



HONG KONG MONETARY AUTHORITY

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

3 May 2004



DISCUSSION TOPICS

- **HKMA Annual Report 2003**
- **Updates on:**
 - **Currency**
 - **Banking**
 - **Financial Infrastructure**
 - **Hong Kong as an International Financial Centre**
 - **Exchange Fund**

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- The first part of the presentation will highlight the key messages from the HKMA Annual Report 2003, copies of which were sent to Members on 26 April.
- This will be followed by an update on the work of the HKMA in its key policy areas.



- **Monetary stability**
 - **monetary stability maintained despite:**
 - **volatility in world currency markets**
 - **weakness in domestic economy and public finances**
 - **Hong Kong hard hit by SARS outbreak**
 - **sudden shift of sentiment in second half 2003**

- Despite an eventful and turbulent year, and considerable volatility in the world's main currencies, the Hong Kong Dollar continued to be stable under the Linked Exchange Rate System.
- Concerns about downward pressure on the Link during the SARS outbreak gave way to concerns about the strengthening of the Hong Kong Dollar towards the end of the year. The shift in sentiment reflected speculation on renminbi appreciation, the recovery in growth as well as confidence about economic prospects, helped by a series of measures to facilitate economic integration with the Mainland.

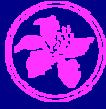


- **Banking stability**

- **banking stability maintained during a period of economic difficulty**
- **significant progress made in the establishment of the Deposit Protection Scheme**
- **smooth implementation of sharing of positive consumer credit data and commercial credit data**
- **secured a lower entry barrier under CEPA for Hong Kong banks in the Mainland market**

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- Not only did the banking system withstand the stresses of SARS, the sector as a whole managed to show an increase in profits for the year as a whole. The HKMA continued to work with the Legislative Council on the bill for establishing a Deposit Protection Scheme, and with the banking industry on establishing a Commercial Credit Reference Agency. Since August 2003, banks have been able to share positive consumer credit data, which helps nurture a healthier credit environment. The HKMA also played a key role in securing a lower barrier for access by Hong Kong banks into the Mainland market under CEPA - the asset size requirement was reduced substantially from US\$20 billion to US\$6 billion. This will provide more business opportunities for banks in Hong Kong.



- **Market infrastructure**

- **successful launch of the Euro Clearing System**
- **introduced a new legislation for strengthening the oversight of important clearing and settlement systems and providing settlement finality**
- **smooth launch and issue of the 1st phase of the New Series banknotes with additional security features**

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- In April 2003, we took a further step to enhance our financial infrastructure by launching a Euro Clearing System.
- To provide a sound legal basis to ensure the stability and integrity of our payment systems, we introduced a bill in December 2003 for strengthening the oversight of important clearing and settlement systems and for providing finality of settlement of transactions effected through such systems.
- In December 2003, the note issuing banks launched new \$100 and \$500 banknotes. These are the first of a new series of Hong Kong banknotes, with fresh designs and improved security features.



- **Hong Kong as an International Financial Centre**
 - approval for personal renminbi business in Hong Kong
 - successful launch of the USD Asian Bond Fund under the EMEAP Forum led by HKMA
 - launch of a pro-active strategy for tackling international credit rating agencies leading to a two-notch upgrade to A1 by Moody's

- Further progress was made in consolidating Hong Kong's status as an international financial centre, including the facilitation of personal renminbi business in Hong Kong and the successful launch of the USD Asian Bond Fund under the EMEAP Forum led by HKMA. The HKMA also launched a more pro-active strategy for engaging the credit rating agencies, which led to Moody's upgrade of Hong Kong's credit rating by two notches to A1.



- **Exchange Fund**
 - **achieved investment return of HK\$89.6 billion or 10.2%, which was 70 basis points above benchmark**

- Benefiting from a strong recovery in the investment environment in the second half of the year, the Exchange Fund recorded an investment return of HK\$89.6 billion, or 10.2%, for the year.



HKMA ANNUAL REPORT 2003 OPERATING EXPENSES IN 2003

	2003 (\$mn)	2002 (\$mn)
Exchange Fund Operating Expenses (prepared for Exchange Fund Accounts in the Annual Report in accordance with the Statements of Standard Accounting Practice)	1,179	1,162
Of which:		
HKMA Operating Expenses (2003 vs 2002: -6%)	614	654

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- In the Exchange Fund Annual Accounts, the operating expenses of the Exchange Fund are shown as \$1,179 mn (page 103 of the 2003 HKMA Annual Report). This figure is computed in accordance with requirements under the Statements of Standard Accounting Practice of the Hong Kong Society of Accountants. It covers not only the operating expenses of the HKMA (which includes staff and premises costs, and general operating costs), but also market expenses and non-cash accounting items such as depreciation. Market expenses cover costs related to the investment process of the Exchange Fund, including trading and custodian costs and fees for the external managers.
- For the purpose of budgeting and reporting to the Exchange Fund Advisory Committee, items such as market expenses and depreciation are separated from the HKMA operating expenses. In 2003, the HKMA operating expenses amounted to \$614 mn, representing a reduction of 6% over 2002.



HKMA ANNUAL REPORT 2003 OPERATING EXPENSES IN 2003

	<u>2003</u> (\$mn)	<u>2002</u> (\$mn)	<u>2001</u> (\$mn)	<u>2003</u> vs <u>2002</u>
HKMA Operating Expenses				
Staff Costs	462	478	480	-3%
Premises Costs	72	84	108	-15%
General Operating Costs	<u>80</u>	<u>92</u>	<u>109</u>	<u>-13%</u>
Total	614	654	697	-6%
HKMA Capital Expenses	<u>3</u>	<u>10</u>	<u>29</u>	<u>-70%</u>
HKMA Total Expenses	617	664	726	-7%
	===	===	===	====

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- In response to the request for further information on the HKMA administrative expenditure, and following the endorsement of the Exchange Fund Advisory Committee, the breakdown of the HKMA total expenses (including both operating and capital expenses) into the major block items for the past three years is shown above. A further breakdown of the expenses and details of the establishment of the HKMA by department is annexed to this slide.
- The HKMA has made considerable efforts to achieve efficiencies in all areas of expenses through process improvement or reprioritisation of work. As a result, there have been significant savings in the past two years on all four categories of costs.
- In 2003, the HKMA total expenses are \$617 mn, representing a reduction of 7% compared with 2002, or 15% compared with 2001.

(NB: staff costs in this table do not include leave accruals, which is a non-cash item required for accounting purposes under SSAP 34 from 2002. The 2002 figure is therefore different from that in the accounts for 2002.)



UPDATES

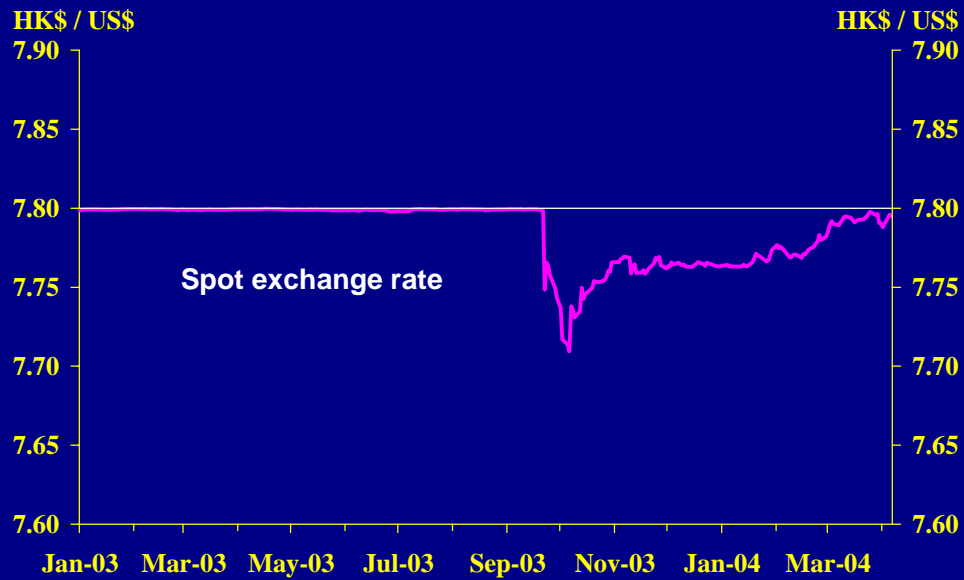
- **Currency**
- **Banking**
- **Financial Infrastructure**
- **Hong Kong as an International Financial Centre**
- **Exchange Fund**

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- The second part of the presentation will provide updates on the HKMA's work in these five major policy areas.



