

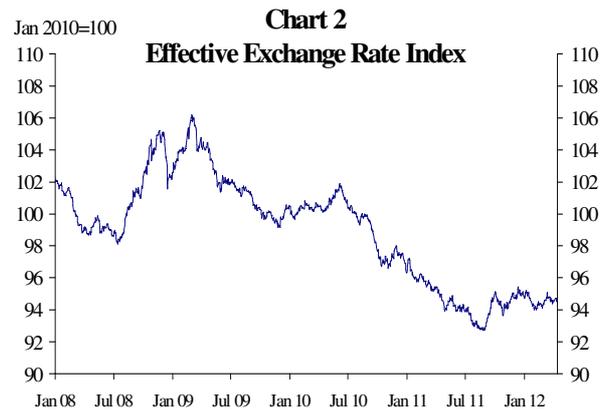
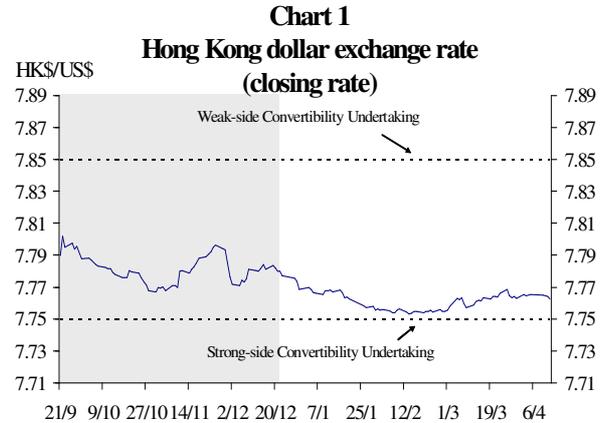
**EXCHANGE FUND ADVISORY COMMITTEE**  
**Currency Board Sub-Committee**

**Report on Currency Board Operations**  
**(22 December 2011 – 13 April 2012)**

The Hong Kong dollar exchange rate continued to trade within a narrow range. It strengthened in the first two months of 2012 as market sentiment improved amid a respite from the eurozone crisis, a buoyant local equity market and an appreciation in the regional currencies. Afterwards the spot exchange rate weakened amid some correction in the local stock market. In the money market, Hong Kong dollar interbank interest rates declined slightly during the review period following temporary rises in the preceding one. In line with broadly stable interest rate spreads, Hong Kong dollar forward discounts also stabilised after last year's sharp narrowing reportedly due to increased demand for Hong Kong dollar liquidity. The Monetary Base expanded from HK\$1,068.41 billion to HK\$1,085.98 billion, underpinned 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.

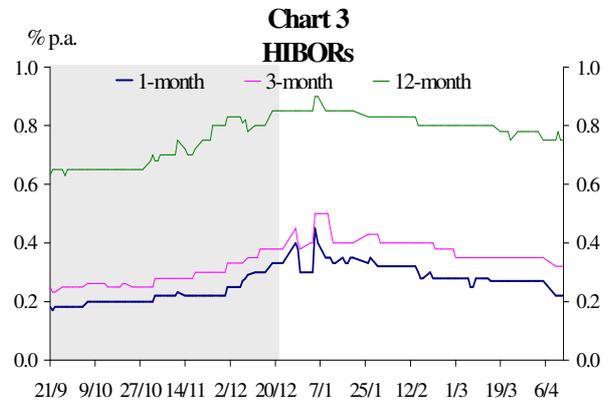
## Hong Kong dollar exchange rate

1. **The Hong Kong dollar exchange rate strengthened in January and February 2012** (Chart 1) as market sentiment improved along with some temporary easing of worries over the eurozone sovereign debt crisis, a buoyant local stock market and an appreciation of the regional currencies. **The spot exchange rate weakened slightly thereafter** amid some correction in the local stock market. For the review period as a whole, the exchange rate strengthened from 7.7799 on 22 December 2011 to 7.7625 on 13 April 2012. Meanwhile, **the nominal effective exchange rate index of the Hong Kong dollar fluctuated within a small range** between 94.0 and 95.2 during the reporting period, partly reflecting similar movements in the US dollar (Chart 2).

