

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

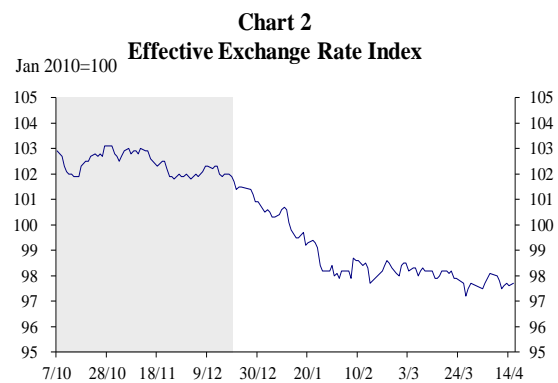
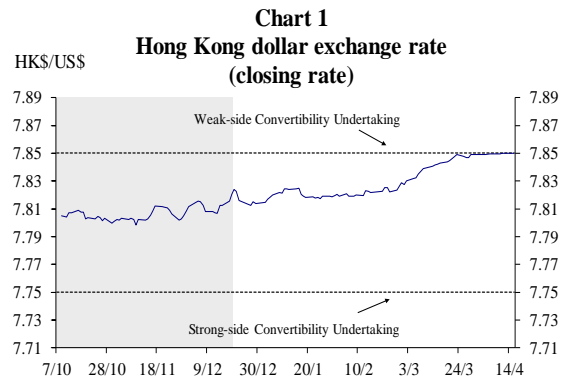
Report on Currency Board Operations

(20 December 2017 – 16 April 2018)

During the review period, the Hong Kong dollar (HKD) traded within a range of 7.8127 – 7.8500 against the US dollar (USD). After stabilising at around 7.82 in the early part of the review period, the HKD eased gradually against the USD since March 2018, with the weak-side Convertibility Undertaking (CU) being triggered repeatedly between 12 and 16 April. The weakening and triggering largely reflected the increased interest carry trade activities amid the widening of the negative HKD-USD interest rate spread. The short-dated HKD interbank interest rates generally declined in the first two months of 2018 but picked up in March, partly reflecting the growing expectation of faster US interest rate hikes. Overall, the HKD exchange and interbank markets continued to function normally. The Aggregate Balance decreased due to the triggering of the weak-side CU, but the Monetary Base increased to HK\$1,712.09 billion mainly driven by 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.

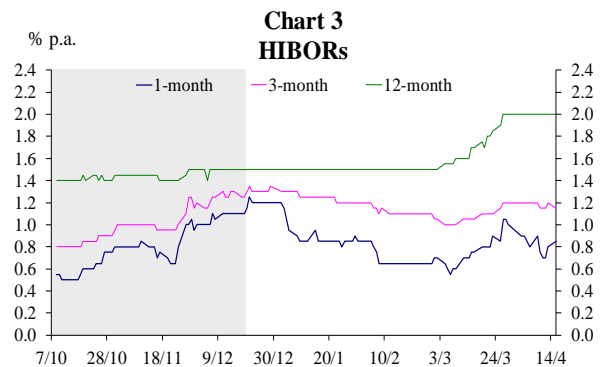
Hong Kong dollar exchange rate

1. During the review period, **the HKD moved within a range of 7.8127 – 7.8500 against the USD** (Chart 1). Despite the pick-up in interest carry trade activities, **the HKD spot exchange rate remained broadly stable around 7.82 level in the early part of the review period** in part supported by south-bound stock connect inflow. **Stepping into March 2018, however, the HKD softened gradually towards 7.8500, with the weak-side CU being triggered six times between 12 and 16 April.**¹ This weakening mainly reflected the increased interest carry trade activities amid the widening of the negative HKD-USD interest rate spreads. Overall, the HKD continued to trade in an orderly manner, closing at 7.8499 against the USD at the end of the review period. **The nominal effective exchange rate index of the HKD generally declined during the review period** (Chart 2), largely reflecting the broad weakness in the USD against most major currencies.



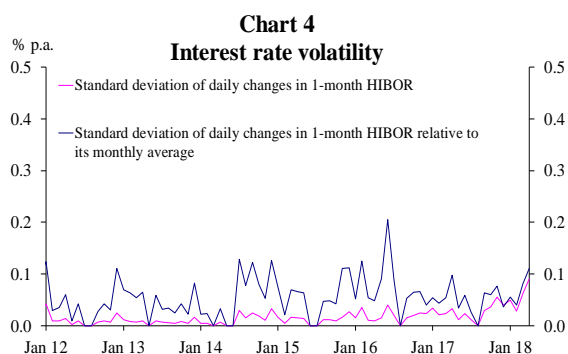
Interest rates

2. During the review period, the HKD interbank market continued to function normally despite increased volatilities in the local stock market. **The short-dated HKD interbank interest rates (i.e., HIBORs) declined between January and February** as the year-end funding demand receded (Chart 3). **Thereafter**, reflecting growing expectation of faster US interest rate hikes and market's growing anticipation of triggering the weak-side CU as HKD exchange rate moved towards 7.8500, **HIBORs picked up across different tenors in March**. Following a brief stabilisation after the quarter-end, HIBORs moved up gradually again towards the end of the review period subsequent to the triggerings of the weak-side CU. Compared with the levels at the end of the preceding review period, the one-month and three-month HIBORs decreased by 30 basis points and 15 basis points, closing at 0.85% and 1.15% respectively, while the 12-month HIBOR increased by 50 basis points to 2.00% at the end of the current review period.

