In the first quarter of 1995, the linked exchange rate system proved robust in delivering exchange rate stability amidst volatility in the foreign exchange market. Along with the weakening of the US dollar, the Effective Exchange Rate Index (EERI) of the HK dollar fell moderately by 3% during the quarter. Meanwhile, overnight interbank interest rates moved down from the peak in mid-January and settled down when the exchange rate returned to the prevailing level at around 7.73.

HK dollar exchange rate

At the beginning of 1995, the HK dollar exchange rate softened slightly against the US dollar due to possible outflows of funds, accompanied by downward movements of local stock prices since the last quarter of 1994.

In the aftermath of the Mexican currency crisis, there was an unusual speculative interest against several Asian currencies in the second week of January. The HK dollar, affected also by unfounded rumours of Moody's possible downgrading of Hong Kong and China's ratings, came under some selling pressure along with the currencies of some Asian emerging markets. Speculators were apparently unable to distinguish Mexico's balance of payments position from the generally sound economic fundamentals in the Asian region. In the event, the HK dollar exchange rate eased briefly against the US dollar, touching a low of 7.7725 as selling pressure intensified on 12 January. However, with HKMA's intervention in the foreign exchange market and the money market, the HK dollar exchange rate quickly returned, in around a week, to around 7.73, the prevailing level before the speculative attack.

On the back of the strong form of currency board arrangements operating in Hong Kong and effective monetary management by the HKMA, the HK dollar exchange rate moved by less than 0.5% and remained on the strong side of the linked rate in the second week of January (Chart 1). Prompt and decisive action by the HKMA had achieved the monetary policy objective of exchange rate stability.

In February, financial markets turned volatile as the US dollar continued to weaken against other major currencies due to a multitude of factors. While markets were expecting the US dollar interest rates to peak, they were also concerned about the possible contagion effect of the Mexican problem on other highly indebted countries, the worsening US trade deficit, and the potential repatriation of funds by Japanese companies in the wake of the Kobe earthquake. The collapse of the Barings Group offset the news of the success of the Sino-US negotiations on intellectual property rights. In the March quarter of 1995, the US dollar weakened by 12% against the D-Mark, by 14% against the Yen, and by 4% against Sterling.

Notwithstanding these developments, the HK dollar exchange rate remained stable against the US dollar and has traded within a narrow range between 7.730 and 7.734 since February. The trade-weighted Effective Exchange Rate Index (EERI) of the HK dollar weakened slightly by 3% from 121 at the beginning of the year to 117 at the close of the quarter.

Monetary Management

On the first trading day of 1995, some $4.9 bn was withdrawn from the interbank market (Chart 2) to recycle the monies injected earlier by the HKMA to meet the larger demand for year-end settlements. The net injection[1] during the last two trading days of 1994 amounted to some $6.9 bn. When the tightness eased, the Balance before LAF declined from $6.2 bn on 31 December 1994 to $1.9 bn on 3 January 1995 (Chart 3).

From early January, overnight HIBOR remained close to the LAF offer rate (Chart 4). As the HK dollar exchange rate softened, the HKMA slowly reduced the supply of interbank liquidity. When the speculative attack against the HK dollar occurred

1 Net injection refers to the effect of the money market activity undertaken by the HKMA during the day, net of the effect of reversal of LAF at the opening of the day.

