1. Summary and overview

The global economy is entering a period of greater uncertainty after Donald Trump's victory in the US presidential election. A paradigm shift in US policy under the new US administration is possible in two major areas that might have a profound impact on the global economic landscape – the shift from monetary easing to fiscal expansion and from globalisation to deglobalisation. In particular, risks facing emerging market economies have intensified amid faster US interest rate hikes and a stronger US dollar, as well as possible protectionist measures from the US.

The Hong Kong dollar exchange rate remained broadly stable while the Hong Kong dollar interbank rates picked up alongside the movements in their US dollar counterparts. Despite this, liquidity conditions remained favourable, and growth in total loans picked up further in the second half of 2016. The residential property market showed signs of consolidation immediately after the introduction of the new stamp duty measure before picking up more recently. Going forward, banks should carefully assess the implications of possible faster-than-expected US rate rises and, on a broader scale, policy uncertainties in the US, particularly the risk of drastic capital outflows and their potential impact on local interest rates.

The external environment

The global economy is entering a period of greater uncertainty following the election of Donald Trump as the new US president. Not only has the election outcome surprised the market, but the associated reaction was also largely unexpected. In particular, global equity markets rallied on expectation of a reflationary effect on the US economy from Donald Trump's pro-growth policies of tax reforms, infrastructure spending and deregulation.

Indeed, the new US administration is likely to lead to a paradigm shift in US policy in two major areas that could have a profound impact on the global economic landscape, namely the shift in policy stimulus from monetary easing to fiscal expansion and the shift in trade policy from globalisation to deglobalisation. However, the much-anticipated Trump tax cuts may not provide as much of a boost to US growth as markets may have been expecting. In particular, with the US economy now operating close to its potential, fiscal stimulus may provide only a small cyclical boost to growth while adding further upside risks to US inflation. It remains uncertain whether the US Federal Reserve (Fed) will hasten the pace of monetary tightening markedly in response, but long-term bond yields have already risen sharply, partly reflecting expectations of higher inflation risk. Meanwhile, trade protectionist measures will be a "lose-lose" proposition for the US and the rest of the world. More barriers to trade will create welfare-reducing distortion, hamper global trade flows, weaken global supply chain efficiency and pose downside risks to the global economic outlook. At the same time, political instability remains a major risk and headwind, particularly to the fragile recovery in Europe.

For emerging market economies (EMEs), the risks stemming from a faster rise in US interest rates and further strengthening of the US dollar on capital outflows have intensified. This could dampen economic growth and heighten the risks of sharp capital outflows. Indeed, the repricing of inflationary risk amid expectations of large-scale fiscal expansion under the Trump administration and concerns over surging energy inflation have led to widespread and notable increases in long-term yields, not only in advanced economies (AEs) but also in many EMEs. Box 1 (see Page 15) assesses the potential spillover impact of higher interest rate expectations in the US on the sovereign bond markets in 26 selected economies. The findings suggest that the influence of the US Treasury bond market on sovereign bond markets has increased since the "taper tantrum" in 2013, and that higher interest rates and tighter financial conditions in the US will significantly affect many AEs and EMEs.

In East Asia, growth improved marginally in the second half of 2016, supported by a rebound in exports, but the spillover from concerns about policy changes by the new US administration led to currency depreciation and rises in sovereign bond yields before the situation stabilised early this year. Looking ahead, growth in East Asia is likely to be stable in 2017, but the risks and uncertainties have intensified. A combination of higher US interest rates, weaker currencies and more volatile financial markets could lead to tighter financial conditions. The potential protectionist policies in the US are also a threat to regional economies, although there is considerable uncertainty over their actual impact.

In Mainland China, economic growth crept up in the second half of 2016 amid robust infrastructure investment and improved private sector business spending. While there have been increased signs of stabilisation, Mainland growth outlook remains uncertain. In particular, the real estate sector would likely extend less support to growth this year if property markets continue to cool down along with the authorities' determination to rein in the housing price rally. Meanwhile, the ongoing economic restructuring and the dynamics in the Sino-US trade relations may add uncertainty to the near-term economic outlook. On the external front, capital outflow pressures increased towards the end of 2016 amid the strengthening of the US dollar and an interest rate hike in the US before appearing to have eased somewhat in early 2017, despite the stability of the renminbi against the currencies in the China Foreign Exchange Trade System (CFETS) basket during the review period.

