

Economic and Banking Environment

In 1998 the Hong Kong economy experienced its largest contraction since statistics began in 1961. Real GDP shrank by 5.1%, unemployment increased, and exports and imports declined. During the first eight months of the year speculative attacks on the Hong Kong dollar continued, leading to surges in interest rates and sharp declines in asset prices. Stability returned in the last four months, as interest rates settled and asset markets staged a significant comeback.

The Economy in Review

Overview

The Hong Kong economy underwent a year of sharp adjustment in 1998, with real GDP contracting by around 5.1% (Table 1). Consumption and investment weakened, inflation slowed sharply, and unemployment soared to historic highs. Externally,

both exports and imports declined. The trade deficit narrowed substantially, however, as a sharp fall in imports outpaced the decline in exports.

During the first eight months of 1998, the Hong Kong dollar came under periodic speculative attacks amidst the repercussions of the Asian financial turmoil, leading to sharp declines in asset prices and surges in interest rates. In the last four months of

Table 1 : Contributions to GDP growth by components (%)

	1996	1997			1998		
		H1 ^P	H2 ^P	Overall ^P	H1 ^P	H2 ^P	Overall ^P
Private consumption expenditure	2.8	4.0	4.0	4.0	-2.4	-5.8	-4.1
Government consumption expenditure	0.3	0.4	0.0	0.2	-0.1	0.2	0.1
Gross domestic fixed capital formation	3.5	6.1	4.6	5.3	0.9	-5.2	-2.3
Change in inventories	-4.0	-1.2	-0.1	-0.6	-2.9	-3.2	-3.1
Net domestic exports of goods	-2.7	-5.9	-4.5	-5.2	3.6	9.9	6.9
Net re-exports of goods	2.9	2.3	2.6	2.4	0.2	-2.0	-1.0
Net exports of services	1.7	0.5	-2.2	-0.9	-3.1	-0.2	-1.6
GDP	4.5	6.2	4.4	5.3	-3.9	-6.3	-5.1

Note: ^P: Preliminary estimates

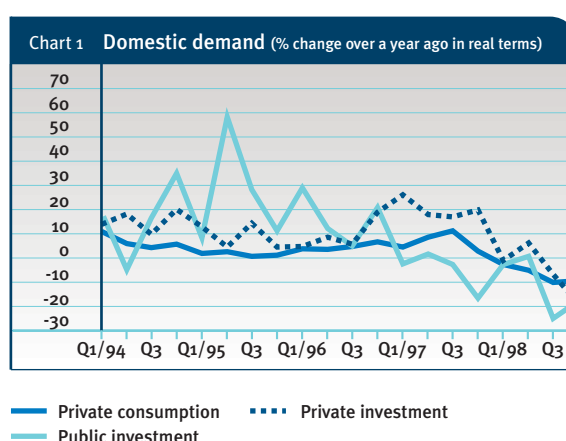
1998, favourable developments in global markets and measures to enhance the operation of the currency board system led to declines in local interest rates and a narrowing in spreads over US dollar counterparts. Reflecting improved liquidity and market sentiment, asset markets staged a significant recovery during the last quarter of 1998. The Hong Kong dollar exchange rate remained stable under the linked exchange rate system during the course of 1998.

Total deposits rose by 1.7% in the first half of 1998, but increased by 9.0% in the second half, in part due to measures adopted by the Government to ease credit tightening. For the year as a whole, total deposits increased by 10.9%, compared with a rise of 8.4% in 1997. Despite the increase in deposits, domestic loans (including trade financing) dropped by 5.5% and non-domestic loans declined by 36.7% in 1998, reflecting weak loan demand and cautious lending attitudes by banks. The Hong Kong dollar loan-to-deposit ratio of the banking system decreased significantly from 113.3% at end-1997 to 100.6% at end-1998.

Weak domestic demand

Private consumption, which accounts for 60% of GDP, fell by 6.8% in 1998, although the rate of decline moderated in the fourth quarter (Chart 1). The sharp fall in asset prices, increased job uncertainty, downward pressure on wages, and high real interest rates all contributed to the setback in local consumer spending. There were signs of increased substitution of domestic consumption for spending across the border in the Mainland to take advantage of lower prices. Declines in sales of durable and non-durable goods other than food were particularly sharp, while sales of basic necessities,

such as food-stuffs and commodities in supermarkets, declined more modestly. The drop in the volume of retail sales moderated in the last few months of 1998, in line with improved liquidity and consumer sentiment.



Following an increase of 20% in 1997, private sector investment slowed to a 2.9% growth rate in the first half of 1998, and fell by 13.1% in the second half. The downturn in the property market, high real interest rates, and an uncertain business environment overshadowed investment sentiment. Public sector investment dropped by 1.2% in the first half of the year, and further by a sharp 21.3% in the second half as the Airport Core Programme was completed.