Chart 1
HK Dollar Exchange Rate

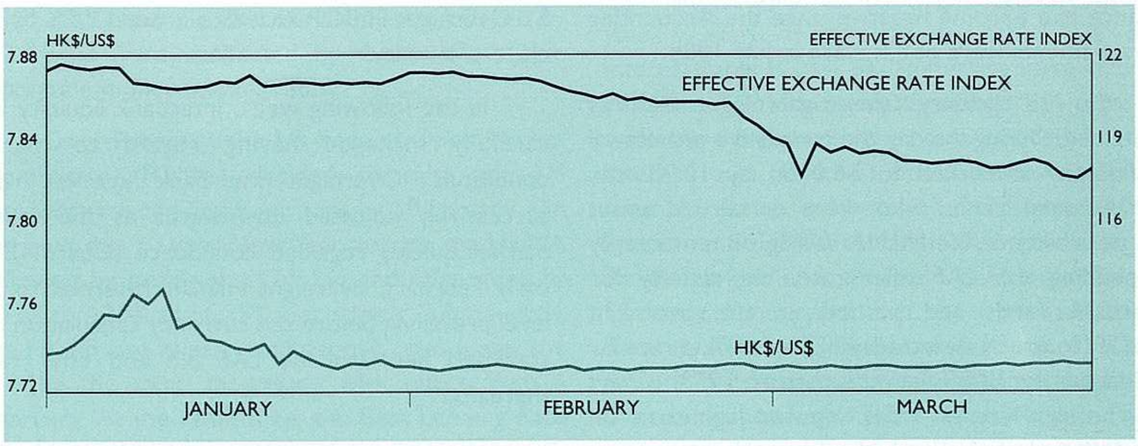
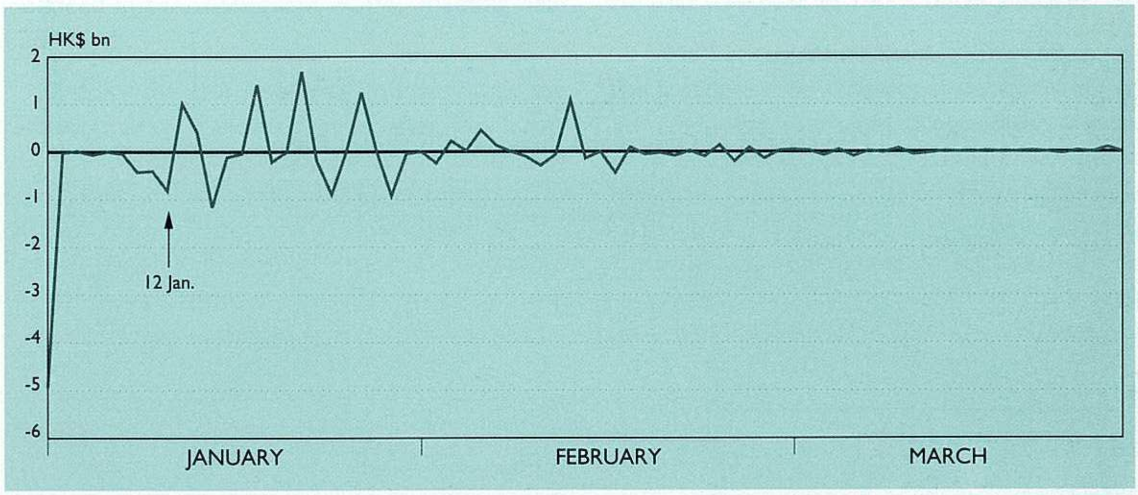
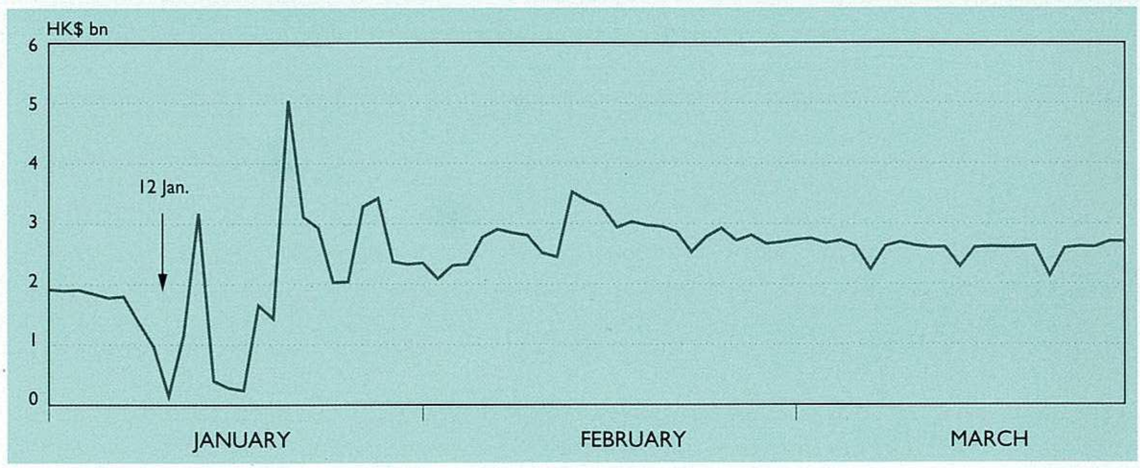


Chart 2
Net Injection * of Interbank Liquidity



* Net Injection refers to the effect of money market activity undertaken by HKMA during the day, net of the effect of the reversal of LAF in the morning.

