

Economic and Financial Environment

The Hong Kong economy experienced slower growth in 2015 reflecting weaker domestic demand and poor export performance. Economic growth for 2016 is expected to remain soft amid stiff external headwinds and fragile financial market conditions.

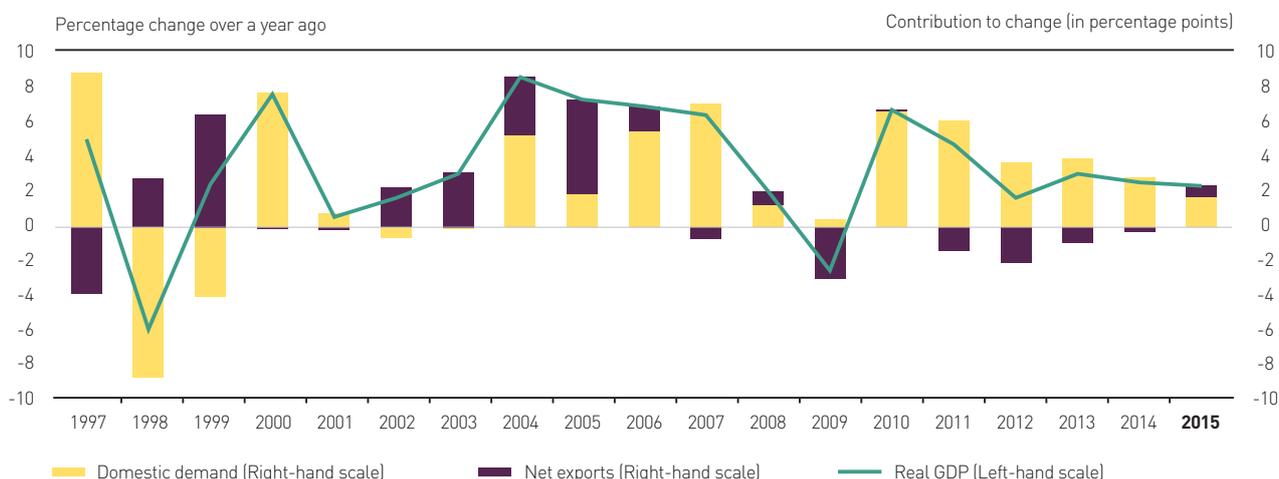
THE ECONOMY IN REVIEW

Overview

Economic growth in Hong Kong moderated during the year, with real Gross Domestic Product (GDP) growth slowing to 2.4% from 2.6% in 2014 (Table 1). This reflected milder expansion in domestic demand, although net exports reverted to a positive contributor to GDP growth as total imports declined faster than total exports (Chart 1). Despite the modest economic performance, the labour

market held broadly stable, with the unemployment rate staying low at about 3.3%. Inflation eased further due to subsiding pressures on domestic costs and import prices. Local stock prices saw large swings amid heightened volatility in global financial markets. The residential property market started to soften after the announcement of the seventh round of prudential measures in February, with housing prices showing further signs of consolidation towards the end of the year.

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]	2015				2015	2014				2014
	Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4	
Gross Domestic Product	0.6	0.5	0.6	0.2	2.4	0.8	-0.1	1.4	0.4	2.6
(year-on-year growth)	2.4	2.9	2.2	1.9		2.9	2.1	3.1	2.5	
Private consumption expenditure	1.5	1.2	0.2	0.3	4.8	0.5	0.3	2.0	1.4	3.3
Government consumption expenditure	1.1	0.7	0.5	1.1	3.4	0.7	1.2	1.2	0.4	3.0
Gross domestic fixed capital formation	-	-	-	-	-2.2	-	-	-	-	-0.1
Exports										
Exports of goods	-1.8	-2.4	0.4	2.7	-1.7	-1.6	1.0	0.1	0.9	0.8
Exports of services	0.4	-1.0	-1.2	-0.9	-0.6	0.4	-1.8	0.7	0.9	1.1
Imports										
Imports of goods	-2.4	-2.5	-0.8	2.3	-2.5	-1.3	0.1	0.2	2.0	0.9
Imports of services	1.6	1.5	0.4	1.8	5.1	-4.0	3.9	-0.6	1.3	2.0
Overall trade balance (% of GDP)	0.0	-4.2	8.2	4.6	2.4	-1.2	-6.4	5.8	1.4	0.1

Note: The seasonally-adjusted quarter-on-quarter rates of change in the gross domestic fixed capital formation are not available.

Source: Census and Statistics Department.

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On the monetary front, exchange-rate stability was maintained in 2015, with the Hong Kong dollar exchange rate hovering near 7.75 against the US dollar. The strong-side Convertibility Undertaking was triggered in April due to equity-related inflows, and again in September and October reflecting conversions of the offshore renminbi into Hong Kong dollars and some commercial demand for Hong Kong dollars. With the enlarged Aggregate Balance, local interest rates continued to stay low, while the HKMA Base Rate was adjusted upwards from 0.5% to 0.75% following the US interest rate lift-off in mid-December. Because of softer credit demand, total loan growth in the banking sector slowed further to 3.5% in 2015 from 12.7% in 2014. The banking industry's overall loan quality weakened slightly, but the classified loan ratios remained at low levels.