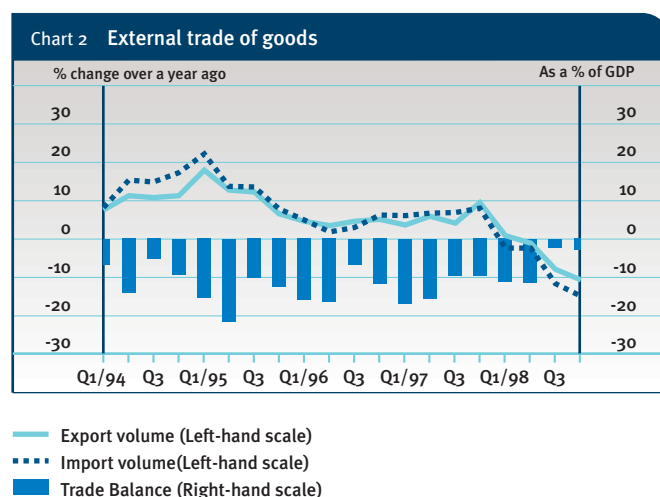
A decline in imports outpaced the drop in exports

Export performance moderated steadily over the course of 1998, with goods export volume declining by 4.3%, compared with an increase of 6.1% in the previous year. Of the total, domestic export volume dropped by 7.9%, while re-exports decreased by 3.7% (Chart 2). Export value dropped by 7.4% while export price, as measured by the unit value index, declined by 3.8%.

While the contraction in exports reflected, in part, the pressure on Hong Kong's competitiveness—the average real effective exchange rate of the Hong Kong dollar increased by 7.9% in 1998—it was mainly due to weaker foreign demand. Exports were first hit by weak import demand from Japan and the crisis-hit Asian economies, and then suffered from the disruptions in air cargo operations at the new airport and the severe flooding in central Mainland China in July and August. Towards the end of the year, they were further affected by a slowdown in import demand from Mainland China and the United States, Hong Kong's two most important trading partners. Table 2 depicts the weak economic conditions in the region and the slowdown in import demand from our major trading partners.

Imports recorded an even steeper decline than exports in 1998, falling by 7.2% in volume and 11.5% in value terms. Imports were curbed by sluggish re-export activities associated with the regional economic downturn and by weak domestic demand. The latter resulted in a marked 13.4% fall in retained import volume. By category of goods, retained imports of consumer goods and raw material and

semi-manufactures fell sharply, while there was a more moderate decline in retained imports of capital goods, and an increase in fuels.



As the decline in imports of goods was much larger than the fall in exports, the visible trade deficit narrowed to \$84.8 billion for 1998, half of the \$163.5 billion deficit recorded in 1997. Although inbound tourism rebounded in the second half of the year, exports of services remained lacklustre in 1998. Meanwhile, imports of services fell by a modest 0.7%. Nevertheless, the invisible trade account continued to yield a large surplus in 1998. Taking visible and invisible trade together, the overall trade

Table 2 : Value of Hong Kong's exports by major trading partners (% change over a year ago)

	% of Share	1997			1998		
		H1	H2	Overall	H1	H2	Overall
Mainland China	34.3	4.5	7.2	5.9	-0.7	-15.9	-8.7
United States	23.4	8.0	6.0	6.8	5.5	-5.3	-0.6
European Union	15.7	0.9	5.0	3.1	1.9	-3.7	-1.2
Japan	5.2	-1.6	-5.1	-3.4	-18.3	-21.7	-20.1
ASEAN ₅ + Korea	6.2	-0.4	-1.7	-1.0	-24.5	-25.4	-25.0
Others	15.1	0.4	6.3	3.5	-0.9	-11.3	-6.5
Total	100.0	3.2	5.0	4.2	-2.1	-12.0	-7.4

Note: ASEAN₅ includes the Philippines, Malaysia, Indonesia, Singapore and Thailand.

account registered a surplus of 0.3% of GDP for 1998 as a whole, in contrast with the deficits observed in the past few years.

Inflation declined progressively

Inflation eased steadily over the first ten months of 1998 and turned negative in the last two months of the year, the first time Hong Kong has recorded negative inflation since 1975. The growth of the Composite Consumer Price Index (CCPI) slowed progressively from 5% in the first quarter to -0.8% in the fourth quarter. For the year as a whole, average CCPI inflation was 2.8%. In addition to weak domestic demand, import prices declined as a result of softening world commodity prices and a strong US dollar, particularly during the first three quarters of 1998. Other special factors contributing to the sharp disinflation in the last quarter included the freezing of Government and public utilities fees and charges and the one-off rates rebates, which trimmed inflation by 1.4 percentage points.

Unemployment rose sharply

Having tightened in 1997, labour market conditions eased significantly through 1998 (Chart 3). The unemployment rate surged to a post-1976 peak of 5.7% in the fourth quarter of 1998, up from 2.5% in the same period of 1997. The rise was across the board, with the construction, restaurant, manufacturing and trade-related sectors suffering most. Wage increases moderated, as indicated by a year-on-year 0.1% decline in the real wage index in September 1998, compared with a rise of 1.7% in the same period in 1997.



These adjustments in the labour market reflected mainly the cyclical downturn in the economy, as the corporate sector downsized and retrenched. The expansion in the labour force, boosted by housewives re-entering the labour market, returning emigrants, and new arrivals from the Mainland, also contributed to the rise in the unemployment rate.

Large swings in asset markets

Asset markets recorded large swings in the course of 1998. The stock market underwent a significant setback in July-August as global financial turmoil intensified. The Hang Seng Index dipped to a low of 6,660 on 13 August, 38% below the level at the end of 1997, while daily turnover fell from an average of \$15.5 billion in 1997 to around \$3-4 billion in July and early August. Initial public offerings were curtailed by poor market sentiment, falling by 60% in terms of the number of new listings. The property market also took a sharp downturn, with prices falling by 44% and sales and purchase agreements declining by 60% during the first ten months of 1998.

