

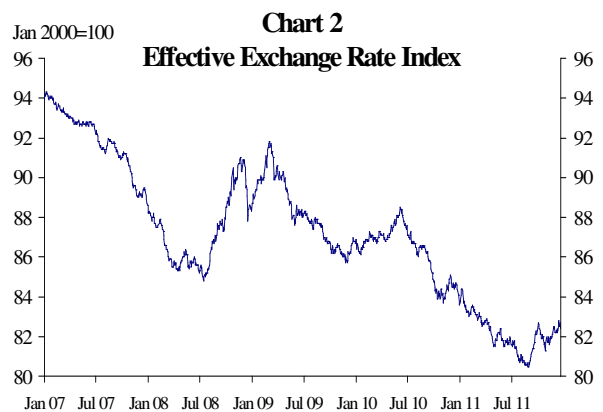
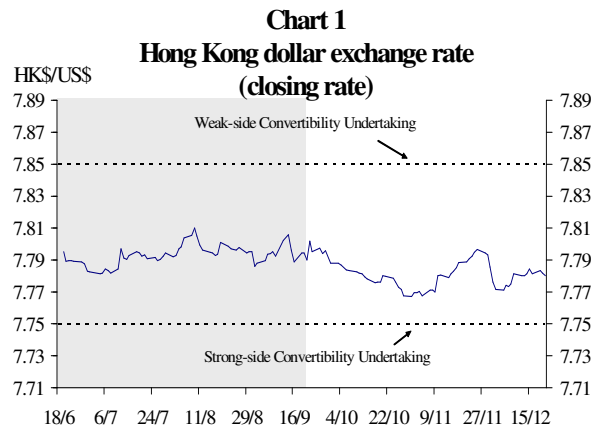
EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

Report on Currency Board Operations
(21 September 2011 – 21 December 2011)

Despite lingering concerns about the European sovereign debt crisis and deteriorating global macroeconomic prospects, the Hong Kong dollar exchange rate moved within a narrow range of 7.7671 – 7.8019 during the reporting period. In the money market, Hong Kong dollar interbank interest rates rose slightly towards the end of December along with their US dollar counterparts, and Hong Kong dollar forward discounts narrowed reportedly because of increased demand for Hong Kong dollar liquidity. The Monetary Base climbed from HK\$1,056.02 billion to HK\$1,066.49 billion, driven by a rise in Certificates of Indebtedness. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by changes in foreign reserves.

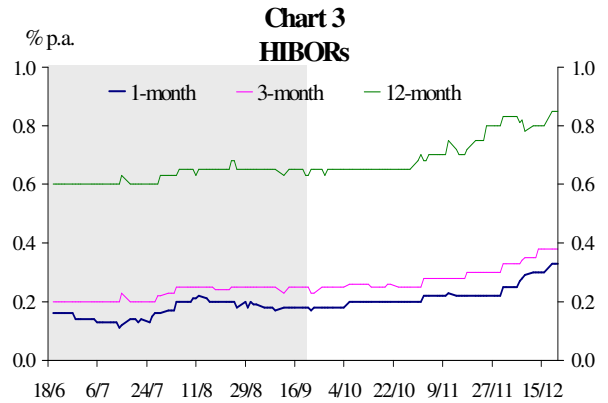
Hong Kong dollar exchange rate

1. During the reporting period, **the Hong Kong dollar exchange rate traded within a narrow range of 7.7671 – 7.8019** (Chart 1). The market remained orderly despite lingering concerns about the European sovereign debt crisis, worries about the spillover effect of Euro area bank funding pressures and increased volatility in global financial markets. For the review period as a whole, the exchange rate strengthened slightly to 7.7800 on 21 December from 7.7898 on 21 September. Meanwhile, **the nominal effective exchange rate index of the Hong Kong dollar increased to 82.4 from 81.7** during the reporting period, reflecting the appreciation of the US dollar against most major currencies (Chart 2).

