1. Summary and overview

Capital outflow pressures emerged in the Asian region, amid a sharp upward shift of the US dollar yield curve triggered by expectations of a scaling-down of asset purchases by the US Federal Reserve. In contrast, the Hong Kong dollar exchange rate has remained stable, hovering near the strong-side Convertibility Undertaking (CU) of 7.75.

The property market has been subdued, but fragility remains. Mainland exposure of Hong Kong banks has continued to increase, but are under more intensive supervisory scrutiny as the Mainland economy slows visibly and corporate leverage rises. Banks are advised to prepare for more adverse scenarios from credit, interest rate and liquidity risks.

The external environment

Global financial markets have witnessed sharp gyrations over the past six months, as market participants reappraise the prospect of normalisation of monetary policy in the US. Markets initially experienced sharp sell-offs and the US dollar appreciated sharply when US Fed Chairman Ben Bernanke outlined a roadmap for tapering and eventually stopping the open-ended asset purchase programme. Subsequently, global stock markets have recovered most of their lost ground as the Fed clarifies that "the end of asset purchase does not necessarily imply imminent rate hikes" and major advanced economies show better-than-expected economic performance.

In the US, the strong second quarter GDP figure defies concerns about the summer soft patch amid fiscal drags. As such, the Fed seems to be on track to follow its plan to start to scale back its asset purchases by the end of 2013. In Europe, economic contraction seems to have stabilised but a recovery remains elusive. The European Central Bank (ECB) introduced in the July Governing Council meeting a forward guidance by stating that it "expects the key ECB interest rates to remain at present or lower levels for an extended period of time". In Japan, economic recovery has gained traction and asset markets have had a good run giving "quantitative and qualitative monetary easing" (i.e. QQE) and "Abenomics" a good start, but it remains to be seen whether the Abe government can deliver on much-hoped structural reforms.

The biggest swing factor for global monetary and financial stability at present is whether the US Fed can manage an orderly unwinding of its asset purchase programme. The abrupt rises in global long-term bond yields and synchronised global stock market declines on fear of Fed tightening back in late May - June 2013 serves as a rehearsal of what would happen in the case of a disorderly exit. The announcement of the Fed's quantitative easing tapering has also led to a repricing of risks, resulting in a reversal of fund flows in emerging market economies (EMEs).

Along with the emerging market sell-off, signs of capital outflows in East Asia were pronounced in late May and late August as worries over the Fed's tapering of its asset purchases triggered a sell-off in the region's risky assets, posing downward pressures on some regional economies' currencies. This might have also reflected a repricing of risks by investors amid relatively stronger US recovery and softening of the region's economic growth, including in Mainland China.

Box 1 attempts to explain the recent divergence between credit expansion and GDP growth in Mainland China. Our analysis suggests this possibly reflects the lengthening of the credit intermediation chain, and at the same time credit might not have been allocated to those firms that have the capacity to generate higher investment and output. Indeed, excess leverage seems to be concentrated among large firms in sectors that already have excess capacity.

The domestic economy

In Hong Kong, real GDP grew at a below-trend rate of 0.2% and 0.8% quarter on quarter in the first two quarters respectively. Net exports continued to be the main drag on growth due to weak demand from the advanced economies and growth moderation of the Mainland economy and the region. Domestic consumption remained relatively strong, albeit with signs of moderation emerging in the second quarter. Overall investment spending, however, seemed to lack growth momentum.

The labour market continued to hold up despite moderate growth momentum in the economy. The seasonally adjusted three-month moving average unemployment rate continued to stay low at about 3.4% in the first seven months of 2013, while total employment further increased to 3.75 million in July from 3.71 million in January. The tightness of the labour market appears to be at odds with an economy judged to be operating below its potential in the past several quarters.

Local inflationary pressure stayed firm during the first four months of 2013 but has slightly moderated since May. On an annualised three-month-on-three-month basis, the underlying inflation rate edged down to 3.1% in July after reaching 5.3% in April. The alleviation in the sequential momentum was largely driven by the non-tradables and rentals, while the inflationary pressure of tradables edged up between April and June before retreating in July. Looking ahead, the sequential inflation momentum is likely to ease slightly amid more moderate housing rentals increase. However, the inflation outlook is subject to risks on both sides. On the upside, the geopolitical tension in Middle East may boost the oil price. On the downside, the US Fed's tapering of its asset purchase programme may dampen asset prices and domestic economic activity and consequently local inflationary pressure.

