Economic and Financial Environment

Hong Kong's economic growth softened in 2016 alongside subdued global economic and trade activities. Economic growth for 2017 is expected to remain moderate amid heightened uncertainties surrounding the external environment.

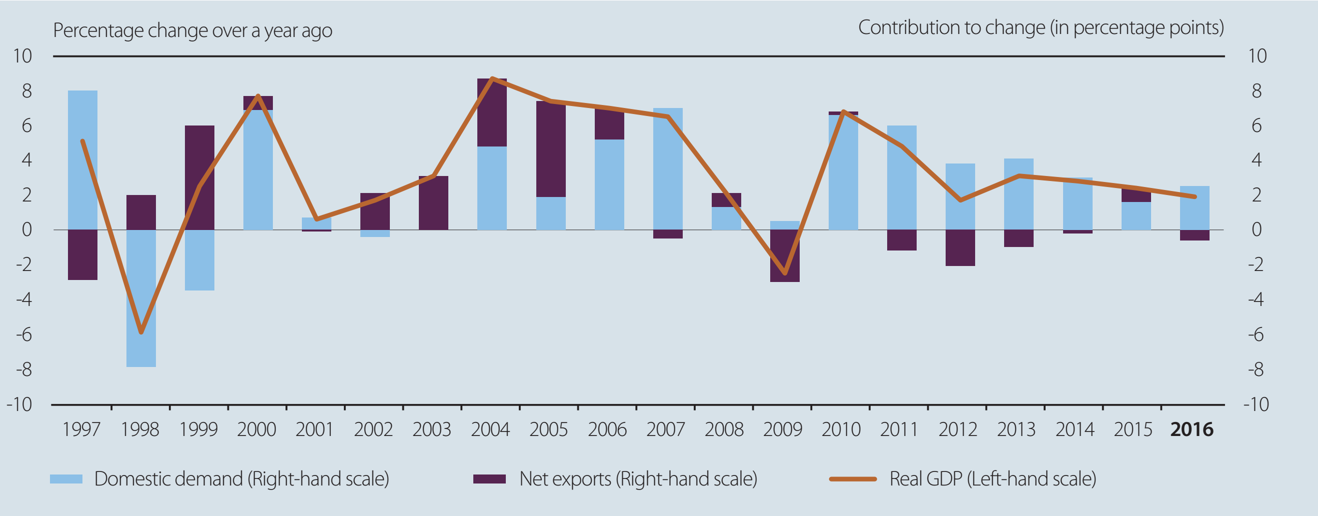
THE ECONOMY IN REVIEW

Overview

The Hong Kong economy grew at a slower pace in 2016 with real Gross Domestic Product (GDP) growth declining to 1.9% from 2.4% in 2015 (Table 1). Net exports were the main drag, weighed down by exports of services alongside weak inbound tourism (Chart 1). Domestic demand also showed slackened momentum, although it continued to provide the major support to overall GDP growth. The labour market remained broadly stable with the unemployment rate staying low at 3.3–3.4%. Consumer price inflation moderated further, attributable to easing pressures on domestic costs and external prices. Amid a volatile external environment and shifts in market sentiments, the asset markets recorded more fluctuations. In view of the renewed buoyancy in the residential property market, the Government introduced a new stamp duty measure in November.

The local foreign exchange and money markets continued to operate smoothly despite a turbulent external environment and higher US dollar interest rates. After some easing in January, the Hong Kong dollar spot exchange rate hovered near 7.75 thereafter. The Convertibility Undertakings were not triggered during the year, and the Aggregate Balance and the outstanding Exchange Fund paper combined remained virtually unchanged at around HK$1,200 billion. Following the US rate hike in mid-December, the HKMA Base Rate was adjusted upward from 0.75% to 1%. While remaining at relatively low levels, the Hong Kong dollar interbank interest rates and longer-dated bond yields picked up towards the end of the year, partly reflecting the movements in their US dollar counterparts. Total bank loans grew at a faster rate of 6.5% in 2016. Although the overall loan quality weakened slightly, the classified loan ratios were still very low.

Chart 1 **Real GDP growth by contribution**



Source: Census and Statistics Department.

Economic and Financial Environment

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

(%Period-over-period, unless otherwise specified)	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2016	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2015
Gross Domestic Product	**-0.3**	**1.4**	**0.8**	**1.2**	**1.9**	0.6	0.7	0.6	0.1	2.4
(year-on-year growth)	**1.0**	**1.7**	**2.0**	**3.1**		2.3	3.1	2.3	1.9	
Private consumption expenditure	**0.2**	**0.6**	**0.9**	**1.5**	**1.6**	1.4	1.8	0.0	-0.4	4.8
Government consumption expenditure	**0.9**	**0.9**	**0.5**	**1.0**	**3.3**	1.1	0.7	0.6	0.9	3.5
Gross domestic fixed capital formation	**-**	**-**	**-**	**-**	**-0.5**	-	-	-	-	-3.2
Exports										
Exports of goods	**-2.4**	**2.8**	**0.7**	**3.9**	**1.7**	-0.1	-3.0	0.7	1.6	-1.7
Exports of services	**-1.1**	**-0.3**	**1.6**	**1.2**	**-3.1**	1.1	-0.1	-1.9	-2.5	0.3
Imports										
Imports of goods	**-3.7**	**3.5**	**1.8**	**4.0**	**1.0**	-1.7	-2.8	-0.6	1.8	-2.7
Imports of services	**1.5**	**-1.0**	**-0.3**	**1.6**	**1.9**	2.4	1.8	-0.1	0.6	5.1
Overall trade balance (% of GDP)	**2.0**	**-3.1**	**5.6**	**3.1**	**2.0**	0.2	-4.3	8.3	4.6	2.4

