

During the September quarter of 1995, the HK dollar exchange rate remained stable. Alongside the strengthening of the US dollar, the Effective Exchange Rate Index (EERI) of the HK dollar rose by around 3% during the quarter. In response to some easing of the HK dollar against the US dollar in mid-August, the HKMA reduced the level of interbank liquidity, resulting in the short term HK dollar interest rates edging up. The money market remained tight until the end of the quarter as a result of strong demand for liquidity, particularly from foreign authorised institutions, to meet quarter-end settlement needs.

HK dollar exchange rate

The exchange rate of the HK dollar traded within the range of 7.730 to 7.745 against the US dollar in the September quarter (Chart 1). Commercial selling orders associated with the half year-end book closing, coupled with an interest rate differential in favour of the US dollar at the short end, led to a marginal easing of the HK dollar from 7.735 in mid-June to 7.741 in early July. The HKMA withdrew some excess interbank liquidity in mid-July and the exchange rate strengthened from 7.743 on 12 July to around 7.736 to 7.739 during mid-July to mid-August.

In the third week of August, the exchange rate of the HK dollar eased to around 7.746, as market sentiment was affected by Moody's comment on the link, the escalation of political tension across Taiwan straits and a brief downward adjustment in share prices. The Hang Seng Index fell through the 9,000 level in mid-August from over 9,700 in mid-July. In response to some weakening pressure on the HK dollar, the HKMA further tightened liquidity in the interbank market. A total of \$800 mn was withdrawn on 2 consecutive days (10 and 11 August). A further \$220 mn was taken out on 16 August (Chart 2). The exchange rate soon stabilised and moved back to the range of 7.736 to 7.738 in mid-September.

Towards the end of the quarter, the demand from banks for HK dollar funds for quarter-end settlement and the rally in the stock market resulted in buying pressure for the HK dollar. The exchange rate edged up from the opening of 7.738 to the closing of 7.735 on 21 September and further to a high of 7.731 on the following day. To stabilise the exchange rate, the HKMA increased the level of interbank liquidity to bring short term interest rates down slightly. Over \$200 mn was

injected into the interbank market in mid-September. This was followed by further injections of \$961 mn and \$698 mn on 25 September and 29 September respectively. The exchange rate gradually eased to 7.732 by the end of the quarter.

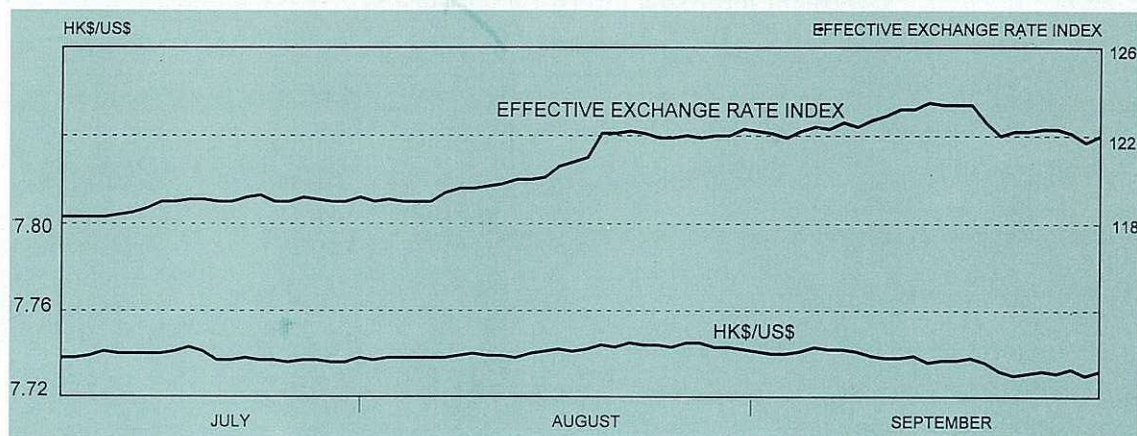
In the international foreign exchange markets, the US dollar showed a sharp rebound against other major currencies during the quarter, on the back of concerted intervention by G7 countries. Interest rate differentials also turned in favour of the US dollar following the cut in the discount rate by the Bundesbank on 24 August and the Bank of Japan on 8 September. Problems in Japan's financial sector and relaxation of rules governing foreign investment by Japanese insurance companies lent further support to the US dollar. From 84.8 Yen and 1.38 DM in early July, the US dollar rose sharply to over 104 Yen and 1.49 DM in mid-September before closing the quarter at 99.7 Yen and 1.43 DM.

In line with the strengthening of the US dollar, the trade-weighted Effective Exchange Rate Index of the HK dollar rose by 3% during the quarter, from around 118 at end-June to a high of over 123 in mid-September before easing slightly to close the quarter at 122 (Chart 1).

