

Record of Discussion of the Exchange Fund Advisory Committee Currency Board Sub-Committee on 13 May 2005

(Approved for Issue by the Exchange Fund Advisory Committee on 26 May 2005)

Report on Currency Board Operations (1 April – 28 April 2005)

The Sub-Committee noted that the Hong Kong dollar had strengthened briefly in late April. Part of the explanation for this could be increased expectations of a change in Mainland China's exchange rate arrangements in the near future. Interbank interest rates had eased, and the Monetary Base had declined from HK\$287.31 billion to HK\$284.74 billion during the reporting period, largely as a result of a decline in the outstanding amount of Certificates of Indebtedness. Members noted that the Backing Ratio had hit the Upper Trigger Level of 112.5% in mid-March, when, in accordance with the triggering arrangements, assets had been transferred out of the Backing Portfolio to the Investment Portfolio in order to reduce the Backing Ratio to 110%.

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

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

Monitoring of Risks and Vulnerabilities

Members noted that growth in the region continued to be solid, but that there has been a slowing of growth in the US. Domestic demand and inbound tourism had continued to show expansion in Hong Kong. Members also considered a special analysis examining recent developments in the property market, making use of the graphical framework developed by the HKMA. The indicators suggested that the risk of another residential property bubble continued to be low for the time being. However, the increase in "confirmor" transactions pointed to a rise in the speculative demand for housing, and easy monetary conditions and their subsequent reversal might lead to sharp fluctuations in asset prices.

Convertibility Arrangements for the Aggregate Balance

The Sub-Committee considered a paper re-examining the convertibility arrangements for the Aggregate Balance. Members noted that the Hong Kong dollar had been under strong-side pressures since late 2003 and that these pressures were likely to persist as the Hong Kong dollar continued to be used as a vehicle for speculation on a

revaluation of the renminbi. Members considered what refinements might be introduced to remove the uncertainty about the extent to which the exchange rate might strengthen under the Linked Exchange Rate system and to promote the smooth functioning of the money and foreign exchange markets in accordance with Currency Board arrangements, in particular by helping to ensure that Hong Kong dollar interest rates tracked more closely their US dollar counterparts.

Taking into account the recent experience with strong-side operations, the Sub-Committee considered that there was room for strengthening the operations on the strong side of the Linked Exchange Rate and advised that, in the light of changed market conditions, there was now a case for introducing a strong-side convertibility undertaking for the Aggregate Balance in addition to the existing weak-side Convertibility Undertaking. The Sub-Committee advised that, taking into account the monetary policy objective of achieving a stable external exchange value of the Hong Kong dollar at around HK\$7.80 to US\$1, the two Convertibility Undertakings should be symmetrically positioned around the Linked Rate of 7.80. Members noted that this would involve shifting the existing weak-side Convertibility Undertaking above 7.80 and advised that, in order to address possible market concerns, the shift could be carried out in a gradual manner.

Members considered that the actual width between the two Convertibility Undertakings should be set having regard to the desire, on the one hand, to avoid excessive exchange rate volatility by imposing too great a width, and, on the other hand, to avoid displacing foreign exchange business involving the Hong Kong dollar by imposing too small a width. Members advised that, within the Convertibility Zone bounded by the two Convertibility Undertakings, it would be appropriate for the HKMA to conduct market operations aimed at promoting the smooth functioning of the Linked Exchange Rate system, for example, by removing any market anomalies that might arise from time to time. Members advised that these operations should be conducted in strict conformity with Currency Board principles: both the stock and changes in the Monetary Base would be fully backed by foreign exchange reserves at the level of the Linked Exchange Rate; and the impact on the Aggregate Balance arising from any market operations would be announced immediately, with the relevant information included in the monthly Reports on Currency Board Operations to the Sub-Committee, which were subsequently published on the HKMA website and in the HKMA's *Quarterly Bulletin*.

Members further considered the question of whether there should be transferability between the Certificates of Indebtedness, issued under the Exchange Fund Ordinance as cover for the banknotes issued by the note-issuing banks, and the Aggregate Balance. Members advised that this question should be further researched into by the HKMA, in consultation with the three note-issuing banks, with a view to producing practical proposals for the Sub-Committee's consideration.

The Relationship between commodity and Consumer Prices in Mainland China and Hong Kong

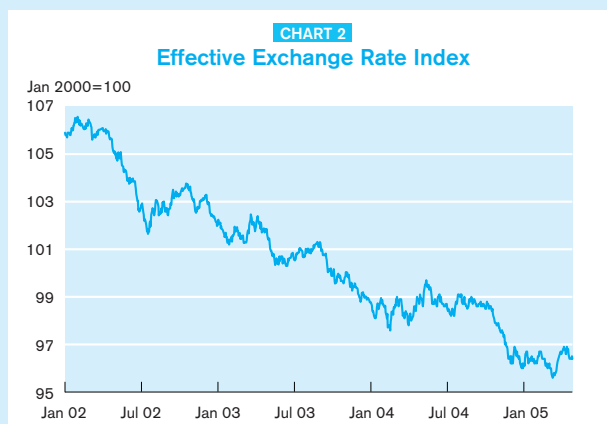
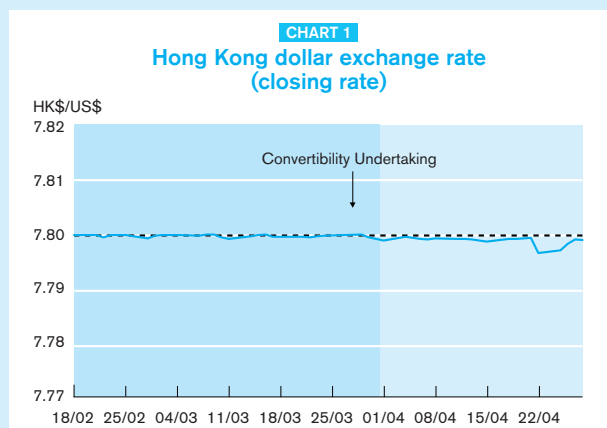
The Sub-Committee considered a paper presenting the empirical results of a study of whether changes in commodity prices were a leading indicator of future Consumer Price Index (CPI) inflation in Mainland China and Hong Kong. The results suggested that changes in non-oil commodity prices had significant predictive power for headline CPI inflation, while changes in oil prices were not significant. The impact of a 1% rise in non-oil commodity prices was associated with a larger increase in future CPI inflation in Hong Kong and Mainland China than was typically found in other economies such as the US. There were several explanations for this. First, these economies were highly open (especially Hong Kong), and so the domestic business cycle was highly synchronised with the global business cycle. Consequently, one might expect a close correlation between measures of domestic and global inflation. Secondly, food prices accounted for a larger share of the CPI basket in Hong Kong and Mainland China than in the US, so that global food price shocks tended to have a larger effect on CPI inflation, other things being equal. Thirdly, production processes in Mainland China were commodity-intensive.

Annex Report on Currency Board Operations (1 April – 28 April 2005)

The Hong Kong dollar exchange rate stayed close to the Linked Rate during the reporting period. Interbank interest rates eased. The Monetary Base decreased from HK\$287.31 billion to HK\$284.74 billion, largely reflecting a decline in 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 stayed largely near the Linked Rate, but strengthened briefly in the latter part of the reporting period. This was partly associated with heightened political pressure from the US to revalue the renminbi. The Hong Kong dollar exchange rate **closed at 7.7989 at the end of the reporting period** (Chart 1). Separately, the effective exchange rate of the Hong Kong dollar decreased slightly (Chart 2).

