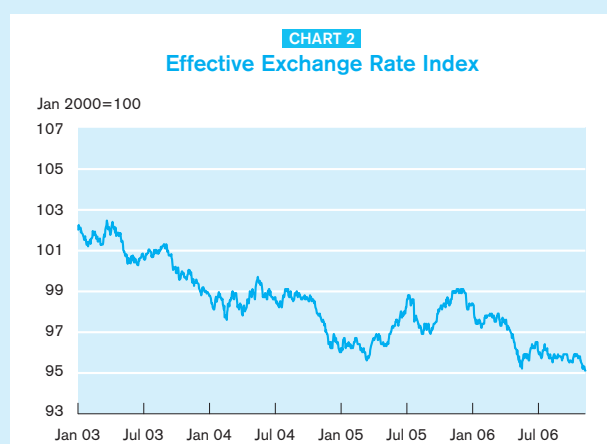
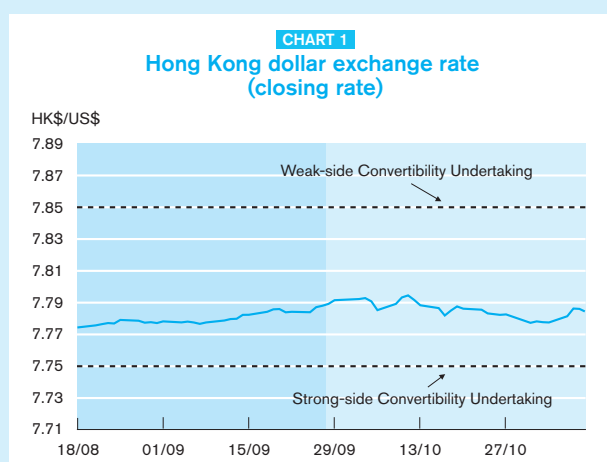


Annex Report on Currency Board Operations (28 September – 9 November 2006)

The Hong Kong dollar exchange rate strengthened slightly during the reporting period. Interbank interest rates declined and their negative spreads against US dollar rates widened. The Monetary Base rose from HK\$289.91 billion to HK\$291.87 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

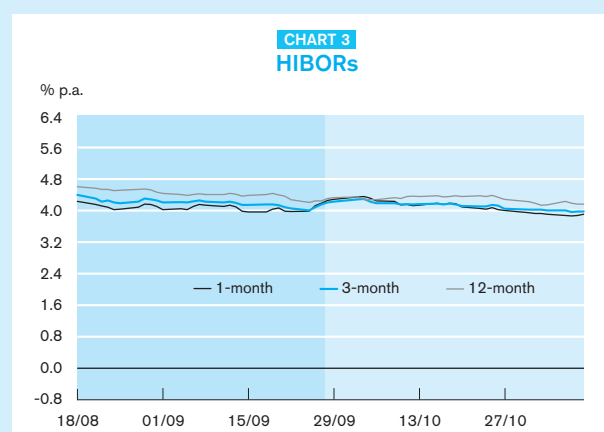
The Hong Kong dollar exchange rate strengthened slightly from 7.7892 to 7.7845 during the reporting period (Chart 1). The strengthening was reportedly associated with equity-related demand for Hong Kong dollars from overseas investors. Meanwhile, the effective exchange rate of the Hong Kong dollar eased slightly (Chart 2).



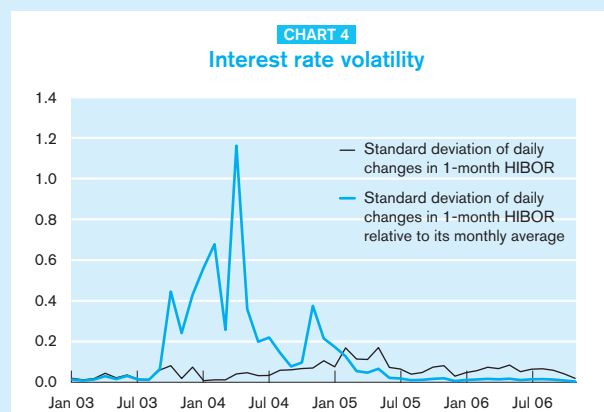
¹ The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

