Chief Executive's Statement

2014 was another unusual and volatile year for the global economy and financial markets, which were in no small part affected by the unconventional monetary policies of the advanced economies. It was a highly challenging year for the HKMA.

While the US economy was recovering steadily, growth in Europe and Japan was weak, resulting in divergent monetary policy paths in the major economies. The US Federal Reserve started to taper its asset purchase programme in January 2014 and wrapped up the programme in October as planned. Nevertheless, there were still considerable uncertainties in the timing and pace of interest rate hikes. The euro-zone economy stagnated, and while the long-awaited monetary easing finally materialised, the prospects were somehow undermined by the outcome of the Greek election early this year. Last November, the Bank of Japan announced an expansion of its quantitative and qualitative monetary easing programme, but the effectiveness remains to be seen. Throughout last year, the myriad of factors contributed to the uncertainty and volatility of the financial markets. US interest rates went down instead of up during the year, defying market expectations; the US dollar strengthened sharply in the second half; equity markets in the US and Japan rallied, while those in Europe swung; oil prices plummeted by more than half in the second half; growth in emerging economies, including China, lost steam; and geopolitical tensions heightened. These developments, taken together, had made the macro environment more complex and uncertain.

In addition to a complicated global environment, Hong Kong had its own domestic challenges. Normal services in some bank branches were disrupted during the 79-day Occupy Movement. Despite this, the business continuity plans activated by the HKMA and by the affected banks operated smoothly and without incidents. The HKMA also stood ready to provide liquidity support to the banking system as and when needed. During the Occupy Movement, the local banking system and financial markets continued to function normally and the Hong Kong dollar exchange rate and interest rates remained stable, reflecting the strong market and public confidence in Hong Kong.

The Linked Exchange Rate System has been the cornerstone of Hong Kong's monetary and financial stability since its introduction in 1983. As a result of fund-raising and other commercial activities, a total of US$9.7 billion equivalent of funds flowed into the Hong Kong dollar in July and August. The strong-side Convertibility Undertaking under the Currency Board system was repeatedly triggered, injecting Hong Kong dollar liquidity into the market to maintain exchange rate stability. The Hong Kong dollar softened in the fourth quarter. Throughout the year, there was ample liquidity in the interbank market, while the interbank rates remained largely steady, which provided a stable monetary environment for trading, commercial and other economic activities in Hong Kong.

The emergence of high-quality counterfeit HK$1,000 banknotes in December 2013 and early 2014 aroused widespread public concern. The HKMA responded swiftly with multipronged measures that helped curb the further circulation of such counterfeit notes. Separately, we launched a two-year pilot Coin Collection Programme in September. Two coin collection carts served the 18 districts in Hong Kong on a rotation basis. The programme was very well received and at the end of 2014 had collected 46 million coins with a total face value of $41 million from 50,000 persons.

2014 was also a challenging year for the HKMA in terms of banking supervision. Credit growth accelerated sharply at the beginning of the year before it moderated in the second half. Total loans for the year increased by 12.7%, compared with 16% in 2013. We took steps to further strengthen our supervision of banks' credit growth and asset quality. The Stable Funding Requirement, which came into effect from January 2014 and further refined in November, helped strengthen banks' liquidity management and mitigated the potential impact of financial market fluctuations on the banking system and the credit market. In view of the continued expansion of Mainland-related lending, the HKMA enhanced its supervisory capability through more comprehensive and granular reviews and analyses. At the same time, household indebtedness reached a record high of 64% of GDP on the back of rapid growth in personal loans. In this connection, we required banks to adopt more prudent risk management measures when underwriting personal loans, having regard to the potential default risks associated with interest rates rises. The property market became buoyant again in the second half of 2014, with notable increases in prices and transaction volumes compared with 2013, particularly in the small- and medium-sized residential units. To safeguard banking stability, the HKMA introduced the seventh round of countercyclical prudential measures at the end of February 2015 after closely monitoring developments in the property cycle and carefully assessing the potential impact on the banking sector. We will continue to carefully monitor the property market and will introduce appropriate countercyclical prudential measures.

We are also seeking to protect banking and financial stability through the enhancement of the legislative framework. Legislation for the second stage implementation of the Basel III requirements was enacted last year, introducing regulatory requirements on capital buffers and a liquidity coverage ratio for banks. To reduce the systemic risk posed by the "too big to fail" financial institutions, the HKMA joined hands with the Government, the Securities and Futures Commission and the Insurance Authority to consult the public and develop a piece of new legislation that creates a robust resolution regime for financial institutions that meets the latest international standards promulgated by the Financial Stability Board. Our aim is to introduce a bill into the Legislative Council before the end of 2015. We also sought to enhance the Deposit Protection Scheme in order to expedite the compensation payout process in the event of bank failures.

