Economic and Financial Environment

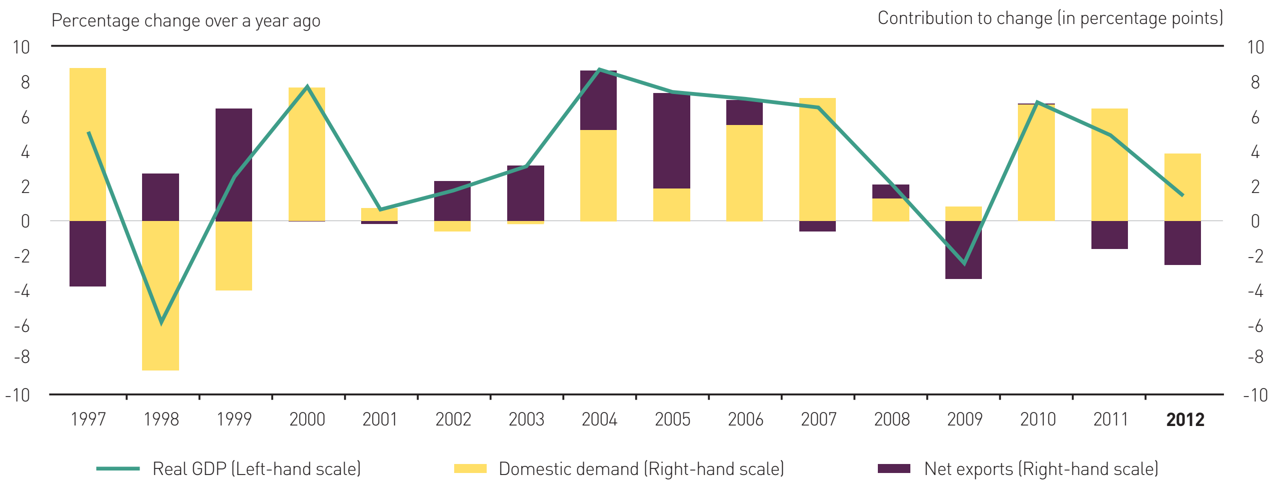
The Hong Kong economy continued to face strong external headwinds, showing only modest growth in 2012. Economic activity is expected to pick up gradually in 2013, but risks to consumer and asset prices remain amid loose global monetary conditions.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy advanced at a tepid pace during the year amid external pressures stemming from the lingering European sovereign debt problems and fragile growth in the US (Chart 1). Domestic demand, on the other hand, remained resilient on the strength of a tight labour market and rising income, robust capital spending and supportive fiscal policy. For 2012, real GDP growth slowed visibly to 1.4% from 4.9% in 2011 (Table 1). Consumer price pressures receded in line with the slowing economy. The stock market fluctuated in the first half, but shored up later in the year with increased investor demand amid fund inflows. The property market turned buoyant again after some consolidation in the second half of 2011, prompting the HKMA and the Administration to introduce fresh rounds of measures to address the increasing risk of overheating.

Chart 1 Real GDP growth by contribution



Source: Census and Statistics Department.

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

(% Period-over-period, unless otherwise specified)	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2012	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2011
Gross Domestic Product	**0.4**	**-0.1**	**0.8**	**1.2**	**1.4**	2.7	-0.4	0.2	0.5	4.9
(year-on-year growth)	**0.8**	**1.0**	**1.4**	**2.5**		7.6	5.1	4.0	3.0	
Private consumption expenditure	**1.3**	**0.0**	**1.3**	**1.5**	**4.0**	1.7	3.0	1.3	0.3	9.0
Government consumption expenditure	**1.3**	**0.9**	**0.8**	**0.7**	**3.7**	1.2	0.1	0.9	1.0	2.5
Exports										
Exports of goods	**0.9**	**-1.7**	**3.0**	**4.8**	**1.3**	8.4	-7.4	0.2	1.1	3.4
Exports of services	**0.3**	**1.1**	**-2.1**	**2.1**	**1.2**	1.2	1.1	0.5	0.1	4.9
Imports										
Imports of goods	**2.3**	**-0.9**	**1.5**	**5.2**	**2.7**	8.3	-4.2	-0.6	0.5	4.7
Imports of services	**0.6**	**-1.0**	**-1.2**	**1.2**	**0.7**	0.4	0.5	0.3	1.2	3.5
Overall trade balance (% of GDP)	**-0.6**	**-5.9**	**4.2**	**1.8**	**0.0**	4.9	-3.4	6.1	4.4	3.1

Source: Census and Statistics Department.

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Monetary conditions remained loose in Hong Kong in 2012. The Hong Kong dollar interbank interest rates still hovered at low levels, while banks' funding costs edged down slightly. In the fourth quarter, the strong-side Convertibility Undertaking was triggered alongside inflows of funds, resulting in a sharp expansion in the Aggregate Balance and the Hong Kong dollar Monetary Base. On the credit side, after two years of rapid growth, bank lending increased at a much slower pace of 9.6% in 2012. If only Hong Kong dollar loans for domestic use were considered, there was just a mild 4.6% growth, which was slower than Hong Kong's nominal GDP growth of 5.4% during the year.

