Economic and Financial Environment

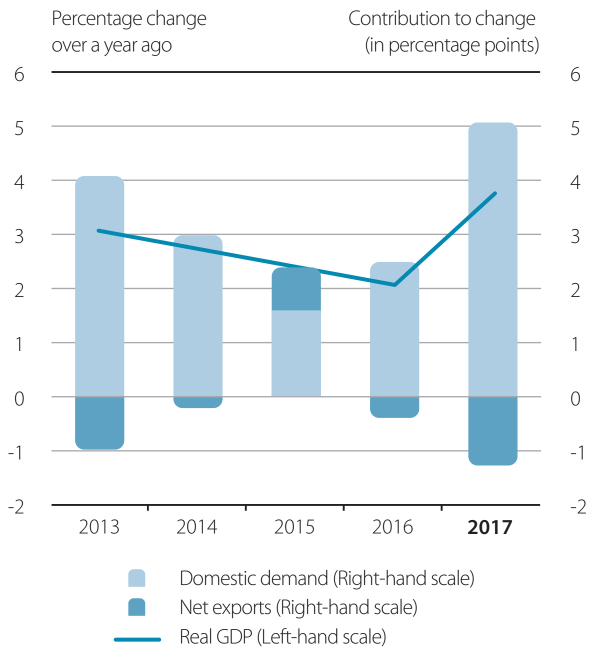
Against the backdrop of a more synchronised expansion of the global economy, Hong Kong saw faster economic growth, tighter labour market conditions and subdued inflationary pressures in 2017. Economic growth for 2018 is expected to remain solid.

THE ECONOMY IN REVIEW

Real activities

Amid a more synchronised expansion of the global economy, the Hong Kong economy grew faster in 2017. Growth in real Gross Domestic Product (GDP) increased to 3.8%, much higher than the 2.1% growth in 2016 and the long-term growth of about 3% over the past decade (Chart 1 and Table 1). Domestic demand firmed up, with private consumption growth accelerating and overall investment spending reviving. Stronger domestic demand reflected favourable job and income conditions, booming asset prices and improved business sentiment. Externally, Hong Kong's exports of goods expanded at a faster pace due to increased global trade flows, and exports of services recovered because of vibrant trade and cargo flows and improving inbound tourism. Imports of goods recorded stronger growth on export-induced demand, and imports of services increased steadily amid strong travel interest among residents. On a net basis, the overall trade surplus shrank, making a negative contribution to GDP growth.

Chart 1 Real GDP growth by contribution



Source: Census and Statistics Department.

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

(%Period-over-period, unless otherwise specified)	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2017	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2016
Gross Domestic Product	0.9	0.9	0.8	0.8	**3.8**	-0.1	1.3	1.0	1.1	2.1
(year-on-year growth)	4.3	3.9	3.7	3.4		1.1	1.8	2.2	3.3	
Private consumption expenditure	0.8	1.8	2.0	1.4	**5.4**	0.9	0.2	1.2	1.5	1.9
Government consumption expenditure	0.6	1.0	1.8	-0.3	**3.4**	0.9	1.0	0.3	1.0	3.3
Gross domestic fixed capital formation	–	–	–	–	**4.2**	–	–	–	–	-0.1
Exports										
Exports of goods	1.2	0.2	0.7	1.1	**5.9**	-3.2	3.9	0.7	3.5	1.6
Exports of services	1.1	-1.1	2.8	1.1	**3.5**	-1.4	-0.4	1.7	1.0	-3.4
Imports										
Imports of goods	0.8	0.4	1.5	2.4	**6.9**	-4.2	4.1	1.7	3.3	0.7
Imports of services	0.2	1.2	-1.2	0.5	**1.8**	1.9	-2.0	1.1	1.6	2.1
Overall trade balance (% of GDP)	0.6	-4.2	5.2	1.1	**0.8**	2.1	-2.8	5.8	3.6	2.3

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.

