

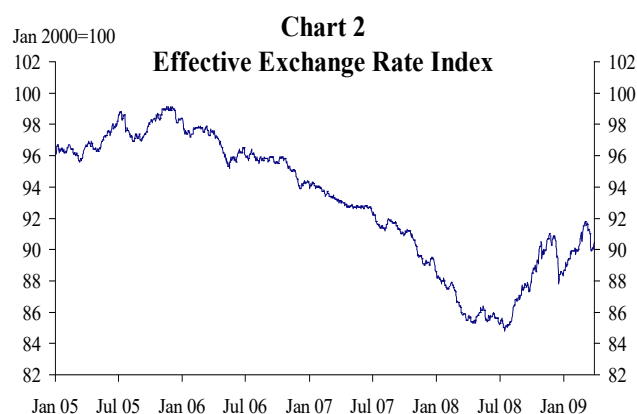
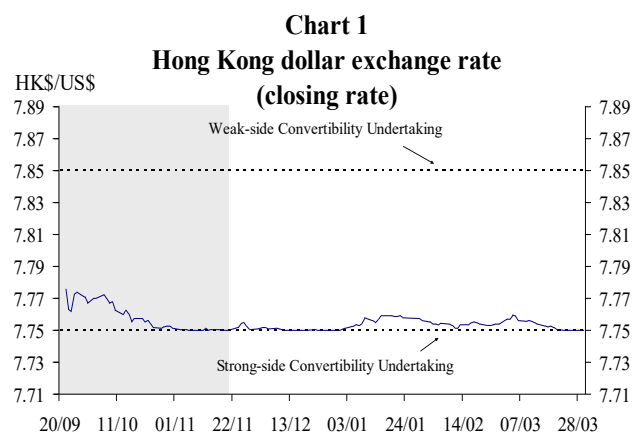
EXCHANGE FUND ADVISORY COMMITTEE
Currency Board Sub-Committee

Report on Currency Board Operations
(21 November 2008 – 30 March 2009)

The Hong Kong dollar exchange rate stayed close to the strong-side Convertibility Undertaking (CU) of 7.75 during the reporting period. The strong-side CU was repeatedly triggered in November and December 2008 due to unwinding of carry trades and possible repatriation of funds by domestic corporations, and in late March 2009 because of equity-related demand for Hong Kong dollars. The Aggregate Balance increased markedly during the review period as a result of the triggering of the strong-side CU. The market value of outstanding Exchange Fund Bills and Notes also expanded, mainly due to additional issuance of Exchange Fund Bills. These operations were in line with Currency Board principles, with changes in the Monetary Base fully matched by changes in foreign reserves. The interbank money market stabilised and Hong Kong dollar interbank interest rates declined following the introduction of various temporary financial measures in late 2008. The HKMA announced on 26 March 2009 that it will incorporate the forex swap and term repo into its ongoing market operations to offer Hong Kong dollar liquidity assistance to banks, if needed, on a case-by-case basis after the five temporary measures expire at the end of March 2009.

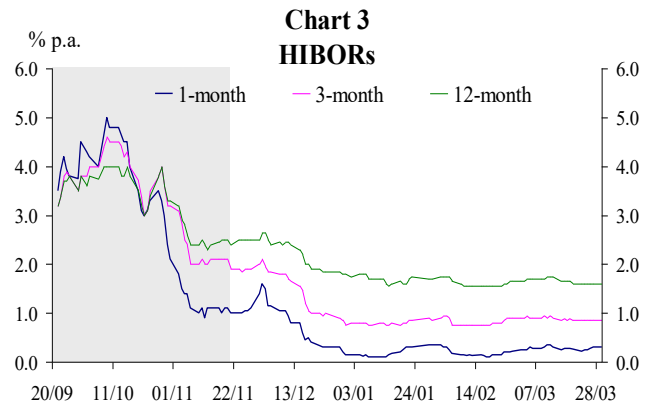
Hong Kong dollar exchange rate

1. **The Hong Kong dollar exchange rate traded within a narrow range of 7.7500 and 7.7594 during the review period (Chart 1), with the strong-side Convertibility Undertaking (CU) being triggered 45 times between 28 November and 31 December 2008, and 13 times from 20 to 26 March 2009.** In November and December 2008, the strong demand for Hong Kong dollars partly reflected the unwinding of carry trades and possible repatriation of funds by domestic corporations. After an 11-week hiatus, the strong-side CU was triggered again in late March 2009 due to increased equity-related demand for Hong Kong dollars, possibly because of the demands associated with the HSBC rights issue. The exchange rate closed at 7.7501 at the end of reporting period. On the other hand, the effective exchange rate index of the Hong Kong dollar declined from 91.0 on 21 November 2008 to a low of 87.8 on 18 December 2008, partly reflecting an expected lowering of US policy interest rate and the strengthening of the euro against the US dollar. The index rebounded afterwards, before generally softening in March 2009 to close at 90.5 (Chart 2).



