# Economic and Financial Environment

Hong Kong's economic expansion continued in 2018 but its momentum softened during the year amid tighter financial conditions and heightened uncertainty due to rising trade protectionism. Economic growth for 2019 is expected to moderate along with weakening global economic expansion.

# THE ECONOMY IN REVIEW

## Real activities

The Hong Kong economy expanded further in 2018 but its year-on-year growth rate moderated successively from 4.6% in the first quarter to 1.3% in the final quarter (Table 1). This dragged the full-year growth rate down to 3.0%, compared with 3.8% in 2017. The weakening economic expansion reflected slower domestic demand growth and a continued drag from net exports (Chart 1). Domestically, private consumption increased strongly in the first quarter, but then lost steam, in part reflecting heightened uncertainty due to rising trade protectionism and some negative wealth effects associated with local asset price corrections. Overall investment spending also grew at a slower pace amid fragile business confidence. Externally, exports of goods broadly held up in the first three quarters but performance worsened visibly in the fourth quarter as the US-China trade tensions escalated. Imports of goods also slackened on weaker export-induced demand. In comparison, exports of services recorded faster annual growth partly driven by vibrant inbound tourism, and imports of services broadly maintained their growth momentum due to rises in transport, business and other services. On a net basis, net trade turned from a surplus in 2017 to a small deficit in 2018, making a negative contribution to Gross Domestic Product (GDP) growth.

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

| (%Period-over-period, unless otherwise specified) | 2018 | | | | | 2017 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **Q1** | **Q2** | **Q3** | **Q4** | **2018** | Q1 | Q2 | Q3 | Q4 | 2017 |
| **Gross Domestic Product** | **1.9** | **(0.3)** | **0.1** | **(0.3)** | **3.0** | 0.8 | 0.8 | 0.8 | 1.1 | 3.8 |
| (year-on-year growth) | **4.6** | **3.5** | **2.8** | **1.3** | | 4.4 | 4.0 | 3.6 | 3.5 | |
| Private consumption expenditure | **3.2** | **(0.9)** | **0.6** | **0.2** | **5.6** | 0.7 | 1.9 | 1.8 | 1.8 | 5.5 |
| Government consumption expenditure | **1.8** | **1.0** | **0.7** | **1.4** | **4.2** | 0.3 | 1.2 | 1.6 | (0.3) | 2.8 |
| Gross domestic fixed capital formation | **–** | **–** | **–** | **–** | **2.2** | – | – | – | – | 2.9 |
| Exports | | | | | | | | | | |
| Exports of goods | **1.8** | **(0.4)** | **1.2** | **(2.7)** | **3.5** | 1.5 | (0.1) | 1.0 | 2.2 | 6.5 |
| Exports of services | **5.3** | **(3.6)** | **0.5** | **0.7** | **4.9** | 1.1 | (1.7) | 2.7 | 1.3 | 2.9 |
| Imports | | | | | | | | | | |
| Imports of goods | **1.6** | **(0.2)** | **3.1** | **(5.0)** | **4.9** | 1.0 | 0.2 | 1.8 | 2.9 | 7.3 |
| Imports of services | **3.8** | **(2.5)** | **0.7** | **0.1** | **2.2** | 0.5 | 1.4 | (1.7) | 0.7 | 2.1 |

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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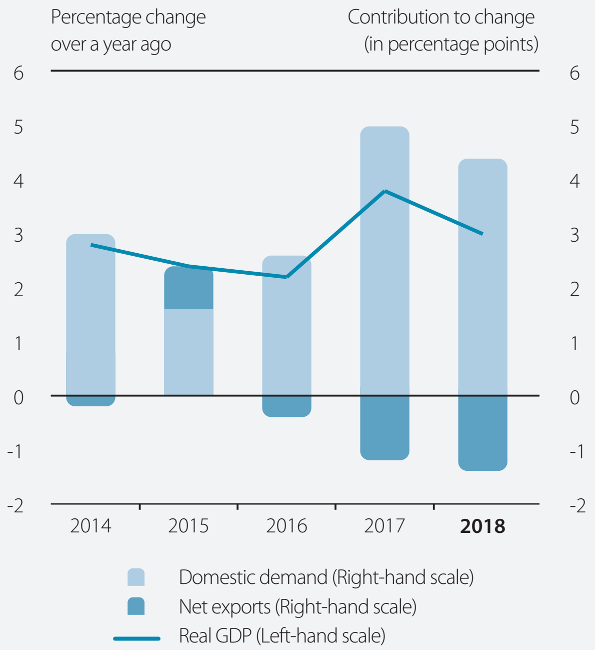
**Chart 1 Real GDP growth by contribution**




