



The Chinese banyan, *Ficus microcarpa*, one of Hong Kong's most popular native trees, provides shade and windbreaks for streets and neighbourhoods. Its extensive roots enable it to grow in almost any location.

ECONOMIC AND BANKING ENVIRONMENT

The Hong Kong economy experienced broad-based recovery in 2004 following its rebound in the second half of 2003, reflecting strong domestic and external demand. Benefiting from the thriving economy, the banking sector performed well in 2004, but strong liquidity and increased competition continued to put pressure on profit margins.

THE ECONOMY IN REVIEW

Overview

The recovery in Hong Kong's economy gathered momentum and became more broad-based in 2004, following a strong rebound in the second half of 2003. Real GDP grew by 8.1% in 2004, compared with 3.2% in 2003. Exports of goods and services increased, driven by robust global growth, an expansion in Mainland China's external trade, and a sustained revival in inbound tourism. Domestic demand was supported by rises in asset prices and improved labour market conditions (Table 1). Consumer prices were broadly stable in 2004, following marked declines in previous years. The unemployment rate fell steadily during the year, although it remained high by historical standards.

Monetary conditions continued to be favourable during the year, with low levels of Hong Kong dollar interest rates and a further decrease in the real effective exchange rate. Broad money growth picked

up notably alongside robust economic growth. Narrow money growth remained strong, owing to the low interest rates and high transaction demand for money arising from buoyant economic and stock market activities.

Strong domestic demand

Private domestic demand increased strongly in 2004, supported by appreciating asset prices, improving labour market conditions, and rising household income. For the year as a whole, private consumption expenditure increased by 6.7% — the highest annual growth rate in 11 years. Private investment spending also picked up sharply, rising by 6.6%, reflecting improved profitability and optimism in the business outlook. Expenditure on machinery, equipment and computer software continued to drive overall investment, while the rate of decline in spending on building and construction slowed in the second half of 2004. By contrast, public investment spending declined by 5.8%, reflecting a fall in construction output under the

TABLE 1 GDP annual growth by expenditure components (%)

	2003					2004				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private consumption expenditure	-2.7	-3.8	0.9	4.4	-0.3	5.4	10.7	5.0	5.7	6.7
Government consumption expenditure	1.0	0.5	0.5	5.5	1.9	5.4	-0.2	-1.4	-1.8	0.5
Gross domestic fixed capital formation	4.2	-5.3	0.0	1.9	0.1	5.5	12.7	2.7	-2.0	4.5
Change in inventories ¹	1.7	0.0	-1.2	0.8	0.3	1.5	2.2	-0.1	-4.2	-0.3
Net exports of goods ¹	-1.0	3.3	2.1	-1.9	0.6	-2.9	-3.5	1.2	7.5	0.9
Net exports of services ¹	4.2	-0.2	2.5	2.5	2.2	3.2	3.9	2.3	1.4	2.6
GDP	4.4	-0.6	3.9	4.8	3.2	7.0	12.1	6.8	7.1	8.1

¹ Percentage point contribution to annual growth of GDP.
Source: Census and Statistics Department.

Public Housing Programme and the winding down of work on railway projects (Chart 1).

Remarkable export performance

Exports of goods and services increased in 2004, driven by robust global growth, an expansion in Mainland China's external trade, and a revival in inbound tourism. However, the rate of increase in Hong Kong's exports slowed in the second half of the year because of a moderation in growth in Hong Kong's major trading partners. For 2004 as a whole, exports of goods increased by 15.3%. Among major markets, exports to East Asia and the European Union grew strongly, and those to

the United States also recovered (Table 2). Exports of services rose sharply by 14.9%, led mainly by buoyant trade-related exports of services and an increase in tourism-related earnings, which were helped by a further broadening of the Individual Visit Scheme. The trade surplus widened from 8.2% of GDP in 2003 to 10.9% in 2004, owing to an increase in the surplus in exports of services, which more than offset a rise in the deficit in goods (Chart 2). The latter reflected the recovery in domestic demand. Nevertheless, the goods deficit narrowed markedly in the second half of the year, along with the moderation in domestic demand growth.

CHART 1 Domestic demand

Percentage change over a year ago in real terms



Source: Census and Statistics Department.

TABLE 2 Merchandise exports by major trading partners¹

	Share %	2003					2004				
		Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	44	27	21	16	21	21	16	22	23	17	20
United States	17	7	-5	-7	-3	-3	4	6	4	7	5
European Union	14	16	17	8	8	12	12	19	20	22	18
Japan	5	14	17	11	9	12	10	17	14	16	14
ASEAN ⁵ + Korea	8	9	11	7	10	9	24	23	17	13	19
Taiwan	2	25	17	15	32	22	20	25	14	7	16
Others	10	10	6	-2	6	5	10	13	11	12	9
Total	100	18	12	7	11	12	13	18	17	15	16

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

² ASEAN⁵ consists of The Philippines, Malaysia, Indonesia, Singapore and Thailand.

Source: Census and Statistics Department.

End of deflation

Consumer prices were broadly stable in 2004, following marked declines in the previous six years. The Composite Consumer Price Index decreased by 0.4% in 2004, with year-on-year changes turning positive in July. However, the rises mainly reflect a low base of comparison because of the Government relief measures implemented in July-November 2003. Adjusted for the effects of these measures and seasonal factors, the index was broadly flat throughout the year. While deflationary pressures eased rapidly and, by some measures, dissipated, there were few signs of a pick-up in inflation.

The broad stability in the index masked divergent movements in its main components. The synchronised recovery in global growth and the revival in domestic economic activity led to increases in the prices of tradable and non-tradable goods and non-housing services. The rental component of the index continued to decline, exerting downward pressure on the aggregate index. The decline in the rental component contrasted with a moderate increase in market rents, as changes in the rental component lagged behind movements in market rents owing to fixed-term rental contracts, typically of one or two years (Chart 3).

