

Economic and Financial Environment

The Hong Kong economy grew moderately on the back of solid domestic demand and a mild recovery in external demand. Economic growth is expected to improve in 2014, although the uncertainty stemming from the normalisation of the US monetary policy continues to pose a major risk.

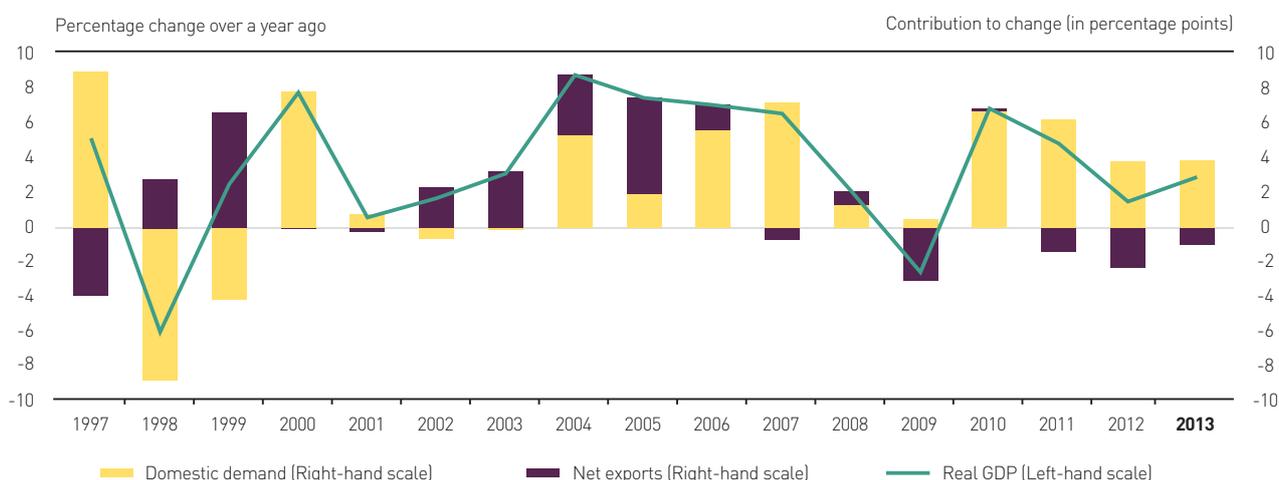
THE ECONOMY IN REVIEW

Overview

The Hong Kong economy grew at a moderate pace in 2013, with domestic demand providing the main support and export performance improving gradually (Chart 1). In particular, a pick-up in the sequential momentum later in the year helped raise the full-year real GDP growth rate to 2.9% from a modest 1.5% in 2012 (Table 1). The labour market was still relatively tight, with the unemployment rate remaining at a low level. Consumer price pressure

remained, albeit moderating slightly towards the end of the year amid milder increases in housing rentals. The equity market fluctuated on concerns about the reduction of the US Federal Reserve's asset purchases and the uncertain growth prospects in Mainland China and other emerging market economies. Following the introduction of a new round of property market measures in Hong Kong in early 2013, the property market turned less exuberant, characterised by a moderation in housing price inflation and reduced transactions.

Chart 1 Real GDP growth by contribution



Source: Census and Statistics Department.

Table 1 Real GDP growth by expenditure component (period-over-period)

[% Period-over-period, unless otherwise specified]	2013					2012				
	Q1	Q2	Q3	Q4	2013	Q1	Q2	Q3	Q4	2012
Gross Domestic Product (year-on-year growth)	0.5	0.6	0.7	1.1	2.9	0.2	0.3	0.9	1.1	1.5
Private consumption expenditure	3.1	-1.1	-0.4	1.7	4.2	1.1	0.4	1.4	1.1	4.1
Government consumption expenditure	0.3	1.5	0.2	1.1	2.7	1.3	0.7	0.8	0.3	3.6
Gross domestic fixed capital formation	-	-	-	-	3.3	-	-	-	-	6.8
Exports										
Exports of goods	1.5	-1.4	3.2	2.1	6.7	0.8	-0.3	3.2	3.3	1.8
Exports of services	2.1	3.2	-2.6	2.3	5.8	0.6	0.6	-0.7	2.9	2.2
Imports										
Imports of goods	3.5	-1.8	1.9	2.5	7.6	3.0	-0.8	2.3	3.7	3.0
Imports of services	1.5	-1.7	1.7	2.3	1.5	1.9	-0.7	-1.9	1.4	1.9
Overall trade balance (% of GDP)	-1.9	-5.7	6.7	4.0	1.1	0.4	-5.2	5.4	3.1	1.1

Note: The seasonally-adjusted quarter-on-quarter rates of change in the gross domestic fixed capital formation are not available.

Source: Census and Statistics Department.

