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HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

4 June 2007

DISCUSSION TOPICS

Updates on

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

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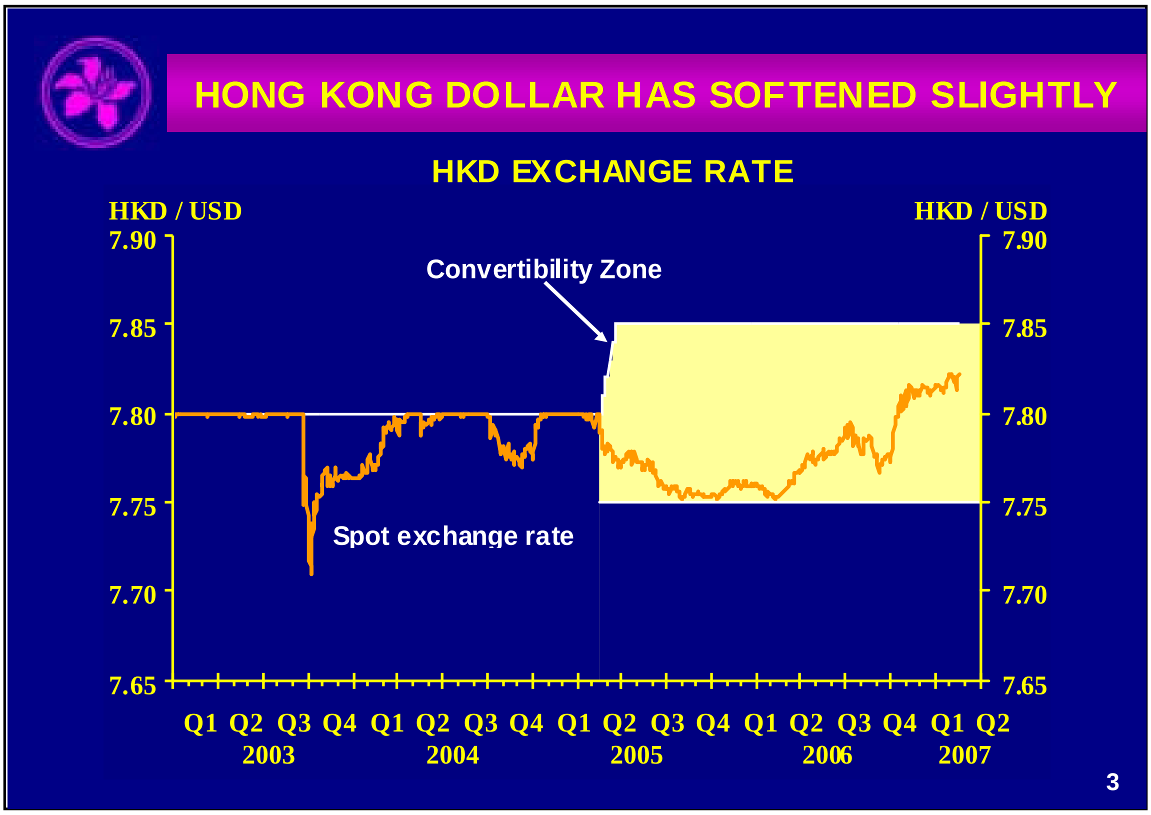
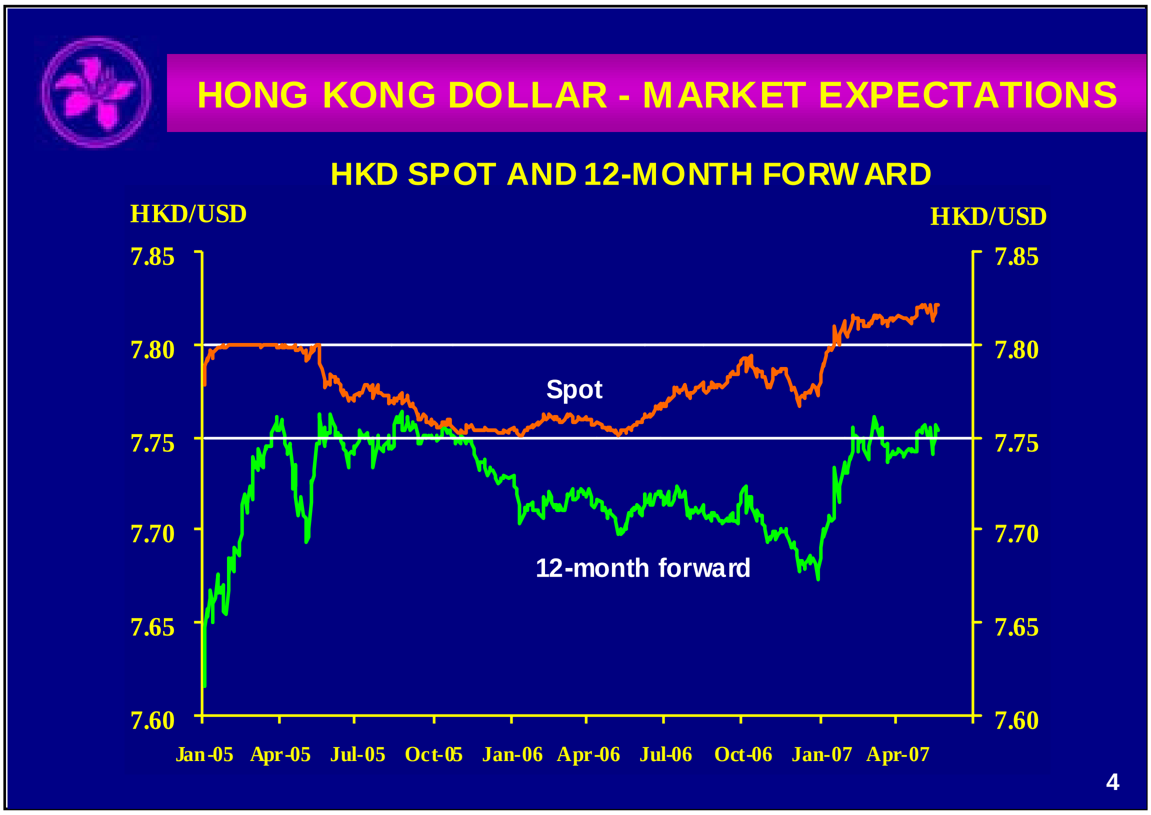


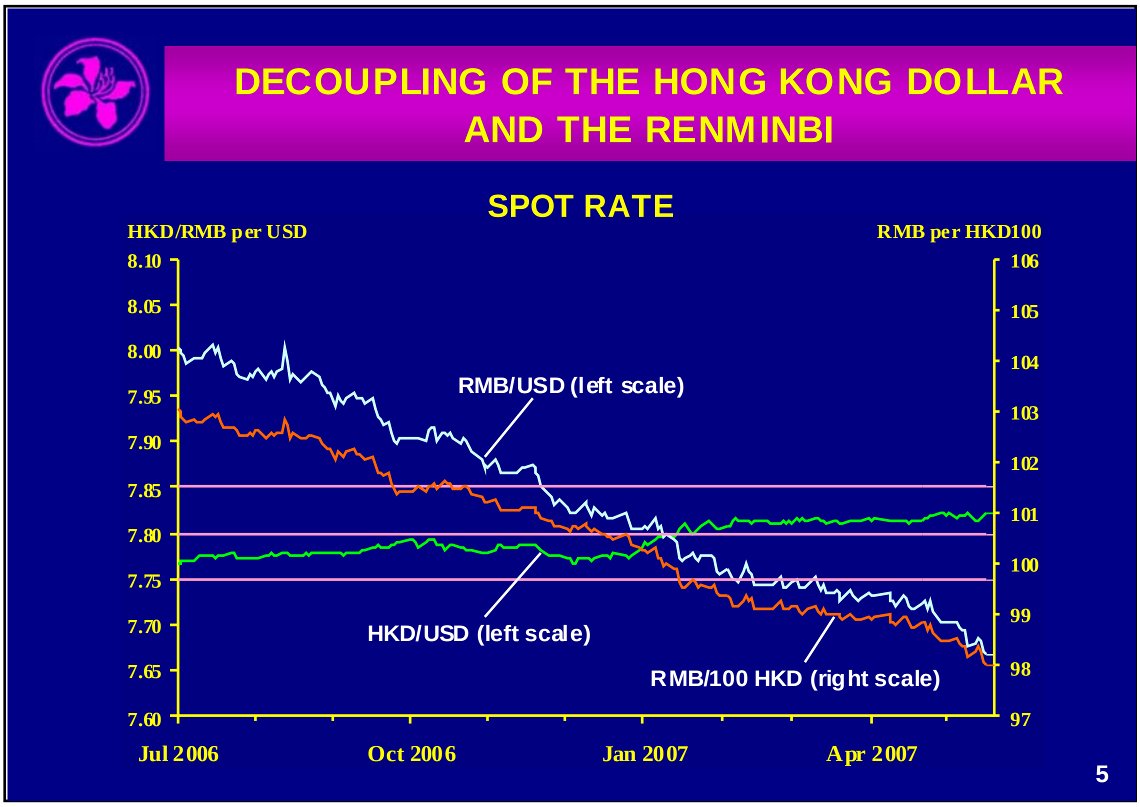
- The Hong Kong dollar spot exchange rate has softened slightly since February 2007, attributable to:
  - interest rate arbitrage: market participants taking advantage of the difference between Hong Kong dollar and US interest rates; and
  - the conversion of IPO proceeds out of the Hong Kong dollar, following a series of large IPOs of Mainland companies.
- There is evidence showing decoupling of the exchange rate of the Hong Kong dollar from that of the renminbi (to be discussed in detail later).



