HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

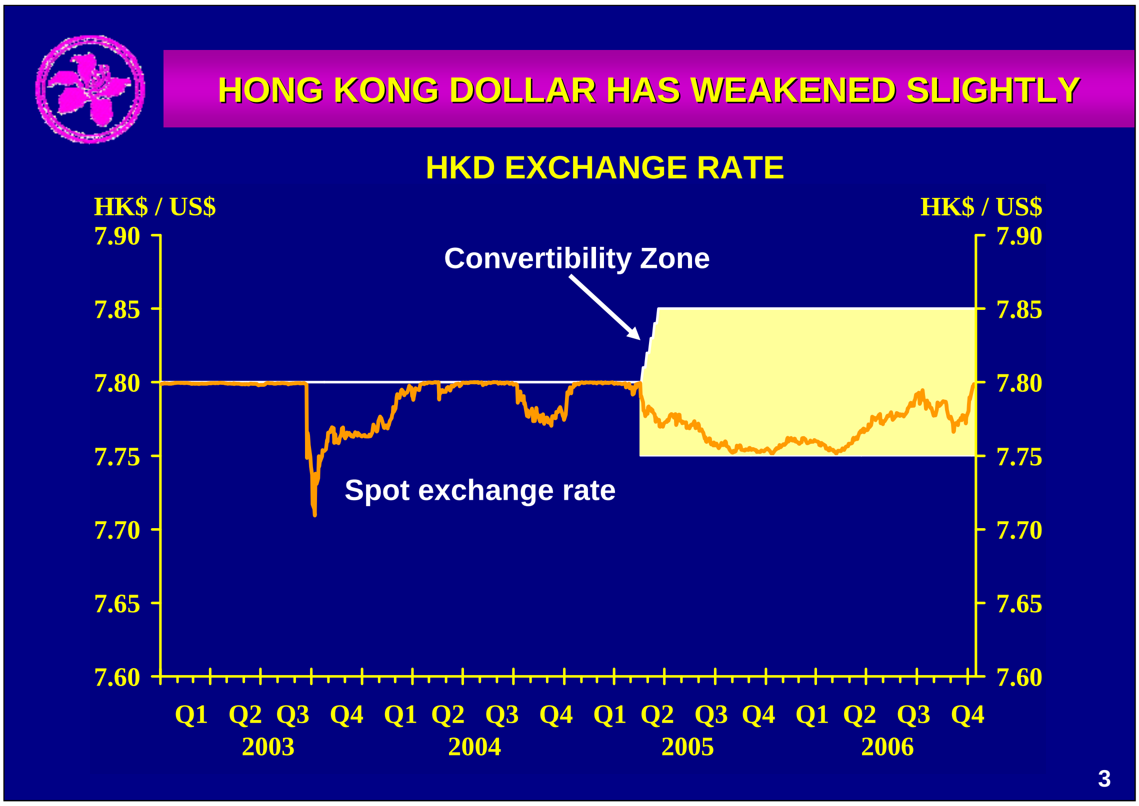
5 February 2007

DISCUSSION TOPICS

Updates on

– Currency Stability
– Banking
– Financial Infrastructure
– Hong Kong as an International Financial Centre
– Exchange Fund

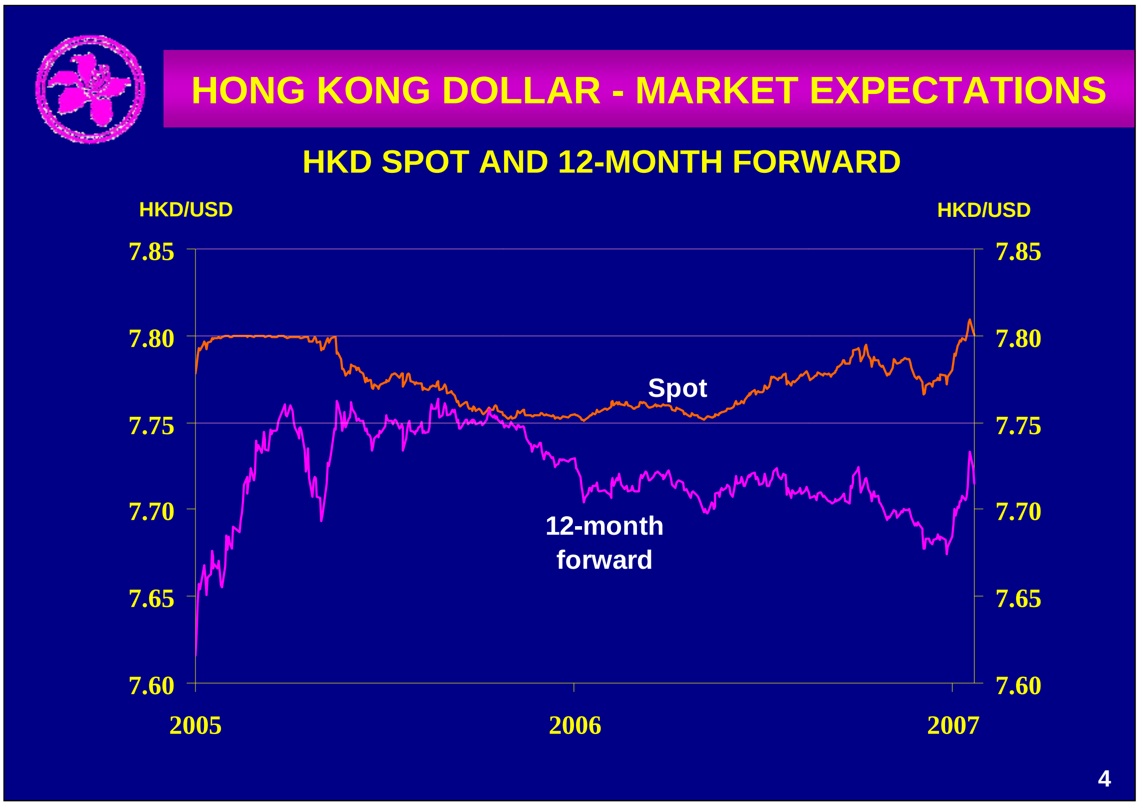
2



- Despite an appreciation of the renminbi and IPO-related inflow of funds, the Hong Kong dollar exchange rate gradually weakened towards the centre of the Convertibility Zone between May 2006 and January 2007, attributable to interest rate arbitrage taking advantage of lower domestic interest rates relative to those of the US.

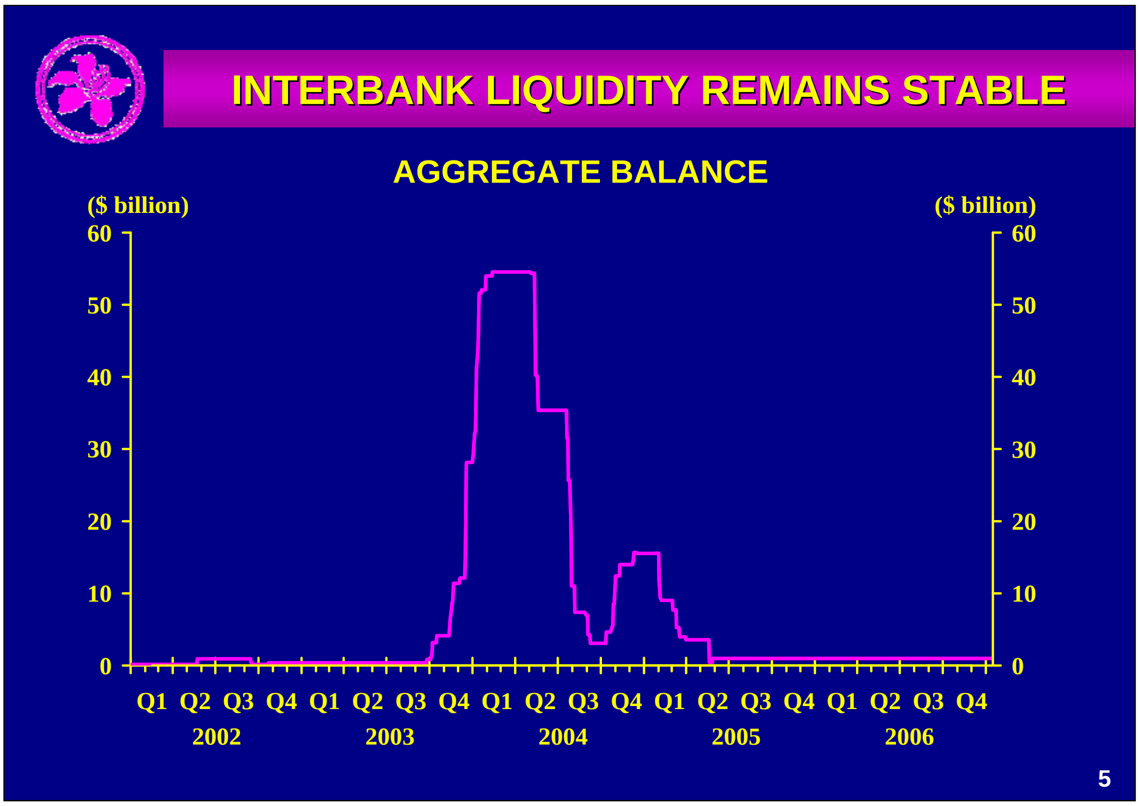
- In January 2007, the Hong Kong dollar weakened slightly below the 7.8 level against the US dollar but was well within the convertibility zone of 7.75 and 7.85. The HKMA has not conducted any market operations to affect the exchange rate of the Hong Kong dollar.

- The renminbi exchange rate used to have significant influence on market sentiments about the movement of the Hong Kong dollar, but recent evidence suggested that the Hong Kong dollar is no longer used as a proxy for trading the renminbi, reflecting the market's confidence in the Linked Exchange Rate system.



- Interest rate discount can be translated into a discount of the forward exchange rate from the spot exchange rate.

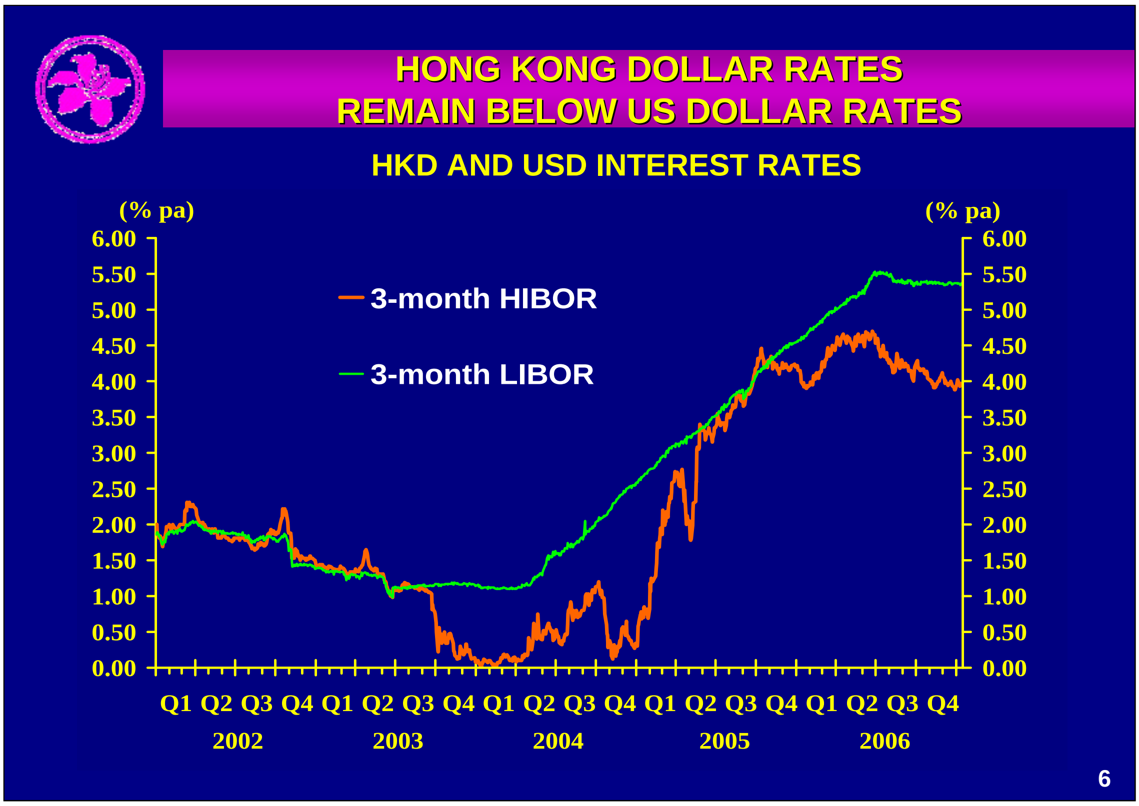
- The discount of the 12-month forward exchange rate from the spot exchange rate had widened to over 900 pips towards the end of 2006 but narrowed slightly by mid-January 2007.



- Since the HKMA did not carry out any market operations, the Aggregate Balance was little changed at around HK$1.3 billion in 2006.

