

**EXCHANGE FUND ADVISORY COMMITTEE**

**Currency Board Sub-Committee**

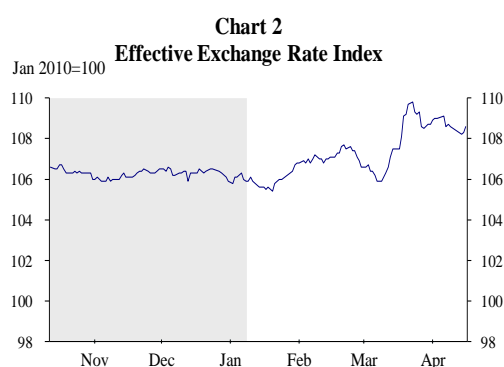
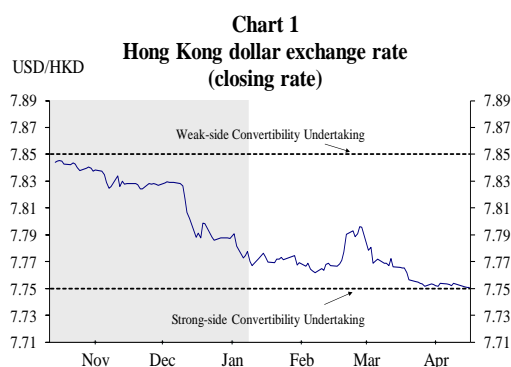
**Report on Currency Board Operations**

**Review period: 9 January 2020 – 16 April 2020**

During the review period, the Hong Kong dollar (HKD) traded in the range of 7.7506 – 7.7962 against the US dollar (USD). The HKD remained firm in January, partly due to the HKD demand for equity initial public offerings (IPOs) and partly due to tightened liquidity around the Chinese New Year holiday. After softening briefly towards the end of February, the HKD firmed again in March and traded close to the strong-side Convertibility Undertaking (CU) due to the unwinding of short HKD positions, equity-related inflows under the Stock-Connect and quarter-end demand. HKD interbank interest rates (i.e. HIBORs) generally picked up in March amid global USD funding stress, quarter-end and IPO-related funding demand. Overall, the HKD exchange and interbank markets continued to trade in a smooth and orderly manner despite negative market sentiments due to the coronavirus disease 2019 outbreak. At the end of the review period, the Aggregate Balance remained little changed at around HK\$54.1 billion, while the Monetary Base increased slightly to HK\$1,685.07 billion. 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

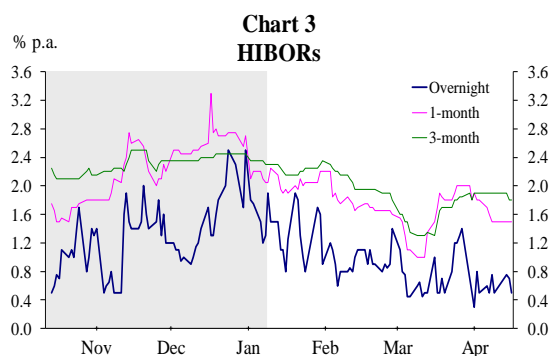
1. During the review period of 9 January 2020 to 16 April 2020, **the HKD traded in the range of 7.7506 – 7.7962 (closing rate) against the USD (Chart 1).**<sup>1</sup> The HKD remained firm in January, partly due to the HKD demand for equity IPOs and partly due to tightened liquidity around the Chinese New Year holiday. After softening briefly towards the end of February, the HKD firmed again in March and traded close to the strong-side Convertibility Undertaking (CU) due to unwinding of short HKD positions, equity-related inflows under the Stock-Connect and quarter-end demand. Despite negative market sentiments due to the novel coronavirus outbreak during the review period, the HKD traded in a smooth and orderly manner, closing at 7.7506 on 16 April 2020. **The 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).



