



SUMMARY VERSION



The Hong Kong Monetary Authority

Established in April 1993, the Hong Kong Monetary Authority (HKMA) is the government authority in Hong Kong responsible for maintaining monetary and banking stability. The HKMA's policy objectives are

- to maintain currency stability, within the framework of the Linked Exchange Rate system, through sound management of the Exchange Fund, monetary policy operations and other means deemed necessary
- to promote the safety and stability of the banking system through the regulation of banking business and the business of taking deposits, and the supervision of authorized institutions
- to enhance the efficiency, integrity and development of the financial system, particularly payment and settlement arrangements.

This booklet is a summary of the HKMA's Annual Report for 2002. The full Annual Report may be purchased from the HKMA for HK\$100 (see Reference Resources on page 32 for details). It is also available on the HKMA website in interactive form and on PDF files.

**The main photographs in this Report show scenes in rural Hong Kong.
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High Island Reservoir, Sai Kung East Country Park

Rock formations at Tai Long Wan, Sai Kung East Country Park

Sai Kung Inner Port Shelter

Cofferdam at High Island Reservoir, Sai Kung East Country Park

Tsang Pang Kok Tsui, Sai Kung East Country Park


Waterfalls at Man On Shan Country Park

Trees at Kai Kung Shan, Sai Kung West Country Park

Other photographs show HKMA staff at work.

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All amounts in this Report are in Hong Kong dollars unless otherwise stated.

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.

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.

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.

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 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.

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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 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

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.

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, 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

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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. 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

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.

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, 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.

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Joseph Yam
Chief Executive

About The HKMA

The Hong Kong Monetary Authority (HKMA) is Hong Kong's central banking institution. The HKMA has four main functions: maintaining the stability of the Hong Kong dollar; promoting the safety of Hong Kong's banking system; managing Hong Kong's official reserves; and developing Hong Kong's financial infrastructure to enable money to flow smoothly, freely and without obstruction.

The HKMA's legal mandate

The HKMA was established on 1 April 1993 by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. To facilitate the establishment of the HKMA, the Legislative Council passed amendments to the Exchange Fund Ordinance in 1992 empowering the Financial Secretary to appoint a Monetary Authority.

The powers, functions and responsibilities of the Monetary Authority are set out in the Exchange Fund Ordinance and the Banking Ordinance.

The Exchange Fund Ordinance establishes the Exchange Fund under the control of the Financial Secretary. According to the Ordinance, the Fund shall be used primarily for affecting the exchange value of the Hong Kong dollar. It may also be used for maintaining the stability and integrity of the monetary and financial systems of Hong

Kong, with a view to maintaining Hong Kong as an international financial centre.

The Monetary Authority is appointed under the Exchange Fund Ordinance to assist the Financial Secretary in performing his functions under the Exchange Fund Ordinance and to perform such other functions as are assigned by other Ordinances or by the Financial Secretary. The office of the Monetary Authority is known as the HKMA and the Monetary Authority as the Chief Executive of the HKMA.

The Banking Ordinance provides the Monetary Authority with the responsibility and powers for regulating and supervising banking business and the business of taking deposits. Under the Ordinance, the Monetary Authority is responsible, among other things, for the authorization of licensed banks, restricted licence banks, and deposit-taking institutions in Hong Kong.

[www.hkma.gov.hk](#) > [About the HKMA](#) > [The HKMA](#) > [Who we are](#)

The HKMA and the Hong Kong SAR Government

The HKMA is an integral part of the Hong Kong SAR Government but is able to employ staff on terms different from those of the civil service in order to attract personnel of the right experience and

expertise. The Chief Executive of the HKMA is a public officer, as are his staff. In its day-to-day work the HKMA operates with a high degree of autonomy within the relevant statutory powers conferred upon, or delegated to, the Monetary Authority.

The Financial Secretary is responsible for determining the monetary policy objective and the structure of the monetary system of Hong Kong. The Monetary Authority is on his own responsible for achieving the monetary policy objective, including determining the strategy, instruments and operational means for doing so. He is also responsible for maintaining the stability and integrity of the monetary system of Hong Kong.

The Financial Secretary, assisted by the Secretary for Financial Services and the Treasury, has responsibility for policies for maintaining the stability and integrity of Hong Kong's financial system and the status of Hong Kong as an international financial centre. In support of these policies, the Monetary Authority is responsible, among other things, for

- promoting the general stability and effective working of the banking system
- promoting the development of the debt market, in co-operation with other relevant bodies
- matters relating to the issuance and circulation of legal tender notes and coins
- promoting the safety and efficiency of the financial infrastructure through the

development of payment, clearing and settlement systems and, where appropriate, the operation of these systems

- seeking to promote, in co-operation with other relevant bodies, confidence in Hong Kong's monetary and financial systems, and appropriate market development initiatives to help strengthen the international competitiveness of Hong Kong's financial services.

The Exchange Fund is under the control of the Financial Secretary. The Monetary Authority, under delegation from the Financial Secretary, is responsible to the Financial Secretary for the use of the Exchange Fund, and for the investment management of the Fund.

Accountability and transparency

The autonomy given to the HKMA in its day-to-day operations, and in the methods it uses to pursue policy objectives determined by the Government, is complemented by a high degree of accountability and transparency.

The HKMA serves Hong Kong by promoting monetary and banking stability, by managing the official reserves effectively, and by developing a robust and diverse financial infrastructure. These processes help to strengthen Hong Kong's role as an international financial centre and to foster Hong Kong's economic well-being.

The HKMA must have the confidence of the community if it is to perform its duties

well. The HKMA therefore takes seriously the duty of explaining its policies and work to the general public and makes every effort to address the concerns of the community.

