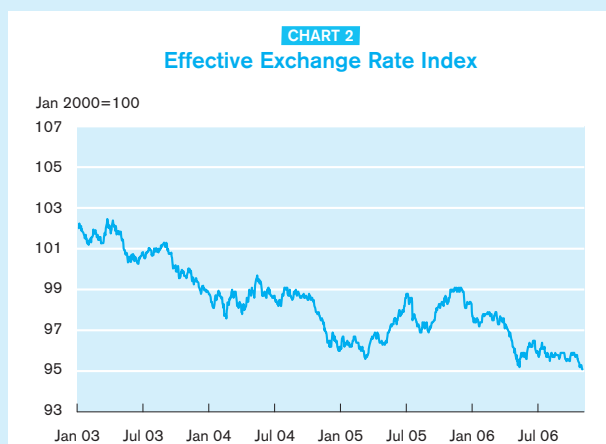


## Report on Currency Board Operations (2 December – 28 December 2006)

The Hong Kong dollar exchange rate was generally stable during the reporting period. Interbank interest rates movements showed a mixed pattern, while their negative spreads against US dollar rates widened. The Monetary Base rose from HK\$293.74 billion to HK\$295.52 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

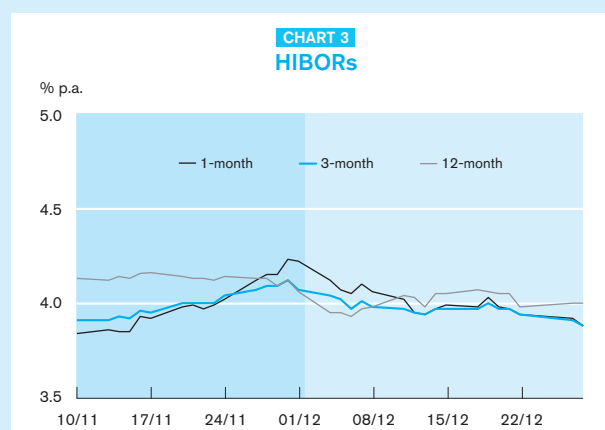
The Hong Kong dollar exchange rate was generally stable during the review period (Chart 1). It closed at 7.7720 on 28 December. The Hong Kong dollar market was not significantly affected by the new capital control measures announced by the Bank of Thailand on 18 December, which caused some confusion in its stock market. Meanwhile, the effective exchange rate index of the Hong Kong dollar moved within a narrow range between 93.9 and 94.4 (Chart 2).



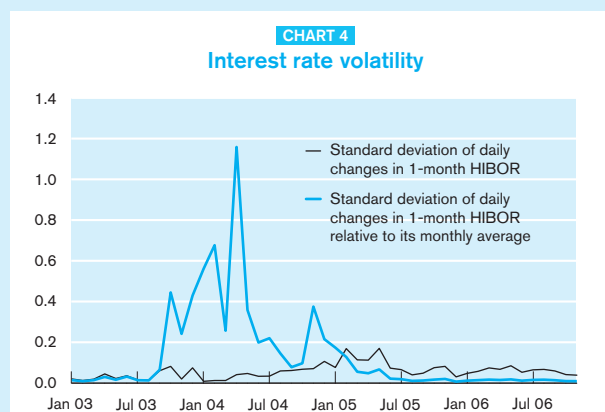
<sup>1</sup> The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

### Interest rates

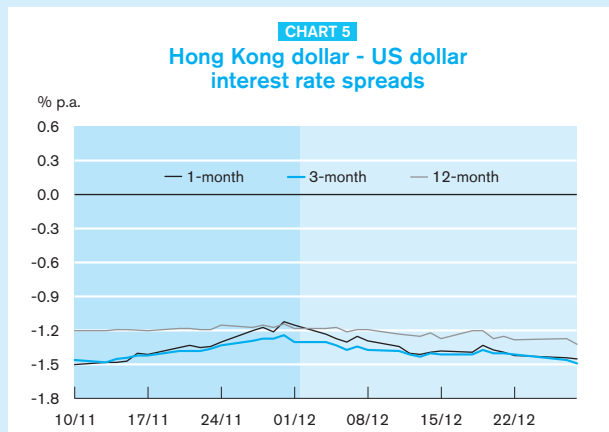
Hong Kong dollar interbank interest rates showed a mixed pattern. The one-month and three-month HIBORs declined by 24 and 16 basis points respectively, both reaching 3.88% at the end of the review period, whereas the 12-month HIBOR increased slightly from 3.95% to 4.00% (Chart 3).



