

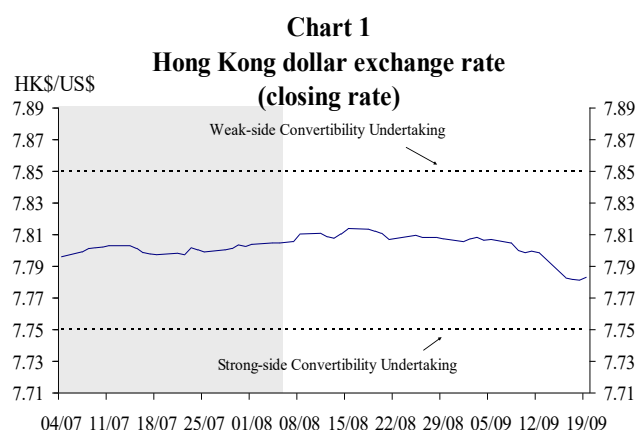
EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

Report on Currency Board Operations
(6 August 2008 – 19 September 2008)

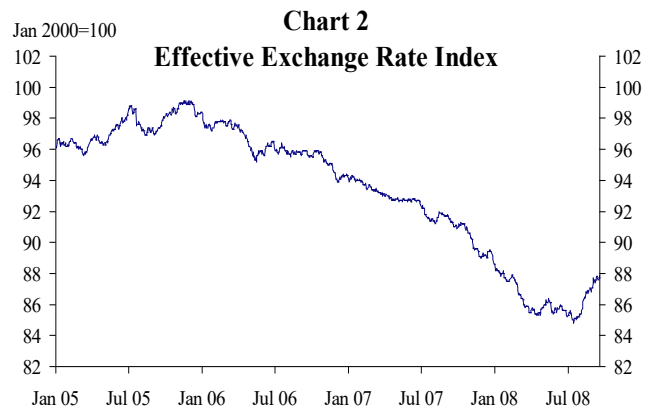
The Hong Kong dollar exchange rate strengthened towards the end of the review period due to some unwinding of carry trade positions and a weakened US dollar. Concurrently, the short-dated HIBORs rose markedly and their negative spreads against US dollar interest rates widened, reflecting heightened concerns about global credit and liquidity conditions. In order to address the tightness in the interbank market as a result of recent developments in the global financial markets, the HKMA operated within the Convertibility Zone on 18 September to inject liquidity into the banking system, increasing the Aggregate Balance by HK\$1.56 billion on 22 September. This had helped calm the interbank market.

Hong Kong dollar exchange rate

1. The Hong Kong dollar exchange rate softened slightly to 7.8139 on 15 August due to a stronger US dollar, but strengthened afterwards to close at 7.7830 on 19 September (Chart 1). The strengthening gained momentum towards the end of the reporting period partly because of some unwinding of carry trade positions and a softened US dollar induced by the deepening US financial crisis. Overall, the Hong Kong dollar market remained largely stable against the backdrop



of marked depreciation in a number of Asian currencies. During the review period, the effective exchange rate index of the Hong Kong dollar rose from 85.8 to 87.9, as the US dollar appreciated against other major currencies except for the Japanese yen (Chart 2).



Interest rates

2. **The short-dated HIBORs increased markedly towards the end of the review period,** reflecting heightened concerns about global credit and liquidity conditions following the fallout of some large financial institutions in the US (Chart 3). The continued increase in the loan-to-deposit ratio, representing tighter funding conditions for banks, might also have contributed to the gradual increase in interbank rates since May this year. Taking into account market conditions, the HKMA operated within the Convertibility Zone on 18 September, purchasing US dollars against Hong Kong dollars (Table 1). The Aggregate Balance is projected to increase by HK\$1.56 billion to HK\$6.40 billion on 22 September as a result. The injection has been helpful in calming the interbank market. The overnight HIBOR has eased to around 2.00% from 3.5% before the injection and the one-month

