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HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

6 November 2006

DISCUSSION TOPICS

Updates on

- Currency Stability
- Banking
- Financial Infrastructure
- Hong Kong as an International Financial Centre
- Exchange Fund

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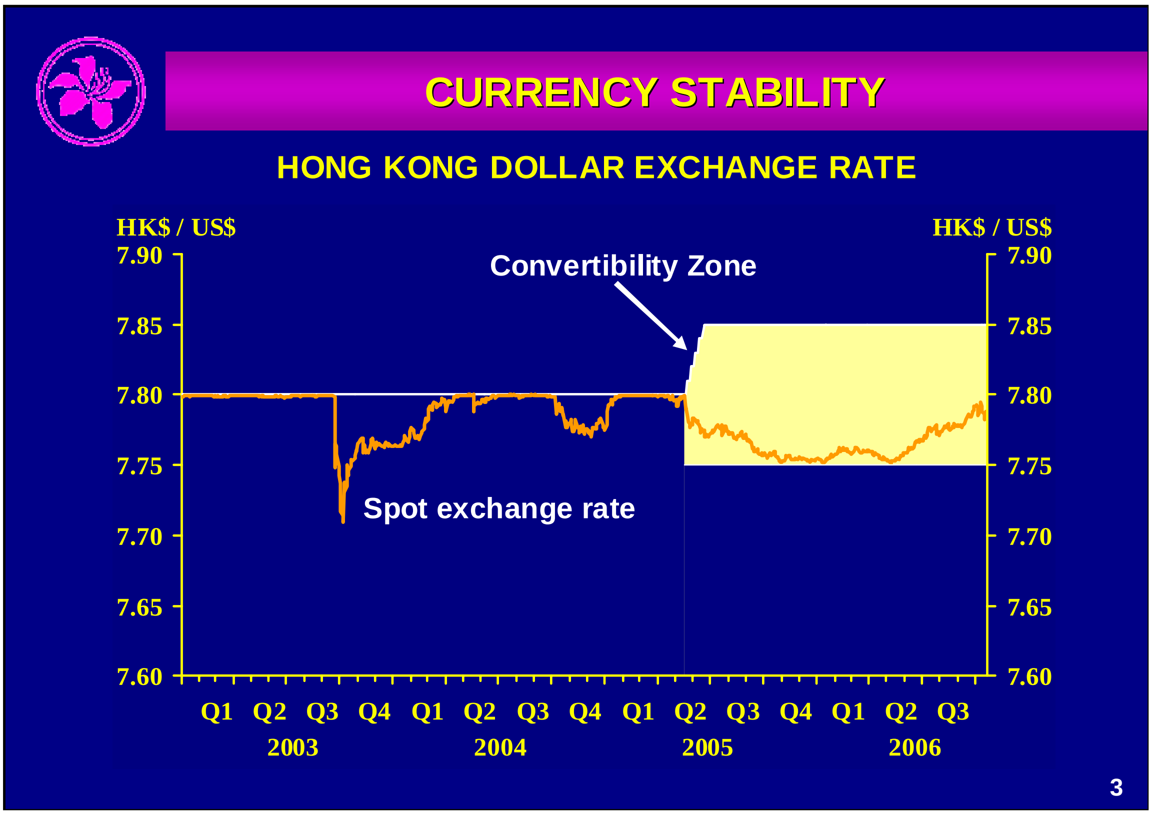
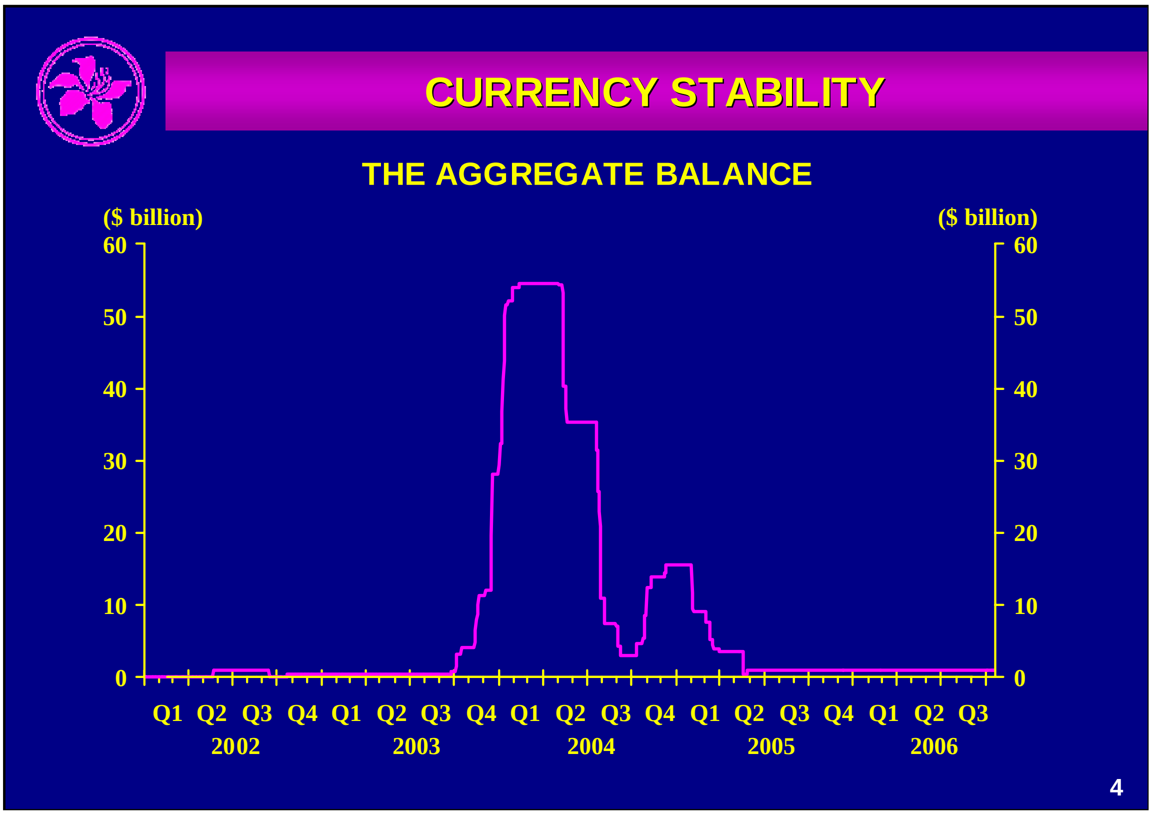


- The Hong Kong dollar exchange rate remained stable within the Convertibility Zone. It stayed close to the strong side of the Zone for most of the early part of 2006, reflecting (1) market expectation of Hong Kong dollar appreciation alongside the renminbi and (2) equity-related demand for Hong Kong dollars associated with a buoyant stock market (including a number of H-share IPOs).

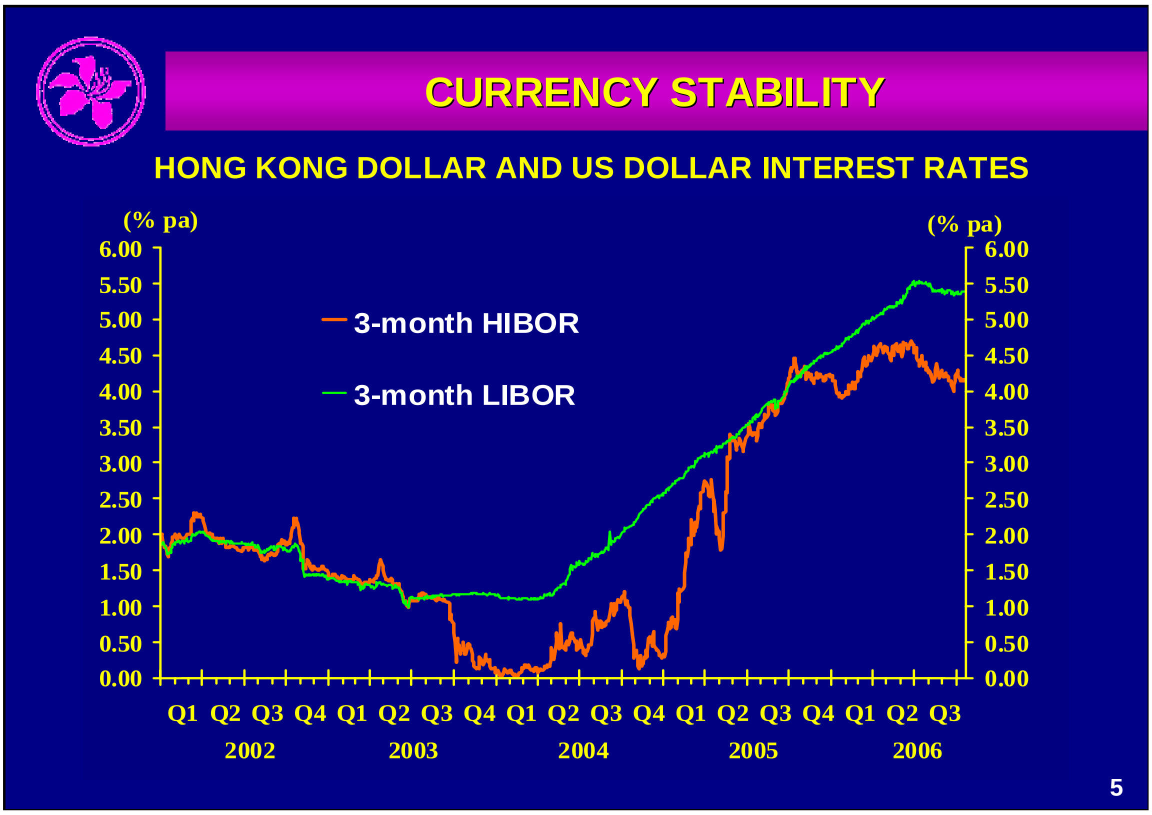
- The Hong Kong dollar exchange rate has gradually weakened since May 2006 as a result of interest carry trades taking advantage of lower domestic interest rates relative to that of the US.

- There were no significant signs of currency speculation or the use of the Hong Kong dollar as a proxy for taking a position on the renminbi.



- The Aggregate Balance remained stable at around HK$1.3 billion. It is probably larger than what is required to "oil" the interbank payment system under normal circumstances, given the highly efficient Real Time Gross Settlement System for handling such payments. But the excess, if any, has been helpful to the banking system in coping with the occasional surge in demand for interbank funds associated with large IPOs in the stock market.

- The stability of the Aggregate Balance since May 2005 reflects smooth functioning of the Linked Exchange Rate System after the introduction of the three refinements, despite rather complex external circumstances.



- The US dollar interbank interest rates stabilised as a result of a pause in interest-rate increases by the Fed in August, September and October, with Fed Funds Target Rate at 5.25% and 3-month US dollar LIBOR at a slightly higher level.

- Three-month Hong Kong dollar interbank interest rates also stabilised at around 4.25%. Some fluctuation, however, was seen, particularly in the shorter-term interbank rates, under the influence of IPO related activities. The fluctuations are normal, given the structure of the monetary system with a constant supply of interbank liquidity but sharply fluctuating demand, which is typical of an international financial centre like Hong Kong.

- Ample supply of liquidity in relation to normal demand was reflected in a discount of Hong Kong dollar interest rates below corresponding US dollar interest rates.

- Interest rate discount encouraged some interest rate/exchange rate arbitrage, contributing to some weakening of the Hong Kong dollar, but a positive outlook for Hong Kong dollar as the renminbi exchange rate continues to appreciate has been a constraint to such arbitrage activity.

- Interest rate discount can be translated into a discount of the forward exchange rate from the spot exchange rate.

- The discount of the 12-month forward exchange rate from the spot exchange rate has widened recently to over 700 pips.

- Despite the weakening of the spot exchange rate, market expectation is still for the Hong Kong dollar exchange rate to be around 7.71 against the US dollar in 12 months. This is, of course, beyond the strong side convertibility undertaking of 7.75.

- Market expectation has been influenced by the appreciating trend of renminbi and the perception that the Hong Kong dollar may appreciate in parallel.

- The position of the HKSAR on the Linked Exchange Rate System remains clear and firm.

