Economic and Financial Environment

Hong Kong's growth momentum slowed in 2011 amid an increasingly austere global environment. In 2012, growth is expected to remain held back by the strong external headwinds, while inflationary pressures are likely to ease.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy moderated over the course of 2011 to grow by 5.0%, down from 7.0% in 2010 (Table 1 and Chart 1). The slowing growth reflected a slackening in the external sector amid an increasingly austere global environment. Domestic demand was remarkably resilient, underpinned by favourable labour market conditions. Inflationary pressures increased sharply in the first half of 2011 but were showing signs of tapering off towards the end of the year. The headline inflation rate reached a post-1997 high of 5.3% for the year. The stock market was subject to volatility throughout the year, while the residential property market has undergone some consolidation.

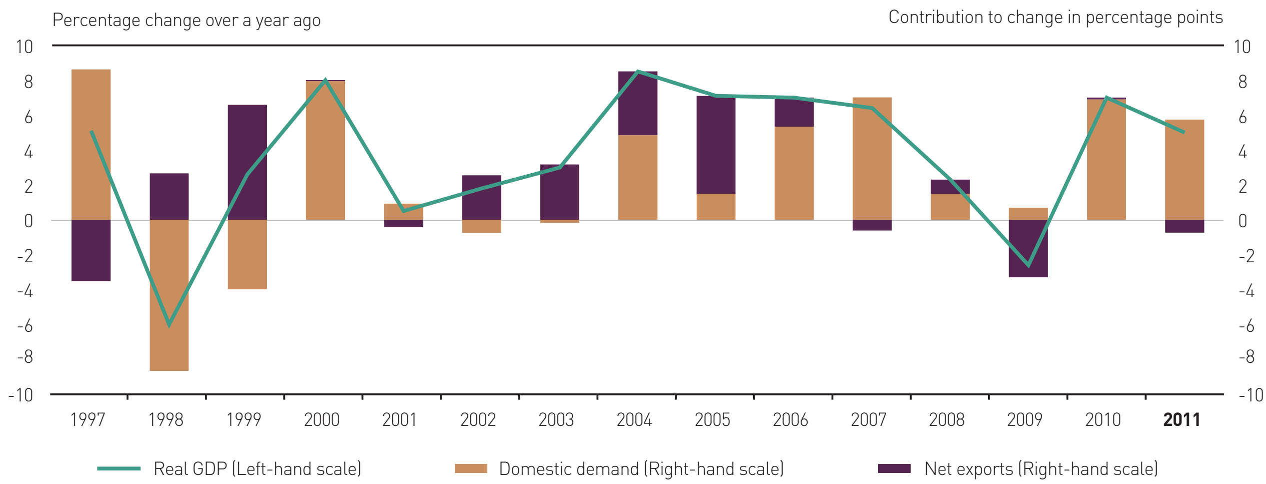
Monetary conditions remained loose in 2011, although there was some tightening in the second half of the year on a rise in the Hong Kong dollar effective exchange rate and interest rates. The Convertibility Undertakings were not triggered and the Aggregate Balance was virtually unchanged at a high level. Credit growth was strong, although the momentum slowed towards the end of the year. Growth in deposits, however, lagged behind the rises in loans, resulting in increases in loan-to-deposit ratios. Banks generally raised their effective deposit and lending interest rates, reflecting upward funding pressures.

Table 1 Real GDP growth by expenditure component (period-over-period)

(% Period-over-period, unless otherwise specified)	**2011**					2010				
	Q1	**Q2**	**Q3**	**Q4**	**2011**	Q1	Q2	Q3	Q4	2010
Gross Domestic Product	**3.0**	**-0.5**	**0.1**	**0.4**	**5.0**	1.9	1.9	0.9	1.7	7.0
(year-on-year growth)	**7.6**	**5.3**	**4.3**	**3.0**		8.0	6.8	6.9	6.6	
Private consumption expenditure	**0.6**	**3.1**	**2.1**	**1.0**	**8.6**	0.9	1.6	1.9	3.7	6.7
Government consumption expenditure	**1.7**	**-0.8**	**1.0**	**0.6**	**1.8**	1.0	0.8	0.8	-0.8	2.8
Exports										
Exports of goods	**10.1**	**-9.5**	**0.7**	**1.5**	**3.6**	4.1	4.7	2.2	-2.1	17.3
Exports of services	**3.5**	**0.6**	**0.1**	**-0.3**	**6.3**	3.8	2.1	2.4	0.7	14.6
Imports										
Imports of goods	**8.6**	**-5.1**	**-0.2**	**0.9**	**4.8**	5.7	3.4	0.1	-0.7	18.1
Imports of services	**-0.6**	**0.5**	**-0.4**	**3.4**	**3.1**	2.1	2.6	1.0	2.0	10.7
Overall trade balance (% of GDP)	**5.6**	**-3.0**	**7.5**	**4.2**	**3.7**	2.7	-1.1	12.5	6.8	5.4

