Economic and Financial Environment

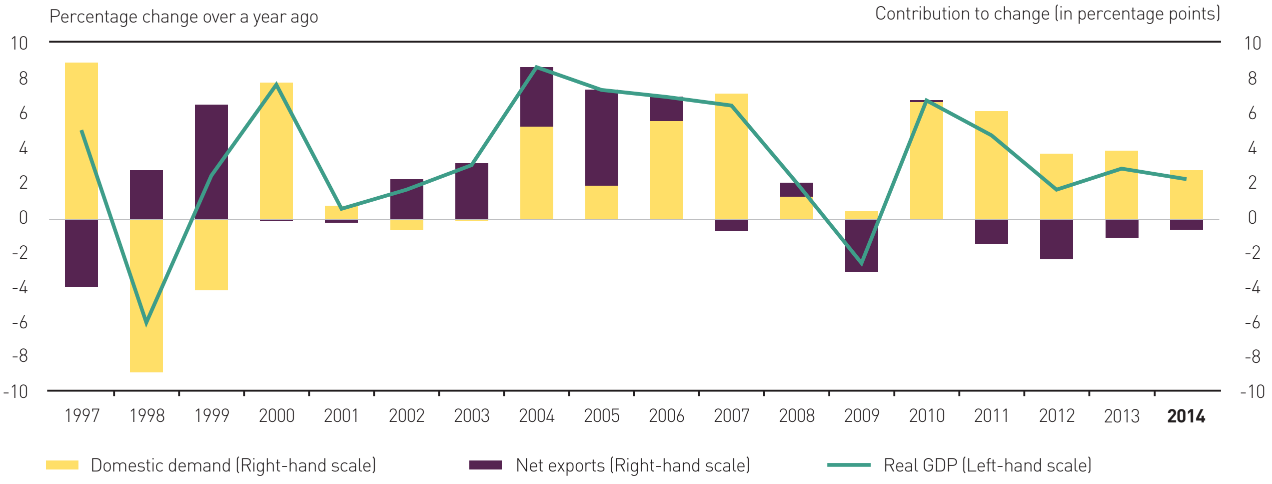
Hong Kong's economic growth momentum slowed in 2014 amid softer domestic demand and a weaker external trading environment. In 2015, economic growth is expected to remain moderate, although subject to risks relating to global growth prospects and monetary conditions.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy expanded at a slower pace in 2014, with real GDP growth slowing to 2.3% from 2.9% in 2013 (Chart 1 and Table 1). This mainly reflected milder growth in domestic demand, including softer private consumption and sluggish fixed investment activities. External trade performance remained weak, although in net terms its drag on GDP growth moderated. Despite slower economic growth, labour market conditions remained broadly solid, with the unemployment rate staying low at 3.3%. Underlying consumer price inflation eased further with the feed-through of milder increases in housing rentals and modest business cost pressures. A host of global macro-financial factors caused some swings in the local stock market, while the property market turned more active, with housing prices picking up by 13.5% in 2014.

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)	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2014	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2013
Gross Domestic Product	**0.5**	**-0.2**	**1.4**	**0.4**	**2.3**	0.6	0.5	0.6	1.0	2.9
(year-on-year growth)	**2.6**	**1.8**	**2.7**	**2.2**		3.2	2.8	2.8	2.8	
Private consumption expenditure	**0.4**	**0.2**	**1.9**	**1.1**	**2.7**	2.8	0.1	-0.8	1.7	4.6
Government consumption expenditure	**0.6**	**1.3**	**1.0**	**0.3**	**3.1**	0.7	1.4	0.0	0.6	3.0
Gross domestic fixed capital formation	**–**	**–**	**–**	**–**	**-0.3**	–	–	–	–	2.2
Exports										
Exports of goods	**-2.5**	**0.7**	**1.8**	**-0.3**	**1.0**	2.3	-1.3	2.8	1.4	6.5
Exports of services	**0.2**	**-1.6**	**0.2**	**0.6**	**0.5**	0.8	3.9	-2.9	2.4	4.9
Imports										
Imports of goods	**-0.4**	**-1.1**	**0.8**	**0.8**	**1.0**	3.8	-1.3	1.3	1.7	7.2
Imports of services	**-4.4**	**4.2**	**-0.7**	**2.3**	**1.9**	1.1	-1.3	2.0	3.3	1.8
Overall trade balance (% of GDP)	**-1.2**	**-6.2**	**5.8**	**1.3**	**0.1**	-2.4	-6.5	6.5	3.5	0.6

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.

The domestic money and foreign-exchange markets continued to function smoothly despite increased volatility in global financial markets and ongoing concerns about monetary policy paths in the major economies. The Hong Kong dollar exchange rate stayed near 7.75 against the US dollar for the better part of the year, and the strong-side Convertibility Undertaking was repeatedly triggered in July and August with strong inflows driven by commercial activities and equity-related demand. The Aggregate Balance increased markedly as a result, supporting the low interest rate environment locally. On the credit front, growth in total bank loans moderated to 12.7% in 2014 from 16.0% in 2013. The Hong Kong dollar loan-to-deposit ratio stabilised while the same ratio for the US dollar tapered off.