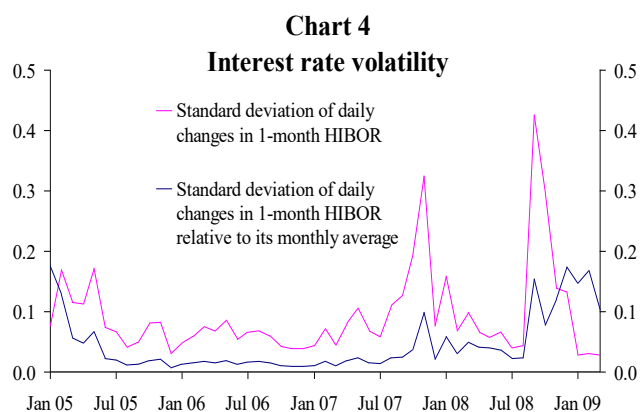
Interest rates

2. Following the introduction of various temporary measures in response to the global financial crisis, the local interbank market generally stabilised. Broadly tracking their US dollar counterparts, **Hong Kong dollar interbank interest rates generally decreased in November and December 2008 and remained fairly stable thereafter** (Chart 3). In particular, the one-month HIBOR declined by 70 basis points to close at 0.30% during the reporting period. The three-month and 12-month HIBORs decreased by 105 and 80 basis points to close at 0.85% and 1.6% respectively. Efforts around the world to provide liquidity to the markets, coupled with an improvement in market sentiment, also helped the recovery of the interbank money market. As the strong-side CU was repeatedly triggered, Hong Kong dollar liquidity injections by the HKMA provided an accommodative monetary environment to support general economic activity. After the introduction of the five temporary measures at the end of the September 2008, utilisation was mainly confined to the fourth and fifth measures (i.e. forex swap and term repo with the HKMA). Against this background, and taking into account market views, the HKMA announced on 26 March 2009 that it will incorporate the forex



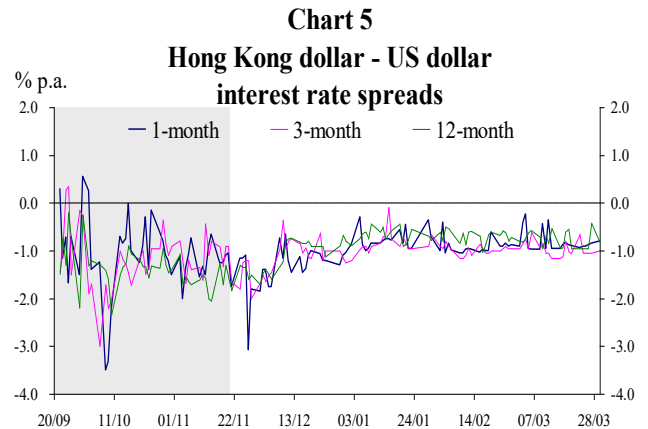
swap and term repo (against securities of acceptable quality to the HKMA) into its ongoing market operations to offer Hong Kong dollar liquidity assistance to banks, if needed, on a case-by-case basis after the five temporary measures expire at the end of March 2009. The HKMA also decided to resume the previous arrangements for the Discount Window (that is, using only Exchange Fund paper for overnight repo) so as to safeguard exchange rate stability under the Currency Board system. These policy actions should provide assurance to banks on the availability of liquidity in case of need.