CURRENCY STABILITY (1)

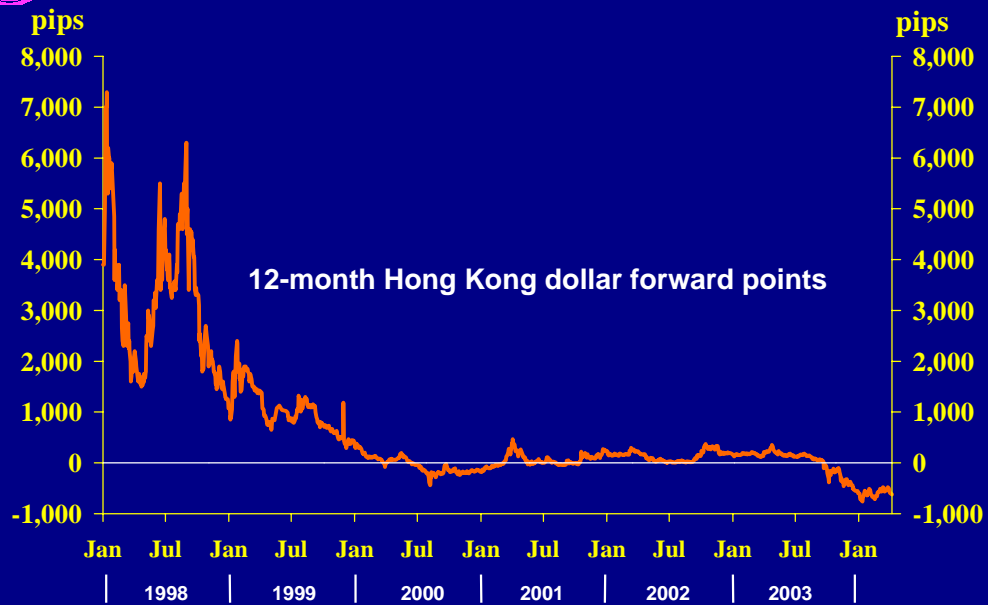


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- The Hong Kong Dollar strengthened markedly in the third quarter of 2003. This episode of strengthening has been gradually playing itself out through the normal operation of the Currency Board System.



CURRENCY - MARKET EXPECTATIONS (1)



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- 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)



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- 12-month forward points widened to a discount of 765 pips on 13 January 2004, but gradually narrowed thereafter to around 550 pips recently as a result of the recent strengthening of the USD on the back of the release of a series of strong economic data.



MONETARY CONDITIONS

- **Currency Board arrangements working effectively**
- **Concerns about conditions in the inter-bank market: large Aggregate Balance and low interest rates**
- **Option of issuing Exchange Fund paper to mop up liquidity: Currency Board Sub-Committee advises there is no need in present circumstances to issue additional paper.**

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- The market exchange rate for the Hong Kong Dollar is now very near to 7.80, but the Aggregate Balance in the clearing accounts of licensed banks has grown to over HK\$54 billion. Correspondingly, interest rates in the inter-bank market, particularly those for short-term money, have fallen to near zero. Concerns have consequently been expressed about the conditions in the inter-bank market, which was obviously making it difficult for banks with Hong Kong dollar liquidity to earn a return. These concerns have also taken the form of suggestions for us to issue additional Exchange Fund paper to tighten conditions in the inter-bank market. We have considered the suggestion and concluded that there was no need in present circumstances to do so. The record of the discussion of this matter at a recent meeting of the Currency Board Sub-Committee has just been published.



MONETARY CONDITIONS (CON'T)

- **Wait for interest rate arbitrage to generate the outflow necessary for the Aggregate Balance to be reduced to a normal level**
- **The process may take some time given the large current account surplus**
- **Easy monetary conditions helpful to sustaining the economic recovery**
- **No signs of inflationary pressures**

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- Thus we continue to wait for the interest rate differential against the holding of Hong Kong dollars to generate, in the fullness of time, the outflow necessary for the Aggregate Balance to be reduced back to a more normal level. This may take a little more time, given the significant current account balance of payments surplus that Hong Kong is running and the continuing international focus on renminbi exchange rate policy. Easy monetary conditions are for the time being also helpful to sustaining the economic recovery in Hong Kong, which is now supported by favourable global economic conditions, and there are no signs of any inflationary pressures developing. Indeed, with the problems of negative equity and bankruptcies rapidly dissipating, financial conditions now present much less risk than before to monetary and banking stability in Hong Kong.



CURRENCY - RISKS & VULNERABILITIES

External factors

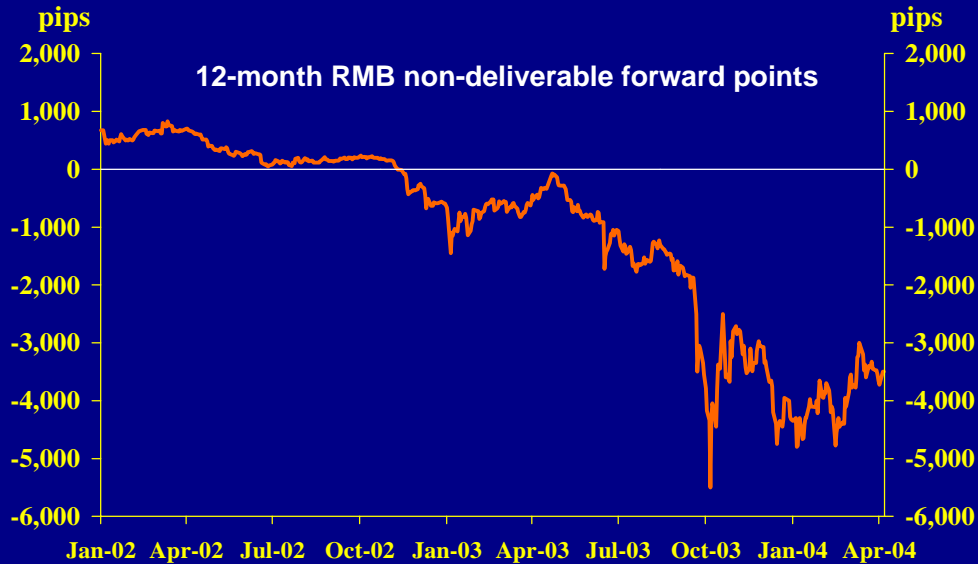
- **Global economic recovery**
- **Bottoming of interest rates**
- **External imbalances of the US**
- **Volatility in currency and equity markets**
- **Political pressure on renminbi exchange rate**
- **Macroeconomic policies of the Mainland**
- **Geopolitical issues**

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- **Global economic recovery:** The US recorded further strong growth in Q4 2003 despite a high comparison base. While the Japanese economy has continued to recover, the pace of recovery in the euro area has remained slow.
- **Bottoming of interest rates:** Short-term interest rates in the US are generally expected to climb gradually in 2H2004 along with further revival of economic activity.
- **External imbalances of the US:** Although current account deficit fell slightly from 5.2% of GDP in 2003Q1 to 4.5% in 2003Q4, it remains high by historical standard.
- **Volatility of currency and equity markets:** The US dollar appreciated by about 6% against the euro so far this year, following the depreciation in 2003. Meanwhile, the Japan/USD rate has been relatively volatile, partly due to the reported interventions of the BoJ.
- **Political pressure on the renminbi exchange rate:** The political pressure for a revaluation of the renminbi or more flexible management of its exchange rate remains.
- **Geopolitical issues:** Continuing concerns over the situation in Iraq and increasing cross-strait tension.



RENMINBI - MARKET EXPECTATIONS

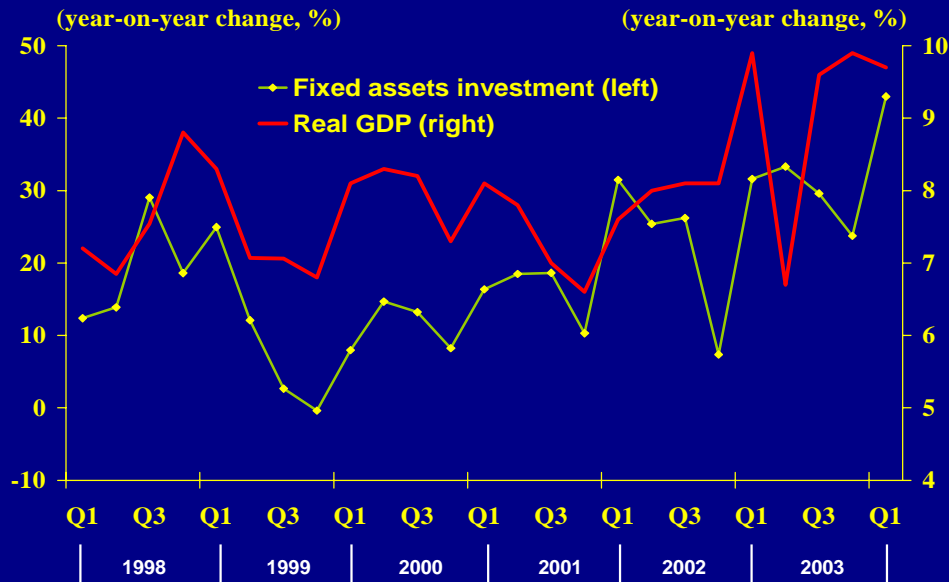


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- Political pressures on revaluation of the renminbi, coupled with the significant trade surplus and fast accumulation of foreign reserves in the Mainland, have brought the 12-month renminbi non-deliverable forward points to a discount since April 2003. But as shown in the next few slides, this market expectation for appreciation of renminbi does not seem to be backed up by the underlying economic data. In fact, the 12-month NDF on RMB has been easing to -3,000 on 21 April, suggesting a lowering of market expectation of RMB appreciation.