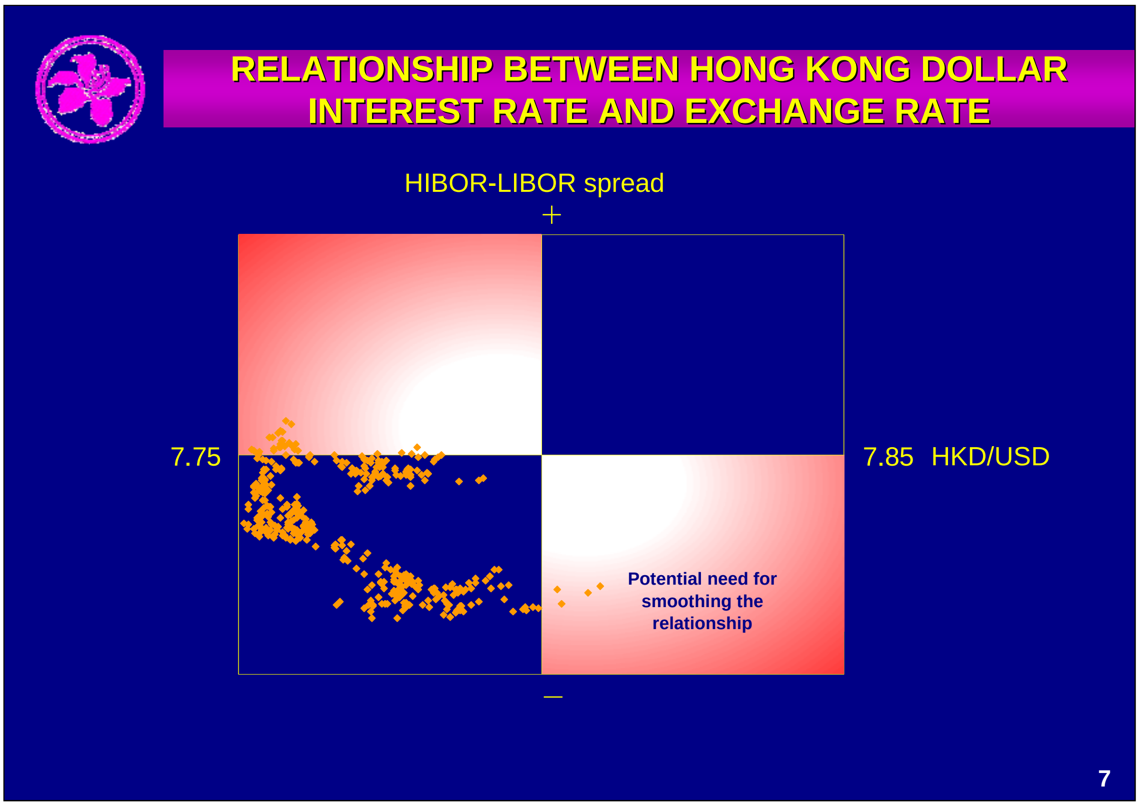
- The current level of the Aggregate Balance is probably more than sufficient to allow smooth interbank clearing and settlements, given the highly efficient Hong Kong dollar Real Time Gross Settlement system. The excess interbank liquidity, however, has been helpful for the banking system to cope with high funding demand associated with large IPOs in the stock market.

- The stability of the Aggregate Balance reflects smooth functioning of the Linked Exchange Rate system after the introduction of the three refinements in 2005, despite changing external circumstances.



- US dollar interbank interest rates have remained stable since the Fed stopped increasing interest rate in August 2006, with the Federal Funds Target Rate staying at 5.25% and the three-month LIBOR slightly higher.

- Despite the stable US interest rates, the three-month Hong Kong dollar interbank interest rate dropped by about 50 basis points in the second half of 2006. The negative spread between the Hong Kong dollar rate and that of the US dollar widened to about 140 basis points recently, reflecting abundant liquidity. Partly as a result, banks cut their best lending rates by 25 basis points in November 2006.



- Normally, when the Hong Kong dollar is near the strong-side Convertibility Undertaking (CU) of 7.75 , market participants would expect that the strong-side CU might be triggered upon continued capital inflows. Thus, they would be discounting a possible expansion of monetary base and hence lower interest rates. As a result, HIBORs would tend to be lower than LIBORs. This would be represented by points in the lower-left quadrant of the above diagram (the orange dots represent actual observations since the introduction of the three refinements in May 2005).

- Likewise, when the Hong Kong dollar is near the weak-side CU of 7.85, HIBORs would tend to be higher than LIBORs, represented by points in the upper-right quadrant.

- Any deviation of interest rates and the exchange rate from their normal relationship would be represented by the upper-left and lower-right quadrants where there could potentially be room for smoothening the relationship.

RELATIONSHIP BETWEEN HONG KONG DOLLAR INTEREST RATE AND EXCHANGE RATE

- **Hong Kong dollar rates lower than the US dollar rates now and Hong Kong dollar exchange rate on the weak side of the Convertibility Zone (7.80-7.85).**
- **Is there scope for market operations to smooth the relationship between interest rate and exchange rate?**
- **There is justification; room; ability; and the tool to do so.**
- **But we do not see the need for now.**

8

- At present, HIBORs are lower than LIBORs and the Hong Kong dollar is on the weak side of the Convertibility Zone. Theoretically, there are justifications and room for the HKMA to conduct market operations to smoothen the relationship between interest rate and exchange rate. However, the HKMA does not see the need for now.

RISKS TO CURRENCY STABILITY – EXTERNAL FACTORS

- **Renminbi exchange rate hitting key psychological levels.**
- **Financial stability concerns:**
  - **global imbalance**
  - **higher risk appetite of market participants and increasing financial market volatility**
  - **activities of hedge funds**
- **Other factors:**
  - **Macro adjustment and control on the Mainland**
  - **Further monetary tightening prompted by persistent inflationary pressure**
  - **Geo-political tension in the Middle East and Asia**

9

- Two key risks: renminbi appreciation and global financial stability.

- Continued appreciation of the renminbi is unlikely to affect Hong Kong significantly in the professional markets although there may be some short-term psychological impact on consumers travelling to the Mainland.

- Global financial stability remains a concern. In particular, economic buoyancy and ample liquidity worldwide have led to a higher risk appetite of market participants. The growing hedge fund sector, which tends to use leverage and invest in derivatives, also represents a threat to financial stability.

PERSPECTIVES ON THE RENMINBI

- **China is:**
  - **third largest trading nation**
  - **fourth largest economy**
  - **holder of the largest foreign exchange reserves**
- **Rising international status of the renminbi**
- **Major currency, reserve currency**

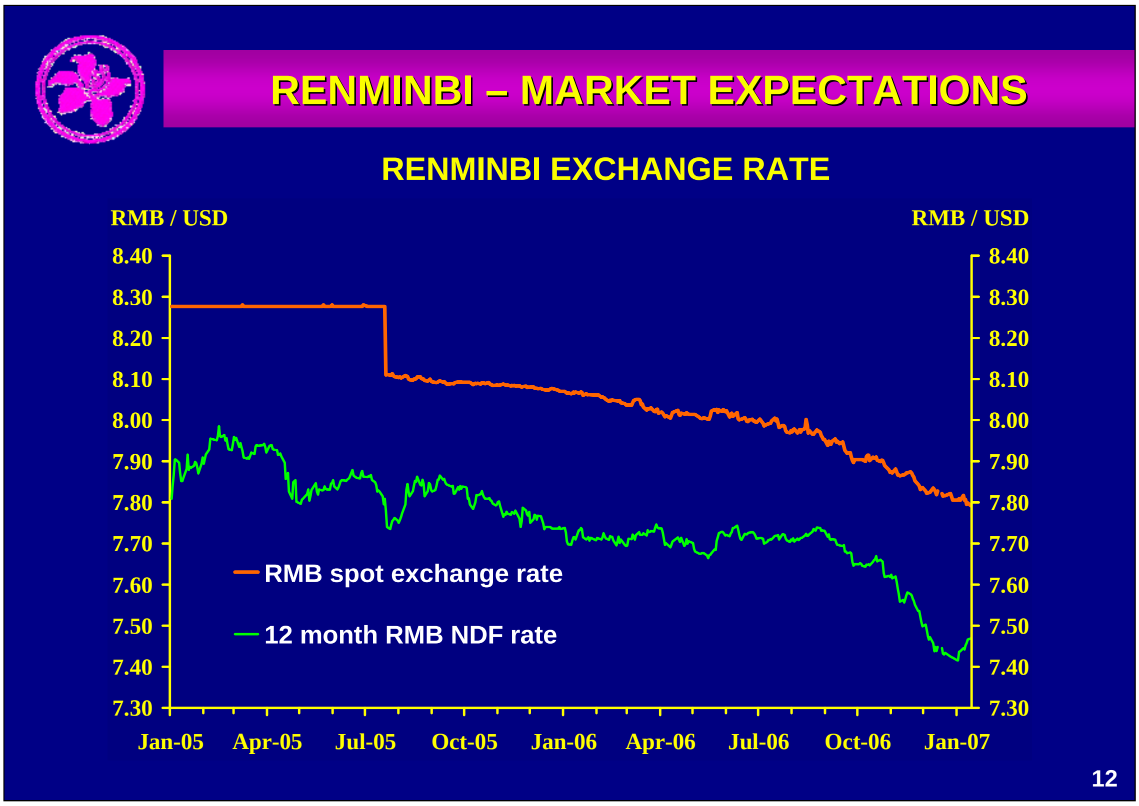
10

- Total trade: US$2,626bn (2006).
- GDP: US$1,761bn (2006).
- Foreign reserves: US$1,066bn (Dec 2006).
- As the Mainland economy grows rapidly with continued market liberalisation and increasing economic openness, the renminbi could evolve into a major international currency or even a reserve currency in the fullness of time.

STATUS OF RENMINBI – RELEVANT POLICIES

- 11th Five Year Plan (March 2006)
  - To improve the managed floating exchange rate system
  - To achieve renminbi convertibility for capital account items gradually
- National Finance Working Meeting (January 2007）
  - To further improve the renminbi exchange rate determination mechanism
  - To proceed with opening-up of capital markets in a paced manner
  - To strengthen and improve reserves management
  - To press ahead with reform, encourage outflows, strengthen supervision and explore new means to achieve objectives

11



- The renminbi spot exchange rate has continued to appreciate and shown greater flexibility.

- When the renminbi breached 7.85 per US dollar (the weak-side Convertibility Undertaking of the Hong Kong dollar) in late November 2006 and 7.80 per US dollar in January 2007, the impact on the Hong Kong dollar exchange rate was limited.

- The one-year renminbi non-deliverable-forward rate indicates that market participants expect the renminbi to surpass the Hong Kong dollar to reach 7.40 against the US dollar over the next 12 months, which is 4-6% “more expensive” than the Hong Kong dollar.

- The recent divergence in the spot exchange rates of the Hong Kong dollar and the renminbi, as well as the calm reaction in the Hong Kong dollar foreign exchange rate when the renminbi breached psychological levels, suggest that our efforts to manage market expectation and decouple the psychological relationship between the exchange rates of the two currencies have been quite successful. However, we will remain vigilant to the renminbi exchange rate movements.

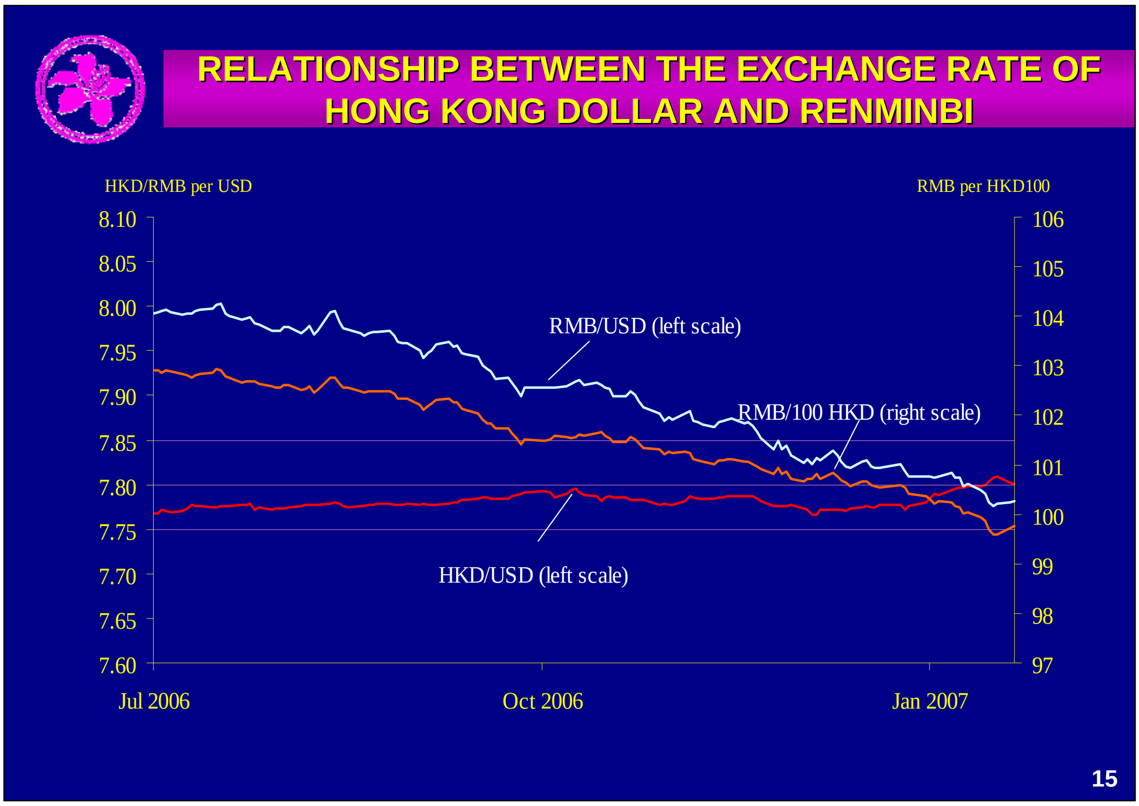
STATUS OF HONG KONG DOLLAR

- The Hong Kong dollar is the legal tender in the HKSAR (BL (Basic Law) Article 111).
- The issue of Hong Kong currency must be backed by a 100 per cent reserve fund (BL Article 111).
- No foreign exchange control policies (BL Article 112).
- The Hong Kong dollar shall be freely convertible (BL Article 112).
- The Exchange Fund shall be used primarily for regulating the exchange value of the Hong Kong dollar (BL Article 113).
- Status of the Hong Kong dollar is secure.

EXCHANGE RATE POLICY OF THE HKSAR

- Exchange rate stability is an appropriate policy for an extremely open economy.
- The Government is firmly committed to the Link, which has served Hong Kong well.
- The Link is the cornerstone of Hong Kong's monetary and financial stability.
- Business cycle synchronisation is higher between Hong Kong and the US than that between Hong Kong and the Mainland.
- The US dollar remains the most appropriate anchor for the Hong Kong dollar.
- Establishing a stable exchange rate between the Hong Kong dollar and renminbi is neither appropriate nor technically feasible.
- The Link is understood and supported by the international financial community.
- Market impact of renminbi appreciation on the Link has been minimal through effective management of market expectations.

14



- The renminbi appreciated beyond the 7.85 level (i.e. entering the Convertibility Zone of 7.75-7.85 of the Hong Kong dollar) on 27 November, 2006, breached the psychological level of 7.80 on 11 January, 2007, and "surpassed" the Hong Kong dollar on 15 January, 2007.