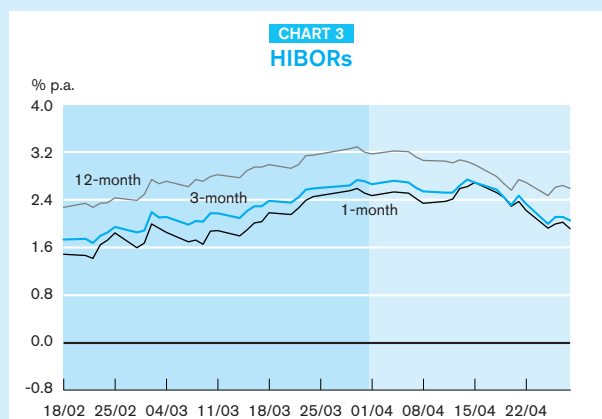


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

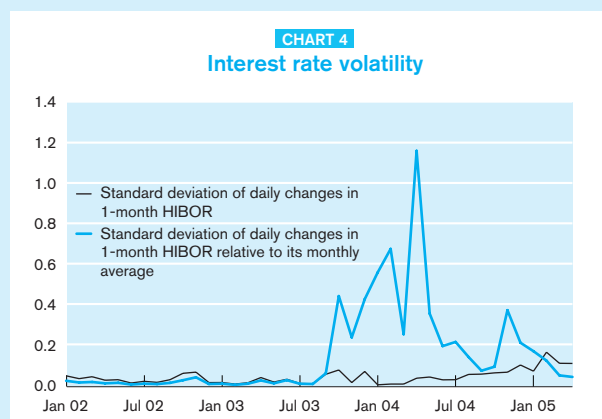
Interest rates

Hong Kong dollar interbank interest rates eased.

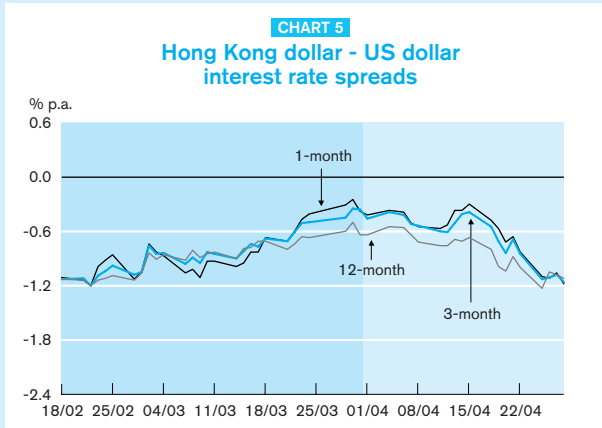
The one-month and three-month HIBORs decreased by 56 bp and 61 bp to close at 1.92% and 2.06% respectively. The 12-month HIBOR declined by 58 bp to close at 2.60% (Chart 3).



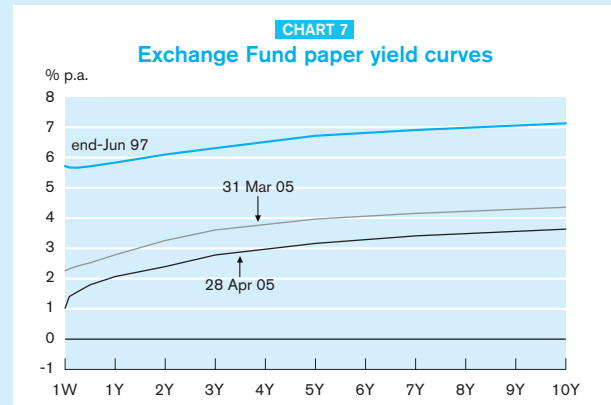
Interest rate volatility, as measured by the standard deviation of daily changes in one-month HIBOR, **decreased** in April. As a ratio to the average level of one-month HIBOR, it declined as well (Chart 4).¹



Hong Kong dollar interbank interest rates fell further below US dollar rates, widening their negative spreads during the period. The one-month and three-month spreads increased by 76 bp and 70 bp to close at -118 bp and -116 bp respectively, while the 12-month spread rose by 48 bp to close at -112 bp (Chart 5).



Yields of Exchange Fund paper dropped markedly across different maturities during the period (Chart 7). The negative yield spreads against US Treasuries widened notably, with the five-year and 10-year spreads decreasing to -74 bp and -60 bp respectively at the end of the period (Table 1).



Reflecting the movements in interest rate spreads, the **Hong Kong dollar 12-month forward discount rose by 355 pips to close at 810 pips**. The three-month forward discount increased by 126 pips to close at 210 pips (Chart 6).

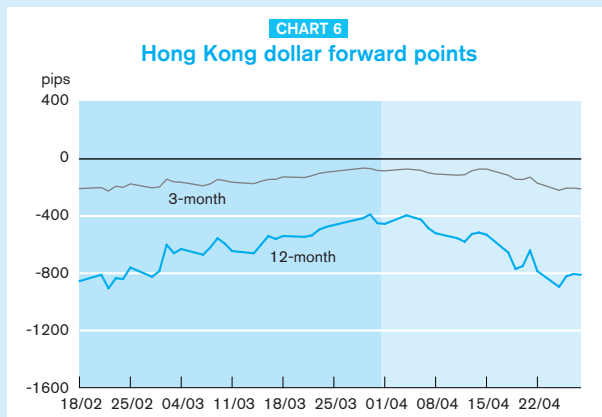
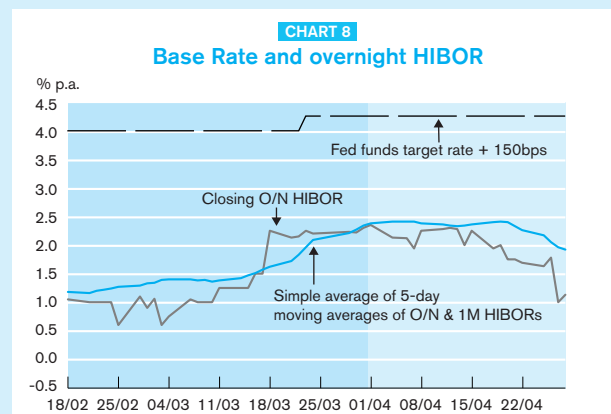


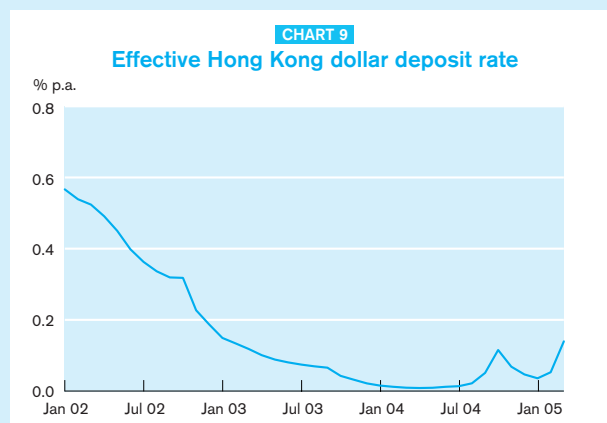
TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	31 Mar 05	28 Apr 05
3-month	56	-37	-124
1-year	21	-25	-121
3-year	3	-38	-90
5-year	27	-28	-74
10-year	54	-21	-60

The HKMA Base Rate remained at 4.25% throughout the period (Chart 8). **Some banks raised their Best Lending Rate by 25 bp to 5.5% on 6 April**, while the others left the rate unchanged.



The average one-month time deposit rate offered by major authorized institutions rose from 0.456% to 0.613% during the period.² Meanwhile, the effective deposit rate increased from 0.05% to 0.14% in March (Chart 9).³



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, **decreased from HK\$287.31 billion to HK\$284.74 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

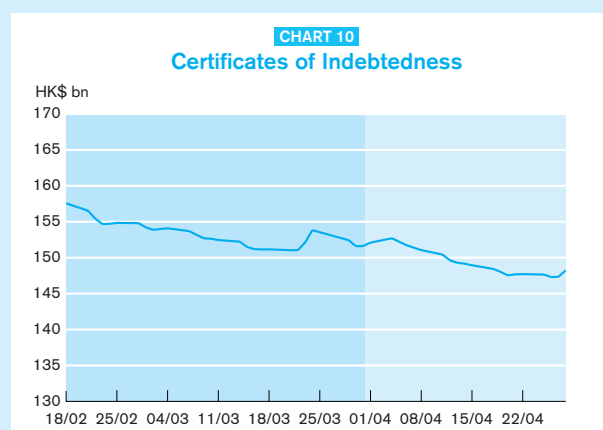
(HK\$ bn)	1 Apr 05	28 Apr 05
CIs	152.10	148.25
Government-issued Currency Notes and Coins in Circulation	7.09	6.94
Aggregate Balance	3.85	3.88
Outstanding EFBNs	124.28	125.68
Monetary Base	287.31	284.74

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.

