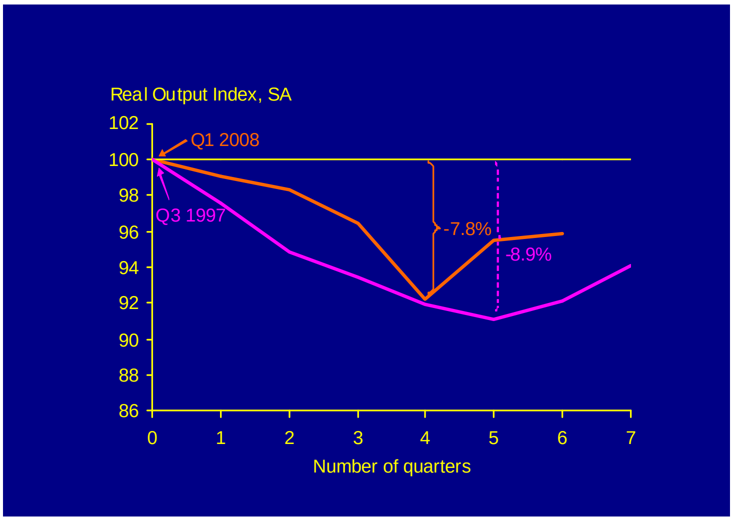
HONG KONG MONETARY AUTHORITY

Briefing to the Legislative Council Panel on Financial Affairs

19 November 2009

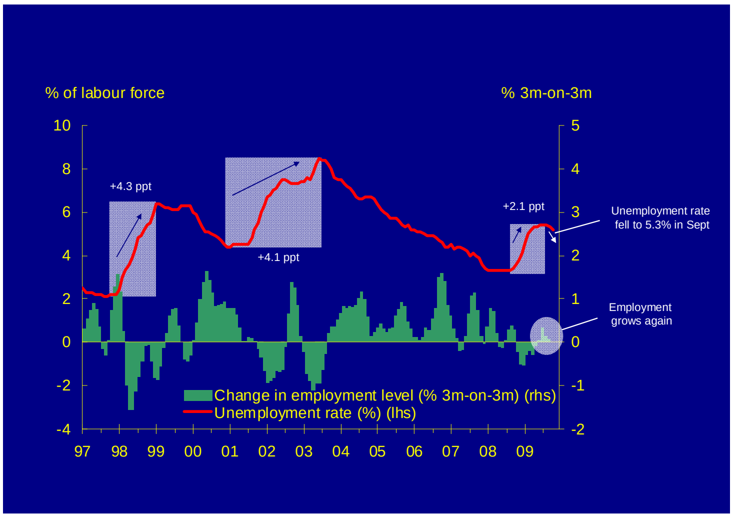
Output loss in comparison with the Asian Financial Crisis

- The current global financial crisis has resulted in a large output shock to Hong Kong. Real GDP fell for four consecutive quarters by a cumulative 7.8% from the second quarter of 2008 to the first quarter of 2009. During the 1997-98 Asian Financial Crisis, real GDP fell by a similar magnitude (a cumulative drop of 8.9% for five consecutive quarters).



Labour market conditions

- The unemployment rate declined to 5.3% in September from 5.4% in August. This is the first decline since the outbreak of the global financial crisis.

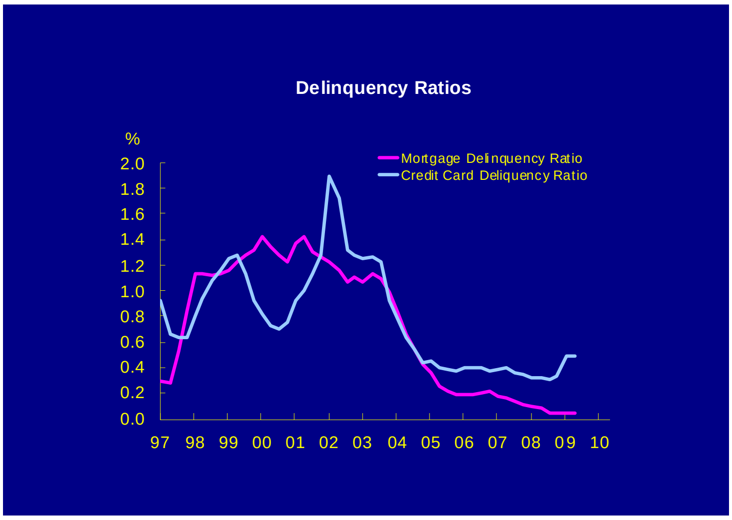


- The impact of the current global financial crisis on the labour market is less serious than previous crises. The unemployment rate rose for 12 consecutive months by a total of 2.1 percentage points since September last year. However, this is relatively moderate when compared with the conditions during the Asian financial crisis and the bursting of the IT bubble. During the Asian Financial Crisis, the unemployment rate began to rise sharply in October 1997 and reached a peak after 16 months, with a cumulative increase of 4.3 percentage points. It stayed high until the end of 1999. The impact of the bursting of the IT bubble on the labour market was first felt in early 2001. The unemployment rate rose continuously for 29 months and peaked in June 2003, with a cumulative increase of 4.1 percentage points.

- The labour market is more resilient this time and job losses have been less severe than during the Asian Financial Crisis. Apart from solid corporate balance sheets, the Government has been prompt and proactive in stabilising the financial system, supporting enterprises and preserving employment. In particular, the Government quickly introduced measures to create jobs and provide assistance to companies with financial difficulties. For example, the Government's SME Loan Guarantee Scheme was enhanced and a Special Loan Guarantee Scheme was introduced to help companies through this difficult time. Up to the end of October, financial assistance has been provided to more than 14,600 companies under these programs, indirectly securing more than 250,000 jobs. The Government also introduced various relief measures involving a total of HK$87.6 billion (5.2% of GDP) in 2008 and 2009. These measures helped stimulate the local economy. Government departments also expedited recruitment processes to fill some 7,700 civil service vacancies.

