

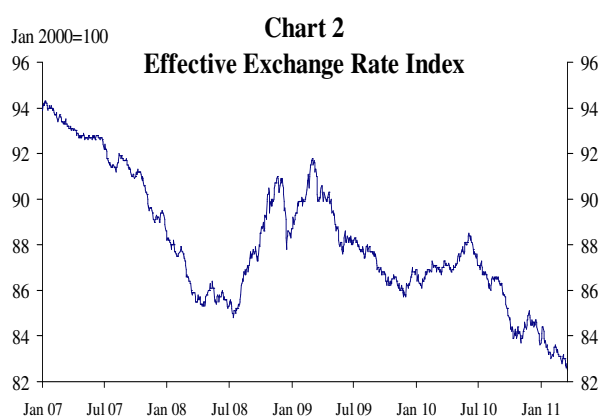
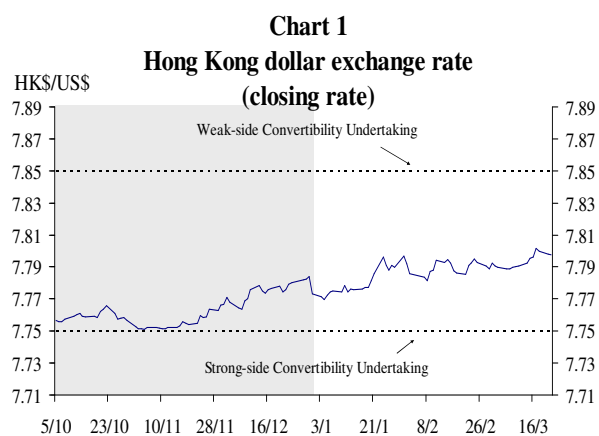
**EXCHANGE FUND ADVISORY COMMITTEE**  
**Currency Board Sub-Committee**

**Report on Currency Board Operations**  
**(1 January 2011 – 22 March 2011)**

The Hong Kong dollar exchange rate weakened from 7.7715 to 7.7974 during the reporting period, due in part to some repatriation of equity-related funds. The market remained calm despite the earthquake and nuclear crisis in Japan and the geopolitical tensions in the Middle East and North Africa. Following slight decline in January and early February, Hong Kong dollar interbank interest rates increased marginally in mid-March. The Monetary Base rose from HK\$1,038.14 billion to HK\$1,046.94 billion, mainly driven by an increase in Certificates of Indebtedness arising from increased demand for banknotes during the Lunar New Year holidays. The Aggregate Balance and the market value of outstanding Exchange Fund Bills and Notes were little changed. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by changes in foreign reserves.

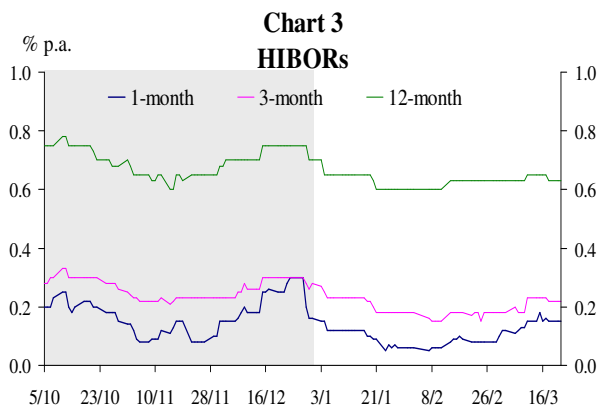
## Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate weakened from 7.7715 to 7.7974 during the reporting period, partly reflecting some repatriation of equity-related funds (Chart 1). The market reacted calmly to the earthquake and nuclear crisis in Japan and the geopolitical tensions in the Middle East and North Africa. The nominal effective exchange rate index of the Hong Kong dollar also weakened from 83.7 to 82.5 during the review period, as the US dollar generally depreciated against other major currencies (Chart 2).

