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The Hong Kong economy contracted in 2019, reflecting global economic slowdown, lingering US-China trade conflicts and local social incidents. As economic conditions deteriorated rapidly in the second half of the year, the labour market faced increasing pressures. Inflation also increased due to a sharp rise in pork prices. Economic performance for 2020 is expected to remain challenging as the novel coronavirus outbreak hits the already weakening economy. Given the difficult economic environment, the Government and the HKMA have rolled out measures to support the economy, especially households and small and medium-sized enterprises.

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THE ECONOMY IN REVIEW

Real activities

Following a 2.9% expansion in 2018, the Hong Kong economy contracted by 1.2% in 2019, marking the first annual contraction since 2009. In particular, the economy entered into a recession in the second half of the year, with the seasonally adjusted real Gross Domestic Product (GDP) shrinking consecutively in the second, third and fourth quarters (Table 1). The decline in economic activities reflected a notable reduction in domestic demand (Chart 1). As the local social incidents weighed significantly on consumption activities and sentiments in the latter part of the year, private consumption expenditure recorded the first annual decline since 2003. Overall investment spending also dropped amid dampened business sentiments. On the external front, slowing global economic growth and additional tariffs levied amid the US-China trade tensions led to a decline in Hong Kong's exports of goods. Exports of services also saw the largest annual decline on record because the social incidents led to a severe deterioration in inbound tourism. With smaller domestic and re-export-induced demand, imports of goods and services also worsened. On a net basis, net trade contributed positively to GDP in 2019 (Chart 1) because total imports declined even faster than total exports.

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

(% Period-over-period, unless otherwise specified)	**2019**					2018				
	Q1	**Q2**	**Q3**	**Q4**	**2019**	Q1	Q2	Q3	Q4	2018
Gross Domestic Product	**0.9**	**(0.4)**	**(3.0)**	**(0.3)**	**(1.2)**	1.5	(0.1)	0.1	(0.3)	2.9
(year-on-year growth)	**0.7**	**0.4**	**(2.8)**	**(2.9)**		4.5	3.4	2.6	1.1	
Private consumption expenditure	**0.8**	**0.1**	**(4.1)**	**0.5**	**(1.1)**	2.8	(0.6)	0.4	(0.1)	5.3
Government consumption expenditure	**1.0**	**0.8**	**2.6**	**1.6**	**5.1**	1.6	1.4	0.5	1.5	4.3
Gross domestic fixed capital formation	**–**	**–**	**–**	**–**	**(12.3)**	–	–	–	–	1.7
Exports										
Exports of goods	**(1.7)**	**(1.6)**	**(1.2)**	**1.9**	**(4.7)**	1.6	0.1	0.7	(2.8)	3.5
Exports of services	**1.0**	**(3.6)**	**(13.4)**	**(11.0)**	**(10.4)**	4.7	(2.8)	0.0	1.2	4.6
Imports										
Imports of goods	**(2.2)**	**(2.6)**	**(2.0)**	**(0.5)**	**(7.4)**	1.4	0.1	2.8	(4.8)	4.7
Imports of services	**0.4**	**0.4**	**(5.7)**	**0.0**	**(2.3)**	4.1	(2.2)	0.3	0.3	2.7

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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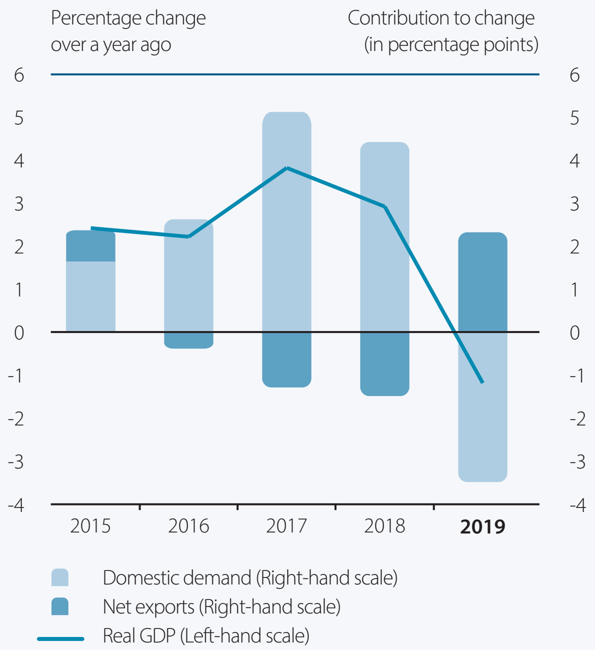
Chart 1 Real GDP growth by contribution



Source: Census and Statistics Department.

In view of the strong economic headwinds, the Government introduced several rounds of measures between August and December 2019 to alleviate the financial burden of residents, safeguard jobs and support enterprises, particularly small and medium-sized enterprises (SMEs) as well as those in the hard-hit sectors, such as retail, food services, transport and tourism. To allow banks to be more supportive to the domestic economy and help mitigate the economic cycle, the HKMA announced on 14 October a reduction in the Countercyclical Capital Buffer ratio of banks from 2.5% to 2.0%, thereby providing banks with more flexibility to release HK$200–300 billion in bank credit to enterprises including SMEs, and also established a Banking Sector SME Lending Coordination Mechanism. A new relief measure for the 80% Guarantee Product of the SME Financing Guarantee Scheme (SFGS) was introduced in September, allowing SME borrowers facing weakening cash flows to apply for principal moratorium to get immediate support. Further, a new 90% loan guarantee product under the SFGS was introduced in December to provide additional support to SMEs, businesses with relatively less operating experience, as well as professionals seeking to set up their own practices, to obtain financing.

