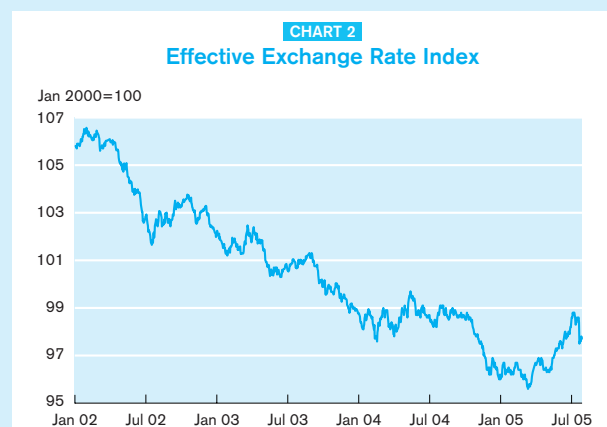
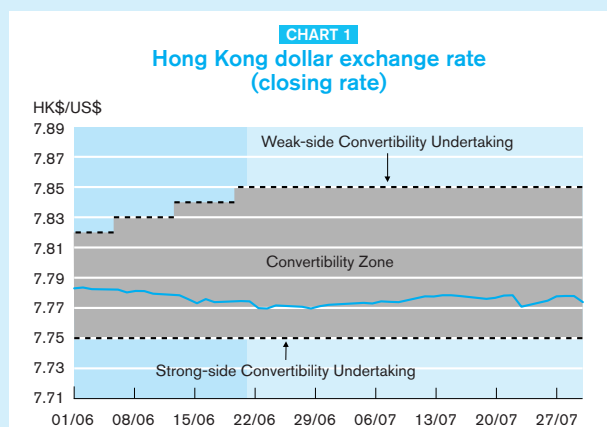


Report on Currency Board Operations (21 June – 29 July 2005)

Despite a change in the renminbi exchange rate regime, the Hong Kong dollar exchange rate was generally stable during the reporting period. Interbank interest rates rose. The Monetary Base decreased from HK\$279.30 billion to HK\$279.05 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.

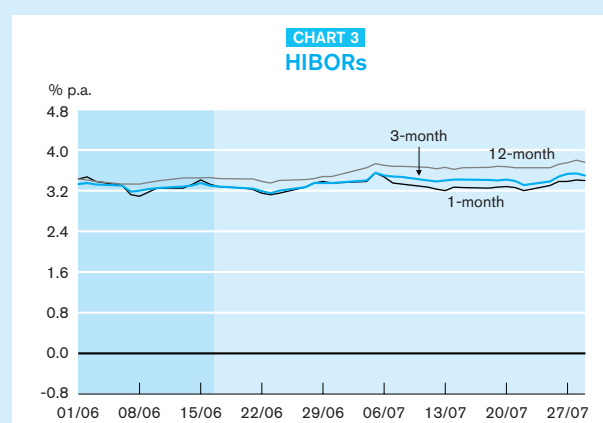
Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate was little changed in the early part of the report period. Following the announcement of a change in the renminbi exchange rate regime by the Mainland authorities, the Hong Kong dollar exchange rate immediately appreciated by 0.1% to close at 7.7709 on 22 July. However, the strengthening was not sustained and the market exchange rate softened to **close at 7.7739 at the end of the reporting period** (Chart 1). Separately, the effective exchange rate of the Hong Kong dollar eased slightly (Chart 2).

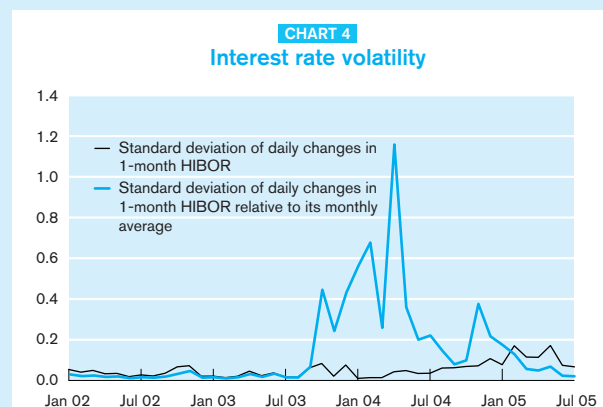


Interest rates

Hong Kong dollar interbank interest rates increased during the reporting period. The one-month and three-month HIBORs increased by 18 basis points and 26 basis points to close at 3.40% and 3.50% respectively. The 12-month HIBOR rose to close at 3.76% (Chart 3).

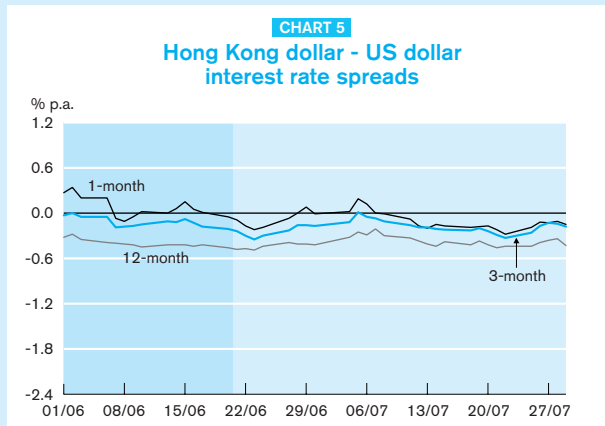


Interest rate volatility, as measured by the standard deviation of daily changes in one-month HIBOR, declined in July. The standard deviation as a ratio to the average level of one-month HIBOR also decreased (Chart 4).¹

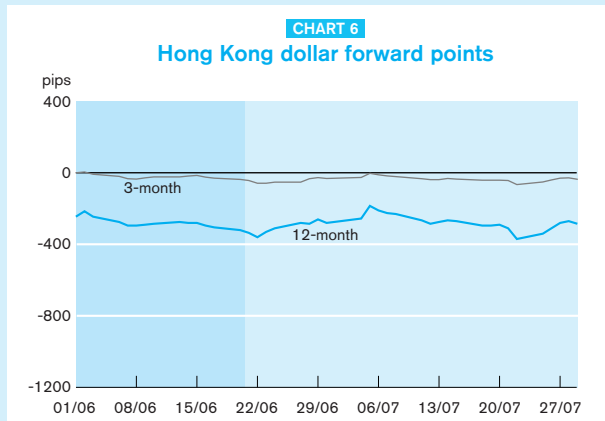


¹ The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

Hong Kong dollar interbank interest rates stayed below the corresponding US dollar rates. The negative one-month spread of Hong Kong dollar interest rate over the US dollar counterpart widened by 6 basis points to close at -15 basis points, while the three-month and 12-month spreads narrowed by 6 basis points and 5 basis points to close at -18 basis points and -43 basis points respectively (Chart 5).



Reflecting the movements in interest rate spreads, the **Hong Kong dollar 12-month forward discount narrowed by 50 pips to close at 285 pips.** The three-month forward discount narrowed by 7 pips to close at -36 pips (Chart 6).



