



# Economic and Banking Environment



Hong Kong experienced a difficult year in 2001. Real Gross Domestic Product remained virtually flat during the year, reflecting weak domestic and external demand. In the banking industry, competition for lending business intensified and lending margins were further squeezed. However, profitability held up well, mainly as a result of improved asset quality, and the capital and liquidity positions of the sector remained strong.

## The economy in review

### Overview

The Hong Kong economy went through a difficult year of 2001, but weathered the adverse global economic environment better than many other economies in the region. Real GDP increased marginally by 0.1% in 2001, following a sharp rebound of 10.5% in 2000. The economic slowdown reflected weaknesses both in the

domestic and external sectors. Owing to slack external demand, exports contracted in 2001 after recording double-digit growth in 2000. Domestic demand was weak as a result of falling asset prices, rising unemployment and an uncertain economic outlook, especially after the events of 11 September (Table 1).

Reflecting the substantial relaxation of monetary policy by the US Federal Reserve, local interest rates fell considerably during the year. In the

TABLE 1

Contributions to GDP growth by components (%)

	2000 <sup>1</sup>					2001 <sup>2</sup>				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	5.3	3.1	3.1	1.5	3.1	1.7	2.0	0.6	0.2	1.1
Government Consumption Expenditure	0.3	0.2	0.2	0.0	0.2	0.3	0.3	0.4	0.4	0.4
Gross Domestic Fixed Capital Formation	1.7	1.6	4.1	3.5	2.8	3.2	0.4	0.9	-1.8	0.6
Change in Inventories	6.8	4.5	1.7	0.4	3.2	-1.9	-1.4	-2.2	-1.8	-1.9
Net Domestic Exports of Goods	-9.0	-7.4	-6.2	-4.1	-6.6	-3.8	-1.9	-0.3	3.1	-0.6
Net Re-exports of Goods	4.4	4.3	4.4	3.5	4.1	1.4	-0.2	-0.7	-2.1	-0.5
Net Exports of Services	4.5	4.3	3.4	2.3	3.6	1.1	1.7	0.8	0.5	1.0
<b>GDP</b>	<b>14.1</b>	<b>10.7</b>	<b>10.7</b>	<b>7.0</b>	<b>10.5</b>	<b>2.2</b>	<b>0.8</b>	<b>-0.4</b>	<b>-1.6</b>	<b>0.1</b>

<sup>1</sup> Revised figures

<sup>2</sup> Preliminary figures

foreign exchange market, the spot rate of the Hong Kong dollar against the US dollar remained close to the convertibility rate of 7.80 throughout 2001. Influenced by developments in global financial markets, the local stock market experienced a volatile year. Share prices were weighed down by the gloomy global outlook and lower corporate earnings, and dropped to a near three-year low in the second part of September. At the end of 2001, the Hang Seng Index was 25% lower than its level a year before, but 28% above the low in September.

Growth of narrow money significantly outpaced that of broad money, largely reflecting the reduced opportunity cost of holding narrow money because of the declines in interest rates. Total deposits with authorized institutions (AIs) fell by 3.6% in 2001, which was largely attributable to declines in foreign currency deposits. Reflecting weak business activity, domestic loans contracted by about 4.4%. As Hong Kong dollar loans shrank while Hong Kong dollar deposits rose slightly, the Hong Kong dollar loan-to-deposit ratio fell to 89% at the end of 2001.

### **Dampened domestic demand**

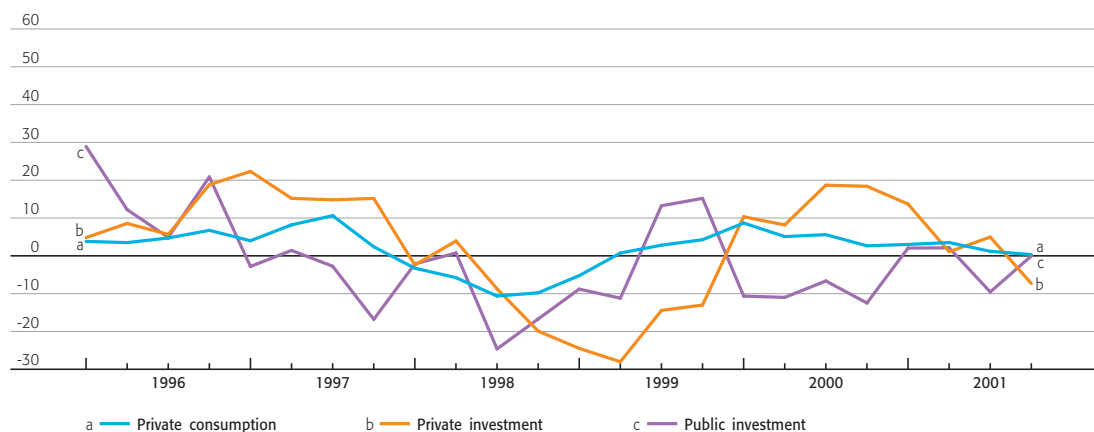
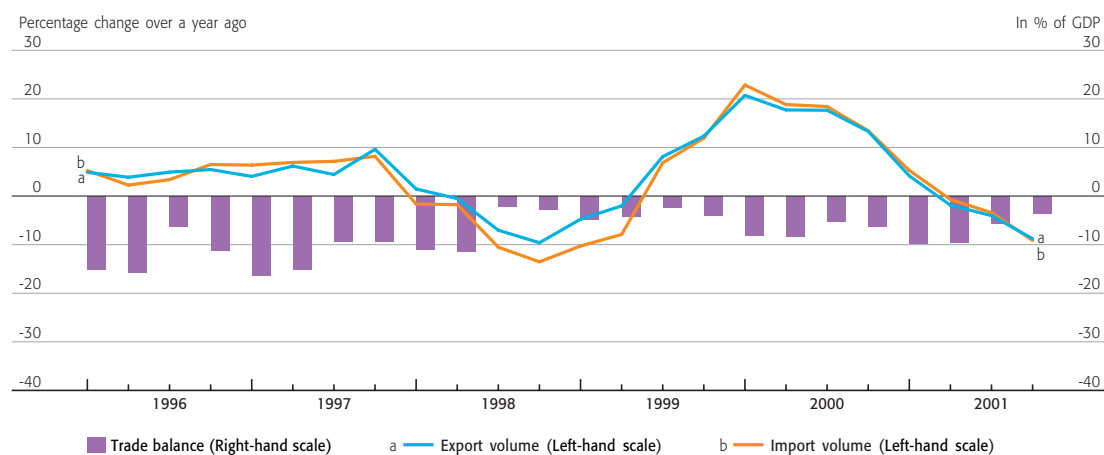
Private consumption expenditure grew by 2% in 2001, compared with an increase of 5.4% in 2000. The slowdown in growth was particularly significant in the latter part of the year, reflecting increased uncertainties about the world economic outlook. Consumer sentiment was also affected by the rising unemployment rate as businesses stepped up corporate restructuring in response to the economic downturn.

