

RECORD OF DISCUSSION OF THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE ON CURRENCY BOARD OPERATIONS ON 2 NOVEMBER 2001

(Approved for Issue by the Exchange Fund Advisory Committee on 29 November 2001)

Currency Board Operations for the Period 27 September - 19 October 2001

The Sub-Committee noted that, despite the unstable world situation, the Hong Kong dollar exchange and money markets had remained generally stable throughout the reporting period. Hong Kong dollar interbank interest rates had eased following the 50 bp cut in the US Fed Funds Target Rate on 2 October, and reflecting market expectations of further US rate cuts. They had stayed below their US dollar counterparts for most of the period, although towards the middle of October, they had risen slightly above US rates, following market reports and concerns that a change to Hong Kong's monetary system was being contemplated, and worries about the impact of the crisis in Argentina. Members noted that market sentiment on these issues had also been reflected in the Hong Kong dollar 12-month forward points, which had moved sharply higher in mid-October, registering a premium against the US dollar.

The Sub-Committee noted that, in accordance with Currency Board principles, changes in the monetary base continued to be fully matched by 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. Members noted that there was no evidence that the economic downturn in the US was moderating, moreover, the slowdown in economic activity in the euro zone was now clearer. The repricing of risks and the inevitable boost in insurance and security-related expenditure by both the public and private sectors were likely to have long-term macroeconomic effects. Members also noted the deteriorating situation in Japan. Against the backdrop of worsening economic conditions worldwide, Argentina's public debt problem had developed into a major financial crisis, the impact of which had created some slight volatility in the Hong Kong dollar 12-month forward market around the middle of October.

With regard to Hong Kong's economy, the Sub-Committee noted that the October consensus forecast for 2001 GDP growth had been revised downwards to slightly below zero, and that unemployment was increasing. They observed that this deterioration was a reflection of the world downturn, which was having a particularly severe impact on Asia, and was not the result of risks or vulnerabilities specific to Hong Kong.

Sources of Unemployment

The Sub-Committee noted an information paper on the main determinants of unemployment in Hong Kong with reference to the two components of the unemployment rate: the natural rate and the cyclical component. The analysis suggested that the natural unemployment rate had edged up from around 2-3% in the early 1990s to around 3-4% in more recent years, reflecting structural changes in the economy. This rate was still nevertheless low by international standards, and it suggested that Hong Kong's labour market had been highly flexible in adapting to changing conditions. The paper also observed that most of the variations in the unemployment rate in recent years were attributable to cyclical conditions.


Measures of Core Inflation in Hong Kong

The Sub-Committee noted an information paper examining different approaches to measuring core inflation in Hong Kong. The paper observed that in many economies alternative indicators to the "headline" statistic based on the overall Consumer Price Index were found to provide superior measures of underlying inflation. By contrast, the evidence suggested that in Hong Kong the headline inflation rate and various core inflation measures showed strikingly similar trends, and did not differ significantly in terms of volatility. Thus, the CCPI constituted a very good measure of inflation in Hong Kong.

Inflation Targeting in Asia

The Sub-Committee noted an information paper reporting on inflation targeting policies in various Asian economies.

Hong Kong's External Claims and Liabilities vis-à-vis Mainland China

The Sub-Committee noted an information paper on the considerable increase in 2000 in Hong Kong's banks' net external liabilities vis-à-vis the Mainland. The main contributory factors to this increase included fund-raising activities of H-share enterprises, surplus foreign currency liquidity in the Mainland's banking system, changes in the Mainland's foreign exchange policy, and foreign banks' cautious lending attitude towards the Mainland. Although still small as a proportion of total Hong Kong funding, the significant rise in Hong Kong dollar net liabilities vis-à-vis the Mainland accounted for nearly two thirds of the overall increase in Hong Kong dollar funding in Hong Kong's banking system. The increase may also have contributed to a softening of Hong Kong dollar interest rates. 

REPORT ON CURRENCY BOARD OPERATIONS (27 SEPTEMBER - 19 OCTOBER 2001)

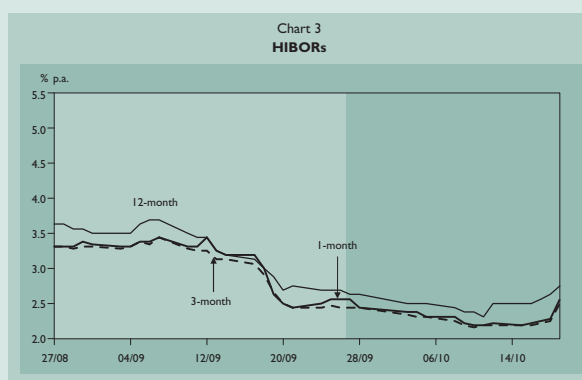
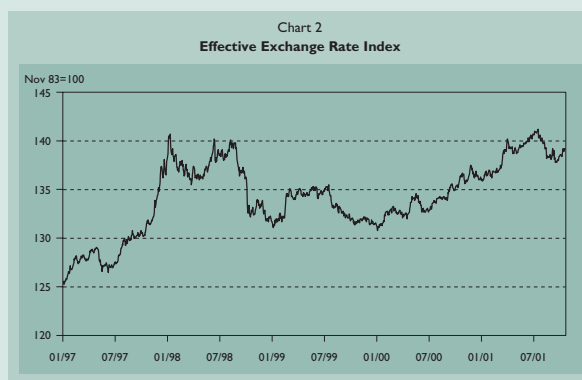
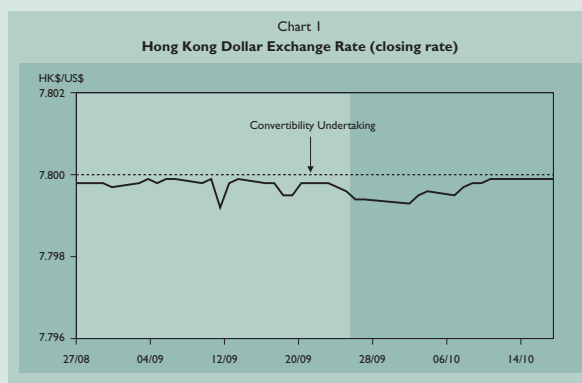
The Hong Kong dollar exchange and money markets remained stable during the reporting period despite increased tensions in Afghanistan. Local interbank interest rates eased alongside the 50 bp cut in the US Fed Funds Target Rate on 2 October and market expectations of further US rate-cuts. Nevertheless, towards the end of the period, amid market rumours of a change in the linked exchange rate system and increased commercial hedging orders, interbank interest rates rose modestly above US interest rates. The monetary base increased from HK\$223.91 bn to HK\$226.08 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

Despite the commencement of military operations in Afghanistan and increased volatility in Argentina's financial markets, the Hong Kong dollar exchange rate remained stable throughout the reporting period. Partly reflecting increased demand for Hong Kong dollar assets, reportedly equity-related, the exchange rate strengthened in the first half of the period. Thereafter, on the back of soft local interest rates and market rumours about possible alterations to the linked exchange rate system, the exchange rate eased to a level very close to the linked rate at 7.8000 towards the end of the period (Chart 1 and Chart 2).

