

Chief Executive's Statement



Domestic recovery, external uncertainties

Hong Kong enjoyed a year of broadening and sustained economic growth in 2000. Gross domestic product rose by 10.5%, the highest rate of growth in 13 years. Exports increased by 17.1%. Consumer confidence continued to revive. Employment expanded across all major service sectors, and real household income increased. A continuing, though moderating, decline in prices, a stable Hong Kong dollar, and easing interest rates all helped the adjustments triggered by the Asian financial crisis to work their way through the economy. Through restructuring and increased productivity, Hong Kong is regaining its competitiveness and improving its position as a regional centre.

Despite the largely positive domestic performance, volatilities and uncertainties in the rest of the world inevitably had their effect on Hong Kong. Financial markets across the world experienced considerable instability, partly as a result of the swelling and bursting of Internet and telecom stock bubbles in the second quarter of the year. The Hang Seng Index, having ascended to an all-time high of 18,302 on 28 March, lost 11% of its value during the course of the year. Much of the Asian region continued to be unsettled in 2000, with political difficulties adding to the lingering effects of financial crisis. By the end of 2000, signs of flagging energy in the US economy and a deepening of the problems in Japan were causing nervousness throughout the world.

Although financial markets have so far coped well with the downturn, such nervousness carries with it an increased risk of financial instability. As we saw in this region in 1997 and 1998, financial crisis can be transmitted with ever increasing rapidity, and with more damaging consequences. At this time of diminished optimism, the pressure on the international community to strengthen an international financial architecture that does not fully accommodate the needs and behaviour of international finance becomes all the greater. And, if international action takes longer than smaller, more open economies such as our own might wish, we need to do all that we can to make our domestic financial systems resilient and flexible, and, where possible, a step ahead of the needs of the market.

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| Stronger financial systems |

The year 2000 saw some progress in reform to the international financial architecture and important advances in Hong Kong's domestic infrastructure. In a number of international forums, including the Financial Stability Forum, the HKMA continued to urge greater recognition of the concerns and vulnerabilities of small and open economies, and to promote solutions. Among the initiatives pursued in 2000 was the development of draft Model Forex Guidelines by a task force composed of private sector bankers and sponsored by a small group of central bank institutions, including the HKMA. The Guidelines, which were promulgated in February 2001, tackle concerns about problematic trading practices: we expect to see them adopted by industry associations across the world over the coming year or so. The opening in Hong Kong in 2000 of an IMF Sub-Office and of a joint regional office of the International Finance Corporation and the International Bank for Reconstruction and Development strengthened the resources in the region for promoting financial market development and stability. Their presence here also underlines Hong Kong's position as a regional financial centre.

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A milestone in the development of our domestic and regional financial infrastructure came with the completion, in the second half of 2000, of Hong Kong's US Dollar Clearing System. This state-of-the-art facility saves time and risk by enabling the full range of US dollar transactions – from securities to paper cheques - to be cleared real time during Asian trading hours. The interface connecting it with our Real Time Gross Settlement system for the Hong Kong dollar made possible a ground-breaking event, with the first Payment-versus-Payment settlement of a foreign exchange transaction in world financial history taking place in Hong Kong on 25 September 2000. The US Dollar Clearing System clearly satisfies a need: more than 120 financial institutions, many of them from overseas, are now using it, with an average total turnover of around US\$3 billion per day. If a demand can be established, we shall consider applying the technology to other major currencies. Advances of this nature, including also the debt market linkages that we are progressively forging with other financial centres, help lay down the infrastructure necessary for more efficient and liquid markets.

| A credible currency |

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The Hong Kong dollar enjoyed remarkable stability during 2000. The risk premium on the Hong Kong dollar continued to fall, with interbank interest rates well below their US counterparts for most of the year – a reflection of the strong demand for Hong Kong dollar assets and the confidence in our currency. Under the guidance of the Sub-Committee on Currency Board Operations, further improvements to the Currency Board system were completed during the year. In January a clear framework was set out for transferring surplus foreign currency assets from the backing portfolio to the investment portfolio, where they can yield a higher return. On 12 August the convertibility undertakings for the Aggregate Balance and Certificates of Indebtedness converged, at the end of a 500-day process of gradual adjustment.

The credibility of our currency, and of the Linked Exchange Rate system that maintains its stability, rests ultimately in the availability of adequate official reserves to back it up. Representing over eight times the amount of Hong Kong dollar cash in circulation and around 40% of Hong Kong dollar M3, the foreign currency assets in Hong Kong's Exchange Fund provide some of the strongest backing available for any currency in the world. Despite an extremely difficult investment environment, and general expectations of a loss, the Exchange Fund's assets rose by more than two per cent during the year.

The integrity of any currency also depends on the trust that people have in the banknotes and coins that are its most tangible manifestations. Although the incidence of counterfeit Hong Kong banknotes remains very low by international standards, no amount of counterfeiting can be acceptable. The practice became a matter of some public anxiety during the summer of 2000, as the number of counterfeit notes surfacing increased. Concern focused in particular on certain high quality forgeries of the HSBC \$1,000 note. The inclusion of additional security features in HSBC \$1,000 notes put into circulation from December 2000, combined with intensified police action, has helped to deter counterfeiting, and the incidence of counterfeit notes has substantially declined. Similar security features will be included in the \$1,000 notes issued by the Bank of China and Standard Chartered Bank during the course of 2001. A comprehensive review of the design and security features of all Hong Kong banknotes is making good progress.

| A competitive yet sound banking system |

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Hong Kong’s banking sector performed strongly in 2000, with profits returning to – and in some cases exceeding – pre-crisis levels. Problem loans declined, asset quality improved, and net interest income increased. The capital and liquidity positions of banks in Hong Kong continued to be strong: indeed, liquidity positions were so strong, and domestic loan demand so weak, that competition for new business precipitated an aggressive price-cutting war in the field of residential mortgages. An increasingly competitive climate has encouraged a number of banks to explore new financial products, and to reduce costs and expand services through the use of new technology, such as the Internet. A particularly encouraging development in 2000 was the completion of a number of

mergers and acquisitions and the announcement of other planned mergers. Consolidation of this kind will help Hong Kong’s banks to achieve economies of scale and play a larger role outside Hong Kong.

