The HKMA has conducted a review of the current economic and financial conditions and has concluded that the environment is not unfavourable for the final phase of interest rate deregulation, covering Hong Kong dollar savings and current accounts, to take place as scheduled on 3 July 2001. This article explains the considerations behind this decision.

Background

In 1999, the HKMA undertook to deregulate the remaining interest rate rules (IRRs) in two phases. Phase 1 of the deregulation, covering time deposits with a maturity of less than 7 days, was implemented in July 2000. The prohibition on benefits for deposits (with the exception of HK dollar savings and current accounts) was also lifted at the same time. Since the amount of deposits affected only accounted for less than 0.1% of total HK dollar deposits, the impact of the deregulation on the banking sector has been insignificant.

Phase 2 of the deregulation covering savings and current account deposits was scheduled to take place in July 2001, provided that the prevailing economic and financial conditions were not unfavourable. To gauge this, a set of monitoring indicators, comprising both quantitative and qualitative factors, was developed in 1999. The performance of the monitoring indicators is discussed in the following paragraphs.

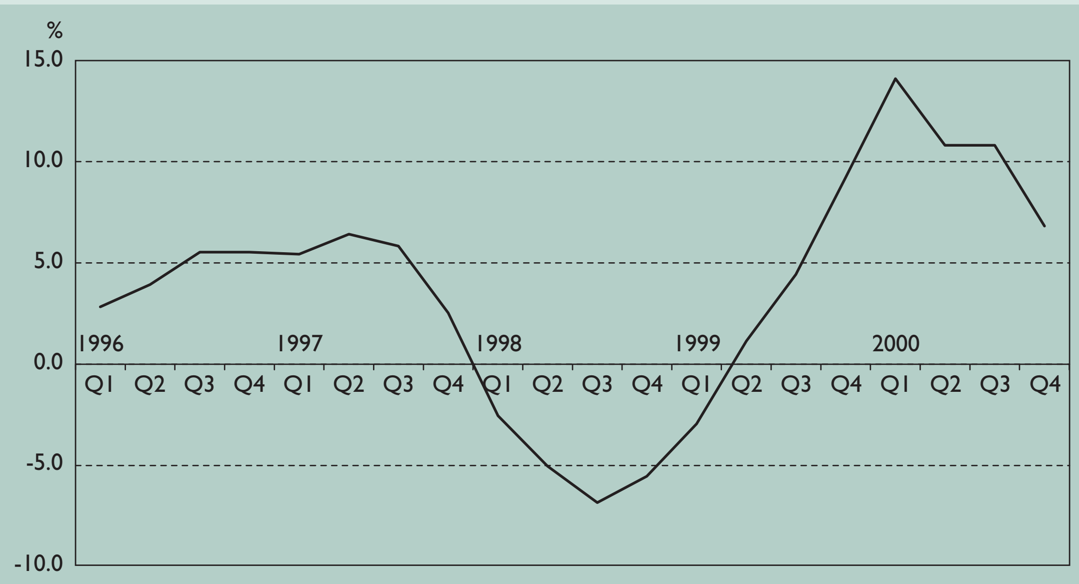
Assessment of The Prevailing Economic and Financial Environment

Two consecutive quarters of real GDP growth

Having emerged out of the recession brought about by the Asian financial crisis, the Hong Kong economy staged a remarkable rebound in 2000. Real GDP recorded three consecutive quarters of double-digit growth in the year, although the pace of recovery slowed to 6.8% in the fourth quarter of 2000. Up to now, seven consecutive quarters of real GDP growth have been recorded since Q2/1999 (see Chart 1 and Table 1).

Chart 1

GDP (year-on-year rate of change in real terms)



