HONG KONG MONETARY AUTHORITY

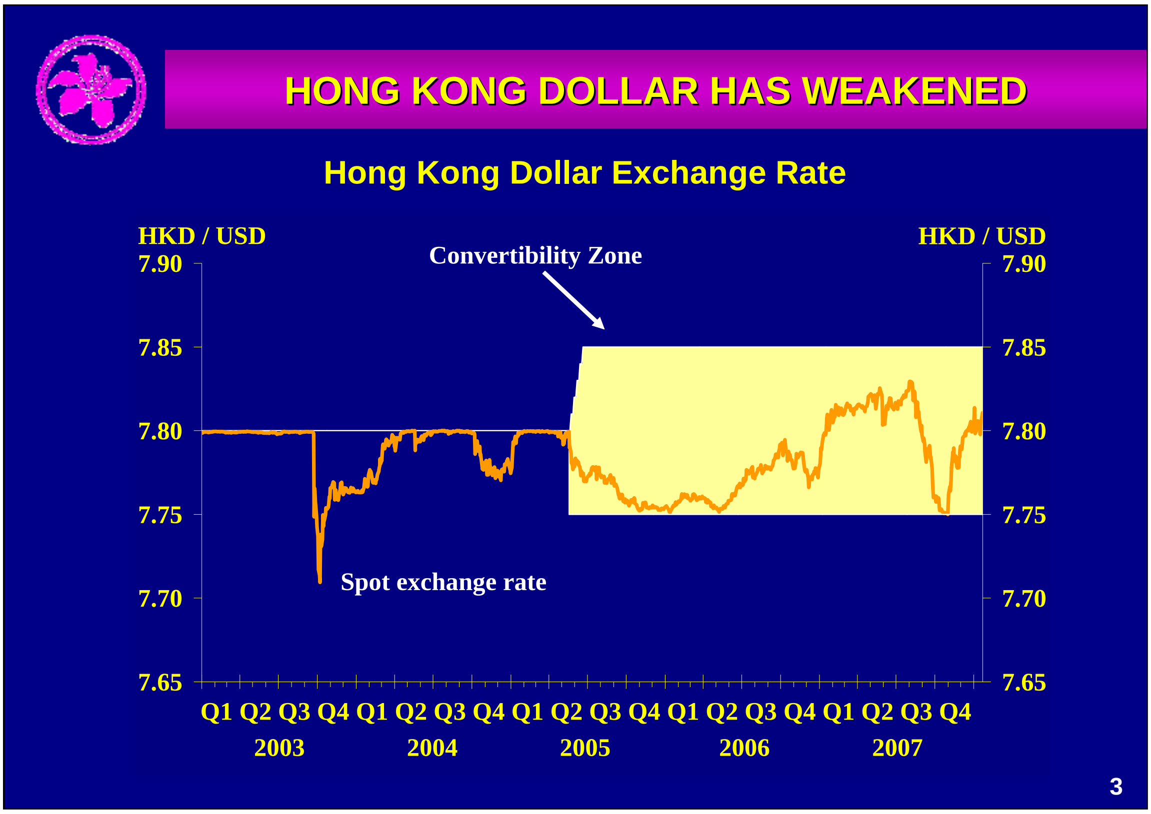
Briefing to the Legislative Council Panel on Financial Affairs

29 January 2008

DISCUSSION TOPICS

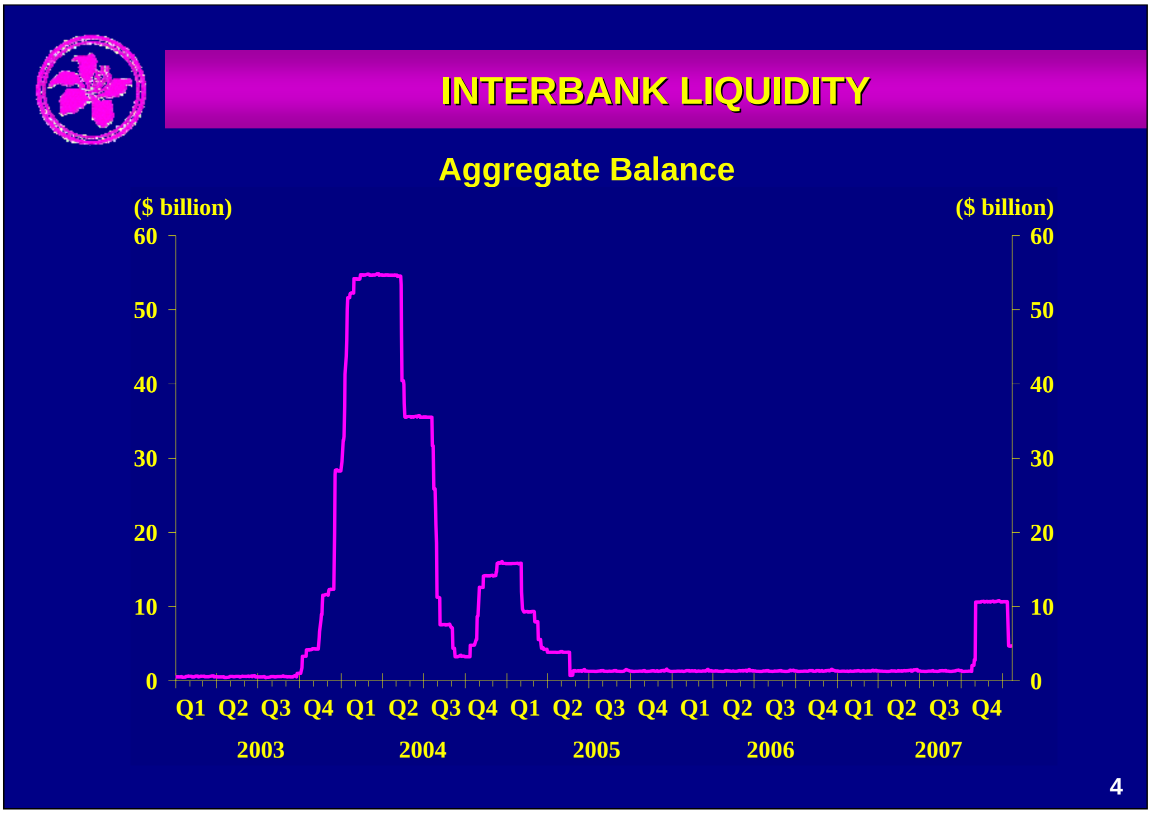
Updates on

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



- The Hong Kong dollar spot exchange rate strengthened towards the strong-side Convertibility Undertaking (CU) in late October 2007. Taking into account market conditions, the HKMA operated within the Convertibility Zone to sell Hong Kong dollars on 23 October 2007. Subsequently, the strong-side CU was triggered on 26 and 31 October 2007. As a result, the Aggregate Balance expanded, interbank interest rates declined and their negative spreads against US dollar interest rates widened.

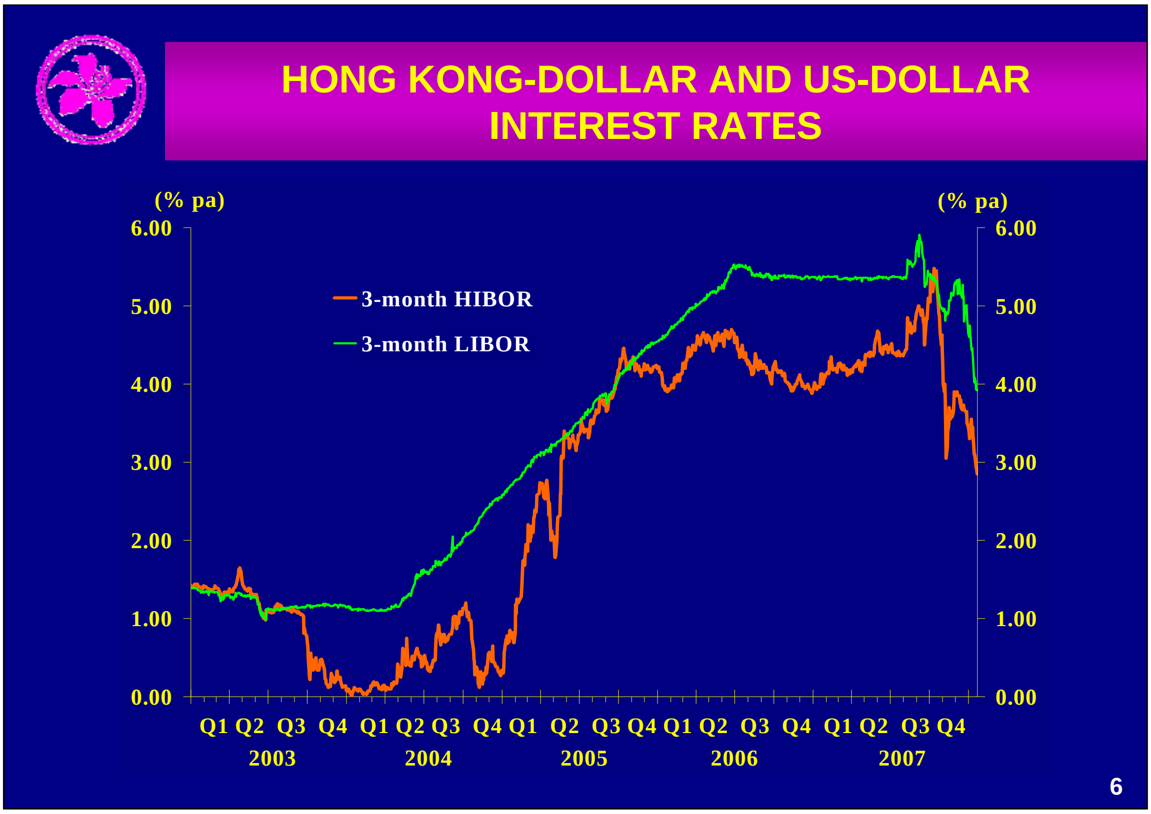
- Since November 2007, the Hong Kong dollar spot exchange rate has weakened to around the central rate of 7.80, reflecting interest rate arbitrage as market participants took advantage of the negative differentials between Hong Kong dollar interest rates and their US dollar counterparts.



- The Aggregate Balance expanded to about $10.6 billion after the HKMA's market operations in late October 2007. Thereafter, the Aggregate Balance stayed around this level before falling to about $4.7 billion in mid-January 2008 after the issuance of additional Exchange Fund paper, which involved debiting the clearing accounts of the successful bidders for the paper. This action will be explained in later charts.