Growth of private investment spending decelerated to 2.7% in 2001. Private investment growth was largely driven by expenditure on machinery and equipment, which rose by 4.9%. In contrast, private expenditure on building and construction remained weak throughout 2001. Public investment rose slightly in the first half of the year, but declined in the latter part largely owing to the scale-back of the Public Housing Program (Chart 1).

### **Weak external trade performance**

Sluggish external demand resulting from a synchronised global economic slowdown significantly impacted on Hong Kong's export performance. Merchandise exports contracted by 3% in real terms in 2001, with re-exports and domestic exports falling by 2% and 11% respectively. Export growth was already weaker in the first half of the year than the double-digit rise of the previous year, and further slowed in the latter part when external demand weakened. Imports also declined in 2001, in line with weaker re-exports and slower growth in domestic demand. As the contraction in exports outpaced that in imports, the merchandise trade deficit widened to \$89.8 billion in 2001, from \$88.7 billion in 2000 (Chart 2 and Table 2).

Growth in invisible trade also slowed from 2000. Exports of services registered a modest increase of 3.5% in real terms in 2001, compared with a growth of 14.1% in 2000. Among the major categories of services, financial services were the hardest hit. After achieving a moderate growth in the first half of the year, exports of travel services slackened in the wake of the 11 September events as inbound tourism plummeted. Imports of services recorded a modest growth in the first half, but slowed down in the second half. Taking invisible and visible trade together, Hong Kong achieved a trade surplus, of \$67.1 billion, for the consecutive fourth year.

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

**CHART 2**
**External merchandise trade**

**TABLE 2**
**Exports to major trading partners<sup>1</sup>**

	Share %	2000					2001				
		Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	37	21	23	23	17	21	8	1	3	-8	1
United States	22	19	13	14	11	14	-1	-10	-12	-15	-10
European Union	14	19	11	9	5	11	-3	-10	-14	-15	-11
Japan	6	20	20	20	18	19	14	4	-3	-10	1
ASEAN5 <sup>2</sup> + Korea	7	27	21	27	12	21	-3	-10	-17	-13	-11
Taiwan	2	23	26	25	11	21	-5	-10	-21	-9	-11
Others	11	16	12	15	10	13	-1	-7	-10	-17	-9
<b>Total</b>	<b>100</b>	<b>20</b>	<b>17</b>	<b>18</b>	<b>12</b>	<b>17</b>	<b>2</b>	<b>-5</b>	<b>-7</b>	<b>-12</b>	<b>-6</b>

<sup>1</sup> Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.

<sup>2</sup> ASEAN5 includes the Philippines, Malaysia, Indonesia, Singapore, and Thailand.

### Decline in consumer prices moderated

The decline in consumer prices slowed to 1.6% in 2001, compared with 3.8% in 2000. The pace of deflation moderated in the first seven months of the year owing to modest increases in wages and earnings, and upward adjustments in some Government fees and public utility charges. However, prices fell more sharply in the latter part of the year, reflecting a combination of factors, including weak domestic demand, declines in import prices and the waiver of public housing rentals in December. Import prices declined by 3.3% in 2001, reflecting weaker world commodity prices as well as the strengthening of the US dollar against most other currencies.

