1. Summary and overview

The global economy has been resilient, but as major advanced economies (AEs) are travelling the last mile of disinflation, the "high for longer" interest rate outlook will likely continue to cloud the global growth prospects, while exposing hidden vulnerabilities accumulated during the earlier low interest rate environment.

Hong Kong's exchange rate and interbank market continued to trade in a smooth and orderly manner. Along with successive US policy rate hikes, local interbank rates generally headed higher, in line with the design and operation of the Linked Exchange Rate System (LERS), and many banks further raised their Best Lending Rates. With total deposits remaining stable during the review period, there was no notable sign of outflows from the Hong Kong banking system. In part reflecting weaker loan demand, bank credit declined slightly during the same period. Meanwhile, the residential property market consolidated after experiencing a strong rebound in the first quarter of 2023.

In the period ahead, uncertainties on the future US interest rate path and the associated impact on local interest rates, concerns about the growth prospects for major AEs and the pace of economic recovery of the Mainland economy, and the lingering geopolitical risks will continue to pose challenges to the banking sector. Banks should carefully assess how the possible intensification of these risk factors could impact the asset quality of their loan portfolios.

The external environment

With swift policy responses and last-minute compromises in the US Congress, the recent US and Swiss banking sector problems and the US debt ceiling brinkmanship did not result in systemic repercussions to global financial stability. Yet, risks to global growth remain tilted to the downside, as the still-tight labour markets across major AEs prompted their central banks to signal a "high for longer" policy rate outlook, which could weigh on the global economy, render financial markets sensitive to inflation surprises, and expose hidden vulnerabilities that were accumulated during the earlier low interest rate environment.

In emerging Asia, economic growth softened amid subdued export performance due to weak global demand and a tech down cycle. Headline Consumer Price Index (CPI) inflation eased in the first half of 2023 along with lower food and energy prices, though core inflationary pressures remained firm amid the still-elevated service inflation. In the near term, to curb inflationary pressures and maintain the interest rate differential vis-à-vis the US to reduce foreign exchange pressures, regional central banks may need to keep interest rates "high for longer".

However, as the debt levels in the region have increased in recent years, "high for longer" interest rates will pose loan repayment challenges. Such development warrants close monitoring in view of the signs that the cash buffer of regional corporates has decreased somewhat.

In Mainland China, economic activities recorded faster year-on-year growth during the first half of the year, thanks to the post-COVID reopening and a favourable base effect. However, the recovery was uneven, with the services sector generally outperforming the goods sector. The sequential recovery momentum also slowed during the second quarter, reflecting fragile private-sector confidence, renewed weakness in the property market and a slowdown in exports (Box 1 discusses the export competitiveness of Mainland China). Looking ahead, economic activities are expected to recover, but the economy is still facing headwinds from the challenging external environment and soft domestic demand. To support the economic recovery, the authorities introduced countercyclical policy adjustments, including cuts in interest rates and the required reserve ratio, and pledged to invigorate the capital market, boost consumption and push forward the development of the private economy to support confidence.

The domestic economy

The Hong Kong economy experienced a sharp rebound in the first quarter of 2023 on the back of the reopening of Mainland China and Hong Kong, and continued to recover in the second quarter, although the momentum softened. After contracting for four consecutive quarters, real gross domestic product (GDP) expanded by 2.9% and 1.5% year on year in the first and second quarters respectively. Private consumption improved markedly with the support provided by the relaxation of COVID-19 restrictions and the disbursement of the first instalment of consumption vouchers. Overall investment spending picked up in the first quarter alongside the revival in economic activities, although there was a mild decline in the second quarter amid tightened financial conditions. Box 2 uses granular data to examine the effectiveness of the enhancements to the SME Financing Guarantee Scheme (SFGS) and provides evidence that the SFGS helped lift the size of loans granted to small-to-medium-sized enterprises (SMEs), thereby supporting them through the pandemic. Externally, inbound tourism bounced back following the full resumption of cross-boundary travel, driving growth in Hong Kong's exports of services. In contrast, merchandise exports plummeted further amid a challenging external environment.