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Despite market concerns about the US Federal Reserve's plan to reduce asset purchases and volatile global financial conditions, the domestic money and foreign-exchange markets continued to operate smoothly. The Hong Kong dollar exchange rate remained stable amid mild fund flow pressures. Interbank interest rates stayed low, with small fluctuations occasionally arising from temporary liquidity needs. The longer-dated yields of the Exchange Fund paper followed their US dollar counterparts to trend up slightly, ending the year with a steeper Hong Kong dollar yield curve compared with a year ago. On the credit front, growth in total loans accelerated to 16% in 2013 from 9.6% a year earlier, spurred by strong demand for trade finance and US dollar loans. However, rises in deposits and broader monetary aggregates generally lagged behind. As a result, the loan-to-deposit ratio and particularly the US dollar ratio rose further in 2013. In view of the rise in loan growth, the HKMA introduced a Stable Funding Requirement that banks with higher rates of loan growth are required to maintain a specific level of stable funds in 2014.

Domestic demand

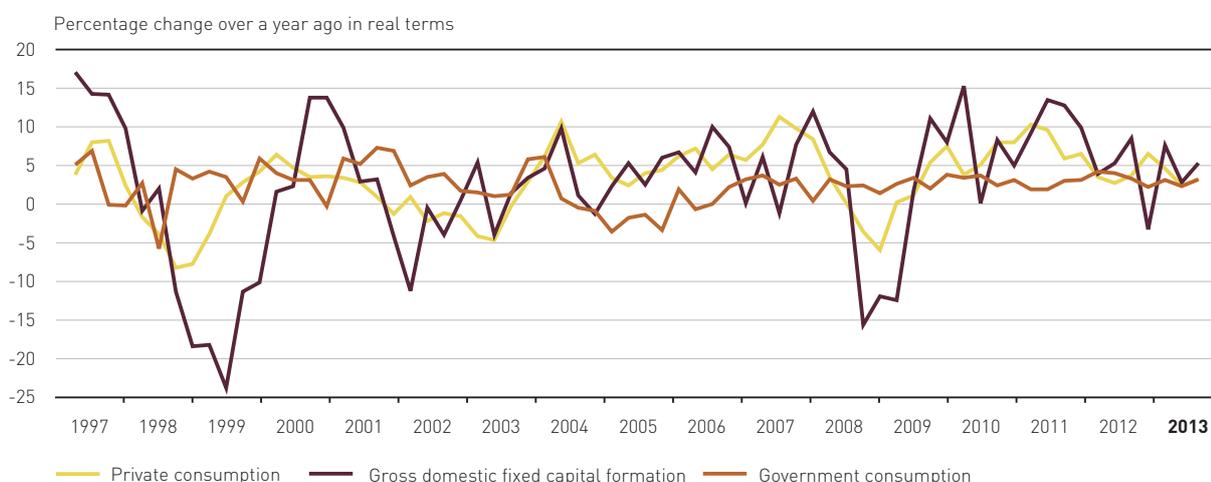
Domestic demand held up in 2013 (Chart 2). On the back of still-favourable job conditions and higher incomes, private consumption grew by a solid 4.2%, similar to 2012. Growth in government consumption was steady at 2.7%. However,

amid cautious business sentiment, gross domestic fixed capital formation expanded at a slower rate of 3.3%. While machinery and equipment investment maintained its growth momentum, private-sector building and construction activities continued to be a drag on overall investment growth. Public infrastructure works grew moderately after some years of strong growth.

External demand

Hong Kong's total exports improved gradually in 2013. Exports of goods grew faster by 6.7%, bolstered by rising intra-regional trade (Chart 3). However, overall external demand from the advanced markets remained weak, while that from Mainland China increased at a moderating pace along with the Mainland's slower economic growth. Underpinned by vibrant inbound tourism and a revival in stock market activities in the second half of the year, exports of services also rose at a faster pace of 5.8%. Growth in imports gathered pace on robust domestic demand and somewhat stronger export-induced demand. Overall, net exports reduced real GDP growth by 1.0 percentage points in 2013. In nominal terms, the overall trade balance was a surplus of \$22.3 billion (1.1% of GDP) in 2013, compared with a surplus of \$23.0 billion (1.1% of GDP) in 2012.

