



HONG KONG MONETARY AUTHORITY
香港金融管理局

(Translation)

Legislative Council
Panel on Financial Affairs

Report on the Work of the Hong Kong
Monetary Authority

Joseph Yam, Chief Executive,
Hong Kong Monetary Authority

21 May 2009

Contents

| | <u>Paragraphs</u> |
|---|-------------------|
| Introduction | 1 to 2 |
| International developments affecting Hong Kong's financial stability | 3 |
| Exchange rate | 4 to 7 |
| Money market | 8 to 10 |
| Credit supply | 11 to 12 |
| The banking system | 13 to 15 |
| Lehman incident | 16 to 21 |
| Hong Kong's status as an IFC | 22 to 25 |
| Exchange Fund | 26 to 28 |
| Conclusion | 29 |

Introduction

1. Chairman, this is the last time for me, as the Chief Executive of the HKMA, to brief the Panel on the work of the HKMA. I remember the Panel accepted my proposal in May 1999 offering to conduct these regular briefings, with the aim of increasing the HKMA's transparency and its accountability to the community through the representatives of the people we serve. Today is the thirtieth briefing. These briefings have now been formalised and have become an effective forum for the HKMA to explain its work, increase the credibility of and support for that work, and help the Panel to monitor what we do. They have also helped establish a solid foundation for maintaining Hong Kong's monetary and financial stability. On behalf of the HKMA I would like to extend my heartfelt thanks to the Panel.

2. In this interactive process of us taking the initiative to maintain a high degree of transparency and the Panel's actively monitoring our performance, I am sure Members would agree that the depth and width of the issues discussed in these briefings and their relevance to the well-being of the community have been continuously increasing over the years. The results and benefits of these briefings have surpassed my expectation 10 years ago. Legislative Council Members and Government officials often enter into vigorous debates and exchange views on policy issues in the Chamber. For this reason, my colleagues and I are mindful of the importance of providing the Panel with regular briefings. For us it is a spur reminding us to do our job as best to the best of our abilities.

International developments affecting Hong Kong's financial stability

3. Chairman, since the last briefing to the Panel in early February, there have been considerable changes in the international developments affecting Hong Kong's financial stability. Let me summarise these changes.

- First, global recession clearly intensified in the first quarter of

this year, but there are signs of moderation in the second quarter;

- Second, the structures of the banking sectors in the US and Europe have stabilised following the introduction of massive rescue measures by the governments, and this observation is to a certain extent supported by the results of the stress tests;
- Third, as the impact of de-leveraging persists, the financial systems in the US and Europe have not yet returned to normal functioning and credit supply is still too tight to support rapid economic recovery;
- Fourth, the risk-aversion sentiment in the financial markets seems to have moderated in the second quarter, possibly because, at least to a degree, governments have become more forthcoming in buying problematic assets and providing banks with capital;
- Fifth, equity markets rebounded because of the resulting improvement in risk appetites, helped by the easy monetary environment;
- Sixth, while economic downturn led to short-term declining trends in consumer prices in certain economies, the easy monetary environment has created concerns about the return of inflation and resulted in policy dilemma; and
- Seventh, H1N1 Influenza has become another adverse factor affecting the global economy.

These factors have brought about challenges to the maintenance of Hong Kong's monetary and financial stability from different dimensions.

Exchange rate

4. Hong Kong's monetary policy objective is to maintain the stability of the exchange rate of the Hong Kong dollar against the US dollar in accordance with

the Linked Exchange Rate system. This policy has contributed significantly to the prosperity and stability of Hong Kong throughout a period of extremely complex external and internal circumstances spanning more than a quarter of a century. The Linked Exchange Rate system provided a crucial calming effect during the politically sensitive period before 1997, the Asian financial crisis that was so damaging to the region, and the recent once-in-a-century global financial crisis.

