



**HONG KONG MONETARY AUTHORITY**

**Briefing to the Legislative Council  
Panel on Financial Affairs**

**4 February 2013**



- 1. Financial and Economic Environment**
2. Banking Stability
3. Financial Infrastructure
4. Hong Kong as an International Financial Centre
5. Investment Performance of the Exchange Fund



## ASSESSMENT OF EUROPE'S ECONOMY

- Market concerns for the collapse of the euro zone eased further:
  - Yields for government bonds in Spain, Italy and Greece dropped
  - European stock markets have rebounded since mid-November 2012
  - European Central Bank introduced measures to preserve the euro
- However, structural measures have to be introduced by European countries in regard to fiscal consolidation and labour market reforms, with a lengthy process expected to be involved
- Clouds of recession spreaded towards core countries; IMF estimates suggest a contraction of 0.4% in 2012 and 0.2% in 2013

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- Market concerns for the collapse of the euro zone eased further.
- Economic outlook for euro zone will remain bleak before restructuring is completed. IMF estimates suggest the euro zone will have contracted by 0.4% in 2012, followed by a further contraction of 0.2% in 2013. (European Central Bank forecasts range between a contraction of 0.9% and an expansion of 0.3% in 2013)



## **ASSESSMENT OF THE US ECONOMY: SLOW PACE OF RECOVERY CONTINUED**

- US recovery continued at a slow pace (2012 Q4: -0.1%; full-year 2012: 2.2%)
- Market forecasts of growth in 2013: 2.0%; Fed forecasts: 2.3% - 3.0%
- Signs of improvement in private sector:
  - Housing market continued to trend up from its trough
  - Car sales rose
  - Ratio of household debt to after-tax income dropped from its peak of 1.29 to the latest 1.08
  - Employment continued to grow as jobless rate fell

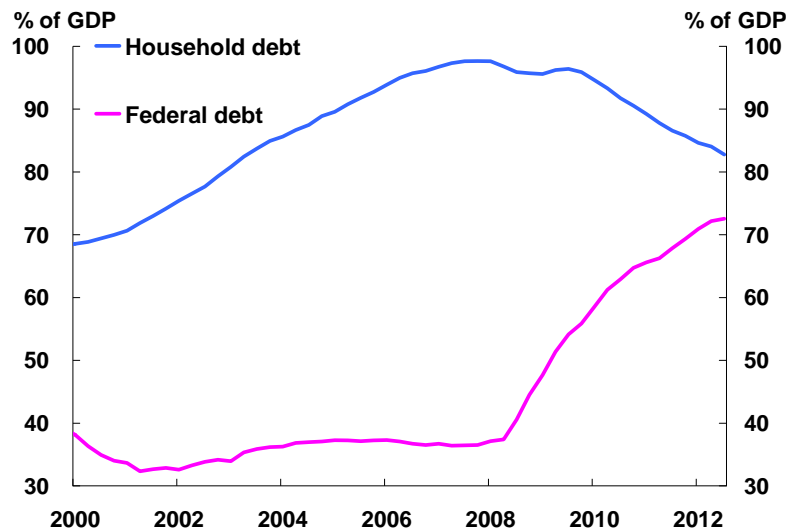
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- The US economy contracted slightly by 0.1% in Q4 2012 (Q3 2012: 3.1%) and expanded by 2.2% for the whole year.
- Market forecasts suggested a full-year growth of 2.0% in 2013 while Fed forecasts put it between 2.3% and 3.0%.
- Employment continued to rise in the past year, with jobless rate falling from 8.3% at the beginning of 2012 to 7.9% in January 2013. However, the rise in employment failed to inspire many discouraged workers who have left the labour force earlier to find a position again.



## ASSESSMENT OF THE US ECONOMY: BUT PUBLIC SECTOR DELEVERAGING WILL BEGIN TO DRAG ON GROWTH

Deleveraging at household level has progressed substantially  
while that at government just at its start



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- The chart shows the ratio of household debt to GDP fell from its peak of 98% in Q4 2007 to 83% recently (Q3 2012).
- However, the ratio of federal debt to GDP has continued to rise, almost doubling from 37% before recession set in (Q4 2007) to 73% recently (Q3 2012). To revive fiscal sustainability, the US government must undertake a massive fiscal restructuring programme in the medium to long term. Public sector deleveraging will start to drag on output growth.



