

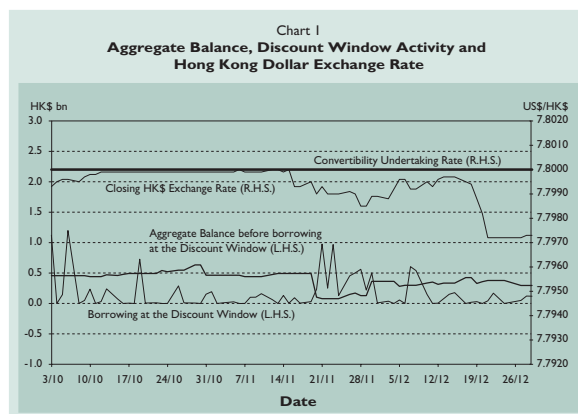
## OPERATION OF MONETARY POLICY

The Hong Kong dollar exchange rate hovered in the range 7.7990-7.8000 for most of the fourth quarter of 2001. Speculation on the Financial Secretary's comment on the long-term sustainability of the Linked Exchange Rate system caused the exchange rate to weaken and Hong Kong dollar term deposit rates to rise notably in mid-October. The positive interest carry available for holding US dollars resulted in some outflows from Hong Kong dollar. The meltdown of Argentina's currency board system and the sharp weakening of the yen towards the year-end also weighed on the forward points. Although the firm denial of de-linking from the Financial Secretary and other senior officials helped to restore some calm in the forward market, the spot exchange rate continued to stay close to 7.8000 on persistent outflows. Outflows triggered the Convertibility Undertaking (CU) on 16 November. As a result, the Aggregate Balance shrank to HK\$103 mn on 20 November and short-term interest rates moved higher. The US Federal Reserve maintained its easing monetary policy stance during the quarter and lowered the Fed funds target rate (FFTR) three times by 125 b.p. to 1.75%. Hong Kong dollar interest rates eased in tandem, though at a slower pace than their US counterparts. Tracking movements in US Treasuries, yields on Exchange Fund Notes eased initially during the quarter, but moved upwards from mid-November on growing expectation that the US rate easing cycle had been completed.

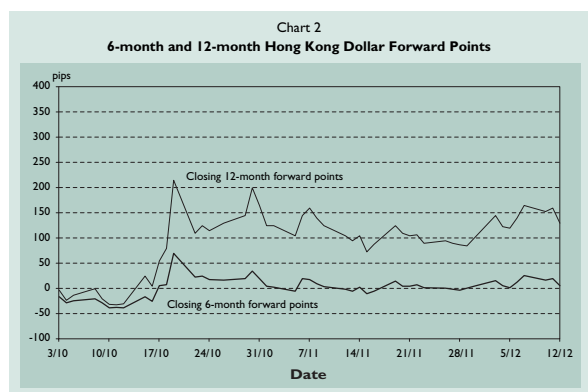
### Convertibility Undertaking and Aggregate Balance

A combination of domestic and overseas developments in the quarter caused some volatility in the Hong Kong dollar market. Hong Kong dollar forward points picked up in mid-October in response to the Financial Secretary's earlier comments on the Linked Exchange Rate system, which raised speculation about the Government's long-term commitment to it. This induced strong corporate demand to hedge Hong Kong dollar exposures in the forward market. As a result, 12-month forwards rose from a slight discount to as high as +300 pips on 19 October. Subsequently, clarification from the Financial Secretary and senior officials helped to relieve some of the pressure. The forward points then hovered around +100 pips until early December when hedging demand emerged again following the

meltdown of Argentina's currency board system and the sharp depreciation of the Japanese yen. After touching +260 pips on 21 December, 12-month forward points retreated slightly to close at +240 pips on 31 December, as compared to -10 pips on 28 September (Chart 1).



The Hong Kong dollar exchange rate drifted towards 7.8000 in mid-October and the Convertibility Undertaking (CU) was triggered on 16 November, lowering the Aggregate Balance from HK\$493 mn to HK\$103 mn on 20 November. With tighter interbank liquidity, domestic interest rates went up swiftly and effectively stemmed further outflows. On 29 November, the exchange rate went as high as 7.7983 and the HKMA passively bought a small amount of US dollars through the Currency Board Account, thus replenishing the Aggregate Balance to HK\$363 mn on 30 November. Subsequently, the usual year-end demand for funds again lifted the exchange rate, which touched 7.7965 on 27 December before ending at 7.7978 on 31 December, as compared to 7.7994 at end-September. The Aggregate Balance ended the quarter at HK\$296 mn, as compared to HK\$497 mn at end-September (Chart 2).



Meanwhile, US economic figures released during the fourth quarter were mixed as to the prospects of an early US economic recovery. It was generally expected, however, that the US economy would bottom out soon. To help lift the US economy out of the trough, the Federal Reserve retained an easing bias and lowered the Fed funds target rate (FFTR) three times during the quarter, twice by 50 b.p. and once by 25 b.p. on 2 October, 6 November and 11 December respectively. This brought the FFTR down to 1.75%, as against 3.00% at end-September.

In Hong Kong, the HKMA Base Rate<sup>1</sup> was adjusted in parallel with the FFTR cuts, coming down by 125 b.p. to 3.25% on 12 December. The savings rates quoted by the major banks stood at 0.125% at end-December, as compared to 1.00% at the end of previous quarter.

