



HONG KONG MONETARY AUTHORITY

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

1 March 2011



DISCUSSION TOPICS

Updates on

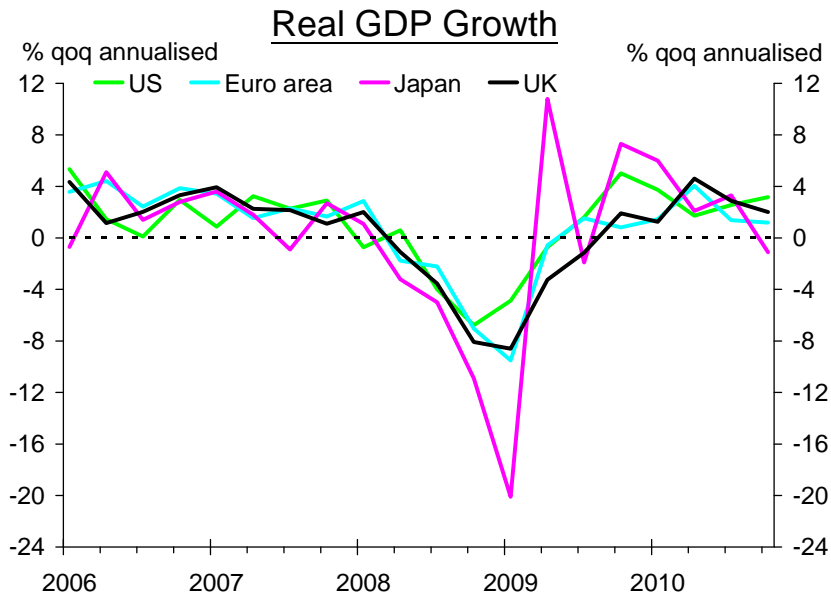
- Financial and Economic Conditions
- Currency Stability
- Banking Stability
- Financial Infrastructure
- Hong Kong as an International Financial Centre
- The Exchange Fund



FINANCIAL AND ECONOMIC CONDITIONS



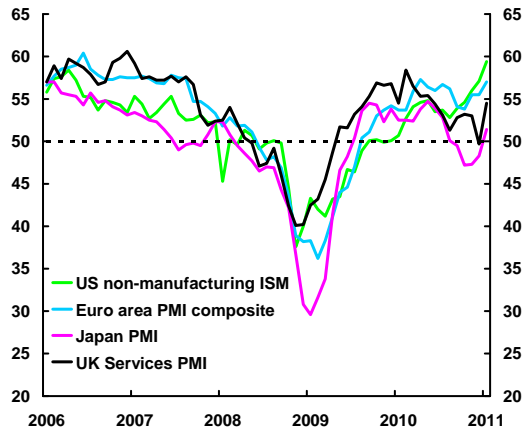
ECONOMIC SITUATION IN MAJOR COUNTRIES



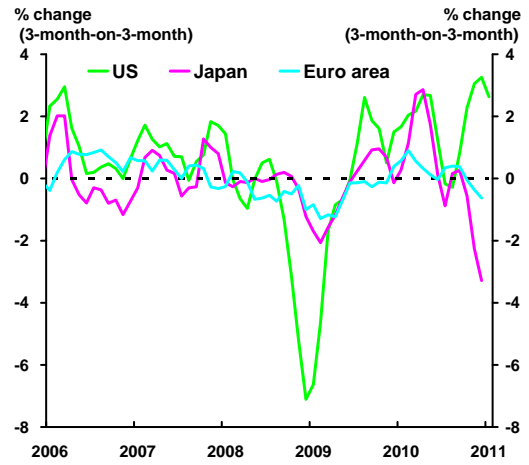


ECONOMIC SITUATION IN MAJOR COUNTRIES

Purchasing Manager Index



Retail Sales



Source: Bloomberg and CEIC



GLOBAL ECONOMIC GROWTH FORECASTS

(% year-on-year)

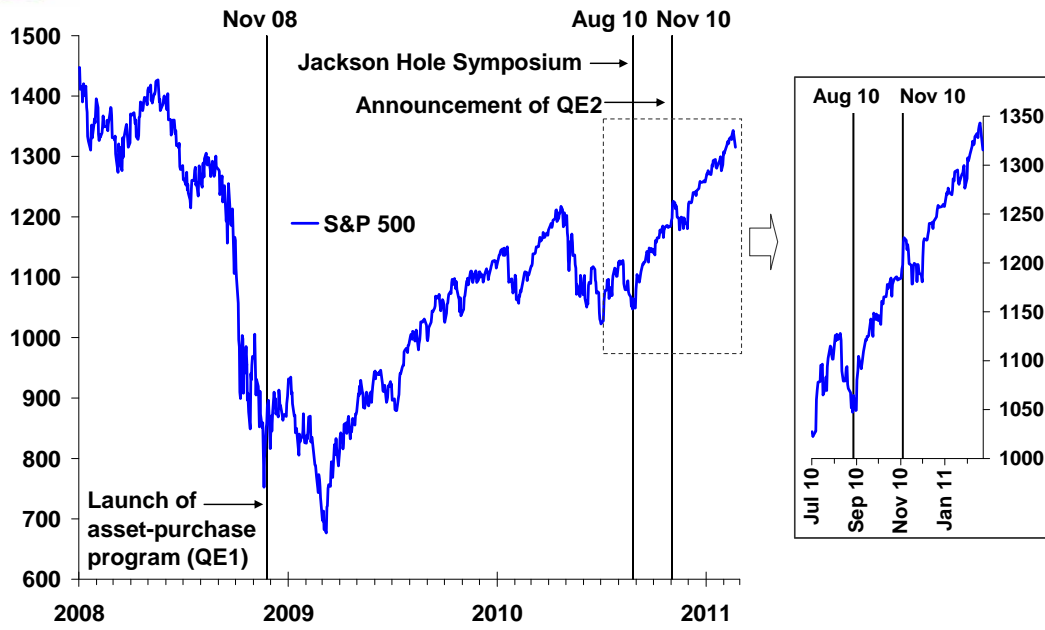
Real GDP Growth

	2010	2011 Forecasts		
		May 2010 FAP briefing	Nov 2010 FAP briefing	Feb 2011
US	2.9	3.1	2.4	3.2
Euro area	1.7	1.5	1.4	1.6
Japan	3.9	1.7	1.2	1.5

Source: Consensus Forecasts



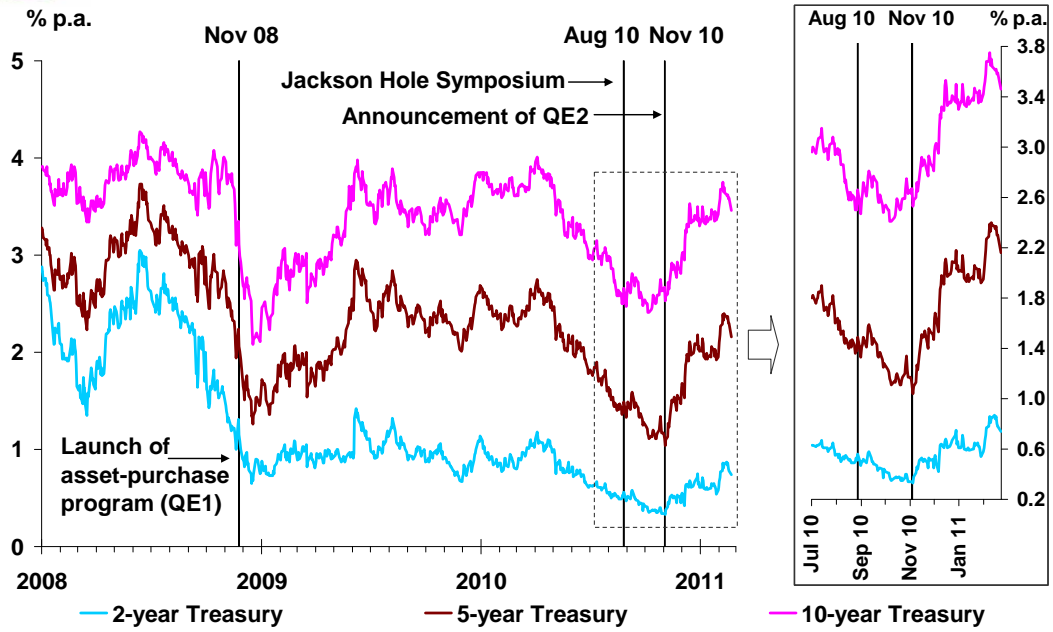
US EQUITY INDEX



Source: CEIC



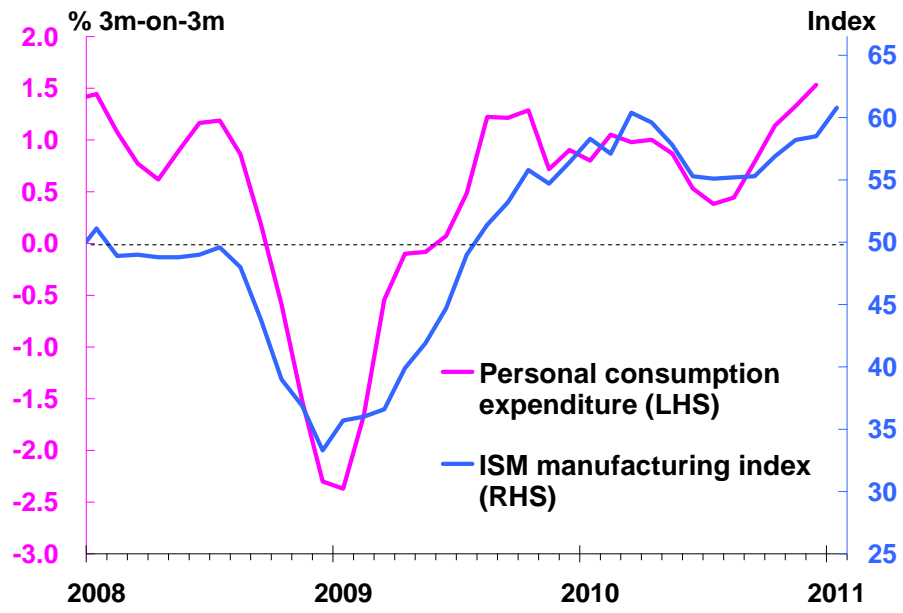
US LONGER-TERM INTEREST RATES



Source: CEIC



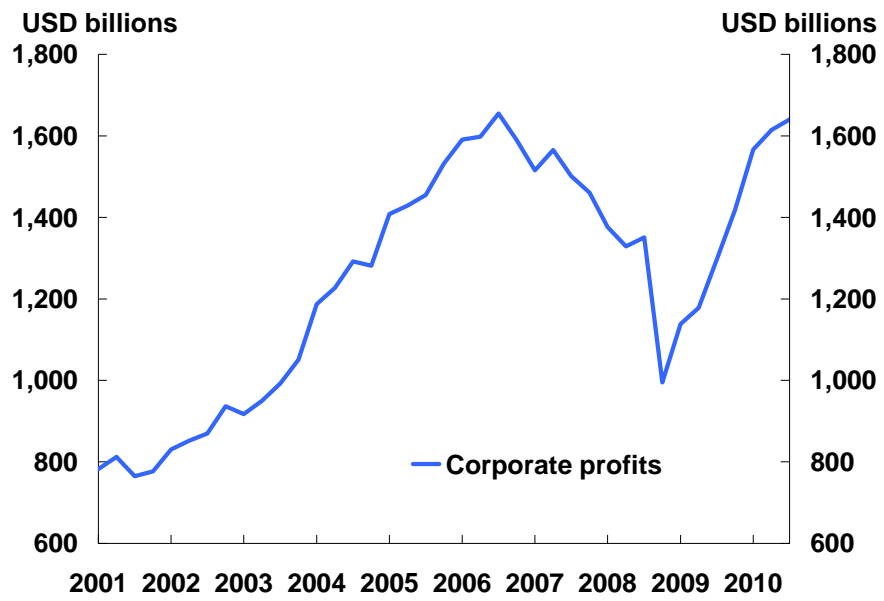
US: CONSUMPTION GROWTH & BUSINESS ACTIVITY



Source: CEIC



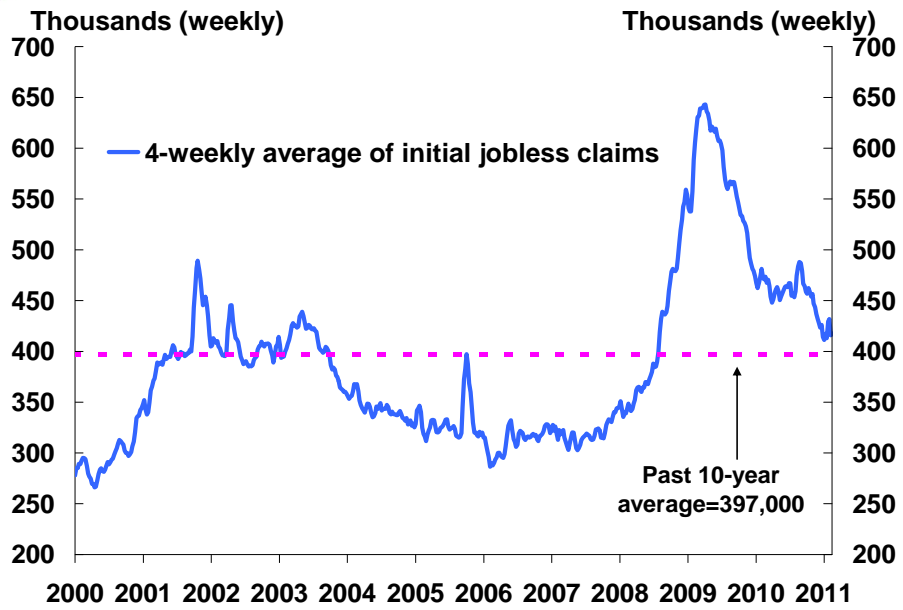
US: CORPORATE PROFITS



Source: CEIC



US: WEEKLY INITIAL JOBLESS CLAIMS



Source: CEIC

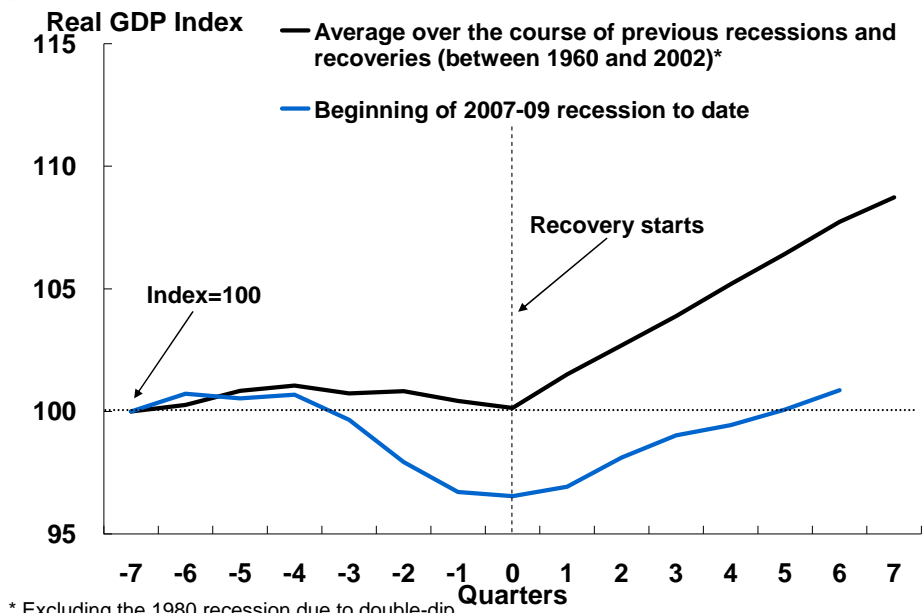


US: NEW FISCAL STIMULUS PACKAGE

- The new US\$858 billion fiscal stimulus package passed by the Congress in December 2010:
 - Temporary extension of tax relief, including all Bush-era tax cuts (\$668 billion)
 - A 2%, one-year cut in Social Security payroll tax from 6.2% to 4.2% (\$112 billion)
 - Temporary extension of emergency unemployment benefits (\$57 billion)
 - Temporary extension of investment incentives (\$22 billion)