## **ASSESSMENT OF THE US ECONOMY: FISCAL POLICY RISKS**

- Last-minute bipartisan agreement on a tax compromise deal has temporarily averted the fiscal cliff
- Deadlines for government spending cuts and raising debt ceiling delayed to end of February and mid-May respectively
- Deficit reduction, a daunting task itself, involves a dilemma to be resolved

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- Despite a bipartisan consensus on reducing fiscal deficit, political bickering has seen a last-minute compromise deal that only address the tax issue. In avoiding hefty tax hikes, the deal will add a mere US\$600 billion in new government revenue over 10 years, far lower than the original target of US\$1.6 trillion set by the Obama administration.
- According to current fiscal status, the US government will need to beef up its deficit reduction effort to stabilise the public debt level. However a major gap still exists between the parties in regard to ways of reducing public spending.



## ASSESSMENT OF THE US ECONOMY: MONETARY POLICY RISKS

- US Fed expanded quantitative easing with purchase of US\$85 billion in long-term Treasury bonds and mortgage-backed securities each month until substantial improvement in labour market
- Announced two thresholds for maintaining low interest rate policy: jobless rate to remain above 6.5%; projected inflation for one to two years ahead to stay below 2.5%
- Latest monetary policy involves some risks:
  - More intensive quantitative easing will further suppress historically low long-term interest rates and distort bond market operation
  - The use of economic thresholds increases the uncertainties over the timing for an exit from the easing policy

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- The US Fed announced to replace the mid-2015 expiry date with economic thresholds for determining the duration of its low interest rate policy. The Fed declared that as long as jobless rate remains above 6.5% and projected inflation for one to two years ahead stays at no more than 2.5%, it will continue to keep interest rates at the currently low level.



## JAPAN'S MONETARY AND FISCAL POLICY RISKS

- Bank of Japan raised its inflation target from 1% to 2% and will implement an open-ended easing policy from 2014
- New Prime Minister Shinzo Abe announced to bolster his fiscal policies; Japanese cabinet approved a 20 trillion yen economic stimulus plan, which will substantially increase fiscal deficit and increase government debt burden
- Japanese yen fell by almost 16%, from below 80 yen against the dollar in mid-November 2012 to over 92 yen
- Japan's new policies have caused concern among other countries

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- The Bank of Japan announced on 22 January 2013 to raise its inflation target from 1% to 2% and introduce monetary easing with a net purchase of 36 trillion yen in assets in 2013 and an asset purchase programme with no specific limit or time frame from 2014 onward.
- Bank of Japan's inflation projections (fiscal year) for 2012: -0.2%; 2013: +0.4%; and 2014: +2.9% (including consumption tax effect), +0.9% (not including consumption tax effect)





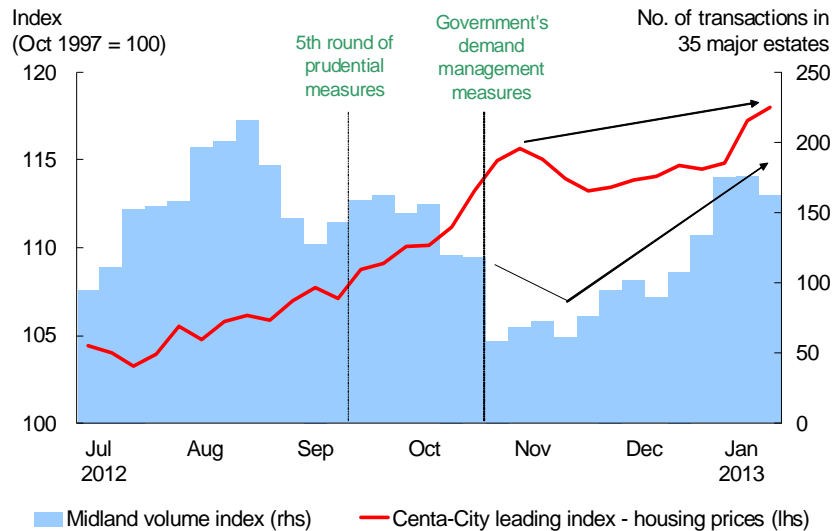
## ASSESSMENT OF MAINLAND CHINA'S ECONOMY

