Economic and Banking Environment

Helped by a robust external trade performance and a revived domestic demand, Hong Kong's economy recorded a real GDP growth of 10.5% in 2000. Local banks' profits generally rebounded sharply in 2000. The banking environment, however, became more competitive and difficult. Domestic loan growth remained sluggish, thus squeezing lending margins. Several mergers and acquisitions also took place during the year.

The economy in review

Overview

Hong Kong's economic performance strengthened in 2000. Real GDP increased by 10.5%, the fastest growth recorded since 1987. This buoyancy reflected improvements on both external and domestic fronts. Growth in exports of goods and services accelerated to double digits in 2000, helped by a strong increase in external demand as well as improved price competitiveness. There was, however, some easing towards the end of the year as global demand slowed. Domestically, consumer spending revived further in 2000, despite some moderation in the last quarter associated with weakness in asset markets. Private investment also grew strongly, reflecting mainly a robust pick-up in spending on machinery and equipment (Table 1).

Local financial markets were broadly stable in 2000. Interest rates firmed in the earlier part of the year – in line with US interest rate hikes – but eased in the latter period. For the year as a whole, interest rates were on average slightly higher than in 1999. Nevertheless, reflecting strong demand for Hong Kong dollar assets, Hong Kong dollar interest rates stayed below their US dollar counterparts for most of 2000. In the foreign exchange market the Hong Kong dollar exchange rate closely tracked the convertibility rate in respect of the Aggregate Balance, notwithstanding some occasions of strengthening pressure in the face of equity-related inflows, which were partly underpinned by market perceptions of Hong Kong as a safe haven amid regional volatility. Influenced by developments in the global markets, the Hang Seng Index recorded some large fluctuations, closing the year at 15,096, 11% lower than the level at the end of 1999.

Table 1 Contributions to GDP growth by components (%)

	1999 [1]					2000 [2]				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	-3.2	0.5	1.6	2.6	0.4	5.3	3.0	3.1	1.5	3.1
Government Consumption Expenditure	0.4	0.3	0.0	0.4	0.3	0.3	0.2	0.2	0.0	0.2
Gross Domestic Fixed Capital Formation	-7.9	-10.6	-3.6	-3.3	-6.2	1.4	1.4	3.8	3.2	2.5
Change in Inventories	-3.2	-2.1	1.5	5.3	0.5	7.3	4.9	2.1	0.2	3.4
Net Domestic Exports of Goods	11.4	12.1	-0.5	-2.8	4.8	-9.0	-7.4	-6.2	-4.1	-6.5
Net Re-exports of Goods	-0.9	-0.1	2.4	3.1	1.2	4.4	4.3	4.4	3.5	4.1
Net Exports of Services	0.4	1.0	3.0	3.9	2.1	4.4	4.4	3.4	2.5	3.6
GDP	**-2.9**	**1.1**	**4.3**	**9.2**	**3.1**	**14.1**	**10.8**	**10.8**	**6.8**	**10.5**

1 Revised figures
2 Preliminary figures

Total deposits with authorized institutions increased by 9.6% in 2000, with US dollar deposits registering a stronger increase than Hong Kong dollar deposits. Despite higher US dollar deposit rates, Hong Kong dollar deposits rose steadily in 2000, broadly in line with nominal GDP growth. The decline in domestic loans moderated, and reverted to a modest increase from August 2000 on the back of sustained economic recovery. As Hong Kong dollar deposits grew faster than loans, the Hong Kong dollar loan-to-deposit ratio declined, from 91.3% at the end of 1999 to 89.4% at the end of 2000.

Domestic demand revived more markedly than in 1999

Private consumption expenditure increased by 5.4% in 2000, compared with an increase of 0.7% in 1999. The pick-up in growth was supported by continued improvement in the labour market, a booming stock market in the earlier part of the year, and the inducement of large price discounts in retail outlets. Towards the end of the year, consumer spending eased back, as sentiment was affected by the continued weakness in the property market and a correction in stock prices.

Private investment rebounded strongly from a low base in 1999, registering an increase of about 13% in 2000. Spending on machinery and equipment grew by over 20% in 2000, while the decline in private building and construction output moderated significantly. Public sector investment declined throughout the year, as the tapering output of the Public Housing Programme more than offset the increase in spending on priority railway projects. Inventory accumulation, having started in the second half of 1999, continued into 2000, along with the recovery in final domestic demand (Chart 1).

Robust external trade performance

Growth in merchandise exports accelerated in the first ten months of 2000, before slowing in November and December. For 2000 as a whole, re-exports and domestic exports increased by 18.1% and 6.1% respectively in value terms, and 18.5% and 7.5% respectively after discounting changes in export prices. Buoyant demand from our main trading partners, improved price competitiveness, and robust growth in Mainland exports all contributed to the strong performance. As global growth slackened towards the end of the year, growth in total export value moderated to a year-on-year rate of 6.7% in the last two months, from about 18.8% in the first ten months of 2000. Growth in imports was also very robust in 2000, in line with the pick-up in re-exports and domestic demand. Total imports rose by 19% in value terms and 18.1% in volume terms. As growth in imports outpaced that in exports, the merchandise trade deficit widened to $88.7 billion in 2000, from $46.5 billion in 1999 (Chart 2 and Table 2).

In invisible trade, exports of services grew by 14.3% in real terms in 2000, compared with an increase of 7.8% in 1999. Most major categories of services recorded double-digit