US: COMPARISON OF CURRENT ECONOMIC RECOVERY WITH PAST CYCLES

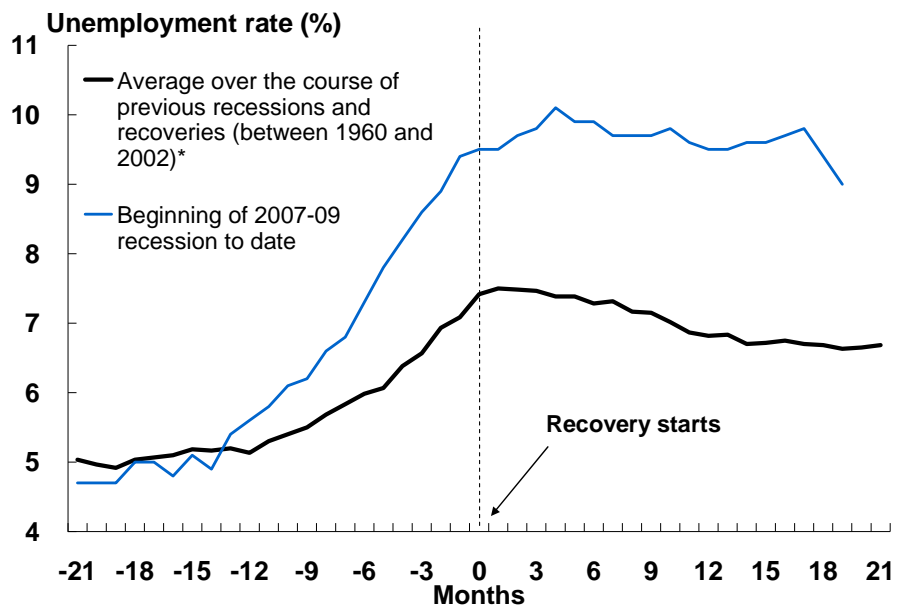


* Excluding the 1980 recession due to double-dip

Source: CEIC



US: COMPARISON OF UNEMPLOYMENT RATES WITH PAST CYCLES

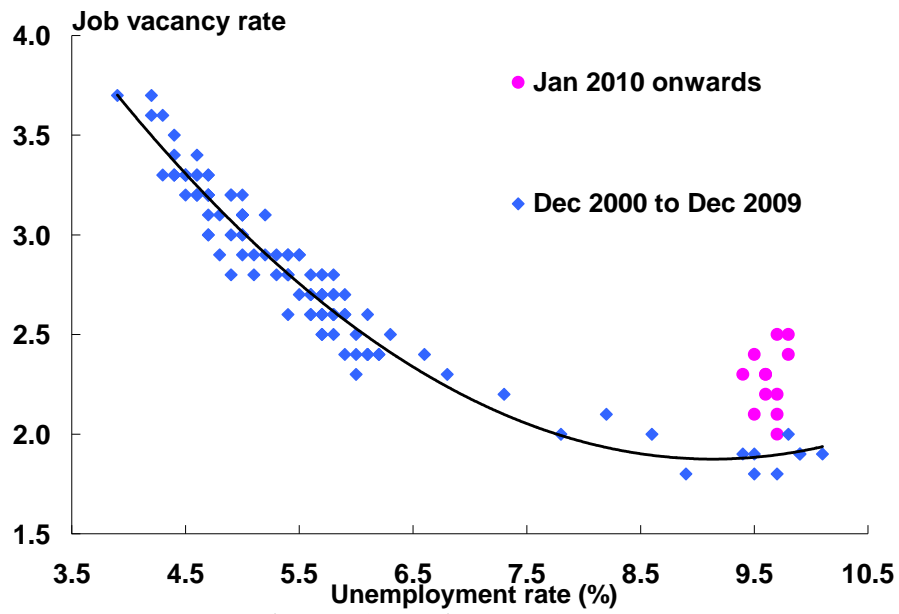


* Excluding the 1980 recession due to double-dip

Source: CEIC



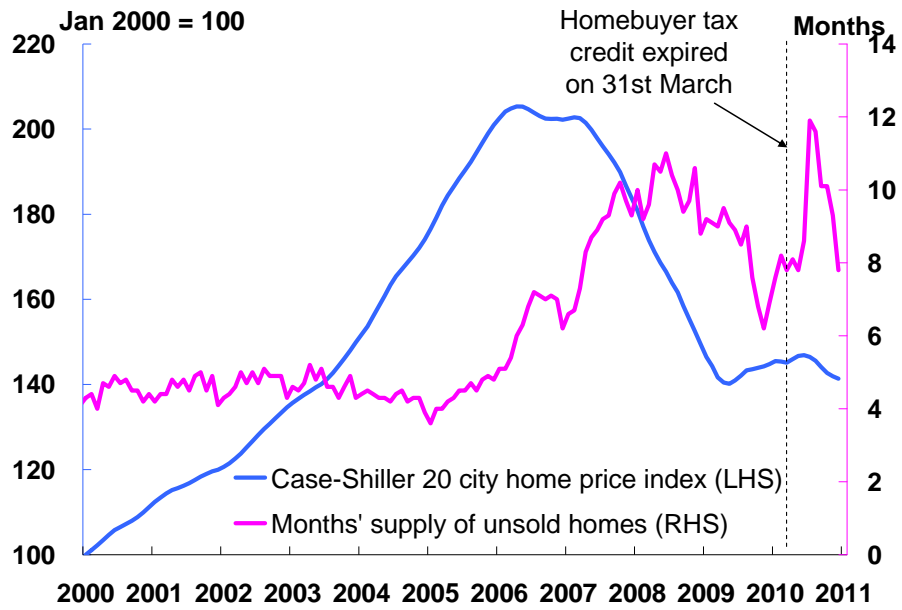
US: STRUCTURAL MISMATCH IN THE LABOUR MARKET



Note: The Beveridge curve (the black fitted line) is derived from monthly data between December 2000 and December 2009.
Source: CEIC



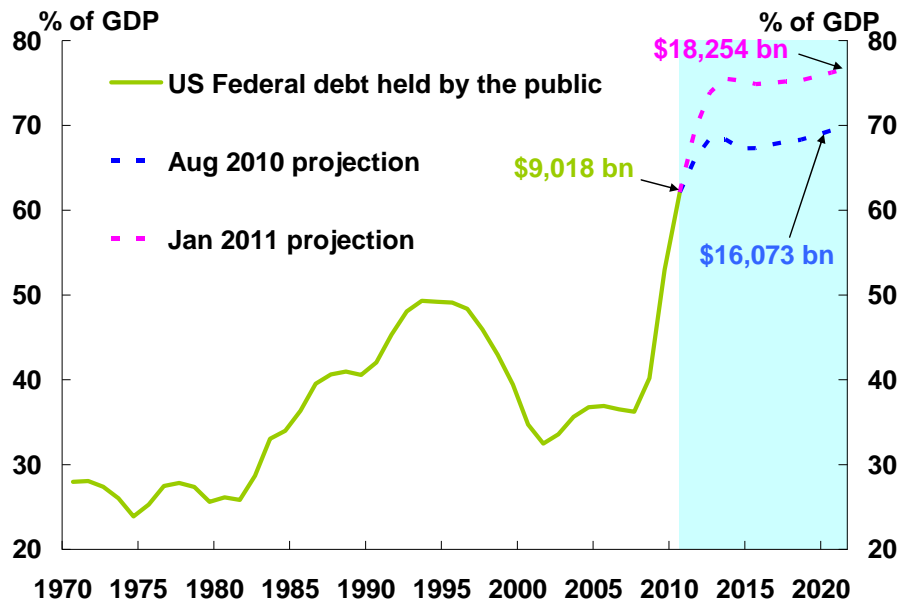
US: HOUSE PRICES AND SUPPLY OF UNSOLD HOMES



Source: CEIC



US: FISCAL SITUATION

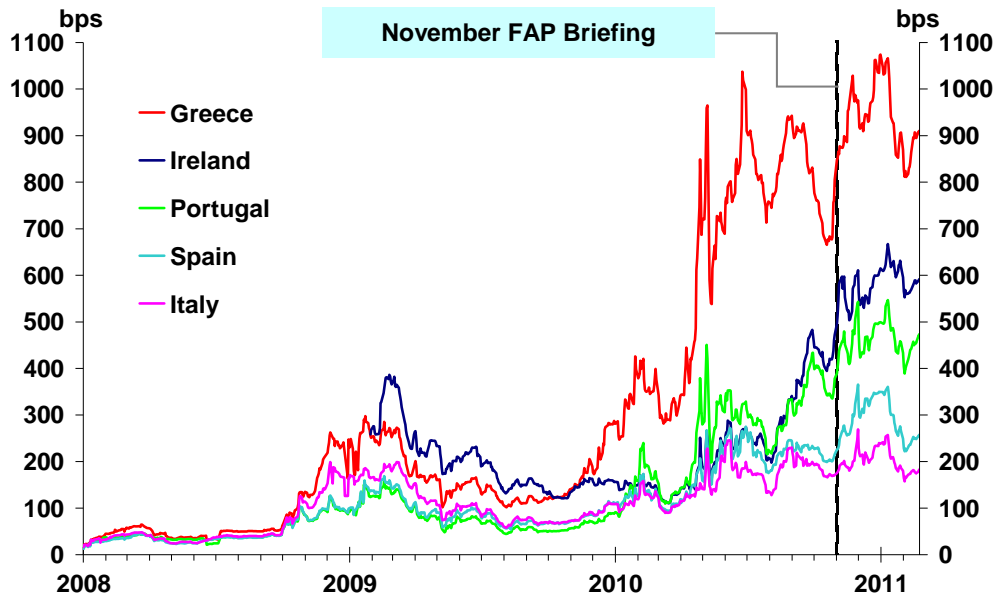


Source: Congressional Budget Office



EUROPEAN SOVEREIGN DEBT PROBLEM: CDS SPREADS

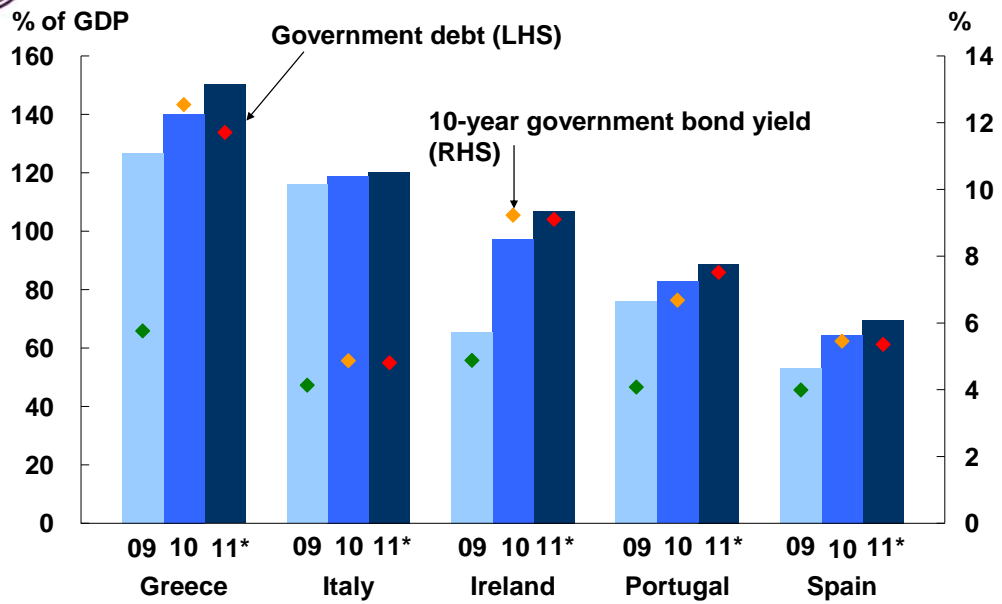
Prices of 5-year sovereign CDS



Source: Bloomberg



EUROPEAN SOVEREIGN DEBT PROBLEM: PUBLIC DEBT & BORROWING COST

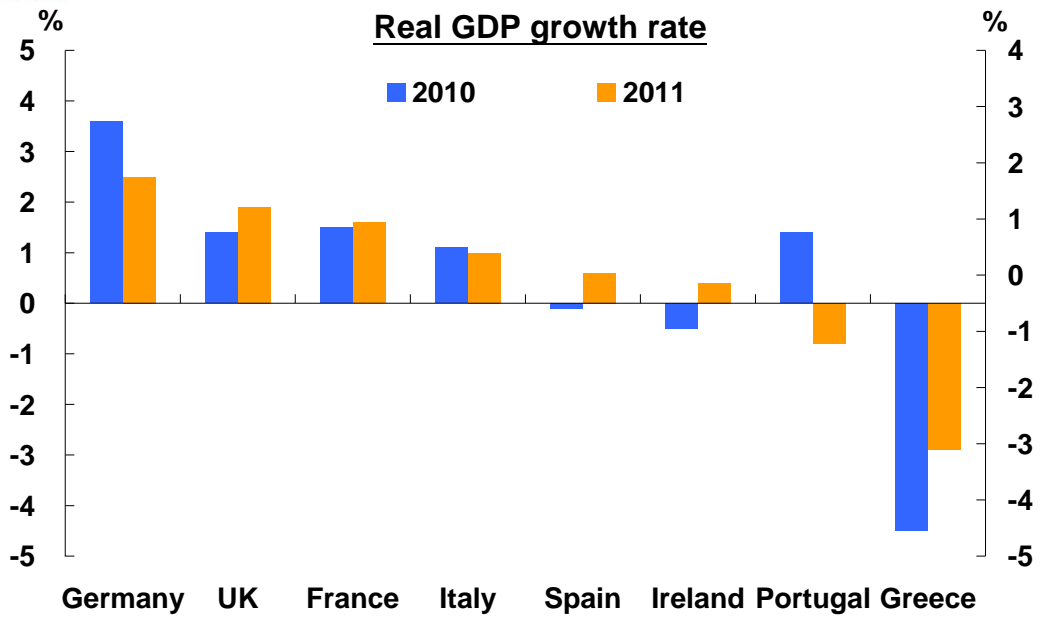


* Government debts in 2011 are forecasts; bond yields are the latest available.

Source: European Commission (European Economic Forecast, Autumn 2010) and EcoWin.



