

ANNUAL REPORT 2001



HONG KONG MONETARY AUTHORITY
香港金融管理局



SUMMARY VERSION

Understanding this Summary Report

This booklet presents a summary of the HKMA's Annual Report for 2001, published in 2002. The full Annual Report may be purchased from the HKMA for HK\$110 (see the contact details on the back cover). It is also available, in interactive form, on the HKMA's website at www.hkma.gov.hk

A number of HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include:

HKMA Publications	Price
HKMA Factsheets	No charge
New Security Features for Hong Kong's \$1,000 Banknote	No charge
Security Features for Hong Kong Coins	No charge
HKMA Background Brief No. 1: Hong Kong's Linked Exchange Rate System	HK\$20
Money in Hong Kong: A Brief Introduction	HK\$30
Guide to Hong Kong Monetary and Banking Terms (Second Edition)	HK\$50
HKMA Quarterly Bulletin	HK\$100
HKMA Monthly Statistical Bulletin	HK\$50

These publications are available direct from the HKMA. They can also be found on the HKMA's website.

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All amounts in this Summary Report are in Hong Kong dollars unless otherwise stated.

The Hong Kong Monetary Authority

The Hong Kong Monetary Authority is the government authority responsible for:

- keeping the Hong Kong dollar stable
- managing the Exchange Fund — Hong Kong's official reserves — in a sound and effective way
- promoting the safety of Hong Kong's banking system
- developing Hong Kong's financial infrastructure

The HKMA was established in 1993. Its main functions and responsibilities are governed by the Exchange Fund Ordinance and the Banking Ordinance. It reports to the Financial Secretary.

Three advisory committees, comprising expert members of the financial community, advise the Financial Secretary on the policies and work of the HKMA:

- The **Exchange Fund Advisory Committee** advises on general policy relating to the deployment of the Exchange Fund. Its **Sub-Committee on Currency Board Operations** advises on the operation and development of the Currency Board arrangements in Hong Kong.
- The **Banking Advisory Committee** advises on matters relating to the Banking Ordinance, particularly to banks and the carrying out of banking business.
- The **Deposit-taking Companies Advisory Committee** advises on matters relating to the Banking Ordinance, particularly to deposit-taking companies and restricted licence banks.

Chief Executive's Statement



A difficult year

Hong Kong experienced difficult times in 2001. The world economic downturn, exacerbated by the events of 11 September, put pressure on an economy which, despite the rebound in 2000, had still not fully recovered from the Asian financial crisis of the late nineties. New anxieties and hardships brought further challenges to our stamina and self-confidence as a community.

The growth rate of gross domestic product in real terms was virtually flat and slipped from positive to negative as the year progressed. The unemployment rate rose from 4.4% in the last quarter of 2000 to 6.1% in the last quarter of 2001. Property and share prices declined further. Price deflation, at 1.6%, continued, although at a slower pace than in 2000.

The effects of this downturn on Hong Kong are without question negative. But, while it is natural in times like this that there should be debate about Hong Kong's future direction and viability as an international city, it should also be understood that the adverse influences currently affecting our economy are mainly external. This point is underlined by the fact that most of our neighbours were also affected – to varying degrees – by the sudden deterioration in the US, by the deepening malaise in Japan, and by the slowdown in most of the rest of the industrial world.

Our economic fundamentals remain strong, and our inherent qualities as a free and open city are as vital as ever. Our financial and banking systems have continued to be robust, despite prolonged economic problems and the

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dramatic fall in asset prices. Under our effective and credible Currency Board system, which has been greatly strengthened in recent years, the Hong Kong dollar has seen no repeat of the shocks it experienced in 1997-8: it remained remarkably stable in 2001, despite instabilities elsewhere in the world.

Against the background of these fundamental strengths, three processes, now in train, give grounds for optimism about the future. The first of these is our progressive economic integration with the Mainland of China, an enterprise that has been in progress for more than a generation now, but which has received added impetus from China's accession to the World Trade Organisation in 2001, and from the fact that – alone among the major economies – China continues to enjoy substantial economic growth. The second process is the internal price adjustments and economic restructuring that have been taking place in Hong Kong within the discipline of the Linked Exchange Rate system. This is unpleasant medicine because it involves pain and distress. But it will help ensure that Hong Kong maintains, and increases, its competitiveness in a deeper and more lasting way than could be achieved through currency devaluation. The third process is the global recovery that will inevitably follow the synchronised global slowdown that began in 2001. The signs, in early 2002, are that this recovery may arise earlier than many had feared, although it is too soon to say whether it will be sustained. What is important is that Hong Kong should continue to position itself to get the best out of recovery – as we have done in previous recoveries, and as we did in the dramatic but short-lived recovery of 2000. A large part of this task involves shaping, consolidating, and promoting Hong Kong's role as an international financial centre at a time when considerable opportunities are coming into view.

Infrastructure for an international financial centre

In recent years Hong Kong has increasingly assumed the role of premier financial centre in the Asian time zone. A number of well-known factors have contributed to this: our geographical position, our free and open markets, the rule of law, and the critical mass of expertise and experience that has accumulated in the financial industry over time. Less often acknowledged, because it is practically invisible, is the financial infrastructure itself – the network which connects the parts of our financial industry with each other and with other parts of the world, the channels which carry money around quickly, safely and efficiently, and the machinery which clears and settles the millions of transactions that take place in our city each day.

The reliability of this infrastructure and its capacity to take on new forms of transactions are critical if we are to expand and deepen our financial business and develop further as an international financial centre. Indeed, the advanced state of Hong Kong's financial infrastructure is one of Hong Kong's greatest competitive advantages as an international

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financial centre. The objective should be to ensure that Hong Kong has a financial infrastructure that not only meets present needs but also anticipates future market opportunities. The strategy in pursuing this objective consists of three main tasks: developing domestic financial activity; drawing in international financial activity; and deepening and

expanding financial activity between Hong Kong and the Mainland. To achieve these objectives, Hong Kong's financial infrastructure has to have the capacity, efficiency, accessibility, diversity and flexibility to prepare for the emerging opportunities in the region, and to be able to catch these opportunities before they pass us by.

