

EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

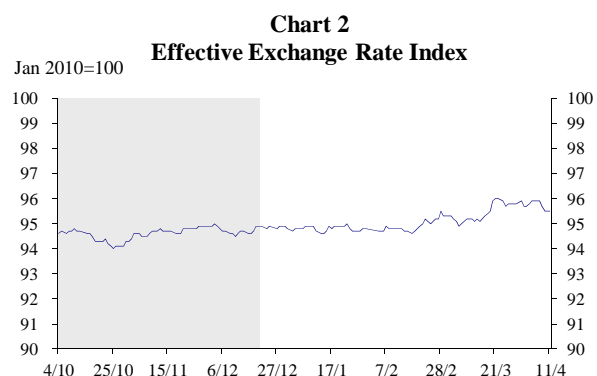
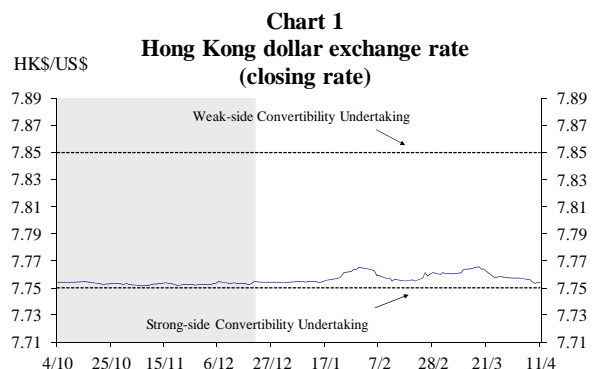
Report on Currency Board Operations
(21 December 2013 – 11 April 2014)

The Hong Kong dollar exchange rate traded within a narrow range of 7.7536–7.7656 during the review period, notwithstanding concerns about the US Federal Reserve’s reduction in the pace of its asset purchases and a volatile stock market performance. In the money market, the Hong Kong dollar interbank interest rates remained at low levels during the review period, while the Hong Kong dollar forward discounts widened slightly. The Monetary Base edged up mainly due to an increase 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

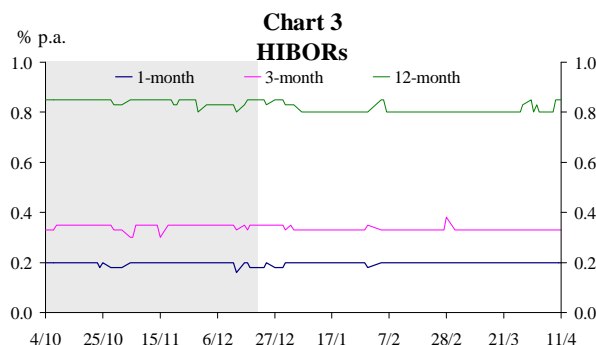
The Hong Kong dollar exchange rate traded within a narrow range of 7.7536–7.7656 against the US dollar during the review period (Chart 1), notwithstanding concerns about the US Federal Reserve’s reduction in the pace of its asset purchases and a volatile stock market performance.

The announcement of the Shanghai-Hong Kong Stock Connect on 11 April 2014 did not have much impact on the Hong Kong dollar so far, with most traders waiting for more details of the arrangement. At the end of the review period, the spot exchange rate closed at 7.7540 on 11 April 2014, little changed from 7.7541 on 23 December 2013. The nominal effective exchange rate index of the Hong Kong dollar was stable in the early part of the review period and then strengthened slightly (Chart 2), primarily reflecting a stronger US dollar against a broad basket of currencies of Hong Kong’s trading partners.

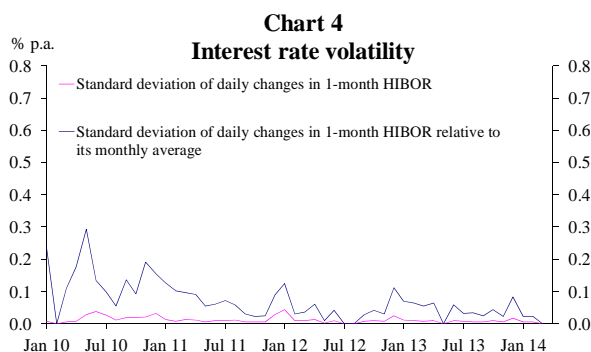


Interest rates

2. **Hong Kong dollar interbank interest rates remained generally stable at low levels (Chart 3).** The one-month, three-month and 12-month HIBORs moved closely around 0.20%, 0.33% and 0.81%, respectively during the review period.