CURRENCY STABILITY

Monetary conditions

- Pause in interest rate increases in the US at the August, September and October FOMC meetings
- Housing market and inflation concerns in the US
- US interest rate stance is generally appropriate for the economic circumstances of Hong Kong
- Some risks of event-driven rapid re-alignment of Hong Kong dollar interest rates with US interest rates

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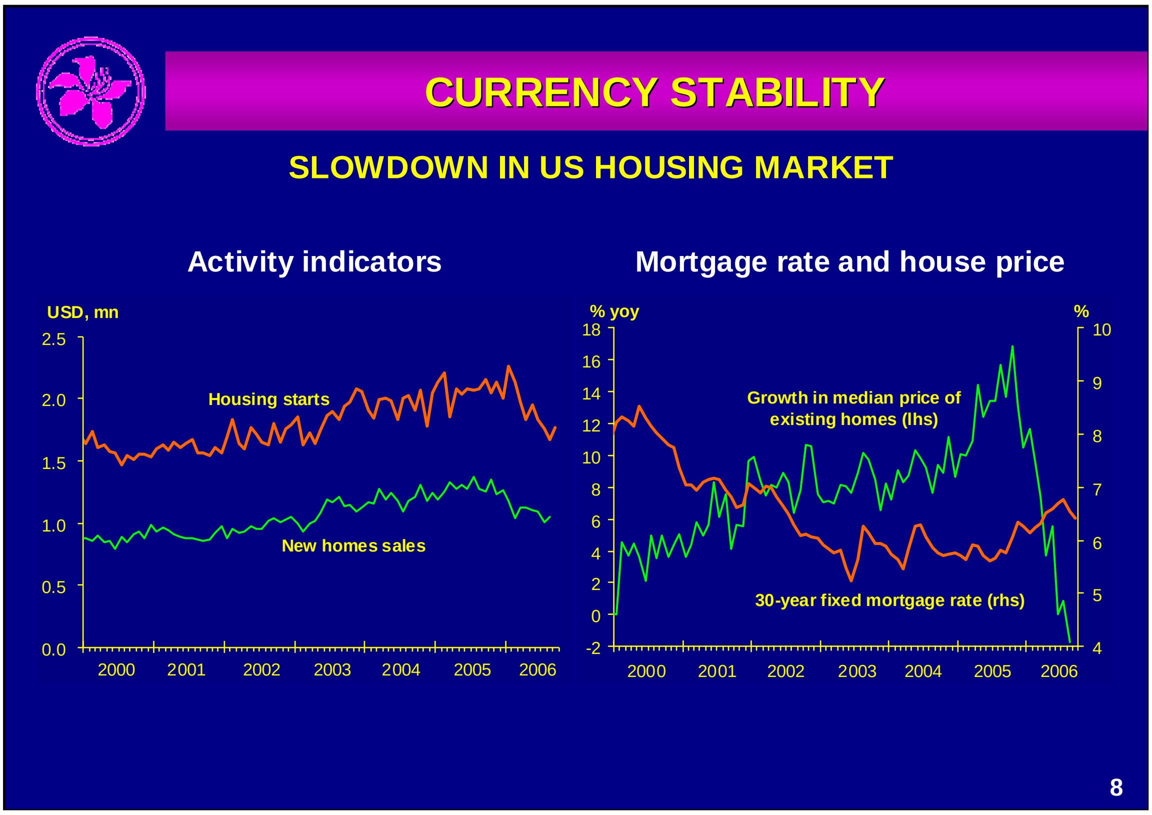
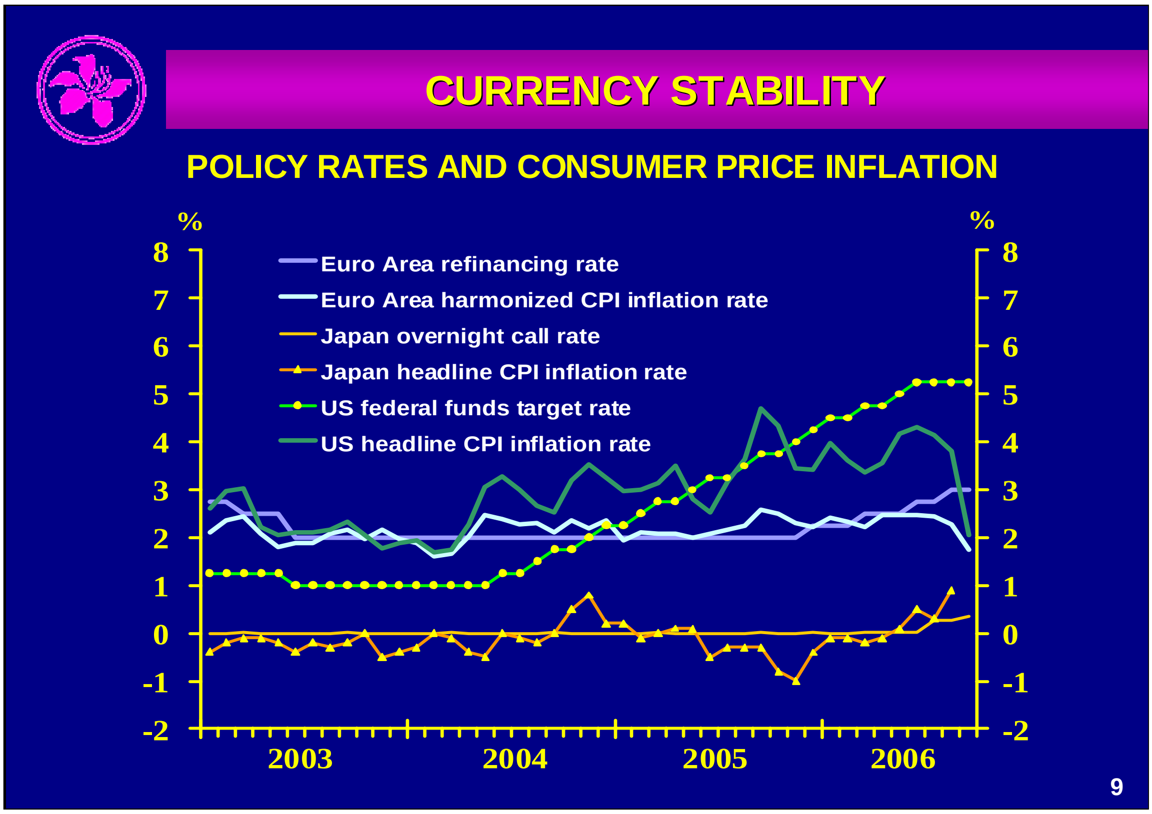
- The US Fed kept its policy rate unchanged at the August, September and October FOMC meetings, after 17 consecutive interest rate increases since June 2004.
- The duration of the US interest rate pause is unclear.
- Conflicting concerns over US housing market adjustment and higher US inflation.
- US interest rates may undulate with ups and downs reflecting fine-tuning and no clear trends.
- US interest rate stance is generally appropriate for the economic circumstances of Hong Kong.
- Some risk of event-driven rapid re-alignment of Hong Kong dollar interest rates with US dollar rates. But the three refinements have had a constraining effect on the extent of the interest rate differential.



- US housing activity has slowed rapidly over the past 12 months. Both new and existing home sales recorded double-digit declines from their peaks in 2005, and housing starts have dropped by 11% since the start of 2006. Although national house prices remain high, slowing housing demand has significantly curtailed the rate of house price increase.

- The cooling of the housing market in the US may pose significant risks to the near-term growth prospect. Residential investment has fallen for the third consecutive quarter in Q2. Rising mortgage payments reduce household disposable income and may adversely affect household consumption, while a faster-than-expected decline in house price inflation could further weigh on consumer spending through the negative wealth effect.



- Global monetary tightening is expected to curb inflationary pressure and contain inflation expectations, but also increases the risk to the global growth outlook.

- Elevated oil prices, tight labour market conditions and a high rate of capacity utilisation appear to have increased inflationary pressure in the US, with core CPI inflation rising to 2.9% year on year in September from 2.8% in August. However, the recent decline in house price inflation and weaker business activity indicators point to a possible slowdown in growth of domestic demand in the second half of 2006.

- In view of these developments, the US Fed kept its policy rate at 5.25% at its FOMC meetings in August, September and October.

- Although the European Central Bank (ECB) and the Bank of Japan (BoJ) lag behind in their tightening cycles, the pace of tightening may accelerate. The BoJ raised its policy rate to 0.25% in July, ending its zero interest rate policy. The ECB raised the refinancing rate by 25 basis points to 3% in August, the third increase this year, and hinted that further tightening might be necessary should inflation pressure persist.

- Global monetary tightening may slow the demand for Hong Kong's exports if it affects growth in our main trading partners. The external position may weaken, although a sharp reversal of the current account surplus seems unlikely. But financial markets tend to telescope future trends into present day activity, possibly triggering outflows of funds.

CURRENCY STABILITY

Risks to Currency Stability – External Factors

- Geo-political tension, particularly in Asia
- Macro adjustment and control on Mainland
- Renminbi exchange rate hitting psychological levels
- Hedge funds and global financial stability

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- Heightened geo-political concerns (particularly in North Korea and Taiwan) may cause sharp adjustments to Asian financial markets and pressure on Asian currencies as global investment funds exit from those markets.

CURRENCY STABILITY

MACRO ADJUSTMENT AND CONTROL ON MAINLAND

Monetary measures

Interest rate
- 1-year base lending rate raised twice by 54 bps to 6.12% and deposit rate once by 27 bps to 2.52%

Central bank bills
- 1-year central bank bills worth RMB 250 bn were issued

Reserve requirement
- Reserve requirement ratio raised twice by 100 bps to 8.5%

Administrative measures

Direct credit control
- The PBoC convened “window guidance” meetings with banks to urge control over excessive credit expansion

Industrial sectors
- The NDRC issued guidelines for three overheated sectors (cement, coke & steel alloys)

Property sector
- Regulatory authorities issued a set of policies to ensure healthy development of the property market and reduce speculative pressures

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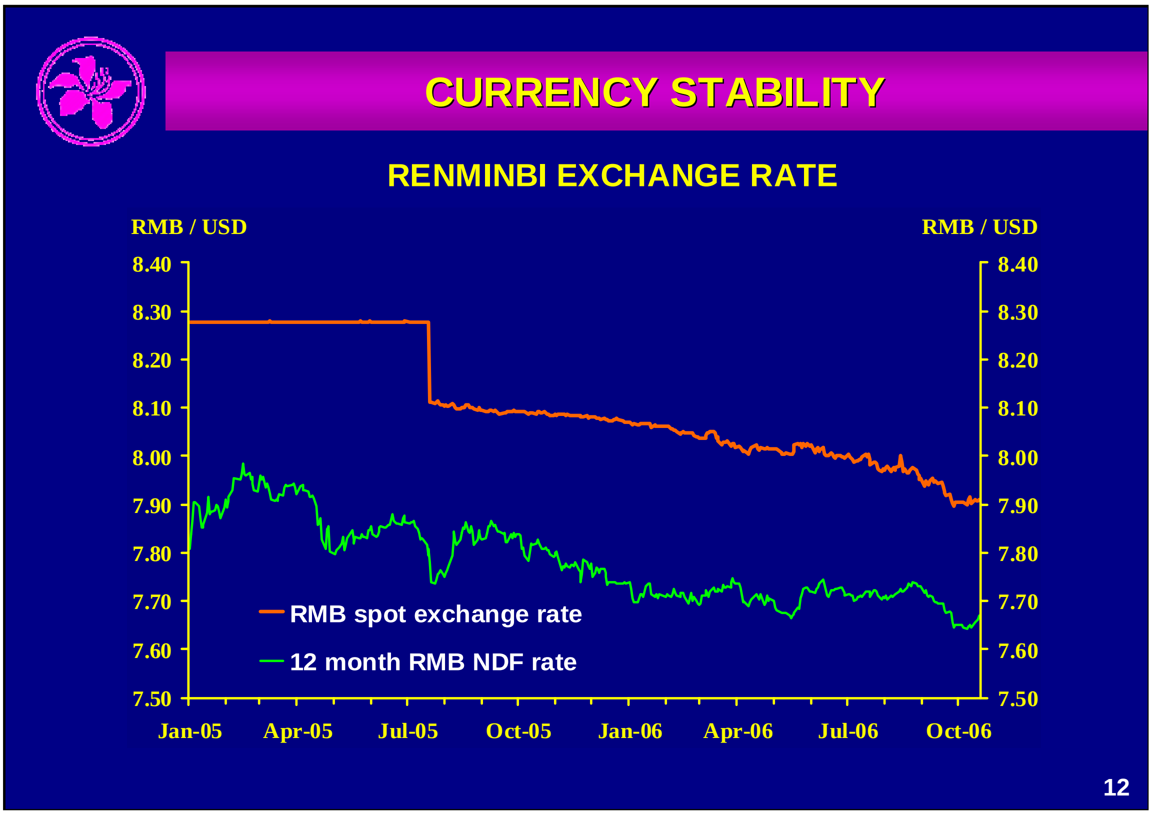
- In response to the signs of overheating in the Mainland economy during 2006 Q1, particularly a re-acceleration of investment and credit expansion, the Mainland authorities started another round of macroeconomic tightening in April 2006.
- The authorities have adopted a coordinated approach in implementing macroeconomic tightening measures. These mainly involve:
  - Monetary measures – The People’s Bank of China (PBoC) raised the benchmark interest rates and the reserve requirement ratio, and issued central bank bills worth RMB 250 billion to selected banks which were considered to be too aggressive in lending activities.
  - Administrative measures
    - Direct credit control – The PBoC convened “window guidance” meetings with banks to urge control over excessive lending to “over-invested sectors”.
    - Reducing capacity of selected industrial sectors – The National Development and Reform Commission (NDRC) issued guidelines for reducing capacity and restructuring in the cement, coke and steel alloys industries.
    - Curbing investment in the property sector – The authorities have implemented various measures which aim to rein in the property market by containing speculative demand, promoting affordable housing for lower-income groups, as well as clamping down on irregular practices in the real estate sector.
- The major macroeconomic indicators for Q3 pointed to a slowdown in economic growth to a more sustainable pace, suggesting that the tightening measures have started to take effect. Real GDP expanded by 10.4% year on year, close to one percentage point down from the exceptionally high growth of 11.3% in Q2.
- Market response to the macroeconomic adjustment measures on the Mainland may have an impact on the Hong Kong dollar.



- Greater flexibility observed recently in the form of larger daily appreciation. Also larger total appreciation in 2006 Q3 (1.1%) compared with 2006 Q2 (0.3%).

