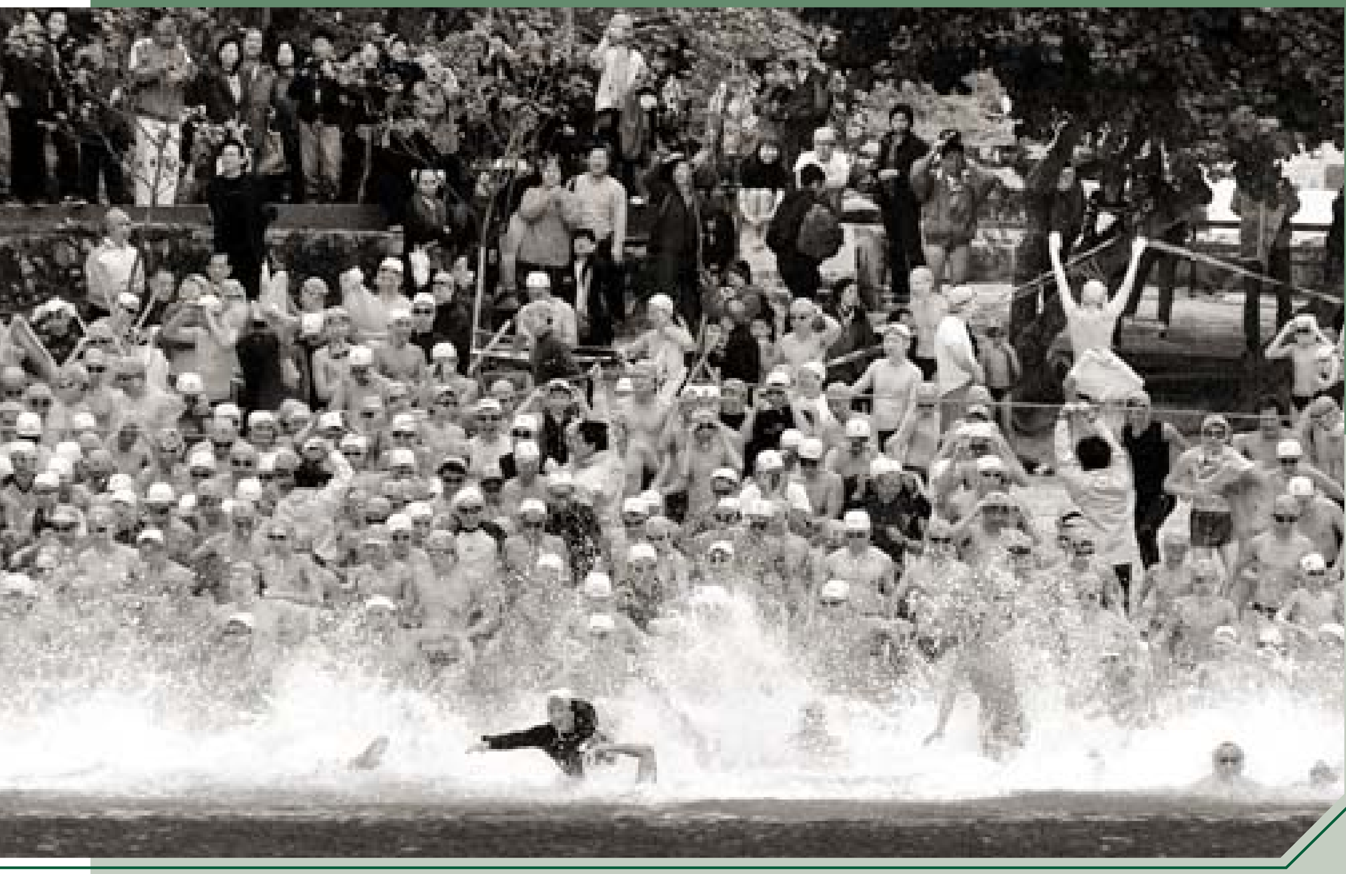


More than 2,000 swimmers brave chilly waters to take part in the 27th International New Year Winter Swimming Championships held on the south side of Hong Kong Island to welcome the New Year in 2003.

ECONOMIC AND BANKING ENVIRONMENT

After the severe disruption by the outbreak of SARS (severe acute respiratory syndrome) in the second quarter of 2003, Hong Kong's economy rebounded sharply in the second half of the year. The overall asset quality of the banking sector improved. With improved economic conditions in the second half, the banking sector ended the year with a modest growth in profitability.

THE ECONOMY IN REVIEW

Overview

Hong Kong experienced very difficult economic conditions in the first half of 2003 reflecting, in particular, the effects of the outbreak of SARS in the second quarter. Growth returned in the second half of the year and Hong Kong emerged as a strong-performing economy in the region. Real GDP rose by 3.3% in 2003, compared with 2.3% in 2002. Exports of goods and trade-related services were largely unaffected by the SARS outbreak. Exports of tourism-related services showed a sharp turnaround in the second half of 2003, boosted by a relaxation of travel restrictions on Mainland visitors to Hong Kong. Private consumption also picked up markedly as consumer confidence recovered. Investment spending on machinery, equipment and computers started to recover in the second half, but spending on building and construction remained weak (Table 1).

Monetary conditions eased further during the year, with declines in both Hong Kong dollar interest rates and the real effective exchange rate. Broad money growth picked up moderately alongside the recovery in economic activity. Narrow money growth was strong, owing to low interest rates and an increase in transaction demand resulting, in part, from robust stock market activity.

TABLE 1 Contributions to GDP growth by components (%)

	2002[1]					2003[2]				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	0.0	-1.5	-0.5	-0.7	-0.7	-1.1	-2.1	0.9	2.0	0.0
Government Consumption Expenditure	0.2	0.3	0.3	0.1	0.2	0.1	0.0	0.1	0.5	0.2
Gross Domestic Fixed Capital Formation	-3.4	0.0	-1.2	-0.2	-1.2	0.9	-1.5	-0.1	0.6	0.0
Change in Inventories	-1.2	-0.1	1.3	2.3	0.6	1.8	0.1	-1.0	1.0	0.5
Net Exports of Goods	2.2	-0.5	0.3	-0.5	0.3	-1.0	3.3	2.1	-1.9	0.6
Net Exports of Services	1.6	2.8	3.3	4.2	3.0	3.9	-0.3	2.1	2.8	2.1
GDP	**-0.6**	**0.8**	**3.4**	**5.1**	**2.3**	**4.5**	**-0.5**	**4.0**	**5.0**	**3.3**

