

Report on Currency Board Operations (29 June – 26 July 2006)

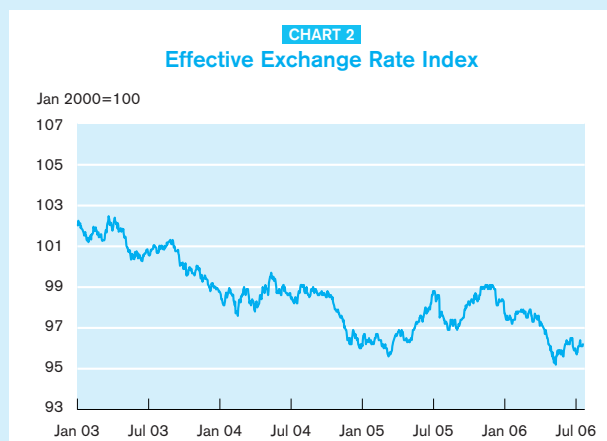
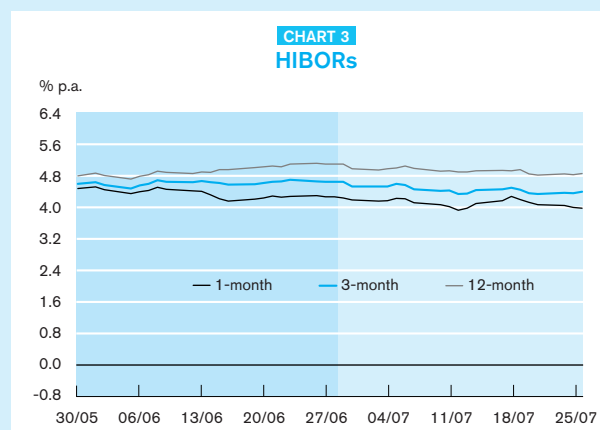
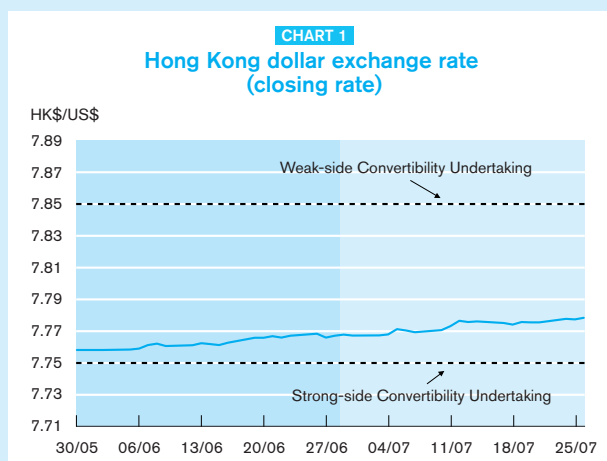
The Hong Kong dollar exchange rate weakened, reflecting interest rate arbitrage activities during the reporting period. Interbank interest rates eased and their negative spreads against US dollar rates widened. The Monetary Base declined from HK\$285.82 billion to HK\$285.47 billion, largely because of 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

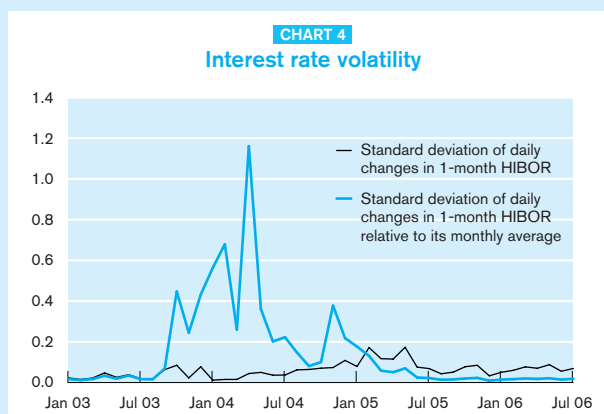
The Hong Kong dollar exchange rate softened from 7.7679 to 7.7785 during the reporting period, reportedly relating to interest rate arbitrage activities to take advantage of wider negative interest rate differentials (Chart 1). Meanwhile, the effective exchange rate of the Hong Kong dollar eased slightly, reflecting weakness in the US dollar (Chart 2).

