EXCHANGE FUND ADVISORY COMMITTEE

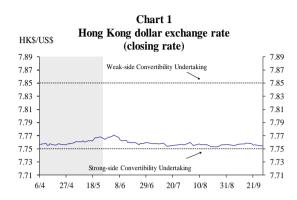
Currency Board Sub-Committee

Report on Currency Board Operations (26 May 2016 – 28 September 2016)

During the review period, the Hong Kong dollar traded within a range of 7.7529 - 7.7712 against the US dollar. After weakening to a low of 7.7712 on 3 June, the Hong Kong dollar exchange rate regained some strength following the US Federal Open Market Committee's decision to keep interest rates unchanged at its meeting on 14-15 June. Despite heightened financial volatilities immediately after Brexit, the Hong Kong dollar exchange rate remained stable and the Hong Kong dollar interbank interest rates stayed steadily low. The 12-month Hong Kong dollar forward point reverted to a discount, which increased along with widened longer-term negative HIBOR-LIBOR spreads amid the impending US money market fund reforms. The Aggregate Balance decreased due to the additional issuance of Exchange Fund Bills, and the Monetary Base increased slightly to HK\$1,612.44 billion mainly due to an increase 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 range of 7.7529-7.7712 against the US dollar (Chart 1). The Hong Kong dollar exchange rate weakened to a low of 7.7712 June amid heightened on expectation of US interest rate before regaining strength following the US Federal Market Committee's Open decision to keep interest rates unchanged at its meeting 14-15 June. While the outcome of the Brexit referendum sent shock waves through the global financial markets in late June, the Hong Kong dollar exchange rate remained broadly stable on the back of corporate demand for dividend distributions. Stepping into the third quarter, the Hong Kong dollar exchange rate strengthened on the back equity-related demand driven by fund-raising activities, closing at 7.7543 at the end of the review The nominal effective period. exchange rate index of the Hong Kong dollar generally moved sideways during the review period (Chart 2).

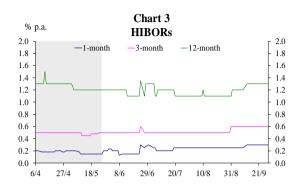


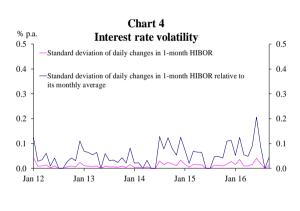


Interest rates

- During the review period, the Hong Kong dollar interbank interest rates remained steadily low, notwithstanding heightened financial market volatilities immediately after the **Brexit** referendum (Chart 3). For the review period as a whole, the one-month HIBOR picked up by 15 basis points to 0.30% at the of the review period. Meanwhile, the three-month and 12-month **HIBORs** increased by 10 basis points to 0.60% and 1.30% respectively.
- 3. **Interest** rate volatility, measured by the standard deviation of daily changes in the one-month HIBOR, rose to 4.0 basis points in June before falling back to an average of 1.3 basis points in the latter part of the review period (Chart 4). standard deviation as a ratio of the average of one-month HIBOR

also followed similar pattern¹.





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. Compared with the preceding period, the negative spreads of Hong Kong dollar interbank interest rates against their US dollar counterparts widened generally maturities beyond three months (Chart 5). This in part reflected the larger pick-ups in the US dollar LIBORs ahead of the US money market fund reforms. Overall, the one-month, threemonth and 12-month negative interest rate spreads averaged -40, -29 and basis points respectively during the review period.
- 5. Roughly tracking the movements of the Hong Kong dollar-US dollar interest spreads, the three-month Hong Kong dollar forward discount remained stable, while the 12month forward discount widened (Chart 6). At the end of the review period, the threemonth and 12-month Hong Kong dollar forward points closed at pips and -173 pips respectively.





6. During the review period, the Hong Kong dollar yield curve flattened along with the movement of the US dollar yield The yield of the 2-year curve. Exchange Fund Note decreased by 15 basis points to 0.44%, and the yield of the 10-year Hong Kong Government Bond declined by 31 basis points to 0.98% 7). Meanwhile, (Chart negative yield spreads of longertenor Hong Kong dollar Exchange Paper and Government Fund Bonds over the US Treasuries widened slightly due to smaller declines in the longer-tenor US dollar yields (Table 1).

7. the June, July At and September meetings, 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 staved 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.