The HKMA is accountable to the people of Hong Kong through the Financial Secretary, who appoints the Monetary Authority, and through the laws passed by the Legislative Council that set out the Monetary Authority's powers and responsibilities.

The HKMA also recognises a broader responsibility to promote a better understanding of its roles and objectives and to keep itself informed of community concerns. In its day-to-day operations and in its wider contacts with the community, the HKMA pursues a policy of transparency and accessibility. This policy has two main objectives:

- to keep the financial industry and the public as fully informed about the work of the HKMA as possible, subject to considerations of market sensitivity, commercial confidentiality and statutory restrictions on disclosure of confidential information
- to ensure that the HKMA is in touch with, and responsive to, the community it serves.

The HKMA seeks to follow international best practices in its transparency arrangements. It maintains extensive relations with the mass media and produces a range of regular and special publications in both English and Chinese. The HKMA's bilingual website (www.hkma.gov.hk) carries

all of the HKMA's publications, press releases, speeches and presentations, in addition to special sections on research, statistics, consumer information and other topics. An annual education programme seeks to inform the public, and in particular students, about the work of the HKMA through lectures, seminars, radio events and exhibitions. The HKMA's weekly *Viewpoint* column, carried on the HKMA website and in around ten Hong Kong newspapers, informs the public about aspects of the HKMA's work. Further information on the HKMA's media work, publications and public education programmes is contained in the Section on Professional and Corporate Services on page 30.

 [Viewpoint](#)

Over the years the HKMA has progressively increased the detail and frequency of its disclosure of information on the Exchange Fund and Currency Board Accounts. Since 1999 the HKMA has participated in the International Monetary Fund's Special Data Dissemination Standard project for central banks. The HKMA publishes records of meetings of the Exchange Fund Advisory Committee's Sub-Committee on Currency Board Operations, along with the monthly reports on Currency Board operations. The supervisory policies and guidelines on banking have been published on the website since 1996.

 [Information Centre » Press Releases » the Exchange Fund category](#)

 [Policy Areas » Supervisory Policy Manual](#)

The relations between the HKMA and the Legislative Council play an important part in the process of accountability and transparency. There is a formal commitment from the Chief Executive of the HKMA to appear before the Legislative Council Panel on Financial Affairs three times a year to brief Members and to answer questions on the HKMA's work. At one of these briefings, usually in May, the HKMA's Annual Report is presented. In addition, staff from the HKMA attend Legislative Council Panel meetings to explain and discuss particular issues, and attend Committee meetings to assist Members in their scrutiny of draft legislation.

[Information Centre](#) » [Legislative Council Issues](#)

Advisory and other committees

Exchange Fund Advisory Committee

In his control of the Exchange Fund, the Financial Secretary is advised by the Exchange Fund Advisory Committee (EFAC). EFAC is established under Section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Exchange Fund. The Financial Secretary is ex officio chairman of EFAC. Other members, including the Monetary Authority, are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR.

EFAC advises the Financial Secretary on investment policies and strategies for the

Fund and on projects, such as the development of financial infrastructure, that are charged to the Fund. Since the operating and staff costs of the HKMA are also chargeable to the Exchange Fund, EFAC advises the Financial Secretary on the HKMA's annual administration budget and on the terms and conditions of service of HKMA staff. EFAC meets regularly and on other occasions when particular advice is being sought.

EFAC is assisted in its work by three specialised sub-committees, which monitor specific areas of the HKMA's work and report and make recommendations to EFAC.

The *Sub-Committee on Currency Board Operations* monitors and reports on the Currency Board arrangements that underpin Hong Kong's Linked Exchange Rate system. It is responsible, among other things, for ensuring that Currency Board operations are in accordance with established policy, recommending improvements to the Currency Board system, and ensuring a high degree of transparency in the operation of the system. The Sub-Committee is composed of members of EFAC, a representative of the Hong Kong Association of Banks, additional members with expertise on the Currency Board system, and senior HKMA staff. Records of the Sub-Committee's meetings and the reports on Currency Board operations submitted monthly to the Sub-Committee are published.

[Information Centre](#) » [Press Releases](#) » [Monetary Policy category](#)

The *Remuneration and Finance Sub-Committee* makes recommendations to EFAC on pay and conditions of service, human resources policy, and budgetary and administrative issues. The Sub-Committee is composed of six non-official non-banking Members of EFAC.

The *Audit Sub-Committee* reviews and reports to EFAC on the HKMA's financial reporting process and the adequacy and effectiveness of the internal control systems of the HKMA. The Sub-Committee reviews the HKMA's financial statements, and the composition and accounting principles adopted in such statements. It also examines and reviews with both the external and internal auditors the scope and results of their audits. The Sub-Committee consists of four non-executive, non-official members of EFAC. It held two meetings in 2002.

The Banking Advisory Committee

The Banking Advisory Committee is established under Section 4(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong SAR on matters relating to the Banking Ordinance, in particular matters relating to banks and the carrying on of banking business. The Committee consists of the Financial Secretary, who is the chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR.

The Deposit-Taking Companies Advisory Committee

The Deposit-Taking Companies Advisory Committee is established under Section 5(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong SAR on matters relating to the Banking Ordinance, in particular matters relating to deposit-taking companies and restricted licence banks and the carrying on of the business of taking deposits by them. The Committee consists of the Financial Secretary, who is the chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR.

Chief Executive's Committee

The Chief Executive's Committee is chaired by the Chief Executive of the HKMA and consists of the Deputy Chief Executives and the Executive Directors of the HKMA. The Committee meets weekly to report to the Chief Executive on the progress of major tasks being undertaken by the various departments of the HKMA and to advise him on policy matters relating to the operations of the HKMA.

