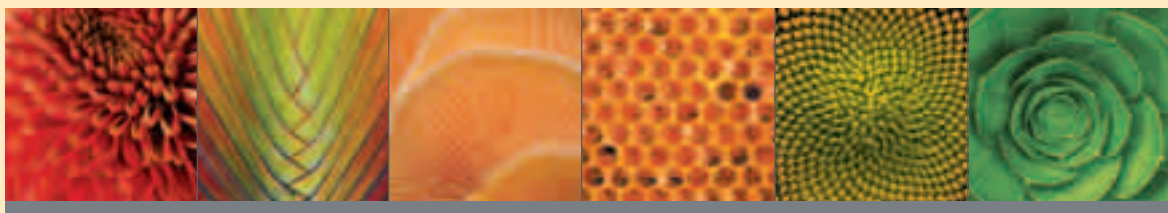


**AN INTRODUCTION TO THE
HONG KONG MONETARY AUTHORITY
2006 EDITION**



Incorporating the Summary Version of the HKMA Annual Report 2005



**HONG KONG MONETARY AUTHORITY
香港金融管理局**

THE HONG KONG MONETARY AUTHORITY

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

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

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The first part of this booklet introduces the work and policies of the HKMA. The second part contains a summary of the HKMA's Annual Report for 2005. The full Annual Report is available on the HKMA website both in interactive form and on PDF files. Hard copies may also be purchased from the HKMA: see Reference Resources on page 49 for details.

This booklet makes reference to documents and other materials available on the HKMA website www.hkma.gov.hk. These references appear as , followed by navigation guidance from the HKMA homepage.

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

ABOUT THE HKMA

The Hong Kong Monetary Authority is Hong Kong's central banking institution. The HKMA has four main functions: maintaining the stability of the Hong Kong dollar; promoting the safety of Hong Kong's banking system; managing Hong Kong's official reserves; and maintaining and developing Hong Kong's financial infrastructure.

THE HKMA'S LEGAL MANDATE

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

The powers, functions and responsibilities of the Monetary Authority are set out in the Exchange Fund Ordinance, the Banking Ordinance, the Deposit Protection Scheme Ordinance, the Clearing and Settlement Systems Ordinance and other relevant Ordinances. The division of functions and responsibilities in monetary and financial affairs between the Financial Secretary and the Monetary Authority is set out in an Exchange of Letters between the two dated 25 June 2003. This Exchange of Letters also discloses the delegations made by the Financial Secretary to the Monetary Authority under these Ordinances. The letters are public documents: copies of them may be found on the HKMA website.

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

for maintaining the stability and integrity of the monetary and financial systems of Hong Kong, with a view to maintaining Hong Kong as an international financial centre.

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

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

The Clearing and Settlement Systems Ordinance provides a statutory regime for the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre.

Under the Deposit Protection Scheme Ordinance the Monetary Authority is charged with implementing the decisions of the Hong Kong Deposit Protection Board, and among other things, deciding whether compensation should be paid to the depositors of a failed scheme bank pursuant to the Ordinance.

 > The HKMA

THE HKMA AND THE HONG KONG SAR GOVERNMENT

The HKMA is an integral part of the Hong Kong SAR Government, but is able to employ staff on terms different from those of the civil service in order to attract personnel of the right experience and expertise. The Chief Executive of the HKMA remains a public officer, as do his staff. In its day-to-day work the HKMA operates with a high degree of autonomy within the relevant statutory powers conferred upon, or delegated to, the Monetary Authority.

The Financial Secretary is responsible for determining the monetary policy objective and the structure of the monetary system of Hong Kong: a letter from the Financial Secretary to the Monetary Authority dated 25 June 2003 specifies that these should be currency stability defined as a stable exchange value at around HK\$7.80 to one US dollar maintained by Currency Board arrangements. The Monetary Authority is on his own responsible for achieving the monetary policy objective, including determining the strategy, instruments and operational means for doing so. He is also responsible for maintaining the stability and integrity of the monetary system of Hong Kong.

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

- promoting the general stability and effective working of the banking system
- promoting the development of the debt market, in co-operation with other relevant bodies
- matters relating to the issuance and circulation of legal tender notes and coins
- promoting the safety and efficiency of the financial infrastructure through the development of payment, clearing and settlement systems and, where appropriate, the operation of these systems
- seeking to promote, in co-operation with other relevant bodies, confidence in Hong Kong's monetary and financial systems, and appropriate market development initiatives to help strengthen the international competitiveness of Hong Kong's financial services.

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

ACCOUNTABILITY AND TRANSPARENCY

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

The HKMA serves Hong Kong by promoting monetary and banking stability, by managing the official reserves effectively, and by developing and overseeing a robust and diverse financial infrastructure. These processes help to strengthen Hong Kong's role as an international financial centre and to foster Hong Kong's economic well-being. The HKMA must have the confidence of the community if it is to perform its duties well. The HKMA therefore takes seriously the duty of explaining its policies and work to the general public and makes every effort to address any concerns within the community relevant to the HKMA's responsibilities.

The HKMA is accountable to the people of Hong Kong through the Financial Secretary, who appoints the Monetary Authority, and through the laws passed by the Legislative Council that set out the Monetary Authority's powers and responsibilities. The HKMA also recognises a broader responsibility to promote a better understanding of its roles and objectives and to keep itself informed of community concerns. In its day-to-day operations and in its wider contacts with the community, the HKMA pursues a policy of transparency and accessibility. This policy has two main objectives:

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

The HKMA seeks to follow international best practices in its transparency arrangements. It maintains extensive relations with the mass media and produces a range of regular and special publications in both English and Chinese. The HKMA's bilingual website (www.hkma.gov.hk) carries all HKMA publications, press releases, speeches and presentations, in addition to special sections on research, statistics, consumer information and other topics. The HKMA maintains an Information Centre at its offices, consisting of a library and an exhibition area, which is open to the public six days a week. The HKMA also organises an annual public education programme, which seeks to inform the public, and in particular students, about the work of the HKMA through seminars and guided tours at the Information Centre. The HKMA's weekly *Viewpoint* column, carried on the HKMA website and in several Hong Kong newspapers, informs the public about aspects of the HKMA's work. Further information on the HKMA's media work, publications and public education programmes is contained in the Chapter on Professional and Corporate Services in the full Annual Report.

 > [Viewpoint](#)

 > [HKMA Information Centre](#)

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

 > [Press Releases > Exchange Fund](#)

 > [Supervisory Policy Manual](#)

 > [Guidelines and Circulars](#)

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

 > [Legislative Council Issues](#)

ADVISORY AND OTHER COMMITTEES

Exchange Fund Advisory Committee

In his control of the Exchange Fund, the Financial Secretary is advised by the Exchange Fund Advisory Committee (EFAC). EFAC is established under Section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Exchange Fund. The Financial Secretary is ex officio Chairman of EFAC. Other members, including the Monetary Authority, are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR. Members of EFAC are appointed for the expertise and experience that they can bring to the committee. Such expertise and experience includes knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

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

EFAC is assisted in its work by five subcommittees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC. The Committee held six regular meetings in 2005 to discuss the full range of issues relating to the work of the HKMA, most of which had been previously discussed by the relevant Sub-Committees. An additional meeting was held in May to discuss the refinements to the Linked Exchange Rate mechanism introduced on 18 May 2005.

Membership (1 April 2006)

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP
The Financial Secretary

Members

Mr Joseph YAM, GBS, JP
The Monetary Authority

Dr The Hon. David LI Kwok-po, LLD, GBS, JP
Chairman and Chief Executive
The Bank of East Asia Limited

Dr The Hon. Marvin CHEUNG Kin-tung,
DBA Hon., SBS, JP

Professor Richard Y C WONG, SBS, JP
Deputy Vice-Chancellor
The University of Hong Kong

Mr Christopher CHENG Wai-chee, GBS, JP
Chairman
USI Holdings Limited

The Hon. Victor LO Chung-wing, GBS, JP
Chairman and Chief Executive
Gold Peak Industries (Holdings) Limited

Dr Patrick WANG Shui-chung, JP
Chairman and Chief Executive Officer
Johnson Electric Holdings Limited

Mr HE Guangbei
Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

Professor K C CHAN
Dean of Business and Management
Hong Kong University of Science and Technology

The Hon. Henry FAN Hung-ling, SBS, JP
Managing Director
CITIC Pacific Limited

Mr Simon IP Sik-on, JP

Mr Thomas KWOK Ping-kwong, JP
Vice-Chairman and Managing Director
Sun Hung Kai Properties Limited