Local financial markets began to rebound from late August onward, and staged a significant recovery in the last few months of the year. The Hang Seng Index recovered to above 10,000 by the end of October and remained near that level through the end of the year, while turnover rose to around \$6-7 billion per day. In the property market, prices recorded a partial recovery – as indicated by a 14.5% rise in the price indices for selected popular private residential developments – and the transaction volume increased by 84.6% in the last two months of 1998, boosted by lower interest rates and improved market sentiment.

Monetary Situation

The Hong Kong dollar remained stable

Amid a turbulent external environment and bouts of speculative attacks against the Hong Kong dollar in 1998, the Hong Kong dollar exchange rate vis-a-vis the US dollar remained very stable under the linked exchange rate system, moving within a narrow range of 7.736 to 7.750. Along with the appreciation of the US dollar against the Deutschmark and the Yen in the first half of 1998, the overall exchange value of the Hong Kong dollar, as measured by the trade-weighted Effective Exchange Rate Index (EERI), rose to 140.2 in mid-June. As the US dollar gradually weakened in the second half of the year, the EERI fell to 131.8 at the end of 1998, 4.6% lower than the figure of 138.1 at the beginning of the year.

Interest rate volatility reduced since September

There were three notable interest rate spikes associated with speculative attacks on the Hong Kong

dollar during the year, in January, June and August respectively. One-month HIBOR, for instance, rose briefly to around 19% in the January and June episodes. With the successful defence against simultaneous pressures in the exchange and equity markets in August, and following the introduction of the seven technical measures in early September, market sentiment improved. Also reflecting a decline in the US interest rates, Hong Kong dollar interest rates moved on a downward trend in the last quarter. One-month and three-month HIBORs fell gradually to 5.13% and 5.25% respectively at the end of 1998, compared with 7.13% and 9.18% respectively at the beginning of the year.

In line with the firming of interbank interest rates in early January 1998, both the HKAB savings deposit rate and the best lending rates quoted by major banks were raised by 75 bp in January. As market conditions stabilised and interbank interest rates eased, both rates were cut by 25 bp in March. They were further adjusted downward on four occasions by a total of 100 bp from October to December, to stand at 4.25% and 9% respectively at the end of the year.

The interest rate differential between Hong Kong dollar and US dollar assets widened substantially during the speculative attacks in January, June and August. As market conditions stabilised and investor confidence improved after September, the interest rate differential, in terms of one-month and three-month interbank interest rates over their corresponding US dollar counterparts, narrowed substantially to 7 bp and 19 bp respectively at the end of 1998, compared with 147 bp and 346 bp at the beginning of the year.

Long-term interest rate differentials, in terms of the spread between yields of ten-year Exchange Fund Notes and corresponding US Treasuries, for instance, narrowed to 162 bp at the end of 1998, compared with 329 bp at the beginning of the year.

Broad money supply increased moderately

Affected by sluggish economic activity, the sharp correction in asset markets, and a downsizing of some foreign banks in Asia, total bank deposits grew by only 1.7%, and total loans and advances contracted by 12.8% during the first half of 1998.

To ease the credit tightening, the Hong Kong SAR Government introduced several measures to improve the liquidity of the banking system. In June, the Government exempted interest income derived from deposits placed in Hong Kong from the profits tax. This provided incentives for corporations to repatriate funds to the Hong Kong banking system. Separately, the Hong Kong Mortgage Corporation introduced the Forward Commitment Facility in late May, under which it has committed to purchasing \$15 billion of mortgages from banks within the next 12 months, thus giving them assurance about the availability of liquidity and helping them to plan their new loan business more effectively.

Partly aided by these developments, deposit growth accelerated in the second half of the year, with total deposits increasing by 9.0%, taking annual growth to 10.9%. Despite improved liquidity in the banking system, lending activity remained subdued in the second half of the year alongside the domestic economic downturn. For the year as a whole, total

loans and advances fell by 19.8%. Of the total, loans for use outside Hong Kong contracted by 36.7% and domestic loans (including trade financing) were down by 5.5%. The Hong Kong dollar loan-to-deposit ratio of the banking system decreased significantly from 113.3% at end-1997 to 100.6% at end-1998.

HK\$M1 contracted by 5.2% during 1998 as transaction demand for money fell in line with the weakening in economic activity. HK\$M2 and HK\$M3 expanded moderately by 9.8% and 9.4% respectively. The rise in savings and time deposits was motivated in part by higher Hong Kong dollar deposit rates and the repatriation of offshore deposits following the exemption of profits tax on corporate deposits since mid-1998.

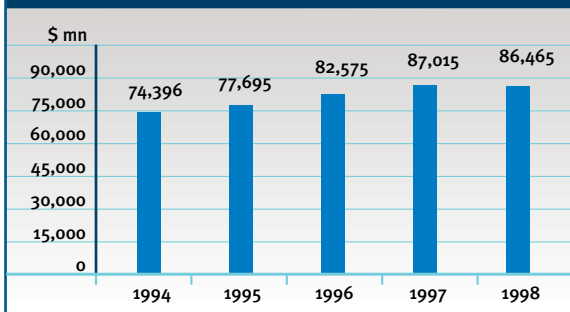
Notes and coins

At the end of 1998, the total value of notes in circulation was \$86,465 mn, a decrease of 0.6% from a year earlier (Charts 4, 5, 6). The total value of coins in circulation was \$5,554 mn (excluding commemorative gold coins and coin sets), an increase of 7.3% from a year earlier (Charts 7 and 8).



A coin sorting machine in action.

