Chief Executive's Statement

Developments in 2007 kept the HKMA very busy: the further weakening of the US dollar and appreciation of the renminbi; the various measures by the Mainland authorities to cool the economy; continued strong economic growth at home; record activity in the Hong Kong stock market, resulting in significant inflows of funds and some upward pressure on the Hong Kong dollar; the sub-prime crisis and the resulting international liquidity and credit crunch in the second half of the year – all of these helped make 2007 an interesting and challenging year for us. Volatility is a favourite word in central-banking circles, and we heard it often last year. And yet, against this difficult background, the Exchange Fund achieved a record investment return for the people of Hong Kong, the Hong Kong dollar and the local banking sector remained stable despite the market turbulence, we continued to strengthen Hong Kong's financial infrastructure and made further progress in developing and maintaining Hong Kong as an international financial centre.

Continuing economic growth

The local economy continued its above-trend growth, expanding by 6.3% in 2007, compared with 7.0% in 2006. Monetary conditions eased further as the US Federal Reserve began a series of interest-rate reductions in September, partly in response to the sub-prime problems that emerged in August. The unemployment rate continued to decline, reaching 3.4% in December, its lowest level for nearly 10 years. Although the average inflation rate in Hong Kong for the year measured by the Composite Consumer Price Index remained low at 2% (the figure was 3.8% at the end of 2007), underlying inflation picked up to 2.8%. The main factors in this increase were strong domestic demand; increases in the prices of retained imports, especially food; a tightening labour market; and the weakness of the US dollar. We will need to be alert for any increase in the rate of inflation in the coming year.

The stock market had a very strong year with the Hang Seng Index closing at a record high of 31,638 points on 30 October before falling back towards the end of the year. But volatility also increased significantly and the turmoil in global markets clearly affected sentiment. Average daily turnover for the year was $87 billion with a peak of $210 billion on 3 October.

The Exchange Fund

The Exchange Fund achieved a record investment income of $142.2 billion, a rate of return of 11.8%. It also outperformed the benchmark set by the Financial Secretary on the advice of the Exchange Fund Advisory Committee by 126 basis points. This was a very pleasing result, particularly since it was achieved in a year when there was more volatility and turbulence in global financial markets than we have seen for some time. And of course that volatility and turbulence have continued into 2008, making the investment environment for this year uncertain at best.

In these circumstances, it would be well to remember that the Exchange Fund is not primarily an investment fund: its primary purpose, set out in the Exchange Fund Ordinance, is to support the Hong Kong dollar. While it is obviously important to make the best return we can, it is even more important to maintain monetary stability for the benefit of the economic well-being of Hong Kong and its people.

Hong Kong dollar stability

And 2007 was also an eventful year in the area of monetary stability. In January, the renminbi appreciated past the Hong Kong-dollar spot exchange rate with the US dollar, passing through the Hong Kong-dollar Convertibility Zone by mid-February. This was, at least potentially, a psychologically sensitive event, and there was some market speculation that the Hong Kong dollar would be allowed to rise in the wake of the renminbi. To address this potentially de-stabilising sentiment, the HKMA re-doubled its efforts to communicate with the markets and the general community to stress that there was no intention of abandoning the Linked Exchange Rate system, which has served Hong Kong well through a number of financial storms in the last 24 years, and continues to be the best guarantee of stability. In the event, the appreciation of the renminbi past the Hong Kong dollar / US dollar exchange rate passed without much reaction in the markets, suggesting that our view of the importance of monetary stability is widely shared.

In the first seven months of the year, the Hong Kong dollar weakened as domestic interest rates were below their US counterparts, and newly listed companies switched the proceeds of their IPOs out of the local currency. But from August to October, the exchange rate strengthened as the sub-prime crisis led to global risk aversion and the unwinding of Hong Kong-dollar-funded carry trades, demand for the local currency increased because of a series of large IPOs in the stock market, and a pilot scheme to allow individual Mainland investors to buy Hong Kong equities was announced. Short-term interest rates were firm and an up-coming IPO was expected to tighten the money market further. On 23 October, after the Hong Kong dollar had strengthened close to (and at one point touched) the strong-side Convertibility Undertaking, the HKMA operated within the Convertibility Zone to sell Hong Kong dollars against US dollars. Then the strong-side Convertibility Undertaking was triggered passively once on 26 October and five times on 31 October, with the HKMA selling Hong Kong dollars in accordance with the automatic mechanism of the Currency Board.

