

**EXCHANGE FUND ADVISORY COMMITTEE**

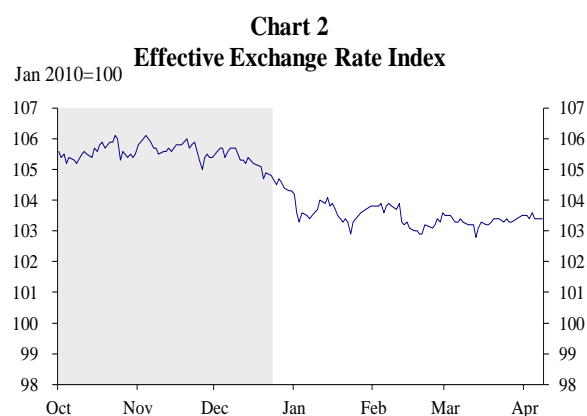
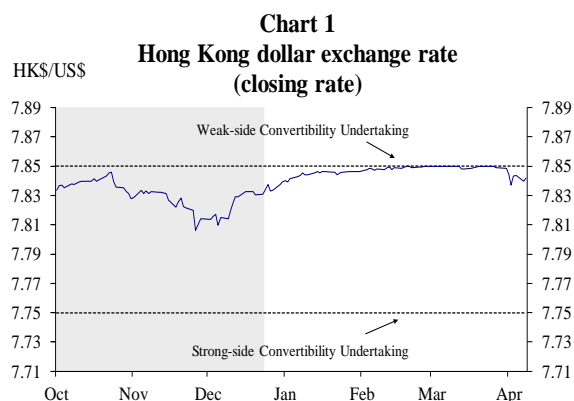
**Currency Board Sub-Committee**

**Report on Currency Board Operations**  
**(1 January – 16 April 2019)**

During the review period, the Hong Kong dollar (HKD) traded within a range of 7.8331 – 7.8500 against the US dollar (USD). Mainly because of the drop in banks' funding demand, the interest rate gaps between the HKD and USD widened after the year-end. The widening of interest rate gaps attracted carry trade activities to sell HKD for USD, pushing the HKD towards the weak-side Convertibility Undertaking (CU) as a result. The weak-side CU was eventually triggered 8 times in March. Reflecting the decrease in liquidity demand after the year-end, the HKD interbank interest rates generally declined, with short-dated interbank rates picking up after the triggering of the weak-side CU in March. Stepping into April, the HKD strengthened due to the unwinding of carry trades as short-dated rates tightened. Overall, the HKD exchange and interbank markets continued to trade in a smooth and orderly manner. As a result of the triggering of the weak-side CU, the Aggregate Balance and the Monetary Base declined to HK\$54.3 billion and HK\$1,623.6 billion at the end of the review period respectively. 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 of January 1 to April 16, the **HKD traded within a range of 7.8331 – 7.8500 against the USD** (Chart 1).<sup>1</sup> The HKD eased gradually since the beginning of 2019, mainly because of the drop in banks' funding demand and large gaps between Hong Kong and US interest rates. The widening of interest rate gaps occurred since year-end 2018 and attracted carry trade activities to sell HKD for USD, pushing the HKD towards the weak-side CU as a result. The weak-side CU was eventually triggered 8 times in March, with accumulated outflows of HK\$22.1 billion.<sup>2</sup> Stepping into April, the HKD strengthened due to the unwinding of carry trades as short-dated rates tightened. Despite this, the HKD continued to trade in a smooth and orderly manner, closing at 7.8421 against the USD on April 16. During the review period, **the nominal effective exchange rate index of the HKD declined slightly**, mainly reflecting the modest depreciation of the HKD against most major currencies (Chart 2).