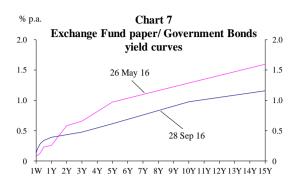
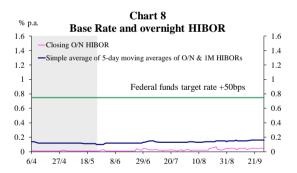
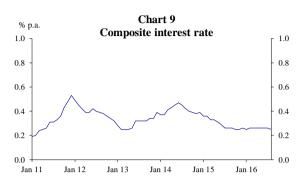


Table 1 Yield spreads of Exchange Fund paper and Hong Kong Government Bonds over US Treasuries (basis points)				
	26 May 16	28 Sep 16		
3-month EFB	-18	1		
12-month EFB	-39	-21		
3-year HKGB	-37	-40		
5-year HKGB	-38	-52		
10-year HKGB	-55	-60		



8. Banks kept their Best Lending Rates unchanged, consistent with the stable US FFTR. The two Best Lending Rates stayed at 5.00% and 5.25% during the review period. 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, edged down from 0.26% in May to 0.25% in August (Chart 9). Likewise, the average mortgage interest rate for newly approved mortgage loans decreased amid competition keener the residential lending mortgage business.



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

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 Certificates consists ofofIndebtedness (CIs), governmentissued currency notes and coins in circulation, the Aggregate Balance and Exchange Fund Bills Notes. increased slightly to HK\$1,612.44 billion 28 from HK\$1,600.18 September billion on 26 May (Table 2). Movements of the individual components are discussed below.

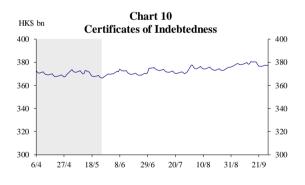
Table 2 Monetary Base				
(HK\$bn)	26 May 16	28 Sep 16		
CIs	366.52	377.52		
Government-issued Currency Notes and Coins in Circulation	11.90	11.93		
Aggregate Balance	322.40	259.51		
Outstanding EFBNs	899.37	963.49		
Monetary Base	1600.18	1612.44		

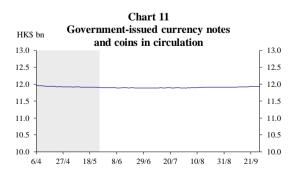
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$1.41 billion to the HKMA in exchange for HK\$11.0 billion worth of CIs. As a result, the outstanding CIs increased to HK\$377.52 billion 28 on from HK\$366.52 September billion on 26 May (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 increased slightly** to HK\$11.93 billion on 28 September from HK\$11.90 billion on 26 May (Chart 11).





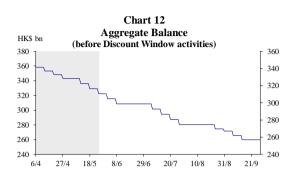
Aggregate Balance

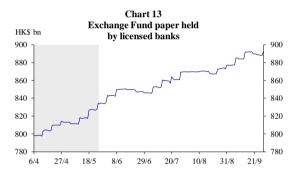
12. The Aggregate Balance declined to HK\$259.51 billion on 28 September from HK\$322.40 billion on 26 May (Chart 12), as additional Exchange Fund Bills were issued to meet the increased demand by banks for such bills for liquidity management purpose.

Outstanding Exchange Fund Bills and Notes

13. The market value outstanding Exchange Fund Bills **Notes** increased and HK\$963.49 billion from HK\$899.37 billion during the review period. **Holdings** Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$892.13 billion (92.6% of total) from HK\$833.85 billion (92.7% 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\$63 billion of additional Exchange Fund Bills were issued during the review period. The additional consistent issuance is Currency Board principles, as it





represents change in the a 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\$1,215.92 million. A total of HK\$1,017.31 million (in market value) of Exchange Fund paper was issued to absorb 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).

D .	TT70	4 • • 4 •
Discount	window	activities

15. During the review period, two banks borrowed HK\$2.02 billion from the Discount Window, compared with a total borrowing of HK\$100 million in the preceding period (Chart 14 and Table 4).

Table 3 Issuance of Exchange Fund Bills and Notes (26 May – 28 Sep 16)		
	No. of issues launched	Over- subscription ratio
1-month EFB	3	1.34-8.50
3-month EFB	18	0.41-4.71
6-month EFB	17	0.80-6.51
12-month EFB	5	1.74-4.93
2-year EFN	1	8.17

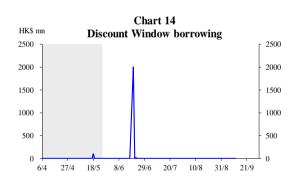
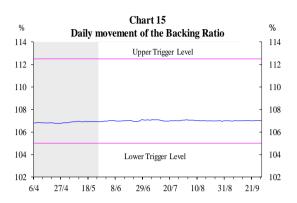


Table 4 Frequency of individual bank's access to the Discount Window (26 May – 28 Sep 16)		
Frequency of using Discount Window	No. of banks	
1	2	

Backing Portfolio

16. The Backing Assets increased slightly to HK\$1,723.95 billion on 28 September, as the note-issuing banks submitted more US dollars to the Exchange Fund in return for the CIs required for issuance of banknotes. As the Backing Assets increased proportionally more than Monetary Base, the Backing Ratio edged up to 107.03% from 106.92% 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 available are support the Hong Kong dollar exchange rate.



Hong Kong Monetary Authority 1 December 2016