Chief Executive's Statement

The HKMA had another busy and, I believe, successful and productive year in 2006: the Hong Kong dollar exchange rate remained stable despite record fund flows, the banking sector remained strong, the Exchange Fund earned a respectable investment return, and some real progress was made in mapping out a strategy for Hong Kong's world-class financial infrastructure to contribute to the further development of China's economy.

Economic trends

Hong Kong's economy grew by 6.8% in 2006, lower than the 7.5% in 2005 but still above trend and very respectable. Monetary conditions eased, reflecting high levels of liquidity in the banking sector, but were broadly neutral. Unemployment declined to its lowest level in six years, while inflation picked up slightly but not yet to levels that would cause concern. Growth in the economy was mainly driven by domestic demand, particularly consumer spending and investment in business equipment. At the same time, exports of goods and services were robust with increases in trade with the Mainland and solid demand from our other major trading partners.

Asset markets performed well: the residential property market was stable after a strong rise in 2005, with little sign of overheating; and the stock market staged a strong rally in the second half of the year, with the Hang Seng Index increasing by 34% to reach a record high of 20,001 on 28 December. This rise was supported by Hong Kong's strong economic performance, the pause in monetary tightening in the US, and large inflows of funds related to initial public offerings, mostly of Mainland stocks.

The Exchange Fund

That the Exchange Fund enjoyed a good year in 2006 is already old news: the Fund earned an investment return of $103.8 billion, a rate of return of 9.5%. This exceeded the rate of return of the benchmark portfolio approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee (EFAC) by more than 0.6%. The share of the investment income going to the fiscal reserves placed with the Exchange Fund was $28.9 billion.

Good results are always welcome, of course. We are glad to have contributed to a healthy investment return for the people of Hong Kong. But we are also very conscious that this is not the primary purpose of the Exchange Fund. The purposes and investment objectives of the Fund are set out in detail in the Reserves Management chapter: in essence, the Fund is there to back the Hong Kong dollar, and to do that it has to be held primarily in liquid US dollar assets and its investment objectives emphasise capital preservation and liquidity. I have said this many times but perhaps it bears repeating once more: the Exchange Fund has to be invested, but it is not an investment fund and investment is not its primary purpose.

The implication of this is that we cannot and should not expect high returns from the Fund every year. Like the savings that many of us hold, the Exchange Fund can be thought of as rainy-day money: we want to get a good return on it but we must always remember that we might need it for some emergency and therefore be prudent in how we invest it. Looking ahead to 2007, I believe that caution is called for. While I believe we did well in outperforming the benchmark, the overall results of 2006 were due in large part to equities and bond markets rising together towards the end of the year and a number of equities markets in particular reaching historic highs. We all understand that markets are cyclical and when you reach high levels, the outlook for the future is uncertain at best.

Hong Kong dollar stability

The Hong Kong dollar exchange rate is always a focus for the HKMA given our mandate to preserve currency stability. I am pleased to say that the Hong Kong dollar remained stable within the Convertibility Zone throughout the year, despite some very large fund flows related to initial public offerings and speculation about the effect on the Hong Kong dollar of the renminbi's appreciation. Looking back at the 2005 Annual Report, I note that last year I talked about record fund flows from initial public offerings: those records were greatly exceeded in 2006 with $333 billion being raised in the local stock market, including $125 billion for a single issue.

Earlier in the year, many in the financial markets seemed to believe that the Hong Kong dollar would follow the renminbi in appreciating against the US dollar and other major currencies, and there was speculation that we would abandon the Linked Exchange Rate system. Quite why anyone should think that we would give up an anchor that has served us well and helped to maintain stability through some very difficult and potentially destabilising times over the last 23 years is something of a mystery. But the HKMA's job is to ensure stability and if people found my repeated statements that there was no plan or intention to abandon the link to the US dollar a little boring, then I do not mind very much. Dullness can be a virtue in our business. We spent a lot of time explaining to the markets and the wider community that the strengthening of the renminbi to parity with the Hong Kong dollar and beyond would not affect the Hong Kong dollar exchange rate, although we of course could not rule out short-term psychological effects on the financial markets. We also explained that, given the correlation of the business cycles in Hong Kong and the US and the fact that an overwhelming amount of our external trade is denominated in US dollars, the link with the US dollar remained appropriate for the Hong Kong economy and the best way to ensure stability. In the event, the markets largely shared this view and the renminbi passed through various psychologically significant levels without causing any ripples to the stability of the Hong Kong dollar: the Currency Board system functioned normally and we were not required to take any action to stabilise the exchange rate.