Monetary conditions

On the monetary front, the Hong Kong dollar exchange rate generally eased against the US dollar driven primarily by interest rate arbitrage activities amid the negative interest rate differentials between the Hong Kong dollar and the US dollar. This reflected the normal functioning of the Linked Exchange Rate System in accordance with its design. While still at relatively low levels, Hong Kong dollar interbank interest rates faced more upward pressures towards the end of 2017 due to Initial Public Offering-related funding demand and banks' year-end liquidity needs. For credit growth, after two years of single-digit growth, total bank loans increased at a notably faster pace of 16.1% in 2017, reflecting improving economic conditions and positive financial market sentiment. Despite faster loan growth, there were no signs of loosening of banks' credit underwriting standards, and overall loan quality remained good.

Inflation

Inflationary pressures remained well contained throughout 2017 (Chart 2). Netting out the effects of the Government's one-off relief measures, the underlying inflation rate declined to 1.7%, down from 2.3% in 2016. In particular, the housing component of the price index increased at a milder pace, reflecting the filter-through of slower increases in fresh-letting private residential rentals in 2016. More broadly, milder increases in nominal wages and earnings amid strong output growth helped keep local cost pressures in check. Import price inflation was also tame, in line with low inflation in Hong Kong's major import sources despite a weaker US dollar.

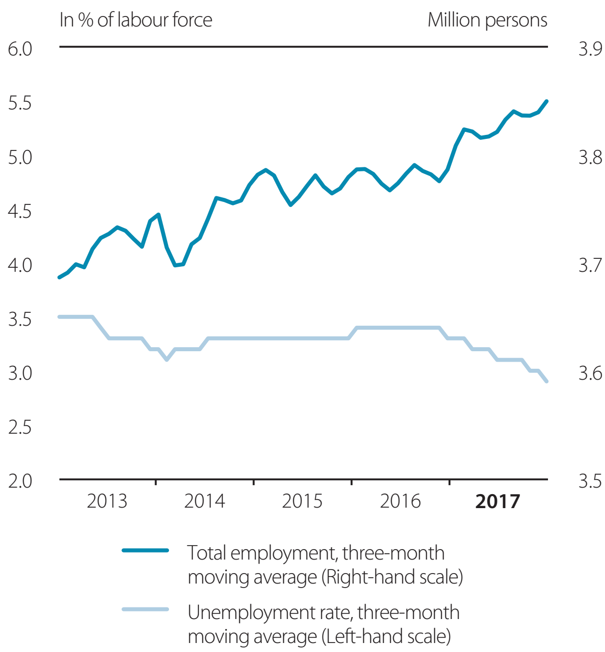
Chart 2 Underlying consumer price inflation

Source: Census and Statistics Department.

Labour market

The labour market tightened in 2017 along with above-par economic growth. The seasonally adjusted unemployment rate fell from 3.4% in 2016 to 2.9% towards the end of 2017, below 3% for the first time in nearly 20 years (Chart 3). Most major economic sectors registered decreases in their respective unemployment rates, with more notable declines seen in the retail, financing and professional and business services sectors. As total employment grew faster and the number of private-sector vacancies picked up, overall labour demand continued to strengthen. The labour force also expanded, partly reflecting more active participation of older-age workers (aged 55 and above). Consistent with tighter labour market conditions and lower inflation, real wages and earnings saw faster increases.

Chart 3 Labour market conditions



Source: Census and Statistics Department.

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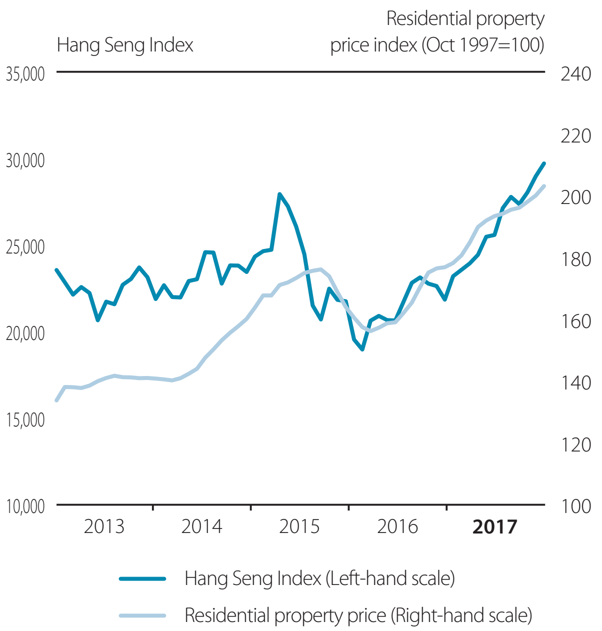
Stock market