- Economic growth rebounded
  - 7.8% in 2012;  
consensus forecast of 8.1% in 2013
- Inflationary pressure remained moderate
  - 2.6% in 2012;  
consensus forecast of 3.2% in 2013
- Central Economic Work Conference: to continue pursuing an active fiscal policy and prudent monetary policy, with emphasis on quality of economic growth, and to ensure sustained and healthy development of the economy



## ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

Residential property prices and transactions fell following relevant measures in October 2012, but have both trended up recently



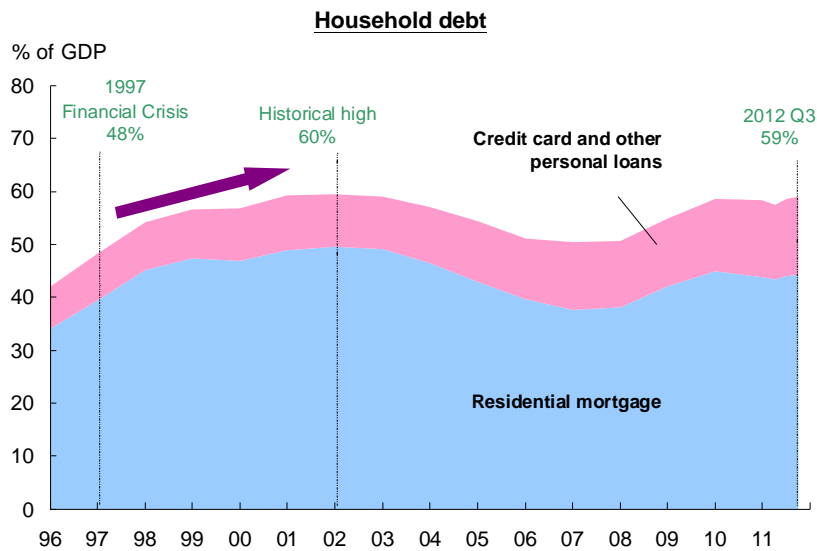
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- HKMA's measures have helped lessen the risk of banks' residential mortgage lending:
  - Average loan-to-value ratio of newly approved mortgages fell from 64% in September 2009 to 52% in December 2012
  - Average income-gearing ratio of newly approved mortgages also fell from 41% in August 2010 to 36% in December 2012



## ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: PROPERTY MARKET

### Household debt burden remained heavy



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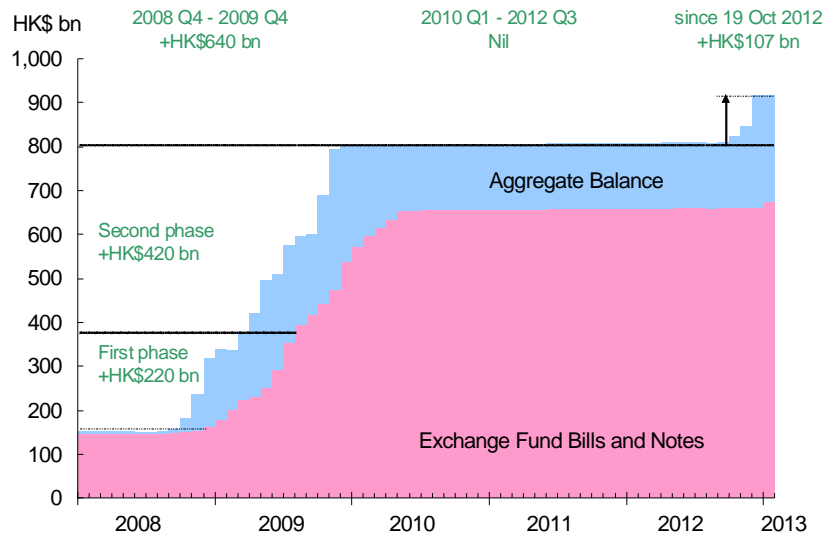
- Following the burst of the property bubble in Hong Kong in 1997, household income dropped, causing household debt to GDP ratio to rise from 48% that year to a peak of 60% in 2002. Household debt now is edging close to the high level of 2002. Should there be an economic downturn followed by a rise in unemployment, the ratio may go up further.

