

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

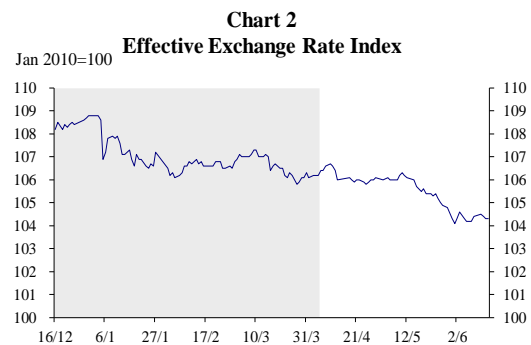
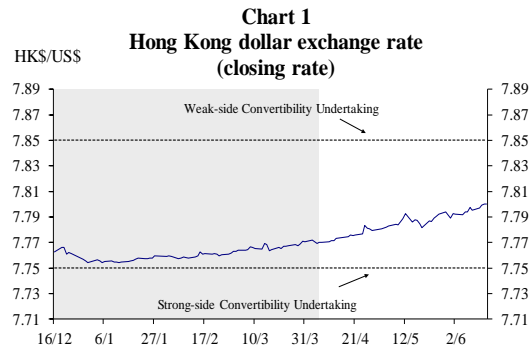
Report on Currency Board Operations

(6 April – 15 June 2017)

During the review period, the Hong Kong dollar interbank interest rates remained soft despite continued rises in the US dollar interest rates. Reflecting increased carry trade activities amid widening negative Hong Kong dollar-US dollar interest rate spreads, the Hong Kong dollar exchange rate softened gradually to trade within a range of 7.7700 – 7.8002. The discounts of Hong Kong dollar forward points also widened during the review period, largely reflecting the interest rate gap between Hong Kong dollar and US dollar. The Aggregate Balance stayed virtually unchanged, and the Monetary Base increased slightly to HK\$1,656.53 billion, mainly driven by 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.

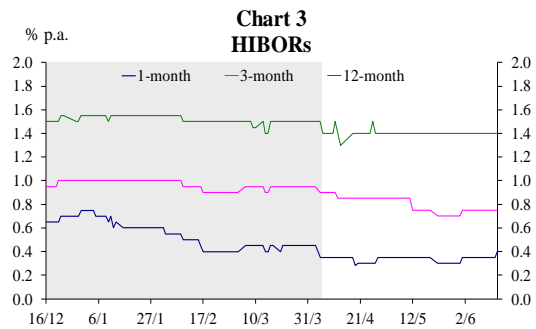
Hong Kong dollar exchange rate

1. During the review period, **the Hong Kong dollar softened gradually to trade within a range of 7.7700 – 7.8002 against the US dollar**, mainly reflecting increased carry trade activities amid widening negative Hong Kong dollar-US dollar interest rate spreads (Chart 1). Despite Moody’s downgrade of Hong Kong’s credit rating in late May, the Hong Kong dollar exchange rate and interbank markets continued to function normally. At the end of the review period, the Hong Kong dollar closed at 7.8002 against the US dollar. During the review period, **the nominal effective exchange rate index of the Hong Kong dollar declined**, reflecting the weakening of the US dollar against most major currencies (Chart 2).

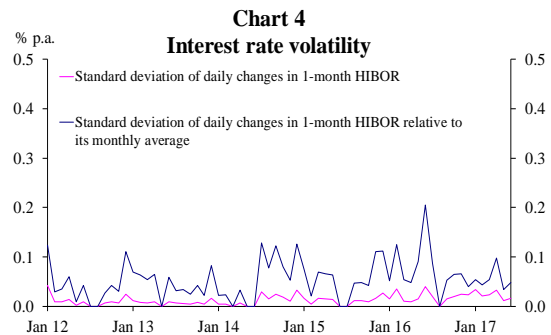


Interest rates

2. Despite continued rises in the US dollar interest rates, **the Hong Kong dollar interbank interest rates remained soft** during the review period in view of the ample liquidity in the Hong Kong banking system (Chart 3). The one-month, three-month and the 12-month HIBORs generally trended downwards and averaged 0.34%, 0.79% and 1.40% respectively during the review period, or 19, 17 and 11 basis points lower than their average levels in the preceding period.

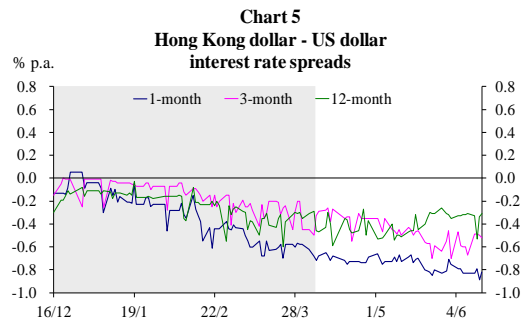


3. **Interest rate volatility**, measured by the standard deviation of daily changes in the one-month HIBOR, **remained low** at around 1.8 basis points during the review period (Chart 4). The standard deviation as a ratio of the average of one-month HIBOR also followed similar pattern¹.

