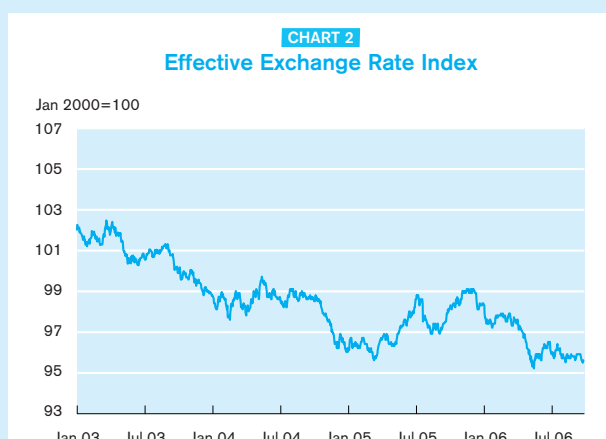
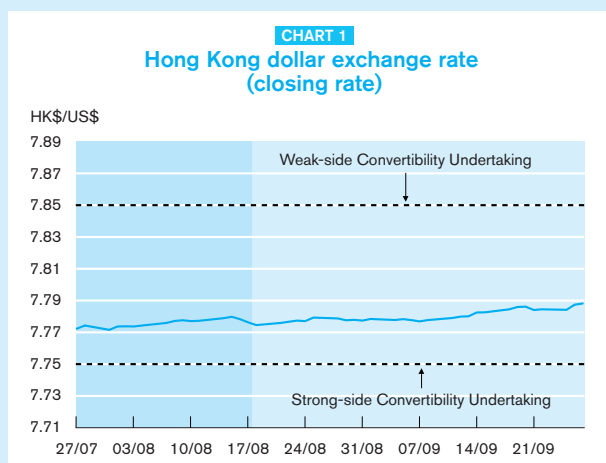


Report on Currency Board Operations (18 August – 27 September 2006)

The Hong Kong dollar exchange rate weakened during the reporting period. Interbank interest rates decreased and their negative spreads against US dollar rates widened. The Monetary Base rose from HK\$287.25 billion to HK\$288.76 billion. 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

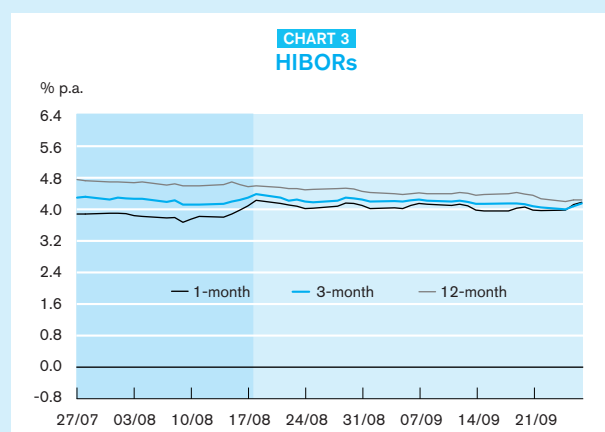
The Hong Kong dollar exchange rate softened from 7.7744 to 7.7880 during the reporting period, reportedly related to interest carry trades (Chart 1). Meanwhile, the effective exchange rate of the Hong Kong dollar was little changed (Chart 2).



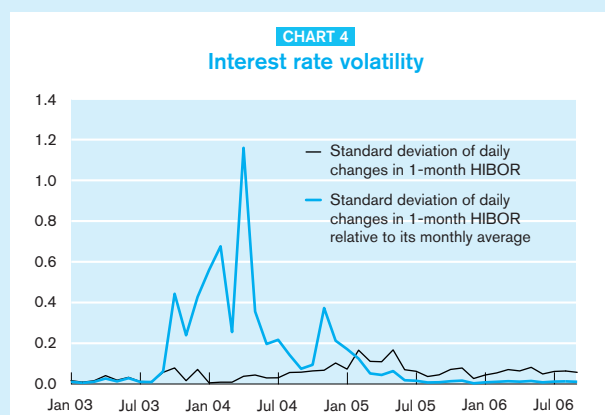
¹ The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