*Source: Census and Statistics Department.*

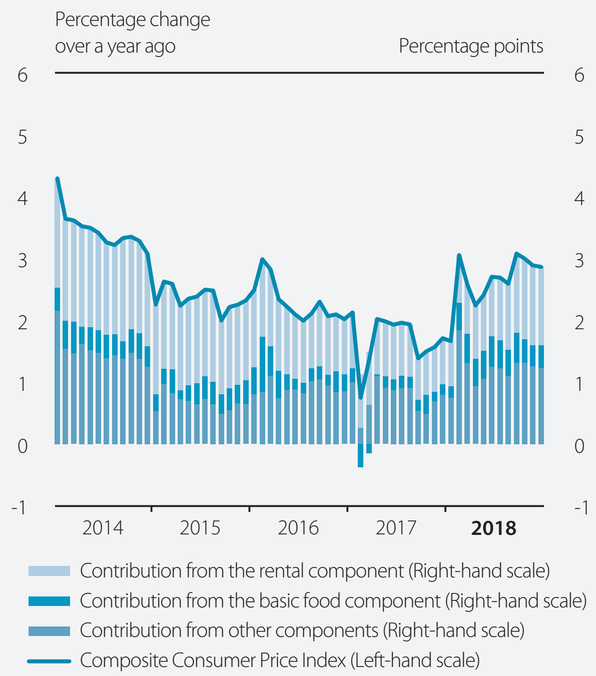
## Monetary conditions

The Hong Kong dollar exchange rate generally eased against the US dollar during 2018, driven primarily by interest carry trade activities amid the negative Hong Kong dollar-US dollar interest rate differentials. In particular, the weak-side Convertibility Undertaking was triggered in April, May and August, prompting the HKMA to purchase Hong Kong dollars from, and sell US dollars to, banks at the rate of HK$7.85/US$1, as stipulated by the Linked Exchange Rate System (LERS). As a result, the Hong Kong dollar Monetary Base shrank in accordance with the design of the LERS, signalling reduced interbank liquidity. This, coupled with market expectations of US interest rate hikes, led to a general pick-up in the Hong Kong dollar interbank interest rates. As the funding cost of the banking system increased, banks raised their Best Lending Rates by 12.5–25 basis points following the increase in the target range for the US Federal Funds Rate in late September. For credit growth, total bank loans increased at a notably slower pace of 4.4% in 2018, compared with 16.1% in 2017, due in part to softening domestic economic growth and weaker external trade performance.

## Inflation

Inflationary pressures increased mildly in 2018. Netting out the effects of the Government's one-off relief measures, the underlying inflation rate edged up to a still-moderate level of 2.6% in 2018, from a low of 1.7% in 2017. In particular, the housing component of the price index increased faster, reflecting the pass-through of the earlier rises in fresh-letting private residential rentals (Chart 2). More broadly, domestic cost pressures turned more visible due to modestly faster growth in nominal labour costs and commercial rentals. Import price inflation also climbed along with higher inflation in some of Hong Kong's major import sources.

