EDITORIAL

Recent trends and events

Economic growth in Hong Kong strengthened in the second quarter. Real GDP rose by 3.0% on a quarter-on-quarter basis, following an increase of 1.4% in the first quarter, while the year-on-year growth rate accelerated from 6.2% to 6.8%. Growth was broad based, with most GDP components recording quarterly and annual increases. Labour market conditions continued to improve with the unemployment rate declining to 5.7% in the three months up to the end of July from 6.1% in the first quarter. The inflation rate continued to edge up, with the consumer price index increasing by 1.3% in July from a year before, the highest rate of increase in seven years. Factory prices continued to rise, but residential property, retail shop and office prices declined in the past few months as a result of the rise in interest rates. The number of property transactions also decreased sharply.

The US Federal Open Market Committee continued to raise the federal funds target rate, by a total of 50 basis points to 3.5% over the past three months. Many retail banks in Hong Kong raised their best lending and savings rates accordingly. The refinements to the Linked Exchange Rate system announced by the HKMA in May worked well, driving the Aggregate Balance back to a more normal level of HK$1.3 billion on 31 August, and aligning short-term Hong Kong dollar interest rates more closely with their US dollar counterparts. The Hang Seng Index rose from 14,000 in mid-June to 15,500 in mid-August, before easing back to around 14,900 at the end of August.

The People's Bank of China announced on 21 July that, with immediate effect, the renminbi exchange regime would move to a managed floating rate system based on market supply and demand with reference to a basket of currencies. The renminbi would no longer be pegged to the US dollar. The exchange rate was adjusted to RMB 8.11 yuan per US dollar on the same day, which represented a 2% appreciation.

The Legislative Council passed the Banking (Amendment) Ordinance 2005 on 6 July, putting in place a legislative framework for the implementation of Basel II in Hong Kong. On 28 July the HKMA announced that the Exchange Fund had recorded unaudited investment income of HK$11.5 billion for the first half of 2005. Two bond funds under the Asian Bond Fund 2 Initiative (ABF2), the ABF Hong Kong Bond Index Fund and ABF Pan Asia Bond Index Fund, were listed on the Hong Kong Stock Exchange during late June and early July.

In this issue

The first feature article in this issue of the *Quarterly Bulletin*, entitled implementation of Basel II in Hong Kong, reports the progress in implementing the revised capital adequacy framework in Hong Kong. The second article is about research on the determinants of the capital level of banks in Hong Kong. The article concludes that the minimum capital requirement remains an effective policy instrument even though banks in Hong Kong consistently maintain capital adequacy ratios above the regulatory requirement. The paper also suggests that Basel II is expected to help address the issue of how banks can improve the use of their capital.