

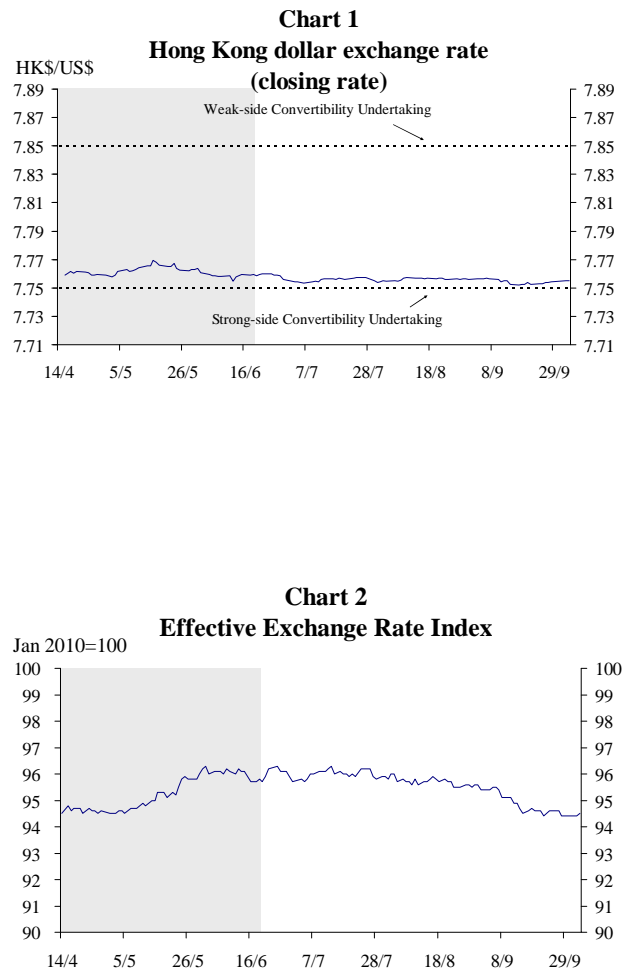
**EXCHANGE FUND ADVISORY COMMITTEE**  
**Currency Board Sub-Committee**

**Report on Currency Board Operations**  
**(20 June 2012 – 4 October 2012)**

The Hong Kong dollar exchange rate remained stable during the review period, notwithstanding that the announcement of major accommodative monetary policies by the European Central Bank (ECB) and the US Federal Reserve has led to some strengthening of the spot exchange rate. In the money market, the Hong Kong dollar interbank interest rates were also broadly stable. The spreads of Hong Kong dollar interest rates against their US dollar counterparts were steady in the early part of the review period, and then narrowed in September amid declines in the US dollar interest rates. Hong Kong dollar forward points also followed similar patterns. The Monetary Base increased to HK\$1,103.29 billion from HK\$1,081.33 billion, largely due to the rise in Certificates of Indebtedness. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by changes in foreign reserves.

