

Economic and Banking Environment

Economic activities slowed notably in the second half of 2008 as a result of the global financial crisis and the downturn among Hong Kong's major trading partners. Inflationary pressures receded following weaker domestic demand and smaller increases in food prices and rental costs. Unemployment rose towards the end of the year. With the effects of the global financial crisis on the real sector still unfolding, and the depth and length of recessions in major industrialised economies uncertain, there are significant risks to the economic outlook for 2009.

THE ECONOMY IN REVIEW

Overview

Following the robust economic expansion over the past few years, real GDP growth slowed markedly in the second half of 2008 as the domestic economy was hit by the global financial crisis. For 2008 as a whole, real GDP growth moderated to 2.5% from 6.4% in 2007, reflecting weaker domestic demand and a slowdown in export growth (Table 1). Labour market conditions deteriorated as business owners streamlined their operations under the worsening economic environment. The unemployment rate rose to a 16-month high of 4.1% in December from 3.2% in July. Inflationary pressures receded as lower food and commodity prices dragged down import-price inflation. The decline in property prices in the second half also helped alleviate rental-cost pressures.

Turbulence in global financial markets caused by the collapse of the sub-prime mortgage market in the US resulted in tightened credit conditions in Hong Kong. Interest rates for interbank borrowings rose in September and October before easing gradually towards the end of

2008. On a quarter-on-quarter basis, growth in domestic credit turned negative to -3.5% in the fourth quarter of 2008 from 2.7% in the third quarter, in part reflecting more conservative lending by banks. Meanwhile, growth in Hong Kong dollar broad money picked up to 2.9% from 2.6%. With domestic credit contracting and broad money expanding, the Hong Kong dollar loan-to-deposit ratio declined to 77.6% in December from a near three-year high of 83.8% in August 2008.

Weakening domestic demand

Domestic demand weakened in the second half of 2008, as the effects of the global financial crisis fed through to domestic real-sector activities. Growth in private consumption slowed to 1.8% in 2008 from 8.5% in 2007, as rising unemployment and falling asset prices weighed on household spending. Tightened credit conditions and the weakening external environment also restrained private investment. In particular, machinery and equipment spending contracted by 18.7% year on year in the fourth quarter, while construction spending declined by 3.6%. An expansion in the Government's operating expenditure and the implementation of various relief measures boosted

Table 1 Contribution to real GDP growth by expenditure components (% yoy)

	2008					2007				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	4.5	2.2	0.0	-1.9	1.1	3.1	4.7	6.3	5.5	5.0
Government Consumption Expenditure	0.1	0.3	0.2	0.2	0.2	0.2	0.3	0.2	0.3	0.2
Gross Domestic Fixed Capital Formation	2.1	1.1	0.7	-3.7	-0.1	0.1	1.5	-0.2	1.7	0.8
Change in Inventories	-0.4	-0.2	0.7	-0.9	-0.2	0.8	1.2	0.6	1.5	1.0
Net Exports of Goods	-1.1	-1.5	-1.6	3.2	-0.1	-1.7	-3.7	-3.7	-5.3	-3.6
Net Exports of Services	2.1	2.4	1.8	0.4	1.6	3.1	2.2	3.6	3.1	3.0
GDP	7.3	4.3	1.7	-2.5	2.5	5.6	6.1	6.7	6.9	6.4

Figures may not add up to total due to rounding.

Source: Census and Statistics Department.

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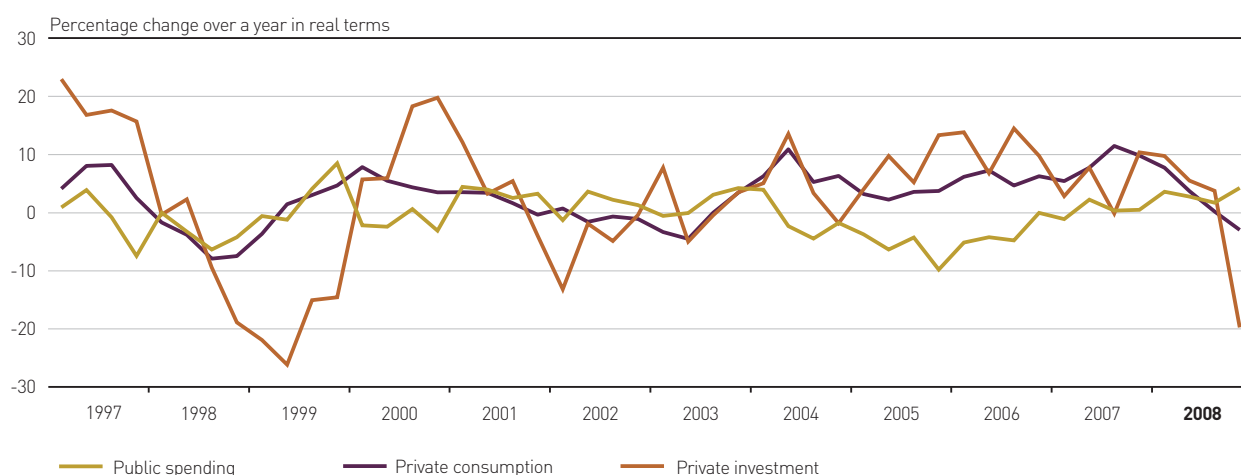
government consumption spending in 2008, which rose by 2% following an increase of 3% in 2007 (Chart 1).

Slowdown in export growth

Hong Kong's export performance deteriorated in 2008, as recessions in the US and other major industrialised economies reduced the external demand from major trading partners. Growth in merchandise exports moderated to 5.1% in 2008 from 9.2% in 2007 in nominal terms. The slowdown in export growth was across the board. Growth in exports to Mainland China declined to

4.7% in 2008 from 13.2% in 2007. Over the same period, exports to the US shrank by 2.4% after contracting by 0.8% in 2007 (Table 2). Because the US and Europe are major final destinations for Hong Kong's exports, there is likely to be a further weakening in the export performance of Hong Kong in 2009 given the economic difficulties faced by those economies. Growth in exports of services also decelerated in the second half of 2008, as the global economic downturn and turbulence in financial markets weighed on offshore trade and external demand for financial services. Meanwhile, imports of goods and

Chart 1 Domestic demand



Source: Census and Statistics Department.