Yields of Exchange Fund paper rose across the board during the period (Chart 7). The negative yield spreads against US Treasuries generally contracted (except for the 3-month maturity), with the five-year and 10-year spreads narrowing to -46 basis points and -44 basis points respectively at the end of the period (Table 1).

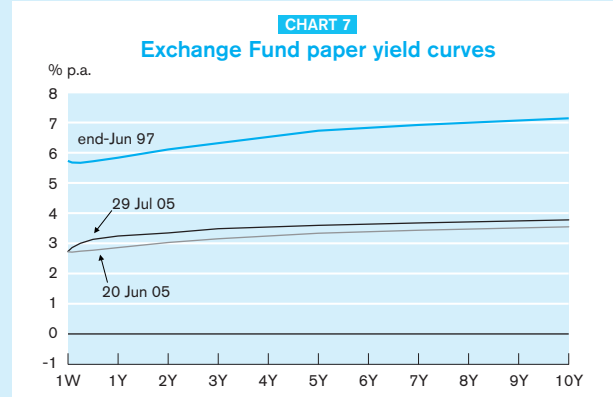
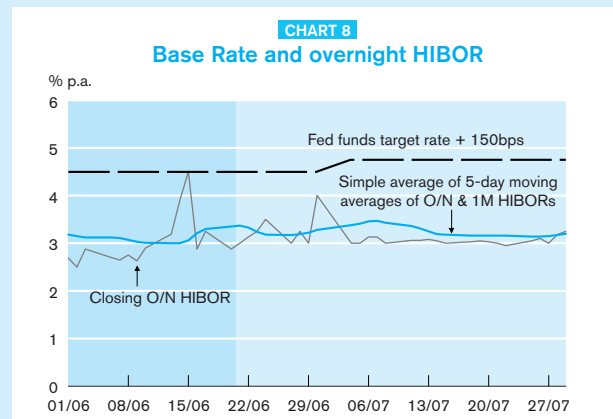


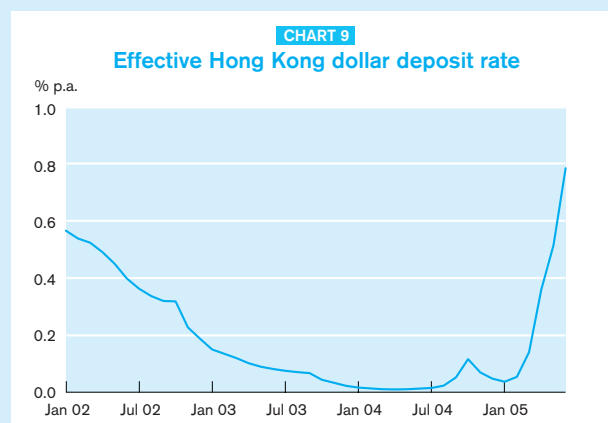
TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	20 Jun 05	29 Jul 05
3-month	56	-22	-41
1-year	21	-62	-59
3-year	3	-57	-52
5-year	27	-54	-46
10-year	54	-53	-44

Following a 25-basis-point rate hike in the US, **the HKMA Base Rate was adjusted upward by 25 basis points to 4.75% on 4 July** according to the established formula (Chart 8). **Banks subsequently raised their Best Lending Rates (BLRs) by 50 basis points to 6.25% on 5 July.** Some banks further increased their BLRs by another 25 basis points to 6.5% on 22 July.



The average one-month time deposit rate offered by major authorized institutions increased from 1.074% to 1.516% during the period.² The effective deposit rate rose from 0.51% to 0.78% in June (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\$279.30 billion to HK\$279.05 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

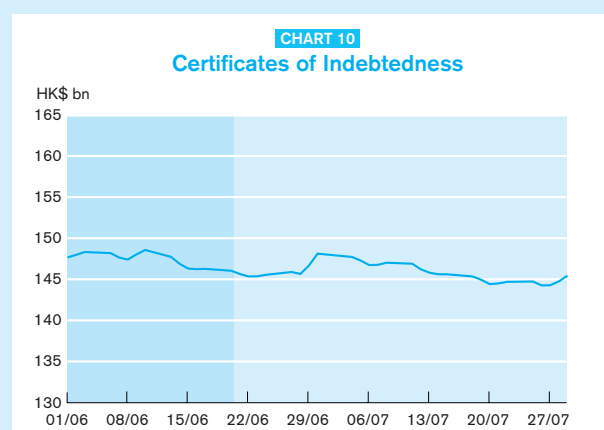
(HK\$ bn)	21 Jun 05	29 Jul 05
CIs	145.65	145.46
Government-issued Currency Notes and Coins in Circulation	6.80	6.77
Aggregate Balance	1.50	1.36
Outstanding EFBNs	125.35	125.47
Monetary Base	279.30	279.05

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.

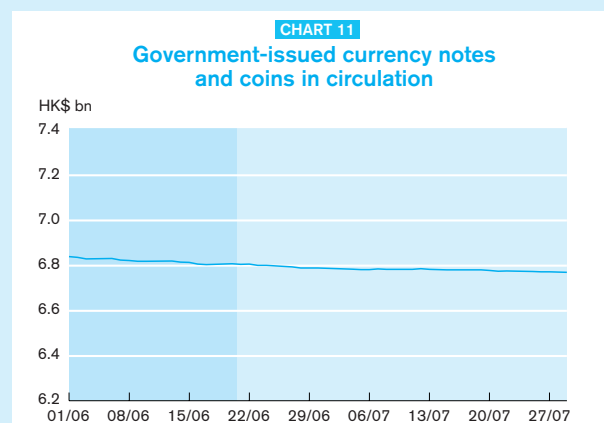
Certificates of Indebtedness

The three note-issuing banks redeemed HK\$190 million of CIs to the HKMA in exchange for US\$24.4 million during the period. As a result, **the outstanding amount of CIs decreased from HK\$145.65 billion to HK\$145.46 billion** (Chart 10).



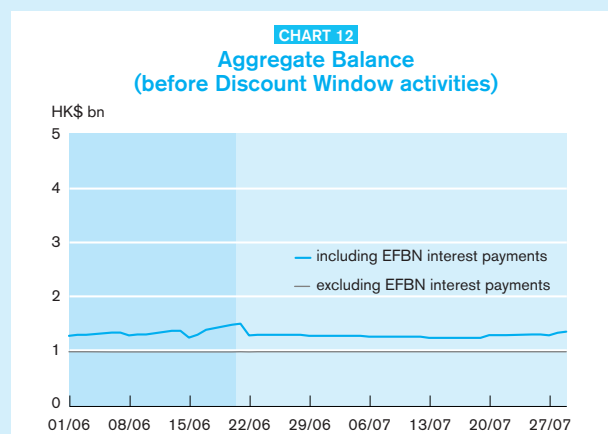
Government-issued currency notes and coins in circulation

Alongside the decline in CIs, the total amount of **government-issued currency notes and coins in circulation declined from HK\$6.80 billion to HK\$6.77 billion** during the reporting period (Chart 11).



