4. Monetary and financial conditions

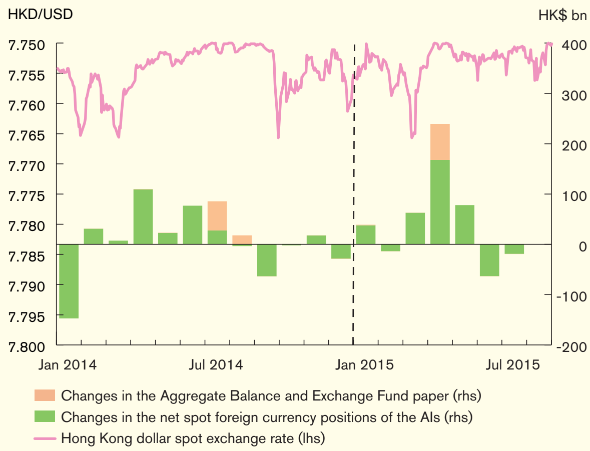
Exchange rate, capital flows and monetary developments

The Hong Kong dollar exchange rate remained broadly stable despite fickle global financial market conditions, the Mainland stock market corrections and the aftershocks of renminbi depreciation following the change in the central parity rate fixing mechanism. Bank liquidity remained abundant while loan growth moderated slightly compared with last year. Looking ahead, the uncertainty surrounding global financial markets and the US interest rate normalisation process will be the major risks to fund flows and the monetary and financial stability of Hong Kong.

4.1 Exchange rate and capital flows

Despite bouts of external shocks and increased fund flow volatilities, the Hong Kong dollar spot exchange rate remained broadly stable against the US dollar, hovering between 7.7500 and 7.7657 in the first half of 2015 and recent months (Chart 4.1). After some weakening in early 2015 on concerns about lift-off of the US interest rate, the Hong Kong dollar exchange rate strengthened towards the 7.75 level as inflow pressures increased again in late March through May. In particular, the strong-side Convertibility Undertaking (CU) was triggered repeatedly during 9–24 April. This prompted the HKMA to passively purchase a total of US$9.2 billion from banks in exchange for HK$71.5 billion, leading to a corresponding increase in the Aggregate Balance (Chart 4.2). The inflows were largely driven by a surge in equity-related demand for Hong Kong dollars, buoyed by the Mainland new rules which allow qualified Mainland China mutual funds and insurance companies to invest in the Hong Kong stock market under the Shanghai-Hong Kong Stock Connect (SHKSC) without having to obtain the Qualified Domestic Institutional Investor status. Banks' net spot foreign currency positions also increased noticeably between March and May, signalling considerable net Hong Kong dollar inflows into the non-bank private sector alongside a buoyant local stock market during the period.

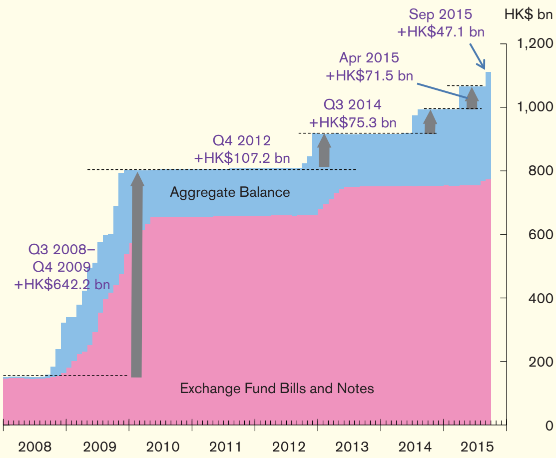
Chart 4.1
Exchange rate and fund flow indicators



Note: For fund flow indicators, a positive value indicates inflows. The data for changes in the net spot foreign currency positions in July are tentative estimates only, and there are no estimates for August.

Sources: HKMA and staff estimates.

Chart 4.2
Fund flow indicators

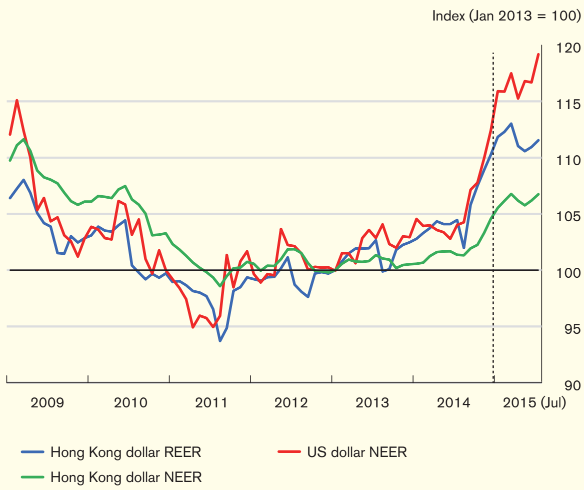


Note: Data up to 15 September.
Source: HKMA.

Between June and August, despite heightened volatility across global financial markets, the Hong Kong dollar spot exchange rate remained broadly stable. There were some net Hong Kong dollar outflows from the non-bank private sector in June and July, as revealed by the decreases in banks' net spot foreign currency positions. The Hong Kong dollar spot exchange rate eased moderately, but then strengthened to close to 7.75 in late July amid strong merger and acquisition and dividend distribution related Hong Kong dollar buying interests. In August, expectations of higher US policy rates and rising concerns over the outlook of Mainland China and renminbi depreciation following changes in the mechanism for determining central parity rate, have fuelled significant depreciation of Asian currencies and sharply lower prices in commodities and many emerging market assets. The perceived dimmer prospects for global growth have triggered sharp corrections in stock markets worldwide. Nonetheless, domestic monetary stability and the credibility of the Linked Exchange Rate system remained intact. In late August and early September, the Hong Kong dollar spot exchange rate touched 7.75 and the strong-side CU was triggered multiple times in September, possibly because of asset reallocations following the renminbi depreciation.

Because of the broad strength of the US dollar, the Hong Kong dollar also strengthened against other currencies in the first half and recent months. The trade-weighted Hong Kong dollar nominal effective exchange rate index (NEER) picked up by 2.1% in the year to July after rising by 4.0% in 2014 (Chart 4.3). Meanwhile, the Hong Kong dollar real effective exchange rate index (REER) recorded a smaller increase of 1.2% during the first seven months due to slightly lower inflation in Hong Kong relative to its trading partners.

Chart 4.3
Nominal and real effective exchange rates



Note: The real effective exchange rate index is seasonally adjusted.
Sources: C&SD and HKMA staff estimates.

