



HONG KONG MONETARY AUTHORITY

**Briefing to the Legislative Council
Panel on Financial Affairs**

19 February 2003



DISCUSSION TOPICS

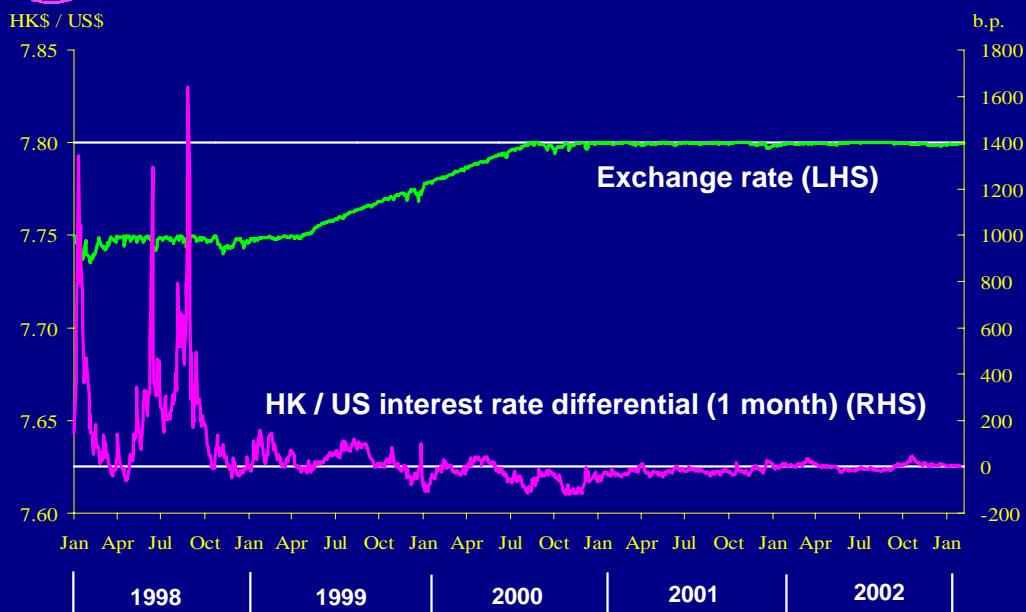
- **Currency**
- **Banking**
- **Financial Infrastructure**
- **Exchange Fund**

2

- This presentation will cover the four key responsibilities of the HKMA:
 - to maintain the stability and integrity of the monetary system of Hong Kong;
 - to promote the general stability and effective working of the banking system;
 - to enhance the safety and efficiency of the financial infrastructure, particularly payment and settlement arrangements; and
 - to manage the Exchange Fund in a sound and prudent manner.



CURRENCY STABILITY



3

- Notwithstanding the uncertain external environment and domestic economic situation, the Hong Kong dollar exchange rate has continued to be stable against the US dollar. The differential between Hong Kong and US dollar short-term interest rates has stayed low.



CURRENCY - MARKET EXPECTATIONS



4

- The 12-month Hong Kong dollar forward points gradually declined after the subsidence of the Asian financial crisis and the introduction of the technical measures to strengthen the Currency Board system in August 1998. It has, on the whole, stayed close to zero since the middle of 2000.



CURRENCY - MARKET EXPECTATIONS



5

- In view of the widening fiscal deficit and rumours about the Link, the forward points rose to a recent high of 370 points in mid-October. Following Premier Zhu's supportive comments during his visit to Hong Kong in November, the one-year forward premium fell back to 160 pips and is at around 180 pips at present.



CURRENCY - RISKS & VULNERABILITIES

General

- **Geopolitical tensions**
- **Uncertain global economic outlook**
- **Volatility in exchange rates among G3 currencies**
- **Financial market volatility**

6

- **The geopolitical tensions**, or more specifically, the prospect of military conflict in Iraq and concerns about terrorist attacks, are a key risk to the global outlook.
- **The global economic outlook has become more uncertain.** In the US, weak corporate earnings, the fall in equity prices, and the already-high household debt burden led to doubts about the growth prospects. The room for further monetary easing is limited while fiscal measures tend to take longer time to deliver and impact on the economy. The euro zone growth is sluggish, and structural rigidities remain abound. The Japanese economy continues to struggle to expand, but the state of the banking system is still a major concern.
- **Exchange rates of G3 currencies have become more volatile.** The US dollar weakened to a three-year low of 1.09 against the euro and a four-month low of 117.8 against the yen in late January. The increasing geopolitical risks, a widening current account deficit, and concerns over the pace of recovery in the US exert downward pressure on the US dollar. Nevertheless, any sharp and abrupt adjustment of the US dollar may disrupt financial market stability.
- **Financial market volatility also increased as a result of the above factors.** Global stock prices fell considerably over the past year (S&P500 down by 27%, FTSE100 31%, and HSI 19% since the beginning of 2002). This is likely to have further repercussions on economic growth.



CURRENCY - RISKS & VULNERABILITIES

Hong Kong specific

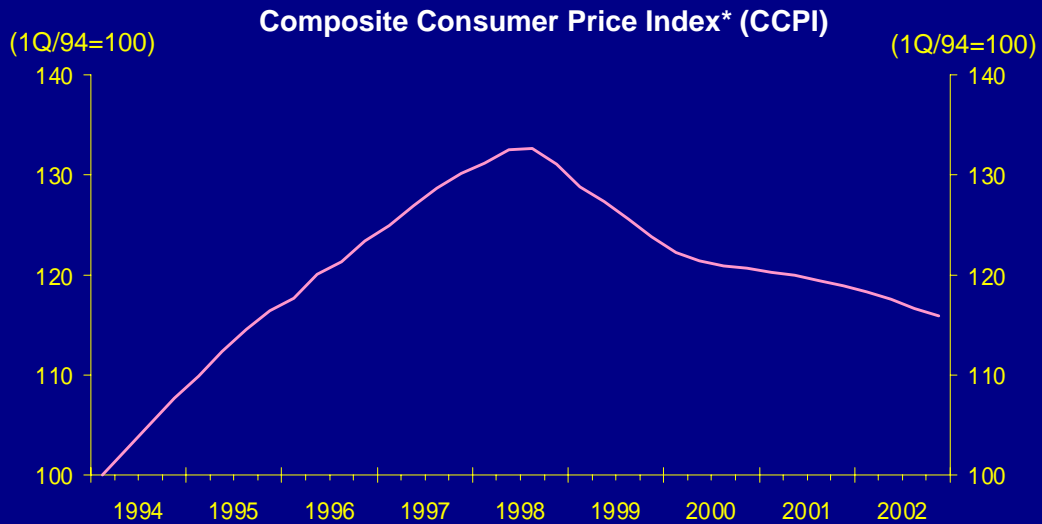
- Continuing deflation
- Public finance
- RMB exchange rate policy

7

- Domestic price deflation, the state of public finance and the RMB exchange rate policy are risk factors specific to Hong Kong. The next slides explain these risk factors in greater detail.



DEFLATION - STABILISING



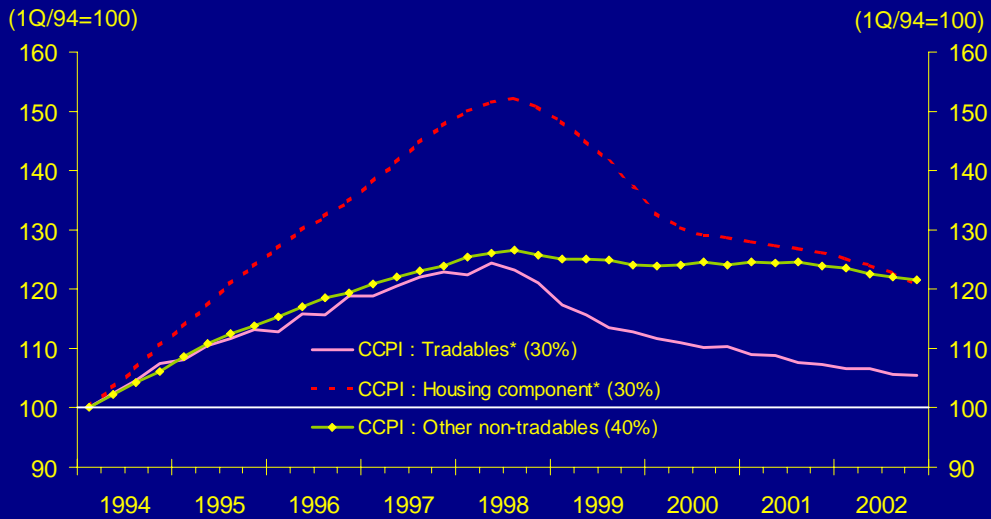
* Adjusted for the effects of government relief measures, such as the rates concession and waiver of water and sewage charges.

