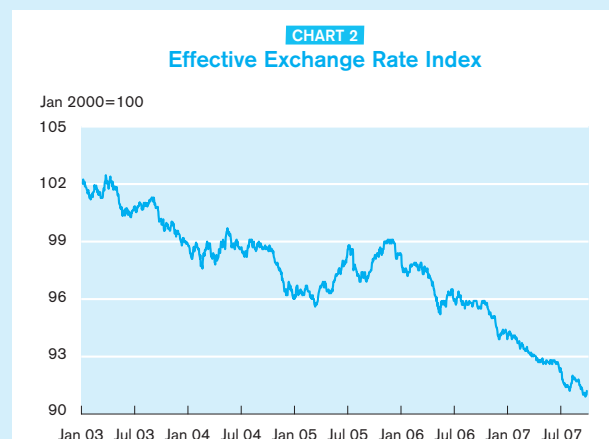
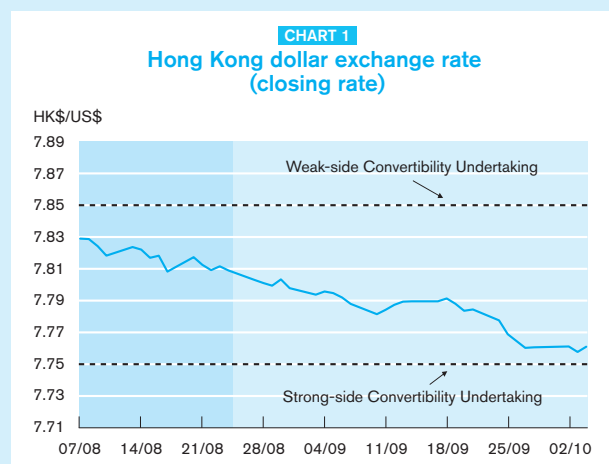


## Report on Currency Board Operations (25 August – 4 October 2007)

The Hong Kong dollar exchange rate strengthened during the reporting period and interbank interest rates increased. The Monetary Base increased from HK\$296.23 billion to HK\$301.69 billion. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by corresponding changes in foreign reserves.

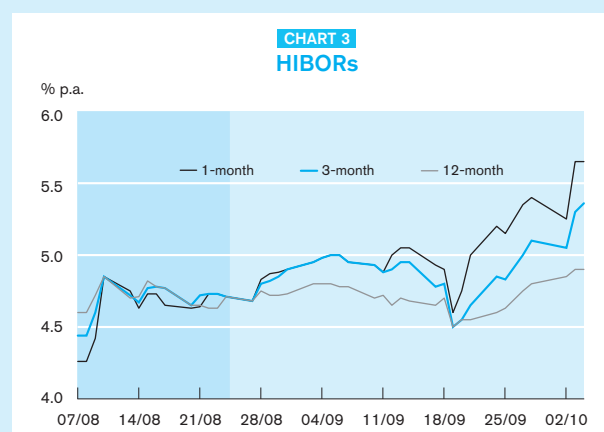
### Hong Kong dollar exchange rate

**The Hong Kong dollar exchange rate against the US dollar strengthened** from 7.8027 to 7.7607 during the review period, reflecting some unwinding of carry trade positions and equity-related demand for the Hong Kong dollar (Chart 1). Meanwhile, the effective exchange rate index of the Hong Kong dollar declined from 91.8 to 91.2 (Chart 2).