INVESTMENT GROWTH ON THE MAINLAND

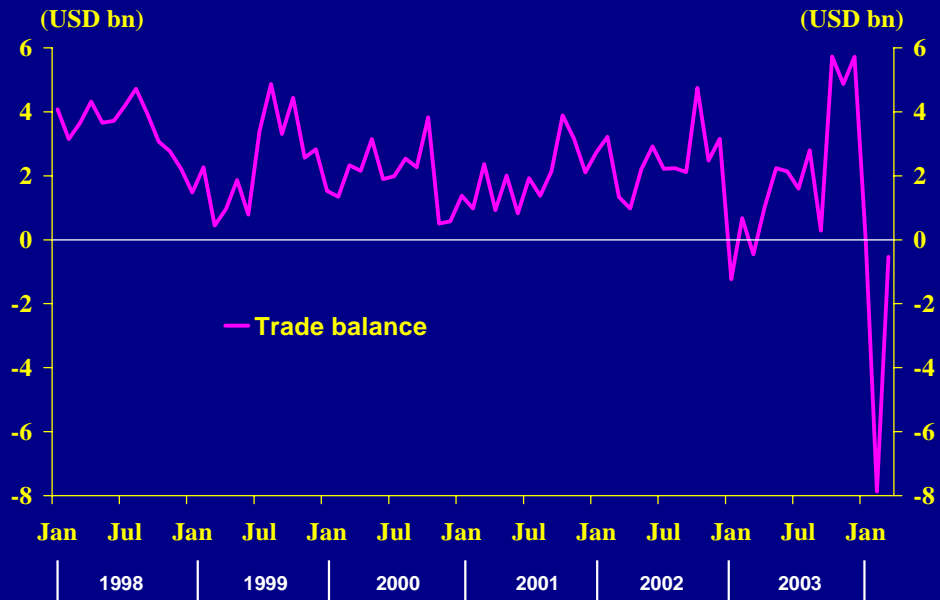


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- Signs of excess demand and overheating pressures have emerged in the Mainland.
- Real GDP growth accelerated to an annual rate of 9.7% in 2004 Q1.
- In particular, fixed investment growth has accelerated to a very high level (over 40%).
- As a result of rapid economic expansion, certain key industries (particularly the energy sector) have nearly reached their capacity limits.



TRADE BALANCE OF THE MAINLAND

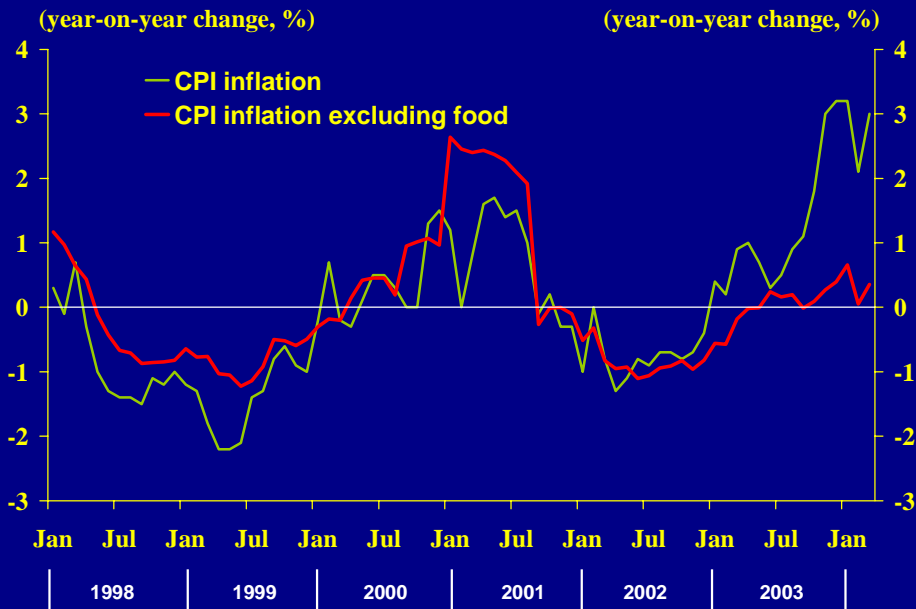


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- Reflecting mainly the strong domestic demand, a sharp increase in imports in early 2004 turned the trade balance from surplus to deficit, despite continued strong growth in exports.



INFLATION ON THE MAINLAND



- Deflation ended in early 2003. CPI inflation rose gradually to 2.8% in the first two months of 2004. However, the rise has so far been driven mainly by food prices, while CPI excluding food has remained steady.
- Thus, there is a debate about whether the overall economy is facing inflationary pressure, or whether overheating is a significant concern only in specific sectors.



MONEY AND CREDIT GROWTH ON THE MAINLAND



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- In an attempt to curb excessive credit expansion, the PBoC has tightened monetary policy. The tightening was also prompted by concerns about the asset quality of banks, as excessive credit growth may eventually lead to more problematic loans.
- The reserve requirement has been raised three times since September 2003, from 6% to 7.5% for all banks, and to 8% for commercial banks with low capital adequacy ratio.
- Broad money growth and loan growth have decelerated in the past few months, but remained relatively strong at the start of 2004. Meanwhile, investment growth has shown no sign of deceleration, suggesting that more time is required for the policy effects to filter through.
- The mixed picture of moderate CPI inflation but rapid investment and credit growth has complicated macroeconomic management in the Mainland. The possibility of more drastic measures of tightening and thus a “hardlanding”, i.e. a significant slowdown in the Mainland economy, is still small, but represents a risk to Hong Kong’s growth outlook.
- We shall continue to watch the developments closely, particularly any change in exchange rate and monetary policies that could have an impact on monetary stability in Hong Kong.



CURRENCY - RISKS & VULNERABILITIES

Domestic factors

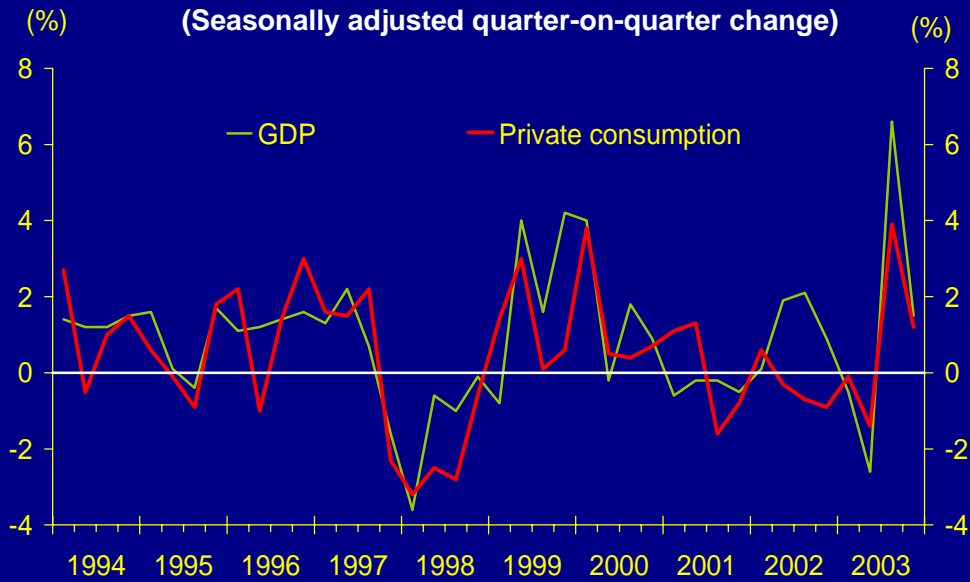
- **Robust economic recovery**
- **Strong external position**
- **Deflation**
- **Property market**
- **Unemployment**
- **Public finance**

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- **Robust economic recovery:** Real GDP rose further by 1.5% in Q4 2003 on a seasonally adjusted quarter-on-quarter basis, following a distinct rebound of 6.6% in Q3 2003. Unemployment rate eased to 7.2% in the three months to February 2004, from a record high of 8.7% in the April-July 2003 period.
- **Policies facilitating economic integration with the Mainland** have 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 Q4 2003) and a large net international investment position (at more than two times of GDP), has supported the currency.
- **Deflation** continued on a year-on-year comparison, but the CPI has stabilised and recorded a small rise since the second half of 2003. Property prices have recorded a marked rebound.
- **Unemployment rate** remains high, although there has been significant improvement recently.
- **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.



