Economic and Banking Environment

The Hong Kong economy emerged from recession in mid-2009 with a gradual recovery in domestic and external demand helped by significant and timely government stimulus programmes. Labour market conditions stabilised with the unemployment rate moderating. Consumer-price inflation was contained given the tapering off of food and fuel prices and continuing weak demand. Economic recovery is expected to strengthen in 2010, but risks remain because of the fragile recovery in developed economies and uncertainties about their exit strategies from the unconventional stimulus measures introduced to combat the global financial crisis.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy experienced a difficult year in 2009 as the worst global recession in more than 60 years unfolded. While a turnaround was finally observed in the second half, real GDP fell by 2.7% for the year, marking the first outright contraction since the Asian financial crisis more than a decade ago. The downturn, especially the severe decline in external demand, weakened domestic private consumption and investment (Table 1). Labour market conditions deteriorated with a steep rise in the unemployment rate to a three-year high by mid-year, although stabilising somewhat thereafter alongside a gradual pick-up in economic activity. Consumer-price inflation receded with food and fuel prices tapering off, a drop in rental costs, and weak demand conditions. On the other hand, asset market activities were buoyed by sharp increases in stock and housing prices from the early part of the year.

The money and foreign-exchange markets weathered the global recession and the financial crisis reasonably well. The Hong Kong dollar spot exchange rate stayed close to 7.75 throughout the year with repeated triggering of the strong-side Convertibility Undertaking. This was not related to speculation against the Linked Exchange Rate system; instead, it was attributable to the repatriation of funds by Hong Kong residents and investment portfolio inflows. The Aggregate Balance increased markedly as a result, while the short-term interbank rates, savings rates and deposit rates all edged down to very low levels. On the back of strong inflows and a gradual economic recovery, Hong Kong dollar deposits and money supply grew at a faster rate over the year. However, domestic credit expansion was modest despite some easing in credit conditions.

Domestic demand

As the recession abated, domestic demand swung from decline to growth in 2009. With the overall improvement in economic prospects and stabilisation in the labour market, private consumption bottomed out in the third quarter and increased in the final quarter. Despite this, the significant drag of the first two quarters still resulted in private consumption decreasing by 0.3% over the full year. Investment spending also declined by 2.2% in 2009 despite some recovery in the second half. Public investment was strong as the Government sought to expedite public sector projects, while private investment remained weak owing to slack capacity and cautious business sentiment. The Government's move to shore up demand in the economy

Table 1 Contribution to real GDP growth by expenditure components (% yoy)

	2009					2008				
	Q1	**Q2**	**Q3**	**Q4**	**Overall**	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	-3.7	-0.5	0.3	2.9	-0.2	5.2	2.5	0.4	-1.9	1.4
Government Consumption Expenditure	0.1	0.2	0.2	0.1	0.2	0.1	0.2	0.2	0.2	0.1
Gross Domestic Fixed Capital Formation	-2.3	-2.7	0.5	2.5	-0.4	2.3	1.3	0.8	-3.3	0.2
Change in Inventories	-1.4	-1.9	4.0	3.7	1.2	-0.5	-0.2	0.4	-1.0	-0.3
Net Exports of Goods	0.0	2.2	-7.8	-9.5	-3.9	-0.9	-1.4	-1.3	3.2	0.0
Net Exports of Services	-0.2	-1.0	0.5	2.8	0.6	0.8	1.5	0.6	0.2	0.8
GDP	**-7.5**	**-3.7**	**-2.2**	**2.6**	**-2.7**	7.0	4.0	1.1	-2.7	2.1

Figures may not add up to total because of rounding.

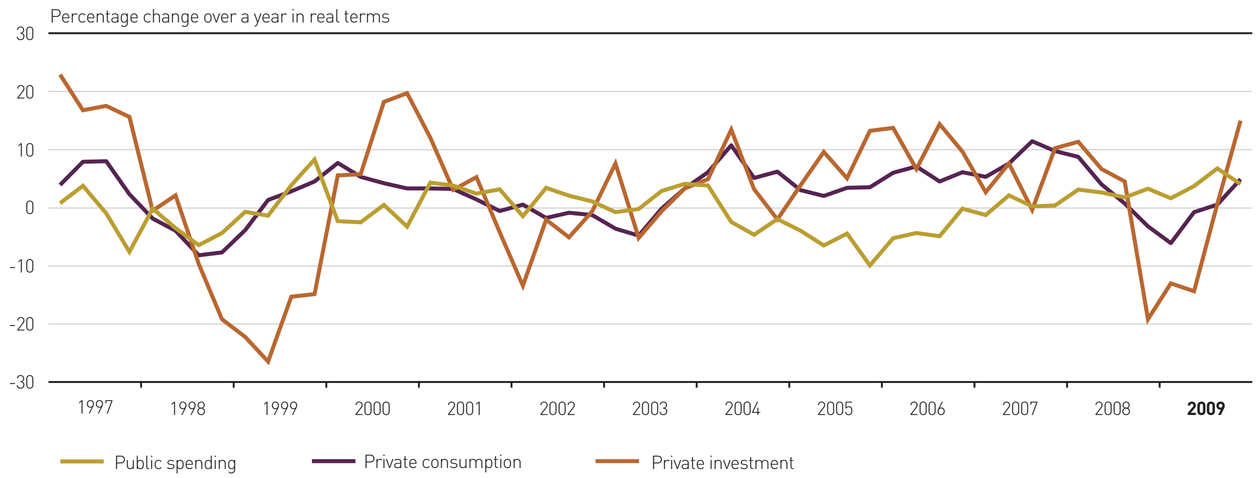
Source: Census and Statistics Department.

was reflected in the steady 2.0% increase in government consumption in 2009 (Chart 1).

External demand

External demand faltered in 2009 with the world economy in a deep downturn. Merchandise exports fell in value terms by 12.6% from 2008, although they increased in the final two months of the year. Broad-based declines were recorded across all major export destinations including Mainland China, the US and other industrialised economies (Table 2). Moving into the second half, the swift turnaround in the Mainland and regional economies helped bolster Hong Kong's exports to some extent, resulting in smaller yearly declines for these destinations than for others. Exports of services likewise weakened due to falling offshore trading activity and transportation services that outweighed the notable pick-up in inbound tourism and financial activities during the second half. For 2009 as a whole, exports of services decreased in value terms by 6.6%. Imports of goods and services fared progressively better with the strengthening of domestic demand, although still posting yearly declines of 11.0% and 6.1% respectively in value terms. Taken together, there

Chart 1 **Domestic demand**



Source: Census and Statistics Department.

