

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

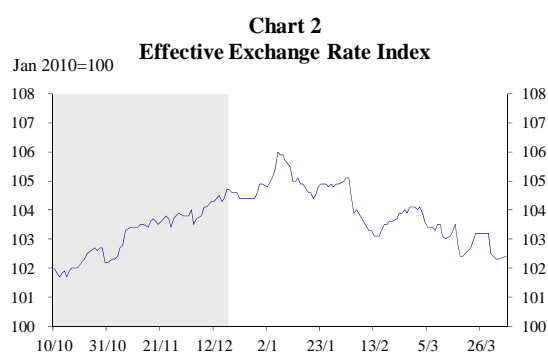
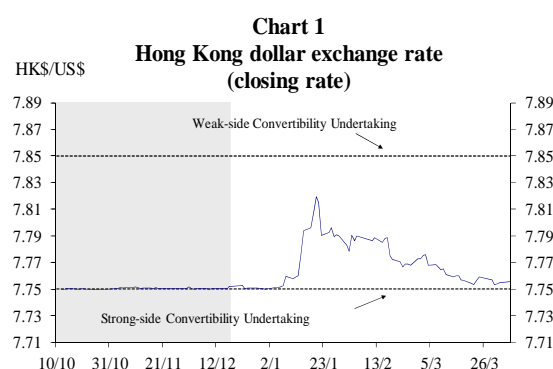
Report on Currency Board Operations

(18 December 2015 – 5 April 2016)

During the review period, the Hong Kong dollar moved within a range of 7.7500–7.8295 against the US dollar. In the early part of the review period, the Hong Kong dollar weakened notably against the US dollar amid widened negative spreads between the Hong Kong dollar and US dollar interest rates following the US interest rate lift-off and heightened global financial market volatility. Since February 2016, the Hong Kong dollar has strengthened against the US dollar due to improved market sentiment and commercial demand for the Hong Kong dollar. In the money market, the Hong Kong dollar interbank interest rates remained at relatively low levels, despite some upward pressures in late January and early February. The Hong Kong dollar forward points shifted to notable premiums in late January before softening gradually towards the end of the review period. The Convertibility Undertakings have not been triggered during the review period. The Aggregate Balance decreased due to the additional issuance of Exchange Fund Bills, and the Monetary Base increased slightly to HK\$1,608 billion due to a rise in Certificates of Indebtedness. 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

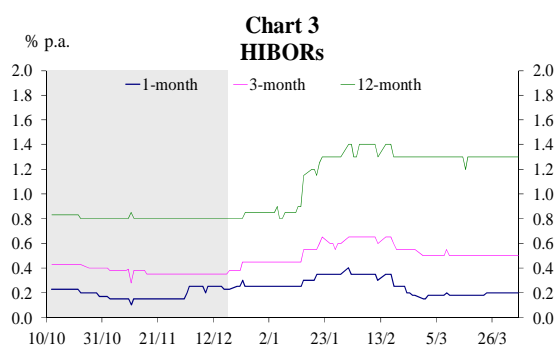
1. During the early part of the review period, the Hong Kong dollar weakened notably against the US dollar, easing from 7.7520 on 18 December 2015 to an intra-day low of 7.8295 on 20 January 2016 (Chart 1). The movements in the Hong Kong dollar was in line with the normal functioning of the Linked Exchange Rate System, given widened negative spreads between the Hong Kong dollar and the US dollar interest rates following the US interest rate lift-off. Other market-related factors, including sell-off in the domestic equity market, heightened volatility of the renminbi exchange rate, general weakness in Asian currencies, and less optimistic outlook for the Mainland and the Hong Kong economies also contributed to the decrease in demand for the Hong Kong dollar. Since February 2016, the Hong Kong dollar has strengthened gradually against the US dollar amid improved market sentiment and commercial demand for the Hong Kong dollar, closing at 7.7555 at the end of the review period. The nominal effective exchange rate index of the Hong Kong dollar declined during the review period (Chart 2), reflecting



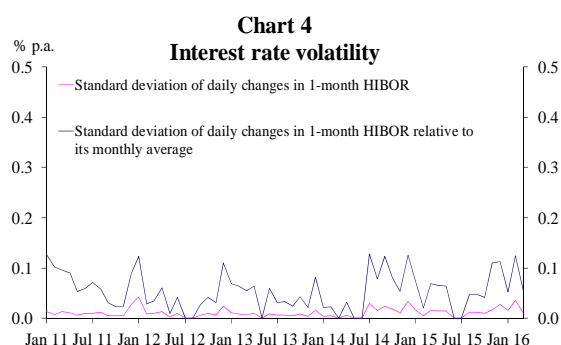
the depreciation of the US dollar against most major currencies.