STRONG ECONOMIC RECOVERY

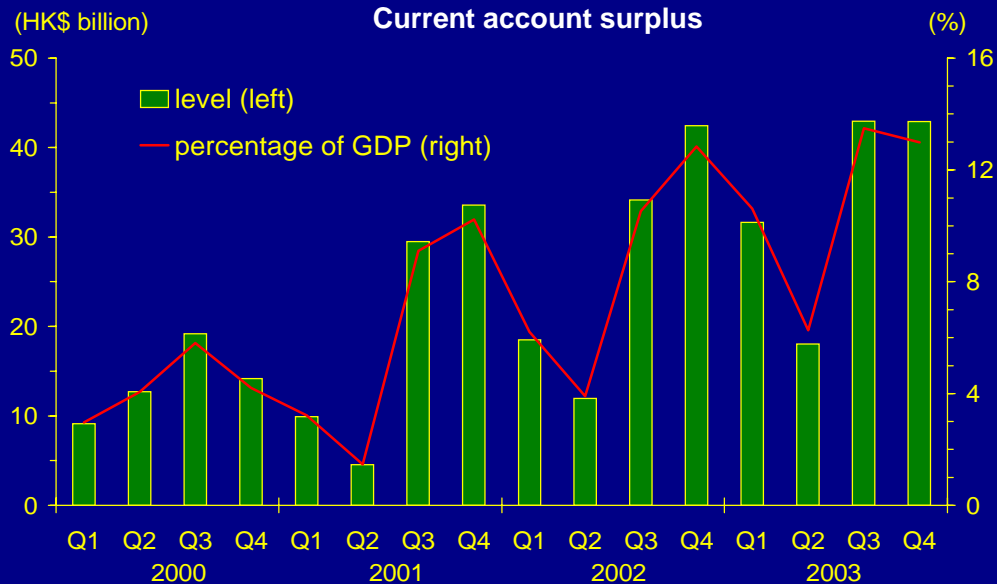


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- Having rebounded strongly in Q3 2003, real GDP registered a more broad-based recovery in Q4. In particular, it expanded by 1.5% in Q4 on a seasonally adjusted quarter-on-quarter basis, following an increase of 6.6% in Q3.
- The growth reflected mainly a sustained revival in private domestic demand and tourism. 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 consumption expenditure increased by 1.2% in Q4 from Q3, after expanding by 3.9% in Q3. Exports of services rose by 2.2% in Q4, following a sharp rebound of 33.5% in Q3.



BALANCE OF PAYMENTS ACCOUNT

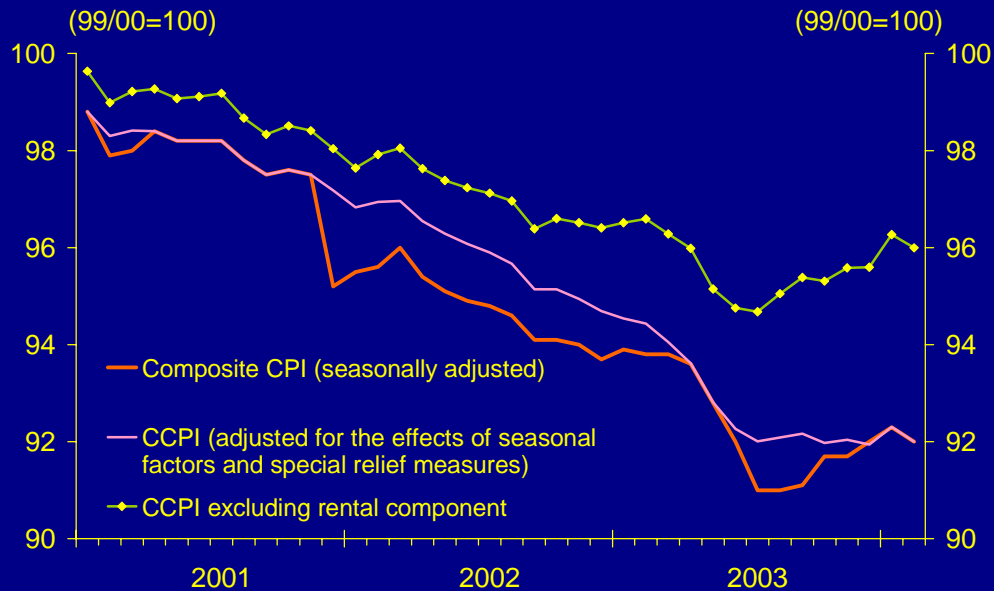


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- Reflecting in part the improved competitiveness, external payment position has been strong.
- In particular, the current account surplus increased to around 13% of GDP in both Q3 and Q4 of 2003. This reflected a rebound in the tourism-related sectors 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.



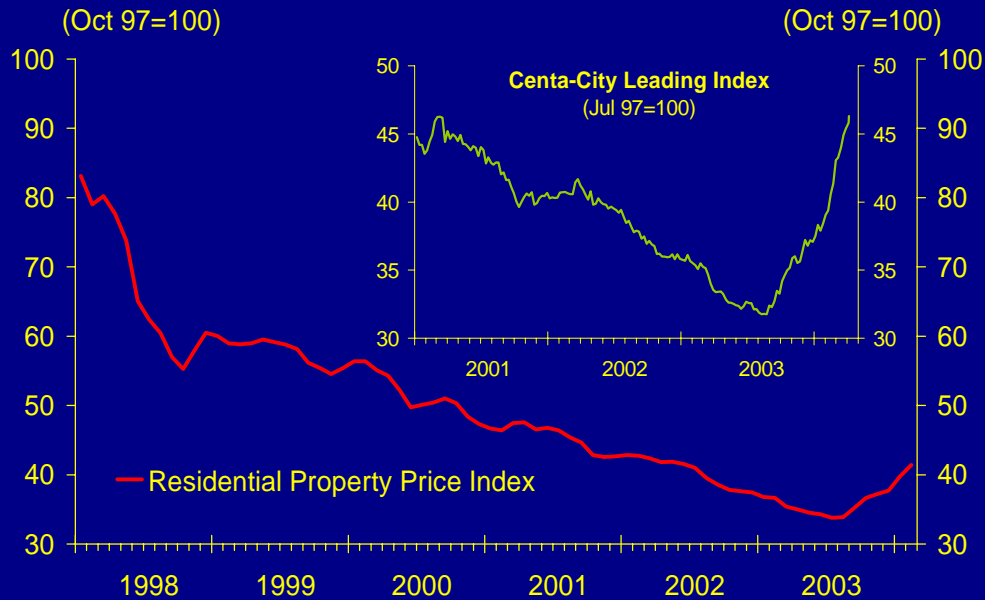
CONSUMER PRICE DEFLATION



- To better assess underlying price developments, the Composite Consumer Price Index (CCPI) should be adjusted for the effects of seasonal factors and government relief measures.
- 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 have lowered the overall price index during their effective periods. For example, the decline in the CCPI in July 2003 and its subsequent rebound in October were attributable largely to the introduction and termination of rates concession respectively.
- After removing the effects of the relief measures, consumer prices have stabilised since last summer.
- Rental component accounts for a significant weight (27%) of the consumer price index. 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.)
- After excluding the rental component, the CCPI increased by 1.4% from July 2003 to February 2004.



RESIDENTIAL PROPERTY PRICES

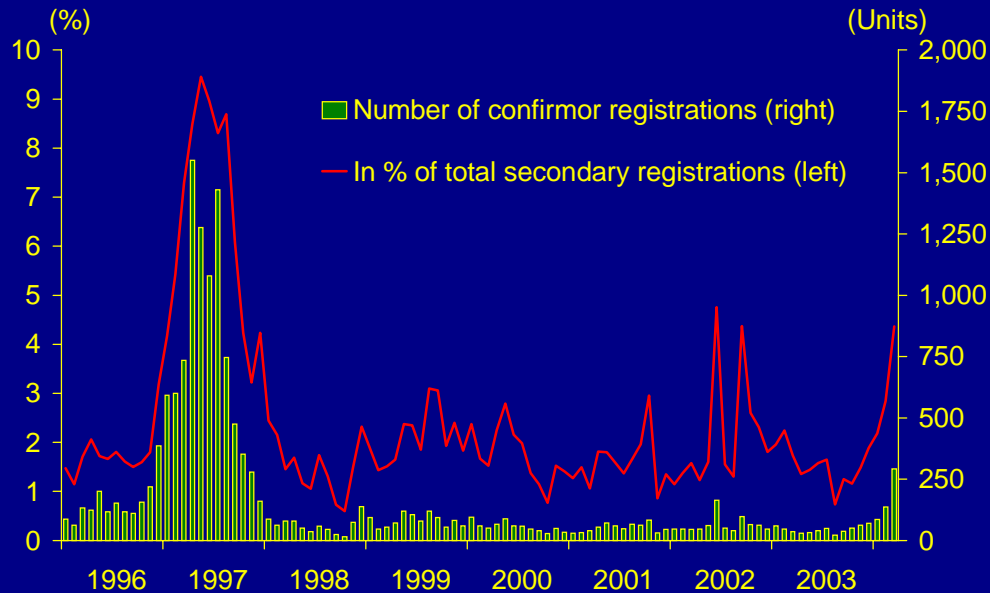


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- The residential property price index rebounded by over 20% in February 2004 from its trough in July 2003, but remained about 60% below the peak in October 1997.
- The Centa-City Leading Index suggests that property prices continued to increase in recent weeks. (The Centa-City Leading Index is a weekly index constructed by the Centaline Property Agency Limited based on preliminary transaction prices in the secondary market of selected major estates.)



