Chief Executive's Statement

A difficult year

Hong Kong experienced difficult times in 2001. The world economic downturn, exacerbated by the events of 11 September, put pressure on an economy which, despite the rebound in 2000, had still not fully recovered from the Asian financial crisis of the late nineties. New anxieties and hardships brought further challenges to our stamina and self-confidence as a community. The growth rate of gross domestic product in real terms was virtually flat and slipped from positive to negative as the year progressed. The unemployment rate rose from 4.4% in the last quarter of 2000 to 6.1% in the last quarter of 2001. Property and share prices declined further. Price deflation, at 1.6%, continued, although at a slower pace than in 2000.

Our economic fundamentals remain strong, and our inherent qualities as a free and open city are as vital as ever. Our financial and banking systems have continued to be robust, despite prolonged economic problems and the dramatic fall in asset prices.

The effects of this downturn on Hong Kong are without question negative. But, while it is natural in times like this that there should be debate about Hong Kong's future direction and viability as an international city, it should also be understood that the adverse influences currently affecting our economy are mainly external. This point is underlined by the fact that most of our neighbours were also affected – to varying degrees – by the sudden deterioration in the US, by the deepening malaise in Japan, and by the slowdown in most of the rest of the industrial world.

Our economic fundamentals remain strong, and our inherent qualities as a free and open city are as vital as ever. Our financial and banking systems have continued to be robust, despite prolonged economic problems and the dramatic fall in asset prices. Under our effective and credible Currency Board system, which has been greatly strengthened in recent years, the Hong Kong dollar has seen no repeat of the shocks it experienced in 1997-8: it remained remarkably stable in 2001, despite instabilities elsewhere in the world.

Against the background of these fundamental strengths, three processes, now in train, give grounds for optimism about the future. The first of these is our progressive economic integration with the Mainland of China, an enterprise that has been in progress for more than a generation now, but which has received added impetus from China's accession to the World Trade Organisation in 2001, and from the fact that – alone among the major economies – China continues to enjoy substantial economic growth. The second process is the internal price adjustments and economic restructuring that have been taking place in Hong Kong within the discipline of the Linked Exchange Rate system. This is unpleasant medicine because it involves pain and distress. But it will help ensure that Hong Kong maintains, and increases, its competitiveness in a deeper and more lasting way than could be achieved through currency devaluation. The third process is the global recovery that will inevitably follow the synchronised global slowdown that began in 2001. The signs, in early 2002, are that this recovery may arise earlier than many had feared, although it is too soon to say whether it will be sustained. What is important is that Hong Kong should continue to position itself to get the best out of recovery – as we have done in previous recoveries, and as we did in the dramatic but short-lived recovery of 2000. A large part of this task involves shaping, consolidating, and promoting Hong Kong's role as an international financial centre at a time when considerable opportunities are coming into view.

Infrastructure for an international financial centre

In recent years Hong Kong has increasingly assumed the role of premier financial centre in the Asian time zone. A number of well-known factors have contributed to this: our geographical position, our free and open markets, the rule of law, and the critical mass of expertise and experience that has accumulated in the financial industry over time. Less often acknowledged, because it is practically invisible, is the financial infrastructure itself – the network which connects the parts of our financial industry with each other and with other parts of the world, the channels which carry money around quickly, safely and efficiently, and the machinery which clears and settles the millions of transactions that take place in our city each day.

The reliability of this infrastructure and its capacity to take on new forms of transactions are critical if we are to expand and deepen our financial business and develop further as an international financial centre. Indeed, the advanced state of Hong Kong's financial infrastructure is one of Hong Kong's greatest competitive advantages as an international financial centre. The objective should be to ensure that Hong Kong has a financial infrastructure that not only meets present needs but also anticipates future market opportunities. The strategy in pursuing this objective consists of three main tasks: developing domestic financial activity; drawing in international financial activity; and deepening and expanding financial activity between Hong Kong and the Mainland. To achieve these objectives, Hong Kong's financial infrastructure has to have the capacity, efficiency, accessibility, diversity and flexibility to prepare for the emerging opportunities in the region, and to be able to catch these opportunities before they pass us by.

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Because of its nature and scale, developing this infrastructure has been an enterprise initiated largely by the public sector, through the HKMA, although it is an enterprise that we pursue in collaboration with the banking and financial industry, and one that has many private-sector characteristics. We saw considerable progress in 2001. Hong Kong further consolidated its position within the Asian time zone with the first full year of operation of our new US dollar clearing system, which saw a steady increase in business – much of it from outside Hong Kong. We are now working on plans for introducing parallel clearing systems for other major currencies, such as the euro and yen, using the same advanced Real Time Gross Settlement technology that supports our Hong Kong dollar and US dollar systems.

