

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

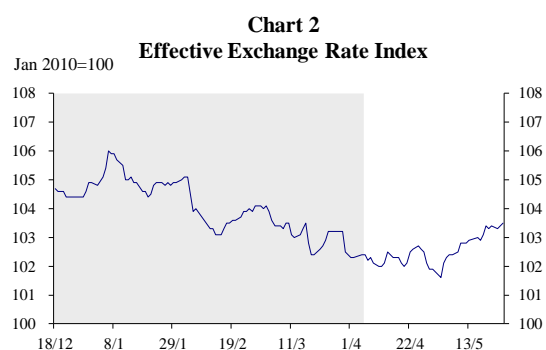
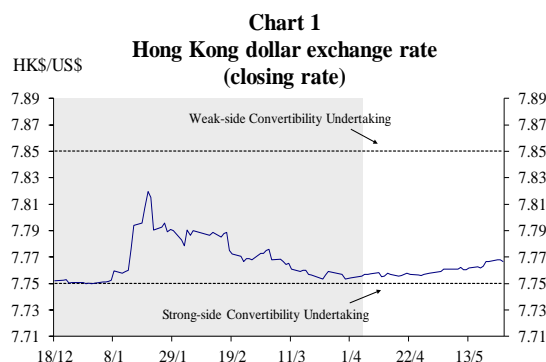
Report on Currency Board Operations

(6 April 2016 – 25 May 2016)

During the review period, the Hong Kong dollar traded within a narrow range of 7.7550–7.7679 against the US dollar. Partly reflecting the growing expectation of a US interest rate hike in June or July, the Hong Kong dollar softened against the US dollar towards the end of the review period. In the money market, the Hong Kong dollar interbank interest rates stayed steadily low. The additional issuance of Exchange Fund Bills had no impact on the interbank rates. The short-dated Hong Kong dollar forward points traded at a discount, while the long-dated forward points mostly traded at a premium. The Convertibility Undertakings have not been triggered during the review period. The Aggregate Balance decreased due to the additional issuance of Exchange Fund Bills, and the Monetary Base decreased slightly to HK\$1,600.28 billion mainly due to a decline in Certificates of Indebtedness. All changes in the Monetary Base were fully matched by changes in foreign reserves in accordance with the Currency Board principles.

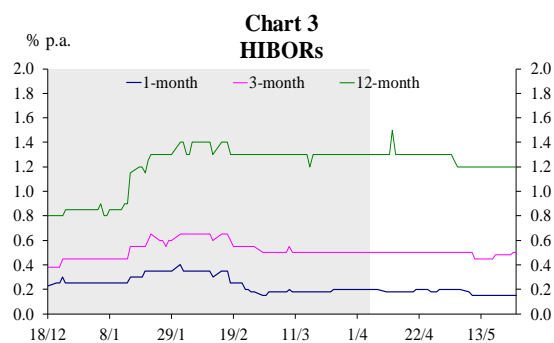
Hong Kong dollar exchange rate

1. During the review period, the Hong Kong dollar traded within a narrow range of 7.7550 – 7.7679 against the US dollar (Chart 1). Partly reflecting the growing expectation of a US interest rate hike in June or July, the Hong Kong dollar softened against the US dollar along with the domestic equity market consolidation and the weakness of Asian currencies, closing at 7.7668 at the end of the review period. The nominal effective exchange rate index of the Hong Kong dollar picked up during the review period (Chart 2), due to strengthening of the US dollar against most major currencies.

