Economic and Financial Environment

The Hong Kong economy experienced a broad-based recovery in 2010. The outlook for 2011 remains favourable, but consumer price inflation is likely to rise.

THE ECONOMY IN REVIEW

Overview

The recovery in Hong Kong's economy from the global financial crisis was broad-based, with real GDP rising by 6.8%. Supported mainly by private consumption, government investment and net exports, the economy maintained a solid, albeit slowing, pace of growth over the year as the inventory cycle had run its course (Table 1). Labour market conditions continued to improve on the back of buoyant economic activity. Following some moderation in earlier months, consumer price inflation revived in the fourth quarter due mainly to surging food prices and rental costs. While equity markets gained some momentum in the latter part of the year, the property market remained buoyant throughout 2010.

Monetary conditions were expansionary in 2010 with interest rates staying at historically low levels and domestic credit experiencing rapid growth. The Monetary Base changed little during the year, with the Aggregate Balance, a measure of interbank liquidity, staying at a high level. Monetary aggregates rose gradually during the second half following a largely flat path in the first half. While short-term interbank rates remained low, the Hong Kong dollar spot exchange rate fluctuated on the strong-side of the Convertibility Zone for most of the year without triggering the Convertibility Undertaking. Major developments in renminbi business since the beginning of the year set off a surge in renminbi deposits. Despite this, Hong Kong dollar deposits as a share of total deposits remained largely unchanged over the year.

Domestic demand

Domestic demand recovered strongly in 2010. Private consumption growth gathered pace and registered 5.8%, underpinned by solid consumer confidence and continued improvement in labour market conditions. Government consumption also grew steadily by 2.7% (Chart 1). Inventory accumulation contributed substantially to output growth in the earlier part of the year, but weakened in the second and third quarters before picking up again in the latter part of the year in anticipation of stronger domestic demand. Private investment increased in the first half, but reversed its course in the second half amid slower building and construction activities. Overall fixed capital formation increased by 8.1% as public fixed investment expanded notably due to large-scale infrastructure projects in the pipeline.

Table 1 Real GDP growth by expenditure component (quarter on quarter)

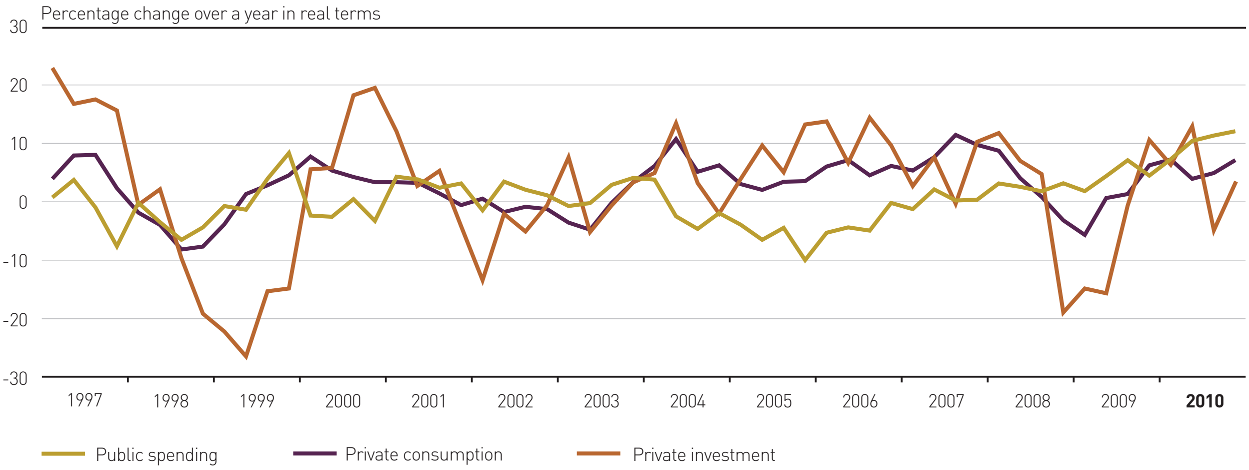
(% quarter-on-quarter seasonally adjusted, unless otherwise specified)	**2010**				2009			
	Q1	**Q2**	**Q3**	**Q4**	Q1	Q2	Q3	Q4
Gross Domestic Product	**1.8**	**1.7**	**0.9**	**1.5**	-3.6	3.6	0.4	2.2
(year-on-year growth)	**8.1**	**6.4**	**6.7**	**6.2**	-7.9	-3.4	-2.1	2.5
Private consumption expenditure	**0.5**	**1.3**	**1.6**	**3.2**	-0.9	4.9	0.4	1.6
Government consumption expenditure	**0.9**	**0.7**	**0.9**	**-0.7**	-0.4	1.6	0.4	0.4
Exports								
Exports of goods	**6.2**	**3.8**	**1.8**	**-3.4**	-14.2	5.7	0.2	7.9
Exports of services	**4.1**	**2.4**	**2.1**	**0.4**	-3.5	2.8	4.1	6.1
Imports								
Imports of goods	**7.3**	**3.7**	**-1.0**	**-2.2**	-12.5	7.2	4.7	5.6
Imports of services	**2.5**	**2.9**	**0.7**	**1.3**	-4.8	1.3	2.3	5.0
Overall trade balance (% of GDP)	**2.7**	**-0.9**	**12.7**	**8.3**	11.2	6.7	5.0	7.3

