

**EXCHANGE FUND ADVISORY COMMITTEE**

**Currency Board Sub-Committee**

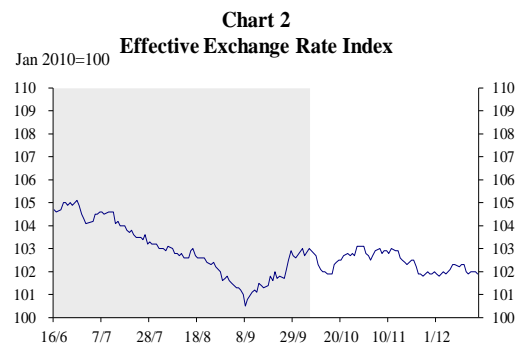
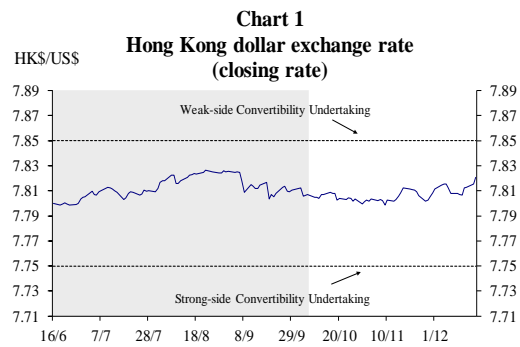
**Report on Currency Board Operations**

**(7 October – 19 December 2017)**

During the review period, the short-dated Hong Kong dollar (HKD) interbank interest rates went higher, mainly driven by initial public offering (IPO)-related funding demand and banks' cautious stance on liquidity management ahead of month-end and year-end. The tighter liquidity conditions led to an increase in covering of short HKD position, driving the HKD firmer to around 7.80 against the US dollar (USD) in the early part of the review period. Thereafter, alongside a rise in year-end commercial demand for the USD and a pick-up in interest carry trade activities as HKD liquidity conditions improved, HKD eased again. For the review period as a whole, the HKD exchange rate traded within a range of 7.7985 – 7.8205 against USD. The Aggregate Balance declined due to issuances of additional Exchange Fund Bills (EFBs). The Monetary Base increased slightly to HK\$1,682.66 billion, mainly due to a rise in Certificates of Indebtedness (CIs). All changes in the Monetary Base were fully matched by changes in foreign reserves in accordance with the Currency Board principles.

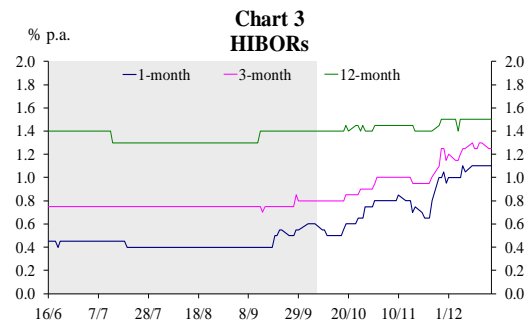
## Hong Kong dollar exchange rate

1. During the review period, **the HKD traded within a range of 7.7985 – 7.8205 against the USD** (Chart 1). Largely driven by the covering of short HKD positions amid concerns about HKD liquidity tightening, the HKD spot exchange rate firmed to around 7.80 between early October and mid-November. Towards the end of the review period, the HKD eased again, partly reflecting the pick-up in the momentum of interest carry trade activities amid improved HKD liquidity conditions, as well as an increase in year-end commercial demand for the USD. The HKD spot exchange rate closed at 7.8205 against the USD at the end of the review period. **The nominal effective exchange rate index of the HKD generally moved sideways** during the review period (Chart 2), largely following the movements of the USD against most major currencies.

