

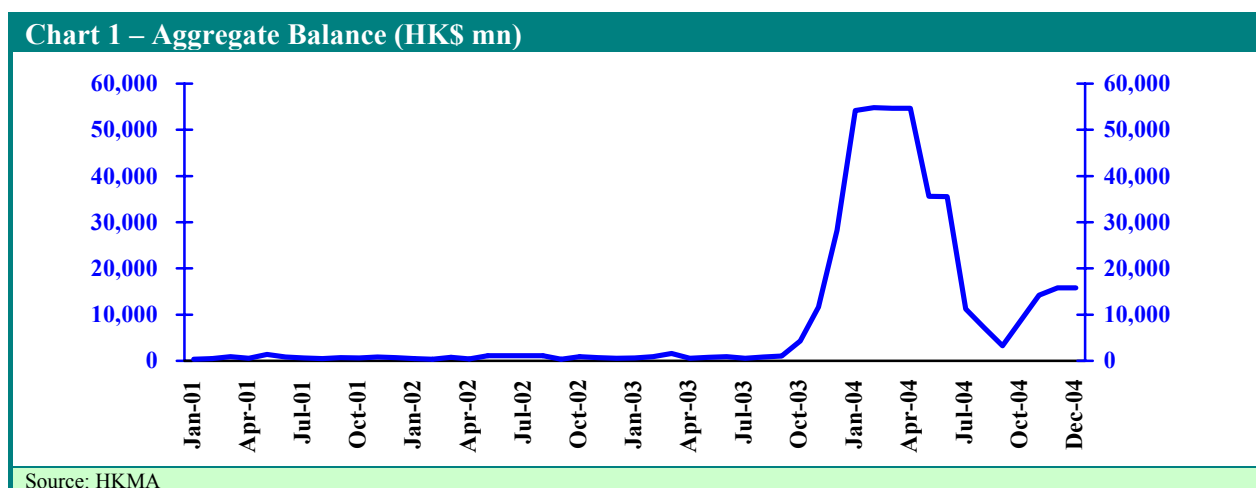
Interest Rate and Capital Movements

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Summary

Under the linked exchange rate system, interest rate movements in Hong Kong should follow those in the US. However, the interest rate gap between the US and UK continued to widen. This was largely attributable to an inflow of capital. At present, the Hong Kong stock market benefits from the inflow of capital and the resulting low level of interest rates. Nevertheless, this may be a temporary phenomenon. When the bullish sentiment over the RMB settles, capital may be drawn out from the HKD and there may be upward pressure on local interest rates.

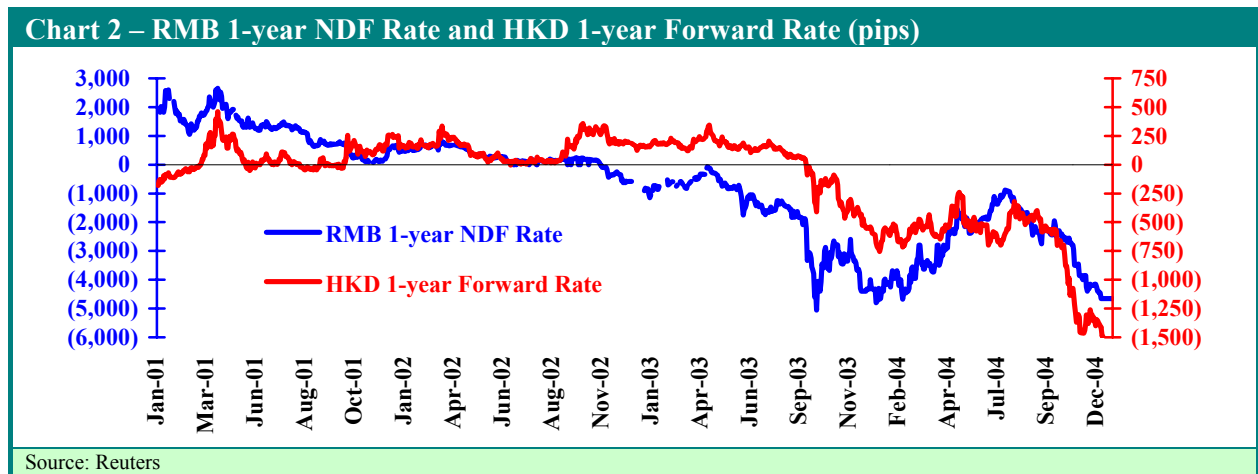
- Under the linked exchange rate system, interest rate movements in Hong Kong should follow those in the US. However, the interest rate gap between the US and Hong Kong continued to widen. On 10 November 2004, despite the FFTR in the US being raised by 25 basis points (bps), banks in Hong Kong cut the BLR back to 5% on the following day. Moreover, the Fed raised the FFTR by an additional 25 bps on 14 December 2004. Yet banks in Hong Kong left the BLR unchanged. This was largely attributable to an inflow of capital. Reflecting this, the Aggregate Balance rose from HK\$3.2 bn as of the end of September 2004 to HK\$14.1 bn as of 11 November 2004 and further to HK\$15.8 bn as of 15 December 2004 (Chart 1).