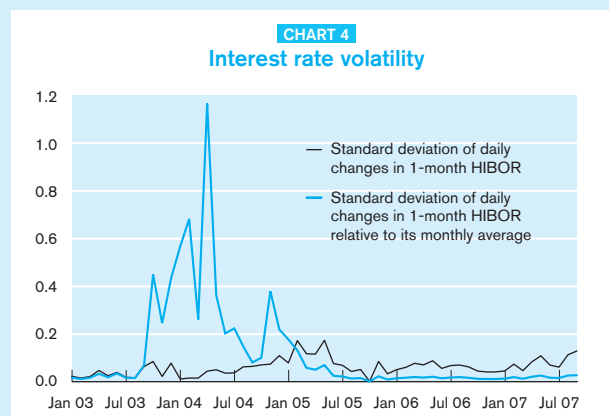


### Interest rates

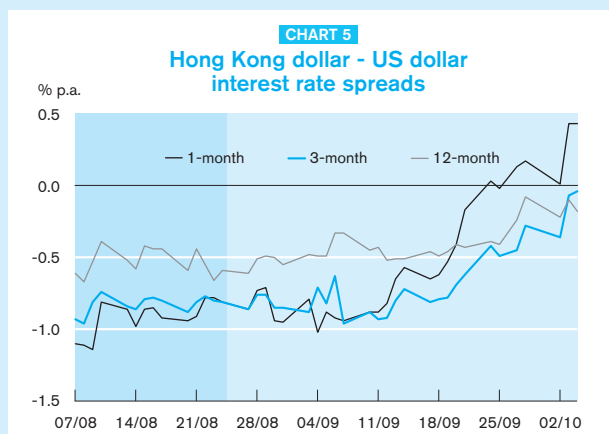
**Hong Kong dollar interbank interest rates rose** during the reporting period despite a temporary decline after the US Fed lowered its target interest rate on 18 September. The rise in HIBORs was driven by increased funding demand associated with vigorous initial public offering activities. The one-month and three-month HIBORs increased by 97 and 68 basis points to close at 5.65% and 5.36% respectively. The 12-month HIBOR expanded from 4.68% to 4.90% (Chart 3).



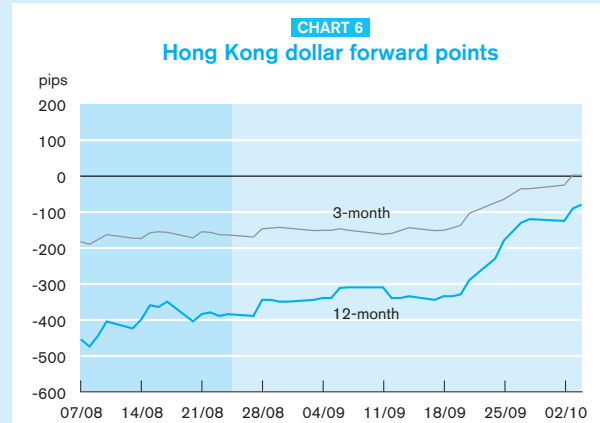
**Interest rate volatility**, measured by the standard deviation of daily changes in one-month HIBOR, **increased** in September. However, the standard deviation as a ratio of the average level of one-month HIBOR was little changed (Chart 4).<sup>1</sup>



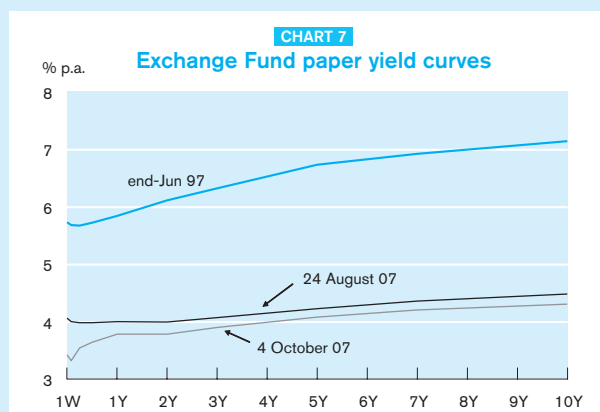
In line with the increases in HIBORs, **the spreads of Hong Kong dollar interest rates against their US dollar counterparts narrowed in general**. The one-month interest rate spread turned positive to close at 43 basis points. The three-month and 12-month negative interest rate spreads declined by 82 and 43 basis points to -4 and -18 basis points respectively (Chart 5).



Reflecting the movements in the interest rate spreads, **the 12-month forward discount narrowed** by 310 pips to close at 80 pips (Chart 6). Meanwhile, the Hong Kong dollar three-month forward points turned from a discount to a small premium, rising from -170 pips to 2 pips.



**Yields of Exchange Fund paper decreased during the period** (Chart 7). With the launch of the 15-year Exchange Fund Notes in August, the benchmark yield curve was extended. On 4 October, the yield of this debt paper was 4.36%. Meanwhile, the yield spreads against US Treasuries widened in general. The three-month spread turned negative to close at -51 basis points while the one-year negative spread expanded by 19 basis points to -45 basis points (Table 1).