### Deterioration in labour market conditions

In the climate of economic slowdown and corporate cost cutting, labour market conditions deteriorated considerably in 2001. The unemployment rate rose steadily in the second half, and reached a high of 6.1% in the final quarter. The growth in total employment slowed to 1.3% in 2001 from 3.1% in the previous year (Chart 3). Employment in financial and personal services held steady while

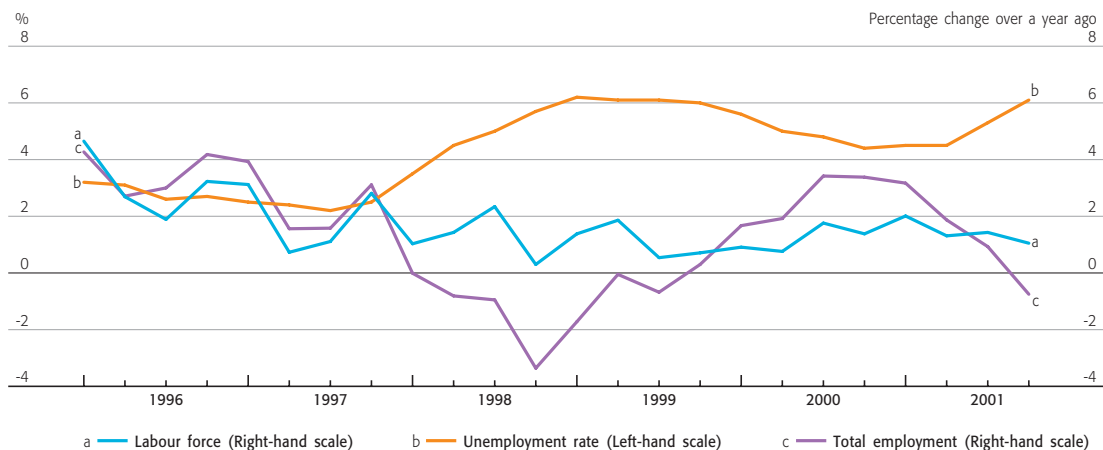
employment in trade, tourism and transport declined significantly. Outside the service sector, employment in manufacturing and construction shrank. Labour earnings and household income improved slightly in 2001, mainly attributable to pay rises at the beginning of the year on the back of the strong economic performance in 2000. The real payroll per person engaged rose by 3.5%. Median household income fell slightly in 2001 in nominal terms.

### Continuing corrections in asset markets

The local stock market was volatile in 2001, mirroring movements in the US markets. It rallied in the first few months of the year as the initial US interest rate cuts led to market optimism that the slowdown in the US might be short-lived. The market returned to a downward trend around the middle of the year as investor sentiment changed amid a worsening of the US economic downturn, signs of a synchronised global slowdown and persistent poor corporate earnings. Widespread anxieties in the global financial markets pushed the Hang Seng Index to a near three-year low of 8,934 on 21 September. However, the index recovered some of the lost ground, and closed the year at 11,397, representing a loss of 25% from the end of 2000.

CHART 3

#### Labour market



In the property market, residential property prices continued to decline in 2001. The deteriorating economic situation, falling share prices and rising unemployment outweighed the positive effect of lower mortgage rates and a suspension of flat sales under the Home Ownership Scheme/Private Sector Participation Scheme up to mid-2002. The events of 11 September further disrupted the property market, bringing it to a near standstill in late September and early October. Towards the end of the year, heavier discounts on prices and more flexible financing arrangements seem to have stimulated sales in the primary market. The number of transactions increased slightly in 2001 from 2000.

### Monetary situation

The local money and exchange markets were generally stable in 2001 despite increased volatility in the global financial markets. Short-term Hong Kong dollar interest rates stayed below their US dollar counterparts for most of 2001.

Hong Kong dollar narrow money grew considerably, while growth in broad money moderated during the year.

### The Hong Kong dollar remained stable

The Hong Kong dollar was stable against the US dollar under the Linked Exchange Rate system, notwithstanding increased volatility in the global financial market, a weakening Japanese yen and the financial crisis in Argentina, which, like Hong Kong, maintained a currency board system. The market exchange rate for the Hong Kong dollar tracked closely the convertibility rate throughout the year.

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 against other major currencies. Largely reflecting a strengthening of the US dollar against the yen, the euro and the British pound, the EERI rose during the first seven months of 2001 from 103 at the end of 2000 to 106 in mid-July 2001. Thereafter, the EERI fell slightly, along with the weakening of the US dollar against the yen and the euro. Towards the end of the year, the US dollar strengthened again against the yen in the face of a deepening recession in Japan, and the EERI rose back to close the year at 106.

### Hong Kong dollar interest rates stayed below their US dollar counterparts

Hong Kong dollar interest rates were on a general downtrend during the year, in parallel with the reduction in US interest rates. For most of the year, short-term Hong Kong dollar rates of six months and below stayed below their US dollar counterparts, largely reflecting abundant domestic liquidity. In terms of one-month money, the Hong Kong dollar interbank rate (HIBOR) eased from 6.1% to 2%.

### Narrow money rose amid lower interest rates

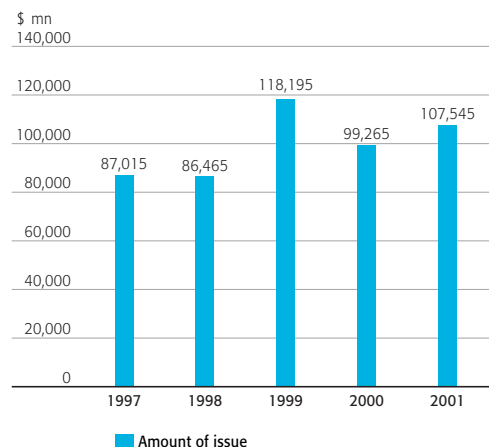
Growth of Hong Kong dollar narrow money accelerated during the year, reaching a year-on-year rate of 13% in December 2001, substantially outpacing growth in private consumption in nominal terms. This was in part due to the lower opportunity cost of holding narrow money amid continued decreases in deposit rates. Meanwhile, the growth of Hong Kong dollar broad money stabilised at around 5% in the first half of 2001, and moderated to near 1% by December 2001.