5. While providing the Monetary Base with 100% foreign-reserves backing remains the theoretical foundation of the Linked Exchange Rate system, the system, in its current form, is considerably different from the one introduced in 1983 as a result of our efforts to introduce strengthening and refinement measures during the “good times”, before problems arose. The definition of the Monetary Base has been modified considerably over the period of more than a quarter of a century in response to changes in the economic environment and the expectations of the community with regard to overall financial stability. It has been expanded from comprising only the issued Hong Kong-dollar banknotes to include the Aggregate Balance and the Exchange Fund Bills and Notes. This has considerably lessened any short-term economic costs for all sectors of the economy that would have incurred in order to maintain exchange-rate stability. The provision of 100% foreign-reserves backing for the Monetary Base has also been formalised with the introduction of Convertibility Undertakings, making the Linked Exchange Rate system more transparent and credible. These are all factors supporting the persistent stability of the Hong Kong dollar.

6. In an environment where money flows are not restricted, establishing international credibility for an exchange-rate system is not an easy task and should not be taken for granted. The division of functions and responsibilities in monetary and financial affairs of Hong Kong is clearly stipulated as follows: “the Monetary Authority shall on his own be responsible for achieving the monetary policy objective, including determining the strategy, instrument and operational means for doing so, and for maintaining the stability and integrity of the monetary system of Hong Kong.” In my opinion, the credibility of a monetary system depends to a large extent on

whether the monetary authority can operate independently, be free from political influences, and seen to operate in a highly transparent way. I believe that Hong Kong's monetary system fulfils these requirements following the reform and reinforcement measures introduced over the years.

7. The Financial Secretary is responsible for determining the monetary policy objective and the structure of the monetary system of Hong Kong, although the HKMA will obviously give advice on these important matters. The recent discussions about the status of the US dollar as the reserve currency and the prospect of the renminbi becoming an international currency, against the background of the current global financial crisis, have become a hot topic in the financial markets. It has also led to some people questioning the long-term suitability of linking the Hong Kong dollar to the US dollar. I support objective discussions on this subject. But what I would also like to share with everyone is the reality that objective conditions or arguments for changing the monetary policy objective or the structure of the monetary system of Hong Kong simply do not exist, now or for the foreseeable future. Clearly, the anchor currency of an economy adopting a fixed-exchange-rate policy should ideally be the currency of another economy that is the most important trading partner of the economy in question. But according to our research results, the degree of synchronisation of the economic cycles of the US and Hong Kong is still higher than that between Hong Kong and the Mainland. Moreover, the renminbi is neither a freely convertible nor a reserve currency, and it will not be easy for it to achieve these long-term goals in the near future. The Asian financial crisis and the global financial crisis indicate the importance for the authorities of carefully managing the risks arising from financial reform and liberalisation on the Mainland. The crisis has also indicated that, from the angle of using monetary and financial stability to support economic development, the prospects for development in the financial arena of a controlled socialist market economy are not necessarily worse than those of a capitalist free-market economy. Another important point for consideration is that the renminbi and the US dollar have actually been quite stable against each other, and have not resulted in any conflict undermining the interaction between Hong Kong-dollar exchange-rate stability and the need for economic development.

Money market

8. Since the eruption of the global financial crisis in mid-September of last year, an unusual phenomenon has developed in Hong Kong's money market. Capital has continued to flow into the Hong Kong dollar. The fact that Hong Kong's monetary and financial system is more robust than those of other places has turned Hong Kong into a safe haven for funds. Moreover, with the Mainland economy as our backyard, the prospects of Hong Kong have attracted large amounts of international investment funds. In the past nine months the HKMA purchased US\$43.9 billion from the money market, creating HK\$340.4 billion, a majority of which (HK\$245.5 billion) is reflected in the accounts placed by banks with the HKMA, and the remaining (HK\$94.9 billion) in the increased issuance of the Exchange Fund Bills. The distribution between these two figures depends on market demand for Exchange Fund Bills. The HKMA's stance is to fulfil market demand as best as we can by increasing the issuance of this extremely liquid money-market instrument, in response to the ability of the market to absorb them. In fact, under the Linked Exchange Rate system, large amounts of capital inflow help create a very "easy" monetary environment, effectively creating a situation similar to that in the US, Europe and other major developed economies, where lending is encouraged and a "quantitative easing" policy is implemented. This development is ideal for Hong Kong's current economic situation. We do not wish to see shrinkage in credit supply because it would put pressure on the economy that is already deteriorating or create a vicious, self-reinforcing cycle. "Quantitative easing" is exactly what is needed to prevent this from happening.