Portfolio investment flows relating to Hong Kong have also seen more fluctuations so far this year. The Balance of Payments (BoP) statistics showed sizable equity portfolio outflows in the first quarter, as Hong Kong residents increased their holdings of foreign equities and non-residents reduced their holdings of Hong Kong stocks (Table 4.A).[28] In regard to debt portfolio investments, Hong Kong residents acquired more long-term foreign debt securities while foreigners continued to invest in Hong Kong debt

28 At the time of writing, the BoP statistics for the second quarter of 2015 were not yet available.

securities. Generally speaking, the net portfolio investment outflows in the first quarter partly reflected market concerns about outflows from emerging markets amid a prospective US interest rate hike and increased attractiveness of US assets for international investors.[29]

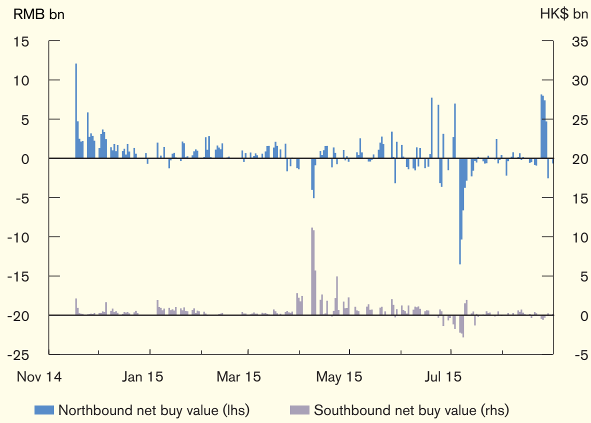
Table 4.A
Cross-border portfolio investment flows

(HK$ bn)	2013	2014	2014 Q1	Q2	Q3	Q4	2015 Q1
By Hong Kong residents							
Equity and investment fund shares	-179.4	-109.4	-75.7	10.7	32.9	-77.3	-105.4
Debt securities	-335.2	71.7	63.3	-100.3	40.3	68.4	-81.0
By non-residents							
Equity and investment fund shares	67.6	136.9	-8.5	24.7	160.3	-39.6	-119.4
Debt securities	61.0	57.9	9.4	11.4	11.9	25.2	23.0

Note: A positive value indicates capital inflows.
Source: C&SD.

According to market data and information, it appears that capital flow volatility has further increased since the second quarter. In particular, under the SHKSC, net southbound stock purchases surged to HK$27.7 billion during 8–10 April, with the southbound quota being exhausted on 8 and 9 April (Chart 4.4).[30] But later in June and July, there were strong selling pressures on both A-shares and Hong Kong-listed shares. Meanwhile, EPFR survey of global mutual funds also showed oscillations in portfolio investments relating to Hong Kong in the second quarter and recent months, particularly with signs of outflows since mid-June.

Chart 4.4
Market trading under the Shanghai-Hong Kong Stock Connect



Source: HKEx.

In the near term, the direction and size of fund flows will remain largely dependent on developments in the global financial markets and the process of US interest rate normalisation. There is a risk that a sudden rise in risk-off sentiment could lead to negative spillovers in Hong Kong through the financial channels. The future developments in the renminbi and other regional currencies may also affect market sentiment and put pressures on Hong Kong dollar fund flows. Furthermore, as the US interest rate lift-off is drawing near, the pressure on funds flowing back from some emerging markets to the US is likely to continue and this would also affect fund flows in Hong Kong.

4.2 Money and credit

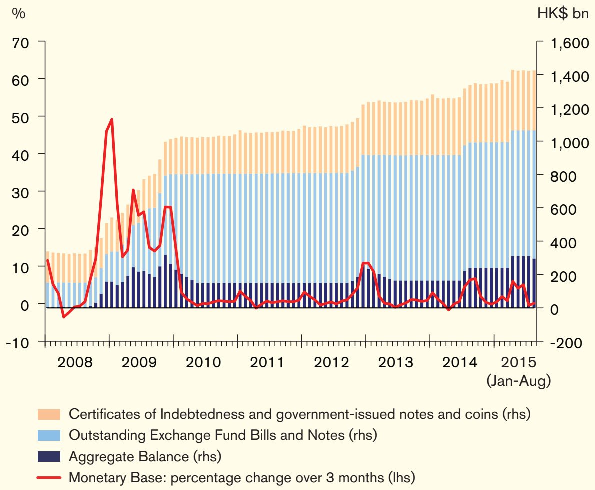
The monetary environment in Hong Kong remained accommodative amid continuation of low interest rates in the first half of 2015 and recent months. The Hong Kong dollar Monetary Base picked up by a cumulative 5.9% in the first half of 2015, as the Aggregate Balance expanded after repeated triggering of the strong-side CU in April (Chart 4.5). Other Monetary Base components, including Certificates of indebtedness, government-issued notes and coins in circulation, and the outstanding amount of

[29] The equity portfolio outflows were also due to the restructuring of Cheung Kong and Hutchison Whampoa, under which the shares of both companies were swapped into shares of CK Hutchison in Cayman Islands.

[30] Note that the net turnover value recorded under the SHKSC scheme does not exactly match the equity flows as defined by the BoP statistics under such a scheme. For example, if southbound trade buying H-shares in Hong Kong involves transactions among non-residents only, these capital flows are excluded in Hong Kong's BoP data.

Exchange Fund paper, were little changed. More recently, the Monetary Base expanded further with the strong-side CU being triggered in early September.

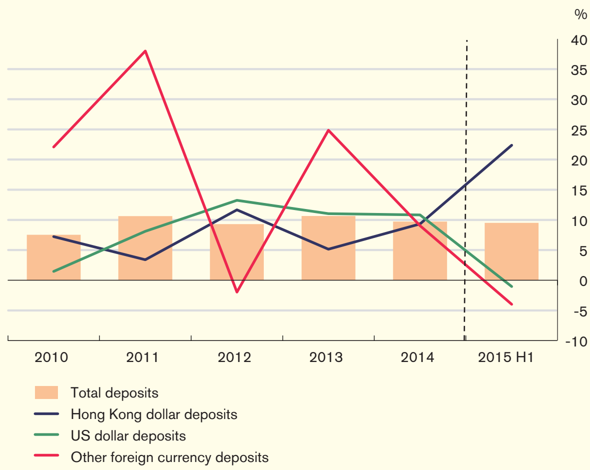
Chart 4.5
Monetary Base components



Source: HKMA.

