

# Economic and Banking Environment

Hong Kong's economy rebounded sharply in 1999 and recorded a real GDP growth of 2.9% for the year. Nineteen-ninety-nine was also a year of consolidation for the banking industry in Hong Kong. Economic recovery is expected to gain further momentum in 2000, amid improved consumer and investment sentiments. Stable funding conditions and an expected decline in debt provisioning levels should bring about further recovery in profits for the banking sector in 2000.

## The economy in review

### Overview

After emerging out of recession in the second quarter of 1999, the economy gathered momentum during the second half of the year, taking annual real GDP growth to 2.9%. Consumer spending picked up from the second quarter of 1999, while the decline in private investment moderated during the second half of the year. Both the labour market and the decline in consumer prices have shown signs of stabilisation. Externally, merchandise exports staged a significant upturn in the second half of the year, while export of services registered strong growth in 1999, along with the strong performance of inbound tourism.

Local financial markets recorded significant improvements in 1999. Volatility in interest rates declined sharply, as rates firmed up only temporarily amid the Brazilian financial crisis, the closure of the Guangdong International Trust and Investment Corporation (GITIC), and concerns over heightened tensions across the Taiwan Strait. Largely reflecting a reduction in the risk premium, local interest rates were



on average lower in 1999 than in 1998. Spreads on Hong Kong dollar interest rates over their US dollar counterparts narrowed to pre-crisis levels at the longer end, and fell to negative levels at the shorter end. The Hang Seng Index recovered all its losses during the Asian financial crisis to close 1999 with a year high of 16,962. The Hong Kong dollar exchange rate against the US dollar depreciated slightly, tracking closely the convertibility rate in respect of the Aggregate Balance.

Total deposits increased by 6.2% during the second half of 1999, having risen by 1.3% during the first half. For the year as a whole, deposits grew by 7.6% in 1999, following an increase of 10.9% in 1998. On the other hand, domestic loans declined for the second straight year, by 8.2% in 1999, following a drop of 5.4% in 1998. Nevertheless, reflecting the pick-up in economic activity, the rate of decline moderated during the course of the year. As Hong Kong dollar loans contracted while deposits increased, the Hong Kong dollar loan-to-deposit ratio declined to 91.3% at end-1999 from 100.6% at the end of 1998.

### Domestic demand driven by consumer spending

Following a decline in the first quarter of 1999, private consumption expenditure picked up in subsequent quarters, increasing by 1.1% for 1999 as a whole. More stable labour and property market conditions and the stock market rally have helped improve consumer sentiment. The increase in retail sales has become more broadly based. Sales by supermarkets and department stores and of motor vehicles registered double-digit year-on-year growth in the fourth quarter of 1999. Sales of fuel, clothing and other consumer durable goods also recorded positive growth during the same period.

Private investment remained weak, declining by 20.9% in 1999. Some improvements were evident through the year, however, as declines in private investment moderated from 26% in the first half to 15% in the second half. Public sector investment increased by 19.8% in the second half of 1999, following a 8.8% decline in the first half, as a result of the stepping up of the priority railway projects and the Public Housing Programme.

**Table 1 Contributions to GDP growth by components (%)**

	1997		1998		1999		
		H1*	H2*	Overall*	H1*	H2*	Overall*
Private Consumption Expenditure	3.7	-2.3	-5.6	-4.0	-1.0	2.2	0.6
Government Consumption Expenditure	0.2	-0.1	0.2	0.0	0.3	0.2	0.3
Gross Domestic Fixed Capital Formation	4.4	0.9	-5.3	-2.3	-9.5	-3.4	-6.4
Change in Inventories	0.2	-3.0	-3.3	-3.1	-2.5	3.9	0.8
Net Domestic Exports of goods	-4.2	3.6	9.6	6.7	11.7	-1.6	4.8
Net Re-exports of Goods	1.4	0.2	-1.7	-0.8	-0.5	2.7	1.2
Net Exports of Services	-0.7	-3.2	-0.3	-1.7	0.4	2.6	1.6
<b>GDP</b>	<b>5.0</b>	<b>-3.9</b>	<b>-6.3</b>	<b>-5.1</b>	<b>-1.0</b>	<b>6.5</b>	<b>2.9</b>

\* These are preliminary figures only and are subject to revision.



Chart 1 Domestic demand (% change over a year ago in real terms)



### Significant upturn in external trade

Reflecting the rebound in Mainland exports, a general pick-up in demand in the East Asian economies, as well as a broad strengthening in import absorption in the US and Europe, exports recorded a significant upturn in 1999. Re-exports value reversed its downtrend since April 1998, increasing significantly by a year-on-year rate of 9.3% in the second half of 1999, compared with a 6.3% decline in the first half. For the year as a whole, re-exports grew in value by 1.7%. Domestic exports also returned to positive

growth in the last two months of 1999. Nevertheless, reflecting sharp declines in the early part of 1999, domestic export value recorded a drop of 9.5% for the year as a whole, compared with a 10.9% fall in 1998. After discounting the declines in export prices, re-exports increased by 5.4% and domestic exports declined by 7.2% in volume terms in 1999.