Interest Rates

Interbank interest rates were largely stable during the period. Reflecting in part the 50 bp rate-cut in the US Fed Funds Target Rate on 2 October and expectation of further easing, 1-month HIBOR eased in the first half of the period. Nevertheless, amid market rumours about possible changes in the exchange rate system as well as increased commercial hedging orders, 1-month HIBOR firmed towards the end of the period, closing at 2.56%. 3-month HIBOR tracked closely the movement of 1-month HIBOR and closed at 2.50%. 12-month HIBOR also edged up from 2.63% to 2.75% during the period (Chart 3).

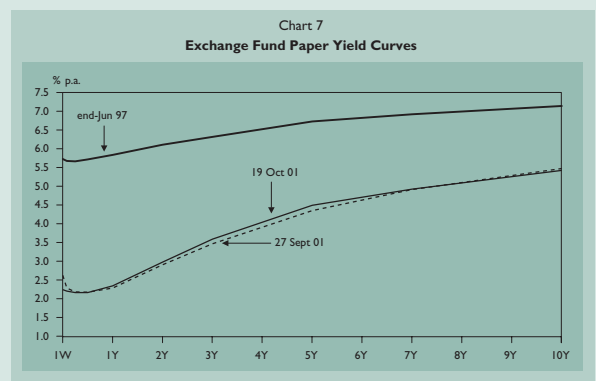
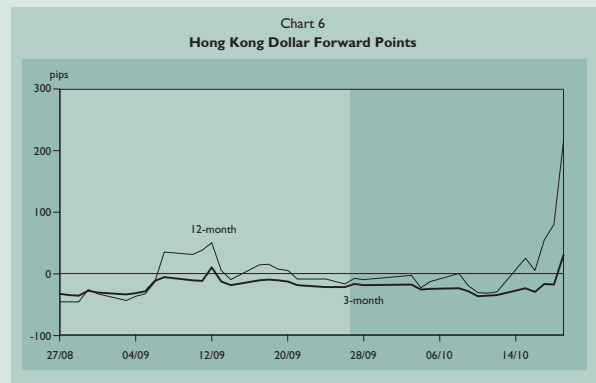
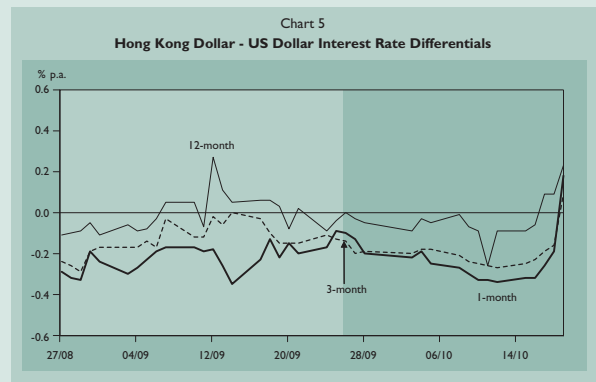
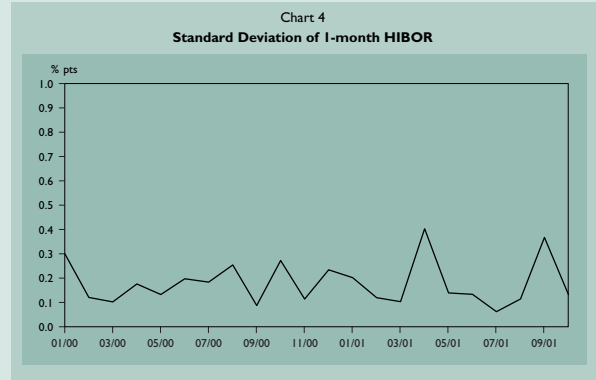


Interest rate changes, measured by the **standard deviation of 1-month HIBOR**, decreased slightly from 0.36 percentage points in September to 0.10 percentage points in October (up to 19 October) (Chart 4).

Hong Kong dollar interbank interest rates stayed below their US dollar counterparts during most of the period. Towards the end of the period, however, the spreads turned positive. The spreads in terms of 1-month and 3-month money closed at 18 bp and 9 bp respectively. The negative spread in terms of 12-month money at one point widened to 26 bp in mid-October. It then reversed to a positive spread towards the end of the period and closed at 23 bp (Chart 5).

Reflecting the interest rate differentials between the Hong Kong dollar and the US dollar, Hong Kong dollar 3-month forward points turned into a premium of 30 pips at the end of the period. 12-month forward points, which was at a discount of -8 pips in the beginning of the period, moved up sharply in mid-October and reached 215 pips at the end of the period (Chart 6).

Yields on Exchange Fund paper were little changed during the period (Chart 7). The yield spreads between 5-year and 10-year Exchange Fund



paper and US Treasuries widened by 10 bp and 1 bp, to 64 bp and 79 bp respectively (Table 1).

Following the 50 bp rate cut in the US Fed Funds Target Rate on 2 October, the **Base Rate was adjusted downwards on 3 October to 4.00%** in accordance with the established formula (Chart 8). The **Best Lending Rate offered by major banks was also lowered from 6.00% to 5.50%**.

The weighted average deposit rate offered by 43 major authorized institutions for 1-month time deposits decreased from to 3.06% on 31 August to 2.59% in 28 September. Meanwhile, the effective deposit rate decreased from 2.22% in August to 1.82% in September (Chart 9).¹

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 from HK\$223.91 bn to HK\$226.08 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	27-Sep-01	19-Oct-01
3-month	56	-16	-22
1-year	21	-12	5
3-year	3	18	19
5-year	27	54	64
10-year	54	78	79

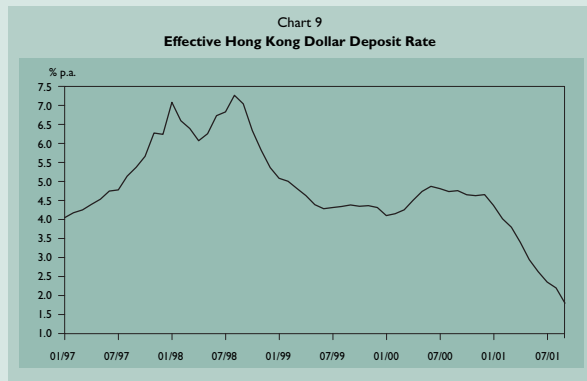
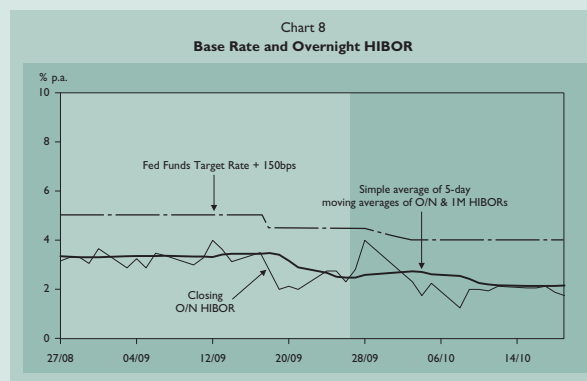


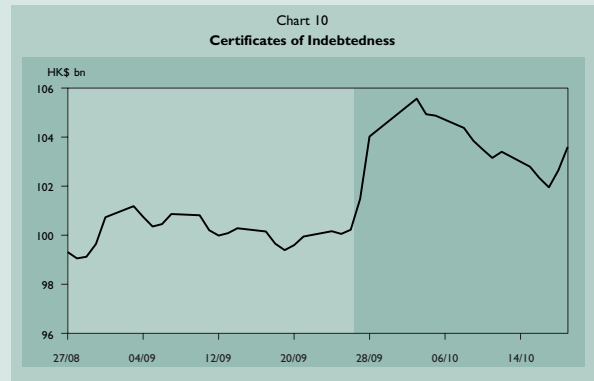
Table 2
Monetary Base

(HK\$ bn)	27-Sep-01	19-Oct-01
CIs	101.49	103.61
Coins in Circulation	5.99	5.97
Aggregate Balance	0.50	0.49
Outstanding EFBNs	115.93	116.01
Monetary Base	223.91	226.08

¹ This is the weighted average of the interest rates on demand, 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.

