CHIEF EXECUTIVE'S STATEMENT

recovery in the second half of 2003

After six years of difficulty and uncertainty, Hong Kong's economy experienced a strong rebound in the second half of 2003. Helped by a more benign global environment, and by measures to strengthen economic ties between Hong Kong and the Mainland, this rebound continued its momentum into 2004. A broad and sustained economic recovery now appears to be in progress.

The rebound came after one of the most distressing episodes in Hong Kong's recent history: the outbreak between March and June of SARS (severe acute respiratory syndrome), which infected 1,755 people in Hong Kong, of whom 299 died. The people of Hong Kong faced this epidemic with courage and resilience, but the anxieties created by a new and virulent disease inevitably had their effects on daily life, on economic activity, and on confidence in the future. The difficulties in Hong Kong came against the background of the spread of SARS on the Mainland and in other parts of the world, uncertainties about the impact of the war in Iraq, and concerns about the performance of some of the major world economies.

Economic indicators for the second quarter of 2003 dramatically reflected the sharp decline in activity and confidence. Tourist arrivals plunged by 58% from a year earlier. Private consumption, already weak, continued to decline. The unemployment rate rose to a record high of 8.7% in the middle of the year. Deflation deepened. Residential property prices continued to decline, and by July had dropped to about a third of their value when the property market peaked in 1997. The number of residential mortgages in negative equity rose to around 106,000 in June, which was around 22% of all residential mortgages.

the economic impact of SARS

These were indeed troubled times. But the economic impact of SARS was short-lived, and some important sectors of the economy, such as merchandise trade, were hardly affected at all. The rebound in the second half of the year was sufficient not only to cancel the negative economic impact of SARS but also to propel Hong Kong into what appears by all signs to be a robust recovery.

sharp rebound supported by deepening economic integration with the Mainland

This rebound has been boosted by measures taken by the authorities in Hong Kong and the Mainland to strengthen economic ties through the Closer Economic Partnership Arrangement (CEPA) and by the relaxation of restrictions on travel by individuals to Hong Kong. With the sharp turnaround in tourist visits in the third quarter, a marked revival in private consumption, and continued buoyancy in exports, Hong Kong's real GDP grew by 3.3% for the year as a whole, compared with 2.3% in 2002 and 0.5% in 2001. Asset markets stabilised in the second half of the year, and the number of residential mortgages in negative equity declined by 36% to around 67,600 by the end of the year. Deflation, if measured month on month, appears to have come to an end in around August 2003. The unemployment rate, though still high by historical standards, declined to 7.3% in the fourth quarter of 2003.

strong investment return on the Exchange Fund

During this eventful and turbulent year the Hong Kong Monetary Authority achieved its objectives of maintaining currency stability, promoting the safety and stability of the banking system, and enhancing the efficiency, integrity and development of the financial system. Hong Kong's Exchange Fund, which is managed by the HKMA, produced an investment return of 10.2%: this was 70 basis points above the return on the benchmark set by the Financial Secretary on the advice of the Exchange Fund Advisory Committee.

a robust and effective banking system

Hong Kong's banking sector withstood the stresses and strains of the second quarter and came out stronger. Banks had to manage a combination of challenges brought on by persistent economic difficulty and exacerbated by SARS: sluggish loan growth, pressure on lending margins, negative equity, and a high bankruptcy rate. Like many other organisations, they also had to cope with the challenge of maintaining essential services and staff morale during a time of crisis. Not only did Hong Kong's banking system remain stable and effective: the banking sector as a whole managed to show an increase in profits for the year as a whole, thanks to the markedly improved economic conditions in the second half of the year and to their own efforts to diversify business. The HKMA continued to work with the banking sector on the planned implementation of a Commercial Credit Reference Agency in 2004, and with the Legislative Council on the bill for establishing a Deposit Protection Scheme. Since August 2003 banks have been able to share positive consumer credit data. This will help nurture a healthier credit environment and provide more competitive products for borrowers with good credit standing.

a stable Hong Kong dollar against volatile world markets

Despite the difficult second quarter and considerable volatility in the world's main currencies, the Hong Kong dollar continued to be stable under the Linked Exchange Rate system. There was a moderate rise in 12-month Hong Kong dollar forward points in April, reflecting concerns about the effects of SARS. But the most striking event of the year was the sharp strengthening of the Hong Kong dollar in late September. Forward points went into discount, and the Aggregate Balance – the most sensitive component of the Monetary Base – grew to historically high levels as the HKMA sold Hong Kong dollars to banks in response to the increased demand for Hong Kong dollar assets. Almost overnight, longstanding concerns about downward pressure on the Link gave way to complaints from some that the Hong Kong dollar was being allowed to strengthen too much.

This episode of strengthening is gradually playing itself out through the normal operation of the Currency Board arrangements, through which the Linked Exchange Rate is maintained. The causes of the strengthening were complex, but there were three main elements. Economic recovery and a rapid revival in confidence attracted a strong inflow of funds into the Hong Kong dollar. The sharp decline in the value of the US dollar against other major currencies pulled the Hong Kong dollar down with it – unjustifiably in the view of the market. Political pressure from outside for a revaluation of the renminbi encouraged the view that, if the renminbi were to be revalued, the Hong Kong dollar would be pulled up with it. The strong inflow of funds is a matter of fact. The other two elements are an interesting example of how suddenly market sentiment can change.

A strengthening Hong Kong dollar is a much more straightforward problem than a weakening Hong Kong dollar. In addition to normal Currency Board operations, the HKMA has a range of tools – all of them consistent with Currency Board principles – that can be deployed to dampen excessive volatility in the Hong Kong dollar. Together with the Sub-Committee on Currency Board Operations of the Exchange Fund Advisory Committee, we shall continue to watch the situation carefully.