**Chart 2 Underlying consumer price inflation**




*Source: Census and Statistics Department.*

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## Labour market

Labour market conditions remained robust in 2018 (Chart 3). For the year as a whole, the unemployment rate edged down from 3.1% in 2017 to 2.8% in 2018, the lowest level since 1997. In particular, the unemployment rates in most of the major service sectors, especially the accommodation and food services sector, moderated. Overall labour demand continued to strengthen as total employment and the number of private-sector vacancies grew further, and the labour force participation rate inched up. Amid a tight labour market, real wage and earnings posted further gains.

**Chart 3 Labour market conditions**


*Source: Census and Statistics Department.*

## Stock market

The local stock market experienced a drastic turnaround in 2018. Following the strong upward momentum in 2017, the Hang Seng Index rose to a historical high of 33,484 in January 2018 (Chart 4). However, the bullish sentiments reversed sharply afterwards amid concerns about monetary policy tightening by major central banks, the escalation of US-China trade tensions, and the weakening domestic economy. The Hang Seng Index fell to a low of 24,586 in October and closed the year at 25,846, down by 13.6% from a year earlier. Despite the decline, the average daily turnover expanded to HK$107.4 billion in 2018 from HK$88.2 billion in 2017, and funds raised through initial public offerings soared due to the listings of several companies from emerging and innovative sectors.

**Chart 4 Asset prices**


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

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### Property market

The residential property market remained buoyant in the first half of 2018, but cooled down in the second half amid the escalating US-China trade tensions, global stock market corrections and higher local prime rates. The overall housing prices decreased by 9% from the peak in July through December, though still recorded a gain of 2% for the whole year (Chart 4). Transaction volume in 2018 also fell by 7% from a year earlier to 57,247 units, as trading activities in both primary and secondary markets declined notably in the second half of the year. Housing affordability remained stretched, with the price-to-income ratio and the income-gearing ratio staying high at 17.0 and 75.7 respectively, far above their long-term averages.[1] On the other hand, non-residential property prices increased overall in 2018, though it also showed some cool-off towards the end of the year. For the year as a whole, prices and rentals recorded further gains and rental yields continued to stay at low levels.

## OUTLOOK FOR THE ECONOMY

### Economic environment

Economic growth for 2019 is expected to moderate as the global economic expansion wanes. In particular, Hong Kong's export performance is expected to continue to struggle in a challenging external environment. Domestically, low unemployment rate and rising household income will continue to support private consumption, but its pace of growth is anticipated to ease partly owing to weaker consumer confidence and the negative wealth effects from earlier asset price corrections. For fixed capital formation, the outlook may become more uncertain. While building and construction activities should progress steadily on the back of increasing housing supply, firms may become more cautious about making capital investments amid the heightened economic uncertainty. The Government forecasts real GDP growth for 2019 in the range of 2–3%, while the latest growth forecasts by private-sector analysts averaged 2.3%.

### Inflation and the labour market

Inflationary pressures are expected to remain moderate in 2019 as weaker global growth, including that of Hong Kong, may keep external price and local cost pressures in check. The recent moderation in fresh-letting residential rentals would also have a dampening effect on inflation. Market consensus forecasts a headline inflation rate of 2.2% in 2019, and the Government projects the underlying inflation rate at 2.5%. Sustained economic growth and still-robust inbound tourism are expected to keep the labour market tight. Private sector analysts expect the unemployment rate to stay at about 3% in 2019.

### Uncertainties and risks

The economic outlook for 2019 is subject to a number of uncertainties and risks, including those stemming from the trade tensions, the future direction of the US monetary policy, Mainland's economic performance, as well as Brexit and other geopolitical concerns. Should these uncertainties intensify and persist into the longer term, they could significantly dampen financial market sentiments and business confidence, thereby posing downward pressures on the local asset markets and domestic real activities.

On the property front, a host of external and domestic factors make the outlook for the local housing market uncertain. Externally, the uncertainty over US-China trade tensions will continue to cloud Hong Kong's property market outlook possibly through changes in market sentiments, economic prospects and financial conditions. Domestically, economic growth is softening but employment conditions and income growth have remained largely stable which could provide some support for property demand. The trajectory for domestic interest rates partly hinges on the future path of the US policy rate, which in itself is uncertain. Over the longer term, the supply-demand gap is expected to narrow given increased flat completions during the past few years and the Government's efforts to increase land and housing supply.

