

EXCHANGE FUND ADVISORY COMMITTEE

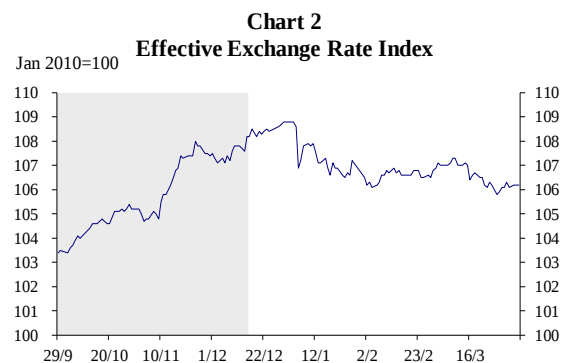
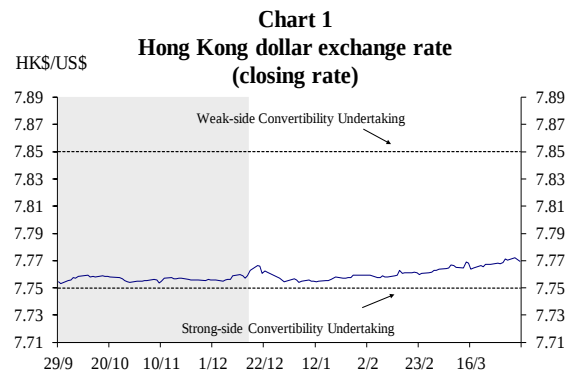
Currency Board Sub-Committee

Report on Currency Board Operations
(16 December 2016 – 5 April 2017)

During the review period, the Hong Kong dollar interbank interest rates were broadly steady despite the rise in the US dollar interest rates. Alongside widening negative spreads between the Hong Kong dollar and the US dollar interest rates, the Hong Kong dollar exchange rate softened gradually and traded within a range of 7.7542–7.7720, while the Hong Kong dollar forward points moved into deeper discounts. The Aggregate Balance stayed virtually unchanged, and the Monetary Base increased slightly to HK\$1,653.75 billion driven by an increase 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.

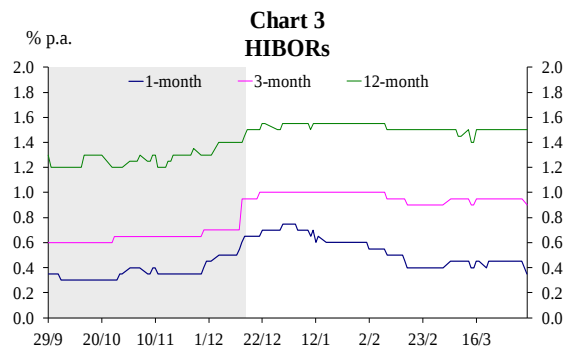
Hong Kong dollar exchange rate

1. During the review period, **the Hong Kong dollar moved within a range of 7.7542–7.7720 against the US dollar (Chart 1).** In mid-December 2016, the Hong Kong dollar eased slightly alongside increases in financial market volatilities amid concerns about the US interest rate hike. Nonetheless, the Hong Kong dollar quickly regained some strength in late December on increases in the southbound flows via the stock connects and flows related to position-squaring before the year-end. The renewed strength, however, was only short-lived and the Hong Kong dollar has softened gradually against the US dollar since mid-January, in part reflecting the widened negative Hong Kong dollar-US dollar interest rate spreads. At the end of the review period, the Hong Kong dollar closed at 7.7695 against the US dollar. Overall, the Hong Kong dollar exchange and interbank markets continued to function in an orderly manner. During the review period, **the nominal effective exchange rate index of the Hong Kong dollar declined slightly**, reflecting the weakening of the US dollar against most major currencies (Chart 2).