Looking ahead, Hong Kong's economic activities are expected to recover further in the second half of 2023. Although merchandise exports are likely to be dampened by lackluster external demand, inbound tourism and domestic demand are expected to strengthen, given (i) the improvement in transportation and handling capacity; (ii) the improved labour market conditions; and (iii) the disbursement of the second instalment of consumption vouchers in July. In view of the softened business sentiment in recent months, the Government has also been exploring various measures to further strengthen the sustainability of the economic recovery. Taking into account the actual outturn in the first half of the year, the Government revised the real GDP growth forecast for 2023 to 4.0%–5.0%. That said, the growth outlook is subject to a number of risks and uncertainties, including those relating to the US policy rate path, the pace of the Mainland economic recovery, the prospects for global economic growth, and risks stemming from geopolitical tensions.

Local labour market conditions continued to improve in recent months, with the unemployment rate declining to a decade-low of

2.8% in August 2023. Total employment increased further, albeit still below its pre-pandemic level. In view of the labour shortage, the Government launched the labour importation schemes in July 2023 for the construction and transport sectors, and introduced the Enhanced Supplementary Labour Scheme (ESLS) in September 2023 for other sectors. Alongside the continued recovery in domestic economic activities, the labour market is expected to improve further for the rest of this year.

The underlying inflation rate in Hong Kong remained modest at around 1.8% in the first eight months of this year. In the near term, the domestic business costs may edge up given the upward pressures stemming from the economic recovery and improving labour market. Nevertheless, overall inflation is expected to stay moderate as the price pressures on the external front may recede further. The Government projections for the underlying and headline inflation rates for 2023 are 2.0% and 2.4% respectively.

Monetary conditions and capital flows

The Hong Kong dollar (HKD) traded close to the weak-side Convertibility Undertaking (CU) from March to early May, reflecting market expectation of a "high for longer" US policy rate and a cautious sentiment for the local stock market. From early May to July, the HKD exchange rate regained some strength, mainly driven by dividend payment-related demand from listed companies and half-year-end funding needs by corporates. Towards the end of August, the HKD softened to close to the weak-side CU again amid weak equity sentiment. During the review period, the weak-side CU was triggered six times, five times in April and once in early May. In accordance with the design of the LERS, the HKMA bought a total of HK$32.45 billion. Accordingly, the Aggregate Balance of the banking system declined from HK$77.1 billion at the end of February to HK$44.9 billion at the end of August, but the day-to-day interbank operations and settlement activities continued to operate in a smooth and orderly manner.

During the review period, the overnight and one-month Hong Kong Interbank Offered Rates (HIBORs) generally tracked their USD counterparts, in line with the design and operation of the LERS. Alongside the successive US policy rate hikes and market expectation of a "high for longer" US policy rate, the HIBORs generally headed higher, before some easing towards the end of the review period. On the retail front, following the US policy rate hikes, many banks raised their Best Lending Rates twice or by 25 basis points (bps) in total from May to July 2023. At the end of the review period, the Best Lending Rates in the market ranged from 5.875-6.375%. Accordingly, the average lending rate for new mortgages increased slightly from 3.50% in January 2023 to 3.57% in July 2023. Banks will decide when and by how much to adjust their lending and savings rates, taking into account the structure of their funding costs and other relevant considerations.

Hong Kong's offshore renminbi (CNH) liquidity pool expanded further during the review period, with the total outstanding amount of renminbi customer deposits and certificates of deposit increasing to RMB1,067.0 billion at the end of July 2023. Both the outstanding amount of renminbi loans and renminbi trade settlement continued to grow steadily in the first seven months of 2023. The average daily turnover of the renminbi Real Time Gross Settlement (RTGS) system stayed high at RMB1,704.0 billion during the same period.