Source: Census and Statistics Department.

Chart 1 Real GDP growth by contribution



Source: Census and Statistics Department.

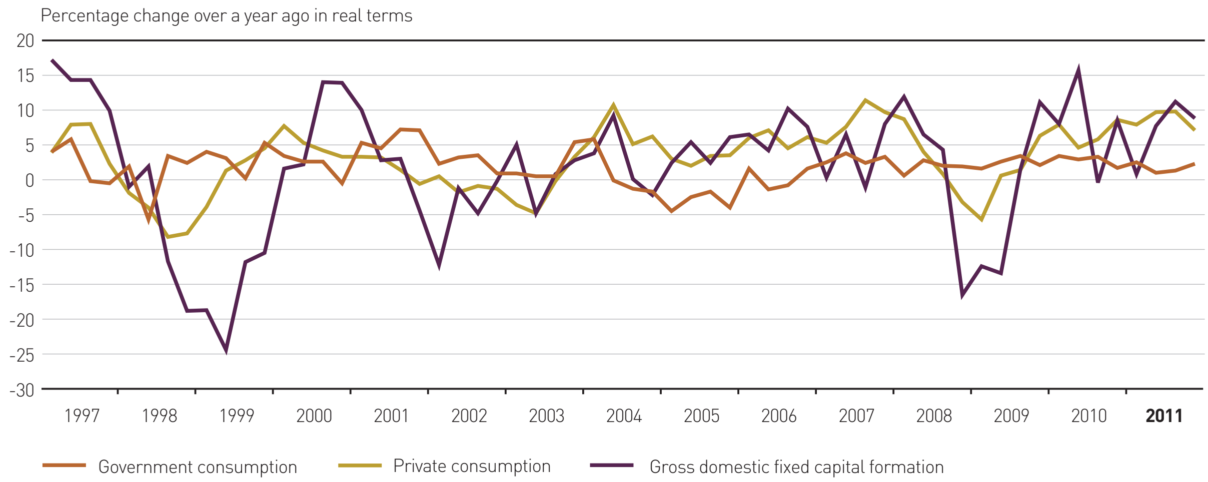
Domestic demand

Domestic demand increased strongly in 2011 (Chart 2). Private consumption grew at a remarkable 8.6%, underpinned by continued improvement in labour market conditions, rising household incomes and solid consumer confidence. Government consumption growth was steady at 1.8%. Overall fixed capital formation increased by 7.2%, with public infrastructure works and private capital spending taking the lead. Private-sector construction activities however remained on a downward trend. Inventory investment decreased slightly to become a drag on output growth.

