



HONG KONG MONETARY AUTHORITY

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

1 February 2010



DISCUSSION TOPICS

Updates on

- **Financial and Economic Environment**
- **Currency Stability**
- **Banking Stability**
- **Financial Infrastructure**
- **Hong Kong as an International Financial Centre**
- **The Exchange Fund**

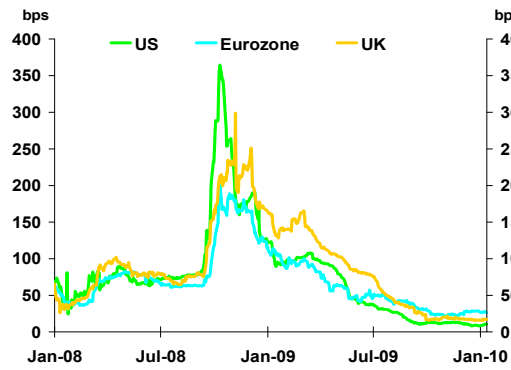


FINANCIAL AND ECONOMIC ENVIRONMENT



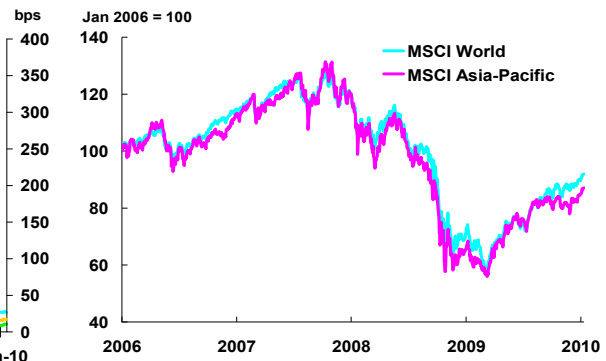
GLOBAL FINANCIAL MARKETS

3-Month Libor spread over OIS



Source: Bloomberg

MSCI World and Asia Indices



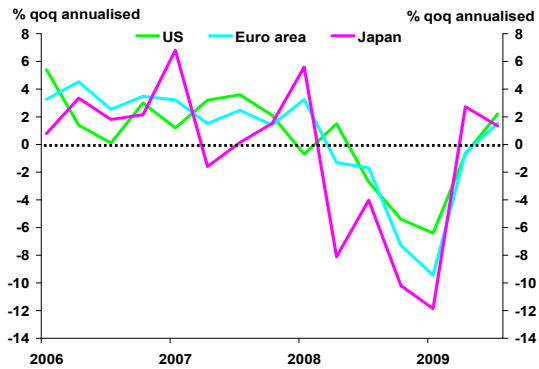
Source: Bloomberg

- Credit market conditions improved further and equity markets rebounded in 2009.



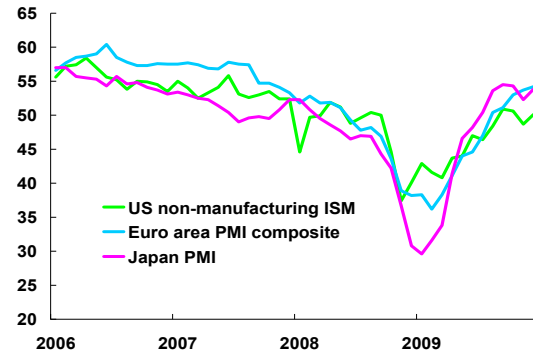
ECONOMIC CONDITIONS IN ADVANCED ECONOMIES

Real GDP growth



Source: CEIC

Purchasing Managers' Index (PMI)

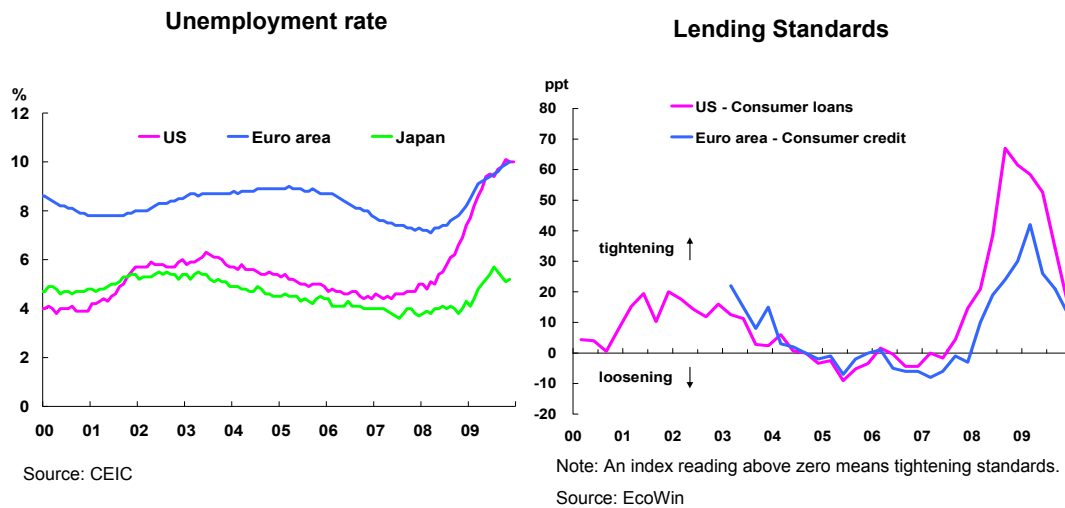


Source: Bloomberg

- Major economies emerged from recession in the third quarter of 2009, while business sentiment steadily improved.



CONSTRAINTS ON GROWTH



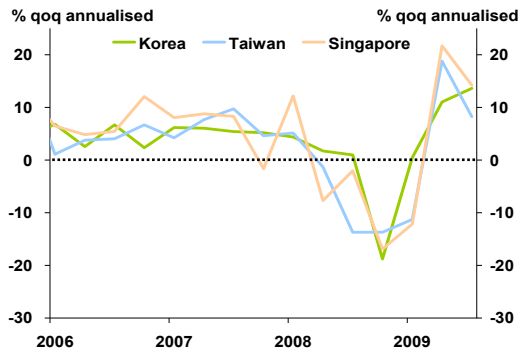
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- Unemployment rates remained high, and lending standards remained tight.

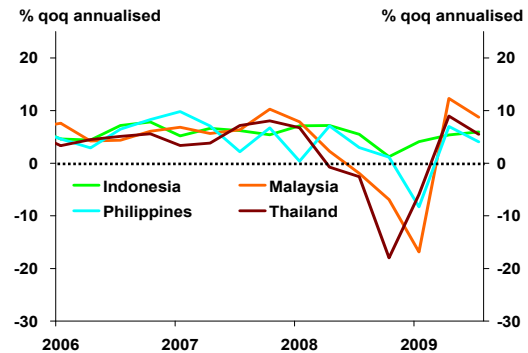


ECONOMIC CONDITIONS IN EMERGING ASIA

GDP Growth: NIE-3



GDP Growth: ASEAN-4

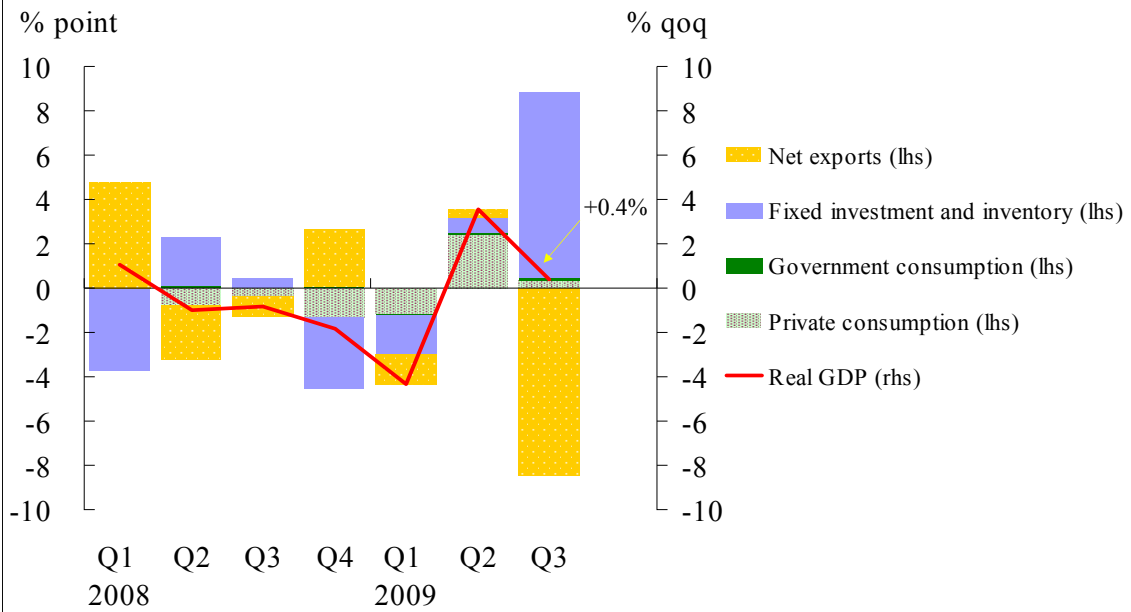


Source: CEIC

- The emerging Asian economies continued to gain momentum in Q3 2009, albeit at a slower pace than in Q2.



RECOVERY OF THE HONG KONG ECONOMY

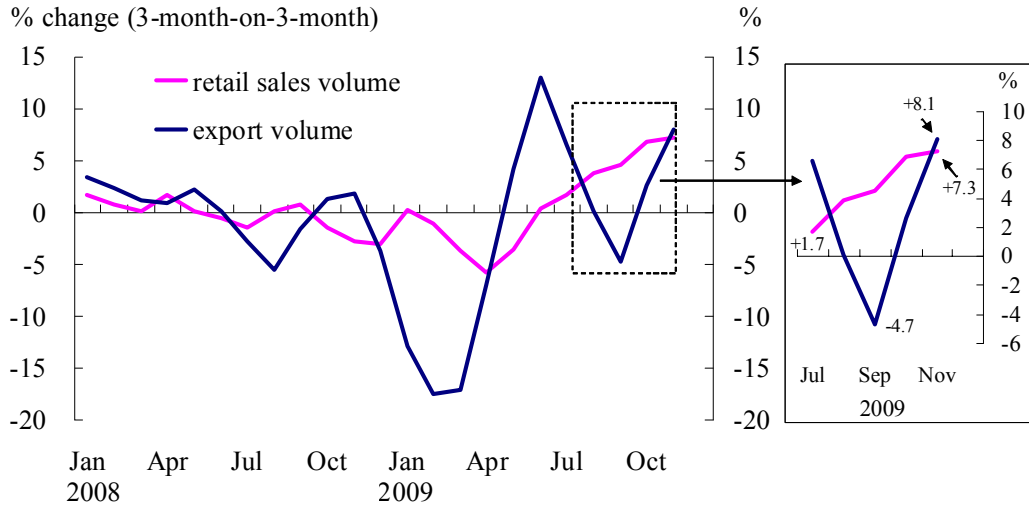


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- Real GDP grew by 0.4% quarter on quarter in Q3, after a strong rebound of 3.5% in Q2.
- The rebound was fuelled by domestic demand and massive inventory restocking. External demand remained weak.



