

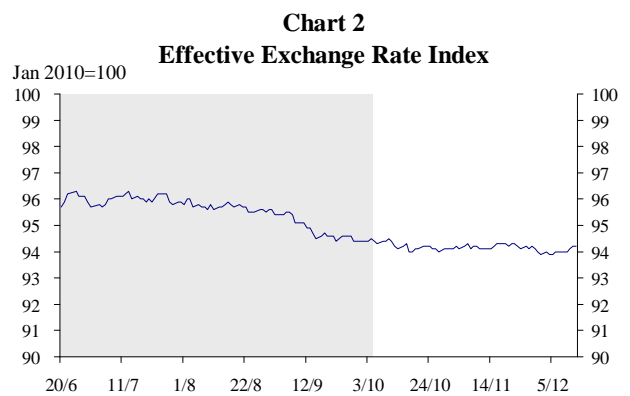
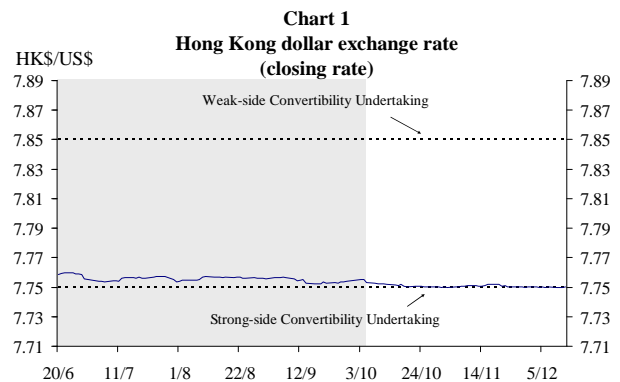
**EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee**

**Report on Currency Board Operations
(5 October 2012 – 13 December 2012)**

The Hong Kong dollar exchange rate strengthened and stayed close to the strong-side Convertibility Undertaking (CU) of 7.75 during the review period. Meanwhile, the strong-side CU was intermittently triggered due to inflows of funds, partly reflecting increased allocation to Hong Kong dollar assets by overseas investors and proceeds from issuance of foreign currency bonds by Hong Kong firms in exchange for Hong Kong dollars. As a result, the Aggregate Balance increased markedly, and the Monetary Base rose to HK\$1,175.92 billion at the end of the review period. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by changes in foreign reserves. The Hong Kong dollar interbank interest rates edged down along with the US dollar counterparts.

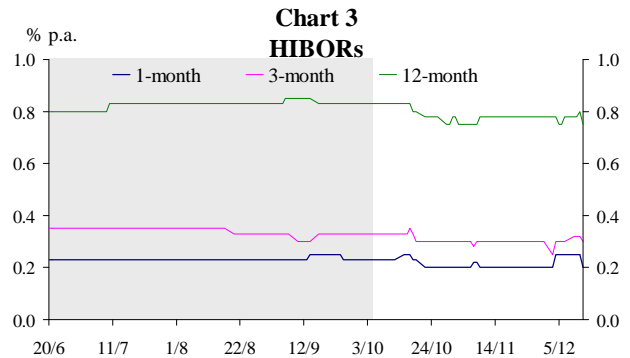
Hong Kong dollar exchange rate

1. **The Hong Kong dollar exchange rate strengthened and stayed close to the strong-side CU of 7.75 during the review period (Chart 1). The exchange rate stood at 7.7501 at the end of the review period. The strong-side CU was triggered intermittently, involving inflows of HK\$90.1 billion.** The inflows partly reflected increased allocation to Hong Kong dollar assets by overseas investors and the proceeds from issuance of foreign currency bonds by Hong Kong firms in exchange for Hong Kong dollars. The stronger equity initial public offerings (IPO) activities also to some extent supported the inflows towards late November. **The nominal effective exchange rate index of the Hong Kong dollar was broadly stable during the review period (Chart 2).**