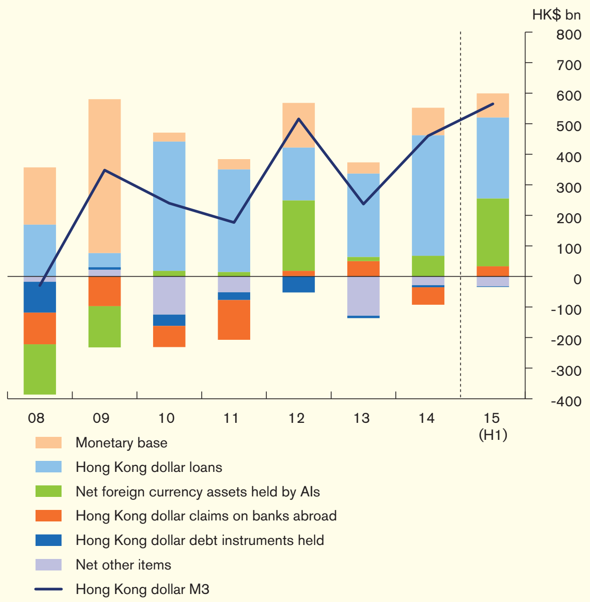
The Hong Kong dollar broad money supply (HK$M3) also picked up noticeably by 10.5% (or 21.1% annualised) in the first half, after rising by 9.0% in 2014. Within this, Hong Kong dollar deposits rose by 11.2% (or 22.4% annualised) in the first half, following a 9.3% increase in 2014 (Chart 4.6). In particular, demand deposits increased notably alongside buoyant trading and Initial Public Offering (IPO) activities in the equity market. Analysed by the asset-side counterparts, growth in the HK$M3 mainly reflected strong expansion in the Monetary Base and the net foreign currency assets of the authorized institutions (AIs), as well as growth in Hong Kong dollar loans (Chart 4.7).

Chart 4.6
Deposit growth



Note: Growth rates in 2015 H1 are annualised.
Source: HKMA.

Chart 4.7
Changes in the HK$M3 and the asset-side counterparts



Note: The HK$M3 in the monetary survey has been adjusted to include foreign currency swap deposits and to exclude government deposits and Exchange Fund deposits with licensed banks.
Source: HKMA staff estimates.

While the HK$M3 and Hong Kong dollar deposits increased in the first half, foreign currency deposits declined mildly. In the first six months, US dollar deposits edged down by 0.5% (or 1.0% annualised) and other foreign currency deposits fell by 2.0% (or 4.0% annualised) with modest drags from renminbi deposits. But overall, total deposits with the AIs (covering both Hong Kong dollar and foreign currency deposits) expanded by 4.8% (or 9.5% annualised) in the first half, roughly the same pace as in 2014.

With abundant liquidity in the banking system, wholesale funding costs continued to stay at low levels. The overnight and three-month HIBOR fixing rates were little changed at around 0.06% and 0.39% respectively in the first half, only showing occasional fluctuations due to increased equity funding demand and banks' liquidity needs ahead of the quarter-ends (Chart 4.8). Reflecting stable interbank funding conditions through currency swaps with US dollar, the Hong Kong dollar forward points saw little change during the same period. Broadly tracking the US dollar counterpart, the Hong Kong dollar yield curve flattened in the first four months and then steepened a bit. This left the average yield of 10-year Hong Kong Government Bond at 1.84% in June, still lower than the 1.97% level last December. At the retail level, mainly due to a lower weighted deposit rate, banks' average funding costs (measured by the composite interest rate) declined to a recent low of 0.29% in June, down 10 basis points from six months earlier. Meanwhile, banks' average lending rate for new mortgages remained steadily low at around 1.95% in the first half.

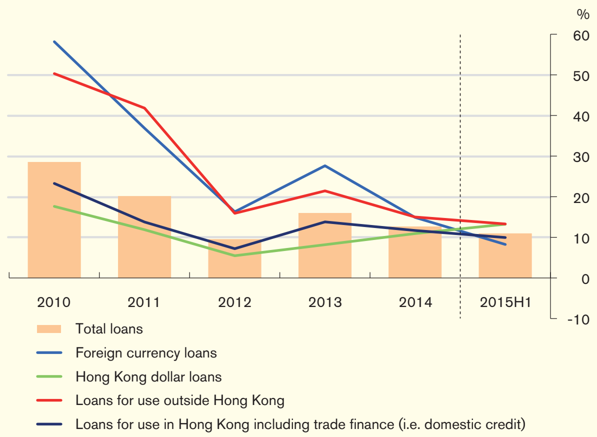
Chart 4.8
Hong Kong dollar interbank interest rates and yield of the 10-year Government Bond

Sources: CEIC and HKMA.

Monetary conditions in Hong Kong faced some pressure more recently. Along with the worsened financial market conditions, Hong Kong dollar interbank interest rates increased by a couple of basis points in August, while the Hong Kong dollar forward points turned to a premium.

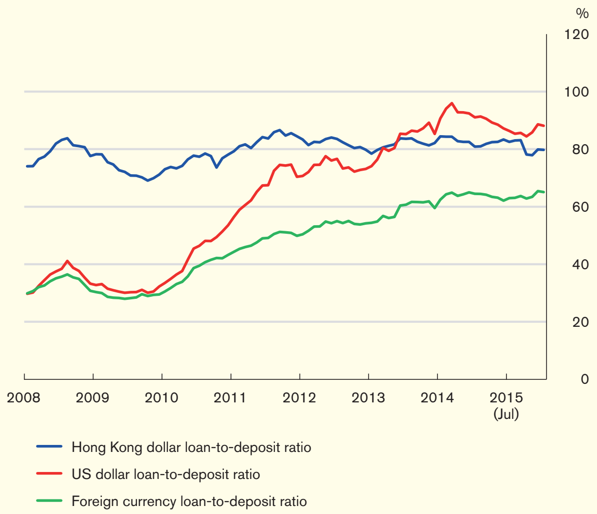
Total loan growth moderated slightly to an annualised rate of 11.0% in the first half of 2015 from 12.7% in 2014 (Chart 4.9). The moderation was due to softer growth in domestic credit, at an annualised 10.0% in the first half compared with 11.7% in 2014, while loans for use outside Hong Kong picked up by 13.3% (annualised), roughly the same pace as last year. Analysed by currency type, Hong Kong dollar loans grew faster than last year in part supported by surges in IPO loans and equity-related financing. On the other hand, foreign currency loans recorded a slower increase in the first half, particularly with growth in US dollar loans decelerating to an annualised 2.1% from 13.3% in 2014. Reflecting the relative changes in deposits and loans, the Hong Kong dollar loan-to-deposit ratio declined to 79.9% in June from 83.3% last December, while the US dollar loan-to-deposit ratio rose to 88.6% from 87.2% (Chart 4.10).

Chart 4.9
Loan growth



Note: Growth rates in 2015 H1 are annualised.
Source: HKMA.

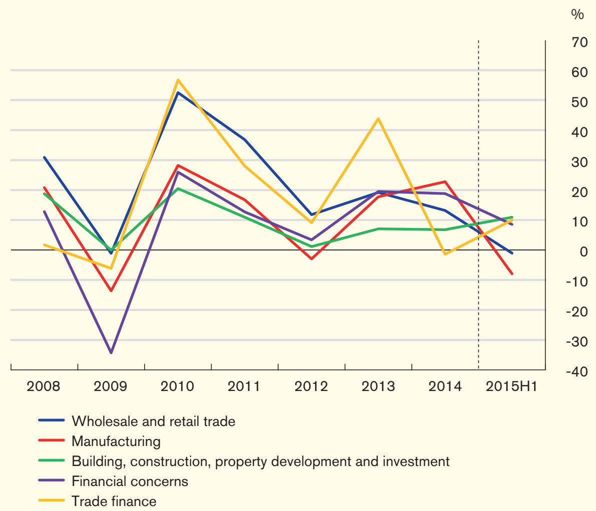
Chart 4.10
Loan-to-deposit ratios



Source: HKMA.