The Hong Kong stock market had an almost uninterrupted rally in 2017. The Hang Seng Index rose by 36%, the largest annual gain since 2010 (Chart 4). The rally reflected optimism about the global economy and corporate earnings, and was in part supported by substantial fund inflows from Mainland investors through the Stock Connects. The Hang Seng Index hit a ten-year high in November and remained at high levels towards the end of 2017. Average daily turnover expanded to HK$88.3 billion from HK$66.9 billion in the previous year, and overall equity funds raised from the local market also increased to HK$581.4 billion, compared with HK$490.1 billion a year earlier.

Chart 4 Asset prices



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

Property market

The residential property market maintained its upward momentum throughout the year (Chart 4). Transaction volume expanded from 54,701 units a year ago to 61,591 units and housing prices increased by 14.8% in 2017. Housing affordability stretched further, with a price-to-income ratio of 16.4, higher than the previous peak in 1997, and an income-gearing ratio of 74.1, far above its long-term average.[1] In view of rising property prices and the intensifying competition for mortgage business among banks, the HKMA introduced the eighth round of prudential measures in May to strengthen banks' risk management and safeguard banking stability. Housing price growth moderated temporarily following these measures before accelerating in the fourth quarter. As for the commercial and industrial property markets, trading activities increased significantly during the year, with both transaction value and volume registering double-digit growth. With the pick-up in non-residential property prices, corresponding rental yields fell slightly compared to the previous year.

[1] 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 amount of 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.

OUTLOOK FOR THE ECONOMY

Economic environment

Economic growth for 2018 is expected to remain solid. The Government forecasts growth in the range of 3–4%, while private-sector analysts project the economy to expand at an average rate of 3.2%. Externally, Hong Kong's export performance will continue to benefit from the improving global growth outlook and the gradual recovery in inbound tourism. Domestically, private consumption growth is expected to hold up mainly as a result of favourable labour market conditions. As for fixed capital formation, building and construction activity should progress steadily on the back of rising housing supply and continuing infrastructure projects. While improved economic conditions will support business capital spending, headwinds may come from potential rises in interest rates.

Inflation and the labour market

With still-moderate global inflation and steady increase in local costs, inflationary pressures in Hong Kong are anticipated to remain moderate in 2018, but the inflation rate is likely to pick up gradually from the low in 2017. For example, the rental component of inflation may gather momentum in the latter part of 2018 because of feed-through from increases in fresh-letting private residential rentals. Market consensus predicts the headline inflation rate to be a still-moderate 2.2% for 2018, and the Government projects the underlying inflation rate to be 2.5%. On the other hand, sustained economic growth, expanding building and construction activity and the gradual recovery in inbound tourism are expected to keep the labour market tight in the near future. Private-sector analysts forecast the unemployment rate to stay at about 3.0% in 2018.

Uncertainties and risks

The economic outlook for 2018 is subject to a number of uncertainties and risks including those relating to major central banks' monetary policy normalisation and global financial market stability, as well as heightened protectionist sentiment and deteriorating geopolitical tensions. In particular, if such risks materialise to trigger reversal of fund flows in Hong Kong, local monetary conditions could tighten faster than expected, putting downward pressures on the real economy and asset prices.

The outlook for the residential property market remains uncertain. In the near term, the current favourable domestic economic conditions, perceived housing shortage, low mortgage rates and alternative sources of home financing (including mortgage loans provided by property developers and financial support from parents), will continue to support the demand for properties. However, the recent sell-off in global financial markets may dampen sentiments. Over the longer term, the property market will continue to face a number of headwinds. In particular, as the US monetary policy normalisation continues, domestic mortgage rates will rise eventually. In addition, on the back of the Government's effort to increase the supply of land and residential properties, the housing demand-supply gap is expected to narrow gradually, which would ease the upward pressure on property prices in the longer term.