Following these market operations, the exchange rate and local interbank interest rates softened. In November and December the exchange rate moved back towards the centre of the Convertibility Zone and the Aggregate Balance stood at $10.6 billion at the end of the year, having been steady at $1.3 billion for more than two years. Earlier this year, the balance was reduced to $4.6 billion through a tap issue of $6 billion of three-month Exchange Fund Bills. This issue was well received by the market since it helped meet the increased demand for Exchange Fund paper for intra-day liquidity management.

Despite all the volatility, the very large fund flows, the external shocks and market speculation, monetary conditions remained stable during the year. I believe this underlines both the robustness of the Linked Exchange Rate system and its importance in protecting us from the turbulence in the global financial systems that is inevitable from time to time.

The banking sector

On 1 January, after long and intensive preparation, the new capital-adequacy framework for banks, known as Basel II, was implemented in Hong Kong, making us one of the first jurisdictions in the world to introduce the new system. This marks the fruition of several years' work for us and for the authorized institutions. But the work is far from over, and we are continuing to work with individual institutions, and the sector as a whole, on implementing the new system.

The banking sector remained very strong in 2007: aggregate pre-tax operating profits of retail banks' Hong Kong offices rose by 31.1%; the net interest margin widened to 1.87% from 1.80% in 2006; the retail banks saw improvements in income from fees, commissions and trading investment; and bad debt charges, although increasing in absolute terms compared with 2006, amounted to only 0.04% of average total assets, a record low. Lending grew strongly across the board as activity in the stock and property markets increased, and economic growth stimulated the trade and manufacturing sectors. Customer deposits also expanded and the banks remained highly liquid, with aggregate loan-to-deposit ratios of 65.1% in Hong Kong dollars and 45.5% in all currencies. The sector also remained very well capitalised, with the average consolidated capital-adequacy ratio of locally incorporated authorized institutions standing at 13.4% at the end of the year, calculated on the new Basel II basis.

Of course, the Hong Kong banking sector could not escape entirely the effects of the sub-prime crisis that began in the US in August, and some local institutions saw their profits adversely affected by exposure to sub-prime assets. Fortunately, the strong financial and liquidity positions of the sector as a whole provide a substantial cushion against any further problems in the global system, and I am sure the banks will exercise their customary prudence. But the world is an uncertain place, and in 2008 banks will need to pay particular attention to liquidity management and the risks arising from increased market volatility.

Towards the end of the year, we appointed a consultant to review how the HKMA can best fulfil its responsibilities in the area of ensuring banking stability. The local banking sector is healthy and, we believe, well regulated. But it does not pay to be complacent in a rapidly changing world, and we believe that an objective, outside view will help us to identify current and future challenges. The consultant will make his recommendations later this year, after consulting widely with the industry and the community.

Hong Kong as an international financial centre

The volatility in financial markets in 2007 underlines the need to keep a careful watch for risks to stability globally and in the region, including Hong Kong. We therefore stepped up our efforts, in co-operation with other central banks and regional and international bodies, to monitor and study economic and market developments that could affect financial stability.

We were particularly pleased to see a series of upgrades of Hong Kong's sovereign credit ratings during the year. At the end of the year Hong Kong enjoyed AA ratings, its highest ever. This may seem an obscure subject to many people, but better sovereign ratings lower the costs of funding for local debt issuers and help to increase market confidence in the Linked Exchange Rate system and monetary stability, which in turn helps to underpin economic growth. The HKMA was heavily involved during the year, with the Government, in making the case to the international credit rating agencies that Hong Kong's strong economic fundamentals and fiscal position merit higher ratings. We firmly believe that Hong Kong belongs among the world's triple-A economies and we will continue to argue for improvements to our ratings.

Probably the biggest factor in Hong Kong's status as an international financial centre is, of course, the increasing integration of our economy and financial systems with those of the Mainland. The HKMA played an important role in helping to draw up the Action Agenda on "China's 11th Five Year Plan and the Development of Hong Kong" released in January, and we continued to contribute to its implementation throughout the year. As a result, new measures were included in Supplement IV to CEPA to make it easier for Hong Kong banks to establish and expand their presence on the Mainland; expanded Qualified Domestic Institutional Investors schemes were introduced in August; and the State Administration of Foreign Exchange announced a pilot scheme for Mainland residents to invest in overseas markets. These developments will all contribute to making Hong Kong a platform for the orderly outflow of funds from the Mainland and help to develop the market.