8

- Hong Kong has experienced deflation—as measured by the year-on-year change of the Composite Consumer Price Index (CCPI)—for over four years. The headline CCPI has fallen by about 14% from the peak in May 1998.
- The decline in consumer prices showed signs of stabilising in recent months. Adjusted for seasonal factors and effects of government relief measures, the average month-on-month decline in the CCPI narrowed to 0.2% in the last quarter of 2002, from 0.3% in the previous two quarters.



DEFLATION CCPI COMPONENTS



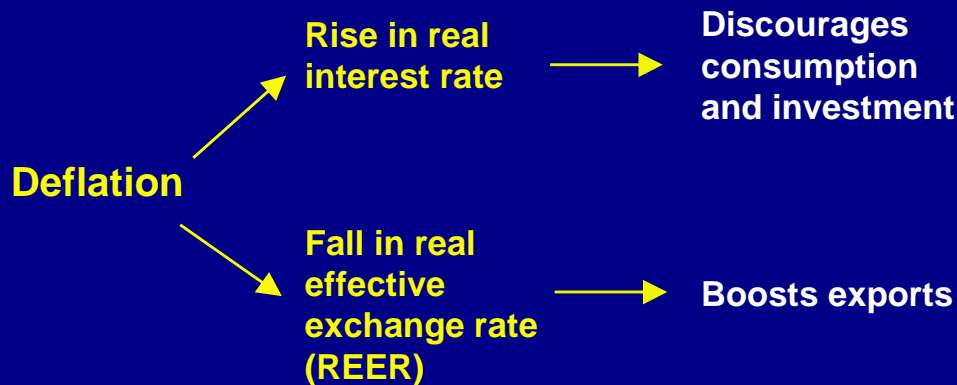
* Adjusted for the effects of government relief measures, such as the rates concession and waiver of water and sewage charges.

9

- The decline in the overall CCPI was in large part contributed by the drop in the housing component, which has declined by more than 23% since May 1998.
- Other non-tradable prices dropped moderately by about 3% during the same period, as most of the fees and charges of public transport and government services were frozen.
- Meanwhile, tradable good prices fell by 17%, in part reflecting lower import prices.



DEFLATION AN ADJUSTMENT PROCESS



10

Rise in real interest rate

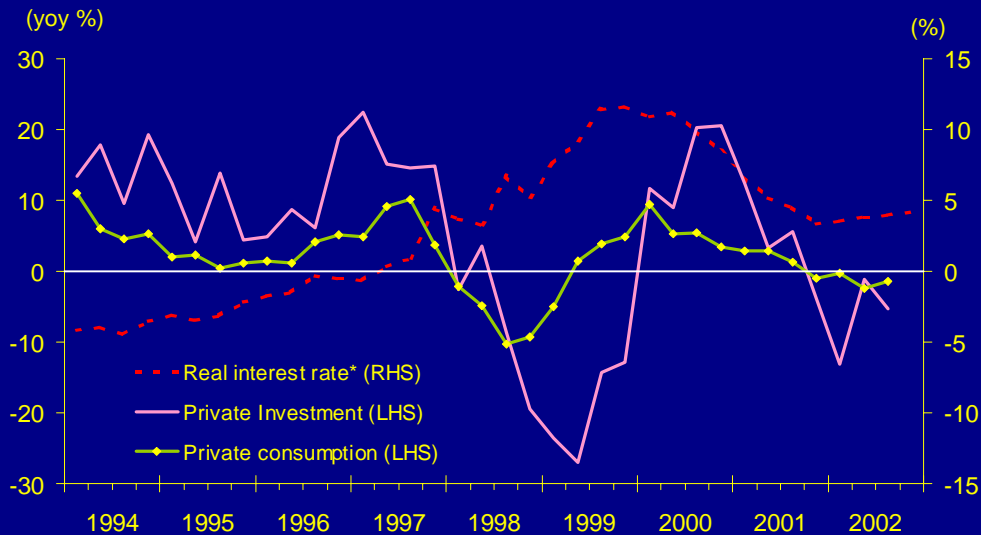
- Deflation increases the real interest rate for a given nominal rate.
- Real interest rates in Hong Kong influence private domestic demand through the impact on asset prices.
- High borrowing costs in real terms also depress investment.
- Nominal wages tend to adjust slower than prices. Other things being equal, profits are squeezed in periods of deflation. As a result, investment is depressed and employment reduced, further affecting consumption.

Fall in real effective exchange rate (REER)

- Under the Linked Exchange Rate system, declines in domestic prices will improve Hong Kong's external competitiveness. Hong Kong's REER has declined by about 20% from the peak in 1998, reflecting mainly domestic price adjustments in the past few years and, to a lesser extent, the recent weakening of the US dollar. The improvement in competitiveness is evidenced by the strong trade surpluses in the past few years.



DEFLATION - REAL INTEREST RATE, CONSUMPTION & INVESTMENT



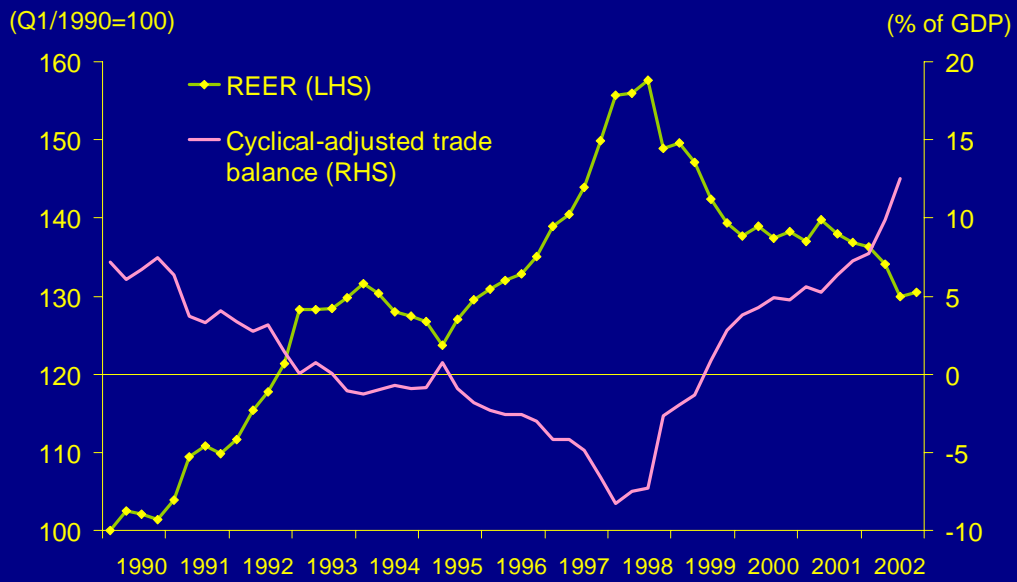
* 3-month HIBOR minus year-on-year change of the CCPI.

11

- While the nominal interest rate has declined significantly in the past couple of years, the real interest rate has remained at a relatively high level compared to the pre-crisis period. The high real interest rate has dampened private domestic demand in Hong Kong.
- Having recovered in 2000 and the earlier part of 2001, both private consumption and investment spending have declined on a year-on-year basis since the last quarter of 2001.



DEFLATION REER & EXPORT PERFORMANCE



12

- Hong Kong's REER has returned to its 1993 level.
- The improvement in competitiveness is evidenced by the strong trade balance in the past three years.



DEFLATION - OUTLOOK

- **No Japanese style spiralling deflation**
- **Economic integration with Mainland may involve further deflation**
- **Monetary response risky and inappropriate**

13

- The prolonged decline in prices has raised concerns about risks of entering a deflationary spiral. However, unlike Japan, which has also suffered from deflationary pressures for a long period of time, Hong Kong's economic growth is largely determined by external conditions, and domestic deflationary forces should be less significant than in Japan. Furthermore, the banking sector in Hong Kong is healthier than in Japan. Thus, bank lending should expand when general economic conditions improve.
- The effect of price convergence with the Mainland is likely to continue, in the light of growing economic integration as well as the existing price differentials.
- Deflation is part of the necessary structural adjustment in Hong Kong. It is the counterpart of currency depreciation under a floating exchange rate regime, with the exception that it tends to involve less instability, less overshooting, but also, understandably, less instant adjustment to changing economic conditions.