- Expectation of a sudden jump in renminbi exchange rate considerably dampened by comments of the Premier and PBoC Governor. One-year NDF quite stable at around 7.70-7.73, equivalent to about a 2% appreciation in one year.

- Very short-term effect on Hong Kong dollar exchange rate when the renminbi broke the psychological levels of 8.00 and then 7.90, but effect may be larger at the psychological levels of 7.85 (weak side convertibility undertaking of Hong Kong dollar), 7.80 (the Linked Rate) and 7.75 (strong side convertibility undertaking).

- HKMA is monitoring the situation closely. There have also been efforts to decouple the psychological relationship between the exchange rates of the two currencies.

CURRENCY STABILITY

Is the US dollar still the appropriate anchor for the Hong Kong dollar?

HKMA Research Findings:

- **Significant increase in the synchronisation of business cycles among Mainland, Hong Kong and the US**
- **Significant variations in output and prices in Hong Kong can be explained by US shocks, while the impact of Mainland shocks concentrates on price movements**
- **Little correlation between business cycles in Hong Kong and the Mainland in the absence of common US shocks**
- **US dollar continues to be the appropriate anchor for the Hong Kong dollar**

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Impression

- The Hong Kong economy is increasingly integrated with that of the Mainland through trade, foreign direct investment and financial flows. Hong Kong is more economically dependent upon the Mainland now than it was on the US in 1983 when the Link was established.

Question

- Is it now more appropriate, if a stable exchange rate remains the monetary policy objective of Hong Kong, for the exchange rate anchor to be the renminbi rather than the US dollar?

HKMA Research Findings suggest that

- There has been significant increase in the synchronisation of business cycles among the economies of the Mainland, Hong Kong and the US since 2000.
- In the short run, Hong Kong's output and price changes are mostly affected by its own shocks. Over the medium to long run, about 60% and 45% respectively of variations in output and prices in Hong Kong can be explained by US shocks, while the impact of Mainland shocks concentrates mostly on Hong Kong's price movements, explaining about one third of them.
- There is little correlation between the business cycles in Hong Kong and the Mainland in the absence of the common US shocks, whereas the impact of US shocks on the two economies leads to a high degree of synchronisation.
- The lack of similarity of domestic shocks between Hong Kong and the Mainland can be mostly attributed to their continuing differences in economic structure and being at different stages of economic development.

Conclusions

- The US dollar continues to be the appropriate anchor for the Hong Kong dollar for the foreseeable future. In any case, with the renminbi not being a freely convertible currency and not a reserve currency, it is technically not possible for it to be a currency anchor. Hence no change to the Link is needed.

CURRENCY STABILITY

Hedge funds and global financial stability

- Risk taking by hedge funds
- Counterparty risk management
- Derivatives markets
- Currency bets

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- Excessive risk taking by hedge funds, eg. the problem with Amaranth Advisors, which reportedly lost US$6 bn in September 2006.
- Counterparty risk management working and still the agreed international approach, but may not work when there is a confluence of adverse events.
- Current concerns are over-the-counter credit and equity derivatives markets. The backlog in the confirmation of over-the-counter trading contracts may pose problems.
- Banks in Hong Kong alerted to the potential problems and managing well.
- Global financial stability affects currency stability.
- Nothing to stop hedge funds from taking big currency bets again.

CURRENCY STABILITY

Risks to Currency Stability – Domestic Factors

- Domestic environment largely benign
- Sustainable growth rate and fading unemployment rate
- Higher inflation but stable trend
- Balance of Payments healthy
- Property market stable
- Fiscal position healthy

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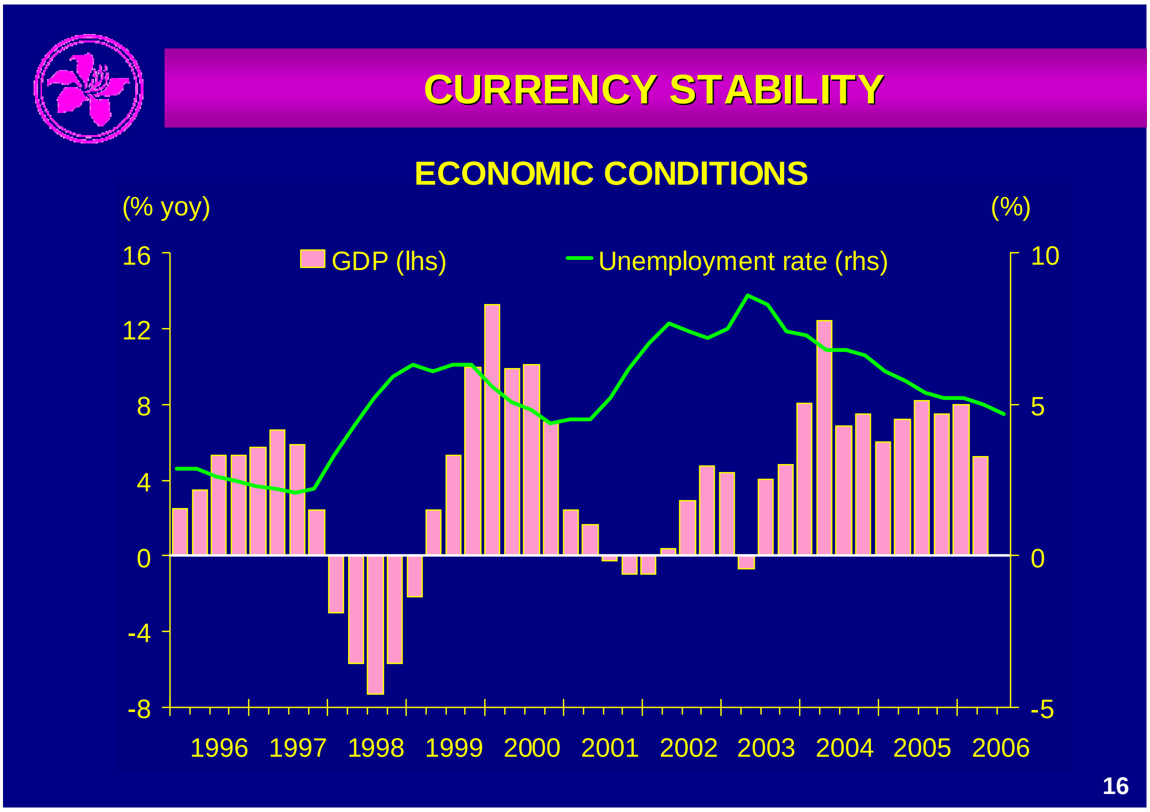
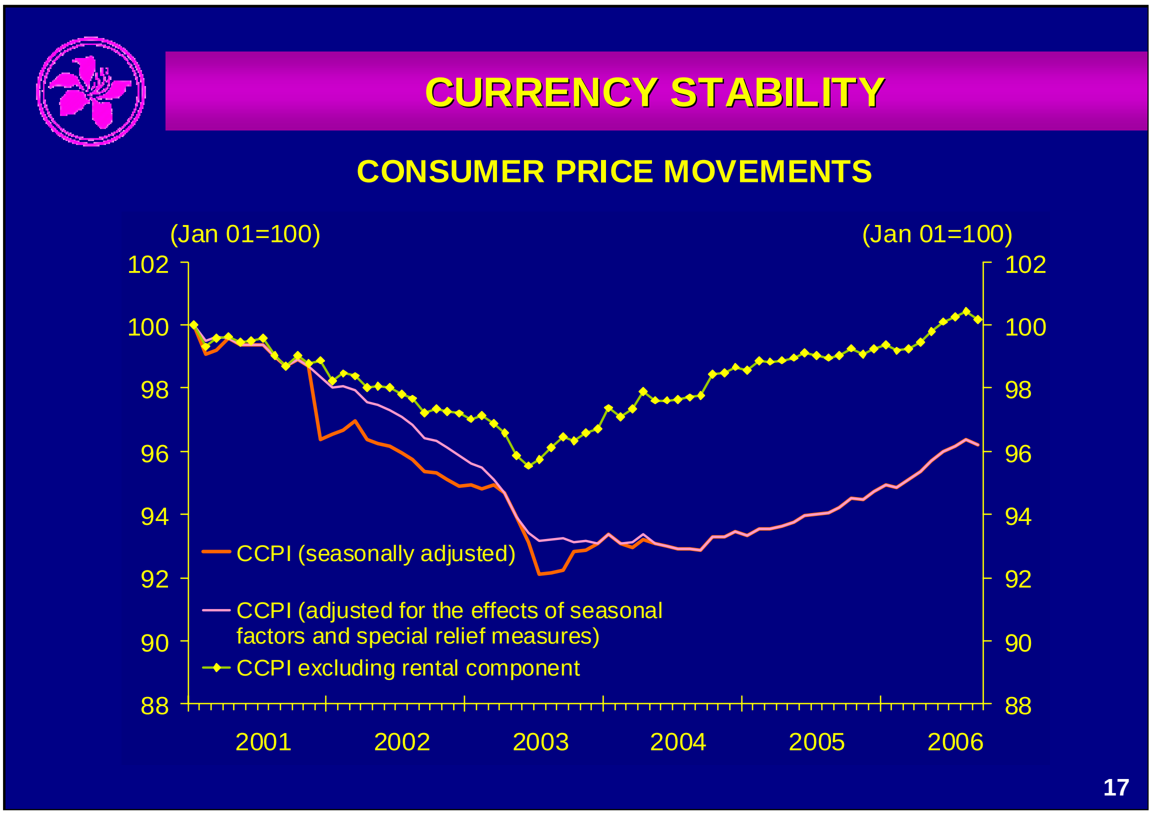


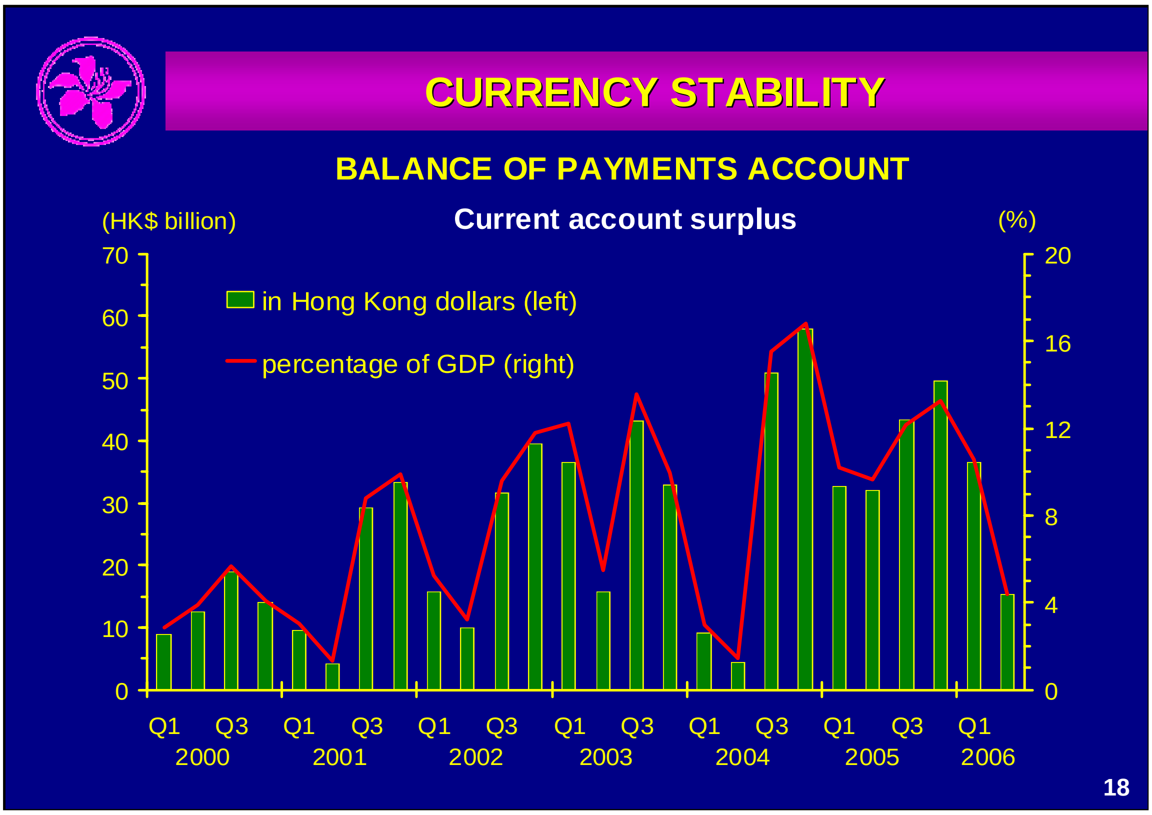
- Year-on-year GDP growth continued to be robust, at 5.2% in 2006 Q2.
- Continuing downward trend in the unemployment rate. Seasonally adjusted, the unemployment rate fell to a 5-year low of 4.7% in the three months ending September 2006.



