Notwithstanding another round of heavy selling pressure on Asian currencies in June amidst the weakening of the Japanese Yen, the Hong Kong dollar remained remarkably stable throughout the June quarter. The capital outflow in mid-June was quickly stemmed by the shrinkage in interbank liquidity and the rise in interest rates under the automatic adjustment mechanism of the currency board system. The improved transparency of HKMA's market activities through the announcement of the forecast change in the Aggregate Balance facilitated a more efficient and orderly interest rate adjustment. The Hong Kong dollar exchange rate remained stable. Compared with October 1997, the market reaction and interest rate hike were much more moderate in June 1998.

Monetary Conditions Prior to mid-June

Monetary conditions in Hong Kong were generally stable for most of April, with the Hong Kong dollar exchange rate trading within a narrow range of around 7.744 to 7.750 (Chart 1). Due to a sizable commercial order to buy US dollars against Hong Kong dollars towards the end of April, the aggregate clearing balance of the banking system before LAF (the Aggregate Balance) fell substantially from HK$15.5 bn to HK$7.8 bn on 29 April (Chart 2). Overnight HIBOR touched 6.75% in the morning of 30 April but quickly eased to around 4% by the close of the day when the market realized that there were no signs of speculative attack on Hong Kong dollar.

Increasing concerns over the political and social unrest in Indonesia sent Indonesian Rupiah to a low of 10,200 on 7 May. Other Asian currencies were also adversely affected. As a result, Korean Won and Malaysian Ringgit depreciated by 4.6% and 3.1% respectively as compared to the beginning of May. There were some small selling orders on the Hong Kong dollar, as a result of which the Aggregate Balance declined further to around HK$5 bn in late May. But, the exchange rate of the Hong Kong dollar remained stable throughout.

Events in mid-June

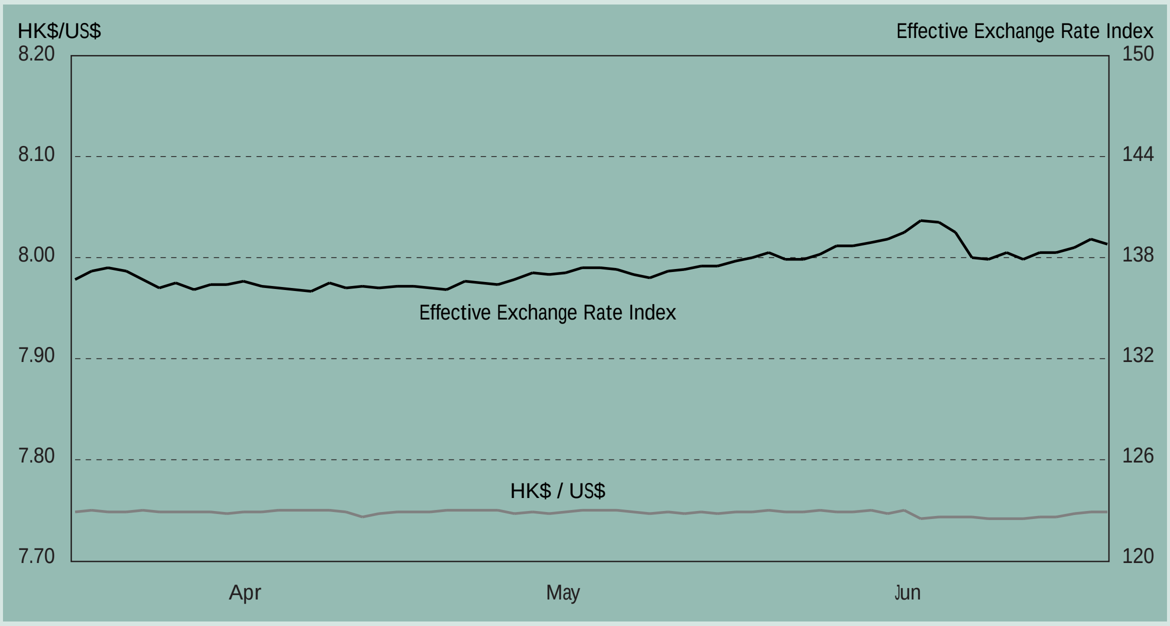
In mid-June, a further weakening of the Japanese Yen to an 8-year low of 146 triggered substantial selling pressure in the regional currency and stock markets. From end-May to mid-June, the stock markets in Korea, Philippines, Malaysia and Thailand fell by 13 - 19%. Thai Baht, Philippine Peso and Indonesian Rupiah depreciated by 8%, 8.5% and 23% respectively during the same period. The worsening of the external environment coupled with concerns over the sluggishness of the domestic economy sent the Hang Seng Index to 7,438 on 15 June. Selling pressure on the Hong Kong dollar emerged in the second week of June. But the outflow of funds was again quickly stemmed by a shortage of liquidity and a rise in interest rates. In this episode, overnight and 1-month HIBOR rose to 17% and 18.5% respectively, much more moderate than the hike in October 1997 when the rates surged to 280% and over 45% respectively. As the Japanese Yen rebounded sharply on 17 June on the back of joint intervention by the US and Japan authorities, the overnight and 1-month HIBOR quickly eased to 9.5% and 10.5% respectively.