[1] Revised figures
[2] Preliminary figures

Reviving domestic demand

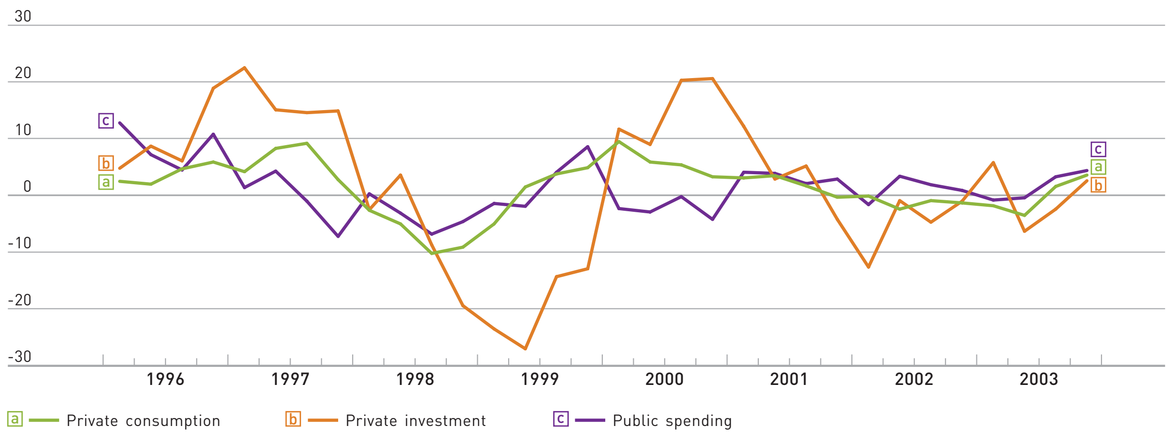
Private consumption was weak in the early part of 2003 but recovered strongly in the second half of the year. Consumer confidence rose, as a result of improvements in the global economy and a decline in unemployment and more stable asset markets at home. One important source of optimism was the policy initiatives designed to facilitate closer economic integration between Hong Kong and the Mainland. These include the Closer Economic Partnership Arrangement (CEPA), the relaxation of travel restrictions on Mainland visitors to Hong Kong, and approval for Hong Kong banks to undertake personal renminbi banking business on a trial basis. Spending on durable goods and services registered particularly strong growth in the second half. For the year as a whole, private consumption expenditure was little changed in 2003, after a decline of 1.2% in 2002 (Chart 1).

Despite the improvement in the economy in the second half of 2003, investment remained weak. Private investment continued to decline, by 0.3%, largely owing to lower expenditure on building and construction, although at a more moderate rate than in the preceding year. Investment in machinery, equipment and computer software by the private sector recorded a rise of 6.9%. Public investment rose slightly as a number of new infrastructure projects came on stream in the second half of the year (Chart 1).

Buoyant external trade

Exports of goods recorded double-digit growth rates throughout the year, supported by robust growth of Mainland exports, and improved competitiveness as a result of the depreciation of the US dollar (to which the Hong Kong dollar is linked). The rush by Chinese exporters to ship products ahead of the pre-announced reduction in VAT rebates, due to be implemented on the Mainland in January 2004, also contributed to particularly strong growth of merchandise exports in the fourth quarter of the year. Among the major markets, exports to East Asia and to the European Union grew strongly, while export performance to

CHART 1 Domestic demand (percentage change over a year ago in real terms)



the United States was somewhat weak (Table 2). Along with a buoyant re-export trade, imports of goods rose by 13.1% in 2003 compared with 2002. The merchandise trade deficit widened to $45.0 billion in 2003, from $39.4 billion in 2002 (Chart 2), reflecting faster growth of goods exports relative to imports.

Trade-related exports of services also grew strongly, partly owing to vibrant merchandise exports. By contrast, tourism-related earnings, affected by the SARS outbreak, fell sharply in the second quarter. Earnings bounced back very sharply in the second half of the year helped by the relaxation of travel restrictions on Mainland visitors, making the tourism industry an important driver of growth in the economy. The recovery in imports of services was more modest. The overall trade surplus, goods and services combined, amounted to $116.1 billion, or 9.4% of GDP.

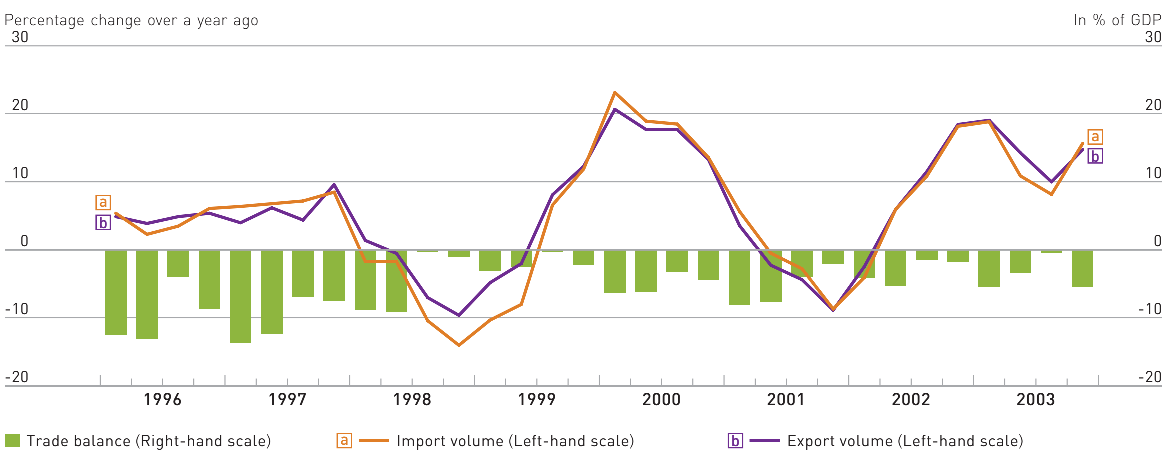
TABLE 2 **Exports to major trading partners**[1]

	Share	2002					2003				
	%	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	43	3	8	13	25	12	27	21	16	21	21
United States	19	-15	1	6	9	1	7	-5	-7	-3	-3
European Union	13	-15	-7	1	7	-3	16	17	8	8	12
Japan	5	-14	-10	-2	7	-4	14	17	11	9	12
ASEAN5[2] + Korea	7	4	10	20	22	14	9	11	7	10	9
Taiwan	2	-10	-7	11	-2	-2	25	17	15	32	22
Others	10	-7	3	6	13	4	10	6	-2	6	5
Total	**100**	**-6**	**3**	**8**	**16**	**5**	**18**	**12**	**7**	**11**	**12**

1 Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.

2 ASEAN5 includes the Philippines, Malaysia, Indonesia, Singapore and Thailand.

CHART 2 **External merchandise trade**



Easing deflationary pressures

Deflationary pressures intensified in the first half of 2003, but eased markedly towards the year's end. The Composite Consumer Price Index (CCPI) recorded the sharpest falls during May and July, reflecting the impact of SARS. Since then, prices appeared to stabilise, as economic growth recovered, with the seasonally adjusted CCPI rising slightly month on month since August. For 2003 as a whole, the CCPI fell by 2.6% compared with 2002. Import prices declined by 0.4%, less than the 3.9% fall in 2002, owing to a weaker US dollar and firmer world commodity prices.

Improving labour market conditions

Labour market conditions lagged behind the economic recovery but improved in the last quarter of 2003 after a substantial deterioration in the first half of the year. The unemployment rate reached a record high of 8.7% in the three months to July, partly owing to the impact of the outbreak of SARS, but it subsequently fell to 7.3% in the three months to December as growth recovered (Chart 3). The improvement was broadly based, but consumption and tourism-related sectors did particularly well. Labour income, however, has yet to recover. The nominal index of payroll per person engaged was 2.1% lower in the first three quarters of the year compared with the same period a year earlier, while median household income fell by 6.1% in 2003.