CHART 2 Overall trade balance and export growth

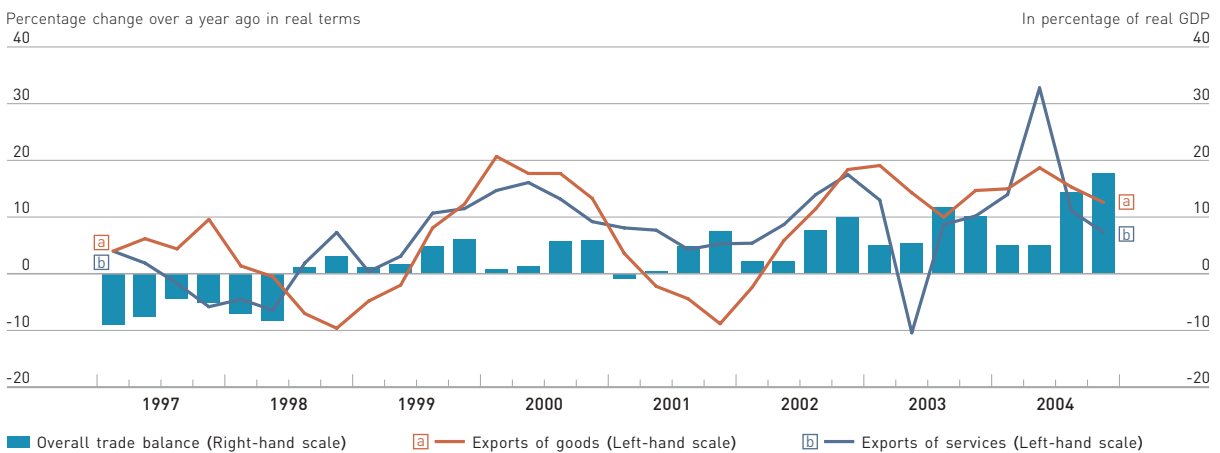
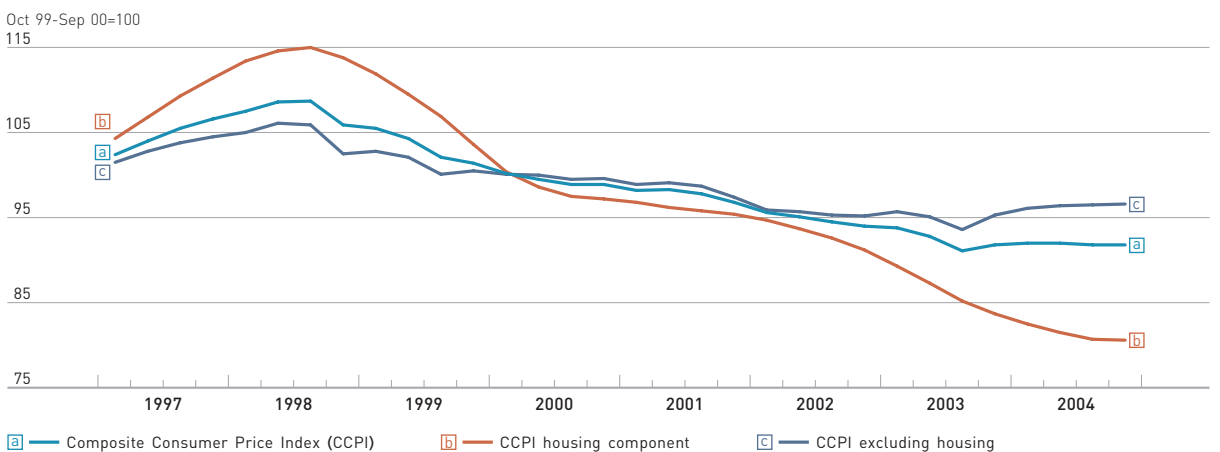


CHART 3 Consumer prices¹



¹ The Composite Consumer Price Index and its sub-indices are adjusted for the effects of special relief measures and seasonal factors.

Source: Census and Statistics Department and staff estimates.

Improved labour market conditions

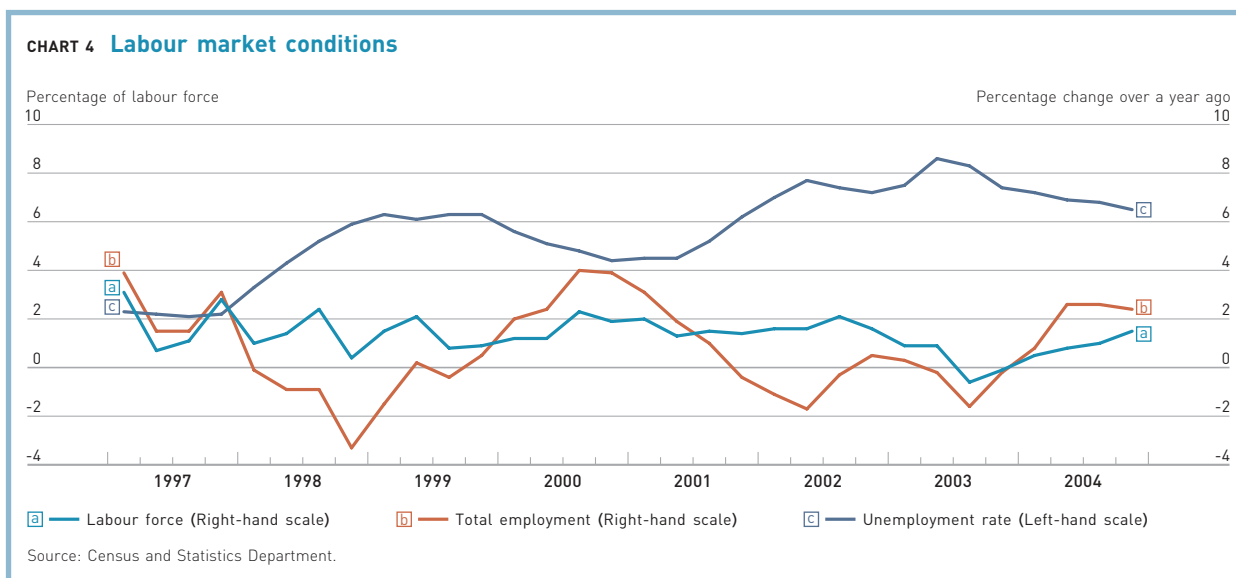
The recovery resulted in a pick-up in employment, which helped bring down the unemployment rate to 6.5% in the three months ending in December, from a record high of 8.6% in May-July 2003. However, the pace of decline in the unemployment rate slowed in 2004, as increases in employment were partly offset by a rise in the labour force. The working-age population rose, and labour force participation increased as improved employment prospects attracted more people into the job market (Chart 4).

While increased employment led to a rise in household income, labour earnings remained broadly flat, as the relatively high rate of unemployment restrained wage increases. Median household income rose by 1.1% in 2004, following a drop of 7% in the previous year. Average nominal payroll, which includes remuneration, overtime payments, back-pay, and other irregular allowances and bonuses, decreased modestly by 0.7% in the first three quarters of 2004 over a year before, compared with a decline of 1.8% in 2003.