### Notes and coins

At the end of 2001, the total value of notes in circulation was \$107,545 million, an increase of 8.3% from a year earlier (Charts 4, 5 and 6). The total value of coins in circulation was \$5,466 million (excluding commemorative gold coins and coin sets), a decrease of 4.1% from a year earlier (Charts 7 and 8): the decrease may be due to increased usage of electronic payment systems.

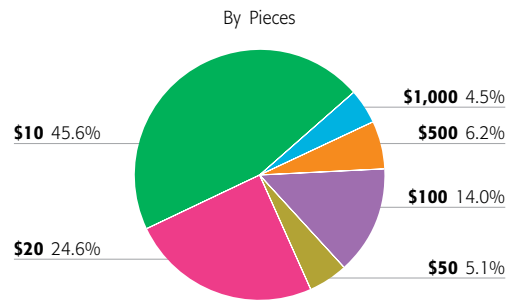
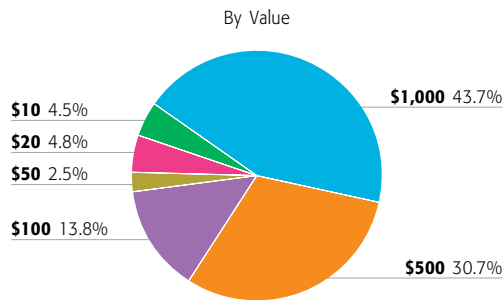
CHART 4

### Notes in circulation at end of year



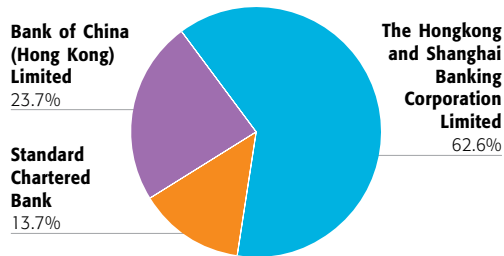
**CHART 5**

**Distribution of notes in circulation at end of 2001**



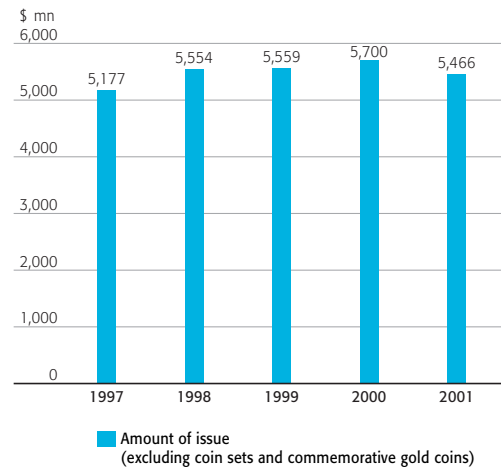
**CHART 6**

**Notes in circulation by note-issuing bank at end of 2001**



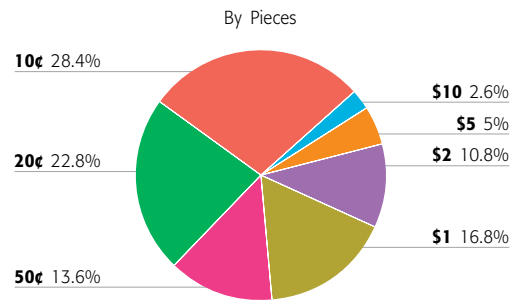
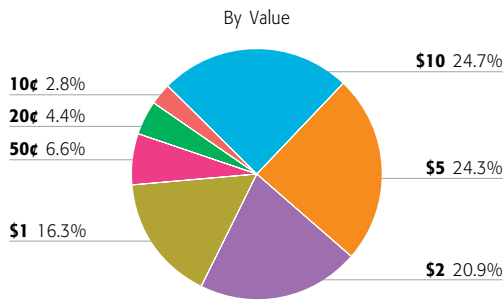
**CHART 7**

**Coins in circulation at end of year**



**CHART 8**

**Distribution of coins in circulation at end of 2001**



## Review of banknote design

The comprehensive review of the design of Hong Kong dollar banknotes, due for completion in 2002, has been progressing smoothly. Ahead of the completion of the review, as a measure to combat counterfeiting, new security features, including a holographic windowed thread, embedded fluorescent fibres and highlight watermarks have been added to the \$1,000 note. The Hongkong and Shanghai Banking Corporation Limited launched the new security features on its \$1,000 notes on 18 December 2000. The Bank of China (Hong Kong) Limited and Standard Chartered Bank followed on 20 June 2001.

## Coin stock

At the end of 2001, a stock of 1,163 million pieces of coins of all denominations was held in Hong Kong, ready to meet demand at any time. In addition, there was further stock of about 758 million pieces 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. As a result of the replacement exercise, the number of Queen's Head coins surfacing has declined progressively. In 2001, 19 million pieces of such coins were retired from circulation.



■ Deputy Chief Executive Tony Litter announces the launch of the enhanced \$1,000 banknotes of the Bank of China (Hong Kong) Limited and Standard Chartered Bank in June 2001.

## Outlook for the economy

### Growth prospect subject to great uncertainties of the global economy

The economic outlook in Hong Kong for 2002 crucially hinges on developments in the global economy. Monetary and fiscal stimulus provided in major industrial countries should provide support to a recovery of the world economy. Hong Kong should also benefit from China's accession to the World Trade Organisation. However, Japan is unlikely to provide a strong regional impetus as it struggles to lift its economy out of the recession.