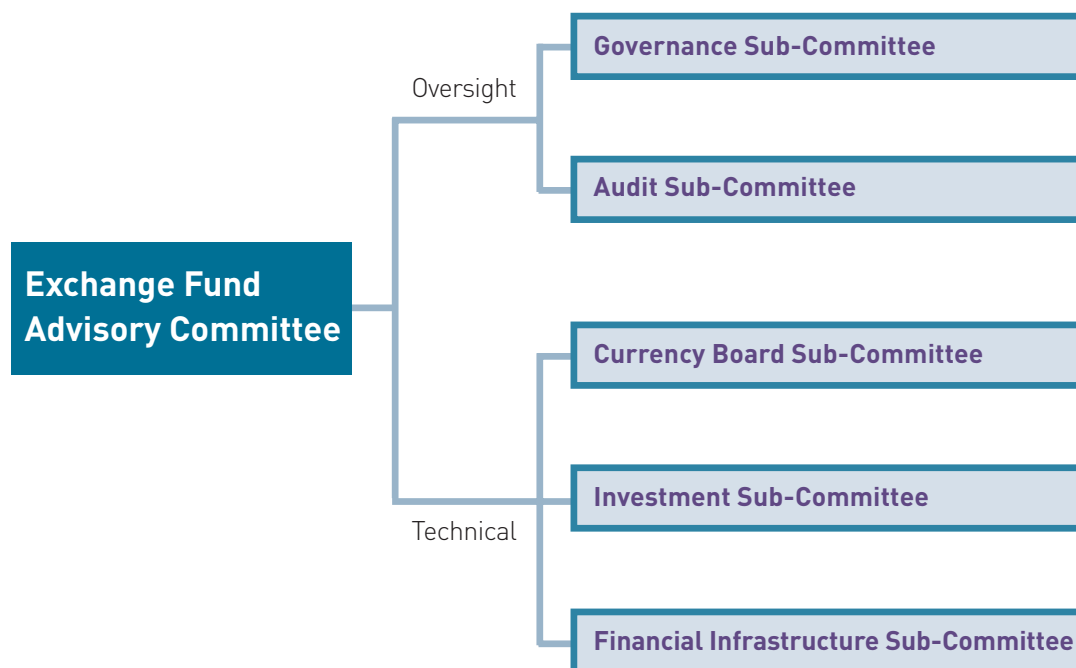
Mr Peter SULLIVAN
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation
Limited

Secretary

Mr Trevor KEEN

EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



The *Governance Sub-Committee* monitors the performance of the HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues. The Sub-Committee met seven times in 2005 to consider a range of subjects including disclosure of information on the HKMA's expenditure budget, the HKMA's performance in 2004, the 2005 annual pay review, the *2004 HKMA Annual Report*, business continuity planning, strategic planning matters and the 2006 HKMA budget. The Sub-Committee also received regular reports on the work of the HKMA.

Membership (1 April 2006)

Chairman

Dr The Hon. Marvin CHEUNG Kin-tung,

DBA Hon., SBS, JP

Members

Professor Richard Y C WONG, SBS, JP

Deputy Vice-Chancellor

The University of Hong Kong

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

The Hon. Victor LO Chung-wing, GBS, JP

Chairman and Chief Executive

Gold Peak Industries (Holdings) Limited

Dr Patrick WANG Shui-chung, JP

Chairman and Chief Executive Officer

Johnson Electric Holdings Limited

Professor K C CHAN

Dean of Business and Management

Hong Kong University of Science and Technology

The Hon. Henry FAN Hung-ling, SBS, JP

Managing Director

CITIC Pacific Limited

Mr Simon IP Sik-on, JP

Mr Thomas KWOK Ping-kwong, JP

Vice-Chairman and Managing Director

Sun Hung Kai Properties Limited

Secretary

Mr Trevor KEEN

The *Audit Sub-Committee* reviews and reports on the HKMA's financial reporting process and the adequacy and effectiveness of the internal control systems of the HKMA. The Sub-Committee reviews the HKMA's financial statements, and the composition and accounting principles adopted in such statements. It also examines and reviews with both the external and internal auditors the scope and results of their audits. The Sub-Committee met three times in 2005. In addition to regular reports, the Sub-Committee reviewed a consultancy report on the implementation of Hong Kong Financial Reporting Standards and assessed its impact on the Exchange Fund Accounts.

Membership (1 April 2006)

Chairman

Dr The Hon. Marvin CHEUNG Kin-tung,

DBA Hon., SBS, JP

Members

Mr HE Guangbei

Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Dr The Hon. David LI Kwok-po, LLD, GBS, JP

Chairman and Chief Executive
The Bank of East Asia Limited

Mr Simon IP Sik-on, JP

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman
The Hongkong and Shanghai Banking Corporation
Limited

Secretary

Mr Trevor KEEN

The *Currency Board Sub-Committee* monitors and reports on the Currency Board arrangements that underpin Hong Kong's Linked Exchange Rate system. It is responsible, among other things, for ensuring that Currency Board operations are in accordance with established policy, recommending improvements to the Currency Board system, and ensuring a high degree of transparency in the operation of the system. Records of the Sub-Committee's meetings and the reports on Currency Board operations submitted monthly to the Sub-Committee are published. In 2005 the Sub-Committee met six times. Topics discussed included a monetary conditions index for Mainland China, convertibility arrangements for the Aggregate Balance and operations within the Convertibility Zone, transferability between Certificates of Indebtedness and the Aggregate Balance, and the implications of the new renminbi exchange rate regime for Hong Kong.

 > [Press Releases](#) > [Monetary Policy](#)

Membership (1 April 2006)

Chairman

Mr Joseph YAM, GBS, JP
The Monetary Authority

Members

Mr William RYBACK, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Peter PANG, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Dr The Hon. David LI Kwok-po, LLD, GBS, JP
Chairman and Chief Executive
The Bank of East Asia Limited

Professor Richard Y C WONG, SBS, JP
Deputy Vice-Chancellor
The University of Hong Kong

Mr John GREENWOOD
Group Chief Economist
INVESCO Asset Management Limited

Professor TSANG Shu-ki
Department of Economics
Hong Kong Baptist University

Professor K C CHAN
Dean of Business and Management
Hong Kong University of Science and Technology

Mr Peter WONG Tung-shun, JP
Chairman
The Hong Kong Association of Banks

Secretary

Mr Trevor KEEN

The *Investment Sub-Committee* monitors the HKMA's investment management work and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters. The Sub-Committee held six meetings during 2005 to give advice on the investment strategy of the Exchange Fund and related issues.

Membership (1 April 2006)

Chairman

Mr Joseph Yam, GBS, JP
The Monetary Authority

Members

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Christopher CHENG Wai-chee, GBS, JP
Chairman
USI Holdings Limited

Mr HE Guangbei

Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

Professor K C CHAN

Dean of Business and Management
Hong Kong University of Science and Technology

The Hon. Henry FAN Hung-ling

, SBS, JP

Managing Director
CITIC Pacific Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Mr Vincent CHENG Hoi-chuen

, GBS, JP

Chairman
The Hongkong and Shanghai Banking Corporation
Limited

Secretary

Mr Trevor KEEN

The *Financial Infrastructure Sub-Committee* monitors the work of the HKMA in relation to the development and operation of the financial infrastructure in Hong Kong and makes recommendations on measures and initiatives relating to the HKMA's responsibilities for promoting the safety, efficiency and development of Hong Kong's financial infrastructure. In 2005 the Sub-Committee met four times. The subjects discussed included the review of financial infrastructure development, progress of project and business development arising from the review, and the establishment of the Treasury Markets Association.

Membership (1 April 2006)

Chairman

Mr Joseph YAM, GBS, JP
The Monetary Authority

Members

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Dr The Hon. David LI Kwok-po, LLD, GBS, JP
Chairman and Chief Executive
The Bank of East Asia Limited

Mr Christopher CHENG Wai-chee, GBS, JP
Chairman
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Executive Director and Chief Executive Officer
Standard Chartered Bank(Hong Kong) Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation
Limited

Secretary

Mr Trevor KEEN

The Banking Advisory Committee

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

Membership (1 April 2006)

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP

The Financial Secretary

Ex Officio Member

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

The Hon. Frederick MA Si-hang, JP

Secretary for Financial Services and the Treasury

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Representing Bank of China (Hong Kong) Limited

Mr Peter WONG Tung-shun, JP

Executive Director

The Hongkong and Shanghai Banking Corporation Limited

Representing The Hongkong and Shanghai Banking Corporation Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

Representing Standard Chartered Bank (Hong Kong) Limited

Mrs Doreen CHAN HUI Dor-lam

President and Chief Executive Officer

CITIC Ka Wah Bank Limited

Mrs Mignonne CHENG

Head of North and East Asia

BNP Paribas

Dr The Hon. David LI Kwok-po, LLD, GBS, JP

Chairman and Chief Executive

The Bank of East Asia Limited

Ms Maria XUEREB

Financial Services Partner
Deloitte Touche Tohmatsu

Mr Ignatius CHAN Tze-ching, JP

Citigroup Country Officer, Hong Kong & Head of Greater
China
Corporate and Investment Banking
Citibank, N.A.

Mr Hideo HIYAMA

Director, General Manager & Regional Chief Executive
Sumitomo Mitsui Banking Corporation
Hong Kong Branch

Mr Randolph G SULLIVAN

Chief Executive Officer
DBS Bank (Hong Kong) Limited

Mr James C K WONG

Chief Executive Officer
The Prudential Assurance Co. Ltd.