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

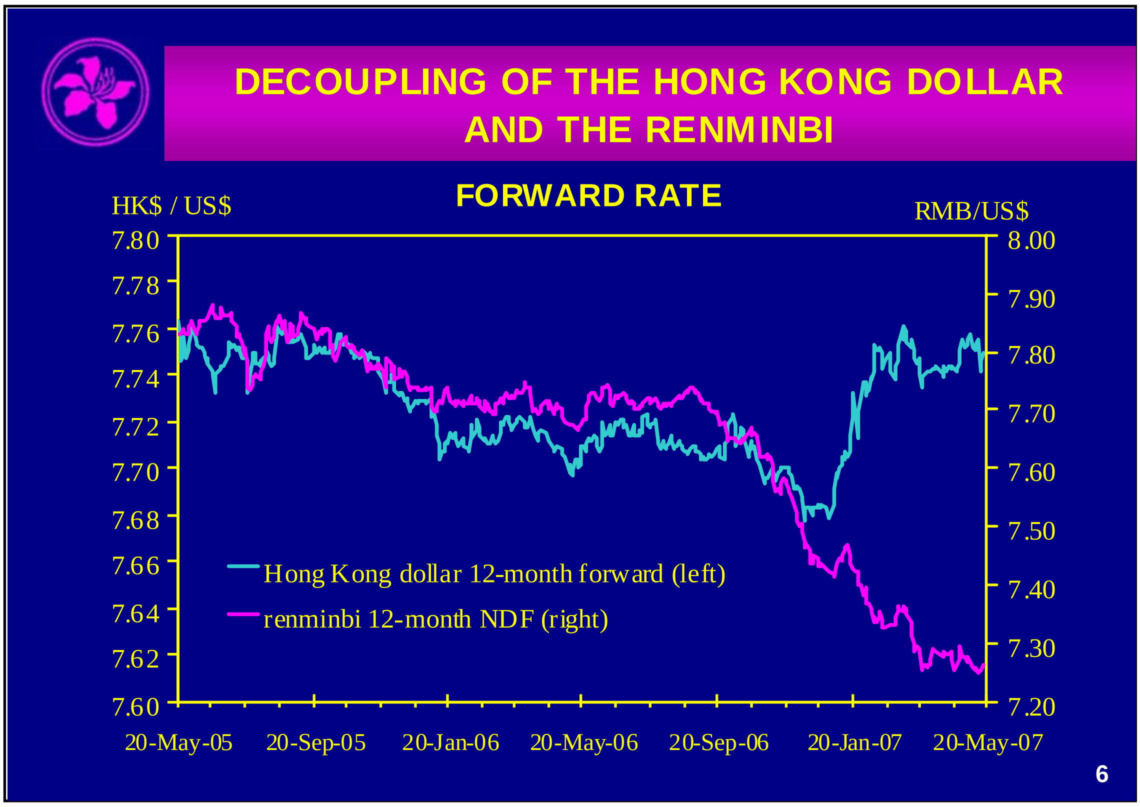
- The discount of the 12-month forward exchange rate from the spot exchange rate widened to over 900 pips towards the end of 2006, affected by buoyant stock market related activities in the second half of 2006. This narrowed to 670 pips on 21 May. The forward rate hovered near 7.75, the level of strong-side Convertibility Undertaking.

- The recent narrowing of the forward discount is consistent with the decoupling of the renminbi and Hong Kong dollar spot exchange rates.



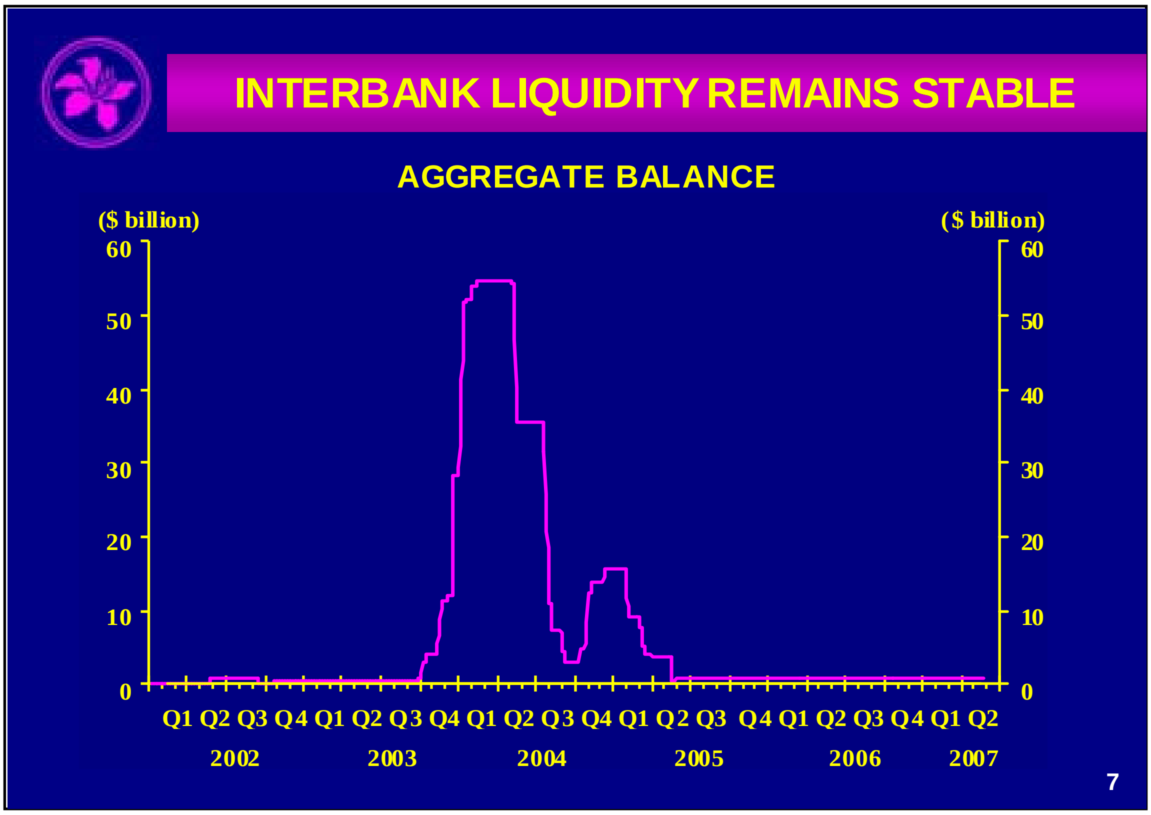
- The renminbi appreciated beyond 7.85 (entering the Convertibility Zone of 7.75-7.85 of the Hong Kong dollar) on 27 November 2006, breached the psychological level of 7.80 on 11 January 2007, "surpassed" the Hong Kong dollar on 15 January 2007, and appreciated beyond 7.75 (leaving the Convertibility Zone) on 16 February 2007.

- To prepare the market for the breaching of these psychological levels, the HKMA adopted a communication strategy to manage market expectations. Articles and research papers were published to support the argument that continuation of the peg with the US dollar is the most appropriate option for Hong Kong. HKMA staff in charge of monetary operations also maintained close communication with their market counterparts. These efforts helped to anchor market expectations and made the appreciation of the renminbi beyond the Hong Kong dollar spot rate a non-event.



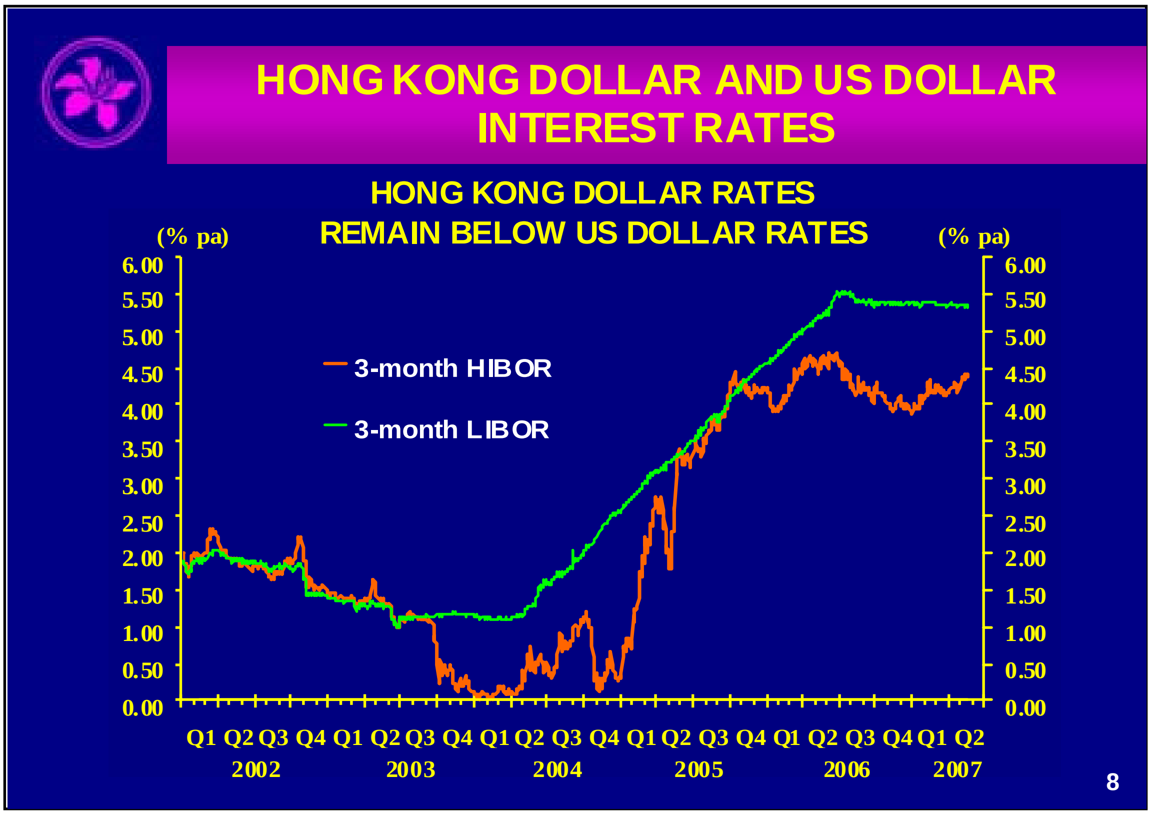
- Correlation between 12-month Hong Kong dollar forward and 12-month RMB NDF appeared to be quite strong prior to the introduction of the three refinements in May 2005. After the three refinements were introduced, the correlation weakened substantially.

- Since early 2007, the correlation between the two forward rates further diminished, reflecting increasing acceptance in financial markets that movements in the renminbi exchange rate is unlikely to affect the Hong Kong dollar's fixed link with the US dollar.



- As the HKMA did not carry out any market operations, the Aggregate Balance has been little changed at around HK$1.3 billion in 2007.

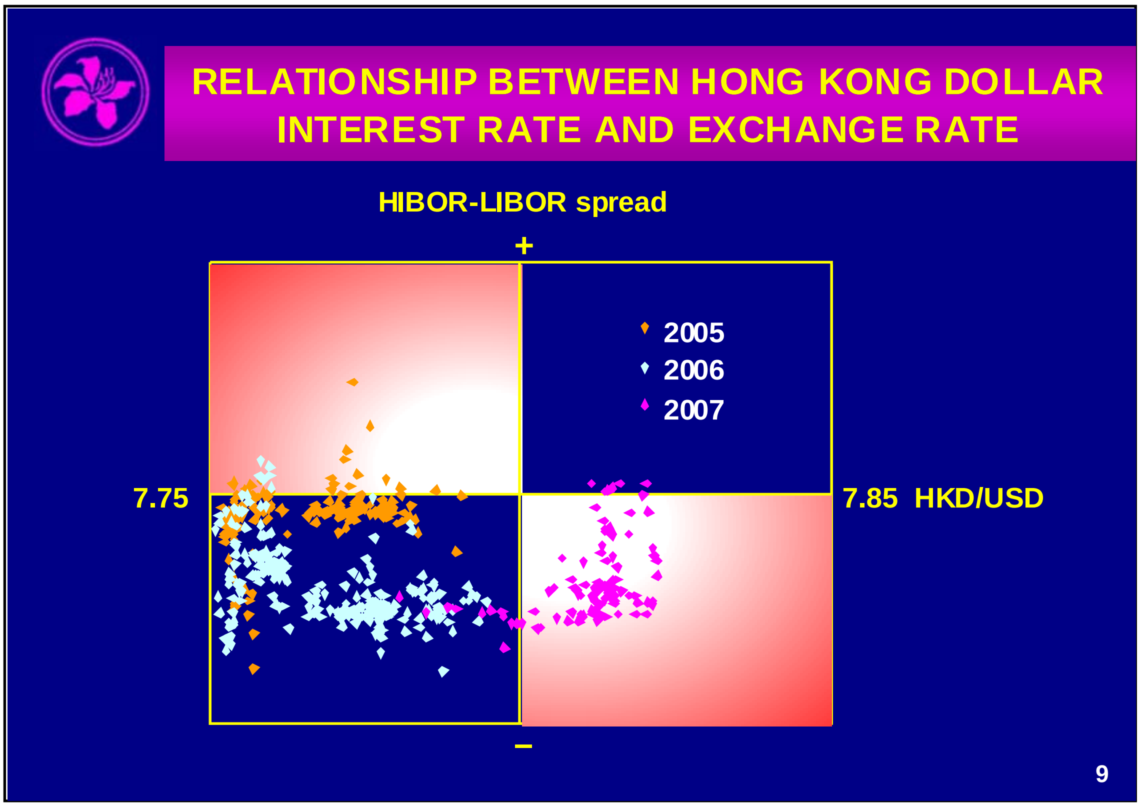
- Clearance of interbank payments associated with large and highly over-subscribed equity IPOs in recent months (e.g. CITIC, Country Garden, China Molybdenum and Belle International Holdings) proceeded smoothly and efficiently.