Table 2 **Merchandise exports by major trading partners (in value terms)[1]**

	Share %	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2009 Overall	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2008 Overall
Mainland China	51	-24	-5	-8	4	-8	11	8	4	-2	5
United States	12	-21	-21	-24	-16	-21	-1	-1	1	-7	-2
European Union	12	-18	-22	-26	-15	-20	8	8	10	-1	6
Japan	4	-13	-18	-8	-2	-10	-2	-1	3	4	1
ASEAN5[2] + Korea	7	-32	-25	-18	-3	-20	15	9	3	-8	4
Taiwan	2	-26	-6	3	25	-1	3	7	5	0	4
Others	12	-17	-18	-18	0	-13	30	24	17	4	18
Total	**100**	**-22**	**-13**	**-14**	**-2**	**-13**	10	8	6	-2	5

1 Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.
2 ASEAN5 includes the Philippines, Malaysia, Indonesia, Singapore and Thailand.

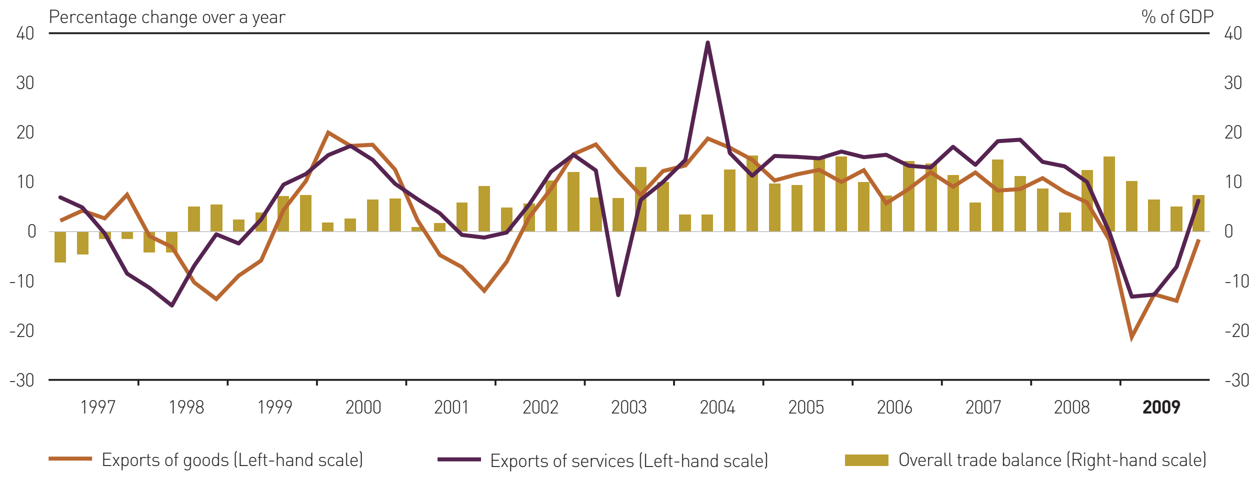
Source: Census and Statistics Department.

was an overall trade surplus of 7.2% of GDP, compared with a surplus of 10.2% of GDP in 2008 (Chart 2).

Inflation

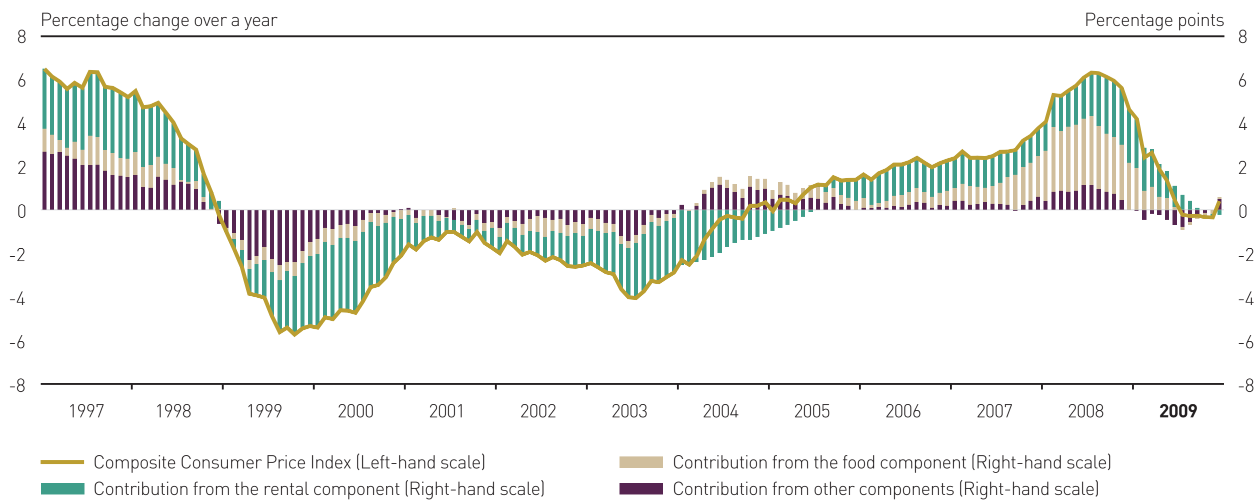
Inflationary pressure remained soft in 2009, following a moderation in the second half of 2008. Netting out the effects of government relief measures, the year-on-year underlying inflation rate turned moderately negative for a brief period due to the tapering off in food and rental costs, but it later revived to positive 0.3% in December. The downward price pressure in the economy indeed dissipated towards the end of 2009, with the three-month-on-three-month annualised underlying inflation rate turning positive in October, and reaching 2.0% in December. Fading deflationary pressure was also evident in the headline inflation rate, which showed signs of picking-up in the fourth quarter, reaching 1.3% year on year in December from a year-low of-1.6% in August. For 2009 as a whole, the underlying CCPI inflation rate slowed to 1.0% from 5.6% in 2008, while the headline CCPI inflation rate similarly dropped to 0.5% from 4.3% the previous year (Chart 3).

Chart 2 Overall trade balance and export growth (in nominal terms)



Source: Census and Statistics Department.

Chart 3 Consumer prices[1]



[1] The Composite Consumer Price Index and its component indices are adjusted for the effects of special relief measures.

