The HK dollar exchange rate remained stable in the March quarter. Following a 25 bp cut in the US discount rate in early February, the LAF bid and offer rates were lowered by the same magnitude. Towards mid-March, long term interest rate started to edge up as the market expected that future interest rate cuts would not be imminent.

HK Dollar Exchange Rate

The HK dollar exchange rate remained stable throughout the first quarter of 1996, moving within a narrow range of 7.731 – 7.735 against the US dollar. Opening the year at 7.733, the exchange rate strengthened marginally to 7.731 – 7.732 in mid January, partly reflecting an inflow of funds to the local stock market. The Hang Seng Index gained more than 1000 points from 10073 at the end of 1995 to 11103 on 25 January. Interbank liquidity tightened amidst increased demand for Hong Kong dollar. Upon the injection of liquidity by the Monetary Authority to alleviate the tight money market conditions, the exchange rate quickly returned to the 7.733 – 7.734 level towards the end of January. Notwithstanding the correction in the local stock market and the escalation of military tensions across the Taiwan Straits in March, the Hong Kong dollar exchange rate remained very stable.

In the international foreign exchange market, the US dollar strengthened against the yen, from 103.4 at the end of 1995 to around 107.3 at the end of March 1996. The exchange rate of the US dollar vis-a-vis deutschemark fluctuated between 1.44 and 1.49 during the March quarter. On the other hand, the RMB exchange rate was fairly stable. Reflecting these developments, the overall exchange value of the Hong Kong dollar, as measured by the effective exchange rate index (EERI) showed a marginal appreciation from 122.7 at the end of 1995 to 123.7 at end March (Chart 1).

Management of Interbank Liquidity

The foreign exchange and money markets were stable in the March quarter. The Monetary Authority did not operate on any significant scale to affect the level of interbank liquidity, though small adjustments were made occasionally to smooth short-term fluctuations in market conditions.

In mid-January, the increase in the demand for HK dollar, partly for investment in the local stock market, resulted in a tightening of money market conditions. Overnight HIBOR edged up to around 6% on 23 January, approaching the LAF offer rate at 6.25%. In response, the HKMA injected $248 mn and $227 mn on 23 and 26 January respectively to relieve the tightness in the money market, increasing the Balance to around $2.5 bn (Chart 2).

Another injection of $293 mn was made on 9 February in response to a firming up of the

Chart 1
HK Dollar Exchange Rate (Jan-Mar 96)