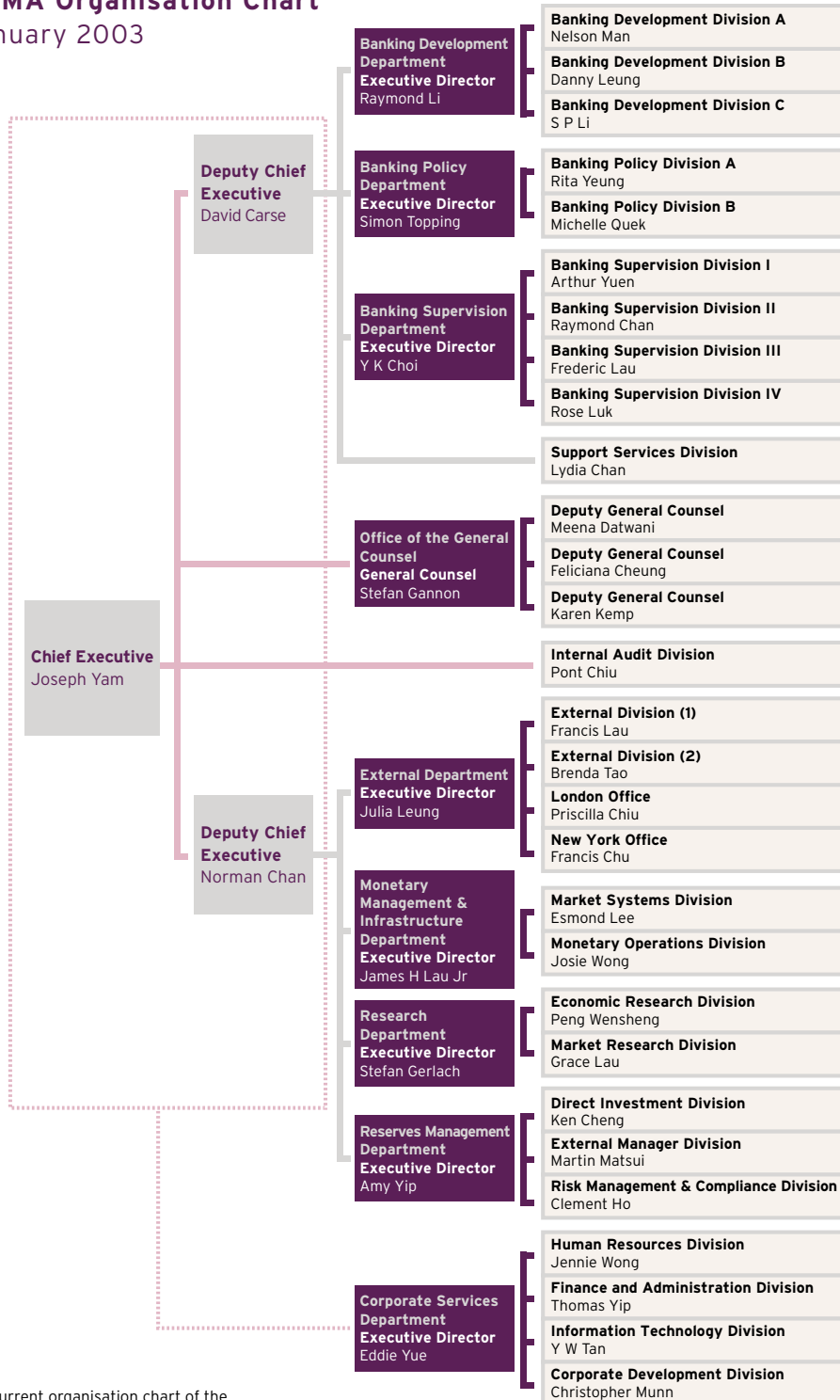
The membership lists of the various Committees and Sub-Committees and brief biographies of the members of the Exchange Fund Advisory Committee can be found on the HKMA website. A Register of Members' Interests, which contains the declarations of interests by Members of EFAC, is available for public inspection during office hours (9:00 a.m. to 5:00 p.m. Monday to Friday and 9.00 a.m. to 12 noon Saturday) at the HKMA Resource Centre, 8th Floor, 3 Garden Road, Hong Kong.

Further details on the governance arrangements for the HKMA may be found in the paper on this subject produced for the Legislative Council Panel on Financial Affairs in September 2002.

 [» About the HKMA](#) [» The HKMA](#) [» Advisory Committees](#)

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HKMA Organisation Chart January 2003



The current organisation chart of the HKMA may be found on the HKMA website
[» About the HKMA » The HKMA » Organisation Chart](#)

Economic and Banking Environment



Performance of the economy in 2002

The Hong Kong economy began to recover in 2002. Growth in real gross domestic product accelerated in the latter part of the year and registered an increase of 2.3% for the year as a whole. The main driver was strong export growth. Domestic demand, however, was constrained by the high unemployment rate and weak asset prices.

Prospects for 2003

Economic growth is expected to continue in 2003 in line with an expected recovery in the major economies. There are, however, two main uncertainties: the impact of the Iraq war on the global economy, and the impact of the atypical pneumonia

outbreak on domestic consumption and tourism.

Currency

A new \$10 note was introduced in response to a continuing demand for a \$10 note in addition to the \$10 coin. The new note, issued by the Hong Kong Special Administrative Region Government, began circulation in September 2002.

[» Consumer Information » Notes and Coins](#)

A comprehensive review of the design of Hong Kong dollar banknotes was completed in 2002 in preparation for a new series of banknotes for issue from late 2003 onwards. Additional security features will be included in the new series.