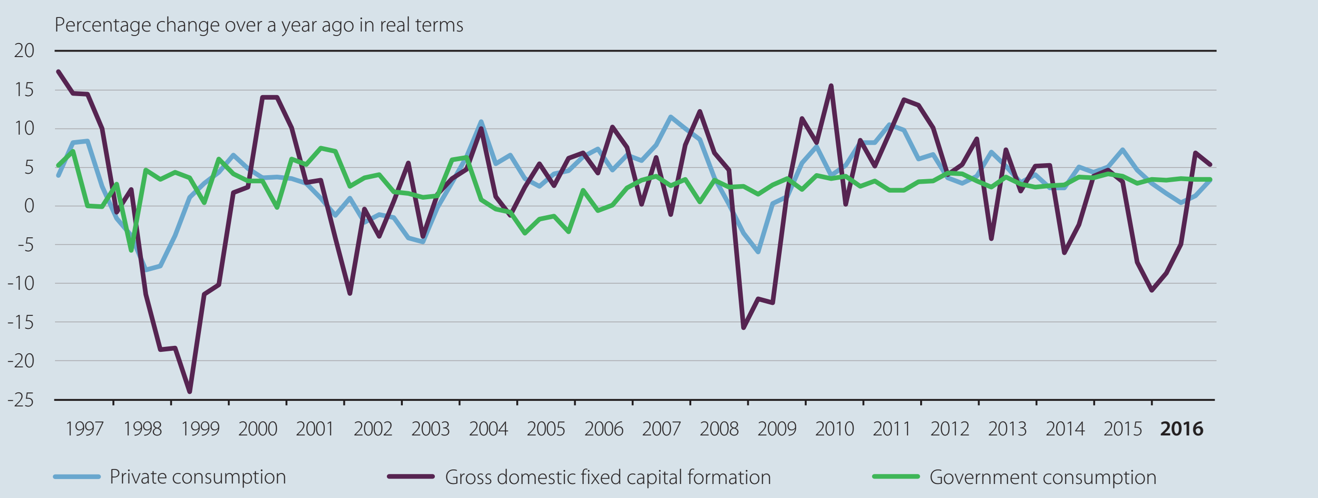
Note: The seasonally adjusted quarter-on-quarter rates of change in the gross domestic fixed capital formation are not available.

Source: Census and Statistics Department.

Domestic demand

Domestic demand showed moderated momentum in 2016. Despite the continued support from stable employment and earnings conditions, growth in private consumption slowed to 1.6%, partly reflecting heightened economic uncertainty. Government consumption also increased at a slightly slower rate of 3.3%. Gross domestic fixed capital formation continued to display large quarterly swings (Chart 2), culminating in a full-year contraction of 0.5%. The drag came mainly from private-sector machinery and equipment acquisition, which contracted for the third straight year amid unfavourable business prospects, while building and construction activities strengthened, along with the increase in housing commencement.

Chart 2 Domestic demand



Source: Census and Statistics Department.

