

# Operation of Monetary Policy

by the Monetary Management and Infrastructure Department

Despite the war in Iraq, the Hong Kong dollar exchange rate and interest rate markets remained stable during the first quarter of 2003. The Convertibility Undertaking was not triggered and the Hong Kong dollar exchange rate moved in a narrow range. The forward points picked up briefly in late January and late February on renewed concerns about the currency peg and the growing fiscal deficits respectively. As expected, the US Federal Reserve left the Fed funds target rate unchanged but, in an unusual move, declined to characterise the balance of risks concerning price stability and economic growth amidst the uncertainty caused by the Iraqi war. The Hong Kong dollar interest rates moved lower in tandem with their US dollar counterparts. Tracking the movements of the yields on US Treasuries, the yields on Exchange Fund Notes dropped initially, but picked up towards the end of the quarter.

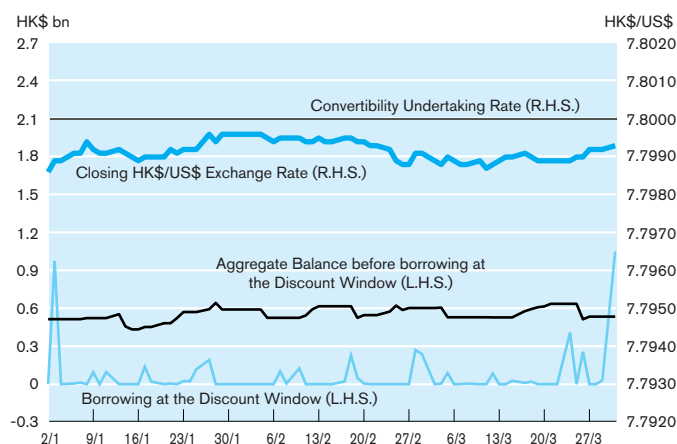
## Convertibility Undertaking and Aggregate Balance

The Hong Kong dollar exchange rate exhibited a stable pattern during the quarter. For the first two months, it moved mostly in the range 7.7990 - 7.7995. The exchange rate, however, strengthened slightly in late February as the relatively firm short-term Hong Kong dollar interest rates attracted some Hong Kong dollar buying interest. The exchange rate then stayed marginally below 7.7990 before picking up slightly to end at 7.7993 on 31 March 2003, compared to 7.7987 on 31 December 2002. The Convertibility Undertaking was not triggered during the quarter and the level of the Aggregate Balance stayed largely within the range HK\$500-600 million. The Aggregate Balance ended the quarter at HK\$535 million, compared to HK\$525 million at end-December 2002 (Chart 1).

The Hong Kong dollar forward points firmed slightly in late January apparently in response to a bank's research report suggesting the Government to

devalue the Hong Kong dollar and adopt a managed float exchange rate regime. 12-month forward points touched +193 pips on 30 January 2003, but soon softened as the concerns about the peg subsided. Prior to the Financial Secretary's Budget Speech on 5 March 2003, the forward points rose again on market scepticism about the effectiveness of the

**CHART 1**  
Aggregate Balance, Discount Window Activity and Hong Kong Dollar Exchange Rate



proposed belt-tightening measures to address the growing fiscal deficit problem. The 12-month forward points reached +220 pips on 26 February 2003, but then retreated gradually as the market assimilated the impact of the Budget. After dipping to a low of +118 pips on 25 March 2003, the 12-month forward points moved upwards again as the market became concerned over the outbreak of severe acute respiratory syndrome (SARS). 6-month and 12-month forward points closed at +46 pips and +140 pips respectively on 31 March 2003, compared to +65 pips and +170 pips at end-December 2002 (Chart 2).

As widely expected, the Federal Reserve left the Fed funds target rate unchanged at 1.25% at the two Federal Open Market Committee (FOMC) meetings held on 28 & 29 January and 18 March 2003. However, in a highly unusual move, the Federal Reserve said at the FOMC meeting on 18 March 2003, the day before US President George Bush formally announced the start of military action in Iraq, it would not characterise the current balance of risks on price stability or economic growth because of the large uncertainties clouding the geopolitical situation. Under the circumstances, the Federal Reserve pledged "heightened surveillance" of the US economy. Meanwhile, the US economic indicators were dismal, reflecting a lacklustre economy. In

Hong Kong, the Base Rate remained unchanged at 2.75% while the savings rates quoted by major banks stayed at 0.01% throughout the first quarter of 2003.

## Short-term Hong Kong Dollar Interest Rates

Amidst abundant interbank liquidity, the Hong Kong dollar overnight interest rate stayed soft during the first quarter despite some spikes due to month-end demands for funds. For most of the time, the overnight rate stayed below its US dollar counterparts and moved between the narrow range 1.18% - 1.40%. The overnight rate finally ended the quarter at 1.44%, compared to 1.59% on 31 December 2002 (Chart 3).