Sustained recovery in asset markets

The recovery in the property market continued in 2004, following the sharp rebound in the second half of 2003. Residential property prices increased by 27% during the year, while prices of commercial properties rose by 62%. Despite the recovery in the property market, the prices of most premises remained 40%–50% below their peaks in 1997. The rise in prices has been associated with increases in transactions, particularly at the high end of the market. The number of Sale and Purchase Agreements increased to a seven-year high in 2004, but was still 40% lower than in 1997.

Local stock prices were more volatile than property prices. After gaining 35% in 2003, the Hang Seng Index continued to rise in early 2004 before falling sharply between March and May on market expectations of an increase in US interest rates and concerns about the impact of monetary tightening in Mainland China. Stock prices rebounded strongly in the second half of 2004, supported by renewed capital inflows and the resulting low interest rates. The Hang Seng Index closed the year at 14,230, 13% higher than that at the end of 2003.



MONETARY CONDITIONS

Monetary conditions continued to be favourable in 2004, with low interest rates and a further decline in the effective exchange value of the Hong Kong dollar. With the Aggregate Balance gradually falling from unusually high levels and US dollar interest rates rising, Hong Kong dollar interest rates registered some moderate increases between April and September. Nonetheless, Hong Kong dollar interest rates declined markedly in the fourth quarter on inflows of funds, despite a further rise in US dollar rates. The trade-weighted real effective exchange increase continued to fall in 2004, reflecting a significant US dollar depreciation against other major international currencies and relatively low domestic price inflation.

Strong growth of narrow money and acceleration in broad money growth

Monetary aggregates increased in 2004. Hong Kong dollar narrow money rose by 16.3% during the year, reflecting buoyant stock market activity and the low opportunity cost of holding liquid monetary assets with near-zero short-term deposit rates. Meanwhile, growth of Hong Kong dollar broad money accelerated in the fourth quarter, after registering moderate increases in the first three quarters. Compared with the end of previous year, broad money grew by 4.6% in 2004, largely in line with nominal GDP growth.

Notes and coins

At the end of 2004 the total value of banknotes in circulation was \$146,775 million, an increase of 9.4% from a year ago (Charts 5, 6, 7). The total value of government-issued notes and coins in circulation was \$6,122 million, an increase of 0.9% from a year ago (Charts 8 and 9). By the end of the year, the \$10 note in circulation had reached a value of \$1,131 million, an increase of 8.5% from 2003.

New Hong Kong banknotes

The three note-issuing banks issued the remaining three denominations of the new series of Hong Kong banknotes (\$20, \$50 and \$1,000) in October 2004. The first two denominations (\$100 and \$500) had been put into circulation in December 2003. Additional security features have been incorporated in the new series. These include denomination numerals in optical variable ink, a fluorescent machine readable barcode, a four-millimetre-wide windowed thread and iridescent images. Security features and colour schemes have also been standardised among the banknotes to enable easy recognition by the public.

[www.hkma.gov.hk](#) > Consumer Information > New Hong Kong Banknotes

The HKMA carried out an extensive educational campaign with the aim of promoting public awareness of the designs and security features of the new series banknotes. Activities in the education campaign include

- distribution of more than 770,000 educational leaflets on the new banknotes
- 30 public seminars on the new banknotes, including outreach talks for centres for the elderly and societies for persons with visual impairments
- visits by student ambassadors to around 40,000 retailers in shopping malls, markets and streets throughout Hong Kong.