Behind the softer growth in domestic credit, sectoral performance was quite mixed, however (Chart 4.11). While trade finance picked up in the first half from a low recorded late last year, at the end of June it remained down by about 10% year on year, in part due to weak merchandise trade performance. Also, along with weak performance in the retail business, loans to wholesale and retail trade also declined. On the other hand, loans to stockbrokers rose notably faster, underpinned by vibrant equity IPOs and trading activities, and loans to financial concerns grew at a moderate pace. Meanwhile, loans to building, construction and property development also increased somewhat faster amid robust construction activities.

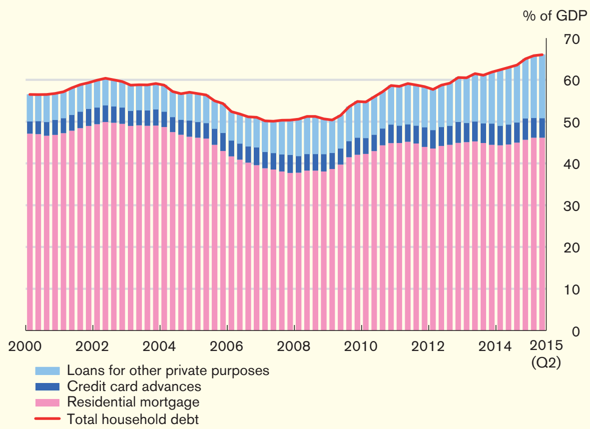
Chart 4.11
Growth in domestic loans by selected sectors



Note: Growth rates in 2015 H1 are annualised.
Source: HKMA.

Household debt continued to increase steadily in the first half. In particular, growth in personal loans (which comprise credit card advances and loans for other private purposes) remained fast at an annualised rate of 12.4%. Meanwhile, residential mortgage loans picked up by 9.0% (annualised) in the first half, although the growth momentum has decelerated after the HKMA introduced the seventh round of prudential measures in late February and early March. Overall, the household debt-to-GDP ratio edged higher to 66.0% in the second quarter from 65.7% in the first quarter (Chart 4.12).

Chart 4.12
Household debt-to-GDP ratio and its components



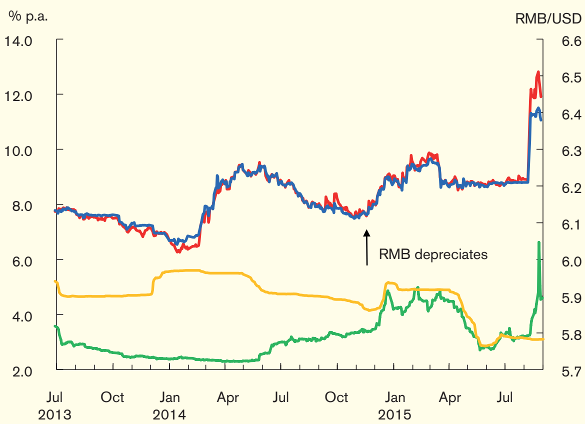
Note: Only borrowings from AIs are covered.
Source: HKMA.

Entering into the third quarter, credit growth showed signs of moderation. Total loans declined by 0.6% in July from a month earlier, bringing down the annualised growth rate to 8.3% for the first seven months as a whole. In the near term, credit growth would remain restrained by heightened uncertainties in the macro-financial environments amid expectation of US interest rate hike, a slowdown of the Mainland economy and renminbi depreciation.

Offshore renminbi banking business

Following mild depreciation against the US dollar in the first quarter of 2015, the offshore renminbi (CNH) exchange rate held steady between April and July while closely tracking the stable path of its onshore counterpart (CNY) (Chart 4.13). In August, however, the CNH faced increased depreciation pressure following the change in the renminbi exchange rate fixing mechanism on 11 August. The CNH weakened along with the CNY, and its discount vis-à-vis the CNY widened to as high as 1,000 pips in late August. Funding conditions in the CNH interbank markets also tightened in August amid renminbi depreciation pressure. Overall, the three-month CNH HIBOR picked up by about 130 basis points from the end of June, to 4.6% at the end of August.

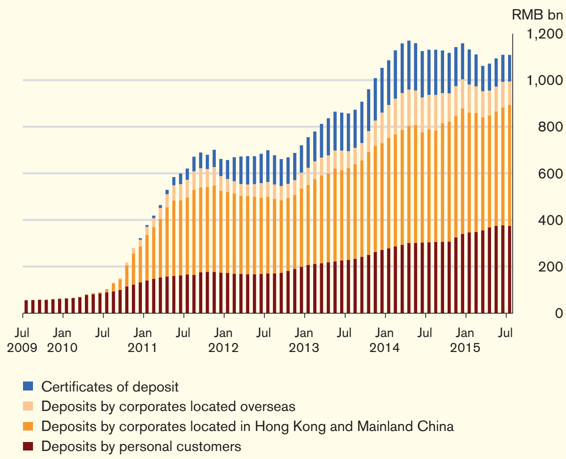
Chart 4.13
Onshore and offshore renminbi exchange rates and interbank interest rates



Sources: Bloomberg and Treasury Markets Association.

The renminbi liquidity pool in Hong Kong levelled off in the first quarter of 2015 and then picked up again in the second quarter. As a whole, the total outstanding amount of renminbi customer deposits and certificates of deposit (CDs) still decreased by 4.3% from six months earlier to RMB1,108.8 billion at the end of June (Chart 4.14 and Table 4.B). Renminbi customer deposits saw a modest 1.1% decline in the first half of the year. This was mainly attributable to a decline in corporate deposits, although personal customer deposits continued to increase at a steady pace. The market expectation of renminbi depreciation, if persistent, could potentially slow down growth in renminbi deposits in the near term. Yet, at the same time, the liquidity pressure might be partially offset by banks offering higher interest rates to lure customer deposits. Outstanding CDs dropped by 25.1% as there was a decrease in issuance year on year and a relative large amount of CDs reaching maturity.

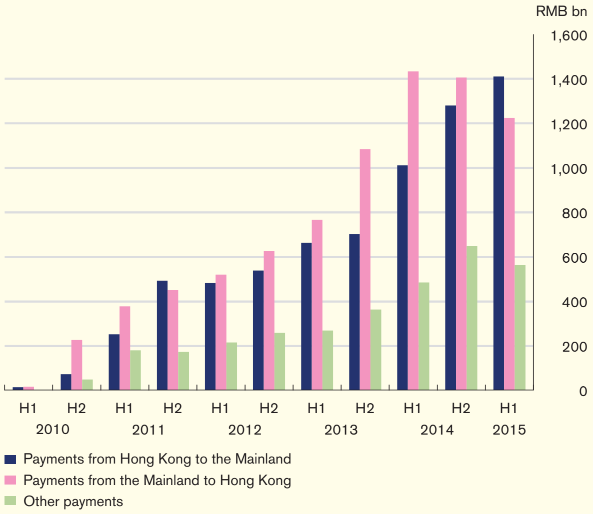
Chart 4.14
Renminbi deposits and CDs in Hong Kong



Source: HKMA.