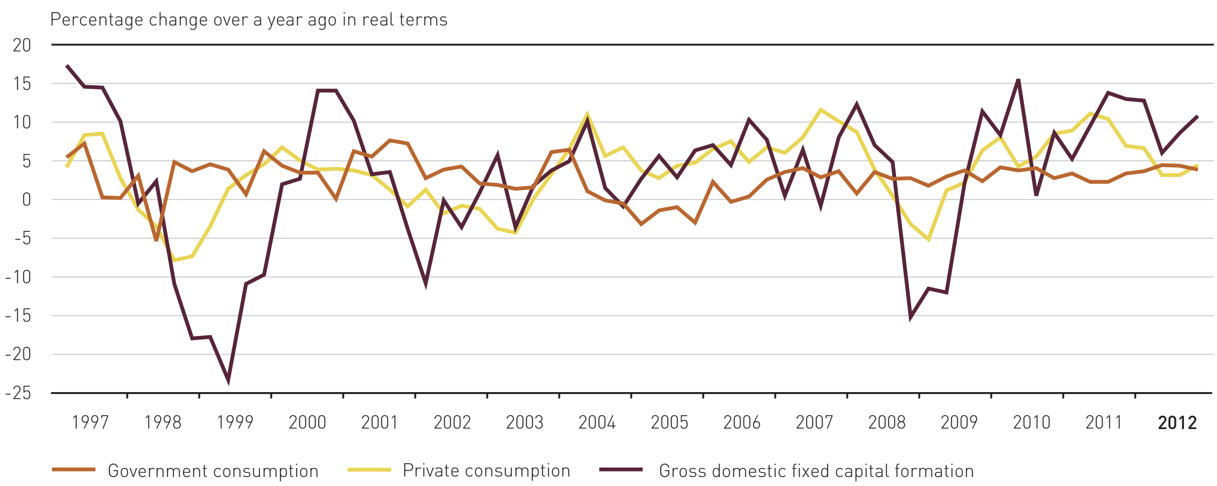
Domestic demand

Domestic demand remained resilient against the external headwinds. Private consumption grew further by 4.0% on the back of stable job and income conditions, greater housing wealth and the fiscal stimulus (Chart 2). Government consumption growth also held up well at 3.7%. While business sentiment was generally cautious, overall fixed capital formation expanded appreciably by 9.1%, buoyed by robust public and private construction activity and increased capital spending on machinery and equipment. Inventory investment, however, remained a drag on output growth.

External demand

External demand for Hong Kong's exports remained weak in general, although signs of improvement were emerging in the second half of the year. Drags continued to come mainly from the still-unresolved European sovereign debt problems and protracted sluggish growth in the US, which also weighed on the activities of Hong Kong's other trading partners. As a result, Hong Kong's merchandise exports struggled, and just managed to increase mildly in 2012, while exports of services grew by a meagre 1.2% (Chart 3). Imports of goods and services still fared relatively well as domestic demand remained firm. Taken together, net exports dragged down output growth by 2.5 percentage points during the year. In nominal terms, the overall trade balance was in surplus, amounting to $0.8 billion (0.04% of GDP), compared with the $60.0 billion surplus (3.10% of GDP) in 2011.

Chart 2 Domestic demand

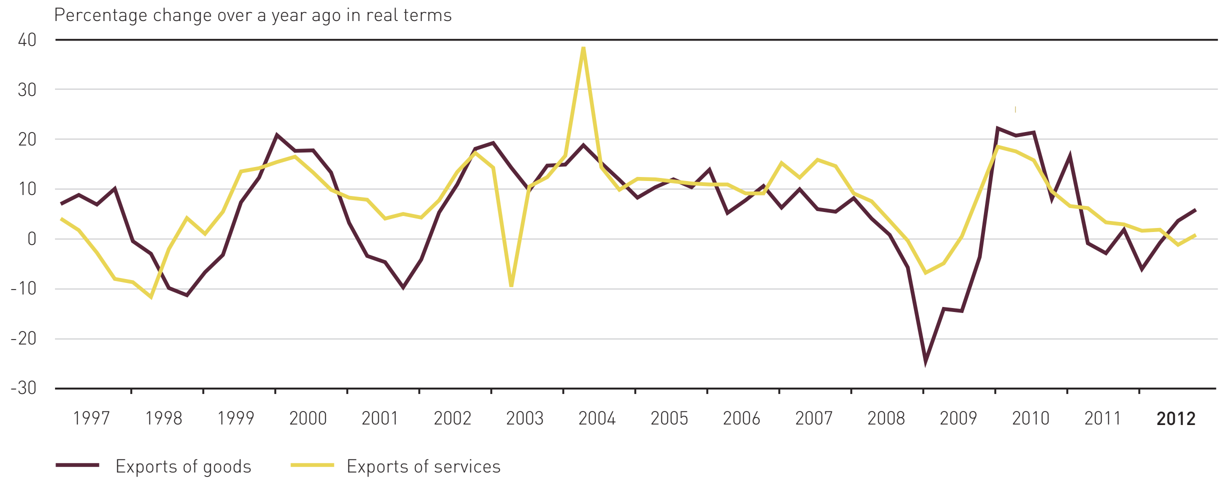


Source: Census and Statistics Department.

