

EXCHANGE FUND ADVISORY COMMITTEE

Currency Board Sub-Committee

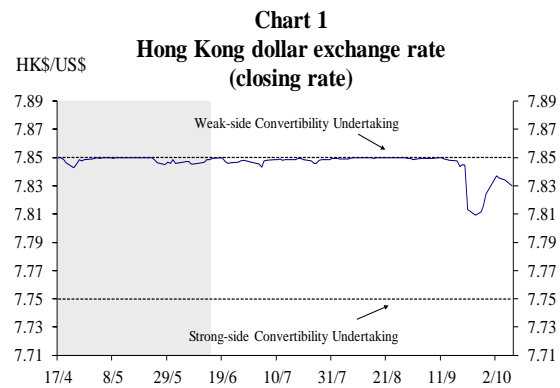
Report on Currency Board Operations

(15 June – 8 October 2018)

During the review period, the Hong Kong dollar (HKD) traded within a range of 7.8090 – 7.8500 (closing rate) against the US dollar (USD). The HKD stayed close to the weak-side Convertibility Undertaking (CU) between mid-June and mid-September amid carry trade activities, repatriation of funds raised in recent initial public offerings (IPOs) and equity-related outflows. Partly reflecting squaring of interest carry trade positions amid tightening of interbank liquidity ahead of the quarter-end, the HKD exchange rate strengthened in late September, before easing gradually at the end of the review period. Since the first triggering on 12 April, the weak-side CU has been triggered 27 times and the HKMA has bought HK\$103.5 billion under the weak-side CU. Correspondingly, the Aggregate Balance and the Monetary Base declined to HK\$76.58 billion and HK\$1,616.14 billion respectively at the end of the review period. HKD interbank interest rates broadly picked up during the review period, largely underpinned by reduced interbank liquidity following the triggering of the weak-side CU, expectation of US rate hikes, IPO-related funding demand and seasonal liquidity needs. Throughout the review period, the Monetary Base remained fully backed by foreign reserves, and all changes in the Monetary Base were fully matched by corresponding changes in foreign reserves in accordance with the Currency Board principles.

Hong Kong dollar exchange rate

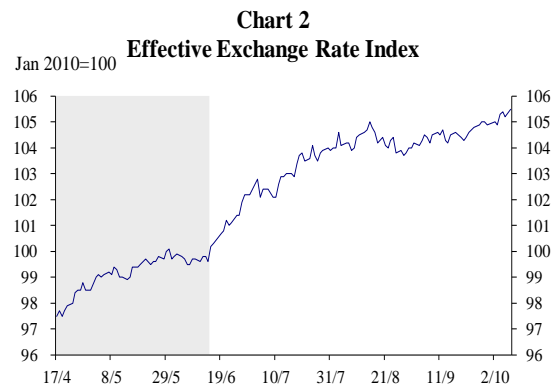
1. During the review period of 15 June to 8 October 2018, **the HKD traded within a range of 7.8090 – 7.8500 (closing rate) against the USD (Chart 1).**¹ The HKD traded close to the weak-side CU between mid-June and mid-September, with the weak-side CU being triggered 8 times in August amid increased carry trade activities, repatriation of funds raised in recent initial public offerings (IPOs) and equity-related outflows. On 21 September, the HKD exchange rate strengthened to an intraday high of 7.7925, reflecting squaring of interest carry trade positions amid higher short-dated HKD interbank interest rates on the back of strong liquidity needs around the mid-Autumn festival and the quarter-end. Thereafter, as quarter-end funding demand receded, the HKD eased gradually and closed at 7.8299 at the end of review period. **Since the first triggering on 12 April, the weak-side CU has been triggered 27 times², accumulating outflows of HK\$103.5 billion.** Despite this, the HKD continued to trade in an orderly and smooth manner. **The**



¹ In this report, daily time series charts also cover developments in the preceding review period (as shown in shaded region) for reference and comparison.

