Notwithstanding renewed concerns about the debt crisis in Argentina and the devastating terrorist attacks in the US on 11 September, the Hong Kong dollar financial markets remained stable in the third quarter of 2001. The Convertibility Undertaking was not triggered and the level of Aggregate Balance remained unchanged, save for minor movements associated with interest payments on Exchange Fund paper. Meanwhile, the US Federal Reserve retained its "easing" monetary policy stance and hastened the pace of rate reduction following the 11 September attacks. Hong Kong dollar interest rates softened in line with the US rate reductions. The Hong Kong dollar forward points responded only mildly to the financial turmoil in Argentina and the 11 September attacks, reflecting strong market confidence in the Linked Exchange Rate System. Yields on long-term Exchange Fund Notes fell in tandem with those on US Treasuries, which were driven by expectations of further rate cuts and a flurry of safe haven buying.

Convertibility Undertaking and Aggregate Balance

In the light of sporadic signs of improvement in some economic sectors, the Federal Reserve began to slow its pace of easing towards the end of the second quarter. The Fed Funds target rate (FFTR) was lowered by 25 b.p. at the regular Federal Open Market Committee meeting on 21 August, in line with market expectation. The easing bias was retained on the view that the risks remained weighed towards conditions that might generate economic weakness in the foreseeable future. The 11 September attacks sent a shock wave across the world financial markets and triggered renewed fears that the slowing US economy might dip into severe recession. To help restore consumer confidence and keep the US economy afloat, the FFTR was cut by a further 50 b.p. just before the US stock market re-opened on 17 September, bringing the rate down to 3.00% as against 3.75% at end-June.

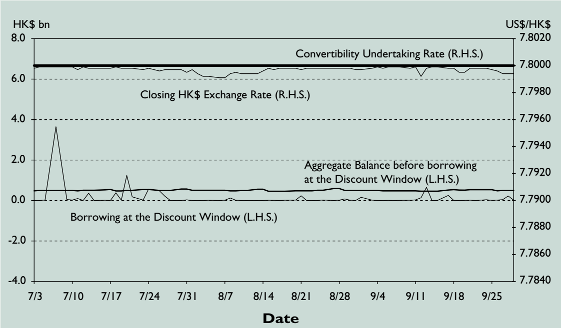
In Hong Kong, the HKMA Base Rate[1] was adjusted in parallel with the FFTR cuts, coming down to 4.50% on 18 September.

The Hong Kong dollar exchange rate remained stable during the third quarter within the range of 7.7990 - 7.8000 for most of the time, except for two occasions. In early August, a brief bulge in demand for term money attracted some switching into Hong Kong dollars and sent the exchange rate marginally below 7.7990. On 12 September, the exchange rate strengthened initially in reaction to the terrorist attacks on 11 September, touching an intraday high of 7.7980 as some banks sold US dollar to raise Hong Kong dollar funds, in anticipation of a possible liquidity squeeze. The Convertibility Undertaking was not triggered during the quarter and the level of the Aggregate Balance remained steady at around HK$500 mn, save for intra-week fluctuations when interest on outstanding issues of Exchange Fund paper was disbursed and before additional Exchange

1 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.

Fund Bills were issued to absorb those amounts. The exchange rate closed at 7.7994 on 28 September, as compared to 7.7999 at end-June, while the Aggregate Balance ended at HK$497 mn, compared to HK$475 mn at end-June (Chart 1).

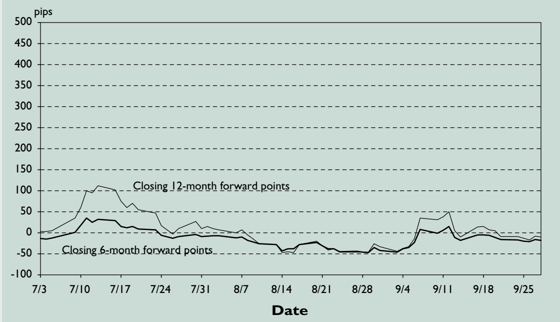
Chart 1
Aggregate Balance, Discount Window Activities and Hong Kong Dollar Exchange Rate



Hong Kong dollar forward points edged up mildly from early July. The escalating debt crisis in Argentina and heightened concern over its ability to uphold its currency board system triggered some worries about Hong Kong. Meanwhile, the weakening of regional currencies exacerbated the concern over a negative spillover effect. As a result, the 12-month forward points briefly breached +100 pips in mid July, but subsequently eased back into negative territory in August, as the situation in Argentina stabilised and sentiment in the Asian currency markets recovered.

Hedging demand in the forward market picked up again in early September after release of a lower-than-expected GDP growth figure for the second quarter and the Financial Secretary's comment that the Linked Exchange Rate System was an "obstacle" to an efficient economy. On 12 September, as many market participants stayed on the sidelines amidst the uncertainties surrounding the 11 September attacks, Hong Kong dollar borrowing activity in the thin forward market pushed the forward points higher. 12-month forwards briefly touched +100 pips again but once more eased back to discount level as the market nervousness subsided. 6-month and 12-month forward points closed at -18 pips and -10 pips respectively on 28 September, as against -13 pips and par at end-June (Chart 2).

