Chief Executive's Statement

During the past year the financial world has seen some of the most dramatic events in living memory. The US sub-prime crisis turned into a global financial crisis, leading to a sharp slowdown in the world economy. The worldwide credit crunch was so severe that financial intermediation all but ceased for a time. Some of the best-known financial institutions were forced to sell themselves to rivals, or were bailed out by their governments, or ceased to exist altogether. Central banks and governments around the world took unprecedented actions to boost liquidity in the financial markets and stimulate their economies. Although Asia was not at the centre of the crisis, the HKMA, like other central banks in the region, has had to act quickly to safeguard monetary and financial stability against waves of shock and contagion.

That Hong Kong has come through so far with its monetary system intact and its financial system still robust is due, in no small part, to the actions that we have taken, not just during the crisis itself but also over many years, to prepare for unforeseen events. The investment we as a society have made in the Linked Exchange Rate system, which passed its 25th year in 2008, and in a strong and stable banking sector have paid dividends and continue to do so. Sound preparation in robust systems and a strong fiscal position have certainly served us well. But the outlook is an extremely complex one, and we must expect prolonged uncertainty and hardship. Continued vigilance, and a readiness to deal with the unexpected, will be necessary in facing the difficult times ahead.

A ROUGH PATCH FOR THE ECONOMY

After four years of above-trend growth, the rate of expansion in the local economy declined to 2.5% in 2008 compared with 6.4% in 2007. Much of that slowdown occurred in the second half as we felt the effects of the global financial crisis and domestic demand and export growth both declined. Inflation, which was becoming a concern earlier in the year slowed with the CCPI easing to 4.6% year on year in December from 6.3% in August as food prices on the Mainland stabilised and housing rents eased. The unemployment rate also rose in the fourth quarter, and into 2009, rising to 5.0% in February: we can expect it to continue to rise as recession among our major trading partners deepens. And of course the slowdown was reflected in asset prices as residential property prices declined by 11% during 2008 and the Hang Seng Index shed nearly half of its value.

DEALING WITH A FINANCIAL CRISIS

By September, when the US investment bank Lehman Brothers filed for bankruptcy protection, it was clear that the global financial system was in serious trouble. The trust between counterparties that is essential to the normal functioning of the system had largely evaporated and interbank rates had increased sharply, with one-month LIBOR rising from 2.65% to 3.95% during September and the equivalent HIBOR rising to 4.36% at the end of the month. This made it difficult for financial institutions to secure funding and led them to reduce lending. In Hong Kong, on 24 September a small-scale run on a bank, resulting from unfounded market rumours, led to further tightness in the local money market. At the same time, demand from banks for Exchange Fund paper for liquidity management increased.

In response, the HKMA injected liquidity into the banking system by buying US dollars for Hong Kong dollars within the Convertibility Zone in September and October and these operations, together with repeated triggering of the strong-side Convertibility Undertaking in the remainder of the year, helped to ease the tightness in the market. The HKMA introduced five temporary measures on 30 September to provide collateralised liquidity to banks that might need it, either through or outside of the Discount Window, to give banks greater assurance about the availability of funds and make them more willing to lend in the interbank market. These measures were then refined in early November in response to market needs. An additional $12 billion of three-month Exchange Fund Bills, which can be used for borrowing at the Discount Window, were issued between late October and early December to assist banks in their liquidity management and improve their access to the new measures.

In mid-October the Financial Secretary announced two precautionary measures to bolster public confidence in the banking system: using the Exchange Fund to provide a temporary 100% deposit guarantee and a contingent capital facility for banks. These measures, both of which are set to expire at the end of 2010, were designed to stabilise the banks' deposits as a source of funding and give them comfort that additional capital would be available in case they need it. Finally, the HKMA lowered the price of liquidity at the Discount Window by adjusting the formula for determining the Base Rate on 9 October.

All of these measures were designed to respond to developments in the market and, wherever possible, to pre-empt further problems by supporting confidence. As a result of them, the interbank market returned to largely normal functioning by the end of the year, although uncertainties remain in the global environment. The HKMA will remain vigilant and stand ready to take further measures if needed.