Domestic demand

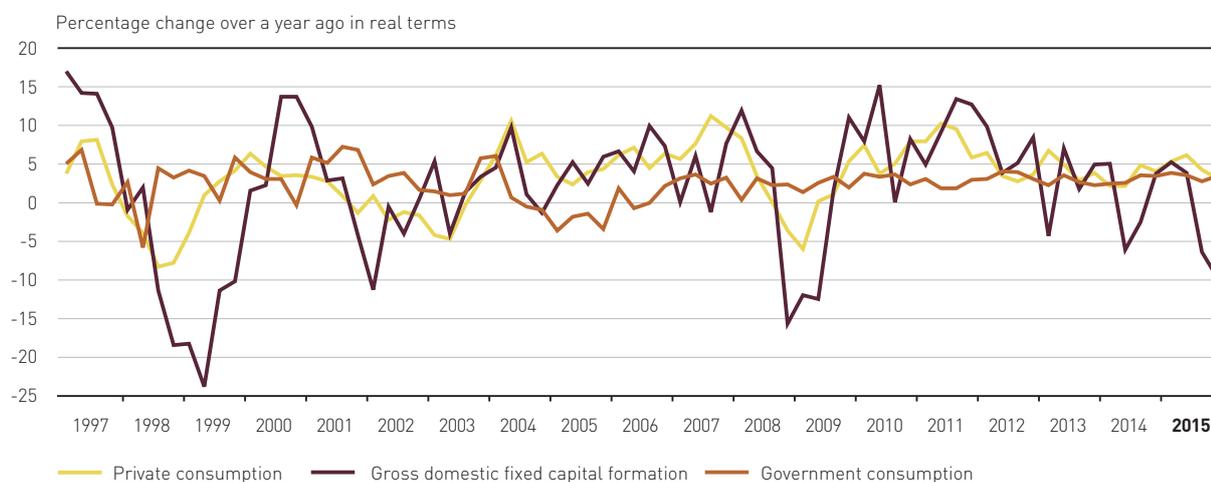
Domestic demand grew at a slower pace in 2015. While broadly stable job and income conditions continued to provide support, weak consumer confidence and corrections in asset prices weighed on private consumption growth in the second half of the year. However, due to the relatively strong growth momentum in the first half, the full-year growth in private consumption increased to 4.8% from 3.3% in 2014. Government consumption increased slightly faster by 3.4%. In fact, the slower growth in

domestic demand was mainly due to the 2.2% decline in gross domestic fixed capital formation (Chart 2). Private-sector machinery and equipment acquisition contracted for the second consecutive year amid deteriorating business sentiment, and building and construction activities also showed weaker growth momentum alongside slower progress in public projects.

External demand

Hong Kong's export performance deteriorated in 2015 (Chart 3). Exports of goods recorded a broad-based 1.7% decline, the first time since 2009. Exports to Japan and the European Union declined, while those to the US recorded little growth. The feeble final demand from these advanced markets also weighed on regional industrial activities and intra-regional trade. As a result, Hong Kong's exports to Mainland China, Singapore, South Korea and Taiwan also decreased amid weak intermediate and final demand from these economies. Hong Kong's exports of services continued to moderate from a high growth path in earlier years, which culminated in a 0.6% decline in 2015, mainly due to the slowdown in inbound tourism. Imports of goods also fell back alongside weaker domestic and export-induced demand. In contrast, growth in imports of services accelerated due to strong travel interest among local residents. On a net basis, the overall trade surplus improved slightly in 2015, leading to a modest positive contribution to GDP growth.

Chart 2 Domestic demand



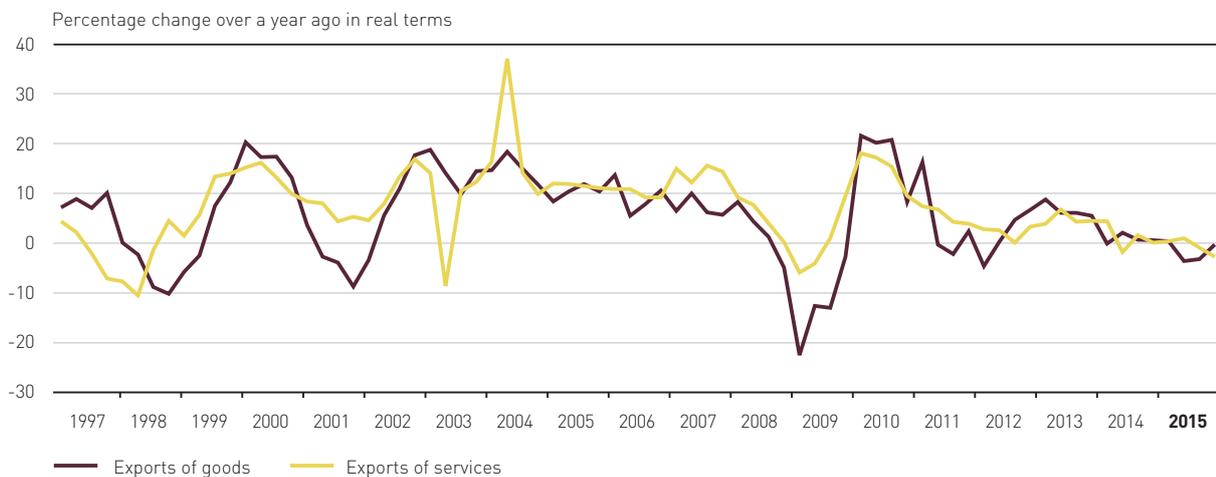
Source: Census and Statistics Department.

