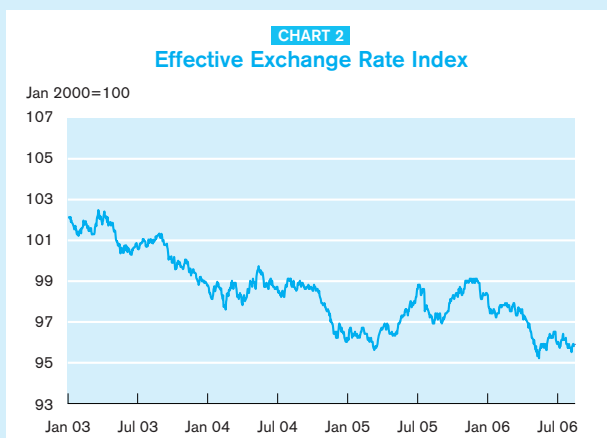
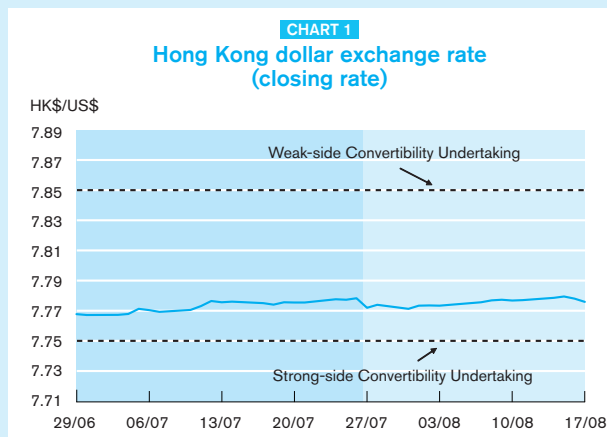


## Annex Report on Currency Board Operations (27 July – 17 August 2006)

The Hong Kong dollar exchange rate weakened slightly during the reporting period. Interbank interest rates and their negative spreads against US dollar rates showed mixed patterns. The Monetary Base rose from HK\$285.91 billion to HK\$286.94 billion, reflecting increases in Certificates of Indebtedness and Exchange Fund Bills and Notes. 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

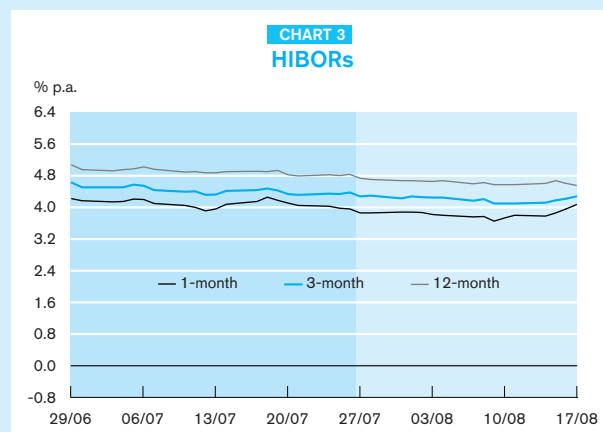
The Hong Kong dollar exchange rate softened moderately from 7.7721 to 7.7761 during the reporting period (Chart 1). Meanwhile, the effective exchange rate of the Hong Kong dollar was little changed (Chart 2).



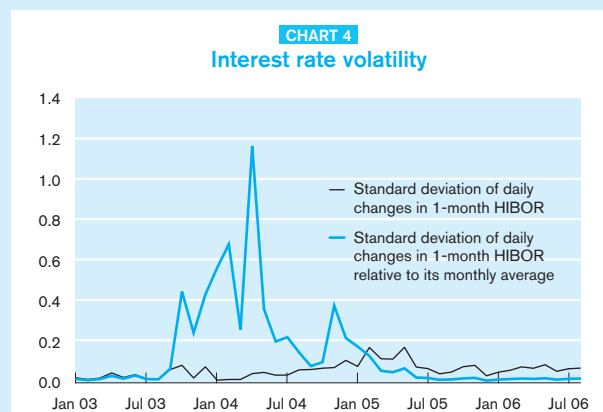
<sup>1</sup> The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