THE EXCHANGE FUND

Asset prices declined around the world in 2008 with global equities markets measured by the MSCI Global Index declining by 42%. The investment environment in Hong Kong and elsewhere affected the Exchange Fund, which experienced an investment loss of $75 billion, or 5.6%, for the year, its first loss since the HKMA was established in 1993. Any loss is a matter of regret, but the conservative investment approach of the Fund helped to ensure that losses were kept to a relatively modest level. The Fund also had minimal or no exposure to financial institutions that experienced problems during the year or to the kinds of toxic investment assets that caused many of those problems. The compounded average annual investment return of the Exchange Fund since 1994 is 6.1%, well above the compounded annual inflation rate of 1.4% for the same period. The Exchange Fund is not primarily an investment fund: its statutory purposes are to maintain the exchange value of the Hong Kong dollar and to maintain the stability and integrity of the monetary and financial systems of Hong Kong. The Fund continues to serve those purposes effectively.

Another important point to note is that, under the fee arrangement with the Government for the use by the Exchange Fund of the fiscal reserves, the Treasury received $46.4 billion. This helps to insulate the fiscal reserves from the immediate effects of the financial crisis and to make annual budgeting more predictable and stable.

HONG KONG DOLLAR STABILITY

The Hong Kong dollar remained stable in 2008 despite the volatility in financial markets. The exchange rate was stable in the first eight months of the year despite the strengthening of the renminbi, inflationary pressure in Hong Kong and volatility in financial markets. The market remained calm when the renminbi appreciated past the Hong Kong dollar Convertibility Zone in February, suggesting that we had been successful in managing market expectations.

The worsening of the financial crisis in September made currency markets extremely volatile. As a result of the unwinding of carry trades and repatriation of funds to Hong Kong, the Hong Kong dollar strengthened with the strong-side Convertibility Undertaking being triggered repeatedly in the last two months of the year. This created conditions that were conducive to an easing of monetary conditions, which was helpful in addressing the effects of the crisis.

THE BANKING SECTOR

The Hong Kong banking sector entered the crisis in 2008 in a stronger condition than many of its counterparts in other economies and this helped it to withstand the effects. The average consolidated capital adequacy ratio of the locally incorporated authorized institutions actually rose slightly from 13.4% in 2007 to 14.8% at the end of 2008, well above the statutory minimum and in marked contrast to the position of banking sectors overseas, where a number of governments had to inject capital into banks. Liquidity ratios were also well above statutory requirements. But local banks could not escape the effects of the crisis altogether and profitability deteriorated with both interest and non-interest income declining and cost-to-income ratios rising. Asset quality also showed some signs of deterioration, although the levels of problem loans remained low by historical standards with the classified loan ratio slightly above 1% at the end of 2008, and the quality of mortgage and credit card lending remaining stable. Total lending by retail banks increased by 10.6% while the loan-to-deposit ratio increased from 45.5% in 2007 to 47.2%. However, the last quarter of the year saw a contraction in lending by banks. This is something that will need to be watched carefully, with the aim of preventing credit tightness and economic downturn feeding off each other and producing a downward spiral. The HKMA has been encouraging banks to be particularly supportive of their SME customers, which are the backbone of the Hong Kong economy, and the banks have generally responded positively, for example by establishing their own SME lending funds and by taking part in the Government's newly introduced Special Loan Guarantee Scheme.

A key focus of our banking supervisory work during the year – and in fact since mid-2007 – was to step up our monitoring of AIs' exposures to problem institutions and assets, and stress-testing their capital adequacy in light of the growing financial stress. This was in addition to our normal banking supervisory work and naturally attracted little attention. But it is essential, especially at times of stress, for us to maintain a close and careful watch over the health and soundness of individual institutions and the system as a whole.