Chart 3
HSBC's Balance (Before LAF) with the Exchange Fund



on 12 January, the HKMA drained liquidity during the day until the Balance reached a record low of - $4.6 bn at noon. It was the first time that the Balance had become negative since the Accounting Arrangements were put in place in July 1988.

On 13 January, the tightening measures continued. During the day, the cumulative withdrawal of liquidity amounted to $6.0 bn by 10:00 a.m. Market participants, who were concerned about the possibility of the HKMA raising or temporarily suspending the LAF offer rate, bid actively for interbank funds and pushed up the overnight HIBOR to touch an intraday high of 12%, a rate far exceeding the LAF offer rate then at 5.75% (Chart 4). The high interest rates imposed high costs on those speculators who had taken a short position in the HK dollar. To relieve market tightness, liquidity was gradually injected into the market in the afternoon, bringing the Balance before LAF to close the day at $1.2 bn. Liquidity was injected into the market through LAF's lending activity (Chart 5). Overnight HIBOR eased to around 7.5% by the close of the day.

In the following week, interbank liquidity was carefully managed having regard to market conditions. Overnight interbank interest rates successively adjusted downwards as the money market quickly regained confidence (Chart 4). By early February, overnight HIBOR returned to the level prevailing before the currency speculation and stabilised between the LAF bid and offer rates thereafter.

The prompt monetary policy action taken by the HKMA demonstrated its firm commitment to maintaining exchange rate stability under the linked

Chart 4
Movement of Overnight Interbank Interest Rate

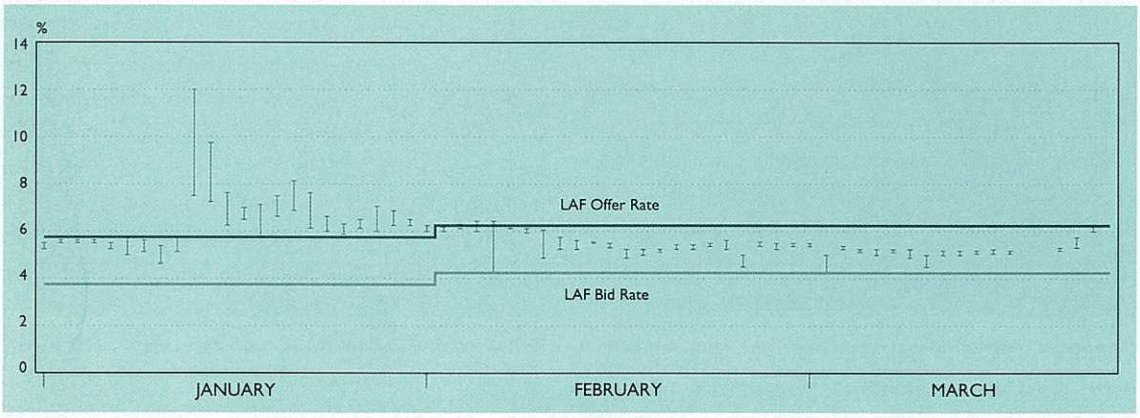
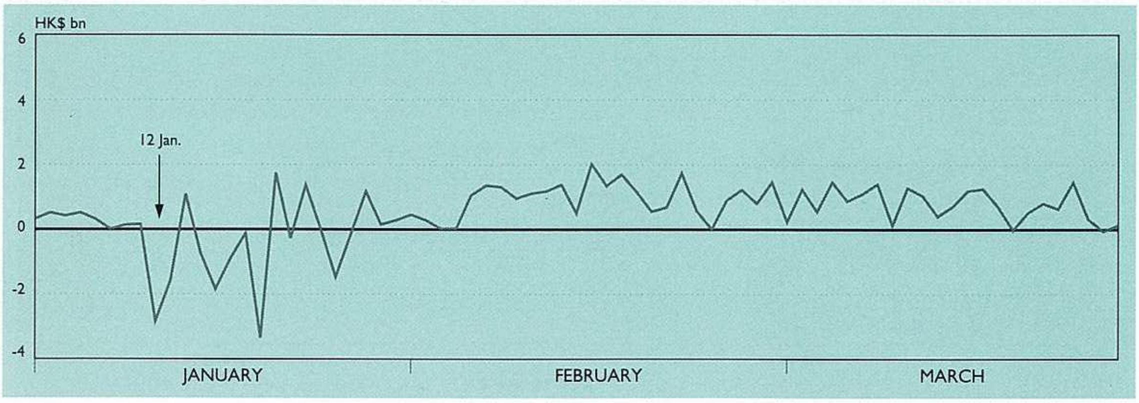


Chart 5
Net Amount Deposited by banks with LAF



exchange rate system. These measures proved to be effective in fending off speculators. In the event, deposit rates governed by HKAB's Interest Rate Rules (IRR) and the Best Lending Rates offered by the banks were unaffected by the brief surge in wholesale money market rates.

