

THE OBJECTIVE OF MONETARY POLICY IS EXCHANGE RATE STABILITY WITHIN THE FRAMEWORK OF THE LINKED EXCHANGE RATE SYSTEM. THIS CLEAR OBJECTIVE WAS COMFORTABLY ACHIEVED IN 1995. THE EXCHANGE RATE STAYED SLIGHTLY ON THE STRONGER SIDE BUT CLOSE TO THE FIXED RATE OF 7.80 THROUGHOUT THE YEAR. THERE WAS AT THE BEGINNING OF THE YEAR SOME SPECULATIVE ACTIVITY IN THE CURRENCY, ALONG WITH THOSE OF EMERGING MARKETS IN THE ASIAN REGION. PROMPT AND EFFECTIVE ACTION WAS TAKEN TO DEAL WITH IT, INVOLVING SLIGHTLY HIGHER SHORT-TERM INTEREST RATES FOR A FEW DAYS. WITH THIS EXCEPTION, LOCAL INTEREST RATES TRACKED U.S. INTEREST RATES CLOSELY THROUGHOUT THE YEAR AND WERE GENERALLY ON A DOWNWARD TREND IN THE SECOND HALF OF THE YEAR.

MONETARY REGIME IN HONG KONG

Providing a credible monetary policy anchor in Hong Kong is the linked exchange rate system, which is a form of currency board arrangement practised in Hong Kong since October 1983. A core feature of the currency board arrangement is the full backing of domestic currency notes by a foreign currency at a fixed exchange rate. In Hong Kong, the currency notes are issued by three commercial banks. Under the linked exchange rate system, the three note-issuing banks are required by law to hold Certificates of Indebtedness (CIs) as cover for the banknotes issued by them. The CIs are issued and redeemed against US dollar at a fixed rate of US\$1 to HK\$7.80. In the foreign exchange market, the HK dollar exchange rate

is determined by supply and demand. Against the fixed rate for the issue and redemption of banknotes, the exchange rate has stayed close to the linked rate of 7.80. When there is a significant deviation from 7.80, due to inflow or outflow of funds, interest rate adjustments would correct the deviation. As and when appropriate, the HKMA may operate in the foreign exchange and money markets to maintain exchange rate stability.

The strength of any monetary regime hinges upon its policy credibility and systemic credibility. The Government's total commitment to the link, coupled with the consistency, clarity and transparency of the monetary policy objective has



HONG KONG Exchange Fund Ordinance (Chapter 66)

Certificate of Indebtedness for \$10,000,000

This certificate

Chapter 66) requires the Exchange Fund to issue a certificate of indebtedness without interest to the Government of the Hong Kong Special Administrative Region

for the amount of dollars ten million

and is redeemable at any time at its face value



Such a certificate shall be signed by the Secretary.

helped to build up credibility in Hong Kong's monetary policy. The strength of the system has been reinforced by systemic credibility, which is in turn underpinned by sound economic fundamentals, a robust monetary management system, prudent public finances, strong official reserves, as well as a healthy banking sector.

EXCHANGE RATE OF THE HONG KONG DOLLAR IN 1995

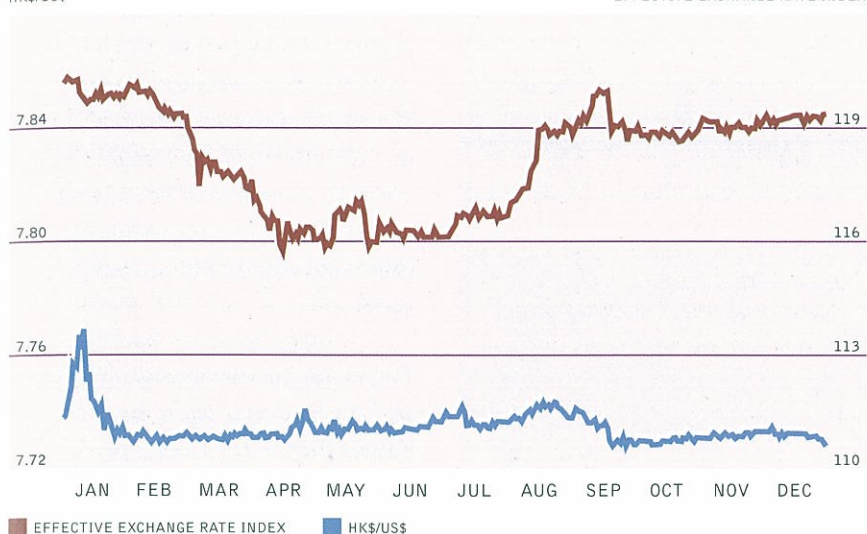
The exchange rate of the HK dollar remained stable against the US dollar, moving within a narrow range of 7.730 to 7.745 during most of 1995 (Chart 1). There was brief speculative activity in the HK dollar in mid-January, along with a number of Asian currencies, in the aftermath of the Mexican currency crisis. In the first week of January, the exchange rate of the HK dollar began to ease, to around 7.758. Selling pressure increased in the second week of January, pushing the exchange rate to 7.772 in the morning of 12 January. The HKMA took prompt and effective action to deal with the speculative activity. It supplemented its foreign exchange market interventions by money market operations. The liquidity withdrawn from the interbank market as a result of the purchase of HK dollars was not immediately recycled back to the system. A shortage in interbank liquidity to the tune of around \$6 bn was created in the morning of 13 January. In response, overnight

