

Record of Discussion of the Exchange Fund Advisory Committee Sub-Committee on Currency Board Operations on 7 November 2003

(Approved for Issue by the Exchange Fund Advisory Committee on 3 December 2003)

Report on Currency Board Operations (29 September - 24 October 2003)

The Sub-Committee noted that, following the sharp strengthening of the Hong Kong dollar on 23 September, the dollar had continued to strengthen into the period under review, reaching a recent high of 7.7094 against the US dollar on 7 October as a result of strong capital inflows. The dollar had, since the end of the period under review, stabilised to around 7.77. Members noted that during the period short-term interbank interest rates had dropped to close to zero, and the HKMA had sold a total of HK\$3.29 billion under the Currency Board Account. Reflecting the inflow of funds, Hong Kong dollar forward points had continued to be at a considerable discount, and the negative spreads between Hong Kong dollar interbank interest rates and their US dollar counterparts had widened during the period.

The Sub-Committee noted that, in accordance with Currency Board principles, changes in the Monetary Base during the reporting period had been fully matched by changes in the foreign reserves.

The report on Currency Board operations for the period under review is at [Annex](#).

Monitoring of risks and vulnerabilities

The Sub-Committee noted that the economic recovery now in progress in the major economies had become more balanced and robust. The Asian economies had also showed signs of acceleration in growth. There were, however, concerns that the pace of recovery could moderate in some economies, including the US. In Hong Kong the Government had revised upwards its growth projection for 2003 to 3% in the light of the reviving economy. Most indicators pointed to a broadening of the economic recovery.

Members noted that financial markets in Hong Kong continued to be strong, driven by the brighter economic prospects and increased fund flows. Sentiment towards the Hong Kong currency had changed markedly in the light of these developments and against the background of a weakening US dollar and political pressure for a revaluation of the renminbi. It appeared that the concerns in the market about deflation, the budget deficit and unemployment had for the time being subsided.

Recent developments in Hong Kong dollar exchange and money markets

The Sub-Committee considered a report on the recent sharp strengthening of the Hong Kong dollar. Members noted that

among the factors behind this strengthening were improved economic prospects, helped by the rebound from the SARS outbreak, policy measures to facilitate further economic co-operation between Hong Kong and the Mainland, and the background of a depreciating US dollar. Other factors, such as speculations about the revaluation of the renminbi and market dynamics, had played a role in triggering and magnifying the process. The limited room for further falls in interest rates appeared to be a further factor in the adjustment of the exchange rate.

Members observed that the impact of the strengthening of the dollar on the real economy had been minimal. They noted that the Hong Kong dollar had in fact depreciated in effective terms by 0.5% between 23 September and 23 October because other currencies had appreciated more against the US dollar.

In the light of the recent strengthening of the Hong Kong dollar and of the discussions at the meetings held in October 1999 and July 2000, the Sub-Committee considered the question of whether or not it was desirable for a convertibility undertaking to be introduced on the strong side of the Linked Exchange Rate. The Sub-Committee was supportive of the actions taken by the Hong Kong Monetary Authority to dampen excessive market volatility during the recent strengthening of the Hong Kong dollar: Members considered that these actions were appropriate in the circumstances and that they were in accordance with Currency Board principles. The Sub-Committee concluded that the current system was working effectively and that it was not necessary to introduce a strong-side convertibility undertaking for the time being.

Macroeconomic conditions and banking performance in Hong Kong: A panel data study

The Sub-Committee noted a paper reporting on research using supervisory data to examine the determinants of banking performance in Hong Kong. The main findings of the paper suggested that the reduced profitability of banks in recent years was related to the difficult macroeconomic conditions and increased competition. The paper also noted that, while the bursting of the property bubble had placed banks under stress, property-related loans remained relatively safe assets compared with other types of bank lending during the study period.

The prospects of a return of inflation in Hong Kong

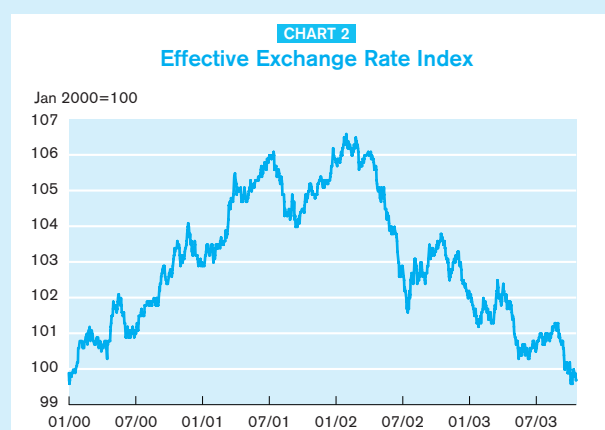
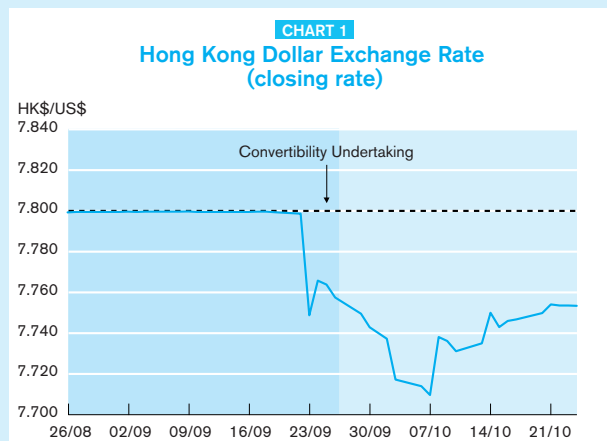
The Sub-Committee noted a paper discussing factors affecting the prospects of a return of inflation in Hong Kong. Members noted that projections about inflation were subject to considerable uncertainties.

Annex Report on Currency Board Operations (29 September — 24 October 2003)

The Hong Kong dollar exchange rate strengthened in the early part of the reporting period in the face of capital inflows, but subsequently softened to close at 7.7532. In response to banks' bids, the HKMA sold a total of HK\$3.29 billion under the Currency Board account during the period. Short-term interbank interest rates dropped to close to zero, partly associated with the expansion in the Aggregate Balance. The Monetary Base rose from HK\$257.53 billion to HK\$259.30 billion, mainly attributable to the expansion in the Aggregate Balance. In accordance with currency board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

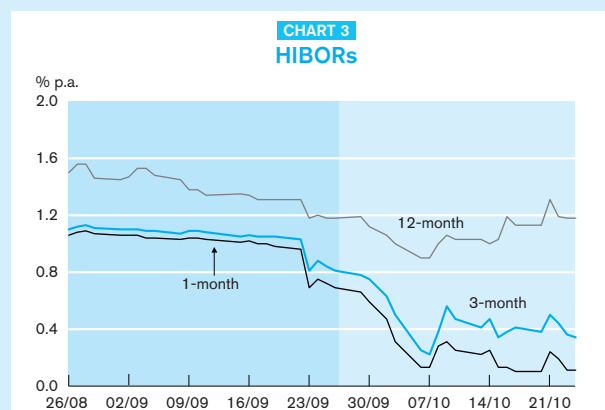
Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate strengthened in the early part of the reporting period and reached a recent high of 7.7094 on 7 October in the light of strong capital inflows. Reportedly, the unwinding of previously accumulated short positions in the Hong Kong dollar was also a factor. **It weakened thereafter to close at 7.7532**, owing in part to the decline in Hong Kong dollar-US dollar interest rate differentials and the HKMA's sales of Hong Kong dollar in response to banks' offer of US dollar (Charts 1 and 2).