External demand

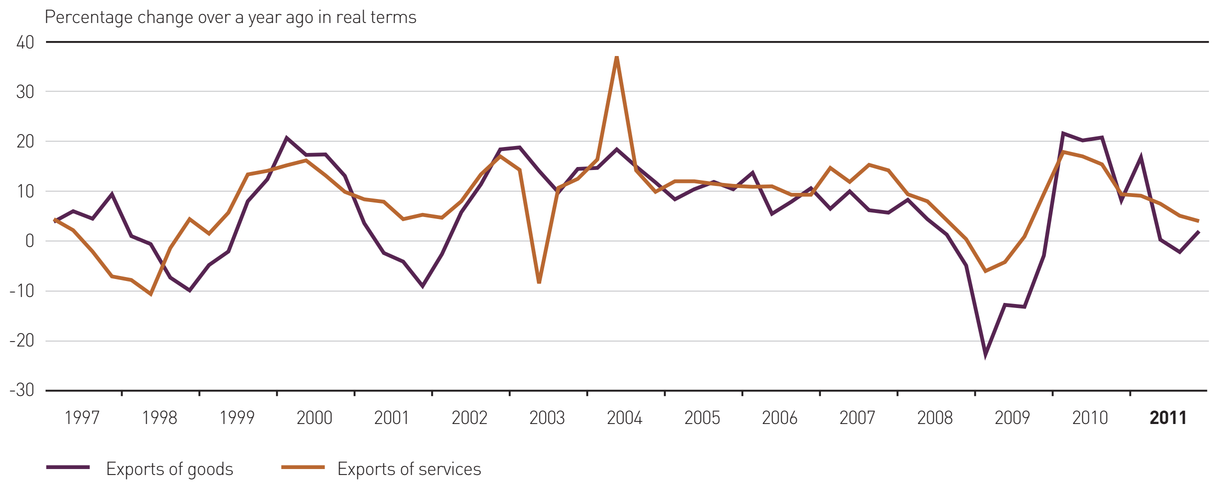
External trade performance slackened amid austere global conditions, in particular the deepening European sovereign debt crisis and sluggish recovery in the United States (Chart 3). Exports of goods increased by 3.6% in real terms in 2011, much weaker than the 17.3% rise in 2010. Exports to the US and other advanced markets faltered, while exports to Asian markets, including Mainland China, also slowed gradually. Exports of services were up 6.3% in real terms in 2011, following a 14.6% increase in 2010. Exports of travel services provided the main growth impetus, but exports of trade-related services and transportation

Chart 2 **Domestic demand**



Source: Census and Statistics Department.

Chart 3 **Exports of goods and services**



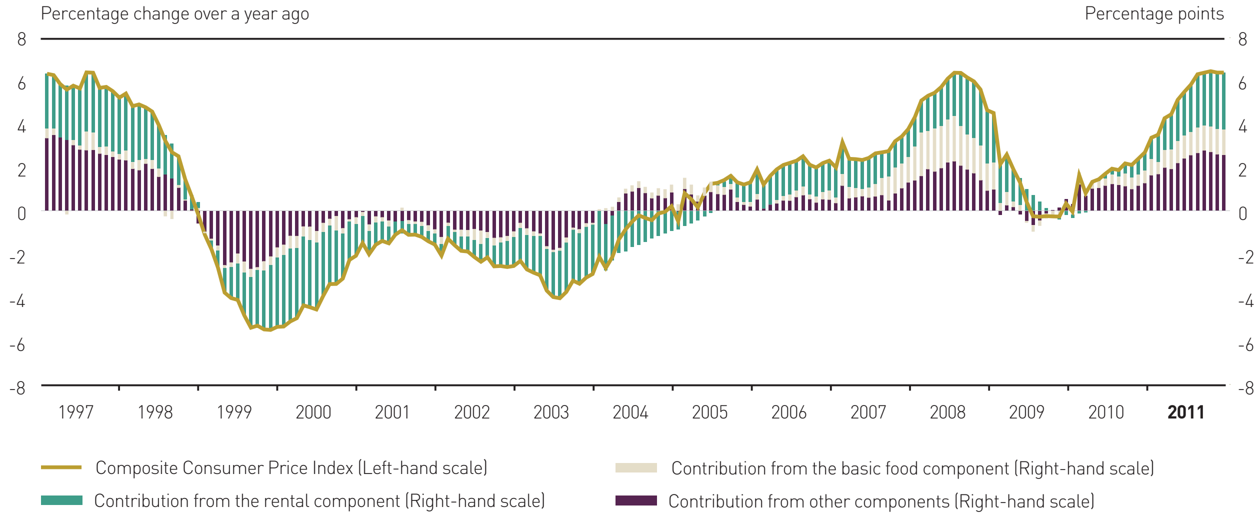
Source: Census and Statistics Department.

services, which are closely connected to merchandise trade, increased at a soft pace. Imports of goods and services rose by 4.8% and 3.1% in real terms respectively as domestic demand strengthened. Overall, net exports dragged down the output growth by 0.8 percentage points in 2011. In nominal terms, the trade surplus amounted to 3.7% of GDP, compared with 5.4% of GDP in 2010.