Hong Kong dollar term deposit rates moved in close proximity to their US dollar counterparts, which eased gradually from the beginning of the quarter as disappointing economic data showed persistent weakness in the US economy. In line with the movements of the forward points, the spreads between Hong Kong dollar and US dollar interest rates widened briefly in late January and late February, but remained steady for the rest of the quarter. 3-month Hong Kong dollar money market rate ended the quarter at 1.33%, 3 basis points

CHART 2

### 6-month and 12-month Hong Kong Dollar Forward Points

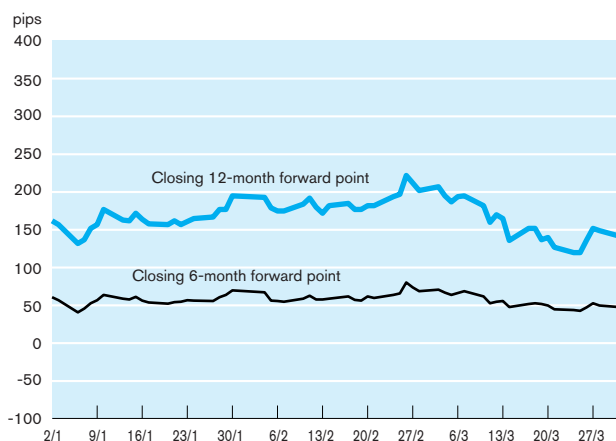
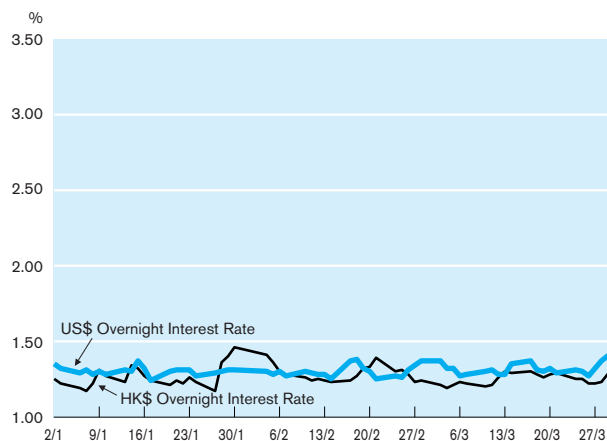


CHART 3

### Overnight Hong Kong Dollar and Overnight US Dollar Interest Rates



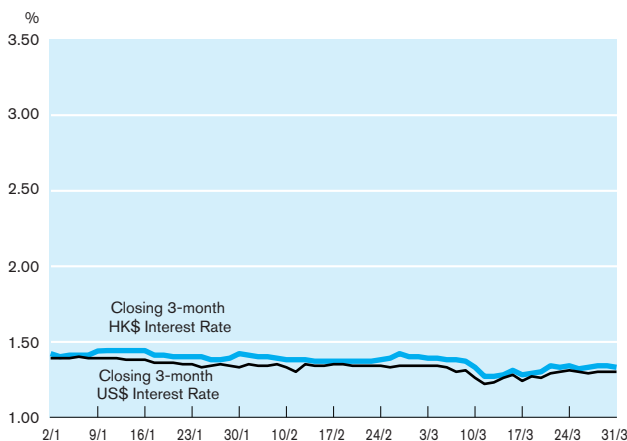
above its US dollar counterpart, compared to 1.47% at end-December 2002, 9 basis points above the corresponding US dollar rate (Chart 4).

## Long-term Hong Kong Dollar Interest Rates

US Treasuries gained on safe-haven buying amidst poor performance of the US equity market, the looming war threat and anxiety about possible terrorist attacks. Nevertheless, as the war in Iraq began on 19 March 2003, optimism, premised on a quick conclusion to the war, weighed on the US Treasuries prices. Mirroring the movements of their US counterparts, the yields on Exchange Fund Notes (EFN) bottomed out in mid-March and picked up gradually towards the end of the quarter. The 10-year EFN yield finally closed at 4.44% on 31 March 2003, compared to 4.27% on 31 December 2002. As the EFN yield rose at a slightly faster pace than the US Treasuries, the yield spread of 10-year EFN over the US Treasuries widened to 59 basis points on 31 March 2003, compared to 44 basis points on 31 December 2002 (Chart 5).

CHART 4

### 3-Month Hong Kong Dollar and 3-Month US Dollar Interest Rates



## 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 the Hong Kong dollar against currencies of major trading partners, closed marginally lower at 101.90 on 31 March 2003, compared to 102.00 at end-December 2002 (Chart 6). The lower NEERI reflected the weakening of the US dollar against other major currencies, in particular the euro.

CHART 5

### Yield of 10-year Exchange Fund Notes and 10-year US Treasuries

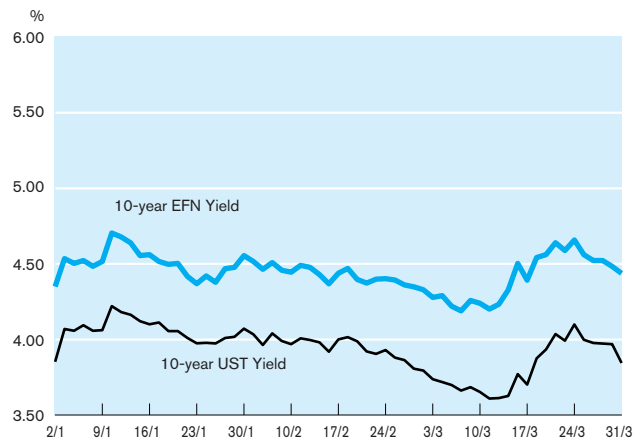


CHART 6

### Hong Kong Dollar / US Dollar Exchange Rate and Hong Kong Dollar Nominal Effective Exchange Rate Index

