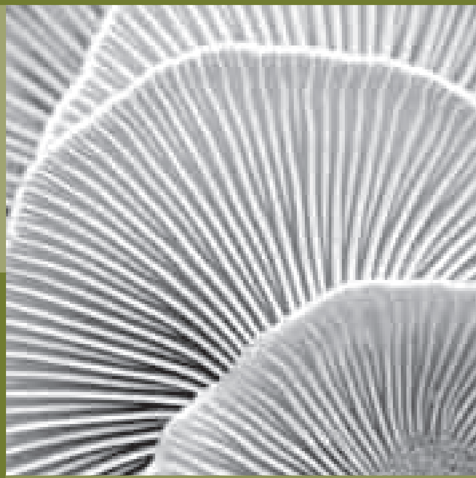


ECONOMIC AND BANKING ENVIRONMENT

Hong Kong's economy showed remarkable growth in 2005, continuing the robust and broad-based recovery the previous year. The buoyant domestic economy helped improve the operating environment of retail banks enabling them to record healthy profit growth.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy registered an impressive performance in 2005, following a strong and broad-based recovery in 2004. Real GDP grew by 7.3% in 2005, compared with a rise of 8.6% in 2004. Export earnings remained vibrant, aided by solid growth among Hong Kong's major trading partners. Despite higher interest rates and a moderation in the property market, private consumer and investment spending increased further (Table 1). Consumer price inflation remained benign, notwithstanding a moderate rise during the year. The unemployment rate fell steadily, although it remained high by historical standards.

Monetary conditions tightened during the year, reflecting rises in local interest rates and a real appreciation of the Hong Kong dollar. Broad money growth picked up notably alongside robust economic expansion. Narrow money declined, partly owing to a shift away from liquid monetary assets to term deposits.

Robust domestic demand

Private domestic demand remained robust, but the growth rate slowed somewhat from that in 2004 due to higher interest rates and a moderation in the property market. Helped by improved labour market conditions and household income, private consumption rose by 3.7% in 2005, compared with a rise of 7.3% in 2004.

Table 1. GDP by components (percentage change over a year ago in real terms)

	2004					2005				
	Q1	**Q2**	**Q3**	**Q4**	**Overall**	**Q1**	**Q2**	**Q3**	**Q4**	**Overall**
Private consumption expenditure	6.5	11.2	5.7	6.0	7.3	4.2	2.7	4.1	3.7	3.7
Government consumption expenditure	5.6	0.0	-1.3	-1.7	0.7	-4.6	-2.3	-1.6	-3.4	-3.0
Gross domestic fixed capital formation	4.4	10.3	0.8	-2.4	3.0	0.4	4.9	2.8	7.5	3.9
Change in inventories[1]	1.9	2.4	-0.2	-4.2	-0.2	-4.2	-3.3	0.9	2.7	-0.8
Net exports of goods[1]	-2.8	-3.4	1.2	7.4	0.9	6.5	5.5	2.5	-0.7	3.3
Net exports of services[1]	3.6	4.4	2.7	1.8	3.1	1.8	2.6	2.2	2.3	2.2
GDP	**8.1**	**12.4**	**6.8**	**7.5**	**8.6**	**6.0**	**7.3**	**8.3**	**7.6**	**7.3**

[1] Percentage-point contribution to annual growth of GDP.

Source: Census and Statistics Department.

Private investment spending grew by 7.6%, following an increase of 5.1% in 2004. Growth in expenditure on machinery, equipment and computer software picked up slightly, while the rate of decline in spending on building and construction slowed. The decline in public spending expanded to 6.8%, reflecting the Government's cost-saving efforts, the scaling down of the Public Housing Programme and the completion of several large railway projects (Chart 1).

Outstanding export performance

Exports of goods and services increased distinctly in 2005, bolstered by robust global growth and strong expansion in the Mainland's external trade. Exports of goods recorded the third consecutive year of double-digit growth of 11.2%, following an increase of 15.3% in 2004. Among Hong Kong's major markets, exports to the Mainland, the European Union and Japan continued to increase notably, while growth in exports to some Asian economies moderated (Table 2). Exports of services rose by 8.4%, driven mainly by buoyant trade-related services, although

Chart 1. Domestic demand

Source: Census and Statistics Department.

Table 2. Merchandise exports by major trading partners[1]

	Share	2004					2005				
	%	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	45	16	22	23	17	20	12	15	14	14	14
United States	16	4	6	4	7	5	6	7	8	2	6
European Union	15	12	18	20	22	18	17	18	16	13	16
Japan	5	10	17	14	16	14	12	12	13	6	10
ASEAN5[2] + Korea	7	24	23	17	13	19	6	8	6	9	7
Taiwan	2	20	25	14	7	16	-3	4	7	3	3
Others	10	10	14	16	17	15	11	9	15	5	10
Total	**100**	**13**	**18**	**17**	**15**	**16**	**11**	**12**	**13**	**10**	**11**

1 Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.
2 ASEAN5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand.

Source: Census and Statistics Department.

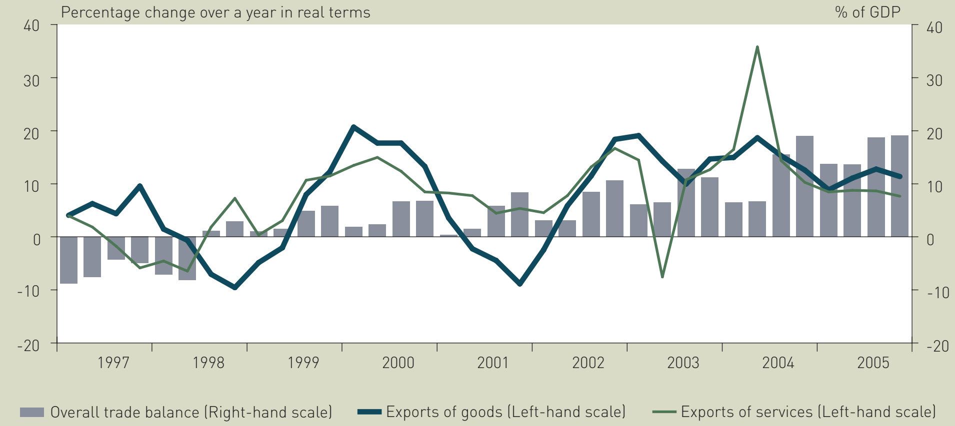
growth in exports of travel-related services slowed markedly to 7.3% from 19.2% in 2004. However, the strong growth in 2004 in part reflected a rebound from the severe disruption caused by the outbreak of SARS (Severe Acute Respiratory Syndrome) in 2003. The overall trade surplus widened from 12.1% of GDP in 2004 to 16.4% in 2005, reflecting a decline in the merchandise trade deficit and an increase in the service trade surplus (Chart 2).