Inflation

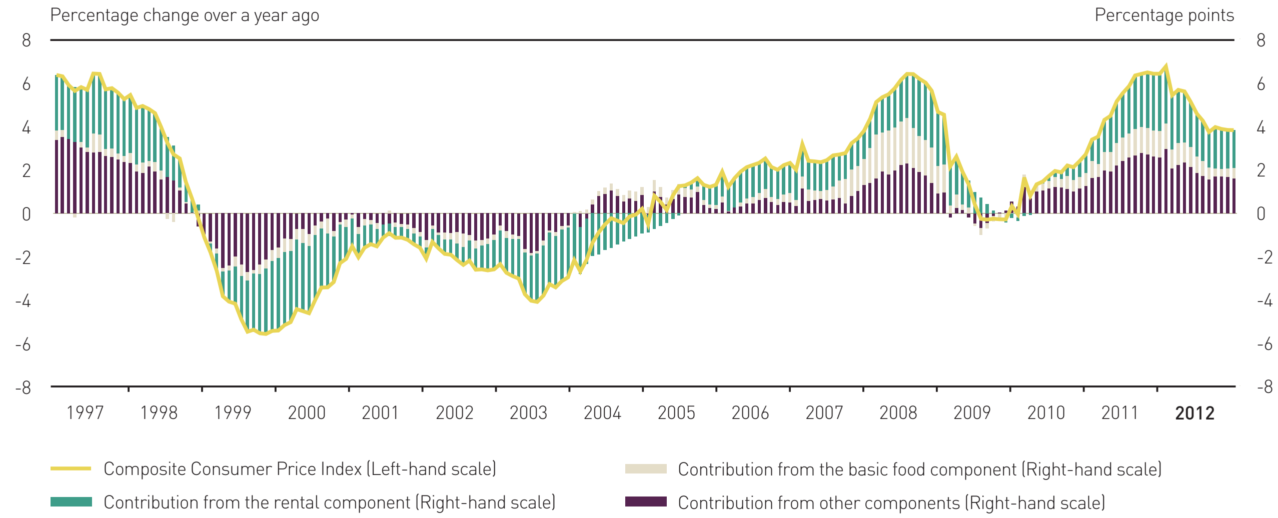
There was some relief in consumer price pressures in 2012, with the headline inflation rate receding to 4.1% from 5.3% a year ago. Netting out the effects of the Government's one-off relief measures, the underlying inflation rate weakened to 4.7%, with all major components showing some moderation (Chart 4). In particular, food inflation tapered off alongside a stabilisation in global food prices, while the pass-through of rising residential rentals slowed during most of 2012. Upward pressures on wages and non-tradable costs also softened. However, consumer price pressures appeared to have increased towards the end of the year as the economy improved gradually and residential rentals for fresh leases surged again.

Chart 3 Exports of goods and services



Source: Census and Statistics Department.

Chart 4 Consumer price inflation



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

Source: Census and Statistics Department.

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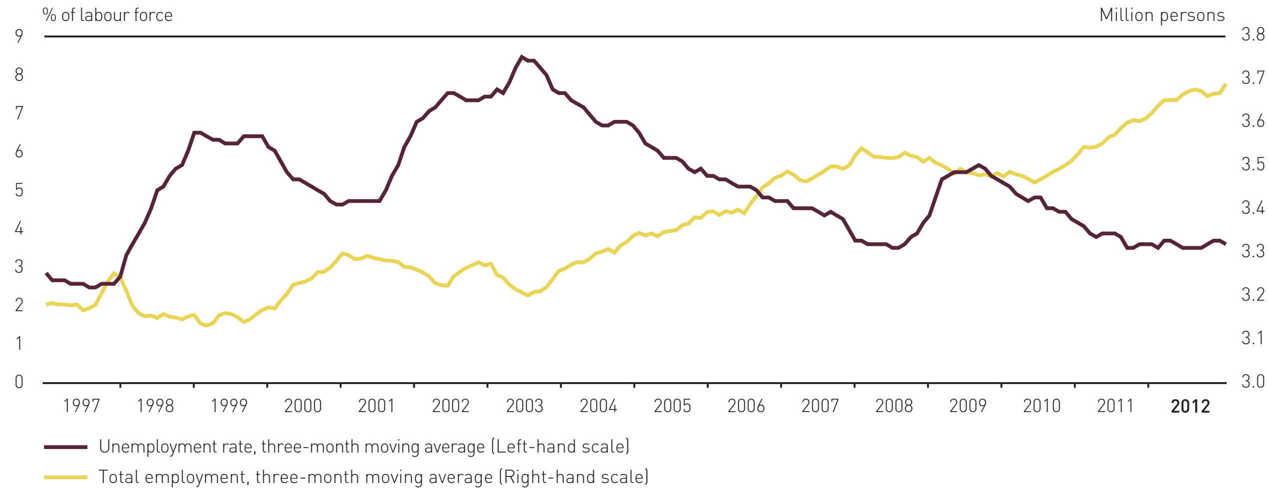
Labour market