The increased transparency of HKMA's market activities has contributed to a more orderly and moderate interest rate adjustment in the June round of selling pressure. Starting from 11 June, the HKMA has announced the forecast change in the Aggregate Balance arising from its foreign exchange transactions[1]. This enables the market participants to anticipate the changes in the liquidity conditions in the interbank market and position themselves accordingly. As an illustration, when the forecast announced on 12 June showed that the Aggregate Balance would shrink to a negative HK$6.6 bn on 16 June, the impending shortage of interbank liquidity drove interbank interest rates up on 15 June, with 1-month and 3-month HIBOR touching a recent high of 18.5% and 16.0% respectively. The high interest rates induced some banks to sell US dollars on a "value today" or "value tomorrow" basis to obtain Hong Kong dollars to meet their settlement needs. As a result of the reversal of capital flows, the Aggregate Balance returned to a positive HK$268 mn on 16 June and further increased to HK$500 mn on 17 June. Both 1-month and 3-month HIBOR eased significantly to close at 10.5% on 17 June. As the regional markets stabilized with the rebound of the Japanese Yen, there was an inflow into Hong Kong dollar and the Aggregate Balance restored to around HK$3.5 bn on 23 June and remained at that level until the end of the June quarter.

The differential between the Hong Kong dollar interbank interest rates and the corresponding US dollar interest rates, in terms of the one-month

Chart 1

HK Dollar Exchange Rate (April-June 98)



[1] See "Greater Transparency of HKMA's Market Activities" on page [ ] of this report.

Chart 2

Money Market Operations and Movement of Overnight Interbank Interest Rate (April-June 1998)