Interest rates

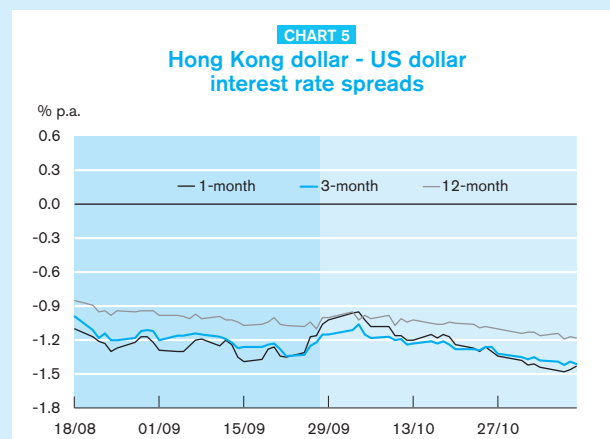
Amid ample interbank liquidity, the one-month and three-month HIBORs dropped by 35 and 23 basis points to 3.90% and 3.97% respectively in the period (Chart 3). On the other hand, the 12-month HIBOR was largely stable at around 4.3% in October, but decreased near the end of the reporting period to close at 4.16%.



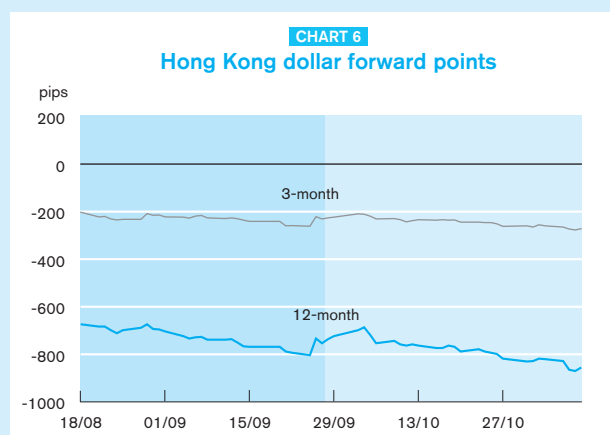
Interest rate volatility measured by the standard deviation of daily changes in one-month HIBOR decreased in October. The standard deviation as a ratio of the average level of one-month HIBOR also decreased (Chart 4).¹



The **negative spreads of Hong Kong dollar interest rates against the US dollar rates widened**. The 1-month and 3-month negative interest rate spreads increased by 37 and 26 basis points to -143 basis points and -141 basis points respectively. Meanwhile the 12-month negative spread increased by 18 basis points to -118 basis points (Chart 5).



In line with the wider interest rate spreads, the **Hong Kong dollar three-month and 12-month forward discount increased** by 46 and 119 pips to close at 273 and 857 pips respectively (Chart 6).



The **yields of Exchange Fund paper remained stable across different maturities during the period** (Chart 7). The negative yield spreads against US Treasuries remained stable except for the three-month and 10-year tenors. The three-month negative spread increased to 161 basis points and the 10-year spread increased to 80 basis points at the end of the period (Table 1).

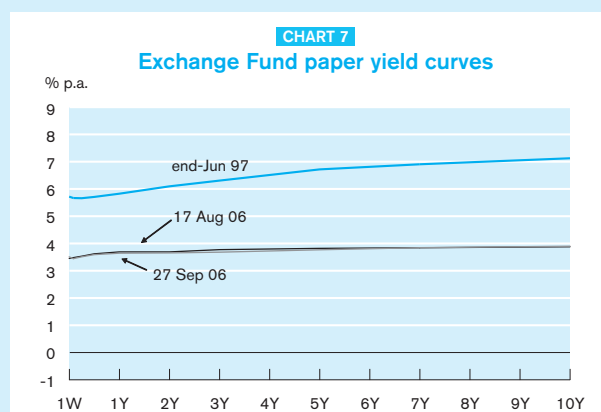
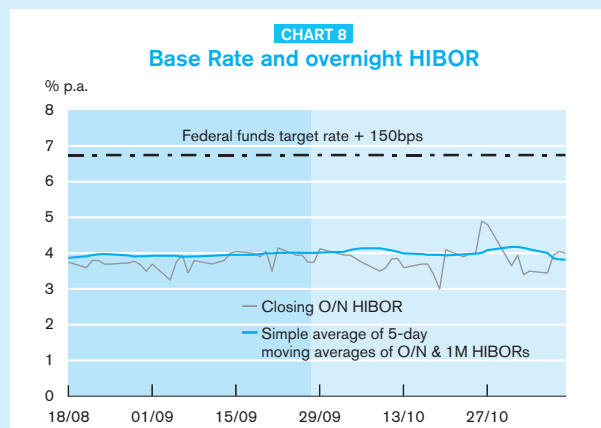


