HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

8 November 2007

DISCUSSION TOPICS

Updates on

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

FACTORS AFFECTING CURRENCY STABILITY

- **Sub-prime crisis**
- **Monetary and financial conditions on the Mainland**
- **Inflation**

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- Risks to global financial stability have increased. Global financial markets have been experiencing protracted turbulence since mid-June. Increased uncertainties arising from the sub-prime problem are likely to keep market sentiment and conditions unsettled for some time. The chances of more severe tightening of credit conditions cannot be dismissed, and we may observe more volatile capital flows especially if risk appetite shifts abruptly.

- Recent financial market volatility has renewed concerns over global growth prospects. The US housing market has deteriorated further in recent months. A continued housing slump would increase the risks of spill-over to the broader US economy, particularly to consumer spending. The real economy may experience significant negative repercussions if a further deterioration of the financing conditions prolongs the housing market adjustment and disrupts financial intermediation. A significant slowdown or recession of the US economy therefore cannot be ruled out, and the growth of Hong Kong and major trading partners of the US are likely to be affected.

- Growth momentum in the Mainland economy showed signs of a slight moderation in Q3 after registering a remarkable growth of 11.9% year on year in Q2. However, rising inflationary pressures and persistent excess liquidity have remained the key concerns. Headline inflation reached 6.2% in September. The People’s Bank of China raised the benchmark lending and deposit rates on September 15 for the fifth time this year. The reserve requirement ratio has also been increased eight times this year to 13%.

- While risks to global inflation appear to have reduced due to the expected slower growth, sharp increases in commodity (such as oil) and food prices might raise inflationary expectations and lead to higher inflation. This might constrain central banks’ ability to cut interest rates.

SUB-PRIME CRISIS

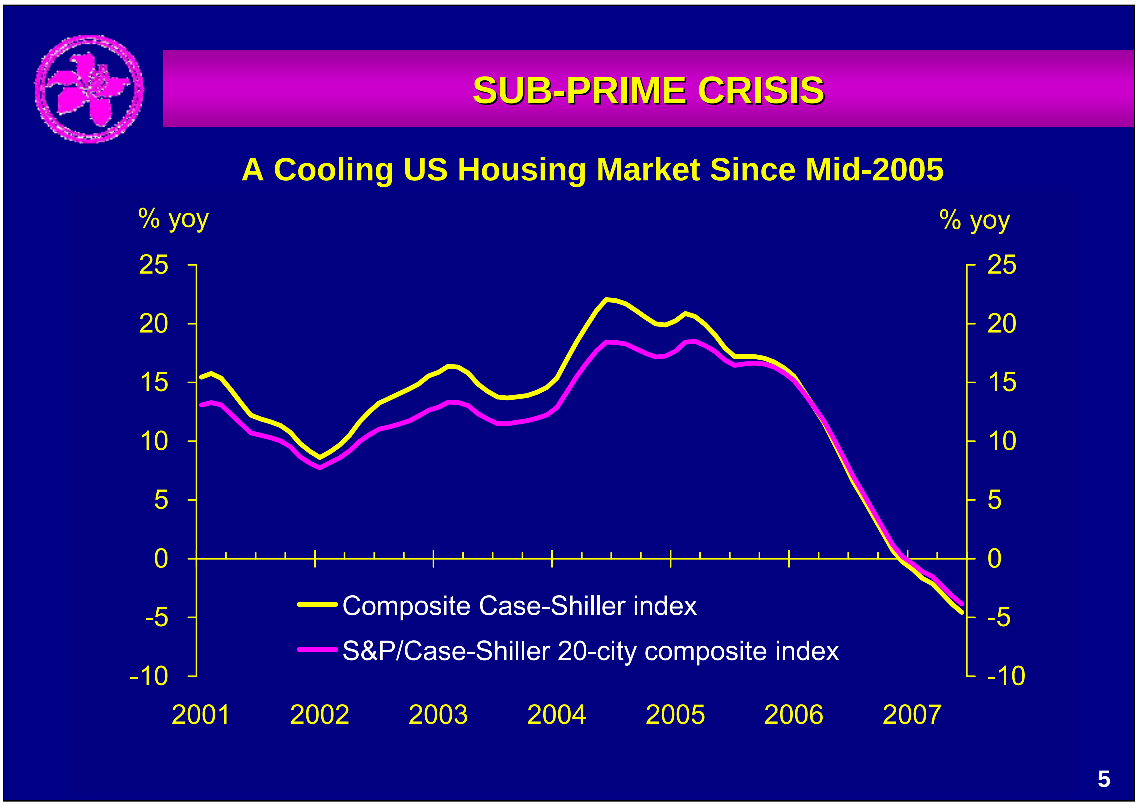
- **Financial innovation and securitisation of the mortgage market**
- **Low-interest-rate environment and search-for-yield behaviour led to rapid development for sub-prime mortgage-backed securities**
- **Risks transferred through securitization has**
  - **distorted relationship between risks and return**
  - **weakened lending standards**
- **Through securitisation and other innovative means, sub-prime mortgage became highly-rated asset-backed securities, or structured products**

- The sub-prime mortgage market caters to borrowers with low credit scores, incomplete credit documents, and high loan-to-value ratios — those who would otherwise be denied access to credit in the standard (prime) market.

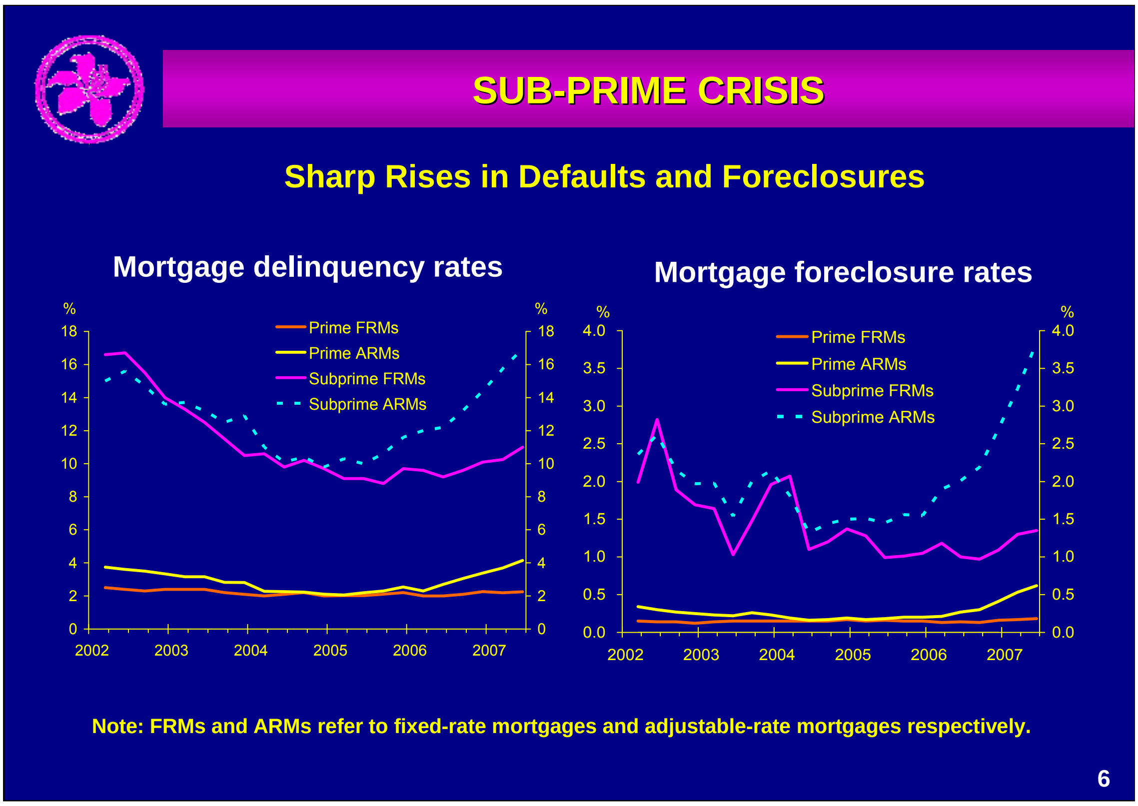
- It has developed against the background of rapid financial innovation and securitisation of the mortgage market, through which mortgage loans are repackaged, pooled and resold to investors (who are willing to assume such risks) in the form of securities. Mortgage securitisation has significantly contributed to growth in sub-prime lending through increased liquidity and better distribution and allocation of risks.

- Although it emerged in the early 1980s, sub-prime lending took off only in mid-1990s, when sub-prime mortgage-backed securities (MBS) became more attractive to investors. The search-for-yield behaviour in a low-interest-rate environment in recent years resulted in increased demand for sub-prime mortgage-backed securities.

- Lucrative profits during a booming housing market attracted new players into the mortgage market and encouraged a lowering of lending standards and an increasing use of non-traditional repayment features.



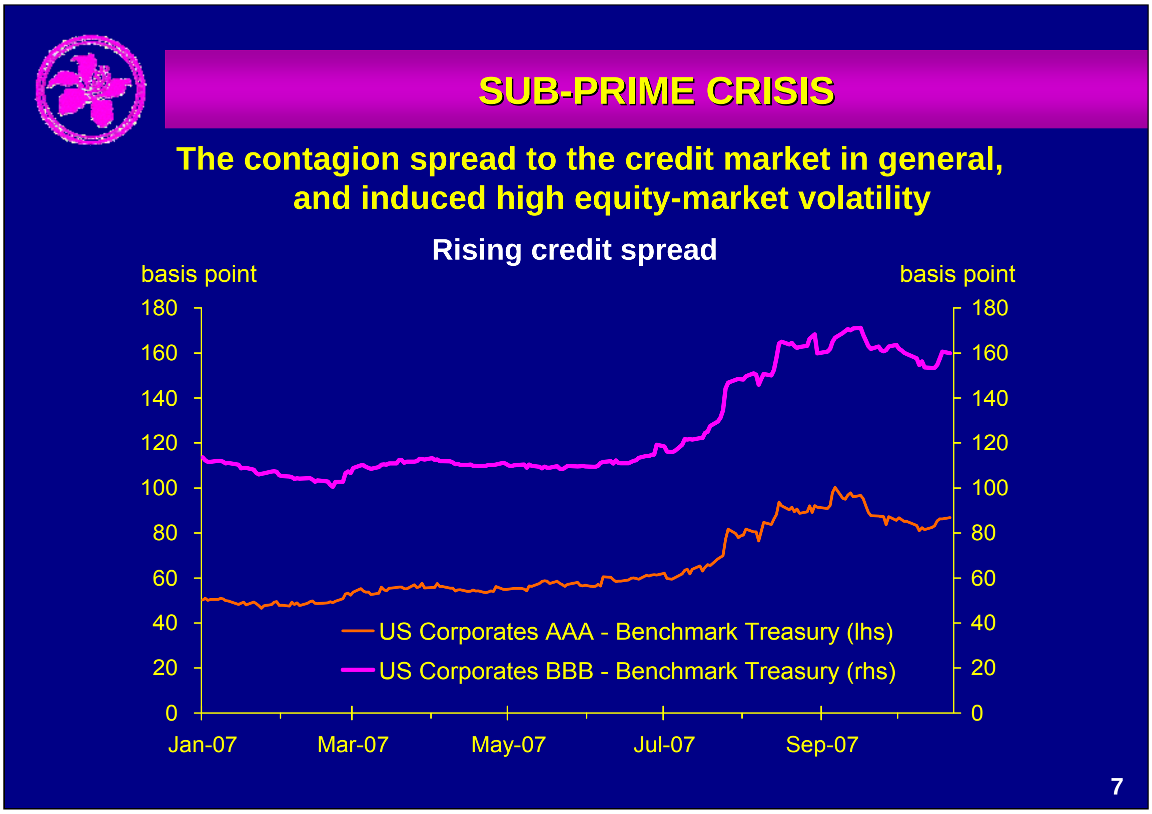
- After reaching a peak between 2004 and mid-2005, US home price appreciation had slowed sharply since mid- to late- 2006 and declined in 2007.



