CHIEF EXECUTIVE'S STATEMENT

Favourable economic trends

Hong Kong enjoyed robust economic growth in 2005, following a strong and broad-based recovery in 2004. Real GDP grew by a healthy 7.3%, slightly lower than the 8.6% growth in 2004, which reflected the rebound from the SARS outbreak in the previous year. The unemployment rate continued to decline to a four-year low of 5.3% at the end of December, well down from its historic peak of 8.6% in mid-2003, although still high by historical standards. Exports of goods and services increased by 11.2% and 8.4% respectively in 2005, reflecting solid growth among Hong Kong's trading partners. Despite higher interest rates and a moderation in the property market towards the end of the year, private consumer and investment spending both increased.

Factors contributing to Hong Kong's robust performance in 2005 included strong growth in the US economy (despite high oil prices and the gradual removal of the Federal Reserve's accommodative monetary policy) and solid growth among our other major trading partners, which supported our export performance. Private consumption rebounded as a result of increasing employment and household income. The property market continued to recover, further reducing the number of residential property mortgages in negative equity, which, despite rising slightly towards the end of the year as property prices moderated, has come down by about 90% from its peak in mid-2003. Interest rates caught up with their US counterparts and tracked them fairly closely in the second half of the year. Inflation returned in 2005, with the year-on-year change in the Composite Consumer Price Index reaching 1.8% in December and averaging 1.1% for the year. This was the first increase for seven years and inflationary pressure remains benign.

Mixed markets

2005 saw a significant rise in energy prices and the continued removal of the accommodative stance in the monetary policy of the US Federal Reserve. The price of benchmark crude oil rose from US$43.5 a barrel at the beginning of the year to US$61 at the end. The Fed continued to increase the federal funds target rate, which was raised eight times in 2005 to end the year at 4.25%. Global equity markets showed mixed results; improving economic prospects in Japan caused the TOPIX to rise by 43.5%, while the euro-zone stock indices rose by 13% to 33%. The US and Hong Kong equities markets fared less well with the S&P 500 rising by 3.0% and the Hang Seng Index by 4.5%.

The investment objectives of the Exchange Fund emphasise capital preservation and liquidity because the Exchange Fund must be available for backing the Monetary Base to safeguard the exchange value of the Hong Kong dollar. This sets the Fund apart from conventional investment funds, which seek to maximise returns. The high volatility in the financial markets in recent years has highlighted the importance of risk management in the investment of the Fund and the need to diversify into new markets and instruments. Despite the difficult investment environment in 2005, in particular the strengthening of the US dollar, which affected the value of the Exchange Fund's non-US-dollar holdings, the Exchange Fund earned an investment income of $38.2 billion in 2005, and a rate of return exceeding that of the investment benchmark approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee (EFAC) by more than 0.2%. The share of investment income going to the fiscal reserves placed with the Exchange Fund was $10 billion.

Hong Kong dollar stability

The exchange and money markets were largely stable during the year despite massive fund flows with a record $166 billion being raised locally arising from initial public offerings in the stock market, including $72 billion for a single offering. There were also speculative inflows, particularly in the first few months of the year, as the Hong Kong dollar was used as a proxy by people taking a position on the renminbi. Market sentiment was that the Hong Kong dollar would appreciate alongside the renminbi when flexibility was introduced into the exchange rate of the latter. This position-taking had widened the interest rate differentials between the Hong Kong dollar and the US dollar, and resulted in very easy monetary conditions, which could be destabilising if they were sustained.

To normalise the situation, on 18 May the HKMA introduced the three refinements to the Linked Exchange Rate system. The intention behind the three refinements was to remove the uncertainty about the extent to which the Hong Kong dollar would be allowed to appreciate against the US dollar. Anchoring exchange rate expectations on the strong side would discourage speculative inflows and allow interest rate arbitrage to exert a greater influence in the maintenance of a stable exchange rate. This proved to be the case when, following the announcement, expectations of an appreciation in the Hong Kong dollar diminished, speculative inflows reversed and the weak-side Convertibility

Undertaking was triggered. The Aggregate Balance swiftly declined and interest rates rose, reflecting the tightening of interbank liquidity following the introduction of the three refinements, tracking their US counterparts quite closely for the remainder of the year. When the reform of the renminbi exchange rate system was announced in July, the Hong Kong dollar exchange rate was barely affected, suggesting that the three refinements had achieved their purpose.