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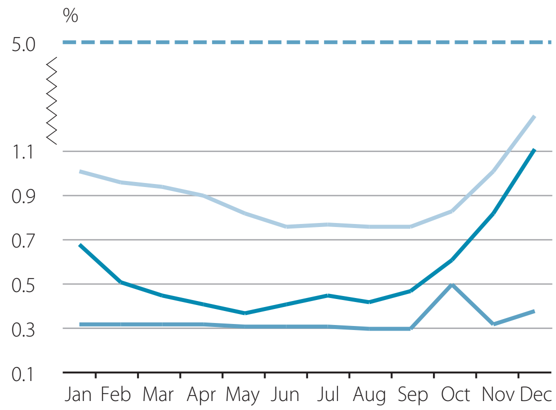
PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector continued to be safe and sound in 2017 notwithstanding uncertainties surrounding the global economy. The capital and liquidity positions of authorized institutions (AIs) remained strong, asset quality stayed at healthy levels, and profitability improved notably thanks to increased interest margins and robust credit growth.

Interest rate trends

As the US interest rate normalisation continued, the one-month and three-month Hong Kong Interbank Offered Rate (HIBOR) fixings increased by 49 basis points and 39 basis points respectively in 2017. More notable rises were observed in the fourth quarter. Nevertheless, the Hong Kong dollar funding cost of retail banks, as measured by the composite interest rate, remained broadly stable over the year (Chart 5).

Chart 5 HIBOR fixings, composite interest rate and best lending rate (BLR)

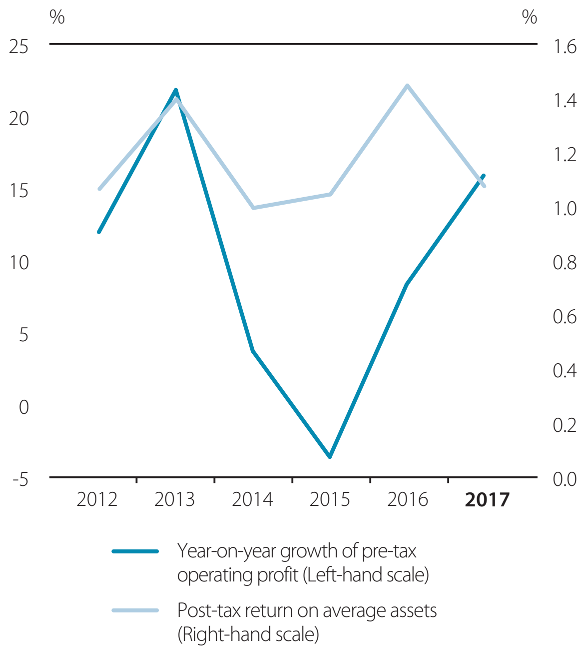


Notes:
1. HIBOR fixings (monthly averages) refer to the Hong Kong Interbank Offered Rates released by the Hong Kong Association of Banks.
2. BLR (monthly averages) refers to the best lending rate quoted by the Hongkong and Shanghai Banking Corporation Limited.

Profitability trends

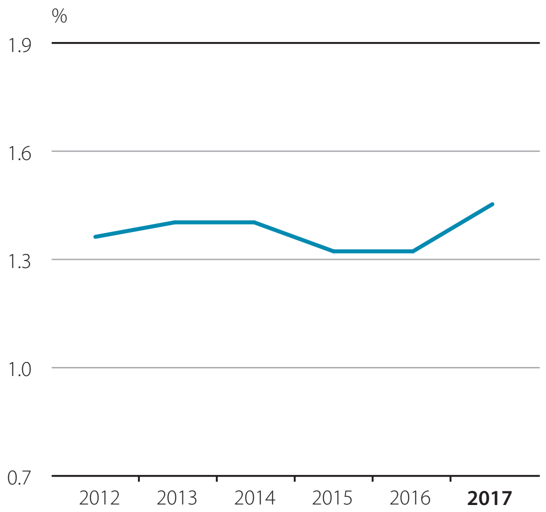
The aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 15.8% in 2017. The improved performance was mainly due to increases in net interest income (+20.3%) and fee and commission income (+9.4%). However, these increases were partially offset by a decline in income from foreign exchange and derivatives operations (-29.9%) and a growth in operating expenses (+8.4%). The aggregate post-tax profit of retail banks dropped by 18.1% because of certain non-recurring items recorded in 2016. The post-tax return on average assets of retail banks dropped to 1.07% from 1.44% in 2016 (Chart 6).

Chart 6 Retail banks' performance



Retail banks' net interest margin widened to 1.45% in 2017 from 1.32% in 2016 (Chart 7) mainly due to rising market interest rates.