Inflation

Inflationary pressures increased considerably in 2011. Domestically, the earlier surge in private housing rentals continued to feed through to the housing component of the Consumer Price Index. Meanwhile, labour costs picked up due to a relatively tight labour market, while other non-tradable costs rose on the back of the solid economic growth. On the external front, increases in import prices remained elevated owing to the earlier surge in global food and commodity prices. For 2011 as a whole, the headline inflation rate reached 5.3%, compared with 2.4% in 2010. Netting out the effects of government relief measures, the underlying inflation rose to 5.3% from 1.7% a year earlier (Chart 4). However, towards the end of 2011, inflationary pressures showed incipient signs of tapering off amid a slowing in economic activity and a retreat in global food prices.

Chart 4 Consumer price inflation



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

Sources: Census and Statistics Department, and HKMA staff estimates.

Labour market

The labour market showed broad-based improvements in 2011. Labour demand increased strongly, with job vacancies sustaining a rapid pace of increase, largely offsetting the pressure on labour demand brought about by the implementation of the statutory minimum wage. For the year, total employment rose by 2.9% to a record high, while the unemployment rate dropped to 3.4%, the lowest level since 1997 (Chart 5). In tandem with the relatively tight labour market, wages and earnings rose noticeably across major sectors and occupation categories. Labour earnings rose by 7.9% in nominal terms and 2.5% in real terms. Such increases were more noticeable in the lower decile group, in part due to the additional boost from the statutory minimum wage.

Stock market

The Hong Kong stock market experienced a great deal of volatility throughout 2011, reflecting the jittery global investor sentiment. The Hang Seng Index dropped 20.0% to close the year at 18,434 (Chart 6). The downbeat performance was broadly in line with movements in the major European and emerging Asian markets in US dollar terms. The average daily turnover of the stock market remained virtually unchanged from 2010 at

Chart 5 Unemployment rate

Source: Census and Statistics Department.

Chart 6 Asset prices

Sources: Rating and Valuation Department, and CEIC.

$70.0 billion, but there was a sharp increase in short-selling turnover. Total capital raised through new share floatation and post-listing arrangements decreased by 42.9% to $490.4 billion in 2011.

Property market

The residential property market remained relatively buoyant in the first half of 2011 but cooled down thereafter, reflecting the combined impact of the multiple rounds of stabilising policy measures, a weaker global growth outlook and rising mortgage interest rates. For 2011 as a whole, housing prices rose by 10.9%, despite a 3.9% decline in the period between June and December. Trading activities became increasingly sluggish, falling by 37.8% in 2011 in terms of transaction agreements lodged with the Land Registry. Confirmor transactions and flipping trade dropped notably after the introduction of the Special Stamp Duty in late 2010. New mortgage lending rose in the first half of 2011 but shrank dramatically in the second half. Meanwhile, credit conditions for mortgage lending gradually tightened as mortgage interest rates rose and loan-to-value ratios fell.

OUTLOOK FOR THE ECONOMY

Economic environment

Economic activity is expected to slow visibly in 2012. The stiff headwinds from the external environment – owing to sluggish growth prospects in advanced economies, an unresolved European sovereign debt crisis and the ensuing global market volatilities – will in all likelihood remain a significant drag on Hong Kong's exports. Domestic demand in Hong Kong, mainly driven by private consumption, is expected to provide some cushion against the potential setback in exports. Overall, the Hong Kong economy is expected to expand at a below-trend rate in 2012. Most private sector analysts are currently projecting the economy to grow by 1.6 - 3.9%, averaging at around 3.0%.

Inflation and the labour market

Inflationary pressures are expected to recede in 2012, largely due to the likely slowdown in growth and closing of the positive output gap. Upward pressures from basic food prices and private housing rentals will also likely lessen, albeit remaining significant. Private sector analysts now expect the headline inflation rate to ease to 4.3% in 2012. Meanwhile, labour market conditions will likely become less favourable. Corporate hiring activity is expected to slow amid weaker economic prospects. A number of corporate surveys have already indicated a softening in hiring intentions. Private sector analysts project the unemployment rate to rise gradually to 3.6% by the end of 2012.

