

**EXCHANGE FUND ADVISORY COMMITTEE**

**Currency Board Sub-Committee**

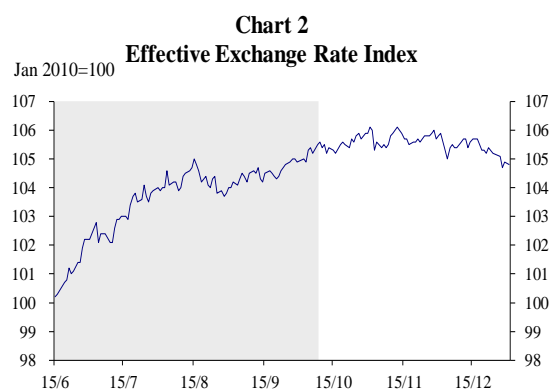
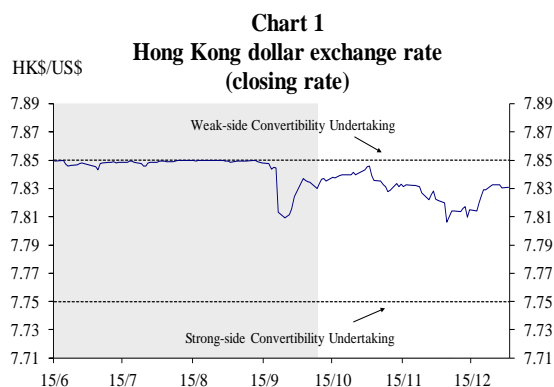
**Report on Currency Board Operations**

**(9 October – 31 December 2018)**

During the review period, the Hong Kong dollar (HKD) traded within a range of 7.8062 – 7.8459 against the US dollar (USD). The HKD firmed against the USD since November, due to unwinding of interest carry positions as liquidity conditions tightened amid year-end funding demand. Towards the year-end, the HKD eased, partly associated with repatriation of proceeds raised in initial public offerings (IPOs), note-issuance activities ahead of holidays, and possibly some re-building of interest carry positions. During the review period, the HKD interbank interest rates generally picked up, reflecting the expectation of US rate hikes and anticipated funding needs towards the year-end. The Aggregate Balance remained little changed, averaging around HK\$76.4 billion during the review period. The Monetary Base increased to HK\$1,632.87 billion at the end of the review period, mainly driven by an increase in the Certificates of Indebtedness (CIs). Throughout the review period, the Monetary Base remained fully backed by foreign reserves, and all changes in the Monetary Base were fully matched by corresponding changes in foreign reserves in accordance with the Currency Board principles.

## Hong Kong dollar exchange rate

1. During the review period, **the HKD traded within a range of 7.8062 – 7.8459 against the USD** (Chart 1).<sup>1</sup> The HKD eased gradually in October as quarter-end funding demand receded. Stepping into November, the HKD firmed against the USD, due to unwinding of interest carry positions as liquidity conditions tightened amid year-end funding demand. There were also some equity-related flows supporting the HKD. In the latter part of December, the HKD eased, partly associated with repatriation of proceeds raised in IPOs, note-issuance activities ahead of holidays (i.e. sell HKD/buy USD to purchase CIs), and possibly some re-building of interest carry positions amid widening of forward discount. Overall, the HKD continued to trade in a smooth and orderly manner.<sup>2</sup> During the review period, **the nominal effective exchange rate index of the HKD declined slightly**, mainly reflecting the modest depreciation of the HKD against Asian currencies including renminbi (Chart 2).

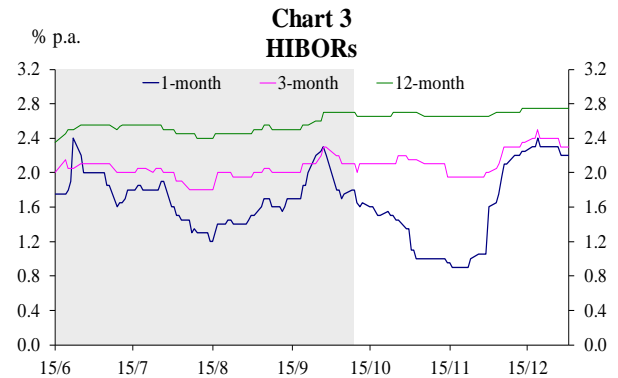


<sup>1</sup> In this report, daily time series charts also cover developments in the preceding review period (as shown in shaded region) for reference and comparison.