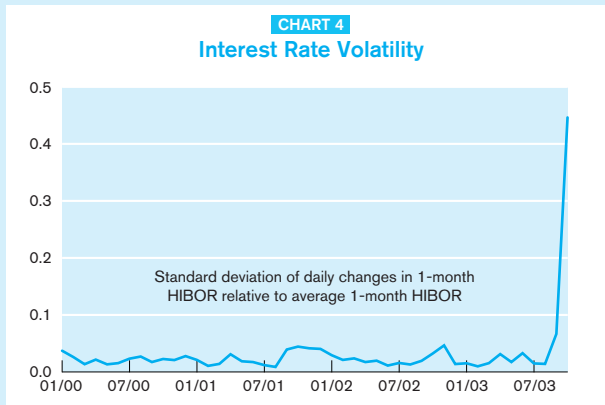


Interest rates

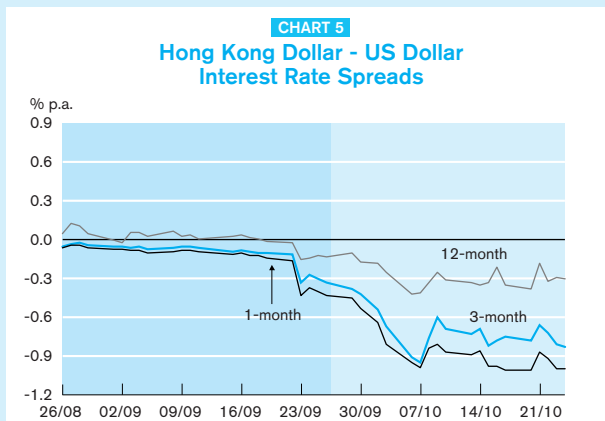
Hong Kong dollar interest rates fell noticeably in the face of capital inflows and the rises in interbank liquidity. The 1-month and 3-month HIBORs decreased by 55 bp and 44 bp to close at 0.11% and 0.34% respectively. The 12-month HIBOR dropped to 0.90% during the early part of the period, before rising gradually back to close at 1.18% (Chart 3).



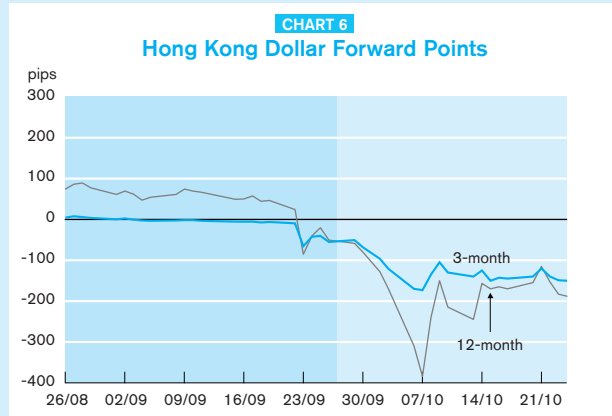
Interest rate volatility, as measured by the ratio of standard deviation of daily changes in the 1-month HIBOR to its average, **rose** during the period. This reflected mainly the abrupt shift in fund flows, which led to the decline in the interest rate (Chart 4).¹



The negative spreads of Hong Kong dollar interbank interest rates over their US dollar counterparts widened further during the period. The 1-month and 3-month spreads dropped by 55 bp and 45 bp to -100 bp and -83 bp respectively, while the 12-month spread declined by 20 bp to close at -30 bp (Chart 5).



Reflecting the movements in interest rate spreads, the Hong Kong dollar 3-month forward points decreased to a discount of 150 pips. Similarly, **the 12-month forward points fell to -188 pips at the end of the period** (Chart 6).



Yields on Exchange Fund paper declined at the short-end of the yield curve during the period, reflecting the fall in yield spreads (Chart 7). The spreads of the 5-year and 10-year paper over their US counterparts both dropped by about 20 bp to -10 bp and -4 bp respectively (Table 1).

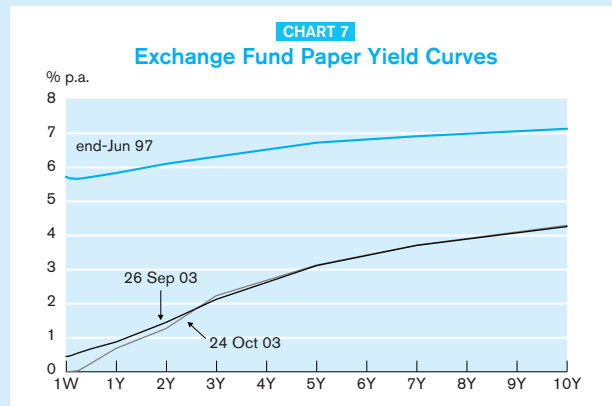
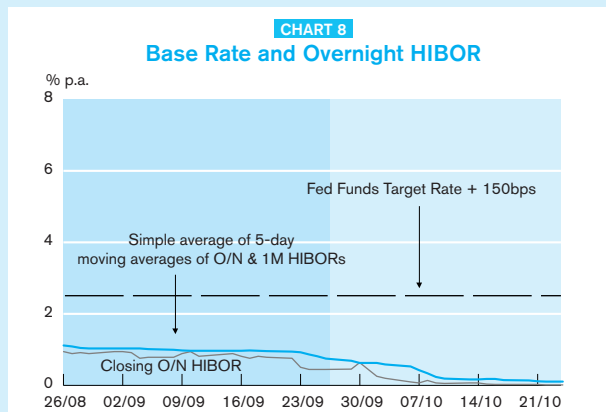


TABLE 1
Yield Spreads of Exchange Fund Paper over US Treasuries (basis points)

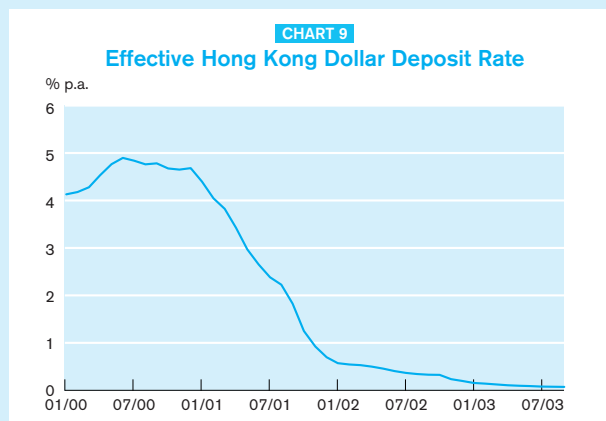
	27 Jun 97	26 Sep 03	24 Oct 03
3-month	56	-38	-92
1-year	21	-23	-55
3-year	3	6	2
5-year	27	9	-10
10-year	54	16	-4

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, which may vary over time.

The HKMA Base Rate remained at 2.50% (Chart 8). The banks also kept their Best Lending Rate unchanged at 5%.



The average rate offered by major authorized institutions for 1-month time deposits dropped to 0.01% during the period.² Meanwhile, the effective deposit rate was unchanged in September 2003 (Chart 9).³



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 used certain assumptions regarding the maturity distribution to compute the effective deposit rate.

Monetary Base

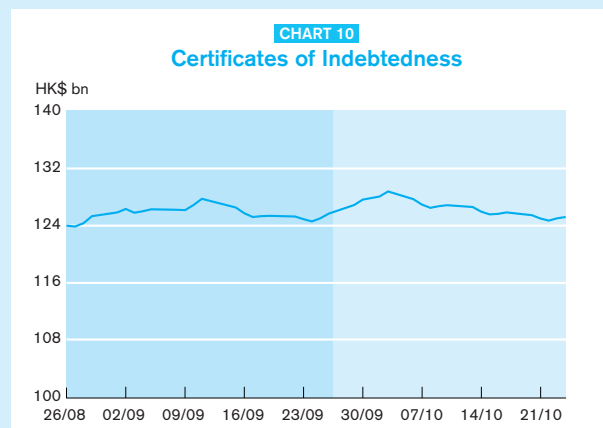
The **Monetary Base**, which comprises Certificates of Indebtedness (CIs), Government-issued currency notes and coins in circulation, the Aggregate Balance, and Exchange Fund Bills and Notes, **increased from HK\$257.53 billion to HK\$259.30 billion during the reporting period** (Table 2). Movements in individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	29 Sep 03	24 Oct 03
CIs	126.74	125.09
Government-issued Currency Notes and Coins in Circulation	6.27	6.26
Aggregate Balance	1.01	4.17
Outstanding EFBNs	123.53	123.79
Monetary Base	257.53	259.30