Return of inflation

Consumer price inflation edged up steadily during 2005 because aggregate demand continued to pick up and increases in residential rents started to feed through into the consumer price index. Nevertheless, overall inflationary pressure remained benign. The year-on-year change in the Composite Consumer Price Index (CCPI) increased from -0.5% in January to 1.8% in December and averaged 1.1% for 2005 as a whole, following a mild decline of 0.4% in 2004. This was the first annual increase in seven years.

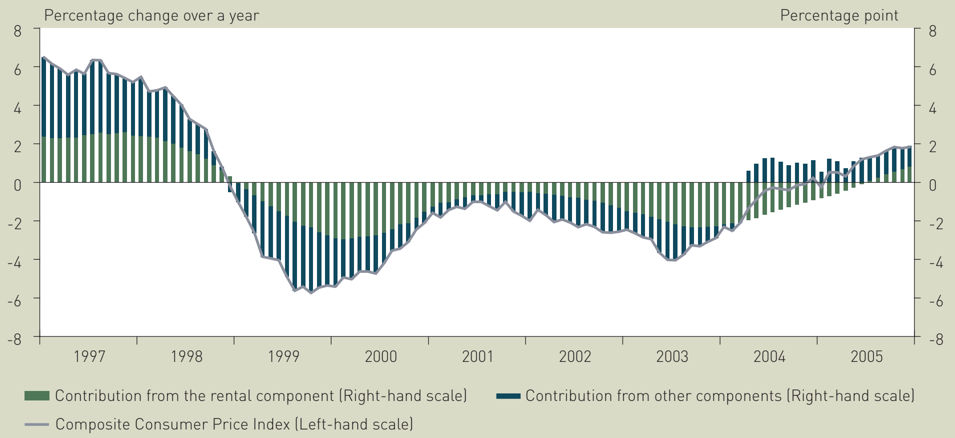
The pick-up in the year-on-year inflation rate occurred across most major components in the CCPI. In particular, the rental component rose markedly from –3.5% in January to 3.5% in December, contributing almost half of the increase in the overall CCPI in the final month of 2005 (Chart 3). Reflecting Hong Kong's high service orientation and low oil intensity, energy price increases had little effect on overall inflation.

Chart 2. Overall trade balance and export growth



Source: Census and Statistics Department.

Chart 3. Consumer prices[1]



[1] The Composite Consumer Price Index and its component indices are adjusted for the effects of special relief measures.

Source: Census and Statistics Department and staff estimates.

Improved labour market conditions

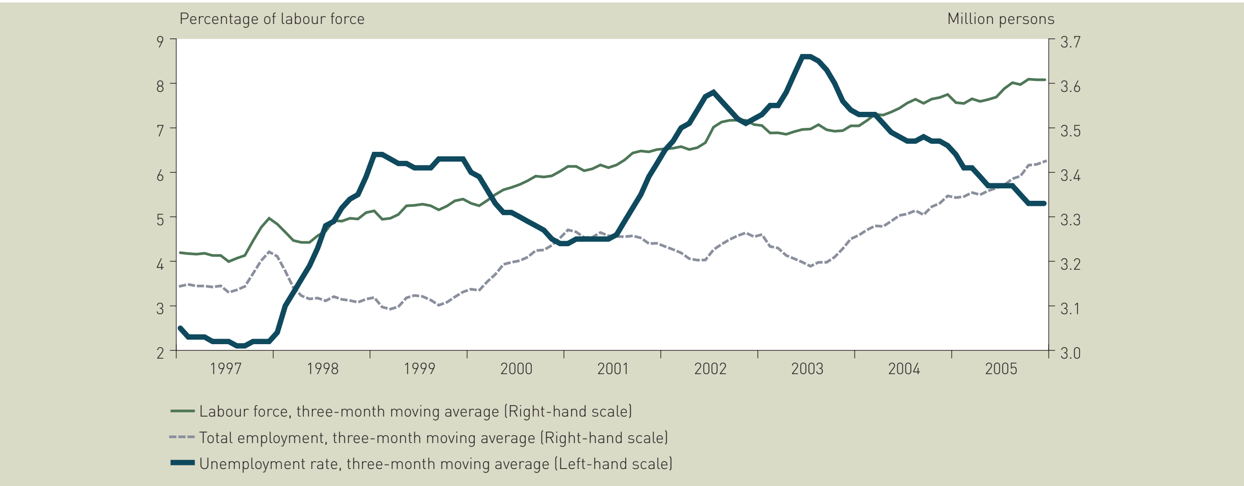
The sustained economic recovery further boosted labour demand, which helped to bring the unemployment rate down to a four-year low of 5.3% in the final quarter of 2005, from a historic high of 8.6% in mid-2003. However, the effect of employment growth on the unemployment rate was partly offset by a rise in the labour force. The relatively stable participation rate suggests that the increase in the labour force was due largely to an expansion in the working-age population (Chart 4).

Increased labour demand has led to rises in labour earnings. The nominal payroll per worker, which includes remuneration, overtime payments, back-pay, and other irregular allowances and bonuses, increased by 3.5% in the first three quarters of 2005 over a year earlier, compared with a decline of 0.7% in 2004. The increase was particularly strong in the retail, trade, hotel and transport sectors.