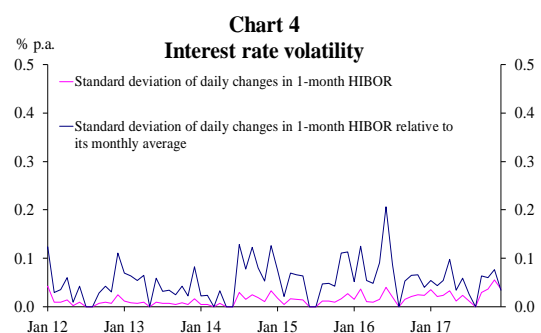


## Interest rates

2. During the review period, **the short-dated HKD interbank interest rates (i.e., the HIBORs) went higher** (Chart 3). Noticeable pick-ups were seen in October-November, largely due to equity- and IPO-related funding demand, banks' cautious stance on managing liquidity ahead of month-end and year-end, and expectations of the US rate hike. The HIBORs continued to rise in December, albeit at a slower pace. By the end of the review period, the one-month, three-month and 12-month HIBORs were respectively 50 basis points (to 1.10%), 45 basis points (to 1.25%) , and 10 basis points (to 1.50%) higher than those at the end of the preceding review period. The HKD interbank market continued to function normally.

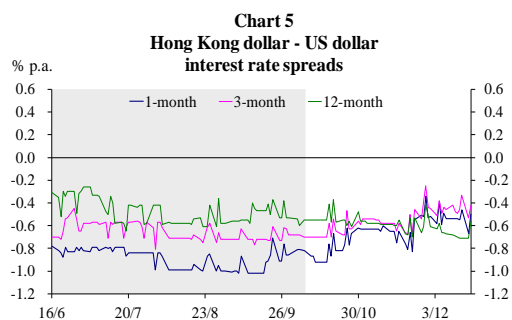


3. **Interest rate volatility**, measured by the standard deviation of daily changes in the one-month HIBOR, **rose** to 5.2 basis points in the current review period from 2.0 basis points in the preceding review period (Chart 4). The standard deviation as a ratio of the average of one-month

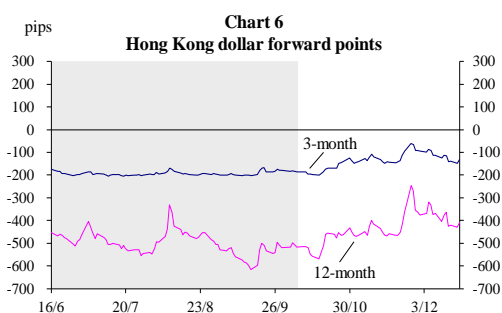


HIBOR also exhibited similar movements<sup>1</sup>.

4. Largely reflecting the movements of HIBORs, **the one-month and three-month negative HKD-USD interbank interest rate spreads narrowed somewhat in October-November, before seeing some stabilisation in early December** (Chart 5). At the end of the review period, the one-month and three-month interest rate spreads closed at -50 and -42 basis points respectively. Meanwhile, **the 12-month interest rate spread widened** to around -70 basis points in mid-December as the increase in 12-month HIBOR was less than its USD counterpart.

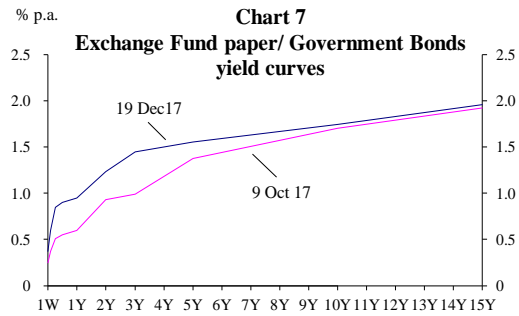


5. Broadly tracking the HKD-USD interbank interest rate spreads, **the discounts of HKD forward points narrowed in October-November, but widened gradually again in December** (Chart 6). At the end of the review period, the three-month and 12-month HKD forward points closed at -131 pips and -408 pips respectively.



