

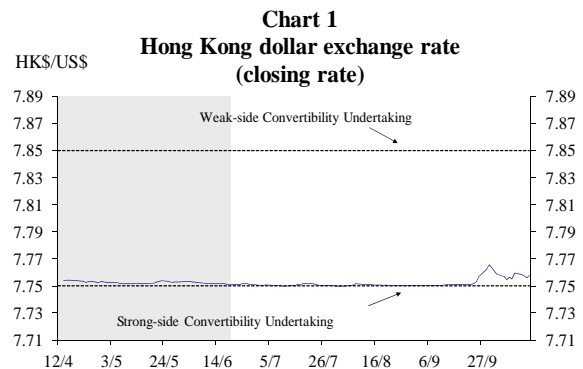
EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

Report on Currency Board Operations
(20 June – 16 October 2014)

The Hong Kong dollar stayed close to 7.75 against the US dollar during most of the review period. The strong-side Convertibility Undertaking (CU) was repeatedly triggered between 1 July and 5 August on the back of strong commercial and equity-related demand. The Hong Kong dollar exchange rate softened in late September and early October. During the whole review period, the Hong Kong dollar interbank interest rates remained at low levels. The foreign exchange and money markets continued to function in an orderly manner. As a result of the triggering of the strong-side CU in July and August, the Aggregate Balance increased, and the Monetary Base rose to HK\$1,340.28 billion at the end of the review period. 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

1. The Hong Kong dollar stayed close to 7.75 against the US dollar during most of the review period. The strong-side CU was repeatedly triggered between 1 July and 5 August (Chart 1). The triggering involved inflows of HK\$75.3 billion on the back of strong commercial and equity-related demand for the Hong Kong dollar. The Hong Kong dollar exchange rate then softened in late September and early October along with the broad US dollar strength and corrections in local stock market on renewed worries about the global economic prospects. Concerns about the local protests had briefly weighed on the Hong Kong dollar. Nonetheless, the Hong Kong dollar exchange rate has remained broadly stable. For the review period as a whole, the Hong Kong dollar exchange rate weakened slightly to 7.7577 on 16 October 2014 from 7.7513 on 20 June 2014. On the whole, the foreign exchange market continued to function in an orderly manner. The nominal effective exchange rate index of the Hong Kong

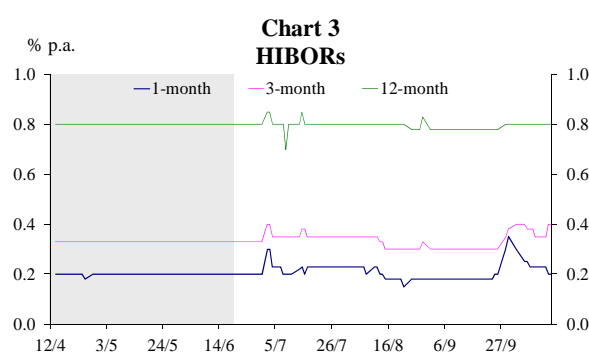
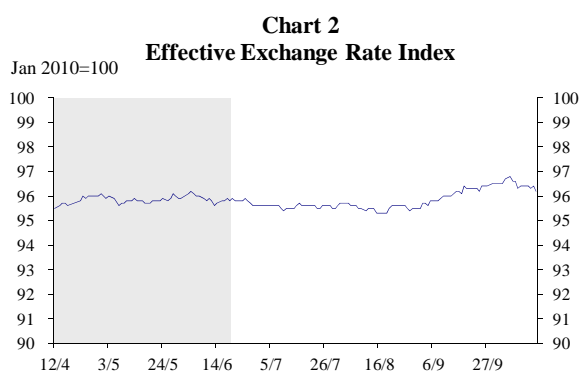


dollar strengthened slightly during the review period alongside the US dollar appreciation against major currencies (Chart 2).

