Hong Kong’s Latest Economic Situation and Outlook

The Government furnished LegCo Members with a paper titled “Hong Kong’s Recent Economic Situation and Near-term Outlook” in late-May and described Hong Kong’s overall economic development and forecasts for 2012 as a whole at the Panel meeting on 4 June.

This paper analyses further Hong Kong’s latest economic developments and outlook for the rest of the year, and discusses the strategies and measures adopted by the Government to meet with the challenges posed by the austere external environment.

Financial Services and the Treasury Bureau
Economic Analysis and Business Facilitation Unit
Financial Secretary’s Office
6 July 2012
Latest Economic Situation and Outlook
For the Hong Kong Economy

Introduction

This paper describes the latest developments in the Hong Kong economy and its near-term outlook, and briefly discusses the strategies and measures adopted by the Government to cope with the euro debt crisis.

Recent economic situation

2. The Hong Kong economy decelerated further to only a 0.4% year-on-year growth in the first quarter of 2012, the slowest pace since the third quarter of 2009, mainly dragged by a fall-off in goods exports amid a challenging external environment. With the lacklustre performance of the US and EU economies amid the further worsening of the euro debt crisis, Hong Kong’s merchandise exports still lacked momentum in recent months. Domestic demand and inbound tourism also moderated somewhat. Hong Kong’s overall economic performance is thus expected to remain rather tepid in the second quarter (Chart 1).

Chart 1 : The economy slowed visibly to only a meagre growth in the first quarter of 2012 on weak export performance

![Chart 1](chart1.png)

External trade

3. Total exports of goods (reckoned on GDP basis) fell by 5.7% in real terms
in the first quarter of 2012 over a year earlier. Despite some relative improvement in April and May, merchandise exports should show only a modest year-on-year growth in real terms in these two months combined, indicating the continued sluggishness in external demand (Chart 2(a)). While exports to the Mainland and Japan regained some momentum, other major markets such as the EU, the US and many other Asian markets continued to show weak performance. On a seasonally adjusted basis, the volume of merchandise exports is expected to shrink by around 4% in March–May over the preceding three-month period.

4. Exports of services grew by 3.6% year-on-year in real terms in the first quarter of 2012, mainly on the back of buoyant inbound tourism, while exports of trade-related services and financial and business services slowed visibly. In April and May, the number of visitor arrivals increased strongly further, by 13.5% over a year earlier (Chart 2(b)). With the escalation of the eurozone sovereign debt crisis, financial market activities had turned quieter in the recent period. Meanwhile, with the slack in external trade, port transportation data remained soft in April and May.

![Chart 2(a): Merchandise exports stayed sluggish after entering the second quarter](image1)
![Chart 2(b): Inbound tourism remained buoyant](image2)

**Domestic sector**

5. The domestic sector held up well in the first quarter of 2012. Thanks to the stable employment conditions and marked improvement in incomes over the past year, private consumption expenditure grew briskly further by 5.6% year-on-year in the first quarter. However, retail sales volume decelerated somewhat in recent months, with the year-on-year growth slowing from 10.7% in the first quarter to
6.7% in April and May combined. Nevertheless, the year-on-year growth in the first five months of 2012 combined was still notable, at 9.1% *(Chart 3(a))*.

6. Overall investment spending posted a strong growth of 12.2% year-on-year in real terms in the first quarter of 2012. Machinery and equipment acquisition stayed robust, leaping by 23.1% year-on-year in real terms. On top of this, overall building and construction expenditure showed a notable increase of 11.1% in real terms over a year earlier, thereby providing additional impetus. However, the volume of retained imports of capital goods fell by 13.3% year-on-year in April, and despite an expected moderate rebound in May, still suggesting some slackening in private investment activities amid a more uncertain global economic outlook *(Chart 3(b))*.

![Chart 3(a): Retail sales growth decelerated in April and May](image)

![Chart 3(b): Capital goods acquisition also slackened somewhat in recent months](image)

**Labour Market**

7. The labour market remained in a state of full employment since entering 2012, amid prevailing positive hiring sentiment in the corporate sector. In March – May 2012, the seasonally adjusted unemployment rate fell to 3.2%, and the underemployment rate also fell to 1.4% *(Chart 4)*. On the back of buoyant labour demand, job creation remained brisk. Specifically, total employment in March – May reached an all-time high of 3 662 600, up by 105 100 or 3.0% over a year earlier. Employment growth was seen across the board, with more notable gains in the social work activities (+12.7% year-on-year); professional and business services (+11.5%); construction (+6.4%); financing and insurance (+4.8%); import/export
trade and wholesale (+4.1%); and retail (+2.4%) sectors (Chart 5).

