

# RECORD OF DISCUSSION OF THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE ON CURRENCY BOARD OPERATIONS ON 4 MAY 2001

(Approved for Issue by the Exchange Fund Advisory Committee on 31 May 2001)

## Currency Board Operations for the Period 1 April - 23 April 2001

The Sub-Committee noted that, despite the more volatile external environment, this had been a period of stability for the Hong Kong dollar. The 50 basis point cut in the US Fed Funds Target Rate on 18 April had prompted a sharp drop in interbank interest rates. In mid-April, the spreads between US dollar and Hong Kong dollar interest rates had narrowed at the longer end and had returned to negative at the shorter end. Members noted that there had been no significant movement in the Aggregate Balance, and that the Convertibility Undertaking had not been triggered during the period under review.

The Sub-Committee noted that, in accordance with Currency Board principles, changes in the monetary base during the period under review had been fully matched by corresponding changes in foreign reserves.

The report on Currency Board operations for the period under review is at [Annex A](#).

## Monitoring of Risks and Vulnerabilities

The Sub-Committee noted the regular information paper on external and internal risks facing Hong Kong. The Sub-Committee noted that the more volatile and uncertain external environment presented certain risks. Members focused in particular on the continuing weakness of the Japanese economy. They observed that, while the economic ties in terms of investment and bank lending between regional economies and Japan had substantially decreased since the Asian financial crisis, Japan was still an important influence in the region. The main risk from Japan appeared to be the possibility that any sharp weakening in the yen might trigger a round of competitive depreciation among regional currencies. Although Hong Kong's currency board arrangements had amply demonstrated the resilience of the exchange rate to such events, there might nevertheless be temporary upward pressure on local interest rates, and any lasting depreciation of the region's currencies against the dollar would be likely to spark renewed deflationary pressures within Hong Kong.

Within Hong Kong, Members noted an analysis of the impact of stock market developments on the economy, particularly in the light of the sharp

corrections in March and early April. Members noted the assessment that the declines so far should have only modest negative effects on economic growth and that the impact on the banking system was likely to be minimal.

## Policy on Foreign Exchange Reserves

The Sub-Committee considered a discussion paper on the desirability and feasibility of determining the optimal level of foreign exchange reserves for Hong Kong. Members agreed that this was too complex an issue to be dealt with conclusively in a single session and recommended that further research and deliberation on the subject should be carried out.


## Use of Interest Rate Swaps

The Sub-Committee considered a proposal for using Hong Kong dollar interest rate swaps as a means of reducing the cost of issuing more long-dated Exchange Fund Notes. Members noted that, under the technical measures to strengthen the Currency Board arrangements in September 1998, restrictions had been imposed on the issue of new Exchange Fund paper. In the interests of facilitating market development, however, the HKMA had in June 1999 resumed the issue of ten-year paper through the displacement of shorter Exchange Fund paper. Because of the positively sloping Hong Kong dollar yield curve, and the tendency of the yield margin over US Treasuries to rise along the curve, the increasing proportion of longer paper tended to incur higher interest costs. One way of reducing the cost would be for the HKMA to enter into a set of Hong Kong dollar interest rate swap transactions the maturity of which would correspond to that of the Exchange Fund Notes issued.

Having considered the likely gains and the possible risks associated with such a practice, the Sub-Committee supported the proposal to use Hong Kong dollar interest rate swaps as a means of reducing the cost of issuing Exchange Fund Notes. Members observed that such transactions would be unlikely to be large enough to materially influence market yields. The Sub-Committee also recommended that the net interest payable or receivable and revaluation gains or losses on interest rate swaps should be included in the Currency Board Account.

## Review of Fungibility Arrangements between Exchange Fund Bills & Notes and Specified Instruments

The Sub-Committee considered the question of whether the current fungibility arrangements between Exchange Fund Bills and Notes and Specified Instruments should be either abolished or capped. Members noted that Specified Instruments consisted of paper issued by the Mass Transit Railway Corporation, the Airport Authority, the Kowloon-Canton Railway Corporation and the Hong Kong Mortgage Corporation under a Notes Issuance programme initiated by the HKMA. Under the technical measures introduced to strengthen the Currency Board arrangements in September 1998, Specified Instruments newly issued since then became ineligible for access to the Discount Window, since, unlike the components of the Monetary Base, they were not backed by US dollar assets. But because of the fungibility between Specified Instruments and Exchange Fund Bills and Notes, a loophole existed in that there was a possibility that holders of Specified Instruments could create additional Exchange Fund paper (without the normal backing arrangements) for discounting at the Discount Window. The Sub-Committee agreed that, in view of the rapid growth in the total Specified Instruments outstanding, it was timely to review the fungibility arrangements.

The Sub-Committee recommended that a cap should be placed on the total of fungible Specified Instruments. Members were of the view that the total outstanding amount of fungible Specified Instruments should be capped at the current level (of around HK\$15 bn). The pool of fungible Specified Instruments would diminish over time as they mature. Members noted that the amount of Exchange Fund paper so created could be backed by the cushion in the existing Backing Portfolio. 

## REPORT ON CURRENCY BOARD OPERATIONS (1 - 23 APRIL 2001)

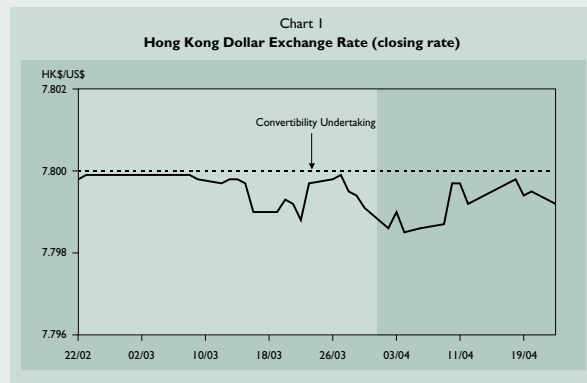
The Hong Kong dollar exchange and money markets remained stable during the reporting period, although the external environment turned less favourable. Following the 50 bp cut in the US Fed Funds Target Rate on 18 April, interbank interest rates eased across the board. The spreads with US interest rates narrowed at the longer end, while those at the shorter end turned negative again. The monetary base decreased marginally from HK\$217.30 bn to HK\$216.28 bn, mainly due to a reduction in the outstanding amount of Certificates of Indebtedness. In accordance with currency board principles, changes in the monetary base were fully matched by corresponding changes in foreign reserves.

### Hong Kong Dollar Exchange Rate

Notwithstanding escalating Sino-US tensions, a weakening of the Japanese Yen, as well as increased volatility in Argentina's financial markets, the Hong Kong dollar exchange rate remained stable throughout the reporting period. It strengthened to around 7.7985 in the early part of April on the back of higher local interest rates. It then eased to around 7.7998 before firming slightly again towards the end of the period, reportedly associated with some commercial buying orders (Charts 1 and 2).

### Interest Rates

**Interbank interest rates eased across the board.** 1-month HIBOR remained firm at around 5.19% at the beginning of the period, but then eased to around 4.81% straddling the Easter holidays. The surprise 50 bp "inter-FOMC meeting" US rate-cut on 18 April led to a further drop in 1-month HIBOR, which reached a low of 4.25% towards the end of the period. **3-month and 12-month HIBORs followed a similar pattern, closing at 4.31% and 4.50% respectively** (Chart 3).



As a result of the significant decline in interest rates, **volatility**, as measured by the standard deviation of 1-month HIBOR, **increased** from 0.09 percentage points in March to 0.35 percentage points in April (up to 23 April) (Chart 4).