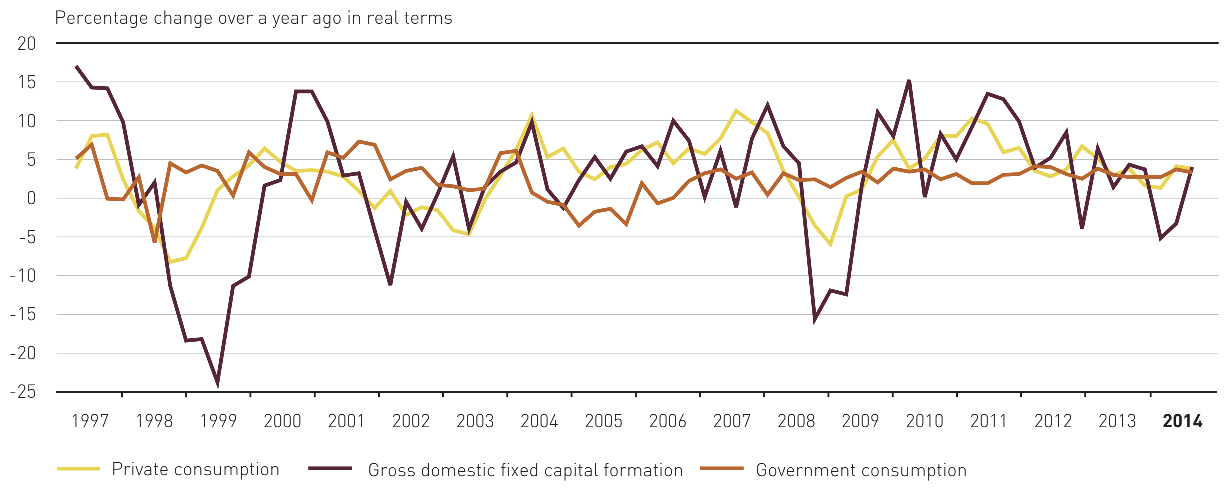
Domestic demand

Domestic demand softened in 2014 (Chart 2). Before picking up somewhat in the second half of the year, growth in private consumption weakened in the first half, which brought down the full-year growth rate to 2.7% from 4.6% in 2013. While the still-favourable labour market conditions continued to render support, weaker economic prospects and slower increases in real incomes weighed on consumption growth. The drag on domestic demand also came from a 0.3% decline in gross domestic fixed capital formation. In particular, amid cautious business sentiment, machinery and equipment acquisition in the private sector declined after three years of double-digit growth. On the other hand, building and construction activities increased, driven by robust housing projects and ongoing public infrastructure works.

External demand

Hong Kong's export performance remained sluggish in 2014 amid demand weakness in some major economies (Chart 3). Exports of goods increased by 1.0%, down from 6.5% in 2013. Reflecting the uneven growth in the advanced economies, demand from the US strengthened, while the EU and Japanese markets were lacklustre. Growth in exports to Mainland China slowed, despite support from intra-Asia trade driven to some extent by the launch of new smart-phones. Exports of services also moderated from a high growth path in earlier years, weighed mainly by a decline in tourist spending. Growth in imports of goods moderated along with softer domestic and export-induced demand, while imports of services progressed steadily. Taken together, net exports resulted in a modest negative contribution to GDP growth in 2014.

Chart 2 Domestic demand

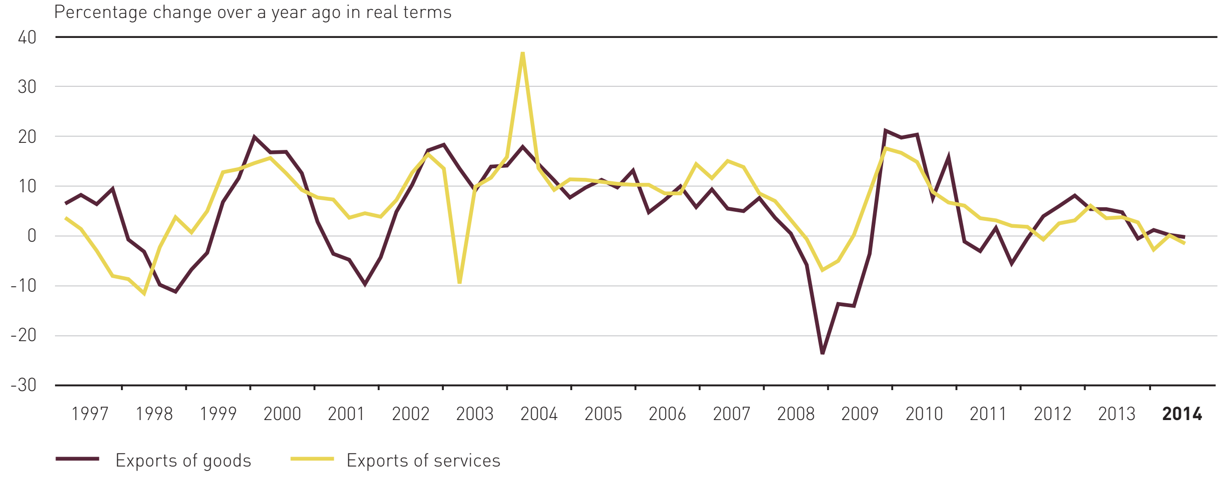


Source: Census and Statistics Department.