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

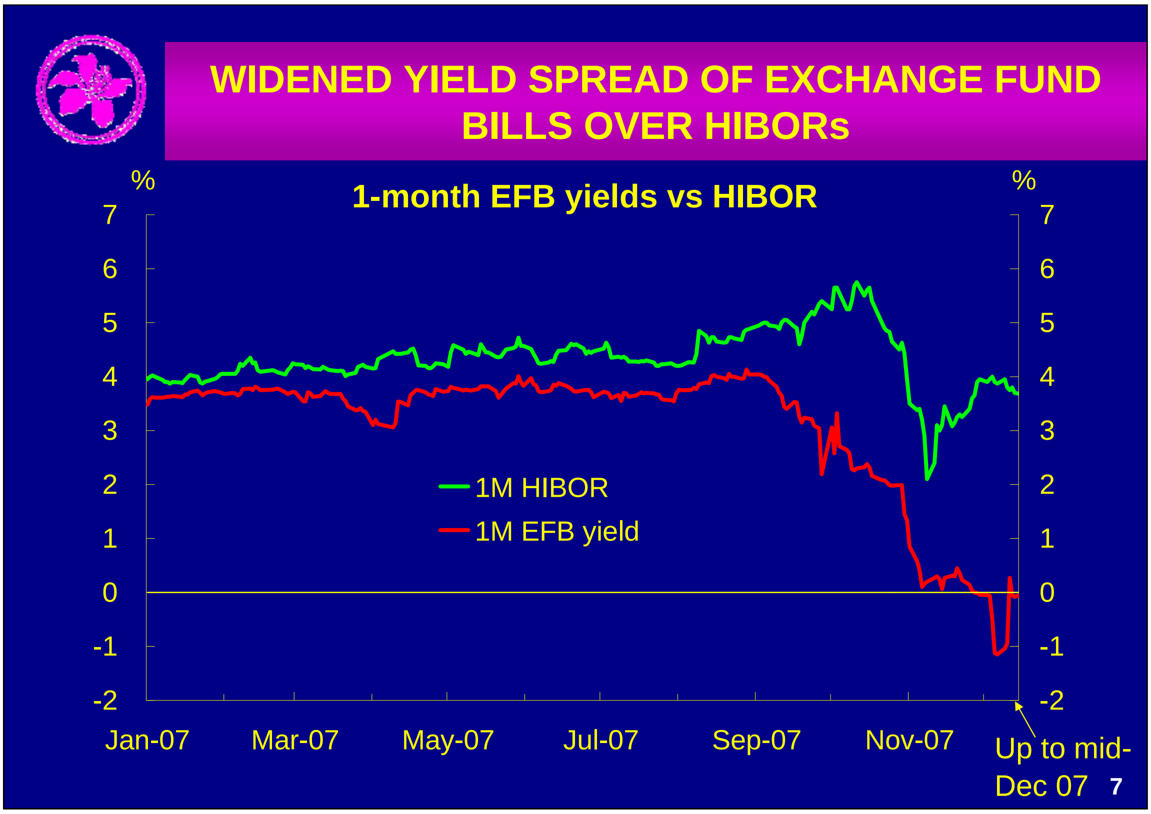
- The discount of the 12-month forward exchange rate from the spot exchange rate has been roughly stable since November 2007. This was in line with the persistently negative interest-rate spreads because of the expansion of the Aggregate Balance following the HKMA's market operations in late October 2007.



- Hong Kong-dollar interbank interest rates eased in late October 2007 following the expansion in the Aggregate Balance after the HKMA's market operations. However, they rebounded in mid-November 2007, reflecting higher liquidity demand associated with IPO activities.

- Short-term HIBORs and LIBORs declined since December 2007 due to interest-rate cuts in the US.

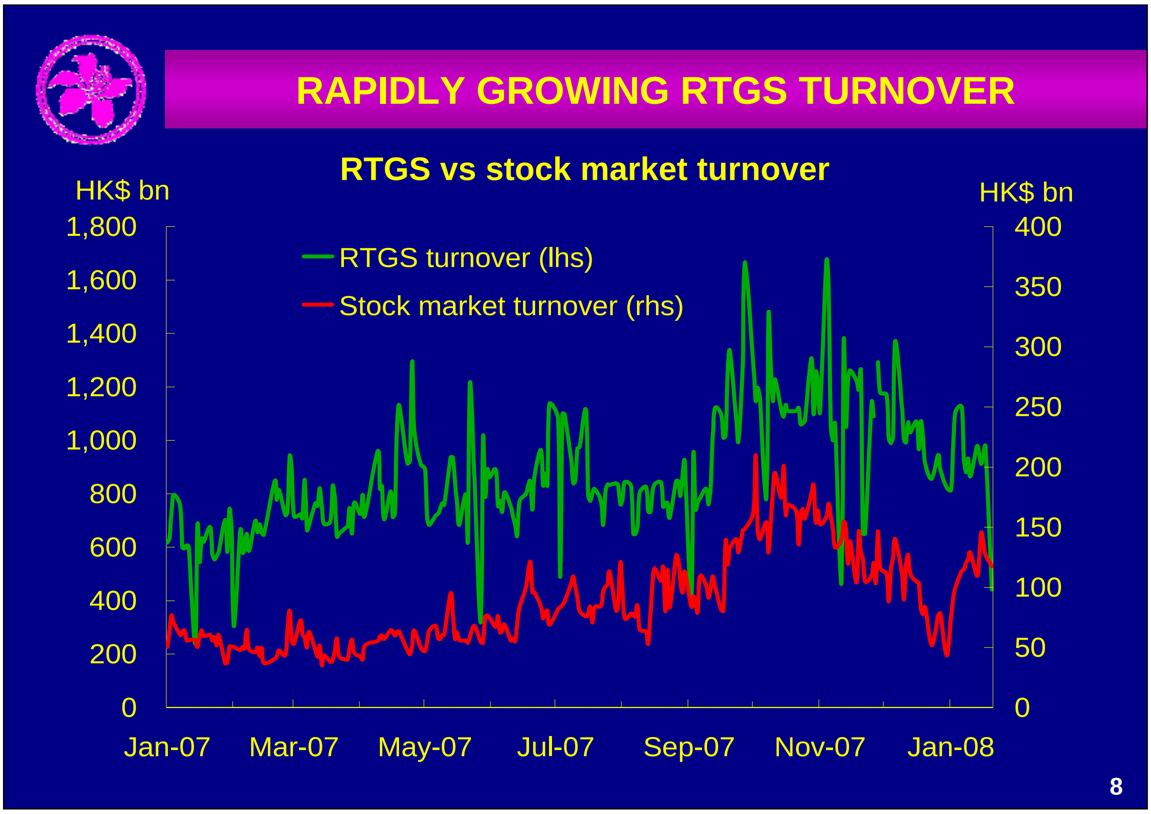
- After the expansion in the Aggregate Balance, the negative spread between 3-month HIBOR and LIBOR was around 140 basis points between November and December 2007. The spread then narrowed to around 100 basis points following the issuance of additional Exchange Fund paper.



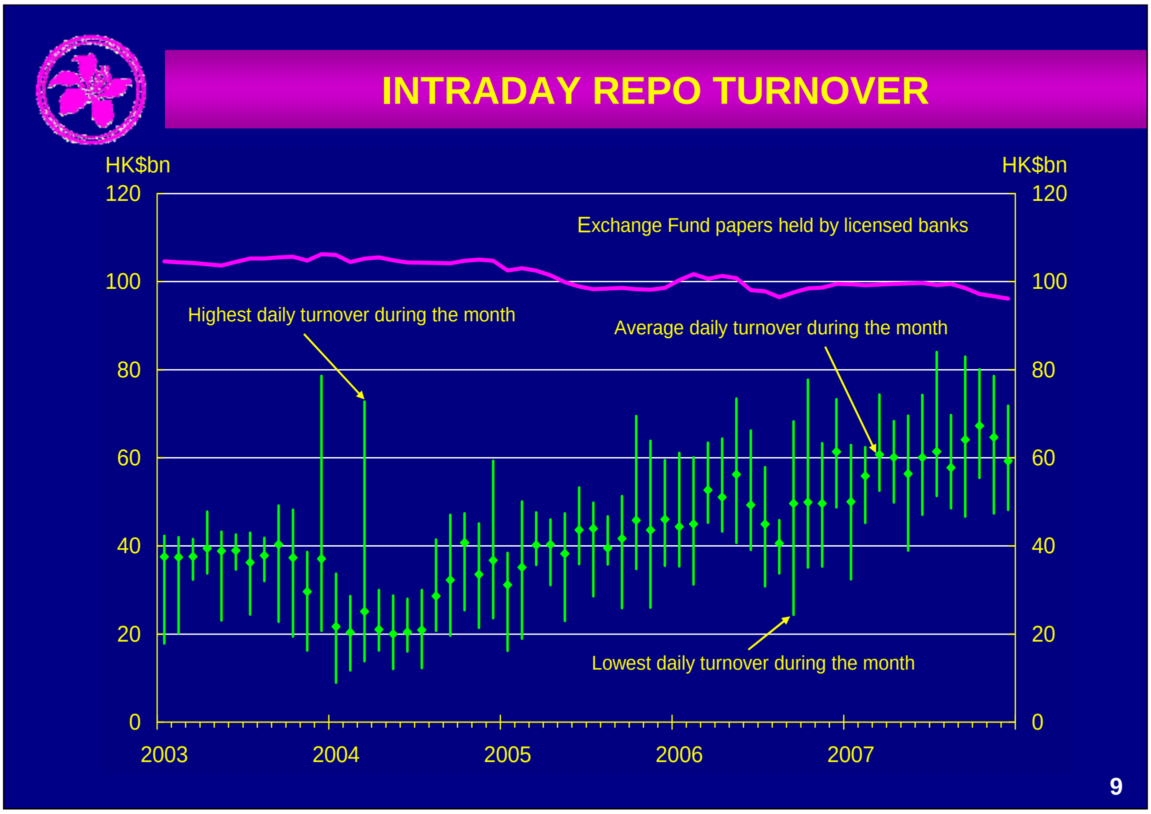
- Yield spreads between EFB and HIBORs have widened since late August 2007, from about 60 basis points to about 400 basis points in mid-December. While this may partly reflect credit concerns arising from the US sub-prime mortgage problem, a more important factor is the increased demand for intraday liquidity.

- Since September 2007, primary and secondary stock-market activity has significantly boosted interbank transactions in the Real Time Gross Settlement (RTGS) system. To cope with the rapidly increasing interbank transactions, banks tend to hold substantial amounts of Exchange Fund paper for use in the automatic intraday repurchase arrangement (repo) with the HKMA for intraday liquidity.

- The supply of Exchange Fund paper has been virtually constant since 1998. Shortage of EFBs in the market has reduced banks' willingness to trade them. Secondary-market liquidity dried up and precautionary holdings increased, putting further demand pressure on the EFB market.



- A string of large IPOs and an active stock market in the latter part of 2007 substantially increased RTGS turnover. The daily turnover of Hong Kong-dollar RTGS transactions in the interbank market frequently surpassed $1.2 trillion in October and November 2007, and reached a record $1.67 trillion on 5 November 2007. Meanwhile, the average daily stock market turnover increased considerably to more than $100 billion in the second half of 2007 from only $35 billion in the second half of 2006.



- The volume of intraday repos in the RTGS system has been increasing steadily, sometimes exceeding 80% of the Exchange Fund paper held by banks.

ADDRESSING THE INCREASED DEMAND FOR EXCHANGE FUND PAPER

- **Increase the supply of Exchange Fund paper via tap issues**
  - **Consistent with Currency Board principles as the Monetary Base remains fully backed by foreign reserves**
  - **Primary objective is to meet the increased demand of Exchange Fund paper for managing intraday liquidity**

- The HKMA launched a tap issue of 91-day Exchange Fund Bills, totalling $6 billion, on 11 January 2008, to help meet the increased demand for Exchange Fund paper and satisfy banks' intraday liquidity needs. Tap issues are ad hoc issues of Exchange Fund paper in addition to the regular tenders.

- The issuance of additional Exchange Fund paper is in line with the three refinements to the Linked Exchange Rate system introduced in May 2005 and Currency Board principles. The Monetary Base remains fully backed by foreign reserves, as the additional issuance of Exchange Fund paper simply represents a shift within the Monetary Base from the Aggregate Balance to the Exchange Fund paper.