Local interest rates across all maturities stayed above their corresponding US dollar counterparts in early April. The differentials, in terms of 1-month and 3-month rates, then disappeared in the second week of April, and turned negative thereafter, closing at -29 bp and -10 bp respectively. The spread in terms of 12-month money, at 41 bp in the beginning of April, narrowed to 9 bp at the end of the period. On the whole, the money market stayed calm notwithstanding a more eventful external environment (Chart 5).

Largely following the movement of the US treasuries yield curve, **yields on Exchange Fund paper declined at the shorter end, but firmed slightly at the longer end** (Chart 6). **The yield spreads between 5-year and 10-year Exchange Fund paper and US Treasuries narrowed by 12 bp and 13 bp, to 60 bp and 93 bp respectively** (Table 1).

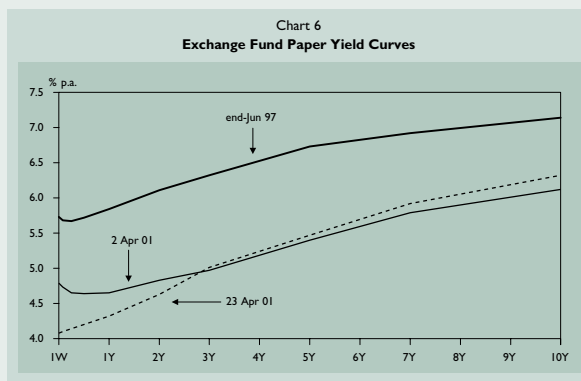
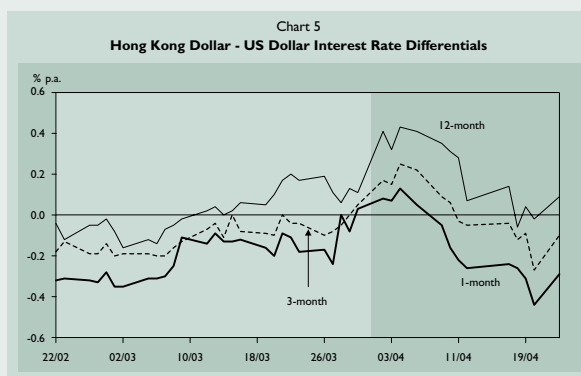
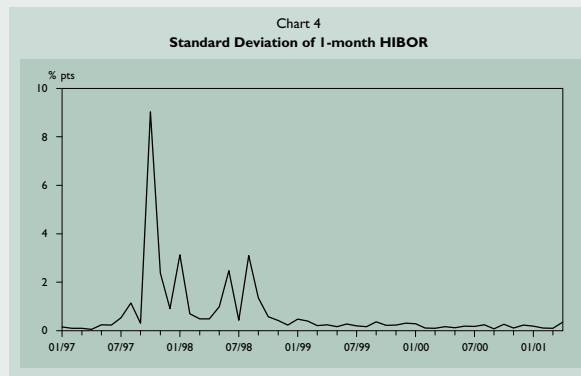


Table 1  
Yield Spreads between Exchange Fund Paper  
and US Treasuries (basis points)

	27-Jun-97	2-Apr-01	23-Apr-01
3-month	56	28	34
1-year	21	47	41
3-year	3	49	49
5-year	27	72	60
10-year	54	106	93

Following the 50 bp cut in the US Fed Funds Target Rate on 18 April, the **Base Rate was adjusted downwards on 19 April to 6.00%**, in accordance with the established formula – 150 basis points above the US Fed Funds Target Rate (Chart 7). The Hong Kong Association of Banks **reduced the Savings Rate by 50 bp to 2.75%**, effective on 23 April. Concurrently, the **Best Lending Rate offered by major banks was also lowered, from 8.00% to 7.50%**. The weighted average deposit rate offered by 44 major authorized institutions for 1-month time deposits decreased from 4.69% on 30 March to 4.14% on 20 April. Meanwhile, the effective deposit rate decreased from 4.03% in February to 3.81% in March (Chart 8)<sup>1</sup>.

### Monetary Base

The **monetary base**, which comprises the outstanding amount of Certificates of Indebtedness (CIs), coins in circulation, the Aggregate Balance, and the outstanding amount of Exchange Fund Bills and Notes, **decreased slightly from HK\$217.31 bn to HK\$216.28 bn during the reporting period** (Table 2). Movements in individual components are discussed below.

#### Certificates of Indebtedness

Reflecting a significant rise in public demand for cash ahead of the Easter holidays, the three note-issuing banks (NIBs) submitted to the HKMA a total of US\$0.38 bn in exchange for \$2.97 bn worth of CIs between 2 and 12 April. As cash demand gradually subsided following the holidays, the NIBs redeemed a total of HK\$4.39 bn of CIs in exchange for US\$0.56 bn during the rest of the period. As a result, the **outstanding amount of CIs decreased from HK\$98.82 bn to HK\$97.40 bn** (Chart 9).

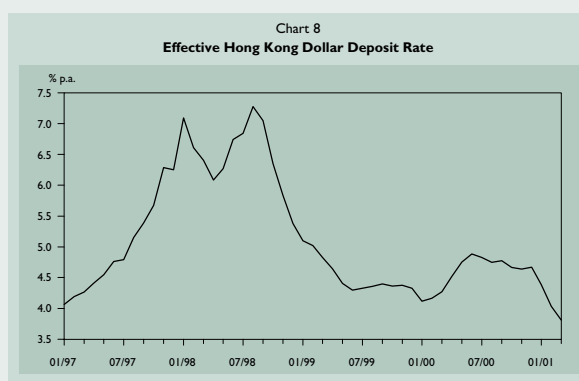
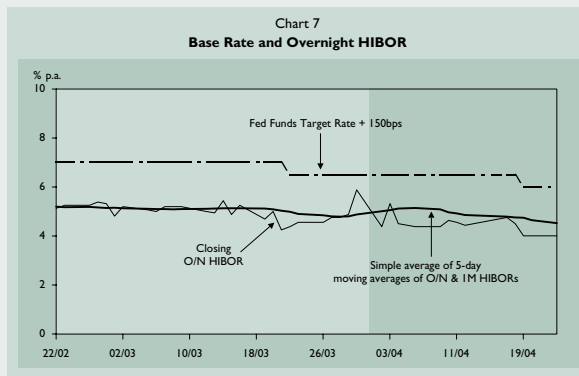
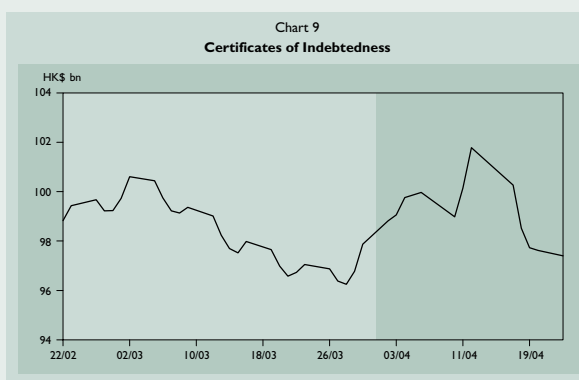


Table 2  
Monetary Base

(HK\$ bn)	2 Apr 01	23 Apr 01
CIs	98.82	97.39
Coins in Circulation	6.13	6.11
Aggregate Balance	0.49	0.57
Outstanding EFBNs	111.87	112.21
Monetary Base	217.31	216.28



<sup>1</sup> This is the weighted average of the interest rates on demand deposits, savings and time deposits. As the banking statistics classify deposits by remaining maturities, we have used certain assumptions regarding the maturity distribution to compute the effective deposit rate.

## Coins

The total amount of **coins in circulation** decreased from HK\$6.13 bn to HK\$6.11 bn during the period (Chart 10).

