

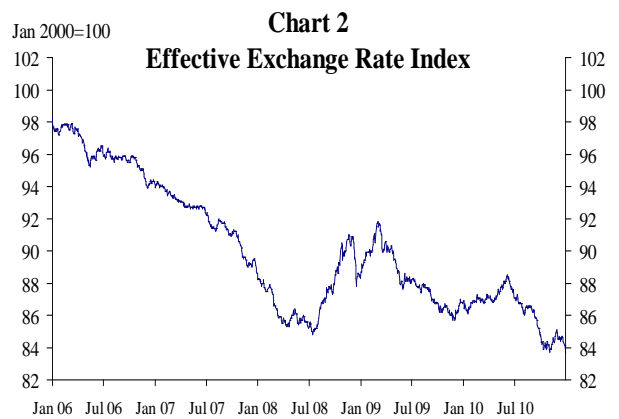
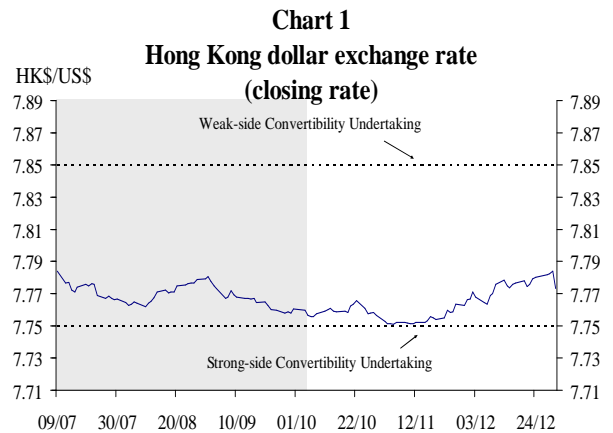
EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

Report on Currency Board Operations
(5 October 2010 – 31 December 2010)

The Hong Kong dollar exchange rate strengthened towards the strong-side Convertibility Undertaking in October and early November amid buoyant stock market activities, but softened to 7.7733 at the end of the reporting period partly because of the repatriation of funds raised in the equity market. The exchange rate movements were in line with the Hong Kong dollar interbank interest rates, which moved downwards in October and early November before rising slightly in December. The Monetary Base increased from HK\$1,031.71 billion to HK\$1,039.81 billion, driven by an increase in Certificates of Indebtedness arising from increased demand for banknotes during the Christmas and New Year holidays. The Aggregate Balance and the market value of outstanding Exchange Fund Bills and Notes were little changed. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by changes in foreign reserves.

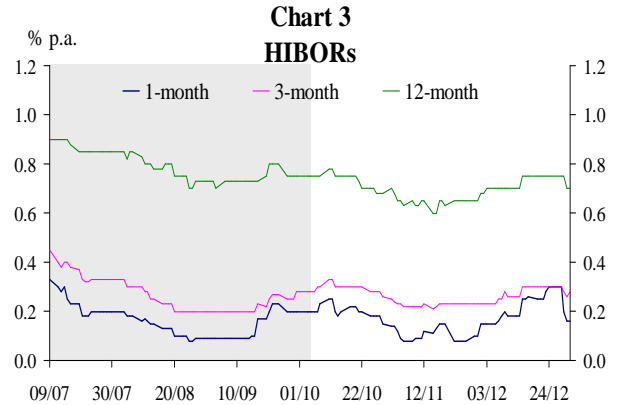
Hong Kong dollar exchange rate

The Hong Kong dollar exchange rate strengthened towards the strong-side Convertibility Undertaking in October and early November, underpinned by equity-related demands associated with a buoyant stock market and vibrant activities in equity initial public offerings (IPOs) (Chart 1). However, the Hong Kong dollar exchange rate softened in the latter part of the reporting period, partly reflecting repatriation of funds raised in the equity market. For the reporting period as a whole, the Hong Kong dollar weakened from 7.7566 on 5 October to 7.7733 on 31 December. The nominal effective exchange rate index of the Hong Kong dollar also weakened to 83.6 from 84.8 during the reporting period, as the US dollar depreciated against other major currencies except the pound and the euro (Chart 2).

