

**EXCHANGE FUND ADVISORY COMMITTEE**

**Currency Board Sub-Committee**

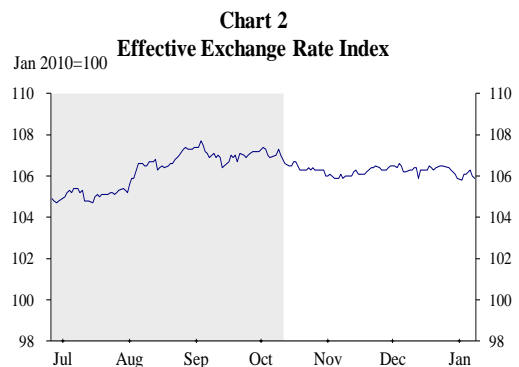
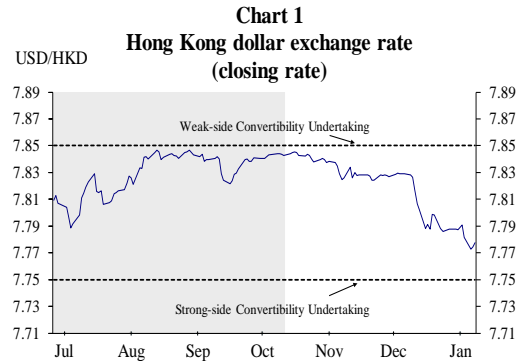
**Report on Currency Board Operations**

**Review period: 12 October 2019 – 8 January 2020**

During the review period, the Hong Kong dollar (HKD) traded in the range of 7.7726 – 7.8452 against the US dollar (USD). Underpinned by the HKD demand for equity initial public offerings (IPOs), the HKD strengthened gradually since mid-October. Stepping into December, the strengthening of HKD gained further momentum, with HKD staying in the strong side of the Convertibility Zone towards the end of the review period. The strong demand for HKD was due partly to equity-related demand, and partly to unwinding of short HKD positions with tightened liquidity near the year-end. Overall, the HKD exchange and interbank markets continued to trade in a smooth and orderly manner. As liquidity tightened, the short-dated HKD interbank interest rates (i.e. HIBORs) broadly picked up during the review period, with overnight and 1-month HIBORs seeing larger fluctuations. At the end of the review period, the Aggregate Balance remained little changed at around HK\$54.4 billion, while the Monetary Base increased slightly to HK\$1,664.13 billion. 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

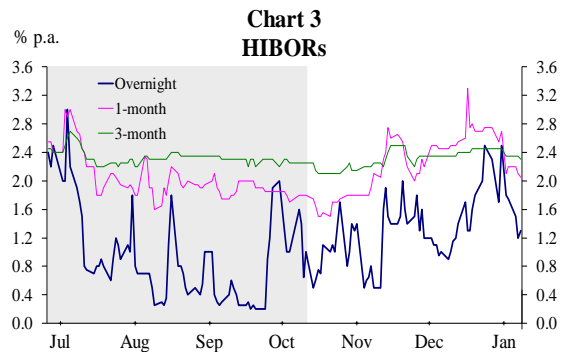
1. During the review period of 12 October 2019 to 8 January 2020, the HKD traded in the range of 7.7726 – 7.8452 (closing rate) against the USD (Chart 1).<sup>1</sup> Underpinned by the HKD demand for equity IPOs, the HKD started strengthening gradually since mid-October. Stepping into December, the strengthening of HKD gained further momentum, with HKD staying in the strong side of the Convertibility Zone towards the end of the review period. The strong demand for HKD was partly equity-related, and partly due to unwinding of short HKD positions with tightened liquidity near the year-end. Overall, the HKD traded in a smooth and orderly manner during the review period, closing at 7.7777 against the USD on 8 January 2020. **The nominal effective exchange rate index of the HKD edged down**, reflecting the depreciation of the US dollar against most major currencies (Chart 2).



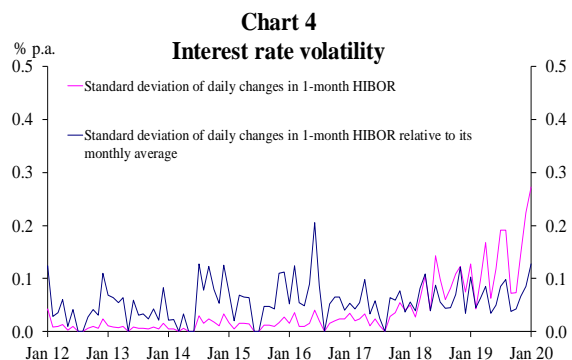
<sup>1</sup> In this report, daily time series charts also cover developments in the preceding review period (as shown in shaded region) for reference and comparison.

