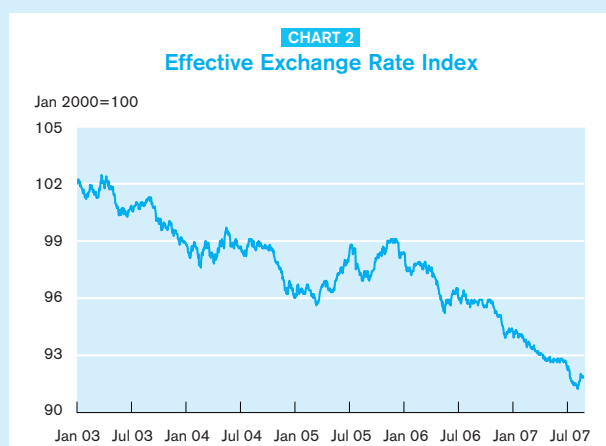
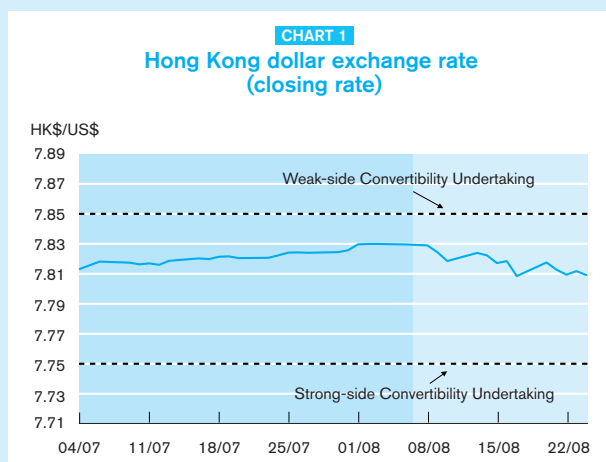


Annex Report on Currency Board Operations (7 August – 24 August 2007)

The Hong Kong dollar exchange rate strengthened during the reporting period. Interbank interest rates increased and their negative spreads against US dollar interest rates narrowed. The Monetary Base decreased from HK\$297.80 billion to HK\$296.46 billion. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

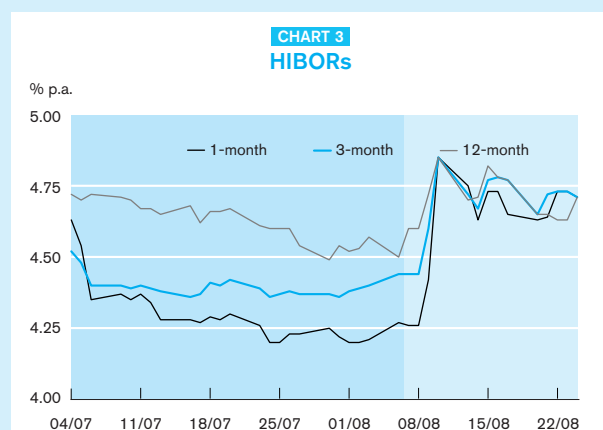
Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate against the US dollar strengthened from 7.8288 to 7.8087 during the review period, reflecting some unwinding of carry trade positions amid concerns about the spillover effects of the US sub-prime mortgage problems (Chart 1). Meanwhile, the effective exchange rate index of the Hong Kong dollar rose modestly from 91.3 to 91.8 (Chart 2).

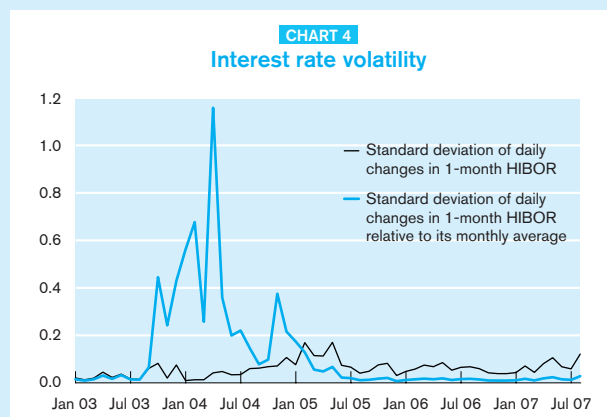


Interest rates

Hong Kong dollar interbank interest rates increased along with the corresponding US interest rates during the reporting period, mainly reflecting worries of a global credit crunch. The one-month and three-month HIBORs rose by 45 and 27 basis points respectively to close at 4.71%. The 12-month HIBOR increased to 4.71% from 4.60% (Chart 3).