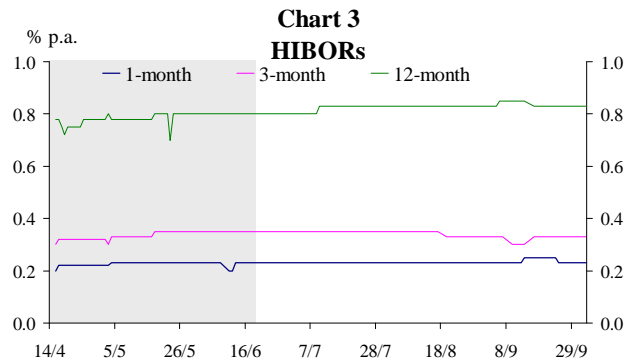
## **Hong Kong dollar exchange rate**

1. The Hong Kong dollar exchange rate moved within a narrow range of 7.7521 – 7.7599 during the review period (Chart 1). There were only small fluctuations in the exchange rate, mainly reflecting equity-related demand for Hong Kong dollars, as well as liquidity management of banks towards the end of September. The announcement of the ECB to undertake Outright Monetary Transactions and of the US Federal Reserve to purchase additional agency mortgage-backed securities has led to some strengthening of the Hong Kong dollar exchange rate. But overall, these developments had little impact on the spot exchange rate. For the review period as a whole, the Hong Kong dollar exchange rate strengthened slightly to 7.7552 on 4 October from 7.7585 on 20 June. **The nominal effective exchange rate index of the Hong Kong dollar weakened during the review period amid US dollar depreciation against most of the major currencies (Chart 2).**

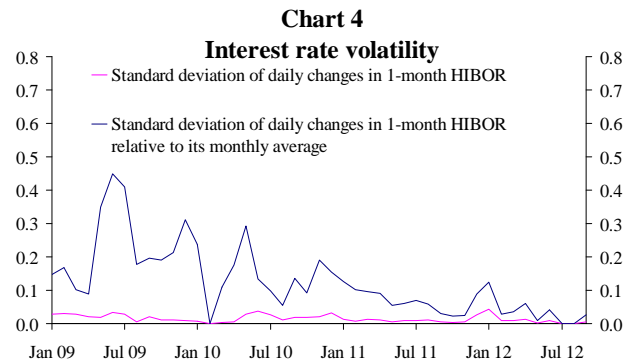


## Interest rates

2. **Hong Kong dollar interbank interest rates were broadly stable** during the review period (Chart 3). The one-month and 12-month HIBORs closed at 0.23% and 0.83% respectively on 4 October.

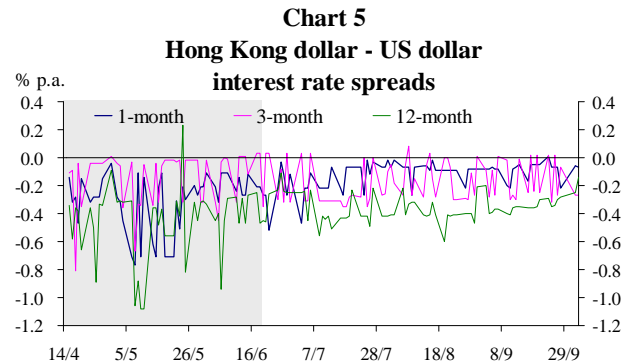


3. Reflecting broadly stable interbank interest rates, **interest rate volatility**, as measured by the standard deviation of daily changes in the one-month HIBOR, **was close to zero** during the review period (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also showed similar movements.<sup>1</sup>

