



HONG KONG MONETARY AUTHORITY

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

2 February 2004



PROGRESS IN KEY FUNCTIONS & RESPONSIBILITIES

- **Review of 2003**
- **Currency**
- **Banking**
- **Financial infrastructure**
- **Hong Kong as an international financial centre**
- **Exchange Fund**

2

- The next slide recaps on the HKMA's progress in key areas in 2003. This will be followed in the presentation by a latest update on the work of the HKMA.



REVIEW OF 2003

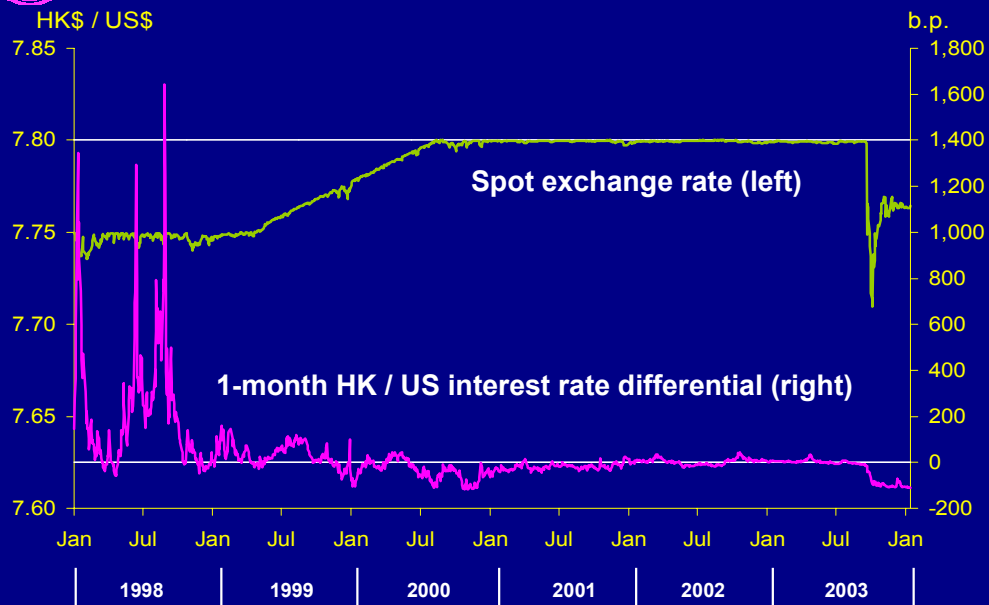
- **Monetary and banking stability notwithstanding heightened risks and volatility**
- **Investment return on Exchange Fund amounted to HK\$89.6 billion**
- **Approval for personal RMB business in Hong Kong**
- **Euro Clearing System commenced operation**
- **Hong Kong's credit rating upgraded to A1**
- **Sharing of positive consumer credit data began**

3

- Against a background of domestic economic difficulties, exacerbated by SARS, and considerable volatility in world markets, Hong Kong enjoyed a high degree of monetary and banking stability in 2003.
- Benefiting from a strong recovery in the investment environment in the second half of 2003, the Exchange Fund recorded an investment income of HK\$89.6 billion for the year.
- Further progress was made in consolidating Hong Kong's status as an international financial centre, including the facilitation of personal RMB business in Hong Kong and the commencement of the Euro Clearing System. The HKMA played a key role in Moody's upgrade of Hong Kong's credit rating, which helps provide more favourable conditions for Hong Kong debt issuers.
- The sharing of positive consumer credit data, which commenced in August, helps contribute to a fairer and healthier credit environment in Hong Kong.



CURRENCY STABILITY (1)

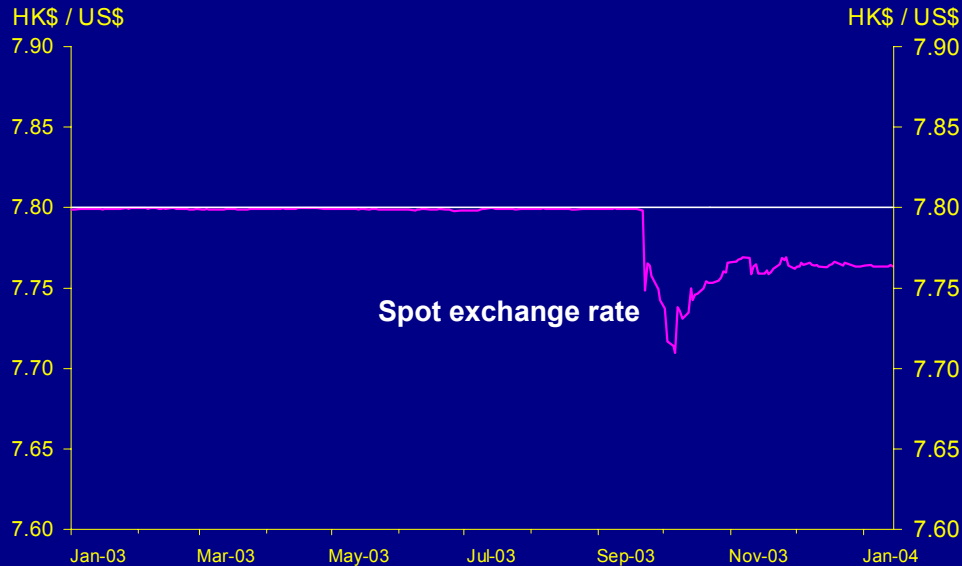


4

- The Hong Kong dollar exchange rate was stable against the US dollar until a marked strengthening from 22 September 2003.
- Short-term Hong Kong dollar interest rates have fallen below US dollar rates since August 2003.



CURRENCY STABILITY (2)



5

- The spot exchange rate is stable at around 7.76, after appreciating at one time to 7.70 in London hours on 22 September 2003.
- Market sentiment shifted abruptly in late September, sparked off by a weakening of the US dollar, intensifying pressure for revaluation (or more flexibility) of the RMB, and an unwinding of short positions in the Hong Kong dollar.
- The strengthening pressure on the Hong Kong dollar has persisted, likely to be associated with investors' greater recognition of a solid economic recovery in Hong Kong, and portfolio re-allocations arising from Hong Kong's robust current account surpluses and international investment position.
- Concerns over the budget deficit, unemployment and deflation, however, remain.



CURRENCY - MARKET EXPECTATIONS (1)



6

- Overall, the market has remained calm by historical standards, although there was a marked shift of expectation from weakness to strength as illustrated by the 12-month forward exchange rate moving from a premium to a discount compared with the spot exchange rate.



CURRENCY - MARKET EXPECTATIONS (2)



7

- Hong Kong dollar forward points shifted to a discount since September 2003.
- 12-month forward points widened to a discount of 765 on 13 January, but gradually narrowed afterwards to around 570 ahead of the Lunar New Year holidays.



CURRENCY - MARKET EXPECTATIONS (3)



8

- The 12-month forward exchange rate has appreciated to below 7.70. The strongest level reached was 7.6709.



CURRENCY BOARD RULES

	<u>Capital inflow</u>	<u>Capital outflow</u>
Aggregate Balance (crucial component of Monetary Base*)	↑	↓
Interbank interest rates	↓	↑

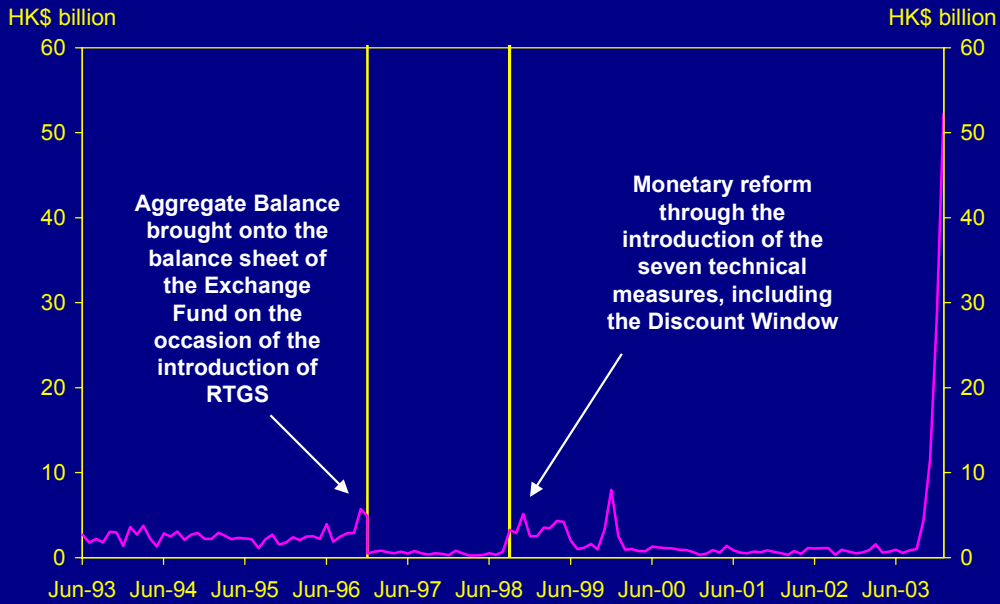
* The other components of the Monetary Base are banknotes and coins in circulation and Exchange Fund paper outstanding, the latter being convertible into the Aggregate Balance through the Discount Window.

9

- On the strong side, Hong Kong's Currency Board arrangements translate currency strength arising from capital inflow into an expansion of the Monetary Base, more foreign reserves and lower domestic interest rates. The converse applies when the currency weakens.



