1. Summary and overview

Global financial markets recovered shortly after the Brexit-related rout on expectations of further policy support. However, the increasing divergence between the liquidity-driven stability in the financial markets and longer-term fundamentals, particularly given the growing unusual economic and political uncertainties, could risk sowing the seeds for future financial volatility and disruptions.

Despite heightened global market volatility, the Hong Kong dollar exchange rate remained broadly stable. Loan growth picked up after a contraction in the second half of 2015. While the property market has shown signs of stabilisation, its outlook has become more uncertain. Looking ahead, the subdued demand for credit, depressed yields of safe assets and keen competition in the mortgage market could pose challenges for banks in managing their surplus funding, putting pressure on their profitability. Although the Hong Kong banking system has not been much affected by the Brexit vote, continued monitoring of potential international spillovers is required.

The external environment

Global financial markets were stunned in late June by the United Kingdom's (UK) vote to leave the European Union (EU) (Brexit). However, the sell-offs were orderly and later proved to be short-lived amid heightened expectations of further policy support from major central banks. While Brexit has so far caused limited market disruptions, its full impact will take years to show and will depend crucially on the outcome of the UK-EU negotiation and whether wider political fallouts can be contained. In the near term, the impact on the global economy should not be large, given the limited real direct linkages of the UK to the global economy. However, the European economy could still be susceptible to the Brexit shock given its fragility and the already difficult operating conditions facing European banks. In the event that Europe is significantly affected by Brexit, the second-round effects on emerging market economies (EMEs) could be larger given their dependence on export demand and investment from Europe.

In response to Brexit, major central banks have maintained, if not further loosened, their accommodative monetary policy. Nevertheless, concerns over major central banks running out of policy ammunitions are increasing, and some governments in advanced economies may find it tempting but politically difficult to implement further fiscal stimulus. Meanwhile, the US Federal Reserve is expected to normalise its monetary policy gradually, but the relatively more solid underlying strength of the US recovery means that global monetary divergence could at some point widen again. Looking ahead, increased demand for US treasuries amid negative sovereign bond yields, record-low interest rates in Europe and Japan, and expected resumption of monetary divergence could provide support to the strong US dollar. In such a case, renewed downward pressure on oil prices and depreciation pressure on emerging market currencies, especially for those with weaker economic fundamentals, cannot be ruled out. The risk is that the increasing divergence between the liquidity-driven stability in the financial markets and longer-term fundamentals, particularly given the growing unusual economic and political uncertainties, could risk sowing the seeds for future financial volatility and disruptions. Financial disruptions, whether in advanced or emerging market economies, could quickly spill over to one another given their increasing interconnectedness. Box 1 (see page 23) analyses the bilateral spillovers between advanced and emerging market economies in the sovereign bond markets.

In East Asia, financial markets have also stabilised after a brief surge of volatility following the Brexit decision. Although the region saw more capital inflows recently as investors renewed their search for yield, the full impacts of Brexit, especially those on real activities through trade and direct investment channels with the EU, remain to be seen. Meanwhile, growth momentum in the regional economies continued to be constrained by sluggish external and domestic demand. In view of this, many regional central banks have eased their monetary policy recently to support growth. Going forward, the region's economic prospect will be subject to increased uncertainties in the external environment, including how US monetary policy normalisation and uncertainty surrounding the Brexit negotiations interact with global and domestic policy responses and dollar strength.

In Mainland China, economic growth continued to trend down in the first half of 2016 with tentative signs of stabilisation in the second quarter thanks to accelerated infrastructure and property investment, as well as narrowed declines in net exports. However, uncertainty over near-term growth prospects remains in view of the rapidly changing domestic and external environment. Domestically, the acceleration in supply-side reforms this year could be contractionary in the short run. Externally, Mainland's export performance will still depend on the pace of recovery in major economies. While the slowdown in economic growth and weak corporate earnings would continue to weigh on asset quality of Mainland banks, the provisions put aside by banks and their solid pre-tax profits should be sufficient to cover potential loan losses.