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

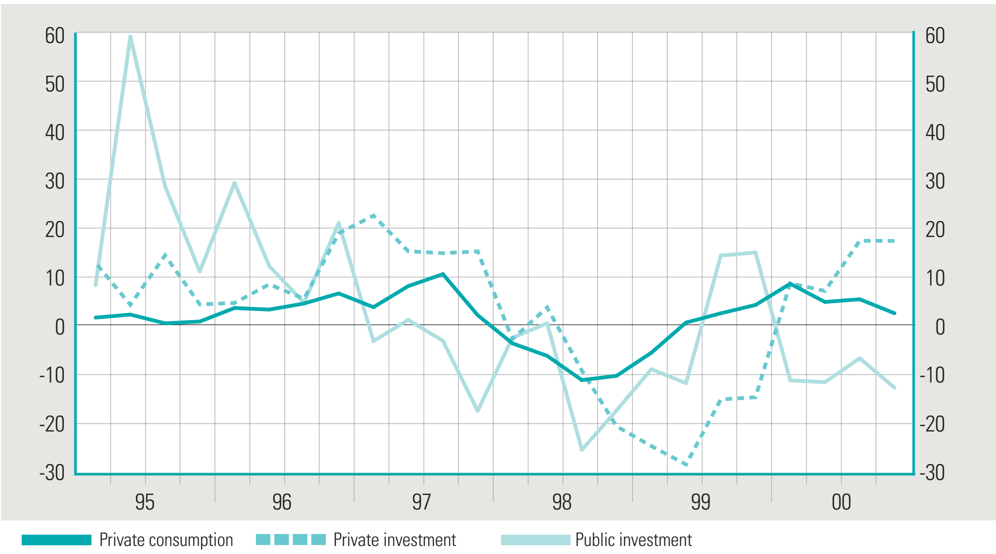


Chart 2 External merchandise trade

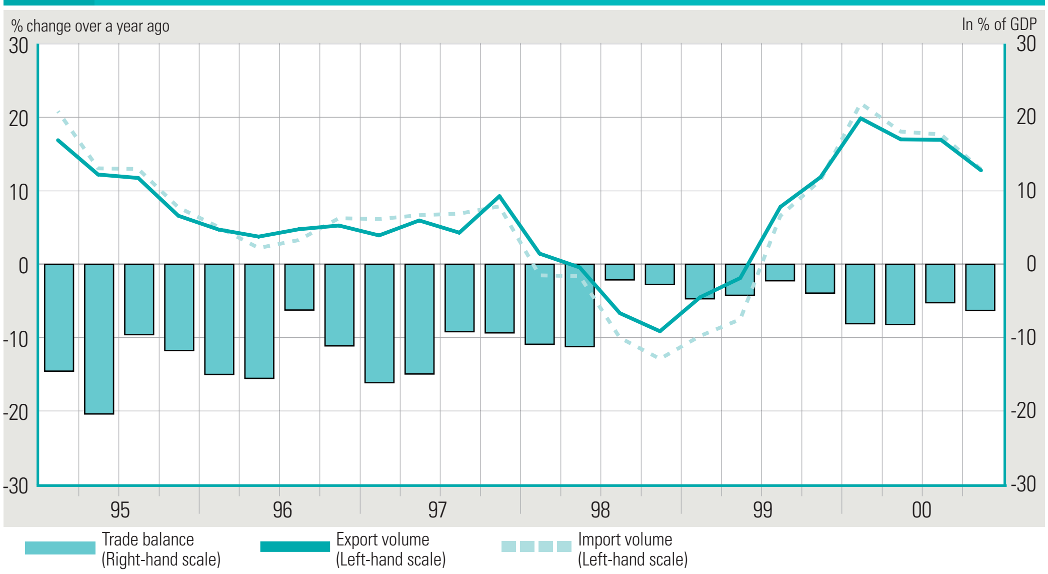


Table 2 Export value by major trading partners (percentage change over a year ago)

	Share	1999					2000				
	%	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	35	-14	-11	4	10	-3	21	23	23	17	21
United States	23	-5	-2	4	10	2	19	14	14	11	14
European Union	15	-3	-3	5	10	3	19	11	9	5	11
Japan	6	-8	-2	8	15	3	20	20	20	18	19
ASEAN5[1] + Korea	7	5	10	23	22	15	27	21	27	12	21
Taiwan	3	-16	-6	2	11	-2	23	26	24	11	21
Others	11	-13	-11	-5	4	-6	16	12	15	10	13
Total	**100**	**-9**	**-6**	**4**	**10**	**0**	**20**	**17**	**18**	**12**	**17**

[1] ASEAN5 includes the Philippines, Malaysia, Indonesia, Singapore and Thailand.

rates of growth, with an impetus from inbound tourism, offshore trading and various trade-related services. Imports of services grew by 2.6%, up from 0.1% in the previous year. Taking invisible and visible trade together, the overall trade balance registered a significant surplus — for the third straight year — of $59.8 billion in 2000.

Progressive moderation in the decline in consumer prices

The decline in the composite consumer price index (CCPI) slowed progressively over the course of 2000, from 5.3% (on a 12-month comparison) in January to 1.8% in December. This was attributable to a combination of factors including the pick-up in domestic demand, the gradual firming in import prices — particularly oil prices — and the dissipation of the lagged effect of the rental decline. For the year as a whole, the CCPI was an average 3.7% lower than in 2000.

Continued improvements in the labour market

The unemployment rate declined from 5.6% in the first quarter to 4.4% in the fourth quarter of 2000. For the year as a whole, the unemployment rate averaged 5%, compared with 6.3% in 1999. Supported by the sustained economic recovery, employment in all the major services sectors recorded marked growth. Workers' earnings and household income improved. The nominal payroll per person engaged registered a small year-on-year increase of 1.7% in both the second and third quarter of 2000, compared with zero growth in the first and a decline of 0.3% in 1999. Median household income increased by 2.6% in 2000, compared with a decline of 3.3% in 1999 (Chart 3).

Chart 3 Labour market

Consolidation in asset markets

The stock market was volatile in 2000, generally echoing movements in the US markets. The Hang Seng Index plunged from an all-time high of 18,302 in March 2000 to 13,723 in May 2000, along with the bursting of Internet stock bubbles and the tightening of US monetary policy. It then rebounded in the third quarter, as the pressure for further US interest rate hikes subsided. Local share prices subsequently declined, as the international oil price surge and weaker-than-expected corporate profits took a toll on major stock markets. The Hang Seng Index closed the year at 15,096, down by 11% from the end of 1999.

The residential property market remained sluggish in 2000. Residential property prices, having dropped by about 10% during the first half of 2000, picked up modestly by 2.3% in the third quarter but declined further by 8.6% in the fourth quarter. The number of transactions dropped to the lowest level since 1990.

Monetary situation

The Hong Kong dollar remained stable

Under the linked exchange rate system, the Hong Kong dollar remained stable against the US dollar. Starting from 1 April 1999, the convertibility rate in respect of the Aggregate Balance moved from 7.75 by 1 pip (i.e. $0.0001) per calendar day. It converged with the convertibility rate applicable to the issuance and redemption of Certificates of Indebtedness at 7.80 on 12 August 2000. Since then, the convertibility rate has remained at 7.80. The market exchange rate for the Hong Kong dollar tracked closely the movement of the convertibility rate during the first eight months of 2000, and stayed near 7.80 thereafter.