Chart 4: Labour market conditions held firm so far

Chart 5: Job gains were broad-based across most sectors and age groups

Total employment rose significantly by 105 100 in March - May 2012 over a year earlier

By economic sector

By age

Note: (*) Figures in brackets refer to the year-on-year rates of change in employment of the corresponding groups.
8. Against the backdrop of full-employment, coupled with the additional boost from the implementation of SMW, household income and employment earnings sustained visible increases over the past year. In particular, median household income rose by 5.1% in the February – April of 2012 over a year earlier. After discounting for price changes, there was a real increase of 0.4%. Meanwhile, average employment earnings for full-time employees went up by 5.2% in nominal terms and 0.4% in real terms. Among them, those in the lowest decile group saw even more impressive increases, at 14.0% and 9.4% respectively.

**Asset markets**

9. With the re-intensification of the eurozone sovereign debt crisis upon entering May and less sanguine US economic data in recent months, the local stock market fell sharply in May and early June alongside other overseas markets. The Hang Seng Index (HSI) closed at 18,186 on 4 June, the lowest level since December 2011. With the rate cut in the Mainland and eurozone finance ministers agreeing to provide joint assistance to Spain’s banking sector, the HSI rebounded briefly, but remained largely volatile in view of the unsettling euro debt crisis. The HSI closed at 19,441 at end-June, down 5% from end-March. Reflecting the more cautious market sentiments, the daily turnover of the local stock market averaged at $50.2 billion in the second quarter, down 21% from that of $63.2 billion in the first quarter (Chart 6).

**Chart 6 : Amid the re-intensification of the euro debt crisis, the local stock market fell sharply since May and remained volatile in June**

![Chart 6](chart6.png)
10. The residential property market rebounded since February 2012, but market sentiment turned more cautious in May and June amid the worsening euro debt crisis and subsequent global stock market gyrations, with shrinking transaction volume and slower increase in flat prices. Preliminary data indicate that overall residential flat prices rose by less than 1% during May, with mixed performance in transaction prices across housing estates. Nevertheless, flat prices in May rose cumulatively by roughly 10% compared with the level in December 2011, and surpassed the 1997 peak by around 15%. On the other hand, overall flat rentals in May 2012 rose moderately by 2% over December 2011 (Chart 7).

Chart 7: Residential property market rebounded since February, and turned somewhat quieter in May and June

11. In terms of trading, the number of residential property transactions in April–May rose sharply by 33% over the low base in the first quarter to a monthly average of about 8 300. This figure was still 4% lower than the same period a year earlier, but on par with the long-term monthly average of around 8 200 over 1997–2010. Reflecting the dwindling trading since May, the number of sale and purchase agreements for residential property received by the Land Registry plunged by 30% month-to-month to around 5 900 in June.

12. Overall flat prices had risen sharply over the past few years, and surged by a cumulative 89% over the trough at end-2008. Also, the home purchase affordability (i.e. the ratio of mortgage payment for a 45-square metre flat to median income of households, excluding those living in public housing) worsened slightly to 46.5% in the first quarter of 2012, and would exceed the long-term average of 50.4% over 1991-2010 by a significant extent should interest rates return to a more normal
level.

13. The Government has been staying alert to the impact of large fluctuations in house prices on overall macroeconomic and financial stability. To ensure a healthy and stable development of the housing market, the Government had since early 2010 rolled out various measures on the housing market, and to a certain extent achieved some results. To carry through with these efforts, the Government announced at end-May that land supply for residential property would be further increased in the third quarter. The Government-initiated land sales together with the West Rail property development projects should provide for the construction of no fewer than 5,000 flats. This will help tackle the issue of demand-supply balance of residential flats from the root.

14. The property market is currently faced with two opposing forces, viz. weakness on the external front on the one hand and super-low interest rates on the other, and thus likely to experience large fluctuations with unpredictable movements. The Government will stay alert to housing market bubble risks and, where necessary, roll out further measures without reservation to ensure the healthy and stable development of the housing market.