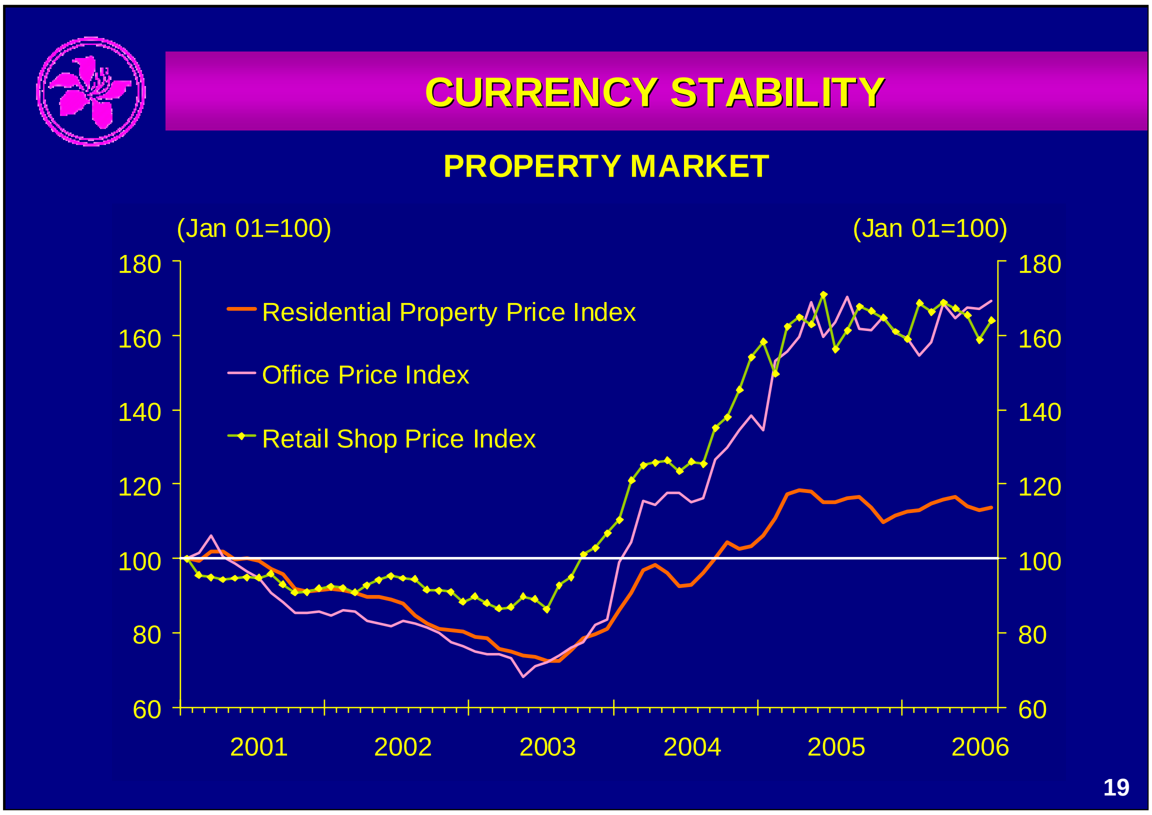
- The annual headline inflation rate increased moderately to 2.3% in 2006 Q3, up from 1.8% in 2006 H1. The inflationary pressure has been increasing since the beginning of 2006, partly reflecting the pass-through of higher rents.

- The Composite CPI, excluding rents, has been increasing along with the recovery in economic activity. The rental component of the index has picked up more noticeably in recent months because of the feeding through of earlier increases in housing rents.

- Consumer prices are expected to rise moderately because of steady economic growth and further pass-through of increases in residential rents to the headline CPI. Nevertheless, the risk of a substantial increase in inflation remains low, given the relatively slow growth of unit labour costs brought about by productivity gains in the past quarters and the moderation in the growth of aggregate demand.



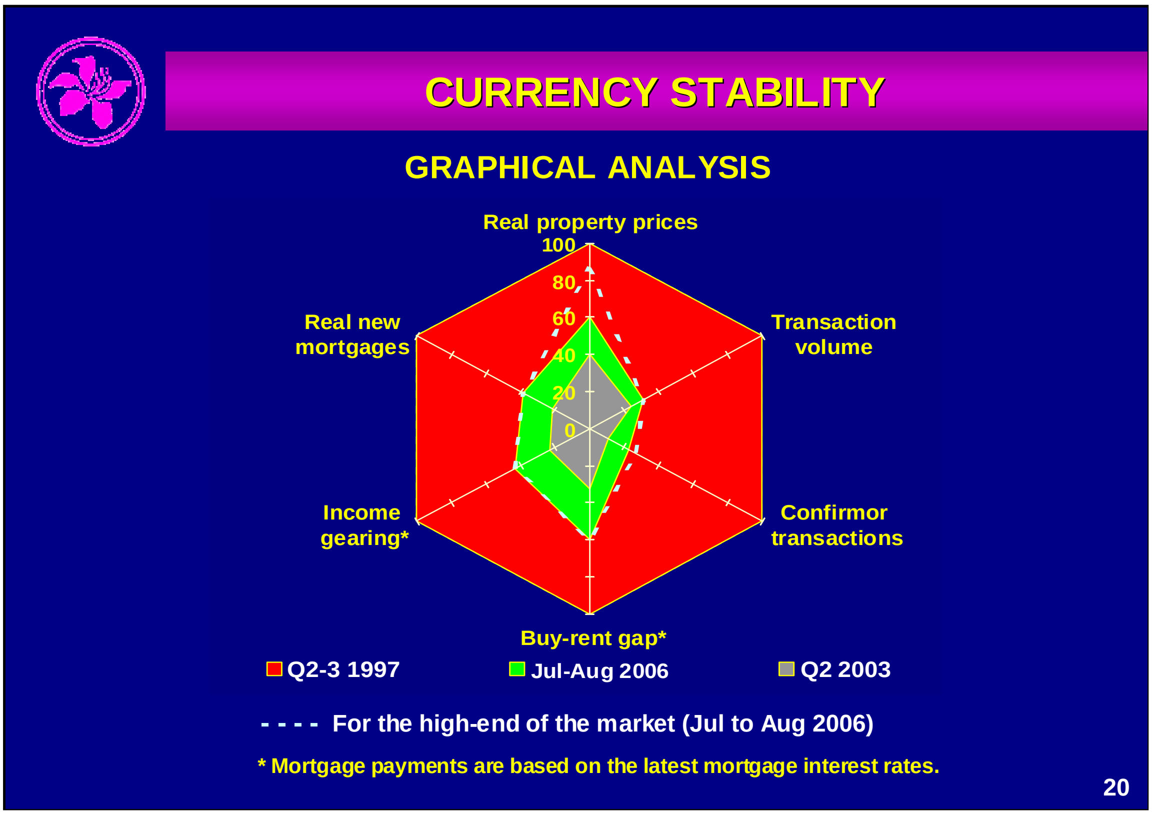
- The external position has remained favourable, partly reflecting improvement in our competitiveness.



- The cumulative effect of a series of interest rate increases has curbed residential property market activities and made the underlying improving trend more sustainable.

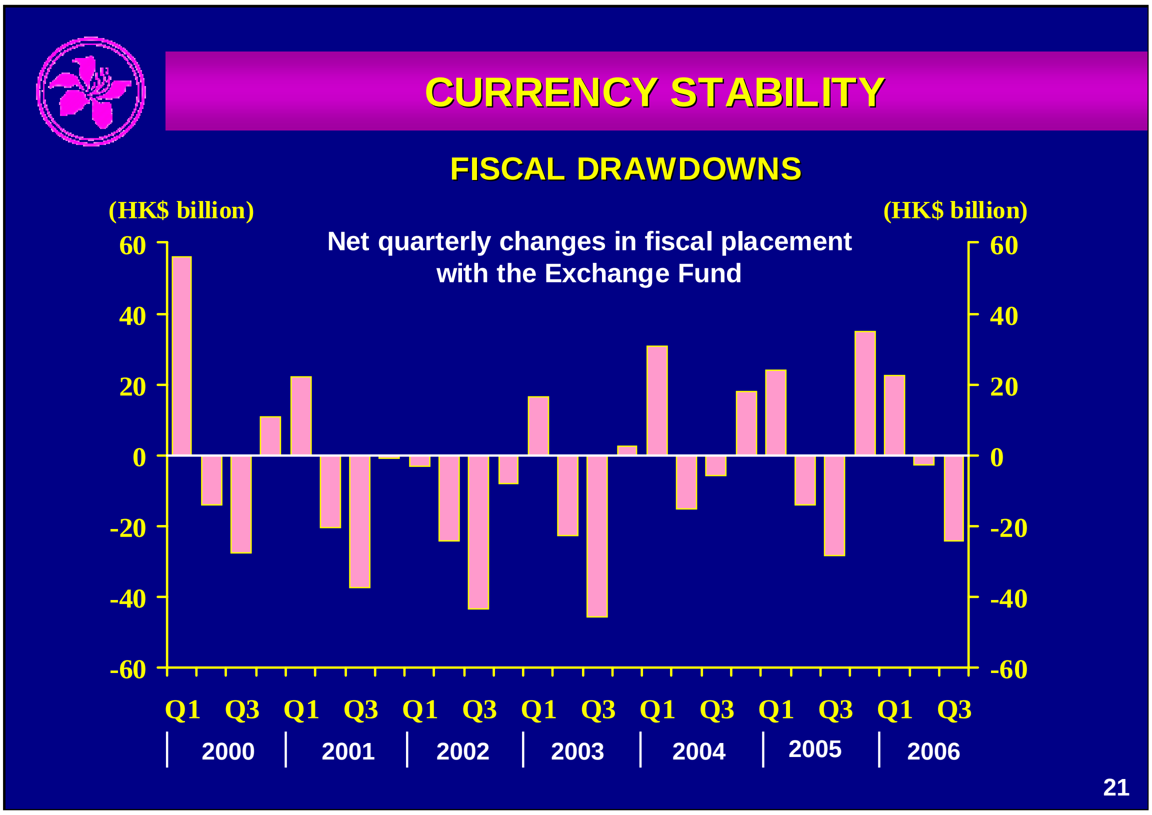
- By August 2006, residential property prices had increased on average by 57% from the trough in the summer of 2003. Prices have increased more sharply at the high end of the market, with prices of large flats (saleable area of 160 sq m or above) rising by 99% during the same period.

- Prices of commercial premises also increased markedly in the past two years, with those of offices and retail shops rising by 148% and 90% respectively from their lowest levels in mid-2003.



- This graphical analysis summarises the evolution of six key property market indicators: real property prices, property transaction volumes, confirmor transactions, real new mortgages, the income-gearing ratio (ratio of mortgage payment to household income), and the buy-rent gap (ratio of mortgage payment to rental). (1997 Q2-3 is treated as the base period.)

- By August 2006, the size of the hexagon remained considerably smaller than that for April-September 1997. The prices of large flats have increased more sharply than the overall prices.



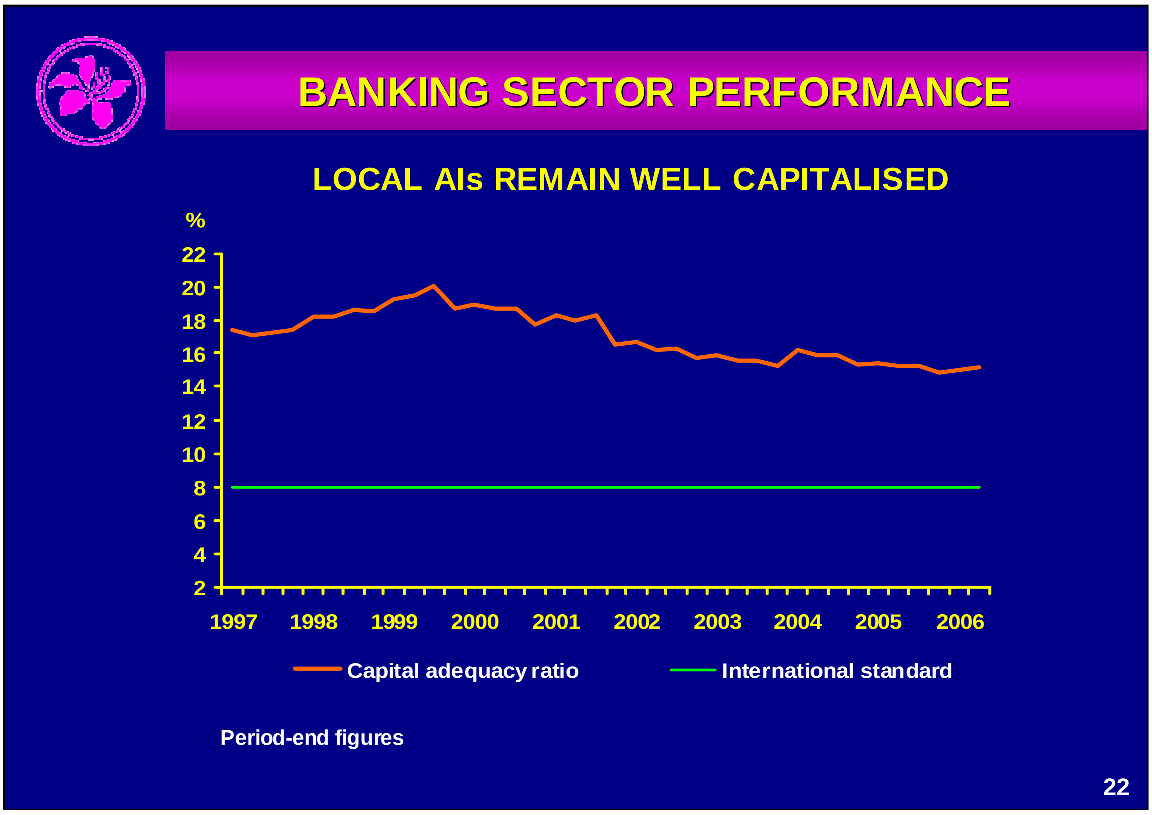
- Reflecting seasonal factors, net placements with the Exchange Fund are usually in surplus in Q1 and Q4, followed by net draw-downs in Q2 and Q3.

