

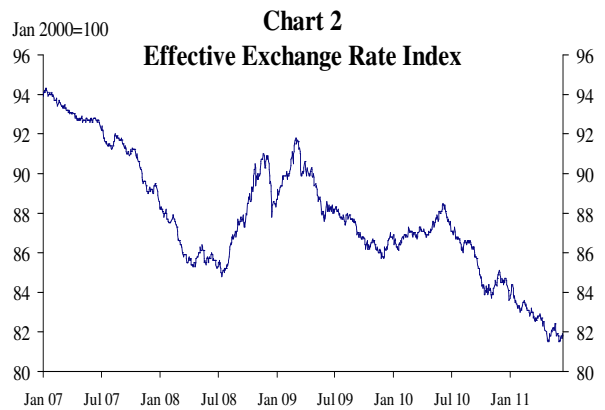
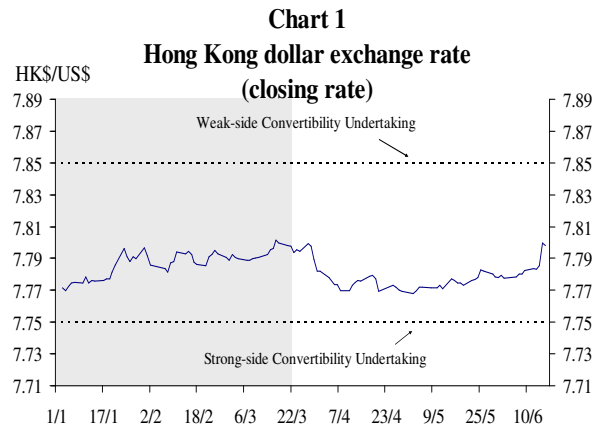
**EXCHANGE FUND ADVISORY COMMITTEE**  
**Currency Board Sub-Committee**

**Report on Currency Board Operations**  
**(23 March 2011 –17 June 2011)**

The Hong Kong dollar exchange rate strengthened from 7.80 to 7.77 during the first half of the reporting period as the US dollar generally depreciated against some major Asian currencies. As market sentiment was undermined by poor performance in the local stock market and renewed concerns over the Greek debt crisis, the Hong Kong dollar exchange rate weakened thereafter to close at 7.7982 on 17 June. Hong Kong dollar interbank interest rates were broadly stable, with small fluctuations reflecting occasional demand for IPO-related funds. The Monetary Base rose from HK\$1,046.21 billion to HK\$1,051.15 billion, mainly driven by an increase in Certificates of Indebtedness arising from increased demand for banknotes during the Easter and Labour Day holidays. The Aggregate Balance and the market value of outstanding Exchange Fund Bills and Notes were little changed. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by changes in foreign reserves.

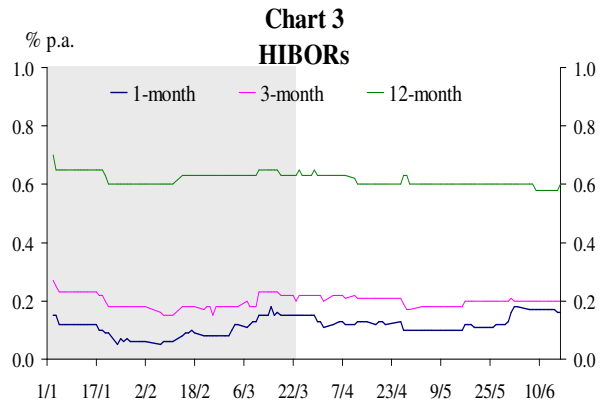
## Hong Kong dollar exchange rate

Amid the weakening of the US dollar against other major Asian currencies, the Hong Kong dollar exchange rate strengthened to around 7.77 from 7.80 during the first half of the reporting period. The Hong Kong dollar exchange rate weakened thereafter as market sentiment was undermined by poor performance in the local stock market and renewed concerns over the Greek debt crisis. The exchange rate closed at 7.7982 on 17 June (Chart 1). Meanwhile, the nominal effective exchange rate index of the Hong Kong dollar weakened from 82.6 to 81.8 during the review period, as the US dollar depreciated against some major Asian currencies (Chart 2).

