

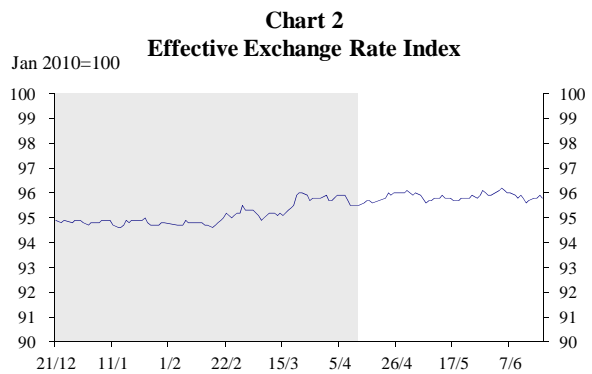
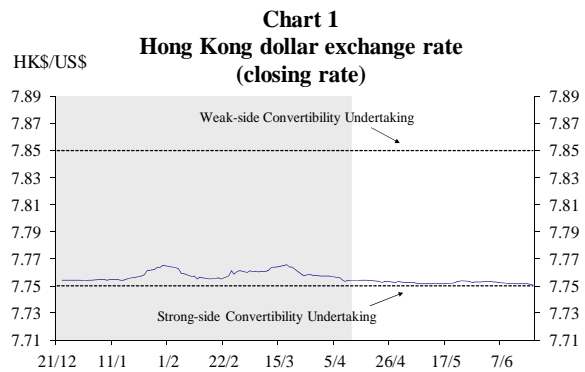
EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

Report on Currency Board Operations
(12 April – 19 June 2014)

The Hong Kong dollar exchange rate strengthened during the review period, in part reflecting mild portfolio inflows and stronger corporate demand for Hong Kong dollar liquidity before the half-year end. In the money market, the Hong Kong dollar interbank interest rates remained stable at low levels, while the Hong Kong dollar forward discounts narrowed. The Monetary Base edged down due to a decline in Certificates of Indebtedness. In accordance with the Currency Board principles, all changes in the Monetary Base were fully matched by changes in foreign reserves.

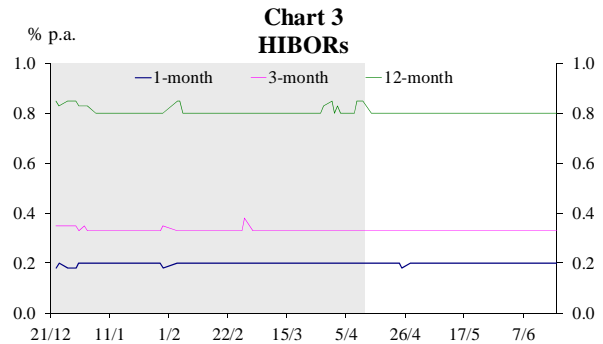
Hong Kong dollar exchange rate

1. **The Hong Kong dollar exchange rate strengthened during the review period, in part reflecting mild portfolio inflows and stronger corporate demand for Hong Kong dollar liquidity before the half-year end to meet operation needs and make dividend payments (Chart 1). Towards the end of the review period, the Hong Kong dollar exchange rate was further supported by increased funding demand for equity initial public offering (IPO) activities. The Hong Kong dollar spot exchange rate closed at 7.7509 on 19 June 2014, compared with 7.7537 on 14 April 2014. **The nominal effective exchange rate index of the Hong Kong dollar edged up during the review period alongside the slight appreciation of the US dollar against the major currencies (Chart 2).****