Table 2 Merchandise exports by major trading partners¹

	Share %	2008					2007				
		Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	48	11	8	4	-2	5	13	16	13	11	13
United States	13	-1	-1	1	-7	-2	2	1	-2	-3	-1
European Union	14	8	8	10	-1	6	5	7	6	6	6
Japan	4	-2	-1	3	4	1	2	4	-6	-1	-1
ASEAN5 ² + Korea	7	15	9	3	11	9	5	11	7	11	9
Taiwan	2	3	7	5	0	4	4	11	-4	-2	2
Others	12	30	24	17	-9	14	14	20	17	20	18
Total	100	10	8	6	-2	5	9	12	8	8	9

¹ Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.

² ASEAN5 includes the Philippines, Malaysia, Indonesia, Singapore and Thailand.

Source: Census and Statistics Department.

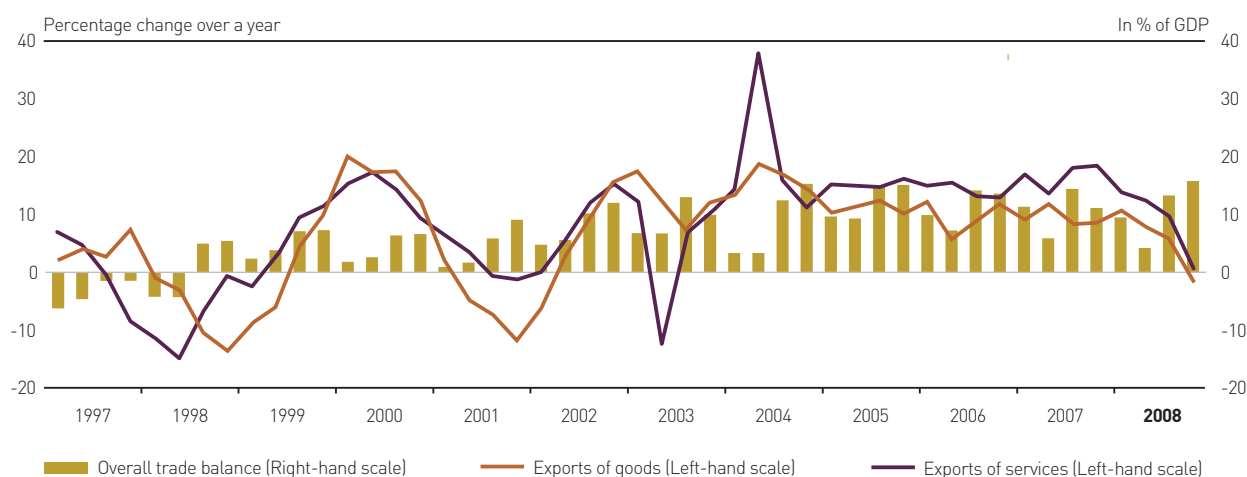
services rose by 6.2% in 2008. Taken together, there was an overall trade surplus of \$182.5 billion (11% of GDP), as against a surplus of \$174.8 billion (also 11% of GDP) in 2007 (Chart 2).

Moderating inflation

Inflationary pressures receded in the second half of 2008 as lower food and commodity prices reduced import-

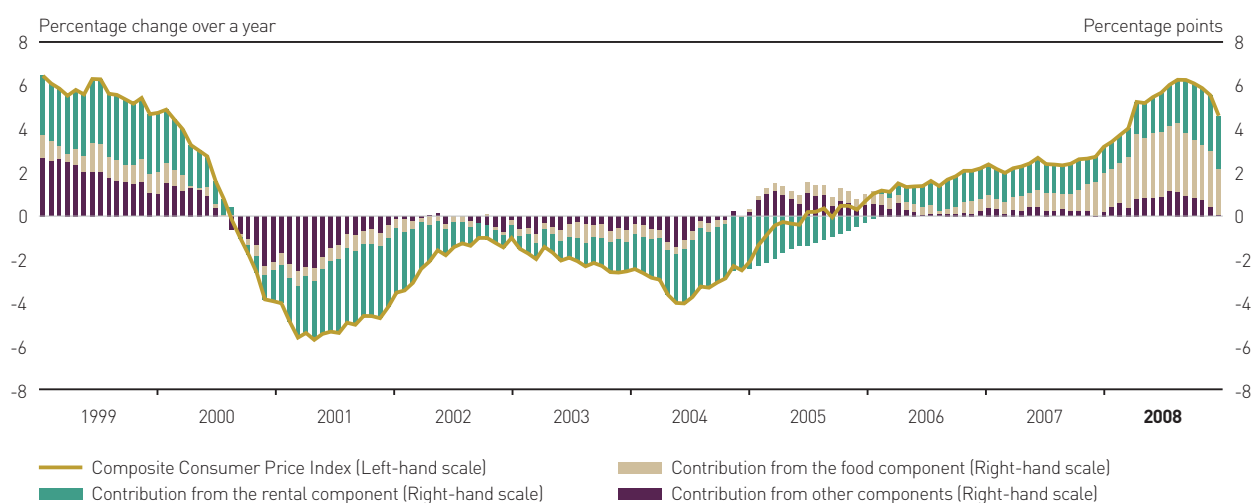
price inflation, while the decline in property prices alleviated rental-cost pressures. After removing the effects of various government relief measures, year-on-year underlying CCPI inflation eased to 4.6% in December from 6.3% in August 2008 (Chart 3). Excluding basic food and energy, core inflation moderated to 4.2% from 4.9% over the same period. For 2008 as a whole, underlying CCPI inflation picked up to 5.6% from 2.8% in 2007, mainly

Chart 2 Overall trade balance and export growth (in nominal terms)



Source: Census and Statistics Department.

Chart 3 Consumer prices¹



¹ The Composite Consumer Price Index and its component indices are adjusted for the effects of special relief measures.

Sources: Census and Statistics Department, and staff estimates.

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driven by higher food prices and rental costs. With the stabilisation of food prices in Mainland China and the moderation in market housing rents, consumer price inflation is expected to ease further in the first half of 2009.