## Aggregate Balance

No foreign exchange operations were conducted for the currency board account during the period. The Aggregate Balance remained stable at around HK\$0.50 bn, with small changes due to interest payments and new issues of Exchange Fund paper (Chart 11).

During the period, a total of HK\$0.88 bn of interest payments on Exchange Fund paper were made, while an additional HK\$0.81 bn (in market value) of Exchange Fund paper was issued to absorb these interest payments. The remaining amount was carried forward in the Aggregate Balance.

## Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund paper increased from HK\$111.87 bn to HK\$112.21 bn. The increase was mainly a result of additional net issues (refer to paragraph 11 above). All issues of Exchange Fund Bills and Notes were well received by the market (Table 4). **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) slightly increased** from HK\$103.35 bn (or 92.4% of total) on 2 April to HK\$103.61 bn (or 92.3% of total) on 23 April (Chart 12).

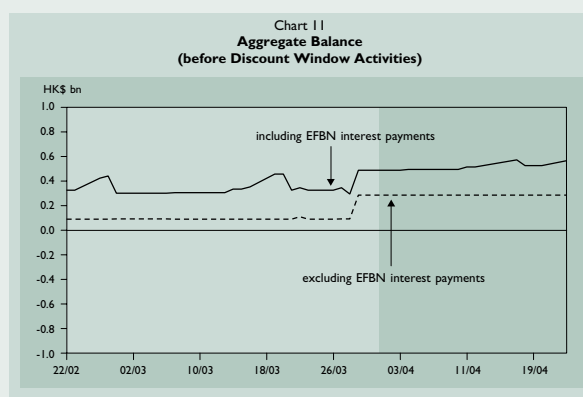
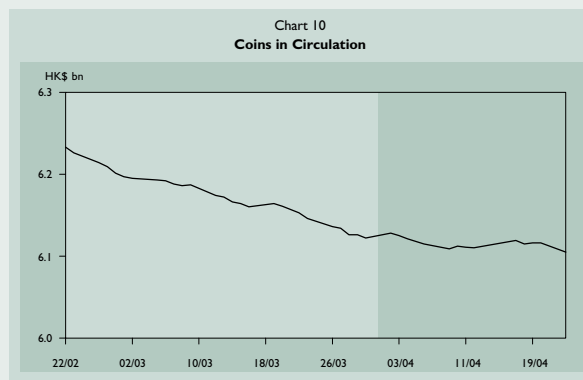
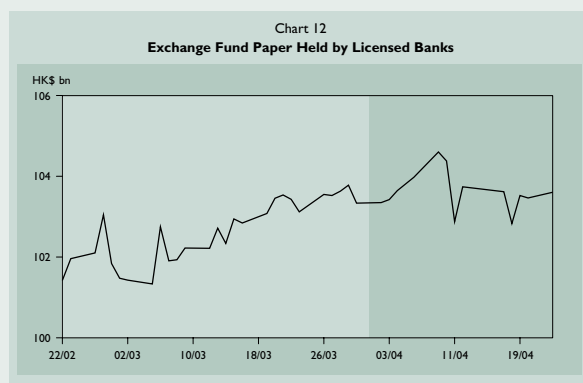


Table 4  
Issuance of Exchange Fund Paper  
(2 – 23 Apr 01)

	No. of Issues Launched	Over-subscription Ratio
1-month EFB	1	10.32
3-month EFB	3	2.49–4.38
6-month EFB	2	2.95–3.73
12-month EFB	1	3.30
3-year EFN	1	2.72




### Discount Window Activities

Reflecting stable liquidity conditions, Discount Window activity generally fell. For the period as a whole, **banks in total borrowed HK\$0.56 bn from the Discount Window**, compared with HK\$5.01 bn in the preceding period. All of the borrowings used Exchange Fund paper as collateral (Chart 13).

**A total of 9 banks borrowed overnight funds through the Discount Window** (Table 5). They used the Discount Window facility only infrequently.

### Backing Portfolio

Along with a decrease in CIs outstanding, backing assets fell accordingly. Nevertheless, the decline in backing assets was more moderate than that of the monetary base, partly due to positive net interest income. As a result, **the backing ratio increased from 110.36% on 2 April to 110.74% on 23 April** (Chart 14). 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 Hong Kong dollar exchange rate. 

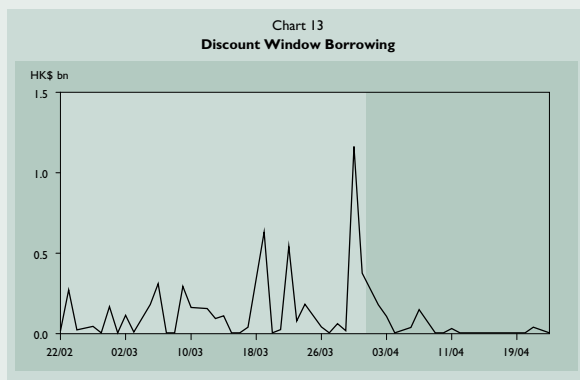
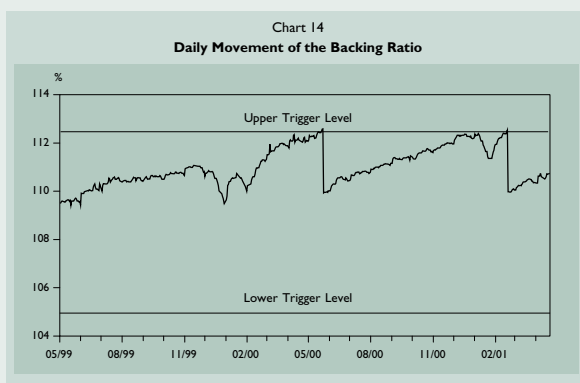


Table 5  
Frequency of Individual Bank's  
Access to the Discount Window  
(2 – 23 Apr 01)

Frequency of Using Discount Window	No. of Banks
1	6
2	2
3	1
<b>Total</b>	<b>9</b>

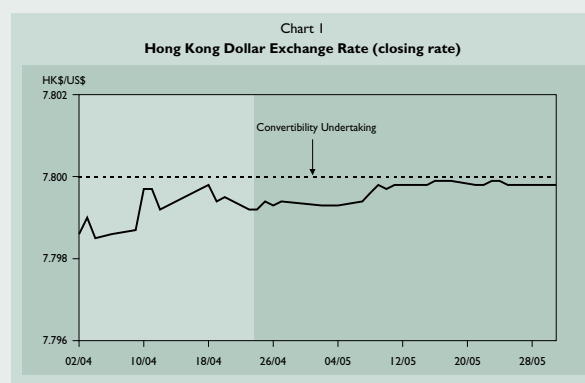


# EFAC SUB-COMMITTEE ON CURRENCY BOARD OPERATIONS REPORT ON CURRENCY BOARD OPERATIONS (24 APRIL - 31 MAY 2001)

*The Hong Kong dollar exchange rate remained stable during the reporting period despite volatility in some regional currencies. Partly reflecting the 50 bp cut in the US Fed Funds Target Rate on 15 May, interbank interest rates remained soft. Longer-term spread against US interest rate turned negative and shorter-term spreads remained negative. The monetary base increased slightly from HK\$215.85 bn to HK\$216.86 bn, mainly due to an increase in the outstanding amount of Certificates of Indebtedness. In accordance with currency board principles, changes in the monetary base were fully matched by corresponding changes in foreign reserves.*