## Interest rates

2. During the review period, **the overnight, 1-month and 3-month HKD interbank interest rates (i.e., HIBORs) broadly picked up** (Chart 3). In particular, the overnight and 1-month HIBORs witnessed larger fluctuations in November and December, mainly driven by liquidity demand for sizeable IPO subscriptions and anticipated funding needs towards the year-end. For the review period as a whole, the overnight, 1-month and 3-month HIBORs increased by 80, 30 and 5 basis points to 1.30%, 2.05% and 2.30% respectively.

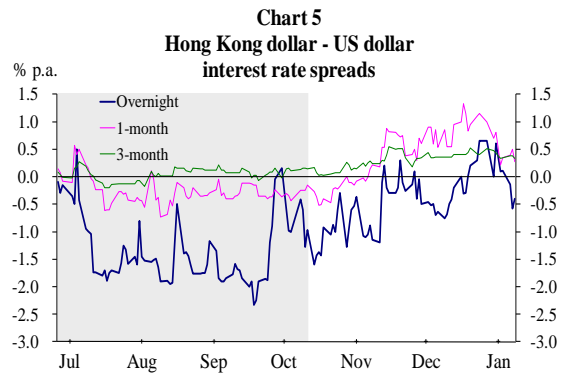


3. **Interest rate volatility**, measured by the standard deviation of daily changes in the 1-month HIBOR, **increased** to 17.8 basis points in the current review period from 15.1 basis points in the preceding review period (Chart 4). The standard deviation as a ratio of the average of 1-month HIBOR also showed similar movements.<sup>2</sup>

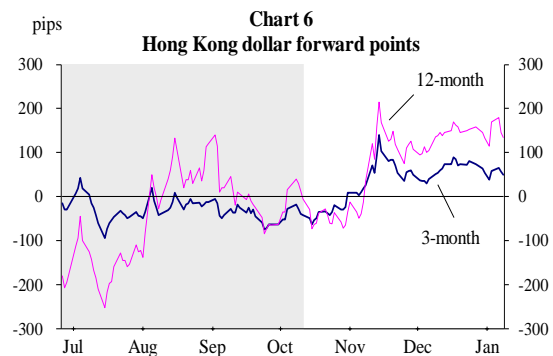


<sup>2</sup> The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

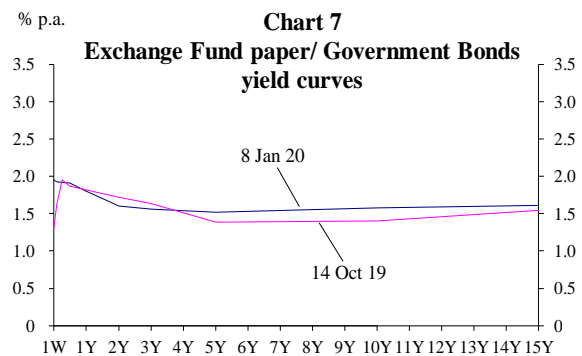
4. **The short-dated HKD-USD interbank interest rate spreads generally turned to the positive territory (Chart 5).** This reflected the declines in the USD interbank interest rates (i.e. LIBORs) following the decrease in the target range for the US Federal Funds Rate, as well as an increase in HIBORs amid a tightening liquidity near the year-end. Meanwhile, the fluctuations of the interest rate spreads largely mirrored the movements of HIBORs. At the end of review period, the overnight, 1-month and 3-month spreads closed at -40, 28 and 33 basis points respectively.



5. Broadly tracking the HKD-USD interbank interest rate spreads, **the 3-month and 12-month HKD forward points turned to premiums since November,** closing at 50 pips and 134 pips respectively at the end of review period (Chart 6).



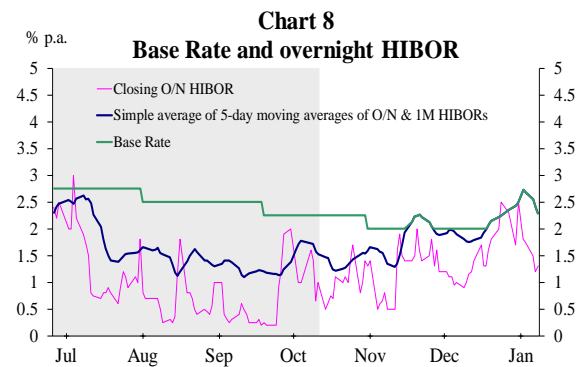
6. **During the review period, the HKD yield curve shifted upwards at the long end, largely tracking movements in their USD counterparts (Chart 7).** The yield of the 10-year Hong Kong Government Bond moved up by 18 basis points to 1.58% during the



