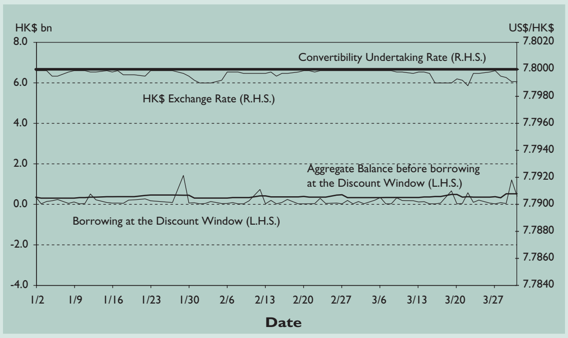
Following a change in the Federal Reserve's policy on 19 December 2000 from "tightening" to "easing" bias, the Fed surprised the market in 2001 with a series of rapid rate cuts. Yet the US dollar remained strong against other major currencies, supported by the view that the US could weather the economic slowdown at least as well as other economies. There were corresponding interest rate cuts in Hong Kong, and the Hong Kong dollar exchange rate remained steady within 7.7977-7.8000 throughout the first quarter of 2001. The Convertibility Undertaking was triggered twice, in early February and late March. In both instances, the fall in the Aggregate Balance were quickly reversed by the market and caused hardly any impact on the local financial markets. Towards the end of the quarter Hong Kong dollar forward points spiked up significantly amidst mounting concerns that the Asian regional markets would be hard hit by the US economic slowdown, the sharp depreciation of the Japanese Yen and renewed uncertainties in Argentina. Short-term Hong Kong dollar interest rates and the yields on longer-term Exchange Fund Notes eased along with their US dollar counterparts.

Convertibility Undertaking and Aggregate Balance

US economic indicators released since late 2000 suggested that the US economy was in danger of losing steam rather abruptly. Amidst the sharp correction in the US equity markets and the deterioration in business and consumer confidence, the US Federal Reserve made a series of aggressive interest rate cuts. It cut the Fed funds target rate (FFTR) three times during the first quarter of 2001 - first with a surprise 50 b.p. inter-meeting rate cut on 3 January, followed by two further 50 b.p. cuts at the Federal Open Market Committee meetings on 31 January and 20 March. This brought the FFTR down from 6.50% at the beginning of the year to 5.00% at the end of March. The sharp change in the Fed's monetary stance and the quantum of FFTR reduction aroused the fear that the US economy was much worse than expected and was on the brink of recession. Nevertheless, the US dollar exchange rate remained strong against other major currencies, which may have reflected the view that the US would still fare no worse than other major economies in this period of slowdown, and that the contraction of the economy was most likely to be only short-lived, given the strong supportive action from the Fed.

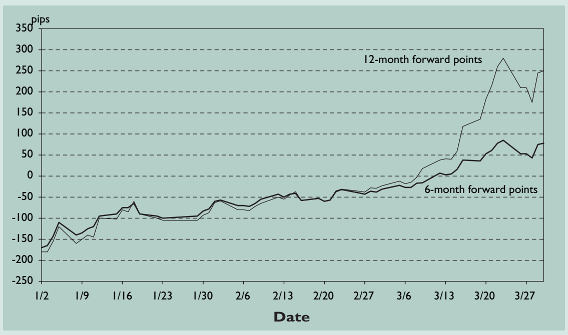
In Hong Kong, there were corresponding cuts in the Base Rate. The exchange rate remained very steady, within the narrow range of HK$7.7977 to 7.8000 to the US Dollar. The Convertibility Undertaking (CU) was triggered twice during the first quarter. In January the exchange rate stayed within a tight range on the strong side of 7.8000. The CU was triggered on 8 February when short-term players bought US dollar to enjoy the higher US yield on their excess liquidity. The CU was triggered again on 27 March with the sharp decline in the Hong Kong equity market. In both cases, the projected Aggregate Balance (AB) dipped briefly into negative territory, but was quickly restored when the resulting tighter money market conditions enticed banks to offer to sell US dollars back to the Exchange Fund. The exchange rate closed at 7.7991 on 30 March 2001, as compared to 7.7998 at end-December 2000, while the AB ended the quarter at HK$488 mn, as compared to HK$321 mn at end-December (Chart 1).

Chart 1
Aggregate Balance, Discount Window Activities and Hong Kong Dollar Exchange Rate



While the spot exchange rate remained very steady during the first quarter, the volatility and activity level in the forward market picked up considerably. Mounting concerns that the Asian regional markets would be hard hit by a possible US recession stimulated Hong Kong dollar selling interest in the forward market as a hedge against the Asian risks. Hong Kong dollar forward points reversed their downward trend and crept higher, crossing over to positive territory by early March. The hedging demands intensified in March amidst the sharp depreciation of the Japanese Yen, the escalating violence in Indonesia, and the political tension in Argentina which weakened confidence in its currency board system. By mid-March, the 6-month and 12-month Hong Kong dollar forward points reached +85 pips and +310 pips respectively, before closing at +78 pips and +250 pips on 30 March, as compared to -155 pips and -170 pips at end-December (Chart 2).