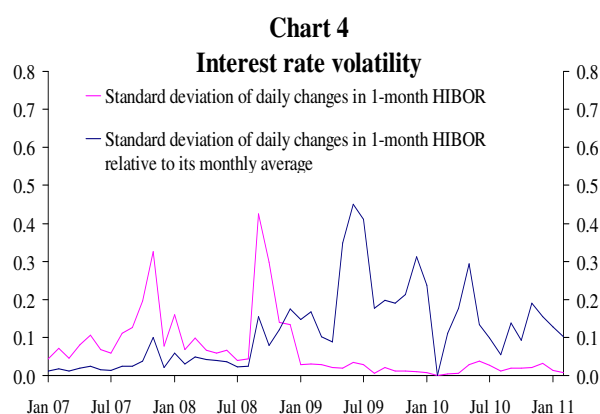


## Interest rates

2. **Hong Kong dollar interbank interest rates declined slightly in January and early February but edged up in mid-March due to funding demand arising from rights issues in the equity market** (Chart 3). For the review period as a whole, the three-month and 12-month HIBORs declined by five and seven basis points to close at 0.22% and 0.63% respectively.

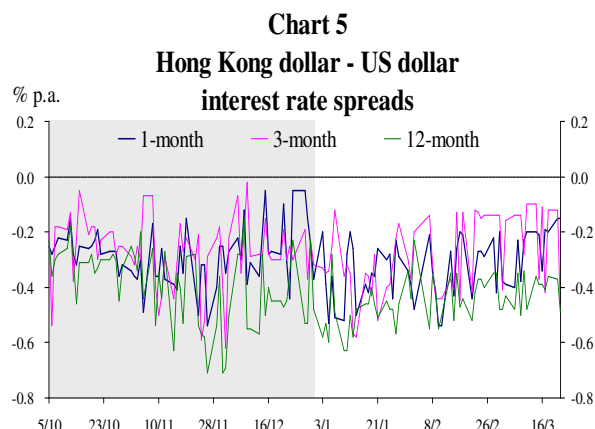


3. **Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, decreased in January and February** (Chart 4), as fund-raising activity in the equity market was less buoyant compared with the previous reporting period. The standard deviation as a ratio of the average one-month HIBOR also declined.<sup>1</sup>

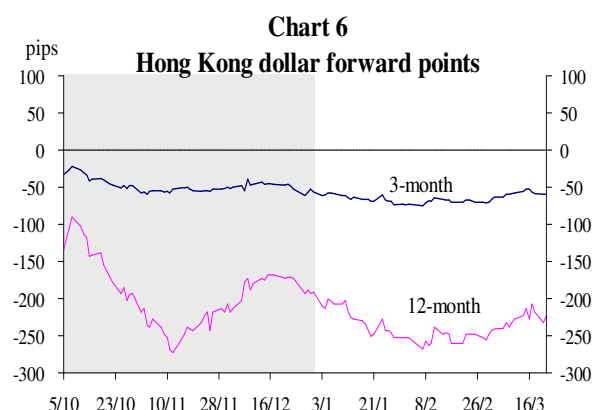


<sup>1</sup> The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

4. The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts remained roughly stable during the reporting period (Chart 5). The one-month and three-month negative spreads averaged -32 and -28 basis points respectively. The 12-month negative spread moved within a range of -23 and -63 basis points, closing at -49 basis points on 22 March.



5. In line with the broadly stable interest rate spreads, the Hong Kong dollar forward discounts also moved within a narrow range during the reporting period. The three-month forward discount averaged -65 pips and the 12-month forward discount fluctuated between -201 and -268 pips (Chart 6).



6. During the review period, **yields of Exchange Fund papers generally declined except for the two-year, three-year and five-year tenors** (Chart 7). The yield spreads against US Treasuries showed mixed patterns (Table 1). The five-year negative yield spread narrowed while the three-year, 10-year and 15-year yield spreads widened.