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

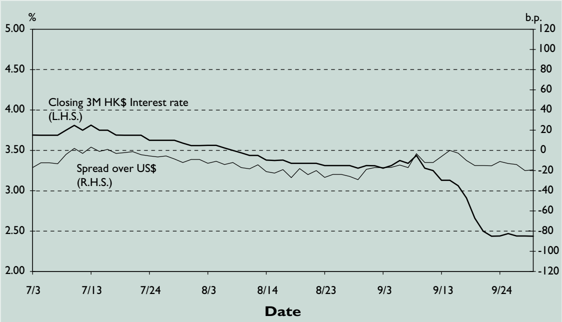


Short-term Hong Kong Dollar Interest Rates

The 11 September attacks did not have any significant impact on the Hong Kong dollar money market. However, to pre-empt possible volatility, the HKMA made an announcement before the opening of the market on 12 September, confirming the normal operation of the Hong Kong dollar and US dollar Real Time Gross Settlement systems in Hong Kong, as well as the availability of the usual intraday repo and discount window facilities. The money market opened relatively quiet; overnight HIBOR began moderately higher at 5.00%, as compared to the previous day's closing of 3.28%, but gradually eased to 4.00% as it became clear that the market was functioning normally. The overnight rate then dipped to as low as 1.69% on 20 September, tracking the overnight US dollar rate which eased significantly as the Federal Reserve injected liquidity into the US banking system. Overnight HIBOR ended the quarter at 4.00%, as compared to 3.81% at end-June.

Term deposit rates eased across the board during the third quarter. 1-6 month rates eased initially at a steady pace along with their US dollar counterparts but dipped sharply after the 11 September attacks on expectations that the Fed would hasten its pace of easing. The three-month Hong Kong dollar money market rate dropped from 3.75% at end-June to 2.44% at end-September, or 19 b.p. below the corresponding US level (Chart 3).

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

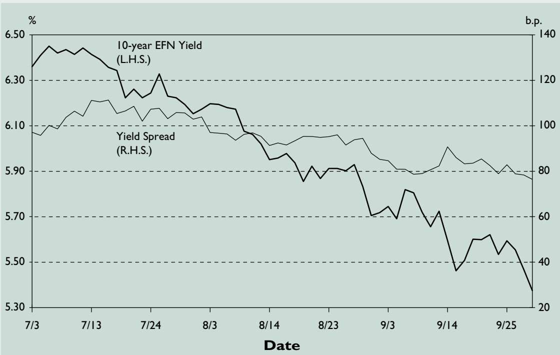


Since the full deregulation of bank interest rates from 1 July, individual banks have been free to set their own Hong Kong dollar interest rates for all deposits, including savings accounts and current accounts. The banks have responded differently to the reductions in the HKMA Base Rate. The saving rates quoted by major banks stood at 1.00% at end-September, as compared to 1.75-2.00% at the beginning of the quarter.

Long-term Hong Kong Dollar Interest Rates

The US Treasuries market rallied on rate cut expectations and a flurry of safe haven buying after the 11 September attacks. 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 6.45% on 5 July to a low of 5.38% on 28 September, as compared to 6.36% at end-June (Chart 4). As the EFN yield eased at a slightly faster pace than that of the US Treasuries, the yield spread of the 10-year EFN over US Treasuries narrowed to 76 b.p. on 28 September from 95 b.p. at end-June.

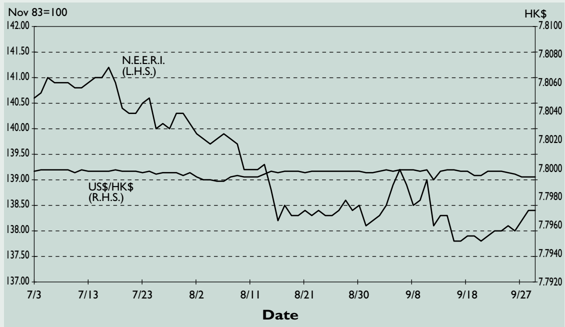
Chart 4
Yield of 10-year EFN and its Spread over 10-year UST



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 138.40 on 29 September, as compared to 140.70 at the end of the second quarter. The lower NEERI reflected the weakening of the US dollar against other major currencies, in particular the Japanese yen and euro (Chart 5).

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



Domestic Credit and Money Supply

Credit expansion remained sluggish in the third quarter of 2001. Domestic loans contracted by 1.7%. This reflected a slowdown in economic activity and increased uncertainties about the business outlook, amid a worsening external environment.

Narrow money supply (HK$M1) increased further by around 5% on a seasonally adjusted basis in the third quarter, reflecting increases in both demand deposits and currency held by the public. The rise may have reflected in part the lower opportunity cost of holding money as a result of low interest rates. Broad money (HK$M3) increased modestly by 0.7% in the third quarter, mainly attributable to a rise in savings deposits. Compared with a year ago, HK$M1 grew by nearly 9%, significantly outpacing growth of the value of retail sales, while HK$M3 was about 2% higher in September than a year earlier.

- Prepared by the Monetary Policy and Markets Department