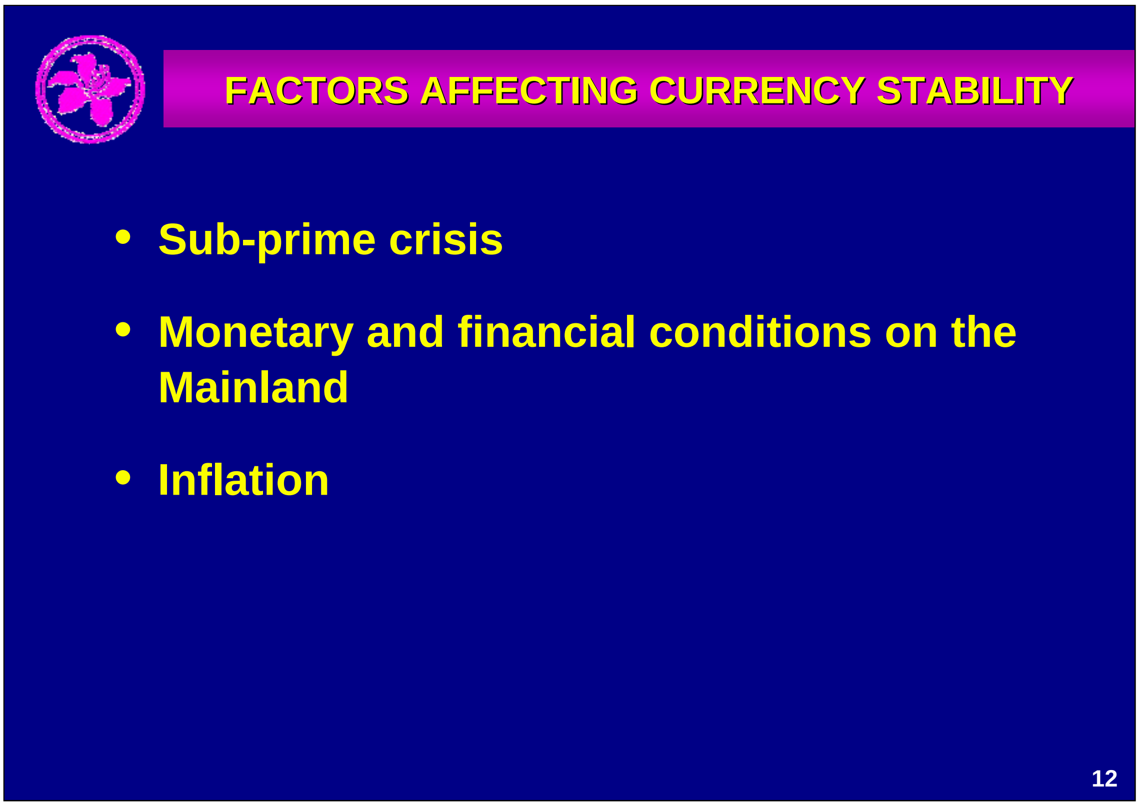
YIELD SPREAD BETWEEN EXCHANGE FUND BILLS AND HIBOR NARROWING

Note: The Viewpoint article on 20 Dec 07 suggested that there might be a need for additional Exchange Fund paper and the article on 3 Jan 08 indicated that the case for increasing the supply of Exchange Fund paper has become clearer.

- Since mid-December 2007 when the HKMA disclosed that it was actively exploring how to increase the supply of Exchange Fund paper to satisfy the increased demand, the yield of Exchange Fund Bills has been rising on expectations of additional issuance of Exchange Fund paper.

- The gap between 1-month HIBOR and yield of Exchange Fund paper with a remaining maturity of one month has narrowed to about 100 basis points in mid-January 2008.

- The tap issue so far has had no significant impact on the Hong Kong dollar exchange rate and interbank interest rates.



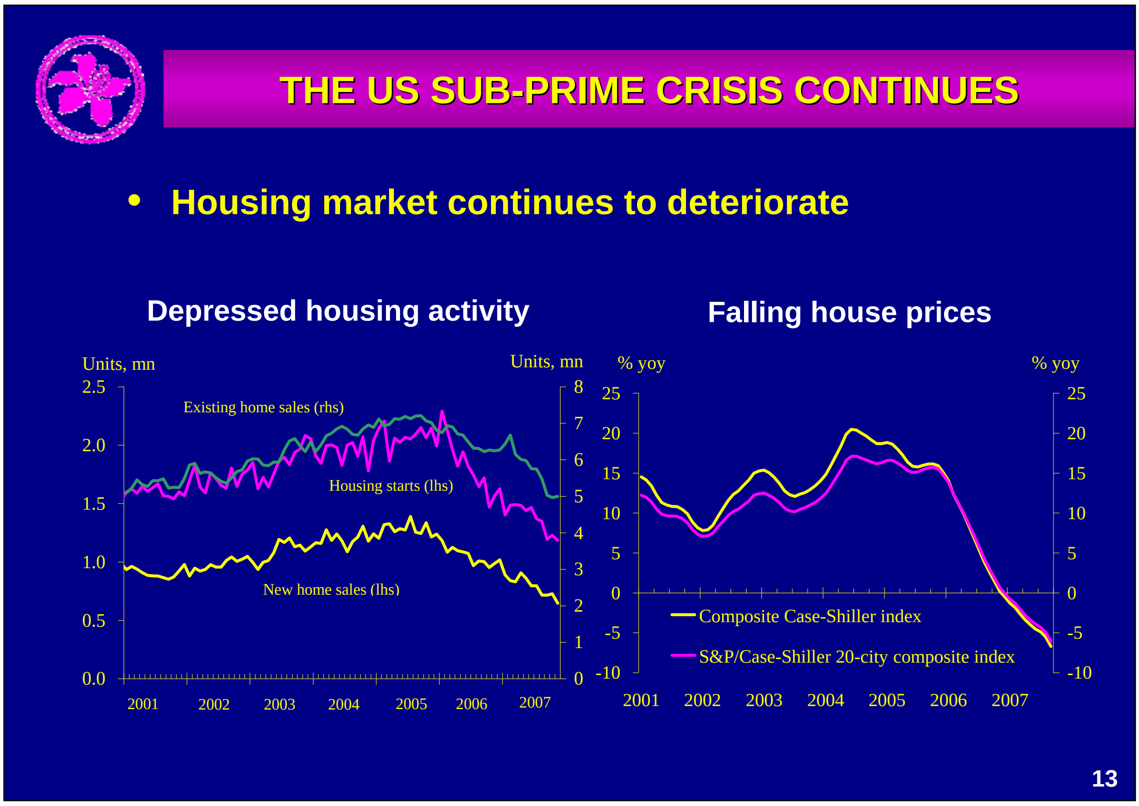
An overview of the potential risks and vulnerabilities:

- The US sub-prime crisis has continued to unfold since the briefing in November 2007. The US housing market has deteriorated further. It seems increasingly likely that the housing woes are spilling over to the broader economy. Against the background of continued housing adjustment, tighter credit conditions, elevated energy prices, and persistent financial market volatility, there are increasing concerns that the US economy might dip into or already be in a recession.

- Risks to global financial stability have increased significantly in recent weeks. Continued bad news from the US finance industry intensified uncertainties about the magnitude and distribution of the sub-prime-related losses have kept market sentiment and conditions unsettled. Money market conditions remain tight. Weak US data and the continuing credit crisis, together with central banks' comments highlighting downside growth risks raised investors' doubts over the 'decoupling' hypothesis and fuelled fears that a US recession would drag the global economy with it, leading to a renewed bout of risk aversion, rising credit spreads, and a global equity-market sell-off. After global stock markets tumbled, the US Fed cut interest rates by 75 basis points in an emergency move on 22 January, one week ahead of its regular meeting.

- Growth momentum in the Mainland economy moderated slightly in Q3 after registering a remarkable growth in Q2. However, rising inflationary pressures and persistent excess liquidity have remained the key concerns. The headline inflation rate rose to 6.9% in November 2007, the highest level in almost 11 years. The People's Bank of China (PBoC) announced in early December 2007 that it would adopt a "tight" monetary policy in 2008. The PBoC raised the benchmark lending and deposit rates on 21 December 2007 for the sixth time in 2007. The reserve requirement ratio for most commercial banks has also been increased to 15% effective 25 January 2008.

- While risks to global inflation appear to have declined 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.



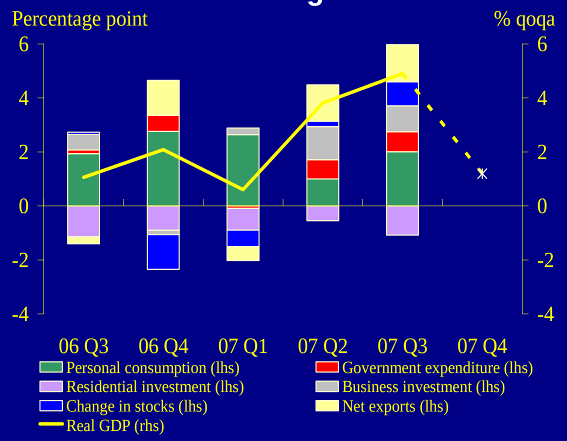
- Housing indicators continued to deteriorate in recent months amid rising delinquency and foreclosure rates. New home sales and housing starts have fallen by about half from their peaks in 2005. In October house prices in 20 US metropolitan areas fell by the most in more than six years, as indicated by the S&P/Case-Shiller home-price index. Prices are likely to fall further as record foreclosures increase the supply of homes while stricter lending rules reduce demand, meaning households are less able to tap equity wealth to fund spending than they did before.

- To stem a wave of foreclosures, the Bush Administration unveiled a plan in early December 2007, which includes a freeze of loan rates at the lower introductory rate for 5 years and allowing sub-prime borrowers to choose to refinance existing mortgages at a lower rate or refinance into a Federal Housing Administration guaranteed mortgage.

Increasing risks of a recession in the US

- **There are increasing talks that the US economy might dip into or is already in a recession.**

US GDP growth



Note: Q4 07 growth figure is market forecast (source: Bloomberg)

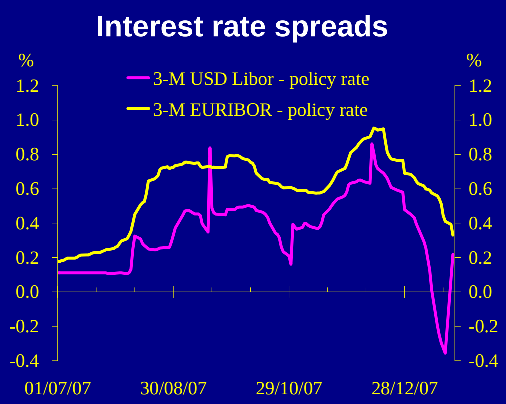
- There is increasing talk among financial market participants that the US economy might dip into or already be in a recession.

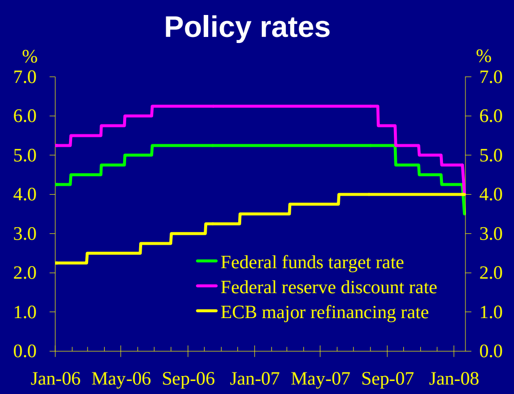
- Incoming data suggest that while growth performance in Q3 has surprised on the upside, the pace of expansion in the US is likely to have slowed considerably in the fourth quarter. Latest market information points to a worsen economic outlook and more pronounced downside risks. As the credit crisis is likely to deepen the housing crisis, residential construction will remain a drag on growth into 2008. There are also increasing signs that falling house prices, higher energy prices, and lower equity prices are likely to weigh on consumer spending. Tighter borrowing conditions, reduced access to credit, and the disappointing December labour-market conditions could further constraint consumption. Business investment also seems likely to slow in light of the adverse developments in credit markets and increased uncertainties about economic growth.