Renminbi trade settlement handled by banks in Hong Kong decreased to RMB3,195.8 billion in the first half of 2015, down 4.1% from the second half of 2014. There were net outflows from Hong Kong to Mainland China under the renminbi trade settlement (Chart 4.15 and Table 4.B), in part because corporates reduced their offshore renminbi holdings amid weaker expectation of renminbi appreciation.

Chart 4.15
Flows of renminbi trade settlement payments



Source: HKMA.

Table 4.B
Offshore renminbi banking statistics

	Dec 2014	Jun 2015
Renminbi deposits & certificates of deposit (CDs) (RMB bn)	1,158.3	1,108.8
Of which:		
Renminbi deposits (RMB bn)	1,003.6	992.9
Non-Hong Kong residents' renminbi deposits (RMB bn)	30.8	28.7
Share of renminbi deposits in total deposits (%)	12.4	11.8
Renminbi certificates of deposit (CDs) (RMB bn)	154.7	115.9
Renminbi outstanding loans (RMB bn)	188.0	236.3
Number of participating banks in Hong Kong's renminbi clearing platform	225	223
Amount due to overseas banks (RMB bn)	145.2	142.2
Amount due from overseas banks (RMB bn)	193.3	174.5
	Jan–Jun 2015	
Renminbi trade settlement in Hong Kong (RMB bn)	3,195.8	
Of which:		
Inward remittances to Hong Kong (RMB bn)	1,224.0	
Outward remittances to Mainland China (RMB bn)	1,409.9	
Ratio of inward to outward remittances to Mainland China	0.9	
Turnover in Hong Kong's RMB RTGS system (Daily average during the period; RMB bn)	890.3	

Source: HKMA.

On the other hand, Hong Kong's renminbi lending business continued to expand, with the outstanding amount of renminbi loans rising by 25.7% from a low base to RMB236.3 billion at the end of June. Hong Kong's position as a global hub for offshore renminbi clearing and settlement also strengthened further. The average daily turnover of renminbi real time gross settlement (RTGS) rose to RMB890.3 billion in the first half of 2015 from RMB732.7 billion in 2014, and of these, around 90% were offshore transactions (i.e. not between Hong Kong and Mainland China) (Table 4.B). Looking ahead, the launch of the Mainland-Hong Kong Mutual Recognition of Funds (MRF) initiative in July, which has broadened cross-border investment channels between the two places with a wider selection of funds, would be conducive to Hong Kong's further development as a renminbi investment and asset management centre.

Asset markets

The Hong Kong equity market has taken a roller coaster ride and fallen sharply amid a major risk reappraisal in the past six months. The price premium of A-shares over H-shares has remained tangible, which is arguably attributable to discrepancies in the equity valuation between the Mainland and Hong Kong investors in the wake of elevated market volatilities. While the Hong Kong dollar debt market continued to grow in the first half of 2015, the offshore renminbi debt market showed signs of moderation after several years of rapid growth. Meanwhile, residential property market activities have softened in recent months after picking up gradually in the second quarter.

4.3 Equity market

The equity market in Hong Kong fluctuated widely in the review period and ended up sharply lower towards the end, subject heavily to external factors. After a flat first quarter, local equities surged sharply to a seven-year-high in April, triggered by the announcement of the China Securities Regulatory Commission to allow Chinese mutual funds to invest in Hong Kong equities (Chart 4.16). However, starting from late June, bouts of sharp selloff in global equities, coupled with weakness of commodity prices and the standoff in the Greek bailout negotiations, triggered a major risk reappraisal. As a result, the Hong Kong equity market took a drastic turnaround, with the Hang Seng Index (HSI) falling by 12.7% between March and August 2015.

Chart 4.16
Equity prices in Hong Kong

Source: Bloomberg.

During the review period, the Hang Seng China Enterprises Index (HSCEI), also known as the H-share index, dropped by 20.1%, mirroring the price correction in the A-share market. The valuation premium of A-shares over H-shares, as gauged by the Hang Seng China AH Premium Index (HSCAHP), though narrowing since early July, has remained tangible (Chart 4.17). This is attributable to discrepancies in the equity valuation between the Mainland and Hong Kong investors in the wake of elevated market volatilities, as reflected by the spike of HSI volatility index (VHSI) (Chart 4.18).[31] Nonetheless, a sharp decrease in the relative turnover of the A-share market to the H-share market, which partly reflected the scaling down of margin financing, hindered the further widening of price disparities between the two markets (Chart 4.19).[32]

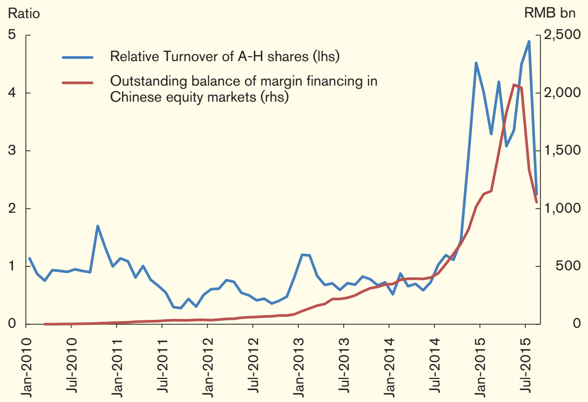
Chart 4.17
Hang Seng China AH Premium Index

Source: Bloomberg.

Chart 4.18
Option-implied volatility of the HSI

Source: Bloomberg.

Chart 4.19
Relative turnover of A- and H-shares and margin financing in Chinese equity markets



Note: Relative turnover is defined as the ratio of the turnover rate of A-shares to that of H-shares. The turnover rate of each market is computed by taking a weighted average of the turnover rates of dual-listed stocks that are constituents of the HSCAHP Index, with the weights being their respective market capitalisation.
Sources: Bloomberg, CEIC and HKMA staff estimates.