PUBLIC FINANCE

- **Sustainability of fixed exchange rate affected by perception on fiscal prudence**
- **No debt and ample fiscal reserves help, but ...**
- **Need to present a credible fiscal adjustment programme**

14

- Public finances in Hong Kong have attracted increased international and public attention. The budget deficit widened in the first three quarters of the current financial year (April to December 2002) to HK\$77 billion (6% of full-year GDP), as compared to HK\$61 billion (4.8% of full-year GDP) in the same period of the previous year.
- Market participants are increasingly sensitive to the fiscal numbers, as evident by the recent rise in the Hong Kong dollar forward points. Although the government has ample fiscal reserves (about HK\$300 billion, or 24% of GDP) and no debt, a credible fiscal adjustment programme is critical in maintaining market confidence about the Link.



RMB EXCHANGE RATE POLICY

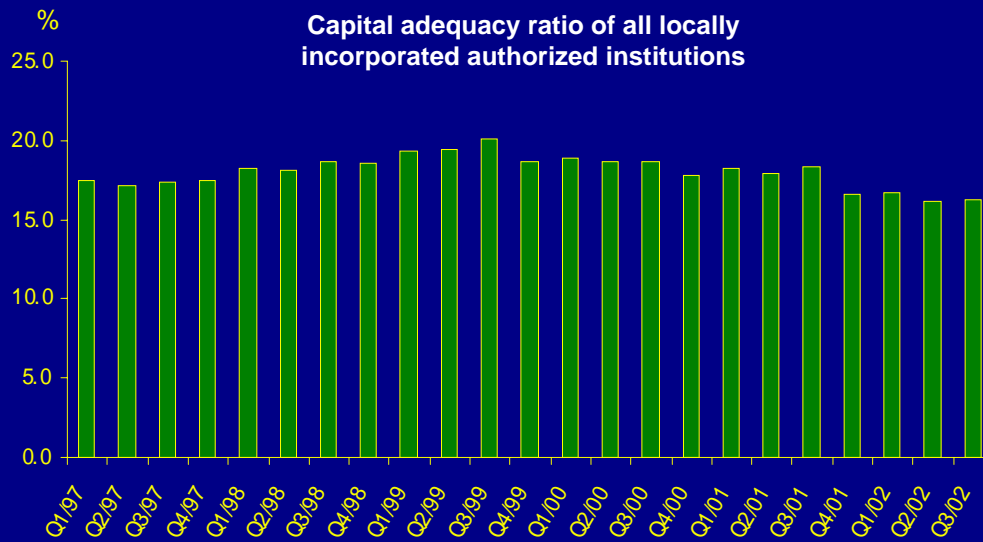
- **Market psychology**
- **RMB exchange rate flexibility**
- **RMB convertibility**
- **Maintaining close dialogue with the Mainland**

15

- In the light of close economic and financial linkages between Hong Kong and the Mainland, a change in the RMB exchange rate policy can affect perceptions about the Hong Kong dollar.
- Notwithstanding increased external pressure for a revaluation of the RMB. The Mainland still maintains substantial capital controls and there are risks that the RMB may depreciate if the Mainland were to relax some of these controls in a gradual move towards a more open capital account. We are maintaining close dialogue with the Mainland authorities.



BANKING SECTOR PERFORMANCE



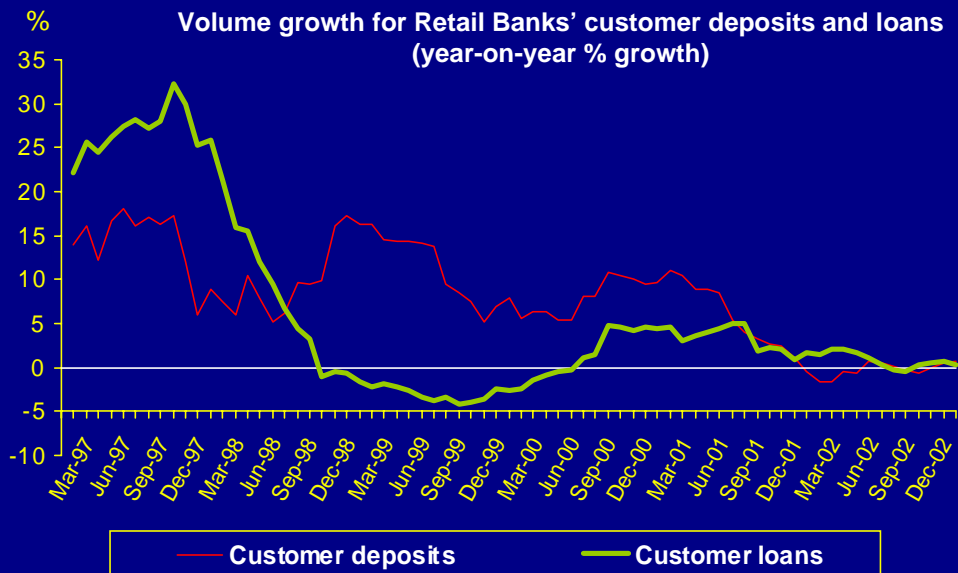
Note: There is a break in series at end-December 2001 owing to a change in the reporting population.

16

- The balance sheets of the locally incorporated authorized institutions (AIs) remain strong.
- The aggregate capital adequacy ratio, which measures the amount of capital that banks hold in relation to the amount of risk assets that they have, was over 16% at end-September, well above the minimum international standard of 8%.



BANKING SECTOR PERFORMANCE

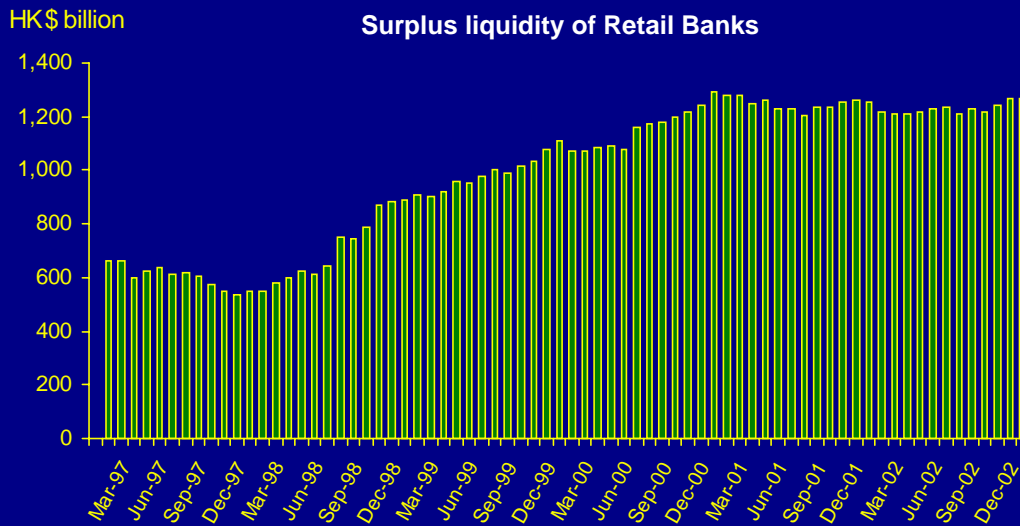


17

- Loan growth has turned negative after the Asian financial crisis as both banks and companies repaired their balance sheets. To some extent this may reflect continuing caution by the banks, but the fundamental issue is that companies are not borrowing.
- For much of the period since the Asian financial crisis, deposit growth was actually quite buoyant as savings built up in the banks. Even so, the excess growth of previous years has resulted in an accumulation of surplus deposits as shown in the next chart.



BANKING SECTOR PERFORMANCE



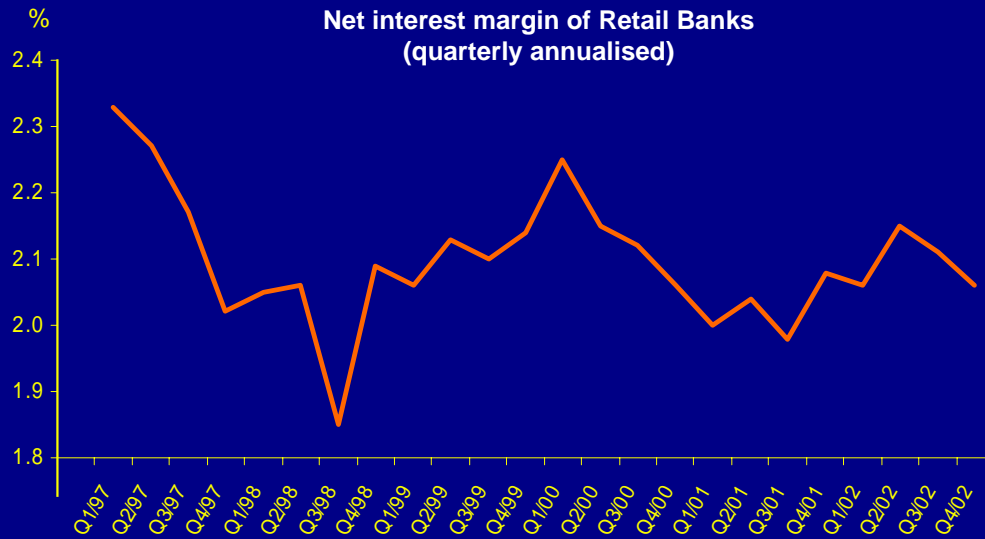
Surplus liquidity is defined as customer deposits minus customer loans.

