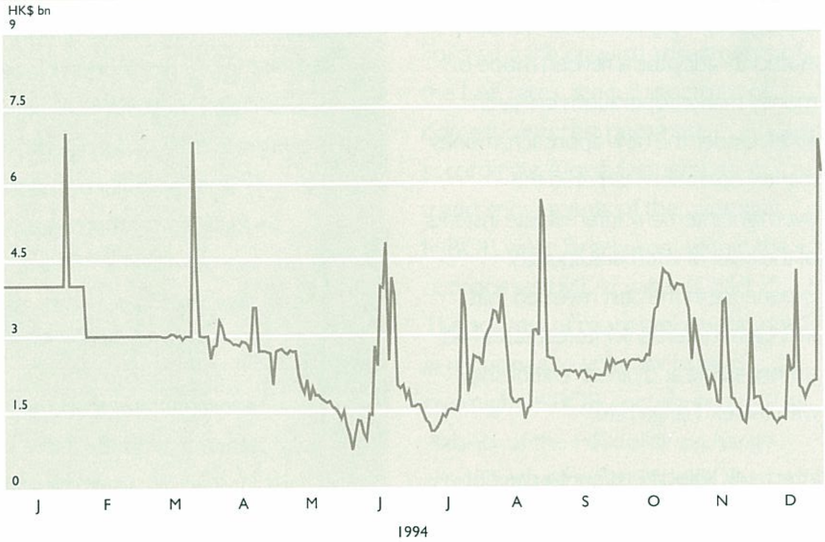
Liquidity was also injected during times of share subscription activities which usually involved substantial amount of subscription monies. Though the scale of IPO activities was much lower in 1994 when compared to 1993, share floatation exercises still led to tightening of the interbank market at times. On 29 January, 1994, for example, temporary liquidity amounting to about HK$2.6 bn was injected to facilitate the refund of application monies for the Contrad International Holdings Ltd. issue. In November, HK$2.1 bn and HK$1.9 bn were injected to ease temporary tightness in the interbank market resulting from the public share offerings by Golden Harvest Entertainment (Holdings) Ltd. and the Guangnan (Holdings) Ltd. respectively. Injections of smaller scale were also made periodically to iron out volatilities in the HIBOR movement.

These injections of interbank liquidity were generally of short term nature. Once the tightness of the interbank market eased, excess liquidity would be withdrawn. In 1994, excess liquidity was frequently absorbed by the LAF deposit facility.

Through the interplay of monetary operations and LAF lending and borrowing activities, the Balance was adjusted depending on the prevailing conditions of the interbank market and in particular the level of overnight HIBOR. From mid-March to end-1994, the average amount of the Balance before LAF was around HK$2.5 bn, a level lower than the HK$3.6 bn recorded from January to mid-March, a period during which the Balance was rarely adjusted under the previous mode of monetary operations (Chart 4). The revised mode of money market operations proved to be very effective in reducing unnecessary volatility in the interbank market.

To improve further the effectiveness of LAF, the range of eligible securities for discounting under LAF was widened in March to include high quality HK dollar debt papers issued by statutory bodies and the private sector (see box). As at end-1994, three private debt issues, of a combined value at HK$8 bn, were approved as eligible securities. The expansion of the scope of securities eligible for discounting under LAF not only spurred growth of the HK dollar debt market but also made LAF more accessible to banks in their management of liquidity position.

Chart 4: HSBC's Balance with the Exchange Fund



Exchange Fund Bills and Notes Programme

Launched in 1990, the Exchange Fund Bills and Notes Programme has served as an effective instrument with which the Monetary Authority could conduct open market operations. Total outstanding Exchange Fund Bills and Notes amounted to HK$52.3 bn at end-December, equivalent to almost 20 times the average level of interbank liquidity in 1994.

Exchange Fund paper has a highly liquid and active secondary market. The average daily turnover reached HK$22.3 bn in 1994. This implied that about 55% of the outstanding Exchange Fund paper changed hands every day, making the paper one of the most actively traded government securities in the world.

The Exchange Fund paper is well received by investors because of its high credit standing, the large size of the market, and the high liquidity facilitated by the well developed market infrastructure. The secondary market also owes its liquidity to an efficient clearing system and the market-making arrangements which allow short-selling by appointed Market-Makers (Table 2).

Eligibility Criteria for Securities Discountable under the LAF

Category A
Exchange Fund Bills/Notes, Government Bonds

Category B
HK dollar debt securities issued by statutory bodies including the Mass Transit Railway Corporation and the Provisional Airport Authority and those with AAA rating by Standard and Poor's or equivalent. These securities have to be lodged with and cleared through the CMU Service operated by the Monetary Authority.

Category C
HK dollar debt securities fulfilling the criteria below and approved by the Monetary Authority:

(i) the issue has to be lodged with and cleared through the CMU Service operated by the Monetary Authority;

(ii) the issue enjoys at all times an explicit rating of not lower than A- (Standard & Poor's) or A3 (Moody's) if issued by a bank, and A (Standard & Poor's) or A2 (Moody's) if issued by a non-bank issuer; and

(iii) to ensure the marketability of the issue and facilitate its daily valuation, there should be at least two institutions acceptable to the Monetary Authority which are prepared to make every effort to quote, from time to time and at the request of the Monetary Authority, a firm bid price of reasonable size in the issue and to provide price information to the Monetary Authority on a daily basis. Structured issues (i.e. other than "plain vanilla" products) are not normally accepted as Repo securities.