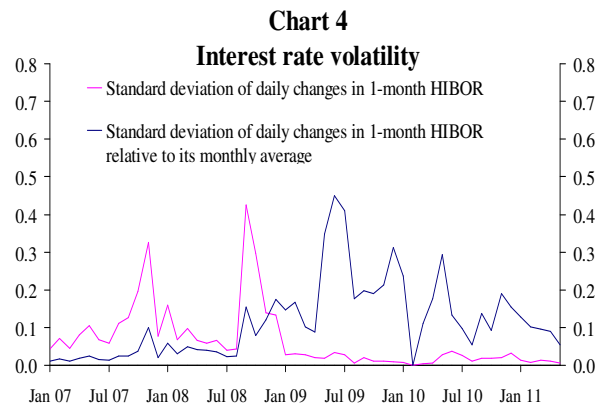


## Interest rates

2. **Hong Kong dollar interbank interest rates were broadly stable during the review period, with small fluctuations reflecting occasional demand for IPO-related funds (Chart 3).** For the review period as a whole, the one-month HIBOR edged up by one basis point to close at 0.16% while the 12-month HIBOR declined by three basis points to close at 0.60%.

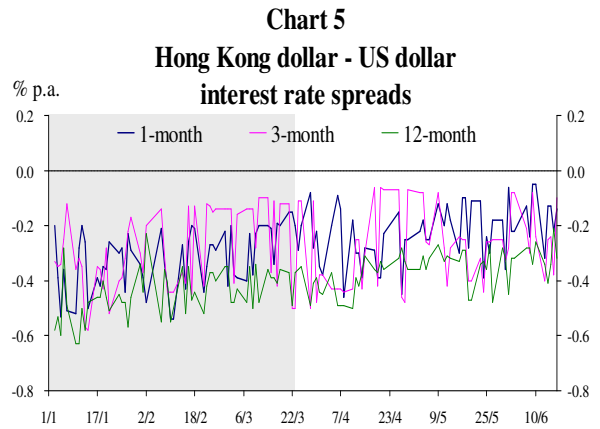


3. **Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, declined slightly from March to May (Chart 4).** The standard deviation as a ratio of the average one-month HIBOR also decreased.<sup>1</sup>

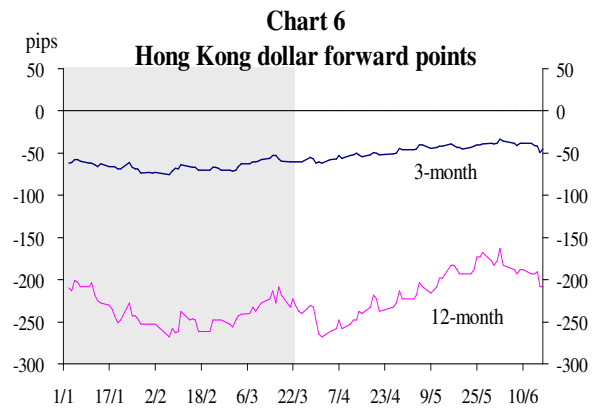


<sup>1</sup> The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

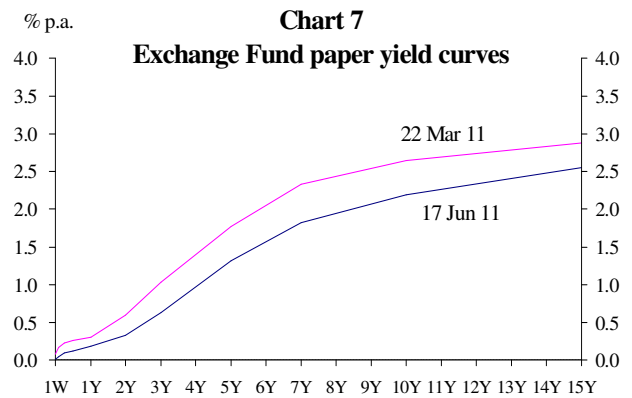
4. **The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts remained roughly stable during the reporting period (Chart 5).** The one-month and three-month negative spreads averaged -22 and -28 basis points respectively. The 12-month negative spread moved within a range between -21 and -50 basis points, closing at -32 basis points on 17 June.