Inflation

15. Inflation displayed an easing trend in the first five months of 2012. On the external front, with retreating international food and commodity prices and receding Mainland inflation, Hong Kong’s imported inflation continued to subside since entering 2012. Locally, the pace of increase in market rentals also moderated visibly, although wage cost pressure was still notable amid a buoyant labour market. In view of a more challenging economic environment and slower inflation in the region, local inflation should come down further in the period ahead.

16. Headline consumer price inflation, as measured by the year-on-year rate of change in the Composite Consumer Price Index (Composite CPI), went down from 5.2% in the first quarter of 2012 to 4.7% in April, and further to 4.3% in May. Underlying consumer price inflation, being more indicative of the underlying inflation trend by netting out the effects of Government’s one-off relief measures, likewise decelerated from 5.9% in the first quarter of 2012 to 5.6% in April, and further to 5.1% in May (Chart 8).
17. Many of the major components in the underlying Composite CPI saw slower year-on-year price increases in April and May 2012, suggesting a broad-based easing of price pressures (*Table 1*). Among these, food inflation (including costs of dining out) eased further from 7.2% in March to 6.8% in May. With the slower increases in fresh letting flat rentals in the past few quarters, the rate of increase in private housing rentals also continued to moderate, from 8.8% in March to 7.5% in May. Prices of many other major CPI components like clothing and footwear and miscellaneous services also saw smaller increases so far in 2012, while prices of durable goods continued their secular downtrend.
Table 1: Composite Consumer Price Index by component
(year-on-year rate of change (%))

<table>
<thead>
<tr>
<th>Expenditure component</th>
<th>Weighting (%)</th>
<th>2011</th>
<th>2012</th>
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<tr>
<td></td>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
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<tr>
<td>Food</td>
<td>27.45</td>
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<td>6.9</td>
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<td>Meals bought away from home</td>
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<td>4.1</td>
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<td>Other foodstuffs</td>
<td>10.38</td>
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<tr>
<td>Housing (a)</td>
<td>31.66</td>
<td>3.8</td>
<td>5.9</td>
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<td></td>
<td>(3.9)</td>
<td>(5.9)</td>
<td>(7.6)</td>
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<tr>
<td>Private dwellings</td>
<td>27.14</td>
<td>4.1</td>
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<tr>
<td></td>
<td>(4.1)</td>
<td>(6.4)</td>
<td>(8.3)</td>
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<tr>
<td>Public dwellings</td>
<td>2.05</td>
<td>4.0</td>
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<td></td>
<td>(3.8)</td>
<td>(3.9)</td>
<td>(2.5)</td>
</tr>
<tr>
<td>Electricity, gas and water</td>
<td>3.10</td>
<td>7.3</td>
<td>8.0</td>
</tr>
<tr>
<td></td>
<td>(3.8)</td>
<td>(3.6)</td>
<td>(3.8)</td>
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<tr>
<td>Alcoholic drinks and tobacco</td>
<td>0.59</td>
<td>8.1</td>
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<tr>
<td>Clothing and footwear</td>
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<td>5.6</td>
<td>6.3</td>
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<td>Durable goods</td>
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<td>-4.3</td>
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<td>4.2</td>
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<td>Transport</td>
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<tr>
<td></td>
<td>(3.7)</td>
<td>(5.0)</td>
<td>(6.1)</td>
</tr>
</tbody>
</table>

Notes: The year-on-year rates of change in the Composite Consumer Price Index are computed from the new 2009/10-based CPI series. Figures in brackets refer to the underlying rate of change after netting out the effect of Government’s one-off relief measures.

(a) The housing component covers rents, rates, Government rent, maintenance costs and other housing charges. Its sub-components on private and public dwellings as presented here, however, cover rents, rates and Government rent only. Hence, the combined weighting of private and public dwellings is slightly less than the weighting of the entire housing component.

(b) The relatively large difference between the headline and underlying year-on-year rates of inflation in July was mainly due to the difference in timing of the waiving of public housing rentals, which took place in July to September last year but fell in August to September this year.

