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HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

6 February 2006

DISCUSSION TOPICS

Updates on

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

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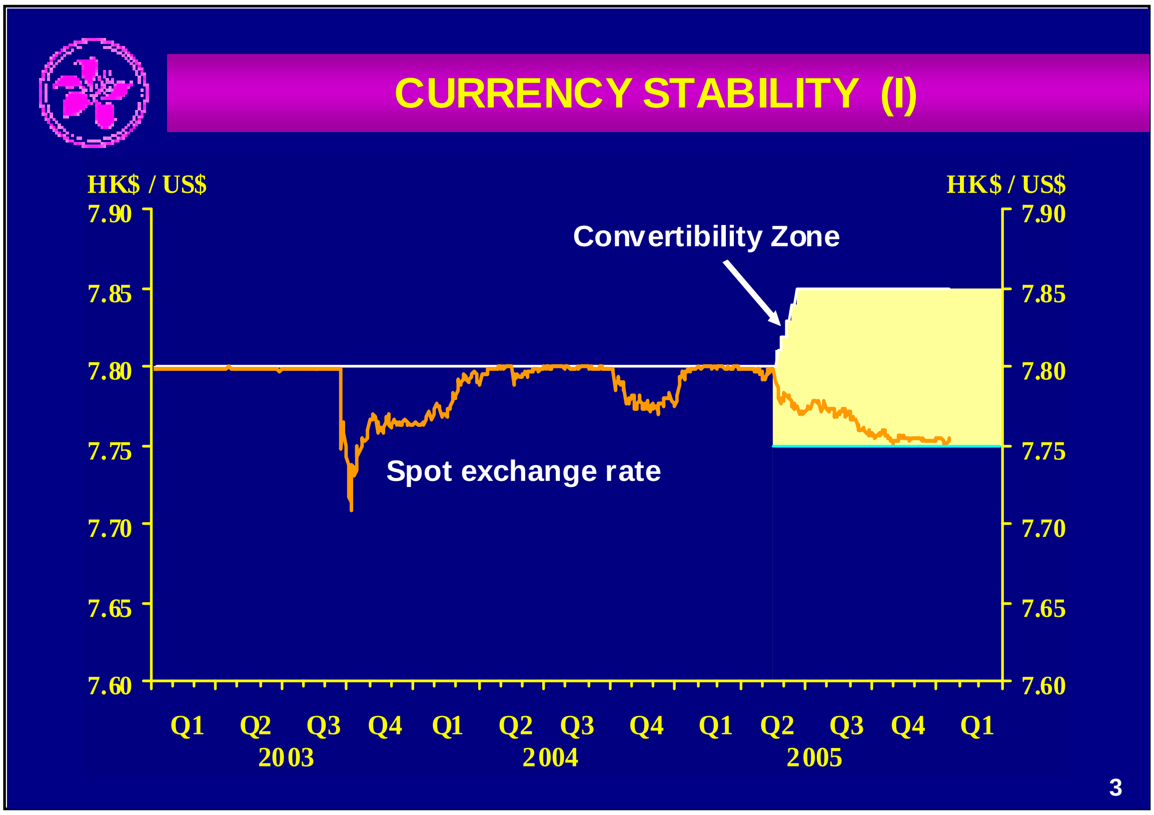
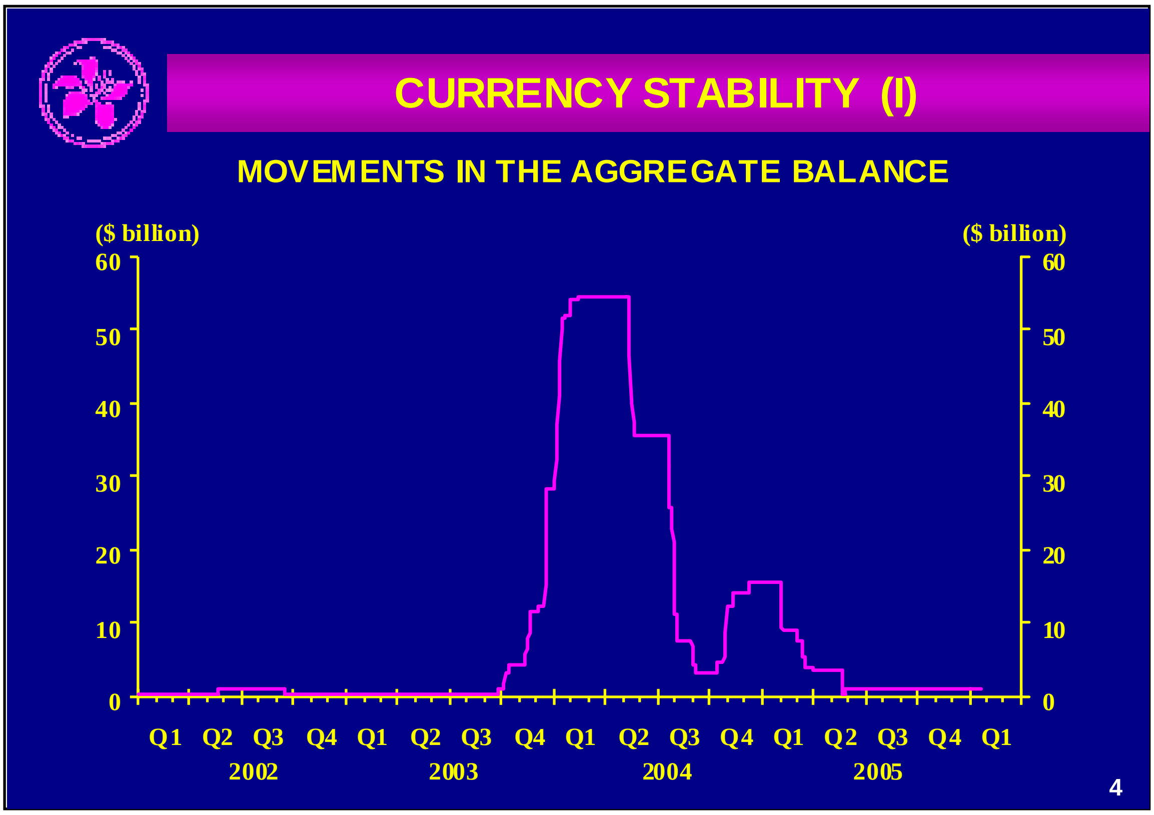
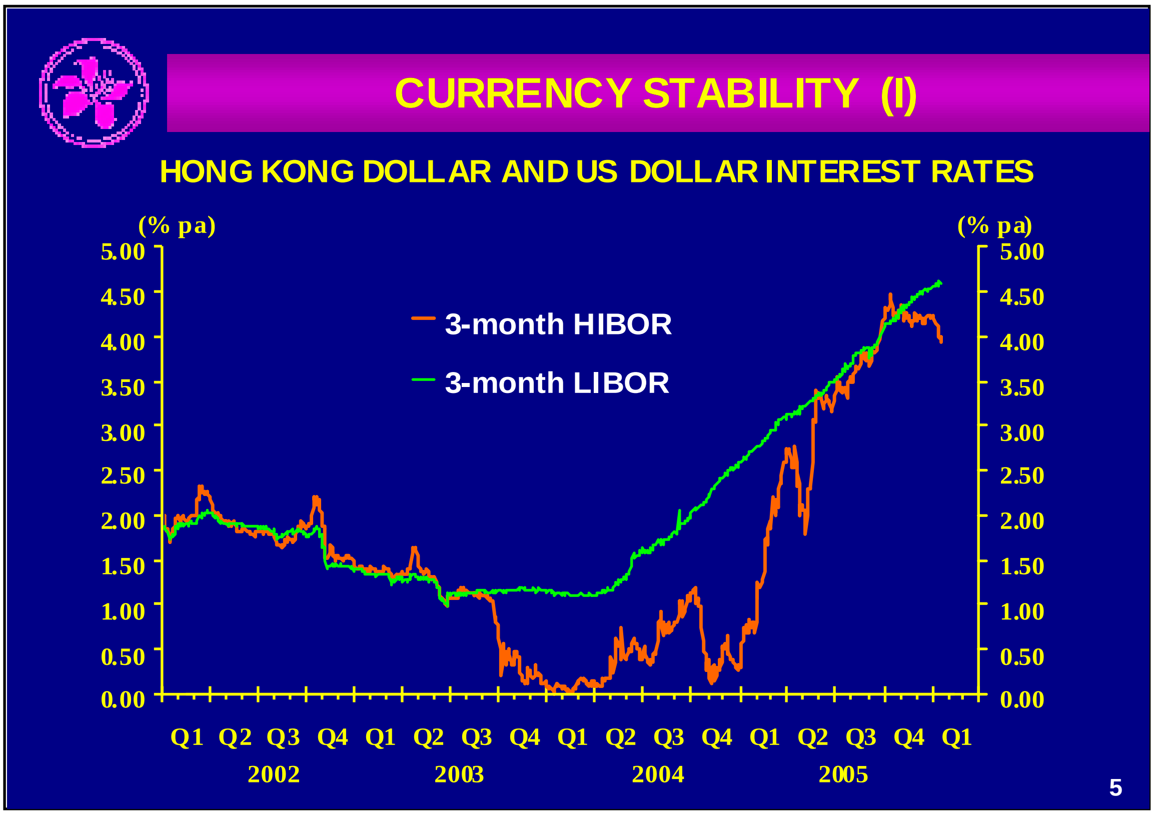


- The Hong Kong dollar exchange rate has strengthened steadily against the US dollar since June 2005, reaching levels close to the strong-side Convertibility Undertaking of 7.75. The strengthening largely reflected IPO-related demand for Hong Kong dollars and some expectation that the Hong Kong dollar might be allowed to strengthen along with the renminbi.



- Since June 2005, the Convertibility Undertakings have not been triggered, and the HKMA has not conducted any monetary operations within the Convertibility Zone. The Aggregate Balance remained stable at around HK$1.3 billion.

- The three refinements to the Linked Exchange Rate system introduced in May 2005 have been effective in keeping the Aggregate Balance and money market conditions generally stable.



- Hong Kong dollar interbank interest rates continue to track closely the corresponding US dollar rates, although a small discount is observed in recent weeks in short-term Hong Kong dollar interest rates compared with US dollar rates. This was due to the recycling of Hong Kong dollar liquidity associated with IPOs.

- The discount in the 12-month forward exchange rate narrowed markedly in the second half of 2005, but started to widen again towards the year-end to around 400 pips.

CURRENCY STABILITY (I)

MONETARY CONDITIONS

- **Currency Board arrangements working effectively to normalise monetary conditions, particularly after the introduction of the three refinements.**
- **Federal funds target rate on an increasing trend; market expects peak in the first half of this year.**

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- To date, the US federal funds target rate (FFTR) had been raised 14 times by a total of 350 basis points to 4.50% since June 2004. This has led to increases in the lending rates and deposit rates of banks in Hong Kong. Market expectation is for the FFTR to peak at around 4.75% to 5% in the first half of this year.

- The significant catch-up of Hong Kong dollar interest rates with US dollar interest rates has largely been completed, although the process involved some overshooting of the prime rate, due to the practice of pricing mortgages by reference to prime and very keen competition with temporarily low cost of funds driving the mortgage rate to an excessive degree below prime. There is some risk that this process may repeat itself with interbank Hong Kong dollar interest rates recently easing to significantly below corresponding US dollar interest rates.

CURRENCY STABILITY (II)

External factors

- Oil prices
- Inflation
- Interest rates
- External imbalances
- Renminbi
- Protectionism
- Influenza pandemic

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- **Oil prices:** Average price of Dubai, Brent and WTI crude has more than tripled since the beginning of 2002. It hit an all-time high of US$66 per barrel on 1 September 2005, and stayed at around US$63 in mid-January 2006. Futures contracts of WTI crude reflect expectations that oil prices will stay high in the foreseeable future. Higher oil prices may lead to higher inflation and monetary tightening.

- **Inflation:** Current global inflation is benign but expected to increase.

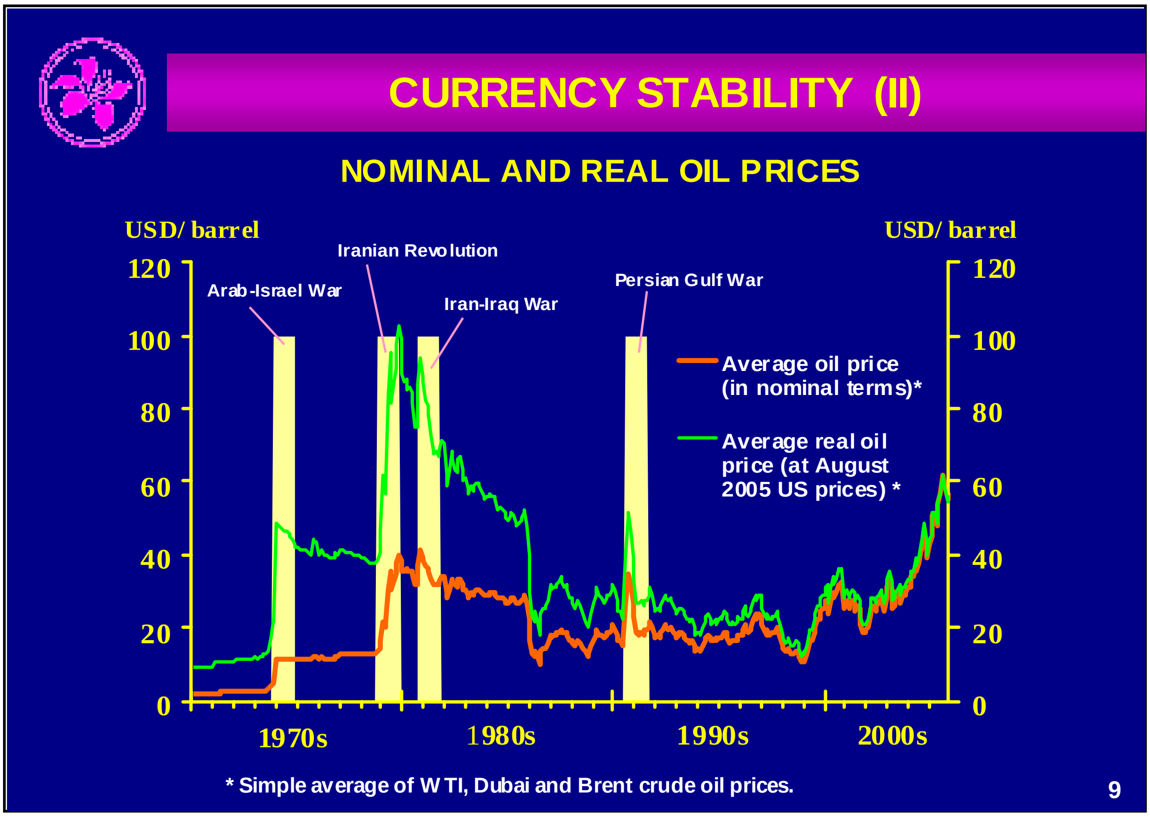
- **Interest rates:** The US policy rate rose to 4.25% in December 2005. Markets generally expect that the Fed's interest rate-hike cycle is nearing the end, with the policy rate reaching 4.75% to 5% by the first half of this year. The European Central Bank raised the refinancing rate for the first time in five years by 25 basis points to 2.25% in December, while the Bank of England kept its policy rate on hold.

- **External imbalances:** The US trade deficit widened to 5.8% of GDP in Q3 from 5.6% in Q2, partly reflecting the impact of high oil prices. However, the US dollar has appreciated by 2.7% in effective terms in 2005, supported by broad-based growth and interest rate differentials in favour of the US. The risk of a disorderly adjustment involving sharp exchange rate changes cannot be ruled out.