Sources: Census and Statistics Department, and staff estimates.

Economic and Banking Environment

Labour market

The labour market continued to worsen in the first half of 2009, with the seasonally adjusted three-month moving average unemployment rate climbing to a three-year high of 5.4% in June. However, the pace of deterioration slowed successively, with the quarter-on-quarter increase in the rate dropping substantially to 0.2% in the second quarter after a sharp rise of 1.1% in the first quarter. Signs of stabilisation became firmer in the third quarter, with the unemployment rate starting to decline in September, and reaching 4.9% in December (Chart 4). A breakdown of the data indicated a broad-based improvement in labour market conditions, reaffirming the view that stabilisation of the market was in place. Despite the encouraging development, employment conditions remained relatively weak, as some 172,800 people were unemployed in December, a net increase of more than 50,000 people since the onset of the global financial crisis.

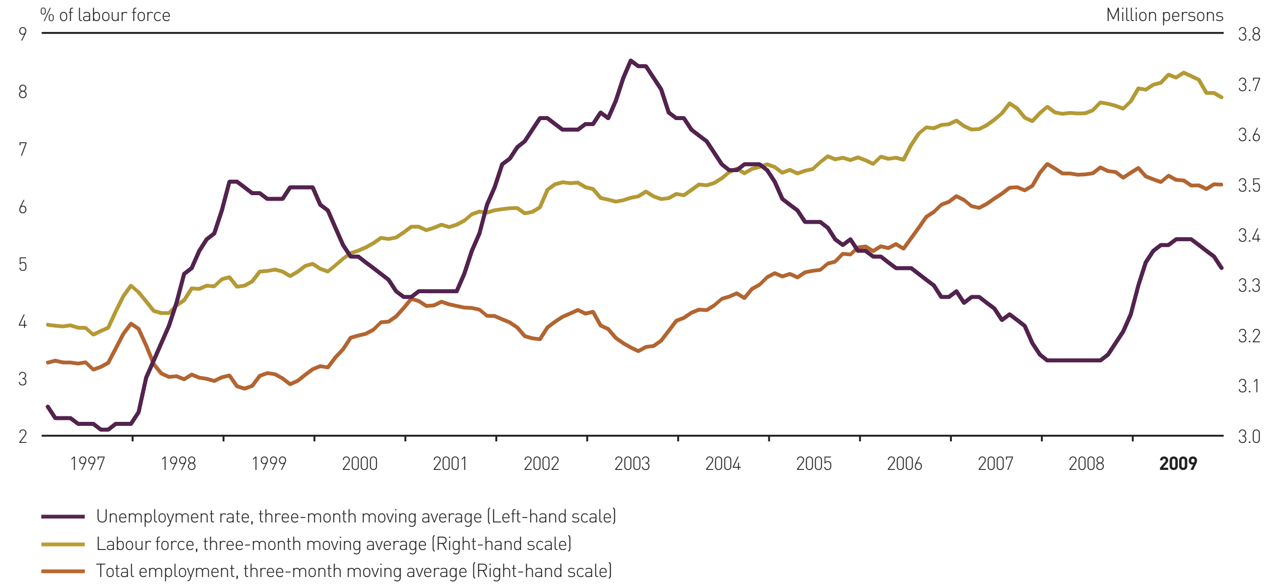
Stock market

The local stock market entered 2009 on a weak note but rallied from March onwards, fuelled by strong capital inflows, an increased risk appetite among market participants and an improving economic outlook for Hong Kong and the Mainland. The Hang Seng Index bounced back after bottoming out in early March, closing the year at 21,873, up 52.0% from the end of 2008. Its movement was broadly in line with other Asian benchmark indices, suggesting a growing interest in investment in the region as a whole. The average daily turnover in the local stock market revived to about $69 billion after falling to $45 billion in the first quarter. Equity IPO activities also picked up in the second half of the year, led by Mainland enterprises.

Property market

After falling to a near standstill towards the end of 2008, the residential property market was buoyed in 2009 with a strong run-up in prices and transaction volumes. Activity was spurred on by the sustained low interest rate environment, tight supply, resurgent sentiment and increased buying interest from high net-worth individuals (including those from the Mainland and overseas). Flat prices rose cumulatively by an average of 27.6% in 2009, although most of the gains were made in the first three quarters of the year. The buying spree slowed in the fourth quarter amid prospective buyers' concerns over home affordability and the issuance of the HKMA's new guidelines on loan-to-value ratios for residential mortgages on high-value flats. Despite this, the total number of transactions showed a notable increase of 20.0% in 2009 over 2008.

Chart 4 Labour market conditions



Source: Census and Statistics Department.

OUTLOOK FOR THE ECONOMY

Economic environment

Recent economic data releases suggest the domestic economic environment will continue to improve in 2010. Stabilising labour market conditions, higher asset prices, and strengthening consumer confidence should provide some support to consumption spending. Private investment may remain weak in the presence of excess capacity, while public investment may strengthen with several major infrastructure projects ready to proceed. External demand is expected to pick up gradually, as many countries have resumed positive economic growth since the second and third quarters of 2009, following swift policy responses to the crisis. The latest market consensus points to real GDP growth of 4.9% in 2010, with the International Monetary Fund projecting 5.0% and Asian Development Bank projecting 3.5%.

Inflation and the labour market

Consumer-price inflation is likely to remain subdued in 2010, given the possibility of moderate local cost pressures and import-price inflation. The sharp increase in property prices and rentals since early 2009, however, will inevitably feed into the rental component of the Consumer Price Index, perhaps as early as the second half of 2010. Therefore, consumer-price inflation may pick up in the second half of the year. The market consensus predicts the headline inflation rate at 2.6% in 2010, compared with 0.5% in 2009. The consensus forecast of the unemployment rate is 4.7% in 2010, a slight drop from 5.2% in 2009. The projected fall in the unemployment rate is in line with recent declines and the pick-up in hiring sentiment as evidenced by the Purchasing Managers' Index employment sub-index.

Uncertainties and risks

Among the possible sources of risk in the economic outlook, some deserve special attention.

The implementation of timely and sizable monetary and fiscal stimuli in response to the crisis helped prevent an economic meltdown in many countries, and financial markets rebounded strongly on the back of abundant liquidity around the globe. However, the real economy and financial markets have remained fragile. For example, the unexpected debt problems in Dubai caused financial markets around the world to drop on renewed concerns about the health of the international financial system. And there is still a risk that the global recovery may falter, resulting in a double-dip recession if worsening labour markets in advanced economies lead to renewed weakness in aggregate demand, and if the effects of various stimulus measures begin to fade.

