

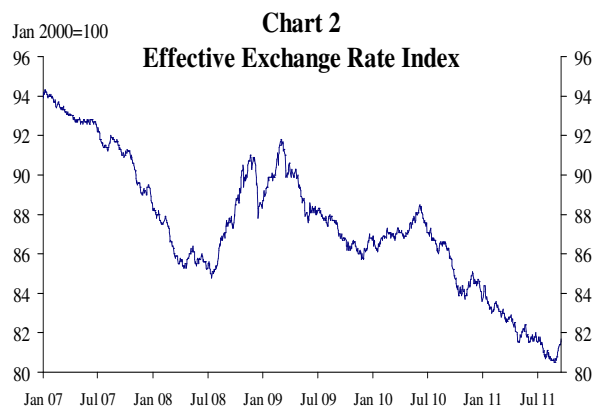
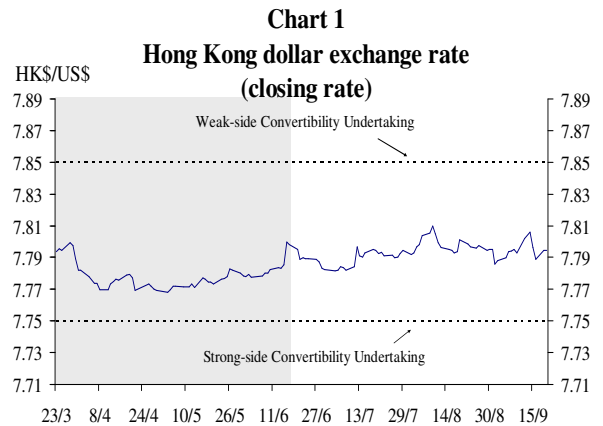
**EXCHANGE FUND ADVISORY COMMITTEE**  
**Currency Board Sub-Committee**

**Report on Currency Board Operations**  
**(18 June 2011 – 20 September 2011)**

Despite the uncertain macro-financial environment, the Hong Kong dollar exchange rate traded within a narrow range between 7.7816 and 7.8097 during the reporting period. In the money market, Hong Kong dollar interbank interest rates increased marginally alongside their US dollar counterparts and Hong Kong dollar forward discounts widened due to increased demand for US dollar liquidity. While the Aggregate Balance was little changed, the Monetary Base rose from HK\$1,051.89 billion to HK\$1,056.02 billion, driven by an increase in Certificates of Indebtedness. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by changes in foreign reserves.

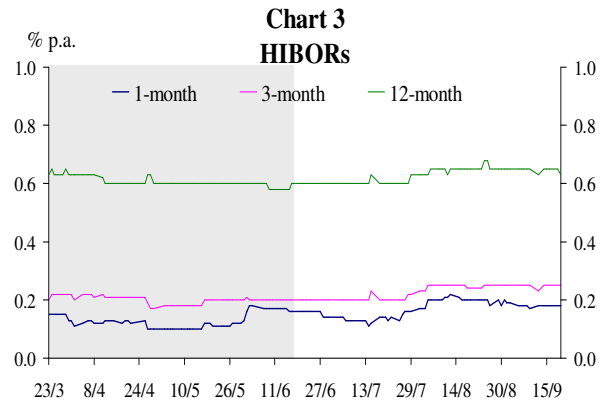
## Hong Kong dollar exchange rate

1. **The Hong Kong dollar exchange rate moved within a narrow range between 7.7816 and 7.8097 during the reporting period (Chart 1). The market remained orderly despite fluctuations in equity-related demand for Hong Kong dollars, growing worries about the European sovereign debt problems, a sharp deterioration in growth outlook for the major advanced economies, the downgrade of the US sovereign credit rating and the subsequent plunge in global equity markets. The exchange rate closed at 7.7946 on 20 September, compared with 7.7951 on 20 June. Meanwhile, the nominal effective exchange rate index of the Hong Kong dollar weakened in July and August but strengthened towards the end of the review period, tracking the movements in the US dollar (Chart 2).**

