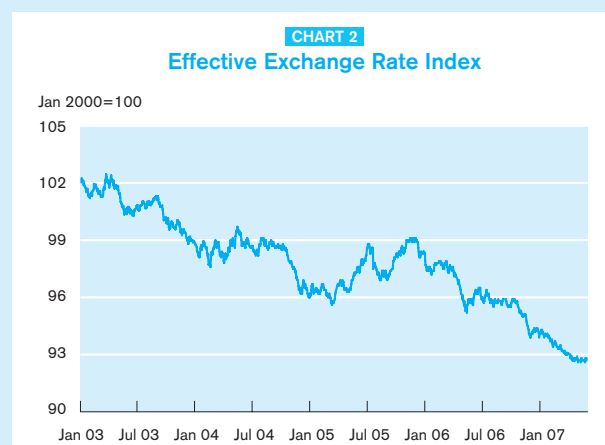
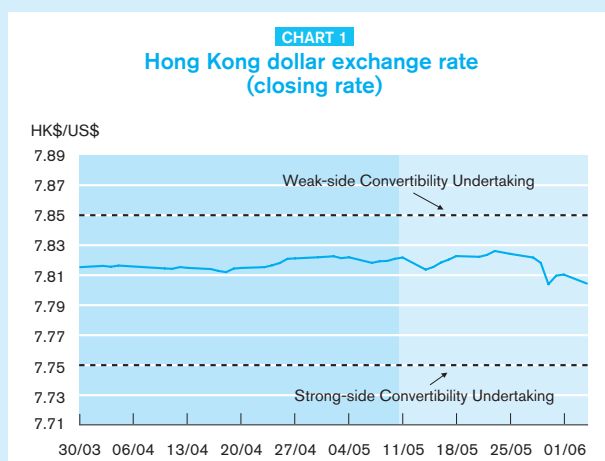


Report on Currency Board Operations (11 May – 4 June 2007)

The Hong Kong dollar exchange rate strengthened during the reporting period. Interbank interest rates rose and their negative spreads against US dollar interest rates narrowed. The Monetary Base declined from HK\$297.07 billion to HK\$296.06 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

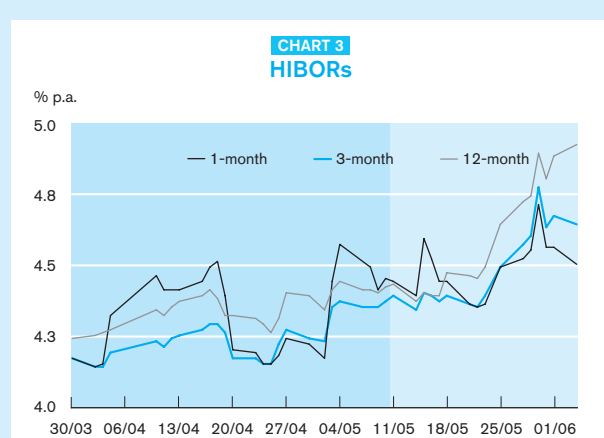
The Hong Kong dollar exchange rate strengthened from 7.8212 to 7.8038 during the review period, reflecting some unwinding of carry trade positions amid narrower negative interest rate spreads (Chart 1). Meanwhile, the effective exchange rate index of the Hong Kong dollar was generally stable (Chart 2).



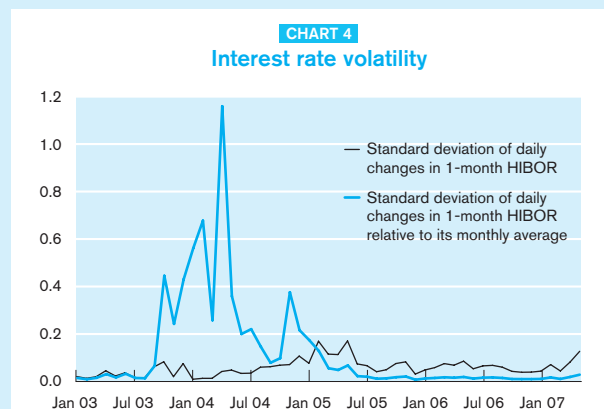
¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

Interest rates

Hong Kong dollar interbank interest rates increased on expectations of capital outflows associated with increased uncertainty about stock market outlook and the slackening of initial public offering activities. The one-month HIBOR rose from 4.45% to 4.51% during the review period. The three-month and 12-month HIBORs increased by 25 and 49 basis points to close at 4.65% and 4.93% respectively (Chart 3).

