

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

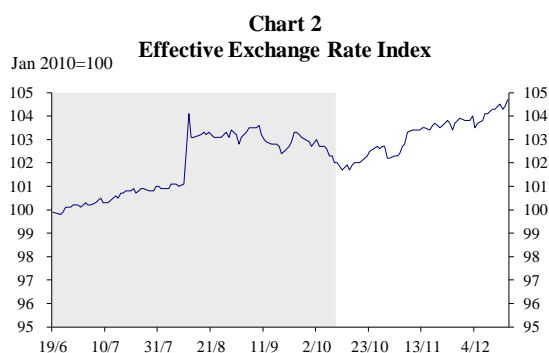
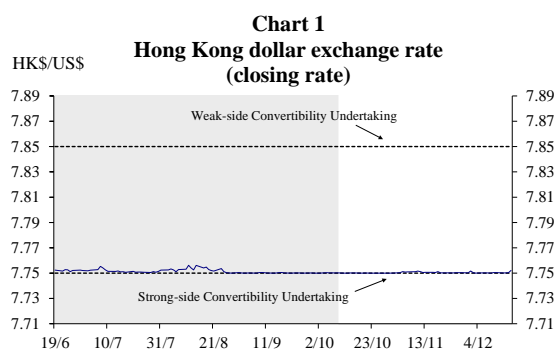
Report on Currency Board Operations

(10 October – 17 December 2015)

During the review period, the Hong Kong dollar moved within a tight range of 7.7500–7.7521 against the US dollar, and the Hong Kong dollar exchange rate remained stable notwithstanding heightened volatility in the global foreign exchange markets. The strong-side Convertibility Undertaking (CU) was triggered between 13 October and 30 October 2015, driven by conversions of the offshore renminbi (CNH) into the Hong Kong dollar, ordinary business demands for the Hong Kong dollar, and inflows related to equity initial public offerings. In the money market, the Hong Kong dollar interbank interest rates continued to stay low, while Hong Kong dollar forward points turned to larger discounts reflecting the widened interest rate spreads between the Hong Kong dollar and the US dollar. Issuance of additional Exchange Fund Bills had little impact on the interest rates. The Aggregate Balance expanded due to the triggering of the strong-side CU, and the Monetary Base increased to HK\$1,584.59 billion. All changes in the Monetary Base were fully matched by changes in foreign reserves in accordance with the Currency Board principles.

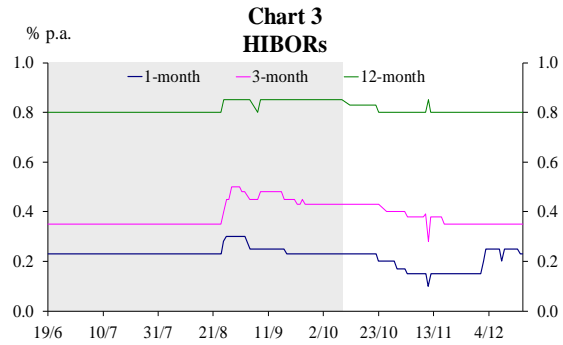
Hong Kong dollar exchange rate

1. During the review period, the Hong Kong dollar moved within a tight range of 7.7500 to 7.7521 against the US dollar (Chart 1). The Hong Kong dollar exchange market remained stable notwithstanding heightened volatility in the global foreign exchange markets. **The strong-side Convertibility Undertaking (CU) was repeatedly triggered between 13 and 30 October 2015,** driven by conversions of the offshore renminbi (CNH) into the Hong Kong dollar, ordinary business demands for the Hong Kong dollar, and inflows related to equity initial public offerings. The HKMA passively purchased a total of US\$9.7 billion from banks in exchange for HK\$75.4 billion. **The nominal effective exchange rate index of the Hong Kong dollar continued to trend up during the review period,** reflecting appreciation of the US dollar against other major currencies (Chart 2).

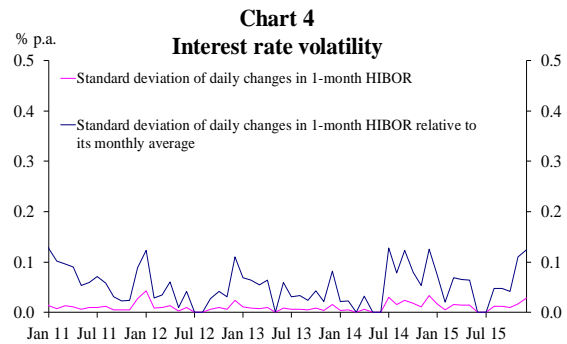


Interest rates

2. **The Hong Kong dollar interbank interest rates remained low during the review period** (Chart 3). Three-month and 12-month HIBORs edged down by 8 and 3 basis points to 0.35% and 0.80% respectively at the end of the review period, while the one-month HIBOR averaged around 0.19% during the review period.

