# 1. Summary and overview

*The impact of monetary tightening is increasingly being felt, with global economic growth slowing while inflation rates are easing further from their recent peaks. Nevertheless, the timing and pace of future interest rate cuts remain uncertain, and the "high for longer" scenario should not be discounted prematurely, particularly given the sticky services inflation in some advanced economies, especially the US.*

*Hong Kong's exchange rate and interbank market continued to trade in a smooth and orderly manner. Total deposits increased in the seven months since end-June 2023, while bank credit declined, reflecting subdued credit demand in part driven by higher borrowing costs. Meanwhile, the residential property market remained soft before showing some signs of stabilisation after the relaxation of policy measures in late-February 2024.*

*In the period ahead, the Hong Kong banking sector is expected to face challenges from a number of risk factors arising from uncertainties over the future path of US monetary policy, global growth prospects, and geopolitical tensions. Banks should remain vigilant against the impact of these risk factors on the asset quality of their loan portfolios.*

### *The external environment*

During the review period, global growth showed notable regional divergences following the steepest interest rate hiking cycle in decades, with the US economy displaying greater-than-expected resilience but the Euro area economy stagnating amidst soft domestic and external demand. Global inflation rates eased further from their recent peaks, encouraging investors to shift their attention to the timing and pace of future interest rate cuts. Looking ahead, global growth is likely to remain subpar, with the US economy expected to decelerate and growth in the Euro area to remain subdued, while moderating inflation should open the door for major central banks to pursue policy-easing plans. However, while financial markets have rallied since late 2023 on rate cut expectations, the timing and pace of future interest rate cuts remain uncertain, given that the still-resilient US labour market may render core US inflation stickier than expected. Indeed, markets have recently pared back their rate cut expectations, which are now broadly in line with major central banks' forward guidance. The high global interest rate environment, should it persist, may pose headwinds to debt sustainability and interest-rate-sensitive sectors such as commercial real estate.

In Emerging Asia, economies saw continued economic growth in the second half of 2023 driven by robust domestic demand. Meanwhile, the recent exports recovery has benefited semi-conductors' exporters, while many regional economies continued to see sluggish export growth, suggesting that more time is likely needed for a broader-based trade recovery. Bond fund outflows from the region moderated amid rising US rate cut expectations in late 2023. Whilst inflation eased gradually along with lower energy prices, some economies continued to face the challenge of sticky service inflation, while the ongoing El Niño climate phenomenon could disrupt staple food production. Looking ahead, interest rate outlook in the region remains uncertain, with any rate cut potentially raising pressures on exchange rate and fund flows stability. Box 1 assesses the effect of the environmental, social and governance (ESG) attribute on mitigating fund outflows in response to macro-financial shocks. On the other hand, if high interest rates were to persist, the repayment capability of indebted firms and households could erode further. Borrowers who found it difficult to secure traditional financing sources (e.g. bank loans) might seek funding from private credit (i.e. non-bank financial intermediaries (NBFIs)). Box 2 studies the development and potential risks of private credit in the region.

In Mainland China, real gross domestic product (GDP) recorded slightly faster year-on-year growth in the fourth quarter of 2023 on improved overall investment activities, a reduced drag from net exports and a favourable base effect. In particular, the authorities strengthened fiscal policy supports to boost infrastructure investment by raising the 2023 budget deficit from 3% to around 3.8% of GDP, and vowed to satisfy the reasonable financing needs of property developers, regardless of their ownerships. For the outlook, the economic growth target for 2024 is set at about 5% for the second consecutive year, likely bolstered by stronger fiscal supports from the Central Government and better coordination of fiscal and monetary policies.

However, the near-term economic outlook continues to face various challenges which include weak global growth, an uncertain geopolitical environment, a soft domestic housing market and lingering concerns about the local government financing vehicle debt risks.

### *The domestic economy*

Economic activities in Hong Kong continued to pick up in the second half of 2023, although the momentum has slowed down somewhat compared to the first half of the year. The continued recovery was driven by the robust revival of inbound tourism and strong private consumption supported by a resilient labour market and various support measures rolled out by the Government. Investment spending increased against a low base of comparison, while sluggish merchandise exports remained the main drag on GDP. For 2023 as a whole, the economy resumed a positive growth of 3.2% after experiencing a contraction of 3.7% in the previous year.

Looking ahead, the domestic economy is expected to continue its recovery at a moderate pace. In addition to the ongoing revival of inbound tourism, the public infrastructure projects will also provide support to the economy. Meanwhile, private consumption would remain stable amid a steady labour market. Both private investment and merchandise exports are likely to stabilise, with the former being supported by the Government's campaigns on attracting businesses to Hong Kong and the latter picking up alongside the expected global tech cycle recovery. Against this background, the Government forecasts real GDP growth for the whole of 2024 in the range of 2.5%–3.5%. The cautiously optimistic outlook is subject to a number of uncertainties and risks, including those stemming from the US policy rate path, the prospects for global economic growth, the recovery pace of the global tech cycle, and heightened geopolitical tensions.