RELATIONSHIP BETWEEN THE EXCHANGE RATE OF HONG KONG DOLLAR AND RENMINBI

- **Market impact of the renminbi's breaching the psychological levels has been minimal, with no impact on confidence in the Link**
- **The illusion of the renminbi's being "bigger" than the Hong Kong dollar has only psychological effects**
- **Impact at the retail level should be temporary.**
- **No sign showing reverse flows of Hong Kong dollar banknotes from the Mainland back to Hong Kong**

16

- At the professional market, the impact of the renminbi breaching the psychological levels has been minimal, as the HKMA has managed market expectations effectively.

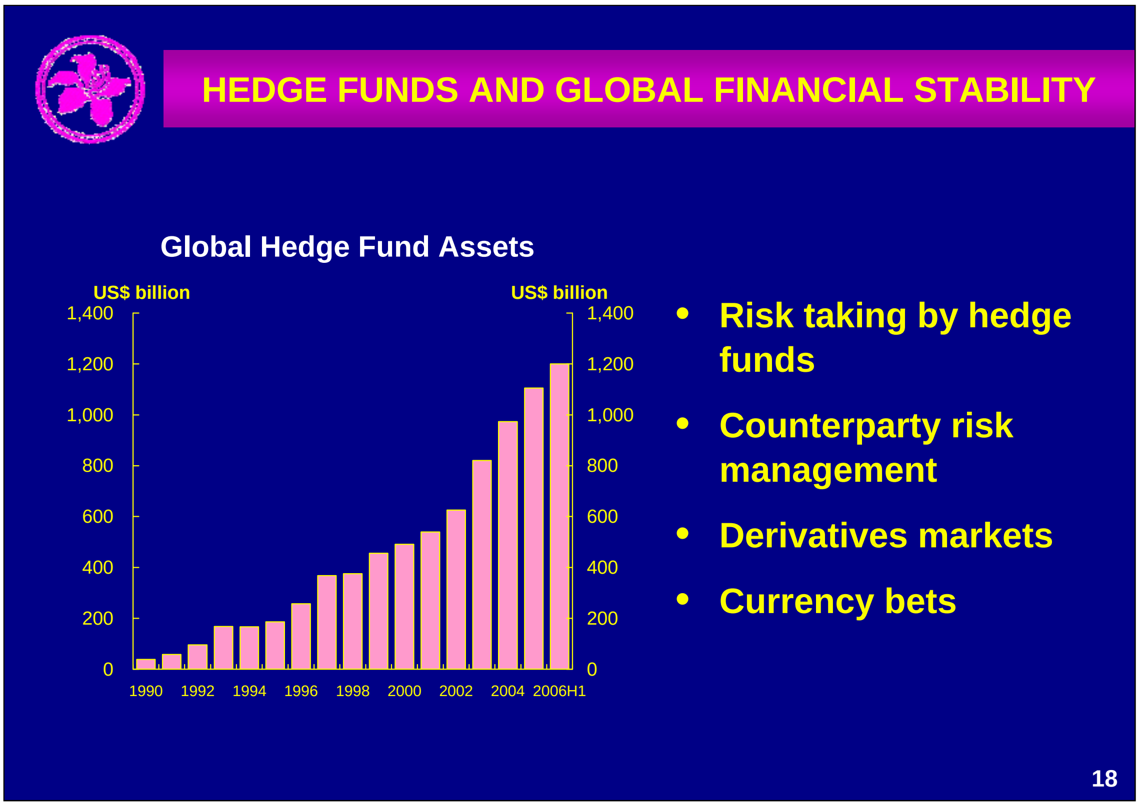
- The perception that the renminbi is "bigger" than the Hong Kong dollar has only psychological effects. It is always possible for any two independent currencies to reach parity, but it does not carry any special economic meaning and there is no "magic" about any particular level.

- At the retail level, when the market get used to a more flexible renminbi exchange rate against the US dollar (and hence against the Hong Kong dollar), the impact will likely dissipate quickly.

- There are two observations on the regional financial scene. First, economic buoyancy in the past years might have induced certain economic units (companies and financial institutions) to take on risks that they were not in a position to manage. Secondly, there had been increasing volatility driven by liquidity.

- The interaction of the two observations might result in three scenarios. First, to dampen volatility, some authorities might make surprising policy shifts that had financial stability implications, as in the case of Thailand. Secondly, some economic units which had been exposed to unmanageable risks might collapse, again raising financial stability concerns, a recent example being the events leading to bank runs in Taiwan. Thirdly, a more fortunate scenario would be for everybody to manage volatility without policy shifts.

- The probability of the first two scenarios had been increasing and we should be on the alert. In Hong Kong, the banking and monetary sector continued to be robust.



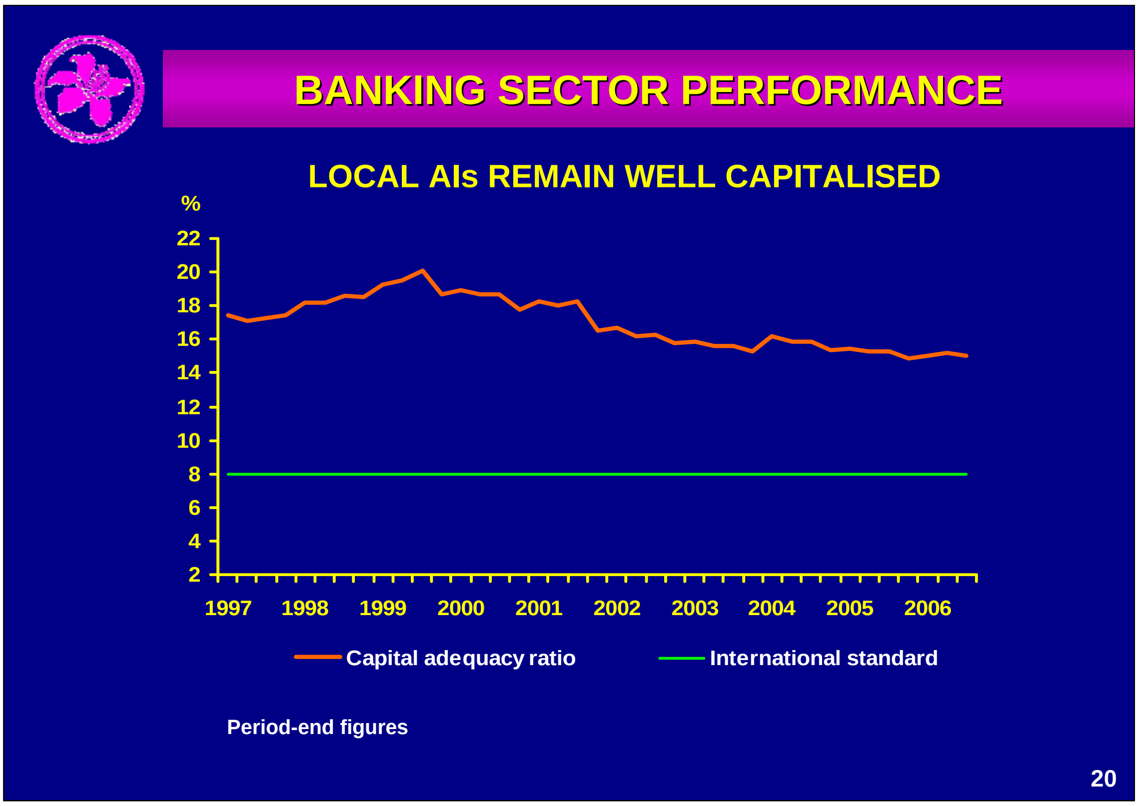
- Hedge funds have been growing rapidly in recent years. By mid-2006, their assets amounted to US$1.2 trillion globally. In Hong Kong, total hedge fund assets under management stood at US$33.5 billion in March 2006.
- The strong growth in hedge funds warrants close monitoring because risk taking by hedge funds is often excessive but difficult to monitor, e.g., the problem with Amaranth Advisors, with reported loss of US$6 billion in September 2006.
- Research suggests that the systemic risks associated with hedge funds cannot be diversified away by investing in different types of hedge funds. The systemic implication is that when one type of hedge funds fails during extreme market conditions, other types of hedge funds with different strategies are also likely to fail or perform poorly.
- Hedge fund trading in over-the-counter credit and equity derivatives markets is also a concern since these activities are hard to monitor and many stock markets around the world are at their historical peaks. Any considerable backlog in the confirmation of over-the-counter trading contracts is potentially very destabilising.
- Banks in Hong Kong are alert to the potential problems and are managing them well.

Risks to Currency Stability – Domestic Factors

- **Domestic environment largely favourable**
- **Sustainable economic growth and declining unemployment rate**
- **Stable inflation outlook**
- **Healthy balance of payments**
- **Stable property market**
- **Improving fiscal position**

19

- Details shown at the annex.



- The banking sector remained well capitalised. At the end of September 2006, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions was about 15%, well above the statutory requirement and international standard of 8%.

BANKING SECTOR PERFORMANCE

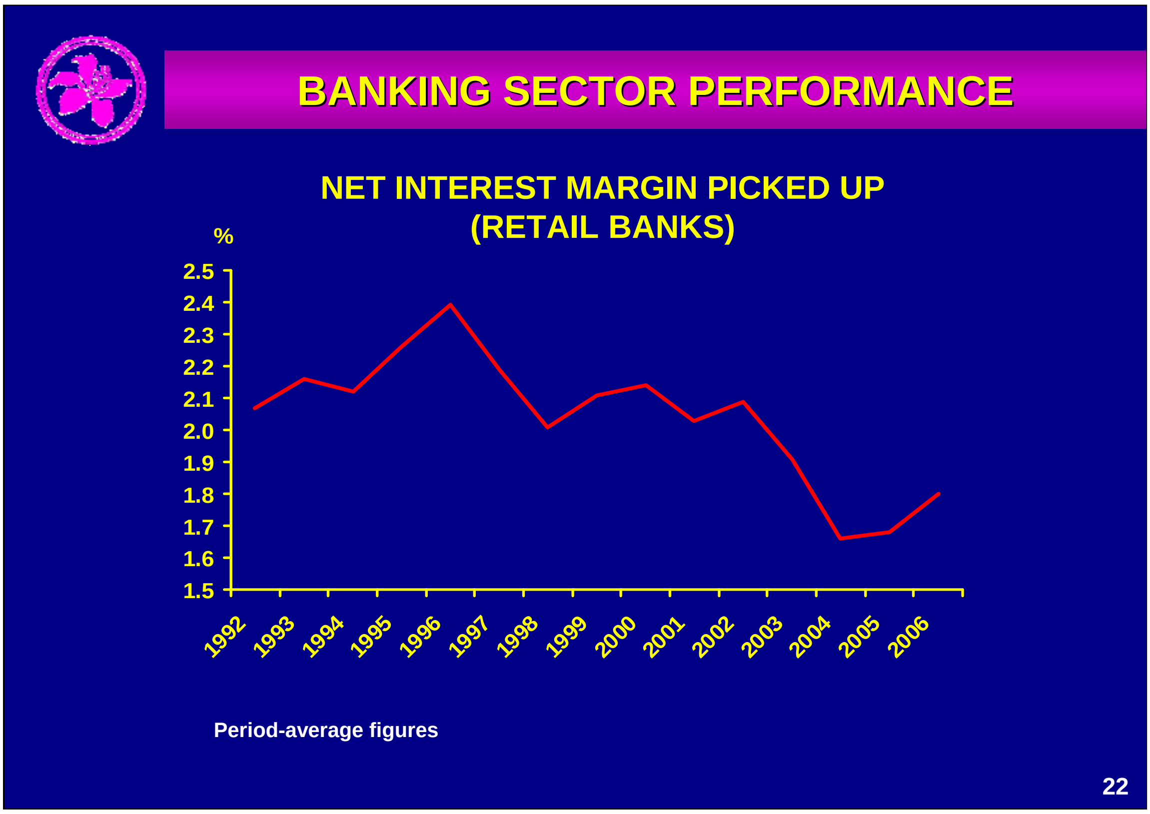
PROFIT GROWTH (RETAIL BANKS)

	2006*	2005
Growth in pre-tax operating profit	+10.1%	+8.2%
Bad debt charge as % of average total assets	0.02%	-0.01%
Cost-to-income ratio	42.7%	41.9%
Net interest margin	1.80%	1.68%

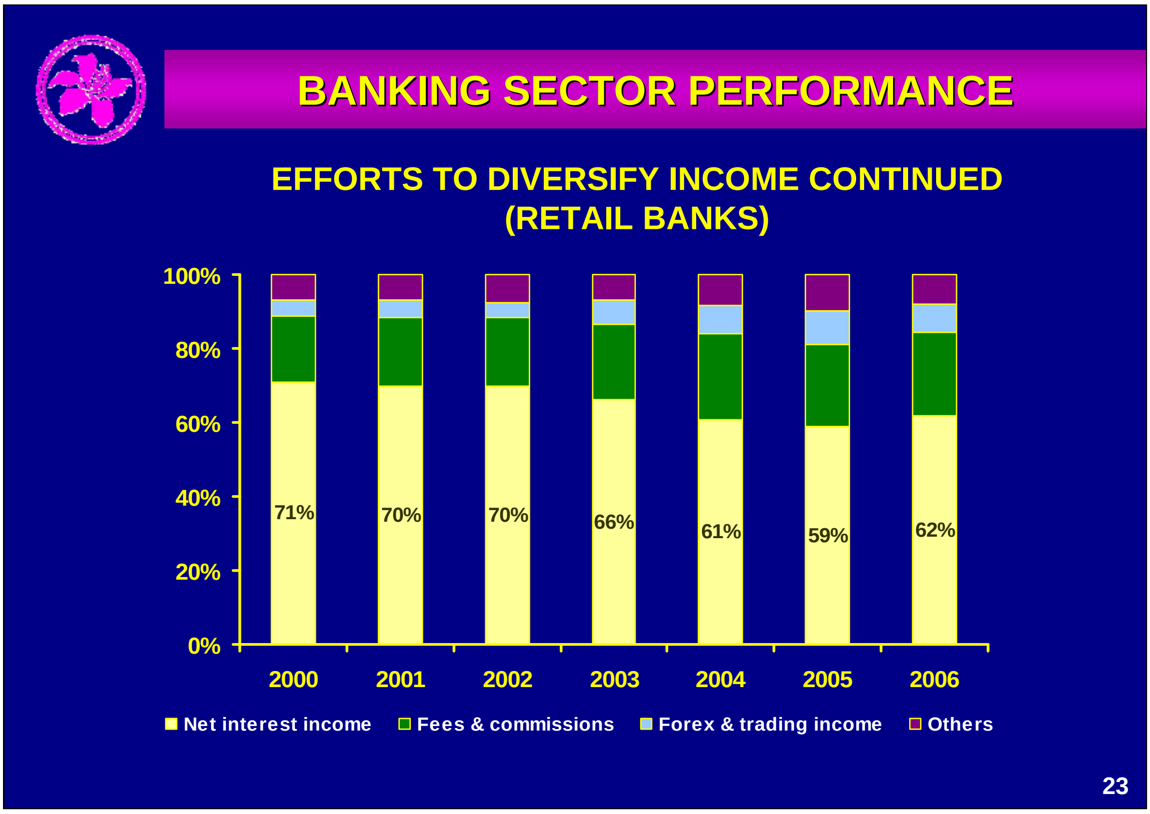
*Preliminary figures

21

- The pre-tax operating profits of retails banks further increased. Net interest income also increased, reflecting both an expansion of assets and recovery in interest margin.
- Banks were making new bad debt provision in the year instead of having provision write-back in previous year.
- Cost-to-income ratio increased due to increasing operating cost.

