

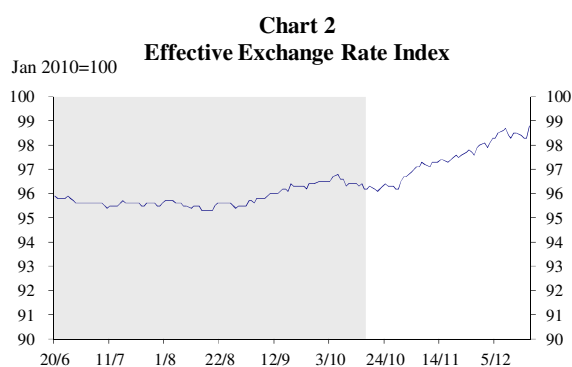
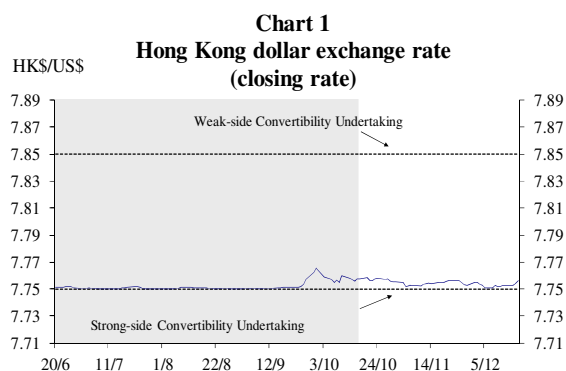
**EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee**

**Report on Currency Board Operations
(17 October – 18 December 2014)**

During the review period, the Hong Kong dollar traded within a narrow range of 7.7511 – 7.7583 against the US dollar, with movements mainly driven by equity-related flows. In December, despite increased volatility in the global financial markets and depreciation pressures in the emerging-market currencies, the Hong Kong dollar remained stable and continued to trade in an orderly manner. During the review period, the Hong Kong dollar interbank interest rates stayed at low levels. The Monetary Base was broadly steady, standing at HK\$1,340.81 billion at the end of the review period. The Aggregate Balance was virtually unchanged. All changes in the Monetary Base were fully matched by changes in foreign reserves in accordance with the Currency Board principles.

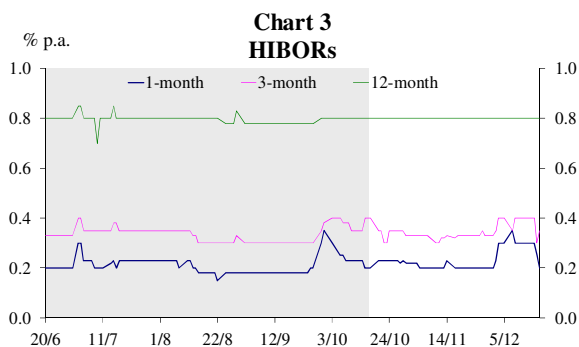
Hong Kong dollar exchange rate

1. During the review period, **the Hong Kong dollar traded within a narrow range of 7.7511 – 7.7583 against the US dollar** (Chart 1), with movements mainly driven by equity-related flows. In December, despite increased volatility in the global financial markets and depreciation pressures in the emerging-market currencies (in part triggered by a sharp decline in oil prices), the Hong Kong dollar remained stable and continued to trade in an orderly manner. The Hong Kong dollar exchange rate closed at 7.7563 on 18 December 2014, compared with 7.7576 on 17 October 2014. **The nominal effective exchange rate index of the Hong Kong dollar strengthened** during the review period, along with a stronger US dollar against major currencies (Chart 2).

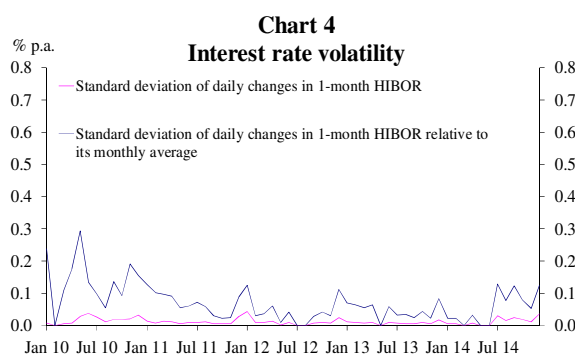


Interest rates

2. **The Hong Kong dollar interbank interest rates stayed at low levels during the review period, despite some fluctuations in December related to equity funding demand (Chart 3). For the review period as a whole, the one-month, three-month and 12-month HIBORs averaged 0.23%, 0.35% and 0.80% respectively.**

