

**EXCHANGE FUND ADVISORY COMMITTEE**

**Currency Board Sub-Committee**

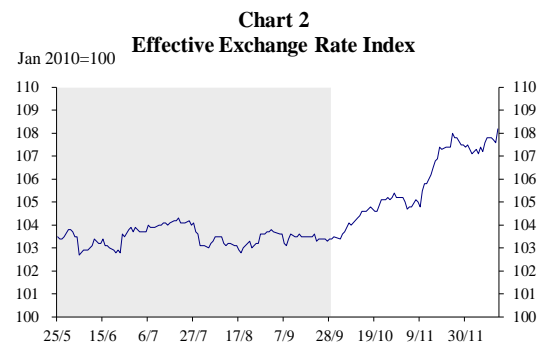
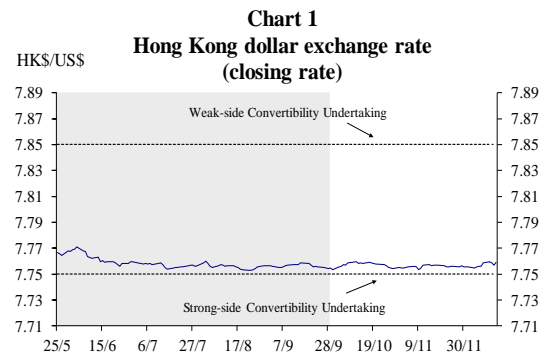
**Report on Currency Board Operations**

**(29 September – 15 December 2016)**

During the review period, the Hong Kong dollar traded within a narrow range of 7.7532–7.7596 against the US dollar. Despite the market volatilities triggered by the US presidential election, the Hong Kong dollar remained largely stable, and the local interbank money markets continued to operate smoothly. Towards the end of the review period, the Hong Kong dollar interbank interest rates and the Hong Kong dollar forward points picked up, reflecting in part a catch-up with the increases in the US dollar interbank interest rates and in part the year-end funding demand. The Aggregate Balance stayed virtually unchanged, and the Monetary Base increased slightly to HK\$1,626.25 billion 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.

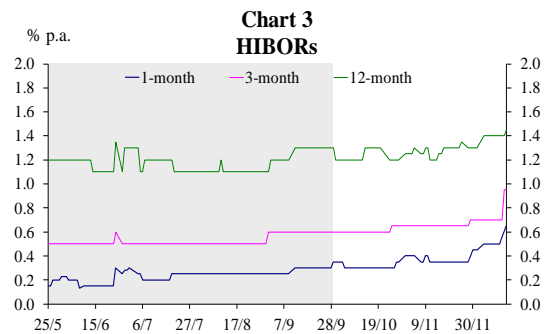
## Hong Kong dollar exchange rate

1. During the review period, the Hong Kong dollar moved within a narrow range of 7.7532–7.7596 against the US dollar (Chart 1). While the US presidential election triggered significant market volatilities, the Hong Kong dollar remained largely stable, and the local interbank money markets continued to operate smoothly. Ahead of the US Federal Open Market Committee (FOMC) meeting on 13–14 December, the Hong Kong dollar softened slightly along with weakness in Asian currencies and consolidation of the local equity market, closing at 7.7591 at the end of review period. **The nominal effective exchange rate index of the Hong Kong dollar picked up** during the review period amid the broad strength of the US dollar (Chart 2).

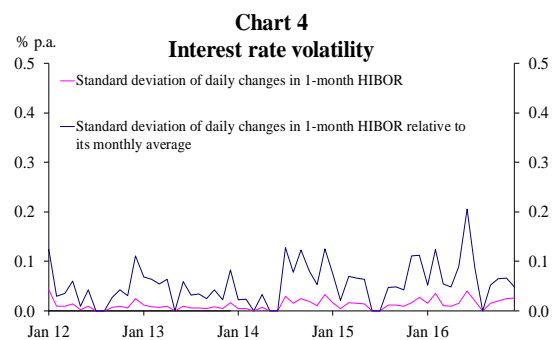


## Interest rates

2. Amid market expectation of a US interest rate hike in December, **the Hong Kong dollar interbank interest rates generally moved up** during the review period (Chart 3). Reflecting in part a catch-up with the US dollar interbank interest rates and in part the year-end funding demand, the short-dated interbank rates saw larger pick-ups towards the end of the review period. The one-month and the three-month HIBORs rose by 30 and 35 basis points to 0.65% and 0.95% respectively at the end of the review period. Meanwhile, the 12-month HIBOR increased by 15 basis points to 1.45%.