- To counter escalating risks to growth, in mid-January, the Bush administration called for a 'fiscal stimulus package' of around US$150 billion, focusing on broad-based tax rebates to families and incentives to encourage business investment. Details may be clarified in President Bush's State of the Union address to Congress on 28 January.

CENTRAL BANKS IN ACTION

- **Co-ordinated central bank actions to inject liquidity**
- **Major central banks cut policy rates**





- As the high term premiums and tight liquidity conditions persist in the short-term money markets, major central banks have continued to inject liquidity to the interbank markets and broadened the range of eligible collateral accepted in their monetary operations.

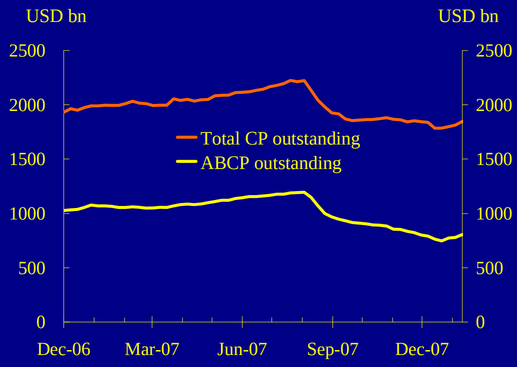
- The US Fed reduced both the Federal funds target rate (FFTR) and the discount rate by another 25 basis points in December 2007 to 4.25% and 4.75% respectively. The Bank of England cut the policy rate by 25 basis points in December 2007, while the European Central Bank (ECB) kept rates on hold. In an emergency move, the US Fed cut both the FFTR and the discount rate by 75 basis points, the biggest one-day reduction on record, on 22 January, one week ahead of its regular meeting. Further rate cuts are widely expected. According to Fed chairman Bernanke, “we stand ready to take substantive additional actions as needed to support growth and to provide adequate insurance against downside risks”.

- To ease the credit squeeze and market tension, the Fed, jointly with the ECB and the Swiss National Bank, announced a Term Auction Facility and temporary reciprocal currency swap lines in December 2007. By allowing the Federal Reserve to inject term funds through a broader range of counterparties and against a broader range of collateral than open-market operations, this facility could help promote the efficient dissemination of liquidity when the unsecured interbank markets are under stress.

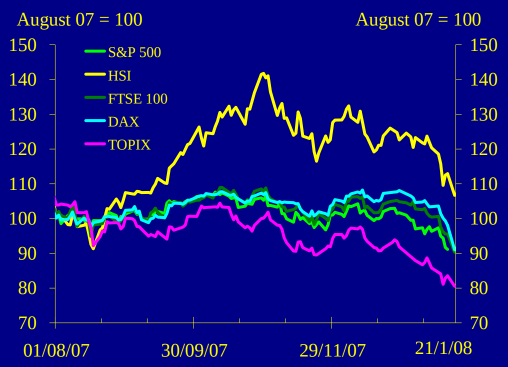
FINANCIAL MARKET STILL IN TURBULENCE

- **Weak US data, persistent credit crisis and fears that a US recession will likely drag down the global economy led to a renewed bout of risk aversion and global equity market sell-off**

US commercial paper outstanding



Global equity markets



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- While financial markets showed signs of improvement following the Fed's action in mid-September 2007, the market situation and sentiment have since deteriorated significantly as major US financial institutions such as Citigroup, Merrill Lynch, and Morgan Stanley as well as some of their SIVs (Structured Investment Vehicles) reported multi-billion dollar write-offs for sub-prime-related debt securities and huge profit losses.

- Against the background of the continued pull-back in risk-taking, both the US and the European short-term money markets have remained tight since September 2007. Banks continue to hoard liquidity and remain reluctant to lend to each other in the interbank market because of concerns about actual or contingent obligations and potential counterparty risks. The commercial paper markets remain under severe strain. The asset-backed commercial paper market continued to shrink. The broader commercial-paper market contracted even more sharply due to a drop in commercial paper issued by financial companies.

- The global credit problems and worsening US economic prospects have also led to turbulence in the global equity markets. While a rather swift recovery was observed following the outburst of the financial turmoil in mid-August 2006, renewed concerns over greater-than-expected credit losses, weaker-than-expected US growth prospect as well as faltering world economic growth have continued to weigh on the global equity market since last November. While capital injections into troubled US financial institutions gave a brief boost, the December FOMC decision disappointed investors and market reaction to the co-ordinated central bank effort towards the end of the year was mixed. US stocks fell following Bush's announcement of the proposed fiscal stimulus package, as investors feared it might not be enough to avert a recession. This triggered a global equity market sell-off on concerns over faltering global economic growth. Both the European and Asian stock markets tumbled, recording their sharpest one-day drop in years.

- If volatility in the global financial markets increases or persists, reactions in the equity and the debt/credit markets could be greater, inducing further increases 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.

- 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 and the global economy, Hong Kong could be affected through both the real-economy and the financial-market channels, subject to some external factors.

- In case of a hard-landing of the US economy, growth might fall sharply should the US housing slump continue and the tightening of credit conditions persist or even get worse. If the housing difficulties spill over to other sectors of the economy, especially to consumer spending, the impact on Hong Kong would be larger.

MONETARY AND FINANCIAL CONDITIONS ON THE MAINLAND

- Widening of balance-of-payments surplus
- Faster appreciation of the renminbi
- Continued capital inflows, and rapid accumulation of foreign-exchange reserves
- Continued increases in reserve requirement of the banking sector
- Large issuance of PBoC paper to sterilise excess liquidity created by the acquisition of foreign reserves

MONETARY AND FINANCIAL CONDITIONS ON THE MAINLAND

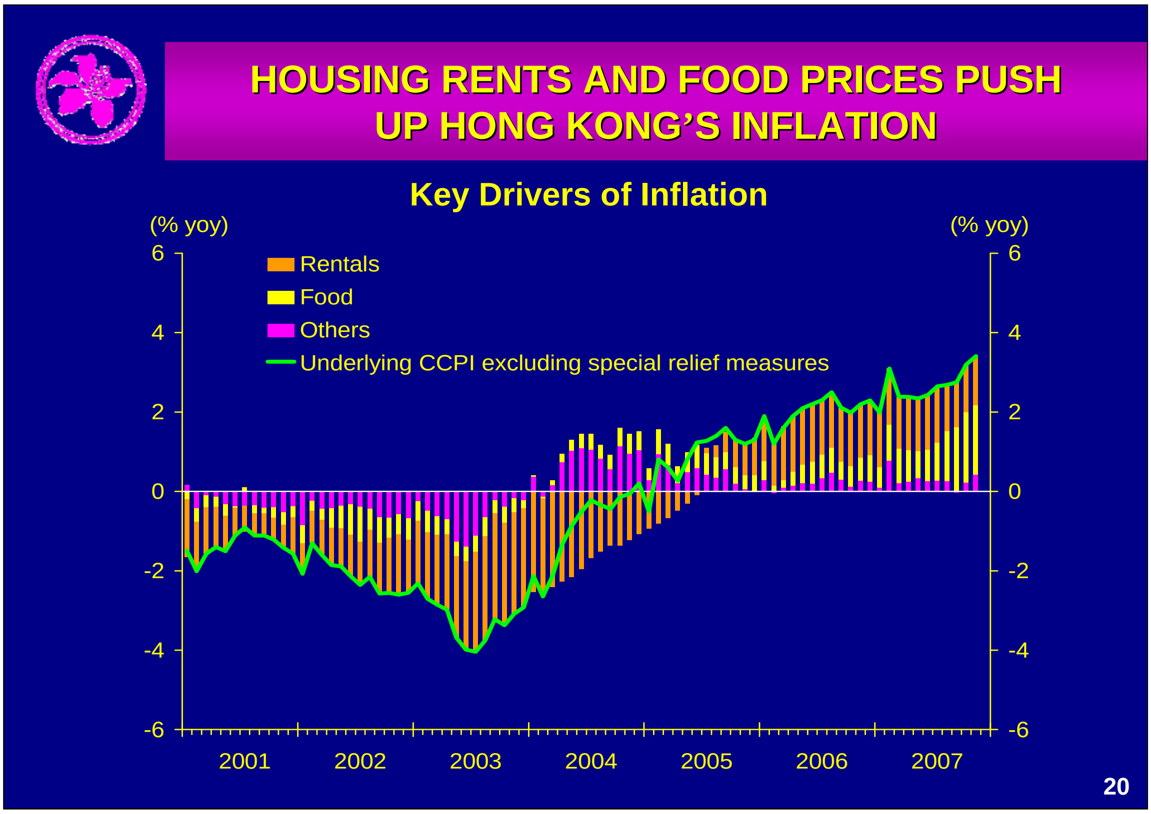
- **Rising inflation**
- **Raising interest rates and using price controls to curb inflation**
- **Implementing policies to encourage orderly capital outflows**
- **Large demand for investment instruments by the non-state sector**
- **Development of capital markets against the background of supply-and-demand imbalance**

- The Mainland authorities have started to use administrative tools to stabilise prices. The State Council executive meeting presided by Premier Wen Jiabao announced on 9 January a freeze mainly on utility and transportation prices. The National Development and Reform Commission subsequently issued further control measures on 15 January, which mainly apply to prices of meat, grain, edible oil and liquefied petroleum gas. There are two key measures: "application for price increases" for manufacturers and "filing for price adjustment" for wholesalers and retailers.

- Following 10 increases totalling 550 basis points in 2007, the PBoC raised the reserve requirement ratio by another 50 basis points to 15%.

- These inter-related developments create forces pulling in different directions and it is very important to manage these forces in order to maintain control of developments and avoid disruption to financial markets.

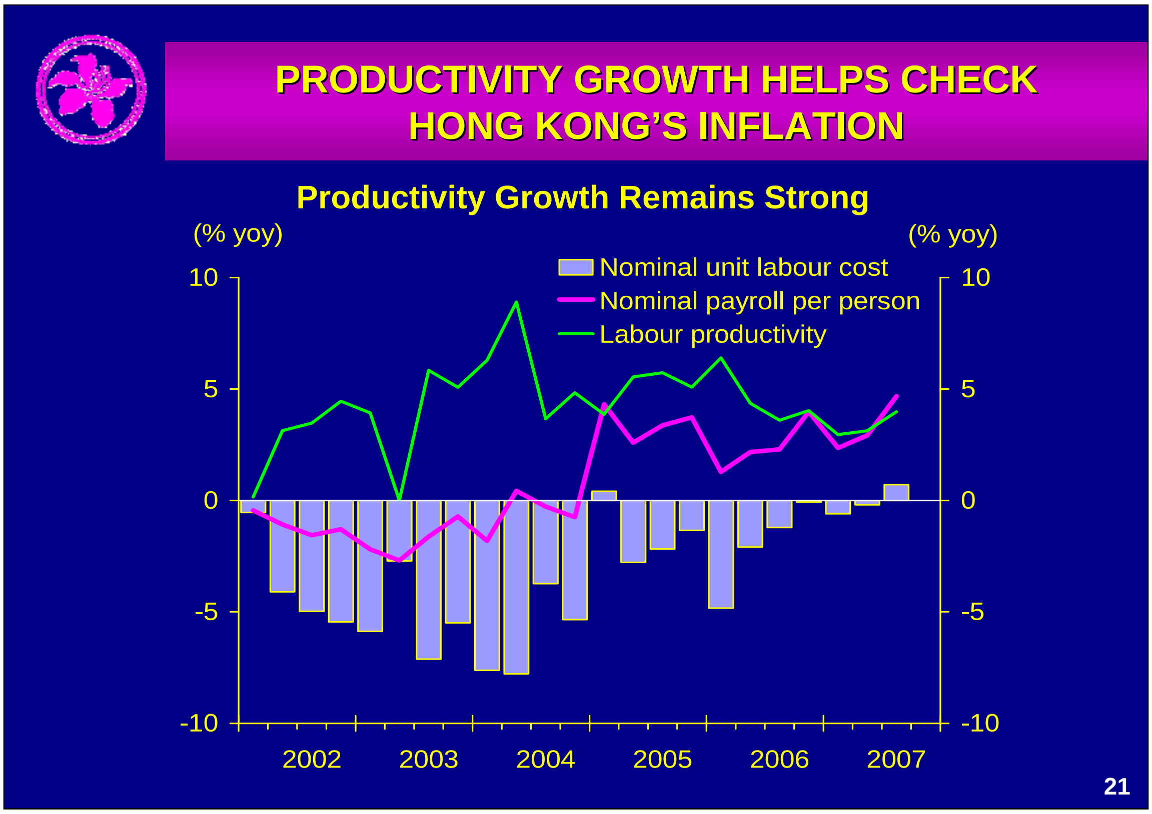
- It is likely that the financial markets will be volatile in response to news and developments, but this is unlikely to cause systemic problems to the robust financial system in Hong Kong.