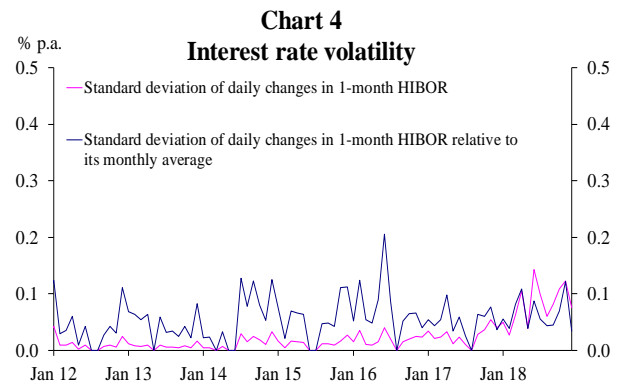
<sup>2</sup> Since the first triggering on 12 April, the weak-side CU has been triggered 27 times in 2018 (13 times in April, 6 times in May, and 8 times in August), accumulating outflows of HK\$103.5 billion.

## Interest rates

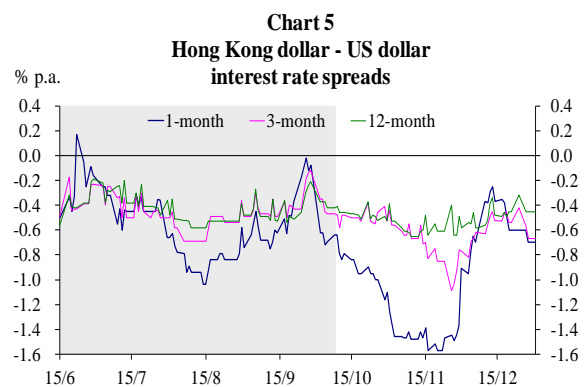
2. During the review period, the HKD interbank interest rates (i.e., HIBORs) generally picked up (Chart 3), mainly reflecting the expectation of US rate hikes and anticipated funding needs towards the year-end. While the long-dated HIBORs moved up at a gradual pace, **more fluctuations were seen in the short-dated HIBORs.** Reflecting the decrease in liquidity demand after the quarter-end and the reduction in IPO activities, the 1-month HIBOR eased in early October before picking up since late November. For the review period as a whole, the 1-month and 3-month HIBORs increased by 40 basis points to 2.20% and 20 basis points to 2.30%, respectively. The 12-month HIBOR moved up gradually by 5 basis points to 2.75%.



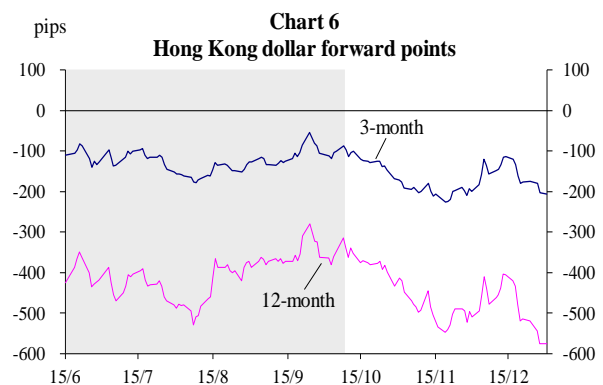
3. **Interest rate volatility**, measured by the standard deviation of daily changes in the 1-month HIBOR, fell to 10.1 basis points in the current review period from 11.2 basis points in the preceding review period (Chart 4). The standard deviation as a ratio of the average of 1-month HIBOR also showed similar movements<sup>3</sup>.



4. Broadly following the movements of HIBORs, **the negative short-dated HKD-USD interbank interest rate spreads saw greater fluctuations** (Chart 5). The 1-month, 3-month and 12-month spreads closed at -70, -67 and -45 basis points, respectively.