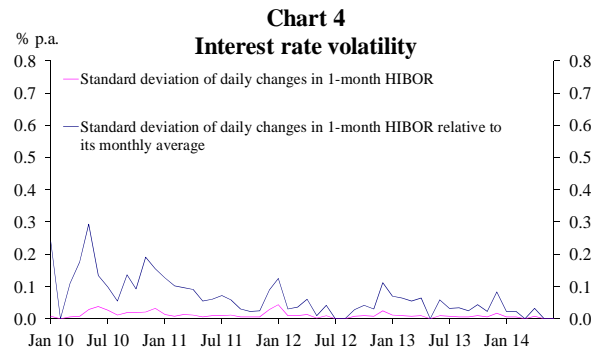


Interest rates

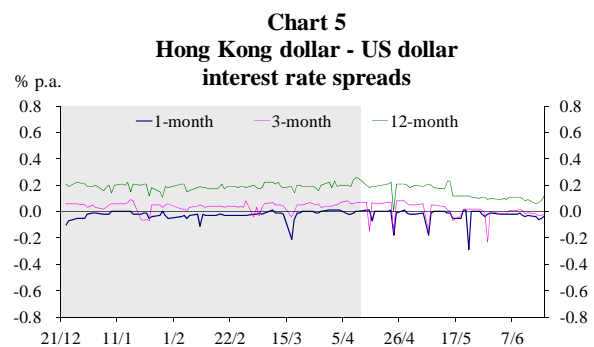
2. **Hong Kong dollar interbank interest rates remained stable at low levels** (Chart 3). The one-month, three-month and 12-month HIBORs hovered around 0.20%, 0.33% and 0.8%, respectively during the review period.



3. **Interest rate volatility stayed low during the review period.** The standard deviation of the one-month HIBOR remained below one 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



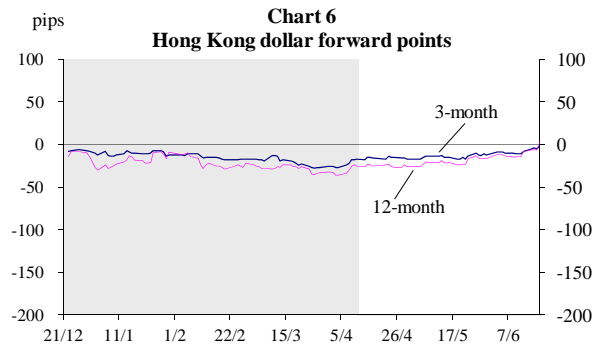
4. **The spreads between Hong Kong dollar interest rates and their US dollar counterparts narrowed during the review period** (Chart 5), reflecting mainly slight increases in the US dollar interest rates. The 12-month spreads decreased by 8 basis points to +12 basis points, while the one-month and three-



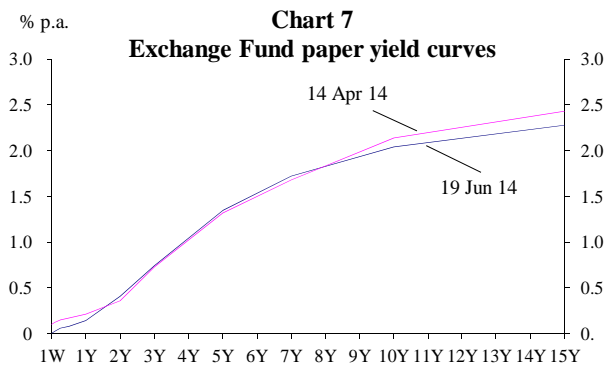
¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

month spreads turned slightly negative.

5. **The Hong Kong dollar forward discounts narrowed during the review period amid increased funding demand before the half-year end and equity IPO activities. The three-month forward discounts narrowed to 2 pips on 19 June 2014, while the 12-month forward points turned into a slight premium of 3 pips (Chart 6).**



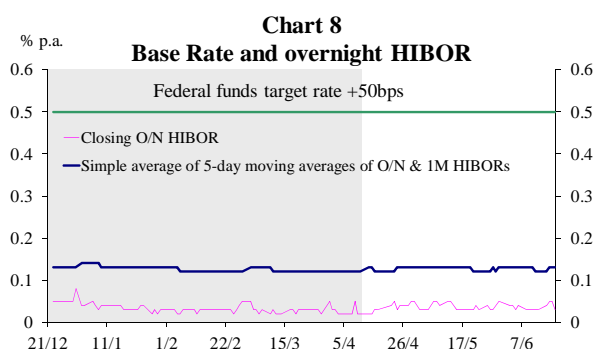
6. **The yield curve of the Exchange Fund paper flattened modestly during the review period (Chart 7).** Broadly tracking the movements of the US Treasury counterparts, the yields of the long-dated Exchange Fund Notes declined in the early part of the review period and then edged up slightly in June. Overall, the negative yield spreads between the long-dated Exchange Fund paper and the US counterparts widened slightly (Table 1).