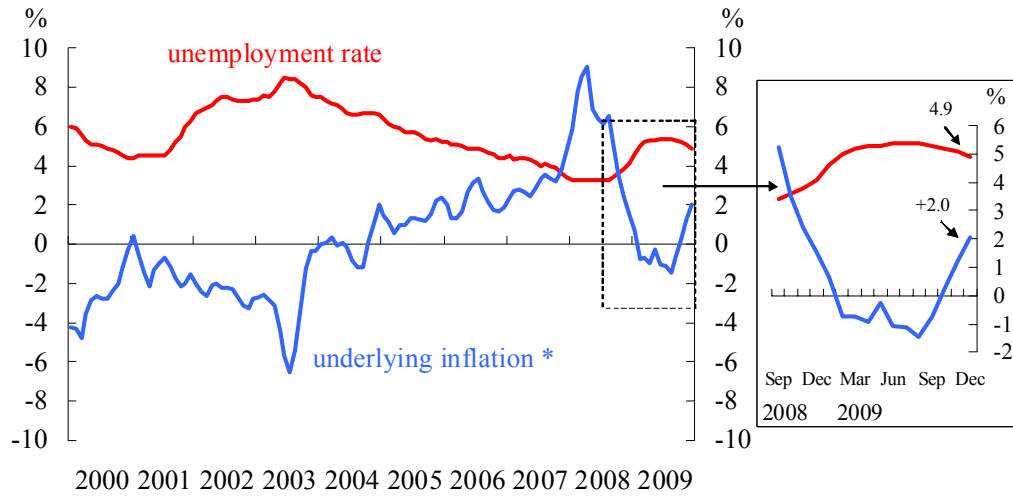
RETAIL SALES AND EXPORTS



- Incoming news and economic releases suggested resilient growth in Q4.



UNEMPLOYMENT AND INFLATION

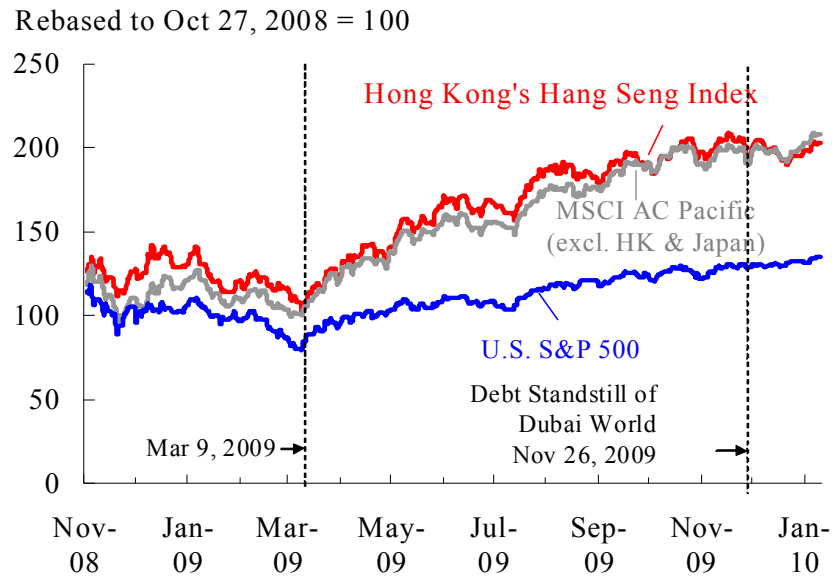


* 3-month-on-3-month annualized change in CCPI

- The unemployment rate edged down further in December while the underlying inflation rate turned positive.



CONSOLIDATION IN EQUITY MARKET

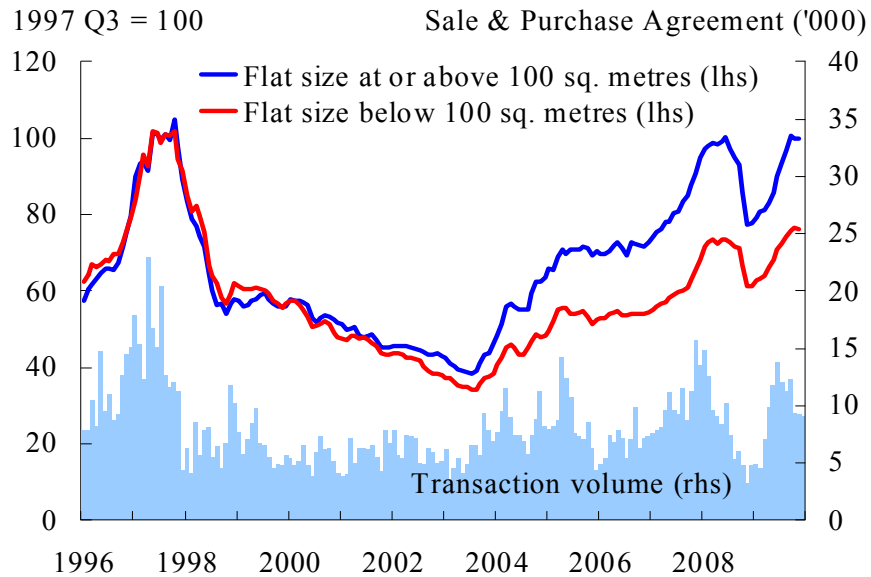


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- The equity market consolidated in late November and December, particularly with the unexpected debt standstill of Dubai World, and then bounced up again towards the end of the year.
- After falling to a 10-week low on 21 December, the Hang Seng index rose to 22,269 on 7 January, posting a 2.1% gain from the end of November.



SLOWDOWN IN PROPERTY MARKET ACTIVITIES

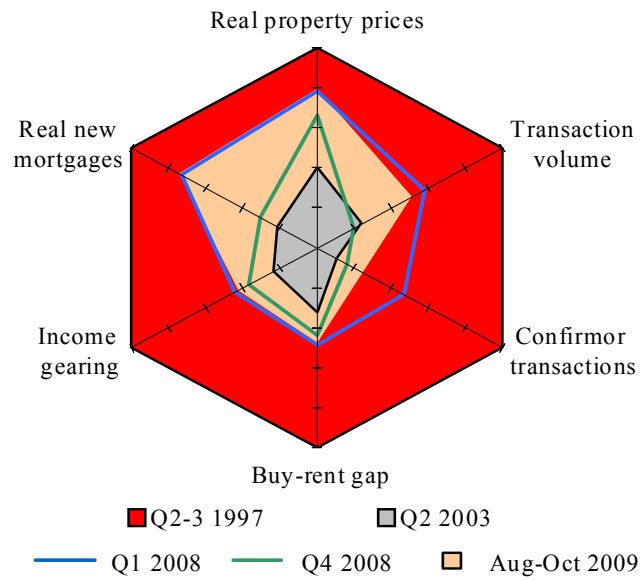


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- The residential property market cooled somewhat moving into Q4.
- Total monthly transaction volume has decreased successively since October, to around 9,000 in December from over 11,000 for the five months to September.



GRAPHICAL ASSESSMENT OF PROPERTY MARKET



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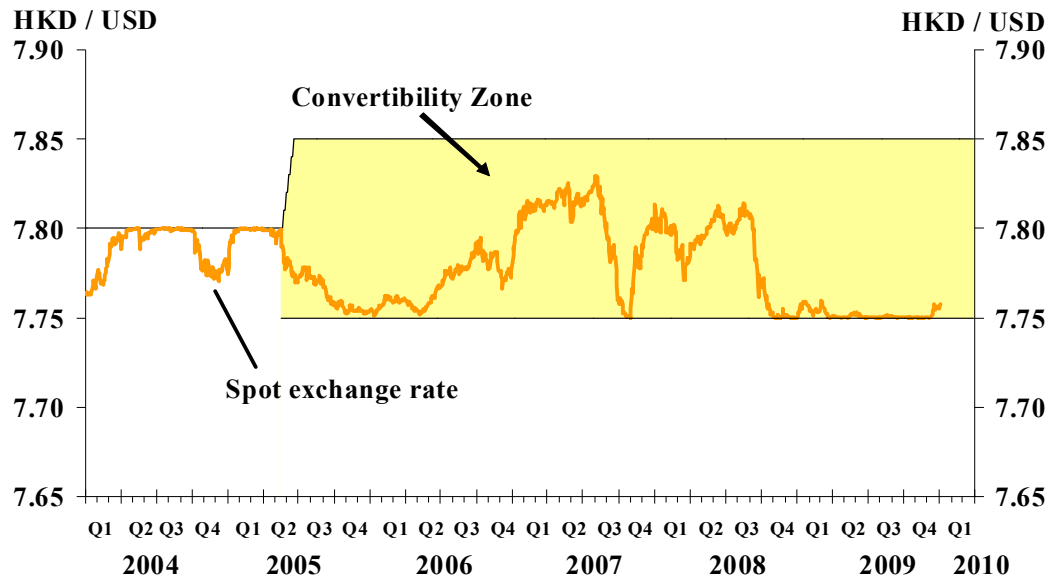
- By October 2009, indicators under the graphical framework had almost swung back to levels before the outbreak of the financial tsunami in September 2008 except for transaction volume and confirmor transactions.



