Chief Executive's Statement

At the beginning of last year I foreshadowed that the imbalances in the global financial system would continue to create uncertainties that would have profound negative consequences for the global economy and financial markets. This proved to be the prevalent theme of 2011 as markets and economies from the United States to Europe to Asia were buffeted by unpredictable volatility.

No region escaped this unsettling uncertainty. The US, the world's biggest economy, saw its positive growth momentum of late 2010 slow to a full year growth rate of only 1.7% in 2011, substantially lower than the consensus forecast of 3.2% at the start of the year. Market confidence and the outlook for the global economy worsened with the historic downgrade of the US foreign currency and local currency long-term ratings from "AAA" to "AA+" by Standard & Poor's in August 2011. The ratings agency's announcement on 5 August triggered a brief period of panic in the markets. Across the Atlantic the situation was even more worrying, with Europe's sovereign debt crisis spreading from the peripheral economies to the major ones. The situation in Asia was also uneasy. Japan experienced a devastating earthquake, tsunami and nuclear crisis. In Mainland China, despite the severe inflationary pressure and risk of asset bubble in early 2011, there was increasing concern about the possibility of a hard landing towards the end of the year.

Against this global backdrop, 2011 was a testing time for the financial stability of Hong Kong.

With the US sovereign rating downgrade and the general economic malaise spreading from the US and Europe, some concerns were expressed locally about the appropriateness of Hong Kong continuing to link the Hong Kong dollar to the US dollar through the Linked Exchange Rate system. The HKMA presented robust analyses showing that the Linked Exchange Rate system remained the most appropriate exchange rate regime for Hong Kong. Our proactive communication not only addressed the anxiety of Hong Kong people, but also earned strong support from the International Monetary Fund, which continued to express support for the Linked Exchange Rate system in its Article IV Consultation for Hong Kong undertaken at the end of last year. In addition, the Hong Kong SAR Government reaffirmed its support for the Linked Exchange Rate system as the cornerstone of Hong Kong's monetary stability and the basis for financial and economic stability.

The Global Financial Crisis taught us in the most emphatic manner that over-borrowing and the creation of asset price bubble is a recipe for financial disaster. In 2011 the HKMA maintained its vigilance against the build-up of systemic risks within the banking sector which, in the early part of the year, faced an exuberant property market and rapid expansion of credit. We implemented positive mortgage data sharing in April and introduced the fourth round of countercyclical macro-prudential measures in June, thereby strengthening banks' risk management and ability to withstand the possible shock of a significant correction in the property market. As a result of successive actions taken by the HKMA, turnover in the property market dropped significantly while price eased by 3.9% in the second half of the year. Banks became more prudent in undertaking their mortgage business. The average loan-to-value ratio for new residential mortgage loans decreased to 53% in December 2011, from 64% in September 2009 before the first round of measures was introduced; and the average debt servicing ratio for new residential mortgage loans fell to 36% in December 2011 from 41% in August 2010, when the tighter requirement on debt servicing ratio was first introduced. Meanwhile, in response to the rapid expansion of credit in other areas, the HKMA repeatedly reminded banks that their credit underwriting standards must not be diluted by strong loan demand from customers, their loan growth must be supported by stable funding sources, and they must have strong buffers against possible deterioration in asset quality. With the joint efforts of the HKMA and the banking industry, credit growth slowed in the latter half of the year.

A very positive development in 2011 was the remarkable growth of Hong Kong as the offshore renminbi business centre. Renminbi trade settled through Hong Kong totalled RMB1,915 billion in 2011, more than five times the amount settled in 2010. With increasing demand for renminbi financing, issuance of dim-sum bonds in Hong Kong tripled to RMB108 billion in 2011 with a broader range of issuers, and the outstanding amount of renminbi corporate loans increased from less than RMB2 billion at the beginning of the year to over RMB30 billion at the end of 2011. Hong Kong now possesses the largest renminbi liquidity pool outside Mainland China, with customer deposits growing from RMB315 billion at the beginning of 2011 to RMB589 billion at the end of the year, and certificates of deposits increasing more than 10 times from RMB7 billion at the beginning of 2011 to RMB73 billion at the end of the year. Such phenomenal growth was partly a result of the continued maturity of offshore renminbi businesses in Hong Kong, and partly because of the expansion of policy framework by the Mainland authorities to facilitate better use and circulation of renminbi funds between the offshore and the onshore markets.

