

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

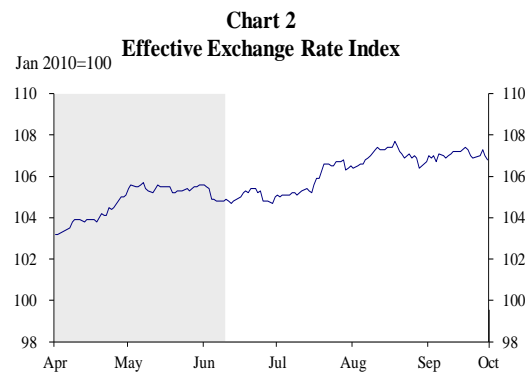
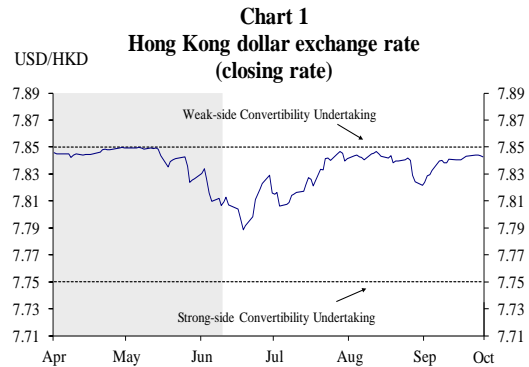
Report on Currency Board Operations

Review period: 26 June – 11 October 2019

During the review period, the Hong Kong dollar (HKD) traded in the range of 7.7886 – 7.8465 against the US dollar (USD). The HKD strengthened in late June and early July, mainly driven by the funding demands arising from sizable initial public offering (IPO) activities, dividend payouts by listed companies in Hong Kong and half-year closing. The HKD eased gradually after the half-year end as these factors faded, before strengthening somewhat again in mid-September amid tightening of liquidity. Overall, the HKD exchange and interbank markets continued to trade in a smooth and orderly manner. During the review period, 3-month HIBOR was relatively stable, while shorter-dated HIBORs broadly declined. At the end of the review period, the Aggregate Balance was virtually unchanged at around HK\$54.4 billion, while the Monetary Base increased to HK\$1,653.79 billion, in part reflecting more Certificates of Indebtedness. 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

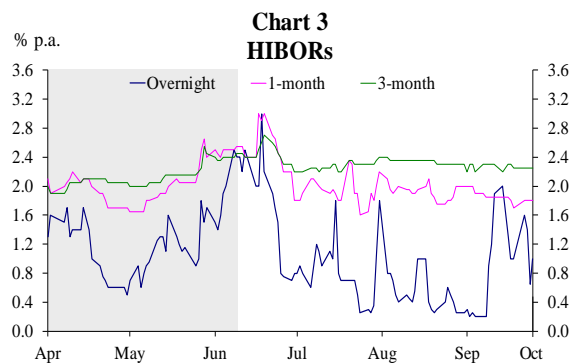
1. During the review period of June 26 to October 11, the **HKD traded in the range of 7.7886 – 7.8465** (closing rate) **against the USD** (Chart 1).¹ The HKD strengthened in late June and early July, mainly driven by the funding demands arising from sizable IPO activities, dividend payouts by listed companies in Hong Kong and half-year closing. Thereafter, the HKD eased gradually as these factors faded. In mid-September, the HKD strengthened somewhat amid the news of the revival of a large IPO as well as the unwinding of short HKD positions. Overall, the HKD traded in a smooth and orderly manner during the review period, closing at 7.8426 against the USD on October 11. **The nominal effective exchange rate index of the HKD picked up**, reflecting the appreciation of the US dollar against most major currencies (Chart 2).



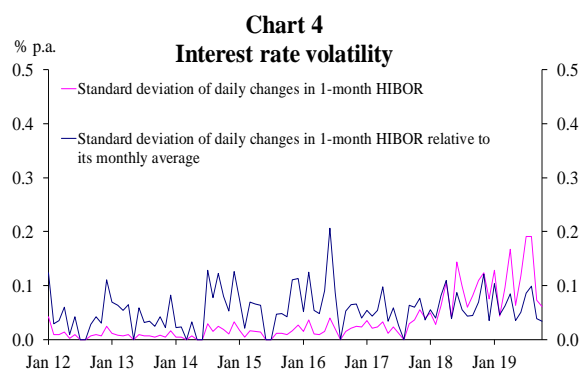
¹ In this report, daily time series charts also cover developments in the preceding review period (as shown in shaded region) for reference and comparison.