- Media reported that some of this capital was speculating on the possible appreciation of the RMB. RMB 1-year non-delivery forward (NDF) rate was trading at a

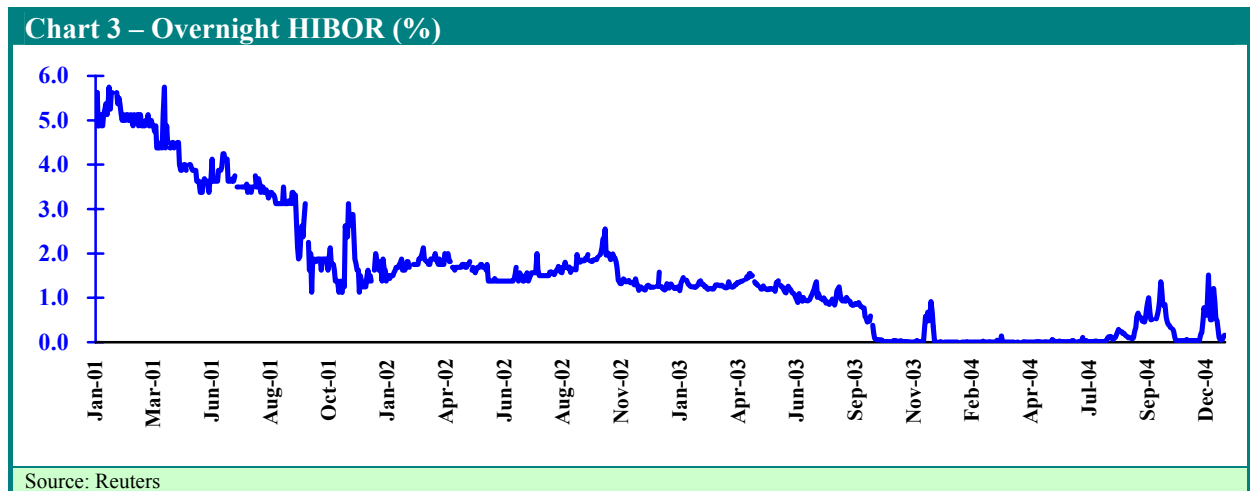
¹ This paper is for pure fact-finding and research purpose, and is not an attempt to comment on the developments of any markets/companies or interpret the policies concerned. The views expressed in this paper do not represent those of the SFC.

discount of 4,650 pips (implying a re-valuation of 5.95%) as of 15 December 2004. In fact, the discount widened from 2,440 pips as of the end of September 2004 (Chart 2).

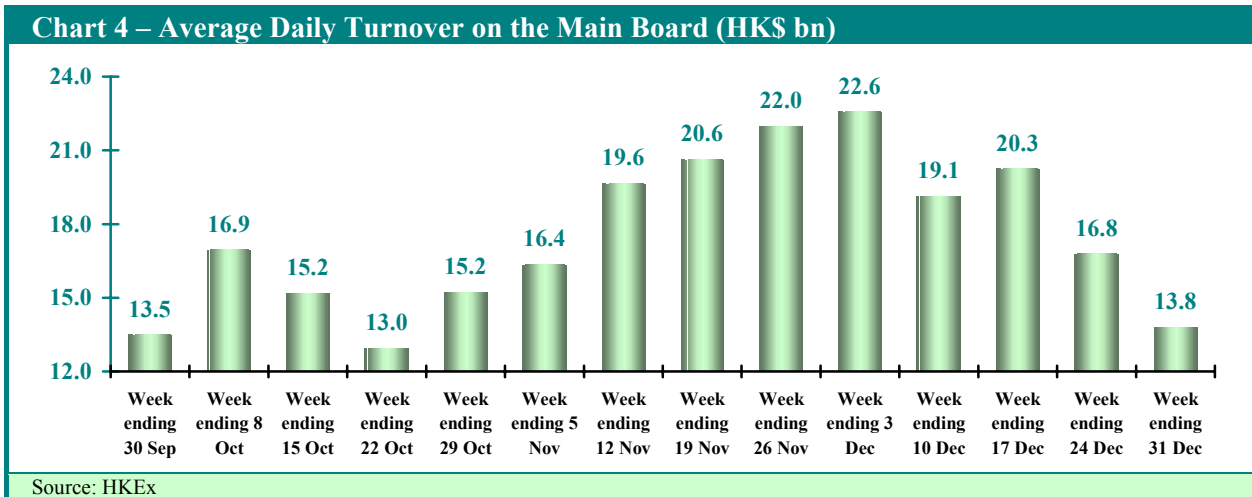


- Hong Kong is the preferred place for overseas listings of Mainland companies and is an international financial centre which is accessible by global investors. When the RMB is expected to appreciate, capital may come to Hong Kong to buy Mainland-related assets (including Mainland stocks listed on HKEx). The demand for HKD increases as a result. The HKD 1-year forward rate was trading at a discount of 1,415 pips as of 15 December 2004. This widened from 605 pips as of the end of September 2004.