Household balance sheets

- Although the Hong Kong economy is severely affected by the current financial crisis, individuals' financial conditions remain relatively healthy.

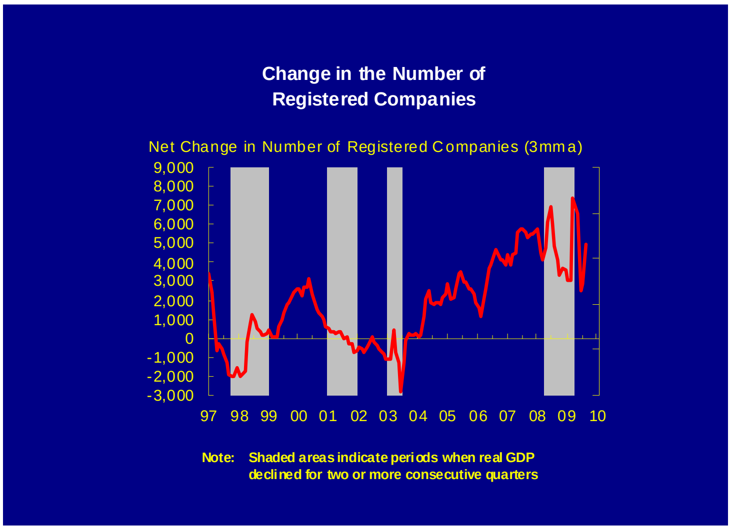


- Household balance sheets remain broadly solid:

  – The mortgage delinquency ratio remained steady at around 0.05%, a historical low, throughout the current global financial crisis. In contrast, the mortgage delinquency ratio rose steeply from 0.29% before the Asian Financial Crisis to over 1% and stayed there until the third quarter of 2003. The rescheduled mortgage loan ratio, another useful indicator, also remained relatively stable at 0.11% in the third quarter of 2009, which is well below its peak of 0.56% recorded in the fourth quarter of 2003.

  – The credit card delinquency ratio rose slightly to 0.5% at the end of June, still lower than its 10-year average and well below the cyclical peaks of 1.28% in early 1999 and 1.9% in 2002.

Corporate balance sheets

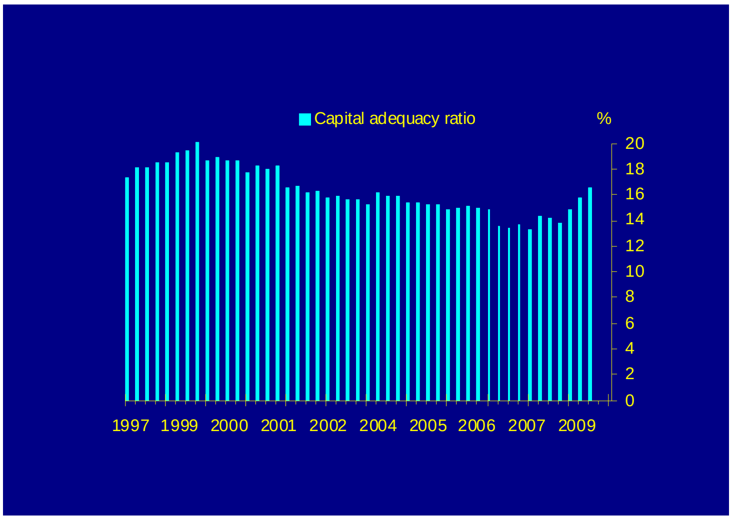


- Corporate financial conditions are healthier this time.

- The number of registered companies in Hong Kong continued to show net growth. This implies that more companies have been established than have been dissolved or gone bankrupt, indirectly reflecting relatively solid financial conditions of corporations. Up to September this year, 80,814 companies have been set up and 35,282 closed, resulting in a net increase of 45,532.

- In previous recessions, the number of companies dissolved (or going bankrupt) was typically larger than the number of companies established.

Banking sector performance (I)

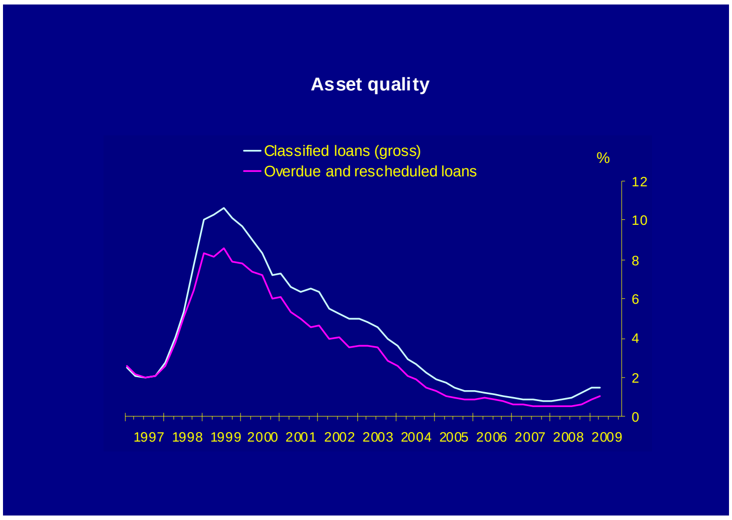


- The banking sector in Hong Kong also remained resilient during this crisis.

- Locally incorporated authorized institutions are well capitalised, with their consolidated capital adequacy ratio rising to 16.5% in the second quarter of 2009 and the liquidity ratio reaching 47.5% in the third quarter.