The implementation of unconventional policy measures also raised market concerns over expanded central bank balance sheets and significantly deteriorating fiscal positions in many countries. As an indirect manifestation of the abundant liquidity associated with the expanded central bank balance sheets, worldwide asset markets have increased substantially. If the lagged effects of the loose monetary conditions become stronger and more prolonged than markets expect, there will be a renewed risk of another asset bubble, particularly if credit resumes strong growth in the major economies fuelling economic and financial market activities. Indeed, Hong Kong's asset markets have absorbed some of the excess global liquidity, raising concerns among the public about the rapid increase in local property prices.

On the other hand, there may be an unexpected and sudden reversal of capital flows into Hong Kong which could result in substantial volatilities on financial markets. In addition to the two scenarios of a double-dip recession and the bursting of a new asset bubble, there are two other possible events that could trigger a reversal of fund flows: a tightening of US monetary policy, or a reversal of the weakening of the US dollar. This latter scenario, in particular, could cause a sudden unwinding of US dollar-funded carry trades, which have become a prominent funding source for various financial assets as a result of the easy monetary conditions in the US. In such a case, declines in global financial markets may overshoot and fund flows may reverse abruptly.

Overall, the local economy is at a turning point. The risks of a double-dip recession and of a tightening in monetary policy amid strong growth are both present. The possibility of the formation of a new asset bubble also deserves attention.

NOTES AND COINS

At the end of 2009, the total value of banknotes in circulation was $200.2 billion, an increase of 13% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to $8.2 billion, up 2% (Charts 8 and 9). The value of $10 notes issued by the Government in circulation (both paper and polymer notes) reached $2.7 billion, an increase of 0.9% from 2008.

Chart 5 Banknotes in circulation by note-issuing banks at the end of 2009

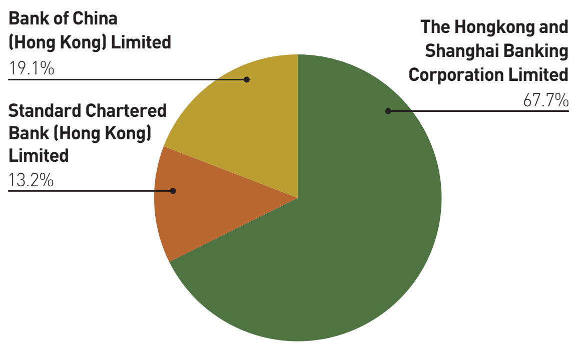
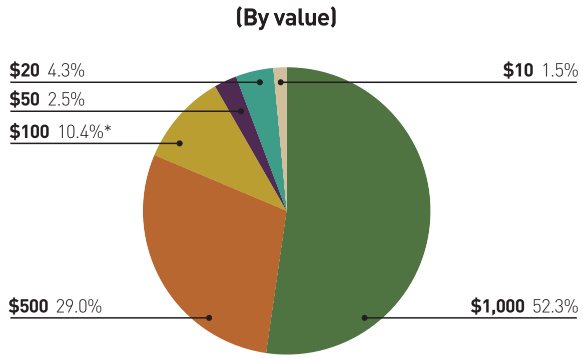


Chart 6 Distribution of banknotes in circulation at the end of 2009



* Includes 0.1 percentage points contributed by the $150 banknotes.

Chart 7 Banknotes in circulation at the end of 2009

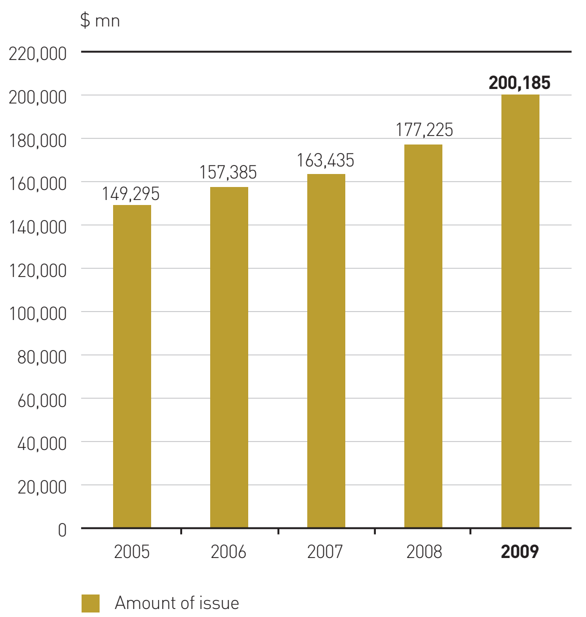


Chart 8 Government-issued notes and coins in circulation at the end of 2009

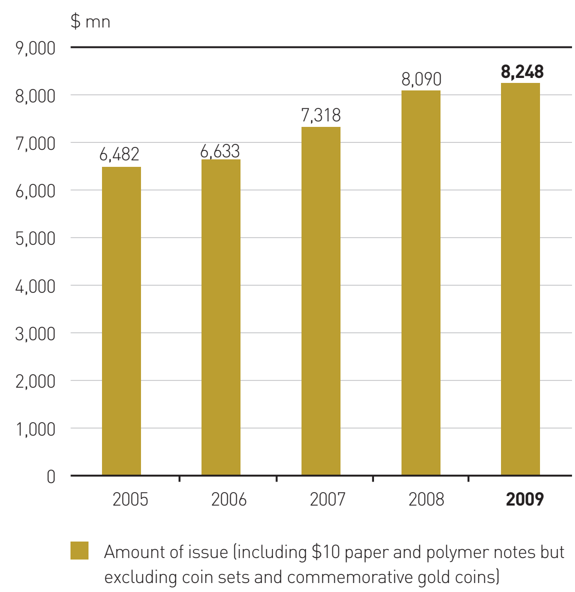
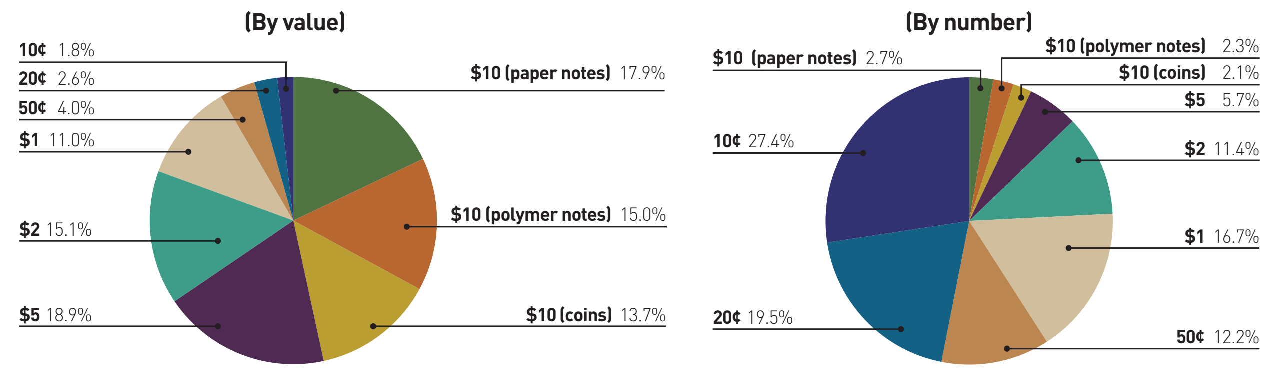