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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's prudential measures.

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## PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained resilient in 2018 notwithstanding external headwinds and heightened financial market volatility stemming from the US-China trade conflict, Brexit and interest rate normalisation. The capital and liquidity positions of the banking sector were strong and asset quality remained good. Profitability increased significantly, underpinned by widening interest rate margins amid an environment of rising interest rates.

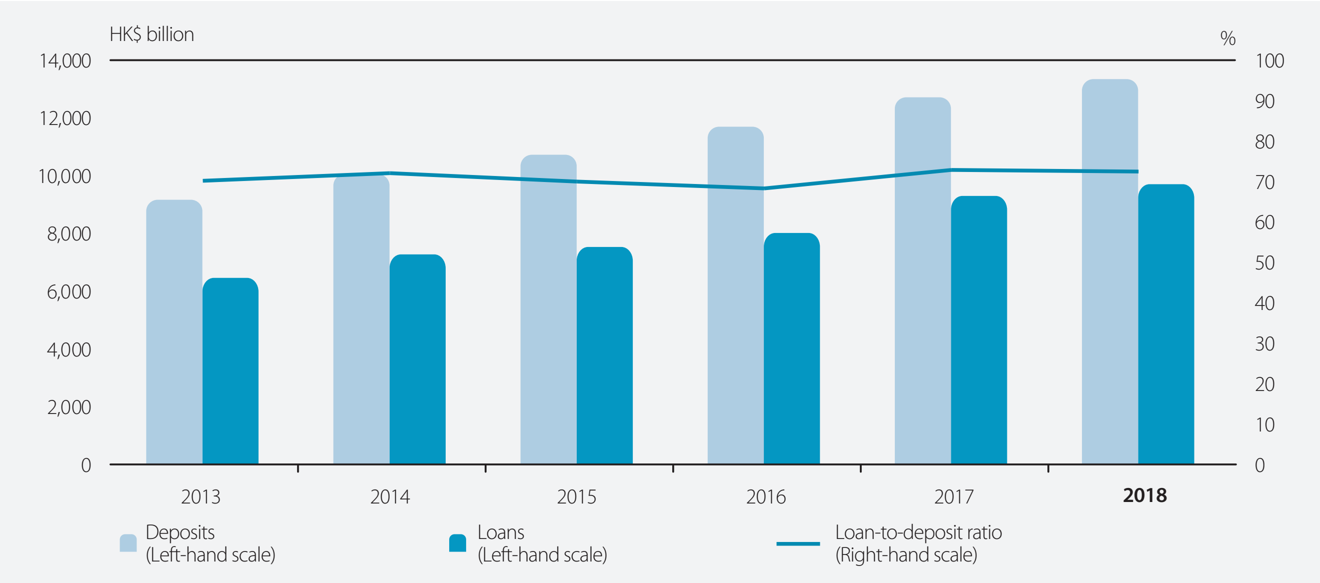
### Balance sheet trends

The banking sector continued to show stable growth, with the balance sheet expanding by 5.9% in 2018. Amid the lingering economic uncertainties, such as trade conflicts among major economies and interest rate hikes, corporations became more conservative in obtaining new loans. Total loan growth moderated to 4.4% during the year, compared with an increase of 16.1% in 2017. The growth was driven by increases in loans for use in Hong Kong (+6.5%) and loans for use outside Hong Kong (+2%). On the other hand, trade finance registered a decline of 7.6%, given the uncertainties in the global trade environment. The growth in Mainland-related lending also slowed to 1.4% in 2018, from 17.5% in 2017.

Debt securities holdings continued to account for 22% of total assets at the end of 2018, on par with that of 2017. The credit risk of these holdings remained low, as most of them were investment-grade debt securities issued by sovereigns and banks.