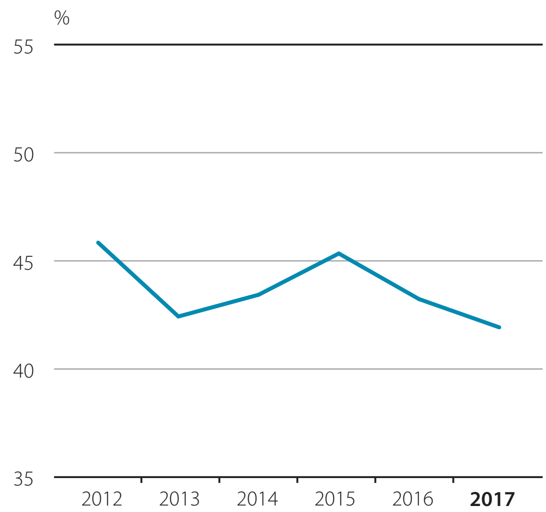
Chart 7 Retail banks' net interest margin



The proportion of retail banks' non-interest income to total operating income decreased to 40% from 44.3% in 2016. While fee and commission income increased by 9.4%, income originated from foreign exchange and derivatives operations dropped by 29.9%.

Retail banks' cost-to-income ratio declined to 41.9% in 2017 from 43.2% in 2016, as operating costs (+8.4%) increased at a slower pace than operating income (+11.8%) (Chart 8). Retail banks' loan impairment charges decreased to HK$7.3 billion from HK$8 billion in 2016.

Chart 8 Retail banks' cost-to-income ratio



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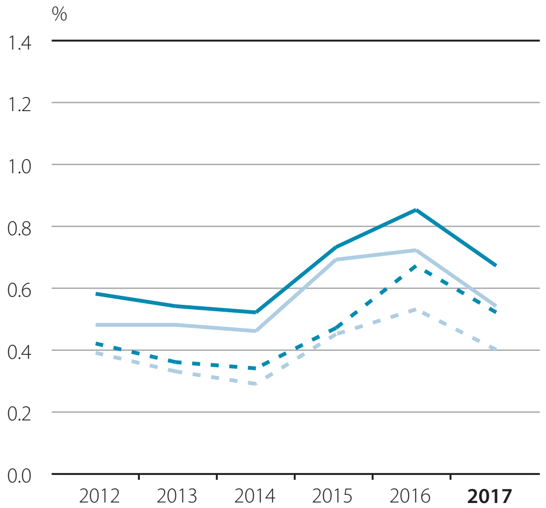
Asset quality

Loan quality of retail banks improved during the year, with the classified loan ratio decreasing to 0.54% from 0.72% a year earlier. The overdue and rescheduled loan ratio also decreased to 0.4% from 0.53% in 2016 (Chart 9). Similarly, the classified loan ratio and the overdue and rescheduled loan ratio of the whole banking sector decreased to 0.67% and 0.52%, from 0.85% and 0.67% respectively.

Chart 9 Asset quality of the banking sector



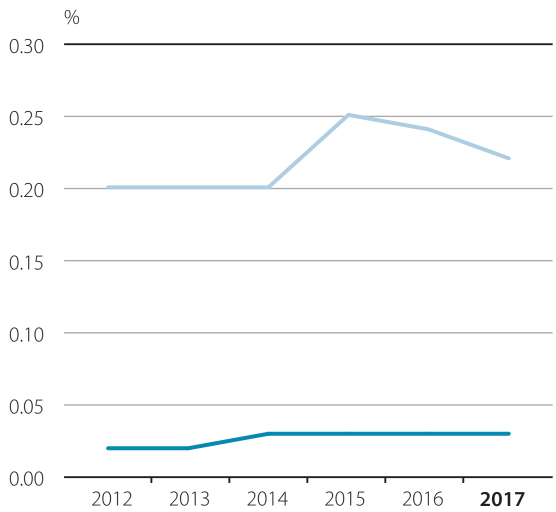
Retail banks' classified loan ratio
Retail banks' overdue and rescheduled loan ratio
All AIs' classified loan ratio
All AIs' overdue and rescheduled loan ratio

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 remained good, with the delinquency ratio staying at a low level of 0.03% at the end of 2017 (Chart 10). The rescheduled loan ratio was close to 0%. There was no residential mortgage loan in negative equity at the end of the year, as compared with four cases a year ago.