Chart 2 Domestic demand



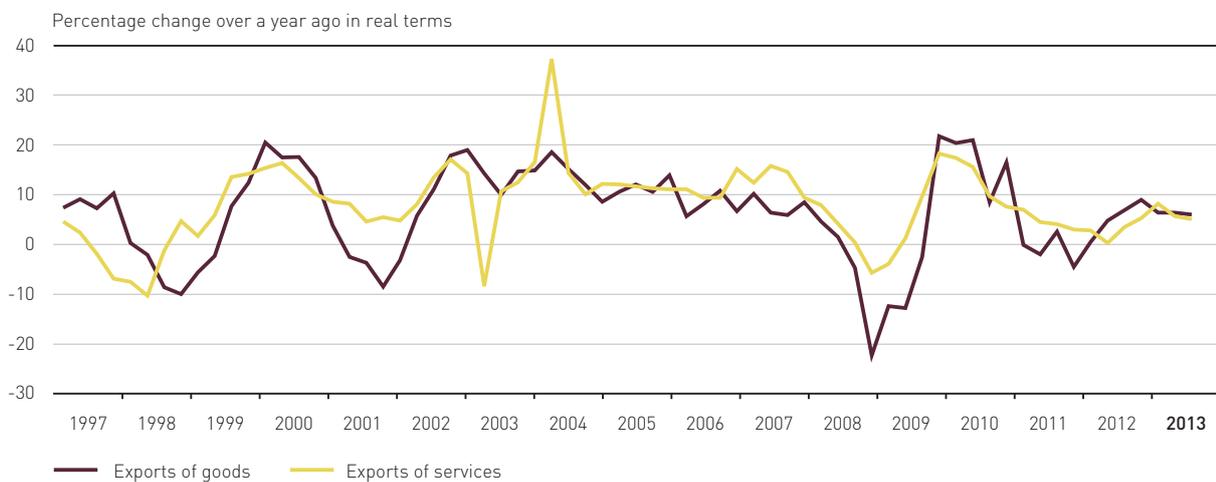
Source: Census and Statistics Department.

Inflation

Inflationary pressures, while moderate, remained in 2013. Netting out the impact of the Government's one-off relief measures, the year-on-year underlying inflation rate hovered around 4% throughout the year, compared with an average of 4.7% in 2012 (Chart 4). The earlier increases in private housing rentals had fed through to the housing component of the Consumer Price Index, but towards

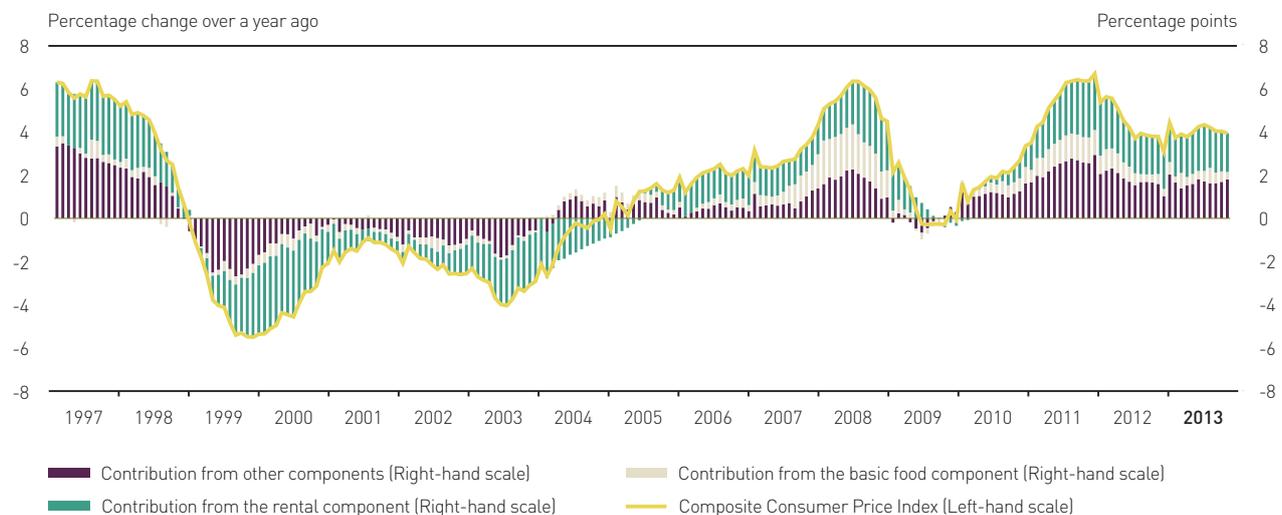
the end of the year the impact of slower growth in fresh-letting private residential rentals began to set in. External price pressures were relatively weak, as shown in subdued imported inflation amid roughly stable international food and commodity prices. Labour costs increased steadily, reflecting a relatively tight labour market, while other non-tradable costs rose along with solid domestic demand.

Chart 3 Exports of goods and services



Source: Census and Statistics Department.

Chart 4 Consumer price inflation



Note: The Composite Consumer Price Index and its component indices are adjusted for the effects of special relief measures.

Source: Census and Statistics Department.