AGGREGATE BALANCE (1)

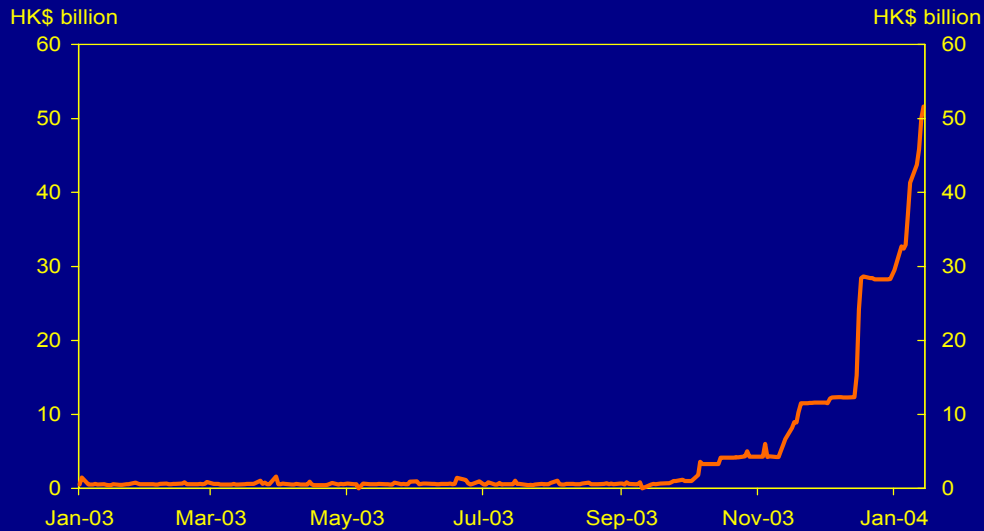


10

- Reflecting inflows of funds, and the sale of US dollars by banks to the HKMA for the account of the Exchange Fund, banks' clearing balances (Aggregate Balance) held with the Exchange Fund went up to historical highs in recent months.



AGGREGATE BALANCE (2)



Note: Figures on the Aggregate Balance are after Discount Window activities.

11

- A total of \$ 51.7 billion of Hong Kong dollars was sold between 23 September 2003 and 16 January 2004, leading to an increase in the Aggregate Balance to HK\$52.2 billion at 21 January 2004.
- There is no limit to the amount of domestic money that can be created if the demand exists. As long as banks want to sell US dollars to the HKMA, for the Currency Board account of the Exchange Fund, at the exchange rate determined by the HKMA, the HKMA has to create those Hong Kong dollars.
- There is no concern on the part of the HKMA about the current size of the Aggregate Balance. Nor do we take a view on what the size should be.



POLICY OPTIONS (1)

- **Continue to take US dollars passively and allow Aggregate Balance to increase, and wait for interest rate differential to reverse the inflow**
- **Enlarge interest rate differential by imposing a charge on large clearing balances of banks: negative interest rates**
- **Absorb large Aggregate Balance through issue of Exchange Fund paper: a transfer between different components of Monetary Base**
- **Introduce Convertibility Undertaking also on the strong side**

12

- There are four policy options to deal with capital inflow. The first is for the Aggregate Balance, which earns no interest for the banks, to increase to a size in which the total opportunity cost for holding on to it becomes too significant for the banking system as a whole. The alternative is for banks to switch out of Hong Kong dollars into foreign assets earning some return, although this carries with it the risk of a sudden appreciation of the Hong Kong dollar.
- The second option would be to increase the risk-adjusted opportunity cost. The HKMA has the powers to introduce charges on large balances maintained by banks in their clearing accounts held with the HKMA, so that the interest rate differential between holding Hong Kong dollars and holding US dollars becomes a lot higher than the current one.
- The third option is for the HKMA to mop up the large pool of Hong Kong dollars in the Aggregate Balance, or part of it, through the issue of more Exchange Fund paper. Since the paper that would replace the Aggregate Balance in this manner would be fully backed by US dollar reserves and would still be part of the Monetary Base, the Currency Board rules would continue to be observed. This would in effect be a mechanism for preventing or mitigating the emergence of extreme monetary conditions on the strong side, and one that would be symmetrical to the cushion afforded on the weak side by the same pool of Exchange Fund paper eligible for accessing the Discount Window.
- The fourth option is the introduction of a more formal convertibility undertaking on the strong side of the Link. There are pros and cons for retaining some discretion in the determination of the intervention level on the strong side. On the one hand, the constructive ambiguity inherent in discretion inhibits speculative shorting of the Hong Kong dollar by making it difficult to calculate the downside risk involved. On the other hand, the total absence of discretion could enhance further the credibility of the system, although it would also limit the downside risks of currency speculation.



POLICY OPTIONS (2)

Currency Board Account (HK\$ billion)

Assets		Liabilities	
Backing assets	364.6	Monetary Base*	335.0
		Certificates of Indebtedness	151.1
		Currency notes & coins	7.4
		Exchange Fund paper	123.9
		Aggregate Balance	52.2

As of 21 January 2004

* Not equal to the sum of breakdown here because of exclusion of items such as interest payable on Exchange Fund Notes.

13

- The Monetary Base increased notably from HK\$293 billion at the end of December 2003 to HK\$335 billion by the Lunar New Year. The increase was mainly due to an expansion in the Aggregate Balance (+24.0 billion), following the HKMA's sales of Hong Kong dollar to banks, and the issue of additional Certificates of Indebtedness (+16.9 billion) supporting the issue of additional banknotes ahead of the Lunar New Year.



NEGATIVE INTEREST RATES ?

Balance Sheet of Banking System (HK\$ billion)

Assets		Liabilities	
Aggregate Balance	28.3	HK dollar deposits	1,930.8
		Demand deposits	226.9
		Savings deposits	936.3
		Time deposits	767.6

As of 31 December 2003

* Based on an ad hoc survey in 2001, Hong Kong dollar time deposits of HK\$0.5 million and above accounted for about 80% of the total value of Hong Kong dollar time deposits.

14

- The HKMA is not currently contemplating introducing charges on large balances maintained by banks in their clearing accounts held with the HKMA, which would amount to the imposition of negative interest rates. However, if this were to materialise, there would seem to be no reason why banks should pass on any such charges to the small depositors: the customer deposit base of a bank is far greater than the clearing balance. There should be scope for banks to arrange matters in a way that would not affect ordinary depositors, for example, by passing the charges on only to very large depositors.



CURRENCY - RISKS & VULNERABILITIES

External factors

- **Global economic recovery**
- **Bottoming of interest rates**
- **External imbalances of the US**
- **Volatility in currency and equity markets**
- **Political pressure on RMB exchange rate**
- **Geopolitical issues**

15

- The first **Half-Yearly Monetary and Financial Stability Report** was published in the December 2003 issue of the HKMA Quarterly Bulletin (copies of which have been sent to Members of the Panel on Financial Affairs). The report provides detailed description and analysis of the main factors, both external and domestic, that have a bearing on Hong Kong's monetary and financial stability. The report presents the HKMA's view of the main forces acting upon the Hong Kong economy, paying particular attention to the implications for the monetary and financial system.
- **Global economic recovery:** The US recorded a significant acceleration in growth. In the euro area, growth in the major economies rebounded, and the recovery in Japan was also sustained in Q3 2003.
- **Bottoming of interest rates:** Fed funds target rate has declined to a historic low.
- **External imbalance of the US:** The US continued to record a sizeable current account deficit, at 5% of GDP in Q3 2003.
- **Volatility in currency and equity markets:** The US dollar weakened by 17% against the euro and 10% against the yen in 2003 on concerns about the external imbalances. Equities in major markets rallied in 2003.
- **Political pressure on the renminbi exchange rate:** There are persistent calls, particularly from the US, for a revaluation of the renminbi or more flexible management of its exchange rate.
- **Geopolitical issues:** continuing concern over situation in Iraq and increasing cross strait tension.



GLOBAL ECONOMIC OUTLOOK

	GDP growth forecasts		
	2003	2004	2005
	% yoy	% yoy	% yoy
Mainland China	8.9	8.3	7.6
US	3.1	4.6	3.6
Eurozone	0.5	1.8	2.1
Japan	2.3	2.1	1.6
Hong Kong	3.0*	5.1	4.5

Source: Consensus Forecasts (January-2004)

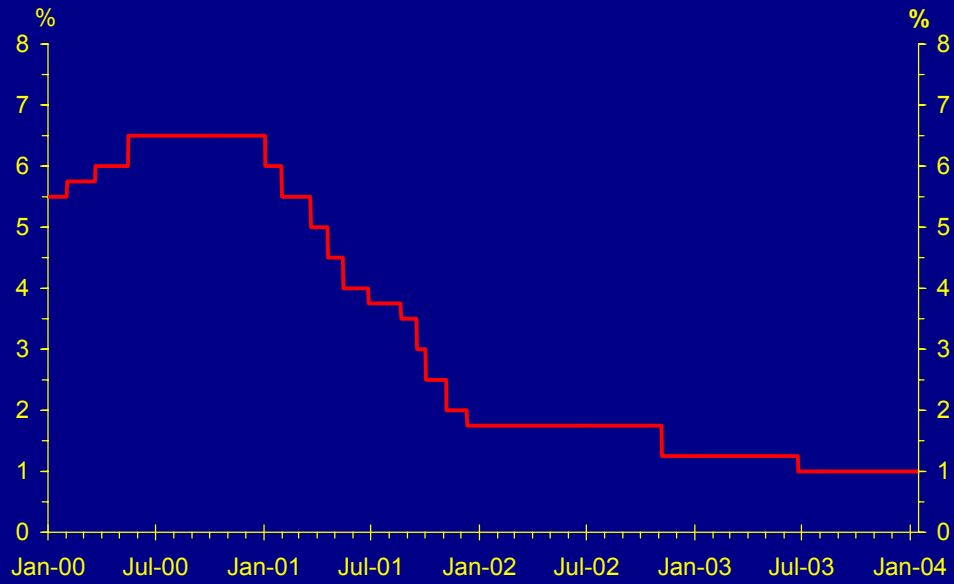
* Forecast by HKSAR Government in November 2003

16

- Consensus forecasts project an acceleration of economic growth in the US as well as the euro area. The pace of recovery in Japan is likely to remain moderate. Mainland China is expected to sustain robust growth.