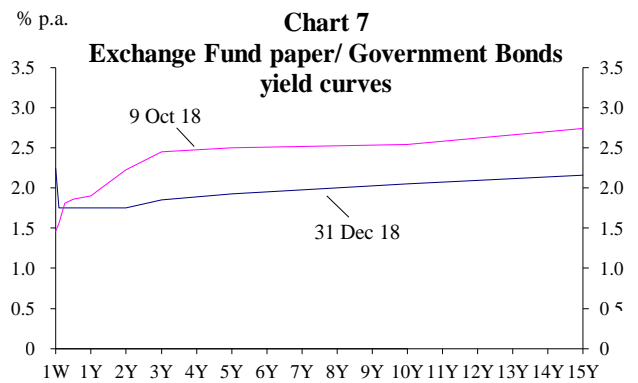


5. Generally tracking the HKD-USD interbank interest rate spreads, **the discounts of HKD forward points widened in November but narrowed moving into early December** (Chart 6). Towards the end of the review period, the 3-month and 12-month HKD forward points widened again to close at -207 pips and -575 pips respectively.



<sup>3</sup> The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

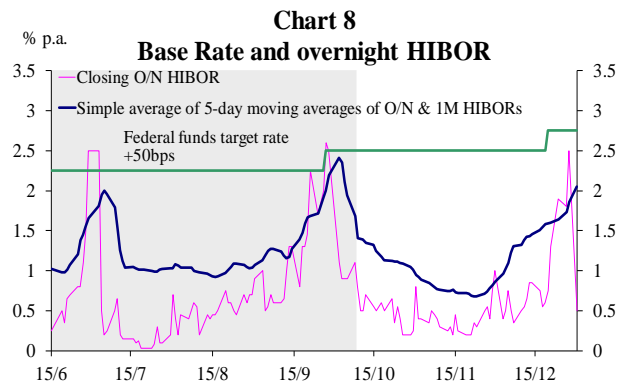
6. Largely following the movement of the USD yield curve, **the HKD yield curve shifted downwards and flattened** during the review period (Chart 7). The yield of the 1-year Exchange Fund Bill decreased by 15 basis points to 1.75% at the end of the review period, while the yields of the 3-year and 10-year Hong Kong Government Bonds dropped faster by 61 basis points to 1.85% and 49 basis points to 2.05% respectively. The negative HKD-USD yield spreads generally widened for tenors shorter than 10 years, reflecting larger declines in the HKD yields relative to USD yields (Table 1).



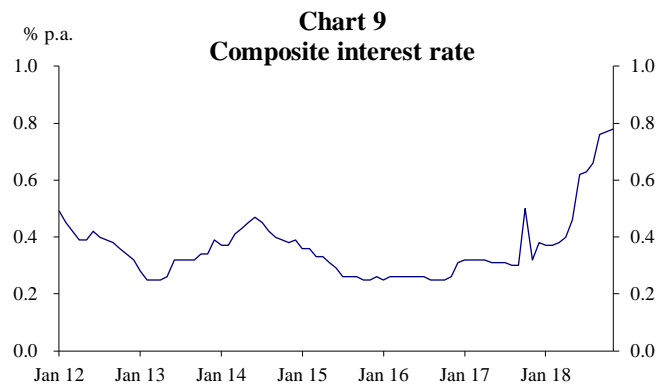
**Table 1**  
Yield spreads of Exchange Fund paper and Hong Kong Government Bonds over US Treasuries (basis points)

	09 Oct 18	31 Dec 18
3-month EFB	-44	-70
12-month EFB	-75	-88
3-year HKGB	-53	-61
5-year HKGB	-55	-58
10-year HKGB	-67	-64

7. **The HKMA Base Rate increased from 2.50% to 2.75%, following the upward adjustment in the target range for the US Federal Funds Rate** from 2.00%-2.25% to 2.25%-2.50% on 19 December (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 mid-December, banks did not adjust their Best Lending Rates during the review period.** At the end of the review period, there were three Best Lending Rates (5.125%, 5.375% and 5.500%) in the market. During the review period, the average 1-month HKD time deposit board rate offered by retail banks remained unchanged at 0.14%<sup>4</sup>. **The composite interest rate<sup>5</sup>**, which indicates the average funding cost of retail banks, **edged up** from 0.76% at the end of September to 0.78% at the end of November (Chart 9). On the lending side, the average interest rate for newly approved mortgage loans hovered at around 2.4%-2.5%.