Inflation

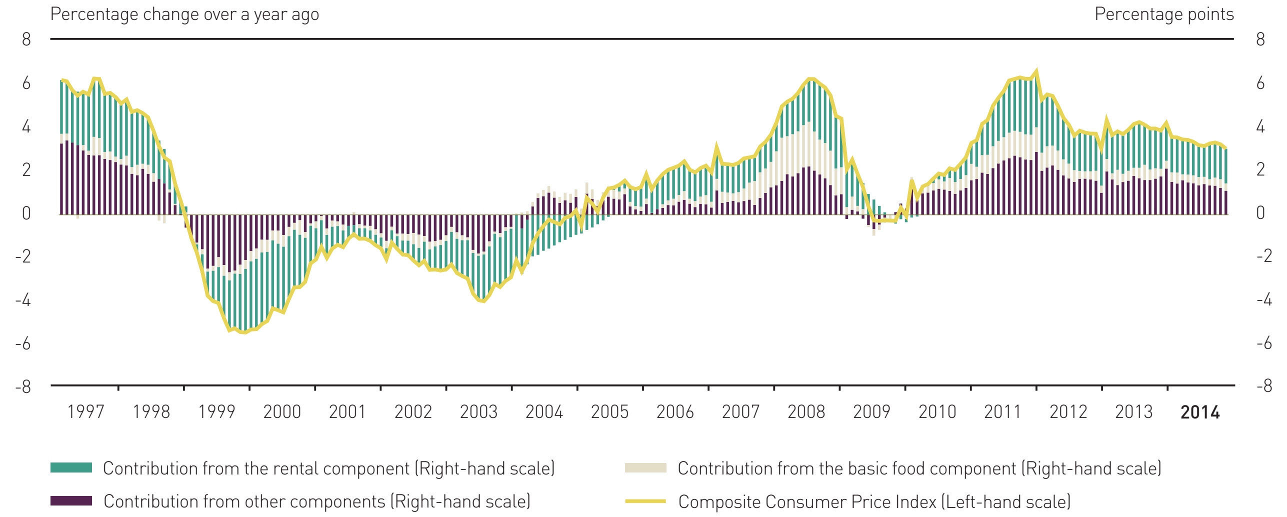
Underlying inflation continued to moderate in 2014, mainly reflecting some easing in domestic cost pressures. After netting out the effects of the Government's one-off relief measures, the underlying inflation rate declined to 3.5% from 4.0% in 2013 (Chart 4). While food inflation held steady, the slower increase in fresh-letting housing rentals in earlier quarters continued to feed through. The rise in other consumer price components also softened, led by a milder increase in the price of consumer goods and miscellaneous services. Overall, domestic cost pressures moderated, as shop and office rentals rose at a slower pace and labour cost increases remained steady. Import price pressure also eased amid the benign global commodity price environment.

Chart 3 Exports of goods and services



Source: Census and Statistics Department.

Chart 4 Underlying consumer price inflation



Source: Census and Statistics Department.