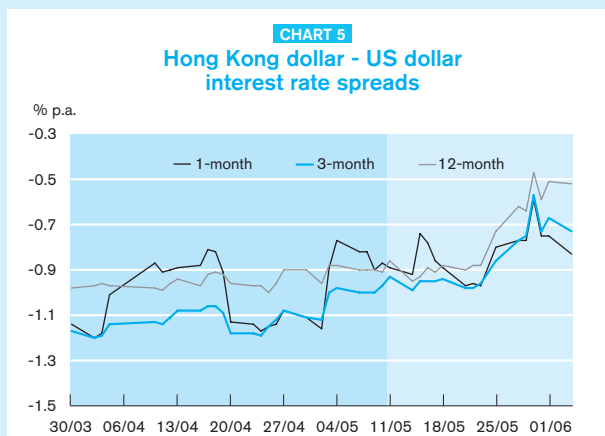


Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, rose in May. The standard deviation as a ratio of the average level of one-month HIBOR also increased (Chart 4).¹

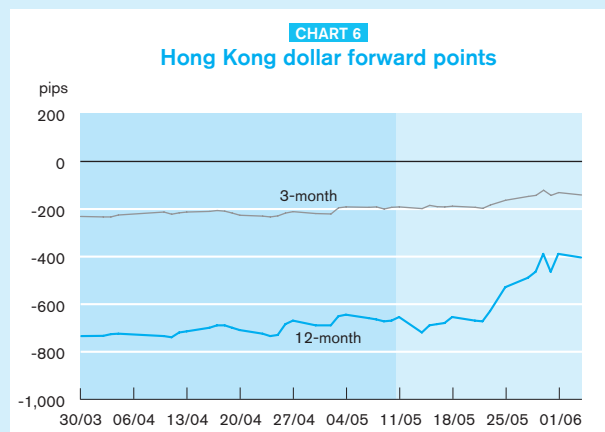


The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts narrowed.

The one-month and three-month negative interest rate spreads decreased by six and 20 basis points to -83 and -73 basis points respectively, while the 12-month negative spread declined by 34 basis points to -52 basis points (Chart 5).



The Hong Kong dollar three-month and 12-month forward discounts decreased by 50 and 250 pips to close at 143 and 405 pips respectively, in line with the narrower negative 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 and one-year negative spreads both narrowed by 39 basis points to -76 and -69 basis points respectively (Table 1).

CHART 7
Exchange Fund paper yield curves

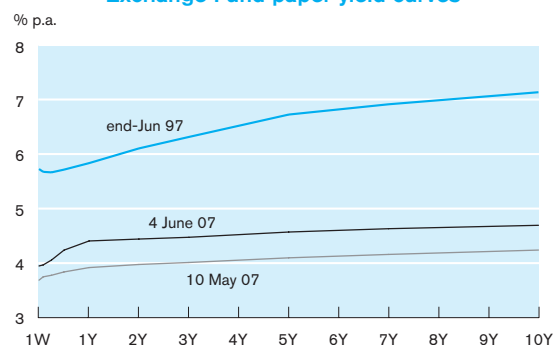
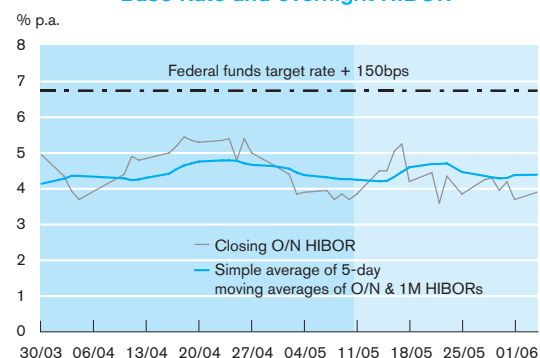


TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

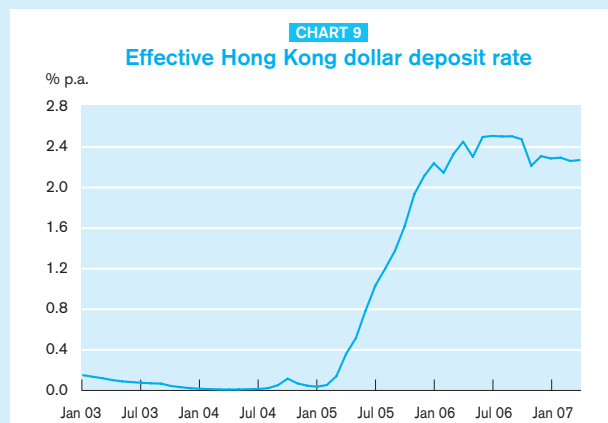
	27 Jun 97	10 May 07	4 Jun 07
3-month	56	-115	-76
1-year	21	-108	-69
3-year	3	-69	-50
5-year	27	-54	-39
10-year	54	-43	-28

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. However, it was reported that major banks were considering raising their Best Lending Rates if short-term interbank interest rates increased further.

CHART 8
Base Rate and overnight HIBOR



The average one-month time deposit rate offered by major authorized institutions rose from 2.546% to 2.585% during the reporting period.² The effective deposit rate increased slightly from 2.25% in March to 2.26% in April (Chart 9).³ In contrast, the composite interest rate, which reflects the average cost of funds of banks, declined by four basis points from 3.00% at the end of March to 2.96% at the end of April.⁴



Monetary Base

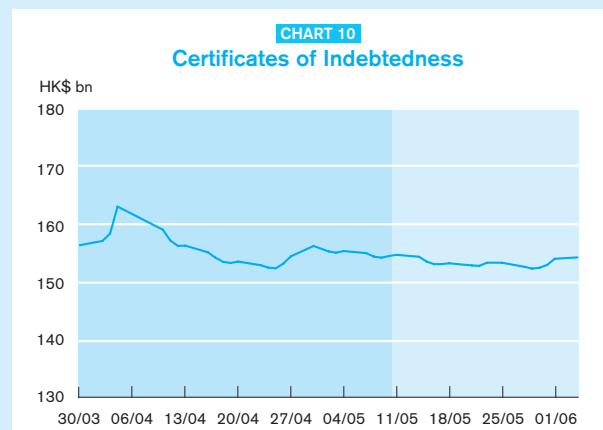
The Monetary Base, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, **declined slightly from HK\$297.07 billion to HK\$296.06 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

(HK\$ bn)	11 May 07	4 Jun 07
CIs	154.76	154.32
Government-issued Currency Notes and Coins in Circulation	7.48	7.41
Aggregate Balance	1.28	1.35
Outstanding EFBNs	133.56	132.98
Monetary Base	297.07	296.06

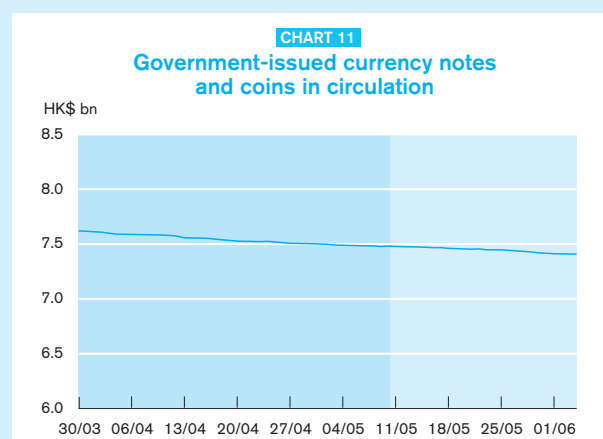
Certificates of Indebtedness

During the reporting period, the three note-issuing banks redeemed a total of HK\$440 million worth of CIs to the HKMA in exchange for US\$56.4 million. Consequently, **the outstanding CIs declined from HK\$154.76 billion to HK\$154.32 billion** (Chart 10).



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\$7.48 billion to HK\$7.41 billion** during the reporting period (Chart 11).