CHART 5 Banknotes in circulation by note-issuing banks at the end of 2004

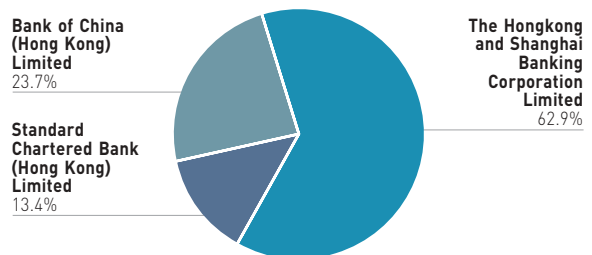


CHART 6 Distribution of banknotes in circulation at the end of 2004

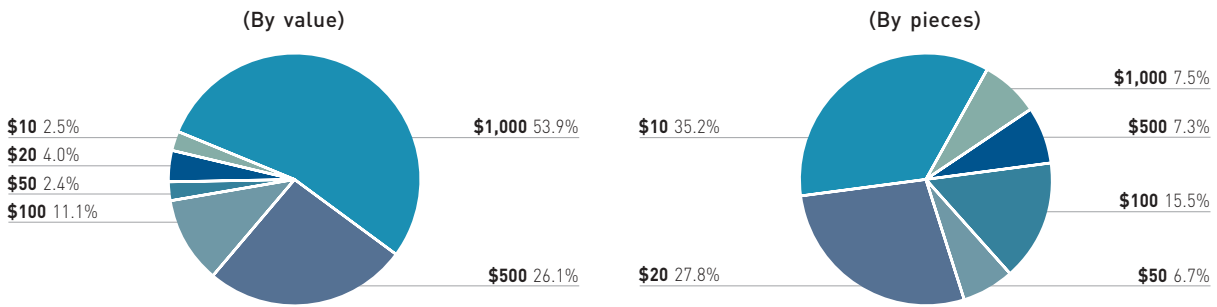


CHART 7 Banknotes in circulation at end of year

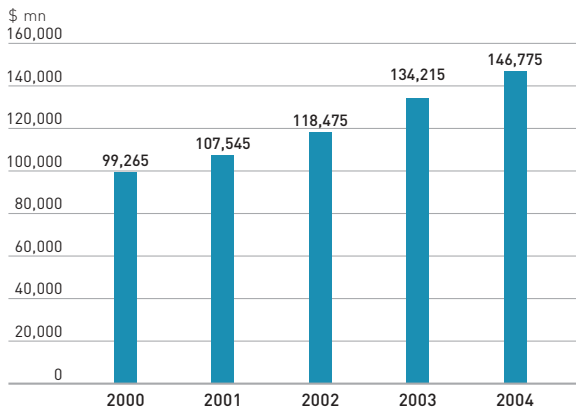
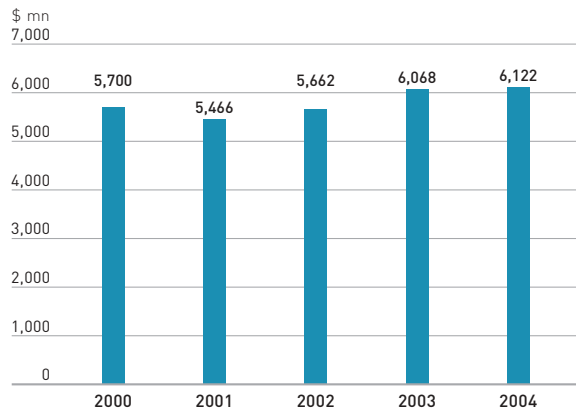
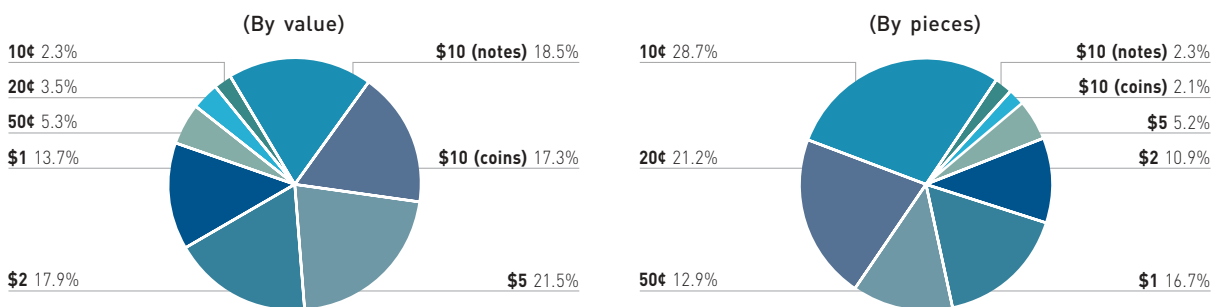


CHART 8 Government-issued notes and coins in circulation at end of year¹



¹ Including \$10 notes but excluding coin sets and commemorative gold coins.

CHART 9 Distribution of government-issued notes and coins in circulation at the end of 2004



Coin replacement programme

The programme to withdraw coins bearing the Queen's Head design continued throughout the year. In 2004, 29 million coins were removed from circulation.

 [Consumer Information > Notes and Coins](#)

OUTLOOK FOR THE ECONOMY

Recovery to continue

The economic recovery is expected to continue in 2005, but the pace of expansion is likely to be slower than in 2004. Growth in Hong Kong's exports of goods and services is expected to moderate because of slower global expansion. Nevertheless, the implementation of the Closer Economic Partnership Arrangement (CEPA) with Mainland China, starting from January 2004, and a broadening of the Individual Visit Scheme for Mainland visitors travelling to Hong Kong should support Hong Kong's exports. Growth in domestic demand may also moderate, in part reflecting a slower increase in export earnings. While growth in domestic demand tends to follow growth in export earnings, experience suggests that the two can deviate as a result of asset price movements. Thus, developments in the property market may provide support to domestic demand in the face of slower external demand growth. However, the outlook for the property sector is difficult to assess, as asset prices are forward-looking in nature and they reflect market expectations about future macroeconomic and financial developments.

Inflation to increase and labour market conditions to improve


Consumer prices are expected to rise moderately in 2005, following a small decline in 2004. A positive output gap, rising import prices (in part associated with the weak US dollar), and higher market rentals will exert upward pressure on consumer prices. On the other hand, with the unemployment rate still at a relatively high level, upward pressure on inflation from labour costs is likely to be modest. Other factors that may help contain inflationary pressures include the expected


slower global growth and a gradual deceleration of growth and inflation in Mainland China.

Labour market conditions are expected to continue to improve in 2005. Employment is likely to expand alongside continued recovery in economic activity. But the pace of increase may be moderated in the light of uncertain external developments and expectations of a slower growth. This suggests that the unemployment rate is unlikely to record a sharp decline in 2005.

Uncertainties and risks

The largely positive outlook for the Hong Kong economy is subject to a number of uncertainties and risks arising from both external and domestic developments. The main external uncertainties are the prospects for the US dollar and interest rates, volatility in oil prices, and macroeconomic and financial conditions in Mainland China. Oil prices are likely to remain volatile, given geopolitical uncertainties. There has been renewed focus in the foreign exchange market on the sustainability of the US current account deficit and its implications for the US dollar. An *orderly* decline in the value of the US dollar, to which the Hong Kong dollar is linked, would help improve Hong Kong's competitiveness. A *disorderly* decline, on the other hand, may disrupt global financial markets. US interest rates may rise by more than expected, although the passthrough to Hong Kong dollar interest rates may not be immediate and complete if it is associated with an increased inflow of funds. Higher interest rates could, however, lead to slower growth in the global economy, which in turn would affect Hong Kong. In Mainland China, the risk of a sharp slowdown in growth has receded, but pressure on monetary conditions arising from capital inflows could increase if the US dollar depreciates further against other currencies. Domestically, one concern arises from easy monetary conditions and their potential impact on inflation and property prices.

 [Information Centre > Publications > Half-Yearly Monetary and Financial Stability Report](#)

 [Information Centre > Statistics](#)

PERFORMANCE OF THE BANKING SECTOR

The banking sector performed well in 2004, benefiting from the broad-based economic upturn and closer ties with Mainland China under the Closer Economic Partnership Arrangement.

Reflecting the improvement in the economy, domestic loan growth of 7.2% was recorded in 2004, reversing the contraction in 2003. This helped contribute to strong profit growth, particularly in retail and private banking sector, and enhanced revenue from treasury business. With the unemployment rate falling and property prices rising, asset quality continued to improve.

Banks' profit margins, however, continued to come under pressure. Although 2004 saw rising interest rates in the United States, the rates in Hong Kong remained low, because of the high level of liquidity

in the banking sector. Competition for new business, in particular residential mortgages, has led to margin contraction.

Interest rate trends

Interbank and deposit rates remained low

Given the high level of liquidity in the banking sector, and a strong inflow of funds, the best lending rate in Hong Kong scarcely moved from 5.00%, despite the series of 25-basis-point increases in US interest rates that began in mid-2004. As a result, one-month HIBOR fell to an annual average of 0.25%, compared with 0.92% in 2003, and the one-month time deposit rate more than halved, from 0.07% to 0.03% (Table 3). The spread between the annual average best lending rate and annual average one-month HIBOR widened to 477 basis points compared with 408 basis points in 2003, while that between best lending rate and one-month time deposit rate was almost unchanged.