3. **Interest rate volatility**, measured by the standard deviation of daily changes in one-month HIBOR, **declined towards the end of 2008, and stabilised afterwards**, as the stress in the interbank market continued to ease. The standard deviation as a ratio of the average level of one-month HIBOR also decreased in March 2009, after staying at relatively high levels between November 2008 and February 2009 (Chart 4).¹

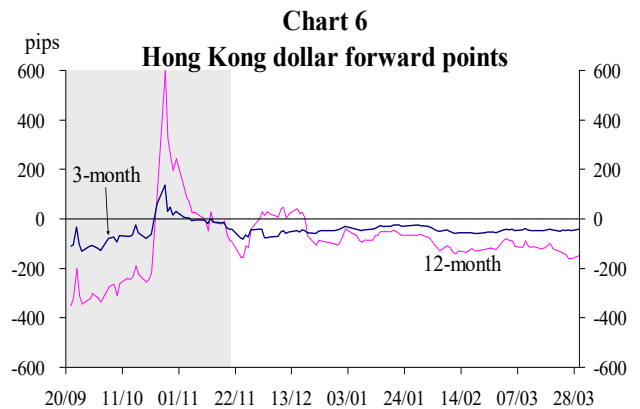


¹ The ratio of the standard deviation of daily changes in the one-month HIBOR to its monthly average measures the extent of interest rate fluctuations relative to the average level of interest rates.

4. **The negative spreads of Hong Kong dollar interest rates against their US dollar counterparts generally narrowed in the early part of the review period, and remained stable afterwards.** For the reporting period as a whole, the one-month and three-month negative interest rate spreads contracted by 95 and 66 basis points to -80 and -100 basis points respectively. The 12-month negative interest rate spread also narrowed by 98 basis points to -85 basis points (Chart 5).



5. Broadly in line with the movements in the interest rate spreads, **the Hong Kong-dollar three-month forward discount generally narrowed in the early part of the review period, and became roughly stable thereafter.** On the other hand, the 12-month forward point was more volatile, with discounts occasionally turning into premia in November and December 2008. At the end of the reporting period, the three-month and 12-month forward discounts closed at -44 and -150 basis points respectively (Chart 6).



6. **Yields of Exchange Fund paper rose during the reporting period except for the one-week tenor (Chart 7).** The implied yields of one-month and three-month Exchange Fund Bills edged up from 0% and 0.01% to 0.05% and 0.12% respectively. The ten-year and 15-year negative yield spreads of Exchange Fund paper over US Treasuries narrowed markedly by 98 and 92 basis points to close at -83 and -154 basis points respectively (Table 1). This partly reflected decreases in the yields of US government bonds after the US Federal Reserve announced on 18 March 2009 that it would purchase US\$300 billion worth of long-term US Treasury Notes.

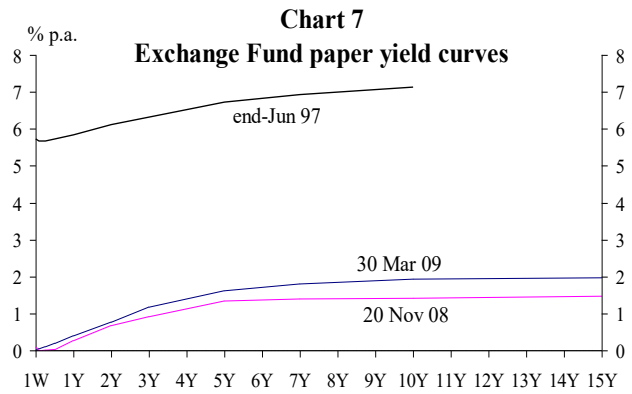
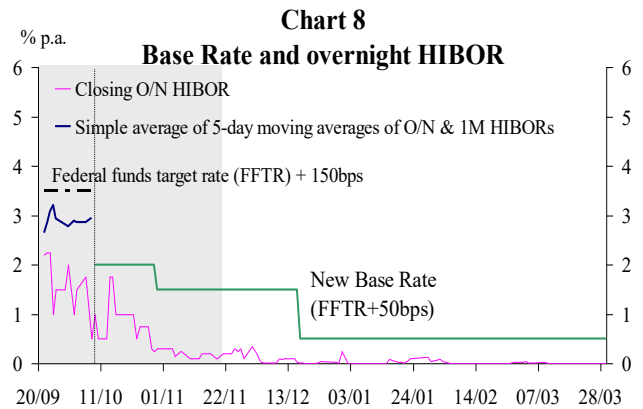


Table 1
Yield spreads of Exchange Fund paper over US Treasuries (basis points)

