CHIEF EXECUTIVE'S STATEMENT

broad and sustained recovery

The economic recovery that began in Hong Kong in the second half of 2003 broadened and deepened in 2004. Real Gross Domestic Product grew by 8.1%, more than double the growth in 2003. Exports of goods and services grew at the highest rate in four years, and domestic consumption continued to recover. Asset markets were buoyant during the year, and the steady recovery in the property market helped bring down further the number of residential mortgages in negative equity. The unemployment rate declined from a high of 8.6% in the middle of 2003 to 6.5% in the fourth quarter of the year: this is still high by historical standards, but it should be weighed against the large number of people entering the labour market and the considerable increase in total employment, which reached a record high of 3.3 million in the last quarter of 2004.

Strong global growth, though moderating in the second half of the year, helped fuel Hong Kong's economic recovery. While the demand for goods and services from Hong Kong increased worldwide, particularly in Europe and the Asian region, it is the vitality of the Chinese economy that has continued to be the most important engine of growth in Hong Kong. Growing numbers of visitors to Hong Kong from the Mainland boosted income from tourism. The expansion in Mainland China's external trade continued to reinforce Hong Kong's offshore trade and exports of services. Within Hong Kong, deflation came to an end, although inflation has not yet returned. Interest rates remained low. These favourable conditions, combined with a more optimistic mood in the community and among businesses, have encouraged greater private spending on consumption and investment. Economically speaking, Hong Kong had a very good year in 2004: in the absence of any unforeseen crisis, there are good reasons for expecting that the healthy and sustained progress made during the year will continue, although growth may be at a more moderate pace.

unsettled markets

In contrast to the largely stable growth in the economy in general, financial markets in 2004 were unsettled. Equity markets throughout the world were volatile. Bond markets retreated on fears of rapid upward adjustments in US interest rates to more "normal" levels. In currency markets, the depreciation of the US dollar against other major currencies, combined with massive fund flows into Hong Kong, had a complex impact on the Hong Kong economy and presented challenges for the HKMA across its various policy areas.

The challenge in reserves management was to achieve the investment objectives of the Exchange Fund in a difficult and volatile environment. Since the Exchange Fund provides the backing for the Monetary Base and safeguards the exchange value of the Hong Kong dollar, these objectives place particular emphasis on capital preservation and high liquidity: they differentiate the Exchange Fund from many ordinary investment funds, which tend to seek maximum investment return. Despite the roller-coaster markets, and the constraints imposed by the investment objectives, the Exchange Fund earned an investment income of $56.7 billion in 2004, and a rate of return meeting that of the investment benchmark set by the Financial Secretary on the advice of the Exchange Fund Advisory Committee. The share of investment income going to the fiscal reserves placed with the Exchange Fund was $14.5 billion, which was $2.2 billion more than the projected amount included in the Government's budget for the fiscal year.

Hong Kong dollar stability

The decline in the exchange value of the US dollar by a cumulative 4.6% in 2004 contributed, through the Linked Exchange Rate system, to a further decline in the effective exchange value of the Hong Kong dollar – and therefore to Hong Kong's competitiveness. An improving economy, greatly increased IPO activities, and continued market expectations of a possible revaluation of the renminbi attracted large inflows of funds into Hong Kong. These inflows supported strong liquidity in the banking system, particularly in the first and last quarters. As a result, Hong Kong dollar interest rates continued to be substantially lower than their US dollar counterparts, with differentials widening in the last quarter: short-term Hong Kong dollar interest rates rose by only about 20 basis points during the year, despite the cumulative increase of 125 basis points in the US rates.

The Hong Kong dollar stayed close to its official Linked Rate of 7.8 to the US dollar throughout the year, despite the massive fund flows, persistent speculation about a renminbi revaluation, and the decline in the US dollar. The strengthening episode that began in September 2003 worked itself out in the first four months of 2004 as the HKMA sold Hong Kong dollars in response to requests from banks. During the middle months of the year the dollar closely tracked the official rate, with repeated triggerings of the Convertibility Undertaking and the purchase of a total of $51.5 billion worth of Hong Kong dollars by the HKMA. As a result, the Aggregate Balance declined from nearly $55 billion in February to $3.2 billion in September, only to begin rising again in October, as the Hong Kong dollar began to strengthen again on fund inflows and renewed renminbi speculation.

