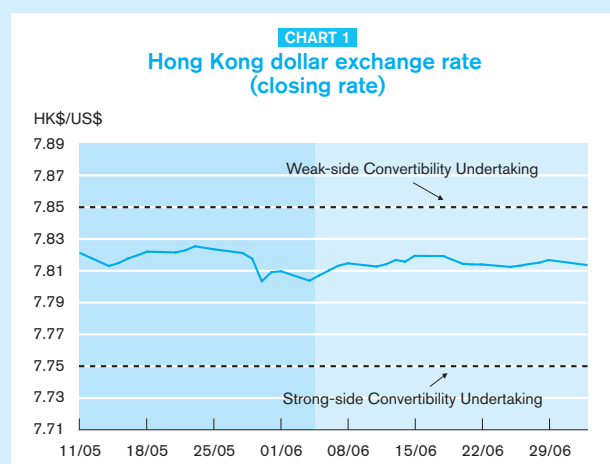


## Report on Currency Board Operations (5 June – 3 July 2007)

The Hong Kong dollar exchange rate softened during the reporting period. Interbank interest rates and their negative spreads against US dollar interest rates showed mixed patterns. The Monetary Base rose from HK\$295.70 billion to HK\$297.21 billion. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

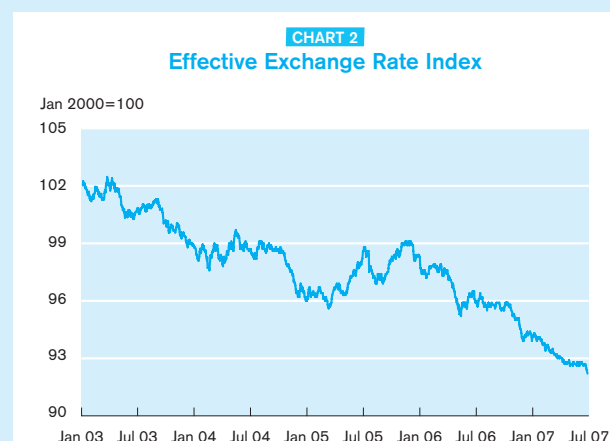
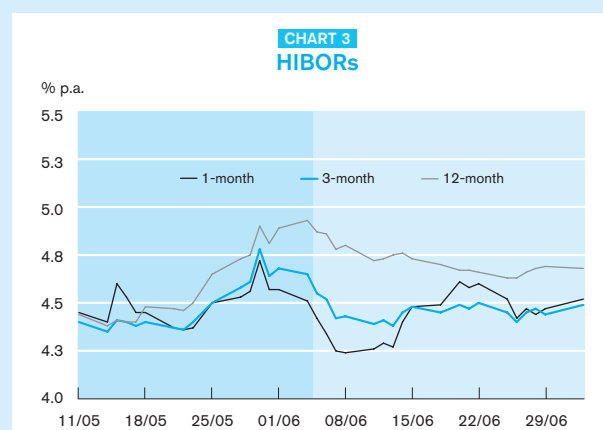
### Hong Kong dollar exchange rate

**The Hong Kong dollar exchange rate softened against the US dollar** from 7.8071 to 7.8137 during the review period, partly reflecting arbitrage buying of the US dollar (Chart 1). Meanwhile, the effective exchange rate index of the Hong Kong dollar decreased from 92.7 to 92.2, as the US dollar weakened against other major currencies (Chart 2).