- Since mid-2005, the US housing market has been cooling amid successive interest rate increases. Higher mortgage rates and house price depreciation left sub-prime borrowers with great payment difficulties, resulting in rising delinquency and foreclosure rates.

- By late 2006, the stress in the US sub-prime mortgage sector began to draw more public attention, as the delinquency and foreclosure rates surged sharply, particularly in adjustable-rate mortgages (ARMs). The situation has worsened and the default rates for ARMs will likely deteriorate further in 2008.

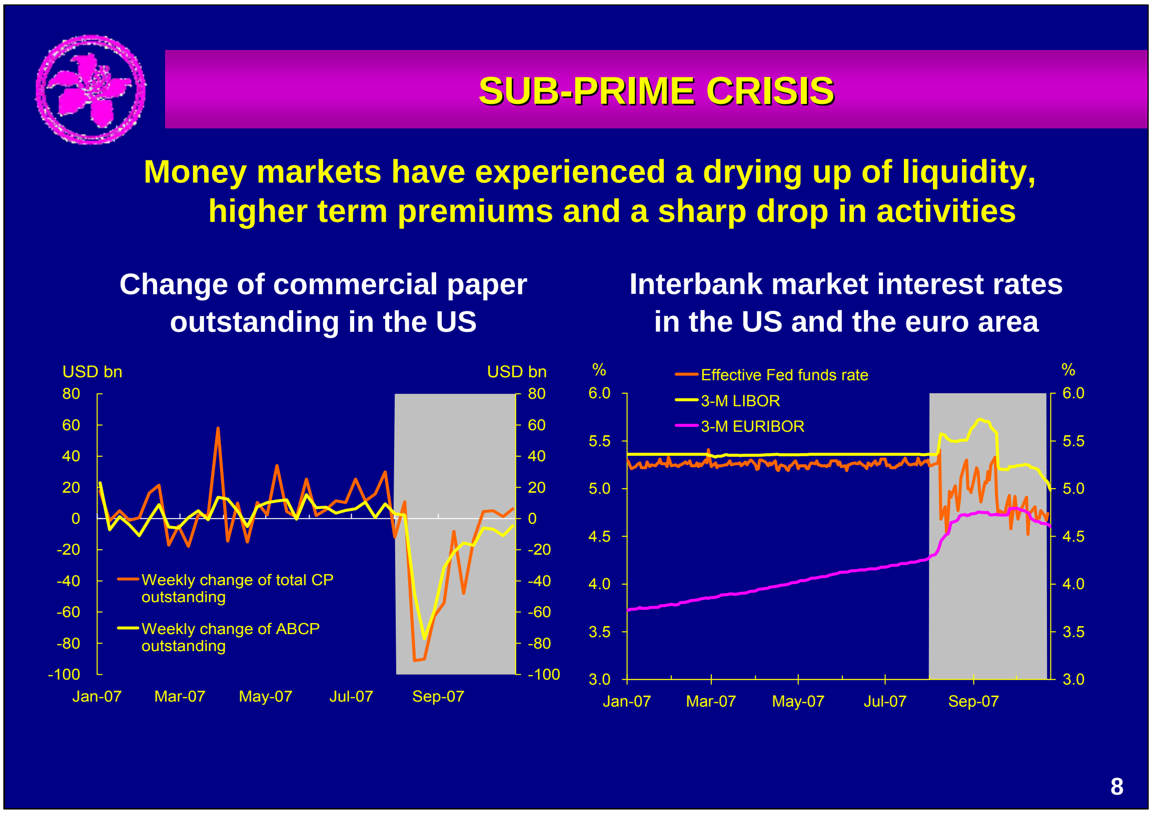
- The difficulties in the US sub-prime mortgage and related structured product markets set off the present financial market turbulence.



- The tightening of credit conditions has spread to the debt market in general. Reflecting the broader repricing of credit risks, even spreads on investment-grade corporate debt have widened significantly. It is likely that risk aversion and illiquidity will continue to restrict the supply of credit for some time.

- Global equity markets have seen a considerable upsurge in volatility, with major stock price indices falling sharply by mid-August. Although the markets rebounded thereafter, we are likely to observe a sustained period of high volatility.

- The recent financial turbulence highlights the increasing complexity of the modern financial system. The system has become so efficient at transferring risks that it has become rather difficult to identify what risks are involved, where they lie and whether those assuming them are aware of them, let alone whether they are in a position to manage the risks in the first place.



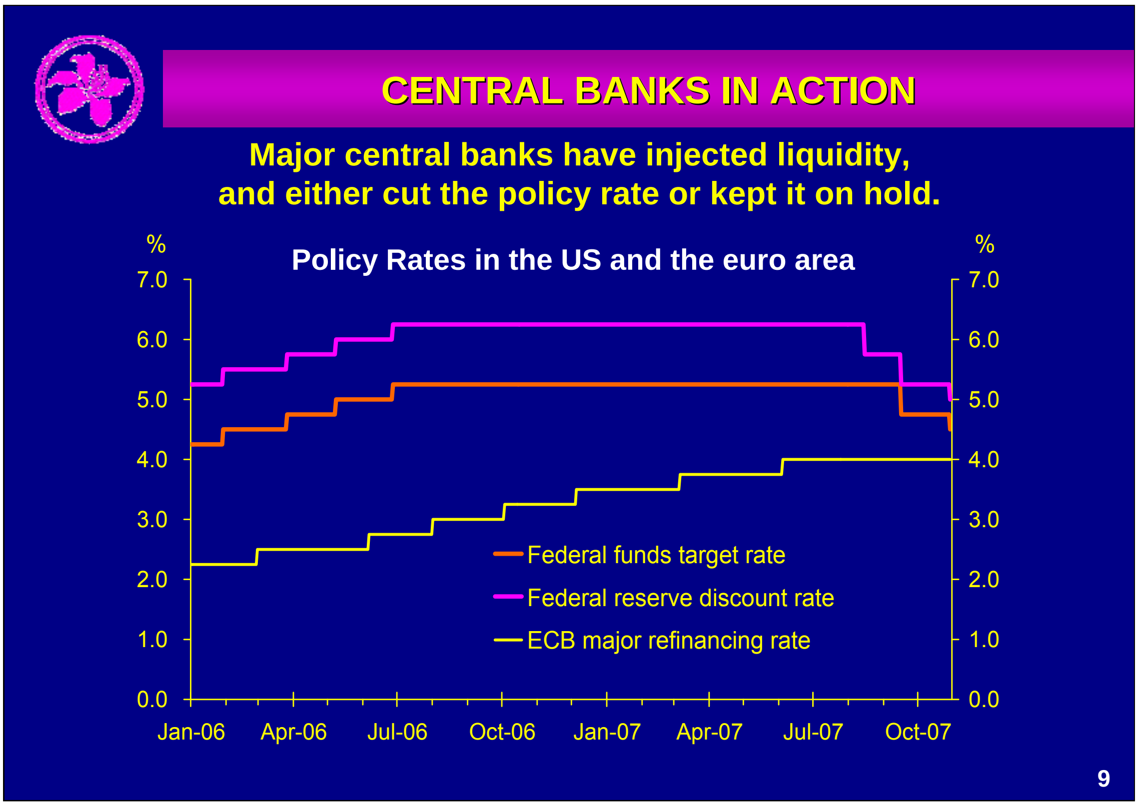
- Following the failure of two hedge funds in June, contagion from the sub-prime troubles spread to other credit markets. The situation deteriorated after the rating agencies downgraded mortgage-related securities.

- As uncertainties increased, concerns have shifted to entities that may have exposure to sub-prime mortgage-backed securities, including underwriters of structured products, hedge funds and large financial institutions.

- Increased risk aversion has led to a sharp pull-back in risk-taking and a loss of liquidity in the markets for short-term funding. The commercial paper market, which is open only to investment-grade companies, has been under severe strain.

- The main problems are in the asset-backed commercial paper market (ABCP), where structured investment vehicles (SIVs) and “conduits” (set up by banks but off the banks’ balance sheet) were borrowing to fund their holdings of asset-backed securities. As investors shied away from potentially risky investment, the commercial paper market, especially the ABCP market, shrank substantially.

- The tension in the ABCP markets then spread to the US and European short-term interbank markets, resulting in high term premiums and sharply reduced activities, as banks began hoarding liquidity to meet actual or contingent obligations. Banks also curtailed lending to each other on concerns of potential counterparty risks.



- Major central banks including the US Fed and the ECB have continued to inject liquidity to the interbank market and broadened the range of collateral they are willing to accept in their monetary operations.

- In response to the increased financial market volatility and tightening of lending conditions, the Fed took the unusual step of cutting the discount rate by 50 basis points to 5.75% in August between two FOMC meetings. To guard against the risks of a significant slowdown of the economy, the Fed reduced the federal funds target rate and the discount rate by 50 basis points in September, and by 25 basis points in October, to 4.5% and 5% respectively. Meanwhile, the ECB, the BoE and the BoJ have kept their policy rates on hold.

- All major central banks have made explicit statements to assure the market that they will stand ready to act as needed to restore financial stability.

IMPACT OF THE SUB-PRIME PROBLEM ON HONG KONG

- **Financial markets have been more volatile but no systematic problem emerges**
- **No sub-prime mortgage lending by banks in Hong Kong**
- **Individual banks may suffer from their investment in asset-backed securities, but unlikely to cause problem to their financial soundness**
- **Interest rate adjustment less than that in the US**

- Should volatility in the global financial markets be higher or more persistent, reactions in the equity and the debt/credit markets could be greater, inducing further increase in risk aversion, higher volatility or a reversal of capital flows. This would have a negative impact on Hong Kong given its role as a major financial centre but so far there has been no systematic problem emerged.

- The recent financial turbulence has had limited impact on Hong Kong's banking system and the real economy. Hong Kong's banking sector has limited direct exposure to the global credit market.

- Nevertheless, given the uncertainties regarding the outlook for the global financial markets as well as the global economy, Hong Kong could be affected through both the real economy and the financial-market channels subject to some external factors.

- While a soft-landing of the US economy is generally expected, its growth might fall more sharply than expected should the US housing slump continue and the tightening of credit conditions persist or even deteriorate. If the housing difficulties spill-over to other sectors of the economy, especially to consumer spending, its impact on Hong Kong would likely be larger.