- The year-on-year headline inflation rate in Hong Kong increased to 3.4% in November 2007.

- 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 underlying 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 rise further, 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.



- 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 4.9% on average since the third quarter of 2003.

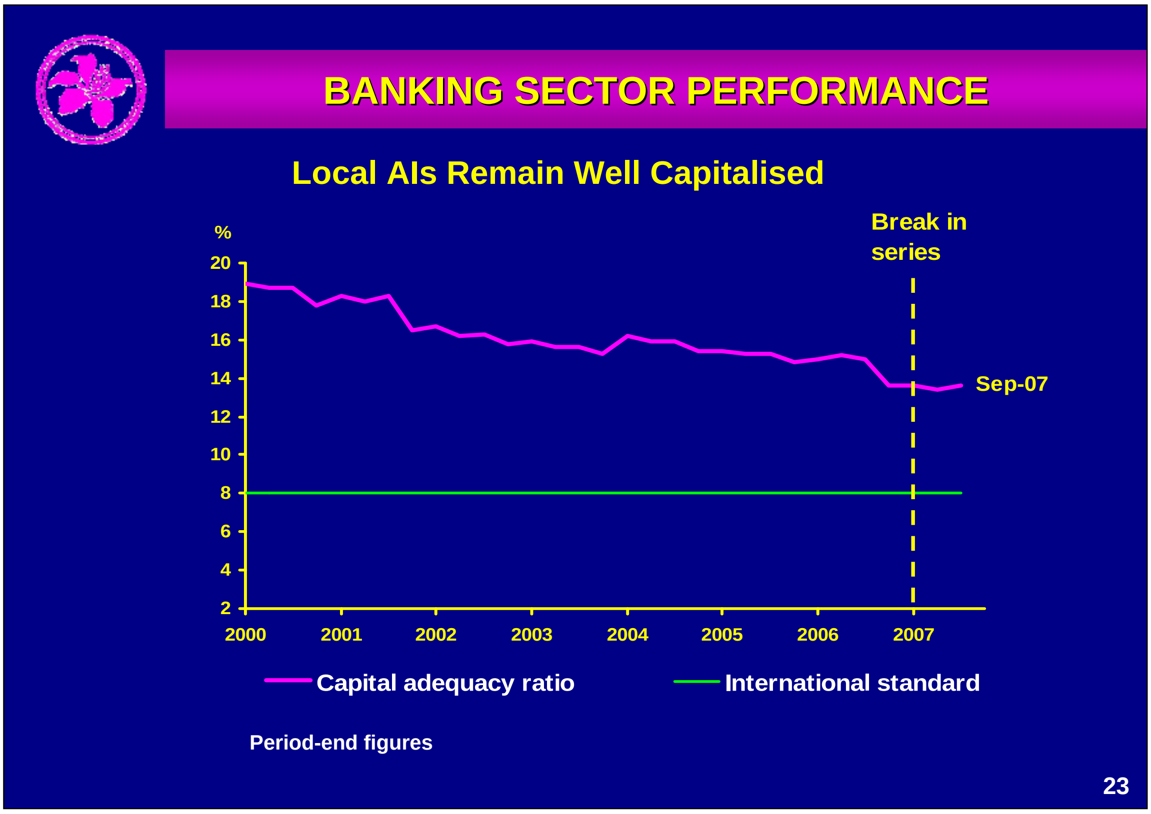
- The change in unit labour cost has been modest in recent years, suggesting inflationary pressure from wage increases remains limited.

CURRENCY NOTES

- **HK$10 Polymer Note**
  - **Put into circulation in July 2007**
  - **Extensive public education programme launched**
  - **Public response favourable so far**
  - **Additional 50 million notes to cater for Chinese New Year demand**
  - **The HKMA will evaluate public acceptance and technical performance of the note in two years**

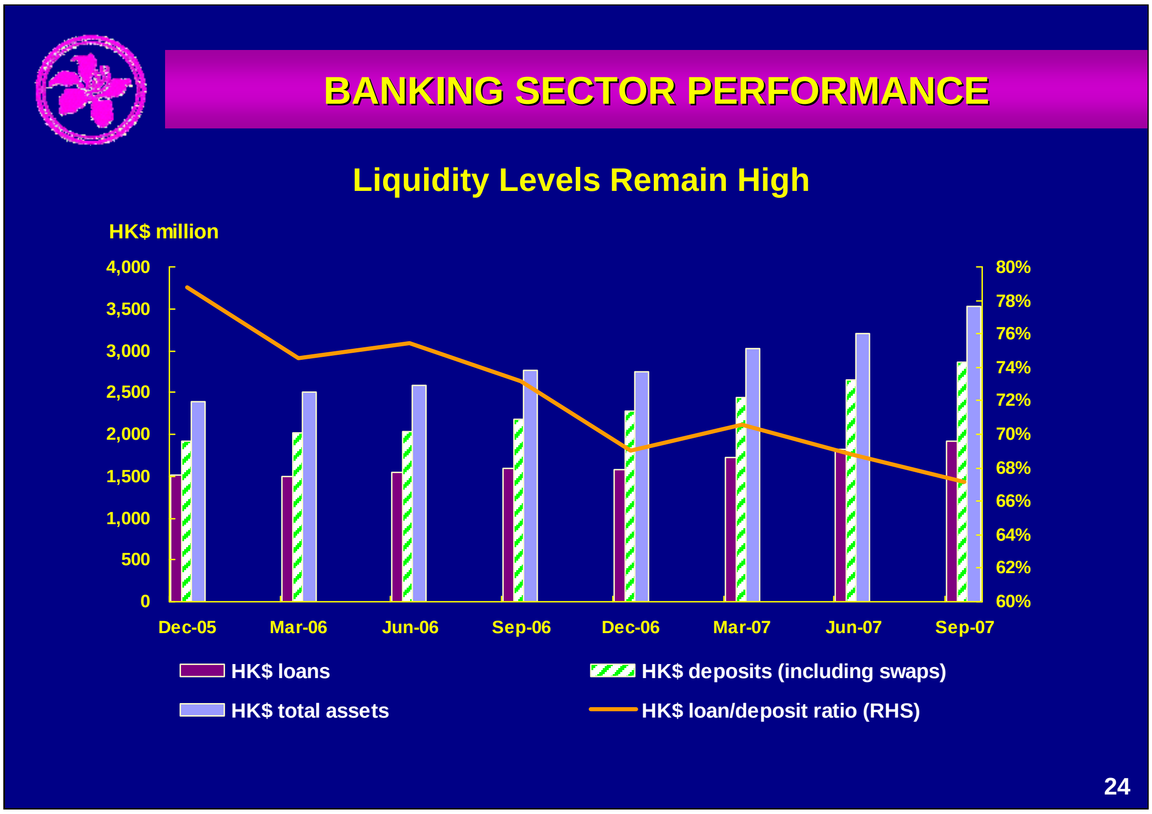
- To educate the public on the security features and characteristics of the new note, an extensive public education programme was launched between May and July 2007. The programme included seminars dedicated to bank tellers, money changers and retailers, displays of posters at bank branches and public offices and exhibitions at public housing estates.

- The HKMA has arranged for the production of an additional 100 million notes. The first 50 million will be available to cater for demand ahead of the Chinese New Year. These notes will be available from 28 January 2008.



- 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. There was therefore a break in series at this date.

- Calculated on the new basis, the average consolidated capital-adequacy ratio of Hong Kong AIs was 13.6% at the end of September 2007, indicating that the capital position of the banking industry remains strong and well above the international minimum standards.



- The Hong Kong banking sector remains highly liquid, as the amount of customer deposits grew faster than that of loans.

BANKING SECTOR PERFORMANCE

Higher Domestic Loan Demand

Quarterly increases (in HK$ bn)

	Trade financing	Share financing	Property lending	Others	Total domestic loans
Mar-07	0	127	10	9	146
Jun-07	18	47	25	21	111
Sep-07	3	43	28	26	100
Total up to Sep-07	21	217	63	56	357

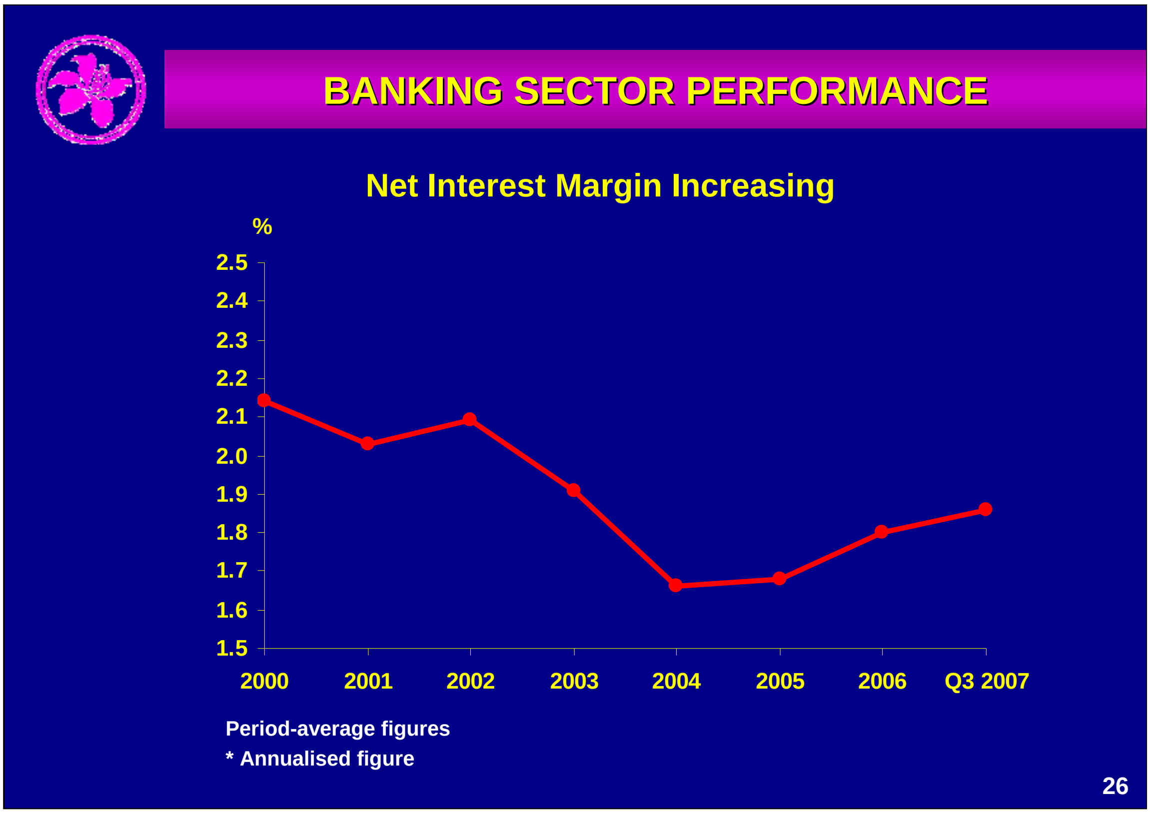
- Domestic loan demand for retail banks continued to be strong in the third quarter of 2007. In the previous two quarters, share financing on the back of active IPO activities and property lending were the main contributors behind the loan growth.