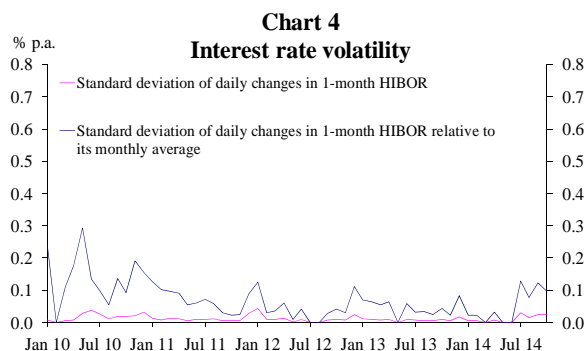
Interest rates

2. **The Hong Kong dollar interbank interest rates were little changed** compared with the start of the review period, though with some fluctuations due to equity initial public offerings (IPOs) and seasonal and quarter-end liquidity demand (Chart 3). For the review period as a whole, the one-month, three-month and 12-month HIBORs averaged 0.21%, 0.34% and 0.80% respectively. The HKMA and the banking sector activated the business contingency plan in late September and early October in view of the local protests. The interbank market continued to function in an orderly manner with ample liquidity, and the interbank fund transfers in the Real Time Gross Settlement systems remained at normal level.

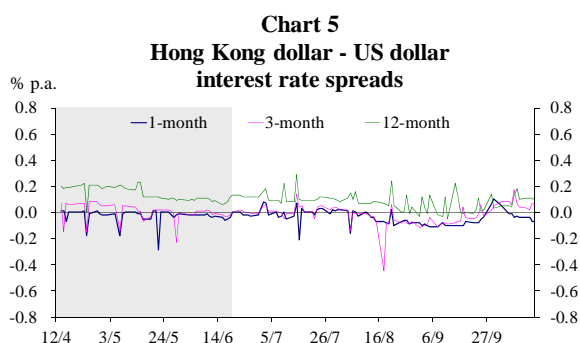
3. **Interest rate volatility**, as measured by the standard deviation of daily changes in the one-month HIBOR,



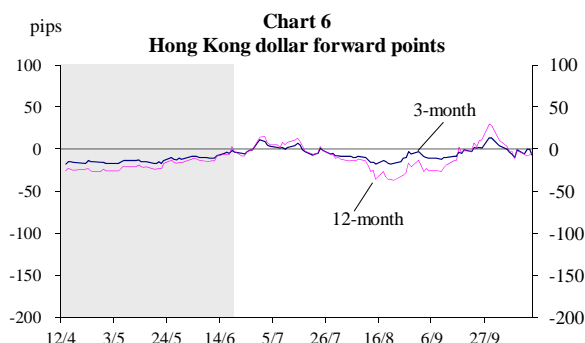
increased to 2.1 basis points in the recent period from virtually zero in June (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also showed similar movement.¹



4. During the review period, the spreads between the Hong Kong dollar interest rates and their US dollar counterparts generally moved within a tight range (Chart 5). Overall, the one-month, three-month and 12-month spreads averaged -4, -1 and 9 basis points respectively.

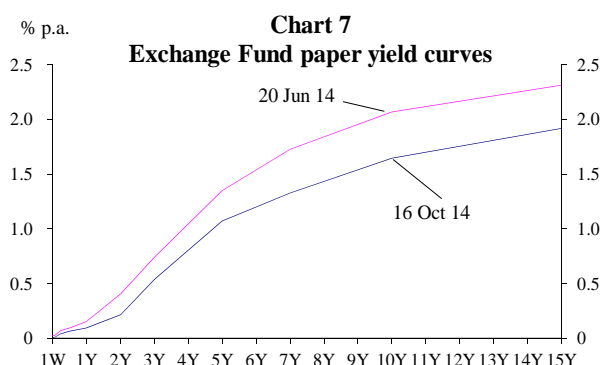


5. The Hong Kong dollar forward points momentarily turned to a premium near the quarter ends in late June and late September, reflecting seasonal liquidity needs and increased funding demand for equity IPOs (Chart 6). At the end of the review period, the three-month and 12-month forward points reverted back to discounts of 7 pips and 5 pips respectively.



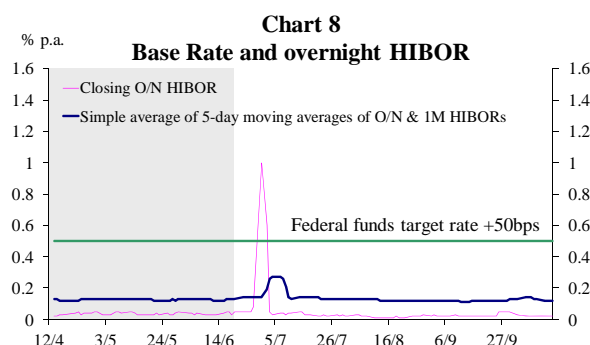
¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

6. Tracking the movements in the US Treasury yields, the yields of the Exchange Fund paper declined across the curve during the review period, with the yield of 10-year tenor down by 42 basis points to 1.65%. The yield curve of the Exchange Fund paper also flattened along with that of the US Treasury (Chart 7). The yield spreads between the Exchange Fund paper and the US Treasury narrowed slightly across the curve (Table 1).