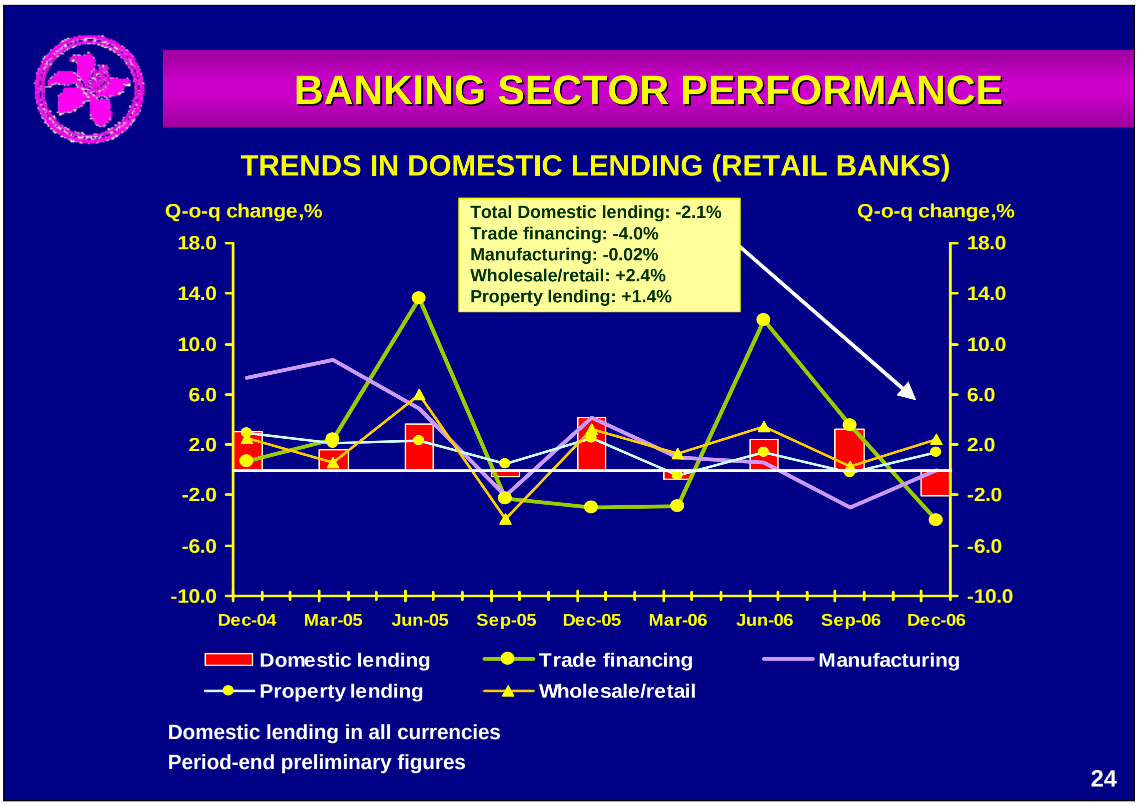


- Net interest margin rose to 1.80% in 2006 from 1.68% in 2005 due to a recovery in lending margins and a faster increase in net interest income than in average interest-bearing assets.



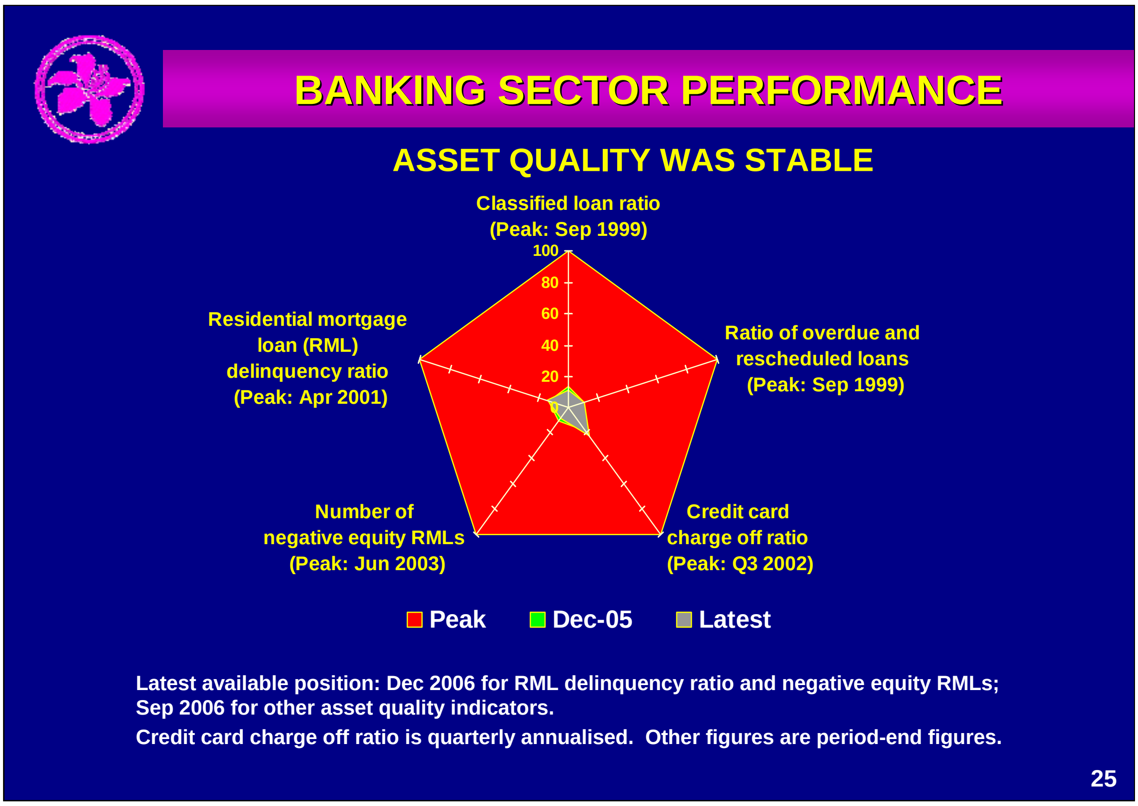
- Pressure on interest spreads in a competitive environment has prompted banks to explore new lines of business for income diversification.

- Net interest income (62% of total income) was still the major income source of retail banks, followed by fees & commissions which constituted 23% of total income.



- Year-on-year, domestic loans rose by 2.8% in 2006, much of which was property-related lending, trade finance and loans to the wholesale and retail trade sector.

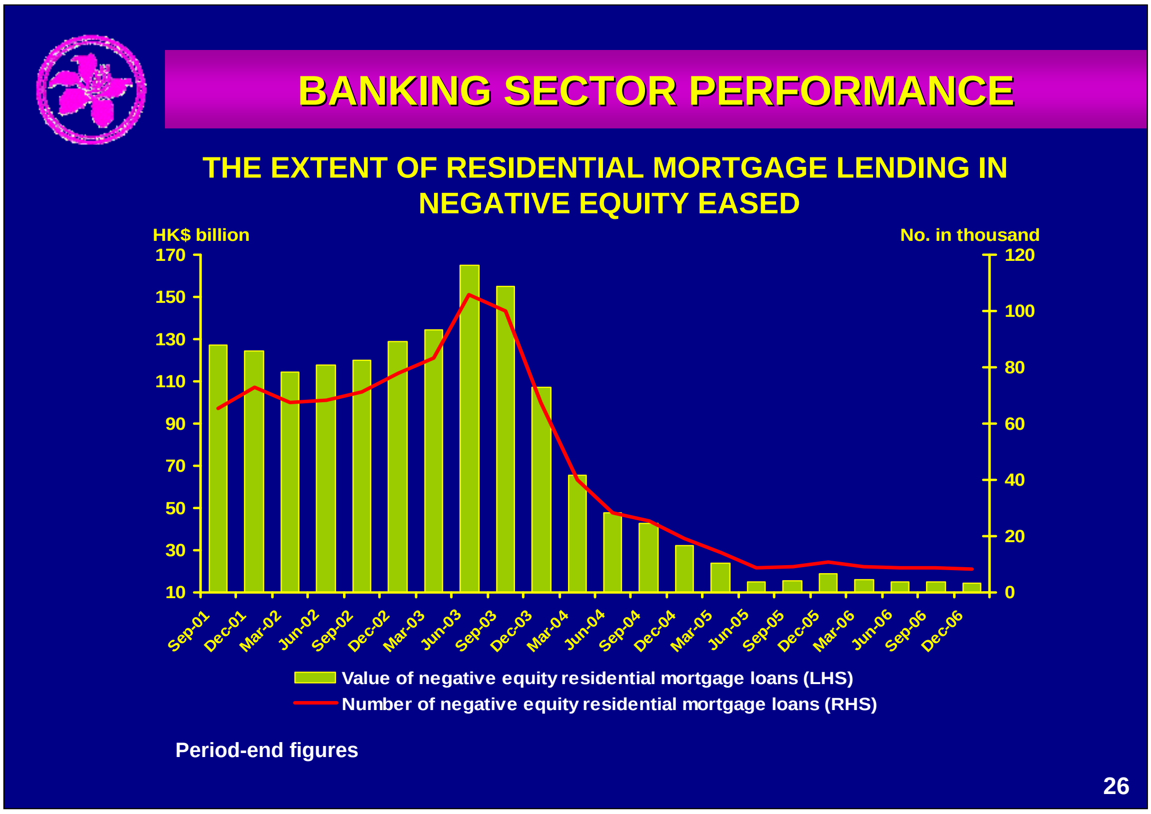
- The quarter-on-quarter decline in lending in the final quarter of 2006 was due to lending having been exceptionally high in the previous quarter owing to IPO-related activities (i.e. lending for share purchase and to stockbrokers).



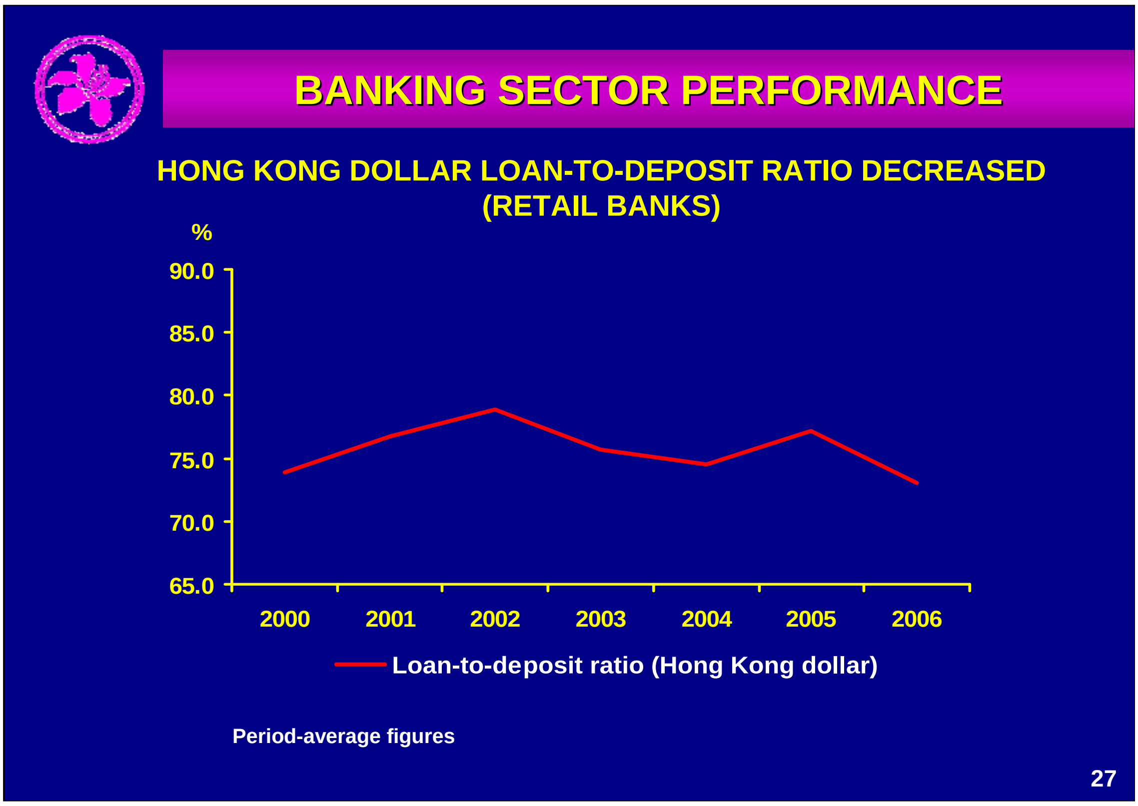
- Overall asset quality showed further improvement with the classified loan ratio and the overdue loan ratio moving down to a new low of 1.19% and 0.65% respectively at the end of September.

- The delinquency ratio of credit card lending was 0.40% at the end of September 2006 and that for mortgage lending was 0.20% at the end of December 2006.

- Despite the positive overall picture, there have been some early warning signs about the quality of credit card portfolios. There was a slight rise in the year-to-date annualised credit card charge-off ratio to 3.02% in 2006 Q3 from 2.81% in 2005 due to write-offs in relation to bankruptcy petitions. There was also an increase in the amount delinquent for more than 90 days. These trends warrant careful monitoring.