In the forex market, the renminbi exchange rate weakened against the US dollar and the currency basket compiled by the China Foreign Exchange Trade System. With improved market sentiment, volatility of the renminbi exchange rate has declined. Meanwhile, outflow pressures have eased with signs of stabilisation in foreign reserves. Following the marked cut back in external debt and foreign currency borrowing, the risk of currency mismatch faced by Mainland firms also reduced. Box 2 (see page 27) assesses the US dollar borrowing by Mainland enterprises using data of listed firms, and the potential impact of the depreciation of the renminbi on the credit risk of these borrowers.

The domestic economy

The Hong Kong economy has avoided a technical recession with quarter-on-quarter real Gross Domestic Product (GDP) growth increasing to 1.6% in the second quarter from -0.5% in the previous quarter. On the domestic front, private consumption growth strengthened from -0.2% in the first quarter to 0.9% in the second quarter amid a pick-up in service spending and a low base effect in the first quarter. Meanwhile, despite weak machinery and equipment acquisition, investment spending also strengthened in the second quarter on the back of stronger public and private building and construction activities. On the external front, exports of goods rebounded in the second quarter, while exports of services remained soft in the first half amid weak inbound tourism. As total import growth exceeded that of total exports in the second quarter, net exports' contribution to real GDP growth turned negative in the second quarter.

Headline unemployment rate edged up to 3.4% in July from 3.3% at the end of 2015, mainly due to slower employment growth in the retail, accommodation and food services sector. The sector has been hit by the decline in Mainland tourists and moderation of domestic private consumption. Box 3 (see page 35) analyses the role of sectoral and aggregate channels in driving the overall unemployment rate.

Local inflation momentum has abated since April with the annualised three-month-on-three-month underlying inflation rate easing to -0.3% in July from 3.5% in April, mainly attributable to subsiding food inflation and slower increases in housing rentals. Looking ahead, upside risks to inflation are likely to remain contained in view of soft import prices and the modest local economic growth.

The Hong Kong economy will continue to face headwinds going forward. Externally, exports will be constrained by a continued slowdown in global economic and trade growth, potential longer-term global repercussions from uncertainties surrounding Brexit and the strong US dollar amid divergence of major economies' growth prospects. Domestically, the property market outlook is still highly uncertain with further ramifications to the domestic economy. The market consensus forecast of the real GDP growth in 2016 has been revised downward to 1.0% from 1.8% registered in March.

Monetary conditions and capital flows

Despite heightened global market volatility, particularly after Brexit, the Hong Kong dollar exchange rate remained broadly stable against the US dollar, trading within a range of 7.7529 and 7.7760 since March. Reflecting the strength of the US dollar, the Hong Kong dollar nominal effective exchange rate has again appreciated since May. During the review period, the Convertibility Undertaking was not triggered.

With the monetary base staying steady at sizeable levels, the overnight Hong Kong Interbank Offered Rate (HIBOR) fixing rates remained low at around 0.05% during the first half, and the three-month HIBOR fixing rate also stabilised at around 0.54% in the second quarter. Amid increased competition for mortgage business, the average mortgage rates edged down slightly to 1.90% in July from 1.93% in December last year.

After contracting by 1.8% in the second half of 2015, total loans increased by 2.2% in the first half of 2016. In particular, domestic credit picked up by 3.2% in the first half along with the recovery in economic activity in the second quarter. As household loan growth remained modest, household debt-to-GDP ratio dropped slightly to 65.8% in the second quarter from 66.5% registered six months ago.

Partly reflecting the strength of the US dollar and concerns about Mainland's economic prospects, both the onshore (CNY) and offshore (CNH) renminbi exchange rates have weakened since April with the CNH reaching the low level of 6.7 against the US dollar in mid-July. Meanwhile, the discount of the CNH vis-à-vis its onshore counterpart remained contained at moderate levels, while CNH HIBORs remained broadly stable, despite occasional pick-ups.