- US dollar interbank interest rates remained stable after the Fed stopped raising the interest rate in August 2006, with the Federal Funds Target Rate staying at 5.25% and the three-month LIBOR slightly higher.

- The negative spread of 3-month HIBOR against 3-month LIBOR narrowed to 98 basis points on 21 May, compared with 149 basis points at the end of 2006, in line with the rise in forward rate.

- Compared with historical episodes of capital inflows, the current negative interest rate spreads are not large. From a macroeconomic perspective, current monetary conditions are broadly neutral, not too loose to risk overheating the economy, nor so tight as to risk stifling economic expansion.



- Normally, when the Hong Kong dollar is near the strong-side Convertibility Undertaking (CU) of 7.75 , market participants would expect that the strong-side CU might be triggered upon continued capital inflows. Thus, they would be discounting a possible expansion of the Monetary Base and lower interest rates. As a result, HIBORs would tend to be lower than LIBORs. This would be represented by points in the lower-left quadrant of the diagram (the dots represent actual observations since the introduction of the three refinements in May 2005).

- The interest-rate spreads narrowed after the Hong Kong dollar eased against the US dollar. The spread in overnight rate turned positive during large equity IPOs because of strong funding demand.

- A certain level of spread of Hong Kong dollar interest rates against US dollar interest rates is not inconsistent with a credible Convertibility Zone. We do not see the need for market operations to smooth the relationship between interest rate and exchange rate for now.

RISKS TO CURRENCY STABILITY EXTERNAL FACTORS

- **Macro adjustment and control on the Mainland.**
- **Concerns about the US economy:**
  - **a sudden and sharp depreciation of the US dollar.**
  - **disorderly unwinding of global imbalances.**
  - **spillover of US housing market weakness to the broader economy.**
- **Financial instability and volatile capital flows induced by:**
  - **increased risk aversion of market participants and higher market volatility.**
  - **destabilising activities of hedge funds.**
- **Heightened protectionism.**

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- Because of overheating concerns, the PBoC continued to tighten monetary conditions. It recently raised the reserve requirement ratio to 11.5% from 11%, effective on 5 June. It also raised the one-year benchmark lending and deposit rates by 18 and 27 basis points respectively on 19 May, following increases of 27 basis points in mid-March.

- The outlook for the US economy remains uncertain. The recent weakness in the US dollar has renewed concerns about the risk of a disorderly unwinding of current account imbalances. A sudden and sharp depreciation of the US dollar might increase inflationary pressures in Hong Kong.

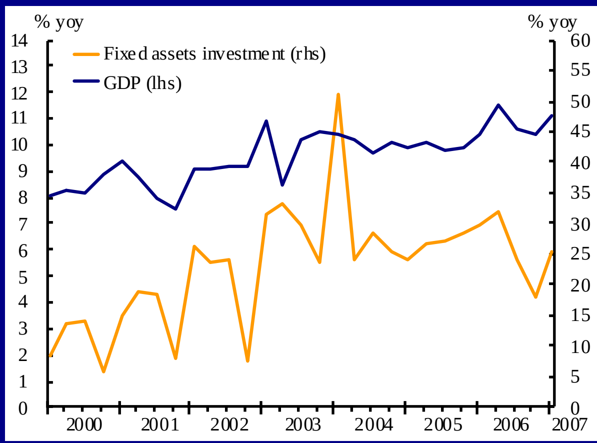
- The conduct of US monetary policy is complicated by conflicting economic signals. On the one hand, if the sub-prime mortgage problem in the US leads to an extended weakness in the housing market, the US economy might slow and result in interest rate cuts by the Fed. On the other hand, resurgent inflationary pressure induced by high resources utilisation and a tight labour market may also drive US interest rate up.

- Recent volatility in global stock markets might spread financial instability across countries quickly. Increased risk aversion could result in a reversal of capital flows. In addition, the under-regulated hedge funds, with their growing presence and influence in financial markets, may aggravate financial instability.

- Trade protectionism in the US may escalate, particularly if the US economy slows sharply and unemployment gets worse. This might represent a threat to currency stability because of the uncertainty surrounding the policy reactions of the US and China.

OVERHEATING CONCERNS ON THE MAINLAND CHINA

- **Economic activity was buoyant in 2007 Q1, with an acceleration of growth in major macroeconomic indicators.**



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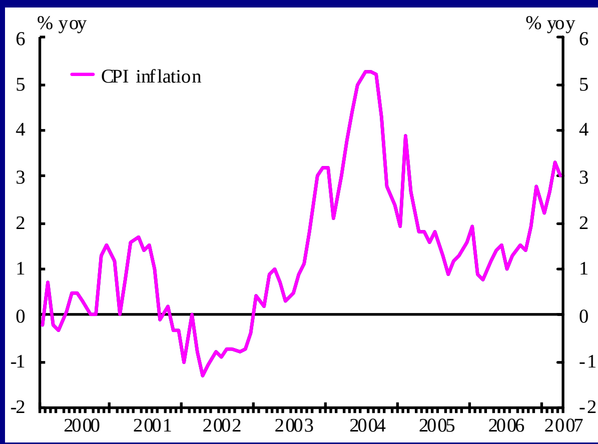
- Economic activity on the Mainland has been buoyant so far in 2007. There was an across-the-board pick-up in growth in Q1, compared with slightly moderated growth in 2006 H2. In the domestic economy, growth in investment, industrial production and private consumption all accelerated, and on the external front, export growth remained strong.

OVERHEATING CONCERNS ON THE MAINLAND CHINA (CONT'D)

- **Inflation continued to trend up.**



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- Inflation on the Mainland has been generally trending up since the last quarter of 2006. While averaging 2.7% in 2007 Q1, inflation reached 3.3% in March, breaching the 3% ceiling set by the PBoC for the whole year. It declined slightly to 3% in April.

OVERHEATING CONCERNS ON THE MAINLAND CHINA (CONT'D)

- **Abundant liquidity fed into fast rising property prices and feverish activity in the stock market.**

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- There are concerns that abundant liquidity is fuelling asset-price bubbles on the Mainland. The property market has remained buoyant, with prices increasing particularly fast in some major cities. The left panel showed the year-on-year changes in the 10 biggest cities in Q1. For 2005 and 2006, the average property prices increased by 7.6% and 5.5% respectively.

- At the same time, there has been frantic activity in the stock market. After rising by 130% in 2006, stock prices on the Mainland continued their rapid ascent, rising by over 40% up to the end of April. There have been sharp increases in the number of new share-trading accounts. In April alone, more than 2.38 million new accounts for Shanghai A-shares were opened, significantly more than the 1.28 million recorded in March.

MACROECONOMIC ADJUSTMENT ON THE MAINLAND

- Monetary policy tools have been actively used this year.
  - 1-year benchmark lending and deposit rates were increased by 18 and 27 bps to 6.57% and 3.06% respectively in May.
  - Required reserve ratio was raised five times in 2007 by 250 bps to 11.5%.
  - PBoC continues to carry out intensive open market operations.
- The RMB/USD daily trading band was widened to +/- 0.5% from +/- 0.3% to increase exchange-rate flexibility.
- Various administrative measures introduced to cool down property market in 2006 and early 2007.

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- Responding to the concerns about overheating, the PBoC has acted more frequently in 2007, using a combination of tools.

- So far this year, the PBoC has raised the 1-year benchmark lending and deposit rates twice, by 45 and 54 basis points respectively. Since April 2006, the 1-year benchmark lending rate has increased by 99 bps, and deposit rate by 81 bps.

- The PBoC raised the required reserve ratio (RRR) five times in 2007, by a total of 250 bps, to 11.5%. Since April 2006, RRR has increased by a total of 400 bps.

- The PBoC has undertaken open-market operations on a large scale. It renewed issuance of 3-year central bank bills to lock up liquidity for longer periods. Central bank bills issued so far this year amounted to RMB 2,343 billion.

- The RMB/USD daily trading band was widened to +/- 0.5% from +/- 0.3% to introduce more flexibility into the renminbi exchange rate.

- There have been no new administrative measures in recent months. The majority of administrative measures were introduced between April 2006 and January 2007, aimed at slowing down credit growth and targeting specific sectors including the real estate sector.

- Financial market participants are concerned that the authorities may intensify macroeconomic tightening if the policies implemented so far fail to lead to some moderation in economic growth, particularly the potential impact on the Hong Kong economy and financial markets.

IMPLICATIONS FOR HONG KONG

TRADE CHANNEL

- **A retrenchment of domestic demand on the Mainland could reduce:**
  - **Exports to the Mainland.**
  - **In-bound tourism from the Mainland.**
- **But HKMA research suggests that Hong Kong will be resilient to Mainland shocks.**
- **Impact of renminbi appreciation on inflation likely to be modest.**

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- Hong Kong's economy could be affected by sharp fluctuations in Mainland macroeconomic variables through the trade and financial market channels. For example,
  - a decline in domestic demand on the Mainland could reduce Hong Kong's exports to the Mainland and in-bound tourists from the Mainland
  - renminbi appreciation could increase import prices of goods from the Mainland, exerting upward pressure on headline inflation in Hong Kong
- HKMA research suggests that Hong Kong will be resilient to Mainland shocks. Simulations of a large shock associated with an investment retrenchment (a 15-percentage-point reduction in the growth of fixed investment) on the Mainland show that the effects on Hong Kong are relatively moderate, reducing economic growth by a cumulative 3.3 percentage points in the following two years.
- The impact of renminbi appreciation on Hong Kong's inflation is likely to be modest, given that the share of imports from Mainland China retaining for domestic use in Hong Kong is small, probably between 5% and 17% by value.