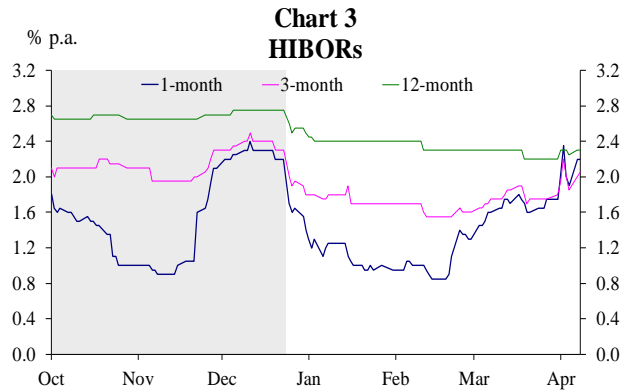


<sup>1</sup> In this report, daily time series charts also cover developments in the preceding review period (as shown in shaded region) for reference and comparison.

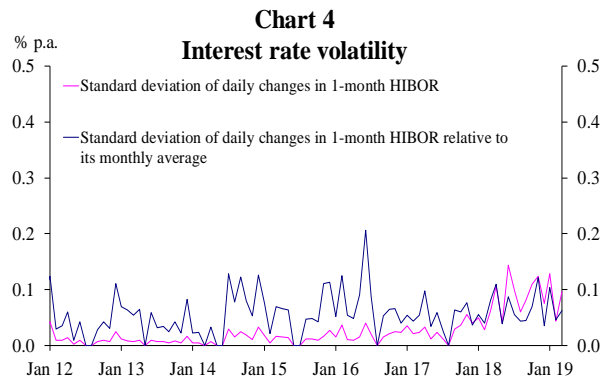
<sup>2</sup> Since the first triggering on 12 April 2018, the weak-side CU has been triggered 27 times in 2018 and 8 times in 2019 up to the end of the review period, accumulating outflows of HK\$125.6 billion.

## Interest rates

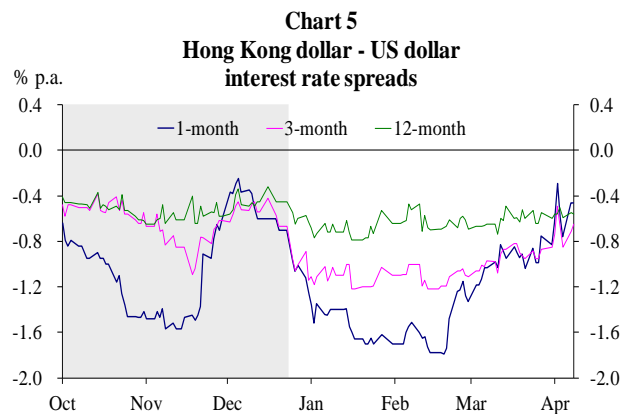
2. **HKD interbank interest rates (i.e., HIBORs) generally softened in the first two months of 2019, before tightening in late March and early April.** Short-dated HIBORs picked up considerably in the latter part of the review period, partly underpinned by the tightening of the interbank liquidity after the triggering of the weak-side CU and partly due to quarter-end funding demand (Chart 3). For the review period as a whole, the 1-month and 3-month HIBORs increased by 50 basis points to 2.20% and 5 basis points to 2.05% respectively. The 12-month HIBOR moved down by 30 basis points to 2.30%.



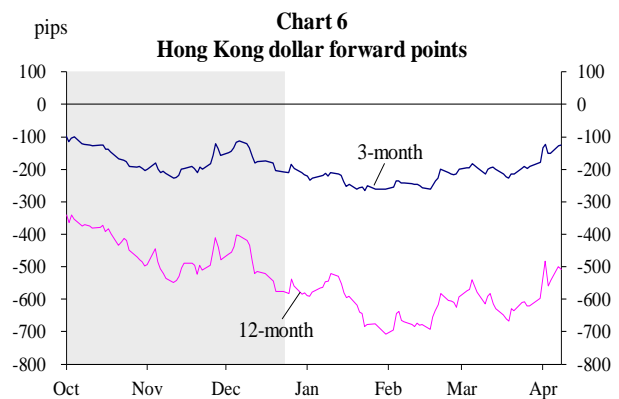
3. **Interest rate volatility**, measured by the standard deviation of daily changes in the 1-month HIBOR, **increased** to 12.4 basis points in the current review period from 10.1 basis points in the preceding review period (Chart 4). The standard deviation as a ratio of the average of 1-month HIBOR also showed similar movements<sup>3</sup>.