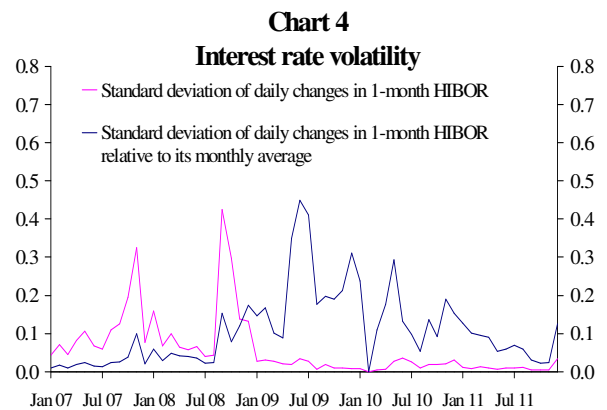


Interest rates

2. **Hong Kong dollar interbank interest rates picked up** towards the end of the review period, reflecting rises in the corresponding US dollar rates and some year-end and IPO-related funding demands (Chart 3). During the reporting period, the three-month HIBOR increased by 13 basis points to close at 0.38% and the 12-month HIBOR rose by 22 basis points to close at 0.85%.

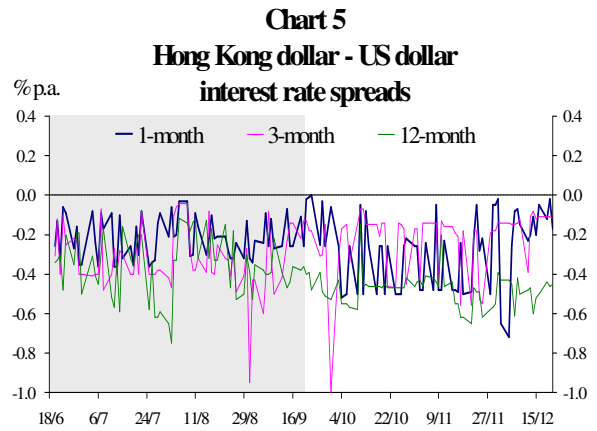


3. **Interest rate volatility**, measured by the standard deviation of daily changes in one-month HIBOR, **rose** from near zero in September to around 4 basis points in December (up to 21 December) (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also increased.¹

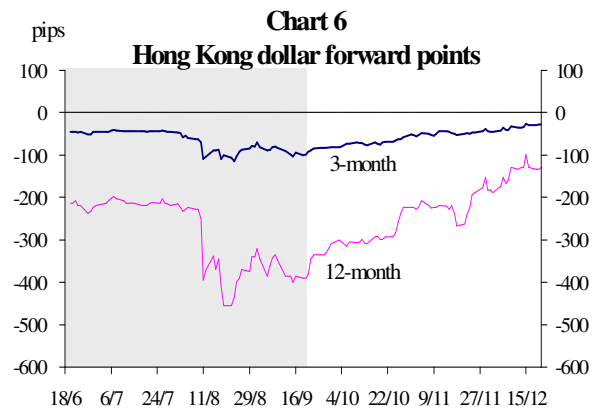


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

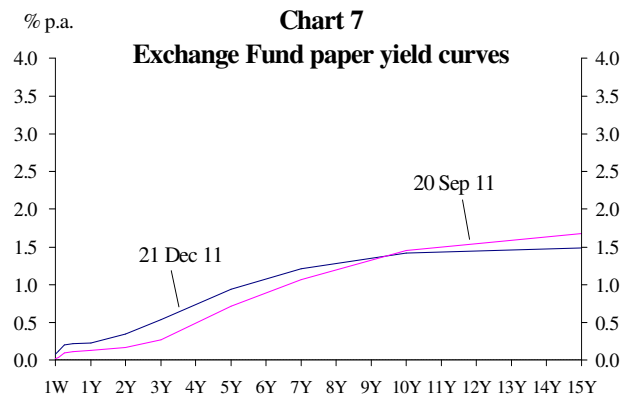
4. During the review period, **the negative spreads of Hong Kong dollar interest rates against their US dollar counterparts were roughly stable** (Chart 5). The one-month negative spread averaged around -28 basis points. The three-month and 12-month negative spreads closed at -12 and -45 basis points respectively on 21 December, little changed from -13 and -40 basis points on 21 September.