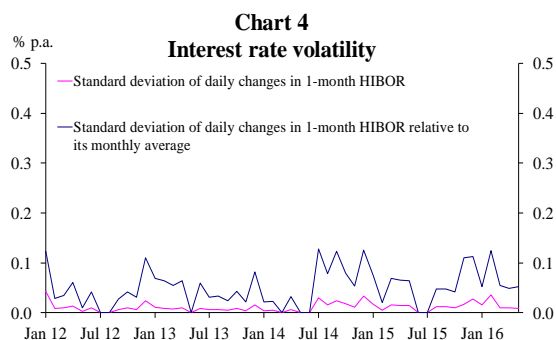


Interest rates

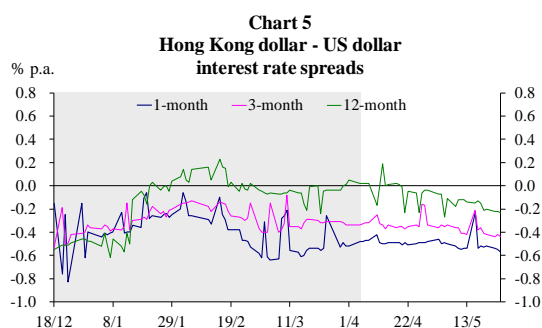
2. During the review period, the Hong Kong dollar interbank interest rates stayed steadily low (Chart 3). The additional issuance of Exchange Fund Bills had no impact on the interbank rates. The one-month and three-month HIBORs averaged around 0.18% and 0.49% respectively during the review period, while the 12-month HIBOR decreased by 10 basis points to 1.20% at the end of review period.



3. **Interest rate volatility**, measured by the standard deviation of daily changes in the one-month HIBOR, **remained low** at around 0.9 basis points in April and May (Chart 4). The standard deviation as a ratio of the average of one-month HIBOR also showed similar pattern¹.

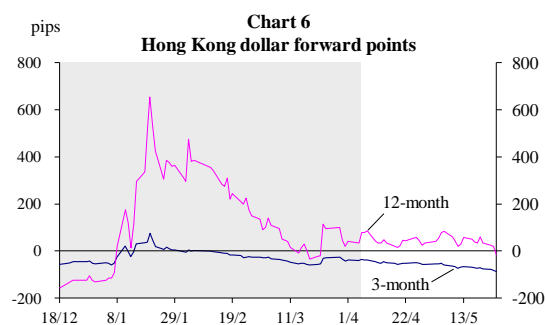


4. During the review period, **the negative spreads of the short-tenor Hong Kong dollar interbank interest rates against their US dollar counterparts were broadly stable** (Chart 5). The one-month and the three-month negative interest rate spreads averaged around -50 and -35 basis points respectively during the review period. The 12-month spread reverted to the negative territory, closing at -23 basis points at the end of the review period.

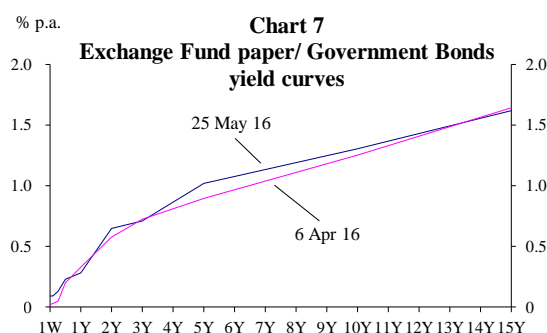


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

5. During the review period, **the short-dated Hong Kong dollar forward points traded at a discount** (Chart 6), with the three-month forward point closing at -87 pips at the end of review period. On the other hand, **the long-dated forward points mostly traded at a premium** mainly underpinned by investors' hedging demand. The 12-month forward point averaged +43 pips during the review period.

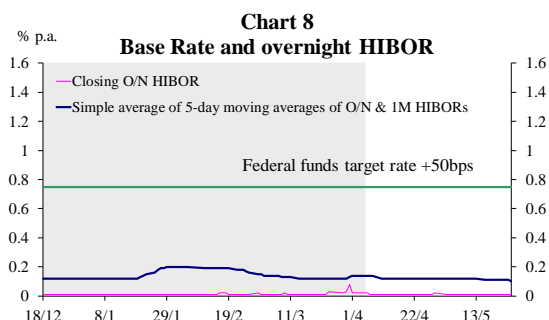


6. During the review period, **the Hong Kong dollar yield curve generally shifted upward** along with the movement of the US dollar yield curve. The yield of the 2-year Exchange Fund Note picked up by 7 basis points to 0.65%, and the yield of the 10-year Hong Kong Government Bond increased by 5 basis points to 1.30% (Chart 7). Meanwhile, the negative yield spreads of Hong Kong dollar Exchange Fund Paper and Government Bonds over the US Treasuries widened due to larger pick-ups in the US dollar yields (Table 1).