Source: Census & Statistics Department

Table 1
GDP growth

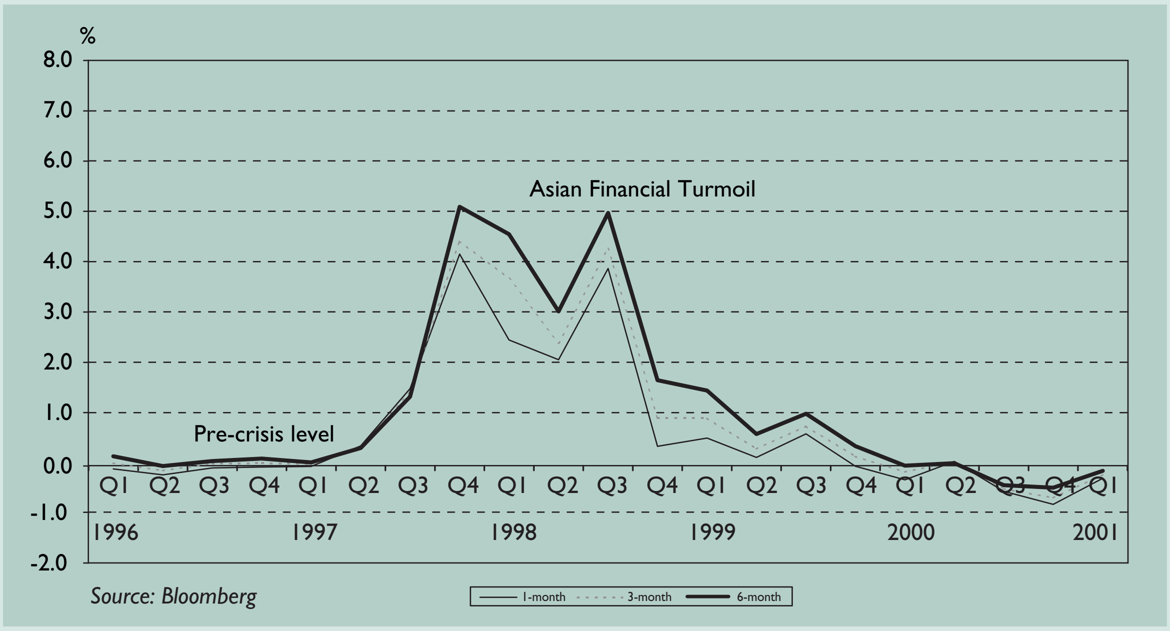
		year-on-year rate of change in real terms (%)
1996	Q1	2.8
	Q2	3.9
	Q3	5.5
	Q4	5.5
1997	Q1	5.4
	Q2	6.4
	Q3	5.8
	Q4	2.5
1998	Q1	-2.6
	Q2	-5.1
	Q3	-6.9
	Q4	-5.6
1999	Q1	-3.0
	Q2	1.1
	Q3	4.4
	Q4	9.2
2000	Q1	14.1
	Q2	10.8
	Q3	10.8
	Q4	6.8

Looking forward, it is generally expected that economic growth will continue in 2001, though at a more moderate pace. The moderation in growth reflects a higher base of comparison in 2000, as well as slower growth in major economies, particularly the US. Nevertheless, the interest rate cuts earlier this year and expectations of further monetary easing in the US should provide some support to both the financial markets and domestic consumption. Moreover, robust economic growth in the Mainland and China's imminent accession to the World Trade Organisation are a distinct positive factor for Hong Kong. It appears, therefore, that the outlook for the local economy remains generally favourable. Market forecasts are for the local economy to grow by around 2.2 - 4.6% in 2001. [1]

Differential between HIBOR and US dollar LIBOR has stabilised and is close to the pre-crisis levels

The differential between HIBOR and US dollar LIBOR is the premium demanded by the market for holding Hong Kong dollars, and is therefore indicative of market confidence in the local currency.

Chart 2
Quarterly Average Differential between Hong Kong Dollar and US Dollar Interest Rates #



Quarterly average of differential between daily HIBOR fixing and US Dollar LIBOR fixing

1 According to Asia Pacific Consensus Forecasts (April 2001) which has surveyed 18 economic forecasters.

Table 2
Quarterly Average Differential between
Hong Kong Dollar and US Dollar Interest Rates #

