

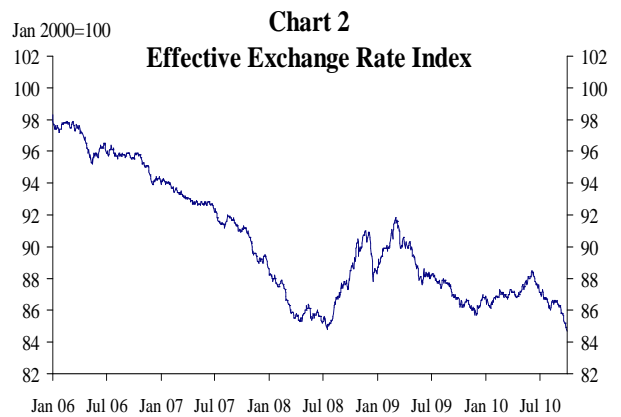
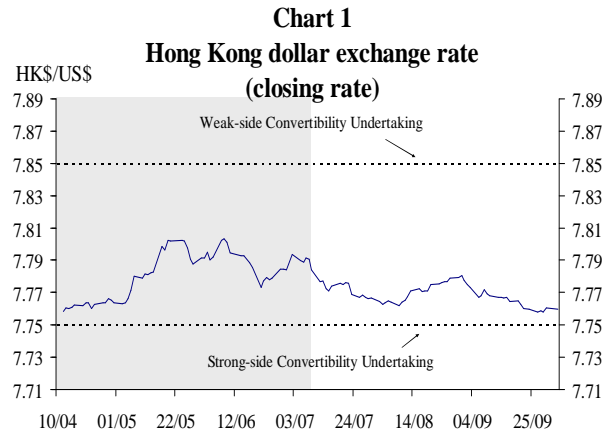
**EXCHANGE FUND ADVISORY COMMITTEE**  
**Currency Board Sub-Committee**

**Report on Currency Board Operations**  
**(9 July 2010 – 4 October 2010)**

Along with a weakening US dollar and appreciation of regional currencies, the Hong Kong dollar exchange rate strengthened from 7.7840 to 7.7599 during the review period, partly reflecting equity-related demand associated with fund raising activities in the equity market. Following slight increases in May and June, the Hong Kong dollar interbank interest rates adjusted downward during the reporting period, tracking decreases in their US dollar counterparts. The Monetary Base increased slightly from HK\$1,023.45 billion to HK\$1,033.00 billion, driven by an increase in Certificates of Indebtedness, while the Aggregate Balance was little changed. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by changes in foreign reserves.

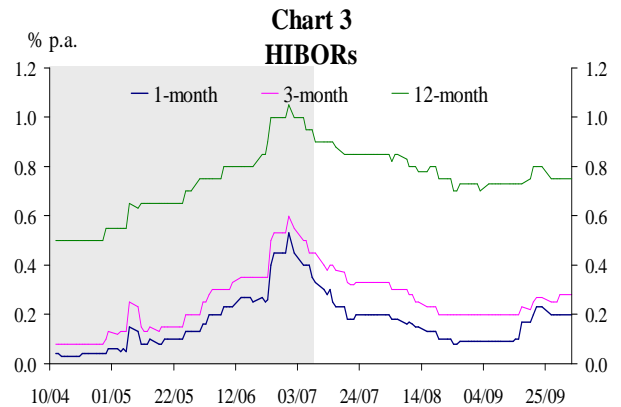
## Hong Kong dollar exchange rate

Along with the weakness in the US dollar and the appreciation of regional currencies, **the Hong Kong dollar exchange rate strengthened to 7.7599 on 4 October from 7.7840 on 9 July**, driven by equity-related demand which was partly boosted by fund raising activities in the equity market (Chart 1). Despite the strengthening of the Hong Kong dollar exchange rate against the US dollar, the effective exchange rate index of the Hong Kong dollar weakened from 86.9 to 84.7 during the reporting period, near a low of 84.6 recorded on 16 July 2008, as the US dollar depreciated against other major currencies (Chart 2).

