

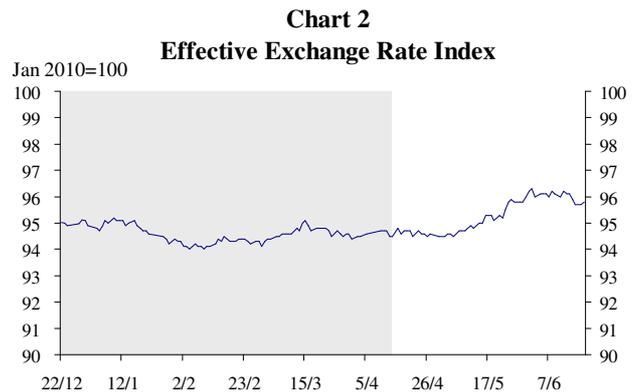
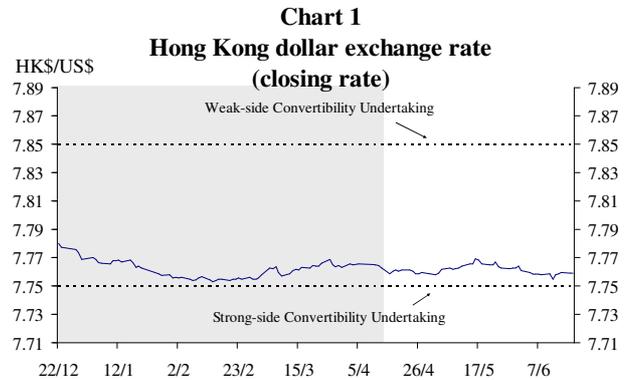
EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

Report on Currency Board Operations
(14 April 2012 – 19 June 2012)

The Hong Kong dollar exchange rate continued to trade orderly within a tight range of 7.7547 – 7.7693 during the review period, notwithstanding some correction in the local stock market and renewed concerns about the European sovereign debt crisis and the global prospects. In the money market, Hong Kong dollar interbank interest rates were roughly stable. In line with broadly stable interest rate spreads, Hong Kong dollar forward discounts were little changed, except that the 12-month spread and forward discount narrowed slightly. The Monetary Base decreased to HK\$1,081.72 billion from HK\$1,085.12 billion, mainly reflecting the decrease in Certificates of Indebtedness. In accordance with Currency Board principles, changes in the Monetary Base were fully matched by changes in foreign reserves.

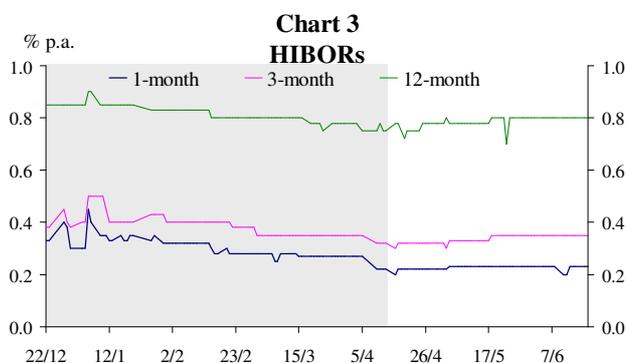
Hong Kong dollar exchange rate

1. The Hong Kong dollar exchange rate was broadly stable in April 2012 and then weakened slightly through mid-May (Chart 1) amid some correction in the local stock market and renewed concerns about the European sovereign debt crisis and the global economic prospects. Thereafter the spot exchange rate strengthened roughly back to the level of mid-April. For the review period as a whole, the exchange rate weakened marginally to 7.7593 on 19 June from 7.7588 on 16 April. The nominal effective exchange rate index of the Hong Kong dollar strengthened during the review period, reflecting appreciations of the US dollar against most of the major currencies (Chart 2).

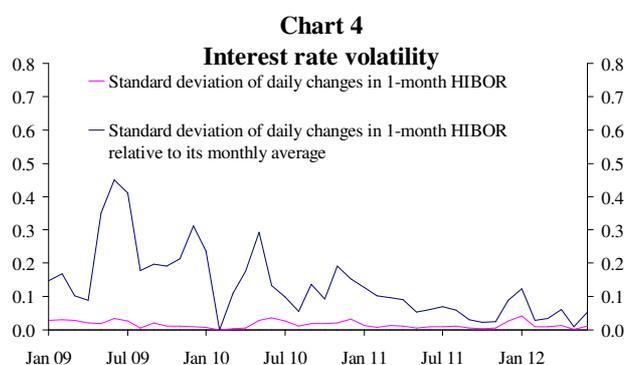


Interest rates

2. **Hong Kong dollar interbank interest rates were roughly stable** during the review period (Chart 3). The one-month and 12-month HIBORs closed at 0.23% and 0.80% on 19 June.