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

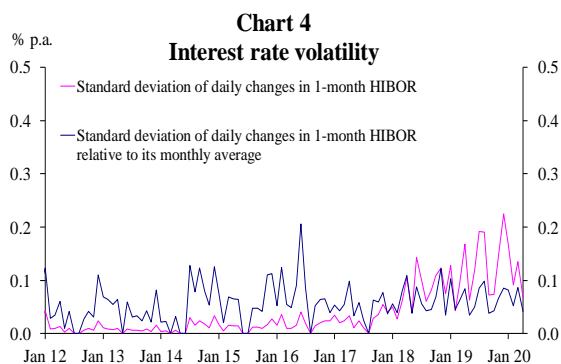
## **Interest rates**

2. **The overnight, 1-month and 3-month HKD interbank interest rates (i.e., HIBORs) declined during the review period (Chart 3).** As liquidity demand receded after the Chinese New Year holiday, HIBORs generally softened in February. Stepping into March, HIBORs picked up again due to global USD funding stress, quarter-end and IPO-related funding demand. For the review period as a whole, the overnight, 1-month and 3-month HIBORs declined by 140, 55 and 50 basis points to 0.50%, 1.50% and 1.80% respectively. To help ensure continued smooth operation of the HKD interbank market amid a volatile global macro environment stemming from the spread of coronavirus, the HKMA planned to provide additional liquidity by reducing the issue size of 91-day Exchange Fund Bills by HK\$5 billion in each of the four regular tenders on 21 April, 28 April, 5 May and 12 May 2020.<sup>2</sup>

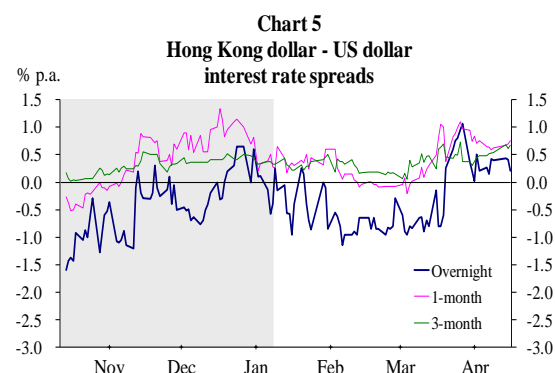


<sup>2</sup> If all the four planned reductions are executed, the issuance of the Bills will be reduced by HK\$20 billion in total and the Aggregate Balance will be increased by the same amount. Notwithstanding the plan, the HKMA will monitor market situations and the effect of each reduction, and reserves the flexibility of not executing all the four reductions as needed.

3. **Interest rate volatility**, measured by the standard deviation of daily changes in the 1-month HIBOR, **decreased** to 10.8 basis points in the current review period from 17.8 basis points in the preceding review period (Chart 4). The standard deviation as a ratio of the average of 1-month HIBOR showed similar movements.<sup>3</sup>

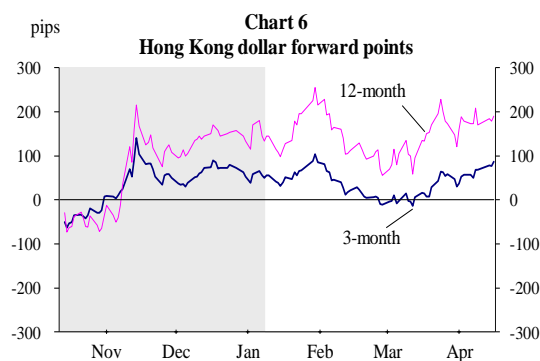


4. **The short-dated HKD-USD interbank interest rate spreads declined in the early part of the review period, but reversed course since mid-March** (Chart 5). This reflected the decline in HIBORs amid easing liquidity demand after the year-end, before the pick-ups due to quarter-end and IPO-related funding demand since mid-March. At the end of the review period, the overnight, 1-month and 3-month spreads closed at 21, 75 and 67 basis points respectively.