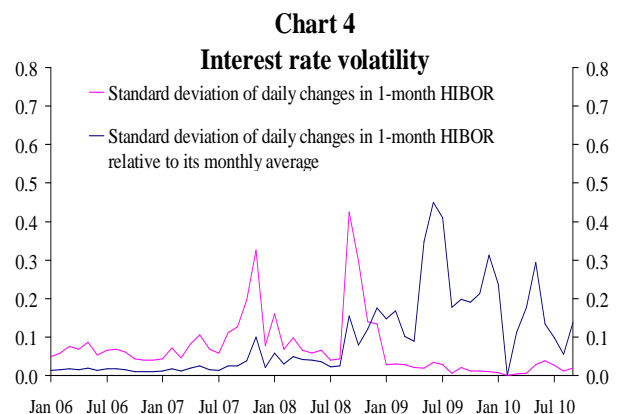


## Interest rates

2. Following small upward adjustments in May and June, **Hong Kong dollar interbank interest rates broadly declined during the reporting period**, with small fluctuations towards the end of September due to IPO activities (Chart 3). The decreases in HIBORs reflected the decline in their US dollar counterparts, which was partly driven by the market expectation of further quantitative easing in the US. During the reporting period, the one-month HIBOR declined from 0.33% to 0.20% and the three-month HIBOR from 0.45% to 0.28%. The 12-month HIBOR also decreased from 0.90% to 0.75%.

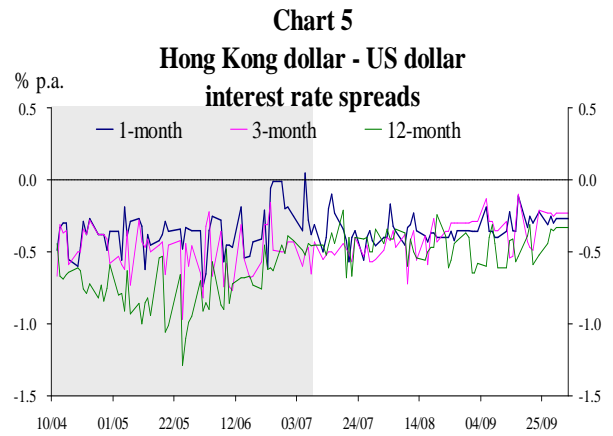


3. **Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, decreased in July and August, but increased slightly in September** due to IPO activities (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also showed similar patterns.<sup>1</sup>

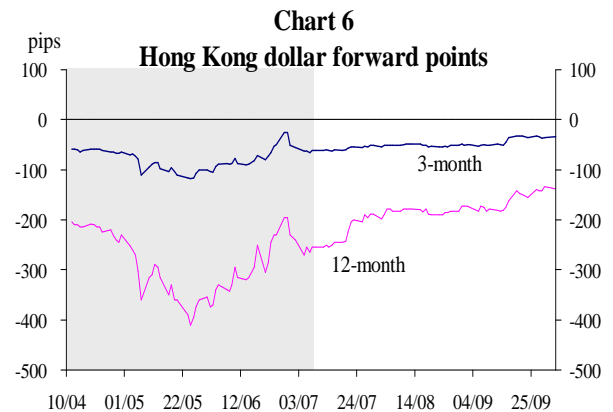


<sup>1</sup> The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

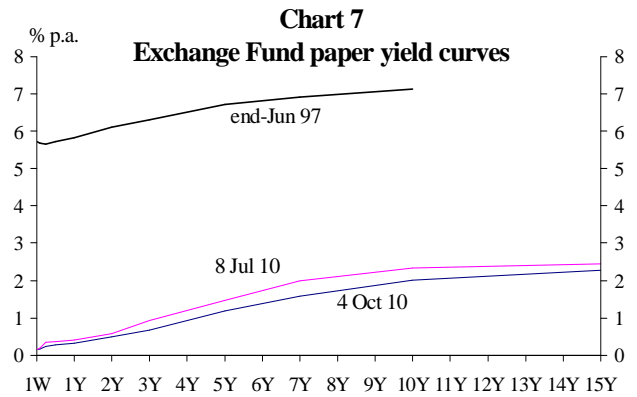
4. **The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts slightly narrowed during the reporting period (Chart 5).** The one-month and three-month negative spreads contracted by 4 and 20 basis points to -27 and -23 basis points respectively. The 12-month negative spread also narrowed from -45 basis points to -33 basis points.