- Mainland stocks have become increasingly important in the Hong Kong equity market. Specifically, the combined market capitalisation of H-shares and red chips companies as a percentage of total market capitalisation rose from 37% at the end of 2005 to 47% in April 2007.

- The Hong Kong equity market saw a notable correction in late February, with the Hang Seng index declining by about 10% or 2,145 points from peak to trough. This followed a similar downward adjustment in the Mainland stock market, which has been more volatile since January 2007, partly because of concerns about the formation of an asset-price bubble and macroeconomic control on the Mainland.

RISK TO CURRENCY STABILITY
DOMESTIC FACTORS

- **No major risks or concerns from domestic economy.**
- **Economic environment largely favourable:**
  - **robust growth and declining unemployment**
  - **benign inflation outlook**
  - **sustainable balance-of-payments surplus**
  - **renewed fiscal strength**
  - **normal behaviour of property and stock markets**

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- Real GDP growth (year on year): 5.6% (Q1 2007), 7.0% (Q4 2006)
- Unemployment rate: 4.3%, near nine-year low (February - April 2007)
- Inflation (year on year): 1.3% in April 2007 (2.4% after adjusting for the rate concessions), versus 2% in 2006
- Balance-of-payment surplus: $46.7 billion or 3.2% of GDP in 2006, up from $10.7 billion or 0.8% of GDP in 2005
- Fiscal surplus: $58.6 billion in 2006/2007, nearly $53 billion above original forecast of $5.6 billion.
- The behaviour of asset prices in the property and stock markets does not cause any serious concerns.

CURRENCY NOTES

- **New Counterfeit HSBC $1,000 note (2000 and 2002 series)**
  - HKMA worked closely with the Police, HKAB and HSBC to
    - alert banks and the public to the new counterfeit note
    - organise seminars for more than 5,300 bank tellers, money changers and retailers
    - expedite the orderly return of the old series HSBC $1,000 banknotes
  - Up to the end of May, over 11 million, or more than half, of the old series banknotes have been withdrawn from circulation
  - Number of counterfeits discovered has declined significantly
    - 1,721 in March; 360 in April and 69 in May

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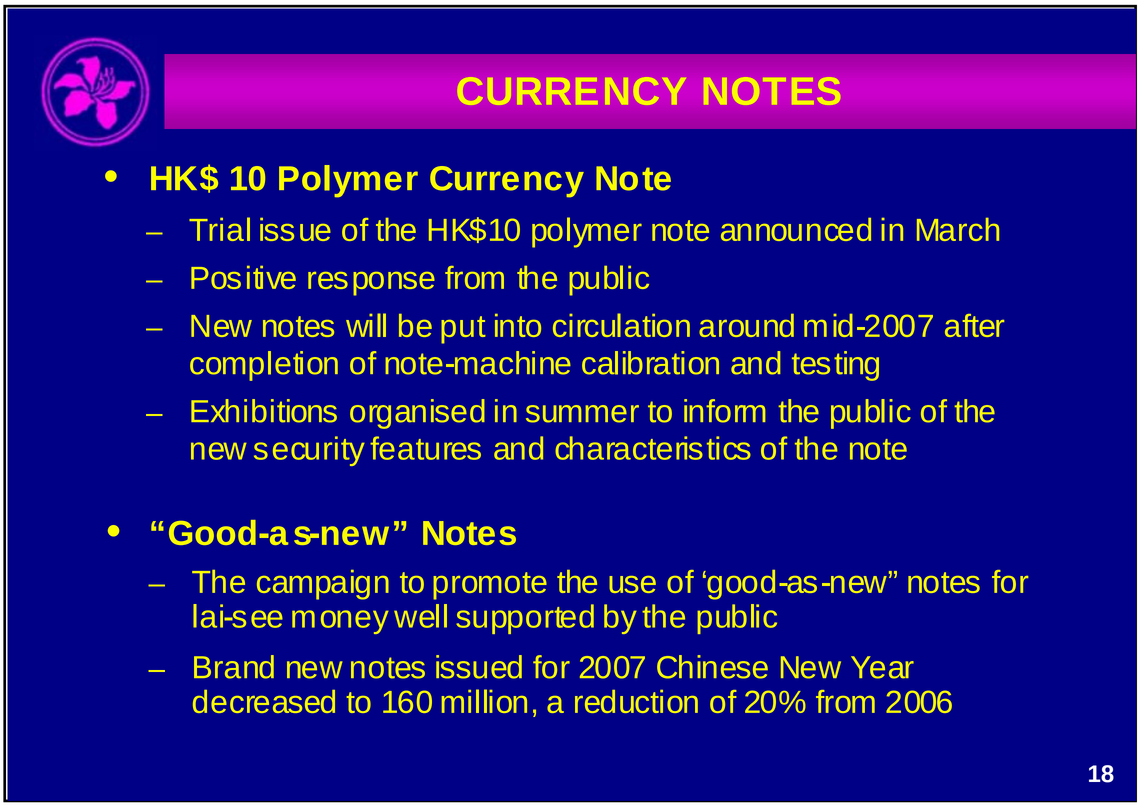
New Counterfeit HSBC $1,000 note (2000 and 2002 series)

- HKMA, the Police, HKAB and HSBC have responded swiftly and robustly to the emergence of the new counterfeit notes by alerting banks and the public of the counterfeit note.

- HKMA's strategy has been successful in achieving a speedy and orderly return of the old series banknotes. Two HKAB circulars were issued advising banks to return these notes to HSBC and not to re-circulate them to customers. Up to the end of May, over 11 million, or more than half, of the old series banknotes have been withdrawn from circulation.

- The number of counterfeits discovered has come down since early April because of heightened public awareness making it harder for the counterfeiters to distribute the fake notes. (1,721 in March, 360 in April and 69 in May). The counterfeiting rate has been contained to about 30 notes per million.

- Up to the end of May, HKMA and the Police have organised 29 seminars for more than 5,300 bank tellers and retailers. Participants have found these seminars useful in helping them to detect the counterfeit notes as reflected in the higher rate of detection of the counterfeit notes by bank tellers (80% in April and May compared with 51% in March).



HK$10 Polymer Currency Note

- A press conference was held on 12 March to announce the trial issue of the HK$10 polymer note. The trial issue will be reviewed within two years to assess the performance and public acceptance of the note before deciding whether to extend it to other denominations.

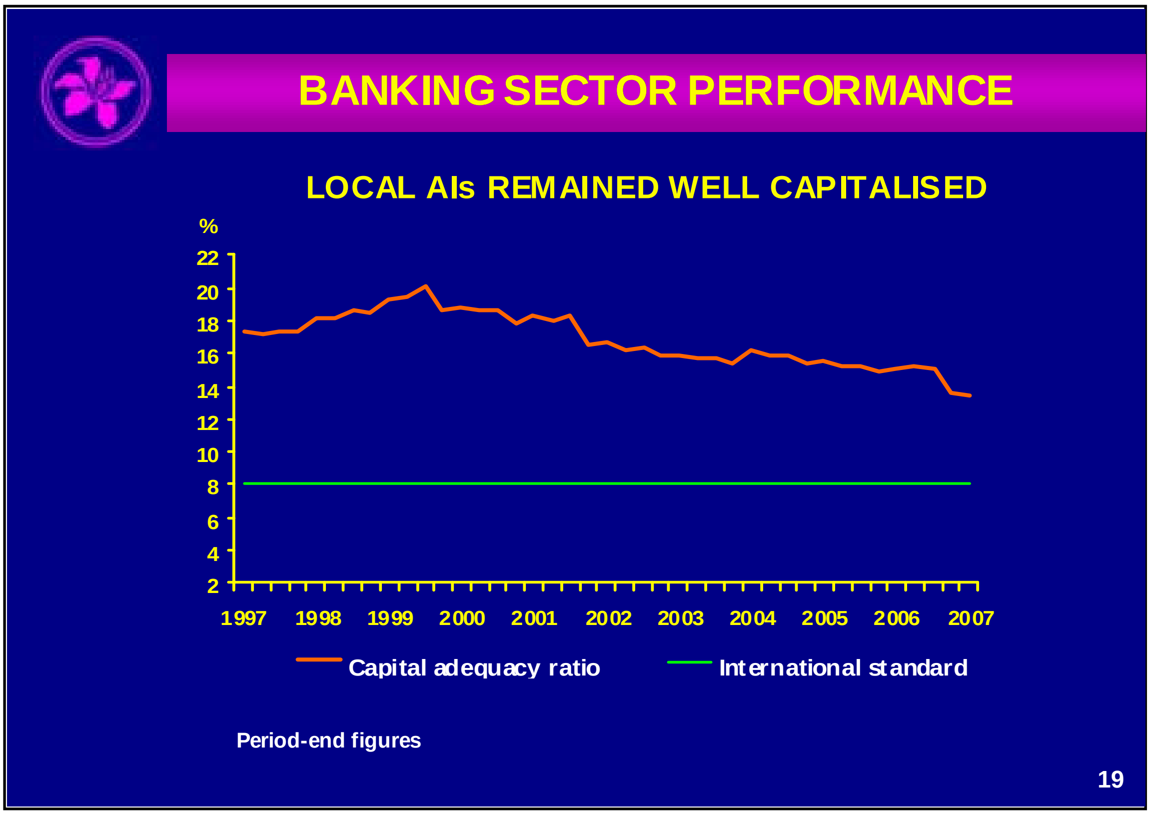
- Machine calibration and testing are progressing well. The new notes will be put into circulation around mid-2007 after completion of the calibration.

- 10 education seminars were held in May for bank tellers, money changers and retailers. An extensive public programme including exhibitions and seminars will be held this summer to inform the public of the new security features and characteristics of the note.