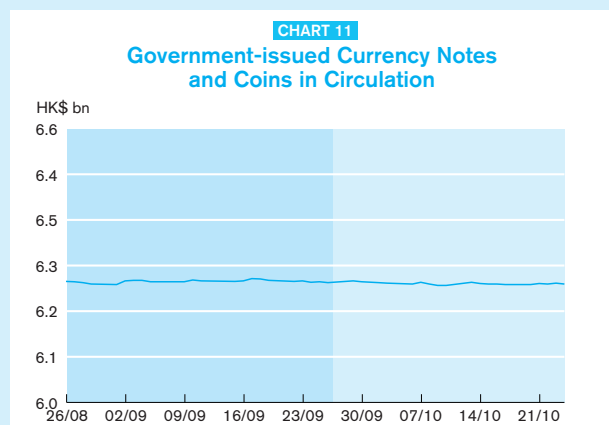
Certificates of Indebtedness

During the period, the three note-issuing banks redeemed a total of HK\$1.65 billion of CIs in exchange for US\$0.21 billion. Consequently, the **outstanding amount of CIs decreased modestly from HK\$126.74 billion to HK\$125.09 billion** (Chart 10).



Government-issued currency notes and coins in circulation

The total amount of **Government-issued currency notes and coins in circulation was stable** at around HK\$6.26 billion during the period (Chart 11).



Aggregate Balance

The HKMA sold a total of HK\$3.29 billion of Hong Kong dollar in response to banks' bids on 2, 3 and 14 October. As a result, **the Aggregate Balance increased to about HK\$4.17 billion at the end of the period.** (Chart 12 and Table 3).

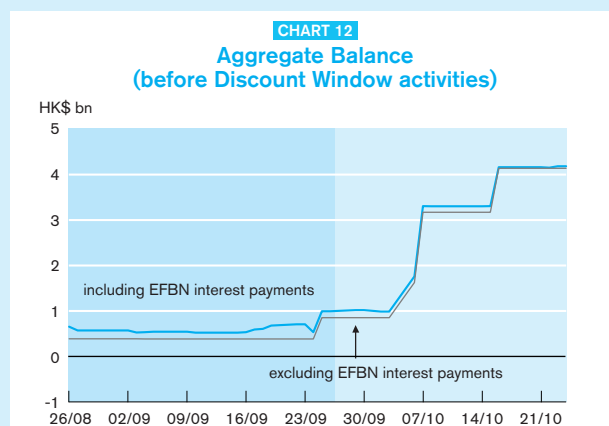


TABLE 3
HKMA HK\$/US\$ FX Transaction (29 September – 24 October 03)

Trade Date	Net HK\$ purchase (+) (HK\$mn)
2 Oct	-773
3 Oct	-1543
14 Oct	-969

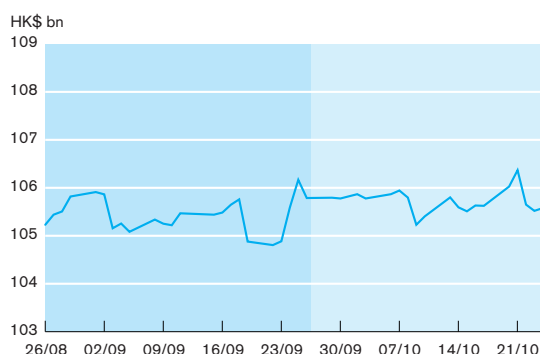
Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund Bills and Notes increased modestly from HK\$123.53 billion to HK\$123.79 billion. All issues of Exchange Fund paper were well received by the market (Table 4). **Holdings of Exchange Fund paper by the banking sector (before Discount Window activity) decreased slightly** from HK\$105.87 billion (85.70% of total) to HK\$105.63 billion (85.33% of total) (Chart 13).

TABLE 4
Issuance of Exchange Fund Bills and Notes (29 September – 24 October 03)

	No. of issues launched	Over-subscription ratio
3-month EFB	4	4.19 - 5.77
6-month EFB	2	5.73 - 6.99
1-year EFB	1	3.32
3-year EFN	1	4.22

CHART 13
Exchange Fund paper held by Licensed Banks



An additional HK\$0.06 billion (in market value) of Exchange Fund paper was issued to absorb interest payments during the period. Nevertheless, because some Exchange Fund Notes were issued at premium, **the net payment on Exchange Fund paper** (i.e. coupon payments less (plus) any premium (discount) on new paper issued) **was -HK\$0.02 billion.** This effect will be neutralised in the next period.

Discount Window activity

For the period as a whole, **5 banks borrowed a total of HK\$0.57 billion from the Discount Window**, much lower than HK\$1.94 billion in the preceding period (Chart 14). All of them used Exchange Fund paper as collateral (Table 5).

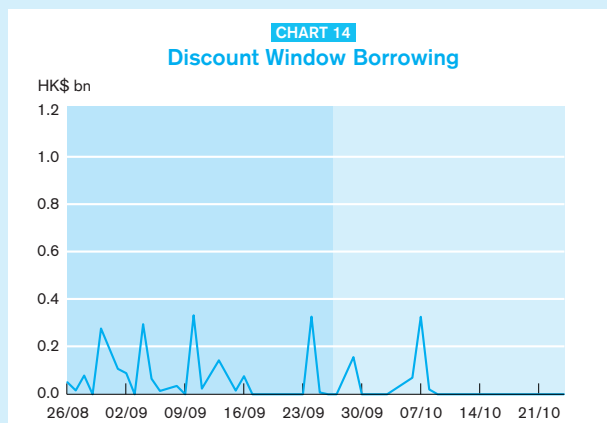
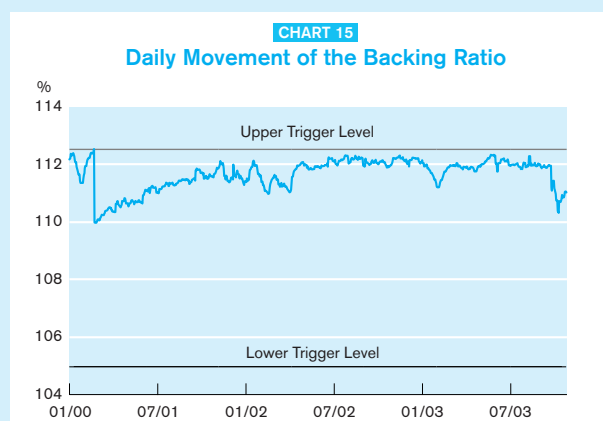


TABLE 5
Frequency of Individual Bank Access to the Discount Window (29 September – 24 October 03)

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

Backing Portfolio

Backing assets increased slightly during the period, largely as a result of the increase in the Aggregate Balance. **The backing ratio decreased marginally from 111.16% on 29 September to 111.02% on 24 October** (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.