Because of its nature and scale, developing this infrastructure has been an enterprise initiated largely by the public sector, through the HKMA, although it is an enterprise that we pursue in collaboration with the banking and financial industry, and one that has many private-sector characteristics. We saw considerable progress in 2001. Hong Kong further consolidated its position within the Asian time zone with the first full year of operation of our new US dollar clearing system, which saw a steady increase in business – much of it from outside Hong Kong. We are now working on plans for introducing parallel clearing systems for other major currencies, such as the euro and yen, using the same advanced Real Time Gross Settlement technology that supports our Hong Kong dollar and US dollar systems.

We continued to extend our linkages with other jurisdictions during the year. Work in this area ranged from improving cheque clearing facilities between Hong Kong and Guangdong province to agreeing on a new automated real-time link between our Central Moneymarkets Unit (CMU) and Euroclear, which will take effect in late 2002. The link between the CMU and Euroclear will enable financial institutions in the region to hold and settle international debt securities lodged with Euroclear through their accounts held in Hong Kong: it is a key part of our strategy for developing the CMU into a full international central securities depository. In parallel with our efforts to develop the hardware for the system, we continued to foster the development of the debt market, both in Hong Kong and in the region generally. In 2001 this work focused on promoting greater transparency and liquidity in the Hong Kong dollar debt market and on enhancing market-making arrangements for Exchange Fund Bills and Notes. An encouraging development in 2001 was the very substantial increase in the size of the retail bond market.

In providing Hong Kong with the equipment and linkages to serve a wider region, rather than just our own markets, we must increasingly take into account the needs of finance on the Mainland of China. Years of positive economic growth in China have produced an accumulation of wealth and capital and an abundance of talent and expectations. China's accession to the World Trade Organisation in 2001 opens up many possibilities for the future. Hong Kong is China's natural international financial centre, and it is the ideal testing ground for future opportunities arising, for example, out of the gradual relaxation of controls on the renminbi. Within the framework of "one country, two monetary systems" the HKMA has, for some time, been in practical and detailed discussions with our Mainland counterparts about how best Hong Kong can assist and participate in China's future financial development. The recent constructive discussion on the Mainland about Hong Kong's potential future financial intermediation roles has been most encouraging.

Competitive, safe and efficient banks

The banking system is at the core of any international financial centre. Unlike infrastructural development (which is largely a public-sector initiative), the growth and development of the banking system is a matter of market competition. The great number of banks operating in Hong Kong, and their diversity – in size, geographical origin, and focus of business – are a reflection of Hong Kong's pull as a financial centre and of market competition at work. The aim of our policies in helping to develop the banking system in Hong Kong is to facilitate greater competition within the banking industry by removing barriers to competition. The main achievement in this area in 2001 was the successful implementation in July of the final phase of interest rate deregulation – affecting Hong Kong dollar savings and current accounts – and the removal of the three-building limit applicable to foreign banks licensed after 1978.

The year also saw considerable progress in the trend – led by market forces but facilitated by the responsive approach adopted by the HKMA – of consolidation in the banking industry within Hong Kong, with the completion of a number of major mergers and acquisitions. We welcome consolidation because it strengthens the banking system within Hong Kong and enables Hong Kong's banks to play a more active role globally, in the region and on the Mainland.

The counterpart to our focus on facilitating competition is an equal focus on the safety and soundness of the banking industry, in view of the potential effects of failure on both the depositor and on the system as a whole. Hong Kong's banks faced an extremely challenging operating environment in 2001, in which they had to contend with the weak state of the economy and with the unfamiliarity of low interest rates.

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Yet the banking sector maintained high levels of liquidity and capital strength, saw continued improvement in overall asset quality, and recorded only a moderate decline in profitability. Clearly, Hong Kong's banking industry remains safe and resilient. Our aim is make sure that this continues to be the case, through

further improvements to our supervisory tools and through measures to ensure that problems faced by individual banks – should they occur – do not become systemic problems for the banking system as a whole.

Our supervisory initiatives in 2001 included extending the risk-based supervisory approach to major local banks and foreign bank branches, strengthening the corporate governance of banks, and focusing on issues of concern, such as the deterioration in credit card default rates. We took further our plans for a deposit insurance scheme in Hong Kong by developing a preliminary design and consulting the industry further. We also finalised recommendations for a commercial credit reference agency, and worked with the industry and other interested organisations to promote proposals for the sharing of positive consumer credit data.

During the year we saw an increased interest in consumer issues relating to banking services, arising from a number of factors. One of these was the introduction of new fees and charges by many banks, reflecting the need, in a difficult operating environment and in a period of intensifying competition, for them to focus on cost recovery. In general, banks have been sensitive and constructive in ensuring that all groups in society have access to basic banking services. While the HKMA's policy is not to interfere in the pricing of services, which are commercial decisions, we paid particular attention to questions of transparency and consumer-friendliness in the comprehensive review we carried out with the industry of the *Code of Banking Practice*, which became effective on 1 December. In view of a general rise in complaints about bank services in 2001, the HKMA began studying the question of whether powers should be available, either to the HKMA or to a special ombudsman, for dealing with complaints about banks. We continue to keep this question under review, in consultation with the industry and the community generally. Our current view, however, is that the present arrangements for handling complaints (which centre largely on the banks themselves, under monitoring by the HKMA) are working reasonably well. These arrangements were strengthened in early 2002 with the issue of a detailed new Guideline on the handling of complaints.

Separately, the issue of negative equity, affecting, we believe, some 16% of domestic mortgage borrowers, came to a head in 2001, as the continuing decline in prices made many properties worth less than the value of the outstanding mortgages taken out to finance them. The HKMA helped facilitate relief to homeowners in this position by indicating that it would not object to banks refinancing residential mortgages in negative equity up to 100% of the current market value of the property. We also encouraged banks to set up centralised units or hotlines to deal with the issue.