“Good-as-new” Notes

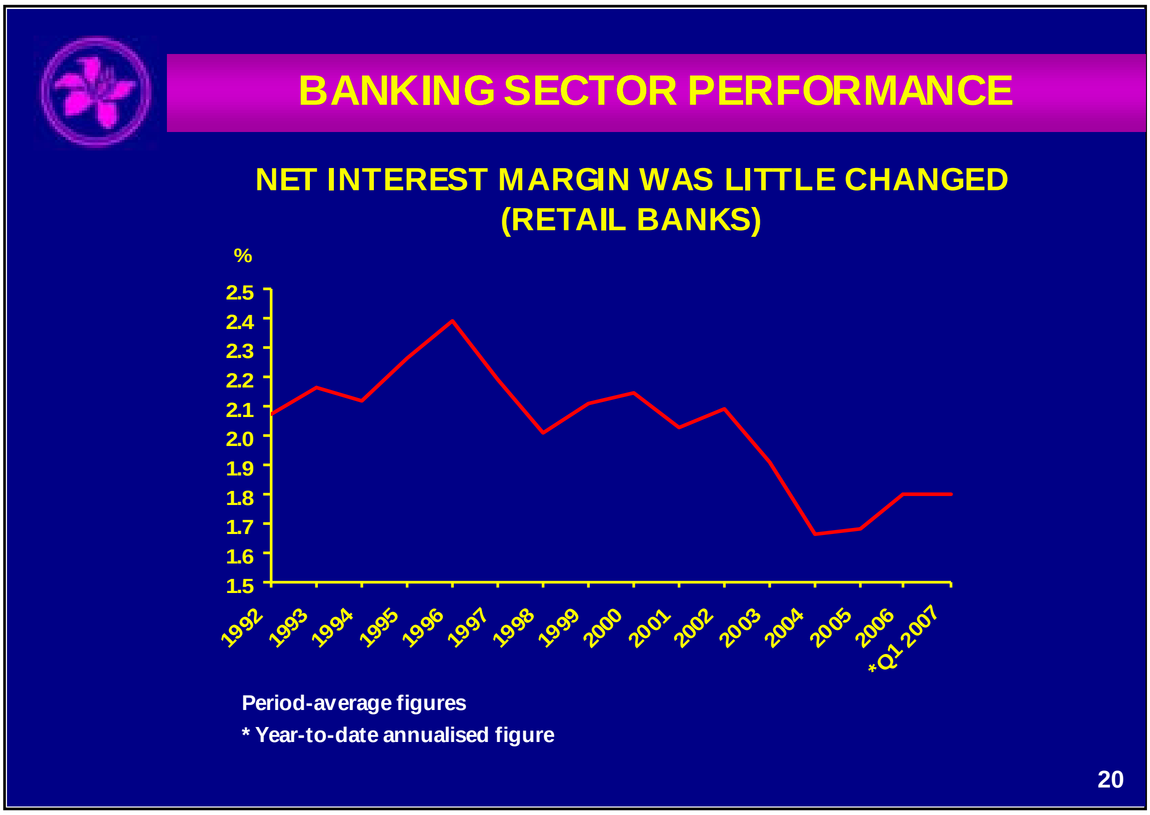
- The campaign to promote the use of “good-as-new” notes instead of brand new ones for lai-see money has been well supported by the public.

- Brand new notes issued for 2007 Chinese New Year decreased to 160 million, a reduction of 20% from 2006.

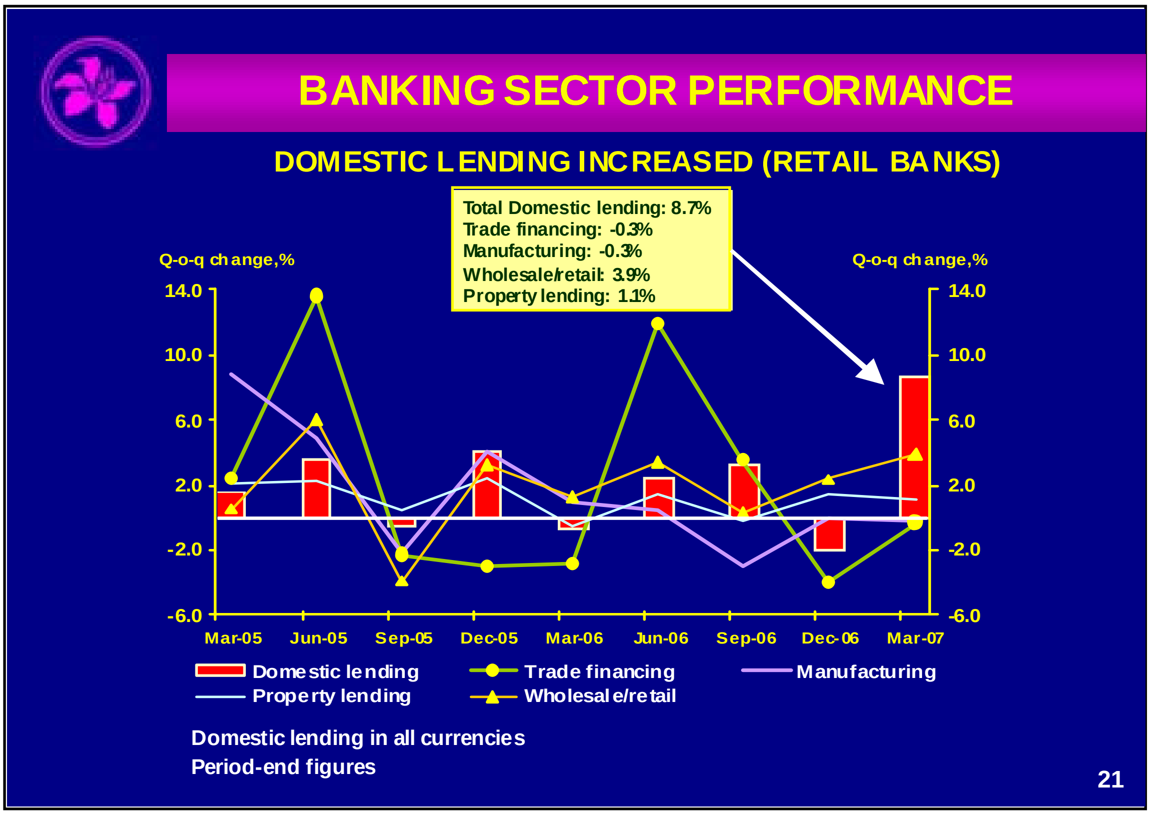


- Starting from 2007, all Hong Kong incorporated authorized institutions (AIs) report their capital adequacy positions under the capital adequacy framework set out in the Banking (Capital) Rules.

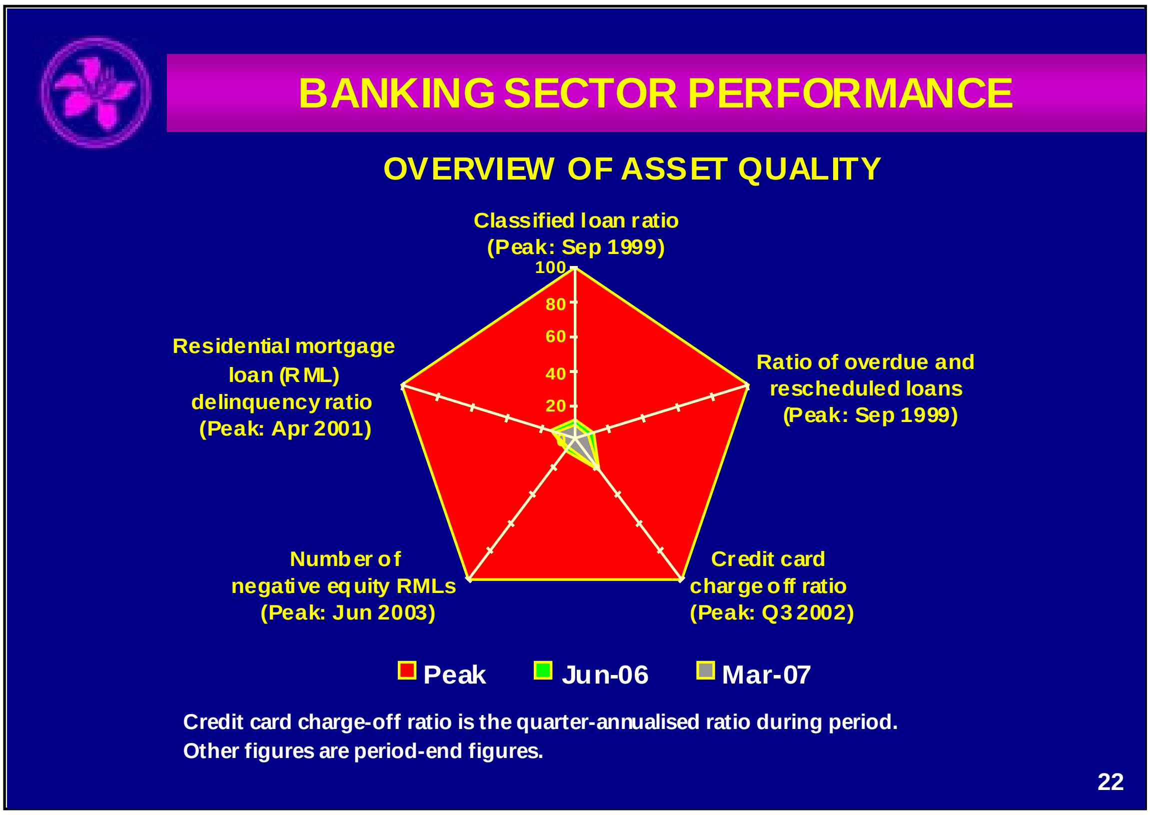
- The aggregate capital adequacy ratio (CAR) of Hong Kong AIs at the end of March 2007, calculated on the new basis, remained very strong at 13.6%. All individual AIs' CARs under the new regime were above the statutory minimum ratios under the Banking Ordinance.



- Following a recovery in 2006, net interest margins in Q1 2007 remained flat at 1.80%.



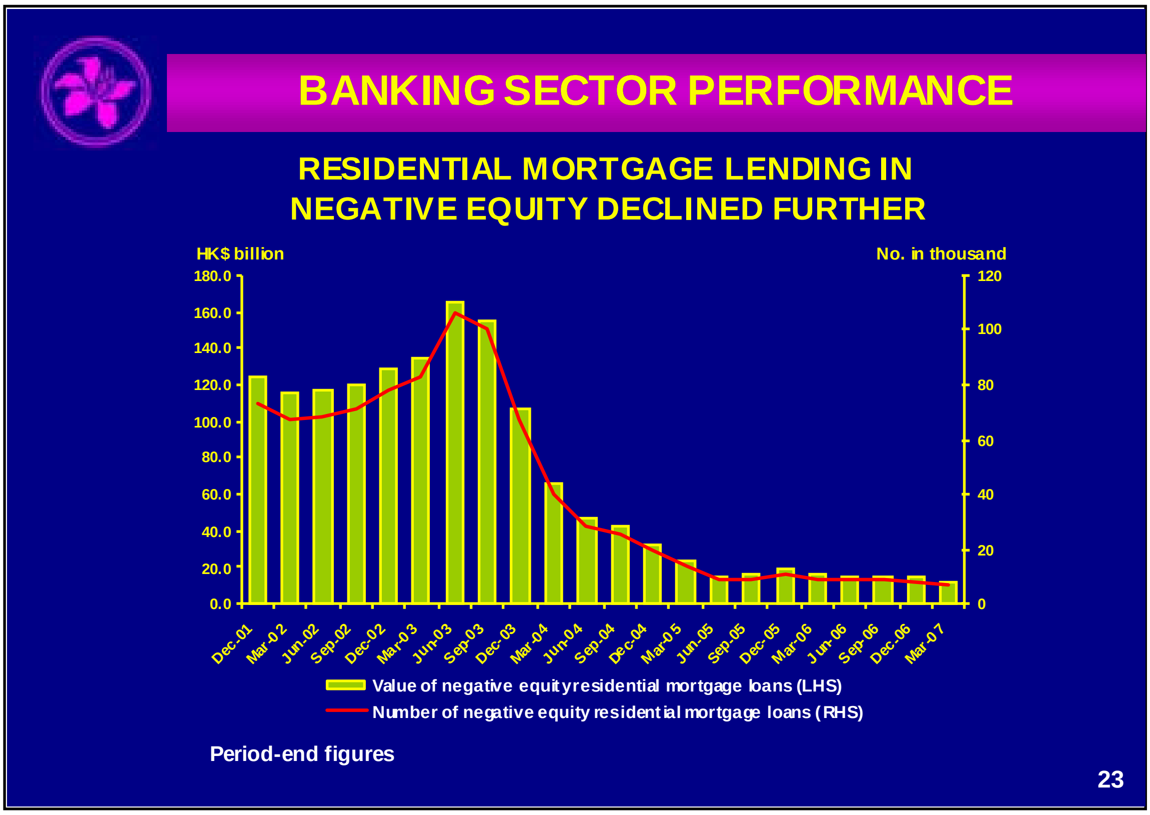
- Domestic loans rose in 2007 Q1, mainly due to strong demand for share financing amid strong IPO-related activity. Loans to the property, finance wholesale and retail trades also increased and offset the slight decline in trade-financing loans.



