



Economic and Banking Environment

The Hong Kong economy maintained a strong momentum in 2007, recording above-trend growth for the fourth consecutive year. Growth was mainly driven by strong domestic demand, boosted by rising labour income and buoyant asset markets. The outlook for 2008 remains solid, although subject to a number of external uncertainties.

THE ECONOMY IN REVIEW

Overview

Real GDP grew by 6.3%, following the healthy 7.0% growth in 2006. Domestic demand and service exports picked up strongly, while growth in merchandise exports moderated (Table 1). More jobs were created, driving down the unemployment rate to its lowest point in nearly 10 years. Although headline inflation in 2007 remained low at 2.0%, underlying inflation accelerated on strong domestic demand and rising prices of retained imports, particularly those of imported food products.

Monetary conditions eased further, with monetary aggregates and domestic loans growing at a brisk pace. For the year as a whole, broad money picked up by 18.1% and domestic credit by 15.7%. Interest rates also moved lower following the US rate cuts amounting to 100 basis points that began in September 2007. The loan-to-deposit ratio declined to a record low towards the end of the year, suggesting a prudent approach to credit quality by individual banks and abundant liquidity in the banking system.

Table 1. Contribution to real GDP growth by expenditure components (% yoy)

	2007					2006				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	2.6	3.5	5.8	5.7	4.5	3.7	4.4	2.6	3.4	3.5
Government Consumption Expenditure	0.2	0.2	0.1	0.2	0.2	0.1	-0.1	-0.1	0.1	0.0
Gross Domestic Fixed Capital Formation	0.6	2.2	0.2	2.1	1.3	1.4	0.9	2.0	1.5	1.5
Change in Inventories	0.8	1.2	0.8	1.7	1.2	1.2	0.5	-0.8	0.2	0.2
Net Exports of Goods	-1.3	-3.3	-3.6	-5.1	-3.4	-0.2	-1.2	0.6	-0.3	-0.3
Net Exports of Services	2.5	2.6	3.0	2.2	2.6	2.8	1.7	2.1	1.7	2.1
GDP	5.5	6.4	6.3	6.7	6.3	9.0	6.2	6.4	6.6	7.0

Source: Census and Statistics Department.

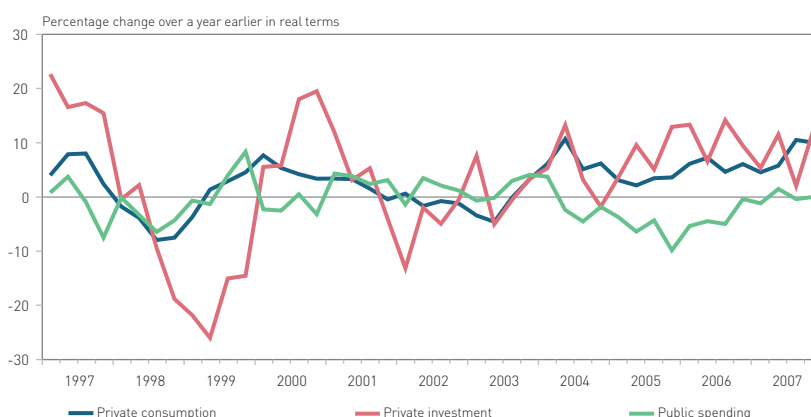
Buoyant domestic demand

Domestic demand continued to be the driving force of economic growth. Rising labour income and buoyant asset markets helped boost private consumption, which increased by 7.8% year on year compared with 6.0% in 2006. Owing to favourable monetary conditions, business investment in equipment spending rose further by 6.0%, after expanding by 19.9% in 2006. In particular, construction spending rebounded significantly following a four-year contraction. Improving fiscal conditions also helped reduce the decrease in government expenditure, which declined slightly by 0.2% in 2007 (Chart 1).

Solid export growth

Hong Kong's exports continued to perform well in 2007 with exports of services again showing strong growth. Merchandise export growth moderated to 7.2% from 9.3% in 2006, reflecting a slower global economy in the second half of the year. Mainland China consolidated its position as Hong Kong's largest trading partner, with the US a distant second and the European Union third (Table 2). Retained imports of goods rose by 9.5%, compared with the 7.7% growth in 2006, boosted by the stronger domestic demand. While the merchandise trade deficit in real terms widened to \$112.9 billion (7.2% of real GDP) in 2007 from \$62.9 billion (4.3% of real GDP) in 2006, exports

Chart 1. Domestic demand



Source: Census and Statistics Department.

Table 2. Merchandise exports by major trading partners¹

	Share %	2007					2006				
		Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	49	13	16	13	11	13	18	8	13	17	14
United States	14	2	1	-2	-3	-1	4	0	1	7	3
European Union	14	5	7	6	6	6	9	4	2	6	5
Japan	4	2	4	-6	-1	-1	7	2	0	-2	1
ASEAN5 ² + Korea	7	5	11	7	11	9	8	2	13	7	8
Taiwan	2	4	11	-4	-2	2	4	-7	9	7	3
Others	10	14	20	17	20	18	11	7	9	17	11
Total	100	9	12	8	8	9	12	5	8	12	9

¹ Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.

² ASEAN5 comprises the Philippines, Malaysia, Indonesia, Singapore and Thailand.