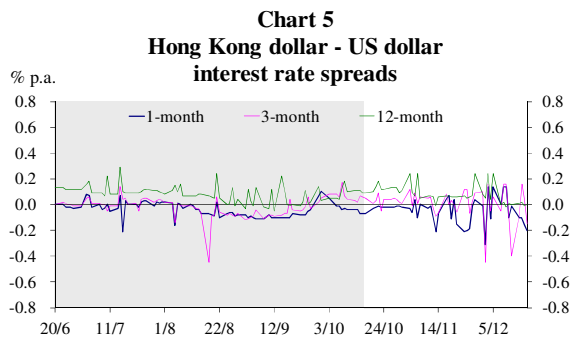


3. **Interest rate volatility (as measured by the standard deviation of daily changes in the one-month HIBOR) increased from 1.8 basis points in October to 3.5 basis points in early December (Chart 4). The standard deviation as a ratio of the average one-month HIBOR also picked up during the review period.¹**

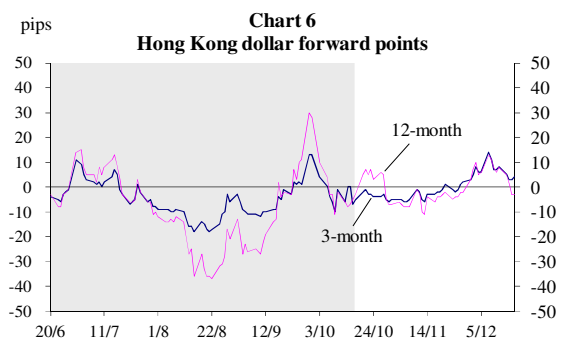


4. **The spreads between the Hong Kong dollar interest rates and their US dollar counterparts were roughly stable in the early part of the review period, but showed more fluctuations in**

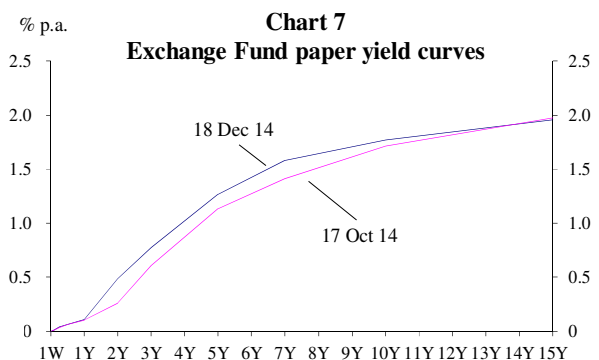
December along with the movement of the Hong Kong dollar interest rates (Chart 5). Overall, the one-month, three-month and 12-month spreads averaged -5, +1 and +8 basis points respectively.



5. The Hong Kong dollar forward points moved broadly around zero during the review period (Chart 6). In early December, forward points edged higher on increased equity fund-raising activities and seasonal funding demand ahead of the year-end and holiday season. At the end of the review period, the three-month forward point closed at a premium of 4 pips, while the 12-month forward point closed at a discount of 3 pips.



6. During the review period, the yields of the Exchange Fund paper broadly picked up along with the movement of the US Treasury yields (Chart 7). Moreover, the long end of the yield curve flattened. The yield of the 10-year tenor edged up by 6 basis points to 1.77%, while that of the 3-year tenor increased by 17 basis

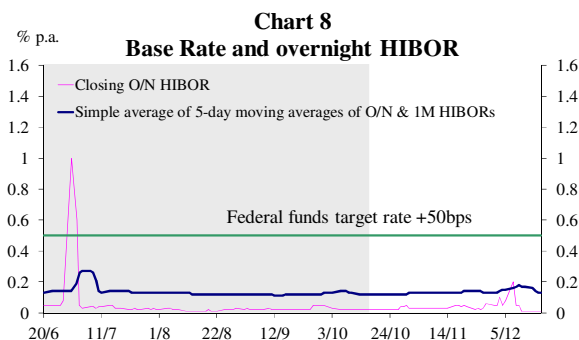


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

points to 0.78%. The yield spreads between the Exchange Fund paper and the US Treasuries narrowed slightly for tenors over 5 years (Table 1). The announcement of cessation of issuance of new EFNs of tenors of three years or above starting from January 2015 had little impact on the yields of the Exchange Fund paper.