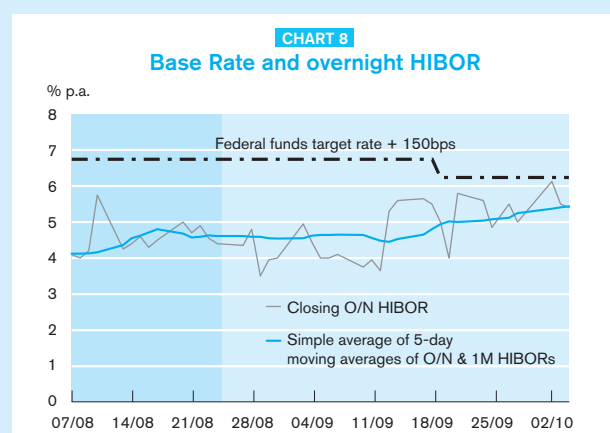


**TABLE 1**  
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

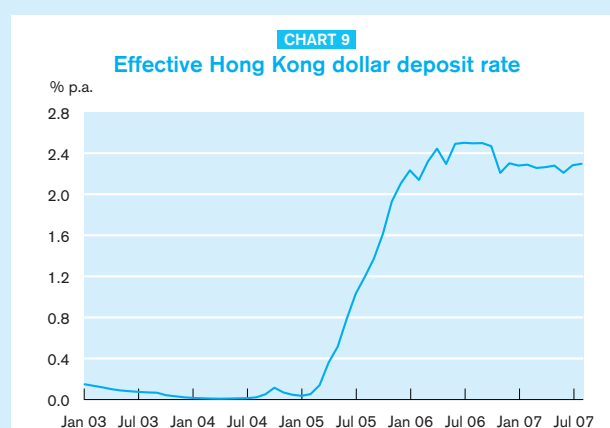
	27 Jun 97	24 Aug 07	4 Oct 07
3-month	56	4	-51
1-year	21	-26	-45
3-year	3	-17	-17
5-year	27	-17	-20
10-year	54	-17	-27

<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.

Immediately after a 50 basis points decrease in the US federal funds target rate, **the HKMA Base Rate was adjusted downward to 6.25% on 19 September** according to the established formula (Chart 8). One day later, **banks reduced their Best Lending Rates by 25 basis points**. There were two Best Lending Rates of 7.50% and 7.75% at the end of the reporting period.



**The average one-month time deposit rate offered by major authorized institutions increased to 2.623%** during the review period.<sup>2</sup> The effective deposit rate expanded slightly from 2.28% in July to 2.29% in August (Chart 9).<sup>3</sup> The composite interest rate, which reflects the average cost of funds of banks, rose by 10 basis points to 3.08% at the end of August from 2.98% at the end of July.<sup>4</sup>



<sup>2</sup> 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.

<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

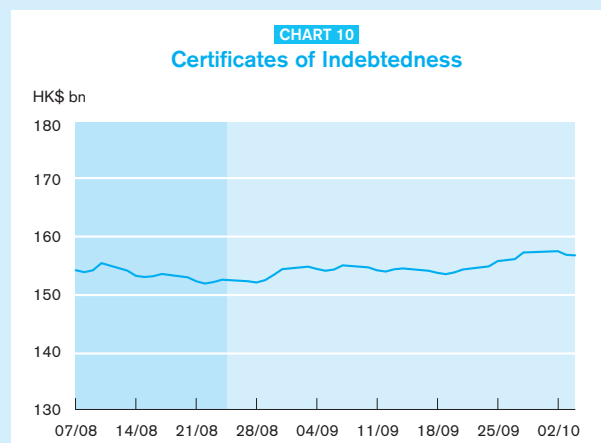
**The Monetary Base**, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills and Notes, **increased from HK\$296.23 billion to HK\$301.69 billion** during the reporting period (Table 2). Movements in the individual components are discussed below.

**TABLE 2**  
Monetary Base

(HK\$ bn)	27 Aug 07	4 Oct 07
CIs	152.38	156.88
Government-issued Currency Notes and Coins in Circulation	7.67	7.69
Aggregate Balance	1.37	1.25
Outstanding EFBNs	134.82	135.88
<b>Monetary Base</b>	<b>296.23</b>	<b>301.69</b>

## Certificates of Indebtedness

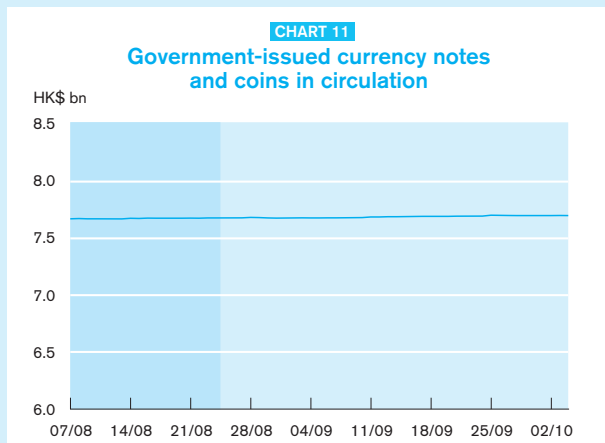
During the reporting period, the three note-issuing banks submitted US\$576.9 million to the HKMA in exchange for HK\$4.5 billion worth of CIs. Consequently, **the outstanding CIs expanded from HK\$152.38 billion to HK\$156.88 billion** (Chart 10).



<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.