On the liabilities side, total deposits increased by 5% in 2018, a slower pace than 2017 (+8.7%). In anticipation of continued US interest rate hikes, some banks offered higher time deposit rates to lock up funding, enticing depositors to shift their current and saving account (CASA) deposits to time deposits. The ratio of CASA deposits to total deposits declined to 51.4% at the end of 2018 from 57.4% a year ago, leading to a higher funding cost. As total deposits increased at a faster pace than total loans, the overall loan-to-deposit ratio edged down to 72.6% at the end of 2018 from 73% a year ago (Chart 5).

**Chart 5 Loans and deposits of the banking sector**



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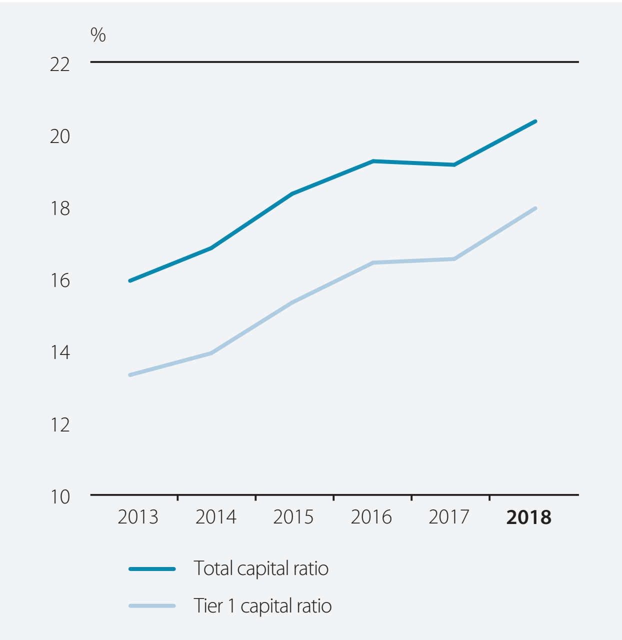
## Capital adequacy

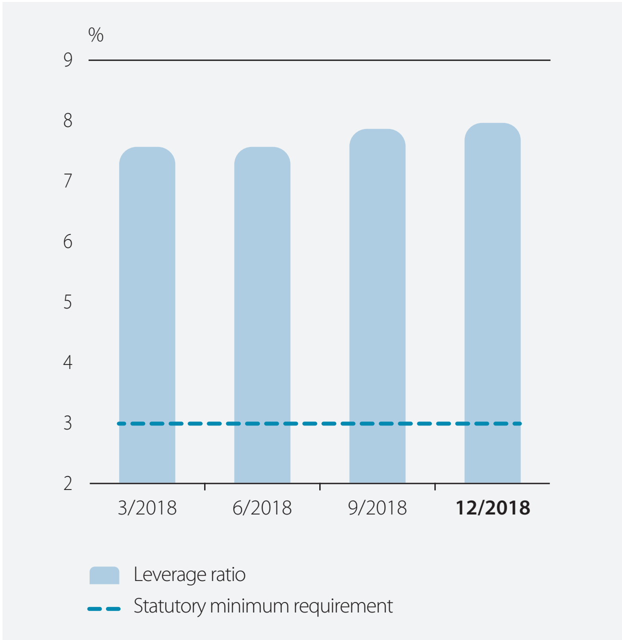
The banking sector was highly capitalised, indicating its strong buffer to withstand potential shocks. Capital ratios reached historical high levels since the implementation of Basel III. The consolidated total capital ratio of locally incorporated authorized institutions (AIs) increased to 20.3% at the end of 2018 from 19.1% at the end of 2017 (Chart 6).

**Chart 6 Consolidated capital ratios of locally incorporated AIs**




The Basel III leverage ratio, a non-risk based requirement aiming to restrict the build-up of excessive leverage in the banking sector, took effect on 1 January 2018. The leverage ratio stood at 8.0% at the end of 2018, well above the statutory minimum requirement of 3% (Chart 7).