Recovery in asset markets

The Hang Seng Index started the year on a weak note in line with developments in other major stock markets, which were affected by the uncertainties surrounding the war in Iraq. The Hong Kong stock market was also affected by SARS, and fell sharply to a low of around 8,400 in late April even as US and European markets rallied. Market sentiment started to improve in May, as SARS was progressively brought under control. Investor confidence was also boosted by the series of measures designed to facilitate economic integration with the Mainland. These measures are expected to help the structural adjustment of the Hong Kong economy and develop its competitiveness. They are thought to have increased investors' appetite for domestic assets, especially for stocks likely to benefit directly. As a result, the Hang Seng Index rebounded strongly to close the year at 12,576, or 35% higher than at the end of 2002.

CHART 3 **Labour market**

The property market was also hit hard by SARS, but the economic recovery, new supply restraint measures introduced in November 2002, and an associated rise in consumer optimism, coupled with low funding costs, led to a revival of the market in the last few months of 2003. The number of transactions increased by 1.6% during the year. Residential property prices rose by 10.3% between their trough in July and the end of year, although they were still lower in 2003 as a whole compared with 2002.

MONETARY CONDITIONS

Monetary conditions continued to ease in 2003 as a result of further declines in interest rates and in the effective exchange value of the Hong Kong dollar. Hong Kong dollar interest rates declined to almost zero per cent in the fourth quarter of the year, owing to a surge in capital inflows. These reflected the recovery in growth as well as confidence about economic prospects stemming from the series of measures undertaken to facilitate economic integration with the Mainland. The trade-weighted real effective exchange rate fell in 2003, reflecting a significant US dollar depreciation against other major international currencies.

Recovery of narrow and broad money growth

Monetary aggregates increased in 2003. Hong Kong dollar narrow money (seasonally adjusted) rose sharply during the year, by 35.8%, while broad money growth recovered in mid-2003 and grew by 5.9% in the year to December 2003. The strong growth of narrow money can be attributed to lower interest rates and the significant rebound in stock market activity during the second half of the year. The growth of broad money reflected the revival in economic activity more generally.

Notes and coins

At the end of 2003 the total value of banknotes in circulation was $134,215 million, an increase of 13.3% on a year earlier (Charts 4, 5, 6). The total value of Government-issued notes and coins in

CHART 4 Banknotes in circulation at end of year

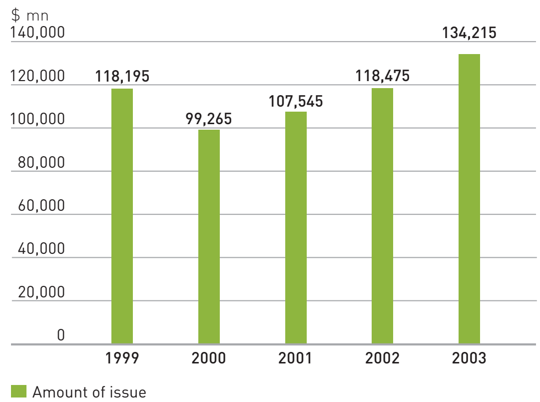


CHART 5 Distribution of banknotes in circulation at the end of 2003

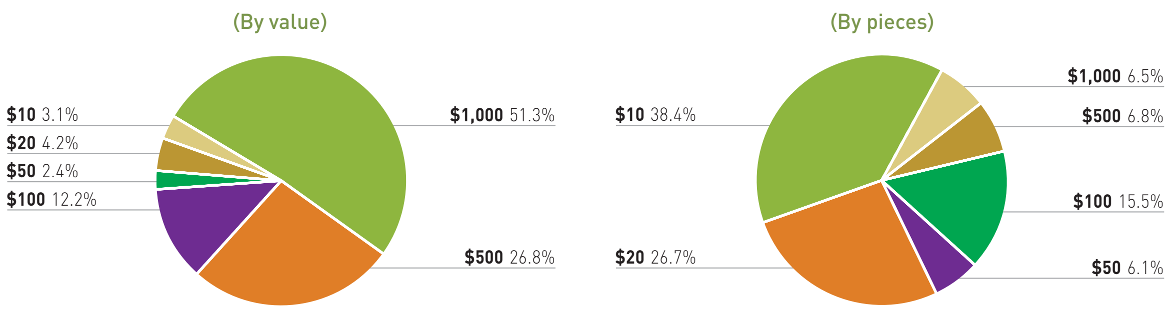


CHART 6 Banknotes in circulation by note-issuing banks at the end of 2003

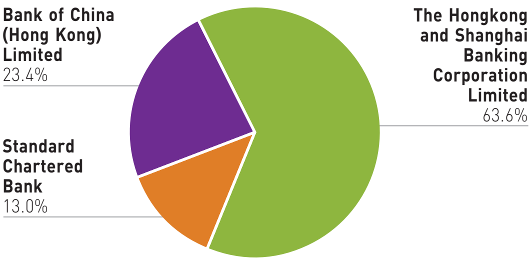


CHART 7 Government-issued notes and coins in circulation at end of year

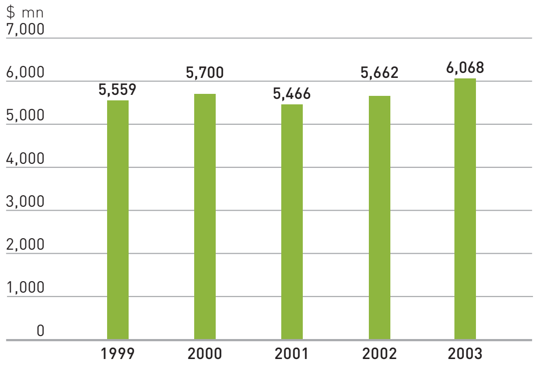
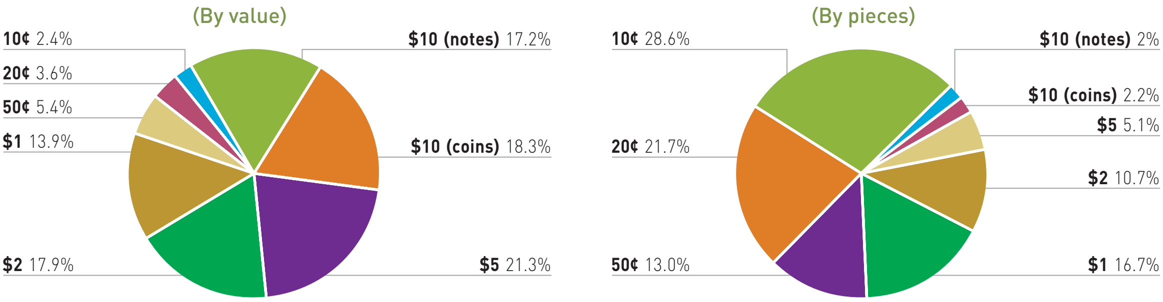


CHART 8 Distribution of Government-issued notes and coins in circulation at the end of 2003



circulation was $6,068 million, an increase of 7.2% on a year earlier (Charts 7 and 8). The value of $10 notes in circulation was $1,042 million, an increase of 109.2% on a year earlier.