Sustained recovery in asset markets

The property market continued to recover in the first quarter of 2005. However, increases in interest rates since March have had some dampening effect on market activities, as indicated by a moderation in prices and transaction volumes. Despite a decline in the latter part of 2005, private residential property prices increased moderately by 6.7% in December from a year ago, following a sharp increase of 27.4% in 2004. Prices of private office also rose by 16.6% while prices of retail space fell by 0.8% during 2005. The number of Sale and

Chart 4. Labour market conditions



Source: Census and Statistics Department.

Purchase Agreements dropped markedly by 32.4% in the second half of the year compared with the first half. Nevertheless, the total number of transactions in 2005 was the highest since 1997.

Local stock prices recorded significant fluctuations during the year, affected by volatile capital flows and energy prices, and expectations of rising interest rates. Following six months of range trading, the Hang Seng Index soared to a four-and-a-half-year high in the third quarter. The rally was driven by a number of factors including better-than-expected corporate interim reports and the revaluation of the renminbi. Owing to renewed concerns about an extension of the interest-rate-hike cycle in the US, the Hang Seng Index fell markedly in October before recovering part of the loss in the last two months of the year. The index recorded its third straight year of increase, closing at 14,876 or 4.5% higher than its level at the end of 2004.

MONETARY CONDITIONS

Monetary conditions tightened in 2005 as a result of rising local interest rates and a real appreciation of the Hong Kong dollar. From June 2004 to the end of 2005, the US federal funds target rate was raised 13 times by a total of 325 basis points. Hong Kong dollar interest rates largely stayed low in the first few months of 2005 due to continued capital inflow, but started to catch up with the US rates from May. On a trade-weighted basis, the Hong Kong dollar appreciated in real terms during 2005, reflecting a broad-based strengthening of the US dollar and moderate inflation.

Narrow money and broad money growth diverged

Hong Kong dollar narrow money fell by 15.6% during the year, while broad money expanded by 5.7%. The divergence of narrow and broad money growth reflected in part a shift from liquid monetary assets to term deposits. The decline in narrow money occurred in response to the increased opportunity cost of holding non-interest bearing monetary assets. Strong growth in time deposits, which was mainly associated with the recovery of the economy and higher deposit rates, accounted for a significant part of the increase in broad money.

Notes and coins

At the end of 2005, the total value of banknotes in circulation was $149,295 million, an increase of 1.7% from a year ago (Charts 5, 6, 7). The total value of government-issued notes and coins in circulation amounted to $6,482 million, an increase of 5.9% from a year ago (Charts 8 and 9). The value of $10 notes in circulation reached $1,447 million, an increase of 28% from 2004.

