During the last quarter of 1998, mounting concern over a possible global recession triggered a series of monetary easings around the world, led by the US Federal Reserve. This, coupled with a steep rise of the yen, led to a fall in local interest rates. This precipitated some small outflows towards the end of October, but these were quickly reversed as the adjustment mechanism of the currency board system caused interest rates to firm. Exchange Fund Notes rallied strongly and outperformed US Treasury Bonds in the period. The Hong Kong dollar remained stable against the US dollar.

External Environment

During the last quarter of 1998, there were two favourable external developments, namely, a series of monetary easings globally and the deleveraging of hedge funds. At the beginning of the quarter, there were growing concerns over the risk of a global recession. To "cushion the effects on prospective economic growth in the US from increasingly weak foreign economies and less accommodative financial conditions domestically," the Federal Reserve cut the Fed Funds Target Rate by 25 basis points to 5.25% on 29 September - the first cut since January 1996. The move sparked off a round of interest rate reductions in the rest of the industrial world. Within the next two weeks, Canada and six European economies — Denmark, Greece, UK, Portugal, Spain and Ireland — each reduced their key interest rates by between 25 and 125 basis points.

However, in the US, despite the rate cut, market sentiment remained bearish on the prospects of sustained economic growth. On 15 October, the Federal Reserve surprised the market with another 25 basis point cut in the Fed Funds Target Rate. The market was surprised not so much by the move itself or the size of the cut, as by the timing of it, which came in between FOMC regular meetings, and only a little more than two weeks after the cut in late September. Consensus then grew rapidly that there were more easings in the pipeline and a further 25 basis point reduction had been fully discounted by financial markets by the time that the Federal Reserve did indeed make a third cut to 4.75% on 17 November. Thereafter, however, the performance of the US economy, especially the housing sector and labour market, turned out stronger than expected. This, coupled with a strong stock market rally in December, restrained the Federal Reserve from easing policy further.

In Europe, in preparation for a uniform monetary policy, the central banks of ten of the euro-11 countries reduced their key interest rates to 3% in a co-ordinated move on 3 December. The exception was Italy, which moved then to only 3.5% but completed the adjustment to 3% on 28 December.

Meanwhile, in the wake of the problems of Long Term Capital Management, there was a tendency for banks to reduce their exposure to hedge funds and other highly leveraged institutions. Tightened credit lines, together with increased redemption pressure from investors, forced these institutions to unwind their speculative positions, especially those in yen carry trades. As a consequence, the dollar plunged against the yen from 130.7 on 7 October to 111.8 on 9 October. The strengthening of the yen considerably reduced the so-called Asia premium and contributed further to downward pressure on interest rates in the region.

Internal Environment

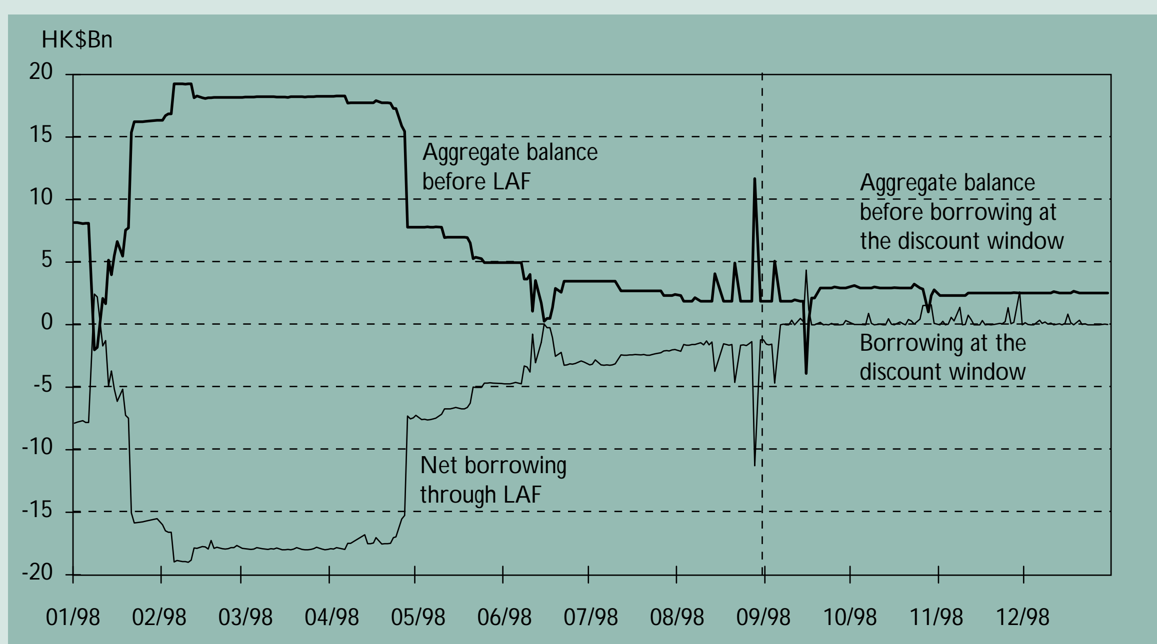
Activity in the foreign exchange and money markets returned to more normal levels during the quarter, and interest rates gradually fell to the levels before the Asian financial crisis started in July 1997. The seven technical measures introduced in early September provided banks with greater