Partly reflecting subdued private investment activity, import value contracted by 12.5% year-on-year in the first half of the year. However, along with the pick-up

Table 2 Value of Hong Kong's exports by major trading partners

	% Share	(% change over a year ago)					
		H1	1998 H2	Overall	H1	1999 H2	Overall
Mainland China	33.3	-0.7	-15.9	-8.7	-12.6	7.2	-3.0
United States	23.8	5.5	-5.3	-0.6	-3.6	7.0	1.9
European Union	16.1	1.9	-3.7	-1.2	-3.0	7.3	2.4
Japan	5.4	-18.3	-21.7	-20.1	-4.9	11.5	3.3
ASEAN5+Korea	7.1	-24.5	-25.4	-25.0	7.6	22.5	15.1
Others	14.3	-0.9	-11.3	-6.5	-11.5	0.5	-5.4
<b>Total</b>	<b>100.0</b>	<b>-2.1</b>	<b>-12.0</b>	<b>-7.4</b>	<b>-7.4</b>	<b>7.2</b>	<b>0.1</b>

Note: ASEAN5 includes the Philippines, Malaysia, Indonesia, Singapore, and Thailand.



in economic activity, imports increased by 7.6% in the second half. For 1999 as a whole, there was a decline of 2.6% in value terms and a modest rise of 0.1% in volume terms. As growth in exports outpaced that in imports, the merchandise trade deficit narrowed significantly to \$46.5 billion in 1999, around half of the \$84.8 billion level in 1998.

Helped by the continued improvement in inbound tourism, exports of services registered strong growth of 5.5% in 1999, compared with a 6.6% decline in 1998. Meanwhile, imports of services declined by 0.9% for the year as a whole. Taking visible and invisible trade together, there was an overall trade surplus of \$54.2bn in 1999, equivalent to 4.4% of GDP. This followed a surplus of \$6.1bn (0.5% of GDP) in the preceding year.

#### Moderating pace of decline in consumer prices

The decline in the composite consumer price index (CCPI) – which started in November 1998 – accelerated to reach a post-1975 low of 6.1% in August 1999. This was mainly attributable to the rates concession in the third quarter, the lagged effect of the decline in rentals,

and continuing price adjustments amid intensified competition in the retail market. However, the pace of decline has slowed since September, with the decline in the CCPI moderating to 4% in December. For 1999 as a whole, the CCPI fell by 4%.

#### Signs of stabilisation in the labour market

The unemployment rate continued to rise in early 1999, and reached a peak of 6.3% for the three-month period ending in April. For 1999 as a whole, the unemployment rate averaged 6.2%, the highest since 1976. On top of the economic downturn, part of this rise was due to a significant increase in the labour force since mid-1997. However, as labour force growth moderated during the course of 1999, while the increase in employment accelerated alongside an upturn of economic activity, the unemployment rate declined to 6% in the fourth quarter. The increase in employment was broadly based, with the financial sector showing the strongest growth. There was also a rebound in the total number of vacancies in both the manufacturing and services sectors in September 1999 over a year earlier, reversing the downtrend in preceding quarters.



Meanwhile, salaries and wages continued to adjust downwards in nominal terms. The nominal payroll index declined by 1.1% year-on-year in the third quarter of 1999, following an increase of 0.4% in the first half. The decline reflected mainly the continued freezing or reduction of wages and bonuses over this period. Nevertheless, adjusted for the decline in the consumer price index, the payroll index increased by 5% in real terms in the third quarter from a year earlier.

### Asset markets broadly stable

The stock market generally saw an uptrend in 1999, notwithstanding intermittent corrections amid the Brazilian financial crisis, the closure of the GITIC in the first quarter of 1999, and concerns over heightened tensions across the Taiwan Strait and a possible devaluation of the Renminbi during May to August. Investor sentiment improved substantially in the last quarter, helped by the conclusion of the Sino-US WTO agreement, the over-subscription of the Tracker Fund, and a stronger-than-expected third quarter economic performance. The Hang Seng Index closed 1999 at a year high level of 16,962.

The property market was broadly stable in 1999. After a surge of 3% during January-May 1999, residential property prices consolidated, declining by 9% between June and November. Market activity also slowed, with the number of sales and purchase agreements falling from over 12,000 in May to below 6,000 in September-November. Nevertheless, helped by the stock market rally in late 1999, sentiment in the property market improved, with residential property prices rising by 1% during December and the number of sales and purchase agreements increasing to 6,711 in that month. In the commercial property market, both sales and rental activity remained sluggish amid an abundant supply of office premises.

## Monetary situation

### The Hong Kong dollar remained stable

The Hong Kong dollar exchange rate remained stable throughout the year, moving within a narrow range of 7.746-7.775 to the US dollar. From 1 April, the convertibility rate in respect of the Aggregate Balance moved by 1 pip (0.0001) per calendar day from



7.7500 in order to converge with the linked exchange rate of 7.8000 for the issue and redemption of Certificates of Indebtedness. The Hong Kong dollar exchange rate moved largely in tandem with the convertibility rate, except towards the end of the year, when a strong increase in the demand for Hong Kong dollar assets led to a strengthening of the exchange rate relative to the convertibility rate. The overall exchange value of the Hong Kong dollar, measured by the trade-weighted Effective Exchange Rate Index (EERI), was predominantly affected by the exchange rate of the US dollar vis-à-vis other major currencies. The EERI increased notably from 131.8 at end-1998 to a high of 135 in early March amid a strengthening of the US dollar against the Japanese Yen and the Euro. It then remained stable at around that level until mid-July, before easing to 131.5 at end-December alongside the weakening of the US dollar against the Japanese Yen. Taking into account the downward adjustment in prices, the real effective exchange rate of the Hong Kong dollar is broadly estimated to have returned to the pre-crisis level.