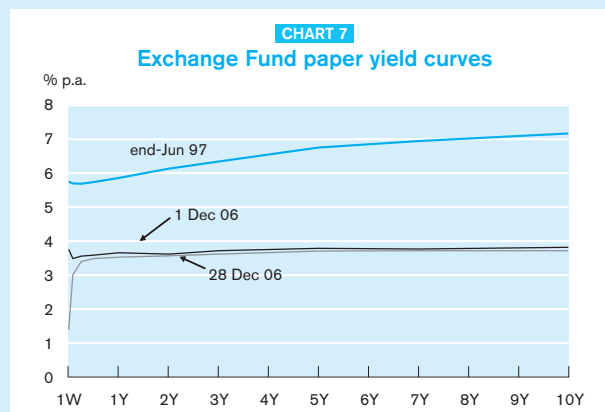
Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, remained low and unchanged in December. The standard deviation as a ratio of the average level of one-month HIBOR was also little changed (Chart 4).<sup>1</sup>



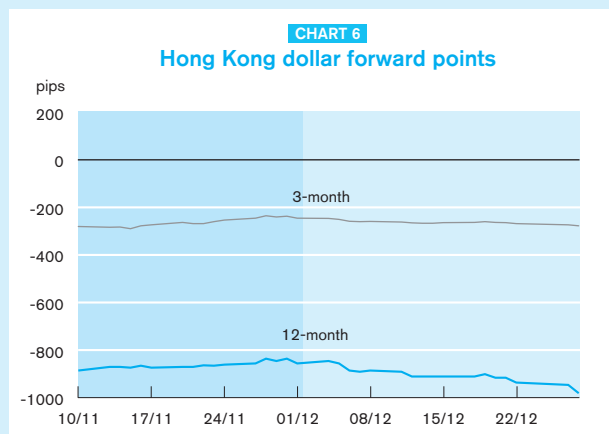
**Negative spreads of Hong Kong dollar interest rates against their US dollar counterparts widened.** The one-month and three-month negative interest rate spreads increased by 22 and 19 basis points to -145 and -149 basis points respectively. Meanwhile, the 12-month negative spread rose by 14 basis points to -132 basis points (Chart 5).



**Yields of Exchange Fund paper decreased during the period** (Chart 7). The yields of the one-week and one-month tenors dropped notably. The negative yield spreads against US Treasuries widened. The three-year and five-year negative spreads rose to 122 and 100 basis points respectively at the end of the period (Table 1).



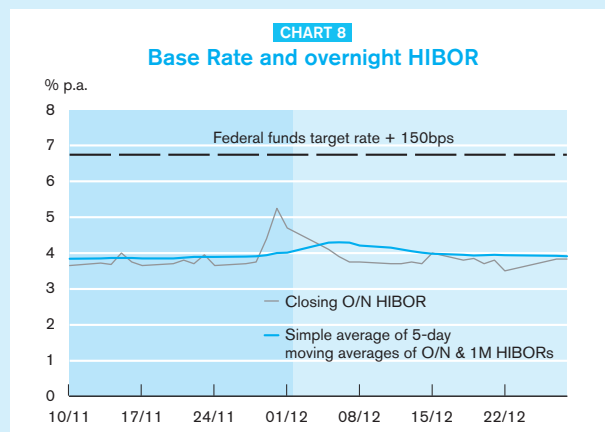
In line with the larger negative interest rate spreads, the **Hong Kong dollar three-month and 12-month forward discount expanded** by 31 and 135 pips to close at 279 and 980 pips respectively (Chart 6).