**Chart 7 Consolidated leverage ratio of locally incorporated AIs**



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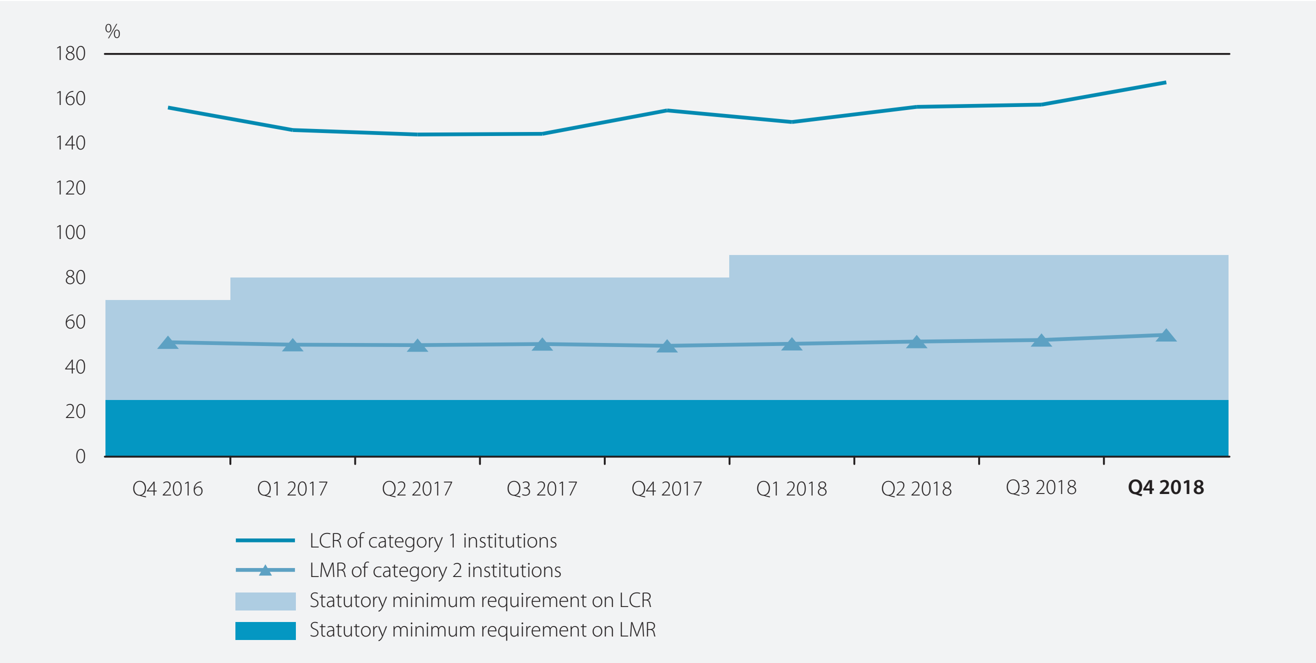
## Liquidity

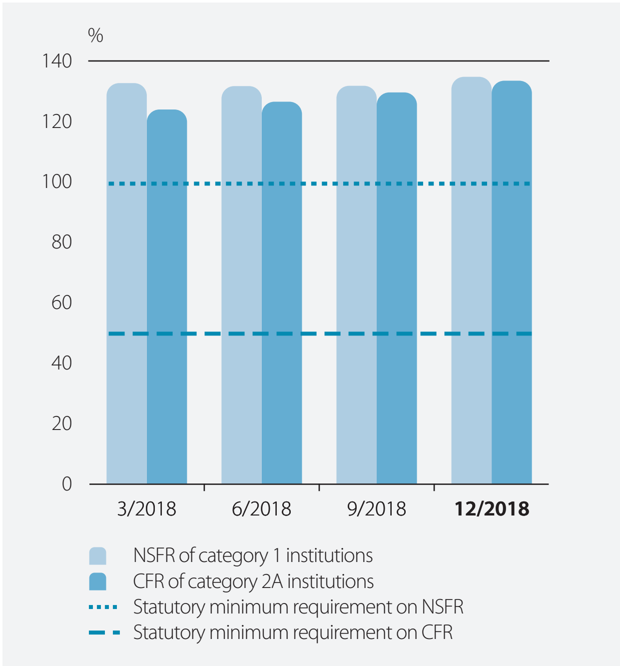
The liquidity position of the banking sector remained sound, reflecting its strong ability to absorb shocks arising from potential financial and economic stress. On short-term liquidity (covering one month), the average Liquidity Coverage Ratio (LCR) of category 1 institutions was 167.6% in the fourth quarter, well above the statutory minimum requirement of 90% applicable for the year. The average Liquidity Maintenance Ratio (LMR) of category 2 institutions was 54.3%, also well above the statutory minimum requirement of 25% (Chart 8).