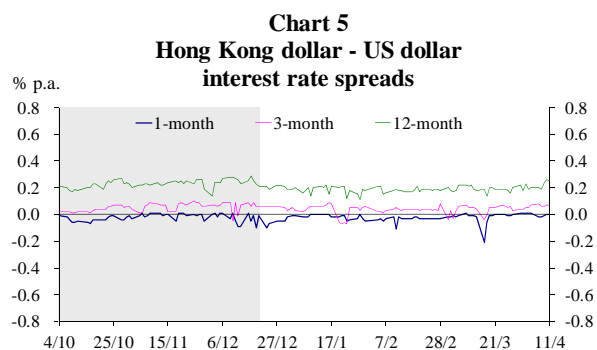


3. **Interest rate volatility decreased after a spike in December 2013.** The standard deviation of the one-month HIBOR edged down below one basis point during the review period (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also decreased.¹

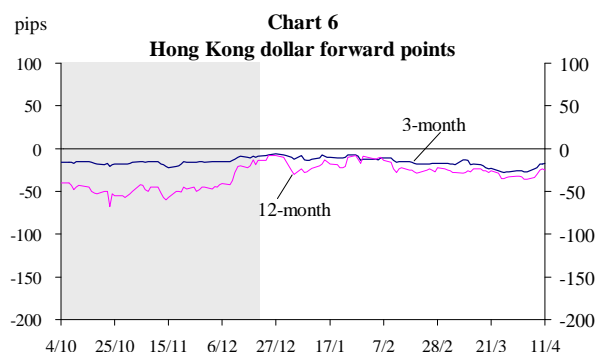


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

4. The spreads of Hong Kong dollar interest rates against their US dollar counterparts remained broadly stable during the review period (Chart 5), only with occasional fluctuations driven by movements in the US dollar rates. The three-month and 12-month spreads averaged +4 and +19 basis points respectively, while the one-month spread averaged around -2 basis points.



5. The Hong Kong dollar forward discounts widened slightly during the review period, to 17 pips for the three-month rate and 25 pips for the 12-month rate on 11 April 2014 (Chart 6).



6. During the review period, the yield curve of the Exchange Fund paper flattened slightly along with that of the US Treasury (Chart 7). Reflecting the relatively smaller decreases in the yields of Exchange Fund paper, the negative yield spreads of long-dated Exchange Fund paper over the US counterparts narrowed slightly (Table 1).

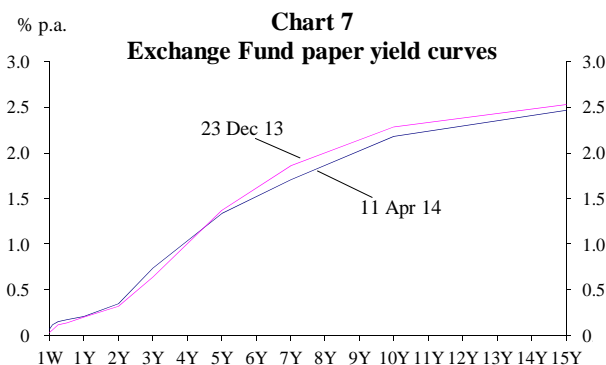
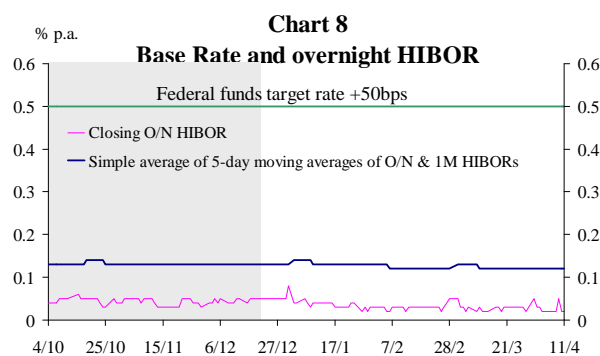