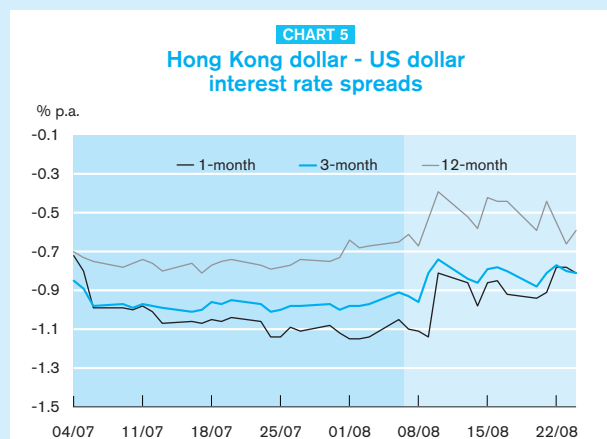


Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, **rose** markedly in August. The standard deviation as a ratio of the average level of one-month HIBOR also increased (Chart 4).¹

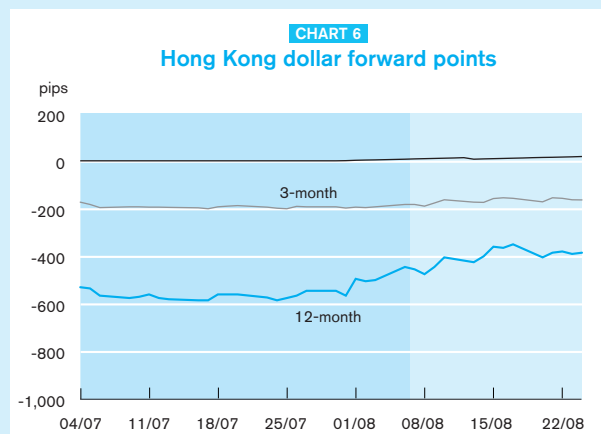


The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts narrowed.

The one-month and three-month negative interest rate spreads shrank by 29 and 12 basis points respectively to -81 basis points. The 12-month negative spread also narrowed by two basis points to -59 basis points (Chart 5).



Reflecting the movements in the interest rate spreads, **the Hong Kong dollar three-month and 12-month forward discounts decreased** by 19 and 70 pips to close at 164 and 385 pips respectively (Chart 6).



Yields of Exchange Fund paper increased during the period except for those with tenors longer than three years (Chart 7). The yield spreads against US Treasuries declined in general. In particular, the three-month spread turned positive to close at four basis points whereas the one-year negative spread contracted by 43 basis points to -26 basis points (Table 1). In contrast, the ten-year negative spread increased slightly by one basis point to -17 basis points.

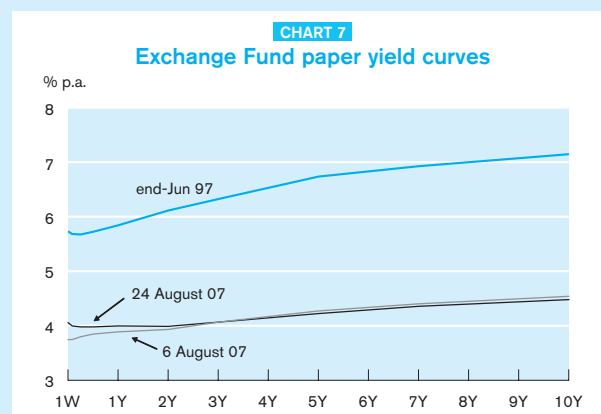
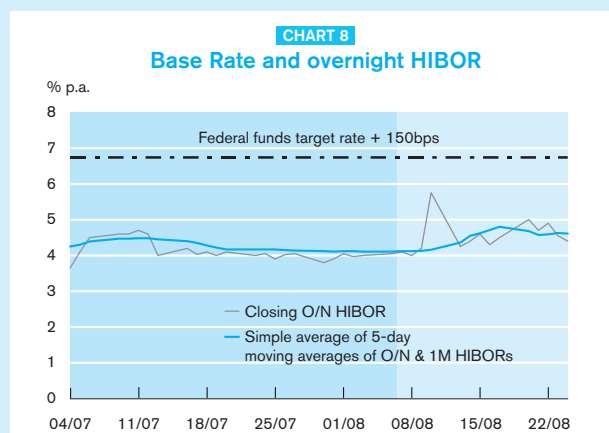