The labour market remained tight in spite of a slowing economy influenced by the adverse external factors. Labour demand on the whole strengthened steadily, especially in the domestic-oriented and tourism-related sectors. For the year, total employment increased by 2.4% to a record high and the unemployment rate edged down to a 15-year low of 3.3% (Chart 5). Together with the tight labour market, wages and earnings rose solidly across major sectors and occupation categories. On average, employment earnings for full-time workers rose by 6.5% in nominal terms and 2.3% in real terms in 2012.

Stock market

The Hong Kong stock market experienced some volatility during the year. After a short rebound in the first two months, local stock prices were weighed down during most of the second quarter by concerns about the European sovereign debt problems and weakness in global growth. Stock prices then recovered previous losses as financial market conditions gradually improved in the second half of the year. Tail risks in Europe were perceived to have diminished after the European Central Bank's announcement of the Outright Monetary Transactions programme, while additional quantitative easing in the US also provided support for investment into riskier assets.

Chart 5 **Labour market conditions**



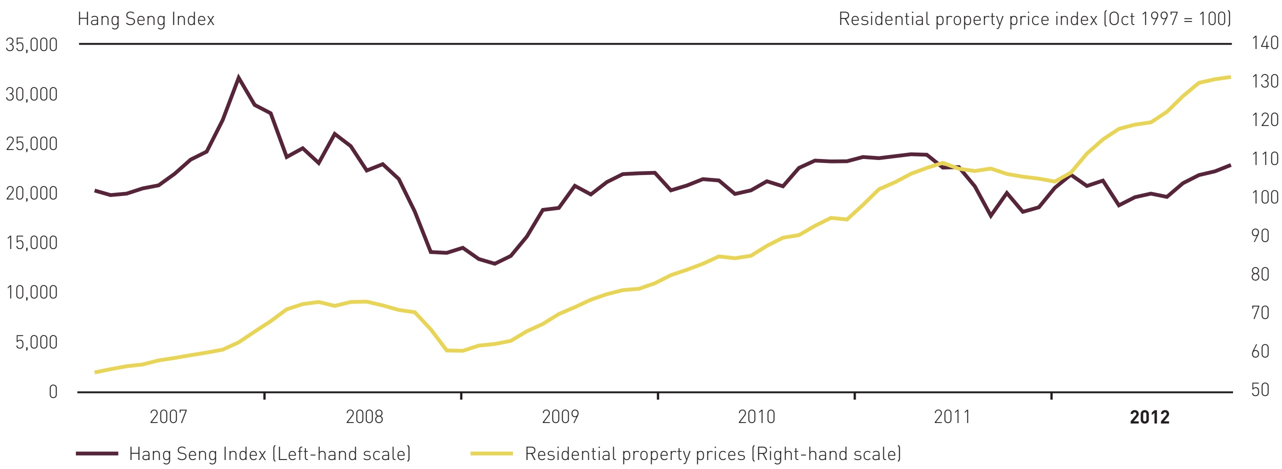
Source: Census and Statistics Department.

Overall, the Hang Seng Index surged by 22.9% to close the year at 22,657 (Chart 6). The average daily turnover of the stock market, however, contracted by 22.7% to $53.7 billion. Meanwhile, equity capital raised through new share flotation and post-listing arrangements on the local stock market declined by 37.7% to $305.4 billion.

Property market

After a brief respite in the second half of 2011, the rise in property prices resumed and trading activities grew again in 2012. Flat prices on average increased by 25.2% and have more than doubled from the trough of 2008, while housing affordability deteriorated further. Indicators, such as the price-to-income ratio and the mortgage payment-to-income ratio, all rose to recent highs and well above their 10-year long-term average levels. To strengthen banks' resilience against a major drop in property prices, the HKMA introduced a new round of prudential measures in mid-September to strengthen banks' risk management in property lending business, by tightening the underwriting criteria for loans to borrowers with multiple property mortgages and imposing a 30-year ceiling for mortgage tenors. The Administration also introduced a series of demand-side and supply-side measures to promote a healthy and stable development of the housing market. Following these measures, flat prices and transaction activity moderated somewhat.

Chart 6 Asset prices



Sources: Rating and Valuation Department, and CEIC.

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OUTLOOK FOR THE ECONOMY

Economic environment

The Hong Kong economy is expected to grow faster in 2013. The drags from external demand should subside gradually, although a full recovery in Hong Kong's exports still takes time as the global economy is struggling to achieve sustained growth, particularly in Europe, which remains burdened with sovereign debt problems. Domestically, consumer spending should continue to lend support to growth in real activity, owing to the strength of the labour market, rising incomes over the past few years and the positive wealth effect. Large-scale infrastructure works and private building activity are also expected to hold up quite well, but the outlook for capital investment and inventory stocking is less certain given that business sentiments remain cautious. Overall for 2013, the Government sees real GDP growth in the range of 1.5 – 3.5% and private sector analysts project the economy to grow by 2.5 – 4.7%, averaging at around 3.5%.

