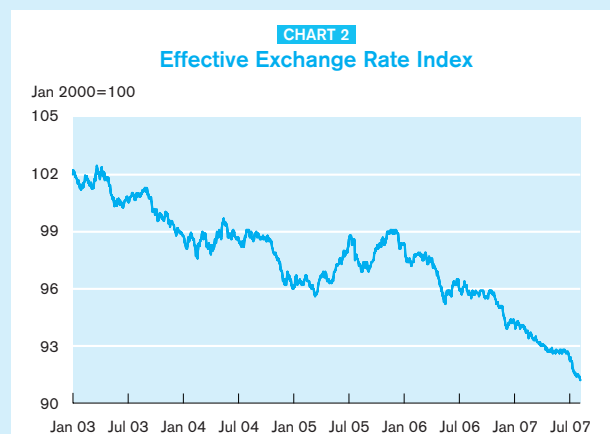
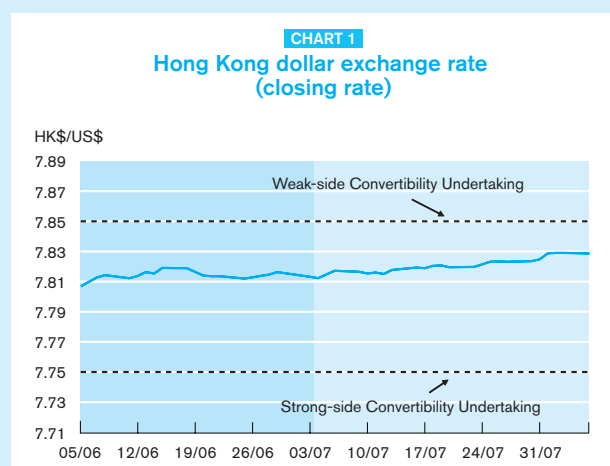


Report on Currency Board Operations (4 July – 6 August 2007)

The Hong Kong dollar exchange rate weakened during the reporting period. While interbank interest rates decreased, their negative spreads against US dollar interest rates showed mixed patterns. The Monetary Base rose from HK\$296.74 billion to HK\$298.38 billion. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

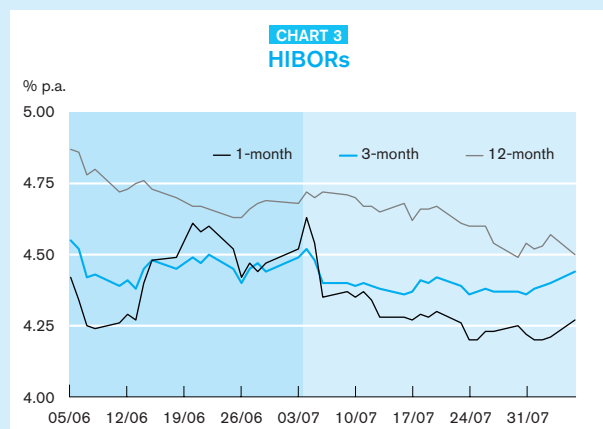
Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate against the US dollar softened from 7.8128 to 7.8291 during the review period, partly reflecting interest rate arbitrage activities (Chart 1). Meanwhile, the effective exchange rate index of the Hong Kong dollar decreased notably from 92.2 to 91.2, as the US dollar weakened against other major currencies (Chart 2).

