The exchange rate of the Hong Kong dollar and the local money markets remained stable in the second quarter of 1999, with active two-way fund flows. The Hong Kong dollar exchange rate tended to converge towards the rate of the Convertibility Undertaking, but nevertheless maintained a small differential. A shift in the US monetary stance towards a tightening bias in May, coupled with rumours of the "unpegging" of the Argentina Peso and an imminent devaluation of the Chinese RMB, reversed the easing trend of Hong Kong dollar interest rates. The deterioration of the Sino-American relationship after the bombing of the Chinese Embassy in Belgrade did not have a significant impact on financial markets in Hong Kong. The Convertibility Undertaking was triggered a few times in June, but US dollar were also sold back to the Exchange Fund. Overall the Aggregate Balance, contracted somewhat. Short-term Hong Kong dollar interest rates, however, remained very stable, reflecting the effectiveness of the seven technical measures introduced by the Hong Kong Monetary Authority in September 1998 to strengthen the currency board system.

Convertibility Undertaking and Aggregate Balance

The commencement of the HKMA's programme to move the rate of the Convertibility Undertaking from 7.7500 to 7.8000 by 1 pip per calendar on 1 April triggered some minor outflows as the market was uncertain about its impact on the HK$ exchange rate. US$260 million were sold under the Convertibility Undertaking arrangement during 31 March to 5 April, which caused the Aggregate Balance to fall to HK$1,000 million on 8 April. This was followed by a substantial reversal of capital flows as many US and European equity fund managers began to replenish their heavily under-weighed Asian equity portfolios. The HKMA bought US$ passively on 20 April and the Aggregate Balance was increased to HK$3,752 million (Chart 1).

A shift in US monetary policy from neutral to a tightening bias led to a significant tightening in long-term US$ interest rates in May 1999. The widening gap between US$ and HK$ interest rates weighed on the HK$ exchange value. Though the Convertibility Undertaking was not triggered and the Aggregate Balance remained unchanged, the HK$ exchange rate eased to track closely the rate of the Convertibility Undertaking. At the end of May, HK$ was trading at 7.7551, 8 pips below the rate of Convertibility Undertaking, as compared to a gap of about 21 pips in late April (Chart 2).

Chart 1
Aggregate Balance and Discount Window Activities

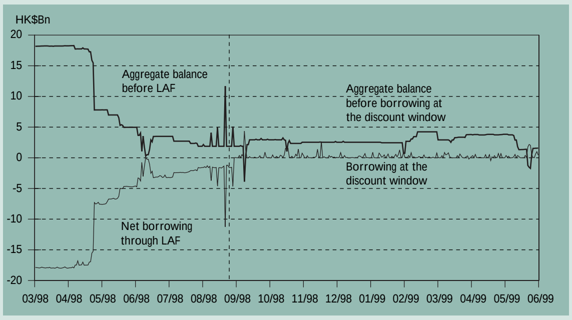
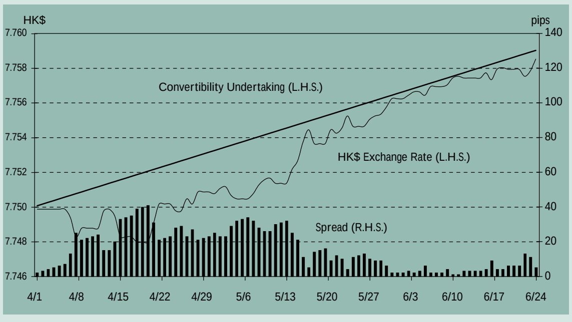


Chart 2
HK$ Exchange Rate, Convertibility Undertaking Rate and their Spread



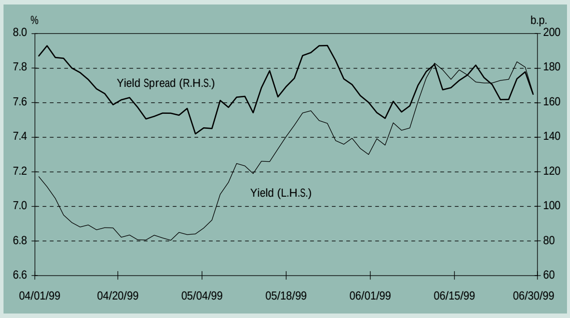
The rapid deterioration of the Argentinean economy, which was under a serious threat of recession, triggered rumours in late May that the Argentinean government was about to abandon the currency board system and devalue the Peso. A notice issued by the Bank of China to its correspondent banks on 3 June on the suspension of overseas RMB inward remittance services on 10 June was mis-interpreted as a preparatory step for an imminent RMB devaluation. Though the rumour was quickly dismissed by Chinese officials, the increase in short HK$ positions as a proxy hedge against a possible RMB devaluation put pressure on the HK$. The Convertibility Undertaking was triggered several times between 3 and 9 June, causing the Aggregate Balance to shrink to HK$153 million on 11 June. It was triggered again on 16 and 17 June, with the HKMA selling a total of US$385 million, which resulted in a reduction of the Aggregate Balance to negative HK$1,561 million on 22 June. With the shortage in interbank liquidity, overnight HIBOR stayed firm at around the Base Rate level of 6.25% for a few days. To take advantage of the higher short-term HK$ interest rates, some local banks bought HK$ from the HKMA and recycled the liquidity back to the interbank market. The HKMA passively bought a total of US$423 million on 22 - 25 June and the Aggregate Balance was restored to HK$1,553 million on 29 June.