Chart 9 Government-issued notes and coins in circulation at the end of 2009



Hong Kong banknotes

Public education programmes on the security features of the latest series of banknotes issued in 2003 continued to be well received. During the year 23 seminars were organised for over 2,300 bank tellers and retail cashiers, providing them with knowledge and skills for authenticating banknotes.

Standard Chartered Bank (Hong Kong) Limited 150th Anniversary Commemorative Banknote

In October the Standard Chartered Bank (Hong Kong) Limited issued one million $150 banknotes to commemorate the 150th anniversary of the bank's establishment in Hong Kong, raising total net proceeds of $130 million for Hong Kong charities.

Good-as-new notes

To help protect the environment, the HKMA continued its efforts to promote the use of "good-as-new notes", instead of brand new notes, as *lai see* (customary gifts of money given during Chinese New Year). A Chinese couplet competition was held during the year to promote the use of "good-as-new notes" with over 680 entries for the three categories. The winning entry, from the Senior Citizens Category, was "鈔票仍新歡樂年年包利是，金融更旺繁榮處處集禎祥".

$10 polymer note

About 123 million polymer notes were in circulation at the end of 2009, representing 45% of the $10 notes issued by the Government.

Coin replacement programme

The withdrawal of coins bearing the Queen's Head design continued, with 23 million coins being removed from circulation in 2009.

Economic and Banking Environment

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector ended the year on a more robust note with a marked strengthening in the capital position of locally incorporated AIs. Deterioration in the quality of loan portfolios was much milder than expected. Delinquency ratios remained at a low level compared with historical standards.

Interest rate trends

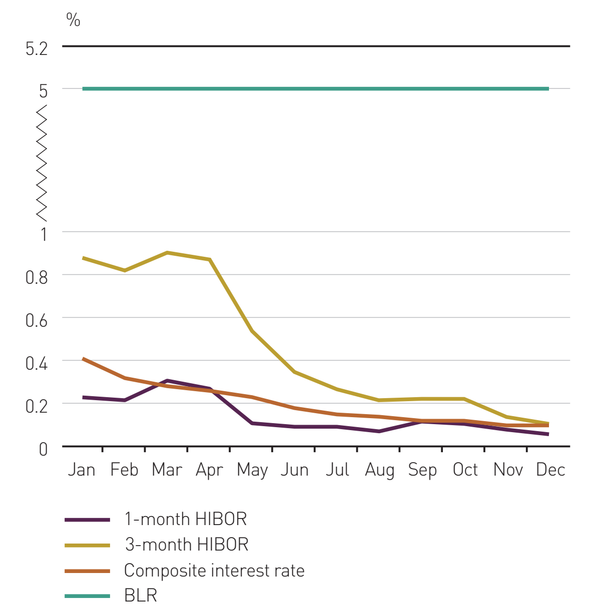
Hong Kong dollar interbank interest rates drifted steadily to nearly zero during the year, driven by exceptionally accommodative monetary policy rates in major advanced economies and ample liquidity in the banking system as a result of substantial fund flows into Hong Kong. The composite interest rate, which reflects the average cost of funds of retail banks, also fell to exceptionally low levels (Chart 10). In March 2009, reflecting the stabilisation of the local interbank market, the HKMA withdrew the temporary measures introduced in September 2008 to provide liquidity assistance to the banking system.

Profitability trends

The net interest margin of retail banks continued to narrow in 2009, falling to 1.48% from 1.84% in 2008 (Chart 11). The narrowing was mainly due to the extraordinarily low interest rate environment. Lingering uncertainties in the credit markets also encouraged retail banks to seek low credit risk exposures (for example, mortgage lending and government bonds), which generally offered lower interest yields.

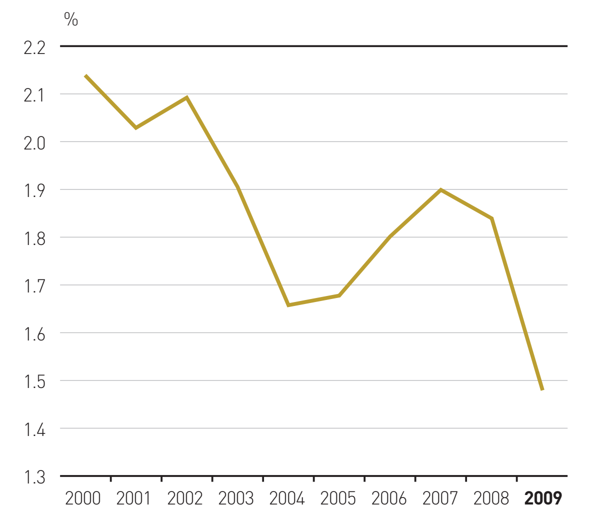
Although interest income declined, retail banks posted an increase in non-interest income in 2009. The normalisation of capital market activities resulted in higher income from trading investment, foreign exchange operations and derivatives. Increased stock market activity during the year, particularly from initial public offerings, also underpinned a strong growth in income from fees and commissions. As a result, the proportion of non-interest income to total income of retail banks rose to 44.9% from 37.4% in 2008.