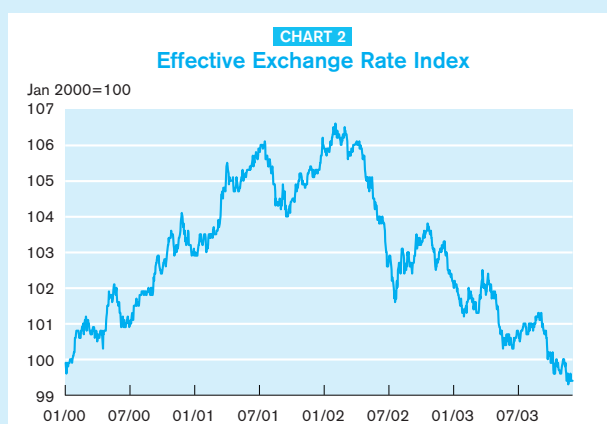
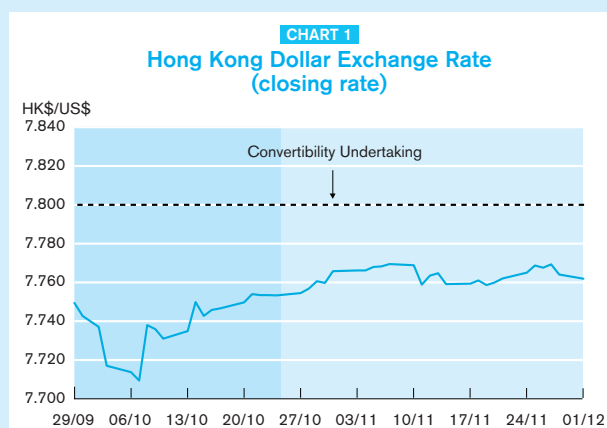


Report on Currency Board Operations (25 October — 1 December 2003)

The Hong Kong dollar exchange rate eased slightly during the reporting period to close at 7.7618, despite strong inflows. This reflected in part the HKMA's sale of a total of HK\$7.27 billion of Hong Kong dollars between 10 and 19 November, and the consequential expansion in the Aggregate Balance. Interbank interest rates eased, leading to a widening of the negative spreads against their US dollar counterparts. The Monetary Base rose notably from HK\$259.24 billion to HK\$269.35 billion, in part also owing to an increase in the outstanding amount of Certificates of Indebtedness. In accordance with currency board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

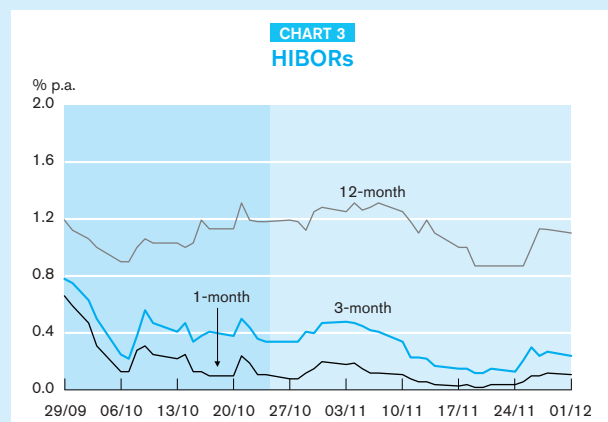
Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate eased slightly from 7.7544 to 7.7618 during the reporting period. This reflected in part the HKMA's sale of Hong Kong dollars (in exchange for US dollars) to banks, in the light of a strong demand for Hong Kong dollar assets (Charts 1 and 2).

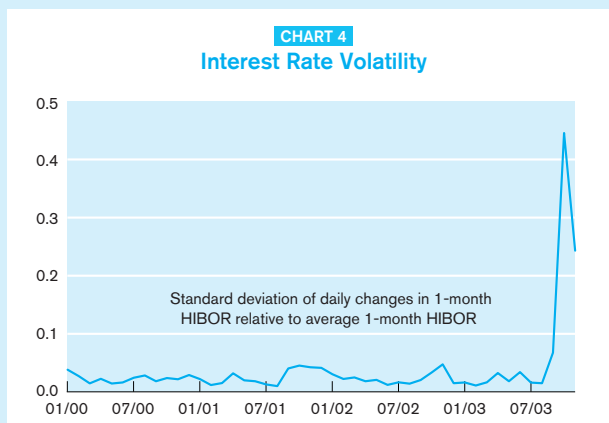


Interest rates

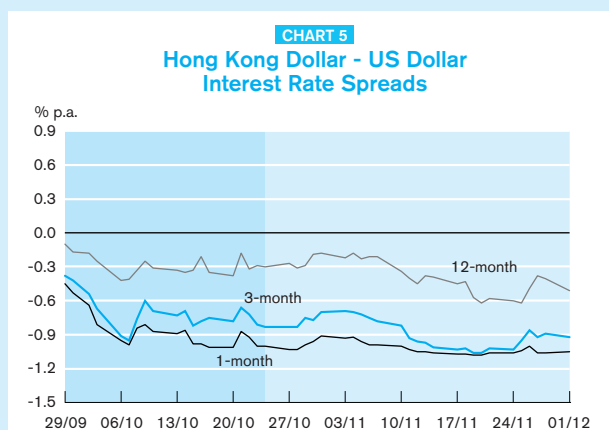
Alongside a marked increase in interbank liquidity, **Hong Kong dollar interest rates eased, particularly for those with longer maturity.** 3-month and 12-month HIBORs fell by about 10 bp to close at 0.24% and 1.10% respectively. 1-month HIBOR stayed low, although it edged up from 0.08% to close at 0.11%. The small rise in interest rates towards the end of the period largely mirrored the movements in their US dollar counterparts (Chart 3).



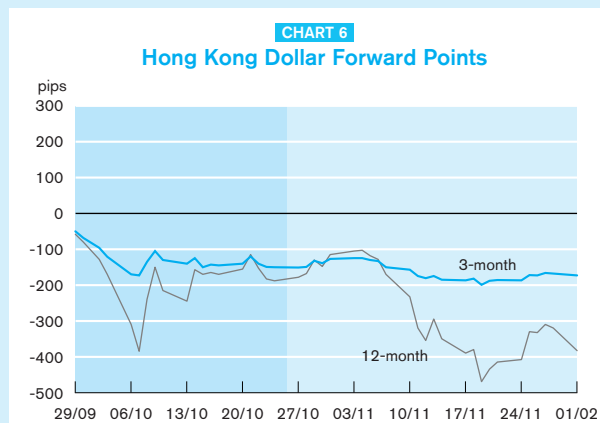
Interest rate volatility, as measured by the ratio of the standard deviation of daily changes in 1-month HIBOR to its average, **declined notably** during the period (Chart 4).¹ While this ratio was higher than that observed in the earlier part of the year, it was distorted by the very low level of interbank interest rates. The standard deviation of daily changes in 1-month HIBOR had in fact returned to its earlier levels.



The negative spreads of Hong Kong dollar interbank interest rates over their US dollar counterparts continued to widen during the period. 1-month and 3-month spreads dropped by 2 bp and 9 bp to -105 bp and -92 bp respectively. 12-month spread followed a similar pattern, declining by 24 bp to close at -51 bp (Chart 5).



In line with the movements in interest rate spreads, Hong Kong dollar 3-month forward points remained at a discount, closing at -173 pips. Meanwhile, **12-month forward points reached a recent low of -470 pips on 19 November before rising to close at -383 pips** (Chart 6).



Yields on Exchange Fund paper rose at the intermediate and long ends of the yield curve during the period, largely reflecting an increase in US Treasury yields (Chart 7). The yield differential of 5-year paper over the US counterpart was virtually unchanged, while that of 10-year paper increased by 10 bp to 6 bp (Table 1).

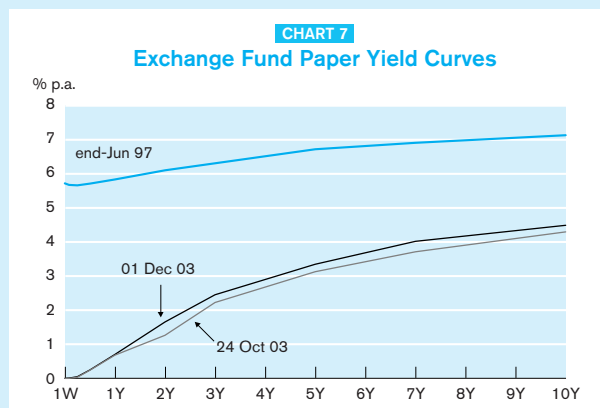
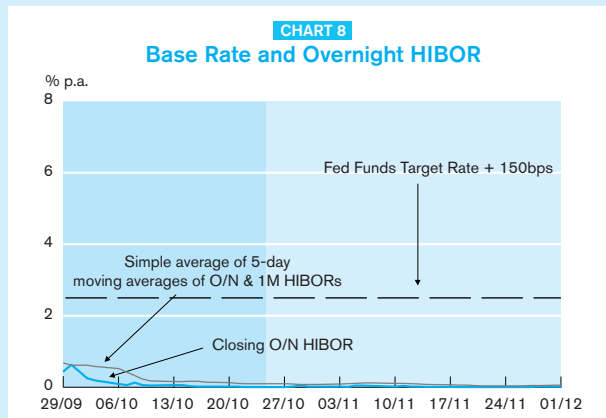


