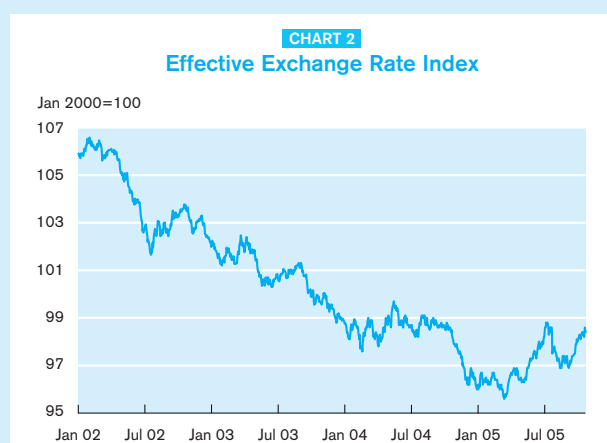
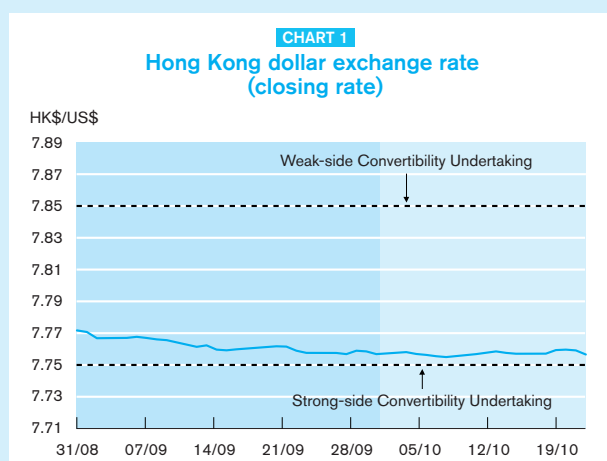


## Annex Report on Currency Board Operations (1 October – 21 October 2005)

The Hong Kong dollar exchange rate strengthened modestly during the reporting period. Interbank interest rates rose. The Monetary Base decreased from HK\$280.26 billion to HK\$277.66 billion, largely reflecting a decline in Certificates of Indebtedness. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

### Hong Kong dollar exchange rate

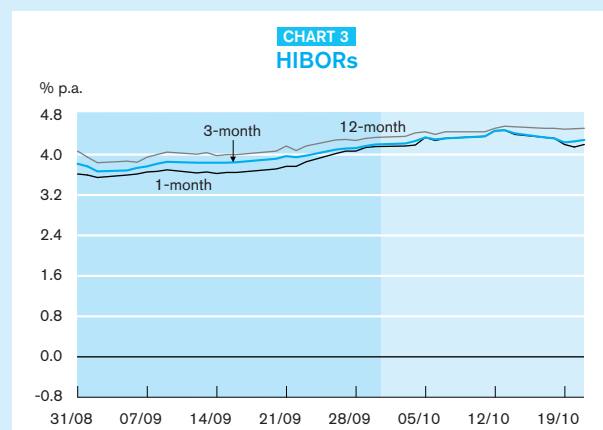
**The Hong Kong dollar exchange rate strengthened moderately, closing at 7.7567** at the end of the reporting period (Chart 1). This partly reflected increased demand for Hong Kong dollars associated with a number of equity initial public offerings (IPOs). The effective exchange rate of the Hong Kong dollar rose, owing to the strengthening of the US dollar against other major currencies (Chart 2).



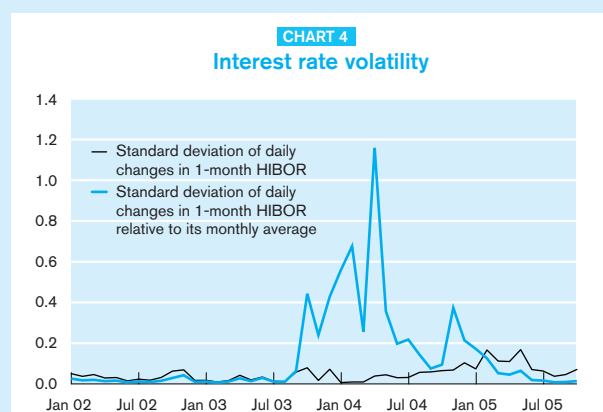
<sup>1</sup> The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