A stable Hong Kong dollar

A strong, flexible and efficient banking system is an essential factor in currency stability, particularly in a Linked Exchange Rate system, such as exists in Hong Kong, under which banks must be able to cope with any fluctuations in interest rates that may arise through the operations of the Currency Board. Despite considerable volatilities across the world financial system, such fluctuations have, in fact, been mild in recent years. This is attributable in part to the technical reforms of 1998, which have been successful in cushioning the Currency Board system against extreme volatilities. Equally important, it is evidence of the confidence, internationally and locally, in the Hong Kong dollar, and the increasing willingness of markets to view the Hong Kong dollar in a rational way. This confidence depends on a recognition of our economic fundamentals, which remain strong and well understood.

Foremost among these fundamentals is our flexible and responsive economy, which enables prices and costs to adjust without the need to move the exchange rate. In addition, our Exchange Fund, which, against expectations, showed a modest investment profit in 2001, provides ample foreign exchange backing to support the Link. Our Government continues to pursue a prudent fiscal policy. Growing concerns emerged during the year about the continuing fiscal deficit, notwithstanding the availability of large accumulated fiscal reserves. It is now clear that the fiscal deficit is the product not only of the prolonged economic downturn but also of what is now generally recognised to be a structural imbalance in Hong Kong's public finances. This imbalance is now being actively addressed by the Government with the aim of restoring fiscal balance over the medium term. The imbalance presents no immediate threat to monetary stability.

The larger question of whether the Link is in Hong Kong's best interests once again became a topic of public debate in 2001. It is natural that there should be such questions at a time of economic distress and rapid change, and it is right that the merits and shortcomings of the Link should be debated whatever the conditions we are facing – although even its strongest critics would not argue that the Link should be

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changed in difficult times such as this. The balance of the arguments is clearly in favour of the Link. It provides a predictable and conducive business environment for an economy which imports practically everything that it consumes, processes or re-exports. And, for a financial centre with heavy international capital flows

but no capital controls, linking our currency to a strong international currency provides stability and strength. Those who advocate changing it have not been able to propose a better alternative.

Confidence in Hong Kong's financial system

The debate about the Link should be put into perspective. We believe that the majority of the community recognise the value of the Link to Hong Kong and understand that there would be no benefit to Hong Kong in changing or abolishing it. There is confidence in the Link, both at home and overseas. And there is confidence in the other components of Hong Kong's financial system: in the safety of our banks, the efficiency of our retail payment systems, the reliability of our clearing systems. Part of our job as a monetary authority is to seek to maintain and strengthen this confidence. We do this, for example, by increasing the transparency of what we do, whether it be in terms of our daily operations or in the thinking behind our broader policy initiatives. We seek to promote a broad understanding of our work among the general public through our contacts with the media, our website, and our many educational initiatives. We also place emphasis on consulting the community and its representatives about planned initiatives and policies and measures in progress: in 2001 we attended a total of 45 Legislative Council Panel and Committee meetings to discuss a variety of issues.

Confidence in Hong Kong's financial system also requires that real or potential threats to its stability, whether large or small, are addressed promptly and effectively. We do this quietly in our day-to-day supervisory work of banks and other authorized institutions. We did it quickly and successfully in 2000-2001 by working with the note-issuing banks and Hong Kong Note Printing Limited to add new security features to the \$1,000 banknotes when the spread of counterfeits began to undermine public trust in the note: partly as a result of this measure, counterfeit notes discovered in 2001 declined by 26%. The tragic events of 11 September forced us to take a harder look at our already well-developed contingency plans and to implement measures in support of the global effort to trace terrorist money.

More broadly, in our participation on behalf of Hong Kong in a number of international bodies, we have been seeking to promote reforms to the international financial architecture that will reduce the risk of volatility and crisis for small and open markets. This has proved to be a slow process. But there was some encouraging progress in this area in 2001 with the promulgation internationally of good practice guidelines for foreign exchange, and with various bilateral initiatives.

Maintaining confidence in our financial system requires constant vigilance and responsiveness on the part of the regulator and a strong record of safety and efficiency in the industries that operate the system. It is not an easy set of tasks in any environment. And the fact that the stability and safety of Hong Kong's monetary and banking systems have not been brought seriously into question during this period of economic distress is a remarkable indicator of Hong Kong's energy and resources as a financial centre.

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The past year has been another challenging and productive one for the HKMA. It is largely owing to the determination and resourcefulness of the staff of the HKMA that we have been able to fulfil all of our major policy objectives, and to achieve more besides. I take great pleasure in recording here my appreciation of the effort and commitment they have put into their work, and my thanks for the strong and helpful guidance received from the Financial Secretary and the Exchange Fund Advisory Committee.



Joseph Yam
Chief Executive

Economic and Banking Environment



Performance of the economy in 2001

Hong Kong went through a difficult year in 2001. Real Gross Domestic Product remained virtually flat during the year, reflecting weak domestic and external demand. Local financial markets remained broadly stable.

Prospects for 2002

Hong Kong's economy is expected to grow moderately in 2002, in line with the general expectations of a gradual recovery in the global economy.

Banknotes

A comprehensive review of the design of Hong Kong's banknotes is progressing smoothly. The Bank of China (Hong Kong) Limited and Standard Chartered Bank introduced new security features on their \$1,000 notes in June 2001, following the introduction of similar new features on The Hongkong and Shanghai Banking Corporation Limited \$1,000 notes in December 2000.

■ The HKMA, Bank of China (Hong Kong) Limited and Standard Chartered Bank announce the launch of enhanced \$1,000 notes with new security features.