Performance of the banking sector in 2002

The banking sector continued to perform well in 2002. The banking industry remained resilient in the face of a number of challenges:

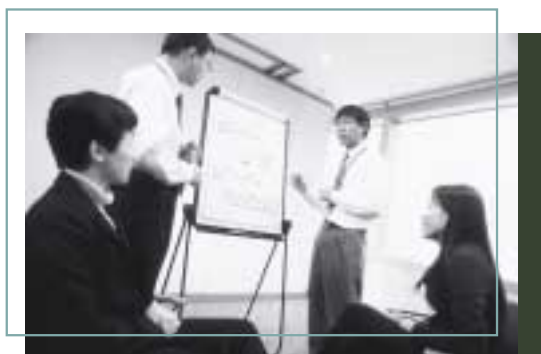
- the prolonged weakness of both the global and domestic economies
- increased bad debts in consumer lending portfolios and a high level of personal bankruptcies
- increased negative equity in residential mortgage loans caused by declining property prices.

The banks have generally responded to these challenges by diversifying into treasury business, fee-based financial products and wealth management.

Prospects for the banking sector in 2003

The banking sector will continue to be challenged by economic uncertainty in 2003. Loan demand is expected to remain subdued and the profit margin from consumer loan products such as mortgage and personal loans will continue to be squeezed owing to keen competition. Negative equity mortgage loans remain a concern for banks.

Consolidation within the industry is expected to continue as a means of achieving growth and cost reductions.



Hong Kong's economy in 2002

	2001	2002
Economic Growth and Inflation		
Real growth in Gross Domestic Product (%)	0.6	2.3^(a)
of which:		
Real growth in private consumption expenditure (%)	1.4	-1.6^(a)
Real growth in gross domestic fixed capital formation (%)	2.9	-4.4^(a)
Real growth in exports (%)	-1.8	9.3^(a)
Real growth in imports (%)	-1.7	7.0^(a)
Composite Consumer Price Index (annual change, %)	-1.6	-3.0
Labour Market		
Employment (annual change, %)	1.4	-0.6
Unemployment rate (annual average, %)	5.1	7.3
Money Supply (annual change, %)		
Hong Kong dollar M1	12.7	12.9
Hong Kong dollar M2 ^(b)	0.5	-0.7
Hong Kong dollar M3 ^(b)	0.7	-0.6
Interest Rates (end of year, %)		
Savings deposit rate	0.15	0.03
Best lending rate	5.13	5.00
Three-month interbank rate	1.88	1.41
Exchange Rates (end of year)		
Hong Kong dollar/US dollar	7.797	7.798
Trade-weighted effective exchange rate index (Jan 2000=100)	105.9	102.0
Hang Seng Index (end of year)		
	11,397	9,321

(a) The estimates are preliminary.

(b) Adjusted to include foreign currency swap deposits.

Performance of Hong Kong's banking sector in 2002

	2001 %	2002 %	2001 %	2002 %
	All AIs		Retail banks*	
Profitability^(a)				
Growth of pre-tax operating profit	N.A.	N.A.	-9.3	11.5
Return on assets (operating profit before tax)	0.83	0.91	1.15	1.32
Return on assets (post-tax profit)	0.76	0.81	1.05	1.18
Net interest margin	1.45	1.52	2.03	2.09
Bad debt charge to average total assets	0.23	0.24	0.40	0.34
Business Profile^(a)				
Growth in loans to customers	-11.2	-5.0	1.6	0.4
Growth in customer deposits (all currencies)	-3.4	-2.6	-0.5	0.7
Hong Kong dollar loan to deposit ^(b) ratio	88.8	88.5	77.2	78.6
Asset Quality^(c)				
Classified loans ^(d) as % of total loans	5.73	4.53	6.53	5.05
Non-performing loans ^(e) as % of total loans	4.37	3.47	5.16	3.95
			All locally incorporated AIs	
Capital Adequacy Ratio (consolidated)			16.5	15.8

(a) Figures relate to Hong Kong office(s) only.

(b) Includes swap deposits.

(c) Figures relate to Hong Kong office(s) and in the case of local AIs include overseas branches.

(d) Denotes loans graded as "substandard", "doubtful" or "loss".

(e) Denotes loans on which interest has been placed in suspense or on which interest accrual has ceased.

* This comprises all the locally incorporated banks plus a number of the larger foreign banks which are not locally incorporated but whose operations are similar to those of the locally incorporated banks in that they operate a branch network and are active in retail banking.

N.A.: not available

Monetary Stability



The Linked Exchange Rate system

The primary policy objective of the HKMA is to maintain exchange rate stability under the Linked Exchange Rate system. The Linked Exchange Rate system, through which the Hong Kong dollar is fixed at the rate of HK\$7.8 to the US dollar, is the foundation of monetary stability in Hong Kong. Established in 1983, the system operates according to Currency Board principles, which require the Monetary Base to be fully backed by US dollars. The Monetary Base consists of Certificates of Indebtedness (for backing the banknotes issued by the note-issuing banks), Government-issued currency notes and coins, the balance of the clearing accounts of banks kept with the HKMA, and Exchange Fund Bills and Notes.

dollar weakens, the HKMA stands ready to purchase Hong Kong dollars from banks at the convertibility undertaking rate of HK\$7.80 per US dollar. This leads to a contraction of the Monetary Base. Interest rates then rise, creating the monetary conditions conducive to capital inflows to maintain exchange rate stability. Conversely, if there is an increase in the demand for Hong Kong dollar assets, leading to a strengthening of the market exchange rate, banks may purchase Hong Kong dollars from the HKMA. The Monetary Base correspondingly expands, exerting downward pressure on interest rates and so discouraging continued inflows.