Uncertainties and risks

The outlook for 2012 is subject to considerable downside risks, in particular how the European sovereign debt crisis will evolve and whether the euro-zone policymakers can defuse the problems. In the event that the policymakers in the euro zone fail to formulate a decisive and sustainable resolution, causing the debt crisis to degenerate into a full-blown global financial crisis, contagion through the financial channels could knock the global and Hong Kong economy into a much more severe downturn than is expected. At the same time, the continued risks of a double-dip recession in the major advanced economies and of a sharper-than-expected slowdown in the Mainland China economy could heavily weigh on Hong Kong's economic performance.

Risks to the inflation outlook appear to be broadly balanced. Inflationary pressures could ease back further than expected should the economy fall into a deeper downturn. On the other hand, another bout of large-scale monetary easing by the central banks in the major advanced economies could fuel a resurgence in global commodity price pressures, which would translate into higher cost-push inflation in Hong Kong.

Economic and Financial Environment

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained robust in 2011 despite a worsening of the European sovereign debt crisis. Bank lending continued to grow significantly, resulting in tightened liquidity conditions, but the liquidity ratio of banks remained well above the statutory minimum. Asset quality improved further and locally incorporated AIs remained well capitalised.

Interest rate trends

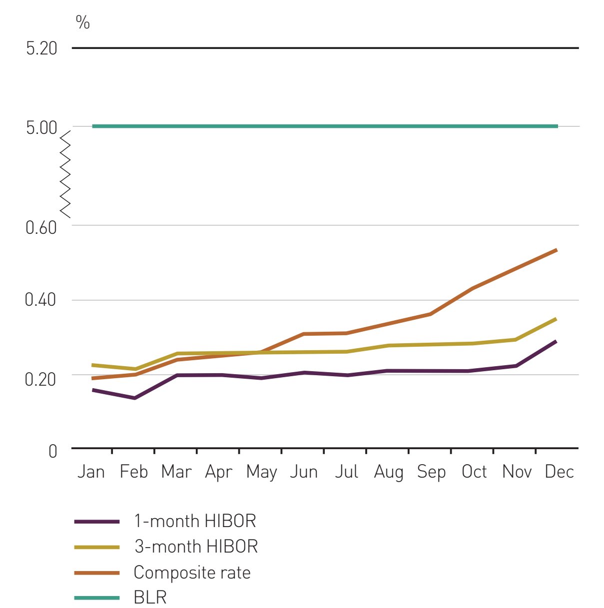
The accommodative monetary policies adopted by central banks in major developed economies extended into 2011. In line with the US dollar rates, Hong Kong dollar interbank interest rates remained low throughout the year. However, the composite interest rate, which reflects the average cost of funds of retail banks, trended higher as retail banks offered higher interest rates to attract customer deposits partly in response to tighter liquidity (Chart 7).

Profitability trends

The aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 18.0% in 2011. As their balance sheets grew briskly during the year, the post-tax return on average assets of retail banks remained stable at 1.01% in 2011 compared with 2010 (Chart 8). Increases in both interest and non-interest incomes contributed to the profit growth.

The net interest margin (NIM) of retail banks narrowed further in 2011 to a yearly average of 1.25% compared with 1.32% in 2010 (Chart 9), mainly due to persistently low interest rates and the competitive lending environment. In view of tighter liquidity, banks started to adjust their pricing strategies more notably in the second half of 2011 by raising loan spreads, such as for residential mortgage lending, and interest rates paid on customer deposits. This resulted in a mild rebound in the annualised NIM in the fourth quarter of 2011 to 1.29%, from 1.19% in the second quarter. For 2011 as a whole, the net interest income of retail banks rose by 11.1%, as the contribution from credit growth more than offset the reduction in NIM.

Chart 7 **HIBORs, composite rate and BLR**

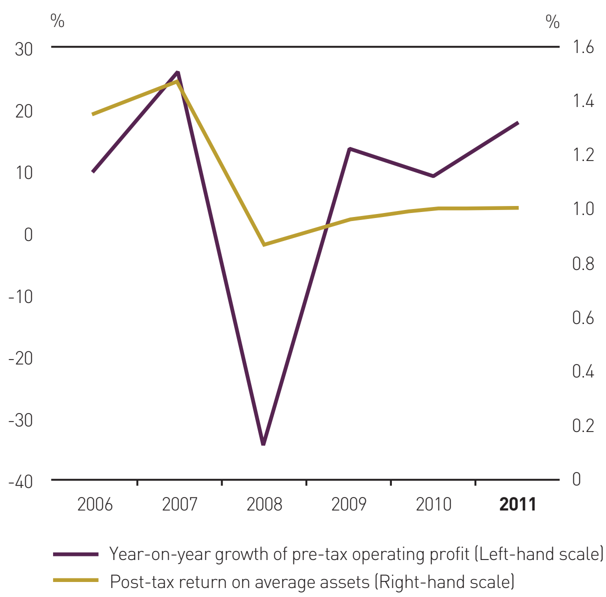


Notes:

