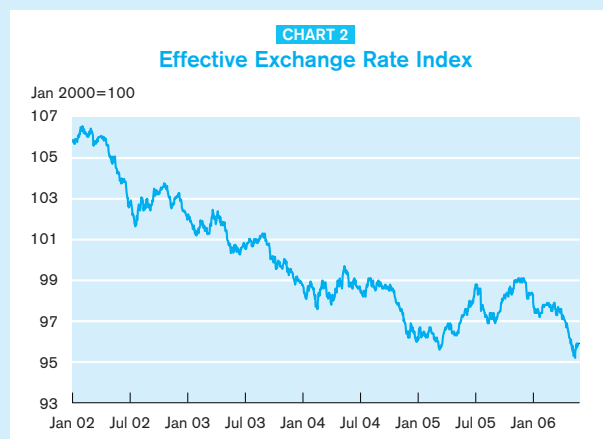
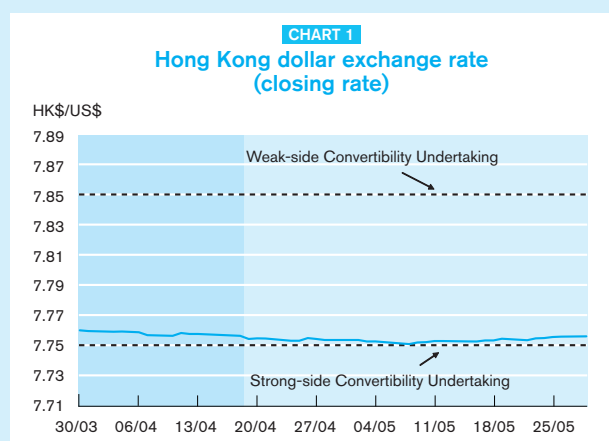


## Report on Currency Board Operations (19 April – 29 May 2006)

The Hong Kong dollar exchange rate weakened slightly on the back of interest rate arbitrage activities during the reporting period. Interbank interest rates eased slightly and their negative spreads against US dollar rates widened. The Monetary Base fell from HK\$287.12 billion to HK\$286.93 billion, largely due to a decrease in Certificates of Indebtedness. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

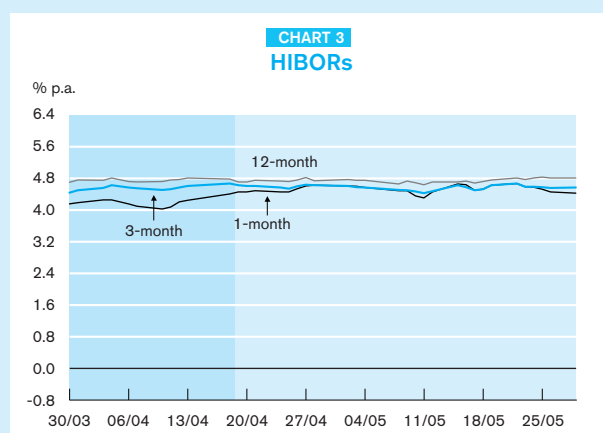
### Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate strengthened in the early part of the reporting period, reaching 7.7514 on 8 May, 14 pips above the strong-side Convertibility Undertaking (Chart 1). The strength was due to continued weakness in US dollar and increased demand for Hong Kong dollars associated with equity IPOs. The Hong Kong dollar weakened for the remainder of the reporting period, attributable to interest rate arbitrage activities (in which banks borrowed Hong Kong dollars and converted them into US dollars to take advantage of negative interest rate differentials) as well as corrections in the local equity market. **Overall, the Hong Kong dollar exchange rate weakened slightly to close at 7.7565** at the end of the reporting period. Meanwhile, the effective exchange rate of the Hong Kong dollar eased further, reflecting weakness in the US dollar (Chart 2).