assurance of liquidity. This, coupled with falling interest rates globally, induced the banks to lower their lending rates further. When the sharp appreciation of the yen occurred in the second week of the month, the fall in domestic interest rates further gathered pace. On 19 October, the 1-month, 3-month and 6-month HIBORs hit lows of 5.13%, 5.81% and 6.63% respectively, as compared with 7.25%, 8.25% and 9.00% at the end of September. At the retail level, prompted by the Federal Reserve's move on 15 October, HKAB reduced the savings deposit rate from 5.25% to 5.00% the following day, and the best lending rate of major banks was also adjusted downward from 10.00% to 9.75%.

In the second half of October, however, selling pressure on the HK$ emerged as domestic interest rates overshot to below their US counterparts. A rumour that the HKMA would move the rate of Convertibility Undertaking immediately from 7.75 to 7.80 also added pressure on the HK$ exchange rate. The HKMA sold US$245 million under the Convertibility Undertaking between 23 and 26 October. As a result, the aggregate balance, which stood at HK$2,918 million in the first few weeks of the month, fell to HK$1,019 million by 29 October (Chart 1). Outflow peaked during New York hours on 27 October on concerns over Brazil, and at one point the *forecast* aggregate balance for 30 October dropped to only HK$112 million. To halt speculation about the rate at which the Convertibility Undertaking would be exercised, the HKMA announced on 26 November 1998 that the rate would remain at 7.75 until the end of March 1999, but that from 1 April it would be adjusted by one pip (i.e. $0.0001) per day over the following 500 calendar days, so as to reach 7.80 on 12 August 2000.

The tightening of liquidity as a result of the reduction in the Aggregate Balance produced substantial upward pressure on interest rates, lifting the 1-month and 3-month HIBORs to 6.88% and 7.25% on 29 October, respectively. The firming of the domestic interest rates and the HKMA announcement quickly reversed the direction of funds flow. The HKMA bought back about US$169 million between 27 and 29 October. As a result, the *actual* aggregate balance ended at HK$2,328 million on 30 October, much higher than the level forecast on 27 October.

Chart 1
Aggregate Balance and Discount Window Activities



A return of foreign buying interest to the local stock market caused another inflow of funds on 9 November. This time, a further US$25 million was bought and the aggregate balance rose further to HK$2,521 million. There was no further inflow or outflow up to the end of the year.