18

- The excess of the retail banks' customer deposits over their customer loans has doubled from around \$600 billion in 1997 to the current \$1,200 billion. During the same period the loan-to-deposit ratio (all currencies) fell from around 70% to the current 54%.
- The surplus liquidity puts pressure on lending margins because there is too much spare liquidity chasing too few loans. We have seen the impact of this particularly in the residential mortgage market.
- But if the banks can raise deposits cheaply enough, they can earn a profit by lending them out in the interbank market or, better still, investing them in higher yielding instruments like government or corporate debt. This is what the banks have been doing, helped by a shift by depositors from time deposits to lower cost savings accounts as interest rates have fallen.



BANKING SECTOR PERFORMANCE



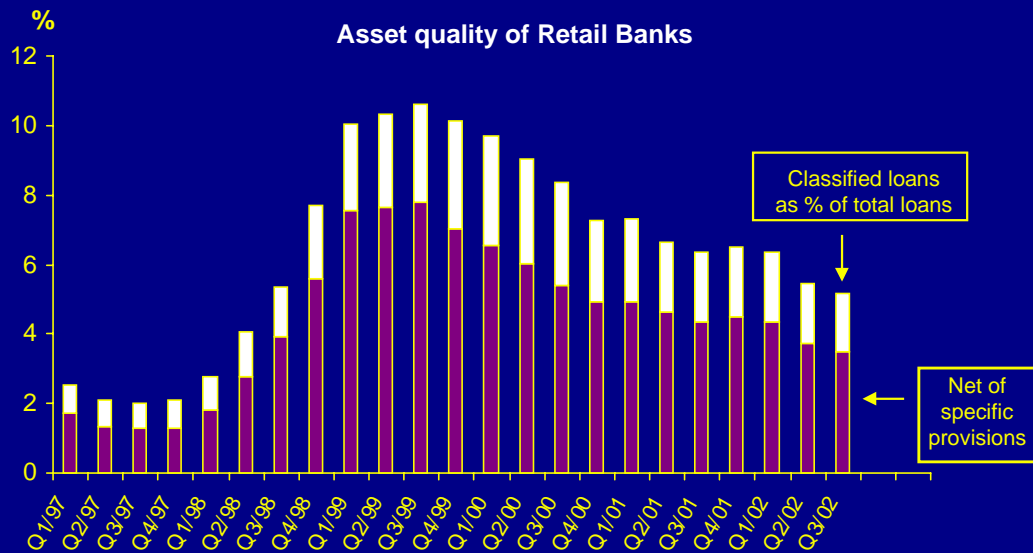
Note: Figure for Q4/02 is provisional.

19

- As a result, the net interest margin of the retail banks remained relatively stable at slightly over 2%.



BANKING SECTOR PERFORMANCE

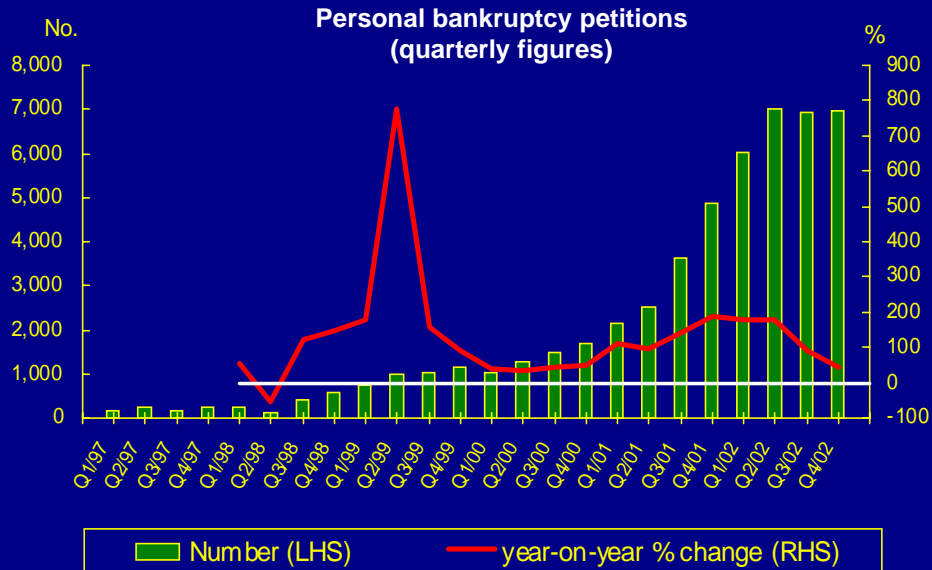


20

- Asset quality, as measured by the ratio of classified loans to total loans, has continued to improve and this has reduced the banks' need to make provisions for bad debts against corporate loans.
- The low level of interest rates, which reduces the debt servicing burden, in nominal terms at least, has helped to bring down classified loans (to 3.48% net of specific provisions at the end of September).
- Despite this good overall performance, the quality of the consumer portfolio has deteriorated significantly, reflecting the influence of rising bankruptcies.



BANKING SECTOR PERFORMANCE

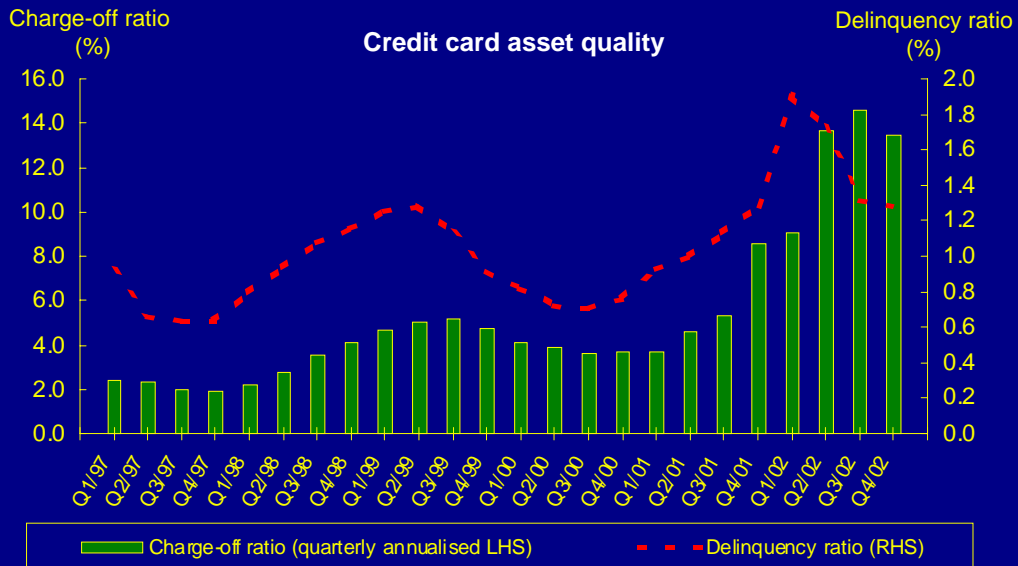


21

- The number of bankruptcy petitions presented was 26,922 for 2002, compared with 13,186 in 2001. This was against a backdrop of rising unemployment and slowdown in the economy. However, the figures stabilised in the second half of the year.