Interest rates

2. **The Hong Kong dollar interbank interest rates faced upward pressures in late January and early February amid heightened financial market volatilities. However, the HIBORs remained at relatively low levels (Chart 3), with the three-month and 12-month HIBORs rising by 12 and 50 basis points respectively to 0.50% and 1.30% at the end of the period, while the one-month HIBOR averaged about 0.25% during the review period.**

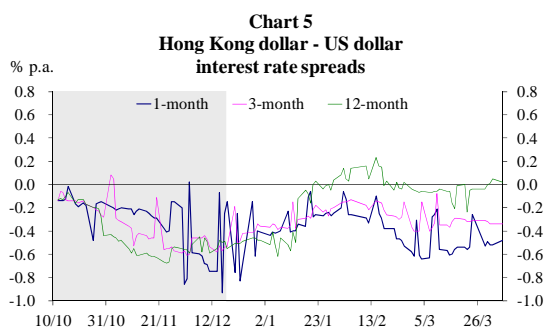


3. **Interest rate volatility, measured by the standard deviation of daily changes in the one-month HIBOR, rose to 3.6 basis points in February 2016 before falling back to 1.0 basis point in March 2016 (Chart 4). The standard deviation as a ratio of the average of one-month HIBOR also followed similar pattern¹.**

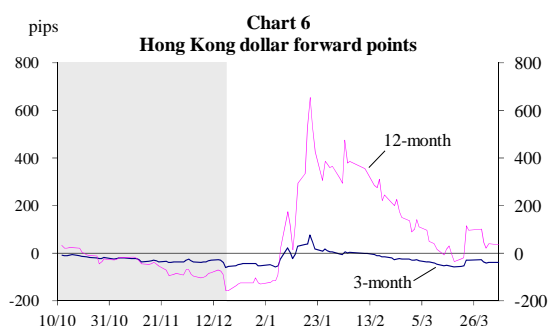


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

4. Along with the pick-up in the Hong Kong dollar interbank interest rates, **the negative spreads of the Hong Kong dollar interbank interest rates against their US dollar counterparts narrowed in late January and early February** (Chart 5), with the 12-month spread reaching the positive territory. During the latter part of the review period, the one-month and the three month negative interest rate spreads widened again, closing at -48 and -34 basis points respectively at the end of the review period, while the 12-month interest rate spread closed at +2 basis points.



5. **The Hong Kong dollar forward points turned to notable premiums in late January** (Chart 6), in part due to investors' currency hedging demand for their Hong Kong equity portfolios. **Thereafter, the forward points softened gradually** along with the strengthening of the Hong Kong dollar spot rate, with the three-month and the 12-month forward points registering at a discount of 40 pips and a premium of 35 pips respectively at the end of the review period.



6. Broadly tracking the movement of the US dollar yield curve, **the Hong Kong dollar yield curve flattened during the review period.** The yield of the 3-year Hong Kong dollar Government Bond went down by 5 basis points to 0.69%, while that of the 10-year tenor decreased by 33 basis points to 1.23% (Chart 7). Meanwhile, the negative yield spreads of Hong Kong dollar Exchange Fund Paper and Government Bonds over the US Treasuries narrowed, due to larger declines in the US dollar yields (Table 1).