**Chart 8 Liquidity ratios (quarterly averages) of designated AIs**




To ensure that banks have sufficient stable funding sources to support their activities over a longer horizon, the Basel III Net Stable Funding Ratio (NSFR) and local Core Funding Ratio (CFR) were implemented in Hong Kong with effect from 1 January 2018. The NSFR of category 1 institutions was 135.6% at end-2018, well above the statutory minimum requirement of 100%. The CFR of category 2A institutions was 134.3%, also well above the statutory minimum requirement of 50% applicable for 2018 (Chart 9). The strong liquidity and stable funding positions of banks suggested that the banking sector was able to withstand a variety of potential liquidity shocks.

**Chart 9 Funding ratios of designated AIs**



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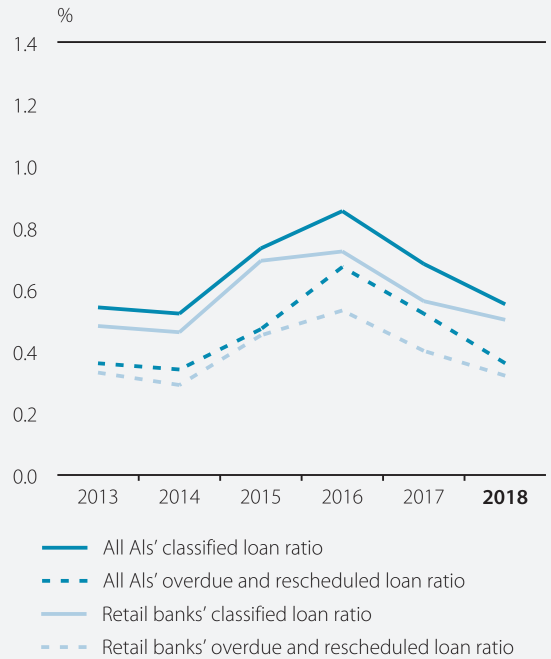
## Asset quality

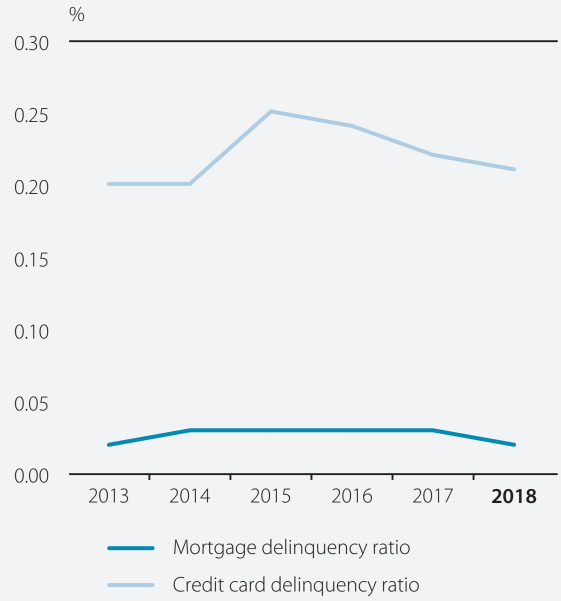
The loan quality of the banking sector remained good, notwithstanding heightened global economic and political uncertainties. The classified loan ratio decreased to 0.55% in 2018 from 0.68% a year earlier. The overdue and rescheduled loan ratio also decreased to 0.36% from 0.52% (Chart 10). Similarly, the classified loan ratio of Mainland-related lending decreased to 0.54% at the end of 2018 from 0.67% a year earlier. The delinquency ratios of residential mortgage lending and credit card lending remained low at 0.02% and 0.21% respectively (Chart 11).