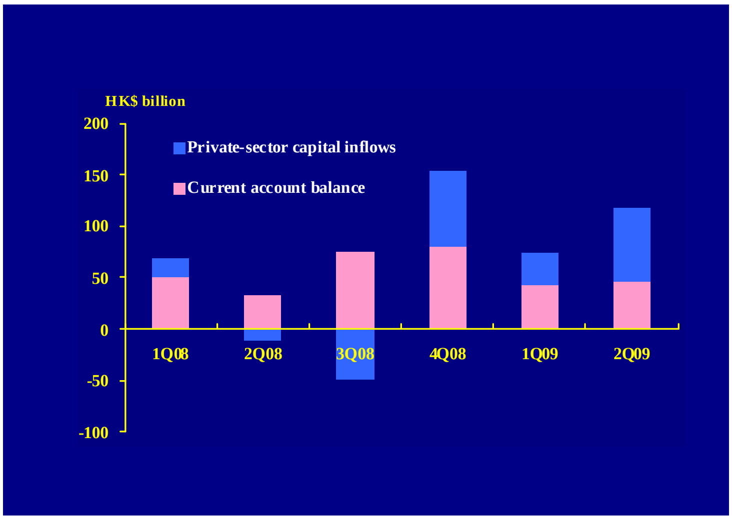
Banking sector performance (II)

- Credit quality of retail banks' loan portfolios remains good. The classified loan ratio was 1.51% in June 2009 and the ratio of overdue and rescheduled loans was 1.05%. Both are far below their peaks (10.61% and 8.58% respectively in September 1999) during the Asian Financial Crisis.



Cross-border capital inflows

- Balance-of-payments statistics indicate that there have been strong capital inflows since the fourth quarter of 2008, in particular during the fourth quarter of 2008 and the second quarter of 2009.

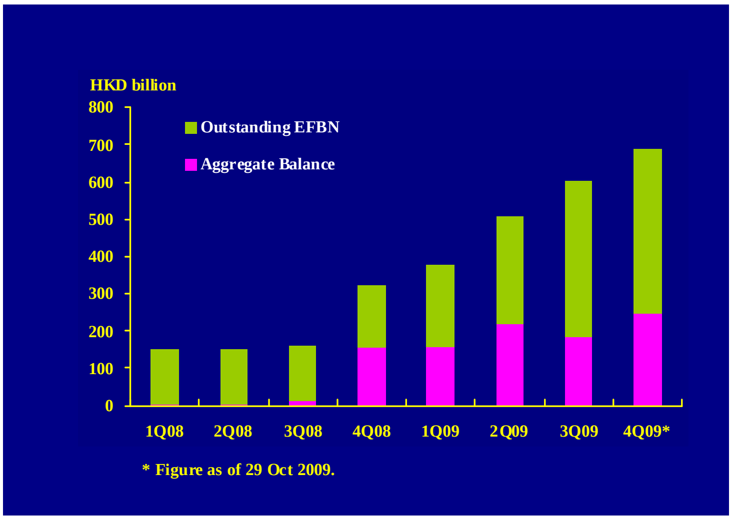


- Balance-of-payments statistics also suggest that private-sector capital inflows in the fourth quarter of 2008 were mainly in the form of a reduction in currencies and deposits held overseas (HK$303.6 billion). This might reflect repatriation of funds by local enterprises in the face of liquidity shortage at that time.

- Capital inflows continued in the first and second quarters of 2009. Amid a buoyant stock market, the size of inflows was particularly strong in the second quarter. Some of these inflows were related to repatriation of currencies and deposits held overseas by Hong Kong residents. Balance-of-payments statistics alone do not reveal the final destinations of these capital inflows. However, as liquidity conditions in the banking sector had already stabilised at that time, the nature of these inflows appeared to be different from what we saw in the fourth quarter of 2008. According to market sources, these inflows might be related to stock-market activities.

Inflows into the Hong Kong dollar

- Partly reflecting better prospects for recovery and increased demand for Hong Kong-dollar assets amid abundant global liquidity, there have been strong inflows into the Hong Kong dollar, as evidenced by the rise in the Aggregate Balance of the banking sector and the issuance of additional Exchange Fund Bills.

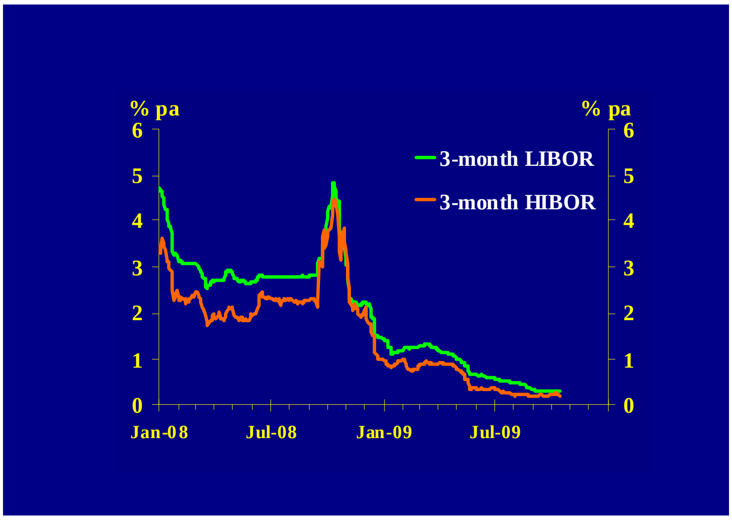


- There have been substantial inflows of funds into Asian economies in the recent few months – Hong Kong is no exception.

- Driven by the strong Hong Kong-dollar inflows, the Aggregate Balance and the market value of outstanding Exchange Fund paper increased by HK$567.5 billion between 1 October 2008 and 13 November 2009.