Looking ahead, the continuing development of Hong Kong's CNH ecosystem will further reinforce Hong Kong's role as the leading CNH business hub. On liquidity, the enhanced

Currency Swap Agreement with the People's Bank of China (PBoC) will provide the necessary liquidity support to the offshore market through the renminbi liquidity facilities set up by the HKMA. This provides a favourable environment for financial institutions to expand their renminbi-related activities and services. On products, the continuous efforts to upgrade and expand the family of Connect schemes between the Mainland and Hong Kong, including the Swap Connect, the two-way Stock, Bond, and Cross-boundary Wealth Management Connects, will widen the spectrum of renminbi products and tools for asset allocation and risk management, enabling two-way traffic between the two markets. The financial infrastructure is also being upgraded with the Central Moneymarkets Unit (CMU) undergoing a major overhaul to enhance its operational capacity and product offerings, with the aim of better supporting the growth of renminbi bond issuances and associated custodian services. With these developments, Hong Kong will continue to play a unique role in supporting China's capital account opening, the development of the green finance market, as well as the Belt and Road and the Guangdong-Hong Kong-Macao Greater Bay Area initiatives.

Asset market

In contrast to the buoyant global equity market led by the technology sector, performance of the Hong Kong equity market during the review period was clouded by concerns over the pace of the Mainland economic recovery. Overall, the Hang Sang Index declined by 7.1% from the end of February 2023 to the end of August 2023. Equity market funds registered net flows into Hong Kong from February to July 2023.

Supported by the steady issuance, the HKD and CNH debt markets in Hong Kong continued to register stable growth in the first half of 2023. Although an agreement on raising the US government debt limit was reached on 27 May, bond yields in the US as well as those in Hong Kong have remained at a high level amid possible further rate hikes in the US.

Looking ahead, the local equity market is subject to the downside risks of a global economic slowdown, a "high for longer" interest rate environment and an escalation of geopolitical tensions, while further policy measures that may be rolled out by the Mainland authorities to support the Mainland economic recovery could help lift sentiment in the local equity market. Meanwhile, the near-term prospect for the local debt market will continue to hinge on global economic and interest rate outlooks.

During the review period, policy initiatives were introduced to develop an infrastructure financing securitisation platform and promote the green and sustainable debt market in Hong Kong. Moreover, the issuance of the first 10-year RMB green bond by the Hong Kong Government helps to extend the CNH yield curve and continues to enrich CNH product offerings, promoting the RMB internationalisation in an orderly manner.

In early 2023, the Government issued the world's first government-issued tokenised green bond to promote the application of innovative technologies in the debt market. Box 3 analyses how the global tokenised bond market has evolved and assesses the potential benefits of bond tokenisation for issuers and investors.

The residential property market consolidated after experiencing a strong rebound in the first quarter of 2023, due in part to more cautious market sentiment amid rising local mortgage rates. The average monthly housing transaction volume dropped to 3,702 units in April – August from 4,674 units in the first quarter, despite primary-market sales being supported by property developers' competitive pricing strategies for their new project launches. Reflecting subdued market activities, the secondary-market housing prices retreated by 3.7% between April and August after surging by 5.3% in the first quarter.

Taking into consideration all relevant factors, the HKMA announced on 7 July 2023 the first relaxation of the countercyclical macroprudential measures for residential properties since their introduction in 2009. The relaxation, which took effect on the same day, enables the public to take out property mortgage loans at higher loan-to-value (LTV) ratios. The HKMA will continue to closely monitor market developments and introduce necessary measures to ensure banks' proper risk management of their property mortgage loans, thereby safeguarding banking stability.