HIBOR rose from 6% to 12%. The exchange rate then started to rebound. Towards the end of the following week, the exchange rate returned to the level before the onset of the speculative activity. In the event, the HK dollar fluctuated by less than 0.4%, considerably less than the fluctuations in other Asian currencies (e.g. 3.6% for Thai Baht and 2.7% for Philippines Peso).

Around end April, unfounded rumours on the health of Mr. Deng Xiaoping led to a brief easing of the HK dollar exchange rate, from 7.738 to around 7.742. It rebounded to the 7.735 level in the following week as the rumours subsided. In the third week of August, the exchange rate of the HK dollar eased slightly to around 7.746, as market sentiment was affected by Moody's comment on the Hong Kong economy, the escalation of political tension across the Taiwan Straits and a correction in the local stock market. After the HKMA withdrew about \$1 bn from the interbank market in mid-August, overnight HIBOR firmed up from 5.25% to 6%, and the exchange rate moved back to around 7.736 in mid-September. Partly reflecting some inflows of funds, the local stock market rallied towards the end of the year, with the Hang Seng Index rising from 9,288 in mid-November to 10,073 by end of the year. Along with this, the HK dollar exchange rate strengthened marginally and closed the year at 7.732.

Under the linked exchange rate system, the overall exchange value of the HK dollar is affected predominantly by the movements of the US dollar against other major currencies in the international foreign exchange market. The US dollar was generally on a down trend in the first half of 1995, as the market was worried about the adverse impact of the Mexican crisis on the US economy, a peaking of the US interest rate as well as the worsening US trade deficit. From 100.67 Yen and 1.557 DM to 1 US dollar at the beginning of 1995, the US dollar exchange rate fell to 79.7 Yen and 1.345 DM on 19 April. However, on the back of concerted central bank interventions, the US dollar rebounded sharply in August. The improved economic prospects in the USA, coupled with the problems in the Japanese financial system, lent further support to the US dollar. At the end of the year, the US dollar closed at 103.40 yen and 1.4365 DM. The Renminbi, which has a heavy weight in the HK dollar effective exchange rate index (EERI)¹, remained stable against US dollar during the year. Reflecting the above developments, the EERI fell from 123.6 at the beginning of 1995 to a low of 117.7 on 19 April. It then rose to 123.5 in September before closing the year at 122.7 (Chart 1).

CHART 1: HK DOLLAR EXCHANGE RATE AND EFFECTIVE EXCHANGE RATE INDEX (JAN-DEC 95)
HK\$/US\$ EFFECTIVE EXCHANGE RATE INDEX



MANAGEMENT OF INTERBANK LIQUIDITY

The HK dollar money market was stable in 1995. Occasional injections were nevertheless made at quarter-ends to relieve market tightness due to seasonal demand. From January to August, the level of interbank liquidity (represented by the “Balance” maintained by the Management Bank with the Exchange Fund) stood at around \$2.5 bn for most of the time (Chart 2).

On signs of HK dollar exchange rate easing in August, liquidity was drained from the interbank market, and the “Balance” was reduced to \$1.2 bn. In response, the exchange rate stabilised, and the HKMA gradually injected the liquidity back into the market. Around mid-November, overnight HIBOR

showed some easing and its differential with the US interest rate widened. The HKMA withdrew excess liquidity from the market and the “Balance” was reduced to \$1.2 bn. At the end of the year, the “Balance” stood at \$1.95 bn, compared with \$2.2 bn at the end of 1994 (Chart 2).

In managing the level of interbank liquidity, the “Balance” is increased through the purchase of foreign currencies (including currency swaps) or through the buying of Exchange Fund Bills and Notes which are in effect fully backed by US dollars. In other words, consistent with the operations of the currency board arrangement, any increase in the “Balance” is effectively matched by an increase in US dollar assets in the Exchange Fund.