Reflecting these considerations, the Hong Kong economy is expected to remain weak in the first part of 2002, but to experience a mild recovery later in the year. Following the sharp decline in 2001, exports are expected to grow modestly when the global economy begins to recover. Consumption and investment are expected to remain subdued for some time in the near term, as the rise in unemployment and weak asset prices weigh on consumer and business sentiment. Domestic demand should revive gradually in line with the recovery of the global economy and the lagged effects of low interest rates.

### Price and labour market adjustment to continue

Prices are expected to adjust further downward, in part reflecting the lagged effects of a considerable decline in rental prices in 2001, and weak import prices due to the depreciation of the yen. The lifting of restrictions on some frozen food items imported from the Mainland in 2002 may also place some downward pressure on consumer prices. The labour market may remain weak in the immediate future, but should improve in the latter part of the year as the economy recovers. The Government's plan to create over 30,000 new jobs (equivalent to 1% of the total labour force), announced in the Policy Address in October 2001, should also help to reduce the unemployment rate.



## Performance of the banking sector

The operating environment in 2001 was challenging, with banks having to contend with the weak state of the domestic and global economy, exacerbated by the events of 11 September, and an unfamiliar low interest rate environment. Nonetheless, the banking sector remained strong and resilient.

The series of interest rate cuts during the year served to make debt servicing more affordable, thereby helping to protect asset quality. However, the cuts failed to stimulate domestic loan demand, which remained weak. With the banks very liquid and keen to lend, but lending volumes shrinking, competition for business intensified. With competition sharply reducing the margins on residential mortgage lending, and little loan demand from the corporate sector, banks turned increasingly to other types of consumer lending, such as credit card business, personal loans and wealth management products to provide some asset growth and broaden income sources.

The final phase of interest rate deregulation, which took place on 3 July 2001, proceeded smoothly. Given the large amount of liquidity in the system, deregulation did not immediately intensify competition for deposits, which might impact on banks' cost of funding and thereby on their profitability. However, this situation may change when lending picks up.

The aggregate balance sheet of the banking sector contracted by 7.6% in 2001, with loans to customers contracting by 11.2% and deposits from customers by 3.6%. Despite the contraction in lending, the retail banks' aggregate operating profits declined only moderately, by 3.6%, in 2001. As usual, however, there was wide variation from institution to institution.

## Low interest rate environment

Following the cuts in the US Federal Fund rate, Hong Kong dollar interest rates moved downwards and reached historical lows in 2001. The domestic best lending rate fell by a total of 438 basis points

## Introduction of the "retail banks" grouping

With effect from this Annual Report, a new bank grouping, termed "retail banks", is introduced for the purpose of presenting statistics. This grouping comprises all the locally incorporated banks plus a number of the larger foreign banks that are not locally incorporated but whose operations are similar to those of the locally incorporated banks in that they operate a branch network and are active in retail banking. The thinking behind creating this new grouping is that it will be more

representative of "mainstream banking" trends in Hong Kong than the "all authorized institutions" grouping (which includes many institutions whose activities are primarily of an offshore or wholesale nature), while at the same time it will capture a greater percentage of domestic lending and deposits (around three-quarters of the total) than the "locally incorporated banks" grouping (around one half of the total).

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 2000	4.88	4.91	5.08	5.80	5.95	6.17	4.75	9.50
Q1 2001	4.09	4.06	4.01	5.17	5.08	4.94	3.94	8.69
Q2 2001	2.79	2.82	3.02	4.04	4.02	4.25	2.65	7.40
Q3 2001	1.99	1.98	2.21	3.30	3.28	3.44	1.73	6.59
Q4 2001	0.64	0.65	0.96	1.93	1.92	2.36	0.37	5.33
2000*	4.80	4.97	5.40	5.95	6.12	6.63	4.47	9.22
2001*	2.38	2.38	2.55	3.61	3.57	3.75	2.17	7.00

\* annual average figures

during the year, and banks reduced their savings rate to a low of 0.25%. One-month HIBOR decreased to an annual average of 3.61% from 5.95% in 2000 and the one-month time deposit rate to 2.38% from 4.80% (Table 3). Because of the faster decline in average one-month HIBOR than in the average best lending rate, the spread between these rates widened to 339 basis points, compared with 326 basis points in 2000.

For the first time in many years, total customer deposits contracted during the year, by 3.6% against an increase of 9.6% in 2000 (Chart 9). This is not surprising in view of the low interest rate environment and the lack of domestic credit expansion. Foreign currency deposits contracted sharply by 7.8%, while Hong Kong dollar deposits rose marginally by 0.2% (Chart 10). Reflecting this, the share of Hong Kong dollar deposits to total deposits rose to 55.1% at the end of 2001 from 53.1% at the end of 2000.