CURRENCY STABILITY



HONG KONG DOLLAR EXCHANGE RATE

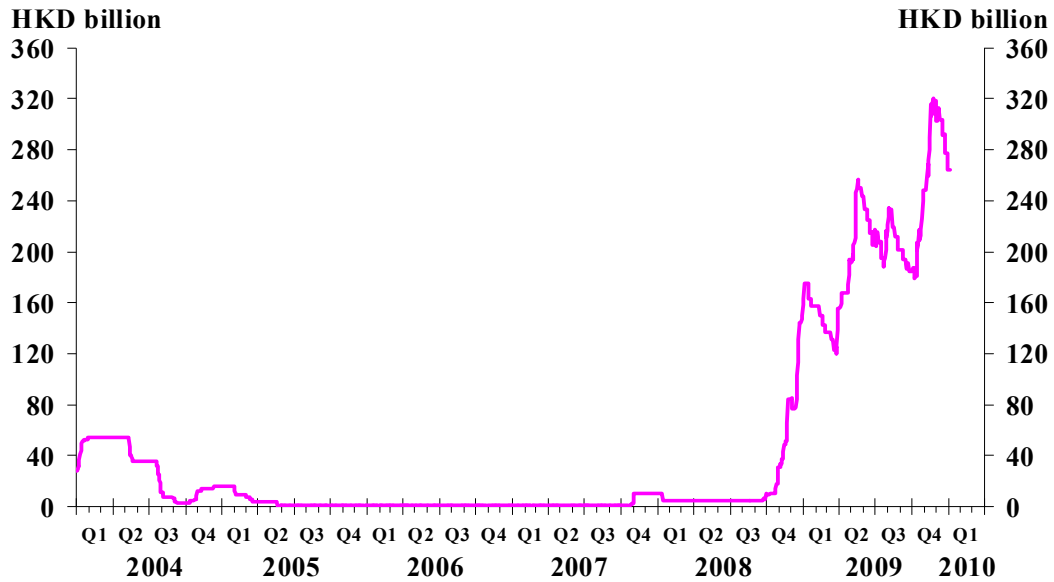


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- The Hong Kong dollar has stayed close to the strong-side Convertibility Undertaking (CU) level on strong inflows since the last quarter of 2008. Equity-related investment, in particular IPOs, continued to drive funds into the Hong Kong dollar over the past few months.
- Since late December 2009, the spot exchange rate against the US dollar eased slightly.



AGGREGATE BALANCE REMAINED HIGH



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- With the repeated triggering of the strong-side CU, the HKMA injected a total of HK\$640.7 billion into the banking system between Q4 2008 and Q4 2009.
- On the other hand, to meet the strong demand for Exchange Fund Bills as manifested in the very low yields of the short-dated papers, a total of HK\$386.4 billion of additional Exchange Fund Bills were issued during the period, moderating the expansion of the Aggregate Balance.
- As a result, the Aggregate Balance stood at HK\$264.6 billion by the end of 2009.



FORWARD DISCOUNT REMAINED STABLE

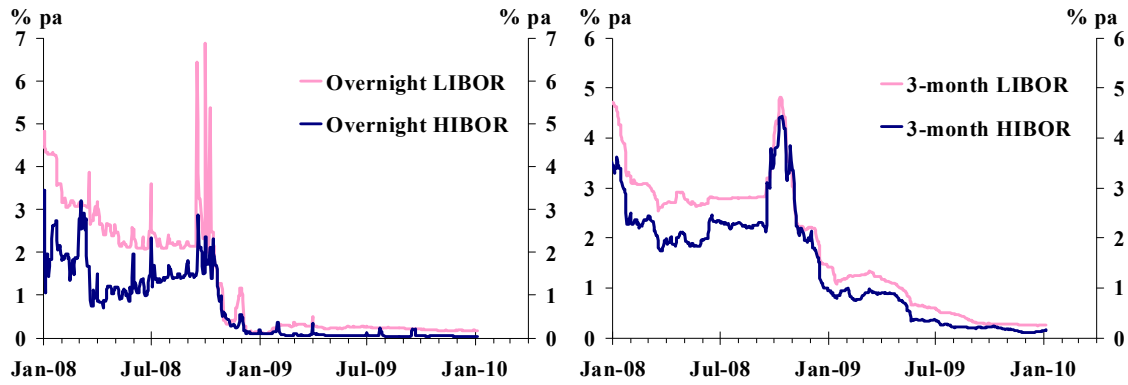


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- In the forward market, the HK dollar forward discount remained largely stable.



LOW DOMESTIC INTEREST RATES



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- With ample liquidity in the banking system, Hong Kong dollar interest rates remained fairly stable at near zero levels and were slightly below their US dollar counterparts.



ECONOMIC OUTLOOK AND RISKS

- **Market consensus is positive about 2010 economic outlook**
- **But risks remain:**
 - The strength and sustainability of recovery in advanced economies
 - Soundness of global financial institutions and financial market stability
 - Timing of exit strategies
 - Pressure of international capital flows on asset markets



RISK (1): UNDERLYING STRENGTH OF THE RECOVERY IN ADVANCED ECONOMIES

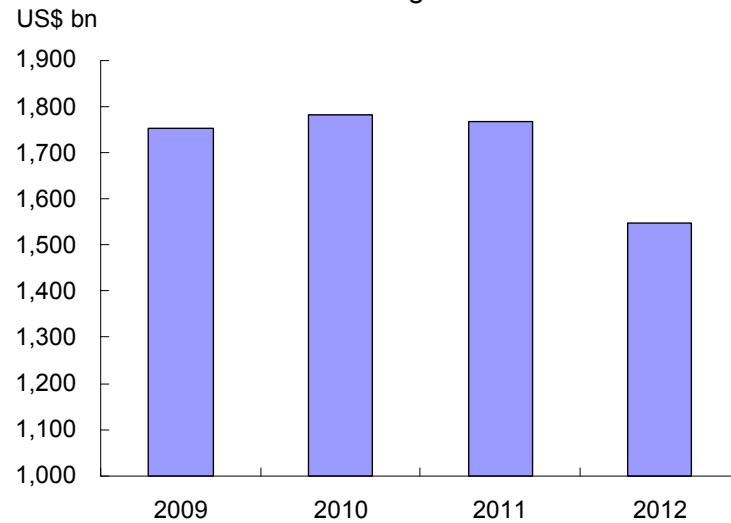
	GDP (%)			
	2007	2008	2009e	2010f
Advanced economies	2.7	0.6	-3.4	1.3
Of which: US	2.1	0.4	-2.7	1.5
Euro area	2.7	0.7	-4.2	0.3
Japan	2.3	-0.7	-5.4	1.7
UK	2.6	0.7	-4.4	0.9

Source: IMF *World Economic Outlook*, October 2009



RISK (2): SOUNDNESS OF GLOBAL FINANCIAL INSTITUTIONS AND MARKETS

Bank debt maturing in 2009-2012*



These numbers refer to the amount of Moody's-rated bank debt maturing in the respective years. Actual total numbers could be considerably higher.

Source: Moody's



RISK (3): TIMING OF EXIT STRATEGY

Quantitative Easing: Major Central Banks' Balance Sheets

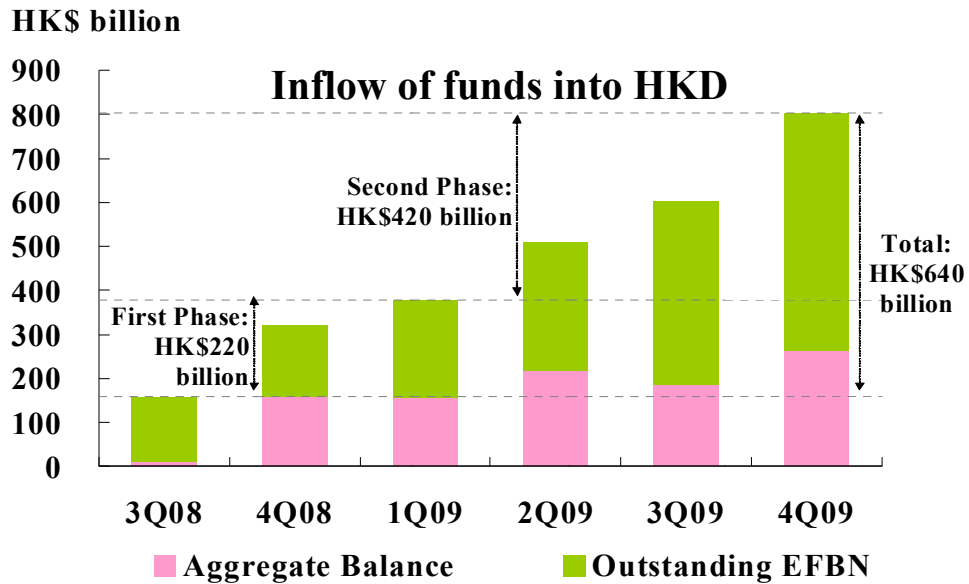
	Before QE¹	Latest²	Growth (%)
US Fed (USD billion)	909	2,237	1,328 (146)
Bank of England (GBP billion)	93	238	145 (155)
European Central Bank (EUR billion)	1,449	1,905	456 (32)

1. End-August 2008 •
2. US Fed and the BoE: end-2009; ECB: early January 2010.

Sources: Websites of various central banks, CEIC



RISK (4) : PRESSURES FROM INTERNATIONAL CAPITAL FLOWS ON ASSET MARKETS

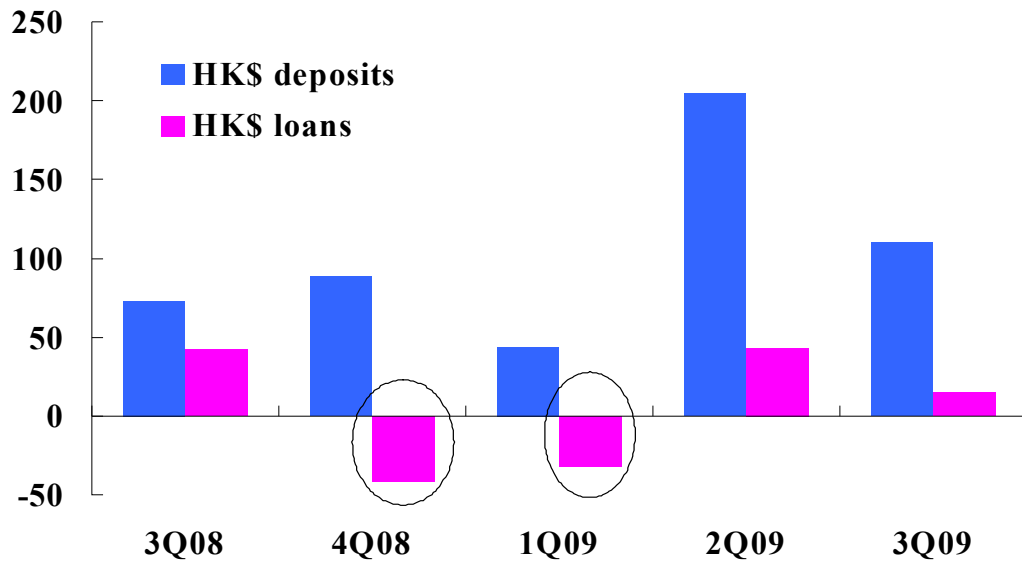


Note: The Outstanding EFBN and the Aggregate Balance are quarter-end figures.