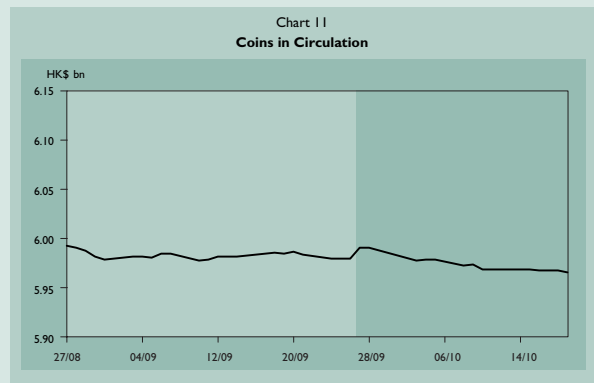
Certificates of Indebtedness

Owing to increased demand for banknotes by the public ahead of the long holidays in early October, the three note-issuing banks (NIBs) submitted to the HKMA a total of US\$0.52 bn in exchange for HK\$4.08 bn worth of Certificates of Indebtedness (CIs) between 27 September and 3 October. They then redeemed a total of HK\$1.96 bn of CIs in exchange for US\$0.25 bn during the rest of the period. As a result, the **outstanding amount of CIs increased** from HK\$101.49 bn to HK\$103.61 bn (Chart 10).



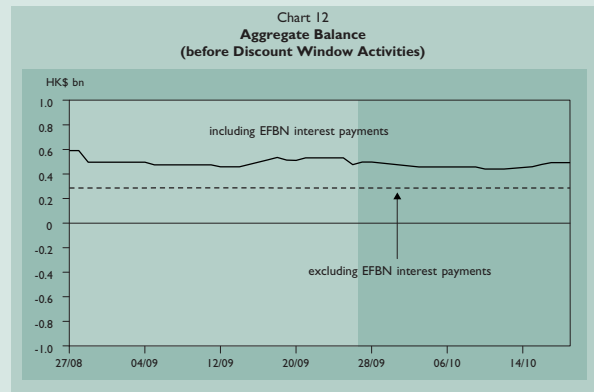
Coins

The total amount of **coins in circulation decreased marginally** from HK\$5.99 bn to HK\$5.97 bn during the period (Chart 11).



Aggregate Balance

In the absence of foreign exchange operations conducted for the currency board account, the **Aggregate Balance remained stable at around HK\$0.50 bn**, with small fluctuations due to interest payments and new issues of Exchange Fund paper (Chart 12).



During the period, a total of HK\$0.14 bn of interest payments on Exchange Fund paper were made, while an additional HK\$0.12 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\$115.93 bn to HK\$116.01 bn. The increase was mainly a result of additional net issues (paragraph above). All issues of Exchange Fund Bills and Notes were well received by the market (Table 4). **Holdings of Exchange Fund**

Table 4
Issuance of Exchange Fund Paper
(27 Sep – 19 Oct 01)

	No. of Issues Launched	Over-subscription Ratio
1-month EFB	1	21.43
3-month EFB	3	2.81–6.44
6-month EFB	2	5.63–6.13

paper by the banking sector (before Discount Window activities) decreased marginally from HK\$109.87 bn (94.8% of total) to HK\$109.15 bn (94.1% of total) during the period (Chart 13).

Discount Window Activities

For the period as a whole, **15 banks in total borrowed HK\$4.11 bn from the Discount Window**, compared with HK\$1.47 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 111.78% on 27 September to 111.59% on 19 October** (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. 🌀

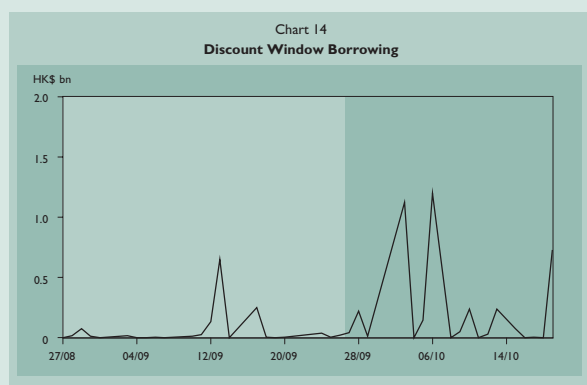
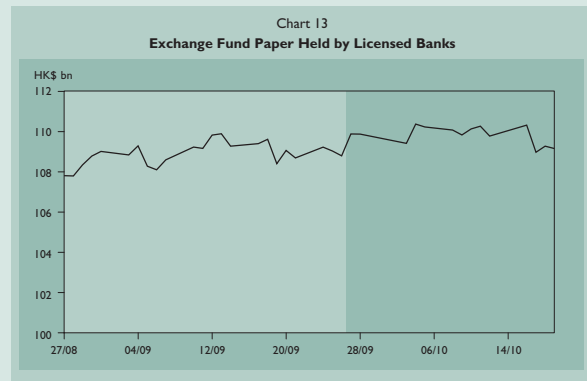
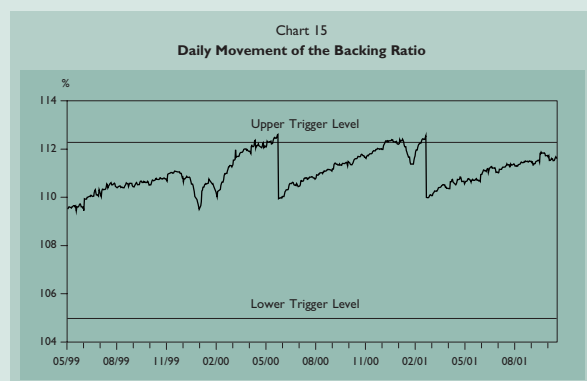


Table 5
Frequency of Individual Bank's
Access to the Discount Window
(27 Sep – 19 Oct 01)

Frequency of Using Discount Window	No. of Banks
1	12
2	2
>3	1
Total	15



REPORT ON CURRENCY BOARD OPERATIONS (20 OCTOBER - 28 NOVEMBER 2001)