Aggregate Balance

The **Aggregate Balance** remained stable at around **HK\$1.30 billion**, with small fluctuations due to interest payments on Exchange Fund paper (Chart 12).



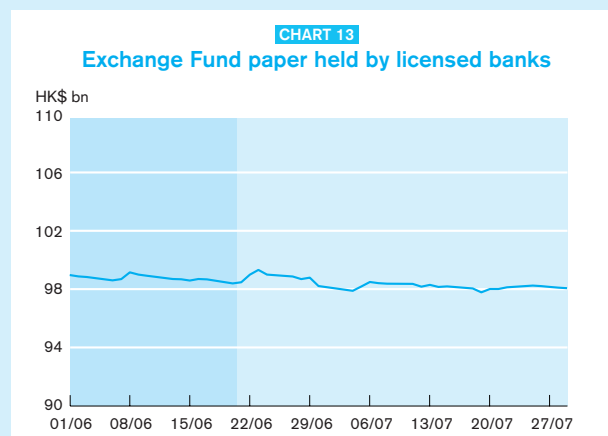
During the period, a total of **HK\$387.35 million of interest payments on Exchange Fund paper were made**. Taking into account interest payments carried forward from the last reporting period, **an additional HK\$512.44 million (in market value) of Exchange Fund paper was issued to absorb these interest payments**. Most issues of Exchange Fund paper were well received by the market (Table 3).

TABLE 3
Issuance of Exchange Fund Bills and Notes
(21 Jun – 29 Jul 05)

	No. of issues launched	Over-subscription ratio
3-month EFB	6	2.34-6.99
6-month EFB	3	2.62-5.98
1-year EFB	2	1.32-2.34
3-year EFN	1	0.43
10-year EFN	1	1.26

Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund Bills and Notes increased slightly from **HK\$125.35 billion to HK\$125.47 billion**. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased modestly from **HK\$98.60 billion (78.66% of total) to HK\$98.19 billion (78.26% of total)** (Chart 13).



Discount Window activities

During the period, **eleven banks borrowed a total of HK\$5.60 billion from the Discount Window**, compared with **HK\$3.97 billion** in the preceding period (Chart 14). All borrowings used Exchange Fund paper as collateral (Table 4).

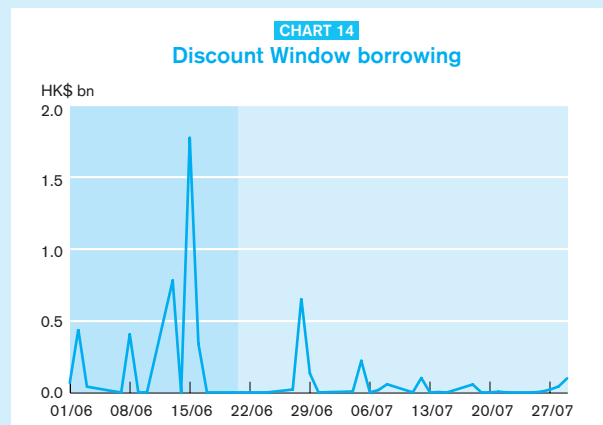
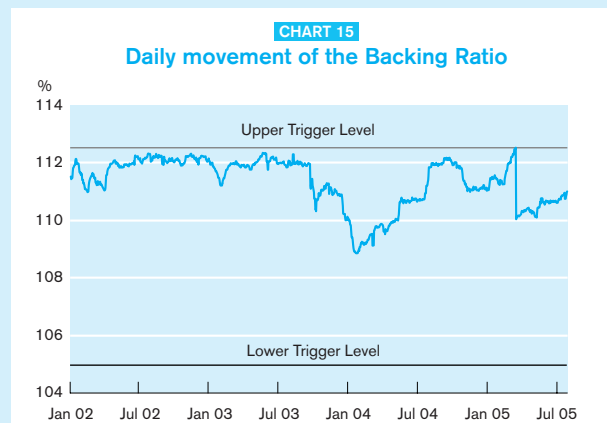


TABLE 4
Frequency of individual bank's access to the Discount Window
(21 Jun – 29 Jul 05)

Frequency of using Discount Window	No. of banks
1	6
2	4
6	1
Total	11

Backing Portfolio

Backing Assets increased during the period, largely reflecting valuation gains and interest income on investments, which more than offset the contraction in the Monetary Base. As a result, **the Backing Ratio increased from 110.67% on 21 June to 110.92% on 29 July 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 14 September 2005

(Approved for Issue by the Exchange Fund Advisory Committee on 29 September 2005)

Report on Currency Board Operations (30 July – 30 August 2005)

The Sub-Committee noted that the Hong Kong dollar exchange rate had strengthened slightly to close at 7.7707 at the end of the reporting period. Hong Kong dollar interbank interest rates had increased and continued to be close to but slightly below their US dollar counterparts. The Monetary Base had decreased from HK\$279.60 billion to HK\$277.91 billion, largely reflecting a decline in Certificates of Indebtedness. The Aggregate Balance had remained relatively stable at around HK\$1.3 billion.

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 the global economy had been resilient to higher oil prices with robust growth in the US and Mainland China. There were signs of increased economic activity in Europe and Japan following a slowed expansion in the second quarter. Global inflation had increased, mainly due to higher oil prices, but core inflation remained low. Members noted that the Hong Kong economy had gathered further momentum in the second quarter but that the pace of expansion was likely to moderate. Headline inflation had increased in recent months. The rise in interest rates had had some dampening effect on the property market.

Members noted a special analysis in the report which suggested that, if oil prices stayed at current levels for a sustained period or increased further, the impact on global growth and Hong Kong could be more significant than that seen so far.

Transferability between Certificates of Indebtedness and the Aggregate Balance

The Sub-Committee considered a paper outlining the arguments for and against introducing transferability between CIs and the Aggregate Balance. This subject had previously been raised in May and the HKMA had, on the advice of the Sub-Committee, undertaken to carry out further research into the implications of such a change. While noting that such an arrangement would bring some advantages in terms of tidying up the Currency Board system, Members advised that the system should remain unchanged for the time being but that the issue might be revisited at a future date.