CHANGES IN HKD LOANS AND DEPOSITS

HK\$ billion

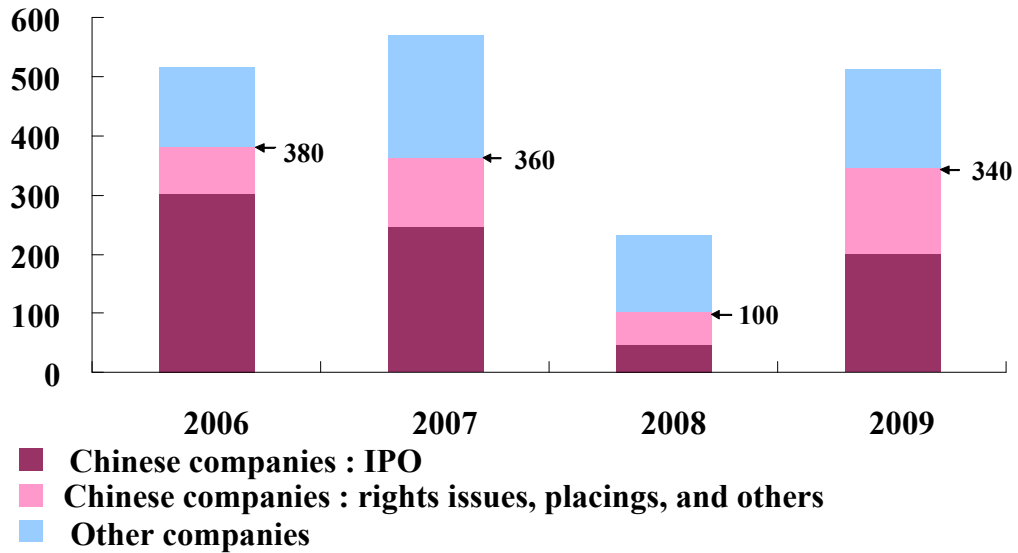


Note: Nominal changes during the quarter.



EQUITY FUNDS RAISED IN HONG KONG

HK\$ billion

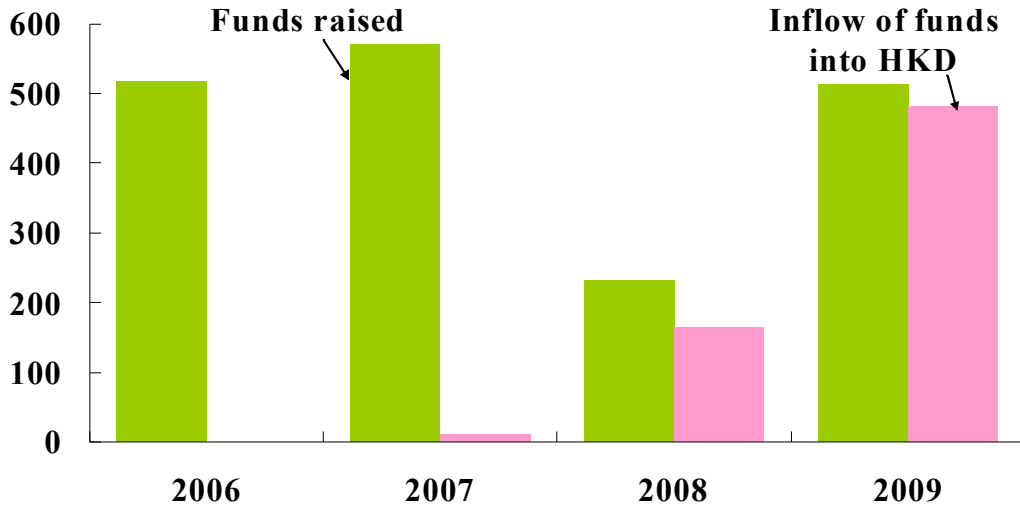


Note: 2008-2009 figures differ from those provided by the HKEx as the activities which did not involve HKD flows have been excluded.



EQUITY FUND-RAISING AND INFLOWS

HK\$ billion

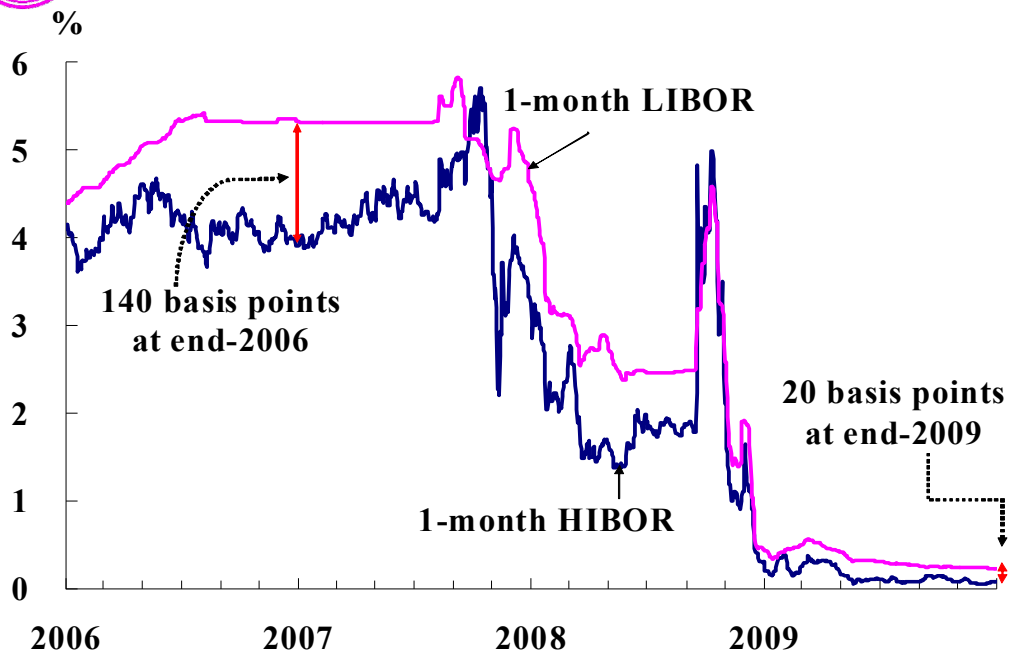


Note (1): Equities funds raised include IPO, right issues, placings, open offers, consideration issues, warrants exercised and share option scheme.

Note (2): 2008-2009 figures differ from those provided by the HKEx as the activities which did not involve HKD flows have been excluded.

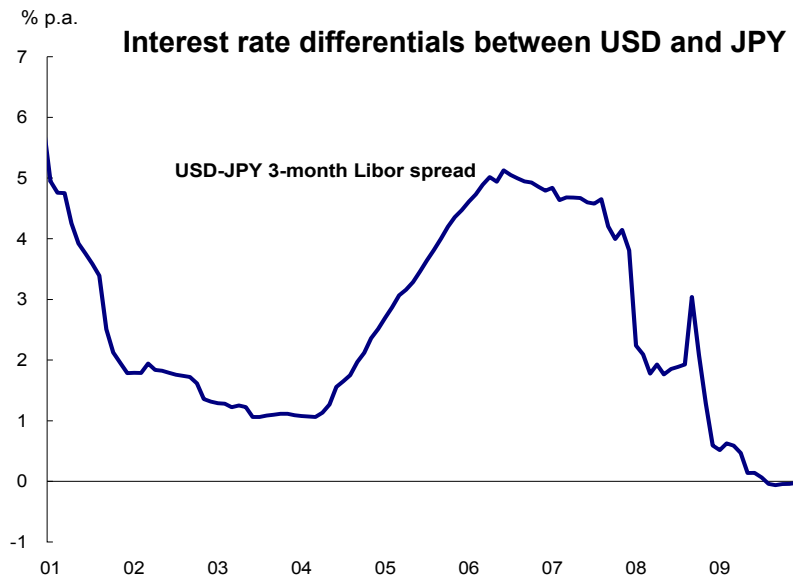


HKD AND USD INTEREST RATES





INTERNATIONAL CAPITAL FLOWS: USD CARRY TRADES (1)

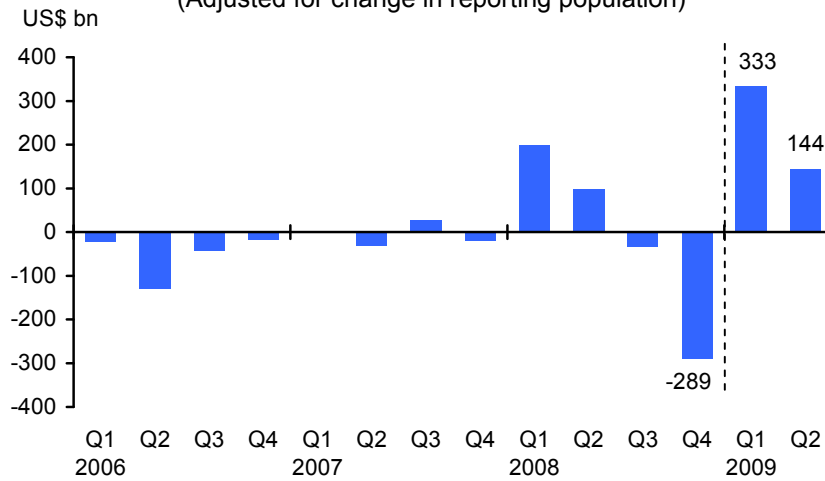


Source: Bloomberg



INTERNATIONAL CAPITAL FLOWS: USD CARRY TRADES (2)

Change in net external claims of banks in the US
(Adjusted for change in reporting population)

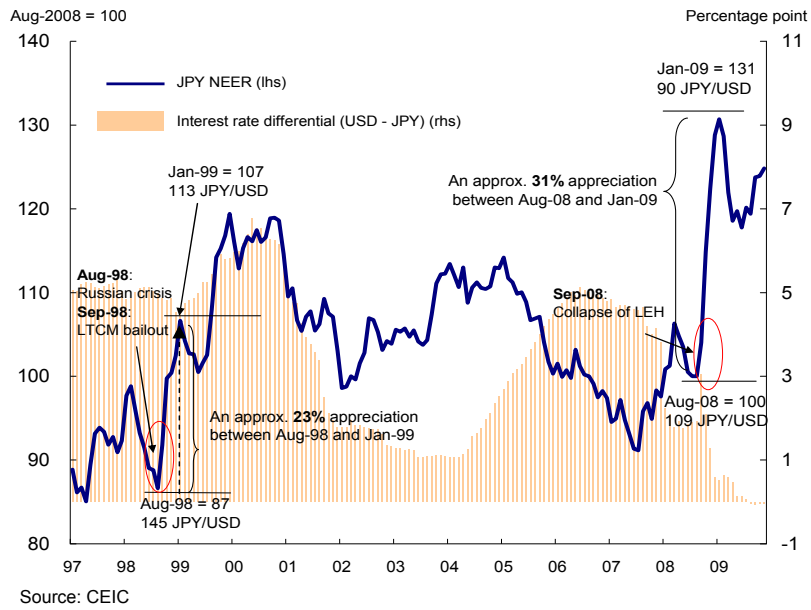


Note: Reporting population has increased to include former investment banks since Dec 2008.

