Operation of monetary policy

by the Monetary Management and Infrastructure Department

A statement issued on 20 September 2003 by the G7 finance ministers calling for more exchange rate flexibility triggered an exodus of capital from US dollar denominated assets. The euro and the yen appreciated significantly as a result, while the Asian currencies in general, including the Hong Kong dollar, also felt the pressure to strengthen. The Hong Kong dollar exchange rate spiked up sharply in late September before gradually settling in October, though at levels considerably stronger than in the previous quarter. To maintain monetary stability and avoid excessive deviation of the Hong Kong dollar exchange rate from the linked rate of HK$7.8 to US$1, the HKMA purchased US dollars from the interbank market. As a result, the Aggregate Balance expanded by over HK$27 billion during the quarter. Amidst abundant interbank liquidity, the Hong Kong dollar interest rates fell noticeably. With the widening negative interest differential between Hong Kong dollar and US dollar, Hong Kong dollar forward points dipped into deep discounts. Meanwhile, the US Federal Reserve left the Fed funds target rate unchanged during the quarter, and the US economic outlook brightened, as reflected by a series of positive economic data. Yields on long-term Exchange Fund Notes moved up slightly, in parallel with movements in the yields on US Treasuries.

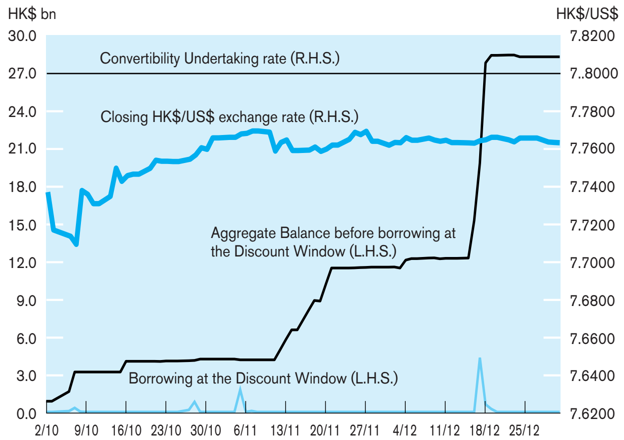
Convertibility Undertaking and Aggregate Balance

While the market interpreted that the G7 statement issued on 20 September calling for more exchange rate flexibility was targeting the implicit or explicit peg rate regimes essentially adopted by most of the Asian countries, buying interest in Hong Kong dollar emerged also because of the speculation that the Hong Kong dollar would strengthen alongside a possible renminbi revaluation. In late September and early October, the Hong Kong dollar strengthened towards the 7.70 level in thin market conditions. Coupled with signs of improvement in the domestic economy, sentiments on Hong Kong improved significantly towards the end of last quarter. The listing and IPO of a number of Chinese enterprises, including Great Wall Automobile, China Life Insurance and Zijin Mining Industry in the local equity market attracted significant equity-related inflows in December. To maintain monetary stability and avoid excessive deviation of the Hong Kong dollar exchange rate from the linked rate of HK$7.8 to US$1, the HKMA has accepted offers to buy US dollars through the Currency Board Account since early October. As a result, the Hong Kong dollar exchange rate stabilised between 7.7600 - 7.7700 from early November. The exchange rate ended at 7.7631 on 31 December as compared to 7.7426 on 30 September. With the purchase of US dollars through the Currency Board Account, the Aggregate Balance was inflated progressively from late September. The Aggregate Balance ended the quarter at HK$28,277 million, as compared to HK$1,006 million at end-September (Chart 1).

The forward discount in the Hong Kong dollar exchange rate mirrored the interest rate gap between US dollar and Hong Kong dollar, narrowing initially with the easing Hong Kong dollar exchange rate in October, but widening in early November. 12-month forward points dipped to -385 pips on 7 October

CHART 1

Aggregate Balance, Discount Window activity and Hong Kong dollar exchange rate



and rose gradually to -103 pips on 4 November, and dropped again as Hong Kong dollar interest rate fell on the rapid expansion of the Aggregate Balance. 6-month and 12-month forward points closed at -365 pips and -600 pips respectively on 31 December, as compared to -85 pips and -80 pips at end-September (Chart 2).

As widely expected, the Federal Reserve left the Fed funds target rate unchanged at 1.00% at the Federal Open Market Committee (FOMC) meetings on 28 October and 9 December 2003. The FOMC press statements reiterated that the Federal Reserve would hold its accommodating monetary policy stance for a considerable period and upgraded its assessment on the US economy. The Federal Reserve changed its assessment on the balance of risk at the 9 December FOMC meeting, saying in the press statement that the risk for inflation had become equal to that of disinflation. Meanwhile, US economic data released during the quarter continued to show signs of strengthening in the US economy, and significant improvements were noted in the manufacturing sector. The labour market was also showing some signs of improvement after an extended period of weakness. In Hong Kong, the Base Rate remained unchanged at 2.50% during the quarter while the savings rates quoted by major banks stayed at 0.01% throughout the period.

Short-term Hong Kong dollar interest rates

The exceptionally large Aggregate Balance sent short-term Hong Kong dollar interest rates down quickly. Overnight rate stayed close to zero for most of the time during the quarter, except on a few occasions in mid December when vigorous IPO activities resulted in keen demand for short-term Hong Kong dollar funding and drove the overnight rate higher. The overnight rate spiked to 1% on 17 December but then eased quickly after the IPO-related funding demand subsided. On 31 December, the overnight rate ended at 0.002%, as compared to 0.63% on 30 September (Chart 3).