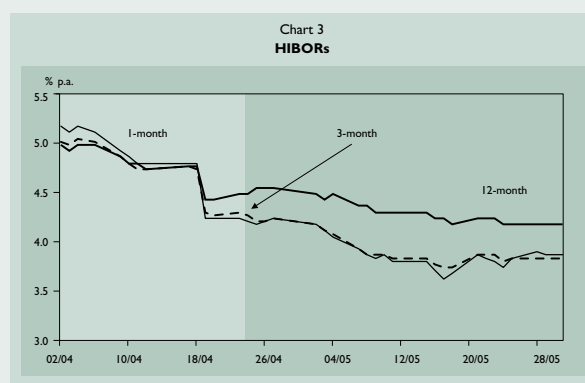
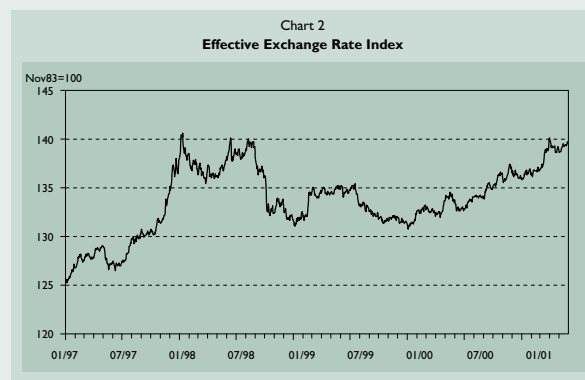
## Hong Kong Dollar Exchange Rate

Notwithstanding the volatility in some regional currencies, especially the Japanese yen and the Taiwanese dollar, the Hong Kong dollar exchange rate remained stable throughout the reporting period. Partly reflecting soft local interest rates, the exchange rate eased slightly in the second week of May, and stayed close to the linked rate at 7.8000 during the rest of the period. (Charts 1 and 2).



## Interest Rates

**Interbank interest rates eased during the reporting period.** Reflecting in part market expectations of a rate-cut in early May as well as the subsequent 50 bp rate-cut by the US Fed in mid-May, 1-month HIBOR declined from 4.22% at the beginning of the period to a low of 3.63% on 17 May. It was fairly stable thereafter and closed at 3.88% at the end of the period. **3-month and 12-month HIBORs followed a similar pattern, closing at 3.84% and 4.19% respectively** (Chart 3).



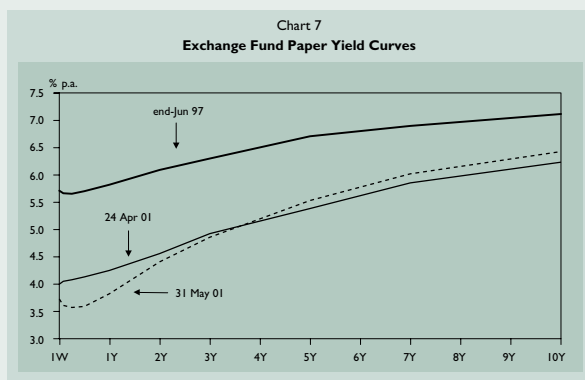
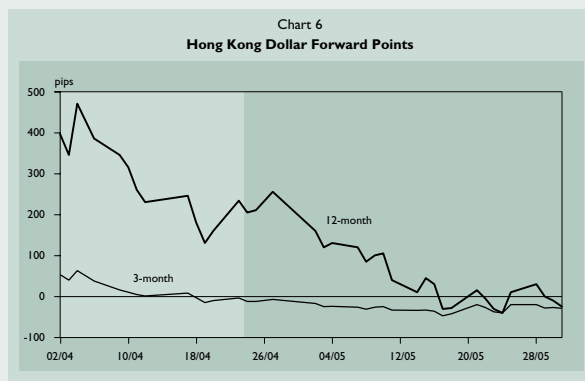
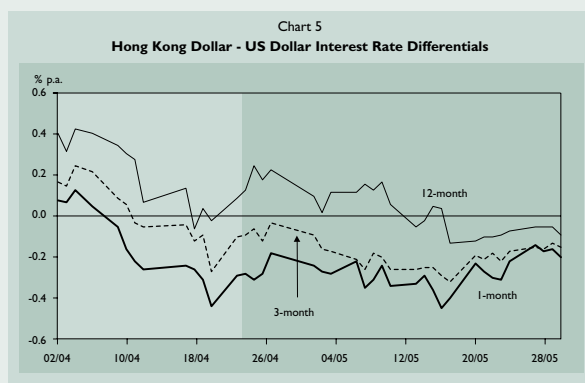
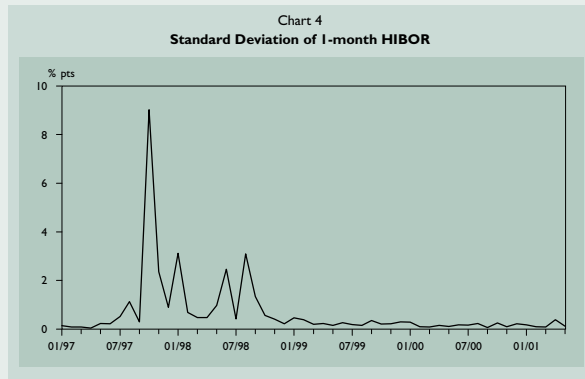


Money market activity has been relatively subdued. **Interest rate volatility** (measured by the standard deviation of 1-month HIBOR) **decreased** from 0.40 percentage points in April to 0.13 percentage points in May (Chart 4).

Hong Kong dollar interbank rates in terms of 1-month and 3-month rates stayed below their US dollar counterparts throughout the period, closing at -20 bp and -15 bp respectively. The spread in terms of 12-month money turned negative from mid-May onwards, and closed at -9 bp at the end of the period (Chart 5).

The Hong Kong dollar 3-month forward points remained at discount and closed at -29 pips, while 12-month forward points moved down from 205 pips at the beginning of the period to close at -25 pips at the end of May (Chart 6).

In part reflecting the movement of the US Treasuries yield curve, **yields on Exchange Fund paper declined at the shorter end, but firmed slightly at the longer end** (Chart 7). **The yield spreads between 5-year and 10-year Exchange Fund paper and US Treasuries narrowed by 21 bp and 11 bp, to close at 47 bp and 91 bp respectively** (Table 1).



Following the 50 bp cut in the US Fed Funds Target Rate on 15 May, the **Base Rate was adjusted downwards on 16 May to 5.50%**, in accordance with the established formula - 150 basis points above the US Fed Funds Target Rate (Chart 8). HKAB **reduced the Savings Rate by 50 bp to 2.25%**, effective on 21 May. Concurrently, the **Best Lending Rate offered by major banks was also lowered, from 7.50% to 7.00%**. The weighted average deposit rate offered by 44 major authorized institutions for 1-month time deposits decreased from 4.14% on 20 April to 3.52% on 25 May. Meanwhile, the effective deposit rate decreased from 3.81% in March to 3.41% in April (Chart 9).<sup>1</sup>

### Monetary Base

The **monetary base**, which comprises the outstanding amount of Certificates of Indebtedness (CIs), coins in circulation, the Aggregate Balance, and the outstanding amount of Exchange Fund Bills and Notes, **increased slightly from HK\$215.85 bn to HK\$216.86 bn during the reporting period** (Table 2). Movements in individual components are discussed below.