### Interest rates

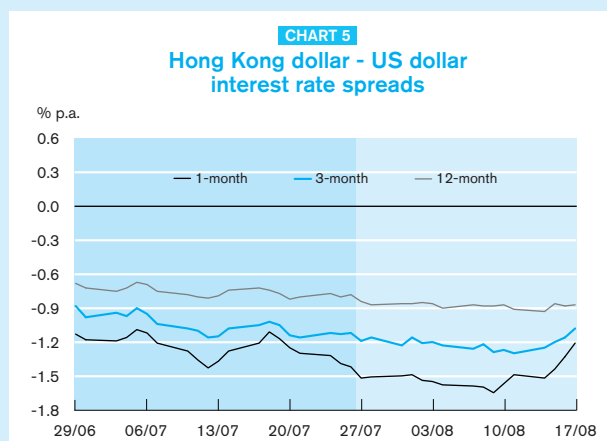
Hong Kong dollar interbank interest rates showed a mixed pattern during the reporting period. Specifically, the one-month HIBOR increased by 21 basis points to close at 4.09%, while the 12-month HIBOR fell by 18 basis points to close at 4.58% (Chart 3).



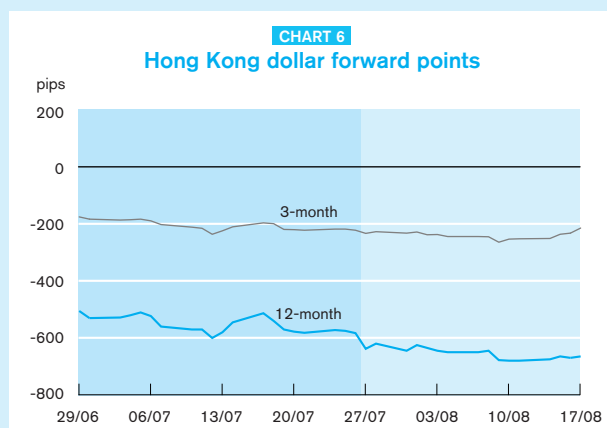
Interest rate volatility, as measured by the standard deviation of daily changes in one-month HIBOR, rose in August. The standard deviation as a ratio of the average level of one-month HIBOR also increased slightly (Chart 4).<sup>1</sup>



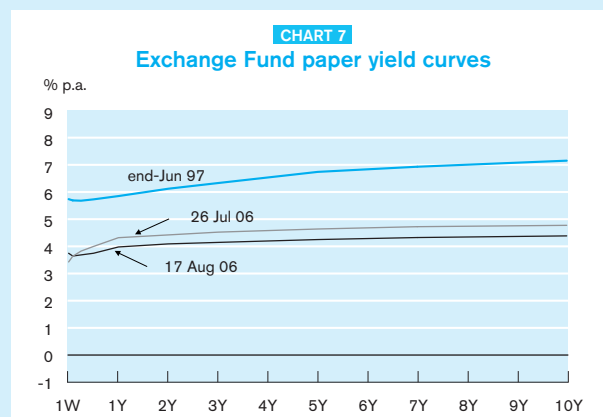
During the reporting period, **negative spreads of Hong Kong dollar interest rates over the US dollar rates narrowed at the short end, but widened slightly at the long end.** The one-month and three-month spreads narrowed by 31 basis points and 11 basis points to -121 basis points and -108 basis points respectively. Meanwhile, the 12-month spread widened slightly by 3 basis points to close at -87 basis points (Chart 5).



Reflecting the movements in the interest rate spreads, the **Hong Kong dollar 12-month forward discount increased by 27 pips to close at 665 pips**, whereas the three-month forward discount decreased by 19 pips to close at 213 pips (Chart 6).



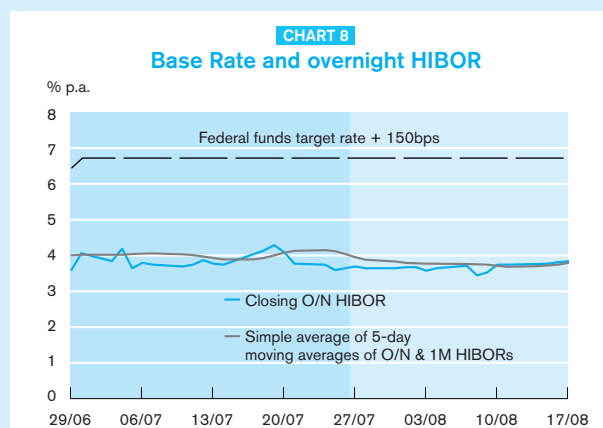
**Yields of Exchange Fund paper decreased during the period except for the one-week tenor (Chart 7).** The negative yield spreads against US Treasuries widened. In particular, the three-month negative spread rose to 142 basis points. The five-year and 10-year negative spreads increased to 61 basis points and 54 basis points respectively at the end of the period (Table 1).