|          | Mortgage loans                                  | Credit card advances and other personal loans | Total household debt | As % of GDP           |
|----------|---|---|----------------------|-----------------------|
|          | <i>HK\$ billion</i>                             |   |                      |                       |
|          | <i>% of total household debt in parenthesis</i> |   |                      |                       |
| 1997     | 540.8<br>(82%)                                  | 122.0<br>(18%)                                | 662.8<br>(100%)      | 48%                   |
| 2002     | 641.6<br>(83%)                                  | 131.4<br>(17%)                                | 773.1<br>(100%)      | 60% (Historical high) |
| 2008     | 650.2<br>(75%)                                  | 214.8<br>(25%)                                | 865.0<br>(100%)      | 51%                   |
| Jun 2012 | 871.1<br>(75%)                                  | 286.8<br>(25%)                                | 1,158.0<br>(100%)    | 59%                   |
| Sep 2012 | 888.9<br>(75%)                                  | 294.9<br>(25%)                                | 1,183.9<br>(100%)    | 59%                   |



## ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: CAPITAL FLOWS

**Aggregate Balance of banking sector has expanded by more than HK\$107 billion since 19 October 2012**



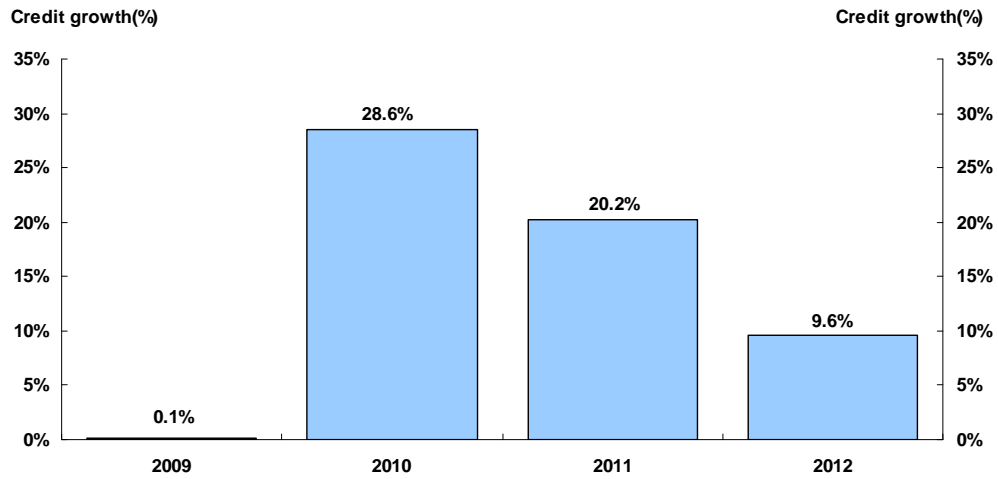
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- The Hong Kong dollar exchange rate strengthened to 7.75 in Q4 2012. The strong-side convertibility undertaking was triggered repeatedly between 19 October and 21 December 2012. Net inflows of over HK\$107 billion were recorded during this time, much smaller than the amount of over HK\$640 billion during 2008 and 2009.



## ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: BANK CREDIT GROWTH

**Moderate bank credit growth in 2012**





## **ASSESSMENT OF RISK TO HONG KONG'S FINANCIAL STABILITY: CONCLUSION**

- Short-term sentiment in the financial markets improves but fiscal and economic imbalances in the US, Europe and Japan remain unresolved. Intensified quantitative easing will further distort the operation of interest rate markets and increase global capital flows. There are still material risks in global financial and macroeconomic environment
- Persistent capital flows into emerging economies with faster growth may bring inflationary and asset price pressures
- As property market developments have become disconnected from economic fundamentals and household incomes, overheating in the property market remains the biggest threat to our financial stability
- People should be cautious about a possible reversal of interest rate trends and manage their risks prudently. The HKMA will continue to monitor market developments closely and stand ready to introduce supervisory measures as appropriate to maintain financial stability



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## Basel III Implementation Progress

- Capital standards
  - Banking (Capital) Rules – further amendment/refinement
  - Revised guideline on Pillar 2 "Supervisory Review Process"
  - Consultation conducted on revised banking return
- Disclosure standards
  - Statutory consultation – Rules to be tabled before LegCo in April
- Liquidity standards
  - To proceed with policy consultation shortly (taking into account Basel revisions to the Liquidity Coverage Ratio)