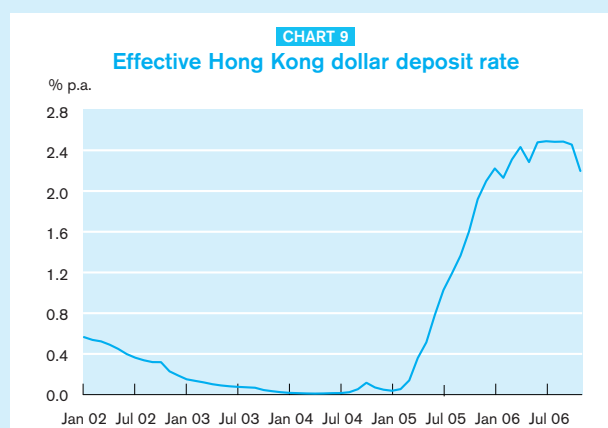
**TABLE 1**  
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	1 Dec 06	28 Dec 06
3-month	56	-154	-166
1-year	21	-128	-155
3-year	3	-84	-122
5-year	27	-71	-100
10-year	54	-70	-100

**The HKMA Base Rate remained unchanged at 6.75% throughout the period** (Chart 8). There continued to be two Best Lending Rates at 7.75% and 8% at the end of the reporting period.

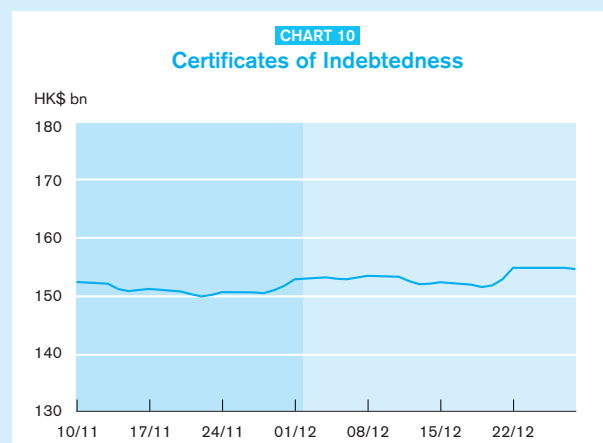


The average one-month time deposit rate offered by major authorized institutions remained steady at 2.519% during the period.<sup>2</sup> The effective deposit rate decreased from 2.47% in October to 2.21% in November (Chart 9).<sup>3</sup> The composite interest rate, which reflects the average cost of funds of banks, declined slightly to 3.02% at the end of November.<sup>4</sup>



## Certificates of Indebtedness

During the reporting period, the three note-issuing banks submitted a total of US\$183.33 million to the HKMA in exchange for HK\$1.43 billion worth of CIs. As a result, the outstanding CIs rose from HK\$153.25 billion to HK\$154.68 billion (Chart 10).



## Monetary Base

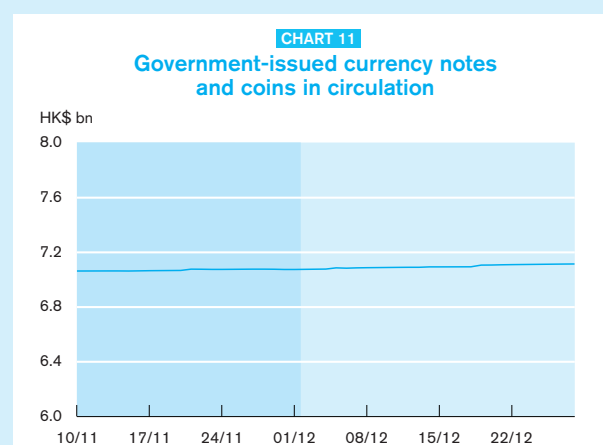
The Monetary Base, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, increased from HK\$293.74 billion to HK\$295.52 billion during the reporting period (Table 2). Movements in the individual components are discussed below.

**TABLE 2**  
Monetary Base

(HK\$ bn)	4 Dec 06	28 Dec 06
CIs	153.25	154.68
Government-issued Currency Notes and Coins in Circulation	7.08	7.11
Aggregate Balance	1.31	1.31
Outstanding EFBNs	132.10	132.42
<b>Monetary Base</b>	<b>293.74</b>	<b>295.52</b>

## Government-issued currency notes and coins in circulation

The total of government-issued currency notes and coins in circulation was little changed at HK\$7.11 billion at the end of the reporting period (Chart 11).



