

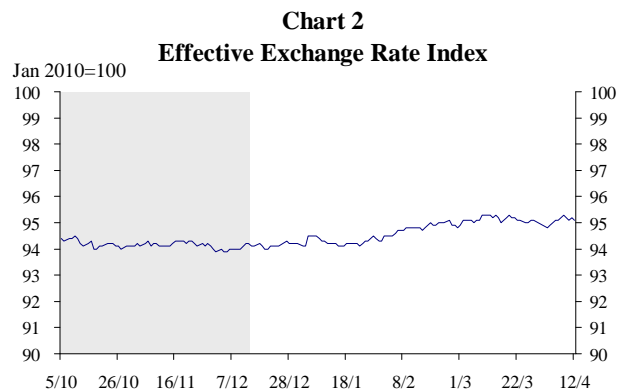
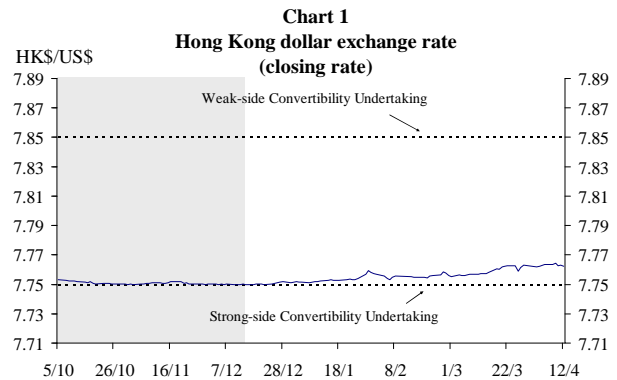
EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

Report on Currency Board Operations
(14 December 2012 – 12 April 2013)

The Hong Kong dollar spot exchange rate stayed close to the strong-side Convertibility Undertaking (CU) level of 7.75 in December 2012, with the strong-side CU being triggered occasionally. The exchange rate softened in the remainder of the review period, partly reflecting equity-related outflows. The Hong Kong dollar interbank interest rates remained largely steady. The Monetary Base expanded mainly due to the triggering of the strong-side CU. Additional Exchange Fund Bills were issued to meet banks' demand, leading to an increase in the outstanding Exchange Fund papers and a corresponding decrease in the Aggregate Balance. These operations, representing a change in the composition of the Monetary Base, were in line with Currency Board principles, as the Monetary Base remained fully backed by foreign exchange reserves.

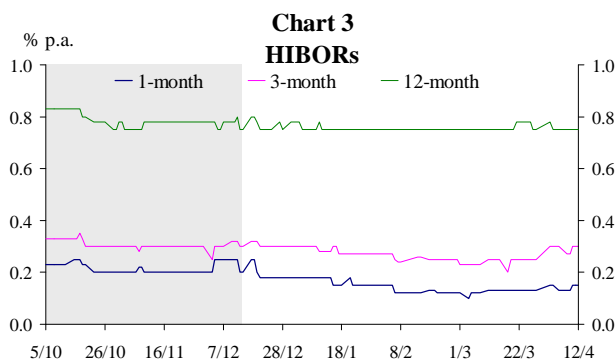
Hong Kong dollar exchange rate

1. The Hong Kong dollar exchange rate hovered around the strong-side CU level of 7.75 in December 2012, and then weakened in the remainder of the review period (Chart 1). Between 14 December and 21 December, the strong-side CU was triggered alongside continued allocations of funds to Hong Kong dollar assets by overseas investors. Thereafter, the Hong Kong dollar exchange rate softened partly reflecting equity-related outflows. While the Bank of Japan announced a new phase of quantitative easing measures on 4 April 2013, the Hong Kong dollar exchange rate continued to trade in an orderly manner. For the review period as a whole, the Hong Kong dollar exchange rate softened to 7.7621 on 12 April 2013 from 7.7500 on 14 December 2012. **The nominal effective exchange rate index of the Hong Kong dollar strengthened slightly during the review period (Chart 2), mainly reflecting the appreciation of US dollar against the euro, British pound and Japanese yen.**

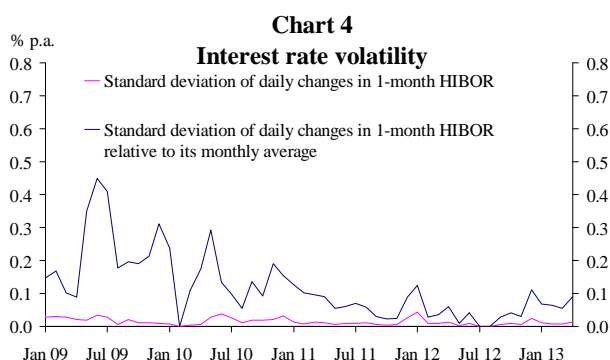


Interest rates

2. **Hong Kong dollar interbank interest rates remained largely steady in the review period (Chart 3).** The 3-month and 12-month HIBORs remained unchanged at 0.30% and 0.75% respectively, while the one-month HIBOR decreased by 5 basis points to 0.15%.