US FED FUNDS TARGET RATE

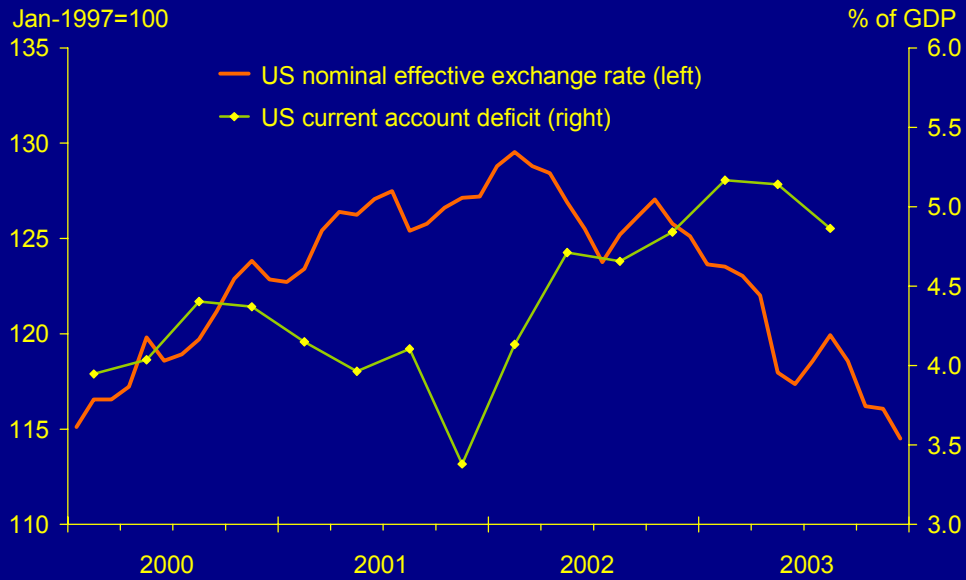


17

- The Fed funds target rate has declined to a historical low level of 1%.
- There are concerns that US interest rates are heading higher.



US CURRENT ACCOUNT DEFICIT

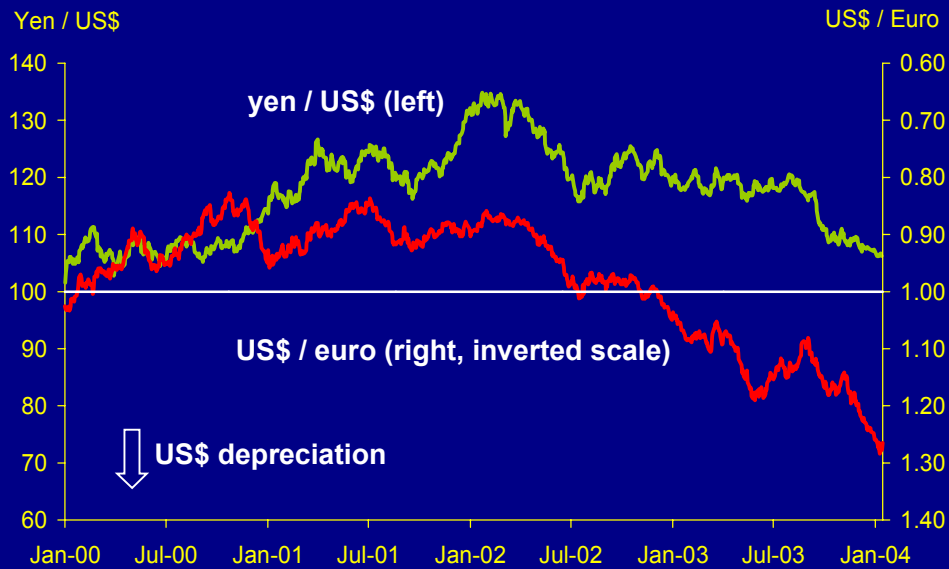


18

- The US dollar has weakened by about 13% from its peak in early 2002 in terms of its nominal effective exchange rate.
- Despite the depreciation, the current account deficit in the US remains high. This implies that the US dollar could depreciate further should the exchange rate adjustment play a significant role in the correction of the imbalance.



EXCHANGE RATE VOLATILITY



19

- The US dollar has weakened markedly against the yen and the euro since early 2002. The euro and the yen appreciated by about 43% and 24% respectively during this period.



EQUITY PRICES IN MAJOR MARKETS

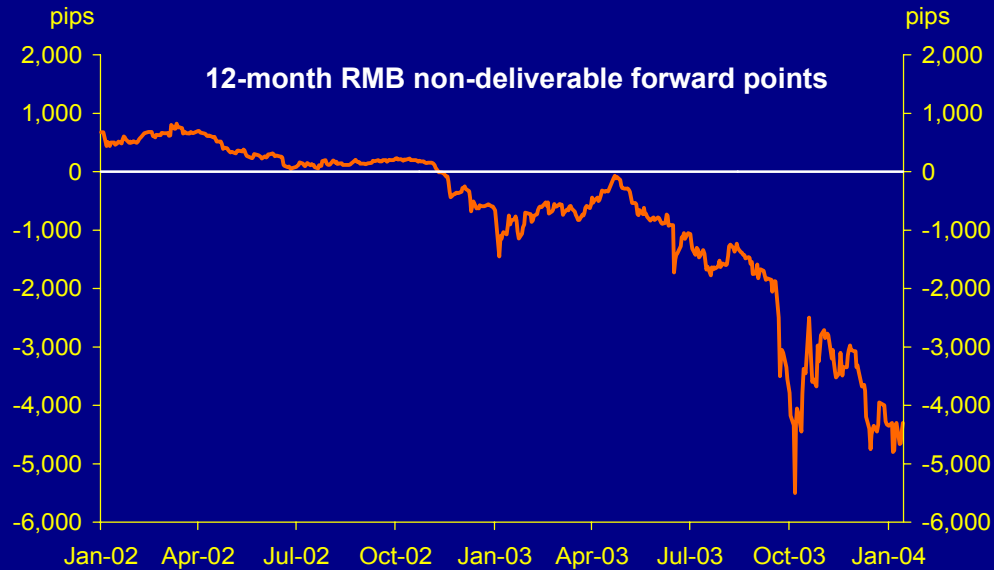


20

- Stock prices rose markedly since the second quarter of 2003, reflecting optimism about economic prospects and easy monetary conditions globally. A change in these conditions could lead to sharp adjustments that may undermine monetary and financial stability.



RENMINBI - MARKET EXPECTATIONS

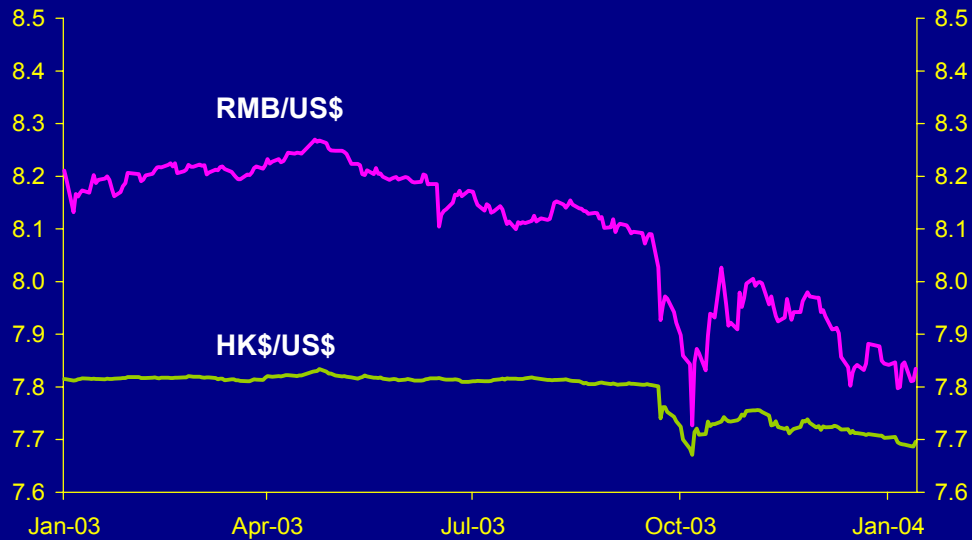


21

- The 12-month RMB non-deliverable forward points shifted to a discount in late 2002, reflecting the strong economic fundamentals and rapid accumulation of foreign reserves.
- The discount narrowed briefly upon the outbreak of SARS, but widened again as the concern receded.
- As international political pressure for a more flexible RMB exchange rate intensified, the discount increased markedly to 5,500 pips before returning to about 4,500 pips recently.



12-MONTH HONG KONG DOLLAR AND RENMINBI FORWARD EXCHANGE RATES



22

- The movements of RMB and Hong Kong dollar forward exchange rates diverged in 2002 and the first half of 2003, reflecting in part different conditions of the two economies.
- A positive correlation between the two has re-emerged since September 2003, as both were under appreciation pressure.
- HKMA has been attempting to de-couple the two trends, through rational explanation and reiteration of relevant policies.



CURRENCY - RISKS & VULNERABILITIES

Domestic factors

Supportive factors

- **Robust economic recovery**
- **Positive impact of policies facilitating economic integration with the Mainland**
- **Hong Kong's strong external position**

Concerns and uncertainties

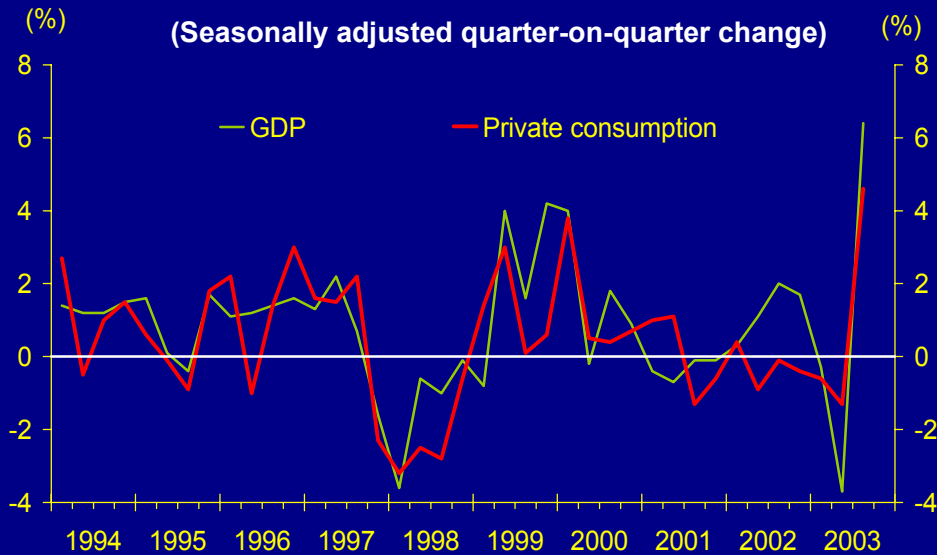
- **Public finance**
- **Unemployment**
- **Deflation**
- **Possible re-emergence of SARS**

23

- **Robust economic recovery:** The recently released numbers suggest a distinct rebound in economic growth in Q3 2003, with real GDP rising by 6.4% on a seasonally adjusted quarter-on-quarter basis. Unemployment rate has eased to 7.3% in the three months to December 2003, from a record high of 8.7% in the April-July 2003 period.
- **Policies facilitating economic integration with the Mainland** has provided impetus to the economic recovery, via a rebound in the tourism-related sectors and sustained growth in exports of goods and trade-related services.
- **The external position of Hong Kong**, as manifested in robust current account surpluses (over 10% of GDP in Q3 2003) and a large net international investment position (at more than two times of GDP), has supported the currency.
- **Public finances** are still a concern. Investors are likely to remain watchful of the fiscal position and the policy strategy adopted by the authorities to address the imbalance.
- **Unemployment rate** remains stubbornly high, although there has been significant improvement recently.
- **Deflation** depending on how it is measured, may still be a concern, although there has been improvement.
- **Possible re-emergence of SARS** is an issue of concern, even though its impact is likely to be lesser, as the government and the community are more prepared for any contingency.