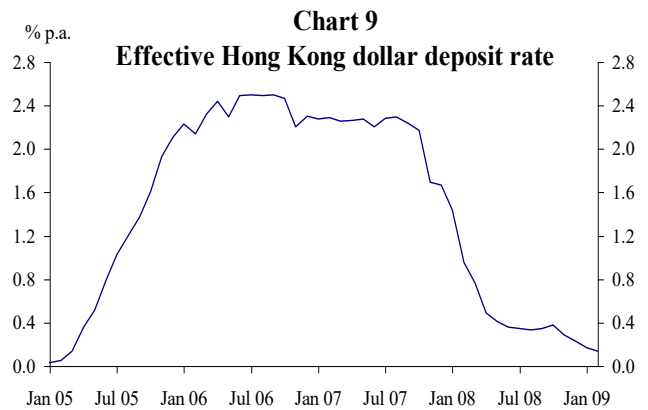
	27 Jun 97	20 Nov 08	30 Mar 09
3-month	56	0	1
1-year	21	-51	-13
3-year	3	-30	-8
5-year	27	-58	-19
10-year	54	-181	-83
15-year	-	-246	-154

7. **The HKMA Base Rate was reduced from 1.5% to 0.5%** following a downward adjustment in the US Federal Funds Target Rate (FFTR) from 1.00% to 0-0.25% on 16 December 2008 (US time) (Chart 8). As federal funds were effectively traded at 0%, the Base Rate was set at 50 basis points above the lower boundary of the target range at 0.5% according to the new formula announced on 8 October 2008. After a review of the appropriateness of the new Base Rate formula, the HKMA announced on 26 March 2009 that the narrower 50-basis point spread over the US FFTR will be retained compared to the previous



spread of 150 basis points, while the HIBOR leg will be re-instated in the calculation of the Base Rate.

8. **Despite the cut in the US FFTR in December 2008, banks kept their Best Lending Rates unchanged.** There continued to be two Best Lending Rates of 5.00% and 5.25% at the end of the reporting period. On the other hand, **the average one-month time deposit rate offered by major authorized institutions edged down** from 0.08% to 0.01% during the review period.² The effective deposit rate also decreased to 0.14% in February 2009 from a recent high of 0.38% in October 2008 (Chart 9).³ The composite interest rate, which indicates the average cost of funds of banks, declined to 0.33% at the end of February 2009, compared with a high of 1.28% at the end of October 2008.⁴ The lower average cost of funds reflected downward adjustments in the time deposit and interbank interest rates.



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

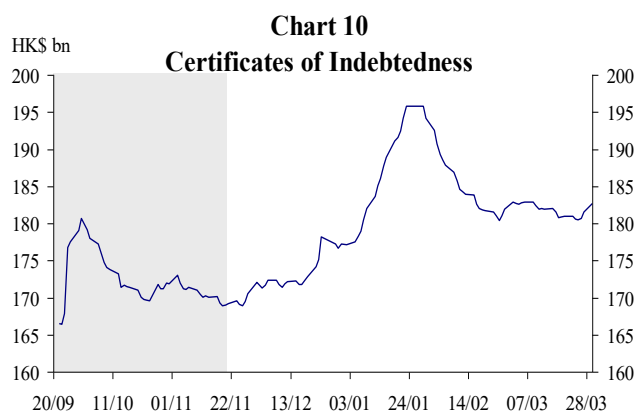
Monetary Base

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, **expanded markedly from HK\$398.71 billion to HK\$570.41 billion** during the reporting period (Table 2), mainly reflecting the increases in the Aggregate Balance and outstanding Exchange Fund Bills and Notes. Movements in the individual components are discussed below.

(HK\$bn)	21 Nov 08	30 Mar 09
CIs	169.16	182.72
Government-issued Currency Notes and Coins in Circulation	8.22	8.74
Aggregate Balance	66.02	155.32
Outstanding EFBNs	155.32	223.64
Monetary Base	398.71	570.41

Certificates of Indebtedness

10. During the reporting period, the three note-issuing banks submitted a total of US\$1,738 million to the HKMA in exchange for HK\$13.56 billion worth of CIs. **The outstanding CIs rose to around HK\$196 billion in late January 2009** due to increased public demand for banknotes associated with the Chinese New Year festival, **but gradually declined to HK\$182.72 billion at the end of the reporting period** because of a reversal of currency demand (Chart 10).