A strong and stable banking sector

The banking sector continued to perform strongly in 2005 benefiting from the buoyant domestic economy with aggregate pre-tax operating profits of retail banks' Hong Kong offices increasing by 8.2%. Both increases in net interest income and non-interest income contributed to this growth in profits with the share of non-interest income increasing to 40.9% from 39.3% in 2004. Total lending by retail banks grew by 9.8% in 2005. The average net interest margin of retail banks for the year increased slightly to 1.68% compared with 1.66% in 2004 despite pressure in the first half due to excess liquidity. Asset quality continued to improve in 2005 as a result of improvements in the domestic economy, the labour market and property values. The classified loan ratio declined to 1.38% from 2.25% at the end of 2004. Retail banks remained highly liquid in 2005, although loan-to-deposit ratios increased. The capital adequacy ratio of all authorized institutions declined slightly to 14.9% at the end of 2005, still well above the statutory minimum of 8%. Retail banks' operating costs increased during the year, mainly as a result of higher staff expenses, and the cost-to-income ratio rose to 41.9% from 41.4% in 2004. Continued competition and pressure on costs are likely to make the operating environment challenging for the banks in 2006.

The HKMA expanded its efforts to promote the safety and stability of the banking system in 2005, reorganising the Banking Supervision Department to make the risk-based approach to supervision more effective and increasing the number of on-site examinations. Further progress towards the implementation of Basel II was made with the enactment in July of the Banking (Amendment) Ordinance 2005 and consultation with the banks on the draft rules for implementing the capital adequacy standards. Hong Kong is among the first economies to introduce the improved risk-management regime under the Basel II initiative. Good progress has been made with the establishment of the Deposit Protection Board in preparation for the launch of the Deposit Protection Scheme in 2006. To improve the safety and security of Internet banking, two-factor authentication was launched jointly with the Hong Kong Association of Banks and the Police in May. Following the end of a two-year moratorium on the access to credit data by financial institutions for credit review, the HKMA conducted a review of the benefits of positive credit data sharing. The results showed clear benefits to consumers with a significant portion of credit card rollover balances being substituted by cheaper forms of non-card credit.

Hong Kong continues to support the prevention of money laundering and terrorist financing by ensuring that the banking system adopts the latest and best practices issued by the standard-setters in this area. In 2005, the HKMA stepped up its efforts by conducting more examinations of anti-money laundering procedures in authorized institutions and sharing the findings with the banking industry to help them better understand the issues involved and prioritise their resources.

Developing Hong Kong as an international financial centre

The HKMA was involved in several key initiatives to strengthen Hong Kong's status as an international financial centre. These included the successful launch of the second phase of the Asian Bond Fund initiative (ABF2), which comprises a number of local-currency denominated funds designed to strengthen and deepen regional bond markets. The component funds of ABF2 have been specifically designed to keep costs and investment thresholds low to appeal to a broader class of investors. Two key components launched in Hong Kong, the Pan Asia Bond Index Fund and the Hong Kong Bond Index Fund, have been well received by the market. This initiative, instigated by Hong Kong with the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), is widely seen as a model for successful co-operation in the development of financial markets in Asia.

The steady development of renminbi business in Hong Kong continued following its launch in 2004. Outstanding renminbi deposits in Hong Kong banks almost doubled to reach RMB 22.6 billion yuan at the end of December. In November the scope of renminbi business was expanded. The definition of designated merchants was widened and designated merchants are now allowed to open renminbi deposit accounts; Hong Kong residents are allowed to use renminbi cheques in Guangdong Province; limits on the exchange and remittance of renminbi by individuals have been relaxed; and the cap on credit limits for renminbi credit cards has been removed. Discussions with Mainland authorities are continuing about further expansion, including the settlement of trade transactions in Hong Kong in renminbi and the issuance of renminbi-denominated bonds in Hong Kong. Under Phase III of the Closer Economic Partnership Arrangement, the Mainland authorities agreed to relax the requirements regarding the amount of operating funds for Hong Kong banks to open branches on the Mainland to offer renminbi and foreign-currency business to local customers.