5. Despite roughly stable interest rate spreads between the Hong Kong dollar and the US dollar, **the three-month and 12-month Hong Kong dollar forward discounts contracted** during the reporting period, reportedly owing to increased demand for Hong Kong dollar liquidity (Chart 6). The three-month and 12-month forward discounts narrowed by 64 and 252 pips respectively to close at -28 and -128 pips on 21 December.

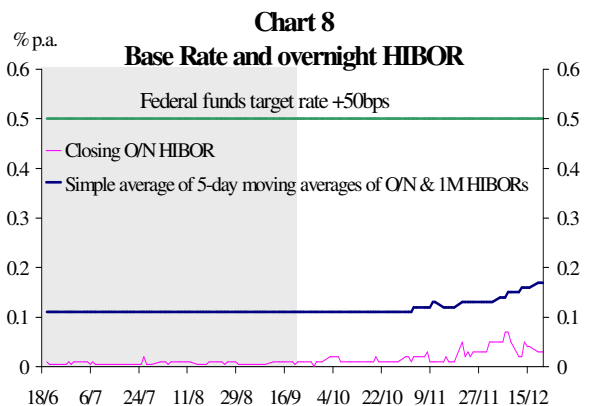


6. During the review period, **the implied yields of short-dated Exchange Fund Bills picked up from low levels while the yields of longer-term Exchange Fund Notes declined** (Chart 7). Meanwhile, the yield spreads over US Treasuries generally widened (Table 1). This partly reflected the fact that although the Hong Kong dollar yield curve flattened during the reporting period, the US dollar yield curve changed little despite the introduction of the maturity extension program (the so-called Operation Twist) which should put downward pressure on longer-term US dollar interest rates.

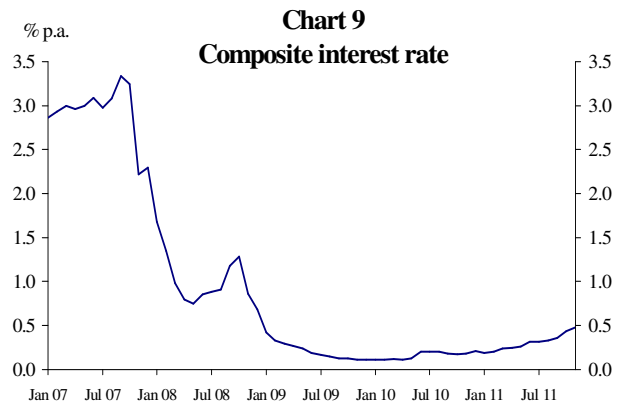


	20 Sep 11	21 Dec 11
3-month	8	18
1-year	4	13
3-year	0	17
5-year	-9	1
10-year	-45	-57
15-year	-79	-94

7. At the meetings in September, November and December, the US Federal Open Market Committee decided to keep the Federal Funds Target Rate (FFTR) at 0 – 0.25%. The Committee reiterated that current economic conditions would warrant exceptionally low levels for the federal funds rate at least through mid-2013. As such, **the HKMA Base Rate was unchanged at 0.5%** (Chart 8). 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. In line with the stable US FFTR, banks kept their Best Lending Rates unchanged. There continued to be two Best Lending Rates of 5.00% and 5.25% at the end of the reporting period. Despite stable Best Lending Rates, mortgage interest rates for newly-approved loans continued to rise, with banks charging borrowers a larger positive spread over the interbank interest rate for HIBOR-based mortgage plans. The Hong Kong dollar term deposit interest rates offered by retail banks also climbed up along with growing funding demand. As a result, **the composite interest rate², which indicates the average cost of funds for banks, increased from 0.36% in September to 0.48% in November** (Chart 9), driven by the upward movements in deposit and interbank interest rates.