With abundant interbank liquidity, Hong Kong dollar term deposit rates dropped noticeably during the quarter to stay well below their US dollar

CHART 2

6-month and 12-month Hong Kong dollar forward points

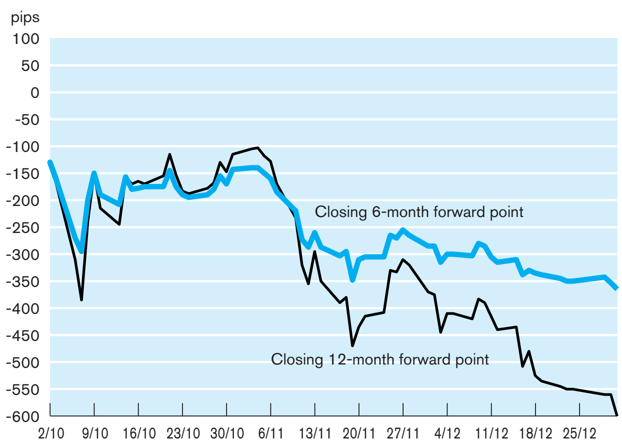
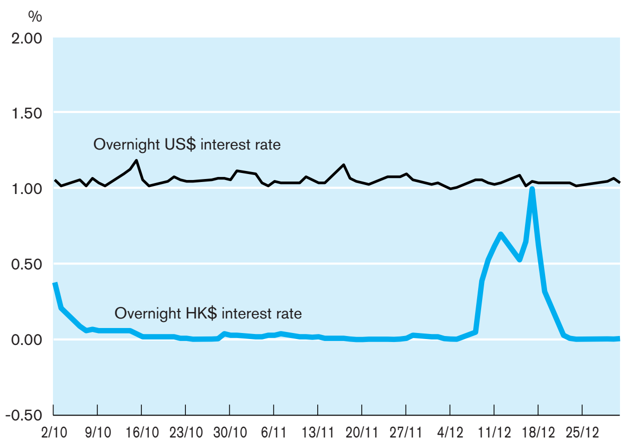


CHART 3

Overnight Hong Kong dollar and overnight US dollar interest rates



counterparts. As US dollar interest rates barely changed during the reporting period, the negative interest differential between Hong Kong dollar and US dollar widened significantly. 3-month Hong Kong dollar money market rate ended the quarter at 0.08%, 106 basis points below its US dollar counterpart, as compared to 0.75% at end-September, 42 basis points below the corresponding US dollar rate (Chart 4).

Long-term Hong Kong dollar interest rates

The yields on US Treasuries rose initially during the quarter on the back of favourable economic data that heightened expectation of earlier tightening by the Federal Reserve. Nevertheless, repeated assurance from the Federal Reserve convinced the market that inflation was not a threat to US economic recovery in the near term horizon. As a result, US Treasuries yields started to retrace in mid-November. Yields on Exchange Fund Notes (EFN) moved in tandem with the yields on US Treasuries. The 10-year EFN yield peaked at 4.66% on 2 December before ending at 4.39% on 31 December, as compared to 4.27% at the end-September. The yield spread of 10-year EFN over US Treasuries once narrowed to -4 basis points on 24 October before picking up gradually to 8 basis points on 31 December, as compared to 15 basis points on 30 September. (Chart 5).

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 weaker at 98.8 on 31 December, as compared to 99.9 at end-September (Chart 6). The lower NEERI reflected the weakening of the US dollar against the major currencies, in particular the euro and the Japanese yen.

CHART 5

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

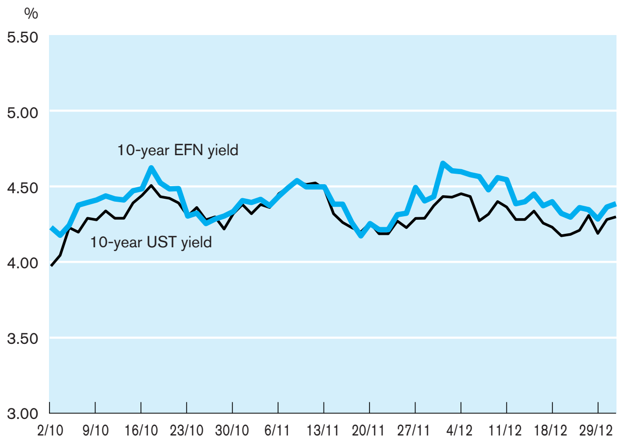


CHART 4

3-month Hong Kong dollar and 3-month US dollar interest rates

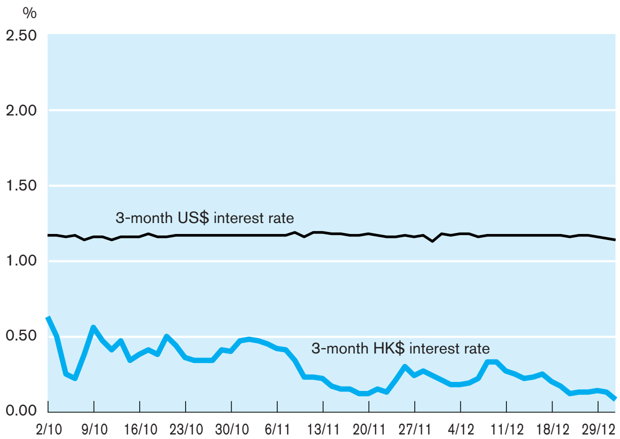


CHART 6

Hong Kong dollar / US dollar exchange rate and Hong Kong dollar nominal effective exchange rate index