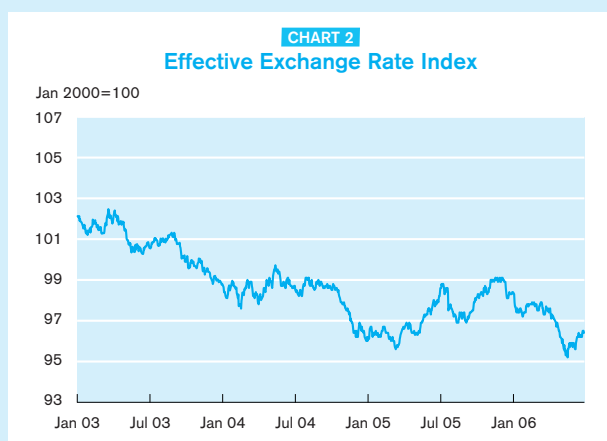
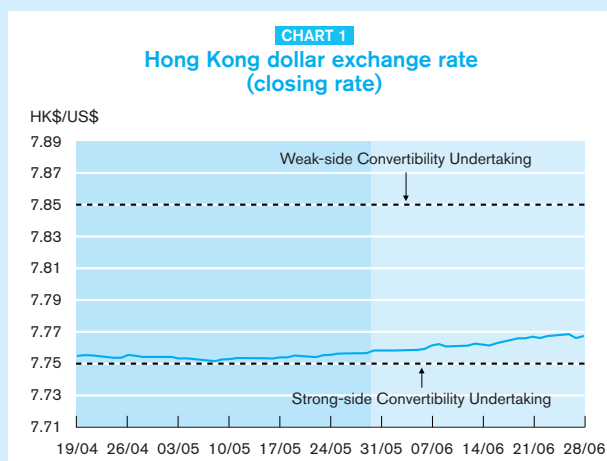


Report on Currency Board Operations (30 May – 28 June 2006)

The Hong Kong dollar exchange rate weakened alongside corrections in the local equity market during the reporting period. Short-term interbank interest rates eased slightly and their negative spreads against US dollar rates widened. The Monetary Base declined from HK\$287.63 billion to HK\$284.83 billion, largely due to decreases 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 depreciated from 7.7582 to 7.7672 during the reporting period, attributable to corrections in the local equity market as well as broad-based strengthening of the US dollar (Chart 1). Meanwhile, the effective exchange rate of the Hong Kong dollar rose alongside the US dollar (Chart 2).

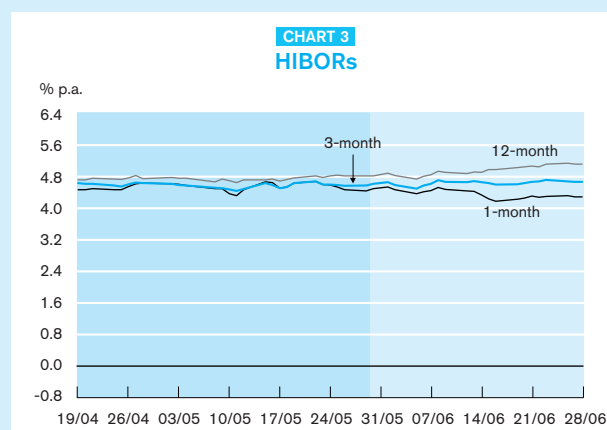


¹ The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

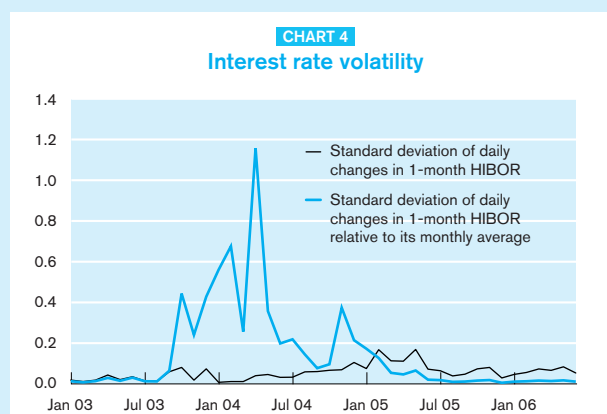
Interest rates

Short-term Hong Kong dollar interbank interest rates dropped moderately during the reporting period.