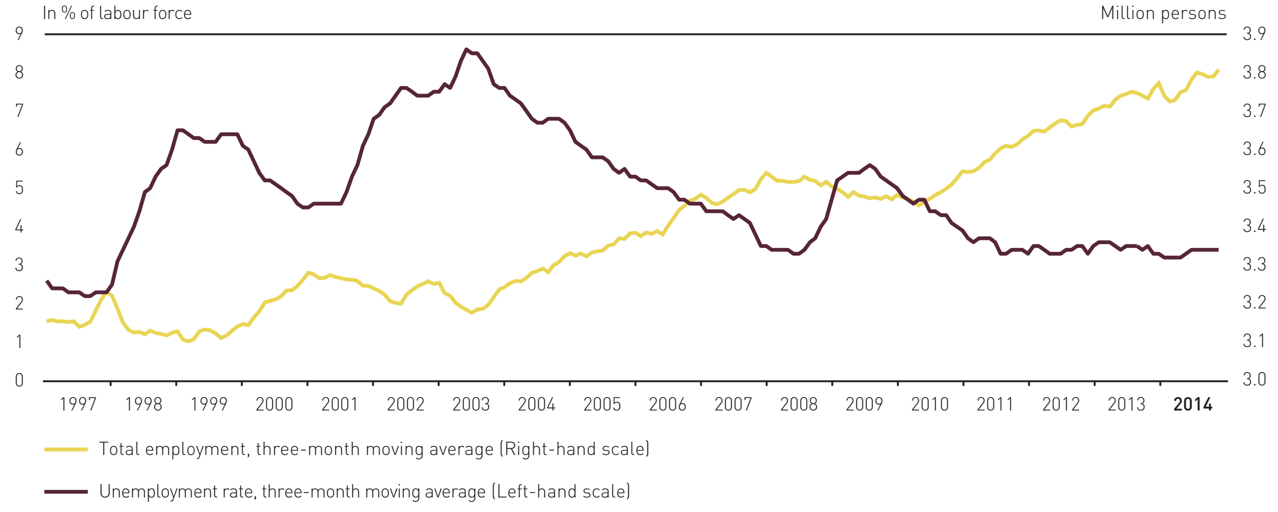
Labour market

While labour market conditions remained broadly stable in 2014, the overall demand for labour actually softened along with the slowdown in the Hong Kong economy. Total employment grew by a modest 0.6%, the slowest pace in four years. Corporate hiring sentiment also turned less optimistic, as shown in manpower demand surveys and the levelling off in job vacancy figures. On the other hand, labour supply increased mildly by 0.5% and broadly on par with the change in total employment. As a result, given the still-tight manpower resource balance, the seasonally adjusted unemployment rate was low at 3.3% in 2014 (Chart 5). Labour earnings rose moderately in nominal terms by 4.4% in the first three quarters of 2014 compared with 5.4% in 2013. After discounting for inflation, there was a real improvement of 0.2%, down from 1.0% in 2013.

Stock market

The Hong Kong stock market experienced a year of sharp fluctuations. Market performance was choppy early in 2014 because of concerns over the US Federal Reserve's tapering of its asset purchase programme and signs of a slowdown in Mainland China's economy. In the second quarter, market sentiment revived with the announcement of the Shanghai-Hong Kong Stock Connect, an improving US outlook and the Federal Reserve's accommodative monetary stance. Better-than-expected earnings of blue-chip corporations and robust equity fund flows also posted gains for the local stock market, with the Hang Seng Index reaching a six-year high in early September (Chart 6). However, the local stock market then underwent a sharp correction amid renewed concerns about global growth prospects and intensified geopolitical tensions. Increased

Chart 5 Labour market conditions



Source: Census and Statistics Department.

volatility on global financial markets and depreciation pressures on emerging-market currencies (in part triggered by a sharp decline in oil prices) also weighed on the local stock market. For the year as a whole, the Hang Seng Index rose by a modest 1.3%, compared with a 2.9% gain in 2013. Trading was active, particularly after the launch of the Shanghai-Hong Kong Stock Connect, while total funds raised from the local market surged to $942.7 billion, compared with $378.9 billion in 2013.

Property market

The residential property market turned more active after some consolidation in 2013. Housing prices picked up visibly from the second quarter onwards, leading to a cumulative increase of 13.5% in 2014, compared with 7.7% a year earlier (Chart 6). Trading activity also increased noticably to a total of 63,807 units, up 25.9% from a record low in 2013, in part reflecting stronger sales in the primary market. Speculative transactions stayed at low levels, as shown in the number of confirmor transactions and short-term flipping trades. As income growth lagged behind the accelerated increase in housing prices, household affordability deteriorated further with the price-to-income ratio rising to a high of 14.8 and the income-gearing ratio deviating further above its long-term average.[1] Commercial and industrial property markets also revived, with prices and transaction volume broadly picking up. As rentals rose in tandem with prices, the rental yields saw little change and stayed near their historical lows.

Chart 6 Asset prices

Sources: Rating and Valuation Department, and Hong Kong Exchanges and Clearing Limited.

[1] The price-to-income ratio measures the average price of a typical 50 m^2 flat relative to the median annual income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio compares the amount of mortgage payment for a typical flat of 50 m^2 (under a 20-year mortgage scheme with a 70% loan-to-value ratio) with the median income of households living in private housing, from a potential home buyer's perspective. 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.

Economic and Financial Environment

OUTLOOK FOR THE ECONOMY

Economic environment

Hong Kong's economic growth is expected to remain moderate in 2015. Slightly stronger global growth led by the US should provide moderate support for Hong Kong's export performance. Nevertheless, export growth is not likely to see a sharp turnaround as demand from the euro-zone and Japan remains weak, and growth in Mainland China and other emerging market economies is slowing. On the domestic front, private consumption should stay broadly resilient on the back of stable labour market conditions. Large-scale public infrastructure works and private building activities are also expected to hold up quite well, but the mixed business outlook and possible rises in interest rates in the future will likely continue to weigh on business capital investment. The Consensus Forecasts for Hong Kong's GDP growth project an average rate of 2.6%, while the Government forecasts growth in the range of 1-3%.