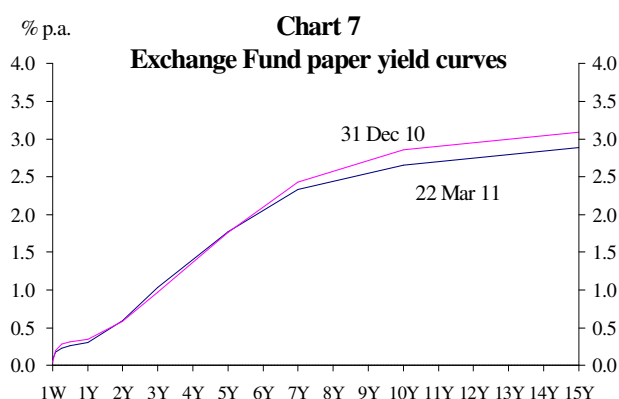
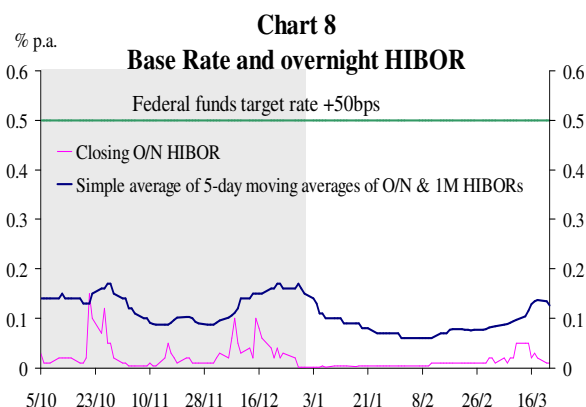
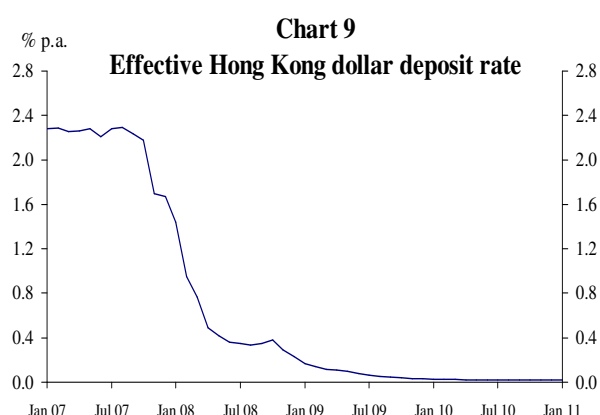


Table 1 Yield spreads of Exchange Fund paper over US Treasuries (basis points)		
	31 Dec 10	22 Mar 11
3-month	17	12
1-year	7	8
3-year	-8	-11
5-year	-31	-28
10-year	-56	-73
15-year	-86	-111

7. **The HKMA Base Rate remained unchanged at 0.5%** (Chart 8), as the US Federal Open Market Committee decided to keep the Federal Funds Target Rate (FFTR) at 0 – 0.25% at the meetings in January and March 2011. 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.



8. **Banks kept their Best Lending Rates unchanged**, in line with the stable US FFTR. There continued to be two Best Lending Rates of 5.00% and 5.25% at the end of the reporting period. **The average one-month time deposit rate offered by major authorized institutions was little changed** at around 0.01%.<sup>2</sup> The effective deposit rate has also been stable at 0.02% since March 2010 (Chart 9).<sup>3</sup> The composite interest rate, which indicates the average cost of funds of banks, stayed at around 0.2% between December 2010 and February 2011.<sup>4</sup>



<sup>2</sup> The figures refer to the average of interest rates offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

<sup>3</sup> This is the average of the interest rates on demand, savings and time deposits. As the banking statistics classify deposits by remaining maturities, we have made certain assumptions regarding the maturity distribution in computing the effective deposit rate.

<sup>4</sup> 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.

