

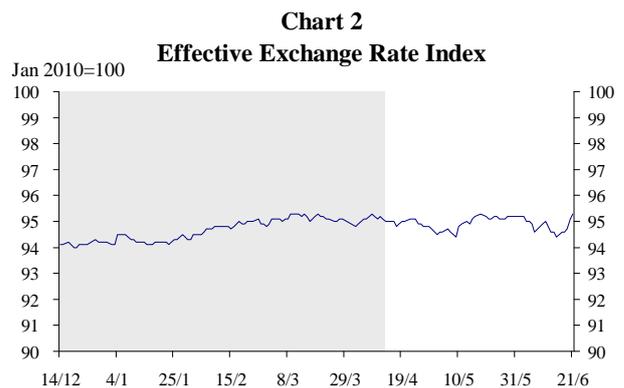
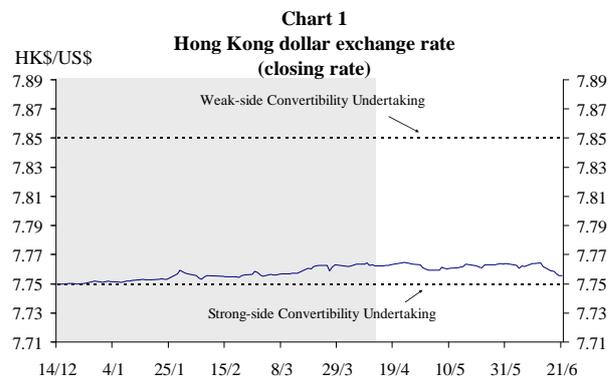
EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

Report on Currency Board Operations
(13 April 2013 – 21 June 2013)

The Hong Kong dollar exchange rate moved within a narrow range in April and May, and then strengthened slightly towards mid-June, in part reflecting increased liquidity demand for Hong Kong dollar. While concerns about tapering of the US Federal Reserve's asset purchase programmes and a slowing Mainland economy have heightened volatilities and led to significant sell-offs in the global and domestic equity markets, the Hong Kong dollar exchange rate was little affected and continued to trade in an orderly manner. The Hong Kong dollar interbank interest rates were also stable during most of the review period, only moving up slightly towards mid-June amid a rise in banks' funding demand for half-year-end liquidity management. The Monetary Base decreased during the review period mainly due to the redemption of Certificates of Indebtedness. Additional Exchange Fund Bills were issued to meet banks' demand, leading to an increase in the outstanding Exchange Fund papers and a corresponding decrease in the Aggregate Balance. These operations, representing a change in the composition of the Monetary Base, were in line with Currency Board principles, as the Monetary Base remained fully backed by foreign exchange reserves.

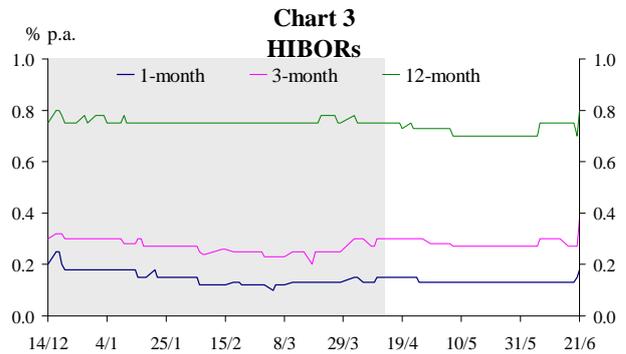
Hong Kong dollar exchange rate

1. The Hong Kong dollar exchange rate moved within a narrow range in April and May, and then strengthened slightly towards mid-June in part reflecting increased liquidity demand for Hong Kong dollar (Chart 1). While concerns about tapering of the US Federal Reserve's asset purchase programme and a slowing Mainland economy have heightened volatilities and led to significant sell-offs in the global and domestic equity markets, the Hong Kong dollar exchange rate was little affected and continued to trade in an orderly manner. For the review period as a whole, the exchange rate strengthened to 7.7555 on 21 June from 7.7621 on 15 April. **The nominal effective exchange rate index of the Hong Kong dollar picked up marginally during the review period (Chart 2), along with the appreciation of US dollar against major currencies.**