4. **The HKD-USD interbank interest rate spreads generally widened in the first two months of 2019 before narrowing in late March and early April**, with the short-dated HKD-USD interbank interest rate spreads showing larger fluctuations along the movements of HIBORs (Chart 5). At the end of review period, the 1-month, 3-month and 12-month spreads closed at -46, -65 and -56 basis points, respectively.



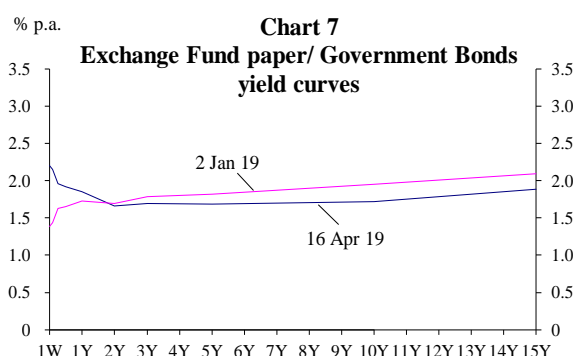
5. Broadly tracking the HKD-USD interbank interest rate spreads, **the discounts of HKD forward points widened in the first two months of 2019 but narrowed in late March and early April**, with the 3-month and 12-month HKD forward points



<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.

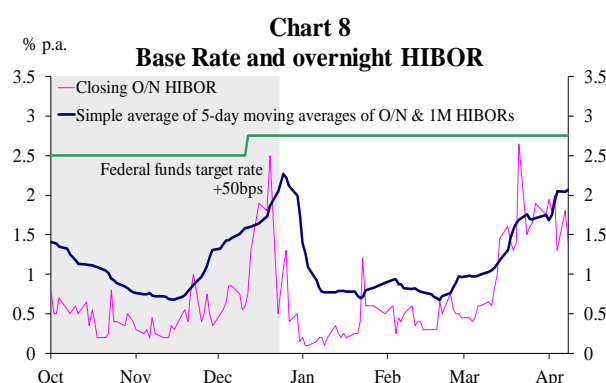
closing at -126 pips and -508 pips respectively (Chart 6).

6. Generally following the movement of the USD yield curve, **the HKD yield curve shifted downwards and flattened in the longer-term segment** during the review period (Chart 7). The yield of the 1-year Exchange Fund Bill increased by 12 basis points to 1.85% at the end of the review period, while the yields of the 3-year and 10-year Hong Kong Government Bonds witnessed declines of 9 basis points to 1.69% and 23 basis points to 1.72% respectively. The negative HKD-USD yield spreads generally widened in the longer-term segment, reflecting larger decreases in the HKD yields relative to USD yields (Table 1).

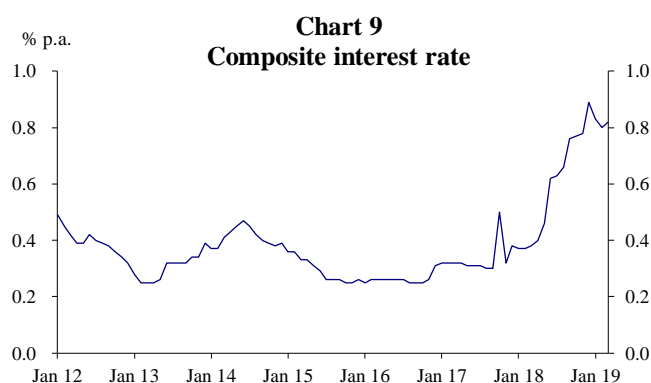


	02 Jan 19	16 Apr 19
3-month EFB	-79	-47
12-month EFB	-87	-60
3-year HKGB	-69	-69
5-year HKGB	-67	-73
10-year HKGB	-71	-88