- The number of residential mortgages in negative equity decreased to some 8,400 cases (HK$14 billion) at the end of 2006 from 8,800 cases (HK$15 billion) at the end of September 2006. It was down by 92% from the peak (106,000 cases valued at $165 billion) in June 2003.



- The Hong Kong dollar loan-to-deposit ratio of retail banks declined from its 2005 level, reflecting the abundant liquidity in the banking system.

- The ratio for 2006 was 73%, compared with 77% in 2005, as growth in deposits outpaced the increase in loan demand.

- Underpinned by sound financial positions and high capital levels, the banking sector remains strong.

- With the introduction of Basel II, the ability of banks to identify, monitor and control their risks will be significantly improved.

- However, the current high levels of liquidity in the banking system create risks that need careful monitoring. With deposits growing faster than loan demand, banks' loan-to-deposit ratios are likely to remain relatively low in the foreseeable future.

- One consequence of abundant liquidity is the intense competition seen in some markets, e.g. mortgage lending. Although this benefits customers, bank management will need to ensure that the pricing of loans needs to properly reflect the underlying risks.

- Intense competition may also put pressure on banks to relax their normal credit appraisal and approval processes. This could lead to more bad loans over the longer term. There is a need to make sure that the current high standards for credit underwriting are maintained by banks.

- Intense competition in the domestic market is likely to result in more banks seeking profit opportunities overseas. Regulatory changes permitting Hong Kong banks to establish subsidiaries on the Mainland will accelerate this trend further.

- The Banking (Capital) Rules and Banking (Disclosure) Rules came into effect on 1 January 2007. Hong Kong is in the first wave of jurisdictions introducing the new Basel II standards, which is important to the robustness and stability of the banking system and success of Hong Kong as an international financial centre.

- As required under the Banking Ordinance, the Administration has established the Capital Adequacy Review Tribunal. This independent body will review, on application by institutions, the decisions made by the Monetary Authority under the Banking (Capital) Rules in relation to the choice of approaches for the calculation of credit, market and operational risks.

- Parallel reporting of both the new and existing capital adequacy ratio returns is in progress to allow banks to familiarise with the new reporting requirements and facilitate impact assessment. Data for the end of September 2006 indicates that the overall impact of Basel II on the Capital Adequacy Ratio (CAR) of the banking sector is within expectation. The overall impact on the sector is not large and the average CAR of locally incorporated AIs has shown only a slight decrease, given the additional operational risk capital charge under the revised regime.

- Authorised institutions (AIs) will continue to enhance their risk management to achieve the underlying aim of Basel II. The HKMA will continue to remind AIs to pay greater attention to risks and improve risk management. The HKMA will issue general supervisory guidance on the application of the Rules and to update the existing Supervisory Policy Manual to align with the Basel II requirements.

BANKING SECTOR - WORK PROGRESS

Anti-money-laundering (AML) and Counter-terrorist-financing (CFT)

- **Industry Working Group & three User Sub-groups working on specific issues to share AML/CFT experience and develop industry practices**
- **Amendment of AML/CFT guidelines to implement FATF Special Recommendation VII**
- **Preparation for FATF's mutual evaluation of Hong Kong – to be conducted in November 2007**
- **Consolidation and refinement of existing AML/CFT guidelines**

30

- The Industry Working Group, chaired by the HKMA with 20 representatives from authorised institutions (AIs) was established in June 2006 as a forum for sharing AML/CFT experience and addressing AML/CFT issues and challenges faced by the industry. The Working Group meets on a quarterly basis. Three User Sub-groups, comprising mainly industry representatives, were formed under the Working Group to develop industry standards and best practices for transaction-monitoring and customer due diligence issues. The User Sub-groups will update the Working Group on their work progress from time to time.

- The HKMA announced on 22 November 2006 revised requirements on implementing Special Recommendation VII of the Financial Action Task Force on Money Laundering ("FATF") relating to wire transfers. AIs are required to include the address of the originating customer in addition to the name and account number (or failing this, the customer's date of birth, or the number of identity document) in the message of a cross-border remittance transaction of HK$8,000 or more from 2 January 2007.

- The FATF has begun the third round of mutual evaluations of its member jurisdictions since 2004. The mutual evaluation exercise for to Hong Kong will be conducted in November 2007. The HKMA is working with the Administration to ensure that the banking sector complies, to the extent possible, with the FATF standards.

- The HKMA plans to conduct, later this year, a thorough review of its AML/CFT guidelines and consolidate them into a single supervisory guideline.

BANKING SECTOR
DEPOSIT PROTECTION SCHEME (DPS)

- **The HKMA continues to assist the Hong Kong Deposit Protection Board**
- **In 2007, the Board will focus on**
  - **monitoring compliance of Scheme members with the Board's rules and guidelines**
  - **refining the payout system and procedures**
  - **managing the DPS Fund**
  - **increasing public awareness and understanding of the DPS**

31

- After the launch of the Deposit Protection Scheme (DPS) in September 2006, the HKMA continues to assist the Hong Kong Deposit Protection Board in maintaining and administering the DPS.

- In 2007, the Board will focus on:-

  – monitoring compliance of Scheme members with the Board's rules and guidelines, particularly the Representation Rules which specify how Scheme members should inform customers of their DPS membership status and whether their deposit products are protected by the DPS;

  – refining the payout system and procedures;

  – managing the DPS Fund in accordance with the DPS Ordinance; and

  – carrying out activities to promote a high level of public awareness and understanding of the DPS.

MARKET INFRASTRUCTURE

- **The projects and business initiatives arising from the Review of Financial Infrastructure Development and Review on Debt Market Development are making good progress**
- **Project Development**
  - **Migration to SWIFTNet in progress**
  - **Link between Hong Kong's US dollar RTGS system and Malaysia's ringgit RTGS system launched in November 2006**
  - **Electronic trading platform being developed**

32

- Migration to SWIFTNet. A project to replace the existing proprietary platform for the RTGS systems and the Central Moneymarkets Unit by an open platform to improve compatibility with overseas systems is in progress. The use of an open platform will facilitate overseas financial institutions to make use of the payment and settlement systems in Hong Kong. This is beneficial to the development of Hong Kong as a payment and settlement hub in the region. The migration is expected to take place by 2008 Q1.

- The link between Hong Kong's US dollar RTGS system and Malaysia's ringgit RTGS system was launched on 13 November 2006. It is the first cross-border Payment versus Payment (PvP) link in Asia. The operation of the link has been smooth. It is conducive to the development of Hong Kong as a regional payment and settlement hub.

- Electronic trading platform The HKMA is working with the Treasury Markets Association to establish an electronic trading platform for Exchange Fund Bills and Notes to increase transparency of prices and transactions and facilitate straight-through processing from trading to clearing and settlement.

MARKET INFRASTRUCTURE

- **Issue of Renminbi Bonds**
  - **Improvements to the Central Moneymarkets Unit system and Renminbi Settlement System are in progress to facilitate settlement of transactions**
  - **Upon launch by end-February 2007, Hong Kong will be the only place outside the Mainland that can conduct Delivery-versus-payment (DvP) settlement of Renminbi bonds**

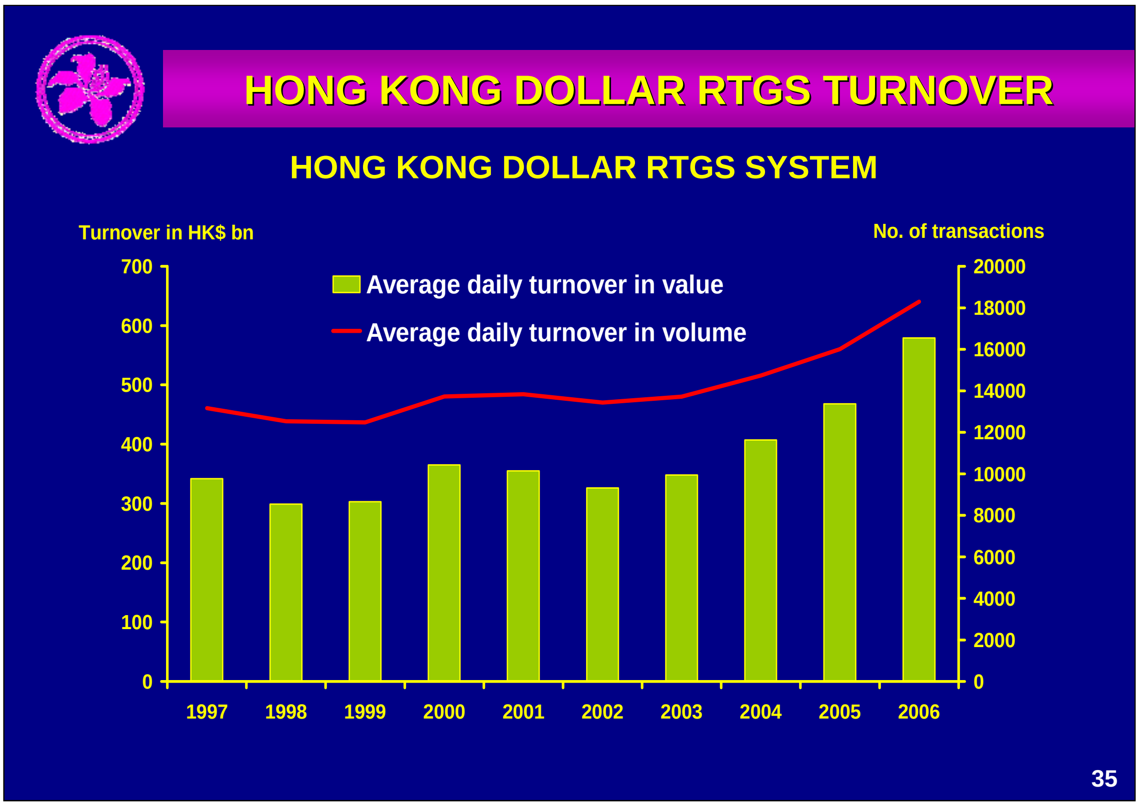
33

- The issue of RMB bonds will further promote economic integration between Hong Kong and the Mainland, develop the local debt market and help building a diversified multi-currency financial infrastructure. All these will enhance Hong Kong's role as an international financial centre.
- Improvements will be made to the Central Moneymarkets Unit and Renminbi Settlement System to permit allotment, redemption and delivery-versus-payment (DvP) functions for RMB bonds, as well as interbank fund transfers.
- The target launch date of the renminbi RTGS is end-February 2007.

- Marketing calls were made in Mainland China and other Asian economies to encourage financial institutions in the region to use Hong Kong's platform to settle US dollar and euro transactions.

- The HKMA is exploring opportunities with other Asian economies to establish links with our RTGS systems and the Central Moneymarkets Unit

- One way to develop Hong Kong into a regional payment and settlement hub is to strengthen regional correspondent banking business in Hong Kong. System development is underway to make use of the US dollar and euro payment systems as conduits for channelling cross-border payments in the region through Hong Kong.



- The average daily Hong Kong dollar RTGS turnover in 2006 was $579 billion, an annual increase of 24%.

- The turnover reached a record high of $1.37 trillion on 27 October 2006 when the Industrial and Commercial Bank of China (ICBC) was listed. This amount was close to Hong Kong's entire GDP for 2005. The system handled the large fund flows efficiently.

MARKET INFRASTRUCTURE

Oversight of the clearing and settlement systems

- **All designated systems remain in compliance with the safety and efficiency requirements of the Clearing and Settlement Systems Ordinance**
- **The Process Review Committee concluded that the HKMA has followed duly the internal operational procedures and been fair in carrying out its oversight of the designated payment systems**
- ***A Code of Practice for Payment Card Scheme Operators,* endorsed by HKMA, was issued by eight credit and debit card scheme operators in December 2006.**

36

- The HKMA designates four local payment systems and one international system under the Clearing and Settlement Systems Ordinance (CSSO). Having completed its second annual oversight cycle, the HKMA concluded that all designated systems are in compliance with the safety and efficiency requirements.

- The Process Review Committee, an independent committee to review the processes and procedures of the HKMA's responsibility in payment system oversight, submitted its annual report to the Financial Secretary.

- To promote the safety and efficiency of operation and to foster public confidence in the retail payment systems, the HKMA encourages the retail payment industry to adopt a self-regulatory approach.

- A Code of Practice for Payment Card Scheme Operators was drawn up and issued by eight major credit and debit card scheme operators in December 2006. This is the first of its kind for the credit and debit card industry in Hong Kong. This Code, effective on 1 January 2007, was endorsed by the HKMA. A self assessment report will be submitted to the HKMA by the eight operators annually.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

Regional Co-operation

- Focuses on promoting regional co-operation, with a view to maintaining financial stability of the region and Hong Kong
- Enhances co-operation with central banks in the region on bond market development, monitoring of cross-border fund flows and crisis management

Mainland Co-operation

- Focuses on matters relating to Mainland's financial activities, so as to further enhance the status of Hong Kong as an international financial centre

37

On regional co-operation:

- With increasing economic and financial integration of the region, the HKMA participates actively in regional collaborative initiatives to promote the financial stability of the region, and therefore of Hong Kong.

- Regional co-operation focuses on bond market development, monitoring of cross-border fund flows and crisis management. The active participation of HKMA in these areas of co-operation will help to establish our leading position as a financial centre in the region.

On Mainland co-operation:

- The Mainland's need for financial services is increasing with the rapid development of its economy, and at the same time, the Mainland is pressing ahead with financial reform. These will have profound impact on the status of Hong Kong as an international financial centre. Thus, the work of HKMA focuses on matters relating to Mainland's financial activities.

MAINLAND'S MAJOR FINANCIAL POLICIES (1)

11th Five-Year Plan, Chapter 33: Expediting financial reform

- **To deepen reform of financial enterprises**
- **To speed up development of direct financing channels**
- **To enhance mechanisms for financial and monetary control and management**
- **To improve financial sector supervision system**

38

- Chapter 33 of the 11th Five-Year Plan has set out clearly the policy direction for expediting financial reform, and the related measures cover four main areas:

  (i) to deepen the reform of financial enterprises, improve corporate governance of financial institutions, and develop different forms of ownership for financial enterprises steadily;

  (ii) to speed up the development of direct financing channels, such as the equity and bond markets, and to develop futures markets gradually;

  (iii) to enhance the mechanisms for financial and monetary control and management, which includes developing money markets and introducing renminbi convertibility for capital account items in a gradual manner; and

  (iv) to improve financial sector supervision, establish proper mechanism for co-ordination between the banking, securities, insurance regulatory bodies and macroeconomic management bodies.