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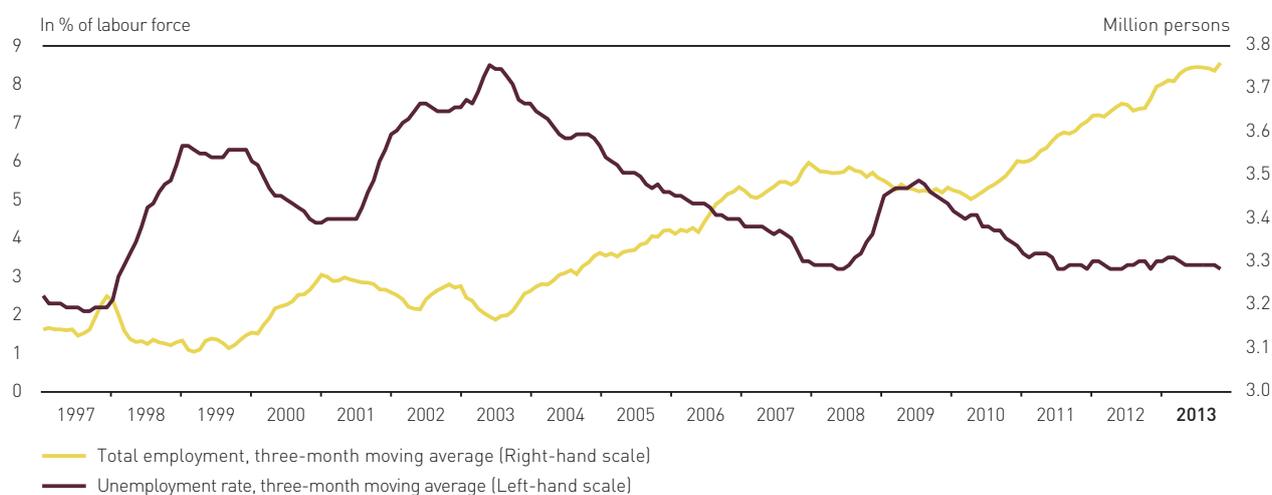
Labour market

Labour demand remained strong in 2013, with private-sector vacancies rising to a record high, due to stable economic growth, vibrant inbound tourism and a favourable hiring sentiment. Labour supply also increased, lured by robust job and income conditions. Taken together, total employment climbed to a new high towards the end of the year, while the unemployment rate and the underemployment rate hovered at low levels (Chart 5). Supported by the relatively tight labour market conditions, nominal wages and earnings continued to improve. In particular, sizable increases in average employment earnings for the lowest decile group were partly driven by the upward adjustment to the Statutory Minimum Wage rate that came into effect in May. The median monthly employment earnings also edged up.

Stock market

The Hong Kong stock market saw sharp fluctuations during the year along with a volatile external environment. Stock prices made a strong start in January and early February, but then experienced corrections amid renewed concerns over the euro area sovereign debt crisis and uncertainties in the US Federal Reserve's plan of reducing the size of the asset purchase programme. After a brief respite, market sentiment turned negative again amid the financial turmoil in emerging markets in August. In the fourth quarter, there were further fluctuations relating to the US Federal Reserve's announcement to begin reducing asset purchases and a rise in Mainland China's macro-financial risk. Overall, the Hang Seng Index gained a modest 2.9% in 2013 and closed at 23,306 on 31 December (Chart 6). The average daily turnover of the stock market

Chart 5 Labour market conditions



Source: Census and Statistics Department.

trended downwards, while the value of short-selling transactions increased. The year saw a revival in equity fund-raising activities, especially in the last four months. For the year as a whole, total funds raised from the market picked up to \$378.9 billion from \$305.4 billion in 2012.

Property market

The once-buoyant property market experienced a period of consolidation in 2013, particularly after the HKMA and the Government further tightened the prudential and stamp duty measures in late February. Residential property price inflation had since softened (Chart 6). Market activity was also sluggish, with the monthly average transaction

volume falling to 4,200 from 6,800 in 2012. Speculative transactions almost vanished as reflected in a sharp decline in confirmor transactions and short-term flipping trades. Nevertheless, residential property valuations remained highly stretched, as the price-to-income ratio of 14.5 had already reached its 1997 peak and the income-gearing ratio remained far above its historical average. Commercial and industrial property markets also became less buoyant, as evidenced by their moderating price inflation and shrinking transaction volume. The overall rental yields stayed near the historical low for the entire year.

Chart 6 Asset prices



Sources: Rating and Valuation Department, and CEIC.

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OUTLOOK FOR THE ECONOMY

Economic environment

The Hong Kong economy is expected to grow moderately faster in 2014. As the advanced economies gradually regain ground and Mainland China's economy remains broadly resilient, external demand is likely to improve. On the domestic front, private consumption is likely to grow at a moderate pace with the support of still-positive consumer confidence, stable labour market conditions and spillovers of global trade recovery, although there will be some offsets from the less favourable wealth effect from potentially weaker asset markets. Ongoing infrastructure works, a pick up in private sector building and construction activities, as well as a sustained increase in machinery and equipment acquisition, thanks to an improving business outlook, will also contribute to GDP growth. For 2014, private sector analysts project the economy to expand by 2.8 – 4.0%, averaging at 3.5%, and the Government sees GDP growth strengthening in the range of 3.0 – 4.0%.