7. At the January and March meetings, the Federal Open Market Committee (FOMC) decided to keep the Federal Funds Target Rate (FFTR) at 2.25 – 2.50%. As such, **the HKMA Base Rate stayed unchanged at 2.75% (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. **Banks kept their Best Lending Rates unchanged during the review period.** At the end of the review period, there remained 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, **decreased** slightly from 0.89% at the end of December to 0.82% at the end of March (Chart 9). On the lending side, the average interest rate for newly approved mortgage loans dropped to around 2.2% in February along with the decline in 1-month HIBOR.



<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.

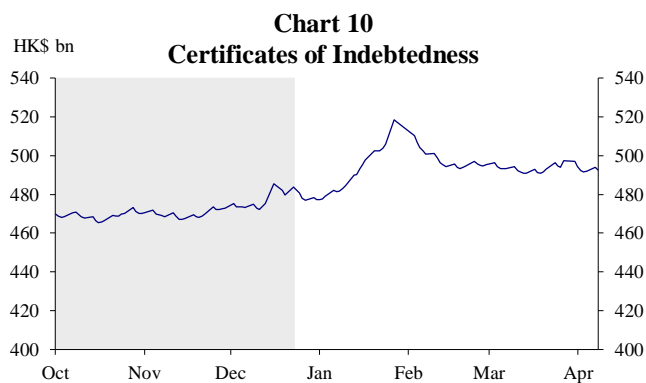
## Monetary Base

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), **decreased to HK\$1,623.65 billion on 16 April 2019 from HK\$1,629.94 billion on 2 January 2019** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	02 Jan 19	16 Apr 19
CIs	480.56	492.49
Government-issued Currency Notes and Coins in Circulation	12.84	13.01
Aggregate Balance	76.51	54.34
Outstanding EFBNs	1060.03	1063.81
<b>Monetary Base</b>	<b>1629.94</b>	<b>1623.65</b>

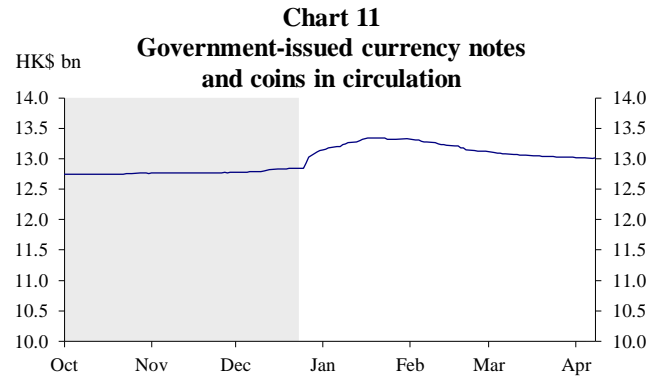
### *Certificates of Indebtedness*

10. During the review period, note-issuing banks submitted a net amount of US\$1.53 billion to the HKMA in exchange for HK\$11.93 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$492.49 billion on 16 April 2019 from HK\$480.56 billion on 2 January 2019** (Chart 10), mainly reflecting a net increase in currency demand during the review period that includes the Chinese New Year holidays.



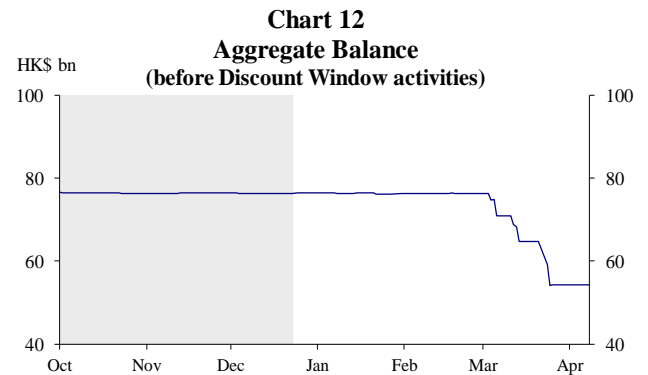
*Government-issued currency notes and coins in circulation*

11. During the review period, the amount of **government-issued currency notes and coins in circulation** increased to HK\$13.01 billion on 16 April 2019 from HK\$12.84 billion on 2 January 2019 (Chart 11).