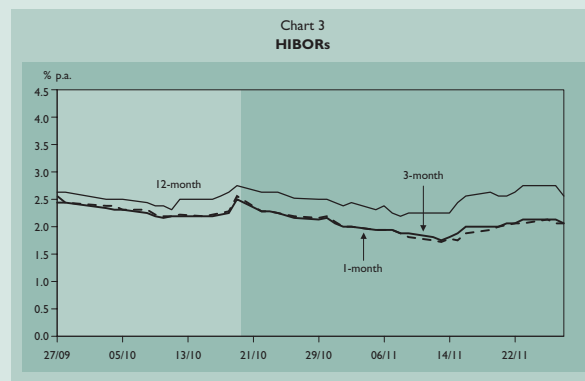
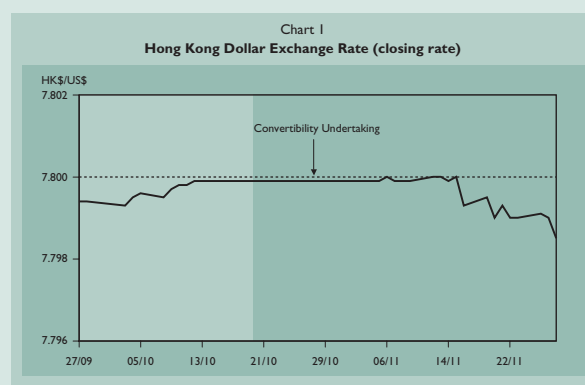
The Hong Kong dollar exchange and money markets remained stable during the reporting period. Local interbank interest rates eased following the 50 bp cut in the US Fed Funds Target Rate on 6 November. In mid-November, the Aggregate Balance contracted upon the triggering of the Convertibility Undertaking. As a result, short-term interest rates firmed and the exchange rate strengthened. During the reporting period, the monetary base decreased from HK\$226.10 bn to HK\$224.00 bn, mainly as a result of 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 was stable and it strengthened towards the end of the reporting period. Reflecting in part soft Hong Kong dollar interest rates, the exchange rate stayed very close to the linked rate of 7.8000 during the first half of the period. The Convertibility Undertaking was triggered on 16 November, leading to a shrinkage in the Aggregate Balance. In response, interbank interest rates firmed, and the exchange rate strengthened towards the end of the period before closing at 7.7985 (Charts 1 and 2).

Interest Rates

Interbank interest rates remained stable during the period. Reflecting in part the 50 bp rate-cut in the US Fed Funds Target Rate on 6 November, Hong Kong dollar interest rates eased in the first half of the period. They then firmed alongside the reduction in the Aggregate Balance resulting from the triggering of the Convertibility Undertaking. Overnight HIBOR stayed close to the Base Rate of 3.50% after the Aggregate Balance fell to around HK\$0.1 bn (Chart 8). 1-month and 3-month HIBORs both closed at 2.06%, compared to 2.28% at the beginning of the period. 12-month HIBOR eased slightly from 2.75% to 2.56% during the period (Chart 3).

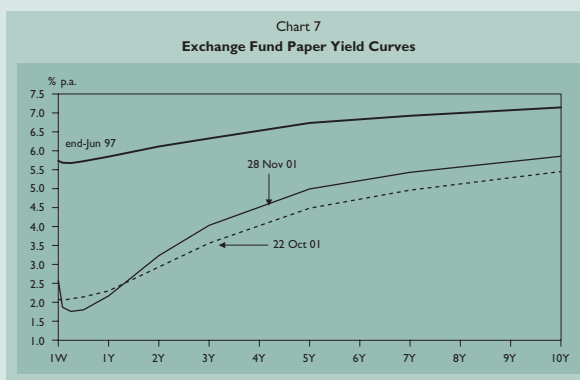
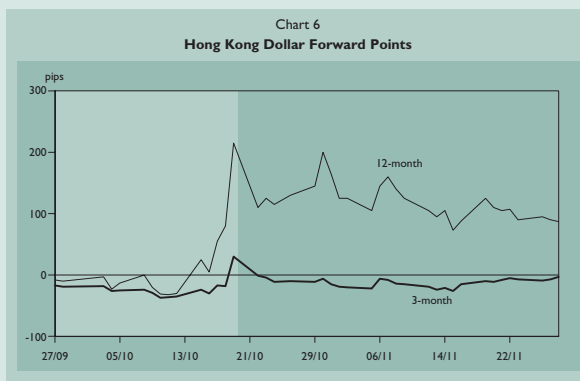
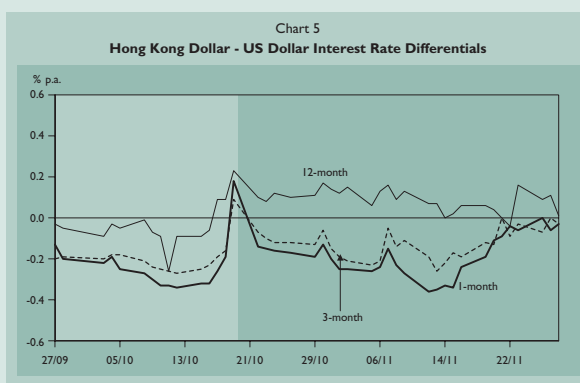
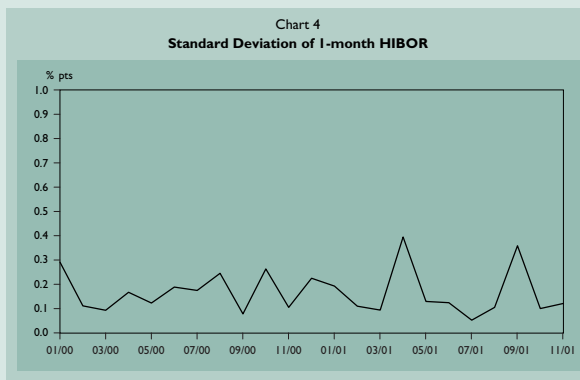


Interest rate volatility, measured by the **standard deviation of 1-month HIBOR**, edged up from 0.10 percentage points in October to 0.12 percentage points in November (up to 28 November) (Chart 4).

1-month and 3-month Hong Kong dollar interbank interest rates stayed below their US dollar counterparts during most of the period. Nevertheless, as Hong Kong dollar interest rates rose as a result of the contraction in the Aggregate Balance, the negative spreads narrowed from mid-November onwards and were almost eliminated at the end of the period. The positive spread in terms of 12-month money generally narrowed during the period to close at only 1 bp at the end of the period (Chart 5).

Reflecting the interest rate differentials between the Hong Kong dollar and the US dollar, Hong Kong dollar 3-month forward points was at a small discount during most of the period. Despite renewed pressure in Argentina's financial markets, the 12-month forward point, which was at a premium of 215 pips in the beginning of the period, gradually came down to reach 87 pips at the end of the period (Chart 6).

Yields on Exchange Fund paper, except for those at the short-end, increased during the period reflecting in part the movements of the US Treasury yield curve (Chart 7). The yield curve became inverted at the short-end as short-term rates firmed. The yield spread between 5-year and 10-year Exchange



Fund paper and US Treasuries widened slightly by 8 bp and 11 bp, to 69 bp and 88 bp respectively (Table 1).