Interest rates

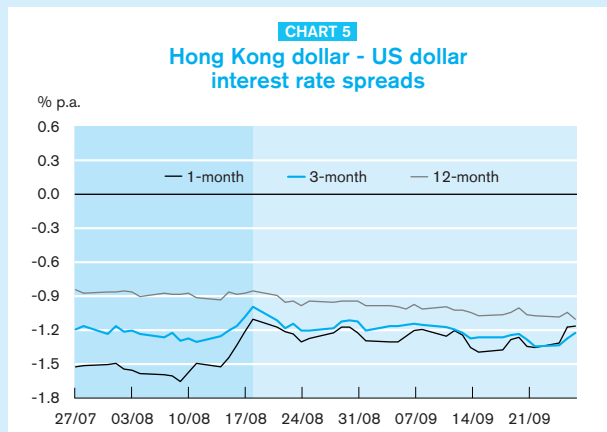
Hong Kong dollar interbank interest rates decreased during the reporting period. The one-month and three-month HIBORs declined by 5 and 24 basis points to 4.18% and 4.15% respectively. Meanwhile the 12-month HIBOR had decreased by 36 basis points to 4.24% at the end of the reporting period (Chart 3).



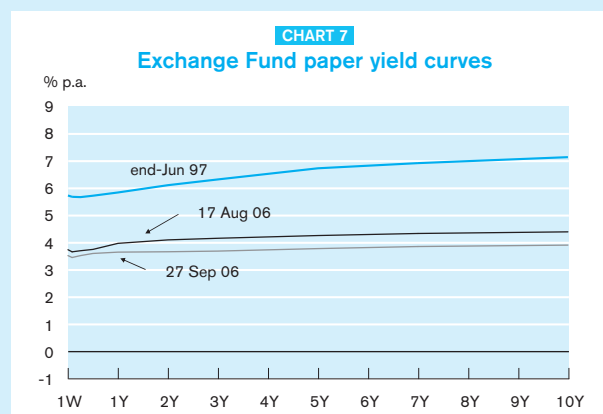
Interest rate volatility, as measured by the standard deviation of daily changes in one-month HIBOR, declined in September. The standard deviation as a ratio of the average level of one-month HIBOR also decreased (Chart 4).¹



During the reporting period, **negative spreads of Hong Kong dollar interest rates over the US dollar rates widened**. The one-month and three-month negative spreads increased by 6 and 23 basis points to -166 and -122 basis points respectively. Meanwhile the 12-month negative spread rose by 25 basis points to -110 basis points (Chart 5).



Yields of Exchange Fund paper dropped across the board during the period (Chart 7). The negative yield spreads against US Treasuries widened. In particular, the one-year negative spread rose to 130 basis points. The 5-year and 10-year negative spreads increased to 82 basis points and 72 basis points respectively at the end of the period (Table 1).



In parallel with the larger interest rate spreads, the **Hong Kong dollar 3-month and 12-month forward discount increased** by 29 and 80 pips to close at 232 and 755 pips respectively (Chart 6).

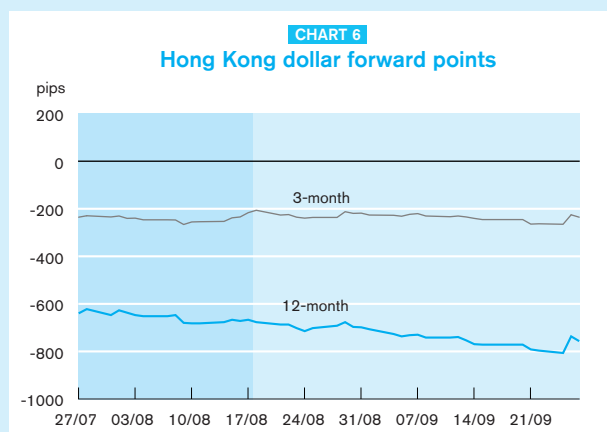
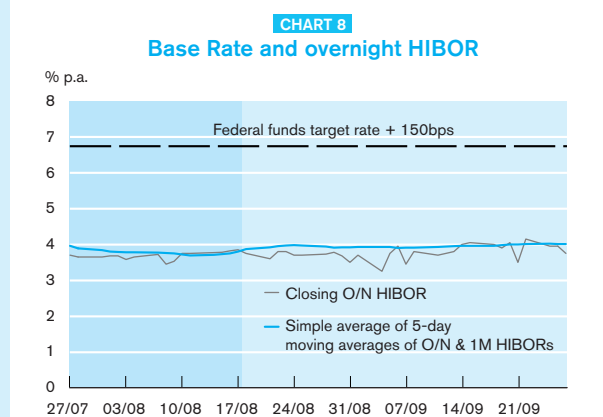