The overall exchange value of the Hong Kong dollar, as 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 was on a general up-trend during the first eleven months, rising from 131.5 at the end of 1999 to a high of 137.5 in late November, in parallel with the strengthening of the US dollar against the Japanese yen and the euro. As the US dollar weakened against the euro from late November, the EERI decreased slightly and ended the year at 136.0.

Hong Kong dollar interest rates fell below their US dollar counterparts

Hong Kong dollar interest rates were on a general up-trend in the first five months of 2000 along with the rise in US dollar interest rates. Thereafter, short-term Hong Kong dollar interest rates eased as concerns over further monetary tightening in the US gave way to rising expectations of a rate cut. Reflecting strong demand for Hong Kong dollar assets, Hong Kong dollar interest rates stayed below their US dollar counterparts during most of the year. At the end of December 2000, the one-month interbank interest rate was 47 basis points below its US dollar counterpart. Interest rate volatility remained low amid stable monetary conditions during the year.

In respect of retail deposit rates, the savings deposit rate governed by the Interest Rate Rules of the Hong Kong Association of Banks was raised three times, by 100 basis points altogether, between January and May 2000. Thereafter, it remained unchanged at 4.75%. The movement of the best lending rate quoted by major banks matched that of the savings deposit rate. The best lending rate at the end of December 2000, at 9.5%, was at par with the US prime rate.

Broad money rose in line with nominal GDP growth

Hong Kong dollar narrow money (M1) rose significantly in January and February 2000, reflecting increases in cash holdings associated with the transition into year 2000 and the Chinese New Year holidays, and a rise in demand deposits due to active initial public offering activities. Thereafter, year-on-year growth of M1 stabilised at around 7% between April and November, except for some occasional gyrations due to stock market activities in July and September. This steady growth reflected sustained transactions demand for money, along with active fund-raising activity on the stock market. However, because of the inflated level of cash holdings in December 1999 arising from the year 2000 transition factor, M1 recorded a 0.7% decline over the year as a whole. The growth of Hong Kong dollar broad money (M3) remained stable at around 4-6% for most of 2000, following a rise of around 5% in 1999. This was largely in line with nominal GDP growth.

Notes and coins

At the end of 2000, the total value of notes in circulation was $99,265 mn, a decrease of 16% from a year earlier (Charts 4, 5, 6). The decrease was due to the normalisation of notes in circulation following the precautionary holding of additional cash by the general public during the year 2000 transitional period. The total value of coins in circulation was $5,700 mn (excluding commemorative gold coins and coin sets), an increase of 2.5% from a year earlier (Charts 7 and 8).

Review of banknote design

The current series of Hong Kong dollar banknotes has been in existence since 1993. In April 2000, the HKMA, with the advice of the Bank Notes Issue Advisory Committee, initiated a comprehensive review of banknote design with a view to introducing a new generation of notes in due course.