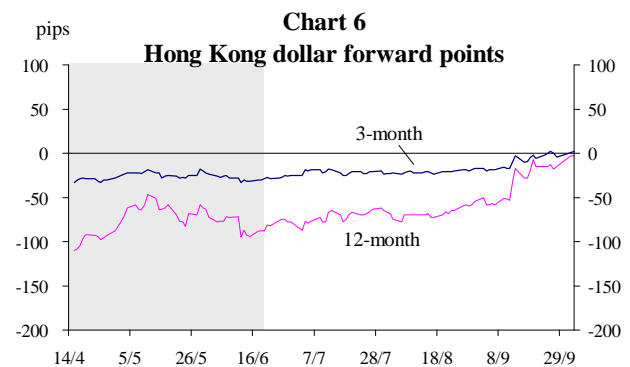


<sup>1</sup> The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

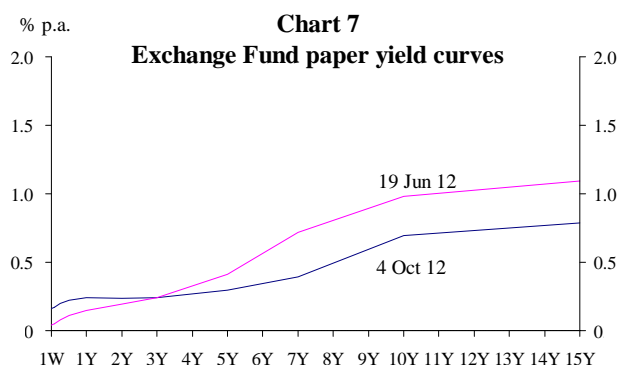
4. The spreads of Hong Kong dollar interest rates against their US dollar counterparts were steady in the early part of the review period, and then narrowed in September amid declines in the US dollar interest rates following the announcement of QE3 (Chart 5). The one-month, three-month and 12-month negative spreads averaged around -12, -18, and -36 basis points respectively.



5. Along with the movements in the interest rate spreads, the Hong Kong dollar forward points were little changed in July and August, and then narrowed in September (Chart 6). The three-month and 12-month forward points closed at +2 and -3 pips respectively on 4 October.



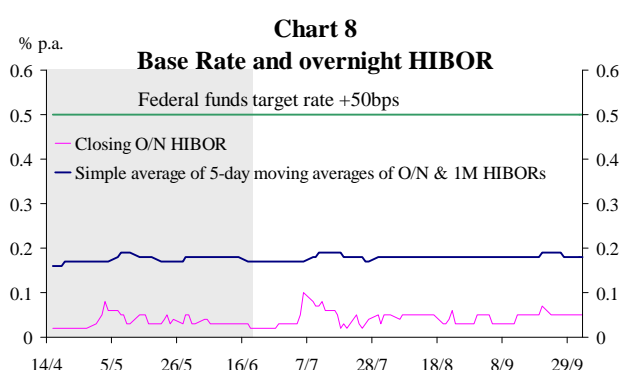
6. **The yield curve of Exchange Fund paper flattened during the review period** (Chart 7). The yield spreads of Exchange Fund paper over US Treasuries turned positive for shorter tenors. On the other hand, the negative yield spreads widened for tenors longer than 3 years. For instance, the 10-year and 15-year negative yield spreads over US Treasuries widened by 37 and 41 basis points to -94 and -136 basis points respectively during the review period (Table 1).



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

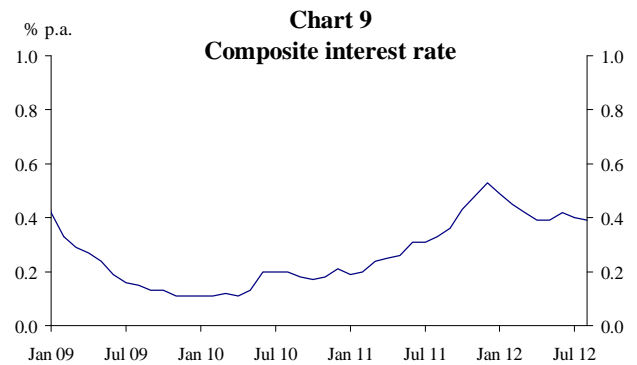
	19 Jun 12	4 Oct 12
3-month	-1	12
1-year	-1	9
3-year	-13	-6
5-year	-26	-30
10-year	-57	-94
15-year	-95	-136

7. At the August and September meetings, the US Federal Open Market Committee (FOMC) decided to keep the Federal Funds Target Rate (FFTR) at 0 – 0.25%.<sup>2</sup> As such, **the HKMA Base Rate remained unchanged at 0.5%** (Chart 8). 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.



<sup>2</sup> At the September meeting, the FOMC stated that economic conditions were likely to warrant exceptionally low levels for the Federal Funds rate for an extended period at least through mid-2015. It also agreed to increase policy accommodation by purchasing US\$40 billion of agency mortgage-backed securities per month.

8. In line with the stable US FFTR, banks in Hong Kong continued to keep their Best Lending Rates unchanged. There continued to be two Best Lending Rates of 5.00% and 5.25% at the end of the review period. Meanwhile, the Hong Kong dollar deposit interest rates offered by retail banks remained broadly stable. **The composite interest rate<sup>3</sup>, which indicates the average cost of funds for retail banks, was roughly stable at 0.39% during the review period (Chart 9).** Mortgage interest rates for newly-approved loans were little changed.