Inflation

Underlying inflation eased further in 2015 amid moderated domestic cost pressures and reduced import price inflation. After netting out the effects of the Government's one-off relief measures, the underlying inflation rate dropped to 2.5% from 3.5% in 2014 (Chart 4). With subdued economic activity, labour cost pressures remained steady,

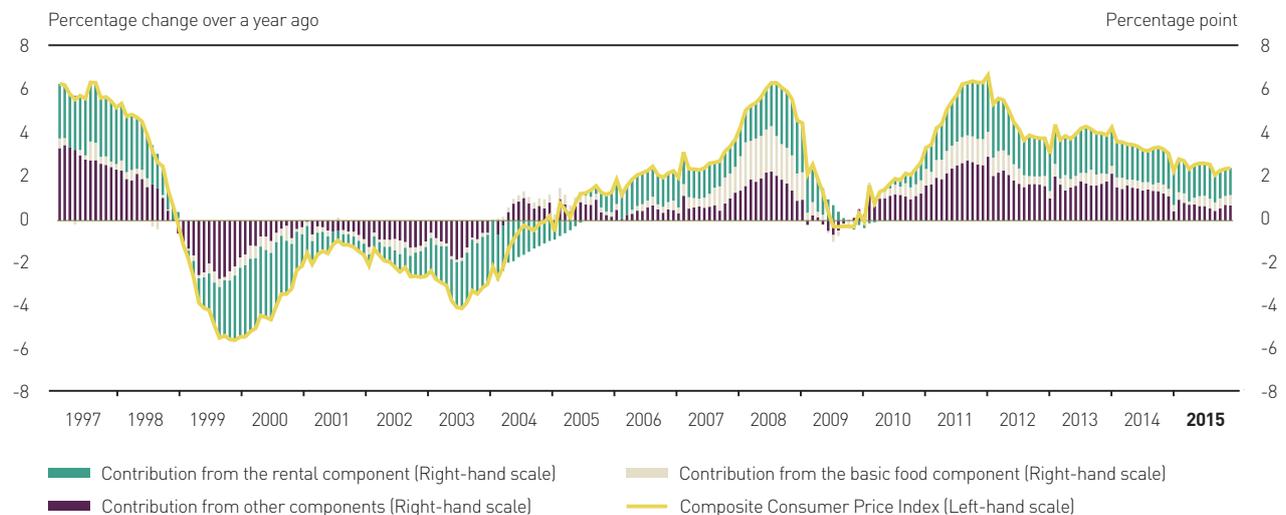
while commercial and industrial rental cost pressures eased, particularly in the second half. Thanks to softened global commodity prices and the strong Hong Kong dollar, import price pressures abated, while food inflation also stayed low. As the feed-through of fresh-letting housing rentals in earlier quarters had been moderate, the rental component of inflation remained contained.

Chart 3 Exports of goods and services



Source: Census and Statistics Department.

Chart 4 Underlying consumer price inflation



Source: Census and Statistics Department.

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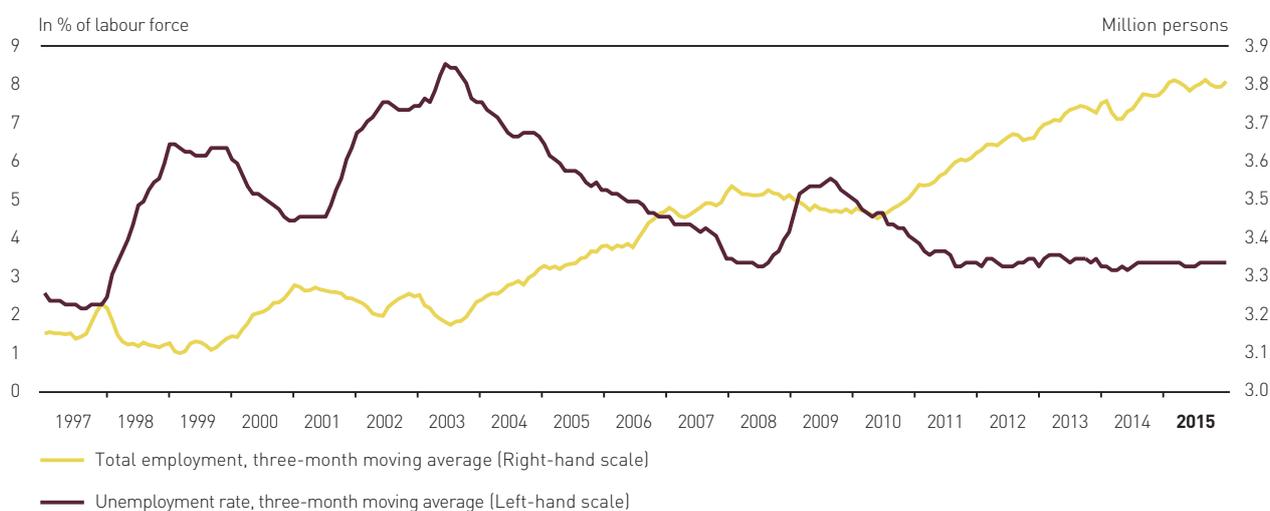
Labour market