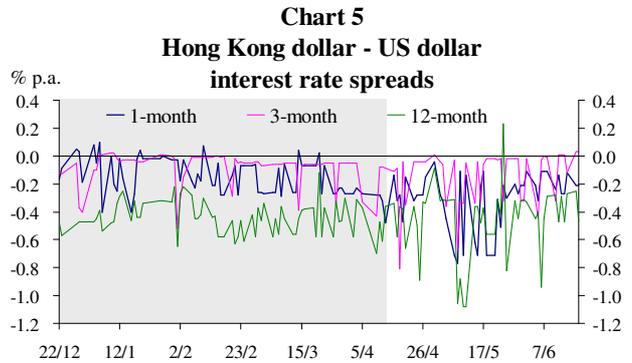


3. **Interest rate volatility, measured by the standard deviation of daily changes in one-month HIBOR, was virtually unchanged** at 1 basis point during the review period (Chart 4). The standard deviation as a ratio of the average one-month HIBOR decreased slightly over the same period.¹

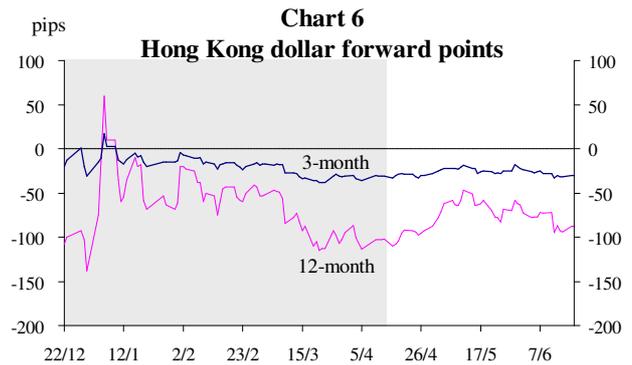


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

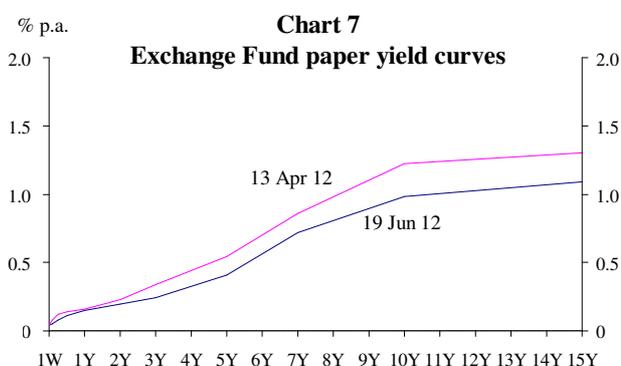
4. The spreads of Hong Kong dollar interest rates against their US dollar counterparts were roughly stable during the review period (Chart 5), except that the 12-month spread narrowed slightly. The one-month, three-month and 12-month negative spreads averaged around -30, -14, and -46 basis points respectively.



5. During the review period, the Hong Kong dollar three-month forward discount stayed broadly unchanged while the 12-month forward discount eased slightly (Chart 6). The three-month and 12-month forward discounts closed at -30 and -88 pips respectively on 19 June.

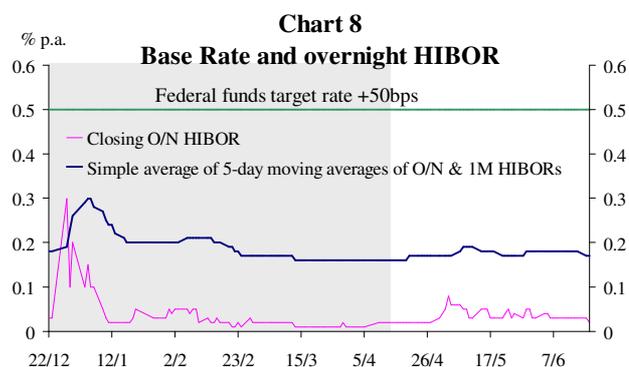


6. **The yield curve of Exchange Fund paper flattened during the review period** (Chart 7), while that of US Treasuries also made similar movements, though recording even more pronounced decreases for longer tenors. As a result, the yield spreads of Exchange Fund paper over US Treasuries were broadly stable for shorter tenors but narrowed for longer tenors. For instance, the 10-year and 15-year negative yield spreads over US Treasuries narrowed by 27 and 36 basis points respectively during the review period (Table 1).