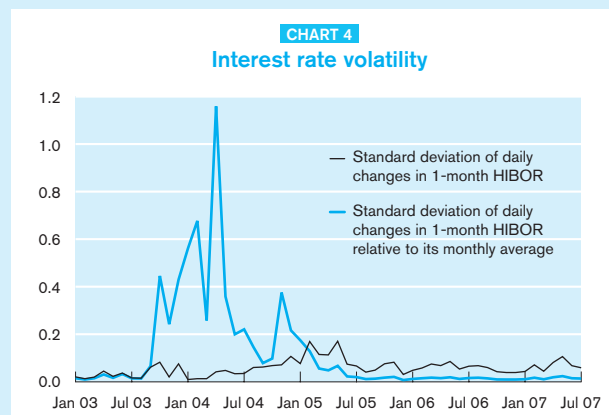


Interest rates

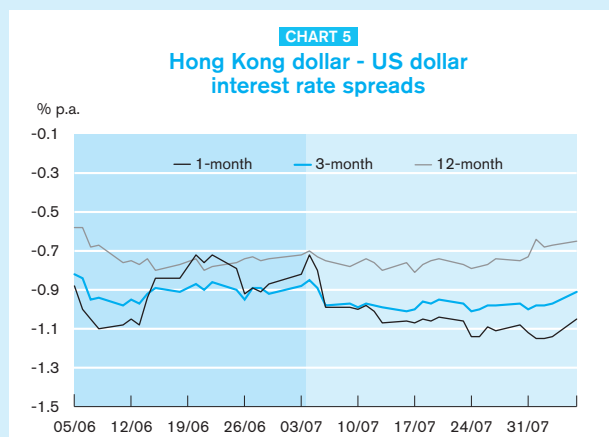
Hong Kong dollar interbank interest rates decreased during the reporting period. The one-month HIBOR declined from 4.63% to 4.27%. In addition, the three-month and 12-month HIBORs decreased by eight and 22 basis points to close at 4.44% and 4.50% respectively (Chart 3).



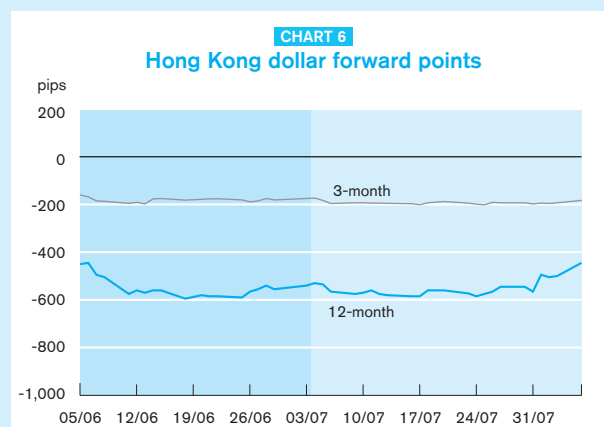
Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, **declined** in July. The standard deviation as a ratio of the average level of one-month HIBOR also decreased (Chart 4).¹



The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts widened at the short end, but narrowed at the long end. The one-month and three-month negative interest rate spreads increased by 33 and six basis points to -105 and -91 basis points respectively. In contrast, the 12-month negative spread narrowed by five basis points to -65 basis points (Chart 5).



While the Hong Kong dollar three-month forward discount increased by ten pips to close at 183 pips, the 12-month forward discount decreased by 85 pips to close at 445 pips, in line with the corresponding movements in the interest rate spreads (Chart 6).



Yields of Exchange Fund paper decreased during the period except for the one-week and one-month tenors (Chart 7). The negative yield spreads against US Treasuries decreased. In particular, the three-month and one-year negative spreads shrank by 13 and 17 basis points to -106 and -69 basis points. Moreover, the ten-year negative spread declined by 11 basis points to -16 basis points (Table 1).

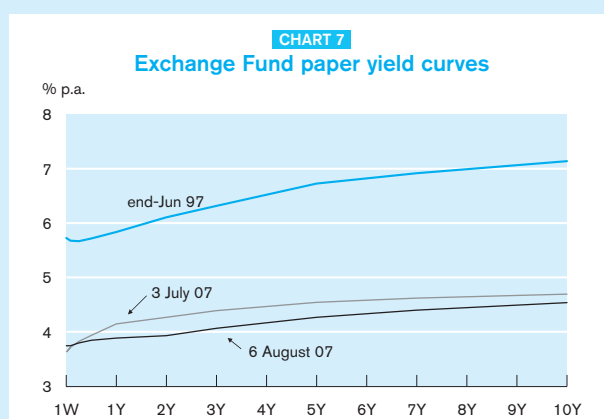
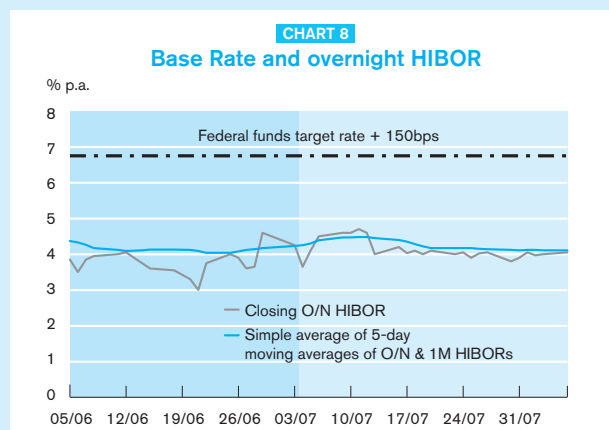


TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

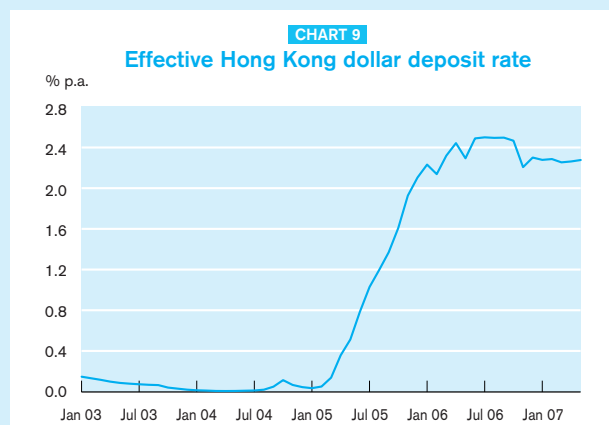
| | 27 Jun 97 | 3 Jul 07 | 6 Aug 07 |
|---------|-----------|----------|----------|
| 3-month | 56 | -119 | -106 |
| 1-year | 21 | -86 | -69 |
| 3-year | 3 | -44 | -30 |
| 5-year | 27 | -31 | -23 |
| 10-year | 54 | -27 | -16 |

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 decreased slightly from 2.579% to 2.545% during the period.² The effective deposit rate declined from 2.28% in May to 2.21% in June (Chart 9).³ In addition, the composite interest rate, which reflects the average cost of funds of banks, increased by nine basis points to 3.09% at the end of June from 3.00% at the end of May.⁴



² The figures refer to the average of interest rates offered by 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

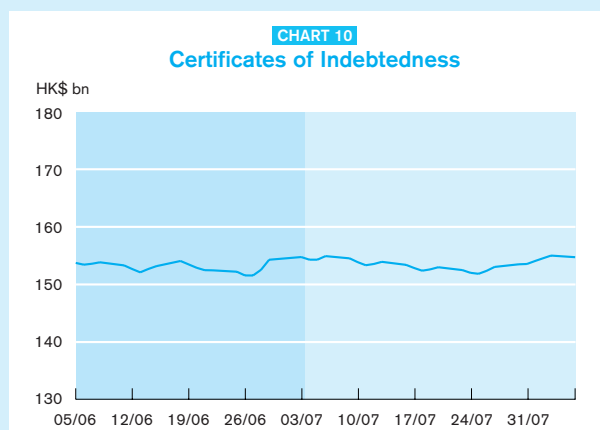
The Monetary Base, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, rose from HK\$296.74 billion to HK\$298.38 billion during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

| (HK\$ bn) | 4 Jul 07 | 6 Aug 07 |
|---|---------------|---------------|
| CIs | 154.45 | 154.88 |
| Government-issued Currency Notes and Coins in Circulation | 7.40 | 7.66 |
| Aggregate Balance | 1.28 | 1.28 |
| Outstanding EFBNs | 133.62 | 134.57 |
| Monetary Base | 296.74 | 298.38 |

Certificates of Indebtedness

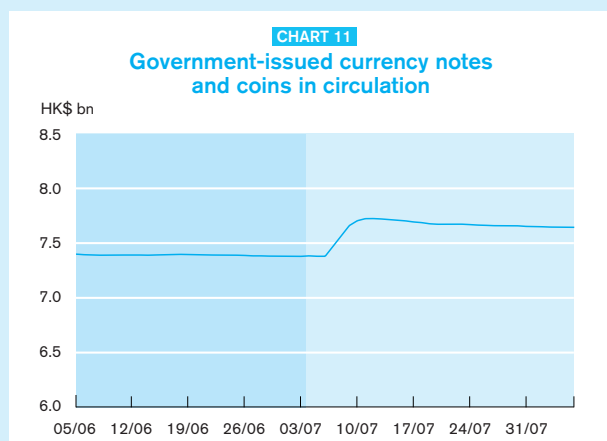
During the reporting period, the three note-issuing banks submitted a total of US\$55.13 million to the HKMA in exchange for HK\$0.43 billion worth of CIs. Consequently, the outstanding CIs increased modestly from HK\$154.45 billion to HK\$154.88 billion (Chart 10).



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.