Hong Kong's economy in 2001

	2000	2001
Economic Growth and Inflation		
– Real growth in Gross Domestic Product (%)	10.5	0.1 ^(a)
of which:		
Real growth in private consumption expenditure (%)	5.4	2.0 ^(a)
Real growth in gross domestic fixed capital formation (%)	9.8	2.1 ^(a)
Real growth in exports (%)	16.7	-2.1 ^(a)
Real growth in imports (%)	16.7	-2.2 ^(a)
– Composite Consumer Price Index (annual change, %)	-3.8	-1.6
Labour Market		
– Employment (annual change, %)	3.1	1.3
– Unemployment rate (annual average, %)	4.9	5.1
Money Supply (annual change, %)		
– Hong Kong money supply (M1)	-0.7	12.8
– Hong Kong money supply (M2) ^(b)	3.9	0.5
– Hong Kong money supply (M3) ^(b)	4.0	0.7
Interest Rates (end of year, %)		
– Savings deposit rate	4.75	0.15
– Best lending rate	9.50	5.13
– Three-month interbank rate	5.75	1.88
Exchange Rates (end of year)		
– Hong Kong dollar/US dollar	7.796	7.797
– Trade-weighted effective exchange rate index (Nov 83 =100)	136.0	141.1
Hang Seng Index (end of year)	15,096	11,397

^(a) The estimates are preliminary.

^(b) Adjusted to include foreign currency swap deposits.

Performance of the banking sector in 2001

The operating environment for the banking sector continued to be difficult. Domestic loan demand was sluggish amid the domestic and global economic slowdown, which was exacerbated by the events of 11 September. However, the overall asset quality of the banking sector improved and the profitability of retail banks held up well, recording only a moderate decline. The capital and liquidity positions of the sector also remained strong.

Greater focus on consumer lending

As competition sharply reduced the margins on residential mortgage lending, and there was little loan demand from the corporate sector, banks turned increasingly to other types of lending, such as credit card business, personal loans and wealth management products. The rapid increase of credit card business was, however, accompanied by a marked worsening of the quality of the receivables.

Prospects for the banking sector in 2002

The operating environment is expected to remain difficult for much of 2002. Banks' strategies are likely to focus on:

- further diversification of income by source and by type;
- enhancement of asset and liability management;
- cost-cutting measures, including relocation of back offices and outsourcing, and greater use of technology such as the Internet and automatic teller machines;
- developing business in Mainland China;
- achieving economies of scale through consolidation.

Performance ratios of Hong Kong's banking sector in 2001

	2000	2001	2000	2001
	%	%	%	%
	All AIs		Retail banks*	
Profitability¹				
– Growth of pre-tax operating profit	N.A.	N.A.	45.2	-3.6
– Return on assets (operating profit)	0.84	0.87	1.33	1.22
– Return on assets (post-tax profit)	0.77	0.80	1.16	1.12
– Net interest margin	1.43	1.45	2.14	2.03
– Bad debt charge to average total assets	0.26	0.20	0.44	0.33
Business Profile¹				
– Growth in loans to customers	-12.5	-11.2	4.5	1.6
– Growth in customer deposits (all currencies)	9.6	-3.6	10.5	-0.9
– Hong Kong dollar loan to deposit ² ratio	89.4	89.0	73.4	77.3
Asset Quality³				
– Classified loans ⁴ as % of total loans	6.08	5.63	7.26	6.37
– Non-performing loans ⁵ as % of total loans	4.72	4.09	5.87	4.74
			All locally incorporated AIs	
Capital Adequacy Ratio (consolidated)			17.8	16.6

Notes:

¹ Figures relate to Hong Kong office(s) only.

² Includes swap deposits.

³ Figures relate to Hong Kong office(s) and in the case of local AIs include overseas branches.

⁴ Denotes loans graded as "substandard", "doubtful" or "loss".

⁵ Denotes loans on which interest has been placed in suspense or on which interest accrual has ceased.

* This comprises all the locally incorporated banks plus a number of the larger foreign banks which 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.

Monetary Stability



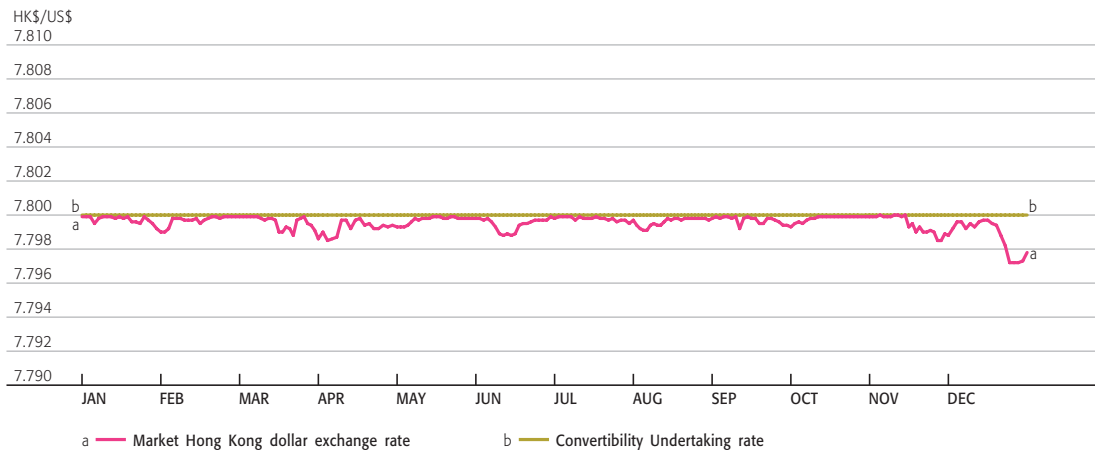
The Linked Exchange Rate system in Hong Kong

The Linked Exchange Rate system, through which the Hong Kong dollar is linked at the rate of HK\$7.80 to the US dollar, is the cornerstone of monetary stability in Hong Kong. The exchange rate is maintained through the operation of a rule-based currency board system, which ensures the entire Monetary Base is backed with US dollars in Hong Kong's Exchange Fund. Any change in the Monetary Base has to be fully matched by corresponding changes in the foreign currency reserves backing it.