Labour market conditions remained stable in 2015. Labour demand held up, with the decline in employment in trade and tourism-related sectors being largely offset by the steady pace of hiring in other business sectors, resulting in an increase in total employment of 1.3% from a year earlier. With labour supply also picking up by 1.3%, the seasonally adjusted unemployment rate stayed at around 3.3% throughout the year (Chart 5). Given the still-tight labour market, labour earnings in nominal terms rose by 4.7% in the first three quarters of the year, compared with 4.3% in 2014. With inflationary pressures easing, real labour earnings increased by 1.3% in the first three quarters, compared with a decline of 0.1% in 2014.

Stock market

The Hong Kong stock market experienced a volatile year due to drastic changes in the external environment. After a flat first quarter, the local stock market was buoyant in the second quarter amid the bullish sentiment in the Mainland A-share market and capital inflows. The Hang Seng Index surged to a seven-year high in April, with the Southbound Daily Quota under the Shanghai-Hong Kong Stock Connect being exhausted for the first time since its inception in November 2014 (Chart 6). However, the local market reversed course starting from late June, with the Hang Seng Index plunging 28% to a year-low in September amid the sell-offs in the Mainland A-share market and global stock markets, the heightened volatility in the global foreign exchange market, and weaknesses in international commodity prices. The Hong Kong stock market

Chart 5 Labour market conditions



Source: Census and Statistics Department.

recovered some ground in the last quarter as global and Mainland financial markets stabilised. For 2015 as a whole, the Hang Seng Index recorded a decline of 7.2%, the worst performance since 2011, while the average daily turnover rose to HK\$105.6 billion from HK\$69.5 billion in 2014. Although fund-raising activities moderated in the second half, the overall equity funds raised from the local stock market increased to HK\$1,115.6 billion from HK\$942.7 billion a year earlier.

Property market

Signs of consolidation emerged in the residential property market. After experiencing a buoyant period in early 2015, the residential property market softened following the announcement of the seventh round of prudential measures in February. With housing prices picking up

at a slower pace before declining in the last quarter, the cumulative increase in housing prices in 2015 was 2.5%, smaller than the 13.5% increase in 2014 (Chart 6). Meanwhile, the transaction volume decreased by 12.3% from a year ago to 55,982 units as trading activities in the secondary market fell noticeably in the second half. Speculative transactions, including confirmor transactions and short-term flipping trades, continued to stay low. Despite this, household affordability remained stretched, with the price-to-income ratio reaching 15.7 and the income-gearing ratio remaining far above its long-term average.¹ The commercial and industrial property markets were buoyant in the first half, but trading activities then softened, with both prices and rents registering declines in the last quarter. Rental yields remained broadly the same from a year earlier and stayed near their historical lows.

Chart 6 Asset prices



Sources: Rating and Valuation Department and Hong Kong Exchanges and Clearing Limited.

¹ The price-to-income ratio measures the average price of a typical 50 square-metre flat relative to the median annual income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio compares the amount of mortgage payment for a typical flat of 50 square metres (under a 20-year mortgage scheme with a 70% loan-to-value ratio) to the median income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio is not the same as a borrower's actual debt-servicing ratio, which is subject to a maximum cap by the HKMA's prudential measures.

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OUTLOOK FOR THE ECONOMY

Economic environment

Hong Kong's economic growth for 2016 is expected to remain soft. Private-sector analysts project the economy to expand at a slower average rate of 1.7% while the Government forecasts growth in the range of 1–2%. More specifically, the lacklustre global growth prospects, sustained weakness in inbound tourism, and the negative spillovers from turbulent global financial market conditions will continue to restrain the performance of Hong Kong's exports. Domestically, private consumption is anticipated to grow moderately, as labour market conditions will likely face some pressures amid weaker economic momentum, and local asset price adjustments may dent consumer confidence and induce negative wealth effects. Building and construction activities may hold up, but weak business sentiment and interest rate rises will weigh on private capital investment.

Inflation and the labour market

Inflationary pressures are expected to remain contained in 2016. Import price pressures will likely stay soft, while domestic cost pressures are expected to be modest amid moderate economic growth momentum. The rental component of inflation may also ease due to diminishing pressures in fresh-letting housing rentals towards the end of 2015. Market consensus predicts the headline inflation rate at 2.5% in 2016, while the Government projects the underlying inflation rate at 2.0%. The labour market may also soften somewhat due to the slowdown in inbound tourism and continued sluggishness in the export sector. Private-sector analysts now expect the unemployment rate to increase to 3.5% in 2016.