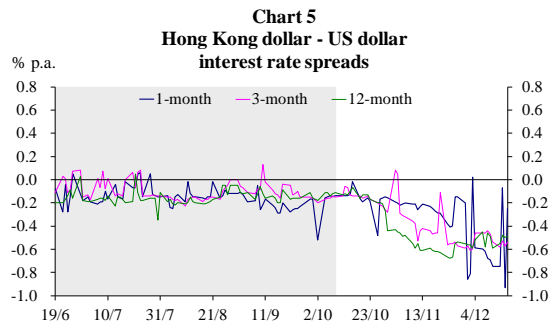


3. **Interest rate volatility, measured by the standard deviation of daily changes in the one-month HIBOR, increased to 2.9 basis points in early-December from 1.2 basis points in September** (Chart 4). The standard deviation as a ratio of the average of one-month HIBOR also picked up¹.

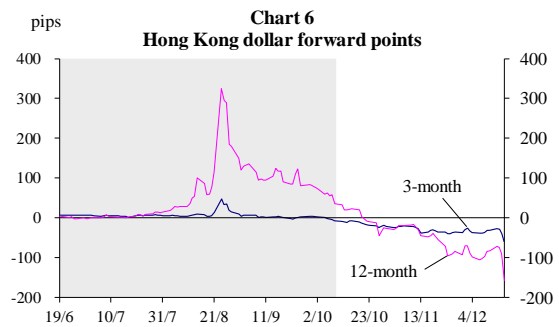


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

4. **The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts widened**, reflecting a broad-based increase in the US dollar interest rates (Chart 5). The one-month, three-month and 12-month negative interest rate spreads widened to -11, -40 and -36 basis points respectively during the review period.



5. In tandem with the widening of negative interest rate spreads, **the Hong Kong dollar forward points turned to larger discounts**. During the review period, the three-month forward discount widened by 51 pips to close at -60 pips, while 12-month forward points reverted from a premium of 33 pips to a discount of -158 pips (Chart 6).



6. Broadly tracking the movement of the US dollar yield curve, **the Hong Kong dollar yield curve shifted upward during the review period.** Yield of 3-year Hong Kong dollar Government Bond went up by 10 basis points to 0.79%, and the 10-year yield also increased by 10 basis points to 1.65% (Chart 7). The negative yield spreads of Hong Kong dollar Exchange Fund Paper and Government Bonds over the US Treasuries widened at the shorter end of the yield curve (three years or below), reflecting the relatively large increase in US dollar yields (Table 1).

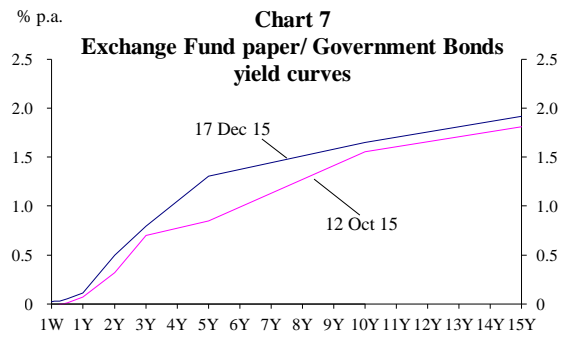
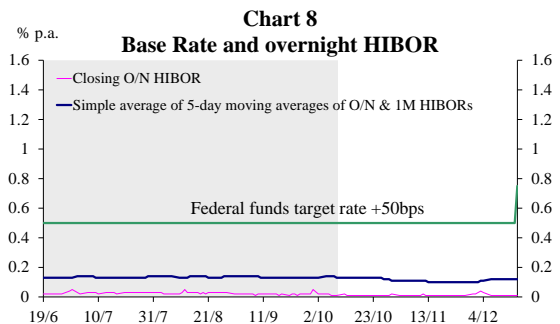