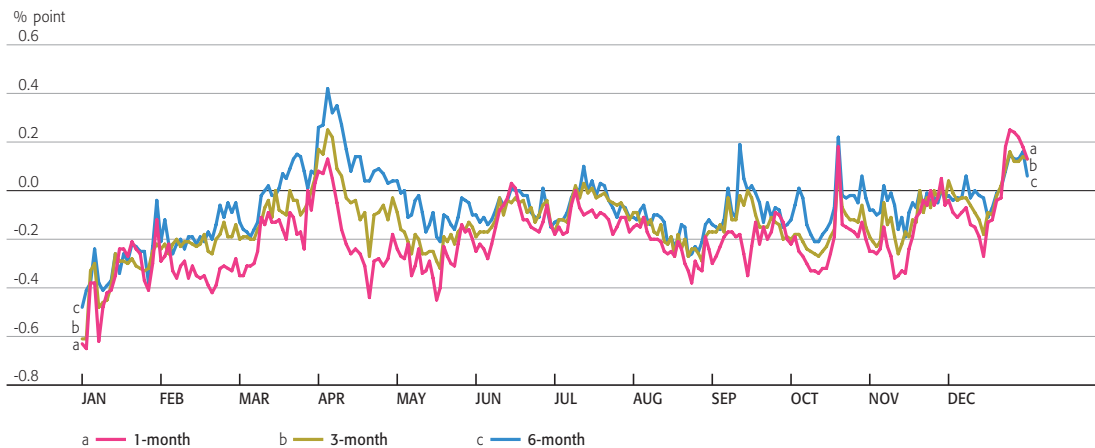
The Hong Kong dollar in 2001

The Linked Exchange Rate system functioned smoothly and effectively to deliver a stable Hong Kong dollar in 2001, despite the worsening of the external environment with the onset of global economic slowdown, renewed weakness in the yen, and the crisis in Argentina. The market exchange rate of the Hong Kong dollar remained within a narrow range of 7.7972 – 7.8000 during the year, close to the Convertibility Undertaking rate of 7.80.

Exchange rate and Convertibility Undertaking, January – December 2001



Hong Kong dollar – US dollar interest rate differentials, January – December 2001



Banking Stability



Policy objectives

A key policy objective of the HKMA is to promote the safety and stability of the banking system through the regulation of banking and deposit-taking business and the supervision of authorized institutions¹.

Supervision of banks

To promote the safety and soundness of authorized institutions, the HKMA continued its efforts to improve the regulatory framework.

Progress in 2001 included:

- developing supervisory policies on areas such as credit risk management, control of large exposures, regulatory capital requirements, outsourcing, and financial disclosure;
- developing and applying the risk-based supervisory framework and implementing a comprehensive electronic banking and technology risk management supervisory framework;
- developing an enhanced regulatory regime for authorized institutions' securities business as embodied in the Securities and Futures Bill and the accompanying Banking (Amendment) Bill 2000²;
- supporting international efforts to combat terrorist financing and money laundering.

¹ Institutions authorized under the Banking Ordinance to carry on banking business or the business of taking deposits. Authorized institutions are divided into three tiers: licensed banks, restricted licence banks and deposit-taking companies.

² These two bills were enacted in March 2002, with implementation to take place later in the year.

Banking reform

The following initiatives were taken in 2001 under the banking sector reform programme announced in July 1999:

- the implementation of the final phase of interest rate deregulation, which involved the removal of the interest rate cap on savings accounts and the prohibition of the payment of interest on current accounts;
- the removal of the three-building condition on certain foreign banks and foreign restricted licence banks;
- the completion of the review of the market entry criteria for licensed banks and the three-tier authorization system.

Significant progress was made towards introducing a deposit insurance scheme and a commercial credit reference agency.

Consumer issues

A comprehensive review of the *Code of Banking Practice* was completed in November to enhance the fairness and transparency of banking operations in such areas as adjustments of fees and charges, credit card services, debt collection practices, and electronic banking.

The HKMA also collaborated with the banking industry and the Privacy Commissioner with a view to developing an appropriate framework for positive consumer credit data sharing.



Market Infrastructure



Overview

One of the main competitive advantages of Hong Kong as an international financial centre lies in the robustness and efficiency of its financial infrastructure. During 2001, the HKMA continued to develop and refine Hong Kong's payment systems infrastructure.

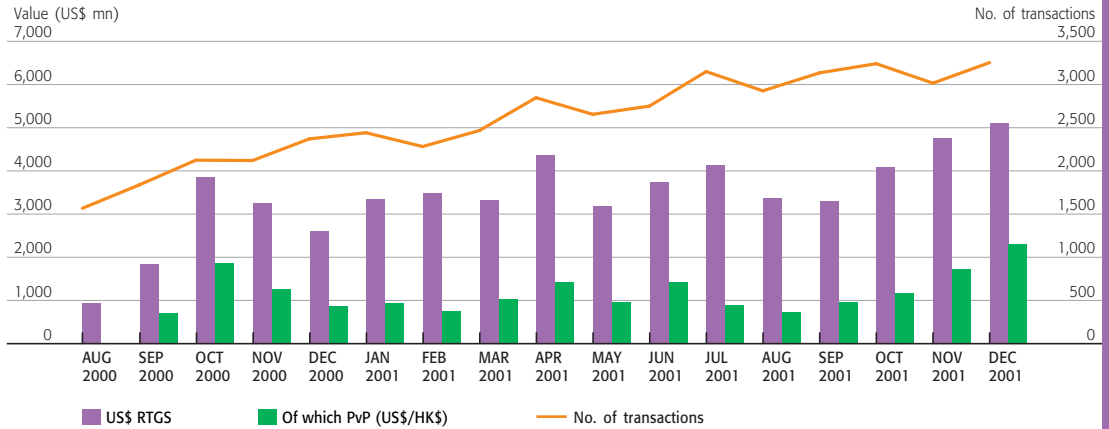
US dollar clearing system

Hong Kong's US dollar clearing system saw its first full year of operation in 2001, handling on average 3,100 transactions daily by December, with a total value of over US\$5.1 billion (Chart).

