

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

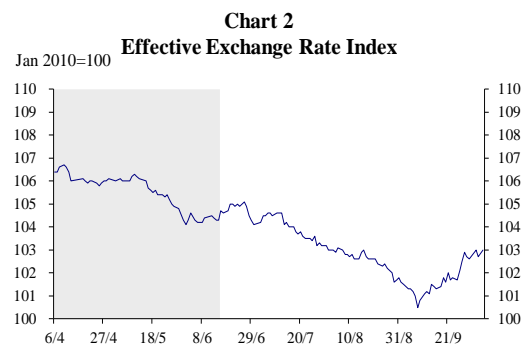
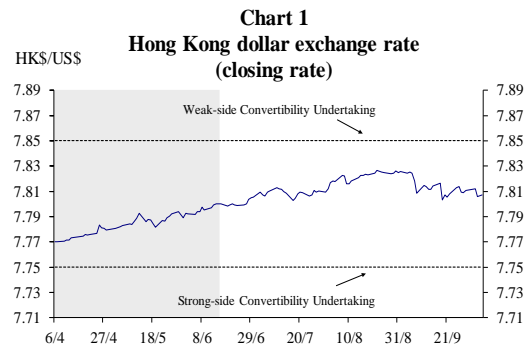
Report on Currency Board Operations

(16 June – 6 October 2017)

During the review period, the Hong Kong dollar (HKD) interbank interest rates mostly stayed soft. There were some pick-ups in the short-dated interbank rates towards the end of the review period, mainly owing to IPO-related and quarter-end funding demand. Meanwhile, the HKD exchange rate traded within a range of 7.7984 – 7.8265. Driven by interest carry trade activities amid the negative HKD-US dollar (USD) interest rate spreads, the HKD spot exchange rate eased gradually between mid-June and late-August. Towards the end of the review period, the HKD exchange rate strengthened slightly amid slower momentum of interest carry trade activities and some covering of short positions. The Aggregate Balance declined due to issuances of additional Exchange Fund Bills (EFBs). The Monetary Base increased slightly to HK\$1,678.96 billion, mainly driven by a rise 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.

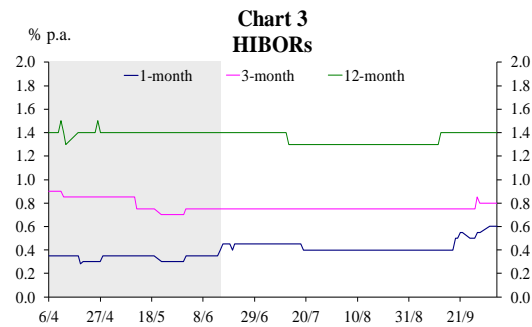
Hong Kong dollar exchange rate

1. During the review period, **the HKD traded within a range of 7.7984 – 7.8265 against the USD.** Driven by interest carry trade activities amid the negative HKD-USD interest rate spreads, the HKD spot exchange rate eased gradually between mid-June and late-August (Chart 1). Thereafter, the HKD strengthened slightly amid slower momentum of interest carry trade activities and some covering of short positions. Meanwhile, the HKD exchange and interbank markets continued to operate in an orderly manner despite Standard & Poor's downgrade of Hong Kong's credit rating in September. At the end of the review period, the HKD spot exchange rate closed at 7.8070 against the USD. **The nominal effective exchange rate index of the HKD declined** compared with the end of the preceding review period, despite a rebound since September (Chart 2). This largely followed the movements of the USD against most major currencies.