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

% per annum	Time deposits			HIBOR			Saving deposits	Best lending rate
	1-month	3-month	12-month	1-month	3-month	12-month		
Q4 2003	0.02	0.02	0.05	0.12	0.24	0.92	0.02	5.00
Q1 2004	0.004	0.01	0.03	0.07	0.08	0.44	0.004	5.00
Q2 2004	0.01	0.02	0.15	0.10	0.30	1.17	0.003	5.00
Q3 2004	0.03	0.06	0.43	0.42	0.69	1.53	0.02	5.01
Q4 2004	0.07	0.09	0.44	0.41	0.48	1.09	0.07	5.06
2003	0.07	0.07	0.12	0.92	0.96	1.24	0.03	5.00
2004	0.03	0.04	0.26	0.25	0.39	1.06	0.02	5.02

Profitability trends

Retail banks by and large recorded strong profit growth in 2004, benefiting from the domestic economic upturn and strong growth in external trade. Retail banks' aggregate pre-tax operating profits for their Hong Kong offices increased by 20.3%, compared with an increase of 5.7%^r in 2003 (Chart 10), and after-tax return on average assets rose to 1.38% from 1.18%^r in 2003 (Chart 11).

Improved profitability was primarily attributable to the sharp reduction in bad debt provisions, solid income from treasury operations, and increased level of fees and commissions. In line with the continuing improvement in asset quality, retail banks' overall bad debt charge fell markedly compared with 2003, while their ratio of bad debt charge to average total assets improved to -0.02%, from 0.29% in 2003 (Chart 12) as provisions write-back by some banks more than

offset new bad debt charges. The proportion of retail banks' non-interest income to total income increased to 39.3% from 33.8% in 2003, while the share of income from treasury operations remained constant at approximately 20%.

CHART 11 Retail banks' return on assets (after-tax profit)

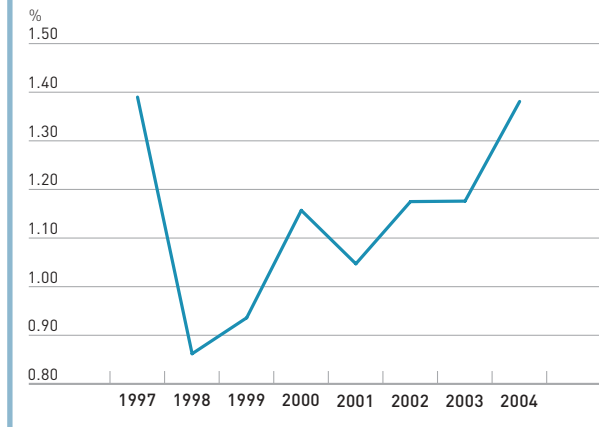


CHART 10 Retail banks' year-on-year growth of operating profit before tax

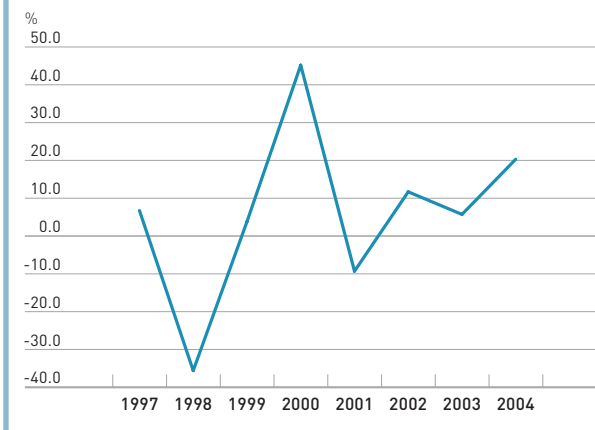
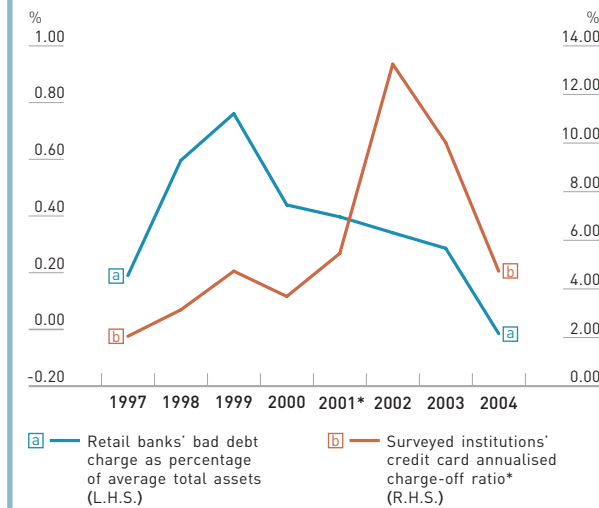


CHART 12 Charge-off ratios



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

^r Figures revised.

The net interest margin of the retail banks contracted to 1.65% from 1.91% in 2003 (Chart 13). The contraction was due to the continued squeeze in lending margins resulting from competition, particularly in residential mortgage lending, and the lower yield on free funds. A decline in net interest income was partially reversed in the fourth quarter as a result of an expansion in interest-bearing assets.

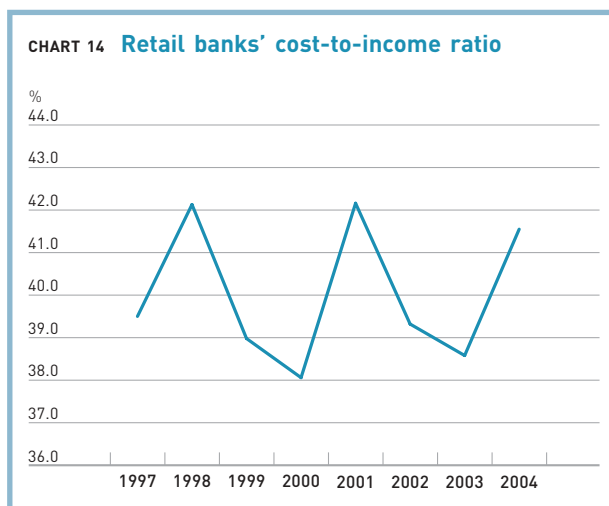
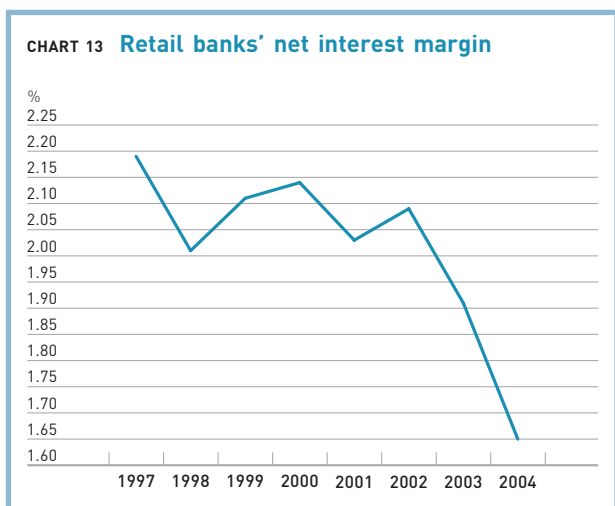
Banks also experienced an increase in their operating costs. Retail banks' cost-to-income ratio rose to 41.6%, from 38.6%^r in 2003, reflecting a general increase in operating costs and other expenses relating to business expansion, especially in Mainland China, as well as system enhancements (Chart 14).