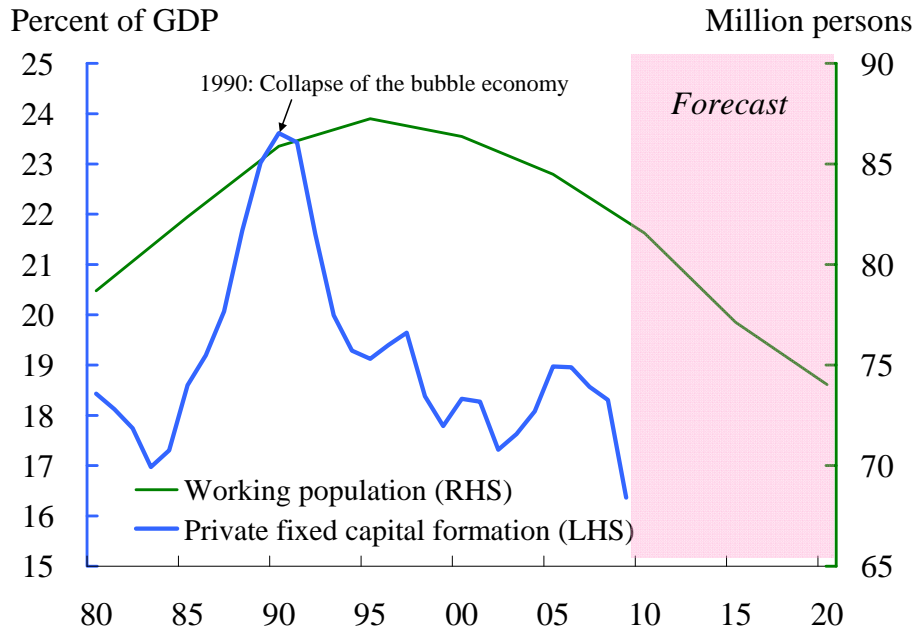
EUROPEAN SOVEREIGN DEBT PROBLEM: ECONOMIC GROWTH



Source: Consensus Forecasts, February 2011



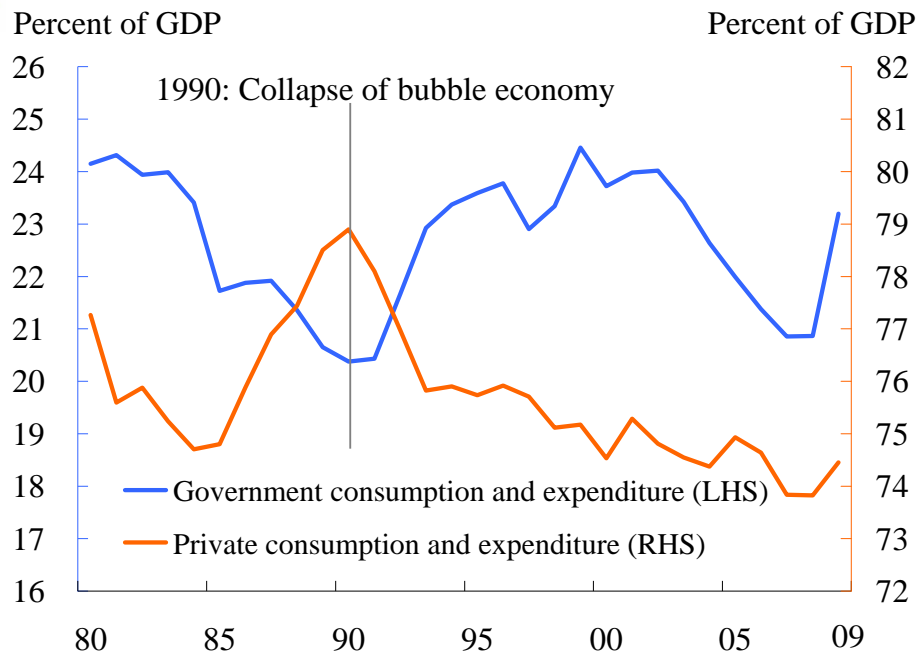
JAPAN: AGEING POPULATION IS REDUCING LONG-TERM POTENTIAL OUTPUT



Source: CEIC and United Nations



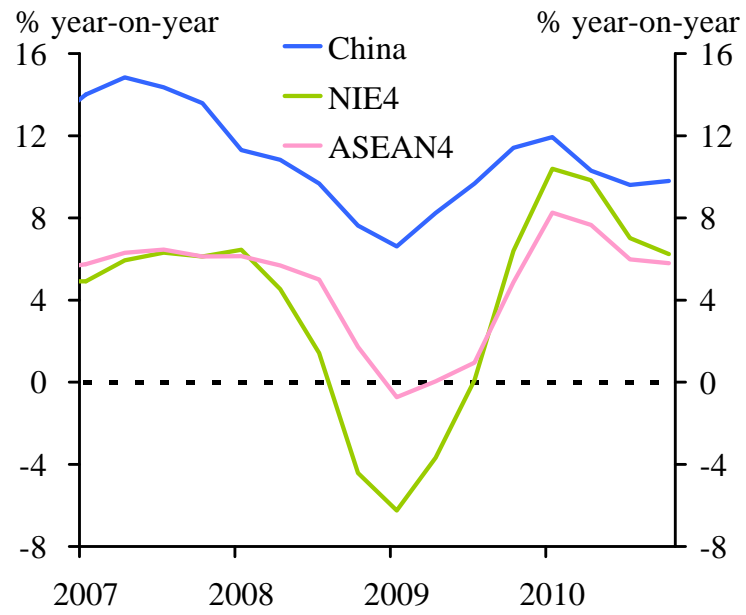
JAPAN : GOVERNMENT AND PRIVATE SPENDING



Source: CEIC



ECONOMIC GROWTH IN ASIA



Source: CEIC



ASIAN ECONOMIC GROWTH FORECASTS

(% year-on-year)

Real GDP Growth

	2010	2011 Forecasts
Hong Kong	6.8	4.8
China	10.3	9.3
Korea	6.1	4.5
Singapore	14.5	5.1
Taiwan	10.5	4.5
Indonesia	6.1	6.2
Thailand	7.8	4.5

Source: CEIC and Consensus Forecasts (Feb 2011)



CURRENCY APPRECIATION AND RESERVES ACCUMULATION IN ASIAN ECONOMIES

	Change in foreign reserves in 2010		Currency appreciation against USD in 2010 (%)
	(USD bn)	(%)	
Hong Kong	12.9 ¹	5.0 ¹	-
Mainland China	448.2	18.7	3.4
Indonesia	30.1	45.5	4.6
Korea	21.6	8.0	3.2
Singapore	37.9	20.2	9.3
Taiwan	33.8	9.7	9.7
Thailand	33.7	24.4	11.0

1. The increase in foreign reserves in Hong Kong was partly contributed by the investment income

Source: Bloomberg and CEIC



INFLATIONARY PRESSURES IN ASIAN ECONOMIES

Annual inflation rate

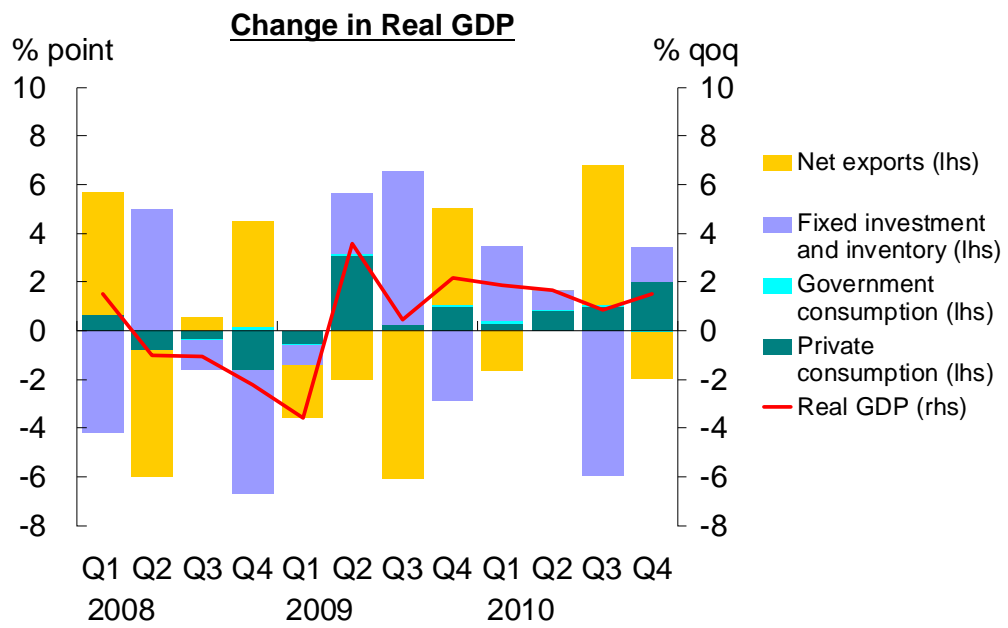
(% year-on-year)

	Hong Kong	Mainland China	Indonesia	Korea	Singapore	Taiwan	Thailand
2008	4.3	5.9	9.8	4.7	6.6	3.5	5.5
2009	0.5	-0.7	4.8	2.8	0.6	-0.9	-0.8
2010	2.4	3.3	5.1	2.9	2.8	1.0	3.3
2011 (Forecast)	3.9	4.5	6.8	3.7	3.2	1.9	3.4

Sources: Census and Statistics Department, CEIC and Consensus Forecasts (Feb 2011)