9. Two elements in the money market are worth noting. We should all understand these issues to help us to assess and manage the associated risks. The first element is the impact on asset prices of the persistent inflow of funds into the Hong Kong dollar. The second is the exit from "quantitative easing". I have mentioned before that persistent inflow of funds will create an upward pressure on asset prices. Of course, increases in asset prices reflect the interaction between

supply and demand. But while central banks around the world are creating substantial amounts of money, leading to considerable increases in money supply and funds searching for higher returns, this might distort the supply of, demand for and prices of highly liquid financial assets, up to a point where they are no longer linked to or supported by economic fundamentals, ultimately threatening financial-system stability. I hope all market participants, whether they are investors in the wholesale or retail levels, or intermediaries, will pay attention to this development and manage their risks properly. The HKMA will, as in the past, provide macro-level analyses. It is worth noting that while purchasing foreign currencies (or other assets) and creating local currencies are the unique functions of a monetary authority that should not be constrained, in reality the credibility of a monetary system is the ultimate determining factor. In Hong Kong, the total assets of the Exchange Fund have increased by only 24%¹ in the past nine months, and since the Fund has only purchased high-quality, highly liquid US-dollar assets, such as US Treasuries, the increase in the foreign reserves will only further strengthen the credibility of our monetary system.

10. The exit from “quantitative easing” is something more difficult to handle partly because of the passive nature of Hong Kong’s monetary system. It can only occur when capital flows out of Hong Kong. However, the occurrence of a capital outflow and its progress may not be rational and orderly. The key to monetary management is to encourage and promote rational analysis to help the market to adjust in an orderly manner. On the other hand, the exit arrangement is not a difficult task in a technical sense. In passively implementing “quantitative easing”, the HKMA buys highly liquid, high-quality US-dollar assets, as opposed to problematic financial assets as in the cases of the central banks in the US and Europe. So if we need to sell the assets that we have bought and lower the Aggregate Balance, the market will be able to absorb these assets. Nevertheless, we cannot rule out the possibility of someone interpreting market developments differently and making

¹ A result of dealing with the financial crisis is the expansion of the balance sheets of central banks in multiple times. For example, the Federal Reserve’s balance sheet has expanded by 2.5 times; the European Central Bank 1.5 times; the Bank of Japan 1.2 times; and the Bank of England 2.5 times.

comments and affecting market sentiment during the time when the Hong Kong dollar moves from the strong-side Convertibility Undertaking at 7.75 to the weak-side Convertibility Undertaking at 7.85. The HKMA will monitor the market closely and conduct operations within the Convertibility Zone if necessary to ensure adjustments are made in an orderly manner.

Credit supply

11. As I said earlier, an easy monetary environment helps avoid a credit crunch and economic downturn from reinforcing each other in Hong Kong. It is true that the credit risks of all sectors of the economy have increased under the influence of the financial crisis and the considerable economic contraction. But credit supply is not a problem when there is so much liquidity in the banking sector and when the Government is providing loan support to the small and medium enterprises. While total loans in the banking sector declined in both the fourth quarter of last year and the first quarter of this year, this mainly reflected decreases in demand for trade financing, rather than shortages in credit supply. The same reason also explains the further decline of the loan-to-deposit ratio of retail banks in the first quarter.