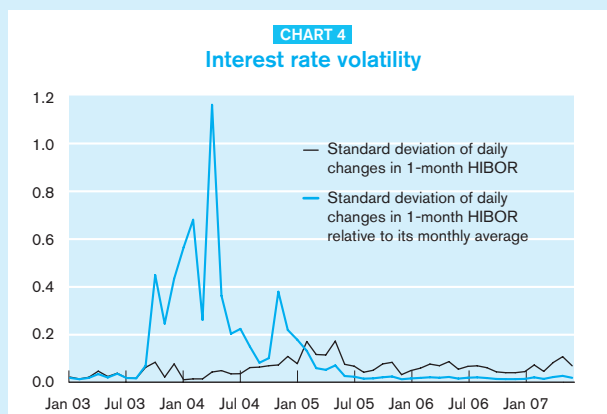


### Interest rates

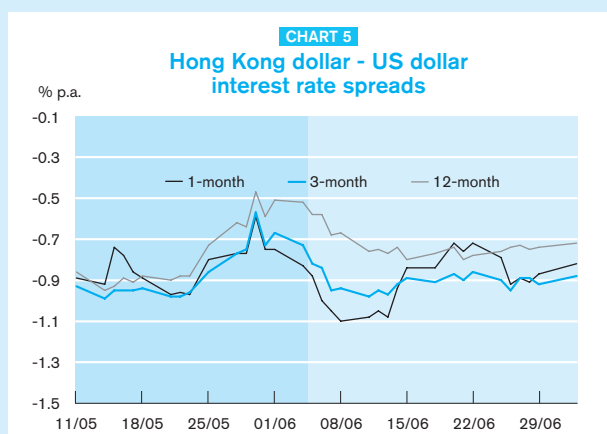
**Hong Kong dollar interbank interest rates showed a mixed pattern.** The one-month HIBOR rose from 4.42% to 4.52%, partly reflecting demand for liquidity associated with initial public offering activities during the reporting period. Meanwhile, the three-month and 12-month HIBORs decreased by six and 19 basis points to close at 4.49% and 4.68% respectively (Chart 3).



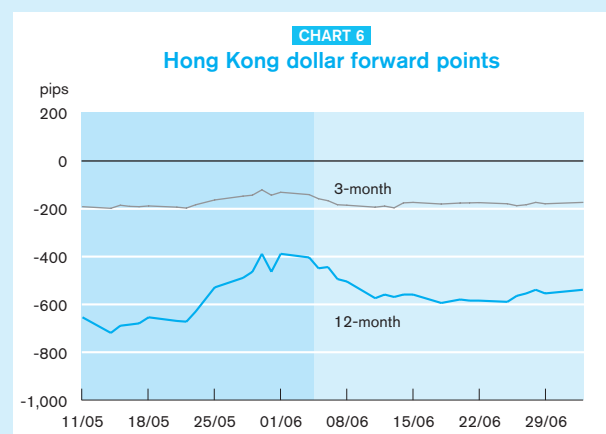
**Interest rate volatility**, measured by the standard deviation of daily changes in one-month HIBOR, **declined** in June. The standard deviation as a ratio of the average level of one-month HIBOR also decreased (Chart 4).<sup>1</sup>



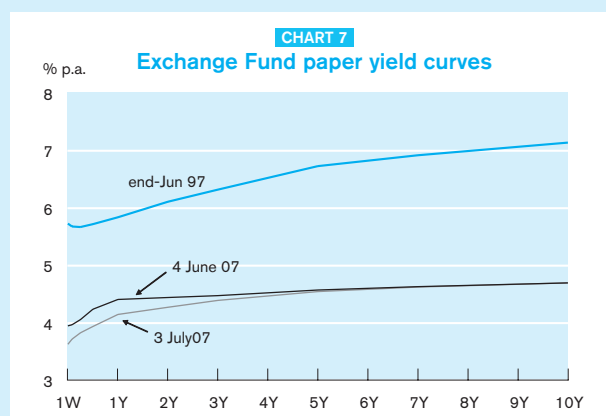
Consistent with the movement of HIBORs, **the negative spreads of Hong Kong dollar interest rates against their US dollar counterparts also exhibited a diverse pattern**. The one-month negative interest rate spread narrowed by six basis points to -82 basis points, while the three-month and 12-month negative spreads expanded modestly by six and 14 basis points to -88 and -72 basis points respectively (Chart 5).



**The Hong Kong dollar three-month and 12-month forward discounts increased** by 15 and 90 pips to close at 175 and 540 pips respectively, in line with the movements in the interest rate spreads (Chart 6).



**Yields of Exchange Fund paper decreased across-the-board during the period** (Chart 7). The negative yield spreads against US Treasuries showed a mixed pattern. In particular, the three-month and one-year negative spreads expanded by 43 and 17 basis points to -119 and -86 basis points, while the three-year and five-year negative spreads declined by six and eight basis points to -44 and -31 basis points respectively (Table 1).