Chart 5. Banknotes in circulation by note-issuing banks at the end of 2005

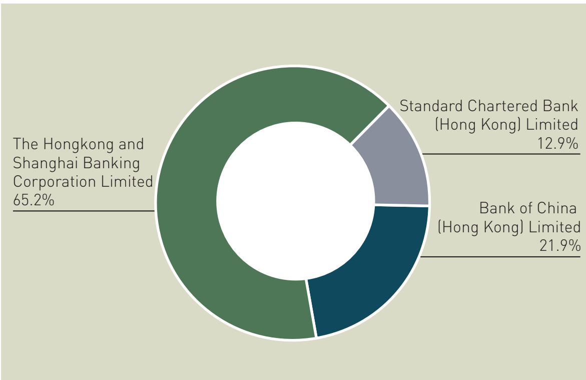


Chart 6. Banknotes in circulation at the end of 2005

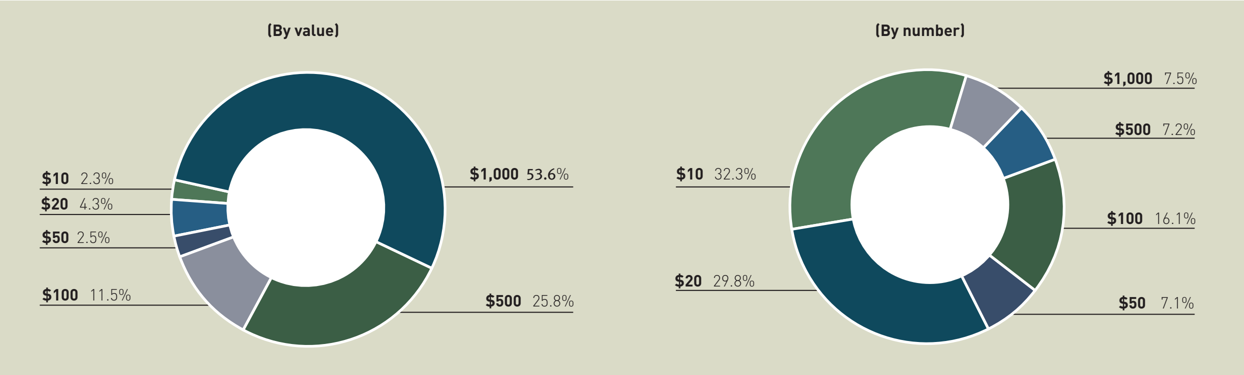


Chart 7. Banknotes in circulation at end of year

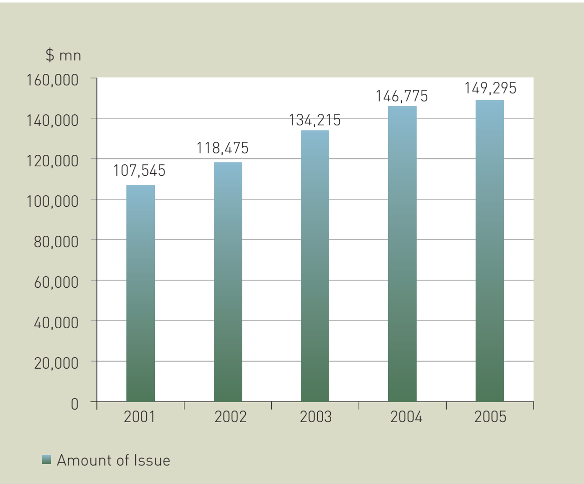
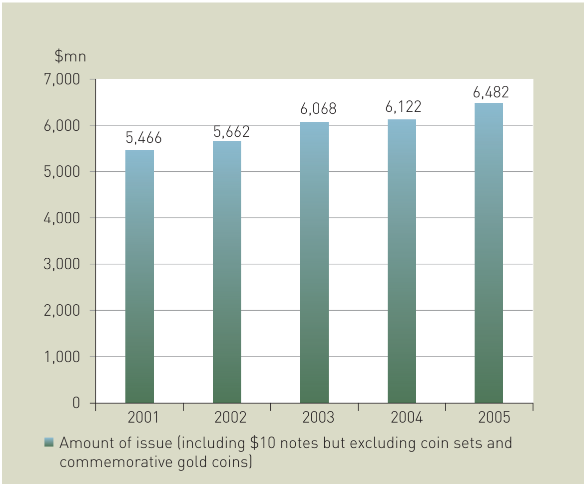


Chart 8. Government-issued notes and coins in circulation at end of year



New Hong Kong banknotes

The new series banknotes issued in 2003/2004 received favourable public response. Additional security features are incorporated in the series to combat counterfeiting.

> Consumer Information > New Hong Kong Banknotes

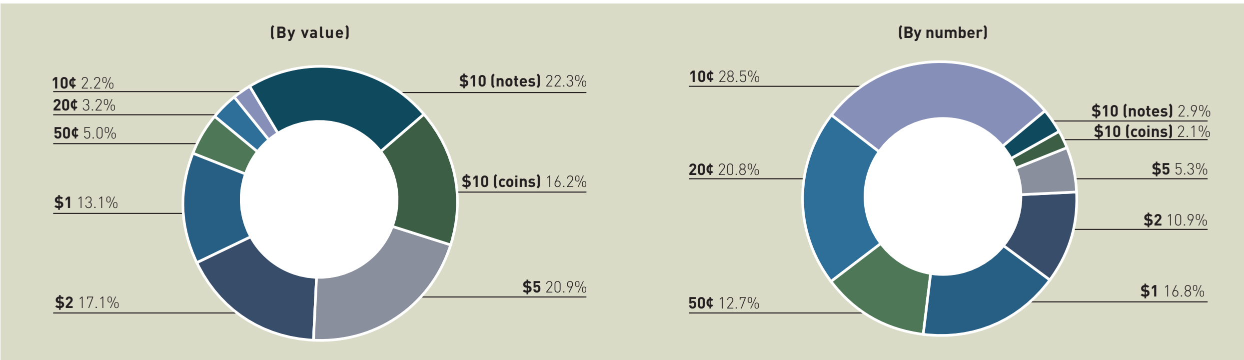
To promote public awareness of the designs and security features of the new banknotes, 33 seminars were organised in 2005 for about 3,200 bank tellers, retail cashiers, moneychangers and cash-handling staff of chain stores and hotels. Participants found the seminars useful in providing them with knowledge and skills for authenticating banknotes. In promoting conservation and a more cost-effective cash management system, the HKMA worked with the three note-issuing banks to encourage members of the public to use "good-as-new notes" for lai-see money instead of using only brand new notes. Talk shows on TV were organised to emphasise this message as well as promoting the security features of banknotes.

Coin replacement programme

The programme to withdraw coins bearing the Queen's Head design continued throughout the year. In 2005, 27 million coins were removed from circulation.

> Consumer Information > Notes and Coins

Chart 9. Government-issued notes and coins in circulation at the end of 2005



OUTLOOK FOR THE ECONOMY

Economic growth to continue

Economic growth in 2006 is expected to remain solid, but the pace of expansion is likely to moderate. The expected slowdown reflects mainly higher interest rates and possible slower growth in some of Hong Kong's main trading partners. Higher interest rates will raise funding costs and debt-service burdens, and dampen consumer and business sentiments, while slower global growth will affect external demand. However, the Hong Kong economy will continue to be supported by some positive factors. First, the third phase of the Closer Economic Partnership Arrangement (CEPA III) between Hong Kong and the Mainland, which comes into effect on 1 January 2006, should benefit Hong Kong's domestic exports and exports of financial and business services. CEPA III covers all Hong Kong products under the tariff exemption scheme and further relaxes the market access conditions for some local service suppliers. Secondly, the opening of Hong Kong Disneyland in September 2005 and the further broadening of the Individual Visit Scheme to include more provinces and cities on the Mainland should support growth in tourism-related sectors. Finally, the continuing improvement in labour market conditions should help consumer spending.

Inflation to increase and labour market conditions to improve

Inflation is expected to pick up modestly in 2006, reflecting a continuous increase in aggregate demand and a further pass-through of rises in residential rents to the consumer price index. In addition, rising rents for commercial properties, especially retail space, will exert upward pressure on firms' operating costs. External factors, such as high oil prices and the appreciation of the renminbi, could also feed into higher import prices. However, the risk of a substantial increase in inflation remains low, largely reflecting the generally benign core inflation in Hong Kong's major trading partners.

Labour market conditions are expected to improve further in 2006. Employment should continue to expand along with the increase in economic activity, although the pace of expansion may moderate. The unemployment rate is expected to decline further.

Uncertainties and risks

The generally positive economic prospects are subject to a number of uncertainties and risks arising from both external and domestic developments. The main external uncertainties include sustained high and volatile oil prices, larger-than-expected interest rate rises in the major economies, and macroeconomic and financial conditions on the Mainland. The rise in oil prices in the past few years has had limited impact on global growth. However, if high oil prices persist or rise further, the impact on the global economy could be larger. In particular, a stronger feeding through to core inflation may trigger more aggressive monetary tightening by major central banks than anticipated. The terms of trade shock arising from high oil prices could also worsen the global imbalance and risk sharp adjustments in exchange rates and interest rates. Under the Linked Exchange Rate system, interest rates in Hong Kong generally move in tandem with those in the US. A marked rise in interest rates will hurt asset markets and, in turn, private consumption and investment through the wealth and balance-sheet effects.