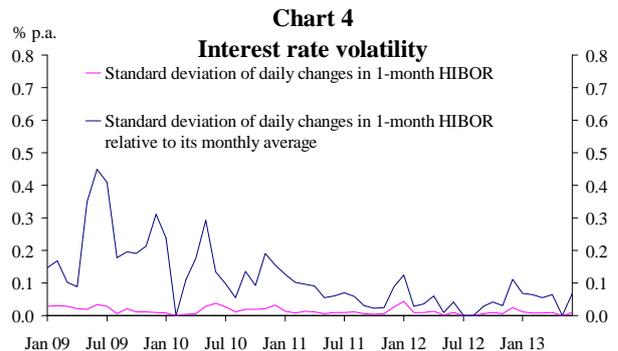


Interest rates

2. **Hong Kong dollar interbank interest rates were stable and only moved up slightly** near the end of the review period amid a rise in banks' funding demand for half-year-end liquidity management (Chart 3). For the review period as a whole, the three-month HIBOR rose by 8 basis points to 0.38%, while the 12-month HIBOR increased by 5 basis points to 0.80%.

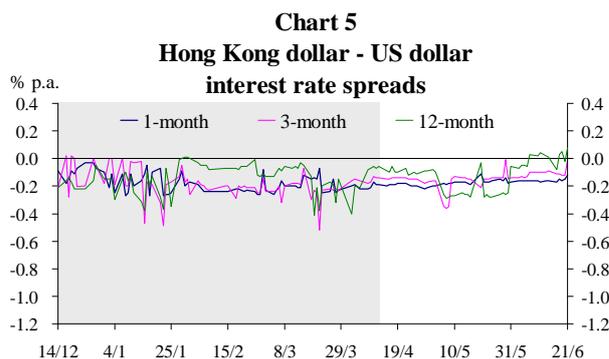


3. **Interest rate volatility remained relatively low.** The standard deviation of daily changes in the one-month HIBOR was below 1 basis point during the review period (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also followed similar pattern.¹

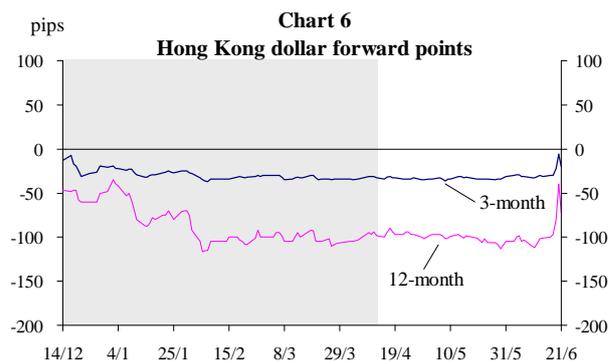


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

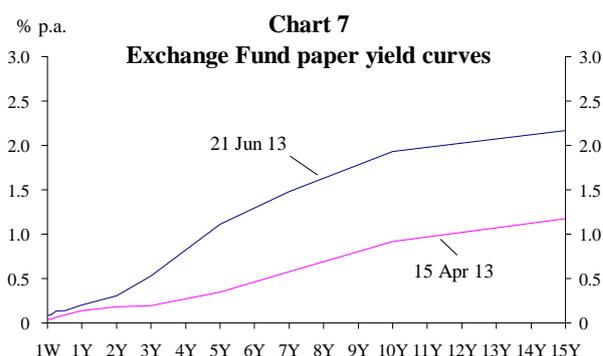
4. During the review period, **the negative spreads of Hong Kong dollar interest rates against their US dollar counterparts broadly contracted** (Chart 5). For the review period as a whole, the three-month spread narrowed by 14 basis points to -1 basis point. The 12-month spread became slightly positive at +8 basis points on 21 June, compared with -9 basis points at the beginning of the review period.



5. Along with the movements in the interest rate spreads, **the Hong Kong dollar forward discount narrowed** during the review period (Chart 6). The three-month and 12-month forward discounts closed at -20 and -72 pips respectively on 21 June.

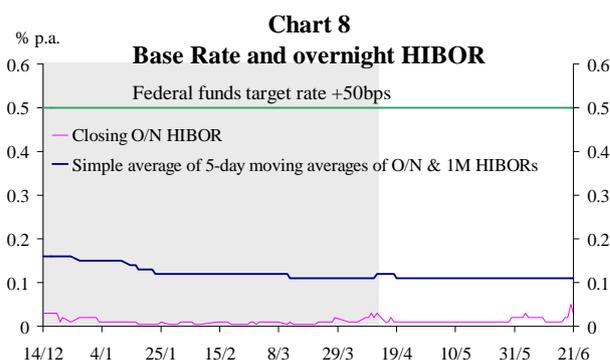


6. **The yield curve of Exchange Fund paper steepened during the review period** (Chart 7). This largely followed the steepening of the US Treasury yield curve amid market expectation of rises in future US dollar interest rates. Overall, the yields of Exchange Fund paper saw slightly more pronounced pick-ups, leading to a narrowing in the negative yield spreads against US Treasuries (Table 1).