- For the first nine months of 2007, domestic loans grew by $357 billion or 21.3%, compared with $73 billion or 4.4% in the same period of 2006.

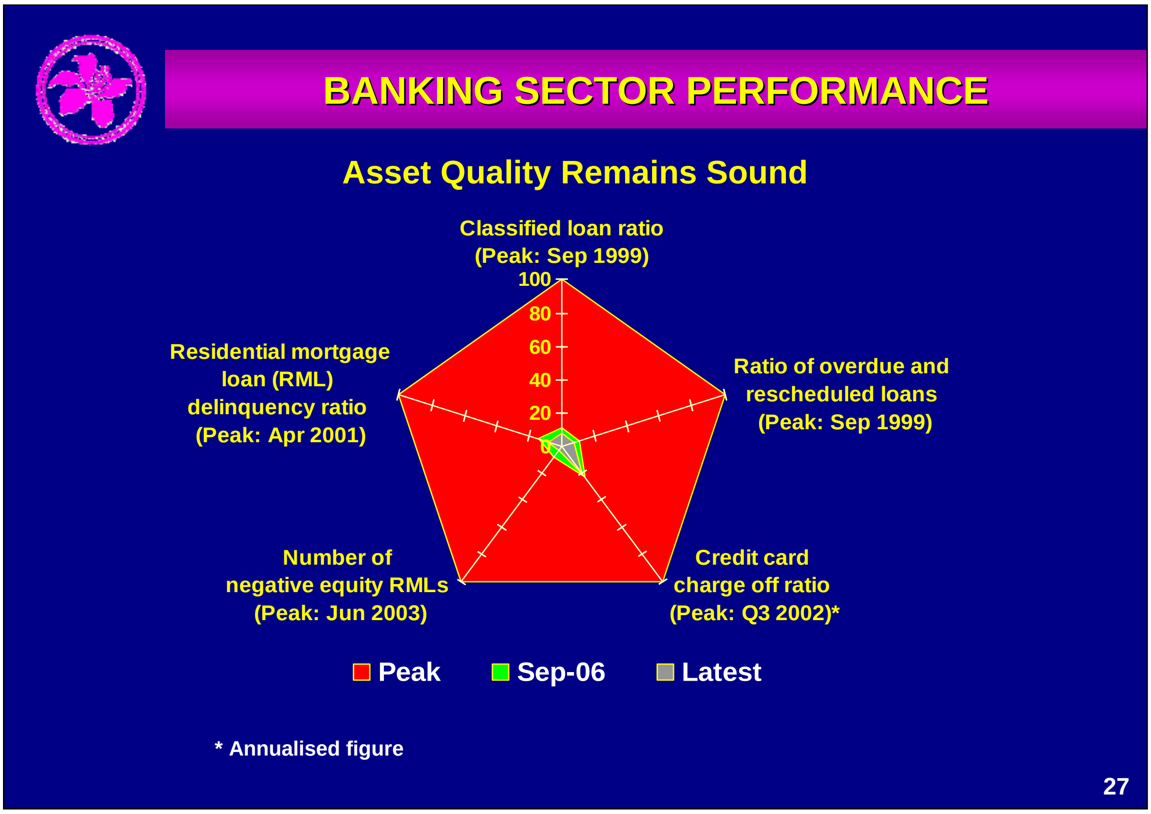
- As IPO activities were more subdued towards the end of 2007, share margin financing is expected to taper off in December 2007.

- On the other hand, the reduction of best lending rates in the fourth quarter of 2007 and rising property prices should bolster property loans.

- The outlook for loan demand in 2008 is a little more uncertain, given the potential spill-over from the US sub-prime problem, and uncertainties regarding the prospects for economic growth, particularly in the US. So far there is no sign of significant slowdown in bank lending in Hong Kong.



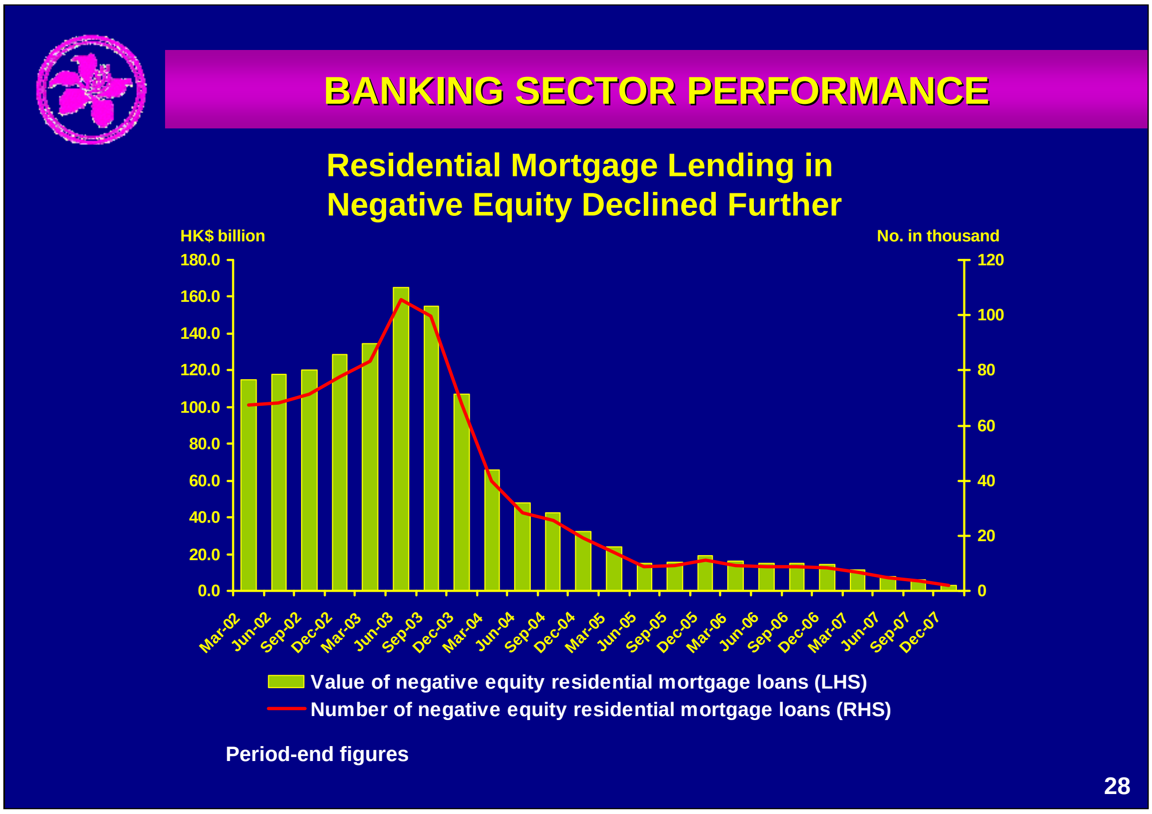
- The retail banks' profitability continues to be healthy, led by strong growth in both net interest income and income from fees and commission. The net interest margin rose from 1.80% at the end of 2006 to 1.86% in the first three quarters of 2007.



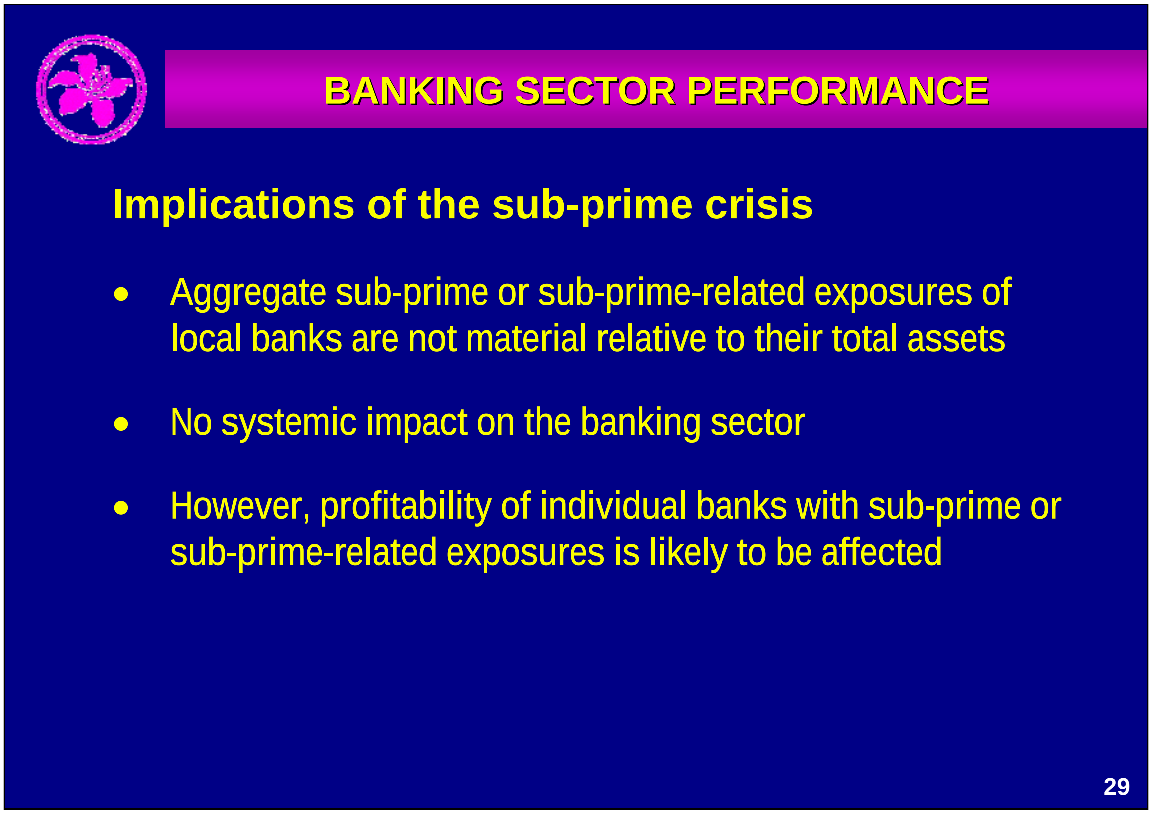
- Despite the sub-prime problem in the US, the Hong Kong banking sector's asset quality remains in very good shape. At the end of September 2007, classified loan, and overdue and rescheduled-loan ratios were at new lows of 0.89% and 0.58% respectively. However, these ratios are expected to be higher for some AIs at the year-end reporting as they take into account the updated performance of their sub-prime related exposures in the classification process.

- The HKMA does not anticipate that the US sub-prime problems will have any systemic impact on the Hong Kong banking sector. But the profitability of individual institutions with exposures to sub-prime or structured investment vehicles will be affected after taking into account the provisions to be set aside for these exposures.