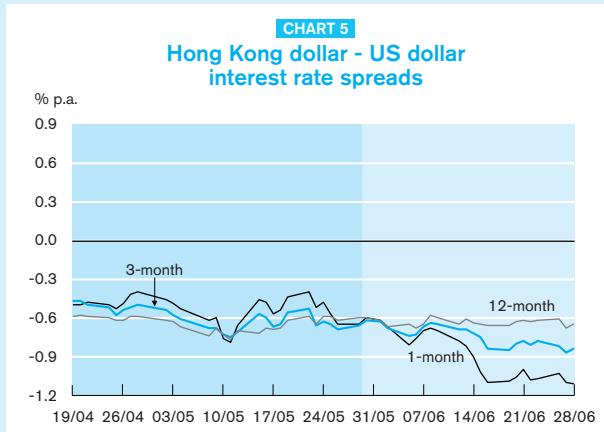
The one-month HIBOR decreased by 21 basis points to close at 4.27%. Meanwhile, the three-month and 12-month HIBORs rose by 5 basis points and 30 basis points to close at 4.65% and 5.10% respectively (Chart 3).



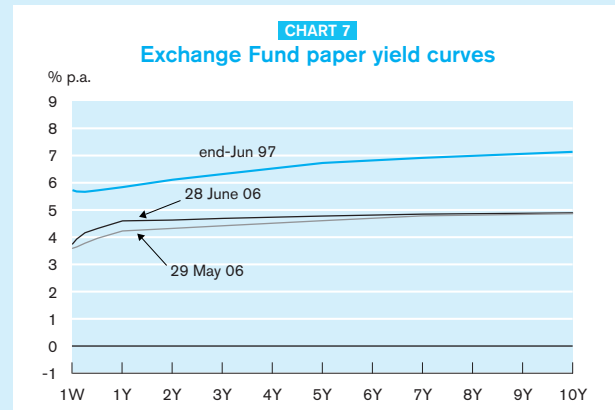
Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, decreased in June. The standard deviation as a ratio of the average level of one-month HIBOR also declined slightly (Chart 4).¹



Negative spreads of Hong Kong dollar interest rates over the US dollar counterparts widened during the reporting period. The one-month and three-month spreads widened by 51 basis points and 22 basis points to -111 basis points and -84 basis points respectively. Meanwhile, the 12-month spread edged up by 5 basis points to close at -65 basis points (Chart 5).



The **yield curve of Exchange Fund paper flattened during the period** (Chart 7). The negative yield spreads against US Treasuries narrowed at the short end, but widened at the long end. In particular, the three-month spread fell to -87 basis points, while the 5-year and 10-year spreads rose to -47 basis points and -37 basis points respectively at the end of the period (Table 1).



In line with the movements in interest rate spreads, the **Hong Kong dollar 12-month forward discount increased by 45 pips to close at 485 pips**, while the three-month forward discount widened by 40 pips to close at 167 pips (Chart 6).

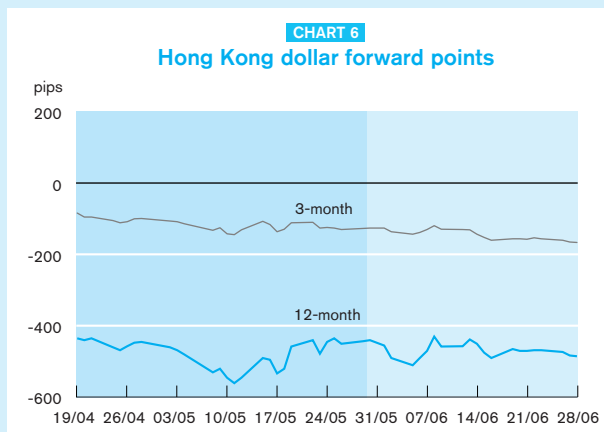
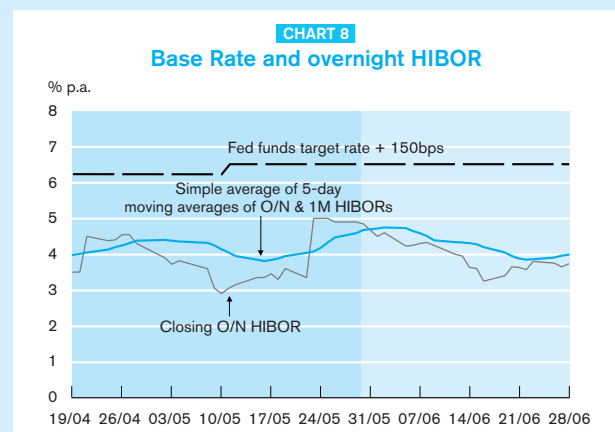