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 8 **Retail banks' performance**



Due to strong revenue growth from foreign exchange operations and from fees and commissions, non-interest income of retail banks increased by 9.1% in 2011. With faster growth in net-interest income, the proportion of non-interest income to total income of retail banks slightly reduced to 47.6% from 48.1% in 2010.

The increase in staff and rental expenses more than offset a recovery of Lehman-related expenses incurred previously and drove up the operating costs of retail banks by 3.2% in 2011. However, the cost-to-income ratio was down to 46.8% from 49.9% in 2010 due to the stronger growth in operating income in the period (Chart 10).

Net charge for debt provisions rose to $2.7 billion in 2011 from $1.8 billion in 2010.

Chart 9 **Retail banks' net interest margin**

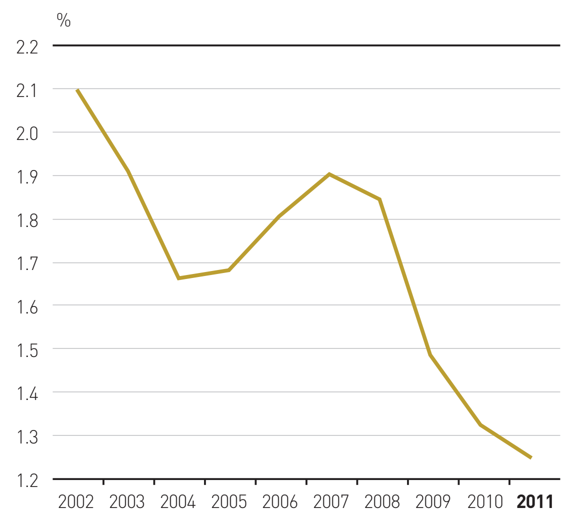
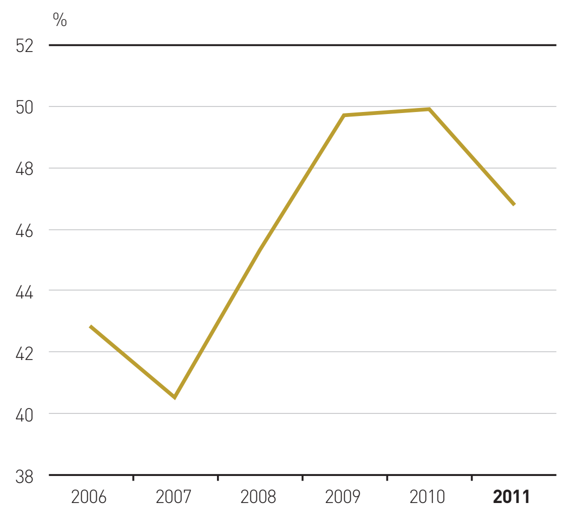


Chart 10 **Retail banks' cost-to-income ratio**



Asset quality

The asset quality of retail banks remained sound in 2011. With a significant growth in bank lending during the period, the classified loan ratio fell to 0.59% at the end of 2011 from 0.77% at the end of 2010 (Chart 11). The combined ratio of overdue and rescheduled loans was also lower at 0.49% compared with 0.60% at the end of 2010.

The quality of surveyed institutions' residential mortgage lending remained solid. The delinquency ratio was unchanged at 0.01% at the end of 2011 (Chart 12). The rescheduled loan ratio edged down to 0.02% from 0.04% in 2010. Although the outstanding number of residential mortgage loans in negative equity rebounded to 1,465 at the end of 2011 from 118 a year earlier, it was lower than the recent peak recorded in December 2008 (10,949). The vast majority of these cases were related to mortgage loans with loan-to-value ratio at 90% or above, including staff housing loans and home loans under the Mortgage Insurance Programme.