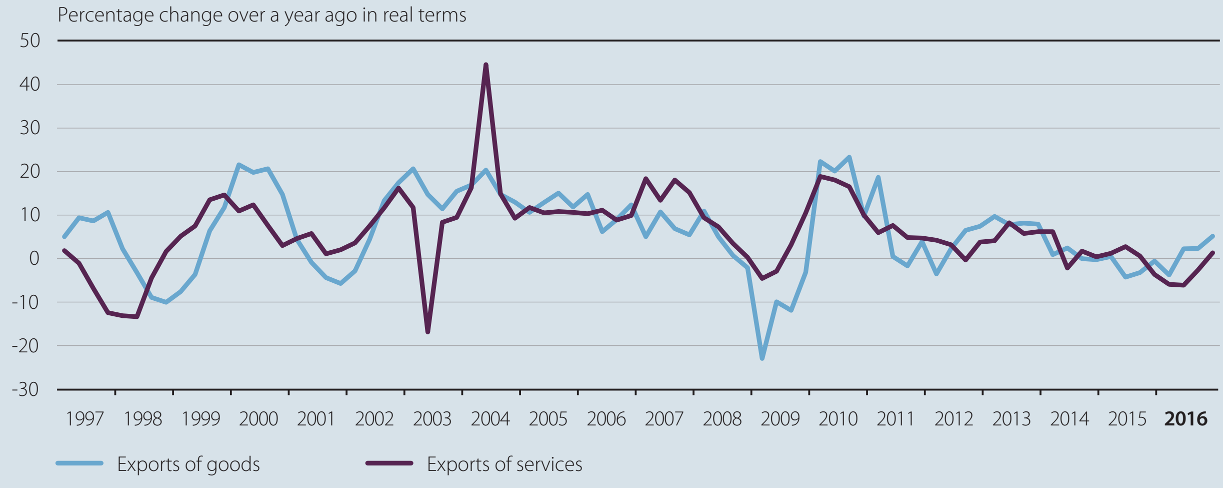
Economic and Financial Environment

External demand

Despite some signs of stabilisation towards the end of 2016, Hong Kong's export performance remained lacklustre for the year (Chart 3).[1] Exports of goods increased by 1.7% from a low base in 2015. Exports to the advanced economies remained sluggish, while exports to Mainland China, India, South Korea, Singapore and Taiwan performed relatively better compared to 2015, along with a stabilisation of regional trade flows.

Partly reflecting the normalisation of retail sales from the extraordinary growth in earlier years, Hong Kong's exports of services contracted markedly by 3.1% in 2016. Imports of goods recouped some ground after a contraction in 2015, and imports of services grew further, owing in part to residents' interest to travel overseas. On a net basis, overall trade surplus shrank in 2016, making a negative contribution to GDP growth.

Chart 3 Exports of goods and services



Source: Census and Statistics Department.

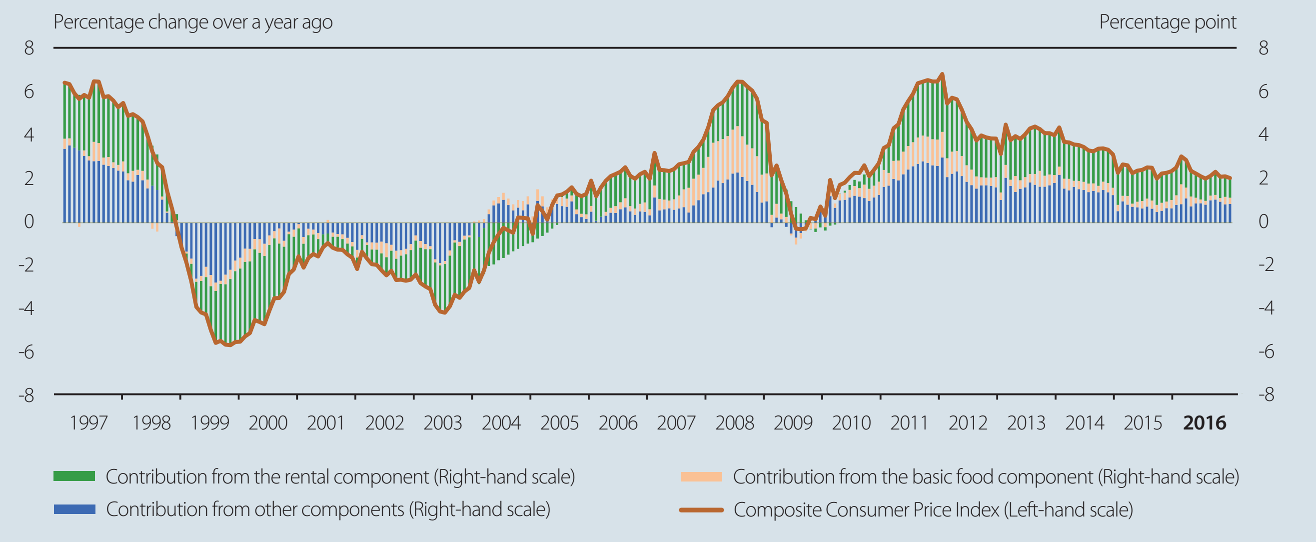
[1] The change of ownership principle was adopted in recording trade in goods and services. More details can be found in *Gross Domestic Product (Quarterly), Fourth Quarter 2016* published by the Census and Statistics Department.

Economic and Financial Environment

Inflation

Inflationary pressures remained contained in 2016. After netting out the effects of the Government's one-off relief measures, the underlying inflation rate edged down to 2.3% in 2016 from 2.5% in 2015 (Chart 4). The inflation of the Composite Consumer Price Index (CCPI) rental component eased amid the feed-through of the earlier decline in fresh-letting private residential rentals. Import price inflation was restrained by soft global commodity prices and the strong Hong Kong dollar. Meanwhile, domestic cost pressures stayed moderate along with the steady growth in labour costs, as well as softened rental cost pressures, particularly in the retail segment.