Source: Census and Statistics Department.

External demand

External demand recovered in 2010, bolstered by strong economic performance in Mainland China and other emerging market economies, as well as the gradual recovery in advanced economies. Following solid growth in the first half, merchandise exports expanded at a slower pace in the second half due to the lingering uncertainties over the European sovereign debt crisis and increasing volatilities in the exchange rates of major currencies. For 2010 as a whole, merchandise exports grew by 22.8% in value terms (Table 2). Exports of services also experienced a strong growth of 24.6% in value terms. In particular, exports of travel services expanded strongly due to thriving inbound tourism, while exports of transportation services, which are closely connected to merchandise trade, also grew at a firm pace. Imports of goods and services rose in value terms by 25.0% and 16.5% respectively as domestic demand strengthened. The trade surplus amounted to 6.0% of GDP, compared with 7.5% of GDP in 2009 (Chart 2).

Chart 1 **Domestic demand**



Source: Census and Statistics Department.

Table 2 **Merchandise exports across major destinations**[1]

	Share	2010					2009				
	%	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	53	40	26	31	14	27	-24	-5	-8	4	-8
United States	11	4	21	23	15	16	-21	-21	-24	-16	-21
European Union	11	-1	12	21	8	10	-18	-22	-26	-15	-20
Japan	4	13	27	18	13	17	-13	-18	-8	-2	-10
ASEAN5[2] + Korea	7	33	33	23	17	26	-32	-25	-18	-3	-20
Taiwan	2	72	30	18	3	25	-26	-6	3	25	-1
Others	12	19	27	33	25	26	-17	-18	-18	0	-13
Total	**100**	**26**	**24**	**28**	**14**	**23**	-22	-13	-14	-2	-13

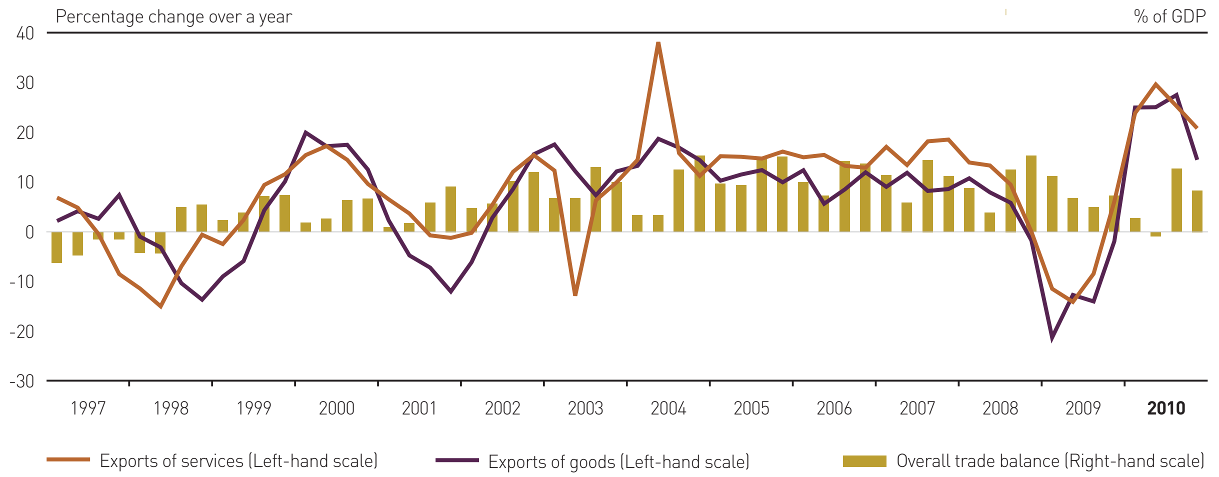
1 Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.
2 ASEAN5 includes the Philippines, Malaysia, Indonesia, Singapore and Thailand.

Source: Census and Statistics Department.