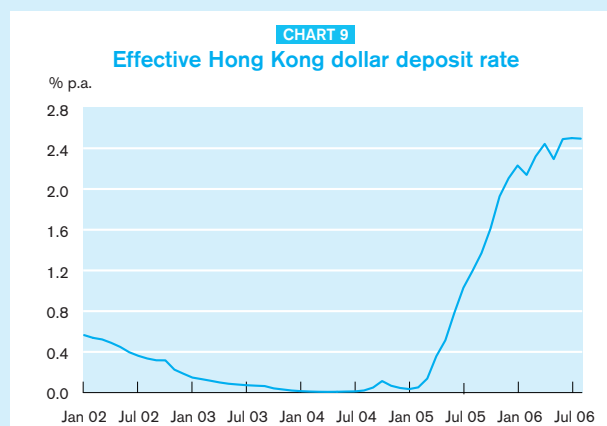
TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	17 Aug 06	27 Sep 06
3-month	56	-142	-143
1-year	21	-113	-130
3-year	3	-73	-95
5-year	27	-61	-82
10-year	54	-54	-72

The HKMA Base Rate remained at 6.75% throughout the period (Chart 8). Meanwhile, banks kept their Best Lending Rates unchanged. There were still two Best Lending Rates at 8% and 8.25% at the end of the reporting period.

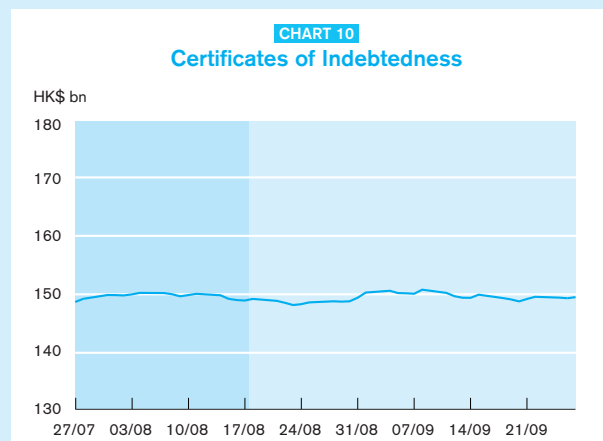


The average one-month time deposit rate offered by major authorized institutions remained unchanged at **2.769%** during the period.² Meanwhile, the effective deposit rate decreased slightly from 2.50% to 2.49% in August (Chart 9).³ The composite interest rate, which reflects the average cost of funds of banks, declined by six basis points to 3.05% at the end of August.⁴



Certificates of Indebtedness

During the reporting period, the three note-issuing banks submitted a total of US\$39.74 million to the HKMA in exchange for HK\$310 million worth of CIs. As a result, **the outstanding amount of CIs increased slightly from HK\$149.15 billion to HK\$149.46 billion** (Chart 10).



Monetary Base

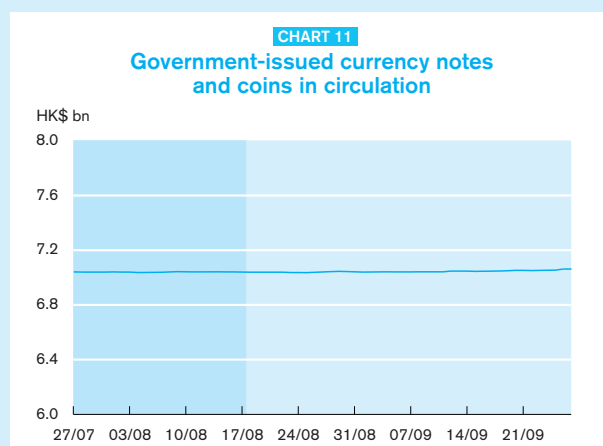
The **Monetary Base**, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, **increased from HK\$287.25 billion to HK\$288.76 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	18 Aug 06	27 Sep 06
CIs	149.15	149.46
Government-issued Currency Notes and Coins in Circulation	7.04	7.06
Aggregate Balance	1.28	1.30
Outstanding EFBNs	129.79	130.94
Monetary Base	287.25	288.76

Government-issued currency notes and coins in circulation

The total amount of **government-issued currency notes and coins in circulation remained stable at around HK\$7.06 billion** during the reporting period (Chart 11).