Chart 4 Underlying consumer price inflation



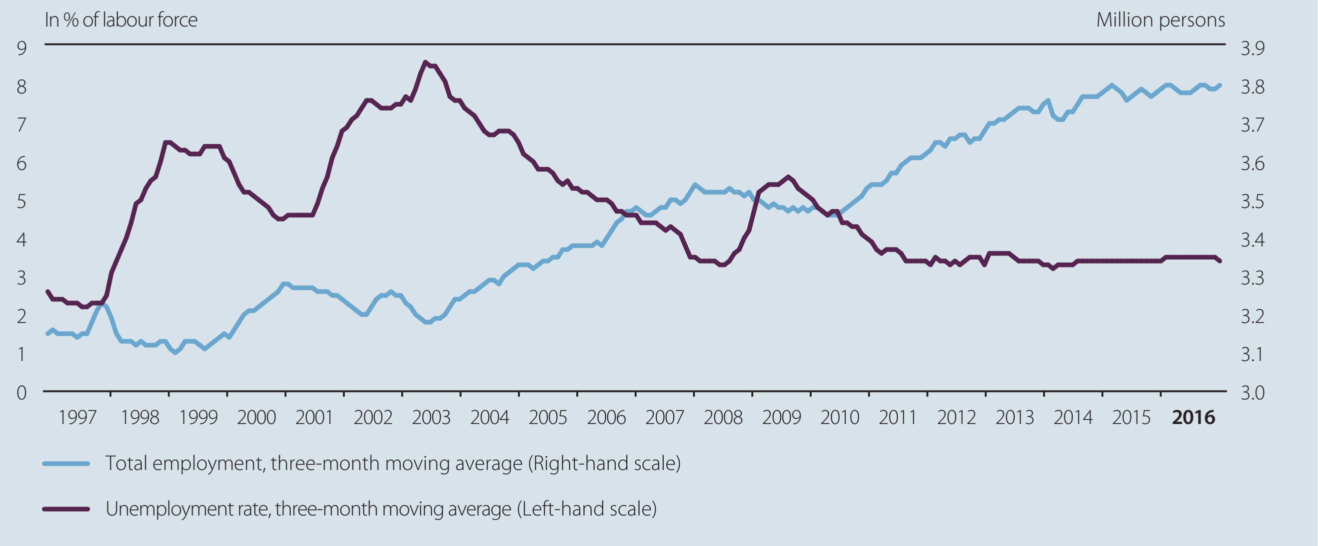
Source: Census and Statistics Department.

Economic and Financial Environment

Labour market

Labour market conditions remained broadly stable in 2016, with labour supply and demand growing at a similar pace. Analysed by sector, labour market conditions in the tourism-related sectors worsened, while those in other sectors were largely stable. Overall, the seasonally adjusted unemployment rate edged up slightly to 3.4% from 3.3% in 2015 (Chart 5). Given the stable labour market, labour earnings in nominal terms rose by 3.8% in the first three quarters, compared with 4.6% in 2015. Real labour earnings also rose by 0.9% in the first three quarters, compared with an increase of 1.5% in 2015.

Chart 5 Labour market conditions



Source: Census and Statistics Department.

Economic and Financial Environment

Stock market

The Hong Kong stock market was volatile in 2016. The Hang Seng Index fell to a three-year low in February amid depreciation pressure in the renminbi and turbulence in the Mainland equity market (Chart 6). The local stock market recovered in March along with the solid gains in the US and other major stock markets. Although the UK's referendum on Brexit triggered market volatilities, sentiments improved quickly amid expectation of more gradual rate hikes by the US Federal Reserve and monetary easing in other major central banks. The Hang Seng Index climbed to a year-high of 24,100 in September. However, the local stock market came under pressure again in the last quarter in response to the outcome of the US presidential election and expectations of a faster pace of US rate hikes. Overall, the Hang Seng Index picked up slightly by 0.4% in 2016 following a fall of 7.2% in 2015. The average daily turnover declined to HK$66.9 billion from HK$105.6 billion in the previous year, and the overall equity fund raised from the local market contracted to HK$490.1 billion from HK$1,115.6 billion a year earlier.

Chart 6 Asset prices

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

Property market

The residential property market experienced some volatility in 2016. After registering a record low in the first quarter, transaction volume picked up in subsequent months before declining again after the introduction of a new stamp duty measure in November. Overall, transaction volume fell slightly from a year ago to 54,701 units in 2016. Meanwhile, housing prices have increased since the second quarter, surpassing the peak in September 2015 and bringing the cumulative increase in 2016 to 7.8% (Chart 6). Housing affordability remained stretched, with a price-to-income ratio of 15.9, higher than the previous peak in 1997, and an income-gearing ratio of 72.0%, far above its long-term average.[2] After some decreases due to the offering of competitive mortgage plans by banks, mortgage rates picked up somewhat towards the end of the year, along with the increase in Hong Kong Interbank Offered Rates (HIBORs). As for the commercial and industrial property markets, trading activities remained broadly stable throughout the year. With non-residential property prices below their peak in 2015, the corresponding rental yields edged up from a year earlier, though remaining at low levels.