TABLE 1
Yield Spreads of Exchange Fund Paper over US Treasuries (basis points)

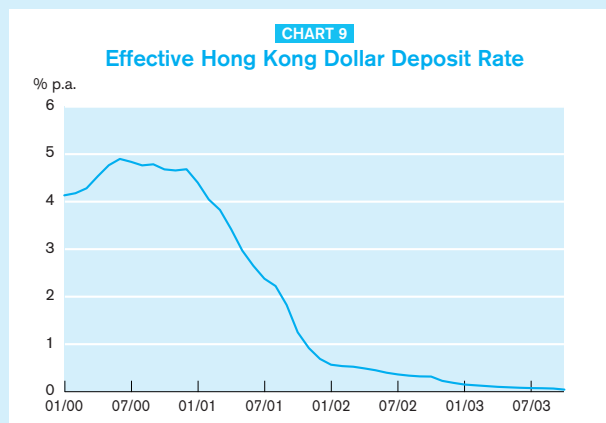
	27 Jun 97	24 Oct 03	1 Dec 03
3-month	56	-92	-86
1-year	21	-55	-33
3-year	3	2	-25
5-year	27	-10	-11
10-year	54	-4	6

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, which may vary over time.

The HKMA Base Rate remained at 2.50% (Chart 8). The banks also kept their Best Lending Rate unchanged at 5%.



The average rate offered by major authorized institutions for 1-month time deposits remained unchanged at 0.01% during the period.² Meanwhile, the effective deposit rate declined modestly in October (Chart 9).³



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 used certain assumptions regarding the maturity distribution to compute the effective deposit rate.

Monetary Base

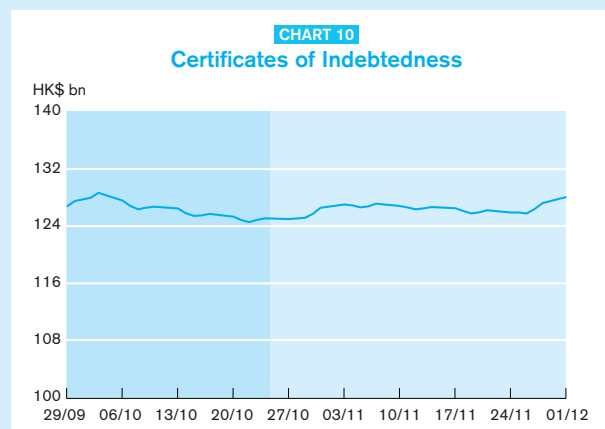
The **Monetary Base**, which comprises Certificates of Indebtedness (CIs), Government-issued currency notes and coins in circulation, the Aggregate Balance, and Exchange Fund Bills and Notes, **increased notably from HK\$259.24 billion to HK\$269.35 billion during the reporting period** (Table 2). Movements in individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	27 Oct 03	1 Dec 03
CIs	124.99	128.09
Government-issued Currency Notes and Coins in Circulation	6.27	6.26
Aggregate Balance	4.19	11.61
Outstanding EFBNs	123.79	123.39
Monetary Base	259.24	269.35

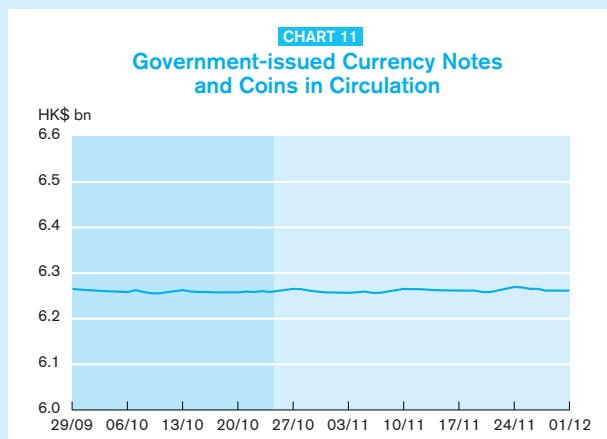
Certificates of Indebtedness

During the period, the three note-issuing banks submitted to the HKMA a total of US\$0.4 billion in exchange for HK\$3.1 billion worth of CIs. Consequently, **the outstanding amount of CIs increased from HK\$124.99 billion to HK\$128.09 billion** (Chart 10).



Government-issued currency notes and coins in circulation

The total amount of **Government-issued currency notes and coins in circulation was stable** at around HK\$6.26 billion during the period (Chart 11).



Aggregate Balance

The HKMA sold a total of HK\$7.27 billion of Hong Kong dollars in response to banks' bids between 10 and 19 November. **The Aggregate Balance increased to HK\$11.61 billion on 1 December** (Chart 12 and Table 3).

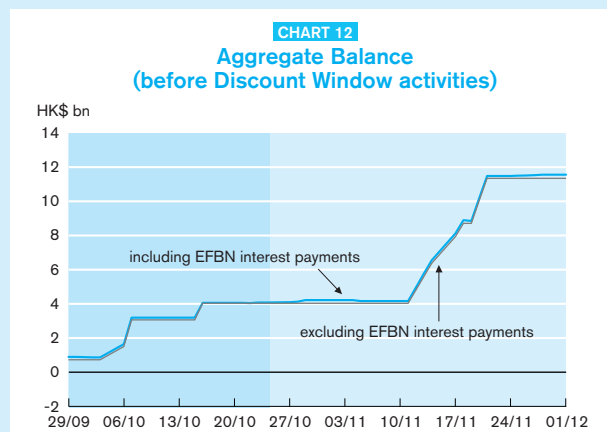
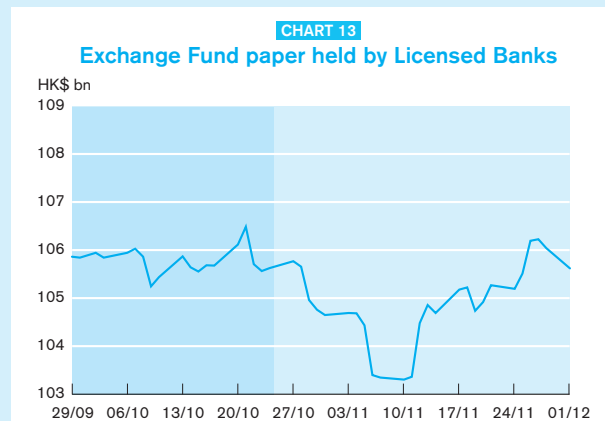


TABLE 3
HKMA HK\$/US\$ FX Transactions
(25 October – 1 December 03)

Trade Date	Net HK\$ purchase (+) (HK\$mn)
10 Nov	-775
11 Nov	-775
12 Nov	-776
13 Nov	-1,553
14 Nov	-776
18 Nov	-1,318
19 Nov	-1,295
Total	-7,268

Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund Bills and Notes decreased slightly from HK\$123.79 billion to HK\$123.39 billion. Meanwhile, holdings of Exchange Fund paper by the banking sector (before Discount Window activity) decreased marginally from HK\$105.77 billion (85.44% of total) to HK\$105.63 billion (85.60% of total) (Chart 13).



During the period, **interest payments of HK\$0.30 billion were made on Exchange Fund paper. An additional HK\$0.05 billion (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 4).