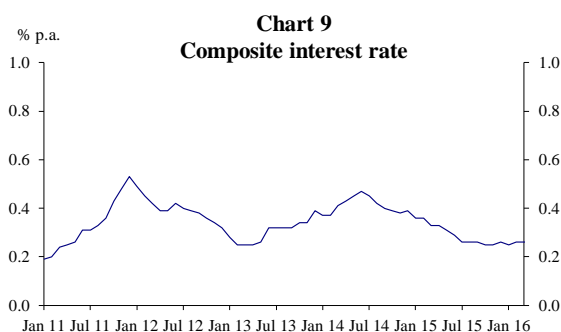


| | 6 Apr 16 | 25 May 16 |
|--------------|----------|-----------|
| 3-month EFB | -18 | -20 |
| 12-month EFB | -22 | -39 |
| 3-year HKGB | -15 | -37 |
| 5-year HKGB | -30 | -38 |
| 10-year HKGB | -51 | -57 |

7. At the April meeting, the US Federal Open Market Committee (FOMC) decided to keep the Federal Funds Target Rate (FFTR) at 0.25 – 0.5%. As such, **the HKMA Base Rate stayed unchanged at 0.75%** (Chart 8), which is 50 basis points above the lower boundary of the FFTR target range in accordance with the revised Base Rate formula announced on 26 March 2009.



8. Consistent with the stable US FFTR, banks kept their Best Lending Rates unchanged. The two Best Lending Rates continued to stay at 5.00% and 5.25% during the review period. The average one-month Hong Kong dollar time deposit rate offered by retail banks remained stable at 0.01%². **The composite interest rate³**, which indicates the average funding cost of retail banks, **remained steady at 0.26% in April** (Chart 9). On the lending side, the average mortgage interest rate for newly approved mortgage loans has decreased slightly since March.



² The figure refers to the average interest rate offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

³ 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.

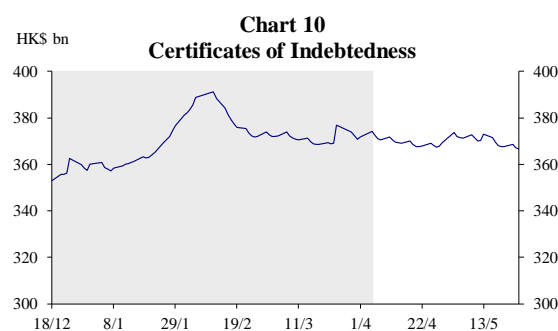
Monetary Base

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, **decreased slightly to HK\$1,600.28 billion on 25 May from HK\$1,606.17 billion on 6 April** (Table 2). Movements of the individual components are discussed below.

| (HK\$bn) | 6 Apr 16 | 25 May 16 |
|---|----------------|----------------|
| CIs | 372.46 | 366.60 |
| Government-issued Currency Notes and Coins in Circulation | 11.97 | 11.90 |
| Aggregate Balance | 358.39 | 322.40 |
| Outstanding EFBNs | 863.36 | 899.39 |
| Monetary Base | 1606.17 | 1600.28 |

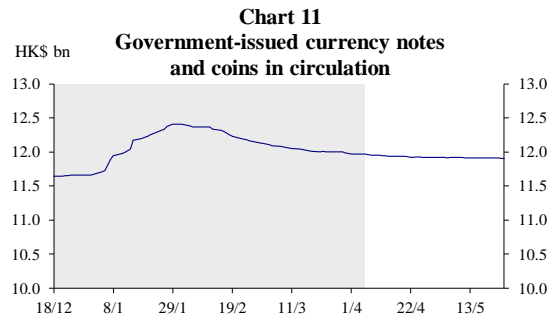
Certificates of Indebtedness

10. During the review period, the three note-issuing banks redeemed HK\$5.86 billion worth of CIs to the HKMA in exchange for US\$751 million. As a result, **the outstanding CIs decreased to HK\$366.60 billion on 25 May from HK\$372.46 billion on 6 April** (Chart 10).



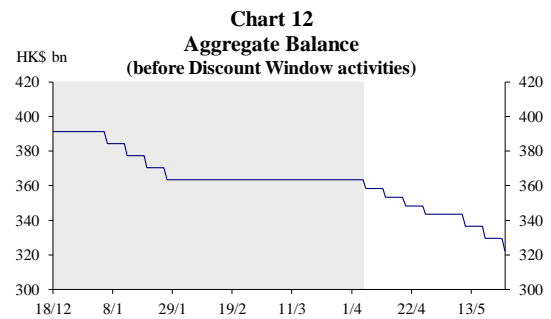
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation** decreased to HK\$11.90 billion on 25 May from HK\$11.97 billion on 6 April (Chart 11).