Inflation and the labour market

Consumer price inflation is expected to moderate slightly in 2014. In particular, slower increases in fresh-letting housing rentals in 2013 will continue to feed through and contain domestic price pressures. At the same time, a stable outlook for food and international commodity prices will also keep external price pressures in check. Market consensus predicts headline inflation at 3.8% in 2014, slightly lower than the 4.3% in 2013. The outlook for the labour market is stable, largely reflecting steady economic expansion and generally positive hiring sentiment. The unemployment rate is projected to stay at a relatively low level of around 3.4%, according to the consensus forecasts.

Uncertainties and risks

The relatively favourable outlook for the Hong Kong economy is subject to a number of uncertainties and risks. On the downside, the predominant external risk comes from the still-uncertain pace and scale of the US Federal Reserve's reduction of asset purchases and interest rate normalisation. Any significant adverse developments could aggravate volatilities in financial markets, fund flows and liquidity, and overshadow Hong Kong's growth prospects through the trade and financial channels. Elsewhere, slower-than-expected growth in Mainland China could cause negative spillovers to Hong Kong given the increasingly close economic relations between the two economies. Domestically, the property market is prone to downward pressures against the background of eventual interest rate hikes. Should the market react unfavourably to the US Federal Reserve's monetary actions or there is a significant reversal of fund flows, it could exacerbate downward adjustments in property prices, thereby threatening broader macroeconomic adjustments and asset price corrections. On the upside, a better-than-expected economic performance of the advanced economies and the Mainland's economy could lift global growth and international trade flows, thereby raising Hong Kong's external demand and boosting consumption expenditure, perhaps through improved consumer sentiment.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector performed well in 2013, despite the US debt ceiling crisis and the uncertainties over the pace of the US Federal Reserve's tapering of its quantitative easing measures. Asset quality and liquidity positions of retail banks remained sound, and locally incorporated authorized institutions (AIs) continued to be well capitalised. Credit growth in the banking sector slowed in the fourth quarter.

Interest rate trends

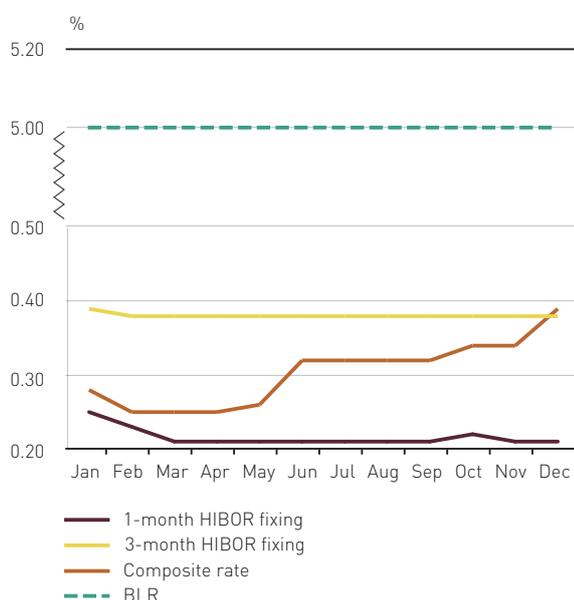
The accommodative policy stance persisted in the major advanced economies to spur economic growth during 2013. In line with the US dollar interest rates, Hong Kong dollar interbank interest rates remained relatively low

throughout the year. However, the composite interest rate, which reflects the average cost of funds for retail banks, rebounded since May from its previous low level (Chart 7). This coincided with the announcement also in May that the US Federal Reserve envisaged phasing out its quantitative easing policy.

Profitability trends

The aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 22.1% in 2013, mainly due to the growth in net interest income by 13.0% and non-interest income by 15.2%. As post-tax profit grew at a much faster pace than that of the average assets, the post-tax return on average assets of retail banks increased to 1.40% in 2013 from 1.06% a year earlier (Chart 8).

Chart 7 HIBOR fixings, composite rate and best lending rate (BLR)



Notes:

1. HIBOR fixings refer to the Hong Kong dollar Interest Settlement Rates released by the Hong Kong Association of Banks and are monthly averages.
2. BLR refers to the best lending rate quoted by the Hongkong and Shanghai Banking Corporation Limited (monthly averages).

Chart 8 Retail banks' performance



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Retail banks' net interest margin (NIM) widened to a yearly average of 1.40% in 2013 from 1.36% in 2012 as a result of lower funding costs compared with a year ago (Chart 9).

Driven by the growth in income from foreign exchange and derivatives operations, as well as income from fees and commissions, retail banks' non-interest income as a share of total operating income rose slightly to 46.7% from 46.3% in 2012.