Inflation and the labour market

Inflationary pressures are anticipated to remain broadly contained in 2015. There should be further relief from external price pressures with the decline in international commodity prices and the resultant disinflationary dynamics. Domestically, labour cost increases will likely remain moderate, but a faster pick up in fresh-letting housing rentals in the second half of 2014 will gradually be reflected in the rental component of the consumer price index, thereby providing some offset. Private-sector analysts now expect the headline inflation rate to ease to 3.3% in 2015, while the Government sees the underlying inflation rate at 3%. The Consensus Forecasts for the unemployment rate are pitched at 3.4% for 2015, while survey results suggest that hiring sentiment is expected to remain broadly positive, despite a rather diverse outlook for different sectors of the economy.

Uncertainties and risks

The economic outlook for 2015 is subject to a number of uncertainties and risks. The divergence in growth and monetary policy paths in the advanced economies could lead to more volatile exchange rates, fund flows and global financial conditions, with potential negative spillovers to the Hong Kong economy through various financial channels. In particular, the timing and pace of US interest rate normalisation remain a major source of uncertainty. When the interest rate up-cycle sets in, monetary conditions in Hong Kong will inevitably tighten under the Linked Exchange Rate system and this in turn could weigh on real economic activities. Interest rate hikes could also dampen housing demand in Hong Kong and exert pressures on property prices. In case there is a sharp adjustment in the property market, the broader economy would also be affected, with repercussions on consumption and business investment. In addition, persistent strengthening of the US dollar, together with higher US interest rates, could increase the risk of a sudden re-pricing of risk assets and capital outflow pressures, as well as a rise in the debt servicing burden of borrowers of US dollar credit. The future path of oil prices also remains highly uncertain. In particular, sharp volatilities in oil prices could put some oil-exporting countries and energy producers under financial and credit stress, with possible contagion risks to global financial markets.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained resilient during the year, despite the economic slowdown in some major economies, and uncertainties over the timing and pace of interest rate rises by the US Federal Reserve following the end of its unprecedented quantitative easing programme. The asset quality and liquidity positions of retail banks remained sound, and locally incorporated authorized institutions continued to be well capitalised. Credit growth in the banking sector slowed in the second half of the year.

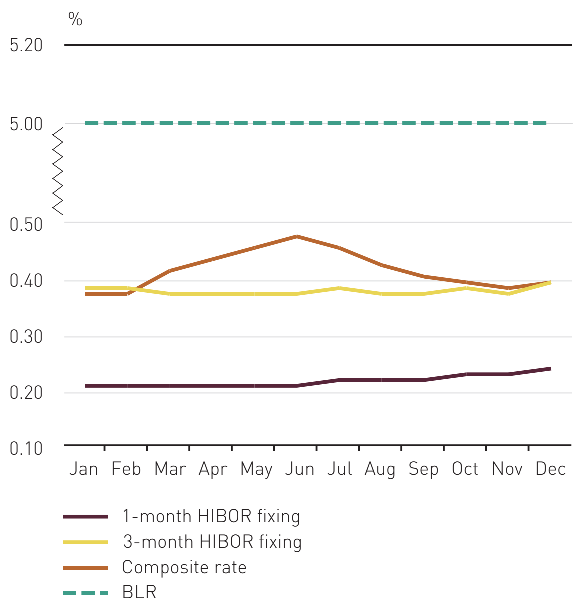
Interest rate trends

In line with the US dollar interest rates, Hong Kong dollar interbank interest rates remained relatively low throughout the year. It is worth noting that the funding costs of retail banks steadily declined after reaching a recent high in June 2014, as indicated by a downward trend in the composite interest rate since then (Chart 7).

Profitability trends

The profitability of the banking sector remained relatively stable in 2014. The aggregate pre-tax operating profits of retail banks' Hong Kong offices registered a modest growth of 3.6% as the 14.0% growth in net interest income was partly offset by a 9.1% increase in operating costs and a 2.1% reduction in non-interest income. As a result of the combined effects of the growth in average assets and a reduction in post-tax profit (mainly due to a drop in extraordinary profit), the post-tax return on the average assets of retail banks dropped to 1.0% in 2014 from 1.4% a year earlier (Chart 8).

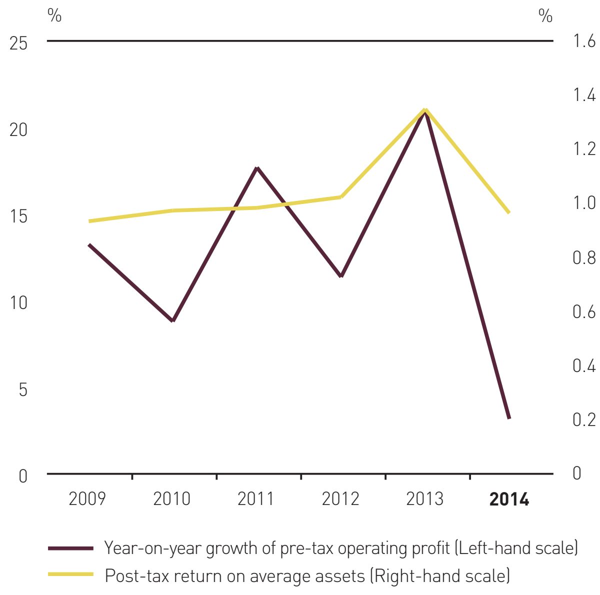
Chart 7 HIBOR fixings, composite rate and best lending rate (BLR)



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



Retail banks' net interest margin remained stable at 1.40% in 2014, unchanged from a year ago (Chart 9).