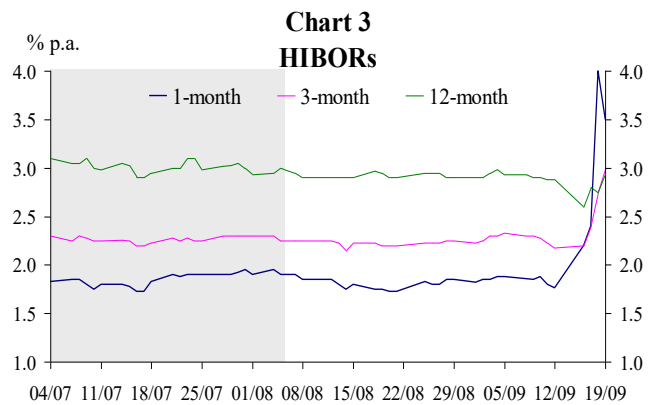
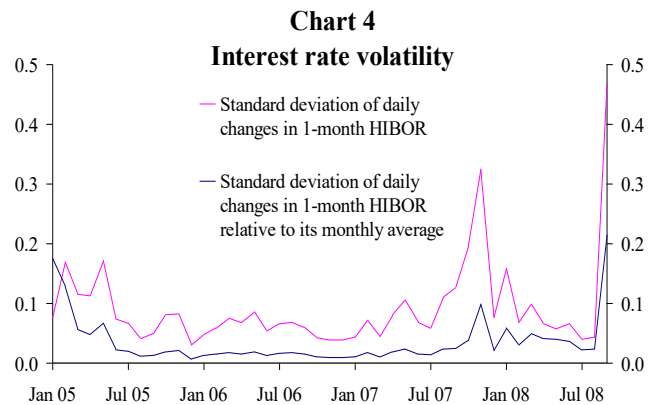


Table 1 HKMA HK\$/US\$ FX Transactions (6 Aug 08 – 19 Sep 08)	
Trade Date	Net HK\$ purchase (+) (HK\$m)
18 Sep	-1,556
Total	-1,556

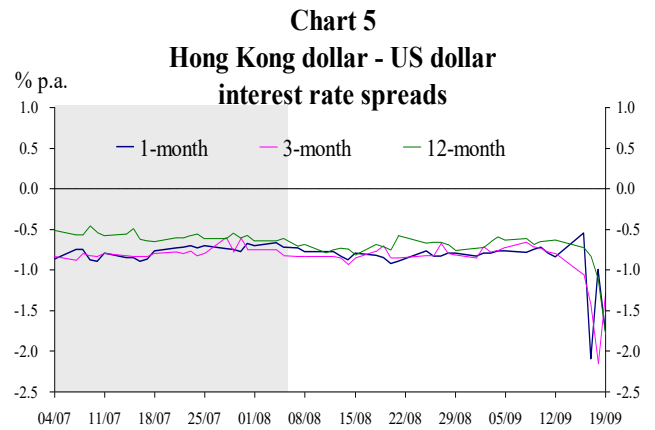
HIBOR has also moderated from 4.5% to around 3.5%. Banks have become less aggressive in bidding for funds. For the review period as a whole, the one-month and three-month HIBORs rose by 160 and 75 basis points to close at 3.50% and 3.00% respectively (Chart 3). On the other hand, the 12-month HIBOR rebounded from a low of 2.60% on 16 September to close at 2.95% at the end of the reporting period, tracking the corresponding US dollar interest rate.

3. **Interest rate volatility**, measured by the standard deviation of daily changes in one-month HIBOR, decreased in July and remained roughly stable in August. The standard deviation as a ratio of the average level of one-month HIBOR also showed the same pattern (Chart 4).¹ However, interest rate volatility **increased markedly between 1 September and 19 September**, reflecting sharp fluctuations in interbank interest rates near the end of this period in the face of heightened concerns about global credit and liquidity conditions.

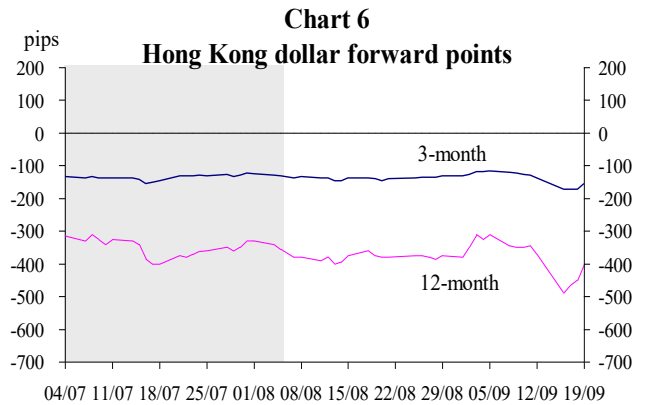


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

4. **The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts widened towards the end of the reporting period.** The one-month and three-month negative interest rate spreads expanded by 102 and 44 basis points to -175 and -127 basis points respectively. The 12-month negative interest rate spread also widened by 110 basis points to -180 basis points (Chart 5).