STRONG ECONOMIC RECOVERY

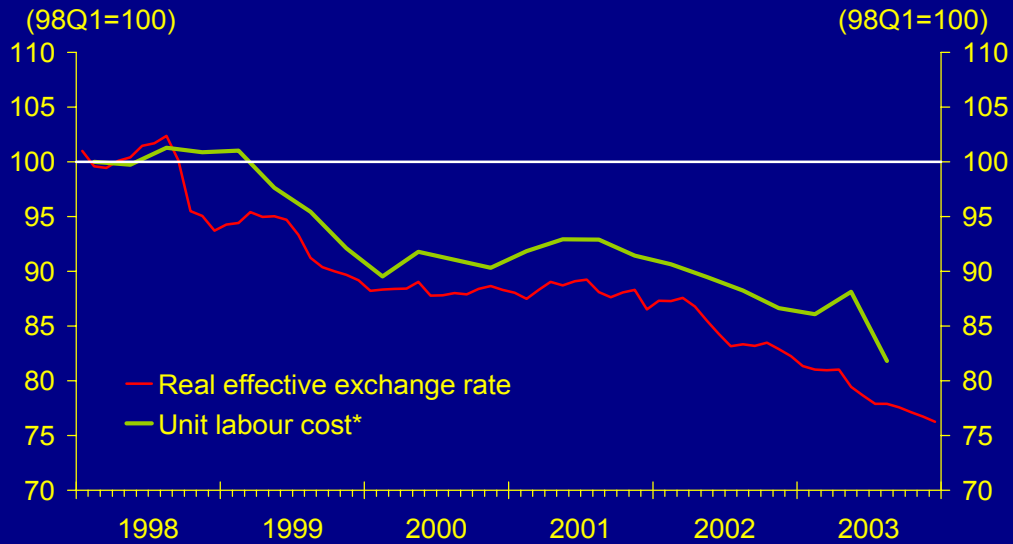


24

- After a severe disruption caused by the outbreak of SARS, economic conditions in Hong Kong improved distinctly in Q3 2003, with real GDP growing markedly by 6.4% on a seasonally-adjusted quarter-on-quarter basis.
- The strong growth reflected mainly a rebound in private domestic demand and tourism from a low base. The latter was given a major boost by the relaxation of travel restrictions on Mainland visitors, while improved consumer and business sentiments and a recovery in the property market supported local spending.
- Specifically, private consumer expenditure rose by 4.6% in Q3 2003 on a seasonally adjusted quarter-on-quarter basis, while exports of services rebounded sharply by 31%, after declining by 20% in Q2 2003.



COMPETITIVENESS



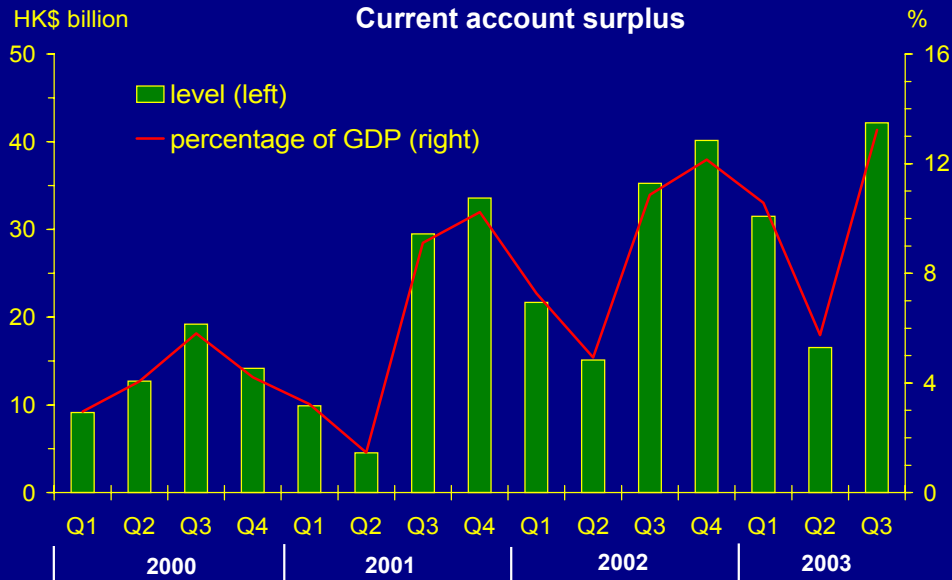
Note: * Constructed as the ratio of total wages of all employees to real GDP.

25

- Hong Kong's external competitiveness has improved significantly in recent years, as evidenced by:
 - The real effective exchange rate (REER) was 25% below its peak in August 1998, mainly due to domestic price deflation.
 - Unit labour cost—constructed as a ratio of total wages of all employees to real GDP—fell by almost 20% from Q3 1998.



BALANCE OF PAYMENTS ACCOUNT

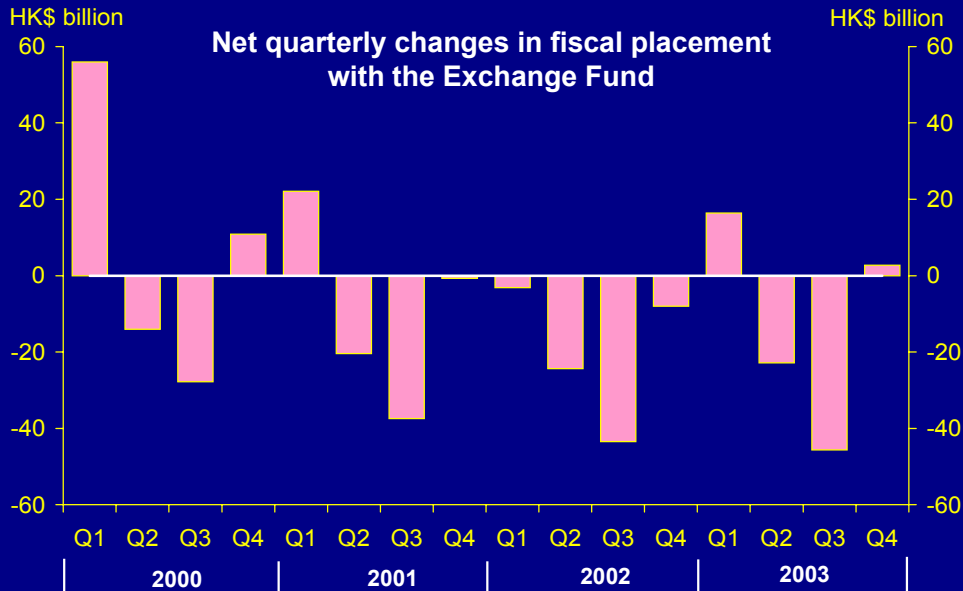


26

- Reflecting in part the improved competitiveness, external payment position has been strong.
- The current account surplus increased in Q3 2003 to 13.2% of GDP. This was brought about by a rebound in the tourism-related sectors and sustained growth in exports of goods and trade-related services.
- The strong current account surpluses are likely to continue to support the Hong Kong dollar, particularly if these earnings, most likely in foreign currency, are invested in domestic markets alongside the economic upturn.



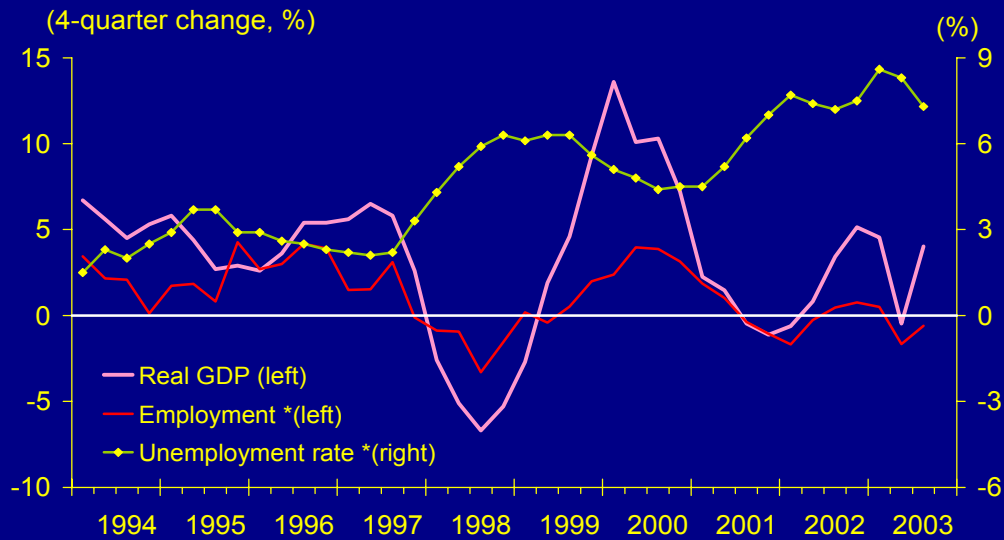
FISCAL DRAWDOWNS



- Fiscal drawdowns returned to a net placement in Q4 2003. The last time when there was a net placement in the fourth quarter was year 2000, when strong economic activities helped revenues.