The wide variation in the size of the Aggregate Balance during 2004 and the considerable activity on both the strong and weak sides of the Linked Exchange Rate offer a lively illustration of the workings of the Currency Board system, which continues to deliver exchange rate stability for Hong Kong.

strong and effective banks

Despite a continuing squeeze on interest margins, largely as a result of the ample liquidity in the banking system, Hong Kong's banking sector saw an average 20% increase in profitability in 2004. All other main indicators showed improvement, reflecting better economic conditions and increased economic activity. Overall asset quality improved. The classified loan ratio declined. The consolidated capital adequacy ratio of local authorized institutions remained high, at almost 16%, nearly twice the statutory minimum requirement of 8%. Loans to all sectors, particularly business, increased.

Following the full implementation of risk-based supervision in 2003, the HKMA used its supervisory resources in 2004 to focus intensively on areas of business, which, for one reason or another, might give rise to concern. Focused examinations took place of residential mortgage loans, in view of the increased competition, and of risk management and other practices in credit card business. The HKMA continued to improve the supervisory framework for preventing money laundering and terrorist financing, taking into account the latest international developments. Special emphasis was placed on banks' business continuity planning, particularly in the light of the growing dependence on technology of both banks and their customers.

A source of concern during the year was the question of the safety of banking through electronic channels. Prompt actions by the banks, the police and the HKMA early in the year helped lessen the risk of ATM frauds through tampering with machines. Internet banking fraud, however, has become a growing concern in Hong Kong, as in other parts of the world. The HKMA, together with the police and the banks, has placed particular emphasis on tackling this problem both through promoting public awareness of good security practices and through improving security-enhancing technology: by mid-2005 two-factor authentication will be introduced for high-risk Internet transactions by banks in Hong Kong providing Internet services.

The banking sector reform programme, initiated in 1999, entered its final stages in 2004 with the launch of the Commercial Credit Reference Agency in November and the enactment of the Deposit Protection Scheme Ordinance in May. The Hong Kong Deposit Protection Board was established in July, and it has since then been working on detailed plans for implementing the scheme in the second half of 2006, if prevailing conditions at the time are suitable.

As the reform programme draws to a successful conclusion, another important set of reforms involving the banking sector moves closer. In June the Basel Committee issued its revised framework on capital adequacy standards for banks, or "Basel II" as it is now usually known. Basel II will make capital requirements more risk-sensitive, and will bring banking regulation more into line with the way that banks themselves perceive and manage risk. It will also give banks the incentive to continue to strengthen and improve their own risk management. Good progress was made in 2004 in planning for the implementation of Basel II in Hong Kong. The aim is to switch over to Basel II at the start of 2007, in line with the approach being adopted in other major international financial centres, and of the Basel Committee members themselves. We see value in being among the first in adopting Basel II, not only because of its intrinsic merits, but also because Hong Kong has one of the highest concentrations of banking institutions in the world, with a strong presence of international banking groups.

developing Hong Kong as an international financial centre

Being among the first banking centres to implement Basel II will help maintain Hong Kong's position as an international financial centre. Other initiatives taken during the year have also helped bolster this position. Thirty-eight banks in Hong Kong began offering personal renminbi deposit, remittance and exchange services during 2004. Renminbi business grew steadily during the year: at the end of December outstanding renminbi deposits in banks in Hong Kong stood at more than RMB12 billion yuan. Clearly, there is a demand for these facilities in Hong Kong, despite the modest range of services currently available: this is not surprising, given the growing integration between the Hong Kong and Mainland economies, and the considerable surge in tourists from the Mainland during the year. Since the renminbi is not yet a freely convertible currency, future development of renminbi banking business in Hong Kong will by necessity be done in a gradual and cautious way. Discussions are in progress to explore how future development may proceed, taking into account the three strategic directions outlined by the Financial Secretary in August: diversification of renminbi assets and liabilities; denomination and settlement of trade in renminbi; and debt issuance in renminbi.