The labour market remained resilient, with the unemployment rate staying low at 2.9% in February 2024. Looking ahead, further improvement in the domestic economy is expected to render support to labour demand, while the various labour importation and talent attraction schemes launched by the Government would help address manpower shortages.

Local inflation remained moderate over the past few months as external price pressures receded. In the near term, local inflation pressures will likely stay mild, even though domestic costs may face further upward pressures as the economy improves, and the housing rental component may gradually pick up.

### *Monetary conditions and capital flows*

The Hong Kong dollar (HKD) strengthened between September and November 2023, mainly driven by seasonal corporate funding needs, buying flows on firmer HKD interest rates and net buying flows through the Southbound Stock Connect. It remained broadly stable in December 2023 but moderated in early 2024 amid softened liquidity. As the Convertibility Undertakings have not been triggered since May 2023, the Aggregate Balance of the banking system remained little changed, closing at HK$44.8 billion at the end of February 2024, and the day-to-day interbank operations and settlement activities among banks have continued to operate in a smooth and orderly manner.

Hong Kong's interbank market also continued to trade in a smooth and orderly manner. The Hong Kong Interbank Offered Rates (HIBORs) headed higher in September 2023, partly reflecting corporate funding needs by the quarter end, and receded slightly stepping into 2024 as the seasonal demand for HKD funding faded. On the retail front, with the US Federal Reserve (Fed) maintaining its policy rate unchanged since July 2023, local banks kept their Best Lending Rates unchanged. At the end of the review period, the Best Lending Rates in the market ranged from 5.875% to 6.375%. Meanwhile, the average lending rate for new mortgages increased from 3.57% in July 2023 to 4.13% in January 2024, partly reflecting the increase in the cap of HIBOR-based mortgage rates.

Hong Kong's offshore renminbi (CNH) liquidity pool consolidated during the review period, with the total outstanding amount of renminbi customer deposits and certificates of deposit increasing to RMB1,068.8 billion at the end of January 2024. Both the amounts of outstanding renminbi loans and renminbi trade settlement continued to grow steadily. The average daily turnover of the renminbi Real Time Gross Settlement (RTGS) system stayed high at RMB2,063.6 billion in 2023.

Moving forward, 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 between the HKMA and the People's Bank of China (PBoC) enables the HKMA to provide the necessary liquidity support to the offshore market through its renminbi liquidity facilities. 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 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. The Multiple Central Bank Digital Currency Bridge (mBridge) project and Faster Payment System (FPS) linkage with digital renminbi (e-CNY) are making progress, with the aim to improve cross-border payment and settlement efficiency for commercial and retail users. With these developments, Hong Kong will continue to play a unique role in supporting Mainland'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*

The global equity markets experienced a roller coaster ride during the review period. The MSCI World Index first declined in September and October 2023 amid the sustained high interest rates in major economies and the escalating geopolitical tensions, before registering a broad-based recovery on the back of prospective interest rate cuts by central banks in major advanced economies in 2024. In contrast to the rise in global equity prices, the local equity market declined during the review period, with the Hang Seng Index decreasing by 10.2% from the end of August 2023 to the end of February 2024.

In the debt market, the 10-year US Treasury yield reached a 16-year high of 5% in October 2023 on the back of strong economic data and persistent inflation pressure, before moving down amid signs of easing inflation in the US. Bond yields in Hong Kong have also moved lower from their recent peaks. Despite fluctuations in interest rates, new issuance in the Hong Kong debt market continued to register stable growth in 2023.

Looking ahead, both the local equity and debt markets will remain susceptible to uncertainties over the interest rate paths in major advanced economies, while the near-term economic performance of the Mainland and expectations on policy stimulus measures to prop up the economy will remain key drivers of sentiments in the local equity market.

During the review period, policy initiatives were introduced to foster the development of the debt market in Hong Kong. These include the issuance of a new batch of retail green bonds and the second digital green bond issuance under the Government Green Bond Programme, the issuance of the Hong Kong International Airport Retail Bonds, the Hong Kong dollar benchmark bonds issued by the Hong Kong Mortgage Corporation Limited, and the signing of a memorandum of understanding between the National Development and Reform Commission and the HKMA to strengthen communication and cooperation, and to facilitate the cross-border financing activities of Chinese enterprises, including bond issuance, by leveraging on Hong Kong's unique strengths in financial and professional services.

The residential property market remained soft in the second half of 2023 amid tightened financial conditions and deteriorated market sentiment. For 2023 as a whole, the total transaction volume declined by 4.5% from 2022 to a record-low of 43,002 units, while housing prices recorded a decrease of 6.9%.

