

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

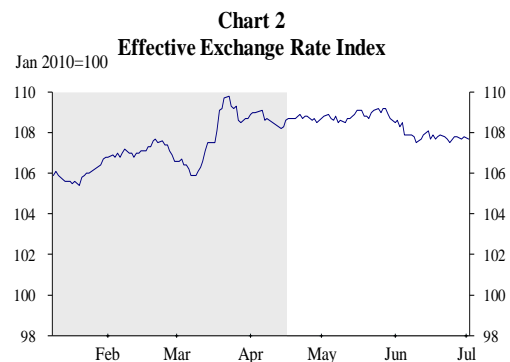
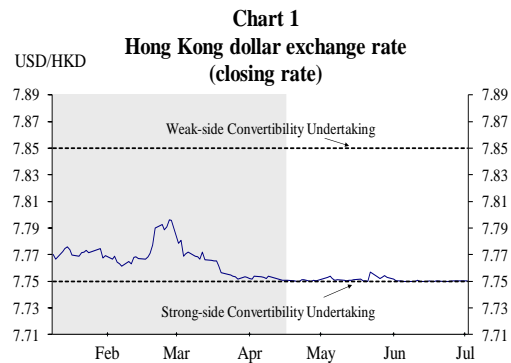
Report on Currency Board Operations

Review period: 17 April 2020 – 2 July 2020

During the review period, the Hong Kong dollar (HKD) traded close to the strong-side Convertibility Undertaking (CU), moving within a narrow range of 7.7500 – 7.7571 against the US dollar (USD). The strong-side CU was triggered 21 times between 21 April and 24 June, with accumulated inflows of HK\$57.6 billion. This was underpinned by equity-related demand, including initial public offering (IPO) activities, southbound Stock-Connect, and dividend payments. With the Aggregate Balance expanding to HK\$131.61 billion at the end of the review period, HKD interbank interest rates (i.e. HIBORs) generally softened. Despite market volatilities arising from potential concerns about the national security legislation in late May, the HKD exchange and interbank markets continued to trade in a smooth and orderly manner. 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

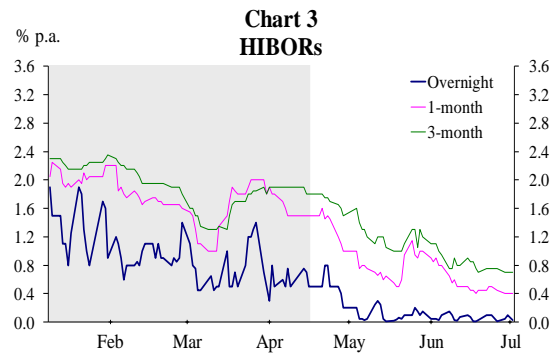
1. During the review period of 17 April 2020 to 2 July 2020, the **HKD traded close to the strong-side CU, moving within a narrow range of 7.7500 – 7.7571 (closing rate) against the USD** (Chart 1).¹ The strong-side CU was triggered 21 times between 21 April and 24 June, with accumulated inflows of HK\$57.6 billion. This was underpinned by equity-related demand, including IPO activities, southbound Stock-Connect, and dividend payments. Despite potential concerns about the national security legislation in late May, the HKD continued to trade in a smooth and orderly manner during the review period, closing at 7.7502 on 2 July 2020. **The nominal effective exchange rate index of the HKD declined** during the review period, reflecting the depreciation of the USD 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.

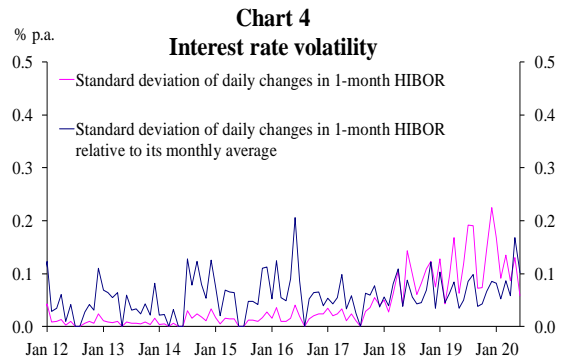
Interest rates

2. **The overnight, 1-month and 3-month HKD HIBORs broadly declined during the review period (Chart 3).** HIBORs have softened since late April along with the expansion of the Aggregate Balance due to the triggering of the strong-side CU and reduced issuance of Exchange Fund Bills.² Despite market volatilities arising from potential concerns about the national security legislation in late May, HIBORs did not witness significant upward pressure and the HKD interbank market functioned normally. Moderate fluctuations of HIBORs were mainly driven by IPO-related funding demand and the knee-jerk increase in the risk premium on the HKD in response to the national security legislation. For the review period as a whole, the overnight HIBOR declined by 47 basis point to 0.03%. Meanwhile, both 1-month and 3-month HIBORs declined by 110 basis points to 0.40% and 0.70% respectively.