- The market outlook for 2008 remains uncertain due to the US sub-prime fallout. The HKMA has conducted stress tests to assess the potential impact of adverse market conditions on banks' capital adequacy and profitability based on various stress scenarios, including a decline in the value of investments in sub-prime mortgages and other asset-backed securities. The results show that despite the severity of the stress scenarios, banks would remain solvent.



- The number of residential mortgages in negative equity continues to contract as property prices rise. It currently stands at around 1,900 cases with an aggregate value of some $3 billion.



- The information submitted to the HKMA by banks indicates that the aggregate sub-prime exposures are not material relative to their total assets. The situation therefore should not affect banks' overall safety and soundness, and should not have any systemic implication for the banking sector in Hong Kong.

- The prolonged adverse market developments (particularly the liquidity problem for the structure investment vehicles), recent downgrading of the credit ratings of these exposures by rating agencies, and the continuous widening of credit spreads have intensified the impact on the profitability of banks with exposures to sub-prime-related investments.

REVIEW OF HKMA'S WORK ON BANKING STABILITY

- **Aims to make recommendations on focus and priorities of the HKMA's banking supervisory functions and policies to be developed in the next five years**
- **Takes into account**
  - **globalisation of finance and banking business**
  - **increasing integration of the financial systems of Hong Kong and Mainland China**
  - **growing complexity of banking products**
  - **increasing reliance of banks on information technology**
  - **increasing need to combat financial crime**
  - **changing nature of supervision**
  - **expectations of the community**
- **To be completed in second quarter of 2008**

- Hong Kong's banking system is robust, healthy and well regulated. But with the considerable changes and developments that have taken place in the banking industry in recent years and the recent completion of the reforms arising from the consultancy study on the Hong Kong banking sector in 1999, now is a good time to take another look at how we can further strengthen our work in regulating the banking system.

- The HKMA has appointed Mr David Carse as consultant to conduct the review. It is expected to be completed in the second quarter of 2008.

COMMERCIAL CREDIT REFERENCE AGENCY

- **The Commercial Credit Reference Agency (CCRA) will be expanded to cover sole proprietorships and partnerships on 1 March 2008.**

- The HKMA has been working with the industry on expanding the coverage of the Commercial Credit Reference Agency (CCRA), which currently covers small and medium-sized enterprises limited companies. All the implementation details for expanding the scheme have now been finalised. In November 2007, the HKMA and the industry associations jointly announced the upcoming expansion of the CCRA to cover sole proprietorships and partnerships from 1 March 2008. The continued development of the CCRA will help further strengthen the credit risk management of the banking sector, which in turn will help to enhance the safety and soundness of the financial system.

ANTI-MONEY LAUNDERING & COUNTER TERRORIST FINANCING

- **The Financial Action Task Force on Money Laundering visited Hong Kong as part of a mutual evaluation of anti-money-laundering and counter-terrorist-financing measures. The report will be finalised in mid-2008.**
- **The HKMA amended its Supplement to the Guideline on Prevention of Money Laundering in November 2007 to take into account recent developments.**
- **The Industry Working Group on Prevention of Money Laundering and Terrorist Financing has prepared several guidance papers on politically exposed persons, offshore companies, and address proof.**

- The Financial Action Task Force (FATF) on Money Laundering visited Hong Kong as part of a mutual evaluation of anti-money-laundering and counter-terrorist-financing measures. A team of 7 assessors visited Hong Kong between 12 and 23 November. The assessors met a number of public and private organisations to evaluate Hong Kong's compliance with the FATF 40+9 Recommendations. They also interviewed several financial institutions to gauge the effectiveness of the AML/CFT regime in Hong Kong. A draft mutual-evaluation report will be available for Hong Kong's comment in the next few months. The report will be discussed and endorsed by the FATF Plenary at its meeting scheduled for June 2008.

- The HKMA has made several amendments to its Supplement to the Guideline on Prevention of Money Laundering to take into account recent developments (such as the conclusion of the exercise on Non-cooperative Countries and Territories by FATF). AIs are given a 6-month grace period to implement the revised requirements.

- The Industry Working Group on Prevention of Money Laundering and Terrorist Financing issued its first guidance paper on the handling of politically exposed persons in November 2007. Two further guidance papers on customer due diligence for offshore companies and address proof for personal customers are at the final stage of industry consultation.

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**
- **New project development**
  - **Electronic trading platform for Exchange Fund Bills and Notes**
  - **Migration to SWIFTNet**

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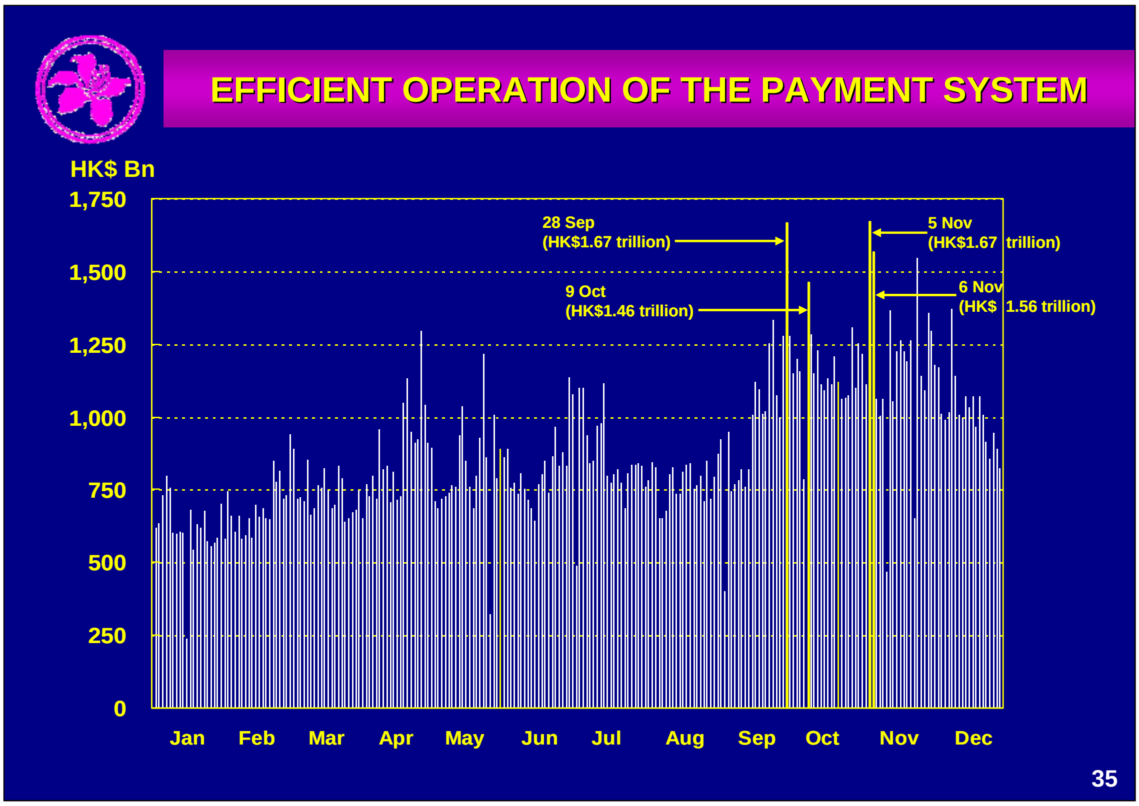
- The average daily turnover of the renminbi RTGS system was around RMB300 million yuan.
- The Regional Cross-border Payment System covers 1,860 beneficiary banks from 42 economies.
- The electronic trading platform for Exchange Fund Bills and Notes was launched on 11 December 2007 to increase transparency 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.

DEVELOPMENT STRATEGY

- **Strategy for development of market infrastructure**
  - **Adding new functions to payment systems**
  - **promoting links and use of financial infrastructure**
- **Success in increasing turnover of RTGS systems and links with overseas systems**
- **Will continue to further strengthen Hong Kong's multi-currency, multi-dimensional payment and settlement platform**

- A new work plan setting out the focus for the coming two years was endorsed by the Exchange Fund Advisory Committee in November 2007. The HKMA will keep up the efforts in project development and business promotion in order to develop Hong Kong into a regional payment and settlement hub.



- 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 in 2007 grew by 52% to $879 billion, compared with $579 billion in 2006.

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

- In view of the increasing turnover of the stock market, the opening time of the Hong Kong dollar RTGS system has been advanced from 9:00 a.m. to 8:30 a.m. since 3 December 2007 to allow more time for banks to arrange funding for their payment obligations for the Central Clearing and Settlement System (CCASS) bulk settlement run at 9:30 a.m.

- A new **CCASS Optimiser** is being developed to enable banks expecting to receive funds in the CCASS bulk settlement run to recycle the funds to banks in need of funds in the bulk settlement run. The new CCASS Optimiser will be launched on 28 January 2008.

MARKET INFRASTRUCTURE

Oversight of the clearing and settlement systems

- **All local designated systems remain in compliance with the safety and efficiency requirements of the Clearing and Settlement Systems Ordinance**
- **Continued support rendered to the Process Review Committee in preparing the third Annual Report to the Financial Secretary.**

- The HKMA oversees 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.

- The Process Review Committee is an independent committee to review the process and procedures adopted by the HKMA in overseeing designated systems. The third annual report on the work of the Committee has been submitted to the Financial Secretary in late January 2008.

Regional co-operation

- **Developing bond market in Asia**
- **Promoting regional financial stability through active participation in an enhanced monitoring mechanism of Asia-Pacific central banks**
- **Providing input to regional financial co-operation initiatives**
- **Strengthening crisis management**

Regional co-operation:

- In promoting greater monetary and financial co-operation in Asia, the HKMA contributed to regional initiatives on the development of the bond market and improving monetary and financial stability in the region.

- The HKMA also actively participates in an enhanced mechanism of Asia-Pacific central banks to monitor risks to financial stability in the region including Hong Kong. The HKMA provides input to regional financial co-operation initiatives and crisis management. The active participation of the HKMA will help strengthen Hong Kong's status as the leading international financial centre in the region.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

- To continue the implementation of the Action Agenda of "China's 11th Five-Year Plan and the Development of Hong Kong", focussing on:

  (1) Renminbi business in HK

  - promote continuous development of the renminbi bond market
  - work further on the proposal for settlement of imports from the Mainland in renminbi

  (2) Use of HK's platform for the orderly outflow of Mainland funds

  - work closely with Mainland authorities on implementation of pilot scheme for direct foreign portfolio investments by Mainland individuals and further development of QDII schemes.

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.