Local interest rates remain low

- Because of continuous capital inflows and abundant liquidity in the banking system, Hong Kong-dollar interest rates remain low and are slightly lower than the corresponding US-dollar interest rates. Overnight HIBOR has stayed close to zero since the beginning of the year. The 3-month HIBOR has also declined slightly (to 0.12% on 13 November).



Causes of fund inflows into Asia and potential risks

- The main causes of the recent persistent inflows of funds into Asia include:

  - Economies around the world continue to implement accommodative monetary and fiscal policies, leading to abundant liquidity in the market. As global financial markets stabilised, risk appetite increased, prompting an intense search for higher returns.

  - The widening of interest-rate spreads between the Asian currencies and the US dollar, as well as continued weakening of the US dollar and near-zero interest rates have helped fuel US dollar-funded carry trades, causing more funds to flow into Asia.

  - Better economic prospects of Asia than in other regions, especially the advanced economies, also underscored the strong capital inflows into the region.

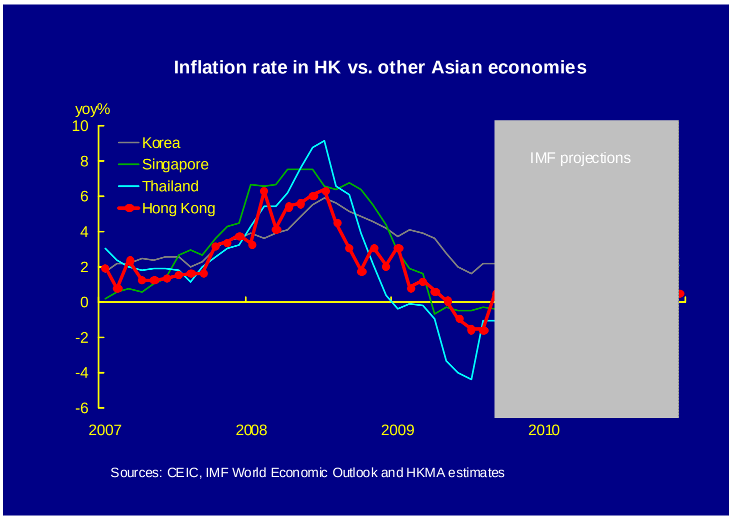
- But the continuous inflows of funds pose potential risks:

  - Sharp rises in property prices might fuel inflation expectations, derailing the economic recovery.

  - Excess liquidity as a result of substantial inflows of funds could feed asset price bubbles. Moreover, if the boom in asset prices is sustained for a protracted period, there will be strong incentives for large leveraged positions to build up, particularly in a low-interest-rate environment.

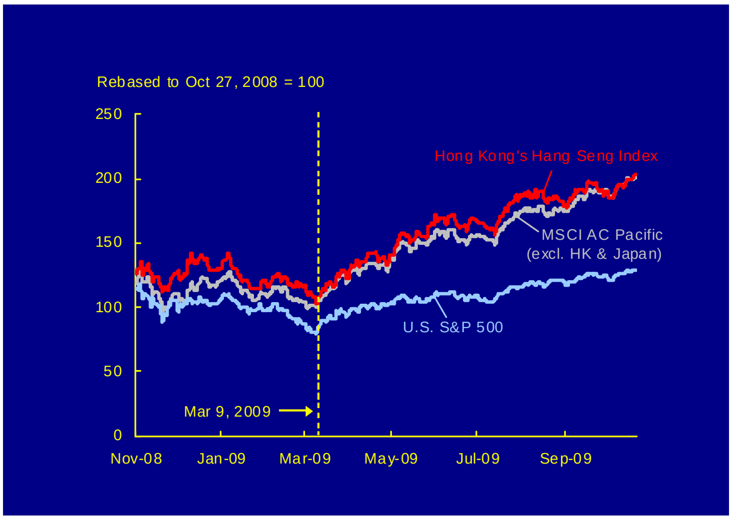
Risks to financial stability in Hong Kong (I): Inflation

- Despite capital inflows and abundant liquidity, upside risks to inflation in Hong Kong in the short run are limited, given low production capacity utilisation and weak labour market conditions globally. Latest inflation figures and projections by the IMF for 2010 indicate that inflationary pressure will be more moderate in Hong Kong than in other Asian economies.



Risks to financial stability in Hong Kong (II): Asset-price bubbles: stock market

- With the market expecting a faster pace of recovery in Hong Kong and the Mainland, and the increase in investors' risk appetite, large amounts of funds flowed in, with domestic equity prices rising sharply since March along with other markets in the region.



- The Hang Seng Index began to decline in September last year, bottoming at 11,345 on 9 March 2009, representing a 46.6% fall. The Index then rebounded sharply by almost 100%, surpassing the 61.6% rise in the S&P 500 over the same period but similar to the rises in other Asian equity markets (the MSCI All Country Pacific Index (excluding Hong Kong and Japan) rose by 98.0%). The rebound reflected the large amounts of capital chasing equities in Asia.

- Securities transaction volumes also recovered to the level before September last year. The daily average for the recent three months reached HK$65.7 billion, slightly higher than HK$63.4 billion recorded in the third quarter of last year.