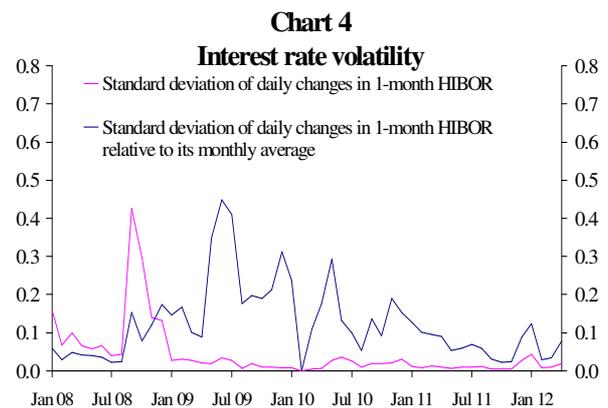


## Interest rates

2. Following temporary rises towards the end of 2011, **Hong Kong dollar interbank interest rates softened slightly** during the review period, in line with small downward adjustments in the corresponding US dollar rates (Chart 3). During the reporting period, the one-month and 12-month HIBORs decreased by 11 and 10 basis points respectively to close at 0.22% and 0.75%.

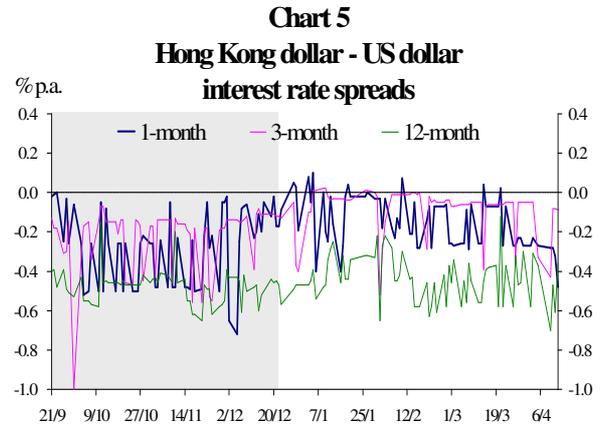


3. **Interest rate volatility**, measured by the standard deviation of daily changes in one-month HIBOR, **declined** slightly from around 4 basis points in January 2012 to 2 basis points in April (up to 13 April) (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also decreased over the same period.<sup>1</sup>

