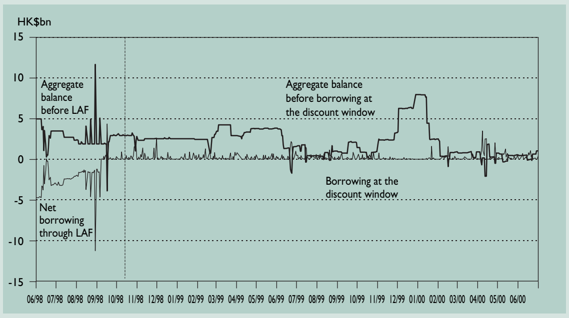
The Hong Kong dollar market exchange rate continued to stay close to the rate of Convertibility Undertaking in the second quarter of 2000, despite spates of equity related flows into and out of Hong Kong causing the gap between the two rates to widen occasionally. The level of the Aggregate Balance fluctuated, but was generally smaller than in the previous quarters, possibly reflecting improved liquidity management by the banks. Overnight Hong Kong dollar interest rates adjusted efficiently to the changes in the level of the Aggregate Balance and hovered around its US dollar counterpart for most of the period. Longer term money market rates edged up modestly in May but then eased gradually from early June to trade below the corresponding US dollar rates, following broadly the movements in the forward points. Yields on Exchange Fund notes tracked closely those of US Treasuries, rising in May before easing in June as the US inflation outlook improved.

Convertibility Undertaking and Aggregate Balance

Hong Kong dollar selling interest emerged in early April, possibly due to the poor performance of the local equity market, triggering the Convertibility Undertaking on several occasions. The Aggregate Balance fell to negative HK$697 mn on 6 April, and further declined to a low of negative HK$2,099 mn on 11 April. As the adjustment mechanism took effect, firmer Hong Kong dollar short-term interest rates quickly reversed the flows and restored the Balance to positive HK$1,864 mn on 17 April; it finally settled at HK$306 mn on 18 April. For most of the remainder of the period it remained narrowly around HK$1 bn, with minor fluctuations as a result of equity related flows passing through the currency board accounts. On average the Aggregate Balance showed some decline from previous quarters, possibly reflecting improvements in the banks' management of their Hong Kong dollar liquidity. The Aggregate Balance ended June at HK$1,025 mn compared to HK$909 mn at end-March. (Chart 1)

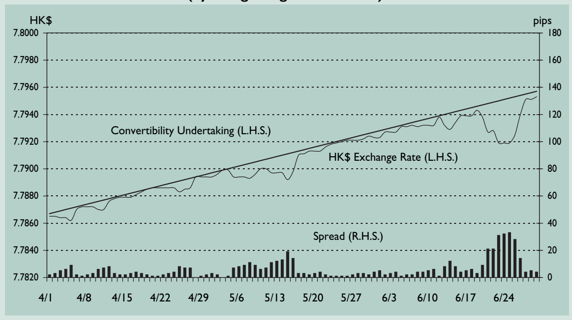
The Hong Kong dollar exchange rate eased gradually during the second quarter, largely following the adjustment of one pip a day to the rate for the Convertibility Undertaking, except in late June when a sudden strengthening of the Hong Kong dollar was recorded. The gradual revival of the local equity market and the rumour of a possible credit rating upgrade for Hong Kong attracted sizeable Hong Kong dollar buying interest and pushed the Hong Kong dollar exchange rate to as high as 7.7887 on 23 June. However, the resulting increase in the Aggregate Balance and the subsequent easing of short-term Hong Kong dollar

Chart 1
Aggregate Balance and Discount Window Activities



interest rates induced the banks holding large clearing balances to switch out into US dollar to enjoy higher returns, hence bringing the Hong Kong dollar exchange rate back closer to the rate of Convertibility Undertaking (Chart 2). A news

Chart 2
Hong Kong Dollar Exchange Rate, Convertibility Undertaking Rate and their Spread (by Hong Kong market close)



report in late June saying that the IMF had pressed China to float the RMB, and that Premier Zhu Rongi had sought opinions from Hong Kong businessmen about the impact on the Hong Kong dollar of the PRC adopting a more flexible exchange rate regime, did not have any significant impact on the Hong Kong dollar exchange rate.