(*) Change within ±0.05%.
Latest economic outlook

18. The performance of the Hong Kong economy for the rest of the year hinges to a large extent on how the euro debt crisis will evolve. Although the EU summit in late-June has made some progress towards tackling the euro debt problem, eurozone leaders have not expanded the firepower of the European bailout fund, and many details of the proposed new measures have yet to be clarified. Markets are thus still skeptical about the outcome of the Summit. Meanwhile, interbank lending activities among European banks remained weak, and the tight credit conditions are stifling severely Europe’s real economy. In addition, market concerns have shifted from Greece to Spain and Italy, fearing that the crisis might spread further to other larger economies. While the pro-bailout parties won in the Greek re-election in mid-June, thereby reducing the risks of an imminent “Grexit” (Greek exit from the eurozone), the political situation remains fluid, and the possibility of a sovereign debt default cannot be entirely ruled out. While EU leaders have expressed their willingness to see Greece staying in the eurozone, markets generally believe that an eventual “Grexit” may just be a matter of time. In such an event, another round of financial market gyrations would inevitably be triggered. This reflects the mounting uncertainties surrounding the euro debt situation, which will continue to haunt the global economy for an extended period. The risks thus involved should not be taken lightly.

19. In any case, the euro debt crisis is deeply rooted in structural problems, and may not be resolved within a short period of time even if the situation can be stabilised temporarily, thereby remaining a drag on the economic growth there. Thus the EU economy is poised for a continued slack in 2012, and the risk of a deep recession is on the rise. Against the deteriorating external environment, the new export orders diffusion index on small and medium-sized enterprises had weakened again in recent months, suggesting that Hong Kong’s export performance is still faced with downside risks for the remainder of the year (Chart 9). Nevertheless, although recent economic data from the US indicate some weakening in growth momentum, the US economy should continue to expand at a moderate pace. Data from the Mainland so far this year likewise suggest that its external trade had also been affected by the slack in the EU and the US, but in view of the Mainland government’s further policy easing in recent months and the ample scope for policy maneuvering given the continued easing of inflation, the Mainland economy is expected to regain some momentum in the latter part of the year, thereby rendering an important stabilising force to Asia and the global economy. Against this background, if EU leaders can manage to stop the euro debt crisis from spreading further, Hong Kong’s exports and overall economy may see some improvement in the second half of the year.
20. On the other hand, the domestic sector is expected to stay relatively resilient despite some deceleration in recent months. The still buoyant employment conditions, further growth in infrastructure spending and the package of measures announced in the Budget will continue to underpin domestic demand and render a cushion to overall economic performance. Barring any abrupt deterioration of the eurozone debt crisis, the Hong Kong economy should be able to attain the forecast GDP growth at 1-3% in real terms for 2012 as a whole (Chart 10). For reference, the latest economic forecasts by most private sector analysts range between 2-3%, averaging at around 2.6%.
21. As for the labour market, the latest employment diffusion index on small and medium-sized enterprises largely held steady. This consultation result and recent vacancy trends indicate that the employers’ hiring sentiment has remained generally positive, which should continue to bode well for the employment situation in the near term. Nevertheless, with mounting uncertainties in the external environment amid the lingering euro debt crisis, the employment situation in the coming months is still challenging. The Government will closely monitor the developments.

22. On inflation, with slower global and local economic growth, imported inflation and local cost pressures are expected to recede gradually. Hong Kong’s inflation should continue to ease in the second half of the year (Chart 11). Nonetheless, some upside risks to inflation still need to be watched over, including a possible resurgence in global commodity and food prices amid abundant global liquidity, and possible fluctuations in international oil prices. The Government will continue to monitor the inflation situation, particularly its impact on the lower-income people.

Chart 11: Inflation should ease further in the latter half of the year
Strategies and measures adopted by the Government to cope with the euro debt crisis

23. The Administration has been adopting multi-pronged strategies and measures to maintain the stability of our financial system, improve the quality of the market, enhance investor protection and promote the long-term development of our financial industry. We are committed to enhancing the resilience of our financial system, as well as promoting Hong Kong’s competitiveness, with a view to equip ourselves for challenges ahead.

