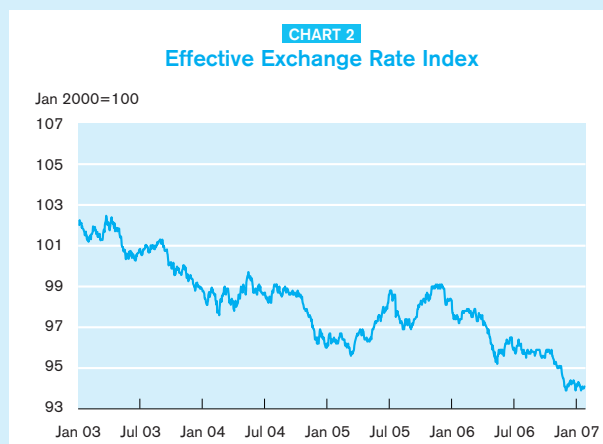
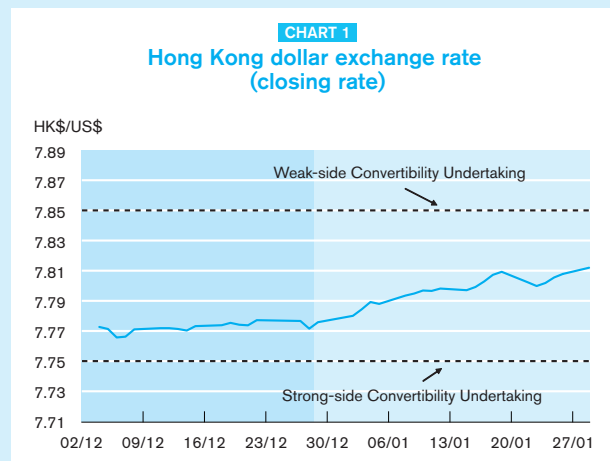


## Report on Currency Board Operations (29 December 2006 – 29 January 2007)

The Hong Kong dollar weakened notably against the US dollar despite continuous appreciation of the renminbi during the reporting period. Interbank interest rates increased, while their negative spreads against US dollar interest rates narrowed. The Monetary Base rose from HK\$296.25 billion to HK\$298.55 billion. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

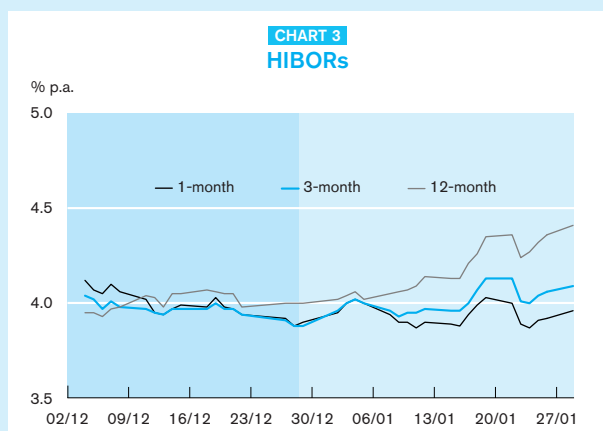
### Hong Kong dollar exchange rate

**The Hong Kong dollar weakened notably against the US dollar** during the review period, partly reflecting arbitrage buying of the US dollar (Chart 1). When the renminbi appreciated to surpass the Hong Kong dollar spot exchange rate on 11 January, there was no significant impact on the Hong Kong dollar. The divergence of the renminbi and Hong Kong dollar spot exchange rates suggested that traders have abandoned using the Hong Kong dollar as a proxy for the renminbi. Meanwhile, the effective exchange rate index of the Hong Kong dollar fluctuated within a narrow range (Chart 2).