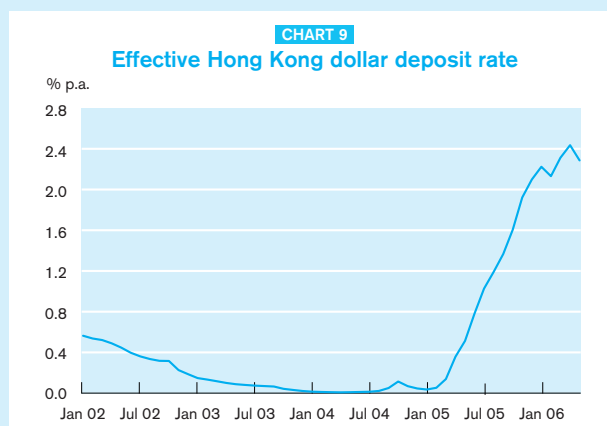
TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	29 May 06	28 Jun 06
3-month	56	-109	-87
1-year	21	-79	-76
3-year	3	-56	-56
5-year	27	-37	-47
10-year	54	-22	-37

In the absence of policy rate changes in the US, **the HKMA Base Rate remained unchanged at 6.50%** (Chart 8). **Banks also kept their Best Lending Rates unchanged.**

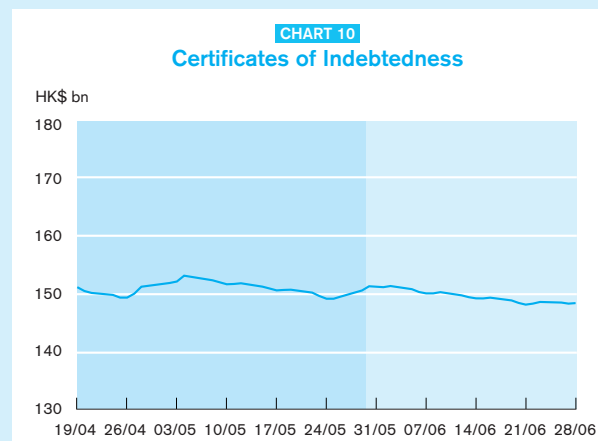


The average one-month time deposit rate offered by major authorized institutions decreased from 2.774% to 2.769% during the period.² Meanwhile, the effective deposit rate fell from 2.44% to 2.29% in May (Chart 9).³ The composite interest rate, which reflects the average cost of funds of banks, rose from 3.10% at the end of April 2006 to 3.39% at the end of May 2006.⁴



Certificates of Indebtedness

During the reporting period, the three note-issuing banks redeemed from the HKMA a total of HK\$2.91 billion of CIs in exchange for US\$0.37 billion. As a result, the outstanding amount of CIs decreased from HK\$151.31 billion to HK\$148.40 billion (Chart 10).



Monetary Base

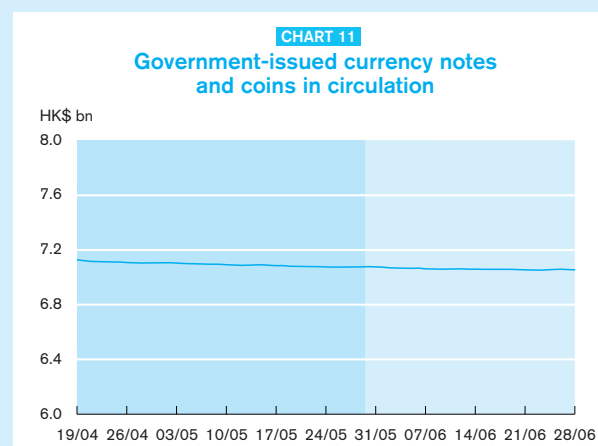
The Monetary Base, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, decreased from HK\$287.63 billion to HK\$284.83 billion during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	30 May 06	28 Jun 06
CIs	151.31	148.40
Government-issued Currency Notes and Coins in Circulation	7.08	7.05
Aggregate Balance	1.35	1.32
Outstanding EFBNs	127.89	128.07
Monetary Base	287.63	284.83

Government-issued currency notes and coins in circulation

The total amount of government-issued currency notes and coins in circulation decreased slightly from HK\$7.08 billion to HK\$7.05 billion during the reporting period (Chart 11).