Uncertainties and risks

The economic outlook for 2016 is subject to a number of uncertainties and risks. In particular, the pace of further US interest rate rises, the global growth prospects and commodity price movements will continue to be the major sources of uncertainty. Any significant adverse developments could heighten volatilities in global financial markets and international capital flows, thereby tightening domestic monetary and financial conditions and casting a shadow over Hong Kong's growth prospects. The resulting impact of these external factors on the domestic economy will depend crucially on their impact on the property market through the wealth and balance-sheet effects. While the property market is facing increasing downside risks stemming from weakening sentiment in the global and domestic financial markets, the normalisation of US interest rates, and a narrowing housing demand-supply gap, more time is needed to establish whether the property market has entered a down-cycle. Although an abrupt adjustment in the property market could pose significant headwinds to the broader economy, the introduction of counter-cyclical macroprudential measures and other supervisory measures over the past few years has significantly enhanced the resilience of Hong Kong's banking system.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained resilient during the year, notwithstanding a further divergence in the monetary policies of advanced economies and the build-up of vulnerabilities in emerging market economies. The liquidity positions of authorized institutions (AIs) continued to be sound, and locally incorporated AIs were well capitalised. The asset quality of retail banks deteriorated slightly, but stayed at a healthy level.

Interest rate trends

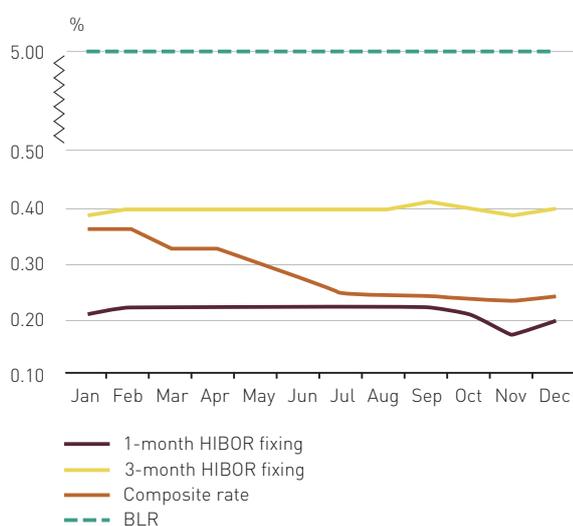
In line with the US dollar interest rates, Hong Kong dollar interbank interest rates were low throughout the year. The Hong Kong dollar funding cost of retail banks declined in the first half of the year as indicated by a downward trend

in the composite interest rate, and remained stable in the second half (Chart 7).

Profitability trends

The profitability of the banking sector moderated in 2015. The aggregate pre-tax operating profits of retail banks' Hong Kong offices declined by 2.8%, as growth in fee and commission income (up 9.7%), foreign exchange and derivatives operation income (up 22.4%), and net interest income (up 1.3%) was offset by an 8.8% increase in operating expenses and a 76% increase in loan impairment charges. However, the post-tax profit of retail banks increased by 14.7%, mainly due to gains from disposals of strategic investments. The post-tax return on average assets of retail banks improved to 1.05% from 0.99% in 2014 (Chart 8).

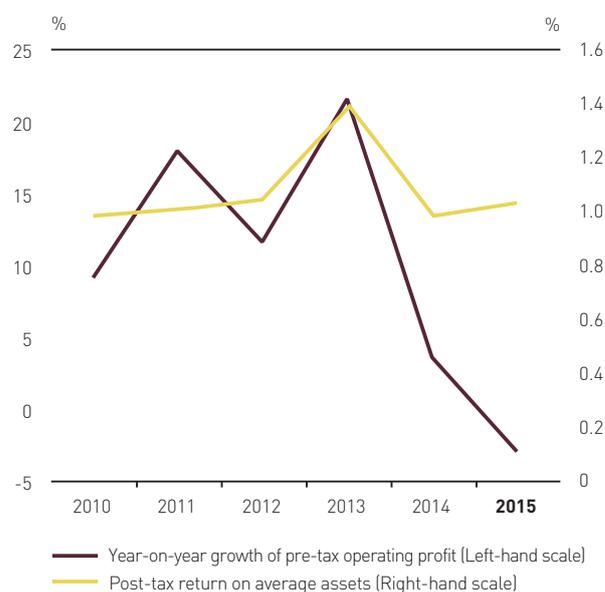
Chart 7 HIBOR fixings, composite rate and best lending rate (BLR)



Notes:

- HIBOR fixings refer to the Hong Kong Dollar Interest Settlement Rates released by the Hong Kong Association of Banks and are monthly averages.
- BLR refers to the best lending rate quoted by the Hongkong and Shanghai Banking Corporation Limited (monthly averages).