Following the 50 bp rate cut in the US Fed Funds Target Rate on 6 November, the **Base Rate was adjusted downwards to 3.50% on 7 November** in accordance with the established formula (Chart 8). **The Best Lending Rate offered by major banks was lowered by 25 bp from 5.50% to 5.25%.**

The average deposit rate offered by 10 major authorized institutions for 1-month time deposits decreased from 0.88% on 19 October to 0.70% on 28 November.¹ Meanwhile, the effective deposit rate decreased from 1.82% in September to 1.24% in October (Chart 9).²

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 from HK\$226.1 bn to HK\$224.0 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	22-Oct-01	28-Nov-01
3-month	56	4	-23
1-year	21	5	15
3-year	3	32	35
5-year	27	61	69
10-year	54	77	88

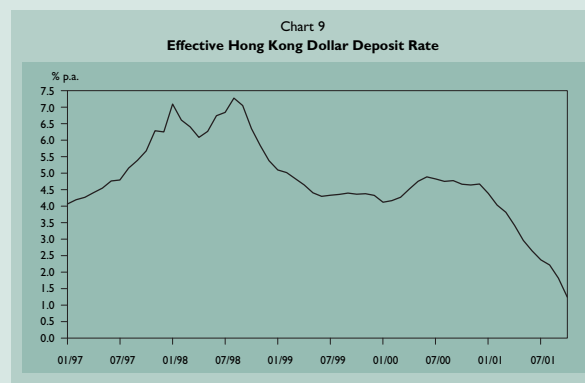
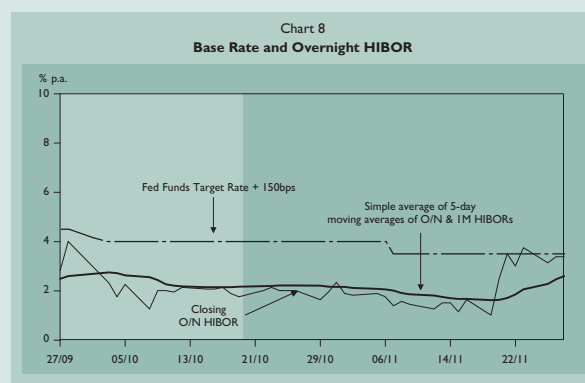


Table 2
Monetary Base

(HK\$ bn)	22-Oct-01	28-Nov-01
CIs	103.56	101.90
Coins in Circulation	5.96	5.93
Aggregate Balance	0.49	0.13
Outstanding EFBNs	116.10	116.04
Monetary Base	226.10	224.00

¹ The quoted figures refer to the average of interest rates offered by 10 major authorized institutions for one-month time deposits of amount less than HK\$100,000.

² This is the average of the interest rates on demand, 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

The three note-issuing banks redeemed a total of HK\$1.66 bn of CIs in exchange for US\$0.21 bn from the HKMA between 22 October and 28 November. As a result, the **outstanding amount of CIs decreased from HK\$103.56 bn to HK\$101.90 bn** (Chart 10).

Coins

The total amount of **coins in circulation decreased marginally from HK\$5.96 bn to HK\$5.93 bn** during the period (Chart 11).

Aggregate Balance

The Aggregate Balance stayed at around HK\$0.50 bn during the first three weeks of the period. **Following the purchase of Hong Kong dollars amounting to HK\$0.39 bn by the HKMA under the Convertibility Undertaking on 16 November, it shrank to a level of around HK\$0.1 bn** (Chart 12 and Table 3).

During the period, a **total of HK\$0.37 bn of interest payments on Exchange Fund paper were made**. Taking into account the interest payments carried forward from the previous reporting period, **an additional HK\$0.52 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 decreased slightly from HK\$116.10 bn to HK\$116.04 bn**. 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) decreased marginally from HK\$109.30 bn** (94.15% of

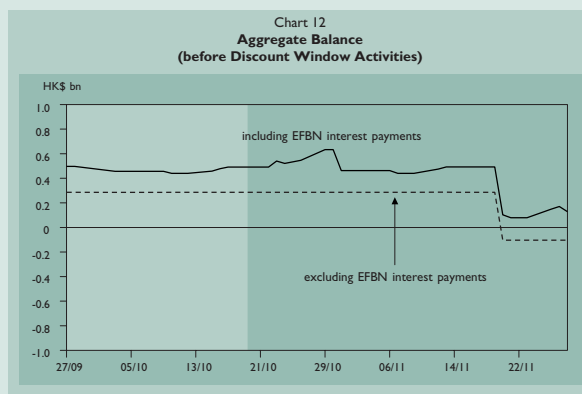
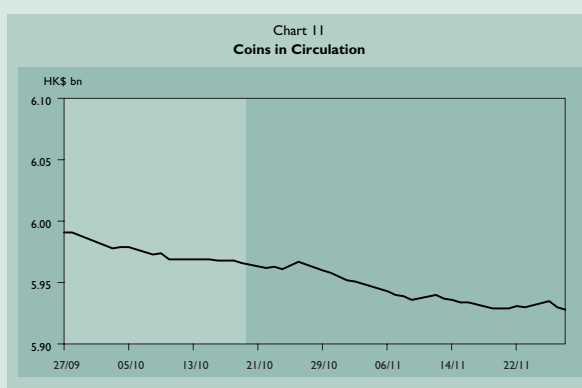
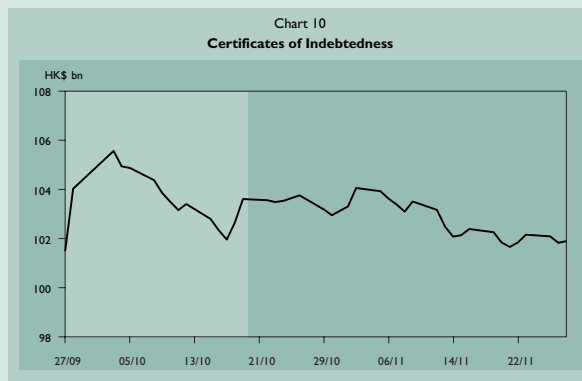


Table 3
HKMA HK\$/US\$ FX Transaction
(20 Oct – 28 Nov 01)

Trade Date	Net HK\$ purchase (+) (HK\$ mn)
16 Nov	+390

total) to HK\$109.04 bn (94.0% of total) during the period (Chart 13).

Discount Window Activities

For the period as a whole, **27 banks in total borrowed HK\$5.47 bn from the Discount Window**, compared with HK\$4.11 bn in the preceding period. All except one of the borrowings used Exchange Fund paper as collateral (Chart 14). The banks used the Discount Window facility only infrequently (Table 5).

Backing Portfolio

Backing assets decreased during the period, due in part to a decline in the outstanding CIs and the Aggregate Balance, and in part valuation losses. **As a result, the backing ratio declined slightly from 111.57% on 22 October to 111.41% on 28 November** (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 4
Issuance of Exchange Fund Paper and Notes
(20 Oct – 28 Nov 01)

	No. of Issues Launched	Over-subscription Ratio
3-month EFB	6	2.45-8.02
6-month EFB	3	3.90-6.04
1-year EFB	2	3.62-6.61
2-year EFN	1	6.76
3-year EFN	1	3.12

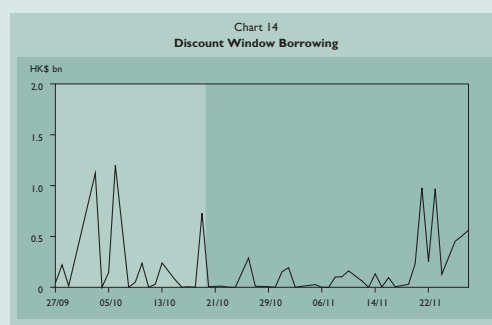
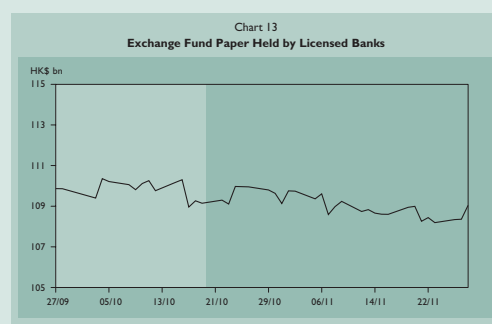
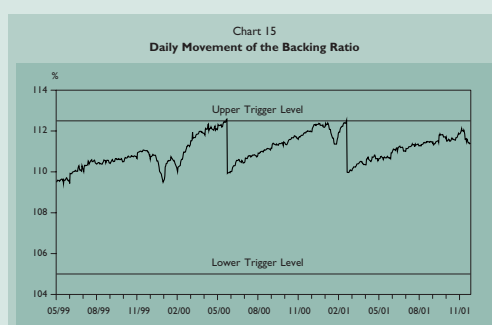