[2] The price-to-income ratio measures the average price of a typical 50 square-metre 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 mortgage payment for a typical flat of 50 square metres (under a 20-year mortgage scheme with a 70% loan-to-value ratio) to 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

Real GDP growth for 2017 is anticipated to remain moderate. The Government forecasts growth in the range of 2–3%, while private-sector analysts project the economy to expand at an average rate of 2.0%. Externally, global economic and trade growth may remain moderate amid increased uncertainty in the global macro-financial environment. This, coupled with the appreciation of the Hong Kong dollar real exchange rate due to the US dollar strength, would restrain Hong Kong's export performance. Domestically, private consumption is expected to grow moderately, supported by stable employment and earnings conditions, while dragged by rising interest rates. Building and construction activities should progress steadily on the back of rising housing supply and infrastructure projects in the pipeline, but weak business sentiment and a pick-up in interest rates will weigh on business capital spending.

Inflation and the labour market

Inflationary pressures are expected to remain moderate in 2017. While higher global commodity prices and inflation in Mainland China could increase import prices, the strengthening of the Hong Kong dollar could keep such pressures in check. Domestic cost pressures will likely remain contained amid moderate economic momentum, but the inflation of the CCPI rental component may pick up somewhat amid the increase in fresh-letting housing rentals in early 2017. Market consensus forecasts the headline inflation rate at 1.9% in 2017, and the Government projects the underlying inflation rate at 2.0%. While heightened uncertainties could weigh on hiring sentiments, private-sector analysts expect the unemployment rate to stay at 3.4% in 2017.

Uncertainties and risks

The economic outlook for 2017 is subject to heightened uncertainties, particularly from the external environment. Policy uncertainties surrounding the new US administration will cloud the global economic outlook, while potential protectionist policies will pose headwinds to global trade flows. The Brexit process and national elections in several major European countries may also result in asset market volatilities and could affect the directions of Hong Kong dollar fund flows. Moreover, the US interest rate normalisation will tighten domestic monetary conditions and pose downward pressure on both the real economy and asset prices. In particular, the property market continues to be stretched and the market outlook remains highly uncertain. In the near term, the still-low mortgage interest rates, stable job and income conditions and the release of pent-up demand amid increased incentives offered by property developers such as discounts and cash rebates could render support to housing demand. On the other hand, the new stamp duty measure, possible pick-up in the pace of US rate hikes and the steady catch-up in housing supply may continue to pose headwinds to the housing market.

Economic and Financial Environment

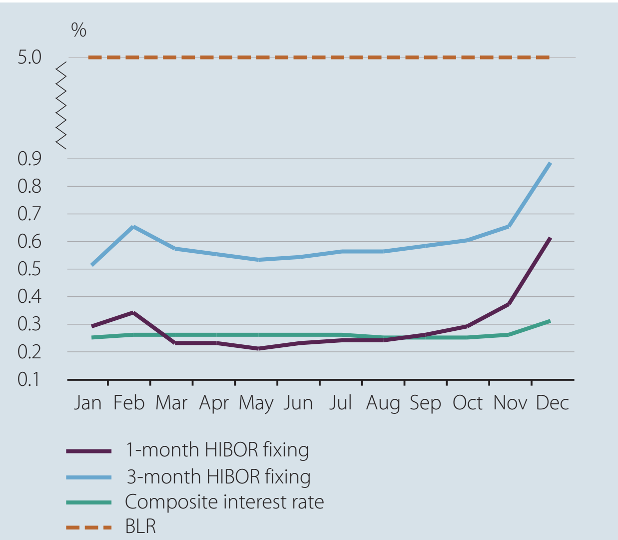
PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained safe and sound in 2016 despite headwinds facing the local economy and increased market volatilities caused by unexpected outcome of political events overseas. The capital and liquidity positions of authorized institutions (AIs) continued to be strong. Asset quality deteriorated slightly, but is still at a healthy level.

Interest rate trends

In tandem with a rise in US interest rates, HIBORs increased notably in November and December. The Hong Kong-dollar funding cost of retail banks, as measured by the composite interest rate, increased modestly (Chart 7).

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

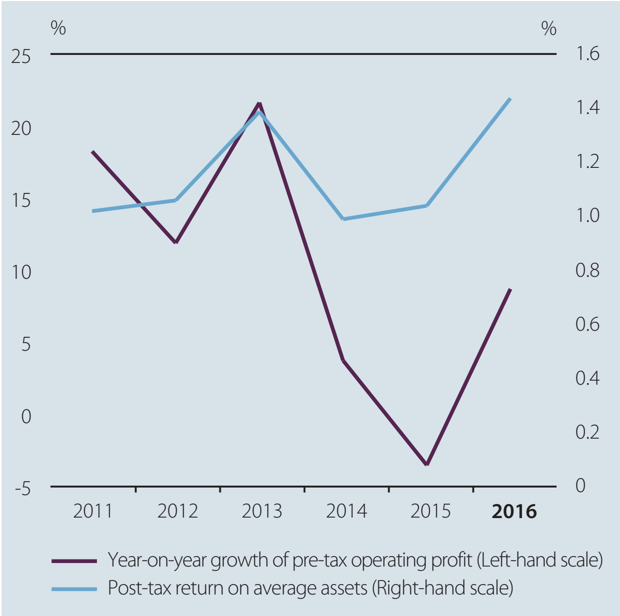


Notes:
1. HIBOR fixings (monthly averages) refer to the Hong Kong Interbank Offered Rates released by the Hong Kong Association of Banks.
2. BLR (monthly averages) refers to the best lending rate quoted by the Hongkong and Shanghai Banking Corporation Limited.