5. In line with the movements in the interest rates spreads, **the Hong Kong dollar three-month and 12-month forward discounts widened by 17 and 20 pips to close at 155 and 400 pips respectively** (Chart 6).



6. **Yields of Exchange Fund paper decreased across-the-board during the review period** (Chart 7). The yield spreads against US Treasuries show mixed patterns. Given growing risk aversion of participants of the US money market, there has been a flight to the US Treasury Bills, hence pushing the yields down. As a result, the three-month yield spread of Exchange Fund paper over US Treasuries turned positive to close at 88 basis points at the

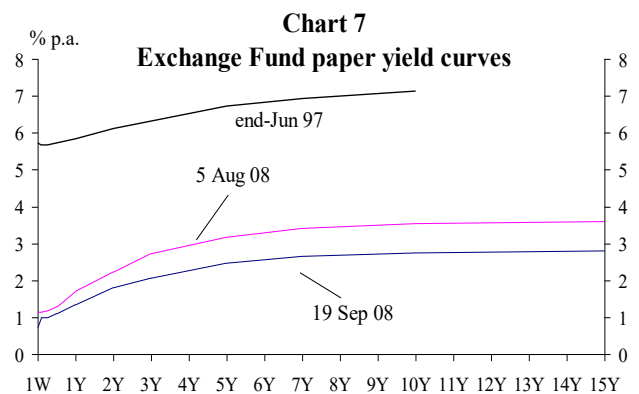
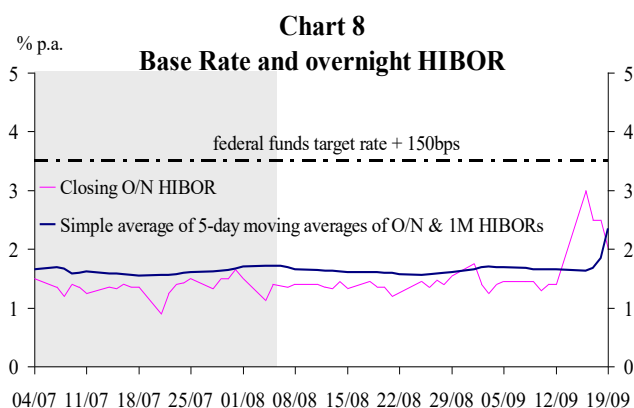


Table 2
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

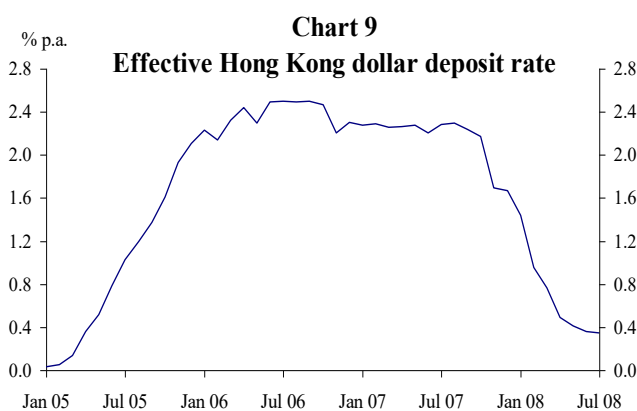
	27 Jun 97	5 Aug 08	19 Sep 08
3-month	56	-50	88
1-year	21	-49	-23
3-year	3	-10	-12
5-year	27	-5	-36
10-year	54	-39	-95
15-year	-	-86	-146

end of the review period. On the other hand, the ten-year and 15-year negative yield spreads expanded by 56 and 60 basis points to close at -95 and -146 basis points respectively at the end of the period (Table 2).

7. The HKMA Base Rate remained stable at 3.50% throughout the period (Chart 8). Banks also kept their Best Lending Rates unchanged. There continued to be two Best Lending Rates of 5.25% and 5.50% at the end of the reporting period.