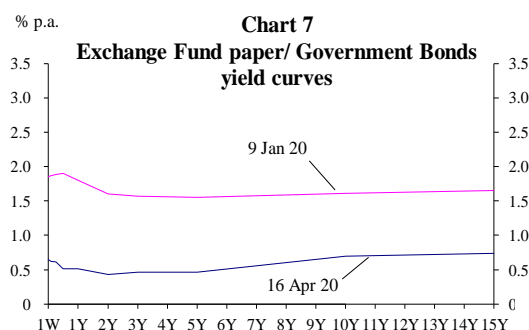


<sup>3</sup> The ratio of the standard deviation of daily changes in the 1-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

5. Broadly tracking the HKD-USD interbank interest rate spreads, the **3-month HKD forward premium declined in the early part of the review period before picking up since mid-March. The 12-month forward premium also showed similar movements.** At the end of review period, the 3-month and 12-month forward points closed at 87 pips and 190 pips respectively (Chart 6).

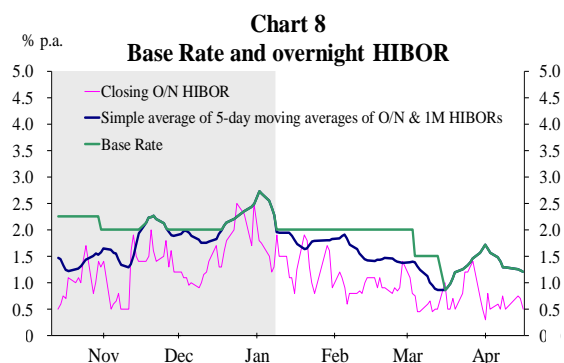


6. **During the review period, the HKD yield curve shifted downwards notably, tracking the movements in their USD counterparts (Chart 7).** The yield of the 1-year Exchange Fund Bill dropped by 129 basis points to 0.51%, while the yields of 10-year Hong Kong Government Bond declined by 92 basis points to 0.69%. The HKD-USD yield spreads turned more positive (Table 1), reflecting larger declines in the USD yields relative to the HKD counterparts after the Fed lowered the target range for the US federal funds rate in March.



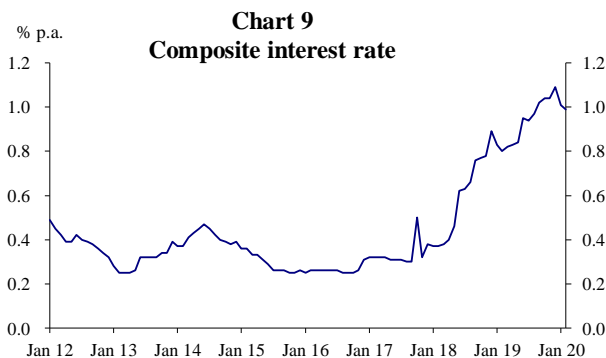
<b>Table 1</b> <b>Yield spreads of Exchange Fund paper and Hong Kong Government Bonds over US Treasuries (basis points)</b>		
	9 Jan 20	16 Apr 20
3-month EFB	35	47
12-month EFB	26	34
3-year HKGB	-2	21
5-year HKGB	-10	11
10-year HKGB	-24	8

7. **The HKMA Base Rate decreased from 2.00% to 0.86% following the downward shifts in the target range for the US federal funds rate on 3 March (US time) and 15 March (US time).**<sup>4</sup> Thereafter, the Base Rate has risen gradually amid the pick-ups of overnight and one-month HIBORs. At the end of the review period, the Base Rate **closed at 1.21% (Chart 8).** According to the established formula, the Base Rate is set at either 50 basis points above the lower end of the prevailing target range for the US federal funds rate or the average of the five-day moving averages of the overnight and one-month HIBORs, whichever is the higher.



<sup>4</sup> In light of evolving risks of the coronavirus posed to US economic activity and in support of achieving the Fed's policy goal, the Fed lowered the target range for the US federal funds rate in the unscheduled meetings on 3 March (US time) and 15 March (US time) by a total of 150 basis points (50 basis points on 3 March and 100 basis points on 15 March) to 0 – 0.25%.