The quality of credit card portfolios improved slightly, with the delinquency ratio declining to 0.19% at the end of 2011 from 0.20% in 2010 (Chart 12). Similarly, the combined delinquent and rescheduled ratio declined to 0.25% from 0.28% last year and the charge-off ratio fell to 1.49% from 1.91% in 2010.

Balance sheet trends

Total loans and advances of retail banks grew by 14.3% in 2011, while total deposits rose by 9.1%. The overall loan-to-deposit ratio of retail banks increased to 55.3% from 52.8% in 2010. The Hong Kong dollar loan-to-deposit ratio also rose to 76.2% from 70.5% in 2010 (Chart 13).

Chart 11 **Asset quality of retail banks**

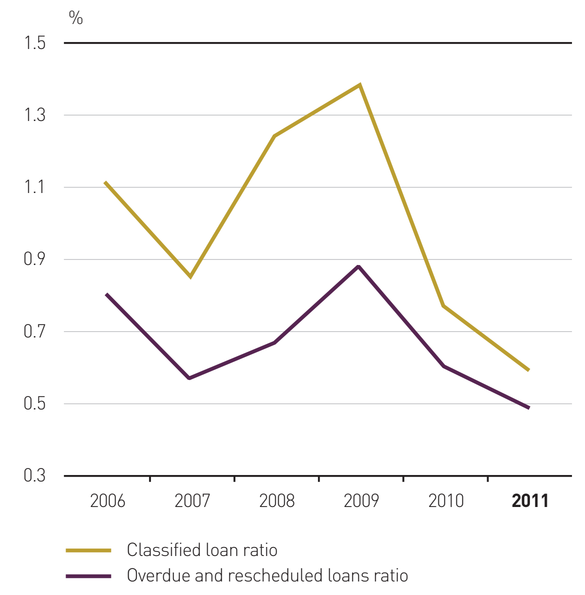
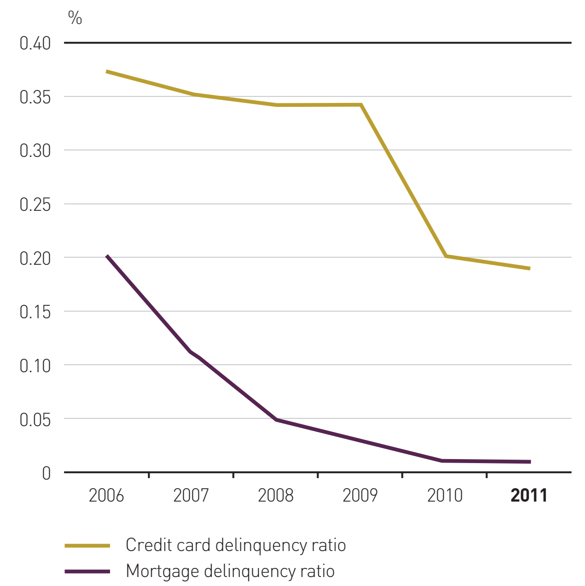


Chart 12 **Delinquency ratios of residential mortgages and credit card lending of surveyed institutions**



While credit growth had moderated since 2011, the overall pace of growth for one year as a whole was still fast. The growth in loans for use outside Hong Kong and trade financing outpaced that in loans for use in Hong Kong. The increase in domestic lending was broad-based with particularly strong growth observed in lending to wholesale and retail sectors.

The continued strong credit growth with milder increase in customer deposits exerted pressure on the liquidity of the banking sector, as reflected in the rising loan-to-deposit ratios. Amid heightened uncertainties of the external environment, the HKMA took a series of supervisory measures to ensure the resilience of the banking sector against potential stress on banks' liquidity and credit risks.

Retail banks' total non-bank China exposures[1] rose to $1,573 billion at the end of 2011 from $1,158 billion in 2010. For the banking sector as a whole, non-bank China exposures increased to $2,318 billion from $1,630 billion in 2010.

Chart 13 **Retail banks' Hong Kong dollar loans and deposits**

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

Economic and Financial Environment

Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit increased by 3.1% in 2011. Compounded by the strong loan growth, the share of total holdings of NDIs relative to total assets reduced to 24% at the end of 2011 from about 26% a year ago. Among the holdings of NDIs, 47% were government-issued (42% in 2010), 31% were issued by non-bank corporates (36% in 2010), and 22% were issued by banks (22% in 2010) (Chart 14).