## **CHIP-BASED ATM TECHNOLOGY TO BE ADOPTED BY BANKS IN HONG KONG**

- The HKMA issued a circular on 1 June 2011 requesting banks to implement chip-based ATM technology. To be introduced in phases from 2013 to 2015, this measure aims to strengthen security controls for card users
- To allow customers to use ATM services in locations outside Hong Kong where chip-based technology is not yet available, the magnetic stripe will be retained on chip cards. Thus the industry will introduce the following measures to strengthen security for the use of chip-based ATM cards:
  - With effect from 1 March 2013, customers are required to activate an overseas ATM cash withdrawal capability via appropriate channels before such withdrawals can be made outside Hong Kong
  - Customers may also specify the expiry date for the overseas ATM cash withdrawal capability and set a lower limit for overseas ATM cash withdrawals

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- The banking industry in Hong Kong will adopt chip-based ATM technology to further strengthen security controls for ATM services.
- Chip-based ATM cards are equipped with a micro-processor inside the chip which protects the sensitive data stored inside and therefore can further strengthen the security of ATM services. Compared with ATM cards using a magnetic stripe, the chip-based technology will make it more difficult for fraudsters to counterfeit cards by using stolen data to make withdrawals in Hong Kong.
- As magnetic stripe cards are still used in many overseas ATMs, the magnetic stripe will be retained in the new chip-based cards to allow card holders to continue to use in locations outside Hong Kong. However authorized institutions will provide additional protection by strengthening security controls to prevent unauthorized overseas ATM transactions. With effect from 1 March 2013, bank customers are required to activate the overseas ATM cash withdrawal capability before leaving Hong Kong. They may also specify the duration and expiry date for the capability and set a lower limit for overseas ATM cash withdrawals. The activation can be done through various channels, including ATMs, ebanking, phone banking and branches. For queries or concerns about the new technology, card holders are encouraged to contact any bank branches.



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## REFORMING OTC DERIVATIVES MARKET

### **G20 Commitments**

- All standardised OTC derivative contracts should be traded on exchanges/electronic trading platforms and cleared through central counterparties
- OTC derivative contracts should be reported to trade repositories

### **Implementation**

- **Regulation:**

- Aim to introduce the Securities and Futures (Amendment) Bill into the Legislative Council in the first half of 2013 to implement the clearing and reporting requirements

- **Central Counterparty:**

- HKEx is building a local central counterparty for OTC derivatives, which is expected to commence operation in Q2 2013

- **Trade Repository:**

- The HKMA is building a trade repository (TR) under its Central Moneymarkets Unit. The matching and confirmation functions of the TR to support clearing at HKEx's central counterparty was launched in December 2012. The reporting function of the TR is targeted to be launched by mid-2013



## RETAIL PAYMENT INITIATIVES

### **e-bill system**

- The majority of retail banks offering internet banking services confirmed participation, including the three note-issuing banks
- major billers such as the Government, utilities companies and telecommunication companies indicated interest in the platform
- plan to launch the system in the second half of 2013

### **e-cheque**

- completed industry consultation and aim to commence system development in the first quarter of 2013
- aim to deliver the service near the end 2014

### **Near Field Communication (NFC) mobile payment services**

- consultancy study to be completed by the end of the first quarter of 2013
- continue to work with the industry to consider and implement the recommendations of the consultancy report

### **Legislative framework for stored value facilities and retail payment systems**

- industry consultation commenced in the second half of December 2012
- commenced preparatory work for the drafting of the Bill

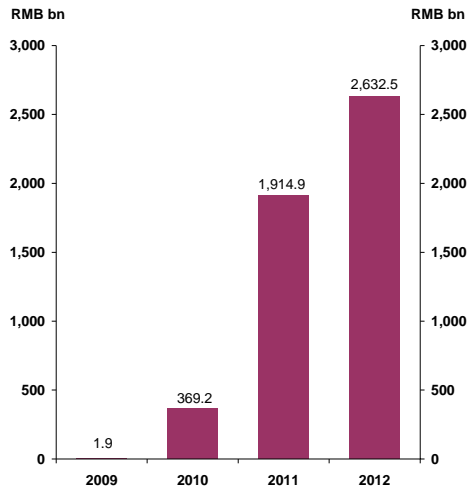


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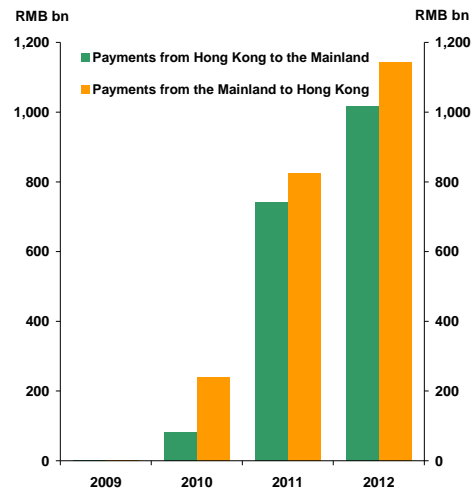