		1-Month			3-Month			6-Month		
		Avg.	Max.	St.Dv.	Avg.	Max.	St.Dv.	Avg.	Max.	St.Dv.
1996	Q1	-0.065	0.250	0.162	0.051	0.313	0.111	0.186	0.422	0.107
	Q2	-0.182	0.079	0.118	-0.097	0.085	0.069	-0.007	0.141	0.046
	Q3	-0.044	0.172	0.065	0.041	0.125	0.032	0.091	0.195	0.042
	Q4	-0.025	0.179	0.074	0.052	0.250	0.059	0.140	0.258	0.040
1997	Q1	-0.013	0.260	0.179	0.029	0.211	0.112	0.065	0.219	0.091
	Q2	0.394	0.953	0.299	0.361	0.860	0.261	0.351	0.813	0.221
	Q3	1.531	5.519	0.899	1.454	4.263	0.751	1.371	3.687	0.660
	Q4	4.199	41.844	5.785	4.458	10.076	2.352	5.139	27.125	3.526
1998	Q1	2.495	13.530	3.341	3.718	12.922	2.905	4.596	12.482	2.599
	Q2	2.105	14.669	2.604	2.436	10.491	2.037	3.061	9.004	1.725
	Q3	3.916	13.632	2.576	4.310	9.500	1.623	5.018	8.817	1.269
	Q4	0.384	5.379	0.834	0.948	2.794	0.530	1.696	3.848	0.603
1999	Q1	0.548	1.766	0.434	0.946	2.515	0.472	1.492	2.942	0.497
	Q2	0.163	0.698	0.264	0.331	0.786	0.161	0.630	1.154	0.161
	Q3	0.632	1.239	0.843	0.783	1.288	0.338	1.033	1.475	0.284
	Q4	-0.010	0.977	0.353	0.185	0.540	0.181	0.390	0.655	0.163
2000	Q1	-0.282	0.229	0.340	-0.126	0.060	0.091	-0.001	0.116	0.066
	Q2	0.084	0.472	0.266	0.075	0.400	0.156	0.051	0.369	0.126
	Q3	-0.508	-0.030	0.284	-0.461	-0.122	0.188	-0.388	-0.169	0.141
	Q4	-0.768	-0.008	0.319	-0.637	-0.366	0.150	-0.436	-0.278	0.088
2001	Q1	-0.251	0.061	0.144	-0.179	0.072	0.139	-0.103	0.207	0.157

 # Quarterly average of differential between daily HIBOR fixing and US Dollar LIBOR fixing

Since the seven technical measures were introduced in 1998 to strengthen the currency board system, the quarterly average differentials between HIBOR and US dollar LIBOR (from 1-month to 6-month) have gradually returned to the pre-crisis level, compared to an average level of 2-5% during the Asian financial crisis (see Chart 2 and Table 2). For a large part of 2000 and into 2001, the quarterly average differentials between HIBOR and US dollar LIBOR were in negative territory (i.e. HIBOR was lower than US dollar LIBOR), reflecting the strong confidence of the market in the local currency.

Capital adequacy ratio of the banking sector remains at traditionally high levels

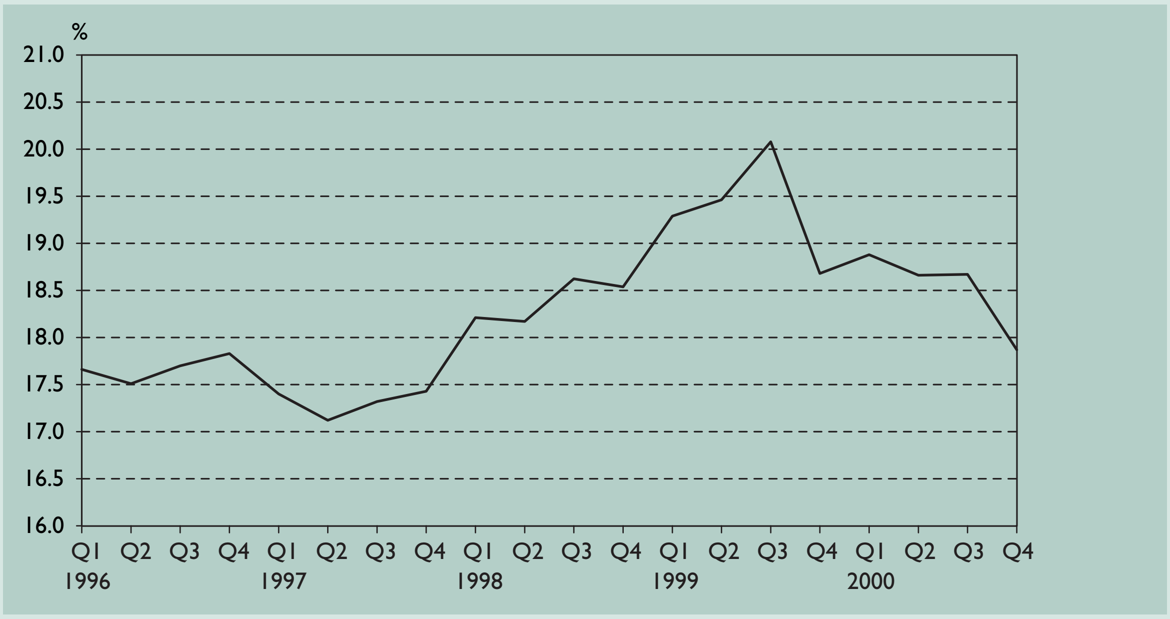
At the end of 2000, the capital adequacy ratio of all local authorized institutions stood at 17.87% (Chart 3 and Table 3). This is comparable to the traditional level of around 17% between 1996 and 1997 and is well above the minimum standard of 8% set by the Basel Committee on Banking Supervision. This high level of capital adequacy provides strong assurance that the banking sector should be able to cope with any possible negative impact of the deregulation on banks' financial performance.