We continued to extend our linkages with other jurisdictions during the year. Work in this area ranged from improving cheque clearing facilities between Hong Kong and Guangdong province to agreeing on a new automated real-time link between our Central Moneymarkets Unit (CMU) and Euroclear, which will take effect in late 2002. The link between the CMU and Euroclear will enable financial institutions in the region to hold and settle international debt securities lodged with Euroclear through their accounts held in Hong Kong: it is a key part of our strategy for developing the CMU into a full international central securities depository. In parallel with our efforts to develop the hardware for the system, we continued to foster the development of the debt market, both in Hong Kong and in the region generally. In 2001 this work focused on promoting greater transparency and liquidity in the Hong Kong dollar debt market and on enhancing market-making arrangements for Exchange Fund Bills and Notes. An encouraging development in 2001 was the very substantial increase in the size of the retail bond market.

In providing Hong Kong with the equipment and linkages to serve a wider region, rather than just our own markets, we must increasingly take into account the needs of finance on the Mainland of China. Years of positive economic growth in China have produced an accumulation of wealth and capital and an abundance of talent and expectations. China's accession to the World Trade Organisation in 2001 opens up many possibilities for the future. Hong Kong is China's natural international financial centre, and it is the ideal testing ground for future opportunities arising, for example, out of the gradual relaxation of controls on the renminbi. Within the framework of "one country, two monetary systems" the HKMA has, for some time, been in practical and detailed discussions with our Mainland counterparts about how best Hong Kong can assist and participate in China's future financial development. The recent constructive discussion on the Mainland about Hong Kong's potential future financial intermediation roles has been most encouraging.

Competitive, safe and efficient banks

The banking system is at the core of any international financial centre. Unlike infrastructural development (which is largely a public-sector initiative), the growth and development of the banking system is a matter of market competition. The great number of banks operating in Hong Kong, and their diversity – in size, geographical origin, and focus of business – are a reflection of Hong Kong's pull as a financial centre and of market competition at work. The aim of our policies in helping to develop the banking system in Hong Kong is to facilitate greater competition within the banking industry by removing barriers to competition. The main achievement in this area in 2001 was the successful implementation in July of the final phase of interest rate deregulation – affecting Hong Kong dollar savings and current accounts – and the removal of the three-building limit applicable to foreign banks licensed after 1978.

The year also saw considerable progress in the trend – led by market forces but facilitated by the responsive approach adopted by the HKMA – of consolidation in the banking industry within Hong Kong, with the completion of a number of major mergers and acquisitions. We welcome consolidation because it strengthens the banking system within Hong Kong and enables Hong Kong's banks to play a more active role globally, in the region and on the Mainland.

The counterpart to our focus on facilitating competition is an equal focus on the safety and soundness of the banking industry, in view of the potential effects of failure on both the depositor and on the system as a whole. Hong Kong's banks faced an extremely challenging operating environment in 2001, in which they had to contend with the weak state of the economy and with the unfamiliarity of low interest rates. Yet the banking sector maintained high levels of liquidity and capital strength, saw continued improvement in overall asset quality, and recorded only a moderate decline in profitability. Clearly, Hong Kong's banking industry remains safe and resilient. Our aim is make sure that this continues to be the case, through further improvements to our supervisory tools and through measures to ensure that problems faced by individual banks – should they occur – do not become systemic problems for the banking system as a whole.

Our supervisory initiatives in 2001 included extending the risk-based supervisory approach to major local banks and foreign bank branches, strengthening the corporate governance of banks, and focusing on issues of concern, such as the deterioration in credit card default rates. We took further our plans for a deposit insurance scheme in Hong Kong by developing a preliminary design and consulting the industry further. We also finalised recommendations for a commercial credit reference agency, and worked with the industry and other interested organisations to promote proposals for the sharing of positive consumer credit data.

During the year we saw an increased interest in consumer issues relating to banking services, arising from a number of factors. One of these was the introduction of new fees and charges by many banks, reflecting the need, in a difficult operating environment and in a period of intensifying competition, for them to focus on cost recovery. In general, banks have been sensitive and constructive in ensuring that all groups in society have access to basic banking services. While the HKMA's policy is not to interfere in the pricing of services, which are commercial decisions, we paid particular attention to questions of transparency and consumer-friendliness in the comprehensive review we carried out with the industry of the *Code of Banking Practice*, which became effective on 1 December. In view of a general rise in complaints about bank services in 2001, the HKMA began studying the question of whether powers should be available, either to the HKMA or to a special ombudsman, for dealing with complaints about banks. We continue to keep this question under review, in consultation with the industry and the community generally. Our current view, however, is that the present arrangements for handling complaints (which centre largely on the banks themselves, under monitoring by the HKMA) are working reasonably well. These arrangements were strengthened in early 2002 with the issue of a detailed new Guideline on the handling of complaints.

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Separately, the issue of negative equity, affecting, we believe, some 16% of domestic mortgage borrowers, came to a head in 2001, as the continuing decline in prices made many properties worth less than the value of the outstanding mortgages taken out to finance them. The HKMA helped facilitate relief to homeowners in this position by indicating that it would not object to banks refinancing residential mortgages in negative equity up to 100% of the current market value of the property. We also encouraged banks to set up centralised units or hotlines to deal with the issue.

