The US Federal Reserve maintained during the quarter an "easing" monetary policy stance and lowered the Fed funds target rate (FFTR) three times to 3.75%. Sporadic signs of improvement in some sectors of the US economy and more hawkisk comments by some Fed officials on inflation led the market to anticipate the end of the easing cycle. Hong Kong dollar interest rates softened in line with the US rate reductions. While the Hong Kong dollar forward points spiked up briefly at the beginning of the quarter amidst some renewed nervousness in Asian regional markets generally, the Hong Kong dollar spot exchange rate remained essentially stable within the tight range 7.7990-7.8000. The Convertibility Undertaking was not triggered during the quarter and the level of Aggregate Balance remained unchanged, save for minor movements associated with payment of interest on Exchange Fund paper. Yields on Exchange Fund Notes tracked closely the yields on US Treasuries, with the yield curve steepening somewhat.

Convertibility Undertaking and Aggregate Balance

US second quarter economic data provided mixed signals on the prospect of a near-term US economic recovery. While consumer confidence and employment conditions appeared to show some signs of improvement, the manufacturing sector remained weak. In the meantime, the US Federal Reserve continued an easing monetary stance, hoping to shorten the period of economic sluggishness in the US. The FFTR was trimmed three times during the quarter, first by a surprise 50 b.p. inter-meeting cut on 18 April, followed by a 50 b.p. and a 25 b.p. cut at the regular Federal Open Market Committee meetings on 15 May and 27 June respectively, bringing the FFTR down from 5% at end-March to 3.75% at end-June. On the other hand, some Fed officials began to caution the market on the possible return of a more inflationary environment following the last few rounds of easing. Together with some signs of haphazard improvement in individual economic sectors, this led some observers to perceive a slower pace of easing or even an imminent end to the rate cut cycle.

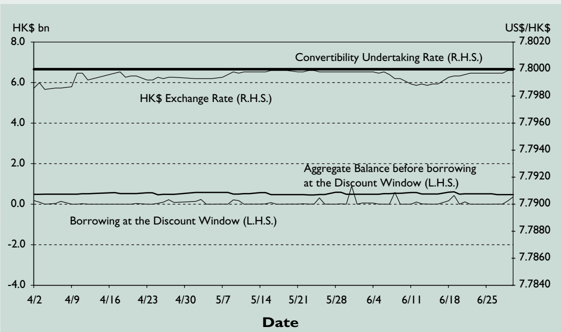
In Hong Kong, the HKMA Base Rate[1] was adjusted in parallel with the FFTR cuts. It was lowered from 6.50% to 5.25% in three stages – 50 b.p. on 19 April and 16 May, and 25 b.p. on 28 June.

Since the US rate cuts were well expected, their impact on the Hong Kong dollar financial markets was relatively mild and predictable. The Hong Kong dollar exchange rate stayed mostly within a narrow range of 7.7990-7.8000, except for two occasions in early-April and mid-June when it briefly strengthened beyond 7.7990 due to tighter short-term interest rates and strong corporate buying interest. The Convertibility Undertaking (CU) was not triggered during the quarter despite the political and economic crisis in Argentina and the increased volatility in some Asian regional currency markets. The level of the Aggregate Balance remained steady at around HK$520 million, save for intra-week fluctuations when interest on outstanding issues of Exchange Fund paper was disbursed and before additional Exchange Fund Bills were issued to absorb those amounts. The exchange rate closed at 7.7999 on 29 June, as

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.

compared to 7.7991 at end-March, while the Aggregate Balance closed at HK$475 mn, compared to HK$488 mn at end-March (Chart 1).

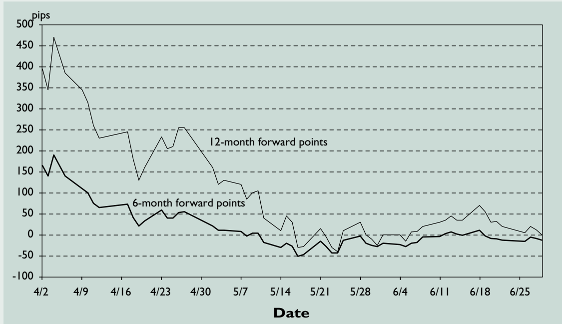
Chart 1
Aggregate Balance, Discount Window Activities and Hong Kong Dollar Exchange Rate



The trend of rising Hong Kong dollar forward points that emerged in March continued until they peaked in early April. A sharp depreciation of the Japanese Yen from 123 to 126 put pressure on Asian currencies in general, and it appeared that the sale of forward Hong Kong dollars as a proxy hedge against Asian risk was once again in play. The pressure on the Hong Kong dollar forwards intensified in the wake of the US spy plane incident on 1 April, and 12-month forwards reached a high of +470 pips on 4 April. Thereafter, the forward points gradually eased, as the recovery of the Yen and relaxation of the Sino-US tensions led to some unwinding of forward positions.

It is particularly noteworthy that the Hong Kong dollar exchange rate was not at all affected by the developments in Argentina. In mid-April, Argentina unveiled a long-term plan to re-peg its Peso to a mix of US dollar and Euro, and in mid-June it introduced a two-tier exchange rate arrangement amounting to a devaluation of the Peso for external trade. The insulation of the Hong Kong dollar from the turmoil in Argentina demonstrated that the market recognised the fundamental differences between the Argentine and Hong Kong economies. 6-month and 12-month forward points closed at -13 pips and par respectively at end June, as against +78 pips and +250 pips on 30 March (Chart 2).