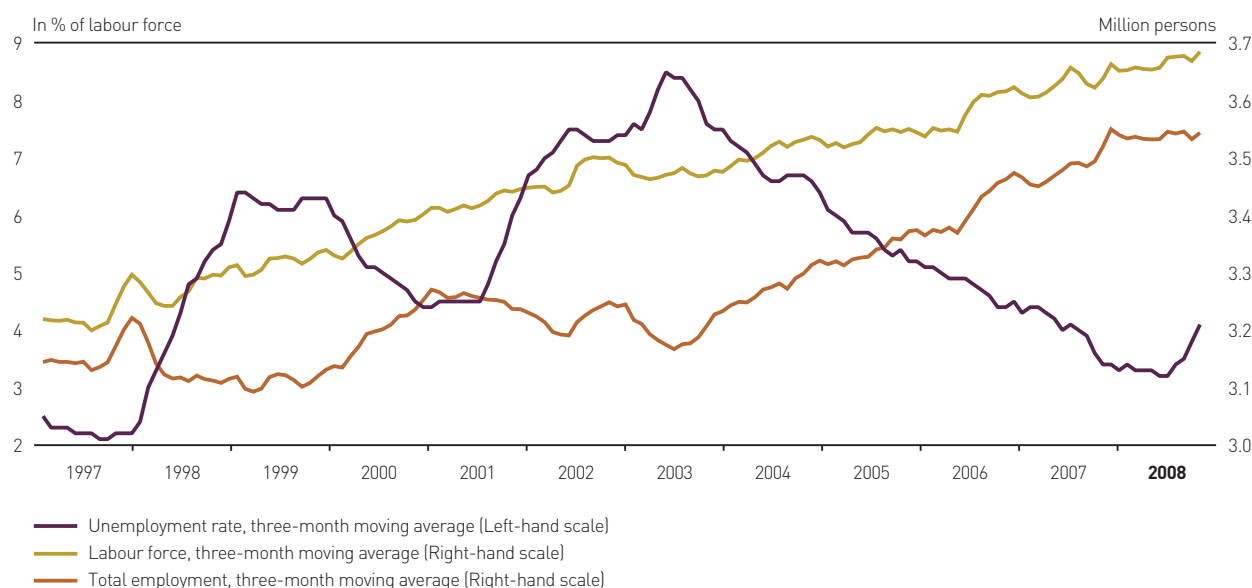
Deteriorating labour market conditions

The slowdown in economic activities and deteriorating business conditions increased the number of unemployed in the fourth quarter of 2008. The unemployment rate rose to 4.1% in December from 3.2% in July (Chart 4). Growth in total employment moderated to 0.7% year on year in the fourth quarter, the slowest pace of expansion since the fourth quarter of 2003. For 2008 as a whole, the unemployment rate declined to 3.6% from 4.0% in 2007, as employment grew faster than the labour force. The near-term employment prospects are likely to deteriorate as business owners streamline their operations and defer their expansion plans in the face of the uncertain economic environment. There have been increased job losses in the import/export and domestic trade sectors, while more layoffs are expected in the financial services sector.

Plummeting stock prices

The bankruptcy of Lehman Brothers and the failure of a number of large financial institutions in the US and Europe triggered a wave of selling in global stock markets, putting downward pressure on domestic equity prices. The Hang Seng Index (HSI) lost nearly half its value during 2008, closing at 14,387 at the end of the year. The decline was across the board, with financial and property-related stocks registering the biggest drop in value, while the H-share index fell more than 50% in 2008. Heightened risk aversion and shattered investor confidence restrained stock market activities, with the average daily turnover shrinking by 18% to \$71.8 billion in 2008. The sharp decline in equity prices drove down the price/earnings ratio of the HSI to 8.5 times at the end of 2008 from 21 times a year earlier. The domestic stock market is expected to remain volatile in the near term given the uncertain global economic outlook.

Chart 4 Labour market conditions



Source: Census and Statistics Department.

Downturn in the property market

The residential property market experienced a marked downturn in the second half of 2008, reversing most of the gains recorded between late 2007 and early 2008. By the end of 2008, house prices declined by 17% and transaction volumes by 54% from June, as tightened credit and worsening economic prospects restrained demand from home buyers. The sharp correction in property prices also exerted downward pressure on rental costs, which declined by 19% for residential property and by 4% for office space between June and December 2008. Increased uncertainty surrounding the economic outlook and less favourable labour market conditions will continue to weigh on property market activity in 2009.

OUTLOOK FOR THE ECONOMY

Slowdown in economic growth

The economic outlook for 2009 has deteriorated. Domestic demand is expected to weaken as rising unemployment and worsening business conditions drag down both household and business spending. Re-export trade and exports of services may slow further in the face of recessions in the economies of our major trading partners. Market consensus suggests that the domestic economy will contract by 3.4% in 2009, as economic activities are likely to decline in the first half of the year. The prospects of a recovery hinge on the duration of the US recession and the resilience of Mainland China's economy in withstanding the recession in developed economies.

Easing inflation and rising unemployment

Consumer price inflation is likely to ease further in 2009 as domestic cost pressures moderate due to weaker aggregate demand. Lower food costs and energy prices will keep import-price inflation in check. Residential rents, which have been a major contributor to inflation, are likely to continue their downward trend in early 2009 following the sharp decline in house prices in 2008. Unemployment may rise, as the weakening external environment and deteriorating business sentiment continue to restrain employment growth.

Uncertainties and risks

There are significant risks to the economic outlook for 2009 as the impact of the global financial crisis on the domestic real sector is still unfolding and the depth and length of recessions in major industrialised economies remain uncertain. Sharper-than-expected recessions in the US and Europe, continuing turbulence in global financial markets and a more visible slowdown in the Mainland economy would deepen and prolong the economic downturn in Hong Kong. Despite this highly uncertain external environment, the domestic economy may weather the current global financial crisis better than the Asian financial crisis in 1997-98. The Asian region, particularly Mainland China, has much stronger economic fundamentals than a decade ago, and policymakers have room for manoeuvre, as demonstrated by the RMB4 trillion fiscal package announced by the Mainland authorities. The ultra loose monetary policy in the US has cushioned the Hong Kong economy under the Linked Exchange Rate system in the current downturn. Policy measures unveiled in the 2008/09 Budget and the supplementary relief measures announced by the Chief Executive in July 2008 have also provided a timely fiscal stimulus to the real economy.

 Publications > [Half-Yearly Monetary and Financial Stability Report](#)
 Statistics

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NOTES AND COINS

At the end of 2008, the total value of banknotes in circulation was \$177.2 billion, an increase of 8.4% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to \$8.1 billion, up 11% (Charts 8 and 9). The value of \$10 notes issued by the Government in circulation (both paper and polymer notes) reached \$2.7 billion, an increase of 30% from 2007.