- **Mainland macroeconomic conditions and renminbi:** The growth of the Mainland economy remained rapid and only a slight moderation is expected. The risk of an abrupt deviation from the present growth path in Hong Kong is therefore small. However, should there be a further appreciation in the renminbi, renewed capital inflows into Hong Kong could raise inflation risks and possibly fuel asset bubbles.

- **Protectionism:** A sharp rise in Mainland textile exports has heightened trade tensions between the Mainland and the US and Europe. While the Mainland reached bilateral agreements in textile trade with the EU and the US in 2005, the possibility of future trade disputes remain, along with growing integration of the Mainland into the global economy.

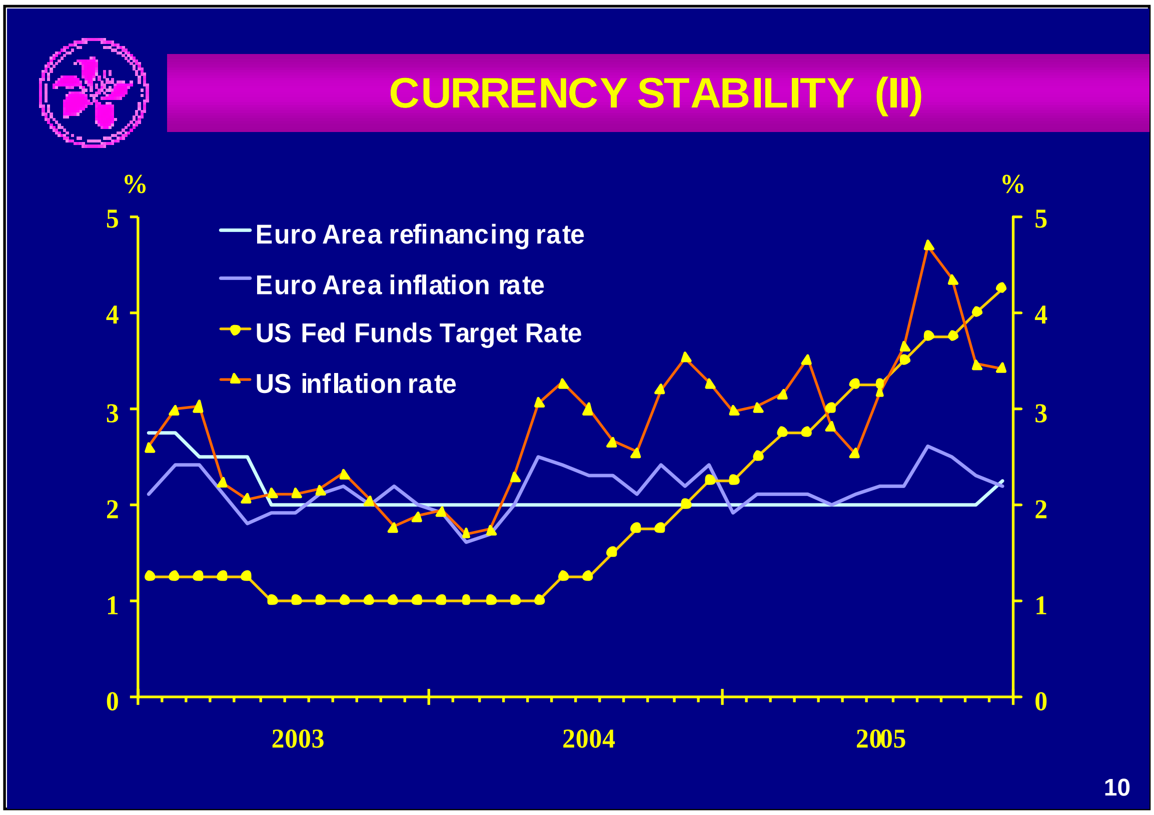
- **Influenza pandemic:** An avian flu pandemic could have a potentially major impact on the global economy. Reactions in the major financial markets could also affect Hong Kong.



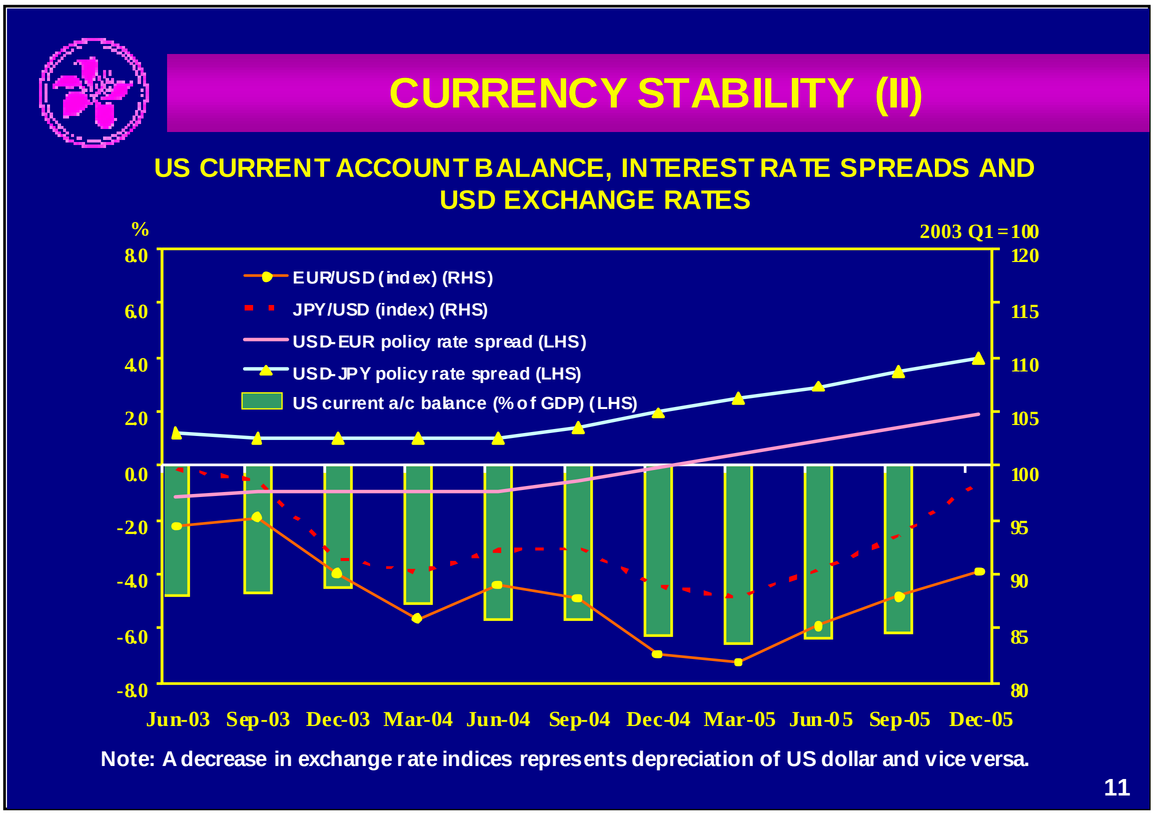
- The price of crude oil (an average of Dubai, Brent and WTI) rose to an all-time high of US$66 per barrel on 1 September, and stayed at around US$63 in mid January 2006. There are risks that further oil price increases will have a more significant impact on global growth. First, as oil production approaches full capacity, the effect will be increasingly reminiscent of a supply shock. Second, a stronger feeding through to core inflation may trigger more aggressive monetary tightening by major central banks than currently anticipated. Third, the global trade imbalance could worsen, as higher oil prices inflate the US import bill and oil-exporting countries import more from Asia and Europe (and less from US). Finally, how oil-exporting economies manage their increased foreign reserves may have implications for the funding of the US trade imbalance.

- However, oil prices are likely to have limited impact on the world economy because (a) oil prices are still well below their historical peaks in real terms in the late 1970s and the early 1980s; (b) global oil intensity has fallen considerably, reflecting increasing energy efficiency in production and a continued shift of the advanced economies away from manufacturing towards service-sector activities; (c) it reflects mainly a strong global demand and not a supply-side shock; and (d) the pass-through to core inflation - and hence monetary policy response - has been limited.

- The direct effect of higher oil prices on Hong Kong is likely to be limited, given the economy's low oil intensity due to its high service orientation.



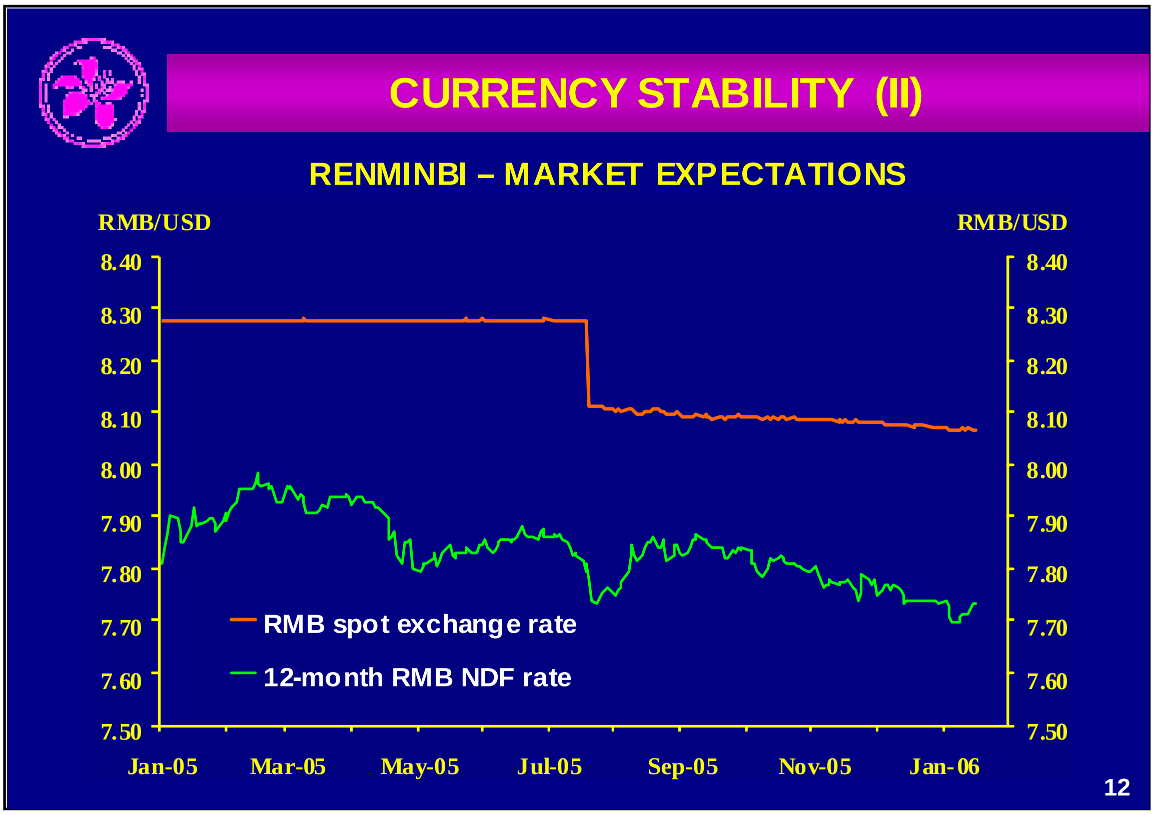
- As inflation climbed in the US, the Fed funds target rate has followed suit.
- The refinancing rate of the euro area could be raised further should inflationary pressure build up.



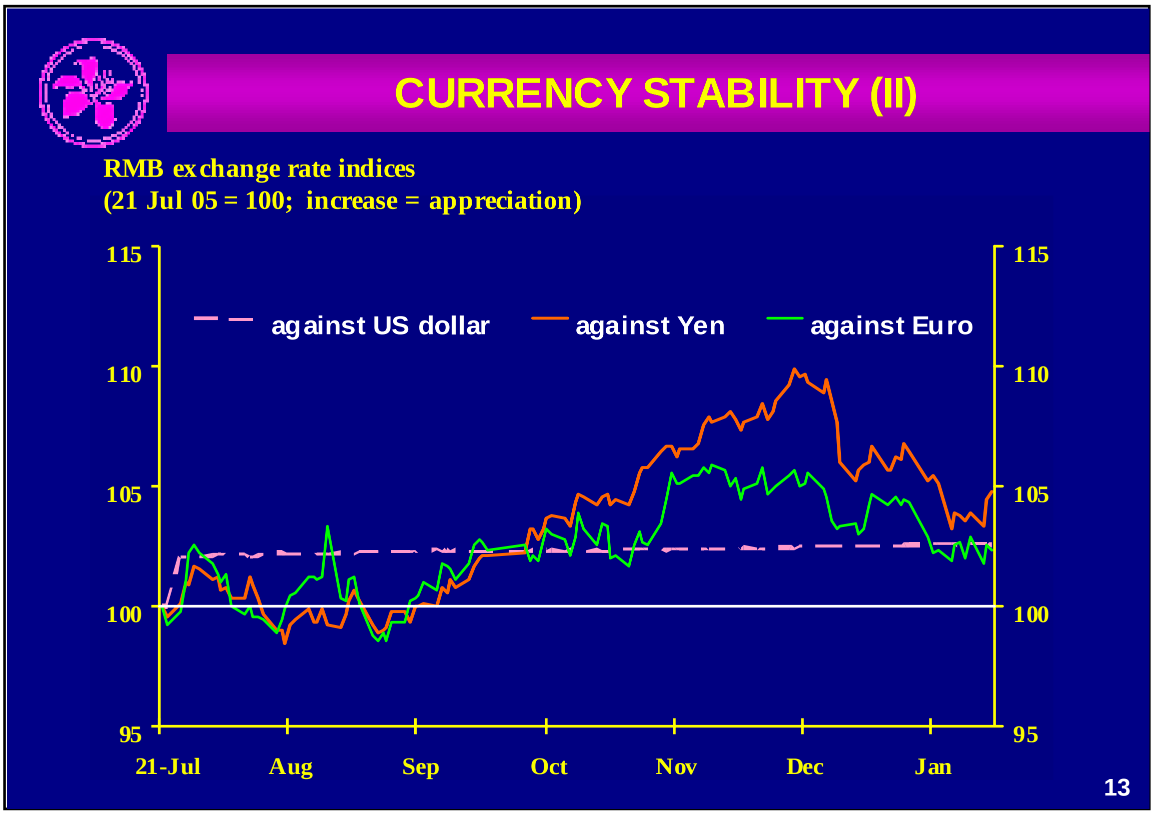
- The US current account deficit has continued to grow in recent years, reaching 6.2% of GDP in 2005 Q3. This partly explained the medium-term weakening trend of the US dollar since 2002. Nevertheless, in 2005 the widening of interest rate differentials in favour of the US gave support to the US dollar and attracted capital inflows into the US to finance its large current account deficit.

- If US dollar interest rates peak in accordance with market expectation, and the interest rates in Europe firm in response to inflationary concerns, the interest rate differentials in favour of the US may narrow.

- The risk of a disorderly adjustment for the huge external imbalance remains and may become large. It is, however, not clear what the trigger may be, although a significant asset re-allocation in foreign reserves has been mentioned as a possibility.



- Speculations about renminbi appreciation intensified again towards the later part of 2005, with the renminbi NDF rate gradually strengthening to around 7.75 to one US dollar by the end of 2005.



- Since the announcement of the reform in the renminbi exchange rate regime in July 2005, the renminbi has strengthened notably against major currencies, particularly the euro and the yen.

CURRENCY STABILITY (III)

Domestic factors

- Growth and inflation
- External position
- Property prices
- Public finance

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- **Economic growth gathered further momentum.** Real GDP grew by 8.2% in 2005 Q3 from a year earlier, following an increase of 7.3% in Q2, driven by rises in net exports and private consumption expenditure.