Government-issued currency notes and coins in circulation

11. In line with the movements in the CIs, the amount of **government-issued currency notes and coins in circulation increased from HK\$8.22 billion to HK\$9.40 billion on 20 January 2009, but decreased to HK\$8.74 billion at the end of the reporting period (Chart 11).**

Aggregate Balance

12. **The Aggregate Balance surged from HK\$66.02 billion at the beginning of the review period to a record high of HK\$175.48 billion on 5 and 6 January 2009 (Chart 12), reflecting the repeated triggering of the strong-side CU between 28 November and 31 December 2008 (Table 3). The upward trend was briefly reversed on 3 December 2008 because of an additional supply of three-month Exchange Fund Bills worth HK\$8 billion. Subsequently, in a series of efforts to meet the increased demand by banks, additional Exchange Fund Bills totalling HK\$60.8 billion were issued in the first quarter of 2009. As a result, the **Aggregate Balance generally declined between January and mid-March 2009.** The increase in the supply of Exchange Fund paper is consistent with**

Chart 11
Government-issued currency notes and coins in circulation

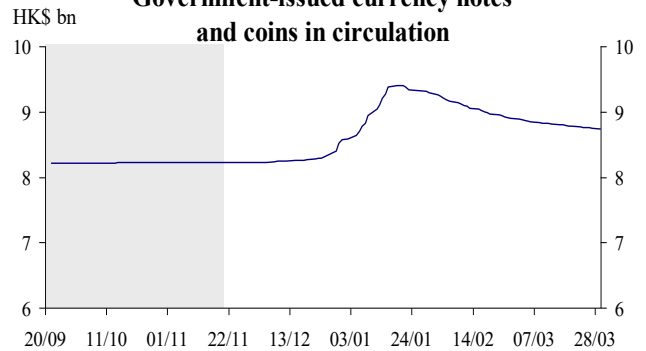
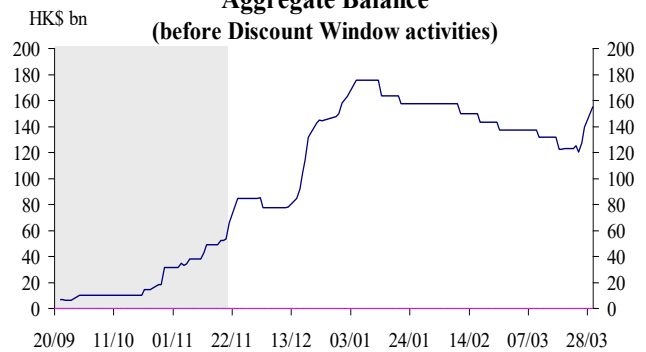


Chart 12
Aggregate Balance (before Discount Window activities)

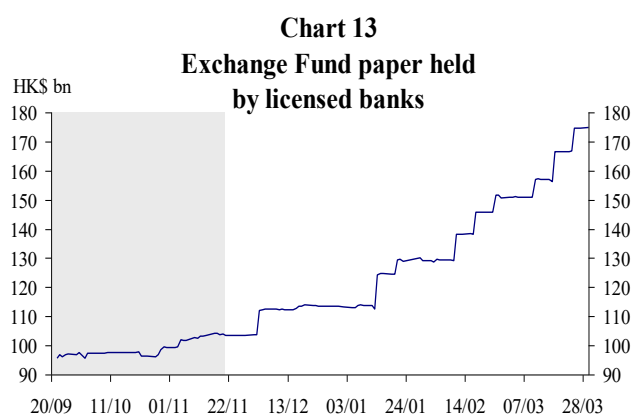


Currency Board principles, as the additional issuance represents a change in the composition of the Monetary Base, with a shift from the Aggregate Balance to Exchange Fund Paper. **The Aggregate Balance rebounded afterwards to close at HK\$155.32 billion on 30 March 2009**, due to the triggering of the strong-side CU between 20 and 26 March 2009 (Table 3). These foreign exchange operations are consistent with Currency Board principles, as the increases in the Monetary Base were matched by the equivalent increases in US dollar reserves.