CONFIRMOR REGISTRATIONS

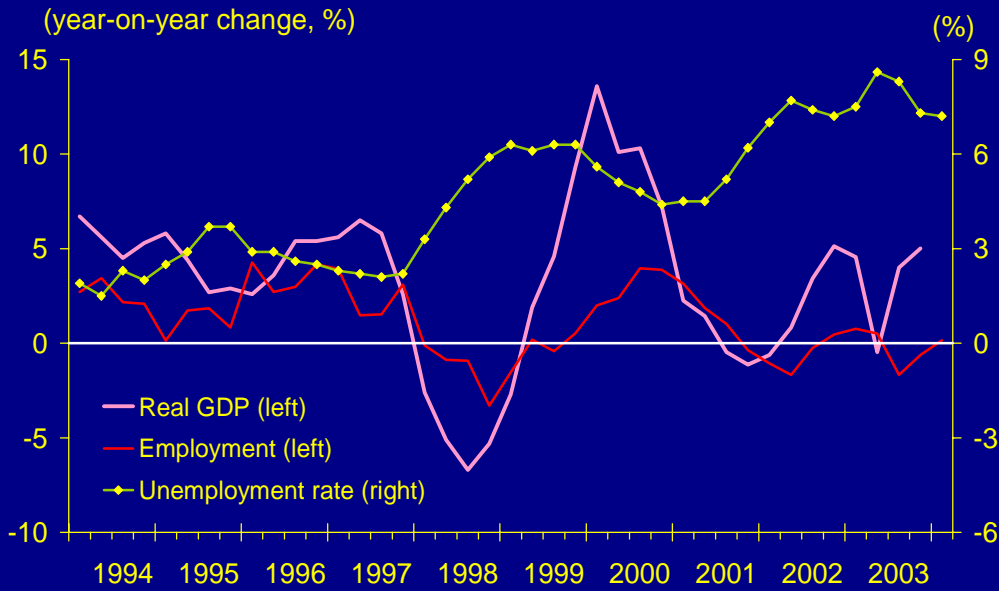


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- Signalling possibly an increase in speculative activity in the property market as there was a significant rise in the number of confirmor transactions in recent months. (If a flat is re-sold before the legal completion of the original sale, all sub-vendors will sign in the capacity as “confirmors” in the Assignment. The legal interests in the flat will pass from the original vendor directly to the final purchaser at the end of the chain.)
- The share of confirmor registrations in total secondary registrations of private residential properties surged to 4.4% in March 2004, from less than 1% in August 2003. However, the share remains considerably below that in mid-1997.



LABOUR MARKET

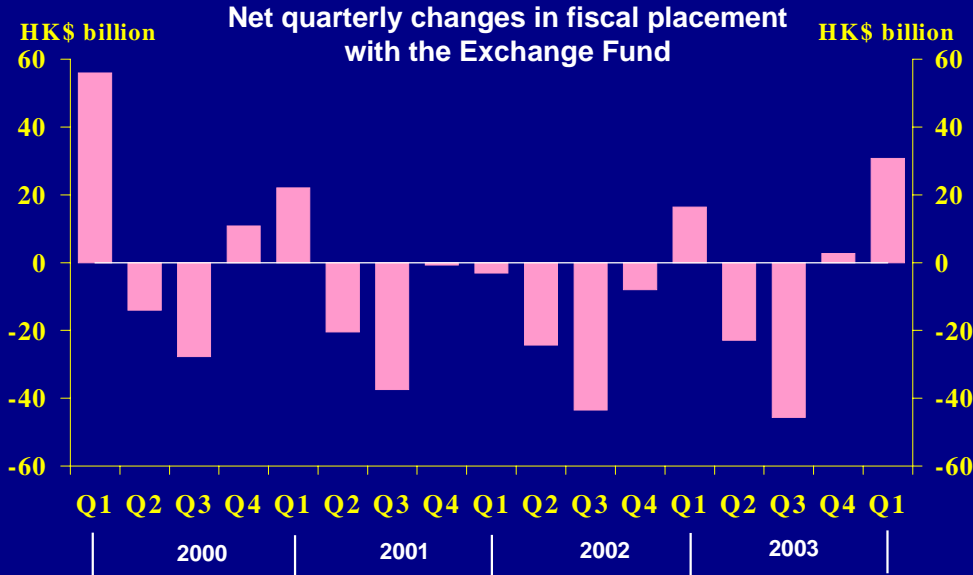


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- Along with the recovery in the economy, labour market conditions have improved considerably. The seasonally adjusted unemployment rate dropped to 7.2% in the three months ending February 2004, from a record high of 8.7% in mid-2003.
- Looking ahead, a sustained recovery of the economy should help reduce the unemployment rate. Typically, changes in the unemployment rate lag behind output growth.



FISCAL DRAWDOWNS



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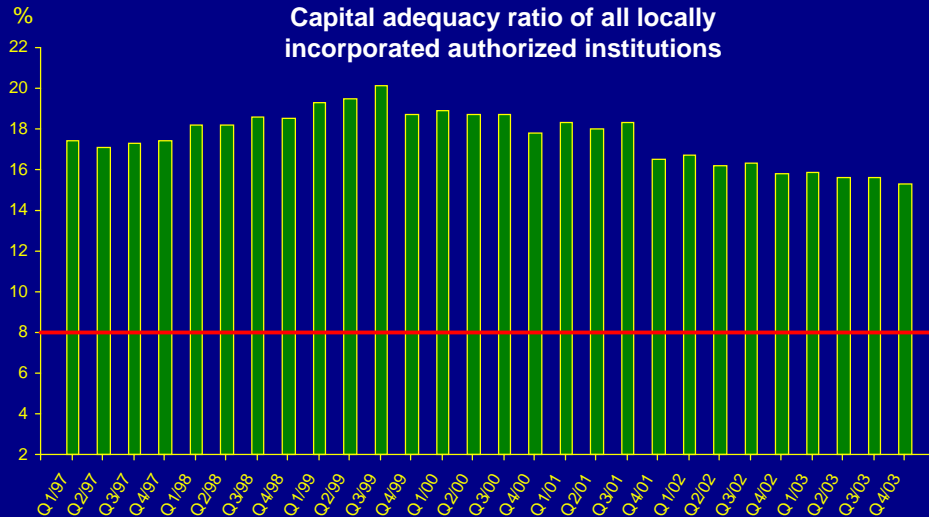
- Fiscal drawdowns returned to a net placement for two consecutive quarters in Q1 2004.
- The rise in Q1 2004 was in part due to seasonal effects, while that in Q4 2003 represented a genuine underlying improvement. The previous time registering a net placement in the fourth quarter was in year 2000, when strong economic activities helped boost revenues.
- Detailed figures for quarterly changes in fiscal placements are as follows.

Net Quarterly Change in Fiscal Placement with the Exchange Fund (HK\$ billion)

year \ quarter	Q1	Q2	Q3	Q4
2000	55.9	-14.1	-27.7	10.8
2001	22.1	-20.4	-37.4	-0.7
2002	-3.1	-24.4	-43.5	-8.0
2003	16.4	-22.9	-45.6	2.7
2004	30.7			



BANKING SECTOR PERFORMANCE



Period-end figures.

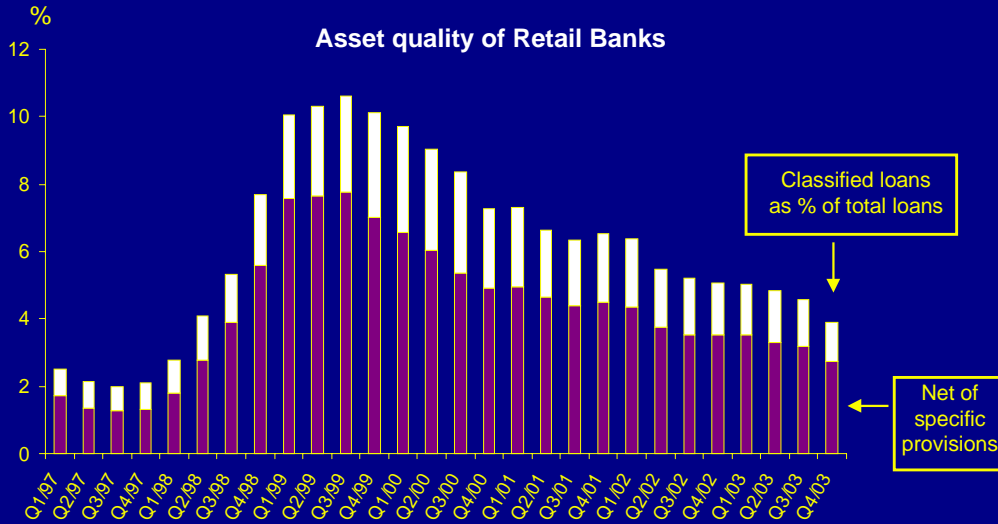
There is a break in series at end-December 2001 owing to a change in the reporting population.

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- The average consolidated capital adequacy ratio of all locally incorporated authorized institutions at end-December 2003 was 15.3%, well above the minimum international standard of 8%.
- The capital adequacy ratio is now lower than pre-Asian financial crisis level due to:
 - consolidation of the banking system
 - deployment of capital against higher yielding but higher risk assets (namely securities holding) in recent years, in light of the lack of lending opportunities.
- The average consolidated capital adequacy ratio is, nonetheless, still about double the international minimum required.



BANKING SECTOR PERFORMANCE



Period-end figures.

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- The overall asset quality of the Retail Banks improved notably in the fourth quarter of 2003, particularly in the consumer lending portfolio. The classified loan ratio decreased to 3.91% at end-December from 4.59% at end-September.