² 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.

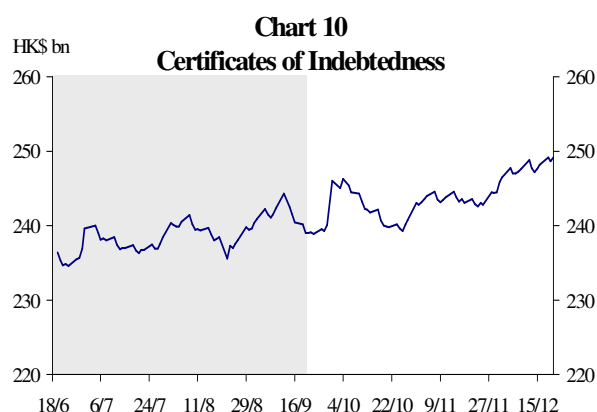
Monetary Base

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, **increased from HK\$1,056.02 billion on 21 September to HK\$1,066.49 billion on 21 December** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	21 Sep 11	21 Dec 11
CIs	239.04	249.15
Government-issued Currency Notes and Coins in Circulation	9.55	9.97
Aggregate Balance	148.74	148.65
Outstanding EFBNs	658.69	658.73
Monetary Base	1,056.02	1,066.49

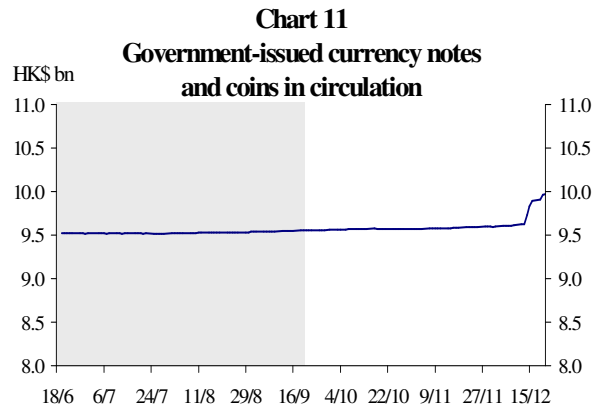
Certificates of Indebtedness

10. During the reporting period, the three note-issuing banks submitted US\$1.30 billion to the HKMA in exchange for HK\$10.11 billion worth of CIs, due partly to increased demand for banknotes around the National Day holiday and before the Christmas holiday. As a result, **the outstanding CIs expanded to HK\$249.15 billion on 21 December from HK\$239.04 billion on 21 September** (Chart 10). The new series of HK\$50 and HK\$100 banknotes that had been put into circulation since 22 November also contributed to the expansion in outstanding CIs.



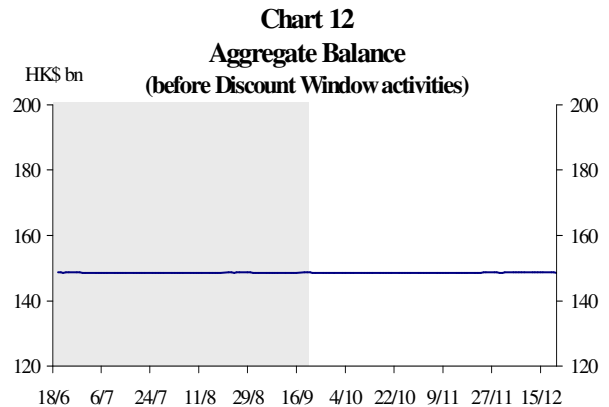
Government-issued currency notes and coins in circulation

11. In line with the movements in the CIs, the amount of **government-issued currency notes and coins in circulation climbed** from HK\$9.55 billion on 21 September to HK\$9.97 billion on 21 December (Chart 11).