Chart 10 HIBORs, composite interest rate and BLR



Notes:
1 BLR refers to the best lending rate quoted by The Hongkong and Shanghai Banking Corporation Limited (monthly averages).
2 HIBORs are monthly averages.

Chart 11 Retail banks' net interest margin (yearly)



The operating costs of retail banks rose by 6.3% in 2009. This increase was partly associated with the expenses related to settlement of cases involving Lehman investment products reported by some retail banks. The cost-to-income ratio rose to 49.3% from 45.3% in 2008 (Chart 12).

Although the credit quality of loan portfolios deteriorated in 2009, the pace of deterioration was milder than originally expected, and there were signs of stabilisation in the second half of the year. Given the better-than-expected credit conditions, the net charge for debt provisions fell to $6.6 billion in 2009 from $10.8 billion a year ago. Impairment allowances for securities holdings were also lower because of the improved credit conditions as shown by a tightening of credit spreads. The net charge for other provisions, most of which related to impairment allowances for securities holdings, improved strongly to $0.1 billion, compared with $12.8 billion in 2008.

The aggregate pre-tax operating profits of retail banks' Hong Kong offices rebounded by 14.9% in 2009 (Chart 13). The post-tax return on average assets also increased to 0.98% from 0.88% in 2008 (Chart 14).

Chart 13 **Retail banks' year-on-year growth of operating profit before tax**

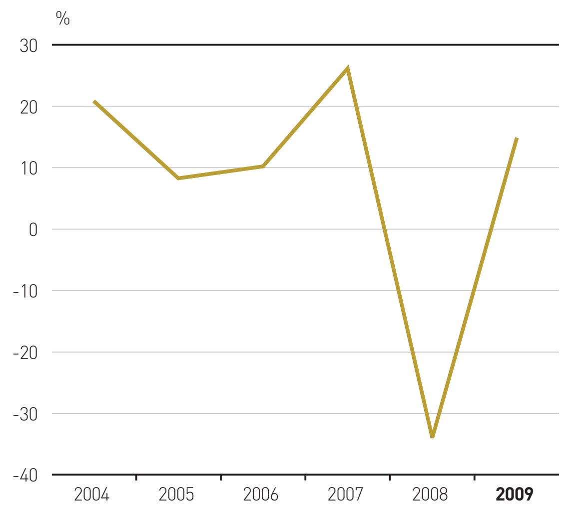


Chart 12 **Retail banks' cost-to-income ratio**

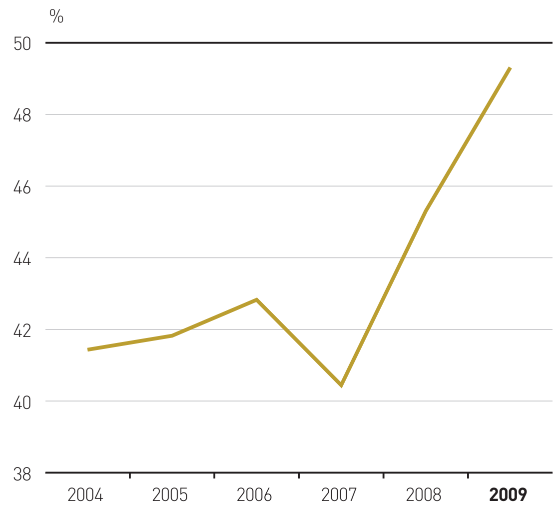
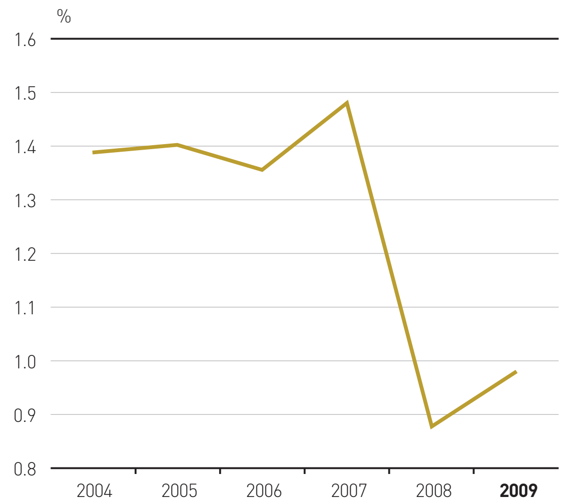


Chart 14 **Retail banks' return on assets (after-tax profit)**



Asset quality

The asset quality of retail banks deteriorated in 2009, although at a slower pace in the second half of the year. The classified loan ratio increased to 1.35% from 1.24% at the end of 2008 (Chart 15). The combined ratio of overdue and rescheduled loans rose to 0.88% from 0.67% in 2008. However, the ratios are still very low compared with their historical peaks of 10.61% and 8.58% respectively at the end of September 1999.

The quality of non-bank China exposures improved. The classified loan ratio for retail banks' Mainland banking subsidiaries was 0.69% in 2009 compared with 0.98% in 2008.

Retail banks' residential mortgage lending assets remained sound with the delinquency ratio edging down to 0.03% from 0.05% in 2008 (Chart 16). The rescheduled loan ratio declined to 0.09% from 0.14% in 2008. The rebound in property prices reduced the outstanding number of residential mortgage loans in negative equity to 466 cases at the end of 2009 from 10,949 a year earlier.

The results of the HKMA's credit card lending survey showed that the quality of credit card portfolios deteriorated slightly, although the delinquency ratio remained unchanged at 0.34% in 2009 (Chart 16). The combined delinquent and rescheduled ratio rose to 0.46% from 0.41% in 2008 and the charge-off ratio increased to 3.71% from 2.72% a year earlier.