	20 Jun 14	16 Oct 14
3-month	5	3
1-year	7	-1
3-year	-18	-14
5-year	-33	-22
10-year	-57	-44
15-year	-70	-50

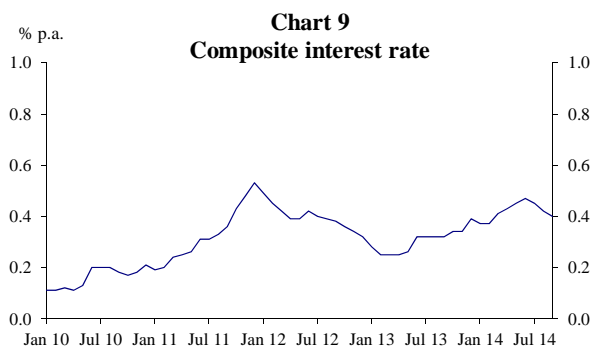
7. At the July and September meetings, the US Federal Open Market Committee (FOMC) decided to keep the current range of the Federal Funds Target Rate (FFTR) unchanged at 0 – 0.25%.² The HKMA Base Rate remained unchanged at 0.5% (Chart 8). It continued to be set at 50 basis points above the lower boundary of the FFTR target range in accordance with the revised



² The FOMC made successive reductions in the pace of its asset purchases at the July and September meetings. Beginning in October, the FOMC will add to its holdings of longer-term Treasury securities and agency mortgage-backed securities at a pace of US\$15 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.

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 review period. The average one-month Hong Kong dollar time deposit rate offered by retail banks stayed flat at 0.01%.³ **The composite interest rate,⁴** which indicates the average cost of funds for retail banks, **decreased to 0.40% in September** from 0.47% in June (Chart 9). On the lending side, the average mortgage interest rates for newly approved mortgage loans edged down further.



³ The figure refers to the average interest rate 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.

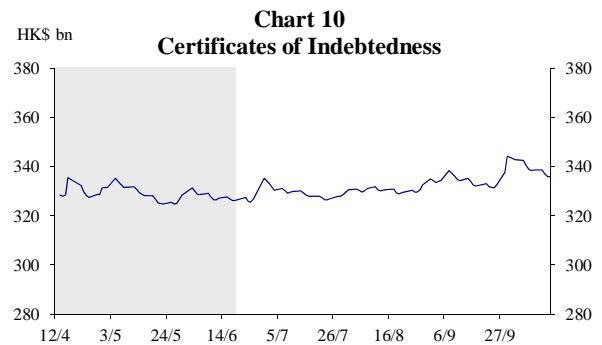
Monetary Base

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, **increased to HK\$1,340.28 billion on 16 October 2014 from HK\$1,254.13 billion on 20 June 2014** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	20 Jun 14	16 Oct 14
CIs	326.35	335.97
Government-issued Currency Notes and Coins in Circulation	11.17	11.25
Aggregate Balance	163.92	239.19
Outstanding EFBNs	752.70	753.88
Monetary Base	1254.13	1340.28

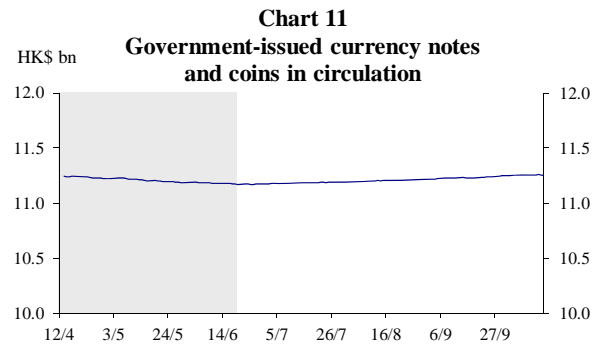
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$1.23 billion to the HKMA in exchange for HK\$9.62 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$335.97 billion on 16 October 2014 from HK\$326.35 billion on 20 June 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** increased to HK\$11.25 billion on 16 October 2014 from HK\$11.17 billion on 20 June 2014 (Chart 11).