New Hong Kong banknotes

The three note-issuing banks (NIBs) put into circulation new $100 and $500 Hong Kong banknotes in December 2003. The remaining three denominations of banknotes, $20, $50 and $1,000, will be issued in the last quarter of 2004. Additional security features have been incorporated in these new notes. These features include the use of optical variable ink for denomination numerals, fluorescent machine-readable barcodes, a 4mm-wide windowed thread, and iridescent images. Security features and colour schemes have also been standardised for banknotes issued by the three NIBs to make it easier for the public to recognise them.

> New Hong Kong Banknotes

Chief Executive Joseph Yam introduces the new security features for the new series of Hong Kong banknotes at a press conference on 3 September 2003.

Coin replacement programme

The programme to withdraw coins bearing the Queen's Head continued throughout the year. In 2003, 39 million coins were removed from circulation.

> Consumer Information > Notes and Coins

OUTLOOK FOR THE ECONOMY

Recovery to gather momentum

The economic recovery is expected to gather momentum and become more broad-based during 2004. The growth of external trade is expected to remain buoyant as exports from Hong Kong and the Mainland continue to take an increasing share of trade in major world markets. Tourism is expected to continue to be an important source of earnings as the number of Mainland visitors increases as a result of the relaxation of restrictions on travel. Private consumption is expected to pick up further, supported by increased optimism brought about by improving labour market conditions, more stable asset prices, and opportunities arising from closer integration with the Mainland. As economic recovery takes a firmer hold, stronger profits growth and an increase in business optimism should lead to higher private investment. Structural changes arising from policy initiatives, such as CEPA and permission for banks to undertake personal renminbi banking business, should help to boost growth in the medium to long term.

Deflation and labour market conditions to improve

Continued economic recovery in Hong Kong together with an expected re-emergence of inflation on the Mainland, should work to ease deflationary pressures in Hong Kong in 2004. This should be helped by continued improvement in labour market conditions as, among other factors, an increase in tourism underpins job growth in consumer and tourism-related sectors. A sustained economic recovery and a return to profit growth is also likely to help employment in other business sectors, while CEPA and the expansion of personal renminbi banking business might create new employment opportunities over the medium term. Nevertheless, labour market conditions are likely to remain difficult, especially for lower-skilled workers, as companies relocate to the Mainland to take advantage of lower costs.

Risks

There are a number of risks surrounding the economic prospects. On the upside, it is possible that the economic recovery in the major economies will become more synchronised and robust than expected. Growth on the Mainland may also turn out stronger than predicted by the consensus forecast without affecting price stability. Domestically, closer integration with the Mainland may provide a stronger boost to the economy than currently expected. But there are a number of downside risks as well. First, any disorderly adjustment of exchange rates between the major currencies could be disruptive to the US and global economy. Secondly, if inflation pressures build up more rapidly on the Mainland and in other major economies, and the authorities respond more quickly and forcefully than expected, this will probably lead to lower global growth. Thirdly, a re-emergence of SARS or an increase in the incidence of avian influenza, if not contained swiftly, could adversely affect growth given Hong Kong's reliance on tourism-related expenditure. Overall, however, the balance of risks appears to be on the upside.

PERFORMANCE OF THE BANKING SECTOR

A combination of negative factors set the scene for a difficult start to the year for the banking sector: the prolonged global and domestic economic sluggishness, continuing deflation and declining property prices, and historically high unemployment and personal bankruptcies. Conditions were aggravated by the SARS outbreak, which hit Hong Kong and the region in the second quarter.

In the second half of the year, however, conditions started to pick up. The general economy improved, which, in turn, strengthened consumer and business sentiment. Banks' lending to most sectors grew, particularly in the fourth quarter. Firmer property prices helped ease the collateral erosion in banks' mortgage portfolios, and the problem of negative equity. An improving labour market and declining bankruptcies, combined with banks' efforts to restructure debts for borrowers in financial difficulties, helped improve the quality of the consumer lending portfolio and banks' overall asset quality. The banking sector ended the year with a modest growth in profitability.

Interest rate trends

Declining interbank and deposit rates

Reflecting diminished competition for funds amid sluggish loan demand and a highly liquid banking sector, Hong Kong dollar interest rates fell during 2003 to a new low. The fall was most evident in the fourth quarter, when the high liquidity brought about by strong capital inflows resulted in lower domestic interest rates. One-month HIBOR fell to an annual average of 0.92% compared with 1.74% in 2002, and the one-month time deposit rate fell to 0.07% from 0.35% (Table 3). Despite a 25 basis point cut in the US Fed funds target rate in the second quarter, the best lending rate in Hong Kong remained unchanged at 5.00%, resulting in a widening in interest rate spreads. The spread between the average best lending rate and average one-month HIBOR widened to 408 basis points, compared with 337 basis points in 2002; while the spread between the best lending rate and the average one-month time deposit rate was 493 basis points, compared with 477 basis points in 2002.

TABLE 3 Hong Kong dollar interest rate movements (period average figures)

	Time deposits			HIBOR			Saving	Best lending
(% per annum)	1-month	3-month	12-month	1-month	3-month	12-month	deposits	rate
Q4 2002	0.22	0.26	0.34	1.66	1.67	1.82	0.09	5.05
Q1 2003	0.09	0.09	0.19	1.31	1.33	1.47	0.03	5.00
Q2 2003	0.08	0.09	0.14	1.26	1.26	1.32	0.03	5.00
Q3 2003	0.08	0.08	0.10	0.99	1.03	1.27	0.03	5.00
Q4 2003	0.02	0.02	0.05	0.12	0.24	0.92	0.02	5.00
*2002**	*0.35*	*0.40*	*0.75*	*1.74*	*1.79*	*2.21*	*0.14*	*5.11*
*2003**	*0.07*	*0.07*	*0.12*	*0.92*	*0.96*	*1.24*	*0.03*	*5.00*

* annual average figures.

Profitability trends

Bank profits declined in the first half of 2003 because of the difficult operating conditions. But the improved economic climate and the receding effects of SARS in the second half helped retail banks increase aggregate pre-tax operating profits for their Hong Kong offices by 5.3% for the year as a whole. This followed a rise of 11.7%[r] in 2002 (Chart 9). The increase was largely due to gains in treasury operations (in particular in foreign exchange trading in the fourth quarter), increased income from fees and commissions, and reduced bad debt provisions and operating expenses, which outweighed the effect of reduced net interest income.

Net interest income continued to fall despite a decline in interest costs. Loan contraction, the continued squeeze on lending margins caused by fierce competition and refinancing, particularly for the residential mortgage market, and lower yield on free funds resulted in the retail banks' net interest margin falling to 1.91% in 2003 from 2.09%[r] in 2002 (Chart 10).

Pressure on interest spreads prompted many banks to focus increasingly on their non-interest income. In particular, most retail banks recorded strong performance in treasury business. Recovery in stock market activity in the second half of the year, strong trade financing and an increased awareness of wealth management products, as investors sought better returns in a low interest rate environment, helped drive the increase in income from fees and commissions. As a consequence, retail banks' other operating (or non-interest) income rose and accounted for about 34% of total operating income, compared with 30% in 2002. The share of income from treasury operations to total non-interest income increased to 19.8% from 15.4% in 2002.

