

The HKMA announced on 25 September that it will change the reference rate for setting the LAF Rates from the US Discount Rate to the US Fed Funds Target Rate. The move is due to the fact that Fed Funds Target Rate tracks more closely overnight London Interbank Bid Rate, is a better indicator of US monetary policy and is transparent.

Functions of LAF

The Liquidity Adjustment Facility (LAF)¹ is the Hong Kong version of Discount Window. It was introduced in June 1992 as one of the reform measures to strengthen monetary management in Hong Kong. LAF serves several important functions in the management of interbank liquidity:

- (a) it enables banks to make late adjustments to their liquidity position after the close of the interbank market;
- (b) it enables the HKMA to supply additional liquidity to or to absorb excess liquidity from the banking system;
- (c) the LAF Bid and Offer Rates effectively set the floor and the ceiling of the overnight Hong Kong dollar Interbank Interest Rate (HIBOR).

With reference to (c) above, the LAF corridor can help prevent sharp fluctuations in short-term interest rates caused by short-term volatility in the demand for interbank liquidity. As such, it forestalls possible unsettling effects that interest rate fluctuations may have on the exchange rate. Although in normal circumstances LAF Rates will be adjusted in line with any change in the reference rate, the LAF Rates may be varied from time to time in order to maintain the stability of the Hong Kong dollar exchange rate.

Choice of reference rate

Under the linked exchange rate system, the Hong Kong dollar interest rates should track closely the key US dollar interest rates in normal circumstances. In this regard, the Bid and Offer Rates under the LAF should ideally be set with reference to the London Interbank Bid Rate (LIBID), which is the interest rate for placing US dollar deposits in the Euro dollar market. The problem in doing so is that the LAF Rates would be following a moving target and frequent adjustments would be required.

As an alternative, the US Discount Rate² has been used as the reference rate in setting the LAF Rates since its inception. There are several reasons for such a choice. First, the LAF and the US Discount Window perform similar functions. Second, the US Discount Rate is transparent³ as any change in this rate is publicly announced. Thirdly, the US Discount Rate is traditionally a firm indicator of US monetary policy. Adjustments in this rate used to carry strong announcement effects.

Experience in the past few years

When the LAF was introduced in June 1992, the US Discount Rate was the same as the Fed Funds Target Rate⁴ and remained so until mid 1993 (Chart 1). However, during the upswing in the US

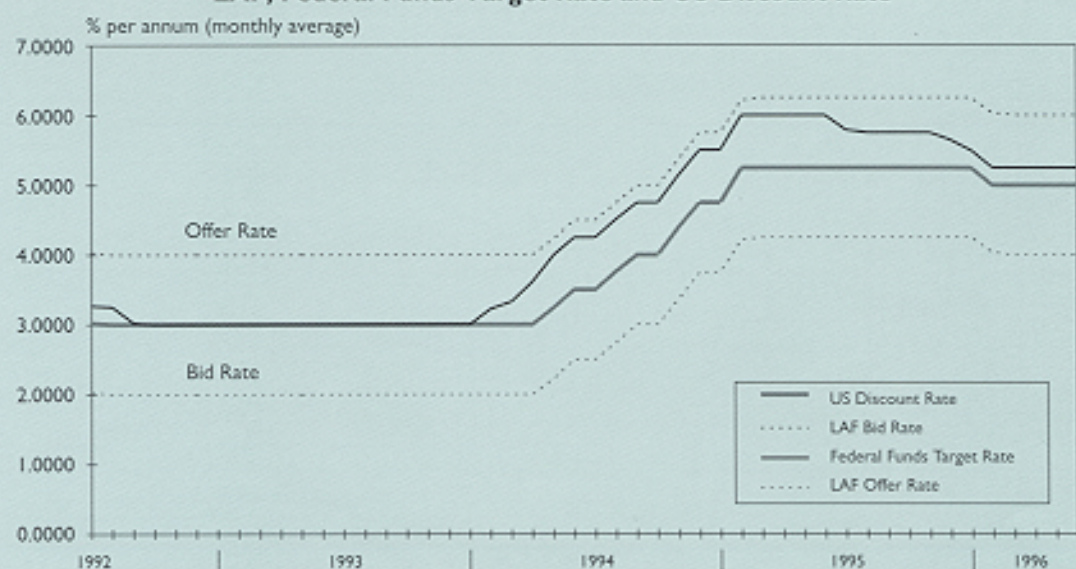
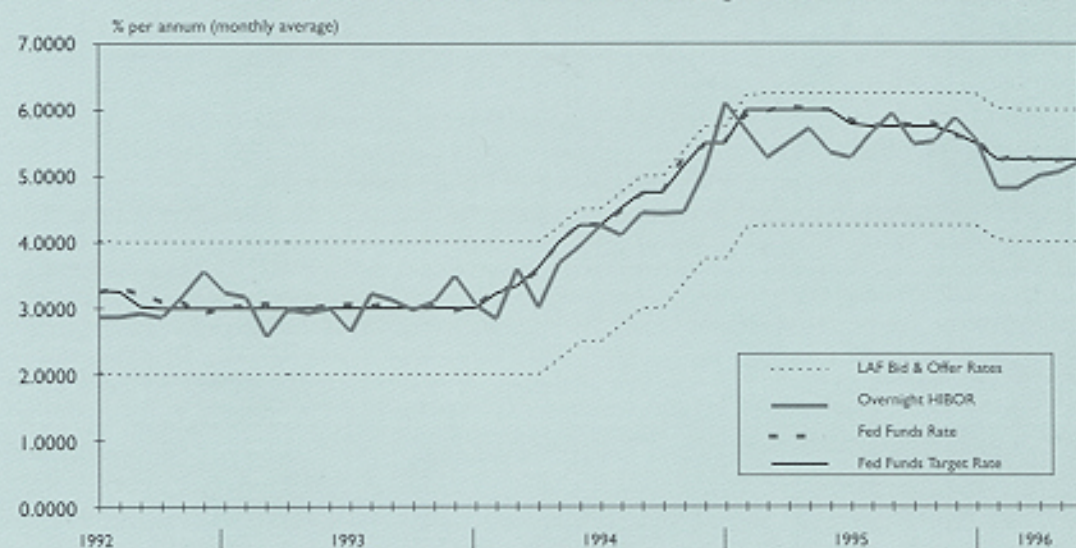
1 The LAF operates after the close of the HK dollar interbank market, between 4:00 and 5:00 p.m. from Monday to Friday, and between 11:30 a.m. and 12:00 noon on Saturday. Banks which find themselves having a negative balance in the clearing accounts may approach the HKMA for liquidity assistance through the LAF. Such assistance is provided at a prescribed offer rate in the form of Repurchase Agreements (Repos) involving eligible securities. The LAF also offers a deposit facility. Banks with surplus funds in their clearing accounts can place them with the Exchange Fund through the LAF at the Bid Rate.