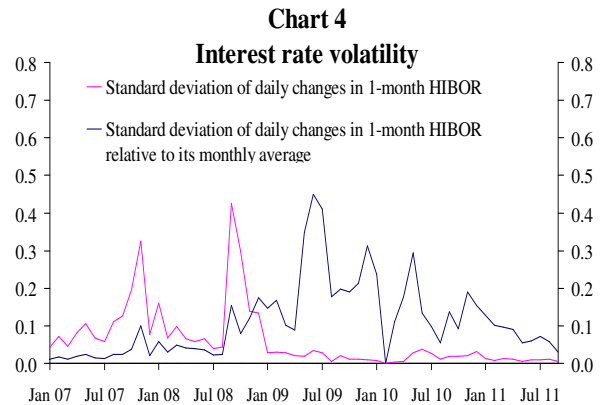


## Interest rates

2. **Hong Kong dollar interbank interest rates edged up** during the review period, along with slight increases in the corresponding US dollar rates (Chart 3). During the reporting period, the three-month HIBOR climbed by five basis points to close at 0.25% and the 12-month HIBOR rose by three basis points to close at 0.63%.

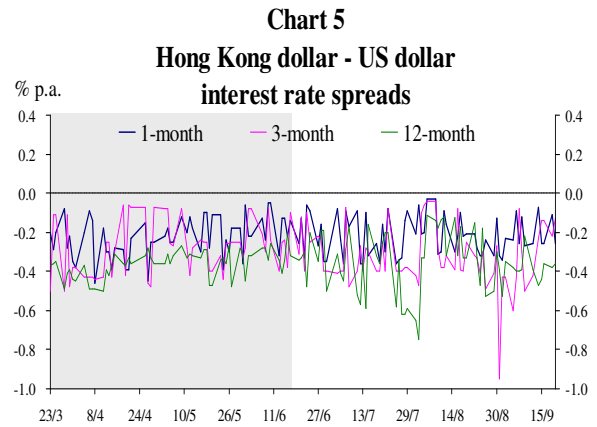


3. **Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, declined slightly** from one basis point in June to almost zero in September (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also decreased.<sup>1</sup>

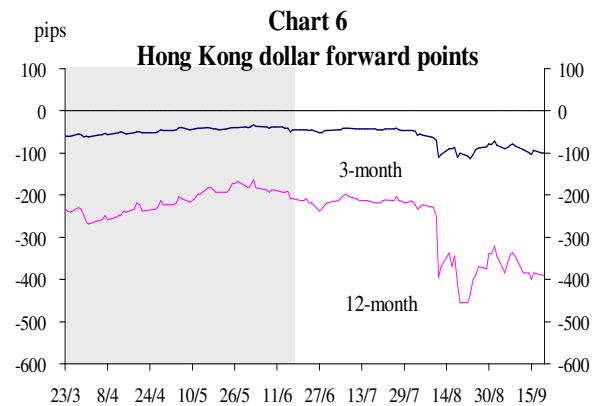


<sup>1</sup> The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

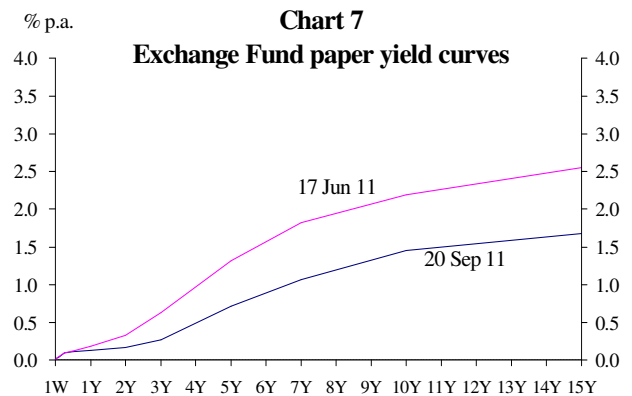
4. **The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts remained roughly stable** during the reporting period (Chart 5). The one-month and three-month spreads averaged around -22 and -32 basis points respectively. The 12-month negative spread moved within a range between -11 and -75 basis points, closing at -36 basis points on 20 September.