Table 5
Frequency of Individual Bank's
Access to the Discount Window
(20 Oct – 28 Nov 01)

Frequency of Using Discount Window	No. of Banks
1	18
2	6
>3	3
Total	27



RECORD OF DISCUSSION OF THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE ON CURRENCY BOARD OPERATIONS ON 4 JANUARY 2002

(Approved for Issue by the Exchange Fund Advisory Committee on 24 January 2002)

Currency Board Operations for the Period 29 November - 19 December 2001

The Sub-Committee noted that the Hong Kong dollar had been generally stable during the period under review. Amid tightening interbank liquidity, the HKMA had, in response to banks' offers, sold a total of HK\$0.23 bn, resulting in an expansion of the Aggregate Balance and a consequent softening of interbank interest rates. Interbank interest rates had further eased in the second week of December, following the 25 bps cut in the US Fed Funds Target Rate. Towards the end of the period, there had, as usual, been an increased demand for the Hong Kong dollar, partly reflecting market anticipation of higher local interest rates during the year-end period: the exchange rate had, as a result, strengthened. The Sub-Committee observed that, largely as a result of net interest income on backing assets and an increase in the outstanding amount of Certificates of Indebtedness, the backing ratio had increased during the period, although, at 111.60% at the end of the period, it was still some distance away from the trigger point of 112.5%, at which assets would be transferred from the Backing Portfolio to the Investment portfolio sufficient to reduce the backing ratio to 110%.

Members noted that neither the crisis in Argentina nor concerns about the depreciation of the yen had had much impact on the Hong Kong dollar exchange and money markets. With reference in particular to the Argentinian situation, it appeared that the markets were clearly differentiating between Hong Kong's currency board system and that in Argentina.

The Sub-Committee noted that, in accordance with Currency Board principles, changes in the monetary base continued to be fully matched by 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 on external and internal risks facing Hong Kong. Members observed that, externally, the situation in the major economies was continuing to evolve very slowly. There had been little hard evidence of any improvement in the indicators for the fourth quarter of 2001. More recently, however, some indicators suggested the

beginnings of an upturn in the US economy, though it was too early to say whether these would be sustained. A particular concern was the deterioration in the labour markets of both the US and Japan, which could have a negative impact on consumer confidence and spending. Members noted the depreciation of the yen during the period under review. This was, in a sense, a two-edged sword: it raised concerns about pressures on other currencies in the region; yet if it helped stimulate Japanese economic growth this would generally be of benefit to the region. Members also noted that, so far, there had been little contagion from the Argentinian crisis into other markets. If, however, the peso devalued, the risk of contagion could increase.

The Sub-Committee noted that, for Hong Kong, the indicators continued to point to a slowdown in economic activity, despite an increase in the transaction volume of residential properties in November. The slowdown was expected to continue well into 2002, although there continued to be uncertainty about the prospects for growth for the year as a whole. Members noted that a particular concern was the continuing difficult fiscal situation.

Estimating Hong Kong's Output Gap and its Impact on Inflation

The Sub-Committee noted an information paper on Hong Kong's output gap and its relationship with inflation, with particular reference to the deceleration in Hong Kong's growth from an annual average of 7% in the period 1977-1994 to 3.5% in 1995-2000. The analysis in the paper suggested that, although Hong Kong's potential growth had moderated since the Asian financial crisis, it was still above the average of the G-7 countries. The negative output gap, which had emerged in 1998-9, had virtually vanished following the strong recovery in 2000, although a negative output gap was likely to re-emerge in 2001. The analysis suggested that the output gap had a significant impact on inflation both in the short run and the long run. A change in the import price had a significant contemporaneous effect on inflation, and was fully passed through to the domestic price over the long run. According to the research, the current deflation process was more a cyclical than a structural phenomenon, and was likely to continue in the immediate future as a result of the possible re-emergence of a negative output gap in 2001 and the long-run effect of the negative gaps of 1998-2000. 

REPORT ON CURRENCY BOARD OPERATIONS (29 NOVEMBER - 19 DECEMBER 2001)

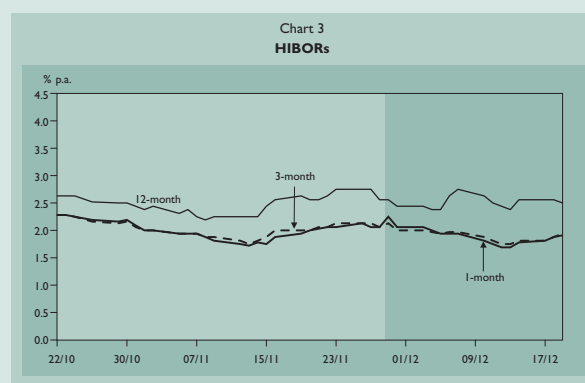
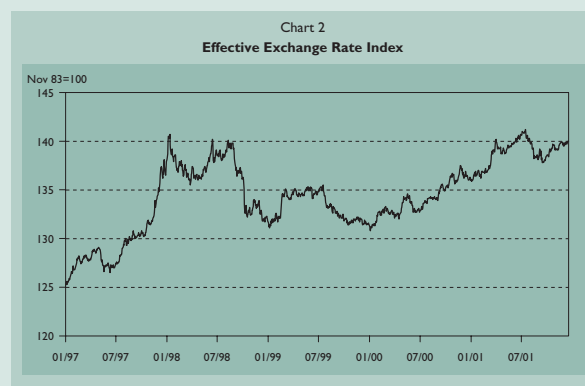
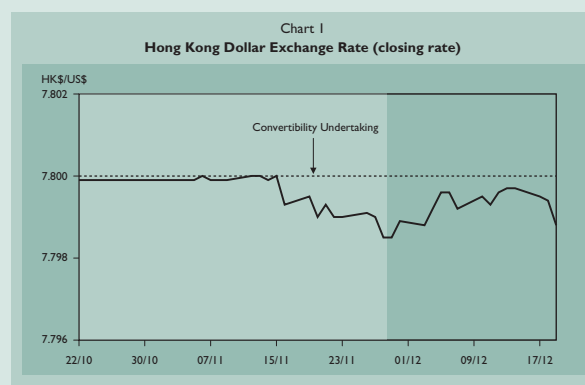
Notwithstanding increased volatility in Argentina's financial markets, the Hong Kong dollar exchange and money markets remained stable during the reporting period. In response to bank offers, the HKMA sold Hong Kong dollars in late November, leading to an expansion in the Aggregate Balance. Interbank interest rates eased during the period, reflecting partly an increase in interbank liquidity, and partly the 25 bp cut in the US Fed Funds Target Rate in the second week of December. The monetary base increased from HK\$224.57 bn to HK\$226.32 bn, mainly as a result of 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