Chart 4 Notes in circulation at end of year

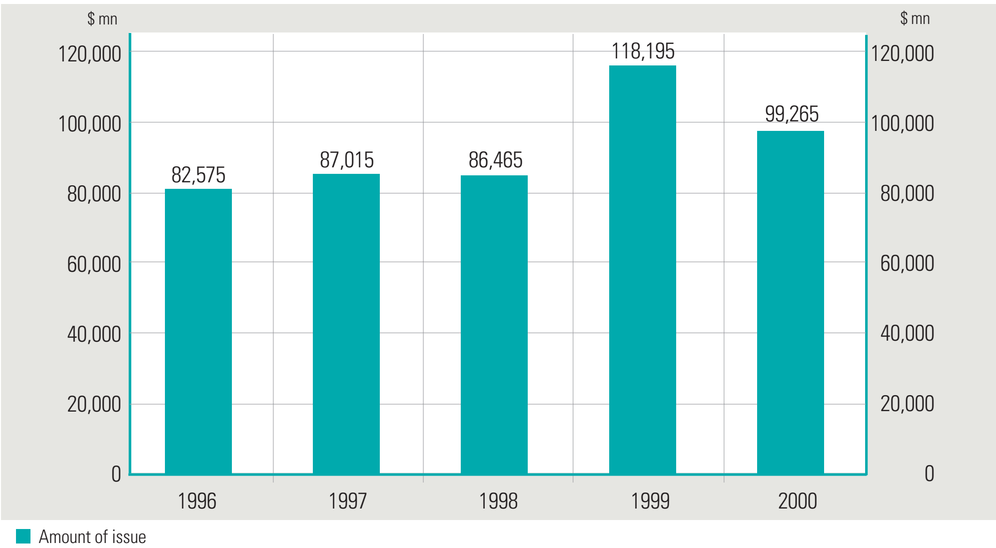


Chart 5 Distribution of notes in circulation at end of 2000

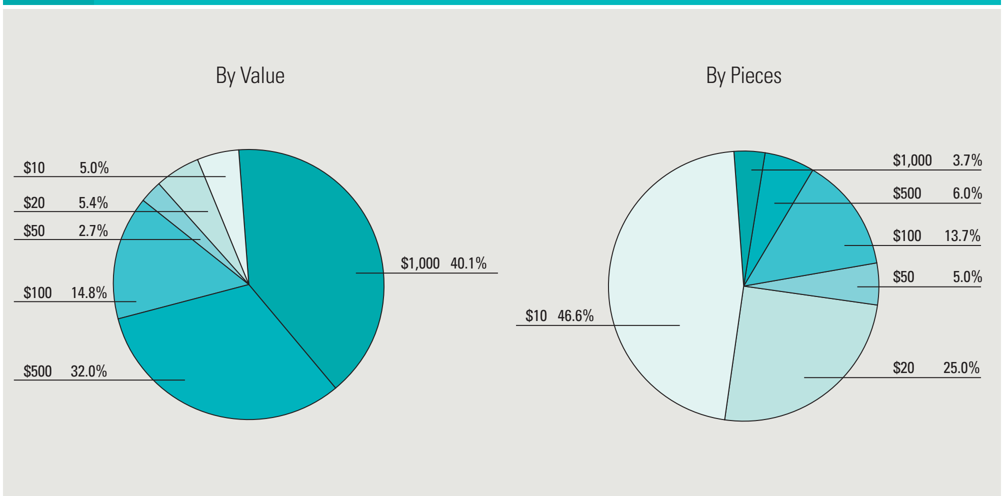


Chart 6 Notes in circulation by Note-Issuing Bank at end of 2000

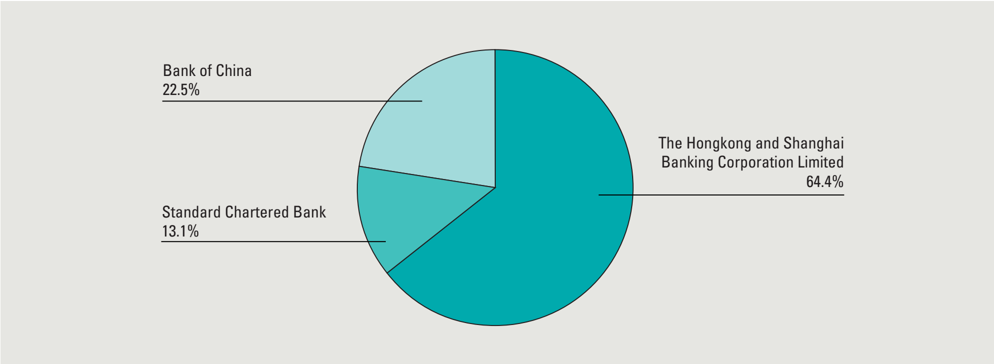


Chart 7 Coins in circulation at end of year

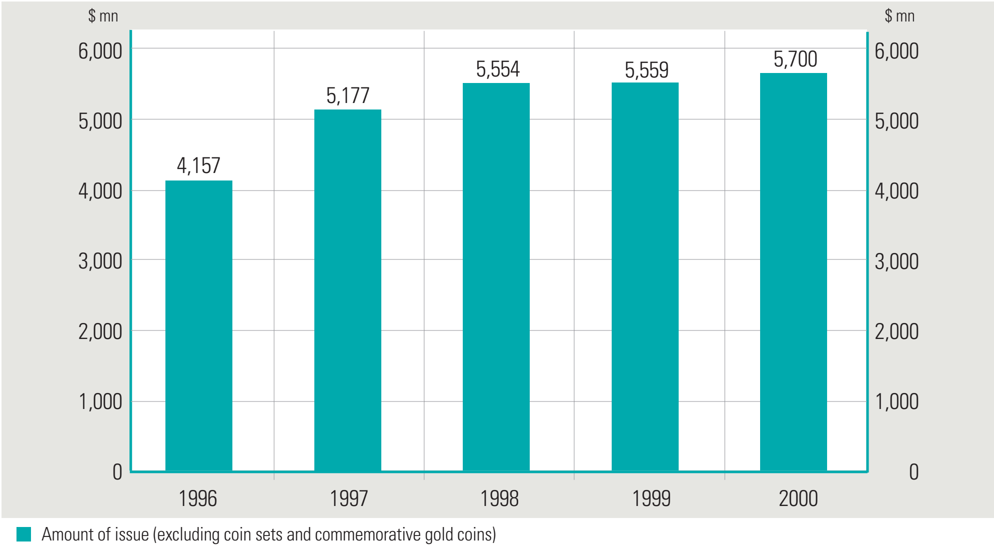
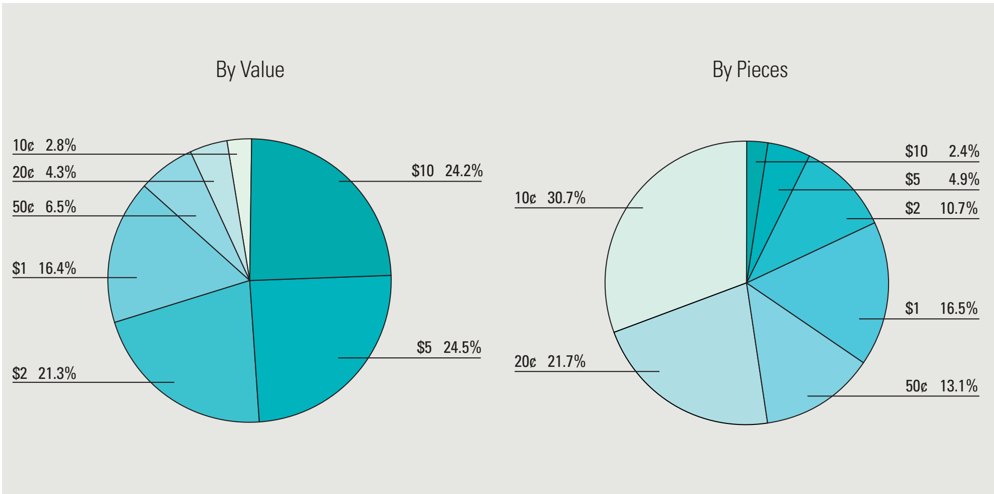


Chart 8 Distribution of coins in circulation at end of 2000



Ahead of the completion of this review, as a measure to combat counterfeiting, a revised version of the $1,000 note of The Hongkong and Shanghai Banking Corporation Limited, incorporating new security features, was launched on 18 December 2000. The new security features include holographic windowed thread, embedded fluorescent fibres and highlight watermark. New security features will also be applied to the $1,000 notes of the Bank of China and Standard Chartered Bank as soon as the necessary preparatory work has been completed.

Chief Executive Joseph Yam, accompanied by HKMA student ambassadors, explains new security features of the $1,000 note to shopkeepers in Mongkok.

Coin stock

At the end of 2000, a stock of 1,000 mn coins of all denominations was being held in Hong Kong, ready to meet demand at any time. In addition, there was further stock of about 680 mn coins held in the mints overseas where they were manufactured, 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 continued throughout the year, although the number of Queen's Head coins surfacing has declined considerably. Up to the end of 2000, 560 mn Queen's Head coins had been retrieved from the market.