Chart 4 Notes in circulation as at end of year



Amount of issue

Chart 5 Distribution of notes issued (as at December 1998)

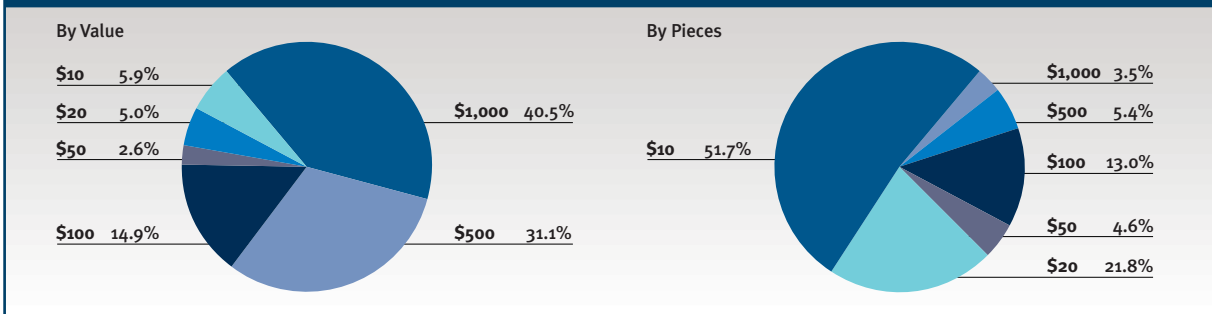


Chart 6 Banknotes issued in 1998 (as at December 1998)

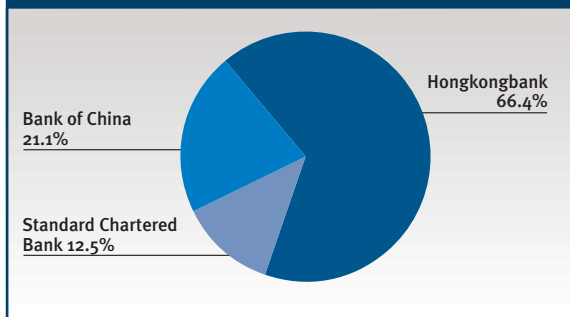
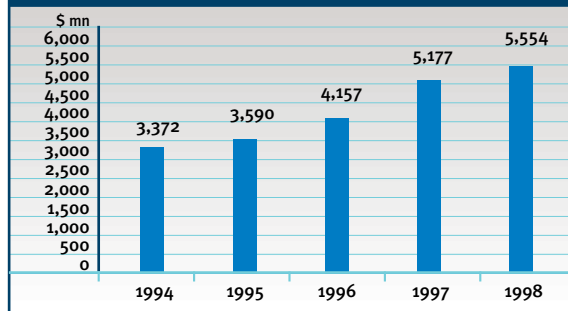
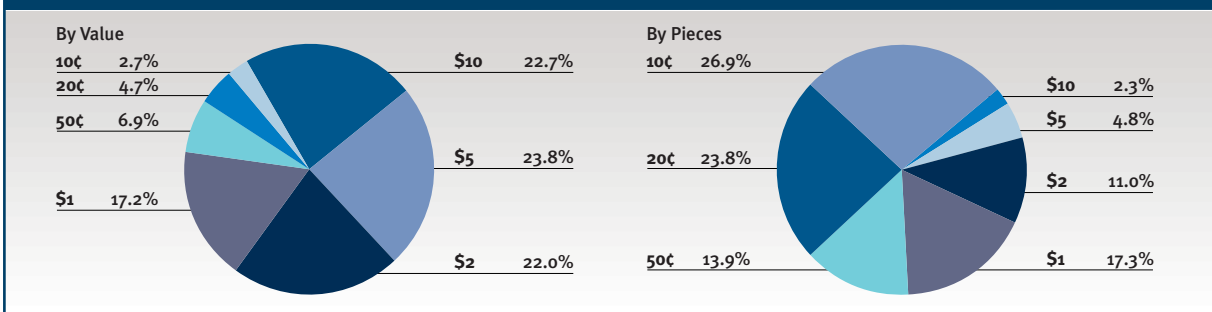


Chart 7 Coins in circulation as at end of year



Amount of issue (excluding coin sets and commemorative gold coins)

Chart 8 Distribution of coins issued (as at December 1998)



Coin shortage

Following the delivery of 900 mn new coins in 1998, the shortage precipitated by collector demand in 1997 for coins bearing the Queen's head design was completely resolved by the end of 1998. Nevertheless, a further 940 mn pieces are on order for 1999 in order to provide a good margin of stock.

Coin replacement programme

The programme to replace coins bearing the Queen's head with those carrying the Bauhinia design was suspended in mid-1997, owing to the shortage of coin, but is now being resumed.

Commemorative gold coin

To mark the opening of the Hong Kong International Airport in July 1998, the HKMA, on behalf of the Government, issued a commemorative \$1,000 proof gold coin. The gold coin features a design symbolising Hong Kong's ascent into the new century, and bears the standard Bauhinia design on the other side.

Outlook for the Economy

Economy expected to bottom out

The pace of Hong Kong's economic recovery will depend upon developments in both the domestic and external environment. Externally, there was an increase in financial volatility in emerging markets in early 1999, as Brazil devalued its currency. But the spillovers to other countries were smaller than during 1997-98. Assuming that global market volatility does not intensify, the environment should be favourable for reductions in Hong Kong dollar interest rates during the course of the year. Improved domestic liquidity and the partial recovery in the asset markets

should lend support to consumer demand. Downward adjustments in domestic prices and wages, combined with the weakening of the US dollar, have eased, to some extent, competitiveness concerns. On the other hand, rising unemployment and high real interest rates will probably continue to affect consumer sentiment. The expected economic slowdown in Hong Kong's major trading partners may increase pressure on exports. On balance, following the large contraction in 1998, the economy is expected to bottom out in the course of 1999, with a modest recovery possible in the second half of the year.