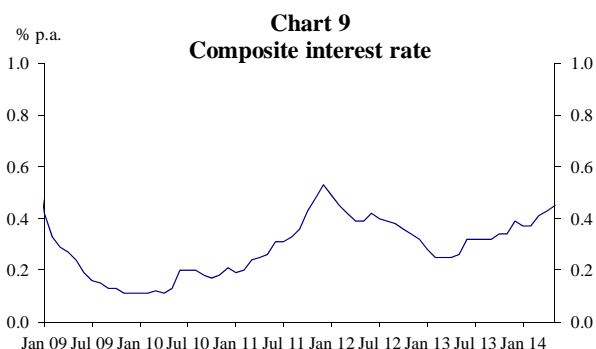
	14 Apr 14	19 Jun 14
3-month	12	3
1-year	12	5
3-year	-6	-19
5-year	-23	-33
10-year	-48	-57
15-year	-61	-69

7. At the April and June meetings, the US Federal Open Market Committee (FOMC) decided to keep the current range of the Federal Funds

Target Rate (FFTR) at 0–0.25%.² **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.



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 remained flat at 0.01%.³ Nonetheless, **the composite interest rate,⁴ which indicates the average cost of funds for retail banks, edged up further to 0.45% in May** (Chart 9). On the lending side, the average mortgage



² The FOMC made successive reductions in the pace of its asset purchases at the April and June meetings. Beginning in July, it will add to its holdings of longer-term Treasury securities and agency mortgage-backed securities at a pace of US\$35 billion per month. The FOMC also indicated that it likely would be appropriate to maintain the current range of the FFTR for 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.

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.

interest rates for the newly approved mortgage loans decreased slightly.

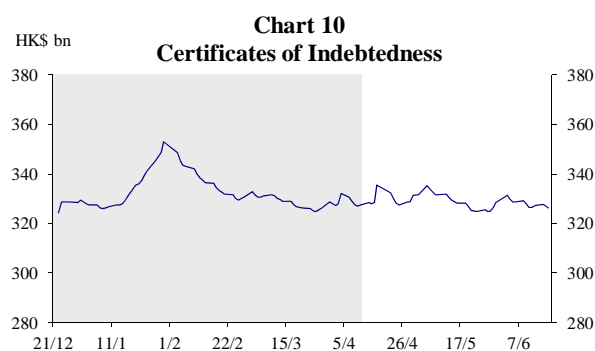
Monetary Base

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 down** to HK\$1,254.08 billion on 19 June 2014 from HK\$1,256.18 billion on 14 April 2014 (Table 2). Movements in the individual components are discussed below.

Table 2		
Monetary Base		
(HK\$bn)	14 Apr 14	19 Jun 14
CIs	328.52	326.31
Government-issued Currency Notes and Coins in Circulation	11.24	11.17
Aggregate Balance	163.88	163.90
Outstanding EFBNs	752.55	752.70
Monetary Base	1256.18	1254.08

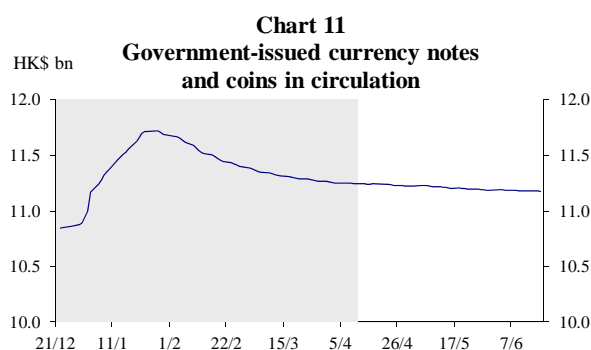
Certificates of Indebtedness

10. During the review period, the three note-issuing banks redeemed HK\$2.21 billion worth of CIs in exchange for US\$283 million. As a result, **the outstanding CIs decreased slightly** to HK\$326.31 billion on 19 June 2014 from HK\$328.52 billion on 14 April 2014 (Chart 10).