The New Renminbi Exchange Rate Regime and Its Implications for Hong Kong

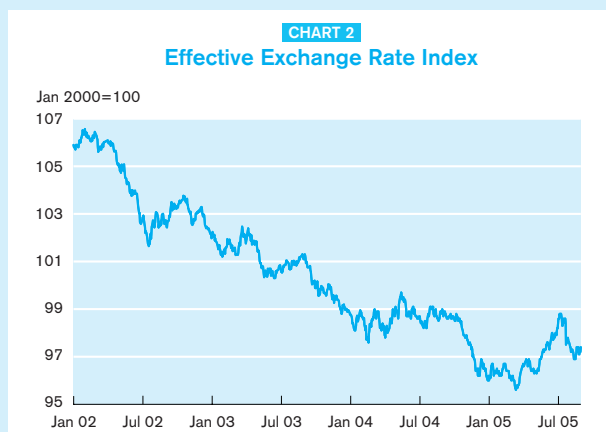
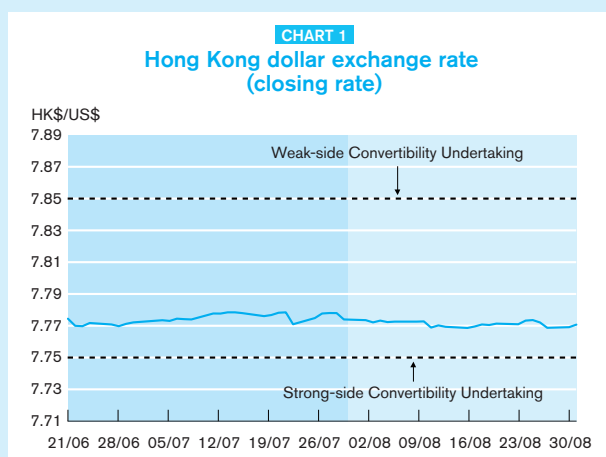
Members noted a report on the new renminbi exchange rate regime announced by the People's Bank of China on 21 July 2005 and its implications for Hong Kong. Developments so far indicated a relatively smooth transition to the new regime. The change to the new regime had not induced speculative inflows into the Hong Kong dollar, helped by the three refinements to the Linked Exchange Rate system which had better anchored exchange rate expectations on the strong side. Members noted that the revaluation of the renminbi was likely to have a limited impact on Hong Kong's output growth and inflation.

Annex Report on Currency Board Operations (30 July – 30 August 2005)

The Hong Kong dollar exchange rate strengthened modestly during the reporting period. Interbank interest rates rose. The Monetary Base decreased from HK\$279.60 billion to HK\$277.91 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

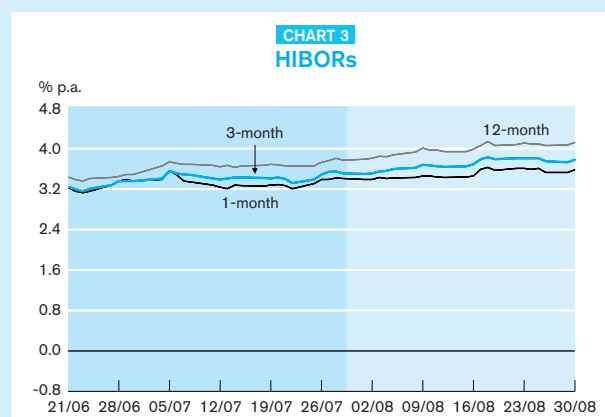
The Hong Kong dollar exchange rate strengthened slightly to close at 7.7707 at the end of the reporting period, reportedly associated with expectation of further renminbi appreciation. (Chart 1). The effective exchange rate of the Hong Kong dollar was little changed (Chart 2).



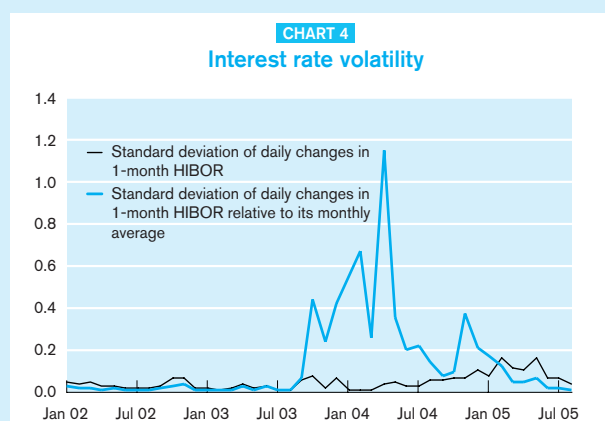
¹ The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

Interest rates

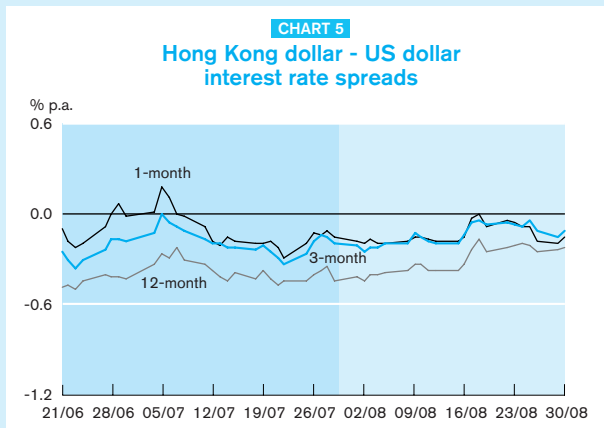
Hong Kong dollar interbank interest rates increased during the reporting period. The one-month and three-month HIBORs increased by 19 basis points and 28 basis points to close at 3.57% and 3.77% respectively. The 12-month HIBOR rose by 33 basis points to close at 4.11% (Chart 3).



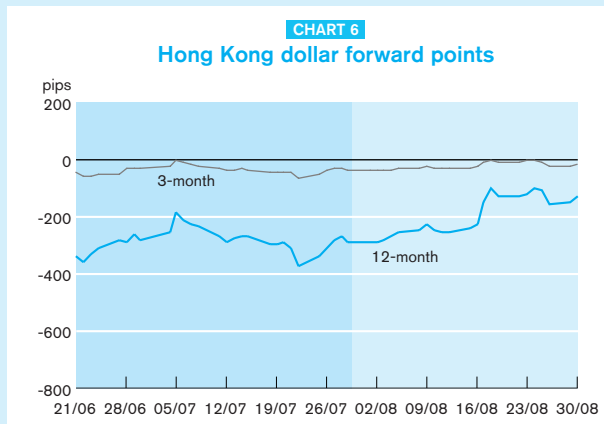
Interest rate volatility, as measured by the standard deviation of daily changes in one-month HIBOR, **declined** in August. The standard deviation as a ratio to the average level of one-month HIBOR also decreased (Chart 4).¹



Hong Kong dollar interbank interest rates continued to stay below the corresponding US dollar rates, but the gap narrowed somewhat. The negative spreads of 3-month and 12-month Hong Kong dollar interest rates over the US dollar counterparts contracted by 9 basis points and 19 basis points to close at -11 basis points and -22 basis points respectively (Chart 5).



Reflecting the movements in interest rate spreads, the **Hong Kong dollar 12-month forward discount narrowed by 160 pips to close at 130 pips.** The three-month forward discount narrowed by 19 pips to close at 19 pips (Chart 6).



Yields of Exchange Fund paper rose across the board during the period (Chart 7). The negative yield spreads against US Treasuries generally contracted (except for the three-month maturity), with the 5-year and 10-year spreads narrowing to -11 basis points and -4 basis points respectively at the end of the period (Table 1).