Inflation

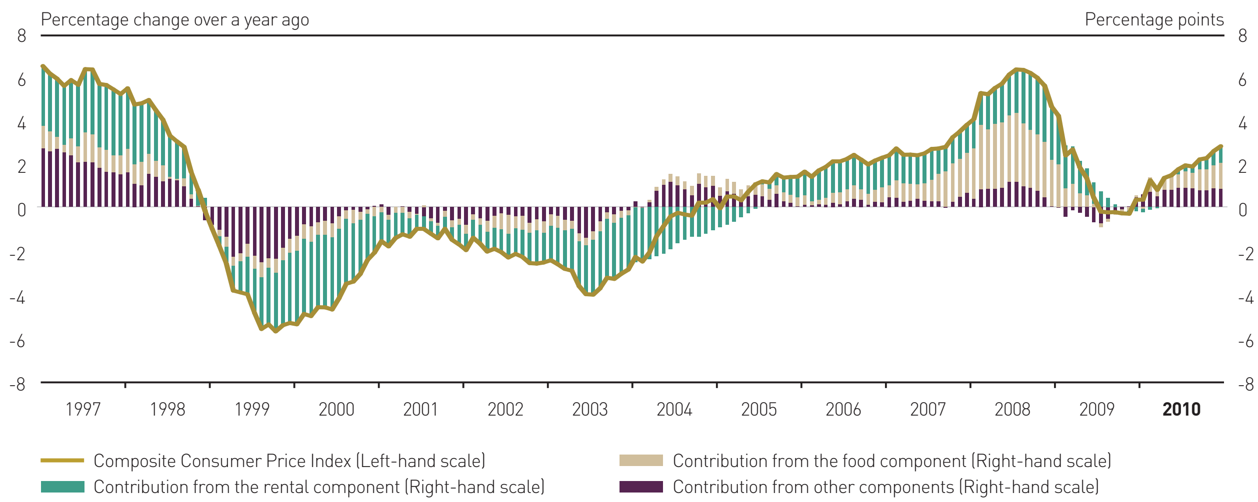
Inflationary pressures increased in 2010, particularly in the fourth quarter, as food prices and rental costs rose gradually. Netting out the effects of government relief measures, the three-month-on-three-month annualised underlying inflation rate reached 2.7% in the earlier part of the year before tapering off to 1.4% in July, largely following the fluctuations in basic food prices and other non-housing prices. After staying flat in the third quarter, the inflation rate picked up again and touched a recent high of 4.3% at the end of the year, reflecting the rise in basic food prices and the filter-through of private housing rental costs. The year-on-year underlying inflation rate trended up throughout the year, reaching 2.8% in December and registered 1.7% for 2010 as a whole, compared with 1.0% in 2009. The headline CCPI inflation also rose to 2.4% from 0.5% a year earlier (Chart 3).

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



Source: Census and Statistics Department.

Chart 3 **Consumer prices[1]**



[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.