Interest rates

2. During the review period, **3-month HKD interbank interest rate (i.e. HIBOR) was relatively stable, while the shorter-dated HIBORs declined** (Chart 3). After picking up briefly in late June due to anticipated funding needs for the half-year end and possible large IPOs in the second half, the short-dated HIBORs eased since early July as these funding demands receded. Towards the latter part of the review period, HIBORs moved within a narrower range. For the review period as a whole, the overnight, 1-month and 3-month HIBORs declined by 140, 75 and 20 basis points to 1.00%, 1.80% and 2.25% respectively.

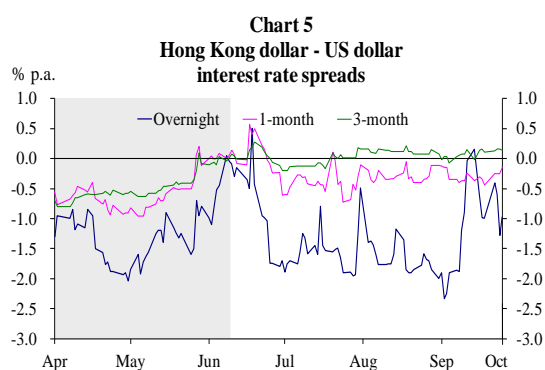


3. **Interest rate volatility**, measured by the standard deviation of daily changes in the 1-month HIBOR, **rose** to 15.1 basis points in the current review period from 9.7 basis points in the preceding review period (Chart 4). The standard deviation as a ratio of the average of 1-month HIBOR also showed similar movements.²

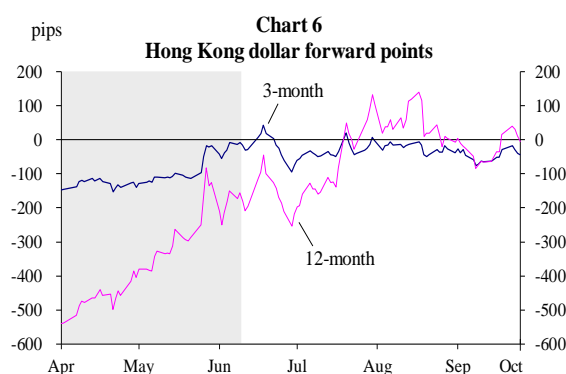


² The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

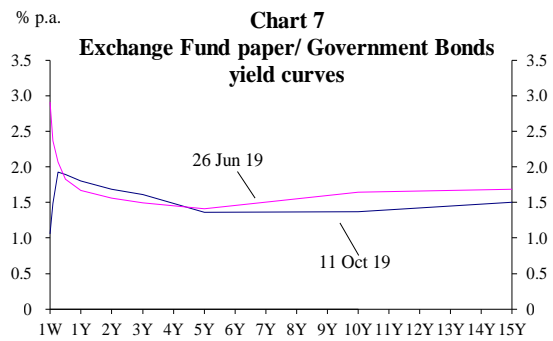
4. As short-dated HIBORs declined more than their USD counterparts (i.e. LIBORs) during the review period, **the overnight and 1-month HKD-USD interbank interest rate spreads turned more negative. The longer-term spread hovered around zero during the review period (Chart 5).** At the end of the review period, the overnight, 1-month and 3-month spreads closed at -97, -15 and 14 basis points, respectively.



5. **During the review period, the 3-month HKD forward point hovered close to zero, while the 12-month HKD forward point turned to premium particularly in the middle of the review period.** The 3-month and 12-month HKD forward points closed at -43 pips and -5 pips respectively (Chart 6).

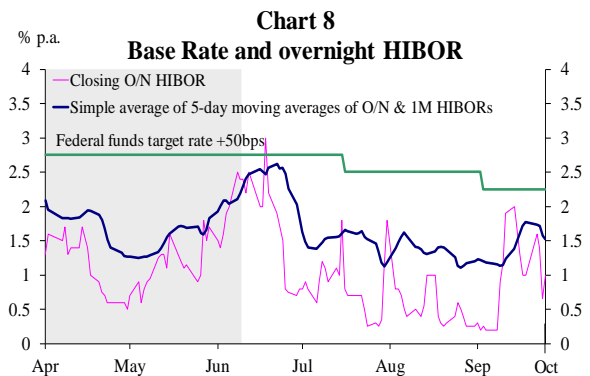


6. During the review period, the HKD yield curve shifted slightly downwards and flattened in the long end (Chart 7). The yield of the 10-year Hong Kong Government Bond witnessed a decrease of 28 basis points to 1.37% at the end of the review period. On the other hand, the yields of the 1-year Exchange Fund Bill and the 3-year Hong Kong Government Bond edged up by 13 basis points to 1.80% and 11 basis points to 1.61% respectively. The negative HKD-USD yield spreads turned positive for tenors shorter than 5 years and narrowed for longer tenors, as HKD yields increased, or declined less than USD yields (Table 1).