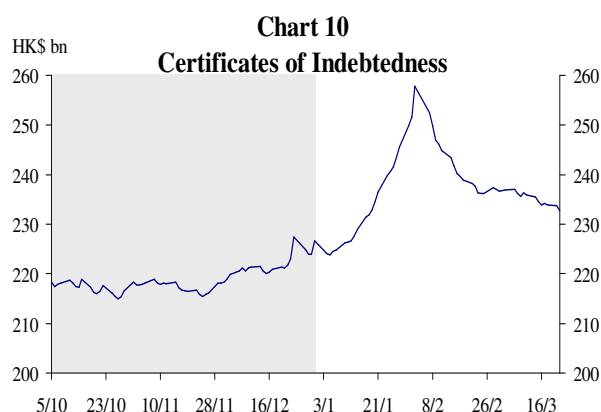
## Monetary Base

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, **expanded from HK\$1,038.14 billion on 3 January to HK\$1,046.94 billion on 22 March** (Table 2). Movements in the individual components are discussed below.

<b>Table 2</b> <b>Monetary Base</b>		
(HK\$bn)	3 Jan 11	22 Mar 11
CIs	224.87	232.69
Government-issued Currency Notes and Coins in Circulation	9.19	9.65
Aggregate Balance	148.70	148.82
Outstanding EFBNs	655.38	655.78
<b>Monetary Base</b>	<b>1,038.14</b>	<b>1,046.94</b>

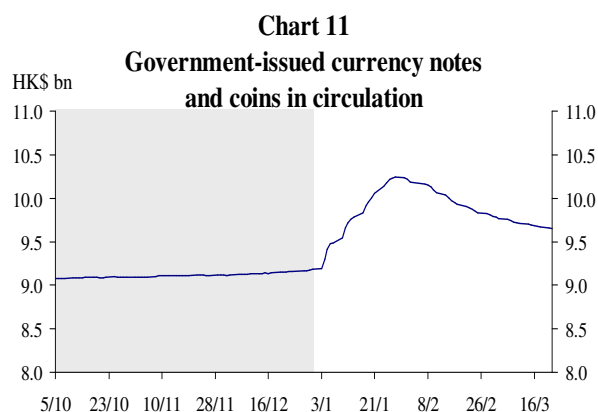
### *Certificates of Indebtedness*

10. During the reporting period, the three note-issuing banks submitted around US\$1 billion to the HKMA in exchange for HK\$7.82 billion worth of CIs, reflecting increased demand for banknotes around the Chinese New Year holidays. As a result, **the outstanding CIs increased to HK\$232.69 billion on 22 March from HK\$224.87 billion on 3 January** (Chart 10).



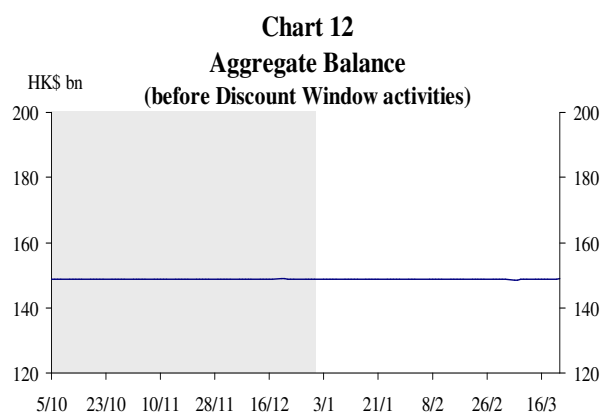
*Government-issued currency notes and coins in circulation*

11. Along with the increase in CIs, the amount of **government-issued currency notes and coins in circulation** rose from **HK\$9.19 billion on 3 January to HK\$9.65 billion on 22 March** (Chart 11).