5. **The Hong Kong dollar three-month and 12-month forward discounts were generally stable in the first half of the reporting period but widened in the second half** reportedly because of increased demand for US dollar liquidity (Chart 6). For the review period as a whole, the three-month and 12-month forward discounts expanded by 53 and 177 pips to close at -98 and -390 pips respectively on 20 September.

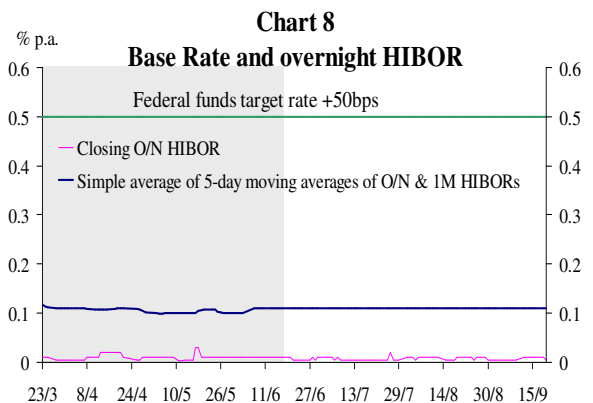


6. During the review period, while the implied yields of short-dated Exchange Fund Bills were roughly stable at low levels, the yields of longer-term Exchange Fund Notes declined (Chart 7), reflecting downward movements in the corresponding yields of US Treasuries amid increased demand for traditional safe haven assets. The yield spreads over US Treasuries generally narrowed except for tenors shorter than three years (Table 1).

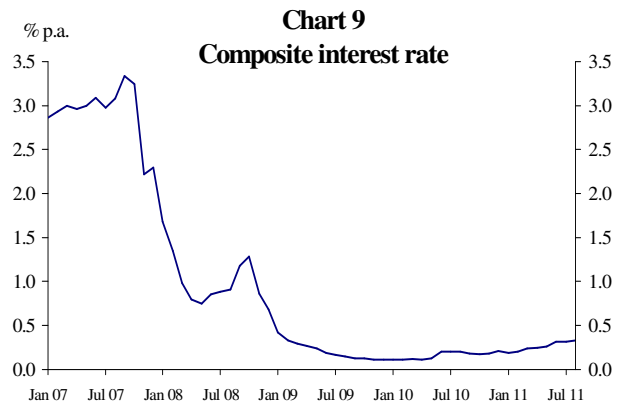


|         | 17 Jun 11 | 20 Sep 11 |
|---------|-----------|-----------|
| 3-month | 7         | 8         |
| 1-year  | 2         | 4         |
| 3-year  | -4        | 0         |
| 5-year  | -22       | -9        |
| 10-year | -76       | -45       |
| 15-year | -106      | -79       |

7. At the August meeting, the US Federal Open Market Committee decided to keep Federal Funds Target Rate (FFTR) at 0 – 0.25% and indicated that current economic conditions would warrant exceptionally low levels for the federal funds rate at least through mid-2013. At the September meeting, the Committee maintained the target range for federal funds rate, though with new initiatives to bring down the longer-term US interest rates. As such, **the HKMA Base Rate remained unchanged at 0.5%** (Chart 8). 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. Despite stable Best Lending Rates and HIBORs, mortgage interest rates for newly-approved loans continued to rise. The Hong Kong dollar deposit interest rates offered by retail banks also edged up due to banks' increased funding demand. **The composite interest rate<sup>2</sup>, which indicates the average cost of funds for banks, increased slightly** from 0.31% in June to 0.33% in August (Chart 9), driven by upward adjustment of deposit interest rates.