The operating costs for retail banks increased by 5.2%, partly caused by rising rental and staff expenses. Nevertheless, the cost-to-income ratio decreased to 42.2% in 2013 from 45.8% in 2012 as the growth in operating income outpaced that of operating costs during the period (Chart 10).

The net charge for debt provisions rose to \$3.6 billion in 2013 from \$3.5 billion a year ago. Despite the increase, the provisions remained at a relatively low level, reflecting the sound quality of retail banks' loan book.

Chart 9 Retail banks' net interest margin

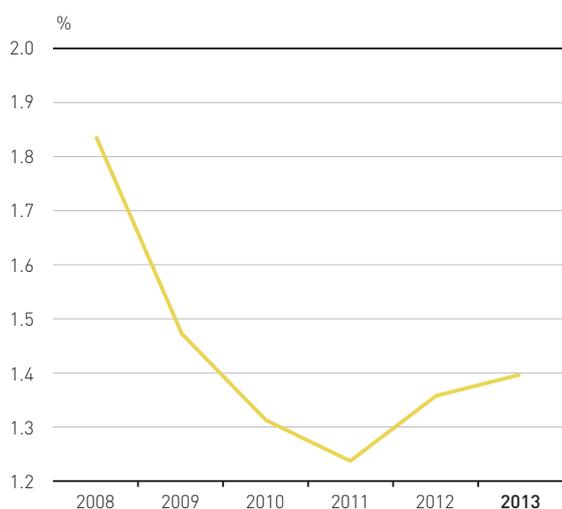
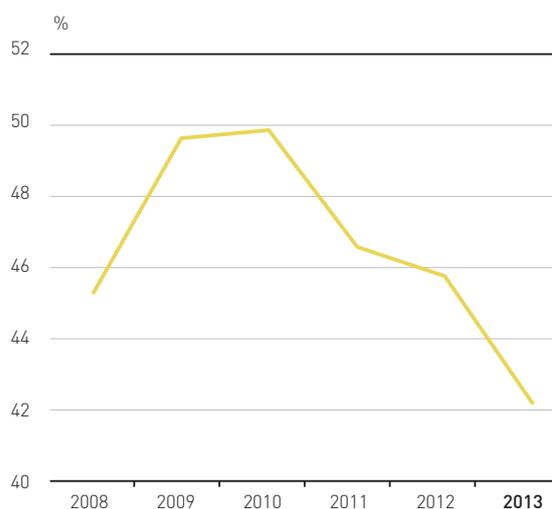


Chart 10 Retail banks' cost-to-income ratio



Asset quality

The asset quality of retail banks remained robust in 2013. The classified loan ratio was maintained at a low level of 0.48% at the end of the year. The combined ratio of overdue and rescheduled loans reduced to 0.33% compared with 0.39% a year earlier (Chart 11).

The quality of surveyed institutions' residential mortgage lending remained sound, with the delinquency ratio staying at a record low of 0.02% at the end of 2013 (Chart 12). The rescheduled loan ratio edged down to nearly 0% from

0.01% in 2012. The surveyed institutions reported 26 cases of residential mortgage loans in negative equity at the end of the year, compared with no cases at the end of 2012.

The delinquency ratio of credit card portfolios remained stable at 0.20% at the end of 2013 compared with a year earlier (Chart 12). The combined delinquent and rescheduled ratio rose slightly to 0.27% from 0.26%, while the charge-off ratio increased to 1.84% from 1.70% in the same period. Despite the increases, these ratios were still low by historical standards.

Chart 11 Asset quality of retail banks

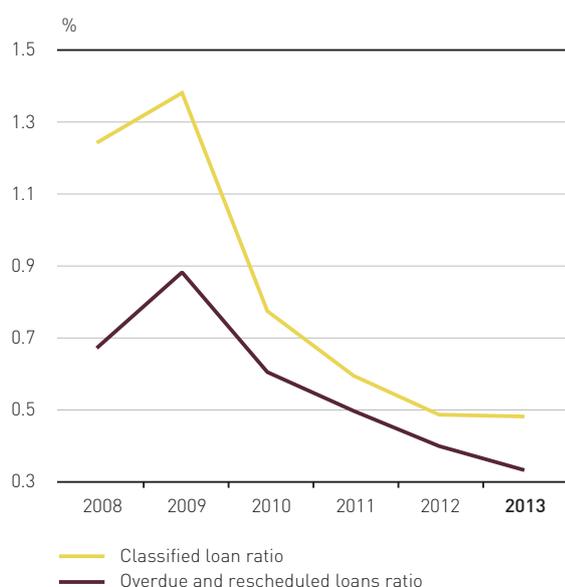
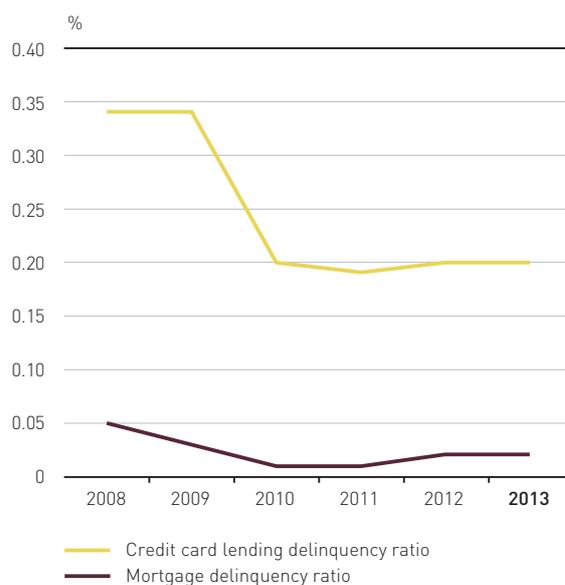