## Steady growth in RMB trade settlement

**RMB trade settlement  
handled by banks in Hong Kong**



**Flows of RMB trade settlement  
between Hong Kong and the Mainland**



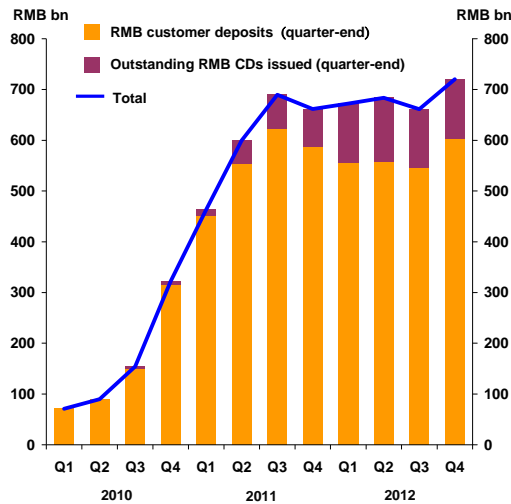
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- In 2012, RMB trade settlement handled by banks in Hong Kong amounted to RMB2,630 billion yuan, a 37% growth compared with 2011. Meanwhile, the payment flows to and from the Mainland were largely balanced.



## Increasing maturity of RMB financing markets

### RMB customer deposits and certificates of deposit (CDs)



### RMB financing activities

#### RMB dim-sum bond market

|                                  | 2012  | 2011  |
|----------------------------------|-------|-------|
| Amount of issuance (RMB billion) | 112.2 | 107.9 |
| Outstanding amount (RMB billion) | 237.2 | 146.7 |

#### RMB bank lending

|                                     | End 2012 | End 2011 |
|-------------------------------------|----------|----------|
| Outstanding RMB loans (RMB billion) | 79.0     | 30.8     |

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- At end-2012, the outstanding amount of RMB customer deposits and CDs issued amounted to RMB603.0 billion yuan and RMB117.3 billion yuan respectively, totalling RMB720.2 billion yuan, up 9% compared with RMB661.6 billion yuan at end-2011.
- At end-2012, over 29,000 accounts were opened by non-resident personal customers, with deposits exceeding RMB4 billion yuan.
- RMB bank lending expanded significantly over the past year, with outstanding RMB loans amounting to RMB79.0 billion yuan at end-2012, a 157% growth from end-2011.



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## INVESTMENT INCOME

| (HK\$ billion)                                   | ← 2012 →     |            |            |               |            | 2011          | 2010         | 2009         | 2008          |
|--|--------------|------------|------------|---------------|------------|---------------|--------------|--------------|---------------|
|  | Full year *  | Q4         | Q3         | Q2            | Q1         | Full year     | Full year    | Full year    | Full year     |
| <b>Hong Kong equities<sup>^</sup>@</b>           | <b>30.7</b>  | 11.8       | 9.3        | (4.0)         | 13.6       | <b>(24.2)</b> | 11.6         | 48.9         | <b>(77.9)</b> |
| <b>Other equities<sup>^</sup></b>                | <b>42.6</b>  | 10.3       | 14.4       | (10.3)        | 28.2       | <b>(12.2)</b> | 27.1         | 48.8         | <b>(73.1)</b> |
| <b>Bonds<sup>#</sup></b>                         | <b>33.1</b>  | 2.5        | 10.8       | 22.7          | (2.9)      | <b>71.9</b>   | 42.1         | <b>(0.6)</b> | 88.4          |
| <b>Other investments<sup>&amp;</sup></b>         | <b>3.6</b>   | 0.3        | 1.3        | 0.5           | 1.5        | <b>0.7</b>    | 1.7          | <b>0.8</b>   | -             |
| <b>Foreign exchange</b>                          | <b>(1.4)</b> | <u>2.4</u> | <u>6.6</u> | <u>(14.5)</u> | <u>4.1</u> | <b>(9.1)</b>  | <b>(3.1)</b> | <b>9.8</b>   | <b>(12.4)</b> |
| <b>Investment income/(loss)<sup>@&amp;</sup></b> | <b>108.6</b> | 27.3       | 42.4       | (5.6)         | 44.5       | <b>27.1</b>   | <b>79.4</b>  | <b>107.7</b> | <b>(75.0)</b> |