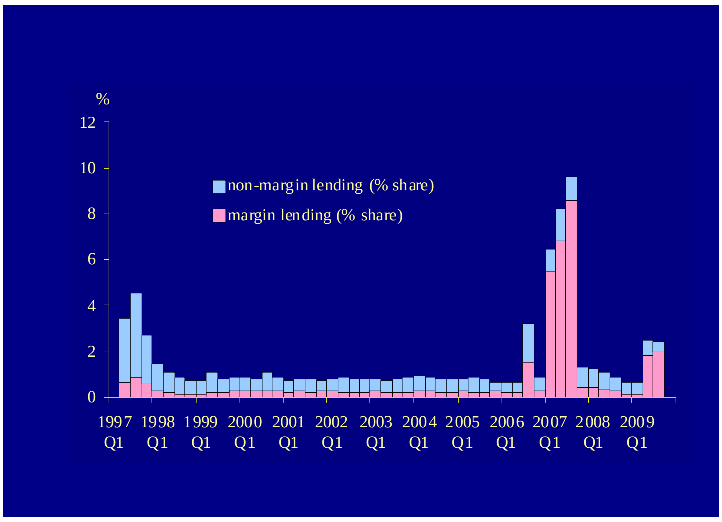
Equity market valuation

- Statistics indicate that the PE ratio of the Hang Seng Index is now above 15 times, which is the historical long-term average in the past 30 years.

- But at this juncture, it is difficult to assess whether this level is too high or too low.

Banking sector's exposure to the stock market

- The recent stock-market rally did not have a large impact on the quality of banks' loans. The ratio of stock-market-related loans to total domestic loans has been below 2% for most of the time, although occasional surges due to IPO-related demands occurred during 2006 to 2007 and the second and third quarters of 2009. Stock-market-related loans amounted to about HK$64.9 billion at the end of the third quarter of 2009.

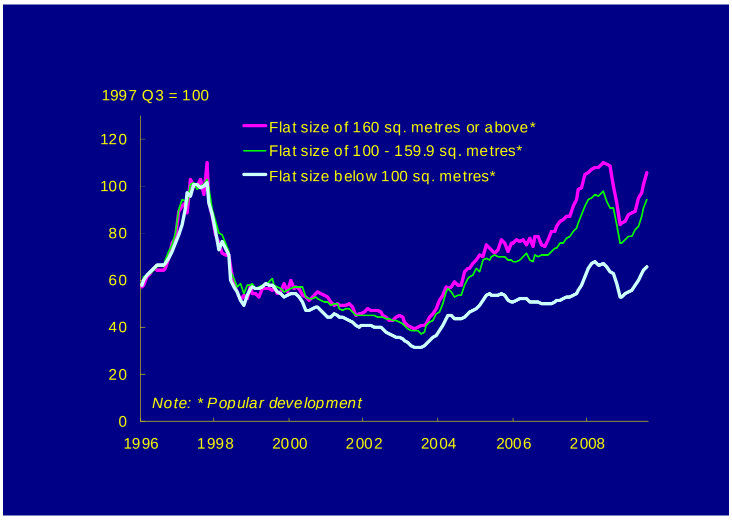


- As a result, risks to the banking system in the recent stock market rally are limited as banking exposure to the stock market has remained low.

Asset-price bubbles: Property market

- The property market has become active again, with residential property prices and transaction volume returning to pre-crisis levels.

- Overall residential property prices in September were equivalent to 75% of the peak reached in 1997, while the prices of luxury properties, which have been rising quicker than those of small to medium flats, have reached their 1997 levels.

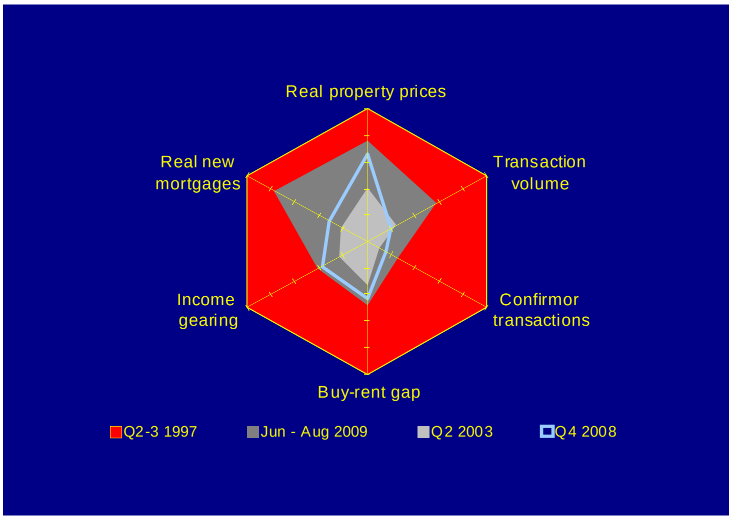


- According to figures provided by the Rating and Valuation Department, residential property prices have increased for the ninth consecutive month in September, after reaching their lowest level in recent years in December 2008, leading to a year-to-date gain of 23%. The Centa-City Leading Index shows that residential property prices recorded a further month-on-month increase of 0.6% at the end of October, while declining slightly by 0.4% month on month in the second week of November.

- Transaction volumes rose above 10,000 for four consecutive months from June to September, before declining to some 9,300 in October.

- In particular, prices of a few ultra-high-end properties have broken records repeatedly. Anecdotal evidence suggests that many buyers of new properties did not require mortgages.

Graphical framework of property market trend



- Judging from the fundamentals of the property market, it appears that market conditions are relatively stable.

- However, the indicators have all gone up considerably within a short time. If this situation continues, the risks in the property market will increase.

- Although measures of households' purchasing power, such as the income-gearing ratio and the buy-rent gap, have changed little in the past 18 months, this situation might have been distorted by the prevailing exceptionally low interest rates (around 2% in 2009 compared with 8 to 10% in 1997).

- Although quantitative easing is expected to continue, the low-interest-rate environment cannot last indefinitely. Home-buyers should be aware that interest rates will go up at some point, increasing their repayment burden and the financing cost of owning an apartment. They should therefore be careful about over-stretching themselves. Otherwise, they might face difficulties in repaying their loans when interest rates return to normal.