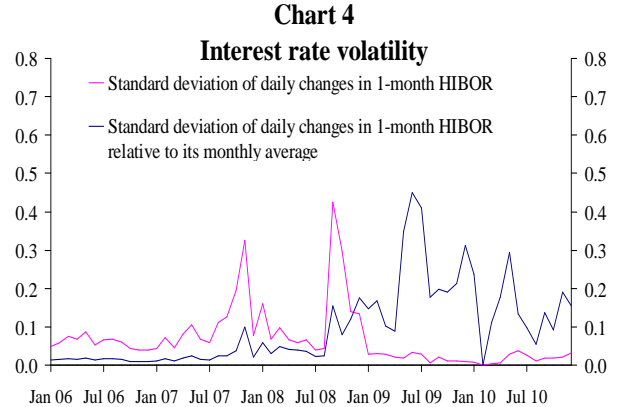


Interest rates

2. **Hong Kong dollar interbank interest rates softened in October and November but increased slightly in December** due to funding demand arising from IPOs and rights issues in the equity market (Chart 3). For the reporting period as a whole, the one-month HIBOR decreased from 0.20% to 0.16% and the 12-month HIBOR from 0.75% to 0.70%. Meanwhile, the three-month HIBOR closed at 0.28% on 31 December, little-changed compared with the start of the reporting period.

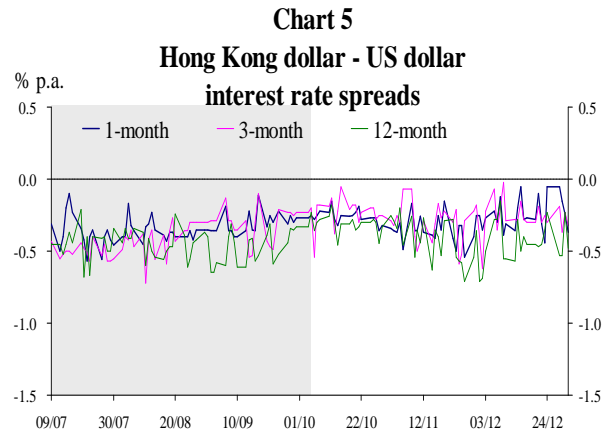


3. **Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, increased slightly in November and December, reflecting fluctuations arising from fund-raising activities in the equity market (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also showed similar patterns.**¹

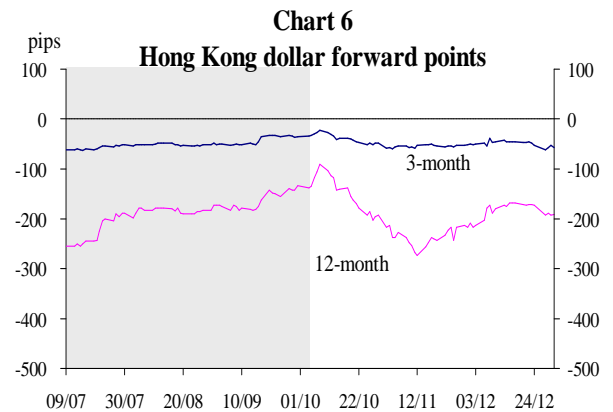


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

4. **The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts expanded slightly in October and November, but stabilised towards the end of the reporting period (Chart 5).** Overall, both the one-month and three-month negative spreads expanded by 12 basis points to -37 and -32 basis points respectively. The 12-month negative spread also widened to -48 basis points from -23 basis points.



5. Broadly in line with the movements in the interest rate spreads, **the Hong Kong dollar forward discounts also widened in October and early November, before narrowing towards the end of December.** Overall, the three-month and 12-month forward discounts expanded by 24 and 56 pips to close at -57 and -191 pips respectively (Chart 6).