[www](#) » [Policy Areas» Monetary Stability »](#)
[Currency Board System](#)



Under the Currency Board system, the stability of Hong Kong dollar exchange rate is maintained through an automatic interest rate mechanism. If there is a decrease in demand for Hong Kong dollar assets and the market exchange rate of the Hong Kong

Monetary conditions in 2002

Although the external and domestic environment was difficult in 2002, the Hong Kong dollar market exchange rate remained stable. The market exchange rate of the Hong Kong dollar stayed within a narrow range of 7.7980 - 7.8000 during the year, close to the convertibility rate.

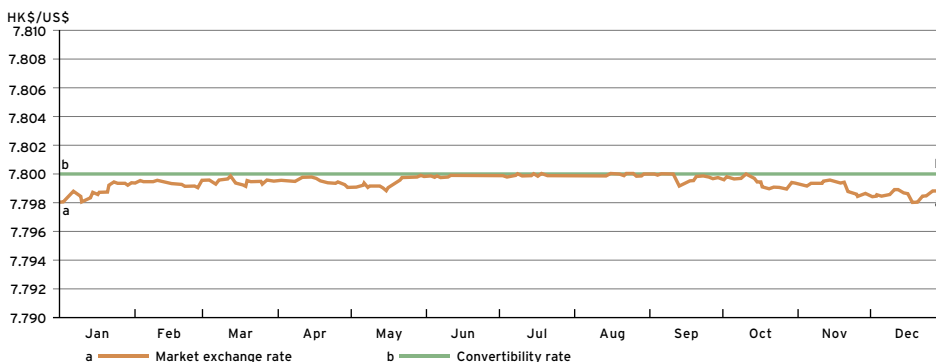
Interbank interest rates also stayed close to their US dollar counterparts. Nevertheless, their spread against the US dollar rates widened in the first and the fourth quarters of 2002, reflecting concerns about the fiscal imbalances and rumours

about a change in the Linked Exchange Rate system.

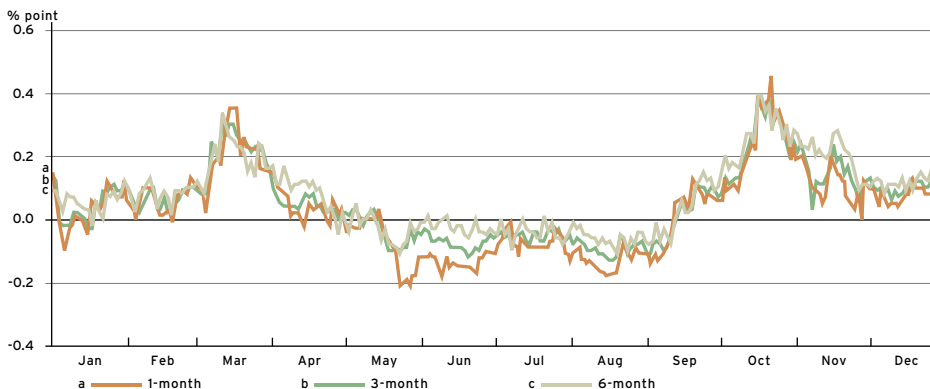
Activities at the HKMA

The Exchange Fund Advisory Committee's Sub-Committee on Currency Board Operations continued to monitor the Currency Board arrangements in 2002 and examined a wide range of issues affecting monetary and financial stability in Hong Kong. The Hong Kong Institute for Monetary Research issued 23 working papers in 2002 on a variety of monetary and financial issues relevant to Hong Kong and the region.

Market exchange rate and convertibility rate, January-December 2002



Hong Kong dollar - US dollar interest rate differentials, January-December 2002



Banking Stability



Policy objective

One of the policy objectives of the HKMA is to promote the safety and stability of the banking system through the regulation of banking and deposit-taking business and the supervision of authorized institutions (AIs)¹. Under the Banking Ordinance, the HKMA is the licensing authority for AIs.

The HKMA's supervisory approach is based on a policy of "continuous supervision". This involves on-going monitoring of AIs through the use of a variety of techniques, including on-site examinations, off-site reviews, prudential meetings, meetings with boards of directors, co-operation with external auditors, and sharing of information with other supervisors. The

aim is to try to ensure that any problems affecting AIs are detected and addressed at an early stage. The HKMA has, since 1999, adopted a risk-based supervisory approach. The objective of this approach is to ensure that AIs have the necessary risk management systems in place to identify, measure, monitor and control risks inherent in their business operations. This in turn enables the HKMA to be more proactive in taking actions to pre-empt any serious threat to the stability of the banking system.

[» Policy Areas » Banking Stability](#)

¹ Institutions authorized under the Banking Ordinance to carry on banking business or the business of taking deposits. Authorized institutions are divided into three tiers: licensed banks, restricted licence banks and deposit-taking companies.

Supervision of banks

To promote the safety and soundness of AIs, in 2002 the HKMA

- continued to monitor closely the asset quality of AIs
- continued to improve the implementation of the risk-based supervisory approach
- made further progress in the development of supervisory policies on general risk management controls, interest rate risk management, stress testing and business continuity planning
- extended on-site examinations to cover AIs' information technology controls and e-banking services
- promoted proposals for the sharing of positive consumer credit data with a view to tackling the bankruptcy problem and improving the general credit environment of Hong Kong
- completed the arrangements for the new securities supervisory regime
- stepped up efforts to combat money laundering and terrorist financing.

Banking reform

The following initiatives were taken in 2002:

- finalising the design and structure of the deposit protection scheme and preparing draft legislation

- establishing the framework for a commercial credit reference agency
- relaxing the market entry criteria to attract a broader range of institutions to set up banking business in Hong Kong.