Chart 5 Banknotes in circulation by note-issuing banks at the end of 2008

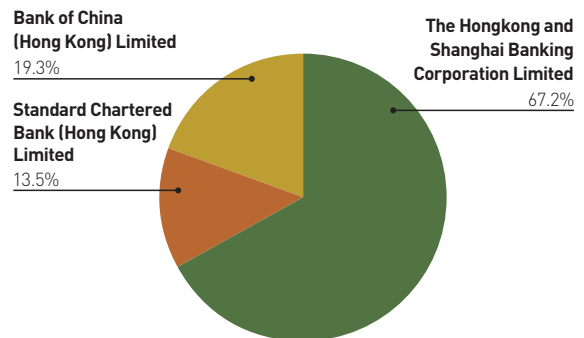


Chart 6 Distribution of banknotes in circulation at the end of 2008

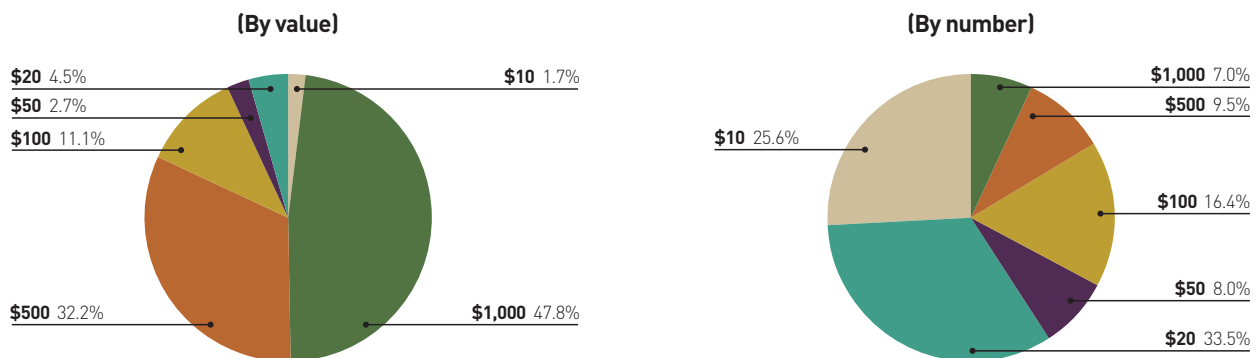


Chart 7 Banknotes in circulation at the end of 2008

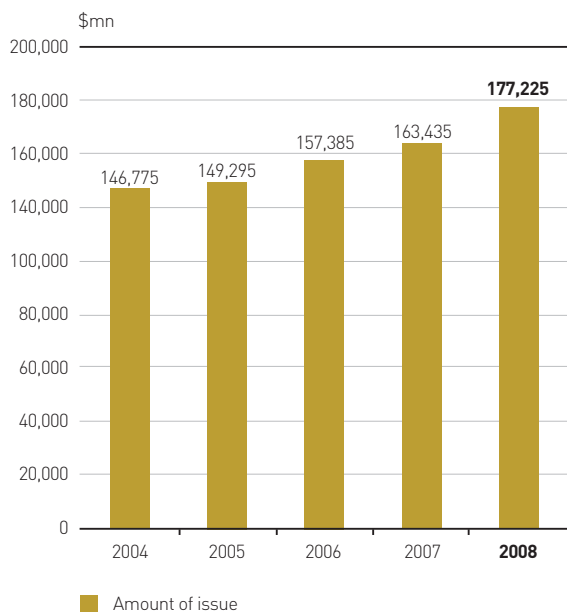


Chart 8 Government-issued notes and coins in circulation at the end of 2008

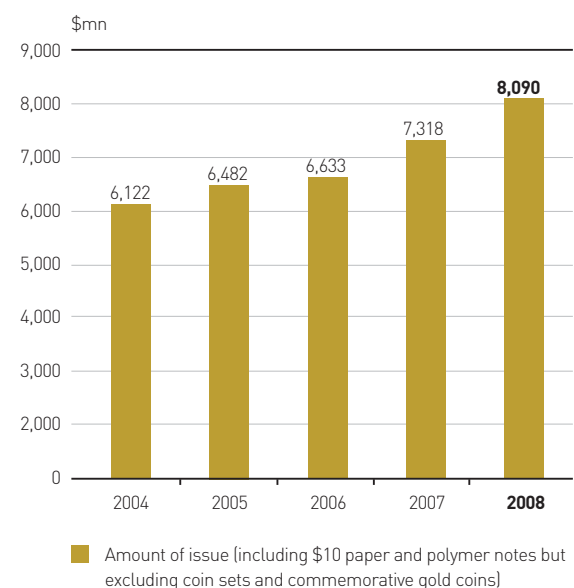
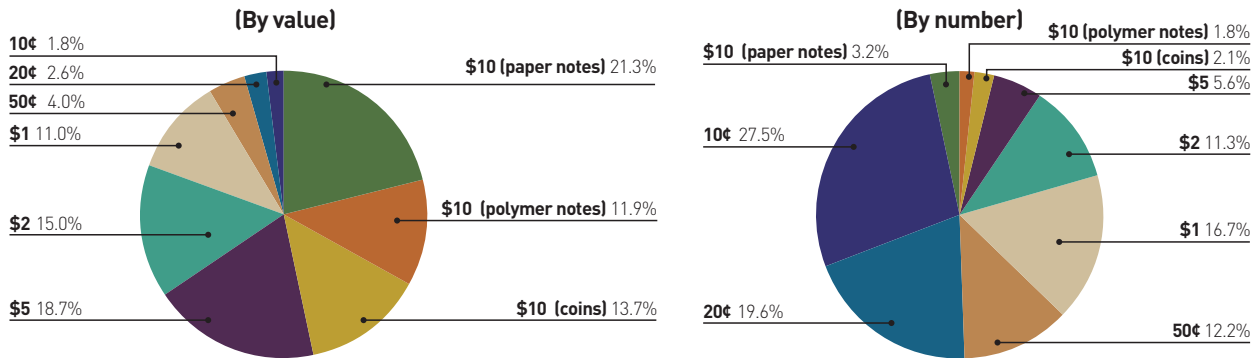


Chart 9

Government-issued notes and coins in circulation at the end of 2008



Hong Kong banknotes

Public education programmes on the security features of the latest series of banknotes issued in 2003 and 2004 continued to be well received. During the year, 31 seminars were organised for over 3,200 bank tellers and retail cashiers, providing them with knowledge and skills for authenticating banknotes.