Another issue that absorbed a great deal of time and resources, and attracted much more public attention, was the investigation of complaints about mis-selling by banks of structured investment products related to Lehman Brothers. After the US investment bank failed in mid-September, the HKMA began to receive large numbers of complaints from investors who had suffered losses on these products, well over 19,000 had been received by the end of the year. Other complaints brought the total for the year to over 21,000 compared with only 469 for 2007. More than 200 staff, both HKMA personnel and some seconded from external auditing firms, were deployed to handle the complaints. All of us will feel great sympathy for those who suffered investment losses because of the collapse of Lehman Brothers and I fully understand their desire and that of the wider community for an early resolution of their complaints. We are working to conclude our investigations as quickly as possible, consistent with the need to observe due process. There is still much work to be done in this area and additional resources have been earmarked for this in 2009.

Towards the end of the year, we agreed with the People's Bank of China (PBoC) an arrangement for Hong Kong banks operating on the Mainland to obtain renminbi liquidity from the PBoC by providing collateral to the HKMA in Hong Kong for safe keeping. This helps ease renminbi liquidity pressure on Hong Kong banks' Mainland branches and subsidiaries.

In late 2007 the HKMA appointed Mr David Carse, an independent consultant, to conduct a review of its work in maintaining banking stability. The review was completed in July 2008 and published for public consultation concluding at the end of October. The review made a number of recommendations and we will prepare a policy response, taking into account the submissions from the public and the industry, in 2009.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

The global financial situation called for an increase in our regional surveillance and co-operation to identify and address possible risks to stability in the region and Hong Kong. The HKMA has also been active in international discussions on the reform of the global financial system. At the end of the year, the State Council agreed to allow Mainland and Hong Kong enterprises, on a trial basis, to use renminbi to settle trade transactions in Hong Kong. A new measure under the fifth supplement to CEPA allows the data centres of Hong Kong banks' Mainland-incorporated institutions to be operated in Hong Kong, increasing economies of scale and reducing technology-related risk. Both these measures help to raise Hong Kong's status as an international financial centre and demonstrate the Mainland authorities' confidence in our financial system.

Standard and Poor's raised Hong Kong's sovereign credit ratings to AA+, the highest ever, and the other agencies confirmed our AA ratings. These ratings reflect a growing recognition of Hong Kong's sound economic fundamentals, fiscal sustainability and diversified economy.

A number of steps were taken during 2008 to provide a platform in Hong Kong for Islamic finance, which is becoming increasingly important in the global economy. These were part of a four-part strategy: to develop the necessary infrastructure, for example, by assisting the Government to review the tax and regulatory framework; to raise Hong Kong's profile by organising and participating in events and entering into a memorandum of understanding with the Dubai International Financial Centre Authority; to encourage development of shariah-compliant financial products; and to raise market awareness locally and internationally.

FINANCIAL INFRASTRUCTURE

One of the prerequisites of an international financial centre and of stable financial markets is a financial infrastructure that is safe, reliable and efficient. This does not just happen on its own and the HKMA places great emphasis, in co-operation with official and private operators here and overseas, on ensuring that Hong Kong's systems are robust, up to date and connected with those of other jurisdictions. In 2008 the operating hours of the local RTGS systems and Central Moneymarkets Unit were extended to meet regional demand, and agreements were reached to establish links between Hong Kong's RTGS systems and those of Indonesia and the Mainland. The payment and settlement systems continued to operate efficiently and turnover increased in a number of areas.

GOVERNANCE AND TRANSPARENCY

As always the HKMA was aided in its work in 2008 by the wise counsel and advice of EFAC and its Sub-Committees, which were of particular value to us in this challenging year. We strive to maintain the highest standards of professionalism in our work and to be accountable to the community both generally and through the Legislative Council. As in earlier years, I briefed the Legislative Council's Panel on Financial Affairs three times during the year on the work of the HKMA and my senior colleagues and I attended a number of meetings to answer questions on aspects of our work and provided written submissions on a variety of subjects.

Finally, 2008 made particularly heavy demands on HKMA staff, many of whom found themselves working longer hours than normal – often much longer – under considerable pressure. As always, they rose to the challenge without fuss or complaint. I would like to extend my heartfelt thanks to all my colleagues.

Joseph Yam
Chief Executive