Remarks by Mr Norman T. L. Chan,
Chief Executive of the Hong Kong Monetary Authority
on 19 January 2012
at the announcement of
Exchange Fund's investment results for 2011

Market Condition in 2011

At the Exchange Fund results press conference last year, I shared my outlook of the investment environment in 2011 and said that as the macro financial environment and investment markets were overshadowed by instability and uncertainty, there were no clear trends in exchange rates, interest rates and capital flows. I anticipated considerable volatilities in the financial markets, which might adversely affect the investments of the Exchange Fund. Therefore, the Exchange Fund should refrain from making investments in any aggressive manner.

2. The year 2011 is now behind us – we have indeed witnessed how such risks and uncertainties had materialised, resulting in market volatilities beyond the expectation of many people. At the beginning of 2011, following the second round of quantitative easing and fiscal stimuli launched in the US earlier, the US equity market boomed, spurring global equity markets in the first quarter. Market conditions went largely unaffected even with the earthquake and tsunami in Japan in March and the political turmoil in the Middle East and North Africa regions. However the markets were hit by the Greek sovereign debt crisis again in May and increased volatilities set in. The Exchange Fund performed quite well in the first half of 2011, bringing in an investment income of HK$46.4 billion.

3. As the European debt crisis intensified, many European countries including Greece, Portugal, Italy, Spain and Belgium were downgraded by credit rating agencies. And Euro area leaders were unable to come up with a credible and effective solution in a timely manner to contain the contagion of the crisis. So risk appetite declined sharply and market confidence weakened considerably in the third quarter. As Standard & Poor's downgraded the US sovereign credit rating from "AAA" to "AA+" in August, which is the first time in history, shock waves were sent through the global financial markets and erased all traces of optimism seen at the beginning of last year. A sell-off frenzy to retreat from risky assets followed. This drove equity markets sharply down while the US dollar strengthened, which wiped out most of the investment income gained by the Exchange Fund in the first half of the year.

4. The fourth quarter of 2011 was marked by some positive developments. These included the 9 December agreement among European countries on a number of issues: a fiscal compact; speeding up the introduction of the European Stability Mechanism; and providing funds to the International Monetary Fund for the aid of troubled countries. The European Central Bank also launched its long-term refinancing operation and joined forces with other central banks in providing liquidity to the market, substantially alleviating the liquidity pressure of European banks. Thereafter, financial markets began to stabilise and the Exchange Fund managed to recoup in the fourth quarter part of its losses incurred in the third quarter.

Investment performance of the Exchange Fund in 2011

5. Despite the very difficult investment environment last year, the Exchange Fund achieved an investment income of HK$26.7 billion for the full year in 2011. The gains from bonds were HK$71.9 billion, which more than offset losses of HK$24.2 billion from Hong Kong equities, HK$12.2 billion from other equities and HK$9.1 billion from foreign exchange. The fee payments to the Fiscal Reserves amounted to HK$37.0 billion, while the fee payments to placements by HKSAR government funds and statutory bodies amounted to HK$5.6 billion. The Accumulated Surplus of the Exchange Fund decreased by HK$23.6 billion to HK$567.9 billion.

6. In terms of investment performance, the investment income of HK$26.7 billion translates to an investment return of 1.1%. This rate of return is quite low, but one should note that in such a volatile and extremely difficult market environment, it was quite a challenge for the Exchange Fund to preserve capital and attain a positive investment return.

Investment outlook for 2012

7. Looking ahead into 2012, Europe still faces great uncertainties. There are clear risks of deterioration of the European sovereign debt crisis, which may deal yet another severe blow to the global financial markets. Even if the crisis does not get worse, European economies will likely face slow growth, or even slip into mild recession. In addition, the US will continue to be troubled by high unemployment, a subdued housing market and fiscal problems, which will constrain the pace of its economic recovery. At the same time, we also need to watch

out for the geopolitical risks around the world. Overall speaking, I expect that confidence of the investment market will remain very fragile in 2012, capital flows will be unpredictable and markets will continue to be volatile.

8. Facing these volatile and difficult global financial conditions, the HKMA will continue to manage the Exchange Fund in a cautious and prudent manner and to pursue the diversification of investments. The aim is to increase medium- and long-term return while ensuring that the Exchange Fund has sufficient liquidity to maintain monetary and financial stability. In 2011, we have already started to invest in renminbi assets, using up the RMB 15 billion yuan quota for investments in the Mainland's interbank bond market, and the US$ 300 million quota under the Qualified Foreign Institutional Investor scheme. Meanwhile, we have been expanding into various classes of investments, including emerging markets equities and bonds, private equity and investment properties overseas.