5. **During the reporting period, the three-month forward discount was generally stable,** moving within a narrow range between -33 and -62 pips (Chart 6). However, the 12-month Hong Kong dollar forward discount narrowed from -268 pips on 1 April to -163 pips on 2 June and closed at -208 pips on 17 June.



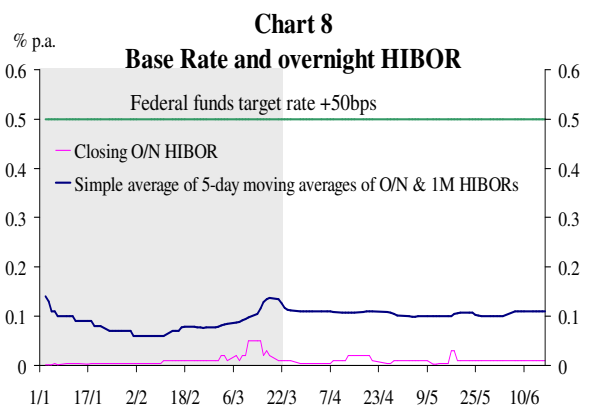
6. During the review period, **yields of Exchange Fund papers declined across the board**, in line with the softening of US Government bond yields (Chart 7). The yield spreads against US Treasuries generally narrowed except for the 10-year tenor (Table 1).



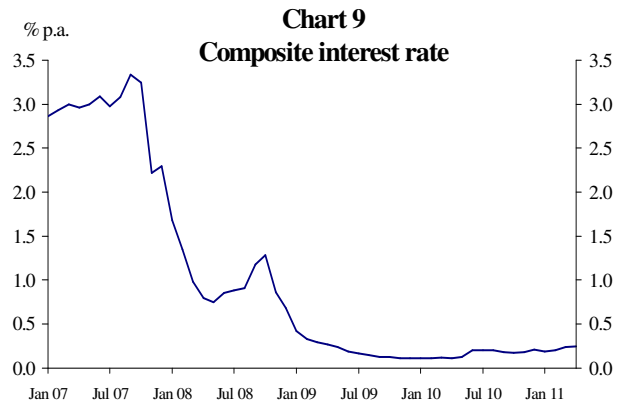
**Table 1**  
**Yield spreads of Exchange Fund paper over US Treasuries (basis points)**

	22 Mar 11	17 Jun 11
3-month	12	7
1-year	8	2
3-year	-11	-4
5-year	-28	-22
10-year	-73	-76
15-year	-111	-106

7. **The HKMA Base Rate remained unchanged at 0.5%** (Chart 8), as the US Federal Open Market Committee (FOMC) maintained the Federal Funds Target Rate (FFTR) at 0 – 0.25% at the April meeting. The Base Rate continued to be set at 50 basis points above the lower boundary of the target range in accordance with the revised Base Rate formula announced on 26 March 2009.



8. **Banks kept their Best Lending Rates unchanged**, in line with the stable US FFTR. There continued to be two Best Lending Rates of 5.00% and 5.25% at the end of the reporting period. There were signs that strong loan demand raised the funding cost pressures of banks and pushed up their effective lending and deposit interest rates. The composite interest rate, which indicates the average cost of funds of banks, increased slightly from 0.24% in March to 0.26% in May (Chart 9), driven by upward adjustment of deposit interest rates .<sup>2</sup>



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<sup>2</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.