Domestic demand expected to stabilise

Domestic demand is expected to remain weak, but the downward trend should moderate in the first half of the year, with a possible recovery in the latter part of the year. The improved stability in asset markets since last September should lend some support to consumer demand, although the outlook for asset prices depends to some extent upon developments in the global markets. Rising unemployment and growing pressure on wage adjustment will probably continue to affect consumer sentiment.

Private investment is expected to slow amid the uncertain business outlook. Despite recent easing in local liquidity conditions, real interest rates remain high due to disinflation. Credit tightening associated with the Guangdong International Trust and Investment Corporation (GITIC) incident and continued cutting back by Japanese banks is expected to discourage private investment spending. Public investment, in contrast, is expected to increase by 6.6%, supported by spending on some major projects, such as the building of major railways and the expansion of the road network.

A difficult year for external trade

A slowdown in export demand from major markets is expected, as Japan's domestic problems remain unsettled and the US and European Union are expected to experience lower economic growth. Export demand from the Mainland will be affected by continued weak consumer demand as well as by the intensification of import substitution as economic growth slows. Hong Kong's exports are also expected to face keener competition from the East Asian economies, as the supply of financing to their exporters improves. On the other hand, the downward adjustment in domestic prices and wages as well as the weakening of the US dollar have eased, to some extent, concerns about competitiveness.

Retained imports are expected to remain weak owing to subdued domestic demand, while imports intended for re-export will likely contract further on the back of an expected further slowdown in Mainland China's external trade. The visible trade deficit is expected to widen slightly, following a large improvement in 1998.

Continued price adjustment and an easing in the labour market

Consumer prices are likely to decline somewhat in 1999 on the back of continued weakness in domestic demand. Increased competition in telecom and petrol charges is also likely to contribute to downward pressure on consumer prices. While the weakening of the US dollar tends to increase import prices, the continued softness in world commodity prices should help contain imported inflation.

As the adjustment process in the domestic economy continues, and with the unemployment rate acting as a lagged indicator of the business cycle, the unemployment rate is expected to rise further, as the corporate sector continues downsizing and retrenchment.

Performance of the Banking Sector

A difficult operating environment in 1998

Authorised institutions experienced a difficult year in 1998 given the slowdown in both the Hong Kong and the Asian economies that followed the regional financial turmoil. High domestic interbank and deposit rates in the first nine months of 1998 increased funding costs and reduced the interest margins previously enjoyed by institutions in 1997. Doubts about the cost and availability of funding, and concerns about increased credit risk, contributed to a fall in lending volume and restricted market liquidity in the banking sector.

The Asian crisis also resulted in financial difficulties for corporate and individual borrowers in Hong Kong, leading to a substantial increase in the non-performing loans of authorised institutions. This, together with the collapse of GITIC, led to a sharp rise in provisions for bad and doubtful debts, which in turn significantly reduced the profitability of the banking sector.

While the performance of institutions in general in 1998 was much less satisfactory than in previous

Table 3 : HK dollar interest rates movement (period average figures)

(per cent per annum)	Time deposits			HIBOR			Savings deposits	Best lending rate
	1-month	3-month	12-month	1-month	3-month	12-month		
Q4 1997	7.46	7.97	7.91	9.06	9.88	10.23	4.54	9.31
Q1 1998	6.97	8.08	9.10	7.64	8.87	10.35	5.41	10.16
Q2 1998	6.79	7.26	8.24	7.29	7.68	8.99	5.25	10.00
Q3 1998	7.65	8.31	8.95	9.37	9.82	10.70	5.25	10.00
Q4 1998	5.09	5.73	6.94	5.45	5.97	7.26	4.85	9.60
1997*	5.99	6.20	6.40	6.85	7.12	7.47	4.08	8.83
1998*	6.63	7.35	8.32	7.42	8.06	9.31	5.19	9.94

* annual average figures

years, the strong capital and liquidity position of local banks continued to assist them to withstand the adverse effects of the crisis.

Volatile funding costs

Funding costs increased sharply in the first nine months of the year (Table 3). Speculative attacks on the Hong Kong dollar and fierce competition for deposits during this period pushed both HIBOR and time deposit rates higher. However, interest rates eased back significantly in the fourth quarter of 1998 after the HKMA introduced seven monetary measures in September to strengthen the currency board system and deter speculation on the Hong Kong dollar. The average spread between one-month HIBOR and the best lending rate widened from 195 bp in the first nine months of the year to 415 bp in the last quarter of 1998.