---

<sup>3</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.

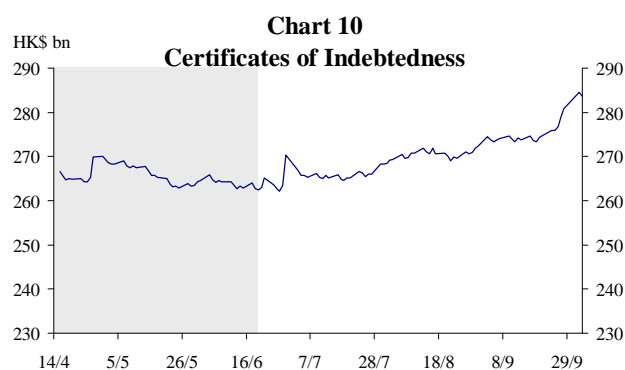
## Monetary Base

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, **increased to HK\$1,103.29 billion on 4 October from HK\$1,081.33 billion on 20 June** (Table 2). Movements in the individual components are discussed below.

<b>Table 2</b> <b>Monetary Base</b>		
(HK\$bn)	20 Jun 12	4 Oct 12
CIs	262.40	283.70
Government-issued Currency Notes and Coins in Circulation	10.02	10.12
Aggregate Balance	148.64	148.66
Outstanding EFBNs	660.27	660.82
<b>Monetary Base</b>	<b>1,081.33</b>	<b>1,103.29</b>

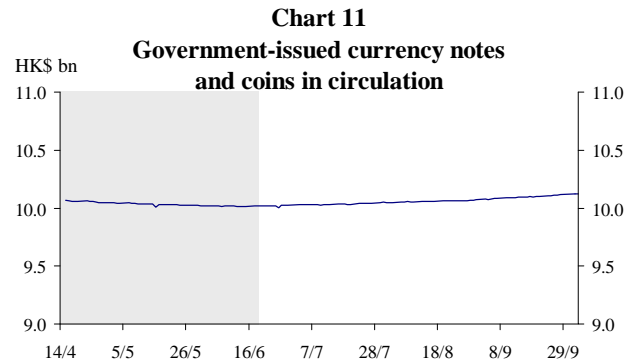
### *Certificates of Indebtedness*

10. During the review period, the three note-issuing banks submitted US\$2.73 billion to the HKMA in exchange for HK\$21.3 billion worth of CIs, in part reflecting an increase in the banknote demand ahead of the long holidays (the Mid-Autumn Festival and the National Day). As a result, **the outstanding CIs rose to HK\$283.70 billion on 4 October from HK\$262.40 billion on 20 June** (Chart 10).



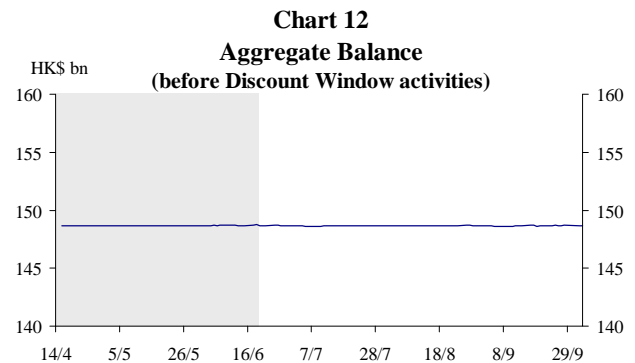
*Government-issued currency notes and coins in circulation*

11. During the review period, the amount of **government-issued currency notes and coins in circulation** edged up to HK\$10.12 billion on 4 October from HK\$10.02 billion on 20 June (Chart 11).



