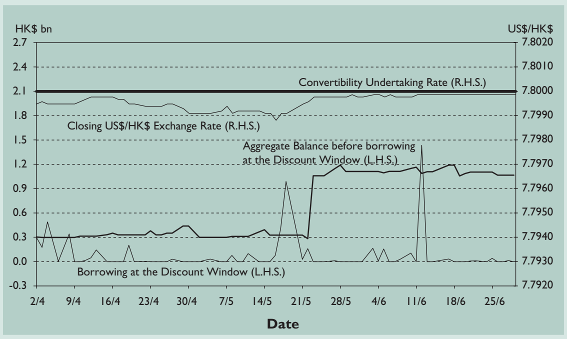
The landscape of the world financial markets changed noticeably during the second quarter of 2002. The US dollar began to trend downwards against other major currencies, including the Japanese yen. Meanwhile, the chance of an early US rate hike diminished on uncertainties about the robustness of the US economic recovery and concerns about the sustained weakness of the US equity market. The Hong Kong dollar exchange rate remained stable in the range 7.7990-7.8000 for most of the quarter. The exchange rate strengthened initially on equity-related inflows but then eased towards the Convertibility Undertaking rate after the inflows eventually triggered a Currency Board transaction, causing an expansion of the Aggregate Balance on 23 May. The Hong Kong dollar forward points eased as the broad-based weakness of the US dollar led to the unwinding of some forward positions. As expected, the US Federal Reserve maintained its "neutral" monetary policy stance and left US rates unchanged. In parallel with the falling forward points, Hong Kong dollar interest rates eased at a faster pace than their US dollar counterparts. Tracking movements in US Treasuries, the yields on Exchange Fund Notes dropped significantly during the quarter.

Convertibility Undertaking and Aggregate Balance

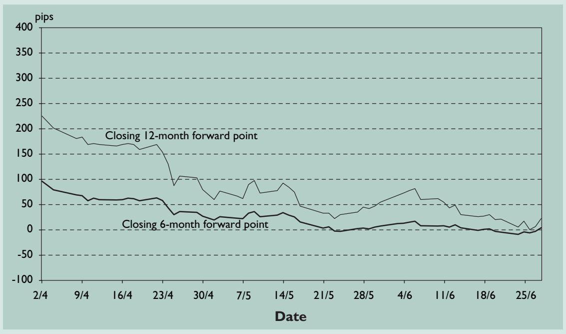
Sentiment in the local equity market turned favourable in mid-April following some investment houses' recommendations to increase weighting in Hong Kong stocks and on speculation that the Chinese authorities might soon approve the Qualified Domestic Institutional Investors (QDII) scheme, which would allow investors in China to invest in Hong Kong stocks. Supported by equity-related inflows, the Hong Kong dollar exchange rate strengthened gradually and dipped below 7.7990 briefly. On 21 May, the HKMA accepted the request from a bank to sell US dollars to the Currency Board account, which brought the Aggregate Balance up from HK$287 mn to HK$1,067 mn on 23 May. The exchange rate then drifted towards 7.8000 as softening short-term interest rates and ample interbank liquidity induced some switching into US dollars, in search of a higher yield. The exchange rate finally ended at 7.7999 on 28 June, as compared to 7.7996 on 28 March, while the Aggregate Balance ended the quarter at HK$1,075 mn, as compared to HK$307 mn at end-March (Chart 1).

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



On the back of the sharp appreciation of the Japanese yen against the US dollar and an improving outlook on the Asian economies, most Asian currencies and equity markets gained during the second quarter. The favourable sentiment prevailing in the Asian markets prompted some market players to unwind their long US dollar forward positions against the Hong Kong dollar. As a result, the Hong Kong dollar forward points eased across the board. 12-month forward points dropped noticeably from +227 pips on 2 April to the par level on 26 June before rebounding slightly as some buying interest in the long dated US dollar forwards emerged on speculation that the Convertibility Undertaking might be triggered soon. 6-month and 12-month forward points closed at +4 pips and +22 pips respectively on 28 June, as compared to +99 pips and +230 pips at end-March (Chart 2).

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

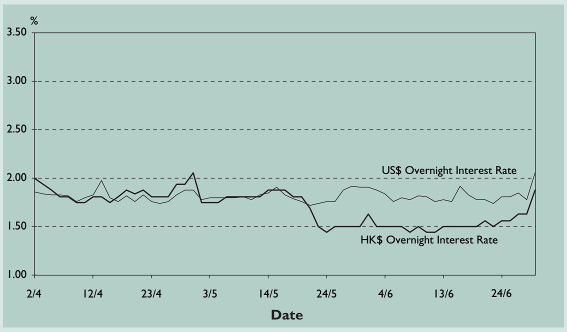


As widely expected, the Federal Reserve left the Fed funds target rate unchanged at 1.75% and retained the "neutral" bias at the two Federal Open Market Committee meetings held during the quarter, on 7 May and 26 June. While the US economic figures released during the quarter gave mixed signals on the strength and sustainability of the economic recovery, the weakness of the US stock market amidst concerns about corporate malfeasance and tepid earnings growth, the escalating Middle East tension and the conflict between nuclear rivals India and Pakistan fuelled market expectations that the Fed might delay any monetary tightening, perhaps even until next year. In Hong Kong, the HKMA Base Rate remained unchanged at 3.25% while the savings rates quoted by major banks stayed at 0.125% throughout the second quarter.

