<u>Annex</u>

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

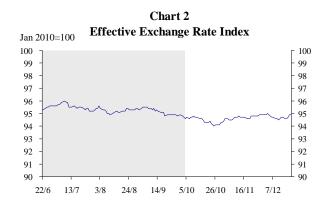
<u>Report on Currency Board Operations</u> (4 October 2013 – 20 December 2013)

The Hong Kong dollar exchange rate moved within a narrow range of 7.7515 - 7.7548 during the review period, notwithstanding volatile stock market performance and momentary IPO funding demand. In the latter part of the review period, the US Federal Open Market Committee (FOMC) decided to reduce the pace of asset purchases at its December meeting, and the Hong Kong dollar exchange rate softened slightly. In the money market, the Hong Kong dollar interbank interest rates remained at low levels throughout the review period, while the Hong Kong dollar forward discounts narrowed slightly. The Monetary Base edged up mainly due to an increase in Certificate of Indebtedness. All changes in the Monetary Base were fully matched by changes in foreign reserves in accordance with Currency Board principles.

Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate moved within a narrow range of 7.7515 -7.7548 during the review period, despite volatile stock market performance and momentary IPO funding demand (Chart 1). This contrasted with the relatively more volatile developments in some emerging market currencies during that time. In the latter part of the review period, the US FOMC decided to reduce the pace of asset purchases at its December meeting, and the Hong Kong dollar exchange rate softened slightly thereafter, closing at 7.7548 on 20 December, with compared 7.7543 on 4 October. The nominal effective exchange rate index of the Hong Kong dollar also hovered within a tight range during the review period (Chart 2), mainly reflecting a stable US dollar exchange rate against a broad basket of currencies of our trading partners.

Chart 1									
HK\$/US\$		Hong		·		hange	rate		
7.89 ד			(0	closiną	g rate)			r 7.89
7.87 -		,	Weak-side	Converti	bility Und	ertaking			- 7.87
7.85	• • • • • • • • • •	• • • • • • • • •		•••••	••••••			•••••	- 7.85
7.83 -									- 7.83
7.81 -									- 7.81
7.79 -									- 7.79
7.77 -									- 7.77
7.75 -						<u> </u>			- 7.75
7.73 -		5	Strong-side	e Converti	bility Und	lertaking			- 7.73
7.71		1			-		-		⊥ 7.71
22/6	13/7	3/8	24/8	14/9	5/10	26/10	16/11	7/12	

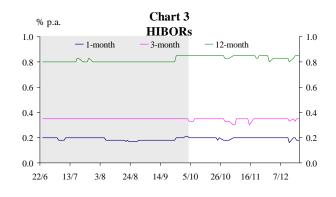


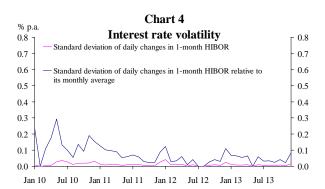
Interest rates

2. Hong Kong dollar interbank interest rates remained at low levels throughout the review period (Chart 3). The one-month, and three-month 12-month HIBORs on average hovered at 0.20%. 0.34% and 0.84% respectively.

3. Interest rate volatility stayed low, though increasing slightly in December. Overall, the standard deviation of daily changes in the one-month HIBOR was around one basis point during the review period (Chart 4). The standard deviation as a ratio of the average one-month **HIBOR** also followed similar pattern.¹

The spreads of Hong 4. Kong dollar interest rates against their US dollar counterparts were roughly steady in the review period The three-month (Chart 5). and 12-month spreads averaged +5 and +23basis points respectively, while the one-







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.

month spread averaged around -2 basis points.

5. The Hong Kong dollar forward discounts narrowed slightly during the review period to -9 pips for the threemonth rate and -14 pips for the 12-month rate as at 20 December (Chart 6).

The yields of Exchange 6. Fund paper steepened during the review period (Chart 7), following largely the movements of the US Treasury vields. On the other hand, reflecting relatively smaller rises in the long-term yields of Exchange Fund paper, the negative yield spreads of longterm Exchange Fund paper US over the counterparts widened modestly (Table 1).

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

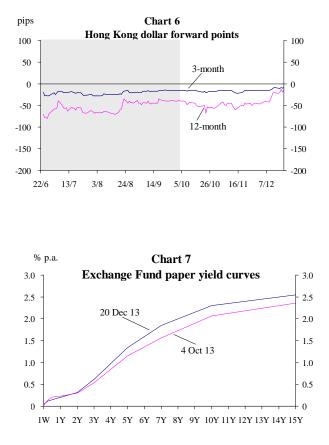
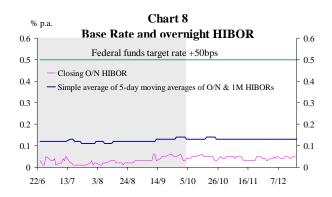


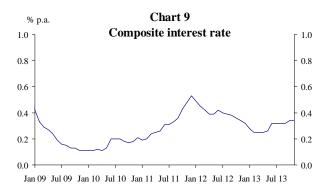
Table 1 Yield spreads of Exchange Fund paper over US Treasuries (basis points)				
	04 Oct 13	20 Dec 13		
3-month	11	5		
1-year	14	7		
3-year	-6	-10		
5-year	-23	-31		
10-year	-58	-65		
15-year	-82	-89		

² At the December meeting, the FOMC decided to modestly reduce the pace of its asset purchase. As such, beginning in January, the FOMC will add to its holdings of longerterm Treasury securities and agency mortgage-backed securities at a pace of US\$75 billion per month rather than US\$85 billion per month. While reiterating the previous statements regarding those preconditions for an exceptionally low Federal Funds Target Rate, the FOMC also hinted that it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the FOMC's 2% longer-run goal.