	13 Apr 12	19 Jun 12
3-month	5	-1
1-year	-1	-1
3-year	-7	-13
5-year	-34	-26
10-year	-84	-57
15-year	-131	-95

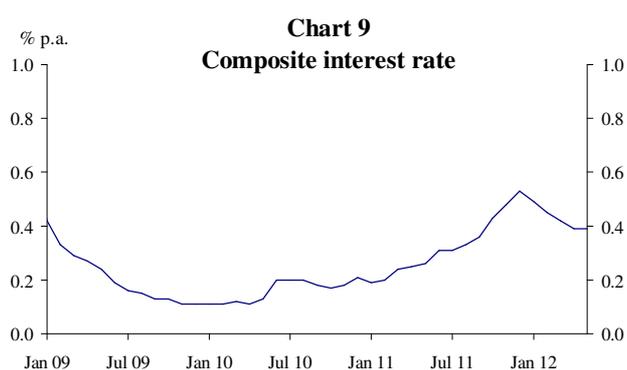
7. At both the April and June meetings, the US Federal Open Market Committee decided to keep the Federal Funds Target Rate (FFTR) at 0 – 0.25% and reiterated that economic conditions were likely to warrant exceptionally low levels for the Federal Funds rate at least through late 2014.² As such, **the HKMA Base Rate remained unchanged at 0.5%** (Chart 8).



² At the June meeting, the Committee extended the Maturity Extension Program (also known as “Operation Twist”) through the end of 2012 with the objective of bringing down the longer-term interest rates.

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 in Hong Kong 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 review period. Despite stable Best Lending Rates, mortgage interest rates for newly-approved loans eased further amid alleviating funding cost pressure of banks and keener competition in the mortgage loan market. On the other hand, the Hong Kong dollar deposit interest rates offered by retail banks were roughly stable. As a result, **the composite interest rate³, which indicates the average cost of funds for banks, edged lower from 0.42% in March to 0.39% in April and May (Chart 9).**



³ 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.

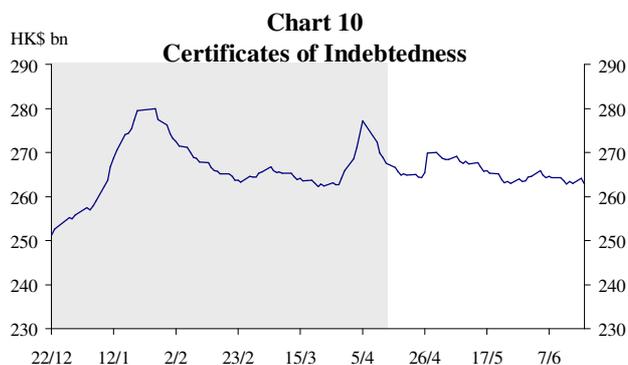
Monetary Base

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, **decreased to HK\$1,081.72 billion on 19 June from HK\$1,085.12 billion on 16 April** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	16 Apr 12	19 Jun 12
CIs	266.62	262.78
Government-issued Currency Notes and Coins in Circulation	10.07	10.02
Aggregate Balance	148.65	148.76
Outstanding EFBNs	659.79	660.18
Monetary Base	1,085.12	1,081.72

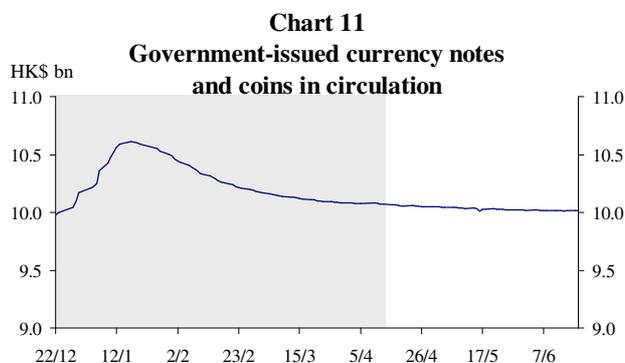
Certificates of Indebtedness

10. During the review period, the three note-issuing banks redeemed HK\$3.84 billion worth of CIs in exchange for US\$492 million, in part unwinding the temporary increase in banknote demand ahead of long holidays in the preceding review period. As a result, **the outstanding CIs decreased to HK\$262.78 billion on 19 June from HK\$266.62 billion on 16 April** (Chart 10).