Acting Secretary

Ms Irene SY

**The Deposit-Taking Companies
Advisory Committee**

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

Membership (1 April 2006)

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP
The Financial Secretary

Ex Officio Member

Mr Joseph YAM, GBS, JP
The Monetary Authority

Members

The Hon. Frederick MA Si-hang, JP
Secretary for Financial Services and the Treasury

Mr Martin WHEATLEY

Chairman
Securities and Futures Commission
Representing The Securities and Futures Commission

Mrs Pamela CHAN WONG Shui, BBS, JP

Chief Executive
Consumer Council
Representing The Consumer Council

Mr Geoffrey J MANSFIELD

Chairman

Hong Kong Association of Restricted Licence Banks and
Deposit-Taking Companies (The DTC Association)
Representing The DTC Association

Mr Mervyn JACOB

Partner

Assurance, Financial Services practice
PricewaterhouseCoopers

Mr Erik Helge WEINER

Chairman & Chief Executive

JP Morgan Securities (Asia Pacific) Limited

Dr Eric K C LI, GBS, JP

Senior Partner

Li, Tang, Chen & Co

Certified Public Accountants (Practising)

Mr TAN Yoke-kong

General Manager

Public Finance Limited

Mr Frank J WANG

Executive Director and Deputy Chief Executive

Wing Hang Finance Company Limited

Ms Kitty IU Pui-pui

Managing Director

Scotiabank (Hong Kong) Limited

Acting Secretary

Ms Irene SY

Chief Executive's Committee

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

Brief biographies and the Code of Conduct for EFAC Members may be found on the HKMA website. A Register of Members' Interests, which contains the declarations of interests by Members of EFAC, is available for public inspection during office hours (9:00 a.m. to 5:00 p.m. Monday to Friday and 9:00 a.m. to 12 noon Saturday) at the HKMA Offices, 55th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong.



> [The HKMA > Advisory Committees](#)



> [The HKMA > The Chief Executive's Committee](#)

MAINTAINING MONETARY STABILITY



THE LINKED EXCHANGE RATE SYSTEM

The monetary policy objective of Hong Kong is currency stability. This is defined as a stable external exchange value of the Hong Kong dollar in terms of its exchange rate against the US dollar at around HK\$7.80 to one US dollar. The monetary policy objective is achieved through the Linked Exchange Rate system, which has been implemented since 17 October 1983. The Linked Exchange Rate system plays an important part in supporting Hong Kong's role as a trading, service and financial centre.

THE CURRENCY BOARD SYSTEM


Exchange rate stability in Hong Kong is achieved through a Currency Board system. The Monetary Base is fully backed by foreign currency reserves at the fixed exchange rate of HK\$7.80 to US\$1. Any change in the Monetary Base must be fully matched by corresponding changes in foreign currency reserves.

Hong Kong's Monetary Base consists of four components:

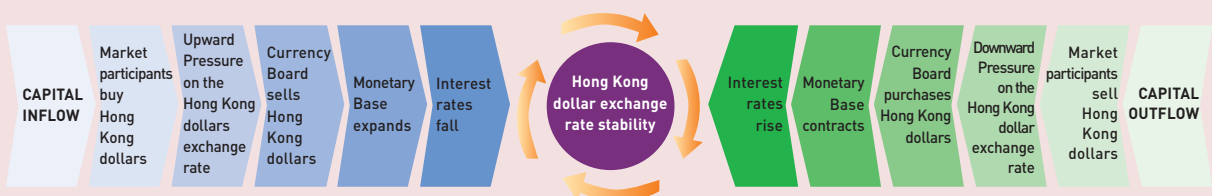
- Certificates of Indebtedness, which back the banknotes issued by the three note-issuing banks
- government-issued currency notes and coins in circulation
- the sum of the balances of the clearing accounts maintained by banks with the HKMA (known as the Aggregate Balance)
- Exchange Fund Bills and Notes, which are issued by the HKMA on behalf of the Government.

Under the Currency Board system, the stability of the Hong Kong dollar exchange rate is maintained through an interest rate adjustment mechanism.

In recent years the Currency Board system has been strengthened to make it more transparent and resilient to external shocks. In particular, the HKMA has provided a clear undertaking to all banks to convert their Hong Kong dollar clearing balances into US dollars at the Convertibility Rate of HK\$7.85 to US\$1, and in the other direction to convert their US dollars into Hong Kong dollars at the Convertibility Rate of HK\$7.75 to US\$1.

 > Monetary Stability > Currency Board Systems

The Currency Board mechanism



PROMOTING BANKING SAFETY



The principal function of the HKMA as banking supervisor is to promote the general stability and effective working of the banking system in Hong Kong. The HKMA seeks to ensure that banks and deposit-taking companies in Hong Kong operate in an effective, responsible, honest and business-like manner to provide a measure of protection to depositors. The HKMA derives its powers as banking supervisor from the Banking Ordinance.

THE THREE TIERS OF BANKING IN HONG KONG

Hong Kong's banks are divided into three tiers of authorized institutions (AIs). The main distinctions lie in the deposit business each tier of institution is allowed to conduct under the Banking Ordinance.

The HKMA is the licensing authority for AIs under the Banking Ordinance. The HKMA's supervisory approach is based on a policy of continuous supervision. This involves continuous monitoring of AIs through the use of a variety of techniques, including on-site examinations, off-site reviews, prudential meetings, meetings with boards of directors, co-operation with external auditors, and sharing of information with other supervisors. The aim is to try to ensure that any problems affecting AIs are detected and addressed at an early stage.

The HKMA uses a risk-based supervisory approach to ensure that AIs have the necessary risk management systems to identify, measure, monitor and control the risks inherent in their operations. This enables the HKMA to be more proactive in pre-empting any serious threat to the stability of the banking system.

 > [Banking Stability](#)

Three tiers of authorized institutions	Deposit business permitted
Licensed banks	<ul style="list-style-type: none"> • Current accounts, savings deposits and time deposits of any size and maturity
Restricted licence banks	<ul style="list-style-type: none"> • Time deposits of HK\$500,000 or more for any maturity • Savings and current accounts are not permitted
Deposit-taking companies	<ul style="list-style-type: none"> • Time deposits of HK\$100,000 or more for at least three months • Savings and current accounts are not permitted

MANAGING THE EXCHANGE FUND



THE EXCHANGE FUND

Established in 1935, the Exchange Fund is the cornerstone of monetary stability in Hong Kong. Its primary objective is to safeguard the exchange value of the Hong Kong dollar. Hong Kong's foreign currency reserves, held in the Exchange Fund, form the backing for the Linked Exchange Rate system.

The Exchange Fund is managed by the HKMA under powers delegated by the Financial Secretary to the Monetary Authority under the Exchange Fund Ordinance. The Exchange Fund Advisory Committee advises the Financial Secretary, as Controller of the Fund, on the investment policies and strategies for the Fund.

INVESTMENT OBJECTIVES

The investment objectives of the Exchange Fund are

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


INVESTMENT PROCESS

The Exchange Fund is managed as two main portfolios – the Backing Portfolio and the Investment Portfolio. The Backing Portfolio is used to back the Monetary Base of Hong Kong. The Investment Portfolio is used to preserve the value and long-term purchasing power of the Fund.

The long-term asset allocation strategy of the Fund is governed by the investment benchmark, which is set by the Exchange Fund Advisory Committee. This defines the allocation of investments to different asset classes by country and by sector as well as the overall currency mix for the Fund.

USE OF EXTERNAL MANAGERS

The Exchange Fund employs global external managers to manage about one third of its total assets and all of its equity portfolios. The purpose of appointing external managers is to tap the best of the investment expertise available in the market, to capture a diverse mix of investment styles within the global investment field, and to transfer market knowledge and information.

 > [Monetary Stability > Exchange Fund](#)

DEVELOPING FINANCIAL INFRASTRUCTURE

POLICY OBJECTIVE

The HKMA is committed to promoting a safe, efficient and reliable financial market infrastructure to help maintain Hong Kong's status as an international financial centre. The HKMA oversees the important clearing and settlement systems in Hong Kong under the Clearing and Settlement Systems Ordinance. It pays particular attention to fostering the local and regional debt markets and developing settlement systems for cross-border transfers of funds and securities. The long-term aim is for Hong Kong to be a leading centre of financial intermediation, where all types of financial transactions, initiated from whatever location or time zone and in whatever currency, whether at the wholesale or retail level, can be executed and settled in real time.

PAYMENT SYSTEMS IN HONG KONG

Since 1996, interbank funds transfers have been settled in real time through the Hong Kong dollar Real Time Gross Settlement (RTGS) system – the

Clearing House Automated Transfer System (CHATS). This means that payment is processed continuously and finality of settlement is instantaneous. The advantages are speed, efficiency and safety.