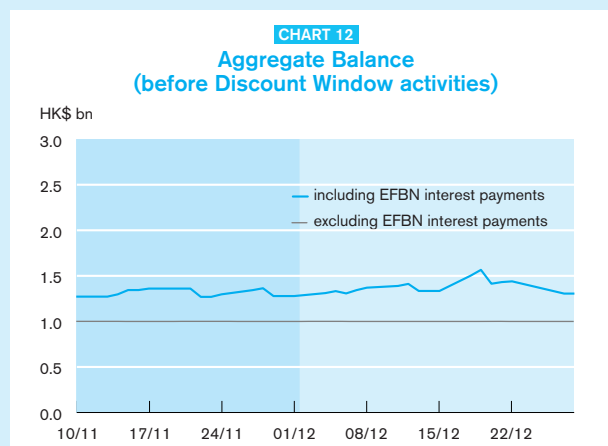
<sup>2</sup> The figures refer to the average of interest rates offered by the major authorized institutions for one-month time deposits of less than HK\$100,000.

<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

In the reporting period, **the Aggregate Balance remained stable at around HK\$1.31 billion**, with small fluctuations due to interest payments on Exchange Fund paper (Chart 12).



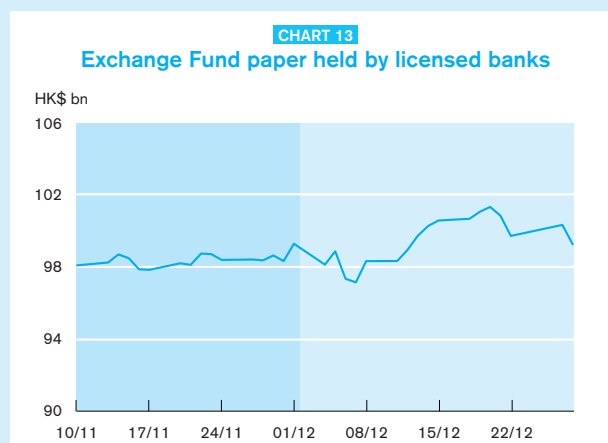
During the period, **a total of HK\$731.51 million of interest payments on Exchange Fund paper were made. An additional HK\$695.91 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were well received by the market (Table 3).

**TABLE 3**  
Issuance of Exchange Fund Bills and Notes  
(2 Dec 06 – 28 Dec 06)

	No. of issues launched	Over-subscription ratio
3-month EFB	4	0.86-2.03
6-month EFB	2	1.73-3.92
12-month EFB	1	3.04
3-year EFN	1	4.53
5-year EFN	1	5.05
10-year EFN	1	2.40

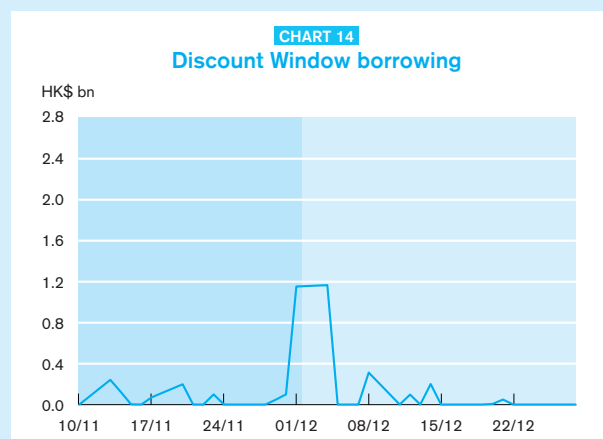
## Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund Bills and Notes rose slightly from HK\$132.10 billion to HK\$132.42 billion. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased moderately from HK\$98.17 billion (74.31% of total) to HK\$99.29 billion (74.98% of total) (Chart 13).



## Discount Window activities

During the period, **14 banks borrowed a total of HK\$1.82 billion from the Discount Window**, compared with HK\$2.03 billion in the preceding period (Chart 14 and Table 4). There were three occasions on which banks



**TABLE 4**  
Frequency of individual bank's access to the Discount Window  
(2 Dec 06 – 28 Dec 06)

Frequency of using Discount Window	No. of banks
1	13
2	1
Total	14

borrowed an amount exceeding 50% of their holdings of Exchange Fund paper. The borrowing, amounting to a total of HK\$32 million by two banks, was charged at the penal rate, currently equal to the Base Rate plus five per cent. All borrowings used Exchange Fund paper as collateral.

## Backing Portfolio

**The Backing Ratio decreased slightly from 112.14% on 3 December to 111.83% on 28 December** (Chart 15), attributable to an increase in the Monetary Base. 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.