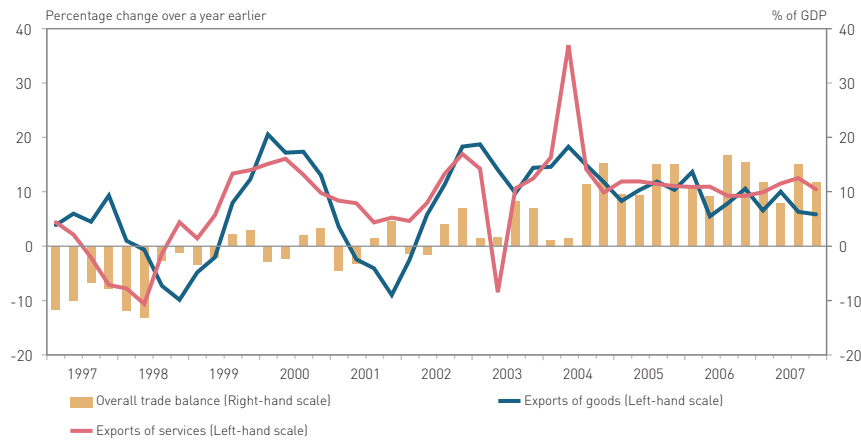
Source: Census and Statistics Department.

of services (particularly financial and tourism-related services) increased faster than imports of services, resulting in an overall trade surplus of \$184.8 billion (11.8% of real GDP), compared with \$196.8 billion (13.3% of real GDP) in 2006 (Chart 2).

Rising inflationary pressures

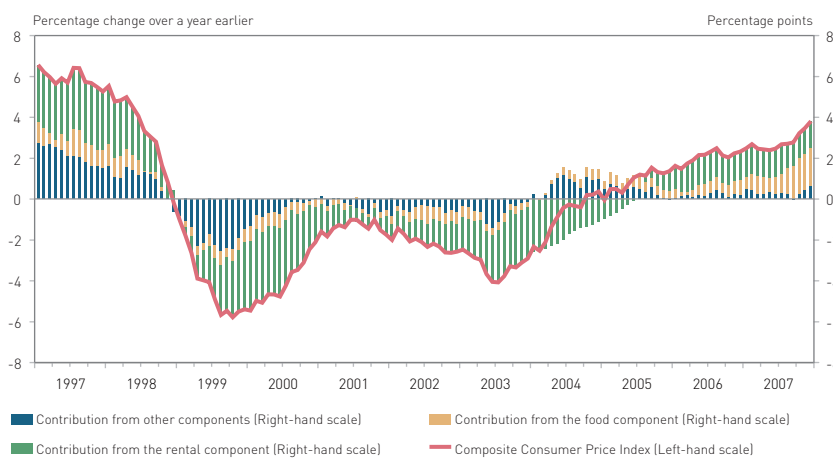
Underlying inflation increased at a faster pace in 2007, rising to an average of 2.8% from 2.0% in 2006, mainly driven by higher residential rents and imported food prices (Chart 3). Rising inflationary pressures were due to an extended period

Chart 2. Overall trade balance and export growth (in real terms)



Source: Census and Statistics Department.

Chart 3. Consumer prices¹



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

Sources: Census and Statistics Department and staff estimates.

of above-trend economic growth and the weak US dollar, to which the Hong Kong dollar is pegged. The headline CCPI inflation rate, however, remained subdued at 2.0%, because of one-off government measures, particularly the rebate of property rates.¹

Tight labour market

Labour market conditions continued to tighten, reflecting the extended period of strong economic growth. In 2007, the seasonally adjusted unemployment rate declined to 3.4% in December from 4.4% in January, the lowest level in nearly 10 years. Employment in sectors such as finance, trade and tourism enjoyed the fastest growth (Chart 4). The fall in the unemployment rate was also due to faster growth in employment than in the labour force.

The tight labour market helped push up nominal wages. The nominal payroll per worker, which includes wages and other non-regular allowances and bonuses,

increased by 3.3% in the first three quarters of 2007 over a year earlier, after growing by 2.4% in 2006. However, rising labour costs were largely offset by a sustained improvement in labour productivity growth. As a result, unit labour costs remained stable.

Booming but volatile stock market prices

The Hang Seng Index (HSI) increased by 39% in 2007, the largest annual gain since 2003. However, market volatility also increased significantly. Apart from strong economic fundamentals, the rise in the Index was also propelled by the expansion of the Qualified Domestic Institutional Investors scheme on the Mainland, expectations that individual Mainland investors would eventually be able to invest directly in the Hong Kong stock market, and the US interest rate cuts after August 2007. Although the global credit market turmoil affected local sentiment significantly, the subsequent rate cuts by the Fed helped sustain the gains. The Index surged briefly to a record



Source: Census and Statistics Department.

¹ Rates are an indirect tax levied on properties. They are charged at a percentage of the rateable value (the estimated annual rental value of a property at a designated valuation reference date, assuming that the property was then vacant and to let). For the financial year 2007/08, the rates percentage charge is 5% and the designated valuation reference date is 1 October 2006.

high of 31,638 at the end of October 2007 before falling back to the 27,000 level towards the end of the year, as investors became increasingly concerned about the sustainability of the high stock valuations, risk appetite fell and profit taking set in. The H-share index, consisting of Mainland firms listed in the Hong Kong market, rose strongly by 56% and was also highly volatile during the year, largely reflecting its lower valuation relative to the A-share market and strong demand for shares of Chinese enterprises among institutional investors.