#### Risk premium on the Hong Kong dollar substantially reduced

Helped by the technical measures to strengthen the currency board system, and the stability in regional financial markets, the risk premium on Hong Kong dollar was significantly reduced across the whole spectrum of interest rates. On the back of a strong demand for Hong Kong dollar assets, the spread between one-month Hong Kong dollar interbank

rates and US dollar rates fell into negative territory in the last quarter of 1999. Interest rate volatility also fell amid stable monetary conditions during the year.

In respect of retail deposit rates, the savings deposit rate governed under the Interest Rate Rules of the Hong Kong Association of Banks (HKAB) was lowered three times, each time by 25 basis points, during January to May. It was then raised by 25 basis points to 3.75% at the end of August, and stayed at that level until the end of the year. The movement of the best lending rate quoted by major banks was similar to that of the savings deposit rate. The best lending rate at the end of December, at 8.5%, was 25 basis points below the pre-crisis level in June 1997.

#### Narrow money grew faster than broad money

Narrow money (HK\$M1) grew by 15.2% in 1999, in stark contrast to the 5.2% decline in 1998. The strong pick-up reflected an increase in transactions demand for money as economic recovery gathered pace and stock market activity rebounded. In addition, currency held by the non-bank public increased before the turn of the year, in part reflecting the Year 2000 concerns.

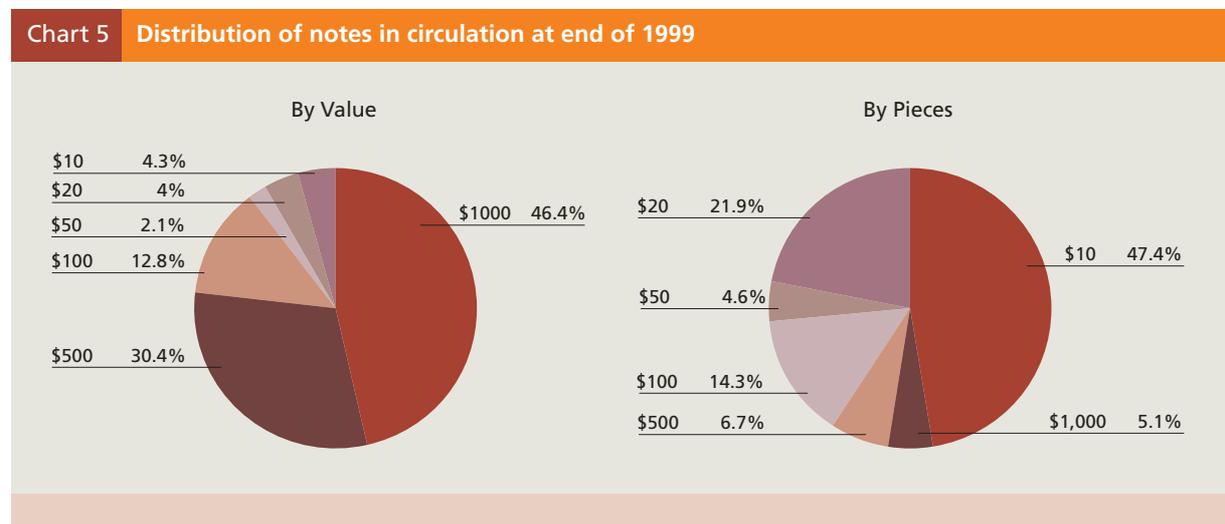
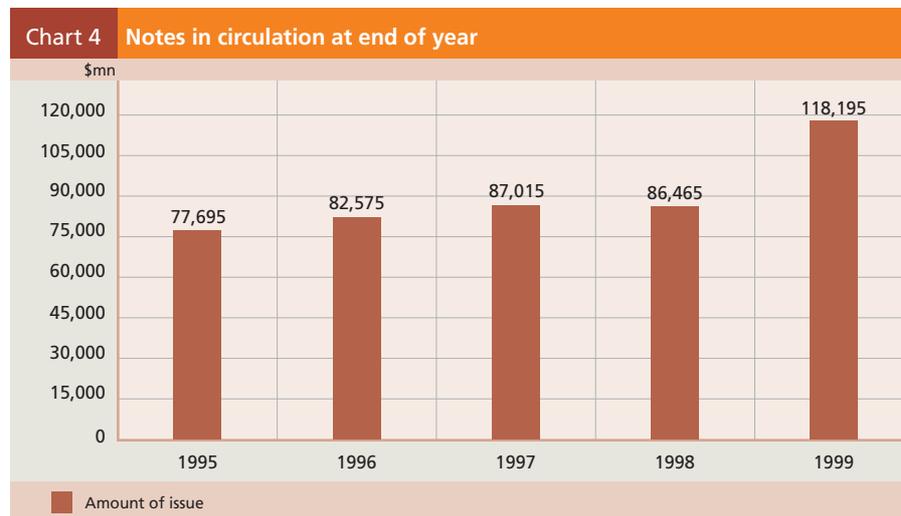
Broad money (HK\$M3) rose moderately by 5.3% in 1999. Adjusted to exclude the repatriation of deposits following the profits tax exemption on interest income from onshore deposits since June 1998, HK\$M3 and Hong Kong dollar deposits rose by 4.5% and 3.6% respectively.