- The National Finance Working Meeting concluded on 20 January has set out six priority tasks for financial development going forward:

(i) To deepen reform of stated-owned banks and speed up establishment of a modern banking regime. This includes: continued deepening of the reform of those state-owned banks that are already listed, and proceeding with the shareholding reform of the Agricultural Bank of China, the commercialisation of China Development Bank and the reform of commercial banks and financial asset management companies.

(ii) To speed up reform and development of rural finance and improve the rural financial system; to enhance credit and insurance services provided to the rural areas in support of the establishment of a new socialist rural system.

(iii) To intensively develop capital markets and insurance market and establish a multi-dimensional financial market system. This includes: to increase the scale and proportion of direct financing, to enhance the quality of listed companies and tighten disclosure requirements; to speed up development of the bond market, focussing on corporate bonds; and to proceed with further reform of the insurance industry.

(iv) To utilise fully the role of financial services and financial management for a balanced economic and social development of the economy. This includes: to reasonably manage the level of money and credit supply and enhance credit structure; to increase support to small and medium sized enterprises; to proceed with reform of the interest rate market in a paced manner; to further enhance the exchange rate determination mechanism; to strengthen management of foreign reserves and explore new means for the use of reserves; and to take co-ordinated measures to achieve balance in the external account.

(v) To actively and prudently open up financial service industries. This includes: to prudently proceed with the opening up of capital markets, to promote a level-playing field for domestic and foreign financial enterprises; and to continue to promote financial cooperation between Mainland and Hong Kong and Macau.

(vi) To enhance financial supervision, strengthen corporate governance and ensure financial stability and soundness; and also to strengthen monitoring of short-term cross-border fund flows particularly those of a speculative nature.

MAINLAND'S STANCES ON HONG KONG'S FINANCIAL MATTERS

11th Five-Year Plan (March 2006)

- Support Hong Kong in developing financial service industries
- Maintain status of Hong Kong as an international financial centre

National Finance Working Meeting (Jan 2007)

- Continue to promote Mainland's financial co-operation with Hong Kong and Macau

40

- The stances regarding Hong Kong's financial matters as presented in recent documents on national financial strategy are noteworthy:
  - The summary document of the 11th Five-Year Plan released in March 2006 mentions "support Hong Kong in developing financial, logistics, tourism and information industries" and "maintain the status of Hong Kong as an international centre of finance, trade and maritime".
  - The National Finance Working Meeting concluded in January this year stated that there is a need to "continue to promote the Mainland's financial co-operation with Hong Kong and Macau.
- In light of the increasing economic and financial integration between Hong Kong and the Mainland, the way forward is about how to combine Mainland's financial needs with Hong Kong's competitive edge. This requires developing an appropriate blueprint for Hong Kong to play a more important role in the country's financial matters while at the same time enhancing the status of Hong Kong as an international financial centre, thereby leading to a win-win outcome.

HONG KONG'S ROLE IN MAINLAND'S WORK ON FINANCIAL MATTERS

- **Hong Kong's developed financial platform can provide diversified financial services for the Mainland, help to enhance the Mainland's financial intermediation efficiency, and act as pulling force for the development of Mainland's financial centres**
- **As an international financial centre, Hong Kong can help the Mainland in channelling two-way cross-border financial flows, thereby achieving better external balance**
- **Hong Kong's financial markets provide a relatively advanced testing platform for the renminbi's gradual move towards full convertibility and internationalisation**

41

- Hong Kong's financial platform has reliable financial infrastructures and a supervisory framework of international standard. By linking the financial markets of the two places gradually, Hong Kong can provide diversified financial services for the Mainland, help to enhance Mainland's financial intermediation efficiency, and act as pulling force for development of Mainland's financial centres.
- In accordance with the Mainland's policy of allowing orderly and prudent increases in capital outflows, Hong Kong can be used as a platform for such outflows, thereby helping the Mainland to achieve better external balance.
- With the Mainland economy becoming one of the largest in the world, the increased use of the renminbi outside the Mainland is inevitable. Since 2004, Hong Kong has acquired experience of conducting renminbi business, and is able to provide a robust and reliable testing ground for renminbi's move towards increased use overseas and internationalisation.

ECONOMIC SUMMIT : "1-3-5" FINANCIAL DEVELOPMENT BLUEPRINT

Strategic perspective:	**Pursue one positioning - to develop Hong Kong as China's IFC of global significance**
Institutional perspective:	**Establish three-dimensional relationship - for the two financial systems within one country to have a complementary, cooperative and interactive relationship**
Practical perspective:	**Identify five areas - expand presence of Hong Kong financial institutions on the Mainland; Increase outward mobility of Mainland's investors, fund-raisers, financial institutions and instruments via Hong Kong; allow Hong Kong financial instruments to be traded on the Mainland; enhance capability of Hong Kong in handling financial transactions denominated in renminbi; strengthen financial infrastructural linkages between Hong Kong and the Mainland**

42

- The HKMA participated actively in the discussion of the Focus Group on Financial Services of the Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong", and has proposed a "1-3-5" blueprint for financial development. The blueprint was adopted by the Focus Group and incorporated in its report submitted to the Chief Executive of the HKSARG on 15 January.

- The blueprint consists of:

  – From a strategic perspective: to pursue a positioning of Hong Kong as China's international financial centre of global significance, that is, comparable to New York and London, in response to intensifying global competition. This can help to enhance the country's overall strength, its resilience to risks and say in international financial issues.

  – From an institutional perspective: to establish a three-dimensional (complementary, cooperative and interactive) working relationship between the two financial systems in Hong Kong and the Mainland, under "One Country, Two Systems". "Complementary" means that the respective strengths are exploited and weaknesses are addressed; "Co-operative" means enhancing co-operation in terms of financial supervision, risk management and technical transfers etc; "Interactive" means that the two financial systems should interact to develop the country's financial centres and to pursue the best interests for the country internationally; and

  – From a practical perspective: to gradually link the financial markets in the two places in five areas, with Hong Kong acting as a pulling force for the development of financial centres on the Mainland, thereby enabling Hong Kong to make greater contribution to financial intermediation on the Mainland.

NEW CATEGORY OF RENMINBI BUSINESS IN HONG KONG

- **Mainland financial institutions can issue renminbi-denominated financial bonds in Hong Kong**
- **People's Bank of China is working on related administrative rules:**
  - **Approval criteria applicable to mainland financial institutions issuing bonds in Hong Kong**
  - **Quota management**
  - **Other details related to Mainland's regulation**
- **Primary and secondary market activities in Hong Kong will be conducted in accordance with existing market practices in Hong Kong; discussion on-going with market practitioners on details**
- **Renminbi Real Time Gross Settlement (RTGS) system in Hong Kong to be established by end-February**

43

- The State Council announced its agreement to a further expansion of renminbi business in Hong Kong on 10 January. Mainland financial institutions, upon obtaining approval, can issue renminbi-denominated financial bonds in Hong Kong.
- People's Bank of China is working on related administrative rules, which will mainly cover matters regarding the approval criteria applicable to financial institutions seeking to issue bonds in Hong Kong, quota management and other details such as application and approval procedures on the Mainland.
- The sale and distribution of the renminbi bonds, trading, settlement and custody and pricing in Hong Kong will be conducted in accordance with existing market practices in Hong Kong. The HKMA is in discussion with market practitioners on the details.
- It is expected that the Hong Kong renminbi Real Time Gross Settlement (RTGS) system will become operational by end-February.

RENMINBI BOND MARKET IN HONG KONG

- **Higher returns for renminbi depositors**
- **Diversification in renminbi assets for banks**
- **Additional capability of handling renminbi denominated bond trading for the Hong Kong financial system**
- **Renminbi bonds to be issued outside Mainland for the first time**

44

- For investors in Hong Kong, renminbi-denominated financial bonds offers a new investment choice, and it is the first time that renminbi bonds can be purchased directly by residents outside the Mainland.

- For the banking industry in Hong Kong, the new category of renminbi business will not only provide new business opportunities but also the diversification of their renminbi assets. Banks can invest in renminbi bonds in addition to placing their customer deposits with the clearing bank.

- With the introduction of the renminbi bonds, the use of renminbi in Hong Kong's financial system will expand to the bond channel in addition to the banking channel. This is a milestone and will greatly enhance the capability of Hong Kong's financial system in handling renminbi-denominated transactions. Upon the establishment of the renminbi Real Time Gross Settlement (RTGS) system, there will be RTGS systems for four currencies in Hong Kong (Hong Kong dollar, US dollar, Euro and renminbi), and this gives Hong Kong a competitive advantage.

- Also, this will be the first time renminbi bonds are issued outside the Mainland. From the Mainland's perspective, it will set a precedent for bonds to be issued in its domestic currency outside its jurisdiction. At present, only a few major economies are able to do this. The further development of the renminbi bond market in Hong Kong can serve as a trial for the use of renminbi in international financial transactions and the eventual internationsation of renminbi.

EXCHANGE FUND

- The Exchange Fund is not a pure investment fund
- The Exchange Fund Ordinance specifies the statutory objectives of the Exchange Fund
  - affecting the exchange value of the currency of Hong Kong
  - maintaining the stability and integrity of the monetary and financial systems of Hong Kong
- Investment of the Exchange Fund has to be consistent with the statutory objectives of the Fund
- It is not appropriate to compare the investment return of the Exchange Fund with that of other investment funds
- The proper comparison should be made between the actual return of the Exchange Fund with the return of the benchmark portfolio

45

INVESTMENT OBJECTIVES OF THE EXCHANGE FUND

Investment objectives of the Exchange Fund:

(1) to preserve capital;

(2) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid US dollar denominated assets;

(3) to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and

(4) subject to (1) – (3), to achieve an investment return that will preserve the long-term purchasing power of the Fund.

46

BENCHMARK PORTFOLIO OF THE EXCHANGE FUND

Benchmark Portfolio

– Asset mix	Bonds	77%
	Equities	23%
– Currency mix	US dollar	88%
	Non-US dollar	12%

Risk Management: a number of limitations (credit, concentration, liquidity and other risks)

47

- Based on the investment objectives of the Exchange Fund and the permissible investment markets, an investment benchmark is established as the long-term strategic asset allocations for the Fund.

- The Exchange Fund's investment strategies are less conservative than that of many of our peer-group central banks. Many of them do not invest in equities.

MANAGEMENT OF THE EXCHANGE FUND

Evaluation of investment performance

	Return on benchmark portfolio (%)	Actual return (%)	Alpha (%)
1999	5.5	10.8	5.3
2000	3.8	4.8	1.0
2001	0.4	0.7	0.3
2002	3.9	5.1	1.2
2003	9.5	10.2	0.7
2004	5.7	5.7	0.0
2005	2.9	3.1	0.2
2006	8.9	9.5	0.6

48

- The investment return of the Exchange Fund has exceeded the benchmark return in every year except in 2004 for the past eight years.

- In 2006, the Exchange Fund achieved an investment return of 9.5%, which was 63 basis points higher than the return of the investment benchmark portfolio. This is equivalent to HK$6.6 billion, or almost 10 times HKMA's administrative expenditure in 2006.

INVESTMENT INCOME

(HK$ billion)	2006[1]	2005	2004	2003
Gain on Hong Kong equities *	35.9	7.0	12.0	21.2
Gain on other equities *	20.0	20.5	11.2	26.8
Exchange gain/(loss)	17.3	(19.5)	8.5	22.9
Return from bonds #	30.5	29.8	25.0	18.8
Investment income	103.7	37.8	56.7	89.7

* Including dividends

\# Including interest

1 Unaudited figures

49

- Investment income for 2006 amounted to HK$103.7 billion.
- In 2006, despite declining bond prices, the bond investments recorded a total net gain of HK$30.5 billion.
- Major global equity markets performed well in 2006. Gains from Hong Kong and foreign equity markets together was HK$55.9 billion, accounted for about 54% of the total investment income.
- In 2006, additional external fund managers were appointed to manage sophisticated investment products and more active managers were employed to manage equity portfolios. The additional appointment of external fund managers is conducive to the strategic development of the investment management of the Exchange Fund and has helped to generate positive returns, although it would cause increases in the management and custodian fees.

TREASURY'S SHARE AND ACCUMULATED SURPLUS

(HK$ billion)	2006 * Full year	2006 * Q4	2006 * Q3	2006 * Q2	2006 * Q1	2005
Investment income	103.7	35.9	37.1	12.5	18.2	37.8
Other income	0.2	0.1	0.0	0.1	0.0	0.2
Interest and other expenses	(10.4)	(2.6)	(2.8)	(2.8)	(2.2)	(7.6)
Net investment income	93.5	33.4	34.3	9.8	16.0	30.4
Treasury's share	(28.9)	(9.9)	(10.3)	(3.4)	(5.3)	(10.1)
Carry to accumulated surplus	64.6	23.5	24.0	6.4	10.7	20.3
Adjustment due to HKAS 39 (1)	0.0	0.0	0.0	0.0	0.0	(0.6)
Increase in EF accumulated surplus	64.6	23.5	24.0	6.4	10.7	19.7

Note 1: The effect of changing from using mid-price to bid-price for valuing securities held, and ask-price for valuing securities issued.

* *Unaudited figures*

50

- Accumulated Surplus of the Exchange Fund at the end of 2006 amounted to HK$508 billion. Fiscal Reserves placed with the Exchange Fund at the end of 2006 were about HK$324.5 billion.

- We expect the investment environment in 2007 to be challenging due to increasing risks in the global economy and financial markets. It would be very difficult, if not impossible, for the Exchange Fund to achieve the same investment performance as in 2006.