The below-trend growth path of the Hong Kong economy is expected to continue into the rest of the year. On one hand, external demand will be supported by stronger recovery in the advanced economies, particularly in the US. On the other hand, less favourable wealth effect from weaker asset markets amid Fed's tapering of asset purchase as well as slower real income growth will translate into softer growth in domestic private consumption. Private sector analysts have revised downward the 2013 growth forecast for Hong Kong to an average of 2.9%, while the Government sees growth in the 2.5 - 3.5% range and our in-house composite index of leading indicators points to moderate growth ahead. Box 2 discusses the potential impact of a sharp rise in the US interest rates on Hong Kong by looking at the experience of the 1994 US bond market crash.

Monetary conditions and capital flows

While the global and domestic financial conditions were volatile in the first half, the Hong Kong dollar exchange market has continued to trade in an orderly manner and the exchange rate has stayed close to 7.75. In the money market, the overnight and three-month HIBOR fixing edged down to 0.09% and 0.38% respectively. On the other hand, retail banks' weighted deposit rates picked up in May and June largely due to increased liquidity demand, thus leading to a modest uptick in their overall funding cost. Meanwhile, the yield curve of Exchange Fund paper has steepened along with that of the US Treasuries in the face of increased concerns about the Fed's tapering of asset purchases and eventual rate hikes.

Demand for Hong Kong dollar assets from the non-bank private sector has weakened somewhat. This contrasted with the strong demand and inflow pressures in the final quarter of last year when there was an inflow of more than HK$100 billion into the Hong Kong dollar. But on the whole, outflow pressures in the non-bank private sector were not particularly large in the first half. The Hong Kong dollar exchange rate still stayed close to the strong-side CU, and there was no significant decrease in the net spot foreign currency positions of authorized institutions (AIs). In the meantime, banks' increased demand for the Hong Kong dollar has provided a partial offset to the outflow pressures.

With limited outflow pressures, the Hong Kong dollar monetary aggregates held relatively steady. The Hong Kong dollar broad money supply (HK$M3) increased marginally, within which bank customers' deposits and negotiable certificates of deposits held by the non-bank sector edged down by an annualised rate of 0.4% and 0.5% respectively.

On the asset side, total loan growth accelerated to an annualised rate of 19.0% in the first half of 2013. Within the total, loans for domestic use rose by 20.5%, reflecting a strong upsurge in trade finance. Loans for external use also expanded by a solid 15.4%, roughly the same pace as in 2012. Hong Kong dollar loans grew moderately by an annualised rate of 9.4%, while foreign currency lending picked up noticeably due to the upsurge in trade finance. As a result, the Hong Kong dollar and foreign currency loan-to-deposit ratios rose to recent highs of 83.7% and 60.4% respectively. However, there are signs of moderation in loan growth more recently and the liquidity conditions have alleviated somewhat. The latest HKMA Opinion Survey on Credit Condition Outlook also points to soft credit demand in the period ahead.

Renminbi financing activities in Hong Kong continued to grow at a robust pace in the first half of 2013, with outstanding loans increasing by 39.8% (not annualised) from six months ago to RMB110.5 billion at the end of June. At the same time, the liquidity pool of renminbi also expanded steadily, with the total outstanding amount of renminbi deposits and certificates of deposit rising by 19.5% to RMB860.7 billion. Within the total, customers' deposits rose by 15.7%, largely driven by corporate accounts amid the growing popularity of renminbi as a settlement currency. Meanwhile, personal customer deposits also increased, of which a growing share, amounting to 4.8% or RMB10.8 billion by the end of June this year, were held by non-resident personal customers. As a result, the proportion of renminbi deposits grew to 10.4% of total deposits with the AIs at the end of June.

Asset markets

Equities went on a roller coaster ride amid a series of negative external shocks in the last six months. The inconclusive election outcome in Italy and the banking crisis in Cyprus initially weighed on equities across the globe including the local market. Although signs of strengthening of the US economy subsequently boosted confidence, they also prompted the Fed to be more vocal and explicit about the exit path from its extraordinary monetary accommodation. This, coupled with a liquidity crunch on the Mainland, triggered a sharp downward adjustment. While the market recouped part of its losses following Chairman Bernanke's clarification of the Fed's policy intentions, uncertainties surrounding the global economic outlook, especially for the EMEs, are expected to continue to weigh on the local equity market.