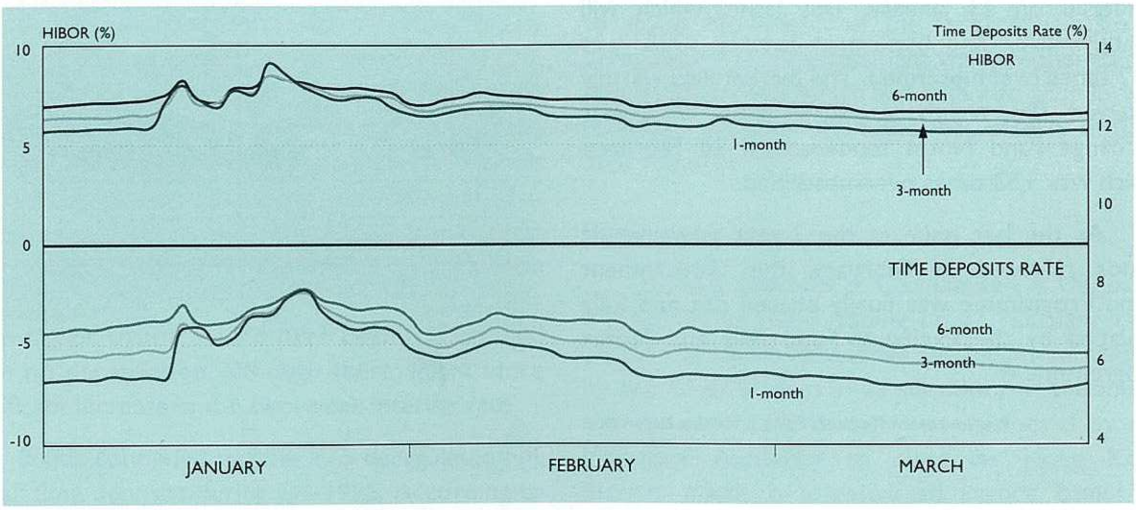
On 1 February, the US Federal Open Market Committee (FOMC) decided to raise the US discount rate and Fed funds rate by 50 bp each. On the next day, a Lunar New Year holiday, the HKMA followed by raising the LAF bid and offer rates by 50 bp to 4.25% and 6.25% respectively. Subsequently, the HKAB also raised retail deposit rates under the IRR by the same magnitude with effect from 6 February. At the same time, the Best Lending Rate of major banks was increased to 9% from 8.5%. The LAF rates have remained unchanged since 2 February. No further rise in US interest rates was announced in the subsequent FOMC meeting held on 28 March.

Despite the rise in official interest rates, the interbank market remained quiet after the Lunar New Year holiday. Stable conditions in the money market and in the HK dollar exchange rate required minimal monetary operations to be initiated. Since mid-February, the Balance (before LAF) has moved within a narrow range of between \$2 bn and \$3 bn (Chart 3) while the net injection of interbank liquidity was small and infrequent (Chart 2).

Fluctuations of overnight HIBOR in mid-January were transmitted to other HK dollar interest rates (Chart 6). The entire term structure of HK dollar interest rates shifted upwards, thus widening the gap with the corresponding US dollar interest rates (Chart 7). In the money market, for example, the spread between the 3-month HIBOR and 3-month LIBOR touched 200 bp on 19 January. At the longer end, the yield differential between Exchange Fund paper and the corresponding US Treasury Bills (USTB) widened (Chart 7). On 13 January, the spread of 5-year Exchange Fund Notes over corresponding USTB widened to over 150 bp. The newly de-regulated retail interest rates[2] were similarly affected. For example, the 1-month time deposit rate firmed from 5.58% at the beginning of the year to a peak of 7.87% on 24 January.