LABOUR MARKET



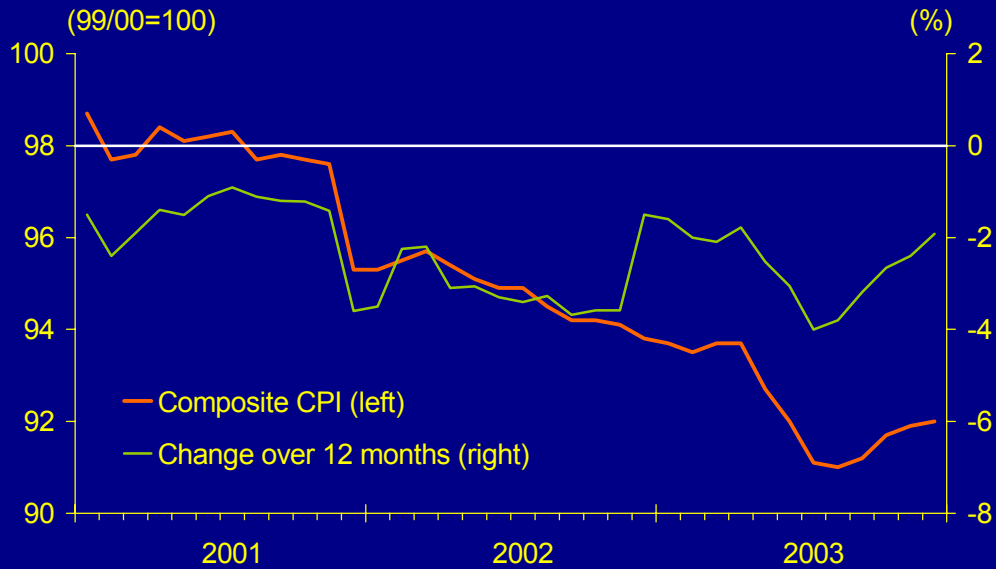
Note: * One-quarter lag.

28

- Along with the recovery in the economy, labour market conditions improved considerably in recent months. The unemployment rate declined to 7.3% in Q4 2003 from a record high of 8.7%.
- Looking ahead, a sustained recovery of the economy should help reduce the unemployment rate. Typically, changes in the unemployment rate lag behind output growth.



CONSUMER PRICE DEFLATION

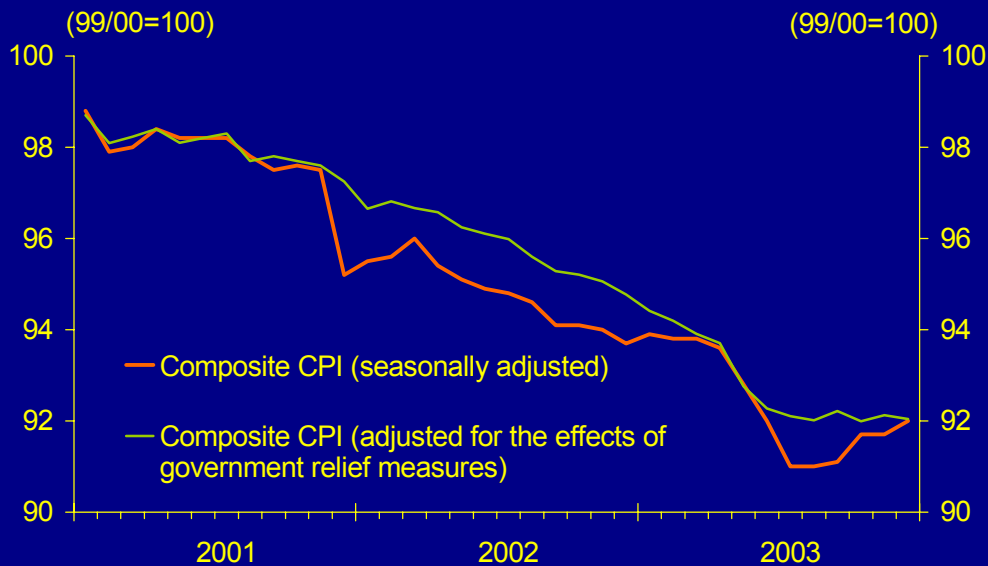


29

- Inflation rate in Hong Kong is typically measured by year-on-year percentage change in the Composite Consumer Price Index (CCPI). By this measure, deflation remained, with overall consumer prices falling by 1.9% in December 2003 from a year earlier, even though it has eased considerably since mid-2003.
- However, the “headline” inflation rate may fail to give the full picture of recent price developments. If we look at the movements of the index, the CCPI has increased by 1.1% from August to December 2003.



CONSUMER PRICE DEFLATION

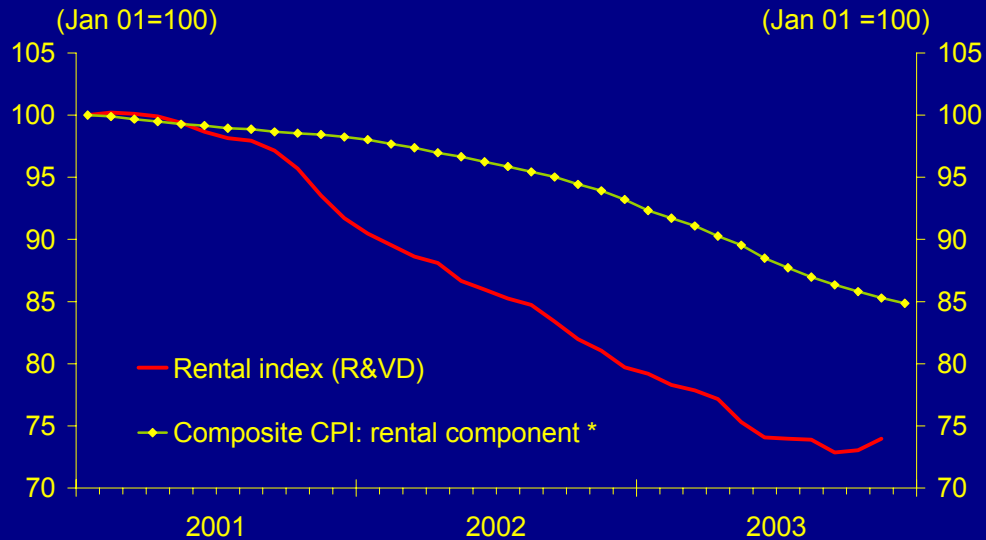


30

- To better assess underlying price developments, the CCPI may be adjusted for the effects of seasonal factors and government relief measures.
- Broadly speaking, the seasonally adjusted CCPI follows closely the headline index.
- Government relief measures, which include rates concession and waiver of water and sewage charges, play a considerable role in affecting overall price developments. These administrative measures will lower the overall price index during their effective periods. For example, the decline in the CCPI in July 2003 and its subsequent rise in October were attributable largely to the introduction and termination of rates concession respectively.
- After removing the effects of the relief measures, we find that consumer prices have stabilised since last summer.



CONSUMER PRICE DEFLATION



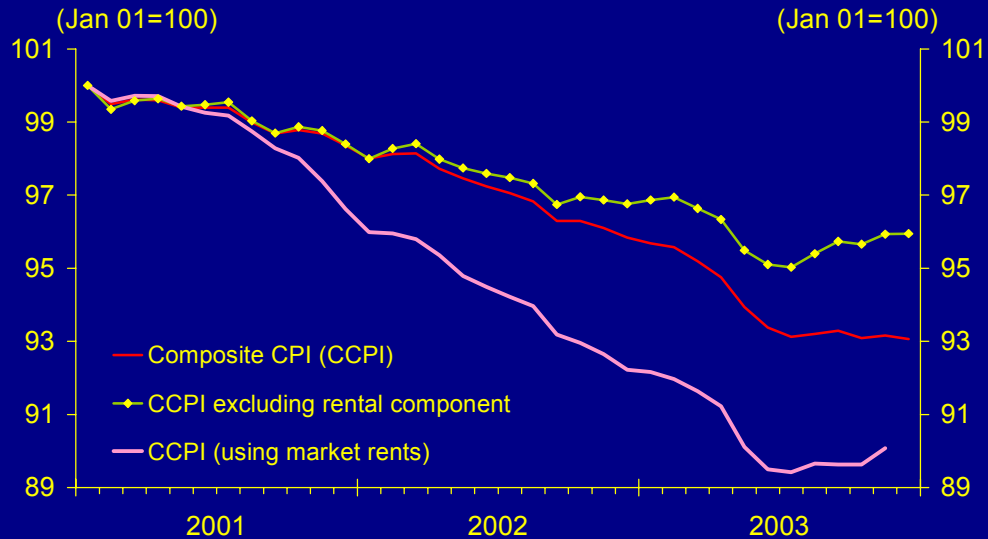
Note: * Adjusted for seasonal factors and the effects of rates concessions.

31

- Rental accounts for a significant weight (27%) in computing the consumer price index. Nevertheless, movements in the rental component of the CCPI tend to lag those in the market rental index, as rental contracts typically have a term of 1-2 years. (The rental component covers all kinds of leases including new, renewed and existing leases.)
- While the rental component of the CCPI continued to decline, the residential property rental index, a measure of market rents for fresh lettings published by the Rating and Valuation Department, rose modestly from September.



CONSUMER PRICE DEFLATION



Note: Adjusted for seasonal factors and the effects of government relief measures.

32

- After excluding the rental component, the CCPI increased by 1% from July to December.
- By replacing the rental component with the market rental index, the overall CCPI also shows an upward trend in the recent periods, rising by 0.7% during July-November.