Outlook for the economy

Economic growth to slow down

Following a year of robust performance in 2000, economic growth is expected to slow in 2001. In addition to a high base of comparison, a number of factors point to moderating growth in both domestic demand and exports of goods and services. Domestically, while lower interest rates and continued improvements in the labour market should support consumer spending, sentiment may be affected by any continuing weakness in the property market or equity market. Public investment is expected to remain lacklustre with a continued decline in public housing output. Nevertheless, the construction of Disneyland and the Science Park and the Ma On Shan railway project should partially offset the decline in public housing construction. Fixed capital investment by the business sector is likely to slow down – following the strong rebound in 2000 – while inventory build-up should also moderate.

The slowdown in export growth in the last months of 2000 is likely to continue, reflecting slower growth in the US and the regional economies, as well as moderation in the Mainland's trade growth. The possibility of a hard-landing in the US economy with repercussions on the other major economies cannot be ruled out. Concern has also been raised about signs of renewed weakness in the Japanese economy. On the other hand, the economic outlook in Europe remains stable.

Continued improvements in labour market and low inflation

The labour market is likely to improve further in 2001. The unemployment rate should continue to ease, supported by the sustained economic recovery. In particular, output tends to have a lagged effect on employment growth and thereby on the unemployment rate. The decline in consumer prices is expected to ease further over the course of 2001, and is likely to revert to a small year-on-year increase towards the end of the year. The lagged effect of rental declines in the earlier years should largely diminish by the latter part of 2001. In addition, increases in some government fees and charges are expected to raise the consumer price index.

Performance of the banking sector

Helped by the rapid rebound in the domestic economy and generally low funding costs, both the asset quality and the operating performance of banks improved during the year. The banking environment has, however, at the same time become more competitive and difficult. Despite banks' increased willingness to lend amid plentiful liquidity, domestic loan demand remained weak. Competition intensified for the limited amount of new business, particularly residential mortgage business, resulting in aggressive price-cutting strategies by banks and further contraction in lending margins.

In the light of the increasingly competitive environment, various banks have begun to place increased emphasis on promoting other financial products and services: for example, personal finance, credit card and wealth management products, and exploring the use of new technology, such as the Internet, to broaden income sources and reduce costs. There has also been added impetus for banks to consider consolidation through mergers and acquisitions as a means of achieving growth and economies of scale. Several mergers and acquisitions were completed in 2000, while others (for example, the planned restructuring of the Bank of China Group announced in 2000) are in the pipeline.

Benefiting from improving economic conditions, the asset quality of the banking sector as a whole recorded continued improvement in the course of 2000, reversing the deteriorating trend of the previous two years. The lengthy restructuring of the Guangdong Enterprises Group was finally concluded towards the end of 2000. As a result of the overall decline in problem loans, the aggregate bad debt charge for the banking sector fell sharply in 2000.

Authorized institutions generally experienced a strong rebound in profitability in 2000, with profits exceeding the pre-crisis levels. This generally derived from an increase in net interest and fee income and a significant drop in the bad debt charge. The overall net interest margin for 2000 widened, largely owing to relatively low funding costs, which helped to offset the contraction in lending margins. The capital and liquidity positions of the banking sector remained strong.

Plentiful liquidity

The banking sector continued to maintain plentiful liquidity in 2000, largely owing to further growth in customer deposits and a decline in lending volume. Following the trend in US interest rates, the best lending rate in Hong Kong increased by a total of 100 basis points during the year. On the funding side, one-month HIBOR increased to an annual average of 5.95% in 2000, from 5.51% in 1999, and the one-month time deposit rate increased from 4.50% to 4.80% (Table 3). However, because the increase in the best lending rate was larger than for one-month HIBOR, the average spread between the two rates widened to 327 basis points in 2000, from 301 basis points in 1999.

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

	Time deposits			HIBOR			Savings	Best lending
(% per annum)	1-month	3-month	12-month	1-month	3-month	12-month	deposits	rate
Q4 1999	4.43	4.95	5.51	5.68	6.15	6.78	3.75	8.50
Q1 2000	4.17	4.58	5.47	5.56	5.83	6.73	3.89	8.64
Q2 2000	5.21	5.38	5.68	6.44	6.57	7.03	4.47	9.22
Q3 2000	4.94	5.03	5.37	6.02	6.12	6.57	4.75	9.50
Q4 2000	4.88	4.91	5.08	5.80	5.95	6.17	4.75	9.50
*1999 **	*4.50*	*4.85*	*5.76*	*5.51*	*5.84*	*6.88*	*3.75*	*8.52*
*2000 **	*4.80*	*4.97*	*5.40*	*5.95*	*6.12*	*6.63*	*4.47*	*9.22*

* annual average figures.

Total customer deposits increased by 9.6% in 2000, after having risen by 7.6% in 1999. Foreign currency deposits grew at the faster rate of 15.3% (11.7% in 1999) compared with an increase of 5.0% in Hong Kong dollar deposits (4.5% in 1999) (Chart 9 and Table 4). This growth mainly came from US dollar deposits, which increased by 27.4% (14.4% in 1999) and offset the decline of 1.5% in non-US dollar deposits (in contrast to an increase of 8.2% in 1999). Because of the stronger growth in foreign currency deposits, the share of Hong Kong dollar deposits as a percentage of total deposits fell to 53.1% from 55.4%.

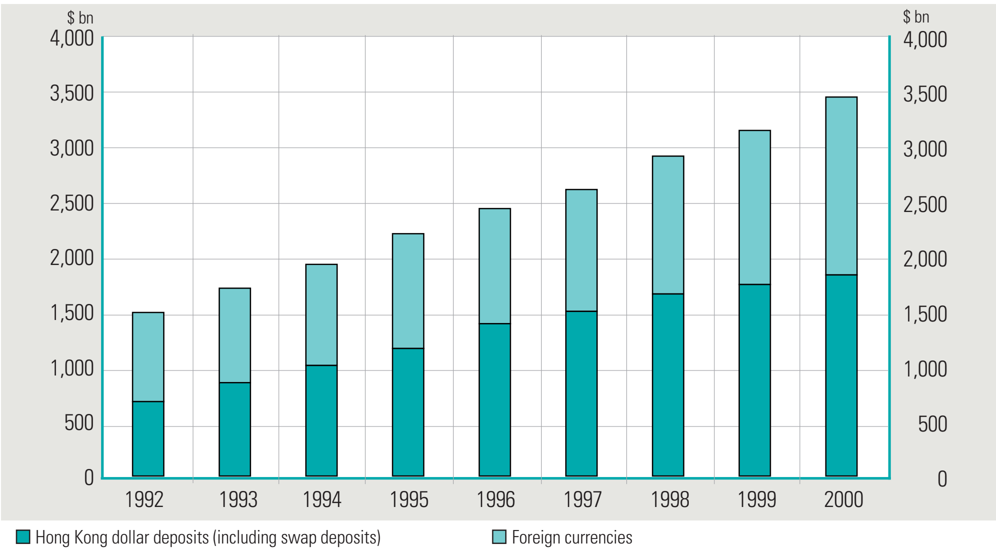
Table 4 Growth of Hong Kong dollar customer deposits

($ bn)	Demand	Savings	Time[a]	Swap	Total
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
2000	112	493	1,239	4	1,848
% growth	6.0	9.0	5.4	(84.7)	5.0

(a) Excluding swap deposits.