With market expectation of continued weakness in the renminbi exchange rate, Hong Kong's renminbi liquidity pool (including outstanding renminbi customer deposits and certificates of deposits) consolidated further in the first half of 2016, while renminbi trade settlement and bank lending also declined over the same period. That said, Hong Kong's position as a global hub for offshore renminbi clearing and settlement remained robust, with the average daily turnover of renminbi real time gross settlement system staying at a high level. Despite the recent slowdown in offshore renminbi activities, the ongoing capital account liberalisation in Mainland China and the implementation of the Belt and Road Strategy are expected to support the development of offshore renminbi business in Hong Kong going forward.

Asset markets

Hong Kong equities have rebounded after reaching a four-year low in February. Against the backdrop of strong rallies in major markets and recovery of oil prices, fears of a possible severe slowdown in the global economy have subsided. The UK referendum to leave the EU caused some anxiety at one stage, triggering a pullback by international investors, but it was short-lived. Subsequently, increased expectations of a more gradual pace of monetary normalisation in the US and further easing of monetary policy in other major economies have lent support to global equities, including those of Hong Kong. Nonetheless, the outlook for local equities remains highly uncertain in light of the weakened outlook for the global economy, except the US.

Meanwhile, the domestic debt market has expanded markedly, on the back of a strong pickup in issuance by both domestic and international borrowers. The public sector, private sector and overseas institutions, especially the multilateral development banks (MDBs), all tapped the market aggressively in the first half of this year, compared to the same period a year ago. As a consequence, the total amount of local currency debt outstanding rose sharply. This is in sharp contrast with the offshore renminbi market, which saw issuance fall further in the review period. The decline was attributable to a combination of factors, including reduced financing needs of the slowing Mainland economy, further weakness of the renminbi and lower borrowing costs onshore. While the trend is unlikely to reverse any time soon, the longer-term outlook is still optimistic in view of rising long-term demand for renminbi assets.

The residential property market has stabilised since the second quarter. With property developers increasing new launches and providing aggressive promotional schemes to lure buyers, including the offering of very high loan-to-value mortgage plans, primary market transactions picked up, while secondary-market transactions also increased. With increase in the transaction volume, housing prices also picked up, with the Centa-City leading index rising since March. The outlook for the property market has become more uncertain. On the one hand, the uncertainty surrounding the pace and effect of US rate hike will continue to pose headwinds. New launches in the pipeline and the uncertain global economic environment will also put downward pressure on housing prices. On the other hand, market expectation of still-abundant global liquidity would provide some support in the near term.

Banking sector performance

The profitability of retail banks improved in the first half of 2016, mainly attributable to lower operating costs. Their pre-tax operating profit increased by 14.9% in the first half of 2016 as compared with the second half of 2015, contributing a rebound of the return on assets to 1.07% from 0.95%.

The banking sector maintained strong fundamentals. Banks' capital and liquidity positions, as measured by Basel III standards, were structurally robust. The consolidated capital adequacy ratio of locally incorporated authorized institutions (AIs) rose to 19.4% at the end of June 2016. The average Liquidity Coverage Ratio for category 1 institutions rose further to 158.0% in the second quarter, while the average Liquidity Maintenance Ratio for category 2 institutions stood at 53.8%. All these ratios were well above their regulatory minimums. Asset quality remained sound by historical standards despite slight deterioration during the review period. To enhance banks' resilience against systemic risks, the countercyclical capital buffer will rise to 1.25% of total risk-weighted assets with effect from 1 January 2017 from the current 0.625%.

Box 4 (see page 66) provides a comprehensive assessment of corporate leverage in Hong Kong based on different indicators. Overall, the assessment shows that non-local corporates in Hong Kong play a bigger role in driving up the aggregate corporate leverage in Hong Kong after the global financial crisis. If the global economic environment deteriorates further and/or the US interest rate rise resumes, the debt-servicing ability of some non-local corporates will be under significant pressure. Banks should manage credit risk in relation to their corporate exposure more prudently.

Looking ahead, the banking sector will face multiple headwinds. The subdued demand for credit, depressed yields of safe assets and keen competition in the mortgage market could pose challenges for banks in managing their surplus funding, putting pressure on their profitability. Although the Hong Kong banking system has not been much affected by the Brexit vote, continued monitoring of potential international spillover risks is required in view of the unmatched role of the UK banking system in channelling international banking flows and the significant interbank linkage between Hong Kong and the UK.

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