Profitability trends

The profitability of retail banks improved slightly in 2016 with the aggregate pre-tax operating profits of their Hong Kong offices growing by 8.7%. The growth was mainly driven by increases in income from foreign exchange and derivatives operations (+39.7%), dividends received from subsidiaries (+123.5%) and net interest income (+2.8%). The increases were partly offset by an 11.3% fall in fee and commission income. The post-tax profit of retail banks increased by 44.4% largely due to non-recurring items. Correspondingly, the post-tax return on average assets of retail banks rose to 1.44% from 1.04% in 2015 (Chart 8).

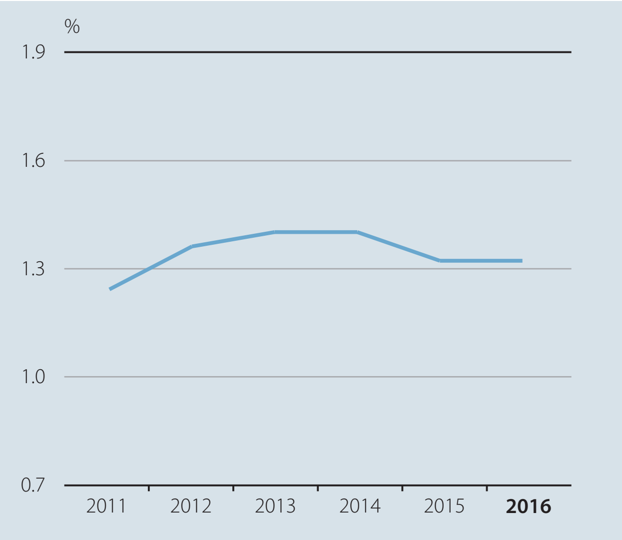
Chart 8 **Retail banks' performance**



Economic and Financial Environment

Retail banks' net interest margin stayed at 1.32% in 2016, the same level as 2015 (Chart 9). Although retail banks continued to deploy surplus funds in relatively lower-yielding but more liquid financial investments, the reduction in interest yield was offset by lower interest costs.

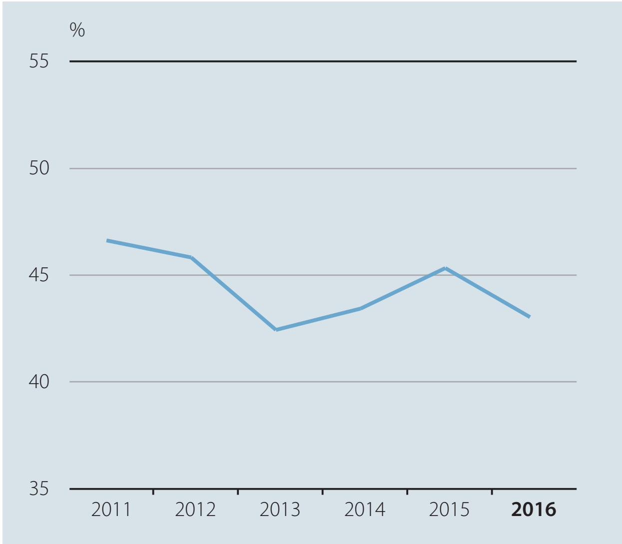
Chart 9 **Retail banks' net interest margin**



The share of retail banks' non-interest income to total operating income remained broadly stable at 44.3%. While fee and commission income dropped by 11.3%, dividend income and income from foreign exchange and derivatives operations rose by 123.5% and 39.7% respectively.

Retail banks' cost-to-income ratio dropped to 43.0% in 2016 from 45.3% in 2015, as operating costs decreased by 2.9% while operating income grew by 2.5% (Chart 10). Retail banks' loan impairment charges decreased to HK$8.2 billion from HK$9.8 billion in 2015.