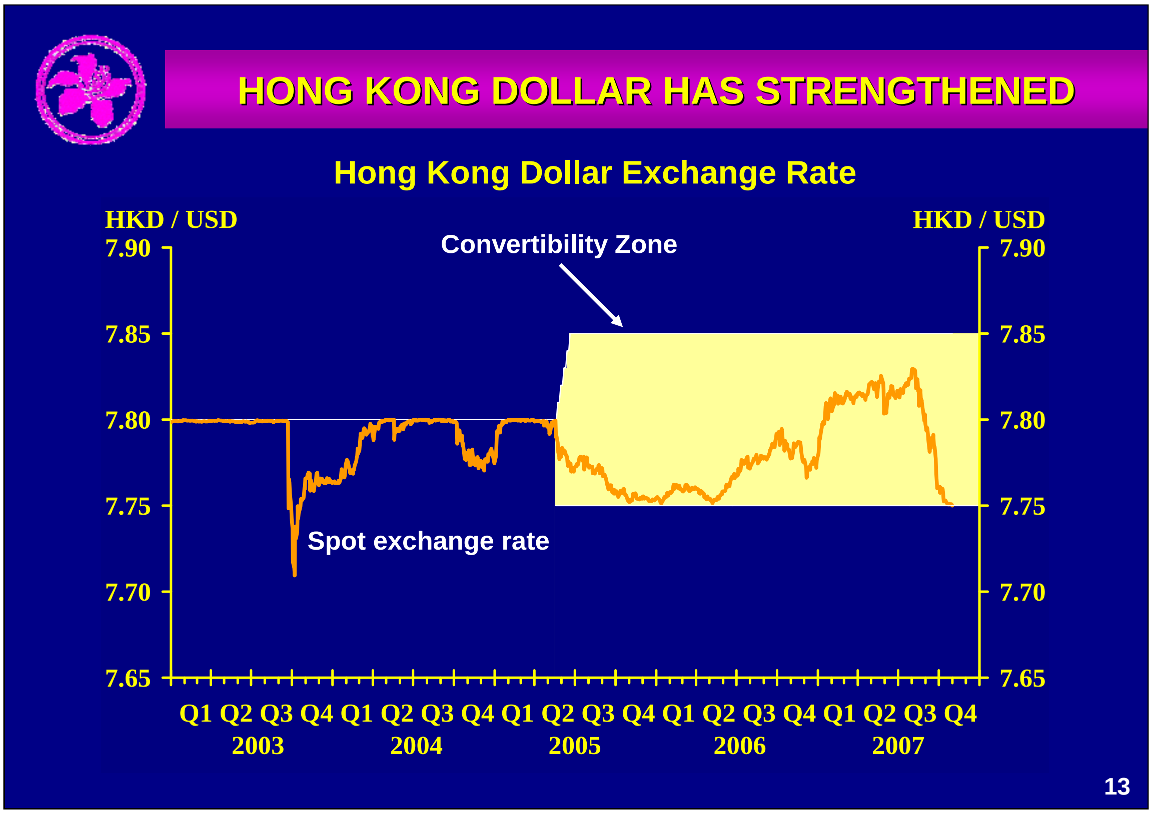
MONETARY AND FINANCIAL CONDITIONS ON THE MAINLAND

- **Expansion of Balance of Payments surplus**
- **Appreciation of the renminbi**
- **Continued capital inflow, and rapid accumulation of foreign exchange reserves**
- **Continued rising of reserves requirement of the banking sector**
- **Issuance of large amount of PBoC papers to sterilize excess liquidity created by the acquisition of foreign reserves**

MONETARY AND FINANCIAL CONDITIONS ON THE MAINLAND

- **Rising inflation**
- **Raising interest rates to curb inflation**
- **Implementation of policy to encourage outflow of capital in an orderly way**
- **Large demand for investment instruments by the non-state sector**
- **Development of capital markets against the background of supply-and-demand imbalance**

- These inter-related development create different pulling forces and it is very important to manage these forces in order to avoid the development being out of control, which will be disruptive to financial markets.
- It is inevitable that the financial markets will be volatile in response to different news and development, but it is unlikely to cause systemic problems to the robust financial system in Hong Kong.



- The Hong Kong dollar spot exchange rate gradually weakened in the first seven months of 2007. This in part reflected interest rate arbitrage activities, as market participants took advantage of the negative differentials between Hong Kong dollar interest rates and their US dollar counterparts.

- Thereafter, the Hong Kong dollar exchange rate strengthened, mainly attributable to two factors:

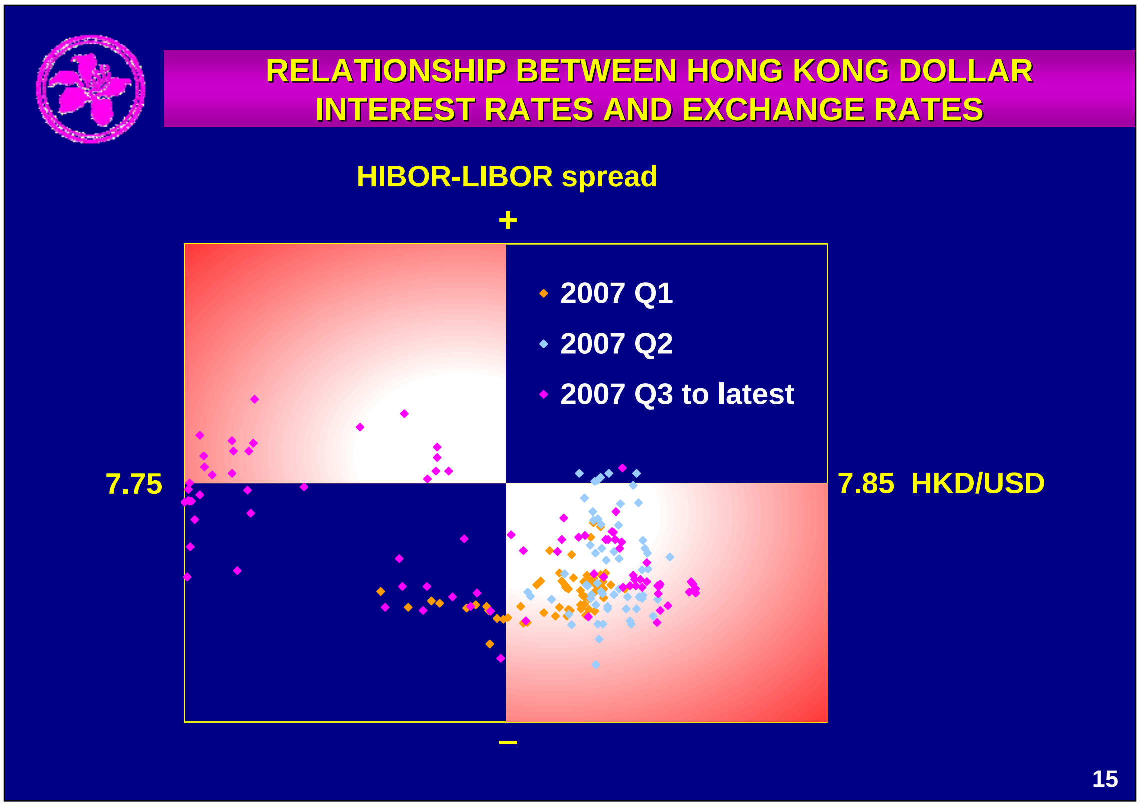
  – In August, the US sub-prime mortgage problems and the resulting increase in global risk aversion led to unwinding of carry trades.

  – A series of well-received IPOs resulted in increased equity-related demand for the Hong Kong dollar. The higher domestic interest rates associated with liquidity demand around the IPOs also led to unwinding of long US dollar positions or sales of US dollars for Hong Kong dollar funding.

- In late October, the Hong Kong dollar strengthened to near the strong-side Convertibility Undertaking (CU). The exchange rate once touched 7.7500 on 23 October although no banks approached the HKMA to invoke the Convertibility Undertaking. Short-dated Hong Kong dollar interest rates were firm as liquidity demand was likely to increase in the face of a forthcoming large-scale IPO. Taking into account the market conditions, the HKMA operated within the Convertibility Zone. HKMA bought HK$775 million worth of US dollars on 23 October and the Aggregate Balance increased by HK$775 million to HK$2,032 million on 25 October.

- Subsequently, the strong-side CU of 7.75 was triggered on 26 and 31 October. On these two days, the HKMA bought a total of HK$8,603 million worth of US dollars from banks and the Aggregate Balance increased to HK$10,619 million on 2 November. The pressures on the strong side arose in part from the equity-related inflows and in part from unfounded market rumours about the peg.

- The 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 has narrowed until September 2007. But the interest-rate spreads widened in October after the HKMA's market operations and the forward discount has also increased.



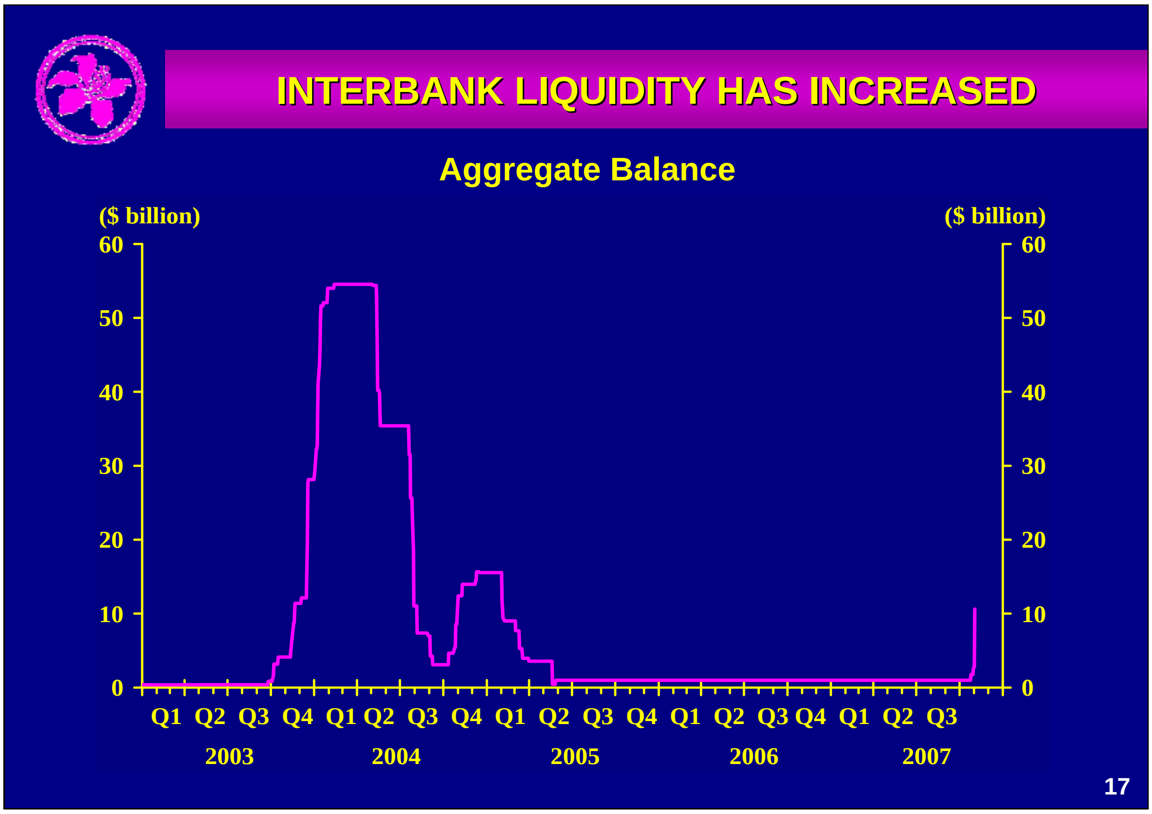
- Normally, when the Hong Kong dollar is near the strong-side Convertibility Undertaking (CU) of 7.75 , market participants would expect that the strong-side CU might be triggered upon continued capital inflows. Thus, they would be discounting a possible expansion of the Monetary Base and lower interest 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 diagram (the dots represent actual observations since the beginning of this year).

- In September, the spread in the overnight rates turned positive during the heavily subscribed equity IPOs, although the Hong Kong dollar strengthened to near the strong-side CU. This largely reflected the strong funding demand in those periods.

- The HKMA took action on 23 October to purchase US dollars against Hong Kong dollars, taking into account market conditions. At that time, the Hong Kong dollar exchange rate was near the strong-side Convertibility Undertaking rate but interest rates were firm at significant premiums to US interest rates. The active market operation by the HKMA to normalise the relationship between interest rate and exchange rate was thus necessary. Later in the month, the strong-side CU was triggered on 26 and 31 October, against the background of a number of factors including equity-related inflows and market rumours about the Link, prompting the HKMA to buy US dollars passively at 7.75.