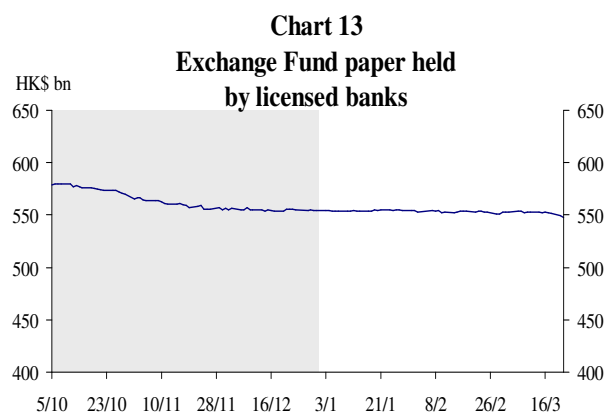
*Aggregate Balance*

12. **The Aggregate Balance was little changed** and stayed at around HK\$148.80 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 Bills and Notes was also stable**, closing at HK\$655.78 billion at the end of the reporting period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased slightly to HK\$547.73 billion (83.5% of total) on 22 March from HK\$554.44 billion on 3 January (84.6% of total) (Chart 13).

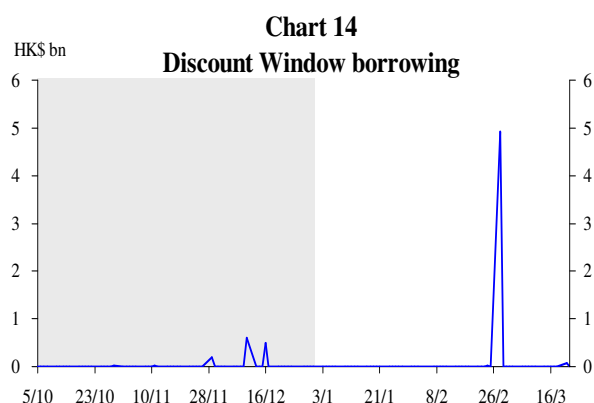


14. During the reporting period, **interest payments on Exchange Fund paper amounting to HK\$578.82 million were made. An additional HK\$360.81 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were well received by the market (Table 3).

<b>Table 3</b> <b>Issuance of Exchange Fund Bills and Notes</b> <b>(1 Jan 11 – 22 Mar 11)</b>		
	No. of issues launched	Over-subscription ratio
3-month EFB	12	1.26-4.20
6-month EFB	10	1.82-5.21
12-month EFB	3	16.23-23.46
2-year EFN	1	5.71
5-year EFN	2	3.15-5.58
15-year EFN	1	1.98

### **Discount Window activities**

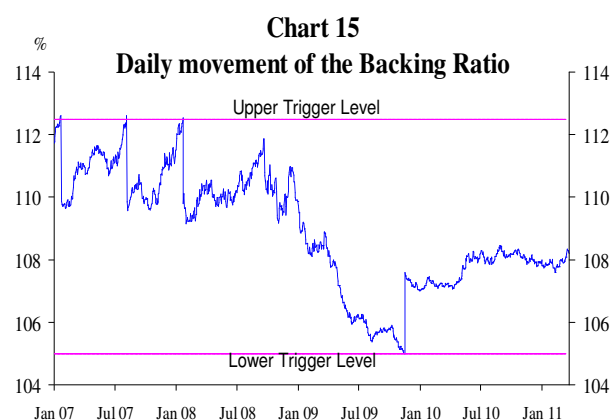
15. During the reporting period, **three banks borrowed a total of HK\$5.01 billion from the Discount Window,** compared with HK\$1.34 billion in the preceding period (Chart 14 and Table 4).



<b>Table 4</b> <b>Frequency of individual bank's access to the Discount Window</b> <b>(1 Jan 11– 22 Mar 11)</b>	
Frequency of using Discount Window	No. of banks
1	3
Total	3

### **Backing Portfolio**

16. Backing Assets increased slightly during the reporting period, reflecting the expansion in CIs and valuation gains. As the Backing Assets rose proportionally more than the Monetary Base, **the Backing Ratio climbed from 107.81% to 108.21% during the reporting 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**  
**19 May 2011**