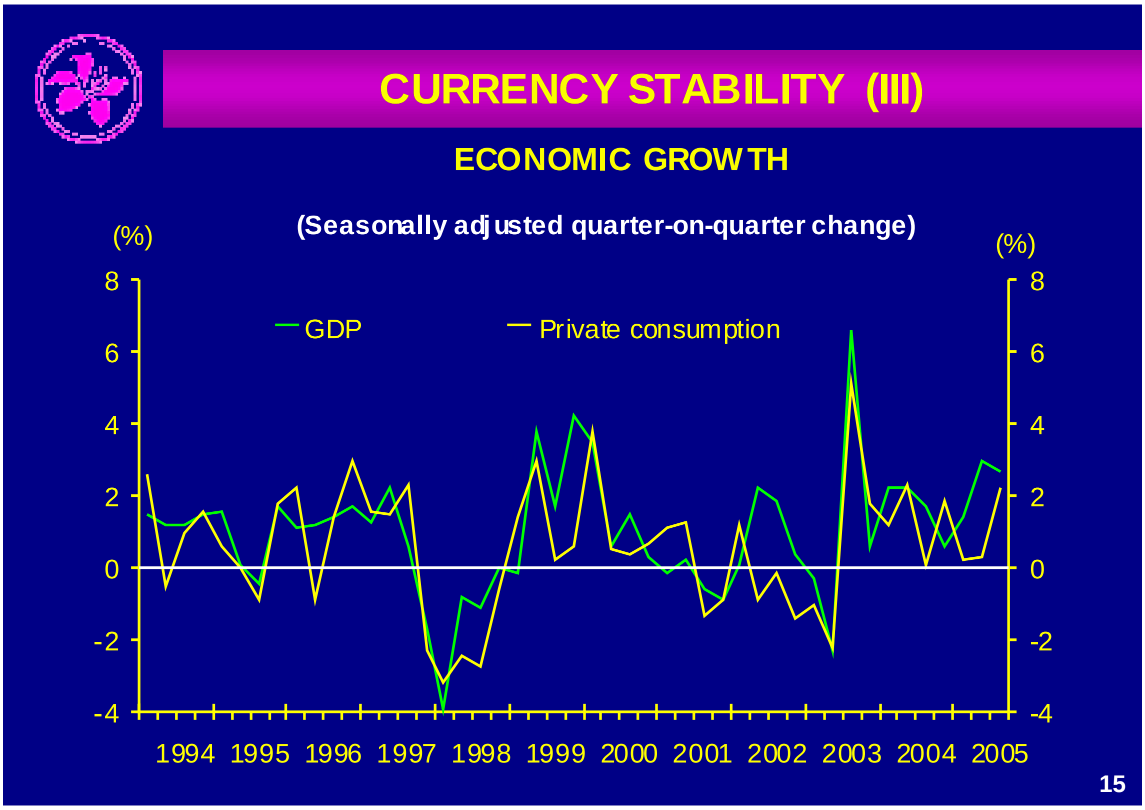
- **The headline Consumer Price Index** edged up steadily in recent months, but the risk of a sharp increase in inflation remains low.

- **The external position of Hong Kong remains healthy.** The current account surplus increased markedly in the first three quarters of 2005 from the same period of 2004, reflecting a rise in service account surplus and a decline in merchandise trade deficit. The latter reflects strong exports in the first three quarters of the year. The net international investment position remains very strong (at about 2.6 times GDP at the end of 2004).

- **Property prices** have increased quite sharply from the trough in 2003 despite some moderation in recent months, contributing to the recovery of the economy through the wealth effect.

- **Public finances:** The fiscal position has improved considerably, helped by recovery in economic activity. The fiscal deficit for 2004/05 narrowed markedly to 0.3% of GDP (after excluding HK$26 billion from sales of government notes and bonds) due to stronger revenue and lower expenditure. There seem to have been further improvements in 2005/06.

- While these factors continue to enhance confidence in the Hong Kong dollar, they may interact with some of the external factors discussed earlier and stimulate capital inflows. Hopefully, this will not lead local monetary conditions to become so easy as to encourage inflation and asset price bubbles.



- On a seasonally adjusted quarter-on-quarter basis, GDP grew by 2.7% in real terms in 2005 Q3, following an increase of 3.4% in Q2. The remarkable economic performance has been broadly based.

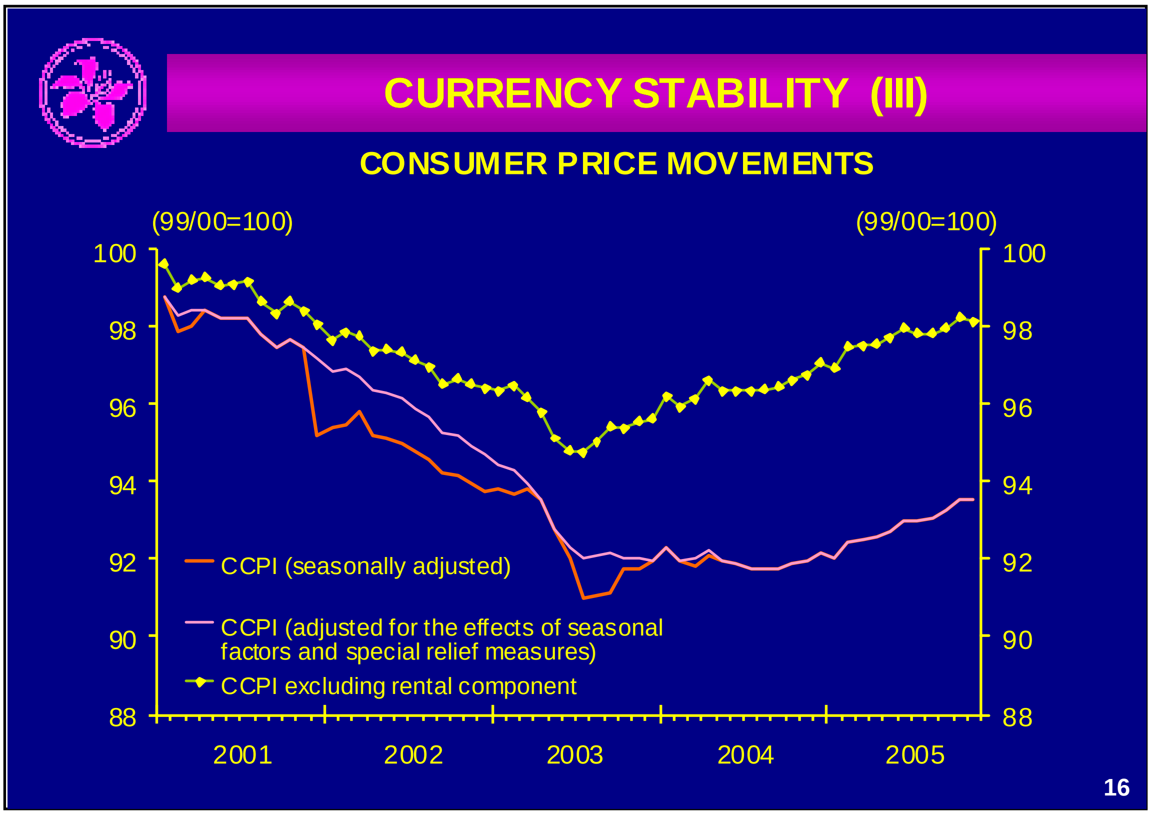
- Despite higher interest rates and a moderation in the property market, private consumption growth picked up in Q3. Private consumption expenditure rose markedly by 2.2% from Q2, owing to a continued improvement in labour market and household income.

- Recent data suggest that the economy continued to expand in Q4. The average value of goods exports in October and November increased by 1.9% from the average level in Q3 (seasonally adjusted). Meanwhile, the average volume of retail sales rose by 0.6% in October-November from the average level in Q3 (seasonally adjusted), in part reflecting an increase in the number of incoming tourists.

- Economic growth is expected to continue in 2006, although at a more moderate rates. The expected slowdown in growth reflects mainly increases in interest rates and slower growth in Hong Kong's major trading partners.

- Along with the economic recovery, labour market conditions continued to improve. The seasonally adjusted unemployment rate declined to 5.3% in the three months ending December 2005, compared with a historic high of 8.6% recorded in mid-2003. During the period, employment increased by 242,900 to an all-time high of 3,432,000.

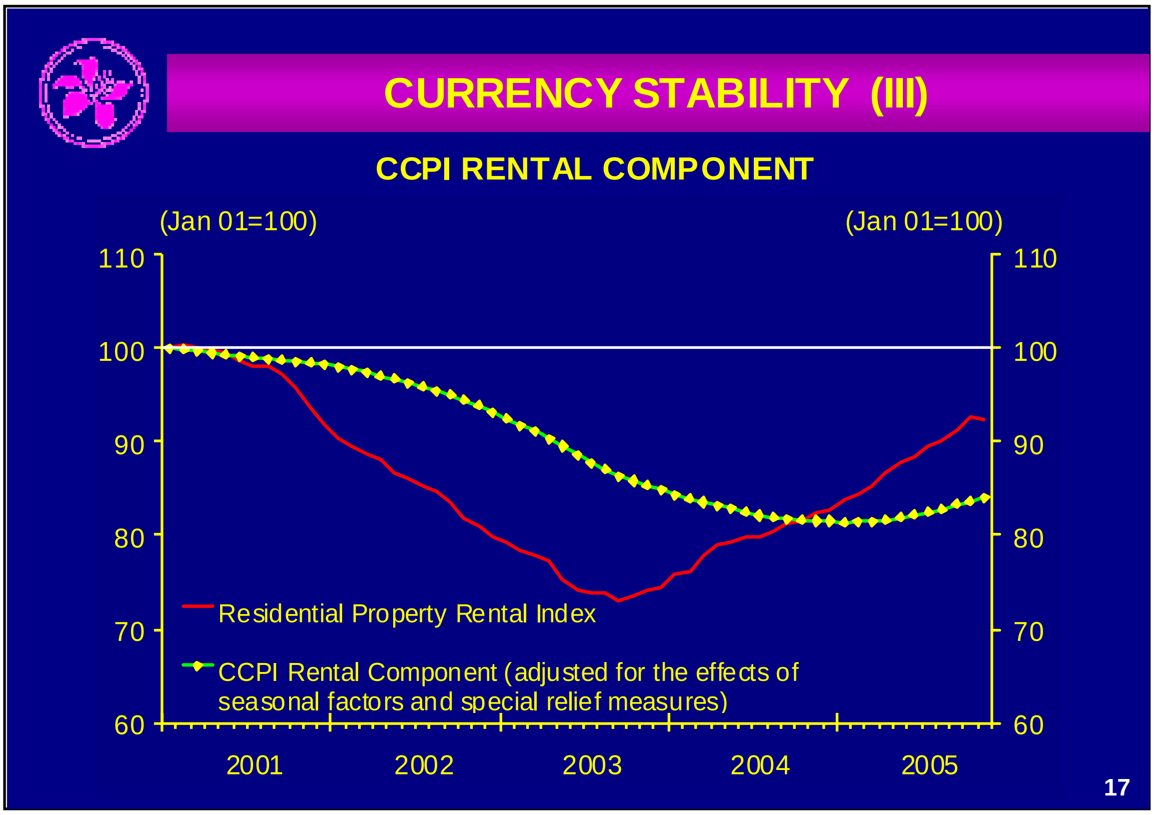
- A sustained recovery in the economy should help reduce the unemployment rate further. In 2005, the Labour Department received some 426,000 private sector vacancies, surpassing the figure of 297,000 in 2004 by 43%.



- The headline inflation rate has increased in recent months, but the annual inflation rate remained modest at 1.7% in November 2005.

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

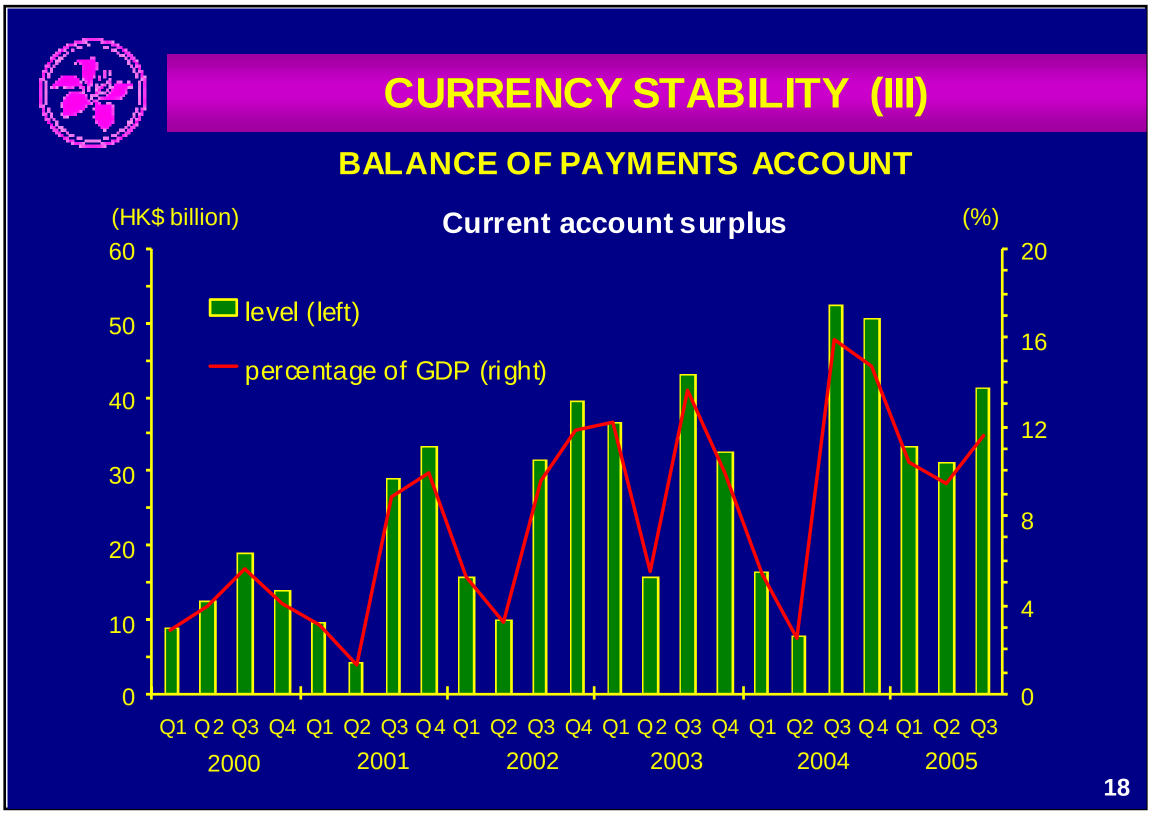
- Consumer prices are expected to rise moderately due to robust economic growth and further pass-through of increases in residential rents to the headline CPI. Nevertheless, the risk of a sharp increase in inflation remains low, given generally low inflation in our major trading partners and the recent increases in interest rates.