International linkages

Operated by the HKMA, the Central Moneymarkets Unit (CMU) provides an efficient clearing and depository service for the Hong Kong debt market. By linking the CMU to other major central securities depositories, the CMU is gradually developing into an international central securities depository. As a start, in December 2001 the HKMA has agreed to establish linkages between the CMU and Euroclear, which will take effect in late 2002. This automated real-time link will enable investors in Hong Kong and other parts of Asia to hold and settle Euroclear debt securities directly via their CMU accounts, and vice versa.

US dollar clearing system turnover (daily average)



Review of retail payment systems

The review of retail payment systems in Hong Kong, addressing the accessibility, cost, pricing, efficiency, competition and risks of various retail payment channels, was completed in October 2001. The review found that Hong Kong is well served by a variety of retail payment channels, including cash, cheques, credit cards, debit cards and stored value cards. It nonetheless identified policy issues and recommendations for the enhancement of sectoral efficiency and transparency of the retail payment systems in Hong Kong.

International Financial Centre



Overview

The participation of the HKMA in various international and regional central banking forums helps promote international understanding of, and support for, monetary and banking policies in Hong Kong and strengthens Hong Kong's role as an international financial centre.

Strengthening the international financial system

2001 was a tough year for the global economy. To enhance global financial stability, the HKMA has been actively participating in the discussions and supporting the international initiatives aimed at strengthening the international financial system. The HKMA has participated in regular meetings of the Financial Stability Forum, established by the G-7 countries, to discuss financial vulnerabilities.

Regional monetary co-operation and participation in multilateral institutions

To keep close track of international financial developments, the HKMA actively participated in the activities of the International Monetary Fund, the Bank for International Settlements and the Asian Development Bank. Among those activities was a conference on Financial Co-operation and Regionalism in East Asia jointly organised by the HKMA, the World Bank and the Pacific Economic Cooperation Council in September 2001.

With the aim of fostering regional monetary co-operation, the HKMA held bilateral meetings with a number of central banks in the region during the year. The HKMA also hosted the Central Banking Group of South East Asia, New Zealand and Australia (SEANZA) Advisors' Meeting in September 2001.

Development of bond markets in the region

To strengthen financial intermediation for domestic and regional savings to fund economic development and recovery, the HKMA stepped up its efforts to promote the development of the regional bond market by initiating a study on securitisation and credit enhancement in Asia. In addition, the HKMA, the Ministry of Finance of the People's Republic of China and the World Bank co-organised a forum on "China's Government Securities Market in the New Century" in Hong Kong in November 2001 to enhance international co-operation on government securities market development.



■ The HKMA plays host to the central bank representatives attending the SEANZA Advisors' Meeting in September 2001.



■ Chief Executive Joseph Yam speaking at the Forum on China's Government Securities Market in the New Century jointly organised by the HKMA, the Ministry of Finance of the People's Republic of China and the World Bank.

Reserves Management



Performance of the Exchange Fund in 2001

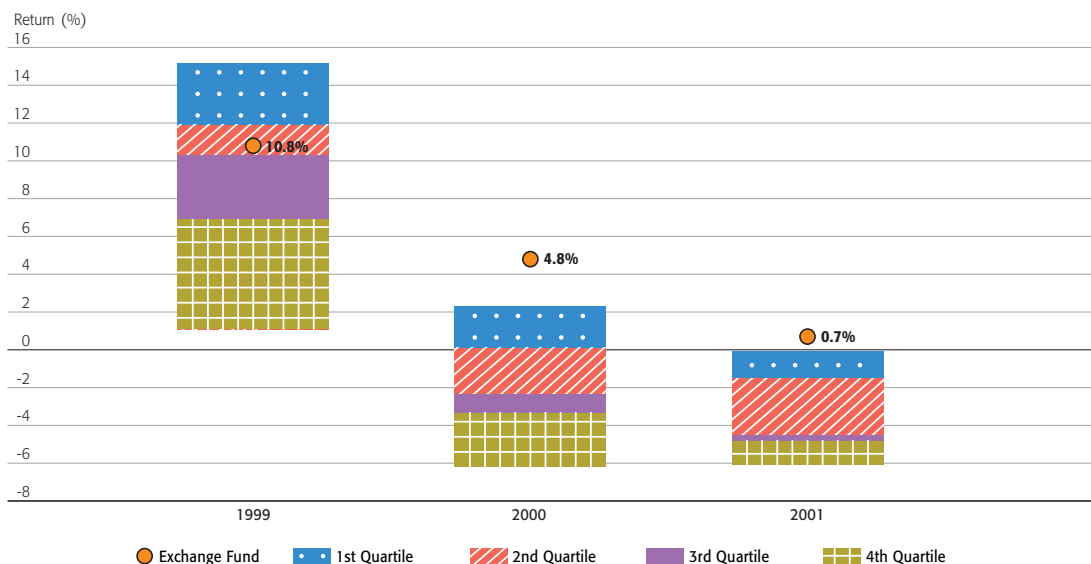
Hong Kong's foreign currency reserves, held in the Exchange Fund, form the backing for Hong Kong's Linked Exchange Rate system. In 2001, the HKMA achieved a positive investment return for the Exchange Fund, despite an extremely difficult investment environment:

- at the end of 2001, Hong Kong's foreign currency reserves totalled US\$111.2 billion, making them the fourth largest in the world;
- the high gains in the bond markets during the year were to a large extent cancelled out by losses on the Hong Kong equities portfolio and exchange losses on the euro and the yen. Despite the volatility in the markets, the Exchange Fund produced a modest positive investment return in 2001;
- the 0.7% actual return on the Exchange Fund was higher than the 0.4% return on the investment benchmark. This return also compares favourably with the returns achieved by similar funds in the private sector (Chart).