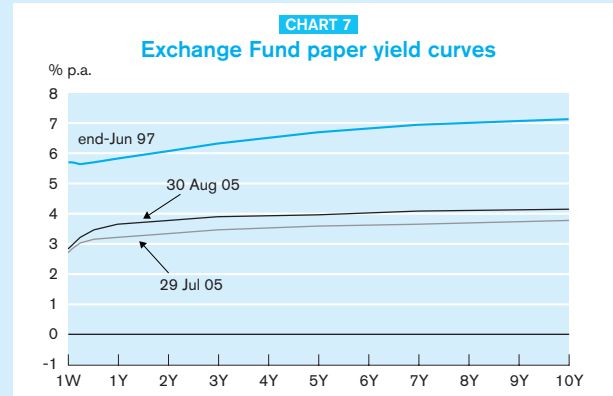
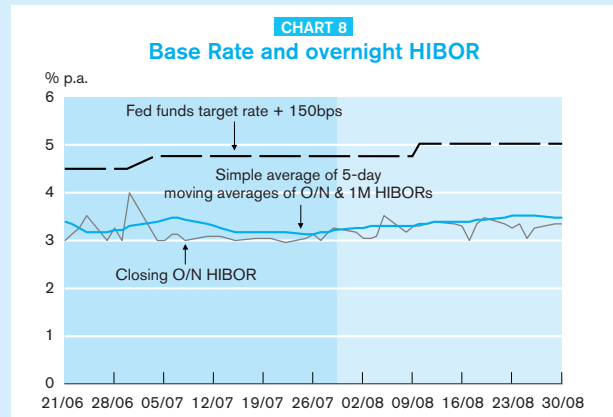


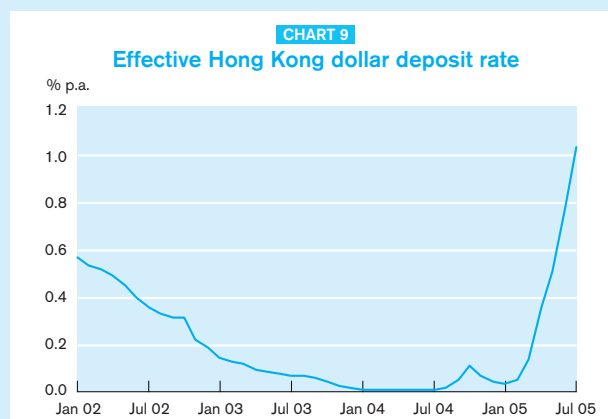
TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	29 Jul 05	30 Aug 05
3-month	56	-41	-43
1-year	21	-59	-35
3-year	3	-52	-21
5-year	27	-46	-11
10-year	54	-44	-4

Following a 25-basis-point increase in the US Fed funds target rate, **the HKMA Base Rate was adjusted upward by 25 basis points to 5.00% on 10 August** according to the established formula (Chart 8). **Banks raised their Best Lending Rates by the same magnitude to 6.75% on 11 August.**



The average one-month time deposit rate offered by major authorized institutions increased from 1.516% to 1.718% during the period.² The effective deposit rate rose from 0.78% to 1.03% in July (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\$279.60 billion to HK\$277.91 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

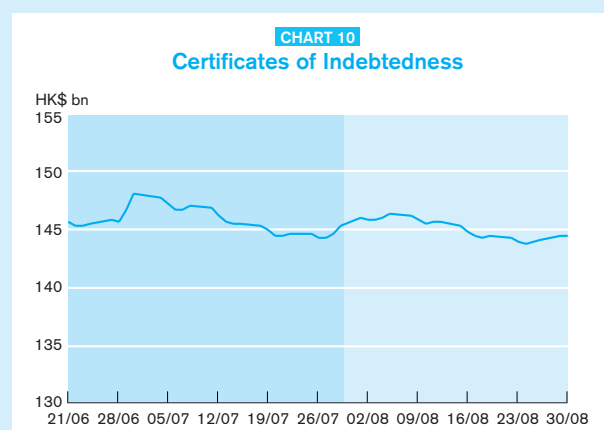
(HK\$ bn)	1 Aug 05	30 Aug 05
CIs	146.08	144.54
Government-issued Currency Notes and Coins in Circulation	6.77	6.76
Aggregate Balance	1.36	1.37
Outstanding EFBNs	125.40	125.25
Monetary Base	279.60	277.91

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.

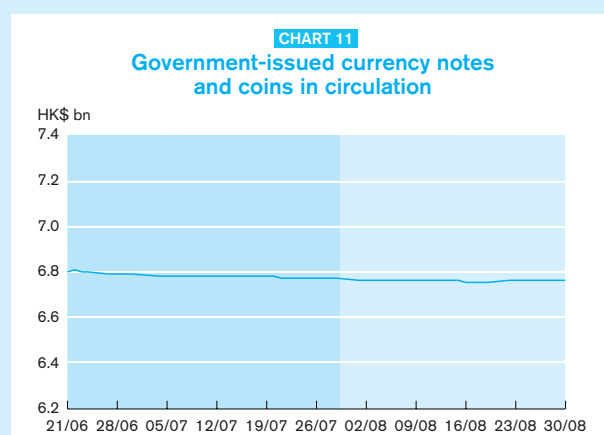
Certificates of Indebtedness

The three note-issuing banks redeemed HK\$1.54 billion of CIs to the HKMA in exchange for US\$197.4 million during the period. As a result, **the outstanding amount of CIs decreased from HK\$146.08 billion to HK\$144.54 billion** (Chart 10).



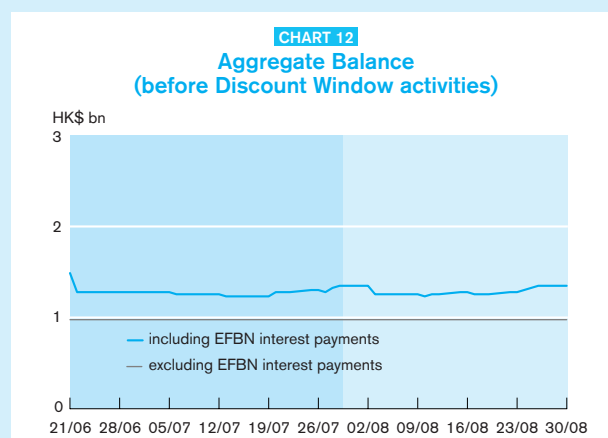
Government-issued currency notes and coins in circulation

The total amount of **government-issued currency notes and coins in circulation was little changed at around HK\$6.76 billion** during the reporting period (Chart 11).