CHART 9

**Growth of total customer deposits (year-on-year)**

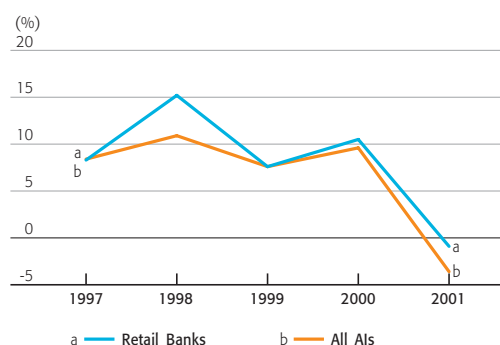
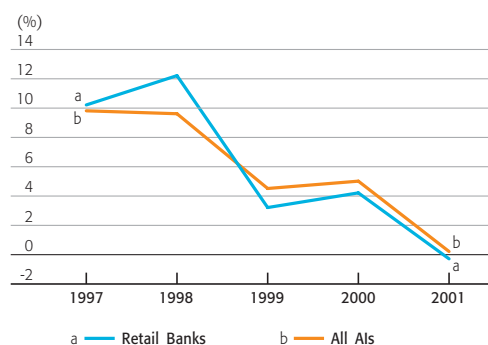


CHART 10

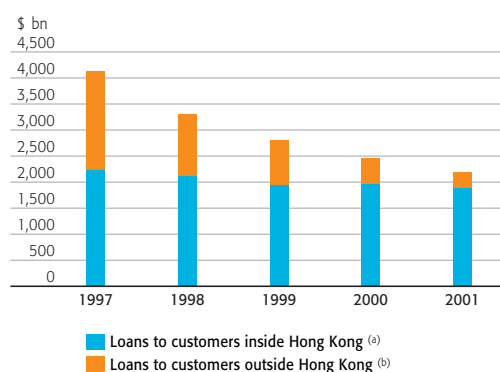
**Growth of Hong Kong dollar deposits\* (year-on-year)**



\* Including swap deposits

CHART 11

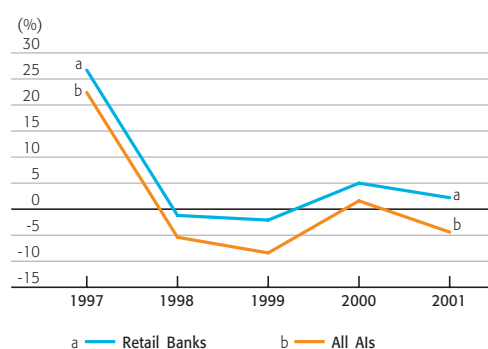
**Loans to customers inside and outside Hong Kong (All AIs)**



Notes:  
 (a) Defined as loans for use in Hong Kong plus trade financing loans  
 (b) Includes "others" (i.e. unallocated)

CHART 12

**Growth of loans to customers inside Hong Kong\* (year-on-year)**



\* Defined as loans for use in Hong Kong plus trade financing loans

**Continued fall in offshore lending**

Total loans to customers declined for the fourth consecutive year, by 11.2%, in 2001 (Chart 11). Much of the decline in total lending continued to be in loans to customers outside Hong Kong, caused by the contraction in the Japanese banks' euroyen lending activities. This has little impact on Hong Kong's domestic economy and market liquidity as Hong Kong acts only as a booking centre for such loans. Euroyen loans accounted for 7.0% of total loans to customers at the end of 2001 compared to 11.4% a year before and the peak of 49.5% at the end of September 1995.

**Weak demand for domestic lending**

Affected by the weakening of the economy, loans to customers inside Hong Kong fell by 4.4% in 2001 against an increase of 1.6% in 2000 (Chart 12). Reflecting a subdued property market, property lending dropped by 1.0% after

rising by 1.6% in 2000. Within this, lending for property development and investment fell by 4.4% and 2.0% respectively, compared with increases of 5.5% and 2.1% in 2000. Residential mortgage loans (excluding loans under Home Ownership Scheme and Private Sector Participation Scheme), however, grew modestly by 0.4% after rising by 0.5% in the preceding year due to the lower interest rates and favourable sales programmes launched by property developers. The competition among banks for residential business remained intense, as reflected by the continued lowering of mortgage rates to an all-time low of 2.6% below the best lending rate for new mortgage loans.

After significant growth of 177.3% in 2000, loans to the electricity, gas and telecommunications sector registered a decline of 25.7% in 2001. Within this, aggregate lending to the telecommunications sector<sup>1</sup>, which represented 1.8% of the banking sector's loans to customers inside Hong Kong, dropped by 41.8% to \$33.7 billion at the end of 2001 from \$57.8 billion at the end of 2000. This was largely due to loan repayments. There have been recent moves by this sector towards cheaper funding through the issue of debt.

While the decline in loans to manufacturing slowed to 2.5% in 2001 from 7.5% in 2000, loans to the wholesale and retail sector fell by 15.7% following a drop of 16.0% in 2000. In line with the subdued stock market, loans to stockbroking companies declined by 2.6%, compared with an increase of 52.1% in the preceding year, and loans to non-stockbroking companies and individuals to purchase share also fell markedly by 39.8%, following a decline of 24.8% in 2000.

Consumer lending, however, increased, particularly in the area of credit cards. According to the survey of AIs active in credit card businesses, the number of credit card accounts and total credit card receivables totalled

9.2 million and \$62.1 billion respectively at the end of 2001, up from 7.2 million and \$51.2 billion respectively at the end of 2000. After discounting a change in the reporting population, the figures showed an increase of 16.4% and 14.5% respectively in 2001 after rising by 23.9% and 27.3% in 2000.

The banking sector's exposure to non-bank Chinese entities declined by 17.8% during the year to \$159.8 billion at the end of 2001, representing 2.4% of the sector's total assets. The reduction was mainly caused by write-offs and loan repayments.

### Continued high level of liquidity

The loan-to-deposit ratios of the banking sector remained historically low throughout 2001. The all-currencies ratio declined to 65.1% at the end of 2001 from 70.7% at the end of 2000 due to the faster decline in loans, particularly in offshore loans, than in deposits. The Hong Kong dollar ratio also declined marginally to 89.0% from 89.4%. In contrast, both the all-currencies and the Hong Kong dollar ratios of the retail banks rose, to 54.4% from 53.1% at the end of 2000 and to 77.3% from 73.4% respectively, reflecting an increase in lending by the retail banks and a decrease in their customer deposits.