*Aggregate Balance*

12. **The Aggregate Balance declined from HK\$76.51 billion to HK\$54.34 billion during the review period** (Chart 12) owing to the triggering of the weak-side CU in March (Table 3). These foreign exchange operations were consistent with Currency Board principles, as the decreases in the Monetary Base were matched by equivalent decreases in US dollar reserves.

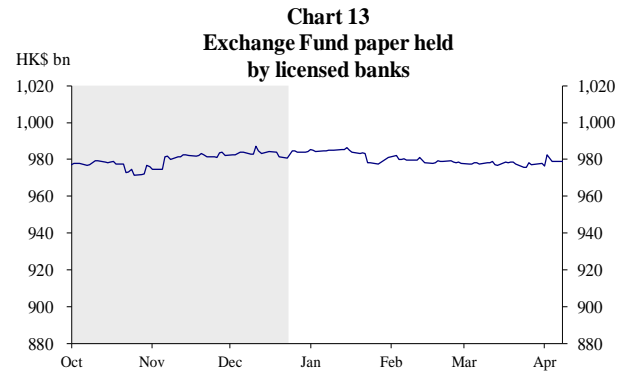


Trade Date	Net purchase of HK\$ (HK\$mn)
8-Mar-19	1,507
12-Mar-19	3,925
18-Mar-19	2,010
19-Mar-19	604
20-Mar-19	3,540
28-Mar-19	5,574
29-Mar-19	4,969
<b>Total</b>	<b>22,129</b>



*Outstanding Exchange Fund Bills and Notes*

13. The market value of the outstanding EFBNs increased to HK\$1,063.81 billion from HK\$1,060.03 billion during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) edged down to HK\$978.97 billion (92.0% of total) from HK\$984.63 billion (92.9% of total) (Chart 13).**

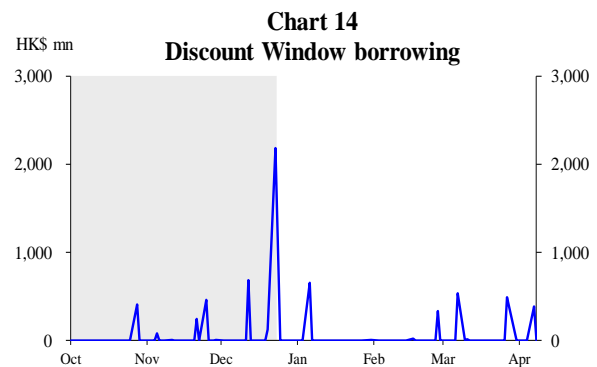


14. During the review period, **interest payments on Exchange Fund paper amounted to HK\$4,408.78 million. A total of HK\$4,316.63 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance at the end of the review period, expected to be absorbed in the next. The Exchange Fund paper issued during the review period was generally well received by the market (Table 4).

	No. of issues launched	Over-subscription ratio
1-month EFB	1	5.35
3-month EFB	15	0.85-1.82
6-month EFB	15	0.96-4.23
12-month EFB	4	3.69-18.68
2-year EFN	1	2.93

### **Discount Window activities**

15. During the review period, a total of HK\$2.4 billion was borrowed from the Discount Window, compared with HK\$4.2 billion in the preceding period from 9 October to 31 December 2018 (Chart 14).



### **Backing Portfolio**

16. The Backing Assets increased slightly to HK\$1,798.63 billion on 16 April 2019, mainly reflecting an increase in the CIs and valuation gains from investments more than offsetting the sale of USD backing assets under the weak-side CU. **The Backing Ratio increased to 110.81% from 109.98% 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.