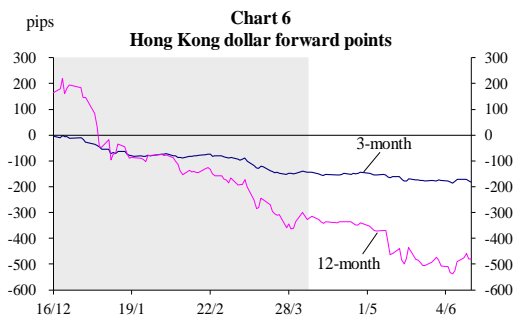


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

4. During the review period, as the US dollar interest rates increased but the Hong Kong dollar interest rates declined, **the Hong Kong dollar-US dollar interbank interest rate spreads generally moved lower in the negative territory** (Chart 5). The movement in the one-month tenor was more pronounced, with the spread widening by 14 bps at the end of the review period vis-à-vis that of the preceding period. At the end of the review period, the one-month, three-month and 12-month interest rate spreads closed at -82, -52 and -31 basis points respectively.



5. Broadly tracking the Hong Kong dollar-US dollar interbank interest rate spreads, **the Hong Kong dollar forward points moved into deeper discounts during the review period** (Chart 6). The three-month and 12-month Hong Kong dollar forward points declined by 38 pips and 152 pips respectively to close at -181 pips and -480 pips.



6. **The Hong Kong dollar yield curve moved downward** during the review period. The yield of the 2-year Exchange Fund Note decreased by 23 basis points to 0.64%, and the yield of the 10-year Hong Kong Government Bond declined by 31 basis points to 1.19% (Chart 7). The negative yield spreads of the Hong Kong Exchange Fund Paper and Hong Kong Government Bonds over their US counterparts widened at the short end (up to 3-year) as yields of the US Treasuries picked up. Negative spreads at the medium and long end (5-year and 10-year) also widened but to a lesser extent (Table 1).

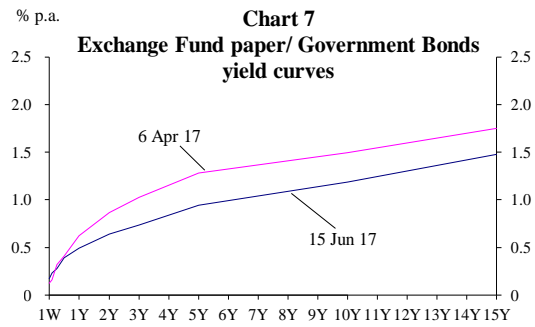
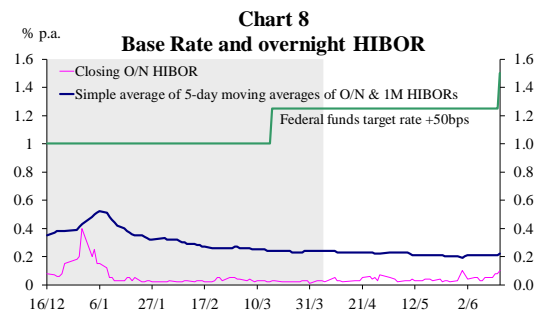


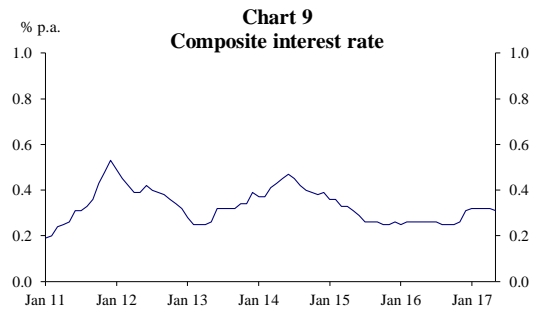
Table 1
Yield spreads of Exchange Fund paper and Hong Kong Government Bonds over US Treasuries (basis points)

	06 Apr 17	15 Jun 17
3-month EFB	-47	-74
12-month EFB	-43	-72
3-year HKGB	-42	-75
5-year HKGB	-59	-82
10-year HKGB	-84	-97

7. **The HKMA Base Rate increased from 1.25% to 1.50%**, following the upward adjustment in the target range for the US Federal Funds Rate from 0.75-1.00% to 1.00-1.25% on 14 June 2017 (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 increase in the target range for the US Federal Funds Rate in June, banks kept their Best Lending Rates unchanged.** The two Best Lending Rates stayed 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%². **The composite interest rate³, which indicates the average funding cost of retail banks, edged down to 0.31% in May** (Chart 9). On the lending side, the average mortgage interest rate for newly approved mortgage loans mostly stayed soft during the review period on the back of keen competition in the residential mortgage lending business. Nonetheless, market sources indicated that such rate generally inched higher towards the end of the review period amid an increase in the costs of mortgage business after the HKMA introduced the 8th-round of counter-cyclical macro-prudential measures on 19 May to strengthen banks' risk management and resilience.