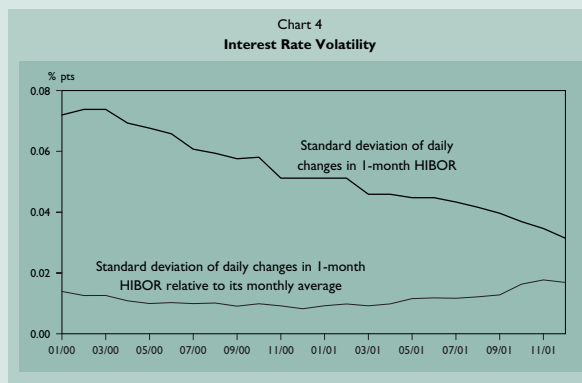
The Hong Kong dollar exchange rate remained stable throughout the reporting period despite increased volatility in Argentina's financial markets. Amid tight interbank liquidity, the HKMA sold a total of HK\$0.23 bn on 30 November in response to banks' offer. The Aggregate Balance expanded accordingly, leading to a softening of local interbank interest rates and an easing of the exchange rate. Thereafter, partly reflecting market anticipation of higher local interest rates during the year-end period, there was increased demand for Hong Kong dollar. As a result, the exchange rate strengthened towards the end of the period and closed at 7.7988 (Charts 1 and 2).

Interest Rates

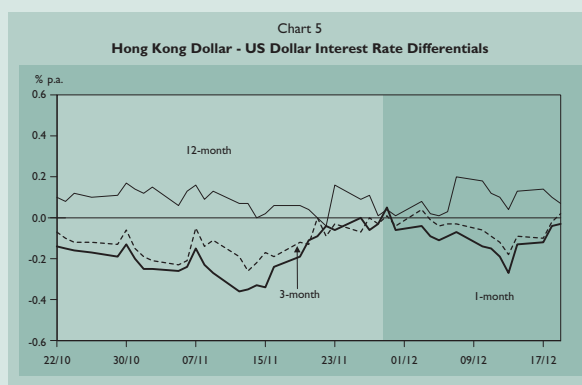
Interbank interest rates remained stable during the period. Reflecting partly an expansion in the Aggregate Balance in late November, and partly the 25 bp rate-cut in the US Fed Funds Target Rate on 11 December, Hong Kong dollar interest rates eased in the first half of December. Thereafter, reflecting increased demand for Hong Kong dollar funding during the year-end period, local interest rates firmed slightly towards the end of the period. 1-month and 3-month HIBORs closed at 1.91% and 1.94% respectively, compared to 2.25% and 2.13% at the beginning of the period. 12-month HIBOR eased slightly from 2.56% to 2.50% during the period (Chart 3).



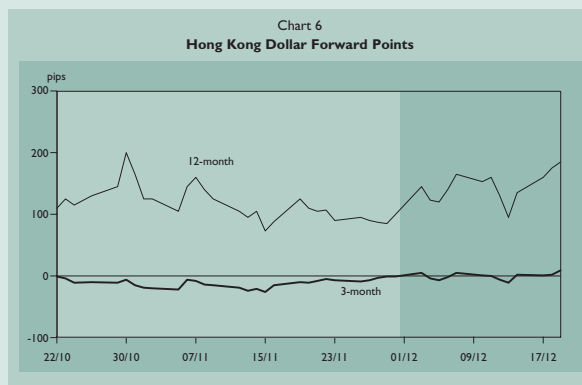
Interest rate volatility, measured by the standard deviation of daily changes in 1-month HIBOR relative to its monthly average, **decreased** from 0.018 percentage points in November to 0.017 percentage points in December (up to 19 December).¹ Reflecting the easing trend in local interest rates, the standard deviation of daily changes in 1-month HIBOR has been decreasing throughout the year (Chart 4).



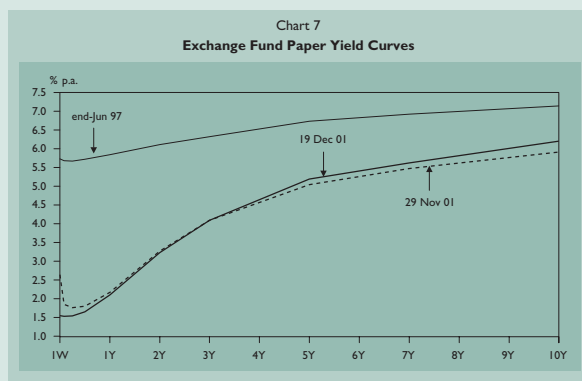
1-month and 3-month Hong Kong dollar interbank interest rates stayed below their US dollar counterparts during most of the period. Nevertheless, as Hong Kong dollar interest rates firmed towards the end of the period, the negative spreads narrowed from the second week of December onwards and were largely eliminated at the end of the period. The positive spread in terms of 12-month money widened slightly during the period to close at 7 bp at the end of the period (Chart 5).



Reflecting the interest rate differentials between the Hong Kong dollar and the US dollar, Hong Kong dollar 3-month forward points stayed close to par during most of the period. Amid increased pressure in Argentina's financial markets, 12-month forward point rose to 185 pips at the end of the period (Chart 6).



Reflecting in part the movements of the US Treasury yield curve, **yields on Exchange Fund paper, except for those at the short-end, increased slightly during the period** (Chart 7). The yield spread between 5-year and 10-year Exchange Fund paper



¹ The standard deviation of daily changes in 1-month HIBOR relative to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates, which may vary over time.

and US Treasuries widened by 10 bp and 14 bp, to 74 bp and 104 bp respectively (Table 1).

Following the 25 bp rate cut in the US Fed Funds Target Rate on 11 December, the **Base Rate was adjusted downwards to 3.25% on 12 December** in accordance with the established formula (Chart 8). **The Best Lending Rate offered by major banks was lowered by 12.5 bp from 5.25% to 5.125%.**

The average deposit rate offered by 10 major authorized institutions for 1-month time deposits decreased from 0.70% on 28 November to 0.43% on 19 December.² Meanwhile, the effective deposit rate decreased from 1.24% in October to 0.91% in November (Chart 9).³

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 from HK\$224.6 bn to HK\$226.3 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	29-Nov-01	19-Dec-01
3-month	56	-13	-19
1-year	21	23	30
3-year	3	39	44
5-year	27	64	74
10-year	54	90	104

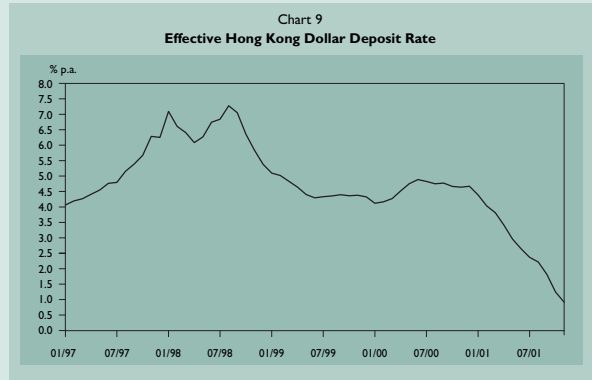
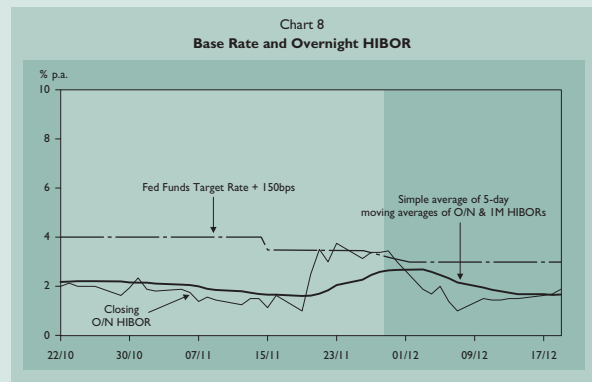