The excitement over the short-term movements of markets in the last quarter of 2003 may perhaps have obscured the longer-term view. The weakness of the US dollar has had the benign effect of moderating the pain of structural adjustment arising from the increasing economic integration between the Mainland and Hong Kong. It has helped lessen the extent of deflation necessary as part of that structural adjustment. Along with deflation, it has contributed to a decline in Hong Kong's real effective exchange rate – the true measure of an economy's competitiveness – of as much as 26% between its peak in August 1998 and the end of 2003.

developing Hong Kong as an international financial centre

Hong Kong's competitiveness as an international city has been strengthened considerably by the reductions in the cost of doing business here. But competitiveness is not just a matter of low costs. An international city must have the institutions, the talent, and the infrastructure to attract business. An important, though largely invisible, part of this infrastructure is the machinery for clearing and settling financial transactions and for linking the financial system with other financial systems.

introduction of renminbi banking in Hong Kong

Hong Kong has one of the world's most advanced financial infrastructures. We introduced real time gross settlement for the Hong Kong dollar in 1996 and extended this to the US dollar in 2000. In April 2003 we launched a euro clearing system, and in November, following approval from the State Council, the People's Bank of China agreed to provide clearing arrangements for personal renminbi business in Hong Kong. In February 2004, 35 banks in Hong Kong began to provide personal renminbi deposit, remittance and exchange services. These new arrangements are made on the principle of cautious and gradual change, taking into account the fact that the renminbi is not yet a fully convertible currency. Renminbi services in Hong Kong will facilitate the growing economic integration between Hong Kong and the Mainland. Looking further ahead, they will also help place Hong Kong in an excellent position as a centre for China's international financial transactions with the gradual liberalisation of the Mainland's monetary and financial systems in the future.

Other developments in Hong Kong's financial infrastructure in 2003 included the introduction in June of cheque imaging and truncation, which greatly reduces the need for physically delivering cheques for clearance, and the launch by the note-issuing banks in December of new $100 and $500 banknotes. These are the first of a new series of Hong Kong banknotes with fresh designs and improved security features: the remaining denominations in the new series will be issued later in 2004.

new Hong Kong banknotes

One of the aims of the HKMA is to ensure that Hong Kong's banking and monetary systems comply with international codes and standards. For this reason, the groundwork continued in 2003 for implementing the New Basel Capital Accord, which is targeted for implementation in late 2006. In June 2003 the joint IMF-World Bank mission under the Financial Sector Assessment Programme (FSAP) delivered its comprehensive report on Hong Kong. The report confirmed that Hong Kong complies with key international standards, that its financial system is fundamentally sound, and that its market infrastructure is robust and efficient.

international standards

The FSAP mission made a number of recommendations for improving the regulation and transparency of Hong Kong's financial system. The great majority of these have been swiftly implemented. One of the recommendations was that the legal foundation of the HKMA should be clarified and the operational autonomy of the HKMA for the implementation of monetary policy should be explicitly recognised in a formal document. On 25 June the Financial Secretary and I, as Monetary Authority, exchanged a series of letters setting out the division between the two of us of functions and responsibilities in monetary and financial affairs. These letters, which are public documents, summarise governance and other provisions, under the Exchange Fund and Banking Ordinances, that have been in place for some years, and as such they make no change to existing arrangements.

operational autonomy of the HKMA

Two aspects of this Exchange of Letters are, however, worth drawing particular attention to for the emphasis they place on the operational independence of the HKMA. First, disclosure is made in the letters, for the first time, of the details of the delegation of statutory powers from the Financial Secretary to the Monetary Authority. The Financial Secretary makes an undertaking to disclose publicly, within three months and giving reasons, any exercise by himself of those delegated powers or any overriding of the Monetary Authority in his exercise of the delegated powers. Secondly, the Financial Secretary formally lays down, for the first time, the monetary policy objective and the structure of Hong Kong's monetary system: a stable exchange value of the Hong Kong dollar in terms of its exchange rate against the US dollar at around HK$7.80 to US$1 maintained by Currency Board arrangements.

20th anniversary of the Link, 10th anniversary of the HKMA

These are, of course, the monetary arrangements that have been in place in Hong Kong for 20 years, and it is perhaps appropriate that, as it comes of age, the Linked Exchange Rate system, which was introduced on 17 October 1983, should be formally enunciated in this way. In April 2003 we also marked the 10th anniversary of the foundation of the HKMA. This has been a momentous decade for Hong Kong, and a time of great difficulty and anxiety. I believe, however, that the HKMA can look back on its achievements during these years with some satisfaction. In its contributions to maintaining monetary and financial stability, the HKMA has relied heavily upon its greatest asset – an excellent staff – and I pay tribute to them for their unfailing dedication and determination over the years. The HKMA has also received skilled guidance from successive Financial Secretaries and Members of the Exchange Fund Advisory Committee. And, most important of all, we have enjoyed the support and confidence of the people of Hong Kong: without this, and without the co-operation from their representatives on the Legislative Council, we could not fulfil our objectives.

Ten challenging years have taught us that there are few certainties and many surprises in this rapidly changing world. It would be unwise to try to predict what might happen in the next decade, although the prospects for Hong Kong in the coming year at least seem to be brighter than they have been for some time. The HKMA will, however, continue to do its best to ensure that Hong Kong's monetary and financial systems have the stability, the infrastructure, and the resources to manage whatever challenges, opportunities and crises that may lie ahead.

Joseph Yam

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