HKMA operations within the Convertibility Zone

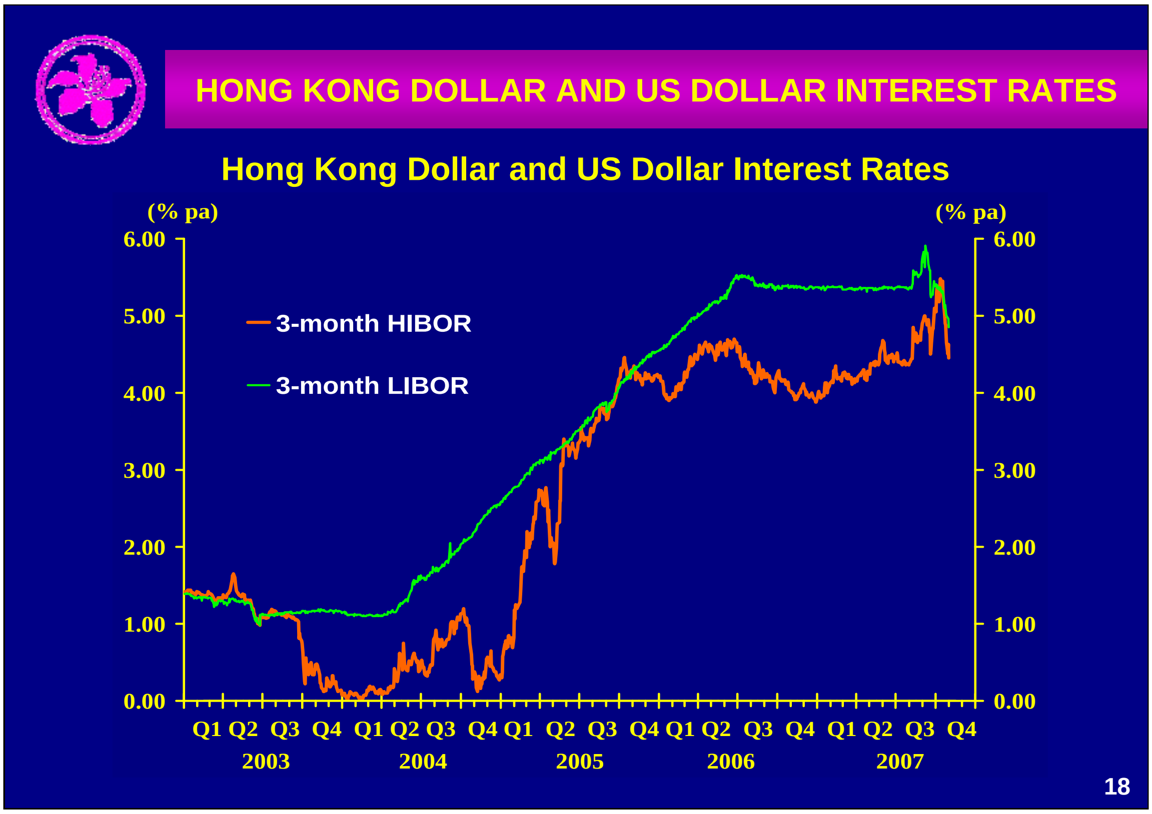
- Short-dated Hong Kong dollar interest rates above the US rates owing to liquidity demand associated with IPOs
- Hong Kong dollar near strong-side Convertibility Undertaking of 7.7500
- Active market operation conducted on 23 October to normalise the relationship between interest rates and exchange rates
- Subsequent operations were passive and done at the Convertibility Rate of 7.7500



- Activities in the interbank money market have been smooth and orderly despite the recent financial market volatility.

- As a result of the purchase of US dollars against Hong Kong dollars within the Convertibility Zone on 23 October and at the strong-side Convertibility Undertaking on 26 and 31 October, the Aggregate Balance increased by a total of HK$9,378 million to HK$10,619 million on 2 November.

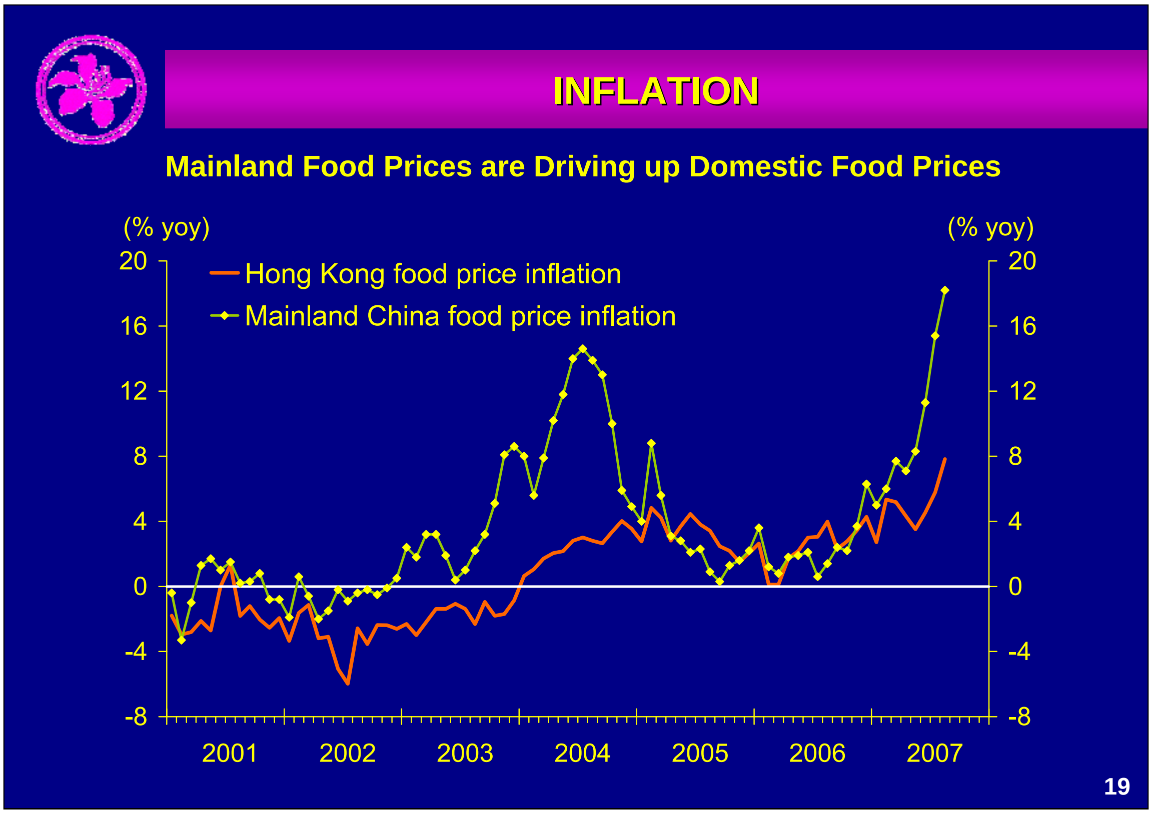
- Discount Window borrowing activities remained normal.



- Since early August 2007, the US sub-prime mortgage problems has been affecting market sentiment significantly, resulting in sharp rises in the three-month LIBOR. In response, the Fed injected emergency liquidity into the banking system and reduced the discount rate by 50 basis points on 17 August.

- On 18 September, the Fed cut both the Target Rate and the discount rate by 50 basis points to 4.75% and 5.25% respectively to prevent the disruptions in financial markets from spilling over to the broader economy. The three-month LIBOR then declined but tightness in the interbank market remains even after the rate cut and provision of liquidity by the central bank. The Fed cut the Target Rate and the discount rate by 25 basis points on 31 October, to 4.5% and 5% respectively.

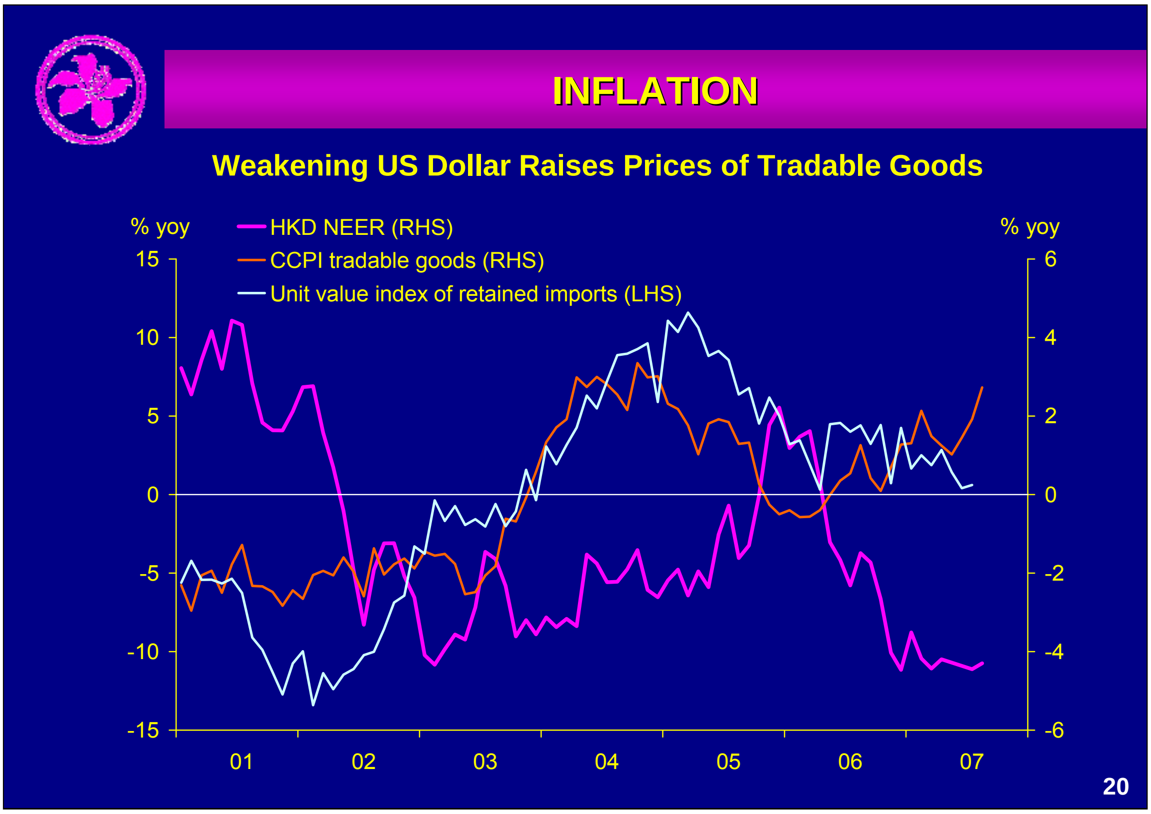
- In August, during the episodes of financial market volatility, the Hong Kong dollar money market continued to function in an orderly way. Movements of short-term Hong Kong dollar interest rates largely tracked their US dollar counterparts. Nevertheless, the negative spreads between Hong Kong dollar and US dollar interest rates narrowed largely due to strong funding demand arising from a number of IPOs. More recently, following our market operations, the resultant expansion of the Aggregate Balance has led to an easing of local interest rates.



- Recent increases in food prices in Hong Kong may be affected by the surges in food prices on the Mainland.