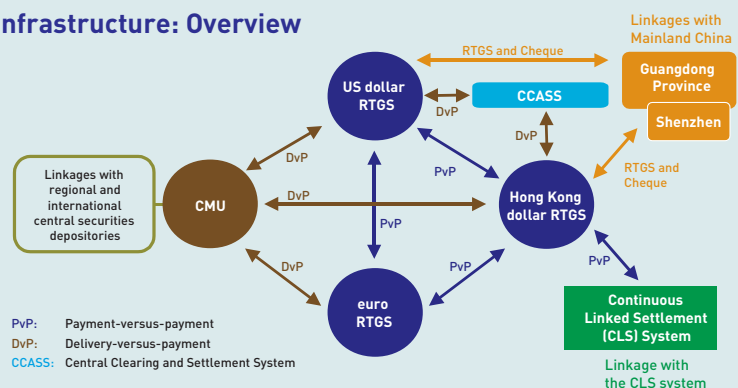
Building on the technology of the Hong Kong dollar RTGS system, the HKMA introduced a US dollar RTGS system in 2000 and a euro RTGS system in 2003.

CENTRAL MONEYMARKETS UNIT

The Central Moneymarkets Unit (CMU), operated by the HKMA, provides an efficient clearing, settlement and depository service for both Hong Kong dollar and other international debt securities. Since its establishment in 1990 the CMU has developed links with overseas central securities depositories. Through these links, local investors can hold and settle securities lodged with overseas depositories more efficiently, and overseas investors can do the same in Hong Kong.

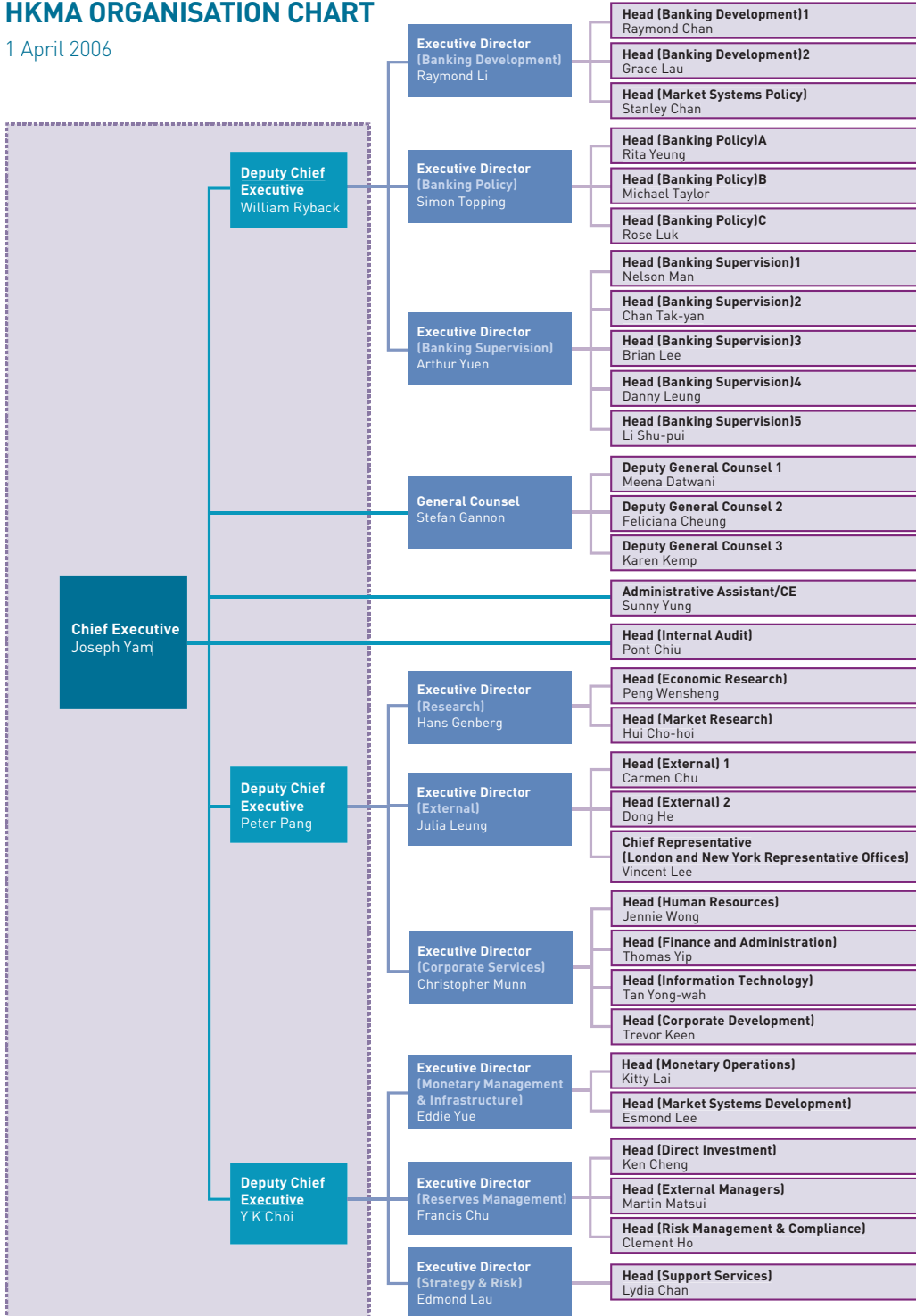
 > Financial Infrastructure

Hong Kong's Financial Infrastructure: Overview



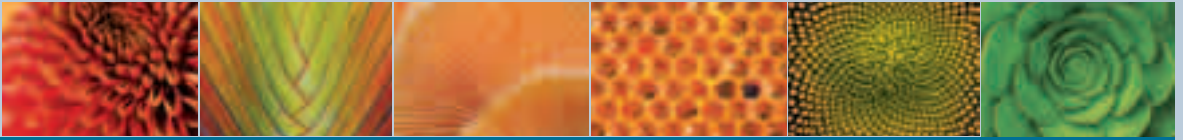
HKMA ORGANISATION CHART

1 April 2006



REVIEW OF 2005

Summary Version of the
HKMA Annual Report 2005



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

A strong and stable banking sector

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.

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.

Developing Hong Kong as an international financial centre

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.

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.

A handwritten signature in black ink, appearing to be 'Joseph Yam', with a long horizontal flourish extending to the right.

Joseph Yam
Chief Executive



ECONOMIC AND BANKING ENVIRONMENT IN 2005

ECONOMIC PERFORMANCE

The Hong Kong economy continued to grow markedly in 2005, following a broad-based recovery in 2004. Real GDP expanded by 7.3% in 2005, driven mainly by an increase in net exports. Domestic demand continued to increase, but at a slower rate than in 2004 partly because of higher interest rates and a moderation in the property market. Inflation rose moderately during the year.

PROSPECTS FOR 2006

Economic growth in 2006 is expected to remain robust, but the pace of expansion is likely to be slower than in 2005. Inflation is expected to edge up moderately and labour market conditions to continue to improve. However, a number of uncertainties and risks still exist. These include volatility of oil prices, monetary tightening in the US, global imbalances, trade protectionism against the Mainland, and the possibility of an avian flu pandemic.

PERFORMANCE OF THE BANKING SECTOR

The banking sector performed well in 2005 as the buoyant domestic economy helped improve the operating environment. Retail banks recorded healthy pre-tax operating profits of 8.2%, with loan growth of 9.2%, improved margins, and continued improvements in asset quality.

PROSPECTS FOR THE BANKING SECTOR IN 2006

Heightened competition and pressure on costs are likely to be key factors in 2006. The greatest uncertainty relates to the effect on loan demand and credit quality of the increases in interest rates which began in the second half of 2005. The key to sustained profitability will be the continuing ability of banks to keep their operating and funding costs under control and to diversify their sources of income.

CURRENCY

The new series banknotes issued in 2003 and 2004 have been well received. During 2005, 33 seminars were organised for about 3,200 bank tellers, retail cashiers, money changers and cash-handling staff of chain retail stores and hotels. Similar seminars will be held in 2006.



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

HONG KONG'S ECONOMY

	2004	2005
Economic growth and inflation		
Real growth in gross domestic product (%)	8.6	7.3^(a)
of which:		
Real growth in private consumption expenditure (%)	7.3	3.7^(a)
Real growth in gross domestic fixed capital formation (%)	3.0	3.9^(a)
Real growth in exports (%)	15.8	10.7^(a)
Real growth in imports (%)	14.2	8.1^(a)
Composite Consumer Price Index (annual change, %)	-0.4	1.1
Labour market		
Employment (annual change, %)	2.8	2.3
Unemployment rate (annual average, %)	6.8	5.6
Money supply (annual change, %)		
Hong Kong money supply (M1)	16.3	-15.6
Hong Kong money supply (M2) ^(b)	4.8	5.5
Hong Kong money supply (M3) ^(b)	4.6	5.7
Interest rates (end of year, %)		
Three-month interbank rate	0.28	4.16
Savings deposit rate	0.01	2.32
Best lending rate	5.00	7.75
Composite rate	0.30	2.88
Exchange rates (end of year)		
Hong Kong dollar/US dollar	7.774	7.753
Trade-weighted effective exchange rate index (Jan 2000=100)	96.0	98.4
Hang Seng Index (end of year)		
	14,230	14,876

(a) The estimates are preliminary.

(b) Adjusted to include foreign currency swap deposits.