As in previous years, investment in negotiable debt instruments (NDIs) continued to offer a conduit for employment of banks' surplus funds. The holding of NDIs (other than negotiable certificate of deposits (NCDs)) by the banking sector rose by 20.1% following a growth of 29.8% in 2000 as banks placed their surplus funds in these instruments amid limited lending opportunities. Total holdings of NDIs as a percentage of the banking sector's total assets thus grew to 14.7% (11.4% at the end of 2000).

In the light of a declining interest rate environment and high liquidity in the sector, funding through NCDs issued continued to drop, by 2.9%, following a decline of 10.9% in 2000. The contraction came largely in Hong Kong dollar denominated NCDs. As a result, the share of Hong Kong dollar denominated NCDs to total outstanding fell to 78.3% at the end of 2001 from 85.3% at the end of 2000. Of these, 55.3% were held by AIs compared with 60.8% in 2000.

<sup>1</sup> Comprising on-balance sheet lending booked in Hong Kong offices only.

### Profitability held up well

Despite the difficult operating environment, the pre-tax operating profits of the retail banks in respect of their Hong Kong offices recorded only a moderate decline, by 3.6% (Chart 13), following a strong recovery in 2000. This was largely due to a double-digit increase in operating expenses and flat net interest income resulting from the continued squeeze in lending margins, particularly for the residential mortgage business.

The decline was, however, moderated by a decline in the bad debt charge, which fell to 0.33% of average total assets compared to 0.44% in 2000 (Chart 14). The cost-income ratio rose to 42.9% in 2001 from 38.1% in 2000 (Chart 15). Reflecting largely the increase in average interest bearing assets, net interest margin (NIM) fell to 2.03% from 2.14% in 2000 (Chart 16).

CHART 13

#### Growth of operating profit (year-on-year)

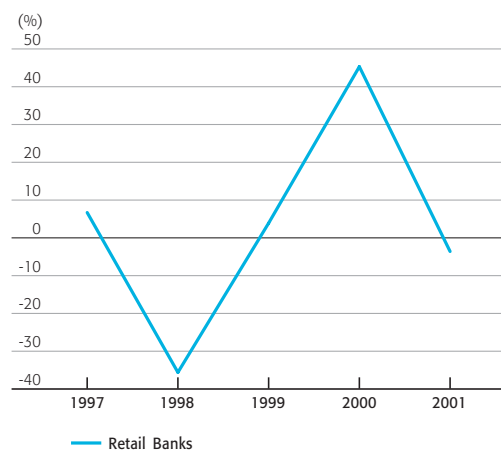


CHART 14

#### Bad debt charge as percentage of average total assets

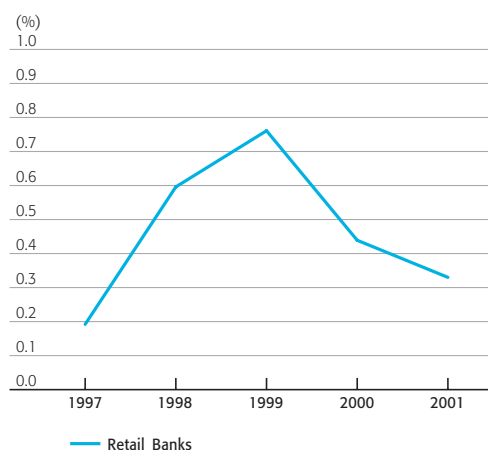


CHART 15

#### Cost-income ratio

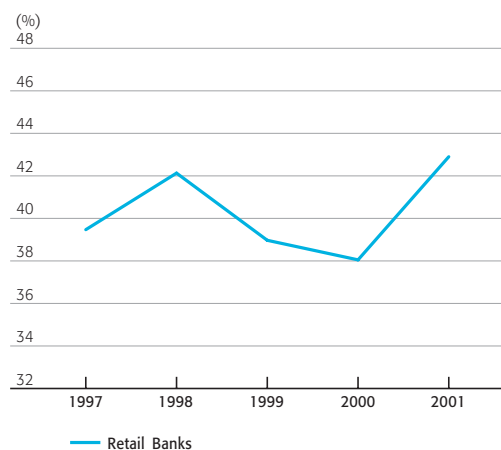
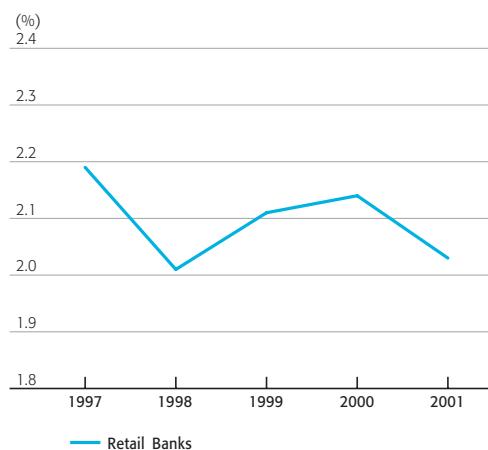