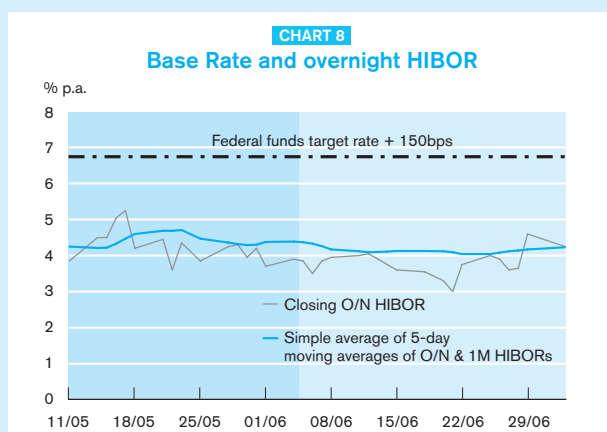


**TABLE 1**  
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

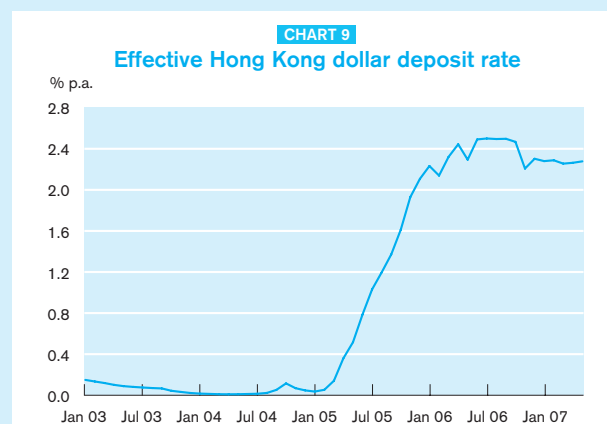
	27 Jun 97	4 Jun 07	3 Jul 07
3-month	56	-76	-119
1-year	21	-69	-86
3-year	3	-50	-44
5-year	27	-39	-31
10-year	54	-28	-27

<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.

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



The average one-month time deposit rate offered by major authorized institutions remained unchanged at 2.573% during the period.<sup>2</sup> The effective deposit rate rose from 2.26% in April to 2.28% in May (Chart 9).<sup>3</sup> In addition, the composite interest rate, which reflects the average cost of funds of banks, increased by four basis points to 3.00% at the end of May from 2.96% at the end of April.<sup>4</sup>



<sup>2</sup> The figures refer to the average of interest rates offered by 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.

## Monetary Base

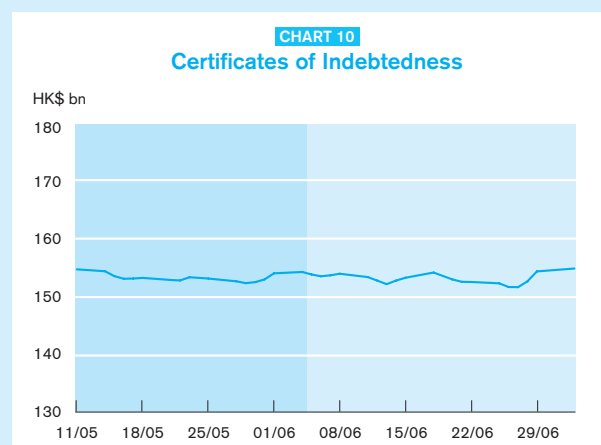
The Monetary Base, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, rose modestly from HK\$295.70 billion to HK\$297.21 billion during the reporting period (Table 2). Movements in the individual components are discussed below.

**TABLE 2**  
Monetary Base

(HK\$ bn)	5 Jun 07	3 Jul 07
CIs	153.87	154.90
Government-issued Currency Notes and Coins in Circulation	7.41	7.39
Aggregate Balance	1.37	1.31
Outstanding EFBNs	133.04	133.62
<b>Monetary Base</b>	<b>295.70</b>	<b>297.21</b>

## Certificates of Indebtedness

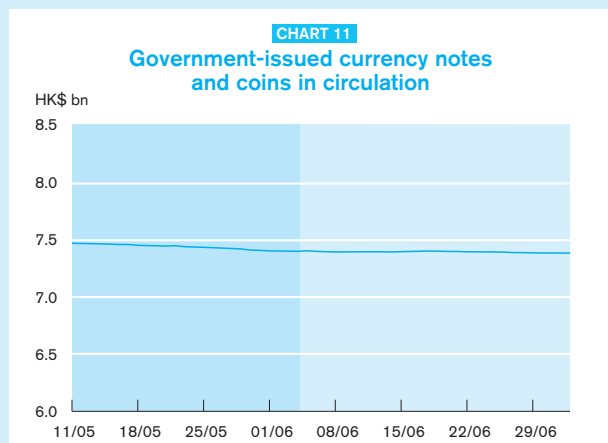
During the reporting period, the three note-issuing banks submitted a total of US\$132.1 million to the HKMA in exchange for HK\$1.03 billion worth of CIs. Consequently, the outstanding CIs increased modestly from HK\$153.87 billion to HK\$154.90 billion (Chart 10).



<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.

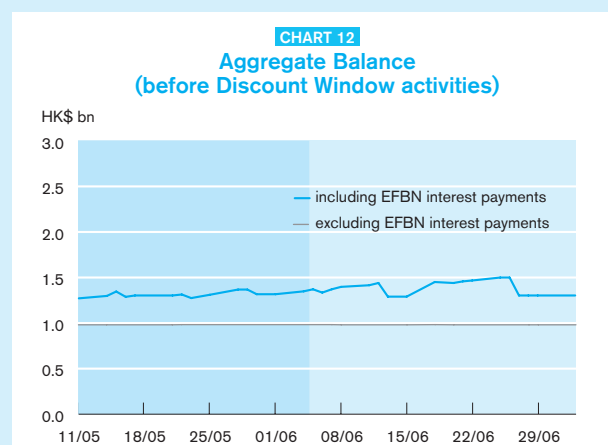
### Government-issued currency notes and coins in circulation

The total of **government-issued currency notes and coins in circulation declined modestly from HK\$7.41 billion to HK\$7.39 billion** during the reporting period (Chart 11).