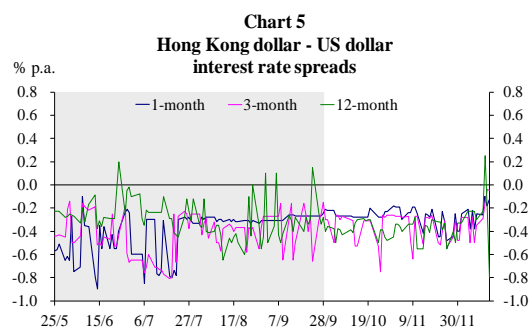


3. **Interest rate volatility**, measured by the standard deviation of daily changes in the one-month HIBOR, **picked up to** an average of 2.5 basis points in November and early December from 1.5 basis points in September (Chart 4). The standard deviation as a ratio of the average of one-month HIBOR also followed similar pattern<sup>1</sup>.

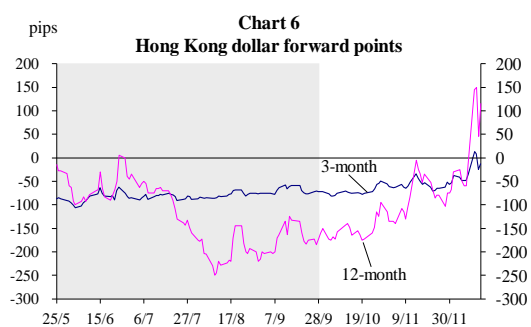


<sup>1</sup> The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

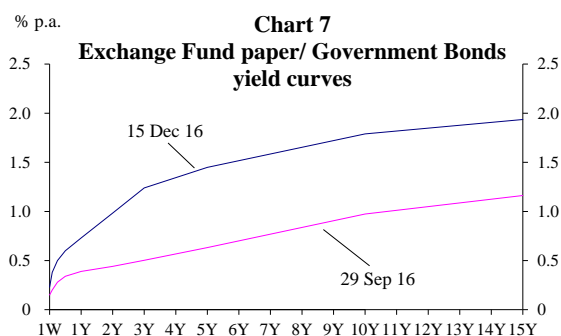
4. With the Hong Kong dollar interbank interest rates moving in tandem with the US dollar counterparts, **the negative Hong Kong dollar-US dollar interbank interest rate spreads were roughly steady for most of the time during the review period** (Chart 5). Towards the end of the review period, the short-dated negative spreads narrowed amid larger pick-ups in the Hong Kong dollar interbank rates, with the one-month and three-month negative spreads closing at -13 and -5 basis points respectively.



5. **The Hong Kong dollar forward points picked up notably during the review period.** In particular, the 12-month forward point once rose to +150 pips towards the end of the review period, driven by the year-end liquidity needs and hedging demand (Chart 6). At the end of the review period, the three-month and 12-month Hong Kong dollar forward points closed at -13 pips and +115 pips respectively.



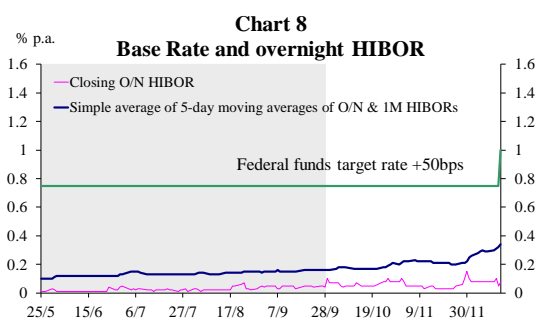
6. During the review period, **the Hong Kong dollar yield curve shifted upward** alongside the movement of the US dollar yield curve. The yield of the 2-year Exchange Fund Note increased by 54 basis points to 0.98%, and the yield of the 10-year Hong Kong Government Bond rose by 82 basis points to 1.79% (Chart 7). The negative yield spreads of Hong Kong Government Bonds over the US Treasuries widened slightly at the longer tenor due to smaller increases in the Hong Kong dollar yields (Table 1).