BANKING SECTOR PERFORMANCE

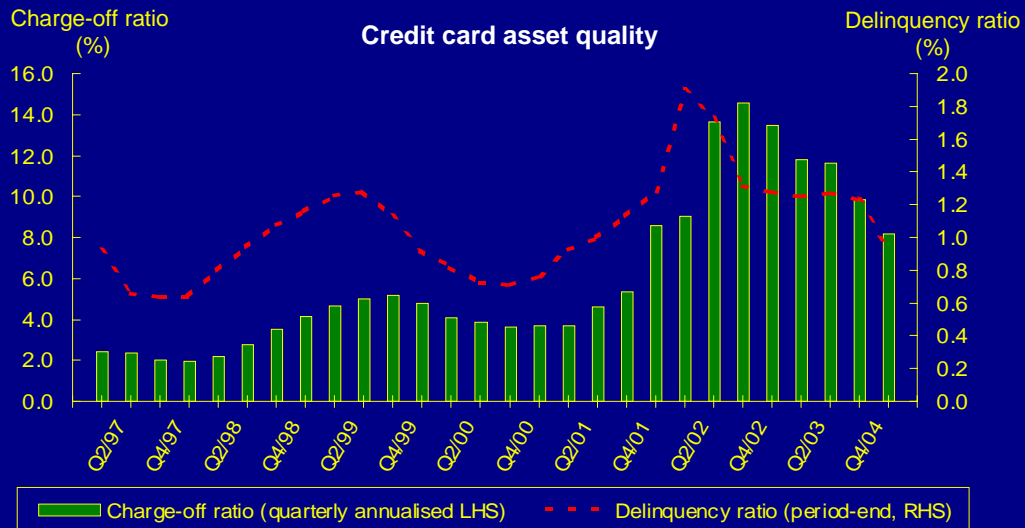


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- For the first quarter of 2004 as a whole, the number of bankruptcy petitions presented was 3,363, down further from 4,356 in the fourth quarter of 2003.
- Within the first quarter of 2004, there was a slight increase in the number of bankruptcy petitions from 1046 in January to 1165 in February and 1296 in March. But it should be noted that the increase in March might be due to more working days in March than in February (the number of petitions received per working day in March was actually lower than that in February).



BANKING SECTOR PERFORMANCE



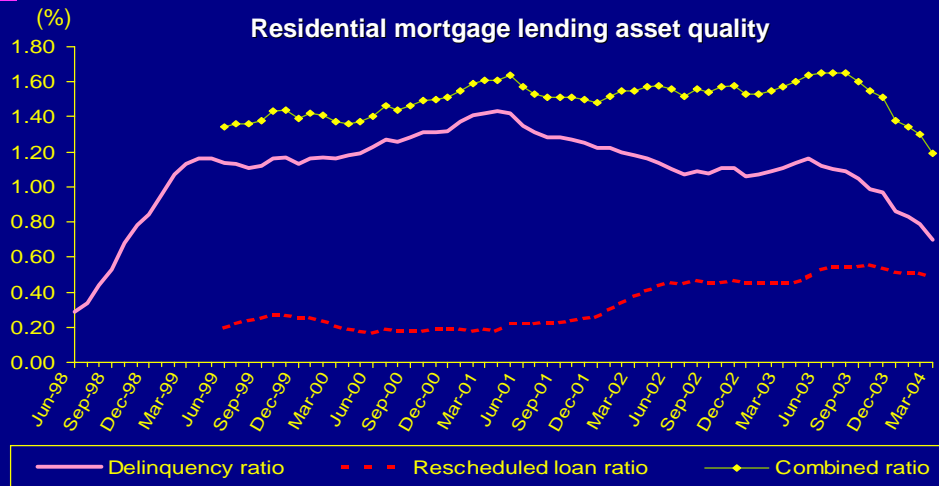
There is a break in series at Q4 2001 owing to an increase in the number of surveyed institutions.

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- The annualised quarterly charge-off ratio fell for five consecutive quarters to 8.19% in the fourth quarter, down from 9.85% in the third quarter. The improvement in the charge-off situation can be explained by the on-going debt rescheduling arrangements as well as the decline in number of personal bankruptcies and the improved employment situation.
- The delinquency ratio also fell to 0.92% from 1.23%.



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.

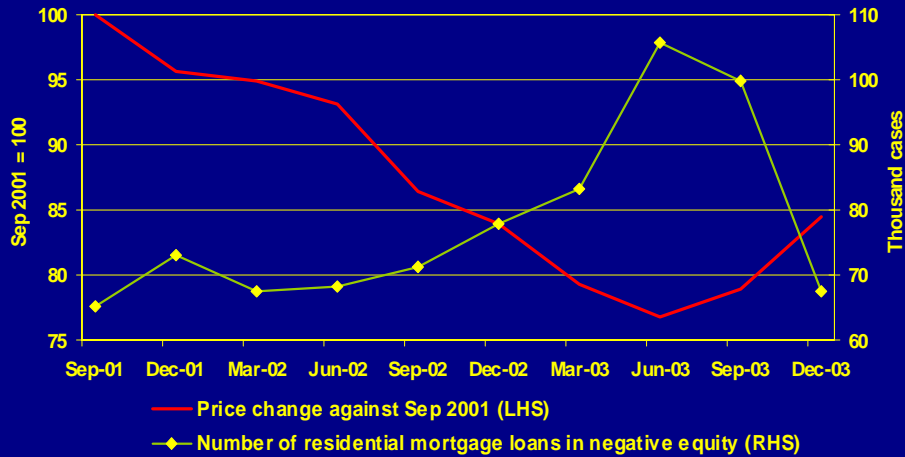
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- Consistent with the improved repayment ability of homeowners along with the recovery of the domestic economy, the quality of the mortgage portfolio improved further. Both the mortgage delinquency ratio and the rescheduled loan ratio declined to 0.70% and 0.49% in March from 0.86% and 0.52% in December 2003 respectively. As a result, the combined ratio improved to 1.19% from 1.38%.



BANKING SECTOR PERFORMANCE

Relationship between price movement of territory-wide private domestic units and number of residential mortgage loans in negative equity



Information source of price movement : Rating & valuation Department

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- The negative equity situation of the residential mortgage loans is sensitive to property price movements in an inverse relationship. The economic downturn, exacerbated by SARS in the second quarter of 2003, led to an increase in negative equity as property prices continued to decline. The number of negative equity mortgage loans within the banking sector alone rose to a peak of 106,000 cases at end-June 2003 from 76,700 cases at end-2002. The situation, however, eased considerably in the second half of 2003, along with the recovery in property prices arising from the improved domestic economy.



BANKING SECTOR PERFORMANCE

Residential mortgage lending in negative equity



Period-end figures.

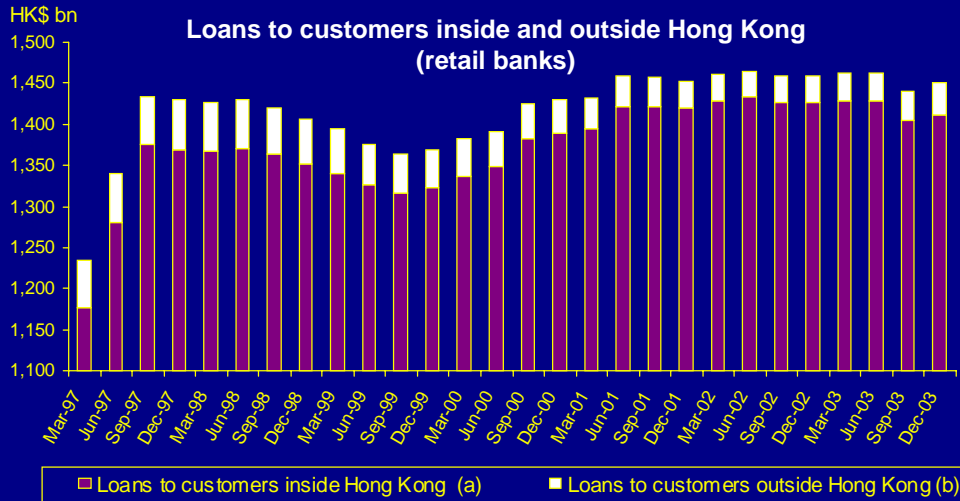
Separate data on secured and unsecured loan value as at end-Sep 2001 are not available.

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- 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 cases over the three-month period to around 67,600 cases with an aggregate value of HK\$107 billion at end-December. 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 data on negative equity loans was first collected in September 2001. It represents 20% of total outstanding mortgage lending.
- The HKMA is finalising the compilation of the March quarter figures. The preliminary figures show that the number of negative equity residential mortgage loans has reduced considerably to around 40,000 cases alongside the pick up in property prices in the first quarter of this year.



BANKING SECTOR PERFORMANCE



Period-end figures.

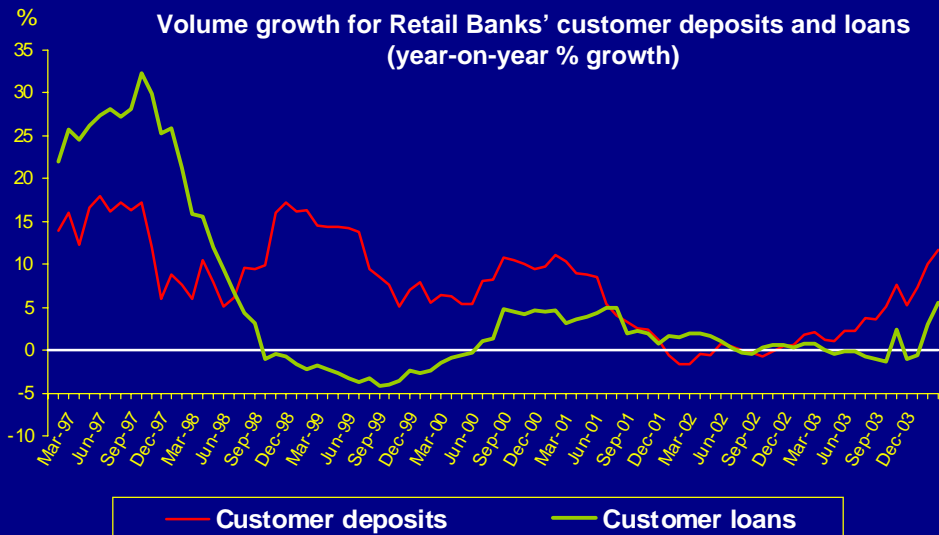
Notes: (a) Defined as loans for use in Hong Kong Plus trade financing loans.
(b) Includes "others" (i.e. unallocated).