12. The increases in the credit risks of various sectors of the economy as a result of the recession are also reflected in the risk premiums. However, the risk-adjusted effective lending rates are, on average, still lower than before the financial crisis because banks' funding cost has reached a very low level (for example, the short-term interbank rates are close to zero). This should help the various economic sectors to ride out this difficult time. Clearly, banks need to continue to carefully assess and manage credit risks to prevent the ratio of problem loans from increasing to a point where it threatens the viability of individual banks and the entire banking sector.

The banking system

13. I am glad to report that Hong Kong's banking system remains sound

and robust despite the once-in-a-century global financial crisis. Statistical data for the sector are shown on the PowerPoint presentation. In the interest of time, I am not going through them one by one. Hong Kong's banking sector has ample capital and liquidity. Its problem-loan ratio is low. Of course, an increase in the problem-loan ratio is a natural result during a recession, and it usually happens with a time lag. But the current ratio of just over 1% is still healthy, comparing favourably, in fact very favourably, with the peak of 10.65% at the end of September 1999. The recession and the narrowing of interest-rate margins also affect the profitability of banks. Banks' operating environment will continue to be difficult.

14. It is well known that one of the supervisory tools regularly used by the HKMA is stress tests on banks. Variables covering different factors are adjusted as necessary. We have recently updated these stress tests by including the worst-case scenarios during the Asian financial crisis, the impact of SARS on Hong Kong in 2003 as a proxy for the potential impact of H1N1 Influenza, and a number of other extraordinary factors as variables. The results indicate that Hong Kong's banking sector remains sound and robust even in such an adverse economic and financial environment.

15. One of the other priorities in our work concerning the banking sector is the review of the Deposit Protection Scheme. The Deposit Protection Board has finished its review and issued a consultation paper to collect views before the end of June. The Board recommends expanding the coverage of the Scheme by increasing the compensation limit from \$100,000 to \$500,000 and including secured deposits as eligible deposits. To avoid putting extra pressure of increased contributions on banks and depositors, the Board also recommends reducing the banks' contribution rates by half and allowing them to report protected deposits for contribution assessment purposes on a net deposit basis (deposits less loans). We aim at submitting the Amendment Bills to the Legislative Council for deliberation in the first quarter of 2010, and implementing the changes during the year, so that a solid foundation can be built before the expiry of the temporary 100% deposit guarantee at the end of 2010. Meanwhile, the HKMA will continue to monitor the situation to

ensure that the temporary 100% deposit guarantee has not created any distorting effect on the banking business that would make the exit from the measure more difficult. I am glad to report that we have not noticed anything worrying up to now.

Lehman incident

16. Let me now brief the Panel on the latest developments in handling complaints concerning Lehman-Brothers-related products.

17. The HKMA has, up to 14 May, received 20,960 complaints concerning Lehman-Brothers-related products, most of which have gone through the preliminary assessment process. According to the expedited process agreed with the Securities and Futures Commission (SFC), the HKMA has so far referred 449 cases, involving 16 banks, to the SFC to facilitate its “top-down” investigation at the bank level.

18. The HKMA will continue to investigate the cases once they are established, whether or not they have been referred to the SFC. We are investigating into 5,956 cases, and 108 cases are under disciplinary consideration. But before making any final determination in these cases, the HKMA has to go through due process to ensure fairness, including giving the subjects of investigation an opportunity to be heard and a right to appeal.

19. In addition, 1,012 complaints have been closed, the majority of which are cases where investigations cannot proceed because the complainants have declined to provide further information to the HKMA. We are seeking further information on the remaining more than 10,000 cases to determine whether further actions are required.

20. The HKMA’s goal is to complete investigation of at least 70% of complaints by the end of March 2010. To achieve this goal, we are stepping up the investigation effort by recruiting more contract staff and hiring more seconded staff from audit firms. There are now more than 200 people participating in the

investigations. We hope to be able to increase the number to 300 quickly. I hope Members will appreciate that processing more than 20,000 complaints is a big task and whether we can achieve our goal is subject to a number of factors outside our control, including the turnover of contract staff and whether we can recruit enough of them. Nevertheless, the HKMA will make every effort to process all complaints in a fair manner.