Source: BIS locational banking statistics



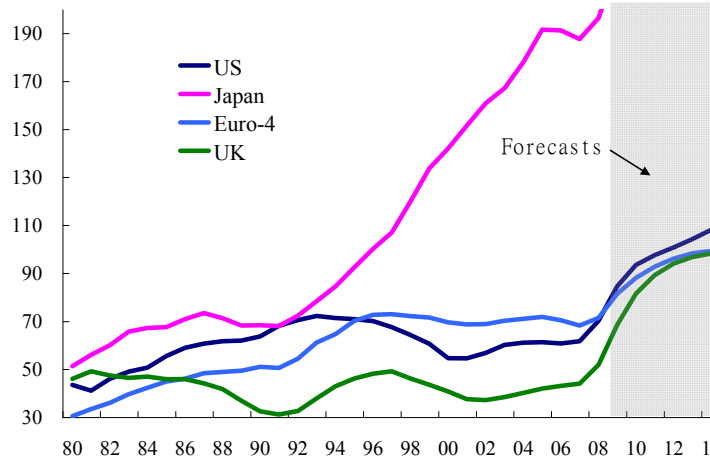
INTERNATIONAL CAPITAL FLOWS: IMPACT OF UNWINDING OF JPY CARRY TRADES ON JPY EXCHANGE RATE





WILL HIGHER GOVERNMENT DEBT LEAD TO A WEAKENING OF CURRENCIES?

General Government Debt: US, euro area, Japan, and the UK
% of GDP

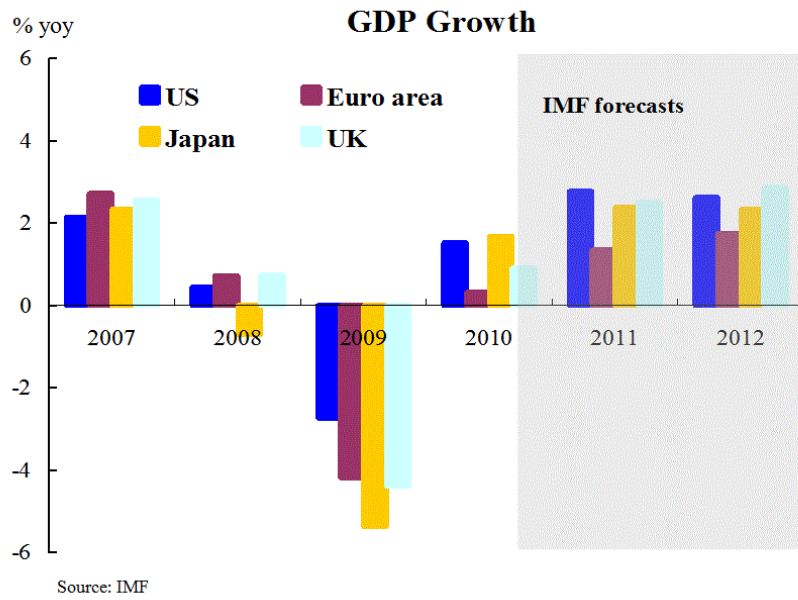


Note: Euro-4 refers to Germany, France, Italy, and Spain. All debt figures are retrieved from the IMF except those of Spain.

Sources: IMF, Oxford Economics

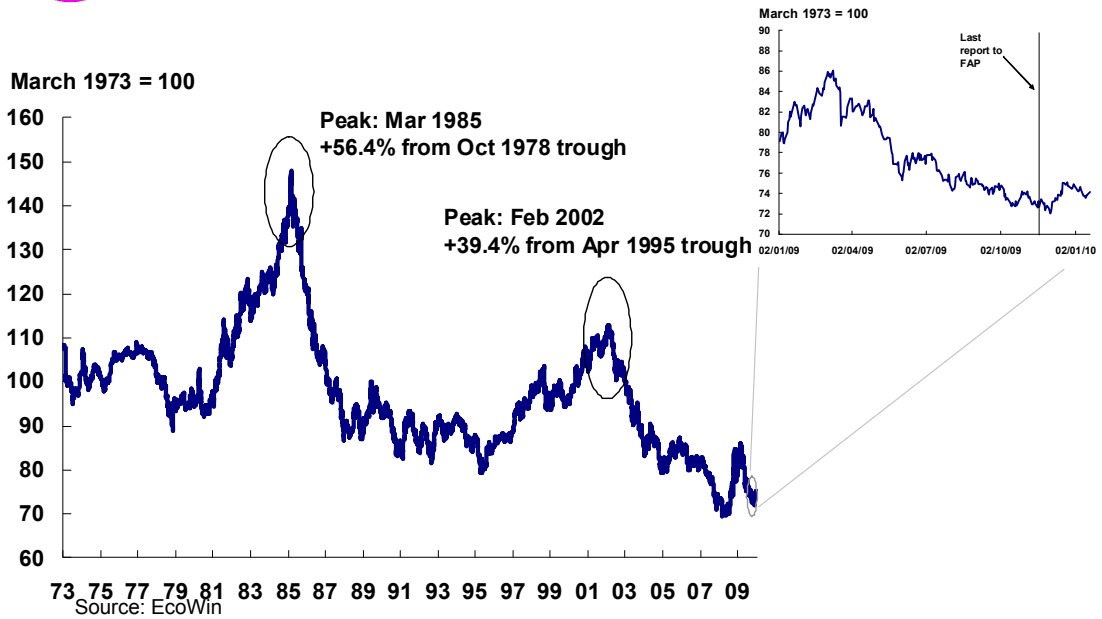


COMPARISON OF GROWTH PROSPECTS OF THE US AND OTHER MAJOR ECONOMIES





US DOLLAR NEER



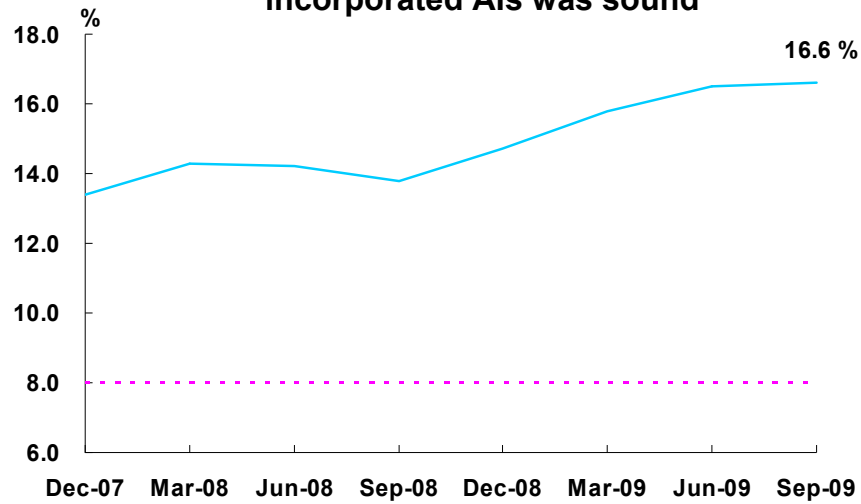


BANKING STABILITY



BANKING SECTOR PERFORMANCE

Capital adequacy ratio of locally incorporated AIs was sound



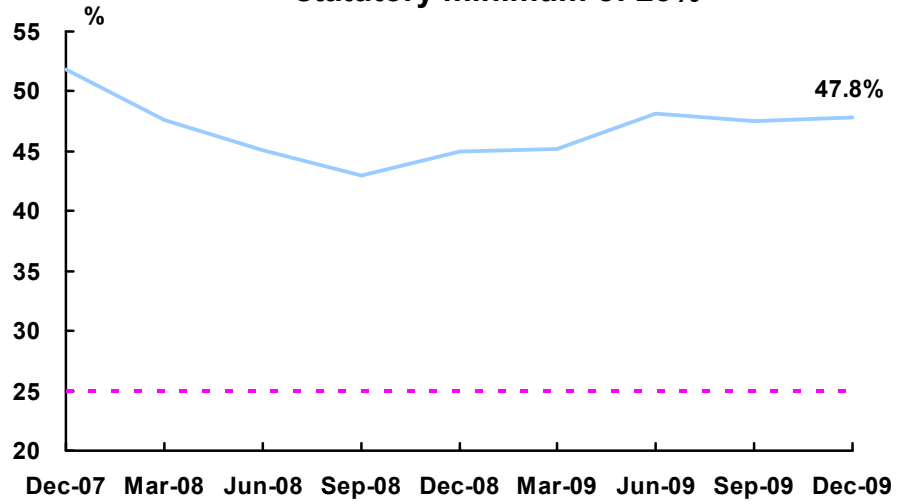
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- The consolidated capital adequacy ratio of locally incorporated AIs rose to 16.6% at the end of September 2009, compared with 16.4% at the end of June 2009 and 14.7% at the end of December 2008. The ratio is well above the international standard of 8%.