Developments in the Mainland economy will continue to have an important bearing on Hong Kong. Growing trade protectionism in the US and Europe against the Mainland and pressure on the renminbi exchange rate are of particular concern. Although the recent bilateral trade agreements on textiles that the Mainland signed with the European Union and the US represent significant progress in reducing trade tensions between the countries, trade protectionist sentiments against the Mainland's exports remain. A slowdown in the Mainland's export growth due to more intense protectionism could affect Hong Kong's export performance. At the same time, Hong Kong will be affected by movements in the renminbi exchange rate through its trade and financial links with the Mainland. Locally, increases in interest rates and the associated dampening effect on the property market raise concerns about the durability of domestic demand growth. Finally, there is the risk of an avian flu pandemic, which represents a shock that has a potentially major effect on the economy.

> Publications > Half-Yearly Monetary and Financial Stability Report

> Statistics

PERFORMANCE OF THE BANKING SECTOR

The banking sector performed well in 2005 as the buoyant domestic economy helped improve the operating environment. The industry enjoyed healthy growth in operating income on the back of sustained loan growth, improved margins, and the release of surplus provisions due to continued improvement in asset quality. Healthy loan growth and improved interest margins combined to permit the first increase in net interest income since 2001. Non-interest income, particularly in areas of treasury operations and retail and private banking, also boosted profitability.

The recovery in net interest margins started after the introduction of the refinements to the Linked Exchange Rate system in May 2005, which ended a period of exceptionally high liquidity in the banking system. Following these refinements, interbank liquidity returned to more normal levels and Hong Kong money market rates adjusted accordingly. As a result, interest rates in Hong Kong began to mirror the tightening path that the US Federal Reserve had been taking, and banks began a series of increases in their best lending rates to reach 7.75% to 8.00% by the end of the year.

In addition to good profitability and asset quality, the banking sector also maintained high levels of capital and liquidity. The favourable indicators suggest that the banking system is well placed to support continuing economic recovery.

Interest rate trends

Interbank and deposit rates increased

The shrinking of excessive interbank liquidity after the introduction of the refinements to the Linked Exchange Rate system in the middle of 2005 allowed Hong Kong money market rates and deposit rates to increase. One-month HIBOR rose to an annual average rate of 2.91% from 0.30% in 2004 and the one-month time deposit rate rose to 1.26% from 0.03% (Table 3). Banks responded to higher funding costs by raising their best lending rates in increments from 5.00% in May to 7.75% or 8.00% in December. As a result, the spread between the annual

Table 3. Hong Kong dollar interest rate movements (period-average figures)

	Time deposits			HIBOR			Savings	Best lending
% per annum	1-month	3-month	12-month	1-month	3-month	12-month	deposits	rate*
Q1-2005	0.12	0.17	0.61	1.28	1.50	2.12	0.04	5.03
Q2-2005	0.83	0.90	1.32	2.72	2.80	3.12	0.59	5.47
Q3-2005	1.65	1.74	2.12	3.53	3.68	3.93	1.25	6.58
Q4-2005	2.45	2.60	2.85	4.10	4.26	4.56	1.98	7.37
2004	*0.03*	*0.04*	*0.26*	*0.30*	*0.46*	*1.19*	*0.02*	*5.02*
2005	*1.26*	*1.35*	*1.72*	*2.91*	*3.06*	*3.44*	*0.97*	*6.11*

* Best lending rate refers to the rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

average best lending rate and the annual average one-month HIBOR narrowed to 320 basis points compared with 472 basis points in 2004. The spread between the average best lending rate and the one-month time deposit rate contracted to 485 basis points from 499 basis points.

Profitability trends

Retail banks continued to record healthy profit growth in 2005, benefiting from the buoyant domestic economy. The aggregate pre-tax operating profits of the retail banks' Hong Kong offices increased by 8.2%, continuing the strong post-SARS rebound in profitability in 2004 (Chart 10). The post-tax return on average assets also rose to 1.40% from 1.39%[r] (Chart 11).

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

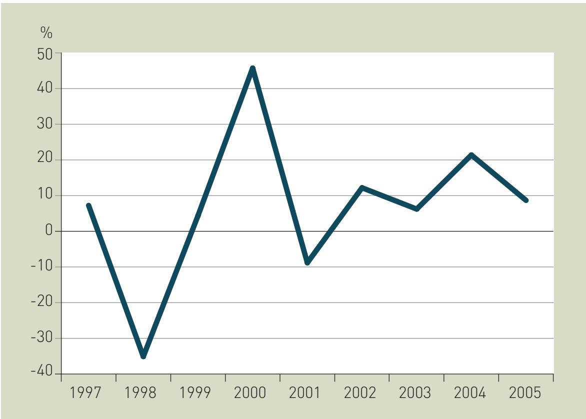
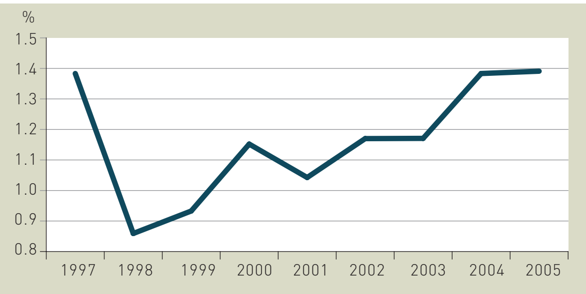
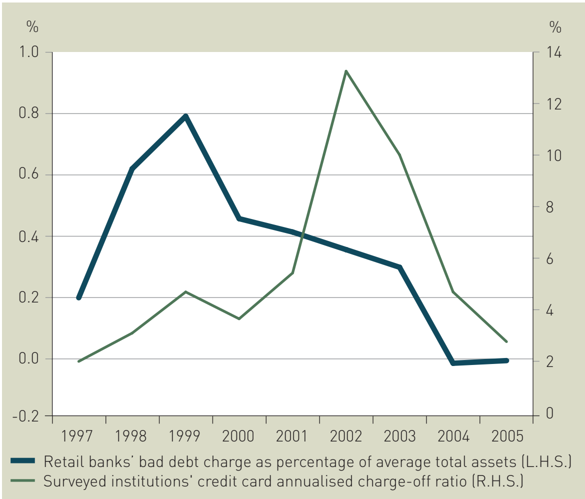