5. In line with the movements in the interest rate spreads, **the Hong Kong dollar forward discounts also narrowed during the reporting period.** The three-month and 12-month forward discounts contracted by 27 and 117 pips to close at -34 and -138 pips respectively (Chart 6).



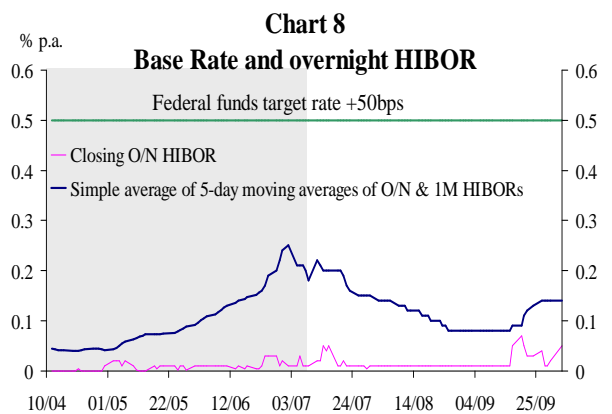
6. During the review period, **yields of Exchange Fund paper declined** alongside the corresponding yields of US Treasuries (Chart 7). Meanwhile, the yield spreads against US Treasuries generally narrowed (Table 1). In particular, the negative yield spreads contracted for the five-year, 10-year and 15-year tenors due to faster decreases in the yields of US Treasuries. The yields of longer-term US government bonds continued to decline partly because the US Federal Reserve decided to keep its bond holdings level by resuming the purchase of US Treasuries and there were market expectations of further quantitative easing measures.



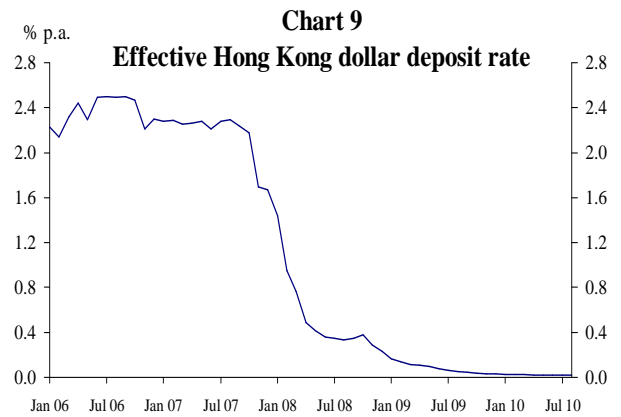
**Table 1**  
**Yield spreads of Exchange Fund paper over US Treasuries (basis points)**

	27 Jun 97	8 Jul 10	4 Oct 10
3-month	56	18	8
1-year	21	12	5
3-year	3	-6	4
5-year	27	-33	-10
10-year	54	-68	-53
15-year	-	-112	-84

7. **The HKMA Base Rate remained at 0.5% during the review period** (Chart 8), as the US Federal Open Market Committee kept the Federal Funds Target Rate (FFTR) at 0 – 0.25% at the meetings in August and September. The Base Rate continued to be set at 50 basis points above the lower boundary of the target range in accordance with the revised Base Rate formula announced on 26 March 2009.



8. In line with the stable US FFTR, **banks kept their Best Lending Rates unchanged.** There continued to be two Best Lending Rates of 5.00% and 5.25% at the end of the reporting period. **The average one-month time deposit rate offered by major authorized institutions remained virtually unchanged at 0.01%.<sup>2</sup>** The effective deposit rate was also stable at 0.02% between June and August (Chart 9).<sup>3</sup> The composite interest rate, which indicates the average cost of funds of banks, stayed at 0.20% at the end of June, July and August.<sup>4</sup>



<sup>2</sup> The figures refer to the average of interest rates offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

<sup>3</sup> 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 made certain assumptions regarding the maturity distribution in computing the effective deposit rate.