	17 Oct 14	18 Dec 14
3-month	1	3
1-year	0	-10
3-year	-15	-30
5-year	-25	-36
10-year	-45	-39
15-year	-50	-39

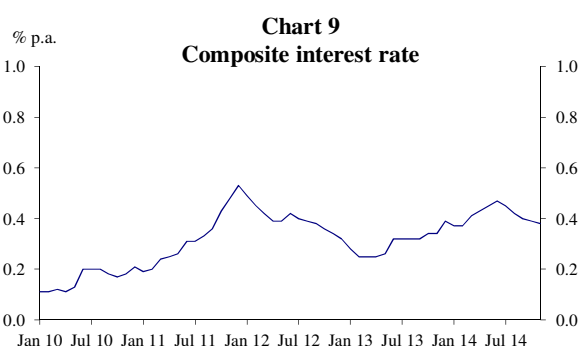
7. At the October and December meetings, the US Federal Open Market Committee (FOMC) decided to keep the current range of the Federal Funds Target Rate (FFTR) unchanged at 0 – 0.25%.² **The HKMA Base Rate remained unchanged at 0.5%** (Chart 8). It continued to be set at 50 basis points above the lower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



8. Banks kept their Best Lending Rates unchanged, consistent with the stable US FFTR. There continued to be

² At the December meeting, the FOMC judged that it could be patient in beginning to normalise the stance of monetary policy. The FOMC considered this guidance as consistent with its previous statement that it likely would be appropriate to maintain the current range of the FFTR for a considerable time following the end of its asset purchase program in October.

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 remained stable at 0.01%.³ **The composite interest rate⁴**, which indicates the average cost of funds for retail banks, **edged down to 0.38% in November** from 0.40% in September (Chart 9). On the lending side, the average mortgage interest rates for newly approved mortgage loans continued to stay at a relatively low level.



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, **was broadly steady at HK\$1,340.81 billion on 18 December 2014, compared with HK\$1,340.46 billion on 17 October 2014** (Table 2).

(HK\$bn)	17 Oct 14	18 Dec 14
CIs	336.28	336.67
Government-issued Currency Notes and Coins in Circulation	11.25	11.33
Aggregate Balance	239.19	239.20
Outstanding EFBNs	753.75	753.62
Monetary Base	1340.46	1340.81

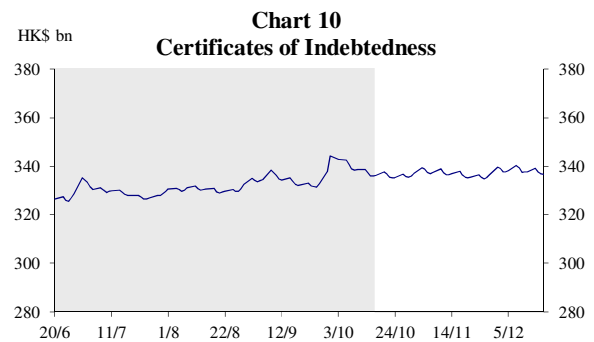
³ The figure refers to the average interest rate offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

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.

Movements in the individual components are discussed below.

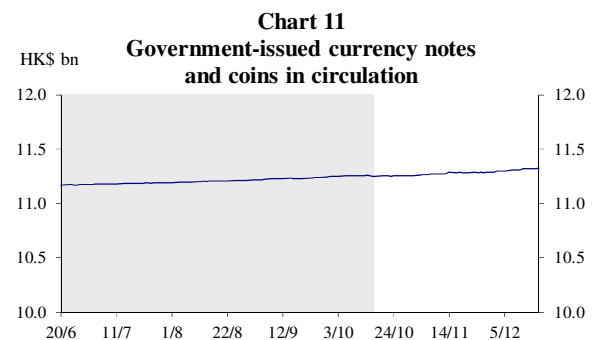
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$50 million to the HKMA in exchange for HK\$390 million worth of CIs. As a result, **the outstanding CIs increased slightly** to HK\$336.67 billion on 18 December 2014 from HK\$336.28 billion on 17 October 2014 (Chart 10).



Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation increased marginally** to HK\$11.33 billion on 18 December 2014 from HK\$11.25 billion on 17 October 2014 (Chart 11).



Aggregate Balance

12. **The Aggregate Balance stayed virtually unchanged** at around HK\$239.2 billion during the review period, with small fluctuations due to

interest payments on the 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\$753.62 billion from HK\$753.75 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$679.36 billion (90.1% of total) from HK\$671.66 billion (89.1% of total) (Chart 13).**

14. During the review period, **HK\$258.91 million of interest payments on Exchange Fund paper were made. An additional HK\$157.96 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 paper issued during the review period was well received by the market (Table 3).

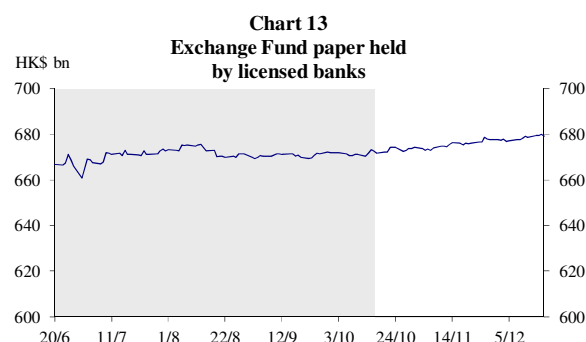
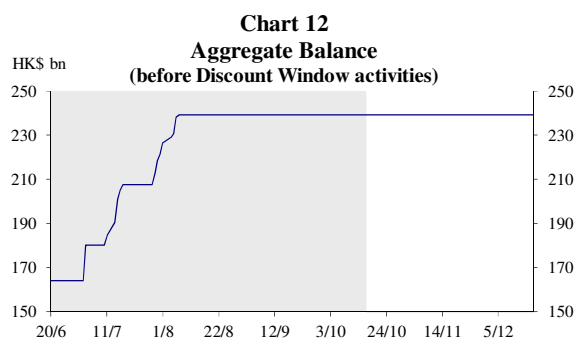
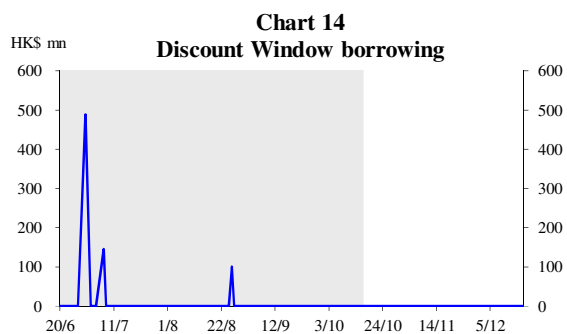


Table 3
Issuance of Exchange Fund Bills and Notes
(17 Oct 14 – 18 Dec 14)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	10.77
3-month EFB	9	0.54-6.34
6-month EFB	9	1.14-8.32
12-month EFB	2	1.33-2.36
2-year EFN	1	4.90
10-year EFN	1	3.31

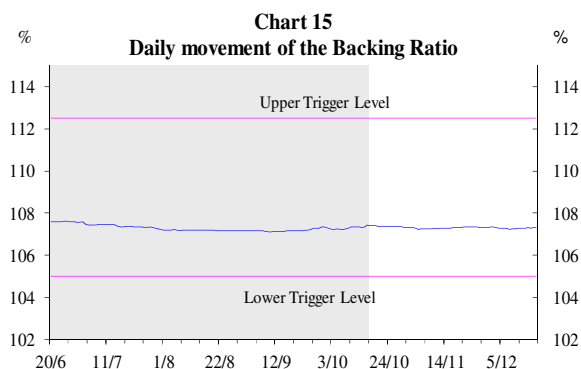
Discount Window activities

15. During the review period, **there were no banks borrowing from the Discount Window**, compared with a total of HK\$735 million borrowed by four banks in the preceding review period (Chart 14).



Backing Portfolio

16. The Backing Assets decreased slightly during the review period, to HK\$1,437.87 billion at 18 December 2014 mainly attributable to revaluation losses on investments. As the Backing Assets decreased while the Monetary Base grew marginally, **the Backing Ratio edged down to 107.32% from 107.39% 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
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