Aggregate Balance

12. **The Aggregate Balance** expanded to HK\$239.19 billion on 16 October from HK\$163.92 billion on 20 June (Chart 12), **due to repeated triggering of the strong-side CU** between 1 July and 5 August (Table 3).

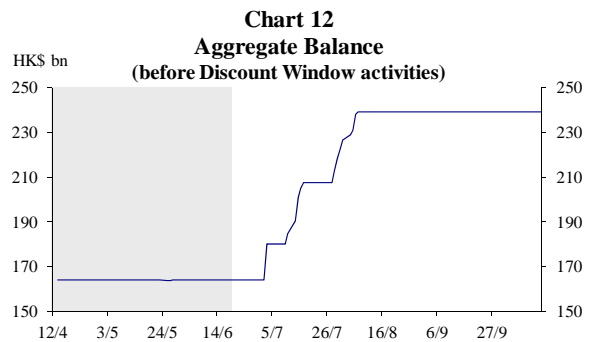
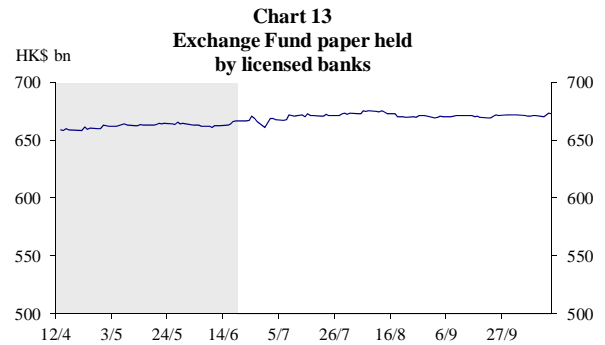


Table 3 HKMA HK\$/US\$ FX Transactions (20 Jun 14 - 16 Oct 14)	
Trade Date	Net sale of HK\$ (HK\$mn)
01-Jul-14	16,267.25
09-Jul-14	4,533.75
10-Jul-14	5,773.75
11-Jul-14	10,540.00
14-Jul-14	3,875.00
15-Jul-14	2,712.50
25-Jul-14	5,347.50
28-Jul-14	5,541.25
29-Jul-14	3,177.50
30-Jul-14	4,960.00
31-Jul-14	2,325.00
01-Aug-14	1,937.50
04-Aug-14	7,168.75
05-Aug-14	1,162.50
Total	75,322.25

Outstanding Exchange Fund Bills and Notes

13. **The market value of outstanding Exchange Fund Bills and Notes edged up to HK\$753.88 billion from HK\$752.70 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$672.75 billion (89.2% of total) from HK\$666.79 billion (88.6% of total) (Chart 13).**

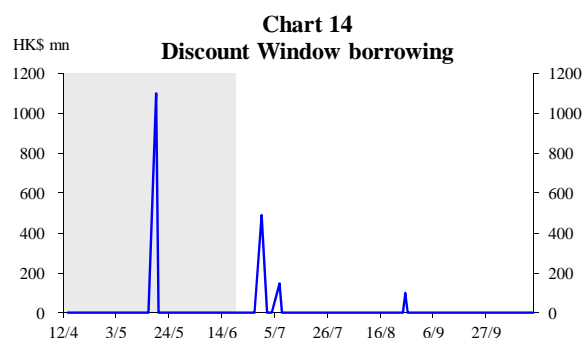


14. During the review period, **HK\$535.33 million of interest payments on Exchange Fund paper were made. An additional HK\$445.92 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund paper issued during the review period was well received by the market (Table 4).

	No. of issues launched	Over-subscription ratio
3-month EFB	17	0.41-5.06
6-month EFB	16	0.93-8.53
12-month EFB	4	1.00-4.33
2-year EFN	1	8.58
3-year EFN	2	5.72-6.58
5-year EFN	2	3.25-4.73
15-year EFN	1	3.18

Discount Window activities

15. During the review period, **four banks borrowed a total of HK\$735 million from the Discount Window**, compared with HK\$1.1 billion in the preceding review period (Chart 14 and Table 5).



Backing Portfolio

16. The Backing Assets expanded to HK\$1,438.57 billion during the review period, mainly reflecting the rise in the Aggregate Balance driven by the repeated triggering of the strong-side CU. As the Backing Assets increased proportionally less than the Monetary Base, **the Backing Ratio edged down to 107.42% from 107.58% 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 5
Frequency of individual bank's access to the Discount Window (20 Jun 14 – 16 Oct 14)

Frequency of using Discount Window	No. of banks
1	4