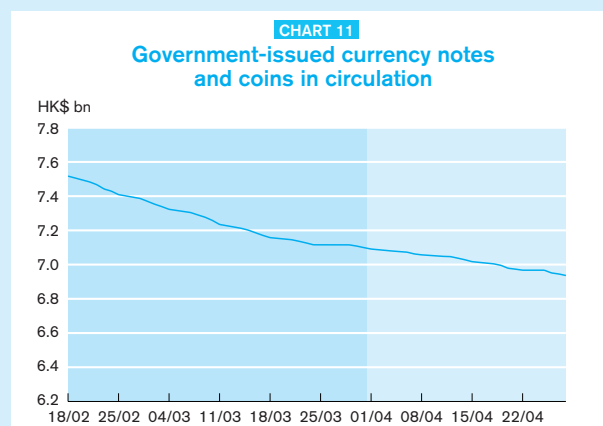
Certificates of Indebtedness

The three note-issuing banks redeemed HK\$3.85 billion of CIs to the HKMA in exchange for US\$0.49 billion during the period. As a result, **the outstanding amount of CIs decreased from HK\$152.10 billion to HK\$148.25 billion** (Chart 10).



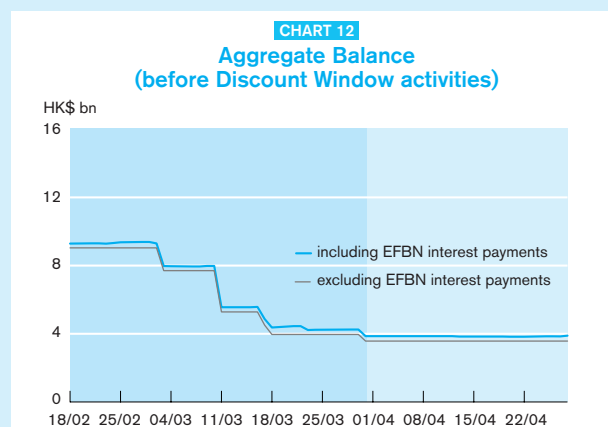
Government-issued currency notes and coins in circulation

Along with the decline in CIs, the total amount of **government-issued currency notes and coins in circulation decreased from HK\$7.09 billion to HK\$6.94 billion** during the reporting period (Chart 11).



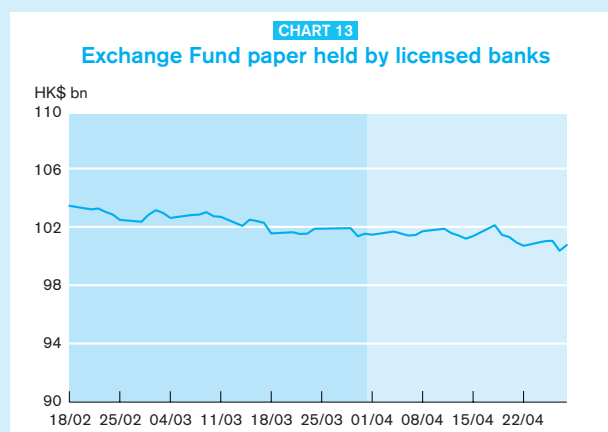
Aggregate Balance

The **Aggregate Balance** remained stable at around **HK\$3.85 billion** throughout the reporting 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 increased mildly from **HK\$124.28 billion** to **HK\$125.68 billion**. Meanwhile, holdings of Exchange Fund paper by the banking sector (before Discount Window activities) declined modestly from **HK\$101.64 billion** (81.78% of total) to **HK\$100.92 billion** (80.30% of total) (Chart 13).



During the period, a total of **HK\$192.72 million** of interest payments on Exchange Fund paper were made. An additional **HK\$164.12 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 generally well received by the market (Table 3).

TABLE 3
Issuance of Exchange Fund Bills and Notes
(1 Apr – 28 Apr 05)

	No. of issues launched	Over-subscription ratio
3-month EFB	4	2.83-6.40
6-month EFB	2	4.49-6.69
1-year EFB	1	2.63
3-year EFN	1	1.23

Discount Window activities

During the period, **five banks borrowed a total of HK\$420 million** from the Discount Window, compared with **HK\$2.73 billion** in the preceding period (Chart 14). All borrowings used Exchange Fund paper as collateral (Table 4).

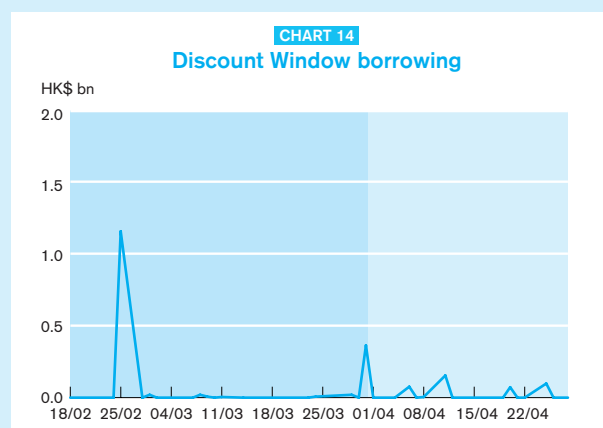
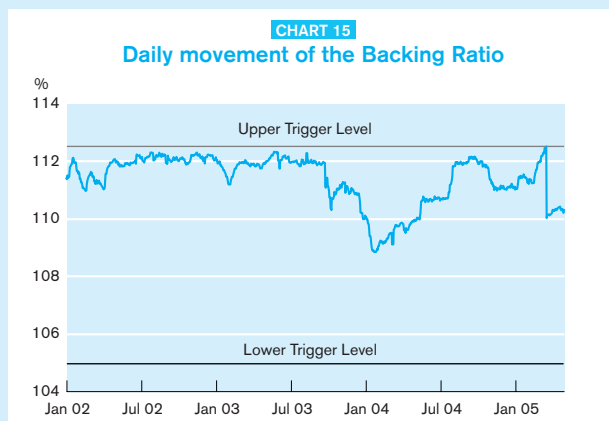


TABLE 4
Frequency of individual bank's access to the Discount Window
(1 Apr – 28 Apr 05)

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

Backing Portfolio

Backing Assets decreased during the period, attributable to valuation losses and decreases in Certificates of Indebtedness. As Backing Assets declined proportionally less than the Monetary Base, **the Backing Ratio increased from 110.29% on 1 April to 110.31% on 28 April 2005** (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.

