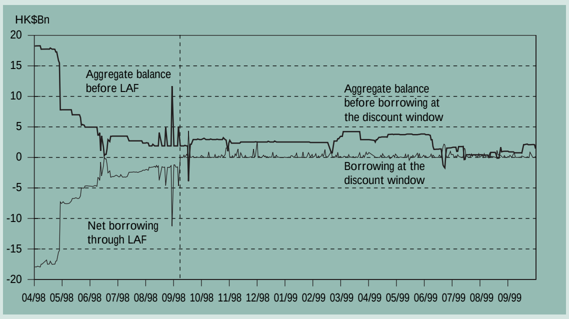
The Hong Kong dollar exchange rate and the local money market remained stable in the third quarter of 1999. Rumours of Renminbi (RMB) devaluation, tensions across the Taiwan Straits in July and the abandoning of foreign exchange intervention bands by Chile's central bank in September induced occasional capital outflows during the reporting period. Nevertheless, as the Aggregate Balance decreased, the moderate firming of interest rates helped to stabilise the Hong Kong dollar exchange rate and US dollars were sold back to the Exchange Fund within a few days. For most of the quarter, short-term Hong Kong dollar interest rates remained very stable, in part reflecting the technical adjustments to the currency board system introduced in September 1998. Furthermore, the yield spread between long-term Exchange Fund paper and the corresponding US Treasury Notes was on an easing trend during the period, reflecting a reduction of the "Hong Kong premium".

Convertibility Undertaking and Aggregate Balance

While the Hong Kong dollar exchange rate and the local money market remained stable during the third quarter, there were several episodes of outflows triggering the Convertibility Undertaking and causing a contraction in the Aggregate Balance. The first such occasion was in the middle of July : mainly due to tension across the Taiwan Straits and rumours concerning RMB devaluation, the Convertibility Undertaking was triggered on 12 July and the HKMA sold US$280 mn. The Aggregate Balance remained in negative territory for two working days. The resultant tightening of interbank liquidity then reversed the flow of funds and, in response to bank offers, the HKMA bought US$100 mn, restoring the Aggregate Balance to a positive level on 16 July (Chart 1).

Chart 1
Aggregate Balance and Discount Window Activities

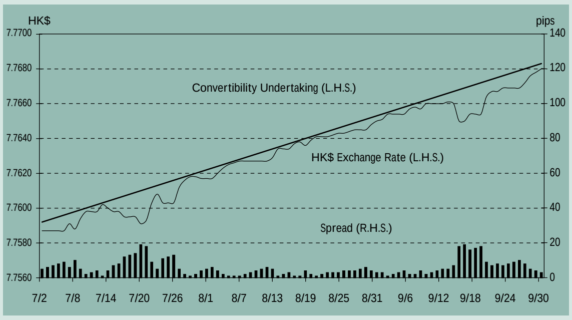


In the middle of August, some financial houses re-aligned the components of their equity portfolios by reducing the weighting of the Hong Kong market in favour of those in Taiwan and Korea. The resulting portfolio adjustments during the week of 16 August induced some outflows and the Convertibility Undertaking was again triggered. The HKMA sold US$227 mn during the week. The reduction of interbank liquidity and a moderate firming of interest rates once again stemmed the outflows. US$250 mn was sold back to the HKMA and the Aggregate Balance was restored to a positive level of HK$1,667 mn on 23 August. The US Federal Reserve raised the Fed Funds Target Rate and the Discount Rate by 25 basis points on 24 August. As the interest rate hike was well discounted by the market, it did not have any significant impact on the local money market.

Chile's central bank abandoned its foreign exchange intervention band on 3 September. Concerns over possible spill-over effects on the Asian markets exerted some pressure on the HK$ exchange rate. The HKMA sold US$20 mn under the Convertibility Undertaking on 6 September. The Aggregate Balance dropped to around HK$750 mn during 7-14 September. Subsequently, the HKMA bought US$170 mn on 16 September on the back of an equity related inflow, increasing the Aggregate Balance to HK$2,096 mn. However, as interbank liquidity was abundant, some banks began to park their excess liquidity in US dollars. Affected also by a correction in the Hang Seng Index, the Convertibility Undertaking was triggered again on 28 September, so that the Aggregate Balance fell to HK$1,440 mn on 30 September.

For most of the quarter, the HK$ exchange rate tracked closely the rate of the Convertibility Undertaking. The largest differential, of 19 pips below the rate of Convertibility Undertaking, was recorded on 19 July and 16 September, amidst equity-related inflows. At the end of September, HK$ was trading at 7.7680, 3 pips below the rate of Convertibility Undertaking, compared to a gap of about 8 pips in late June (Chart 2).