Signs of improvement in the classified loans ratio for the sector

Asset quality of the banking sector continued to improve in 2000. The classified loans ratio (the ratio of loans classified as Substandard or below to total loans outstanding) has trended downwards from the peak of 10.33% in Q3/1999 to 7.12% in Q1/2001, although this is still significantly higher

Chart 3

Capital Adequacy Ratio (all local AIs - consolidated position)



Source: HKMA Banking Statistics Section

Table 3

Capital Adequacy Ratio
(all local AIs - consolidated position)

		(%)
1996	Q1	17.66
	Q2	17.51
	Q3	17.70
	Q4	17.83
1997	Q1	17.40
	Q2	17.12
	Q3	17.32
	Q4	17.43
1998	Q1	18.21
	Q2	18.17
	Q3	18.62
	Q4	18.54
1999	Q1	19.29
	Q2	19.46
	Q3	20.08
	Q4*	18.68
2000	Q1	18.88
	Q2	18.66
	Q3	18.67
	Q4	17.87

* *The decline in Q4 99 was due to a large local bank group distributing a special dividend out of its reserves to its parent company.*

than the pre-crisis level of around 2.5%. (Chart 4 and Table 4). Other measures of asset quality such as the combined ratio of overdue and rescheduled loans also showed improvement (from 6.96% as at the end of 1999 to 5.41% in Q1/2001). Although residential mortgage loans overdue for more than three months as a percentage of the total mortgage portfolio have increased from 1.13% as at the end of 1999 to 1.36% in March 2001, this is still at a comfortable level in view of the secured nature of these loans. The continued improvement in asset quality is mainly attributable to the strong economic recovery, the write-offs made by banks, and the successful restructuring of exposures to some Chinese enterprises (e.g. Guangdong Enterprises Group).

Absence of significant narrowing of net interest margins of the banking sector similar to that experienced during the Asian financial crisis

Reflecting ample liquidity in the banking sector, deposit spreads improved during 2000. However, the effect of this favourable development was not sufficient to fully offset the impact on banks of the downward pressure on lending margins. Given that demand for loans remained

Chart 4

Classified Loan Ratio (all local banks)

Source: HKMA Banking Statistics Section

Table 4

Classified Loan Ratio (all local banks)

		(%)*
1996	Q1	3.01
	Q2	2.91
	Q3	2.69
	Q4	2.68
1997	Q1	2.53
	Q2	2.08
	Q3	1.94
	Q4	2.08
1998	Q1	2.77
	Q2	3.69
	Q3	4.99
	Q4	7.33
1999	Q1	8.82
	Q2	10.14
	Q3	10.33
	Q4	9.81
2000	Q1	9.28
	Q2	8.38
	Q3	7.72
	Q4	7.18
2001	Q1	7.12

** Loans classified as substandard or below as a percentage of total loans*

subdued over the year, banks had to compete intensely for lending opportunities. The mortgage lending rate, in particular, has fallen to a norm of prime - 2.25%. The impact of the intense price competition on interest margins became more apparent in the second half of 2000. The net interest margin of local banks dropped from 2.30% in Q4/1999 to 2.20% in Q4/2000 and further narrowed to 2.13% in Q1/2001 (Chart 5 and Table 5). Nonetheless, for the year 2000 as a whole, the net interest margin of local banks stood at 2.33%, representing a slight improvement of 4 basis points over the previous year.