6. Broadly tracking the corresponding yields of US Treasuries, yields of Exchange Fund paper rose except for the one-week tenor (Chart 7). While the yield spreads against US Treasuries continued to be positive for the three-month and one-year tenors, the yield spread turned negative for the three-year tenor (Table 1). Meanwhile, the negative yield spreads generally widened for those tenors longer than three years. This mainly reflected larger increases in yields of longer-term US government bonds during the reporting period.

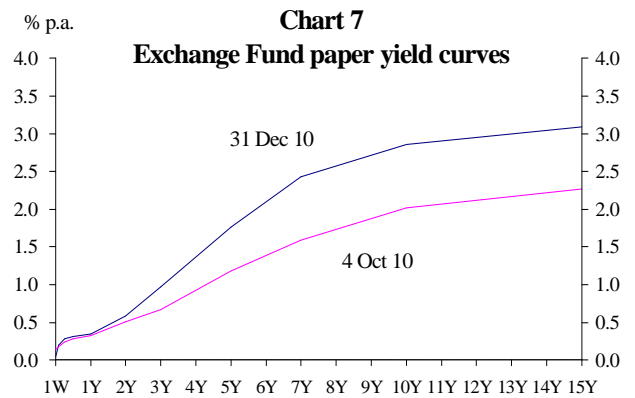
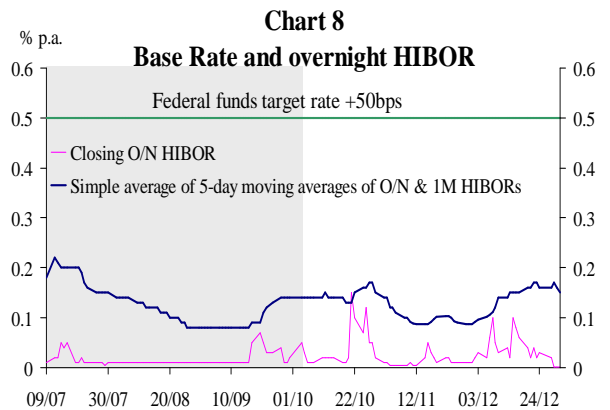


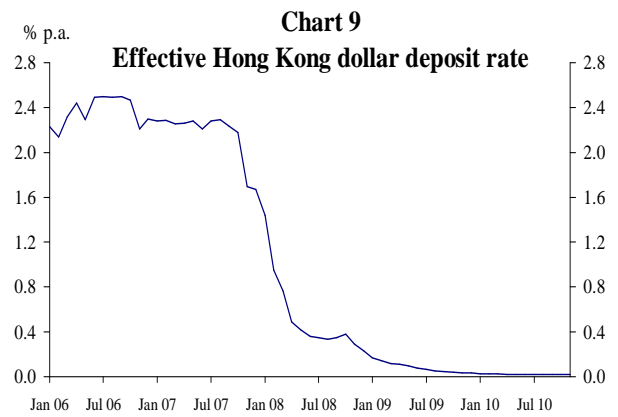
Table 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

	4 Oct 10	31 Dec 10
3-month	8	17
1-year	5	7
3-year	4	-8
5-year	-10	-31
10-year	-53	-56
15-year	-84	-86

7. The HKMA Base Rate remained unchanged at 0.5% (Chart 8), as the US Federal Open Market Committee decided to keep the Federal Funds Target Rate (FFTR) at 0 – 0.25% at the meetings in November and December. 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. **Banks kept their Best Lending Rates unchanged, consistent with the stable US FFTR. 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%.² The effective deposit rate was also stable at 0.02% between September and November (Chart 9).³ The composite interest rate, which indicates the average cost of funds of banks, was little changed, standing at 0.17% at the end of October and 0.18% at the end of September and November.⁴**



² 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.

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 made certain assumptions regarding the maturity distribution in computing the effective deposit rate.