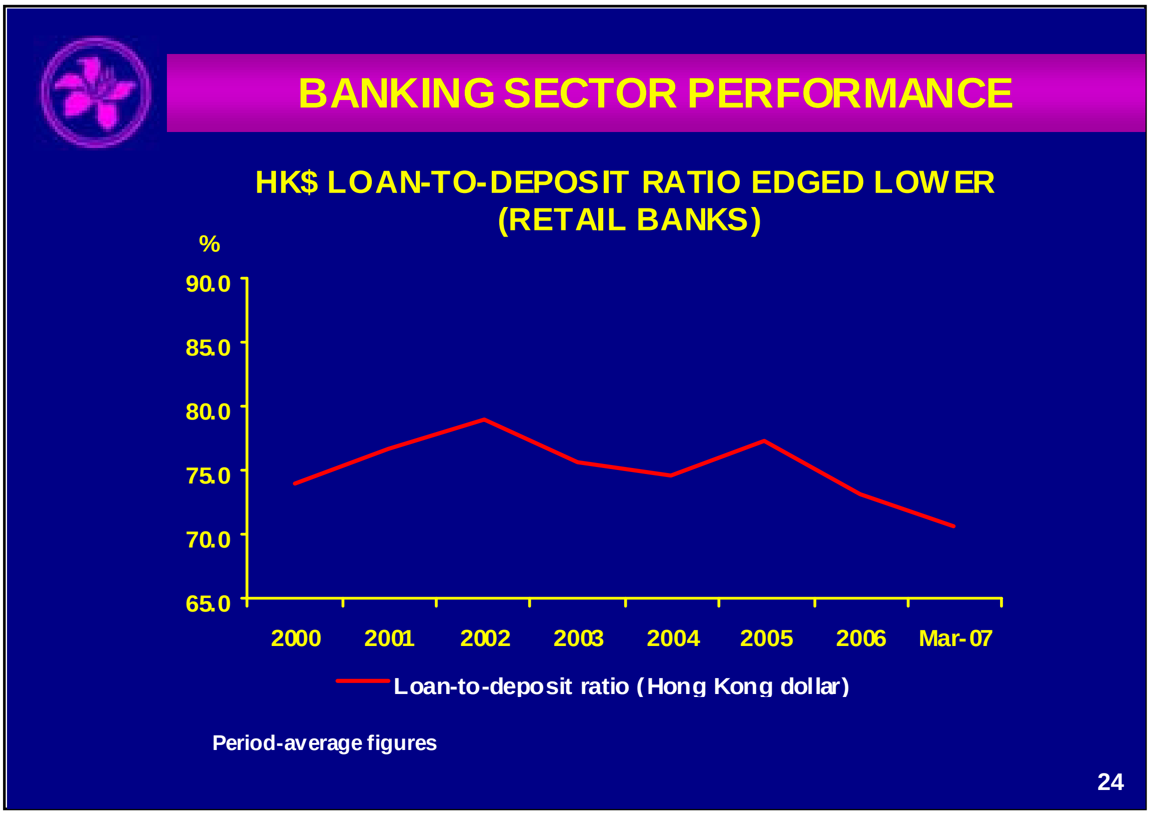
- Overall loan quality strengthened again, with the classified loan ratio and the overdue loan ratio moving down to new lows of 1.00% and 0.69% respectively at the end of March 2007. Residential mortgage delinquency ratio also remained low at 0.17% at the end of March 2007.

- Credit card charge offs, however, showed a modest increase. The value of credit card charge-offs rose by a further 3.7% in 2007 Q1 to HK$555 million and consequently the quarter-annualised charge-off ratio worsened to 3.17% in 2007 Q1 from 3.13% in 2006 Q4. This development is slightly unusual at this point in the economic cycle and seems closely correlated to the increase in personal bankruptcy petitions. Nevertheless, the current level of charge-offs is not alarming.

- The delinquency ratio of credit cards also rose, from 0.37% at the end of 2006 Q4 to 0.39% at the end of 2007 Q1. However, the increase was due to a contraction of outstanding credit card receivables rather than a rapid rise in credit card delinquencies.



- The number of residential mortgages in negative equity continues to decline as property prices rise. At the end of March 2007, the number of residential mortgage loans in negative equity was around 6,700 with an aggregate value of $11 billion, compared with 8,400 ($14 billion) at the end of December 2006. Compared with the peak of around 106,000 cases ($165 billion) in June 2003, the number has declined by around 94%.



- The banking system remains highly liquid. Banks are reacting prudently to the current very high levels of liquidity by placing much of the excess funds in liquid securities. As a result, the loan-to-deposit ratio of retail banks edged lower.

- The Banking (Capital) Rules and Banking (Disclosure) Rules came into effect on 1 January 2007. Hong Kong is in the initial wave of jurisdictions introducing the Basel II standards. The improvements in risk-management expected through the introduction of the new capital framework are important to the robustness and stability of the banking system.

- The aggregate capital adequacy ratio (CAR) of the Hong Kong incorporated authorized institutions (AIs), calculated under the new capital adequacy framework (taking into account the additional operational risk capital charge), remained very strong at 13.6%. The CARs of all AIs under the new framework were above the statutory minimum ratios under the Banking Ordinance.

- The introduction of model-based approaches for more risk-sensitive capital adequacy measurement should encourage AIs to further enhance their overall risk-management. A number of AIs are using market-risk models, and the HKMA expects that several AIs will be approved to use credit-risk models (the "IRB approach") in due course.

- The HKMA will continue to stress that AIs must pay greater attention to risks and improve risk management. The HKMA will continue to provide supervisory guidance on the application of the Rules and update the existing Supervisory Policy Manual to align with the Basel II requirements.

BANKING SECTOR - WORK PROGRESS

The Public Disclosure Regime

- Hong Kong introduced a public disclosure regime closely aligned with international best practices on 1 January 2007
- This regime was formally established by the Banking (Disclosure) Rules and a non-statutory guideline detailing the application of the Rules
- The regime is designed to ensure that relevant and timely information is available to the public. The modifications are particularly important in view of recent changes in global accounting standards and regulatory requirements under Pillar Three of the Basel II Framework

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- The HKMA recently issued a non-statutory guideline on the application of the Banking (Disclosure) Rules, which came into effect on 1 January 2007. The issuance of the Guideline completed the introduction of the enhanced disclosure regime for AIs.

- In line with the HKMA's policy of adhering closely to international standards, these public disclosure requirements are aligned with international best practices, in particular those recommended by the Basel Committee on Banking Supervision.

- The enhanced public disclosure regime will increase the transparency of AIs and will help ensure that relevant and timely information is available to the public, the investor community, and market professionals and that is in line with global best practices.

BANKING SECTOR - WORK PROGRESS

Anti-money-laundering and Counter-terrorist-financing

- **Industry Working Group & three User Sub-groups developing sound industry practices**
- **Preparing for Financial Action Task Force's mutual evaluation of Hong Kong – scheduled for November 2007**
- **Participating in the Administration's review of the regime for remittance agents and money changers**

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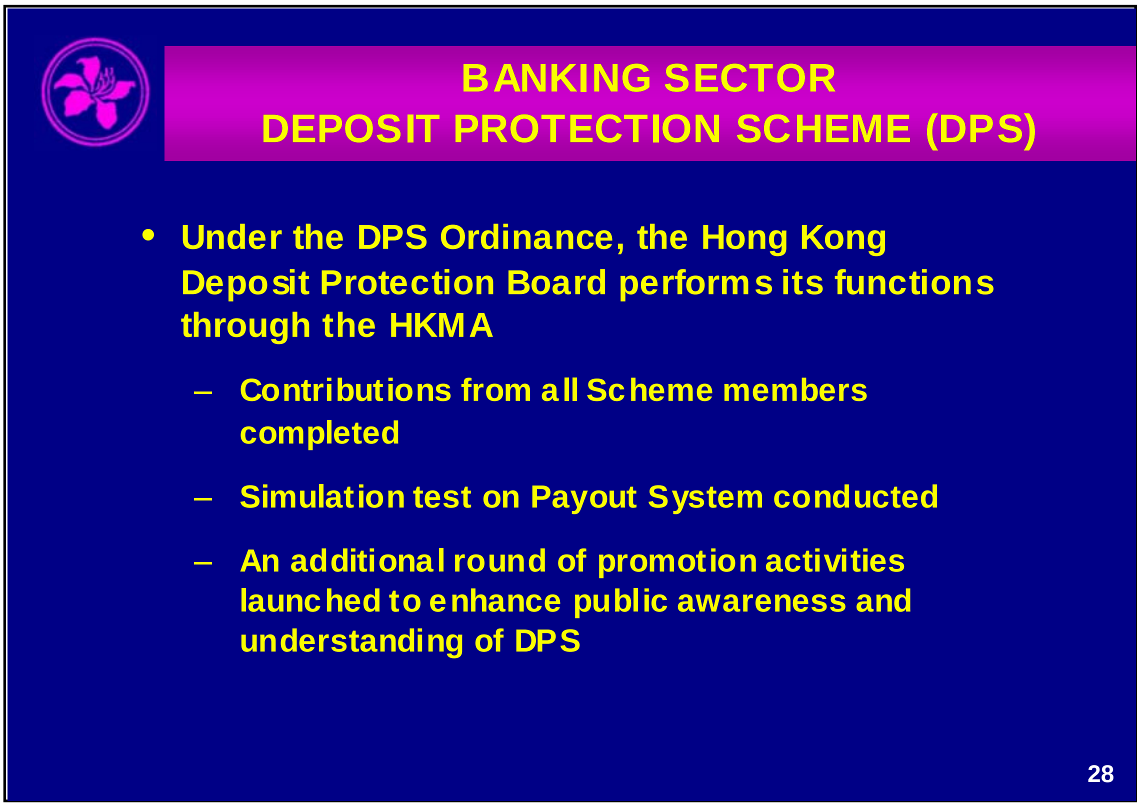
- Since its establishment in June 2006, the Industry Working Group (IWG) has proved to be an effective forum for sharing experience on anti-money-laundering and counter-terrorist-financing issues and developments. The IWG and its three User Sub-groups, are developing guidance papers on various issues such as proof of address for personal customers, customer due diligence for overseas companies and high-level principles for effective transaction monitoring.