8. During the review period, **banks kept their Best Lending Rates unchanged** despite the lower target range for the US federal funds rate. The Best Lending Rates in the market continued to range from 5.00% to 5.50%. During the review period, the average interest rate for newly approved mortgage loans stayed virtually unchanged at 2.53%, while the average 1-month HKD time deposit board rate offered by retail banks decreased from 0.12% to 0.08%.<sup>5</sup> **The composite interest rate**<sup>6</sup>, which indicates the average funding cost of retail banks, **declined** from 1.09% at the end of December 2019 to 0.99% at the end of February 2020 (Chart 9).



<sup>5</sup> The figure refers to the average interest rate offered by major authorized institutions for 1-month time deposits of less than HK\$100,000.

<sup>6</sup> This is a weighted average interest rate of all HKD interest-rate-sensitive liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and all other liabilities that do not involve any formal payment of interest but the values of which are sensitive to interest rate movements (such as 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.

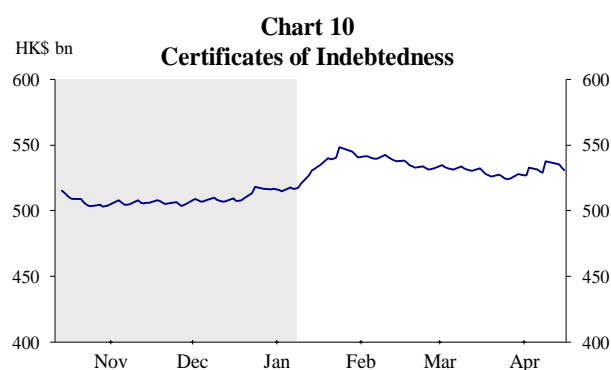
## Monetary Base

9. **The Monetary Base**, which consists of Certificates of Indebtedness (CIs), government-issued currency notes and coins in circulation, the Aggregate Balance, and Exchange Fund Bills and Notes (EFBNs), **increased slightly to HK\$1,685.07 billion on 16 April 2020 from HK\$1,665.11 billion on 9 January 2020** (Table 2). Movements of the individual components are discussed below.

<b>Table 2</b> <b>Monetary Base</b>		
(HK\$bn)	9 Jan 20	16 Apr 20
CIs	517.95	531.01
Government-issued Currency Notes and Coins in Circulation	13.41	13.19
Aggregate Balance	54.42	54.13
Outstanding EFBNs	1,079.34	1,086.74
<b>Monetary Base</b>	<b>1,665.11</b>	<b>1,685.07</b>

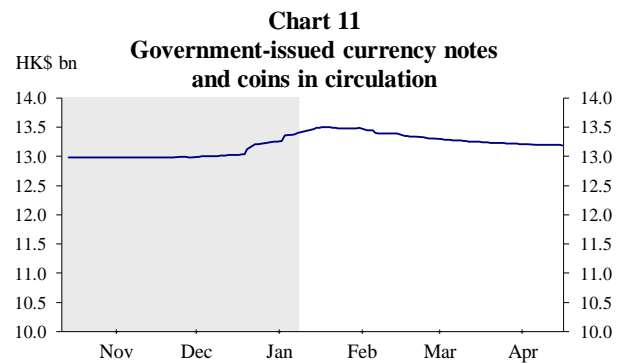
## *Certificates of Indebtedness*

10. Reflecting a net increase in currency demand during the review period, note-issuing banks submitted a net amount of US\$1.67 billion to the HKMA in exchange for HK\$13.06 billion worth of CIs. As a result, **the outstanding CIs increased to HK\$531.01 billion on 16 April 2020 from HK\$517.95 billion on 9 January 2020** (Chart 10), representing a 2.5% increase.



