

# LIQUIDITY ARRANGEMENTS FOR THE MONEY MARKET IN THE YEAR 2000 CONTEXT

*The HKMA announced on 6 September the introduction of an enlarged Discount Window and a term repo facility in the fourth quarter of 1999 to address the potential problem of excessive tightness in the money market which might arise from Year 2000 (Y2K) concerns. The measures are broadly consistent with the operation of the currency board system in Hong Kong and are in line with the practices in other international financial centres. The announcement was well received by the market and has helped alleviate market fears of liquidity shortages around the turn of the year period.*

## Introduction

To allay uncertainty as to the extent of the demand for, and the cost and availability of, credit in the money market during the year-end period, the HKMA announced on 6 September the introduction of an enlarged Discount Window and a term repo facility in the fourth quarter of 1999. These measures aim at increasing the supply of liquidity to the money market during the Y2K critical periods for the purpose of ensuring systematic stability. Notwithstanding these measures, banks are encouraged to establish their own liquidity arrangements as far as possible.

## Enlarged Discount Window

The purpose of the enlarged Discount Window is to increase the amount of HK dollar liquidity that can be obtained by licensed banks through the Discount Window by temporarily removing existing restrictions and by the HKMA accepting a wider range of debt securities as eligible collateral.

### Framework

The framework of the enlarged Discount Window is as follows:

- (a) Available from 15 November 1999 to 31 January 2000.
- (b) For existing categories of eligible paper, the whole of a bank's holdings is discountable at the base rate (or, for certain categories, the base rate plus 1/4%) - i.e. the 5% premium on the second 50% of holdings is suspended.

- (c) The repeated borrowing restriction on the use of non-Exchange Fund ("EF") paper is suspended.
- (d) The "grandfathered issues only" rule for certain non-EF paper is suspended; i.e. non-EF public sector paper (the "Specified Instruments") and AAA-rated issues in CMU will be eligible on the same basis as grandfathered issues, even if issued since September 1998.
- (e) Other investment grade or higher HK dollar paper in CMU will also be eligible, but in this case HKMA will have discretion over the interest rate, up to a maximum of the higher of the base rate plus 5 1/2% and overnight HIBOR.

Upon requests from banks and on a case-by-case basis, the HKMA may decide to grant access to the Discount Window at any time during business hours (instead of the Window being activated only at 4:30 p.m. on weekdays and 12:00 noon on Saturdays). This flexibility will enable the HKMA to pre-empt any gridlock in the payment system that could arise due to excessive tightness in the money market prior to the normal opening time of the Window. This early-day facility will, however, be subject to specific approval by HKMA so as to avoid it being regarded as a substitute for the normal operation of the interbank market.

As a result of the operation of the enlarged Discount Window, total usable paper for discounting during the specified period rises from approximately HK\$110 billion to HK\$210 billion. The amount of

eligible paper which can be submitted at the base rate or the base rate plus 1/4% increases from approximately HK\$70 billion to an estimated HK\$120 billion.

### Term Repos

The term repo facility will allow licensed banks to obtain in advance HK dollar liquidity from the HKMA for the year-end at a known price. The facility will help to remove uncertainty on the availability of HK dollar liquidity in the year-end period. In order to minimise disruptions to the money market, the terms of the facility aim to encourage licensed banks to look to market sources first.

### Framework

The facility is structured as follows:

Availability	1 December 1999 to 31 January 2000. (i.e. last repurchase date)
Form	Repos providing HK dollar against EF paper or, subject to satisfactory delivery, against US Treasuries and other AAA rated US dollar paper.
Maturity	Continuous offer by HKMA of 7-day, 14-day and one-month repos.
Interest rate	HIBOR for relevant term or HKMA Base Rate plus 1/4%, whichever is the higher.
Normal limits	For HK-incorporated banks, subject to, and counting towards, lender-of-last-resort limits as specified in HKMA's recent policy statement <sup>1</sup> (up to 200% of capital base, with cap of HK\$10 billion). For branches of foreign banks, up to 10% of HK dollar assets, with cap of HK\$10 billion.

<sup>1</sup> A Policy Statement on the Lender of Last Resort was issued by the HKMA on 30 June 1999.

### Consistency with Currency Board Principles

The term repo facility is fully consistent with the currency board rules, since any provision of HK dollars is backed either by EF paper (which is, in turn, fully backed by US dollars) or directly by top-class USD securities. As regards discount window, to the extent that lending occurs against the security of paper other than EF paper, it breaches the strict currency board rules. Nevertheless, as the use of most of the non-EF paper will incur an interest rate premium over the Base Rate, it is reasonable to presume that banks would choose, where possible, to submit EF paper first. The arrangements are therefore broadly consistent with the desire to keep breaches of the currency board rule to a minimum and to circumstances close to last resort.