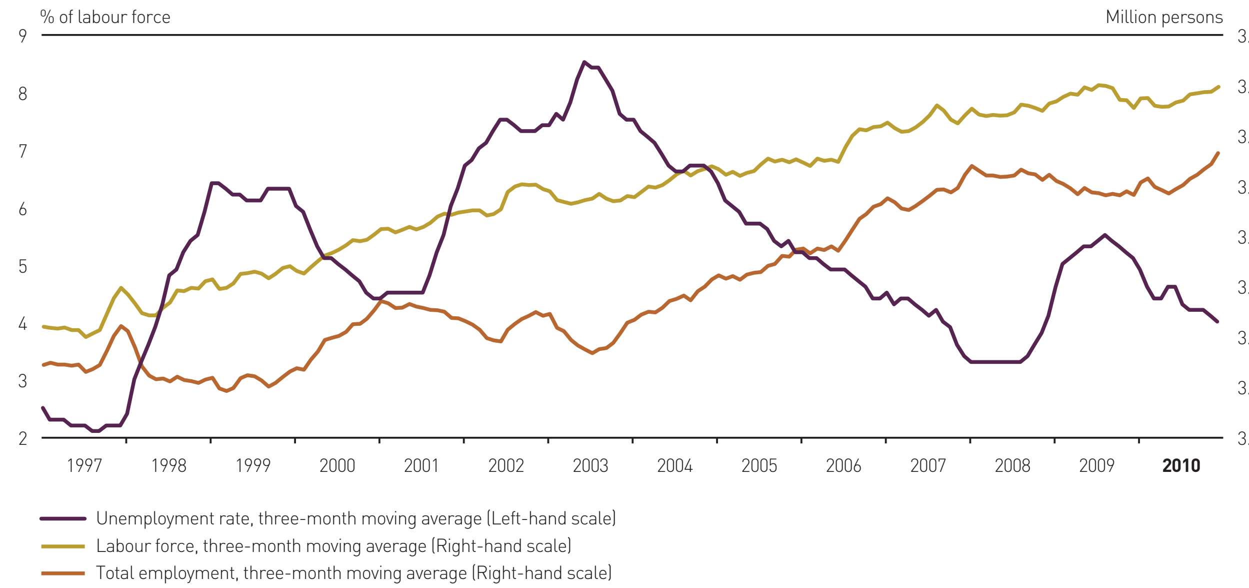
Labour market

Labour market conditions improved further in 2010, supported by strong economic activities. Following a downward trend in the second half of 2009, the seasonally adjusted three-month moving average unemployment rate declined further to 4.4% in March 2010. Heightened concerns over the European sovereign debt crisis had a short-lived impact on the demand for labour in the second quarter. Labour markets resumed improving in the second half underpinned by strong domestic demand and positive business sentiment, with the unemployment rate dropping from 4.6% in June to a two-year low of 4.0% in December (Chart 4). A sectoral breakdown indicated a broad-based improvement in labour market conditions, with manufacturing, construction, and retail, accommodation and food services sectors experiencing significant declines in unemployment rates. Total employment also turned around in June after a slowdown in hiring since February, and rose progressively in the second half to a historical high of 3,563,700 at the end of the year, with gains broadly observed among service sectors.

Stock market

The local stock market had an extended period of consolidation in the earlier part of 2010 amid the bumpy economic recovery of the advanced economies, concerns over sovereign debt problems in Europe and policy tightening on the Mainland. It was not until September that market activities revived visibly, due in large part to the expectation of an appreciation in the renminbi exchange rate, further quantitative easing in the US and solid corporate earnings of blue chip companies listed in Hong Kong. Investor sentiment, however, largely remained cautious throughout the year. At the close of 2010, the Hang Seng Index rose by 5.3% from a year earlier to 23,036. Stock trading picked up, with the average daily turnover increasing by 10.9% to $69.1 billion. Fund raising activities were quiet in the earlier part of the year, but revived later, particularly with the listing of a major Mainland financial institution and a leading pan-Asia life insurer. Equity capital raised through new share floatation and post-listing arrangements on the local stock market reached $858.7 billion in 2010.

Chart 4 **Labour market conditions**



Source: Census and Statistics Department.

Property market

The residential property market boom continued with housing prices rising rapidly by 20.9%. The rise was more notable for flats in the mass market than their luxury counterparts. Residential property trading was highly active, up 18.0% in terms of transaction agreements lodged with the Land Registry. Speculative activities also picked up, as suggested by a surge in re-sale within a short horizon. Mortgage lending also increased rapidly. Although interest rates remained low, housing affordability deteriorated due to a much faster increase in flat prices than household income. Against this background, the Government introduced a series of policy measures to stabilise the residential property market, while the HKMA also deployed a series of macro-prudential measures to protect banking stability and reduce the risk of a credit-asset price cycle. These policy measures have had some effect in preventing excessive mortgage lending and discouraging property speculation.

OUTLOOK FOR THE ECONOMY

Economic environment

The domestic economic environment is expected to remain favourable in 2011. Private consumption growth will continue to be supported by improving labour market conditions, advances in asset prices and solid consumer confidence. Gross fixed investment is expected to strengthen further, underscored by large-scale infrastructure projects in the pipeline and capacity expansion in the private sector amid bright business prospects. For the external environment, the waning global inventory re-building cycle will lead to a moderation in Hong Kong's export growth. Overall, Hong Kong's economic growth is expected to gradually revert to its trend rate. The market consensus in March pointed to real GDP growth of 5.2% in 2011, with the projections of the International Monetary Fund and the Asian Development Bank being 5.0 – 5.5% and 4.3% respectively.

Inflation and the labour market

Inflationary pressures are expected to build up further in 2011. The sharp rises in property prices and market rentals since early 2009 will continue to feed through to the housing component of the Consumer Price Index. Upward pressures from food prices and local costs (such as utilities, education and transportation services) will also likely remain. The mean of the consensus forecasts in March suggested the headline CPI inflation may reach 4.3% for 2011 as a whole. Labour market conditions will continue to improve with the economy on track for healthy growth. Stronger corporate hiring sentiment will drive more job creation with the unemployment rate projected to fall to an average 3.8% in 2011 according to the consensus forecasts.