<sup>4</sup> The figure refers to the average interest rate offered by major authorized institutions for 1-month time deposits of less than HK\$100,000.

<sup>5</sup> This is a weighted average interest rate of all HKD interest bearing liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and HKD 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.

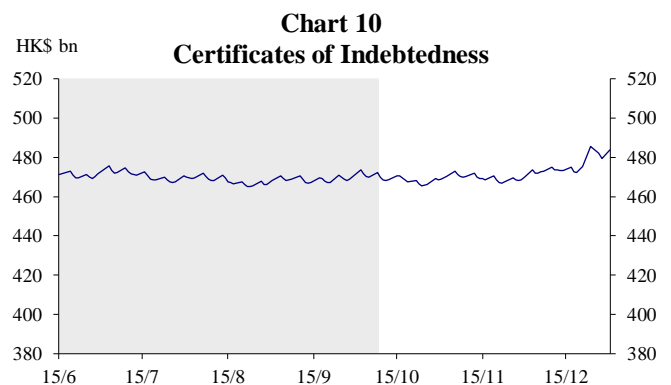
## Monetary Base

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\$1,632.87 billion on 31 December 2018 from HK\$1,613.99 billion on 9 October 2018** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	09 Oct 18	31 Dec 18
CIs	469.91	483.85
Government-issued Currency Notes and Coins in Circulation	12.75	12.85
Aggregate Balance	76.58	76.40
Outstanding EFBNs	1054.76	1059.78
<b>Monetary Base</b>	<b>1613.99</b>	<b>1632.87</b>

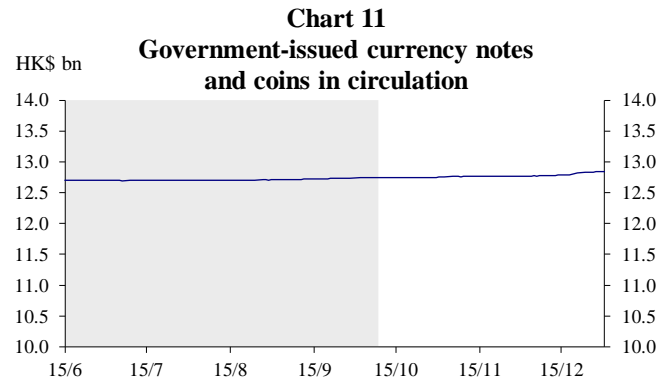
### *Certificates of Indebtedness*

10. During the review period, note-issuing banks submitted a net amount of US\$1.79 billion to the HKMA in exchange for HK\$13.94 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$483.85 billion on 31 December 2018 from HK\$469.91 billion on 9 October 2018** (Chart 10), mainly reflecting increased currency demand ahead of Christmas and New Year holidays.



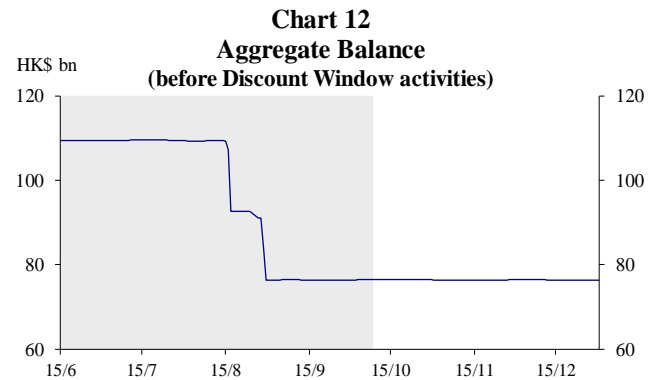
*Government-issued currency notes and coins in circulation*

11. During the review period, the amount of **government-issued currency notes and coins in circulation edged up** to HK\$12.85 billion on 31 December 2018 from HK\$12.75 billion on 9 October 2018 (Chart 11).