- In addition, as shown in the graphical framework, the number of confirmor transactions is relatively small. This may be due to the increases in the costs of property transactions since 1999 when the Government raised the stamp duty for the transfer of second-hand properties with values over $3 million. For example, the rate for a $6 million flat has increased from 2.75% to 3.75%.

- To guard against the risk of imprudent lending in the banking system, the HKMA introduced a new measure on 23 October 2009, lowering the loan-to-value ratio of luxury properties valued at HK$20 million or above to 60%. The HKMA also reminded banks that they should be more prudent in valuing properties and calculating the debt-servicing-ratios of prospective borrowers.

Measures concerning mortgage loans introduced on 23 October

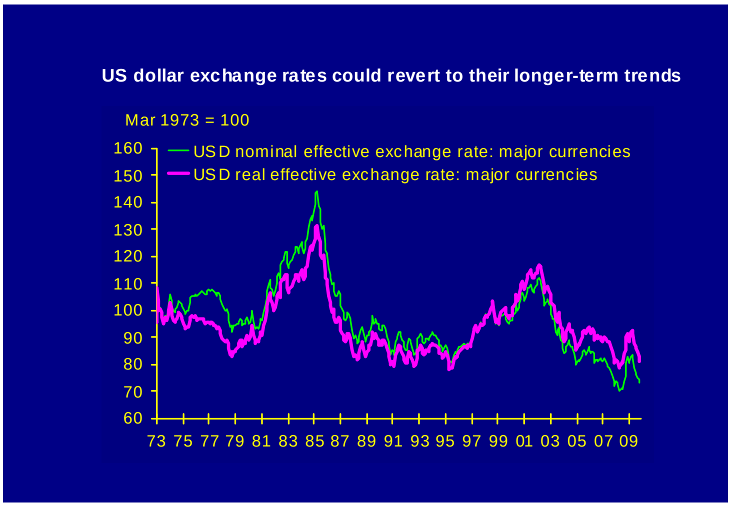
- The prices of luxury properties went up sharply in the third quarter of 2009. To ensure banks manage their risks related to mortgage lending properly and maintain banking stability, the HKMA issued a circular to authorized institutions on 23 October requiring them to lower the loan-to-value ratio for residential mortgages on properties valued at $20 million or more from 70% to 60%.

> - **Lowering the LTV ratio for luxury properties**
> - **Stressing the need for prudence in property valuation and assessment of borrowers' repayment ability and providing additional guidance to AIs**

- The circular also reminded authorized institutions that they should be prudent in valuing properties and calculating borrowers' debt-servicing ratios. In particular, authorized institutions should consider the effect on borrowers' ability to service mortgage payments when interest rates, which were currently at historical low levels, returned to more normal levels. The HKMA issued a guidance note on property valuation and computation of debt-servicing ratio to authorized institutions on 30 October.

- The HKMA and the banking sector have proposed that the privacy regulations should be amended to allow banks to share positive mortgage data through credit reference agencies. This will enable banks to better manage their risks in mortgage lending because they will have a better understanding of prospective borrowers' liabilities when considering their loan applications. Banks will also be in a better position to distinguish whether a borrower buys a property for his own use or for investment purposes, and price the risk accordingly.

Risk of fund flow reversal



- The larger the asset bubbles, the steeper will be the correction should substantial outflows occur. Given the volatile nature of capital flows, the risk of a reversal needs to be monitored closely.

- A reversal of capital flows might be triggered under two possible scenarios: a tightening of monetary policy in the US, or a reassessment of current market expectations of a continued depreciation of the US dollar.

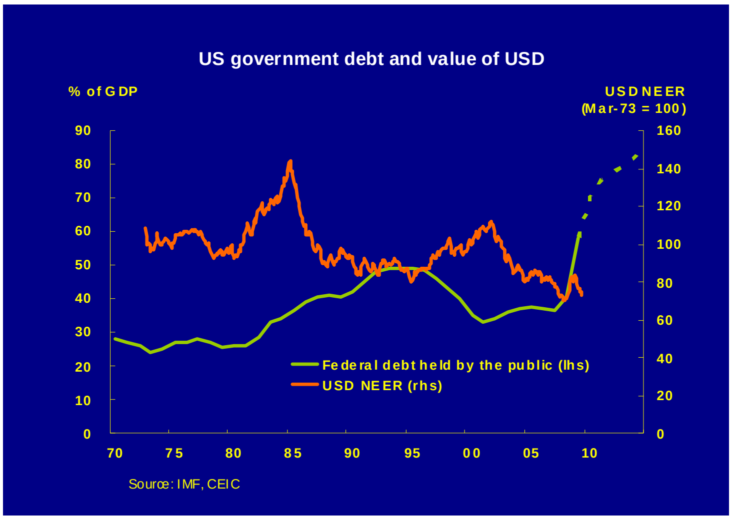
- US interest rates and the US dollar exchange rate are now at their lowest levels in the past 40 years.

- If the recovery in the US picks up momentum and the Federal Reserve starts to tighten monetary policy, or if carry trades begin to be unwound, capital flows may reverse.

- Many financial market participants expect the US dollar to remain weak due to the Fed's continued efforts in quantitative easing. However, history suggests that after a prolonged period of weakening, the US dollar would revert to its long-term trend. As shown in the chart, over the longer term the US-dollar exchange rate displays only a very slight downward trend. After staying weak during the early 1990s, the US-dollar exchange rate strengthened by around 50% between 1995 and 2001.

- It is too early to tell whether history will repeat itself this time but if it does, a strengthening of the US dollar towards its longer-term trend will probably trigger a reversal of capital flows back to the US from Asia.

