

Chief Executive's Statement



The beginnings of economic recovery

Hong Kong's economy began to recover in 2002. Driven mainly by a strong rebound in external trade, particularly in the second half of the year, real gross domestic product grew by 2.3% in 2002 compared with an increase of 0.6% in 2001. Largely owing to export growth, and to the considerable increase in tourist visits and tourist expenditure, Hong Kong's current account surplus grew to 10.7% of GDP, compared with 7.5% in 2001. The global outlook continues to be uncertain, and the outbreak of atypical pneumonia in the spring of 2003 will undoubtedly have a negative impact both on Hong Kong and on other economies - although how great that impact will be remains to be seen.

Nevertheless, there are good grounds for believing that the momentum for growth will be sustained over the long run, particularly in view of the continuing economic vitality of Mainland China.

Despite signs of economic recovery, 2002 was a difficult year for many people in Hong Kong. The average unemployment rate for the year rose to 7.3% from 5.1% in 2001: the unemployment rate peaked at 7.8% in the three months ending in July,

but eased to 7.2% in the final quarter. The Hang Seng Index fell to a four-year low in October and ended the year 18% lower than at the end of 2001. Residential property prices continued to fall, placing more homeowners in negative equity. The number of personal bankruptcies rose to a historic high. Household income and consumer spending declined. The Composite Consumer Price Index fell by 3% during the year, nearly double the rate of decline in 2001.

Clearly it will take time for the strong gains in Hong Kong's external economy to translate into more employment opportunities and improved consumer sentiment within Hong Kong. The shift

in the composition of Hong Kong's external trade from domestic exports and re-exports towards offshore trade (which requires less labour in Hong Kong) also suggests that domestic employment may now be less sensitive to export growth than it was in the past.

The outlook continues to be uncertain, but there are good grounds for believing that the momentum for growth will be sustained over the long run, particularly in view of the continuing economic vitality of Mainland China.

Monetary stability and deflation

Against the background of domestic difficulty and considerable volatility in world markets, the Hong Kong dollar, under the Linked Exchange Rate system, remained stable during 2002, despite concerns about the impact of the Government's fiscal deficit on the Hong Kong dollar forward market.

The Linked Exchange Rate system, under which the Hong Kong dollar is pegged to the US dollar at the fixed rate of \$7.8 to one US dollar, continued to be a topic of debate within Hong Kong. This is to be expected, given the fact that the Link is the vehicle for - though not a cause of - the prolonged deflation that has been affecting Hong Kong. Deflation in Hong Kong is the product of a number of causes: the bursting of the property bubble; the steady decline in import prices; growing integration with the Mainland economy; the global economic slowdown; and, perhaps most important, a gradual unwinding of the appreciation, during the mid-nineties, of the real effective exchange rate of the Hong Kong dollar. The last of these factors, which reflects domestic prices adjustments and, more recently, the weakening of the US dollar, points to

a genuine and substantial increase in Hong Kong's external competitiveness.

In theory, lower prices ought to be welcome to consumers. In practice, however, persistent deflation encourages people to sit on their money rather than to spend it, which inhibits economic growth and feeds pessimism and uncertainty. Hong Kong's deflation is now in its fifth year. Since it began in 1998 consumer prices have declined by 14%. It is likely that deflation will continue, though for how long is one of the many uncertainties that confront us in a very

uncertain world. It is, however, unlikely that Hong Kong is experiencing - or will experience - the kind of spiralling deflation that has affected Japan for so many years. Hong Kong's economic performance - unlike Japan's - is mainly determined by external demand: domestic price declines help to boost

Hong Kong's economic performance is mainly determined by external demand: domestic price declines help to boost external competitiveness, which will in turn bring benefits to Hong Kong in the form of growth and increased employment.

external competitiveness, which will in turn bring benefits to Hong Kong in the form of growth and increased employment.

During 2002 we sought, through studies of deflation and other topics, to promote a greater understanding of the workings of the Linked Exchange Rate system and of its relationship with the larger economy. The findings of these studies were made available on our website and through other channels with the aim of helping to facilitate informed discussion both among specialists and in the community at large. The debate about the advantages and disadvantages of the Link will no doubt continue, and it is right that it should. The balance of opinion, both at home and abroad, seems to be that the Link continues to work in Hong Kong's best interests. Confidence in the Link was reinforced during the year by statements from the Hong Kong SAR Government that it has no plans to change the Linked Exchange Rate system.