PERFORMANCE RATIOS OF HONG KONG'S BANKING SECTOR

	2004	2005	2004	2005
	%	%	%	%
	All AIs		Retail banks*	
Profitability^(a)				
Growth of pre-tax operating profit	N.A.	N.A.	20.9	8.2
Return on assets (operating profit before tax)	1.1	1.1	1.5	1.5
Return on assets (post-tax profit)	1.0	1.0	1.4	1.4
Net interest margin	1.2	1.2	1.7	1.7
Bad debt charge-to-average total assets	0.01	0.01	-0.02	-0.01
Business profile^(a)				
Growth in loans to customers	5.9	7.3	8.3	9.8
Growth in customer deposits (all currencies)	8.4	5.2	7.4	3.1
Hong Kong dollar loan-to-deposit ^(b) ratio	82.6	84.3	73.2	78.8
Asset quality^(c)				
Classified loans ^(d) as percentage of total loans	2.1	1.3	2.3	1.4
	All locally incorporated AIs			
Capital Adequacy Ratio (consolidated)			15.4	14.9

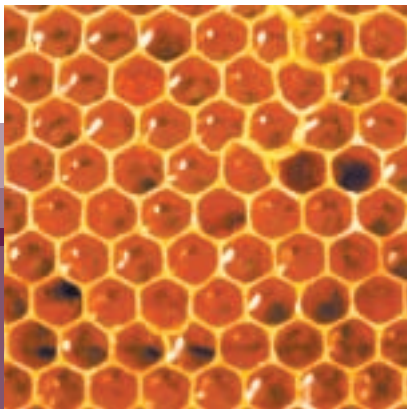
(a) Figures relate to Hong Kong office(s) only.

(b) Includes swap deposits.

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

(d) Denotes loans or exposures graded as "substandard", "doubtful" or "loss" in the HKMA's Loan Classification System.

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



MONETARY CONDITIONS IN 2005

REVIEW OF 2005

The foreign exchange and money markets were largely stable during 2005. The Hong Kong dollar exchange rate began to strengthen in late April, due to speculation about changes in the renminbi exchange rate regime. To normalise the situation, on 18 May 2005 the HKMA introduced three refinements to the Linked Exchange Rate system to remove the uncertainty about the extent to which the Hong Kong dollar would be allowed to appreciate against the US dollar:

- (1) A strong-side Convertibility Undertaking was established, under which the HKMA undertakes to buy US dollars from licensed banks at 7.75.
- (2) The weak-side Convertibility Undertaking was gradually moved from 7.80 to 7.85 to create a symmetric Convertibility Zone around 7.80.
- (3) The HKMA may conduct market operations consistent with Currency Board principles within the Convertibility Zone.

The reaction from the foreign exchange and money markets suggested that the refinements were effective. The Hong Kong dollar exchange rate responded calmly following the reforms to the renminbi exchange rate system announced in July 2005, suggesting that the refinements are effective in anchoring exchange rate expectations on the strong side.

ACTIVITIES AT THE HKMA

The EFAC Currency Board Sub-Committee examines issues affecting monetary and financial stability in Hong Kong. The Sub-Committee's records of discussion and reports on the operations of the Currency Board system are published in the HKMA's *Quarterly Bulletin* and on the HKMA website. Many of the papers discussed by the Sub-Committee are published in the *Quarterly Bulletin* as research articles or on the HKMA website as research memorandums.

The Hong Kong Institute for Monetary Research hosted 18 full-time and two part-time research fellows and published 22 working papers in 2005. In addition to conferences and workshops, 40 public seminars on a broad range of economic and monetary issues were organised during the year.

 > [Press Releases > Monetary Policy](#)

 > [Research Memorandums](#)

Chart 1. Market exchange rate in 2005

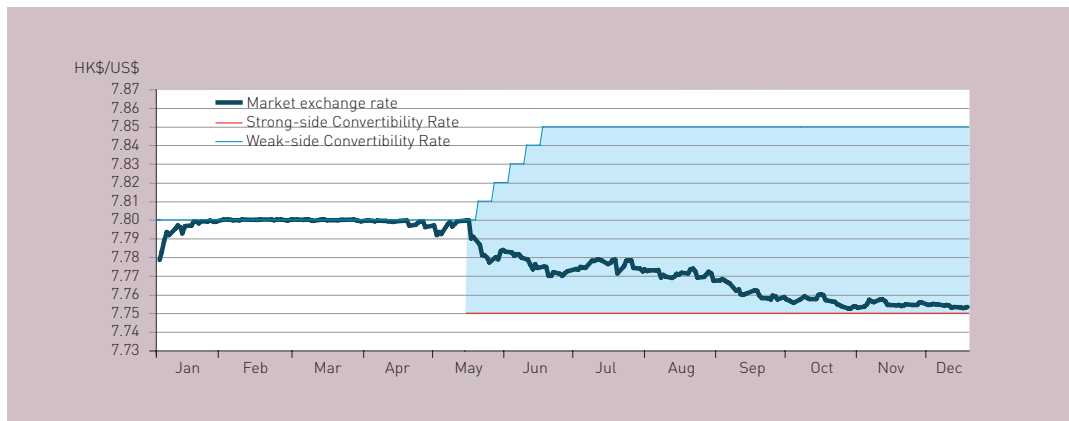


Chart 2. Aggregate Balance in 2005

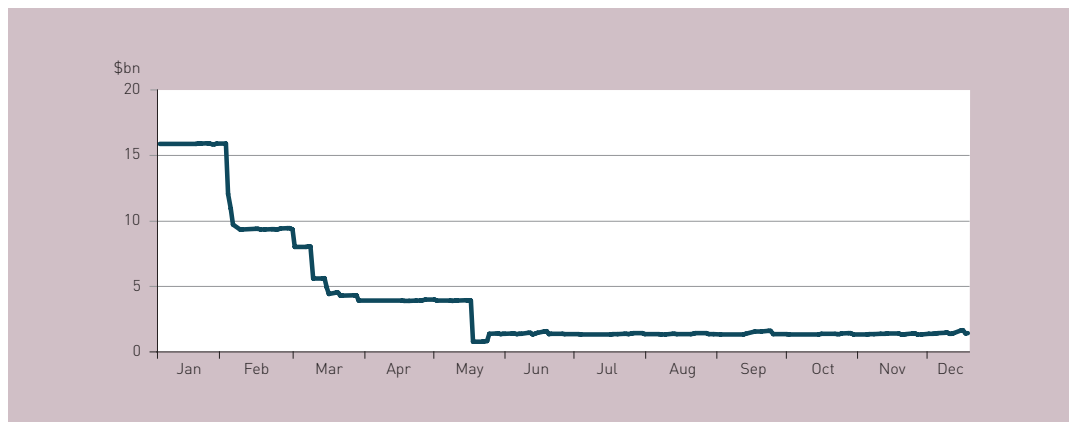
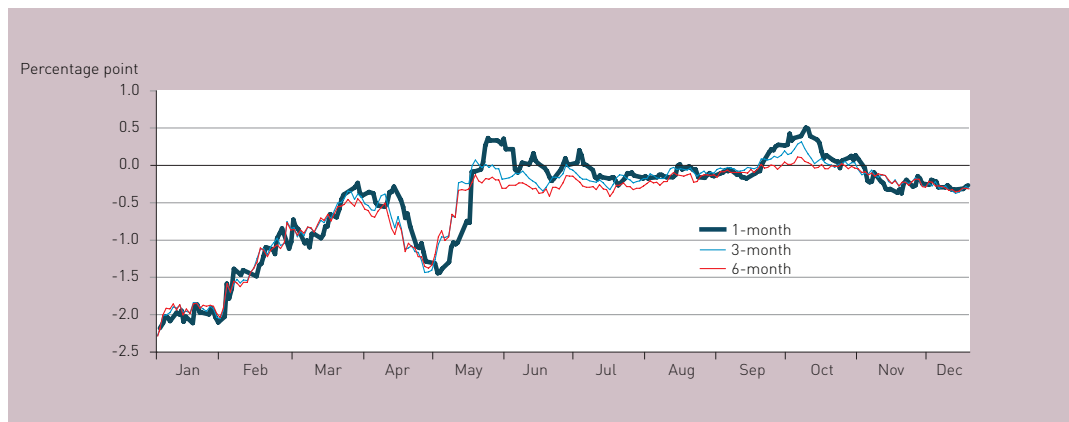
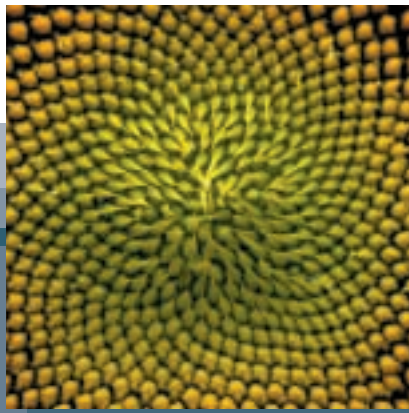


Chart 3. Hong Kong dollar – US dollar interest rate differential in 2005





BANKING POLICY AND SUPERVISORY ISSUES IN 2005

RISK-BASED SUPERVISION

To implement the risk-based approach to banking supervision more effectively, the HKMA has reorganised its Banking Supervision Department to better utilise its resources. Fourteen more risk-based on-site examinations were conducted in 2005 than in 2004, and more focused examinations in areas including banks' retail wealth management and residential mortgage business were carried out. A priority in 2005 was to ensure authorized institutions had adequate policies and risk management procedures to prevent money laundering and terrorist financing.