Interest rates

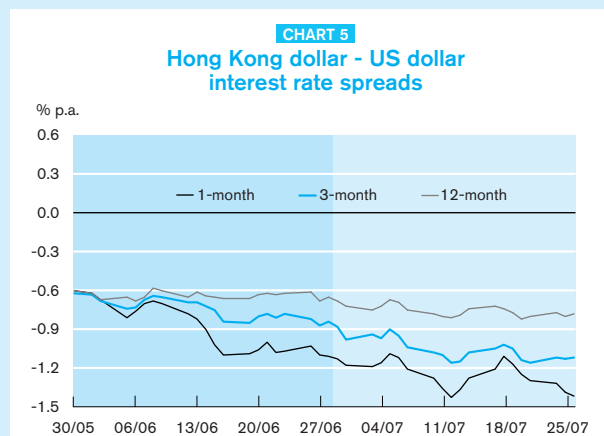
Hong Kong dollar interbank interest rates declined during the reporting period. The one-month HIBOR decreased by 26 basis points to close at 3.98%. The three-month and 12-month HIBORs decreased by 25 basis points and 24 basis points to close at 4.40% and 4.86% respectively (Chart 3).



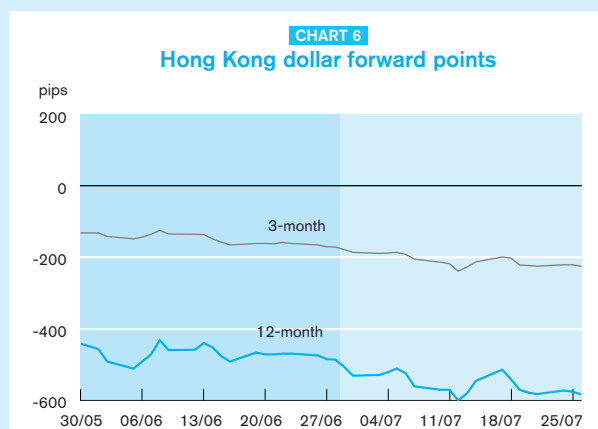
Interest rate volatility, as measured by the standard deviation of daily changes in one-month HIBOR, **rose** in July. The standard deviation as a ratio of the average level of one-month HIBOR also increased slightly (Chart 4).¹



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 29 basis points and 24 basis points to -142 basis points and -112 basis points respectively. The 12-month spread widened by 10 basis points to close at -78 basis points (Chart 5).



In line with the movements in interest rate spreads, the **Hong Kong dollar 12-month forward discount increased by 78 pips to close at 583 pips**, and the three-month forward discount widened by 47 pips to close at 221 pips (Chart 6).



The **yields of Exchange Fund paper decreased across-the-board during the period** (Chart 7). The negative yield spreads against US Treasuries widened at the short end, but narrowed at the long end. In particular, the three-month spread rose to -140 basis points, while the five-year and 10-year spreads decreased to -46 basis points and -35 basis points respectively at the end of the period (Table 1).

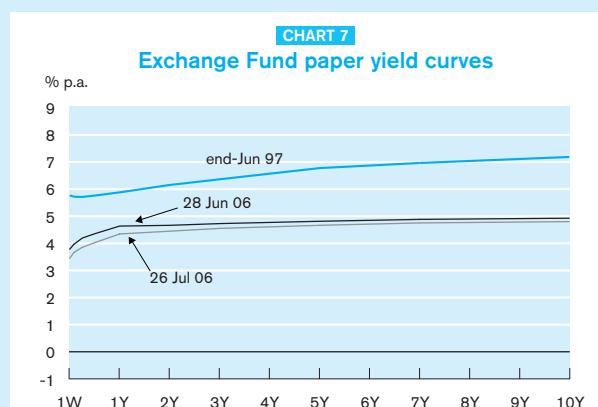
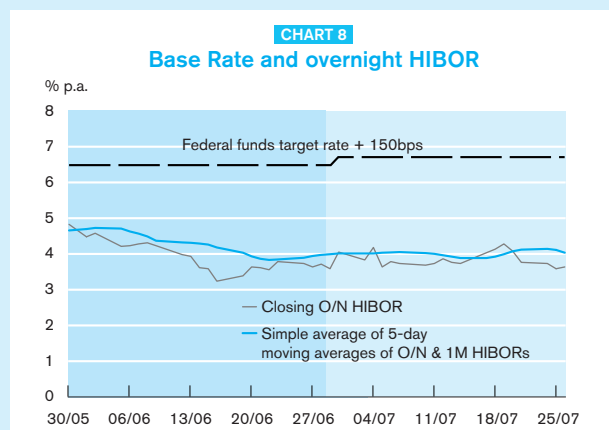


TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

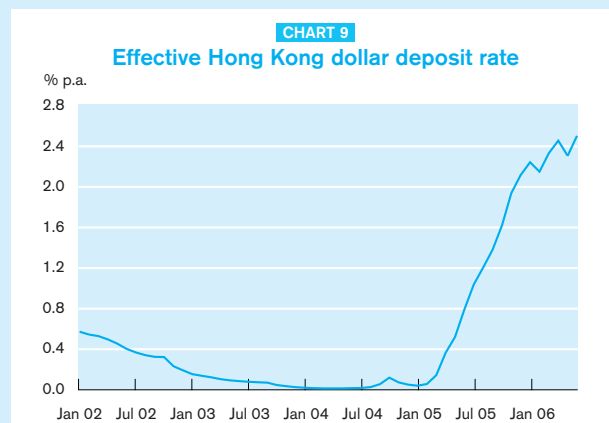
	27 Jun 97	28 Jun 06	26 Jul 06
3-month	56	-87	-140
1-year	21	-76	-96
3-year	3	-56	-61
5-year	27	-47	-46
10-year	54	-37	-35

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.

Following an increase of 25 basis points in the US federal funds target rate, **the HKMA Base Rate was adjusted upward by 25 basis points to 6.75% on 30 June 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 remained unchanged at 2.769% during the period.² Meanwhile, the effective deposit rate increased from 2.29% to 2.49% in June (Chart 9).³ The composite interest rate, which reflects the average cost of funds of banks, declined from 3.39% at the end of May 2006 to 3.16% at the end of June 2006.⁴



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.

Monetary Base

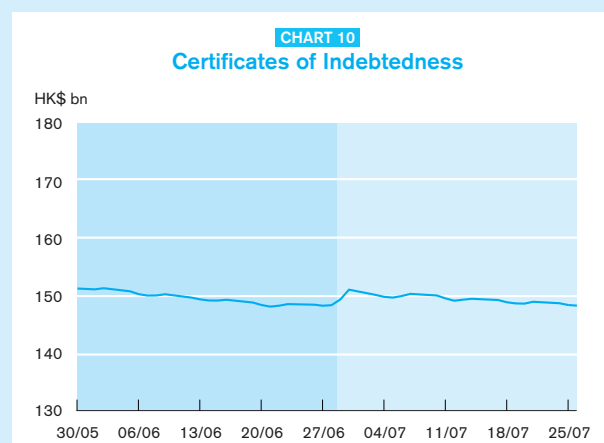
The Monetary Base, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, **decreased slightly from HK\$285.82 billion to HK\$285.47 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	29 Jun 06	26 Jul 06
CIs	149.40	148.31
Government-issued Currency Notes and Coins in Circulation	7.05	7.04
Aggregate Balance	1.32	1.30
Outstanding EFBNs	128.06	128.82
Monetary Base	285.82	285.47

Certificates of Indebtedness

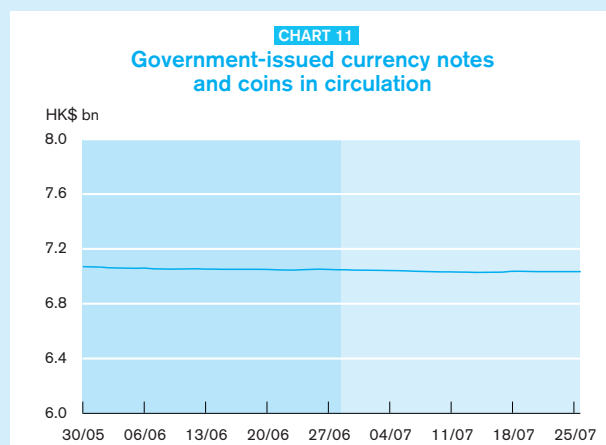
During the reporting period, the three note-issuing banks redeemed from the HKMA a total of HK\$1.09 billion of CIs in exchange for US\$0.14 billion. As a result, **the outstanding amount of CIs decreased from HK\$149.40 billion to HK\$148.31 billion** (Chart 10).