⁴ 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.

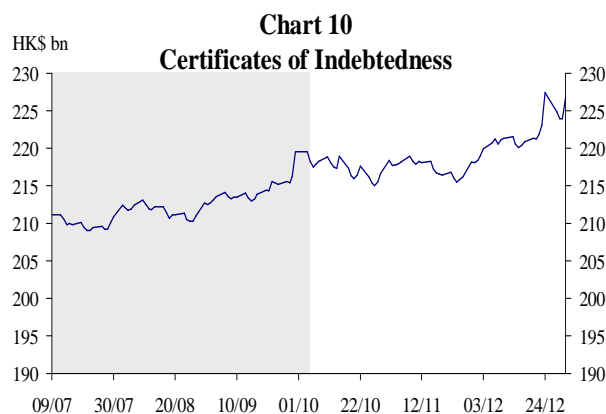
Monetary Base

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\$1,031.71 billion on 5 October to HK\$1,039.81 billion on 31 December** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	5 Oct 10	31 Dec 10
CIs	218.27	226.71
Government-issued Currency Notes and Coins in Circulation	9.08	9.18
Aggregate Balance	148.67	148.70
Outstanding EFBNs	655.70	655.22
Monetary Base	1,031.71	1,039.81

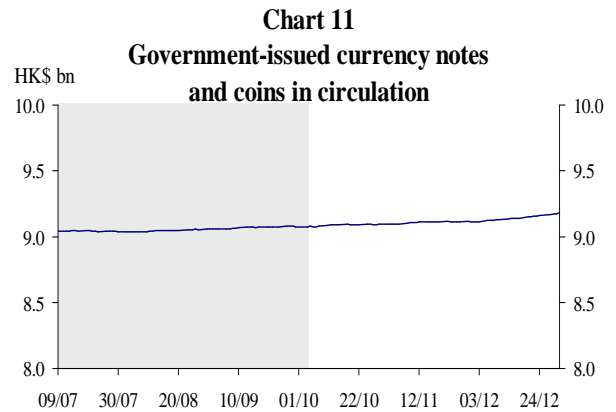
Certificates of Indebtedness

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\$8.44 billion worth of CIs, in part reflecting increased demand for banknotes before the Christmas and New Year holidays. In addition, the new series of HK\$1,000 banknotes, which include new security features, had been put into circulation since 7 December. As a result, **the outstanding CIs climbed to HK\$226.71 billion on 31 December from HK\$218.27 billion on 5 October** (Chart 10).



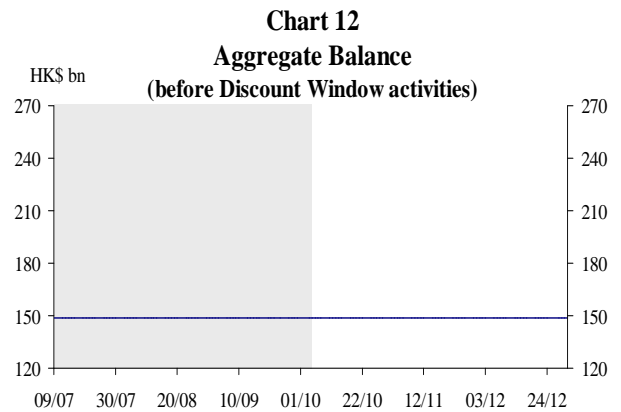
Government-issued currency notes and coins in circulation

11. During the reporting period, the amount of **government-issued currency notes and coins in circulation** increased to **HK\$9.18 billion** from **HK\$9.08 billion** (Chart 11).