BANKING SECTOR PERFORMANCE



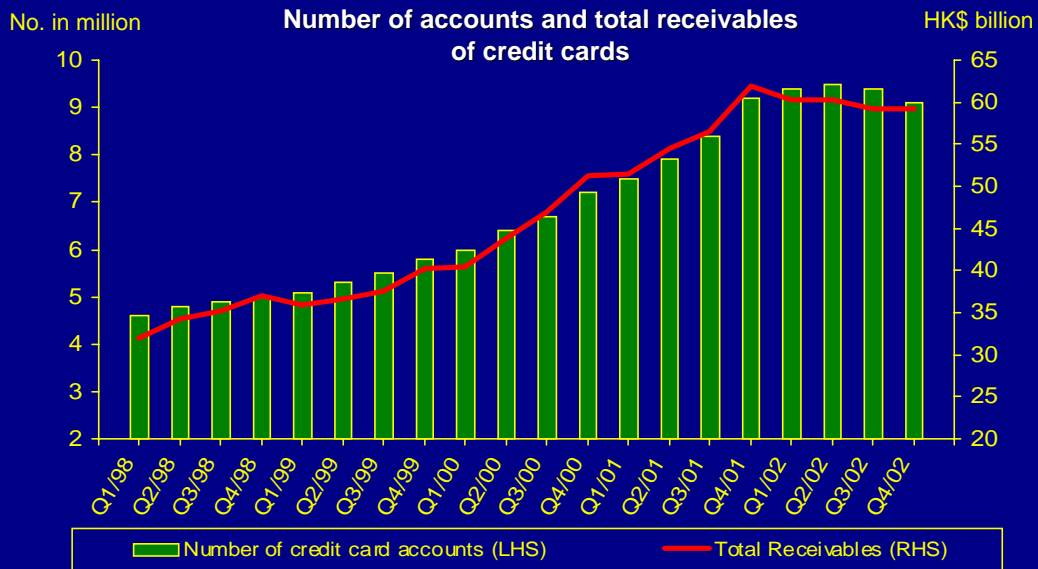
Note: There is a break in series at Q4 2001 owing to an increase in the number of surveyed institutions.

22

- There has been a sharp rise in delinquencies on credit cards, but more importantly an escalation in charge-offs. This has been one of the major depressing influences on bank profitability over the last year. The recent decline in the delinquency ratio was due to earlier write-offs in relation to bankruptcies.
- The annualised charge-off ratio for the fourth quarter has come down slightly after rising for six consecutive quarters. Nonetheless, it is still substantially higher than 5.46% for 2001.



BANKING SECTOR PERFORMANCE



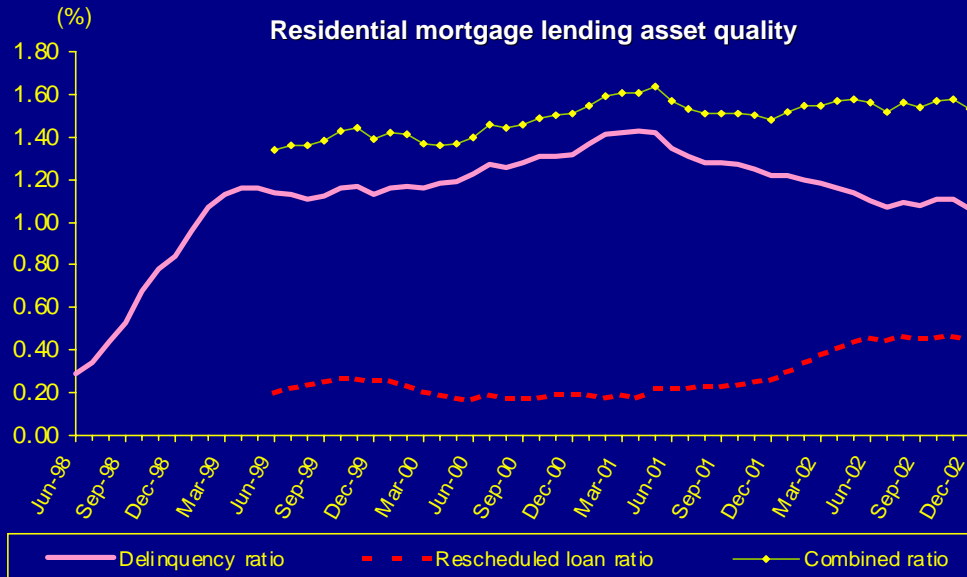
Note: There is a break in series at Q4 2001 owing to an increase in the number of surveyed institutions.

23

- The red line on the chart shows that credit card receivables have declined over the last four quarters, while the number of credit card accounts has been flat.
- This partly reflects a tightening of lending policies by the banks and can be regarded as a healthy and natural development.
- However, there are also dangers if the process is carried too far and a credit crunch develops. This could put more strain on the finances of those borrowers who are struggling to stay afloat, and perhaps have a further dampening effect on personal consumption, which would not be good for the broader economy. We welcome therefore the agreement on sharing of positive data which should enable the banks to expand credit on a sounder basis. I shall speak a bit more about this later on.



BANKING SECTOR PERFORMANCE



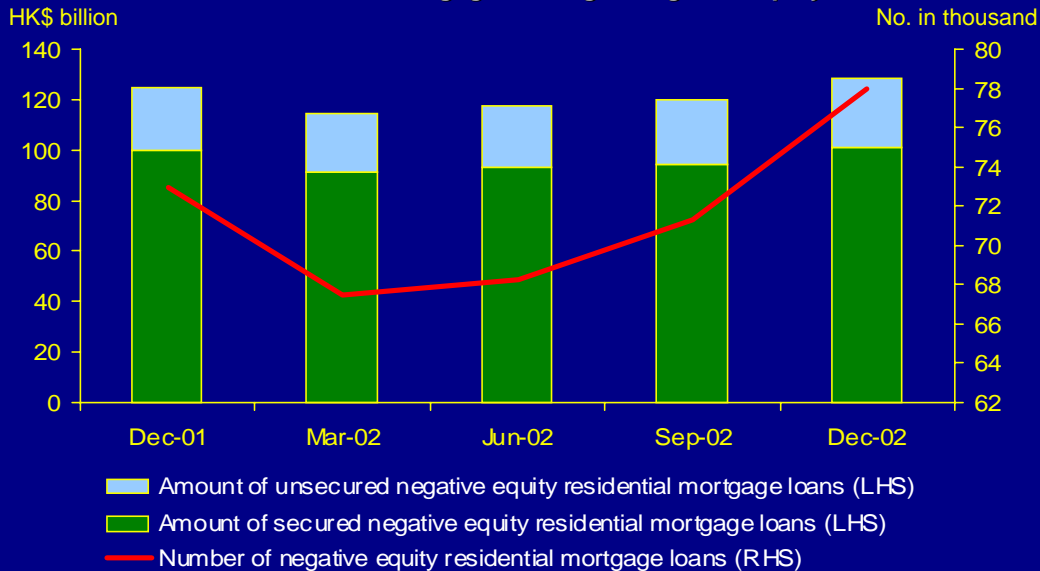
24

- So far the banks' mortgage portfolio has held up well. The above shows that mortgage delinquencies have actually been on a declining trend for some time. This partly reflects the increased willingness of banks to restructure problem loans. But even if we take this into account, the combined ratio of overdue and rescheduled loans has been quite stable.
- In December, the mortgage delinquency ratio and the rescheduled loan ratio dropped slightly to 1.06% and 0.46%. The combined ratio thus decreased to 1.52% from 1.58% in November.



BANKING SECTOR PERFORMANCE

Residential mortgage lending in negative equity



25

- Notwithstanding that the banks' mortgage portfolio has held up well, the number and amount of mortgage loans in negative equity do pose a potential threat to the banks, as well as having a depressing influence on the property market and the economy as a whole.
- Based on the latest survey results, it is estimated that the number of residential mortgage loans in negative equity within the banking sector as a whole increased to about 78,000 (with a value of HK\$129 billion) at end-December 2002, from about 71,000 (with a value of HK\$120 billion) at end-September 2002. The unsecured portion of these loans is estimated at about HK\$28 billion or 5.1% of the total residential mortgage lending of the banking sector. This provides an indication of the risk exposure of the banking sector.
- The average interest rate being charged to negative equity homeowners was 0.83% below the best lending rate (BLR) at end-December, compared with 0.76% below BLR at end-September and 0.70% below BLR at end-June.
- 58% of negative equity homeowners were being charged below BLR at end-December, compared with 55% at end-September and 52% at end-June. These numbers reflect banks' responsiveness in reducing negative equity homeowners' repayment burden by lowering interest rates.
- The HKMA is aware that many banks have set up call centres to assist negative equity homeowners to restructure their loans with a view to ameliorating their repayment burden. Some banks have also offered schemes to allow refinancing of such loans up to 140% of the current market value of the property at more favourable rates.
- In the light of the rising number of negative equity loans and the continuing weak economic condition, the HKMA issued a further letter on 7 February to encourage banks to continue to be sympathetic towards negative equity homeowners in financial difficulties seeking loan restructuring.