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<sup>2</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.

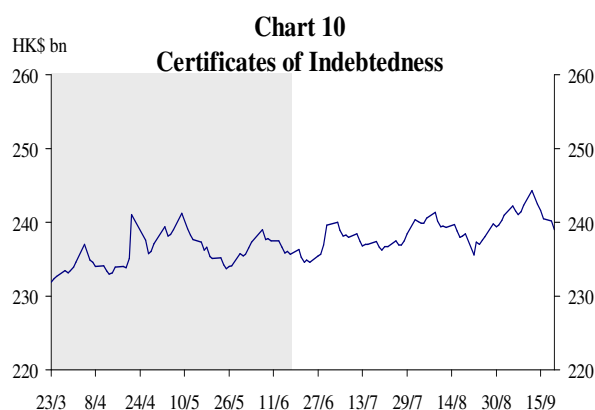
## Monetary Base

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, **increased from HK\$1,051.89 billion on 20 June to HK\$1,056.02 billion on 20 September** (Table 2). Movements in the individual components are discussed below.

| (HK\$bn)  | 20 Jun 11       | 20 Sep 11       |
|---|-----------------|-----------------|
| CIs   | 236.38          | 239.04          |
| Government-issued<br>Currency Notes and<br>Coins in Circulation | 9.53            | 9.55            |
| Aggregate Balance   | 148.75          | 148.74          |
| Outstanding EFBNs   | 657.24          | 658.69          |
| <b>Monetary Base</b>  | <b>1,051.89</b> | <b>1,056.02</b> |

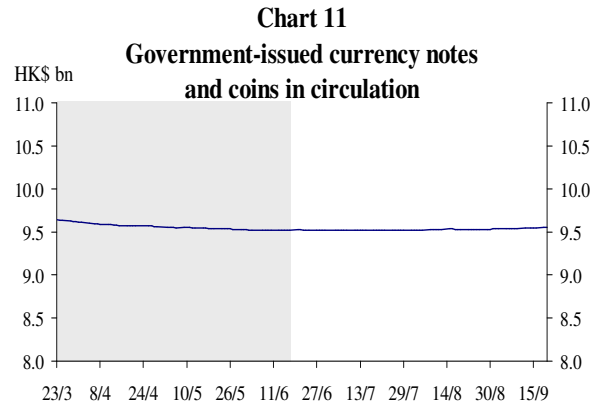
### *Certificates of Indebtedness*

10. During the reporting period, the three note-issuing banks submitted US\$341.03 million to the HKMA in exchange for HK\$2.66 billion worth of CIs, partly reflecting increased demand for banknotes around the Chinese Mid-Autumn Festival. As a result, **the outstanding CIs expanded to HK\$239.04 billion on 20 September from HK\$236.38 billion on 20 June** (Chart 10).



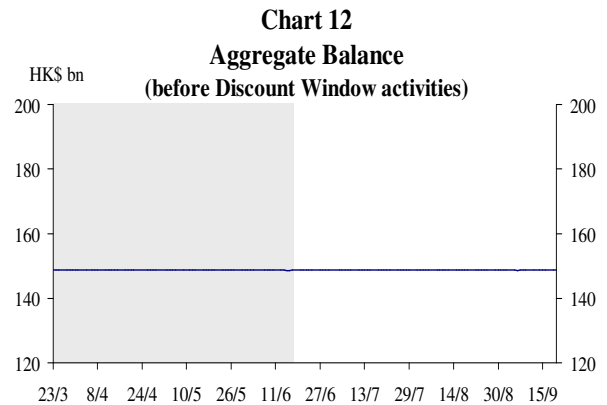
*Government-issued currency notes and coins in circulation*

11. The amount of **government-issued currency notes and coins in circulation** were little changed at around HK\$9.54 billion during the reporting period (Chart 11).