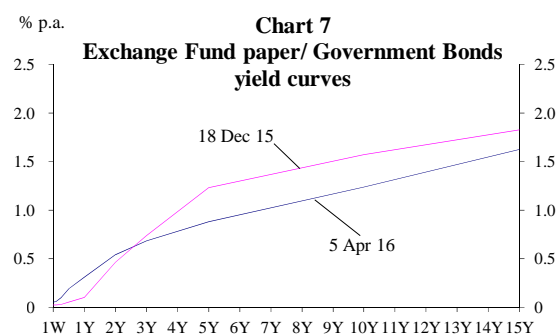
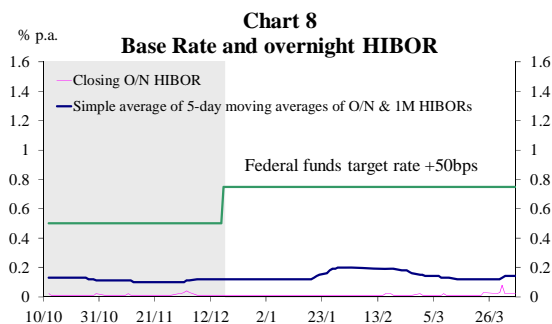
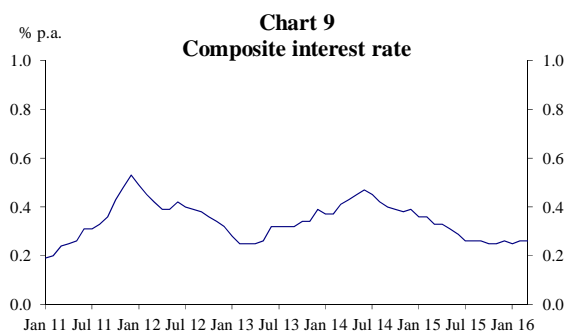


Table 1 Yield spreads of Exchange Fund paper and Hong Kong Government Bonds over US Treasuries (basis points)		
	18 Dec 15	05 Apr 16
3-month EFB	-16	-13
12-month EFB	-57	-25
3-year HKGB	-54	-17
5-year HKGB	-44	-29
10-year HKGB	-62	-50

7. At the January and March meetings, the US Federal Open Market Committee (FOMC) decided to keep the Federal Funds Target Rate (FFTR) at 0.25–0.5%. As such, **the HKMA Base Rate stayed unchanged at 0.75%** (Chart 8), which is 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.** The two Best Lending Rates stayed unchanged at 5.00% and 5.25% during 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, **remained largely steady at 0.26% in March 2016** (Chart 9). On the lending side, the average mortgage interest rate for newly approved mortgage loans picked up slightly in February 2016, but still remained at a relatively low level.



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.

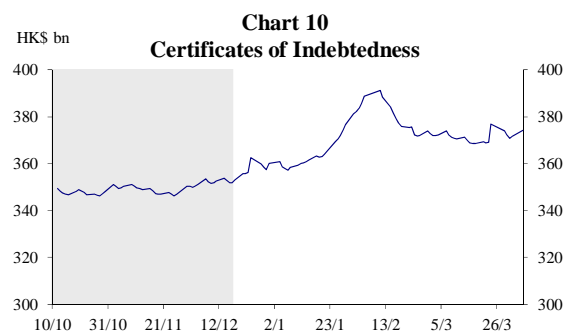
Monetary Base

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\$1,608.00 billion on 5 April 2016 from HK\$1,585.84 billion on 18 December 2015** (Table 2). Movements of the individual components are discussed below.

Table 2 Monetary Base		
(HK\$bn)	18 Dec 15	05 Apr 16
CIs	353.04	374.20
Government-issued Currency Notes and Coins in Circulation	11.65	11.97
Aggregate Balance	391.36	363.39
Outstanding EFBNs	829.80	858.45
Monetary Base	1585.84	1608.00

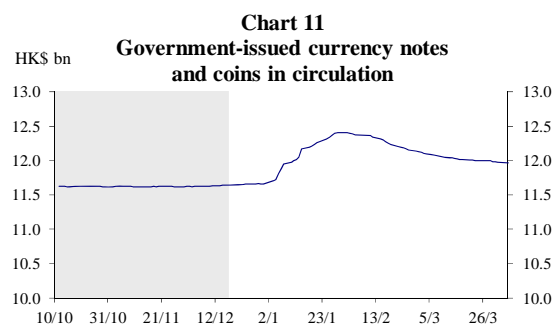
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$2.7 billion to the HKMA in exchange for HK\$21.16 billion worth of CIs. As a result, **the outstanding CIs increased** to HK\$374.20 billion on 5 April 2016 from HK\$353.04 billion on 18 December 2015 (Chart 10), with some fluctuations driven by increased demand for banknotes ahead of the Chinese New Year holidays and the Easter holidays.