Inflation and the labour market

Inflationary pressures are likely to remain steady in 2013, largely reflecting a closing local output gap and soft global commodity prices. In the near term, however, the renewed pick up in residential rentals will pose upward pressure on inflation. Private sector analysts now expect the headline inflation rate will be at 4.2% in 2013. Labour market conditions will likely continue to be broadly favourable with hiring intentions staying positive, according to a number of corporate surveys. For the full year, private sector analysts project the unemployment rate to stay low at 3.4% on average.

Uncertainties and risks

The outlook for 2013 is subject to a number of uncertainties and risks. First and foremost, the unresolved European sovereign debt problems and the uncertain US fiscal outlook will continue to cast a shadow over Hong Kong's growth prospects. Any significant adverse developments could have negative spillover effects on the Hong Kong economy through trade and financial channels. On the other hand, there are potential upside risks to growth from a faster-than-expected stabilisation in external conditions, particularly a speed up in the Mainland economy.

More aggressive monetary easing in advanced economies will further increase global liquidity. This has already resulted in renewed capital inflows into Hong Kong. If capital inflows were to continue this, together with the very loose monetary conditions presently facing Hong Kong, could exert further upward pressures on consumer and asset prices and fuel a fresh round of rapid growth in bank credit. In addition, another rise in housing prices could further aggravate misalignments in Hong Kong's economic fundamentals, which would result in many macro-financial risks for Hong Kong. For example, the mortgage burden remains masked by the current ultra-low interest rate environment and, given the limited room for interest rates to decline, borrowers could face interest rate risks. On the credit front, total loan growth could rebound due in part to a larger Aggregate Balance and improving liquidity.

The uncertain direction and size of fund flows could also be a source of volatility. The experience over the past few years shows that fund flows can be highly sensitive to global financial conditions and investors' risk appetite. The risk of a sudden unwinding could cause considerable volatility to financial market conditions, as well as stress to the domestic banking and financial system.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained robust in 2012, despite the heightened uncertainties in the global economic outlook and external environment. Credit growth moderated during the year and liquidity conditions improved. Asset quality remained sound and locally incorporated authorized institutions (AIs) continued to be well capitalised.

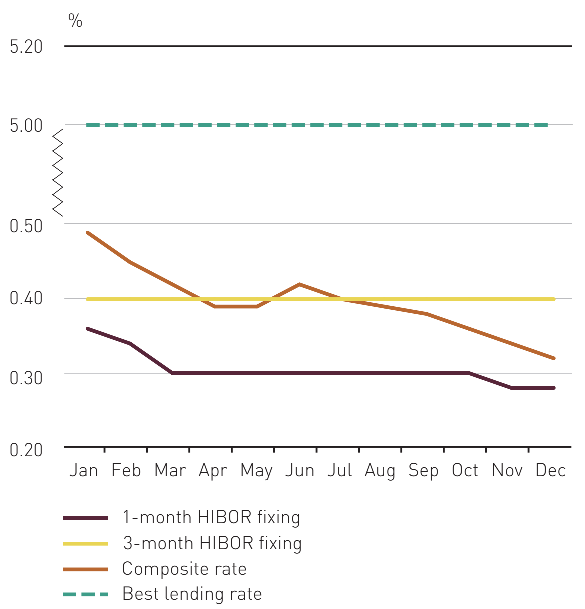
Interest rate trends

Central banks in major developed economies continued to adopt accommodative monetary policies in 2012, with some introducing further easing measures. In line with the US dollar rates, Hong Kong dollar interbank interest rates remained low throughout the year. The composite interest rate, which reflects the average cost of funds of retail banks, also trended lower as liquidity conditions improved during the year (Chart 7).

Profitability trends

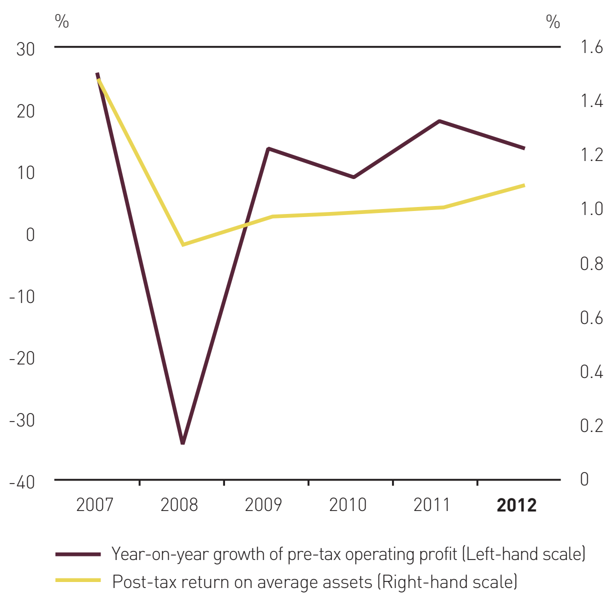
The aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 12.7%, mainly due to a 14.5% increase in net interest income. As their balance sheets grew at a slower pace, the post-tax return on average assets of retail banks increased to 1.07% in 2012 from 1.02% in 2011 (Chart 8).