2 This is the rate charged by the Fed on collateralised borrowing by commercial banks from the Discount Window.

3 This refers to the basic Discount Rate. There are different rates for seasonal credit, extended credit and emergency credit.

4 In the USA, depository institutions can trade the reserves with Federal Reserve among themselves in the Fed funds market. The Fed Funds Rate is the cost for overnight borrowing of such reserves. The Fed Funds Target Rate is the target which the Federal Reserve would like the Fed Funds Rate to stay around. The Federal Reserve will conduct money market operations to influence the Fed Funds Rate if it is considered to deviate too much from the target rate.

Chart 1

LAF, Federal Funds Target Rate and US Discount Rate**LAF, Federal Funds Rates and Overnight HIBOR**

Sources: Datastream

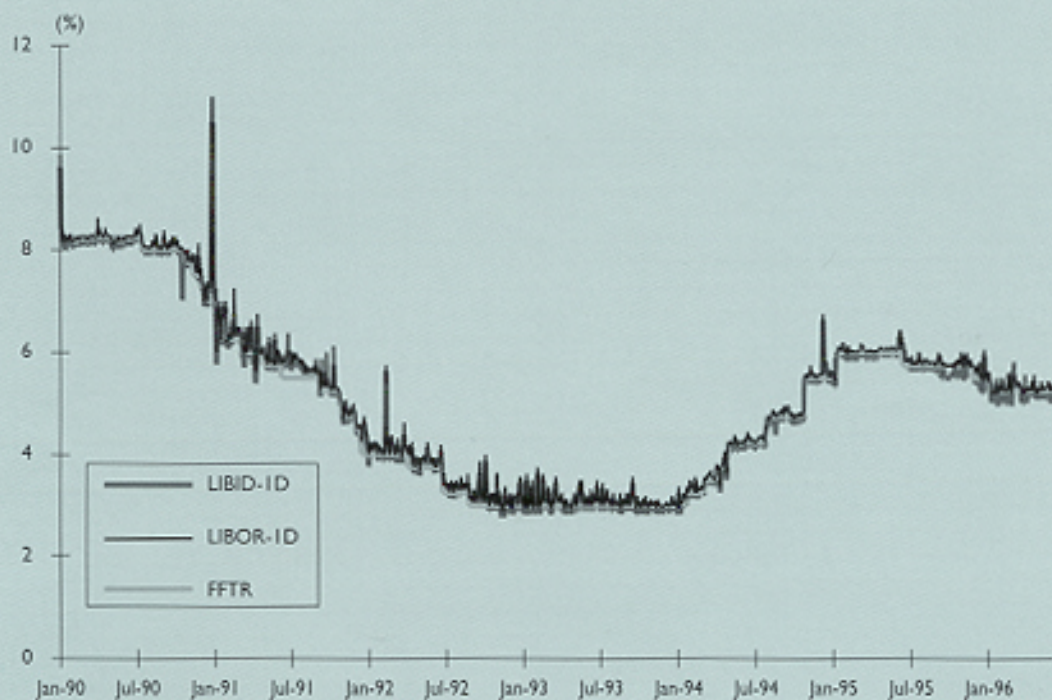
interest rate cycle between February 1994 and February 1995, the FOMC decided to adjust the Fed Funds Target Rate upwards on seven occasions. The combined magnitude of increase was 300 basis points (bps). The Fed Funds Rate and LIBID followed suit, and rose by around 290 bps during the same period. The US Discount Rate, on the other hand, was adjusted only on 4 occasions, by a total of 225 bps. Thus the spread between the US Discount Rate and the US Fed Funds Target Rate widened to 75 bps. The LAF corridor still embraced

the US Fed Funds Target Rate. Nevertheless the headroom for the overnight HIBOR to move above the market interest rate for US dollar (as represented by the Fed Funds Target Rate) was reduced (Chart 1).