Uncertainties and risks

The largely favourable outlook for the Hong Kong economy is subject to a number of uncertainties and risks. The predominant external uncertainties include the effectiveness of the US quantitative easing in supporting its recovery, developments in the European sovereign debt crisis that could heighten financial market volatilities and, in a broader context, the speed and strength of recovery in the advanced economies. Any significant adverse developments in these factors could have spill-over effects on Hong Kong through both trade and financial channels. In addition, further macro-tightening in Mainland China to contain inflationary pressures and stabilise the property market could affect market sentiment in Hong Kong and increase asset market volatilities.

Domestically, the risk of overheating in the property market remains a concern. While the measures launched by the authorities over the past few months have had some impact, factors conducive to the formation of asset bubbles remain given the still low interest rate environment. Meanwhile, Hong Kong dollar flows will likely be volatile as interest rate cycles may start turning in the major advanced economies in the period ahead. While the brisk credit growth already poses some risks to local financial stability, the fickle nature of capital flows may increase interest-rate and liquidity risks in the domestic banking system. The rise in property prices and rentals for fresh leases together with increasing food prices will eventually feed through to inflationary pressures in the economy, further strengthening the demand for real assets as a hedge against inflation.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained resilient in 2010, despite heightened concerns about sovereign debt in Europe. The strength in loan growth and improved asset quality reflected the favourable global economic and financial conditions. The capital position of locally incorporated AIs also remained robust.

Interest rate trends

Prompted by concerns over European sovereign debt, Hong Kong dollar interbank interest rates spiked briefly in the second quarter before stabilising at a low level for the remainder of the year, due largely to the accommodative monetary policy adopted by central banks in major developed countries. The composite interest rate, which reflects the average cost of funds of retail banks, remained low (Chart 5).

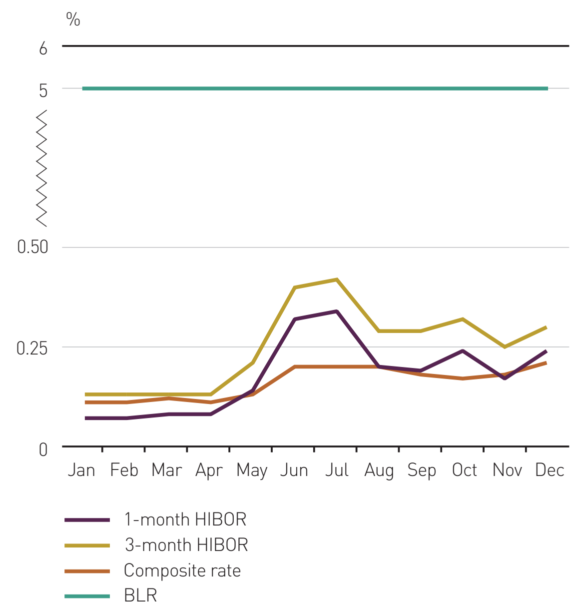
Profitability trends

The aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 10.4% in 2010, while the post-tax return on average assets also edged up to 1.01% from 0.97% in 2009 (Chart 6). Growth in income from fees and commissions and lower debt provisioning levels were the two key drivers for the growth, while net interest income dropped slightly, despite the fast pace of loan growth.

Underpinned by buoyant stock market activities, income from fees and commissions in 2010 increased by 10.3%. The proportion of non-interest income to total income of retail banks rose correspondingly to 47.9% from 45.2% in 2009.

The net interest margin of retail banks narrowed further in 2010 to a yearly average of 1.32%, compared with 1.48% in 2009, due to the persistently low interest rate environment

Chart 5 HIBORs, composite rate and BLR



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

Chart 6 Retail banks' performance

and intense competition for credit business (Chart 7). Net interest income dropped by 1.9% during the year, with the impact of thinner margins being somewhat offset by the strong growth in loans.

Increases in staff and rental expenses pushed up the operating costs of retail banks by 3.5% in 2010. The cost-to-income ratio edged up to 49.8% from 49.7% in 2009 (Chart 8).