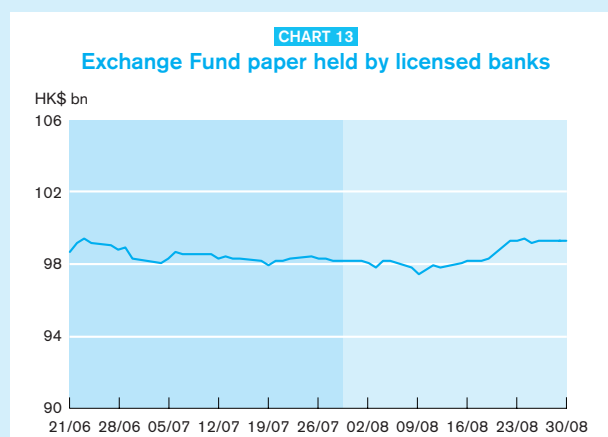
Aggregate Balance

The Aggregate Balance remained relatively stable at around HK\$1.30 billion, 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 decreased slightly from HK\$125.40 billion to HK\$125.25 billion. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased modestly from HK\$98.12 billion (78.25% of total) to HK\$99.27 billion (79.25% of total) (Chart 13).



During the period, **HK\$309.53 million of interest payments on Exchange Fund paper were made. An additional HK\$299.66 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. Most issues of Exchange Fund paper were well received by the market (Table 3).

TABLE 3
Issuance of Exchange Fund Bills and Notes
(30 Jul – 30 Aug 05)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	8.88
3-month EFB	4	2.38-3.77
6-month EFB	2	3.02-3.72
1-year EFB	1	2.63
2-year EFN	1	2.12
7-year EFN	1	0.66

Discount Window activities

During the period, **five banks borrowed a total of HK\$1.58 billion from the Discount Window**, compared with HK\$5.60 billion in the preceding period (Chart 14). All borrowings used Exchange Fund paper as collateral (Table 4).

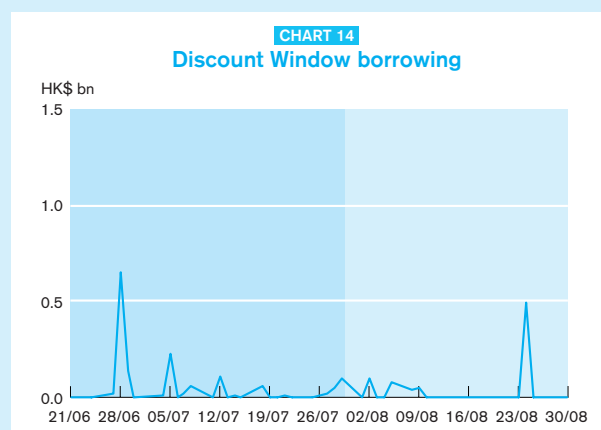
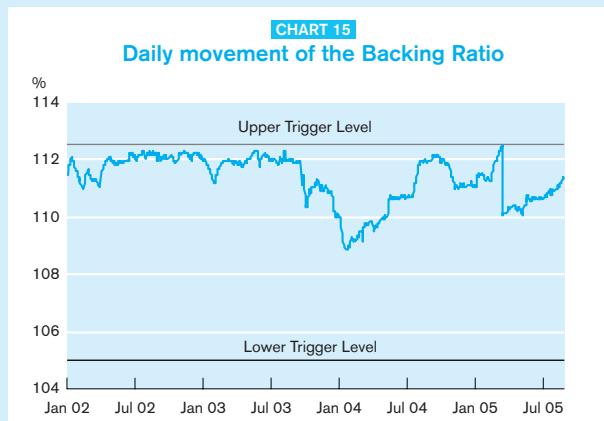


TABLE 4
Frequency of individual bank's access to the Discount Window
(30 Jul – 30 Aug 05)

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

Backing Portfolio

Backing Assets decreased alongside the contraction in the Monetary Base during the period. As the Backing Assets decreased proportionally less than the Monetary Base, **the Backing Ratio increased from 110.92% on 31 July to 111.26% on 30 August 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.

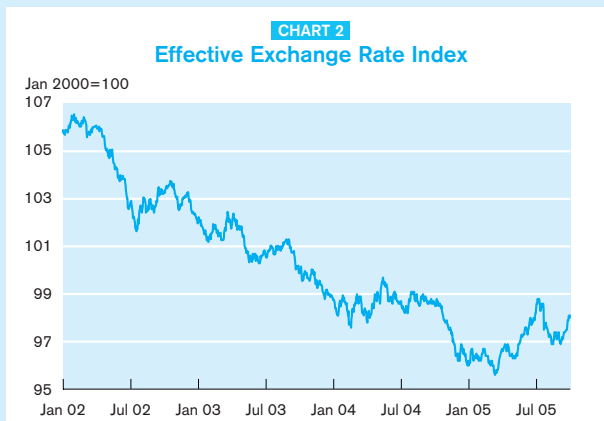
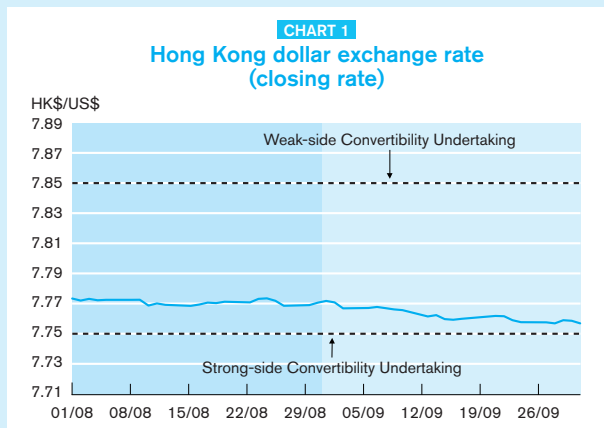


Report on Currency Board Operations (31 August – 30 September 2005)

The Hong Kong dollar exchange rate strengthened modestly during the reporting period. Interbank interest rates rose. The Monetary Base increased from HK\$277.94 billion to HK\$280.94 billion, largely reflecting an increase 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

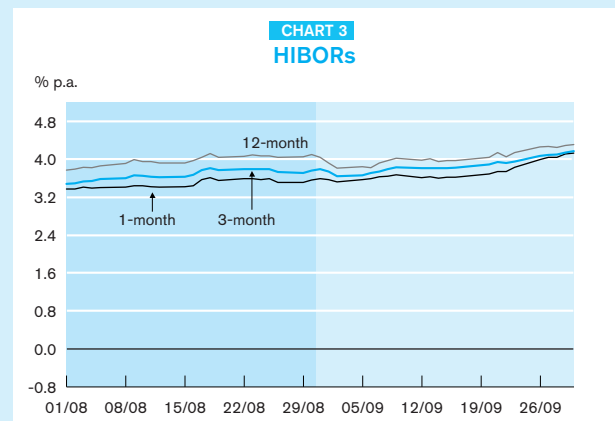
The Hong Kong dollar exchange rate continued to strengthen, closing at 7.7570 at the end of the reporting period (Chart 1). This reflected equity-related demand for Hong Kong dollars ahead of a number of initial public offerings. The effective exchange rate of the Hong Kong dollar rose, owing to a strengthening of the US dollar against other major currencies (Chart 2).