I. Maintaining the stability of the financial system

24. Notwithstanding the volatility of the global financial markets, financial institutions in Hong Kong remain generally stable. Operations in the interbank market, securities market and insurance sector continue to be orderly. Meanwhile, apart from closely monitoring the market situation, the Administration has requested regulators to strengthen their market monitoring work. Hong Kong’s regulators including the Securities and Futures Commission (SFC), Hong Kong Monetary Authority (HKMA), the Commissioner of Insurance at (OCI) and Mandatory Provident Fund Schemes Authority (MPFA) have been implementing various measures to contain systemic risks in the market, keeping close liaison with bodies under its regulation. SFC, HKMA and OCI have also conducted stress tests on their respective regulatees from time to time, so as to ensure that they can still operate normally under extremely volatile market conditions. Moreover, regulators have requested banks to increase their regulatory reserves, strengthen capital and liquidity management, maintain a sound deposit protection scheme, introduce prudential regulatory requirements on mortgage loans, adjust margin requirements for Hang Seng Index Futures and H-share index futures, implement short position reporting requirements and request insurance companies to put in place effective measures to manage their risks. Regulators will maintain close dialogues with each other on various issues, and the Administration will closely monitor the market situation with the regulators through cross-regulator platforms, including the Council of Financial Regulators and Financial Stability Committee led by the Financial Secretary and the Secretary for Financial Services and the Treasury respectively. At the same time, the regulators have been keeping in close contact with their overseas counterparts to exchange latest market information.

25. The regulators have also implemented specific measures to tackle the European debt crisis:
(i) SFC

26. Due to the European debt crisis, some investment products authorised by the SFC are now subject to counterparty risks related to the European market / financial institutions. To address the situation, SFC has implemented a number of measures, including monitoring the products risk exposure to major global financial institutions, requiring domestic synthetic exchange-traded fund (ETF) to top-up the collateral level to achieve at least 100% collateralisation, keeping close liaison with product issuers / arrangers, fund management companies, as well as overseas and local financial regulators, and requiring them to notify SFC of any unusual or abnormal situations.

(ii) HKMA

27. HKMA has been requiring banks to implement prudent management on various risk factors. Meanwhile, banks are also closely monitoring market situations and have put in place effective risk management measures. HKMA considers that Hong Kong’s banks are in a very sound financial position and with sufficient funds. Their capital adequacy ratio and liquidity ratio remain at a high level. HKMA has comprehensive contingency measures to handle regulatory issues that might arise if the European situation deteriorates. It will continue its monitoring work to ensure the stability of Hong Kong’s currency and financial markets.

(iii) OCI

28. OCI has been prudently monitoring the financial conditions of insurance companies, closely monitoring the impact of possible changes in the market on the financial conditions of insurance companies, and requiring insurance companies to carry out risk management measures. Amidst the uncertainties in the current European as well as global financial markets, OCI has stepped up its review on the financial information of insurance companies, including their investment portfolios and the quality of their assets, and conducting stress tests to ensure that the insurance companies are able to meet capital and solvency requirements. OCI will also be in close contact with insurance companies, so as to keep abreast of their financial conditions and their ability to sustain risks, in order to ensure that they would be competent in coping with possible changes in the market. OCI will take appropriate supervisory measures to safeguard the interests of policyholders when necessary.
(iv) MPFA

29. In terms of potential investment impacts to scheme members, MPFA has been maintaining close contact with MPF trustees to monitor the latest market developments and reminded them to stay vigilant to market changes and formulate contingency plans as appropriate. Moreover, all MPF funds have to comply with stringent investment requirements and restrictions. Similar to other investments, MPF cannot be immune to global market condition. Nevertheless, scheme members need not to be overly worried about short-term market fluctuations as MPF are long-term investments. Besides, with MPF investments made on a regular basis with the same amount of capital irrespective of the prices, more MPF units are purchased when prices are low and fewer units are bought when prices are high, thus enjoying the benefits of dollar-cost average. Scheme members will receive better returns when the market turns optimistic.

II. Strengthening the regulatory requirements and risk management

30. The Administration together with regulators is committed to implementing and coordinating various measures to improve the quality of the financial market and ensure that Hong Kong’s regulatory system is on a par with international standards. To maintain the stability of our financial system, and ensure that Hong Kong is resilient enough to face the challenges ahead, the Administration has already strengthened regulatory efforts in a number of areas.