The delinquency ratio of credit card lending stayed low at 0.22% at the end of 2017, compared with 0.24% a year ago (Chart 10). The combined delinquent and rescheduled loan ratio edged down to 0.31% from 0.33% during the period. The charge-off ratio also fell slightly to 1.75% from 1.92% in 2016.

Chart 10 Delinquency ratios of residential mortgages and credit card lending of banks



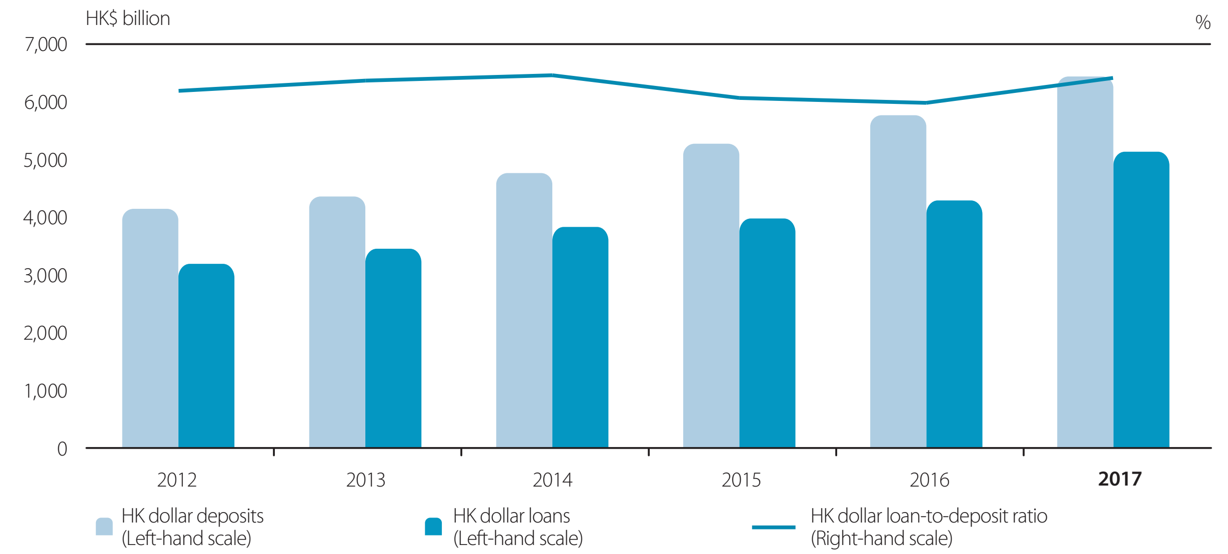
Mortgage delinquency ratio
Credit card delinquency ratio

Balance sheet trends

Total loans of the banking sector grew by 16.1% in 2017, compared with 6.5% in 2016. Demand for credit increased, driven by optimism about the global economic outlook. As total deposits increased at a slower pace than total loans, the overall loan-to-deposit ratio rose to 73% at the end of 2017 from 68.4% a year earlier. The Hong Kong-dollar loan-to-deposit ratio also increased to 82.7% from 77.1% during the same period (Chart 11).

Mainland-related lending (including loans booked in Mainland subsidiaries of locally incorporated banks) increased by 17.5% in 2017, compared with a growth of 7% recorded in 2016.