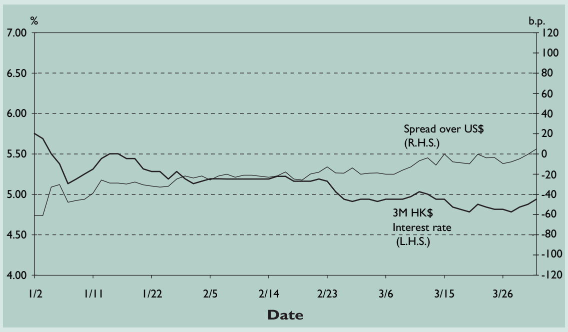
Chart 2
6-month and 12-month Hong Kong Dollar Forward Points



Short-term Hong Kong Dollar Interest Rates

With the stable Hong Kong dollar spot exchange rate and the quick replenishment of the AB on the two occasions when the CU was triggered, liquidity in the interbank market remained abundant. The level of the AB was effectively maintained within the range HK$277mn - HK$488 mn during the quarter. As a result, overnight Hong Kong dollar interest rate also exhibited a very stable pattern, dipping to a low of 4.13% on 21 March and closing at 5.88% on 30 March, as compared to 6.88% at end-December. One-month to six-month Hong Kong dollar money market rates eased along with their US dollar counterparts. The bellwether three-month Hong Kong dollar money market rate eased from 5.81% at end-December to close at 4.94% on 30 March (Chart 3). However, reflecting the fact that the Hong Kong dollar forward rates turned from discount to premium, the interest differential between three-month Hong Kong dollar and US dollar rates narrowed from -58 b.p. at end-December to +5 b.p. at end-March.

Chart 3
3-Month Hong Kong Dollar Interest Rate and its Spread over 3-Month US Dollar Interest Rate

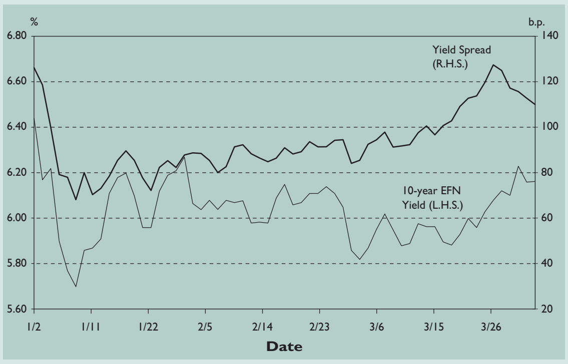


During the quarter, the Hong Kong Association of Banks made three 50 b.p. cuts to the savings rate, from 4.75% to 3.25%, corresponding to the changes in the FFTR.

Long Term Hong Kong dollar Interest Rates

The surprise US rate cut on 3 January marked the beginning of the aggressive rate easing cycle in the US. The Exchange Fund Notes (EFN) yield curve mirrored in general that of US Treasuries and shifted lower during the first quarter. With the sudden change in the interest rate trend, investors sought value in Exchange Fund paper; strong buying interest in longer-term notes brought down the yields significantly. The yield on 10-year EFN reached a low of 5.7% on 9 January, with the spread over the corresponding US Treasuries yield narrowing to a low of 68 b.p. Subsequently, dampened market sentiment in Asia led to some reversal, and at the end of the quarter the yield on 10-year EFN stood at 6.16%, with the yield spread over US Treasuries at 110 b.p., as compared to 6.46% at end-December 2000, or 127 b.p. over US Treasuries (Chart 4).

Chart 4
Yield of 10-year EFN and its Spread over 10-year UST

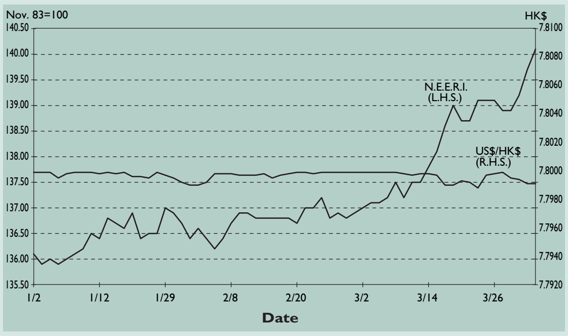


Base Rate and Hong Kong Dollar Effective Exchange Rate

The Base Rate is defined as the higher of the US FFTR plus 150 b.p., and the simple average of the 5-day moving averages of overnight and 1-month HIBOR for the previous five trading days. Following the three reductions in the FFTR during the first quarter, the Base Rate was lowered three times, on 4 January, 1 February and on 21 March, each by 50 b.p., from 8.00% to 6.50%.

The Hong Kong dollar trade-weighted nominal effective exchange rate index (NEERI), which measures the nominal exchange rate of Hong Kong dollar vis-à-vis currencies of major trading partners, closed at 140.10 on 31 March, up from 136.00 at end-December. The higher NEERI reflected the strengthening of the US dollar against the major currencies, in particular the Euro and the Japanese Yen (Chart 5).

Chart 5
US Dollar / Hong Kong Dollar Exchange Rate and Hong Kong Dollar Nominal Effective Exchange Rate Index



Domestic Credit and Money Supply

Domestic loans[1] contracted slightly by 0.9% in the first quarter, although they have shown mild positive year-on-year growth since August 2000. The general sluggishness of lending appears to be related to a number of demand-side factors, including declines in property values, an increase in open account trading, and a diversification of fund-raising channels.[2]

Narrow money supply (HK$M1) decreased by 3.9% on a seasonally adjusted basis in the first quarter, reflecting declines in both demand deposits and currency held by the public. Following three consecutive quarterly increases, broad money (HK$M3) contracted marginally by 0.5%, mainly attributable to a decrease in time deposits. Compared with a year earlier, HK$M1 declined by 0.3%, while HK$M3 was up by 4.5%.

- Prepared by the Monetary Policy and Markets Department

1 Including loans for trade financing.

2 Under an open account arrangement, importers pay directly to the account of exporters, rather than using letters of credit.