1. Summary and overview

Higher demand for Hong Kong dollar assets led to repeated triggering of the strong-side Convertibility Undertaking (CU) in the fourth quarter of 2012. In the face of such inflow pressures, the Hong Kong dollar exchange market functioned normally and the Linked Exchange Rate system continued to enjoy a high degree of market credibility.

Risks to financial stability posed by property market volatility have continued to mount. Macroprudential policies have leaned against the build-up of leverage, but expectations of property price movements could be reversed abruptly by unforeseen events. Participants in the Hong Kong financial system should brace themselves for the potential volatilities of the current financial cycle.

The external environment

Global financial conditions have improved significantly over the past six months, driven by reduced tail risks in the US and Europe, more aggressive monetary policy easing in the advanced economies, as well as a revival of the growth momentum in Mainland China. In Europe, the announcement of a new bond purchase programme known as the Outright Monetary Transactions (OMTs) by the European Central Bank (ECB) in September 2012 has helped reduce the tail risk of the European sovereign debt crisis. In the US, the US Federal Reserve has pursued unlimited quantitative easing and has explicitly linked its forward interest rate guidance to the inflation and unemployment rates. In Japan, the new Abe government also announced more aggressive monetary easing and fiscal stimulus package. That said, downside risks to growth in the advanced economies and global financial stability remain. While the temporary extension of the debt ceiling deadline in the US helps avoid an imminent political stand-off, fiscal uncertainty will continue to cloud the US economic prospects. In Europe, household, bank and sovereign balance sheet stresses would continue to drag on growth. Meanwhile, the sharp depreciation of the Japanese yen and the pound sterling on expectations of more aggressive monetary policy moves reignites concerns about currency volatilities.

Amid the stabilisation of the external environment, growth momentum in East Asian emerging economies, including Mainland China, recovered in the last quarter of 2012, after registering a general downward cycle in the previous quarters. Inflationary pressures remained contained. In Mainland China, there have been concerns that the decline in working age population would push up wages and inflation. Box 1 discusses the extent to which changing demographics and labour market tightness have affected labour costs in Mainland China. Meanwhile, the latest round of monetary easing in major advanced economies has generated some capital inflow pressures for most East Asian economies. Regional currencies have generally appreciated against the US dollar since late August 2012, but the appreciation pressures appeared to have eased recently.

The domestic economy

In Hong Kong, growth momentum picked up gradually during the second half of 2012 along with some stabilisation in the merchandise trade performance. Domestic demand strengthened on a broad base, led by robust growth in private consumption and fixed investment. This lifted real GDP growth to a sequential 0.8% in the third quarter and 1.2% in the fourth quarter. For 2012 as a whole, however, growth slowed to a below-trend rate of 1.4% from 4.9% in 2011. Box 2 analyses the deterioration in Hong Kong's current account balance and argues that such developments warrant close monitoring as they may be symptoms of financial imbalances.

The labour market remained tight on the back of an improving economy. The seasonally adjusted three-month moving-average unemployment rate continued to stay at a low level of about 3.3% over the past six months, while total employment increased to a historical high of 3.71 million in January. With growth momentum picking up, the output gap was also estimated to have largely closed in the fourth quarter of 2012.

Local inflation also rose along with the improvement in the local economic environment. On an annualised three-month-on-three-month basis, the underlying inflation rate increased steadily to 4.7% in December 2012 from 1.6% in August, with all major CCPI components, including rental, tradables and services, registering some increases in momentum during the period. Looking ahead, the inflation momentum is expected to remain steady as the fragile global economic environment is expected to help contain commodity price pressures. However, there is the chance that inflationary pressures may pick up to higher-than-expected levels, particularly if the local property market were more buoyant than expected.

The Hong Kong economy is expected to grow faster at a close-to-trend rate in 2013. The drags from external demand should subside gradually, but a full recovery in exports will still take some time as the global economy is struggling to achieve sustained growth. Domestically, consumer spending should continue to lend support to growth in real activity, and large-scale infrastructure works and private building activity are expected to hold up quite well. Overall for 2013, private sector analysts project the economy to grow by 2.5-4.7%, averaging at around 3.5%. The Government also sees growth strengthening to the range of 1.5-3.5%.