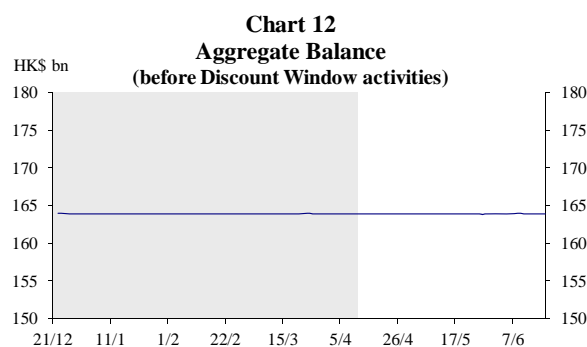
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation decreased** to HK\$11.17 billion on 19 June 2014 from HK\$11.24 billion on 14 April 2014 (Chart 11).



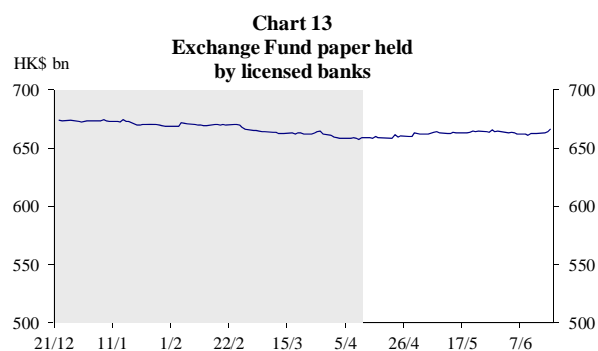
Aggregate Balance

12. **The Aggregate Balance remained stable** at around HK\$163.9 billion during the review period, with small fluctuations due to interest payments on the 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\$752.70 billion from HK\$752.55 billion during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased** to HK\$666.71 billion (88.6% of total) from HK\$658.79 billion (87.5% of total) (Chart 13).

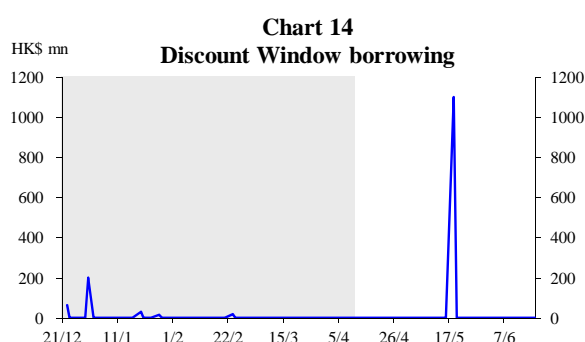


14. During the review period, **HK\$388.55 million of interest payments on Exchange Fund paper were made. An additional HK\$281.93 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund paper issued during the review period was well received by the market (Table 3).

	No. of issues launched	Over-subscription ratio
1-month EFB	2	8.67-11.67
3-month EFB	10	2.11-4.12
6-month EFB	10	1.65-5.06
12-month EFB	3	2.88-6.40
2-year EFN	1	4.66
10-year EFN	1	5.19

Discount Window activities

15. During the review period, **two banks borrowed a total of HK\$1.1 billion from the Discount Window**, compared with HK\$328 million in the preceding review period (Chart 14 and Table 4).

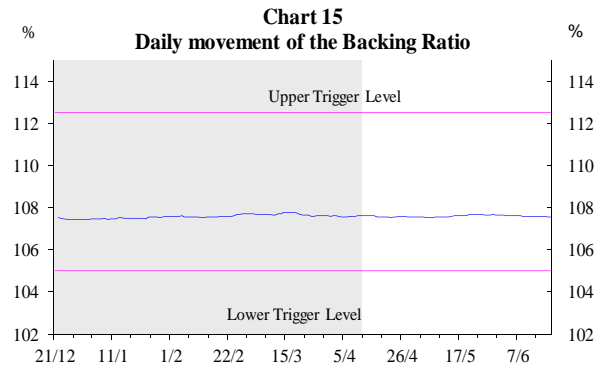


Frequency of using Discount Window	No. of banks
1	2

Backing Portfolio

16. The Backing Assets decreased slightly to HK\$1,348.49 billion during the review period, mainly reflecting a decrease in the CIs and the revaluation losses on investments. As the Backing Assets decreased proportionally more than the Monetary Base, **the Backing Ratio edged down**

to 107.56% from 107.62% 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
11 August 2014