Following the relaxation of the macroprudential measures, the average LTV ratio for new residential mortgage loans (RMLs) remained largely stable at about 53% in July and the corresponding debt-servicing ratio stayed below 40%. Meanwhile, the estimated number of RMLs in negative equity dropped to 3,341 cases at end-June 2023 from 12,164 cases at end-December 2022, mainly reflecting the increase in housing prices in the first half of this year. Given that over half of the private housing units did not carry any outstanding mortgages at the end of 2022, and that the mortgage delinquency ratio remained at a very low level of 0.07% in July 2023, the systemic risks relating to banks' RMLs are properly managed on various fronts.

In the near term, the residential property market is subject to a number of uncertainties and risks as discussed previously. In particular, rising mortgage rates, weaker global economic prospects, and increased short-term private housing supply, may continue to pose headwinds to the housing market. That said, the continued economic recovery in Hong Kong, coupled with the Government's measures to attract businesses, investments and talents, may provide support to housing demand. Over the longer term, the outlook for the housing market will depend on the supply-demand gap. The Government projects that private housing supply will remain high in the coming years.

Thanks to the revival in domestic economic activities, the non-residential property market saw signs of recovery in the first half of 2023. The prices of commercial and industrial buildings bottomed out alongside the increase in transactions during the period. Rentals of retail premises and flatted factories also recovered gradually, resulting in a mild increase in the rental yields. The near-term outlook for the non-residential property market is expected to vary across segments. On the one hand, the robust recovery in domestic consumption and inbound tourism will likely provide support to the retail segment. On the other hand, the capital values of commercial properties could continue to be dragged down by the high vacancy rates and the increased supply in the near term.

Taking into account the correction in non-residential property prices following the COVID-19 pandemic, the rising interest rate environment, as well as other relevant factors discussed above, the HKMA also adjusted the countercyclical macroprudential measures for non-residential property mortgage loans by raising the maximum LTV ratio to 60% from 50%. The adjustment was announced on 7 July 2023 with immediate effect.

Banking sector performance

The profitability of retail banks improved notably in the first half of 2023, attributable to higher net interest income and income from investments held for trading. Specifically, the aggregate pre-tax operating profit of retail banks increased substantially by 120.5% in the first half of 2023 compared with the same period in 2022, while the return on assets rose notably to 1.15% in the first half of 2023.

Amid continued US interest rate hikes, the overall funding costs of retail banks increased at a gradual pace in the first half of 2023. Despite the rapid rise in global interest rates in the past year, the interest rate risk impact on banks in Hong Kong remained relatively small and contained. The classified loan ratios of all authorized institutions (AIs) increased during the first half of 2023, but remained at a healthy level.

Overall, the Hong Kong banking sector remained resilient, underpinned by the robust capital and liquidity positions. The consolidated total capital ratio of locally incorporated AIs stood high at 21.0% at the end of June 2023, well above the minimum international standard. The average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions were 169.8% and 63.8% respectively in the second quarter of 2023, well above their statutory minimum requirements. The latest Net Stable Funding Ratio of banks also stayed at levels well exceeding their statutory minimum requirements.

In part reflecting weaker loan demand amid higher borrowing costs and slower global growth outlook, total loans and advances of all AIs declined slightly by 0.5% during the first half of 2023. The decline was mostly driven by a decrease in loans for use outside Hong Kong, which more than offset an increase in domestic loans (comprising loans for use in Hong Kong and trade financing).

Box 4 presents a refined framework for stress testing the credit risk of Hong Kong's banking sector. By incorporating the default risk and key financial performance ratios of Hong Kong corporate sector into the macro stress testing framework, the refined framework will strengthen our capacity to obtain a clearer and fuller assessment on the resilience of the banking sector.

In the period ahead, uncertainties on the future US interest rate path and the associated impact on local interest rates, concerns about the growth prospects for major AEs and the pace of economic recovery of the Mainland economy, and the lingering geopolitical risks will continue to pose challenges to the banking sector. Banks should carefully assess how the possible intensification of these risk factors could impact the asset quality of their loan portfolios.

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