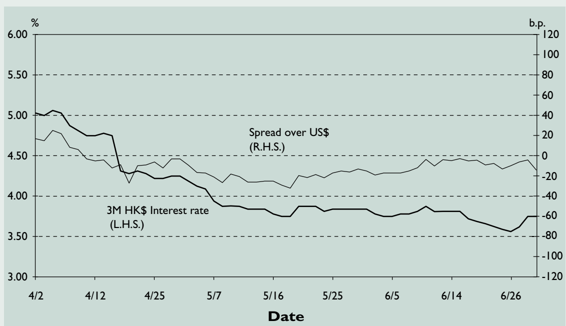
Chart 2
6-month and 12-month Hong Kong Dollar Forward Points



Short-term Hong Kong Dollar Interest Rates

With the level of the Aggregate Balance holding steady at around HK$520 million, short-term Hong Kong dollar interest rates exhibited a very stable pattern, easing gradually with their US dollar counterparts during the quarter. Overnight HIBOR fell from a high of 5.38% on 2 April to a low of 3.47% on 17 May and closed at 3.81% on 29 June, as compared to 5.88% at end-March. Term deposit rates also fell across the board, with 1-6 month rates all dipping below the corresponding US levels. The bellwether 3-month Hong Kong dollar money market rate dropped from 4.94% at end-March to close at 3.75% on 29 June (Chart 3). The negative spreads between Hong Kong and US interest rates resulted in the forward points moving from a small premium to a slight discount. 3-month forwards closed at -14 pips at end-June, down from +11 pips on 30 March.

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

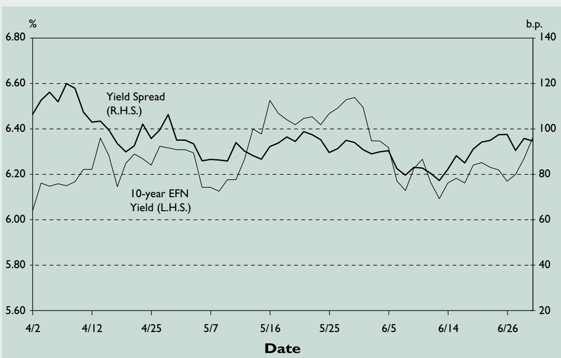


The Hong Kong Association of Banks (HKAB) lowered its Savings Rate by 50 b.p. twice, effective 23 April and 21 May, in response to the lowering of the HKMA Base Rate. The savings rate then stood at 2.25%. However, HKAB took no action on 29 June, following the 25 b.p. reduction in the HKMA Base Rate because any adjustment to the savings rate would only have taken effect on the following Monday, 3 July, whereas full deregulation of bank interest rates was set to take effect on 1 July, with individual banks free to set Hong Kong dollar interest rates for all deposits, including savings accounts and current accounts. Instead, several individual banks announced separately on 29 June their plans to trim their savings rates, by amounts ranging from 25 to 50 b.p.

Long Term Hong Kong Dollar Interest Rates

Concerns that the substantial easing by the US Federal Reserve might have adverse implications for inflation in the longer term caused the US Treasuries yield curve to steepen significantly, with the spread between 2-year and 30-year yields widening from 127 b.p. in early April to 151 b.p. at end-June. Correspondingly, in Hong Kong the Exchange Fund Notes (EFN) yield curve also steepened. The yield on 10-year EFN rose gradually from a low of 6.04% on 2 April to a high of 6.54% on 30 May before retreating slightly to close at 6.36% on 29 June, or 95 b.p. over the US Treasuries, as compared to 6.16% at end-March, or 110 b.p. over US Treasuries (Chart 4).

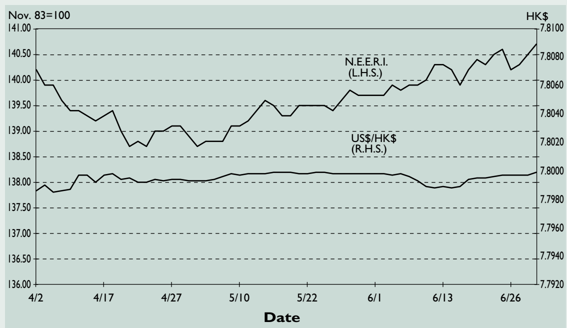
Chart 4
Yield of 10-year EFN and its Spread over 10-year UST



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 vis-a-vis currencies of major trading partners, closed at 140.70 on 30 June, as compared to 140.10 on 31 March. The higher NEERI reflected the strengthening of the US dollar against other major currencies, in particular the 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 second quarter of 2001. Domestic loans[2] contracted slightly, by 0.4% although they have shown mild positive year-on-year growth since August 2000. The subdued lending appears to be related to the slowdown in economic activity, amid a worsening external environment.

Following a decline in the first quarter, narrow money supply (HK$M1) rebounded by 5.3% on a seasonally adjusted basis in the second quarter, reflecting increases in both demand deposits and currency held by the public. Broad money (HK$M3) also increased modestly, by 0.3%, mainly on account of a rise in savings deposits. At end-June, HK$M1 and HK$M3 were respectively 3.9% and 3.1% higher than a year earlier.

- Prepared by the Monetary Policy and Markets Department

2 Including loans for trade financing.