TABLE 4
Issuance of Exchange Fund Bills and Notes
(25 October – 1 December 03)

	No. of issues launched	Over-subscription ratio
1-month EFB	2	37.24 - 39.00
3-month EFB	5	3.56 - 3.81
6-month EFB	3	4.96 - 5.74
1-year EFB	1	3.94
2-year EFN	1	3.82
7-year EFN	1	2.18
10-year EFN	1	3.24

Discount Window activity

For the period as a whole, **5 banks borrowed a total of HK\$2.81 billion from the Discount Window**, compared with HK\$0.57 billion in the preceding period (Chart 14). All of them used Exchange Fund paper as collateral (Table 5).

CHART 14
Discount Window Borrowing

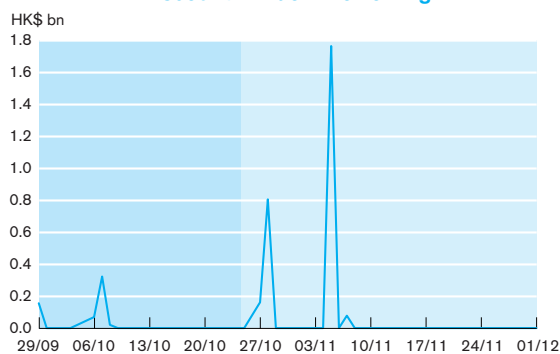


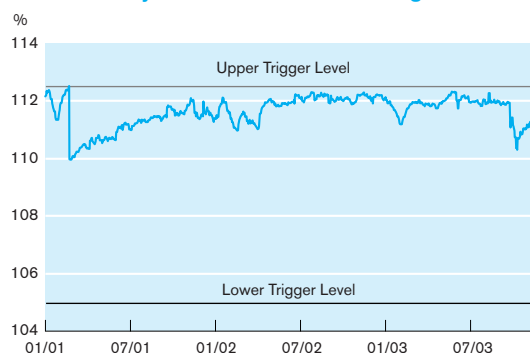
TABLE 5
Frequency of Individual Bank Access to the Discount Window
(25 October – 1 December 03)

Frequency of using Discount Window	No. of banks
1	4
2	1
Total	5

Backing Portfolio

Alongside the rise in the outstanding amount of CIs and the Aggregate Balance, backing assets increased during the period. Nevertheless, as the Monetary Base increased proportionately more than backing assets, **the backing ratio decreased marginally from 111.02% on 26 October to 110.95% on 1 December** (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



Record of Discussion of the Exchange Fund Advisory Committee Sub-Committee on Currency Board Operations on 9 January 2004

(Approved for Issue by the Exchange Fund Advisory Committee on 29 January 2004)

Report on Currency Board Operations (2 December — 22 December 2003)

The Sub-Committee noted that funds had continued to flow into the Hong Kong dollar, bringing the Aggregate Balance to over \$28 billion at the end of the report period, and to a level forecast to be around \$44 billion on 12 January. Interbank interest rates had in consequence eased, and the negative spreads between the Hong Kong dollar and US dollar interest rates had widened. Members noted that, despite the strong inflows, the Hong Kong dollar had remained stable throughout the report period. Members also noted that the increase in the size of the Aggregate Balance, as well as the sale of Hong Kong dollars by the HKMA, had been in accordance with Currency Board principles.

Members observed that the ratio between the Backing Assets and the Monetary Base, the Backing Ratio, had decreased from 110.93% to 110.21% during the reporting period. The increases in the Aggregate Balance and outstanding amount of Certificates of Indebtedness had been matched by the increase in the Backing Assets in magnitude, rather than by proportion. Members noted that, with the Backing Assets being larger than the Monetary Base, a rise in the Monetary Base had led to a lower Backing Ratio. This factor had outweighed the positive effect of net interest income, thus leading to a decline in the Backing Ratio.

The Sub-Committee noted that, in accordance with Currency Board principles, changes in the Monetary Base during the reporting period had been fully matched by changes in the foreign reserves.

The report on Currency Board operations for the period under review is at [Annex](#).

Monitoring of risks and vulnerabilities

The Sub-Committee noted the regular report on risks and vulnerabilities, both international and domestic, relevant to monetary stability in Hong Kong. Internationally, economic data from the major economies continued to be generally favourable. In the US in particular consumer confidence continued to be high, and the manufacturing sector had expanded further in December, with the manufacturing Purchasing Managers' Index reaching the highest level since 1983. Members noted, however, that the picture in Japan and the euro area was a mixed one.

Members noted that in Hong Kong the latest retail sales figures showed a further improvement, and the Purchasing Managers' Index suggested that the economy had continued to expand in December, although the pace of expansion might have eased somewhat. In general, the latest data indicated continued improvements in both the domestic and external environments, which were helpful to Hong Kong's economic recovery and conducive to monetary stability.

Personal renminbi business: Will the Hong Kong dollar be marginalised?

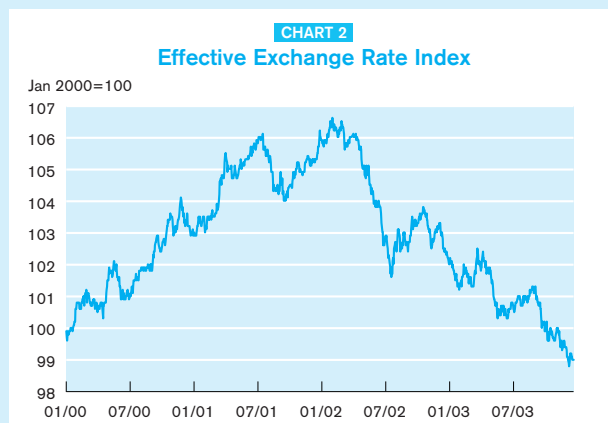
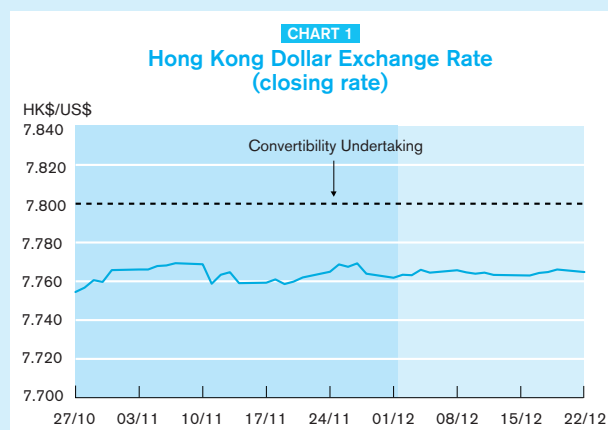
The Sub-Committee considered a paper addressing the question of whether the expected introduction of personal renminbi business by banks in Hong Kong in the near future would lead to a marginalisation of the Hong Kong dollar. The conclusion of the paper was that it was unlikely, in the foreseeable future, that the renminbi would replace the Hong Kong dollar to any significant extent in domestic transactions. In the longer run, when the renminbi became fully convertible, the degree of renminbisation in Hong Kong was likely to grow. Even then, however, the role of the Hong Kong dollar was likely to remain significant, not least because of its legal tender status and its use for tax and other official payments.

Annex Report on Currency Board Operations (2 December – 22 December 2003)

The Hong Kong dollar exchange rate was stable despite the strong demand for Hong Kong dollar assets. The HKMA sold a total of HK\$16.75 billion of Hong Kong dollars between 2 and 17 December, increasing the Aggregate Balance to HK\$28.42 billion. Interbank interest rates thus eased and their negative spreads against the US dollar counterparts widened. The Monetary Base rose markedly from HK\$269.34 billion to HK\$289.89 billion during the period, resulting mainly from the increase in the Aggregate Balance. In accordance with currency board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

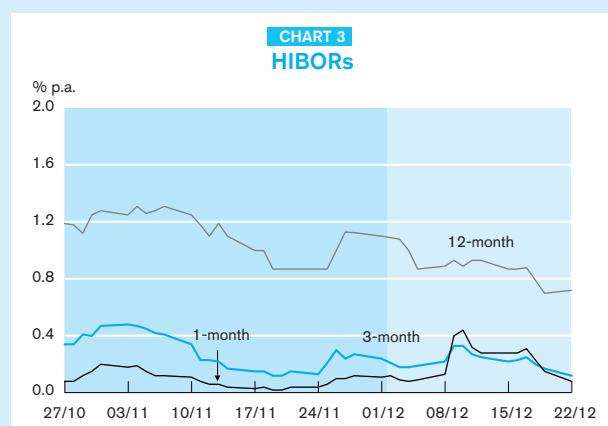
Hong Kong dollar exchange rate

In spite of the strong demand for Hong Kong dollar assets, **the Hong Kong dollar remained stable during the reporting period.** This reflected in part the sales of Hong Kong dollars by the HKMA. The exchange rate closed at 7.7647 (Charts 1 and 2).