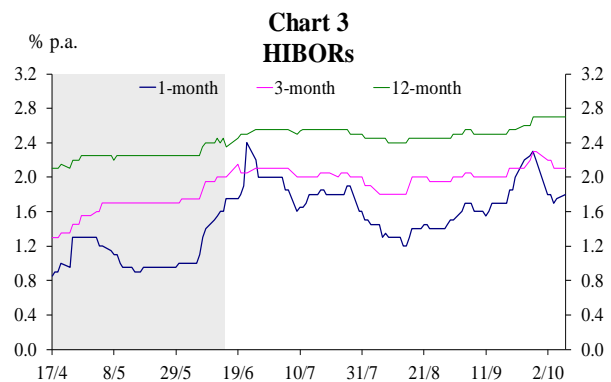
² The weak-side CU was triggered 13 times in April, 6 times in May, and 8 times in August.

nominal effective exchange rate index of the HKD picked up during the review period, reflecting the appreciation of the US dollar against most major currencies (Chart 2).

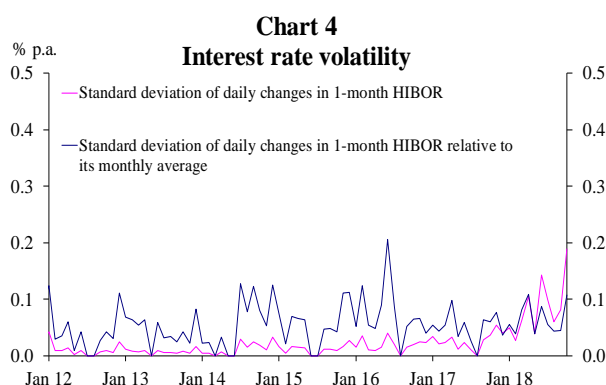


Interest rates

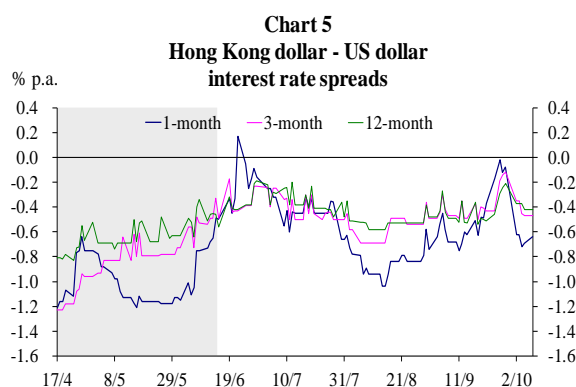
2. **During the review period, the HKD interbank interest rates (i.e., HIBORs) broadly picked up** (Chart 3), largely underpinned by reduced interbank liquidity following the triggering of the weak-side CU, expectation of US rate hikes, IPO-related funding demand and seasonal liquidity needs. **Short-dated HIBORs witnessed more fluctuations.** The one-month HIBOR moved up somewhat at end-June and end-September, reflecting tightened liquidity near the quarter-end. Liquidity conditions improved stepping into October. For the review period as a whole, the 1-month and 3-month HIBORs increased by 5 basis points to 1.8% and 10 basis points to 2.1%, respectively. The 12-month HIBOR moved up by 35 basis points to 2.7%.



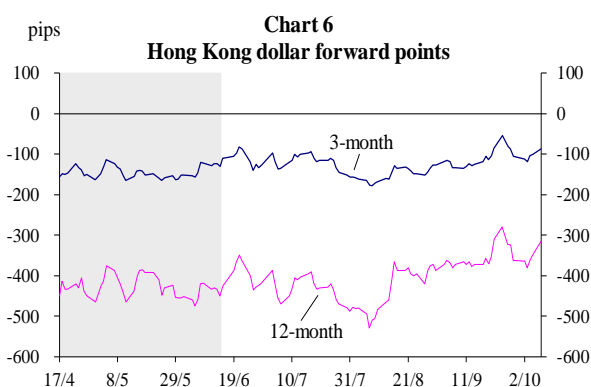
3. **Interest rate volatility**, measured by the standard deviation of daily changes in the one-month HIBOR, **rose** to 11.2 basis points in the current review period from 7.6 basis points in the preceding review period (Chart 4). The standard deviation as a ratio of the average of 1-month HIBOR also showed similar movements³.



4. **The negative HKD-USD interbank interest rate spreads broadly narrowed towards end-September** (Chart 5). The 1-month spread turned slightly positive at end-June with the 1-month HIBOR seeing a sharper increase during the half-year-end. Towards the end of the review period, the negative spreads widened again, with the 1-month, 3-month and 12-month spreads closing at -64, -47 and -42 basis points at the end of the review period respectively.