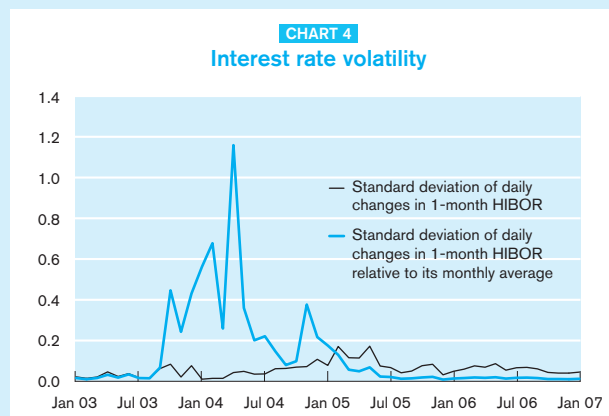


### Interest rates

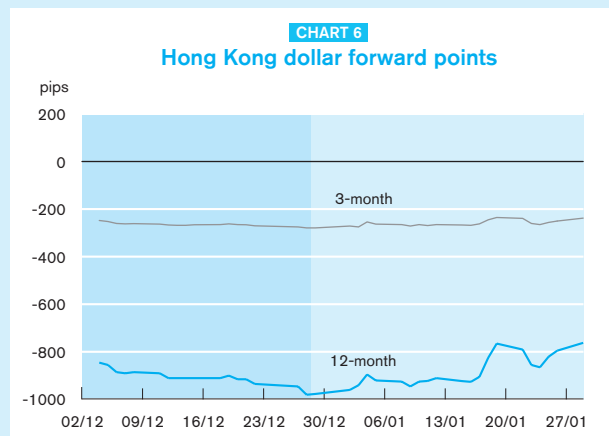
**Hong Kong dollar interbank interest rates increased** during the reporting period. The one-month and three-month HIBORs increased by six and 21 basis points to close at 3.96% and 4.09% respectively. The 12-month HIBOR rose by 41 basis points to close at 4.41% (Chart 3).



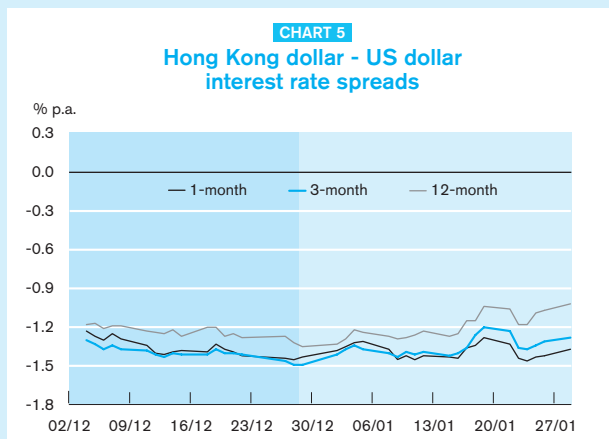
**Interest rate volatility**, measured by the standard deviation of daily changes in one-month HIBOR, **increased slightly** in January. The standard deviation as a ratio of the average level of one-month HIBOR was little changed (Chart 4).<sup>1</sup>



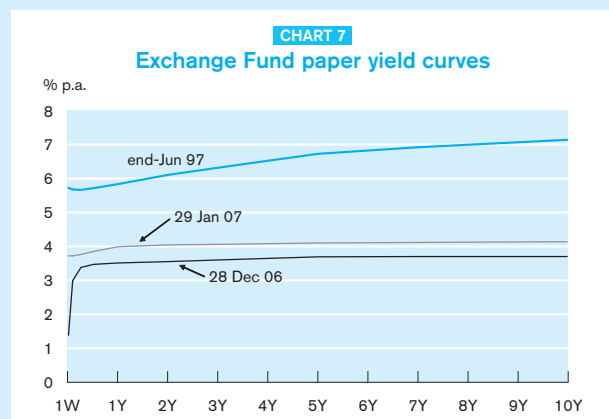
Reflecting the movements in the interest rate spreads, the **Hong Kong dollar three-month and 12-month forward discounts declined** by 41 and 215 pips to close at 238 and 762 pips respectively (Chart 6).



**Negative spreads of Hong Kong dollar interest rates against their US dollar counterparts narrowed.** The one-month and three-month negative interest rate spreads decreased by six and 21 basis points to -137 and -128 basis points respectively, while the 12-month negative spread declined by 33 basis points to -102 basis points (Chart 5).



**Yields of Exchange Fund paper increased during the period** (Chart 7). The yields rose notably for the one-week and one-month tenors. The negative yield spreads against US Treasuries narrowed across the board. In particular, the one-year negative spreads narrowed by 37 basis points to -118 basis points, while the three-year and 10-year negative spreads decreased by 26 and 21 basis points to -96 and -79 basis points respectively at the end of the period (Table 1).