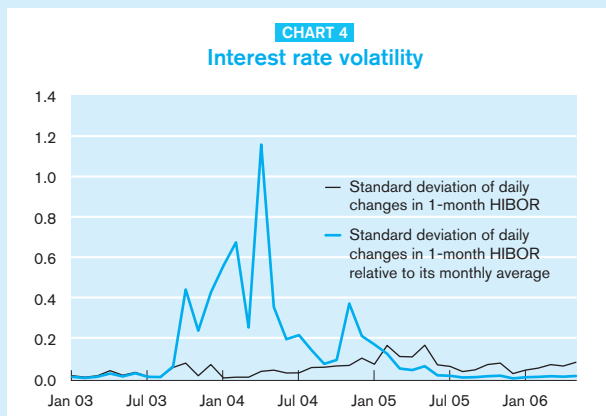


### Interest rates

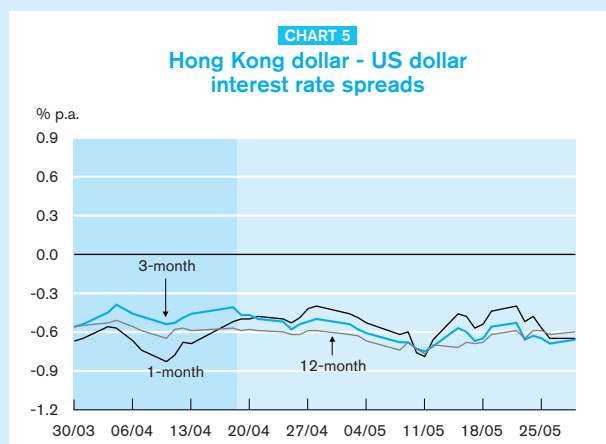
**Short-term Hong Kong dollar interbank interest rates dropped moderately** during the reporting period. Specifically, the one-month and three-month HIBORs dropped by three basis points and six basis points to close at 4.42% and 4.56% respectively. Meanwhile, the 12-month HIBOR rose by 10 basis points to close at 4.80% (Chart 3).



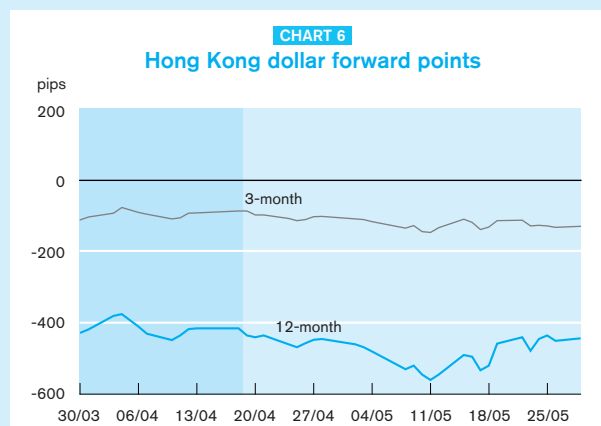
**Interest rate volatility**, measured by the standard deviation of daily changes in one-month HIBOR, **rose** in May. The standard deviation as a ratio of the average level of one-month HIBOR also increased slightly (Chart 4).<sup>1</sup>



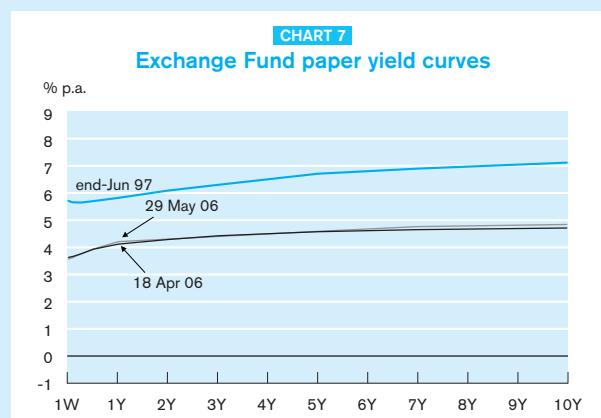
**Negative spreads of Hong Kong dollar interest rates over the US dollar counterparts widened slightly** during the reporting period. The one-month and three-month spreads rose by 15 basis points and 19 basis points to -65 basis points and -66 basis points respectively. The 12-month spread widened by one basis point to close at -60 basis points (Chart 5).



In line with the movements in interest rate spreads, the **Hong Kong dollar 12-month forward discount increased by eight pips to close at 443 pips**, while the three-month forward discount widened by 43 pips to close at 128 pips (Chart 6).



The **yield curve of Exchange Fund paper steepened during the period** (Chart 7). The negative yield spreads against US Treasuries narrowed in the long-end. The three-month spread increased to -109 basis points, while the 5-year and 10-year spreads fell to -37 basis points and -22 basis points respectively at the end of the period (Table 1).