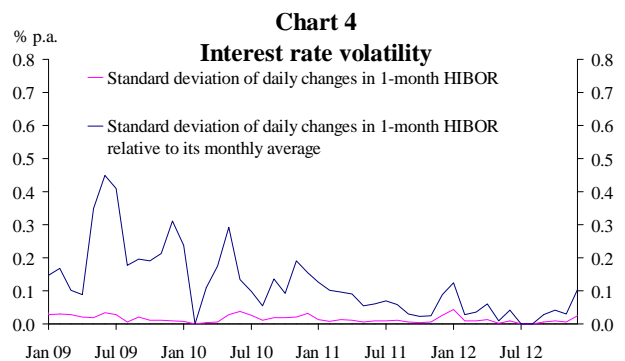


Interest rates

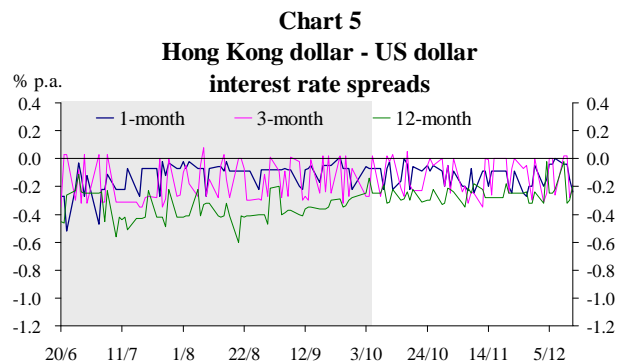
2. Along with the US dollar counterparts, **Hong Kong dollar interbank interest rates edged down** during the review period (Chart 3). Both the one-month and three-month HIBORs declined by 3 basis points to 0.20% and 0.30% respectively. The 12-month HIBOR decreased by 8 basis points to 0.75%.



3. **Interest rate volatility**, as measured by the standard deviation of daily changes in the one-month HIBOR, **increased gradually** to around 2.5 basis points from virtually zero in August (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also followed similar pattern.¹

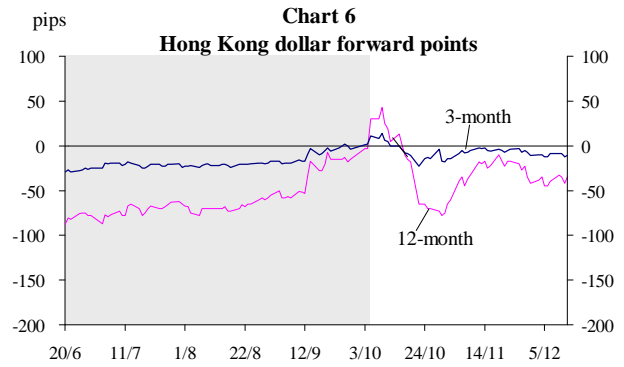


4. **The spreads of Hong Kong dollar interest rates against their US dollar counterparts remained steady in the review period** (Chart 5). The one-month, three-month and 12-month spreads averaged around -13, -12, and -25 basis points respectively.

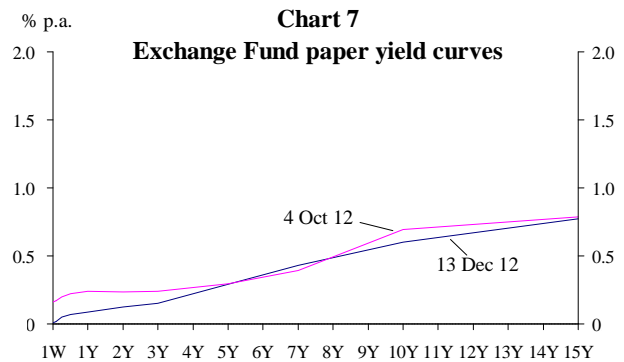


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

5. **The Hong Kong dollar forward points moved from premium to discount during the review period (Chart 6). The three-month and 12-month forward points closed at -11 and -35 pips respectively on 13 December.**

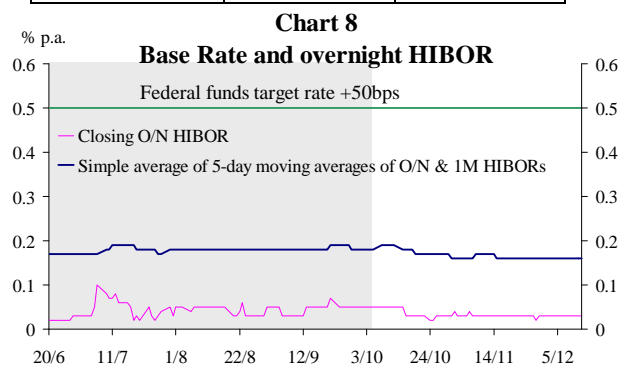


6. **During the review period, the yields of Exchange Fund paper shifted broadly downwards (Chart 7). The yield spreads of Exchange Fund paper over US Treasuries reverted to negative for tenors shorter than two years, while the negative yield spreads widened for other longer-term tenors (Table 1).**