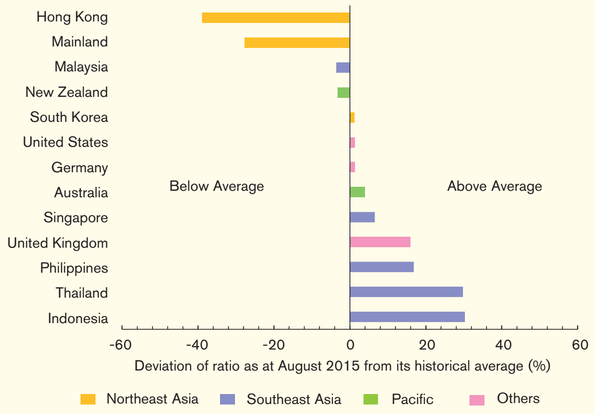
Looking ahead, the local equity market is likely to remain highly susceptible to external market conditions, although it still offers attractive valuation, compared to other markets in the region (Chart 4.20). In particular, given the increased economic ties and market connectivity between Hong Kong and Mainland China, growing concerns over an economic slowdown in Mainland China will continue to cast a shadow over the Hong Kong equity market. This, coupled with uncertainties over the course of monetary normalisation in the US and the global economic outlook, suggests that the local equity market is likely to remain volatile for the remainder of 2015.

---

[31] See Chung, Hui and Li (2013) "Explaining share price disparity with parameter uncertainty: Evidence from Chinese A- and H-shares", *Journal of Banking and Finance*, Vol. 37, 2013, pp. 1073–1083.

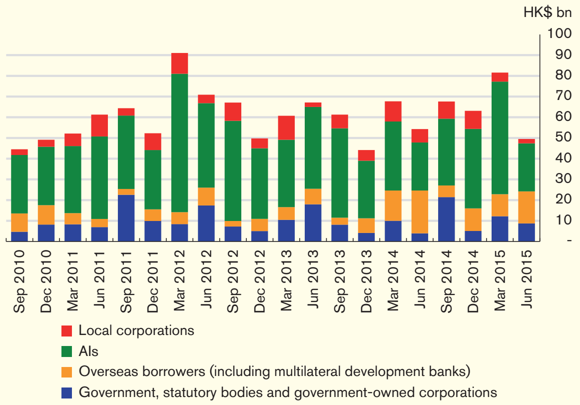
[32] See Fong, Wong and Yong (2010) "Share price disparity in Chinese stock markets", *Journal of Financial Transformation*, Vol. 30, 2010, pp. 23–31.

Chart 4.20
Price-earnings ratios of Asia Pacific (excluding Japan) and other major markets



Sources: Bloomberg and HKMA staff estimates.

Chart 4.21
New issuance of non-Exchange Fund Bills and Notes Hong Kong dollar debt

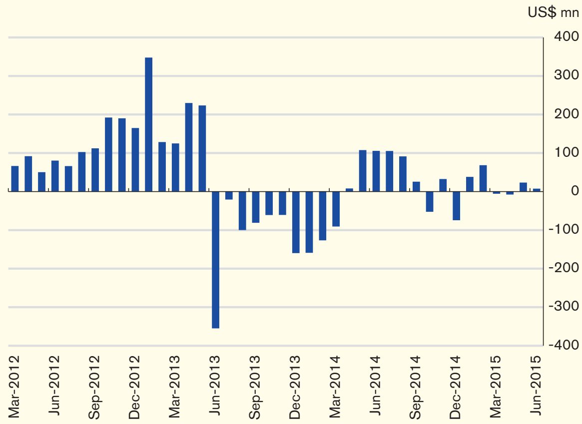


Source: HKMA.

4.4 Debt market

Less debt was issued in the Hong Kong dollar debt market in the first half of 2015 (Chart 4.21). Total issuance dropped by 1.9% year on year to HK$1,164.3 billion. The public sector registered the largest decline, issuing HK$1,054.1 billion or 2.3% less debt than in the same period of 2014, as a result of reduced issuance of Exchange Fund papers.[33] In contrast, the local private sector, which consists of AIs and local corporations, posted a year-on-year increase of 15.5% in its debt issuance.[34] However, on a quarterly basis, new debt issued by the local private sector fell sharply by 43.1% in the second quarter. This, to some extent, was attributable to reduced investor appetite for bonds in the local market in view of growing expectation that the US Federal Reserve will raise interest rates later this year, as reflected by the slowdown in bond fund flows into the city over the past few months (Chart 4.22).

Chart 4.22
Bond fund flows into Hong Kong



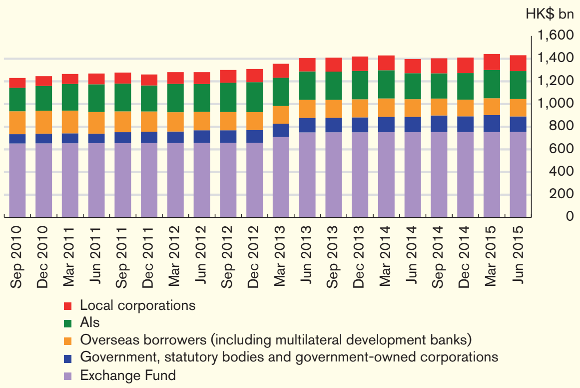
Source: EPFR Global.

33 The Exchange Fund papers issuance, which accounted for 86.9% of new issuances in the Hong Kong dollar debt market, dropped by 3.0% year on year in the first half of 2015.

34 In the first half of 2015, issuance by local corporations fell by 60.4% year on year to HK$6.5 billion, which was more than offset by the growth of 37.4% in new debts issued by AIs.

Notwithstanding the decrease in total issuance, the total outstanding amount of Hong Kong dollar debt rose by 2.4% year on year to HK$1,430.1 billion at the end of June 2015, equivalent to 24.7% of Hong Kong dollar M3 or 21.0% of Hong Kong dollar denominated assets of the entire banking sector (Chart 4.23). Overseas borrowers including multilateral development banks (MDBs) saw their outstanding debt fall by 0.7%, whereas the outstanding amount of debt issued by the local private sector increased by 9.2%. That said, as driven by the sharp decline in local private sector issuance in the second quarter, the Hong Kong dollar debt market saw a quarter-on-quarter contraction of 0.7% in Q2 2015 after rising three quarters in a row.

Chart 4.23
Outstanding Hong Kong dollar debt

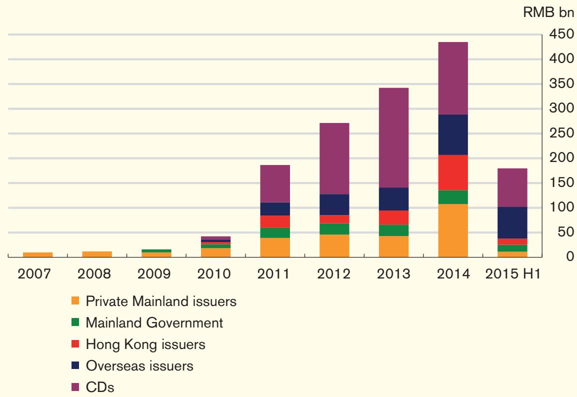


Source: HKMA.