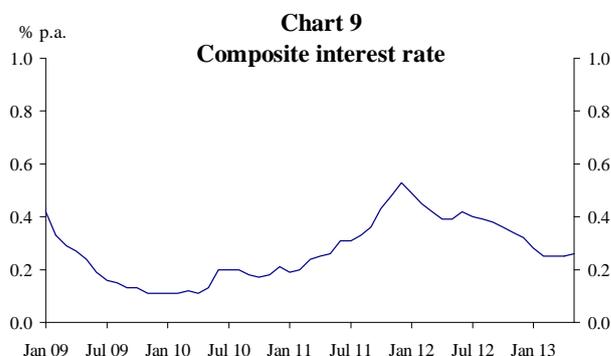
	15 Apr 13	21 Jun 13
3-month	0	8
1-year	2	7
3-year	-14	-12
5-year	-35	-21
10-year	-82	-52
15-year	-113	-65

7. At the April and June meetings, the US Federal Open Market Committee (FOMC) decided to keep the Federal Funds Target Rate (FFTR) at 0–0.25%². As such, **the HKMA Base Rate stayed unchanged at 0.5%** (Chart 8). The Base Rate continued to be set at 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.



² At the April and June meetings, the FOMC decided to continue purchasing additional agency mortgage-backed securities at a pace of US\$40 billion per month and longer-term Treasury securities at a pace of US\$45 billion per month. The FOMC also anticipated that the exceptionally low range for the Federal Funds Target Rate will be appropriate at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percentage point above the FOMC's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored.

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 review period. The average one-month Hong Kong dollar time deposit rate offered by retail banks remained stable at 0.01%³. **The composite interest rate⁴**, which indicates the average cost of funds for retail banks, **edged up to 0.26% in May from 0.25% in March and April** (Chart 9). The average mortgage interest rate for newly-approved loans increased to 2.40% in May from 2.28% in March.



³ The figure refers to the average of interest rates offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

⁴ 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.

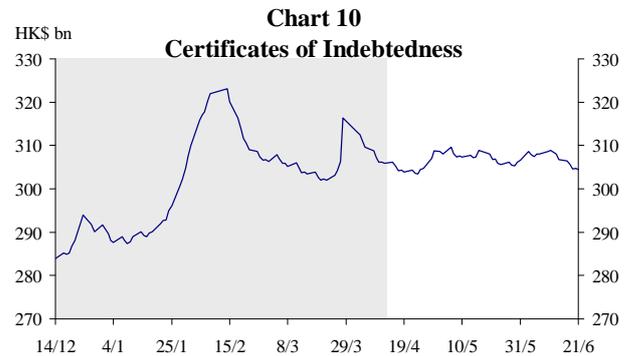
Monetary Base

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, **decreased to HK\$1,230.39 billion on 21 June from HK\$1,233.86 billion on 15 April** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	15 Apr 13	21 Jun 13
CIs	306.19	304.39
Government-issued Currency Notes and Coins in Circulation	10.73	10.65
Aggregate Balance	193.85	163.91
Outstanding EFBNs	723.09	751.45
Monetary Base	1233.86	1230.39

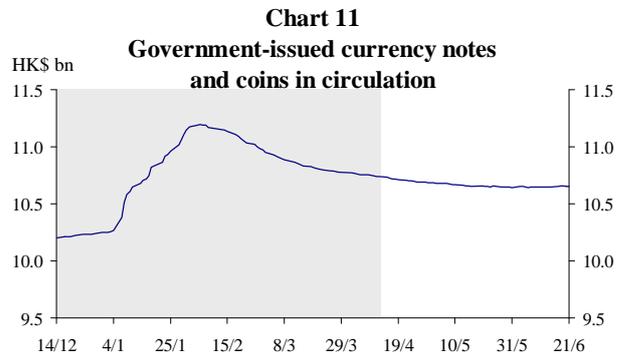
Certificates of Indebtedness

10. During the review period, the three note-issuing banks redeemed HK\$1.80 billion worth of CIs in exchange for US\$231 million. As a result, **the outstanding CIs decreased to HK\$304.39 billion on 21 June from HK\$306.19 billion on 15 April** (Chart 10).