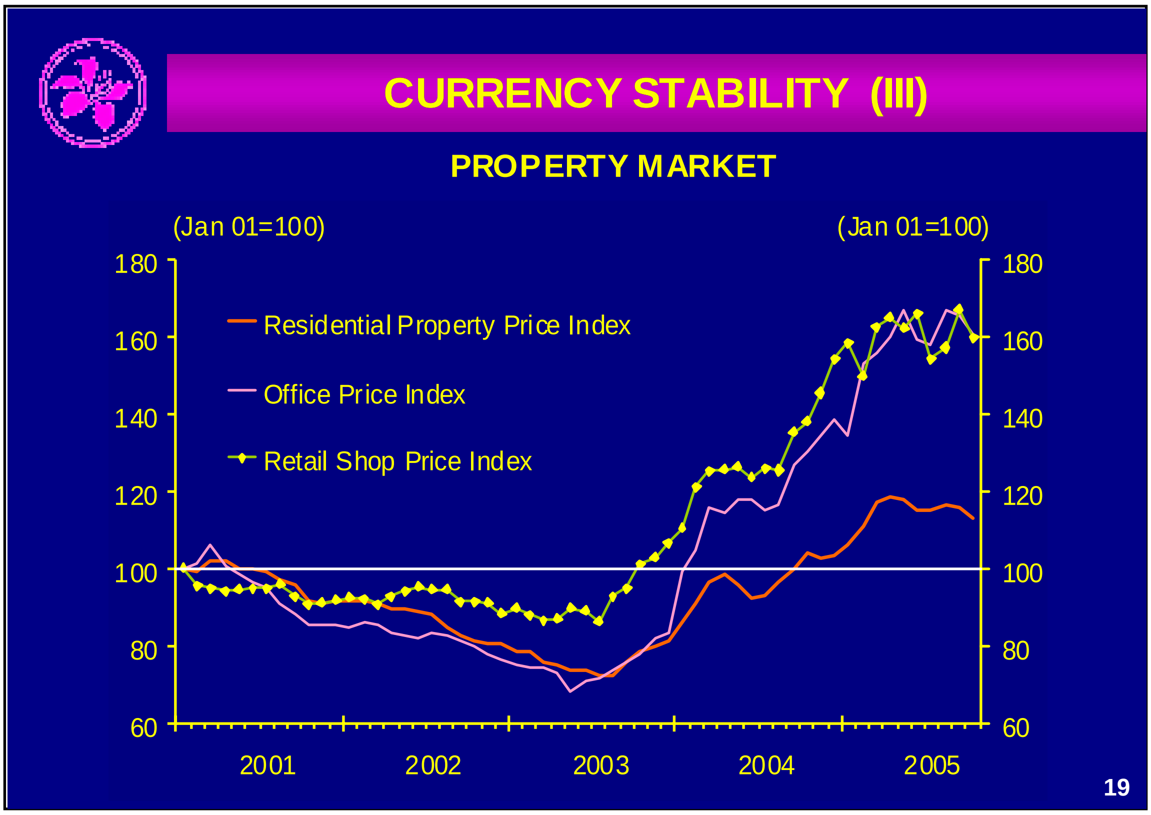
- Rises in residential rents have continued to feed through into the rental component of the Composite CPI as rental contracts are renewed. In November 2005, the rental component increased by 3.0% from a year ago, while market rents rose by 12.0%.

- Changes in the rental component tend to lag behind movements in market rents owing to fixed-term rental contracts, which are typically for two years. (Rental indexes are compiled by the Rating & Valuation Department based on fresh lettings, while the rental component includes both new and existing lettings.)

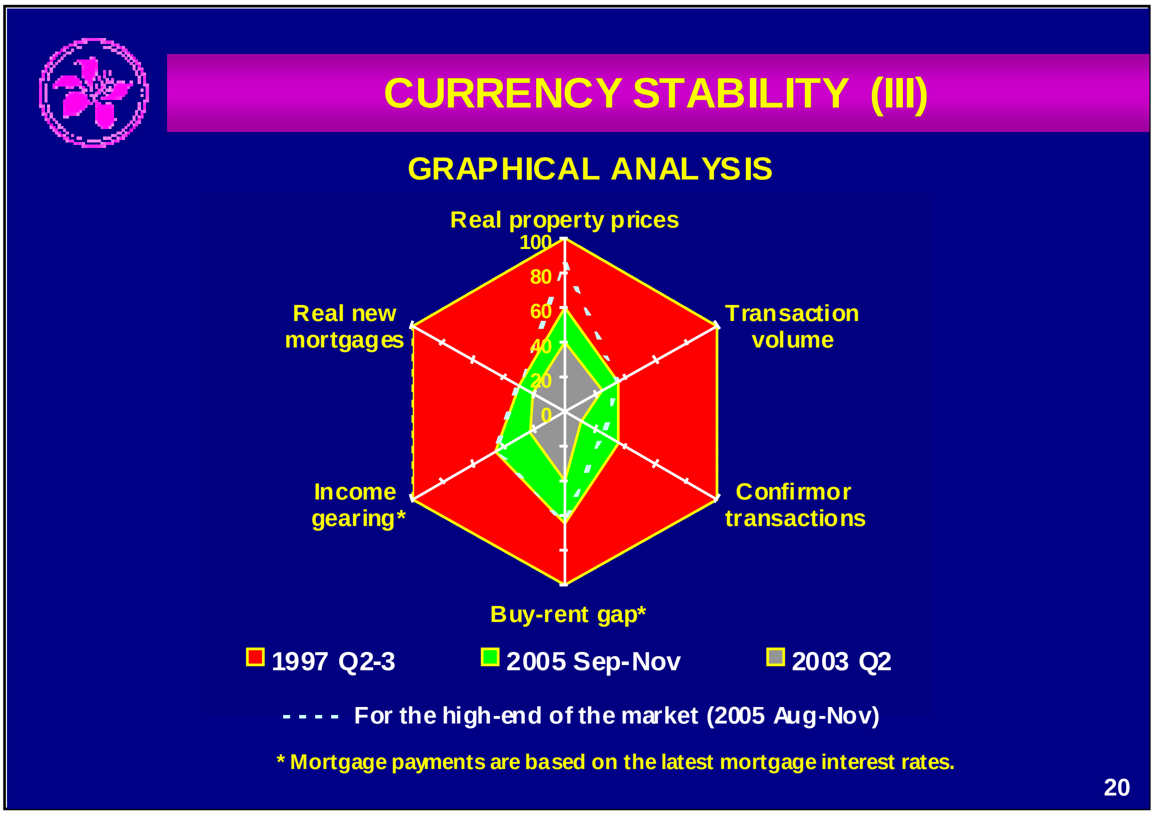
- As market rents have risen by 27% since the trough in September 2003, the rental component is expected to continue to increase and exert further upward pressure on the Composite CPI.



- The external position has remained favourable, partly reflecting improvement in our competitiveness.
- The current account continued to register a notable surplus of around 12% of GDP in the third quarter of 2005, underpinned by solid growth in exports of goods and trade-related services, and strong growth in tourism-related earnings.
- The investment income generated by the accumulated net foreign assets (nearly 260% of GDP) will continue to support the Hong Kong dollar, particularly if these earnings, most likely in foreign currency, are invested back into domestic markets.



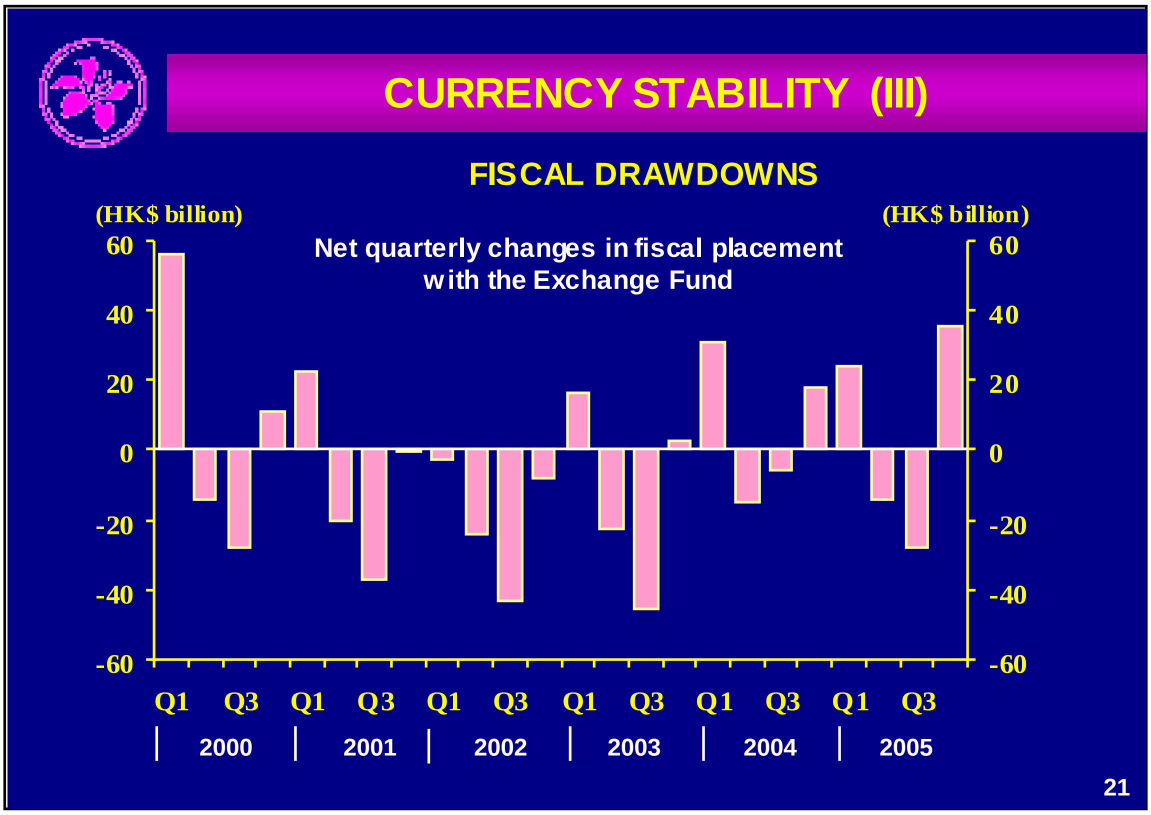
- The interest rate hikes since March 2005 have dampened property market activities.
- Residential property prices declined by 8.7% in November 2005 compared with seven months ago.
- Nevertheless, residential property prices have increased on average by 49% from the trough in the summer of 2003. Prices have increased more sharply at the high-end of the market, with prices of large flats (saleable area of 160 m^2 or above) rising by more than 80% 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 139% and 80% 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.)

- The prices of large flats have increased more sharply than indicated by the overall price index.

- Mortgage rates may rise further if high oil prices lead to a sharp increase in US interest rates. This would further worsen housing affordability and raise the cost of buying a property relative to renting.



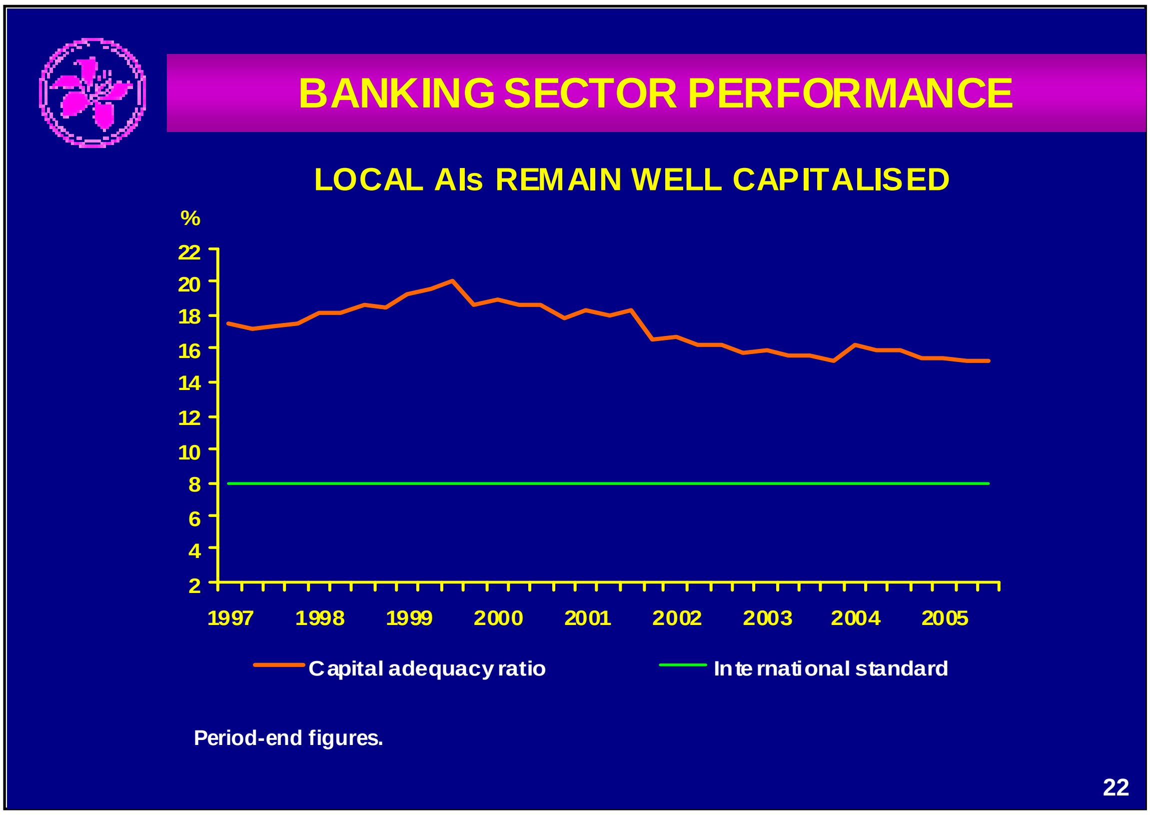
- Alongside the economic recovery, the Government's fiscal position has improved since 2003 Q4.

- There were two consecutive quarters of net placements with the Exchange Fund in 2004 Q4 and 2005 Q1, followed by net draw-downs in 2005 Q2 and 2005 Q3. The balance returned to a surplus again in 2005 Q4.

- The draw-downs in 2005 Q2 and 2005 Q3 were largely seasonal. The draw-down in 2005 Q3 was larger than a year ago because the 2004 figure was distorted by bond issuance by the Government.

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



- The banking sector is well capitalised. At the end of September 2005, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions was above 15%, well above the statutory requirement and international standard (8%).

BANKING SECTOR PERFORMANCE

PROFIT GROWTH (RETAIL BANKS)

	2005	2004
Growth in pre-tax operating profit	+8.0%	+20.9%
Bad debt charge as % of average total assets	-0.01%	-0.02%
Cost-to-income ratio	42.0%	41.4%
Net interest margin	1.68%	1.66%

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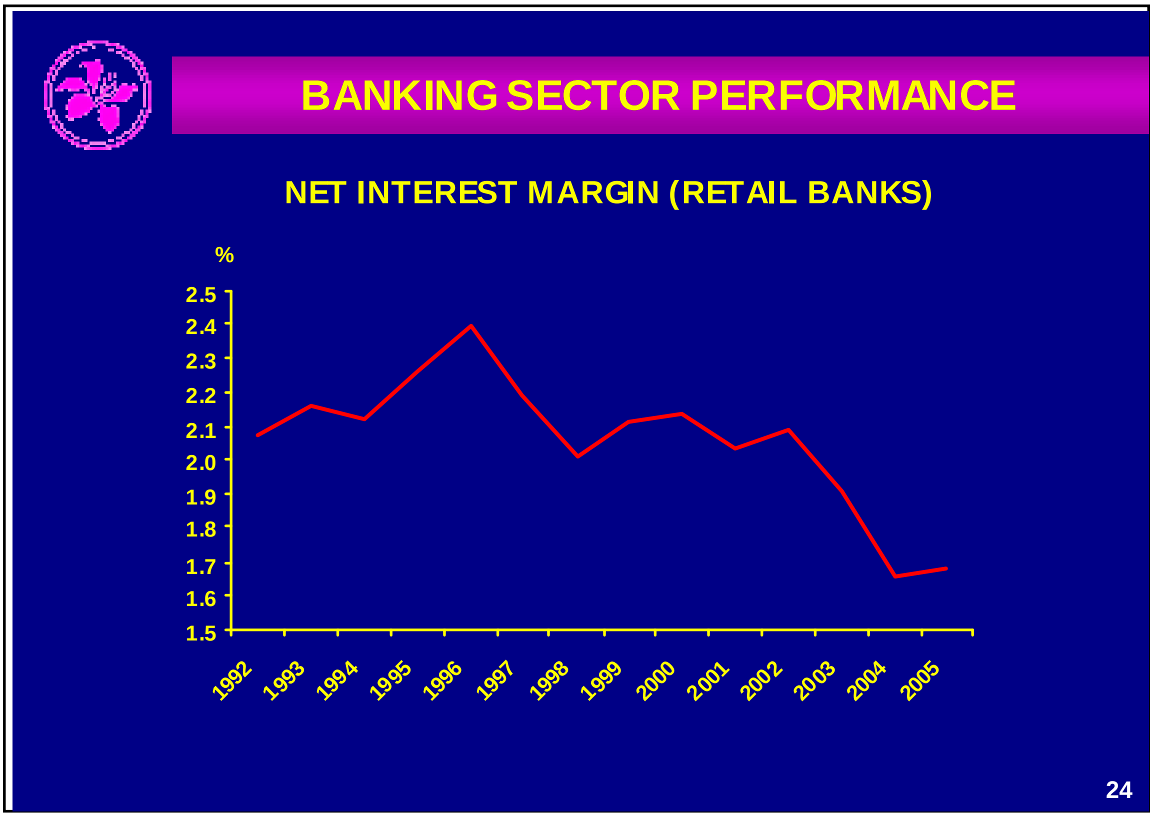
- The aggregate pre-tax operating profit of the retail banks' Hong Kong offices grew by 8.0% in 2005, compared with 20.9% in 2004.