BANKING STABILITY - REVIEW OF 2003

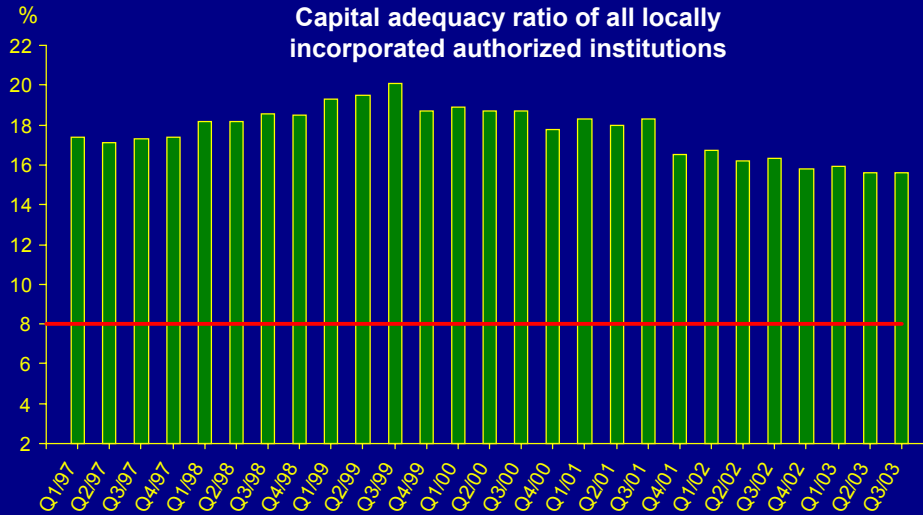
- **Economic downturn**
- **Worsening problem of negative home equity**
- **Sluggish loan growth**
- **Increased diversification of banks' business**
- **Increased popularity of electronic banking**

33

- Banking stability was largely maintained in 2003. This is despite the industry's having been through one of its toughest times in recent years: the economic downturn, exacerbated by SARS, led to a decline in asset quality and worsening negative home equity. The demand for loans remained sluggish. To increase revenue many banks expanded into new areas of business. This and the increased popularity of electronic banking posed new risks and challenges to the HKMA in supervision.



BANKING SECTOR PERFORMANCE



Period-end figures.

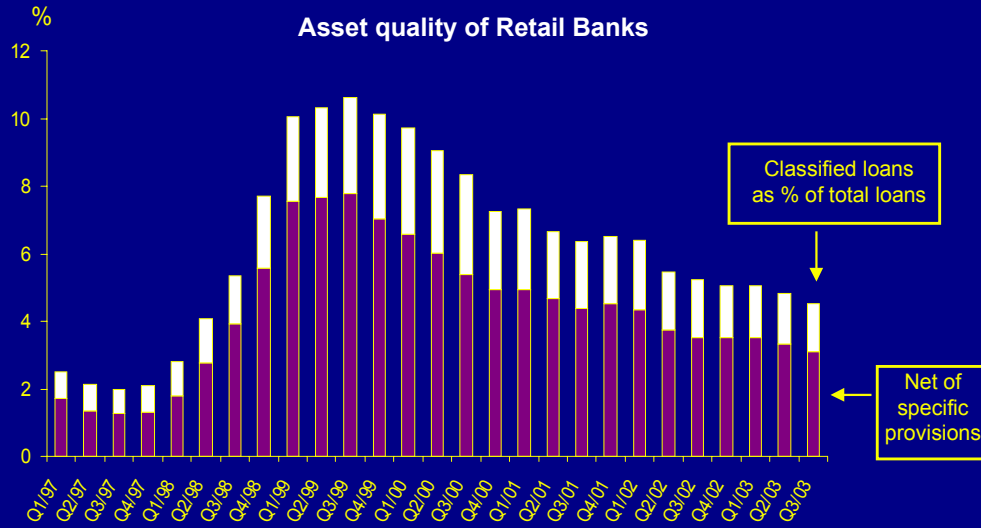
There is a break in series at end-December 2001 owing to a change in the reporting population.

34

- The average consolidated capital adequacy ratio of all locally incorporated authorized institutions remained stable at 15.6% at end-September, well above the minimum international standard of 8%.



BANKING SECTOR PERFORMANCE



Period-end figures.

35

- The overall asset quality of the Retail Banks improved in the third quarter on the back of loan write-offs and loan repayments. The classified loan ratio decreased to 4.53% at end-September from 4.83% at end-June.



BANKING SECTOR PERFORMANCE

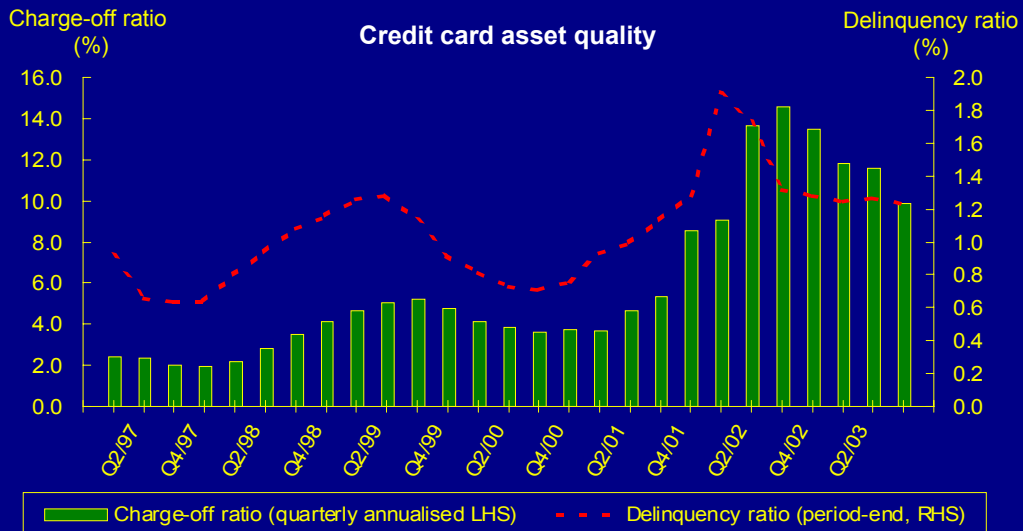


36

- The number of bankruptcy petitions fell to 1,291 in December, the lowest level since September 2001. For the fourth quarter as a whole, the number of bankruptcy petitions presented was 4,356, down further from 5,080 in the third quarter.



BANKING SECTOR PERFORMANCE



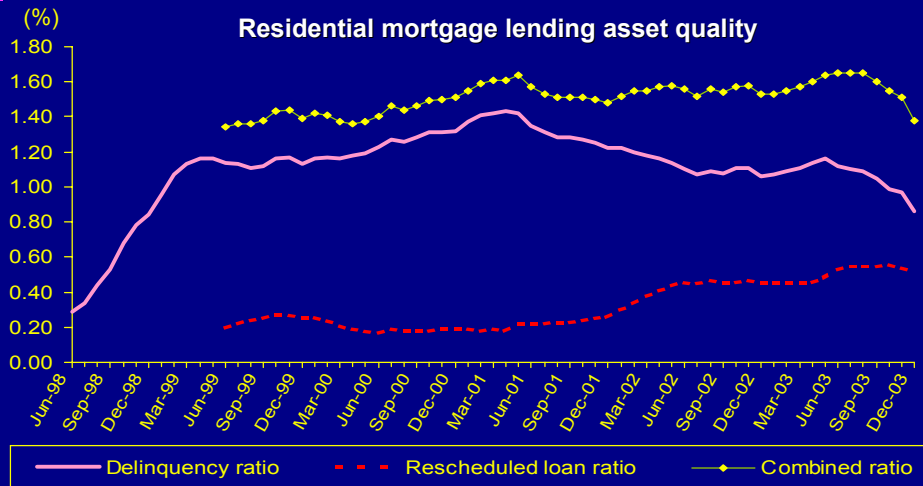
There is a break in series at Q4 2001 owing to an increase in the number of surveyed institutions.

37

- The annualised quarterly charge-off ratio fell for four consecutive quarters to 9.85% in the third quarter, down from 11.60% in the second quarter. The improvement in the charge-off situation can be explained by the continued debt rescheduling arrangements and the improvements in the employment and bankruptcy situations.
- The delinquency ratio also fell to 1.23% from 1.27%.



BANKING SECTOR PERFORMANCE



Period-end figures.

There is a break in series at December 2000 owing to an increase in the number of surveyed institutions.

Combined ratio is the sum of delinquency ratio and the rescheduled loan ratio.

38

- Helped by the improved repayment ability of homeowners along with the recovery of the domestic economy, the quality of the mortgage portfolio improved further. Both the mortgage delinquency ratio and the rescheduled loan ratio declined to 0.86% and 0.52% in December from 0.97% and 0.54% in November respectively. As a result, the combined ratio improved to 1.38% from 1.51%.



BANKING SECTOR PERFORMANCE

Residential mortgage lending in negative equity



Period-end figures.

* Preliminary figures.

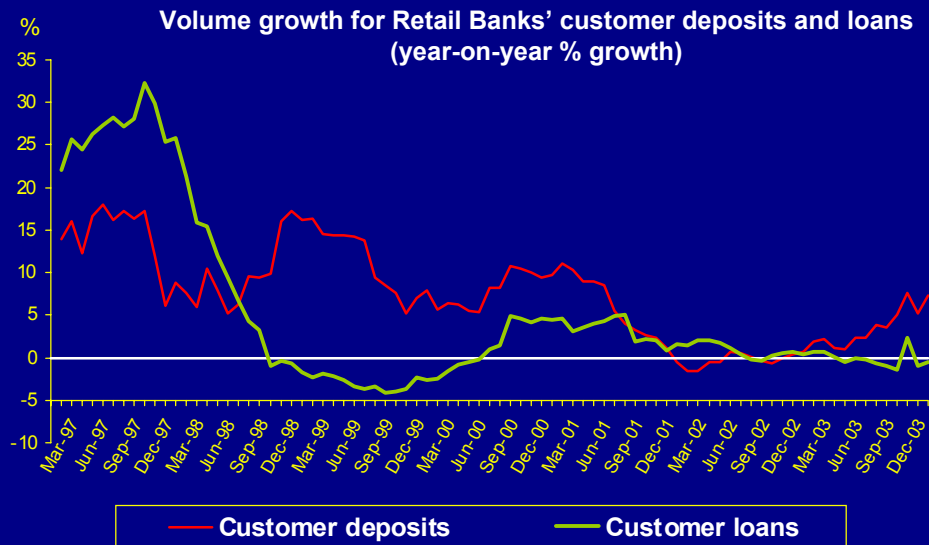
Separate data on secured and unsecured loan value as at end-Sep 2001 are not available.

39

- Reflecting a pick up in property market sentiment and property prices following the upturn in the domestic economy, banks' residential mortgage loans in negative equity declined by around 32,200 over the three-month period to around 67,600 with a value of HK\$107 billion at end-December, according to preliminary figures. The unsecured portion of these loans is estimated at about HK\$23 billion, down from HK\$33 billion at end-September, indicating a decrease in risk exposure of the banking sector.
- Total outstanding value (HK\$107 billion) is the lowest since record begun in September 2001.