HISTORICAL FIGURES OF INVESTMENT INCOME, TREASURY'S SHARE AND ACCUMULATED SURPLUS

(HK$ billion)	2006*	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996
Investment income	103.7	37.8	56.7	89.7	47.0	7.4	45.1	103.8	93.8	35.6	25.4
Other income	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Interest and other expenses	(10.4)	(7.6)	(4.8)	(5.6)	(7.0)	(10.5)	(11.0)	(10.0)	(16.0)	(18.4)	(12.9)
Net investment income	93.5	30.4	52.1	84.3	40.2	(2.9)	34.3	94.0	78.0	17.4	12.7
Treasury's share	(28.9)	(10.1)	(14.5)	(25.7)	(15.6)	(1.6)	(18.1)	(45.4)	(26.0)	N/A	N/A
Revaluation gain/(loss) on premises	N/A	0.0	0.9	(0.9)	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Carry to accumulated surplus	64.6	20.3	38.5	57.7	24.6	(4.5)	16.2	48.6	52.0	17.4	12.7
Adjustment to accumulated surplus											
Effect of implementation of HKAS 39	0.0	(0.6)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Increase/(Decrease) in EF accumulated surplus	64.6	19.7	38.5	57.7	24.6	(4.5)	16.2	48.6	52.0	17.4	12.7

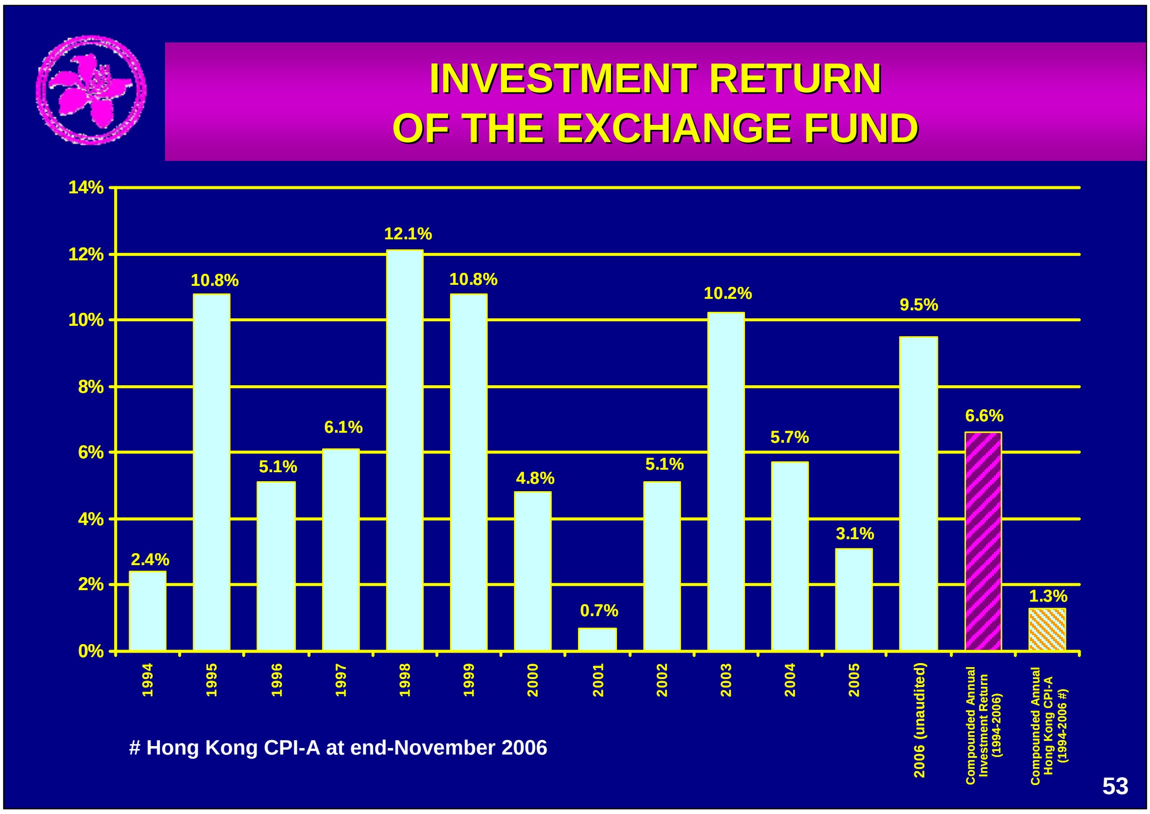
* Unaudited figures

51

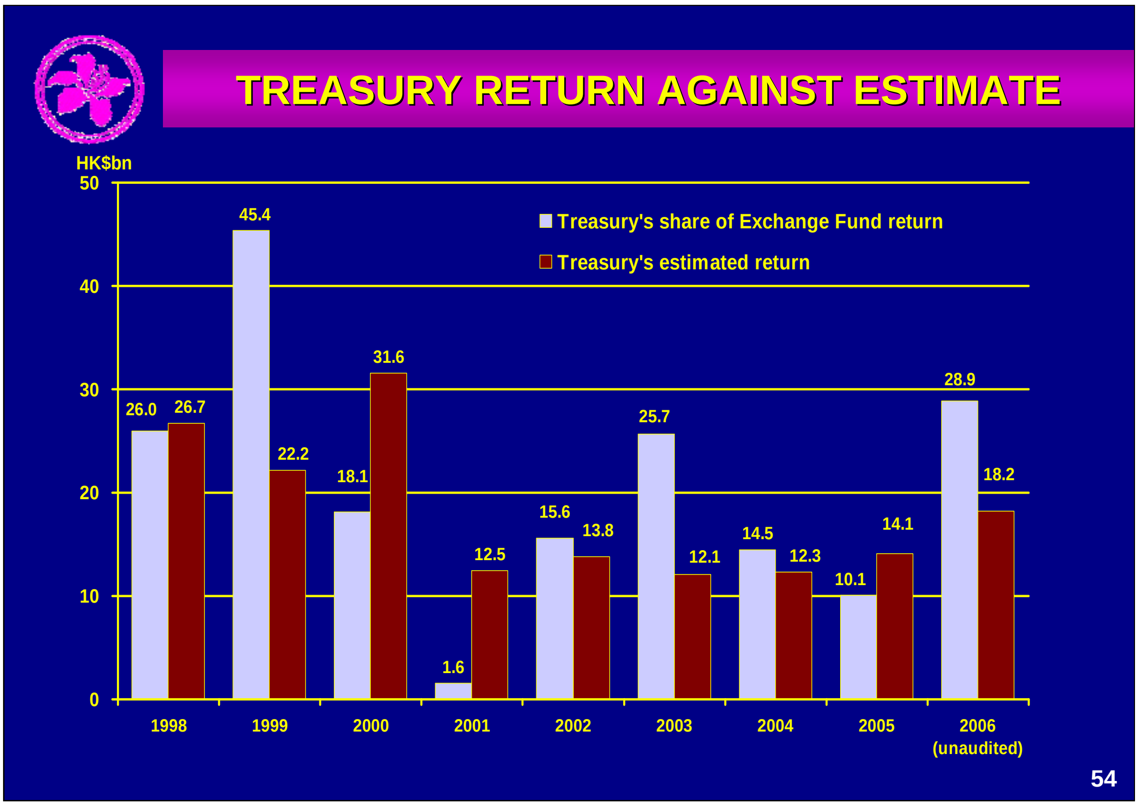
EXCHANGE FUND
ABRIDGED BALANCE SHEET

(HK$ billion)	At 31 Dec 2006 (unaudited)	At 31 Dec 2005	Change
ASSETS			
Deposits	62.1	89.0	(26.9)
Debt securities	811.9	738.0	73.9
Hong Kong equities	122.4	87.9	34.5
Other equities	154.2	127.2	27.0
Other assets	26.1	24.7	1.4
Total assets	1,176.7	1,066.8	109.9
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	156.9	148.4	8.5
Government-issued currency notes & coins in circulation	6.9	6.7	0.2
Balance of the banking system	2.0	1.6	0.4
Exchange Fund Bills and Notes	129.1	118.1	11.0
Placements by other HKSAR government funds	324.5	297.1	27.4
Other liabilities	49.6	51.8	(2.2)
Total liabilities	669.0	623.7	45.3
Accumulated surplus	507.7	443.1	64.6
Total liabilities and fund equity	1,176.7	1,066.8	109.9

52

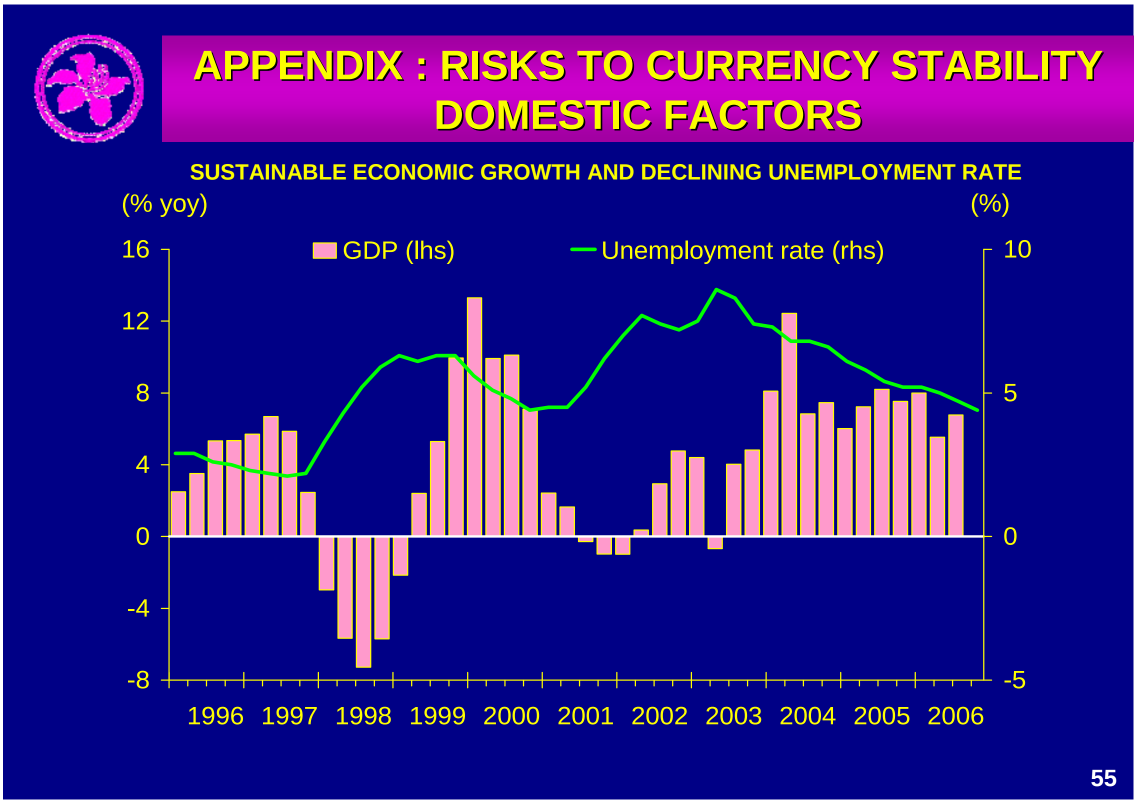


- One of the investment objectives of the Exchange Fund is to maintain the long-term purchasing power of the Fund. Since 1994, the Exchange Fund has generated a compounded annual investment return of 6.6%. This compares favourably with the compounded annual inflation rate of 1.3% over the same period. The HKMA has been successful in achieving the objective.



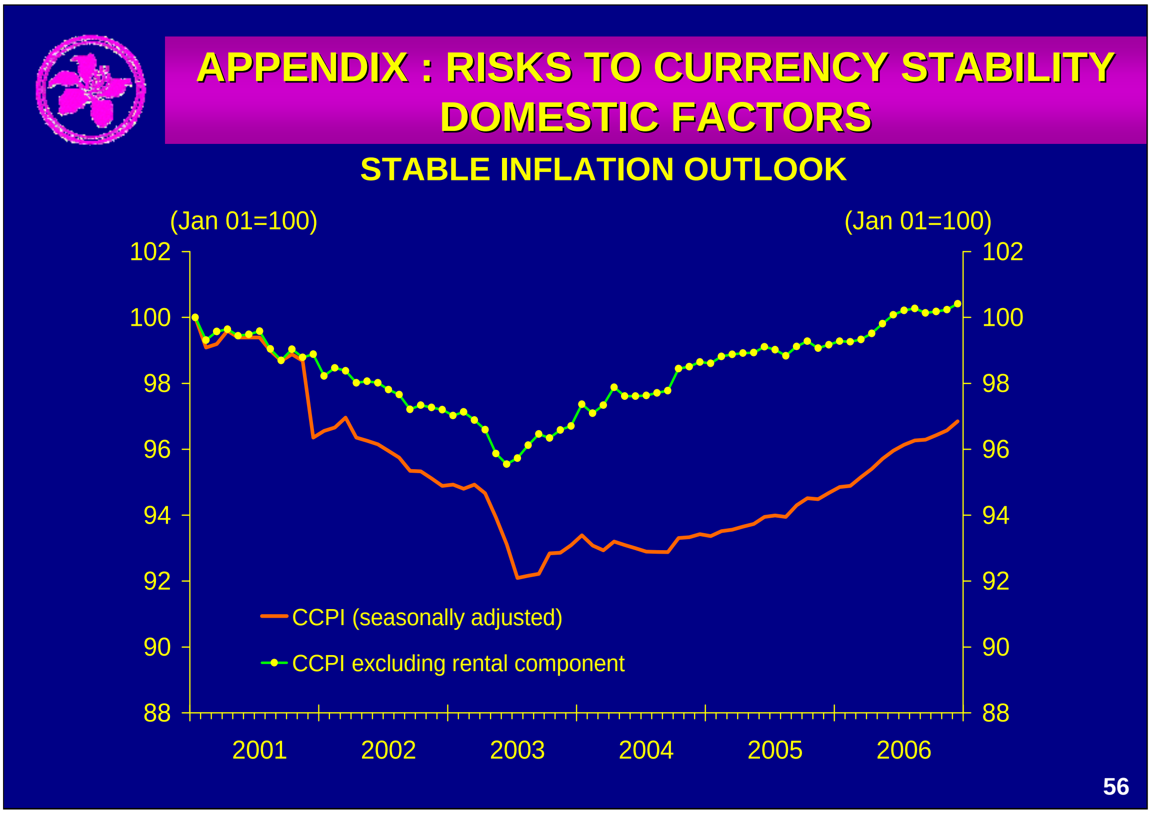
- Since April 1998, the return on the fiscal reserves placed with the Exchange Fund was linked to the overall return achieved by the Exchange Fund. Since the introduction of the existing arrangement, the Treasury has been able to enjoy an actual return that exceeded its original estimate in five out of nine years.

- The Treasury's actual share of the investment income for 2006 is HK$28.9 billion, exceeding the original estimate of HK$18.2 billion. In the past nine years, the Treasury's actual return totalled HK$185.9 billion, which was HK$22.4 billion higher than the budgeted amount.