CHART 16

#### Net interest margin



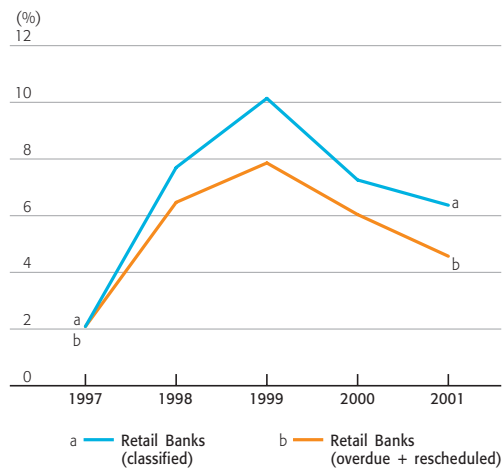
### Continued improvement in asset quality

With low interest rates making debt servicing easier for borrowers, the overall asset quality of institutions' loan portfolio continued to improve in 2001. For retail banks, the ratio of classified loans declined to 6.37% of total loans at the end of 2001, while the combined ratio of overdue and rescheduled loans dropped to 4.57% (Chart 17). Within the latter, loans overdue for more than three months and rescheduled loans fell to 3.96% and 0.61% respectively. Similarly, non-performing loans fell to 4.74%.

For the banking sector as a whole, the ratio of classified loans fell to 5.63% at the end of 2001. Loans overdue for more than three months decreased to 3.49%. Together with the decline in rescheduled loans to 0.68%, the combined ratio of overdue and rescheduled loans fell to 4.17%. The ratio of non-performing loans also decreased to 4.09%.

CHART 17

#### Gross classified loans and overdue and rescheduled loans as percentage of total loans

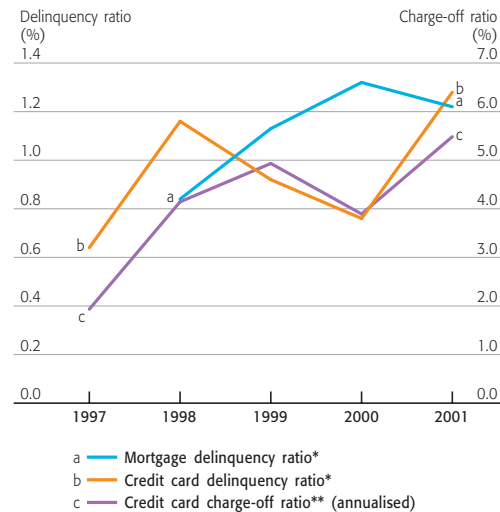


According to the monthly survey, the quality of banks' residential mortgage portfolio continued to improve in 2001. The delinquency ratio for such loans rose from 1.32% at the end of 2000 to peak at 1.43% at the end of April 2001 but ended the year at 1.22% (Chart 18). The rescheduled loan ratio increased to 0.26% from 0.19% at the end of December 2000. Despite concerns about the effects of the economic slowdown, the low interest rate environment together with the banks' willingness to restructure mortgage loans with their customers appears to have helped reduce pressure on the mortgage delinquency ratio.

In contrast, the quality of credit card receivables worsened. According to the monthly survey, the delinquency ratio stood at 1.28% at the end of 2001 compared to 0.76% at the end of 2000 and the annual charge-off ratio was 5.47% compared to 3.88% for 2000 (Chart 18).

CHART 18

#### Asset quality of credit card and mortgage lending (surveyed institutions)



\* There is a break in series at December 2000 owing to an increase in the number of surveyed institutions.

\*\* There is a break in series at Q4 2001 owing to an increase in the number of surveyed institutions.

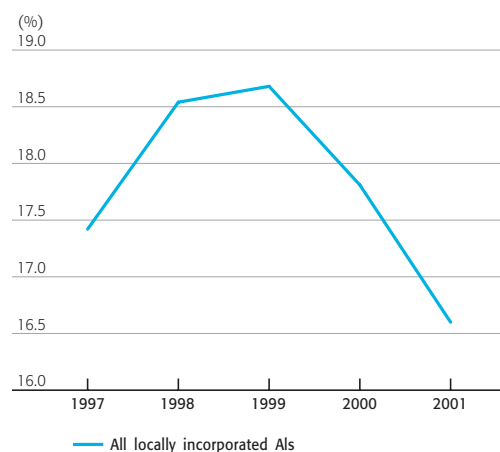
The deterioration was largely attributable to the sharp increase in the number of personal bankruptcies and a change in policy by a number of banks which began charging off accounts once a bankruptcy petition was made rather than when a bankruptcy order was made.

### Capital strength remained strong

The average consolidated capital adequacy ratio of all locally incorporated AIs was 16.6% at the end of 2001, a drop from 17.8% at the end of 2000 (Chart 19). This reflects in part the effects of changes in the reporting population. The capital strength of local AIs remains very strong by international standards.

CHART 19

### Consolidated capital adequacy ratio



### Prospects for 2002

The operating environment remained difficult in the early part of 2002 and is likely to remain so for much, if not all, of the year. In the absence of further major shocks, which could worsen the situation, the banks are generally expecting some modest recovery in lending, but also some increase in provisions, although asset quality is not expected to deteriorate substantially. On profitability, again there is unlikely to be substantial variation, but overall some profit growth may be achieved.

The banks are under pressure to improve their services to maintain their profitability while facing challenges of increased customer awareness and intense competition. In view of this environment, banks' strategies are likely to include focusing on diversifying income by source and by type; enhancing asset and liability management; cost-cutting (including relocation of back offices and outsourcing, and greater use of technology, including the internet and ATMs); and developing business in Mainland China. For the local banks, consolidation, with the objective of achieving economies of scale, is likely to remain an issue for consideration.