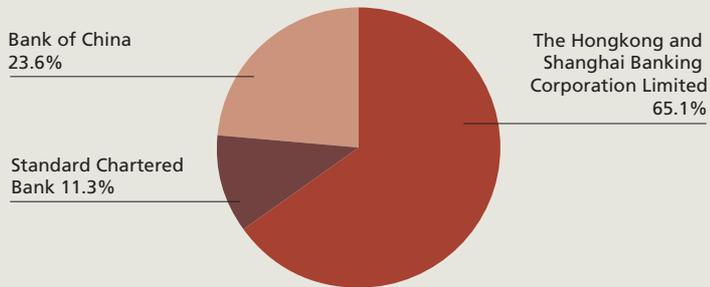
### Notes and coins

At the end of 1999, the total value of notes in circulation was \$118,195 mn, an increase of 37% from a year earlier (Charts 4, 5, 6). The steep increase was due to increased precautionary holding of cash by the general public ahead of the Year 2000, as well as the additional festive spending to celebrate the new

millennium. The total value of coins in circulation was \$5,559 mn (excluding commemorative gold coins and coin sets), which was similar to that of a year earlier (Charts 7 and 8). Any rise in demand for immediate transaction purposes was probably offset by reduced hoarding, as an earlier coin shortage was resolved and attendant concerns subsided.



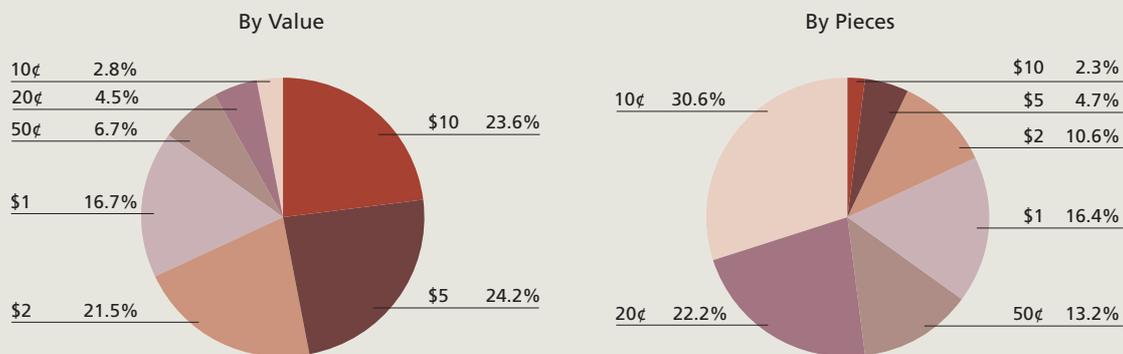
**Chart 6** Notes in circulation by Note-Issuing Bank at end of 1999



**Chart 7** Coins in circulation at end of year



**Chart 8** Distribution of coins in circulation at end of 1999



### Coin stock

At the end of 1999, there was a stock of 835 mn pieces of coins in all denominations ready to meet demand at any time. In addition, there was further stock of about 971 mn pieces kept in the mints, which could be delivered quickly to Hong Kong if required.

### Coin replacement programme

The programme to replace coins bearing the Queen's Head with those carrying the Bauhinia design was resumed in 1999 and the programme will continue, although the number of Queen's Head coins surfacing has declined considerably.

## Outlook for the economy

### Economic recovery to gain further momentum

Recent developments suggest that economic recovery in Hong Kong will gather further momentum in 2000. The recent rally in the stock market, a more stable property market, and the levelling off of the unemployment rate should lend support to consumer spending. Public investment should be boosted by the stepping up of the priority railway projects and the building of Disneyland and the Science Park, while private investment is expected to rebound from a low base in 1999. The moderation in the decline of domestic loans, and an increase in fund-raising activity in equity and debt markets, probably reflect a bottoming out of private investment demand.

Exports are expected to pick up further against continued recovery in the regional economies and steady growth in the Mainland. While China's possible accession to the WTO later this year may not give an immediate boost to its exports, import demand is likely to rise as Mainland enterprises upgrade their productive capacity to prepare for increased competition. Among the developed economies, there are considerable uncertainties about whether strong, non-inflationary growth in the US can be sustained. On the other hand, the economic outlook for Europe appears to have improved, while signals remain mixed in Japan. Notwithstanding uncertainties in the external environment, Hong Kong's exports should be helped by a further improvement in competitiveness, as the real effective exchange rate is expected to decline further due mainly to lower inflation in Hong Kong than in its trading partners. On the other hand, import growth is likely to accelerate to meet increased domestic demand and to replenish depleted inventories, particularly as there is expected to be a build-up of building materials for infrastructural works.

### Moderating pace of price adjustment and stabilising labour market

The decline in consumer prices is expected to ease, as increased demand, the dissipation of the rental component effect, and expected increases in government fees and charges raise the Consumer



Price Index. Meanwhile, the unemployment rate is likely to decline further in 2000, as the economic recovery gathers pace. In particular, major infrastructural and public works projects – including the Science Park and the West Rail Project – are expected to create new job opportunities.

## Performance of the banking sector

### A year of consolidation

Nineteen-ninety-nine was a year of consolidation for the banking industry, as authorised institutions focused on improving their balance sheets and dealing with problem loans. Stable domestic interest rates and ample liquidity within the banking system kept funding costs down and enabled the banking sector to operate under more benign conditions than those of the previous year. Concerns about credit risk tended to ease during the year and the banks became more willing to lend as liquidity increased. But there continued to be a lack of bankable lending propositions, resulting in further shrinkage in lending volume and intensified competition among banks for residential mortgage business, which is regarded as a safer type of lending because of its lower delinquency ratio. With limited investment opportunities in the domestic market, some authorised institutions switched a portion of their surplus funds to buying corporate debt securities in addition to raising their

holdings in Exchange Fund paper in preparation for the millennium change.