The domestic debt market expanded further despite the more difficult external environment. Box 3 reviews the developments of the bond market in Hong Kong in recent years and discusses the driving factors. In the past six months, there was a decline in bond issuance by the private sector. The decline was, to some extent, attributed to a reduction in appetite for bonds in June, as uncertainties over quantitative easing tapering sent investors to the sideline. In contrast, the offshore renminbi debt market continued to steam ahead. Corporate issuance rose particularly strongly alongside a rising proportion of speculative grade debt, which may be attributable to the recent tight liquidity conditions on the Mainland. Looking ahead, in view of an increasingly refined financial infrastructure (e.g. the launch of the CNH HIBOR fixing), the offshore renminbi debt market is expected to remain on a steady growth path in the foreseeable future.

Housing prices have softened and transaction volume declined noticeably since February this year following the introduction of additional stamp duty and prudential measures by the Administration and the HKMA. However, housing affordability has continued to deteriorate, and property market imbalances are still elevated. The once-buoyant non-residential market has also cooled quite notably, but prices continued to increase moderately. Rentals were relatively resilient, and overall rental yields remained close to the historical low of 2 - 3%. Potential overvaluation risks and pressure of higher rentals on business activities would remain a key concern. The impending reversal of low interest rates and continued soft growth in Hong Kong's domestic economic activity may cloud the prospects of the property market.

Banking sector performance

Notwithstanding an uncertain external environment and the slowdown of the Mainland economy, the Hong Kong banking sector continued to post vibrant performance, with the aggregate pre-tax profit of retail banks growing by 30.9% in the first half of 2013, from the second half of 2012. Average pre-tax return on assets also rose to 1.39% during the first half, compared with a return of 1.1% in the second half of 2012. Improvements in both net interest and non-interest incomes, plus better control of operating expenses and lower net provisions, were the main drivers of profitability growth. Net interest income was partly boosted by higher net interest margins which rose to 1.41% due to a fall in banks' average funding costs.

Bank lending grew more rapidly by 9.5% in the six months ended June 2013, compared with an increase of only 4.7% in the preceding six months. The pick-up in credit expansion was largely attributable to a significant growth in foreign-currency loans, in particular trade finance. As loan growth outpaced deposit growth, the loan-to-deposit ratios of the banking system rose in the first half of 2013, in particular the ratio for foreign currency lending rose significantly to 60.4% by the end of June, from 54.2% at the end of 2012. Nevertheless, domestic liquidity conditions remained healthy, with banks' liquidity ratios staying well above the regulatory requirements.

Looking ahead, the banking sector will face rising domestic and external risks in the year to come. Domestically, the risk of interest rate volatility is expected to escalate amid lingering global financial uncertainties. Specifically, in the process of the likely eventual normalisation of US monetary policy, the possible impact of any shift in the yield curve on banks' balance sheets may not be small. In addition, any significant rise in interest rates would likely have adverse effects on banks' asset quality. In particular, the rise in corporate leverage over the past year suggests that corporations' debt servicing abilities could be under test, while property prices could be under significant pressures. To the extent that a large outflow of funds from Hong Kong may take place as a result of US tapering, as some market participants anticipate, the situation would be aggravated. Box 4 examines factors behind the rising loan spreads of syndicated loans after the global financial crisis and suggests that, even if the near-zero interest rate environment remains unchanged in the near term, a significant change in domestic liquidity conditions due to external factors could drive the loan pricing in Hong Kong noticeably.

Externally, the rising share of banks' Mainland exposure continues to be a significant risk factor. Despite that banks' lending to Mainland-related customers is largely backed by guarantees or collateralised, given market's rising concerns about Mainland's growth outlook, corporate leverage and funding conditions, banks should continue to maintain their stringent prudential management of their Mainland exposure.

At the initiative of the Financial Stability Board, the Macroeconomic Assessment Group on Derivatives conducted an assessment of the costs and benefits of the over-the-counter derivatives reform. Box 5 presents key findings of the exercise, which estimates that the reform could generate median net benefits equivalent to 0.12% of GDP across 16 jurisdictions. For Hong Kong, the net benefits are estimated to be around 0.13% of GDP.

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