- Real GDP growth picked up to 6.8% year on year in Q3 from 5.5% in 2006 Q2, reflecting strong growth in re-exports and investment in capital goods (machinery, equipment and computer software). On a quarter-on-quarter comparison, growth increased notably to 3.5% during the period. In light of the strong economic performance, the Government revised upward its growth forecast for 2006 to 6.5% from 4-5%.

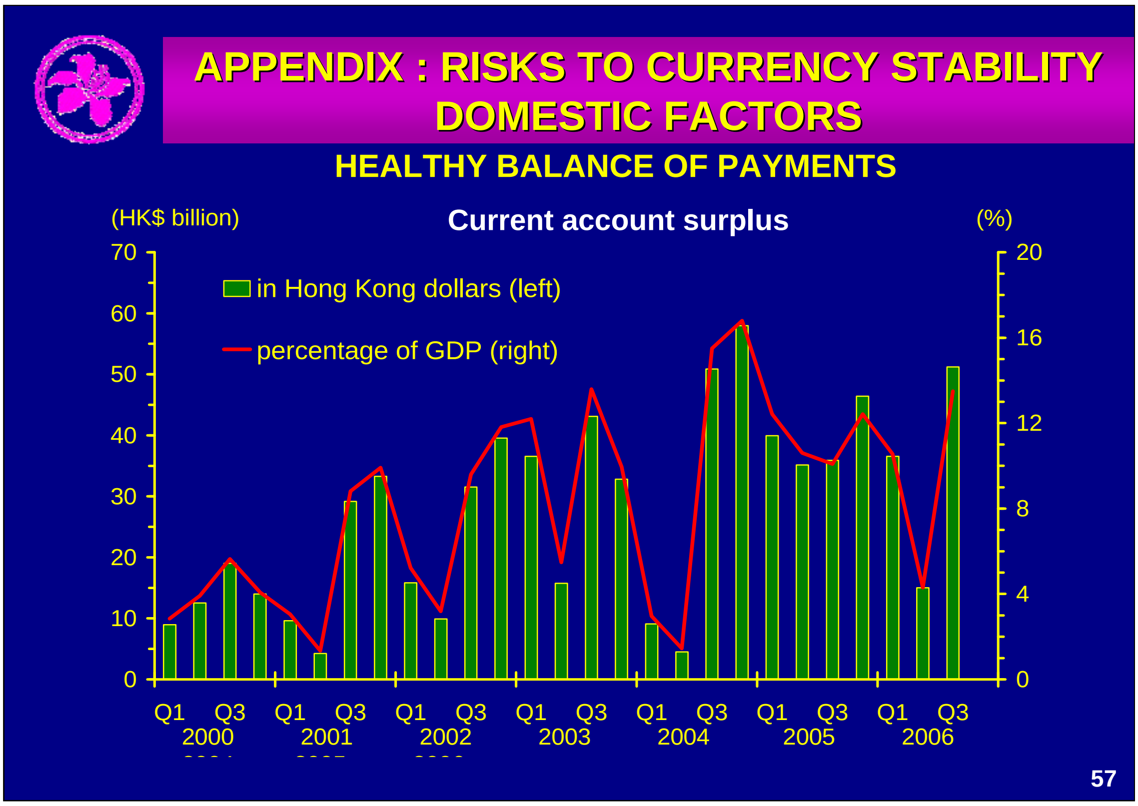
- The continued downward trend in the unemployment rate reflects rising employment relative to labour force growth. The three-month moving average unemployment rate fell to 4.4% in December 2006, the lowest in six years.



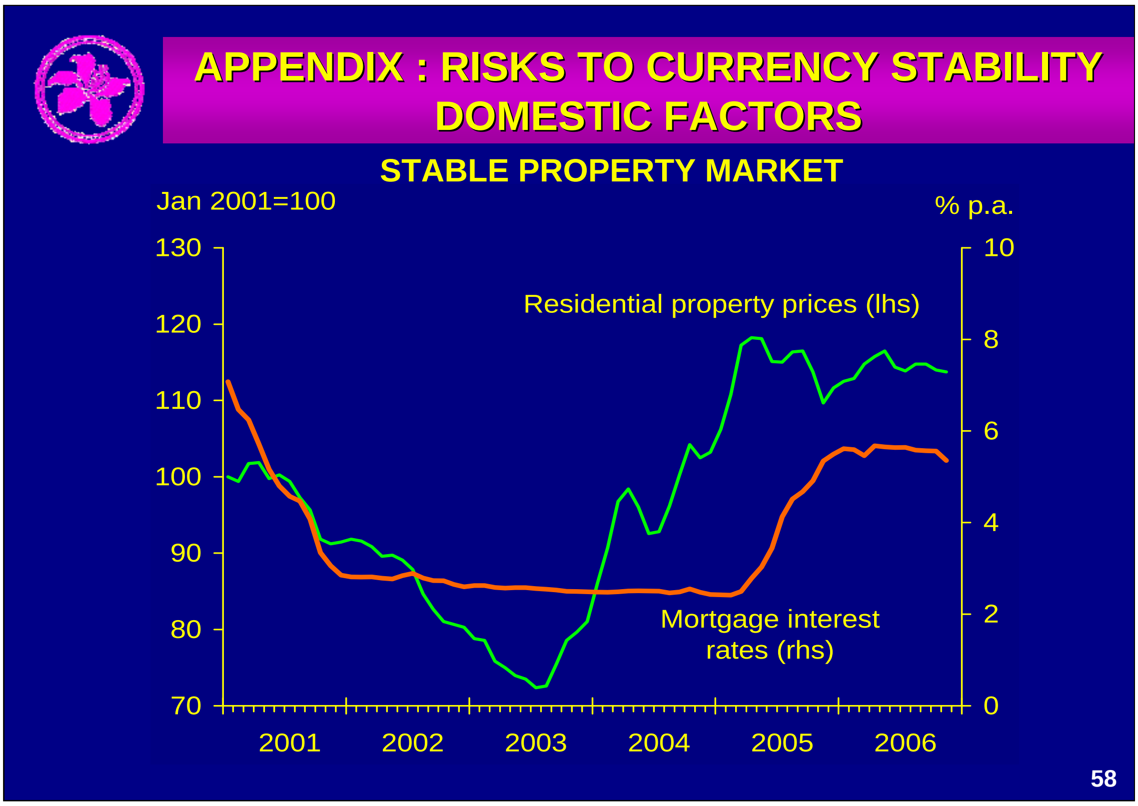
- The (seasonally adjusted) year-on-year headline CPI inflation eased to 2.2% in Q4 from 2.3% in Q3, reflecting declines in utilities and miscellaneous services charges and smaller increases in rental costs.

- The Composite CPI, excluding rents, has been increasing along with the recovery in economic activity. On a three-month-on-three-month basis, rental price inflation has eased steadily since the middle of 2006, reflecting slower but still positive pass-through of market rentals. The rate of increase in market rentals is expected to ease following the stabilisation of residential property prices.

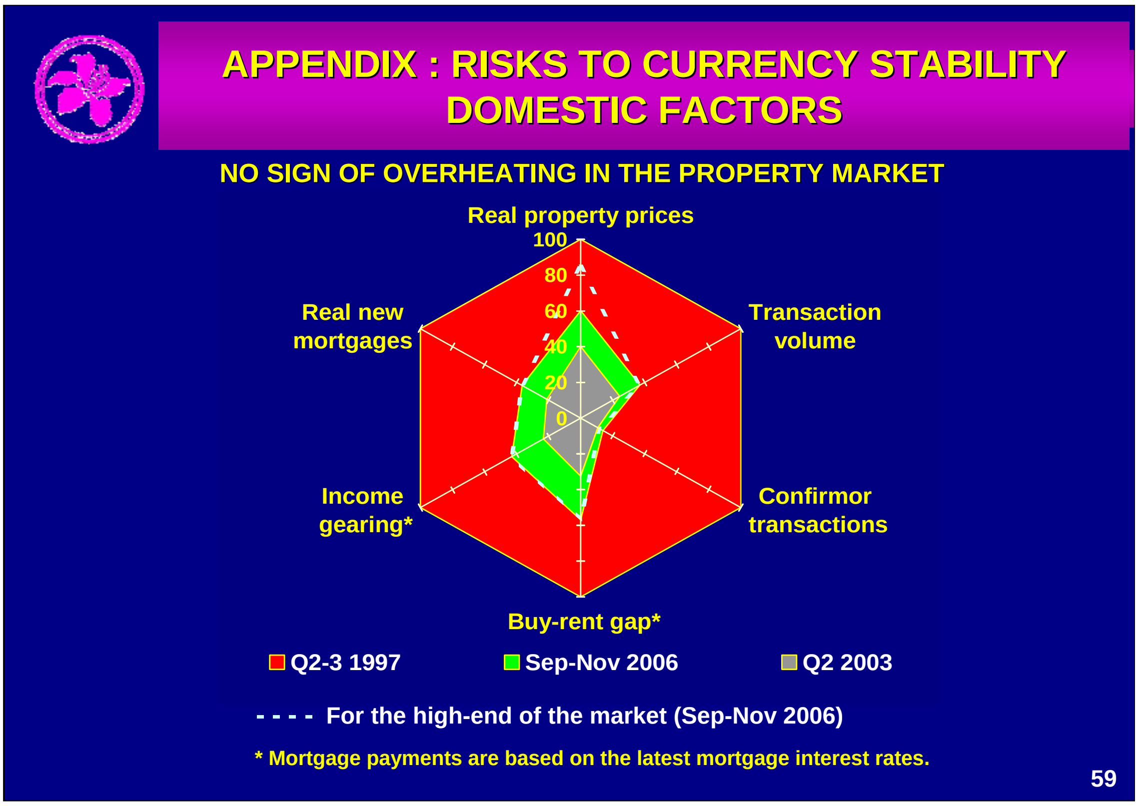
- Consumer prices are expected to rise moderately in 2007, reflecting solid growth in domestic demand and continued pass-through of residential rents to the headline CPI. The risk of a substantial increase in inflation remains low, given the relatively slow growth of unit labour costs brought about by productivity gains and lower energy prices.



- The external position remained favourable, with the latest Balance of Payments statistics showing an overall balance of payments surplus in 2006 Q3, in part relating to seasonal factors.

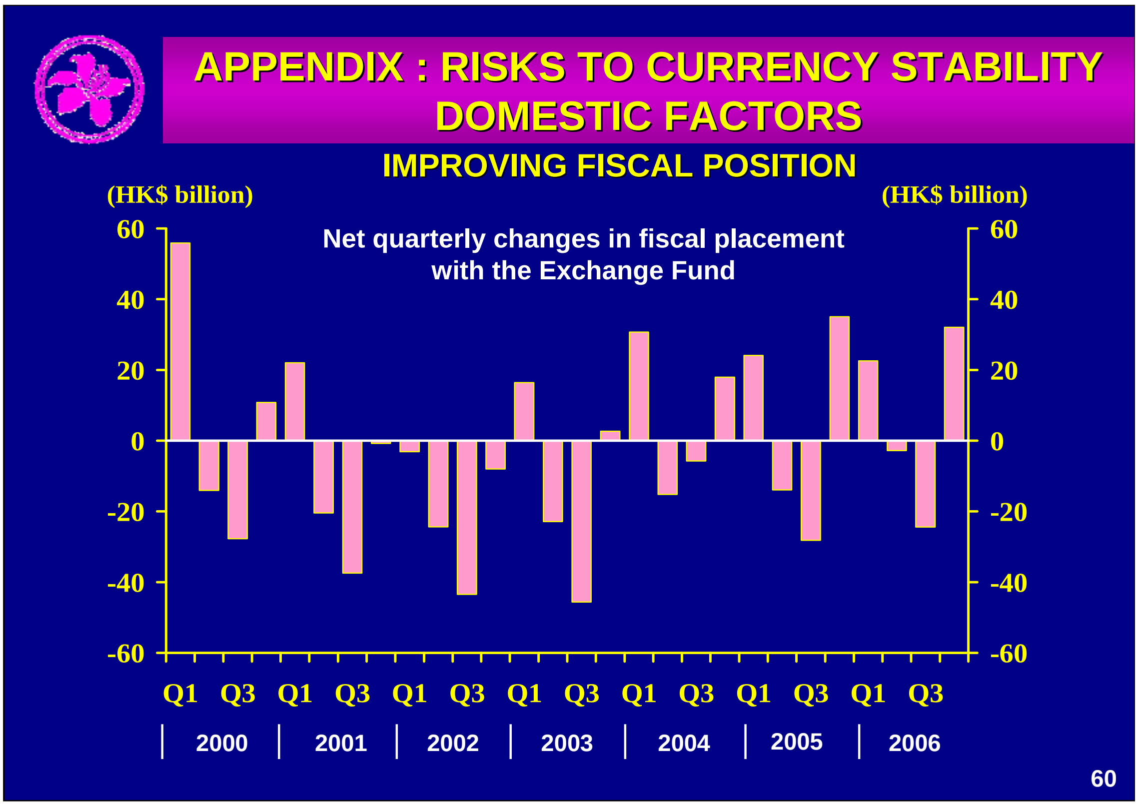


- The cumulative effect of a series of interest rate increases has curbed residential property transactions and house price inflation in 2006, contributing to a more stable outlook for the property market.



- To identify signs of overheating in the property market, this graphical analysis summarises the evolution of six key property market indicators: real property prices, property transaction volume, confirmor transactions, real new mortgages, the income-gearing ratio (ratio of mortgage payment to household income), and the buy-rent gap (ratio of mortgage payment to rental). The property market conditions in 1997 Q2-3 was treated as the base period.

- For the three months ending October 2006, the size of the hexagon remained considerably smaller than that in April-September 1997. This suggests that there are no major signs of overheating in the property market.



- Reflecting seasonal factors, net placements with the Exchange Fund are usually in surplus in Q1 and Q4, followed by net draw-downs in Q2 and Q3.

- Latest figures show that net placements with the Exchange Fund recorded a surplus of around HK$32 billion in 2006 Q4, slightly smaller than the surplus in the same period of last year.

- Overall, the fiscal position of the Government remains healthy on the back of ongoing economic expansion.

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	-15.2	-5.7	18.0
2005	24.1	-13.9	-28.2	35.0
2006	22.6	-2.8	-24.4	32.1