Balance sheet trends

On the back of domestic economic upturn and a strong inflow of funds, the total assets of the banking sector increased by 10.0%, and those of retail banks by 9.1%, with much of the increase occurring in domestic lending, interbank lending, and the holding of debt securities. Retail banks' deposit liabilities increased by 7.4%, the same as in 2003, but the growth was particularly strong in the fourth quarter, reflecting the inflow of funds.

Domestic loan demand grew

Stimulated by the improving domestic economy and strong growth in external trade, retail banks' total lending rose by 8.3% in 2004. Domestic lending increased by 7.2%, compared with the decrease of 1.0% in 2003, much of it for property-related lending



^r Figures revised.

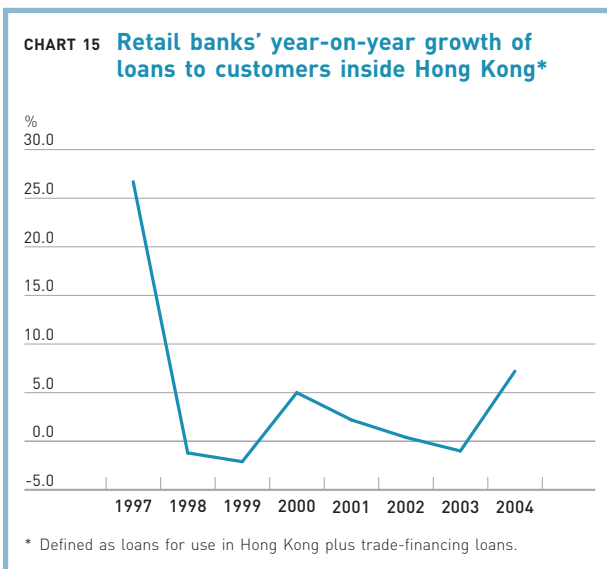
and trade finance (Chart 15). The broad-based economic recovery was reflected in increased lending to almost all major economic sectors.

In line with the rebound in property market activity, property lending rose by 5.7%, compared with a decrease of 2.0% in 2003. The growth was particularly strong in loans for property investment, which recorded a 16.0% increase after having been flat in 2003. Residential mortgage loans increased by 2.9% compared with a decrease of 1.4% in the previous year. Loans for property development fell by 3.8% for the year as a whole, much smaller than the 11.0% decline recorded in 2003, and witnessed an increase in the final quarter. Loans for the purchase of flats under the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme fell by 11.3% because of the continuing freeze on sales of flats under these schemes.

Reflecting the robust growth in external trade, trade finance rose by 17.6% compared with an increase of 11.7% in 2003. Loans to the manufacturing sector and transport and transport equipment sector also rose by 29.6% and 11.1% respectively, having increased by 12.0%^r and 9.6% respectively in 2003. Driven by the inflow of Mainland visitors and growth in private consumption, lending to the wholesale and retail trade sector grew by 11.6% against a decline of 7.7% in 2003. Despite the high level of stock market activity, loans to stockbrokers fell by 30.4%, compared with an increase of 13.4% in 2003. However, loans to non-stockbroking companies and individuals for purchasing shares rose by 11.9% against a decrease of 9.5% in 2003. Lending to the telecommunications sector continued to decrease, although at a slower rate than previously, falling by 20.8%, after a 35.6% fall in 2003.

Led by the revival in consumer confidence, consumer lending, particularly credit card business, expanded in 2004, with much of the increase occurring in the fourth quarter. According to the regular survey of authorized institutions active in credit card business, total credit card receivables rose by 5.2% after a decline of 5.0% in 2003.

Total outstanding exposure to non-bank Chinese entities increased in 2004. This was attributable largely to the increase in exposures to red chip companies and their subsidiaries. Retail banks' exposure increased by 24.3% to \$128.4 billion at the end of 2004 and accounted for 2.7% of their total assets. The exposure of the banking sector also increased to \$178.5 billion (2.4% of total assets).



^r Figures revised.