Chart 11. Retail banks' return on assets (after-tax profit)



Both net interest income and non-interest income (mainly income from treasury operations and fees and commissions) contributed to the healthy growth in profits. The proportion of retail banks' non-interest income to total income increased to 40.9% from 39.3% in 2004, while the share of income from treasury operations remained broadly unchanged at 20%. Provision write-backs continued to contribute to profitability, reflecting a continuing improvement in asset quality, although some banks began to make net new provisions in the second half of the year. Overall, retail banks' ratio of bad debt charge to average total assets stood at -0.01% compared with -0.02% in 2004 (Chart 12).

Chart 12. Charge-off ratios



[r] Figure revised.

For the first time in three years retail banks experienced an increase in net interest income. The increase was attributable to improved lending margins, particularly in residential mortgages, and higher yield on free funds. Although the net interest margin was under pressure in the first half of the year due to excessive liquidity, retail banks' net interest margin increased to 1.68% from 1.66%[r] in 2004 on the back of an expansion in interest-bearing assets and improvement in lending margins in the second half of the year (Chart 13).

Retail banks' operating costs continued to increase in 2005. This was largely due to the rise in staff expenses resulting from additional recruitment for business expansion and pay rises. As a result, retail banks' cost-to-income ratio rose to 41.9% from 41.4%[r] in 2004 (Chart 14).

Chart 13. Retail banks' net interest margin

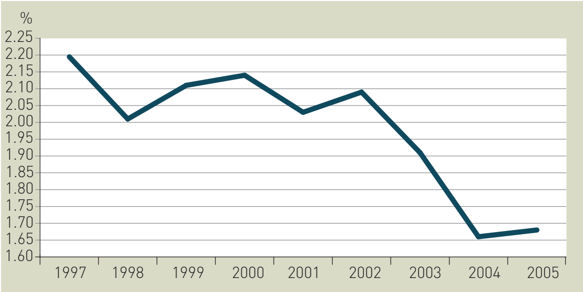
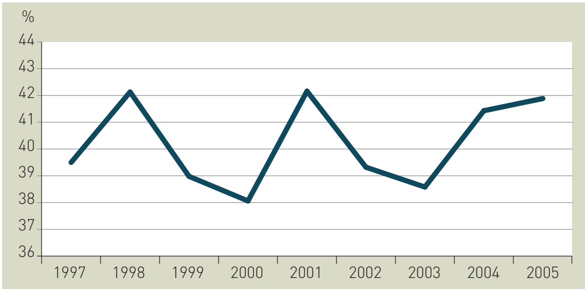


Chart 14. Retail banks' cost-to-income ratio



[r] Figure revised.

Balance sheet trends

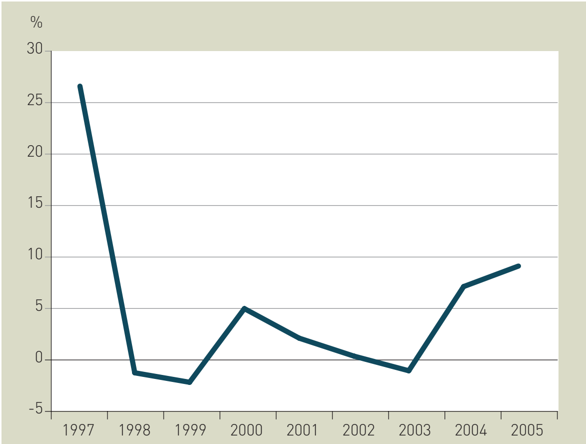
Driven by the buoyant domestic economy, total assets of the banking sector and the retail banks expanded by 1.5% and 3.4% respectively. Retail banks' deposit liabilities also increased by 3.1%. The increase was larger in the fourth quarter as higher deposit rates attracted more funds.

Growth in domestic loan demand

Benefiting from the robust domestic economy and growth in external trade, retail banks' total lending rose by 9.8% in 2005. Domestic lending, mainly property lending and trade financing, increased by 9.2% (Chart 15), compared with 7.2% in 2004. Reflecting broad-based economic growth, lending to all major economic sectors increased. Loans for use outside Hong Kong also increased considerably by 27.1%.

Property lending rose by 7.6% after an increase of 5.7% in 2004. Loans for property investment and residential mortgages increased by 17.1% and 2.1% respectively compared with 16.0% and 2.9% in 2004. Loans for property development reversed a decline of 3.8% in 2004 to grow by 13.8%.

Chart 15. Retail banks' year-on-year growth of loans to customers inside Hong Kong*



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

Helped by strong external trade growth, trade financing rose by 10.7% compared with 17.6% in 2004. Loans to the manufacturing sector also rose by 16.4% after the post-SARS rebound of 29.6% in 2004. As the number of Mainland visitors continued to increase and consumption demand continued to grow, lending to the wholesale and retail trade sector grew by 5.8%. Amid the buoyant stock market activity, the decline in loans to stockbrokers slowed to 0.1% from 30.4% in 2004. Loans to non-stock-broking companies and individuals for purchasing shares rose further by 42.4% following an increase of 11.9% in 2004. Lending to the information technology sector also rose by 12.7%, with much of the increase attributable to lending to the telecommunication sector, which grew by 22.8% after having fallen for two consecutive years.

Better labour market conditions and improving household income encouraged a further expansion in lending to individuals, particularly credit card lending. According to the regular survey of authorized institutions active in credit card business, total credit card receivables rose by 14.9% following an increase of 5.2% in 2004.