Rising property prices

The residential property market picked up markedly in 2007 on growing household income and easing monetary conditions. Residential housing prices in 2007 rose by 11.6% year on year after an increase of only 0.8% in 2006, while residential property transactions expanded sharply by 47%. In the light of falling real interest rates, property prices are expected to rise further, thus raising concerns of more property price inflation. The average transacted price of luxury flats (160 m² or above) on Hong Kong Island breached the peak level seen in 1997, while luxury flat prices in other areas rose close to their record highs. Nevertheless, various indicators suggest developments in the housing market remained healthy in 2007. The income-gearing ratio remained relatively low and the affordability of housing continued to improve because of falling real mortgage rates and rising incomes.

Notes and coins

At the end of 2007, the total value of banknotes in circulation was \$163,435 million, an increase of 3.8% from a year earlier (Charts 5, 6, 7). The total value of government-issued notes and coins in circulation amounted to \$7,318 million, up 10.3% (Charts 8 and 9). The value of \$10 notes issued by the Government in circulation (both paper and polymer notes) reached \$2,068 million, an increase of 36.5% from 2006.

Chart 5. Banknotes in circulation by note-issuing banks at the end of 2007

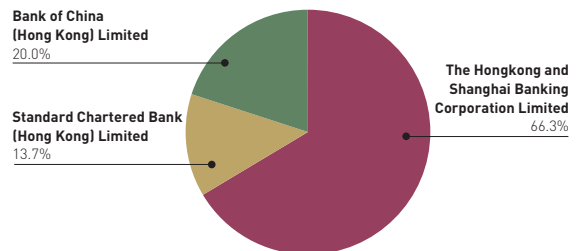
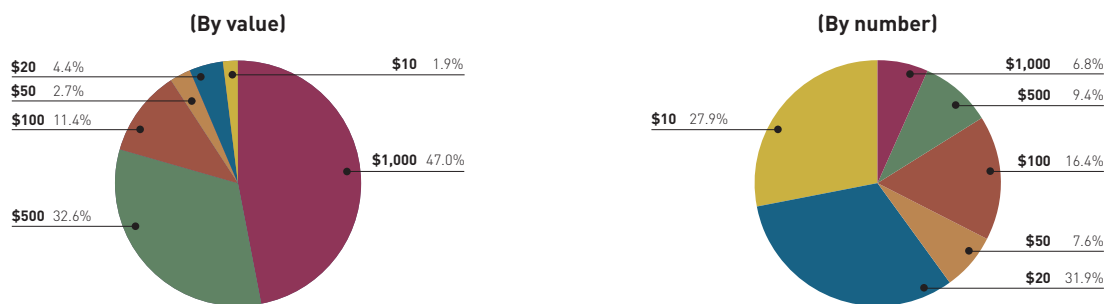


Chart 6. Distribution of banknotes in circulation at the end of 2007



Economic and Banking Environment

Chart 7. Banknotes in circulation at the end of year

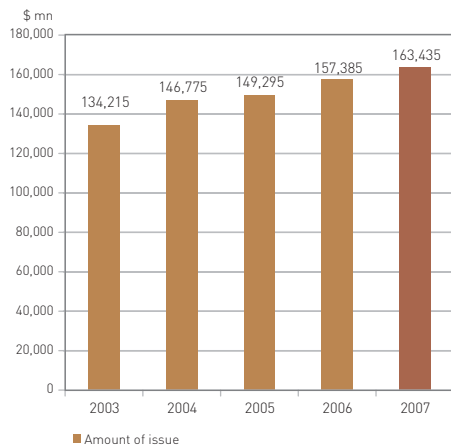


Chart 8. Government-issued notes and coins in circulation at the end of year

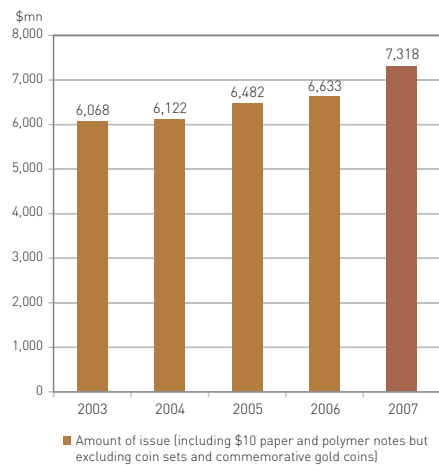
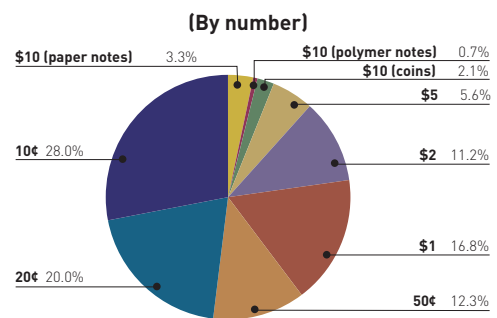
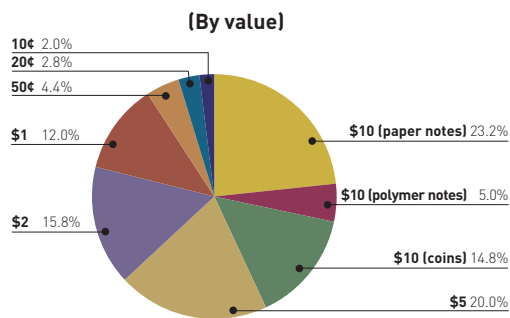


Chart 9. Government-issued notes and coins in circulation at the end of 2007



Hong Kong banknotes

Public education programmes on the security features of the latest series of banknotes issued in 2003 and 2004 continued to be well received. During the year, 49 seminars were organised for over 7,000 bank tellers and retail cashiers, providing them with knowledge and skills for authenticating banknotes.

