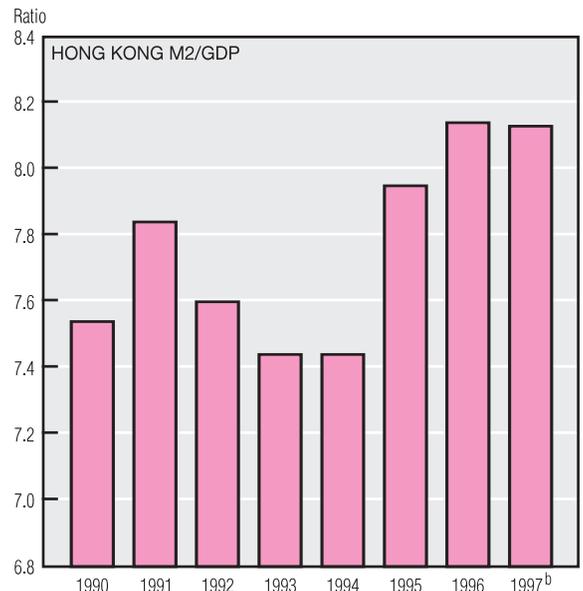
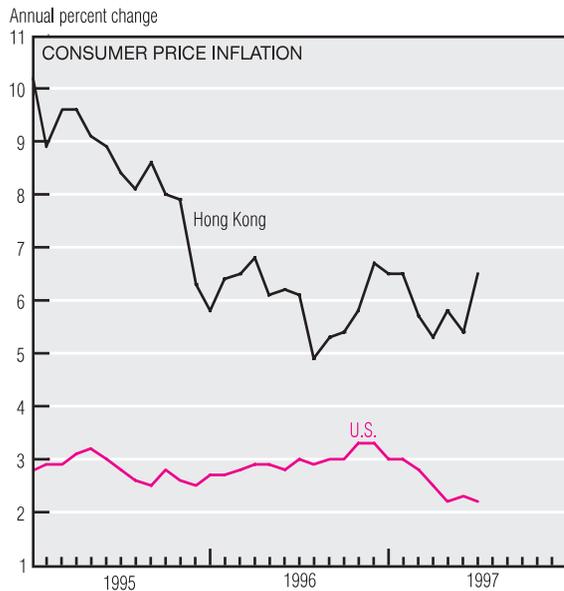


Hong Kong Financial Markets



a. Index base: July 31, 1964 = 100.
b. Average of the first two quarters.
SOURCES: International Monetary Fund, *International Financial Statistics*; and DRI/McGraw-Hill.

The financial tremors that shook Southeast Asia this summer left the Hong Kong dollar relatively unrattled. One cause of the October aftershock was uncertainty about Hong Kong's ability to sustain its currency peg to the U.S. dollar following the realignments of other Southeast Asian currencies. In addition, the U.S. dollar's nominal appreciation of nearly 50% against the Japanese yen since April 1995 pulled the Hong Kong dollar along with it. Last year, nearly 7% of Hong Kong's exports went to Japan.

Moreover, although the inflation differential has generally narrowed since 1994, Hong Kong's inflation rate remains higher than that of the U.S. This indicates that Hong Kong's currency has appreciated in real terms relative to the dollar. The U.S. bought almost 40% of Hong Kong's exports in 1996.

To defend the peg, Hong Kong's monetary authority reduced liquidity, thereby raising money market rates. While this move should relieve pressure on the peg from

capital outflows, if maintained it could aggravate another aspect of Hong Kong's recent financial turmoil: Many analysts consider the country's property to be overvalued and worry that its banks could be exposed to a price adjustment. Sustained high interest rates could deflate property values, weakening banks' balance sheets in the process. Growth in the money stock relative to GDP since 1995, a somewhat ambiguous indicator of asset-price pressures, may have helped to sustain inflated property values.