Total outstanding exposure to non-bank Chinese entities increased in 2005. The increase mainly reflected the increase in exposures to H-share companies and their subsidiaries and other entities known to be owned or controlled by Chinese interests. Retail banks' exposure increased by 10.0% to $141.3 billion and accounted for 2.8% of their total assets. The exposure of the banking sector also increased to $206.1 billion (2.6% of total assets).

Increased holding of negotiable debt instruments

As a result of improved lending opportunities, retail banks' holding of negotiable debt instruments (NDIs, excluding negotiable certificate of deposits (NCDs)) grew by a slower rate of 6.0% compared with 6.7% in 2004. The increase was largely attributable to corporate debt instruments denominated in foreign currencies. NDIs denominated in Hong Kong dollars edged down by 0.5%, while foreign currency NDIs rose by 9.6% (Chart 16). About 54.8% of the NDIs were issued by corporates, while 22.8% were issued by governments and 22.4% by banks (Chart 17). The share of total holdings of NDIs by the retail banks to their total assets was stable at about 22% at the end of 2005.

Chart 16. Negotiable debt instruments held by retail banks (currency breakdown)

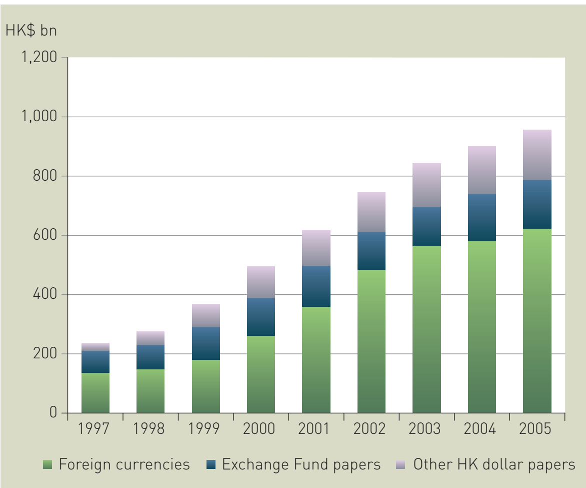
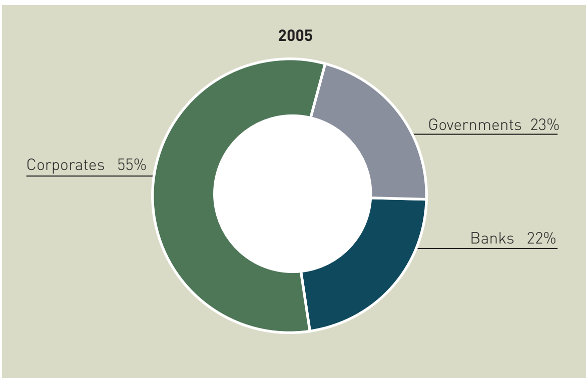


Chart 17. Negotiable debt instruments held by retail banks (counterparty breakdown)



Reflecting the continued demand for NCDs by retail customers, the outstanding amount of issued NCDs increased by 1.6% in 2005 after rising 10.4% in 2004. As holdings of NCDs by retail customers increased, the proportion of outstanding NCDs held by retail banks fell to 26.9% at the end of 2005, compared with 31.0% a year before.

Customer deposits expanded

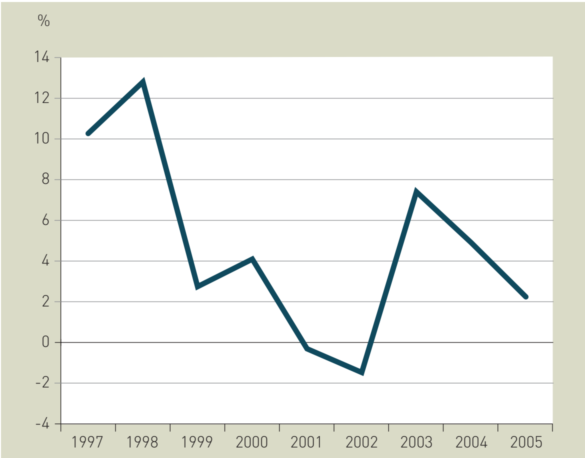
Despite the outflow of funds following the introduction of the refinements to the Linked Exchange Rate system, retail banks' total customer deposits for the year as a whole expanded by 3.1%, after increasing 7.4% in 2004 (Chart 18). Much of the increase was recorded in the fourth quarter, especially in foreign currency deposits. With the 4.4% increase in foreign currency deposits outweighing the 2.2% increase in Hong Kong dollar deposits (Chart 19), the proportion of Hong Kong dollar deposits to total deposits decreased to 59% from 60% at the end of 2004. Attracted by the higher interest rates, depositors shifted their savings and demand deposits to time deposits. This resulted in a sizeable increase in time deposits by 30.1% in 2005 compared with 1.1% in 2004. Savings and demand deposits fell by 21.2% and 17.0% respectively as opposed to an increase of 11.8% and 22.9% in 2004. At the end of 2005, savings and demand deposits together accounted for 41.1% of total deposits, down from 53.3% a year earlier.

Chart 18. Retail banks' year-on-year growth of total customer deposits

Retail banks remained highly liquid

Retail banks remained highly liquid in 2005, although the industry's loan-to-deposit ratios in all currencies (2005: 53.2%; 2004: 50.0%) and in Hong Kong dollar (2005: 78.8%; 2004: 73.2%) increased as loans grew faster than deposits.

Chart 19. Retail banks' year-on-year growth of Hong Kong dollar deposits*



* Including swap deposits.

Improvement in overall asset quality continued

The overall asset quality of retail banks strengthened further in 2005 with the continued improvements in the domestic economy, the labour market, income levels and property values. All problem loan ratios of the retail banks declined from 2004. The ratio of loans overdue for more than three months dropped to 0.69% from 1.05%[r] at the end of 2004. Together with a decrease in the rescheduled loan ratio to 0.23%, the combined ratio of overdue and rescheduled loans improved to 0.92% from 1.48%. The classified loan ratio also declined to 1.38% from 2.25%[r] at the end of 2004 (Chart 20).