Note: The growth rates are calculated with figures before rounding.

Chart 9 Currency mix of customer deposits



Within Hong Kong dollar deposits, the growth in demand deposits moderated to 6.0% in 2000 from 9.0% in 1999, and savings deposits grew by 9.0% following a similar increase in 1999. Time deposits grew at a faster pace of 3.3%, compared with 2.5% in 1999. As some banks switched swap deposits into Hong Kong dollar time deposits, swap deposits contracted significantly by 84.7% in 2000 after a decline of 3.2% in 1999.

Reflecting faster growth in Hong Kong dollar deposits than in Hong Kong dollar loans, the Hong Kong dollar loan-to-deposit ratio of the banking sector fell to 89.4% at the end of 2000 from 91.3% at the end of 1999. However, the ratio for local banks rose to 69.8% from 68.4%, owing to a slower increase in their Hong Kong dollar customer deposits than in their Hong Kong dollar loans. Because of the significant decline in offshore loans (see next section), the loan-to-deposit ratio of the banking sector in all currencies dropped to 70.7% from 88.5%. The same ratio for local banks decreased to 50.1% from 52.8%.

Issuance of new negotiable certificates of deposits (NCDs) declined in 2000. The outstanding amount of NCDs shrank by 10.4% in 2000 after falling by 4.8% in 1999. Out of all outstanding NCDs issued in Hong Kong, 85% were denominated in Hong Kong dollars (up from 82% in 1999), of which around 61% were held by authorized institutions (compared with 62% in 1999).

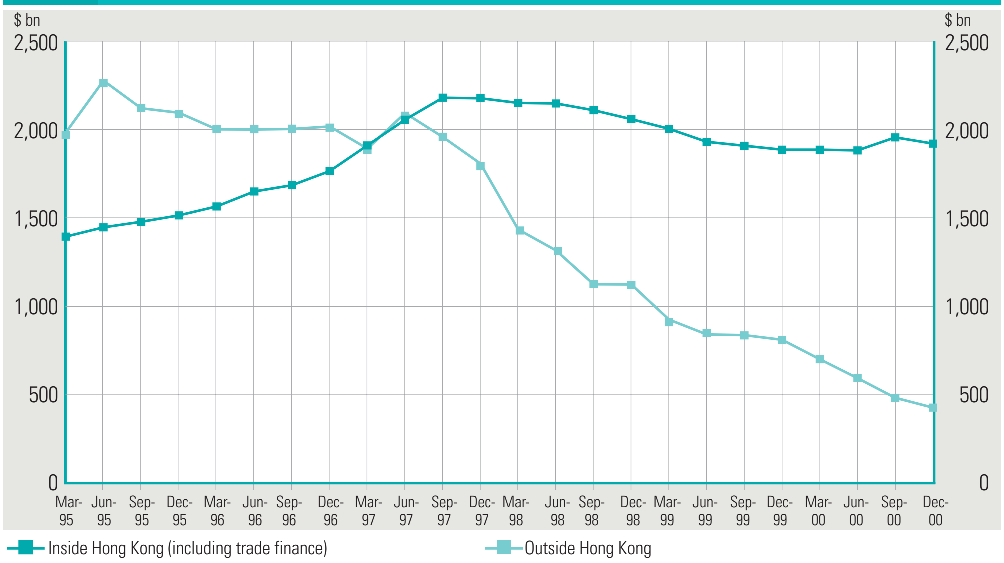
As in 1999, some banks continued to divert their surplus funds released by sluggish loan demand into other negotiable debt instruments. The banking sector's holdings of Hong Kong dollar negotiable debt instruments (other than NCDs) increased further by 26.1% in 2000 after strong growth of 27.9% in 1999.

Domestic loan demand remained sluggish

Helped by a modest increase in domestic lending, the decline in total loans and advances moderated to 12.5% in 2000 from 14.9% in 1999. As in previous years, much of the decline was due to offshore loans, which fell by 44.3% in 2000 (Chart 10). This was largely the result of contraction in Japanese banks' Euroyen lending activities, which has little impact on Hong Kong's economy and market liquidity, since Hong Kong only serves as a booking centre.

Following a decline of 8.3% in 1999, domestic lending increased modestly by 1.6% in 2000. A large part of this increase was due to loans extended by banks to finance the acquisition of a large corporate in the third quarter of the year. Other than this, domestic loan demand remained sluggish in general, despite the strong recovery in the domestic economy. Property lending reversed a decline of 1.6% in 1999 to record an increase of 1.6% in 2000.

Chart 10 Loans for use inside and outside Hong Kong



Within this, loans for property development and property investment grew by 5.5% and 2.0% respectively in 2000, compared with declines of 7.7% and 8.6% in 1999 (Chart 11). Affected by sluggish conditions in the property market, the growth in residential mortgage lending slowed to 0.5% in 2000 from 3.6% in 1999. The general lack of bankable lending propositions encouraged keen competition for residential mortgage business, which is regarded as a low risk type of lending because of its low delinquency ratio. By the end of 2000, the most common margin on new mortgage loans was 2.25% below the best lending rate. With existing loans also being refinanced to take advantage of the lower rates, this contributed to the squeeze on banks' lending margins.