HONG KONG ECONOMIC SITUATION





HONG KONG ECONOMIC SITUATION

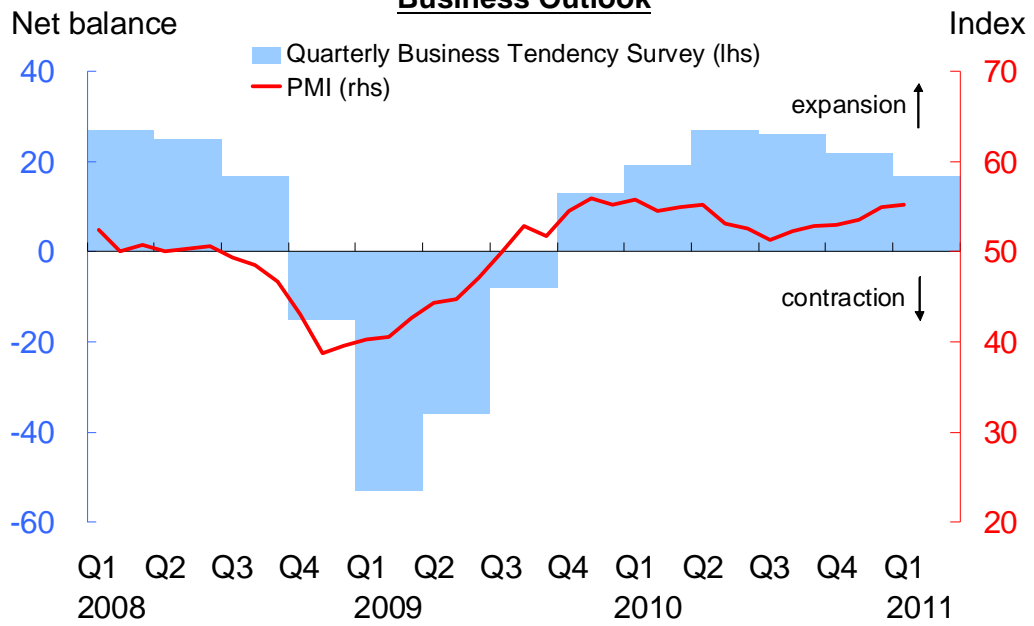
Retail Sales and Exports





HONG KONG ECONOMIC SITUATION

Business Outlook

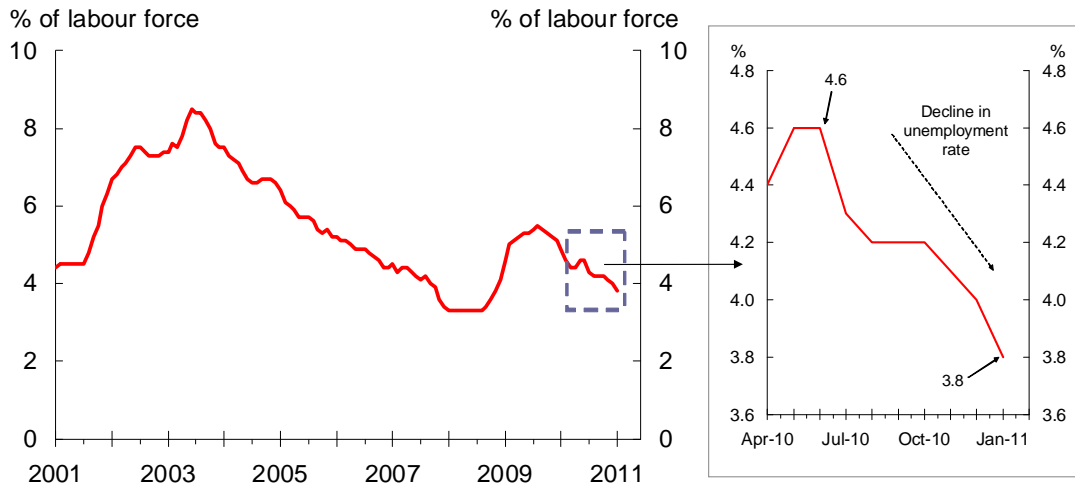




HONG KONG ECONOMIC SITUATION

Labour Market

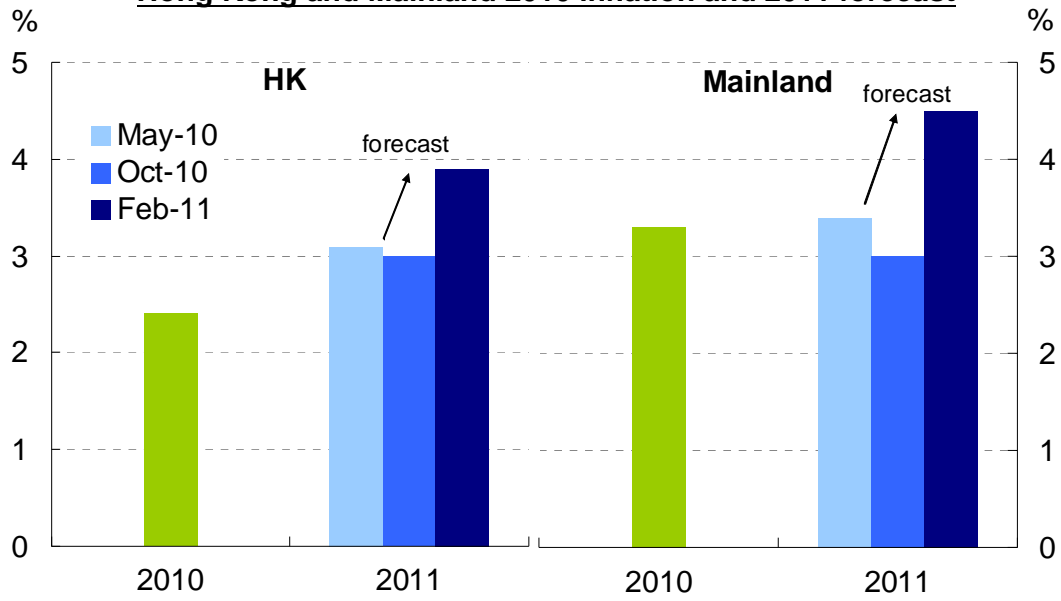
Unemployment rate





ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

Hong Kong and Mainland 2010 inflation and 2011 forecast

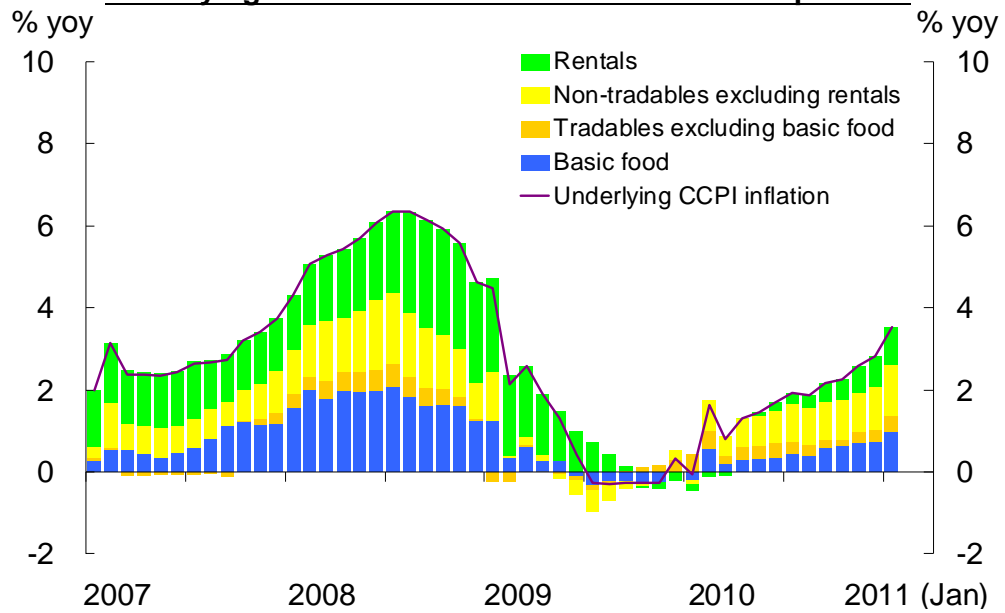


Source : Consensus Forecast (May and Oct 2010 and Feb 2011)



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

Underlying inflation and contributions of its components

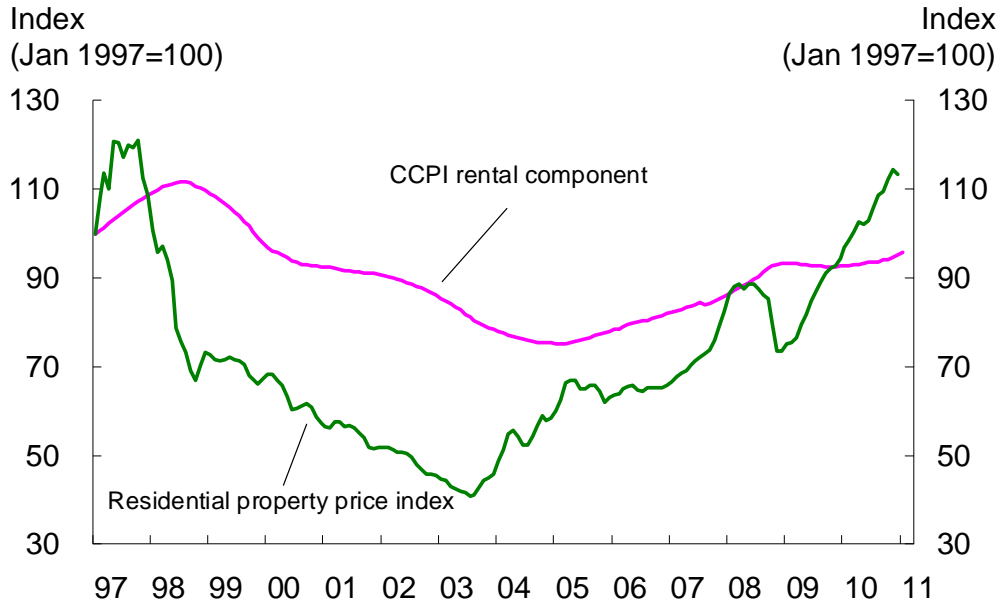


Underlying inflation: Netting out the effects of all Government's one-off relief measures from headline inflation.



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: INFLATION

CCPI rental component and residential property price index

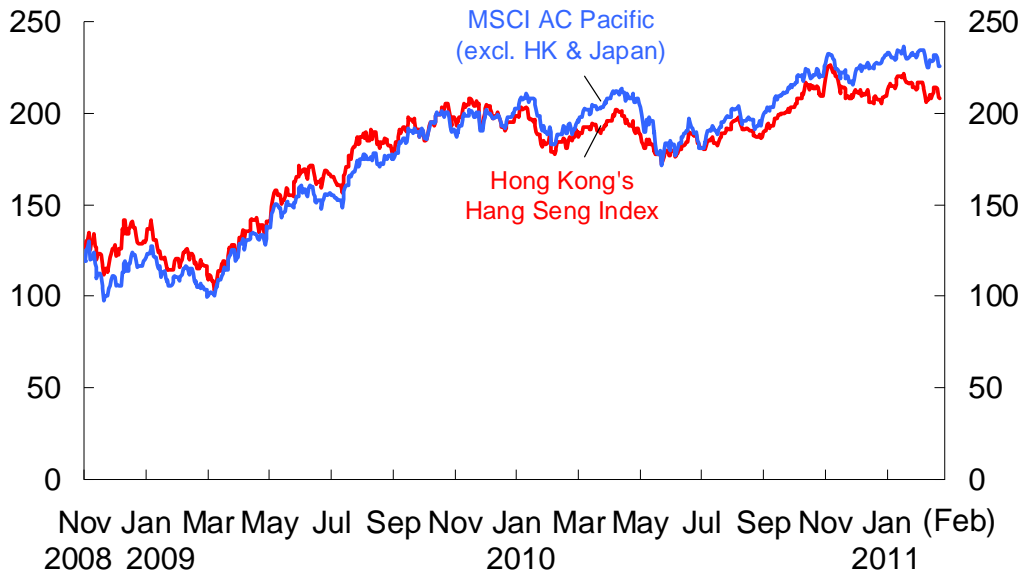




ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: EQUITY MARKET

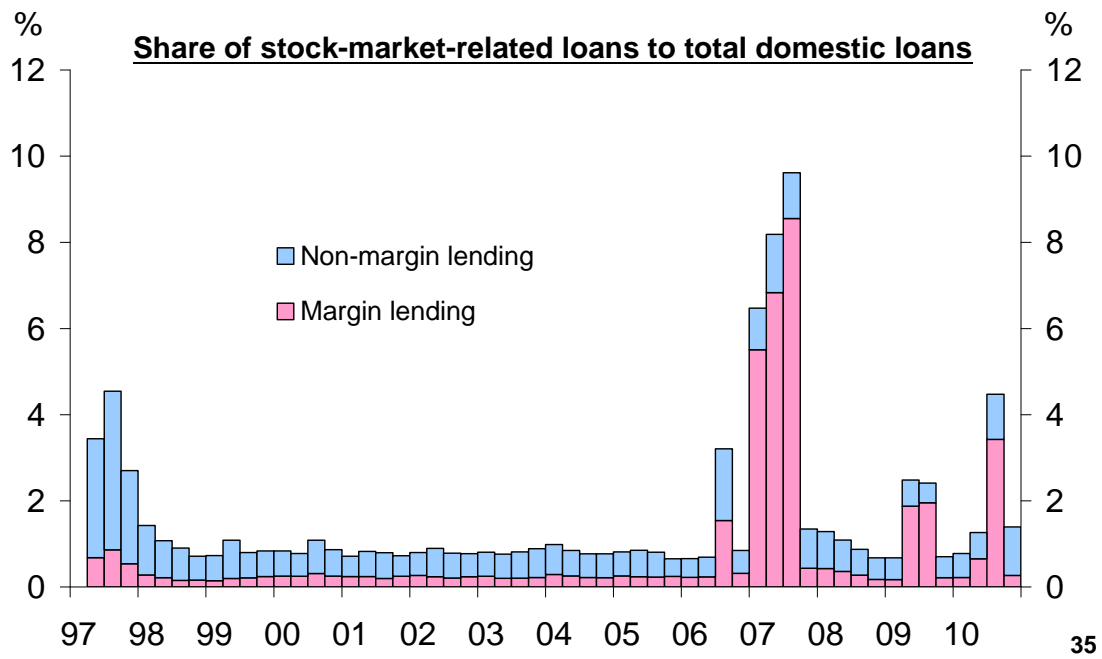
Hong Kong and Asia Pacific equity market performance

Rebased to Oct 27, 2008 = 100





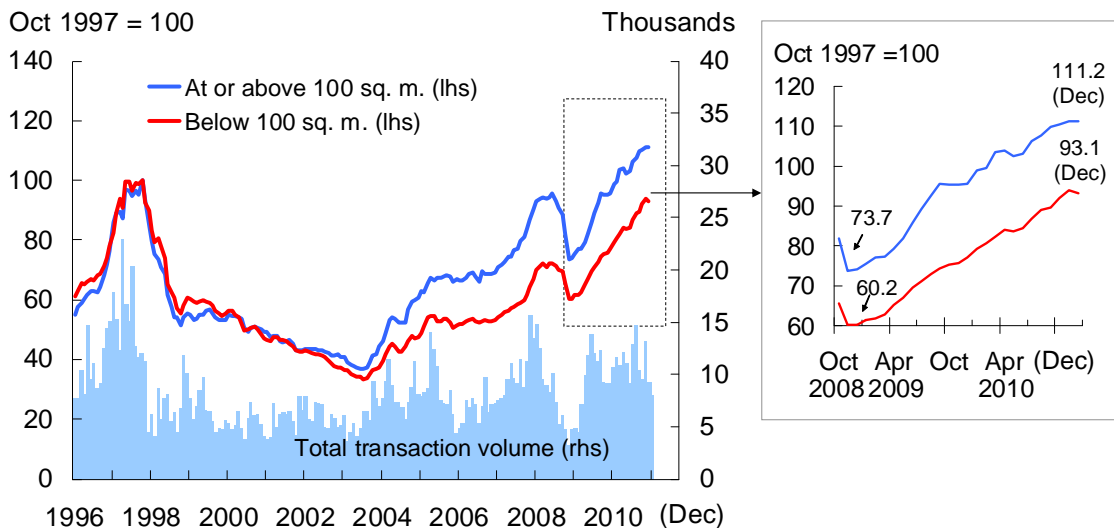
ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: EQUITY MARKET





ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Residential property prices and transaction volume

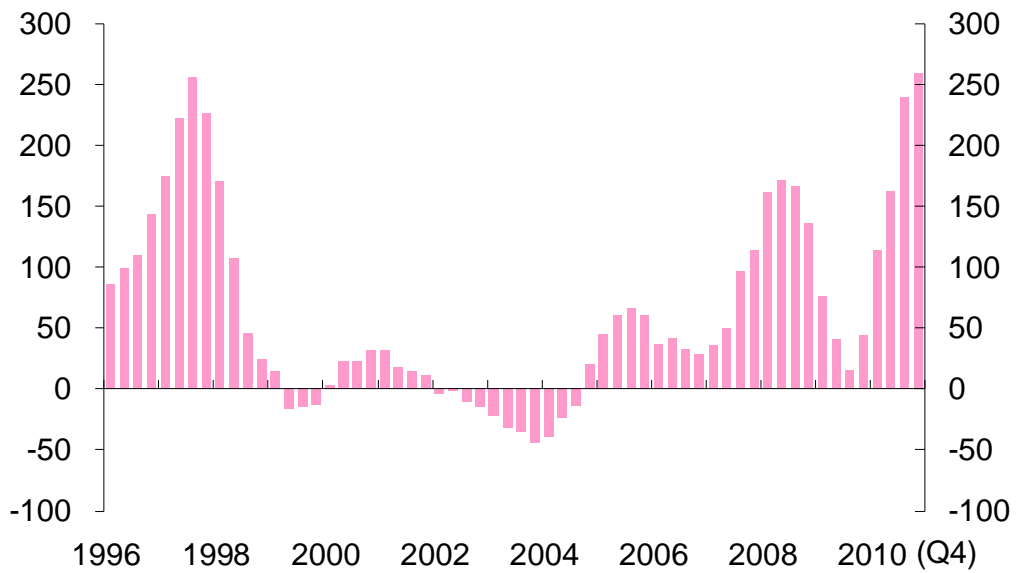




ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Changes in property-related loans

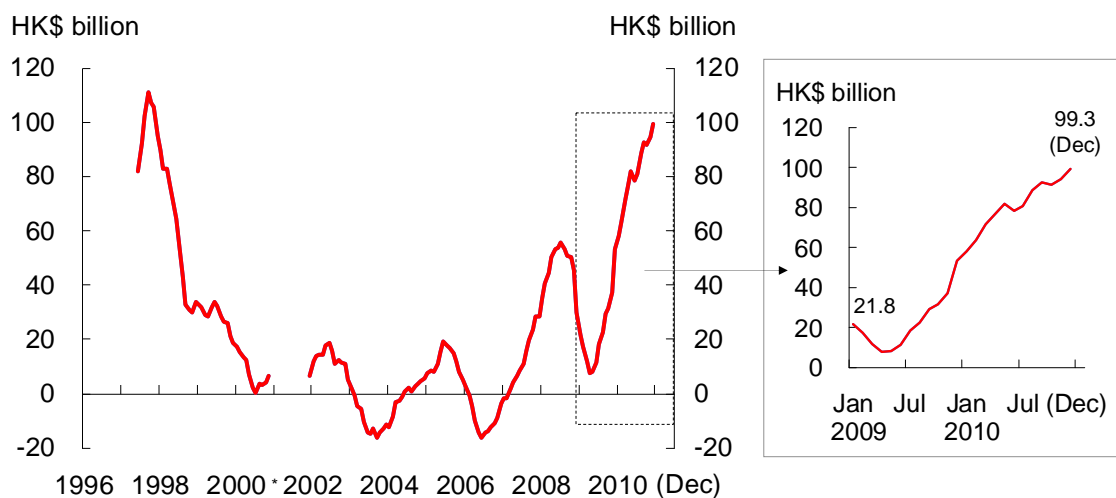
Changes over a year (HK\$ bn)





ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

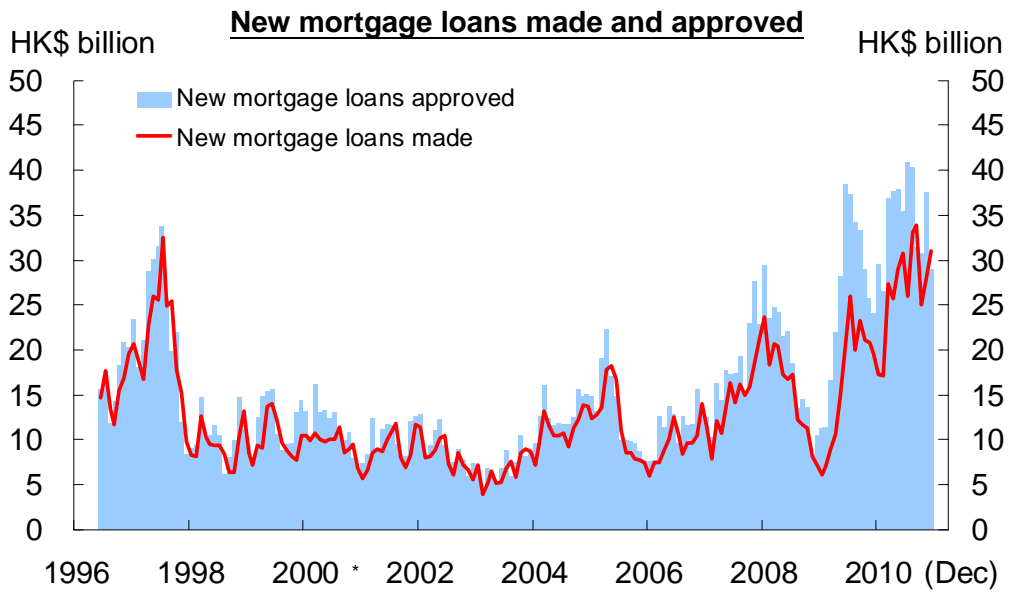
Year-on-year change in outstanding mortgage loans



*There is a break in data series at December 2000 due to an increase in the number of surveyed institutions.



ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

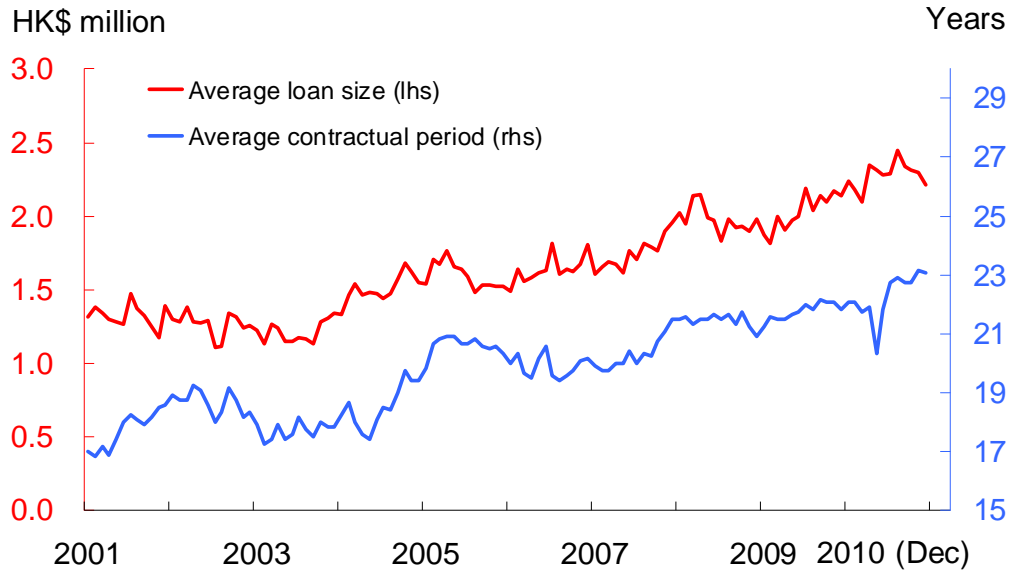


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ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

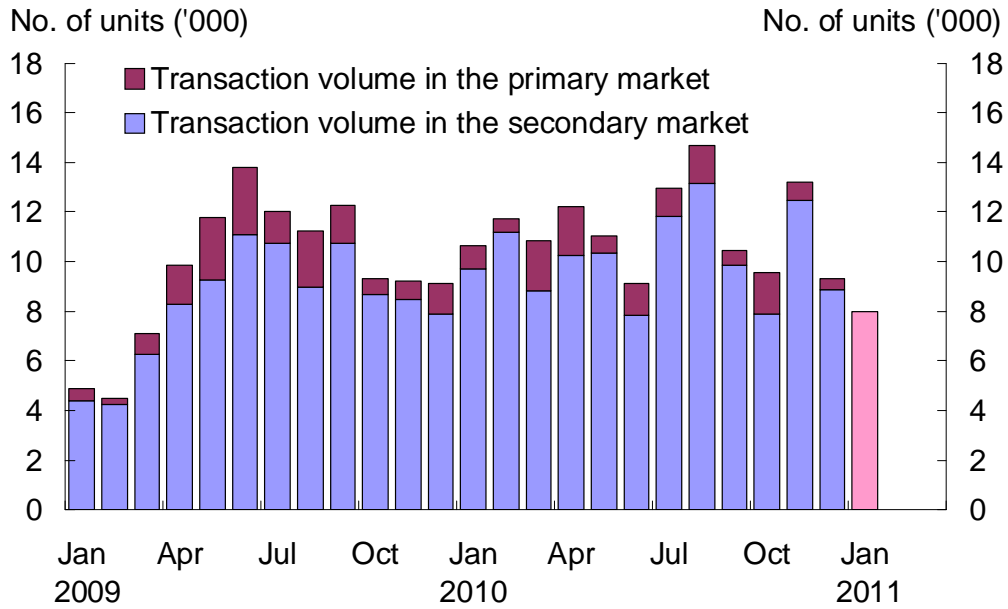
Average loan size and average mortgage period





ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

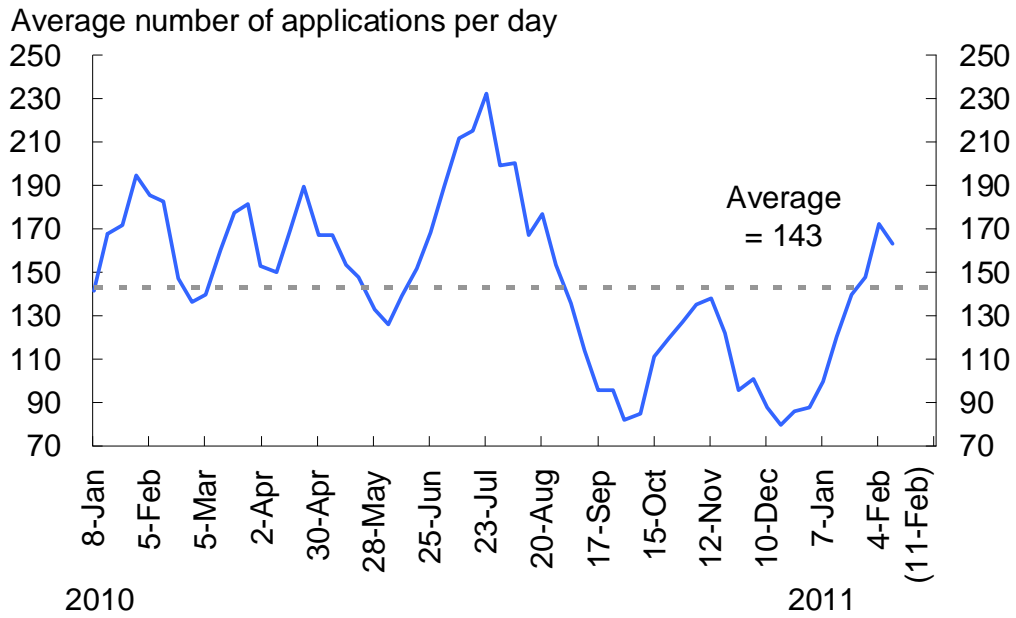
Transaction volumes in residential property market





ASSESSMENT OF RISK ON HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Applications under Mortgage Insurance Programme

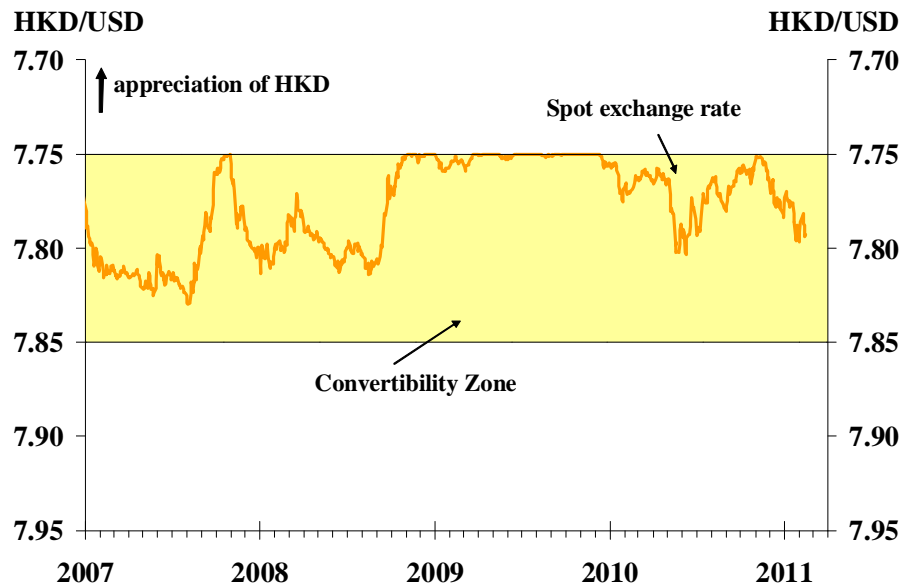




CURRENCY STABILITY



HONG KONG DOLLAR SPOT EXCHANGE RATE

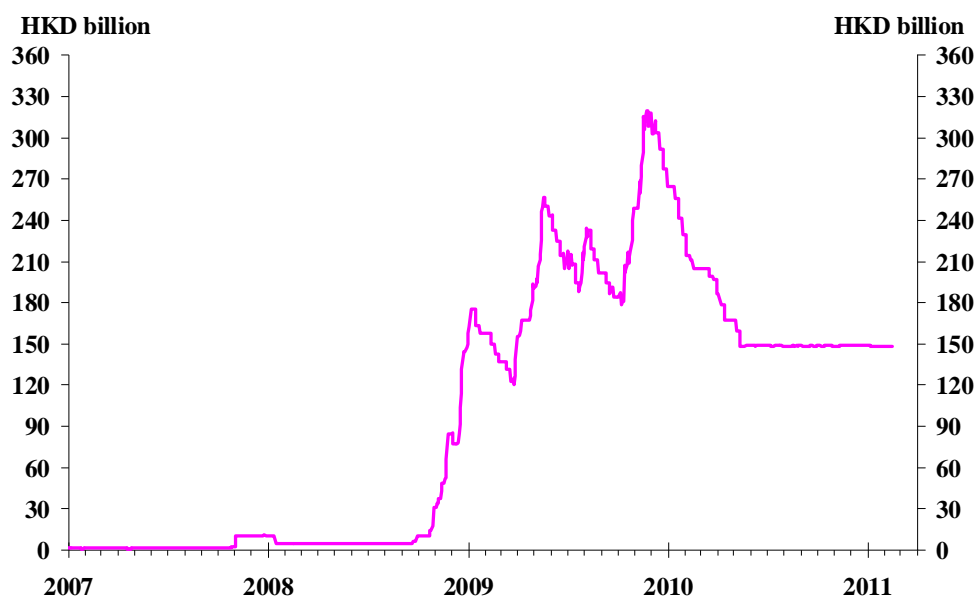


44

- Having been in a generally strong tone for the second half of 2010, the Hong Kong dollar eased against the US dollar since late-November amid renewed concerns of the European sovereign debt problems and political tensions in the Korean peninsula.
- For the year as whole, the strong-side Convertibility Undertaking has not been triggered.



AGGREGATE BALANCE



45

- Liquidity remained abundant in the interbank market. The Aggregate Balance stayed steady at around HK\$150 billion since mid-May.



HONG KONG DOLLAR FORWARD EXCHANGE RATE

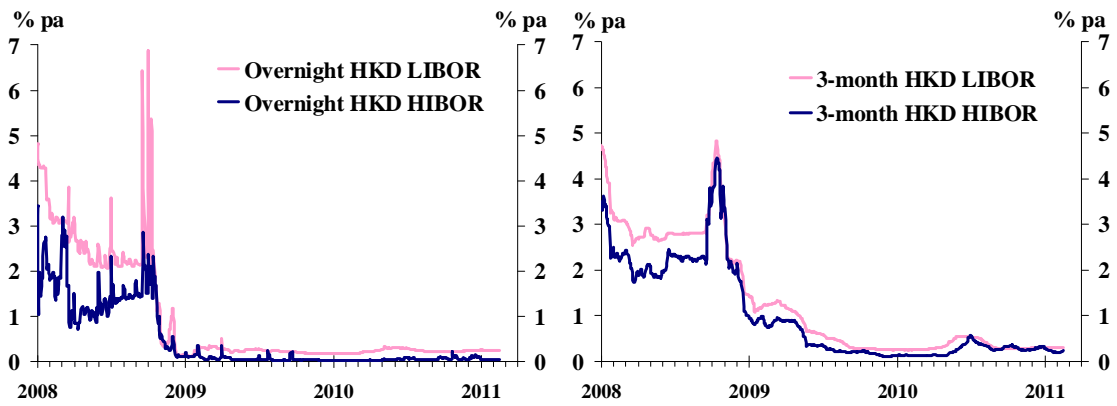


46

- The Hong Kong dollar forward spreads were broadly stable in the past few months, in line with the interest rate differentials between the Hong Kong and US dollars.



DOMESTIC INTEREST RATES

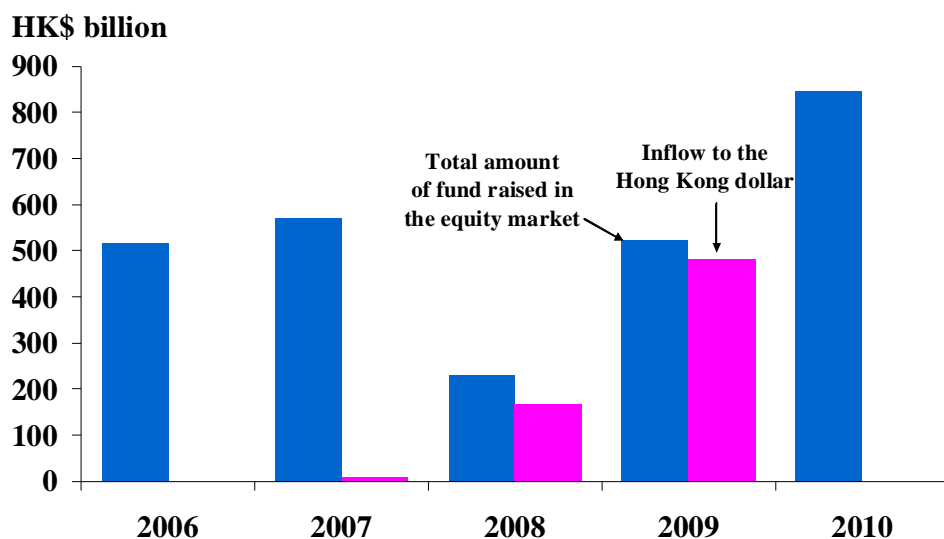


47

- With abundant liquidity, Hong Kong dollar interest rates were broadly stable and remained below their US dollar counterparts.



EQUITY FUND-RAISING AND NET INFLOWS



Note (1): Total amount of fund raised in the equity market include those from IPOs, right issues, placings, open offers, consideration issues, exercise of warrants and share option scheme.