The HKMA continued its efforts to promote the use of “good-as-new notes”, instead of brand new notes for *lai see* (customary gifts of money given during Chinese New Year). During the year, the HKMA organised a cartoon competition for secondary school students in Hong Kong to promote the use of the “good-as-new notes”. Over 750 students participated.

\$10 polymer note

The Hong Kong \$10 polymer note, which was launched in mid-2007, was in continuous demand. More than 96 million polymer notes were in circulation at the end of 2008, representing 36% of the \$10 notes issued by the Government.

Commemorative Note Issue for the Beijing Olympics

In July four million Bank of China (Hong Kong) Limited \$20 notes commemorating the 2008 Beijing Olympic Games were issued, raising total net proceeds of \$313 million for charitable causes in Hong Kong.

Coin replacement programme

Under the coin replacement programme, 35 million coins bearing the Queen’s Head design were removed from circulation in 2008.

[Consumer Information > Notes and Coins](#)

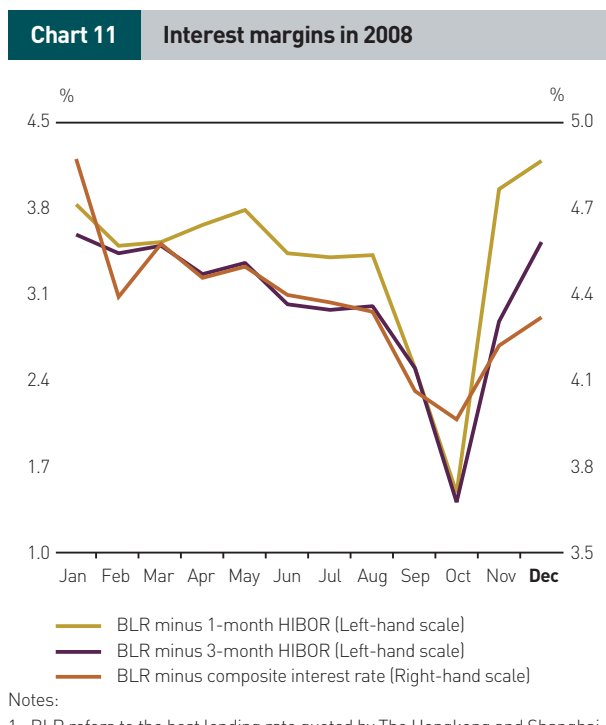
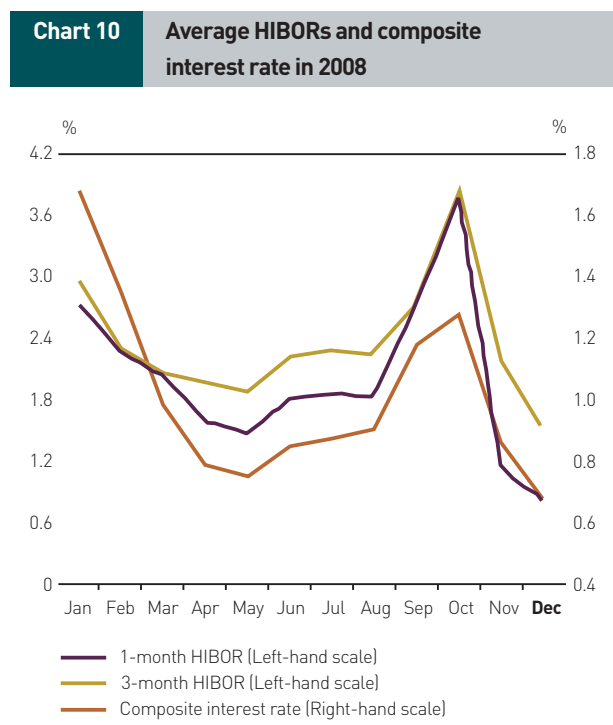
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PERFORMANCE OF THE BANKING SECTOR

Despite a challenging year with profits adversely affected by the global financial crisis, the Hong Kong banking sector remained financially sound and well capitalised. Various asset quality indicators remained good by historical standards, although signs of deterioration in a few of the indicators appeared towards the end of the year.

Interest rate trends

In tandem with monetary easing in the US, Hong Kong dollar interest rates fell in the first half of the year. In September the collapse of Lehman Brothers and a brief deposit run on a local bank drove interest rates sharply higher (Chart 10). As a result, the interest margins of banks narrowed significantly (Chart 11). In the fourth quarter, the situation gradually improved following various measures taken by the HKMA to provide liquidity to the banking system.



Notes:

- 1 BLR refers to the best lending rate quoted by The Hongkong and Shanghai Banking Corporation Limited (monthly average).
- 2 HIBORs are monthly averages.

Profitability trends

The profitability of retail banks deteriorated during the year. The net interest margin, measured on a quarterly annualised basis, declined from 2.00% in the first quarter to 1.78% in the final quarter (Chart 12). For 2008 as a whole, the net interest margin of retail banks fell to 1.84% compared with 1.90% in 2007 (Chart 13).

Chart 12 Retail banks' net interest margin (quarterly annualised)