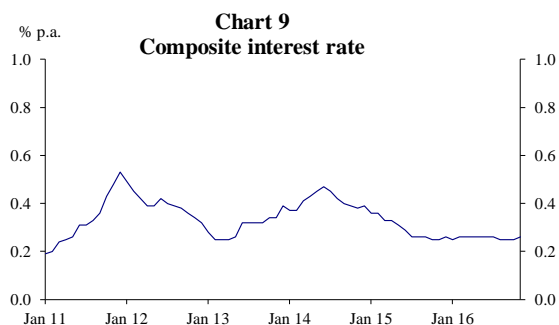
**Table 1**  
**Yield spreads of Exchange Fund paper and Hong Kong Government Bonds over US Treasuries (basis points)**

	29 Sep 16	15 Dec 16
3-month EFB	2	-1
12-month EFB	-20	-18
3-year HKGB	-35	-37
5-year HKGB	-49	-65
10-year HKGB	-59	-81

7. **The HKMA Base Rate increased from 0.75% to 1.00%**, following the upward adjustment in the target range for the US Federal Funds Rate from 0.25 – 0.50% to 0.50 – 0.75% on 14 December 2016 (US time) (Chart 8). The Base Rate continued to be set at 50 basis points above the lower bound of the target range for the US Federal Funds Rate in accordance with the revised Base Rate formula announced on 26 March 2009.



8. **Despite the rise in the US Federal Funds Rate in December, banks kept their Best Lending Rates unchanged.** The two Best Lending Rates continued to stay at 5.00% and 5.25% during the review period. The average one-month Hong Kong dollar time deposit rate offered by retail banks remained stable at 0.01%<sup>2</sup>. **The composite interest rate<sup>3</sup>**, which indicates the average funding cost of retail banks, **edged up from 0.25% in September to 0.26% in November** (Chart 9). On the lending side, the average mortgage interest rate for newly approved mortgage loans decreased, reflecting keener competition in the residential mortgage lending business.



<sup>2</sup> The figure refers to the average interest rate offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

<sup>3</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.

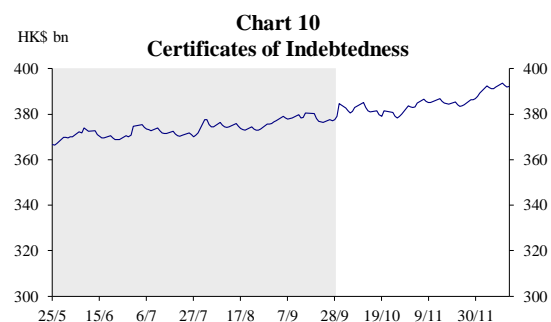
## Monetary Base

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 to HK\$1,626.25 billion on 15 December from HK\$1,613.87 billion on 29 September** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	29 Sep 16	15 Dec 16
CIs	378.96	392.10
Government-issued Currency Notes and Coins in Circulation	11.93	12.00
Aggregate Balance	259.52	259.54
Outstanding EFBNs	963.48	962.62
<b>Monetary Base</b>	<b>1613.87</b>	<b>1626.25</b>

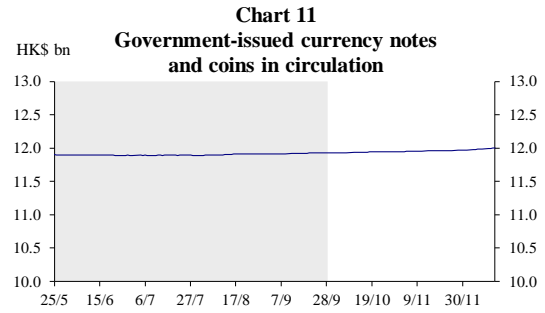
### *Certificates of Indebtedness*

10. During the review period, the three note-issuing banks submitted US\$1.68 billion to the HKMA in exchange for HK\$13.1 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$392.10 billion on 15 December from HK\$378.96 billion on 29 September** (Chart 10).