The HKMA responded swiftly, alerting banks and the public, to the emergence in March 2007 of new counterfeit notes of the 2000- and 2002-series \$1,000 notes issued by The Hongkong and Shanghai Banking Corporation (HSBC). Seminars were organised for bank tellers, retailers and moneychangers to advise them on how to identify the new counterfeit notes. Speeding up the withdrawal of the old-series HSBC banknotes from circulation also helped contain the problem, which subsided in May.

The HKMA continued with its efforts to promote the use of “good-as-new” notes instead of brand new notes for *lai see* (customary monetary gifts given during Chinese New Year). Thanks to the support of the public and the three note-issuing banks, the number of new \$10, \$20 and \$50 notes issued for the 2007 Chinese New Year decreased by 22% compared with 2006.

\$10 polymer note

The Hong Kong \$10 polymer note was put into circulation in July 2007. The HKMA, which has been examining alternative technologies for the production of currency notes, issued the note to assess the performance and acceptability of polymer notes in Hong Kong.



Mr Henry Tang, then Financial Secretary, and HKMA student ambassadors at an exhibition of the \$10 polymer note.

An extensive publicity campaign including exhibitions at public housing estates was launched during the year to brief the public on the characteristics of the notes. In November, the Community Chest held a charity sale of a special edition of the \$10 polymer notes bearing a serial number without an alphabetical prefix. The sale raised more than \$5.8 million to help improve social services for the mentally handicapped.

Coin replacement programme

The withdrawal of coins bearing the Queen's Head design continued, with 38 million coins being removed from circulation in 2007.

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

OUTLOOK FOR THE ECONOMY

Economic growth to continue

Economic growth is expected to remain solid in 2008, although growth momentum is likely to moderate. Domestic demand will continue to provide the main impetus, with increasing private consumption expenditure underpinned by income and wage growth amid favourable labour market conditions, aided by the positive wealth effect associated with buoyant asset markets. Low real interest rates and buoyant asset markets should also boost fixed-asset investment, but increased uncertainty about the outlook for the US economy may affect investment sentiment. Merchandise exports are projected to moderate, mainly due to a possible US-led global slowdown and a sustained appreciation of the renminbi, which would reduce Hong Kong's re-exports from the Mainland to the rest of the world. However, the moderation in export growth is likely to be offset, to some extent, by the weak US dollar. Exports of services are expected to remain steady, in part supported by an anticipated increase in tourists to the Mainland transiting Hong Kong, particularly during the 2008 Beijing Olympics. The market consensus forecasts a slowdown in real GDP growth from 6.3% in 2007 to 4.9% in 2008, driven largely by a deceleration in external demand.

Inflationary pressures to increase

Barring a significant slowdown in the global economy, strong domestic demand and the weak US dollar will continue to put upward pressure on domestic inflation. In particular, rising property prices will push up private housing rents, leading to rising inflation in the CCPI rental component. Although the rapid labour productivity growth has mitigated some of the inflationary pressures in previous years, the non-rental component of CCPI inflation is also expected to rise faster, largely reflecting strong domestic demand. While headline inflation was lower than the underlying inflation rate in 2007, it is expected to converge to the level of underlying inflation once the effects of special government tax-relief measures are phased out, especially those relating to the rebate of property rates.

Uncertainties and risks

The solid baseline outlook for 2008 is subject to a number of risks and uncertainties, mainly led by external factors. A sharper-than-expected slowdown in the US would have a particularly adverse effect on re-export trade between Hong Kong and the Mainland. As global investors re-balance their portfolios reflecting the turmoil in developed financial markets, there could be increased market volatility in Hong Kong, which may undermine consumer and business confidence. Nevertheless, even if these risks were to materialise, Hong Kong should still be able to achieve positive growth, largely because of its strong economic fundamentals. A further tightening of labour market conditions and a larger-than-expected increase in housing rentals would be important risk factors for inflation. The prospect of rising inflation and lower real interest rates could help fuel domestic credit growth and stimulate the build-up of leveraged positions. It is therefore important for financial institutions to manage risks prudently in an environment of rising asset prices.

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PERFORMANCE OF THE BANKING SECTOR

The banking sector remained sound in 2007, with retail banks highly profitable and locally incorporated authorized institutions (AIs) well capitalised. Stable macroeconomic conditions underpinned profitability and kept credit losses low.

Retail banks' balance sheets continued to grow in a stable operating environment. Strong growth in domestic lending, supported particularly by the buoyant domestic stock market, and the improvement in net interest margins contributed to a significant increase in net interest income. Profit growth was also supported by continued robust growth in fees and commission income, which was mainly associated with equity-related business and accounted for a larger share of total income.

Asset quality remained very good, notwithstanding that the quality of investment in debt securities worsened mainly due to the sub-prime turmoil. The number of negative-equity residential mortgages declined further. Although the quality of the credit card portfolio showed signs of weakening alongside an increase in personal bankruptcies, the charge-off ratio remained low.