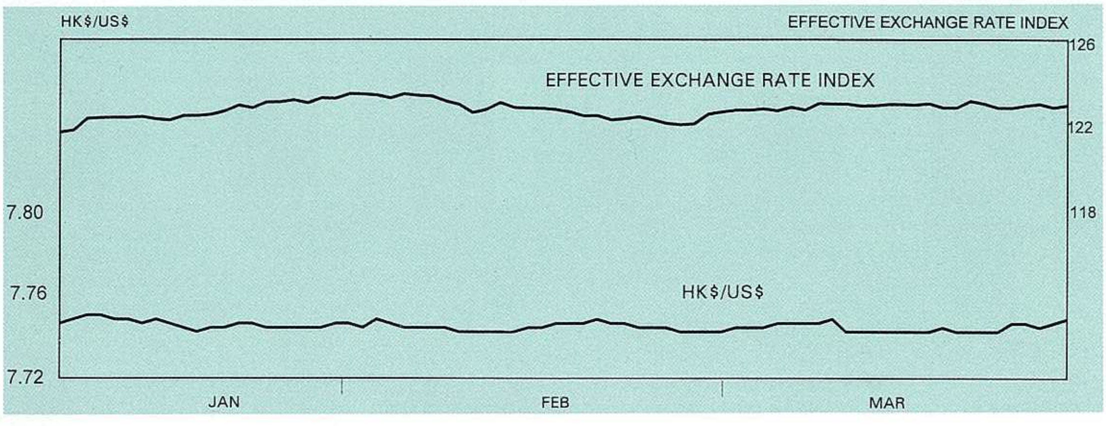
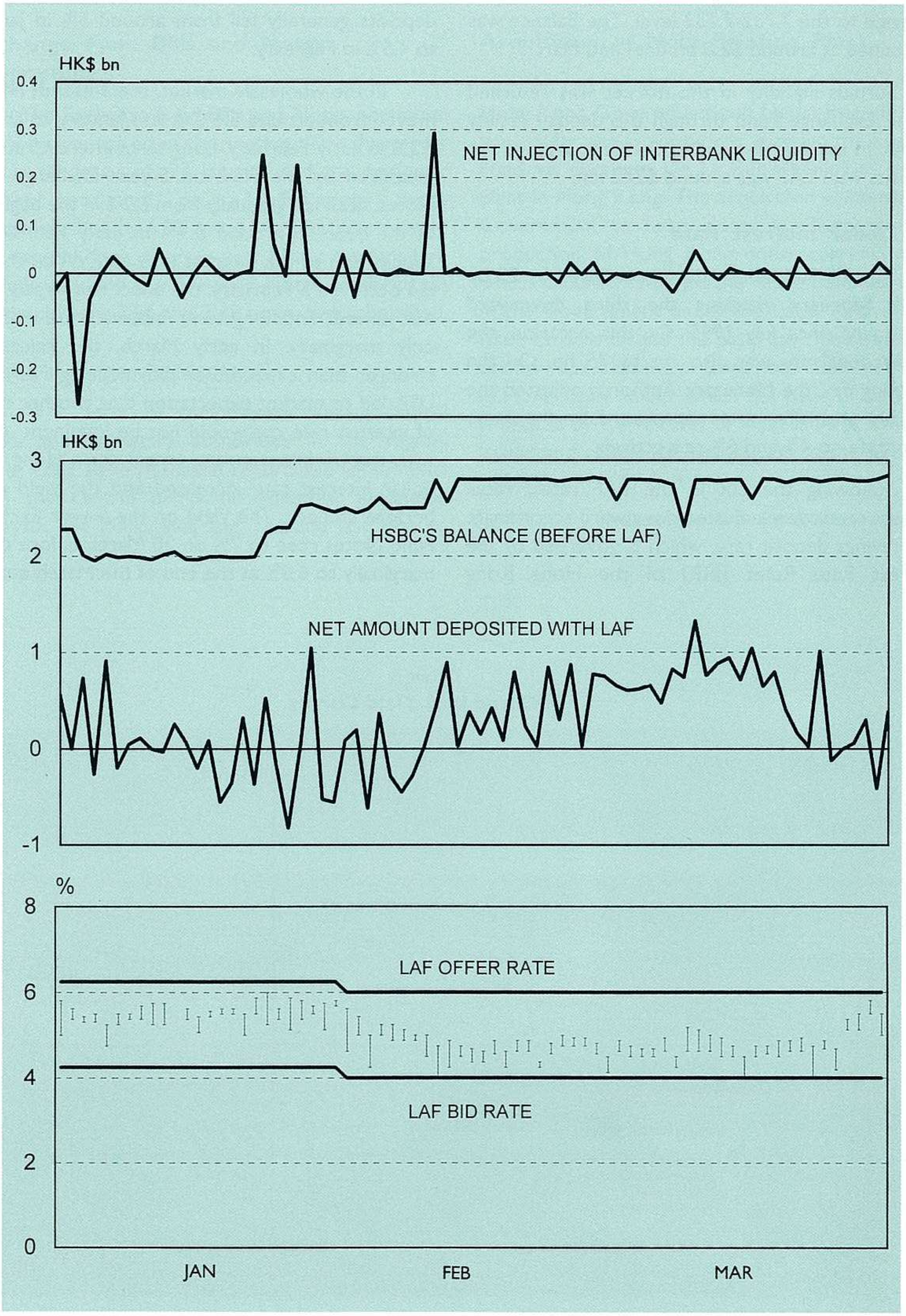


Chart 2
Money Market Operations and Movement of Overnight Interbank Interest Rate
(Jan-Mar 1996)



exchange rate, to around 7.731. This resulted in an easing of overnight HIBOR, widening the differential between short-term Hong Kong dollar and US dollar interest rates. The exchange rate soon returned to the 7.732-7.733 level. The Balance was maintained at around $2.8 bn until end March.

Surplus liquidity in the market was returned to the Exchange Fund through the deposit facility of LAF. In the March quarter, the daily average net deposits with LAF was around $272 mn.