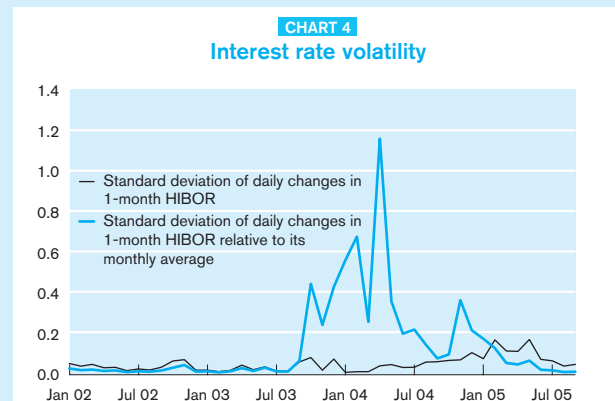
¹ The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

Interest rates

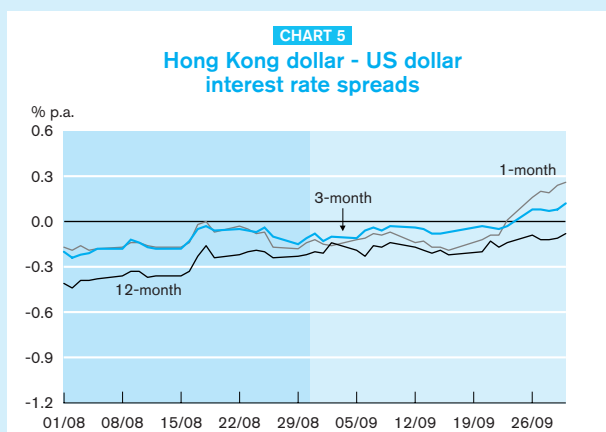
Hong Kong dollar interbank interest rates increased during the reporting period. The one-month and three-month HIBORs increased by 54 basis points and 38 basis points to close at 4.14% and 4.18% respectively. The 12-month HIBOR rose by 27 basis points to close at 4.32% (Chart 3).



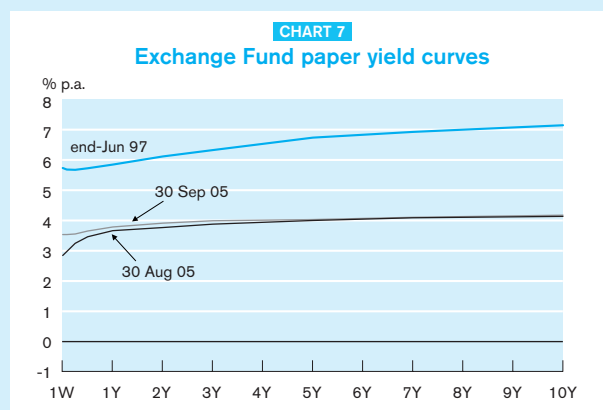
Interest rate volatility, as measured by the standard deviation of daily changes in one-month HIBOR, increased in September. The standard deviation as a ratio to the average level of one-month HIBOR also increased slightly (Chart 4).¹



As **Hong Kong dollar interbank interest rates rose by more than the corresponding US dollar rates**, short-term interest rate spreads turned positive during the reporting period. The three-month spread increased by 20 basis points to close at 12 basis points, while the 12-month spread rose by 12 basis points to close at -8 basis points (Chart 5).



Yields of Exchange Fund paper rose across the board during the period (Chart 7). The negative yield spreads against US Treasuries generally increased at the long end but fell at the short end. In particular, the five-year and 10-year spreads widened to -16 basis points and -19 basis points respectively at the end of the period (Table 1).



Reflecting the movements in interest rate spread, the **Hong Kong dollar 12-month forward discount narrowed by 30 pips to close at 80 pips**. The three-month forward points turned from a discount to a premium and closed at 25 pips (Chart 6).

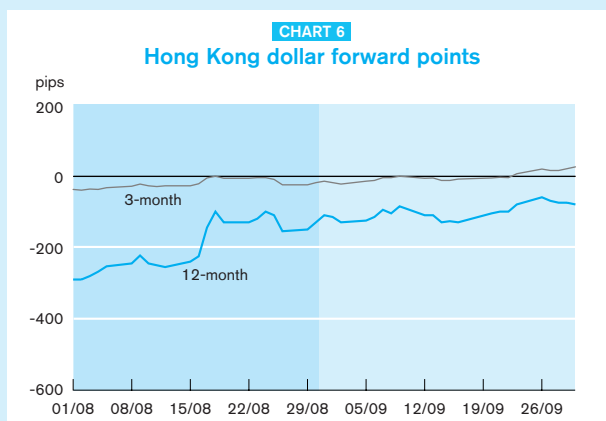
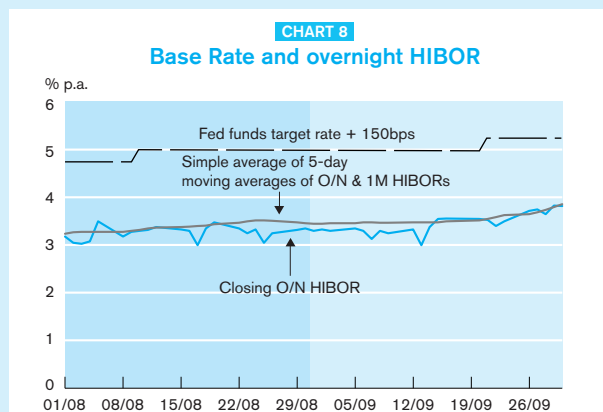


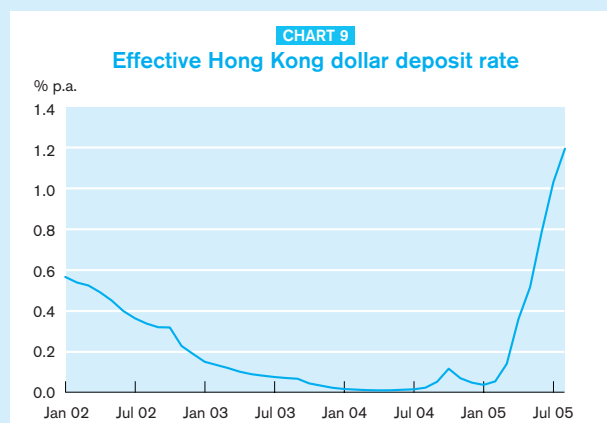
TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	27 Jun 97	30 Aug 05	30 Sep 05
3-month	56	-43	0
1-year	21	-35	-32
3-year	3	-21	-20
5-year	27	-11	-16
10-year	54	-4	-19

Following a 25-basis-point increase in the US Fed funds target rate, **the HKMA Base Rate was adjusted upward by 25 basis points to 5.25% on 21 September** according to the established formula (Chart 8). Benchmark commercial lending rates offered by banks continued to diverge, with **banks raising their Best Lending Rates by 25 or 50 basis points to either 7% or 7.25% on 22 September**.