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

³ 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.

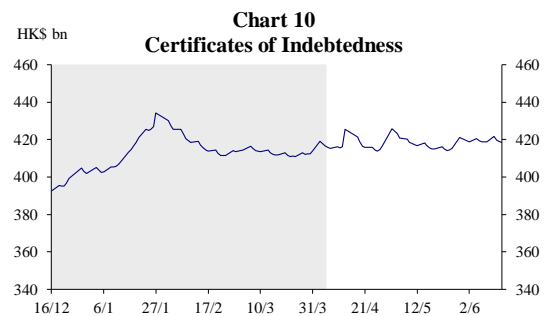
Monetary Base

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 (EFBNs), **increased to HK\$1,656.53 billion on 15 June from HK\$1,652.64 billion on 6 April** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	06 Apr 17	15 Jun 17
CIs	415.75	418.55
Government-issued Currency Notes and Coins in Circulation	12.31	12.27
Aggregate Balance	259.53	259.53
Outstanding EFBNs	965.06	966.20
Monetary Base	1652.64	1656.53

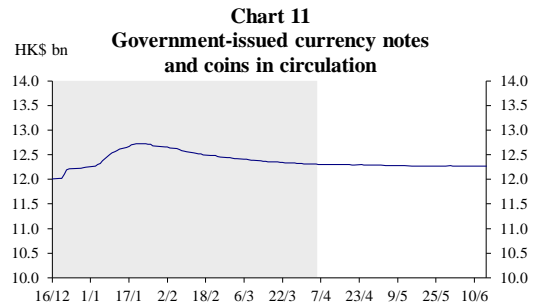
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$359 million to the HKMA in exchange for HK\$2.8 billion worth of CIs. As a result, **the outstanding CIs increased** to HK\$418.55 billion on 15 June from HK\$415.75 billion on 6 April (Chart 10).



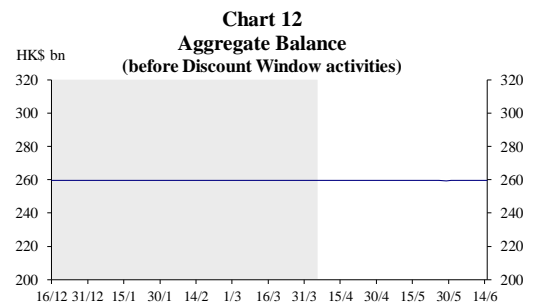
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation decreased slightly**. The total amount stood at HK\$12.27 billion on 15 June, down from HK\$12.31 billion on 6 April (Chart 11).



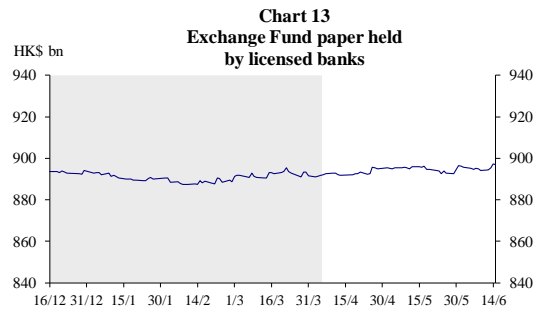
Aggregate Balance

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 the outstanding EFBNs edged up to HK\$966.20 billion from HK\$965.06 billion during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$896.97 billion (92.8% of total) from HK\$892.00 billion (92.4% of total) (Chart 13).**



14. During the review period, **interest payments on Exchange Fund paper amounted to HK\$818.48 million. A total of HK\$759.32 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 generally well received by the market (Table 3).

Table 3
Issuance of EFBNs
(6 Apr – 15 Jun 17)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	1.03
3-month EFB	10	0.63-2.10
6-month EFB	10	1.18-2.81
12-month EFB	3	2.86-4.71
2-year EFN	1	2.43

Discount Window activities

15. During the review period, **five banks borrowed a total of HK\$2.3 billion from the Discount Window**, compared with a total borrowing of HK\$530 million in the preceding period (Chart 14 and Table 4).

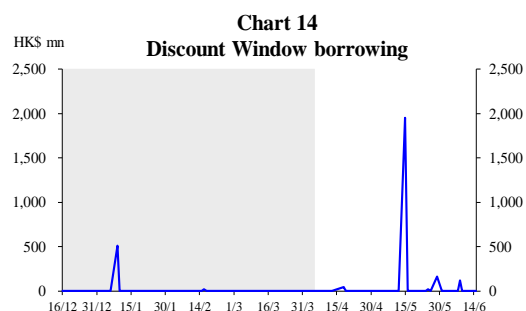


Table 4 Frequency of individual bank's access to the Discount Window (6 Apr – 15 Jun 17)	
Frequency of using Discount Window	No. of banks
1	5

Backing Portfolio

16. The Backing Assets increased to HK\$1,782.07 billion on 15 June, mainly reflecting an increase in CIs and valuation gains from investments. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio stood at 107.65% at the end of the review period, up from 107.04% at the end of the preceding 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.