(i) Short Position Reporting Regime

31. For short-selling in stocks, Hong Kong’s regulatory regime on short selling activities has always been very robust when compared with various overseas markets. For example, naked short selling activities are generally prohibited, and short selling activities are subject to the “uptick rule”, i.e. short selling cannot take place at a price lower than the best ask price at that time. These measures can effectively reduce the risks that short selling activities may bring to the market. To enable SFC to collect more market information so as to strengthen its market surveillance ability, we have introduced the new short position reporting regime through legislation in June 2012, requiring those who hold short positions in specific shares to report to the SFC. Starting from 7 September 2012, SFC will publish the aggregate short positions of each stock in an anonymous manner three business days after they received the reports.
32. Separately, the Hong Kong Exchanges and Clearing Limited has reviewed earlier the eligibility criteria for designating securities for short selling, and decided to amend the relevant eligibility criteria to reflect the developments of the securities market in Hong Kong. The eligibility criterion related to the market capitalisation and turnover velocity (i.e. the ratio of aggregate turnover during the preceding 12 months to market capitalisation) will be increased from $1 billion to $3 billion, and from 40 per cent to 50 per cent respectively. The revised short selling eligibility criteria have been approved by the SFC and will come into effect on 3 July 2012.

(ii) Basel III

33. To enhance the resilience of the global banking system, the Basel Committee on Banking Supervision (“BCBS”) has put forward a set of enhanced capital requirements and global liquidity standards. Hong Kong, as a major international financial center and a member of BCBS, will follow the internationally-agreed implementation timetable, so as to ensure that the capital and liquidity framework of Hong Kong’s authorised institutions aligns with the international standards and are on par with those applying to other financial institutions outside Hong Kong. To this end, we intend to implement Basel III requirements in phases from 2013 in accordance with the BCBS’s timetable. The Banking (Amendment) Ordinance 2012 was enacted on 29 February 2012. Meanwhile, the Administration is formulating the amendments to the subsidiary legislation of the Banking (Capital) Rules and Banking (Disclosure) Rules for the first phase of Basel III implementation. HKMA will consult the industry on these amendments in the third quarter this year. We aim to table the subsidiary legislation before LegCo in the fourth quarter.

(iii) The OTC derivatives market

34. To implement the G20 commitments on the regulation of OTC derivatives, the Administration and the regulators are now working on the regulatory regime of OTC derivatives which seeks to enable regulators to assess, mitigate and manage systemic risks in the OTC derivatives market in a more effective manner. We plan to introduce the relevant legislative proposal to LegCo in the next legislative session.

III. Strengthening Investor Protection

35. Over the past few years, the Administration has been joining hands with relevant regulators to launch a series of measures to strengthen investor protection in a comprehensive manner.
(i) The Financial Dispute Resolution Centre (FDRC)

36. The Administration has been committed to providing protection for investors. In the wake of the global financial crisis, the Administration considered it necessary to establish a financial dispute settlement mechanism to further enhance the protection to investors. In this regard, FDRC came into operation on 19 June 2012. FDRC was incorporated as a limited company by guarantee, aiming to assist financial institutions and their individual clients to resolve monetary disputes through “mediation first, arbitration next”. The maximum claimable amount is $500,000. FDRC is governed by a Board of Directors to oversee its operation and formulate overall policies and strategies. Financial institutions regulated by HKMA and SFC are required to become members of the financial dispute resolution mechanism.

(ii) Investor Education Centre

37. Later this year, SFC will establish a cross-sectoral investor education centre to review and conduct investor education holistically so as to enhance the public’s understanding of investment risks and financial management knowledge.

38. The Administration and the regulators will continue to monitor market operation closely, maintain financial stability, improve market quality and strengthen investor protection. We will also facilitate market development, grasp the new opportunities brought by the transfer of economic momentum to Asia, and foster Hong Kong's position as China’s global financial center. Dealing with the current situation, the Administration and the relevant regulators have already implemented various measures to monitor systemic risks in the markets, keeping in close liaison with the regulated institutions and our overseas counterparts, so as to understand the latest operating and financial situation of foreign financial institutions. We are taking active steps to improve market quality, and encourage the sustainable development of Hong Kong’s financial industry. The Administration will continue to be in close cooperation and communication with market players and stakeholders. When necessary, we stand ready to take decisive, effective and timely measures to ensure the normal functioning of the financial markets.

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