The asset quality of the banking sector continued to deteriorate in 1999, but signs of improvement emerged in the last quarter of the year. Provisions for bad and doubtful debts remained a major factor affecting banks' profitability. Nevertheless, the aggregate bad debt charge reported by local banks showed little change in 1999 compared with a sharp rise in 1998, indicating that the level of non-performing loans has stabilised.

The performance of authorised institutions improved generally in 1999, as evidenced by the recovery in their aggregate operating profits (both in terms of interest-based and fee-based income). The local banks, in particular, benefited from lower funding costs, which helped them to withstand the squeeze on lending margins. Their strong capital and liquidity position also enabled them to sustain the adverse effects of the Asian crisis.

### Stable funding costs

Funding costs eased in the course of 1999 as a result of ample liquidity in the banking sector. This was largely attributable to continued growth in customer deposits and a decline in lending volume. One-month HIBOR fell to an annual average of 5.51% in 1999 from 7.42% in 1998, while that for the one-month



time deposit rate dropped to 4.50% in 1999 from 6.64% in 1998 (Table 3). The average spread between one-month HIBOR and the best lending rate also widened to 298 basis points in 1999 from 252 basis points in the preceding year.

9.0% in 1999. Growth in savings deposits slowed to 9.0% after a strong rise of 23.3% in 1998. Time deposits also grew at a slower pace of 2.5%, compared with 7.3% in 1998. The increase in demand and savings deposits, much of which occurred in the

**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		
Q4 1998	5.09	5.73	6.94	5.45	5.97	7.26	4.85	9.60
Q1 1999	4.77	5.16	6.19	5.38	5.80	7.12	4.03	8.78
Q2 1999	4.25	4.50	5.67	5.03	5.28	6.51	3.62	8.37
Q3 1999	4.55	4.79	5.68	5.93	6.12	7.10	3.59	8.42
Q4 1999	4.43	4.95	5.51	6.68	6.15	6.78	3.75	8.50
1998*	6.64	7.35	8.32	7.42	8.06	9.31	5.19	9.94
1999*	4.50	4.85	5.76	5.51	5.84	6.88	3.74	8.49

\* annual average figures

Total customer deposits expanded by 7.6% in 1999 after rising by 10.9% in 1998. In terms of currency, Hong Kong dollar deposits grew by a moderate 4.5% after a 9.6% increase in 1998 (Table 4). Compared with Hong Kong dollar deposits, foreign currency deposits grew at a faster pace of 11.6% following growth of 12.6% in 1998 (Chart 9). The major driving force behind this growth came from US dollar deposits, which increased by 14.3% in 1999 after growing by 19.5% in 1998. Because of the strong growth in foreign currency deposits, the share of Hong Kong dollar deposits in total deposits fell to 55.4% at end-1999 from 57.0% at the end of 1998.

Within Hong Kong dollar deposits, demand deposits reversed the declining trend since 1997 and rose by

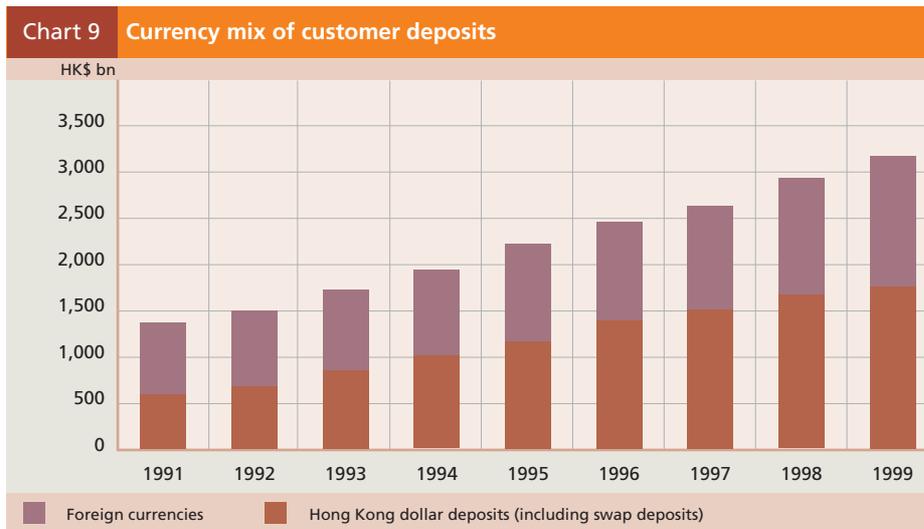
last quarter of the year, reflected in part the rise in transaction demand for money as stock market activities recovered. The decline in swap deposits moderated to 3.2% in 1999 after the contraction of 30.8% in 1998.

**Table 4 Growth of Hong Kong dollar customer deposits**

(HK\$ bn)	Demand	Savings	Time <sup>(a)</sup>	Swap	Total
1995	100	301	721	50	1,172
% growth	0.2	9.5	34.1	(52.0)	15.3
1996	122	366	874	39	1,400
% growth	21.4	21.8	21.2	(22.7)	19.5
1997	108	336	1,052	42	1,538
% growth	(11.7)	(8.2)	20.4	9.9	9.8
1998	97	414	1,144	29	1,685
% growth	(9.7)	23.3	8.8	(30.8)	9.6
1999	106	452	1,175	28	1,761
% growth	9.0	9.0	2.7	(3.2)	4.5

(a) Excluding swap deposits.





Reflecting continued growth in Hong Kong dollar deposits and the decline in Hong Kong dollar loans, the Hong Kong dollar loan-to-deposit ratio of the banking sector fell further to 91.3% at the end of 1999 from 100.6% at end-1998. The same ratio for local banks decreased to 68.5% from 71.6%. The loan-to-deposit ratio of local banks in all currencies dropped to 52.9% from 58.9%.