Meanwhile, after years of phenomenal growth since the launch of the CNH market, the offshore renminbi debt market in Hong Kong showed signs of moderation in the first half of 2015, which can be attributed to both demand- and supply-side factors. On the demand side, investor appetite for offshore renminbi debt securities has receded, in part due to renminbi depreciation in late 2014 and early 2015. Meanwhile, the Shanghai-Hong Kong Stock Connect launched last November has offered an alternative channel for offshore investors to gain exposure to Mainland China. On the supply side, following a series of monetary easing measures introduced by the People's Bank of China (PBoC), funding costs in the domestic market have been reduced. Hence, Mainland's enterprises may be less motivated to raise funds through issuing bonds offshore.

Against this backdrop, new issuance of offshore renminbi debt securities in the first half of 2015 totalled RMB179.7 billion, 36.2% lower than the same period a year earlier (Chart 4.24). In particular, non-CD debt securities issued by private Mainland's issuers decreased by 82.1% to RMB11.4 billion. Nevertheless, those issued by overseas issuers increased by 61.7% year on year to RMB64.6 billion, suggesting that overseas issuers might either have significant demand for renminbi or find it cost-effective to raise renminbi funds and swap the proceeds to US dollar.[35] With the fall in total issuance, the outstanding amount of the offshore renminbi market in Hong Kong dropped by 7.6% year on year to RMB584.9 billion as at end-June 2015.

Chart 4.24
New issuance of offshore renminbi debt securities

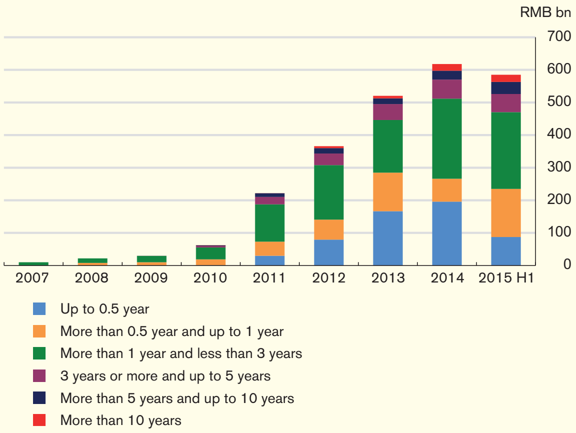


Sources: Newswires and HKMA staff estimates.

35 For details about USD/CNH cross-currency swap, see Box 4 in *Half-Yearly Monetary and Financial Stability Report* (March 2014).

Looking forward, near-term development of the offshore renminbi debt market will hinge on a host of factors. Firstly, in a drive to reform the renminbi exchange rate regime, the resulting exchange rate uncertainty may affect both investor appetite and issuers' fund raising strategy. Second, in view of increased global financial volatility, investors are likely to stay on the sideline in the near term. Third, as the authorities try to maintain growth momentum, more monetary easings are likely to be in the pipeline. Hence, issuance by Mainland's enterprises in the offshore market might stay lukewarm should funding costs in the onshore market remain relatively low. This is despite the fact that the market will see strong refinancing needs in the period ahead (Chart 4.25).

Chart 4.25
Outstanding amount of offshore renminbi debt securities by remaining tenor



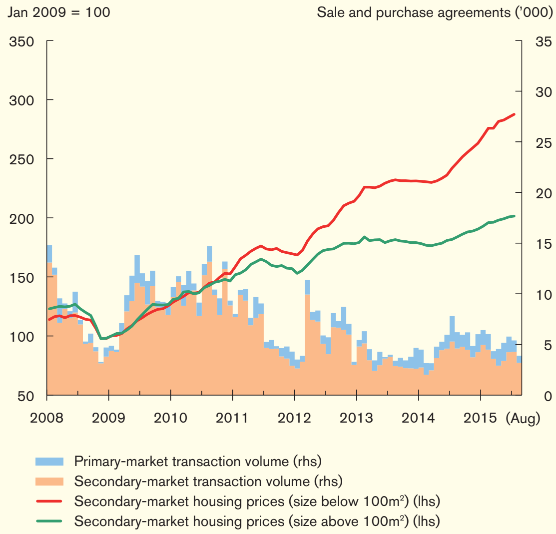
Sources: Newswires and HKMA staff estimates.

4.5 Property markets

Residential property market

The residential property market showed some signs of consolidation in March after the HKMA introduced the latest round of prudential tightening, but market activities picked up gradually in April–June before softening again in July–August. As a whole, housing transactions dropped in March by nearly 30% from a month earlier, which then revived in April–June amid robust primary-market sales and recovery in secondary-market transactions (Chart 4.26). The average monthly primary-market transaction was 1,370 units between March and July, similar to the average level recorded in the 12 months before the February prudential tightening. Meanwhile, secondary-market transactions rose gradually from a recent low of 2,915 units in April to 4,271 units in July. Speculative and investment activity, such as confirmor transactions, short-term flipping trade and company holdings, remained at low levels (Chart 4.27). Entering into August, however, housing market sentiment weakened amid the stock market sell-off. In particular, secondary-market transactions fell to 3,132 units in August, while Midland volume index pointed to continuous decline more recently. Primary-market sales have reportedly been slower as well.

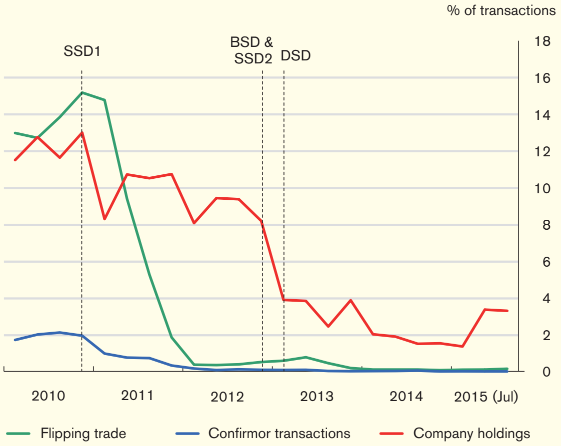
Chart 4.26
Residential property prices and transaction volume



Sources: Rating and Valuation Department (R&VD) and Land Registry.

As regards housing prices, a fast pick-up was recorded in the first two months of this year but the pace of increase has decelerated since then (Chart 4.26). Still, with the rapid increase early in the year, housing prices rose by a cumulative 9.1% in the first seven months, and prices of small and medium-sized flats (with saleable area of less than 100 m^2) continued to increase faster than prices of larger flats (with saleable area of at least 100 m^2). Housing prices continued to pick up further more recently, as suggested by the Centa-City leading index. Meanwhile, the price premium of primary-market flats relative to secondary-market flats has reportedly narrowed in recent months as developers offer more discounts and concessions.

Chart 4.27
Confirmor transactions, flipping trade and company purchasers



Note: SSD1 and SSD2 refer to Special Stamp Duties introduced in November 2010 and October 2012, respectively; BSD refers to Buyer's Stamp Duty introduced in October 2012; DSD refers to doubling of the ad valorem stamp duty introduced in February 2013.

Source: Centaline Property Agency Limited.