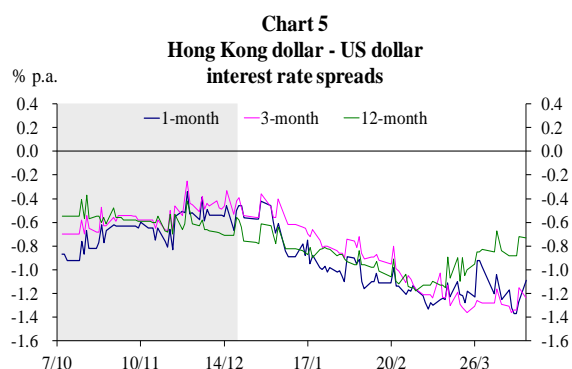


¹ The HKMA passively purchased a total of HK\$19.02 billion from banks in exchange for US\$2.42 billion.

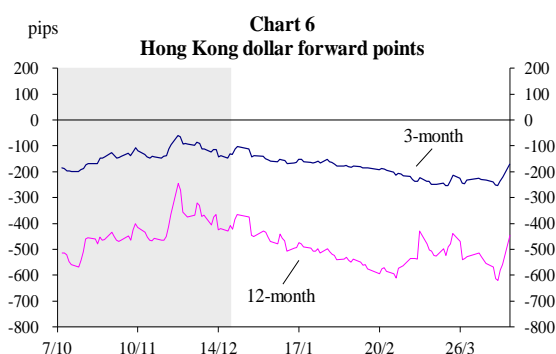
3. **Interest rate volatility**, measured by the standard deviation of daily changes in the one-month HIBOR, **edged up to 5.6 basis points** in the current review period from 5.2 basis points in the preceding review period (Chart 4). The standard deviation as a ratio of the average of one-month HIBOR also showed similar movements².



4. Mainly reflecting the rises in USD interbank interest rates, **the negative HKD-USD interbank interest rate spreads widened gradually during the review period.** Nevertheless, **the 12-month negative spreads narrowed somewhat towards the end of the review period**, due to a larger pick-up in the 12-month HIBOR than its USD counterpart (Chart 5). At the end of the review period, the one-month, three-month and 12-month spread closed at -109, -124 and -73 basis points, respectively.



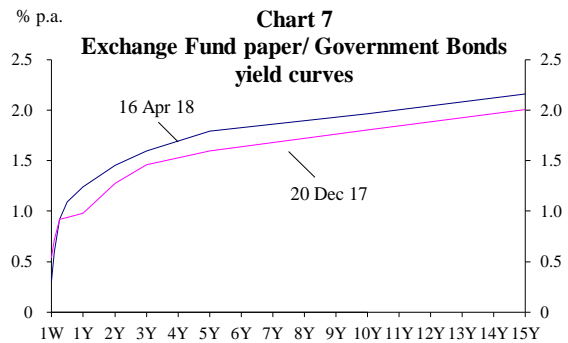
5. Broadly tracking the HKD-USD interbank interest rate spreads, **the discounts of HKD forward points generally widened during the review period** (Chart 6). At the end of the review period, the



² 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.

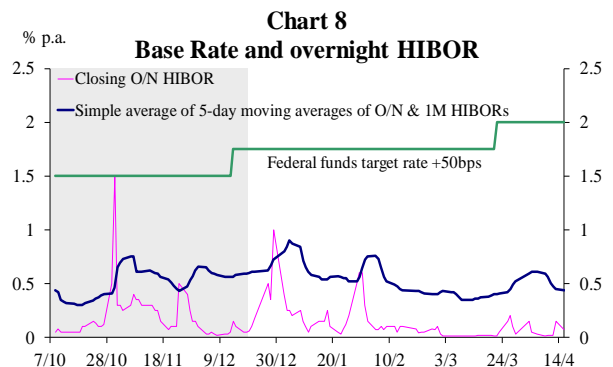
three-month and 12-month HKD forward points closed at -170 pips and -445 pips respectively.