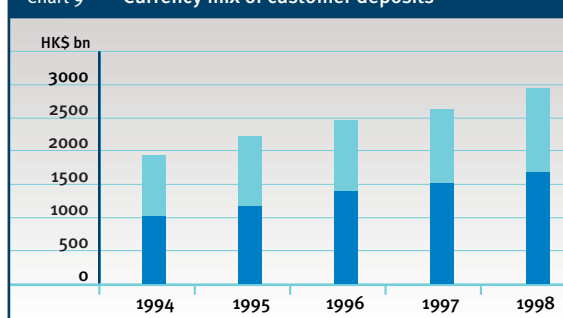
Aided by the repatriation of offshore deposits back to Hong Kong following the announcement in June of the exemption of profit tax on interest income derived from corporate deposits, the growth of total deposits rose from 8.4% in 1997 to 10.9% in 1998. Most of

Table 4 : Growth of Hong Kong dollar customer deposits

(HK\$ bn)	Demand	Savings	Time (a)	Swap	Total
1994	100	275	538	104	1,016
% growth	(4.7)	(2.5)	34.5	44.6	18.4
1995	100	301	721	50	1,172
% growth	0.2	9.5	34.1	(52.0)	15.3
1996	122	366	874	39	1,400
% growth	21.4	21.8	21.2	(22.7)	19.5
1997	108	336	1,052	42	1,538
% growth	(11.7)	(8.2)	20.4	9.9	9.8
1998	97	414	1,144	29	1,685
% growth	(9.7)	23.3	8.8	(30.8)	9.6

(a) Excluding swap deposits

Chart 9 Currency mix of customer deposits



Legend: Foreign currencies (light blue), HK\$ deposits (including swap deposits) (dark blue)

this growth took place from June onwards. In terms of currency, Hong Kong dollar deposits grew by 9.6%, little changed from the 9.8% rise in 1997

(Table 4). Foreign currency deposits grew at a somewhat faster pace of 12.6% in 1998, compared with 6.5% in 1997: most of the impetus came from US dollar deposits, which grew by 19.5%. Despite the robust growth in foreign currency deposits, Hong Kong dollar deposits still represented 57.0% of total deposits at the end of 1998, slightly lower than 57.7% at the end of 1997 (Chart 9).

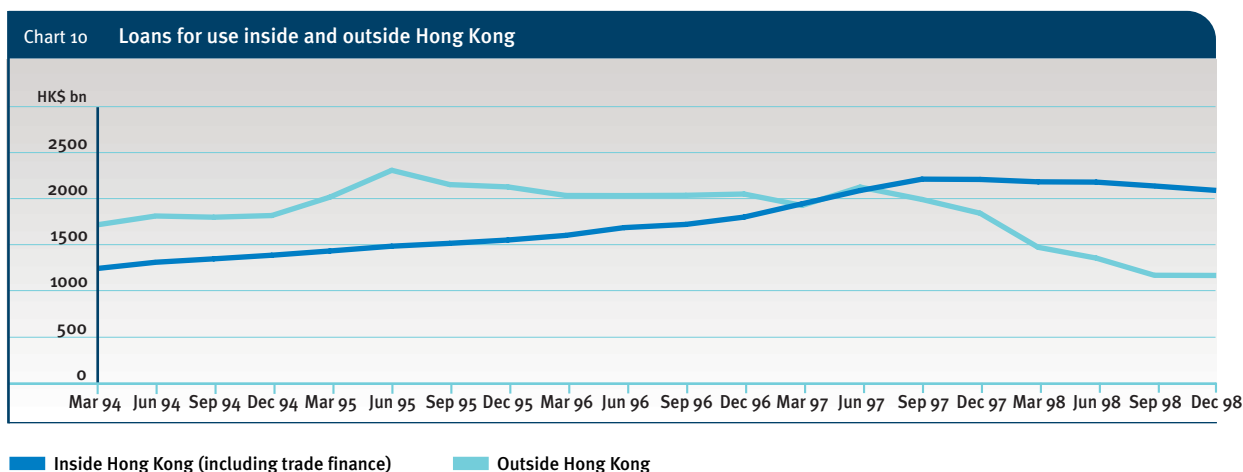
Within Hong Kong dollar deposits, demand deposits continued on a declining trend, dropping by 9.7% in 1998 on the heels of an 11.7% decline in 1997. Time deposits grew at the slower pace of 8.8%, compared with a much stronger rise of 20.4% in 1997. The slowdown in the growth of time deposits partly reflected the fall in time deposit rates in the fourth quarter of 1998. In contrast, savings deposits reversed their decline of 8.2% in 1997 and grew by 23.3% in 1998. Most of the increase took place in the final quarter of the year, as interest rates fell and a revival in the stock and property markets prompted an increase in the transactions demand for money. Swap deposits, which had been on a declining trend since the partial deregulation of interest rates, resumed their decline in 1998 after a modest increase in 1997.