Chart 7 **HIBOR fixings, composite rate and best lending rate**



Notes:
1. HIBOR fixings refer to the Hong Kong dollar Interest Settlement Rates released by the Hong Kong Association of Banks and are monthly averages.
2. Best lending rate refers to the rate quoted by the Hongkong and Shanghai Banking Corporation Limited (monthly averages).

Chart 8 **Retail banks' performance**



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With the improved liquidity conditions and lower funding costs, the net interest margin of retail banks widened slightly to a yearly average of 1.36% compared with 1.24% in 2011 (Chart 9).

The growth in net interest income (+14.5%) of retail banks outpaced that of non-interest income (+6.5%) in 2012. Apart from the widened net interest margin, moderate credit expansion also contributed to the growth in net interest income. As a result, retail banks' non-interest income as a share of total operating income fell to 46.1% from 47.9% in 2011.

The operating costs of retail banks increased by 8.2%, partly due to rising staff and rental expenses. Nonetheless, the cost-to-income ratio was down for the second consecutive year to 45.6% from 46.6% in 2011 driven by the stronger growth in operating income during the period (Chart 10).

The net charge for debt provisions rose slightly to $3.2 billion from $2.8 billion in 2011.

Chart 9 Retail banks' net interest margin

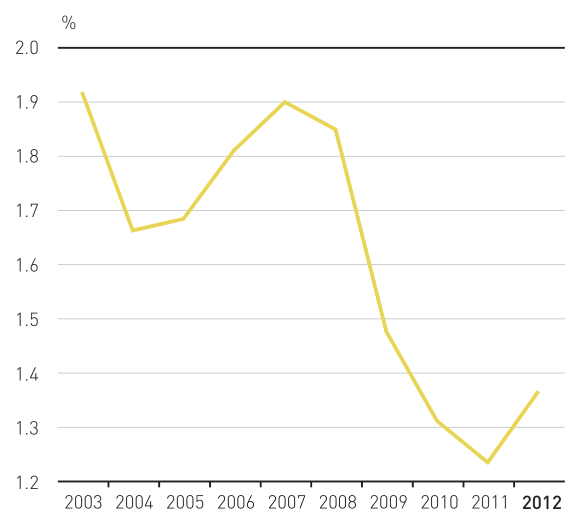
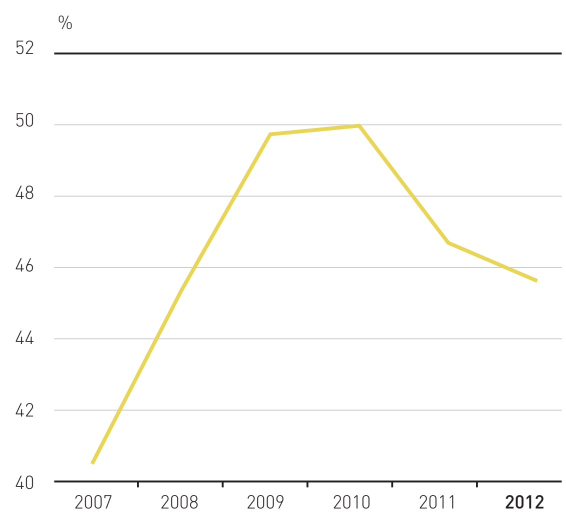


Chart 10 Retail banks' cost-to-income ratio



Asset quality

The asset quality of retail banks remained sound in 2012. Notwithstanding the overall loan expansion, the aggregate amount of classified loans declined during the year. As a result, the classified loan ratio continued its downward trend and reached 0.47% at the end of 2012 from 0.59% at the end of 2011. The combined ratio of overdue and rescheduled loans also reduced to 0.37% compared with 0.49% a year earlier (Chart 11).

The quality of surveyed institutions' residential mortgage lending remained good. The delinquency ratio rose slightly to 0.02% at the end of 2012 from 0.01% a year earlier (Chart 12). The rescheduled loan ratio edged down to 0.01% from 0.02% in 2011. With higher residential property prices, the surveyed institutions did not report any residential mortgage loans in negative equity at the end of the year, compared with 1,465 cases at the end of 2011.

The quality of credit card portfolios deteriorated slightly. The delinquency ratio rose to 0.20% at the end of 2012 from 0.19% in 2011 (Chart 12). The combined delinquent and rescheduled ratio edged up to 0.26% from 0.25% last year and the charge-off ratio rose to 1.70% from 1.49% in 2011. Despite the increases, these ratios were still low by historical standards.