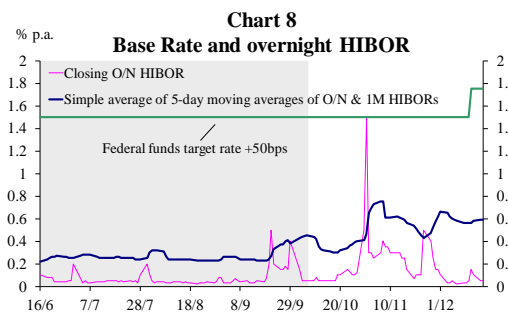
<sup>1</sup> The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

6. Broadly following the movement of the USD yield curve, the **HKD yield curve shifted upward but flattened** during the review period (Chart 7). The yield of the 3-year Hong Kong Government Bond rose by 44 basis points to 1.45% against the end of the preceding review period, while the yield of the 10-year Hong Kong Government Bond increased marginally by 4 basis points to 1.74%. The negative yield spreads of the longer-term Hong Kong Government Bonds over US Treasuries widened slightly as HKD yields rose less than their US counterparts in that segment (Table 1).

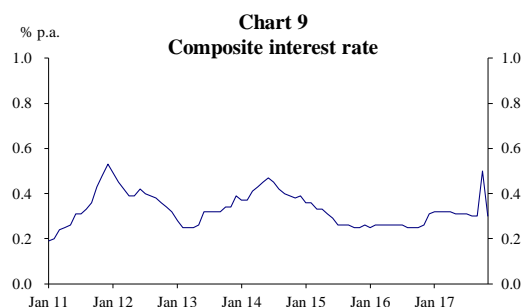


	09 Oct 17	19 Dec 17
3-month EFB	-56	-52
12-month EFB	-75	-76
3-year HKGB	-67	-53
5-year HKGB	-59	-68
10-year HKGB	-66	-72

7. **The HKMA Base Rate increased from 1.50% to 1.75%, following the upward adjustment in the target range for the Federal Funds Rate from 1.00-1.25% to 1.25%-1.50% on 13 December 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. **Despite the increase in the target range for the US Federal Funds Rate in December, banks kept their Best Lending Rates unchanged.** The two Best Lending Rates stayed at 5.00% and 5.25% during the review period. The average one-month HKD time deposit rate offered by retail banks remained stable at 0.01%<sup>2</sup>. **The composite interest rate<sup>3</sup>**, which indicates the average funding cost of retail banks, **remained relatively low** at 0.32% in November (Chart 9), although it picked up briefly to 0.50% in October amid a rise in funding cost due to IPO activities. On the lending side, the average interest rate for newly approved mortgage loans increased alongside the rise in one-month HIBOR.



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

<sup>3</sup> This is a weighted average interest rate of all HKD interest bearing liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and HKD 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.

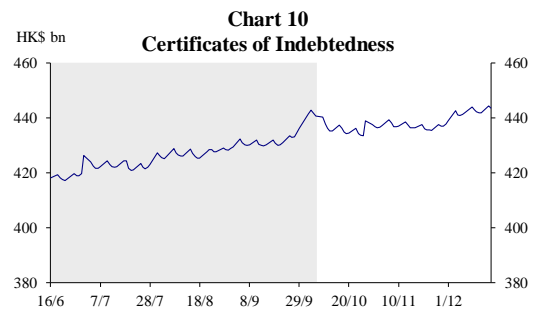
## Monetary Base

9. **The Monetary Base**, which consists of CIs, government-issued currency notes and coins in circulation, the Aggregate Balance, and Exchange Fund Bills and Notes, **increased to HK\$1,682.66 billion on 19 December from HK\$1,678.81 billion on 9 October** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	09 Oct 17	19 Dec 17
CIs	440.41	443.56
Government-issued Currency Notes and Coins in Circulation	12.34	12.41
Aggregate Balance	203.64	179.70
Outstanding EFBNs	1,022.42	1,047.00
<b>Monetary Base</b>	<b>1,678.81</b>	<b>1,682.66</b>

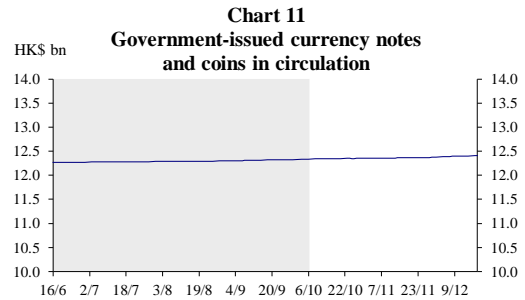
### *Certificates of Indebtedness*

10. During the review period, **the outstanding CIs increased to HK\$443.56 billion on 19 December from HK\$440.41 billion on 9 October** (Chart 10). The increase was due to the note-issuing banks submitting a net amount of US\$404 million to the HKMA in exchange for around HK\$3.2 billion worth of CIs.