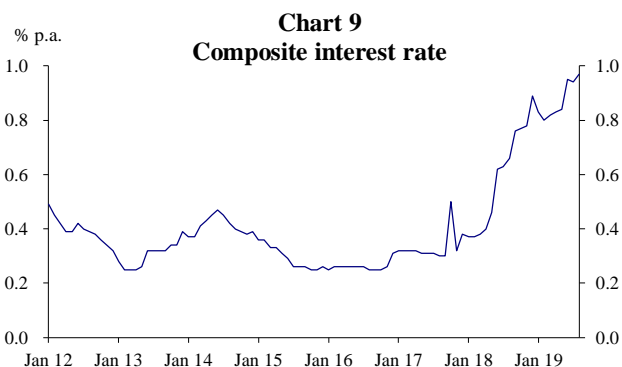


	26 Jun 19	11 Oct 19
3-month EFB	-8	25
12-month EFB	-29	13
3-year HKGB	-24	1
5-year HKGB	-39	-23
10-year HKGB	-41	-39

7. The HKMA Base Rate decreased from 2.75% to 2.25% following the two 25 basis point cuts to the target range for the US Federal Funds Rate on 31 July and 18 September (US time) respectively (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. During the review period, **banks kept their Best Lending Rates unchanged.** At the end of the review period, there remained three Best Lending Rates (5.125%, 5.375% and 5.500%) in the market. The average interest rate for newly approved mortgage loans picked up from around 2.4% in June to around 2.5% in August, mainly reflecting the increase in prime-based cap for HIBOR-based mortgages. Stepping into September, major banks further raised the levels of the prime-based caps for their new mortgage lending. During the review period, the average 1-month HKD time deposit board rate offered by retail banks remained unchanged at 0.14%.³ **The composite interest rate**⁴, which indicates the average funding cost of retail banks, **edged up** from 0.95% at the end of June to 0.97% at the end of August (Chart 9).



³ The figure refers to the average interest rate offered by major authorized institutions for 1-month time deposits of less than HK\$100,000.

⁴ This is a weighted average interest rate of all HKD interest-rate-sensitive liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and all other liabilities that do not involve any formal payment of interest but the values of which are sensitive to interest rate movements (such as 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.

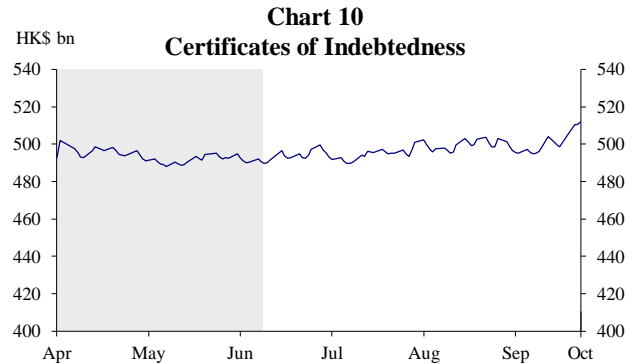
Monetary Base

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\$1,653.79 billion on 11 October 2019 from HK\$1,624.79 billion on 26 June 2019** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	26 Jun 19	11 Oct 19
CIs	489.72	511.95
Government-issued Currency Notes and Coins in Circulation	12.98	12.98
Aggregate Balance	54.27	54.42
Outstanding EFBNs	1067.83	1,074.44
Monetary Base	1624.79	1,653.79

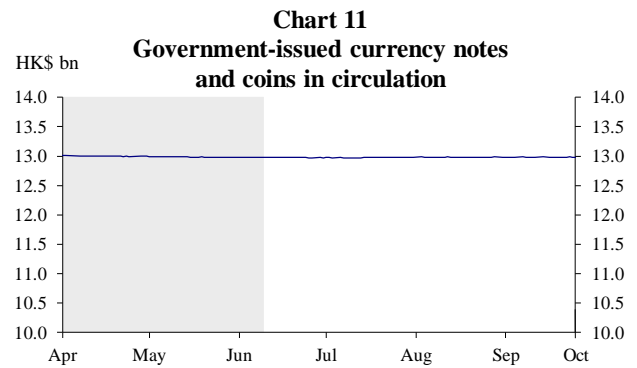
Certificates of Indebtedness

10. Reflecting a net increase in currency demand during the review period, note-issuing banks submitted a net amount of US\$2,850 million to the HKMA in exchange for HK\$22.23 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$511.95 billion on 11 October 2019 from HK\$489.72 billion on 26 June 2019** (Chart 10), representing a 4.5% increase.