8. The average one-month time deposit rate offered by major authorized institutions increased from 0.29% to 0.53% during the review period, as banks searched for more stable and lower-cost funding.² The effective deposit rate continued to decrease, from 0.42% in May to 0.36% in June and 0.34% in July (Chart 9).³ The composite interest rate, which reflects the average cost of funds of banks, increased further to 0.91% at the end of August, compared with 0.88% at the end of July.⁴



² The figures refer to the average of interest rates offered by major authorized institutions for one-month time deposits of less than HK\$100,000.

³ This is the average of the interest rates on demand, savings and time deposits. As the banking statistics classify deposits by remaining maturities, we have made certain assumptions regarding the maturity distribution in computing the effective deposit rate.

⁴ 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

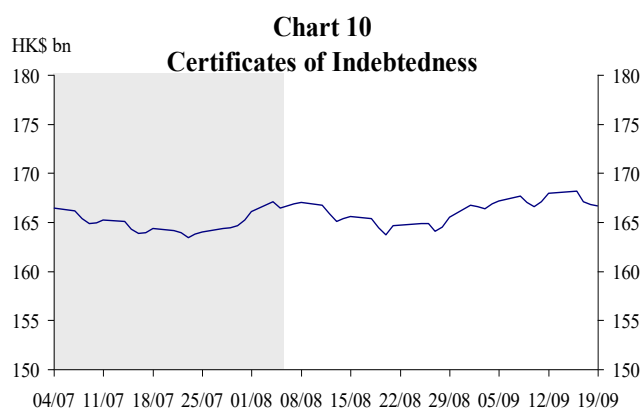
Monetary Base

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, **remained broadly stable at around HK\$327 billion** during the reporting period (Table 3). Movements in the individual components are discussed below.

(HK\$bn)	7 Aug 08	19 Sep 08
CIs	166.85	166.69
Government-issued Currency Notes and Coins in Circulation	8.18	8.21
Aggregate Balance	4.65	4.73
Outstanding EFBNs	146.72	148.09
Monetary Base	326.39	327.71

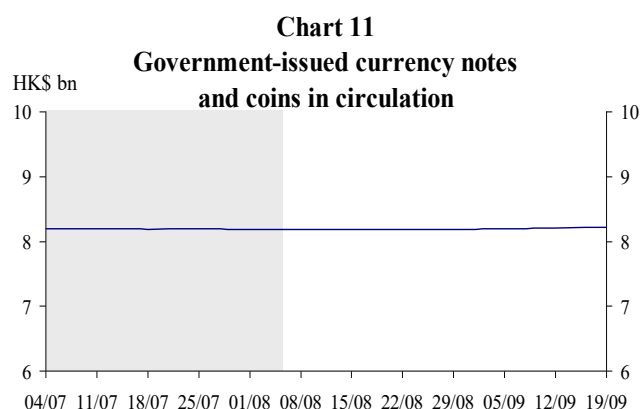
Certificates of Indebtedness

10. During the reporting period, the three note-issuing banks redeemed HK\$160 million worth of the CIs to the HKMA in exchange for US\$20.51 million. Consequently, **the outstanding CIs declined slightly from HK\$166.85 billion to HK\$166.69 billion** (Chart 10).



Government-issued currency notes and coins in circulation

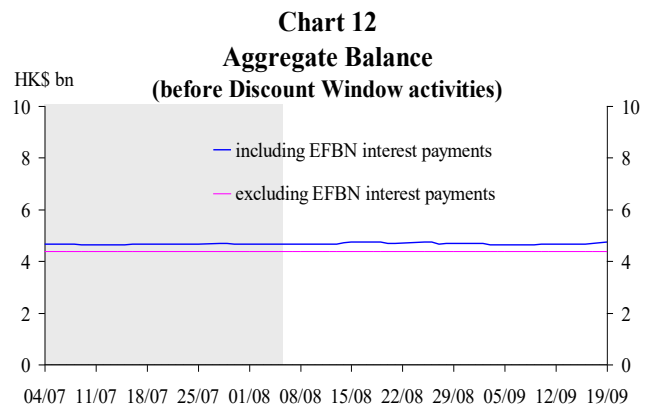
11. The amount of **government-issued currency notes and coins in circulation remained stable at around HK\$8.2 billion** during the review period (Chart 11).



from retail banks, which account for about 90% of the total customers' deposits in the banking sector, are used in the calculation.