<sup>4</sup> This is a weighted average interest rate of all Hong Kong dollar interest bearing liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and Hong Kong dollar 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.

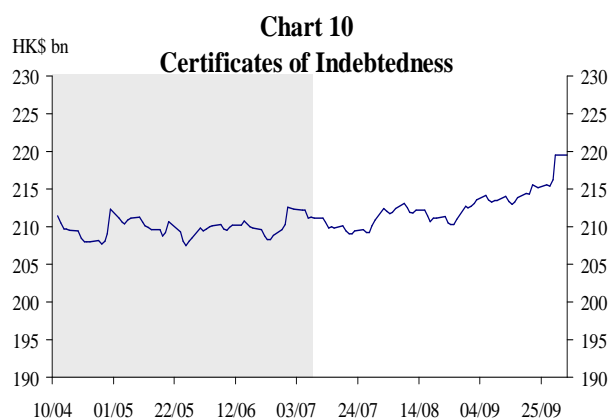
## Monetary Base

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, **expanded slightly from HK\$1,023.45 billion on 9 July to HK\$1,033.00 billion on 4 October** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	9 Jul 10	4 Oct 10
CIs	211.15	219.54
Government-issued Currency Notes and Coins in Circulation	9.04	9.08
Aggregate Balance	148.66	148.67
Outstanding EFBNs	654.61	655.72
<b>Monetary Base</b>	<b>1,023.45</b>	<b>1,033.00</b>

### *Certificates of Indebtedness*

10. During the reporting period, the three note-issuing banks submitted a total of US\$1.08 billion to the HKMA in exchange for HK\$8.39 billion worth of CIs, partly reflecting increased demand for banknotes associated with the National Day holiday. As a result, **the outstanding CIs rose to HK\$219.54 billion on 4 October from HK\$211.15 billion on 9 July** (Chart 10).



*Government-issued currency notes and coins in circulation*

11. During the reporting period, the amount of **government-issued currency notes and coins in circulation edged up to HK\$9.08 billion from HK\$9.04 billion** (Chart 11).

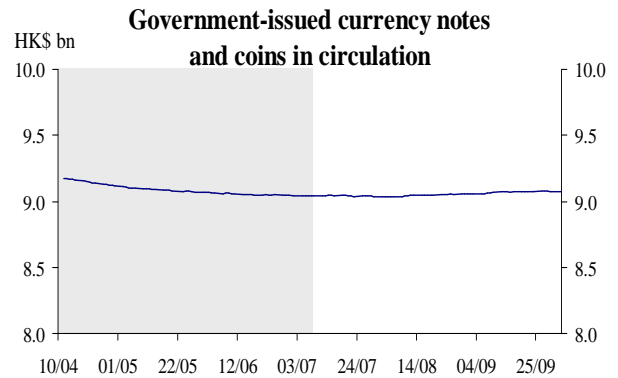
*Aggregate Balance*

12. **The Aggregate Balance was little changed during the reporting period, at around HK\$148.66 billion, with small fluctuations due to interest payments on Exchange Fund paper** (Chart 12).

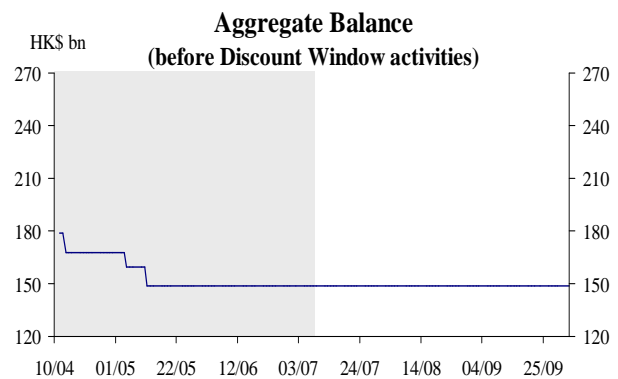
*Outstanding Exchange Fund Bills and Notes*

13. **The market value of outstanding Exchange Fund Bills and Notes increased slightly from HK\$654.61 billion to HK\$655.72 billion during the reporting period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) also expanded from HK\$575.73 billion (87.9% of total) to HK\$579.48 billion (88.4% of total)** (Chart 13).