Driven by a decrease in income from foreign exchange and derivatives operations, but partly offset by the growth in income from fees and commissions, retail banks' non-interest income as a share of total operating income decreased to 43.0% from 46.8% in 2013.

The operating costs for retail banks increased by 9.1%, largely caused by rising staff expenses. As the growth in operating costs outpaced that of operating income, the cost-to-income ratio increased to 43.5% in 2014 from 42.4% in 2013 (Chart 10).

The net charge for debt provisions rose to $4.8 billion from $3.6 billion in 2013. Despite the increase, the bad debt charge to average assets was still at a low level of 0.05%, reflecting the sound quality of retail banks' loan book.

Chart 9 **Retail banks' net interest margin**

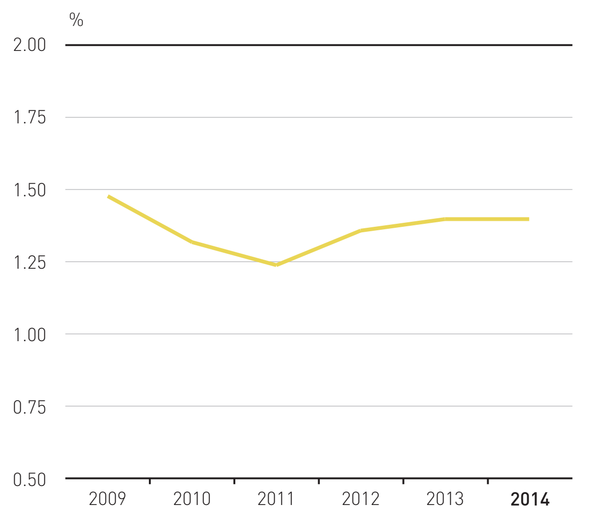
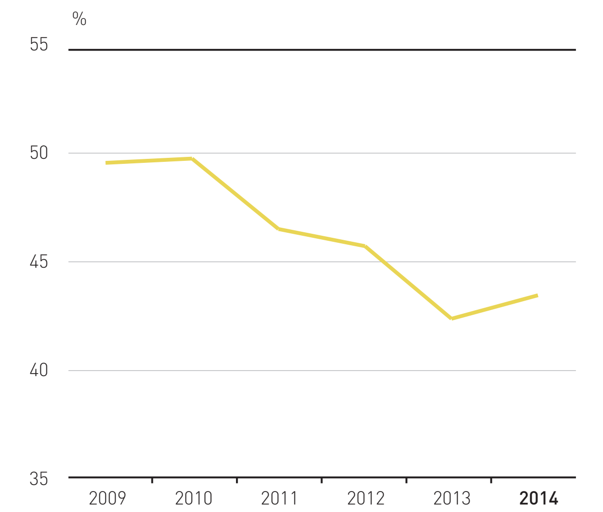


Chart 10 **Retail banks' cost-to-income ratio**



Asset quality

The asset quality of retail banks remained sound during the year. The classified loan ratio slightly reduced to 0.45% at the end of 2014 from 0.48% a year earlier. The combined ratio of overdue and rescheduled loans also dropped to 0.29% from 0.33% during the same period (Chart 11).

The quality of surveyed institutions' residential mortgage lending remained good, with the delinquency ratio of 0.03% at the end of 2014 (Chart 12). The rescheduled loan ratio was unchanged at nearly 0%. The surveyed institutions reported no case of residential mortgage loans in negative equity at the end of the year, compared with 26 cases at the end of 2013.

The credit card portfolios' delinquency ratio and the combined delinquent and rescheduled ratio were kept at a low level of 0.20% and 0.27% respectively at the end of 2014 (Chart 12). Both ratios remained unchanged compared with a year ago. The charge-off ratio edged down to 1.83% from 1.84% in 2013.