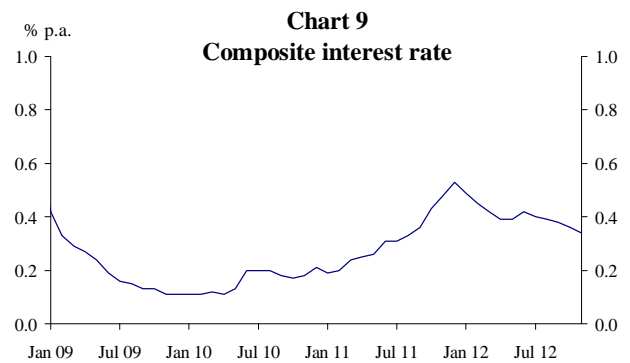
	4 Oct 12	13 Dec 12
3-month	12	-2
1-year	9	-6
3-year	-6	-19
5-year	-30	-38
10-year	-94	-103
15-year	-136	-141

7. At the October and December meetings, the US Federal Open Market Committee (FOMC) decided to keep the Federal Funds Target Rate (FFTR) at 0 – 0.25%.² 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.



² At the December meeting, the FOMC decided to purchase longer-term Treasury securities, initially at a pace of \$45 billion per month, after the completion of Maturity Extension Program (also known as the “Operation Twist”) at the end of 2012. The FOMC also considered the exceptionally low range for the Federal Funds Target Rate will be appropriate at least as long as the unemployment rate remains above 6.5%, inflation rate is projected to be no more than 2% between one and two years ahead, and longer-term inflation expectations continue to be well anchored.

8. Banks kept their Best Lending Rates unchanged, consistent with the stable US FFTR. There continued to be two Best Lending Rates of 5.00% and 5.25% at the end of the review period. Meanwhile, the average one-month Hong Kong dollar time deposit rate offered by retail banks remained stable at 0.01%³. Reflecting decreases in the weighted funding costs for both deposits and interbank funds, **the composite interest rate⁴**, which indicates the average cost of funds for retail banks, **declined to 0.34% in November from 0.38% in September** (Chart 9). Mortgage interest rates for newly-approved loans also edged down.



³ The figure refers to the average of interest rates offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

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.

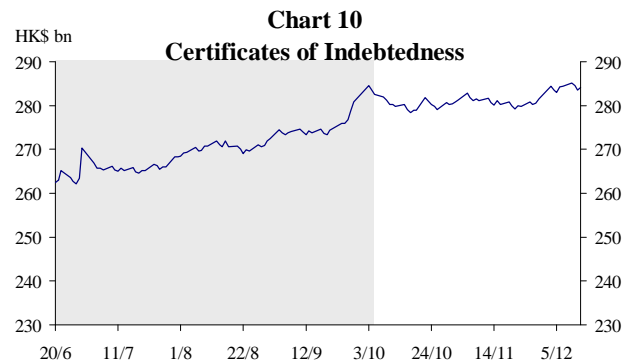
Monetary Base

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\$1,175.92 billion on 13 December from HK\$1,102.05 billion on 5 October** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	5 Oct 12	13 Dec 12
CIs	282.51	284.14
Government-issued Currency Notes and Coins in Circulation	10.13	10.20
Aggregate Balance	148.66	220.34
Outstanding EFBNs	660.76	661.25
Monetary Base	1,102.05	1,175.92

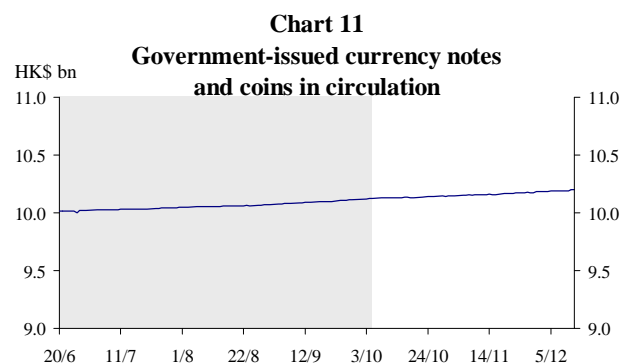
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$209 million to the HKMA in exchange for HK\$1.63 billion worth of CIs. As a result, **the outstanding CIs rose to HK\$284.14 billion on 13 December from HK\$282.51 billion on 5 October** (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\$10.20 billion on 13 December from HK\$10.13 billion on 5 October** (Chart 11).



Aggregate Balance

12. The Aggregate Balance expanded to HK\$220.34 billion on 13 December from HK\$148.66 billion on 19 October (Chart 12), due to the repeated triggering of the strong-side CU between 19 October and 13 December (Table 3).