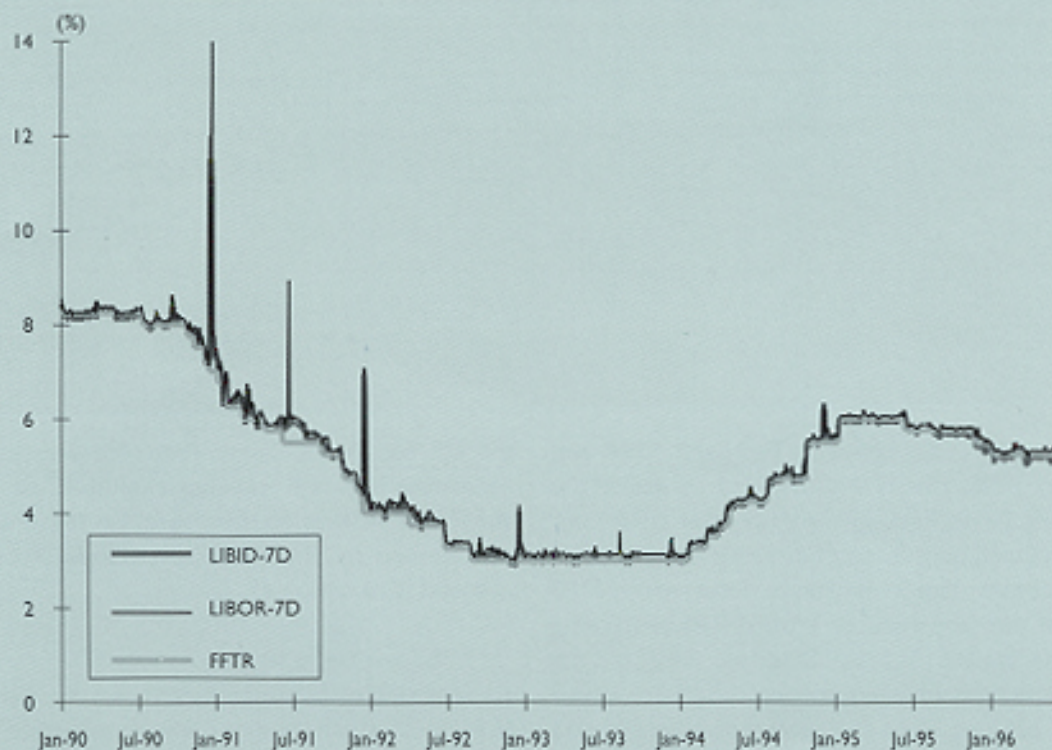
Too narrow a headroom would unnecessarily constrain the upward movement in overnight HIBOR. This may at times lead to an interest rate differential in favour of the US dollar, which could in turn affect the Hong Kong dollar exchange rate.

Chart 2

Short Term LIBID, LIBOR & Fed Funds Target Rate
(Jan 90 – June 96)



7-Day LIBID, LIBOR & Fed Funds Target Rate
(Jan 90 – June 96)



Source: Datastream

The Fed Funds Target Rate as a Reference Rate

The HKMA can adjust the LAF Rates whenever there is too little headroom. However, a tidier approach would be to choose a reference rate which is more representative of the US dollar market interest rates. The Fed Funds Target Rate should be a suitable choice for the following reasons :

- (a) the Fed Funds Target Rate tracks closely overnight LIBID (Chart 2). The average differential during 1990-1995 was only around 12 bps as compared with a differential of 55 bps between the Discount Rate and LIBID;
- (b) the Fed Funds Target Rate is now as transparent as the Discount Rate. Since February 1994, the FOMC announced the adjustments in the Fed Funds Target

Rate on the same day when the change was made⁵; and

- (c) the Fed Funds Target Rate now appears to be a better indicator of US monetary policy than the US Discount Rate. Banks in the USA appear to have become increasingly reluctant to borrow from the Discount Window. The Discount Rate has become little more than an indicator, arguably a lagging indicator, of the Fed's policy stance.

Following consultation with the Exchange Fund Advisory Committee, the Hong Kong Monetary Authority (HKMA) has decided that the reference rate for setting the LAF Bid and Offer Rates should be changed from the US Discount Rate to the Fed Funds Target Rate, subject to the US Federal Reserve continuing with the present practice of making timely announcement on changes in the Fed Funds Target Rate. *

— Prepared by the Monetary Policy & Markets Department

5 Previously, the market had to gauge the policy intention of FOMC from the minutes of its meetings, and phrases like "slightly higher degree of reserve pressure" or "higher degree of reserve pressure" were used to indicate the intended magnitude of adjustment in the Fed Funds Target Rate.