- The Financial Action Task Force (FATF) began the third round of mutual evaluations of member jurisdictions in 2004. The mutual evaluation of Hong Kong is scheduled for November 2007. The HKMA will continue to work with the Government and the industry to ensure high compliance to the recommendations of the FATF.

- The HKMA continues to assist the Government in reviewing the oversight system for remittance agents and money changers to ensure that it is consistent with emerging global practice. We will also work with the industry to address the difficulty faced by remittance agents and money changers in complying with enhanced due-diligence requirements under FATF guidelines.



- As the Hong Kong Deposit Protection Board (the Board) is required to perform its functions through the HKMA under the Deposit Protection Scheme (DPS) Ordinance, after the launch of the DPS in September 2006, the HKMA continues to assist the Board in administering the DPS.

- In the first five months of 2007:

  – the Board collected over HK$390 million of contributions from Scheme members and is managing the DPS Fund in accordance with the DPS Ordinance.

  – with the collaboration of a Scheme member, the Board successfully completed the first simulation test of the Payout System.

  – the Board has also launched another round of promotion activities which include TV commercials and newspaper advertisements to enhance public awareness and understanding of the DPS.

MARKET INFRASTRUCTURE

- **Objective**
  - To develop Hong Kong into a regional payment and settlement hub
- **Project Development**
  - Renminbi RTGS system (ready to launch)
  - Regional Cross-border Payment System (Q3 2007)
  - Electronic trading platform for Exchange Fund Bills and Notes (Q4 2007)
  - Migration to SWIFTNet (H1 2008)
  - DvP link with Malaysian securities settlement system (Q4 2007)

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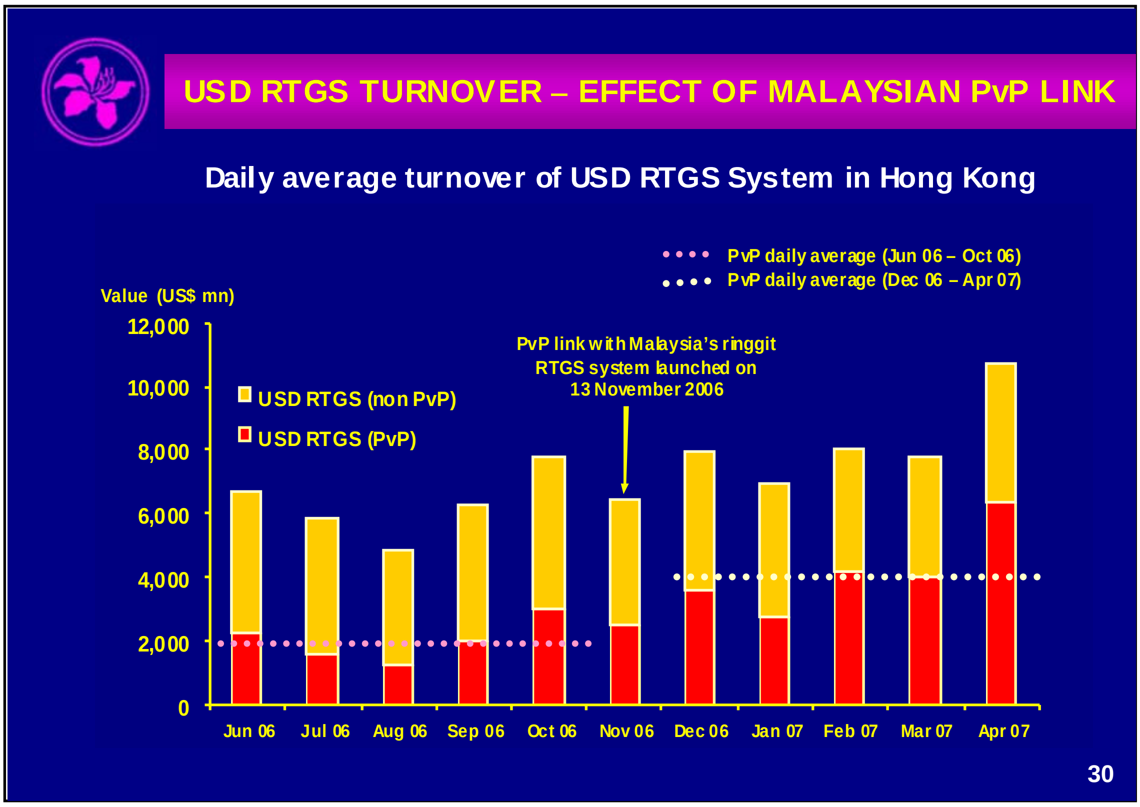
- Renminbi RTGS system - System enhancements were completed in February 2007 to facilitate the issuance of renminbi bonds in Hong Kong. The enhanced system will come into operation when the administrative rules on the bond issuance are ready and upon the signing of an agreement between the People's Bank of China and Bank of China (Hong Kong), the Clearing Bank of the Renminbi RTGS system.

- Regional Cross-border Payment System – System development is underway to use the US dollar and euro payment systems to process cross-border payments in the region through Hong Kong. The system is expected to be launched in Q3 2007.

- Electronic trading platform for Exchange Fund Bills and Notes - The HKMA is working with the Treasury Markets Association to establish an electronic trading platform for Exchange Fund Bills and Notes to increase transparency of prices and transactions, and facilitate straight-through processing from trading to clearing and settlement. The platform is expected to be launched in Q4 2007.

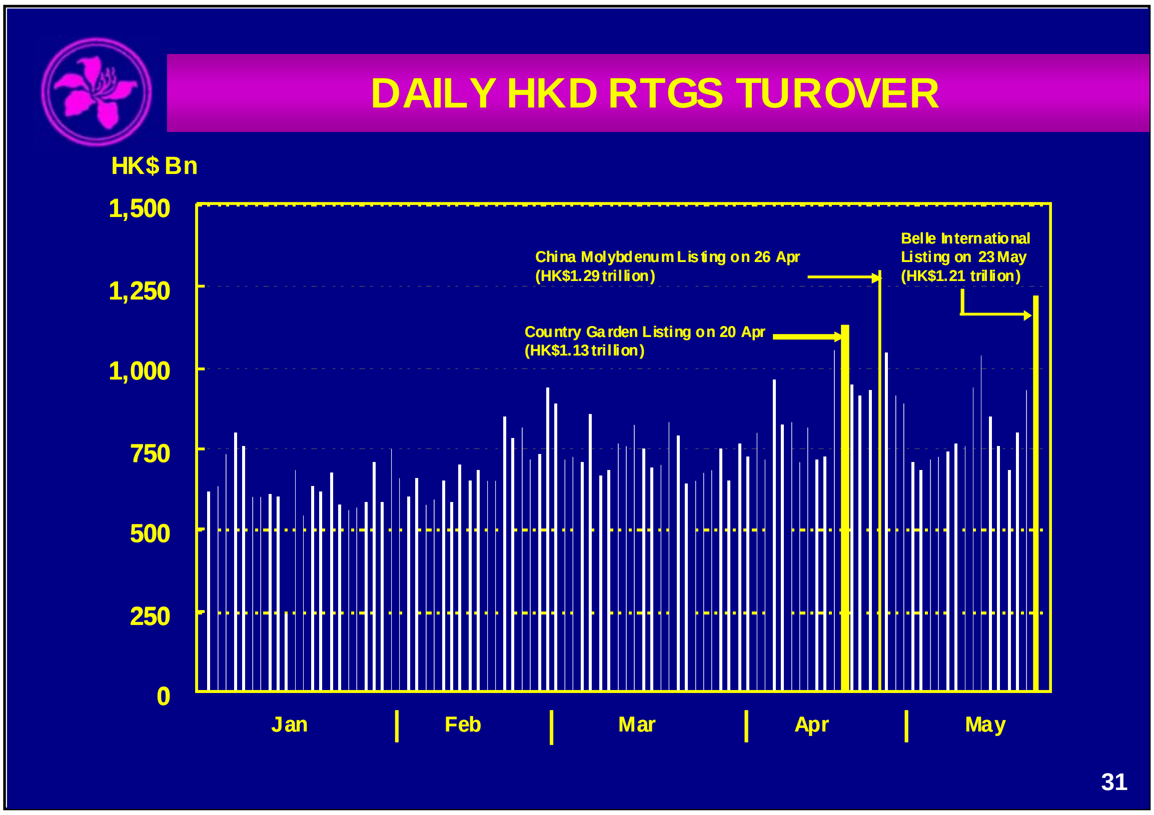
- Migration to SWIFTNet - This project replaces the existing proprietary platform for the RTGS systems and the Central Moneymarkets Unit by an open platform to make it easier for overseas financial institutions to use the payment and settlement systems in Hong Kong. The migration is expected to take place in H1 2008.

- DvP link between Hong Kong's USD RTGS system and Malaysian securities settlement system - Following the successful PvP link between Hong Kong's US dollar RTGS system and Malaysia's ringgit RTGS system, the link is being expanded to provide DvP service for US dollar denominated securities traded in Malaysia. This link is part of the HKMA's effort to develop Hong Kong into a regional payment and settlement hub. The DvP link is scheduled for completion in Q4 2007.



- Following the launch of the PvP link between Hong Kong's US dollar RTGS system and Malaysia's ringgit RTGS system on 13 November 2006, daily average turnover involving PvP more than doubled from around US$2 billion for the five months before the launch of the PvP link (Jun 06 – Oct 06) to over US$4 billion for the five months after the launch (Dec 06 – Apr 07).

- The PvP link eliminates settlement risk in foreign exchange transactions between the US dollar and Malaysian ringgit by ensuring the simultaneous delivery of US dollars in Hong Kong and ringgit in Malaysia.



- Average daily HKD RTGS turnover in the first four months in 2007 was HK$729 billion, compared with a daily average of HK$579 billion in 2006.

- High turnover in the HKD RTGS system was largely due to IPO activities:

20 April 2007	HK$1.13 trillion (the sixth highest so far) when Country Garden Holdings Company Limited was listed on the Stock Exchange
26 April 2007	HK$1.29 trillion (the second highest so far) when China Molybdenum Co., Ltd. was listed on the Stock Exchange
23 May 2007	HK$1.21 trillion (the fifth highest so far) when Belle International Holdings Limited was listed on the Stock Exchange

MARKET INFRASTRUCTURE

Oversight of the clearing and settlement systems

- All designated systems are in compliance with the safety and efficiency requirements of the Clearing and Settlement Systems Ordinance.
- The second Process Review Committee Annual Report was submitted to FS and published on HKMA's website. The report concluded that the HKMA had followed the procedures required and was procedurally fair in carrying out its oversight activities over designated systems in 2006.

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- The HKMA exercises continuing oversight on the four local designated systems through off-site reviews and continuous monitoring. All systems are in compliance with the safety and efficiency requirements under the Clearing and Settlement Systems Ordinance.

- The Process Review Committee, an independent committee to review the processes and procedures of the HKMA in carrying out the payment system oversight, submitted its second annual report to the Financial Secretary. In the report, the Committee concluded that it was not aware of any case where the HKMA had not followed the procedures, or had been procedurally unfair in carrying out its oversight activities. The annual report was published on the HKMA's website to promote transparency of the work of the Committee.