\* Unaudited figures

<sup>^</sup> Including dividends

<sup>@</sup> Excluding valuation changes in Strategic Portfolio (a gain of HK\$0.8 billion in 2012)

<sup>#</sup> Including interest

<sup>&</sup> Including valuation changes of investment held by EF's investment holding subsidiaries



## CHANGES IN INVESTMENT INCOME, PAYMENT TO FISCAL RESERVES AND ACCUMULATED SURPLUS

| (HK\$ billion)  | 2012                     |              |              |              |              | 2011          |
|---|--------------------------|--------------|--------------|--------------|--------------|---------------|
|   | Full year<br>(unaudited) | Q4           | Q3           | Q2           | Q1           | Full year     |
| <b>Investment income/(loss)</b>   | <b>108.6</b>             | 27.3         | 42.4         | (5.6)        | 44.5         | 27.1          |
| Other income  | 0.2                      | -            | 0.1          | 0.1          | -            | 0.2           |
| Interest and other expenses   | <u>(4.4)</u>             | <u>(1.0)</u> | <u>(1.1)</u> | <u>(1.4)</u> | <u>(0.9)</u> | <u>(4.7)</u>  |
| Net investment income/(loss)  | 104.4                    | 26.3         | 41.4         | (6.9)        | 43.6         | 22.6          |
| <b>Payment to Fiscal Reserves #</b>   | <b>(37.8)</b>            | (9.3)        | (9.2)        | (9.6)        | (9.7)        | <b>(37.0)</b> |
| Payment to HKSAR government funds and statutory bodies #  | (8.0)                    | (2.2)        | (2.1)        | (1.9)        | (1.8)        | (5.6)         |
| Valuation change of Strategic Portfolio less valuation change of investment held by EF's investment holding subsidiaries^ | <u>(2.8)</u>             | <u>0.7</u>   | <u>(0.7)</u> | <u>(1.7)</u> | <u>(1.1)</u> | <u>(3.6)</u>  |
| <b>Increase/(Decrease) in EF Accumulated Surplus</b>  | <b>55.8</b>              | 15.5         | 29.4         | (20.1)       | 31.0         | <b>(23.6)</b> |

# The fixed rate of fee payment is 5.6% for 2012 and 6.0% for 2011

^ Including dividends



## INVESTMENT DIVERSIFICATION

- To enhance the return of the Exchange Fund in the medium and long term, the HKMA has, since 2008, been diversifying part of the Fund's investment into more asset classes, including emerging market bonds and equities, private equity, real estate, and Mainland renminbi bonds and equities
- These assets are housed under the Long-Term Growth Portfolio (LTGP). Positions at end-2012 and performance since inception are as follows:

As of end 2012

| New Asset Classes                         | Market Value<br>HK\$ billion | Annualised return since<br>inception till end 2012 |
|---|------------------------------|--|
| Emerging market bonds and equities        | 41.4                         | 8%   |
| RMB assets (including bonds and equities) | 46.9                         |  |
| Private equity                            | 47.1                         | 10% (IRR)  |
| Real Estate                               | 13.5                         |  |
| <b>Total</b>                              | <b>148.9</b>                 |  |

Note: Outstanding investment commitments at the end of 2012 amounted to HK\$63.8 billion



## REVIEW OF THE LTGP

- In 2012, the HKMA conducted a review of the overall strategy of investment diversification. Results support that investment diversification should further be pursued.
- In November 2012, the Financial Secretary, on the advice of the Exchange Fund Advisory Committee (EFAC), endorsed the following recommendations:
  - To maintain the investment cap on LTGP size at one-third of the accumulated surplus of the Exchange Fund
  - To transfer Emerging Market Bonds and Equities and Renminbi Assets into the Investment Portfolio of the Exchange Fund
  - Private Equity and Real Estate will remain in the LTGP