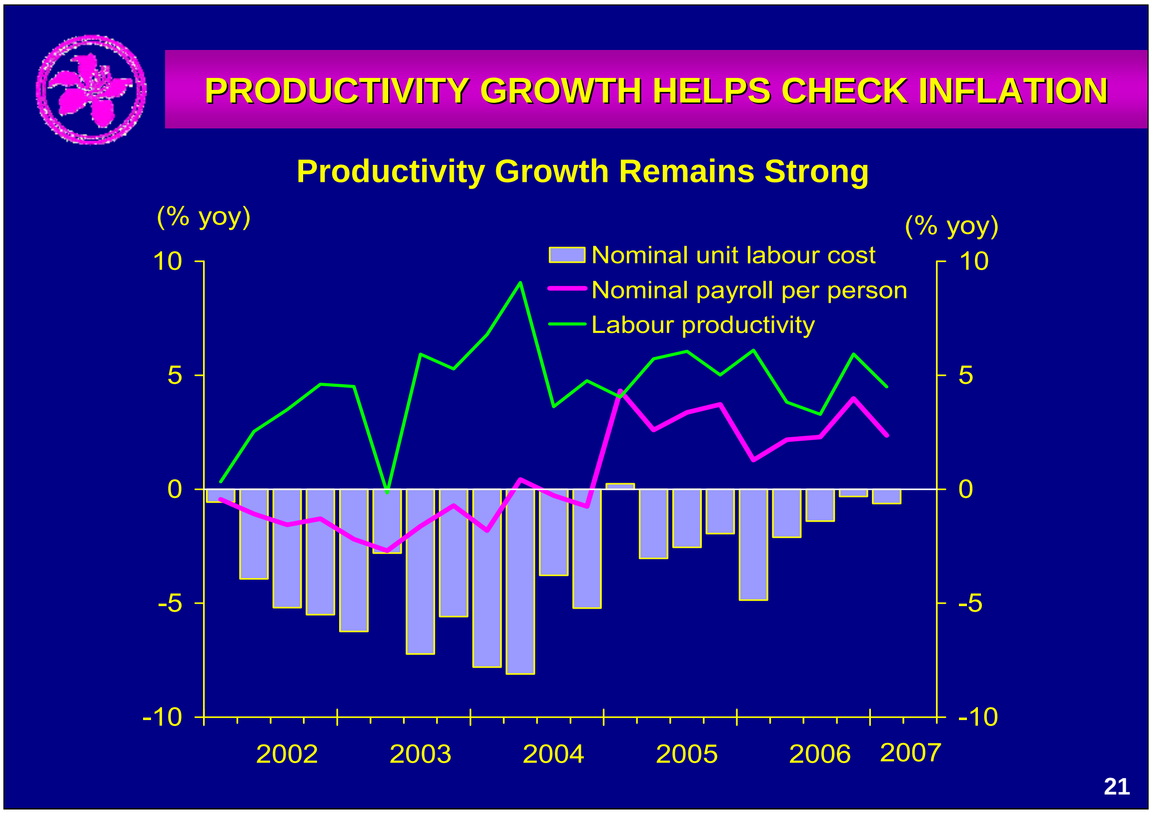
- The increase in CPI inflation on the Mainland was mainly due to increases in food prices, particularly pork. However, price pressure in basic food items may ease gradually in the rest of the year because of initiatives to increase pork and other food supply to Hong Kong by the Mainland Government.

- Rises in food prices have been the most important contributor to the price increases on the Mainland. Non-food prices have been quite stable. So a major surge of inflation on the Mainland is unlikely.



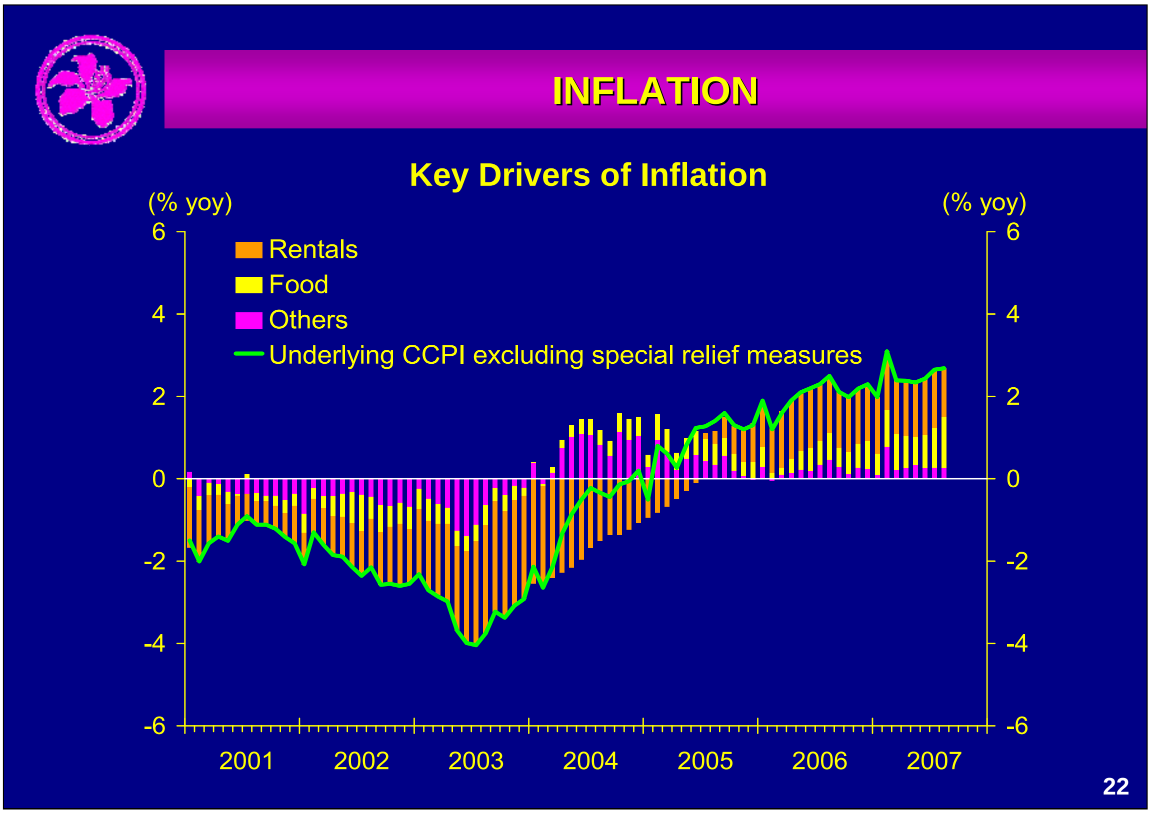
- The trade-weighted US dollar nominal effective exchange rate (NEER) is at historical low. Given the Linked Exchange Rate system, the Hong Kong dollar NEER has also been depreciating steadily. By August 2007, the trade-weighted nominal effective exchange rate of the Hong Kong dollar has declined by almost 14% from February 2002 when the US dollar started to depreciate.

- Because Hong Kong is a small open economy, the tradable goods component in the CCPI moves closely with the prices of retained imports. In the light of nominal exchange rate depreciation, prices of retained imports and tradable goods are expected to rise. Although the risk of a surge in tradable-goods prices remains low, the speed of pass-through from this segment of CCPI to the aggregate CCPI is expected to increase further.



- Strong labour productivity growth has kept Hong Kong's inflation in check. Growth in labour productivity, measured in output per worker, has been increasing at a year-on-year rate of 5.3% on average since 2003 Q3.

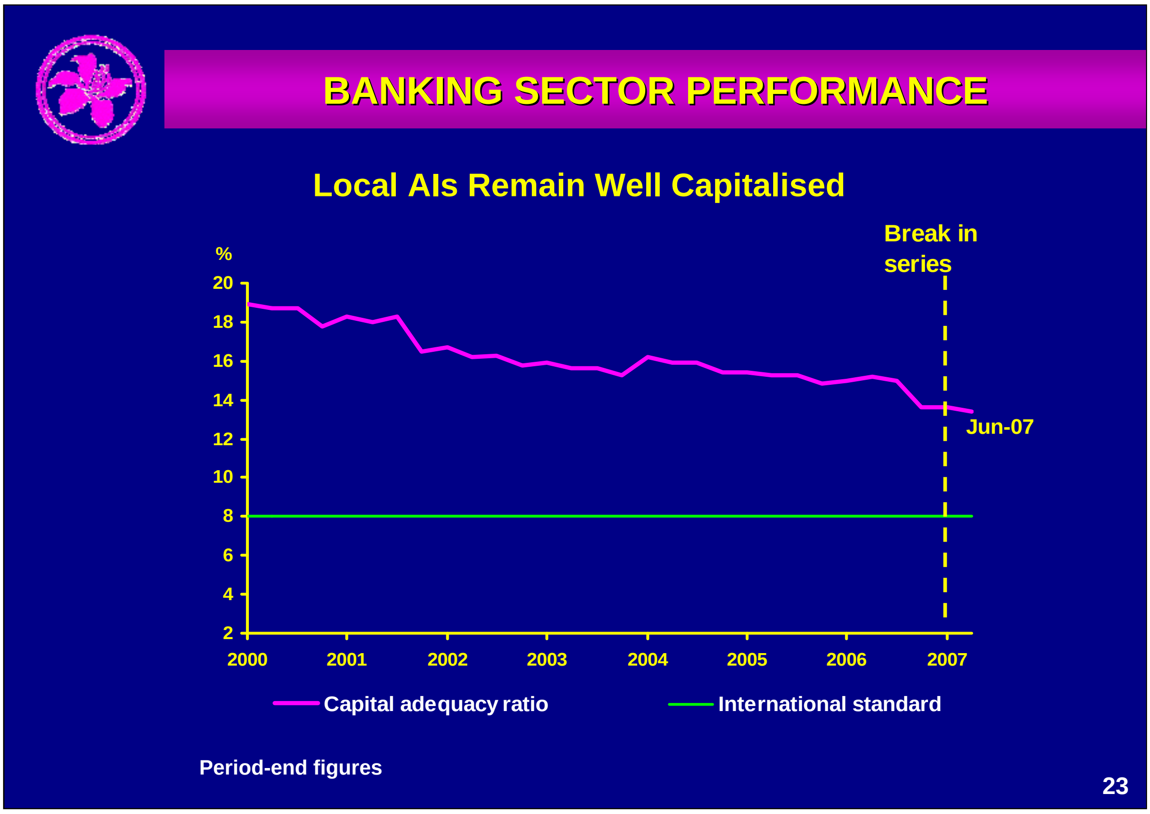
- The change in unit labour cost has been modest in recent years, suggesting inflationary pressure from wage increases remains limited.



- Although the year-on-year headline inflation rate was benign at 1.6% in August 2007, the underlying inflation pressure has risen steadily this year, reaching 2.7% after removing the effect of one-off government relief measures.

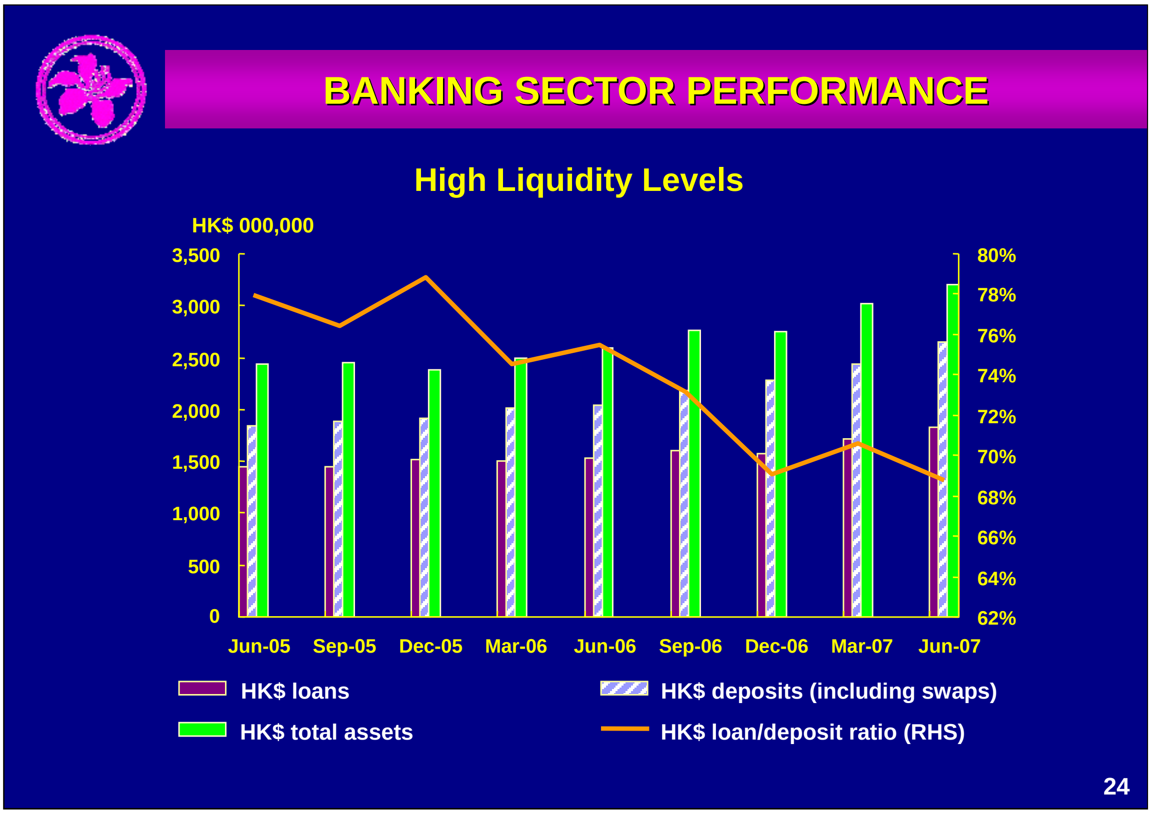
- On top of the recent rises in food prices and the weak-US-dollar effect, increases in rents continued to be the main driver of CCPI inflation. Excluding the special relief measures (e.g. rates waiver in this fiscal year), the rental component of the consumer price index has picked up steadily because of continued increases in private housing rents.