Table 1 Operational supervision

	2004	2005
1. On-site examinations	247	228
Including		
– risk-based	78	92
– treasury	11	8
– securities	7	5
– e-banking	24	17
– review of business continuity plan	17	17
– review of renminbi business	36	18
– overseas examinations	20	11
– retail wealth management	–	14
– trade financing	–	22
– residential mortgage	17	24
2. Off-site reviews and prudential interviews	183	187
3. Tripartite meetings	66	71
4. Meetings with boards of directors or board-level committee of AIs	8	18
5. Approval of applications to become controllers, directors, chief executives, alternate chief executives of AIs	376	332
6. Reports commissioned under Section 59(2) of the Banking Ordinance	1	4
7. Cases considered by the Banking Supervision Review Committee	9	7

DEVELOPMENT OF BANKING SECTOR INFRASTRUCTURE

The Commercial Credit Reference Agency has been operating smoothly in its first full year of operation. The number of participating authorized institutions and small and medium-sized enterprises covered has been increasing steadily. Preparatory work for launching the Deposit Protection Scheme is close to completion. The Scheme is expected to begin operating in the second half of 2006. The first review conducted by the HKMA shows that the sharing of positive consumer credit data, which began in mid-2003, benefits both the financial institutions and consumers.

BASEL II

The HKMA continued in 2005 to prepare for implementing Basel II in Hong Kong in January 2007. The Banking (Amendment) Ordinance 2005 was enacted in July and consultation with the banks on the draft rules for implementing the capital adequacy standards has been progressing well.

CONSUMER PROTECTION

In 2005, the HKMA received 328 complaints about banking business, compared with 383 in 2004. The decrease was due mainly to a reduction in the number of complaints relating to the practices of debt collection agencies. Authorized institutions have been vigilant in monitoring the performance of their debt collection agencies. They received 171 complaints in this area during 2005, compared with 348 in 2004.



> Banking Stability



> Consumer Information



MARKET INFRASTRUCTURE IN 2005

The Hong Kong dollar, US dollar and euro payment systems functioned smoothly in 2005.

Chart 1. Hong Kong dollar payment system daily average turnover

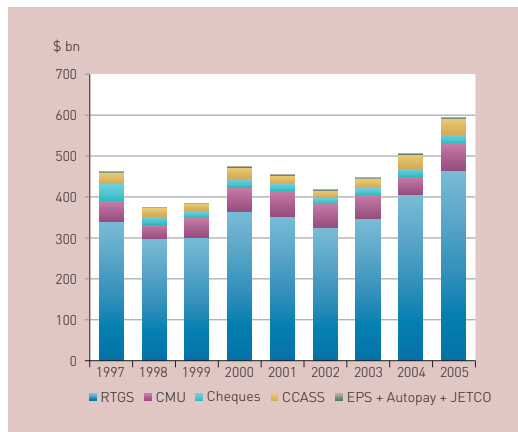
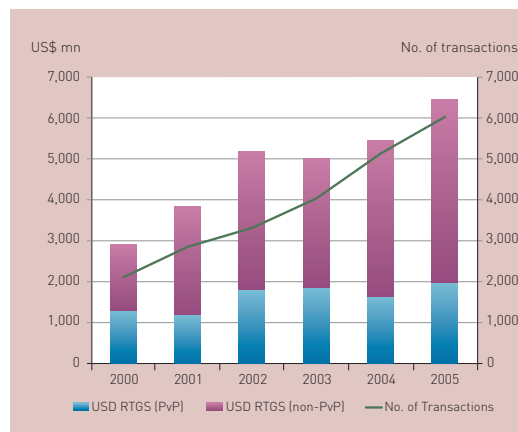
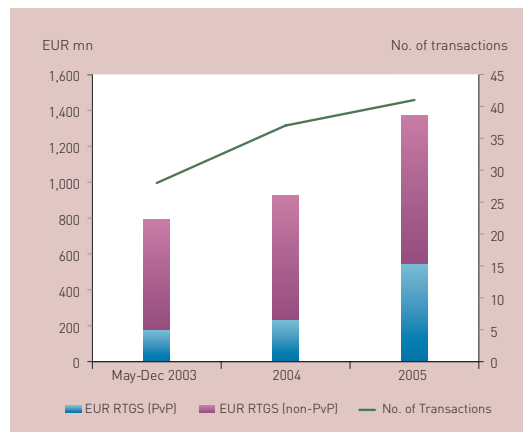


Chart 2. US dollar payment system daily average turnover



In 2005 the HKMA conducted a comprehensive review of financial infrastructure development. The review recommended a number of key strategies and reforms in payment system, bond market and Mainland-related financial infrastructure. The implementation of these recommendations has been progressing well.

Chart 3. Euro payment system daily average turnover



OVERSIGHT OF CLEARING AND SETTLEMENT SYSTEMS

The HKMA completed the first-year oversight cycle of the five clearing and settlement systems designated under the Clearing and Settlement Systems Ordinance. All five systems were found to be in compliance with the safety and efficiency requirements. The HKMA encourages the industry to adopt a self-regulatory approach to retail payment systems. Following the issuance of a Code of Practice for Multi-purpose Stored Value Card Operation in 2005, the HKMA plans to work with the credit card industry to develop a code of practice on credit card payment processing systems in Hong Kong.

EXCHANGE FUND BILLS AND NOTES PROGRAMME

The HKMA has improved the liquidity and credibility of the Hong Kong dollar benchmark yield curve by lengthening the maturity distribution of the Exchange Fund Bills and Notes portfolio. It also re-launched the retail Exchange Fund Notes programme in 2005 to promote bond investment by retail investors. Two retail issues were offered and both of them were well received.

TREASURY MARKETS ASSOCIATION

The Association was established in December 2005 by merging the Treasury Markets Forum and the ACI-The Financial Markets Association of Hong Kong to promote the professionalism and competitiveness of the treasury markets in Hong Kong.

 > Financial Infrastructure



INTERNATIONAL FINANCIAL CENTRE

THE HKMA AND THE INTERNATIONAL FINANCIAL COMMUNITY

The HKMA maintains contacts with the international central banking and financial community to enhance international understanding of, and confidence in Hong Kong's monetary and financial systems. It regularly discusses market development initiatives with its Mainland counterparts to help strengthen the competitiveness of Hong Kong's financial services. In particular, the HKMA seeks to

- explore further development opportunities for renminbi business in Hong Kong and expand the presence and scope of services offered by Hong Kong financial institutions on the Mainland
- promote Hong Kong as a financial intermediary for Mainland savings to be channelled to Mainland investments
- promote the development of regional bond markets
- provide leadership and policy response to economic and financial issues brought up in international and regional financial organisations
- engage international credit rating agencies proactively to ensure more balanced assessments of Hong Kong's credit and economic position.

DEVELOPMENT OF REGIONAL BOND MARKETS

In May 2005, the HKMA and the other 10 central banks and monetary authorities of the Executives' Meeting of East Asia-Pacific Central Banks announced the completion of funding for Asian Bond Fund 2 and the appointment of the master custodian and fund managers for its nine component funds. The ABF Hong Kong Bond Index Fund and Pan Asia Bond Index Fund – two key components of ABF2 – were listed in Hong Kong in June and July 2005 respectively.

EXPANSION OF RENMINBI BUSINESS

Renminbi business in Hong Kong has developed steadily since its launch in early 2004. The scope of renminbi business was expanded in late 2005. The definition of designated merchants, who can now open renminbi deposit accounts, has been widened; Hong Kong residents can open renminbi current accounts and use renminbi cheques for consumer spending in Guangdong Province; the limits for exchange and remittance of renminbi by individuals have been relaxed; and the cap on credit limits for renminbi cards issued by participating banks has been removed.

UPGRADING HONG KONG'S SOVEREIGN CREDIT RATING

The HKMA plays a major role in improving the communication between the international credit rating agencies and the relevant authorities to ensure the agencies maintain a more balanced view on Hong Kong. In 2005, Standard & Poor's upgraded Hong Kong's foreign currency sovereign credit rating by one notch to AA- from A+. Moody's, Fitch Ratings, and Rating and Investment Information affirmed Hong Kong's sovereign credit ratings in 2005.

REGIONAL MONETARY CO- OPERATION AND PARTICIPATION IN MULTILATERAL INSTITUTIONS

In 2005, the Chief Executive of the HKMA became a member of the Review Group on the Organisation of Financial Sector and Capital Markets Work of International Monetary Fund. The HKMA also participated in the meetings of the APEC forum, the Financial Stability Forum and the Bank for International Settlements, and in regional central banking co-operation.