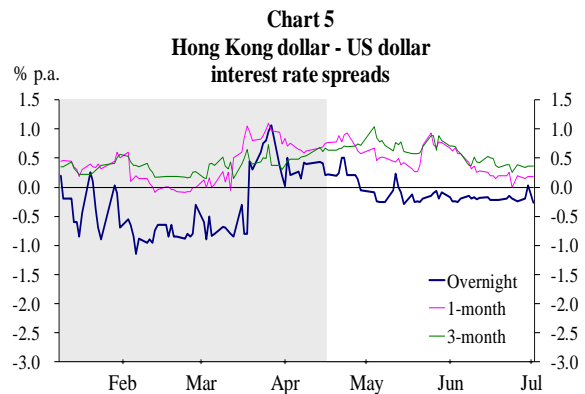


² To help ensure continued smooth operation of the HKD interbank market amid a volatile global macro environment stemming from the spread of coronavirus, the HKMA made available more HKD liquidity in the banking system by reducing the issue size of 91-day Exchange Fund Bills by HK\$5 billion in each of the four regular tenders on 21 April, 28 April, 5 May and 12 May 2020. The issuance of the Bills was reduced by HK\$20 billion in total and the Aggregate Balance increased by the same amount.

3. **Interest rate volatility**, measured by the standard deviation of daily changes in the 1-month HIBOR, **decreased** to 10.0 basis points in the current review period from 10.8 basis points in the preceding review period (Chart 4). The standard deviation as a ratio of the average of 1-month HIBOR showed similar movements.³

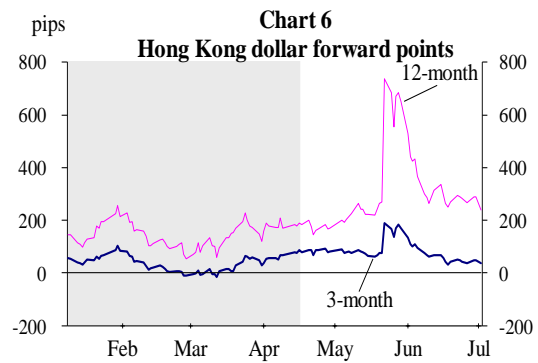


4. **The HKD-USD interbank interest rate spreads generally declined during the review period** (Chart 5). At the end of the review period, the overnight, 1-month and 3-month spreads closed at -27, 18 and 36 basis points respectively.

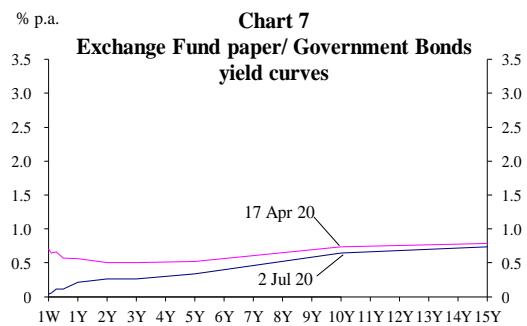


³ The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

5. During the review period, **the HKD forward premiums saw noticeable fluctuations**, with the 12-month forward premiums picking up to over 700 pips on 22 May amid potential concerns about the national security legislation. As market sentiment improved, the forward premiums eased to the original level. At the end of review period, the 3-month and 12-month forward points closed at 38 pips and 238 pips respectively (Chart 6).

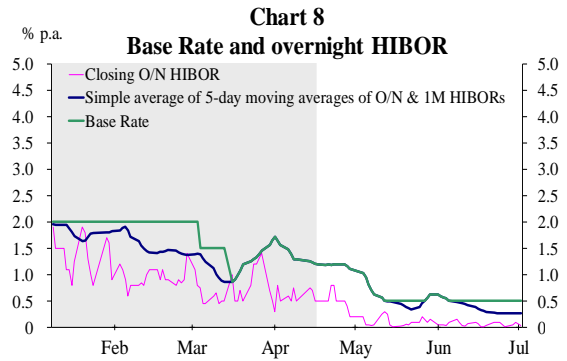


6. **During the review period, the HKD yield curve generally shifted downward** (Chart 7). The yield of the 1-year Exchange Fund Bill declined by 35 basis points to 0.21%, while the yields of 10-year Hong Kong Government Bond decreased by 9 basis points to 0.65%. As HKD yields declined while the USD counterparts remained relatively stable, the positive HKD-USD yield spreads in general narrowed, while the 3-month and the 10-year yield spreads even turned negative (Table 1).