The Hong Kong dollar/US dollar rate eased from 7.7865 on 31 March to 7.7953 on 30 June, 4 pips below the rate of the Convertibility Undertaking, as compared to a 1-pip gap at the end of the previous quarter.

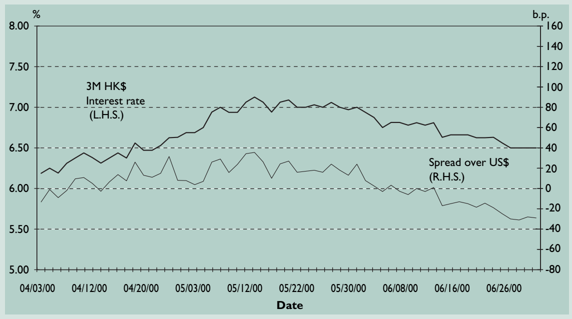
Short Term Hong Kong Dollar Interest Rates

The overnight Hong Kong dollar interest rate adjusted efficiently to the changes in the level of Aggregate Balance during the quarter. The rate moved towards the level of the HKMA Base Rate each time that the Aggregate Balance dropped below zero, and eased correspondingly when the Aggregate Balance was restored to a positive figure. The overnight rate bottomed at 3.25% on 14 April when the Aggregate Balance was at a relatively generous level of HK$1,824 mn, but stayed close to the prevailing Base Rate (7.50% until 16 May and 8.00% thereafter) when the Balance was below zero. It ended at 6.88% on 30 June, as compared to 5.69% on 31 March. The volatility of the Hong Kong dollar overnight rate did not spill over to longer term money market rates, reflecting market confidence in the exchange rate and the perception that the shortfalls in the Aggregate Balance would be reversed in a timely manner. Hong Kong dollar interest rates generally edged up in early May ahead of the US Federal Open Market Committee (FOMC) meeting as fear of more aggressive monetary tightening by the US central bank escalated, but gradually returned to lower levels after a 50 b.p. rate hike in the US Fed funds target rate (FFTR) to 6.5% was announced. The 3-month Hong Kong dollar interbank rate moved up from a low of 6.13% on 3 April to a high of 7.13% on 16 May and eased to close at 6.50% on 30 June, which was 29 b.p. lower than its US dollar counterpart (Chart 3).

Hong Kong dollar forward points, which eased significantly by the end of the first quarter on reported position liquidation by international

Chart 3

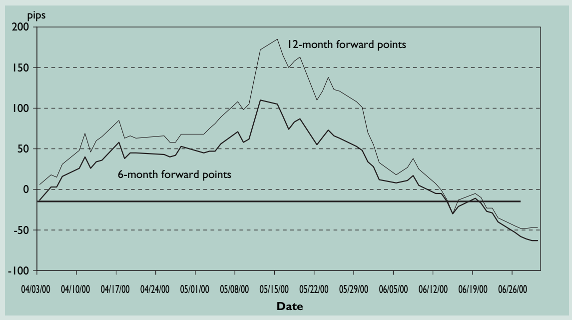
3-Month Hong Kong Dollar Interest Rate and its Spread over 3-Month US Dollar Interest Rate



investors including some dissolving hedge funds, picked up during the early part of the second quarter. The easing trend, however, re-emerged after mid May as the general economic environment in Hong Kong improved and the local equity market picked up strength again. With a more stable Hong Kong dollar exchange rate, the need to hedge the Hong Kong dollar exposures through the forward market was reduced. Also, there was a market perception that short-term Hong Kong dollar forward points might stay close to zero after August 12 when the one pip a day easing of the rate of Convertibility Undertaking was completed. 6-month and 12-month Hong Kong dollar forward points peaked at +105 pips and +185 pips respectively on 15 May before easing to the low of -63 pips and -47 pips on 29 June. At the quarter end, they closed at -59 pips and -43 pips respectively, as compared to -27 pips and -20 pips on 31 March (Chart 4).