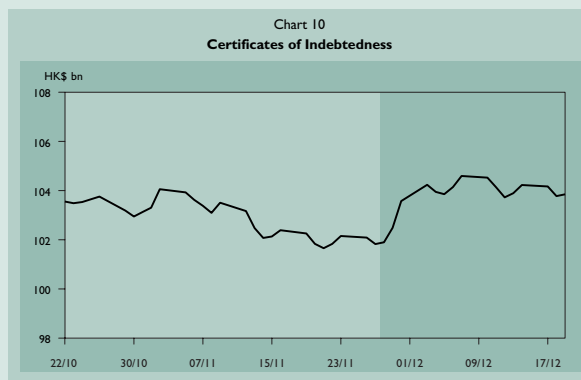
Table 2
Monetary Base

(HK\$ bn)	29-Nov-01	19-Dec-01
CIs	102.48	103.85
Coins in Circulation	5.93	5.94
Aggregate Balance	0.13	0.33
Outstanding EFBNs	116.03	116.20
Monetary Base	224.57	226.32

2 The quoted figures refer to the average of interest rates offered by 10 major authorized institutions for one-month time deposits of amount less than HK\$100,000.
3 This is the average of the interest rates on demand, 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.

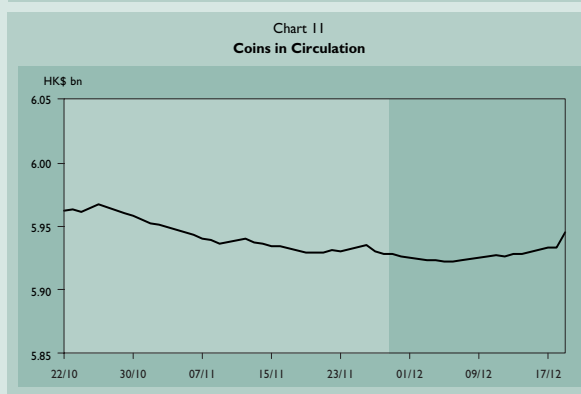
Certificates of Indebtedness

Reflecting in part increased demand for banknotes by the public before the seasonal holidays, the outstanding amount of CIs increased during the period. For the period as a whole, the three note-issuing banks (NIBs) submitted to the HKMA a total of US\$0.18 bn in exchange for HK\$1.37 bn worth of CIs. As a result, the **outstanding amount of CIs increased from HK\$102.48 bn to HK\$103.85 bn** (Chart 10).



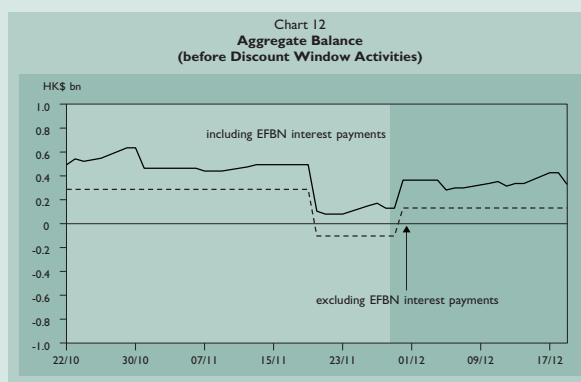
Coins

The total amount of **coins in circulation increased marginally** from HK\$5.93 bn to HK\$5.94 bn during the period (Chart 11).



Aggregate Balance

Following the sale of HK\$0.23 bn by the HKMA in response to banks' offer on 30 November, the Aggregate Balance increased to a **level of around HK\$0.30 bn** and remained stable during the rest of the period (Chart 12 and Table 3).



During the period, a **total of HK\$0.24 bn of interest payments on Exchange Fund paper were made**. Taking into account the interest payments carried forward from the previous reporting period, **an additional HK\$0.27 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 slightly from HK\$116.03 bn to HK\$116.20 bn. The increase was mainly a result of additional net issues (paragraph 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) decreased marginally** from HK\$109.11 bn (94.04% of total) to HK\$108.59 bn (93.45% of total) during the period (Chart 13).

Table 3
HKMA HK\$/US\$ FX Transactions
(29 Nov – 19 Dec 01)

Trade Date	Net HK\$ purchase (+) (HK\$ mn)
30 Nov	-234

Table 4
Issuance of Exchange Fund Paper and Notes
(29 Nov – 19 Dec 01)

	No. of Issues Launched	Over-subscription Ratio
3-month EFB	3	2.32–5.24
6-month EFB	1	5.80
1-year EFB	1	2.58
5-year EFN	1	3.04
10-year EFN	1	3.65

Discount Window Activities

For the period as a whole, **19 banks in total borrowed HK\$2.58 bn from the Discount Window**, compared with HK\$5.47 bn in the preceding period. All of the borrowing 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 the outstanding amount of CIs and the Aggregate Balance during the period, backing assets increased accordingly. Nevertheless, partly because of positive net interest income, backing assets increased by more than the monetary base. As a result, **the backing ratio increased from 111.44% on 29 November to 111.60% on 19 December** (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. 🌀

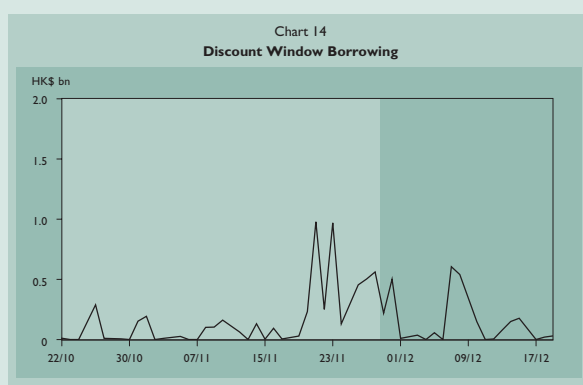
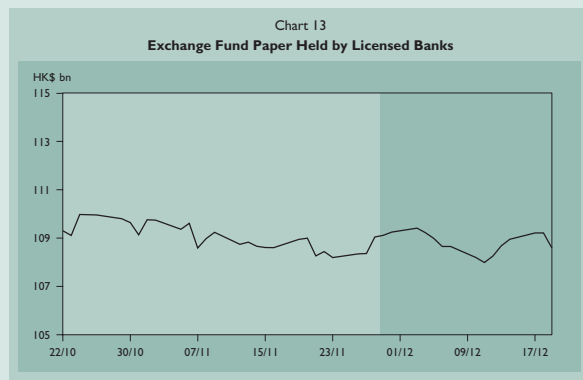


Table 5
Frequency of Individual Bank's
Access to the Discount Window
(29 Nov – 19 Dec 01)

Frequency of Using Discount Window	No. of Banks
1	13
2	4
>3	2
Total	19