Trade Date	Net HK\$ purchase (+) (HK\$mnn)
28 Nov 2008	-775.00
10 Dec 2008	-775.00
11 Dec 2008	-6,587.50
12 Dec 2008	-6,975.00
15 Dec 2008	-12,012.50
16 Dec 2008	-10,462.50
17 Dec 2008	-17,825.00
18 Dec 2008	-10,850.00
19 Dec 2008	-1,937.50
23 Dec 2008	-3,100.00
24 Dec 2008	-2,325.00
29 Dec 2008	-8,137.50
30 Dec 2008	-4,650.00
31 Dec 2008	-12,787.50
20 Mar 2009	-2,712.50
23 Mar 2009	-2,712.50
24 Mar 2009	-6,975.00
25 Mar 2009	-12,012.50
26 Mar 2009	-16,275.00
Total	-139,887.50

Outstanding Exchange Fund Bills and Notes

13. **The market value of outstanding Exchange Fund Bills and Notes increased from HK\$155.32 billion to HK\$223.64 billion during the reporting period, mainly because of the additional supply of Exchange Fund Bills. Holdings of Exchange Fund paper by the banking sector (before Discount Window activities) also expanded from HK\$103.34 billion (66.5% of total) to HK\$174.75 billion (78.1% of total) (Chart 13).**

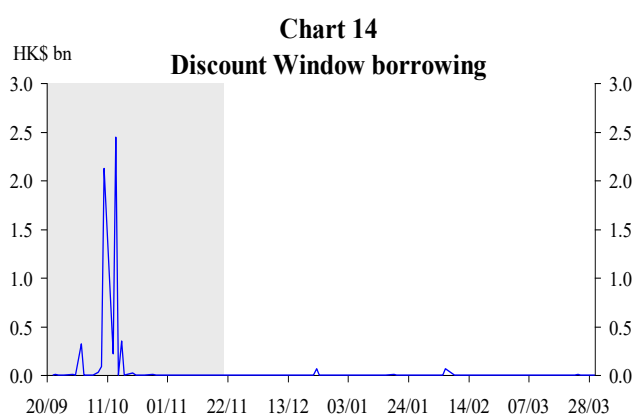


14. During the reporting period, **HK\$996.96 million of interest payments on Exchange Fund paper were made. An additional HK\$963.66 million (in market value) of Exchange Fund paper was issued to absorb these interest payments.** The remaining amount was carried forward in the Aggregate Balance. The Exchange Fund papers issued were largely well received by the market (Table 4).

	No. of issues launched	Over-subscription ratio
1-month EFB	4	3.67-8.95
3-month EFB	20	0.33-8.84
6-month EFB	11	1.16-5.08
12-month EFB	4	2.75-3.96
2-year EFN	1	2.49
3-year EFN	2	0.46-1.80
5-year EFN	2	1.38-2.56
10-year EFN	1	3.19
15-year EFN	1	1.57

Discount Window activities

15. During the reporting period, **four banks borrowed a total of HK\$141 million from the Discount Window**, compared with HK\$5.61 billion in the preceding period (Chart 14 and Table 5). All borrowings used Exchange Fund paper as collateral.

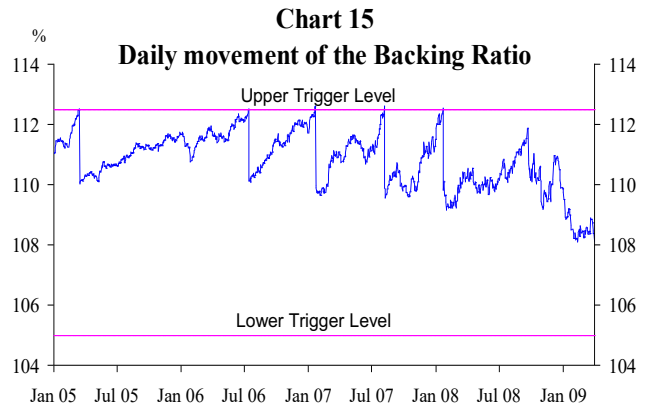


Backing Portfolio

16. Backing assets generally expanded during the reporting period, mainly reflecting the rise in the Monetary Base. However, increases in the yields of short-term US Treasuries exerted downward pressure on the backing assets in January and

Frequency of using Discount Window	No. of banks
1	4
Total	4

February 2009 due to valuation losses. For the reporting period as a whole, **the Backing Ratio decreased from 110.09% on 21 November 2008 to 108.10% on 30 March 2009** (Chart 15), because the backing assets rose proportionally less than the Monetary Base. 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