Long Term HK$ Interest Rate and Exchange Fund Notes

The yield of 10-year Exchange Fund Notes (EFN) fell from 7.17% at the beginning of the second quarter to a low of 6.80% on 28 April, reflecting a gradual decline in the "Hong Kong premium". The subsequent release of a series of strong economic figures in the US, together with the clear signal from the US Federal Reserve Bank about its intention to tighten monetary policy at the 29 June FOMC meeting, pushed the yield of 10-year US Treasuries to the high of 6.04% on 24 June. The yield of 10-year EFN rose in tandem, reaching the high of 7.84% on 28 June before closing at 7.67% on 30 June. The yield spread of 10-year EFN over its US counterpart, however, tightened in general during the reporting period (Chart 3).

Chart 3

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



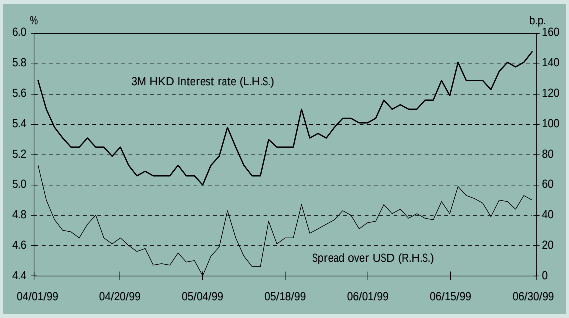
HK$500 million of 10-year Exchange Fund Notes was issued on 9 June to replace an equivalent amount of 28-day Exchange Fund Bills. The aim was to ensure that the Hong Kong Government yield curve was maintained up to the 10-year segment. The tender of the Notes received positive response, being over-subscribed by 1.5 times.

3-Month Hong Kong Dollar Interest Rate

The 3-month interbank rate remained largely stable during the reporting period, within the range between 5.00% and 5.88%. HK$ interest rates eased in April following the inflows marking the return of foreign investors to the region. In mid-May, a surge in US$ interest rates, the jitters caused by the rumours of Argentina abandoning the currency board system and RMB devaluation, and deterioration of the Sino-American relationship put some pressure on HK$ interest rates. However, the increase in interbank term rates was mild and orderly. Even in the short period in late June when the Aggregate Balance fell below zero, there was no panic in the market. This reflected to a large extent the effectiveness of the seven technical measures introduced last September in moderating the adjustment of interest rates to fund flows (Chart 4).

During the second quarter, HK$1,356 million of additional 3-month Exchange Fund Bills were issued, representing the accrued interest payments on outstanding Exchange Fund paper. As at 30 June, total outstanding Exchange Fund paper amounted to HK$99,308 billion.

Chart 4
3-Month HKD Interest Rate and its Spread over 3-Month USD Interest Rate

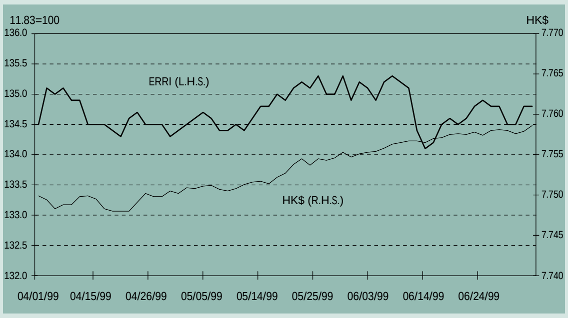


Base Rate and the HK$ Effective Exchange Rate

The Base Rate is set as the higher of the US Fed Funds Target Rate plus 150 basis points, and the simple average of the 5-day moving averages of overnight and 1-month HIBOR for the previous five trading days. The US Fed Fund Target Rate remained unchanged at 4.75% throughout the second quarter, and the relevant short-term HK$ interest rates stayed at relatively low levels. As a result, the Base Rate remained unchanged at the floor of 6.25% for the full reporting period.

The HK$ trade weighted Effective Exchange Rate Index (ERRI) closed at 134.8 on 30 June, little changed from the 134.5 level at the beginning of the second quarter, and reflecting the continuing overall strengthen of the US$ against the major currencies. The HK$ nominal exchange rate, however, tracked the changes in the Convertibility Undertaking rate and eased slightly to 7.7586 at the end of June from 7.7499 on 1 April (Chart 5).

Chart 5
HK$ Exchange Rate



Domestic Credit and Money Supply

Domestic credit[1] decreased by 3.6% in the second quarter of 1999, the seventh quarter of decline in succession. Loans to most economic sectors continued to fall, with the notable exception of residential mortgage loans, which grew by 2.1% as property market activity recovered. In the twelve months to June 1999, domestic credit contracted by 10.1%. The decline in lending appeared to have been driven mainly by banks' concerns over credit risk and by subdued loan demand, while liquidity appeared plentiful.

Narrow money supply (HK$M1) increased slightly by 0.2% during the second quarter, compared with a 2.0% rise in the preceding quarter. Following an increase of 0.4% in the preceding quarter, the growth in broad money (HK$M3) increased further to 1.3%. Compared with a year ago, HK$M1 was 7.0% higher in June 1999, while HK$M3 was up by 9.5%. The growth in HK$M3 was attributable in part to the repatriation of offshore deposits following the exemption of profits tax on corporate deposits since mid-1998.

- Prepared by the Monetary Policy and Markets Department

1 Including loans for trade financing.