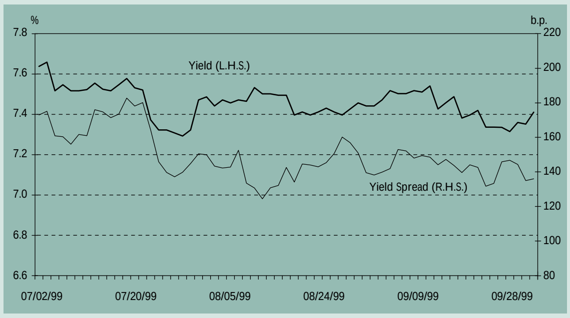
Chart 2
HK$ Exchange Rate, Convertibility Undertaking Rate and their Spread



Long Term HK$ Interest Rate and the Hong Kong Premium

The yield on 10-year Exchange Fund Notes (EFN) hovered between 7.29% and 7.66% during the quarter. The yield spread over corresponding US Treasury Notes, often referred to as the "Hong Kong premium", rose from 167 bp at the end of June to a high of 183 b.p. on 19 July, due to tensions across the Taiwan Straits. Apart from that episode, the spread remained generally steady at around 150 bp during July and early August. It then narrowed in late August, as rumours of RMB devaluation subsided. Furthermore, in preparation for the millennium, banks started to bid more aggressively for EFNs, which can be used as collateral for discount window borrowing. The spread ended September at 136 b.p. (Chart 3).

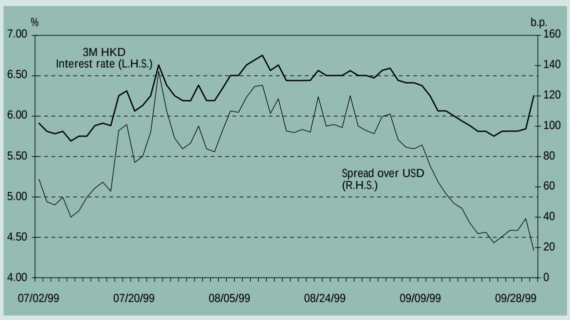
Chart 3
Yield of 10-year EFN and its Spread over 10-year UST



3-Month Hong Kong Dollar Interest Rate

The 3-month interbank rate was steady at the beginning of the quarter. From mid-July it moved on a general uptrend, and peaking at 6.75% on 11 August amid renewed rumours concerning RMB devaluation. The Federal Reserve's tightening in June and August also contributed to firmer HK$ interbank rates. In early September, the HKMA announced the introduction of an enlarged discount window and a term repo facility to help banks to meet liquidity needs in the Y2K context. This has helped to ease pressure in the interbank market. Interbank rates softened significantly following the safe passage of 9 September, which was widely regarded as the first critical date for the millennium transition. The Hong Kong 3-month interbank rate ended the month at 6.25%, with a narrow spread of 18 b.p. over the corresponding US rate. Although the Aggregate Balance fell below zero several times during the quarter, the market reacted calmly and orderly. This reflected to a large extent the effectiveness of the seven technical measures in moderating the adjustment of interest rates to fund flows (Chart 4).

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

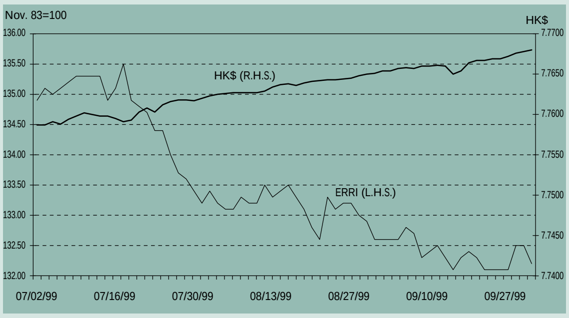


Base Rate and the HK$ Effective Exchange Rate

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. During the third quarter, as the relevant short-term HK$ interest rates stayed at relatively low levels, the Base Rate was continuously determined by the Fed Funds Target Rate. Following a total of 50 bp rise in the Fed Funds Target Rate in the September quarter, the Base Rate was adjusted upwards by the same margin, to 6.75%.

The HK$ trade weighted Effective Exchange Rate Index (ERRI), which measures the nominal exchange rate of the Hong Kong Dollar vis-à-vis currencies of major trading partners, closed at 132.20 on 30 September, down from 134.90 level at the beginning of the third quarter. This reflected the weakening of the US$ against the major currencies, in particular the Japanese yen. The HK$ nominal exchange rate, however, tracked the changes in the Convertibility Undertaking rate and eased slightly to 7.7680 at the end of September from 7.7587 on 2 July (Chart 5).

Chart 5
HK$ Exchange Rate



Domestic Credit and Money Supply

Domestic credit[1] continued to decline, by 1.2% in the third quarter of 1999. Nevertheless, the rate of decline has moderated when compared with previous quarters. The decline in lending appeared to have been driven mainly by banks' concerns over credit risk and subdued loan demand rather than by liquidity concerns. Analysed by economic use, loans to most economic sectors continued to register decreases, albeit at a slower rate, on a quarter-on-quarter basis. Residential mortgage loans[2] and loans for financial concerns, however, grew by 0.4% and 0.5% respectively during the September quarter. In the twelve months to September 1999, domestic credit plummeted by 9.5%.

Narrow money supply (HK$M1) saw a notable rise of 2.5% in the third quarter along with signs of economic recovery. Following an increase of 1.3% in the preceding quarter, broad money supply (HK$M3) increased further by 0.6% in the third quarter. Compared with a year ago, HK$M1 rose by 10.5% in September 1999, while HK$M3 was up by 4.8%.

- Prepared by the Monetary Policy and Markets Department

1 Including loans for trade financing.

2 Residential mortgage includes loans for Home Ownership Scheme and Private Sector Participation Scheme.