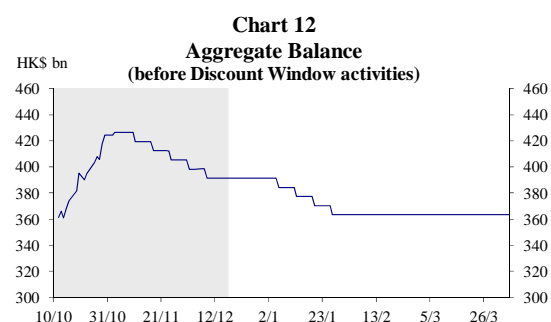
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation** increased to HK\$11.97 billion on 5 April 2016 from HK\$11.65 billion on 18 December 2015 (Chart 11).



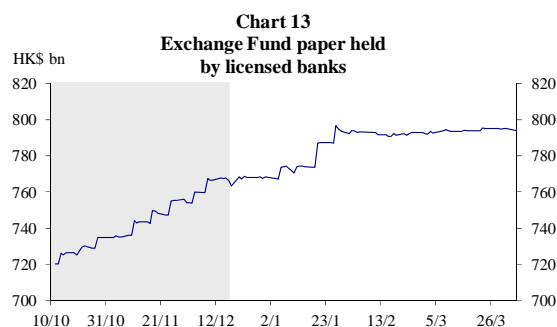
Aggregate Balance

12. The **Aggregate Balance** declined to HK\$363.39 billion on 5 April 2016 from HK\$391.36 billion on 18 December 2015 (Chart 12), as additional Exchange Fund Bills totalling HK\$28 billion were issued to meet the increased demand by banks for such bills for liquidity management purpose.



*Outstanding Exchange Fund
Bills and Notes*

13. The market value of outstanding Exchange Fund Bills and Notes increased to HK\$858.45 billion from HK\$829.80 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased to HK\$793.83 billion (92.5% of total) from HK\$ 763.27 billion (92.0% 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. 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\$698.43 million. A total of HK\$555.76 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 (18 Dec 15 – 5 Apr 16)		
	No. of issues launched	Over-subscription ratio
1-month EFB	2	2.41-5.70
3-month EFB	15	0.37-6.14
6-month EFB	14	0.58-3.60
12-month EFB	4	3.27-16.68
2-year EFN	1	5.41

Discount Window activities

15. During the review period, **four banks borrowed HK\$550 million from the Discount Window**, compared with HK\$1.7 billion in the preceding period (Chart 14 and Table 4).

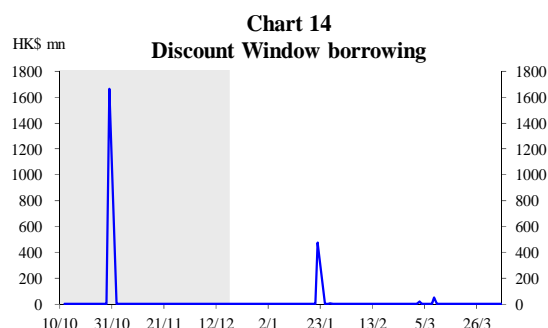
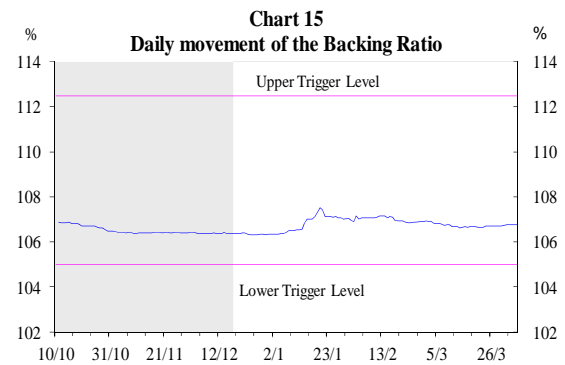


Table 4 Frequency of individual bank's access to the Discount Window (18 Dec 15 – 5 Apr 16)	
Frequency of using Discount Window	No. of banks
1	4

Backing Portfolio

16. The Backing Assets expanded to HK\$1,715.24 billion on 5 April 2016, mainly reflecting an increase in the CIs and valuation gains. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio increased slightly to 106.78% from 106.36% 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
6 June 2016