Chart 7 **Retail banks' net interest margin (yearly)**

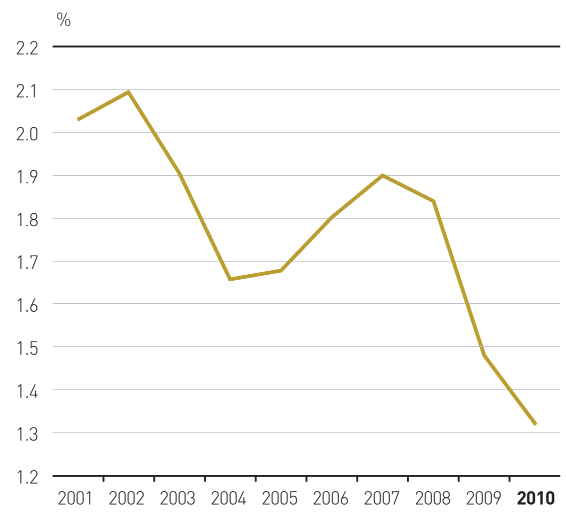
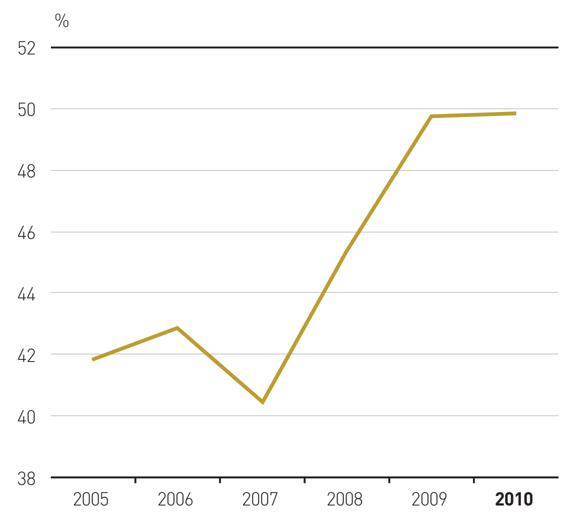


Chart 8 **Retail banks' cost-to-income ratio**

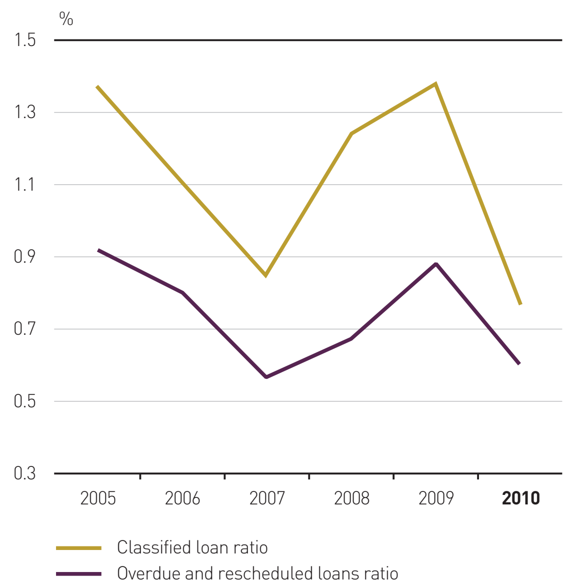


The net charge for debt provisions fell to $1.8 billion from $6.8 billion a year ago, as improved loan quality reduced the loan impairment charges.

Asset quality

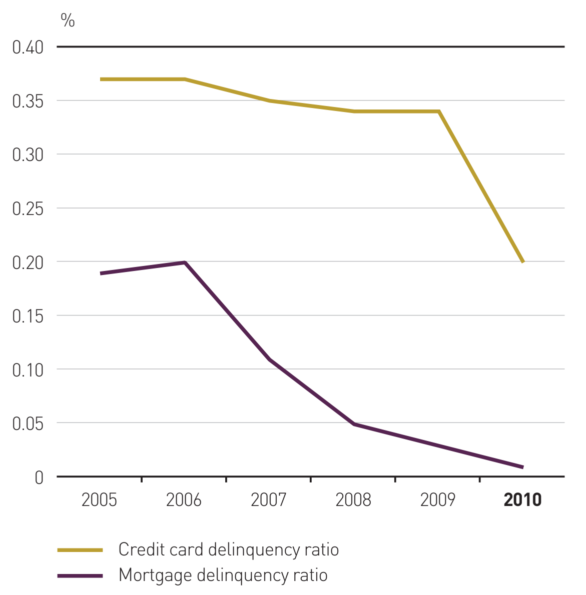
The asset quality of retail banks improved as the Hong Kong economy remained robust and global recovery gained some traction. The classified loan ratio fell to 0.77% at the end of 2010 from 1.38% a year earlier (Chart 9). The combined ratio of overdue and rescheduled loans was also lower at 0.60% compared with 0.88% at the end of 2009.

Chart 9 **Asset quality of retail banks**



The quality of surveyed institutions' residential mortgage lending remained sound. The delinquency ratio edged lower to 0.01% from 0.03% in 2009 (Chart 10). The rescheduled loan ratio declined to 0.04% from 0.09% in 2009. Higher property prices reduced the outstanding number of residential mortgage loans in negative equity to 118 cases at the end of 2010 from 466 a year ago.