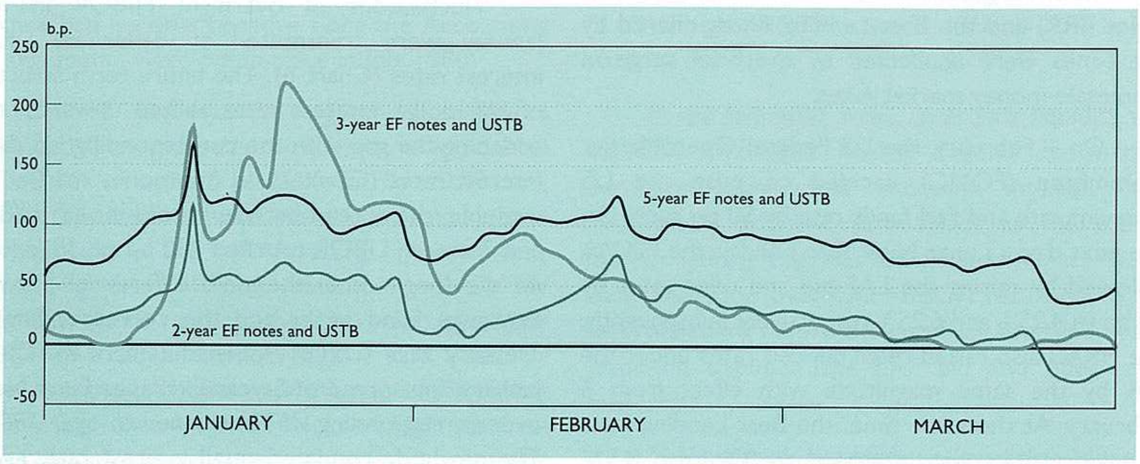
Market conditions quickly returned to normal. The interest rate differential between HK dollar and US dollar narrowed progressively across the maturity spectrum (Chart 7). In line with the rise in LAF rates, most HK dollar interest rates moved up briefly in early February but gradually eased (Chart 6) as the market was optimistic over a possible peaking of US dollar interest rates. By end March, both the HIBOR and LIBOR 3-month rates were at

Chart 6
Movement of HK dollar Interest Rate



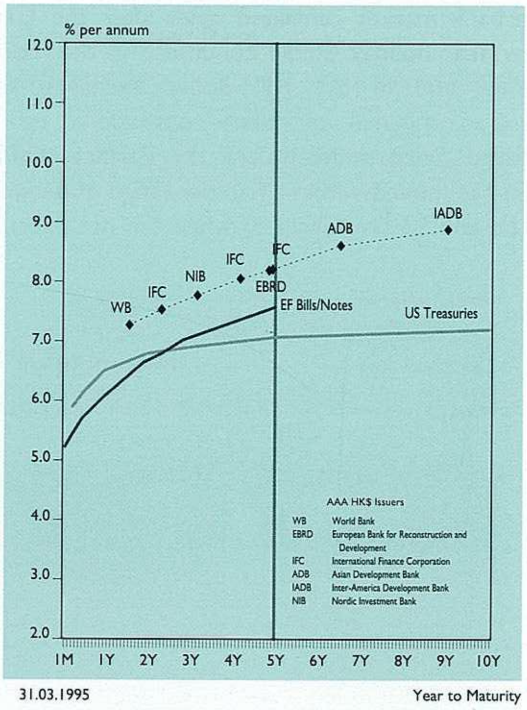
2 Time deposits of over 1 month and time deposits of more than seven days which were previously governed under the Interest Rate Rules of the HKAB have been deregulated since 1 October 1994 and 3 January 1995 respectively.

Chart 7
Movement of Interest Rate Differential



the same level of 6.1875%. Similarly, the 5-year yield spread narrowed significantly to only 51 bp by the end of the quarter (Chart 8). Meanwhile, the 1-month time deposit rate also softened to 5.52% at end March.

Chart 8
HK$ and US$ Yield Curves



Exchange Fund Bills and Notes Programme

Notwithstanding the volatile money market conditions in January, Exchange Fund paper continued to command public confidence, as evidenced by the encouraging demand for the sixth quarterly issue of the 3-year Exchange Fund Notes tendered on 23 January. This issue, which will straddle 1997 and mature in January 1998, was 4.72 times oversubscribed. The market also warmly received the eighth quarterly issue of 2-year Exchange Fund Notes tendered on 20 February, which was 5.53 times oversubscribed.

As the last issue of the 2-year government bonds matured in February, the Government Bond Programme was finally phased out and fully replaced by the Exchange Fund Bills and Notes Programme.

– Prepared by the Monetary Policy & Markets Department