Interest rate trends

Hong Kong dollar interest rates were stable in the first half of the year until the sub-prime problem emerged. Sparked by a tightening of global liquidity, Hong Kong dollar interbank interest rates rose. A decline in best lending rates following interest-rate cuts by the Federal Reserve in September mitigated the impact briefly, but it was not until the Hong Kong dollar exchange rate moved from the strong side to the middle of the Convertibility Zone following the market operations conducted in October by the HKMA under the Currency Board arrangements that interest rates in Hong Kong began to soften. Amid the higher volatility, the average one-month Hong Kong Interbank Offered Rate (HIBOR) increased to 4.29% in 2007 from 4.12% in 2006. Under the influence of an easing US monetary policy, best lending rates declined to 6.75% or 7.00% at the end of 2007. Deposit rates moved in tandem with best lending rates. The average one-month time deposit rate declined to 2.42% in 2007 from 2.70% in 2006 (Table 3). The spread between the average best lending rate of The Hongkong and Shanghai Banking Corporation and the average one-month HIBOR narrowed to 331 basis points compared with 378 in 2006. However, the spread between the annual average best lending rate and the average one-month time deposit rate was little changed at 517 basis points, compared with 520 in 2006.

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

% per annum	Time deposits			HIBOR			Savings deposits	Best lending rate*
	1-month	3-month	12-month	1-month	3-month	12-month		
Q1-2007	2.52	2.58	2.82	4.08	4.15	4.35	2.26	7.75
Q2-2007	2.55	2.59	2.86	4.40	4.38	4.53	2.26	7.75
Q3-2007	2.58	2.62	2.88	4.62	4.64	4.68	2.23	7.72
Q4-2007	2.04	2.29	2.62	4.04	4.17	4.07	1.66	7.15
2006	2.70	2.78	3.02	4.12	4.27	4.52	2.50	7.90
2007	2.42	2.52	2.80	4.29	4.33	4.41	2.10	7.59

* Refers to the best lending rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

Profitability trends

The aggregate pre-tax operating profits of retail banks' Hong Kong offices increased strongly by 31.1% following a 10.2%^r increase in 2006 (Chart 10). Post-tax return on average assets climbed to 1.53% from 1.36%^r in 2006 (Chart 11) as profits grew faster than the amount of assets.

The strong profit growth was mainly attributable to an increase in net interest income, reflecting both an expansion of assets and an improving net interest margin, which widened to 1.87% from 1.80% in 2006 (Chart 12). Retail banks posted sharp increases in fees and commission income and trading investment income, as a result of which the proportion of non-interest income to total income increased to 44.1% from 38.4% in 2006.

Retail banks' net charge for debt provisions more than tripled compared with 2006, as the amount of provision write-back decreased and new provisions increased in the year. Because of the deterioration in the quality of investment portfolios in relation to banks' exposure to sub-prime related products, the banks' net charge for other provisions also grew sharply to \$1.3 billion from a nearly zero-base in 2006. Nevertheless, retail banks' net charge for debt and other provisions to average assets ratio remained relatively low, at 0.06% at the end of 2007 (Chart 13).

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



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

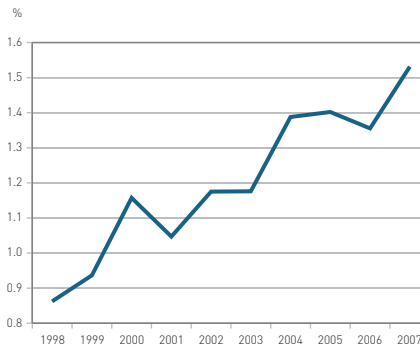
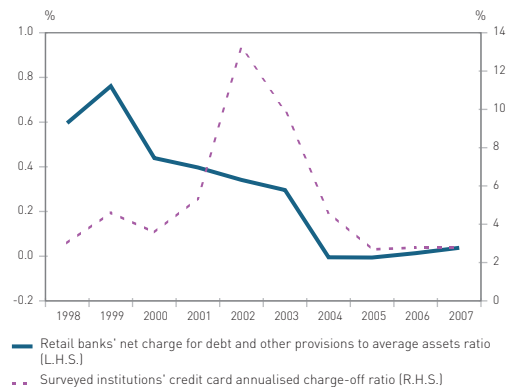


Chart 12. Retail banks' net interest margin



Chart 13. Charge-off ratios



^r 2006 figures revised.

Reflecting the favourable economic conditions and the tighter labour market, staff expenses continued to rise, while business expansion also drove operating costs higher. However, the faster increase in income than in operating costs resulted in a decline in retail banks' cost-to-income ratio to 40.4% from 42.8%^r in 2006 (Chart 14).

Balance sheet trends

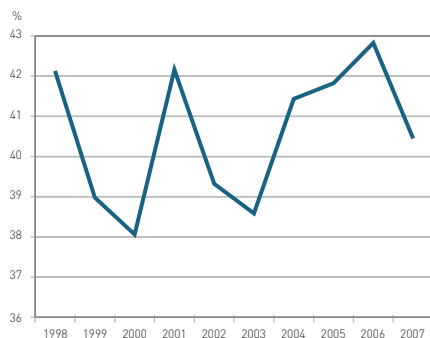
Total assets of the banking sector expanded by 24.6% and those of the retail banks by 17.6%. This mainly reflected the continuing growth of domestic lending. Supported by

steady economic growth, retail banks' customer deposits registered strong growth. With customer deposits increasing more than loans and advances, retail banks were less reliant on negotiable debt instruments (NDIs) for funding.