- Consumer prices are expected to be on a rising path, largely reflecting recent rises in food prices, the weakness of the US dollar, a strong renminbi, continued pass-through of residential rents to the headline CPI, and solid growth in domestic demand.



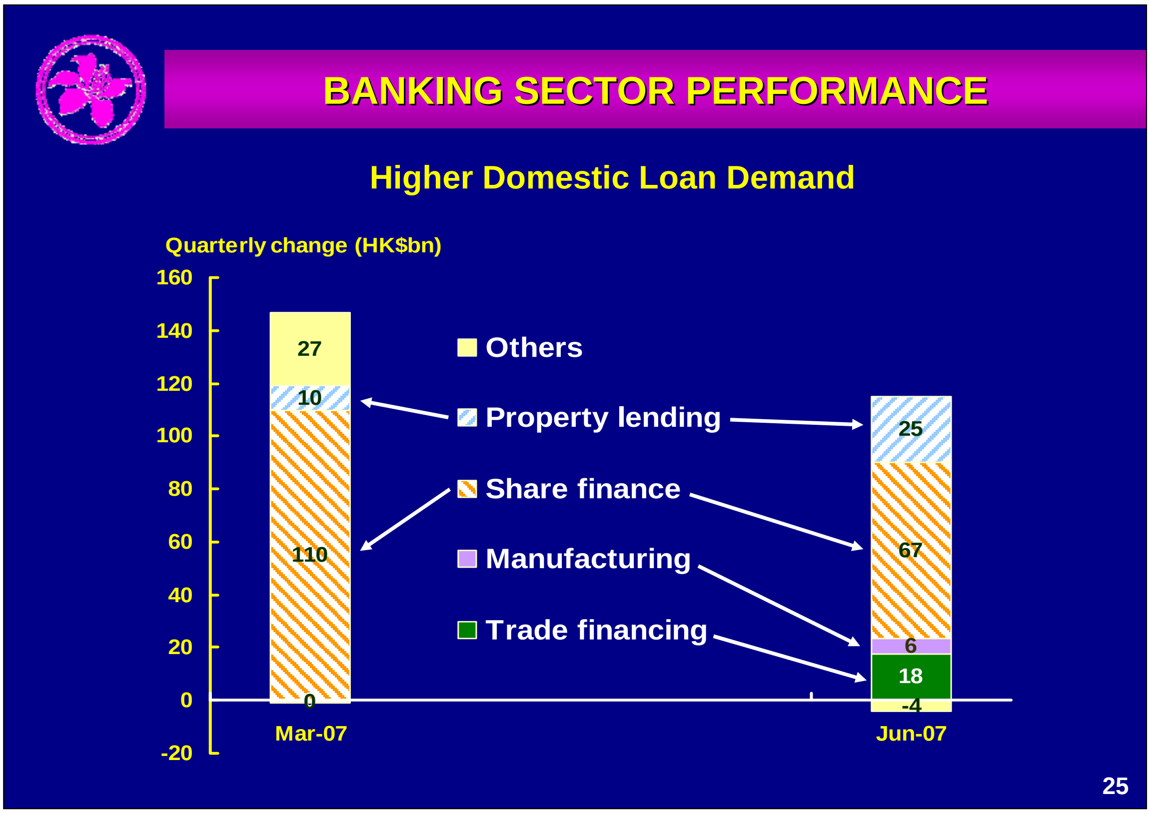
- From January 2007, all Hong Kong-incorporated authorized institutions (AIs) are required to report their capital adequacy positions under the revised capital adequacy framework set out in the Banking (Capital) Rules. Therefore, there was a break in series at this date.

- The aggregate capital-adequacy ratio of Hong Kong AIs at the end of June 2007, calculated on the new basis, was 13.4%, indicating that the capital position of the banking industry remains strong and well above the international minimum standards.



- The Hong Kong banking sector remains liquid although equity-related demand and concerns about spill-over of the US sub-prime problems have caused interbank rates to rise.

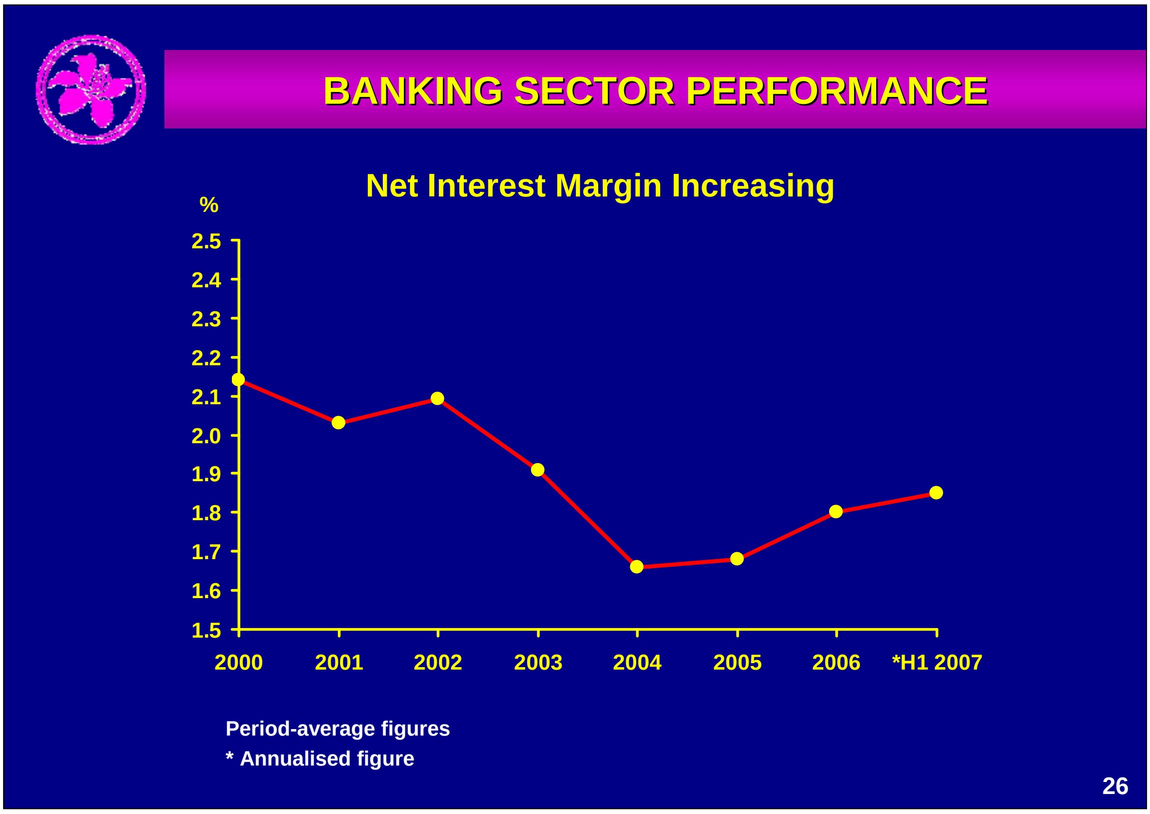
- One of the sub-prime related issues in the US and Europe is the funding by conduits (established to issue financial products related to the sub-prime mortgage market) of long-term assets by short-term liabilities. This is not a problem in Hong Kong, as there is no such conduit operating in Hong Kong.



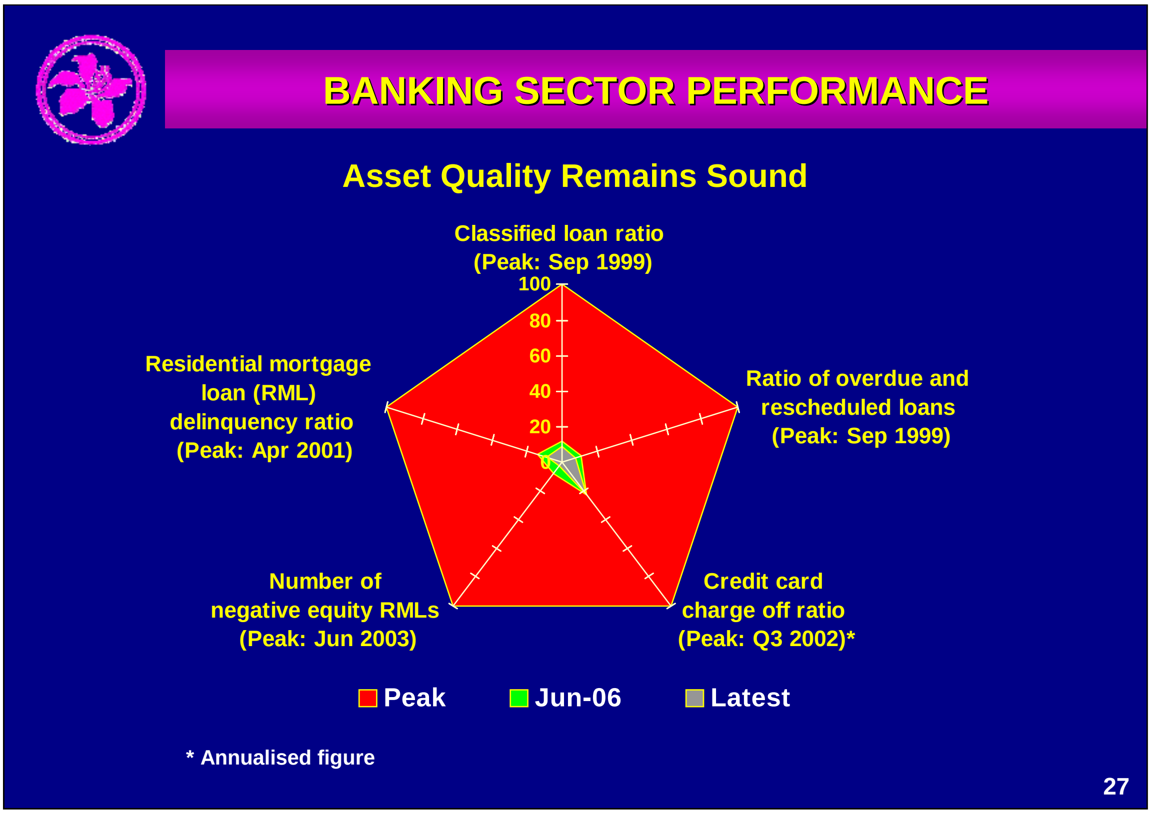
- There continues to be robust growth in domestic lending, which grew by HK$123 billion or 7.4% in the first eight months of the year. Clearly, share finance on the back of high IPO volumes provided a major impetus to growth.

- As shown in the chart, the quarterly loan increase in March was predominantly related to share finance. While the increase in share-financing loans was equally prominent in the June quarter, the increase in other areas, such as property lending and trade finance, was also strong. This suggests that there is broad-based growth in the economy.

- The outlook for the rest of the year is a little more uncertain, given the potential spill-over from the US sub-prime problems, and uncertainties regarding the prospects for growth, particularly in the US. So far, however, any negative effects have been limited, and there is no sign yet of any particular slowdown in bank lending in Hong Kong.