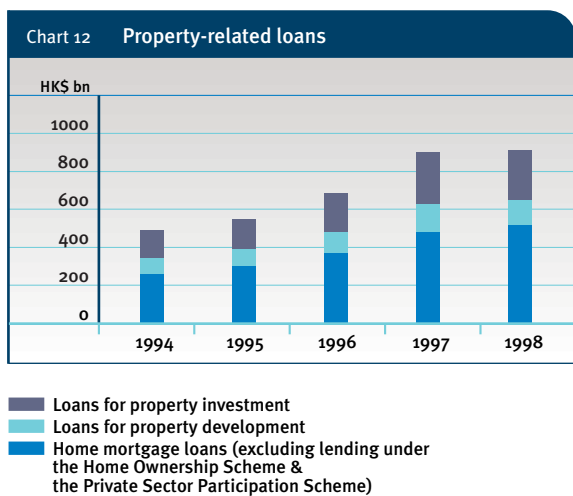
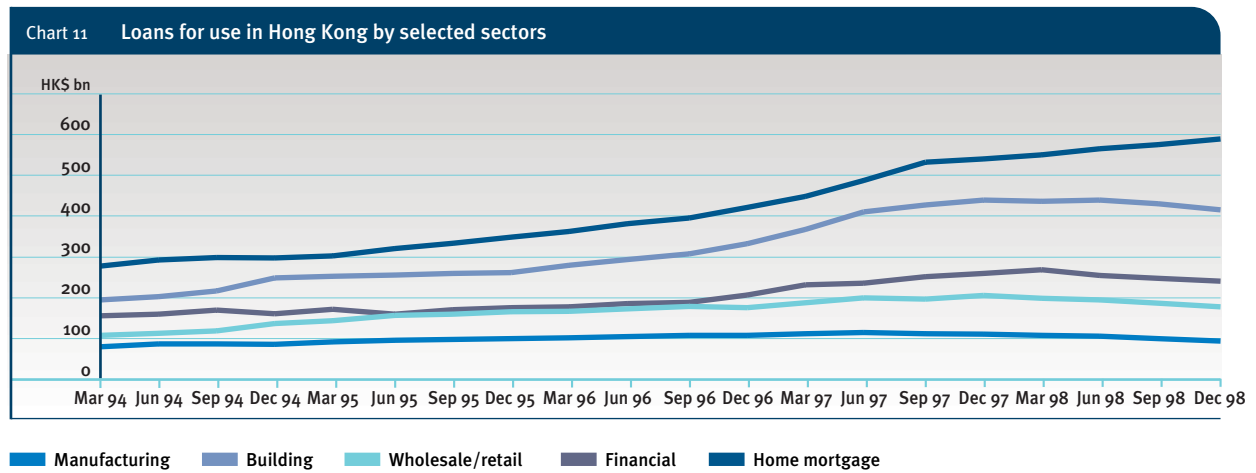
With the continued growth in Hong Kong dollar deposits against a decline in Hong Kong dollar loans, the Hong Kong dollar loan-to-deposit ratio of the banking sector fell to 100.6% at end-December 1998, from 113.3% at end-December 1997. The ratio for local banks also declined to 71.6% from 78.6%. The loan-to-deposit ratio of local banks for all currencies dropped to 58.9% from 68.6%.

Reflecting lacklustre demand for negotiable certificates of deposits (NCDs), the total amount of outstanding NCDs decreased by 4.9% in 1998. Hong Kong dollar denominated NCDs maintained their share at around 78% of all outstanding NCDs issued in Hong Kong, of which about 63% were held by authorised institutions (compared with 70% in 1997).

Contraction in domestic lending

Total loans and advances shrank by 19.7% in 1998, against a rise of 5.3% in 1997. Much of the decline was due to a sharp 36.5% fall in offshore lending caused mainly by a contraction in Euroyen activities (Chart 10). Euroyen loans are loans made to customers in Japan by a domestic branch of a





Japanese bank but booked in an overseas office of the bank. Since Hong Kong serves only as a booking centre for such loans, the decline in offshore loans has little impact on Hong Kong's economic activity and market liquidity.

With the banks displaying a cautious lending attitude and subdued demand for loans, domestic credit dropped by 3.7% in 1998, following the sharp growth of 24.5% in 1997. Property lending, the mainstay of loan growth in 1997, slowed sharply in 1998 on the back of sluggish activity in the property market. Loans for property development and property investment declined by 6.6% and 4.2%

respectively in 1998, against rises of 37.6% and 29.8% respectively in 1997 (Charts 11 & 12). Growth in loans for residential mortgage lending moderated to 8.2% in 1998 from 29.9% in 1997. Despite the rebound in the Hang Seng Index in the fourth quarter of 1998, loans for share financing decreased for the year as a whole. Loans to stockbrokers dropped by 71.6% while loans to non-stock-broking companies and individuals for the purchase of shares fell by 56.3%, against rises of 0.5% and 56.8% respectively in 1997.

A lean year for local banks

Local banks reported sizable decreases in profits as their operating conditions deteriorated markedly, reflecting the difficulties faced by the banking sector in 1998. Pre-tax operating profits from local banks' Hong Kong offices fell by 33.8% and post-tax profits by 34.7%, a stark contrast to growth of 11.7% and 9.7% respectively in 1997.

Operating profits of local banks were squeezed by the fall in the overall net interest margin (from 2.44% to 2.26%) and the decline in lending volume. Income

was also affected by a volume-related decline in fees and commissions. While total income fell, operating expenses continued to rise slightly, leading to a deterioration in the cost-income ratio for Hong Kong offices, which increased to almost 40%.

Higher bad debt charge

The main factor in the decline in profits was the substantial increase in the bad debt charge. For local banks, the bad debt charge* in their domestic books rose by 347% and, as a percentage of average total assets, rose to 0.64% in 1998 from 0.15% in 1997 (Table 5). The bad debt charge of the banking sector as a whole also rose, but to a lesser degree than for the local banks, to 0.43% in 1998 from 0.13% in 1997. This could be explained by the larger asset base of the sector as a whole and by the fact that part of the provisions of branches of foreign banks may be made at head office.

Table 5 : Return on assets for locally incorporated banks

Components of ROA	Contribution to ROA as % of average total assets	
	1997	1998
1. Net interest income	2.26	2.07
2. Other operating income	1.03	0.95
3. Total operating income (1 + 2)	3.29	3.02
4. Operating expenses	1.25	1.20
5. Bad debt charges	0.15	0.64
6. Other provisions	0.01	0.01
7. Operating profit before tax (3 - 4 - 5 - 6)	1.88	1.17
8. Profit on sale of fixed assets & other investments exceptional items	0.04	0.00
9. Profit before tax (7 + 8)	1.92	1.17
10. Taxation	0.27	0.16
11. Extraordinary items	0.00	0.00
12. Post tax profits (ROA) (9 - 10 + 11)	1.65	1.01

* This figure does not include certain general provisions made against regional exposures outside the domestic books.