Having considered prudently the overall situation, the Government has successively announced the adjustment of the demand-side management measures for residential properties in October 2023, and the cancellation of these measures in late-February 2024. In tandem, the HKMA also suitably adjusted the countercyclical macroprudential measures for property mortgage loans and other related supervisory requirements on property loans, after detailed analyses and having considered that there was room to make these adjustments, while continuing to maintain banking stability and ensuring the proper risk management of property lending by banks. The HKMA will continue to monitor market developments closely and introduce measures to safeguard banking stability as conditions in the property market evolve. Following all the above policy adjustments, the housing market saw signs of stabilisation in March.

With the downward adjustments in housing prices, the estimated number of residential mortgage loans (RMLs) in negative equity increased to 25,163 cases at end-December 2023. These cases were related to bank staff housing loans or RMLs under the Mortgage Insurance Programme (MIP), and hence have in general a very low delinquency ratio given MIP's strict requirements on the applicants' repayment ability. In a wider context, the HKMA's macroprudential measures introduced since 2009 have helped contain household leverage and strengthen banks' risk management for mortgage loans. With these measures, the average loan-to-value (LTV) ratio for new RMLs remained largely stable at about 59% in January 2024 and the corresponding debt servicing ratio (DSR) also stayed at around 40%. In addition, over half of the private housing units do not carry any outstanding mortgages as of end-2023. Overall, the systemic risks relating to banks' RMLs are properly managed on various fronts.

The residential property market outlook is subject to a number of uncertainties and risks. On one hand, factors such as the elevated mortgage rates, accumulated private housing supply, and an uncertain external economic outlook may continue to exert pressures on the market in the near term. On the other hand, the removal of the demand-side management measures for residential properties, coupled with the expectation of interest rate cuts by the US Fed this year and the Government's policies to attract businesses and talents, may render support to the market. Box 3 presents an initial analysis on the impact of climate change on Hong Kong housing prices.

The commercial real estate market remained sluggish in the second half of 2023. Along with reduced transaction volume, the prices for office spaces, retail premises, and flatted factories subsided amid tightened financial conditions. The leasing market showed mixed performance, with rentals of retail premises edging up, while rentals of office spaces remaining under pressure amid high vacancy rates and a challenging external environment. After detailed analyses, the HKMA also adjusted the countercyclical macroprudential measures for non-residential property mortgage loans with effect from 28 February 2024.

Looking ahead, the commercial real estate market's outlook varies across segments. On one hand, the retail segment is expected to benefit from the improving domestic consumption and inbound tourism, although the strong recovery of outbound tourism may partly offset the benefit. On the other hand, the capital values of offices may remain under pressure due to high vacancy rates amid the completions of new upcoming supply. That said, the inclusion of commercial real estate as a permissible investment in the Government's new Capital Investment Entrant Scheme (CIES) might provide some support to the market.

## *Banking sector performance*

The profitability of retail banks continued to improve, with the return on assets rising to 0.99% in the second half of 2023 compared with 0.80% in the same period of 2022. The improvement in profit was mainly contributed by increases in net interest income and income from investments held for trading. This was partly offset by an increase in loan impairment charges.

Reflecting subdued credit demand in part driven by higher borrowing costs, total loans and advances of all authorized institutions (AIs) decreased by 3.6% for the year 2023 as a whole. On a half-yearly basis, bank credit declined by 3.1% in the second half of 2023, which was driven by decreases in both domestic loans (comprising loans for use in Hong Kong and trade financing) and loans for use outside Hong Kong. Meanwhile, the classified loan ratios of all AIs slightly increased during the second half of 2023, but remained at a healthy level.

Overall, the Hong Kong banking sector continued to be resilient, underpinned by the robust capital and liquidity positions. The consolidated total capital ratio of locally incorporated AIs stood high at 21.1% at the end of December 2023, well above the international minimum requirement of 8%. The average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions were 178.6% and 65.7% respectively in the fourth quarter of 2023, well above their statutory minimum requirements.

Given the significant cross-border lending of the Hong Kong banking sector, particularly to the Asia-Pacific region, it is important to examine the debt servicing ability of corporates in the region under the current macro-financial environment. Findings in Box 4 suggest that the additional cash buffers accumulated by corporates in the region during the pandemic have played an important role in mitigating the credit risk impact arising from higher funding costs and lower economic growth. This may help explain why corporate defaults in the region have not increased notably so far. However, signs of depletion in cash buffers have appeared. More corporates in the region may see repayment difficulties if the high interest rate and weak economic growth environment persist. Banks should therefore remain vigilant and carefully assess the possible negative impacts on their corporate loan portfolios.

Going forward, the Hong Kong banking sector is expected to face challenges from a number of risk factors arising from uncertainties over the future path of US monetary policy, global growth prospects, and geopolitical tensions. Banks should remain vigilant against the impacts of these risk factors on 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*