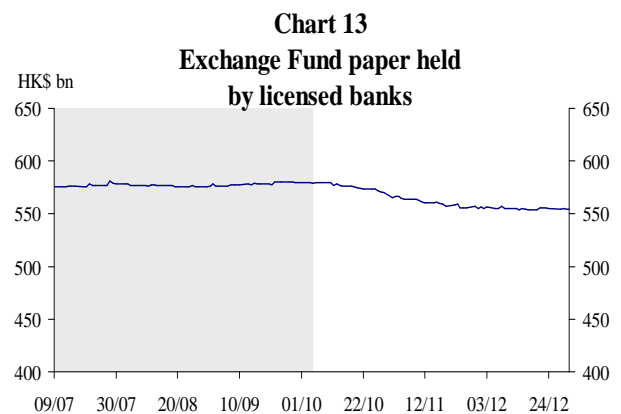
Aggregate Balance

12. The **Aggregate Balance** was little changed during the reporting period, at around **HK\$148.70 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** edged down to **HK\$655.22 billion** from **HK\$655.70 billion** during the reporting period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities)** decreased to **HK\$554.39 billion** (84.6% of total) from **HK\$579.29 billion** (88.3% of total) (Chart 13).

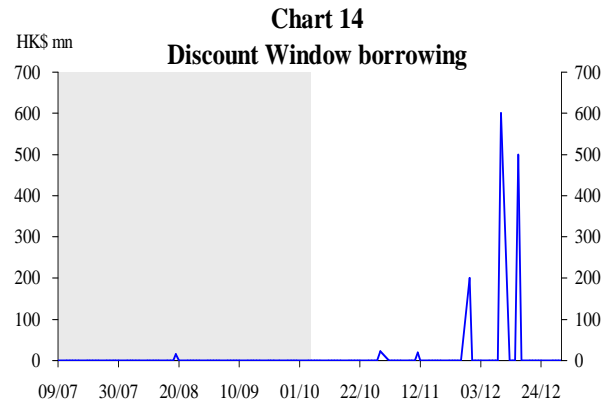


14. During the reporting period, **HK\$1,191.36 million of interest payments on Exchange Fund paper were made. An additional HK\$1,058.02 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were largely well received by the market (Table 3).

	No. of issues launched	Over-subscription ratio
1-month EFB	2	1.33-4.33
3-month EFB	13	0.60-1.99
6-month EFB	11	2.26-5.83
12-month EFB	3	4.89-5.14
2-year EFN	1	4.34
3-year EFN	1	4.44
5-year EFN	1	2.75
10-year EFN	1	2.72

Discount Window activities

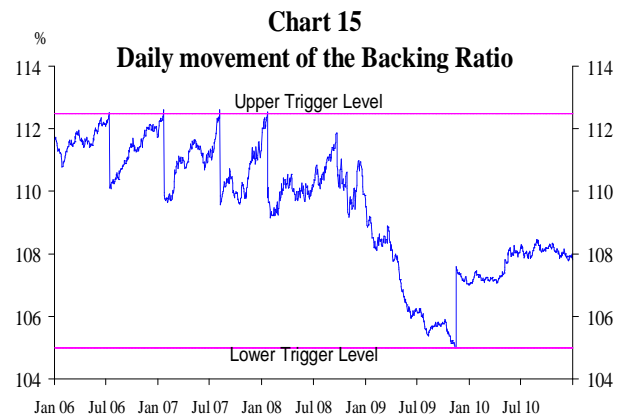
15. During the reporting period, **five banks borrowed a total of HK\$1.34 billion from the Discount Window, compared with HK\$15 million in the preceding period (Chart 14 and Table 4).**



Frequency of using Discount Window	No. of banks
1	5
Total	5

Backing Portfolio

16. Backing Assets increased slightly during the reporting period, as the expansion in the Monetary Base more than offset valuation loss. As the Backing Assets rose proportionally less than the Monetary Base, **the Backing Ratio decreased from 108.17% to 107.81% during the reporting period (Chart 15).**



Under the Linked Exchange Rate system, while specific Exchange Fund assets have been designated for the Backing Portfolio, all Exchange Fund assets are available to support the Hong Kong dollar exchange rate.

**Hong Kong Monetary Authority
2 March 2011**