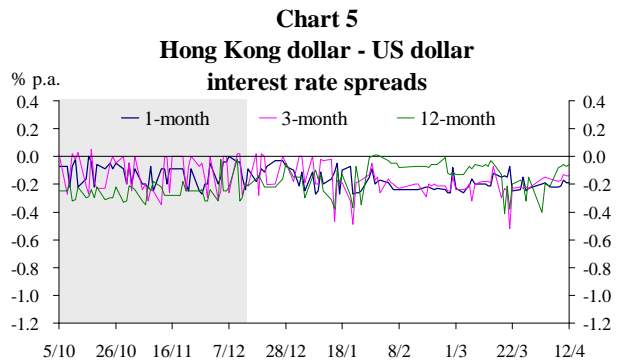


3. **Interest rate volatility remained relatively low, with the standard deviation of daily changes in the one-month HIBOR staying at 1.3 basis points between December 2012 and April 2013 (Chart 4).** The standard deviation as a ratio of the average one-month HIBOR also followed similar pattern.¹

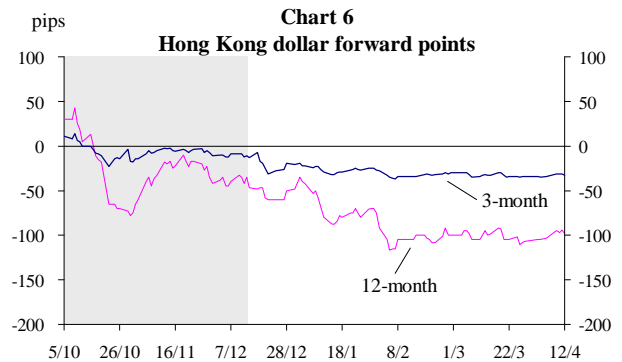


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

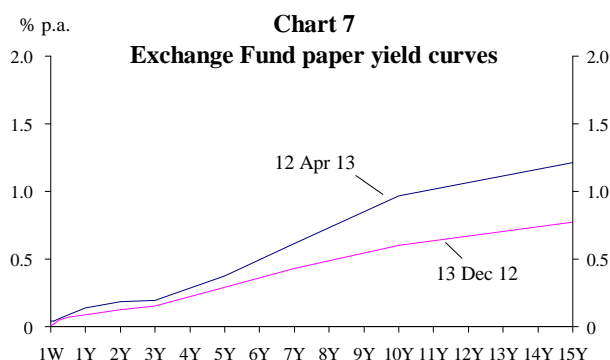
4. **The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts were roughly stable in the review period (Chart 5).** Both the one-month and three-month spreads averaged around -18 basis points, while the 12-month spread averaged around -14 basis points.



5. **The Hong Kong dollar forward discount widened during the review period (Chart 6).** The three-month and 12-month forward discounts closed at -33 and -98 pips respectively on 12 April 2013.

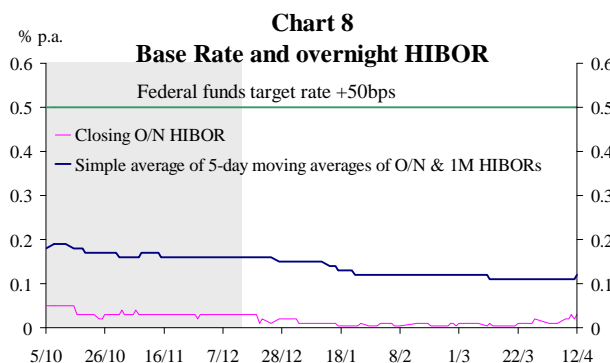


6. The yields of Exchange Fund paper broadly steepened during the review period (Chart 7). The yield spreads of Exchange Fund paper over US treasuries turned positive for shorter tenors, while the negative spreads narrowed for tenors of two years and beyond (Table 1).