The Exchange Fund

The Exchange Fund, which provides the foreign exchange backing for the Hong Kong dollar under the Linked Exchange Rate system, contains the foreign reserves of Hong Kong. Prudent management of the Fund, with

The Exchange Fund's investment return of 5.1% in 2002 was 120 basis points higher than the return on the benchmark set for the Fund.

the aim, among other things, of ensuring sufficient liquidity for the purpose of monetary stability and preserving the Fund's long-term purchasing power, is one of the main functions of the HKMA. The Exchange Fund had a very satisfactory year in 2002. The investment income of the Fund for the year was \$47 billion, representing an investment return of 5.1%. This was 120 basis points higher

than the return on the benchmark set for the Fund by the Exchange Fund Advisory Committee and favourable in comparison with similar funds in the market.

In December 2002 Exchange Fund Investment Ltd (EFIL) completed its programme, begun in 1999, for disposing of the greater part of the Hong Kong equities purchased by the Exchange Fund in August 1998, during the Asian financial crisis, at a cost of just over \$118 billion. The programme raised more than \$165 billion for the Exchange Fund. The remainder of the portfolio, valued at \$50.9 billion at the end of 2002, has been retained as a long-term investment. The conclusion of EFIL's work, without disruption to the market and with considerable profit to the Exchange Fund, marks the end of an important - and controversial - chapter in Hong Kong's monetary history.

Banking stability

Hong Kong's banking sector continued to perform well in 2002, despite the economic difficulties facing the community as a whole: retail banks' profitability generally held up well, overall asset quality improved, and capital adequacy remained well above international standards. The ability of banks to weather this extended period of economic difficulty so well says a great deal about their robustness and effective management,

The ability of banks to weather the extended period of economic difficulty so well says a great deal about their robustness and effective management.

particularly since this has also been a time of restructuring and increased competition within the industry.

During 2002 this restructuring - in the form of further consolidation and diversification of business - continued. Further progress was also made towards reducing barriers to competition with the relaxation of market entry criteria, the last of the market liberalisation measures in the HKMA's banking sector reform programme begun in 1999. Work proceeded on two schemes aimed at complementing market liberalisation with measures to enhance the safety and soundness of the banking system. The structure and design of a deposit protection scheme for Hong Kong was finalised, and draft legislation prepared for planned introduction into the Legislative Council in 2003. Consensus was reached with the industry on the framework for a commercial credit reference agency scheme, which is expected to begin operation in 2004. During 2002 the HKMA worked closely with industry associations and the Privacy Commissioner with the aim of contributing to a fairer and healthier credit environment by allowing the sharing of positive consumer credit data. Following a public consultation, revisions were made to the Code of Practice on Consumer Credit Data, which will take effect later in 2003.

The sharing of positive consumer credit data will, among other things, help address the rise in credit card defaults and the related problem of high rates of personal bankruptcies. Credit card and personal loan operations of banks were among the special areas of focus of the HKMA in its supervisory work. During the year, the HKMA also strengthened its supervision in the rapidly growing field of e-banking, and in areas of special concern, such as action against money laundering and terrorist financing and the business continuity plans of banks.

Efficient and safe payment and settlement systems

The HKMA paid attention to its own business continuity and contingency plans in 2002, in the light of the risky international situation, with the aim of ensuring in particular that Hong Kong's advanced payment and settlement systems have adequate back-up and disaster recovery arrangements.

The US dollar clearing system is becoming a facility for the whole region, and not just for Hong Kong, and is thus serving its purpose of improving settlement efficiency and reducing settlement risk in the Asian time zone.

Hong Kong's financial infrastructure continued to operate with 100% efficiency and reliability. The US dollar clearing system, now in its third year of operation, saw a steady increase in turnover, despite the difficult economic conditions. Increasingly it is becoming a facility for the whole region, and not just for Hong Kong, and is thus serving its purpose of improving settlement efficiency and reducing settlement risk in the Asian time zone. Plans were finalised for Hong Kong's euro clearing system, built on the same real time gross settlement design as the tried and tested Hong Kong dollar and US dollar systems. The euro clearing system was launched on schedule in April 2003. Work also continued on developing the HKMA's Central Moneymarkets Unit into a comprehensive securities clearing and settlement platform to serve both Hong Kong and the region: this was carried out through expanding external linkages and adding new features, such as the US Treasuries settlement capability introduced in December 2002.