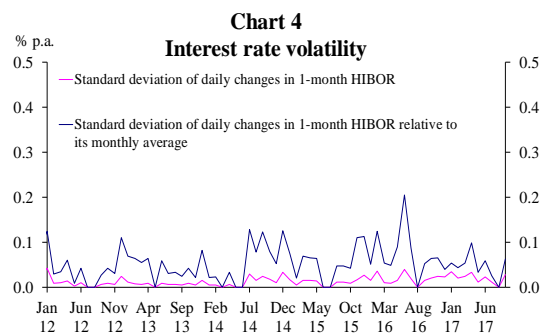


Interest rates

2. During the review period, **the HKD interbank interest rates (i.e. the HIBORs) mostly stayed soft.** Nevertheless, there were some pick-ups in the short-dated interbank rates towards the end of the review period, mainly owing to IPO-related and quarter-end funding demand. Compared with the levels at the end of the preceding review period, the three-month and the 12-month HIBORs were largely steady, averaging around 0.75% and 1.34% respectively, while the one-month HIBOR increased by 15 basis points to 0.60% at the end of the review period (Chart 3).

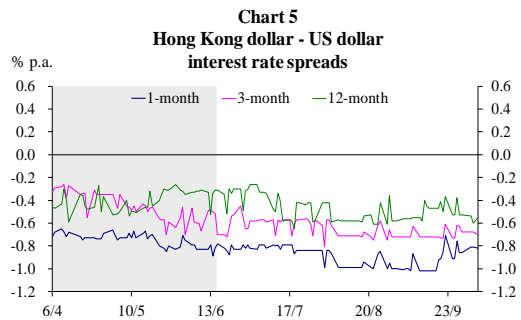


3. **Interest rate volatility**, measured by the standard deviation of daily changes in the one-month HIBOR, **picked up** from a low level of 0.8 basis points in July-August to 2.9 basis points in September (Chart 4). The standard deviation as a ratio of the average of one-month HIBOR also exhibited similar movements¹.

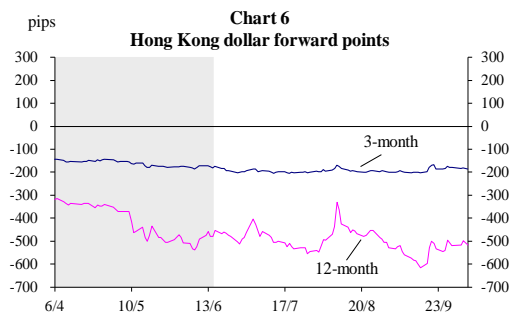


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

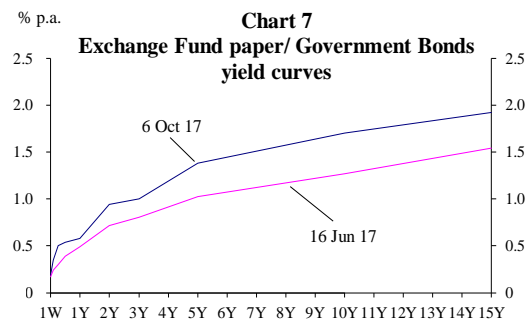
4. During the review period, **the negative HKD-USD interbank interest rate spreads generally stayed wide** (Chart 5), although the short-dated negative spreads narrowed slightly towards the end of review period, largely reflecting the pick-ups in the short-dated HKD interbank rates. At the end of the review period, the one-month, three-month and 12-month interest rate spreads closed at -82, -70 and -55 basis points respectively.



5. Broadly tracking the HKD-USD interbank interest rate spreads, **the discounts of HKD forward points remained wide during the review period** (Chart 6), with the three-month and 12-month HKD forward points closing at -187 pips and -518 pips respectively.

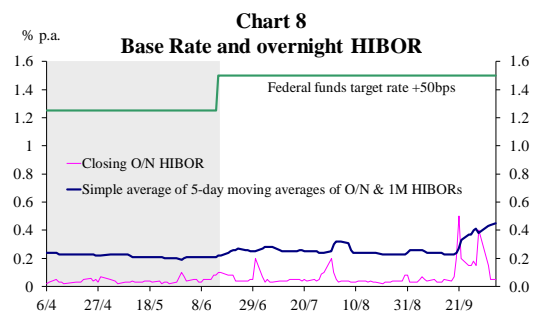


6. Broadly following the movement of the USD yield curve, **the HKD yield curve shifted upward** during the review period (Chart 7). The longer-tenor yields saw larger pick-ups, with the yield of the 10-year Hong Kong Government Bond rising by 44 basis points against the end of the preceding review period to 1.70%, compared with a 23 basis points increase in the 2-year Exchange Fund Note. The negative yield spreads of the Hong Kong Government Bonds over the US Treasuries narrowed at the longer end (Table 1) as HKD yields rose more than their US counterparts in that segment.