- **The HKMA, through its support of the work of the Treasury Markets Association, has been actively promoting the development of the treasury markets in Hong Kong.**

- Incorporated in November 2005, the TMA made a strong start last year in pursuing its strategic objectives of enhancing the competitiveness of the Hong Kong treasury markets, promoting the professionalism of market practitioners, and promoting the position of Hong Kong as the regional treasury hub.

- The TMA launched the Renminbi Non-Deliverable Interest Rate Swap (CNY NDIRS) in August 2006 for corporations and financial institutions that do not have access to the onshore Mainland market to manage their renminbi interest rate exposure. The TMA has also developed various fixings in consultation with market participations. These include:

  – the Spot USD/HKD Fixing, which provides a reference rate for the pricing of Hong Kong dollar-linked currency products; and

  – CNY Swap Offer Rate Fixing, CNY NDF Fixing and USD HIBOR Fixing, which are required for the pricing of CNY NDIRS products.

- In order to further raise the professionalism of market practitioners, the TMA has developed two certificate programmes: the Treasury Markets Certificate and the Treasury Markets (Debt Securities) Certificate. Training programmes were held regularly to keep market participants abreast of the latest market developments. To ensure that market practices and code of conduct conform with international best practices, the TMA has also been actively promoting the ACI Model Code in Hong Kong and on the Mainland.

- The TMA maintained very close contacts with the Mainland and other financial centres through visits, networking events, seminars/conferences.

Regional co-operation:

- With increasing economic and financial integration of the region, the HKMA participates actively in regional initiatives to promote the financial stability of the region, and therefore of Hong Kong.

- Regional co-operation focuses on bond market development, monitoring of monetary and financial stability, and crisis management. The active participation of the HKMA will help establish our leading position as an international financial centre in the region.

Mainland co-operation:

- The Mainland's need for financial services is increasing with the rapid development of its economy, and the Mainland is pressing ahead with financial reform. These developments will have profound impact on the status of Hong Kong as an international financial centre. The work of the HKMA in this regard will therefore focus on matters relating to Mainland's financial activities.

- The State Council announced its agreement to a further expansion of renminbi business in Hong Kong on 10 January. Mainland financial institutions, upon obtaining approval, can issue renminbi-denominated financial bonds in Hong Kong.

- As planned, the establishment of Renminbi Real Time Gross Settlement (RTGS) system in Hong Kong was completed on 26 February.

- Implementation work on the other aspects is also in progress. Mainland authorities are actively preparing the administrative measures for Mainland financial institutions to issue bonds in Hong Kong. Meanwhile, amendments to clearing agreements and other legal documents relating to renminbi business in Hong Kong are being finalised.

- We understand that several financial institutions on the Mainland have expressed interest in issuing renminbi-denominated financial bonds in Hong Kong. First renminbi bond issuance is expected soon.

- At the end of March 2007, renminbi deposits totalled RMB25.2 billion yuan.

EXPANSION OF QUALIFIED DOMESTIC INSTITUTIONAL INVESTORS (QDII) SCHEME

- **Following the launch of offshore wealth management services by banks on the Mainland last year, the CBRC and the HKMA, in conjunction with SAFE and the SFC, have established a four-party working group**
- **CBRC announced on 11 May an expansion of the investment scope of the scheme to allow equity investment, subject to certain conditions**
- **The expansion makes use of Hong Kong market and Hong Kong authorised and regulated financial products and intermediaries**

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- The investment scope was limited to fixed-income products when the QDII scheme was launched in 2006. The expansion announced on 11 May allows equity investment, subject to certain conditions, whereby, among other things:
  - When issuing a wealth management product that **invests in a portfolio of equities offshore,** the bank is required to invest in an equity market and via an investment manager, both of which are authorised and regulated by regulators who have signed an MOU on offshore wealth management with the CBRC;
  - A product that **invests in funds (equity or otherwise)** can only invest in funds authorised by or registered with regulators that have signed an MOU on offshore wealth management with the CBRC.
- At present, it is understood that only the HKMA and the SFC have signed MOUs with the CBRC that cover offshore wealth management.
- The expansion will provide Hong Kong banks and the financial industry with more business opportunities. More importantly, it is an important strategic decision that opens up a new channel for the orderly outflow of funds from the Mainland, while establishing an interactive and co-operative relationship between the financial systems of the Mainland and Hong Kong.

EXCHANGE FUND

- The Exchange Fund is not a pure investment fund
- The Exchange Fund Ordinance specifies the statutory objectives of the Exchange Fund
  - affecting the exchange value of the currency of Hong Kong
  - maintaining the stability and integrity of the monetary and financial systems of Hong Kong
- Investment of the Exchange Fund has to be consistent with the statutory objectives of the Fund
- It is not appropriate to compare the investment return of the Exchange Fund with that of other investment funds
- The proper comparison should be made between the actual return of the Exchange Fund with the return of the benchmark portfolio

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INVESTMENT OBJECTIVES OF THE EXCHANGE FUND

Investment objectives of the Exchange Fund:

(1) to preserve capital;

(2) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid US dollar-denominated securities;

(3) to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and

(4) subject to (1) – (3), to achieve an investment return that will preserve the long-term purchasing power of the Fund.

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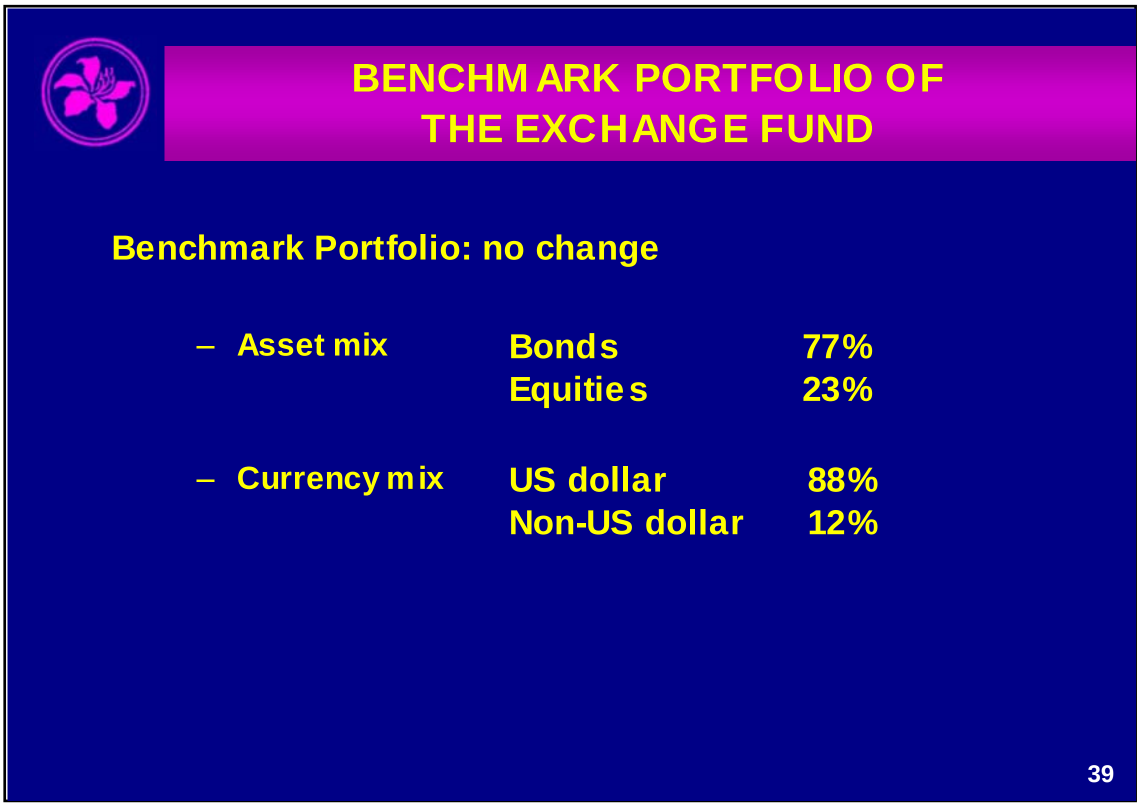

- Based on the investment objectives of the Exchange Fund and the permissible investment markets, an investment benchmark is established as the long-term strategic asset allocations for the Fund. The benchmark has remained unchanged.

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

INVESTMENT INCOME

(HK$ billion)	2007[1] Q1	2006 Full Year	2005 Full Year	2004 Full Year
Gain on Hong Kong equities *	0.2	35.9	7.0	12.0
Gain on other equities *	2.2	18.7	20.5	11.2
Exchange gain/(loss)	6.0	17.3	(19.5)	8.5
Return from bonds #	12.3	31.9	29.8	25.0
Investment income	20.7	103.8	37.8	56.7

* Including dividends

\# Including interest

1 *Unaudited*

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TREASURY'S SHARE AND INCREASE IN ACCUMULATED SURPLUS

(HK$ billion)	2007 Q1 *	2006 Full Year	2006 Q4	2006 Q3	2006 Q2	2006 Q1
Investment income	20.7	103.8	36.0	37.1	12.5	18.2
Other income	0.0	0.2	0.1	0.0	0.1	0.0
Interest and other expenses	(2.3)	(10.5)	(2.7)	(2.8)	(2.8)	(2.2)
Net investment income	18.4	93.5	33.4	34.3	9.8	16.0
Treasury's share	(6.4)	(28.9)	(9.9)	(10.3)	(3.4)	(5.3)
Increase in EF accumulated surplus	12.0	64.6	23.5	24.0	6.4	10.7

* *Unaudited*

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- The new fee arrangement was announced by the Financial Secretary in his budget speech. The new scheme has been effective on 1 April 2007.

EXCHANGE FUND
ABRIDGED BALANCE SHEET

(HK$ billion)	At 31 Mar 2007 (Unaudited)	At 31 Dec 2006 (Audited)	At 31 Dec 2005 (Audited)
ASSETS			
Deposits	82.2	62.4	89.0
Debt securities	851.6	828.4	741.0
Hong Kong equities	122.0	122.4	87.9
Other equities	140.6	137.4	124.2
Other assets	27.1	25.8	24.7
Total assets	1,223.5	1,176.4	1,066.8
LIABILITIES AND FUND EQUITY			
Certificates of Indebtedness	157.6	156.9	148.4
Government-issued currency notes & coins in circulation	7.4	6.9	6.7
Balance of the banking system	1.3	2.0	1.6
Exchange Fund Bills and Notes	131.7	129.2	118.1
Fiscal Reserves Account	380.1	324.5	297.1
Other liabilities	25.7	49.2	51.8
Total liabilities	703.8	668.7	623.7
Accumulated surplus	519.7	507.7	443.1
Total liabilities and fund equity	1,223.5	1,176.4	1,066.8

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- Accumulated Surplus of the Exchange Fund at the end of March 2007 amounted to HK$519.7 billion.

- Fiscal Reserves placed with the Exchange Fund at the end of March 2007 were about HK$380.1 billion.