BANKING SECTOR PERFORMANCE

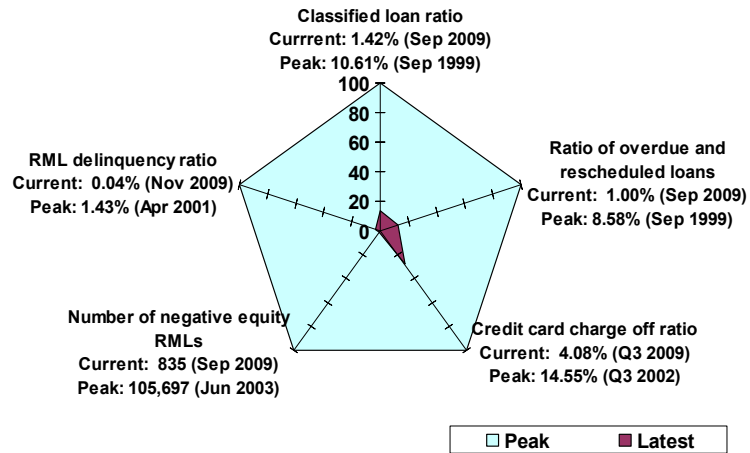
Liquidity ratio of retail banks remained above statutory minimum of 25%





BANKING SECTOR PERFORMANCE

Asset quality indicators remained at comfortable levels compared with their historical peaks

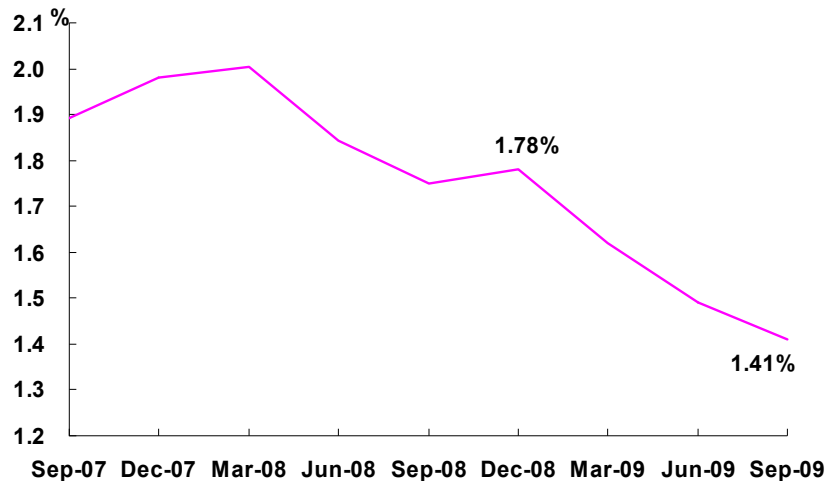


- The latest asset quality indicators improved from the levels reported in the last meeting. The HKMA will continue to monitor the quality of retail banks' loan portfolios closely.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks further narrowed



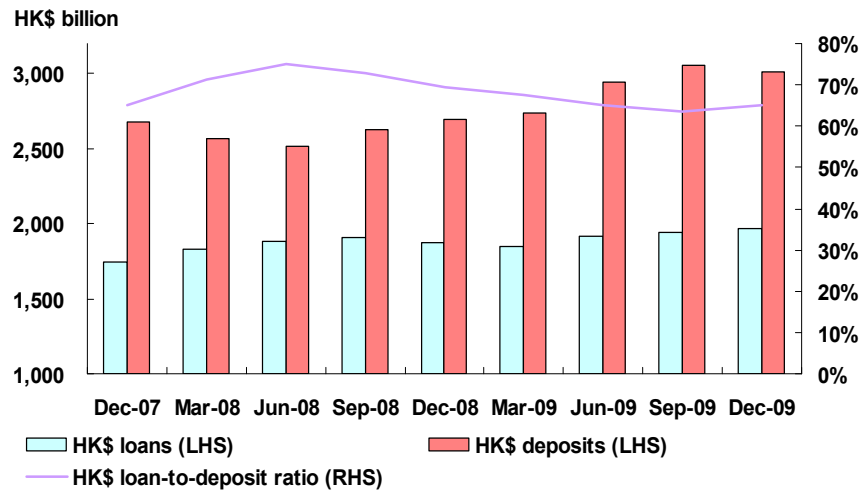
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- Retail banks' profitability continued to be under pressure with a 9.7% decline in the aggregate pre-tax operating profit of retail banks' Hong Kong offices in the first three quarters of 2009, compared with the same period in 2008.
- The net interest margin of retail banks narrowed to 1.41% in Q3 2009 from 1.78% in Q4 2008. The narrowing appears to be mainly the result of : (1) the low-interest-rate environment; (2) increased competition in mortgage lending; and (3) redeployment of surplus funding to safer and more liquid assets such as government paper, which generally offer lower interest yields.



BANKING SECTOR PERFORMANCE

Hong Kong-dollar loan-to-deposit ratio of retail banks rose

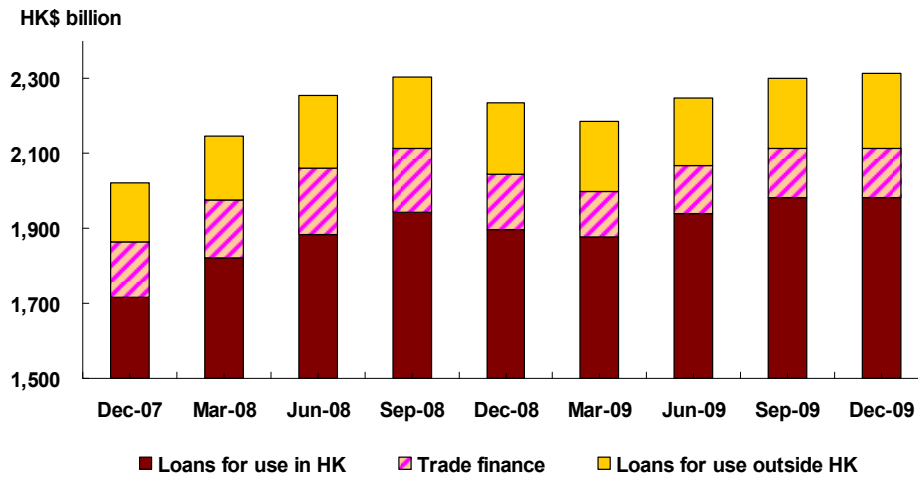


- The Hong Kong-dollar loan-to-deposit ratio of retail banks rose to 65.2% at the end of December 2009 from 63.7% in September.



BANKING SECTOR PERFORMANCE

Total loans of retail banks returned to pre-crisis level



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- Total loans of retail banks have returned to pre-crisis levels. They increased by 0.6% in Q4 2009, following an increase of 2.4% in Q3.
- The banking industry continued to support the SME sector. Over 35 AIs have joined the Government's enhanced SME Loan Guarantee Scheme and Special Loan Guarantee Scheme as participating lending institutions. Up to 15 January 2010, they had forwarded over 30,500 loan applications to the Trade and Industry Department for processing. Around 28,000 have been approved, involving a total loan amount of over HK\$70 billion.



RESIDENTIAL MORTGAGE LENDING

- **The HKMA reminded banks again to be prudent in setting mortgage rates**
- **Conducting onsite examinations to ensure compliance with recent guidance on property valuation and assessment of borrowers' repayment ability**



SUPERVISORY POLICY INITIATIVES

- **Banking (Capital) Rules: proposed amendment**
- **Basel Committee Regulatory Reform Proposals: industry consultation and quantitative impact study**
- **Liquidity Regime: industry consultation on proposals to implement international standards**
- **Supervisory Guidance:**
 - **Guideline on remuneration being finalised**
 - **Consultation on valuation and market risk guidelines within 1H 2010**

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- Banking (Capital) Rules : Consulted the industry on proposals to implement the Basel Committee's enhancements to the Basel II framework issued in July (primarily to raise capital on trading book and securitisation activities) and make a few other refinements to the capital framework (largely prompted by local implementation experience). Preparation for legislative amendments is underway.
- Basel Committee Regulatory Reform Proposals : The Basel Committee's proposals to strengthen global capital and liquidity standards* were issued in December 2009 for consultation until 16 April 2010. The HKMA has encouraged the industry to comment. The Basel Committee is conducting a comprehensive Quantitative Influence Study to enable it to calibrate the standards by year-end. The HKMA is participating in the Study.
- Liquidity Regime : The HKMA plans to consult the industry in Q1 2010 on enhanced supervisory guidance for liquidity risk management, designed to align with the Basel Committee's 2008 *Principles for Sound Liquidity Risk Management and Supervision*. Other proposals to strengthen the existing regime, including new quantitative liquidity requirements and a correspondingly revised regulatory reporting framework, are being developed having regard to international developments and local circumstances.
- Remuneration Guideline : The HKMA has consulted the industry on its draft Guideline on A Sound Remuneration System. The industry is generally supportive of the proposal to align the Hong Kong standards on sound remuneration practices with those adopted in other leading financial centres. We are in the process of finalising the Guideline, and aim to issue it within Q1 2010.
- Valuation Guideline : Recognising the critical importance of sound valuation to risk management, financial reporting and capital regulation, the HKMA is revising its supervisory guideline on "Use of Fair Value Option for Financial Instruments" in light of the recommendations of the Basel Committee and best international practices. A draft is expected to be put out for industry consultation in the first half of 2010.
- Market Risk Guideline : The HKMA is compiling a new guideline addressing the key elements of an effective market risk management system, taking into account lessons from the global financial crisis. The HKMA plans to consult the industry in the first quarter of 2010.

* These standards seek to (i) improve the quality, consistency and transparency of banks' capital base; (ii) strengthen the risk coverage of the Basel II counterparty credit risk framework; (iii) introduce a leverage ratio to supplement the Basel II risk-based measure and help contain the build-up of excessive leverage in the banking system; (iv) promote the build-up of countercyclical capital buffers within the banking sector outside periods of stress which can be drawn down as losses are incurred; and (v) introduce a minimum global liquidity standard to enhance banks' resilience to liquidity stress.



DEPOSIT PROTECTION

- **Concluded the review of the Deposit Protection Scheme (DPS) after considering the results of the consultation**
- **Aims at submit legislative proposals to LegCo in Q2 2010 to raise coverage amount to HK\$500,000 and introduce other changes**
- **Making preparations to facilitate a smooth transition**
- **Discussing with Malaysia and Singapore in the tripartite working group to co-ordinate the exit from full deposit guarantees by the end of 2010**

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- Hong Kong Deposit Protection Board finalised its proposals on enhancing the DPS taking into consideration the results of the consultation on the review.
- The Board aims to submit legislative proposals to LegCo in Q2 2010 to raise the coverage amount to \$500,000 and introduce other changes, and complete the legislative process before the full deposit guarantee expires at the end of 2010.
- The Board is making preparations for the transition, such as organising briefings to banks on the impending changes, and public education and promotion activities,.
- The HKMA continued to discuss with Bank Negara Malaysia and the Monetary Authority of Singapore in the tripartite working group to co-ordinate the exit from full deposit guarantees.



LEHMAN-RELATED INVESTMENT PRODUCTS

- **Reviewing comments of banking industry on SFC's proposals to enhance investor protection**
- **Mystery shopping programme to be implemented this year**
- **Assisting the Government on proposals to improve investor education and establish a financial dispute resolution system**

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- The consultation period for SFC's proposals to enhance protection for the investing public ended on 31 December 2009. The Hong Kong Association of Banks indicated support for the SFC's overall objective to further enhance the protection of the investing public. However, it stressed the importance of balancing investor protection with the need to maintain an efficient distribution system for investment products. The HKMA is reviewing the banking industry's comments.
- A report jointly commissioned by the HKMA and the SFC on details of the proposed mystery shopping programme was completed in December 2009. The programme will assist the HKMA and SFC in assessing the sales processes of regulated entities. The programme will be implemented this year.
- The HKMA supports the initiatives to enhance investor education and establish a financial dispute resolution system, and is assisting the Government in preparing for the launch of consultations on these proposals.



