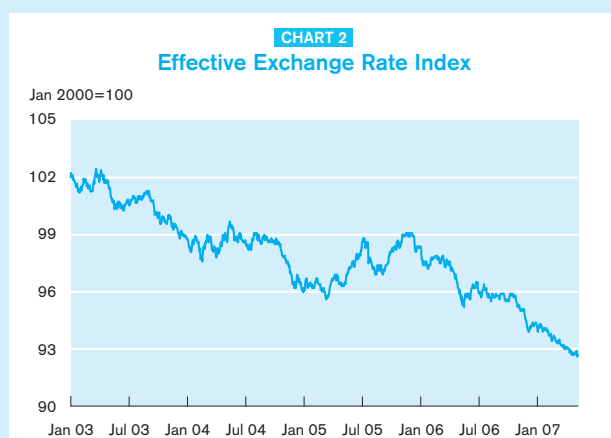
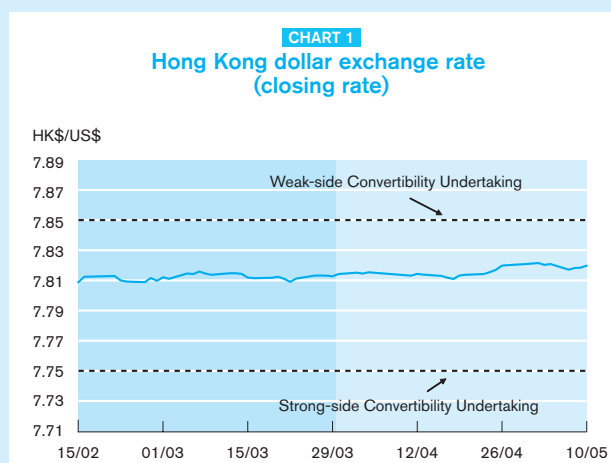


Annex Report on Currency Board Operations (30 March – 10 May 2007)

The Hong Kong dollar exchange rate weakened moderately during the reporting period. Interbank interest rates rose and their negative spreads against US dollar interest rates narrowed. The Monetary Base declined from HK\$298.48 billion to HK\$296.79 billion. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

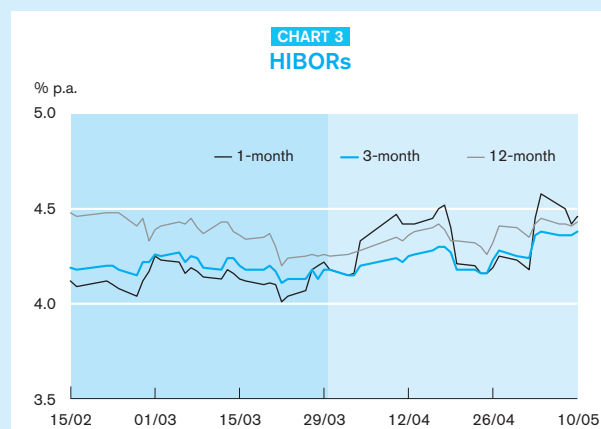
Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate softened moderately from 7.8147 to 7.8203 during the review period, reportedly because of interest rate arbitrage activities (Chart 1). Meanwhile, the effective exchange rate index of the Hong Kong dollar decreased from 93.1 to 92.7, as the US dollar weakened against other major currencies (Chart 2).

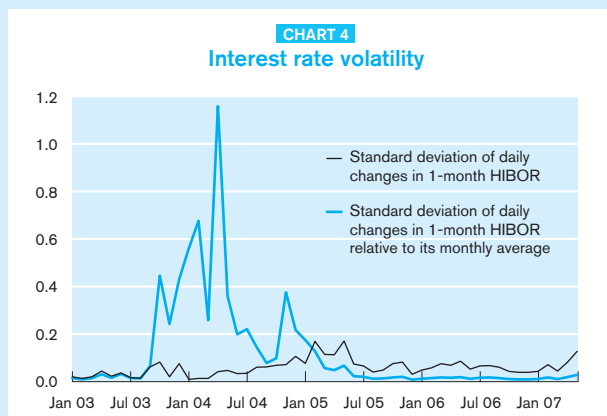


Interest rates

Hong Kong dollar interbank interest rates increased during the reporting period. The one-month HIBOR fluctuated between 4.15% and 4.58% mainly due to the equity initial public offerings activities. It gradually increased towards the end of the review period to close at 4.46%. Meanwhile, the three-month and 12-month HIBORs rose by 20 and 18 basis points to close at 4.38% and 4.43% respectively (Chart 3).