Hong Kong equity holdings

In 2001 the Exchange Fund, through Exchange Fund Investment Limited, continued to dispose of Hong Kong shares acquired during the 1998 stock market operation through the Tap Facility of the Tracker Fund of Hong Kong. By 11 April 2001, the Exchange Fund had fully recouped the cost of the market operation through the initial public offering of the Tracker Fund, the subsequent Tap Facility of the Tracker Fund and dividends received in respect of the Exchange Fund's Hong Kong equity portfolio. In 2001 proceeds amounting to \$35,163 million were received from the disposal through the Tap Facility.

Investment performance of the Exchange Fund and comparable Balanced Funds¹



¹ Balanced Funds with 20% – 30% equity component
Source: Watson Wyatt and Standard & Poor's

Investment benchmark of the Exchange Fund

Bonds	80%
Equities	20% (Hong Kong: 5%)
Currencies	80% US dollar bloc 15% European bloc 5% yen

Gross investment return of the Exchange Fund (in US dollar term)¹

	Return on total assets	Return on investment benchmark ²	CPI(A) ³
2001	0.7%	0.4%	-6.2%
2000	4.8%	3.8%	-1.9%
1993 – 2001 cumulative	76.5%	N/A	24.3%
1993 – 2001 annualised	6.5%	N/A	2.4%

¹ For the Annual Reports in 2000 and before, return on total assets and return on investment benchmark is in Hong Kong dollar term

² Established since January 1999

³ HK-CPI(A) on 1999/2000 base new series

2001 market returns

Currencies

Appreciation of the US dollar	
Against the yen	15.1%
Against the euro	6.0%

Bond markets

Merrill Lynch Global Government Bond Index, 1–10 years (in US dollar terms)	-0.8%
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Equity markets

Standard & Poor's 500 Index	-13.0%
Hang Seng Index	-24.5%

Currency mix of the Exchange Fund's assets (at 31 December 2001) – including forward transactions

	HK\$ billion	%
US dollar	688.1	70.3
Hong Kong dollar	101.7	10.4
European currencies	153.9	15.7
Yen	33.0	3.4
Others	2.4	0.2
Total	979.1	100.0

The Exchange Fund

The results of the Exchange Fund for 2001 and its financial position at the end of 2001 are shown respectively in the following Income and Expenditure Account and Balance Sheet, which are extracted from the HKMA Annual Report for 2001. For the audited, full statement of accounts of the Exchange Fund for 2001, please see pages 72 to 97 of the full Annual Report.

Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2001

(Expressed in millions of Hong Kong dollars)	2001	2000
INCOME		
Interest income		
Interest income on debt securities	34,091	29,710
Other interest income	5,818	6,643
Total interest income	39,909	36,353
Dividend income from listed equity securities	3,668	4,871
Net realised and revaluation gains/(losses) on other investments in securities	(24,956)	10,695
Other net realised and revaluation gains/(losses)	1,801	4,370
Net exchange losses	(13,059)	(11,189)
Bank licence fees	154	151
Others	26	22
TOTAL INCOME	7,543	45,273
EXPENDITURE		
Note and coin expenses	144	172
Operating expenses	1,070	983
Interest expenses	10,839	27,877
TOTAL EXPENDITURE	12,053	29,032
SURPLUS/(DEFICIT) FOR THE YEAR	(4,510)	16,241

Exchange Fund – Balance Sheet

as at 31 December 2001

(Expressed in millions of Hong Kong dollars)	2001	2000
ASSETS		
Cash and money at call	13,848	16,953
Placements with banks and other financial institutions	85,403	56,093
Investment securities	300	300
Other investments in securities	853,898	923,360
Gold	145	142
Thailand financing package	4,149	6,724
Other assets	18,534	17,448
Investments in subsidiaries	2,145	2,145
Investment in associate	7	14
Fixed assets	717	184
TOTAL ASSETS	979,146	1,023,363
LIABILITIES AND FUND RESOURCES		
Certificates of Indebtedness	107,545	99,265
Coins in circulation	5,691	5,918
Balance of the banking system	671	669
Exchange Fund Bills and Notes	118,157	109,288
Placements by banks and other financial institutions	47,122	35,389
Placements by other Hong Kong Special Administrative Region government funds	380,602	417,162
Placements by Hong Kong statutory bodies	5,124	9,660
Other liabilities	11,645	38,913
Total liabilities	676,557	716,264
Accumulated surplus	302,589	307,099
TOTAL LIABILITIES AND FUND RESOURCES	979,146	1,023,363

The HKMA in the Community



Transparency, accountability and accessibility

In its day-to-day operations and in its wider contacts with the community, the HKMA pursues a policy of transparency and accessibility. During a year of change and uncertainties worldwide and of economic difficulty in Hong Kong, the tasks of explaining our policies and of maintaining dialogue with the community took on an even greater significance than in the past.

Contacts with the community

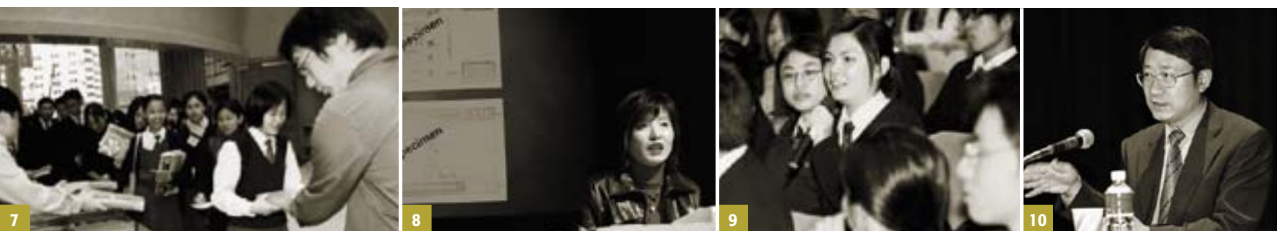
During 2001 the HKMA continued to maintain close relations with the media, with community representatives, and with the community at large. A number of special initiatives were organised during the year:

- the HKMA held its summer exhibition *Money in Hong Kong 2001* in three shopping centres between 20 July and 5 August, attracting over 80,000 visitors. The exhibition presented the key policy objectives of the HKMA and Hong Kong's monetary development, with a special focus on the security features of banknotes and coins. The exhibition was supplemented by a radio quiz on finance and economics, and workshops on "How to identify counterfeit banknotes" conducted by representatives from the Commercial Crime Bureau;
- the HKMA produced two e-publications on its website: an on-line interactive glossary *Guide to Hong Kong Monetary and Banking Terms* in early 2001 and *Money in Hong Kong* in October 2001, presenting a brief survey of Hong Kong's monetary and banking systems;

- the HKMA arranged four special educational briefings for reporters and editors, covering topics such as banking supervision, banks' securities business and regulation, and the development of bond market in Hong Kong;
- the HKMA posted new sections on its website to disseminate topical and timely information to the public.