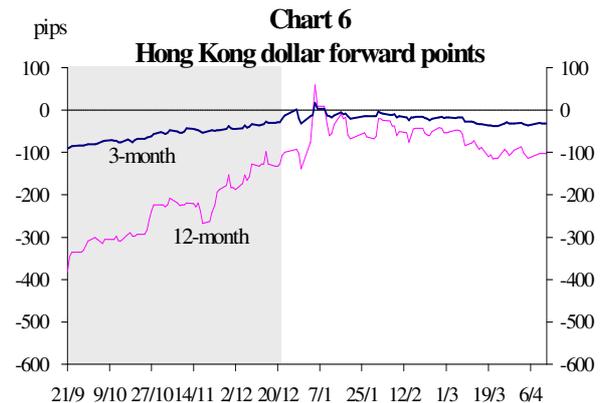


<sup>1</sup> The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

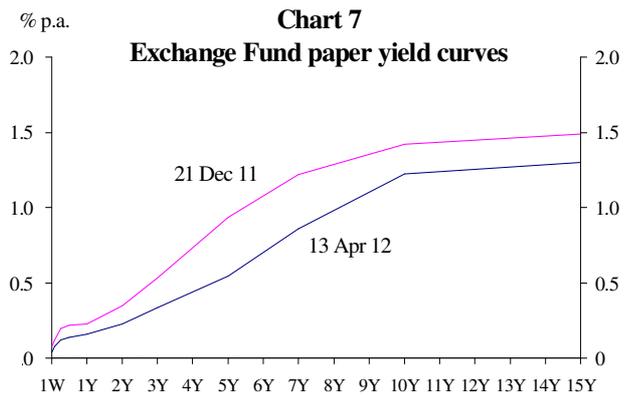
4. **The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts were roughly stable** during the review period (Chart 5). The one-month negative spread averaged around -15 basis points. The three-month and 12-month negative spreads closed at -9 and -36 basis points respectively on 13 April 2012, little changed from -12 and -47 basis points on 22 December 2011.



5. In line with the 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 traded within a narrow range** during the reporting period (Chart 6). This followed a marked narrowing of the forward discounts in the preceding review period reportedly due to increased demand for Hong Kong dollar liquidity. The three-month and 12-month forward discounts closed at -31 and -102 pips on 13 April 2012.

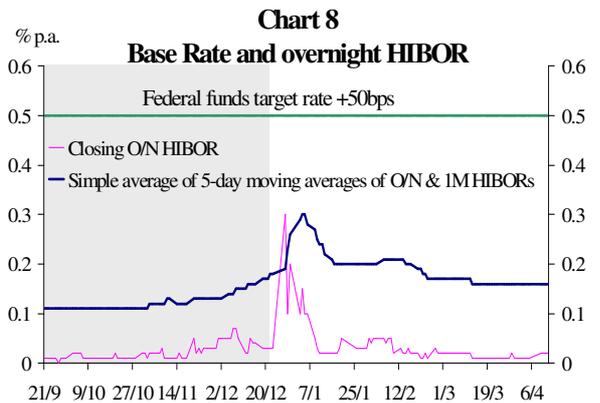


6. **Yields of Exchange Fund paper declined** during the review period (Chart 7). Because the yields of Exchange Fund Notes generally recorded larger decreases than the implied yields of Exchange Fund Bills, the nominal yield curve somewhat flattened. Partly reflecting this, the 10-year and 15-year negative yield spreads over US Treasuries widened by 27 and 37 basis points to close at -84 and -131 basis points respectively at the end of the period (Table 1).

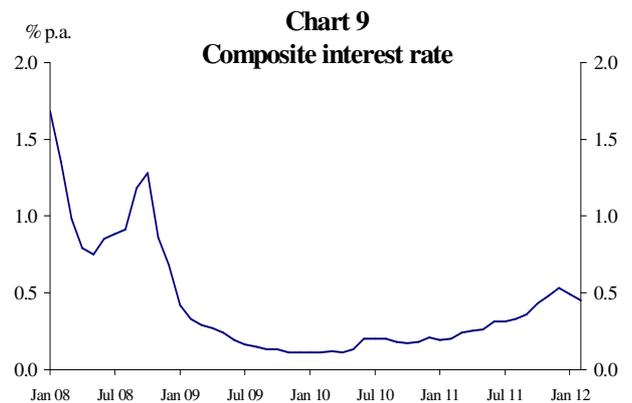


	21 Dec 11	13 Apr 12
3-month	18	5
1-year	13	-1
3-year	17	-7
5-year	1	-34
10-year	-57	-84
15-year	-94	-131

7. At the meetings in January and March 2012, the US Federal Open Market Committee decided to keep the Federal Funds Target Rate (FFTR) at 0 – 0.25%, and anticipated that economic conditions were likely to warrant exceptionally low levels for the Federal Funds rate through late 2014. As such, **the HKMA Base Rate remained 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. Consistent 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 have shown signs of moderation recently amid keener competition in the mortgage loan market. The Hong Kong dollar term deposit interest rates offered by retail banks also softened in the first three months of 2012, following slight rises during 2011 due to increased funding needs. As a result, **the composite interest rate<sup>2</sup>, which indicates the average cost of funds for banks, declined from 0.53% in December 2011 to 0.42% in March 2012 (Chart 9), mainly reflecting the downward adjustments in the weighted funding cost for deposits.**



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<sup>2</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.