Hong Kong's position as an international financial centre also benefited in 2004 from progress in the infrastructure for other currencies. Hong Kong dollar and US dollar real time gross settlement links were introduced between Hong Kong and Guangdong province in March, extending the arrangements made between Hong Kong and Shenzhen in 2003. Joint cheque-clearing arrangements for US dollar cheques were introduced between Hong Kong and Shenzhen in July 2004. In December, the Hong Kong dollar entered the Continuous Linked Settlement (CLS) System, a global clearing and settlement system that complements Hong Kong's own multi-currency clearing systems. Entry into the CLS System was made possible by the enactment in July of the Clearing and

Settlement Systems Ordinance, which came into effect in November. The Ordinance gives statutory backing to the Monetary Authority's oversight of important clearing and settlement systems, and legal certainty for settlement finality. In doing this, it will help promote the safety and robustness of Hong Kong's financial infrastructure and the financial stability of Hong Kong.

regional and international co-operation

Hong Kong's financial stability is dependent not just on the structures and systems that we build within Hong Kong but on the movements of markets throughout the world, and particularly on the health of the regional financial system. Memories of the Asian financial crisis in 1997-8 inevitably fade as the region in general continues to enjoy financial stability and economic growth. But the weaknesses that contributed to this crisis continue to be very much in the minds of Asian central banks, as they work together towards strengthening the regional financial system. Two regional initiatives bore fruit in 2004. The structuring, design and launch of the local currency component of the Asian Bond Fund (ABF2) under the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) was announced in December. The APEC Initiative on Development of Securitisation and Credit Guarantee Markets came to a successful conclusion in September. Both of these initiatives will help stimulate the development of deep, liquid and mature regional bond markets, which can play an important role when, in times of crisis, the other channels of financial intermediation – the banks and the equity markets – falter or fail.

The HKMA played a leading role in both of these initiatives, and, because of its advantages as an international financial centre, Hong Kong has been chosen as the place of listing for two of the key components of ABF2. The HKMA is also contributing extensively to the work of the Bank for International Settlements (BIS), through its chairmanship of the BIS Asian Consultative Council and Central Bank Governance Steering Group, and in playing a leading role in the drafting process in the review of the Basel Core Principles for Effective Banking Supervision, which began in 2004.

governance of the HKMA

Enabling active participation by Hong Kong in the various international bodies and initiatives was one of the reasons for establishing the HKMA in 1993 as a central banking organisation with a clear identity and mission. Although it is an agency of the Government, the HKMA, following general central banking principles, is separate from the main organs of government in its ability to employ staff on terms different from those of the civil service and in its funding arrangements. These arrangements enable the HKMA to operate with flexibility, in response to rapidly changing conditions, and to maintain a level of resource independence sufficient to enable it to carry out its responsibilities without political influence. This measure of autonomy in the HKMA's operations is balanced by an apparatus of accountability, to the Financial Secretary through the Exchange Fund Advisory Committee (EFAC), and to the community, both directly and through its elected representatives on the Legislative Council.

During 2004 the governance arrangements of the HKMA were strengthened with an expansion of the EFAC sub-committee system. A new Governance Sub-Committee was created, replacing the old Remuneration and Finance Sub-Committee, with the task of monitoring the performance of the HKMA and making recommendations to the Financial Secretary, through EFAC, on the full range of remuneration, human resources, budgetary, administrative and governance issues affecting the HKMA. This Sub-Committee is composed of the non-official, non-banking Members of EFAC. Two new sub-committees – one on investment, the other on financial infrastructure – were formed at the end of 2004 and held their first meetings in early 2005. These two new sub-committees will enable Members to focus more on the technical details of these important areas of the HKMA's work.

The HKMA continued in 2004 to develop its policy of transparency and accessibility. The HKMA's *Half-Yearly Monetary and Financial Stability Report*, first issued in December 2003, has become well established as the main channel of clear and systematic information on the HKMA's view of the main forces acting upon Hong Kong's monetary and financial systems. The HKMA's Information Centre, which opened towards the end of 2003, received nearly 50,000 visitors of all ages and walks of life in 2004. Increasing numbers of people are using our enquiries service and visiting our website. During 2004 the HKMA also mounted an extensive campaign of seminars and visits to inform members of the public about the new $20, $50 and $1,000 banknotes, which went into circulation in October: in all, some 93,000 people were reached during this campaign. At no time has the HKMA been in direct contact with so many people. In helping people better understand Hong Kong's monetary and banking systems, these initiatives have, we believe, helped contribute to Hong Kong's monetary and financial stability. They have also provided further informal channels for keeping ourselves abreast of public views on the policies we pursue.

The work of the HKMA has increased in volume and complexity over the past few years, as new responsibilities and new issues have emerged. Despite this, our staff establishment has remained stable, and our staff strength actually declined in 2004. I take this opportunity to pay tribute to the staff of the HKMA for their hard work and resourcefulness during another busy year. My colleagues and I are also grateful to the Financial Secretary and to Members of EFAC for their continued guidance and support.

Joseph Yam
Chief Executive