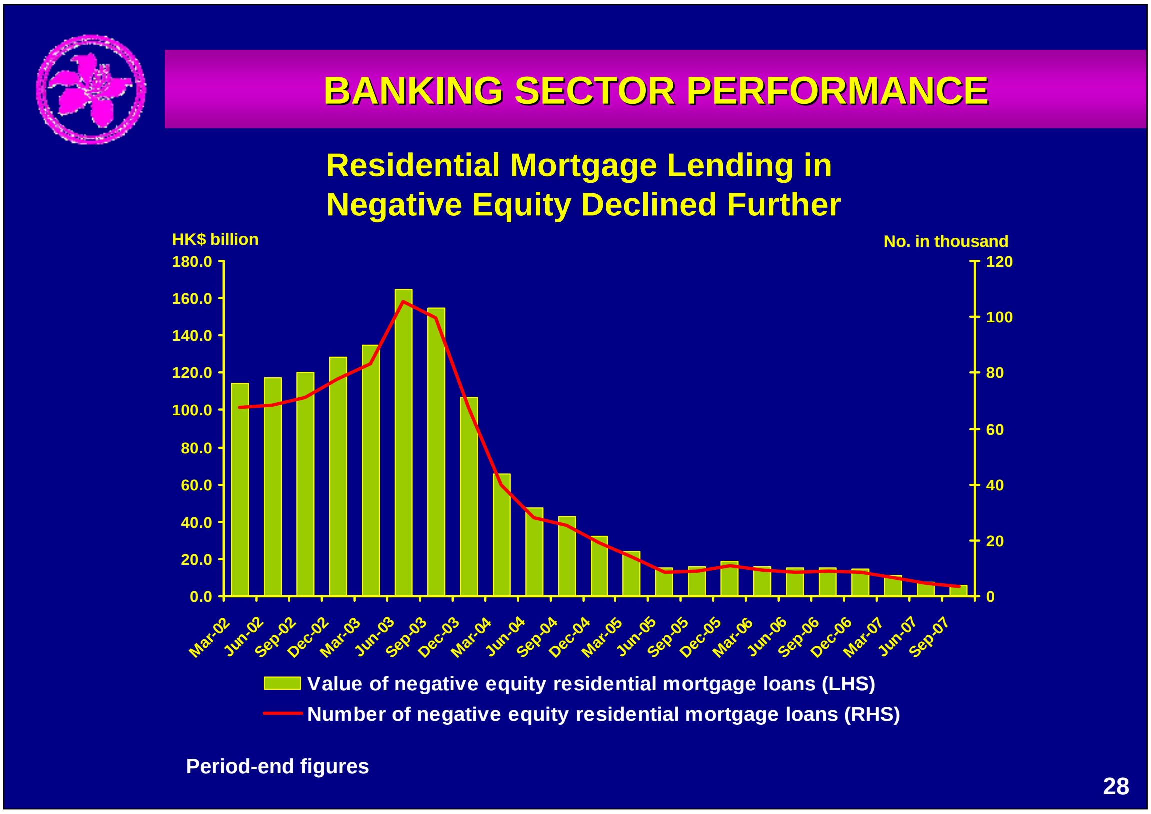
- The retail banks' profitability continues to be healthy, with the main contributors being strong growth in both net interest income and income from fees and commission. The net interest margin rose from 1.74% at the end of 2006 to 1.85% at the end of June 2007. However, the current uncertain market conditions and volatility in interest rates triggered by the sub-prime concerns have introduced uncertainty for banks' operations in the remainder of this year.



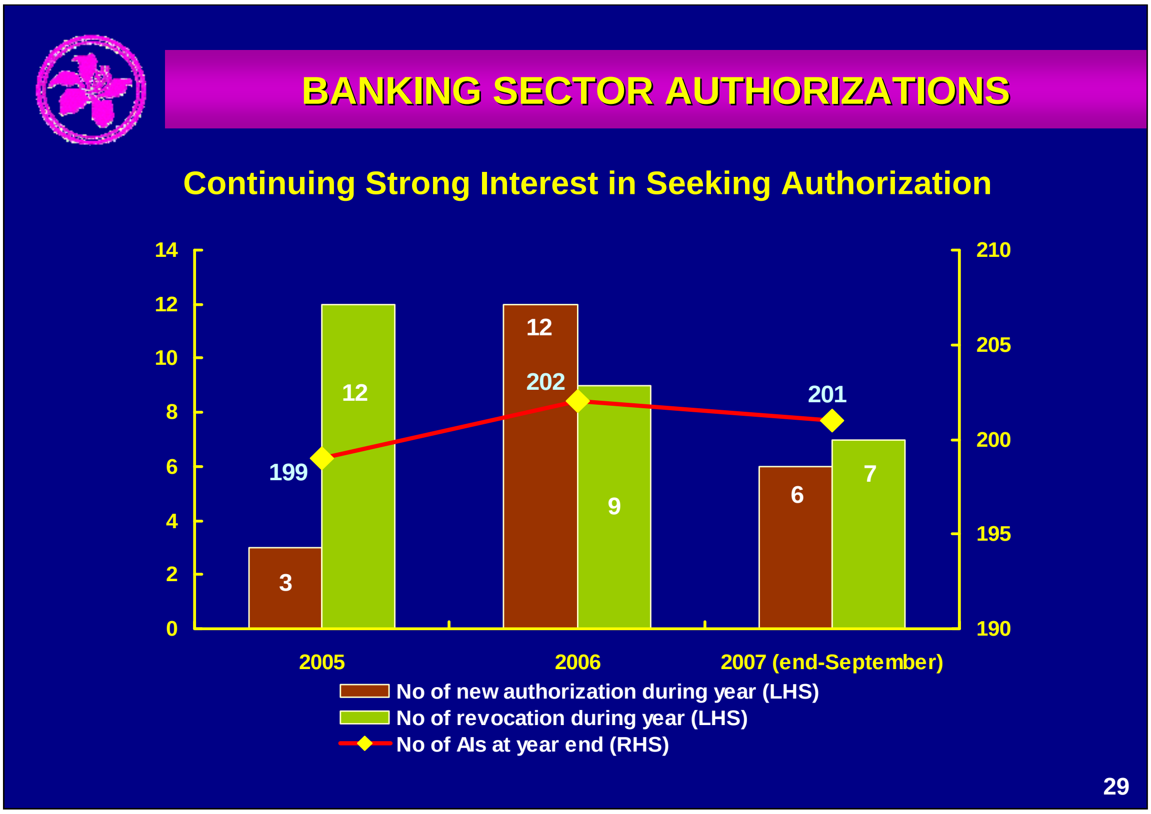
- The banking sector's asset quality remains in very good shape, with classified loan and overdue and rescheduled-loan ratios standing at new lows of 0.90% and 0.68% respectively. The only sign of slight weakening is the softening in the quality of consumer lending as indicated by a mild pick-up in the credit-card delinquency ratio.

- The HKMA has conducted stress tests on the impact of the sub-prime fallout (including the decline in the value of notes issued by special investment vehicles with a sub-prime component) on banks' capital adequacy and profitability. The test results show that the banking sector would remain resilient even under quite severe scenarios.

- In view of the small amount of sub-prime mortgage exposures and the reassuring stress-test results, the HKMA does not anticipate that the US sub-prime will have any systemic impact on the Hong Kong banking sector. However, the HKMA will continue to monitor market developments on sub-prime related issues and money-market liquidity.



- The number of residential mortgages in negative equity continues to contract as property prices rise. It currently stands at around 3,500 cases with an aggregate value of some $6 billion.



- Foreign banks are showing an increased interest in setting up a presence in Hong Kong to capitalise on the strong economic growth and activities in this region, particularly on the Mainland.

- The number of applications for authorization has increased significantly since 2005. Twelve institutions were authorized in 2006, compared with three in 2005, and so far this year HKMA have already authorized another six, with more to come.

- Banks in the region, notably those from India and Taiwan, have a strong interest in establishing a presence in Hong Kong.

- The HKMA oversees the four local designated systems through on-site examination, off-site reviews and continuous monitoring. The Hong Kong dollar Clearing House Automated Transfer System (CHATS), US dollar CHATS, Euro CHATS and the Central Moneymarkets Unit are all in compliance with the safety and efficiency requirements under the Clearing and Settlement Systems Ordinance (CSSO).

- The HKMA completed the annual assessment of the Continuous Linked Settlement (CLS) System, a designated system under the CSSO, and concluded that it satisfied the criteria for designation and the issuance of certificate of finality. The HKMA will continue to monitor the CLS to ensure it is in compliance with the requirements under the CSSO.

- Quarterly reports covering the HKMA's oversight activities from April to September 2007 have been submitted to the Process Review Committee. The third annual report on the work of the Committee is being prepared and will be submitted to the Financial Secretary later.

MARKET INFRASTRUCTURE

- **To develop Hong Kong into a regional payment and settlement hub, enhancing Hong Kong's role and status as an international financial centre**
- **Project development**
  - **Renminbi RTGS system (launched on 18 June 2007)**
  - **Regional Cross-border Payment System (launched on 16 July 2007)**
  - **DvP link with Malaysian securities settlement system (launched on 29 October 2007)**
  - **Electronic trading platform for Exchange Fund Bills and Notes (December 2007)**
  - **Migration to SWIFTNet (Q3 2008)**

- The renminbi RTGS system became operational on 18 June to allow interbank transfers of renminbi on a real-time-gross-settlement (RTGS) basis and settlement of renminbi bonds on a delivery-versus-payment (DvP) basis. In the first four months of operation, the average daily turnover was around RMB323 million yuan.

- The Regional Cross-border Payment System was launched on 16 July to facilitate banks in the region to make cross-border commercial payments in Hong Kong dollars, US dollars and euros through Hong Kong's RTGS systems. The system covers 1,864 beneficiary banks from 42 economies.

- The delivery-versus-payment link between Hong Kong's US dollar RTGS system and Malaysian securities settlement system became operational on 29 October 2007.

- The electronic trading platform for Exchange Fund Bills and Notes is scheduled for launch in December 2007 to increase transparency of prices and transactions and facilitate straight-through processing from trading to clearing and settlement.

- The existing proprietary platform for the RTGS systems and the Central Moneymarkets Unit will be replaced by an open platform to facilitate a greater use of the payment and settlement systems in Hong Kong by overseas financial institutions. Scheduled for launch in Q3 2008.