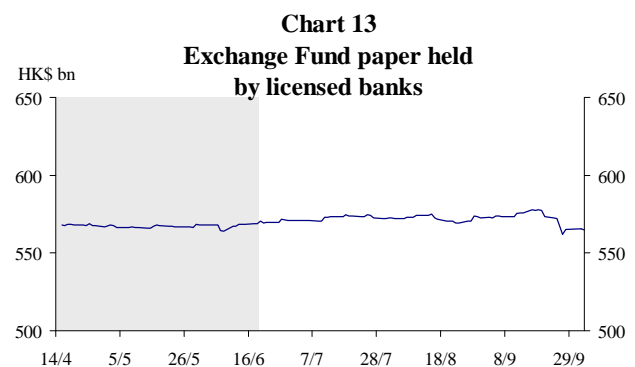
*Aggregate Balance*

12. **The Aggregate Balance remained little changed** at around HK\$148.66 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 increased slightly** to HK\$660.82 billion from HK\$660.27 billion during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased** to HK\$564.93 billion (85.5% of total) from HK\$570.31 billion (86.4% of total) (Chart 13).



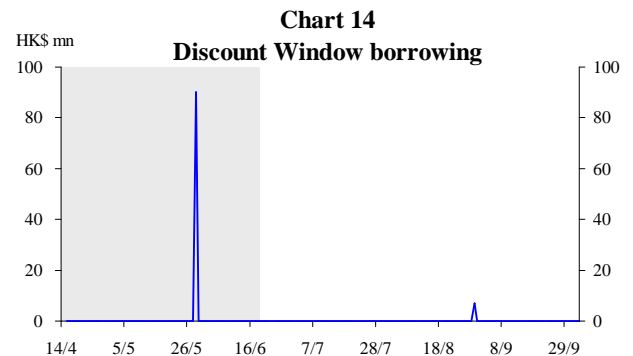


14. During the review period, **HK\$711.95 million of interest payments on Exchange Fund paper were made. An additional HK\$688.72 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were well received by the market (Table 3).

<b>Table 3</b> <b>Issuance of Exchange Fund Bills and Notes</b> <b>(20 Jun - 4 Oct 12)</b>		
	No. of issues launched	Over-subscription ratio
1-month EFB	1	10.35
3-month EFB	16	0.76-2.43
6-month EFB	14	1.22-4.89
12-month EFB	4	2.12-6.83
2-year EFN	1	4.83
3-year EFN	1	2.02
5-year EFN	1	1.22
15-year EFN	1	1.93

### **Discount Window activities**

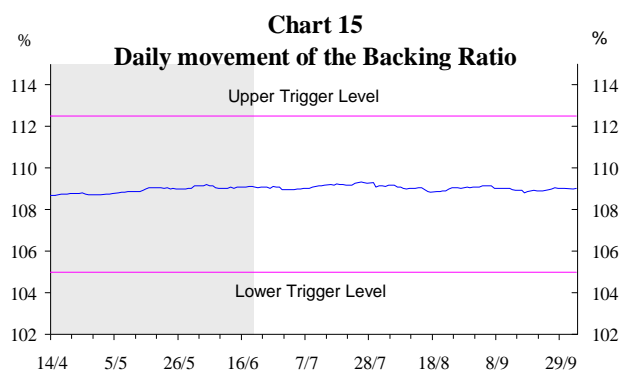
15. During the review period, **only one bank borrowed a total of HK\$7 million from the Discount Window**, compared with HK\$90 million in the preceding period (Chart 14 and Table 4).



<b>Table 4</b> <b>Frequency of individual bank's access to the Discount Window</b> <b>(20 Jun - 4 Oct 12)</b>	
Frequency of using Discount Window	No. of banks
1	1

### **Backing Portfolio**

16. The Backing Assets expanded to HK\$1,200.79 billion during the review period, mainly reflecting the rise in the CIs. On the other hand, as the Backing Assets increased proportionally less than the Monetary Base, **the Backing Ratio decreased slightly to 109.02% from 109.08% during the review 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**  
**4 December 2012**