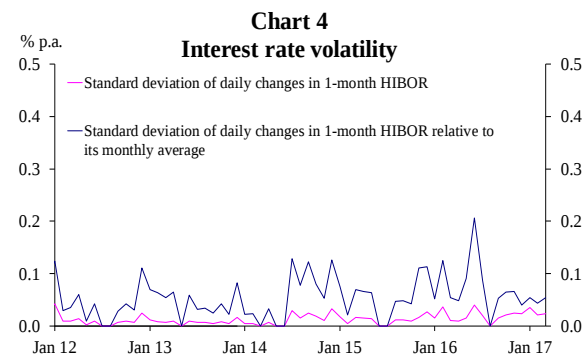


Interest rates

2. Despite the rise in the US dollar interest rates, **the Hong Kong dollar interbank interest rates were broadly steady** during the review period (Chart 3), with the short-term interbank rates seeing moderate fluctuations due to year-end funding demand. The three-month and 12-month HIBORs averaged about 0.96% and 1.51% respectively during the review period, while the one-month HIBOR decreased by 30 basis points to 0.35% at the end of the review period.

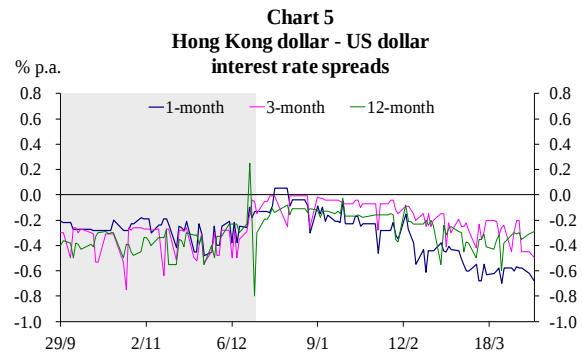


3. **Interest rate volatility**, measured by the standard deviation of daily changes in the one-month HIBOR, **remained low** at around 2.7 basis points between January and March (Chart 4). The standard deviation as a ratio of the average of one-month HIBOR followed a similar pattern.¹

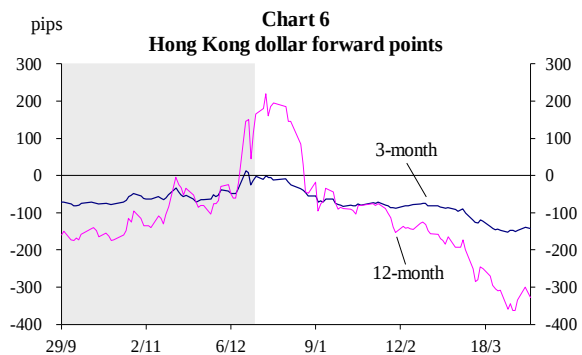


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

4. During the review period, **the negative Hong Kong dollar-US dollar interbank interest rate spreads generally widened** (Chart 5), reflecting increases in the US dollar interest rates as well as declines in the short-term Hong Kong dollar interest rates. At the end of the review period, the one-month, three-month and 12-month interest rate spreads closed at -68, -50 and -29 basis points respectively.



5. Broadly tracking the Hong Kong dollar-US dollar interbank interest rate spreads, **the Hong Kong dollar forward points moved into deeper discounts towards the end of the review period** (Chart 6), with the three-month and 12-month Hong Kong dollar forward points closing at -143 pips and -328 pips respectively.



6. **Hong Kong dollar yield curve moved downward** during the review period. The yield of the 2-year Exchange Fund Note decreased by 19 basis points to 0.86%, and the yield of the 10-year Hong Kong Government Bond declined by 29 basis points to 1.54% (Chart 7). The negative yield spreads of Hong Kong Government Bonds over the US Treasuries generally widened, mainly reflecting larger decreases in the Hong Kong dollar yields relative to the US dollar counterparts (Table 1).