Level of negotiable debt instruments rose

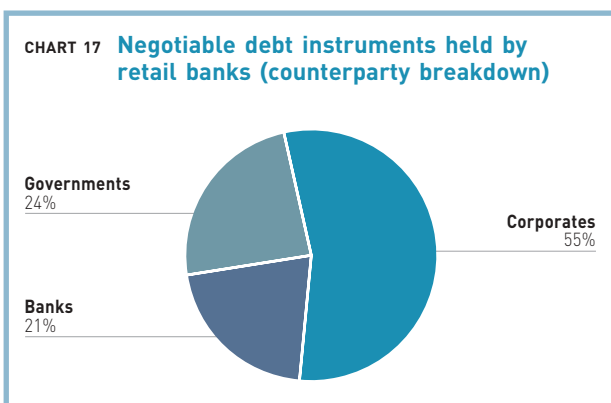
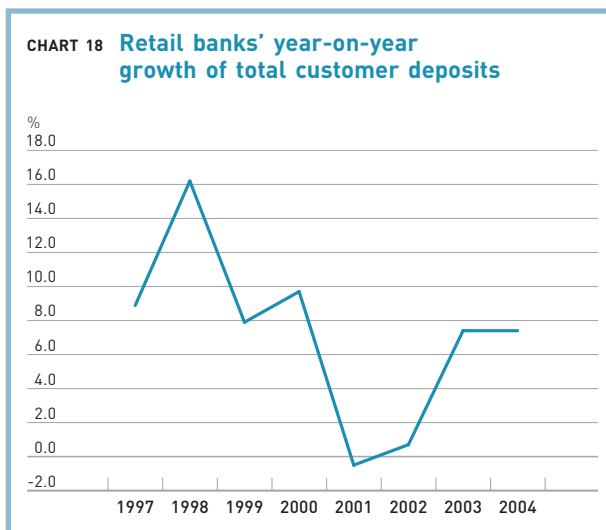
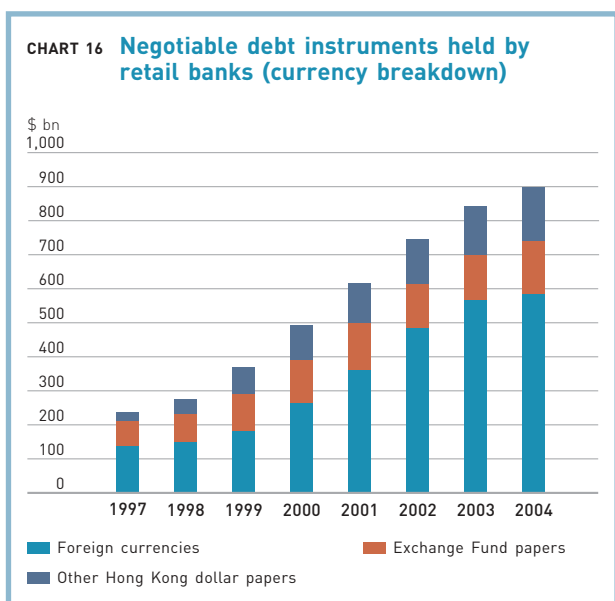
The holding of negotiable debt instruments (NDIs, excluding negotiable certificate of deposits (NCDs)) by the retail banks continued to grow, but at a slower pace than in the past two years. The increase of 6.7% compared with double-digit increases in both 2002 and 2003. The increase was largely in Exchange Fund papers and corporate debt instruments denominated in Hong Kong dollars. NDIs denominated in Hong Kong dollars grew by 14.0% while foreign currency NDIs rose by 3.1% (Chart 16). A total of 55.3% of NDIs were issued by corporates, 23.5% by governments and

21.2% by banks (Chart 17). Total holdings of NDIs by the retail banks remained steady at 21.3% of their total assets at the end of 2004, compared with 21.8%^r a year before.

In view of the continuing low interest rate environment, demand for NCDs by retail customers continued in 2004, as reflected by the 10.4% increase in outstanding NCDs issued following an increase of 17.3% in 2003. With increased holdings of NCDs by retail customers, the proportion of outstanding NCDs held by retail banks dropped to 31.0% at the end of 2004, compared with 35.0% a year before.

Customer deposits grew

Retail banks' total customer deposits grew by 7.4%, the same rate as in 2003 (Chart 18). The growth was partly associated with the strong inflow of funds, particularly in the fourth quarter.



^r Figures revised.

The increase in foreign currency deposits of 11.3% far outpaced the 4.9% increase in Hong Kong dollar deposits (Chart 19), resulting in a slight fall in the proportion of Hong Kong dollar deposits to total deposits to 59.6% compared with 61.0% at the end of 2003. After falling for three consecutive years, time deposits increased slightly by only 1.1% in 2004 against a decrease of 12.3% in 2003. Both savings and demand deposits continued to increase by 11.8% and 22.9% respectively. At the end of 2004, savings and demand deposits together accounted for 53.3% of total deposits, up from 50.4% a year before. The bulk of the increase in savings and demand deposits, however, occurred largely in the fourth quarter.

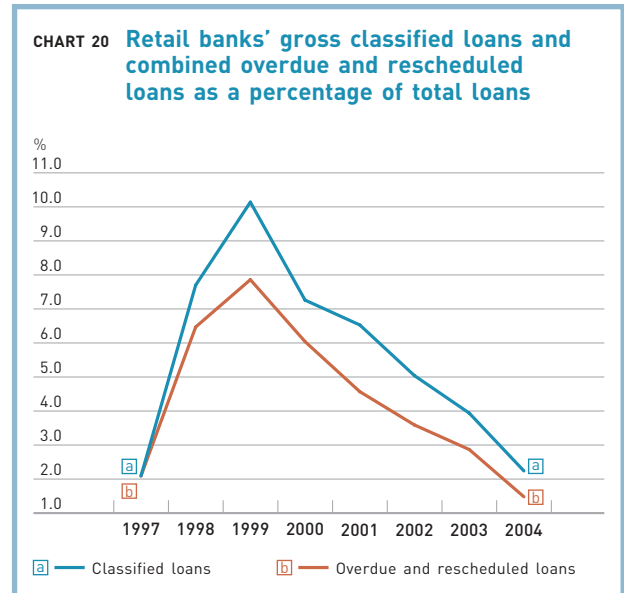
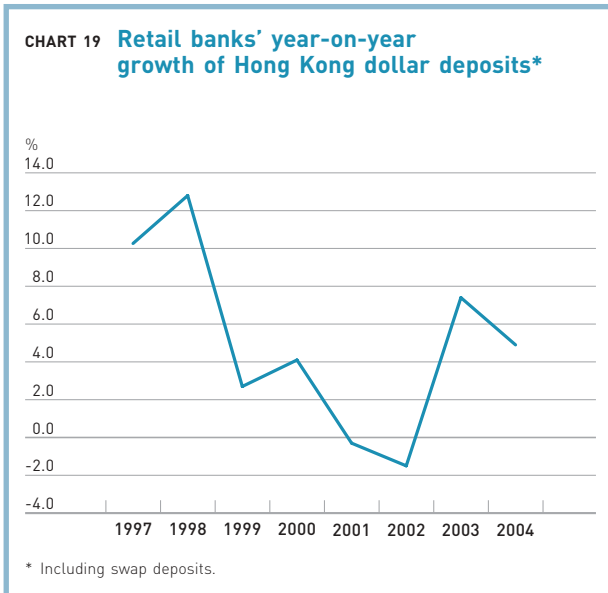
Retail banks remained highly liquid

Despite strong loan growth in 2004 retail banks remained highly liquid. Retail banks' loan-to-deposit ratios in all currencies stood at 50.0%, recovering slightly from their all-time low in 2003.