Chart 15 Asset quality of retail banks

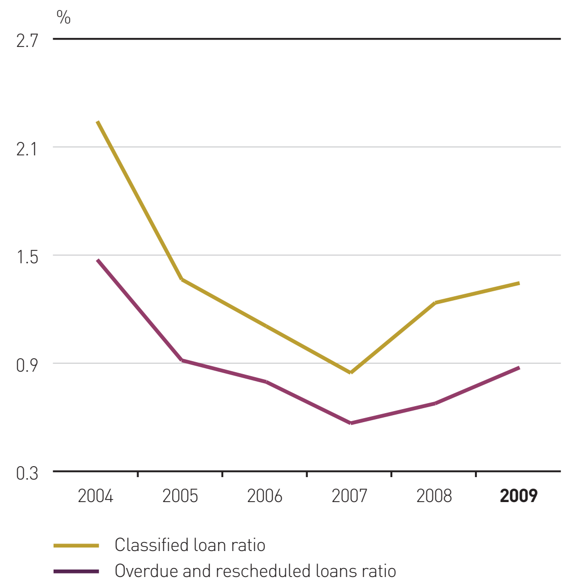
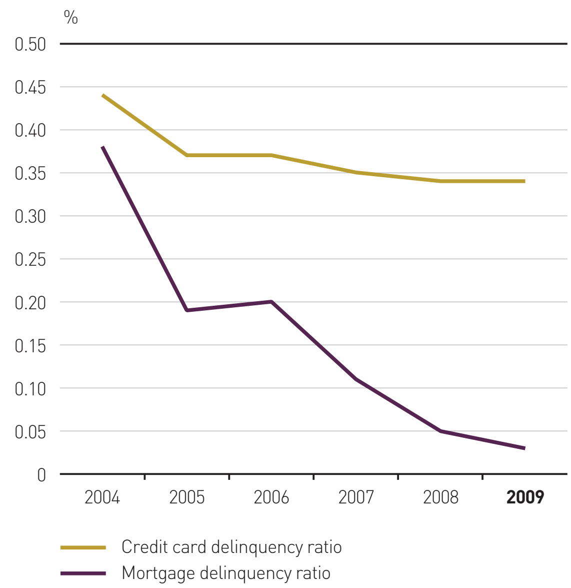


Chart 16 Delinquency ratios of residential mortgages and credit card lending of surveyed institutions



Balance sheet trends

Total loans and advances by retail banks increased by 3.6% in 2009, while total customer deposits grew by 5.8%. The overall loan-to-deposit ratio of retail banks declined to 46.3% from 47.3% in 2008. The Hong Kong dollar loan-to-deposit ratio also declined to 65.2% from 69.4% in 2008 (Chart 17).

The changes in retail banks' loans for use in Hong Kong by selected economic sectors are shown in Chart 18. Property lending grew by 6.7%, and lending to the wholesale and retail sector grew by 6.8%. On the other hand, trade finance declined by 10.6% and lending to the manufacturing sector declined by 2.0%.

Chart 17 **Retail banks' Hong Kong dollar loans and customer deposits**

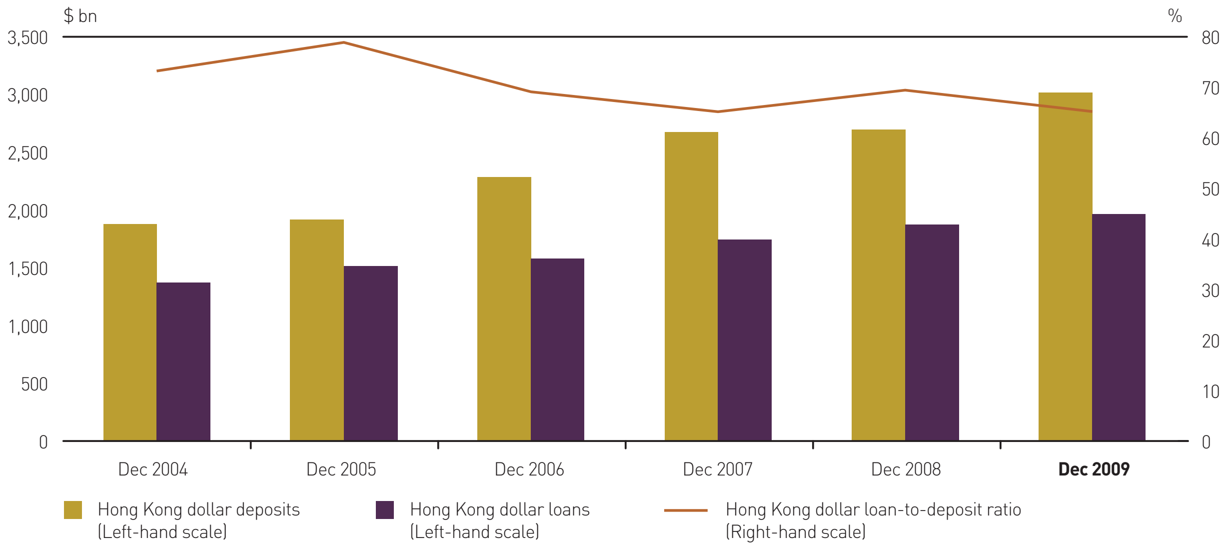
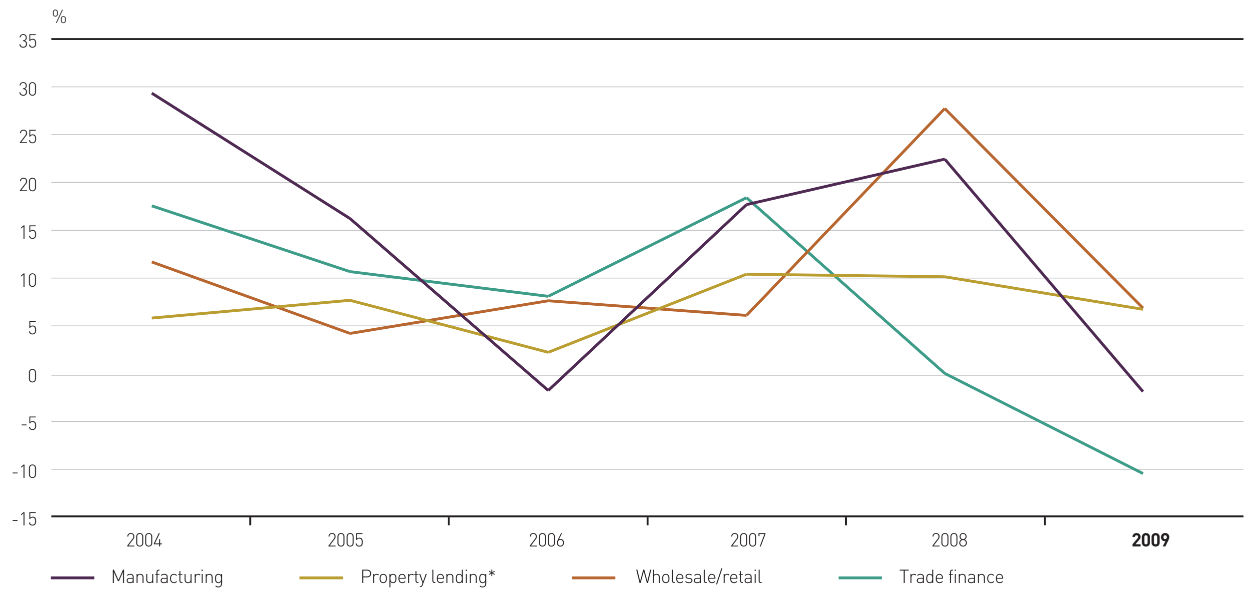


Chart 18 **Retail banks' loans for use in Hong Kong by selected sectors (year-on-year growth)**



* Property lending denotes lending for property development and investment, and residential mortgage loans (excluding lending under the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme).