An important aspect of developing Hong Kong as an international financial centre is ensuring that it has a well developed and flexible financial infrastructure. The HKMA undertook a review of financial infrastructure development in the first half of 2005 with the objective of establishing a safe and efficient, multi-dimensional and multi-currency payment and settlement platform. While perhaps largely unnoticed by the general public, robust and effective clearing and payment systems help to keep the financial and monetary systems stable and competitive. The recommendations of the review are now being implemented. Highlights in 2005 included the re-launch of a refined scheme for retail investment in Exchange Fund Notes, the launch of the CMU Bond Price Bulletin for retail investors, and the development of the RTGS Liquidity Optimiser to help banks better manage their intraday liquidity. Preparation also began during the year for the establishment of an automated renminbi settlement system to cater for the expanded scope of renminbi business in Hong Kong and the migration of the Real Time Gross Settlement system and Central Moneymarkets Unit from a proprietary platform to the SWIFTNet open platform to allow greater international participation. Payment links with the Mainland have also been developed to meet increasing demand following the rapid increase in economic activities between the Mainland and Hong Kong. The establishment of the Treasury Markets Association is also a major step forward in our effort to promote the treasury markets of Hong Kong and enhance the professionalism of market practitioners.

Governance and transparency

The HKMA is an integral part of the Hong Kong Special Administrative Region Government but, like central banking institutions elsewhere in the world, we maintain a degree of separation from the main structure of government. This is reflected in the autonomy given to the HKMA in its daily operation, in our funding arrangements, and in our employment of staff on terms different from those of the civil service. There are sound reasons for these arrangements: they are consistent with the generally accepted principle that central banking institutions should have resource independence to allow them to pursue their objectives without political influence. This independence allows the HKMA to do its job flexibly in an environment that is often changing rapidly and, when necessary, to take steps that might not be popular in the short term but which are necessary to achieve the Financial Secretary's stated policy objective of ensuring exchange rate stability. But the HKMA is funded by public money and responsible for the management of over a trillion dollars of public funds. It is therefore right and necessary that there should be a system of accountability to balance our operational autonomy, and the HKMA is accountable to the Financial Secretary through EFAC, and to the community, both directly and through its elected representatives on the Legislative Council. My thrice-yearly briefings of the Legislative Council's Financial Affairs Panel on the work of the HKMA have become an established and important channel for keeping Members, and the wider community, informed about what we are doing and developments in the monetary, financial and banking fields.

2005 was the first full year of operation for the expanded system of EFAC Sub-Committees introduced in 2004. The arrangements functioned well and the Sub-Committees' responsibilities and activities during the year are summarised in the "About the HKMA" chapter.

The HKMA makes great efforts to explain its work to the community it serves through its publications, public education programmes and website. In 2005, the HKMA's website received over 21 million page views, a 40% increase from 2004. I took great pleasure in welcoming the hundred-thousandth visitor to the HKMA Information Centre in December; more than 110,000 people have now visited the Centre since it opened in late 2003. This policy of accessibility is a two-way process, allowing the community to know more about what we do and helping us to keep in touch with people's views about our work and the policies we pursue.

The staff establishment of the HKMA again remained stable in 2005 despite our having expanded our work and taken on a number of new responsibilities. Following approval by the Financial Secretary, on the advice of EFAC and its Governance Sub-Committee, the staff establishment was increased by 10 posts at the beginning of 2006 to 614 to help the HKMA cope with a considerably expanded workload in a number of key areas including the prevention of money laundering, supervision of banks' securities business and financial links with the Mainland. I would like to thank staff of the HKMA for their hard work and dedication during another challenging year.

My colleagues and I are also grateful to the Financial Secretary and to Members of EFAC for their continued guidance and support.

Joseph Yam
Chief Executive