Operation of monetary policy

by the Monetary Management and Infrastructure Department

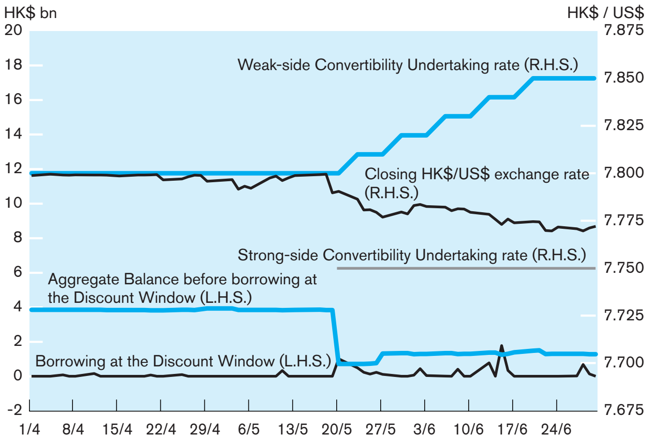
The HKMA's announcement of the three refinements to the Linked Exchange Rate system on 18 May successfully removed the anomalies in the market, driving the Aggregate Balance back to a more normal level and aligning short-term Hong Kong dollar interest rates more closely with their US dollar counterparts. The introduction of an explicit strong-side Convertibility Undertaking cleared the uncertainty about how much the Hong Kong dollar can appreciate, and effectively ended the hoarding of Hong Kong dollar as a proxy hedge to the renminbi. Immediately after the announcement of the refinements, the weak-side Convertibility Undertaking of 7.8 was triggered, prompting the HKMA to buy HK$3.12 billion from banks. Thereafter, as political pressure from the US for renminbi revaluation intensified, the Hong Kong dollar exchange rate strengthened again. To address the rising demand for Hong Kong dollar funding for a number of equity initial public offerings (IPOs) in June, the HKMA conducted market operations within the Convertibility Zone on 25 May, selling HK$544 million to banks. Meanwhile, the US Federal Reserve raised the Fed funds target rate by a total of 50 basis points in May and June. However, yields on long-term Exchange Fund Notes declined modestly, in line with the movement in the yields of the corresponding US Treasuries.

Convertibility Undertaking and Aggregate Balance

The Hong Kong dollar strengthened in the second quarter as the market sought to use it as a proxy hedge for an imminent renminbi revaluation. The appreciation of the Hong Kong dollar was interrupted when the HKMA announced the three refinements to the Linked Exchange Rate system on 18 May. The weak-side Convertibility Undertaking was triggered on the same day, causing the HKMA to buy HK$3.12 billion from banks, bringing the Aggregate Balance down from HK$3.83 billion to HK$714 million on 20 May. The optimism about the Hong Kong dollar resumed quickly amid a series of equity-related IPO activities in early June. In order to ease the liquidity tightness in the interbank market and reduce any unnecessary stress in the payment system, the HKMA bought a small amount of US dollars through the Currency Board accounts, increasing the Aggregate Balance by about HK$500 million to HK$1,317 million on 27 May. The operation was effective in limiting the sharp increase of overnight Hong Kong dollar interest rates throughout the subscription periods of the IPOs of the Bank of Communications and China Shenhua Energy, both of which ended in mid-June. The Aggregate Balance closed at HK$1.28 billion on 30 June, compared with HK$3.85 billion on 1 April. The Hong Kong dollar exchange rate closed stronger at 7.7721 on 30 June, compared with 7.7988 on 1 April (Chart 1).

CHART 1

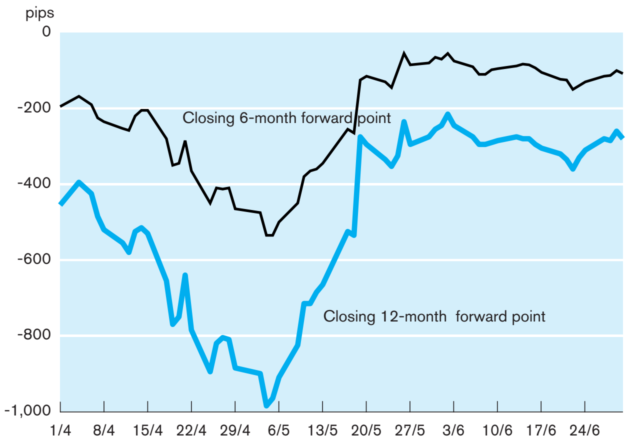
Aggregate Balance, Discount Window activity and Hong Kong dollar exchange rate



The implementation of the three refinements successfully removed the anomalies in the Hong Kong dollar interbank money market and the gap between the Hong Kong dollar and US dollar interest rates narrowed immediately. As a result, the forward discounts in the Hong Kong dollar exchange rate narrowed significantly. The 6-month and 12-month Hong Kong dollar forward points closed higher at -108 pips and -280 pips respectively on 30 June, compared with -195 pips and -445 pips on 1 April (Chart 2).