TABLE 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

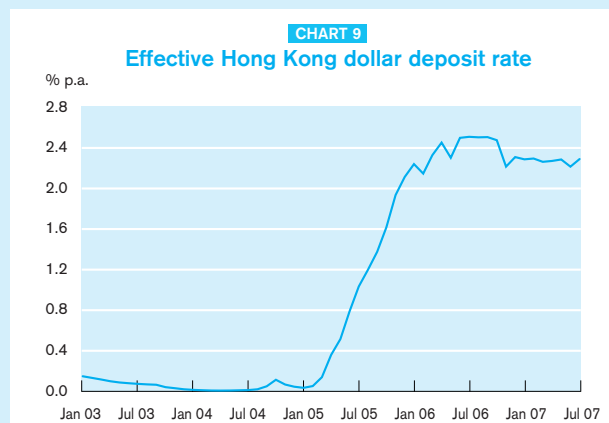
| | 27 Jun 97 | 6 Aug 07 | 24 Aug 07 |
|---------|-----------|----------|-----------|
| 3-month | 56 | -106 | 4 |
| 1-year | 21 | -69 | -26 |
| 3-year | 3 | -30 | -17 |
| 5-year | 27 | -23 | -17 |
| 10-year | 54 | -16 | -17 |

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 picked up to 2.599% from 2.549% during the period.² The effective deposit rate increased from 2.21% in June to 2.28% in July (Chart 9).³ The composite interest rate, which reflects the average cost of funds of banks, declined by 11 basis points to 2.98% at the end of July from 3.09% at the end of June.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

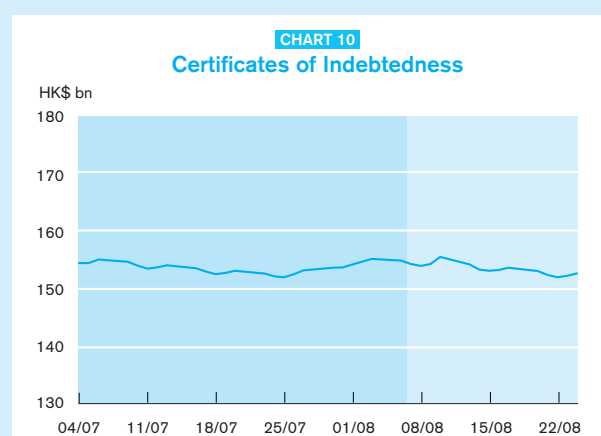
The Monetary Base, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, decreased from HK\$297.80 billion to HK\$296.46 billion during the reporting period (Table 2). Movements in the individual components are discussed below.

TABLE 2
Monetary Base

| (HK\$ bn) | 7 Aug 07 | 24 Aug 07 |
|---|---------------|---------------|
| CIs | 154.30 | 152.64 |
| Government-issued Currency Notes and Coins in Circulation | 7.66 | 7.67 |
| Aggregate Balance | 1.28 | 1.33 |
| Outstanding EFBNs | 134.57 | 134.83 |
| Monetary Base | 297.80 | 296.46 |

Certificates of Indebtedness

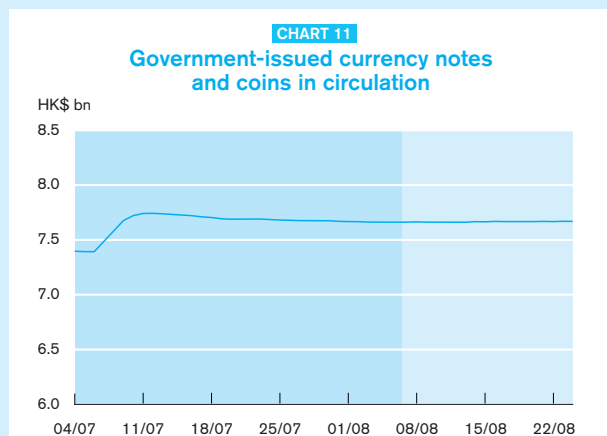
During the reporting period, the three note-issuing banks redeemed HK\$1.66 billion of CIs to the HKMA in exchange for US\$212.82 million. Consequently, the outstanding CIs declined modestly from HK\$154.30 billion to HK\$152.64 billion (Chart 10).



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.