The demand for negotiable certificates of deposits (NCDs) remained lacklustre in 1999, with a 4.8% decrease in outstanding NCDs by amount (similar to the fall of 4.9% in 1998). The share of Hong Kong dollar denominated NCDs increased to around 82% of all outstanding NCDs issued in Hong Kong, of which about 62% were held by authorised institutions in 1999 (compared with 63% in 1998). In contrast, the banking sector's holdings of Hong Kong dollar negotiable debt instruments (other than NCDs)

increased sharply by 27.9% following a rise of 8.9% in 1998. This reflected the combined effects of a precautionary build-up of liquidity (including in the form of Exchange Fund paper) ahead of the millennium date change and the diversion into negotiable debt instruments of the surplus funds released by sluggish loan demand.

#### Further shrinkage in domestic lending

Total loans and advances declined further by 14.8% in 1999, moderating from a drop of 19.8% in 1998. Much of the decline occurred in the first half of the year as evidenced by the slow-down in the rate of decline to 2.6% in the second half of the year from 12.5% in the first half. Offshore loans, which accounted for the bulk of the decline in total loans and advances, shrank by 26.7% in 1999 after



Chart 10 Loans for use inside and outside Hong Kong



falling by 36.7% in 1998 (Chart 10). As in the preceding year, the shrinkage in offshore loans was due mainly to the contraction in Japanese banks' Euroyen lending activities. The contraction in Euroyen lending activities has little impact on Hong Kong's domestic economy and market liquidity since Hong Kong acts only as a booking centre for such loans. Reflecting the cautious lending attitude of banks and the subdued demand for loans, domestic lending declined by 8.2% in 1999 following a 5.4% drop in 1998. The rate of decline, however, moderated to 2.2% in the second half of 1999, compared with the fall of 6.2% in the first half of the year.

In 1999 lending to most economic sectors fell, including loans to the property sector, the mainstay of loan growth in past years. Property lending fell by 1.7% in 1999, reflecting an accelerated decline in lending for property development (8.0% in 1999 against 6.6% in 1998) and property investment (8.8% against 5.2%) (Charts 11 and 12). Growth in

residential mortgage loans slowed to 3.6% in 1999 from 8.1% in 1998, in line with the sluggish activity in the property market. However, the competition for loans to refinance existing mortgages and the aggressive pricing of mortgage loans below the best lending rate resulted in a squeeze on banks' lending margins. The proportion of refinancing loans and loans granted at mortgage rates below the best lending rate for the whole mortgage term continued to rise during the year, reaching 51.1% and 10.5% respectively of new loans approved in December 1999. Helped by the recovery in the domestic stock market, loans to stockbrokers rose notably by 36.6% in 1999, against a decline of 71.9% in 1998. Loans to non-stockbroking companies and individuals to purchase shares however continued to fall, albeit at a much slower pace of 5.4% in 1999, compared with the decrease of 56.3% in 1998. In total, the amount of loans to finance share purchase (\$16 billion) remained well below the peak reached in the third quarter of 1997 (\$102 billion).



Chart 11 Loans for use in Hong Kong by selected sectors

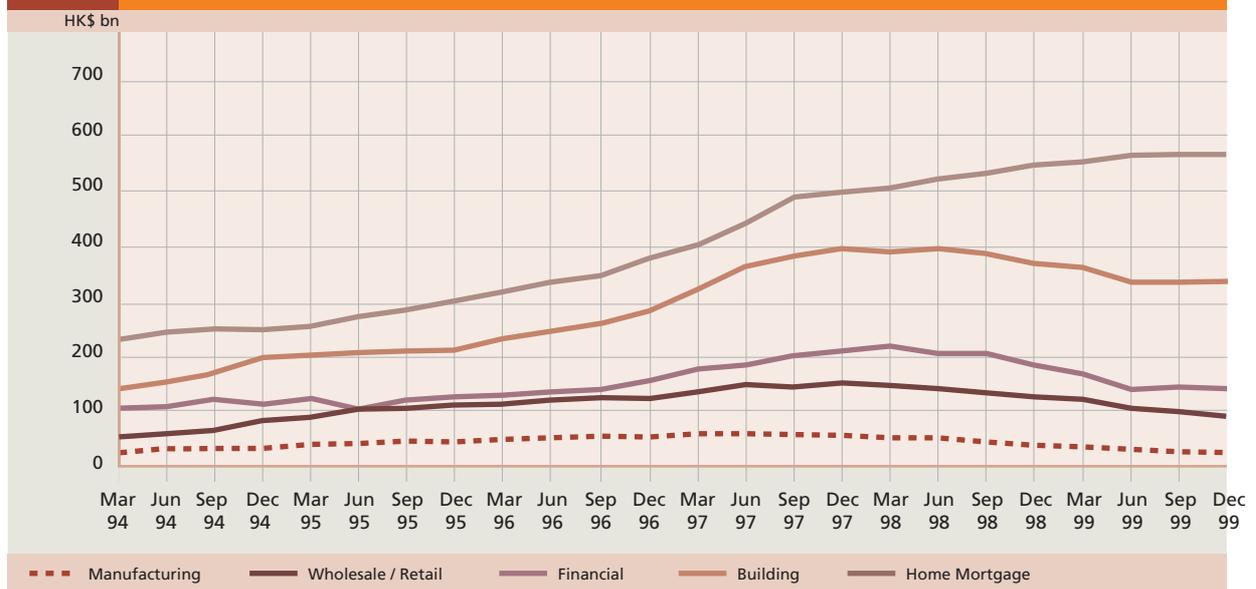
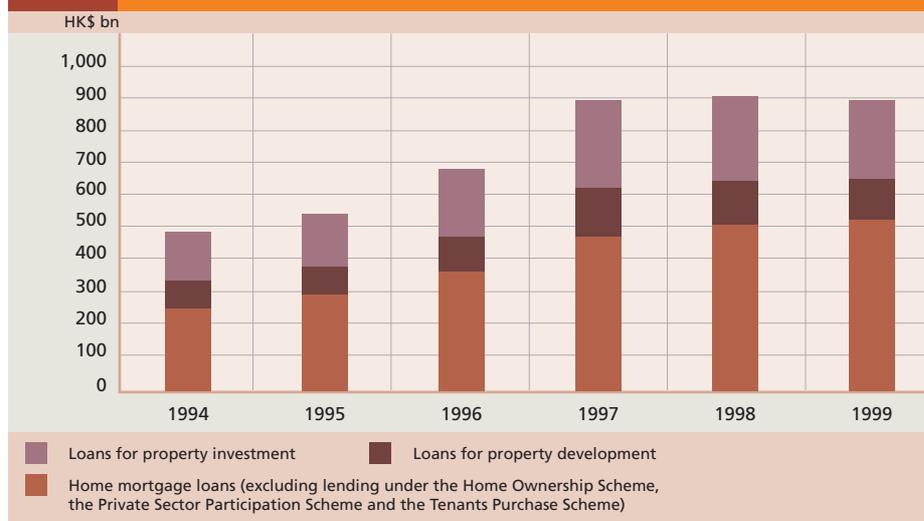