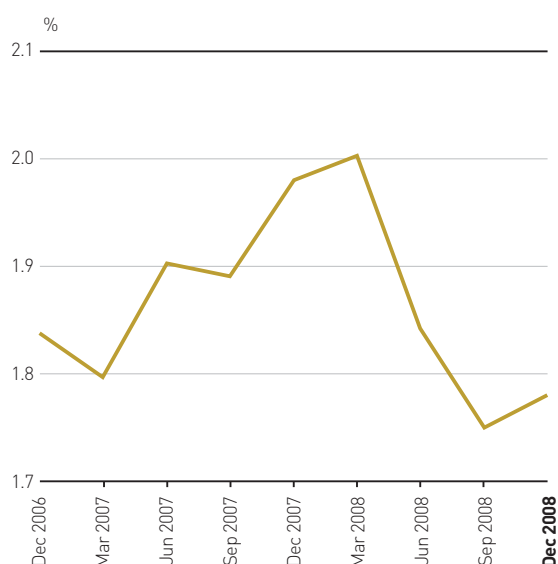
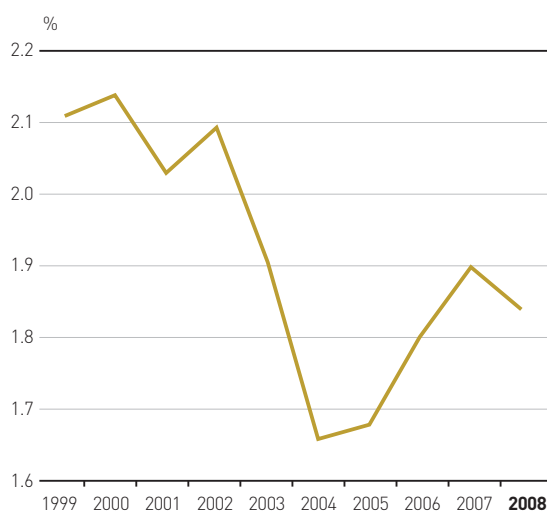


Chart 13 Retail banks' net interest margin (yearly)

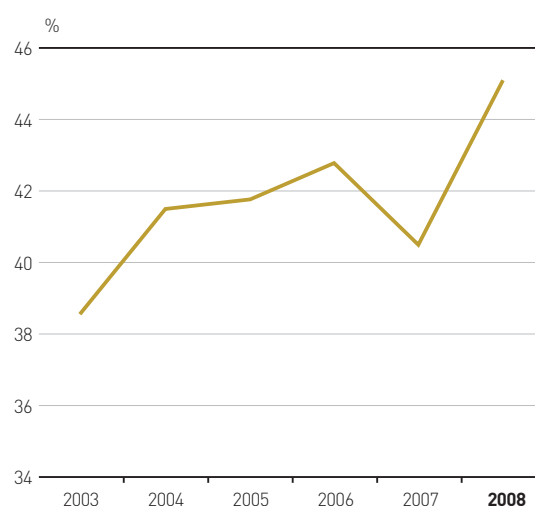


The non-interest income of retail banks recorded a sharp decline in 2008. The lacklustre performance of the local stock market and declining wealth management business led to a reduction in fees and commission income. Losses on investments held for trading further reduced retail banks' non-interest income. As a result, the proportion of non-interest income to total income declined to 37.4% from 43.0% in 2007.

On the other hand, the operating costs of retail banks rose by 3.7% in 2008, with the cost-to-income ratio climbing to 45.1% from 40.5% in 2007 (Chart 14).

A deterioration in the business environment and credit downgrades of assets resulted in an increase in provisions. The net charge for debt provisions increased sharply to \$10.7 billion in 2008 from \$2.1 billion a year ago. The net charge for other provisions, most of which relate to impairment allowances for securities holdings, surged to \$14.6 billion from \$4.4 billion in 2007.

Chart 14 Retail banks' cost-to-income ratio



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As a result of lower income and increased provisions, the aggregate pre-tax operating profits of retail banks' Hong Kong offices fell substantially by 35.7% in 2008 compared with 2007 (Chart 15). The post-tax return on average assets declined to 0.85% in 2008 from 1.48% a year earlier (Chart 16).

Chart 15 Retail banks' year-on-year growth in operating profit before tax

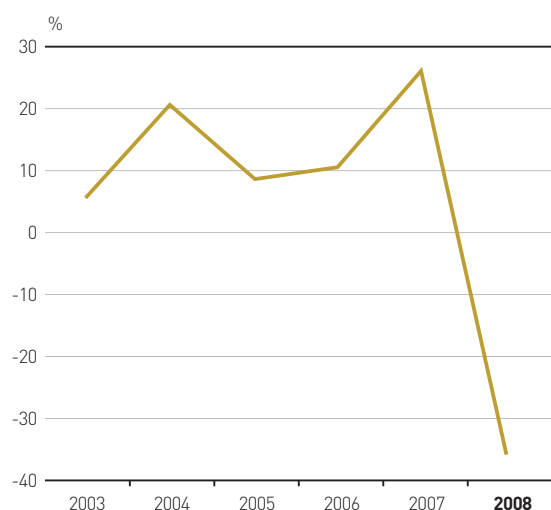
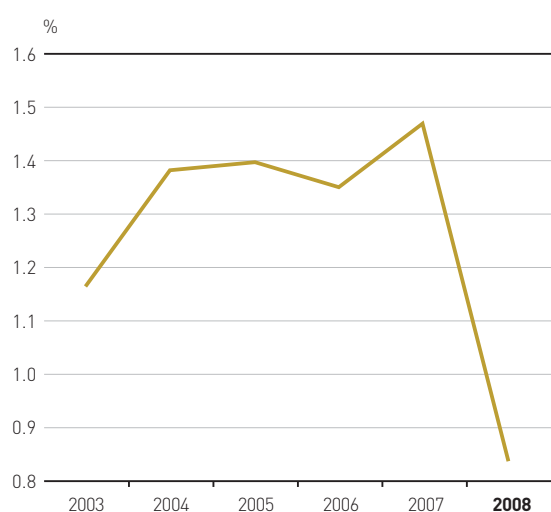


Chart 16 Retail banks' return on assets (after-tax profit)



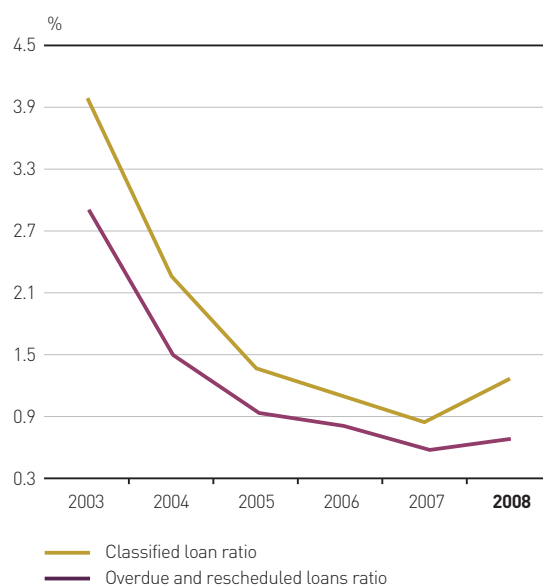
Asset quality

The asset quality of retail banks remained good by historical standards, but a few indicators showed signs of deterioration. The combined ratio of overdue and rescheduled loans increased to 0.68% at the end of 2008 from 0.57% a year earlier. The classified loan ratio increased to 1.24% from 0.85% in 2007 (Chart 17).