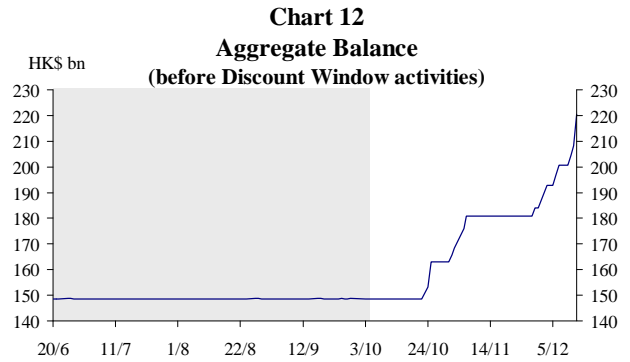


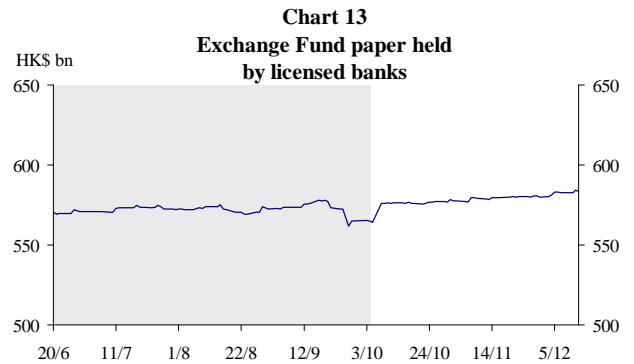
Table 3
HKMA HK\$/US\$ FX Transactions
(5 Oct 12 - 13 Dec 12)

Trade Date	Net HK\$ purchase (+) (HK\$m)
19-Oct-12	-4,673.25
23-Oct-12	-9,687.50
30-Oct-12	-2,712.50
31-Oct-12	-2,712.50
01-Nov-12	-7,401.25
02-Nov-12	-5,037.50
27-Nov-12	-3,100.00
29-Nov-12	-8,858.25
04-Dec-12	-3,875.00
05-Dec-12	-3,875.00
07-Dec-12	-3,875.00
10-Dec-12	-3,875.00
11-Dec-12	-12,012.50
12-Dec-12	-11,663.75*
13-Dec-12	-6,781.25*
Total	-90,140.25

* The figures were shown in the Aggregate Balance on 17 December, which rose to HK\$238.8 billion.

Outstanding Exchange Fund Bills and Notes

13. **The market value of outstanding Exchange Fund Bills and Notes increased slightly to HK\$661.25 billion from HK\$660.76 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$583.33 billion (88.2% of total) from HK\$564.22 billion (85.4% of total) (Chart 13).**

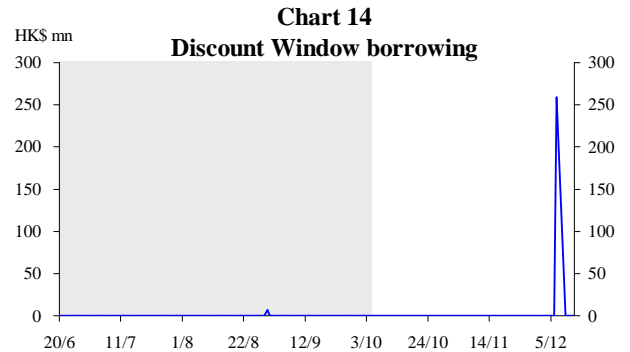


14. During the review period, **HK\$381.67 million of interest payments on Exchange Fund paper were made. An additional HK\$311.91 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were well received by the market (Table 4).

	No. of issues launched	Over-subscription ratio
1-month EFB	2	10.50-13.77
3-month EFB	10	0.93-2.92
6-month EFB	8	1.49-6.08
12-month EFB	3	2.57-6.31
2-year EFN	1	5.70
10-year EFN	1	1.97

Discount Window activities

15. During the review period, **only one bank borrowed a total of HK\$259 million from the Discount Window**, compared with HK\$7 million in the preceding period (Chart 14 and Table 5).



Backing Portfolio

16. The Backing Assets expanded to HK\$1,272.76 billion during the review period, mainly reflecting the rise in the Aggregate Balance. On the other hand, as the Backing Assets increased proportionally less than the Monetary Base, **the Backing Ratio decreased slightly to 108.41% from 108.95% 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.

Table 5
Frequency of individual bank's access to the Discount Window (5 Oct - 13 Dec 12)

Frequency of using Discount Window	No. of banks
1	1