Markets in 2007

- Exchange rates:
  - US dollar weakened against the euro and yen
- Equity markets:
  - Foreign equities market rose in the 1H but retreated in the 2H as the US subprime mortgage crisis intensified
  - Local equities market gained significantly on the back of ample liquidity but correction set in during Nov-Dec
- Interest rates:
  - Monetary easing by major central banks
  - Bond yields fell in general as risk appetite declined but money market rates rose on concerns about credit availability
  - Credit spread widened significantly

Investment Income

(HK$ billion)	2007 Full year*	2007 Q4	2007 Q3	2007 Q2	2007 Q1	2006 Full year	2005 Full year	2004 Full year	2003 Full year
Gain on Hong Kong equities^	55.8	5.7	35.0	14.9	0.2	35.9	7.0	12.0	21.2
Gain/(Loss) on other equities^	6.7	(4.4)	(1.0)	9.9	2.2	18.7	20.5	11.2	26.8
Exchange gain/(loss)	18.7	8.2	3.0	1.5	6.0	17.3	(19.5)	8.5	22.9
Return from bonds#	61.0	23.9	24.8	0.0	12.3	31.9	29.8	25.0	18.8
Investment income	142.2	33.4	61.8	26.3	20.7	103.8	37.8	56.7	89.7

* Unaudited figures
^ Including dividends
# Including interest

Change in Investment Income, Treasury's Share and Accumulated Surplus

(HK$ billion)	2007 Full year (unaudited)	2007 Q4	2007 Q3	2007 Q2	2007 Q1	2006 Full year
Investment income	**142.2**	**33.4**	**61.8**	**26.3**	**20.7**	**103.8**
Other income	0.2	0.1	0.0	0.1	0.0	0.2
Interest and other expenses	(10.2)	(2.2)	(2.8)	(2.9)	(2.3)	(10.5)
Net investment income	132.2	31.3	59.0	23.5	18.4	93.5
Payment to Treasury #	**(27.6)**	**(7.4)**	**(6.9)**	**(6.9)**	**(6.4)**	**(28.9)**
Valuation change of Strategic Portfolio^	4.7	(1.1)	5.8	N/A	N/A	N/A
Increase in EF accumulated surplus	**109.3**	**22.8**	**57.9**	**16.6**	**12.0**	**64.6**

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

^ Including dividends

Historical Change in Investment Income, Treasury's Share and Accumulated Surplus

(HK$ billion)	2007*	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Investment income	**142.2**	**103.8**	**37.8**	**56.7**	**89.7**	**47.0**	**7.4**	**45.1**	**103.8**	**93.8**	**35.6**
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	(10.2)	(10.5)	(7.6)	(4.8)	(5.6)	(7.0)	(10.5)	(11.0)	(10.0)	(16.0)	(18.4)
Net investment income	132.2	93.5	30.4	52.1	84.3	40.2	(2.9)	34.3	94.0	78.0	17.4
Payment to Treasury	**(27.6)**	**(28.9)**	**(10.1)**	**(14.5)**	**(25.7)**	**(15.6)**	**(1.6)**	**(18.1)**	**(45.4)**	**(26.0)**	**N/A**
Valuation change of Strategic Portfolio^	4.7	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Revaluation gain/(loss) on premises	N/A	N/A	N/A	0.9	(0.9)	N/A	N/A	N/A	N/A	N/A	N/A
Carry to accumulated surplus	**109.3**	**64.6**	**20.3**	**38.5**	**57.7**	**24.6**	**(4.5)**	**16.2**	**48.6**	**52.0**	**17.4**
Adjustment to accumulated surplus											
Effect of implementation of HKAS 39	N/A	N/A	(0.6)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Increase/(Decrease) in EF accumulated surplus	**109.3**	**64.6**	**19.7**	**38.5**	**57.7**	**24.6**	**(4.5)**	**16.2**	**48.6**	**52.0**	**17.4**

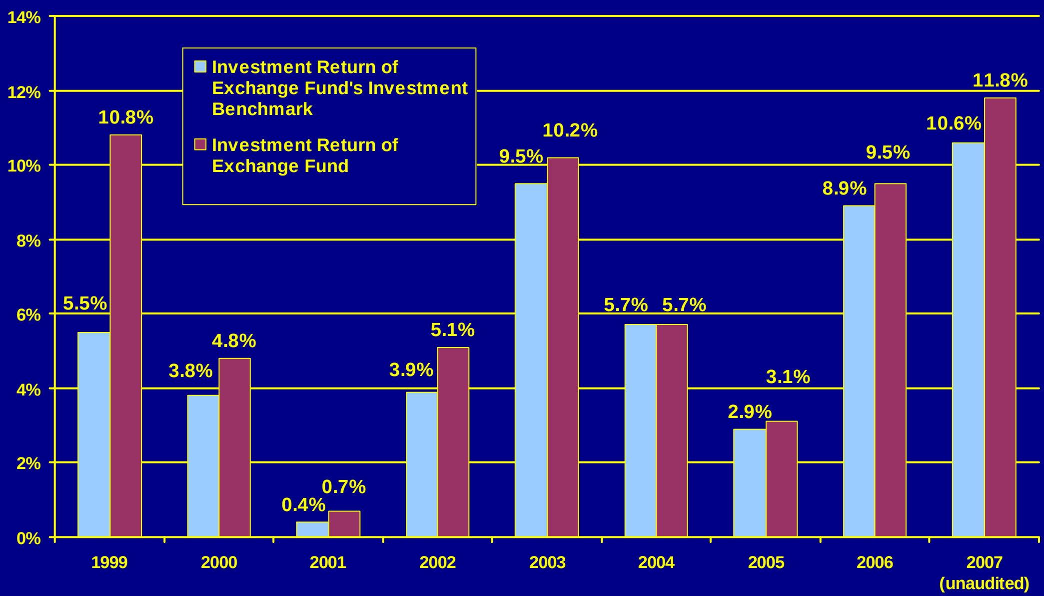
* unaudited figures
^ including dividends

Exchange Fund
Abridged Balance Sheet

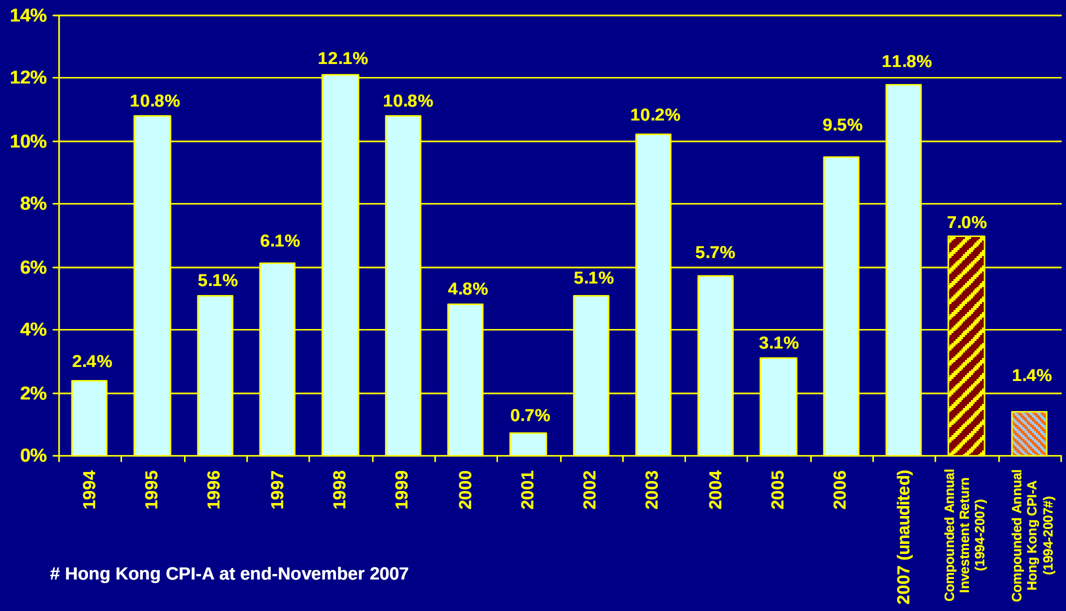
(HK$ billion)	At 31 Dec 2007 (unaudited)	At 31 Dec 2006	Change
ASSETS			
Deposits	133.9	62.4	71.5
Debt securities	922.3	828.4	93.9
Hong Kong equities	184.6	122.4	62.2
Other equities	145.6	137.4	8.2
Other assets	30.6	25.8	4.8
Total assets	**1,417.0**	**1,176.4**	**240.6**
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	163.4	156.9	6.5
Government-issued currency notes & coins in circulation	7.5	6.9	0.6
Balance of the banking system	10.6	2.0	8.6
Exchange Fund Bills and Notes	141.8	129.2	12.6
Fiscal Reserves Account[1]	464.6	324.5	140.1
Other liabilities[1]	12.1	49.2	(37.1)
Total liabilities	800.0	668.7	131.3
Accumulated surplus	617.0	507.7	109.3
Total liabilities and fund equity	**1,417.0**	**1,176.4**	**240.6**

Note 1: Under the new fee arrangement, the payment of $27.6 billion has been included in Fiscal Reserves Account balance of $464.6 billion. With the old arrangement, the return on Fiscal Reserves of $28.9 billion in 2006 was accrued under Other liabilities of $49.2 billion.

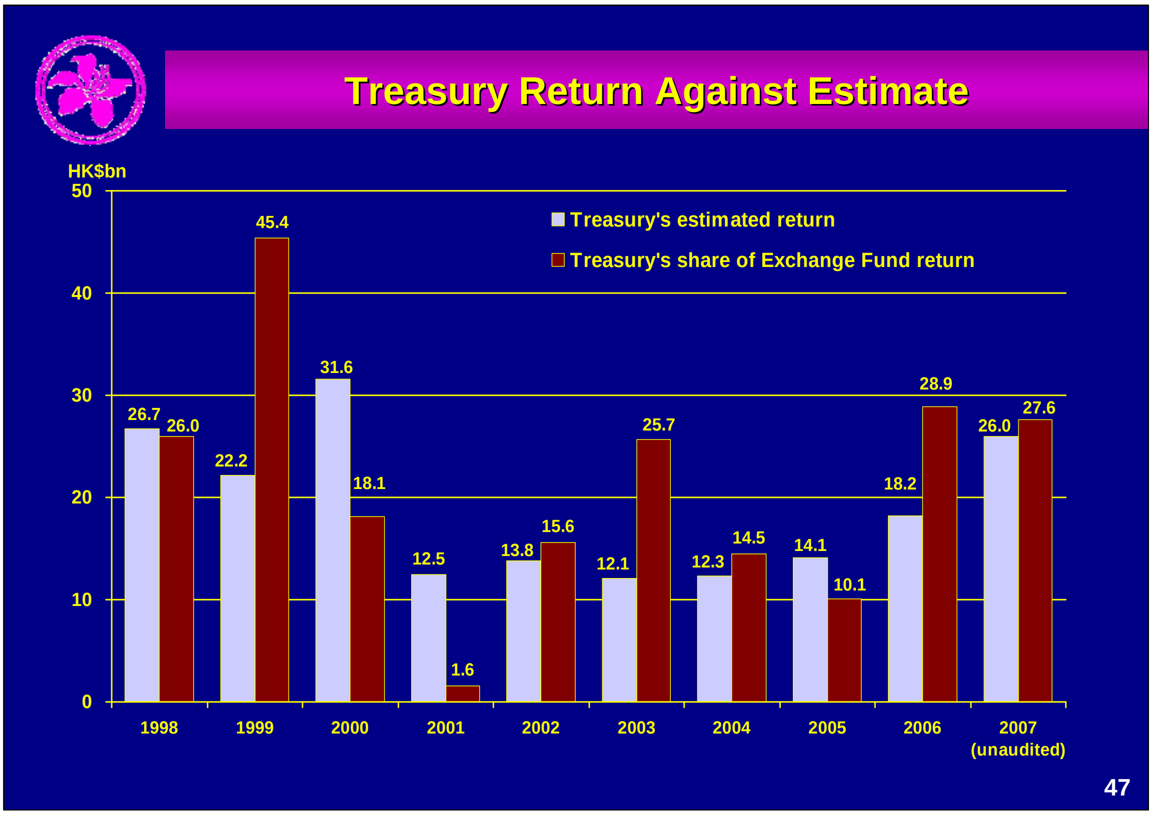
Exchange Fund
Performance Against Investment Benchmark



Investment Return of the Exchange Fund



Hong Kong CPI-A at end-November 2007



Treasury Return Against Estimate
HK$bn
50
40
30
20
10
0
Treasury's estimated return
Treasury's share of Exchange Fund return
26.7
26.0
22.2
45.4
31.6
18.1
12.5
1.6
13.8
15.6
12.1
25.7
12.3
14.5
14.1
10.1
18.2
28.9
26.0
27.6
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
(unaudited)
47