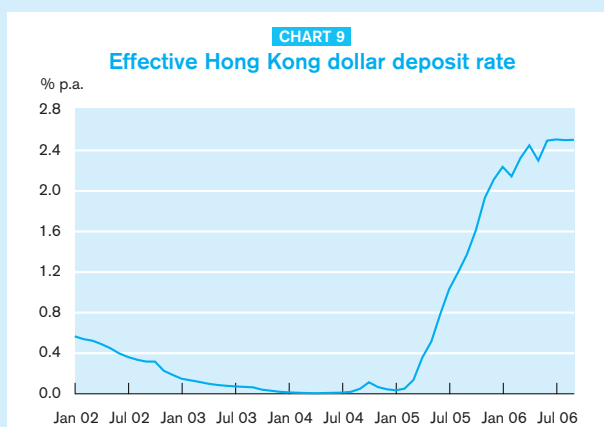
TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	27 Sep 06	9 Nov 06
3-month	56	-143	-161
1-year	21	-130	-128
3-year	3	-95	-93
5-year	27	-82	-83
10-year	54	-72	-80

The **HKMA Base Rate remained at 6.75% throughout the period** (Chart 8). Following a reduction of the Best Lending Rate by 25 basis points to 7.75% by HSBC on 7 November, **banks decreased their Best Lending Rates** by the same magnitude. There were two Best Lending Rates at 7.75% and 8% at the end of the reporting period.

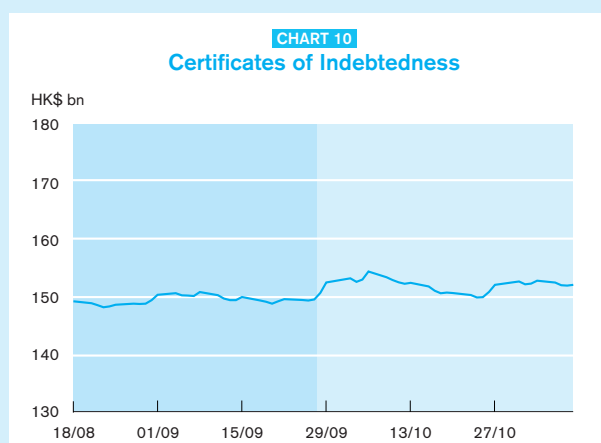


The average one-month time deposit rate offered by major authorized institutions decreased by 25 basis points to 2.519% during the period.² The effective deposit rate increased slightly from 2.49% in August to 2.50% in September (Chart 9).³ The composite interest rate, which reflects the average cost of funds of banks, was little changed at 3.06% at the end of September.⁴



Certificates of Indebtedness

During the reporting period, the three note-issuing banks submitted a total of US\$179.49 million to the HKMA in exchange for HK\$1.4 billion worth of CIs. As a result, **the outstanding amount of CIs rose from HK\$150.60 billion to HK\$152.00 billion** (Chart 10).



Monetary Base

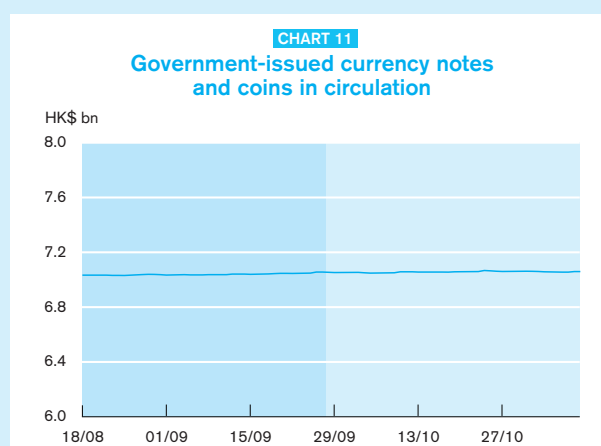
The **Monetary Base**, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, **increased from HK\$289.91 billion to HK\$291.87 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	28 Sep 06	9 Nov 06
CIs	150.60	152.00
Government-issued Currency Notes and Coins in Circulation	7.06	7.06
Aggregate Balance	1.30	1.27
Outstanding EFBNs	130.95	131.54
Monetary Base	289.91	291.87