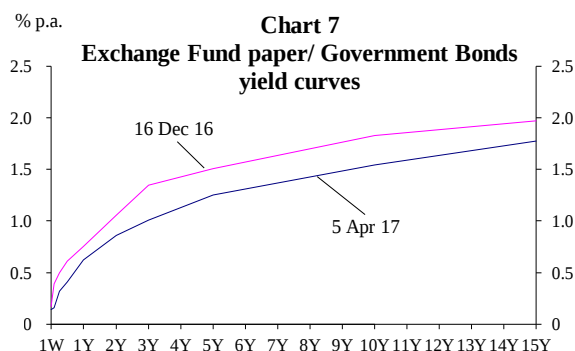
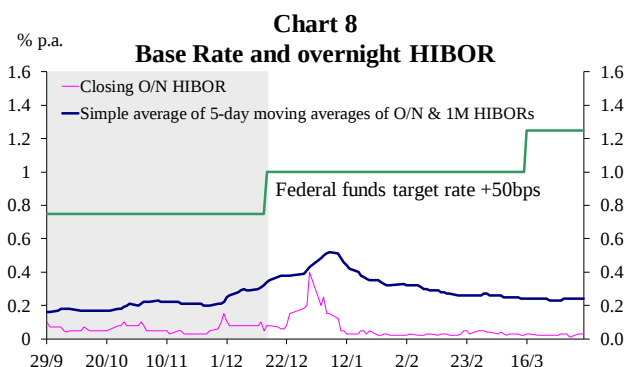
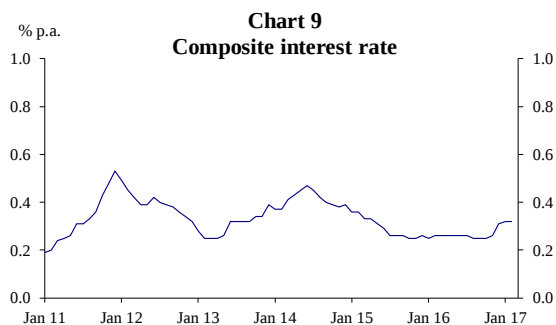


Table 1 Yield spreads of Exchange Fund paper and Hong Kong Government Bonds over US Treasuries (basis points)		
	16 Dec 16	05 Apr 17
3-month EFB	-1	-48
12-month EFB	-16	-41
3-year HKGB	-24	-43
5-year HKGB	-56	-60
10-year HKGB	-77	-80

7. **The HKMA Base Rate increased from 1.00% to 1.25%**, following the upward adjustment in the target range for the US Federal Funds Rate from 0.50 – 0.75% to 0.75 – 1.00% on 15 March 2017 (US time) (Chart 8). The Base Rate continued to be set at 50 basis points above the lower bound of the target range for the US Federal Funds Rate in accordance with the revised Base Rate formula announced on 26 March 2009.



8. **Banks kept their Best Lending Rates unchanged despite the rise in the US Federal Funds Rate in March 2017.** The two Best Lending Rates stayed 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, **edged up from 0.31% in December 2016 to 0.32% in March 2017** (Chart 9). On the lending side, the average mortgage interest rate for newly approved mortgage loans stayed at a relatively low level amid relatively stable funding costs and keen competition in the residential mortgage lending business.



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.

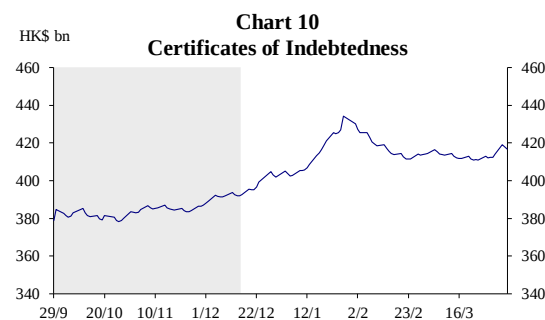
Monetary Base

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\$1,653.75 billion on 5 April 2017 from HK\$1,626.42 billion on 16 December 2016** (Table 2). Movements of the individual components are discussed below.

Table 2 Monetary Base		
(HK\$bn)	16 Dec 16	05 Apr 17
CIs	392.43	416.89
Government-issued Currency Notes and Coins in Circulation	12.01	12.31
Aggregate Balance	259.54	259.53
Outstanding EFBNs	962.44	965.02
Monetary Base	1626.42	1653.75

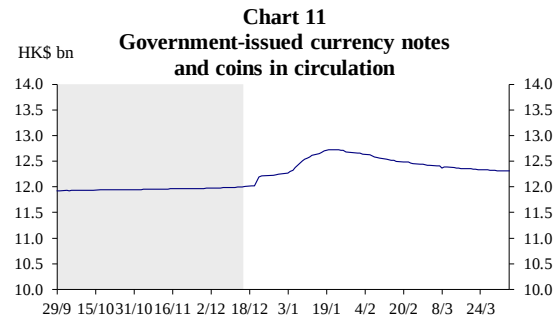
Certificates of Indebtedness

10. During the review period, the three note-issuing banks submitted US\$3.14 billion to the HKMA in exchange for HK\$24.5 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$416.89 billion on 5 April 2017 from HK\$392.43 billion on 16 December 2016** (Chart 10), with fluctuations mainly driven by increased demand for banknotes ahead of the Chinese New Year holidays.