*Aggregate Balance*

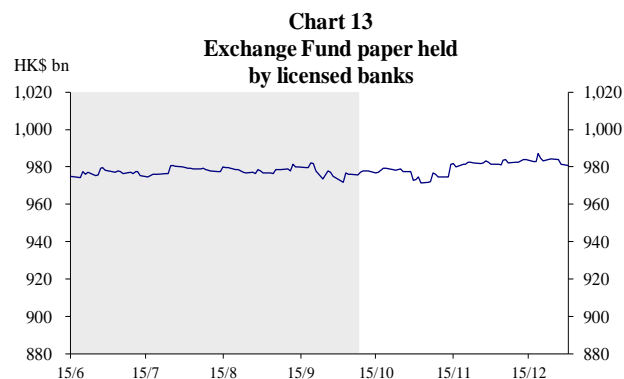
12. During the review period, the Convertibility Undertakings were not triggered and **the Aggregate Balance (before Discount Window activities) stayed little changed**, averaging around HK\$76.4 billion (Chart 12).





*Outstanding Exchange Fund Bills and Notes*

13. The market value of the outstanding EFBNs increased to HK\$1,059.78 billion from HK\$1,054.76 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) edged up to HK\$980.74 billion (92.5% of total) from HK\$977.10 billion (92.6% of total) (Chart 13).



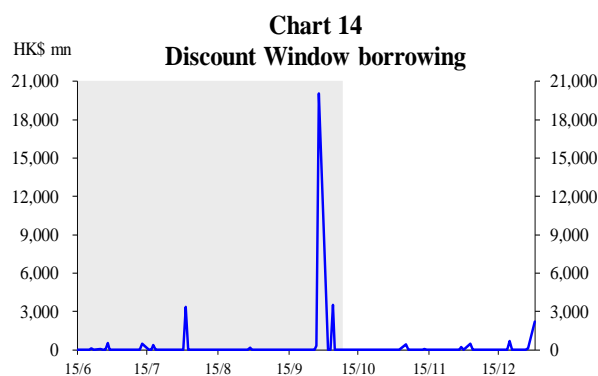
14. During the review period, interest payments on Exchange Fund paper amounted to HK\$4,240.52 million. A total of HK\$4,388.53 million (in market value) of Exchange Fund paper was issued to absorb these interest payments. The Exchange Fund paper issued during the review period was generally well received by the market (Table 3).

**Table 3**  
Issuance of Exchange Fund Bills and Notes  
(9 Oct 18 – 31 Dec 18)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	3.13
3-month EFB	13	0.81-2.27
6-month EFB	13	0.92-4.25
12-month EFB	3	0.73-3.37
2-year EFN	1	4.28

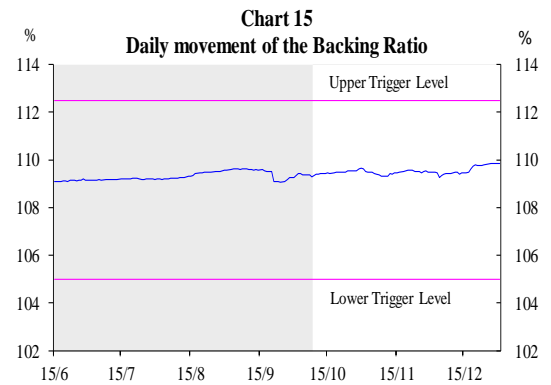
**Discount Window activities**

15. During the review period, a total of HK\$4.2 billion was borrowed from the Discount Window, compared with HK\$29.1 billion in the preceding period from 15 June to 8 October (Chart 14).



### **Backing Portfolio**

16. The Backing Assets increased to HK\$1,793.45 billion on 31 December 2018, mainly reflecting an increase in the CIs and valuation gains from investments. **The Backing Ratio edged up to 109.85% from 109.35% 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 HKD exchange rate.



**Hong Kong Monetary Authority**  
**26 February 2019**