Table 1  
Yield Spreads between Exchange Fund Paper and US Treasuries (basis points)

	27 Jun 97	24 Apr 01	31 May 01
3-month	56	35	-14
1-year	21	49	12
3-year	3	51	25
5-year	27	68	47
10-year	54	102	91

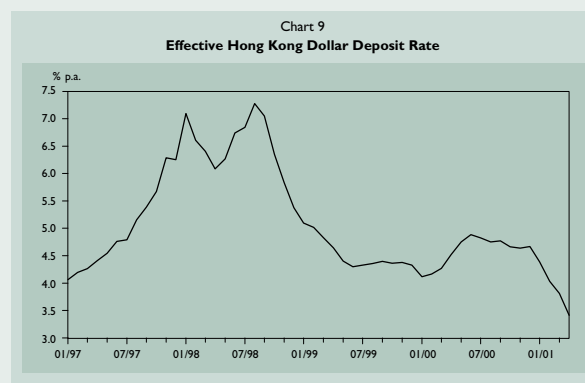
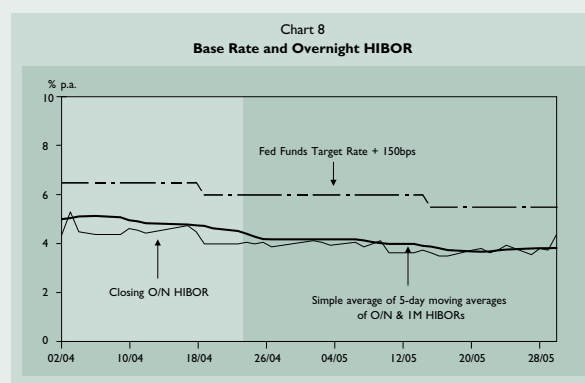


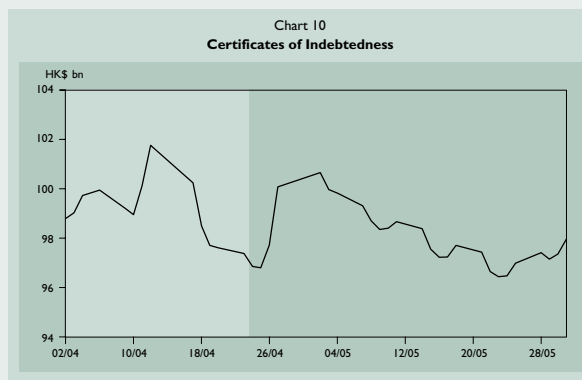
Table 2  
Monetary Base

(HK\$ bn)	24 Apr 01	31 May 01
CIs	96.88	97.99
Coins in Circulation	6.11	6.06
Aggregate Balance	0.57	0.49
Outstanding EFBNs	112.29	112.32
Monetary Base	215.85	216.86

<sup>1</sup> This is the weighted average of the interest rates on demand deposits, savings and time deposits. As the banking statistics classify deposits by remaining maturities, we have used certain assumptions regarding the maturity distribution to compute the effective deposit rate.

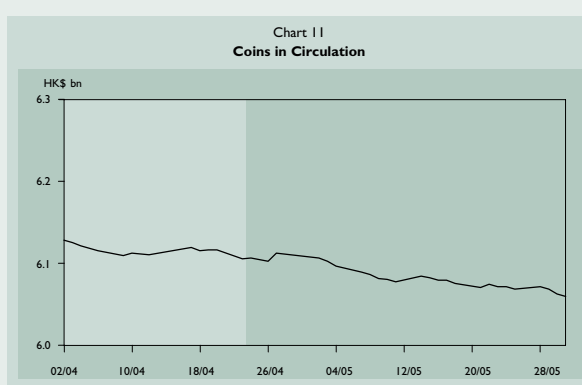
### Certificates of Indebtedness

Reflecting a rise in public demand for cash ahead of the long holidays straddling the month-end, the three note-issuing banks submitted to the HKMA a total of US\$0.40 bn in exchange for \$3.12 bn worth of CIs between 24 April and 3 May. They then redeemed a total of HK\$2.01 bn of CIs in exchange for US\$0.26 bn during the rest of the period. As a result, the **outstanding amount of CIs increased** slightly from HK\$96.88 bn to HK\$97.99 bn (Chart 10).



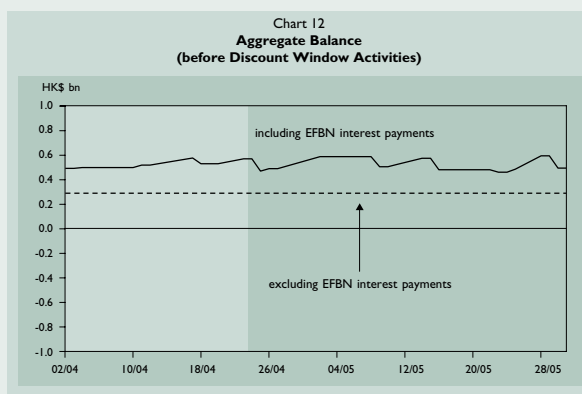
### Coins

The total amount of **coins in circulation decreased** from HK\$6.11 bn to HK\$6.06 bn during the period (Chart 11).



### Aggregate Balance

No foreign exchange operations were conducted for the currency board account during the period. The Aggregate Balance remained stable at around HK\$0.50 bn, with small changes due to interest payments and new issues of Exchange Fund paper (Chart 12).



During the period, a **total of HK\$0.62 bn of interest payments on Exchange Fund paper were made**. Taking into account the interest payments carried forward from the last reporting period, **an additional HK\$0.70 bn (in market value) of Exchange Fund paper was issued to absorb these interest payments**.

### Outstanding Exchange Fund Bills and Notes

The market value of outstanding Exchange Fund paper increased from HK\$112.29 bn to HK\$112.32 bn. The increase was mainly a result of additional net issues (paragraph 12 above). All issues of Exchange Fund Bills and Notes were well received by the market (Table 4). **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) slightly decreased** from HK\$102.97 bn (or 91.7% of total) to HK\$102.36 bn (or 91.1% of total) during the period (Chart 13).


Table 4  
Issuance of Exchange Fund Paper  
(24 Apr – 31 May 01)

	No. of Issues Launched	Over-subscription Ratio
3-month EFB	6	3.10-5.99
6-month EFB	3	4.15-4.86
12-month EFB	1	5.25
2-year EFN	1	4.02

## Discount Window Activities

For the period as a whole, **29 banks in total borrowed HK\$2.61 bn from the Discount Window**, compared with HK\$0.56 bn in the preceding period. All of the borrowings used Exchange Fund paper as collateral (Chart 14). The banks used the Discount Window facility only infrequently (Table 5).

## Backing Portfolio

Alongside the increase in outstanding CIs during the period, backing assets increased accordingly. This, nevertheless, has the effect of reducing the **backing ratio from 110.82% on 24 April to 110.64% on 31 May** (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 Hong Kong dollar exchange rate. 

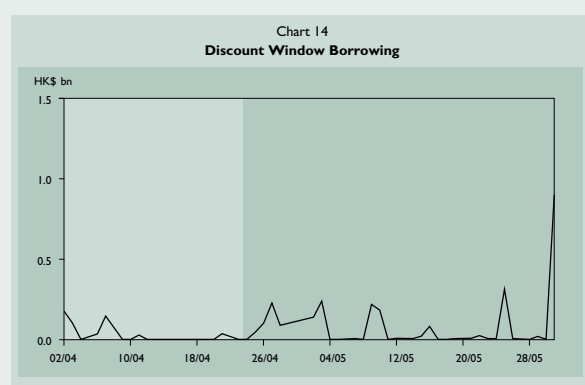
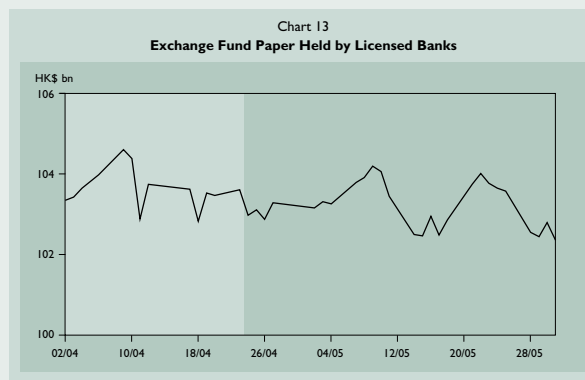
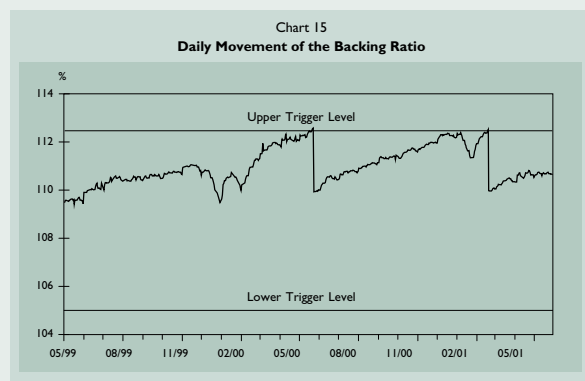