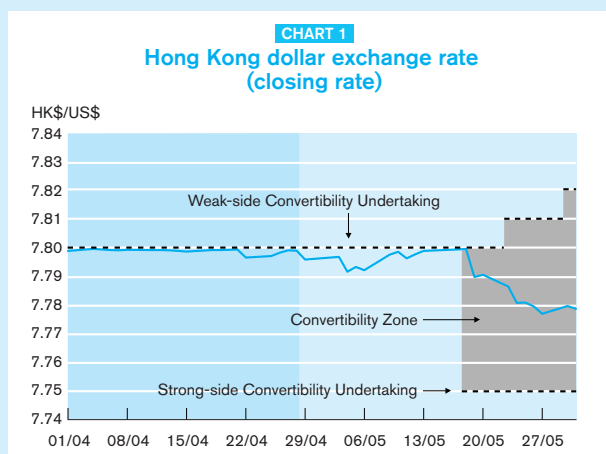


Report on Currency Board Operations (29 April – 31 May 2005)

The HKMA introduced three refinements to the Linked Exchange Rate system on 18 May: introducing a strong-side Convertibility Undertaking (CU) at 7.75, shifting the existing weak-side CU to 7.85, and creating a Convertibility Zone defined by the levels of the CUs, within which the HKMA may choose to conduct market operations consistent with Currency Board principles. Markets generally responded favourably to these refinements. The Hong Kong dollar exchange rate strengthened markedly during the reporting period. The HKMA conducted market operations both within and on the weak side of the Convertibility Zone. Interbank interest rates rose considerably. Largely reflecting declines in the Aggregate Balance and Certificates of Indebtedness (CIs), the Monetary Base decreased from HK\$285.93 billion to HK\$281.08 billion. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

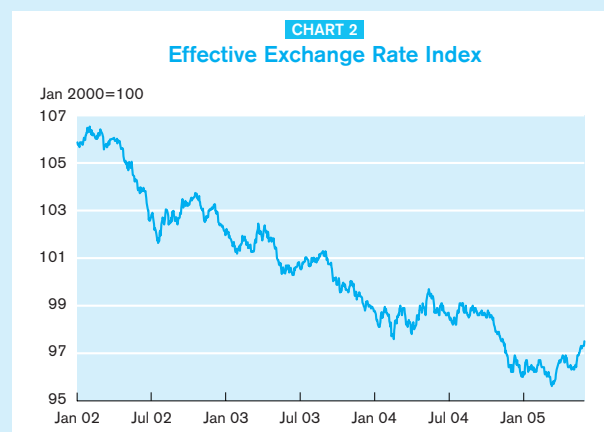
Refinements to the Linked Exchange Rate system

On 18 May three refinements to the Linked Exchange Rate system (LES) were introduced to remove uncertainty about the extent to which the exchange rate may strengthen under the Linked Exchange Rate system and promote the smooth functioning of the money and foreign exchange markets in accordance with Currency Board arrangements. A strong-side CU was established at 7.75 to anchor expectations of Hong Kong dollar appreciation, the weak-side CU was moved to 7.85 gradually so as to create a symmetric Convertibility Zone around 7.80, and the possibility of carrying out market operations consistent with Currency Board principles within the Convertibility Zone was introduced. Short-term interest rates reacted as anticipated, with the one-month HIBOR increasing by 68 basis points on 19 May, and stayed closer to the corresponding US rates for the remainder of the reporting period than they had in the first three weeks of the period. The discount in the Hong Kong dollar forward market fell as well.



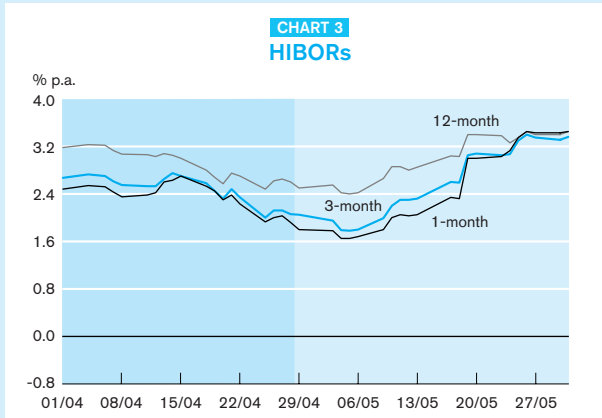
Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate strengthened briefly in the early part of the reporting period, attributable to speculations about a change in renminbi exchange rate regime (Chart 1). Immediately after the announcement of the three refinements to the LES by the HKMA, the weak-side CU of 7.8 was triggered on 18 May, prompting the HKMA to buy HK\$3.12 billion of Hong Kong dollar from banks. Thereafter, as political pressure from the US on renminbi revaluation intensified, the Hong Kong dollar exchange rate strengthened. To address rising demand for Hong Kong dollar funding in anticipation of a number of equity initial public offerings (IPOs), the HKMA conducted market operations within the Convertibility Zone on 25 May, selling HK\$544 million of Hong Kong dollar to banks. The Hong Kong dollar exchange rate continued to strengthen afterwards and **closed at 7.7786 at the end of the reporting period**. Separately, the effective exchange rate of the Hong Kong dollar rose slightly (Chart 2).

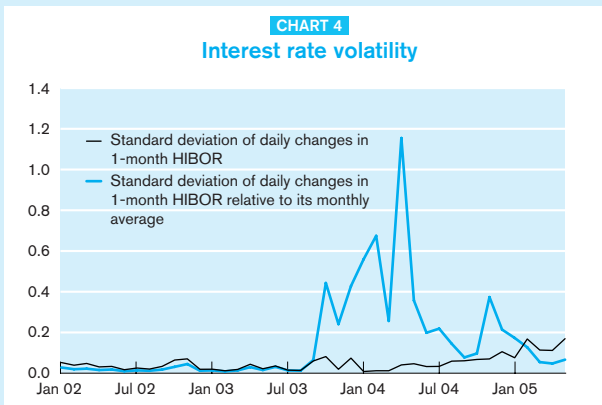


Interest rates

Hong Kong dollar interbank interest rates rose markedly during the reporting period. The one-month and three-month HIBORs increased by 165 basis points and 131 basis points to close at 3.45% and 3.36% respectively. Meanwhile, the 12-month HIBOR rose by 95 basis points to close at 3.45% (Chart 3).

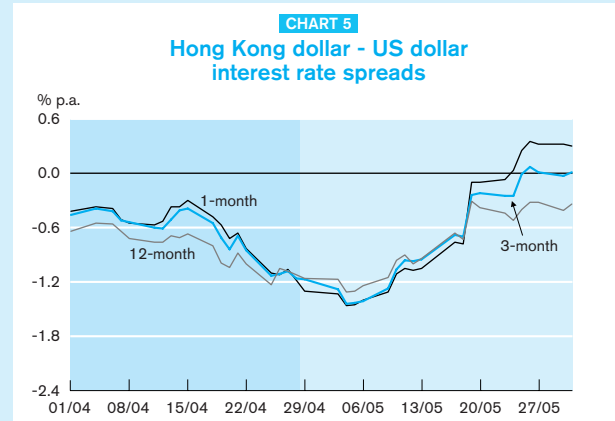


Interest rate volatility, as measured by the standard deviation of daily changes in one-month HIBOR, **increased** in May. As a ratio to the average level of one-month HIBOR, it rose as well (Chart 4).¹

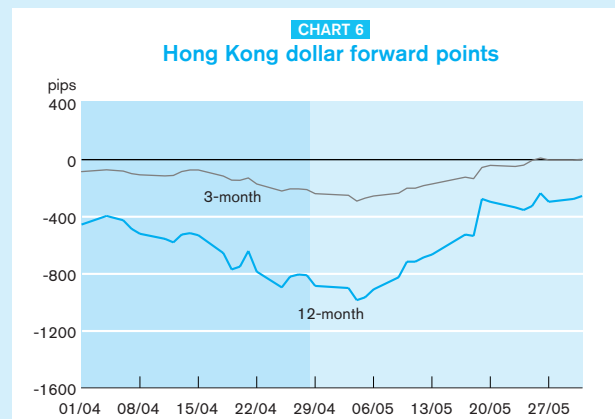


¹ The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

As **Hong Kong dollar interbank interest rates rose more sharply than US dollar rates did**, short-term interest rate spreads turned positive during the period. A substantial part of the rise in interest rate spreads took place after the introduction of the refinements to the LES on 18 May. The one-month and three-month spreads increased by 160 basis points and 118 basis points to close at 30 basis points and 1 basis point respectively, while the 12-month spread rose by 82 basis points to close at -34 basis points (Chart 5).



In line with the movements in interest rate spreads, the **Hong Kong dollar 12-month forward discount narrowed significantly by 630 pips to close at 255 pips**. Meanwhile, the three-month forward points turned from a discount to a small premium, rising by 240 pips to close at 2 pips (Chart 6).



Short-term yields of Exchange Fund paper rose considerably during the period (Chart 7). The negative yield spreads against US Treasuries narrowed substantially, with the five-year and 10-year spreads decreasing to -50 basis points and -49 basis points respectively at the end of the period (Table 1).