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- Stimulated by improved business sentiment arising from the economic recovery and the positive economic outlook, domestic loans of retail banks grew by 0.5% in the fourth quarter having fallen by 1.5% in the previous quarter. This, coupled with the 6.5% increase in offshore loans, resulted in an increase of 0.7% in retail banks' total loans, against a decline of 1.5% in the third quarter.



BANKING SECTOR PERFORMANCE



Month-end figures.

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- Retail Banks' customer deposits grew by 11.7% year-on-year at end-February 2004. This growth came mainly from the continued increase in demand and savings deposits, while time deposits continued to contract in light of the historically low interest rate environment.
- Retail Banks' customer loans rose by 5.6% year-on-year at end-February, reflecting a revival in demand for loans alongside the economic recovery.
- The HK dollar loan-to-deposit ratio increased to 72.7% at end-February from 71.6% at end-2003.
- The proportion of Hong Kong dollar deposits to total deposits of retail banks was 61.9% at end-February, compared with 61.0% at end-2003 and 60.9% a year ago.



BANKING SECTOR PERFORMANCE



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- Benefiting from the upturn in the domestic economy in the second half of 2003, most retail banks recorded profit growth for the year. However, retail banks' net interest margin contracted to 1.91% in 2003 from 2.09% a year ago. The contraction was mainly due to the continued squeeze on margins on residential mortgage lending and refinancing and the lower yield on free funds, despite the widening of spreads between the best lending rate and funding costs.
- Pressure on interest margins have prompted many banks to focus increasingly on non-interest income business (e.g. treasury business & wealth management). Banks should thus be more alert to risk management. Risk management skills particularly in areas of interest rates and market risks will need to be improved as banks grow their securities holding while operational controls may need to be enhanced to cope with the wealth management business.



BANKING SECTOR - WORK PROGRESS (1)

- **Deposit protection scheme**
 - the bill is scheduled for resumption of Second Reading on 5 May
 - will proceed with the setting up of the DPS Board
 - expected to be launched in early 2006
- **Positive data sharing**
 - smoothly launched
 - differential pricing based on individuals' creditworthiness
- **Commercial credit reference agency**
 - banking industry working with service provider to finalize operational details
 - service expected to be launched in second half of 2004

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- The DPS Bills Committee completed scrutiny of the Bill in March 2004. The Bill is now scheduled for resumption of Second Reading on 5 May 2004. Once enacted, we will proceed with the setting up of the DPS Board which will oversee the implementation of the Scheme. As it will take time to prepare the relevant rules and develop the payout system, we expect the Scheme to be launched in early 2006.
- Sharing of positive consumer credit data among banks began in August 2003. This will help to provide a healthier credit environment and more competitive products for borrowers with good credit standing.
- The banking industry has appointed a service provider to run the CCRA and is finalising the operational details. Banks have begun to seek SME customers' consent for disclosure of their credit data to the CCRA. Customers' feedback has so far been favourable. We expect the CCRA to be able to provide service later in the year. This will help to improve SMEs access to bank lending.



BANKING SECTOR - WORK PROGRESS (2)

- **New capital accord**
 - **preparing for implementation by end-2006**
 - **will brief FA Panel in greater detail in June**

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- The Basel Committee will finalise the new capital accord by mid-2004. The target implementation date of end-2006 remains unchanged. The HKMA has consulted the banking industry on preliminary proposals for implementing the new accord in Hong Kong. We will finalise the proposals for implementation by the international deadline. Legislative changes will be required. We will brief the FA Panel in June.



BANKING SECTOR - WORK PROGRESS (3)

- **ATM fraud problems**
 - **51 suspected ATM fraud cases reported to the Police so far**
 - **HKMA issued advice to AIs on ATM precautionary measures in October 2003**
 - **consumer education increased: TV episode and educational sticker labels**
 - **All reported cases settled and no newly reported case received since mid November 2003. Problem appears to be contained.**

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- 51 suspected ATM fraud cases were received by the Police during the second half of 2003.
- The HKMA issued a circular in October 2003 to authorized institutions (AIs) to set out its expectation on the precautionary measures that should be undertaken and the way in which customer complaints in this relation should be handled. The vast majority of ATMs in Hong Kong have now been installed with acceptable precautionary measures (e.g. anti-skimming devices or CCTVs) and/or are already placed at physically secure locations (e.g. inside a bank branch lobby).
- A TV episode of "Police Magazine" was broadcast on 1 November 2003 to alert the public on how to protect their ATM cards and PINs. Separately, individual banks have also placed educational sticker labels on their ATMs advising customers to cover the keypad while entering the PIN, and to report to the banks of any suspicious devices detected on ATMs through the hotline telephone number on the sticker labels or at ATMs.
- To date, all reported cases have been settled and no new reported case has been received since mid-November 2003. The problem appears to have been contained.



BANKING SECTOR - WORK PROGRESS (4)

- **Fake bank websites**

- alerted the public to 14 fake bank websites since June 2003. Originated from outside Hong Kong increased difficulty in control.
- police so far received no report of members of the public in Hong Kong suffering any financial loss
- supervisory initiatives undertaken by the HKMA included:
 - launch of a multi-channel consumer education programme on Internet banking security
 - issue of a series of supervisory circulars and guidance notes to AIs since May 2003
- In 2004, HKMA will continue to work with banking industry on
 - public education
 - two-factor authentication for high-risk transactions

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- Alerted public to 14 fake bank websites. So far no report of financial loss has been received.
- Initiatives undertaken by the HKMA included:
 - cooperation with the banking industry and the Police to launch a multi-channel consumer education programme to promote awareness of Internet banking security precautions among the general public (including issuance of an educational leaflet, and production of a series of TV episodes and radio segments). Customers have been reminded not to access banks' websites through hyperlinks embedded in e-mails or Internet search engines.
 - issue of supervisory circulars in May and August 2003 to AIs to set out proposed precautionary measures against fake bank websites and e-mails. In February 2004, the HKMA also issued a guidance note on Supervision of Electronic Banking to provide AIs with further guidance on risk management and security controls of e-banking.
- For 2004 initiatives:
 - the industry and the HKMA will continue to develop the consumer education programme, for example, through the production of radio segments and issuance of a revised educational leaflet.
 - the HKMA expects AIs to employ stronger customer authentication for authenticating their customers' transactions with higher risk. In view of the increasing trend of fake bank websites, the HKMA is discussing with the banking industry the enforcement of two-factor authentication for high risk retail Internet banking transactions. For example, two-factor authentication comprising digital certificates and user ID/password has been deployed by banks for authenticating corporate Internet banking transactions.

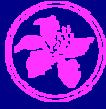


MARKET INFRASTRUCTURE

- **Successful launch of Euro Clearing System in April 2003**
- **Introduction of a Clearing and Settlement Systems Bill in December 2003 with the objectives of**
 - **strengthening the HKMA's oversight of important clearing and settlement systems**
 - **providing settlement finality to such systems**
- **New banknotes**
 - **new HK\$20, HK\$50 and HK\$1,000 banknotes to go into circulation in second half of 2004**

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- The Euro Clearing System has been operating smoothly since its launch in April 2003. The system offers a similar range of advanced clearing functions as the Hong Kong dollar and US dollar payment systems to satisfy the needs of banks, corporates and individuals for real time payment of euro in the Asian time zone. Users of the new system can achieve substantial benefits through streamlining their day-to-day operations and better management of liquidity. The turnover in the system (average of EUR 750 mn a day in Q1/2004) is taking off slowly as it takes time for EUR to become a more commonly traded currency (c.f. US\$4.7 bn daily turnover for USD RTGS).
- A Clearing and Settlement Systems Bill was introduced into the Legislative Council on 10 December 2003 to provide for a statutory oversight regime and settlement finality for important clearing and settlement systems in Hong Kong. This would be in line with the recommendations of the IMF in its Financial Sector Assessment Programme (FSAP) examination for Hong Kong. The proposed legislation will also facilitate the admission of Hong Kong dollar into the Continuous Linked Settlement (CLS) system by providing settlement finality for CLS and HK dollar RTGS systems. The Bills Committee chaired by the Hon. Sin Chung-kai started worked in mid-March and we hope that the deliberation should be completed by early June for enactment in the current session.
- The three note-issuing banks put into circulation new \$500 and \$100 banknotes in December 2003. The remaining three denominations of banknotes, \$20, \$50 and \$1000, will be issued in the last quarter of 2004. Additional security features have been incorporated into these new notes. Security features and colour schemes have also been standardised for banknotes issued by the three note-issuing banks to make it easier for the public to recognise them.