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

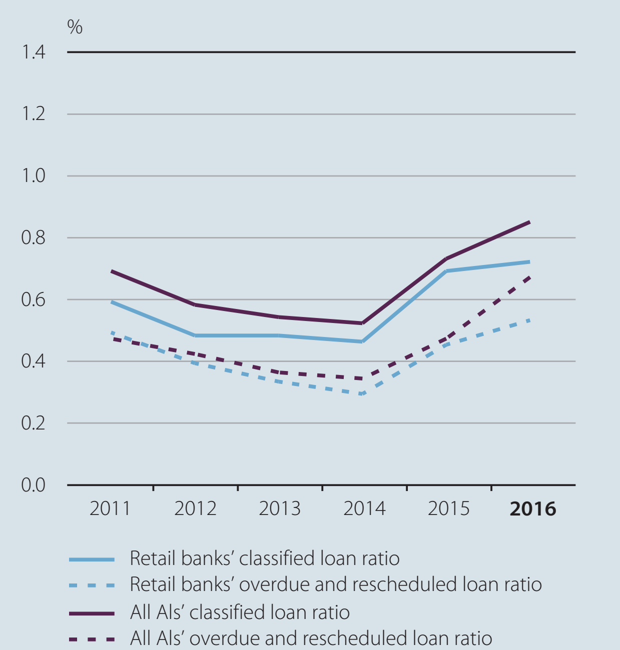


Economic and Financial Environment

Asset quality

The overall loan quality of retail banks deteriorated slightly during the year, but remained healthy by historical standards. The classified loan ratio rose to 0.72% from 0.69% a year earlier. The overdue and rescheduled loan ratio also increased to 0.53% from 0.45% (Chart 11). Similarly, the classified loan ratio and the overdue and rescheduled loan ratio of the whole banking sector increased to 0.85% and 0.67%, from 0.73% and 0.47% respectively.

Chart 11 Asset quality of the banking sector

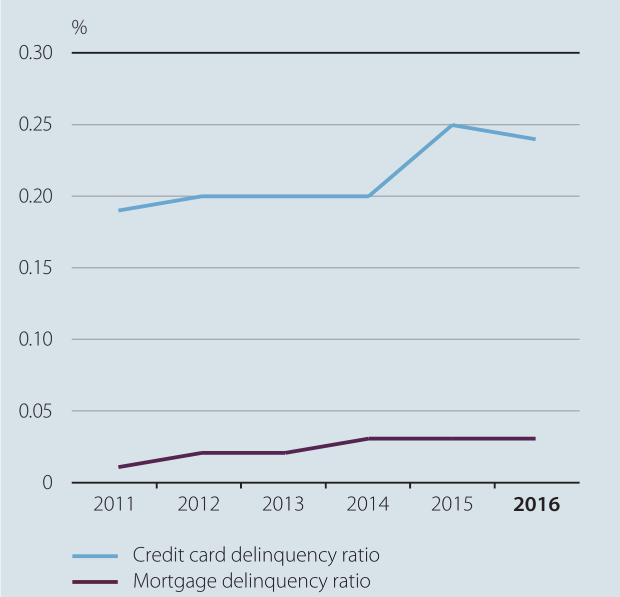


Note: Figures prior to December 2015 covered Hong Kong offices and overseas branches. Starting from December 2015, the coverage was expanded to include major overseas subsidiaries.

The quality of banks' residential mortgage lending portfolios continued to be good with the delinquency ratio staying at a low level of 0.03% at the end of 2016 (Chart 12). The rescheduled loan ratio was close to 0%. There were only four residential mortgage loans in negative equity at the end of the year, as compared with 95 a year ago.

The delinquency ratio of credit card lending remained low at 0.24% at the end of 2016, down from 0.25% a year ago (Chart 12). The combined delinquent and rescheduled loan ratio edged up to 0.33% from 0.32% a year earlier. The charge-off ratio also increased slightly to 1.92% from 1.82% in 2015.

Chart 12 Delinquency ratios of residential mortgages and credit card lending of banks