Chart 11 **Asset quality of retail banks**

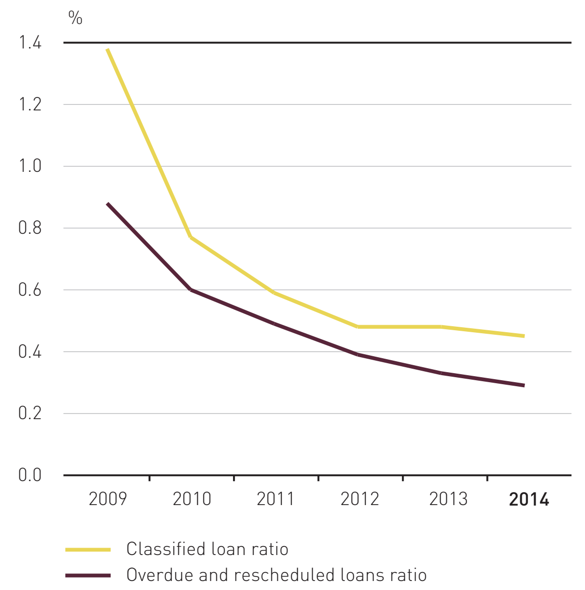
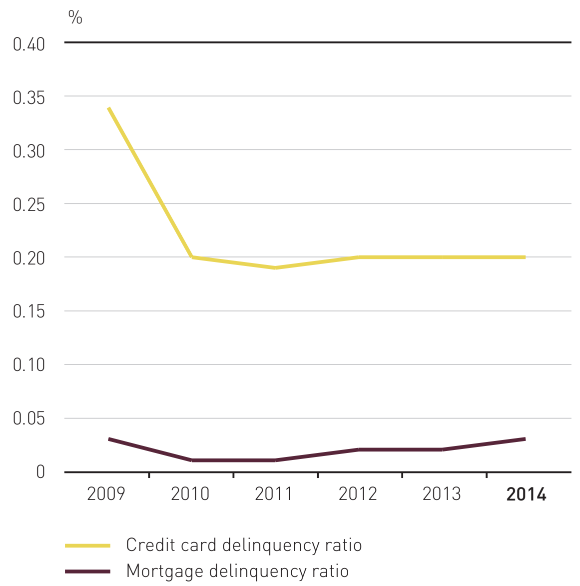


Chart 12 **Delinquency ratios of residential mortgages and credit card lending of surveyed institutions**



Balance sheet trends

Total loans and advances of retail banks grew by 12.0% in 2014, while total deposits rose by 9.6%. As a result, the overall loan-to-deposit ratio of retail banks increased to 57.5% from 56.2% at the end of 2013. The Hong Kong dollar loan-to-deposit ratio edged down to 74.6% from 74.8% during the same period (Chart 13).

Credit growth in the banking sector slowed from 16.0% in 2013 to 12.7% in 2014. The rate of growth in loans for use outside Hong Kong continued to outpace that for use in Hong Kong. The increase in loans for use in Hong Kong was mainly for property lending, loans to financial concerns, as well as electricity and gas.

The banking sector's Mainland-related lending continued to expand in 2014. Total Mainland-related lending[2] increased to $3,117 billion at the end of 2014 from $2,616 billion a year ago.

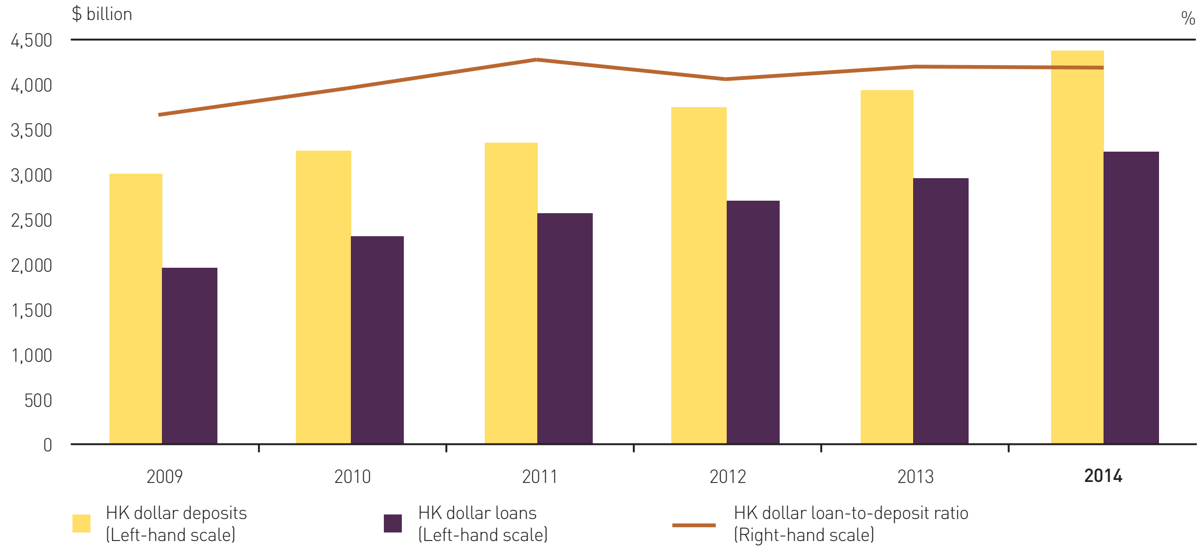
Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit, decreased by 3.9% in 2014. The share of total holdings of NDIs relative to total assets decreased to 22% at the end of the year from 25% at the end of 2013. Among the holdings of NDIs, 47% were government-issued (43% in 2013), 31% were issued by non-bank corporations (28% in 2013), and 22% were issued by banks (29% in 2013) (Chart 14).