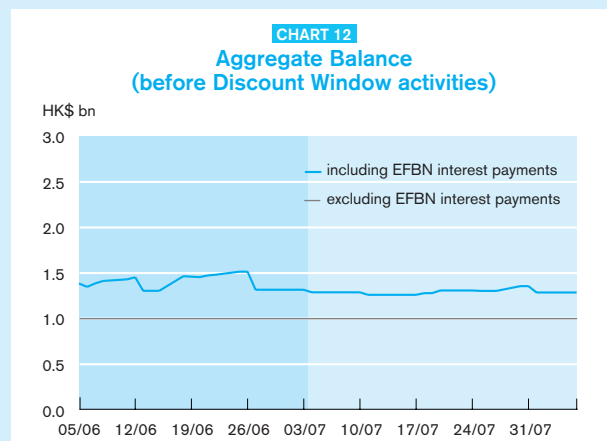
Government-issued currency notes and coins in circulation

The total of **government-issued currency notes and coins in circulation increased notably from HK\$7.40 billion to HK\$7.66 billion** during the reporting period, partly reflecting the launch of the new ten-dollar polymer note (Chart 11).



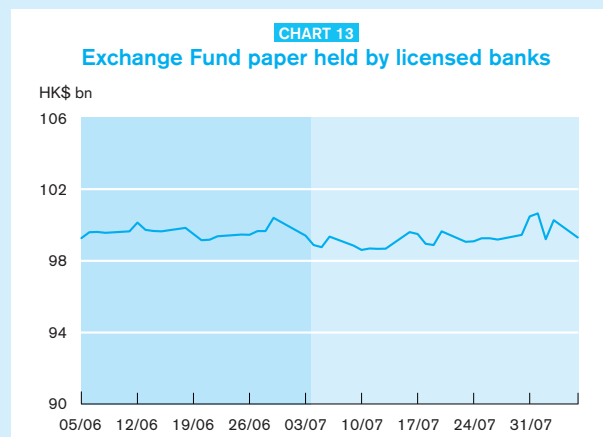
Aggregate Balance

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 rose from HK\$133.62 billion to HK\$134.57 billion** during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased** from HK\$98.93 billion (74.04% of total) to HK\$99.36 billion (73.84% of total) (Chart 13).



During the period, **a total of HK\$312.25 million of interest payments on Exchange Fund paper were made**. Taking into account interest payments brought forward from the last reporting period, **an additional HK\$342.81 million (in market value) of Exchange Fund paper was issued to absorb these interest payments**. The Exchange Fund papers issued were generally well received by the market (Table 3).

TABLE 3
Issuance of Exchange Fund Bills and Notes (4 Jul 07 – 6 Aug 07)

| | No. of issues launched | Over-subscription ratio |
|-------------|------------------------|-------------------------|
| 1-month EFB | 1 | 0.83 |
| 3-month EFB | 5 | 2.66-5.32 |
| 6-month EFB | 3 | 1.15-5.15 |
| 1-year EFB | 1 | 4.31 |

Discount Window activities

During the review period, **12 banks borrowed a total of HK\$3.44 billion from the Discount Window**, compared with HK\$0.81 billion in the preceding period (Chart 14 and Table 4). 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\$0.13 billion, was charged at the penal rate (Base Rate plus five per cent). All borrowings used Exchange Fund paper as collateral.

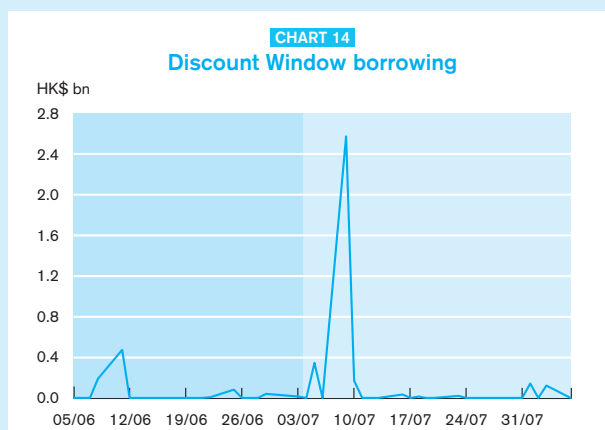


TABLE 4
Frequency of individual bank's access to the Discount Window (4 Jul 07 – 6 Aug 07)

| Frequency of using Discount Window | No. of banks |
|------------------------------------|--------------|
| 1 | 12 |
| Total | 12 |

Backing Portfolio

Backing assets increased during the reporting period, mainly reflecting revaluation gains. As the Backing Assets rose proportionally more than the Monetary Base, **the Backing Ratio increased from 111.26% on 4 July to 112.60% on 6 August**, surpassing the Upper Trigger Level of 112.5% (Chart 15). Pursuant to the arrangement approved by the Financial Secretary in January 2000, assets would be transferred out of the Backing Portfolio to reduce the Backing Ratio to around 110% in due course. 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.