Despite signs of stabilisation in economic activities in the private sector, there were concerns about deterioration in the effectiveness of monetary policy especially in view of accelerated M1 growth along with a slowdown in M2 expansion. Box 2 (see Page 28) addresses the question of whether the Mainland economy is in a liquidity trap, while Box 3 (see Page 31) explores the potential drivers for the divergence between M1 and M2 growth. The findings suggest that there is no evidence of Mainland China having entered into a liquidity trap, and the much faster growth of M1 than M2 was mainly contributed by recent monetary easing that reduced the opportunity costs of holding the liquid form of money, as well as increased economic uncertainty which might have driven up precautionary demand for money.

The domestic economy

The Hong Kong economy showed a modest pick up in growth during the second half of 2016. The quarter-on-quarter real Gross Domestic Product (GDP) growth increased to 1.2% in the fourth quarter from 0.8% in the third quarter. On the domestic front, private consumption growth continued to strengthen, while investment growth was boosted by strong infrastructure activity in the fourth quarter. On the external front, growth in exports of goods strengthened amid improved regional trade flows, while exports of services grew steadily along with the recovery in trade-related and transportation services. Due to faster growth in imports of goods and services, net exports remained a drag on real GDP growth during the second half. Along with the pick up in economic growth, the headline unemployment rate dropped slightly to 3.3% in December.

Economic growth for 2017 is expected to remain moderate. The Government and the market consensus forecast of real GDP growth for 2017 are 2–3% and 2.0% respectively. However, Hong Kong's growth outlook remains subject to strong external headwinds. The protectionist rhetoric of the new US Administration has heightened the downside risks to global trade flows and hence Hong Kong's external demand. Amid upward pressure on the US dollar and the expected faster pace of US rate hikes, global financial environment is expected to turn less favourable and could trigger a tightening of domestic financial conditions, particularly if tail risks are realised. Box 4 (see page 47) discusses the compilation of the Financial Conditions Indexes for Hong Kong which can help monitor domestic financial conditions.

Local inflationary pressures have remained moderate since the second half of 2016, while the sequential momentum picked up in the fourth quarter of 2016, mainly due to volatile food prices and the rise in housing rentals. Inflationary pressures are expected to stay contained amid the backdrop of benign import prices and modest local cost pressures.

Monetary conditions and capital flows

The Hong Kong dollar exchange rate remained broadly stable despite market volatilities, though it eased occasionally since the US interest rate hike in December. The Convertibility Undertaking was not triggered. Along with the strengthening of the US dollar, the Hong Kong dollar effective exchange rate appreciated further.

With a sizable monetary base, the Hong Kong Interbank Offered Rate (HIBOR) remained relatively low, but it picked up somewhat from October amid year-end funding demands, as well as a catch-up with the increases in their US dollar counterparts. As such, the average mortgage rate also increased slightly to 2.07% in January 2017, after dropping to a recent low of 1.71% in October amid intense competition for mortgage lending business.

Growth in total loans accelerated to 4.2% in the second half of 2016, after increasing by 2.2% in the first half. Growth was underpinned by strengthened domestic economic activities and increased funding demand by multinational corporations towards year-end. Domestic loan growth quickened slightly while loans for use outside Hong Kong rebounded after recording a slight decline in the first half. Analysed by currency, Hong Kong dollar loans expanded strongly by 5.0% during the second half, while foreign currency loans grew by 3.2% amid the tapering of foreign currency loan repayments by Mainland borrowers.

Banks' funding conditions remained largely stable. Reflecting faster increases in deposits relative to loans, the Hong Kong dollar loan-to-deposit (LTD) ratio edged down to 77.1% at the end of 2016. The overall foreign currency LTD ratio declined to 59.9% at the end of the year, with the US dollar LTD ratio dropping significantly to 63.8% due to strong increase in US dollar deposits.