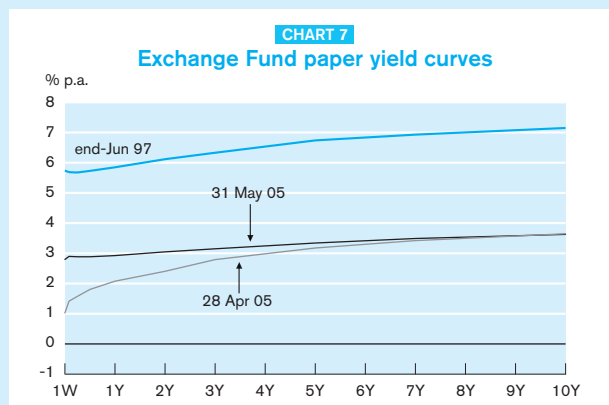
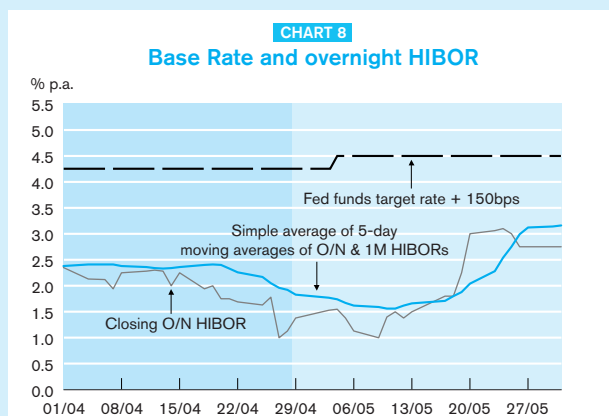


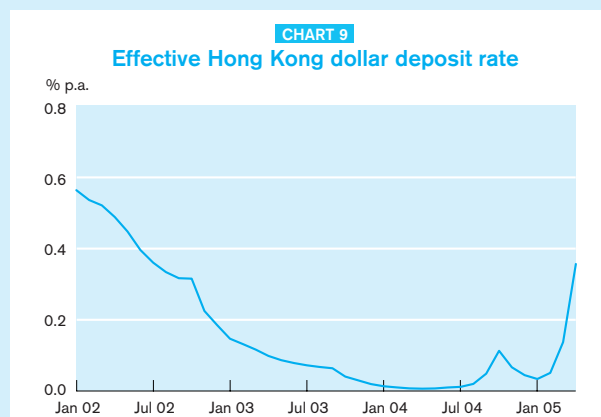
TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	28 Apr 05	31 May 05
3-month	56	-124	-9
1-year	21	-121	-56
3-year	3	-90	-59
5-year	27	-74	-50
10-year	54	-60	-49

Following a 25 basis points hike in the US federal funds target rate, **the HKMA Base Rate was adjusted upward to 4.50% on 4 May according to the established formula** (Chart 8). However, banks kept their Best Lending Rates unchanged until late May, when the rise in HIBORs resulted in **banks raising their Best Lending Rates by 50 basis points on 23 May**.



The average one-month time deposit rate offered by major authorized institutions rose from 0.609% to 1.094% during the period.² Meanwhile, the effective deposit rate increased from 0.14% to 0.36% in April (Chart 9).³



Monetary Base

The Monetary Base, which consists of CIs, government-issued currency notes and coins in circulation, the Aggregate Balance, and Exchange Fund Bills and Notes, **decreased from HK\$285.93 billion to HK\$281.08 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

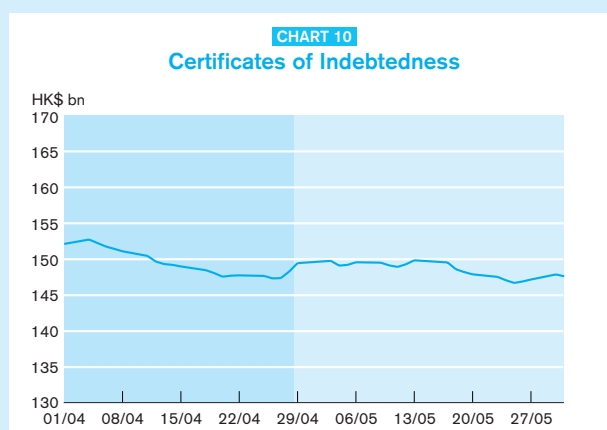
(HK\$ bn)	29 Apr 05	31 May 05
CIs	149.42	147.60
Government-issued Currency Notes and Coins in Circulation	6.93	6.84
Aggregate Balance	3.92	1.34
Outstanding EFBNs	125.66	125.30
Monetary Base	285.93	281.08

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.

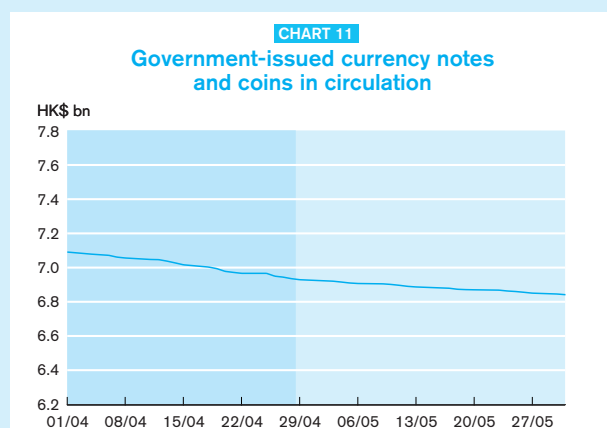
Certificates of Indebtedness

The three note-issuing banks redeemed HK\$1.82 billion of CIs to the HKMA in exchange for US\$0.23 billion during the period. Consequently, **the outstanding amount of CIs dropped from HK\$149.42 billion to HK\$147.60 billion** (Chart 10).



Government-issued currency notes and coins in circulation

Alongside the decrease in CIs, the total amount of **government-issued currency notes and coins in circulation declined from HK\$6.93 billion to HK\$6.84 billion** during the reporting period (Chart 11).



Aggregate Balance

The HKMA bought HK\$3.12 billion of Hong Kong dollar according to the weak-side CU of 7.8 on 18 May. As a result, **the Aggregate Balance shrank from around HK\$3.85 billion to HK\$714 million on 20 May**. In response to the increased demand for Hong Kong dollar ahead of a number of equity IPOs, the HKMA sold HK\$544 million of Hong Kong dollar to banks on 25 May. Consequently, **the Aggregate Balance rose to HK\$1.32 billion on 27 May**. Thereafter, the Aggregate Balance was stable, with small fluctuations due to interest payments of Exchange Fund paper (Chart 12 and Table 3).

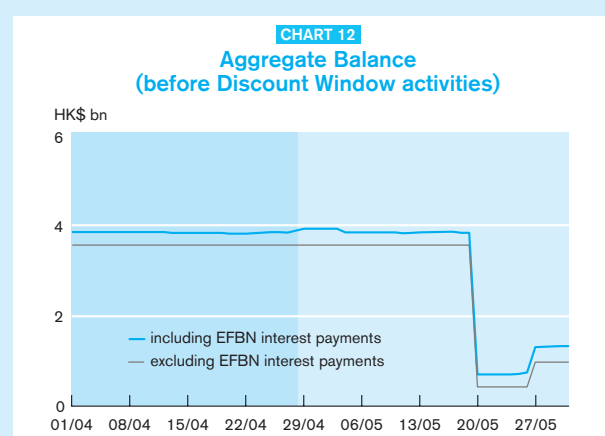
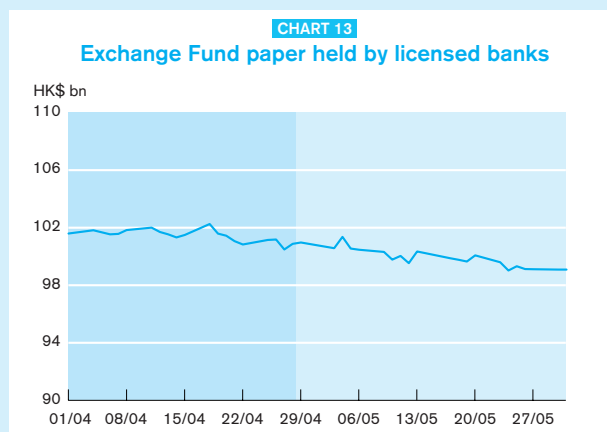


TABLE 3
HKMA HK\$/US\$ FX Transactions
(29 April – 31 May 05)

Trade Date	Net Hong Kong dollar purchase (+) (HK\$mn)
18 May	+3,120
25 May	-544

Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund Bills and Notes declined slightly from HK\$125.66 billion to HK\$125.30 billion. Meanwhile, holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased modestly from HK\$101.01 billion (80.39% of total) to HK\$99.12 billion (79.11% of total) (Chart 13).