Chart 11 Asset quality of retail banks

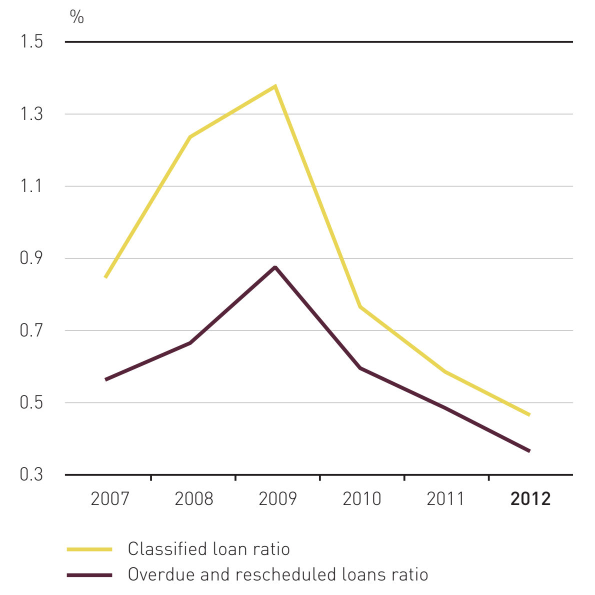
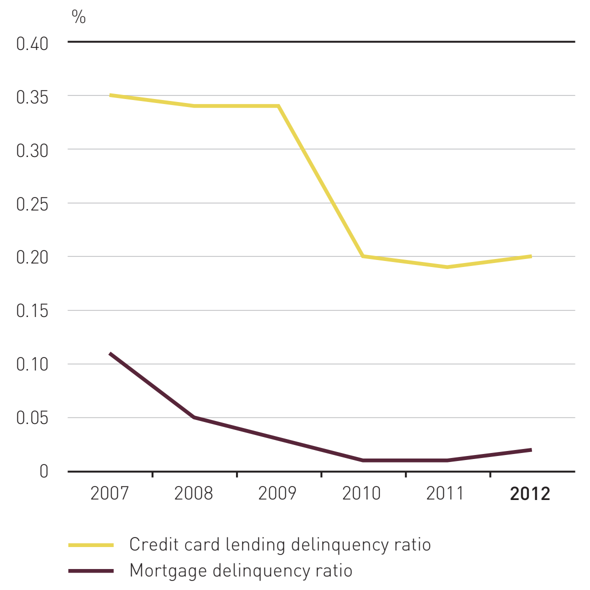


Chart 12 Delinquency ratios of residential mortgages and credit card lending of surveyed institutions



Balance sheet trends

Total loans and advances of retail banks grew by 8.4% in 2012, while total deposits rose by 9.3%. The overall loan-to-deposit ratio of retail banks, therefore, decreased to 54.8% from 55.3% in 2011. The Hong Kong dollar loan-to-deposit ratio also fell to 72.3% from 76.2% a year ago (Chart 13).

Credit growth moderated from 20.2% in 2011 to 9.6% in 2012. The growth in loans for use outside Hong Kong continued to outpace that in loans for use in Hong Kong and trade financing. The increase in domestic lending was mainly led by property lending and lending to wholesale and retail sectors.

Retail banks' total non-bank Mainland exposures[1] rose to $1,777 billion at the end of 2012 from $1,572 billion a year ago. For the banking sector as a whole, non-bank Mainland exposures increased to $2,738 billion from $2,330 billion in 2011.

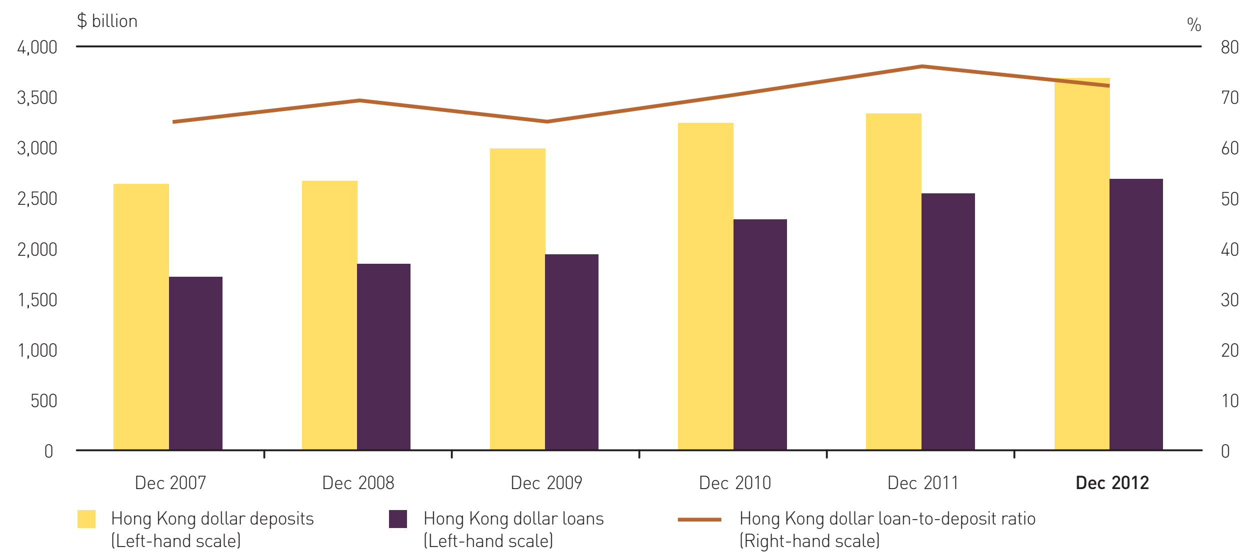
Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit, increased by 10.0% in 2012. Despite the increase, the share of total holdings of NDIs relative to total assets remained unchanged at 24% at the end of 2012. Among the holdings of NDIs, 49% were government-issued (47% in 2011), 29% were issued by non-bank corporates (31% in 2011), and 22% were issued by banks (22% in 2011) (Chart 14).