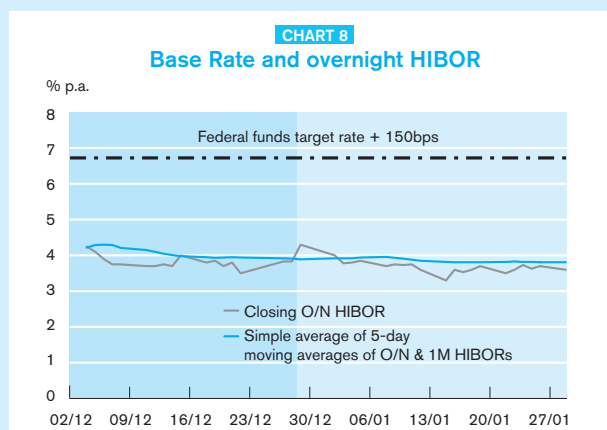


**TABLE 1**  
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

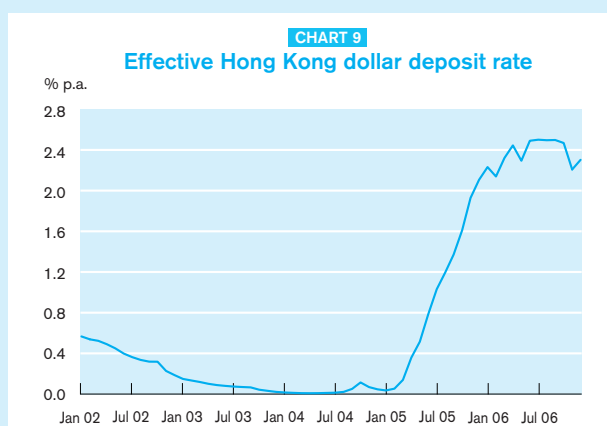
|         | 27 Jun 97 | 28 Dec 06 | 29 Jan 07 |
|---------|-----------|-----------|-----------|
| 3-month | 56        | -166      | -144      |
| 1-year  | 21        | -155      | -118      |
| 3-year  | 3         | -122      | -96       |
| 5-year  | 27        | -100      | -81       |
| 10-year | 54        | -100      | -79       |

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

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



The average one-month time deposit rate offered by major authorized institutions rose slightly from 2.519% to 2.524% during the period.<sup>2</sup> The effective deposit rate increased from 2.21% in November to 2.30% in December (Chart 9).<sup>3</sup> The composite interest rate, which reflects the average cost of funds of banks, declined by 16 basis points from 3.02% at the end of November to 2.86% at the end of December.<sup>4</sup>



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

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

## Monetary Base

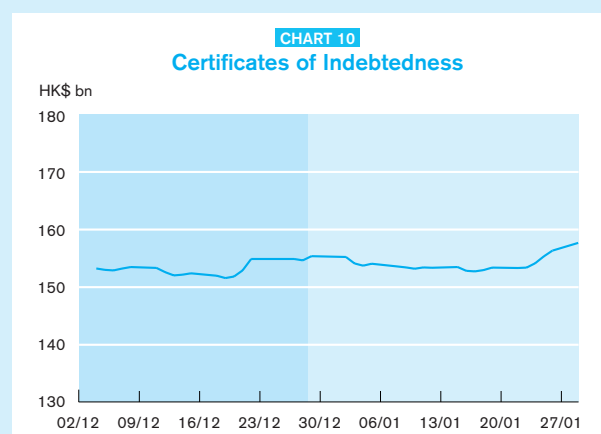
The Monetary Base, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, increased from HK\$296.25 billion to HK\$298.55 billion during the reporting period (Table 2). Movements in the individual components are discussed below.

**TABLE 2**  
Monetary Base

| (HK\$ bn)   | 29 Dec 06     | 29 Jan 07     |
|---|---------------|---------------|
| CIs   | 155.40        | 157.70        |
| Government-issued Currency Notes and Coins in Circulation | 7.12          | 7.52          |
| Aggregate Balance   | 1.31          | 1.31          |
| Outstanding EFBNs   | 132.44        | 132.02        |
| <b>Monetary Base</b>                                      | <b>296.25</b> | <b>298.55</b> |

## Certificates of Indebtedness

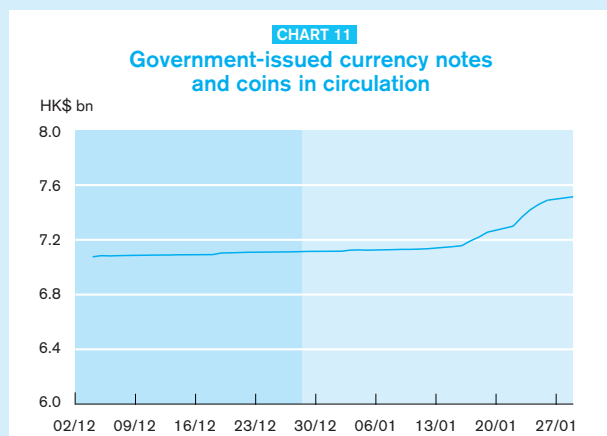
During the reporting period, the three note-issuing banks submitted a total of US\$294.87 million to the HKMA in exchange for HK\$2.30 billion worth of CIs. As a result, the outstanding CIs rose from HK\$155.40 billion to HK\$157.70 billion (Chart 10).



<sup>4</sup> This is a weighted average interest rate of all Hong Kong dollar interest bearing liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and Hong Kong dollar non-interest bearing demand deposits on the books of banks. Data from retail banks, which account for about 90% of the total customers' deposits in the banking sector, are used in the calculation.