A milestone in the development of renminbi business in Hong Kong was reached in July with the first issue of renminbi-denominated bonds by a Mainland institution in Hong Kong, the first time renminbi bonds have been issued anywhere outside the Mainland. By the end of the year, there had been three issues totalling RMB10 billion providing a new investment instrument for banks and depositors and a new source of funding for Mainland issuers.

We also increased our efforts in studying economic developments on the Mainland and their significance for Hong Kong during the year. Many of the studies we have carried out, and our other extensive research, can be viewed on the HKMA website and I hope they will be of interest to anyone who follows the continuing growth and liberalisation of the Mainland economy.

A safe and efficient financial infrastructure

We continued our efforts, in co-operation with the various financial intermediaries, to upgrade Hong Kong's already world-class financial infrastructure to ensure that investors and financial institutions find our city a safe and convenient place to do business.

The very high levels of turnover in the stock market illustrated just how important it is for the financial infrastructure not just to keep up with developments but to be ahead of them wherever possible. The Hong Kong-dollar Clearing House Automated Transfer System, which clears all Hong Kong-dollar interbank payments including those related to securities transactions, processed a daily average of $879 billion in 2007 and, on 5 November, a record $1.67 trillion passed through the system without incident. In these cases, the sheer capacity of the system is obviously a major consideration. A number of improvements were introduced during the year: these included a CCASS Optimiser to make it easier for banks to manage their funding; the Hong Kong-dollar RTGS and Central Moneymarkets Unit systems opening half an hour earlier; and an improved eIPO service introduced jointly with the Hong Kong Association of Banks and Hong Kong Interbank Clearing Limited to make liquidity management and the recycling of IPO funds back into the market more efficient. A renminbi RTGS system was introduced in June to support the expansion of renminbi-denominated business in Hong Kong. A link between the Hong Kong US-dollar RTGS system and Malaysia's securities settlement system was launched in October. An electronic bond-trading platform was introduced in December to improve price transparency and make bond trading more efficient.

There was also progress in the development of the debt market with the HKMA completing the second phase of its review of debt market development and submitting its recommendations to the Government. We also carried out a study, in co-operation with the Treasury Markets Association, on developing an Islamic financing platform in Hong Kong, in particular how our tax laws might be amended or clarified to provide a level playing field for the issuance of Islamic bonds. A number of refinements were also introduced in the Exchange Fund Bills and Notes Programme, including the publication of league tables for market makers and the first issue of 15-year Exchange Fund Notes.

On the currency front, the HKMA responded swiftly to the emergence in March of new counterfeits of the 2000- and 2002-series $1000 notes issued by HSBC by alerting the public and giving information on how to identify the counterfeits. Speeding up the withdrawal of the old-series HSBC banknotes from circulation also helped contain the problem, which subsided in May. A new $10 polymer note was put into circulation in the second half of the year to assess the performance and acceptability of polymer notes in Hong Kong.

Governance and transparency

Everyone at the HKMA strives to achieve the highest possible professionalism in fulfilling our responsibilities, and to be accountable to the community. We are aided in this by EFAC and its Sub-Committees, in particular the Governance Sub-Committee, whose wise advice is of great value to us. We also try to be as transparent as possible and this Annual Report has been expanded in a number of areas to include more information on how we carry out our work.

A particular challenge in 2007 was the turnover of staff. Although the overall figure was below 10%, it was the highest for some years and reached higher levels in some key departments as the economy continued to grow and the labour market tightened. Of course, turnover is inevitable in any organisation and, for a body like the HKMA, is healthy as long as it does not reach levels that undermine our ability to do our job. I am confident that that level has not been reached, but we will need to pay particular attention to how we can best retain staff, recruit replacements for those that do move on and to meet new and expanded responsibilities, and provide appropriate training and development to make the best use of our pool of talent. I am also keenly aware that too-rapid turnover creates additional pressure on staff.

Finally, as always I would like to express my thanks to my colleagues for their hard work and dedication in another busy and challenging year.

Joseph Yam
Chief Executive