### Interest rates

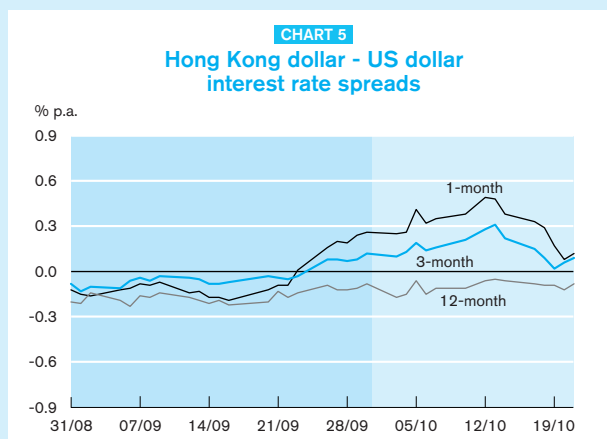
**Hong Kong dollar interbank interest rates increased** during the reporting period. The one-month and three-month HIBORs increased slightly by 3 basis points and 7 basis points to close at 4.18% and 4.27% respectively. The 12-month HIBOR rose by 16 basis points to close at 4.50% (Chart 3).



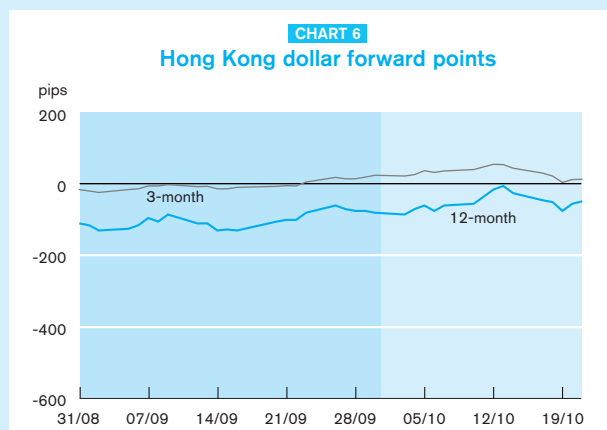
**Interest rate volatility**, as measured by the standard deviation of daily changes in one-month HIBOR, **increased** in October. The standard deviation as a ratio to the average level of one-month HIBOR also increased slightly (Chart 4).<sup>1</sup>



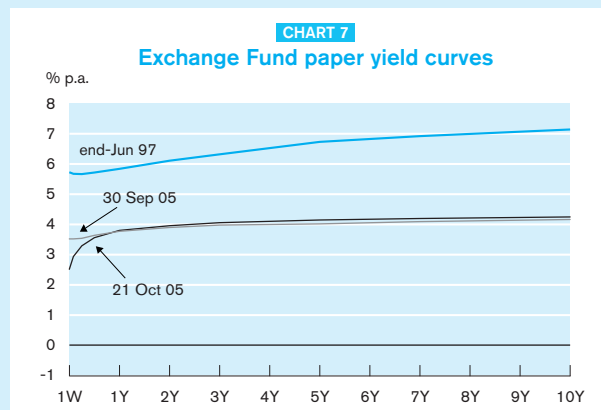
**Short-term interest rate spreads between the Hong Kong dollar and US dollar widened temporarily in mid-October**, partly due to increased demand for liquidity arising from equity IPOs, but narrowed afterwards to close slightly lower than the previous reporting period. The 12-month spread rose by 9 basis points to close at -8 basis points (Chart 5).



Reflecting the movements in the interest rate spreads, the **Hong Kong dollar 12-month forward discount narrowed by 37 pips to close at 48 pips**, while the three-month forward premium fell by 9 pips to close at 14 pips (Chart 6).



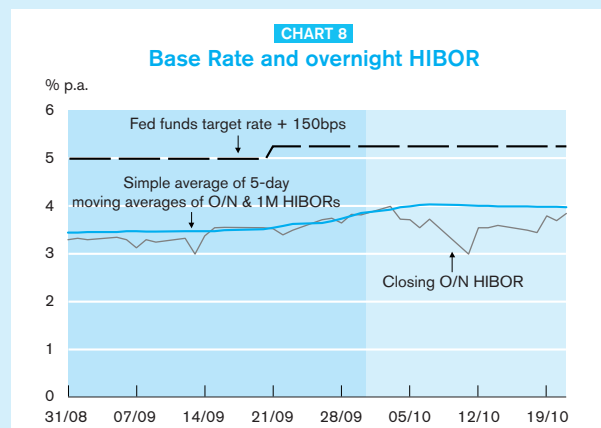
**Short-term yields of Exchange Fund paper eased during the period** (Chart 7). The negative yield spreads against US Treasuries generally increased. In particular, the five-year and 10-year spreads widened to -17 basis points and -21 basis points respectively at the end of the period (Table 1).