6. Along with the movement of the USD yield curve, **the HKD yield curve shifted upward** during the review period (Chart 7). The yields of the 3-year and the 10-year Hong Kong Government Bond increased slightly, by 13 and 16 basis points to 1.60% and 1.96% respectively against the end of the preceding review period. The negative yield spreads of the Hong Kong Government Bonds over US Treasuries widened, reflecting smaller increases in the HKD yields relative to their USD counterparts (Table 1).



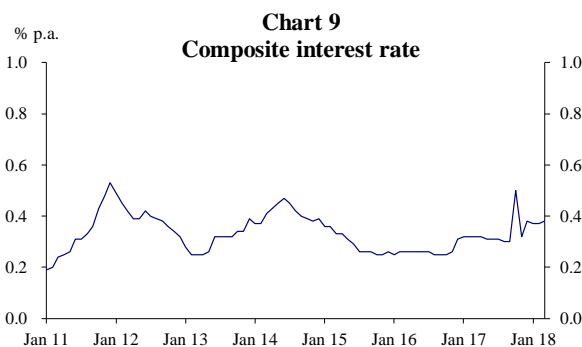
	20 Dec 17	16 Apr 18
3-month EFB	-46	-87
12-month EFB	-74	-88
3-year HKGB	-52	-92
5-year HKGB	-64	-90
10-year HKGB	-69	-87

7. **The HKMA Base Rate increased from 1.75% to 2.00%**, following the upward adjustment in the target range for the US Federal Funds Rate from 1.25%-1.50% to 1.50%-1.75% on 21 March 2018 (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 increase in the target range for the US Federal Funds Rate in March 2018.

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%³. **The composite interest rate**⁴, which indicates the average funding cost of retail banks, **increased slightly** from 0.32% in November 2017 to 0.38% in March 2018 (Chart 9). On the lending side, the average interest rate for newly approved mortgage loans hovered around the prevailing Prime-based cap of 2.15%.⁵



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 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.

⁵ Excluding fixed-rate mortgage.

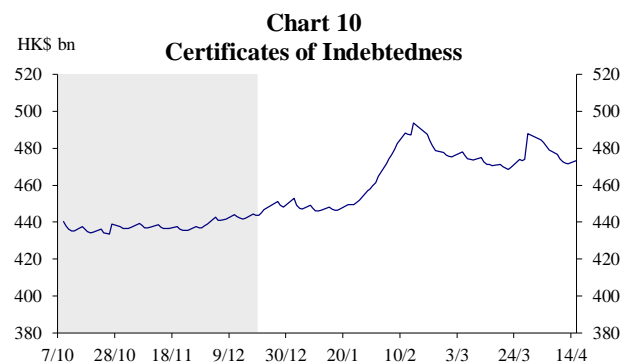
Monetary Base

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\$1,712.09 billion on 16 April 2018 from HK\$1,682.75 billion on 20 December 2017** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	20 Dec 17	16 Apr 18
CIs	443.65	473.32
Government-issued Currency Notes and Coins in Circulation	12.41	12.74
Aggregate Balance	179.71	176.52
Outstanding EFBNs	1,046.99	1,049.52
Monetary Base	1,682.75	1,712.09

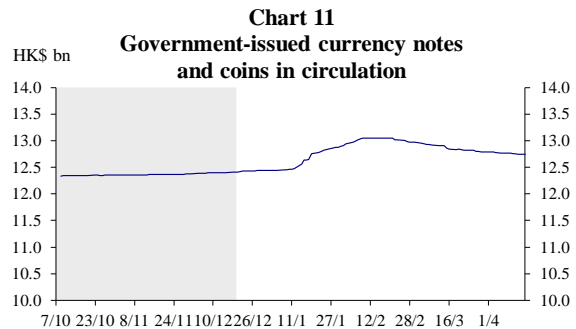
Certificates of Indebtedness

10. During the review period, note-issuing banks submitted a net amount of US\$3.8 billion to the HKMA in exchange for around HK\$29.7 billion worth of CIs. As a result, **the outstanding CIs increased** to HK\$473.32 billion on 16 April 2018 from HK\$443.65 billion on 20 December 2017 (Chart 10). There were two noticeable spikes, mainly attributable to increased demand for banknotes ahead of the Chinese New Year holidays and the Easter holidays.



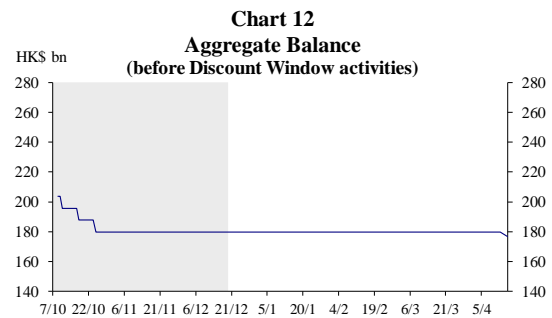
Government-issued currency notes and coins in circulation

11. During the review period, the amount of **government-issued currency notes and coins in circulation** increased slightly to HK\$12.74 billion on 16 April 2018 from HK\$12.41 billion on 20 December 2017 (Chart 11).