Monetary conditions and capital flows

The Hong Kong dollar exchange rate strengthened and stayed close to 7.75 during the second half of 2012, and then softened slightly in early 2013. The strong-side CU was triggered repeatedly in the fourth quarter of 2012, which led to the purchase of US dollars of $13.8 billion and the sale of Hong Kong dollars of $107.2 billion by the HKMA. This inflow of funds partly reflected increased allocation to Hong Kong dollar assets by overseas investors, as well as the proceeds from issuance of foreign currency bonds by Hong Kong firms in exchange for Hong Kong dollars. The stronger equity initial public offerings (IPO) activities in late November and December also to some extent supported the inflows. In the face of inflow pressures, the Hong Kong dollar exchange market has functioned normally. Box 3 assesses the recent performance of the Hong Kong dollar exchange market and argues that the Linked Exchange Rate system has continued to enjoy a high degree of market credibility.

The low interest rate environment has continued. In the money market, the interbank rates stayed low, with the overnight and three-month HIBOR fixings hovering around 0.10% and 0.40% respectively. For maturities beyond three months, the interbank rates edged down slightly along with the LIBOR counterparts. The yield curve of Exchange Fund papers shifted down in the second half of 2012, partly reflecting increases in banks' demand for high-quality Hong Kong dollar assets. But it has steepened slightly in early 2013 amid larger increases in long-dated yields. The average cost of funds for retail banks, as reflected by the composite interest rate, has declined slightly as a result of easing deposit interest rates. Mortgage interest rates also edged down. In mid-March, however, a few leading banks raised the mortgage interest rates by 25 basis points, reportedly in response to higher funding costs.

As a result of repeated triggering of the strong-side CU in the fourth quarter of 2012, the Aggregate Balance and hence the Monetary Base increased appreciably. In early 2013, additional Exchange Fund papers were issued to meet the strong demand by banks for liquidity management. Against this background, the Hong Kong dollar monetary aggregates showed much faster increase in the second half of 2012. For the whole year, the Hong Kong dollar narrow money supply rose by 15.8% and the broad money supply by 12.1%. Meanwhile, Hong Kong dollar deposits increased by 11.7% in 2012 as a whole, compared with a modest annualised 3.8% increase in the first half.

On the credit side, total loan growth slowed visibly to 9.6% in 2012 from 20.2% in the previous year, along with the slowdown in the domestic economy and in part reflecting the impact of prudential measures by the HKMA. But compared with the first half, there was a slight acceleration in loan growth towards the year end led by Hong Kong dollar loans and loans for domestic use, although growth remained modest at 5.5% and 7.3% respectively for the whole year. Foreign currency loans and loans for non-domestic use saw growth decelerating throughout the year to around 16%. Going forward, credit demand is expected to increase in the near term amid signs of improvement in the domestic economy. The latest HKMA Opinion Survey on Credit Condition Outlook also points to stronger credit demand in the period ahead.

Renminbi loans extended by banks in Hong Kong surged by 156.6% from a year ago to RMB79.0 billion at the end of 2012. As a result, banks' renminbi assets have become more diversified. On the liability side, the funding structure of banks' renminbi business has continued to evolve. Banks were increasingly issuing renminbi certificates of deposits (CDs) as a means to tap renminbi funds in the first half of 2012, although such tendency moderated somewhat in the second half of the year. For 2012 as a whole, outstanding CDs surged by 60.5% to RMB117.3 billion while customer deposits increased by 2.5% to RMB603.0 billion. The latter represented 9.1% of total deposits in Hong Kong's banking system. Box 4 provides a preliminary analysis of the determinants to the growth in outstanding renminbi deposits. This helps provide further insights on the development of offshore renminbi liquidity.

Asset markets

The local stock market rebounded following last summer in view of a brighter outlook for global financial markets. Financial conditions stabilised as the Fed and ECB introduced another round of monetary easing measures, while more signs emerged that the Mainland economy was about to bottom out. Except for a brief period towards the end of last year in which concerns over the US economy heading for a "fiscal cliff" pulled investors back to the sideline, the overall sentiment has been bullish in the past six months. Looking ahead, however, the most fundamental fiscal issues remain unresolved in the US and Europe, and noise from political wrestling could now and then hit a nerve. Geopolitical tensions arising from the nuclear testing in North Korea and the sovereign border disputes in East Asia could also potentially unsettle equities.