- 1** Exhibition at the New Town Plaza, Sha Tin.
- 2-3** Visitors learn more about the security features and design of banknotes and coins in Hong Kong through various interactive games.
- 4-5** Representatives from the Commercial Crime Bureau explain the security features of banknotes to the public.
- 6** Chief Executive Joseph Yam presents the first prize to the radio quiz winner.



7-10 The HKMA organises seven educational seminars in 2001.

Professional and Support Services



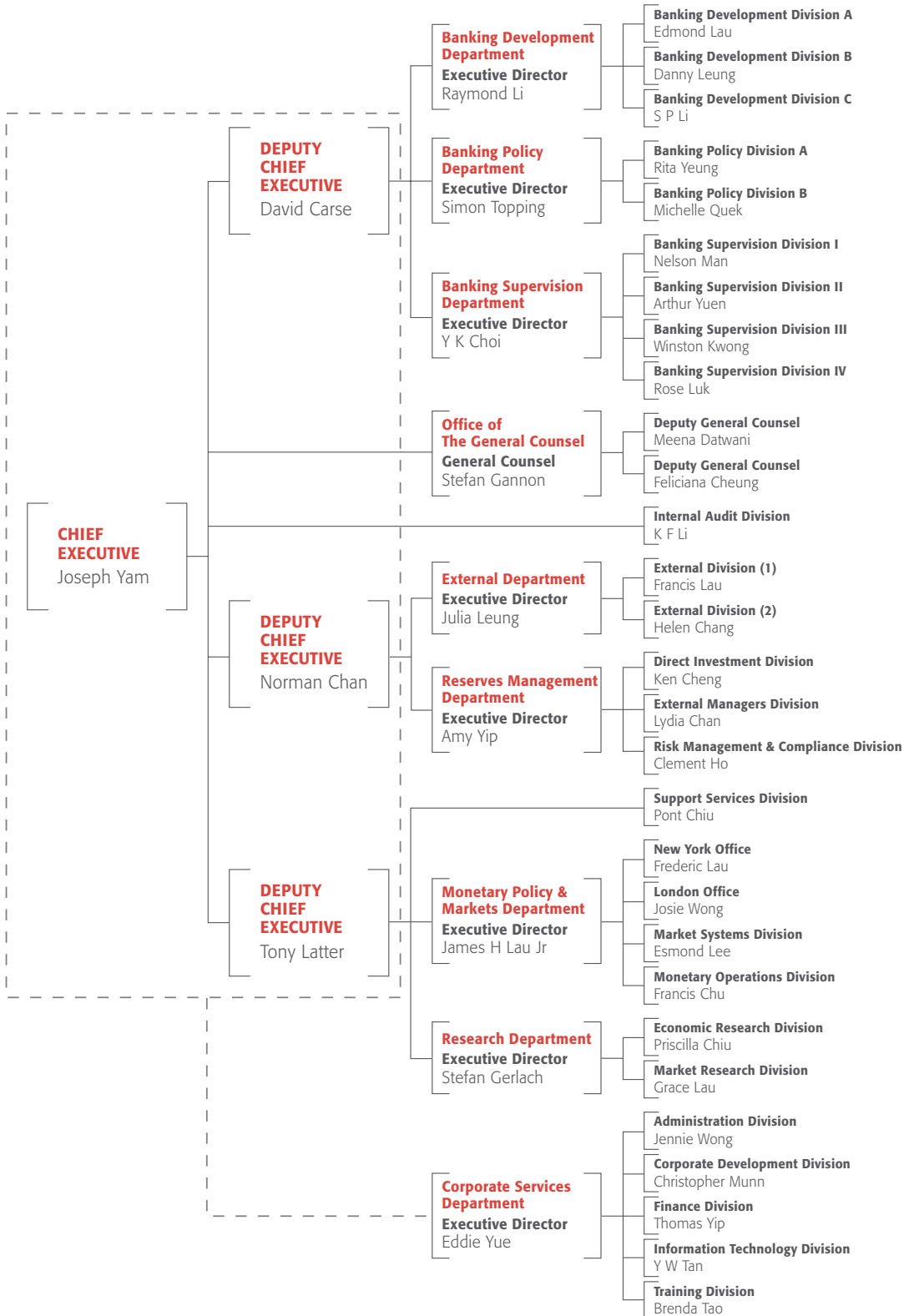
A range of administrative, technological, internal audit and legal services provide essential support to enable the HKMA to carry out its policy objectives effectively. During the year, a number of reforms were implemented to strengthen these services:

- a dedicated Training Division was established in April;
- a comprehensive review of human resources system was conducted, with the aim of making the HKMA towards a more fully performance-based culture;
- contingency plans were reviewed and tested, in light of the events of 11 September;
- an HKMA Environmental Policy was formulated and promulgated in September.

Establishment of the HKMA

Post	Establishment		
	2000	2001	early 2002
Chief Executive	1	1	1
Deputy Chief Executive	3	3	3
Executive Director	8	9	9
Division Head	28	30	31
Senior Manager	70	71	72
Manager	140	149	146
Manager Trainee	10	10	6
Assistant Manager	102	101	98
Technical Officer	102	105	103
Clerk	52	51	50
Secretary	81	74	72
Office Assistant	10	10	10
Total	607	614	601

HKMA Organisation Chart, December 2001



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