

Operation of monetary policy

by the Monetary Management Department

In the second quarter of 2009, capital flows into the territory continued and the Hong Kong-dollar exchange rate stayed close to the strong-side Convertibility Undertaking (CU) level of HK\$7.75. The persistent inflows were reportedly driven by equity-related demand. During the quarter, the strong-side CU was repeatedly triggered, leading to an expansion of the Aggregate Balance. Consequently, interbank interest rates stayed at very low levels. An additional HK\$85.6 billion of Exchange Fund Bills were issued to meet the strong market demand as manifested in the very low yields of the short-dated Exchange Fund papers. In line with the US Federal Funds Target Rate (FFTR), the HKMA Base Rate stayed at 0.50% during the quarter.

Upon the expiry of the five temporary liquidity assistance measures at the end of March, the HKMA decided to incorporate foreign-exchange swaps and term repos into its ongoing market operations to provide liquidity assistance to banks, if needed, on a case-by-case basis, while restoring the previous Discount Window arrangements to safeguard exchange-rate stability. For the review of the Base Rate formula adjusted in October 2008, the HKMA decided to retain the narrower spread of 50 basis points above the prevailing US FFTR but reinstate the HIBOR leg to allow the functioning of interest-rate adjustment under the Currency Board system as necessary.

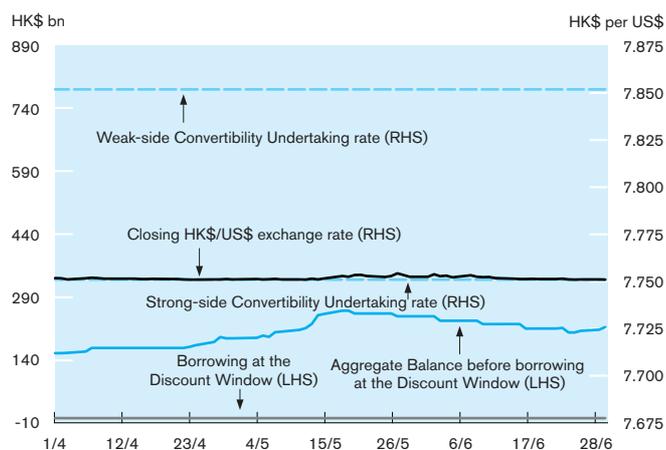
Convertibility Undertaking and Aggregate Balance

In the face of persistent capital inflows, the Hong Kong-dollar exchange rate remained close to the strong-side CU level throughout the quarter. The inflows were reportedly driven by equity-related demand. The strong-side CU was repeatedly triggered (Chart 1) during the quarter. As a result,

the Aggregate Balance rose from HK\$155.3 billion at the beginning of the quarter to HK\$217.7 billion by the end of the quarter, despite the fact that HK\$85.6 billion of additional Exchange Fund Bills were issued against the Aggregate Balance to meet the strong market demand as reflected in the very low yields of these papers.

CHART 1

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



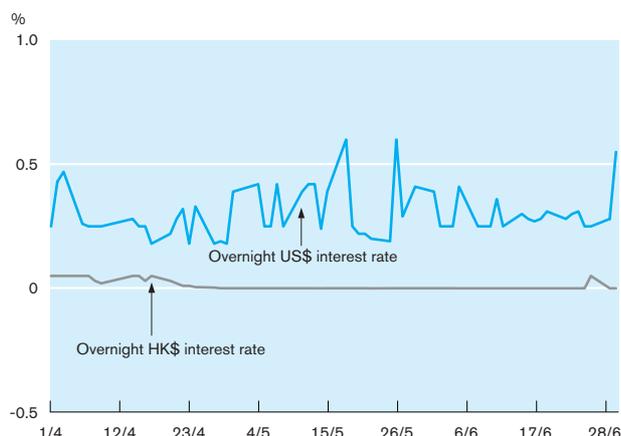
Short-term Hong Kong-dollar interest rates

In March, the HKMA reviewed the five temporary liquidity assistance measures¹ introduced in late September last year. Having taken account of market response, the HKMA announced on 26 March that, after the expiry of the five temporary measures at the end of March, it would incorporate two of the measures, foreign-exchange swaps and term repos, into its ongoing market operations to offer Hong Kong-dollar liquidity assistance to banks, if needed, on a case-by-case basis. Meanwhile, the previous Discount Window arrangements (i.e. using only Exchange Fund paper for overnight repos) would be restored so as to safeguard exchange-rate stability under the Currency Board system. The HKMA also reviewed the Base Rate formula adjusted on 8 October 2008 and decided to retain the narrower spread of 50 basis points over the US FFTR. However, the HIBOR leg was reinstated in the calculation of the Base Rate² to allow the functioning of interest-rate adjustment under the Currency Board system as necessary.