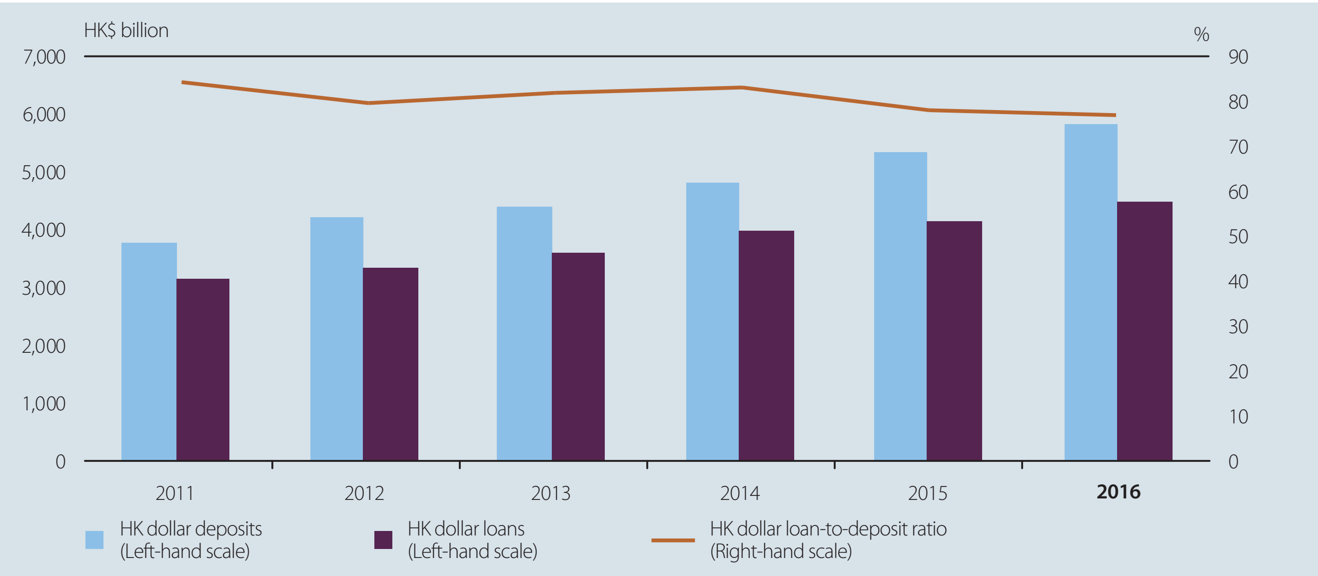


Balance sheet trends

Total loans of the banking sector grew moderately by 6.5% in 2016, faster than a 3.5% growth recorded in 2015. Corporate customers remained cautious in seeking credits given the uncertain macroeconomic outlook. The overall loan-to-deposit ratio fell to 68.4% at the end of 2016 from 70.1% a year earlier. The Hong Kong-dollar loan-to-deposit ratio edged down to 77.1% from 78.2% during the same period (Chart 13).

Mainland-related lending (including loans booked in the Mainland subsidiaries of locally incorporated banks) increased by 7% in 2016, compared with a growth of 3.3% recorded in 2015.

Chart 13 **Hong Kong-dollar loans and deposits of the banking sector**



Economic and Financial Environment

Holdings of negotiable debt securities

Holdings of negotiable debt instruments (NDIs) and negotiable certificates of deposit (NCDs) of the banking sector increased by 12.8% in 2016, and accounted for 22% of the total assets at the end of the year. Around 44% of the holdings were NDIs issued by governments (45% at end-2015), 44% were NDIs issued by banks and non-bank corporations (45% at end-2015), and 12% were NCDs issued by banks (10% at end-2015) (Chart 14).

Chart 14 Holdings of NDIs and NCDs of the banking sector

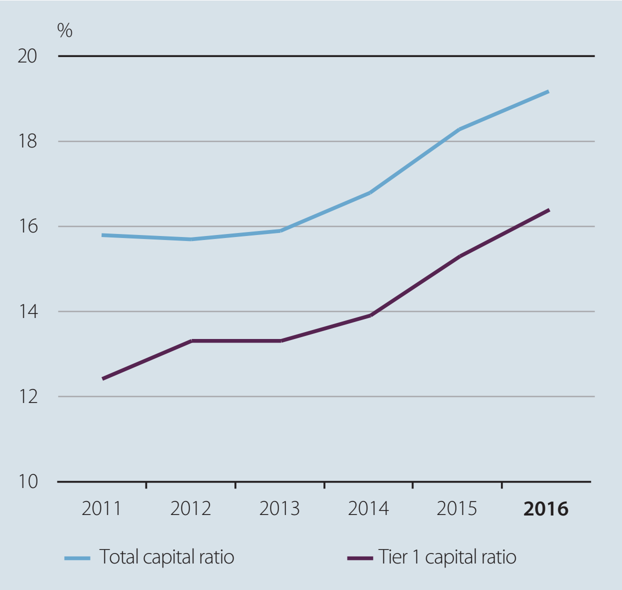
Note: Figures may not add up to 100% due to rounding.

Economic and Financial Environment

Capital adequacy and liquidity

Locally incorporated AIs continued to be well capitalised. Their consolidated total capital ratio rose to 19.2% at the end of 2016 from 18.3% at the end of 2015, as capital base grew faster than the amount of risk-weighted assets (Chart 15). The Tier 1 capital ratio of locally incorporated AIs increased to 16.4% from 15.3% during the period.

Chart 15 Consolidated capital adequacy ratios of locally incorporated AIs



The liquidity position of AIs remained generally sound. The average Liquidity Coverage Ratio (LCR) of category 1 institutions was 156.3% in the fourth quarter of 2016, well above the statutory minimum requirement of 70% applicable for the year. The average Liquidity Maintenance Ratio (LMR) of category 2 institutions was 51.0%, also well above the statutory minimum requirement of 25% (Chart 16).

PROSPECTS FOR 2017

The outlook for the Hong Kong banking sector remains challenging in 2017. The headwinds facing the Hong Kong and Mainland economies will continue to put pressure on asset quality and profitability. In the US, the interest rate normalisation process may gather pace and this may affect global fund flows. In Europe, national elections in several countries and the Brexit process in the UK may lead to increased market volatilities. Given these uncertainties, banks are advised to stay vigilant and manage their business prudently.

Chart 16 Liquidity ratios (quarterly averages)