Note (2): The 2008-09 figures are slightly different from data of Hong Kong Exchanges and Clearing Limited, since fund raising activities not involving Hong Kong dollar flows have been excluded.

- In 2010, a total of HK\$845 billion of funds was raised in the Hong Kong stock market. However, these fund-raising activities did not generate any net inflows into the Hong Kong dollar, possibly because the funds raised in 2010 had been swiftly switched from Hong Kong dollars into foreign currencies. Moreover, the conversion of the funds raised in 2009 had been mostly completed last year. Together, these Hong Kong dollar selling activities offset the equity-related inflows.

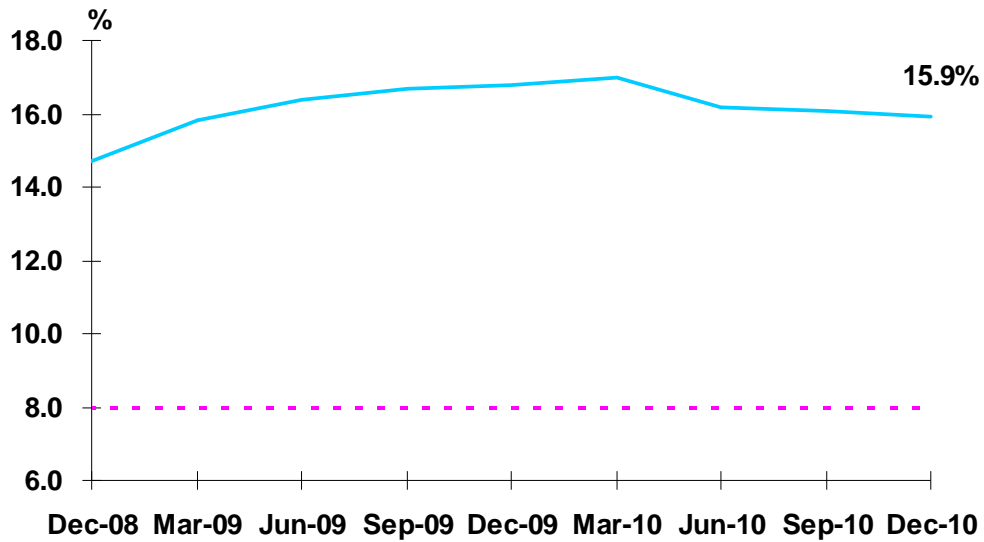


BANKING STABILITY



BANKING SECTOR PERFORMANCE

Locally incorporated AIs continued to be well capitalised



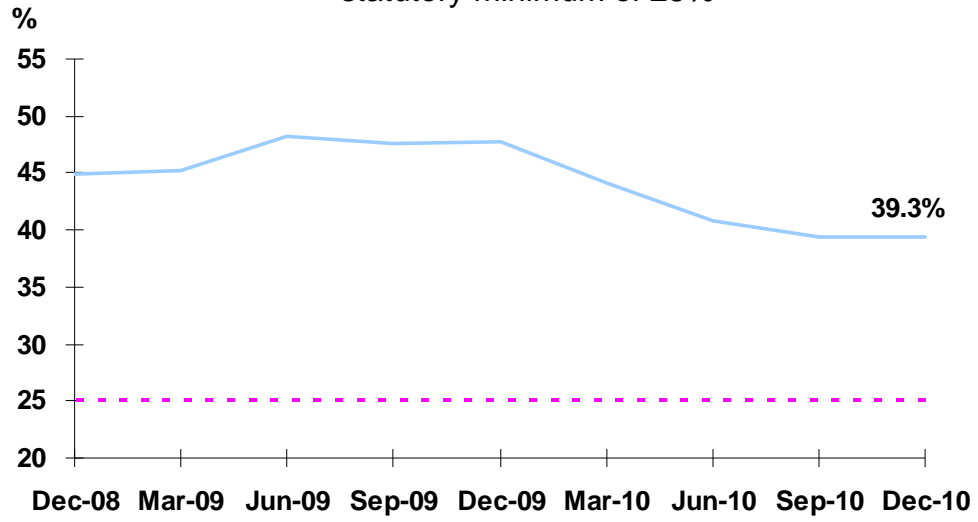
50

- The consolidated capital adequacy ratio of locally incorporated AIs was 15.9% at the end of December 2010, compared with 16.1% at the end of September 2010. The ratio remained well above the international standard of 8% and the pre-crisis levels.



BANKING SECTOR PERFORMANCE

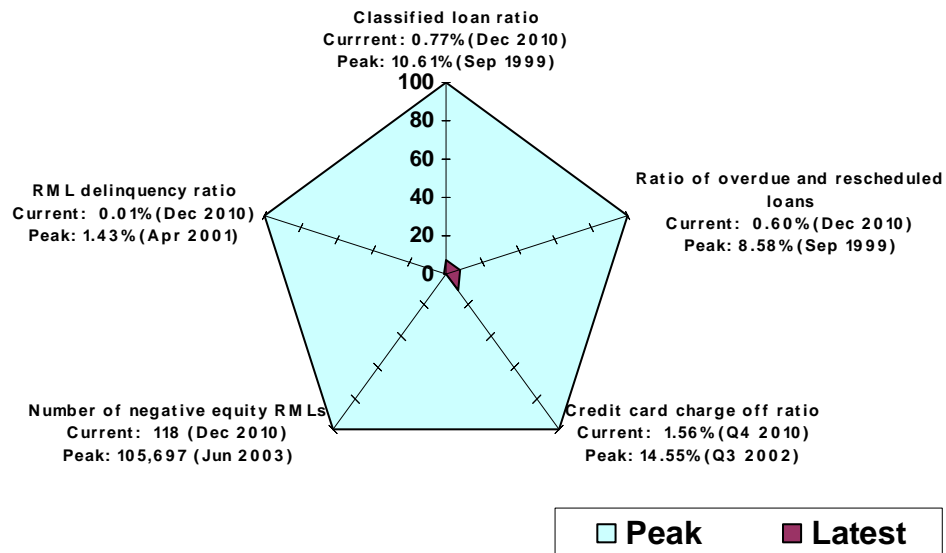
Liquidity ratio of retail banks remained well above statutory minimum of 25%





BANKING SECTOR PERFORMANCE

Asset quality further improved and at comfortable levels compared with historical standards



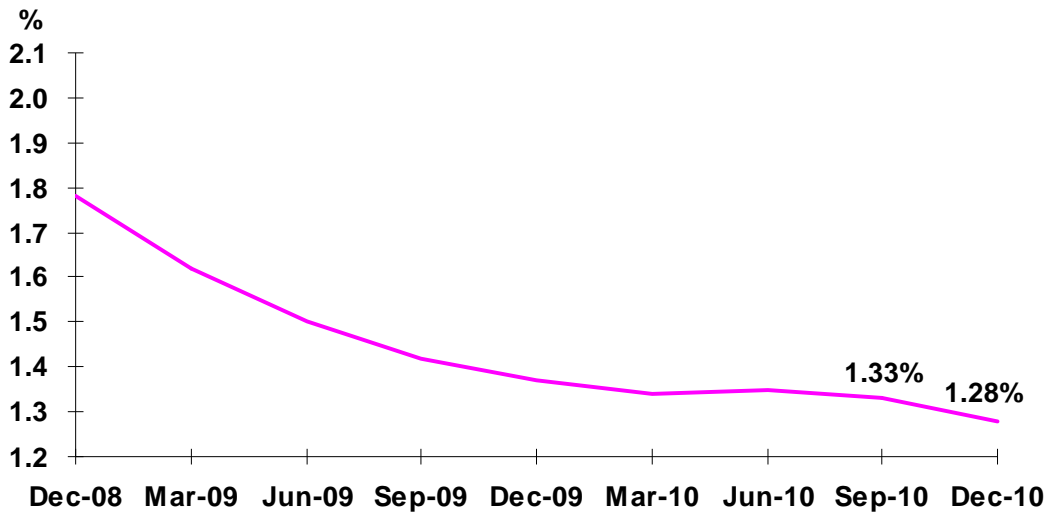
52

- Asset quality further improved in tandem with domestic economic growth.
- The HKMA continues to monitor closely the asset quality of retail banks' loan portfolios.



BANKING SECTOR PERFORMANCE

Net interest margin of retail banks



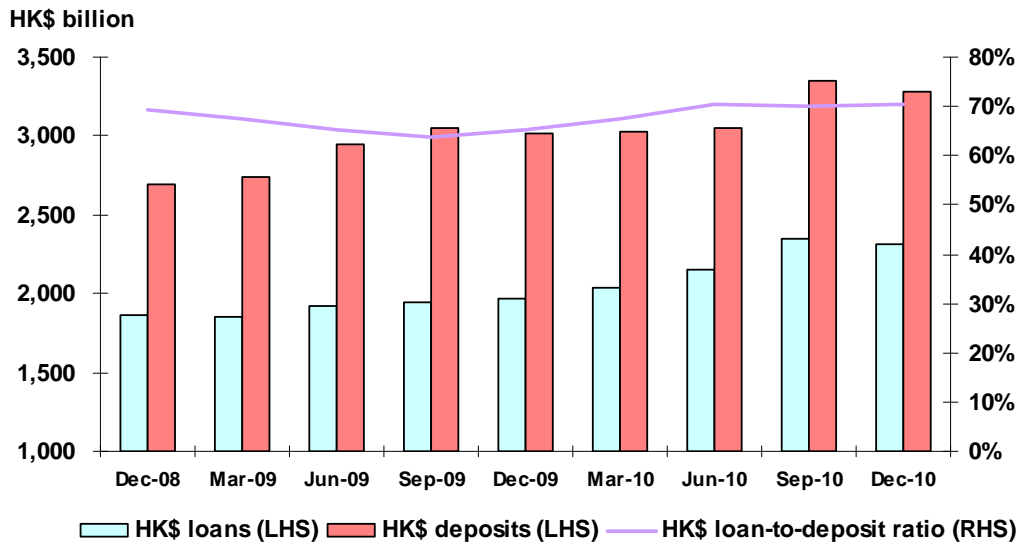
53

- The quarterly annualised net interest margin of retail banks declined to 1.28% in Q4 2010.
- The aggregate pre-tax operating profit of retail banks' Hong Kong offices in 2010 increased by 10.4% compared with 2009, as much lower credit provisions coupled with an improvement in fees and commissions income lifted banks' profitability.



BANKING SECTOR PERFORMANCE

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



54

- The Hong Kong-dollar loan-to-deposit ratio of retail banks slightly increased to 70.5% in December from 70.2% at the end of September 2010. The increase was due to a bigger decline in Hong Kong-dollar deposits (-2.2%) than in Hong Kong-dollar loans (-1.7%) in the fourth quarter.



PRUDENTIAL MEASURES ON PROPERTY MORTGAGES

- Introduced more stringent requirements for mortgage lending to strengthen banks' risk management on 19 November 2010
 - LTV ratio reduced to 50% for properties at or above HK\$12 million, and 60% for value at or above HK\$8 million
 - 50% LTV for non-owner-occupied residential properties, properties held by companies, industrial and commercial properties, and mortgages granted on borrowers' net worth
 - Standardised DSR at 50% and stressed DSR at 60%
- The HKMA is conducting thematic on-site examinations on 21 banks starting from early 2011 to monitor compliance



SUPERVISION ON CREDIT GROWTH

- 29% growth in loans in 2010, with substantial growth in:
 - property related lending (+19%)
 - trade finance (+57%)
 - wholesale and retail sector (+53%)

- The HKMA
 - has gathered information about the reasons for the credit growth
 - will ensure the banks will not lower loan approval requirements
 - is conducting on-site examinations to assess banks' credit underwriting standards



SHARING OF MORTGAGE DATA FOR CREDIT ASSESSMENT

- The financial services industry, represented by the Consumer Credit Forum, proposes the sharing of positive mortgage data for credit assessment
- The HKMA fully supports the proposal
- The Office of the Privacy Commissioner for Personal Data (“PCO”) published a consultation paper on the sharing of mortgage data for credit assessment on 5 January (Consultation period finished on 8 February)
- The public focus is more on whether
 - non-residential mortgage data should be shared
 - banks should be allowed to have access to the shared mortgage data when processing applications for non-mortgage lending (e.g. credit cards or personal loans)
 - Pre-existing mortgage data should be shared
- The HKMA will work closely with the PCO and the banking sector in taking this proposal forward

57

- The proposed positive mortgage data sharing mainly involves the sharing of positive mortgage data in form of a “mortgage count”.
- The HKMA welcomes the PCO’s public consultation on positive mortgage data sharing. The HKMA fully supports the proposal as it would further strengthen credit risk management of lenders and is conducive to the overall stability of the banking system in Hong Kong, which is crucial to the interest of depositors as well as the financial stability and economic development of Hong Kong as a whole.
- The HKMA is aware of the issues that have attracted the interest of the public. The scope of the proposed sharing of data should cover non-residential properties and the pre-existing mortgage data in order to fill the gap and fulfill the objective of the proposal, that is, to strengthen credit risk management of the lending institutions (which in turn encourages responsible lending and borrowing activities and reduce the risk of over-borrowing). In addition, if banks are not allowed to have access to “mortgage count” in processing non-mortgage borrowing applications, they will not be able to assess the borrower’s overall repayment ability (including mortgage, credit card payments and non-collateralised loans). We therefore consider that it would be not appropriate if the banks are not allowed to have access to “mortgage count.”



INVESTOR / CONSUMER PROTECTION

Investor protection

- Fieldwork of mystery shopper exercise completed in 2010
- The HKMA issued circular in December 2010 reminding AIs to adopt a cautious approach when selling accumulators
- The HKMA has been providing assistance to the Financial Services and the Treasury Bureau on the establishment of Investor Education Council and Financial Dispute Resolution Centre

Consumer protection

- Credit card reform measures

58

- The HKMA and the SFC completed the fieldwork of a mystery shopper exercise in 2010 covering the sales process of regulated entities in selling unlisted investment products. The regulators are reviewing the results. Any industry-wide themes that emerge from the exercise would be shared with the industry.
- The HKMA continues to implement measures to further enhance investor protection. In the light of signs of renewed activities of banks in selling of accumulators to investors and the significant investment risks associated with the products, the HKMA issued a circular in December 2010, reminding banks to adopt a cautious selling approach, assign the highest risk rating to accumulators, and adopt stringent controls in relation to suitability assessment and disclosure to customers.
- The Financial Services and the Treasury Bureau (FSTB) announced on 13 December 2010 that the Government has decided to establish Investor Education Council (IEC) and Financial Dispute Resolution Centre (FDRC). The HKMA has been assisting FSTB with these initiatives and will continue to work closely with FSTB, the Securities and Futures Commission and the industry to prepare for the establishment of IEC and FDRC.
- The HKMA is encouraging the banking sector to establish a corporate culture of treating their customers in a fairer manner. One of the ways to achieve this goal is to make reference to the developments in the UK and US on credit card business reforms.
- The industry announced in January 2011 the implementation of Phase 1 of the reform measures before the end of March. The remaining reform measures may require more time to implement because they involve operational and systemic changes or revisions in the agreements between the banks and the customers.
- HKMA will continue to work with the industry to implement the remaining reform measures as soon as practicable.