Chart 12 Property-related loans



### Recovery in profits

Although the performance of individual banks varied markedly in 1999, the aggregate profits of local banks derived from their Hong Kong offices recovered as operating conditions improved during the year. Pre-tax operating profits increased by 14.8% and post-tax profits by 22.2% in 1999, a sharp contrast to declines of 32.9% and 33.8% respectively in 1998.

The recovery in the operating profits of local banks was supported by an increase in interest bearing assets and a slight improvement in the net interest margin<sup>1</sup>, to 2.29% in 1999 from 2.26% in 1998. The latter reflected lower funding costs, which outweighed the downward pressure on lending margins. Backed by the rise in net interest income and income generated

<sup>1</sup> As a percentage of average interest bearing assets.



from fees and commissions, total operating income grew faster than total operating expenses, resulting in an improvement in the cost-income ratio, to 37.8% in 1999 from 39.6% in 1998.

### Slower growth in bad debt charge

The bad debt charge booked in the Hong Kong offices of the banking sector as a whole continued to increase in 1999, but at a much slower pace than in 1998 (28.0% against 211.8%). The improvement was much more obvious in the case of local banks, where the bad debt charge showed little change in 1999 after the 335.1% increase in 1998. The charge in the second half of the year was lower than in the first. This was consistent with indications that the growth of problem loans peaked in the second half (see below). Despite this improvement in the aggregate position, a number of banks were obliged to increase their provisions against Mainland-related companies during the year. As a percentage of average total assets, the bad debt charge for the banking sector as a whole increased to 0.64% in 1999 from 0.45% in 1998. This was partly influenced by a decline in average total assets in 1999. By contrast, the equivalent ratio for the local banks fell to 0.60% in 1999 from 0.63% in 1998 (Table 5).

### Asset quality improved in the final quarter of the year

The deterioration in the asset quality of local banks peaked in the September quarter and showed signs of improvement in the December quarter. This was, however, partly influenced by factors such as write-offs made by banks and the restoration of some restructured loans to performing status before the end of the year.

**Table 5 Return on assets for locally incorporated banks**

Components of ROA	Contribution to ROA as % of average total assets	
	1998	1999
1. Net interest income	2.07	2.13
2. Other operating income	0.95	0.92
3. Total operating income (1+2)	3.02	3.05
4. Operating expenses	1.20	1.15
5. Bad debt charge	0.63	0.60
6. Other provisions	0.01	0.02
7. Operating profit before tax (3-4-5-6)	1.18	1.28
8. Profit on sale of fixed assets and other investments, and exceptional items	-0.01	0.06
9. Profit before tax (7+8)	1.17	1.34
10. Taxation	0.15	0.16
11. Extraordinary items	0.00	0.00
12. Post tax profits (ROA) (9-10+11)	1.02	1.18

For local banks as a whole, the ratio of loans overdue for more than three months to total loans rose from 4.04% at the end of 1998 to a high of 6.32% at the end of September 1999 before moderating to 5.85% at the end of 1999, while rescheduled loans rose from 1.08% at the end of 1998 to a high of 1.22% at the end of September 1999 and fell to 1.10% at the end of 1999. The combined ratio of overdue and rescheduled loans to total loans therefore rose from 5.12% at the end of 1998 to 7.54% at the end of September 1999 and fell to 6.96% at the end of 1999. Similarly, non-accrual loans<sup>2</sup> (first collected in June 1999) rose from 6.70% at the end of June 1999 to 7.22% at the end of September 1999 before falling to 7.14% at the end of

<sup>2</sup> Loans on which interest has been placed in suspense or on which interest accrual has ceased.