Relationship between public debt and exchange rate: situation in the US

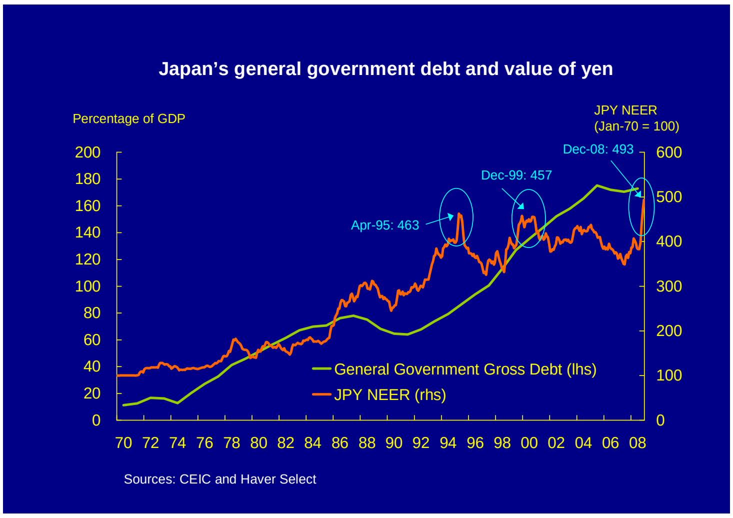


- In the face of the enormous shock from the financial crisis, the US government introduced sizable fiscal stimulus packages to support the economy, leading to an increase in the US federal debt to a historically high level.

- But these large-scale fiscal measures cannot be maintained indefinitely.

- Many market participants expect that the US dollar will remain weak but this should not be taken for granted.

Relationship between public debt and exchange rate: Japan's experience



- Increases in public debt do not necessarily lead to a weak currency. For example, Japan's government debt increased from around 60% of its GDP in early 1990s to more than 170% in recent years, but the yen also appreciated during the same period.

- There is therefore no distinct relationship between the increases in public debt and the strength of a currency.

- In fact, one cannot predict changes in exchange rates by only looking at the level of public debt because exchange rates are determined by a large number of factors domestically and outside the economy.

- Investors should therefore be alert to the possibility of reversals of capital flows triggered by the reverting of the US dollar to an upward trend and the risks that this will create for asset prices.

Investment income

(HK$ billion)	2009 Jan - Sep *	2008 Full Year	2007 Full Year	2006 Full Year
Gain/(Loss) on Hong Kong equities^@	42.0	(77.9)	55.8	35.9
Gain/(Loss) on other equities^	34.8	(73.1)	6.7	18.7
Exchange gain/(loss)	13.2	(12.4)	18.7	17.3
Return from bonds#	6.9	88.4	61.0	31.9
Investment income/(loss)@	96.9	(75.0)	142.2	103.8

* Unaudited figures
^ Including dividends
# Including interest
@ Excluding valuation changes in Strategic Portfolio

- All asset classes of the Exchange Fund recorded investment gains for the first nine months of 2009. Investment income of the Exchange Fund for the first three quarters (excluding valuation changes in the Strategic Portfolio) amounted to HK$96.9 billion.

- Gains on equities made the largest contribution to investment income. As investors felt more optimistic about the prospect for economic recovery and became more aggressive, major equity markets rebounded strongly since March this year.

- Exchange gains mainly came from the weakening of the US dollar against other major foreign currencies since April.

- US government bond yields, especially long-term yields, rose in the first half of 2009 because the market was concerned about the rise in inflation expectation and the substantial increases in the supply of US government bonds. Nevertheless, the Exchange Fund’s interest income from bonds was more than enough to offset the negative impact of the rise in interest rates on investment gains from bonds.

- In addition to a better investment environment this year, our prudent investment strategies also contributed to the investment income of the Exchange Fund.

- The HKMA will continue to be vigilant in the ever-changing investment environment and manage the Exchange Fund prudently under the guidance of the Exchange Fund Advisory Committee and its Investment Sub-Committee.

Investment income, payment to the Treasury and changes in the Accumulated Surplus

- The fixed rate for calculating the amount of payment to the Treasury for 2009 is 6.8%. Based on this fixed rate, the Exchange Fund paid HK$25.6 billion to the Fiscal Reserves for the first three quarters of 2009.

- Taking into account other incomes and expenses and valuation gains in the Strategic Portfolio, the Accumulated Surplus increased by HK$72.5 billion in the first three quarters of the year.

(HK$ billion)	2009 Jan - Sep *	2009 Q3	2009 Q2	2009 Q1	2008 Full year
Investment income / (loss)	**96.9**	**71.9**	**58.5**	**(33.5)**	**(75.0)**
Other income	0.2	0.0	0.2	0.0	0.3
Interest and other expenses	(2.8)	(0.9)	(1.2)	(0.7)	(6.5)
Net investment income / (loss)	94.3	71.0	57.5	(34.2)	(81.2)
Payment to Treasury #	**(25.6)**	**(8.0)**	**(8.5)**	**(9.1)**	**(46.4)**
Payment to HK government / statutory bodies #	(0.6)	(0.3)	(0.3)	0.0	0.0
Valuation change of Strategic Portfolio ^	4.4	1.3	3.2	(0.1)	(8.9)
Increase / (Decrease) in EF accumulated surplus	**72.5**	**64.0**	**51.9**	**(43.4)**	**(136.5)**

* Unaudited figures
\# The fixed rate of fee payment is 6.8% for 2009 and 9.4% for 2008
^ Including dividends

Lehman Bothers – minibonds

- The Securities and Futures Commission, the HKMA and 16 banks reached an agreement under section 201 of the Securities and Futures Ordinance on the repurchase of minibonds in July 2009.

- Around 25,000 customers are eligible for the repurchase scheme. Up to 11 November 2009, more than 24,300 eligible customers (about 97%) have accepted the repurchase offer.