SETTLEMENT AGREEMENT PURSUANT TO SFO S.201

- **About 98% of eligible customers (over 24,400) accepted the minibonds repurchase offer**
- **About 4,800 customers who had previously settled eligible for voluntary top-up offer**
- **Over 500 customers who purchased Lehman equity index-linked principal protected notes from two banks recovered 80% of principal invested**

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- Around 25,000 minibond customers are eligible for the repurchase scheme. By the end of 2009, over 24,400 eligible customers (about 98%) had accepted the repurchase offers.
- In December 2009, two banks agreed, as a result of the enhanced complaint handling procedures under the SFO S.201 agreement, to make offers to repurchase certain Lehman Brothers equity index-linked principal protected notes from eligible customers at 80% of the principal invested, and make ex gratia payments to customers who had received less than 80% of the principal under the previous settlements.



LEHMAN-RELATED ISSUES - INVESTIGATION PROGRESS

- **Received nearly 21,600 Lehman-related complaints, of which 79% had been handled or resolved by mid-January 2010**
- **The HKMA aims to substantially complete the investigation of all outstanding complaints by the end of March 2010**

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- By mid-January 2010, around 13,000 Lehman Brothers minibond complaints had been resolved by settlements under the SFO S.201 agreement and around 550 Lehman Brothers-related complaints resolved through the banks' enhanced complaint handling procedures.
- Together with around 1,000 Lehman Brothers-related complaints under disciplinary process and around 2,700 Lehman Brothers-related complaints closed because of insufficient prima facie evidence or disciplinary grounds, 79% of the Lehman Brothers-related complaints had been dealt with.



FINANCIAL INFRASTRUCTURE



FINANCIAL MARKET INFRASTRUCTURE

Development strategy:

- **Robust and efficient payment and settlement system is essential to monetary and financial stability – important to ensure fault-proof day-to-day operation**
- **Business development – Hong Kong as a settlement service utility centre to attract transaction banking business in the region**



FINANCIAL MARKET INFRASTRUCTURE

- **New functions of payment and settlement systems introduced in the second half of 2009 and early 2010:**
 - **July 2009**: Upgrading the RMB RTGS system in Hong Kong to clear and settle the use of RMB for Mainland's external trade with Hong Kong and ASEAN economies
 - **August 2009**: CMU Fund Order Routing and Settlement Service to provide a standard processing platform for investment funds in Hong Kong and in the region
 - **November 2009** : introducing a new cross bank settlement run to enable banks to offer same-day cross-bank money transfer services to their customers
 - **January 2010** : Payment-versus-payment link between Hong Kong's US dollar RTGS system and Indonesia's Rupiah RTGS system to reduce settlement risk in USD/Rupiah forex transactions and to attract Indonesian banks to settle US-dollar payments in Hong Kong



GOVERNMENT BOND PROGRAMME

Institutional Bond Issuance Programme

- **The third Government bond issue, a 10-year bond with size of HK\$2.5 billion, was successfully tendered on 11 January, with a bid-to-cover ratio of 4.72.**
- **Attracted a diverse group of end-investors, such as insurance companies and pension funds.**

Retail Bond Issuance Programme

- **Necessary preparatory work almost completed. Inaugural retail issue will be launched when market conditions are appropriate.**

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- The establishment of the Government Bond Programme (GBP) was proposed by the Financial Secretary in his Budget Speech in February 2009, and was approved by the Legislative Council in July 2009.
- The primary objective of the GBP is to promote the further and sustainable development of Hong Kong's bond market through systematic issuance of Government bonds. It can also help promote financial stability by making our debt market an effective channel of financial intermediation, complementing the banking and equity markets.
- The GBP is a long-term programme comprising Institutional and Retail Bond Issuance Programmes.
- The Institutional Bond Issuance Programme was launched in September 2009. Following the successful issuance of a 2-year (HK\$3,500 million) and a 5-year (HK\$2,000 million) bond, a total worth of HK\$2,500 million 10-year bond was issued to institutional investors in mid-January. The 10-year issue was well-received by the market, with the bid-to-cover ratio (the ratio of bonds applied for to bonds issued) being 4.72. The Government bonds have attracted a diverse group of institutional investors, particularly end-investors like investment funds, insurance companies and pension funds. The enlarged investor base is expected to improve liquidity and attract more issuers to raise funds via the bond market. This will help increase the breadth and depth of our bond market, consolidating our role as an international financial centre.
- All necessary preparatory work for the Retail Bond Issuance Programme is almost completed. The inaugural retail issue will be launched at an appropriate time, taking into consideration the prevailing market conditions and the advice of Co-arrangers.



DEVELOPMENT OF ISLAMIC FINANCE

Promote market infrastructure

- **Continue to support the Government in drawing up legislative proposals for modifying Hong Kong's tax laws to level the playing field for Islamic and conventional financial products**
- **Assisted the Government in preparing an information package on the interim tax exemption for sukuk under the existing legislative framework**

Enhance regional and international profile

- **Assisted the Treasury Markets Association in organising a workshop on Islamic finance in the 2010 Asian Financial Forum**

Promote market awareness

- **Continue to provide training to the industry and help resolve tax and regulatory issues**

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- **Promote market infrastructure:** The HKMA provided input to the Government in drawing up legislative proposals for modifying the tax laws in Hong Kong, with a view to creating a level playing field for Islamic and conventional financial products. The HKMA also assisted the Government in preparation of an information package, including a procedural flowchart and outline of the key issues involved, detailing the interim arrangements for application of tax exemption for sukuk under the existing legislative framework. The information package was disseminated to market players via various industry bodies, including the Treasury Markets Association (TMA), in late-November 2009. The HKMA will continue to assist the Government to consult the market on its legislative proposals.
- **Build regional and international profile:** The HKMA assisted the TMA in organising a workshop on Islamic finance at the 2010 Asian Financial Forum, focusing on the latest developments of Islamic finance in Hong Kong and other parts of the world, particularly in Islamic capital markets.
- **Promote market awareness:** The HKMA will continue to work with the TMA to deliver training programmes and maintain contacts with market participants.



HONG KONG AS AN INTERNATIONAL FNANCIAL CENTRE



INCREASING REGIONAL AND INTERNATIONAL FINANCIAL CO-OPERATION

- **Financial Stability Board (FSB):** The HKMA participated in the Third Plenary Meeting of the FSB in January 2010, which discussed improving financial regulation and strengthening adherence to international standards.
- **Chiang Mai Initiative Multilateralisation (CMIM):** CMIM Agreement signed in December 2009. This regional joint-defence mechanism will become effective in March 2010.
- **Monitoring of regional monetary and financial stability:** The HKMA conducted analyses for EMEAP Monetary and Financial Stability Committee (MFSC) to assess risks and vulnerabilities in the EMEAP region.

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- The HKMA participated in the Third Plenary Meeting of the FSB in Basel on 9 January 2010. At the meeting, members discussed the latest developments in the financial system and improving financial regulation and strengthening adherence to international standards (including strengthening accounting standards, sound compensation practices, and the framework to strengthen adherence to international standards)
- Finance Ministers and Central Bank Governors of ASEAN+3 and the Monetary Authority of Hong Kong announced on 28 December 2009 the signing of the CMIM Agreement. The CMIM will become effective on 24 March 2010 to provide short-term US dollar funding to participants facing liquidity shortages. Hong Kong undertakes to commit, on a callable basis, up to US\$4.2 bn.
- The multi-region macroeconomic model developed for EMEAP by the HKMA has been further enhanced and used to conduct scenario analyses for EMEAP Monetary and Financial Stability Committee (MFSC) to assess the risks and vulnerabilities in the EMEAP region.



RENMINBI BUSINESS (1)

- **Renminbi trade settlement business on the rise:**
 - **At the end of December 2009, 52 Hong Kong participating AIs had entered into the clearing agreement with the Clearing Bank or Mainland Correspondent Banks**
 - **15 overseas banks have signed relevant clearing agreement with the Clearing Bank**
 - **The amount of renminbi trade settlement increased in November and December 2009 after the Mainland pilot enterprise list and the relevant requirements on export tax rebate were published**

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- The number of Hong Kong authorized institutions engaged in this business has increased to 52 in December 2009 from 32 in the third quarter.
- The number of overseas banks which have signed the clearing agreement with the Hong Kong Clearing Bank increased from two in the third quarter of 2009 to 15 by the end of 2009. These banks can make use of Hong Kong's clearing platform.
- The Mainland pilot enterprise list and the relevant requirements on Mainland export tax rebate were published in August 2009.



RENMINBI BUSINESS (2)

- **Continue to promote Hong Kong’s renminbi business, including:**
 - **Promotion of trade settlement in renminbi**
 - **Development of more diversified renminbi funding products**
 - **Expansion in issuance amount and types of issuers of renminbi bonds**

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- In December 2009, in his visit to Beijing, the Chief Executive of the HKSAR quoted Premier Wen Jia-bao as saying:
 - (The Central Government would) “continue to promote cross-border trade settlement in renminbi in Hong Kong, and explore various types of renminbi business” (businesses mentioned included trade finance, factoring, project finance and the use of renminbi for direct investment in Hong Kong); and
 - “promote the development of renminbi bonds in Hong Kong, including expanding the amount of issuance, increasing the types of bond issuers.”
- The HKMA will follow up on further promoting these areas with Mainland authorities.