Deterioration in domestic asset quality

Part of the increase in the bad debt charge reflected the fall in the value of collateral. However, underlying asset quality also deteriorated as a result of the slowdown of the Hong Kong economy following the regional financial crisis and, in some cases, the weaknesses in regional economies. The closure of GITIC in October 1998 and the knock-on effects on other Mainland-related entities was another factor. For local banks, the ratio of loans overdue for more than three months rose to 4.03% at the end of 1998 from 1.58% at the end of 1997, while rescheduled loans increased to 1.07% from 0.23% (Table 6). The

Table 6 : Problem assets

	As % of total loans	
	Dec-97	Dec-98
(a) All authorised institutions		
Problem assets :		
overdue over 3 months and rescheduled	1.07%	4.10%
3 - 6 months over 6 months rescheduled	0.20%	1.09%
	0.70%	2.26%
	0.17%	0.75%
(b) All local banks		
Problem assets :		
overdue over 3 months and rescheduled	1.81%	5.10%
3 - 6 months over 6 months rescheduled	0.32%	1.45%
	1.26%	2.58%
	0.23%	1.07%

Table 7 : Asset classification

As % of total loans	Special Sub-				
	Pass (%)	Mention (%)	standard (%)	Doubtful (%)	Loss (%)
(a) All authorised institutions					
- 1998	85.81	9.10	2.44	2.26	0.39
- 1997	92.63	6.14	0.57	0.56	0.10
(b) All local banks					
- 1998	84.68	7.99	3.18	3.93	0.22
- 1997	94.87	3.05	0.72	1.29	0.07

combined ratio of overdue and rescheduled loans rose to 5.10% from 1.81%. The broader definition of problem loans, "classified loans" (i.e. loans classified as substandard, doubtful and loss) rose to 7.33% at end-1998 from 2.08% at end-1997. The higher ratio of classified loans than overdue and rescheduled loans shows that institutions were adopting a prudent approach by not simply relying on the period overdue as the criterion for classifying loans (Table 7).

Reflecting the more cautious attitude of local banks in the assessment of their assets, loans classified as "special mention" increased more than twofold from 3.05% at end-1997 to 7.99% of total loans at the end of 1998.

The asset quality of the banking sector as a whole also deteriorated in 1998. The ratio of classified loans rose from 1.23% at the end of 1997 to 5.09% at the end of 1998. Special mention loans, which grew at a slower pace in 1998, rose from 6.14% to 9.10%. The slower increase in the latter category was due partly to the repatriation of these loans back to the head offices of some foreign banks and partly to the "migration" of these loans into classified loans.

The HKMA started collecting data on overdue mortgage loans in its monthly mortgage survey with effect from June 1998. The delinquency ratio, measured by the ratio of mortgage loans overdue for more than three months to total outstanding mortgage loans, rose from 0.29% at the end of June 1998 to 0.84% at the end of 1998. Although this was a significant increase, it was well below the delinquency ratio of other types of lending, indicating that the overall quality of the mortgage portfolio remained sound in the face of the recession.

Credit card business

Credit card business expanded at a reasonable pace in 1998, with total receivables growing by 13.6% and the number of cards by 7.9%, down from growths of 29.2% and 24.0% respectively in 1997. Reflecting the strain on personal finances caused by the recession, the charge-off ratio for 1998 was 3.1%, up from 2.1% in 1997 (Table 8). The delinquency ratio (measured by loans overdue for more than 90 days) also rose, reaching 1.16% at the end of 1998, from 0.64% at the end of 1997.

Table 8 : Credit card survey results

	1997	1998
Total receivables	\$32.5 billion	\$36.9 billion
Delinquent accounts (debts overdue over 90 days)	\$0.2 billion (0.64% of total receivables)	\$0.4 billion (1.16% of total receivables)
Annualised charge-off ratio	2.1%	3.1%

Stronger capital adequacy ratio

The consolidated capital adequacy ratio of all locally incorporated institutions rose from 17.5% at the end of 1997 to 18.6% at the end of 1998. The higher capital adequacy ratio was a result of a decline in risk assets over the year, reflecting an overall reduction in the risk appetite of banks. A stronger capital adequacy ratio means that banks are better equipped to face the challenges ahead.

A Challenging Year Ahead for the Banking Sector

The banking sector has stood up well to the stress of what has been one of the worst years in Hong Kong's recent economic history. The current year is likely to

pose continuing difficulties. Profits should be helped by the wider spread between prime rate and HIBOR and by the full year effect of the cost-cutting measures taken by institutions in 1998. However, balance sheet growth may remain sluggish. While authorised institutions are well positioned to lend in terms of liquidity, the lack of bankable lending propositions will remain a problem. Furthermore, non-performing loans are expected to continue to rise in the first half of the year, leading to a continuing need to make bad debt provisions. An important influence on the size of the bad debt charge will be whether a solution can be found to the current funding difficulties of a number of Mainland-related companies. A major preoccupation for authorised institutions during the course of the year will be to ensure that the Year 2000 problem is successfully dealt with. So far, the indications are that the banking sector in Hong Kong is making good progress. This, together with the good balance sheet position of the local banks, should ensure that the banking sector is well placed to benefit from the eventual economic recovery.