Domestic loan demand grows

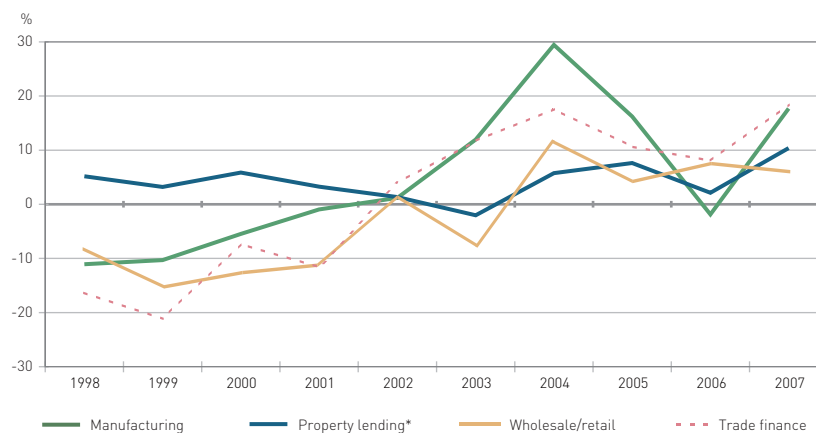
Retail banks' total lending rose by 12.6% in 2007 across a broad range of business. Domestic lending increased by 11.4% compared with an increase of 2.7%^r in 2006. Loans for use outside Hong Kong increased by 29.7% due to the small-base effect.

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



Strong growth was seen in property lending, which increased by 10.4% compared with 2.1% in 2006 (Chart 15), as sentiment improved and property prices increased throughout the year. Loans for property investment increased by 20.1% and those for property development by 6.7%, after growing by 5.5% and 9.7% respectively in 2006. Residential mortgage loans rebounded to grow by 5.5% because of lower best lending rates and higher market activity, reversing a decline of 0.9% in 2006.

Chart 15. Retail banks' loans for use in Hong Kong by selected sectors (year-on-year growth)



* Property lending denotes lending for property development & investment and residential mortgage loans (excluding lending under the Home Ownership Scheme, the Private Sector Participation Scheme & the Tenants Purchase Scheme).

^r 2006 figures revised.

The economic growth momentum stimulated credit demand from trade financing and the manufacturing sector. Trade-financing loans rose by 18.4% following an increase of 8.0%^r in 2006. Loans to the manufacturing sector rose by 17.7%, reversing a 1.9%^r decline in 2006. Lending to the wholesale and retail trade sector grew by 6.0% and to the information technology sector by 6.8%. Lending to the electricity and gas sector continued to contract, declining by 11.4% after a drop of 13.1% in 2006.

Growth in share financing was strong, mainly because of the buoyant domestic stock market and the large number of initial public offerings (IPOs) during the year. Within this portfolio, loans to stockbrokers increased by 79.9% following a 28.4%^r increase in 2006, and loans to non-stockbroking companies and individuals to purchase shares also rose by 44.0% following an increase of 44.0%^r in 2006. Despite the strong growth, the proportion of these loans in overall domestic lending remained small.

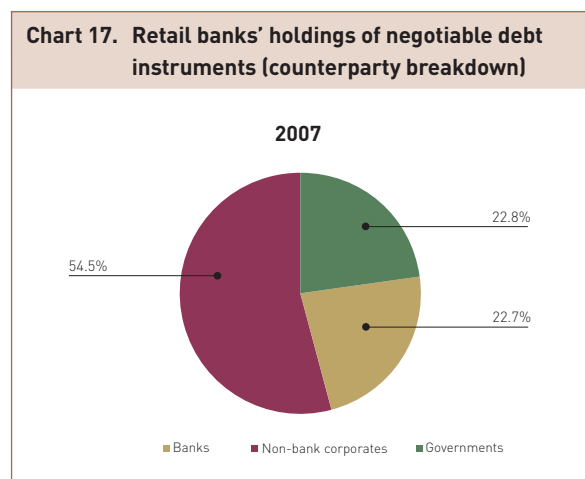
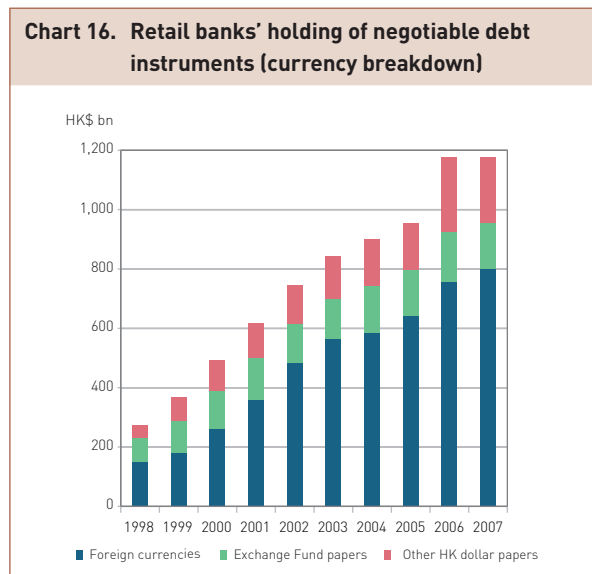
Credit card lending expanded further. According to the regular survey of AIs active in credit card business, total credit card receivables increased by 6.5% after an increase of 6.1% in 2006.