Consumer issues

The HKMA monitored AIs' compliance with the *Code of Banking Practice* by introducing a new annual self-assessment framework in 2002. According to the self-assessment in 2002, 90% of institutions comply fully, or almost fully, with the Code. Where AIs identified non-compliance with the Code, the HKMA required them to take remedial actions to rectify the problem.

The HKMA issued a leaflet advising customers on what to do if they have a complaint against a bank.

 [Consumer Information](#)



Market Infrastructure



Policy Objective

The HKMA is committed to promoting an efficient, safe and reliable financial infrastructure, which is one of the main competitive advantages of Hong Kong as an international financial centre. The long-term aim is for Hong Kong to be a leading centre of financial intermediation, where all types of financial transactions, initiated from whatever location or time zone and in whatever currency, whether at the wholesale or retail level, can be executed and settled in real time.

During 2002 the HKMA continued to develop and refine Hong Kong's payment systems infrastructure, and to expand Hong Kong's external financial linkages.

[» Policy Areas » Financial Infrastructure](#)

Clearing systems

The Hong Kong dollar clearing system and the Central Moneymarkets Unit¹ (CMU) continue to provide efficient and reliable settlement for financial transactions in Hong Kong.

The US dollar clearing system operated smoothly and efficiently in 2002. Despite the slowdown in the economy, the turnover of the system grew steadily (Chart). Preparation for launching the euro clearing system in April 2003 is at an advanced stage.

¹ The Central Moneymarkets Unit (CMU) is a clearing and custodian system operated by the HKMA for Exchange Fund Bills and Notes and for private sector debt paper.

International linkages

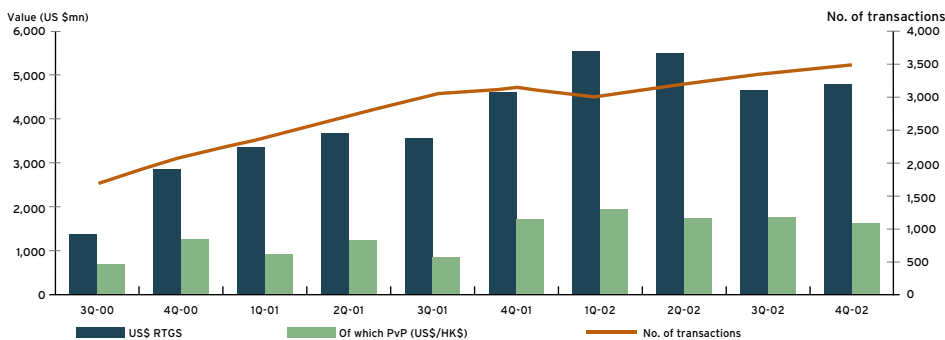
The HKMA continued to develop Hong Kong's external financial linkages in 2002 by

- establishing a two-way link between Euroclear and the HKMA's CMU
- developing the link from the government debt clearing system in Mainland China to the CMU to enable authorized financial institutions in Mainland to hold and settle international securities via the link
- launching a clearing and settlement capability for US Treasuries in the CMU

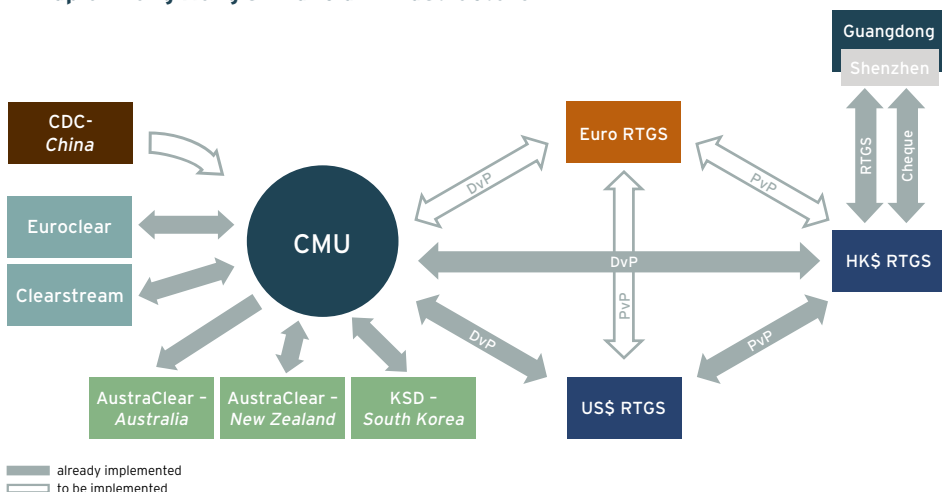
- introducing two-way Hong Kong dollar cheque clearing between Hong Kong and Guangdong
- launching an interface between Shenzhen and the Hong Kong dollar RTGS system.



US dollar RTGS turnover (daily average)



A map of Hong Kong's financial infrastructure



International Financial Centre



The HKMA and the international financial community

The establishment of the HKMA has enabled Hong Kong to strengthen its contacts with the international central banking and financial community. These contacts enable the HKMA

- to promote international understanding of, and support for, monetary and banking policies in Hong Kong
- to share information with other central banks about financial developments so as to facilitate the proper oversight of financial markets and the prudential supervision of financial institutions
- to improve understanding of international economic and financial trends so as to facilitate more effective policy formulation in the HKMA
- to improve the HKMA's access to the technical expertise available in major central banks and multilateral institutions
- to help other central banks and institutions to obtain a better understanding of monetary and general economic developments in Hong Kong and the region.