Capital adequacy and liquidity

All locally incorporated authorized institutions remained well capitalised. Their consolidated capital adequacy ratio rose to 16.8% at the end of 2014 from 15.9% at the end of 2013 (Chart 15). This was due to faster growth in the capital base than in the risk-weighted amount. During the same period, the Tier-1 capital adequacy ratio also increased to 13.9% from 13.3%.

Chart 13 **Retail banks' Hong Kong dollar loans and deposits**



[2] Including loans booked in locally-incorporated banks' banking subsidiaries in Mainland China.

The liquidity ratio of the retail banks was maintained at a comfortable level in 2014. The average liquidity ratio increased from 39.6% in the final quarter of 2013 to 41.1% in the same period of 2014 because the average liquefiable assets rose faster than the average qualifying liabilities (Chart 16). As the Banking (Liquidity) Rules came into effect on 1 January 2015, authorized institutions in Hong Kong began implementing the new liquidity requirements under Basel III, with their liquidity being measured by the Liquidity Coverage Ratio and the Liquidity Maintenance Ratio.

Chart 14 **Retail banks' holdings of negotiable debt instruments at the end of 2014 (issuer breakdown)**

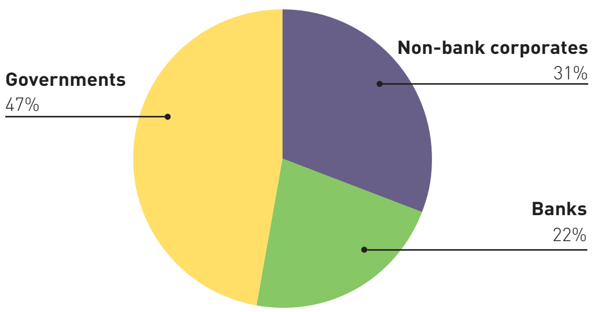


Chart 15 **Consolidated capital adequacy ratio of locally incorporated AIs**

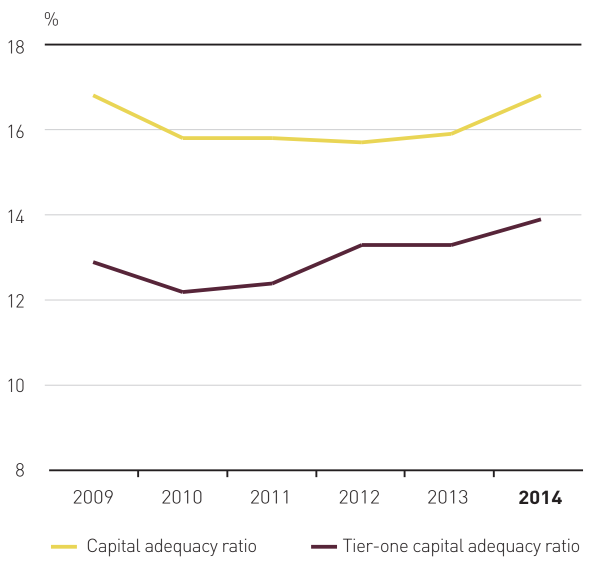
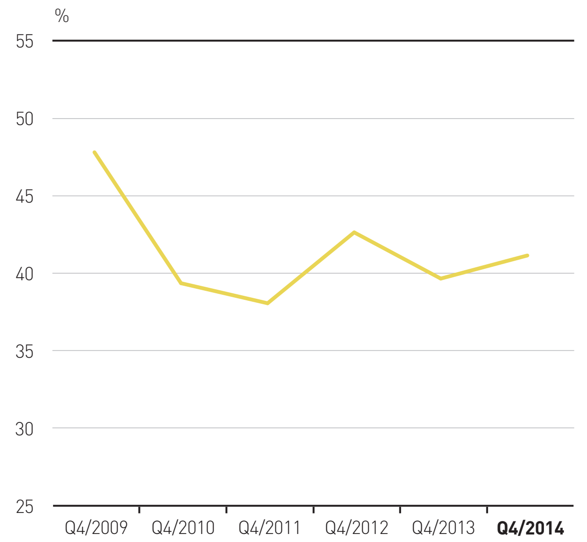


Chart 16 **Retail banks' liquidity ratio (quarterly average)**



PROSPECTS FOR 2015

The divergence in the monetary policies of the major developed economies has increased the uncertainties in the global financial market and the overall economic outlook. The US Federal Reserve is expected to raise its interest rate, but the timing and pace of the rise remain uncertain. In Europe and Japan, the European Central Bank and the Bank of Japan have further expanded their asset purchase programmes. These developments are causing considerable uncertainty for global fund flows and liquidity conditions. At the time of writing this Report, there had been no noticeable impact on Hong Kong's banking sector. Nevertheless, banks have been reminded 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.