The sectoral breakdown of bank lending is given in Chart 12. Helped by the recovery in the domestic economy, the decline in loans to the manufacturing sector and the

Chart 11 Property-related loans

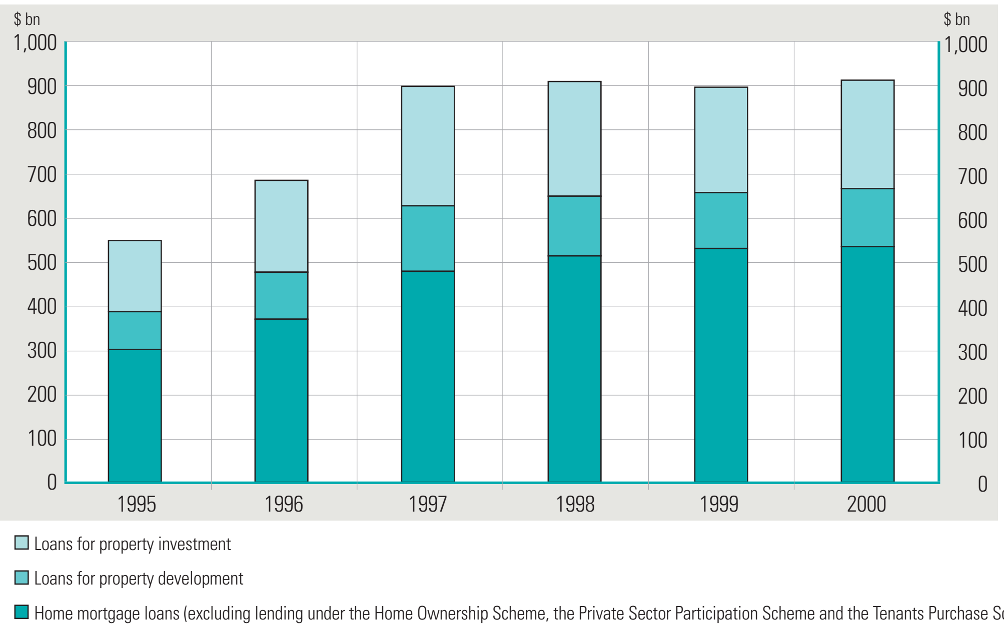
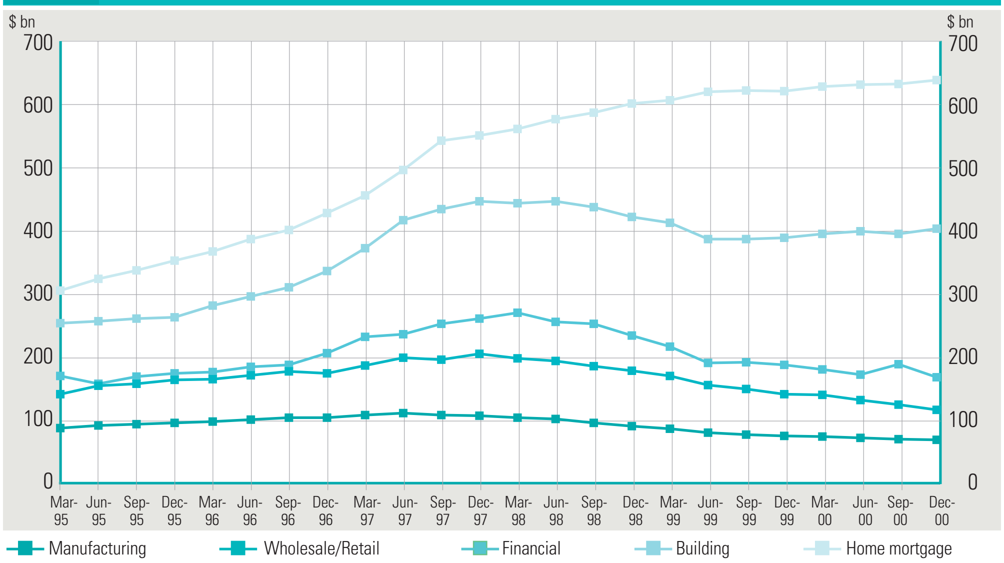


Chart 12 Loans for use in Hong Kong by selected sectors



wholesale and retail sectors moderated to 8.2% and 15.7% respectively from 15.3% and 19.8% in 1999. Loans to finance share purchases remained stable at $17 billion ($16 billion in 1999). Within this, loans to stockbrokers rose sharply by 52.1%, following an increase of 36.5% in 1999. Loans to non-stockbroking companies and individuals to purchase shares decreased by 24.8%, compared with a decrease of 5.4% in 1999.

Strong recovery in profits

Supported by the strong recovery in the domestic economy and improved operating conditions, local banks recorded sharply higher profit growth in 2000. Aggregate profits derived from their Hong Kong offices exceeded those recorded before the Asian crisis. Pre-tax operating profits increased sharply by 37.8% and post-tax profits by 29.8%, compared with 15.2% and 22.6% respectively in 1999. The strong growth in operating profits was due mainly to a significant drop in the bad debt charge and increases in net interest and fee income. Backed by stable funding costs, the net interest margin[1] widened (from 2.29% to 2.33%) despite the squeeze on lending margins caused by fierce competition, in particular for residential mortgage business. As a result of faster growth in total operating income than in total operating expenses, the cost-income ratio dropped to 36.4% in 2000 from 37.8% in 1999.

Significant drop in bad debt charge

Consistent with the improvement in asset quality (see below), the bad debt charge for local banks booked in their Hong Kong offices declined substantially by 48.4% in 2000 after showing little change in 1999. As a percentage of average total assets, the bad debt charge for local banks halved to 0.29% from 0.59% (Table 5). Similarly, the bad debt charge of the banking sector as a whole declined markedly, by 60.8%, against an increase of 28.4% in 1999. This amounted to 0.26% of average total assets, compared with 0.64% in 1999.

Table 5 Return on assets for the locally incorporated banks

Components of ROA	Contribution to ROA as % of average total assets 1999	2000
1. Net interest income	2.12	2.18
2. Other operating income	0.93	0.90
3. Total operating income (1 + 2)	3.05	3.08
4. Operating expenses	1.15	1.11
5. Bad debt charges	0.59	0.29
6. Other provisions	0.02	0.01
7. Operating profit before tax (3 - 4 - 5 - 6)	1.29	1.67
8. Profit on sale of fixed assets and other investments, and exceptional items	0.06	0.01
9. Profit before tax (7 + 8)	1.35	1.68
10. Taxation	0.16	0.24
11. Extraordinary items	0.00	0.00
12. Post tax profits (ROA) (9 - 10 + 11)	1.19	1.44

Continued improvement in asset quality

Along with better economic conditions, the asset quality of local banks and the banking sector as a whole improved in 2000. The improvement was partly influenced by factors such as the restoration of some problem loans to performing status and write-offs made by banks.