CHART 9 **Growth of operating profit before tax (year on year) (retail banks)**

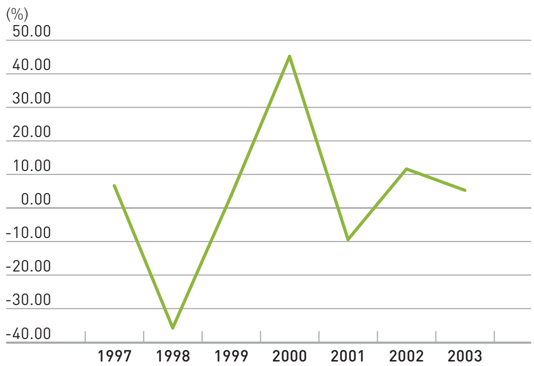
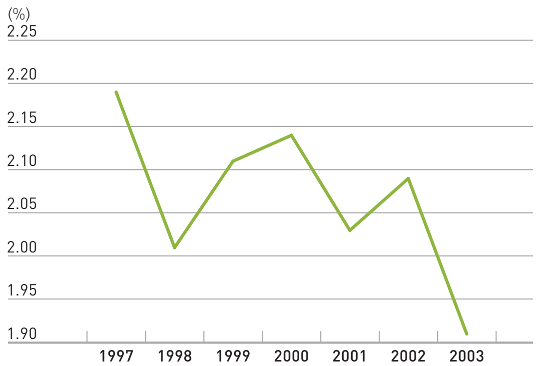


CHART 10 **Net interest margin (retail banks)**



[r] Figure revised.

Continued synergy from previous consolidations and business integration, together with reduced rental expenses, helped bring down total operating costs. As a result, the average cost-to-income ratio dropped to 38.7% in 2003 from 39.3%[r] in 2002 (Chart 11).

Retail banks' overall bad debt charge fell to 0.29% of average total assets, from 0.34% in 2002, the lowest level since the Asian financial crisis (Chart 12). The decline was most apparent in the fourth quarter, when both the employment and personal bankruptcy situations improved.

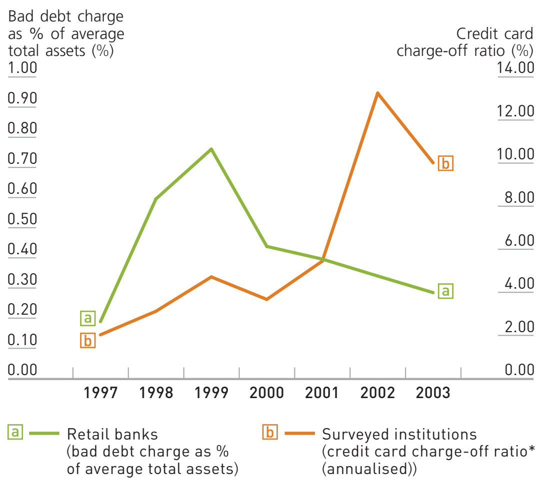
The industry-wide post-tax return on assets fell marginally to 1.17%, from 1.18% in 2002 (Chart 13) owing to the increase in average assets.

Balance sheet trends

Capital inflows, stimulated by the improved economic outlook and the buoyant Hong Kong stock market in the fourth quarter, contributed to a rise in retail banks' deposit liabilities by 7.4%, having risen by only 0.7% in 2002. The banks' total assets rose by 8.9%, with the increase on the asset side coming in higher yielding securities and interbank lending.

After contracting for five consecutive years, total assets of the banking sector increased by 8.5%, principally in interbank lending and the holding of debt securities.

CHART 12 Charge-off ratios



* There is a break in series in December 2001 owing to an increase in the number of surveyed institutions.

CHART 11 Cost-income ratio (retail banks)

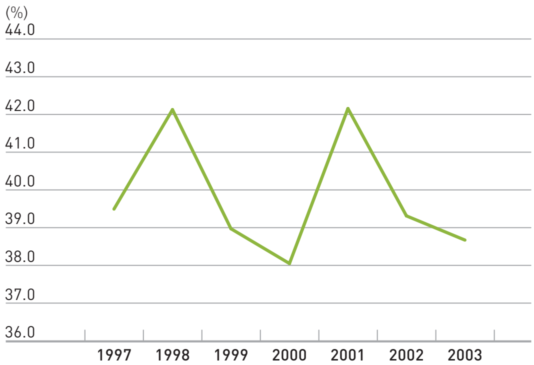
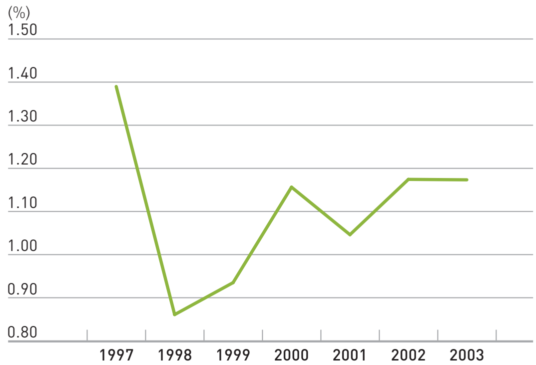


CHART 13 Return on assets (post-tax profit) (retail banks)



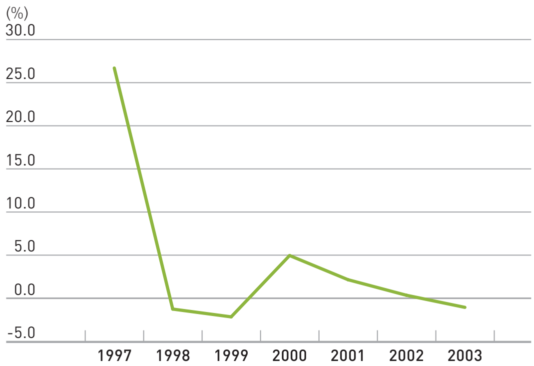
[r] Figure revised.

Domestic loan demand on the way up

Retail banks' total lending fell modestly by 0.6% in 2003. Although total loans to customers outside Hong Kong increased by 18.2%, this was from a very small base of 2.2% of total lending. Domestic lending decreased by 1.0%, having increased by 0.4% in 2002. Much of the decline was attributable to the contraction in property-related lending (Chart 14). The fourth quarter, however, saw a pick-up in lending to most sectors with the recovery in business sentiment and the general economy.

Property lending reversed an increase of 1.4% in 2002 to record a decrease of 2.0% in 2003. Within this, loans for property development and residential mortgage loans decreased by 11.0% and 1.4% compared with increases of 0.8% and 2.2% in 2002 respectively, although the latter recorded an increase in the fourth quarter. Loans for property investment, however, rose by 0.3% following a decrease of 0.4%. Loans for the purchase of flats under the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme fell by 12.1% as sales of flats under these schemes ceased.

CHART 14 Growth of loans to customers inside Hong Kong* (year on year) (retail banks)



* Defined as loans for use in Hong Kong plus trade financing loans.