The Liquidity Adjustment Facility (LAF), Hong Kong’s version of the discount window, helps banks to make late adjustment to their liquidity position. Banks with excess liquidity may deposit the surplus funds with the HKMA through the LAF deposit facility. On the other hand, overnight liquidity assistance may be provided to banks through Repos involving Exchange Fund Bills and Notes and other eligible debt securities. In 1995, the average daily net deposits placed with LAF was \$331 mn (Chart 2).

HONG KONG DOLLAR INTEREST RATE

Under the linked exchange rate system, the movement of the HK dollar interest rates tracks closely that of the US interest rates. Continuing the uptrend in 1994, the US discount rate and Fed funds rate were further adjusted upwards by 50 bp on 2 February 1995. On the following day, the HKMA raised the LAF bid and offer rates by the same magnitude, to 4.25% and 6.25% respectively. In July, the Fed funds rate was cut by 25bp, ending the series of interest rate hikes since February 1994. The Fed funds rate was further adjusted downwards by another 25 bp in December. On both occasions, the HKMA did not adjust the LAF rates because the US discount rate was not changed, and the Fed funds rate was well within the range of the LAF bid and offer rates.

CHART 2: MONEY MARKET OPERATIONS AND MOVEMENT OF OVERNIGHT INTERBANK INTEREST RATE (JAN-DEC 1995)



Except in the January episode, overnight HIBOR generally moved within the range set by the LAF bid and offer rates during the year. While IPO activities remained active in 1995², they did not result in much volatility in interbank interest rates, as the subscription monies were efficiently recycled in the banking system.

Following the downward movement of the US interest rates, the three-month HIBOR fell from a peak of 8.5% in mid-January to 5.75% in the middle of the year, before stabilising at the 6% level towards the end of the year. The differential with the three-month Euro dollar deposit rate narrowed since January. The average differential was a mere 21 bp.

The short-term wholesale interbank interest rate movements were transmitted all the way to interest rates at the longer end. Following the US interest rate cut in July, the entire yield curve of Exchange Fund Bills and Notes shifted downwards. The yield on five-year Notes, for instance, peaked at 9.3% on 13 January but quickly moved down and stabilised at between 6.8% to 7.2% since June. Its differential with the US Treasuries widened in mid-January but it then narrowed to around 85 bp towards the end of 1995. Yield differential in terms of the seven-year paper, introduced in November 1995, was 102 bp at the end of the year.

Retail interest rates largely followed the movement of the wholesale interest rates. Savings deposit rate and time deposit rates which are governed under the Interest Rate Rules³ were raised by 50 bp in February. Following the US interest rate cut in December, these rates were adjusted downwards by 25 bp accordingly. The Best Lending Rate (BLR) quoted by major banks followed identical movements. By the close of the year, savings deposit rate stood at 4% while BLR was at 8.75%, 25 bp above the level at end 1994.

MODERNISATION OF LEGAL FRAMEWORK

A robust legal framework constitutes an important part of the monetary system. In 1995, the HKMA took steps to modernise the Exchange Fund Ordinance and the Bank Notes Issue Ordinance. The Exchange Fund Ordinance was amended to provide statutory backing for the "Accounting Arrangements" and to facilitate the adoption of the new interbank payment system in Hong Kong⁴. The opportunity was also taken to widen the investment ambit of the Exchange Fund to facilitate its prudent management. Amendments were also made to transfer the power over the control of the Exchange Fund previously vested in the UK Secretary of State to the Financial Secretary.

The amendments to the Bank Notes Issue Ordinance were introduced with a view to providing a legal framework for the issue of HK dollar currency notes which is fully consistent with the provisions in the Joint Declaration and the Basic Law.

¹ The EERI measures the overall exchange value of HK dollar. In 1995, the relative weights of RMB, US\$, Yen, New Taiwan \$, DM and others were 32.2%, 17.6%, 12.8%, 9.5%, 4.4%, 23.5% respectively.

² 26 new issues were floated in the Stock Exchange of Hong Kong in 1995. The total amount of subscription monies involved was around \$7.6 bn.

³ The first phase of interest rate deregulation commenced in October 1994, followed by the second phase in January 1995 and the third phase in November 1995. With the third phase of deregulation put in place, interest rate cap on time and fixed deposits of seven days or more have been removed. Details on the implementation of the interest rate deregulation are contained in the chapter on "Banking Development" in this Report.

⁴ Details of the new interbank payment system are discussed in the chapter "Development of Market Infrastructure" in this Report.