For local banks, the ratio of loans overdue for more than three months to total loans fell to 4.39% at the end of 2000 from 5.85% at the end of 1999. Coupled with the fall in rescheduled loans to 1.09% from 1.11%, the combined ratio of overdue and rescheduled loans stood at 5.49% of total loans, down from 6.96% at the end of 1999. Non-performing loans[2] also fell, to 5.37% from 7.14%. Classified loans (i.e. loans classified as substandard, doubtful or loss)

[1] As a percentage of average interest bearing assets.

[2] Loans on which interest has been placed in suspense or on which interest accrual has ceased.

Table 6 Asset quality[1]

	All authorized institutions		Local banks	
	1999	2000	1999	2000
	as % of total loans			
Pass loans	**84.64**	**87.09**	**82.14**	**86.30**
Special mention loans	**8.12**	**6.85**	**8.04**	**6.52**
Classified loans (gross)[2]	**7.24**	**6.06**	**9.81**	**7.18**
of which Substandard	*2.71*	*1.85*	*3.72*	*2.54*
Doubtful	*3.69*	*3.28*	*5.44*	*4.17*
Loss	*0.84*	*0.93*	*0.66*	*0.47*
Classified loans (net)[3]	**4.79**	**3.94**	**6.59**	**4.82**
Overdue > 3 months and rescheduled loans	**5.72**	**5.12**	**6.96**	**5.49**
of which Overdue > 3 months	*4.84*	*4.13*	*5.85*	*4.39*
Rescheduled loans	*0.88*	*0.99*	*1.11*	*1.09*
Non-performing loans[4]	**5.34**	**4.71**	**7.14**	**5.37**

1. Period-end figures relate to Hong Kong offices and overseas branches.
2. Classified loans are those loans graded as "substandard", "doubtful" or "loss".
3. Net of specific provisions.
4. Loans on which interest has been placed in suspense or on which interest accrual has ceased.

Because of rounding, the figures set out in this table may not add up.

ended the year at 7.18% of total loans, down from 9.81% at the end of 1999. The ratio of special mention loans (loans that display signs of weakness but are not yet in difficulty) also dropped to 6.52% from 8.04% (Table 6).

For the banking sector as a whole, the ratio of classified loans fell to 6.06% at the end of 2000 from 7.24% at the end of 1999, and special mention loans, to 6.85% from 8.12%. Loans overdue for more than three months also dropped to 4.13% from 4.84%. In contrast, as a result of the completion of the restructuring of the Guangdong Enterprises Group, rescheduled loans rose to 0.99% from 0.88%. The combined ratio of overdue and rescheduled loans to total loans at the end of 2000 was 5.12%, down from 5.72% at the end of 1999. Similarly, the ratio of non-performing loans declined to 4.71% from 5.34%.

According to the HKMA's 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 1.26% at the end of 2000. This was due to an increase in overdue loans against the contraction in total mortgage loans outstanding. Despite the rise in the delinquency ratio, the overall asset quality of the residential mortgage portfolio was still relatively good.

Credit card business

Growth in credit card business accelerated in 2000. Total receivables grew by 27.3% (9.0% in 1999), and the number of credit card accounts rose by 23.9% (15.9% in 1999). In line with the improvement in banks' asset quality, both the delinquency ratio and the charge-off ratio dropped to 0.76% and 3.9% respectively at the end of 2000, compared with 0.92% and 4.9% at the end of 1999 (Table 7).

Table 7 Credit card survey results

	1999	2000
Total number of accounts ('000)	5,776	7,159
annual growth rate	*15.9%*	*23.9%*
Total receivables ($ bn)	$40.2	$51.2
annual growth rate	*9.0%*	*27.3%*
Delinquent receivables ($ bn) (debts overdue over 90 days)	$0.4 (0.92% of total receivables)	$0.4 (0.76% of total receivables)
Charge-off ratio	4.9%	3.9%

Note: The growth rates are calculated with figures before rounding.

Capital adequacy ratio remained strong

Reflecting a faster growth in risk assets than in capital base, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions declined to 17.9% at the end of 2000 from 18.7% at the end of 1999. Nevertheless, the ratio is still high by international standards.

New opportunities and challenges ahead

Although the banking sector recovered strongly in 2000, it will need to cope with various challenges and risks imposed by an increasingly competitive operating environment. Looking ahead, it is expected that bad debt charges will continue to fall as the asset quality of banks improves further. However, profit growth is likely to be subdued because the decline in bad debt charges will not be as significant as in 2000. Moreover, despite the strong economic recovery in the past year, there are still no clear signs of a sustained recovery in domestic lending. If loan growth remains sluggish, it may put further pressure on banks to compete for limited business, particularly for residential mortgage loans, by reducing lending margins. So far, the effect of this on the overall net interest margin has been mitigated by the fact that ample liquidity has kept funding costs low. Competitive pressure may, however, intensify on the funding side when the last phase of interest rate deregulation covering savings and current accounts takes place in July 2001 (assuming the environment is not unfavourable at the time). It is therefore important for banks to have adequate risk management measures to protect themselves against the risk of higher funding costs, particularly in respect of long-term assets such as mortgage loans.

The operating environment for banks is becoming increasingly complex. Banks have to face risks arising from the rapid changes brought about by financial liberalisation and technological advance. At the same time, they will need to take advantage of new business opportunities to maintain profit growth and broaden income sources. For example, wealth management products and advisory business on debt/equity financing, which are relatively undeveloped in Hong Kong, will present opportunities for growth. China's prospective accession to the World Trade Organisation is also expected to generate new business for banks in capital market activities as well as in traditional banking products such as trade finance. Further developments in Internet banking will provide banks with the opportunity to reduce costs and increase revenue through more effective marketing and cross-selling of products. This will make it necessary for banks to maintain sufficient expertise and skills, and the necessary resources and technology, to develop and market these types of products and services and to manage the associated risks. Because of the changes in the competitive environment, there will be more economic pressure for consolidation of the banking industry, as banks may find it easier to finance the investment in technology, and obtain the skills and staff resources they need, through mergers or business alliances.