Hong Kong's role in supporting renminbi business overseas continues to grow. Our renminbi financial platform now supports banks and financial institutions around the globe. At the end of 2011, 15% of renminbi corporate deposits were held by overseas companies. Of the 187 participating banks, 165 were foreign owned or located overseas, covering over 30 countries in six continents. In 2011 the HKMA conducted promotional roadshows in Australia, Russia, the United Kingdom and Spain to enhance the awareness of overseas corporate and financial institutions of the one-stop services offered by our platform. We also agreed with the UK Treasury in January 2012 to establish the Hong Kong-London Joint Forum to promote co-operation on development of offshore renminbi businesses. The operating hours of our renminbi Real Time Gross Settlement system will be extended to 11:30 p.m. by June 2012 to allow financial institutions in the UK and Europe to make good use of Hong Kong's offshore renminbi platform, which will in turn strengthen the status of Hong Kong as the global hub for offshore renminbi business.

The performance of the Exchange Fund in 2011 was affected by the exceptionally volatile and difficult investment environment but recorded an investment income of HK$27.1 billion, or a return of 1.1%, for the year. It was a roller-coaster year for global equity markets, which went from being strong in the first quarter of 2011 following the second round of quantitative easing and fiscal stimulus measures in the US, to shaky when the Greek sovereign debt crisis flared in May. As the European debt crisis intensified, risk appetite declined sharply and market confidence weakened significantly. A sell-off of risky assets followed the downgrade of the US sovereign credit rating in August. This drove equity markets sharply down while the US dollar strengthened, which wiped out most of the investment income gained by the Exchange Fund in the first half of the year. The Exchange Fund in the fourth quarter recouped part of its losses incurred in the third quarter, following the positive developments in Europe, including the agreement of the European leaders on a Fiscal Compact and the first round of the Longer-Term Refinancing Operations launched by the European Central Bank in December 2011.

Although confidence of the global financial markets recovered somewhat in early 2012, the outlook for the year 2012 is still fraught with uncertainty as the US and European governments grapple to restore their economies to the path of growth. Europe still faces uncertainties arising from its sovereign debt overhang and lack of growth momentum, while the US will continue to be troubled by the slow improvement in the labour and housing markets. Rising geopolitical risks around the world also present potential flashpoints for the global economy. As a result, capital flows will remain highly unpredictable and financial markets can be very volatile in 2012.

Meanwhile, quantitative easing and persistently low interest rates in the advanced economies have led to massive capital flows into emerging market economies in the past few years, fuelling over-heating pressures and heightening the risks of inflation and asset price bubble. With the advanced economies anticipating the maintenance of an accommodative monetary policy for an extended period, a two-speed global recovery will persist. On the one hand, we must prepare ourselves for any downside risks originating from Europe and the US. On the other hand, we must not loosen our guard against the risk of renewed exuberance in the property market. The crucial issue for Hong Kong is to remain alert and vigilant, and be prepared for any unexpected storms that may blow our way.

Hong Kong has a good track record of financial stability over a very long period. As challenges confront the global economy, the HKMA will continue to guard Hong Kong against threats to our banking and monetary stability. We will continue to manage the Exchange Fund in a prudent manner amid a highly uncertain investment environment, and continue the diversification of investment with a view to increasing medium- and long-term return while ensuring that the Fund has sufficient liquidity to maintain monetary and financial stability. At the same time, we will continue to work diligently to grasp the opportunities for developing Hong Kong as the offshore renminbi business centre and an asset management centre, and raising Hong Kong's standing as an international financial centre to new heights.

Norman T.L. CHAN
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