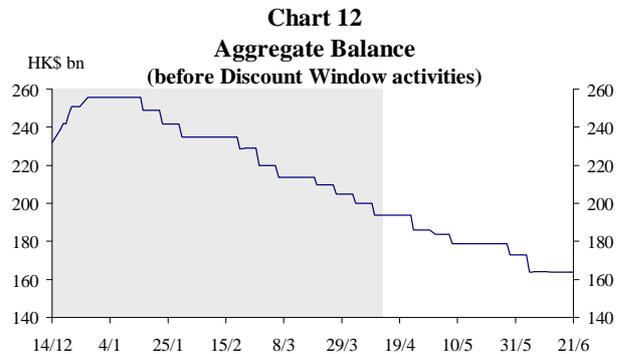
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation edged down** to HK\$10.65 billion on 21 June from HK\$10.73 billion on 15 April (Chart 11).



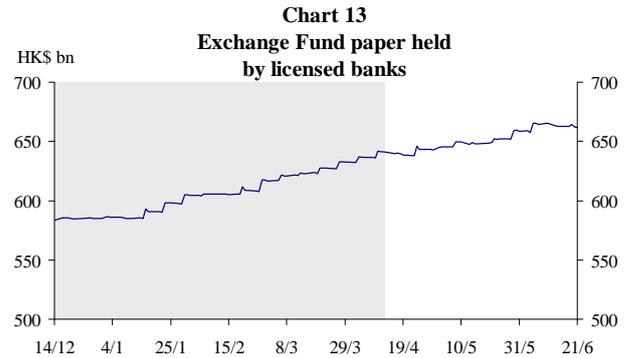
Aggregate Balance

12. **The Aggregate Balance declined to HK\$163.91 billion on 21 June from HK\$193.85 billion on 15 April** (Chart 12), as additional Exchange Fund Bills were issued to meet banks' demand. The increase in the supply of Exchange Fund paper is consistent with Currency Board principles, as the additional issuance represents a change in the composition of the Monetary Base from the Aggregate Balance to Exchange Fund paper, and the Monetary Base remained fully backed by foreign exchange reserves.



Outstanding Exchange Fund Bills and Notes

13. **The market value of outstanding Exchange Fund Bills and Notes rose to HK\$751.45 billion from HK\$723.09 billion during the review period, reflecting mainly the additional issuance of Exchange Fund Bills to meet banks' demand. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) also increased to HK\$661.74 billion (88.1% of total) from HK\$639.97 billion (88.5% of total) (Chart 13).**

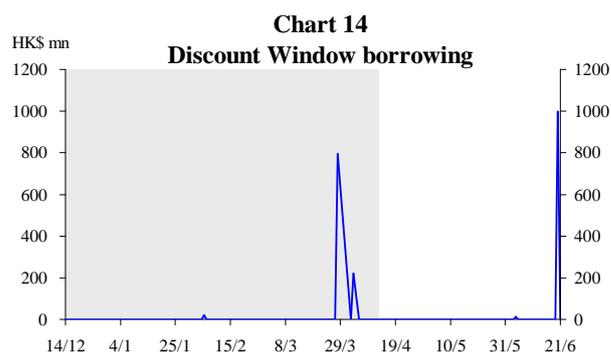


14. During the review period, **HK\$450.58 million of interest payments on Exchange Fund paper were made. An additional HK\$317.91 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were well received by the market (Table 3).

	No. of issues launched	Over-subscription ratio
1-month EFB	2	2.5-15.0
3-month EFB	10	1.12-2.39
6-month EFB	10	1.49-7.00
12-month EFB	3	4.89-9.11
2-year EFN	1	5.37
3-year EFN	1	2.18
5-year EFN	1	1.75
10-year EFN	1	2.44

Discount Window activities

15. During the review period, **two banks borrowed a total of HK\$1.01 billion from the Discount Window**, compared with HK\$1.04 billion in the preceding period (Chart 14 and Table 4).



Backing Portfolio

16. The Backing Assets decreased to HK\$1,325.09 billion during the review period, mainly reflecting the redemption of CIs and revaluation losses on investments. As the Backing Assets decreased proportionally more than the Monetary Base, **the Backing Ratio edged down to 107.75% from 108.27% 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 Hong Kong dollar exchange rate.

Table 4
Frequency of individual bank's access to the Discount Window (13 Apr - 21 Jun 13)

Frequency of using Discount Window	No. of banks
2	2