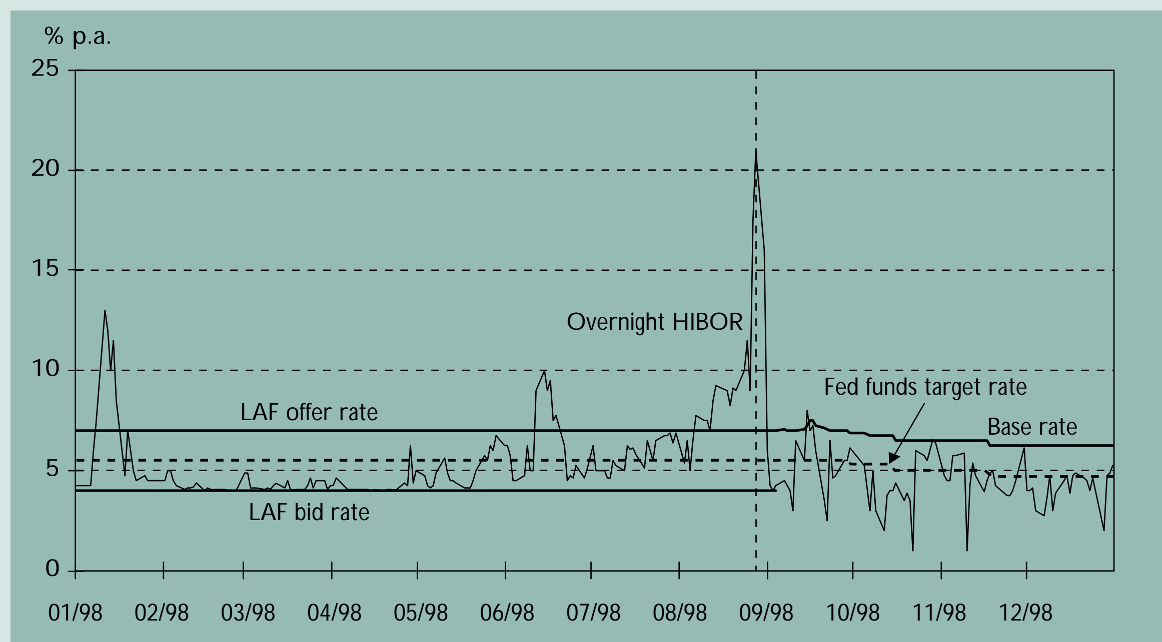
Towards the end of 1998, the market began to predict that the HKAB might lower the saving rate further. The cut in the Fed Funds Target Rate in the US on 17 November and the co-ordinated rate cut by the European Central Banks on 3 December further reinforced that expectation. HKAB made further cuts to the deposit savings rate on 20 November, on 4 December and, somewhat unexpectedly, on 18 December, taking the rate down to 4.25%. Overall, in the interbank market, the 1-month, 3-month and 6-month HIBORs fell from 7.25%, 8.25% and 9.00% at the end of September to 5.13%, 5.25% and 5.63% at the end of December, respectively.

During most of the period, the HKMA base rate stood at 150 basis points above the Fed Funds Target Rate (Chart 2). When the Fed cut the Fed Funds Target Rate on 16 October and 17 November, there was a parallel reduction in the base rate on the following day each time. The gap did widen slightly by 10 basis points on 30 October as interbank rates firmed on 29 October, but that was quickly reversed on 31 October. In line with the 50 basis points cut in the Fed Funds Target Rate in the period, the base rate fell from 6.75% at the beginning of the quarter to 6.25% at the end of it.

As one of the measures to strengthen the currency board arrangements, the HKMA announced on 26 November a formula for setting the base rate. The formula sets the rate at the higher of the US Fed Funds Target Rate plus 150 basis points, and the mean of the 5-day moving averages of the overnight and 1-month HIBORs for the previous 5 trading days. The overnight rate for each day is in turn calculated as an average of hourly observations through the trading day, while the 1-month HIBOR is the fixing established every morning.

On the exchange rate front, the HK$ was fairly stable vis-à-vis the US$ in the fourth quarter of last year, trading mostly within a narrow range

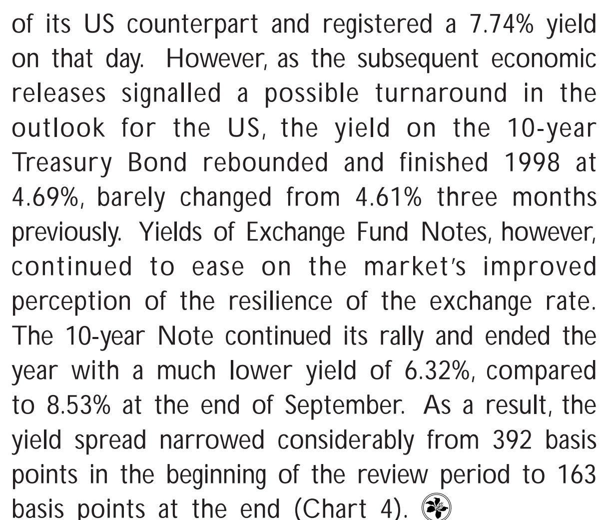
Chart 2
Overnight HIBOR, LAF and Base Rates



between 7.7380 and 7.7495 (Chart 3). Tracking the US$ movement vis-à-vis other major currencies, the HK$ depreciated by 3.2% on an effective exchange rate basis in that quarter.