The delinquency ratio of the residential mortgage portfolio fell to a new low of 0.19% at the end of 2005, reflecting the better labour market conditions and household income levels, both helped strengthen the repayment ability of homeowners (Chart 21). The rescheduled loan ratio also declined to 0.35% from 0.47%.

The outstanding number of residential mortgage loans in negative equity decreased by 43% from 2004 to stand at about 11,000 cases by the end of 2005. This was despite a slight increase in the number of cases in the fourth quarter as interest rate increases affected property valuations. Compared with the peak of 106,000 cases in June 2003, the number of negative equity cases was down by 90%.

The overall quality of credit card lending by the banks improved, with the credit card charge-off ratio for the year dipping to 2.81% from 4.73% in 2004 (Chart 12), and the credit card delinquency ratio declining to a new low of 0.37% from 0.44%. The improvements were also helped in part by the transfer of some rescheduled receivables outside the credit card portfolio. Taking into account the outstanding rescheduled credit card receivables, which amounted to $60 million, or 0.1% of total receivables, the combined delinquent and rescheduled ratio fell to 0.45% at the end of the year.

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Chart 20. Retail banks' gross classified loans and combined overdue and rescheduled loans as a percentage of total loans

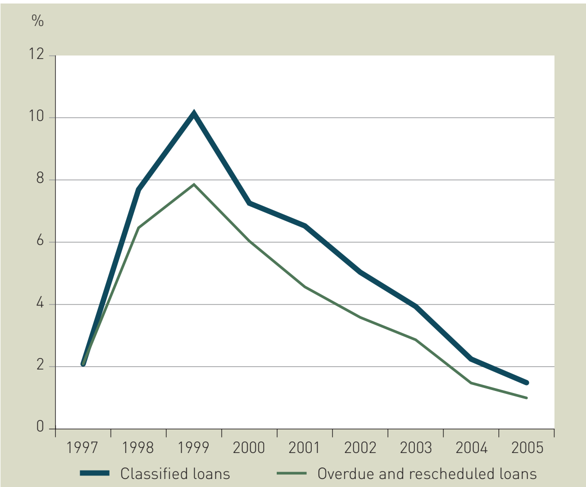
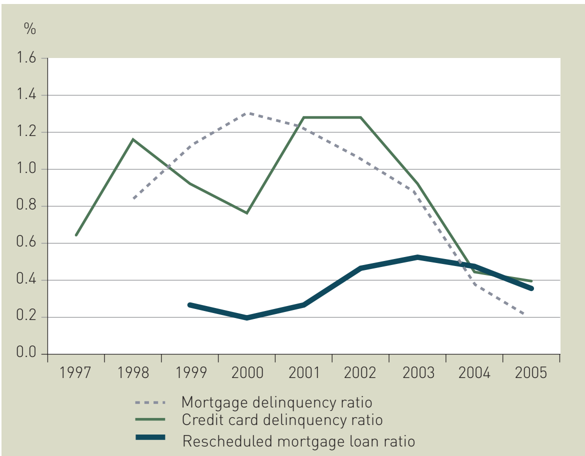


Chart 21. Asset quality of credit card and mortgage lending by surveyed institutions



[r] Figure revised.

Strong capital ratio

With risk-weighted assets growing faster than capital base, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions declined slightly to 14.9% at the end of 2005, still well above the statutory minimum of 8% (Chart 22).

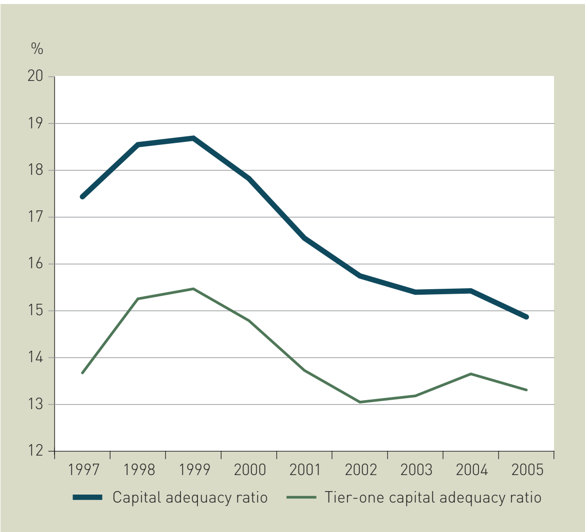
As a result of the increase in risk-weighted assets, the tier-one capital ratio also fell to 13.3% at the end of 2005, compared with 13.6%[r] at the end of 2004 (Chart 22).

PROSPECTS FOR 2006

The strong financial condition of the banking system leaves it well placed to support the continuing economic recovery and to weather any future shocks. The greatest uncertainty for 2006 concerns the effect that the series of interest rate increases, which began in the second half of 2005, will have on loan demand and credit quality. There are early indications that the increased cost of borrowing has had some marginal impact on the demand for new loans, particularly in the residential mortgage market, and there may have been some slight deterioration of loan quality towards the end of 2005. However, given that all indicators show asset qualities are good by historical experience, a slight deterioration of loan quality during 2006 is probably to be expected.

Although interest margins have recovered from the low point reached in the first half of 2005, they nonetheless remain low by historical standards. Highly competitive loan and deposit markets have contributed to the long-run tightening of margins and these conditions persist, notwithstanding the removal of the conditions of excessive liquidity seen in early 2005. Against this background, the key to sustained future profitability will be the continuing ability of banks to keep their operating and funding costs under control and to diversify their sources of income. These conditions are likely to favour large banks with their big retail deposit bases and their ability to diversify their income sources and product range. Smaller banks are likely to continue to find the conditions challenging.

Chart 22. Consolidated capital adequacy ratio of all locally incorporated AIs



[r] Figure revised.