Lending by retail banks to other major economic sectors was mixed in 2003. Aided by robust external trade growth, trade financing loans rose by 11.7%, compared with a 4.0% increase in 2002. Loans to the manufacturing sector rose by 12.1% up from 1.2% in 2002, and to the transport and transport equipment sector by 9.6% up from 4.9%. Driven by the buoyant stock market activity in the fourth quarter, loans to financial concerns rose by 14.3%, after contracting by 10.3% in 2002. Loans to stockbrokers also increased strongly by 13.4%, up from 1.1%. However, loans to non-stockbroking companies and individuals to purchase shares fell by 9.5% against an increase of 18.4% in 2002 despite an increase in the fourth quarter. Similarly, lending to the wholesale and retail trade sector and the electricity, gas and telecommunications sector decreased by 7.7% and 10.0% respectively, against increases of 1.6% and 12.2% in 2002. The decrease in loans to the latter was due to a sharp decline of 35.6% in loans to the telecommunications sector as a result of loan repayments.

Amid the high level of personal bankruptcies and high unemployment rate, aggravated by the SARS outbreak, consumer lending, particularly in the credit card business, contracted further in 2003 despite an increase in the fourth quarter. According to the regular survey of authorized institutions active in credit card businesses, total credit card receivables declined further by 5.0% after a decline of 4.5% in 2002.

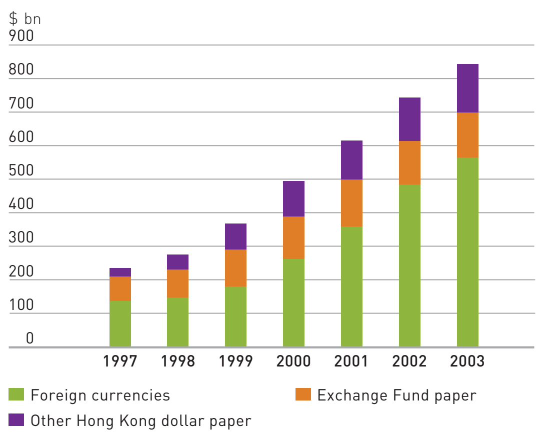
Total outstanding exposure to non-bank Chinese entities increased slightly in 2003, largely attributable to more trade-related contingencies. Retail banks' exposure increased by 1.3% to $103.3 billion at the end of 2003, accounting for 2.3% of their total assets.

Rising level of negotiable debt instruments

The holding of negotiable debt instruments (NDIs), excluding negotiable certificate of deposits (NCDs), by retail banks continued to record double-digit growth in 2003, albeit at a slower pace of 13.3% compared with 20.8% in 2002. Holdings of NDIs by retail banks accounted for 21.7% of their total assets at the end of 2003, compared with 20.9% a year earlier. The increase was largely in corporate debt instruments and floating rate notes denominated in foreign currencies. Foreign currency NDIs grew by 16.7%, while Hong Kong dollar denominated NDIs rose by 7.1% (Chart 15). Of the NDIs, 54.9% were issued by corporates, 25.7% by governments, and 19.4% by banks (Chart 16).

In light of the historically low yield on savings and time deposits, the demand for NCDs by retail customers continued in 2003. This was reflected by the 17.3% rise in outstanding NCDs issued, following the 21.7% surge in 2002. With increased holdings of NCDs by retail customers, the proportion of outstanding NCDs held by retail banks dropped to 35% at the end of 2003, compared with 38% in 2002.

CHART 15 Negotiable debt instruments held (retail banks) by currency breakdown



Growing customer deposits

Retail banks' total customer deposits grew by 7.4% after two years of weak growth or decline (Chart 17). The growth was strong despite all-time-low interest rates, reflecting the improving economy and an external inflow of funds, particularly in the fourth quarter.

CHART 16 Negotiable debt instruments (retail banks) by counterparty breakdown

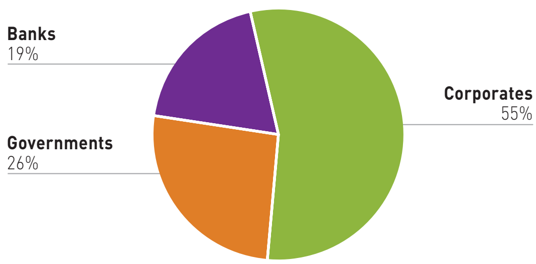
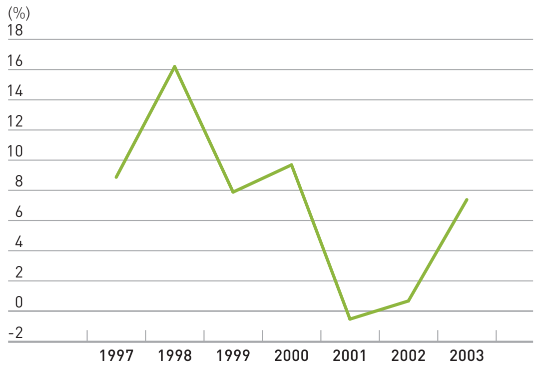


CHART 17 Growth of total customer deposits (year on year) (retail banks)



With Hong Kong dollar and foreign currency deposits growing at a similar rate of about 7.4% (Chart 18), the proportion of Hong Kong dollar deposits to total deposits remained stable at 61.0% in 2003. Of particular interest was the migration of deposits from time to savings and demand deposits during the year. Time deposits fell by 12.3% in 2003, whereas savings and demand deposits increased by 35.2% and 52.9% respectively. As a consequence, savings and demand deposits at the end of 2003 accounted for 50.4% of total deposits, a sharp rise compared with 29.0% three years before. Much of the increase in savings and demand deposits occurred in the fourth quarter, reflecting, in part, the rise in transaction demand for money given the strong rebound in the stock market.

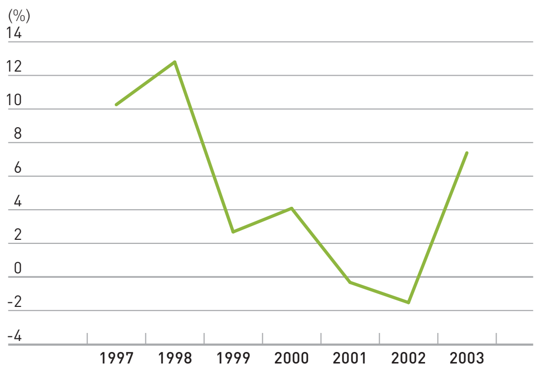
High liquidity

The liquidity of retail banks remained high, as indicated by the decrease in the loan-to-deposit ratios. With deposits increasing and lending decreasing, retail banks' loan-to-deposit ratios in all currencies and in Hong Kong dollars fell significantly. While the former dipped to a new low of 49.6% at the end of 2003, from 53.5% at the end of 2002, the latter fell to 71.6% from 78.6%.