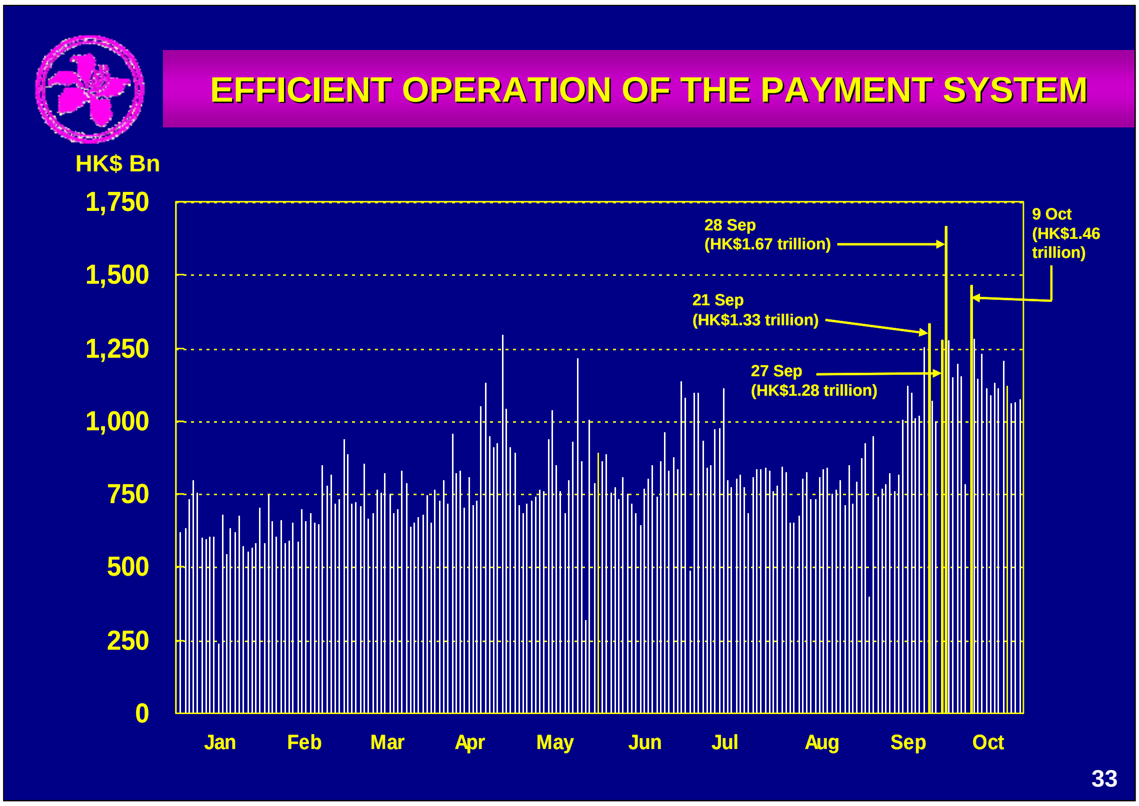
DEVELOPMENT STRATEGY

- **Strategy for development of market infrastructure**
  - **enhancing functionalities of payment systems**
  - **promoting links and usage of financial infrastructure**
- **Successful in increasing turnover of RTGS systems and links with overseas systems**
- **Will continue to adopt this strategy to further strengthen Hong Kong's multi-currency, multi-dimensional payment and settlement platform**

- Following the successful implementation of the two-year work plan approved by the Exchange Fund Advisory Committee (EFAC) in July 2005, we have prepared a new work plan for the next two years. EFAC will consider this new work plan in its meeting in November.

- We have been pursuing a strategy of enhancing the functionalities of our payment systems and promoting links and usage of our financial infrastructure.

- The strategy has proved to be effective as shown by higher turnover in our RTGS systems and links with overseas systems (e.g.PvP link with Malaysia). We will continue to follow this strategy.



- The smooth and efficient operation of the payment system is crucial to support the growing economic and financing activity in Hong Kong.

- Daily average Hong Kong dollar RTGS turnover between June and October (up to 26 October) 2007 was HK$911 billion, compared with HK$746 billion in the first five months of 2007.

- High turnover in the Hong Kong dollar RTGS system was related to the strong economy and especially to IPO activities:

21 September	HK$1.33 trillion for settlement of refund monies of Hidili Industry International Development Ltd and the subscription monies of Qunxing Paper Holdings Company Ltd.
27 September	HK$1.28 trillion for settlement of refund monies of China Starch Holdings Ltd and the subscription monies of DaChan Food (Asia) Ltd.
28 September	HK$1.67 trillion (the highest ever) for settlement of subscription monies for Soho China Ltd and China Aoyuan Property Group Limited and the settlement of refund monies for Sino-Ocean Land Holdings.
9 October	HK$1.46 trillion for settlement of refund monies of China Aoyuan Property Group Ltd.

TREASURY MARKETS ASSOCIATION

- **Renminbi bonds**
  - Renminbi bond price fixing launched to increase price transparency
  - Documentation to facilitate repo of renminbi bonds has been published
- **Islamic bonds**
  - Recommendations made on Islamic bond market development in Hong Kong
- **Foreign-exchange market**
  - Study undertaken to consider ways to enhance competitiveness of Hong Kong's foreign-exchange market

Renminbi bonds

- To increase price transparency of the renminbi bond market in Hong Kong, the TMA launched a daily price fixing on 12 July 2007 for renminbi-denominated bonds issued in Hong Kong. The Renminbi Bond Fixing covers the prices of the renminbi bonds issued by China Development Bank, Export-Import Bank of China and Bank of China.

- To facilitate repo trading of renminbi bonds, the TMA also published Hong Kong Annex for Renminbi Bonds to the Global Master Repurchase Agreement.

Islamic bonds

- In response to the Government's interest in exploring the development of an Islamic bond market in Hong Kong, the TMA has formed a working group to consider the market potential and, drawing from the experience of other financial centres, recommend possible measures to facilitate the issuance of Islamic bonds in Hong Kong.

Foreign exchange

- The TMA has established a working group to recommend ways to further develop the foreign-exchange market in Hong Kong.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

Regional co-operation, focusing on:

- **Promotion of bond market development**
- **Monitoring of risks that may affect regional monetary and financial stability**
- **Establishing Hong Kong's leading position and safeguarding our interest in regional financial cooperation initiatives**
- **Crisis management**

Mainland Co-operation

- **Develop a "mutually-assisting, complementary and interactive" relationship with the Mainland using a five-pronged strategy to enhance Hong Kong's status as China's International Financial Centre**
- **Significant progress has been made recently on the implementation of the five-pronged strategy**

Regional co-operation:

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

- Regional co-operation focuses on bond market development, monitoring of monetary and financial stability, establishing Hong Kong's leading position and safeguarding our interest in regional financial co-operation initiatives and crisis management. The active participation of the HKMA will help establish our leading position as an international financial centre in the region.

Mainland co-operation:

- Since the release of the Report by the Focus Group on Financial Services in January this year, significant progress has been made in implementing the five-pronged strategy for developing a "mutually-assisting, complementary and interactive" relationship with the Mainland.

- Important achievements include:

  (i) New banking sector measures included in CEPA Supplement IV;

  (ii) Expansion of QDII schemes and announcement of the pilot scheme to allow Mainland individual investors to invest directly in Hong Kong stocks; and

  (iii) Further expansion of renminbi business, with issuance of renminbi bonds by Mainland financial institutions in Hong Kong.

IMPLEMENTATION OF FIVE-PRONGED STRATEGY (1) : CEPA

- Five new banking sector measures were added in CEPA Supplement IV :

  (1) Lowering asset requirement for Hong Kong banks to acquire shareholdings in Mainland banks from US$10 billion to US$6 billion

  (2) Establishing a fast track for setting up branches in central western and north eastern areas and in Guangdong Province of the Mainland

  (3) Encouraging Hong Kong banks to set up banks in rural areas on the Mainland

  (4) Providing active support for Mainland banks to set up subsidiaries in Hong Kong

  (5) Relaxing criteria for Hong Kong banks to qualify for CEPA

- The Hong Kong SAR Government and the Central People's Government signed the fourth supplement to CEPA on 29 June 2007. To further strengthen financial cooperation between the Mainland and Hong Kong, five new banking sector measures have been added, with effect from 1 January 2008.

- These new measures are expected to (i) facilitate Hong Kong banks in expanding their business presence on the Mainland; and (ii) increase the outward mobility of Mainland banks. For example,

  (1) small and medium sized banks in Hong Kong can benefit from the lower asset requirement to acquire shareholdings in Mainland banks;

  (2) Hong Kong banks will be able to set up branches in Guangdong Province as well as in the rural and other targeted areas quicker than other foreign banks;

  (3) the flexibility allowed for meeting CEPA criteria (i.e. operate as a branch for two years and as a locally incorporated entity for three years or more) will make it easier for Hong Kong banks to qualify for CEPA benefits than previously; and

  (4) the growing presence of Mainland banks in Hong Kong will enhance Hong Kong's status as an international financial centre.

IMPLEMENTATION OF FIVE-PRONGED STRATEGY (2) :
QDII and investment in Hong Kong stocks by Mainland individuals

- **After expansion of Bank QDII scheme in May 2007, the implementation rules for securities firms, fund management companies and insurance companies were also announced**

- **The Mainland authorities is studying a pilot scheme for Mainland residents to invest directly in overseas securities. The HKMA will work with the relevant Mainland authorities and offer cooperation on supervisory and other related matters.**

- The QDII schemes constitute a significant reform measure in the Mainland's capital account liberalisation and will help establish Hong Kong as an international investment platform for the Mainland.

- At the end of September, the applicable QDII quotas for 21 banks and three fund management firms (Hua An, China Southern and China AMC) have reached US$16.1 billion and US$7 billion respectively.

- Further to SAFE's announcement on 20 August, the relevant Mainland regulatory authorities are studying a pilot scheme that allows Mainland individuals to invest directly in securities listed on the Hong Kong Stock Exchange. The HKMA will work with the relevant Mainland authorities and provide analysis and cooperation as appropriate.

IMPLEMENTATION OF FIVE-PRONGED STRATEGY (3) : Further expansion of RMB business

- The State Council endorsed in January 2007 a further expansion of renminbi business in Hong Kong. Financial institutions on the Mainland can issue renminbi bonds in Hong Kong
- In June 2007, the first renminbi bond in Hong Kong was successfully launched, making Hong Kong the first and only place outside the Mainland to have a renminbi bond market
- So far, three renminbi bonds have been issued in Hong Kong with a total issuance size of RMB10 billion. Investors' response was encouraging.

Issuer	Issue date	Amount
China Development Bank	12 July	RMB 5 billion yuan
Export-Import Bank of China	24 August	RMB 2 billion yuan
Bank of China	28 September	RMB 3 billion yuan

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

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 securities;

(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.

BENCHMARK PORTFOLIO OF THE EXCHANGE FUND

Benchmark Portfolio: no change

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

- 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 benchmark has remained unchanged.

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

EXCHANGE FUND PORTFOLIOS

- Backing Portfolio
- Investment Portfolio
- Strategic Portfolio

INVESTMENT INCOME

(HK$ billion)	2007[1] Jan - Sep	2006 Full Year	2005 Full Year	2004 Full Year
Gain on Hong Kong equities *	55.9	35.9	7.0	12.0
Gain on other equities *	11.1	18.7	20.5	11.2
Exchange gain / (loss)	10.5	17.3	(19.5)	8.5
Return from bonds #	37.1	31.9	29.8	25.0
Investment income	114.6	103.8	37.8	56.7

* Including dividends

\# Including interest

[1] *Unaudited*

TREASURY'S SHARE AND INCREASE IN ACCUMULATED SURPLUS

(HK$ billion)	2007* Jan - Sep	2007* Q3	2007* Q2	2007* Q1	2006 Full Year
Investment income	114.6	67.6	26.3	20.7	103.8
Other income	0.1	0.0	0.1	0.0	0.2
Interest and other expenses	(8.0)	(2.8)	(2.9)	(2.3)	(10.5)
Net investment income	106.7	64.8	23.5	18.4	93.5
Payment to Treasury	(20.2)	(6.9)	(6.9)	(6.4)	(28.9)
Increase in EF accumulated surplus	86.5	57.9	16.6	12.0	64.6

* *Unaudited figures*

\# *The fixed rate of fee payment to Treasury for 2007 (w.e.f. 1 April 2007) is 7%.*

EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK$ billion)	At 30 Sep 2007 (Unaudited)	At 31 Dec 2006 (Audited)	At 31 Dec 2005 (Audited)
ASSETS			
Deposits	99.0	62.4	89.0
Debt securities	857.6	828.4	741.0
Hong Kong equities	180.4	122.4	87.9
Other equities	149.9	137.4	124.2
Other assets	32.2	25.8	24.7
Total assets	1,319.1	1,176.4	1,066.8
	======	======	======
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	158.8	156.9	148.4
Government-issued currency notes & coins in circulation	7.4	6.9	6.7
Balance of the banking system	2.0	2.0	1.6
Exchange Fund Bills and Notes	134.5	129.2	118.1
Fiscal Reserves Account	377.7	324.5	297.1
Other liabilities	44.5	49.2	51.8
Total liabilities	724.9	668.7	623.7
Accumulated surplus	594.2	507.7	443.1
Total liabilities and fund equity	1,319.1	1,176.4	1,066.8
	======	======	======

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- At the end of September 2007, the Accumulated Surplus of the Exchange Fund amounted to $594.2 billion and the fiscal reserves placed with the Exchange Fund amounted to $377.7 billion.