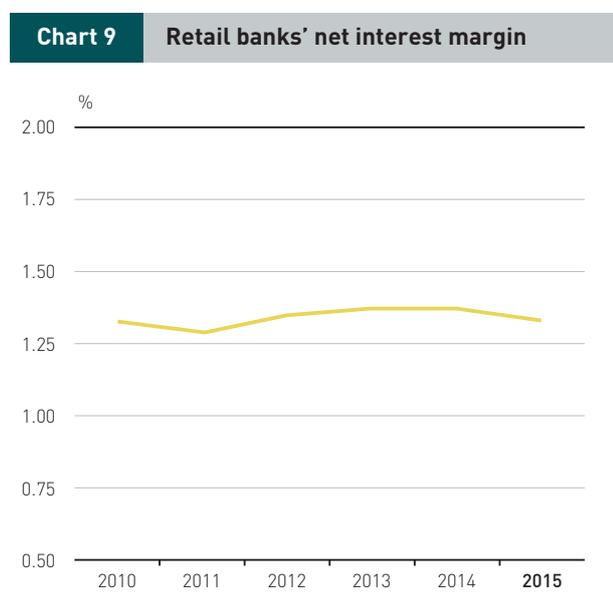
Chart 8 Retail banks' performance



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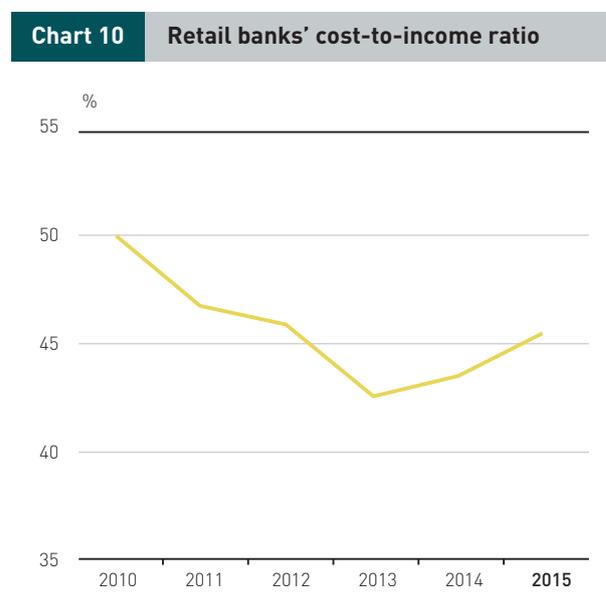
Retail banks' net interest margin narrowed to 1.32% from 1.40% in 2014 (Chart 9), due to a number of factors such as a decrease in interest return on renminbi-denominated assets and the investment of excess funds by banks in lower-yielding assets (for example, interbank placement as well as Exchange Fund Bills and Notes).

Driven by a growth in income from fees and commissions as well as from foreign exchange and derivatives operations, retail banks' non-interest income as a share of total operating income increased to 44.6% from 43.1% in 2014.



The operating costs of retail banks increased by 8.8%, partly caused by rising staff expenses. As the growth in operating costs outpaced that of operating income, the cost-to-income ratio increased to 45.4% in 2015 from 43.4% in 2014 (Chart 10).

Loan impairment charges rose to HK\$9.0 billion from HK\$5.1 billion in 2014. The loan impairment charges to average assets ratio remained at a low level of 0.08%.



Asset quality

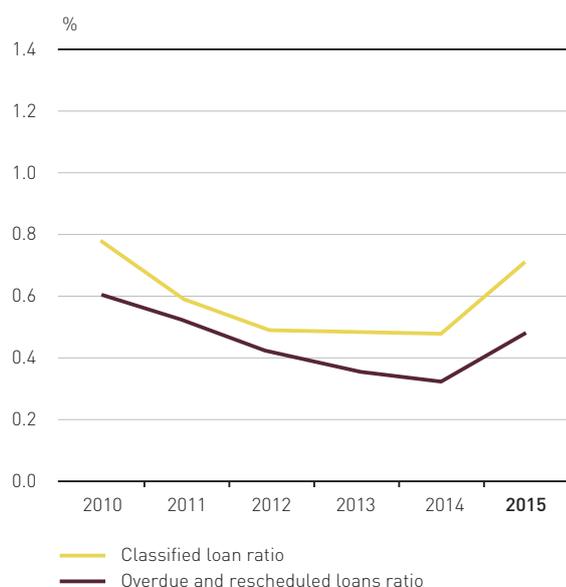
The banking industry's overall loan quality deteriorated slightly during the year, but remained sound with the classified loan ratio staying at a low level by historical standards. Retail banks' classified loan ratio² rose to 0.70% at the end of 2015 from 0.52% a year earlier. The overdue and rescheduled loans ratio stood at 0.45% at the end of the year (Chart 11).

The quality of banks' residential mortgage lending portfolios remained good, with the delinquency ratio staying at a low level of 0.03% at the end of 2015 (Chart 12).

The rescheduled loan ratio was close to 0%. The number of cases of residential mortgage loans in negative equity increased to 95 at the end of the year, compared with zero at the end of 2014. These cases were mainly related to staff housing loans which have higher loan-to-value ratios.