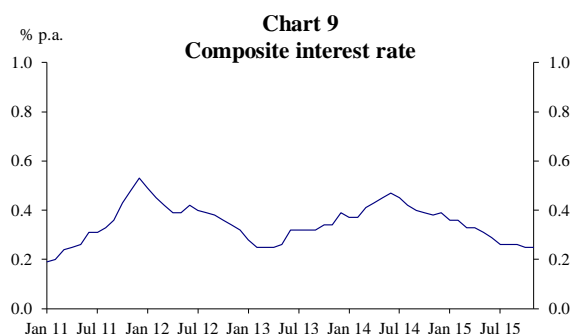
Table 1
Yield spreads of Exchange Fund paper and Hong Kong Government Bonds over US Treasuries (basis points)

	12 Oct 15	17 Dec 15
3-month EFB	-2	-20
12-month EFB	-21	-58
3-year HKGB	-26	-54
5-year HKGB	-56	-42
10-year HKGB	-57	-59

7. **The HKMA Base Rate increased from 0.5% to 0.75%**, following an upward adjustment in the US Federal Funds Target Rate (FFTR) from 0–0.25% to 0.25–0.5% on 16 December 2015 (US time) (Chart 8). The Base Rate continued to be set at 50 basis points above the lower bound of the FFTR target range in accordance with the revised Base Rate formula announced on 26 March 2009.



8. **Despite the rise in the US FFTR in December, banks kept their Best Lending Rates unchanged.** The two Best Lending Rates remained steady at 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%². **The composite interest rate³**, which indicates the average funding cost of retail banks, **edged down to 0.25% in November** from 0.26% in September (Chart 9). On the lending side, the average mortgage interest rate for newly approved mortgage loans continued to stay low.



² The figure refers to the average interest rate offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

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.

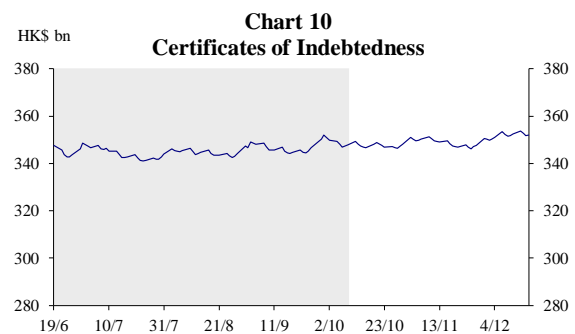
Monetary Base

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, **increased to HK\$1,584.59 billion on 17 December from HK\$1,502.22 billion on 12 October** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	12 Oct 15	17 Dec 15
CIs	349.38	351.89
Government-issued Currency Notes and Coins in Circulation	11.62	11.64
Aggregate Balance	361.48	391.35
Outstanding EFBNs	779.75	829.71
Monetary Base	1502.22	1584.59

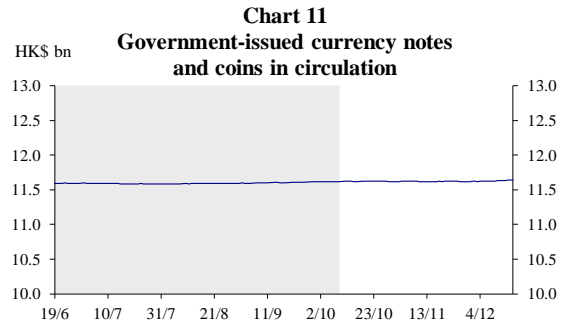
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$322 million to the HKMA in exchange for HK\$2.51 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$351.89 billion on 17 December from HK\$349.38 billion on 12 October** (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 edged up** to HK\$11.64 billion on 17 December from HK\$11.62 billion on 12 October (Chart 11).



Aggregate Balance

12. **The Aggregate Balance expanded to HK\$391.35 billion on 17 December from HK\$361.48 billion on 12 October** (Chart 12). The increase reflected mainly the triggering of the strong-side CU between 13 and 30 October, equivalent to an increase of HK\$75.4 billion in the Aggregate Balance (Table 3). Nonetheless, the increase was partly offset by the issuance of additional Exchange Fund Bills, which amounted to HK\$50 billion and resulted in a smaller net increase in the Aggregate Balance at the end of the review period.