### Consistency with International Practices

The two measures announced by the HKMA are broadly in line with the practices adopted in other major financial centres. Some examples of the practices in other economies are listed below:

- In the US, the Federal Reserve has announced the "Century Date Change Special Liquidity Facility" under which the Fed will provide loans to depository institutions with the same collateral requirements as the regular discount window, but the restrictions on the use and duration of loans will be temporarily suspended.
- In the UK, the Bank of England (BoE) has enlarged the scope of eligible securities for repo transactions to include £2 trillion worth of euro-denominated securities. From October to early 2000, the BoE will also offer a longer-term repo facility, with maturity initially set at 3-month, in the sterling money market.
- The Reserve Bank of Australia has also announced the extension of the term of the repo operations to span the start of the Year 2000, as well as the acceptance of deposits

2000, as well as the acceptance of deposits from institutions for terms maturing around the start of the Year 2000. The deposits are interest-bearing and can be redeemed before maturity.

to suspend or amend these special arrangements if the external situation so requires. The HKMA would not take such decisions lightly, however.

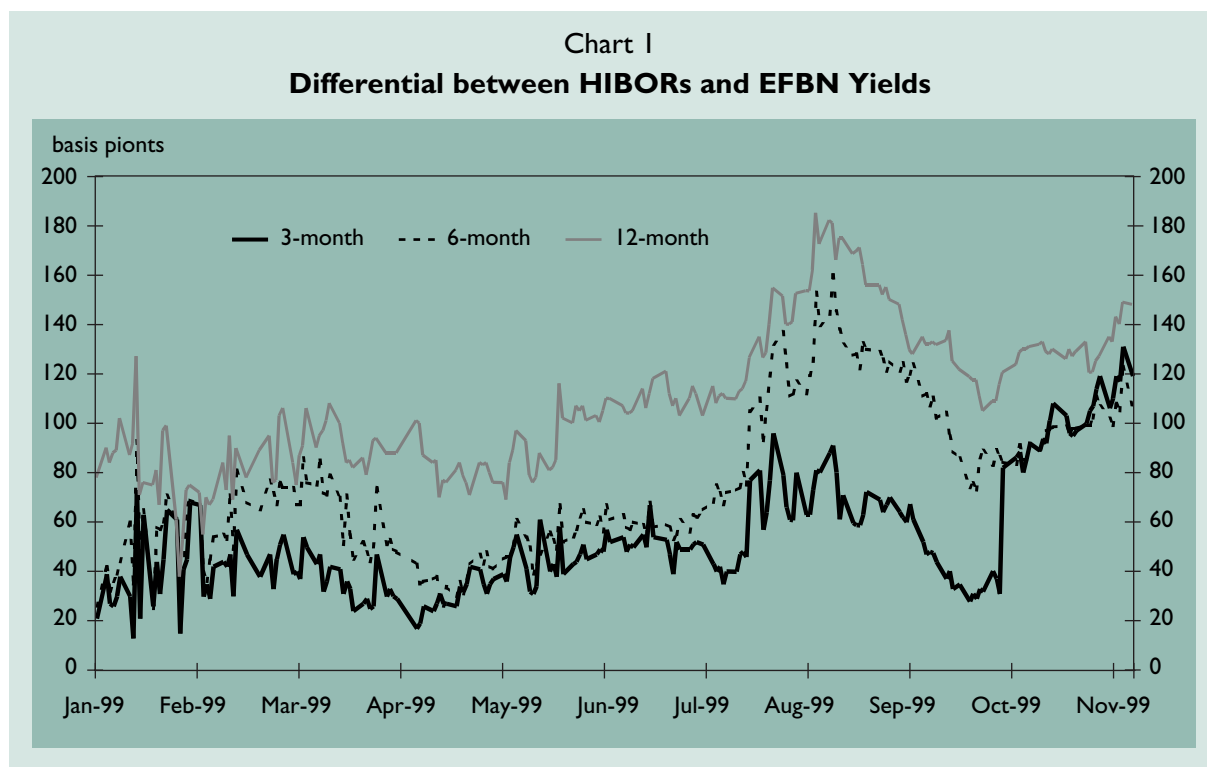
### Flexibility in Applying the Two Measures

It is expected that any tightness in the market is unlikely to be felt until nearer the year-end, but the HKMA stood ready, if conditions had required, to commence these arrangements earlier, or start them earlier but only on a temporary basis. It also stands ready to extend the finishing date. Should extreme conditions arise, the HKMA might, in addition to supplying liquidity through the two measures, inject liquidity directly in the money market for the purpose of ensuring systemic stability. On the other hand, to prevent possible abuse of the two measures, for example to fund speculative outflows, the HKMA reserves the right

### Market Response to the Announcement of the Liquidity Arrangements

The announcement of the liquidity arrangements in the Y2K context and the safe passage of 9 September, which was generally regarded as one of the Y2K-critical dates, have helped alleviate market concerns over the availability of liquidity during the turn of the year. The differential between HIBOR and the yield on Exchange Fund paper, which in part reflects banks' preference for holding the paper instead of lending in the interbank market, came down from a high level of around 90 bp in early August (in terms of 3-month money) to 30 bp in late September (Chart 1). However, on the last business day of

Chart 1  
Differential between HIBORs and EFBN Yields



September, there was a detectable increase in the three-month interbank rate for the Hong Kong dollar when trading first spanned into the new year. Nevertheless, similar movements in 3-month interest rates were observed on other major currencies

including the US dollar, the euro and the pound sterling. There are no indications of any specific Y2K related premium on the Hong Kong dollar (Chart 2).

– Prepared by the Research Department