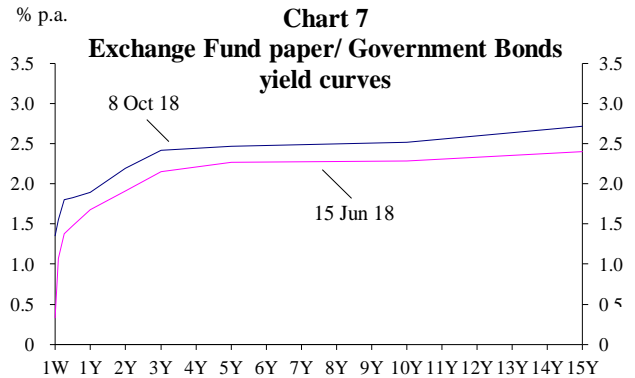
5. Roughly tracking the HKD-USD interbank interest rate spreads, **the discounts of HKD forward points narrowed at end-September** (Chart 6). At the end of the review period, the 3-month and 12-month HKD forward



³ 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.

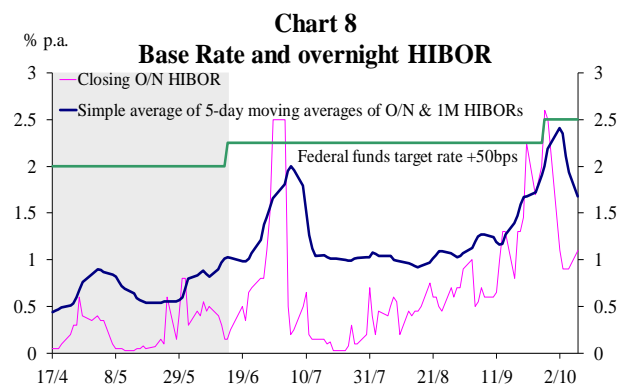
points closed at -87 pips and -315 pips respectively.

6. Largely following the movement of the USD yield curve, **the HKD yield curve shifted upwards** during the review period (Chart 7). The yield of the 10-year Hong Kong Government Bond increased by 23 basis points to 2.52% at the end of the review period, while the 3-year Government Bond yield rose by 27 basis points to 2.42%. The negative yield spreads of the Hong Kong Government Bonds over US Treasuries generally widened as the USD yields rose more than the HKD yields, especially at the longer end of the yield curve (Table 1).

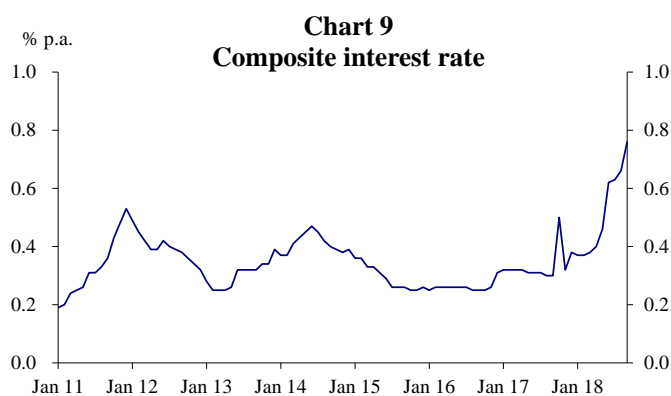


	15 Jun 18	05 Oct 18
3-month EFB	-56	-44
12-month EFB	-67	-75
3-year HKGB	-53	-59
5-year HKGB	-54	-62
10-year HKGB	-64	-74

7. **The HKMA Base Rate increased from 2.25% to 2.50%**, following the increase in the target range for the US Federal Funds Rate from 1.75%-2.00% to 2.00%-2.25% on 26 September (US time) (Chart 8). The Base Rate continues to be set 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. **As the funding cost of the banking system increased amid higher HIBORs, banks have raised their Best Lending Rates and deposit rates.** Following the increase in the target range for the US Federal Funds Rate in late September, banks raised their Best Lending Rates by 12.5-25.0 basis points. At the end of the review period, there were three Best Lending Rates (5.125%, 5.375% and 5.500%) in the market. During the review period, the average one-month HKD time deposit board rate offered by retail banks also increased slightly from 0.01% to 0.14%⁴. **The composite interest rate**⁵, which indicates the average funding cost of retail banks, **picked up** from 0.62% at the end of June to 0.76% at the end of September (Chart 9). On the lending side, the average interest rate for newly approved mortgage loans picked up from around 2.15% in June to around 2.5%, mainly reflecting the increase in Prime-based cap for HIBOR-based mortgages.⁶



⁴ The figure refers to the average interest rate offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

⁵ 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.