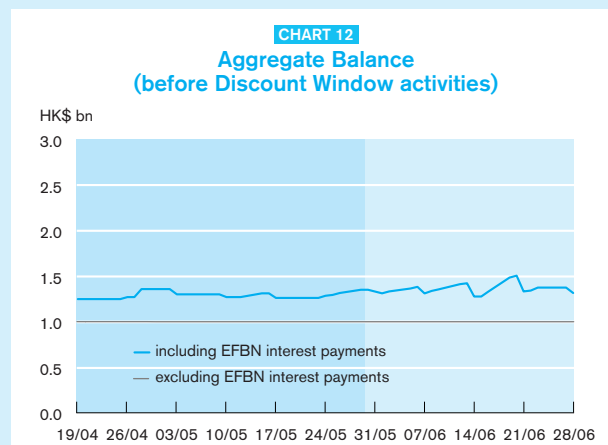
² The figures refer to the average of interest rates offered by the major authorized institutions for one-month time deposits of less than HK\$100,000.

³ 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.

⁴ 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.

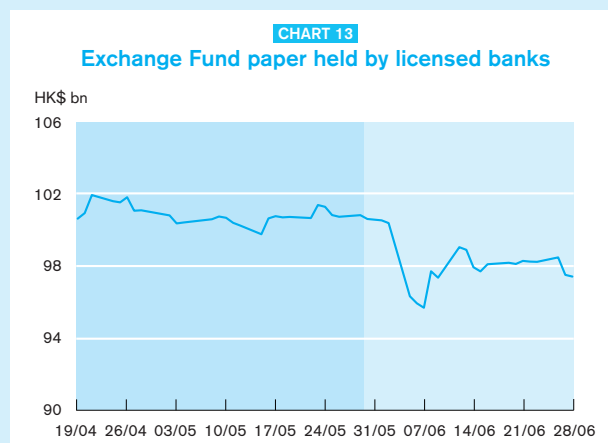
Aggregate Balance

The Aggregate Balance was little changed during the reporting period, closing 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\$127.89 billion to HK\$128.07 billion. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased slightly from HK\$100.72 billion (78.75% of total) to HK\$97.50 billion (76.13% of total) (Chart 13).



During the period, a total of HK\$816.75 million of interest payments on Exchange Fund paper were made. Taking into account the interest payments carried forward from the last reporting period, an additional HK\$843.54 million (in market value) of Exchange Fund paper was issued to absorb these interest payments. All issues of Exchange Fund paper were well received by the market (Table 3).

TABLE 3
Issuance of Exchange Fund Bills and Notes
(30 May 06 – 28 Jun 06)

	No. of issues launched	Over-subscription ratio
3-month EFB	5	1.10-6.67
6-month EFB	2	2.51-5.99
1-year EFB	2	2.78-17.94
3-year EFN	1	1.81
5-year EFN	1	6.01
10-year EFN	1	1.78

Discount Window activities

During the period, nine banks borrowed a total of HK\$1.13 billion from the Discount Window, compared with HK\$1.95 billion in the preceding period (Chart 14). All borrowings used Exchange Fund paper as collateral (Table 4).

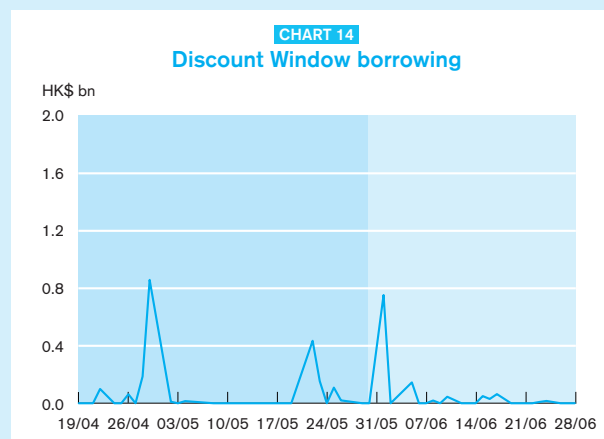


TABLE 4
Frequency of individual bank's access to the Discount Window
(30 May 06 – 28 Jun 06)

Frequency of using Discount Window	No. of banks
1	6
2	3
Total	9

Backing Portfolio

Backing Assets declined during the period, largely due to decreases in Certificates of Indebtedness. As Backing Assets decreased proportionally less than the Monetary Base, **the Backing Ratio increased from 111.94% on 30 May to 112.17% on 28 June 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.