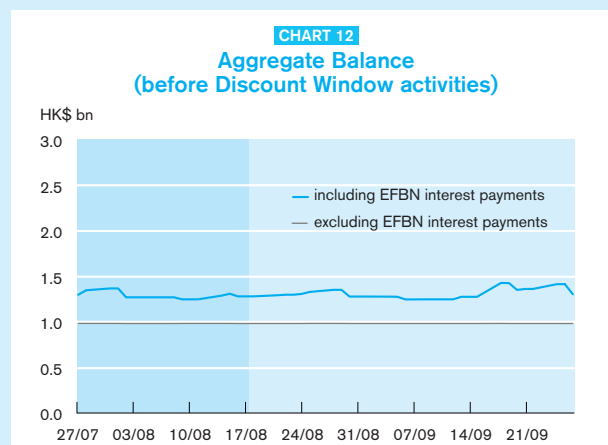
² The figures refer to the average of interest rates offered by the major authorized institutions for one-month time deposits of less than HK\$100,000.

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

In the reporting period, **the Aggregate Balance was little changed at around HK\$1.30 billion**, with small fluctuations due to interest payments on Exchange Fund paper (Chart 12).



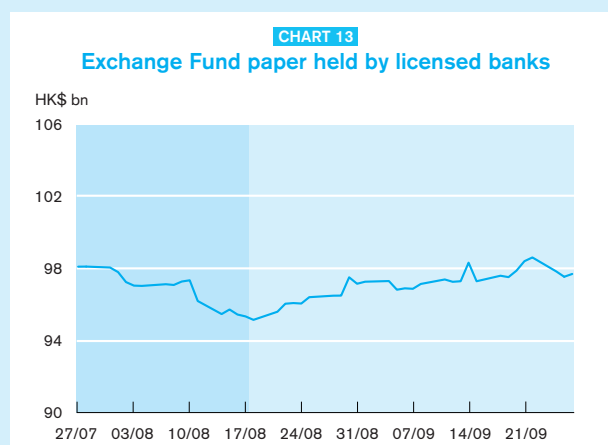
During the period, **a total of HK\$685.27 million of interest payments on Exchange Fund paper were made. An additional HK\$658.25 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. All issues of Exchange Fund paper were well received by the market (Table 3).

TABLE 3
Issuance of Exchange Fund Bills and Notes
(18 Aug 06 – 27 Sep 06)

	No. of issues launched	Over-subscription ratio
3-month EFB	6	1.21-5.26
6-month EFB	3	1.37-5.46
12-month EFB	2	2.48-5.23
3-year EFN	1	3.79
5-year EFN	1	1.69
7-year EFN	1	4.17

Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund Bills and Notes rose from HK\$129.79 billion to HK\$130.94 billion. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased from HK\$95.14 billion (73.30% of total) to HK\$97.71 billion (74.62% of total) (Chart 13).



Discount Window activities

During the period, **nine banks borrowed a total of HK\$2.86 billion from the Discount Window**, compared with a total of HK\$0.19 billion in the preceding period (Chart 14 and Table 4). The borrowing used Exchange Fund paper as collateral.

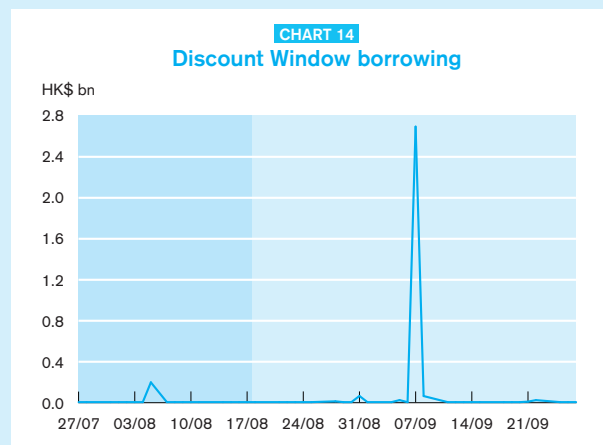


TABLE 4
Frequency of individual bank's access to the Discount Window
(18 Aug 06 – 27 Sep 06)

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

Backing Portfolio

Backing Assets rose during the period, mainly reflecting increases in the Monetary Base and valuation gains. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio rose slightly from 110.57% on 18 August to 111.50% on 27 September** (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.