Overall asset quality improves

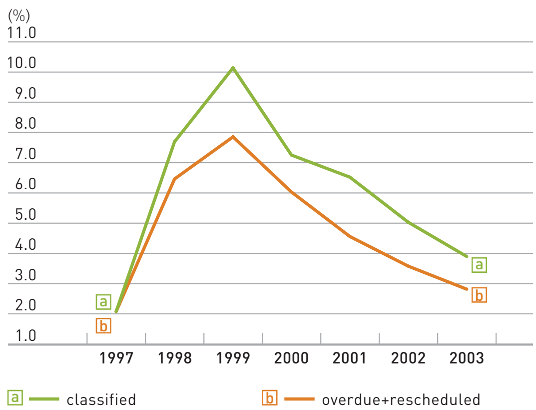
The asset quality of banks improved in 2003, benefiting from various factors, including the economic upturn and the recovering labour market. These factors, together with a persistently low interest rate environment, helped support borrowers' repayment ability, and contributed to the sharp declines in personal bankruptcies and credit card charge-offs. Reflecting this, the problem loan ratios of retail banks declined to almost pre-Asian-financial-crisis levels. The ratio of loans overdue for more than three months dropped to 2.05% from 2.77%[r] at the end of 2002. Coupled with a decrease in the rescheduled loan ratio to 0.79%,the combined ratio of overdue and rescheduled loans improved to 2.83% from 3.59%[r]. The classified and non-performing loan ratios also dropped to 3.91% and 3.16% from 5.04%[r] and 3.94%[r] at the end of 2002 respectively (Chart 19).

CHART 18 Growth of Hong Kong dollar deposits* (year on year) (retail banks)



* Including swap deposits.

CHART 19 Gross classified loans and combined overdue and rescheduled loans as a percentage of total loans (retail banks)



[r] Figure revised.

The delinquency ratio of the residential mortgage portfolio dropped to 0.86% at the end of 2003 from 1.06% at the end of 2002 (Chart 20). Banks' continued support for borrowers in financial difficulties to restructure their problem mortgage loans, led to an increase in the rescheduled loan ratio to 0.52% at the end of 2003, from 0.46% in 2002.

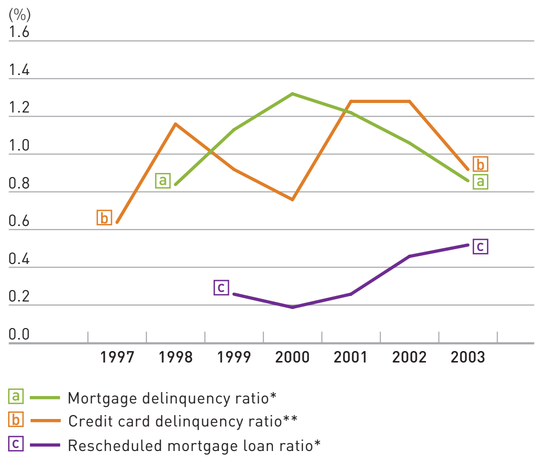
Consumer credit quality, in the form of credit card lending, showed an improvement, with the credit card charge-off ratio for the year, dropping to 10.02%, from 13.25% in 2002 (Chart 12), and the credit card delinquency ratio falling to 0.92%. The improvements were helped in part by the transfer of some rescheduled receivables outside the credit card portfolio. Taking into account outstanding rescheduled credit card receivables amounting to $166 million or 0.3% of total receivables within the card portfolio, the delinquent and rescheduled ratio stood at 1.22% at the end of the year.

> Information Centre > Press Releases > Credit Card Lending Survey Results category

In tandem with the economic recovery and a revival in property prices, particularly in the fourth quarter, there was an easing in the amount of negative equity in the residential mortgage portfolio. Survey results from banks active in mortgage financing indicate that about 67,600 cases within the banking sector (or 14% of total mortgage borrowers) were in negative equity at the end of the year, the problem having peaked at 106,000 cases in mid-2003 (see box). With an average loan-to-value ratio of 128%, the unsecured portion of these loans was estimated at about $23 billion or roughly 5% of the total residential mortgage portfolio. The quality of the negative equity mortgages also improved, as indicated by the decline in the delinquency ratio of the negative equity mortgage loans to 2.11% at the end of the year, from 2.62% in 2002.

> Information Centre > Press Releases > Residential Mortgage Survey Results category

CHART 20 Asset quality of credit card and mortgage lending (surveyed institutions)



* There is a break in series in December 2000 owing to an increase in the number of surveyed institutions.

** There is a break in series in December 2001 owing to an increase in the number of surveyed institutions.

Residential mortgage loans in negative equity[1]

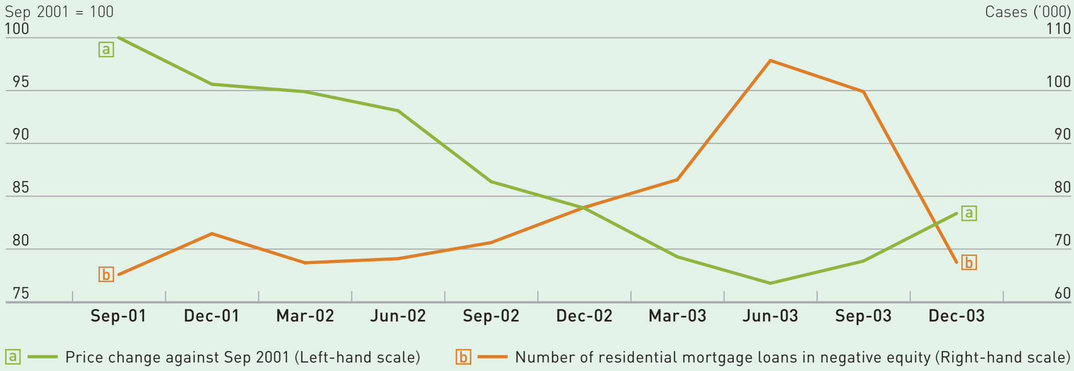
Property prices in Hong Kong have fallen by an average of 65% since the Asian financial crisis triggered the bursting of the asset bubble in 1997. This sharp fall raised concerns about negative equity in banks' residential mortgage loan portfolios.

Chart A tracks the relationship between property prices and the number of negative equity loans in the residential mortgage loan portfolio of the banking sector. This is an inverse relationship. The economic downturn, exacerbated by SARS in the second quarter of 2003, led to an increase in negative equity as property prices continued to decline. According to the figures obtained from banks active in residential mortgage loans, the number of these loans in negative equity within the banking sector alone rose to a peak of 106,000 cases at the end of June 2003, from 76,700 cases at the end of 2002. The problem eased notably in the second half of the year, along with the recovery in property prices arising from the improved domestic economy. At the end of 2003 there were 67,600 negative equity residential mortgage loans (Chart B). The amount involved was estimated at $107 billion.

Notwithstanding the high level of personal bankruptcies in March 2003, the three-month delinquency ratio of residential mortgage loans in negative equity continued to fall to 2.11% at the end of 2003 (Chart C). This reflects the efforts made by negative equity homeowners to service their mortgage loans. The improvement in the asset quality of negative equity mortgage loans can also be attributed, in part, to the responsiveness of banks in reducing the repayment burden on negative equity homeowners by lowering their interest rates. This factor is highlighted by the continued decline in the average mortgage rate paid by negative equity homeowners, from 0.27% below the best lending rate in September 2001 to 0.94% below in December 2003 (Chart D).

Sentiment towards the property market has become more positive, particularly in the latter part of 2003. According to the Rating & Valuation Department's property price index in December, prices had risen by about 10% from the trough in July 2003. If this recovery is maintained, the negative equity problem should ease further.