21. I would also like to report the latest figures on voluntary settlement. According to information provided by the banks, up to 13 May, 6,736 cases have resulted, or will likely result, in voluntary settlement. Of these 4,970 cases have already been concluded, and the remaining 1,766 are under negotiation. While the HKMA welcomes voluntary settlements between the banks and the complainants, its investigation into allegations of mis-selling will not stop regardless of any settlement reached. The HKMA will continue its investigations to determine whether misconduct can be established. The HKMA will treat all proven cases of misconduct seriously.

Hong Kong's status as an IFC

22. Maintaining Hong Kong's status as an international financial centre is a responsibility of the SAR Government stipulated in Article 109 of the Basic Law. As the monetary authority of Hong Kong, the HKMA tries its best to support this important task in accordance with the *Division of Functions and Responsibilities in Monetary and Financial Affairs* promulgated in June 2003. An international financial centre is a place where financial intermediation is conducted on an international level. A successful international financial centre is an ideal place where international investors and fund raisers meet. While local demand for financial intermediation will generate a certain amount of economic activities, the small size of Hong Kong's economy would not be sufficient to propel it into the international arena. Hong Kong needs to continue to attract investors and fund raisers from outside Hong Kong to conduct financial intermediation using Hong Kong's financial system in order to maintain its status as an international financial

centre. Given the current global environment, the focus of work is clearly to facilitate investors and fund raisers on the Mainland and their counterparties from foreign countries to meet in Hong Kong.

23. In an environment where capital items on the Mainland are still subject to a number of controls, a key to developing Hong Kong's status as an international financial centre is whether the Mainland authorities take the initiative to increase the mobility of Mainland investors and fund raisers to go outside the country (especially through Hong Kong) in an orderly and controlled manner. I am not only talking about mobility of individuals in the physical sense, but also that of their capital, the financial intermediaries providing services to them, and the financial products that are designed to fulfil their needs. This is crucial to developing and maintaining the status of Hong Kong as an international financial centre. And it will take time to materialise. A number of considerations need to be taken into account: the pace and order of financial reform and liberalisation on the Mainland, the Mainland's various concerns in developing its financial systems, the theoretical foundation and the development strategy.

24. Under the one-country-two-systems arrangement, our country has two financial systems with different characteristics. Both of them can contribute to the economic development of the country. This is a unique arrangement, unprecedented in any other country in the world. This also gives our country an advantage, since the two financial systems can complement each other, fulfilling the demand of the country for financial intermediation and increasing efficiency. I have mentioned before that we should develop the relationship between the country's two financial systems so that they can co-operate, complement and interact with each other. I am glad that, on the policy level, the Mainland authorities also agree with this viewpoint. This relationship should be viewed as the optimal relationship between Hong Kong and Shanghai, our country's two financial centres. The interest of the country should be the priority, and I do not see any trend of conflicts or competition developing. The "co-operative, complementary and interactive" relationship is not merely a slogan. It is real and worth pursuing. At present the various financial markets on the

Mainland and in Hong Kong are separate. Combining them in an appropriate way to enable the forces of supply and demand in the two places to interact with each other will make the markets much deeper and wider, and the price-discovery mechanism much more efficient. This in turn will attract more Mainland and overseas market participants, allowing finance to support the economy.