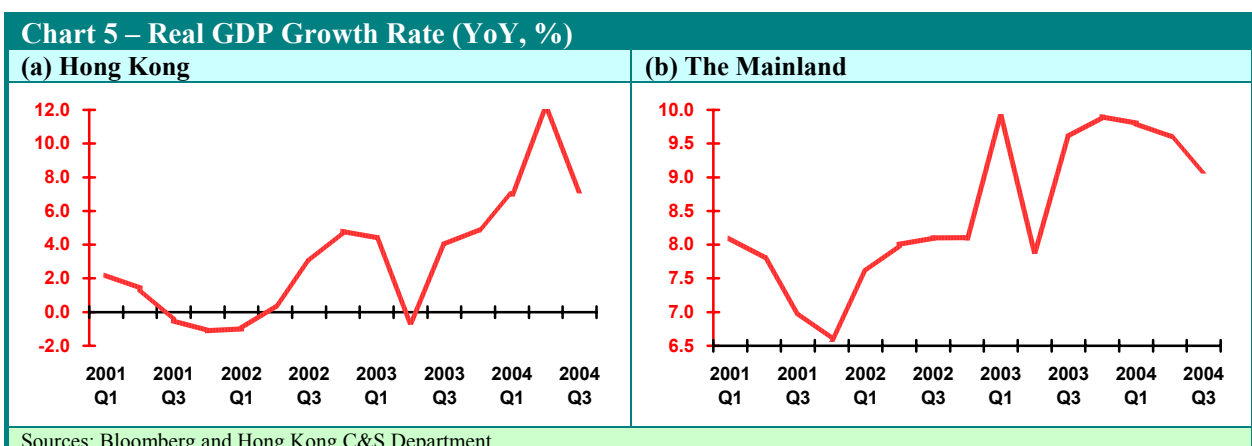
4. The overnight Hongkong Inter-Bank Offer Rate (HIBOR) fell to a few bps recently. Prior to the interest rate cut on 11 November in Hong Kong, HIBOR overnight was only about 3-5 bps (Chart 3), and was lower than the then benchmark savings rate of 0.125%. Subsequently, the benchmark savings rate was cut to 0.01% in mid November. With the exception of a brief period in December where the overnight HIBOR rebounded to some 100-200 bps due to a few large IPOs, the rate was at about 10-15 bps by the end of 2004.



5. Because of the inflow of capital, HKD interest rates have been maintained at a very low level despite the fact that there were interest rate hikes at the 10 November and 14 December 2004 Federal Open Market Committee meetings in the US. The rally of the Hong Kong stock market since the end of September reflected this low level of interest rates in Hong Kong. From the low during the period to the recent peak in December, the HSI rose 8.7%.
6. Market turnover also increased. The average daily turnover on the Main Board amounted to HK\$22.6 bn for the week ending 3 December 2004 (Chart 4). This has increased from HK\$13.5 bn for the week ending 30 September 2004. Market turnover then shrank somewhat, but market analysts believed that it was due to large IPO activities during the period and other factors such as Christmas and New Year holidays.



7. There are some differences between this round of capital inflow and capital inflow late last year / early this year.
- During the previous inflow, underpinned by the supportive measures of the Mainland Government such as the CEPA and the relaxation of Mainland travel rules, the economy of Hong Kong rebounded sharply from the SARS period (Chart 5a). The real estate sector stabilised after consolidating for six years in a row. The Mainland economy was also resilient, with a growth of 9%+ since 2003 Q3 (Chart 5b), and there were expectations that the RMB would revalue.
 - In contrast, during this round of inflow, although the economies of both the Mainland and Hong Kong continue to be robust, economic growth is within market expectations. In the Mainland, macroeconomic measures are in force, and it is uncertain whether there will be any further tightening. Capital inflow this time is mainly attributable to the expectation of a possible revaluation of the RMB.



8. At present, the Hong Kong stock market benefits from the inflow of capital and the resulting low interest rate environment. However, this may be a temporary phenomenon. When the bullish sentiment over the RMB settles, capital may be drawn out from the HKD and there may be pressure on local interest rates to rebound to such levels that are more in line with the US interest rates.
9. In any case, the level of the Aggregate Balance of HK\$15.8 bn as of the end of January 2005 was far higher than the “normal” level of about HK\$300-600 mn during 1997-2003. Bankers and market analysts conjecture that the BLR in Hong Kong will rise when the Aggregate Balance falls to the “normal” level.
10. In addition, the FFTR has been staying at low levels. Prior to the interest rate hikes since June 2003, the FFTR was at a 45-year record low of 1% (Chart 6). The current FFTR was still far lower than the period average of 6.2%. Even if the period of early 1980s (i.e. the oil crisis period) is excluded, the average was 5.6%. Alternatively, the average was 5.2% if we concentrate on the recent 20 years, and it was 4.1% if we concentrate on the recent 10 years. In other words, the current FFTR level is “abnormally” low and will continue to remain “low” for some time even if there are more hikes.