Table 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

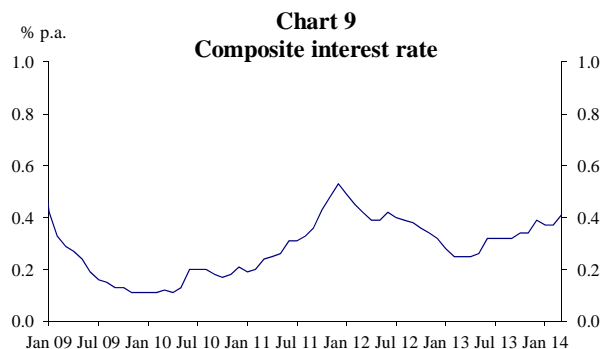
| | 23 Dec 13 | 11 Apr 14 |
|---------|-----------|-----------|
| 3-month | 5 | 12 |
| 1-year | 7 | 12 |
| 3-year | -9 | -7 |
| 5-year | -31 | -25 |
| 10-year | -62 | -48 |
| 15-year | -84 | -62 |

7. The US Federal Open Market Committee (FOMC) decided to maintain the current range of the Federal Funds Target Rate (FFTR) at 0–0.25% at the January and March meetings.² 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 FFTR target range in accordance with the revised Base Rate formula announced on 26 March 2009.



² The FOMC made successive reductions in the pace of its asset purchases at the January and March meetings. Beginning in April, it will add to its holdings of longer-term Treasury securities and agency mortgage-backed securities at a pace of US\$55 billion per month. At the March meeting, the FOMC also updated its forward guidance and indicated that it likely would be appropriate to maintain the current range of the FFTR a considerable time after the asset purchase program ends, especially if projected inflation continued to run below the FOMC's 2% longer-run goal, and provided that longer-term inflation expectations remained well anchored.

8. Banks kept their Best Lending Rates unchanged, consistent 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 continued to stay flat at 0.01%.³ **The composite interest rate,⁴ which indicates the average cost of funds for retail banks, rose higher to 0.41% in March 2014** (Chart 9). On the lending side, the average mortgage interest rates for the newly approved mortgage loans continued to fall slightly.



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.

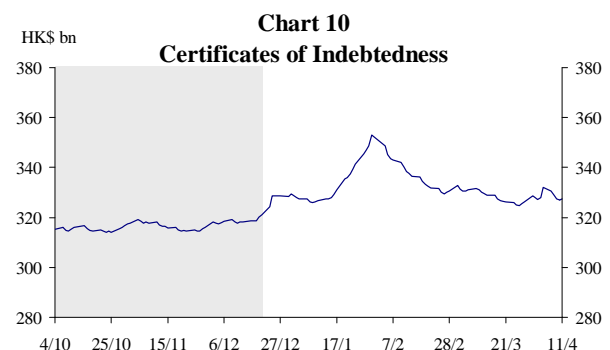
Monetary Base

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, **edged up to HK\$1,255.00 billion on 11 April 2014 from HK\$1,250.66 billion on 23 December 2013** (Table 2). Movements in the individual components are discussed below.

| Table 2 Monetary Base | | |
|---|----------------|----------------|
| (HK\$bn) | 23 Dec 13 | 11 Apr 14 |
| CIs | 324.17 | 327.42 |
| Government-issued Currency Notes and Coins in Circulation | 10.84 | 11.24 |
| Aggregate Balance | 163.98 | 163.88 |
| Outstanding EFBNs | 751.67 | 752.47 |
| Monetary Base | 1250.66 | 1255.00 |

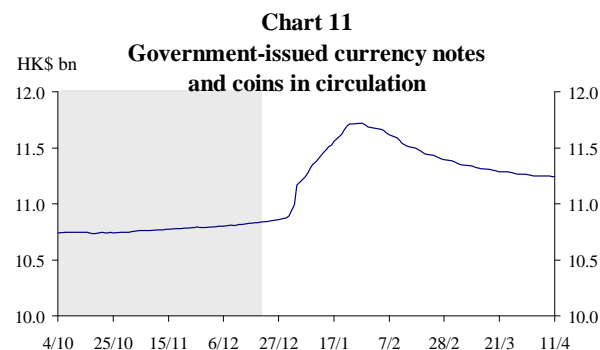
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$417 million in exchange for HK\$3.25 billion worth of CIs to the HKMA. As a result, **the outstanding CIs increased to HK\$327.42 billion on 11 April 2014 from HK\$324.17 billion on 23 December 2013** (Chart 10). The outstanding CIs increased momentarily around the Chinese New Year amid rising demand for banknotes.