CHART 2

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

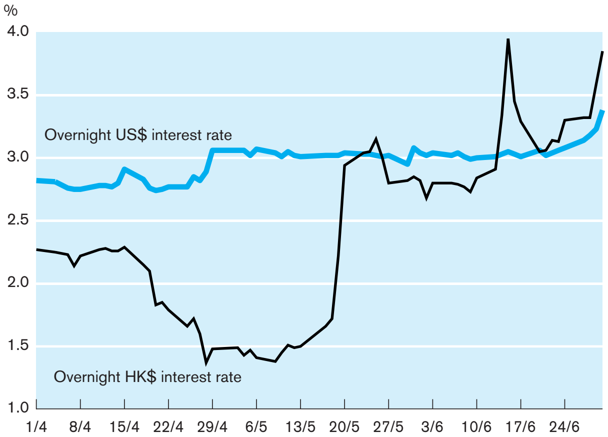


The Federal Reserve maintained its measured pace of monetary policy tightening and raised the Fed funds target rate by a total of 50 basis points at the Federal Open Market Committee meetings in May and June. High oil prices and a spate of upbeat US economic indicators appeared to have caused concern among the Federal Reserve Board members, prompting them to maintain their tightening bias for the remainder of 2005. The HKMA Base Rate was raised to 4.50% on 4 May, and subsequently to 4.75% on 2 July, following the interest rate increases by the Federal Reserve.

Short-term Hong Kong dollar interest rates

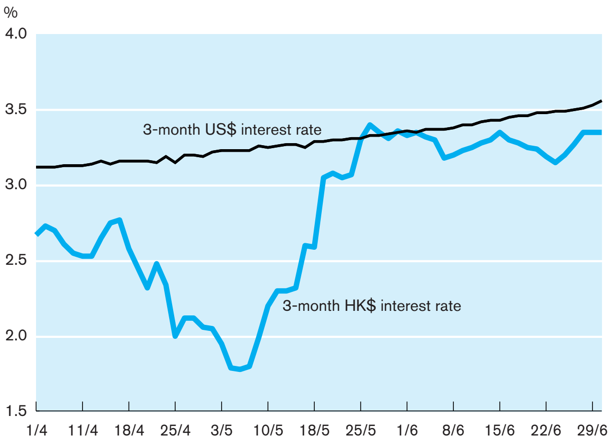
The refinements to the Linked Exchange Rate system effectively eliminated the uncertainty about how much the Hong Kong dollar can strengthen, revitalising interest rate arbitrage activities and helping to align Hong Kong dollar interest rates with their US counterparts. Immediately following the announcement of the refinements, the Hong Kong dollar yield curve shifted up, tracking closely the US dollar yield curve. Subsequently, a flurry of IPOs of Mainland enterprises boosted the sentiment in the local equities market, and the overwhelming response exerted strong pressure on Hong Kong dollar funding demand. The overnight Hong Kong dollar interest rate increased sharply to an intra-day high of 5.0% on 16 June as the Bank of Communications IPO attracted some HK$150 billion of subscription money, and finally closed at 3.85% at the end of June, compared with 2.3% three months ago (Chart 3).

CHART 3
Overnight Hong Kong dollar and US dollar interest rates



Because the refinements announced in mid-May effectively eliminated the interest rate differential between the US and Hong Kong, Hong Kong dollar term rates picked up significantly towards the end of June. The three-month Hong Kong dollar money market rate closed at 3.35% on 30 June, or 21 basis points below its US dollar counterpart, compared with 2.72% or 41 basis points below the corresponding US dollar rate at the end of March (Chart 4).

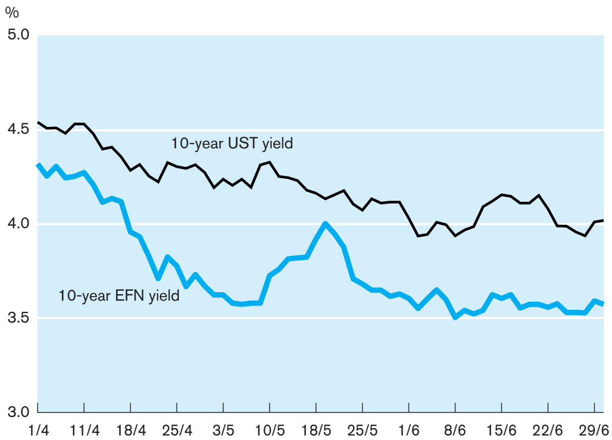
CHART 4
3-month Hong Kong dollar and US dollar interest rates



Long-term Hong Kong dollar interest rates

During the second quarter, long-term yields on the Hong Kong dollar were lower than their US counterparts. While the US Federal Reserve maintained its "measured" pace of removing its "accommodative" monetary policy, US long-term yields actually declined in the second quarter. The 10-year US Treasury yield decreased from 4.61% at the end of March to 4.02% at the end of June. The yield of 10-year Exchange Fund Notes declined at an even faster pace than its US counterpart in early May. The improved sentiment in the local equities market and the general upbeat tone of the local economy helped stabilise Hong Kong dollar term rates, with 10-year Exchange Fund Notes yield closing at 3.6% on 30 June. The yield spread of the 10-year Exchange Fund Notes over US Treasuries widened to -73 basis points on 9 May before closing at -44 basis points at the end of June, compared with -21 basis points at the end of March (Chart 5).

CHART 5
Yields of 10-year Exchange Fund Notes and US Treasuries



Hong Kong dollar effective exchange rate

The Hong Kong dollar trade-weighted nominal effective exchange rate index (NEERI), which measures the nominal exchange value of the Hong Kong dollar against currencies of major trading partners, closed stronger at 98.2 on 30 June, compared with 96.7 at the end of March (Chart 6). The higher NEERI reflects the broad-based strengthening of the US dollar, in particular against the euro and the Japanese yen.

CHART 6

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