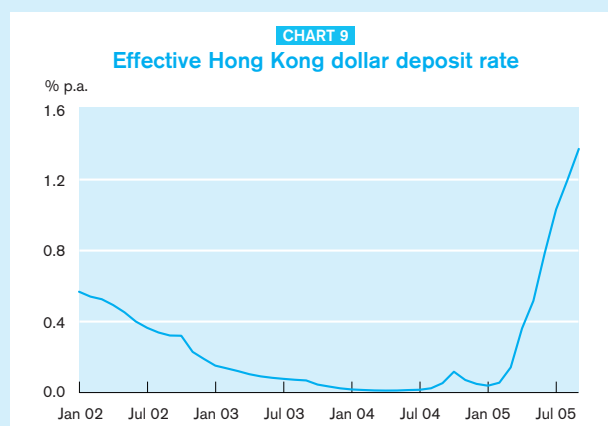
**TABLE 1**  
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	30 Sep 05	21 Oct 05
3-month	56	0	-55
1-year	21	-32	-34
3-year	3	-20	-21
5-year	27	-16	-17
10-year	54	-19	-21

**The HKMA Base Rate remained unchanged at 5.25%** (Chart 8). **Banks also kept their Best Lending Rates unchanged.**



The average one-month time deposit rates offered by major authorized institutions increased from 2.114% to 2.214% during the period.<sup>2</sup> The effective deposit rate rose from 1.20% to 1.37% in September (Chart 9).<sup>3</sup>



## Monetary Base

The **Monetary Base**, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance, and Exchange Fund Bills and Notes, **decreased from HK\$280.26 billion to HK\$277.66 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

**TABLE 2**  
Monetary Base

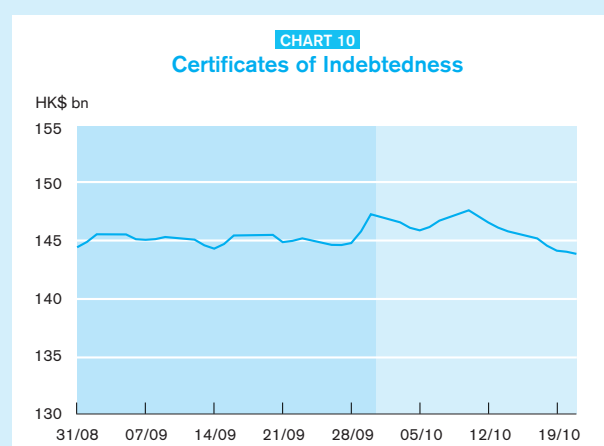
(HK\$ bn)	3 Oct 05	21 Oct 05
CIs	146.65	143.90
Government-issued Currency Notes and Coins in Circulation	6.76	6.75
Aggregate Balance	1.28	1.29
Outstanding EFBNs	125.58	125.72
<b>Monetary Base</b>	<b>280.26</b>	<b>277.66</b>

<sup>2</sup> The figures refer to the average of interest rates offered by the major authorized institutions for one-month time deposits of less than HK\$100,000.

<sup>3</sup> This is the average of the interest rates on demand, savings and time deposits. As the banking statistics classify deposits by remaining maturities, we have made certain assumptions regarding the maturity distribution in computing the effective deposit rate.

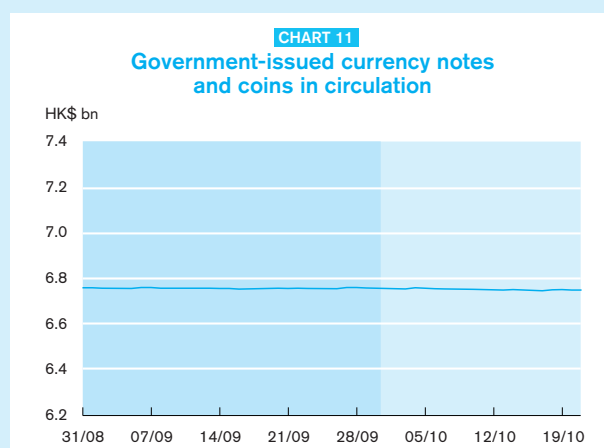
## Certificates of Indebtedness

The three note-issuing banks redeemed HK\$2.75 billion of CIs to the HKMA in exchange for US\$0.35 billion during the period. As a result, **the outstanding amount of CIs decreased from HK\$146.65 billion to HK\$143.90 billion** (Chart 10).