The debt market has registered fast growth, with private sector debt issuance increasing particularly strongly. Last year saw the corporate sector tap the bond market much more aggressively than before. While Hong Kong dollar debt issued by local corporates declined slightly, debt issued in other currencies experienced phenomenal growth with US dollar debt issuance more than doubling. The strong growth in the corporate bond market was attributed to a host of cyclical and structural factors, which are likely to continue to underpin the outlook in the period ahead. The renminbi debt market in Hong Kong also expanded steadily last year with a number of positive developments including an increasingly more diversified mix of issuers, longer maturity of debt issued and better credit quality of bonds.

Risks in the residential property market continue to be a major concern for macroeconomic and financial stability in Hong Kong. While the volume of property transactions has been volatile, flat prices increased notably by 25.2% in 2012 and more than doubled from the end of 2008. But with household income growing at a more gradual pace, flat prices could have run well ahead of the fundamentals, with many of the affordability indicators already flagging warning signals of overvaluation risks.

Going forward, improved market sentiment amid better growth outlook and more aggressive monetary easing in the advanced economies could further aggravate the misalignments between flat prices and the fundamentals. In view of this, the Government introduced further measures in February 2013 by doubling the ad valorem stamp duty rates for all properties.

The HKMA also announced a new round of prudential measures by imposing stricter stress testing requirements for mortgage lending, lowering the maximum loan-to-value (LTV) ratio for non-residential properties and introducing a risk weight floor of 15% for new residential mortgage lending by banks using the internal ratings-based approach.

Banking sector performance

Along with the general stabilisation of global financial market conditions and a more sanguine economic outlook, the local banking sector continued to record healthy growth. The sector's performance was characterised by steady credit expansion and favourable liquidity conditions. These positive developments took place despite continued deleveraging by euro area banks, as local and other foreign banks moved in to fill the void. With strong capital positions by international standards and sound asset quality, banks are well placed to meet the new capital requirements under the Basel III framework.

During the second half of 2012, the sector's profitability moderated from the very buoyant results of the first half, due to lower non-interest income, a rise in operating cost and higher net charges for provisions, which more than offset the increase in interest income. Nevertheless, the performance remained more favourable than the same period of 2011, with retail banks registering a pre-tax return on assets of 1.1%, compared with 1.24% in the first half, and just 1% in the second half of 2011. For 2012 as a whole, the aggregate pre-tax profits recorded an increase of 12.7%, with the average pre-tax return on assets rising to 1.16% from 1.1% in the previous year.

Liquidity conditions continued to be sound. As the growth of deposits outpaced credit expansion, the overall loan-to-deposit (LTD) ratio for all authorized institutions (AIs) went down notably to 67.1% in December 2012, from 69% in June 2012. Reflecting improved funding conditions, average interest costs for the Hong Kong dollar and US dollar funding of licensed banks both declined across the board – for both deposits and market-based funding.

Looking ahead, while external headwinds have seemingly diminished, uncertainties regarding fiscal issues in the US and Europe would continue to cloud economic prospects. Another challenge regards the continued expansion of the sector's credit exposure to Mainland-related business, and banks should continue to be vigilant about the credit risk management on their Mainland-related exposure.

Domestically, the risk of a property-price bubble would continue to overshadow the banking system. Box 5 examines empirically the transmission mechanism of LTV policy and reveals that the sharp rise in property prices after the global financial crisis has led to significant increases in collateral values and thus credit supply, and the LTV cap tightening has partly offset such effect and reduced the risk of credit-asset price spirals.

The recent financial crisis has highlighted the important role of global banks in the transmission of shocks across banking sectors in different economies. Box 6 assesses how US and European banks have adjusted the business models of their Hong Kong branches after the 2008-09 global financial crisis, and implications for the shock transmissions.

The Half-yearly Report on Monetary and Financial Stability is prepared by the staff of the Research Department of the Hong Kong Monetary Authority.