[www](#) » [Policy Areas](#) » [Monetary Stability](#) » [External Relations](#)

Regional monetary co-operation and participation in multilateral forums

The HKMA contributed significantly to policy dialogues in international and regional forums in 2002. The HKMA hosted the 7th semi-annual meeting of the

Financial Stability Forum¹ in March 2002 and facilitated the organisation of the Bank for International Settlement Special Governors' Meeting in Hong Kong in February 2002. Regionally, the HKMA continued to participate in the activities of the Executives' Meeting of East-Asia Pacific Central Banks (EMEAP) and chaired its Working Group on Financial Markets and the Forum on Foreign Exchange Markets since June 2002.

The HKMA hosted a number of important regional forums during the year. These included the Central Banking Group of South East Asia, New Zealand and Australia (SEANZA) Governors' Symposium and Governors' Meeting, and the Asia-Pacific Economic Co-operation (APEC) Policy Dialogues on Strengthening Market Disciplines and Strengthening Corporate Governance in the Financial Sector.

Compliance with international codes and standards

In 2002 the HKMA co-ordinated Hong Kong's participation in the Financial Sector Assessment Programme (FSAP), a joint IMF-World Bank initiative with the aim of promoting financial stability. The FSAP assessed Hong Kong's compliance with the key international standards applicable to the banking and financial sectors. The FSAP

Mission confirmed that the financial system of Hong Kong is fundamentally sound and that the market infrastructure of Hong Kong is robust and efficient.

Development of regional bond markets

The HKMA took the lead in the development of an Asian Bond Fund (ABF) idea under the EMEAP forum. The ABF facilitates the investment of a small portion of Asian central banks' foreign reserves in Asian bonds for the purposes of portfolio diversification and yield enhancement. This represents a significant step in regional central bank co-operation and helps channel some of Asia's official reserves back to the region to finance Asia's own economic development.

The HKMA co-chaired with Korea and Thailand an APEC Initiative on the development of securitisation and credit guarantee markets, with the World Bank as sponsor.



¹ The FSF was established in April 1999, at the initiative of G7 Finance Ministers and Central Bank Governors, to promote international financial stability. Members of the FSF include national financial authorities from G7, Australia, Hong Kong, the Netherlands, and Singapore; the European Central Bank; international financial institutions; international regulatory and supervisory groupings; and committees of central bank experts.

Reserves Management



The Exchange Fund

The Exchange Fund holds the backing for Hong Kong's Linked Exchange Rate system. It is managed by the HKMA under powers delegated by the Financial Secretary to the Monetary Authority under the Exchange Fund Ordinance. The investment objectives of the Exchange Fund are

- (a) to preserve capital;
- (b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid short-term US dollar denominated securities;
- (c) to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and
- (d) subject to (a) and (c) above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

Performance of the Exchange Fund in 2002

In 2002 the HKMA achieved an investment income of \$47 billion for the Exchange Fund, representing an investment return of 5.1%. This was 120 basis points above the return on the benchmark set by the Exchange Fund Advisory Committee and compared favourably with the returns of similar funds in the market.

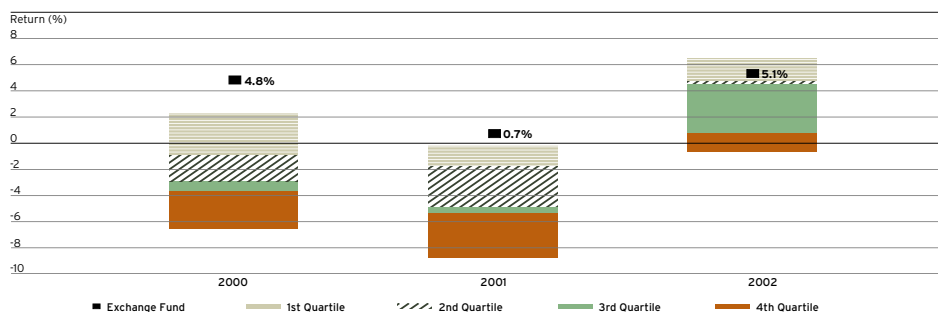
Disposal and investment management of the Hong Kong equity portfolio

In 2002 the Exchange Fund, through Exchange Fund Investment Limited, disposed of a total of \$21,977 million worth of Hong Kong equities acquired during the 1998 stock market operation through the Tap Facility of the Tracker Fund of Hong Kong. The Tap Facility was exhausted in the fourth quarter of 2002 and was subsequently terminated.

The completion of the orderly disposal of Hong Kong equities through the Tap Facility between 1999 and 2002 raised sales proceeds of \$165.2 billion (including dividends). At 31 December 2002 the balance of the Hong Kong equities, valued at \$50.9 billion, was retained by the Exchange Fund as a long-term investment.



Investment performance of the Exchange Fund and comparable Balanced Funds¹



¹ Balanced Funds with 20% - 30% equity component.
Source: Watson Wyatt and Standard & Poor's

2002 market returns

Currencies

Appreciation against the US dollar	
euro	17.9%
yen	10.4%

Bond markets

Merrill Lynch Global Government Bond Index, 1-10 years (in US dollar terms)	18.6%
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Equity markets

Standard & Poor's 500 Index	-23.4%
Hang Seng Index	-18.2%

Currency mix of the Exchange Fund's assets (at 31 December 2002) - including forward transactions

	HK\$ billion	%
US dollar	686.6	71.9
Hong Kong dollar	63.4	6.6
European currencies	174.8	18.3
Yen	26.6	2.8
Others	3.7	0.4
Total	955.1	100.0

Gross investment return of the Exchange Fund (in US dollar terms)¹

	Return on total assets	Return on investment benchmark ²	CPI(A) ³
2002	5.1%	3.9%	+1.0%
2001	0.7%	0.4%	-6.2%
1993-2002 cumulative	86.3%	N/A	25.5%
1993-2002 annualised	6.4%	N/A	2.3%

¹ For the Annual Reports in 2000 and preceding years, return on total assets and return on investment benchmark is in Hong Kong dollar terms.