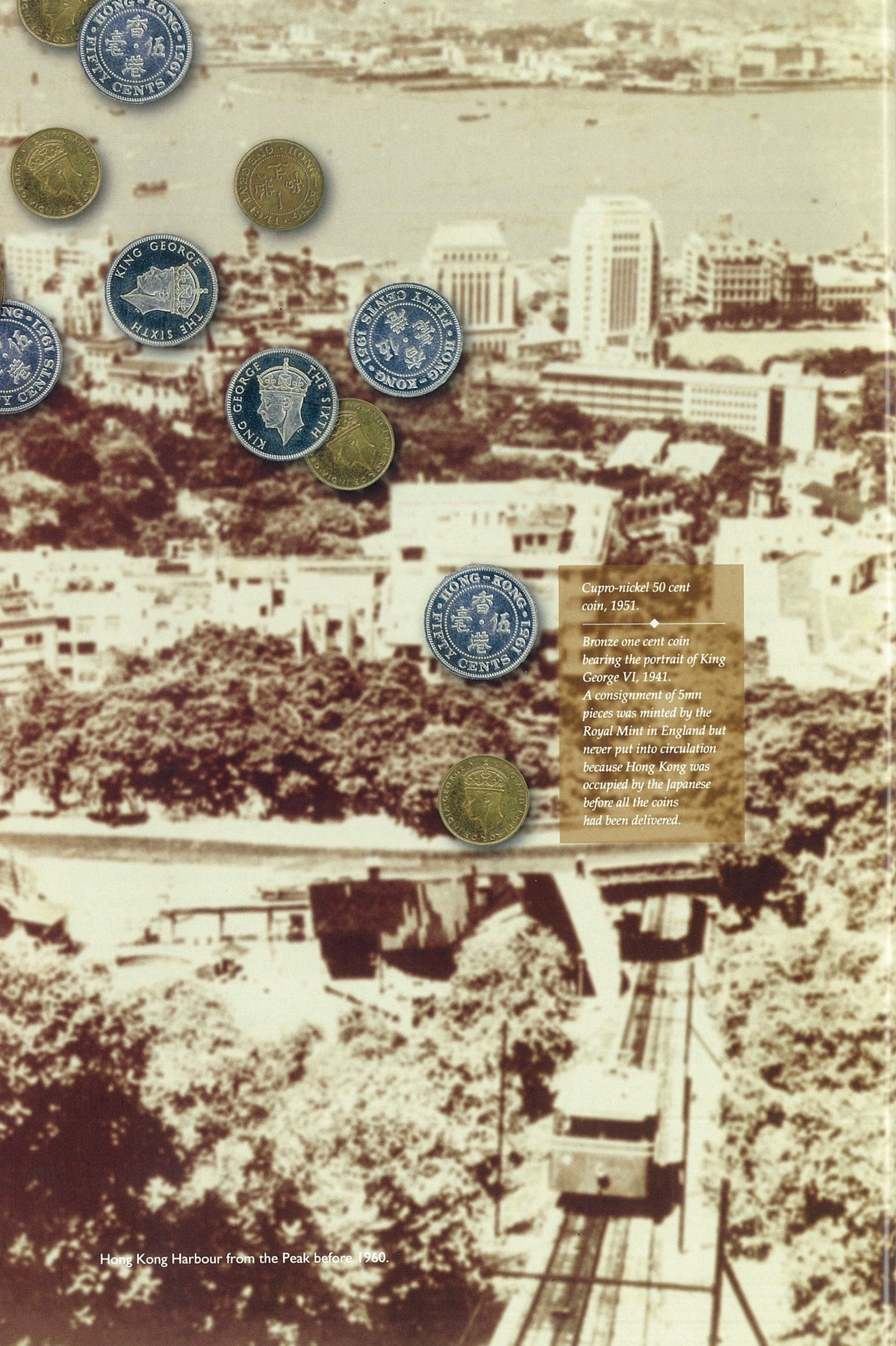
(iv) the minimum size of the issue shall be HK$1 billion.

Under normal circumstances, Category A and B securities will be discounted at the normal LAF offer rate whereas Category C securities will be discounted at the offer rate plus 25 bp.

Table 2: Exchange Fund Bills and Notes – Issue Schedule

Type	Issue size (HK$ mn)	Reserves amount (HK$ mn)	First issue date	Frequency	No. of issues in a full cycle	Actual amount outstanding as at 31/12/94 (HK$ mn)	Authorised maximum amount outstanding (HK$ mn)
91-day bills	1,500	300	14-03-90	weekly	13	23,400	23,400
182-day bills	800	160	31-10-90	every 2 weeks	13	12,480	12,480
364-day bills	500	150	27-02-91	every 4 weeks	13	8,060 *	8,450
2-year Notes	500	100	18-05-93	quarterly	8	4,200	4,800
3-year Notes	500	100	26-10-93	quarterly	12	3,000	7,200
5-year Notes	500	100	27-09-94	quarterly	20	1,200	12,000
					Total	**52,340**	**68,330**

* *includes three issues of HK$400 mn (plus HK$120 mn reserves)*



Cupro-nickel 50 cent coin, 1951.

Bronze one cent coin bearing the portrait of King George VI, 1941. A consignment of 5mn pieces was minted by the Royal Mint in England but never put into circulation because Hong Kong was occupied by the Japanese before all the coins had been delivered.

Hong Kong Harbour from the Peak before 1960.