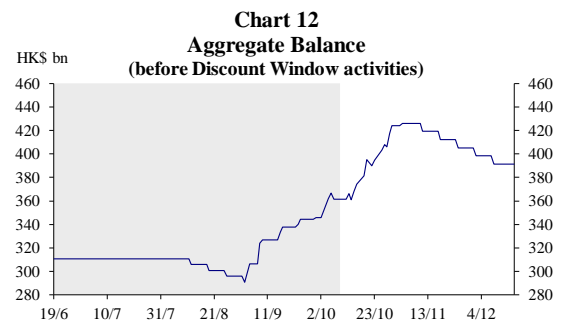
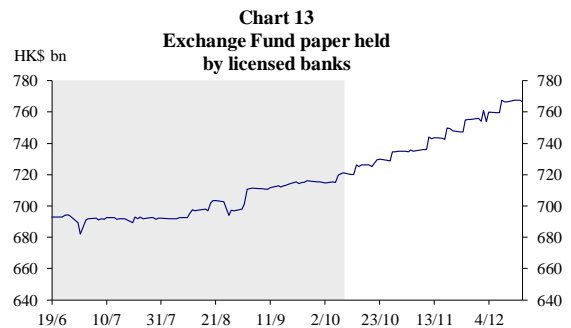


Table 3
HKMA HK\$/US\$ FX Transactions
(10 Oct – 17 Dec 15)

Trade Date	Net sale of HK\$ (HK\$mn)
13-Oct-15	6,975.00
14-Oct-15	6,200.00
15-Oct-15	7,362.50
16-Oct-15	13,640.00
20-Oct-15	4,650.00
22-Oct-15	8,370.00
23-Oct-15	4,650.00
26-Oct-15	3,100.00
27-Oct-15	11,625.00
28-Oct-15	6,858.75
30-Oct-15	1,937.50
Total	75,368.75

Outstanding Exchange Fund Bills and Notes

13. **The market value of outstanding Exchange Fund Bills and Notes increased to HK\$829.71 billion from HK\$779.75 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$766.62 billion (92.4% of total) from HK\$720.28 billion (92.4% of total) (Chart 13).**



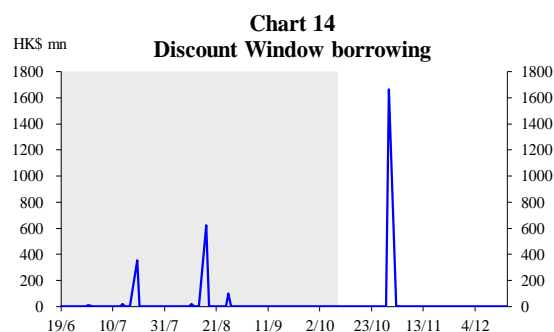
14. **The increase in outstanding Exchange Fund Bills and Notes was mainly due to the issuance of additional Exchange Fund Bills to meet the strong demand by banks for such bills for liquidity management purpose. A total of HK\$50 billion of additional Exchange Fund Bills were issued during the review period. The additional issuance is consistent with Currency Board principles, as it represents a change in the composition of the Monetary Base with a shift from the Aggregate Balance to Exchange Fund Paper, and the Monetary Base remained fully backed by foreign exchange reserves. During the review period, interest payments on**

Exchange Fund paper amounted to HK\$201.71 million. A total of HK\$106.99 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 4).

	No. of issues launched	Over-subscription ratio
1-month EFB	1	11.06
3-month EFB	10	0.50–7.98
6-month EFB	10	0.98–9.33
12-month EFB	2	1.34–4.52
2-year EFN	1	2.40

Discount Window activities

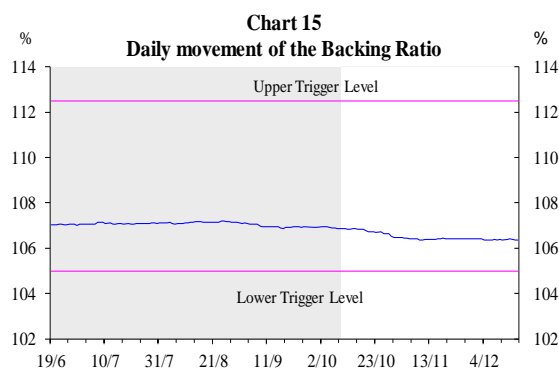
15. During the review period, one bank borrowed HK\$1.7 billion from the Discount Window, compared with HK\$1.1 billion in the preceding period (Chart 14 and Table 5).



Frequency of using Discount Window	No. of banks
1	1

Backing Portfolio

16. The Backing Assets expanded to HK\$1,684.10 billion on 17 December, mainly reflecting an increase in the Aggregate Balance due to the triggering of the strong-side CU. As the Backing Assets increased proportionally less than Monetary Base, **the Backing Ratio decreased to 106.37% from 106.85% 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
16 February 2016