December 1999. “Classified loans” (i.e. loans classified as substandard, doubtful and loss) is a broader definition of problem loans. In this case, the ratio rose from 7.33% of total loans at the end of 1998 to 10.33% at the end of September 1999 and dropped to 9.81% at the end of 1999. The ratio of “special mention” loans (loans that display signs of weakness but are not yet in difficulties) ended the year at 8.05%, down slightly from 8.06% a year earlier, providing further indication of the slow-down in new problem assets (Table 6).

loans to total loans rose to 5.70% from 4.18%. Of these, loans overdue for more than three months increased to 4.82% from 3.39% and rescheduled loans to 0.88% from 0.79%. The lower ratio of classified loans of the banking sector compared with that of local banks was partly explained by the repatriation of problem loans by some foreign banks back to their head offices. On the other hand, “special mention” loans fell to 8.13% at the end of 1999 from 9.18% at the end of 1998.

**Table 6** Asset quality<sup>1</sup>

	All authorised institutions		Local banks	
	1998	1999	1998	1999
	as % of total loans			
<b>Pass loans</b>	85.55	<b>84.64</b>	84.61	<b>82.14</b>
<b>Special mention loans</b>	9.18	<b>8.13</b>	8.06	<b>8.05</b>
<b>Classified loans<sup>2</sup></b>	5.27	<b>7.24</b>	7.33	<b>9.81</b>
of which: Substandard	2.56	2.71	3.18	3.72
Doubtful	2.29	3.70	3.93	5.43
Loss	0.41	0.83	0.22	0.66
<b>Overdue &gt; 3 months and rescheduled<sup>3</sup> loans</b>	4.18	<b>5.70</b>	5.12	<b>6.96</b>
of which: Overdue > 3 months	3.39	4.82	4.04	5.85
Rescheduled <sup>3</sup> loans	0.79	<b>0.88</b>	1.08	1.10
<b>Non-accrual loans<sup>4</sup></b>	–	<b>5.32</b>	–	<b>7.14</b>

1. Period-end figures relate to Hong Kong offices and overseas branches.  
2. Classified loans are loans graded as "substandard", "doubtful" or "loss".  
3. Effective March 1999, rescheduled loans which have also been reported under overdue for more than 3 months are excluded.  
4. Loans on which interest has been placed in suspense or on which interest accrual has ceased. Not available prior to June 1999.  
Because of rounding, the figures set out in this table may not add up.

The trend in asset quality of the banking sector as a whole was similar to that of the local banking sector. Signs of improvement emerged in the final quarter of 1999 after continued deterioration in the three preceding quarters. For the year as a whole, the ratio of classified loans to total loans increased to 7.24% at the end of 1999 from 5.27% at the end of 1998 while the combined ratio of overdue and rescheduled

The asset quality of the mortgage portfolio remained good during the year, despite some increase in arrears. According to the monthly residential mortgage survey, the delinquency ratio, measured by the ratio of mortgage loans overdue for more than three months to total outstanding mortgage loans, rose to 1.13% at the end of 1999 from 0.84% at the end of 1998. However, the ratio was broadly stable in the latter part of the year.



### Credit card business

Credit card business continued to grow in 1999, but at a slower pace. Total receivables grew by 9.0% notwithstanding the 15.9% increase in the number of cards in 1999, compared with the respective rises of 13.6% and 8.3% in 1998 (Table 7). Consistent with the rise in personal bankruptcies resulting from the strain on personal finances, the charge-off ratio for the year of 1999 went up to 4.9% from 3.1% in 1998. However, the ratio showed some signs of improvement in the December quarter. Due partly to earlier charge-off by banks, the delinquency ratio for loans overdue for more than 90 days dropped to 0.92% at the end of 1999 from 1.16% at the end of 1998.

Table 7 Credit card survey results		
	1998 HK\$ billion	1999 HK\$ billion
Total receivables	36.9	40.2
Delinquent accounts (debts overdue over 90 days)	0.4 (1.16% of total receivables)	0.4 (0.92% of total receivables)
Annualised charge- off ratio	3.1%	4.9%

### Strong capital adequacy ratio

The consolidated capital adequacy ratio of all locally incorporated institutions remained high at 18.8% at the end of 1999, up slightly from 18.5% at the end of 1998. The increase in capital adequacy ratio was caused by a decline in risk assets during the year, reflecting a reduction in the risk appetite of banks.

### A better year ahead for the banking sector

Although the performance of individual banks remains mixed, the sector as a whole is showing signs of recovery from the Asian crisis and the domestic recession. Stable funding conditions and a likely decline in provisions for bad and doubtful debts, aided by satisfactory progress in the debt restructuring of Guangdong Enterprises, should bring about further recovery in profits in 2000. While balance sheet growth remains sluggish, domestic lending is expected to pick up as the economic recovery gathers more momentum. The aggressive pricing of residential mortgage loans below the best lending rate is, however, likely to create further downward pressure on banks' lending margins. This will put the overall net interest margin under pressure if funding costs rise. Notwithstanding the signs of improvement in asset quality towards the end of the year, banks have a continuing need to monitor closely the quality of their loan portfolios and institute appropriate measures to



strengthen credit controls in the light of experience during the Asian crisis. With the Year 2000 issue out of the way, banks must also focus more intensively on the need to manage and finance this investment in technology (including internet banking) in order to stay competitive. The year 2000 should also see the start of the final phase of interest rate deregulation. Thus, while the banks in Hong Kong have weathered the Asian crisis well, they cannot afford to relax. The banking environment will undoubtedly become more competitive and complex, as it has around the world. This will present new opportunities for the banks, but it will also pose formidable strategic challenges, not least on decisions about merger and business alliances.