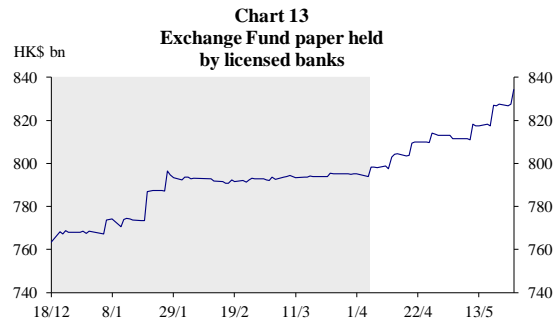
Aggregate Balance

12. **The Aggregate Balance declined to HK\$322.40 billion on 25 May from HK\$358.39 billion on 6 April** (Chart 12), as additional Exchange Fund Bills were issued to meet the increased demand by banks for such bills for liquidity management purpose.



Outstanding Exchange Fund Bills and Notes

13. **The market value of outstanding Exchange Fund Bills and Notes increased to HK\$899.39 billion from HK\$863.36 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$834.29 billion (92.8% of total) from HK\$798.25 billion (92.5% of total) (Chart 13).**



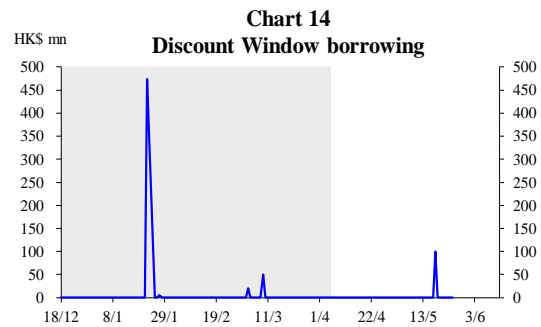
14. **The increase in outstanding Exchange Fund Bills and Notes was mainly due to the issuance of additional Exchange Fund Bills.** A total of HK\$41 billion of additional Exchange Fund Bills were issued during the review period. The additional issuance is consistent with Currency Board principles, as it represents a change in the composition of the Monetary Base with a shift from the Aggregate Balance to Exchange Fund Paper, and the Monetary Base remained fully backed by foreign exchange reserves. During the review period, **interest payments on Exchange Fund paper amounted to HK\$194.46 million. A total of**

HK\$177.96 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 paper issued during the review period was well received by the market (Table 3).

| | No. of issues launched | Over-subscription ratio |
|--------------|------------------------|-------------------------|
| 3-month EFB | 8 | 0.44 – 6.11 |
| 6-month EFB | 8 | 1.08 – 5.08 |
| 12-month EFB | 2 | 5.50 – 6.26 |
| 2-year EFN | 1 | 5.83 |

Discount Window activities

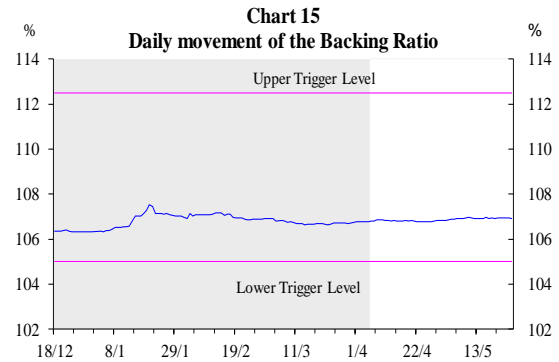
15. During the review period, **a bank borrowed HK\$100 million from the Discount Window**, compared with a total borrowing of HK\$550 million in the preceding period (Chart 14 and Table 4).



| Frequency of using Discount Window | No. of banks |
|------------------------------------|--------------|
| 1 | 1 |

Backing Portfolio

16. The Backing Assets decreased slightly to HK\$1,709.48 billion on 25 May, mainly reflecting a decrease in the CIs. As the Backing Assets decreased proportionally less than the Monetary Base, **the Backing Ratio edged up to 106.91% from 106.81% 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
25 July 2016