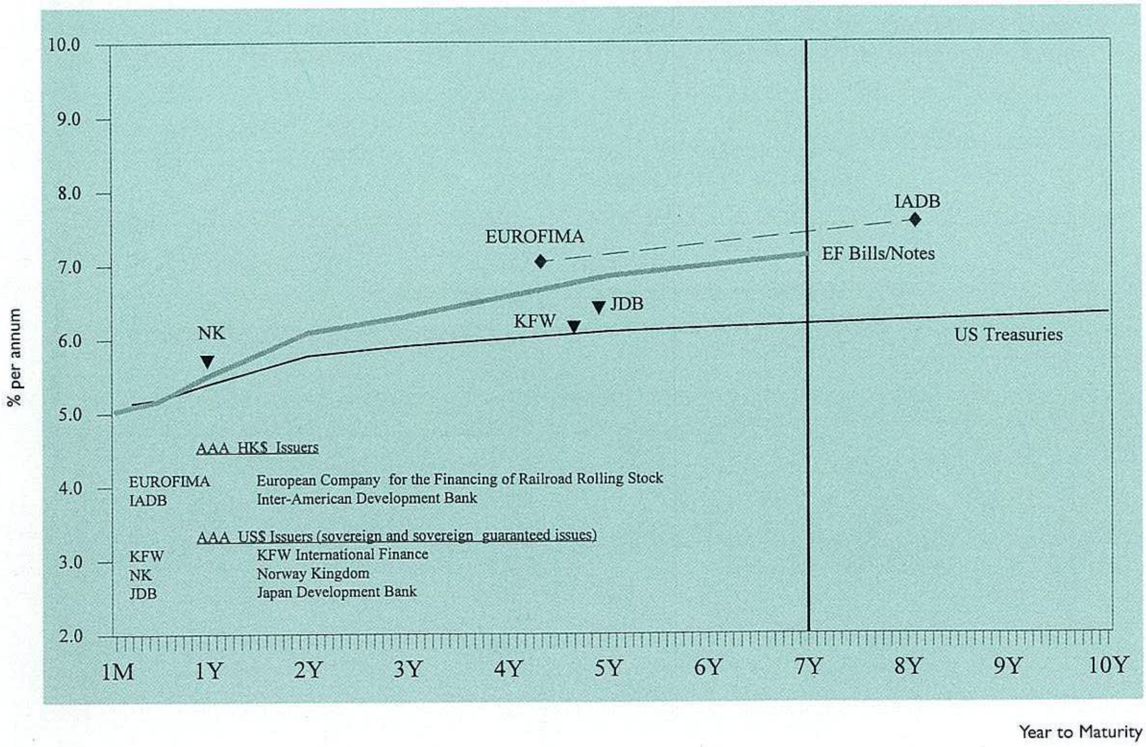
HK Dollar Interest Rate

The US Fed funds rate was lowered by 25 bp on 1 February, marking the third downward adjustment since July 1995. On this occasion, the US discount rate was also cut by 25 bp. On the following day, the Monetary Authority adjusted the LAF bid and offer rates downward by the same magnitude, to 4% and 6% respectively.

Following the cut in the LAF rates, retail interest rates were adjusted downward accordingly. The savings deposit rate, which is governed by the Interest Rate Rules (IRR) of the Hong Kong Association of Banks, was lowered by 25 bp to 3.75% on 5 February. The best lending rate quoted by major banks was also reduced by the same magnitude, to 8.5%. Interest rates on 1-month time deposits generally fell from around 5% in January to 4.5% in February.

In the wholesale market, the 3-month HIBOR moved from around 5.6% in late January to around 5.3% in early February. Long-term interest rates, as measured by the yield on 5-year Exchange Fund Notes, declined gradually from 6.2% in the beginning of the year to around 5.9% in early February in anticipation of the interest rate cut. When the cut did occur on 5 February, the effect had largely been discounted, and long-term interest rate declined only marginally. In early March, the release of stronger than expected employment figures in the USA led to market expectation that another round of interest rate cut would not be imminent. Along with the US interest rate, longer term Hong Kong dollar interest rate increased and the yield curve became steeper. The yield on the 5-year Exchange Fund Notes rose to 7% on 20 March before easing marginally to 6.8% at the end of the March quarter.

Chart 3
HK$ and US$ Yield Curves



The differential with the corresponding US Treasuries was 60 bp in terms of the 5-year paper and 68 bp in terms of the 7-year paper at end-March 1996. (Chart 3).

Exchange Fund Bills and Notes Programme

The Exchange Fund Bills and Notes continued to be well received in the market. The three-year Notes tendered on 23 January and the two-year Notes tendered on 13 February were oversubscribed by 6.82 and 4.84 times respectively. The second issue of seven-year Notes tendered on 27 February and the five-year Notes tendered on 19 March were 2.86 and 3.48 times oversubscribed.

Bilateral Repo Agreement

As a form of cooperation among central banks and monetary authorities in the region, Hong Kong signed bilateral repurchase agreements with the central banks of Australia, Indonesia, Malaysia, the Philippines and Thailand last year to enhance the liquidity of each other's official reserves. On 9 February, the Monetary Authority entered into a similar agreement with the People's Bank of China.

Acquisition of Note Printing Plant

An agreement was reached between the Hong Kong Government and De La Rue plc on 22 January for the Government, through the Exchange Fund, to purchase De La Rue's banknote printing plant in Hong Kong. The acquisition will enable the Government to have closer involvement in the production of Hong Kong dollar currency notes, which is consistent with the responsibilities vested in the Government under the Legal Tender Notes Issue Ordinance and the Basic Law. The acquisition has no impact on the present note issue mechanism in Hong Kong, under which the issue of banknotes is backed by Certificates of Indebtedness which are issued and redeemed against US$ at the fixed rate of US$1 to HK$7.8.

– Prepared by the Monetary Policy & Markets Department