- Latest figures show that net placements with the Exchange Fund recorded a deficit of around HK$24 billion in 2006 Q3, smaller than the deficits in the same period of last year.

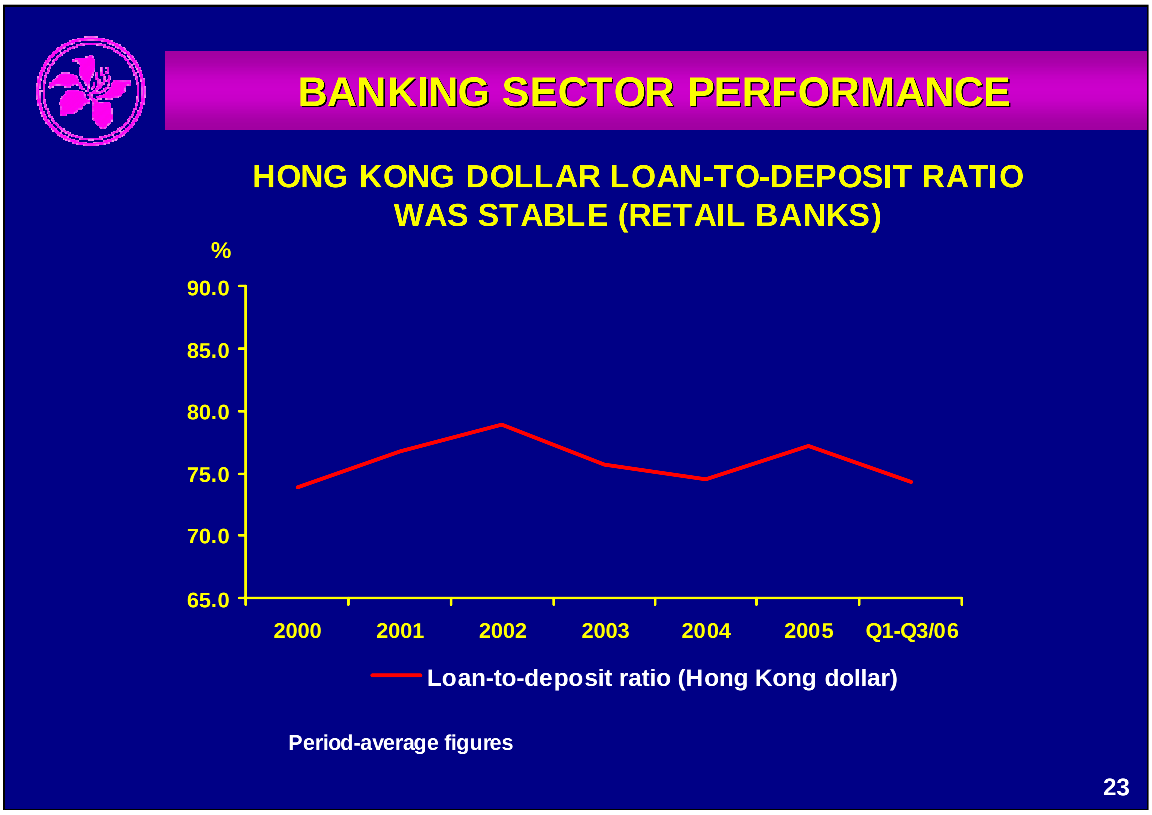
- Overall, the fiscal position of the Government continues to improve alongside economic expansion.

Net Quarterly Change in Fiscal Placement with the Exchange Fund (HK$ billion)

year \ quarter	Q1	Q2	Q3	Q4
2000	55.9	-14.1	-27.7	10.8
2001	22.1	-20.4	-37.4	-0.7
2002	-3.1	-24.4	-43.5	-8.0
2003	16.4	-22.9	-45.6	2.7
2004	30.7	-15.2	-5.7	18.0
2005	24.1	-13.9	-28.2	35.0
2006	22.6	-2.8	-24.4	

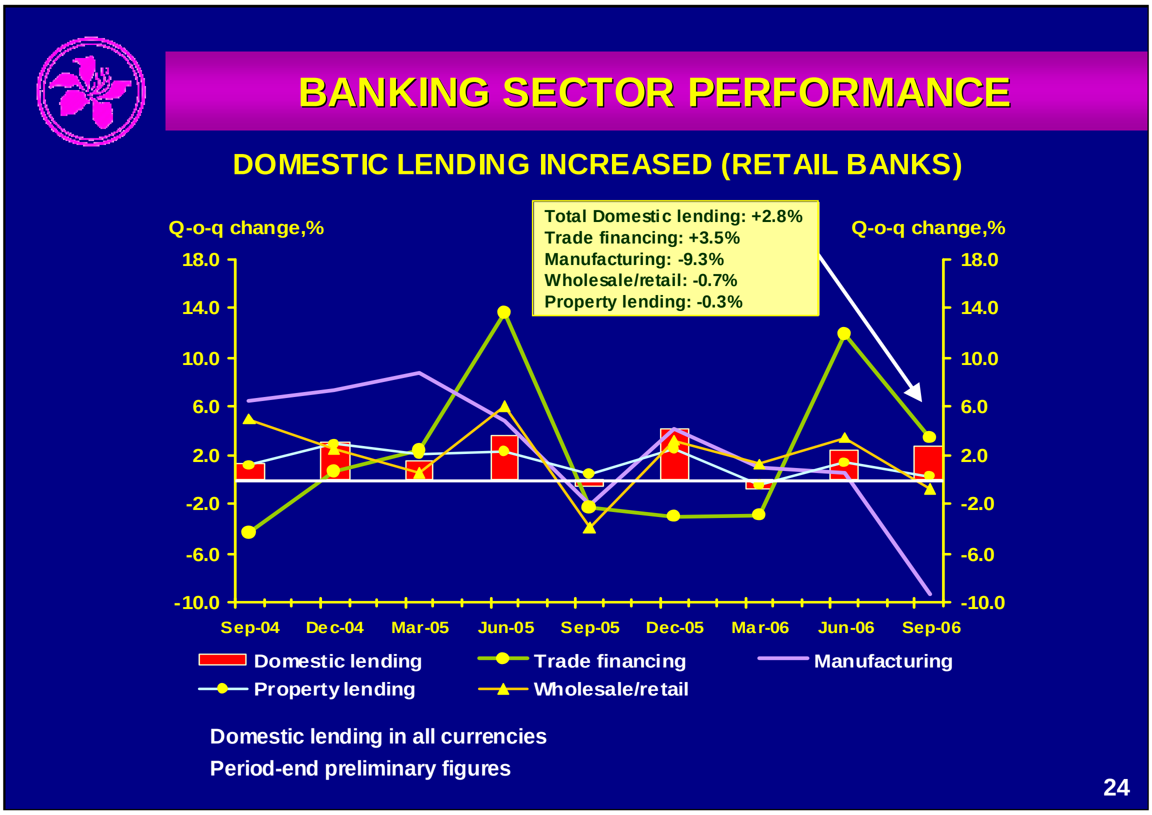


- The banking sector remained well capitalised. At the end of June 2006, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions was about 15%, well above the statutory requirement and international standard (8%).



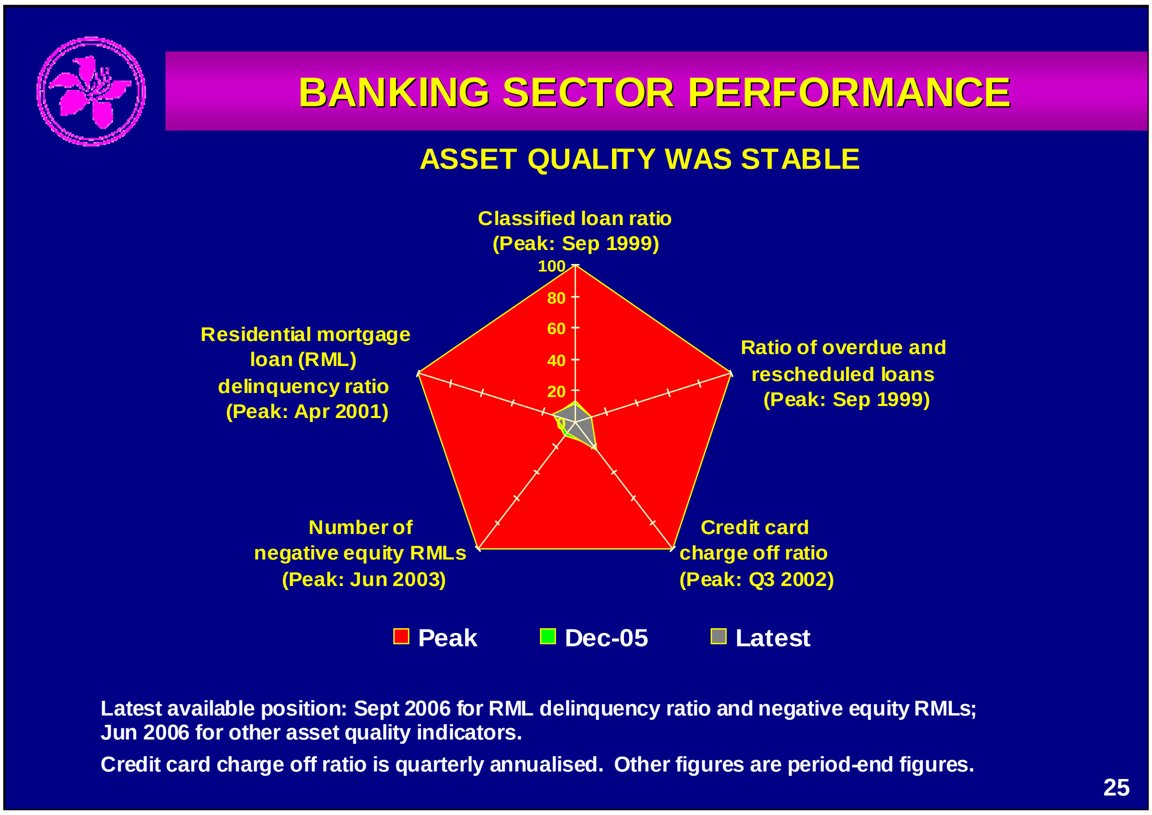
- The Hong Kong dollar loan-to-deposit ratio of retail banks has remained stable in recent years, moving within a fairly narrow range between 75% and 80%, reflecting ample liquidity in the banking sector.

- The ratio for 2006 Q1 to Q3 is 74%, compared with 77% in 2005, as growth in deposits outpaced the demand for loans in a rising-interest-rate environment in the early part of the year.



- Domestic lending by retail banks increased further by 2.8% in 2006 Q3.

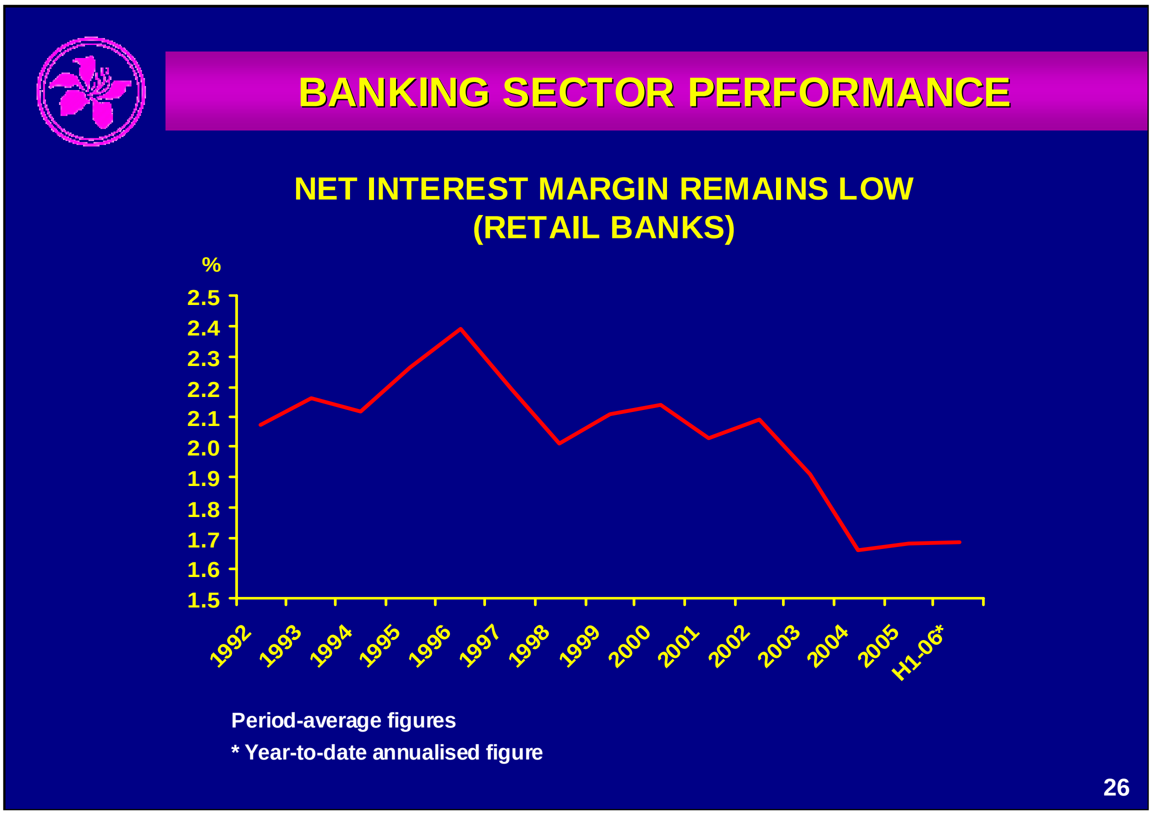
- Loan growth was mainly driven by the significant increase in share financing of 1.3 times over the quarter, which more than offset the declines in other major economic sectors.