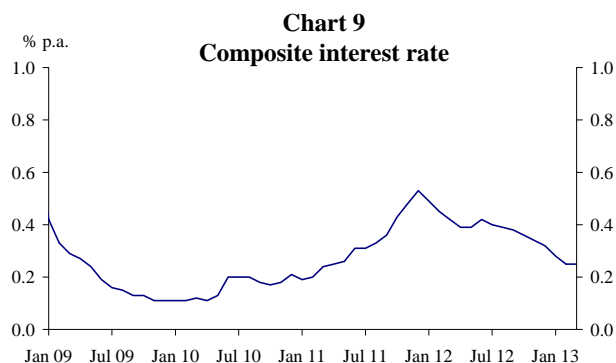
	13 Dec 12	12 Apr 13
3-month	-2	1
1-year	-6	0
3-year	-19	-16
5-year	-38	-35
10-year	-103	-83
15-year	-141	-117

7. At the January and March meetings, the US Federal Open Market Committee (FOMC) decided to keep the Federal Funds Target Rate (FFTR) at 0 – 0.25%.² As such, the **HKMA Base Rate stayed unchanged at 0.5%** (Chart 8). The Base Rate continued to be set at 50 basis points above the lower boundary of the FFTR target range in accordance with the revised Base Rate formula announced on 26 March 2009.



² At the March meeting, the FOMC decided to continue purchasing additional agency mortgage-backed securities at a pace of US\$40 billion per month and longer-term Treasury securities at a pace of US\$45 billion per month. The FOMC also anticipated that the exceptionally low range for the Federal Funds Target Rate will be appropriate at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percentage point above the FOMC's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored.

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 review period. The average one-month Hong Kong dollar time deposit rate offered by retail banks continued to stay flat at 0.01%.³ **The composite interest rate⁴**, which indicates the average cost of funds for retail banks, **dropped to 0.25% in March 2013 from 0.32% in December 2012** (Chart 9). This reflected decreases in the weighted funding costs for both deposits and interbank funds. Although several banks raised the mortgage interest rates in March 2013 reportedly in response to higher funding costs, the average mortgage interest rates for newly-approved loans remained steadily low during the review period.



³ The figure refers to the average of interest rates offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

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.

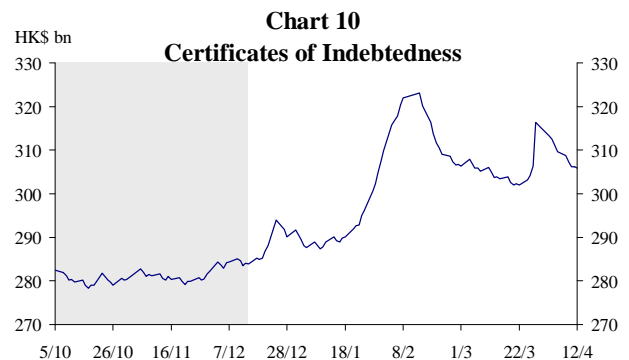
Monetary Base

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, **rose to HK\$1,233.55 billion on 12 April 2013 from HK\$1,187.42 billion on 14 December 2012** (Table 2). Movements in the individual components are discussed below.

(HK\$bn)	14 Dec 12	12 Apr 13
CIs	283.90	305.92
Government-issued Currency Notes and Coins in Circulation	10.20	10.74
Aggregate Balance	232.02	193.85
Outstanding EFBNs	661.30	723.04
Monetary Base	1,187.42	1,233.55

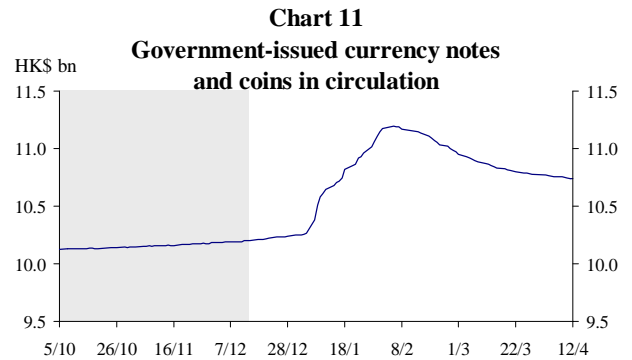
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$2.82 billion to the HKMA in exchange for HK\$22.02 billion worth of CIs. As a result, **the outstanding CIs rose to HK\$305.92 billion on 12 April 2013 from HK\$283.90 billion on 14 December 2012** (Chart 10). The outstanding CIs increased momentarily around the Chinese New Year and Easter holidays amid rising demand for banknotes.



Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation edged up to HK\$10.74 billion on 12 April 2013 from HK\$10.20 billion on 14 December 2012** (Chart 11).