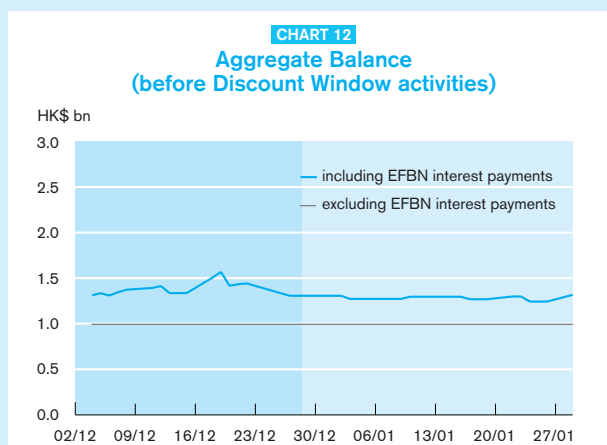
### Government-issued currency notes and coins in circulation

The total of **government-issued currency notes and coins in circulation increased from HK\$7.12 billion to HK\$7.52 billion** during the reporting period (Chart 11).



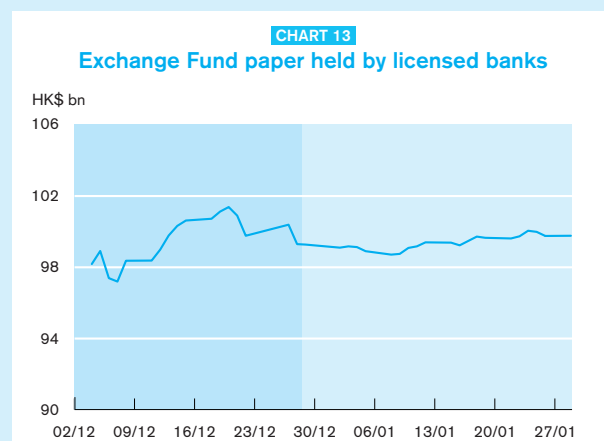
### Aggregate Balance

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



### Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund Bills and Notes declined from HK\$132.44 billion to HK\$132.02 billion. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased moderately from HK\$99.26 billion (74.95% of total) to HK\$99.76 billion (75.56% of total) (Chart 13).



During the period, **a total of HK\$271.18 million of interest payments on Exchange Fund paper were made. An additional HK\$262.64 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were well received by the market (Table 3).

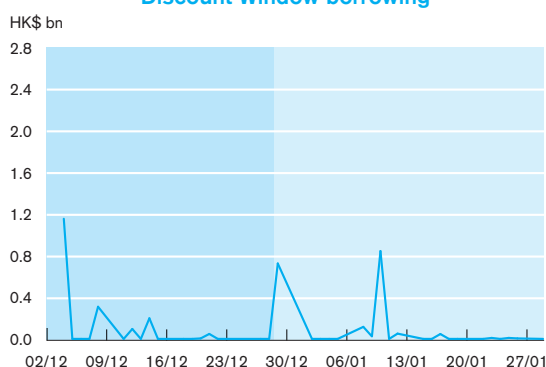
**TABLE 3**  
Issuance of Exchange Fund Bills and Notes (12 Dec 06 – 29 Jan 07)

|              | No. of issues launched | Over-subscription ratio |
|--------------|------------------------|-------------------------|
| 1-month EFB  | 1                      | 2.33                    |
| 3-month EFB  | 4                      | 3.86-7.92               |
| 6-month EFB  | 2                      | 1.54-3.54               |
| 12-month EFB | 1                      | 3.25                    |

## Discount Window activities

During the period, **11 banks borrowed a total of HK\$1.84 billion from the Discount Window**, compared with a total of HK\$1.82 billion in the preceding period (Chart 14 and Table 4). There were two occasions on which banks borrowed an amount exceeding 50% of their holdings of Exchange Fund paper. The borrowing by the two banks, amounting to a total of HK\$103 million, was charged at the penal rate, currently being the Base Rate plus five per cent. All borrowings used Exchange Fund paper as collateral.

**CHART 14**  
Discount Window borrowing



**TABLE 4**  
Frequency of individual bank's access to the Discount Window (29 Dec 06 – 29 Jan 07)

| Frequency of using Discount Window | No. of banks |
|------------------------------------|--------------|
| 1                                  | 10           |
| 2                                  | 1            |
| Total                              | 11           |

## Backing Portfolio

The Monetary Base decreased in the early part of the reporting period, mainly attributable to a decline in CIs. As the Backing Assets increased but the Monetary Base decreased, **the Backing Ratio rose from 111.72% on 29 December 2006 to 112.61% on 21 January 2007, surpassing the Upper Trigger Level of 112.5%. Pursuant to the arrangement approved by the Financial Secretary in January 2000, assets were transferred out of the Backing Portfolio to reduce the Backing Ratio to around 110% on 22 January** (Chart 15). Thereafter, the Backing Ratio moved steadily and closed at 109.75% at the end of the period. 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