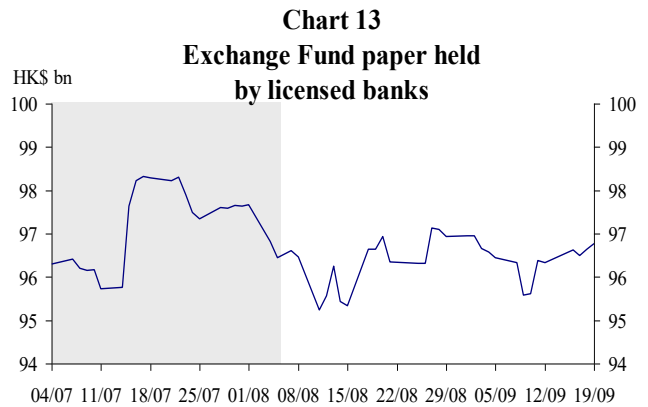
Aggregate Balance

12. **The Aggregate Balance was little changed at around HK\$4.7 billion during the reporting period, with small fluctuations due to interest payments on Exchange Fund paper (Chart 12), but will be increased to HK\$6.40 billion on 22 September following the HKMA's injection of HK\$1.56 billion into the banking system as mentioned earlier.**



Outstanding Exchange Fund Bills and Notes

13. **The market value of outstanding Exchange Fund Bills and Notes increased from HK\$146.72 billion to HK\$148.09 billion during the review period. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) rose slightly from HK\$96.61 billion (65.8% of total) to HK\$96.78 billion (65.4% of total) (Chart 13).**

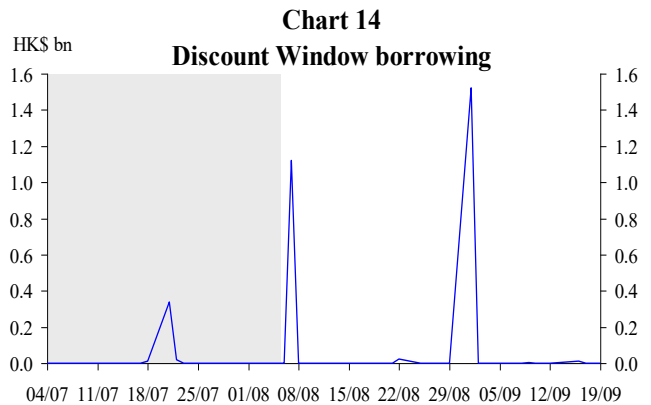


14. During the reporting period, **HK\$411.10 million of interest payments on Exchange Fund paper were made. An additional HK\$309.14 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were largely well received by the market (Table 4).

	No. of issues launched	Over-subscription ratio
1-month EFB	1	2.50
3-month EFB	7	0.47-1.81
6-month EFB	3	0.77-3.23
12-month EFB	2	2.08-2.55
2-year EFN	1	1.60
15-year EFN	1	2.96

Discount Window activities

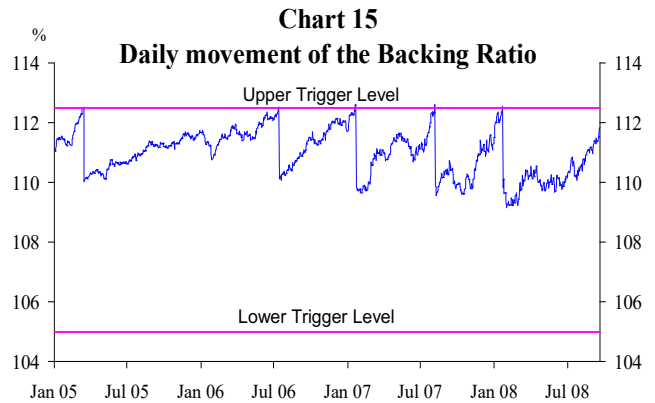
15. Despite the global financial market turmoil, Discount Window activities remained normal. During the review period, **nine banks borrowed a total of HK\$2.69 billion from the Discount Window**, compared with HK\$370 million in the preceding period (Chart 14 and Table 5). All borrowings used Exchange Fund paper as collateral.



Frequency of using Discount Window	No. of banks
1	9
Total	9

Backing Portfolio

16. Backing assets expanded during the reporting period, mainly reflecting the rise in the Monetary Base and valuation gains. As a result, **the Backing Ratio increased from 110.37% on 7 August to 111.86% on 19 September** (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.



Hong Kong Monetary Authority