 > [Monetary Stability](#) > [External Relations](#)



EXCHANGE FUND PERFORMANCE IN 2005

Amid the difficult investment environment in 2005, the Exchange Fund earned a gross investment income of \$38.2 billion, comprising

- \$30.2 billion from bond investments
- \$7.0 billion from Hong Kong equities
- \$20.5 billion from foreign equities
- a foreign exchange revaluation loss of \$19.5 billion.

The total investment income represents an investment return of 3.1%, about 0.2% better than the return of the investment benchmark for the year.

Table 1. 2005 market returns

Currencies	
Appreciation(+)/depreciation(-) against US dollar	
Euro	-13.2%
Yen	-13.2%
Bond markets	
Relevant US Government Bond (1-3 years) Index	+1.6%
Equity markets	
Standard & Poor's 500 Index	+3.0%
Hang Seng Index	+4.5%

Table 2. Gross investment return of the Exchange Fund (in Hong Kong dollar terms)¹

	Return on total assets	Return on investment benchmark²	CPI(A)³
2005	3.1%	2.9%	+1.7%
2004	5.7%	5.7%	+0.4%
1994-2005 annualised	6.3%	N/A	+1.3%
1999-2005 annualised	5.7%	4.5%	-1.3%

¹ For the Annual Reports from 2001 to 2003, return on total assets and return on investment benchmark are in US dollar terms.
² Established in January 1999.
³ December year-on-year percentage change in the HK-CPI(A) index. CPI(A) is calculated based on the 1999/2000 base new series.

Table 3. Currency mix of the Exchange Fund's assets on 31 December 2005 (including forward transactions)

	HK\$ billion	%
US dollar bloc		
US dollar *	843.2	79.0
Hong Kong dollar	95.6	9.0
Non-US dollar bloc	128.0	12.0
Total	1,066.8	100.0

* Includes US dollar bloc foreign currencies such as Canadian dollar, Australian dollar and New Zealand dollar.

The annual return of the Exchange Fund from 1994 to 2005 is shown in Chart 1, and the comparison of the investment return of the Exchange Fund against the benchmark return from 1999 to 2005 is in Chart 2. Since 1994, the Exchange Fund has generated a compounded annual return of 6.3%, which compares favourably with the compounded annual inflation rate of 1.3% over the same period.

 > Monetary Stability > Exchange Fund

Chart 1. Investment return of the Exchange Fund (1994-2005)

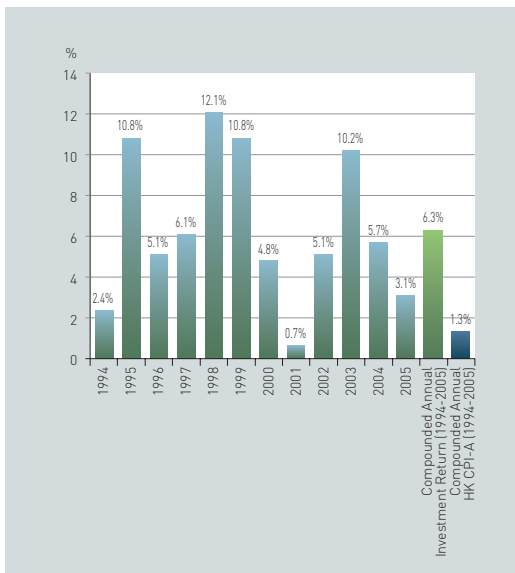
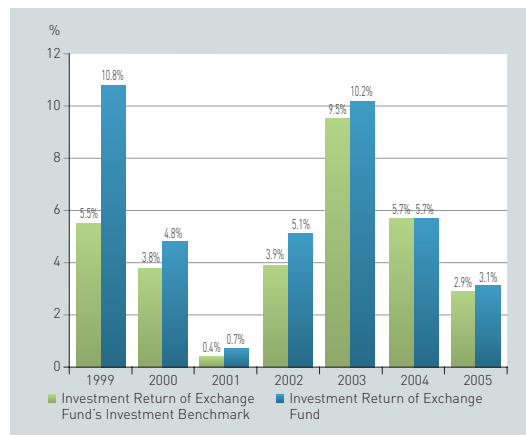


Chart 2. Investment return of the Exchange Fund and the Exchange Fund's investment benchmark (1999-2005)



THE EXCHANGE FUND

The financial position of the Exchange Fund and the Group in 2005 is shown below in the Income and Expenditure Account and Balance Sheet, which are extracted from the *HKMA Annual Report 2005*. The audited full statement of accounts of the Exchange Fund for 2005 may be found on pages 96 to 173 of the full Annual Report.

EXCHANGE FUND - INCOME AND EXPENDITURE ACCOUNT

for the year ended 31 December 2005

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
(Expressed in millions of Hong Kong dollars)				
INCOME				
Interest income	31,307	24,598	29,719	23,574
Dividend income	5,165	4,556	5,430	4,573
Net realised and revaluation gains	22,173	20,120	22,182	20,120
Net exchange gains/(losses)	(19,468)	8,469	(19,474)	8,474
Investment income	39,177	57,743	37,857	56,741
Bank licence fees	129	129	129	129
Other income	308	353	36	70
TOTAL INCOME	39,614	58,225	38,022	56,940
EXPENDITURE				
Interest expense	(16,990)	(18,066)	(16,026)	(17,856)
Operating expenses	(1,626)	(1,454)	(1,463)	(1,271)
Note and coin expenses	(208)	(182)	(208)	(182)
Write-back of impairment losses on loans/ (Provisions made for bad and doubtful loans)	19	(89)	-	-
TOTAL EXPENDITURE	(18,805)	(19,791)	(17,697)	(19,309)
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE	20,809	38,434	20,325	37,631
Share of profit of associate, net of tax	3	3	-	-
SURPLUS BEFORE TAXATION	20,812	38,437	20,325	37,631
Income tax	(100)	(109)	-	-
SURPLUS FOR THE YEAR	20,712	38,328	20,325	37,631
ATTRIBUTABLE TO:				
Owner of the Fund	20,689	38,307	20,325	37,631
Minority interests	23	21	-	-
	20,712	38,328	20,325	37,631

EXCHANGE FUND - BALANCE SHEET

as at 31 December 2005

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
(Expressed in millions of Hong Kong dollars)				
ASSETS				
Cash and money at call	15,937	20,759	15,887	20,738
Placements with banks and other financial institutions	75,648	48,178	73,120	42,747
Derivative financial instruments	1,950	1,438	1,865	1,438
Financial assets designated at fair value through profit or loss	953,145	–	953,145	–
Other investments in securities	–	977,746	–	977,746
Available-for-sale securities	2,483	–	493	–
Investment securities	–	300	–	300
Held-to-maturity securities	4,605	4,130	–	–
Mortgage loans	29,476	34,938	–	–
Gold	266	228	266	228
Other assets	17,015	13,398	16,149	12,476
Investments in subsidiaries	–	–	2,145	2,145
Investment in associate	26	23	–	–
Property, plant and equipment	888	885	625	635
Operating land lease prepayment	3,071	3,145	3,071	3,145
Intangible assets	33	42	33	42
TOTAL ASSETS	1,104,543	1,105,210	1,066,799	1,061,640
LIABILITIES AND EQUITY				
Certificates of Indebtedness	148,406	146,775	148,406	146,775
Government-issued currency notes and coins in circulation	6,671	6,351	6,671	6,351
Balance of the banking system	1,561	15,789	1,561	15,789
Derivative financial instruments	834	2,372	525	2,372
Trading liabilities	7,412	100	7,412	100
Placements by banks and other financial institutions	25,712	39,087	25,712	39,087
Placements by other Hong Kong Special Administrative Region government funds	297,086	280,091	297,086	280,091
Exchange Fund Bills and Notes issued	118,134	125,860	118,134	125,860
Other debt securities issued	27,991	35,495	–	–
Other liabilities	24,636	27,499	18,146	21,838
Total liabilities	658,443	679,419	623,653	638,263
Accumulated surplus	445,828	425,624	443,146	423,377
Available-for-sale securities revaluation reserve	94	–	–	–
Total equity attributable to owner of the Fund	445,922	425,624	443,146	423,377
Minority interests	178	167	–	–
Total equity	446,100	425,791	443,146	423,377
TOTAL LIABILITIES AND EQUITY	1,104,543	1,105,210	1,066,799	1,061,640

MAJOR EVENTS 1993-2005

1993

April 1993

The HKMA is established with responsibility for monetary and banking stability, reserves management, and financial infrastructure.



May 1993

The Government starts to replace the Queen's Head coins with those using the new bauhinia design.

July 1993

The Government announces the sale of Overseas Trust Bank for HK\$4,457 million. The sale of the bank, taken over in June 1985, marks the end of the Government's efforts to rescue banks in the 1980s.



1994

May 1994

The Bank of China issues its first Hong Kong banknotes.



August 1994

The Hang Seng China Enterprises Index is launched to serve as an indicator of the overall performance of Hong Kong-listed, state owned enterprises of the People's Republic of China.

September 1994

The first issue of five-year Exchange Fund Notes is launched. The issue helps extend the benchmark yield curve for Hong Kong dollar debt to the five-year area.