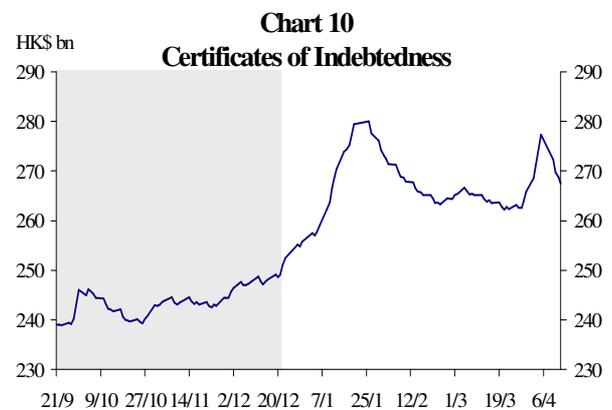
## Monetary Base

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, **increased from HK\$1,068.41 billion on 22 December 2011 to HK\$1,085.98 billion on 13 April 2012** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	22 Dec 11	13 Apr 12
CIs	251.10	267.54
Government-issued Currency Notes and Coins in Circulation	9.98	10.07
Aggregate Balance	148.65	148.65
Outstanding EFBNs	658.68	659.73
<b>Monetary Base</b>	<b>1,068.41</b>	<b>1,085.98</b>

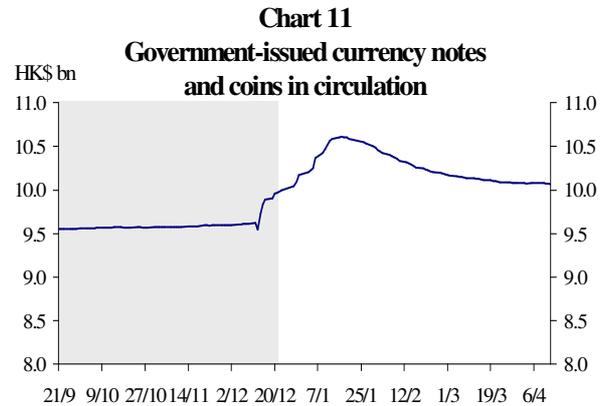
### *Certificates of Indebtedness*

10. During the reporting period, the three note-issuing banks submitted US\$2.11 billion to the HKMA in exchange for HK\$16.44 billion worth of CIs. As a result, **the outstanding CIs expanded to HK\$267.54 billion on 13 April 2012 from HK\$251.10 billion on 22 December 2011** (Chart 10). The outstanding CIs rose sharply around the Chinese New Year and Easter holidays because of increased demand for banknotes. The new series of HK\$20 banknotes that had been put into circulation since 11 January 2012 also contributed to the expansion in the CIs.



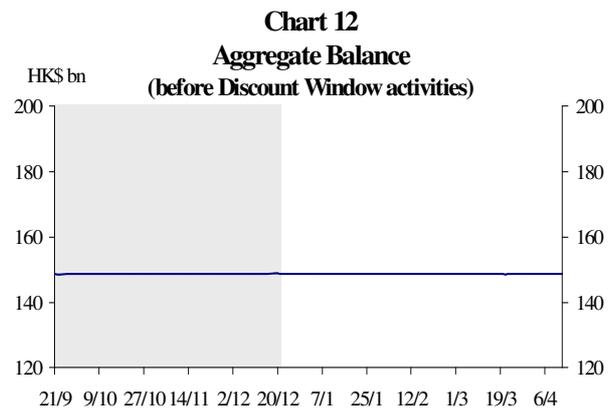
*Government-issued currency notes and coins in circulation*

11. In line with the movements in the CIs, the amount of **government-issued currency notes and coins in circulation** also rose from HK\$9.98 billion on 22 December 2011 to HK\$10.07 billion on 13 April 2012 (Chart 11).