Short-term Hong Kong Dollar Interest Rates

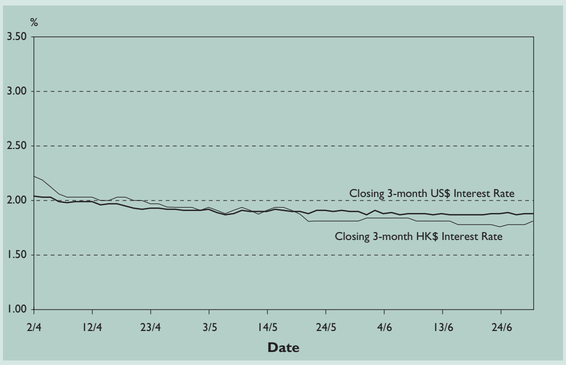
The Hong Kong dollar overnight interest rate stayed close to its US dollar counterpart during the early part of the quarter and moved within the range 1.63-2.06%. The overnight rate, however, eased significantly and stayed below the US dollar rate after the triggering of the Currency Board on 21 May. The overnight rate then hovered around 1.50% before the usually higher half-year end funding demands sent it up to close at 1.81% on 28 June, as compared to 2.31% at end-March (Chart 3).

Chart 3
Overnight Hong Kong Dollar and Overnight US Dollar Interest Rates



Hong Kong dollar term deposit rates moved lower in parallel with US dollar rates on the fading prospect of a near term US rate hike. However, driven by the falling forward points, the term deposit rates eased at a faster pace than their US dollar counterparts. As a result, the interest spreads between Hong Kong dollar and US dollar interest rates narrowed and eventually dropped to the negative zone. 3-month Hong Kong dollar money market rate fell from 2.25% at end-March to 1.81% by end-June 2002, 7 b.p. below its US dollar counterpart (Chart 4).

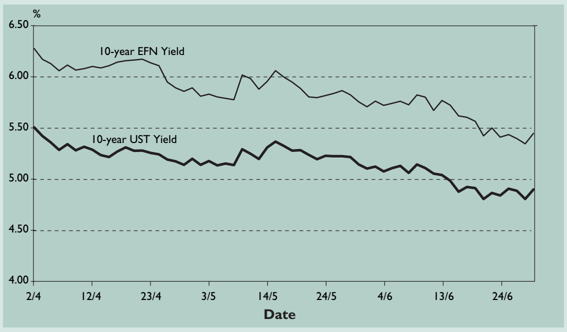
Chart 4
3-month Hong Kong Dollar and 3-month US Dollar Interest Rates



Long-term Hong Kong Dollar Interest Rates

The US Treasuries market rallied as the tame US economic data eased concerns about an imminent US rate hike and the sliding US stocks fuelled buying interest in safe-haven government bonds. Tracking closely the movements of their US counterparts, the yields on Exchange Fund Notes (EFN) dropped substantially. 10-year EFN yield fell from a high of 6.29% on 2 April to 5.44% on 28 June, as compared to 6.22% at end-March (Chart 5). As the EFN yields eased at a slightly faster pace than their US counterparts, the yield spread of the 10-year EFN over US Treasuries narrowed to 56 b.p. on 28 June from 80 b.p. at end-March.

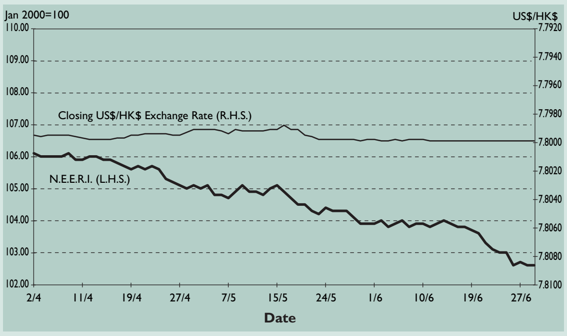
Chart 5
Yield of 10-year Exchange Fund Notes and 10-year US Treasuries



Hong Kong Dollar Effective Exchange Rate

The Hong Kong dollar trade-weighted nominal effective exchange rate index (NEERI), which measures the nominal exchange rate of Hong Kong dollar against currencies of major trading partners, closed at 102.60 on 29 June 2002, as compared to 106.00 at end-March (Chart 6). The lower NEERI reflected the weakening of the US dollar against other major currencies, in particular the Japanese yen and the euro.

Chart 6
US Dollar/Hong Kong Dollar Exchange Rate and Hong Kong Dollar Nominal Effective Exchange Rate Index



- Prepared by the Monetary Policy and Markets Department