The delinquency ratio of credit card lending increased slightly to 0.25% at the end of 2015 from 0.20% a year earlier, but remained at a low level. The combined delinquent and rescheduled loans ratio also increased to 0.32% from 0.27% during the same period (Chart 12). The charge-off ratio edged down to 1.82% from 1.83% in 2014.

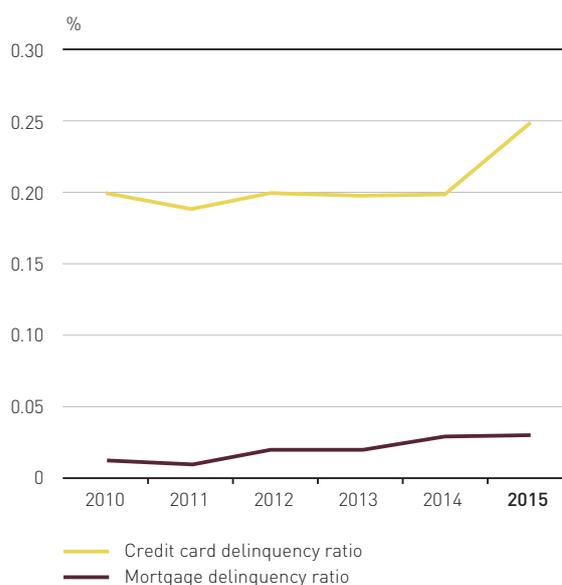
Chart 11 Asset quality of retail banks



Note:

Figures prior to December 2015 cover retail banks' Hong Kong offices and overseas branches. Starting from December 2015, the coverage was expanded to include the banks' major overseas subsidiaries.

Chart 12 Delinquency ratios of residential mortgages and credit card lending of banks



² This covers the Hong Kong offices and overseas branches of retail banks as well as their major overseas subsidiaries. Excluding the major overseas subsidiaries, the classified loan ratio of retail banks was 0.63% at the end of 2015, compared with 0.46% a year earlier.

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Balance sheet trends

Total loans and advances of retail banks grew by 3.2% in 2015, while total deposits rose by 4.9%. The overall loan-to-deposit ratio of retail banks decreased to 56.5% from 57.5% at the end of 2014. The Hong Kong dollar loan-to-deposit ratio also dropped to 71.5% from 74.6% during the same period (Chart 13).

Credit growth in the banking sector moderated to 3.5% in 2015 from 12.7% in 2014, as corporate customers became more conservative in borrowing amid the uncertain macro-economic outlook. While loans for use inside and outside Hong Kong increased by 6.3% and 2.8% respectively, trade finance declined by 16.3%.

The banking sector's Mainland-related lending³ grew moderately to HK\$3,326 billion at the end of 2015 from HK\$3,224 billion a year ago.

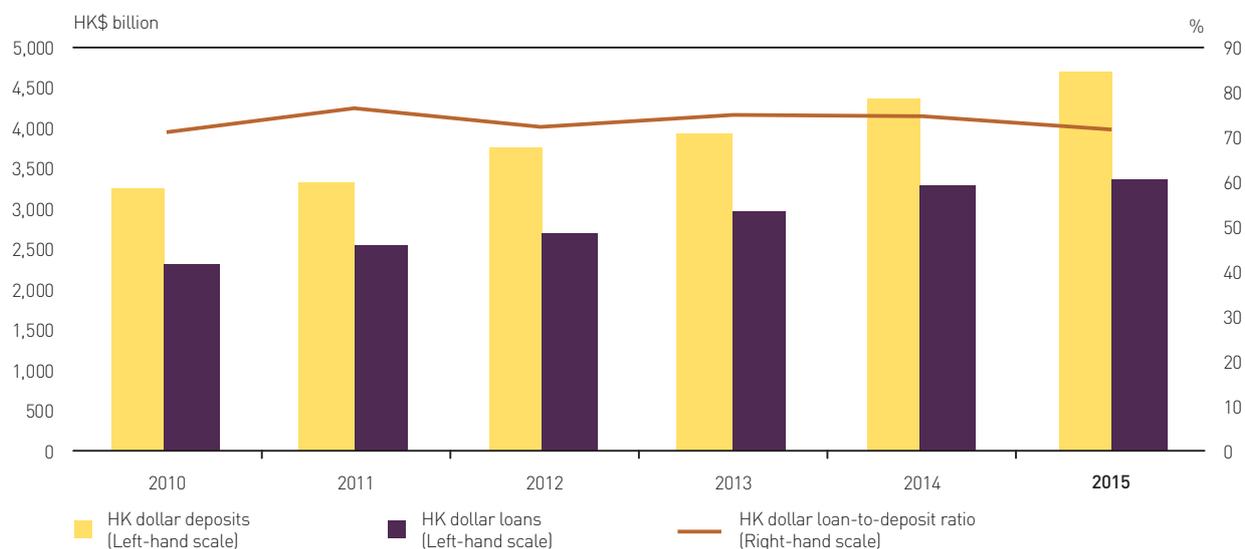
Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit, increased by 15% in 2015. The share of total holdings of NDIs relative to total assets increased to 24% at the end of the year from 22% at the end of 2014. 55% of the holdings of NDIs were issued by governments (47% at end-2014), 31% by non-bank corporations (31% at end-2014), and 14% by banks (22% at end-2014) (Chart 14).