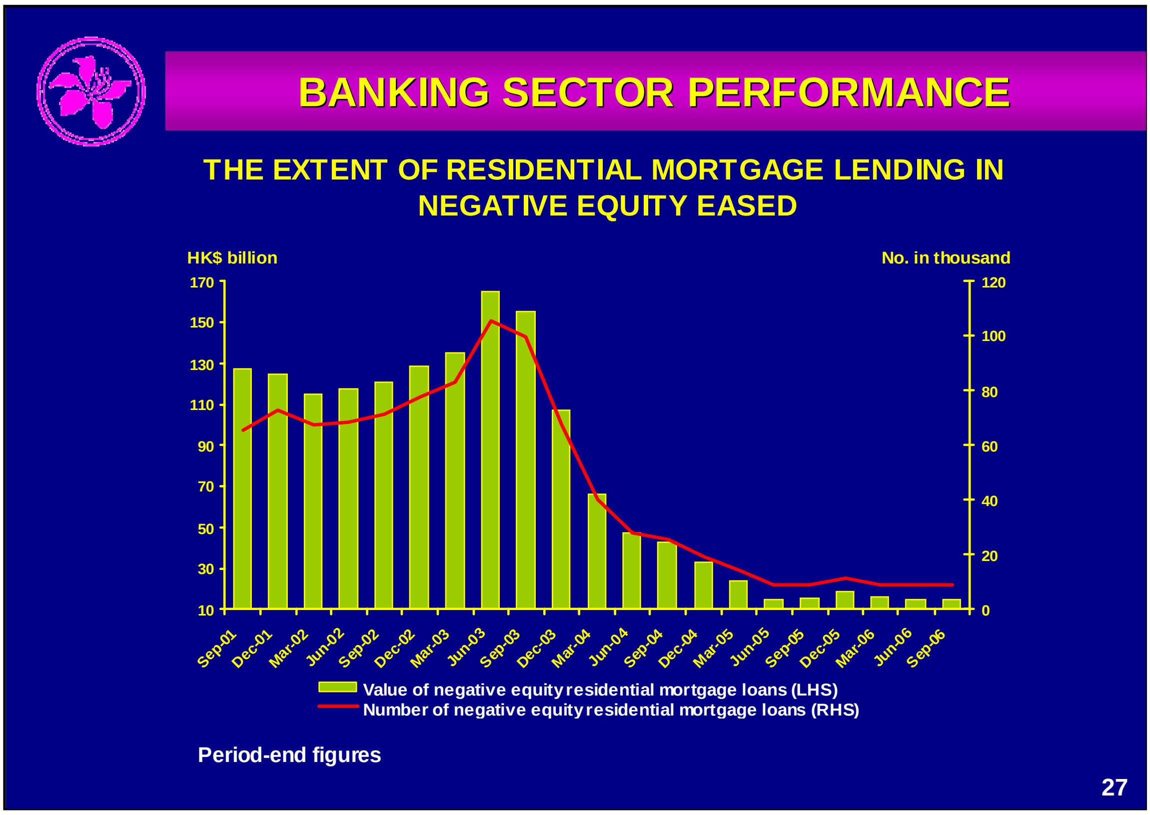
- Overall asset quality was broadly unchanged in 2006 Q2 with the classified loan ratio edging down to a new low of 1.28% at the end of June 2006 and the overdue loan ratio remaining constant at 0.69%.

- The delinquency ratio of credit card lending was 0.40% at the end of June 2006 and that for mortgage lending 0.20% at the end of September 2006. However, there was a slight rise in the quarter-annualised credit card charge-off ratio to 3.28% in 2006 Q2 from 2.89% in 2006 Q1 due to write-offs related to bankruptcy petitions. Nonetheless, these are historically very low numbers.

- Despite the positive overall picture, there have been some early warning signs about the quality of credit card receivables reflected by the increases in the amount delinquent for more than 90 days and charge-offs. These trends warrant careful monitoring.



- Net interest margin rose to 1.74% in 2006 H1 from 1.64% a year ago following a recovery in lending margins and a faster increase in net interest income than in average interest bearing assets. However, net interest margins remain low by historical standards and reflect keen competition in the banking system.



- The negative-equity situation eased. The number of residential mortgages in negative equity was little changed at 8,800 (HK$15 billion) at the end of September 2006 from a quarter earlier. It was down by 92% from the peak (106,000 cases valued at $165 billion) in June 2003.

BANKING SECTOR - WORK PROGRESS

Implementation of Basel II in Hong Kong

- **Banking (Capital) Rules and Banking (Disclosure) Rules tabled in LegCo following extensive consultation**
- **Rules targeted to take effect from 1 January 2007**
- **Parallel-reporting of Capital Adequacy Ratio calculation by AIs in progress to facilitate impact assessment and preparations for compliance**

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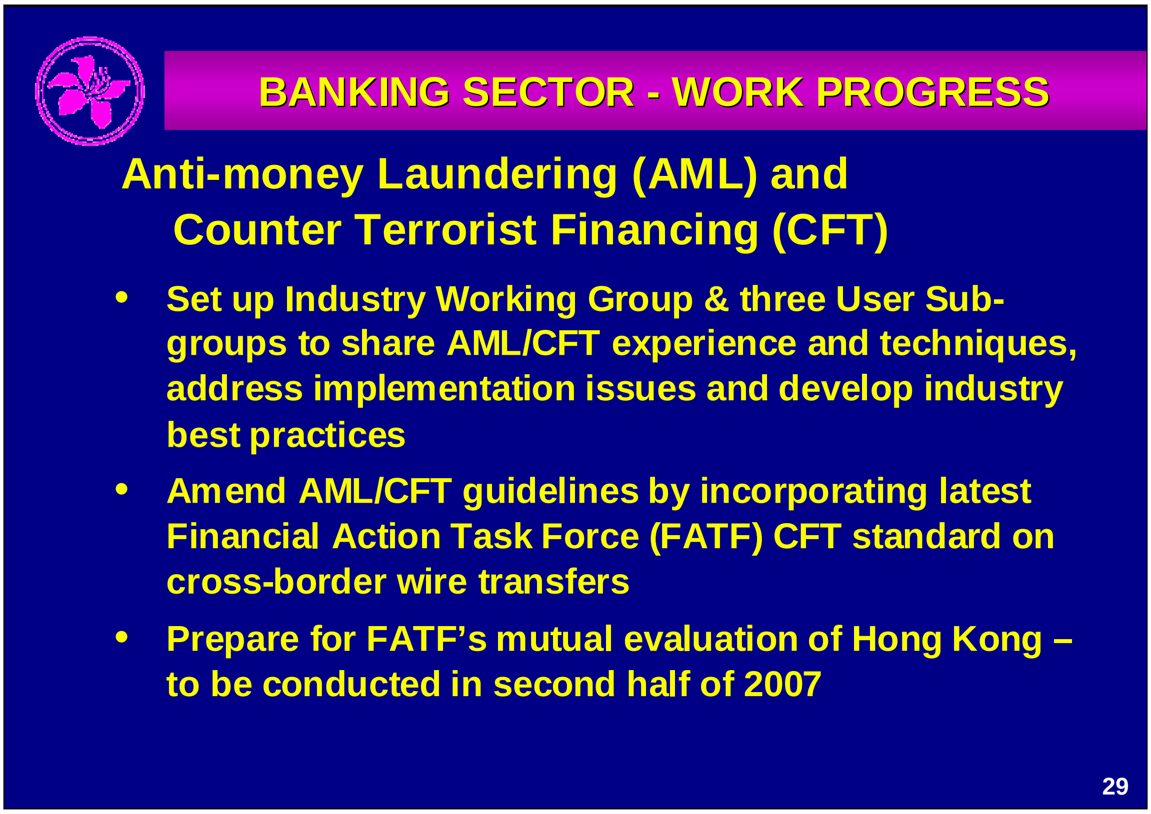
- Following extensive consultation with the banking industry and other interested parties, the Banking (Capital) Rules and Banking (Disclosure) Rules were published in the Gazette on 27 October and tabled in LegCo on 1 November for negative vetting. The banking industry and other consulted parties widely support the objectives of rule making. Comments received (mainly seeking clarification of certain drafting and technical points) have been addressed in the final draft of the Rules.

- In line with the Basel II implementation timetable, the Rules are scheduled for implementation in Hong Kong on 1 January 2007. To meet this schedule, we require continued support from Members.

- To assist AIs to familiarise themselves with the new reporting requirements and to facilitate their impact assessment under the new framework, the HKMA has launched a parallel reporting exercise for AIs to try using the new banking return alongside the old return on capital adequacy ratio for the two preceding quarters (for positions on 30 September and 31 December 2006) before the new framework takes effect in January 2007.



- The Working Group, chaired by the HKMA and including 20 AIs, was established in June 2006 to provide a forum for AML/CFT experience-sharing and addressing AML/CFT issues and challenges faced by the industry. The Working Group meets quarterly. Three user sub-groups, comprising mainly industry representatives, were also formed under the Working Group to study various customer due diligence and transaction-monitoring issues assigned by the Working Group to come up with industry standards and best practices. The user sub-groups will update the Working Group on their work progress from time to time.

- The HKMA plans to amend its AML/CFT guidelines with effect from 2 January 2007 to align with the latest FATF Special Recommendation VII. AIs will be required to include some basic originator information (e.g. name, account number and address or date of birth) in the remittance message of all cross-border wire transfers of HK$8,000 (or more). This is to facilitate tracing of suspicious transactions by law enforcement authorities. The HKMA has written to the industry associations, setting out its response to addressing some practical issues raised during the industry consultation.

- In 2004, the FATF began the third round of mutual evaluations of its member countries. The mutual evaluation of Hong Kong is scheduled for the second half of 2007. The HKMA is working with the Administration in preparing for the mutual evaluation to ensure that the banking sector complies with the FATF standards as far as possible.

BANKING SECTOR - DEPOSIT PROTECTION SCHEME

- **DPS launched on 25 September 2006**
- **Each depositor is entitled to compensation of up to HK$100,000 in the event of a bank failure**
- **Collecting contributions from member banks to build up the DPS Fund**
- **Average contribution rate is 0.08% p.a. during fund build-up period and will be reduced to 0.01% p.a. afterwards**
- **Expect to reach the target fund size of 0.3% of total relevant deposits (around HK$1.3 bn) by 2010**
- **The HKMA will continue to assist the HKDPB in maintaining an effective DPS in Hong Kong**

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- The Deposit Protection Scheme (DPS) was successfully launched on 25 September 2006. From now on, each depositor will be compensated up to a maximum of HK$100,000 in the event of a bank failure.
- The Hong Kong Deposit Protection Board (HKDPB) is collecting contributions from member banks of the Scheme to build up the DPS Fund. The first contributions, amounting to HK$88 million, covering the period between 25 September 2006 and 31 December 2006 has been received.
- Depending on their supervisory rating, Scheme members are required to pay contributions to the DPS Fund at an average rate of 0.08% p.a. during the fund build-up period. After the target fund size of 0.3% of total relevant deposits (around HK$1.3 billion based on the current level of relevant deposits) is reached, the contribution rate will be reduced to an average of 0.01% p.a. It is expected that the target fund size will be reached by 2010.
- Contribution rate of the Scheme:

Supervisory rating	Contribution during fund build-up period	Contribution after fund build-up period
1	0.05%	0.0075%
2	0.08%	0.01%
3	0.11%	0.015%
4&5	0.14%	0.02%

- The HKMA will continue to assist the HKDPB in maintaining an effective DPS in Hong Kong.

MARKET INFRASTRUCTURE

- **The projects and business initiatives arising from the Review of Financial Infrastructure Development are making good progress**
- **Project Development**
  - **Renminbi Settlement System**
  - **Migration to SWIFTNet**
  - **Electronic trading platform**
  - **Bulk settlement for credit card transactions**

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- Renminbi Settlement System – launched on 6 March 2006 to cater for the operations of the expanded renminbi business and the new renminbi cheque business announced in Oct 05. In the first six months of operation, the System handled a daily average of 137 transactions with a total value of RMB 34 million yuan. This provides a safe and efficient platform to support further expansion of renminbi business in Hong Kong.

- Migration to SWIFTNet – to replace the existing proprietary platform for the RTGS systems and the Central Moneymarkets Unit by an open platform to improve compatibility with overseas clearing and settlement systems. The migration is expected to take place by 2008 Q1.