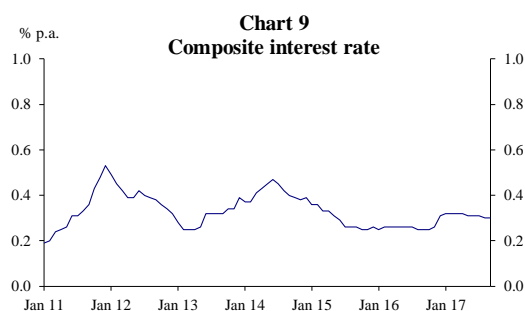


	16 Jun 17	6 Oct 17
3-month EFB	-73	-57
12-month EFB	-72	-77
3-year HKGB	-67	-66
5-year HKGB	-72	-59
10-year HKGB	-89	-67

7. At the July and September meetings, the US Federal Open Market Committee (FOMC) decided to keep the target range for the Federal Funds Rate unchanged at 1.00-1.25%. Hence, **the HKMA Base Rate remained unchanged at 1.50%** (Chart 8). It continued to be set at 50 basis points above the lower bound of the target range for the US Federal Funds Rate in accordance with the revised Base Rate formula announced on 26 March 2009.



8. **Banks kept their Best Lending Rates unchanged.** The two Best Lending Rates stayed at 5.00% and 5.25% during the review period. The average one-month HKD 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 0.31% in June to 0.30% in September** (Chart 9). On the lending side, the average interest rate for newly approved mortgage loans faced more upward pressure towards the end of review period, largely reflecting the rise in one-month HIBOR and a slight increase in the pricing spread of HIBOR-based mortgages.



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 HKD interest bearing liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and HKD 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.

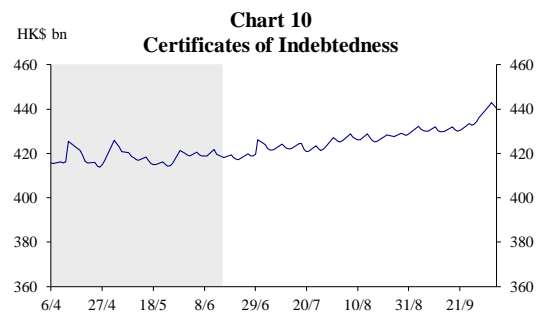
Monetary Base

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\$1,678.96 billion on 6 October from HK\$1,656.09 billion on 16 June** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	16 Jun 17	06 Oct 17
CIs	418.16	440.62
Government-issued Currency Notes and Coins in Circulation	12.27	12.34
Aggregate Balance	259.53	203.64
Outstanding EFBNs	966.14	1022.37
Monetary Base	1656.09	1678.96

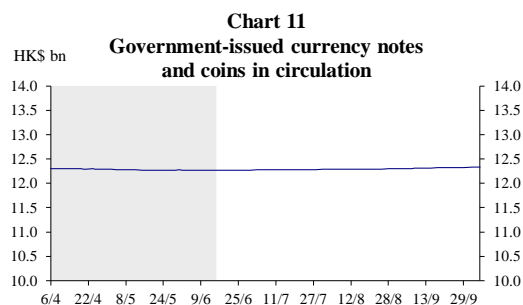
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$2.88 billion to the HKMA in exchange for around HK\$22.5 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$440.62 billion on 6 October from HK\$418.16 billion on 16 June** (Chart 10). There was more visible increase towards the end of the review period, largely attributable to increased demand for banknotes ahead of the early-October holiday period.