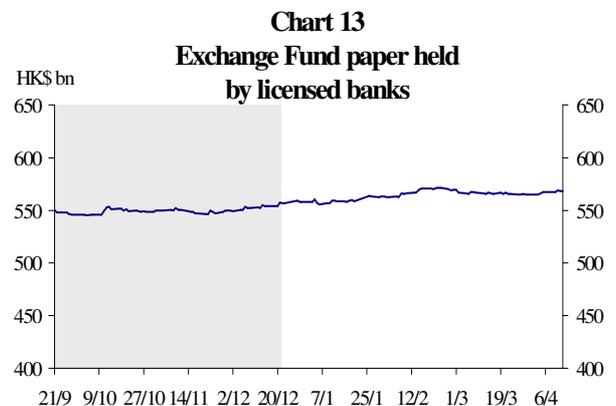
*Aggregate Balance*

12. The **Aggregate Balance** was little changed at around HK\$148.65 billion during the review period, only with very 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** climbed to HK\$659.73 billion on 13 April 2012 from HK\$658.68 billion on 22 December 2011. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) also increased from HK\$557.05 billion (84.6% of total) to HK\$568.02 billion (86.1% of total) (Chart 13).

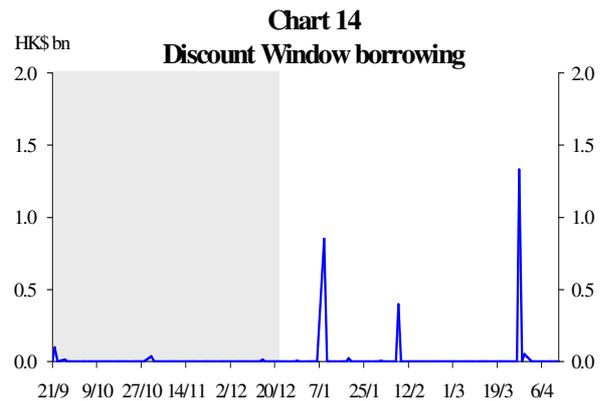


14. During the reporting period, **HK\$692.49 million of interest payments on Exchange Fund paper were made. An additional HK\$577.38 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were well received by the market (Table 3).

	No. of issues launched	Over-subscription ratio
1-month EFB	1	4.82
3-month EFB	16	1.18-3.95
6-month EFB	14	1.78-4.55
12-month EFB	4	4.72-13.08
2-year EFN	1	3.90
3-year EFN	1	4.03
5-year EFN	1	4.07
15-year EFN	1	3.43

**Discount Window activities**

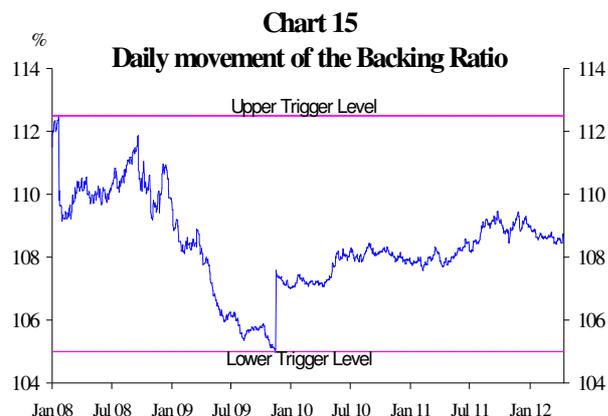
15. During the review period, **seven banks borrowed a total of HK\$2.65 billion from the Discount Window**, compared with HK\$154 million in the preceding period (Chart 14 and Table 4).



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

## Backing Portfolio

16. Driven by the rise in the CIs, the Backing Assets expanded during the reporting period. As the Backing Assets rose proportionally less than the Monetary Base, **the Backing Ratio declined** from 109.10% to 108.68% 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**  
**8 June 2012**