BANKING SECTOR PERFORMANCE



40

- Retail Banks' customer deposits rose by 7.4% in 2003, compared with 0.7% in 2002. While Hong Kong dollar deposits rose by 7.4% after falling by 1.5% in 2002, foreign currency deposits rose 7.3% following a 4.2% increase in 2002. The proportion of Hong Kong dollar deposits to total deposits was 61.0% at end-2003, the same as at end-2002.
- Retail Banks' customer loans fell by 0.6% in 2003, compared with an increase of 0.3% in 2002.



BANKING SECTOR PERFORMANCE



41

- The fundamentals affecting banking sector performance have been steadily improving: stabilisation in the property market, improved labour market and lower bankruptcies, increased activity in the equity market leading to higher non-interest income arising from brokerage, share registry and wealth management services, improved domestic economic conditions and the receding effects of SARS. However, overall net interest margin of Retail Banks declined, mainly as a result of the continuing pressure on residential mortgage margins and lower yield on free funds. Accordingly, the annualised net interest margin fell to 1.94% in the first nine months of 2003 from 2.11% a year ago.



WORK PROGRESS

- **Deposit protection scheme**
 - under the scrutiny of a Bills Committee
- **Positive data sharing**
 - banks have launched more products with interest rates based on individual customers' creditworthiness
- **Commercial credit reference agency**
 - finalising operational details for implementation in second half of 2004

42

Deposit protection scheme

- The Deposit Protection Scheme Bill was introduced into the Legislative Council on 30 April, and is currently under the scrutiny of a Bills Committee.

Positive data sharing

- There are indications that the benefits of positive data sharing are being realised: many banks have launched new products with interest rates based on individual customers' creditworthiness. This will benefit borrowers with good credit standing and promote a positive credit culture in the society.

Commercial credit reference agency

- Banks have begun seeking their SME customers' consent for data sharing. The Industry Working Party is working with the service provider to finalise the operational details of the scheme, which is expected to be up and running in the second half of 2004.



WORK PROGRESS

- **New Capital Accord**
 - preparing for implementation by end-2006
- **Fraudulent bank websites**
 - stepping up surveillance and issue of circular and press statements to alert banks and the public
- **ATM frauds**
 - monitoring banks' progress in upgrading the security safeguards of ATMs

43

New Capital Accord

- Preparatory work is underway for implementing the New Accord by end-2006. This includes developing new banking returns and guidelines, resolving policy issues and considering the legislative approach, which will involve translating lengthy and complicated rules and technical requirements under the New Accord into legislation. The HKMA plans to conduct a briefing to the Panel on Financial Affairs on the New Accord in the next few months.

Fraudulent bank websites

- The number of fraudulent bank websites claiming to have offices and offer various banking services in Hong Kong and overseas has recently risen. In response, the HKMA has issued a circular to banks on fraud cases involving fake emails and websites, and press statements to alert the public to suspicious bank websites. Separately, the HKMA has been receiving assistance from the relevant local and overseas authorities in suspending fraudulent websites.

ATM frauds

- Banks have been stepping up precautions to guard against ATM frauds in line with the measures recommended in the HKMA circular of 14 October 2003. The precautionary measures include upgrading the security safeguards of ATMs, installation of closed-circuit televisions, more frequent and regular patrol of ATMs, and enhanced customer education on the importance of protecting their cards and PINs. The HKMA circular also requires banks to put in place a mechanism whereby transactions conducted through counterfeit cards can be identified quickly. The HKMA will continue to assess the adequacy of individual banks' measures and to ensure that customer complaints are being dealt with fairly and fully.



FINANCIAL INFRASTRUCTURE FOR DOMESTIC FINANCIAL ACTIVITIES

- **Clearing and Settlement Systems Bill**
 - **Bills Committee is being formed**
- **New banknotes**
 - **new HK\$20, HK\$50 and HK\$1000 banknotes to go into circulation in second half of 2004**

44

Clearing and Settlement Systems Bill

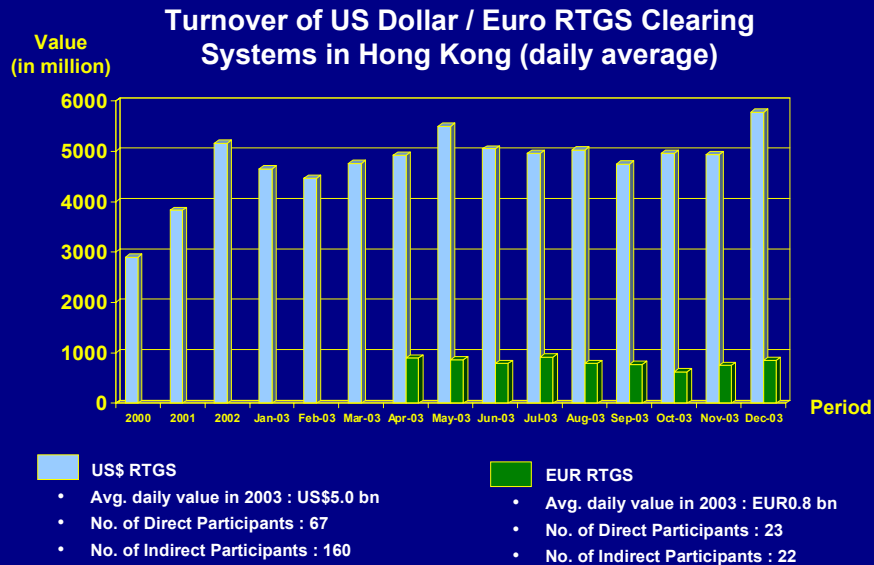
- The Bill was introduced into the Legislative Council on 10 December. A Bills Committee is being formed to examine the Bill.

New banknotes

- The new HK\$500 and HK\$100 banknotes, which carry additional security features, went into circulation on 15 December. The remaining denominations will go into circulation in the second half of 2004.



FINANCIAL INFRASTRUCTURE FOR INTERNATIONAL FINANCIAL ACTIVITIES



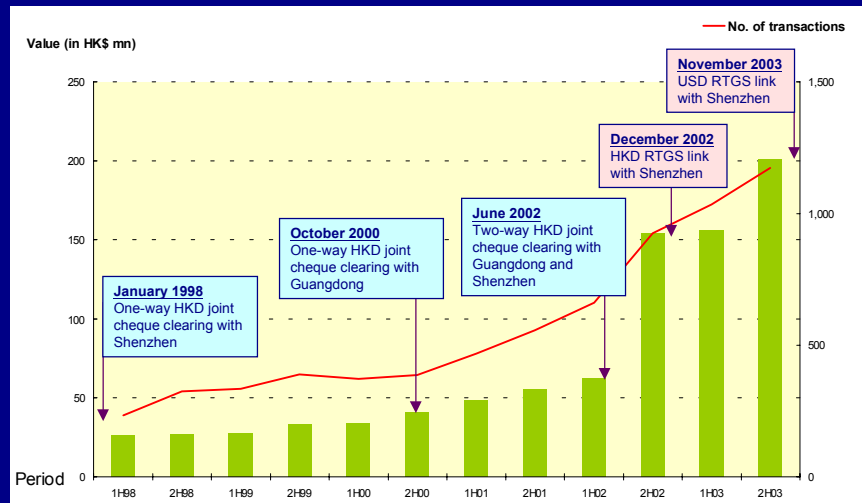
45

- In 2003, the US dollar and euro RTGS clearing systems handled on average US\$5.0 billion and 0.8 billion euro daily respectively.



FINANCIAL INFRASTRUCTURE FOR CROSS BORDER FINANCIAL ACTIVITIES

Turnover of Cross-border Payment Linkages between Hong Kong and the Mainland (daily average)



46

- In 2003, there were over 250,000 cheques amounting to HK\$22 billion processed through the two-way HK dollar joint cheque clearing facility between Hong Kong and Guangdong (including Shenzhen). On average, there were 1,085 cheques processed daily valuing approximately HK\$96 million.
- The Hong Kong dollar RTGS link between Hong Kong and Shenzhen was launched in December 2002. An average daily turnover of HK\$77 million was recorded in 2003. A similar US dollar RTGS link between Hong Kong and Shenzhen was also implemented in November 2003. It recorded a daily average turnover of US\$1 million since its inception.
- The Hong Kong dollar and US dollar RTGS links between Hong Kong and Guangdong are being developed and are targeted to be implemented in 2004.



HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

- **RMB business in Hong Kong**
 - RMB debit and credit cards issued by Mainland banks used in Hong Kong since 18 January 2004
 - preparation of other types of RMB business on schedule and expected to be launched in phases
- **Asian Bond Fund**
 - local currency denominated ABF being studied
- **Hong Kong's credit rating**
 - continuing discussions with rating agencies

47

RMB business in Hong Kong

- The People's Bank of China announced on 16 January that it had approved the use in Hong Kong of RMB debit and credit cards issued by Mainland banks. Starting on 18 January 2004, holders of credit / debit cards with the China UnionPay logo could use their cards to settle payments in Hong Kong at shops that accept China UnionPay cards. Cardholders can also withdraw Hong Kong dollar cash up to the equivalent of RMB5,000 a day from all JETCO ATM machines in Hong Kong.
- Preparation of RMB deposit-taking, currency exchange and remittances is on schedule and expected to be launched before the end of February 2004. The launch of RMB credit cards by banks in Hong Kong may take place later in March or April.

Asian Bond Fund

- The EMEAP Working Group is now studying the second phase of the Asian Bond Fund, with the intention of extending the ABF concept to include bonds denominated in local currencies in the region.

Hong Kong's credit rating

- In October 2003 Moody's upgraded Hong Kong's sovereign rating for long-term foreign currency by two notches to A1, with a stable outlook. The HKMA and other parts of the Government are continuing to work with the rating agencies to ensure that their ratings fully reflect Hong Kong's economic and credit strengths.



EXCHANGE FUND - MARKETS IN 2003

- **Volatile markets: weak H1 but strong H2**
- **Fluctuating bond yields**
- **Strong equity markets**
- **Exchange gains from the euro**

48

- The investment environment in 2003 was particularly volatile and challenging. The strong recovery in the performance of the Exchange Fund in the second half of the year contrasted markedly with a difficult first half, in which world financial markets were clouded with uncertainties about the war in Iraq and the performance of the major economies. Income from bonds, though positive, was lower than in previous years, but this was more than offset by gains in equity holdings. The further sharp appreciation of the euro also contributed to the Exchange Fund's investment performance.