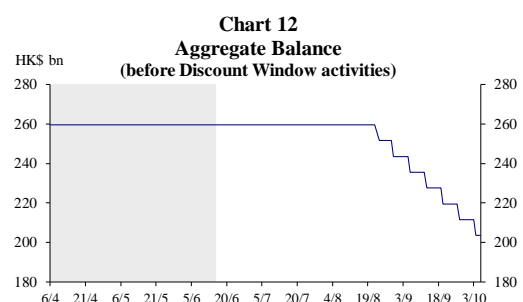
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation** increased slightly to HK\$12.34 billion on 6 October from HK\$12.27 billion on 16 June (Chart 11).



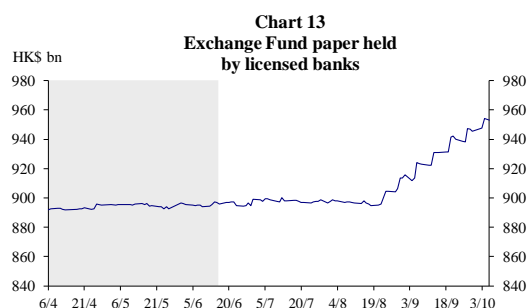
Aggregate Balance

12. **The Aggregate Balance declined** to HK\$203.64 billion on 6 October from HK\$259.53 billion on 16 June (Chart 12), as additional EFBs 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 the outstanding Exchange Fund Bills and Notes increased** to HK\$1,022.37 billion from HK\$966.14 billion during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased** to HK\$953.20 billion (93.2% of total) from HK\$895.68 billion (92.7% of total) (Chart 13).

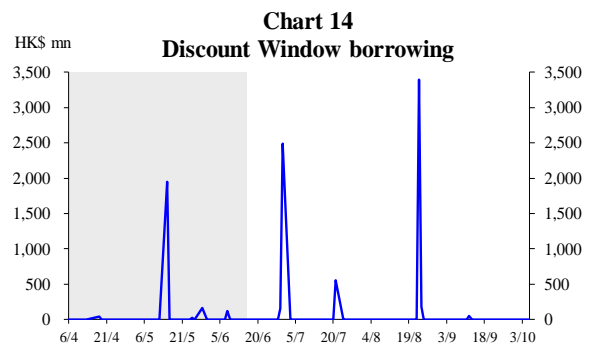


14. **The increase in outstanding Exchange Fund Bills and Notes was mainly due to the issuances of additional EFBs.** A total of HK\$56 billion of additional EFBs were issued during the review period. The additional issuance is consistent with the Currency Board principles, as it represents a change 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\$1,368.24 million.** A total of **HK\$1,198.92 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 generally well received by the market (Table 3).

	No. of issues launched	Over-subscription ratio
1-month EFB	4	2.77-5.95
3-month EFB	16	0.63-1.68
6-month EFB	16	1.21-4.97
12-month EFB	5	3.92-9.94
2-year EFN	1	7.15

Discount Window activities

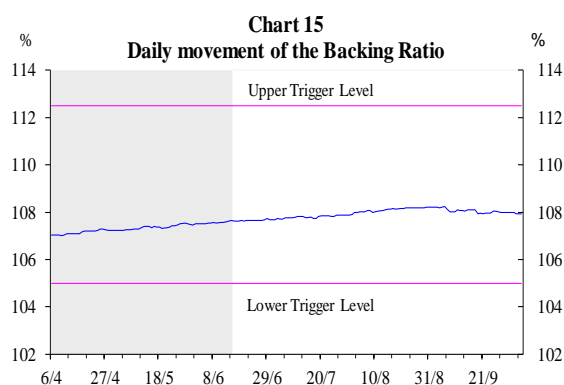
15. During the review period, **eight banks borrowed a total of HK\$6.8 billion from the Discount Window**, compared with a total borrowing of HK\$2.3 billion in the preceding period (Chart 14 and Table 4).



Frequency of using Discount Window	No. of banks
1	7
2	1

Backing Portfolio

16. The Backing Assets increased to HK\$1,811.16 billion on 6 October, mainly reflecting an increase in the CIs and valuation gains from investments. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio edged up to 107.92% from 107.63% 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 HKD exchange rate.



Hong Kong Monetary Authority
6 December 2017