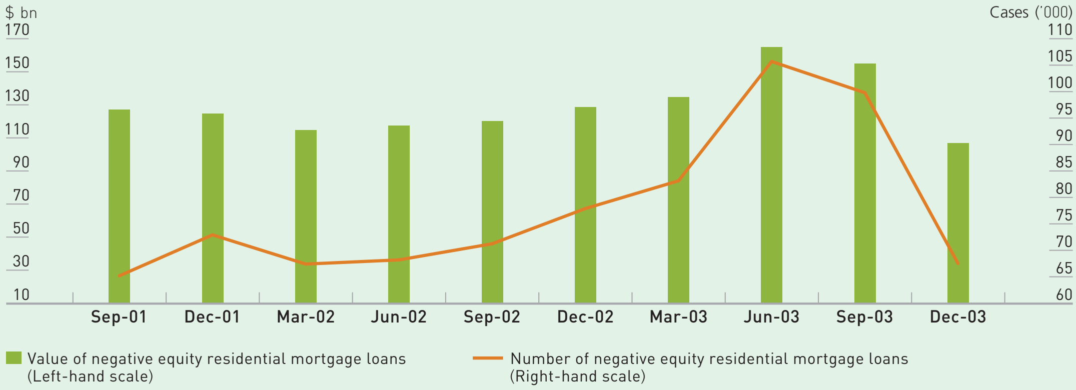
CHART A Relationship between price movement of territory-wide private domestic units and number of residential mortgage loans in negative equity



Note: Information source of price movement: Rating & Valuation Department.

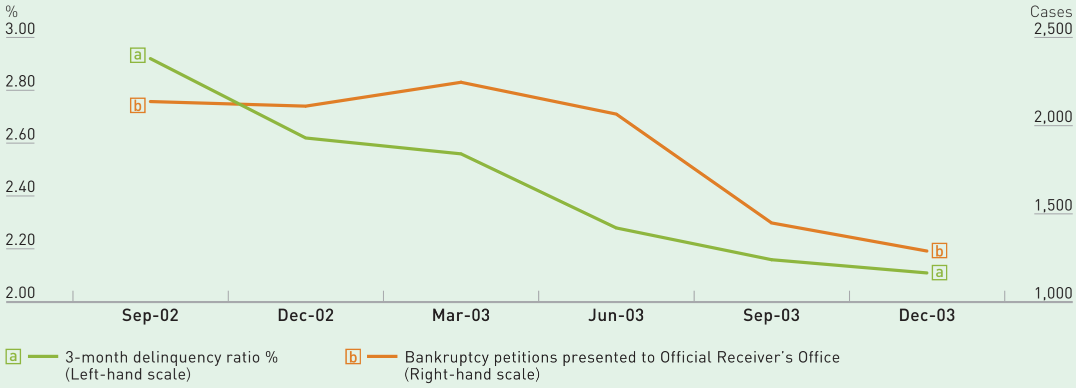
[1] A residential mortgage loan in negative equity is defined as a loan with an outstanding value that exceeds the current market value of the mortgaged property on the basis of first mortgages and which the relevant authorized institution knows to be in negative equity. Second mortgages from developers and other financial sources outside of the banking sector are not included in this definition.

CHART B Residential mortgage lending in negative equity



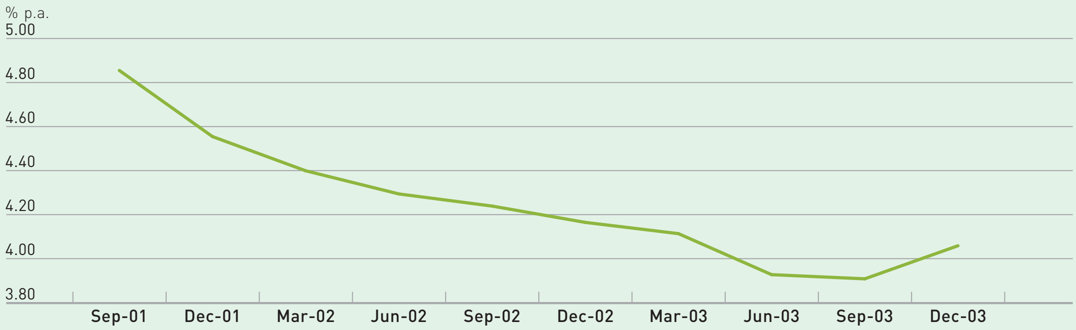
Note: Period-end outstanding figures.

CHART C Relationship between bankruptcy petitions and delinquency ratio for residential mortgage loans in negative equity



Notes: Delinquency refers to outstanding value of residential mortgage loans in negative equity overdue for more than three months.
Information source of bankruptcy petitions: Official Receiver's Office.

CHART D Weighted average mortgage rate for residential mortgage loans in negative equity



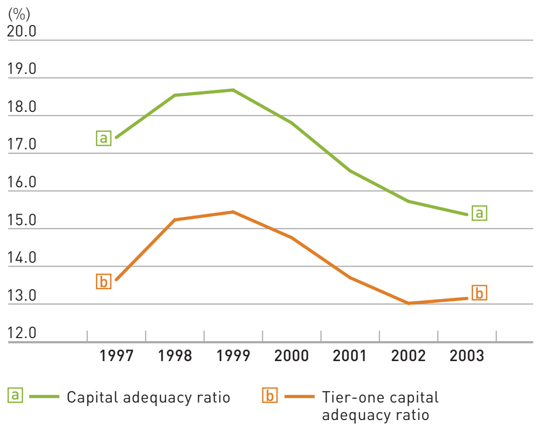
Note: Weighted average mortgage rate refers to weighted average mortgage rate with reference to the best lending rate.

Strong capital ratio

The capital adequacy ratio of all locally incorporated AIs declined to 15.3% from 15.7%[r] at the end of 2002 (Chart 21). The decline was due to an increase in risk-weighted assets, namely in claims on banks.

The tier 1 capital ratio stood at 13.1%, marginally higher than the 13.0%[r] at the end of 2002 (Chart 21).

CHART 21 Consolidated capital adequacy ratio (all locally incorporated AIs)



PROSPECTS FOR 2004

Domestic economic growth is expected to continue to gather pace. Barring any unforeseen external factors, loan growth prospects are positive with the recovery in employment, consumption, domestic demand and tourism. The launch of the positive data sharing credit bureau may prompt banks to repackage or introduce new consumer products with price differentiation to better reflect customer credit risks.

The implementation of programmes under CEPA is also expected to usher in more business opportunities for the banking sector in Hong Kong through easier access to the Mainland banking sector. The introduction of personal renminbi business in early 2004 will broaden banks' revenue sources. The use of renminbi cards in Hong Kong is likely to help tourist spending and boost business income for the tourist-related sectors as well as potentially increasing fee income for the banks.

While embracing the new business opportunities ahead, banks will face challenges in competing to maintain their market positions and expand their market share. Continuing pressure on interest spreads will spur their search for new businesses, such as insurance and securities brokerages. Risk management skills in the areas of interest rates and market risks will also need to be improved as banks grow their NDIs. In view of the competitive operating environment, consolidation and branch rationalisation are expected to continue as banks seek to achieve synergies and rein in costs. Given the robust and sound banking system in Hong Kong, banks are adequately equipped to accept the challenges and turn them into opportunities.

[r] Figure revised.