PRIORITIES IN 2003

- **Continued close monitoring of banks' financial position and performance**
- **Use of stress tests to pick up early warning signals**
- **Continued enhancement of our regulatory framework**

26

- The banks are generally cautious about the outlook for 2003. In the light of the economic and financial environment, the HKMA will continue in 2003 to monitor the banks' financial position and performance through on-site and off-site examinations and supervision.
- The HKMA will continue with its regular stress tests on the banks' ability to withstand a variety of severe shocks, such as a sharp rise in bad debt provisions, further decline in property prices and adverse interest rate changes.
- We will continue to enhance our regulatory framework to keep up with changing local environment and changing international standards.



PRIORITIES IN 2003

- **Consumer credit data sharing**
 - to issue guidelines to achieve comprehensive participation by banks, and to require banks to have sufficient controls to safeguard privacy protection
- **Commercial credit reference agency**
 - the industry's Working Group has reached agreement on the key features of a voluntary participation scheme

27

Consumer credit data sharing

- The HKMA welcomes the decision of the Privacy Commissioner to revise the Code of Practice on Consumer Credit Data to give effect to the greater sharing of consumer credit data. The HKMA will aim to achieve comprehensive participation by all AIs which are involved in consumer lending and will issue industry supervisory guideline to reinforce this.
- To safeguard privacy protection, the HKMA will also issue a guideline to require AIs to put in place sufficient controls to guard against unauthorized access to credit data, and the HKMA will play an active role in monitoring the effectiveness of such controls and the handling of complaints against abusive access to data by AIs. The HKMA will conduct an annual qualitative assessment of the effectiveness of the privacy safeguards in respect of AIs, starting from the first year after the launch of the positive credit data sharing arrangement.

Commercial credit reference agency

- The Working Group formed by the industry associations has agreed on the key features of the scheme, including the ground rules for seeking customer consent, the scope of data sharing, and the definition of SMEs. Before the scheme can be up and running, the working party will need to undertake further preparatory work, including identification of an appropriate service provider, contract negotiation with the shortlisted service provider and systems development to cater for the reporting of data.



PRIORITIES IN 2003

- **Deposit protection scheme**
 - **briefing to the Panel on Financial Affairs on 8 January 2003**
 - **reviewing industry's comments on the draft bill. Planning to introduce the bill into Legislative Council in the next few months**
- **Banking consumer protection**
 - **to update the Panel on Financial Affairs again in March 2003**

28

Deposit insurance scheme

- As reported to the Panel on Financial Affairs on 8 January 2003, the Exchange Fund Advisory Committee has endorsed a proposal to outsource the day-to-day administration of the scheme to the HKMA. The HKMA would be essentially acting as the Deposit Protection Board's agent in administering the scheme and the HKMA's work in this respect would be subject to the Board's oversight. This arrangement is intended to achieve cost savings as the Board would be able to leverage on the existing resources and infrastructure of the HKMA (e.g. IT system and office administration). Also, in normal times, the role and functions of the Board would be limited to the care and maintenance of a "paybox" system, which should require a lower level of resources. Such an arrangement should provide the flexibility in resource requirement and maintain the skills set necessary to administer the scheme.
- The HKMA is reviewing the banking industry's comments on the draft bill. The plan is to introduce the bill into the Legislative Council within the next few months. Depending on the progress of passing the legislation and of the preparatory work in setting up the scheme, it is expected that the scheme would commence operation in 2005.

Banking consumer protection

- The HKMA will update the Panel on Financial Affairs again in March 2003 on the latest developments in relation to consumer protection.



FINANCIAL INFRASTRUCTURE

A financial intermediation platform with emphasis on:

- **Stability**
- **Integrity**
- **Diversity**
- **Efficiency**

29

- An efficient and robust financial infrastructure is essential to Hong Kong's role as an international financial centre. The HKMA's objective is to develop a financial platform on which financial intermediaries can operate in a safe and efficient manner.



FINANCIAL INFRASTRUCTURE

A payment clearing and settlement system in Asian time zone with the following features:

- **Multi-access**
- **Multi-currency**
- **Multi-channel**
- **RTGS, DvP and PvP**

30

- The objective is the provision of a robust financial infrastructure for all types of financial transactions, initiated from whatever location, in whatever time zone, in whatever currency, whether at the wholesale or retail level, to be executed and settled in real time. In brief, this can be described as “universal, 24-hour access to multi-currency clearing and settlement services with RTGS, DvP and PvP capabilities”. With this versatile financial infrastructure, Hong Kong is well placed to support both domestic and international financial activities and also serve as a link between the Mainland and the global financial market.



FINANCIAL INFRASTRUCTURE FOR DOMESTIC FINANCIAL ACTIVITIES

- **Technical upgrade of financial infrastructure**
 - cheque imaging and truncation (Bills of Exchange (Amendment) Bill)
- **Inclusion of Hong Kong dollar in global payment system (CLS system)**
 - Clearing and Settlement Systems Bill
- **Retail payment**
 - issue of new HKSARG \$10 note
 - first batch of new generation of banknotes to be available later this year

31

Technical upgrade of financial infrastructure

- The system development work on modernisation of the Central Moneymarkets Unit (CMU) system was completed on schedule in November.
- The HKMA and the Hong Kong Association of Banks are working on a cheque imaging and truncation project to be implemented by the Hong Kong Interbank Clearing Limited in mid-2003. This would obviate the need for physical presentation of small value cheques for clearing and would improve cheque clearing efficiency and security and reduce costs. The relevant Bills of Exchange Ordinance (Amendment) Bill will be introduced into the Legislative Council on 19 February 2003.

Inclusion of Hong Kong dollar in global payment system

- The HKMA is working on a Clearing and Settlement Systems Bill to cater for, among other things, Hong Kong dollar's participation in the Continuous Linked Settlement (CLS) system.

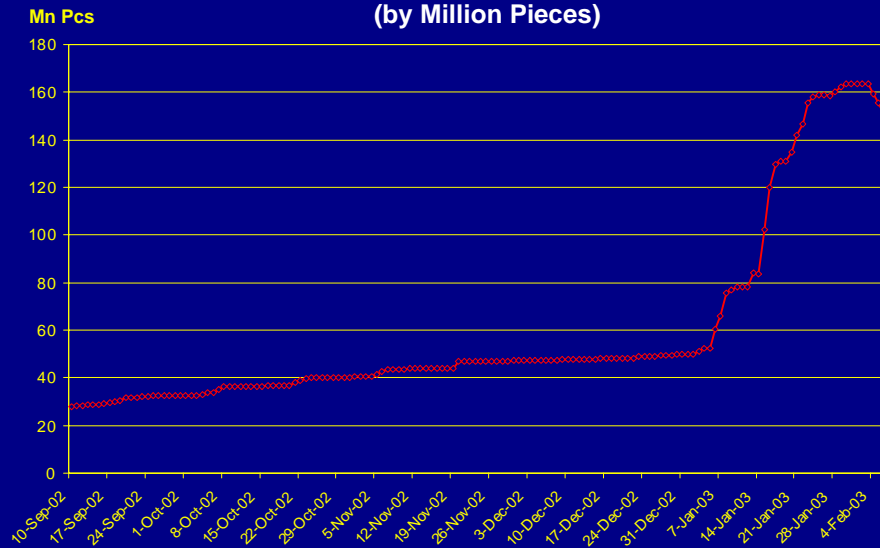
Retail payment

- The HKSARG \$10 note was launched on 10 September. The first batch of the new generation of banknotes is expected to be available later this year.



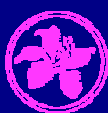
FINANCIAL INFRASTRUCTURE FOR DOMESTIC FINANCIAL ACTIVITIES

HKSARG \$10 Note in Circulation
(by Million Pieces)



32

- The HKSARG \$10 note was launched on 10 September and the number in circulation rose to 163.4 million pieces on 30 January 2003, the last working day before the Lunar New Year.



FINANCIAL INFRASTRUCTURE FOR INTERNATIONAL FINANCIAL ACTIVITIES

- **Development of foreign currency payment systems**
 - US dollar and euro RTGS payment systems
- **Payment system linkages with cities in the Mainland**
 - cheque clearing between Hong Kong and Guangdong
 - Hong Kong dollar RTGS access for banks in Mainland
- **Hong Kong as a regional settlement hub**
 - links from CMU to Euroclear and Clearstream
 - CMU clearing of US treasuries
 - link from CMU to the Mainland's Government Securities Book-Entry System

33

Development of foreign currency payment payments

- The Project Steering Committee chaired by the HKMA is overseeing the establishment of the euro RTGS payment system, which is expected to be ready for live operation in April 2003.