Aggregate Balance

12. **The Aggregate Balance expanded to HK\$255.85 billion on 27 December 2012 from HK\$232.02 billion on 14 December 2012** (Chart 12), due to occasional triggering of the strong-side CU between 14 and 21 December (Table 3). As additional Exchange Fund Bills were issued since January 2013 to meet banks' demand, **the Aggregate Balance declined and closed at HK\$193.85 billion on 12 April 2013**. The increase in the supply of Exchange Fund paper is consistent with Currency Board principles, as the additional issuance represents a change in the composition of the Monetary Base from the Aggregate

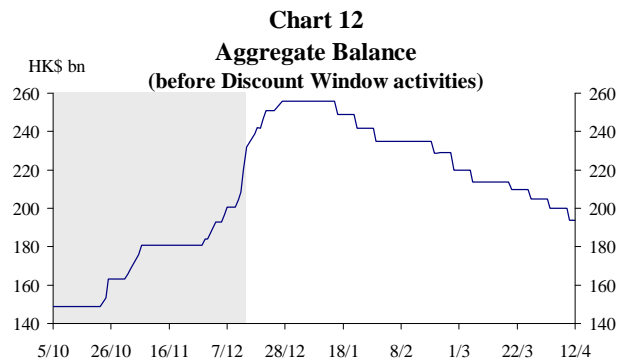
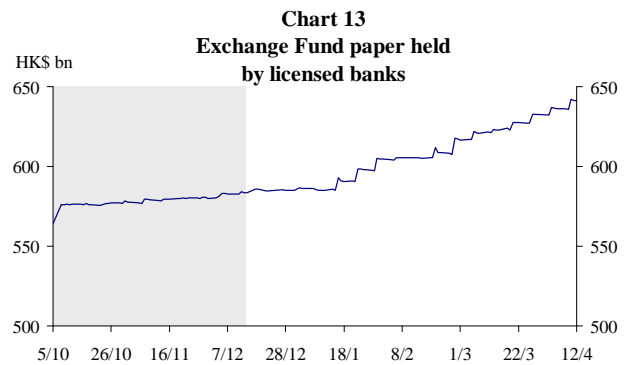


Table 3 HKMA HK\$/US\$ FX Transactions (14 Dec 12 - 12 Apr 13)	
Trade Date	Net HK\$ purchase (+) (HK\$m)
14-Dec-12	-3100.00
18-Dec-12	-4417.50
19-Dec-12	-4495.00
21-Dec-12	-5037.50
Total	-17,050.00

Balance to Exchange Fund Paper, and the Monetary Base remained fully backed by foreign exchange reserves.

Outstanding Exchange Fund Bills and Notes

13. **The market value of outstanding Exchange Fund Bills and Notes rose to HK\$723.04 billion from HK\$661.30 billion during the review period, reflecting mainly the additional issuance of Exchange Fund Bills to meet banks' demand. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) also expanded to HK\$641.17 billion (88.7% of total) from HK\$583.31 billion (88.2% of total) (Chart 13).**

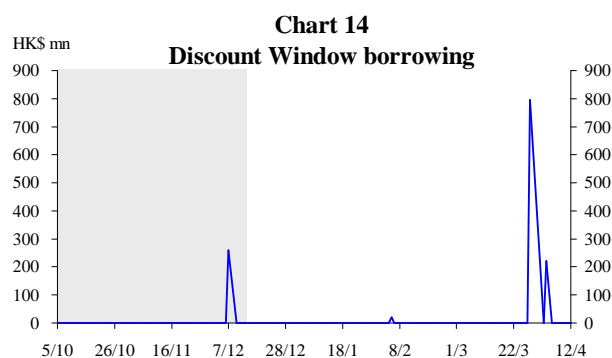


14. During the review period, **HK\$566.34 million of interest payments on Exchange Fund paper were made. An additional HK\$456.97 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were well received by the market (Table 4).

	No. of issues launched	Over-subscription ratio
3-month EFB	17	1.01-3.26
6-month EFB	16	1.30-6.85
12-month EFB	4	9.31-15.50
2-year EFN	1	4.63
3-year EFN	2	3.79-4.11
5-year EFN	2	2.48-3.13
15-year EFN	1	1.52

Discount Window activities

15. During the review period, **three banks borrowed a total of HK\$1.04 billion from the Discount Window**, compared with HK\$259 million in the preceding period (Chart 14 and Table 5).



Backing Portfolio

16. The Backing Assets expanded to HK\$1,333.64 billion during the review period, mainly driven by the triggering of the strong-side CU which led to a corresponding increase in the Monetary Base as well. As the Backing Assets rose proportionally less than the Monetary Base, **the Backing Ratio edged down to 108.26% from 108.31% 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.

Table 5
Frequency of individual bank's access to the Discount Window (14 Dec 12 - 12 Apr 13)

Frequency of using Discount Window	No. of banks
3	3