October 1994

The interest rate cap on time deposits is lifted in phases. This marks the beginning of a relaxation of Interest Rate Rules in Hong Kong.

November 1994

Hong Kong issues its first bimetallic coin – the bauhinia \$10 coin.



1995

May 1995

Hong Kong Interbank Clearing Limited is established to provide interbank clearing services in Hong Kong.



HONG KONG INTERBANK
CLEARING LIMITED
香港銀行同業結算有限公司

June 1995

The HKMA becomes the licensing authority of three types of authorized institutions, following the enactment of the Banking (Amendment) Ordinance 1995.

July 1995

The Companies Ordinance is amended. Depositors are entitled to receive priority payment in the liquidation of banks.

November 1995

The Government decides to publish the size of Hong Kong's foreign exchange reserves (i.e. foreign currency assets of the Exchange Fund) every quarter instead of every six months.

November 1995

The first issue of seven-year Exchange Fund Notes is launched.

1996

January 1996

The Exchange Fund acquires the De La Rue banknote printing plant in Tai Po, which is renamed "Hong Kong Note Printing Limited".



September 1996

The HKMA is invited to join the Bank for International Settlements, the Swiss-based forum promoting co-operation among central banks.

October 1996

The first issue of ten-year Exchange Fund Notes is launched.

December 1996

Real Time Gross Settlement is launched in Hong Kong, enabling interbank payments to be settled in real time.

1997

March 1997

The Hong Kong Mortgage Corporation is established. It buys mortgage loans for its own portfolio and issue mortgage-backed securities.



July 1997

Hong Kong becomes a Special Administrative Region of the People's Republic of China.



July 1997

The *Code of Banking Practice* is issued to improve the transparency and quality of banking services in Hong Kong.



July 1997

The assets of the Land Fund are handed over to Hong Kong SAR Government with a net value of HK\$197 billion. From July 1997 to October 1998 these assets are managed by the HKMA as a separate fund within the fiscal reserves. On 1 November 1998 the assets of the Land Fund are merged with the Exchange Fund and managed as part of the investment portfolio of the Exchange Fund.

September 1997

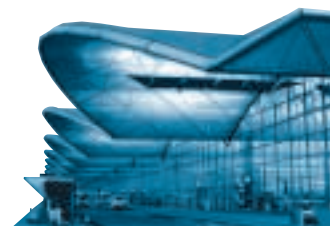
World Bank/IMF Annual Meetings are held in Hong Kong. Central bank and finance ministry officials from some 180 countries attend the meetings.



1998

July 1998

Hong Kong International Airport opens at Chek Lap Kok.



July 1998

The Bank for International Settlements opens its representative office for Asia and the Pacific in Hong Kong.

August 1998

Using HK\$118 billion from the Exchange Fund, the Hong Kong SAR Government launches a stock market operation to frustrate manipulation of the money and stock markets.

September 1998

The HKMA introduces seven technical measures to strengthen the Currency Board arrangements.



MAJOR EVENTS 1993-2005 (cont.)

October 1998

Exchange Fund Investment Limited is established to manage the portfolio of Hang Seng Index constituent stocks acquired by the Exchange Fund in the market operation of August.

1999

January 1999

The foreign currency assets and the balance sheet data of the Exchange Fund are published monthly, in line with the standard set by the International Monetary Fund.

August 1999

Exchange Fund Notes commence listing on the Hong Kong Stock Exchange.

August 1999

The Hong Kong Institute for Monetary Research is established.



November 1999

The Tracker Fund of Hong Kong is established as a vehicle for gradually disposing of the majority of the stocks acquired by the Exchange Fund in the 1998 market operation.



2000

August 2000

Hong Kong processes its first transaction through the new US dollar clearing system.

October 2000

Hong Kong is selected as President for 2001-2002 of the Financial Action Task Force on Money Laundering, an international body.

December 2000

Hong Kong's Mandatory Provident Fund System comes into full operation.

2001

January 2001

The International Monetary Fund opens a sub-office in Hong Kong.

April 2001

The Government approves in principle the proposal to introduce a deposit protection scheme in Hong Kong.

July 2001

Interest Rate Rules are completely deregulated. Banks are free to set interest rates for all types of deposits.

November 2001

All restrictions on the number of branches of foreign banks are lifted.

December 2001

China enters the World Trade Organization.

2002

March 2002

The Securities and Futures Ordinance is passed by the Legislative Council. The Ordinance consolidates and modernises 10 existing ordinances into a single piece of legislation to govern financial and investment products, regulate the securities and futures markets, and protect investors.

May 2002

The Government endorses the HKMA's proposals to relax certain market entry criteria for the banking sector.

September 2002

The Government issues new \$10 currency notes.



2003

March to June 2003

Outbreak of Severe Acute Respiratory Syndrome. 1,755 people in Hong Kong are infected and 299 people die.

April 2003

Hong Kong processes its first transaction through its new euro clearing system.

June 2003

Exchange of letters between the Financial Secretary and the Monetary Authority on functions and responsibilities in monetary and financial affairs.

June 2003

The Mainland and Hong Kong sign the Closer Economic Partnership Arrangement.



December 2003

The three note-issuing banks issue new \$100 and \$500 notes with additional security features.



2004

February 2004

Over 30 banks in Hong Kong introduce renminbi deposit, exchange, remittance, and debit and credit card services.

May 2004

The Deposit Protection Scheme Ordinance is enacted.

July 2004

The Clearing and Settlement Systems Ordinance is enacted.

October 2004

The three note-issuing banks issue new \$20, \$50 and \$1000 notes with additional security features.



November 2004

The Commercial Credit Reference Agency is launched.

2005

May 2005

The HKMA announces three refinements to the operation of the Linked Exchange Rate system.

July 2005

The Banking (Amendment) Ordinance 2005 is passed to provide a legislative framework for the implementation of Basel II in Hong Kong.

July 2005

The People's Bank of China announces reform of the renminbi exchange rate regime.

December 2005

The Sixth Ministerial Conference of the World Trade Organization takes place in Hong Kong.

ABBREVIATIONS

ABF2	-	Local currency denominated Asian Bond Fund
AI	-	Authorized institution
APEC	-	Asia-Pacific Economic Co-operation
bn	-	billion
CCASS	-	Central Clearing and Settlement System
CHATS	-	Clearing House Automated Transfer System
CLS	-	Continuous Linked Settlement
CMU	-	Central Moneymarkets Unit
CPI	-	Consumer Price Index
DvP	-	Delivery-versus-Payment
EFAC	-	Exchange Fund Advisory Committee
EMEAP	-	Executives' Meeting of East Asia-Pacific Central Banks
EPS	-	Easy Pay System
GDP	-	Gross Domestic Product (in real terms unless otherwise stated)
HK	-	Hong Kong
HKMA	-	Hong Kong Monetary Authority
IMF	-	International Monetary Fund
JETCO	-	Joint Electronic Teller Company Limited
mn	-	million
N.A.	-	not applicable
PvP	-	Payment-versus-Payment
RMB	-	Renminbi
RTGS	-	Real Time Gross Settlement
SAR	-	Special Administrative Region
US	-	United States of America

REFERENCE RESOURCES

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

HKMA Quarterly Bulletin

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

HKMA Monthly Statistical Bulletin (on-line publication)

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

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

HKMA Background Brief No. 1 – Hong Kong's Linked Exchange Rate System (Second Edition)

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

Money and Banking in Hong Kong: A Historical Timeline

Money in Hong Kong: A Brief Introduction

Educational leaflets on various topics including notes and coins and banking issues

HKMA publications may be purchased or obtained from the **HKMA Information Centre**, 55th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. The HKMA Information Centre consists of an Exhibition Area and a Library. The Centre introduces the work of the HKMA and houses books, journals and other texts on central banking and related subjects. The Centre is open to the public six days a week.

 > [HKMA Information Centre](#)

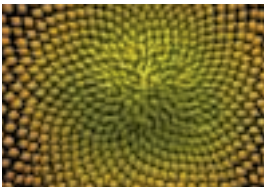
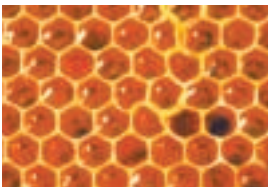
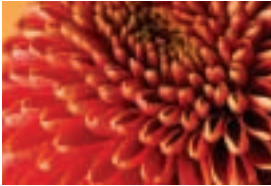
Most HKMA publications are also available for download free of charge from the HKMA website (www.hkma.gov.hk). A mail order form for the purchase of print publications can be found on the website.

 > [Publications](#)

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

 > [Legislative Council Issues](#)

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



The photographs

The theme photographs in this Annual Report show patterns found in the natural environment in Hong Kong. These patterns suggest stability, consistency, growth and health.

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HONG KONG MONETARY AUTHORITY

55/F, Two International Finance Centre,
8 Finance Street, Central, Hong Kong

Enquiries (852) 2878 8222

Fax (852) 2878 2010

E-mail hkma@hkma.gov.hk

www.hkma.gov.hk