Chart 10 **Delinquency ratios of residential mortgages and credit card lending of surveyed institutions**



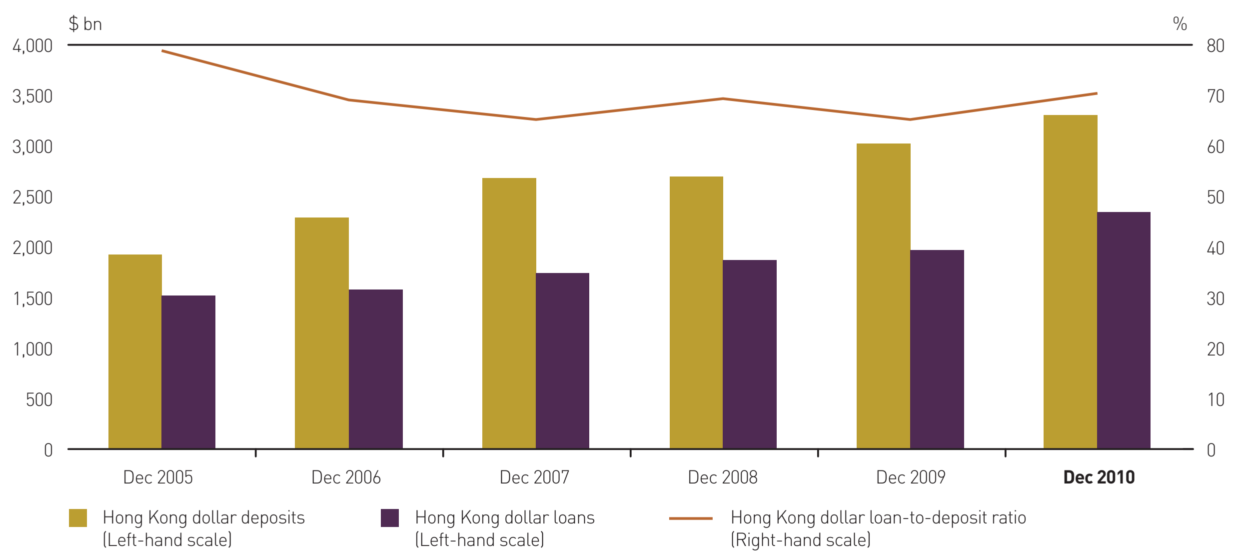
The quality of credit card portfolios also improved, with the delinquency ratio declining to 0.20% at the end of 2010 from 0.34% a year ago (Chart 10). Similarly, the combined delinquent and rescheduled ratio dropped to 0.28% from 0.46% last year and the charge-off ratio fell to 1.91% from 3.71% in 2009.

Balance sheet trends

Total loans and advances by retail banks surged by 26.6% in 2010, while total customer deposits grew by 11.0%. The overall loan-to-deposit ratio of retail banks increased to 52.8% from 46.3% in 2009. The Hong Kong dollar loan-to-deposit ratio also rose to 70.5% from 65.2% a year ago (Chart 11).

Growth in domestic lending was broad-based, which essentially reflected the robust recovery of the local economy. Remarkably strong credit growth was noted in the trade financing and wholesale and retail sectors, and this merits close observation from a supervisory perspective. Property lending also grew strongly, reflecting the buoyancy of the Hong Kong property market. To ensure the resilience of the banking sector, the HKMA introduced two rounds of countercyclical prudential measures on residential mortgage lending in August and November 2010.

Chart 11 **Retail banks' Hong Kong dollar loans and customer deposits**



Retail banks' total non-bank China exposures[1] rose to $1,183 billion at the end of 2010 from $772 billion a year ago. For the banking sector as a whole, non-bank China exposures increased to $1,642 billion from $1,014 billion in 2009.

Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit increased by 4.8% in 2010. However, the strong growth in loans lowered the share of total holdings of NDIs relative to total assets to 26% from about 28% in 2009. Among the holdings of NDIs, 42% were government-issued (44% in 2009), 36% were issued by non-bank corporates (35% in 2009), and 22% were issued by banks (21% in 2009) (Chart 12).

Capital adequacy and liquidity

All locally incorporated AIs remained well capitalised. Largely due to strong loan growth, the consolidated total and Tier 1 capital adequacy ratios of all locally incorporated AIs edged down to 15.9% and 12.3% respectively at the end of 2010, compared with 16.8% and 12.9% a year ago (Chart 13).