Table 5  
Frequency of Individual Bank's  
Access to the Discount Window  
(24 Apr – 31 May 01)

Frequency of Using Discount Window	No. of Banks
1	22
2	5
3	2
<b>Total</b>	<b>29</b>



# RECORD OF DISCUSSION OF THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE ON CURRENCY BOARD OPERATIONS ON 6 JULY 2001

(Approved for Issue by the Exchange Fund Advisory Committee on 26 July 2001)

## Currency Board Operations for the Period 1 June - 21 June 2001

The Sub-Committee noted that the Hong Kong dollar exchange rate had remained stable during the period under review. Interbank interest rates had eased in the latter part of the period, reflecting in part market expectations of a rate cut in the US in late June. The negative spreads between Hong Kong dollar and US dollar interest rates had narrowed, and had turned positive for 12-month maturity. The Sub-Committee noted that, in accordance with Currency Board principles, changes in the monetary base during the period under review had been fully matched by corresponding changes in foreign reserves.

Members observed that developments in Argentina had had no negative repercussions on markets in Hong Kong, and that market participants continued to differentiate between the economic fundamentals on which the two currency board systems rested. Members noted that, following approval by the Financial Secretary for the use of interest rate swaps to manage the cost of issuing long-dated Exchange Fund Notes, the first such transactions had taken place in mid-June.

The report on Currency Board operations for the period under review is at **Annex A**.

## Monitoring of Risks and Vulnerabilities

The Sub-Committee noted the regular information paper on external and internal risks facing Hong Kong. Members noted that a number of risks and uncertainties were creating considerable concern about the outlook for the global economic environment. Among these were the general global slowdown, especially more recently in Europe, and the declining demand for technology-related products, which had contributed to the decline in equity markets. Although some analysis suggested that the slowdown in the US had been arrested, the outlook was by no means clear. Members observed that Japan continued to be a key concern, and that a tension had arisen there between the long-term benefits of the policy measures recently proposed by the new government and the short-term effects of restructuring under those measures.

Members noted that monetary and financial conditions in Hong Kong remained stable, although the broader economy was slowing. Given the importance of

external factors to Hong Kong's economy, it was difficult to assess future developments, although it was noted that the external uncertainties affecting Hong Kong were common to most economies.

## Monetary and Financial Stability

The Sub-Committee considered a paper on the relationship between monetary and financial stability under a fixed exchange rate regime. The paper explored in particular the types of risks that a fixed exchange rate system should pay special attention to, and how far the various policy instruments available were able to manage these risks.


Members noted that the risks to financial stability under a fixed exchange system, particularly a currency board system, included the greater exposure to interest rate volatility from speculative inflows and outflows and the possibility that the economic cycles for the linked currency and the reserve currency may not be perfectly synchronised, thus exacerbating economic swings and increasing the scope for unstable dynamics to develop. Members noted that imperfect synchronisation between economic cycles had in the past created the risk of excessive optimism, which had contributed to asset market bubbles.

Members noted the various policy tools that had been introduced to manage the risks to financial stability in Hong Kong. Among these were the additional cushioning of interest rates provided under the technical measures to strengthen the Currency Board system in September 1998, and the clear policy statement made by the HKMA in 1999 on its role as lender of last resort. Members also noted the use of various prudential supervision methods to identify and manage risks. These included the monitoring of banks' exposure to the property and equity sectors, and the rule capping the maximum loan-to-value ratio at 70% for residential mortgages, as well as the development of a risk-based supervisory approach.

Discussion focused on the question of whether a more formal approach could be adopted towards managing the risks under a counter-cyclical system, not only in the light of excessive optimism during times of economic growth but also in the light of banks' reluctance to lend during downturns. Among the tools used in other jurisdictions were higher capital adequacy requirements during upswings and lower capital adequacy

requirements during downswings, and dynamic provisioning requirements to provide for greater loan provisioning during downswings. Members noted, however, that the difficulties in applying these tools to Hong Kong included the fact that capital adequacy among banks was already very high and certain technical objections to dynamic provisioning among the accounting profession. More broadly, Members also considered that it would not be easy to assess objectively whether asset prices were reflecting economic fundamentals and that frequent changes to prudential requirements could be perceived as policy inconsistency or as intervention in the market by the government.

### **Argentina's Basket Peg Proposal**

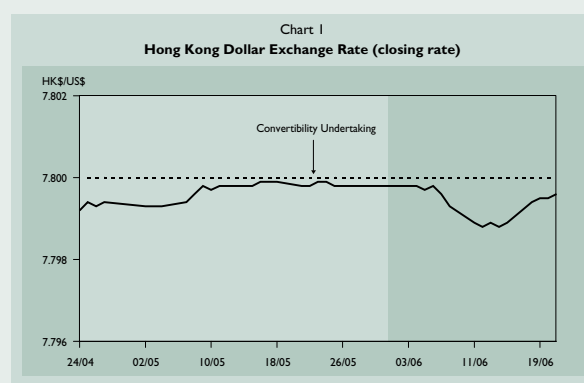
The Sub-Committee noted an information paper on the proposed basket peg in Argentina. 

## REPORT ON CURRENCY BOARD OPERATIONS (1 - 21 JUNE 2001)

The Hong Kong dollar exchange rate remained stable during the reporting period. The spread between Hong Kong dollar and US dollar interest rates for 12-month maturity nevertheless turned slightly positive, but those for shorter maturity remained negative. Partly reflecting market expectations of further US monetary easing, interbank interest rates remained soft. The monetary base decreased slightly from HK\$218.47 bn to HK\$217.53 bn, mainly due to a decrease in the outstanding amount of Certificates of Indebtedness. In accordance with Currency Board principles, changes in the monetary base were fully matched by corresponding changes in foreign reserves.

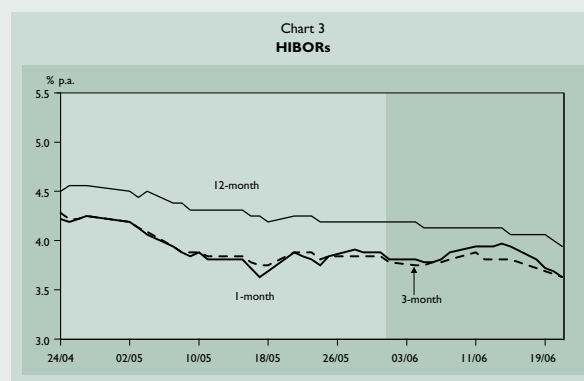
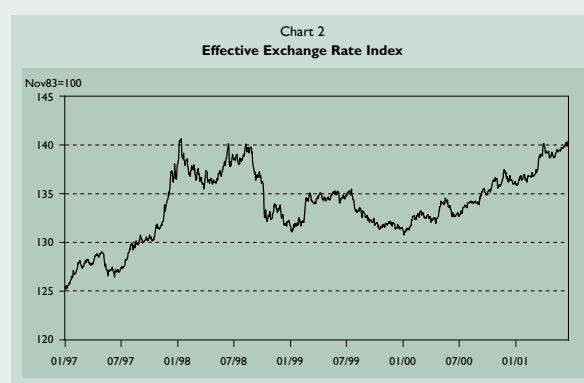
### Hong Kong Dollar Exchange Rate

The Hong Kong dollar exchange rate remained generally stable throughout the reporting period. It strengthened slightly to around 7.7988 in the second week of June on the back of increased demand for Hong Kong dollar assets, reportedly associated with some commercial buying orders. Thereafter, partly reflecting soft local interest rates, the exchange rate eased from the third week of June onwards and closed the period at 7.7996 (Charts 1 and 2).