Payment system linkages with cities in the Mainland

- The operation of the two-way joint cheque clearing with Guangdong has been very smooth. In 2002, more than 180,000 HKD cheques from Hong Kong, with a total value of HK\$18.2 billion was presented for payment in Guangdong. As for HKD cheques from the Mainland and deposited in Hong Kong for clearing, the arrangement started operation on 22 June, with a total of 730 cheques valued at HK\$38 million processed in 2002.
- The HKD link between Hong Kong and Shenzhen started operation on 12 December. In the first month of its operation, through the HKD RTGS system in Hong Kong and that in Shenzhen, banks in Shenzhen paid HK\$1.28 billion to banks in Hong Kong. In the other direction, banks in Hong Kong paid HK\$71 million to banks in Shenzhen.

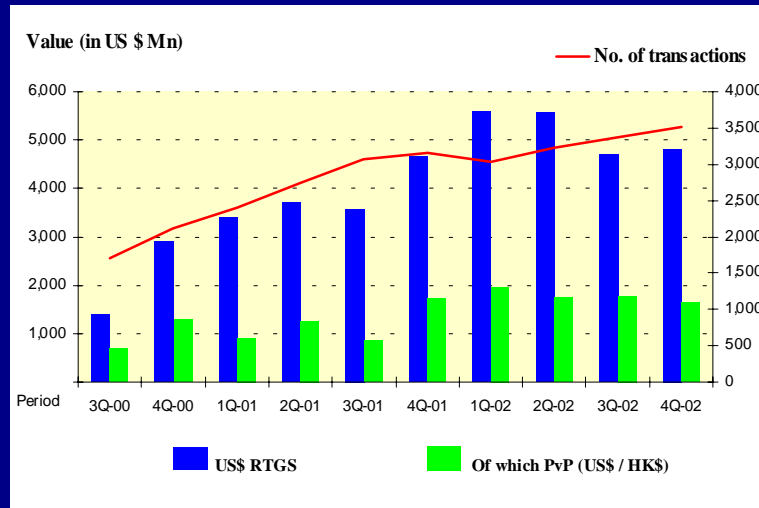
Hong Kong as a regional settlement hub

- The Euroclear linkage was completed on schedule in November. A new service enabling CMU members to clear and settle US Treasuries also started in December. To further enhance the settlement capability of the CMU in international securities, the CMU has implemented a direct link with the settlement system of Clearstream, another international central securities depository, on 27 January.
- Agreement in principle has been reached to establish a link between the CMU and the Government Securities Book-Entry System of China in 2003. The HKMA is finalising the technical arrangements.



FINANCIAL INFRASTRUCTURE FOR INTERNATIONAL FINANCIAL ACTIVITIES

US Dollar RTGS Turnover (daily average)



34

- The USD clearing system has been well used. Market promotion in the Mainland and the rest of the region is continuing. In the quarter ending December 2002, about 3,500 RTGS transactions involving around US\$4.8 billion in value were settled every day. The use of USD cheques recorded a significant increase. During the period, on average 1,430 USD cheques of a total value of US\$47 million were settled everyday.



FINANCIAL INFRASTRUCTURE FOR INTERNATIONAL FINANCIAL ACTIVITIES

- **APEC Initiative on Development of Securitisation and Credit Guarantee Markets**
 - Hong Kong, Korea and Thailand are co-leading the Initiative
 - Work programmes launched in early 2003
- **Asian Bond Fund**
 - EMEAP Working Group on Financial Markets, which the HKMA chairs, has been spearheading the development
 - helps channel some of Asian's official reserves back to the region for economic and bond market development

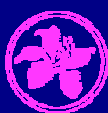
35

APEC Initiative on Development of Securitisation and Credit Guarantee Markets

- The Initiative aims to promote understanding and awareness of the importance of securitisation and credit guarantee to bond market development in the region and to assist APEC economies to identify and take concrete steps to remove impediments to the development of securitisation and credit guarantee markets.
- Following endorsement by the APEC economic leaders in the APEC Leaders' Declaration issued in October, the HKMA has been assisting in carrying out the work programmes, including expert visits to and policy dialogue with those economies which have indicated interest to receive expert advice.

Asian Bond Fund

- The HKMA is spearheading the development of an Asian Bond Fund under the EMEAP forum. The EMEAP Working Group on Financial Markets, which the HKMA chairs, studied the idea of creating an Asian Bond Fund to facilitate the investment of a small portion of Asian central banks' foreign reserves in Asian bonds for portfolio diversification and yield enhancement purposes. Such investment could also help channel some of Asia's official reserves back to the region to finance Asia's own economic development, and promote the development of the regional bond markets.
- The EMEAP Working Group has been working on the technical design and structure of the Asian Bond Fund.



EXCHANGE FUND PERFORMANCE

(HK\$ billion)	2002	2001	2000
Gain / (Loss) on HK equities*	(11.8)	(27.1)	(7.3)
Gain / (Loss) on other equities*	(22.8)	(3.3)	0.5
Exchange gain / (loss)	27.3	(13.0)	(11.2)
Total return from bonds, etc	<u>54.3</u>	<u>50.8</u>	<u>63.1</u>
Investment income	47.0	7.4	45.1

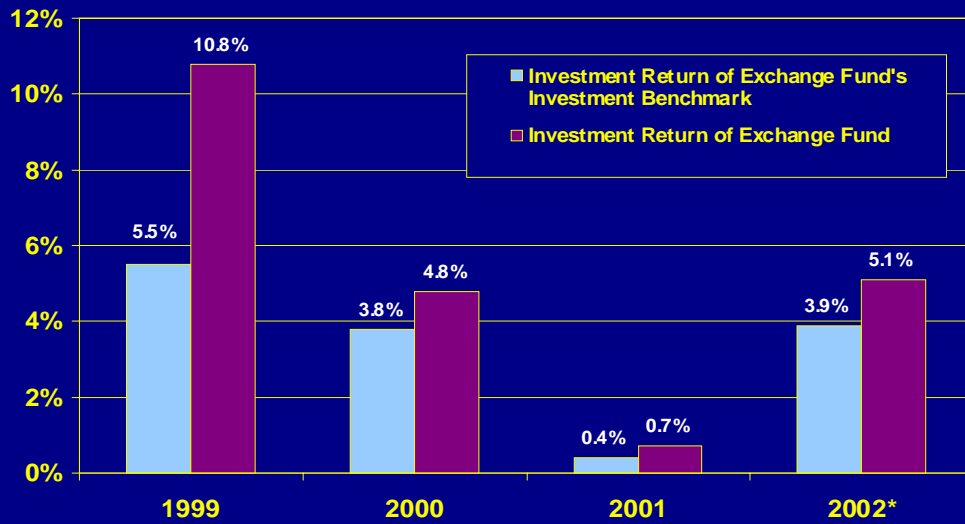
* including dividends

36

- The Exchange Fund recorded an investment income of HK\$47 billion in 2002. The main components of this income were:
 - income and valuation gains of HK\$54.3 billion from bonds and other investments;
 - a valuation loss of HK\$11.8 billion on the Hong Kong equities portfolio (net of dividends);
 - a valuation loss of HK\$22.8 billion on other equities (net of dividends); and
 - an exchange valuation gain of HK\$27.3 billion, mainly as a result of the appreciation of the euro against the US dollar.



EXCHANGE FUND PERFORMANCE AGAINST INVESTMENT BENCHMARK



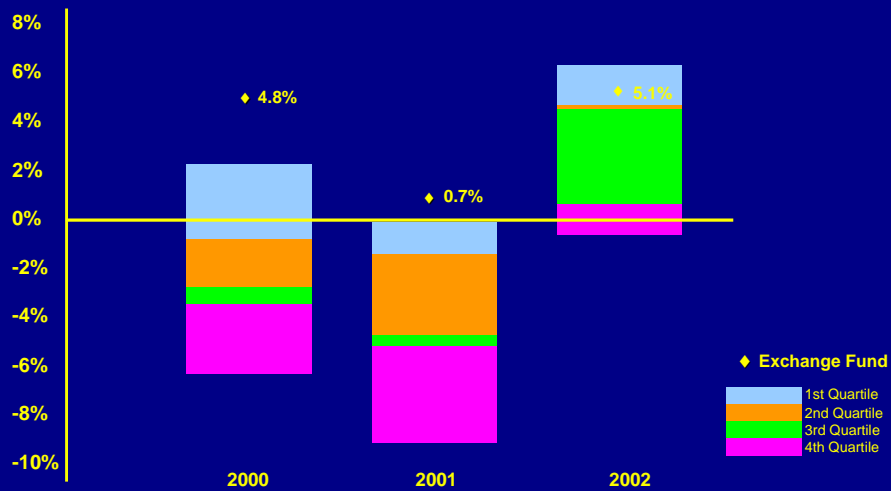
* Preliminary, unaudited figures for 2002

37

- In 2002, the Exchange Fund achieved an investment return of 5.1%, which is 120 basis points above the return of its strategic investment benchmark.
- Since the adoption of the current strategic investment benchmark four years ago, the Exchange Fund has achieved a compounded 5.3% annual return, or an annual out-performance of 190 basis points above the benchmark's compounded 3.4% annual return for the same period.