Capital adequacy and liquidity

All locally incorporated AIs remained well capitalised. Their consolidated total capital ratio rose to 18.3% at the end of 2015 from 16.8% a year earlier (Chart 15). The increase was due to a faster growth in the capital base than in the amount of risk-weighted assets. During the same period, the Tier 1 capital ratio increased to 15.3% from 13.9%.

Chart 13 Retail banks' Hong Kong dollar loans and deposits



³ Including loans booked in locally-incorporated banks' banking subsidiaries in Mainland China.

The Banking (Liquidity) Rules to implement the new liquidity regime under Basel III came into effect on 1 January 2015. AIs in Hong Kong were categorised into category 1 and 2 institutions depending on their significance to the general stability of the local banking system. The liquidity position of category 1 institutions was measured by the Liquidity Coverage Ratio (LCR), whereas that of category 2 institutions was measured by the Liquidity Maintenance Ratio (LMR). In the final quarter of 2015, the average LCR of category 1 institutions was 142.9%, well above the statutory minimum requirement of 60% applicable for the year. The average LMR of category 2 institutions was 53.9%, also well above the statutory minimum requirement of 25% (Chart 16).

Chart 14 Retail banks' holdings of negotiable debt instruments at the end of 2015 (issuer breakdown)

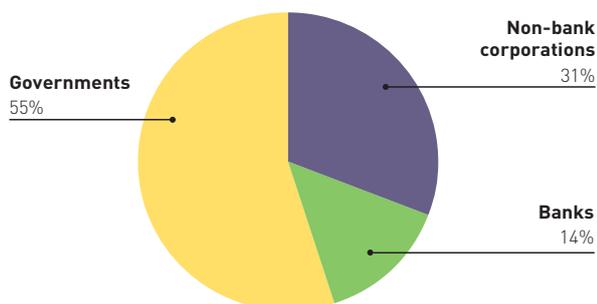


Chart 15 Consolidated capital adequacy ratio of locally incorporated AIs

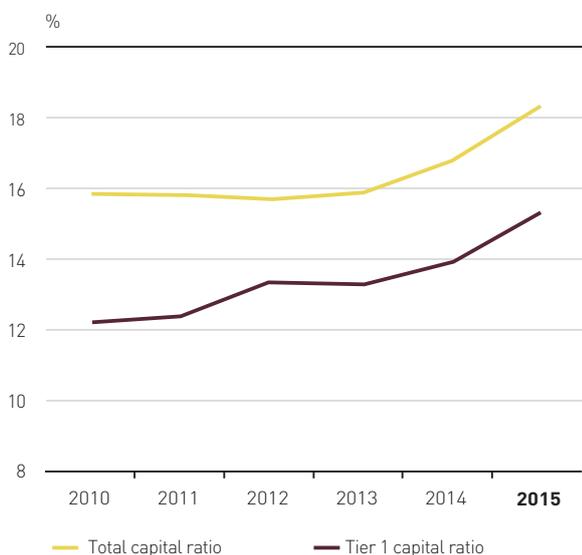
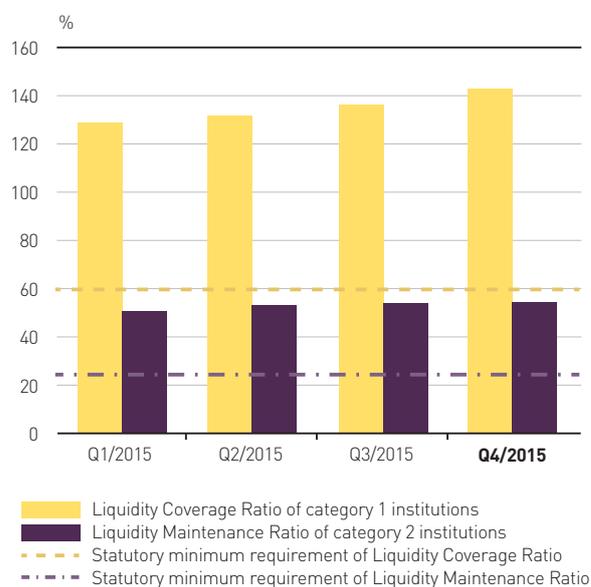


Chart 16 Liquidity ratios (quarterly average)



PROSPECTS FOR 2016

The continued divergence in the monetary policies of the major advanced economies has increased uncertainties in global financial markets. While the US Federal Reserve started to normalise interest rates in December 2015, the Bank of Japan lowered interest rates to negative levels in January 2016, and the European Central Bank announced a further lowering of interest rates and an expansion of its asset purchase programme in March 2016. Against this backdrop, capital flows are expected to remain volatile, with a potential negative spillover effect on the Hong Kong economy through financial and credit channels. At the same time, slower growth in both the Mainland and Hong Kong economies may create further pressure on the profitability and asset quality of banks. In light of these uncertainties, the HKMA has reminded banks of the need to step up their liquidity, interest rate and credit risk management to cope with possible challenges ahead.