### Interest Rates

**Interbank interest rates were largely stable during the period.** 1-month HIBOR firmed to 3.97% in the second week of June. Thereafter, reflecting in part market expectations of a rate-cut by the US Fed in late June, it eased to a low of 3.63% at the end of the period. **3-month HIBOR followed a similar pattern and closed at 3.63%, and 12-month HIBOR eased from 4.19% to 3.94%**, partly reflecting the movement of its US dollar counterparts (Chart 3).

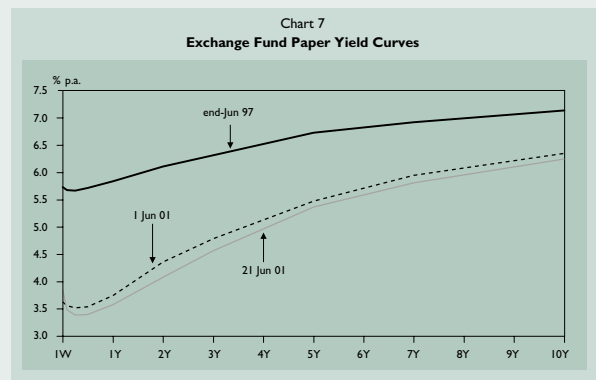
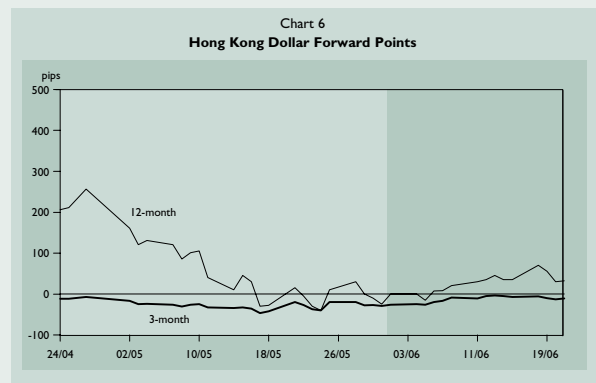
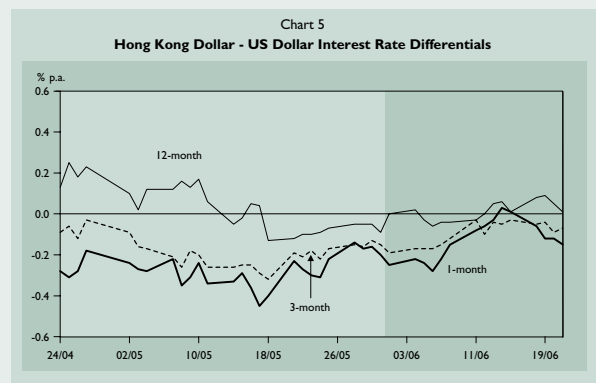
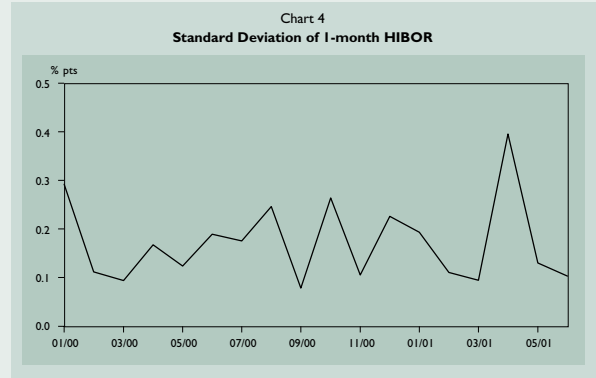


Reflecting a relatively quiet money market, **interest rate volatility** (measured by the standard deviation of 1-month HIBOR) **decreased** from 0.13 percentage point in May to 0.10 percentage point in June (up to 21 June) (Chart 4).

**The negative spreads between Hong Kong dollar interbank rates and their US dollar counterparts narrowed.** In terms of 1-month money, the negative spread narrowed and briefly turned positive in mid-June before widening again to close at 15 bp. The negative spread in terms of 3-month money narrowed from 19 bp to 7 bp, while that of 12-month turned positive and closed at 1 bp at the end of the period (Chart 5).

Reflecting the interest rate differentials between Hong Kong and US dollars, the Hong Kong dollar 3-month forward points remained at a discount, closing at -11 pips. On the other hand, 12-month forward points, which were at par at the beginning of the period, moved up and reached 70 pips before closing at 32 pips (Chart 6).

In line with the softening of local interest rates, **yields on Exchange Fund paper, except those at the very short end, declined during the period** (Chart 7). **The yield spreads between 5-year and 10-year Exchange Fund paper and US Treasuries**





widened by 19 bp and 6 bp, to close at 68 bp and 95 bp respectively (Table 1).

The **Base Rate** remained unchanged at 5.5% (Chart 8). The **Savings Rate and Best Lending Rate** also remained unchanged. The weighted average deposit rate offered by 44 major authorized institutions for 1-month time deposits increased from 3.52% on 25 May to 3.62% on 15 June. Meanwhile, the effective deposit rate decreased from 3.41% in April to 2.96% in May (Chart 9)<sup>1</sup>.

### Monetary Base

The **monetary base**, which comprises the outstanding amount of Certificates of Indebtedness (CIs), coins in circulation, the Aggregate Balance, and the outstanding amount of Exchange Fund Bills and Notes, **decreased slightly from HK\$218.47 bn to HK\$217.53 bn during the reporting period** (Table 2). Movements in individual components are discussed below.

Table 1  
Yield Spreads between Exchange Fund Paper and US Treasuries (basis points)

	27 Jun 97	1 Jun 01	21 Jun 01
3-month	56	-15	-13
1-year	21	11	18
3-year	3	12	18
5-year	27	49	68
10-year	54	89	95

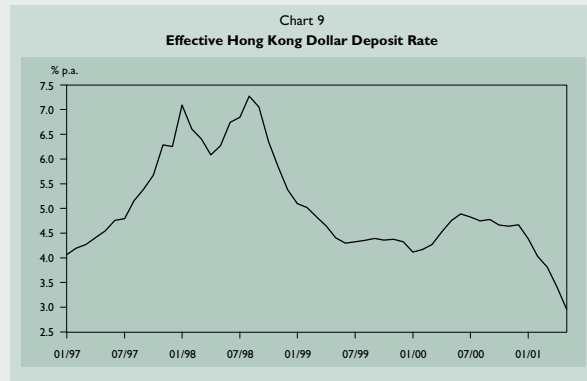
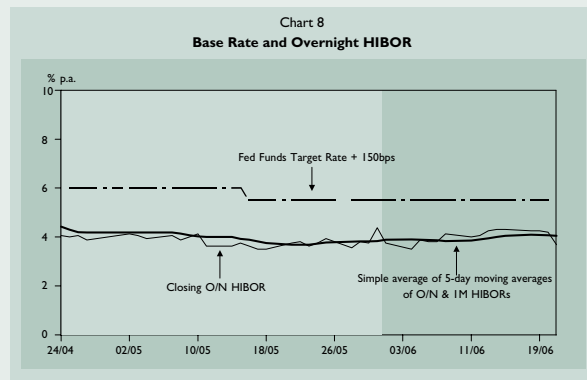


Table 2  
Monetary Base

(HK\$ bn)	1 Jun 01	21 Jun 01
CIs	98.93	97.49
Coins in Circulation	6.06	6.05
Aggregate Balance	0.49	0.52
Outstanding EFBNs	112.99	113.47
Monetary Base	218.47	217.53

<sup>1</sup> This is the weighted average of the interest rates on demand deposits, savings and time deposits. As the banking statistics classify deposits by remaining maturities, we have used certain assumptions regarding the maturity distribution to compute the effective deposit rate.