HKMA the Base Rate remained unchanged at 0.5% (Chart 8). The Base Rate continued to be set at 50 basis the lower points above boundary of the FFTR target range in accordance with the revised Base Rate formula announced on 26 March 2009.

8. Banks kept their Best Rates unchanged, Lending 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. The average one-month Hong Kong dollar time deposit rate offered by retail banks continued to stay flat at 0.01%.³ The composite interest rate⁴, which indicates the average cost of funds for retail banks, edged up to 0.34% in November from 0.32% in September (Chart 9). On the lending side, the average mortgage interest rates for the newly approved loans decreased mortgage slightly.





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.

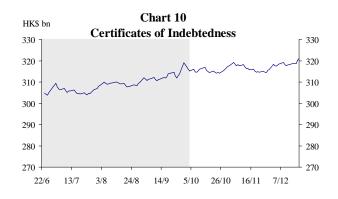
Monetary Base

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, HK\$1,247.54 edged up to billion on 20 December from HK\$1,241.60 billion on (Table 2). **4** October Movements in the individual discussed components are below.

Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$749 million in exchange for HK\$5.84 billion worth of CIs to the HKMA. As a result, the outstanding CIs increased to HK\$321.07 billion 20 on December from HK\$315.23 billion 4 October on (Chart 10).

Table 2Monetary Base					
(HK\$bn)	04 Oct 13	20 Dec 13			
CIs	315.23	321.07			
Government-issued Currency Notes and Coins in Circulation	10.74	10.84			
Aggregate Balance	163.88	163.92			
Outstanding EFBNs	751.75	751.71			
Monetary Base	1241.60	1247.54			



Government-issued currency notes and coins in circulation

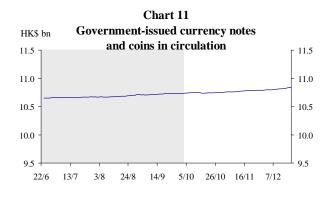
11. During the review period, the amount of **governmentissued currency notes and coins in circulation edged up** to HK\$10.84 billion on 20 December from HK\$10.74 billion on 4 October (Chart 11).

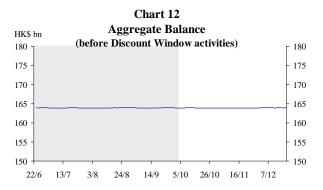
Aggregate Balance

12. The Aggregate Balance remained stable at around HK\$163.9 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 and Notes Bills decreased marginally HK\$751.71 to billion from HK\$751.75 billion during the review period. Meanwhile, holdings of Exchange Fund paper by the sector (before banking **Discount Window activities**) picked to up HK\$674.47 billion (89.7%) of





total) from HK\$658.62 billion (87.6% of total) (Chart 13).

14. During the review period, HK\$524.35 million of interest payments on Exchange Fund were made. An paper additional HK\$394.86 million (in market value) of Exchange Fund paper was issued to absorb these interest payments. The remaining amount was carried forward in the Aggregate The Exchange Fund Balance. papers issued were well received by the market (Table 3).

Discount Window activities

15. During the review period, five banks borrowed a total of HK\$617 million from the Discount Window, compared with HK\$2.13 billion in the preceding period (Chart 14 and Table 4).

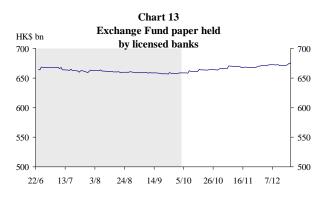


Table 3Issuance of Exchange Fund Bills and Notes(4 Oct 13 - 20 Dec 13)				
	No. of	Over-		
	issues	subscription ratio		
	launched			
1-month EFB	2	9.17-9.33		
3-month EFB	11	0.78-3.02		
6-month EFB	11	1.97-5.41		
12-month EFB	3	1.34-3.90		
2-year EFN	1	2.90		
3-year EFN	1	1.88		
5-year EFN	1	2.50		
10-year EFN	1	2.64		

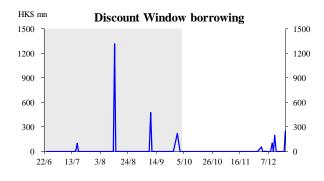


Table 4Frequency of individual bank'saccess to the Discount Window(4 Oct 13 - 20 Dec 13)		
Frequency of using Discount Window	No. of banks	
1	5	

Backing Portfolio

16. The Backing Assets HK\$1,341.37 increased to billion during the review period, mainly reflecting an increase in the CIs. As the Backing Assets increased proportionally less than the Monetary Base, the Backing Ratio edged down to 107.54% from 107.64% 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 17 February 2014