Monetary management

The money market was quiet in the first half of the quarter, with overnight HIBOR moving around 4.5% to 5.5%. In view of the easing of the HK dollar in early July, the HKMA slightly reduced the supply of interbank liquidity by \$214 mn, thus drawing down the Balance to \$2.3 bn on 12 July (Chart 2). The Balance was further reduced to \$1.2 bn in mid-August on signs of a weakening in the HK dollar although it remained on the strong side of the link. Overnight HIBOR firmed up to around 6% as a result.

Chart 1
HK Dollar Exchange Rate (Jul – Sep 95)



Towards the close of the quarter, increasing demand for funds to meet quarter-end settlement needs led to tighter money market conditions. Amidst the financial problems in Japan, borrowing costs of Japanese banks, who are active players in the interbank market, went up. Partly reflecting this, overnight HIBOR was driven to a higher range of 5.38% to 6.25%, and on a few occasions, breached the LAF offer rate touching a high of 7% on 15 September and 6.38% on both 22 September and 29 September (Chart 2). 3-month HIBOR also edged up from 6.06% in mid-September to 6.19% on 29 September. To relieve the tightness of the interbank market which was exerting upward pressure on the exchange rate, the HKMA increased the supply of interbank liquidity during the last week of September, bringing the Balance to around \$2.8 bn at end-September.

Reflecting the tightness of the interbank market since mid-August, banks increased the use of the Liquidity Adjustment Facility (LAF) for obtaining overnight liquidity assistance. For the September quarter as a whole, the net amount of deposits placed with the Exchange Fund through LAF (i.e. deposits through the LAF minus borrowing through LAF) dropped significantly to a daily average of \$169 mn from \$474 mn in the June quarter (Chart 2).

The cut in the US Fed funds rate by 25bp on 6 July marked a halt to the series of interest rate increases since February 1994. As the US discount rate remained unchanged and the Fed funds rate was well within the range set by the LAF bid and offer rates, the LAF rates were left unchanged and remained at 4.25% and 6.25% throughout the quarter. In respect of retail interest rates, the Best Lending Rate stayed at the 9% level during the quarter. As for time deposit rates, the Government announced on 26 September that the Hong Kong Association of Banks would be requested to deregulate 7-day time deposits¹. After its implementation in November 1995, interest rate caps on time and fixed deposits for 7 days or more have been removed.

The HK dollar yield curve moved downwards significantly following the lowering of the Fed funds rate. But it soon firmed up as the market anticipated that the Fed would not rush to further interest rate cuts. The tightening of the money market since mid-August had the effect of flattening the short term interest rates and slightly widening the differential between the HK dollar and the US dollar interest rates. In terms of three-month money the differential was around 30bp near end-September. As for longer term yields, the premium of 5-year Exchange Fund paper over the US Treasuries stayed around 90bp during the quarter (Chart 3).

¹ See 'Developments in the Banking Sector' in this issue of the *Quarterly Bulletin* for details.

Chart 2
**Money Market Operations and Movement of
 Overnight Interbank Interest Rate (Jul – Sep 1995)**

