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Operation of monetary policy

Hong Kong Monetary Authority

REGULAR ARTICLE

Operation of monetary policy

by the Monetary Management Department

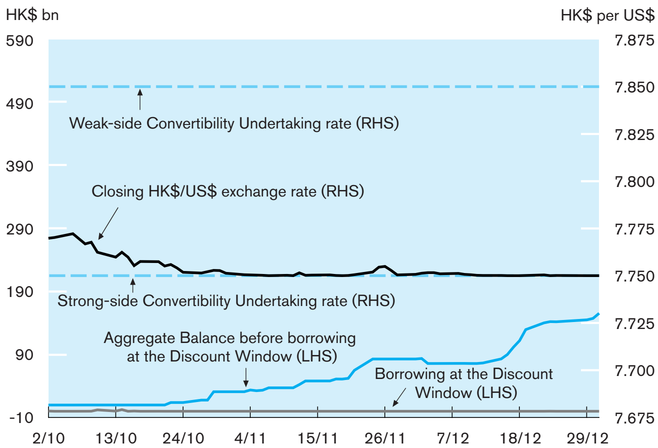
In the fourth quarter of 2008, the Hong Kong-dollar exchange rate rose to near the strong-side Convertibility Undertaking (CU) of HK$7.75, on unwinding of interest carry trades and possible repatriation of funds from abroad. The interbank money market tightened due to growing concerns over the credit-worthiness of market participants. The HKMA introduced a series of temporary measures to ease market tensions, and the Financial Secretary announced a deposit guarantee and a contingent banking capital facility to strengthen public confidence in the local banking system. The HKMA injected large amounts of liquidity into the banking system, partly through foreign exchange operations within the Convertibility Zone, and partly upon the repeated triggering of the strong-side CU by banks. As a result of these measures, combined with global efforts to address banks' liquidity concerns, the interbank interest rates eased significantly. To facilitate banks' liquidity management in the face of tightened credit conditions, a total of HK$12 billion worth of additional Exchange Fund Bills was issued by the HKMA during the quarter. The HKMA base rate was reduced from 3.50% to 0.50% during the quarter, reflecting the adjustment in the formula in determining the base rate and the lowering of the benchmark interest rate in the US.

Convertibility Undertaking and Aggregate Balance

During the quarter, the Hong Kong dollar strengthened to near the strong-side of the CU and the CU was repeatedly triggered (Chart 1). The strengthening of the Hong Kong dollar was partly attributable to the unwinding of interest carry trades. Such trades were previously established to take advantage of the interest-rate differential in favour of the US dollar. However, as the interest-rate spread narrowed and the market turned to a risk-reduction mode alongside a deepening of global financial crisis, the interest carry trades were unwound and Hong Kong dollar strengthened. Another explanation for the strengthening of the Hong Kong dollar is the possible repatriation of funds from abroad by local corporations to finance their operations here.

CHART 1

Aggregate Balance, Discount Window activity and Hong Kong-dollar exchange rate



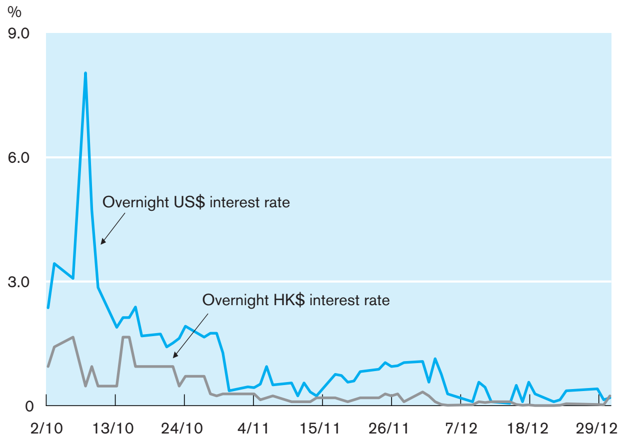
During the reporting period, the HKMA injected large amounts of liquidity into the banking system by purchasing US dollars against Hong Kong dollars, partly through operations within the Convertibility Zone and partly upon the repeated triggering of the strong-side CU by banks. As a result, the Aggregate Balance rose markedly from HK$10 billion to HK$158 billion. Banks' demand for Exchange Fund Bills was strong, as manifested in the low yields of short-dated papers. The HKMA issued a total of HK$12 billion worth of additional Exchange Fund Bills during the quarter.

Short-term Hong Kong-dollar interest rates

To ease tension in the interbank money market, the HKMA introduced five temporary measures on 30 September to provide liquidity assistance to local licensed banks that might require it.[1] These measures facilitate access to the Discount Window by expanding eligible collateral to include US-dollar assets, extending the maturity of Discount-Window borrowing from overnight to up to three months, and waiving the 5% penalty on banks using more than 50% of their Exchange Fund paper holdings as collateral. In addition, under the measures, banks might obtain liquidity from the HKMA through foreign-exchange swaps and borrowing against collateral of acceptable credit quality. To strengthen public confidence in the local banking system, the Financial Secretary announced on 14 October a temporary guarantee on all customer deposits held with authorized institutions and the establishment of a contingent facility to provide capital to locally incorporated banks.[2]

The formula for the determination of the Base Rate was adjusted on 8 October to lower the cost of Discount-Window borrowing by narrowing the spread between the Base Rate and the US federal funds target rate. The Base Rate was reduced by 100 basis points immediately after the adjustment, then by another 200 basis points corresponding to the fall in the US federal funds target rate during the quarter. The interbank market stabilised and short-term interest rates declined following the introduction of these measures and the liquidity injections by the HKMA. The overnight interbank interest rate declined by 0.75% during the fourth quarter, from 1.0% to 0.25% (Chart 2).