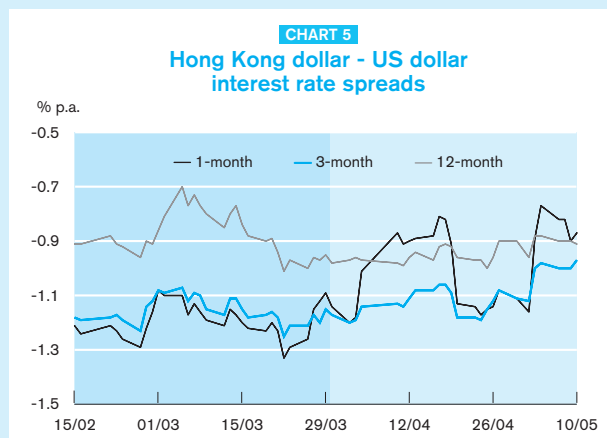


Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, **rose** during the reporting period. The standard deviation as a ratio of the average level of one-month HIBOR also increased (Chart 4).¹

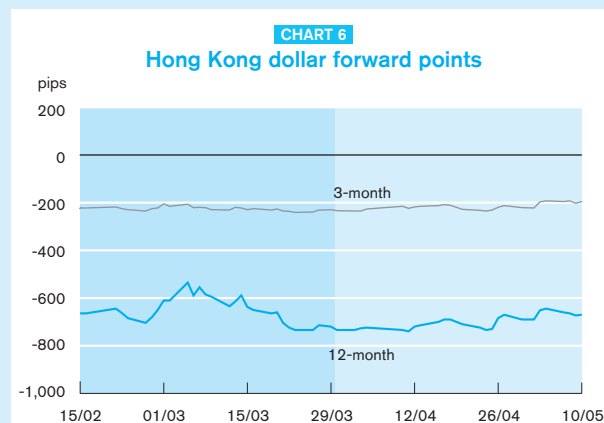


The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts narrowed.

The one-month and three-month negative interest rate spreads decreased by 27 and 20 basis points to -87 and -97 basis points respectively, while the 12-month negative spread declined modestly by seven basis points to -91 basis points (Chart 5).



The Hong Kong dollar three-month and 12-month forward discounts decreased by 38 and 65 pips to close at 195 and 670 pips respectively, in line with the movements in the interest rate spreads (Chart 6).



Yields of Exchange Fund paper increased across the board during the period (Chart 7).

The negative yield spreads against US Treasuries narrowed. In particular, the three-month negative spread narrowed by 43 basis points to -115 basis points, while the ten-year negative spread decreased by 12 basis points to -43 basis points at the end of the period (Table 1).

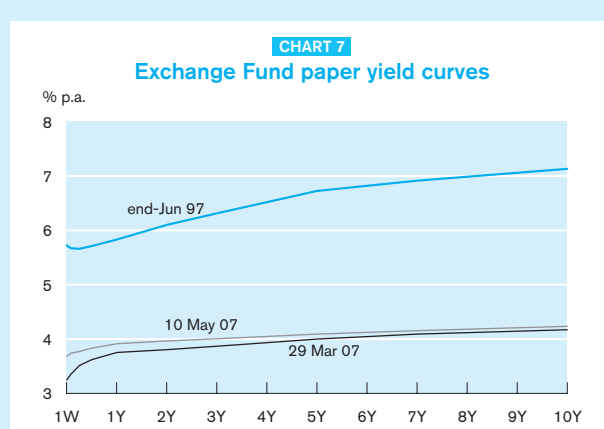
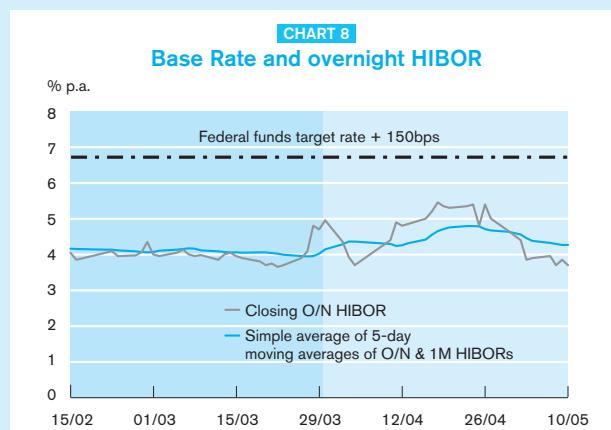


TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

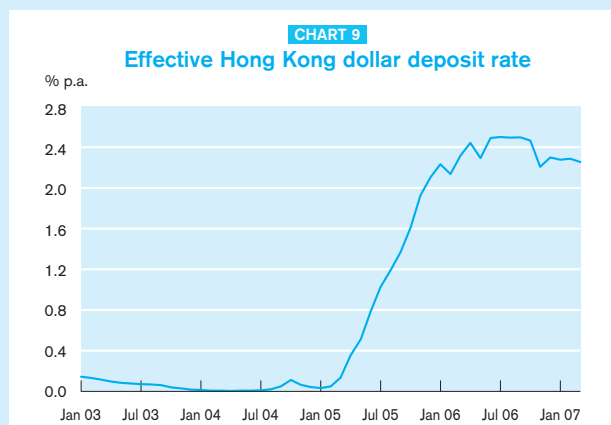
	27 Jun 97	29 Mar 07	10 May 07
3-month	56	-158	-115
1-year	21	-114	-108
3-year	3	-69	-69
5-year	27	-54	-54
10-year	54	-55	-43

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.

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



The average one-month time deposit rate offered by major authorized institutions rose moderately from 2.519% to 2.541% during the reporting period.² The effective deposit rate declined from 2.29% in February to 2.25% in March (Chart 9).³ The composite interest rate, which reflects the average cost of funds of banks, rose by seven basis points from 2.93% at the end of February to 3.00% at the end of March.⁴



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.

Monetary Base

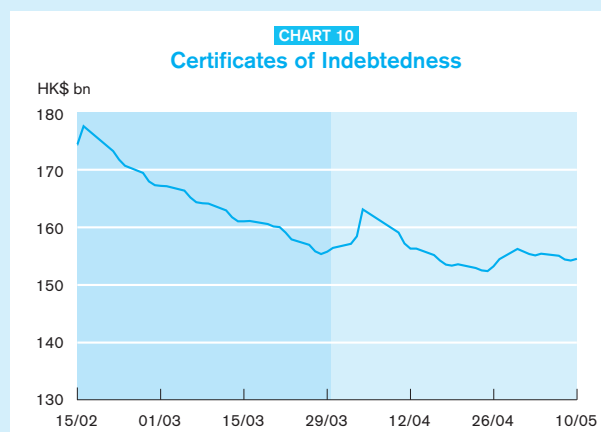
The Monetary Base, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, declined slightly from HK\$298.48 billion to HK\$296.79 billion during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	30 Mar 07	10 May 07
CIs	156.44	154.55
Government-issued Currency Notes and Coins in Circulation	7.62	7.48
Aggregate Balance	1.31	1.28
Outstanding EFBNs	133.12	133.49
Monetary Base	298.48	296.79

Certificates of Indebtedness

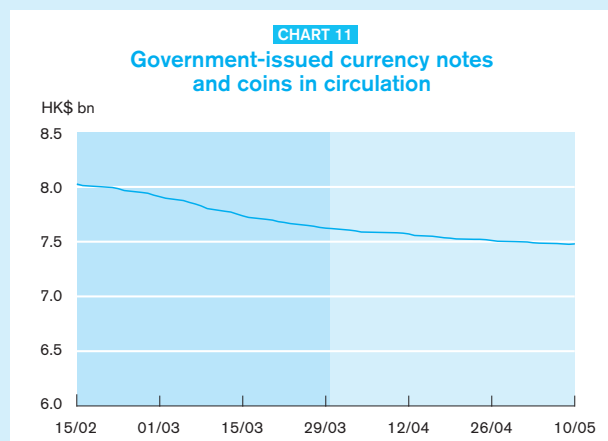
During the reporting period, the three note-issuing banks redeemed a total of HK\$1.89 billion worth of CIs to the HKMA in exchange for US\$0.24 billion. Consequently, the outstanding CIs declined from HK\$156.44 billion to HK\$154.55 billion (Chart 10).



⁴ 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.