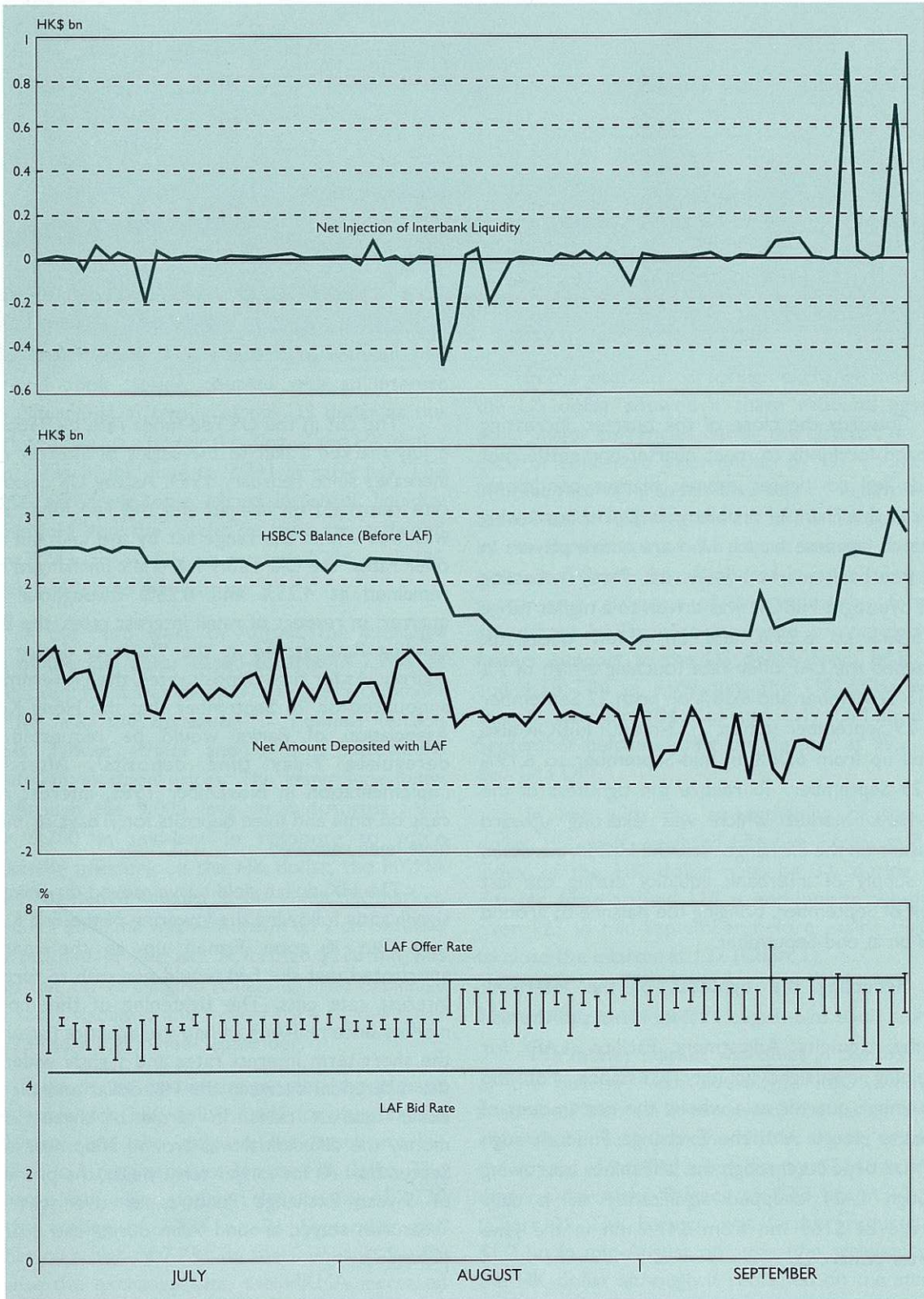
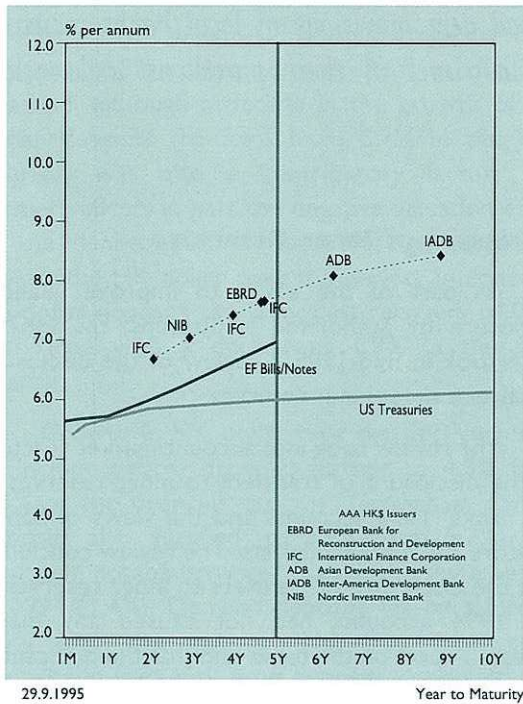


Chart 3
HK\$ and US\$ Yield Curves



Exchange Fund Bills and Notes Programme

Exchange Fund paper continued to be well-received by the market. The eighth quarterly issue of 3-year Exchange Fund Notes tendered on 24 July and the fifth quarterly issue of 5-year Exchange Fund Notes tendered on 18 September were oversubscribed by 7.5 times and 3.7 times respectively. Average accepted yields were 25bp and 98bp respectively above those of corresponding US Treasuries.

Eligible repo securities

In the September quarter of 1995, four additional HK dollar debt issues were accepted as eligible securities for discounting under LAF. They include the \$3 bn issue by Wharf Treasury Ltd., the \$1.5 bn issue by Bank of America (Asia) Ltd., the \$1.2 bn issue by Bank of Tokyo and the \$1 bn issue by Merrill Lynch & Co., Inc. By end September, there were a total of 11 eligible issues involving a total amount of HK\$22.2 bn. ☉

– Prepared by the Monetary Policy & Markets Department