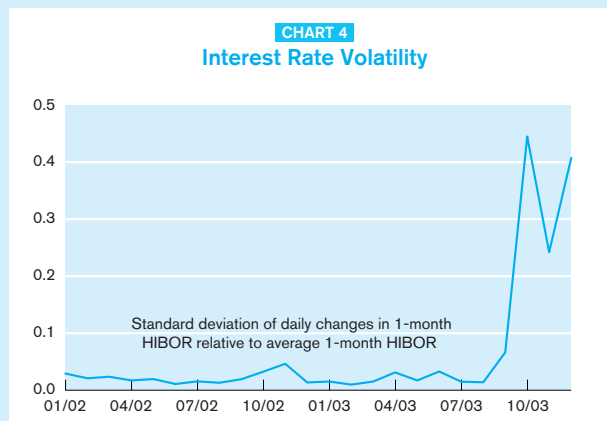


Interest rates

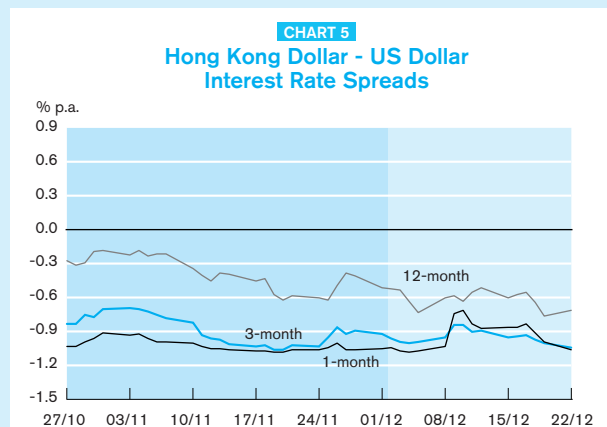
Hong Kong dollar interest rates eased further during the reporting period, partly attributable to an expansion in the Aggregate Balance. In particular, 12-month HIBOR dropped by 37 bp to close at 0.72%. Short-term interest rates rose in mid-December owing to an increased liquidity demand associated with new share subscriptions, but eased towards the end of the period. Overall, 1-month and 3-month HIBORs fell by 4 bp and 9 bp to close at 0.08% and 0.12% respectively (Chart 3).



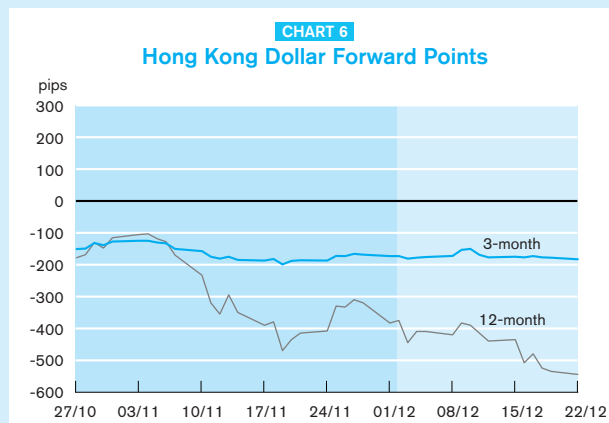
Interest rate volatility, as measured by the ratio of the standard deviation of daily changes in 1-month HIBOR to its average, **increased** during the period (Chart 4).¹ The fluctuations in interest rates reflected mainly a brief tightening in the money market associated with equity IPOs.



The Hong Kong dollar interbank interest rates continued to maintain negative spreads over their US dollar counterparts, although they narrowed briefly in mid-December in the light of tightened liquidity conditions related to equity IPOs. For the period as a whole, the 1-month and 3-month spreads dropped by 2 bp and 8 bp to -106 bp and -104 bp respectively, while the 12-month spread declined by 19 bp to close at -71 bp (Chart 5).



Mirroring the movements in interest rate spreads, Hong Kong dollar 3-month forward points remained at a discount, closing at -183 pips. Meanwhile, **12-month forward discount widened by 170 pips to -545 pips** (Chart 6).



Yields on Exchange Fund paper decreased across the board during the period, largely reflecting lower US Treasury yields (Chart 7). Yields on short-term Exchange Fund paper (up to 6 months) dropped below zero near the end of the reporting period. The negative yields reflected in part banks' preference for short-term paper in a low interest rate environment, given their demand for Exchange Fund paper for liquidity management purpose. The yield differentials of the 5-year and 10-year paper over the US counterparts increased slightly by about 5 bp to -7 bp and 11 bp respectively (Table 1).

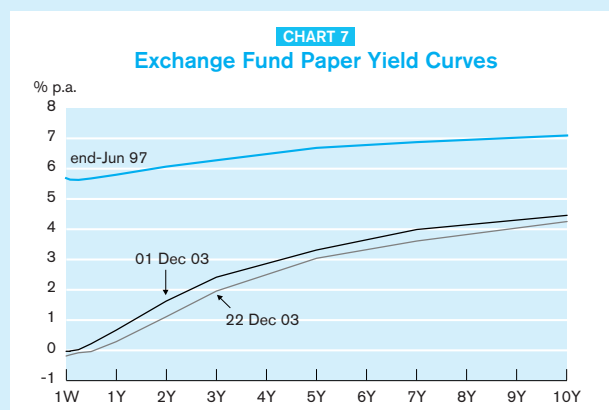
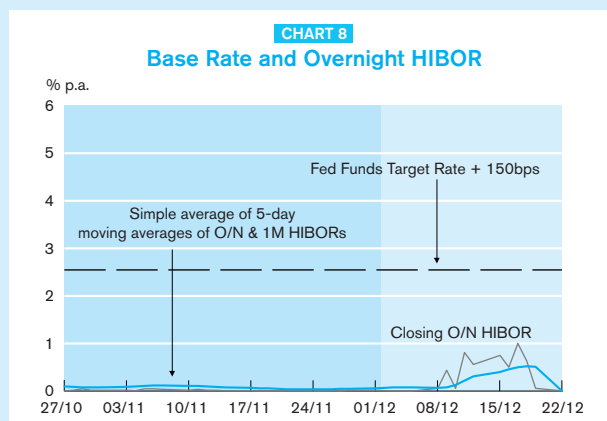


TABLE 1
Yield Spreads of Exchange Fund Paper over US Treasuries (basis points)

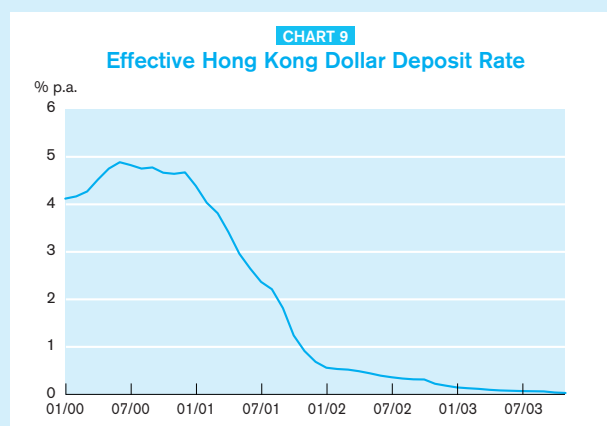
	27 Jun 97	1 Dec 03	22 Dec 03
3-month	56	-86	-87
1-year	21	-33	-72
3-year	3	-25	-32
5-year	27	-11	-7
10-year	54	16	11

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, which may vary over time. This measure of variability may, however, be exaggerated by a low average level of interest rates.