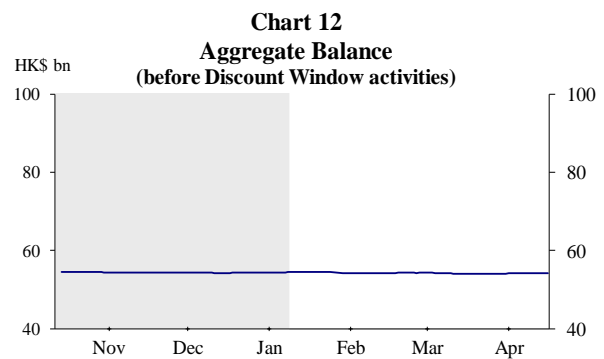
*Government-issued currency  
notes and coins in circulation*

11. During the review period, the amount of **government-issued currency notes and coins in circulation edged down** from HK\$13.41 billion to HK\$13.19 billion (Chart 11).



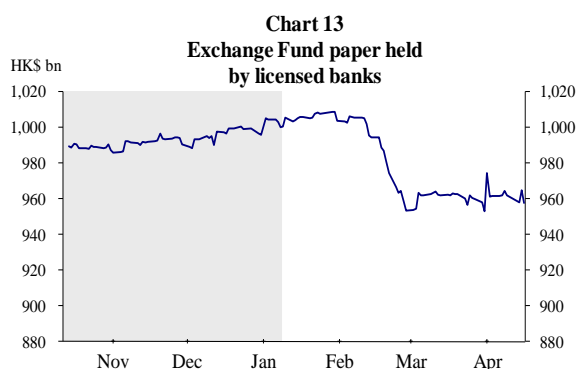
*Aggregate Balance*

12. During the review period, the Convertibility Undertakings were not triggered and **the Aggregate Balance** (before Discount Window activities) **remained little changed** at around HK\$54.1 billion (Chart 12).



# *Outstanding Exchange Fund Bills and Notes*

13. The market value of the outstanding EFBNs rose to HK\$1,086.74 billion from HK\$1,079.34 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) decreased to HK\$957.67 billion (88.1% of total) from HK\$1,000.47 billion (92.7% of total) (Chart 13).

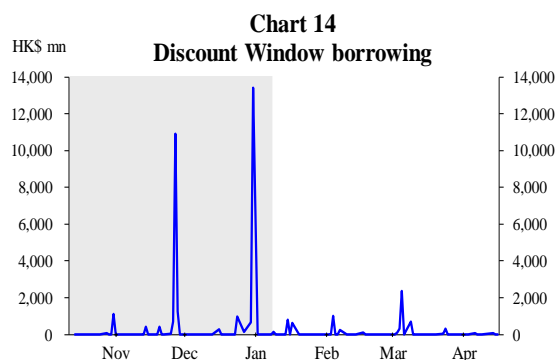


14. During the review period, interest payments on Exchange Fund paper amounted to HK\$3,584.44 million. A total of HK\$3,865.72 million (in market value) of Exchange Fund paper was issued to absorb these interest payments. The Exchange Fund paper issued during the review period was generally well received by the market (Table 3).

Table 3 Issuance of Exchange Fund Bills and Notes (9 Jan 20 – 16 Apr 20)		
	No. of issues launched	Over-subscription ratio
1-month EFB	0	-
3-month EFB	14	1.22 - 2.48
6-month EFB	14	1.76 - 3.88
12-month EFB	4	2.36 - 7.27
2-year EFN	1	2.32

### **Discount Window activities**

15. During the review period, **a total of HK\$6.8 billion was borrowed from the Discount Window**, compared with HK\$30.4 billion in the preceding period from 12 October 2019 to 8 January 2020 (Chart 14).



### **Backing Portfolio**

16. The Backing Assets increased to HK\$1,886.66 billion on 16 April 2020, mainly reflecting valuation gains from investments and the increase in CIs. **The Backing Ratio increased to 112.04% from 110.89% 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.