Chart 14 **Retail banks' holdings of negotiable debt instruments at the end of 2011 (counterparty breakdown)**

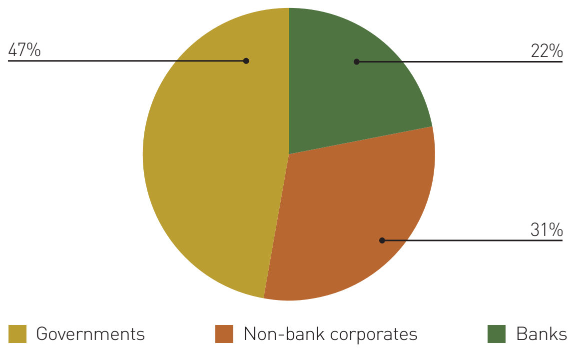
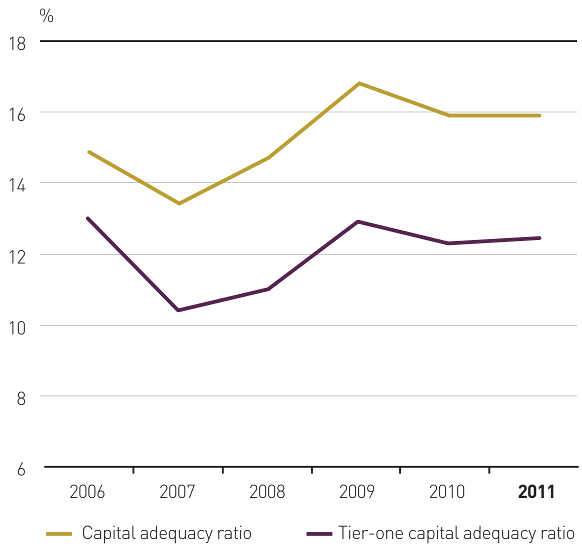


Chart 15 **Consolidated capital adequacy ratio of locally incorporated AIs**

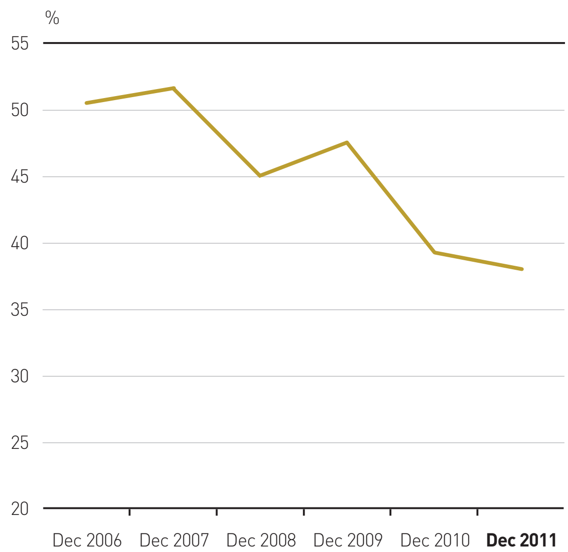


Capital adequacy and liquidity

All locally incorporated AIs remained well capitalised. The consolidated capital adequacy ratio of all locally incorporated AIs was 15.8% at the end of 2011, well above the statutory minimum of 8% (Chart 15). The Tier-1 capital adequacy ratio edged up to 12.4% at the end of 2011 from 12.2% a year earlier as a few banks strengthened their capital positions by raising share capital during the period.

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 38.0% in the final quarter of 2011 from 39.3% in the same quarter in 2010, but remained well above the statutory minimum of 25% (Chart 16).

Chart 16 **Retail banks' liquidity ratio (quarterly average)**



PROSPECTS FOR 2012

The operating environment for banks will continue to be challenging in 2012 in view of heightened uncertainties in the external environment which will affect the domestic economy. Volatility in financial markets has also increased markedly. Against this background, banks must continue to be vigilant towards possible contagion from the European sovereign debt crisis on the Hong Kong banking system and the risk of a sudden outflow of funds. At the same time, it is important to monitor closely the latent systemic impact of continuing rapid credit expansion, and whether the unusually low interest margin environment in Hong Kong may provide incentives for excessive risk taking by banks. In this environment banks should be extra prudent in managing their credit, funding and other risks, including by maintaining robust levels of capital and liquidity.