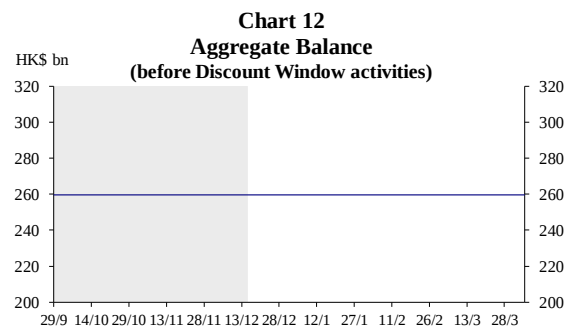
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation** increased slightly to HK\$12.31 billion on 5 April 2017 from HK\$12.01 billion on 16 December 2016 (Chart 11).



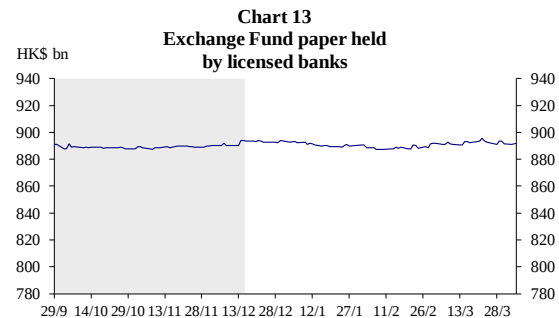
Aggregate Balance

12. **The Aggregate Balance** stayed **virtually unchanged** at around HK\$259.5 billion during the review period, only 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 up to HK\$965.02 billion from HK\$962.44 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased to HK\$891.93 billion (92.4% of total) from HK\$893.55 billion (92.8% of total) (Chart 13).



14. During the review period, interest payments on Exchange Fund paper amounted to HK\$1,894.38 million. A total of HK\$1,794.44 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 generally well received by the market (Table 3).

Table 3 Issuance of Exchange Fund Bills and Notes (16 Dec 16 – 5 Apr 17)		
	No. of issues launched	Over- subscription ratio
1-month EFB	2	1.76-1.95
3-month EFB	16	0.59-1.79
6-month EFB	15	0.90-3.91
12-month EFB	4	1.45-11.52
2-year EFN	1	2.97

Discount Window activities

15. During the review period, **two banks borrowed HK\$530 million from the Discount Window**, compared with a total borrowing of HK\$2.60 billion in the preceding period (Chart 14 and Table 4).

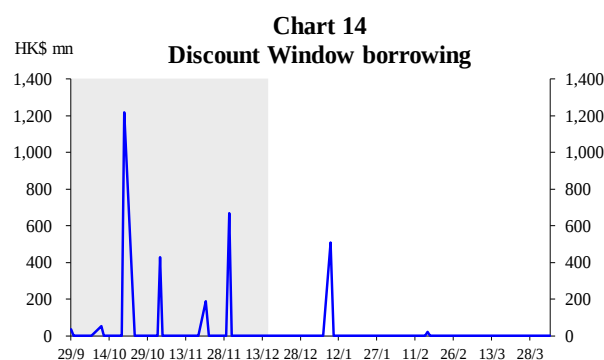


Table 4
Frequency of individual bank's
access to the Discount Window
(16 Dec 16 – 5 Apr 17)

Frequency of using Discount Window	No. of banks
1	2

Backing Portfolio

16. The Backing Assets increased slightly to HK\$1,769.11 billion on 5 April 2017, as the note-issuing banks submitted more US dollars to the Exchange Fund in return for the CIs required for issuance of banknotes. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio edged up to 107.02% from 106.78% 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.