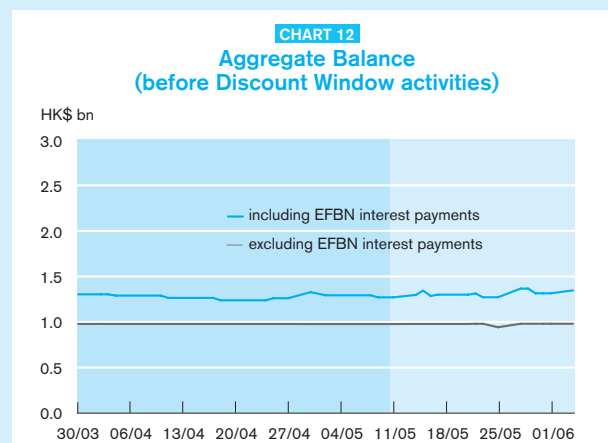
² The figures refer to the average of interest rates offered by the major authorized institutions for one-month time deposits of less than HK\$100,000.

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.

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.

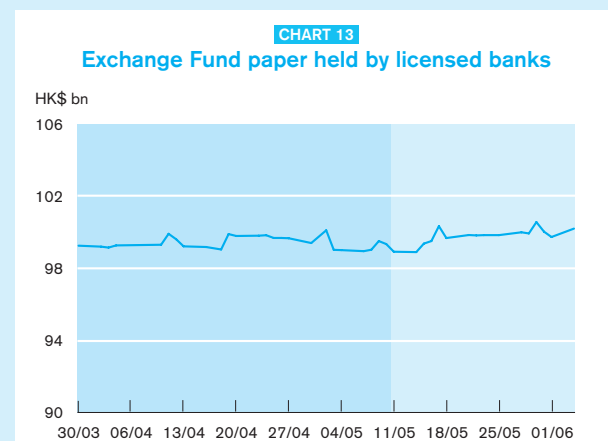
Aggregate Balance

The **Aggregate Balance** was little changed at around **HK\$1.3 billion** during the review 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 decreased from **HK\$133.56 billion** to **HK\$132.98 billion** during the reporting period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities)** increased from **HK\$98.91 billion** (74.05% of total) to **HK\$100.20 billion** (75.34% of total) (Chart 13).



During the period, a total of **HK\$380.82 million** of interest payments on Exchange Fund paper were made. An additional **HK\$302.13 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
(11 May 07 – 4 Jun 07)

	No. of issues launched	Over-subscription ratio
1-month EFB	2	5.00-7.70
3-month EFB	3	2.02-2.86
6-month EFB	1	3.62
1-year EFB	1	2.86
2-year EFN	1	2.53
7-year EFN	1	1.87

Discount Window activities

During the period, **seven banks borrowed a total of HK\$1.06 billion from the Discount Window**, compared with a total of HK\$1.51 billion in the preceding period (Chart 14 and Table 4). There were four occasions on which banks borrowed an amount exceeding 50% of its holdings of Exchange Fund paper. The borrowing, amounting to HK\$356 million by four banks, was charged at the penal rate, currently equal to the Base Rate plus five per cent. All borrowings used Exchange Fund paper as collateral.

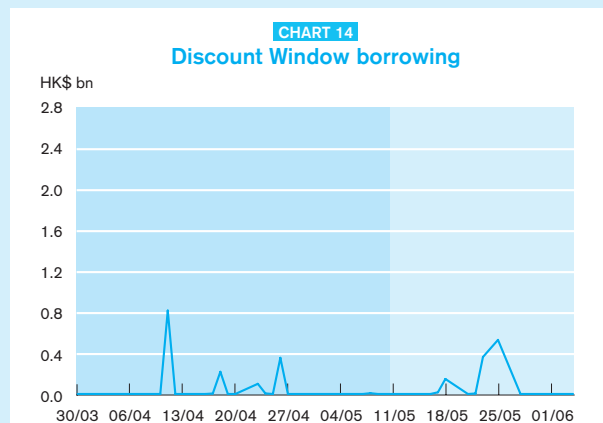


TABLE 4
Frequency of individual bank's access to the Discount Window
(11 May 07 – 4 Jun 07)

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

Backing Portfolio

Backing assets shrank during the review period because of a decline in the Monetary Base and valuation losses. As the Backing Assets decreased proportionally more than the Monetary Base, **the Backing Ratio declined from 111.62% on 11 May to 111.14% on 4 June** (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.