Chart 11 Hong Kong-dollar loans and deposits of the banking sector



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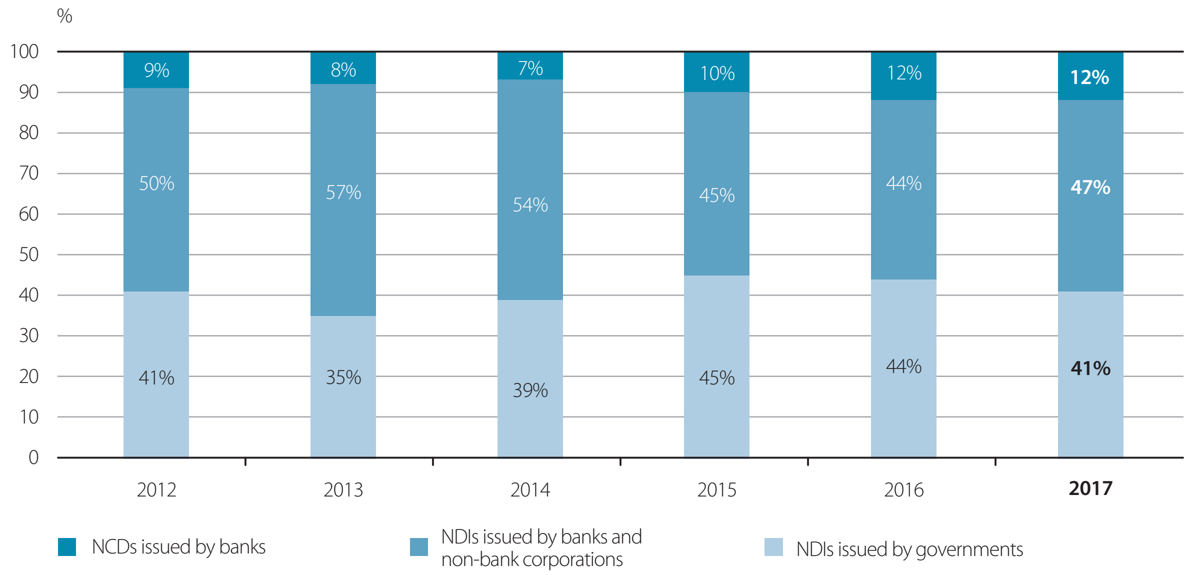
Holdings of negotiable debt securities

Holdings of negotiable debt instruments (NDIs) and negotiable certificates of deposit (NCDs) of the banking sector increased by 7.3% in 2017, accounting for 22% of the total assets at the end of the year (22% at end-2016). 41% of the holdings were NDIs issued by governments (44% at end-2016), 47% were NDIs issued by banks and non-bank corporations (44% at end-2016), and 12% were NCDs issued by banks (12% at end-2016) (Chart 12).

Chart 12 Holdings of NDIs and NCDs of the banking sector

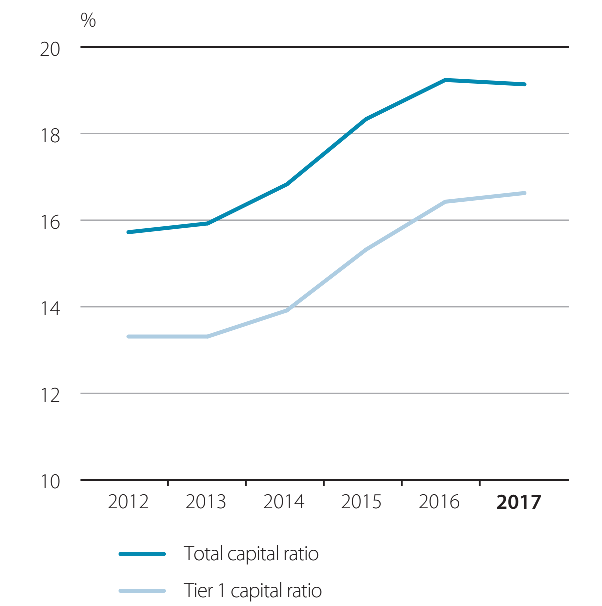


Note: Figures may not add up to 100% due to rounding.

Capital adequacy and liquidity

Locally incorporated AIs continued to be well capitalised. Their consolidated total capital ratio edged down to 19.1% at the end of 2017 from 19.2% at the end of 2016 (Chart 13). The Tier 1 capital ratio of locally incorporated AIs rose slightly to 16.6% from 16.4% during the period.

Chart 13 Consolidated capital adequacy ratios of locally incorporated AIs



The liquidity position of AIs remained sound. The average Liquidity Coverage Ratio (LCR) of category 1 institutions was 155.1% in the fourth quarter of 2017, well above the statutory minimum requirement of 80% applicable for the year. The average Liquidity Maintenance Ratio (LMR) of category 2 institutions was 49.4%, also well above the statutory minimum requirement of 25% (Chart 14).

Capital Adequacy Ratio
19.1%

Liquidity Coverage Ratio
155.1%

Liquidity Maintenance Ratio
49.4%

Chart 14 Liquidity ratios (quarterly averages)