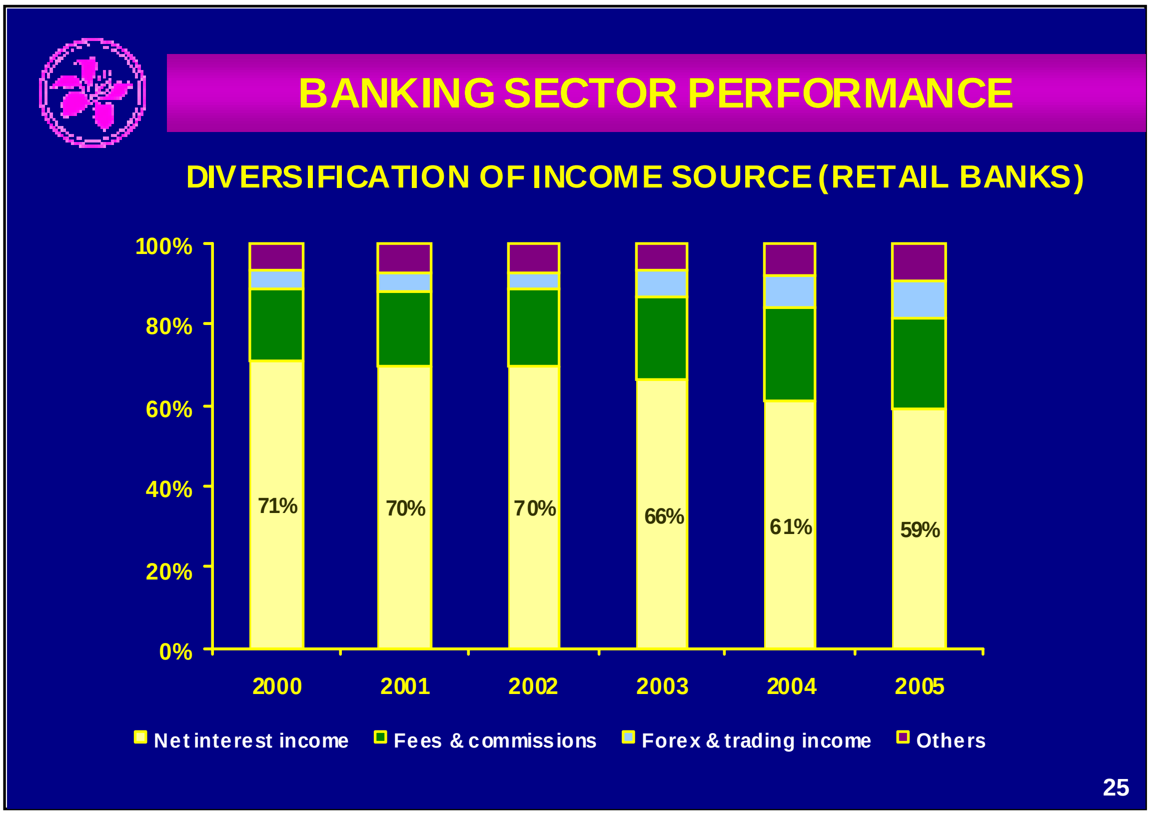
- Profit growth of 8% is considered healthy. The high profit growth in 2004 was largely the result of a post-SARS economic rebound.

- However, as the increase in the cost-to-income ratio indicates, rising operating costs have begun to put pressure on profitability. The increase in this ratio reflects increased costs, particularly in staff expenses due to salary rises and additional recruitment for business expansion.

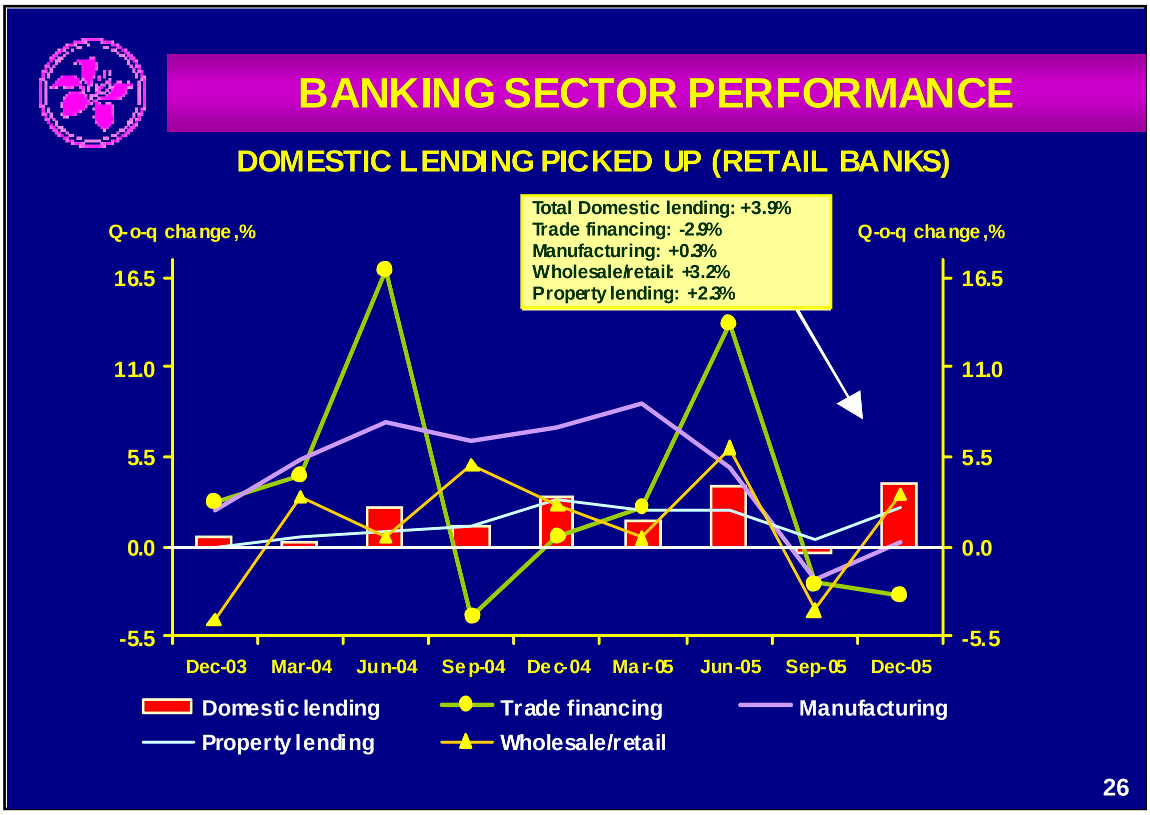
- Moreover, profitability has been boosted by provision write-backs, which are unlikely to be repeated next year.



- Net interest margin of retail banks increased to 1.68% in 2005 from 1.66% in 2004 but remained low by historical standards. The low net interest margin reflects intense competition in the banking sector.



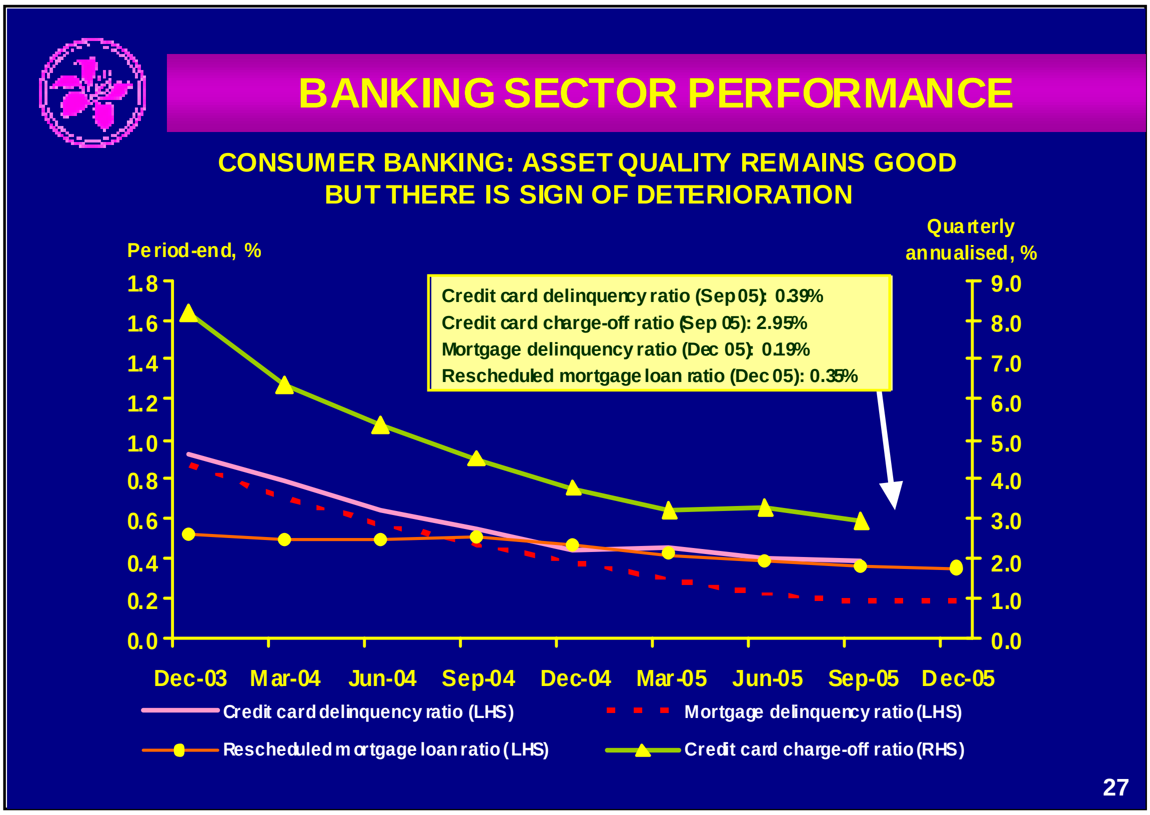
- Narrowing interest spreads in a competitive environment have prompted banks to explore new lines of business for income diversification. The proportion of retail banks' non-interest income to total operating income increased to 40.9% in 2005 from 39.3% in 2004. The increase was mainly seen in fees & commissions and treasury income.



- Total domestic lending increased by 3.9% in 2005 Q4 after a slight decrease of 0.8% in 2005 Q3.

- The increase from 2005 Q3 was mainly due to the increases in loans to other major economic sectors, which more than offset the further decline in trade financing loans.

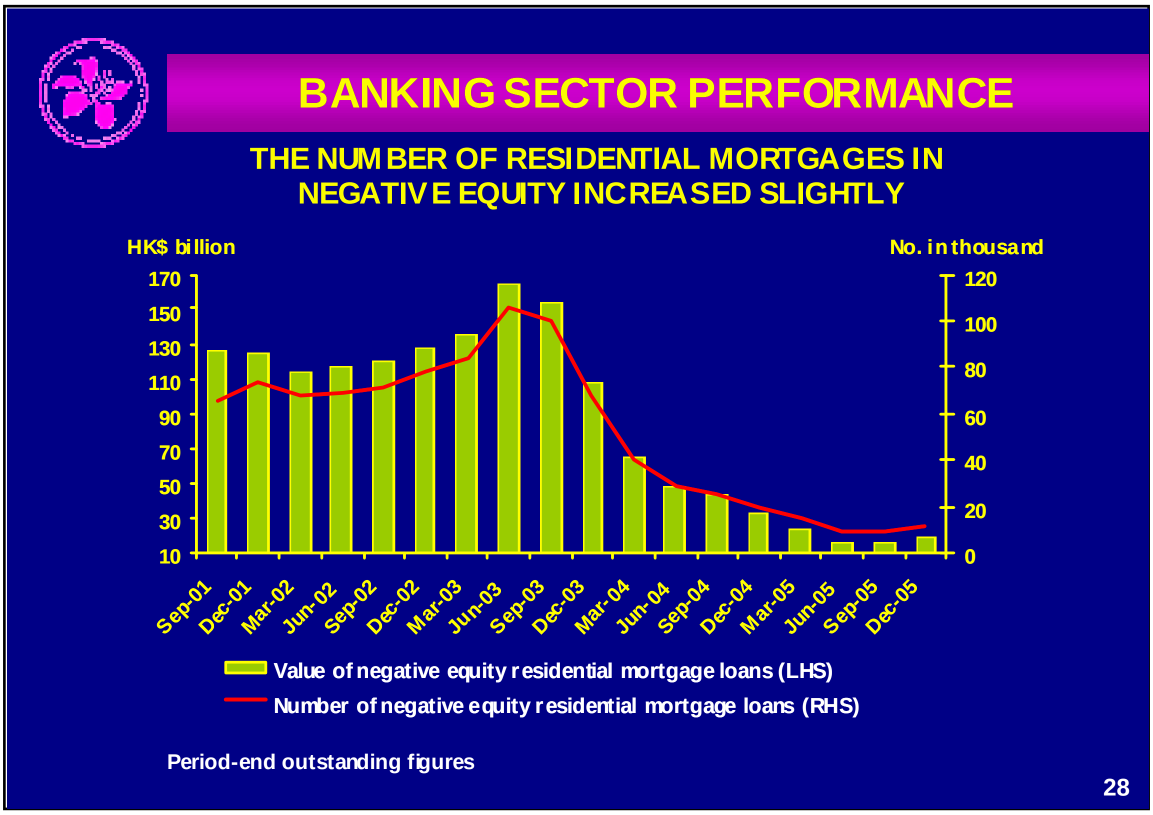
- Note: The sharp decline in trade finance in 2004 Q3 from a strong growth in 2004 Q2 reflected reclassifications initiated by a few banks in the quarter.



- Quality of banks' consumer lending remained good in 2005 Q4. However, there may be signs that rising interest rates are beginning to have an impact on banks' loan quality, as suggested by the increase in the mortgage delinquencies.