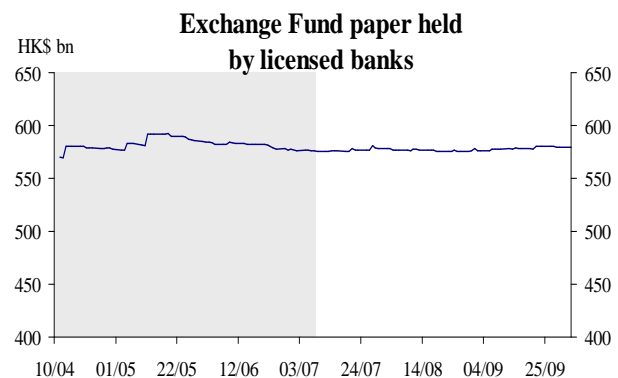
**Chart 11**



**Chart 12**



**Chart 13**



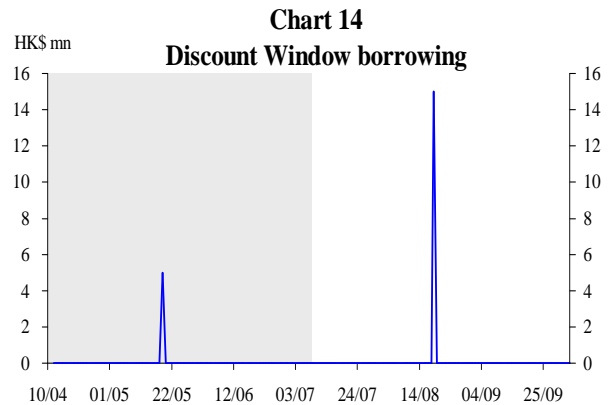


14. During the reporting period, **HK\$722.27 million of interest payments on Exchange Fund paper were made. An additional HK\$611.66 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were largely well received by the market (Table 3).

	No. of issues launched	Over-subscription ratio
3-month EFB	12	0.75-4.67
6-month EFB	11	1.28-6.42
12-month EFB	3	3.86-10.88
2-year EFN	1	5.88
3-year EFN	1	1.88
5-year EFN	1	4.38
15-year EFN	1	2.71

**Discount Window activities**

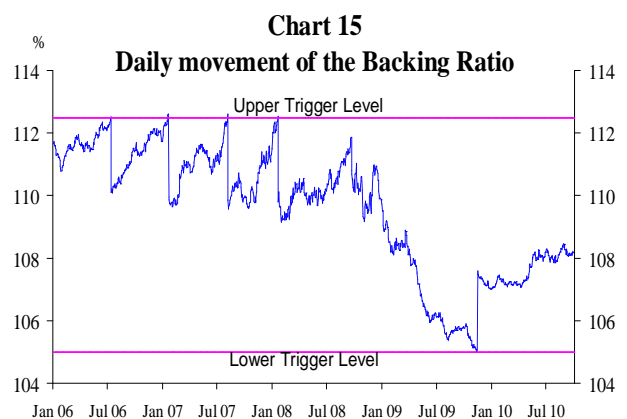
15. During the reporting period, **only one bank borrowed a total of HK\$15.0 million from the Discount Window, compared with HK\$5.0 million in the preceding period (Chart 14 and Table 4).**



Frequency of using Discount Window	No. of banks
1	1
Total	1

**Backing Portfolio**

16. Backing Assets grew slightly during the reporting period, reflecting the increase in the Monetary Base and valuation gains. As the Backing Assets and the Monetary Base rose at roughly the same rate, **the Backing Ratio stayed at around 108% and closed at 108.17% on 4 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.

**Hong Kong Monetary Authority  
2 December 2010**