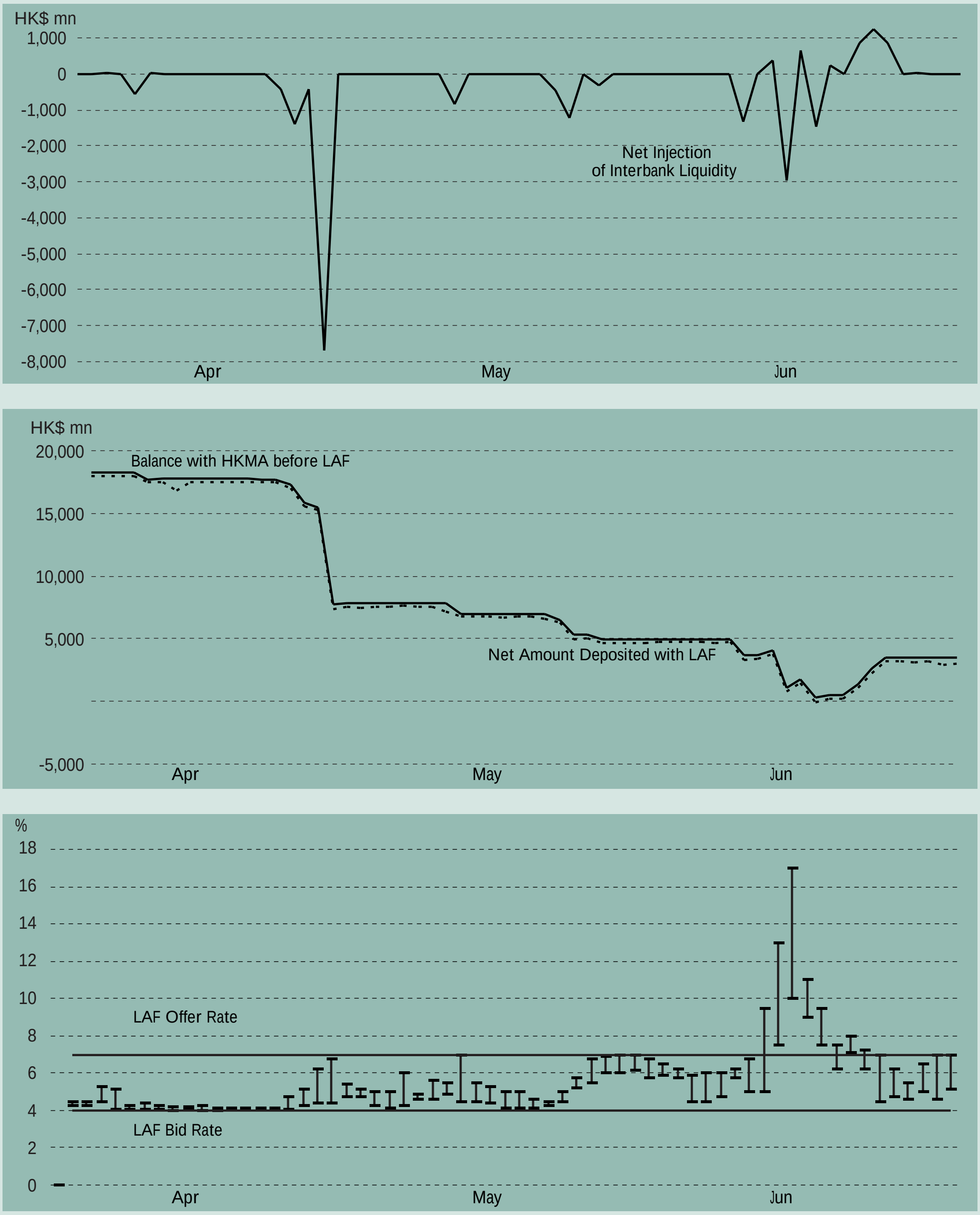


Chart 3

Differentials between Hong Kong Dollar and US Dollar Interest Rate (April - June 98)