Government-issued currency notes and coins in circulation

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



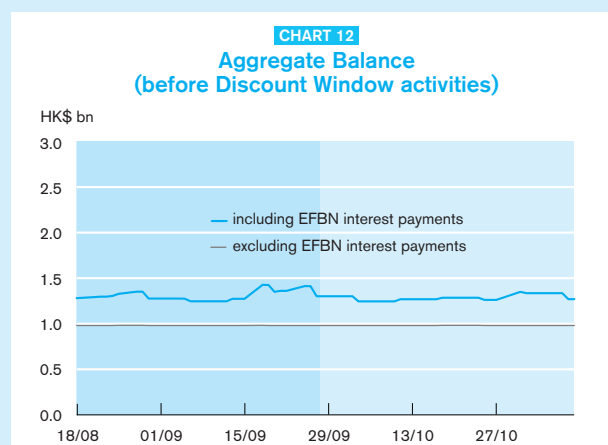
² The figures refer to the average of interest rates offered by the major authorized institutions for one-month time deposits of less than HK\$100,000.

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.

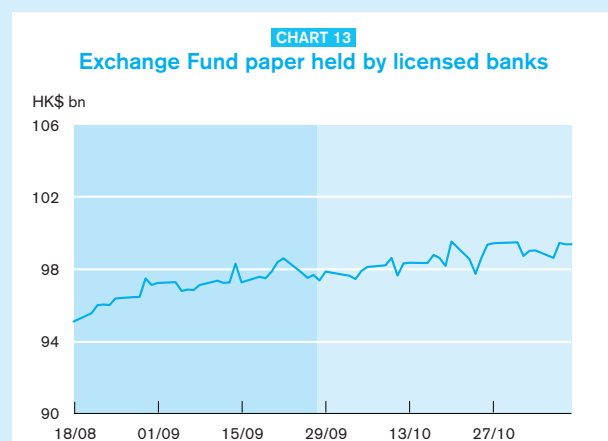
Aggregate Balance

In the reporting period, **the Aggregate Balance remained stable at around HK\$1.30 billion**, with small fluctuations arising from 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 from HK\$130.95 billion to HK\$131.54 billion. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased from HK\$97.40 billion (74.38% of total) to HK\$99.41 billion (75.58% of total) (Chart 13).



During the period, **HK\$328.22 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\$360.82 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
(28 Sep 06 – 9 Nov 06)

	No. of issues launched	Over-subscription ratio
1-month EFB	3	1.89-11.00
3-month EFB	6	2.10-10.42
6-month EFB	3	3.12-3.62
12-month EFB	1	3.35

Discount Window activities

During the period, **nine banks borrowed a total of HK\$931 million from the Discount Window**, compared with HK\$2.86 billion in the preceding period (Chart 14 and Table 4). The borrowing used Exchange Fund paper as collateral.

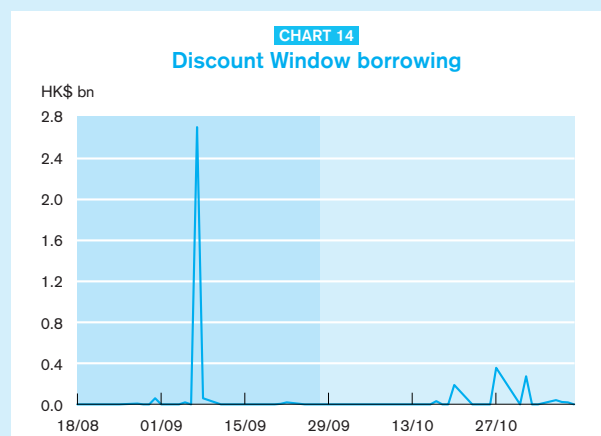


TABLE 4
Frequency of individual bank's access to the Discount Window
(28 Sep 06 – 9 Nov 06)

Frequency of using Discount Window	No. of banks
1	8
2	1
Total	9

Backing Portfolio

Backing Assets rose during the period, reflecting an increase in CIs and revaluation gains. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio rose slightly from 111.52% to 111.71%** (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.