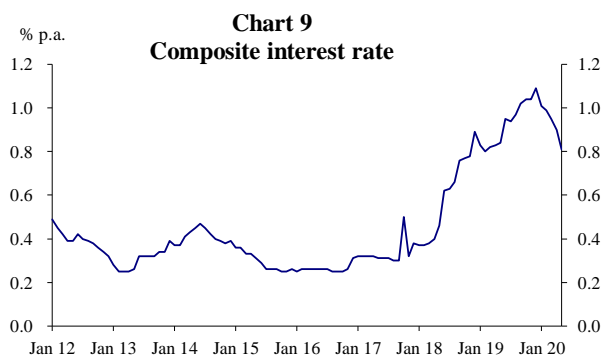


	17 Apr 20	2 Jul 20
3-month EFB	54	-3
12-month EFB	40	5
3-year HKGB	24	7
5-year HKGB	16	5
10-year HKGB	9	-3

7. During the review period, the target range for the US Federal Funds Rate remained unchanged at 0%-0.25%. **The HKMA Base Rate decreased from 1.19% to 0.50% largely following the downward movements of overnight and one-month HIBORs (Chart 8).** According to the 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. During the review period, **banks kept their Best Lending Rates unchanged.** The Best Lending Rates in the market continued to range from 5.00% to 5.50%. During the review period, the average interest rate for newly approved mortgage loans declined from 2.52% in March 2020 to 2.20% in May 2020, while the average 1-month HKD time deposit board rate offered by retail banks edged down from 0.06% to 0.04%.⁴ **The composite interest rate⁵,** which indicates the average funding cost of retail banks, **declined** from 0.95% at the end of March 2020 to 0.81% at the end of May 2020 (Chart 9).



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

⁵ 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.

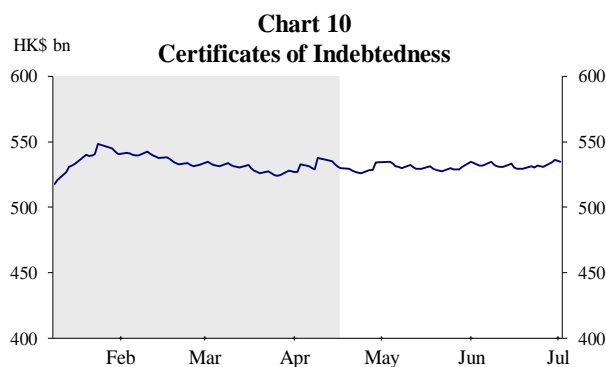
Monetary Base

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), **rose to HK\$1,748.31 billion on 2 July 2020 from HK\$1,683.90 billion on 17 April 2020** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	17 Apr 20	2 Jul 20
CIs	529.83	534.73
Government-issued Currency Notes and Coins in Circulation	13.19	13.14
Aggregate Balance	54.13	131.61
Outstanding EFBNs	1,086.76	1,068.84
Monetary Base	1,683.90	1,748.31

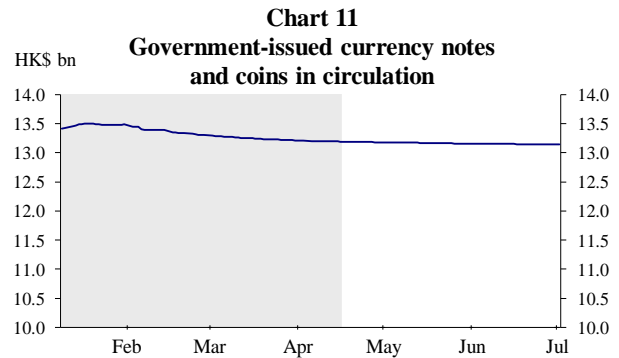
Certificates of Indebtedness

10. Reflecting a net increase in currency demand during the review period, note-issuing banks submitted a net amount of US\$628.2 million to the HKMA in exchange for HK\$4.90 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$534.73 billion on 2 July 2020 from HK\$529.83 billion on 17 April 2020** (Chart 10), representing a 0.9% 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 edged down** from HK\$13.19 billion to HK\$13.14 billion (Chart 11).



Aggregate Balance

12. **The Aggregate Balance rose from HK\$54.13 billion to HK\$131.61 billion during the review period** (Chart 12), owing to the triggering of the strong-side CU in April and June (Table 3) and reduced issuance of Exchange Fund Bills. The foreign exchange operations are consistent with Currency Board principles, as the increases in the Monetary Base were matched by equivalent increases in US dollar reserves. The reduced issuance of Exchange Fund Bills is consistent with Currency Board principles, as this represents a change in a composition of the Monetary Base with the shift from the Exchange Fund Paper to the Aggregate Balance. The Monetary Base remains fully backed by US dollar reserves.