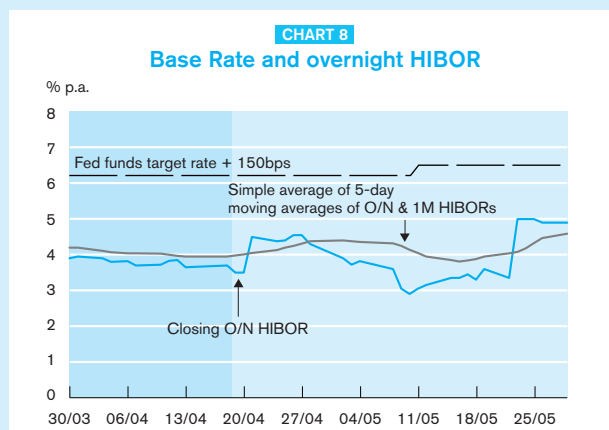


**TABLE 1**  
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

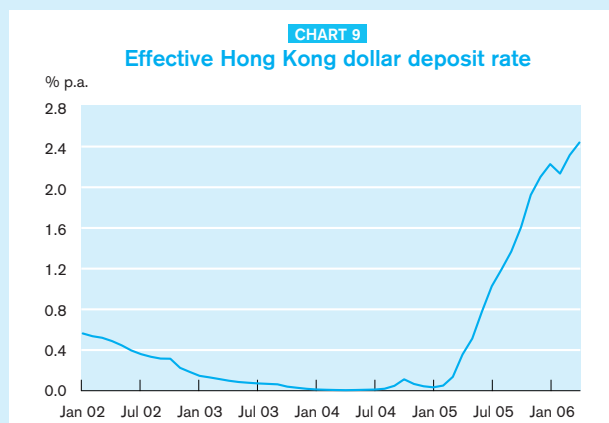
	27 Jun 97	18 Apr 06	29 May 06
3-month	56	-97	-109
1-year	21	-82	-79
3-year	3	-47	-56
5-year	27	-38	-37
10-year	54	-34	-22

<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.

Following a hike of 25 basis points in the US federal funds target rate, **the HKMA Base Rate was adjusted upward by 25 basis points to 6.50% on 11 May 2006** according to the established formula (Chart 8). However, **banks kept their Best Lending Rates unchanged.**



The average one-month time deposit rate offered by major authorized institutions rose from 2.776% to 2.781% during the period.<sup>2</sup> Meanwhile, the effective deposit rate increased from 2.32% to 2.44% in April (Chart 9).<sup>3</sup> The composite interest rate, which reflects the average cost of funds of banks, rose from 3.00% at the end of March 2006 to 3.10% at the end of April 2006.<sup>4</sup>



<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.

## Monetary Base

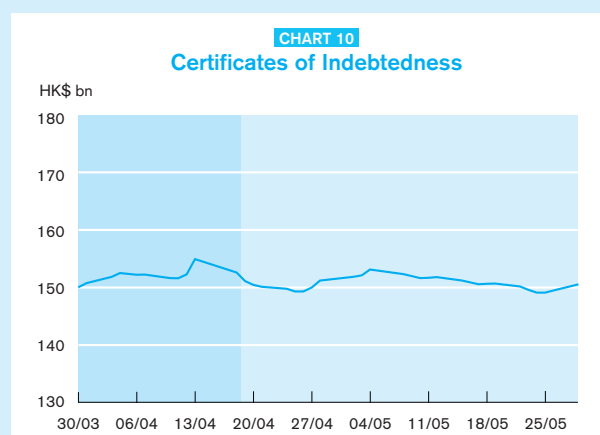
The **Monetary Base**, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, **fell from HK\$287.12 billion to HK\$286.93 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

**TABLE 2**  
Monetary Base

(HK\$ bn)	19 Apr 06	29 May 06
CIs	151.16	150.58
Government-issued Currency Notes and Coins in Circulation	7.13	7.07
Aggregate Balance	1.25	1.35
Outstanding EFBNs	127.60	127.93
<b>Monetary Base</b>	<b>287.12</b>	<b>286.93</b>

## Certificates of Indebtedness

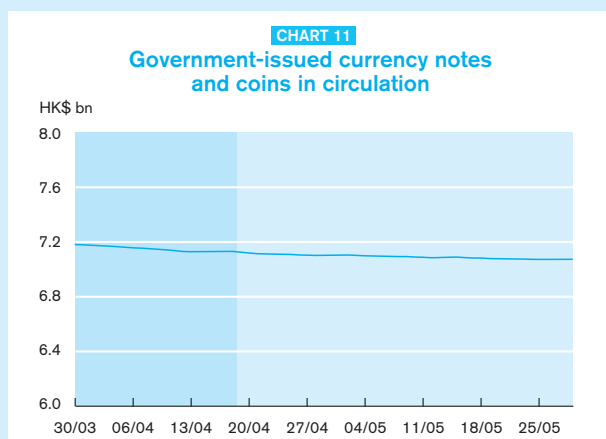
During the reporting period, the three note-issuing banks redeemed from the HKMA a total of HK\$0.58 billion of CIs in exchange for US\$0.07 billion. As a result, **the outstanding amount of CIs declined from HK\$151.16 billion to HK\$150.58 billion** (Chart 10).