The quality of non-bank China exposures also deteriorated. The classified loan ratio for retail banks' Mainland banking subsidiaries rose to 0.98% in 2008 compared with 0.36% in 2007.

The financial crisis, which originated in the US and spread rapidly to Europe and Asia, weighed heavily on the quality of retail banks' debt securities holdings. The amount of securities classified as "special mention" increased to about 0.39% of retail banks' total assets at the end of 2008 from 0.09% a year earlier. Debt securities classified as "sub-standard", "doubtful" or "loss" represented about 0.06% of retail banks' total assets, compared with 0.04% in 2007.

Chart 17 Asset quality of retail banks



The quality of retail banks' residential mortgage lending remained strong. The delinquency ratio declined to 0.05% from 0.11% in 2007 (Chart 18). The rescheduled loan ratio declined to 0.14% from 0.20% in 2007. As a result, the combined ratio of delinquent and rescheduled loans fell to 0.19% from 0.31% in 2007. As property prices declined, however, the outstanding number of residential mortgage loans in negative equity rose to 10,949 at the end of 2008 from 1,861 in 2007.

The results of the credit card survey indicated that the quality of the surveyed institutions' credit card lending remained stable in 2008. The delinquency ratio declined slightly to 0.34% from 0.35% in 2007 (Chart 18). The combined delinquent and rescheduled ratio fell to 0.41% from 0.42% in 2007. The charge-off ratio also fell to 2.72% from 2.90% at the end of 2007.

It should be noted, however, that the quality of credit card and mortgage lending is highly correlated with employment conditions. If the unemployment rate continues to rise, the delinquency ratios of credit card and mortgage lending may reverse their declining trends of the past few years.

[Press Releases > Residential Mortgage Survey](#)

[Press Releases > Credit Card Lending Survey](#)

Balance sheet trends

Total loans and advances by retail banks increased by 10.6% in 2008, while total customer deposits increased by 6.6%. The overall loan-to-deposit ratio of retail banks rose to 47.2% from 45.5% in 2007. The Hong Kong dollar loan-to-deposit ratio rose to 69.4% from 65.1% a year earlier (Chart 19).

Chart 18 Delinquency ratios of residential mortgages and credit card lending of surveyed institutions

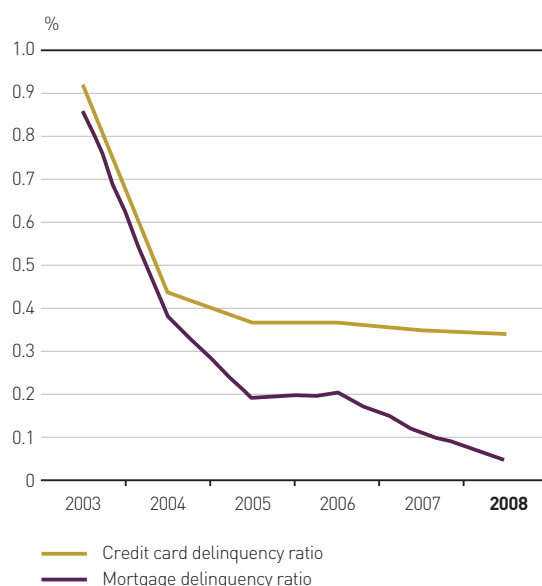
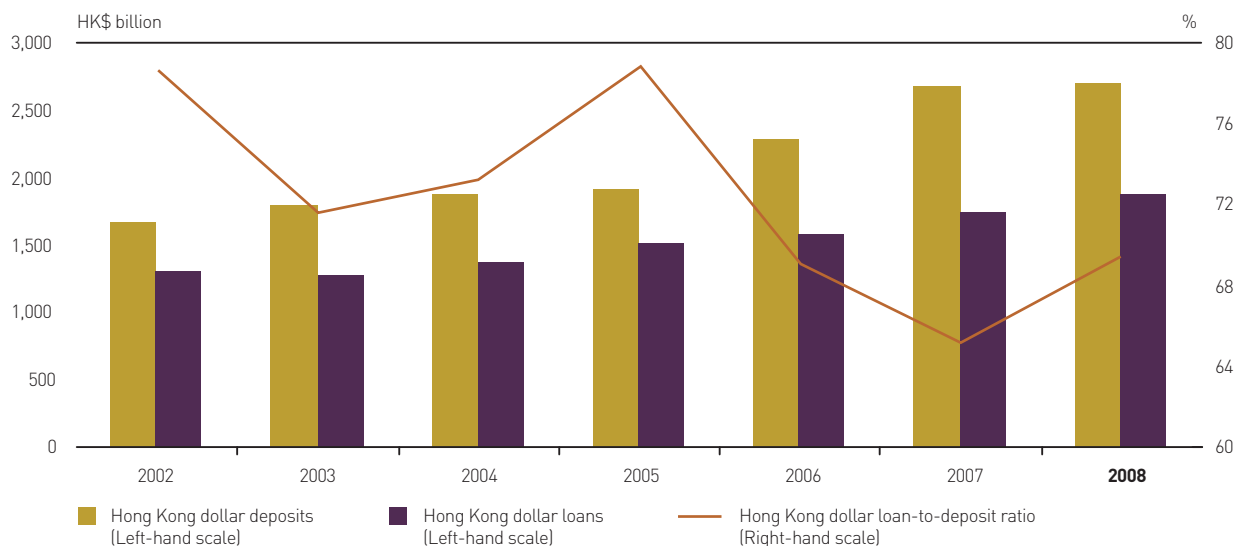


Chart 19 Retail banks' Hong Kong dollar loans and customer deposits



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The changes in retail banks' loans for use in Hong Kong by selected economic sectors are shown in Chart 20. Lending to the manufacturing sector and the wholesale and retail sector grew markedly by 22.9% and 27.4% respectively.

Retail banks' total non-bank China exposures¹ rose to \$644 billion at the end of 2008 from \$568 billion a year earlier. For the banking sector as a whole, non-bank China exposures rose to \$858 billion from \$774 billion at the end of 2007.