THE INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND

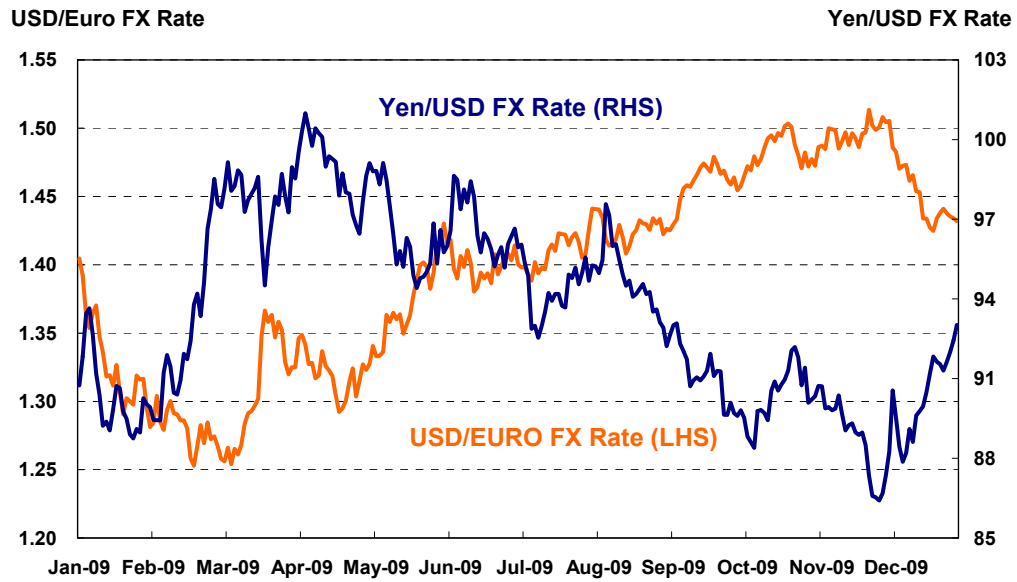


INVESTMENT ENVIRONMENT OF 2009

- **Market optimism emerged from mid-March following unprecedented stimulus measures and quantitative easing by major economies. Risk appetite recovered gradually amid signs of stabilisation in the global economy**
- **Exchange rates: US dollar strengthened against major currencies in the first quarter but resumed its weakening trend for the rest of the year as safe haven flows subsided**
- **Equity markets: Major markets declined in the early months of the year but rebounded strongly from mid-March on positive earnings reports and signs of economic recovery**
- **Interest rates: US government bond yields, especially long-term yields, rose in the first half of 2009 on inflation expectation and concern over large increases in supply, before moving within a range as the Fed reiterated that it would maintain low rates for an extended period**



CURRENCY MARKET FLUCTUATION



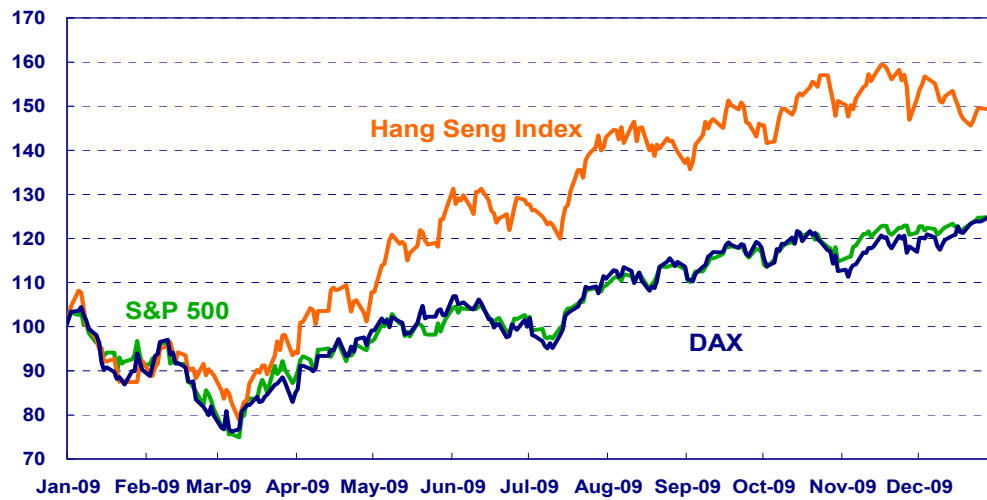
58

- The US dollar strengthened against major currencies in the first quarter but resumed its weakening trend for the rest of the year as safe haven flows subsided.



PERFORMANCE OF MAJOR EQUITY MARKETS

Normalised Index Level (2008 year-end = 100)

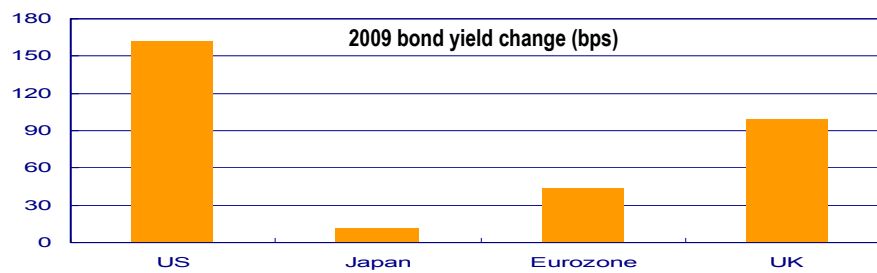


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- Major markets declined in the early months of the year but rebounded strongly from mid-March on positive earnings reports and signs of economic recovery.



CHANGES OF 10-YEAR GOVERNMENT BOND YIELD



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- Government bond yields of major developed economies rose in 2009.
- US government bond yields, especially long-term yields, rose in the first half of 2009 on inflation expectation and concern over large increases in supply, before moving within a range as Fed reiterated to maintain low rate for an extended period.



INVESTMENT INCOME

(HK\$ billion)	2009					2008	2007	2006	2005
	Full year *	Q4	Q3	Q2	Q1	Full year	Full year	Full year	Full year
Gain/(Loss) on Hong Kong equities[^]@			15.9	30.3	(4.2)	(77.9)	55.8	35.9	7.0
Gain/(Loss) on other equities[^]			27.4	27.3	(16.0)	(73.1)	6.7	18.7	20.5
Exchange gain/(loss)			11.2	11.7	(9.7)	(12.4)	18.7	17.3	(19.5)
Return from bonds[#]			<u>17.4</u>	<u>(10.8)</u>	<u>(3.6)</u>	<u>88.4</u>	<u>61.0</u>	<u>31.9</u>	<u>29.8</u>
Investment income/(loss)[@]			71.9	58.5	(33.5)	(75.0)	142.2	103.8	37.8

* Unaudited figures

[^] Including dividends

[#] Including interest

[@] Excluding valuation changes in Strategic Portfolio



CHANGES IN INVESTMENT INCOME, PAYMENT TO FISCAL RESERVES AND ACCUMULATED SURPLUS

(HK\$ billion)	2009					2008
	Full year (unaudited)	Q4	Q3	Q2	Q1	Full year
Investment income/(loss)			71.9	58.5	(33.5)	(75.0)
Other income			0.0	0.2	0.0	0.3
Interest and other expenses			<u>(0.9)</u>	<u>(1.2)</u>	<u>(0.7)</u>	<u>(6.5)</u>
Net investment income/(loss)			71.0	57.5	(34.2)	(81.2)
Payment to Fiscal Reserves #			(8.0)	(8.5)	(9.1)	(46.4)
Payment to HKSAR government funds and statutory bodies #			(0.3)	(0.3)	0.0	0.0
Valuation change of Strategic Portfolio [^]			<u>1.3</u>	<u>3.2</u>	<u>(0.1)</u>	<u>(8.9)</u>
Increase/(Decrease) in EF Accumulated Surplus			64.0	51.9	(43.4)	(136.5)

The fixed rate of fee payment is 6.8% for 2009 and 9.4% for 2008.

[^] Including dividends



HISTORICAL INVESTMENT INCOME

(HK\$ billion)

Year	Full Year	Q4	Q3	Q2	Q1
2001	7.4	13.6	10.4	(2.0)	(14.6)
2002	47.0	26.3	(2.1)	26.5	(3.7)
2003	89.7	33.5	8.4	41.1	6.7
2004	56.7	33.0	14.1	(7.2)	16.8
2005	37.8	7.3	19.0	13.6	(2.1)
2006	103.8	36.0	37.1	12.5	18.2
2007*	142.2	33.4	61.8	26.3	20.7
2008*	(75.0)	8.3	(48.3)	(20.4)	(14.6)
2009*#			71.9	58.5	(33.5)

* Excluding valuation changes in the Strategic Portfolio

Unaudited figures



HISTORICAL CHANGES IN INVESTMENT INCOME, PAYMENT TO FISCAL RESERVES AND ACCUMULATED SURPLUS

(HK\$ billion)	2009*	2008	2007	2006	2005	2004	2003	2002	2001	2000
Investment income/(loss)		(75.0)	142.2	103.8	37.8	56.7	89.7	47.0	7.4	45.1
Other income		0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Interest and other expenses		<u>(6.5)</u>	<u>(10.2)</u>	<u>(10.5)</u>	<u>(7.6)</u>	<u>(4.8)</u>	<u>(5.6)</u>	<u>(7.0)</u>	<u>(10.5)</u>	<u>(11.0)</u>
Net investment income/(loss)		(81.2)	132.2	93.5	30.4	52.1	84.3	40.2	(2.9)	34.3
Payment to Fiscal Reserves		(46.4)	(27.6)	(28.9)	(10.1)	(14.5)	(25.7)	(15.6)	(1.6)	(18.1)
Payment to HKSAR government funds and statutory bodies		N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Valuation change of Strategic Portfolio [^]		(8.9)	4.7	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Revaluation gain/(loss) on premises		<u>N/A</u>	<u>N/A</u>	<u>N/A</u>	<u>N/A</u>	<u>0.9</u>	<u>(0.9)</u>	<u>N/A</u>	<u>N/A</u>	<u>N/A</u>
Carry to Accumulated Surplus		(136.5)	109.3	64.6	20.3	38.5	57.7	24.6	(4.5)	16.2
Adjustment to Accumulated Surplus										
Effect of implementation of HKAS 39		<u>N/A</u>	<u>N/A</u>	<u>N/A</u>	<u>(0.6)</u>	<u>N/A</u>	<u>N/A</u>	<u>N/A</u>	<u>N/A</u>	<u>N/A</u>
Increase/(Decrease) in EF Accumulated Surplus		(136.5)	109.3	64.6	19.7	38.5	57.7	24.6	(4.5)	16.2
* Unaudited figures										
[^] Including dividends										



EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	At 31 Dec 2009 (unaudited)	At 31 Dec 2008	Change
ASSETS			
Deposits		172.8	
Debt securities		1,151.3	
Hong Kong equities		92.9	
Other equities		103.3	
Other assets		<u>40.0</u>	
Total assets		<u>1,560.3</u> =====	
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness		176.1	
Government-issued currency notes & coins in circulation		8.3	
Balance of the banking system		158.0	
Exchange Fund Bills and Notes		162.5	
Placements by banks and other financial institutions		13.6	
Placements by Fiscal Reserves		531.4	
Placements by HKSAR government funds and statutory bodies		0.1	
Other liabilities		<u>29.8</u>	
Total liabilities		1,079.8	
Accumulated Surplus		<u>480.5</u>	
Total liabilities and fund equity		<u>1,560.3</u> =====	