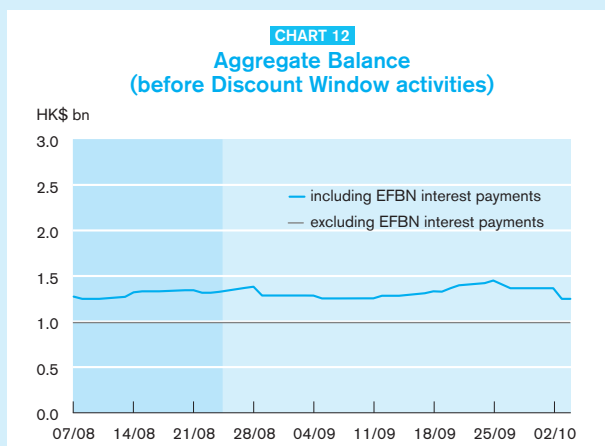
### Government-issued currency notes and coins in circulation

The amount of **government-issued currency notes and coins in circulation rose modestly from HK\$7.67 billion to HK\$7.69 billion** during the reporting period (Chart 11).



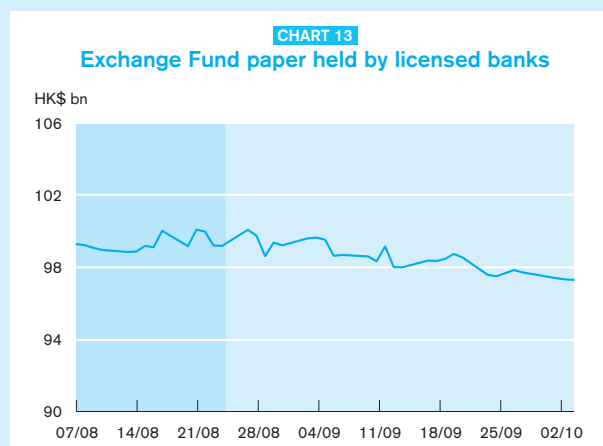
### Aggregate Balance

The **Aggregate Balance remained stable 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\$134.82 billion to HK\$135.88 billion** during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased** from HK\$100.13 billion (74.27% of total) to HK\$97.34 billion (71.63% of total) (Chart 13).



During the period, **HK\$616.33 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\$687.64 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).

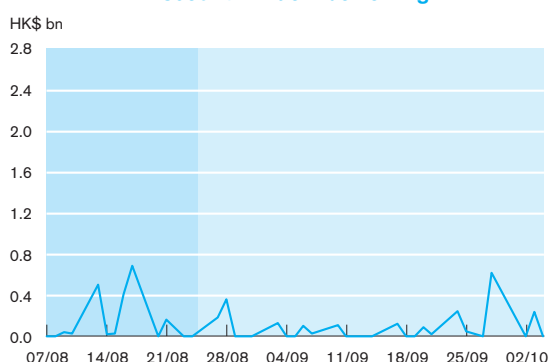
**TABLE 3**  
Issuance of Exchange Fund Bills and Notes (25 Aug 07 – 4 Oct 07)

	No. of issues launched	Over-subscription ratio
3-month EFB	6	0.43-1.09
6-month EFB	3	1.12-1.92
12-month EFB	1	4.46
5-year EFN	2	2.91-4.08
15-year EFN	1	1.20

## Discount Window activities

During the review period, **19 banks borrowed a total of HK\$2.29 billion from the Discount Window**, compared with HK\$1.95 billion in the preceding period (Chart 14 and Table 4). There were five occasions on which banks borrowed an amount exceeding 50% of its holdings of Exchange Fund paper. The borrowing, amounting to a total of HK\$130 million by four banks, was charged at the penal rate (Base Rate plus five per cent). All borrowings used Exchange Fund paper as collateral.

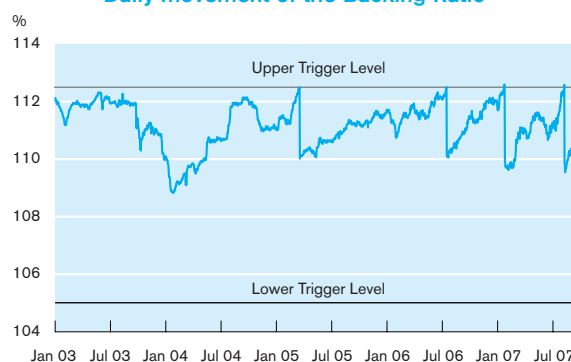
**CHART 14**  
Discount Window borrowing



## Backing Portfolio

Backing assets expanded during the reporting period, mainly reflecting the rise in the Monetary Base. As the Backing Assets increased proportionally less than the Monetary Base, **the Backing Ratio declined from 110.16% on 26 August to 109.95% on 4 October** (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.

**CHART 15**  
Daily movement of the Backing Ratio



**TABLE 4**  
Frequency of individual bank's access to the Discount Window (25 Aug 07 – 4 Oct 07)

Frequency of using Discount Window	No. of banks
1	13
2	5
3	1
Total	19