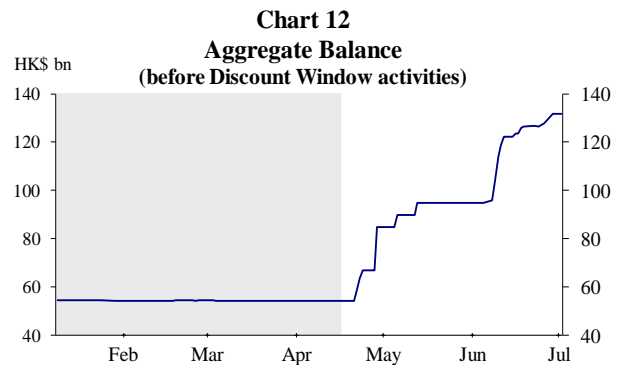


Table 3
HKMA US\$/HK\$ FX Transactions
(17 Apr 20 - 2 Jul 20)

Trade Date	Net purchase of US\$ (HK\$ mn)
21-Apr-20	4,340
22-Apr-20	3,371
27-Apr-20	12,997
04-Jun-20	977
05-Jun-20	8,758
08-Jun-20	9,347
09-Jun-20	4,596
10-Jun-20	3,720
12-Jun-20	1,434
16-Jun-20	2,232
17-Jun-20	775
23-Jun-20	1,139
24-Jun-20	3,953
Total	57,637

Outstanding Exchange Fund Bills and Notes

13. **The market value of the outstanding EFBNs decreased to HK\$1,068.84 billion from HK\$1,086.76 billion during the review period, mainly due to the reduced issuance of Exchange Fund Bills by a total of HK\$20 billion in four regular tenders upon their maturity (see footnote 2 for details). Notwithstanding the decline in the market value of the outstanding EFBNs, holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$986.12 billion (92.3% of total) from HK\$957.56 billion (88.1% of total) (Chart 13).**

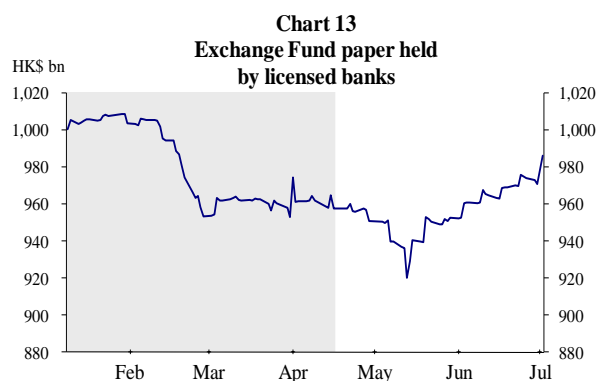


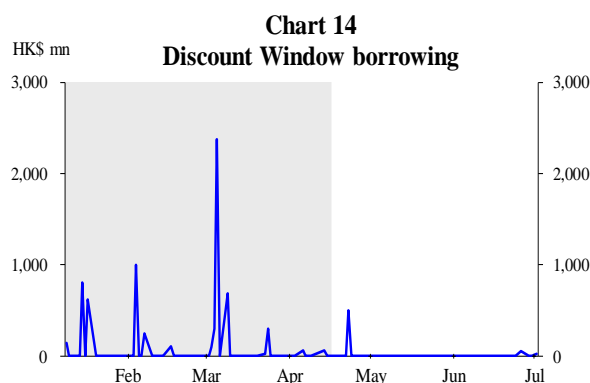
Table 4
Issuance of Exchange Fund Bills and Notes
(17 Apr 20 – 2 Jul 20)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	5.88
3-month EFB	11	0.99 - 2.77
6-month EFB	11	1.46 - 3.92
12-month EFB	2	5.37 - 6.19
2-year EFN	1	1.76

14. During the review period, **interest payments on Exchange Fund paper amounted to HK\$873.97 million. A total of HK\$998.94 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 4).**

Discount Window activities

15. During the review period, a total of **HK\$570 million** was borrowed from the Discount Window, compared with HK\$6,807 million in the preceding period from 9 January 2020 to 16 April 2020 (Chart 14).



Backing Portfolio

16. The Backing Assets increased to HK\$1,951.29 billion on 2 July 2020, mainly due to the purchase of US dollars upon the triggering of strong-side CU. Taking into account the reduced interest income related to the Backing Assets, **the Backing Ratio decreased to 111.68% from 112.06% 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.