The HKMA Base Rate remained at 2.50% (Chart 8). The banks also kept their Best Lending Rate unchanged at 5%.



The average rate offered by major authorized institutions for 1-month time deposits remained unchanged at 0.01% during the period.² Meanwhile, the effective deposit rate declined marginally in November (Chart 9).³



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 used certain assumptions regarding the maturity distribution to compute the effective deposit rate.

Monetary Base

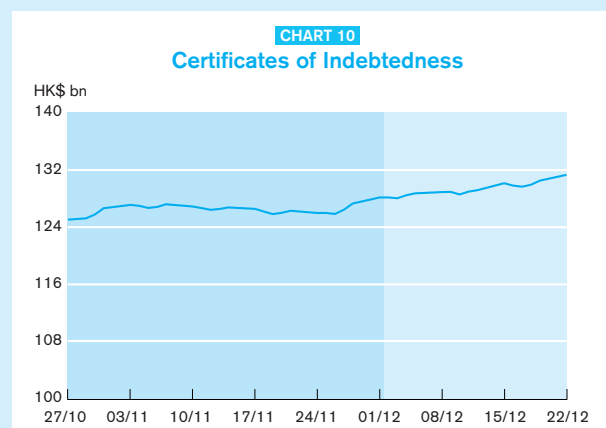
The **Monetary Base**, which comprises Certificates of Indebtedness (CIs), Government-issued currency notes and coins in circulation, the Aggregate Balance, and Exchange Fund Bills and Notes, **increased notably from HK\$269.34 billion to HK\$289.89 billion during the reporting period** (Table 2). The increase was mainly due to an expansion in the Aggregate Balance, following HKMA's sales of Hong Kong dollars to banks. Movements in individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	2 Dec 03	22 Oct 03
CIs	128.07	131.24
Government-issued Currency Notes and Coins in Circulation	6.26	6.36
Aggregate Balance	11.62	28.42
Outstanding EFBNs	123.40	123.88
Monetary Base	269.34	289.89

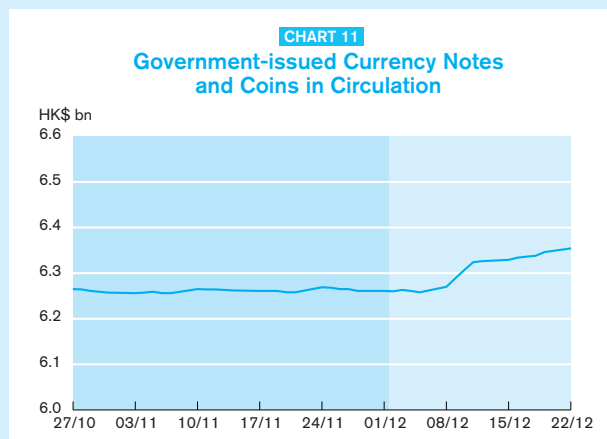
Certificates of Indebtedness

Reflecting in part increased public demand for banknotes before the Christmas and New Year holidays, the total amount of outstanding CIs increased. For the period as a whole, the three note-issuing banks submitted to the HKMA a total of US\$0.4 billion in exchange for HK\$3.17 billion worth of CIs. Consequently, **the outstanding amount of CIs increased from HK\$128.07 billion to HK\$131.24 billion (Chart 10).**



Government-issued currency notes and coins in circulation

The total amount of **Government-issued currency notes and coins in circulation increased** from HK\$6.26 billion to HK\$6.36 billion in the reporting period (Chart 11).



Aggregate Balance

The HKMA sold a total of HK\$16.75 billion of Hong Kong dollars between 2 and 17 December. As a result, **the Aggregate Balance increased to HK\$28.42 billion at the end of the period** (Chart 12 and Table 3).

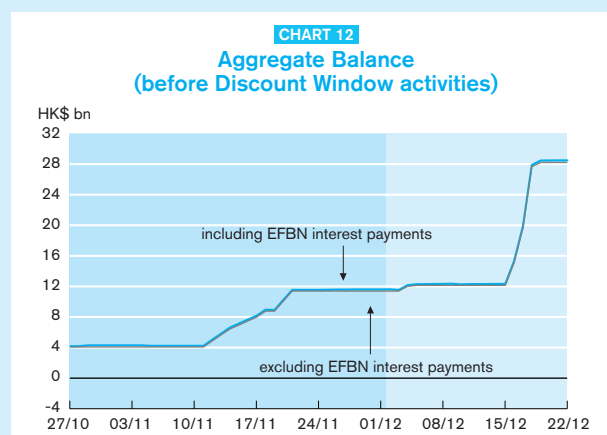
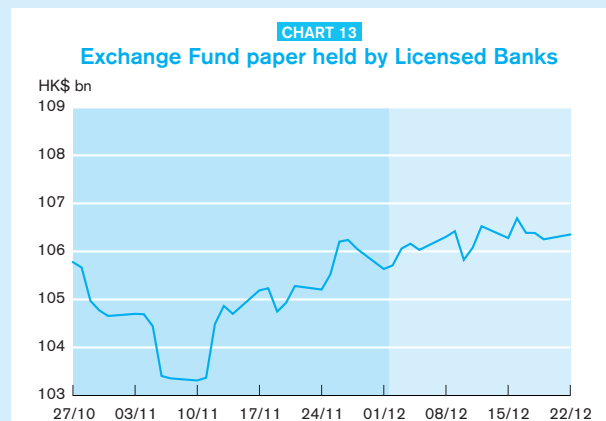


TABLE 3
HKMA HK\$/US\$ FX Transactions
(2 December – 22 December 03)

Trade Date	Net HK\$ purchase (+) (HK\$mn)
2 Dec	-729
12 Dec	-2,958
15 Dec	-4,565
16 Dec	-7,941
17 Dec	-559
Total	-16,752

Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund Bills and Notes increased slightly from HK\$123.40 billion to HK\$123.88 billion. Meanwhile, holdings of Exchange Fund paper by the banking sector (before Discount Window activity) increased marginally from HK\$105.70 billion (85.66% of total) to HK\$106.35 billion (85.85% of total) (Chart 13).



During the period, **interest payments of HK\$0.37 billion were made on Exchange Fund paper. An additional HK\$0.22 billion (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 4).

TABLE 4
Issuance of Exchange Fund Bills and Notes
(2 December – 22 December 03)

	No. of issues launched	Over-subscription ratio
3-month EFB	3	3.04 - 5.25
6-month EFB	1	4.08
1-year EFB	1	2.27
3-year EFN	1	2.67

Discount Window activity

For the period as a whole, **10 banks borrowed a total of HK\$5.17 billion from the Discount Window**, compared with HK\$2.81 billion in the preceding period (Chart 14). The majority of them used Exchange Fund paper as collateral (Table 5).

CHART 14
Discount Window Borrowing

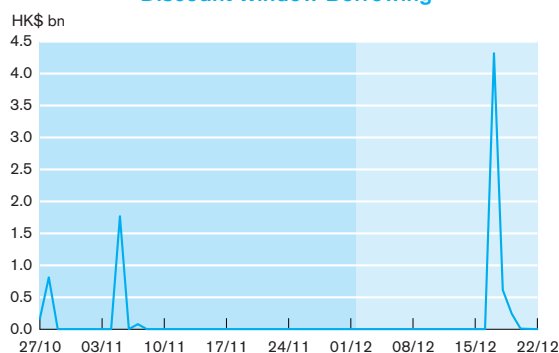


TABLE 5
Frequency of Individual Bank
Access to the Discount Window
(2 December – 22 December 03)

Frequency of using Discount Window	No. of banks
1	10
Total	10

Backing Portfolio

Alongside the rise in the outstanding amount of CIs and the Aggregate Balance, backing assets increased during the period, though less proportionately than the Monetary Base. Thus, **the backing ratio decreased slightly from 110.93% on 2 December to 110.21% on 22 December** (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