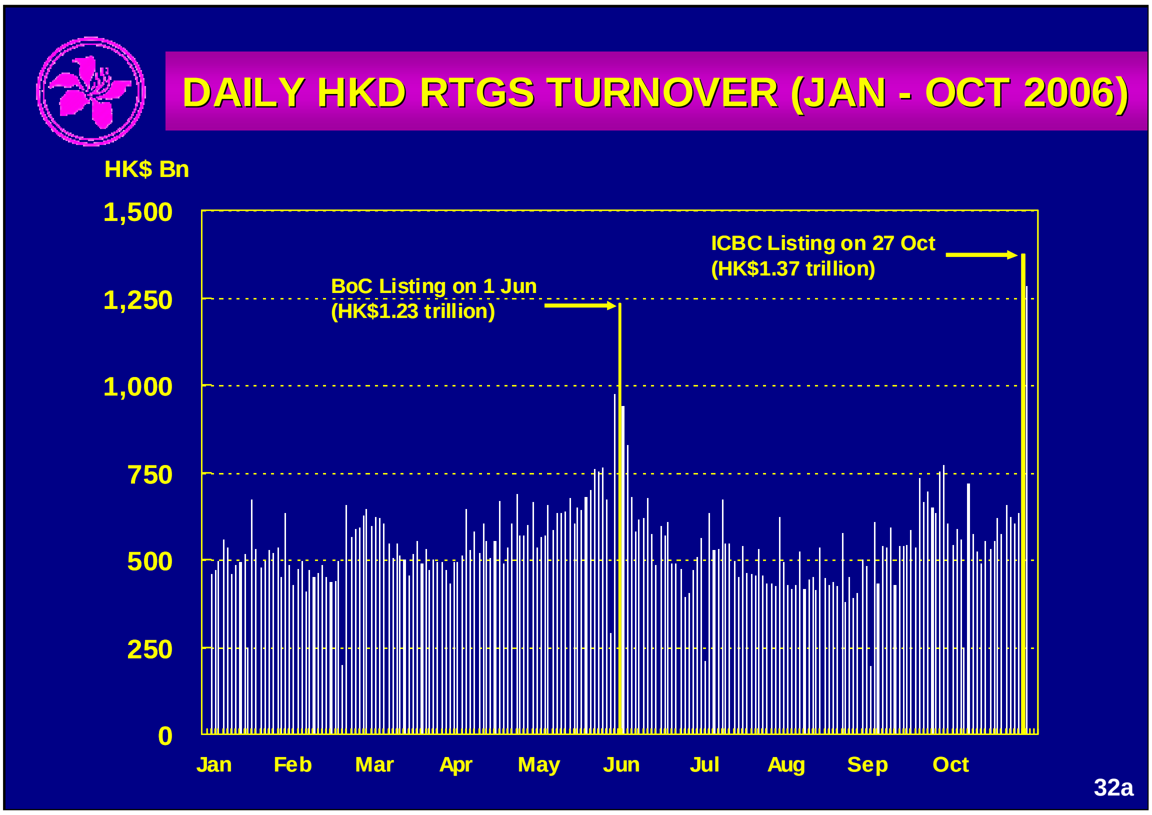
- Electronic trading platform – to establish an electronic trading platform for trading Exchange Fund Bills and Notes to increase transparency of prices and transactions and facilitate straight-through processing from trading to clearing and settlement. The HKMA will work with the Treasury Markets Association to develop the platform.

- Bulk settlement for credit card transactions – to mitigate settlement risks of credit card transactions by settling them in bulk runs by Hong Kong Interbank Clearing Limited. Visa International has started using the new bulk settlement service. Two other credit card scheme operators, namely MasterCard International and China UnionPay will join the arrangement later. The arrangement was launched on 23 October 2006.

- Greater use of the Hong Kong settlement platform by financial institutions on the Mainland – Seminars and marketing calls were held in Beijing, Shanghai, Guangzhou and Shenzhen (some were held jointly with the People's Bank of China) to encourage Mainland financial institutions to use Hong Kong's platform to settle the foreign currency legs of FX transactions.

- Promote PvP links with other Asian economies – The HKMA is exploring opportunities with other Asian economies to establish international links for our RTGS systems and the CMU. The PvP link between Hong Kong's US dollar RTGS system and Malaysia's ringgit RTGS system will go live in November this year.

- Promote regional correspondent banking business – One way to develop Hong Kong into a regional payment and settlement hub is to strengthen regional correspondent banking business in Hong Kong. The existing US dollar payment system in Hong Kong links all of its direct participants to form a substantial network of correspondent banking clientele. Such a network offers a competitive advantage for Hong Kong banks to develop regional correspondent banking business.



- Average daily HKD RTGS turnover was \$0.47 trillion in 2005 and \$0.55 trillion in the first ten months of 2006.

- Turnover was \$1.23 trillion on 1 June 2006 when Bank of China was listed on the Stock Exchange.

- The turnover reached a record high of \$1.37 trillion on 27 October 2006 when Industrial and Commercial Bank of China was listed.

- This shows the HKMA's efforts in the development and operation of our financial infrastructure have been a success.

MARKET INFRASTRUCTURE

Oversight of the clearing and settlement systems

- All local designated systems remain in compliance with the safety and efficiency requirements of the Clearing and Settlement Systems Ordinance
- Completed the annual assessment on Continuous Linked Settlement (CLS) System and confirmed that CLS continued to meet the criteria of designation and the issuance of certificate of finality
- Continued support to the Process Review Committee to perform its function. Quarterly reports covering oversight activities of the HKMA have been submitted to the Committee for review

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- The HKMA oversees the four local designated systems through off-site reviews and continuous monitoring. All systems, including HKD CHATS, USD CHATS, EUR CHATS and CMU, are in compliance with the safety and efficiency requirements under the Clearing and Settlement Systems Ordinance (CSSO).

- The HKMA completed the annual assessment of the Continuous Linked Settlement (CLS) System, a designated system under the CSSO. The oversight of CLS Bank International (CLS Bank) is mainly performed under an international co-operative oversight arrangement. Having considered the latest supervisory report of the Fed (the home overseer) on CLS operation, the information provided by the CLS Bank as well as the assessments of other international technical groups, the HKMA considered that the CLS System continued to meet the criteria for designation and the issuance of certificate of finality. The HKMA will continue to monitor the CLS to ensure it is in compliance with the relevant requirements under the CSSO.

- Three quarterly reports covering the HKMA's oversight activities from December 2005 to September 2006 have been submitted to the Process Review Committee for review. The second annual report on the work of the Committee is being prepared and will be submitted to the Financial Secretary later.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

5-Pronged Strategy to maintain Hong Kong as an IFC

- **Enhance access for Hong Kong financial institutions on the Mainland**
- **Enhance the mobility of fund raisers, investors and financial institutions from the Mainland to Hong Kong**
- **Enhance the mobility of financial instruments to the Mainland from Hong Kong**
- **Enhance the capability of Hong Kong's financial system to handle transactions denominated in renminbi**
- **Strengthen financial-infrastructure links between the Mainland and Hong Kong**

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- At the Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong" on 11 September, the Focus Group on Financial Services discussed and endorsed this five-pronged strategy. The HKMA is working on the details for incorporation into the report and action agenda to be formulated by the Focus Group and submitted to the Chief Executive of the HKSARG.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

Renminbi business in Hong Kong

- Outstanding renminbi deposits: RMB 22.7 billion yuan at the end of August 2006
- State Council is actively considering:
  - Hong Kong importers to settle direct import trade from the Mainland in renminbi; and
  - Financial institutions on the Mainland to issue renminbi financial bonds in Hong Kong on a pilot basis.

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- At the end of August 2006, 40 banks were engaging in renminbi business in Hong Kong and the total outstanding renminbi deposits reached RMB 22.7 billion yuan. The cumulative value of transactions by Mainland visitors using renminbi cards to spend and make cash withdrawals in Hong Kong since the start of renminbi card business was over HK$16 billion. Debit- and credit-card spending by Mainland tourists was about HK$2,700 per transaction on average.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

Regional Co-operation

- Actively participating in the latest review by regional central banks to strengthen co-operation
- Taking the lead in identifying projects and building blocks for enhanced co-operation in the areas of banking supervision and regional surveillance
- The review will be completed by the end of November, with recommendations to be considered by the governors of central banks in Asia

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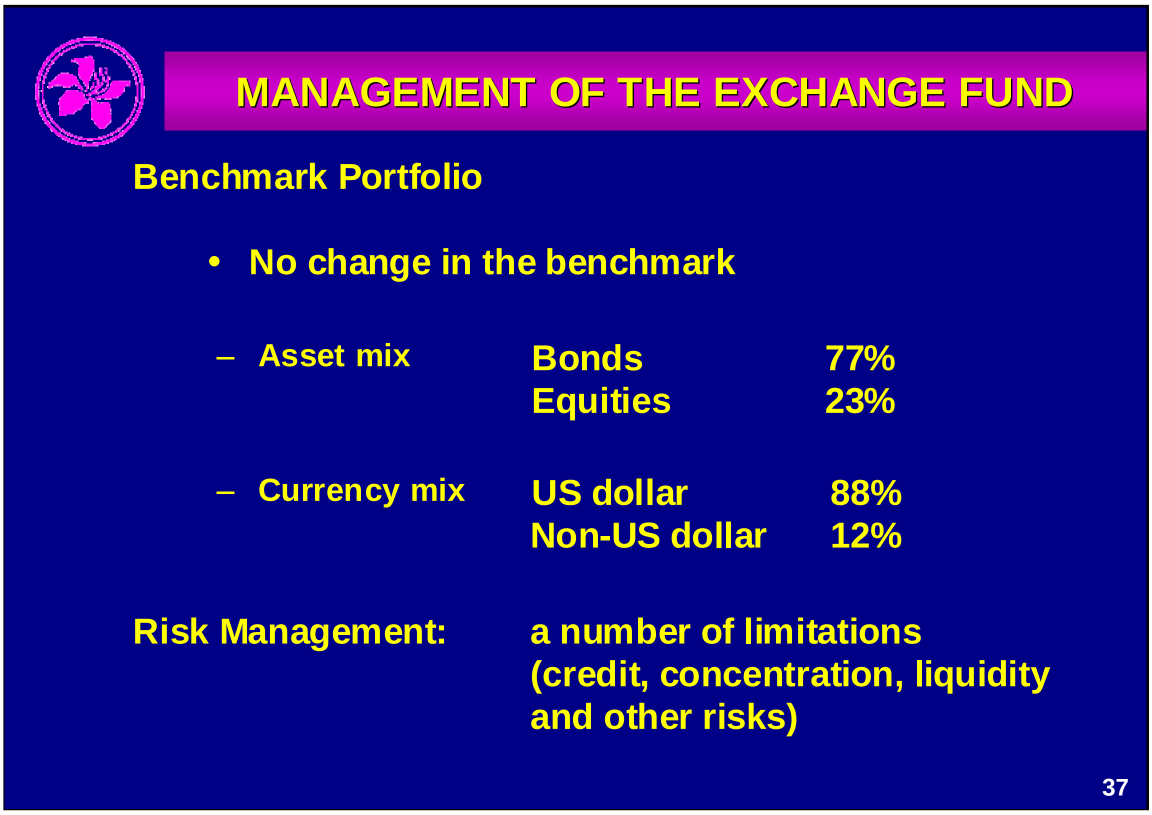
- In February 2006, governors of the central banks in the region agreed to set up a Task Force to outline the future direction of regional central bank co-operation in Asia. The Task Force is chaired by Governor Zeti Akhtar Aziz of Bank Negara Malaysia. Four Working Committees have been set up under the Task Force:

Working Committees	Co-chairs
Asian Monetary and Financial Stability	People's Bank of China Bank of Thailand
Financial Supervision	**Hong Kong Monetary Authority** Reserve Bank of India
Financial Markets	Bank of Japan Bank Negara Malaysia
Payment Systems	Monetary Authority of Singapore Reserve Bank of New Zealand

- The HKMA co-chairs the Working Committee on Financial Supervision and participates actively in the Working Committee on Asian Monetary and Financial Stability co-chaired by the People's Bank of China and Bank of Thailand, taking lead in promoting regional surveillance.

- The Task Force will submit its final report at the EMEAP Informal Governors' Meeting to be held on 21 November in Sydney.



- The EFAC has recently reviewed policies on the use of external managers but the review did not result in any change in the risk appetite of the benchmark portfolio.

- A mean-variance optimisation model was used to construct the investment benchmark for the Exchange Fund. The Preferred Neutral Position is set as above, taking into consideration the investment objectives of the Exchange Fund.

- The Exchange Fund is different from an investment fund, and therefore sets its priorities differently. Capital preservation and liquidity come before yield enhancement.

- The Exchange Fund's investment strategies are less conservative than those of many of our peer group central banks which do not invest in equities.

MANAGEMENT OF THE EXCHANGE FUND

Evaluation of investment performance

	Return on benchmark portfolios (%)	Actual return (%)	Exceeds benchmark	
			Value HK$ bn	%
1999	5.5	10.8	50.7	5.3
2000	3.8	4.8	9.6	1.0
2001	0.4	0.7	2.9	0.3
2002	3.9	5.1	11.2	1.2
2003	9.5	10.2	6.6	0.7
2004	5.7	5.7	0	0.0
2005	2.9	3.1	2.1	0.2
Average for 7 years	4.5 #	5.7 #	11.9	1.2

Compounded growth rate

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- The investment return of the Exchange Fund has exceeded the benchmark return in every year except one (2004) in the past seven years.

- We hope our investment performance will exceed the benchmark return again this year.