During the period, a total of HK\$269.59 million of interest payments on Exchange Fund paper were made. An additional HK\$233.98 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. Major issues of Exchange Fund paper were fairly well received by the market (Table 4).

TABLE 4
Issuance of Exchange Fund Bills and Notes
(29 April – 31 May 05)

	No. of issues launched	Over-subscription ratio
3-month EFB	4	0.35-4.66
6-month EFB	2	0.68-2.46
1-year EFB	1	3.82
2-year EFN	1	1.58
7-year EFN	1	0.99

Discount Window activities

During the period, seven banks borrowed a total of HK\$3.20 billion from the Discount Window, compared with HK\$420 million in the preceding period (Chart 14). All borrowings used Exchange Fund paper as collateral (Table 5).

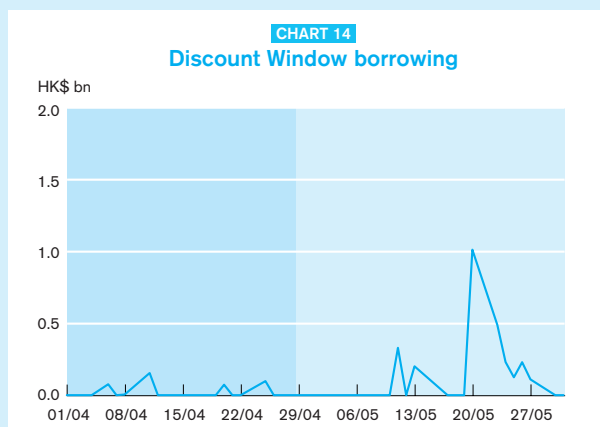
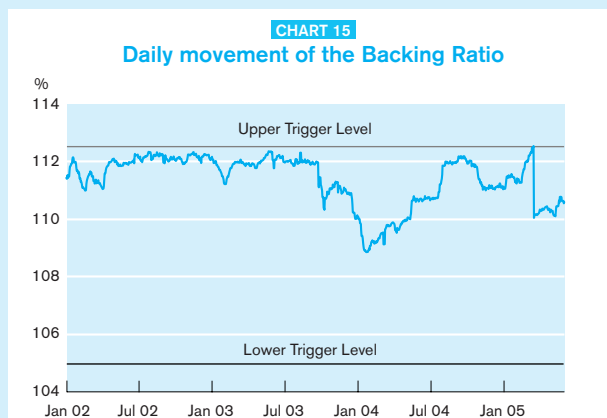


TABLE 5
Frequency of individual bank's access to the Discount Window
(29 April – 31 May 05)

Frequency of using Discount Window	No. of banks
1	4
3	2
4	1
Total	7

Backing Portfolio

Backing Assets decreased during the period, largely due to decreases in CIs and the Aggregate Balance. As Backing Assets fell proportionally less than the Monetary Base, **the Backing Ratio increased from 110.26% on 29 April to 110.58% on 31 May 2005** (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.



Record of Discussion of the Exchange Fund Advisory Committee Currency Board Sub-Committee on 4 July 2005

(Approved for Issue by the Exchange Fund Advisory Committee on 14 July 2005)

Report on Currency Board Operations (1 June – 20 June 2005)

The Sub-Committee noted that the three refinements to the Linked Exchange Rate system introduced on 18 May, including the gradual shifting of the weak-side Convertibility Undertaking from 7.80 to 7.85, which had been completed on 20 June, had so far worked smoothly. Hong Kong dollar interest rates had tracked more closely their US dollar counterparts, despite some slight tightening of interbank rates associated mainly with a number of equity initial public offerings. The Aggregate Balance, having declined sharply after the introduction of the three refinements, had remained stable during the reporting period at around HK\$1.3 billion. Members observed that the correlation between 12-month renminbi non-deliverable forward points and Hong Kong dollar forward points appeared to have weakened since the introduction of the three refinements.

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

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

Monitoring of Risks and Vulnerabilities

Members noted the continuing decline of the euro against the US dollar, reflecting both continued economic weakness in the euro zone and the recent political uncertainty about the future direction of European integration. In the US, although the manufacturing sector had shown signs of weakness, indicators of consumer spending and investment remained firm.

Members noted that growth in Hong Kong and in the region generally continued to be strong, with retail sales in Hong Kong increasing markedly and exports rebounding from their decline in the first quarter of the year.

The Sub-Committee noted a special analysis in the report examining the potential impact on Hong Kong of the recent trade dispute over Mainland textile, clothing and footwear exports to the US and Europe. The analysis suggested that the currently imposed limits on the growth of such exports would have only a minor impact on Hong Kong GDP growth.

Operations within the Convertibility Zone

The Sub-Committee considered a paper setting out the proposed broad guiding principles for market operations conducted by the HKMA within the Convertibility Zone, which had been introduced as one of the three refinements to the Linked Exchange Rate system in May. Members considered that, given complex and changing market conditions, it would be extremely difficult to lay down detailed and specific rules for operations within the Convertibility Zone. They therefore endorsed four broad principles that should govern these operations. The first principle was that all operations within the Convertibility Zone should be carried out in strict accordance with Currency Board rules: that is, both the stock and changes in the Monetary Base should be fully backed by foreign exchange. Secondly, the primary objective of any operations should be to preserve exchange rate stability implied by the Linked Exchange Rate system and to maintain confidence in the system. Thirdly, operations might be undertaken to support such interest rate adjustments as would maintain exchange rate stability under the Linked Exchange Rate system, and would avoid destabilising behaviour in interest rates. Fourthly, operations might also be undertaken in order to remove market anomalies. With regard to the fourth guiding principle, Members acknowledged that it was a matter of judgement what constituted a market anomaly, and that this judgement would need to be exercised case by case, taking account of market dynamics.

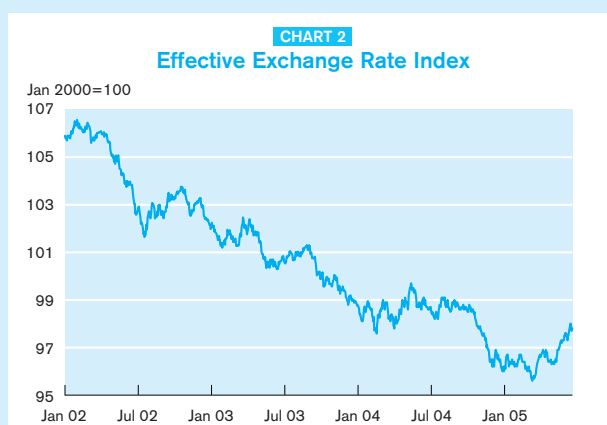
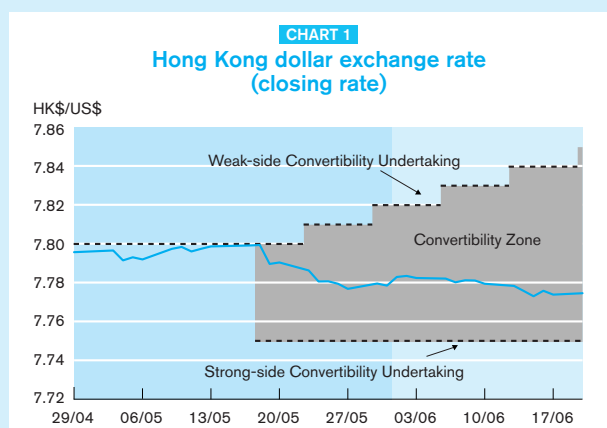
The Sub-Committee also considered that, while these four principles should be generally applicable for the time being, they should be kept under review in the light of experience and changing conditions.