DEPOSIT PROTECTION

- Full deposit guarantee expired at the end of 2010
- The protection limit of the Deposit Protection Scheme (DPS) increased to \$500,000 with effect from 1 January 2011
- Improved representation requirements on protection status of deposits have also taken effect
- Large-scale multi-media publicity activities are continuing to increase public awareness of the expiry of the full deposit guarantee and the increased deposit protection provided by the enhanced DPS



IMPLEMENTATION OF BASEL III

- Final text of Basel III – reforms to strengthen banks' capital adequacy and liquidity – published in December 2010:
 - Tightening the definition of regulatory capital and increasing the minimum requirements of common equity and tier-1 capital
 - Establishing conservation / countercyclical capital buffers
 - Supplementing the capital adequacy ratio with a non-risk based leverage ratio
 - Introducing a new liquidity coverage ratio and a net stable funding ratio
- HKMA plans to phase-in the new requirements from 1 January 2013 in line with Basel Committee timetable
- Legislative process will begin soon

60

- Last December, the Basel Committee on Banking Supervision published the final text of the Basel III regulatory framework which will require banks to maintain higher levels of capital and liquidity buffers so as to strengthen the sector's resilience to financial and economic stress in future.
- The new requirements will be phased in over a period of 6 years from 1 January 2013 to 1 January 2019. The Basel Committee adopted this transitional period so as to allow banks ample time to move to the new standards while still supporting a sound economic recovery. The HKMA's current intention is to follow the Basel Committee's transitional arrangement for the various parts of the Basel III package, to maintain a level playing field internationally.
- Implementation of the Basel III standards in Hong Kong will entail amendment of the Banking Ordinance, the Banking (Capital) Rules and the Banking (Disclosure) Rules. The HKMA will be consulting the banking industry in due course on its implementation proposals and working to transcribe the Basel III standards into the necessary legislation, rules and guidance in preparation for 2013.



FINANCIAL INFRASTRUCTURE



REFORMING OTC DERIVATIVES MARKET

- The Financial Stability Board (FSB) has recently approved a report containing recommendations to promote consistent implementation of the G20's commitments concerning –
 - Increasing the proportion of the market that is standardised
 - Moving standardised OTC derivatives to exchanges or electronic trading platforms
 - Moving to central clearing of standardised OTC derivatives by end 2012
 - Ensuring that OTC derivatives transactions are reported to trade repositories by end 2012
- As a member of the FSB and to fulfil the role of an international financial centre, we have the responsibility to comply with international standards
- Under the current regulatory framework, the HKMA, the SFC and the Government will work together in building the regulatory regime for OTC derivatives market and consult the market on the detailed regulatory requirements by Q3 2011

62

- The G20 leaders at the Pittsburgh meeting in September 2009 agreed that “All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.” This forms the basis for reform of the OTC derivatives market.
- The FSB OTC Derivatives Working Group considered that further work need to be done to identify what actions may be needed to further the G20's objective in shifting more trading to exchanges or electronic trading platforms. In particular, the working group has recommended to delegate IOSCO, with involvement of other appropriate authorities, to conduct further analysis on this area.
- The use of central clearing helps mitigate counterparty credit risk, and reduce interconnectedness between market participants. The development of a trade repository helps improve market transparency and enhances market surveillance role of regulators.



PROMOTING ASSET MANAGEMENT BUSINESS

- Working closely with other Government agencies and the private sector to explore ways to strengthen the competitiveness of Hong Kong's asset management industry and reinforce Hong Kong's position as a leading asset management centre
- Stepping up marketing efforts to proactively reach out to overseas fund managers and investors to promote Hong Kong's financial platform with a view to attracting more fund managers, capital and financial products to Hong Kong

63

- With the promising growth prospects of the Asian region, there has been increasing interest for overseas fund managers to expand into Asia. To capitalise on this trend and attract more fund managers into Hong Kong, the HKMA is working in conjunction with other Government agencies and market players to promote Hong Kong's asset management business, thereby reinforcing Hong Kong's role as a premier international financial centre.
- To this end, the HKMA is taking part in a joint Government campaign, along with the Financial Services and the Treasury Bureau and the Securities and Futures Commission, in holding a series of promotional roadshows in leading global financial centres. The campaign started with a roadshow to London in November 2010, during which the HKMA also took the opportunity to meet with key European fund managers to explain to them the opportunities in Hong Kong and listen to their views. The next roadshow has been scheduled for the first quarter of 2011 to New York.



DEVELOPMENT OF ISLAMIC FINANCE

Develop market infrastructure:

- Supporting the Government in drawing up legislative proposals to modify Hong Kong's tax laws to level the playing field between Islamic and conventional financial products

Build international links and enhance international profile:

- Working closely with Bank Negara Malaysia to explore collaborative initiatives under the scope of the MoU signed
- Seeking to forge closer ties with international Islamic organisations

Promote market awareness:

- Continue to participate in regional seminars and conferences and provide training to the industry

- The HKMA has been working closely with other industry associations and Islamic organisations to provide appropriate training programmes for the industry with a view to nurturing a larger Islamic finance talent pool in Hong Kong. For example, at the end of last year, the HKMA co-ordinated the invitation and selection of Hong Kong candidates for the nomination of two scholarships offered by the International Centre for Education in Islamic Finance to study its Masters-degree programme on Islamic finance in Malaysia commencing in January 2011.



GOVERNMENT BOND PROGRAMME

Institutional Bond Issuance Programme:

- Six issues with a total issuance size of HK\$24 billion have been issued
- The tenders attracted a diverse group of end-investors, such as investment funds, insurance companies and pension funds

Retail Bond Issuance Programme:

- Necessary preparatory work almost completed to achieve maximum readiness

65

- 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 an Institutional Bond Issuance Programme and a Retail Bond Issuance Programme.
- The Institutional Bond Issuance Programme was launched in September 2009. As of end 2010, a total of six issues have been issued under nine tenders, and they are:
 - HK\$3.5 billion of a 2-year bond maturing in September 2011;
 - HK\$3.5 billion of a 2-year bond maturing in March 2012;
 - HK\$3.5 billion of a 2-year bond maturing in September 2012;
 - HK\$3.5 billion of a 5-year bond maturing in November 2014;
 - HK\$2.5 billion of a 5-year bond maturing in December 2015; and
 - HK\$7.5 billion of a 10-year bond maturing in January 2020.
- By enlarging the investor base over time, the GBP 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, thereby consolidating our role as an international financial centre.



FINANCIAL INFRASTRUCTURE

- Continued to maintain safety and efficiency of financial infrastructure
- Continued to enhance financial infrastructure, especially for coping with potential business opportunities arising from the further liberalisation of RMB business in Hong Kong
- Embarked on a project of developing a trade repository for over-the-counter derivatives trades to enhance market surveillance and transparency, and bring Hong Kong in line with international standards

66

Operation of financial infrastructure

- The various Real Time Gross Settlement (RTGS) systems and the Central Moneymarkets Unit (CMU) have been operating smoothly.

Financial infrastructure to support RMB business

- A new liquidity saving device (Liquidity Optimiser) and a new settlement function (real-time delivery-versus-payment) for supporting listing of RMB-denominated securities on the Stock Exchange of Hong Kong were added to the RMB RTGS.
- Will gradually bring the functionalities of the RMB RTGS in line with those of the HKD RTGS to ensure system readiness for supporting full range of financial activities.

Trade Repository

- Announced in early December 2010 to develop a trade repository (TR) for over-the-counter derivatives trades. The TR is targeted for launch in 2012, in line with the G-20 deadline of end-2012.



HONG KONG AS AN INTERNATIONAL FNANCIAL CENTRE



DEVELOPMENT OF OFFSHORE RMB BUSINESS IN HONG KONG

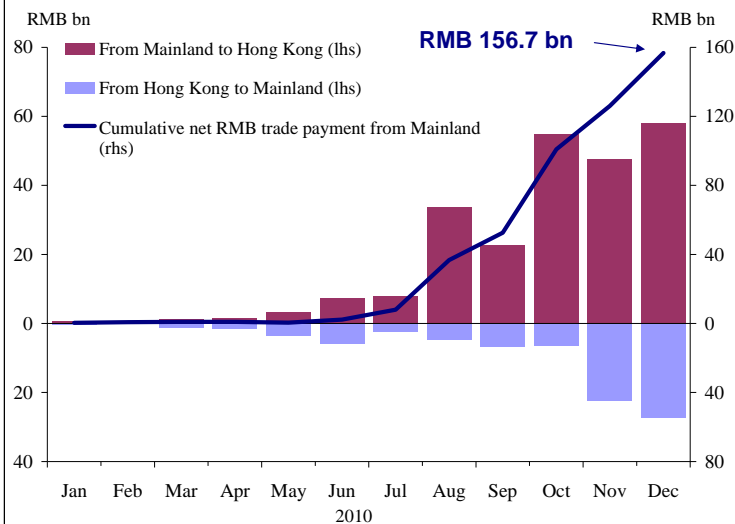
- A year of rapid development

February 2010	HKMA provided elucidation on supervisory principles to streamline operational arrangements of offshore renminbi business in Hong Kong
June 2010	Coverage of renminbi trade settlement pilot scheme expanded
July 2010	Clearing Agreement on Renminbi Business amended, with restrictions on account opening of corporate and interbank fund transfers removed
August 2010	Arrangement allowing Hong Kong banks to invest in the Mainland's interbank bond market launched
November 2010	Renminbi sovereign bonds issued through HKMA's Central Moneymarkets Unit (CMU)
December 2010	Number of Mainland enterprises eligible for settling merchandise exports in renminbi increased significantly
December 2010	Refinement measures regarding Hong Kong's offshore renminbi business introduced
January 2011	Pilot scheme for settlement of Mainland's overseas direct investment in renminbi launched



RMB TRADE SETTLEMENT ON RAPID GROWTH

RMB trade settlement conducted through Hong Kong



- After the expansion of RMB trade settlement scheme in June 2010, the amount of RMB trade settlement conducted through HK increased rapidly, from about RMB 4 bn per month in H1, to about RMB 57 bn per month in H2

- In 2010, total RMB trade settlement conducted through HK amounted to RMB 369.2 bn. Most of them were payments from Mainland importers to Hong Kong, with a net payment of RMB 150 bn to Hong Kong for trade settlement

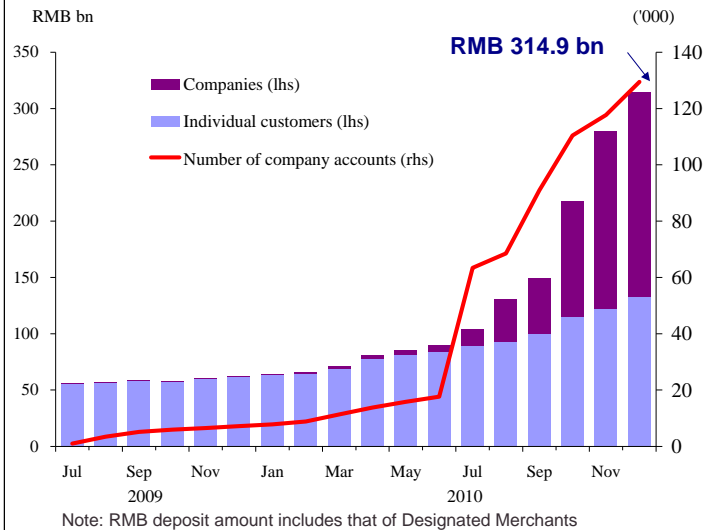
69

- In 2010, total RMB trade settlement conducted through HK amounted to RMB 369.2 bn. Most of them were payments from Mainland to Hong Kong: payments from Hong Kong to Mainland amounted to RMB 82.9 bn, while payments from Mainland to Hong Kong amounted to RMB 239.6 bn; and with a net payment of RMB 156.7 bn to Hong Kong for trade settlement.
- These RMB funds remain in Hong Kong and constitute a main source of supply in the local RMB market. Of the RMB 82.9 bn paid from Hong Kong to Mainland enterprises, only about RMB 10 bn was obtained by conversion in Shanghai's foreign exchange market through the Clearing Bank. Given the abundant supply of RMB funds in the local market, even when the arrangement for conducting RMB conversions in Shanghai was suspended in Oct 2010, RMB business in Hong Kong has progressed well and not been much affected. This shows that the offshore pool of RMB funds in Hong Kong is serving the function of supplying RMB funds to meet the demand from local enterprises, such that there is no need to rely heavily on the onshore conversion window in Shanghai for trade settlement. In other words, the conversion window in Shanghai serves a supplementary rather than the main source of RMB funds for trade settlement purpose.
- Against this background, the HKMA introduced in Dec 2010 the following refinement measures:
 - Clarification on the arrangement for the conversion of RMB for trade settlement purpose conducted by participating banks through the Clearing Bank in the China Foreign Exchange Trading System in Shanghai. It is estimated that the demand for RMB conversion in Shanghai would be within RMB 4 bn in Q1 2011
 - RMB 20 billion provided by the HKMA, through its currency swap arrangement with the PBoC, as a standing arrangement to maintain a stable supply of RMB for cross-border trade settlement
 - Given that the convertibility of RMB is restricted at present, participating AIs are required to limit their RMB net open positions (whether net long or net short) to 10% of their RMB assets or liabilities
- The refinement measures have become effective in Jan 2011. HKMA is having close communications with the banking industry on the implementation arrangements.