EXCHANGE FUND PERFORMANCE

(HK\$ billion)	2003	2002	2001
Gain / (Loss) on Hong Kong equities*	21.2	(11.8)	(27.1)
Gain / (Loss) on other equities*	26.8	(22.7)	(3.3)
Exchange gain / (loss)	22.9	27.2	(13.0)
Total return from bonds, etc	<u>18.7</u>	<u>54.3</u>	<u>50.8</u>
Investment income	89.6	47.0	7.4

* including dividends

49

- The Exchange Fund recorded an investment income of HK\$89.6 billion in 2003. The main components of this income were:
 - total return from bonds and other investments of HK\$18.7 billion
 - valuation gain on and dividends from the Hong Kong equities portfolio amounting to HK\$21.2 billion
 - valuation gain on and dividends from other equities amounting to HK\$26.8 billion
 - an exchange valuation gain of HK\$22.9 billion, mainly as a result of the appreciation of the euro against the US dollar.



EXCHANGE FUND CHANGE IN ACCUMULATED SURPLUS

(HK\$ billion)	← 2003 →					2002
	Full year	Q1	Q2	Q3	Q4	Full year
Investment income	89.6	6.7	41.1	8.4	33.4	47.0
Other income	0.2	0.0	0.1	0.0	0.1	0.2
Interest and expenses	<u>(6.4)</u>	<u>(1.4)</u>	<u>(1.5)</u>	<u>(1.3)</u>	<u>(2.2)</u>	<u>(7.0)</u>
Net investment income	83.4	5.3	39.7	7.1	31.3	40.2
Treasury's share	<u>(25.7)</u>	<u>(2.1)</u>	<u>(13.0)</u>	<u>(2.0)</u>	<u>(8.6)</u>	<u>(15.6)</u>
Increase in EF Accumulated Surplus	57.7	3.2	26.7	5.1	22.7	24.6

50

- After deducting interest and other expenses, net investment income in 2003 was HK\$83.4 billion. Of this, the Fiscal Reserves' share amounted to HK\$25.7 billion, which is more than double the amount budgeted for (HK\$12.1 billion) in the financial year 2003-04. The balance of HK\$57.7 billion has been added to the Exchange Fund's Accumulated Surplus for 2003.



EXCHANGE FUND HISTORICAL CHANGE IN ACCUMULATED SURPLUS

(HK\$ billion)	2003*	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993
Investment income	89.6	47.0	7.4	45.1	103.8	93.8	35.6	25.4	46.7	8.9	19.2
Other income	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.2	4.5
Interest and expenses	(6.4)	(7.0)	(10.5)	(11.0)	(10.0)	(16.0)	(18.4)	(12.9)	(12.6)	(8.2)	(5.4)
Net investment income/(loss)	83.4	40.2	(2.9)	34.3	94.0	78.0	17.4	12.7	34.4	0.9	18.3
Treasury's share	(25.7)	(15.6)	(1.6)	(18.1)	(45.4)	(26.0)	0.0	0.0	0.0	0.0	0.0
Increase/(Decrease) in EF Accumulated Surplus	57.7	24.6	(4.5)	16.2	48.6	52.0	17.4	12.7	34.4	0.9	18.3

* unaudited figures for 2003

51

- In terms of the actual amount, the investment income of HK\$89.6 billion is the third highest return in the history of the Exchange Fund, though it is behind 1998 and 1999, when investment income was boosted by book profits from the stock market intervention.
- After deducting interest and other expenses, the profits made for the Exchange Fund in 2003 amounted to HK\$83.4 billion. This is the second highest on record, next only to 1999, but surpassing 1998, because interest rates, and therefore interest expenses, were much lower in 2003 than in 1998.



EXCHANGE FUND ABRIDGED BALANCE SHEET

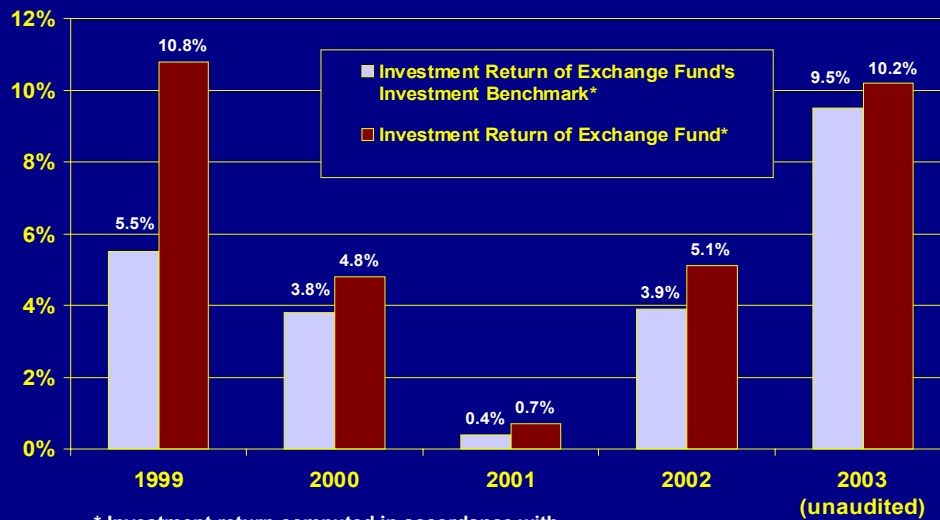
(HK\$ billion)	2003	2002	Change
ASSETS			
Deposits	60.1	51.5	8.6
Debt securities	760.8	764.8	(4.0)
Hong Kong equities	71.2	50.9	20.3
Other equities	99.4	63.1	36.3
Other assets	<u>19.7</u>	<u>24.8</u>	<u>(5.1)</u>
Total assets	1,011.2	955.1	56.1
LIABILITIES AND ACCUMULATED SURPLUS			
Certificates of Indebtedness	134.2	118.5	15.7
Government-issued currency notes & coins in circulation	6.3	5.9	0.4
Balance of the banking system	28.3	0.5	27.8
Exchange Fund Bills and Notes	123.5	122.9	0.6
Placements by other HKSAR government funds	252.3	301.7	(49.4)
Other liabilities	<u>81.7</u>	<u>78.4</u>	<u>3.3</u>
Total liabilities	626.3	627.9	(1.6)
Accumulated Surplus	<u>384.9</u>	<u>327.2</u>	<u>57.7</u>
Total liabilities and Accumulated Surplus	1,011.2	955.1	56.1

52

- The Abridged Balance Sheet shows that in 2003 the total assets of the Exchange Fund increased by HK\$56.1 billion, from HK\$955.1 billion at the end of December 2002 to HK\$1,011.2 billion at the end of December 2003.



EXCHANGE FUND PERFORMANCE AGAINST INVESTMENT BENCHMARK



* Investment return computed in accordance with
AIMR Global Investment Performance Standards

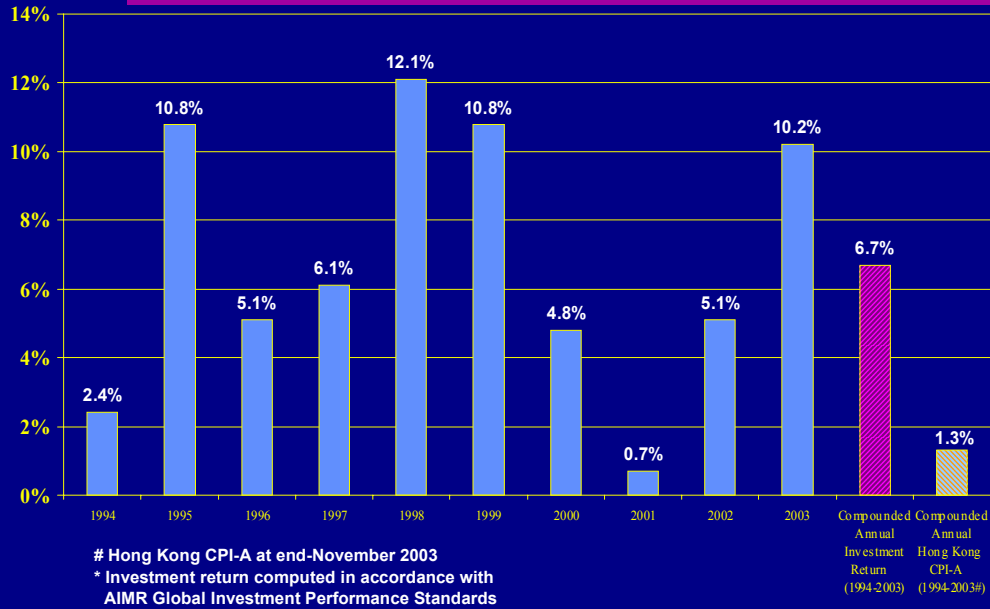
53

- In 2003 the Exchange Fund achieved an investment return of 10.2%, which is 70 basis points above the investment return of the benchmark portfolio determined by the Financial Secretary after consultation with the Exchange Fund Advisory Committee. Since 1999 the Exchange Fund has achieved a compounded 6.3% annual return, or an annual out-performance of 170 basis points above the benchmark's compounded 4.6% annual return for the same period.

Note: The reported investment return of 10.2% is computed in US dollar terms in accordance with AIMR Global Investment Performance Standards. The difference between investment return as reported and simple return is attributable primarily to the difference between gross assets at year-end and average investible assets for the year and the translation differential arising from the strengthening of the Hong Kong dollar against the US dollar.



INVESTMENT RETURN* OF THE EXCHANGE FUND



54

- Since 1994 the Exchange Fund has generated a compounded annual return of 6.7%, compared with the compounded annual inflation rate of 1.3% over the same period.



OUTLOOK FOR 2004

- **Uncertain and difficult environment:**
 - **where are interest rates heading?**
 - **where is the exchange value of US dollar heading?**
 - **where are equity markets heading?**

55

- The investment environment in 2004 is unlikely to be conducive to the kind of gains seen by the Exchange Fund in 2003. Returns on bonds will most likely continue to be limited, the prospects for equities are uncertain, and currency markets will probably continue to be volatile.



HONG KONG MONETARY AUTHORITY

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

2 February 2004

56