Perhaps because it is so efficient and problem-free, the invisible infrastructure that enables complex financial transactions to take place in Hong Kong receives little attention. In contrast, the oldest and most visible component of the financial

infrastructure - the physical currency - is a matter for intense public scrutiny, particularly when changes are introduced. In the summer of 2002, responding to suggestions from the public, the Hong Kong SAR Government issued a new \$10 dollar note to circulate alongside the \$10 coin and the old \$10 notes issued by two of the note-issuing banks. The festive - some have said garish - design received mixed reviews. But the huge surge in issue of the note in the weeks leading up to the Lunar New Year, when presents of money are traditionally given out in red packets, indicated that a strong public demand exists for a note of this denomination. The notes have now found their way out of the red packets and appear to have become well established as part of the currency of Hong Kong.

Coins and notes are the oldest and simplest elements of Hong Kong's increasingly complex retail payment system. Yet they require the application of ever more sophisticated technology to ensure that they are proof against counterfeiting. The new \$10 note makes use of a number of advanced security features. A new generation of banknotes, developed by the note-issuing banks and the HKMA, will also make use of the latest technology to help combat counterfeiting. Planning for these banknotes was completed in 2002. The first batches of the new notes - which are currently at the printing stage - are scheduled for issue later in 2003.

Hong Kong as an international financial centre

The international dimensions of Hong Kong's financial infrastructure - like the circulation of Hong Kong currency well beyond the boundaries of Hong Kong itself - remind us that Hong Kong's financial system plays an important regional role. In support of the Hong Kong SAR Government's policies for maintaining the status of Hong Kong as an international financial centre, the HKMA seeks to promote appropriate market development initiatives to help strengthen the international competitiveness of Hong Kong's financial services. The HKMA also plays an active role in international and regional forums and in promoting initiatives that are conducive to financial stability: a number of these forums were hosted by the HKMA in Hong Kong in 2002. During the year the HKMA helped to develop Government proposals aimed at making Hong Kong a more attractive place for asset management business.

Since the Asian financial crisis great effort has been put into the development of the regional bond market with the aim both of promoting greater financial stability and of helping to enable more savings in the region to be invested within the region. This work is now bearing fruit. During the year a working group chaired by the HKMA under the Executives' Meeting of East Asia-Pacific Central Banks formulated proposals for an Asian Bond Fund, which will enable central banks in the region to invest a small portion of their foreign reserves in the Asian bond market. Together with its counterparts from Korea and Thailand, the HKMA also co-chaired an APEC initiative on the development of securitisation and credit guarantee markets, under the sponsorship of the World Bank.

The challenges ahead

Regional initiatives, such as those aimed at developing the Asian bond market, will help strengthen our financial systems against the kind of volatility seen in the late 1990s. They will also help the broader economic progress of the region by developing channels of financial intermediation - or,

The volume and complexity of our work has increased considerably, yet we cut staff by 5% and administrative expenditure by 9% during 2002 and we expect to achieve more savings in the year ahead.

in simpler terms, by putting savings to productive use. These are long-term projects. In the shorter term the region and

the world face the prospect of further international conflict, further economic slowdown and further volatility in markets.

As a small and open economy, Hong Kong is particularly vulnerable to the risks that arise from the difficult world situation. The HKMA, with its responsibilities for maintaining currency and banking stability and the efficiency of our financial infrastructure, plays a part in helping Hong Kong manage and address these risks. The volume and complexity of our work has increased considerably, yet we cut staff by 5% and administrative expenditure by 9% during 2002 and we expect to achieve more savings in the year ahead. Under considerable pressure, the staff of the HKMA have

successfully maintained the high standards for which the HKMA, in its ten years of existence, has become well known. It is a pleasure to place on record here my thanks for their dedication and hard work over the past ten years. I am also grateful for the strong guidance and support received from successive Financial Secretaries and Members of the Exchange Fund Advisory Committee over the years.



Joseph Yam
Chief Executive