**Chart 10 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.

**Chart 11 Delinquency ratios of residential mortgages and credit card lending**



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## Profitability trends

The profitability of banks continued to grow, strengthening banks' loss absorption capacity. The aggregate pre-tax operating profit of retail banks increased by 19.4% in 2018, mainly driven by an increase in net interest income (+21.8%), which was in turn the result of a widening net interest margin to 1.62% in 2018, compared to 1.45% in 2017 (Charts 12 and 13). On the other hand, the upsurge in income from foreign exchange and derivatives operations (+29.4%) also contributed to the profitability improvement.

Retail banks have generally become more efficient. Their cost-to-income ratio was lowered to 38.7% in 2018 from 41.9% in 2017 (Chart 14).

**Chart 12 Retail banks' performance**

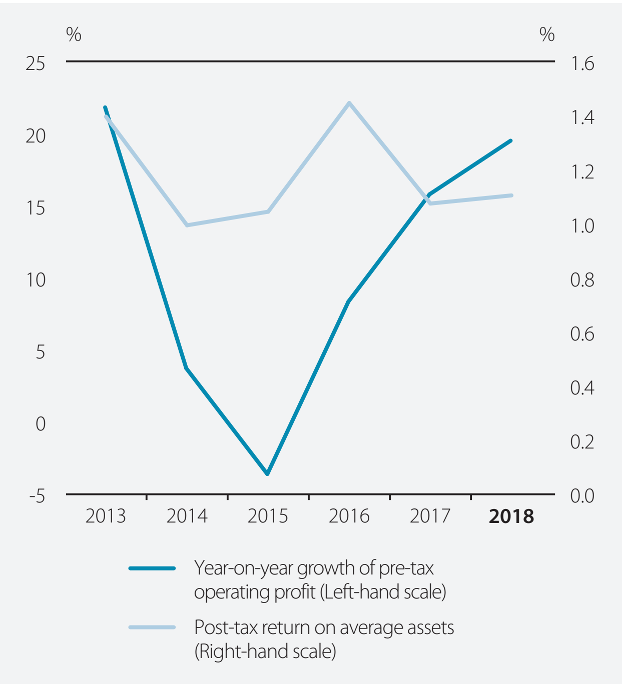


**Chart 13 Retail banks' net interest margin**

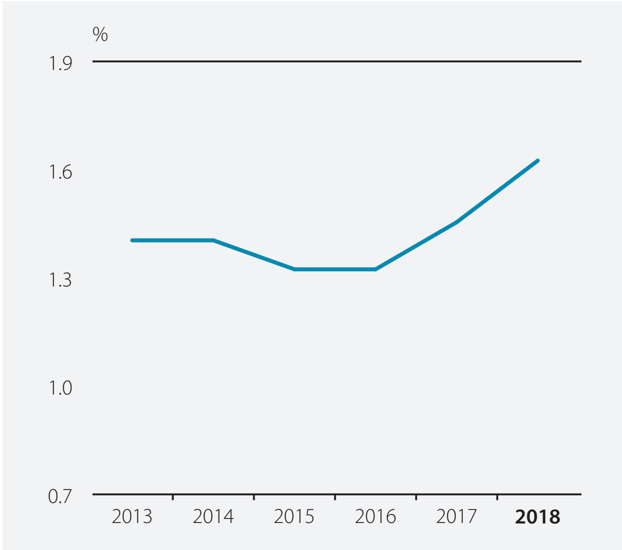


**Chart 14 Retail banks' cost-to-income ratio**