In light of ample liquidity in the interbank market, the short-term interest rates stayed at very low levels throughout the quarter (Chart 2).

CHART 2

Overnight Hong Kong-dollar and US-dollar interest rates



¹ See the relevant HKMA press releases available on the HKMA website: (a) "HKMA to provide liquidity assistance to licensed banks in Hong Kong" (issued on 30 September 2008); (b) "HKMA to adjust the formula for determination of the base rate" (issued on 8 October 2008); and (c) "Refinements to the measures for providing liquidity assistance to licensed banks in Hong Kong" (issued on 6 November 2008).

With short-term Hong Kong-dollar interest rates tracking their US counterparts, the three-month interest-rate differential between the two currencies stayed relatively stable (Chart 3). Nevertheless, 12-month forward points fell slightly (Chart 4).

CHART 3

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

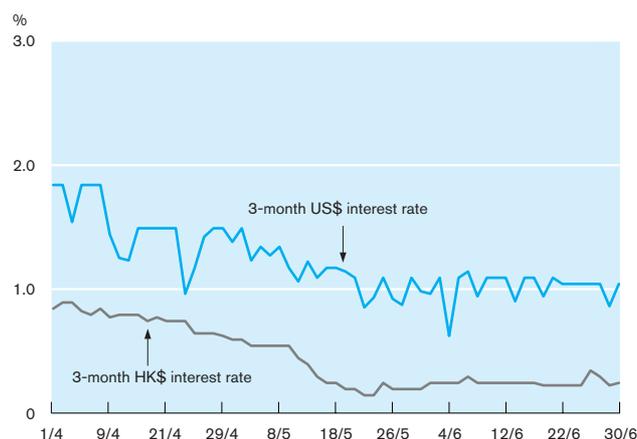
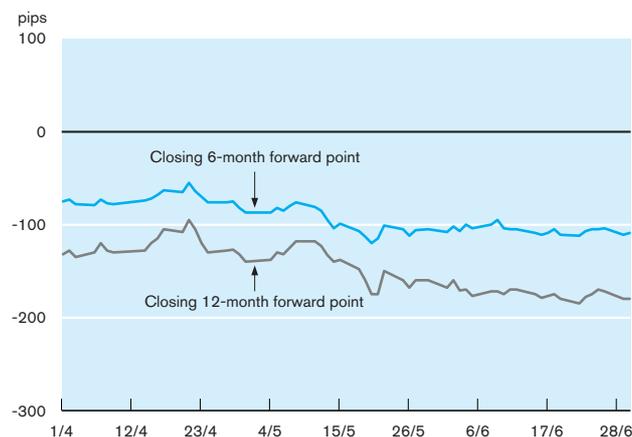


CHART 4

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



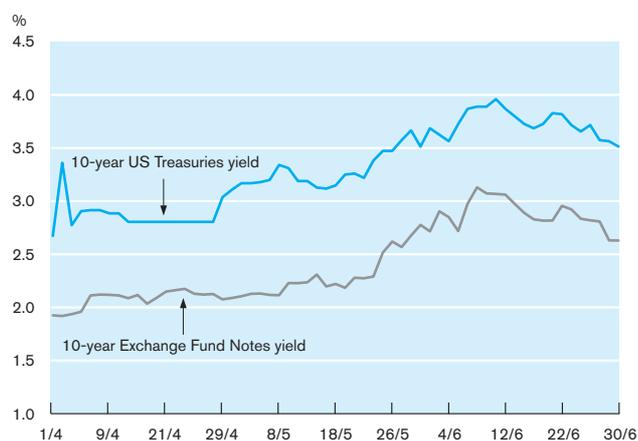
² The Base Rate is set at either 50 basis points above the prevailing US FFTR or the average of the five-day moving averages of the overnight and one-month HIBORs, whichever is the higher.

Long-term Hong Kong-dollar interest rates

Long-term yields of Exchange Fund Notes largely followed those of US Treasuries to rise during the second quarter of 2009. By the end of the quarter, the negative yield spread between 10-year US Treasuries and 10-year Exchange Fund Notes widened marginally to -89 basis points from -75 basis points at the beginning of the quarter (Chart 5).

CHART 5

Yield 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 the currencies of major trading partners, closed slightly lower at 88.0 on 30 June, compared with 90.6 on 1 April (Chart 6). The lower NEERI reflects the weakening of the US dollar, particularly against the euro and the yen.

CHART 6

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