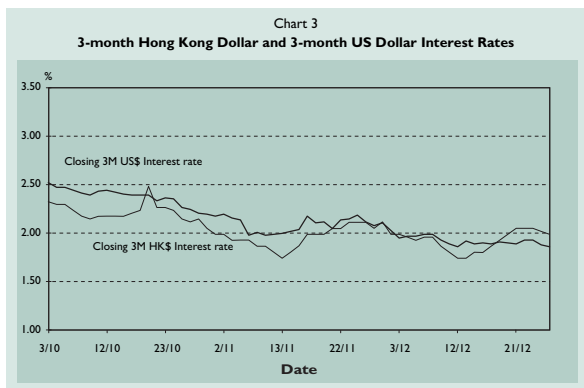
### Short-term Hong Kong Dollar Interest Rates

Hong Kong dollar overnight interest rate eased gradually from around 2.50% to 1.50% between early October and mid-November, following the 100 b.p. easing in the FFTR. It then spiked briefly in late November after the triggering of the CU, rising briefly above the HKMA Base Rate of 3.50%, touching 3.75% and 3.69% on 23 and 30 November respectively. Following the replenishment of the Aggregate Balance on 30 November, the overnight rate immediately eased back to the range 1.50-2.00%. The usual year-end demand for Hong Kong dollar funding sent the overnight rate slightly higher to 2.88% before the rate finally closed at 1.38% on 31 December, as compared to 4.00% at end-September.

Hong Kong dollar term deposit rates eased initially with their US dollar counterparts, but were dragged higher in mid-October by the rising Hong Kong dollar forward points, resulting in a narrower negative spread between Hong Kong dollar and US dollar interest rates. As the nervousness in the forward market subsided, the term rates eased again, widening the negative interest spreads. In mid-November, the term rates picked up along with the US dollar rates as the market became more optimistic about a possible turnaround in the US economy, which dampened the prospect of further Fed easing in the near future. The triggering of the CU in late November, the deepening of the Argentine woes and the yen weakness towards the end of the quarter also set a floor on the term rates. 3-month Hong Kong dollar money market rate rose to end at 2.00% by

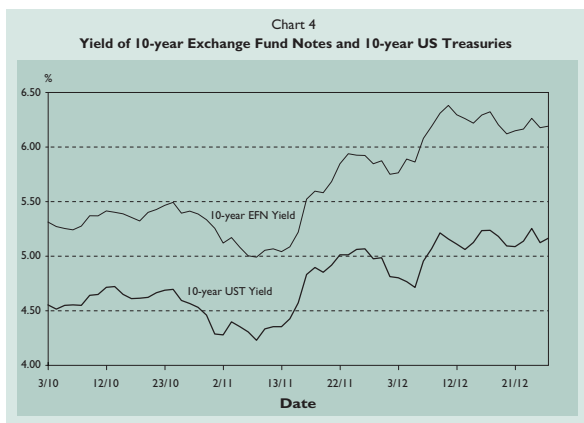
<sup>1</sup> Defined as the higher of the US FFTR plus 150 b.p., and the simple average of the 5-day moving averages of overnight and 1-month HIBOR for the previous five trading days.

end-December, or 13 b.p. above its US dollar counterpart (Chart 3).



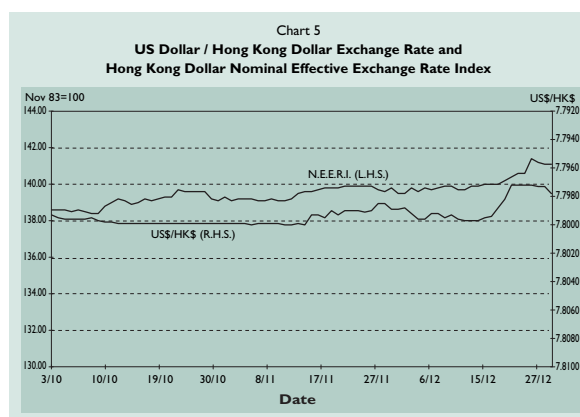
### Long-term Hong Kong Dollar Interest Rates

US Treasuries prices went up during the quarter on continued rate cut expectations, but corrected downwards in mid-November as the release of some favourable US economic data led the market to speculate that the US rate cut cycle might end soon. Mirroring the movements of their US counterparts, the yields on Exchange Fund Notes (EFN) bottomed out in mid-November and picked up gradually towards the end of the quarter. The 10-year EFN yield rose gradually from a low of 5.00% on 8 November to a high of 6.41% on 11 December before closing at 6.22% on 31 December, as compared to 5.38% on 28 September. As the EFN yield rose at a faster pace than that of US Treasuries, the yield spread of the 10-year EFN over US Treasuries widened to 104 b.p. on 31 December from 76 b.p. at end-September (Chart 4).



### Hong Kong Dollar Effective Exchange Rate

The Hong Kong dollar trade-weighted nominal effective exchange rate index (NEERI), which measures the nominal exchange rate of Hong Kong dollar against currencies of major trading partners, closed at 141.10 on 31 December, as compared to 138.40 at the end of the third quarter. The higher NEERI reflected the strengthening of the US dollar against other major currencies, in particular the Japanese yen (Chart 5).



### Domestic Credit and Money Supply

Credit expansion remained sluggish in the fourth quarter of 2001. Domestic loans (including loans for trade financing) contracted moderately by 1.3% during the quarter, leading to a year-on-year decline of 4.3% in 2001. The drop reflected a slowdown in economic activity and increased uncertainties about the business outlook, amid a worsening external environment.

Narrow money supply (HK\$M1) increased further, by around 6% on a seasonally adjusted basis, in the fourth quarter, reflecting increases in both demand deposits and currency held by the public. The rise may in part have reflected the reduced opportunity cost of holding money as a result of lower interest rates. Broad money (HK\$M3) increased slightly, by 0.2%, in the fourth quarter, mainly attributable to increases in demand and savings deposits. Compared with a year earlier, HK\$M1 grew by nearly 13%, significantly outpacing growth of the value of retail sales, while HK\$M3 rose by only about 1%.

- Prepared by the Monetary Policy and Markets Department