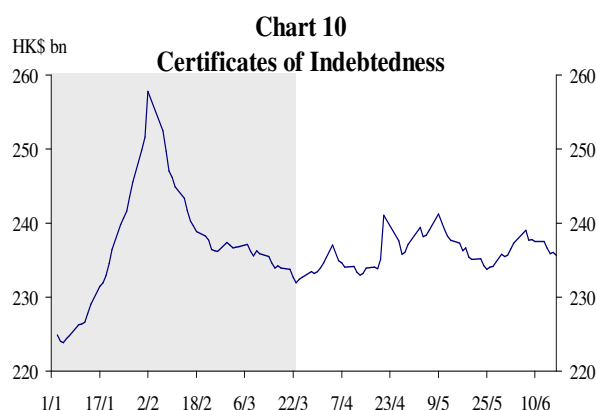
## Monetary Base

9. **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, **expanded from HK\$1,046.21 billion on 23 March to HK\$1,051.15 billion on 17 June** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	23 Mar 11	17 Jun 11
CIs	231.92	235.67
Government-issued Currency Notes and Coins in Circulation	9.65	9.52
Aggregate Balance	148.63	148.62
Outstanding EFBNs	656.02	657.34
<b>Monetary Base</b>	<b>1,046.21</b>	<b>1,051.15</b>

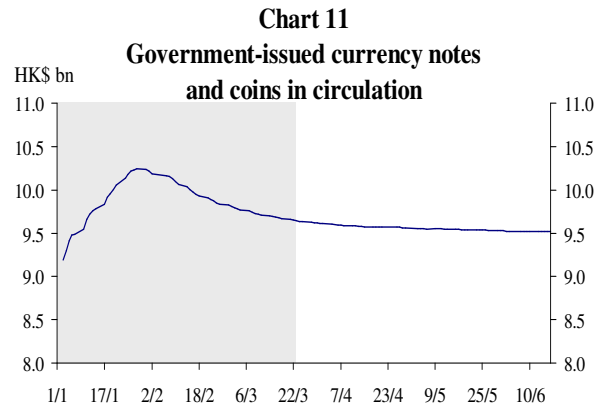
### *Certificates of Indebtedness*

10. During the reporting period, the three note-issuing banks submitted US\$480.8 million to the HKMA in exchange for HK\$3.75 billion worth of CIs, partly reflecting increased demand for banknotes around the Easter and Labour Day holidays. As a result, **the outstanding CIs increased to HK\$235.67 billion on 17 June from HK\$231.92 billion on 23 March** (Chart 10).



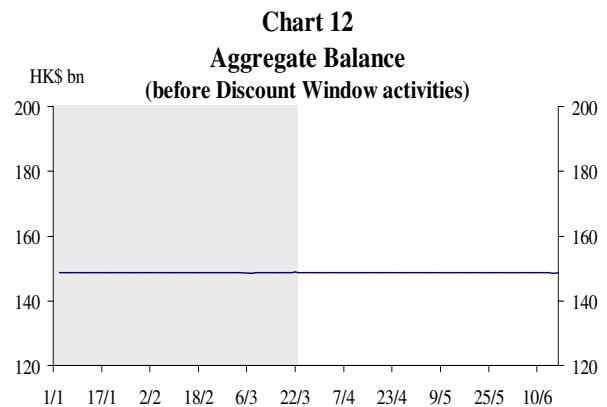
*Government-issued currency notes and coins in circulation*

11. The amount of **government-issued currency notes and coins in circulation** decreased slightly from HK\$9.65 billion on 23 March to HK\$9.52 billion on 17 June (Chart 11).