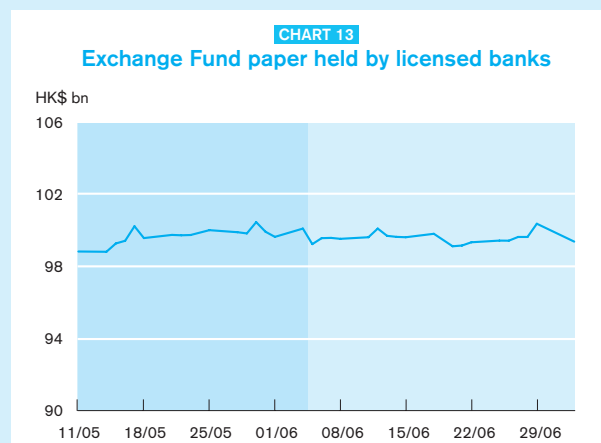
### Aggregate Balance

The **Aggregate Balance was little changed at around HK\$1.3 billion during the review period**, 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 from HK\$133.04 billion to HK\$133.62 billion** during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased slightly** from HK\$99.32 billion (74.65% of total) to HK\$99.46 billion (74.44% of total) (Chart 13).



During the period, **a total of HK\$735.85 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\$776.51 million (in market value) of Exchange Fund paper was issued to absorb these interest payments**. The Exchange Fund papers issued were generally well received by the market (Table 3).

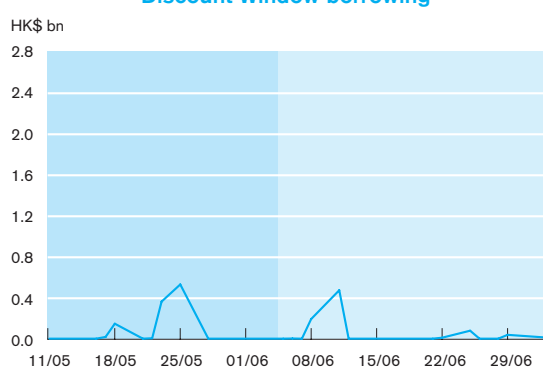
**TABLE 3**  
Issuance of Exchange Fund Bills and Notes (5 Jun 07 – 3 Jul 07)

	No. of issues launched	Over-subscription ratio
3-month EFB	5	1.96-3.49
6-month EFB	3	1.15-2.84
1-year EFB	1	3.48
5-year EFN	2	0.37-0.56
10-year EFN	1	2.49

## Discount Window activities

During the review period, **five banks borrowed a total of HK\$0.81 billion from the Discount Window**, compared with a total of HK\$1.06 billion in the preceding period (Chart 14 and Table 4). There were two occasions on which banks borrowed an amount exceeding 50% of its holdings of Exchange Fund paper. The borrowing, amounting to a total of HK\$15 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.

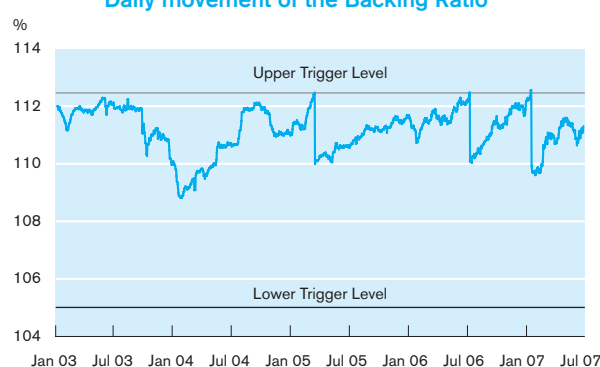
**CHART 14**  
Discount Window borrowing



## Backing Portfolio

Backing assets increased during the reporting period, mainly reflecting an increase in interest income and the Monetary Base. As the Backing Assets rose proportionally more than the Monetary Base, **the Backing Ratio increased from 111.21% on 5 June to 111.35% on 3 July** (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.

**CHART 15**  
Daily movement of the Backing Ratio



**TABLE 4**  
Frequency of individual bank's access to the Discount Window (5 Jun 07 – 3 Jul 07)

Frequency of using Discount Window	No. of banks
1	3
2	2
Total	5