The Hong Kong dollar loan-to-deposit ratio stood at 73.2% against 71.6% at the end of 2003.

Improvement in overall asset quality continued

The asset quality of retail banks continued to improve in 2004 reflecting the improved domestic economy, rising property values, improved employment market, and lower level of bankruptcies. All problem loan ratios of the retail banks declined, returning to their pre-Asian financial crisis levels. Loans overdue for more than three months dropped to 1.04% from 2.04%^r at the end of 2003. Coupled with a decrease in the rescheduled loan ratio to 0.45%, the combined ratio of overdue and rescheduled loans improved to 1.48% from 2.87%^r. The classified and non-performing loan ratios also declined to 2.24% and 1.62% from 3.94%^r and 3.17%^r respectively at the end of 2003 (Chart 20).



^r Figures revised.

The delinquency ratio for the residential mortgage portfolio reached its lowest level of 0.38% since mid-1998, reflecting an improved labour market and the resultant strengthening of homeowners' repayment ability (Chart 21). The rescheduled loan ratio remained stable at 0.47%, reflecting banks' on-going efforts to restructure loans to borrowers in financial difficulties.

The problem of negative equity also eased with the increase in property prices. The outstanding number of residential mortgage loans in negative equity decreased by 80% from the peak of 106,000 cases to 19,200 cases at the end of 2004.

The overall quality of credit card lending by retail banks also improved, with the credit card charge-off ratio for the year dipping to 4.73%, from 10.02% in 2003 (Chart 12), and the credit card delinquency ratio declining to 0.44% from 0.92%. The improvements were helped in part by the transfer of some rescheduled receivables outside the credit

card portfolio. Taking into account the outstanding rescheduled credit card receivables amounting to \$70 million or 0.1% of total receivables within the card portfolio, the combined delinquency and rescheduled ratio stood at 0.55% at the end of the year.

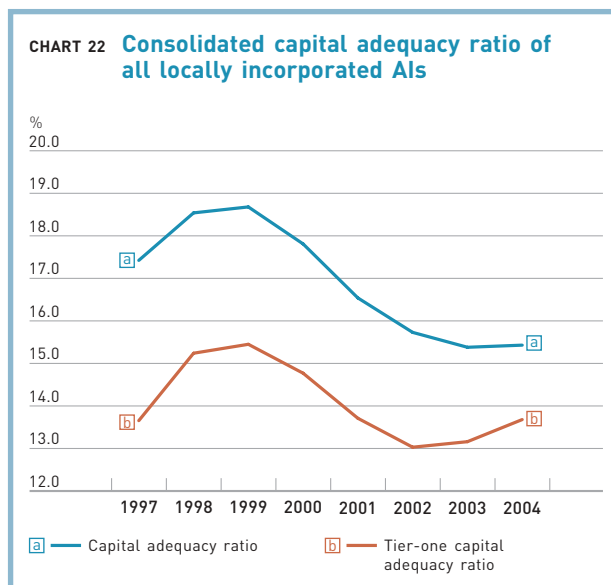
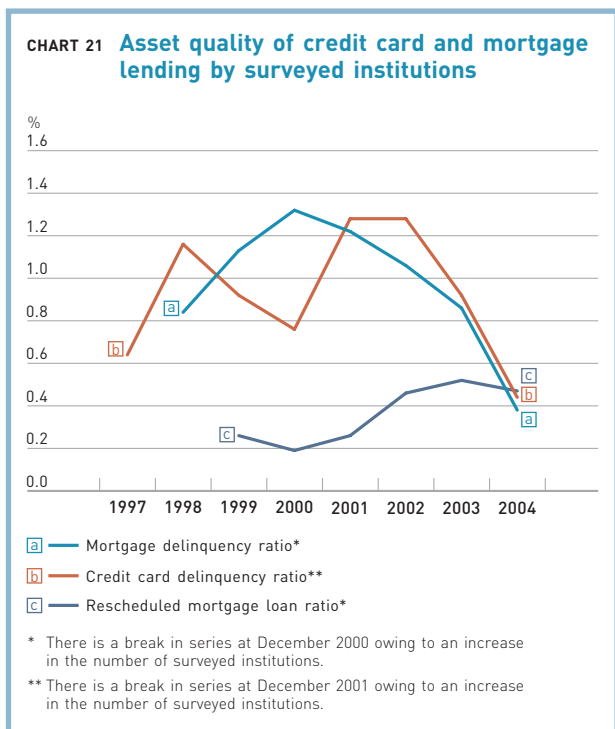
[Information Centre > Press Releases > Residential Mortgage Survey](#)

[Information Centre > Press Releases > Credit Card Lending Survey Results](#)

Strong capital ratio

With a faster increase in the capital base than in risk-weighted assets, the capital adequacy ratio of all locally incorporated AIs increased to 15.4% at the end of 2004 from 15.3% at the end of 2003 (Chart 22).

As a result of the increase in paid up capital, the tier one capital ratio increased to 13.7% at the end of 2004, compared with 13.1% at the end of 2003 (Chart 22).



PROSPECTS FOR 2005

The robust performance of banks in 2004 reflected in large part the improved economic conditions in Hong Kong. The positive economic prospects have also provided a solid platform for continuing improvement in business outlook. The steady increase in property prices, should it continue, will relieve more homeowners from negative equity problems and strengthen households' balance sheets. Buoyant exports and the revival in consumer spending should continue to underpin domestic economic growth in 2005. The improvement in banks' asset quality should therefore continue.

There are, however, uncertainties in the global economic environment, including the impact of the macroeconomic realignment initiatives in Mainland China, the pace and depth of the economic recovery in the United States, and geopolitical tensions.

The greatest uncertainty in banks' operating environment relates to the future direction of capital flows in Hong Kong. Should recent capital inflows reverse suddenly, the banking system will face a challenge in managing its interest rate risk. On the other hand, if no reversal of capital flows occurs, and the liquidity of the banking system remains high, deploying the large amount of free funds in a competitive environment while maintaining a reasonable profit margin will also be a challenge. Together with rising operating costs, this could put pressure on banks' ability to continue to maintain profitability growth as strong as in 2004. Managing these risks will require banks to keep a tight rein on their operating expenses while exploring new revenue and profit streams through development of new business lines.

In addition, the wider use of fair-value accounting required by the adoption of new international accounting standards in 2005 could result in greater volatility in banks' financial statements globally. It is impossible to predict with certainty the underlying effect on banks' balance sheets and earnings.