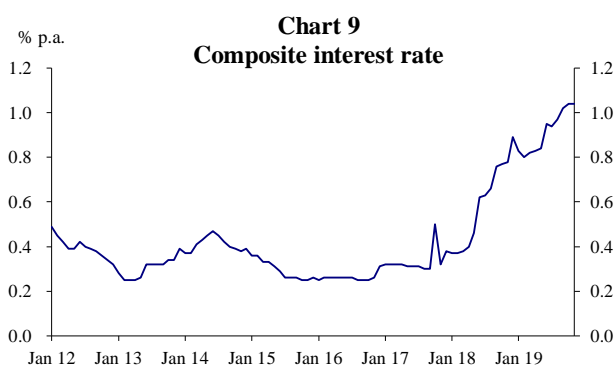
review period, while the yield of the 1-year Exchange Fund Bill edged down by 2 basis points to 1.80%. Reflecting larger pick-ups in the HKD yields relative to the USD counterparts in the long end, the negative HKD-USD yield spreads narrowed for longer tenors (Table 1). Nonetheless, as the declines in the HKD yields were smaller than their USD counterparts in the short end, the positive HKD-USD yield spreads mostly widened for shorter tenors.

	15 Oct 19	8 Jan 20
3-month EFB	28	38
12-month EFB	14	25
3-year HKGB	1	-5
5-year HKGB	-22	-15
10-year HKGB	-39	-29

**7. The HKMA Base Rate decreased from 2.25% to 2.00% following a 25 basis point downward shift in the target range for the US Federal Funds Rate on 30 October (US time). Nevertheless, it rose gradually since mid-December amid the upward trend of overnight and one-month HIBORs, reaching 2.28% at the end of the review period (Chart 8). According to an established formula, the Base Rate is set at either 50 basis points above the lower end of the prevailing target range for the US federal funds rate or the average of the five-day moving averages of the overnight and one-month HIBORs, whichever is the higher.**



8. Following the decrease in the target range for the US Federal Funds Rate in late October, **several retail banks lowered their Best Lending Rates.** At the end of the review period, the Best Lending Rates in the market ranged from 5.00% to 5.50%. The average interest rate for newly approved mortgage loans decreased slightly from 2.56% in September to 2.53% in November. This largely reflected the decline in the Best Lending Rate despite the narrowed spreads in calculating the prime-based cap for HIBOR-based mortgages. During the review period, the average 1-month HKD time deposit board rate offered by retail banks decreased from 0.14% to 0.12%.<sup>3</sup> Notwithstanding these, **the composite interest rate**<sup>4</sup>, which indicates the average funding cost of retail banks, edged up from 1.02% at the end of September to 1.04% at the end of November (Chart 9).



<sup>3</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>4</sup> 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.

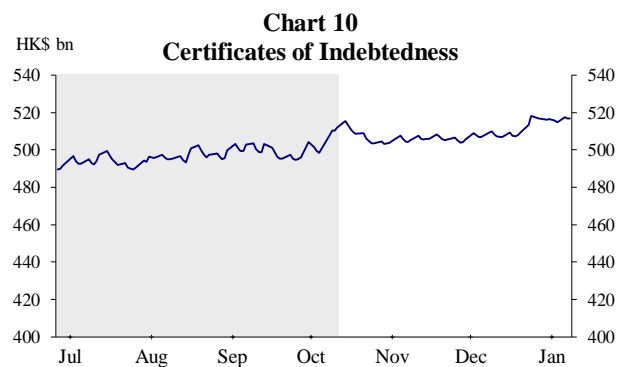
## Monetary Base

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 slightly to HK\$1,664.13 billion on 8 January 2020 from HK\$1,657.50 billion on 14 October 2019** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	14 Oct 19	8 Jan 20
CIs	515.53	517.02
Government-issued Currency Notes and Coins in Circulation	12.99	13.41
Aggregate Balance	54.42	54.42
Outstanding EFBNs	1074.56	1,079.29
<b>Monetary Base</b>	<b>1657.50</b>	<b>1,664.13</b>

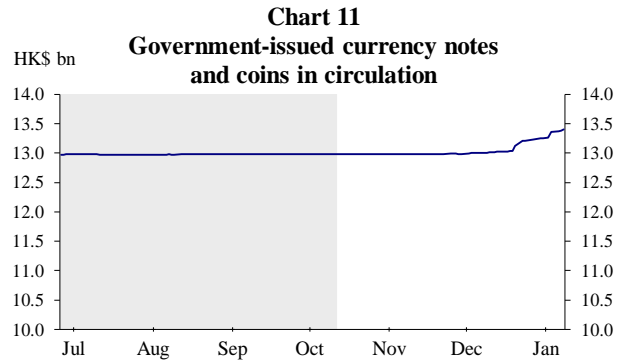
### *Certificates of Indebtedness*

10. Reflecting a net increase in currency demand during the review period, note-issuing banks submitted a net amount of US\$191.0 million to the HKMA in exchange for HK\$1,490.0 million worth of CIs. As a result, **the outstanding CIs increased** to HK\$517.02 billion on 8 January 2020 from HK\$515.53 billion on 14 October 2019 (Chart 10), representing a 0.3% increase.