Chart 12 Delinquency ratios of residential mortgages and credit card lending of surveyed institutions



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Balance sheet trends

Total loans and advances of retail banks grew by 14.6% in 2013, while total deposits rose by 11.7%. As a result, the overall loan-to-deposit ratio of retail banks increased to 56.3% from 54.8% in 2012. The Hong Kong dollar loan-to-deposit ratio also rose to 74.8% from 72.3% a year ago (Chart 13).

For the banking sector as a whole, credit growth accelerated from 9.6% in 2012 to 16.0% in 2013. The rate of growth in trade financing and loans for use outside Hong Kong continued to outpace that for loans for use in Hong Kong. The increase in loans for use in Hong Kong was mainly led by property lending, lending to wholesale and retail sectors and financial concerns. In view of the high credit growth in the banking sector in the first three quarters of 2013 (19.9% on an annualised basis), the HKMA wrote to banks with rapid loan growth informing them of the Stable Funding Requirement to be implemented in 2014. Credit growth slowed in the fourth quarter (3.6% on an annualised basis).

Retail banks' total non-bank Mainland exposures¹ rose to \$2,279 billion at the end of 2013 from \$1,779 billion a year ago. For the banking sector as a whole, non-bank Mainland exposures increased to \$3,602 billion from \$2,739 billion in 2012.

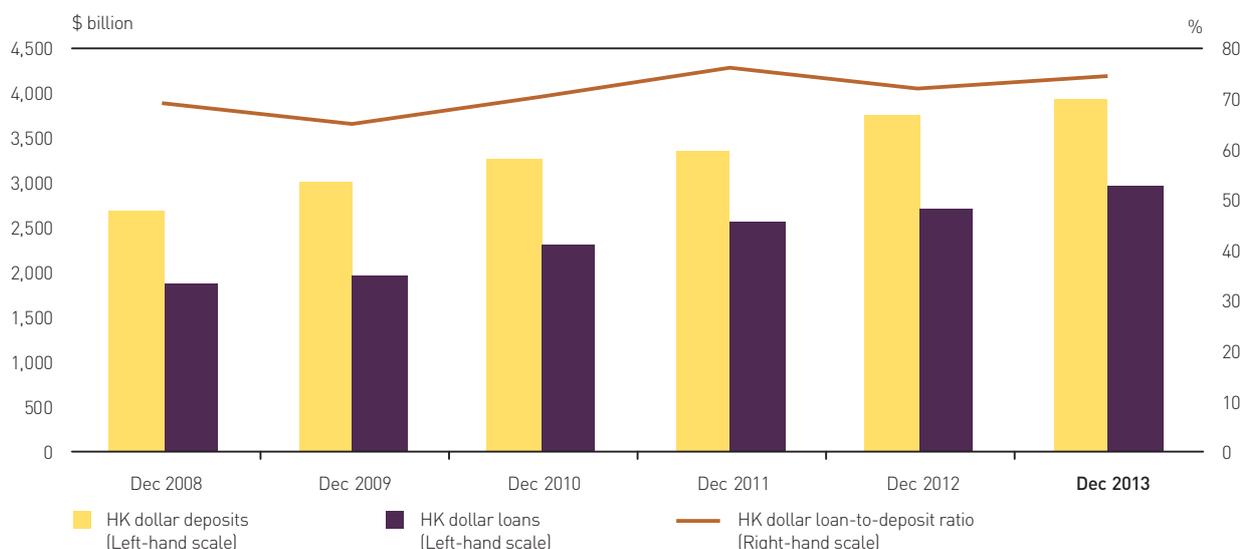
Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit, increased by 17.5% in 2013. The share of total holdings of NDIs relative to total assets rose to 25% at the end of the year from 24% at the end of 2012. Among the holdings of NDIs, 43% were government-issued (49% in 2012), 28% were issued by non-bank corporates (29% in 2012), and 29% were issued by banks (22% in 2012) (Chart 14).