CHART 2
Overnight Hong Kong-dollar and US-dollar interest rates



While Hong Kong-dollar interest rates tracked their US counterparts lower during the quarter, the negative interest-rate differential against the US dollar and forward points narrowed (Chart 3 and Chart 4). Forward points once shifted to a premium in late October amid a sharp correction in the equity market, but then eased to a small discount.

[1] See the following HKMA press releases available on the HKMA website: (a) "HKMA to provide liquidity assistance to licensed banks in Hong Kong" (issued on 30 September 2008); (b) "HKMA to adjust the formula for determination of the Base Rate" (issued on 8 October 2008); and (c) "Refinements to the measures for providing liquidity assistance to licensed banks in Hong Kong" (issued on 6 November 2008).

[2] See the HKMA press release "Financial Secretary announces new measures to support confidence in the Hong Kong banking system" (issued on 14 October 2008) available on the HKMA website.

CHART 3

3-month Hong Kong-dollar and US-dollar interest rates

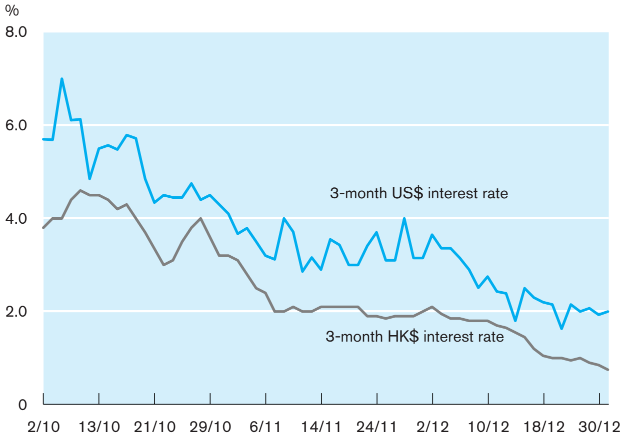
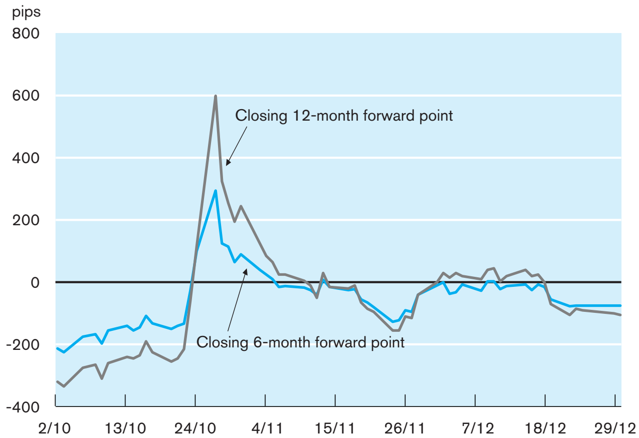


CHART 4

6-month and 12-month Hong Kong-dollar forward points

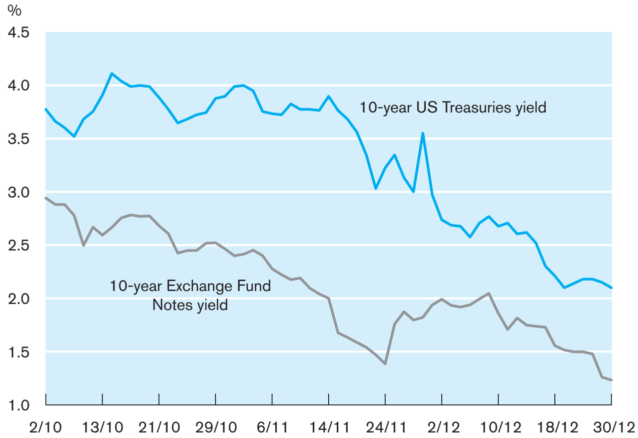


Long-term Hong Kong-dollar interest rates

Long-term yields of Exchange Fund Notes largely followed US Treasuries to decline during the fourth quarter of 2008. By the end of the quarter, the negative yield spreads between 10-year US Treasuries and 10-year Exchange Fund Notes widened marginally to -87 basis points compared with -83 basis points at the beginning of the quarter (Chart 5).

CHART 5

Yield of 10-year Exchange Fund Notes and US Treasuries



Hong Kong-dollar effective exchange rate

The Hong Kong-dollar trade-weighted nominal effective exchange-rate index (NEERI), which measures the nominal exchange value of the Hong Kong dollar against the currencies of major trading partners, closed slightly lower at 88.3 on 31 December, compared with 88.5 on 2 October (Chart 6). The lower NEERI reflects the weakening of the US dollar, particularly against the euro and the yen.

CHART 6

Hong Kong-dollar/US-dollar exchange rate and Hong Kong-dollar nominal effective exchange rate index