Annex Report on Currency Board Operations (1 June – 20 June 2005)

The shifting of the weak-side Convertibility Undertaking to 7.85 was completed on 20 June. During the reporting period, the Hong Kong dollar exchange rate strengthened and interbank interest rates eased. The Monetary Base decreased from HK\$281.19 billion to HK\$279.71 billion, largely reflecting a decline in 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

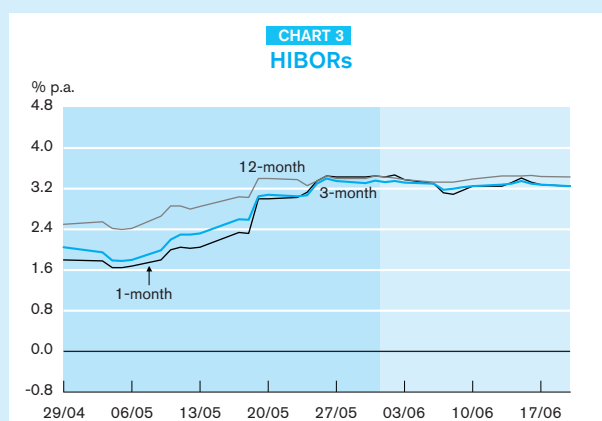
The Hong Kong dollar exchange rate continued to strengthen, closing at 7.7746 at the end of the period (Chart 1). This was reportedly attributable to increased demand for Hong Kong dollar associated with equity initial public offerings (IPOs). Meanwhile, the weak-side Convertibility Undertaking was finally shifted to 7.85 on 20 June, according to the plan as stated in the three refinements. Separately, the effective exchange rate of the Hong Kong dollar rose slightly (Chart 2).



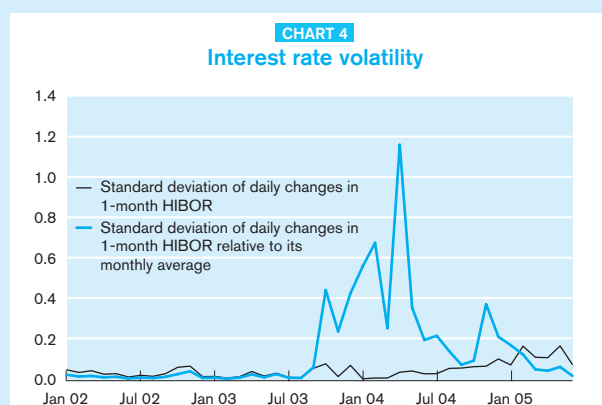
¹ The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

Interest rates

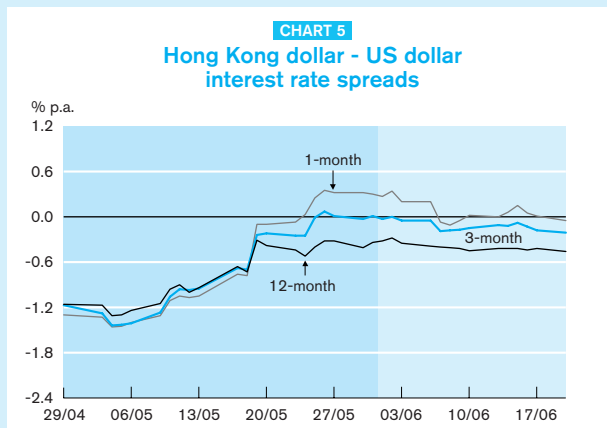
Hong Kong dollar interbank interest rates eased slightly during the reporting period. In particular, the one-month and three-month HIBORs decreased by 18 bp and 8 bp to close at 3.25%. Meanwhile, the 12-month HIBOR remained largely unchanged and closed at 3.43% (Chart 3).



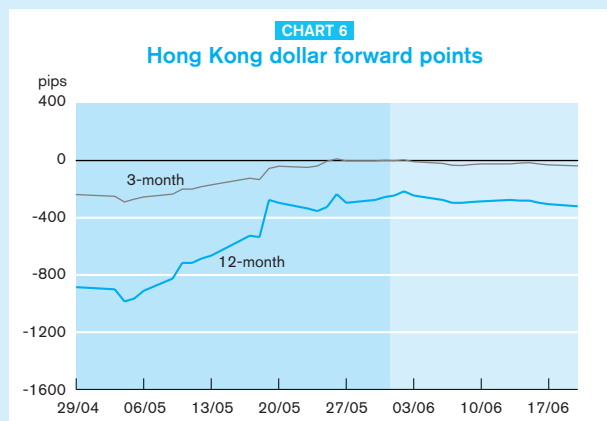
Interest rate volatility, as measured by the standard deviation of daily changes in one-month HIBOR, **decreased** in June. As a ratio to the average level of one-month HIBOR, it declined as well (Chart 4).¹



As **Hong Kong dollar interbank interest rates fell more than the corresponding US dollar rates**, short-term interest rate spreads turned negative during the period. The one-month and three-month spreads decreased by 32 bp and 18 bp to close at -5 bp and -21 bp respectively, while the 12-month spread decreased by 14 bp to close at -46 bp (Chart 5).



In line with the movements in interest rate spreads, the **Hong Kong dollar 12-month forward discount widened by 75 pips to close at 320 pips**. Meanwhile, the three-month forward points turned from a near-zero premium to a small discount, closing at -37 pips (Chart 6).



Short-term yields of Exchange Fund paper eased during the period (Chart 7). The negative yield spreads against US Treasuries widened generally, with the five-year and 10-year spreads decreasing to -54 bp and -53 bp respectively at the end of the period (Table 1).

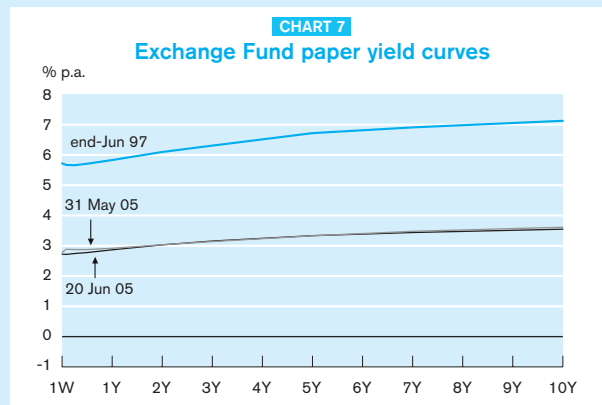
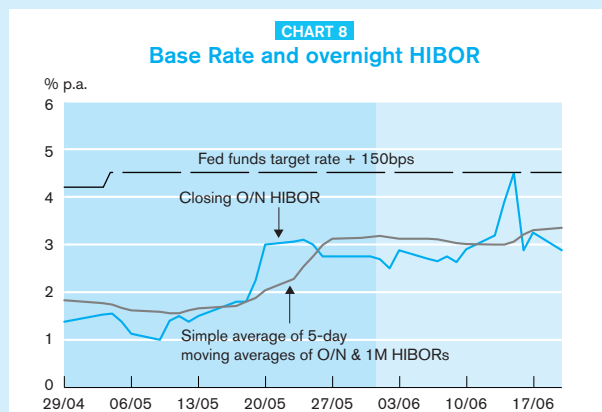