With a strong US dollar, both the onshore (CNY) and offshore (CNH) renminbi exchange rates weakened. Against this backdrop, Hong Kong's offshore renminbi liquidity pool (including outstanding customer deposits and certificates of deposits) consolidated further along with that of other offshore renminbi markets. The volatility of the CNH HIBORs also increased notably. That said, banks' renminbi liquidity management remained robust with the average daily turnover of the renminbi real time gross settlement system remaining at high levels. Hong Kong's offshore renminbi business will likely continue to face headwinds driven by uncertainty surrounding the renminbi exchange rate movements.

Asset markets

The Hong Kong equity market ended sharply higher in the review period amid improved global market conditions. The US presidential election result surprised most investors, but the shock was brief because hopes of a fiscal stimulus under the Trump administration added impetus to global equity markets. While benefiting from the rally on global markets, optimism in the local market was more guarded possibly due to concerns of a faster pace of rate rises, uncertain outlook for the Mainland economy and policy uncertainties about the renminbi and capital flow restrictions. Looking ahead, the local market is likely to be susceptible to external economic conditions, though its attractive valuation could provide some downside support.

The Hong Kong dollar debt market expanded steadily last year, notwithstanding the sharp increase in yields and a widening of spreads over US Treasuries towards the end of the year. The offshore renminbi debt market in Hong Kong recovered in the second half of 2016 after contracting in the first half, although there was a decline in new issuance for the year as a whole. If the earlier global search-for-yield phenomenon is reversed, both Hong Kong dollar and offshore renminbi debts may come under pressure. With the renminbi exchange rate likely to remain volatile amid unpredictable US trade policies, the outlook for both debt markets will be clouded by significant uncertainties in the period ahead.

The residential property market showed signs of consolidation immediately after the introduction of the Government's new stamp duty measure before picking up more recently. In view of the renewed market buoyancy, the Government raised the stamp duty to a flat rate of 15% in November. In response, both primary and secondary market transactions declined in the subsequent two months. Nevertheless, transactions picked up more recently partly reflecting the increase in new launches by property developers in the primary market. Meanwhile, housing prices continued to increase to a new high after the new measure, but at a more moderate pace.

Banking sector performance

The profitability of retail banks improved, with the return on assets increasing to 1.12% in the second half of 2016 compared to 0.95% in the second half of 2015. The improvement was attributable to an increase in net interest income and non-interest income as well as a reduction in loan impairment charges.

The banks maintained their strong capital positions, with the consolidated capital adequacy ratio of locally incorporated authorized institutions staying high at 19.2% at the end of December 2016. To reinforce banks' resilience to systemic risks, the countercyclical capital buffer ratio for Hong Kong will rise to 1.875% with effect from 1 January 2018 from the current 1.25%.

Liquidity conditions remained favourable despite significant rises in Hong Kong dollar interbank rates after the resumption of US interest rate hikes in December. Underpinned by a large retail deposit base, retail banks' funding costs remained low and stable. As measured by Basel III standards, both the average Liquidity Coverage Ratio for category 1 institutions and the average Liquidity Maintenance Ratio for category 2 institutions remained high at 156.3% and 51.0% in the fourth quarter of 2016. All these ratios were well above their regulatory minimums.

While asset quality remained sound by historical standards, banks should stay attentive to the external environment, as the assessment in Box 5 (page 70) shows that the banking sector has registered a rapid growth in loans for use outside Hong Kong following the global financial crisis, implying that their asset quality is more sensitive to the external environment. However, such risk may be counterbalanced by the banks' higher share of holdings of safe assets and a more stable funding structure.

Looking ahead, the possibility of quicker and larger increases in US interest rates under the Trump administration could pose challenges for banks in Hong Kong on various fronts: (i) Faster-than-expected interest rate hikes could put pressure on banks' credit risk management, particularly for their loans to non-local corporates; (ii) Banks' investment portfolios may face higher risks of mark-to-market losses given the increased holding of debt securities after the global financial crisis, even though more investments were allocated to safe-assets; and (iii) Banks are more likely to see a steeper rise in funding costs when they start competing for retail deposits.

On the back of ample domestic liquidity and a strong capital position, the Hong Kong banking sector has remained sound after the US presidential election. Notwithstanding this, banks should carefully assess the implications of possible faster-than-expected US rate hikes and more broadly-based policy uncertainties in the US, particularly the risk of drastic capital outflows and their potential impact on local interest rates.

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