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.

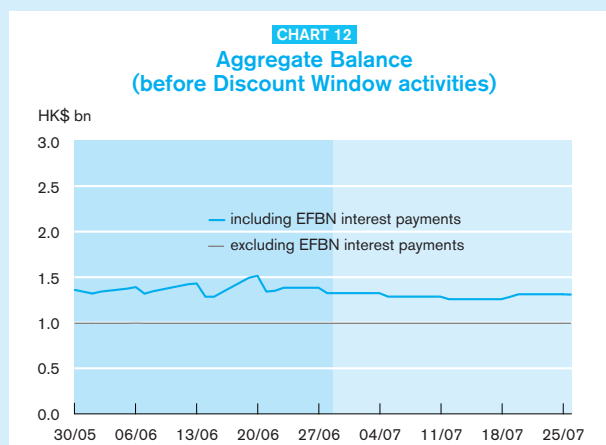
Government-issued currency notes and coins in circulation

The total amount of **government-issued currency notes and coins in circulation was virtually unchanged at HK\$7.04 billion** at the end of the reporting period (Chart 11).



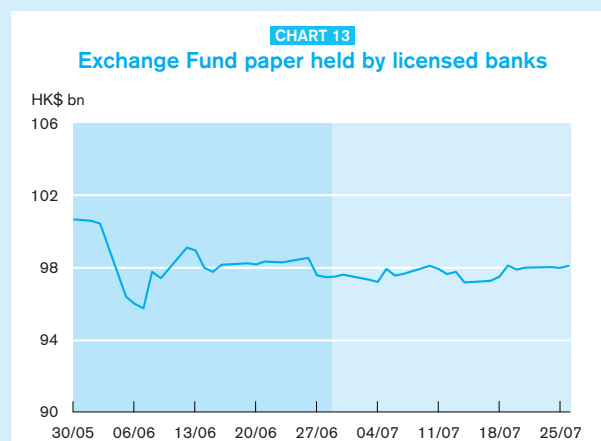
Aggregate Balance

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\$128.06 billion to **HK\$128.82 billion**. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased from HK\$97.52 billion (76.15% of total) to **HK\$98.12 billion (76.17% of total)** (Chart 13).



During the period, a total of **HK\$225.75 million of interest payments on Exchange Fund paper were made**. Taking into account interest payments carried forward from the last reporting period, **an additional HK\$241.63 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 (29 Jun 06 – 26 Jul 06)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	7.92
3-month EFB	4	3.27-4.25
6-month EFB	2	3.60-3.77
1-year EFB	1	3.05

Discount Window activities

During the period, **four banks borrowed a total of HK\$653 million from the Discount Window**, compared with HK\$1.13 billion in the preceding period (Chart 14). All borrowings used Exchange Fund paper as collateral (Table 4).

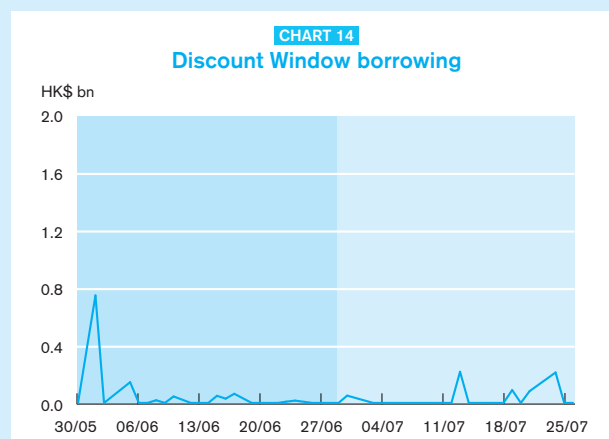


TABLE 4
Frequency of individual bank's access to the Discount Window (29 Jun 06 – 26 Jul 06)

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

Backing Portfolio

Backing Assets increased in the early part of the reporting period, attributable to valuation gains. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio increased from 112.08% on 29 June to 112.52% on 13 July, surpassing the Upper Trigger Level of 112.5%. Pursuant to the arrangement approved by the Financial Secretary in January 2000, assets were transferred out of the backing portfolio to reduce the Backing Ratio to around 110% on 14 July** (Chart 15). Thereafter, the Backing Ratio continued to rise and closed at 110.29% at the end of the period. 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.