INCREASING RMB DEPOSIT BASE IN HONG KONG

RMB deposits in Hong Kong

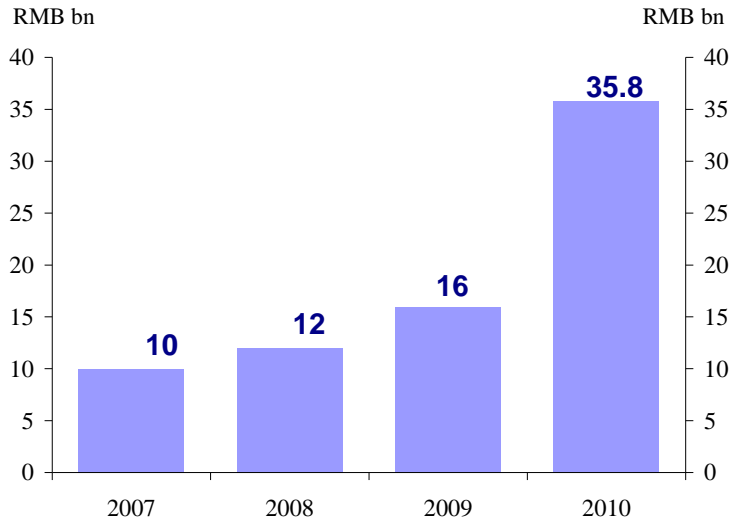


- RMB deposits increased by four times to RMB 314.9 bn at end-Dec
- Mainly attributed to an increase in RMB receipts by corporate customers through trade settlement transactions
- At end-Dec, RMB deposits by corporate customers amounted to RMB 182 bn, accounting for 58% (2009: 1%) of total RMB deposits
- The number of corporate accounts also increased to nearly 130,000 (2009: 7,200)



FURTHER DEVELOPMENT OF RMB BOND MARKET

RMB bond issuance in Hong Kong



- **Expansion of issuers in 2010:** from Mainland financial institutions to HK corporations, multinationals and international financial institutions
- **Tenors:** from 2 or 3 years to 10 years (e.g. bonds issued by the Ministry of Finance of China and the Asian Development Bank)



RMB BUSINESS IN HONG KONG – FURTHER DEVELOPMENT

- Enhance the circulation of RMB funds and interaction between Hong Kong's RMB offshore market and Mainland's onshore market, with an aim to support real economic activities including trade settlement and direct investment
 - So far 11 banks in Hong Kong were approved to invest in the Mainland's interbank bond market
 - To promote use of Hong Kong's RMB platform for Mainland's overseas direct investment (ODI)
 - To pursue the use of RMB for foreign direct investment (FDI) into the Mainland: there have already been pilot cases, and HKMA will continue discussions with the Mainland authorities



ADVANCEMENT OF HONG KONG'S SOVEREIGN CREDIT RATINGS

- Attained upgrades in Hong Kong's sovereign credit ratings by all three major international credit rating agencies:
 - Moody's upgraded Hong Kong's ratings to Aa1, only one notch below the highest rating category, and assigned a "Positive" outlook to Hong Kong's ratings (Nov 2010)
 - Fitch upgraded Hong Kong's ratings to AA+, only one notch below the highest rating category (Nov 2010)
 - S&P upgraded Hong Kong's ratings to triple-A, the highest rating category (Dec 2010)
- Hong Kong was the only economy around the world being upgraded to AAA in 2010



INCREASING REGIONAL AND INTERNATIONAL FINANCIAL CO-OPERATION

- Financial Stability Board (FSB): The HKMA attended the Plenary Meeting of the FSB on 20 October 2010 to finalise and approve the key recommendations for global financial regulatory reform, including measures to address risks arising from systemically important financial institutions, credit rating agencies, and over-the-counter derivatives trading as revealed in the financial crisis.
- Executives' Meeting of East Asia-Pacific Central Banks (EMEAP): The HKMA hosted the 39th EMEAP Deputies' Meeting and the 8th EMEAP Monetary and Financial Stability Committee Meeting on 25-27 November 2010 to assess the risks and vulnerabilities facing the region and exchange views on policy responses.
- Tripartite working group of HKMA, Bank Negara Malaysia and Monetary Authority of Singapore: The three central banks maintained close coordination and facilitated the smooth exit from the full deposit guarantee in their respective jurisdictions at the end of 2010.

74

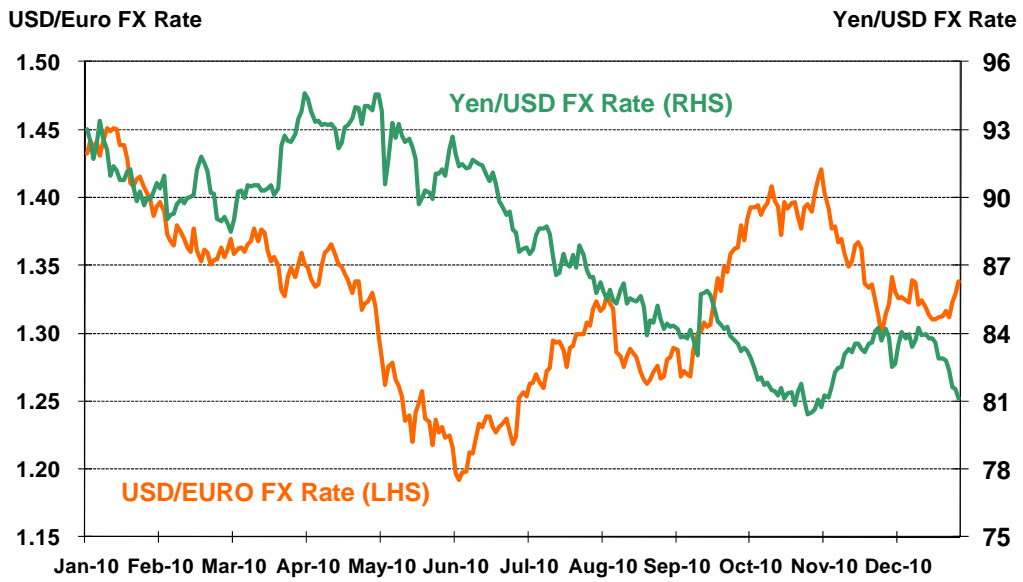
- The HKMA continued to participate actively in meetings and activities of the FSB Plenary and Standing Committees, where issues of significance to global financial stability are discussed. At the October Plenary meeting, members finalised a package of key recommendations for global financial regulatory reform. These include measures to address the moral hazard risk posed by systemically important financial institutions, increase supervisory intensity and effectiveness towards financial institutions, reduce reliance on credit rating agencies, and implement over-the-counter derivatives markets reforms.
- The HKMA hosted the 39th EMEAP Deputies' Meeting and the 8th EMEAP MFSC Meeting in November 2010. As the coordinator of MFSC's macro surveillance, the HKMA conducted analyses and prepared the MFSC's bi-annual Macro-Monitoring Report to assess the region's risks and vulnerabilities, in particular those associated with the global growth outlook, sovereign debt crisis in advanced economies, and strong capital flows into the region.



INVESTMENT ENVIRONMENT AND PERFORMANCE OF THE EXCHANGE FUND



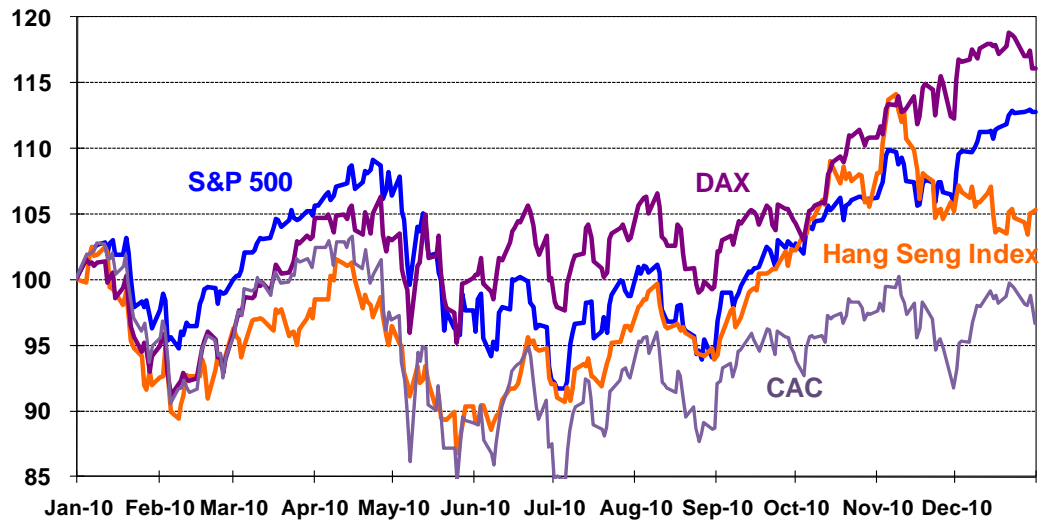
CURRENCY MARKETS IN 2010





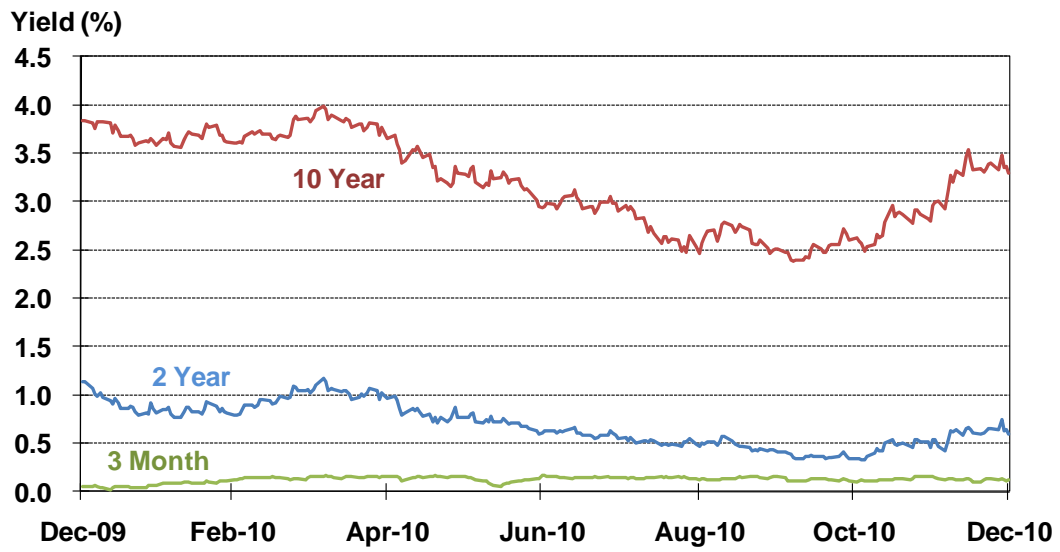
EQUITY MARKETS IN 2010

Normalized Index Level (2009 year-end = 100)





US GOVERNMENT BOND YIELDS IN 2010





INVESTMENT INCOME

(HK\$ billion)	2010					2009	2008	2007	2006
	Full year *	Q4	Q3	Q2	Q1	Full year	Full year	Full year	Full year
Bonds#	42.1	(18.6)	19.9	29.4	11.4	(0.6)	88.4	61.0	31.9
Hong Kong equities^®	11.6	4.3	15.0	(4.6)	(3.1)	48.9	(77.9)	55.8	35.9
Foreign equities^	27.0	19.1	18.1	(21.4)	11.2	48.8	(73.1)	6.7	18.7
Foreign exchange	(3.1)	0.5	20.7	(15.6)	(8.7)	9.8	(12.4)	18.7	17.3
Other investments&	1.4	0.2	0.8	0.1	0.3	0.8	-	-	-
Investment income/(loss)^®&	79.0	5.5	74.5	(12.1)	11.1	107.7	(75.0)	142.2	103.8

* Unaudited figures

Including interest

^ Including dividends

® Excluding valuation changes in Strategic Portfolio (HK\$2.6 billion)

& Including valuation changes of investment held by EF's investment holding subsidiaries



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

(HK\$ billion)	2010					2009
	Full year (unaudited)	Q4	Q3	Q2	Q1	Full year
Investment income/(loss)	79.0	5.5	74.5	(12.1)	11.1	107.7
Other income	0.2	-	0.1	0.1	-	0.2
Interest and other expenses	(4.8)	(1.2)	(1.2)	(1.5)	(0.9)	(3.8)
Net investment income/(loss)	74.4	4.3	73.4	(13.5)	10.2	104.1
Payment to Fiscal Reserves #	(33.8)	(8.6)	(8.3)	(8.4)	(8.5)	(33.5)
Payment to HKSAR government funds and statutory bodies #	(3.9)	(1.1)	(1.1)	(0.9)	(0.8)	(1.2)
Valuation change of Strategic Portfolio less investment held by EF's investment holding subsidiaries^	1.2	1.3	1.2	(0.4)	(0.9)	3.6
Increase/(Decrease) in EF Accumulated Surplus	37.9	(4.1)	65.2	(23.2)	-	73.0

The fixed rate of fee payment is 6.3% for 2010 and 6.8% for 2009.

^ Including dividends



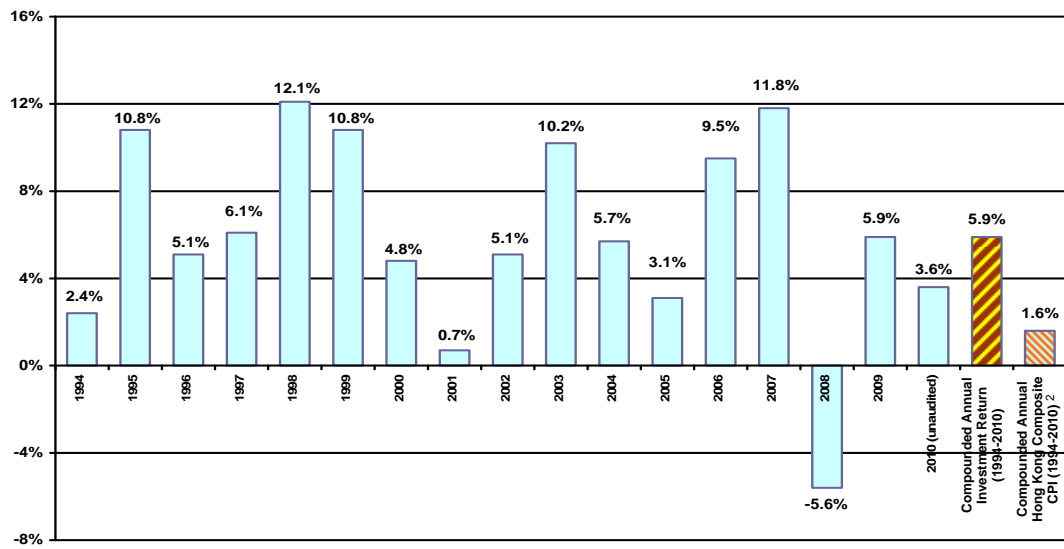
EXCHANGE FUND ABRIDGED BALANCE SHEET

(HK\$ billion)	At 31 Dec 2010 (unaudited)	At 31 Dec 2009	Change
ASSETS			
Deposits	199.4	126.3	73.1
Debt securities	1,706.0	1,637.6	68.4
Hong Kong equities	152.6	142.9	9.7
Foreign equities	246.7	214.9	31.8
Other assets [#]	<u>41.0</u>	<u>27.7</u>	<u>13.3</u>
Total assets	<u>2,345.7</u> =====	<u>2,149.4</u> =====	<u>196.3</u> =====
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	225.9	199.0	26.9
Government-issued currency notes & coins in circulation	8.9	8.4	0.5
Balance of the banking system	148.7	264.6	(115.9)
Exchange Fund Bills and Notes	654.2	536.4	117.8
Placements by banks and other financial institutions	23.2	28.3	(5.1)
Placements by Fiscal Reserves	592.3	504.1	88.2
Placements by HKSAR government funds and statutory bodies	76.8	41.8	35.0
Other liabilities	<u>24.3</u>	<u>13.3</u>	<u>11.0</u>
Total liabilities	<u>1,754.3</u>	<u>1,595.9</u>	<u>158.4</u>
Accumulated Surplus	<u>591.4</u>	<u>553.5</u>	<u>37.9</u>
Total liabilities and fund equity	<u>2,345.7</u> =====	<u>2,149.4</u> =====	<u>196.3</u> =====

[#] Including investment in EF's investment holding subsidiaries amounted to HK\$14.7 billion at 31 Dec 2010 (HK\$2.8 billion at 31 Dec 2009)



INVESTMENT RETURN OF THE EXCHANGE FUND (1994-2010) ¹



¹ Investment return calculation excludes the holdings in the Strategic Portfolio.

² Composite CPI is calculated based on the 2004/2005 base new series.



INVESTMENT RETURN OF THE EXCHANGE FUND IN HONG KONG DOLLAR TERMS ¹

	Investment return ^{2,3}
2010	3.6%
3-year average (2008 – 2010)	1.2%
5-year average (2006 – 2010)	4.9%
10-year average (2001 – 2010)	4.9%
Average since 1994	5.9%

¹ The investment returns for 2001 to 2003 are in US dollar terms.

² Investment return calculation excludes the holdings in the Strategic Portfolio.

³ Averages over different time horizons are calculated on an annually compounded basis.