Holdings of negotiable debt instruments

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit, increased by 18% in 2008. Of those NDIs, 45% were issued by corporates, compared with 55% in 2007. A flight to quality drove the proportion of government-issued NDIs higher to 32% from 23% in 2007. The proportion of NDIs

issued by banks increased slightly to 23% from 22% in 2007 (Chart 21). The share of retail banks' total holdings of NDIs relative to their total assets increased to 22% at the end of 2008 from about 20% a year ago.

Chart 21 Retail banks' holdings of negotiable debt instruments at the end of 2008 (issuer breakdown)

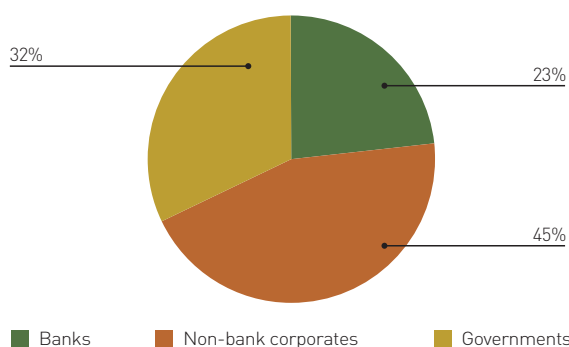
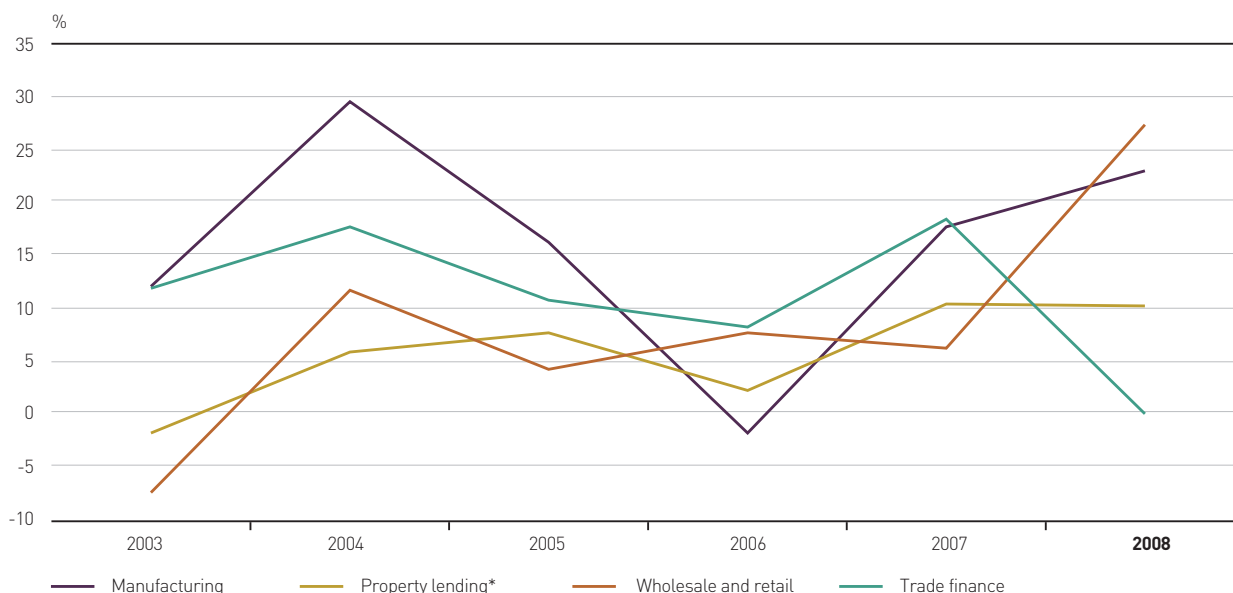


Chart 20 Retail banks' loans for use in Hong Kong by selected sectors (year-on-year growth)



* Property lending denotes lending for property development and investment, and residential mortgage loans (excluding lending under the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme).

¹ Including exposures booked in retail banks' banking subsidiaries in Mainland China.

Capital adequacy and liquidity

The capital positions of locally incorporated AIs generally remained sound despite the difficult operating environment. The consolidated capital adequacy ratio of all locally incorporated AIs rose to 14.8% at the end of 2008 from 13.4% a year ago. Tier-1 capital ratio increased to 11.2% at the end of 2008 from 10.4% in 2007 (Chart 22).

Retail banks generally remained liquid in 2008. In spite of the worsening global financial crisis, the quarterly average liquidity ratio of retail banks stood at 45% in the final quarter of 2008, well above the statutory minimum of 25% (Chart 23).

PROSPECTS FOR 2009

The operating environment remained difficult in the early part of 2009 and is likely to remain so for much, if not all, of the year. The global financial crisis will continue to affect the domestic economy. The asset quality of banks may deteriorate further, and banks may need to make greater provisions for bad and doubtful debts. Demand for investment products will remain subdued following the collapse of Lehman Brothers, which triggered numerous complaints about the sale of Lehman-related investment products to retail investors. This may result in a shift of focus from wealth management to traditional deposit-taking and lending business. Despite continued pressure on profitability, the banking system should be well positioned to meet the challenges in 2009.

Chart 22 Consolidated capital adequacy ratio of locally incorporated AIs

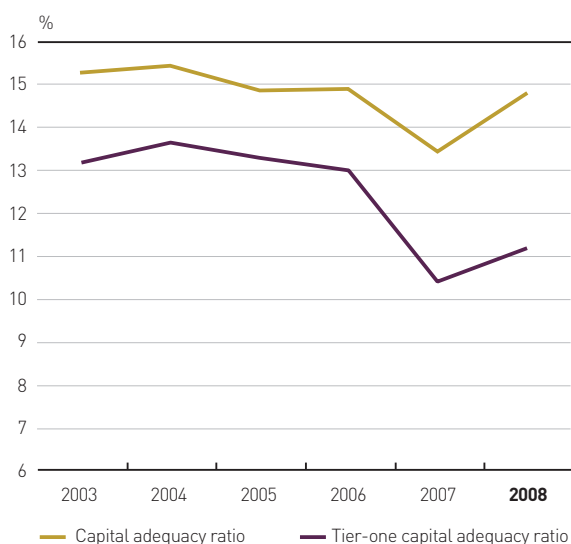


Chart 23 Retail banks' liquidity ratio (quarterly average)