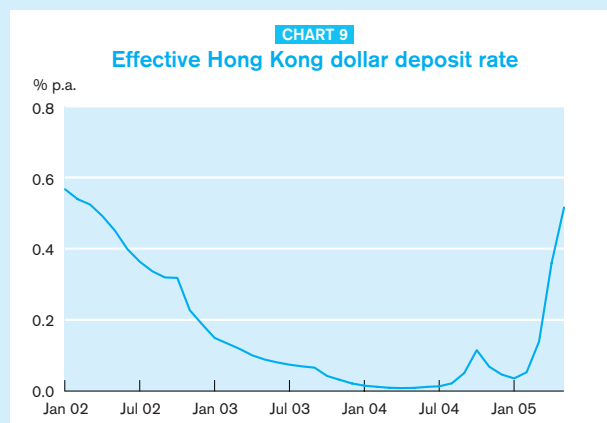
TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	31 May 05	20 Jun 05
3-month	56	-9	-22
1-year	21	-56	-62
3-year	3	-59	-57
5-year	27	-50	-54
10-year	54	-49	-53

The HKMA Base Rate remained unchanged at 4.50% (Chart 8). **Banks also kept their Best Lending Rates unchanged.**



The average one-month time deposit rate offered by major authorized institutions decreased from 1.103% to 1.081% during the period.² Meanwhile, the effective deposit rate increased from 0.36% to 0.51% in May (Chart 9).³



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, **decreased from HK\$281.19 billion to HK\$279.71 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

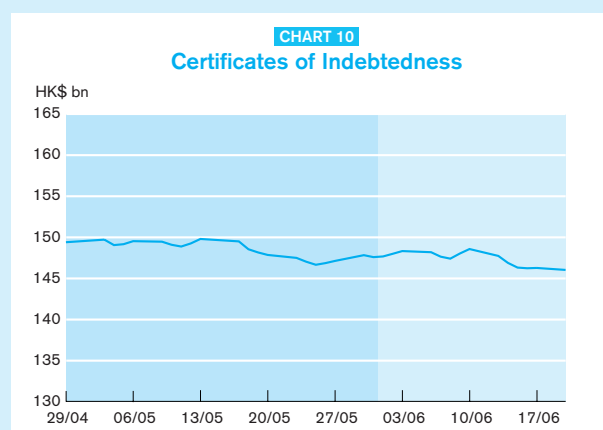
(HK\$ bn)	1 Jun 05	20 Jun 05
CIs	147.68	146.05
Government-issued Currency Notes and Coins in Circulation	6.84	6.81
Aggregate Balance	1.28	1.48
Outstanding EFBNs	125.40	125.38
Monetary Base	281.19	279.71

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.

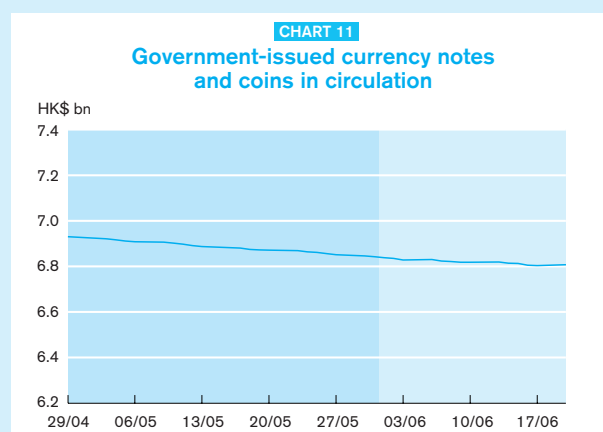
Certificates of Indebtedness

The three note-issuing banks redeemed HK\$1.63 billion of CIs to the HKMA in exchange for US\$0.21 billion during the period. Consequently, **the outstanding amount of CIs decreased from HK\$147.68 billion to HK\$146.05 billion** (Chart 10).



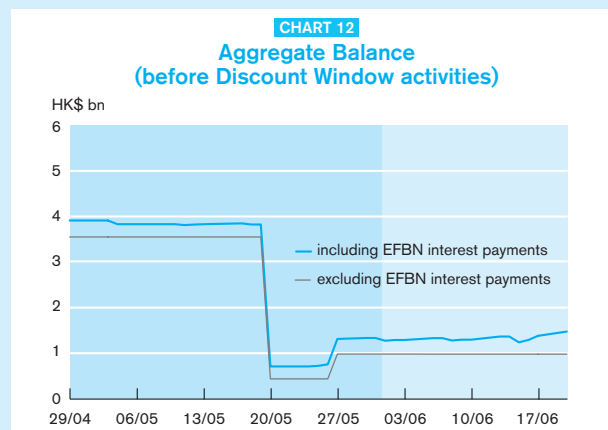
Government-issued currency notes and coins in circulation

Alongside the decrease in CIs, the total amount of **government-issued currency notes and coins in circulation declined from HK\$6.84 billion to HK\$6.81 billion** during the reporting period (Chart 11).



Aggregate Balance

The **Aggregate Balance** remained stable at around **HK\$1.48 billion**, with small fluctuations due to interest payments of Exchange Fund paper (Chart 12).



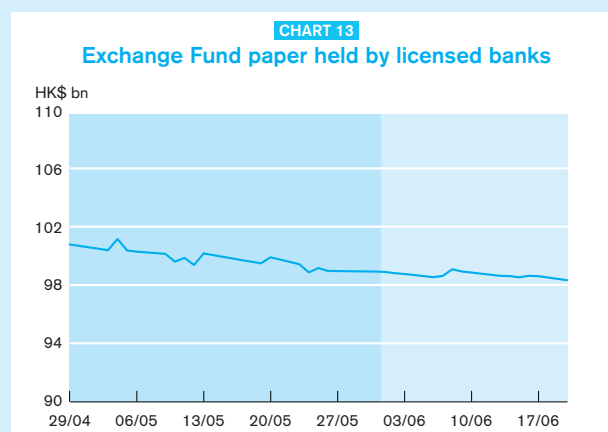
During the period, a **total of HK\$545.79 million of interest payments on Exchange Fund paper were made. An additional HK\$374.39 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. All issues of Exchange Fund paper were generally well received by the market (Table 3).

TABLE 3
Issuance of Exchange Fund Bills and Notes
(1 Jun – 20 Jun 05)

	No. of issues launched	Over-subscription ratio
3-month EFB	3	3.87-5.05
6-month EFB	1	5.41
1-year EFB	1	2.35
5-year EFN	1	1.70

Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund Bills and Notes declined slightly from **HK\$125.40 billion to HK\$125.38 billion**. Meanwhile, **holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased modestly** from **HK\$99.10 billion (79.02% of total) to HK\$98.52 billion (78.58% of total)** (Chart 13).



Discount Window activities

During the period, **23 banks borrowed a total of HK\$3.97 billion from the Discount Window**, compared with HK\$3.2 billion in the preceding period (Chart 14). All borrowings used Exchange Fund paper as collateral (Table 4).

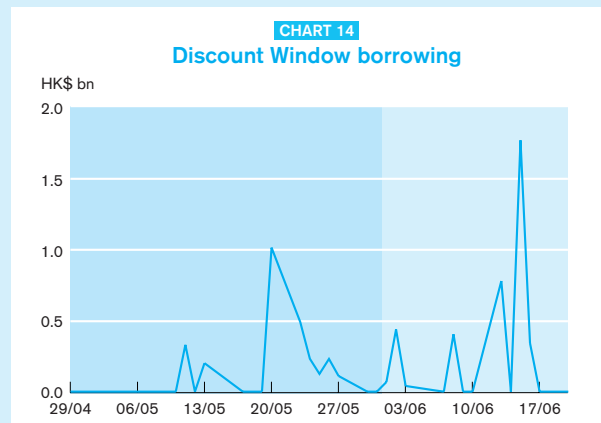


TABLE 4
Frequency of individual bank's access to the Discount Window
(1 Jun – 20 Jun 05)

Frequency of using Discount Window	No. of banks
1	19
2	3
5	1
Total	23

Backing Portfolio

Backing Assets decreased during the period, largely due to decreases in Certificates of Indebtedness. As Backing Assets fell proportionally less than the Monetary Base, **the Backing Ratio increased from 110.60% on 1 June to 110.64% on 20 June 2005** (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.