The average one-month time deposit rate offered by major authorized institutions increased from 1.732% to 2.115% during the period.² The effective deposit rate rose from 1.03% to 1.20% in August (Chart 9).³



Monetary Base

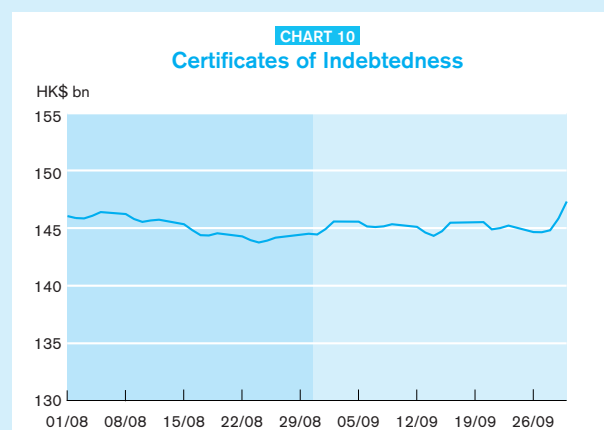
The **Monetary Base**, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance, and Exchange Fund Bills and Notes, **increased from HK\$277.94 billion to HK\$280.94 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	31 Aug 05	30 Sep 05
CIs	144.47	147.35
Government-issued Currency Notes and Coins in Circulation	6.76	6.76
Aggregate Balance	1.28	1.28
Outstanding EFBNs	125.44	125.55
Monetary Base	277.94	280.94

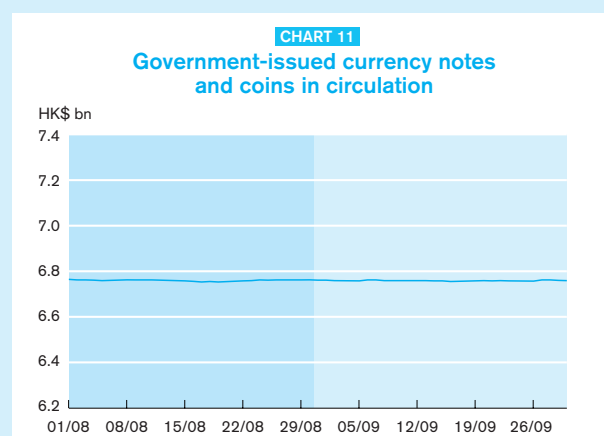
Certificates of Indebtedness

The three note-issuing banks submitted to the HKMA US\$369 million in exchange for HK\$2.88 billion worth of CIs. As a result, **the outstanding amount of CIs increased from HK\$144.47 billion to HK\$147.35 billion** (Chart 10).



Government-issued currency notes and coins in circulation

The total amount of **government-issued currency notes and coins in circulation was little changed at around HK\$6.76 billion** during the reporting period (Chart 11).

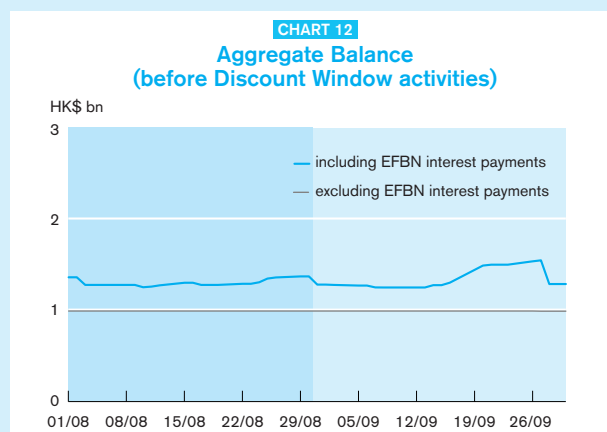


² The figures refer to the average of interest rates offered by the major authorized institutions for one-month time deposits of less than HK\$100,000.

³ This is the average of the interest rates on demand, savings and time deposits. As the banking statistics classify deposits by remaining maturities, we have made certain assumptions regarding the maturity distribution in computing the effective deposit rate.

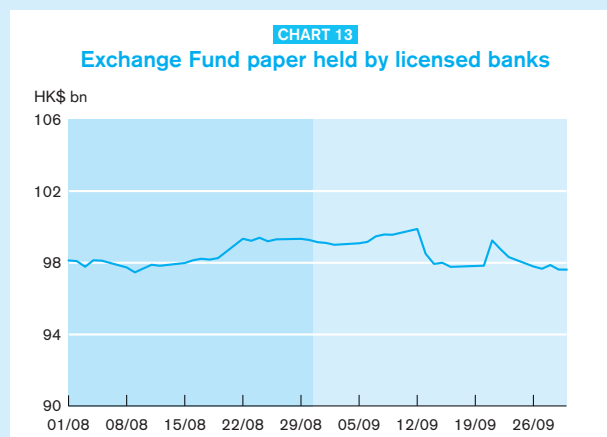
Aggregate Balance

The **Aggregate Balance** remained relatively stable at around **HK\$1.30 billion**, 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 slightly from **HK\$125.44 billion** to **HK\$125.55 billion**. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased modestly from **HK\$99.14 billion** (79.04% of total) to **HK\$97.61 billion** (77.75% of total) (Chart 13).



During the period, **HK\$504.87 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\$570.16 million (in market value) of Exchange Fund paper was issued to absorb these interest payments**. Most issues of Exchange Fund paper were well received by the market (Table 3).

TABLE 3
Issuance of Exchange Fund Bills and Notes
(31 Aug – 30 Sep 05)

	No. of issues launched	Over-subscription ratio
3-month EFB	5	1.52-2.59
6-month EFB	3	1.92-4.50
1-year EFB	1	2.01
5-year EFN	1	0.90

Discount Window activities

During the period, **eight banks borrowed a total of HK\$1.18 billion from the Discount Window**, compared with **HK\$1.58 billion** in the preceding period (Chart 14). All borrowings used Exchange Fund paper as collateral (Table 4).

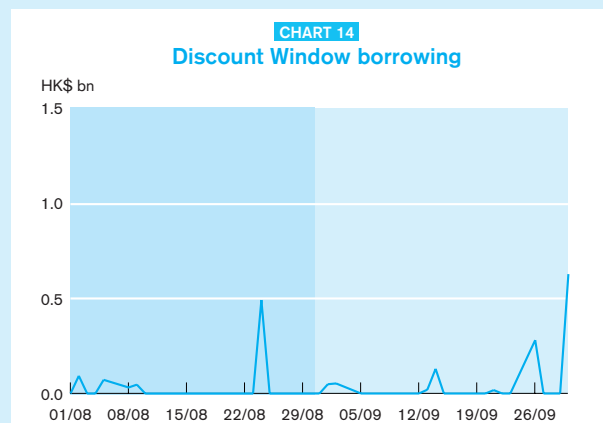


TABLE 4
Frequency of individual bank's access to the Discount Window
(31 Aug – 30 Sep 05)

Frequency of using Discount Window	No. of banks
1	7
2	1
Total	8

Backing Portfolio

Backing Assets increased during the period, largely due to increases in Certificates of Indebtedness. As the Backing Assets increased proportionally less than the Monetary Base, **the Backing Ratio decreased from 111.35% on 31 August to 111.20% on 30 September 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.