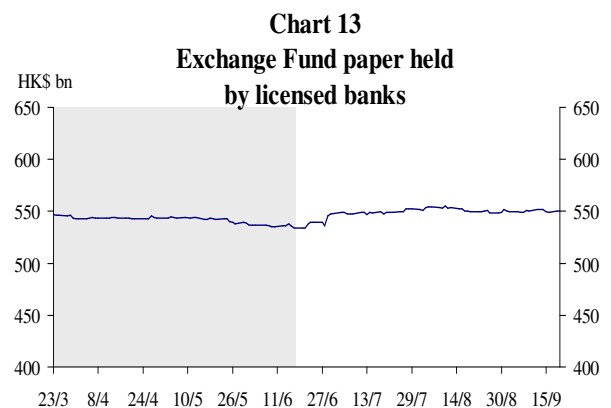
*Aggregate Balance*

12. The **Aggregate Balance** was also stable at around HK\$148.74 billion during the review period, 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** rose slightly from HK\$657.24 billion on 20 June to HK\$658.69 billion on 20 September. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) also increased from HK\$534.11 billion (81.3% of total) to HK\$550.49 billion (83.6% of total) (Chart 13).



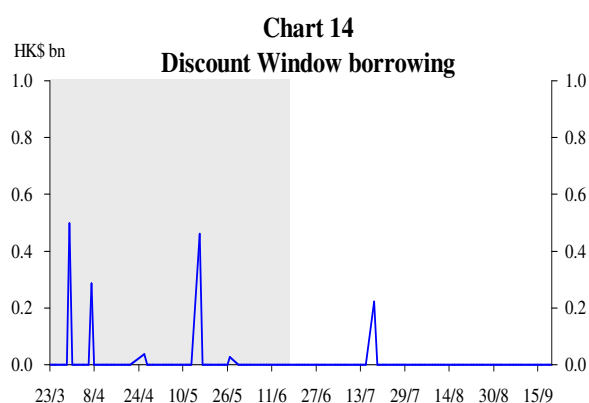


14. During the reporting period, **HK\$628.12 million of interest payments on Exchange Fund paper were made.** An **additional HK\$388.90 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were well received by the market (Table 3).

|              | No. of issues launched | Over-subscription ratio |
|--------------|------------------------|-------------------------|
| 3-month EFB  | 13                     | 0.97-4.17               |
| 6-month EFB  | 11                     | 1.71-8.79               |
| 12-month EFB | 4                      | 2.65-13.99              |
| 2-year EFN   | 1                      | 4.83                    |
| 5-year EFN   | 2                      | 2.07-2.39               |
| 10-year EFN  | 1                      | 2.64                    |
| 15-year EFN  | 1                      | 1.98                    |

### Discount Window activities

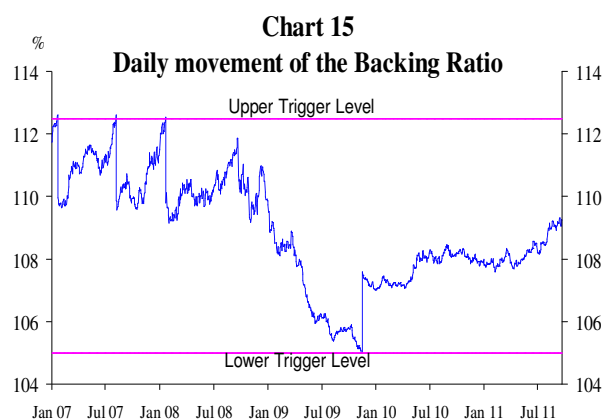
15. During the reporting period, **only one bank borrowed a total of HK\$221 million from the Discount Window,** compared with HK\$1.31 billion in the preceding period (Chart 14 and Table 4).



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

## Backing Portfolio

16. Backing Assets expanded during the reporting period, reflecting the rise in CIs and valuation gains. As the Backing Assets rose proportionally more than the Monetary Base, **the Backing Ratio increased to 109.23% from 108.58% 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**  
**15 November 2011**