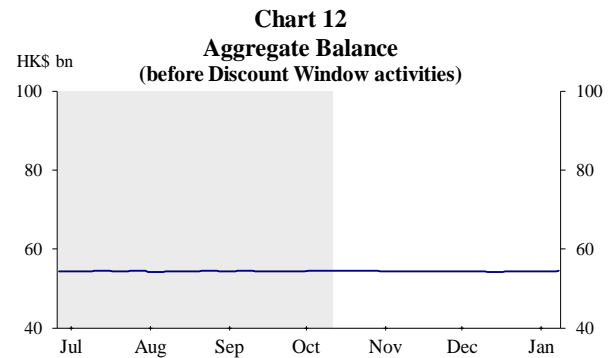
*Government-issued currency notes and coins in circulation*

11. During the review period, the amount of **government-issued currency notes and coins in circulation** increased from HK\$12.99 billion to HK\$13.41 billion (Chart 11).



*Aggregate Balance*

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

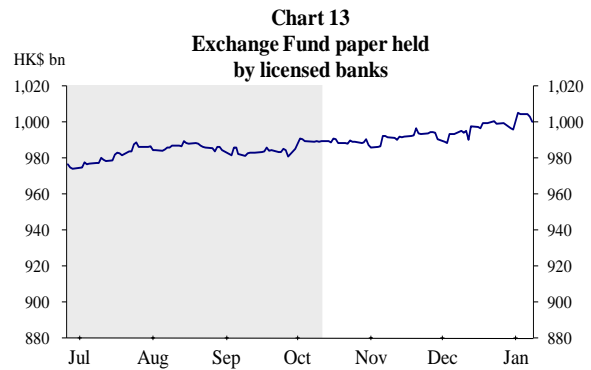


<sup>5</sup> Since the first triggering on 12 April 2018, the weak-side Convertibility Undertaking has been triggered 27 times in 2018 and 8 times in 2019 up to the end of the review period, with total outflows amounting to HK\$125.6 billion.



*Outstanding Exchange Fund Bills and Notes*

13. **The market value of the outstanding EFBNs increased to HK\$1,079.29 billion from HK\$1,074.56 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) rose to HK\$999.99 billion (92.7% of total) from HK\$989.48 billion (92.1% of total) (Chart 13).**



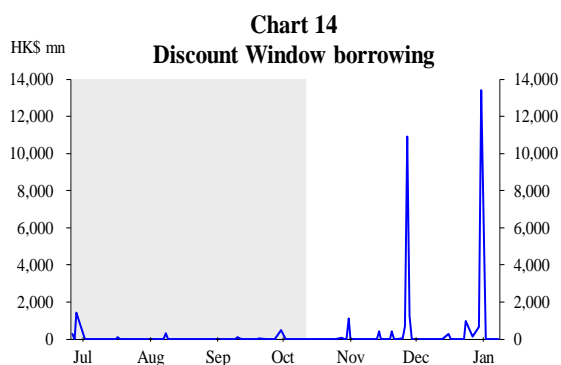
14. **During the review period, interest payments on Exchange Fund paper amounted to HK\$5,214.69 million. A total of HK\$5,208.72 million (in market value) of Exchange Fund paper was issued to absorb these interest payments. The Exchange Fund paper issued during the review period was generally well received by the market (Table 3).**

**Table 3**  
**Issuance of Exchange Fund Bills and Notes**  
**(12 Oct 19 – 8 Jan 20)**

	No. of issues launched	Over-subscription ratio
1-month EFB	2	3.60 - 4.73
3-month EFB	13	1.07 - 2.69
6-month EFB	13	1.80 - 3.90
12-month EFB	3	2.92 - 5.68
2-year EFN	1	2.73

### Discount Window activities

15. During the review period, **a total of HK\$30.4 billion was borrowed from the Discount Window**, compared with HK\$2.8 billion in the preceding period from 26 June to 11 October 2019 (Chart 14).



### Backing Portfolio

16. The Backing Assets decreased to HK\$1,847.27 billion on 8 January 2020, partly reflecting valuation losses from investments. **The Backing Ratio decreased to 111.05% from 111.84% 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.