⁶ The increase in Prime-based cap for HIBOR-based mortgages was driven by both the increase in Best Lending Rate and the narrowing of the spread component in the Prime-based cap.

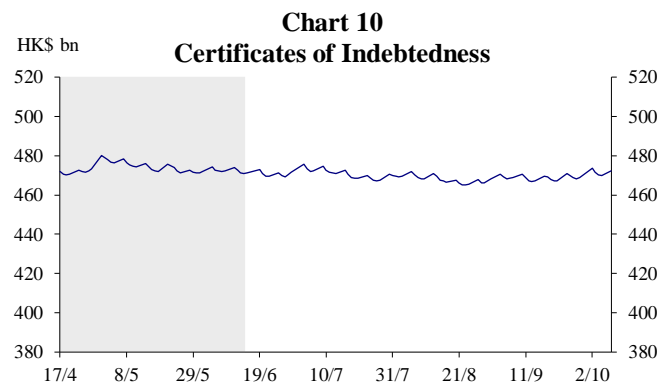
Monetary Base

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 (EFBNs), **decreased to HK\$1,616.14 billion on 8 October 2018 from HK\$1,643.86 billion on 15 June 2018** (Table 2). Movements of the individual components are discussed below.

(HK\$bn)	15 Jun 18	08 Oct 18
CIs	471.13	472.20
Government-issued Currency Notes and Coins in Circulation	12.70	12.75
Aggregate Balance	109.48	76.58
Outstanding EFBNs	1050.56	1054.62
Monetary Base	1643.86	1616.14

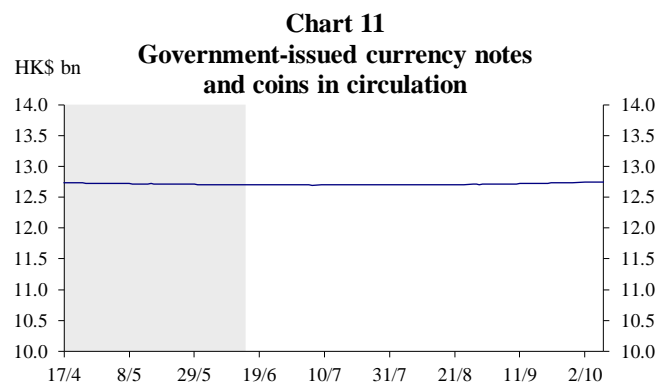
Certificates of Indebtedness

10. During the review period, note-issuing banks submitted a net amount of US\$137 million to the HKMA in exchange for HK\$1.07 billion worth of CIs. As a result, **the outstanding CIs increased slightly to HK\$472.20 billion on 8 October 2018 from HK\$471.13 billion on 15 June 2018** (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\$12.75 billion on 8 October 2018 from HK\$12.70 billion on 15 June 2018** (Chart 11).



Aggregate Balance

12. **The Aggregate Balance declined from HK\$109.48 billion to HK\$76.58 billion during the review period (Chart 12) owing to the triggering of the weak-side CU during August (Table 3). These foreign exchange operations were consistent with Currency Board principles, as the decreases in the Monetary Base were matched by equivalent decreases in US dollar reserves.**