A stable Hong Kong dollar

A strong, flexible and efficient banking system is an essential factor in currency stability, particularly in a Linked Exchange Rate system, such as exists in Hong Kong, under which banks must be able to cope with any fluctuations in interest rates that may arise through the operations of the Currency Board. Despite considerable volatilities across the world financial system, such fluctuations have, in fact, been mild in recent years. This is attributable in part to the technical reforms of 1998, which have been successful in cushioning the Currency Board system against extreme volatilities. Equally important, it is evidence of the confidence, internationally and locally, in the Hong Kong dollar, and the increasing willingness of markets to view the Hong Kong dollar in a rational way. This confidence depends on a recognition of our economic fundamentals, which remain strong and well understood.

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Foremost among these fundamentals is our flexible and responsive economy, which enables prices and costs to adjust without the need to move the exchange rate. In addition, our Exchange Fund, which, against expectations, showed a modest investment profit in 2001, provides ample foreign exchange backing to support the Link. Our Government continues to pursue a prudent fiscal policy. Growing concerns emerged during the year about the continuing fiscal deficit, notwithstanding the availability of large accumulated fiscal reserves. It is now clear that the fiscal deficit is the product not only of the prolonged economic downturn but also of what is now generally recognised to be a structural imbalance in Hong Kong's public finances. This imbalance is now being actively addressed by the Government with the aim of restoring fiscal balance over the medium term. The imbalance presents no immediate threat to monetary stability.

The larger question of whether the Link is in Hong Kong's best interests once again became a topic of public debate in 2001. It is natural that there should be such questions at a time of economic distress and rapid change, and it is right that the merits and shortcomings of the Link should be debated whatever the conditions we are facing – although even its strongest critics would not argue that the Link should be changed in difficult times such as this. The balance of the arguments is clearly in favour of the Link. It provides a predictable and conducive business environment for an economy which imports practically everything that it consumes, processes or re-exports. And, for a financial centre with heavy international capital flows but no capital controls, linking our currency to a strong international currency provides stability and strength. Those who advocate changing it have not been able to propose a better alternative.

Confidence in Hong Kong's financial system

The debate about the Link should be put into perspective. We believe that the majority of the community recognise the value of the Link to Hong Kong and understand that there would be no benefit to Hong Kong in changing or abolishing it. There is confidence in the Link, both at home and overseas. And there is confidence in the other components of Hong Kong's financial system: in the safety of our banks, the efficiency of our retail payment systems, the reliability of our clearing systems. Part of our job as a monetary authority is to seek to maintain and strengthen this confidence. We do this, for example, by increasing the transparency of what we do, whether it be in terms of our daily operations or in the thinking behind our broader policy initiatives. We seek to promote a broad understanding of our work among the general public through our contacts with the media, our website, and our many educational initiatives. We also place emphasis on consulting the community and its representatives about planned initiatives and policies and measures in progress: in 2001 we attended a total of 45 Legislative Council Panel and Committee meetings to discuss a variety of issues.

Confidence in Hong Kong's financial system also requires that real or potential threats to its stability, whether large or small, are addressed promptly and effectively. We do this quietly in our day-to-day supervisory work of banks and other authorized institutions. We did it quickly and successfully in 2000-2001 by working with the note-issuing banks and Hong Kong Note Printing Limited to add new security features to the $1,000 banknotes when the spread of counterfeits began to undermine public trust in the note: partly as a result of this measure, counterfeit notes discovered in 2001 declined by 26%. The tragic events of 11 September forced us to take a harder look at our already well-developed contingency plans and to implement measures in support of the global effort to trace terrorist money.

More broadly, in our participation on behalf of Hong Kong in a number of international bodies, we have been seeking to promote reforms to the

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international financial architecture that will reduce the risk of volatility and crisis for small and open markets. This has proved to be a slow process. But there was some encouraging progress in this area in 2001 with the promulgation internationally of good practice guidelines for foreign exchange, and with various bilateral initiatives.

Maintaining confidence in our financial system requires constant vigilance and responsiveness on the part of the regulator and a strong record of safety and efficiency in the industries that operate the system. It is not an easy set of tasks in any environment. And the fact that the stability and safety of Hong Kong's monetary and banking systems have not been brought seriously into question during this period of economic distress is a remarkable indicator of Hong Kong's energy and resources as a financial centre.

The past year has been another challenging and productive one for the HKMA. It is largely owing to the determination and resourcefulness of the staff of the HKMA that we have been able to fulfil all of our major policy objectives, and to achieve more besides. I take great pleasure in recording here my appreciation of the effort and commitment they have put into their work, and my thanks for the strong and helpful guidance received from the Financial Secretary and the Exchange Fund Advisory Committee.

Joseph Yam
Chief Executive