Economic and Banking Environment

Retail banks' total non-bank China exposures[1] rose to $762 billion at the end of 2009 from $639 billion a year earlier. For the banking sector as a whole, non-bank China exposures surged to $1,004 billion from $853 billion in 2008.

Holdings of negotiable debt securities

Retail banks continued to increase their holdings of liquid assets of high credit quality in 2009, with a 31% rise in negotiable debt instruments (NDIs), excluding negotiable certificates of deposit. The share of retail banks' total holdings of NDIs relative to their total assets increased to 28% at the end of 2009 from about 22% a year ago.

Among the holdings of NDIs, 44% were government-issued (32% in 2008), 35% were issued by non-bank corporates (44% in 2008), and 21% were issued by banks (23% in 2008) (Chart 19).

Capital adequacy and liquidity

The capital positions of locally incorporated AIs generally improved, driven mainly by an increase in retained earnings and the issuance of new capital. The consolidated capital adequacy ratio of locally incorporated AIs rose to 16.9% at the end of 2009 from 14.7% a year ago. Tier-one capital ratio increased to 12.9% from 11.0% in 2008 (Chart 20).

Chart 19 Retail banks' holdings of negotiable debt instruments at the end of 2009 (issuer breakdown)

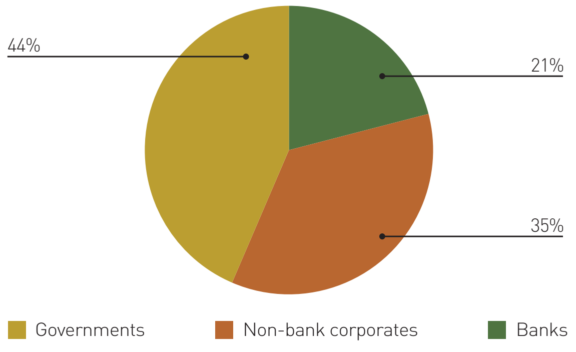
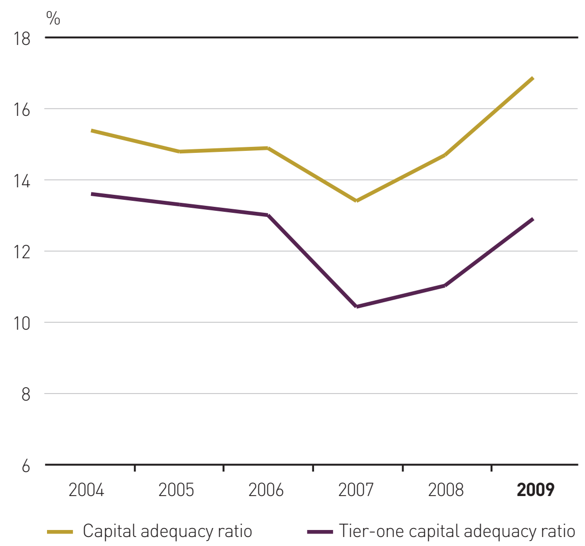


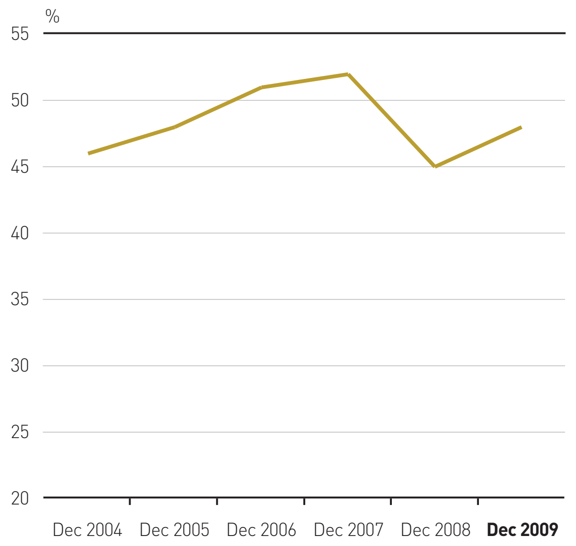
Chart 20 Consolidated capital adequacy ratio of locally incorporated AIs



[1] Including exposures booked in retail banks' banking subsidiaries in Mainland China.

Retail banks generally remained liquid with the quarterly average liquidity ratio at 47.8% in the final quarter of 2009, well above the statutory minimum of 25% (Chart 21).

Chart 21 Retail banks' liquidity ratio (quarterly average)



PROSPECTS FOR 2010

Global financial markets stabilised in 2009, due largely to the unprecedented stimulus measures undertaken by governments around the world. While this stability underscored improvement in the real economy and a return to the normal functioning of capital markets, the economic outlook remains uncertain and challenging. Bank profitability remains susceptible to possible setbacks in macroeconomic and market conditions. Uncertainties surrounding the timing of governments' exit strategies from their stimulus measures will, to some degree, restrain banks' credit risk appetite. Banks may continue to compete on pricing in more traditional areas of business, especially in residential mortgage lending, further weighing on their profit margins. The large inflow of funds in 2009 could have potentially significant implications for asset prices in Hong Kong, and banks should exercise prudence in credit decisions, particularly in the valuation of collateral.

Any renewed stress in the capital markets following the ultimate withdrawal of government support initiatives could also be a source of concern. Measures to strengthen the regulatory and supervisory framework are being implemented to improve the resilience of the banking system and banks should remain vigilant in their risk management. Given the continued uncertainty in the operating environment and bearing in mind that new capital and liquidity supervisory requirements are being formulated at the international level, it is imperative that banks maintain adequate capital and liquidity to safeguard against any reversal in funds flow, increases in interest rates, deterioration in the credit environment and possible tightening of supervisory requirements.