<sup>4</sup> This is a weighted average interest rate of all Hong Kong dollar interest-bearing liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and Hong Kong dollar non-interest bearing demand deposits on the books of banks. Data from retail banks, which account for about 90% of the total customers' deposits in the banking sector, are used in the calculation.

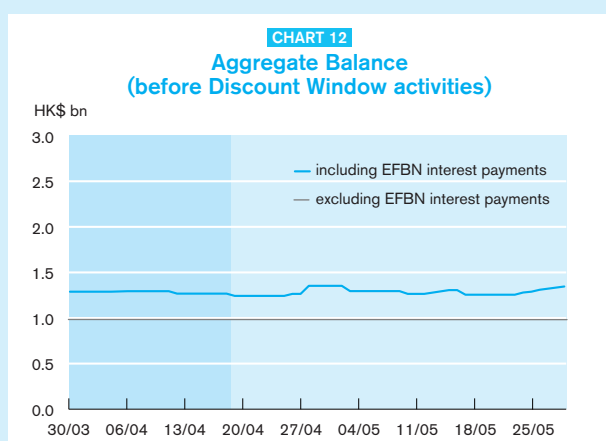
### Government-issued currency notes and coins in circulation

The total amount of **government-issued currency notes and coins in circulation fell modestly from HK\$7.13 billion to HK\$7.07 billion** during the reporting period (Chart 11).



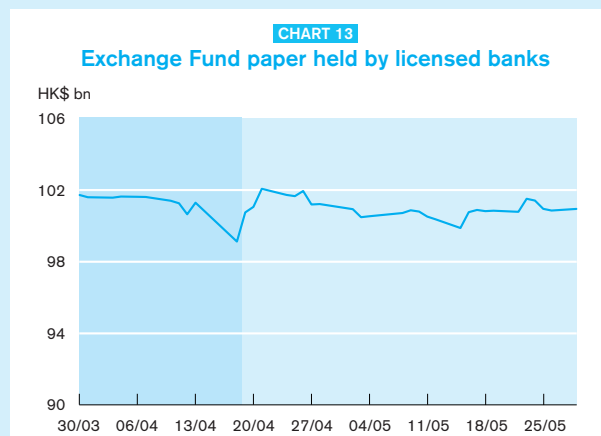
### Aggregate Balance

The **Aggregate Balance was little changed during the reporting period to close at around HK\$1.3 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 rose moderately from HK\$127.60 billion to HK\$127.93 billion**. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) **increased slightly** from HK\$100.74 billion (78.95% of total) to HK\$100.93 billion (78.89% of total) (Chart 13).



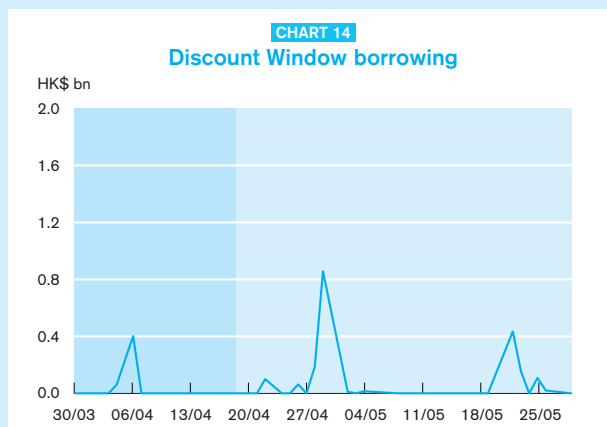
During the period, **a total of HK\$476.61 million of interest payments on Exchange Fund paper were made. An additional HK\$399.38 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. All issues of Exchange Fund paper were well received by the market (Table 3).

**TABLE 3**  
Issuance of Exchange Fund Bills and Notes (19 Apr 06 – 29 May 06)

	No. of issues launched	Over-subscription ratio
1-month EFB	3	8.25-13.88
3-month EFB	6	2.22-4.75
6-month EFB	3	3.35-4.38
1-year EFB	1	2.60
2-year EFN	1	2.65
7-year EFN	1	3.92

## Discount Window activities

During the period, **eight banks borrowed a total of HK\$1.95 billion from the Discount Window**, compared with HK\$461 million in the preceding period (Chart 14). All borrowings used Exchange Fund paper as collateral (Table 4).



**TABLE 4**  
**Frequency of individual bank's access to the Discount Window (19 Apr 06 – 29 May 06)**

Frequency of using Discount Window	No. of banks
1	4
2	3
4	1
Total	8

## Backing Portfolio

Backing Assets increased during the period, largely due to valuation gains, which more than offset the decline in the Monetary Base. As a result, **the Backing Ratio increased from 111.68% on 19 April to 111.97% on 29 May 2006** (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.