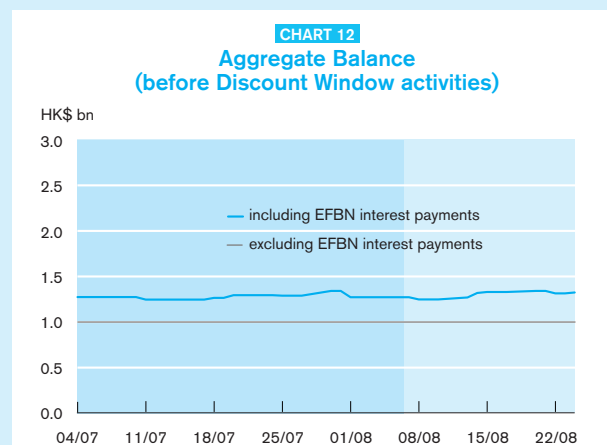
Government-issued currency notes and coins in circulation

The amount of **government-issued currency notes and coins in circulation remained stable at HK\$7.67 billion** during the reporting period (Chart 11).



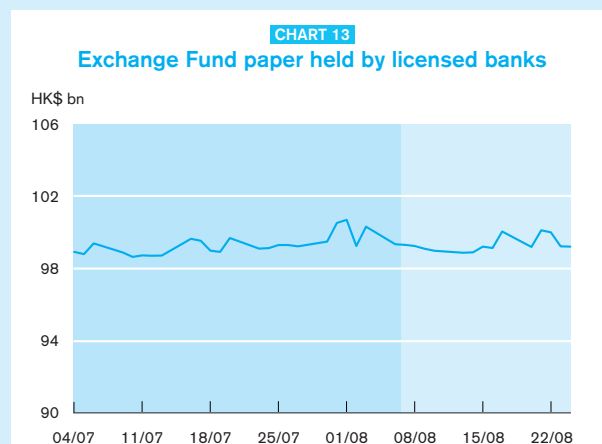
Aggregate Balance

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\$134.57 billion to HK\$134.83 billion** during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased** from HK\$99.33 billion (73.81% of total) to HK\$99.22 billion (73.59% of total) (Chart 13).



During the period, **HK\$267.84 million of interest payments on Exchange Fund paper were made. An additional HK\$215.90 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 (7 Aug 07 – 24 Aug 07)

| | No. of issues launched | Over-subscription ratio |
|--------------|------------------------|-------------------------|
| 1-month EFB | 1 | 2.25 |
| 3-month EFB | 3 | 1.19-3.60 |
| 6-month EFB | 1 | 1.58 |
| 12-month EFB | 1 | 4.50 |
| 2-year EFN | 1 | 1.35 |

Discount Window activities

During the review period, **nine banks borrowed a total of HK\$1.95 billion from the Discount Window**, compared with HK\$3.44 billion in the preceding period (Chart 14 and Table 4). All borrowings used Exchange Fund paper as collateral.

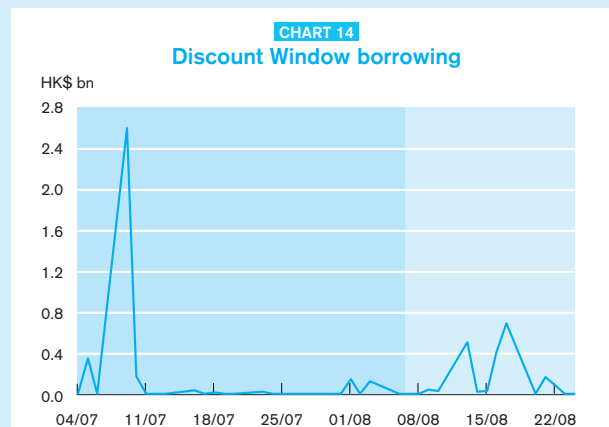


TABLE 4
Frequency of individual bank's access to the Discount Window (7 Aug 07 – 24 Aug 07)

| Frequency of using Discount Window | No. of banks |
|------------------------------------|--------------|
| 1 | 6 |
| 2 | 1 |
| 3 | 1 |
| 4 | 1 |
| Total | 9 |

Backing Portfolio

Backing assets shrank during the reporting period, mainly reflecting decreases in the Monetary Base. As the Monetary Base decreased proportionally more than the Backing Assets, **the Backing Ratio rose from 109.88% on 7 August to 110.14% on 24 August** (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.