The programme of deregulation now in progress will provide further scope for competition and repositioning among banks in Hong Kong. In particular, the final stage in the deregulation of interest rate rules, expected to take place in July 2001, will end the system under which the interest rates paid on most Hong Kong dollar deposits were fixed by agreement between the banks. The benefits of deregulation should include a greater variety of services for customers and more efficient pricing for banks. But there will, as we have often made clear, be winners and losers in the process. Banks will need to handle the transition to a deregulated environment in a sensitive and transparent manner. And customers may have to be more prepared to shop around for the services that best suit their needs.

The efficiency of a banking system depends not just on accurate pricing and flexible services but also on its ability to put savings to work in the economy. With the aim of facilitating greater access to funding, particularly for small and medium sized enterprises, the HKMA

has, as part of the banking reform programme, studied the case for establishing a commercial credit reference agency. We consulted the community on this subject during the summer and found general support. We are now working on the detailed preparations for establishing such an agency.

Greater competition and efficiency form one arm of the HKMA's programme of banking sector reform. The other is increased safety. During the last quarter of 2000 we consulted the community on a proposal to introduce a deposit insurance scheme in Hong Kong. The comments we received indicated broad support in the community for such a scheme, and a Legislative Council motion urging the Government to implement a deposit insurance scheme was passed by an overwhelming majority on 13 December.

Accountability and the HKMA

We began discussions within the HKMA in 2000 about how best to clarify and formalise the structure of monetary management in Hong Kong with the aim of setting out more clearly the policy objectives, responsibilities and powers of the HKMA. We are exploring proposals on these subjects with the Administration. Whatever form they are in, the recommendations arising out of this exercise will be intended to consolidate and take further the measures developed by the HKMA over the years to increase the transparency and accountability of its work. The experience of 2000 shows that these measures are continuing to bear fruit.

During 2000 we continued to enjoy productive relations with legislators, both inside the Council Chamber and in our less formal contacts. I made a formal commitment to brief the Council, through its Financial Affairs Panel, on the full range of the HKMA's work on three occasions in every year. This is, of course, in addition to the various briefings on special topics and proposals that take place during the course of the year. We value the attention that Members of the Council pay to banking and monetary issues, not only because it forms an essential part of our

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accountability, but also because the policy-making process gains considerably from their contributions. We were also pleased to be able to expand our contacts with District Councils, both through special briefings to the Chairmen and through attendance at a number of Councils' meetings to discuss, among other things, measures against counterfeit banknotes and the proposal for a deposit insurance scheme.

In an effort to broaden our direct contacts with the community, we staged a major exhibition – *Money in Hong Kong* – in three shopping centres throughout Hong Kong during the summer. This very popular event was accompanied by a two-week-long radio quiz on financial topics (which revealed an impressive amount of knowledge among the general public) and the launch of our new website. During the year we also placed a great deal of emphasis on expanding our public education programme, improving our publications, and making greater use of web-based publications. One result of these efforts is the publication this year on our website of our first interactive Annual Report (which can be viewed at www.hkma.gov.hk).

We were greatly encouraged by the warm public response to our summer exhibition and other educational programmes. Activities of this kind are a central part of our accountability and transparency, since a broader understanding of our work and policy objectives helps to cultivate confidence in Hong Kong's monetary and banking systems. We intend to hold a second exhibition in the summer of 2001, and we are working on preliminary plans for a permanent exhibition on money and banking in Hong Kong.

| Looking ahead |

Taken together, the reforms and initiatives I have outlined above – all of which are discussed in greater detail in the main body of this Report – will help consolidate Hong Kong's already robust banking and monetary systems and develop our position as an international financial centre. In the coming year or so we shall focus on seeing through the work already in progress and on ensuring that Hong Kong's financial system has the strength and the flexibility to benefit from the opportunities on the horizon – not least China's prospective accession to the World Trade Organisation.

Two particular questions – which form grey areas in Hong Kong's regulatory structure – will need to be addressed in the near future. The first of these is whether a more developed framework is necessary for overseeing retail payment services, which have become increasingly varied and complex in recent years, particularly with advances in information technology. Our review of this subject is expected to be completed in the middle of 2001.

The second question is how far the HKMA should become involved in consumer issues relating to banking services. This is becoming an increasingly pressing issue because, as deregulation proceeds and the range and complexity of services expands, complaints and disputes are likely to increase. Although the HKMA already plays an important part in formulating industry standards for banking services, through the preparation of the Code of Banking Practice, the Monetary Authority at present has no explicit mandate under the Banking Ordinance in relation to consumer issues. In considering how far the HKMA should involve itself in this field we need to take account of possible conflicts with our responsibility for prudential supervision of banks.

Both of these questions have important implications on the future role of the HKMA. We hope to have answers to them before the end of 2001.

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Joseph Yam

Chief Executive