The contraction of net interest margins during 2000 was mainly a result of increased competition in the banking sector in an environment of sluggish demand for loans. This is different to the situation during the Asian crisis when net interest margins of banks were squeezed by sudden and drastic external events. Indeed, the reduction is not entirely unanticipated given that the banking environment is becoming increasingly competitive. Looking ahead, as the economy continues to recover, and with a lower interest rate environment, demand for loans is expected to

Chart 5

Net Interest Margin (all local banks)

Source: HKMA Banking Statistics Section

Table 5

Net Interest Margin (NIM)
(all local banks)

		(%)*
1996	Q1	2.62
	Q2	2.61
	Q3	2.57
	Q4	2.53
1997	Q1	2.50
	Q2	2.46
	Q3	2.42
	Q4	2.36
1998	Q1	2.33
	Q2	2.29
	Q3	2.18
	Q4	2.23
1999	Q1	2.28
	Q2	2.25
	Q3	2.31
	Q4	2.30
2000	Q1	2.40
	Q2	2.39
	Q3	2.33
	Q4	2.20
2001	Q1	2.13

* *Annualised figure*

gradually pick up. This may help alleviate the downward pressure on the lending margins of banks.

There is the possibility that deregulation will in itself cause some contraction of net interest margins as some banks bid more actively for the deregulated deposits. However, the current high level of liquidity in the system should help to dampen any upward pressure on deposit rates and therefore the immediate impact of deregulation on margins may be less than originally anticipated.

Absence of severe strains on the profitability of a significant proportion of the local banking sector

Most of the local banks showed sharp recovery in profits for 2000. Pre-tax operating profits of local banks in respect of their Hong Kong offices grew by around 37.8% in 2000, compared with 15.2% the preceding year. The strong growth, however, mainly reflected the decline in bad debt provisions. Growth in pre-provision profits was less robust.

Given a higher base of comparison in 2000, profit growth is expected to slow in the coming year. Asset quality should continue to improve against a background of continued economic growth and a lower interest rate environment. Against this, lending margins are expected to remain under pressure. Overall, profits of the local banks are expected to show only modest, if any, growth.

Absence of foreseeable significant international or regional economic upheavals

Signs of moderation in global economic growth were increasingly evident towards the end of 2000 and in early 2001. U.S. GDP growth slowed to a quarter-on-quarter annualised 1.0% in Q4/2000, although it improved slightly back to 2.0% in Q1/2001. Growth in the EU has also eased. The Japanese economy has remained in the doldrums, notwithstanding a small positive growth rate in the fourth quarter of 2000.

Central banks of major industrial economies have responded to the economic slowdown by relaxing their monetary policies. The U.S. Federal Reserve has cut interest rates five times by a total of 250 basis points since January 2001. The Bank of Japan has also relaxed its monetary policy and has effectively reverted to the zero interest rate policy which was abandoned in August 2000.

In Asia, the Mainland is expected to sustain its growth of 7-8%, helped by the accommodative fiscal and monetary policies as well as improving investment sentiment due to the impending accession to the World Trade Organisation. In other parts of Asia, there are growing signs of economic slowdown as a result of the softening of the global economy. In response to weakening external demand, many Asian central banks have eased their monetary policies.

Among the emerging economies, the financial markets in Turkey, Argentina and Brazil experienced some turbulence in the past few months. The instability mainly stemmed from economic and political problems in these countries. There is no indication of any significant contagion effects of these incidents on economies in the Asia Pacific region.

The above developments indicate that growth in the global economy and in the region may slow in 2001. However, these appear to be normal adjustments after a period of strong growth. As pointed out by the G7, although global growth has slowed, the foundations for economic expansion remain sound. The IMF also forecasts that the global economy will grow by 3.2% in 2001. In summary, there do not appear to be any significant international or regional economic upheavals that would warrant a slowdown of the deregulation process.

Conclusion

The monitoring indicators seem to suggest that the banking sector has largely, if not fully, recovered from the Asian financial crisis. The amount of problem loans has come down significantly and is expected to trend further downwards. Although the interest margins of the banking sector remain under pressure, the situation may improve as the economy continues to recover providing further impetus to demand for loans. In respect of the global economy, the outlook is less optimistic than in 2000, but the environment seems reasonably stable. On the whole, there do not appear to be significant unfavourable factors which would call for a slowdown of the deregulation process.

In light of the above analysis, the HKMA's assessment is that the prevailing economic and financial environments are not unfavourable for the final phase of the deregulation to take place in July 2001 as planned. This view is endorsed by the Exchange Fund Advisory Committee, the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee. The HKMA and the banking industry therefore agree that the final phase of the deregulation should proceed on 3 July 2001, provided that there are no major adverse developments in the meantime.

- Prepared by the Banking Policy Department