The HKMA has also been at the forefront in advocating financial consumer protection. For example, we took the initiative at the international level to promote greater transparency in "dynamic currency conversion" charges associated with overseas credit card spending. Our proposals were adopted by the task force under the Organisation for Economic Co-operation and Development (OECD) as one of the effective approaches for implementation of the G20 High-level Principles on Financial Consumer Protection. Separately, a series of publicity programmes promoting the "smart and responsible" use of banking services was also launched by the HKMA through different media channels during the year.

Chief Executive's Statement

2014 was a year of accomplishments in the development of offshore renminbi business in Hong Kong. The size of our renminbi liquidity pool, the total issuance of dim sum bonds, the amount of renminbi trade settlement handled by Hong Kong banks, and the turnover of the renminbi Real Time Gross Settlement (RTGS) system all reached record highs. The most important accomplishment of all was the launch of the Shanghai-Hong Kong Stock Connect in November, which was a major milestone for the liberalisation of the Mainland's capital account, creating further channels for the flow of renminbi between the onshore and offshore markets. At the same time, the daily renminbi conversion limit of RMB20,000 for Hong Kong residents was also removed, greatly facilitating the development of renminbi financial products in Hong Kong. To support the Shanghai-Hong Kong Stock Connect, the HKMA introduced an RMB10 billion intraday repo facility and designated seven banks as Primary Liquidity Providers. Both measures were designed to enhance the interbank liquidity and support market-making activities in the CNH market. All these accomplishments in 2014 further solidify Hong Kong's position as the premier global offshore renminbi hub.

Our efforts in developing Islamic finance in Hong Kong also bore fruit. The HKMA successfully launched the inaugural issuance by the HKSAR Government of US$1 billion 5-year sukuk (Islamic bond), the world's first US dollar-denominated sukuk originated by an AAA-rated government. The issuance attracted strong demand from global investors with orders exceeding US$4.7 billion and received a number of international awards.

On a number of occasions, I have argued that the competition among international financial centres is more a battle of soft power than hard infrastructure. The HKMA spares no efforts in Hong Kong's soft power in the financial arena. We continued to press ahead with the amendments to the Inland Revenue Ordinance to attract multi-national corporations to make Hong Kong their global or regional hub for corporate treasury centres. We sought to enhance banks' internal governance through their boards and directors. We also provided support to the banking industry in the development of the technical as well as ethical standards of its practitioners. For example, we joined hands with the Private Wealth Management Association to launch the Enhanced Competency Framework for private wealth management practitioners last June to establish standards for core competency and ongoing professional development.

As for hardware, our various critical financial market infrastructure, including the Hong Kong dollar, renminbi, US dollar and euro RTGS systems and the Central Moneymarkets Unit, continued to run extremely smoothly with total reliability. System developments for the over-the-counter derivatives trade repository are making good progress and it is being rolled out in phases. At the same time, in view of the latest advancement in financial technology and market developments, we have introduced a bill into the Legislative Council in February 2015 to establish a regulatory regime for stored value facilities and retail payment systems. We also planned to launch a brand new e-cheque service by the end of 2015 to provide a more convenient way to issue and deposit cheques through the internet and email system.

The Exchange Fund adopts a prudent asset allocation strategy that aims at capital preservation as well as stable returns in the medium to long run. The global investment environment in 2014 was exceptionally difficult. With the Federal Reserve starting to taper its asset purchases, it was widely expected that US interest rates would pick up gradually from the present low levels and the US dollar would strengthen gradually against other currencies. In view of these likely developments, we took several defensive moves, including holding more cash, reducing the average duration of our bond holdings, reducing the allocation to bonds in favour of equities and reducing our holdings in euro and yen. However, last year saw US interest rates go down instead of up and the US dollar index surge by a surprising magnitude, registering its steepest single-year rise in 17 years. As a result, the non-US dollar assets of the Exchange Fund incurred substantial exchange losses when translating into the US dollar, dragging down the Fund's overall investment return. The Exchange Fund recorded an investment income of $44.7 billion in 2014 and an overall rate of return of 1.4%. The Investment Portfolio posted a return of 2% and the Long-Term Growth Portfolio achieved an annualised since-inception internal rate of return of 13.5%.

Looking ahead, we expect that the global macro environment and financial markets will become even more complicated and volatile than 2014. Asset markets around the world are jittery over the impending normalisation of US interest rates, but there are still significant uncertainties surrounding the timing and pace of the rate hikes. It is also difficult to discern the impact on global financial stability as a result of the normalisation of US interest rates amidst divergent monetary policy paths of major central banks. Therefore, fund flows, exchange rates, interest rates and asset prices will be highly unpredictable. Nevertheless, of all these uncertainties, one thing that is quite certain is the likely outflow of funds from emerging markets, including Hong Kong, when US interest rates enter the upward cycle and the US dollar continues to strengthen. In this cycle, financial and asset markets in Hong Kong, in particular the property market, will inevitably be affected. Emerging markets, including Mainland China, are likely to face further downward pressures, and the potential impact on Hong Kong cannot be underestimated. I and my colleagues in the HKMA will continue to tackle all these challenges and difficulties that may come our way with great care and a high degree of professionalism.

Norman T.L. CHAN
Chief Executive