Given the latest market developments, housing affordability has stretched a lot further. The housing price-to-income ratio rose to a record high of 15.9 in the second quarter compared with the 1997 peak of 14.6, while the income-gearing ratio increased further to 70.7%, well above its long-term average of about 50% (Chart 4.28).[36] Moreover, if the mortgage interest rate returned to a more normal level, say by a 300-basis-point increase, the income-gearing ratio would soar to 92.3%. Meanwhile, the rise in fresh housing rentals still lagged behind the upward trend in housing prices. As a result, residential rental yields dropped to record low levels of 2.2–2.9%, while their spreads relative to the long-term Government bond yields have narrowed. The buy-rent gap as a measure of relative user costs also widened further (Chart 4.29).[37]

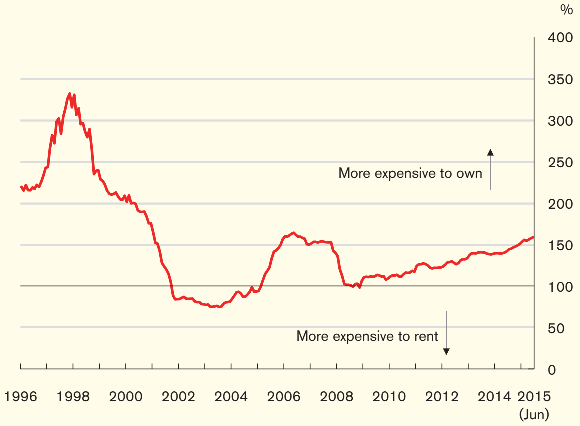
Chart 4.28
Indicators of housing affordability

Sources: R&VD, C&SD and HKMA staff estimates.

36 The price-to-income ratio measures the average price of a typical 50 m^2 flat relative to the median income of households living in private housing. Alternately, the income-gearing ratio compares the amount of mortgage payment for a typical 50 m^2 flat (under a 20-year mortgage scheme with a 70% loan-to-value ratio) to the median income of households living in private housing. The income-gearing ratio is not the same as a borrower's actual debt-servicing ratio, which is subject to a maximum cap by the HKMA prudential measures.

37 The buy-rent gap estimates the cost of owner-occupied housing (under a 20-year mortgage scheme with a 70% loan-to-value ratio) relative to rentals.

Chart 4.29
Buy-rent gap



Note: This indicator is calculated as the ratio of the cost of purchasing and maintaining a 50 m² flat with that of renting it.

Sources: R&VD, C&SD and HKMA staff estimates.

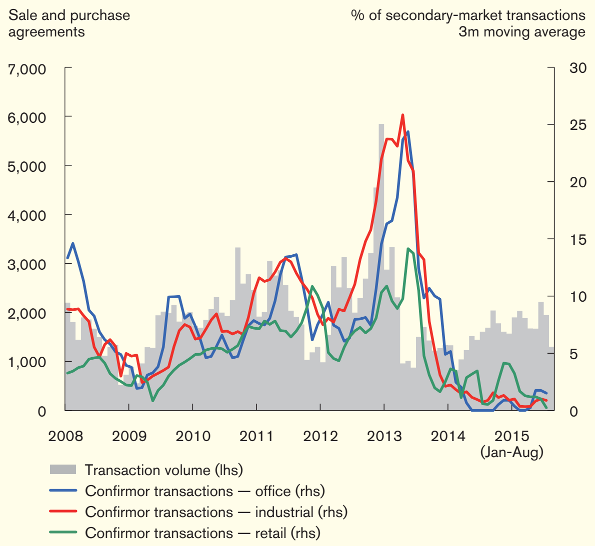
To manage banking risks related to mortgage lending and to enhance borrowers' ability to cope with the impact of a possible property market downturn, the HKMA has introduced seven rounds of macro-prudential measures since 2009, including the latest round in February and early March this year. These measures helped bring down the average loan-to-value ratio for new mortgages from 64% before the introduction of the measures to around 52% more recently. The debt-servicing ratio (DSR) for new mortgages also fell by about 5 percentage points to 35%.

Housing market outlook will likely become more cautious amid increased volatility in the global and Hong Kong's financial markets. While there appears to be near-term support from pent-up demand and tight supply conditions, the weakening stock market sentiment is having an adverse spillover into housing market sentiment. Housing demand of Mainland Chinese in Hong Kong could also weaken in net terms due to diminished purchasing power from a weaker renminbi and growth slowdown of the Mainland economy. But more importantly, the highly-stretched valuation of the property market is not quite in line with economic fundamentals, and the risk of downward adjustment has picked up steadily. Rises in US interest rates and the gradual shrinkage of the housing demand-supply gap are also posing headwinds to housing prices. In particular, once the US rate hike cycle begins, interest rates will eventually reach a level that leads to a more substantial tightening of liquidity conditions in Hong Kong. The effect on housing demand and housing prices, however, depends on the exact pace and magnitude of rate hikes, as well as financial market responses.

Non-residential property market

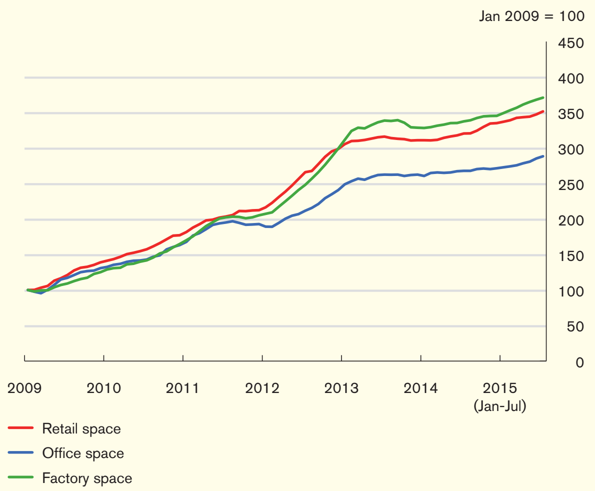
The non-residential property market picked up steadily in the first half of 2015 before showing signs of softening in recent months. Driven mainly by demand for office and factory premises and parking lots, average transaction volume rose by more than 10% in the first half, which saw a reverse more recently (Chart 4.30). Speculative activity remained subdued, with confirmor transactions hovering at very low levels. As regards property value, prices of office and factory premises rose by 6.2% and 7.4% respectively in the first seven months, while prices of retail space saw a slower 5.0% increase (Chart 4.31). Rental growth was generally slower than price increase across market segments, with yields staying low at 2.4–2.9%. Looking ahead, prices and rentals of non-residential properties will largely hinge on business prospects and interest rate developments. In particular, the prices and rentals of retail space, especially at prime locations, will face headwinds from the weak retail sales outlook. Slower economic growth and a possible decline in rentals, together with expectation of interest rate hikes, could exert downward pressure on capital values of non-residential properties.

Chart 4.30
Transactions in non-residential properties



Sources: Land Registry and Centaline Property Agency Limited.

Chart 4.31
Non-residential property price indices



Source: R&VD.