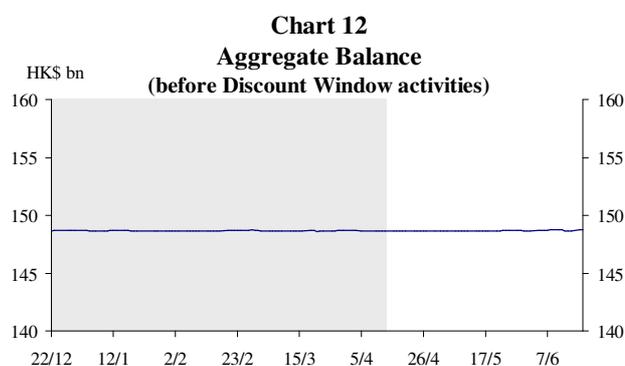
Government-issued currency notes and coins in circulation

11. The amount of **government-issued currency notes and coins in circulation** were steady at around HK\$10.02 billion during the review period (Chart 11).



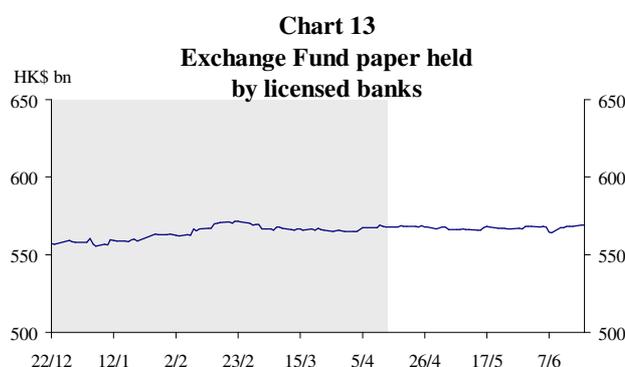
Aggregate Balance

12. **The Aggregate Balance** was little changed at around HK\$148.66 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** increased to HK\$660.18 billion from HK\$659.79 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) also increased to HK\$569.06 billion (86.2% of total) from



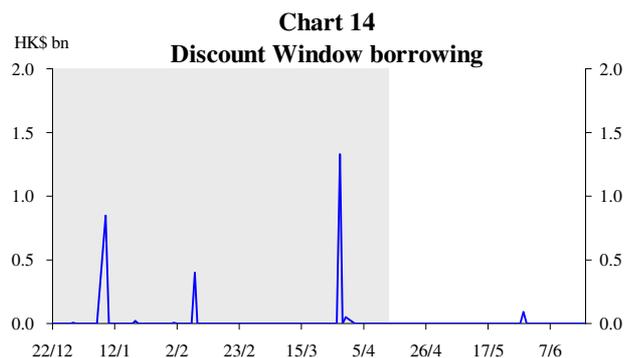
HK\$567.93 billion (86.1% of total) (Chart 13).

14. During the review period, **HK\$479.74 million of interest payments on Exchange Fund paper were made. An additional HK\$281.92 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
1-month EFB	2	1.93-9.93
3-month EFB	9	1.82-3.72
6-month EFB	7	2.13-6.70
12-month EFB	2	4.41-7.98
2-year EFN	1	4.22
3-year EFN	1	3.99
5-year EFN	1	4.51
10-year EFN	1	2.91

Discount Window activities

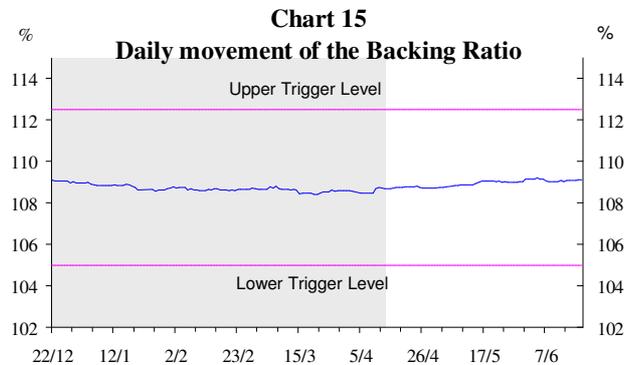
15. During the review period, **only one bank borrowed a total of HK\$90 million from the Discount Window,** compared with HK\$2.65 billion in the preceding period (Chart 14 and Table 4).



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

Backing Portfolio

16. The Backing Assets decreased slightly to HK\$1,178.47 billion during the review period, mainly reflecting the redemption of CIs. On the other hand, as the Backing Assets decreased proportionally less than the Monetary Base, **the Backing Ratio rose slightly to 109.12% from 108.69% during the review 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
13 August 2012