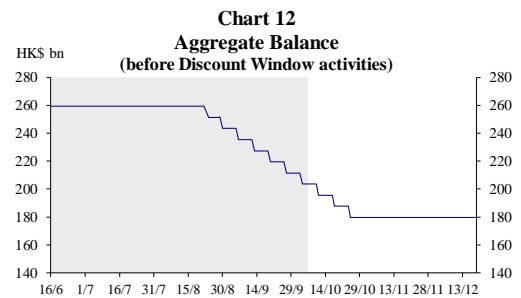
*Government-issued currency notes and coins in circulation*

11. During the review period, the amount of **government-issued currency notes and coins in circulation** increased slightly to HK\$12.41 billion on 19 December from HK\$12.34 billion on 9 October (Chart 11).



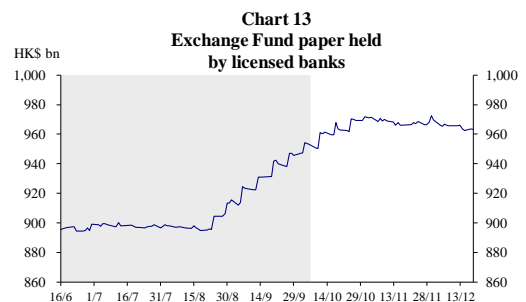
*Aggregate Balance*

12. **The Aggregate Balance declined** to HK\$179.70 billion on 19 December from HK\$203.64 billion on 9 October (Chart 12). The decline in October was attributable to the issuances of additional EFBs 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 the outstanding Exchange Fund Bills and Notes increased** to HK\$1,047.00 billion from HK\$1,022.42 billion during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) increased** to HK\$963.27 billion (92.0% of total) from HK\$950.69 billion (93.0% of total) (Chart 13).



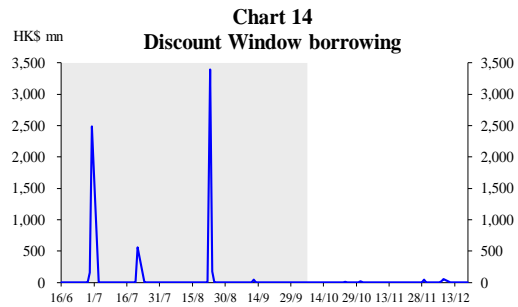


14. **The increase in outstanding Exchange Fund Bills and Notes was mainly due to the issuances of additional EFBs.** A total of HK\$24 billion of additional EFBs were issued during the review period. The additional issuance is consistent with the Currency Board principles, as it represents a change 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. Separately, **interest payments on Exchange Fund paper amounted to HK\$1,635.83 million** during the review period. **A total of HK\$1,545.00 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).

	No. of issues launched	Over- subscription ratio
1-month EFB	2	2.14-5.09
3-month EFB	11	0.64-1.31
6-month EFB	11	1.13-2.68
12-month EFB	2	2.56-2.57
2-year EFN	1	10.21

**Discount Window activities**

15. During the review period, **five banks borrowed a total of HK\$155 million from the Discount Window**, compared with a total borrowing of HK\$6.8 billion in the preceding period (Chart 14 and Table 4).



**Backing Portfolio**

16. The Backing Assets increased to HK\$1,819.27 billion on 19 December, mainly reflecting an increase in the CIs and valuation gains from investments. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio edged up to 108.16% from 107.93% 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 HKD exchange rate.

<b>Table 4</b> <b>Frequency of individual bank's access to the Discount Window (7 Oct –19 Dec 17)</b>	
Frequency of using Discount Window	No. of banks
1	5