Chart 12 **Retail banks' holdings of negotiable debt instruments at the end of 2010 (counterparty breakdown)**

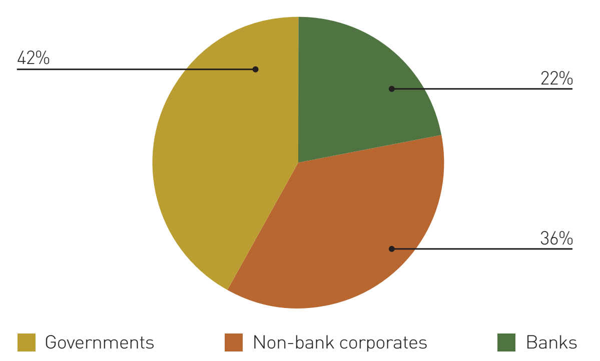
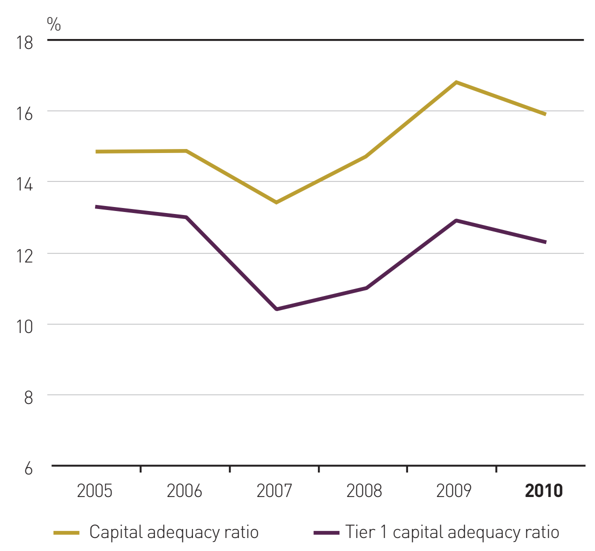


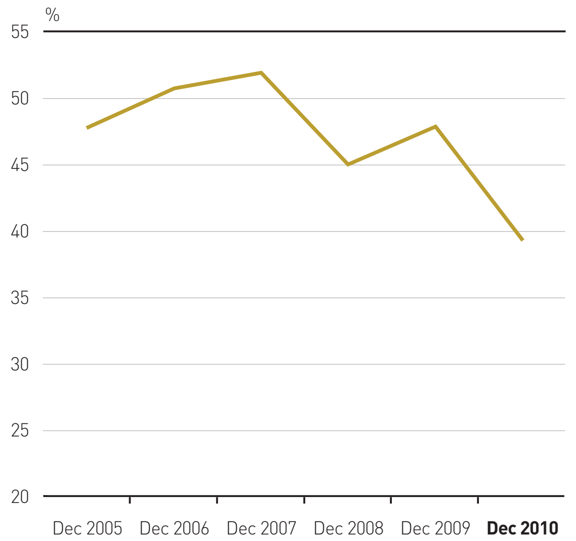
Chart 13 **Consolidated capital adequacy ratio of locally incorporated AIs**



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

With a larger loan book, which is usually less liquid than debt securities and bank placements, the average liquidity ratio of retail banks declined to 39.3% in the final quarter of 2010, down from 47.8% in the same quarter last year, but has remained well above the statutory minimum of 25% (Chart 14).

Chart 14 **Retail banks' liquidity ratio (quarterly average)**



PROSPECTS FOR 2011

The pace of economic recovery in 2010 varied significantly between different countries. The recovery in emerging economies has been much stronger than that of the advanced economies, reigniting concerns over global imbalances. In 2011, vigilance will be needed to address possible tensions created by diverging fiscal and monetary policies across different economies, which may have significant implications for cross-border fund flows, currency exchange rates and asset prices. In addition, the spill-over effect of the European sovereign debt crisis has been manageable so far. However, if the problems spread to other European sovereigns, the potential contagion risk could be significant on a macro-prudential level.

Against this background, it is important for AIs to ensure they are sufficiently resilient to weather unexpected changes in market conditions, such as deterioration in market liquidity or a sharp rise in funding costs. AIs should take account of the inherent pro-cyclicality of the credit cycle. In particular, AIs are expected to assess credit risks vigilantly by analysing carefully the possible impact on asset quality of a sudden reversal in credit growth and a decline in collateral values.

The banking sector should also be alert to the risks associated with an abrupt reversal of the prevailing low interest rate environment triggered by, for instance, capital outflows or an earlier-than-expected change of monetary policy in the US. An unexpected spike in interest rates could create distress for some overstretched borrowers, resulting in higher delinquency rates. Such a spike may also adversely affect the banks' own financial positions as a result of deteriorating market liquidity and mark-to-market losses on debt securities. Banks are advised to remain vigilant and maintain an adequate cushion of capital and liquidity to safeguard against these systemic risks.