² Established in January 1999.

³ December year-on-year percentage change in the HK-CPI(A) index. CPI(A) is calculated based on the 1999/2000 base new series.

The Exchange Fund

The financial position of the Exchange Fund in 2002 is shown below in the Income and Expenditure Account and Balance Sheet, which are extracted from the HKMA Annual Report for 2002. The audited full statement of account of the Exchange Fund for 2002 may be found on pages 84 to 111 of the full Annual Report.

Exchange Fund - Income and Expenditure Account

for the year ending 31 December 2002

(Expressed in millions of Hong Kong dollars)	2002	2001
INCOME		
Interest income		
Interest income on debt securities	29,662	34,091
Other interest income	3,608	5,818
Total interest income	33,270	39,909
Dividend income from listed equity securities	3,237	3,668
Net realised and revaluation gains/(losses) on other investments in securities	(6,542)	(24,956)
Other net realised and revaluation gains/(losses)	(10,184)	1,801
Net exchange gains/(losses)	27,241	(13,059)
Bank licence fees	134	154
Others	33	26
TOTAL INCOME	47,189	7,543
EXPENDITURE		
Note and coin expenses	273	144
Operating expenses	1,162	1,070
Interest expense	21,169	10,839
TOTAL EXPENDITURE	22,604	12,053
SURPLUS/(DEFICIT) FOR THE YEAR	24,585	(4,510)

Exchange Fund - Balance Sheet

at 31 December 2002

(Expressed in millions of Hong Kong dollars)	2002	2001
ASSETS		
Cash and money at call	15,956	13,848
Placements with banks and other financial institutions	35,475	85,403
Investment securities	300	300
Other investments in securities	878,838	853,898
Gold	179	145
Thailand financing package	1,058	4,149
Other assets	19,678	18,534
Investments in subsidiaries	2,145	2,145
Investment in associate	-	7
Fixed assets	1,436	717
TOTAL ASSETS	955,065	979,146
LIABILITIES AND FUND EQUITY		
Certificates of Indebtedness	118,475	107,545
Government-issued currency notes and coins in circulation	5,891	5,691
Balance of the banking system	525	671
Exchange Fund Bills and Notes	122,925	118,157
Placements by banks and other financial institutions	36,270	47,122
Placements by other Hong Kong Special Administrative Region government funds	301,669	380,602
Placements by Hong Kong statutory bodies	4,279	5,124
Other liabilities	37,857	11,645
Total liabilities	627,891	676,557
Accumulated surplus	327,174	302,589
TOTAL LIABILITIES AND FUND EQUITY	955,065	979,146

Professional and Corporate Services



Overview

The HKMA relies on a range of in-house professional and corporate services to carry out its operations. During the year, a number of measures were introduced to improve the quality of services and to make the whole organisation more cost-effective and efficient.

The HKMA in the community

The HKMA places great emphasis on promoting an understanding of its policies and work among the general public. This is done through extensive contacts with the media, publications, a comprehensive website, a public enquiries service and educational programmes.

A comprehensive review of the scope, contents and format of the two HKMA periodicals, the *Monthly Statistical Bulletin* and *Quarterly Bulletin*, was conducted in 2002. The new editions of the two periodicals were launched in early 2003. [» Information Centre » Publications](#)

Cost saving measures

In 2002 the HKMA achieved savings of 31 posts, or 5% of total establishment, through re-engineering work processes and re-prioritising work areas. The total administrative expenses were reduced by 9% in 2002. Two senior posts have been frozen and a further six posts will be deleted in 2003.

A Procurement Office was set up in September to achieve higher cost-effectiveness and to tighten control over procurements.

Human Resources

A more structured and focused approach to staff training was adopted in 2002 to provide a stronger link between the training programme and the career development process. Overall, a total of 4,310 training days were provided for staff.

Office of the General Counsel

The Office of the General Counsel advises the HKMA on the legal aspects of its work. In 2002 the Office of the General Counsel was involved in a number of special projects, including the preparatory work for the introduction of the deposit protection scheme, the development of a euro clearing system in Hong Kong and the issue of the new \$10 note.

Internal Audit

The Internal Audit Division (IAD) was established in 1995 to assist management in controlling risks, monitoring compliance and improving the efficiency and effectiveness of control systems and procedures within the HKMA. The IAD reports directly to the Chief Executive of the HKMA and the Audit Sub-Committee of the Exchange Fund Advisory Committee. In 2002, the results of the audits conducted were satisfactory and the recommendations for improvement put forward by the IAD were well received.

[About the HKMA](#) » [Internal Audit](#)



Reference Resources

The HKMA Annual Report is published in April or May each year. A number of other HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include

HKMA Quarterly Bulletin

(published in March, June, September and December each year)

HKMA Monthly Statistical Bulletin (on-line publication)

(published in two batches on the third and sixth business days of each month)

Guide to Hong Kong Monetary and Banking Terms (Second Edition)

HKMA Background Brief No. 1 - Hong Kong's Linked Exchange Rate System

HKMA Background Brief No. 2 - Banking Supervision in Hong Kong

Money in Hong Kong: A Brief Introduction

Most HKMA publications are available for download free of charge from the HKMA website (www.hkma.gov.hk). An order form for the purchase of print publications can be found on the website.

 » [Information Centre](#) » [Publications](#)

The main texts of the regular briefings by the HKMA to the Legislative Council Panel on Financial Affairs are available on-line.

 » [Information Centre](#) » [Legislative Council Issues](#)

The HKMA website contains detailed and extensive information on the whole range of the HKMA's work. This information includes press releases, statistics, speeches, guidelines and circulars, research memoranda, and features on topical issues.

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