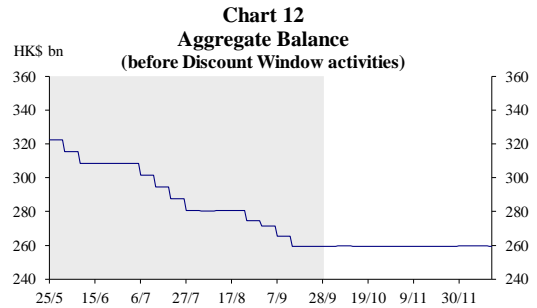
*Government-issued currency notes and coins in circulation*

11. During the review period, the amount of **government-issued currency notes and coins in circulation increased slightly** to HK\$12.00 billion on 15 December from HK\$11.93 billion on 29 September (Chart 11).



*Aggregate Balance*

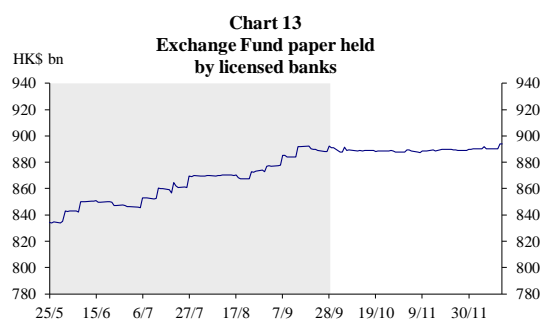
12. **The Aggregate Balance stayed virtually unchanged** at around HK\$259.5 billion during the review period, with small fluctuations due to interest payments on the Exchange Fund paper (Chart 12).





*Outstanding Exchange Fund Bills and Notes*

13. The market value of outstanding Exchange Fund Bills and Notes edged down to HK\$962.62 billion from HK\$963.48 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$893.82 billion (92.9% of total) from HK\$890.90 billion (92.5% of total) (Chart 13).



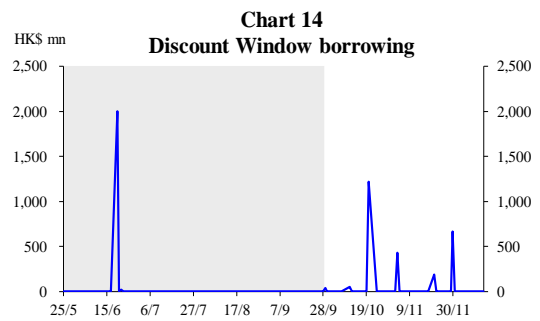
14. During the review period, interest payments on Exchange Fund paper amounted to HK\$943.35 million. A total of HK\$832.28 million (in market value) of Exchange Fund paper was issued to absorb these interest payments. The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund paper issued during the review period was well received by the market (Table 3).

**Table 3**  
Issuance of Exchange Fund Bills and Notes  
(29 Sep – 15 Dec 16)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	5.75
3-month EFB	11	0.53-1.68
6-month EFB	11	1.21-1.62
12-month EFB	3	1.58-2.64
2-year EFN	1	2.42

**Discount Window activities**

15. During the review period, **seven banks borrowed HK\$2.60 billion from the Discount Window**, compared with a total borrowing of HK\$2.02 billion in the preceding period (Chart 14 and Table 4).



<b>Table 4</b> <b>Frequency of individual bank's access to the Discount Window</b> <b>(29 Sep – 15 Dec 16)</b>	
Frequency of using Discount Window	No. of banks
1	7

**Backing Portfolio**

16. The Backing Assets increased slightly to HK\$1,735.80 billion on 15 December, mainly reflecting an increase in the CIs which more than offset the valuation losses. As the Backing Assets increased proportionally less than the Monetary Base, **the Backing Ratio edged down to 106.77% from 107.03% 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.