Retail banks' reported exposures to non-bank Chinese entities stood at \$550 billion, or 7.8% of their total assets, at the end of 2007 compared with \$426 billion (7.3% of total assets) at the end of 2006. For the banking sector as a whole, the exposures were \$756 billion (6.5% of total assets).

Holdings of negotiable debt instruments remained stable

Retail banks' holdings of NDIs (excluding negotiable certificates of deposits (NCDs)) remained little changed after increasing by 23.2% in 2006. NDIs denominated in Hong Kong dollars fell by 10.4%, while foreign-currency-denominated NDIs rose by 5.8% (Chart 16). A majority of NDIs were issued by non-bank corporates (54.5%), while 22.8% were issued by governments and 22.7% by banks (Chart 17). The share of retail banks' total holdings of NDIs to their total assets decreased to 20% at the end of 2007 from about 24% a year earlier.

Retail banks were less reliant on issuing NCDs for funding purposes as customer deposits grew rapidly, outpacing the growth in loans. Outstanding NCDs issued fell by 34.5% in 2007 after contracting by 12.7% in 2006.



^r 2006 figures revised.

Customer deposits rise

Retail banks' customer deposits expanded by 18.4% after increasing 15.6% in 2006 (Chart 18). Hong Kong dollar and foreign currency deposits increased by 17.1% (Chart 19) and 20.3% respectively. The proportion of Hong Kong dollar deposits to total deposits remained stable at 60%. Deposit growth was greatest at shorter maturities, reflecting the increased transaction demand for money arising from the strong domestic stock market and heavy IPO activities in 2007. Demand deposits therefore recorded strong growth of 33.4% after a 17.2% increase in 2006, while savings deposits increased by 19.3% following a 19.3% growth in 2006. Despite the lower average time deposit rates, time deposits rose further by 15.8%, following an increase of 13.3% in 2006. At the end of 2007, savings and demand deposits together accounted for 43.5% of total deposits, up from 42.3% a year earlier.

Retail banks remain highly liquid with good asset quality

Retail banks remained highly liquid in 2007. Faster growth in customer deposits relative to loans drove loan-to-deposit ratios in all currencies down to 45.5% and those in Hong Kong dollars to 65.1%.

The asset quality of retail banks remained sound. The classified loan ratio and the ratio of loans overdue for more than three months reached the new lows of 0.86% and 0.36% respectively, compared with 1.11% and 0.54% at the end of 2006. With the rescheduled loan ratio also declining, the combined ratio of overdue and rescheduled loans fell further to 0.57% from 0.80% (Chart 20).

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

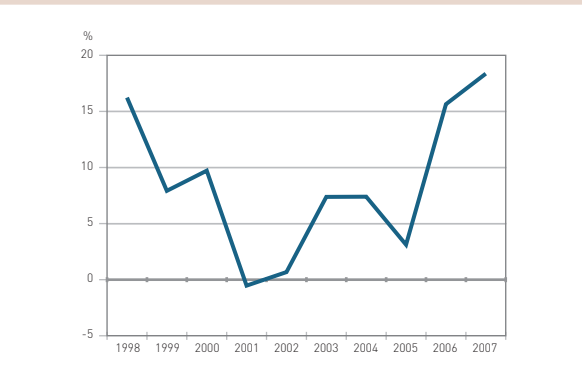


Chart 19. Retail banks' year-on-year growth of Hong Kong dollar deposits*

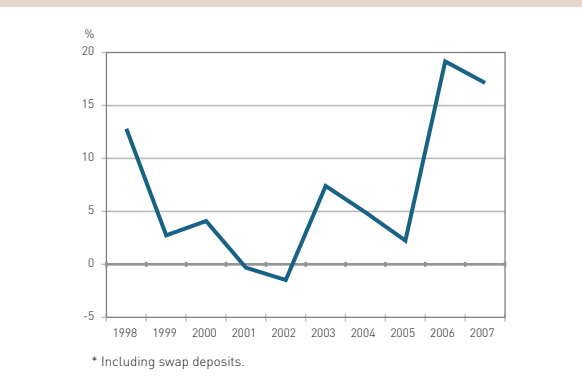


Chart 20. Retail banks' gross classified loans/combined overdue and rescheduled loans as a percentage of total loans



The quality of banks' residential mortgage portfolios remained solid, with the mortgage delinquency ratio declining to 0.11% and the rescheduled loan ratio to 0.20% (Chart 21). The quality of the mortgage portfolio was underpinned by rising property values and higher household incomes.

In line with the increase in property values, the outstanding number of residential mortgage loans in negative equity decreased by 78% to about 1,900 cases by the end of 2007 from about 8,400 at the end of 2006. Compared with the peak of about 106,000 cases in June 2003, the number of negative equity cases had fallen by 98%.