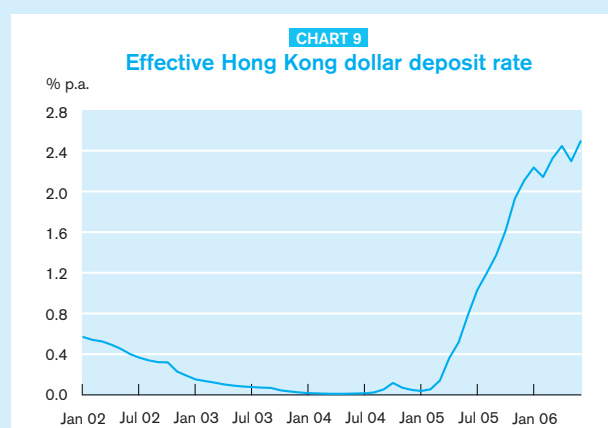
**TABLE 1**  
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	26 Jul 06	17 Aug 06
3-month	56	-140	-142
1-year	21	-96	-113
3-year	3	-61	-73
5-year	27	-46	-61
10-year	54	-35	-54

**The HKMA Base Rate remained at 6.75% throughout the period (Chart 8).** Most banks kept their Best Lending Rates unchanged, but some cut their rates by 25 basis points. Two different Best Lending Rates of 8% and 8.25% still existed at the end of the reporting period.

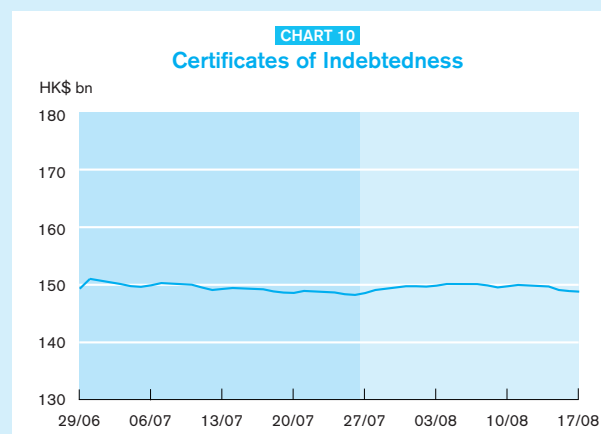


The average one-month time deposit rate offered by major authorized institutions remained unchanged at **2.769%** during the period.<sup>2</sup> Meanwhile, the effective deposit rate increased from 2.29% to 2.49% in June (Chart 9).<sup>3</sup> The composite interest rate, which reflects the average cost of funds of banks, declined by 5 basis points to 3.11% at the end of July.<sup>4</sup>



## Certificates of Indebtedness

During the reporting period, the three note-issuing banks submitted US\$33 million to the HKMA in exchange for HK\$260 million worth of CIs. As a result, **the outstanding amount of CIs increased from HK\$148.62 billion to HK\$148.88 billion** (Chart 10).



## Monetary Base

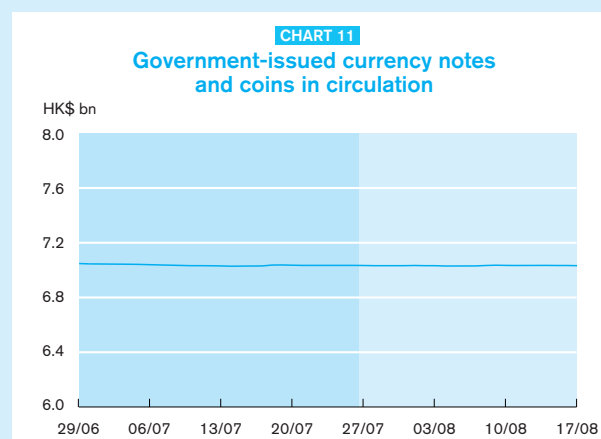
The **Monetary Base**, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, **increased from HK\$285.91 billion to HK\$286.94 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