HONG KONG AS AN IFC

- **Renminbi business in Hong Kong**
 - **Renminbi bank cards used in Hong Kong since 18 January 2004 (boost to domestic consumption by Mainland tourists)**
 - **39 banks have begun to provide personal renminbi deposit, remittance and exchange services since 25 February. Renminbi deposits at around RMB5 billion by end March**
 - **will facilitate growing economic integration between Hong Kong and the Mainland**
- **Asian Bond Fund**
 - **Phase 1 (with a US\$1 billion fund invested in USD bonds issued in the region) successfully launched**
 - **Phase 2 (with the fund invested in local currency denominated bonds) being studied**

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- Renminbi business
 - Since 18 January 2004, there has been a steady increase in the use of renminbi debit and credit cards by Mainland tourists in Hong Kong. The cumulative total of credit/debit card spending amounted to over HK\$219 million as of 3 April, or HK\$ 3,007 per transaction.
 - 39 banks have begun to provide personal renminbi deposit, remittance and exchange services since 25 February. Total outstanding renminbi deposits was about RMB5 billion by end-March.
 - The launch of renminbi services provides a new range of services for customers in Hong Kong, helps diversify banking business, and facilitates cross-border spending and economic integration between Hong Kong and the Mainland.
- Asian Bond Fund
 - The ABF initiative, which is developed by the EMEAP Working Group on Financial Markets chaired by the HKMA, represents an important initiative on regional cooperation, aimed at promoting the development of bond markets in the region via enhancing the market infrastructure.
 - The first phase of the ABF initiative or ABF1 was launched in June 2003. The US\$1 bn Fund is now fully invested in USD-denominated bonds issued by sovereign and quasi-sovereign issuers in EMEAP economies, except Japan, Australia and New Zealand.
 - The second phase of the ABF initiative or ABF2 will invest in local currency-denominated bonds. The preliminary framework consists of a Fund of Bond Funds and a Pan-Asian Bond Index Fund.



EXCHANGE FUND PERFORMANCE

(HK\$ billion)	2004 ² Q1	2003 ¹ Full year	2002 ¹ Full year	2001 ¹ Full year
Gain / (Loss) on HK equities*	1.0	21.2	(11.8)	(27.1)
Gain / (Loss) on other equities*	3.2	26.8	(22.7)	(3.3)
Exchange gain / (loss)	0.6	22.9	27.2	(13.0)
Total return from bonds, etc	<u>12.0</u>	<u>18.8</u>	<u>54.3</u>	<u>50.8</u>
Investment income	16.8	89.7	47.0	7.4

* including dividends

1 Audited figures; 2 Unaudited figures

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- Investment income recorded at end March 2004 was HK\$16.8 billion. But the rest of the year presents challenges because of an uncertain and difficult investment environment.



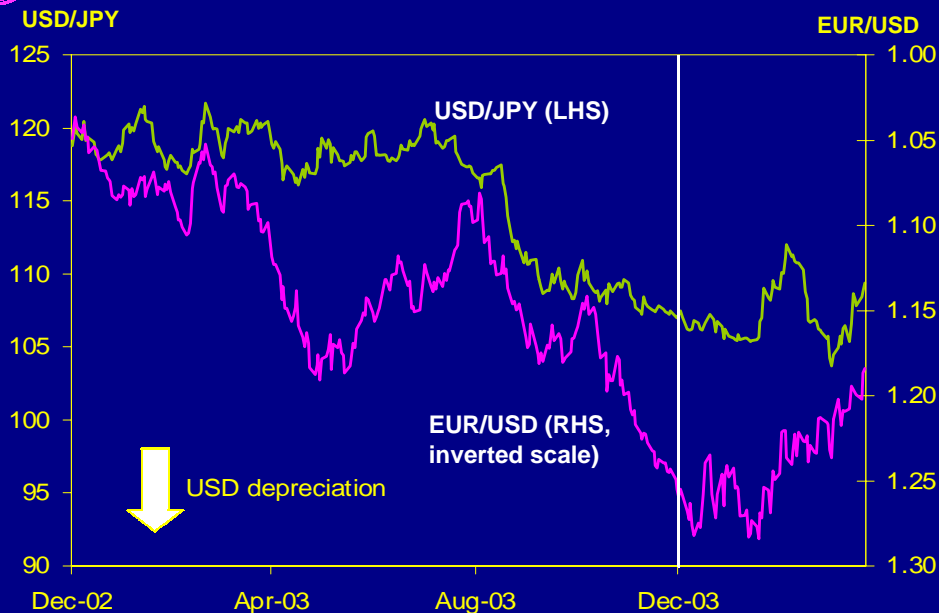
EXCHANGE FUND CHANGE IN ACCUMULATED SURPLUS

(HK\$ billion)	2004	2003		2002		
	Q1	Full year*	Q1	Q2	Q3	Q4
Investment income/(loss)	16.8	89.7	6.7	41.1	8.4	33.5
Other income	0.0	0.2	0.0	0.1	0.0	0.1
Interest and expenses	<u>(1.1)</u>	<u>(6.5)</u>	<u>(1.4)</u>	<u>(1.5)</u>	<u>(1.3)</u>	<u>(2.3)</u>
Net investment income/(loss)	15.7	83.4	5.3	39.7	7.1	31.3
Treasury's share	<u>(4.5)</u>	<u>(25.7)</u>	<u>(2.1)</u>	<u>(13.0)</u>	<u>(2.0)</u>	<u>(8.6)</u>
Increase/(Decrease) in EF accumulated surplus	11.2	57.7	3.2	26.7	5.1	22.7

* Audited figures



VERY VOLATILE FX MARKETS



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- In 2003, the US dollar fell 16.7% against the euro and 9.7% against the yen. As indicated by the chart, the Euro/USD exchange rate was more volatile than the USD/Yen rate. Throughout 2003, the Bank of Japan intervened massively in support of the USD and succeeded in dampening both the magnitude and the volatility of the USD's depreciation against the yen.
- Since the beginning of 2004, the USD has rebounded against the Euro and the yen. Strong economic growth in the US suggests that US interest rates may rise faster than Euroland or Japan. Expectation of widening interest rate differentials in favour of the US has so far been supportive of the US dollar.



UNCERTAIN OUTLOOK FOR EQUITY MARKETS

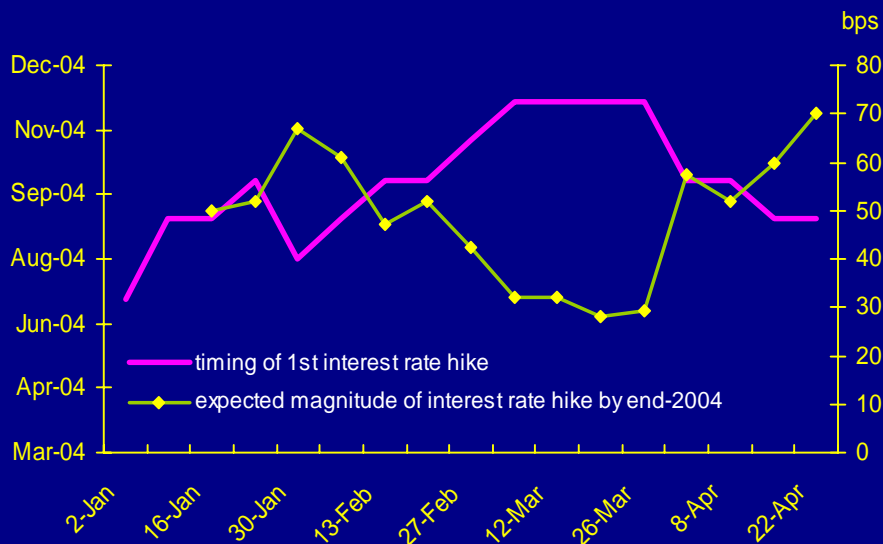


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- In 2003, the Hang Seng Index and the S&P500 rose by 34.9% and 26.4% respectively. The rise in the Hong Kong and the US equity markets began in April/May and the ascent between then and the end of 2003 was fairly interrupted. In the second half of 2003, the markets were enthusiastic about economic growth in the US, the mainland and Hong Kong and projecting expectations for positive corporate earnings in these markets.
- Since the beginning of 2004, the US equity market was clouded initially by uncertainties over the sustainability of the pace of growth in the US, and later upon further confirmation of strong growth, by concerns over interest rate hikes. The performance of the Hong Kong market year-to-date has been marred by worries initially about an over-heating economy in the mainland and later by concerns over rising inflation.



GYRATING EXPECTATIONS FOR INTEREST RATE HIKE IN THE US



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- Expectations of the timing of the first interest rate hike and the magnitude of the rate hike by end-2004 fluctuated widely with releases of economic data in the US.
- The pink line shows the market's expectation of the beginning of the rate hikes. In January, the markets expected the Fed to initiate hikes in June. By March, the timing had been deferred to November. In the past few weeks, this has been revised back to August.
- The green line tracks the market's expectations of the magnitude of the interest rate hikes by year-end. In January, the markets expected the US Fed to raise rates by 50 bps by end-2004. In March this expectation was reduced to 30 bps. In the past few weeks, stronger employment data has led the market to expect the Fed to raise rates by 70 bps by year-end.
- We expect the extreme volatility in currency, equity and bond markets to continue in the foreseeable future.