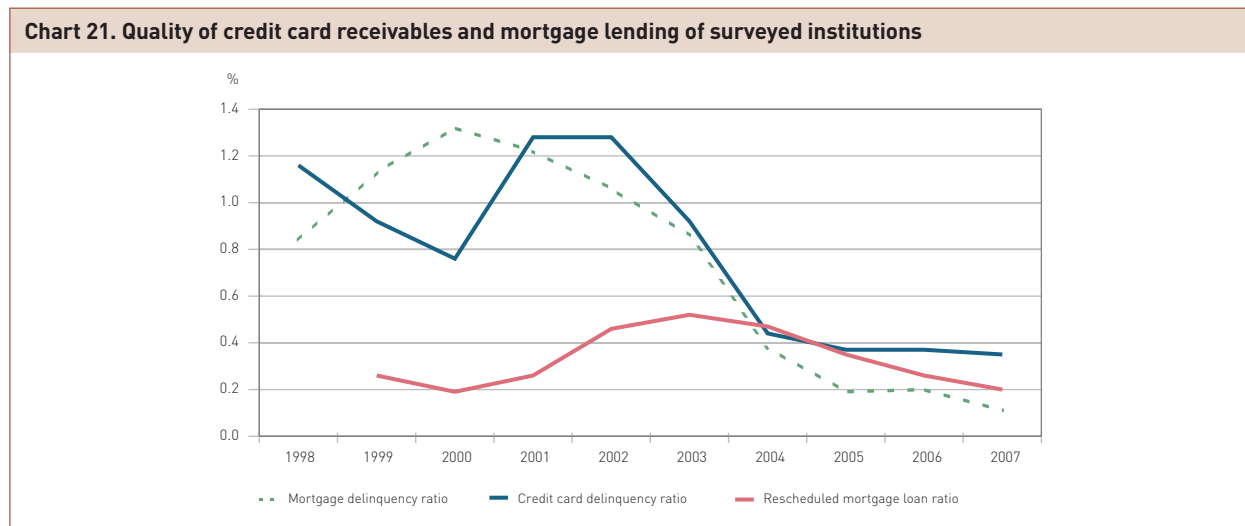
Corresponding to an increase in the number of bankruptcies in 2007, credit card receivables rescheduled during the year increased by 34% and the total charge-off amount grew by 6%. However, because of the strong growth in receivables, the credit card charge-off ratio

for the year was stable at 2.90% (Chart 13) and the delinquency ratio decreased to 0.35% from 0.37% at the end of 2006 (Chart 21). Together with the outstanding rescheduled credit card receivables, which remained stable at \$52 million (0.1% of total credit card receivables), the combined delinquent and rescheduled ratio declined further to 0.42% at the end of the year from 0.44% at the end of 2006.

The quality of the retail banks' investment in debt securities worsened in 2007 mainly due to the sub-prime turmoil. At the end of 2007, retail banks' investments in debt securities which were classified as "substandard", "doubtful" or "loss" represented about 0.05% of the banks' total assets, and investment under special mention was 0.09%. The majority of the special mention and classified investment was sub-prime related instruments.

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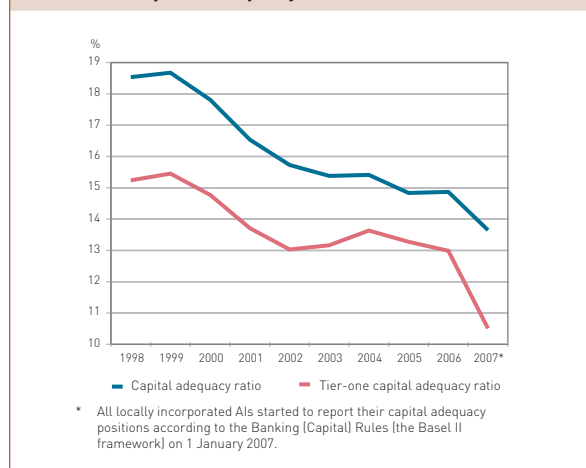
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Strong capital ratio

Since January 2007 when Basel II was implemented in Hong Kong, all Hong Kong-incorporated AIs have been required to report their capital adequacy positions under the revised capital adequacy framework. Under the new system, which is more risk-sensitive than the previous framework, the average consolidated capital adequacy ratio of all locally incorporated AIs at the end of 2007 was 13.4% and the average tier-one capital ratio was 10.6% (Chart 22). The figures at the end of 2006 were 14.9%[†] and 13.0%[†] respectively. Parallel reporting under the two frameworks at the end of December 2006 indicated that the additional capital charge for operational risk was the main reason for the decline. Despite the apparent decline, the capital position of the banking industry remains strong and well above the international minimum of 8%.

Chart 22. Locally incorporated AI's consolidated capital adequacy ratio



PROSPECTS FOR 2008

Although the US sub-prime problem has had a major impact on the global financial system, the Hong Kong banking sector had little direct exposure. The strong financial and liquidity position of the banking sector also provides a substantial buffer against disturbances. The implementation of Basel II has also strengthened supervisory and risk-management practices, making the banking system more resilient. However, there may still be a longer-term impact, depending on developments in the US economy. Given this uncertainty in the operating environment of the banking sector, and with continued keen competition, there is a need for greater focus on liquidity management, more rigorous stress testing, monitoring of asset quality for signs of deterioration, and prudent valuation of structured products.

While deposits increased sharply in 2007 as a result of the buoyant stock market and heavy IPO-related activity, banks must manage their liquidity positions carefully in the light of liquidity events elsewhere. AIs also need to ensure that profits derived from residential mortgage business are commensurate with the risks involved and that underwriting standards remain prudent as competition in the market continues to be intense.

Although the high level of stock market activity has benefited the performance of the banking sector, banks have also become more exposed to the market's volatility, providing another source of uncertainty in 2008.

[†] 2006 figures revised.