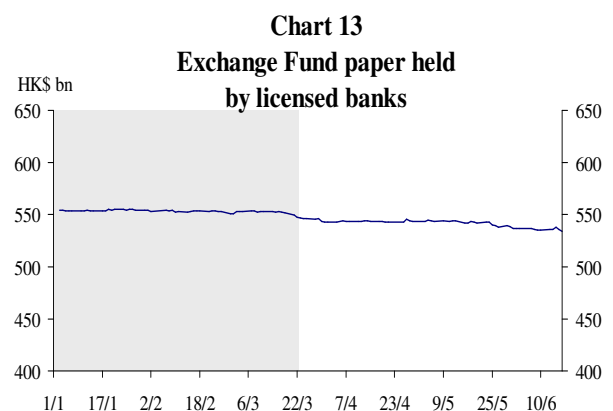
*Aggregate Balance*

12. The **Aggregate Balance** was little changed and stayed at around HK\$148.60 billion during the review period, with small fluctuations due to interest payments on Exchange Fund paper (Chart 12).



*Outstanding Exchange Fund Bills and Notes*

13. The **market value of outstanding Exchange Fund Bills and Notes** was also stable, closing at HK\$657.34 billion at the end of the reporting period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased slightly to HK\$534.20 billion (81.3% of total) on 17 June from HK\$546.68 billion on 23 March (83.3% of total) (Chart 13).



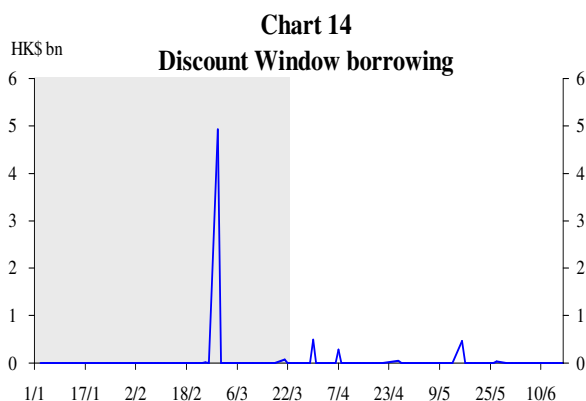


14. During the reporting period, **interest payments on Exchange Fund paper amounting to HK\$603.87 million were made.** Taking into account interest payments brought forward from the last reporting period, **an additional HK\$711.67 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The Exchange Fund papers issued were well received by the market (Table 3).

	No. of issues launched	Over-subscription ratio
1-month EFB	2	6.67
3-month EFB	12	1.39-4.41
6-month EFB	10	1.81-6.43
12-month EFB	3	9.98-15.33
2-year EFN	1	7.11
3-year EFN	1	6.92
5-year EFN	1	4.01

### Discount Window activities

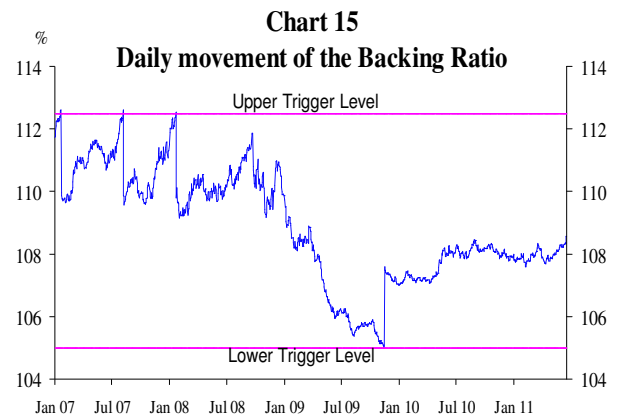
15. During the reporting period, **five banks borrowed a total of HK\$1.31 billion from the Discount Window**, compared with HK\$5.01 billion in the preceding period (Chart 14 and Table 4).



Frequency of using Discount Window	No. of banks
1	5
Total	5

## Backing Portfolio

16. Backing Assets increased slightly during the reporting period, reflecting the expansion in CIs and valuation gains. As the Backing Assets rose proportionally more than the Monetary Base, **the Backing Ratio increased slightly to 108.58% from 108.17% during the reporting period** (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.



**Hong Kong Monetary Authority**  
**12 August 2011**