The banking sector

Hong Kong continues to have a robust banking system despite a very competitive operating environment. The profitability of the banks improved because of higher net interest margins and loan growth, leading to higher net interest income. Income from fees and commissions also increased, more than offsetting lower treasury income and an increase in provisions. Overall asset quality remained good: although the credit card portfolio weakened slightly, the decline in quality was from a level many other markets would regard with envy and the resulting increase in provisions was small by historical standards. The local banking sector is well placed to continue to support economic growth.

But that does not mean the HKMA should not remain active and vigilant in its role of promoting the safety and stability of the banking sector. In addition to the continuing day-to-day regulation work, largely unseen by the public but of great importance to ensuring a stable banking industry, the HKMA has been working hard to make improvements in this area. In 2006 my colleagues in the banking departments continued to develop risk-based supervision and completed the enormous volume of work related to the implementation of the Basel II arrangements, which formally began on 1 January this year when the *Banking (Capital) Rules* and the *Banking (Disclosure) Rules* came into force. Hong Kong is among the first jurisdictions in the world to implement Basel II and this makes us very much a leader in the region. A great deal more detailed and painstaking work lies ahead of us.

The Deposit Protection Scheme commenced operations on 25 September and the evidence so far suggests that the Scheme, which provides a measure of protection to depositors, is already helping to increase confidence in the banking sector. Another area where we increased our efforts in 2006 is in monitoring controls on money laundering and terrorist financing: sad to say, these problems are going to be with us for the foreseeable future and we have had to devote more resources to them. It would be a brave person who would say that we can prevent such dealings, but we are committed to doing everything we can to make it harder for criminals to abuse our financial systems.

Hong Kong as an international financial centre

The year saw a number of highlights in the development of Hong Kong as an international financial centre. The international credit rating agencies upgraded Hong Kong's sovereign ratings to AA, the highest they have ever been. The HKMA, working with the Government, played an important role in helping the agencies achieve a better understanding of Hong Kong's economic and financial strengths. We also worked hard during the year with the Mainland authorities on the expansion of renminbi business in Hong Kong, leading in January this year to the State Council's agreement to the issuance of renminbi bonds in Hong Kong by Mainland institutions, the first time that such instruments will be issued outside the Mainland.

The HKMA also developed a blueprint for the financial development of Hong Kong that was adopted as part of the report by the Focus Group on Financial Services set up by the Chief Executive's Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong". The blueprint aims to set out how Hong Kong's already developed financial systems can contribute to the development of the nation's economy and give China the kind of international financial centre the world's fourth-largest and fastest-growing economy ought to have. This is a long-term goal and I have no doubt the strategy will need to be revised from time to time and progress will sometimes seem slower than we would like. But it is surely something worth achieving and we should all commit ourselves to it.

A safe and efficient financial infrastructure

An aspect of Hong Kong's financial system that receives very little public attention is its world-class financial infrastructure. Efficient and safe payment and settlement systems are often taken for granted and few people not directly involved know much about them: people just assume that when they commit funds to a transaction, the money will arrive safely and on time at the other end. This is not the place for a detailed explanation of what are very complex systems but I will just note that on a single day, 27 October 2006, $1.37 trillion, roughly equivalent to Hong Kong's annual gross domestic product, passed through the clearing-house system without any problems. There were also no settlement failures during the year. This does not just happen: a lot of people work very hard to ensure that the systems operate efficiently and the HKMA puts a great deal of effort not just into maintaining the systems but also into making sure that they are developed and improved to keep ahead of the demands placed upon them.

Governance and transparency

I am always conscious that the HKMA bears a great responsibility in the stewardship of public resources. We manage a very large amount of public money and perform functions that directly affect Hong Kong's financial well-being. The HKMA maintains a degree of separation from the rest of the Hong Kong Special Administrative Region Government, although we are an integral part of it. We have a certain level of autonomy in our day-to-day operations, in our funding arrangements, and in the employment of staff on terms different from those of the civil service. These arrangements are consistent with the generally accepted principle that central banking institutions should have resource independence to allow them to carry out their functions without political interference. But this does not mean that the HKMA should not be accountable for how it performs those functions and we are in fact accountable to the Financial Secretary through EFAC and to the community, both directly and through the Legislative Council. EFAC and its Sub-Committees, especially the Governance Sub-Committee, continue to keep a close eye on our operations and to offer us much valuable advice and guidance. We have adopted a policy of transparency that compares favourably with those of the major central banks around the world. I brief the Legislative Council's Panel on Financial Affairs three times a year on the work of the HKMA and matters affecting the economy. This Annual Report is also an important part of our transparency policy and this year we have included a number of improvements and additional items of information that I hope will help the community better understand what we do and how we do it.

Finally, I would like to thank my colleagues for their continued hard work and dedication during the year, and we are all grateful to the Members of EFAC who give up so much of their time and energy to provide us with their guidance.

Joseph Yam
Chief Executive