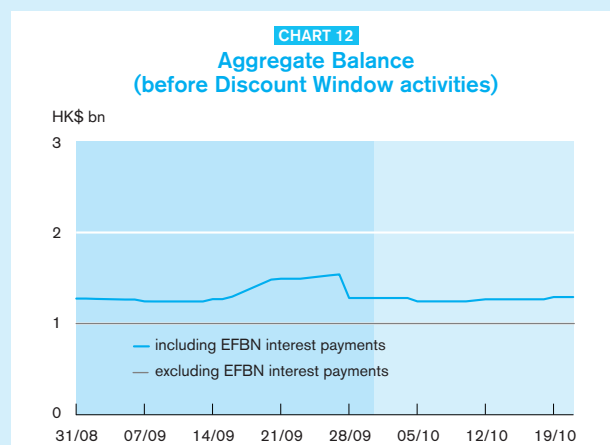
## Government-issued currency notes and coins in circulation

The total amount of **government-issued currency notes and coins in circulation was little changed at around HK\$6.75 billion** during the reporting period (Chart 11).



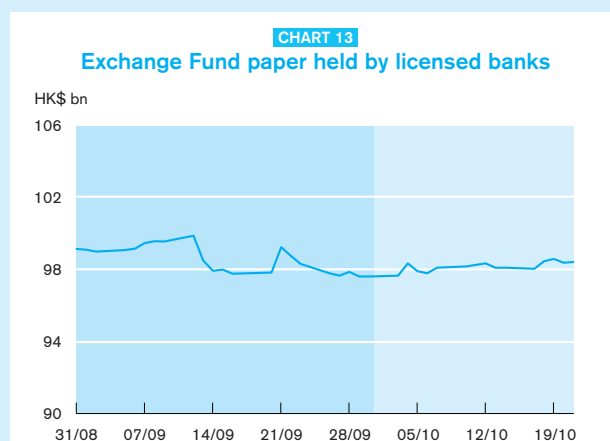
## Aggregate Balance

The **Aggregate Balance** remained generally stable at around **HK\$1.30 billion**, with small fluctuations due to interest payments on Exchange Fund paper (Chart 12).



## Outstanding Exchange Fund Bills and Notes

The market value of outstanding **Exchange Fund Bills and Notes** increased slightly from **HK\$125.58 billion** to **HK\$125.72 billion**. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities)** increased from **HK\$97.66 billion** (77.77% of total) to **HK\$98.42 billion** (78.29% of total) (Chart 13).



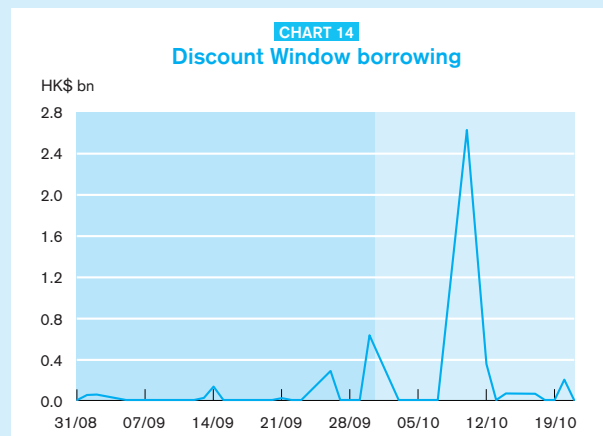
During the period, **HK\$129.07 million** of interest payments on **Exchange Fund paper** were made. An additional **HK\$118.98 million** (in market value) of **Exchange Fund paper** was issued to absorb these interest payments. The remaining amount was carried forward in the Aggregate Balance. Most issues of Exchange Fund paper were well received by the market (Table 3).

**TABLE 3**  
Issuance of Exchange Fund Bills and Notes  
(1 Oct – 21 Oct 05)

	No. of issues launched	Over-subscription ratio
3-month EFB	3	2.91-3.81
6-month EFB	1	1.92
1-year EFB	1	2.02

## Discount Window activities

During the period, **nine banks borrowed a total of HK\$3.47 billion** from the **Discount Window**, compared with **HK\$1.18 billion** in the preceding period (Chart 14). The increase was mainly due to a surge in liquidity demand during the IPOs. All borrowings used Exchange Fund paper as collateral (Table 4).



**TABLE 4**  
Frequency of individual bank's access to the Discount Window  
(1 Oct – 21 Oct 05)

Frequency of using Discount Window	No. of banks
1	9
Total	9

## Backing Portfolio

Backing Assets decreased during the period, largely due to the decline in Certificates of Indebtedness. As the Backing Assets fell proportionally less than the Monetary Base, **the Backing Ratio increased from 111.20% on 2 October to 111.33% on 21 October 2005** (Chart 15). Under the Linked Exchange Rate system, while specific Exchange Fund assets have been designated for the Backing Portfolio, all Exchange Fund assets are available to support the Hong Kong dollar exchange rate.