INVESTMENT PERFORMANCE OF EXCHANGE FUND AND COMPARABLE BALANCED FUNDS



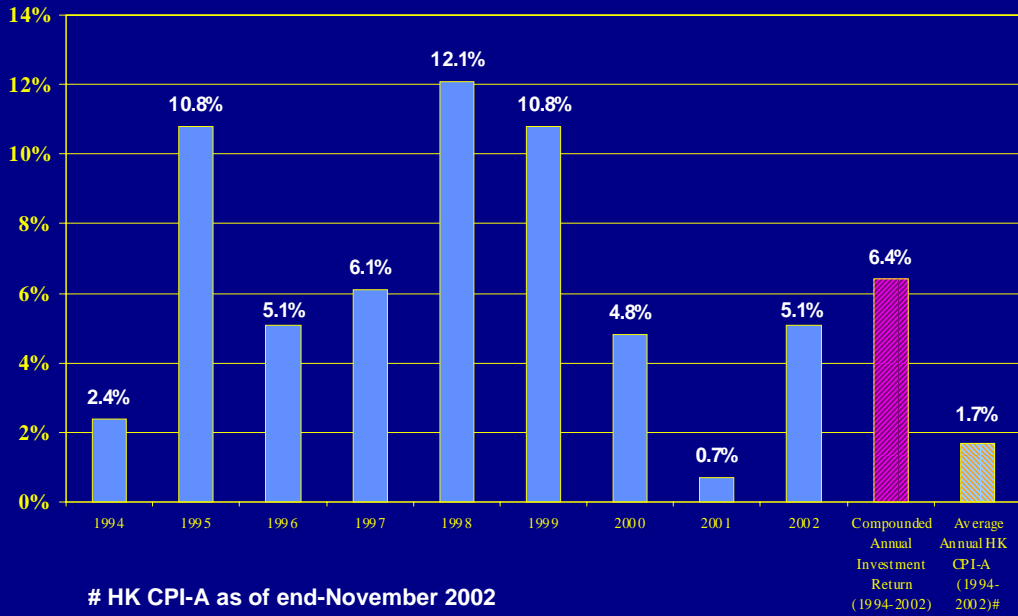
Balanced Funds with 20% - 30% Equity Component
Source: Watson Wyatt and Standard & Poor's

38

- Although direct comparisons are not always easy or appropriate, generally speaking, the Exchange Fund achieved an investment return that was favourable in comparison to that of other similar funds in the private sector.



EXCHANGE FUND HISTORICAL RETURN



39

- Since 1994, the Exchange Fund has generated an average annual return of 6.4%, compared with the average annual inflation rate of 1.7% over the same period.

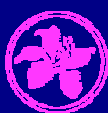


EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	2002	2001	Change
ASSETS			
Deposits	51.2	99.2	(48.0)
Debt securities	764.5	732.7	31.8
Hong Kong equities	50.9	85.9	(35.0)
Other equities	63.2	35.3	27.9
Other assets	<u>25.3</u>	<u>26.0</u>	<u>(0.7)</u>
Total assets	955.1	979.1	(24.0)
LIABILITIES AND ACCUMULATED SURPLUS			
Certificates of Indebtedness	118.5	107.5	11.0
Government-issued currency notes & coins in circulation	5.9	5.7	0.2
Balance of banking system	0.5	0.7	(0.2)
Exchange Fund Bills and Notes	122.9	118.1	4.8
Placements by other HKSAR government funds	301.7	380.6	(78.9)
Other liabilities	<u>78.3</u>	<u>63.9</u>	<u>14.4</u>
Total liabilities	627.8	676.5	(48.7)
Accumulated surplus	<u>327.3</u>	<u>302.6</u>	<u>24.7</u>
Total liabilities and accumulated surplus	955.1	979.1	(24.0)

40

- The Abridged Balance Sheet shows that in 2002 the total assets of the Exchange Fund decreased by HK\$24 billion, from HK\$979.1 billion at the end of December 2001 to HK\$955.1 billion at the end of December 2002.
- The net drawdowns of the fiscal reserves, amounting to HK\$78.9 billion, were the main reason for the decrease in total assets in 2002. This decrease was, however, partly compensated for by net investment income of HK\$40.4 billion - see next slide.



EXCHANGE FUND CHANGE IN ACCUMULATED SURPLUS

(HK\$ billion)	← 2002 →					2001
	Full year	Q1	Q2	Q3	Q4	Full year
Investment income/(loss)	47.0	(3.7)	26.5	(2.1)	26.3	7.4
Other income	0.2	0.0	0.1	0.0	0.1	0.2
Interest and expenses	<u>(6.8)</u>	<u>(1.6)</u>	<u>(1.7)</u>	<u>(1.7)</u>	<u>(1.8)</u>	<u>(10.5)</u>
Net investment income/(loss)	40.4	(5.3)	24.9	(3.8)	24.6	(2.9)
Treasury's share	<u>(15.7)</u>	<u>1.6</u>	<u>(9.7)</u>	<u>0.8</u>	<u>(8.4)</u>	<u>(1.6)</u>
Increase/(Decrease) in EF accumulated surplus	24.7	(3.7)	15.2	(3.0)	16.2	(4.5)

41

- As this chart demonstrates, quarterly returns to the Exchange Fund have been extremely volatile: the Fund made losses in the 1st and 3rd quarters last year, while recorded gains in the 2nd and 4th quarters. The market remains cautious about the outlook for 2003 in the light of increasing uncertainty in the global economy and geopolitical tensions.
- For 2002 as a whole, the Fiscal Reserves' share of the net investment income amounted to HK\$15.7 billion. The balance of HK\$24.7 billion has been added to the Exchange Fund's Accumulated Surplus for 2002.
- Quarterly returns to Fiscal Reserves under the return sharing arrangement, started on 1 April 1998, are as follows:

	(HK\$billion)				
	1998	1999	2000	2001	2002
Q1	n.a.	5.2	2.6	(6.1)	(1.6)
Q2	4.1	18.0	(4.2)	(1.0)	9.7
Q3	6.9	(0.5)	7.7	4.0	(0.8)
Q4	<u>15.0</u>	<u>22.7</u>	<u>12.0</u>	<u>4.7</u>	<u>8.4</u>
	26.0	45.4	18.1	1.6	15.7

It is up to the Treasury to decide when to settle the return to the Fiscal Reserves placed with the Exchange Fund.



EXCHANGE FUND HONG KONG EQUITY PORTFOLIO

	(HK\$ billion)
Cost of shares purchased in August 1998	118.1
Shares transferred from Land Fund (November 1998)	9.0
Proceeds from disposal of Hong Kong stocks	
Initial public offering of TraHK	33.3
Tap facility (Q4 1999 - Q4 2002)	<u>107.1</u>
	140.4
Dividend and other income	24.8
Total disposal and other income	165.2
Long-term Hong Kong equity portfolio (at 31 December 2002)	50.9*

* about 5.3% of the total assets of the Exchange Fund at end Dec 2002

42

- The market value of the equity investments of the Portfolio at the end of December 2002 amounted to HK\$50.9 billion. These holdings, representing what remains after the completion of the disposal programme for the stocks originally purchased in August 1998, have become part of the Exchange Fund's investment portfolio.



REPAYMENT OF THE FINANCING PACKAGE BY THAILAND

- **Loan to Bank of Thailand will be fully repaid in July 2003, almost one year ahead of the original repayment schedule**
- **Since April 2001 Bank of Thailand has been repaying the loan with interest on schedule**

43

- In August 1997 the Government announced the decision to extend up to US\$1 billion in credit facility to Thailand under a financing package led by the International Monetary Fund. Between October 1997 and July 1999, US\$862 million was drawn under the Currency Swap Agreement signed between the HKMA and the Bank of Thailand (BOT). Since April 2001 the BOT has been repaying the loan by instalments according to the terms and conditions of the Agreement.
- In January 2003 the BOT approached the HKMA with an early repayment schedule starting from February 2003. The proposal has been endorsed by the Financial Secretary. Under the proposal, the loan will be fully repaid in July 2003, almost one year ahead of the original repayment schedule under the Agreement.



HONG KONG MONETARY AUTHORITY

**Briefing to the Legislative Council
Panel on Financial Affairs**

19 February 2003

44