### Certificates of Indebtedness

During the period, the three note-issuing banks (NIBs) redeemed a total of HK\$1.44 bn of CIs in exchange for US\$0.18 bn. As a result, the **outstanding amount of CIs decreased** slightly from HK\$98.93 bn to HK\$97.49 bn (Chart 10).

### Coins

The total amount of **coins in circulation decreased marginally** from HK\$6.06 bn to HK\$6.05 bn during the period (Chart 11).

### Aggregate Balance

No foreign exchange operations were conducted for the currency board account during the period. The Aggregate Balance remained stable at around HK\$0.50 bn, with small changes due to interest payments and new issues of Exchange Fund paper (Chart 12).

During the period, **a total of HK\$0.40 bn of interest payments on Exchange Fund paper were made. An additional HK\$0.37 bn (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance.

### Outstanding Exchange Fund Bills and Notes

**The market value of outstanding Exchange Fund paper increased from HK\$112.99 bn to HK\$113.47 bn.** The increase was mainly a result of additional net issues (paragraph 12 above). All issues of Exchange Fund Bills and Notes were well received by the market (Table 4). **Holdings of Exchange Fund paper by the banking sector (before Discount**

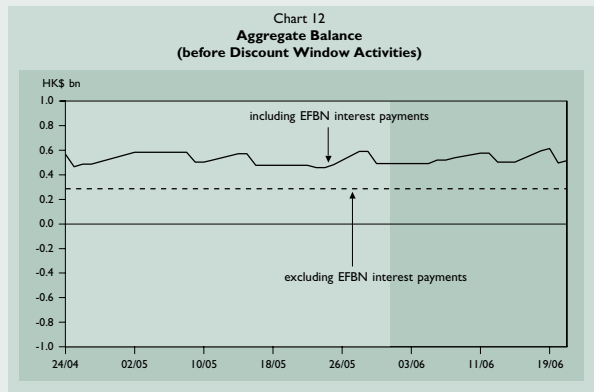
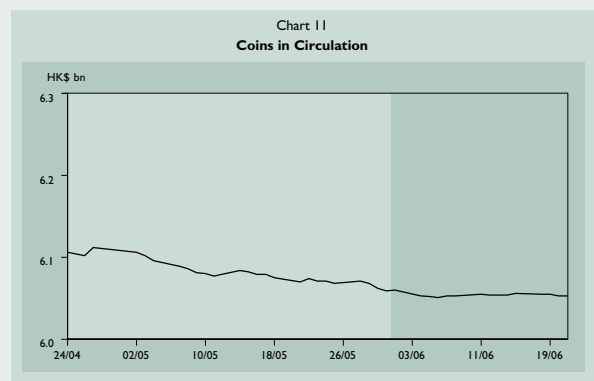
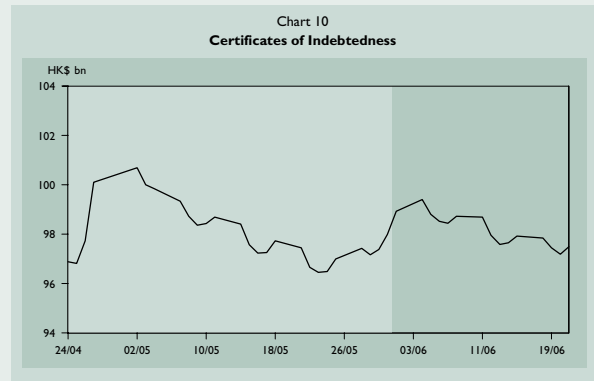


Table 4  
Issuance of Exchange Fund Paper  
(1 – 21 Jun 01)

	No. of Issues Launched	Over-subscription Ratio
3-month EFB	3	2.89-3.93
6-month EFB	1	4.35
12-month EFB	1	5.13
5-year EFN	1	4.88
10-year EFN	1	4.03

**Window activities) slightly increased** from HK\$103.79 bn (or 91.9% of total) to HK\$104.45 bn (or 92.0% of total) during the period (Chart 13).

### Discount Window Activities

For the period as a whole, **12 banks in total borrowed HK\$1.57 bn from the Discount Window**, compared with HK\$2.61 bn in the preceding period. All of the borrowings used Exchange Fund paper as collateral (Chart 14). The banks used the Discount Window facility only infrequently (Table 5).

### Backing Portfolio

Alongside a decrease in outstanding CIs during the period, backing assets fell accordingly. Nevertheless, the decline in backing assets was more moderate than that of the monetary base. As a result, the **backing ratio increased from 110.93% on 1 June to 111.26% on 21 June** (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 Hong Kong dollar exchange rate.

In May the Financial Secretary gave approval for the use of interest rate swaps (IRS) to manage the cost of issuing long-dated Exchange Fund Notes. The first Hong Kong dollar IRS transactions were conducted in June. Under the new arrangement, payable/receivable and revaluation gains/losses on IRS contracts will be included in the currency board account, and thus computation of the backing ratios. Nevertheless, the new arrangement has little impact on the backing ratio. 🌀

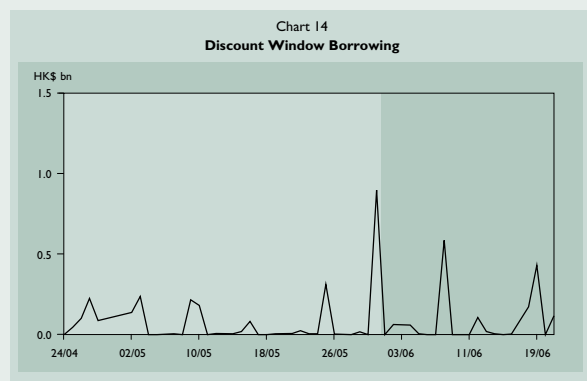
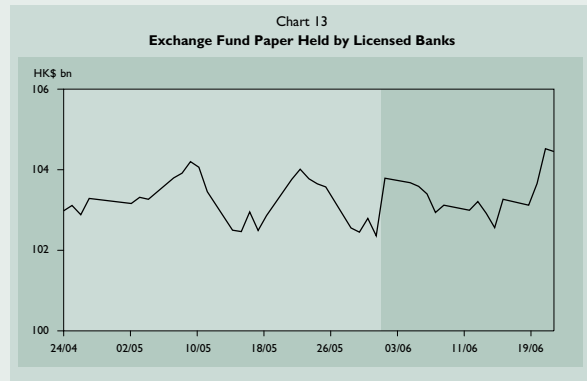


Table 5  
Frequency of Individual Bank's  
Access to the Discount Window  
(1 – 21 Jun 01)

Frequency of Using Discount Window	No. of Banks
1	8
2	2
3	1
4	1
<b>Total</b>	<b>12</b>