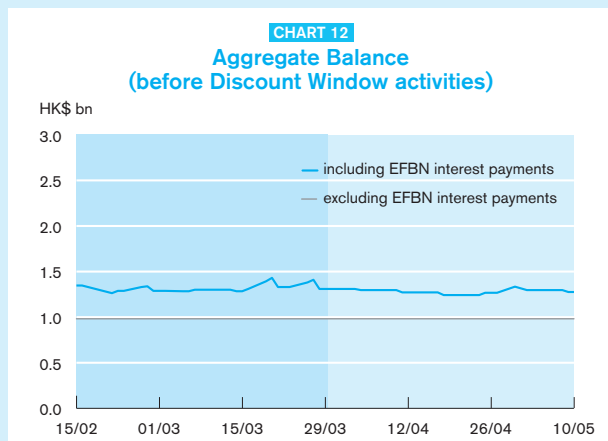
Government-issued currency notes and coins in circulation

In line with the contraction in CIs, **government-issued currency notes and coins in circulation decreased from HK\$7.62 billion to HK\$7.48 billion** during the reporting period (Chart 11).



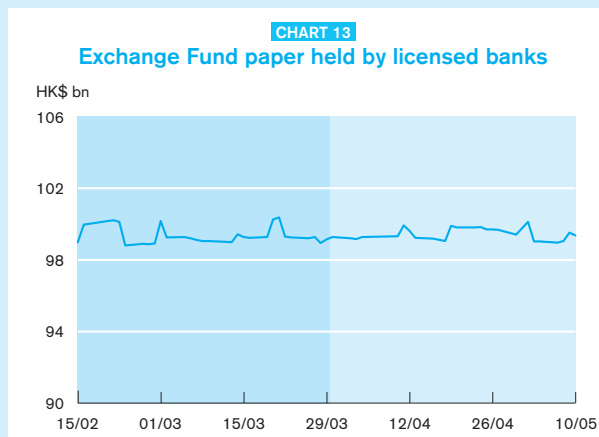
Aggregate Balance

12. The Aggregate Balance was little changed during the review period to close at around HK\$1.3 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 from **HK\$133.12 billion to HK\$133.49 billion** during the reporting period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased** from HK\$99.25 billion (74.56% of total) to HK\$99.33 billion (74.41% of total) (Chart 13).



During the period, **HK\$359.86 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\$393.46 million (in market value) of Exchange Fund paper was issued to absorb these interest payments**. The Exchange Fund papers issued were well received by the market (Table 3).

TABLE 3
Issuance of Exchange Fund Bills and Notes (30 Mar 07 – 10 May 07)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	4.5
3-month EFB	6	2.93-9.25
6-month EFB	3	1.69-4.08
1-year EFB	2	1.68-5.81

Discount Window activities

During the period, **12 banks borrowed a total of HK\$1.51 billion from the Discount Window**, compared with a total of HK\$1.72 billion in the preceding period (Chart 14 and Table 4). All borrowings used Exchange Fund paper as collateral. There was one occasion on which a bank borrowed an amount exceeding 50% of its holdings of Exchange Fund paper. The borrowing, amounting to HK\$42 million, was charged at the penal rate, currently equal to the Base Rate plus five per cent.

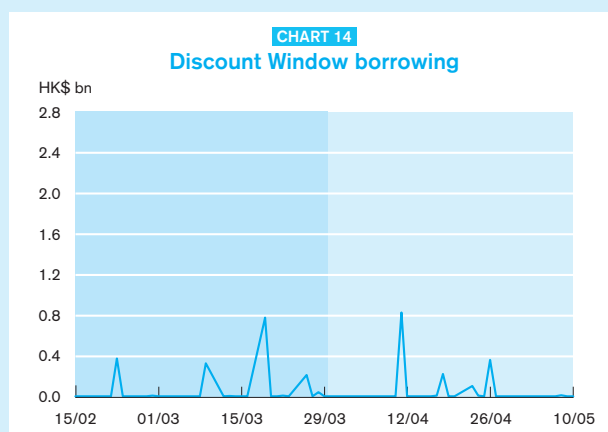


TABLE 4
Frequency of individual bank's access to the Discount Window (30 Mar 07 – 10 May 07)

Frequency of using Discount Window	No. of banks
1	10
2	2
Total	12

Backing Portfolio

The Monetary Base declined during the period, mainly reflecting a decrease in Certificates of Indebtedness. As the Monetary Base decreased proportionally more than the Backing Assets, **the Backing Ratio rose from 110.99% on 30 March to 111.53% on 10 May** (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.