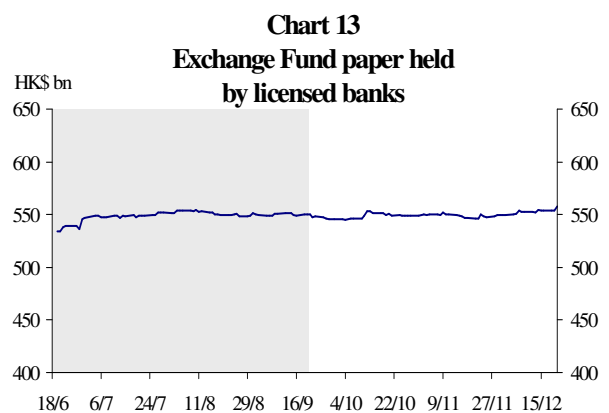
Aggregate Balance

12. **The Aggregate Balance remained little changed** at around HK\$148.67 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 edged up** from HK\$658.69 billion on 21 September to HK\$658.73 billion on 21 December. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) also increased from HK\$550.49 billion (83.6% of total) to HK\$557.72 billion (84.7% of total) (Chart 13).

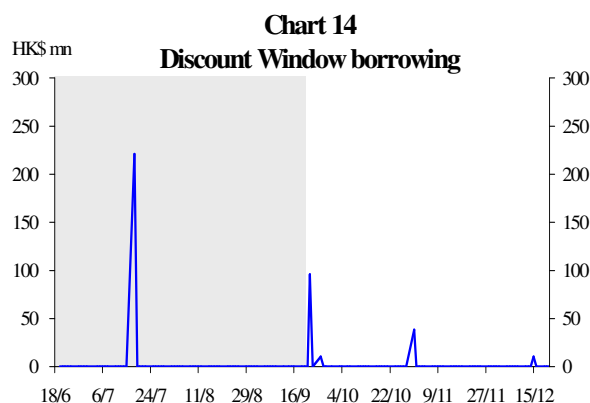


14. During the reporting period, **HK\$786.52 million of interest payments on Exchange Fund papers were made. An additional HK\$764.68 million (in market value) of Exchange Fund papers were issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were generally well received by the market (Table 3).

	No. of issues launched	Over-subscription ratio
1-month EFB	2	2.67-10.00
3-month EFB	14	0.86-3.26
6-month EFB	12	1.38-7.24
12-month EFB	3	1.54-2.21
2-year EFN	1	4.57
3-year EFN	1	3.38
5-year EFN	1	2.69
10-year EFN	1	2.61

Discount Window activities

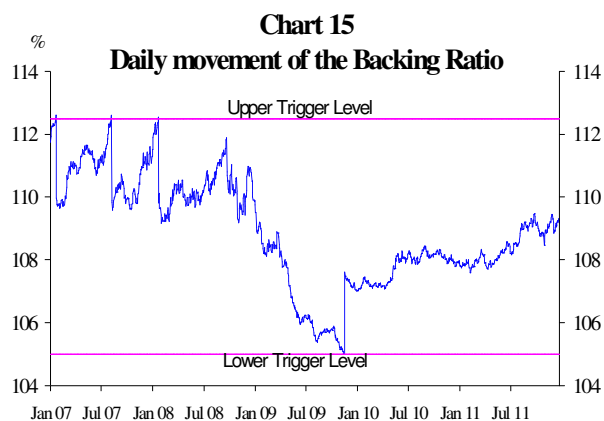
15. During the review period, **four banks borrowed a total of HK\$154 million from the Discount Window**, compared with HK\$221 million in the preceding period (Chart 14 and Table 4).



Frequency of using Discount Window	No. of banks
4	4
Total	4

Backing Portfolio

16. Backing Assets expanded during the reporting period due to the rise in the CIs. As the Backing Assets and the Monetary Base rose at roughly the same pace, **the Backing Ratio moved within a narrow range of 108.47% – 109.47% during the reporting period and closed at 109.16% on 21 December** (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
22 February 2012