Chart 4

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

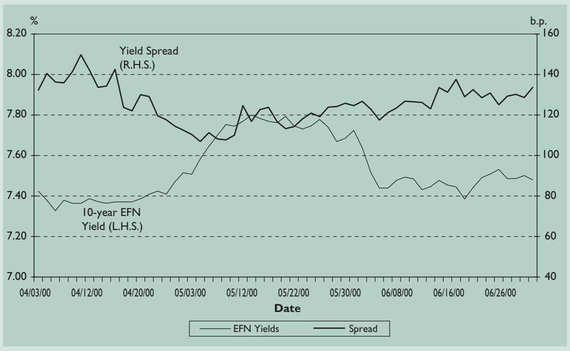


The US Federal Reserve raised the FFTR by 50 b.p. to 6.50% at the FOMC meeting on 16 May but decided to leave it unchanged at the meeting on 27-28 June amidst signs of a slowdown in US economic growth. Correspondingly, the Hong Kong Association of Banks raised the savings rate from 4.25% to 4.75%, effective on 22 May.

Long Term Hong Kong Dollar Interest Rate and the Hong Kong Premium

The longer end of the Hong Kong dollar yield curve remained very stable during the second quarter. The yields on Exchange Fund Notes (EFN) generally moved in tandem with the yields of US Treasuries (UST) of matching maturity. 10-year EFN yield rose and peaked at 7.82% on 19 May as worries of further US rate hikes prevailed. Subsequent release of tame US economic figures, including the lower-than-expected US consumer price index and producer price index for May, and the changing tone of the US officials hinted at a temporary end to the US tightening cycle. As a result, UST yields softened, dragging down the yields of EFN. 10-year EFN yield ended at 7.48% on 30 June, as compared to 7.42% on 31 March. The UST and EFN yield curves were moving largely in parallel so that the yield spread of 10-year EFN over the corresponding UST, often referred to as the "Hong Kong premium", remained generally stable. It ranged from a high of 150 b.p. on 11 April to a low of 107 b.p. on 4 May, and closed at 134 b.p. on 30 June, as compared to 126 b.p on 31 March (Chart 5).

Chart 5
Yield of 10-year EFN and its Spread over 10-year UST

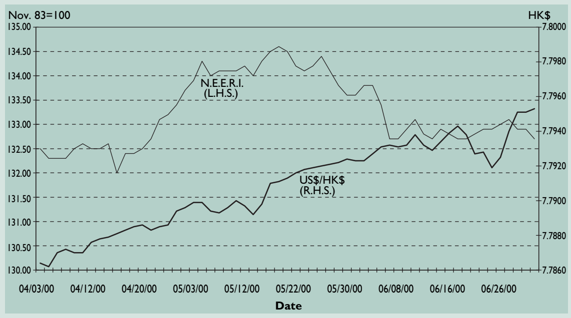


Base Rate and Hong Kong Dollar Effective Exchange Rate

The Base Rate, which is defined as the higher of the US Fed funds target rate plus 150 b.p., and the simple average of the 5-day moving averages of overnight and 1-month HIBOR for the previous 5 trading days, stayed at 7.50% in April. Following the increase in the Fed funds target rate on 16 May, the Base Rate was raised to 8.00% on 17 May.

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 132.7 on 30 June, marginally higher than the 132.4 level recorded at the end of the first quarter. The higher NEERI reflected a stronger US dollar against the major currencies, particularly the yen, during the second quarter of 2000. (Chart 6)

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



Domestic Credit and Money Supply

Along with signs of sustained economic recovery, the decline in domestic credit[1] moderated notably in 1999 and stabilised in the first half of 2000. Domestic loans declined fractionally, by 0.2%, in the second quarter, after being stable in the first quarter. Analysed by economic use, loans for electricity, gas and telecommunications saw the largest quarter-on-quarter rise (8.1%), followed by loans for credit card advances, and trade financing. Notably, loans for trade financing registered the first quarter-on-quarter increase since September 1997. Loans for wholesale and retail trade registered the largest decline, followed by loans for financial concerns, and manufacturing. On a year-on-year basis, the decline in domestic credit moderated from 5.8% in March to 2.5% in June.

Narrow money supply (HK$M1) dropped by 3.1% in the second quarter of 2000, with both currency held by the public and demand deposits registering decreases. Meanwhile, broad money supply (HK$M3) increased moderately by 1.6% in the second quarter. Compared with a year ago, HK$M1 rose by 6.1% in June, while HK$M3 was up by 4.2%.

1 Including loans for trade financing.

- Prepared by the Monetary Policy and Markets Department