Capital adequacy and liquidity

All locally incorporated AIs remained well capitalised. The consolidated capital adequacy ratio of all locally incorporated AIs rose to 15.9% at the end of 2013 from 15.7% a year earlier (Chart 15). The increase was due to faster growth in the capital base than in the risk-weighted amount. The Tier-1 capital adequacy ratio remained unchanged at 13.3% in the same period.

Chart 13 Retail banks' Hong Kong dollar loans and deposits



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

As a result of the average qualifying liabilities rising faster than the average liquefiable assets, the average liquidity ratio of retail banks decreased from 42.6% in the final quarter of 2012 to 39.6% in the same period of 2013. Despite the decrease, the quarterly average liquidity ratio is still well above the statutory minimum of 25% (Chart 16).

Chart 14 Retail banks' holdings of negotiable debt instruments at the end of 2013 (counterparty breakdown)

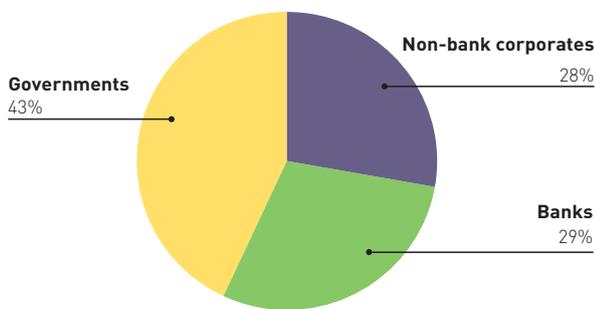


Chart 15 Consolidated capital adequacy ratio of locally incorporated AIs

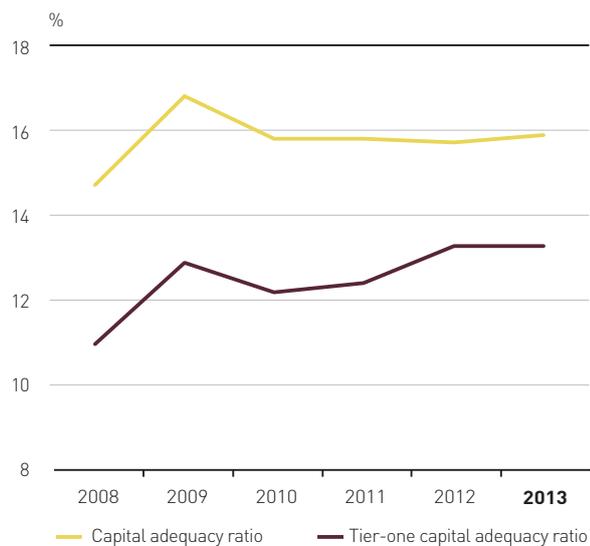
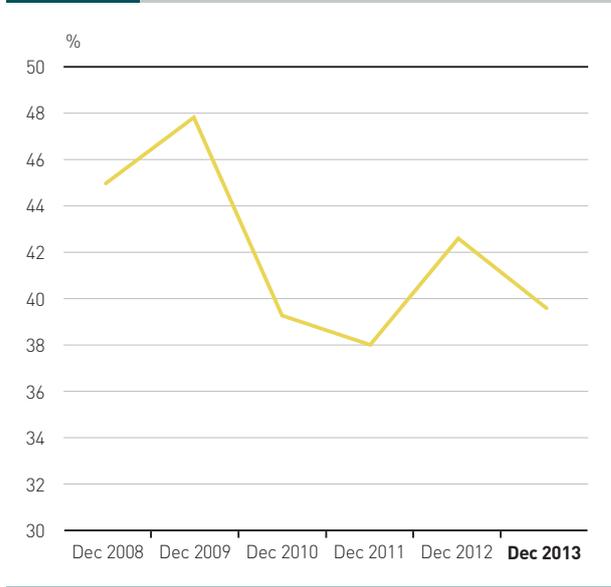


Chart 16 Retail banks' liquidity ratio (quarterly average)



PROSPECTS FOR 2014

The US started to reduce its monthly asset purchases from January 2014. This marked the beginning of the normalisation of US monetary conditions, which will inevitably heighten market volatility especially in emerging markets. The pace of further reductions and when the asset purchase programme may cease also remain uncertain. All these will pose potential risks for worsening liquidity conditions and fund outflows. So far, there has been no noticeable impact on Hong Kong's banking sector. Nevertheless, the HKMA has cautioned banks to enhance the resilience of their liquidity and interest rate risk management to cater for possible fund outflows or an abrupt rise in interest rates. With the high credit growth in 2013, banks are also reminded to exercise prudence in managing credit risk and are required to use stable funding to support their rapid credit growth.