- **The HKMA has received nearly 14,000 minibond-related complaints, of which 13,100 have accepted the repurchase offer or voluntary settlement**
- **Investigations will continue in respect of the remaining 900 cases involving customers ineligible for repurchase or those who rejected the offer**

- About 4,800 customers who had previously settled with banks are also eligible for the voluntary top-up offer.

Lehman Brothers – non-minibond products

- The HKMA is investigating about 4,400 cases involving financial products related to Lehman Brother, in addition to those involving minibonds.

- Following the introduction of the minibond repurchase agreement, the HKMA has been focusing on investigating these cases. The HKMA aims to substantially complete investigations of all outstanding cases by the end of March 2010.

- **The HKMA has received about 7,700 complaints relating to non-minibond products, of which:**
  - **2,526 cases have been closed due to insufficient evidence**
  - **766 cases under disciplinary consideration after detailed investigations**
  - **4,406 cases being investigated**
- **Aims to substantially complete the investigation of all outstanding complaints by the end of March 2010**

Renminbi business (1)

Importance of renminbi business to Hong Kong as an international financial centre

Renminbi trade settlement pilot scheme

- **Commenced operation on 6 July, covering trades between pilot cities in the Mainland and HK, Macau and ASEAN countries**
- **At the end of September, 32 authorized institutions have entered into clearing agreements with the Clearing Bank or Mainland correspondent banks**

- Development of renminbi business is crucial to strengthening Hong Kong's position as an international financial centre.

  - Hong Kong has gained experience since the launch of renminbi business in 2004. The scope of business has expanded from personal banking to subscription and trading of renminbi bonds, trade settlement and finance. Hong Kong is well positioned to provide a robust and reliable testing ground to promote the use of renminbi outside the Mainland.

  - The development of renminbi business in Hong Kong is conducive to developing Hong Kong into a major renminbi clearing centre outside the Mainland. Hong Kong already has the most comprehensive and efficient renminbi clearing platform outside the Mainland. Subject to policy considerations, Hong Kong is well positioned to provide renminbi clearing services for other jurisdictions.

Renminbi trade settlement pilot scheme

- The pilot scheme commenced operation on 6 July, covering cross-border trades between pilot areas on the Mainland and selected regions outside the Mainland.

- The pilot scheme brings new business to local banks. At the end of September, 32 authorized institutions have entered into clearing agreements with the Clearing Bank or Mainland correspondent banks.

- The volume of renminbi trade settlement has gradually increased recently. Preliminary figures indicate that the settled amount in the first half of November already exceeded the monthly average figure since the launch of the scheme.

Renminbi business (2)

HKMA's major initiatives in promoting the renminbi trade settlement pilot scheme

> **HKMA's major initiatives in promoting the renminbi trade settlement pilot scheme**
>
> - **made available to banks and enterprises the lists of designated Mainland enterprises through the Clearing Bank, Hong Kong Trade Development Council and Hong Kong General Chamber of Commerce**
> - **Explored various measures to further develop and promote the pilot scheme (for example, the feasibility of expanding the scope of approved areas and designated enterprises)**
> - **Roadshows were conducted in the second half of 2009 to promote HK's renminbi clearing platform to the ASEAN countries**

- The HKMA has been working closely with the Mainland authorities and local industry to promote the scheme, including:

  – The lists of Mainland enterprises eligible for the scheme were announced in August. To increase transparency, the HKMA made the lists available to banks and enterprises through various channels, including the Clearing Bank, Hong Kong Trade Development Council and Hong Kong General Chamber of Commerce.

  – We will continue to monitor closely the operation of the scheme and explore ways together with Mainland authorities and local industry to further develop the scheme. For example, to study the feasibility of expanding the pilot areas and increasing the number of eligible enterprises of the scheme.

  – The scheme also allows banks or enterprises in ASEAN countries to use Hong Kong's renminbi clearing platform to settle trades between these jurisdictions and the Mainland. The HKMA and the Clearing Bank jointly conducted roadshows in the second half of 2009 in ASEAN countries to promote Hong Kong's renminbi clearing platform. Preliminary responses of the commercial banks in these jurisdictions have been positive, with a number of them having already become participants of Hong Kong's renminbi clearing platform.

Renminbi business (3)

Renminbi bond market in Hong Kong

Renminbi bond issuance in Hong Kong

- **Ministry of Finance issued RMB 6 bn in sovereign bonds in September**
- **HSBC (China) and Bank of East Asia (China) issued RMB 7 bn worth of bonds in total**
- **China Development Bank issued renminbi bonds in Hong Kong raising RMB 3 bn**

- The first renminbi bonds in Hong Kong were issued in mid-2007, with the issue amounts gradually increasing every year. The total amount of renminbi bonds issued in 2009 reached a record of RMB 16 billion.
  - 3 issues in 2007, raising RMB 10 billion
  - 4 issues in 2008, raising RMB 12 billion
  - 6 issues in 2009, raising RMB 16 billion

- Two ground-breaking developments in Hong Kong's renminbi bond market this year
  - Two Hong Kong subsidiary banks on the Mainland were allowed to issue RMB 7 billion worth of bonds in Hong Kong. The issues were completed in the third quarter. The issue of renminbi bonds helps provide Hong Kong subsidiary banks on the Mainland with funds to develop their business.
  - With the support of the Central Government, the Ministry of Finance has chosen Hong Kong as the first place outside the Mainland to issue RMB sovereign bonds. A total of RMB 6 billion in sovereign bonds was issued at the end of October. The issuance of RMB sovereign bonds in Hong Kong not only expands Hong Kong's RMB bond market, but also provides a price benchmark for other RMB bonds.