Capital adequacy and liquidity

All locally incorporated AIs remained well capitalised. The consolidated capital adequacy ratio of all locally incorporated AIs edged down to 15.7% at the end of 2012 from 15.8% a year earlier (Chart 15). However, the Tier-1 capital adequacy ratio climbed to 13.3% at the end of 2012 from 12.4% a year earlier.

Chart 13 Retail banks' Hong Kong dollar loans and deposits



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

Underpinned by a stronger increase in liquefiable assets than in qualifying liabilities, the average liquidity ratio of retail banks rose to 42.6% in the final quarter of 2012 from 38.0% in the same quarter last year, which is well above the statutory minimum of 25% (Chart 16).

Chart 14 **Retail banks' holdings of negotiable debt instruments at the end of 2012 (counterparty breakdown)**

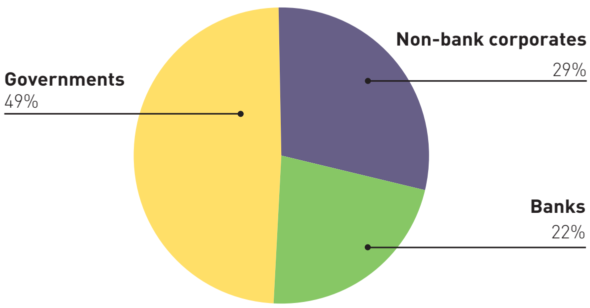


Chart 15 **Consolidated capital adequacy ratio of locally incorporated AIs**

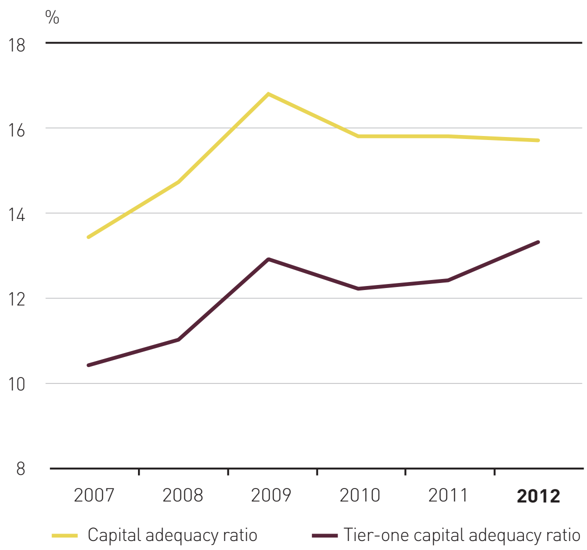
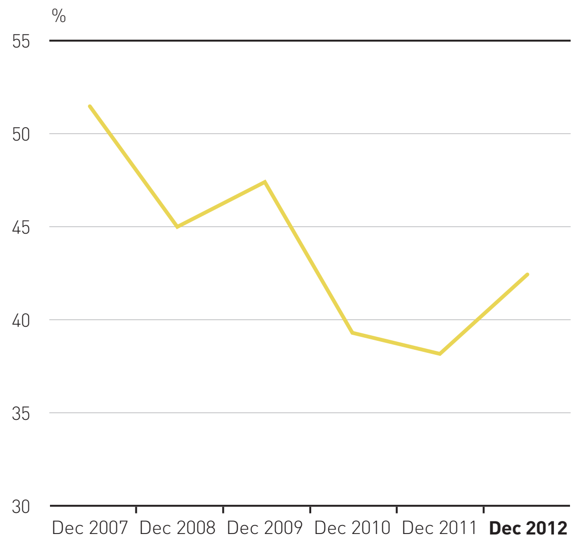


Chart 16 **Retail banks' liquidity ratio (quarterly average)**



PROSPECTS FOR 2013

While the persistently low interest rates in advanced economies are likely to remain in place for some time, the risk arising from the increased uncertainties in the global economic outlook and external environment has yet to recede. This, in turn, could translate into significant systemic risk for the Hong Kong banking sector. Therefore, banks must continue to be vigilant against a possible deterioration in macroeconomic conditions and the risk of a sudden outflow of funds or sharp changes in interest rate trends. Although credit growth in the banking sector moderated in the past year and asset quality remained sound, banks should continue to exercise prudence in managing their credit, liquidity and other risks.