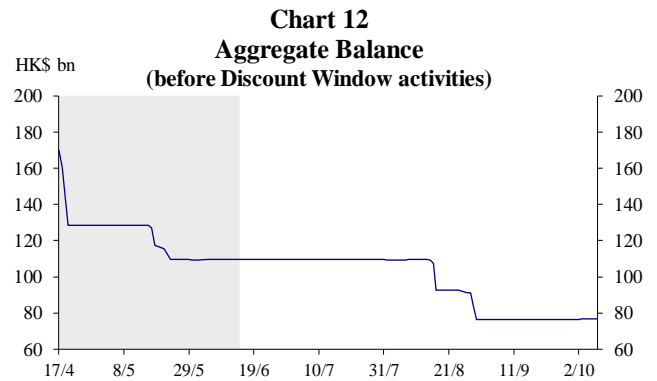
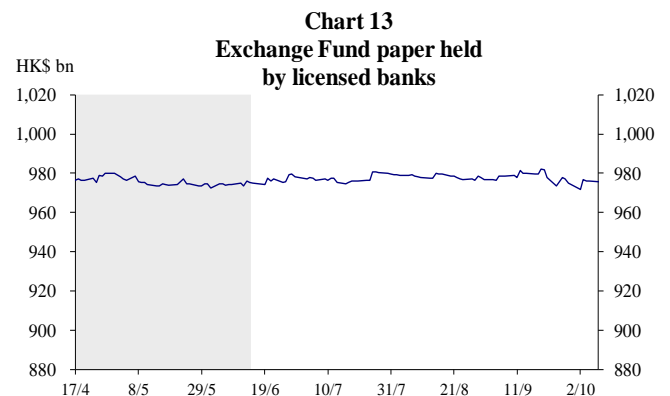


Table 3
HKMA HK\$/US\$ FX Transactions
(15 Jun 18 - 8 Oct 18)

Trade Date	Net purchase of HK\$ (HK\$m)
14-Aug-18	2,159
15-Aug-18	14,632
23-Aug-18	1,766
27-Aug-18	6,720
28-Aug-18	7,850
Total	33,127

Outstanding Exchange Fund Bills and Notes

13. **The market value of the outstanding EFBNs increased to HK\$1,054.62 billion from HK\$1,050.56 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) edged up to HK\$975.77 billion (92.5% of total) from HK\$975.05 billion (92.8% of total) (Chart 13).**



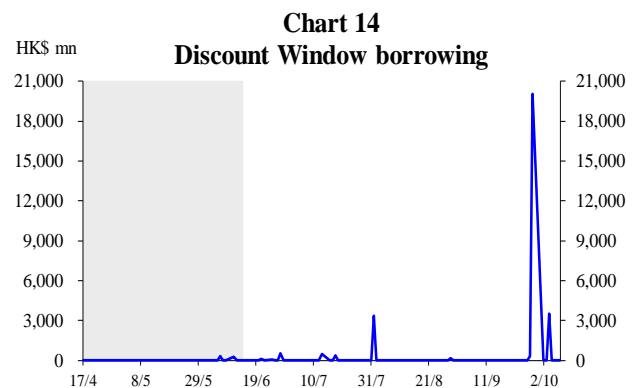
14. During the review period, **interest payments on Exchange Fund paper amounted to HK\$5,207.69 million. A total of HK\$4,932.02 million (in market**

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).

	No. of issues launched	Over-subscription ratio
1-month EFB	3	3.00-4.88
3-month EFB	16	0.87-2.32
6-month EFB	16	1.47-4.00
12-month EFB	5	1.35-3.80
2-year EFN	1	2.94

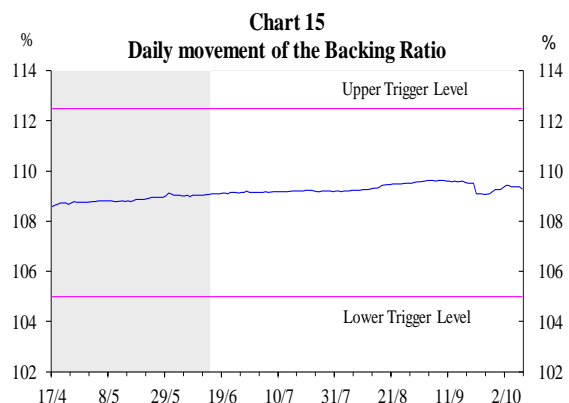
Discount Window activities

15. During the review period, a total of **HK\$29.10 billion** was borrowed from the Discount Window, compared with HK\$636 million in the preceding period from 17 April to 14 June (Chart 14).



Backing Portfolio

16. The Backing Assets decreased to HK\$1,766.63 billion on 8 October 2018, mainly reflecting the sale of USD backing assets under the weak-side CU. Taking into account the interest received and revaluation gains related to the Backing Assets, **the Backing Ratio edged up to 109.29% from 109.08% 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
10 December 2018