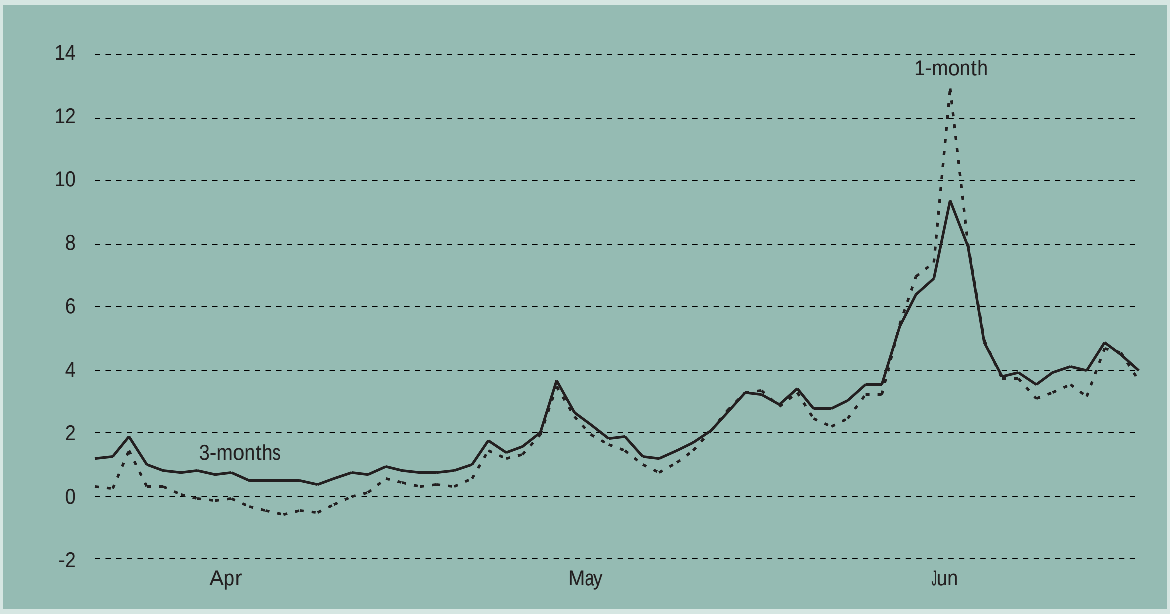
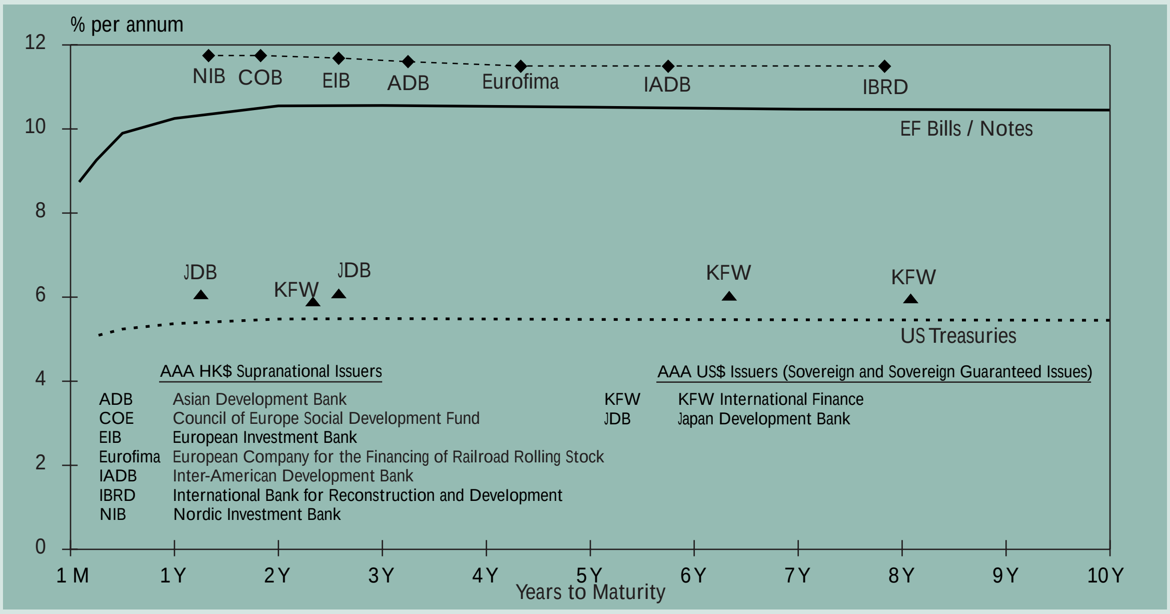


Chart 4

HK$ and US$ Yield Curves



and three-month rates, averaged 214 and 246 basis points respectively during the June quarter (Chart 3), as compared with 252 and 370 basis points respectively in the March quarter. Notwithstanding the movements in the interbank interest rates, the savings deposit rate governed by the Interest Rate Rules (IRR) of the Hong Kong Association of Banks and the best lending rate quoted by major banks remained unchanged at 5.25% and 10% respectively throughout the June quarter.

During the June quarter, the Hong Kong dollar exchange rate moved within a narrow range of HK$7.742 - 7.750 to US$1. The overall exchange value of Hong Kong dollar, as measured by the trade weighted Effective Exchange Rate Index (EERI), is affected by the exchange rate of the US dollar vis-à-vis other currencies. The EERI moved on a gently rising trend from 136.7 at the beginning of the quarter to peak at 140.2 in mid-June on the back of a weakening Japanese Yen. Following a brief rebound of the Yen in the latter part of June, the EERI eased to around 138.

Exchange Fund Bills and Notes

Reflecting the rather weak sentiment in the regional financial markets, the yield spreads between the Exchange Fund Notes and the US Treasuries widened further during the June quarter. In terms of the 7-year and 10-year paper, the yield spread widened from 235 bp and 243 bp respectively at the beginning of April to 490 bp and 497 bp respectively at the end of June (Chart 4). Nevertheless, most of the new issues of the Exchange Fund Bills and Notes continued to be oversubscribed. In view of the reduced demand for the 28-day Exchange Fund Bills as banks have become more proficient in managing their intraday liquidity under the Real Time Gross Settlement system, the HKMA has cut the size of each tap issue of the 28-day bills from HK$5 bn to around HK$2 bn. As at end-June 1998, the total outstanding amount of Exchange Fund Bills and Notes stood at HK$105.3 bn.