**TABLE 2**  
Monetary Base

(HK\$ bn)	27 Jul 06	17 Aug 06
CIs	148.62	148.88
Government-issued Currency Notes and Coins in Circulation	7.04	7.04
Aggregate Balance	1.30	1.28
Outstanding EFBNs	128.96	129.74
<b>Monetary Base</b>	<b>285.91</b>	<b>286.94</b>

## Government-issued currency notes and coins in circulation

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



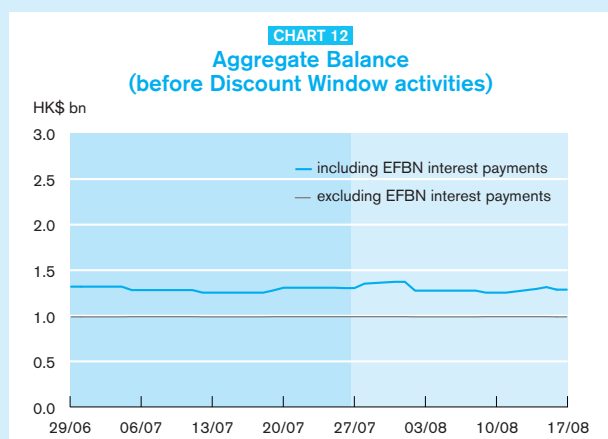
<sup>2</sup> The figures refer to the average of interest rates offered by the major authorized institutions for one-month time deposits of less than HK\$100,000.

<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.

<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.

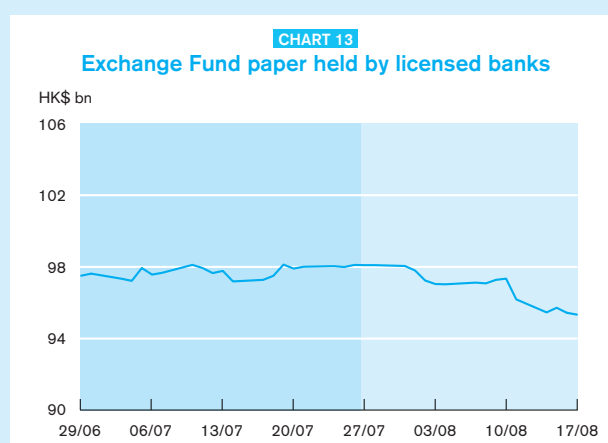
## Aggregate Balance

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 expanded from HK\$128.96 billion to HK\$129.74 billion. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased from HK\$98.11 billion (76.08% of total) to HK\$95.33 billion (73.48% of total) (Chart 13).



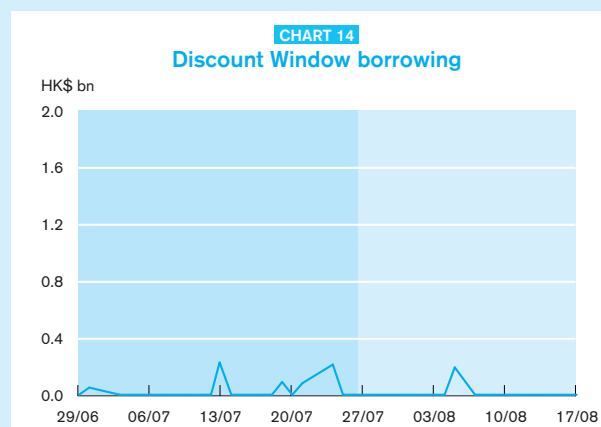
During the period, **HK\$242.72 million of interest payments on Exchange Fund paper were made.** Taking into account interest payments carried forward from the last reporting period, **an additional HK\$259.62 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** All issues of Exchange Fund paper were well received by the market (Table 3).

**TABLE 3**  
Issuance of Exchange Fund Bills and Notes  
(27 Jul 06 – 17 Aug 06)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	7.08
3-month EFB	3	2.80-7.52
6-month EFB	2	3.40-4.54
2-year EFN	1	7.30

## Discount Window activities

During the period, **one bank borrowed a sum of HK\$193 million from the Discount Window**, compared with a total of HK\$653 million in the preceding period (Chart 14). The borrowing used Exchange Fund paper as collateral (Table 4).



**TABLE 4**  
Frequency of individual bank's access to the Discount Window  
(27 Jul 06 – 17 Aug 06)

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

## Backing Portfolio

Backing Assets rose during the period, mainly reflecting increases in Certificates of Indebtedness, Exchange Fund papers and valuation gains. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio rose slightly from 110.38% on 27 July to 110.65% on 17 August** (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.