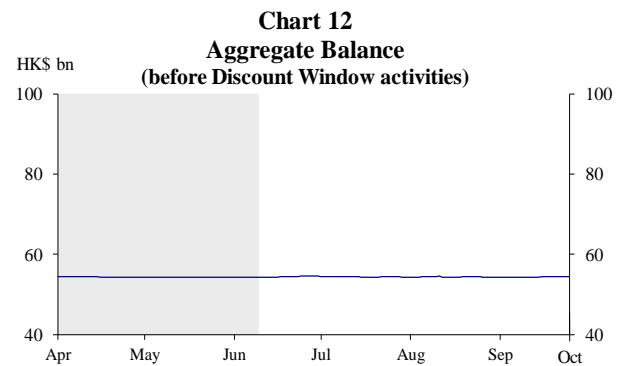
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation** stayed **virtually unchanged** at HK\$12.98 billion on 11 October 2019 (Chart 11).



Aggregate Balance

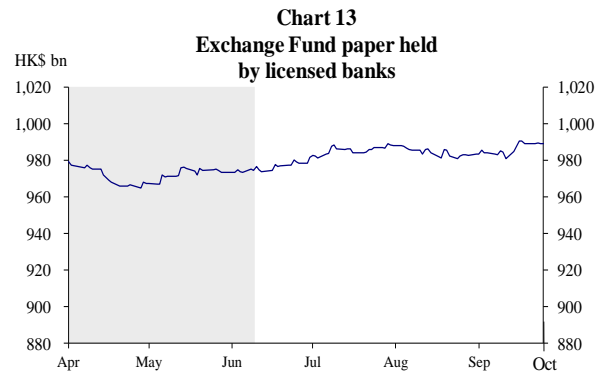
12. During the review period, the Convertibility Undertakings were not triggered and **the Aggregate Balance** (before Discount Window activities) **was little changed**, averaging around HK\$54.4 billion (Chart 12). The Convertibility Undertaking was last triggered in March 2019, on the weak side.⁵



⁵ Since the first triggering on 12 April 2018, the weak-side Convertibility Undertaking has been triggered 27 times in 2018 and 8 times in 2019 up to the end of the review period, with total outflows amounting to HK\$125.6 billion.

Outstanding Exchange Fund Bills and Notes

13. **The market value of the outstanding EFBNs increased to HK\$1,074.44 billion from HK\$1,067.83 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) rose to HK\$989.31 billion (92.1% of total) from HK\$976.56 billion (91.5% of total) (Chart 13).**



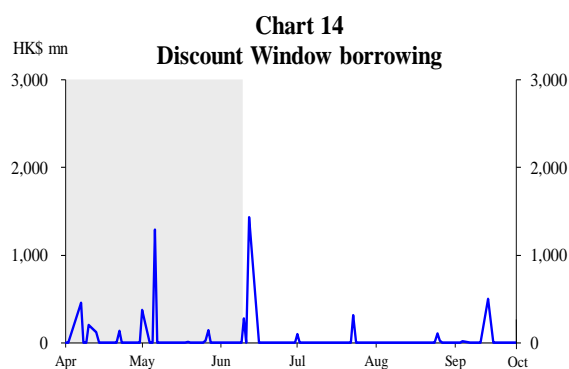
14. **During the review period, interest payments on Exchange Fund paper amounted to HK\$6,746.73 million. A total of HK\$6,606.98 million (in market value) of Exchange Fund paper was issued to absorb these interest payments. The remaining amount was carried forward in the Aggregate Balance at the end of the review period. 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
(26 Jun 19 – 11 Oct 19)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	3
3-month EFB	15	0.79 - 1.91
6-month EFB	15	1.16 - 3.54
12-month EFB	5	2.23 - 5.16
2-year EFN	1	3.79

Discount Window activities

15. During the review period, **a total of HK\$2.8 billion was borrowed from the Discount Window**, compared with HK\$2.7 billion in the preceding period from 17 April to 25 June 2019 (Chart 14).



Backing Portfolio

16. The Backing Assets increased to HK\$1,849.89 billion on 11 October 2019, mainly reflecting valuation gains from investments and the increase in CIs. **The Backing Ratio increased to 111.91% from 111.19% 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.