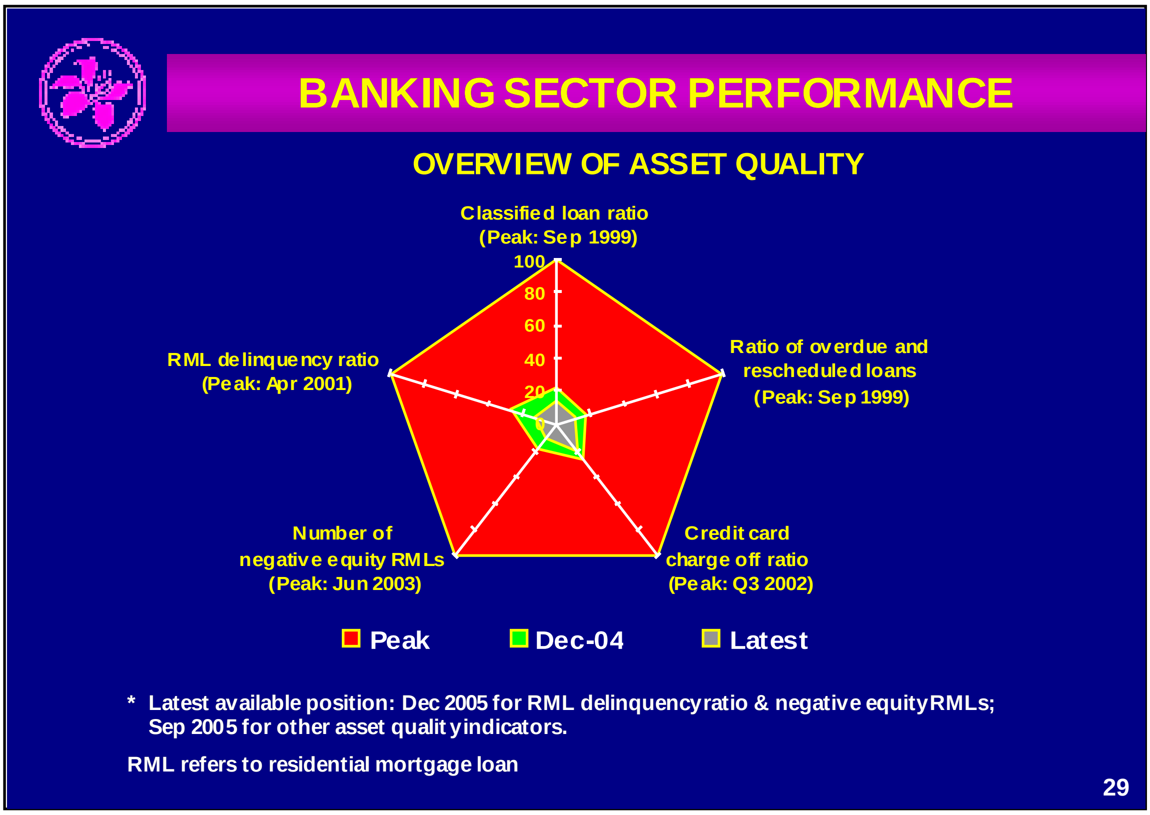
- The residential mortgage delinquency ratio (loans overdue for more than 3 months as a percentage of total mortgage loans) edged up to 0.19% at the end of December 2005 from 0.18% at the end of September 2005. Combined with the rescheduled loans, the ratio was 0.54%, the first increase since June 2003.

- The credit card annualised charge-off ratio and delinquency ratio declined to 2.95% and 0.39% respectively at the end of September 2005 respectively from the peak of 14.55% and 1.32% at the end of September 2002.



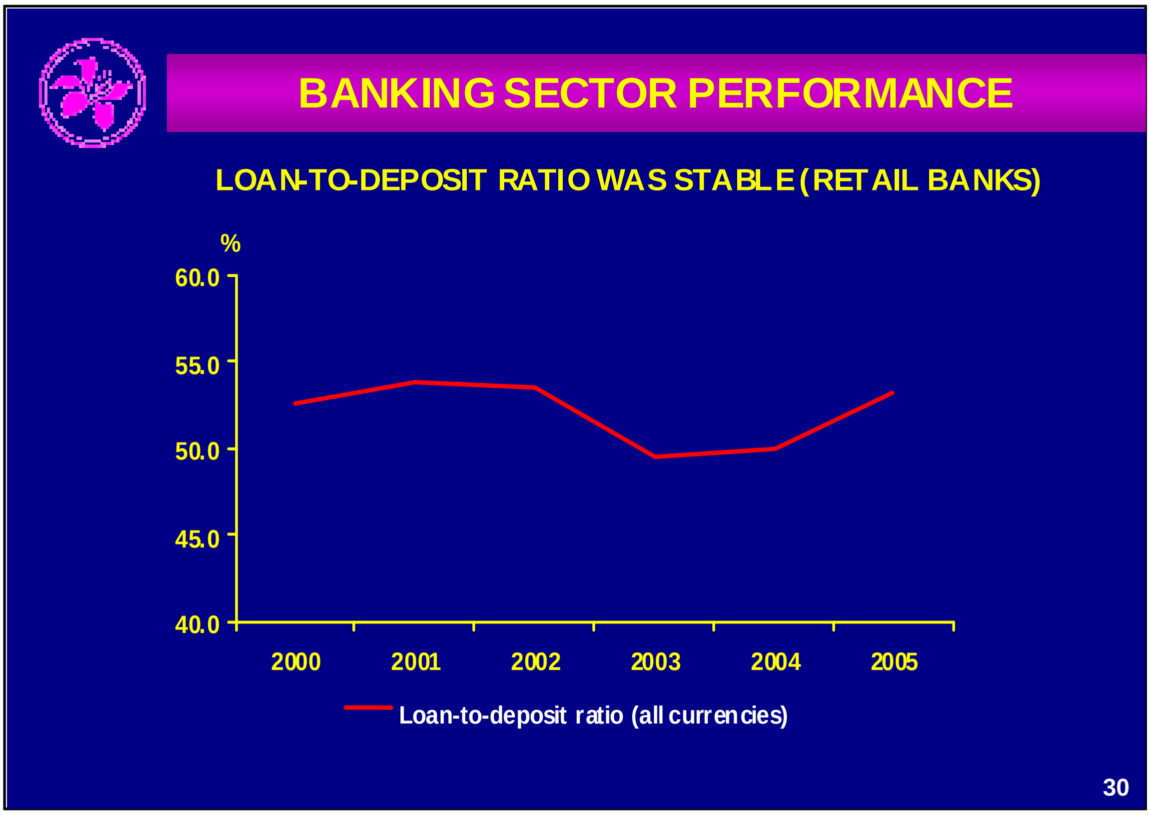
- The number of residential mortgages in negative equity has increased slightly alongside the recent downward adjustment of property prices. At the end of December 2005, the number of residential mortgage loans in negative equity was around 11,000 cases with an aggregate value of $19 billion, compared with 9,000 cases ($16 billion) at the end of September 2005. Compared with the peak of around 106,000 cases ($165 billion) in June 2003, it has declined by around 90%.

- The increase in the number of negative equity mortgages on the books of the banks does not necessarily mean a corresponding deterioration in the quality of the mortgage loan book of the banks. Banks are still adhering to the 70% loan-to-value-ratio rule. The additional top-up portion of the mortgage loans are covered by mortgage insurance, either through the Hong Kong Mortgage Corporation or other insurers.



- A number of indicators of the asset quality of banks have improved considerably compared with their worst positions in recent years.

- All five asset quality indicators at the end of 2004 were about 20% of their worst positions. The indicators improved further at the end of 2005 to around 15% of the peaks.



- Loan-to-deposit ratio of retail banks remained stable in recent years, moving within the range of 50% to 55%. The ratio for 2005 is 53.2%, compared with 50.0% in 2004. The increase was mainly attributable to the faster growth in customer loans than in customer deposits.

BANKING SECTOR - 2006 OUTLOOK

- **More competitive and challenging environment, particularly for smaller banks**
- **Higher interest rates may adversely affect domestic loan demand and asset quality**
- **Provisions will rise if asset quality deteriorates**
- **Good management of interest rate and market risks is crucial**
- **Continuous pressure on profitability**
- **Banks' balance sheets & capital level remain strong**

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- The operating environment of the banking sector is likely to remain challenging owing to the uncertain movement of interest rates and the intense competition in the sector.
- Future movement of interest rates may adversely affect credit demand and banks' asset quality. There may also be early signs that rising interest rates are beginning to have a slight weakening effect on banks' loan quality.
- The rising operating costs will also put pressure on banks' profitability especially since banks' profit margins are already thin. This calls for effective cost control and efforts to diversify income sources.
- Small banks will find the operating environment particularly challenging. In an environment of rising funding costs, small banks that traditionally rely on interbank funding will see a squeeze in profit margins.
- Nevertheless, banks in Hong Kong are still well capitalised and financially resilient.

BANKING SECTOR - WORK PROGRESS

Implementation of Basel II in HK:

- **Development of implementation proposals largely complete**
- **Continue to work closely with AIs to help prepare them for compliance in 2007**
- **Provisions relating to statutory consultation on draft Capital and Disclosure Rules and establishment of Capital Adequacy Review Tribunal under Banking (Amendment) Ordinance 2005 to take effect later this year**

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- Over the last 12 months the HKMA has issued five consultation packages comprising about 900 pages of detailed implementation guidance. This policy-setting stage is now almost complete.

- The HKMA is actively discussing with individual authorized institutions (AIs) their implementation plans and progress, giving guidance wherever applicable to facilitate their preparatory work. Later in the year, there will be a parallel-reporting exercise to assist AIs in getting familiar with the new capital adequacy ratio return and assessing the impact of the revised framework.

- The HKMA aims to bring into effect the provisions relating to the consultation of the Capital and Disclosure Rules and the establishment of a Capital Adequacy Review Tribunal in the course of 2006.

- The HKMA will also conduct working sessions with senior executives of AIs to ensure that the Basel II implementation process, as it applies to Hong Kong, is fully understood.

BANKING SECTOR - WORK PROGRESS

- **Capital and Disclosure Rules are being drafted based on earlier implementation proposals**
- **Certain parts of the draft Rules have already been released for first-round consultation**
- **Second-round consultation will be conducted before the Rules are finalised and submitted to LegCo for negative vetting by end-June 2006**

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- The focus at present is the development of Capital and Disclosure Rules based on earlier implementation proposals. This is a time-critical process requiring substantial resources from the HKMA, the Government and the banking industry.

- Certain parts of the draft Rules have been circulated to the industry and the Government for a first round of consultation. Other parts of the draft Rules are being developed and are expected to be ready for consultation in stages from March to May 2006.

- A second-round consultation for the Rules will be conducted as required under the Banking (Amendment) Ordinance 2005, after which the Rules will be ready for submission to LegCo for negative vetting.

- The HKMA aims to finalise drafting of the Rules in June for submission to LegCo. We plan to provide LegCo with a detailed brief on the content of the first set of Rules in May 2006.

BANKING SECTOR - WORK PROGRESS

Prevention of money laundering

- AIs' self-assessment reports – initial review shows that compliance with anti-money laundering (AML) and counter-terrorist financing (CFT) requirements generally satisfactory
- On-site AML/CFT examination programme – enhancement underway through recruitment of AML consultant and deployment of specialised teams
- Industry user groups – proposal to form these groups for AIs to share AML/CFT experiences/ techniques, identify implementation issues and devise industry best practices

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BANKING SECTOR - DEPOSIT PROTECTION SCHEME

- Continue to assist the Hong Kong Deposit Protection Board in preparing for the launch of the Deposit Protection Scheme (DPS)
- Progress on key preparatory tasks
  - Substantially completed drafting the rules governing the operation of the DPS
  - Testing the payout system for assessing and paying compensation to depositors
  - Formulated a publicity strategy for launch of the DPS
- Expect to start collecting contributions and providing deposit protection in the second half of 2006
- Plan to brief the Panel in March

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BANKING SECTOR - POSITIVE DATA SHARING

- Two-year moratorium on access for review purposes ended in June 2005
- Conducted the first review of the benefits of positive data sharing based on a set of indicators agreed with the Consumer Council
- Benefits of positive data sharing have emerged clearly
  - decline in the average amount of bankruptcy indebtedness
  - shift of credit card rollover balances to cheaper non-card credits

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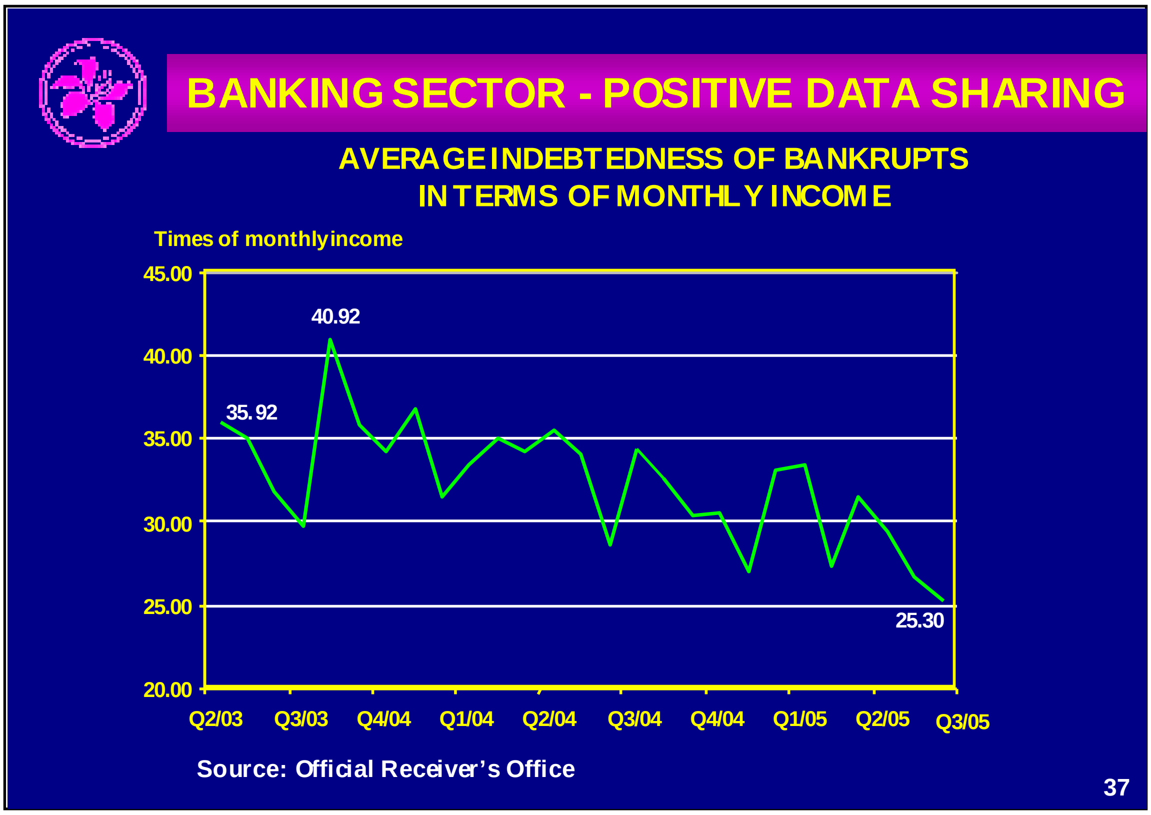
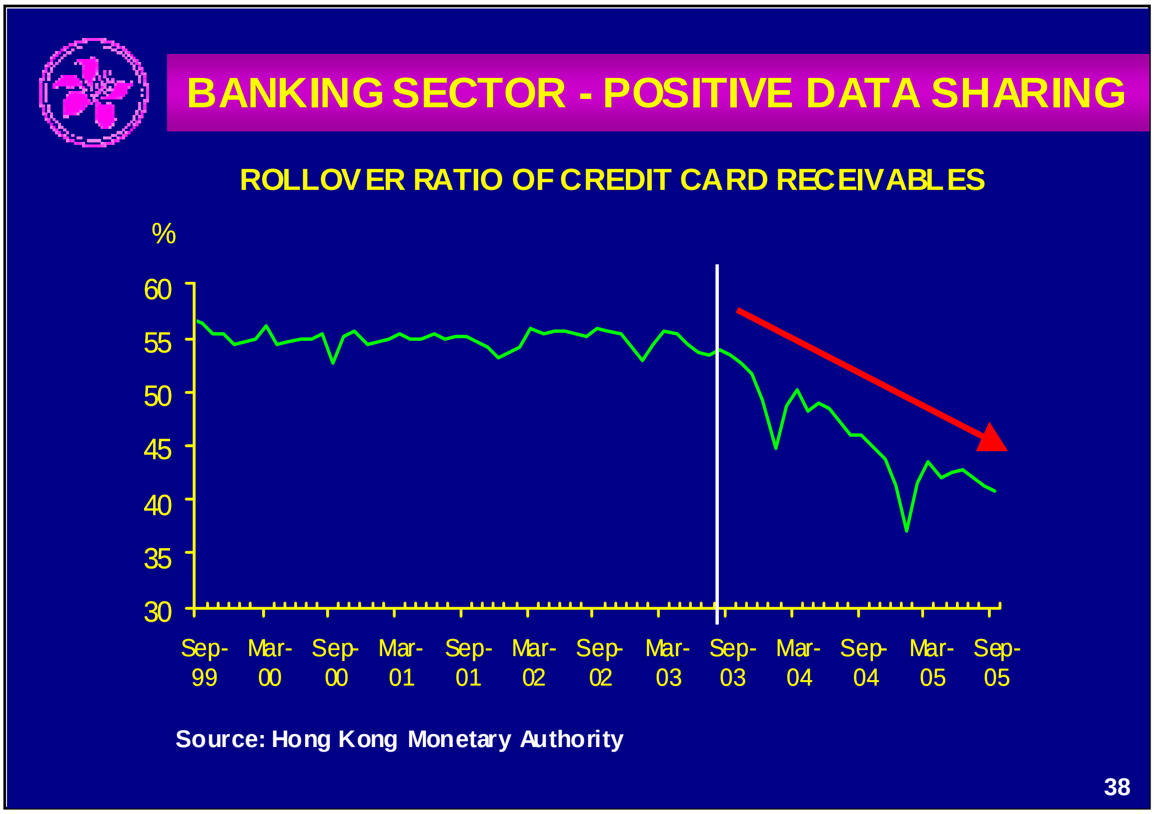