EXCHANGE FUND PERFORMANCE

(HK$ billion)	2006[1] Jan - Sept	2005 Full Year	2004 Full Year	2003 Full Year
Gain / (Loss) on HK equities	19.8	7.0	12.0	21.2
Gain / (Loss) on other equities	9.9	20.5	11.2	26.8
Exchange gain / (loss)	13.9	(19.5)	8.5	22.9
Total return from bonds, etc	24.2	29.8	25.0	18.8
Investment income	67.8	37.8	56.7	89.7

[1] Unaudited figures

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- Year-to-date investment income at the end of September 2006 amounted to HK$67.8 billion. The income is evenly distributed among our holdings in equities, bonds and foreign exchange.

- Gradual rate increases in the US have helped to improve the interest income generated from our bond investments, but higher yields capped the marked-to-market gains.

CHANGE IN ACCUMULATED SURPLUS

(HK$ billion)	2006* Q3	2006* Q2	2006* Q1	2005 Full Year
Investment income / (loss)	37.1	12.5	18.2	37.8
Other income	0.1	0.0	0.0	0.2
Interest and other cost	(2.8)	(2.7)	(2.3)	(7.6)
Net investment income / (loss)	34.4	9.8	15.9	30.4
Treasury's share	(10.3)	(3.5)	(5.2)	(10.1)
Carry to accumulated surplus	24.1	6.3	10.7	20.3
Adjustment to accumulated surplus, effect of implementation of HKAS 39 [1]	0.0	0.0	0.0	(0.6)
Increase / (Decrease) in EF accumulated surplus	24.1	6.3	10.7	19.7

Note 1: The effect of changing from using mid-price to using bid-price for valuing securities held, and using ask-price for valuing securities issued.

* *Unaudited figures*

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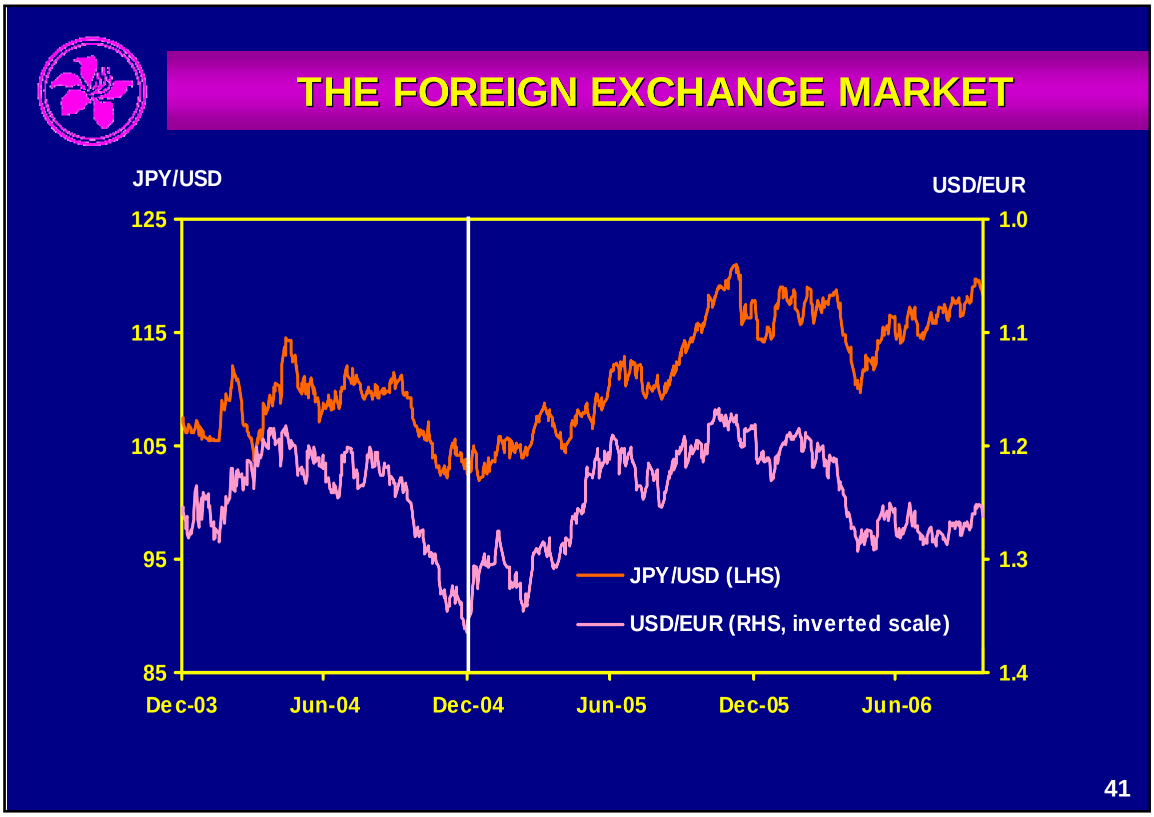
- The investment objectives of the Exchange Fund are to preserve capital, provide liquidity, ensure full backing of the Monetary Base, and maintain the long-term purchasing power of the Fund. Given these objectives, it is not appropriate to compare the investment return of the Exchange Fund with that of a typical investment fund. The Exchange Fund manages its investment prudently, striking a balance between risk and return instead of focusing only on meeting the nominal return target set out in the Financial Secretary's budget plan.

- Based on the latest figures, the Treasury's share of investment income up to the end of September is HK$19.0 billion.

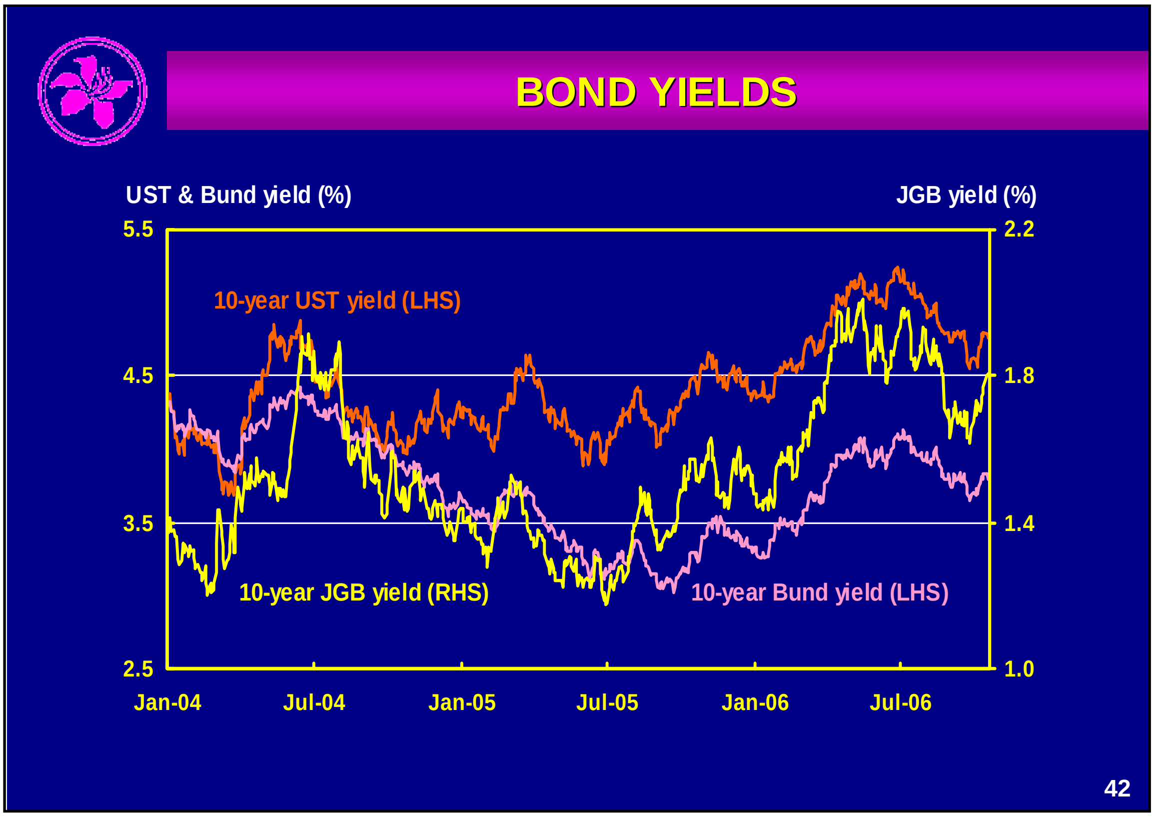
- It should not be taken for granted, however, that the Treasury's share for the whole year will exceed the original forecast of HK$18.2 billion. The financial market remains uncertain in Q4 2006. There are signs of a slowdown in the US housing market. Its future development and impact on economic growth will have a bearing on US interest rate policy. US inflation, with core personal consumption expenditures at 2.5% in August, remains above the Fed's comfort zone. If a slowing economy as well as the lagged effects of the 17 prior rate increases do not slow the inflation as expected, the Fed might have to tighten again. Crude oil prices have come down, which has supported the equities and bond markets, but geopolitical tensions particularly in the Middle East and North Korea could reverse their courses. We will remain vigilant on the market environment.



- The foreign exchange market lacks direction. While the twin deficits in the US argue for a weaker US dollar, the still wide interest rate gaps provide considerable incentive for holding US dollars.

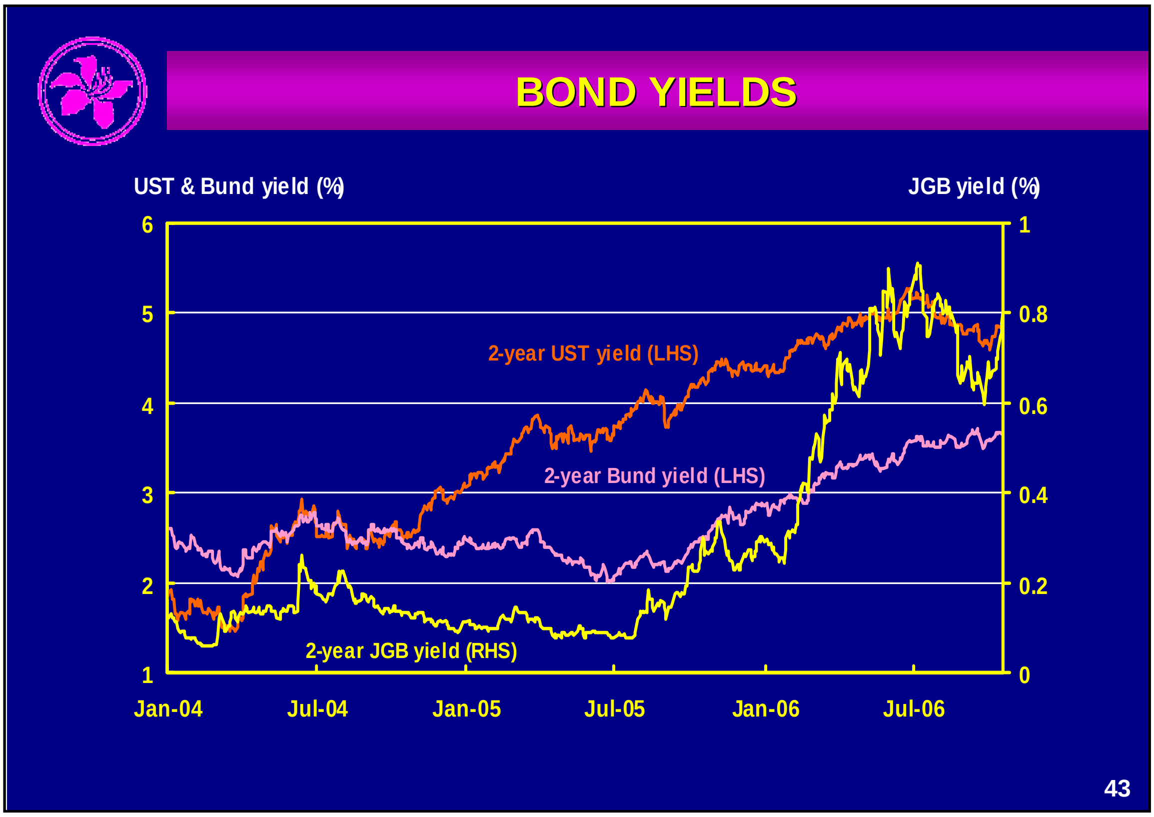
- The possibility of a disorderly adjustment to the US current account deficit, involving a sharp weakening of the US dollar, remains.

- It is difficult, if not impossible, to predict what might trigger such an adjustment, or when it might happen.



- Interest rate movements in 2006 have been experiencing a turnaround. Long-term US Treasury yields rose in general in H1 2006 as the Fed continued to raise rates. Since late June, the Fed funds target rate has remained at 5.25% and at the same time long-term rates have returned to a downward trend. Rates in other markets basically followed, helping the global bond markets to improve their performance.

- Meanwhile the US monetary policy remains clouded as inflation is still above the comfort zone of the Fed. The same applies to the other major central banks and it is far from certain that the tightening in global liquidity is over.



- It appears that the market is becoming very optimistic about the possibility of the ending of the current round of monetary tightening. Two-year bond yields, particularly in the US and Japan, have come down quite significantly.

- While most of the world's major equity markets have been doing well so far this year, it has not been all smooth sailing. At the end of Sept 2006, the Hang Seng Index was up 17.9%, the S&P500 was up 7% but the Nikkei was up only 0.1%. Investment in equities will remain very challenging for the rest of this year, overshadowed by the possibility of a sharp slowdown in US demand, continued drainage of global excess liquidity, and the effect of investment mishaps in the energy and commodity markets.