Aggregate Balance

12. The **Aggregate Balance** decreased from **HK\$179.71 billion** to **HK\$176.52 billion** during the review period (Chart 12). The decline reflected the triggering of the weak-side CU on 12 April (Table 3). These foreign exchange operations are consistent with Currency Board principles, as the decreases in the Monetary Base were matched by equivalent decreases in US dollar reserves.



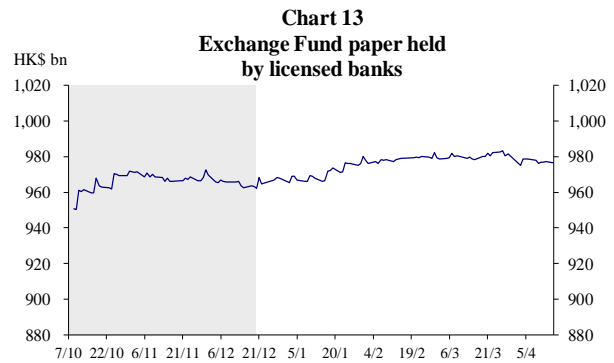
Trade Date	Net purchase of HK\$ (HK\$mn)
12-Apr-18	3,257
13-Apr-18	6,406*
16-Apr-18	9,357*
Total	19,021

*The figures would be reflected in the Aggregate Balance after the review period, on 17 April and 18 April respectively. The Aggregate Balance was projected to decrease further to HK\$160.74 billion as at 18 April.

Outstanding Exchange Fund Bills and Notes

13. The **market value of the outstanding Exchange Fund Bills and Notes** increased to HK\$1,049.52 billion from HK\$1,046.99 billion during the review period. **Holdings of Exchange Fund paper by the banking sector (before Discount**

Window activities) increased to HK\$976.58 billion (93.1% of total) from HK\$962.09 billion (91.9% of total) (Chart 13).



14. During the review period, **interest payments on Exchange Fund paper amounted to HK\$3,001.67 million. A total of HK\$2,831.87 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 4).

Table 4
Issuance of Exchange Fund Bills and Notes
(20 Dec 17 – 16 Apr 18)

	No. of issues launched	Over-subscription ratio
1-month EFB	1	4.91
3-month EFB	16	0.76-2.38
6-month EFB	16	1.09-3.53
12-month EFB	4	3.57-6.08
2-year EFN	1	6.98

Discount Window activities

15. During the review period, **13 banks borrowed a total of HK\$6,804 million from the Discount Window**, compared with a total borrowing of HK\$155 million in the preceding period (Chart 14 and Table 5).

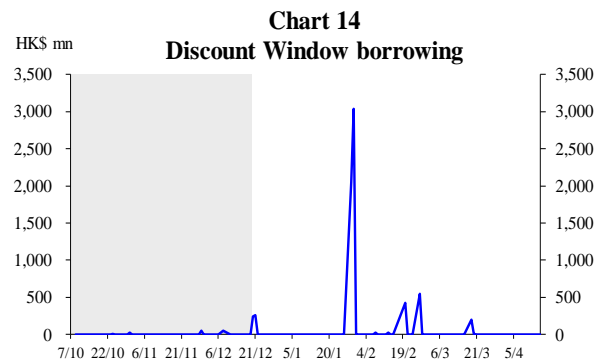
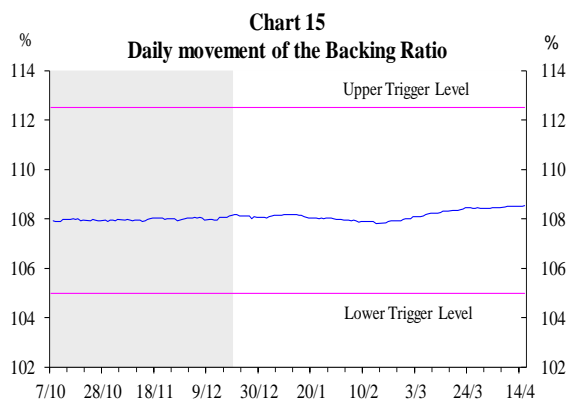


Table 5
Frequency of individual bank's access to the Discount Window
(20 Dec 17 – 16 Apr 18)

Frequency of using Discount Window	No. of banks
1	13

Backing Portfolio

16. The Backing Assets increased to HK\$1,858.02 billion on 16 April 2018, mainly reflecting an increase in CIs and valuation gains from investments. As the Backing Assets increased proportionally more than the Monetary Base, **the Backing Ratio edged up to 108.53% from 108.18% 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.



Hong Kong Monetary Authority
5 June 2018