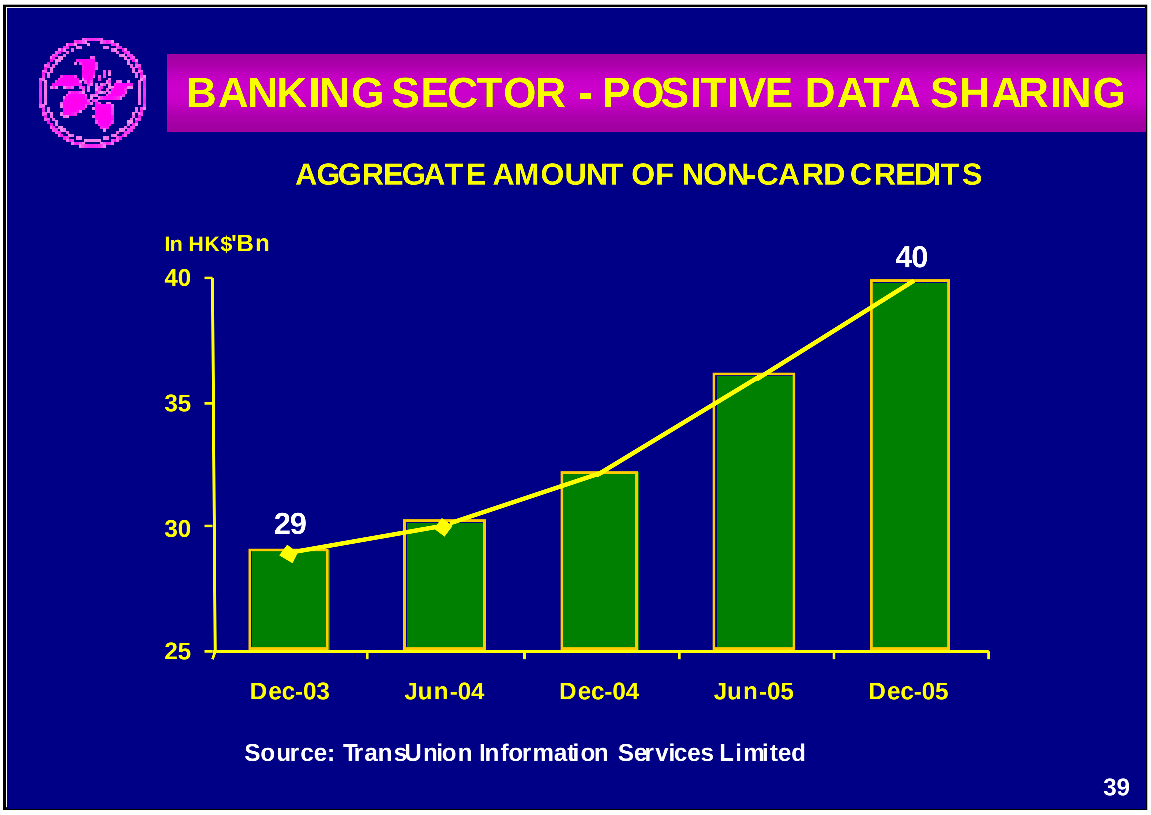
- With the introduction of positive data sharing, financial institutions have fuller information to assess the creditworthiness of their customers. They can avoid lending to borrowers who have already over-extended themselves financially, and will be in a better position to manage their credit risks in consumer credit business.

- Since positive data sharing was introduced, the average indebtedness of bankrupts has declined from over <u>35 times</u> of monthly income to <u>25 times</u>. This shows that, with positive data sharing, it is now more difficult for borrowers who are on the verge of bankruptcy to accumulate additional and an unreasonable amount of debt prior to filing bankruptcy. Also, financial institutions have better tools to avoid lending to such borrowers.



- Positive data sharing should benefit not only financial institutions but also consumers in the long run. To the extent that positive data sharing reduces the credit loss of financial institutions, part of the benefits should be passed on to consumers in a competitive environment.

- Following the introduction of positive data sharing in August 2003, credit card rollover ratio declined from 55% to 41% in 2005 Q3. The aggregate amount of credit card rollover balance reduced from $29 billion to $24 billion during the period.



- The aggregate amount of consumer debt through instalment loans and revolving credit facilities increased by 38% from HK$29 billion in December 2003 to HK$40 billion in December 2005.
- This indicates that financial institutions are now more comfortable in underwriting consumer loans and positive data sharing is no doubt a major factor. According to the industry, interest rates for these consumer loans are on average 6-10% lower than that of debt incurred through credit cards. Bankers have confirmed that positive data sharing has helped them to manage and price better the risks of non-card consumer credit.
- Financial institutions can now make full use of positive data in their credit assessments. There are also new players joining the consumer credit market. It is expected that consumers will benefit even more.

MARKET INFRASTRUCTURE (I)

- **Building Hong Kong's financial infrastructure on a multi-currency platform to facilitate domestic and international financial intermediation.**
  - **Project Development**
    - ⇒ **Migration to SWIFTNet**
    - ⇒ **RMB Settlement System**
    - ⇒ **RTGS Liquidity Optimiser**
    - ⇒ **Bond Price Bulletin**
    - ⇒ **Functional Improvements for Central Moneymarkets Unit (CMU)**

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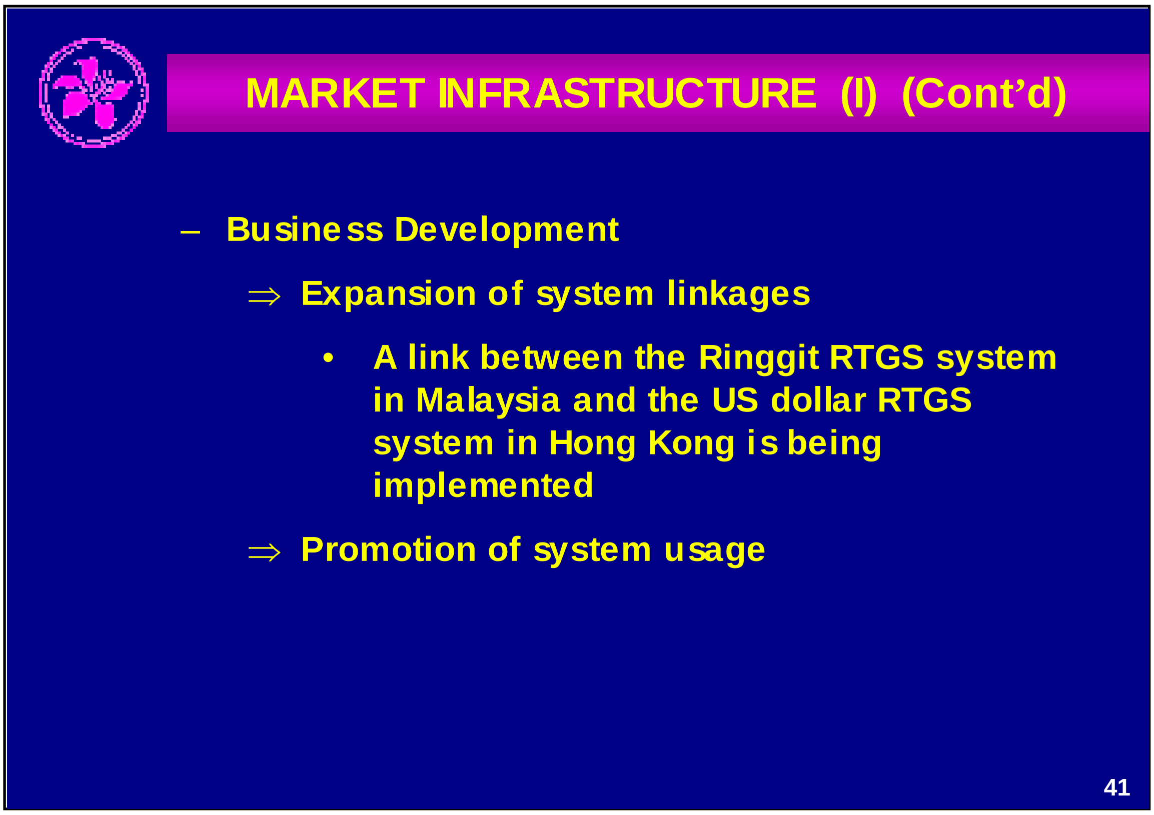
- Recommendations arising from the Review of Financial Infrastructure Development conducted in 2005 cover project development and business development. Specific projects are:

- Project development:
  - Migration to SWIFTNet -- to replace the existing closed, proprietary platform for the RTGS systems and the CMU by an open platform. Proposals from prospective vendors are being reviewed. The migration is targeted to place by 2008 Q1.
  - RMB Settlement System -- to cater for the operations of the expanded RMB business and the new RMB cheque business. The system is scheduled for launch in March 2006.
  - RTGS Liquidity Optimiser -- to increase liquidity efficiency through periodic offsetting of payment instructions queued in the RTGS system. The device was launched on 23 January 2006, and operation has been smooth.
  - Bond Price Bulletin -- to provide an easily accessible web-based platform to list bond information and prices for retail investors. The website went live on 9 January 2006.
  - CMU functional improvements -- these include a system tool to process delivery-versus-payment and collateralisation for Exchange Fund Bills and Notes simultaneously; an Internet-based CMU enquiry system; and further studies of other bond market initiatives.



- Business development:

  – Expanding system linkages -- to explore opportunities to establish international linkages for the RTGS systems and the CMU, focussing on the greater China region, followed by the Asian markets.

  – Promoting system usage -- to devise and execute a marketing programme to promote the use of Hong Kong's foreign currency payment systems, cross-border payment linkages with Mainland China, and CMU services.

MARKET INFRASTRUCTURE (II)

- **Oversight of the clearing and settlement systems**
  - **all local designated systems complying with the safety and efficiency requirements of the Clearing and Settlement Systems Ordinance**
  - **continued support rendered to the Process Review Committee in preparing the first annual report for submission to FS in due course**
  - **information sharing mechanism with major credit card system operators has been enhanced**

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- A Process Review Committee, composed of independent members, was established in December 2004 to review processes and procedures adopted by the Monetary Authority (MA) in making decisions relating to or affecting the designated systems in which the MA has a legal or beneficial interest. An annual report on the work of the Committee will be submitted to FS in due course.

- During the recent overseas incidents of credit card data leakage, the HKMA has enhanced its communication with major credit card operators such that the HKMA can be promptly informed of any such incidents and take appropriate actions with card-issuing banks affected. Cardholders affected will not be required to bear direct losses arising from these incidents.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (I)

Renminbi business in Hong Kong

- **Outstanding renminbi deposits reached RMB 22.6 billion yuan at the end of December 2005**
- **The following expansion measures have been implementated on 5 December 2005:**
  - **widening the definition of "designated merchants" and allowing such to open renminbi deposit accounts;**
  - **relaxing daily limits for conversion of renminbi cash and renminbi remittances; and**
  - **removing the cap on credit limit for credit cards**

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- At the end of December 2005, 38 banks were engaging in renminbi business in Hong Kong and the total outstanding renminbi deposits reached RMB22.6 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 exceeded HK$9.4 billion. Debit- and credit-card spending by Mainland tourists was about HK$2,800 per transaction on average.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (II)

Next steps:

- **RMB cheques will be introduced in March 2006**
- **Continuing discussions with Mainland authorities on proposals for using renminbi to settle cross-border trade and issuing renminbi bonds in Hong Kong**

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HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE (II)

Asian Bond Fund 2 (ABF2)

- 11 EMEAP central banks and monetary authorities, including the HKMA, have invested a total of US$2 billion in ABF2.
- ABF2 consists of the ABF Pan Asia Bond Index Fund (PAIF) and 8 Single-market Funds. So far, the PAIF and 3 Single-market Funds in Hong Kong, Malaysia and Singapore have been listed. The other funds will be launched in the next few months.
- The ABF Hong Kong Bond Index Fund and the PAIF were listed in Hong Kong in June and July 2005 respectively, with asset size having grown by 52% and 9% since launch.

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- Key market data for ABF HK Bond Index Fund and PAIF:

(As of 18 January 2006)	**HK Fund**	**PAIF**
Fund size	HK$2.15 bn (US$277 mn)	US$1.08 bn
Growth of fund size since inception	+52%	+9%
Average daily turnover since inception	HK$5.0 mn (US$0.64 mn)	US$0.10 mn

EXCHANGE FUND INVESTMENT INCOME

(HK$ billion)	2005[2] Full Year	2005[2] Q4	2005[2] Q3	2005[2] Q2	2005[2] Q1	2004[1] Full Year
Gain / (Loss) on Hong Kong equities*	7.0	(2.7)	8.1	5.1	(3.5)	12.0
Gain / (Loss) on other equities*	20.5	7.9	10.1	3.4	(0.9)	11.2
Exchange gain / (loss)	(19.5)	(3.4)	(2.4)	(10.7)	(3.0)	8.5
Total return from bonds, etc	30.1	5.8	3.2	15.8	5.3	25.0
Investment income	38.1	7.6	19.0	13.6	(2.1)	56.7

* Including dividends

[1] Audited figures; [2] Unaudited figures

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- High energy prices and expectations of higher interest rates continued to cloud the bond, equity and currency markets.

- A portion of Hong Kong's foreign currency reserves is held in non-US dollar assets. When the US dollar is strong, the value of this component in terms of Hong Kong dollars will decline because of the link between the Hong Kong dollar and the US dollar. The strength of the US dollar in 2005 has thus dragged down the investment income of the Exchange Fund.