25. While contributing to the financial liberalisation on the Mainland and providing the required financial services to the country, Hong Kong should also focus on developing the most efficient financial infrastructure to prepare itself for processing the financial traffic between the Mainland and the rest of the world that will certainly increase rapidly. It is fair to say that in a free-market environment, demand will normally trigger supply and private-sector financial institutions can be relied upon to use their market sense to provide the required services. But as with airports and highways, sometimes the government needs to take the initiative or involve itself to develop financial infrastructure, rather than relying on the private sector. Thanks to the many years of devotion of the HKMA, Hong Kong's financial infrastructure, including the multi-currency real-time settlement systems, is something that other international financial centres cannot rival. The HKMA anticipated that the renminbi would become a currency for economic and financial transactions, and developed an advanced Renminbi Real-Time Gross Settlement system many years ago, enabling Hong Kong to process different kinds of renminbi transactions. Our preparedness in providing support for specific measures introduced by the Mainland in opening its financial system is shown in Hong Kong's readiness to process renminbi transactions. We do not need much preparation time to get ourselves ready for renminbi banking business, issuance of renminbi bonds, or even stock trading using the renminbi, which is what we hope to see happen. The imminent implementation of the renminbi trade-settlement pilot scheme is also a good example. As soon as the applicable control measures are announced by the Mainland authorities, Hong Kong import and export enterprises can immediately reap the benefits of doing business with their Mainland counterparts using renminbi.

Exchange Fund

26. Let me now turn to the investment management of the Exchange Fund. First of all, I would like to express my gratitude for most Members' objective appreciation of the Fund's 5.6% loss last year. It was indeed not easy to limit the loss to this level given the influence of the once-in-a-century financial crisis. This reflects the effort the HKMA has made over the years to manage the Exchange Fund prudently. Of course, given the size of the Exchange Fund (its total assets reached \$1,560.3 billion at the end of last year), the loss in 2008 in dollar term is still a big number.

27. As we entered 2009, international finance was still in an extremely pessimistic mood. All major stock markets continued to perform considerably badly in the first quarter. The market was worried that "quantitative easing" would ultimately lead to inflation. Long-term bond yields increased, and bond prices declined. In the foreign-exchange market, the US dollar suddenly strengthened against other major currencies, resulting in foreign-exchange losses on the books. Under the simultaneous unfavourable influences in the equity, bond and foreign-exchange markets, the Exchange Fund recorded a loss of \$33.5 billion in the first quarter. Financial markets around the world have clearly rebounded since the beginning of the second quarter. At the middle of this month, the Exchange Fund had recovered the entire amount of its loss in the first quarter. In the current environment of global recession and given the fact that the financial systems in the US and Europe are still not yet functioning normally, it is likely that the financial markets around the world will continue to be extremely volatile. A conservatively managed fund with a size of over \$1,500 billion earning or losing \$10 billion a day is not surprising. I hope everybody will be psychologically prepared when looking at the short-term numbers. The most important thing is to have a well established, suitably conservative investment strategy to ensure that the Exchange Fund can fulfil its statutory objectives effectively.

28. The rapid increase in Hong Kong's foreign reserves as the result of large capital inflows is something worth noting. Between last September and the

end of April, the HKMA purchased more than US\$40 billion. As a result, Hong Kong's foreign reserves were close to US\$200 billion, ranking seventh in the world. Bigger is not necessarily better where foreign reserves are concerned. The increase in US-dollar assets is matched by the corresponding increase in Hong Kong-dollar liabilities (part of the Monetary Base). While this is profitable for the Exchange Fund, since we earn interest on the US-dollar assets that we purchased without having to pay interest on most of the Hong Kong-dollar liabilities created, this should only be treated as temporary. We should be prepared for the possibility that things might reverse at any time. It is difficult to tell when such a reverse will happen, but when it happens, the level of foreign reserves will decline. Nevertheless, we should not be too worried about this possible development, or mistakenly conclude that the Hong Kong financial market is facing a big problem.

Conclusion

29. Chairman, I have covered the work of the HKMA in various major financial topics. Details of the other work areas can be found in the materials that we provided to the Panel earlier. Once again I would like to thank Panel Members for the support they have given me and the encouragement given to the HKMA over the years. My colleagues and I are happy to answer any question about the work of the HKMA that Members may have.

Joseph Yam

Chief Executive of the Hong Kong Monetary Authority

21 May 2009