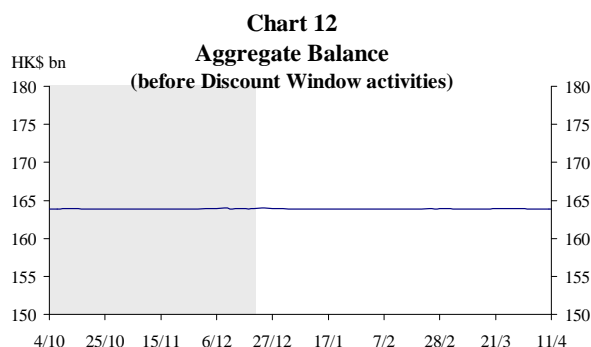
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation increased slightly** to HK\$11.24 billion on 11 April 2014 from HK\$10.84 billion on 23 December 2013 (Chart 11).



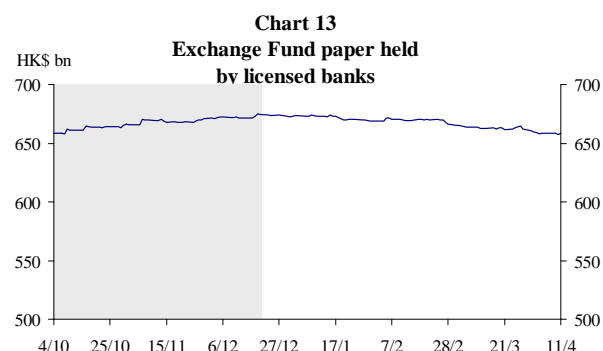
Aggregate Balance

12. **The Aggregate Balance remained stable** at around HK\$163.9 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** to HK\$752.47 billion from HK\$751.67 billion during the review period. On the other hand, **holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased** to HK\$658.79 billion (87.6% of total) from HK\$ 673.96 billion (89.7% of total) (Chart 13).

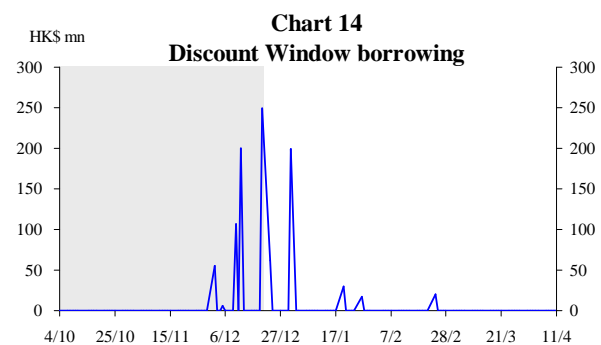


14. During the review period, **HK\$645.57 million of interest payments on Exchange Fund paper were made. An additional HK\$575.80 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund paper issued was well received by the market (Table 3).

| Table 3 Issuance of Exchange Fund Bills and Notes (21 Dec 13 – 11 Apr 14) | | |
|--|------------------------|-------------------------|
| | No. of issues launched | Over-subscription ratio |
| 3-month EFB | 16 | 0.96-3.15 |
| 6-month EFB | 15 | 0.90-3.70 |
| 12-month EFB | 4 | 6.24-13.65 |
| 2-year EFN | 1 | 3.83 |
| 3-year EFN | 1 | 3.91 |
| 5-year EFN | 1 | 3.69 |
| 15-year EFN | 1 | 2.01 |

Discount Window activities

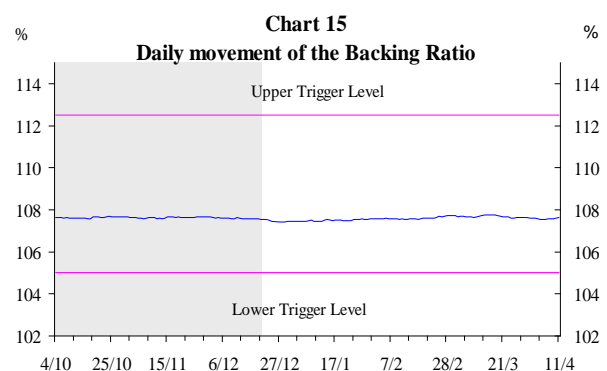
15. During the review period, **five banks borrowed a total of HK\$328 million from the Discount Window**, compared with HK\$617 million in the preceding period (Chart 14 and Table 4).



| Table 4 Frequency of individual bank's access to the Discount Window (21 Dec 13 – 11 Apr 14) | |
|---|--------------|
| Frequency of using Discount Window | No. of banks |
| 1 | 5 |

Backing portfolio

16. The Backing Assets increased to HK\$1,350.08 billion during the review period, mainly reflecting an increase in the CIs. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio edged up to 107.62% from 107.50% 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.

Hong Kong Monetary Authority
9 June 2014