CHANGE IN ACCUMULATED SURPLUS

(HK$ billion)	2005[2]					2004[1]
	Full Year	Q4	Q3	Q2	Q1	Full Year
Investment income / (loss)	38.1	7.6	19.0	13.6	(2.1)	56.7
Other income	0.2	0.1	0.0	0.1	0.0	0.2
Interest, other costs and adjustments	(8.5)	(2.6)	(2.2)	(1.8)	(1.9)	(4.8)
Net investment income / (loss)	29.8	5.1	16.8	11.9	(4.0)	52.1
Treasury's share	(10.0)	(2.3)	(4.9)	(3.5)	0.7	(14.5)
Revaluation gain on premises affecting accumulated surplus	0.0	0.0	0.0	0.0	0.0	0.9
Increase / (Decrease) in EF accumulated surplus	19.8	2.8	11.9	8.4	(3.3)	38.5

[1] *Audited figures;* [2] *Unaudited figures*

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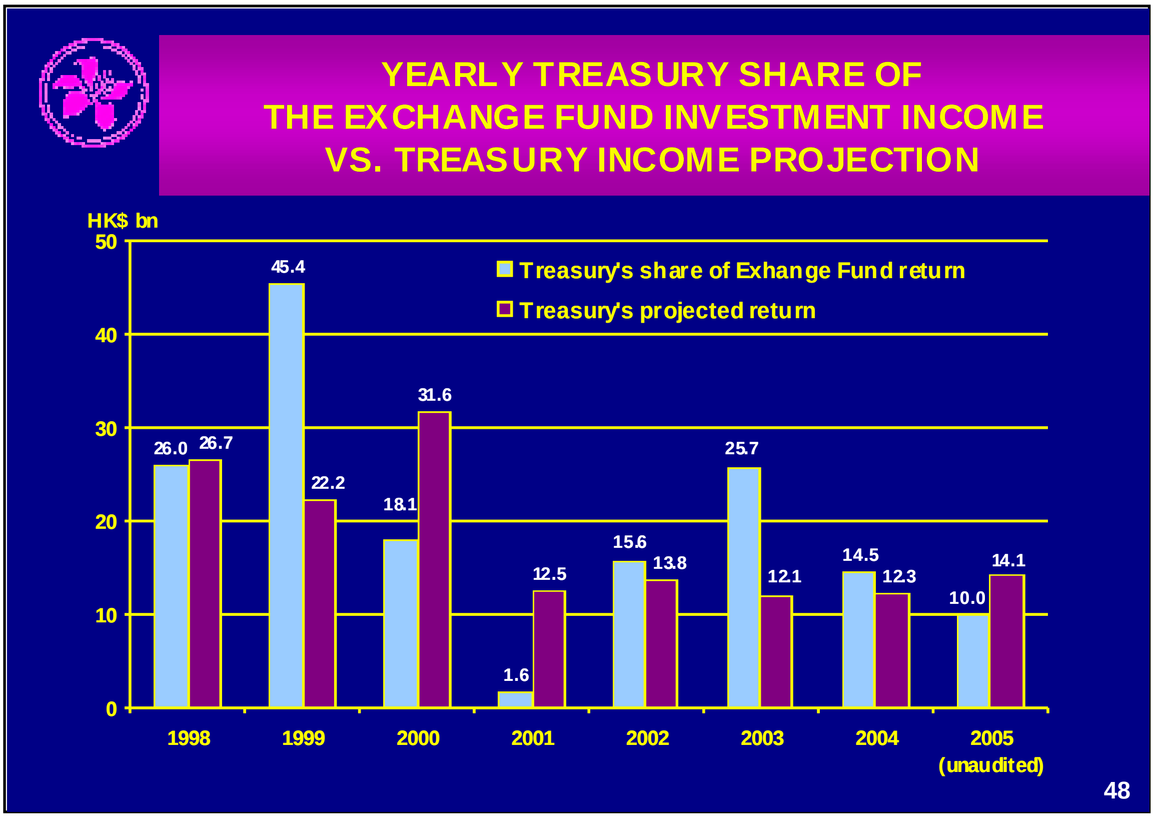
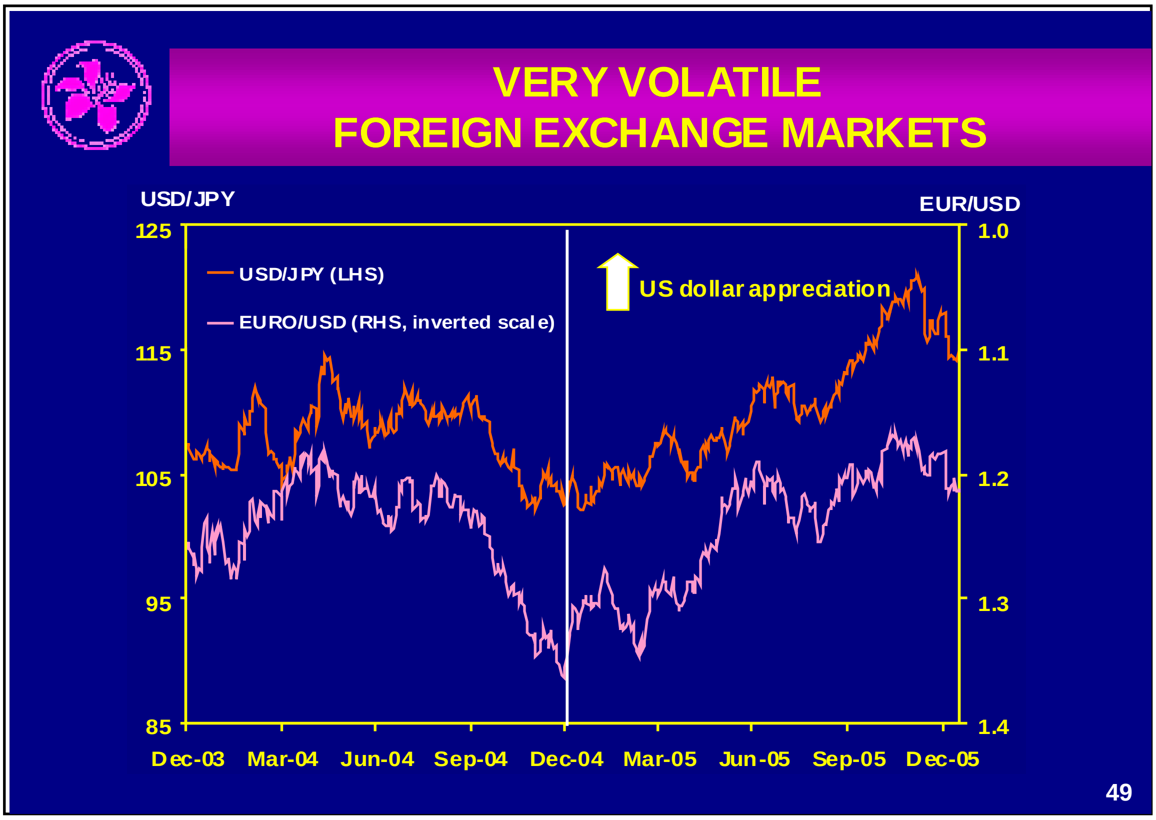
- The investment strategy of the Exchange Fund is determined by the objectives of capital preservation, liquidity, full backing of the Hong Kong-dollar Monetary Base, and maintaining the long-term purchasing power of the assets. The investment return of the Exchange Fund is linked to the returns of allowable asset markets in which the assets are invested. It is therefore difficult to forecast the yearly return of the Exchange Fund and to predict whether the return in any one year will meet the projection by the Treasury.



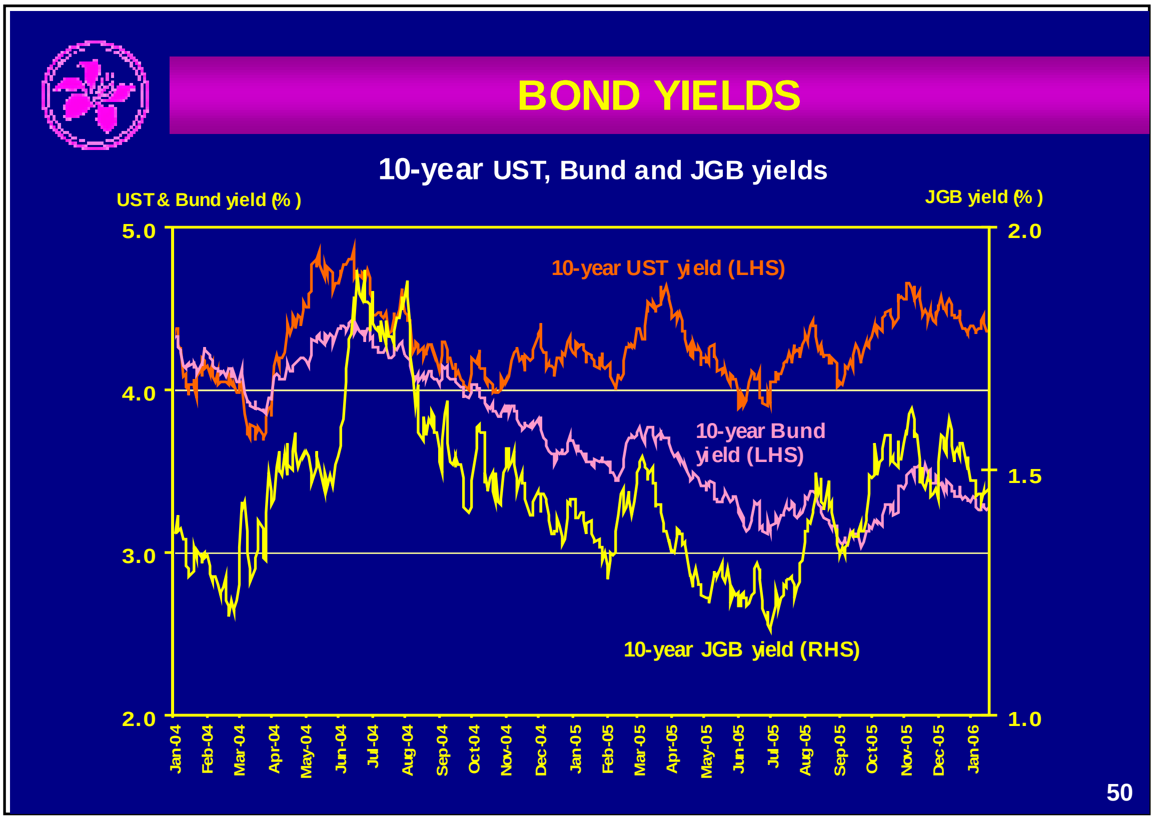
- The Treasury's share of the Exchange Fund investment income fluctuated from year to year, ranging from a low of HK$1.6 billion in 2001 to a high of HK$45.4 billion in 1999.

- Sharing arrangements make investment return on fiscal reserves volatile and difficult to predict.

- The investment returns can vary widely from year to year, depending on the conditions of the financial markets.



- In 2005, interest rate differentials and expectations of further increases in US interest rates provided some support to the US dollar. As a result, the US dollar has appreciated by 14.4% and 14.7% against the euro and yen respectively since the end of 2004. However, imbalances in the global financial system have worsened. The uncertain outlook for growth in view of high energy prices, the increasing size of the imbalances and the possibility that Fed funds rate would be close to a peak in the first half of 2006 suggests that the US dollar will seesaw in the near future.


BOND YIELDS
10-year UST, Bund and JGB yields
UST & Bund yield (%)
JGB yield (%)
10-year UST yield (LHS)
10-year Bund yield (LHS)
10-year JGB yield (RHS)
5.0
4.0
3.0
2.0
2.0
1.5
1.0
Jan-04
Feb-04
Mar-04
Apr-04
May-04
Jun-04
Jul-04
Aug-04
Sep-04
Oct-04
Nov-04
Dec-04
Jan-05
Feb-05
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Jun-05
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Nov-05
Dec-05
Jan-06
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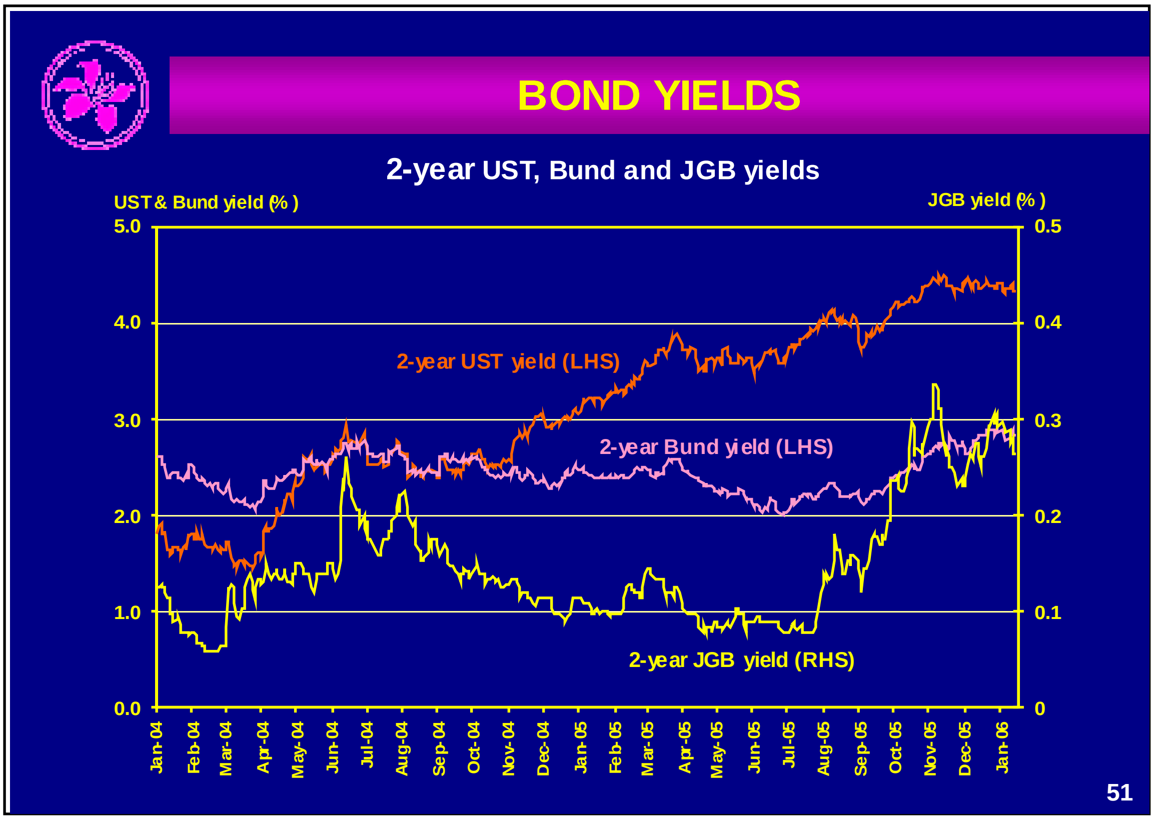
BOND YIELDS
2-year UST, Bund and JGB yields
UST & Bund yield (%)
JGB yield (%)
5.0
4.0
3.0
2.0
1.0
0.0
0.5
0.4
0.3
0.2
0.1
0
2-year UST yield (LHS)
2-year Bund yield (LHS)
2-year JGB yield (RHS)
Jan-04
Feb-04
Mar-04
Apr-04
May-04
Jun-04
Jul-04
Aug-04
Sep-04
Oct-04
Nov-04
Dec-04
Jan-05
Feb-05
Mar-05
Apr-05
May-05
Jun-05
Jul-05
Aug-05
Sep-05
Oct-05
Nov-05
Dec-05
Jan-06
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- Since the beginning of 2005, the US equity market has been negatively affected by high energy prices and concerns over the sustainability of earning prospects and growth in the US. The sombre mood of the US equity market spilled over to other markets including Hong Kong. In 2005, the S&P 500 rose by 3.0% while the Hang Seng Index gained 4.5% from 2004.

UNCERTAIN OUTLOOK FOR EQUITY MARKETS
160
150
140
130
120
110
100
90
80
Hang Seng Index
S & P 500 Index
MSCI Europe
TOPIX Index
Jan-04
Feb-04
Mar-04
Apr-04
May-04
Jun-04
Jul-04
Aug-04
Sep-04
Oct-04
Nov-04
Dec-04
Jan-05
Feb-05
Mar-05
Apr-05
May-05
Jun-05
Jul-05
Aug-05
Sep-05
Oct-05
Nov-05
Dec-05
Jan-06
53