Exchange Fund Bills and Notes

Exchange Fund Notes outperformed US Treasury Bonds during the period. In early October, the effect of monetary easing, combined with the perceived risk of a global recession, sparked a strong rally in US Treasury Bonds. The 10-year yield fell by about 40 basis points, reaching a low of 4.24% on 7 October. The 10-year Exchange Fund Note essentially followed the track of its US counterpart and registered a 7.74% yield on that day. However, as the subsequent economic releases signalled a possible turnaround in the outlook for the US, the yield on the 10-year Treasury Bond rebounded and finished 1998 at 4.69%, barely changed from 4.61% three months previously. Yields of Exchange Fund Notes, however, continued to ease on the market's improved perception of the resilience of the exchange rate. The 10-year Note continued its rally and ended the year with a much lower yield of 6.32%, compared to 8.53% at the end of September. As a result, the yield spread narrowed considerably from 392 basis points in the beginning of the review period to 163 basis points at the end (Chart 4).



- Prepared by the Monetary Policy and Markets Department

Chart 3
Exchange Rate

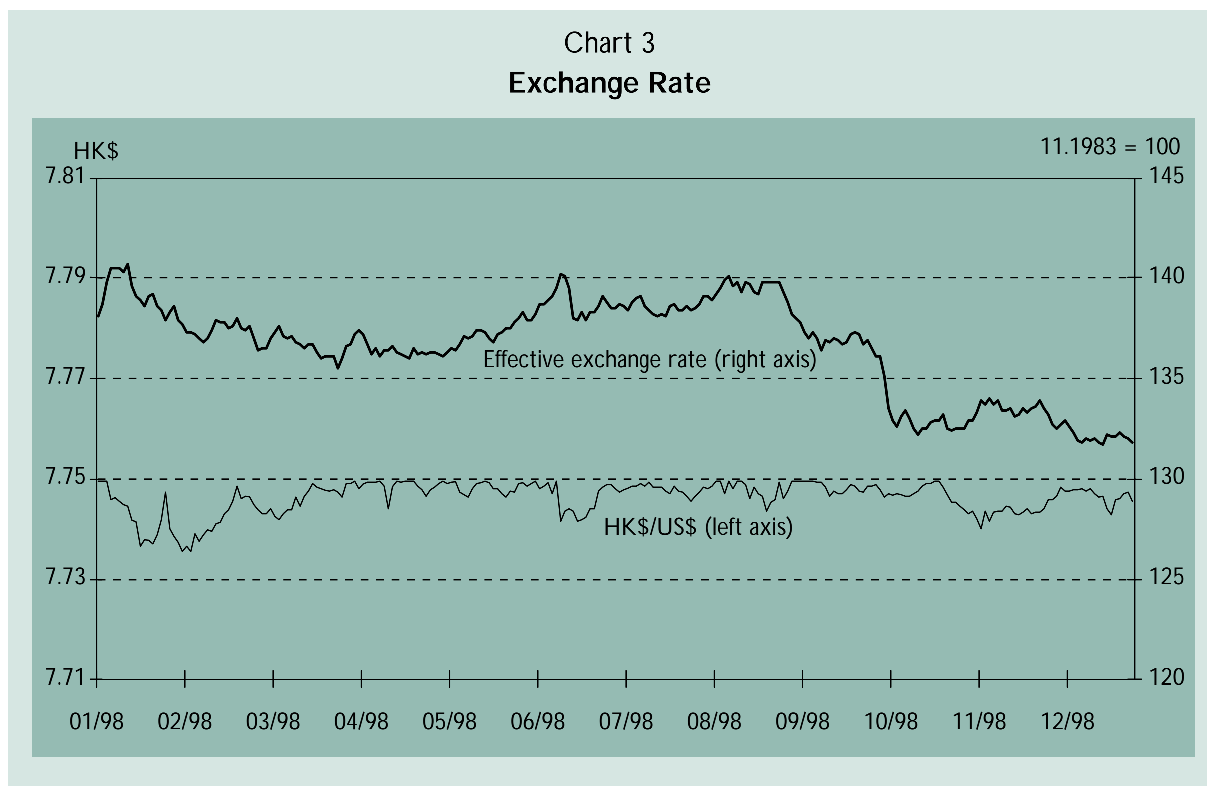


Chart 4

Interest Differentials between US and HK