Monetary conditions

The Hong Kong dollar exchange rate and money markets functioned in a smooth and orderly manner in 2019. The Hong Kong dollar exchange rate remained broadly stable throughout the year. As the weak-side Convertibility Undertaking was triggered in March, the HKMA purchased Hong Kong dollars from, and sold US dollars to, banks at the rate of HK$7.85/US$1, leading to a decline in the Aggregate Balance in accordance with the design of the Linked Exchange Rate System. The Hong Kong dollar interbank interest rates remained largely steady at the longer end, while short-term rates generally picked up. At the retail level, several retail banks lowered their Best Lending Rates by 12.5 basis points in late October following the decreases in the target range for the US federal funds rate. As for monetary aggregates, total bank loans increased by 6.7% in 2019, up from 4.4% in 2018, and total deposits grew by 2.9% during the year.

Inflation

The underlying inflation rate, which nets out the effects of the Government's one-off relief measures, rose slightly to 3.0% in 2019, from 2.6% in 2018. The mild increase in inflation was mainly driven by the elevated pork prices due to the disrupted supply of fresh pork since May (Chart 2). Excluding basic food items, price pressures were held at moderate levels throughout the year. In particular, the housing component of consumer price inflation softened in tandem with an earlier consolidation of fresh-letting private residential rentals. More broadly, the mild growth in nominal wages and the slower increase in commercial rentals[1] helped keep local business costs in check. Externally, import price inflation moderated, in line with lower inflation in some of Hong Kong's major import sources amid slower global economic growth.

[1] Amid the local social incidents, some landlords of commercial properties reportedly provided tenants with temporary rent cuts in the latter part of the year.

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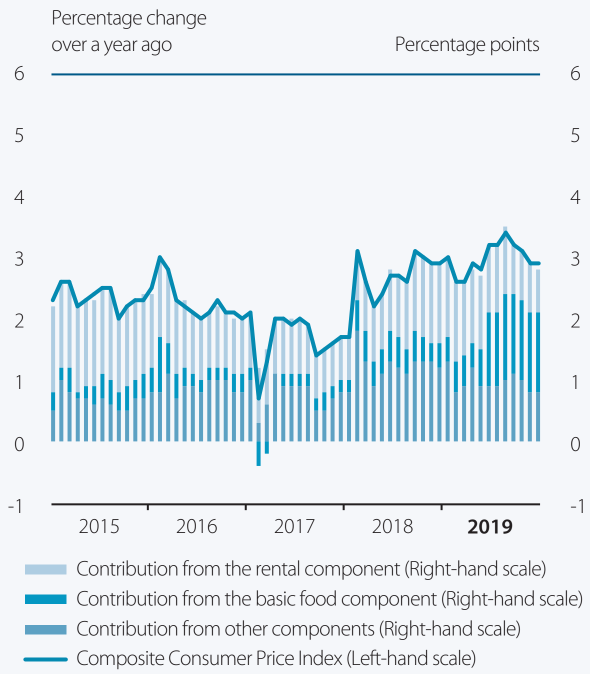
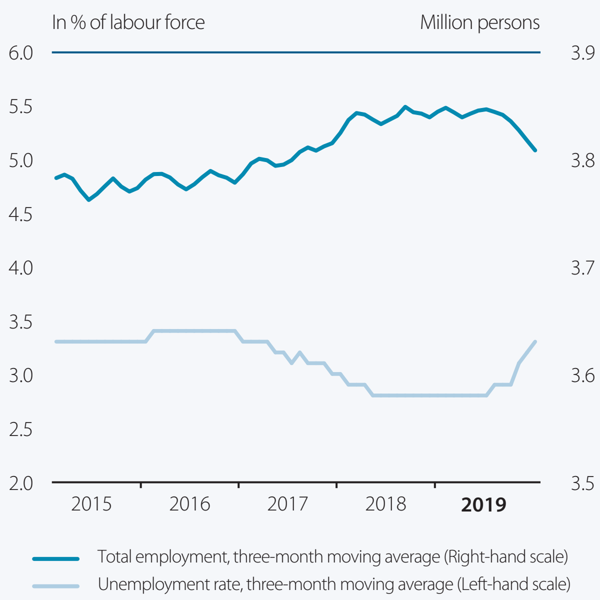
Chart 2 Underlying consumer price inflation



Source: Census and Statistics Department.

Chart 3 Labour market conditions



Source: Census and Statistics Department.

Labour market

The labour market remained broadly resilient in the first half of 2019 but faced mounting pressures in the second half (Chart 3). After staying at a multi-year low of 2.8% in the first two quarters, the seasonally adjusted unemployment rate rose to 2.9% in the third quarter and 3.3% in the final quarter, with those for the consumption and tourism-related sectors recording even more visible rises amid the social incidents. Overall labour demand also shrank visibly in the latter part of the year as total employment and the number of private-sector vacancies fell. The reduction in labour demand was particularly prominent in the retail, accommodation and food services sectors, as well as import/export trade and construction sectors. On the supply side, the labour force participation rate edged down, partly due to a cyclical response to the economic recession. As the labour market came under increasing pressures, growth in nominal wage and earnings showed signs of a slowdown towards the end of the year.

Stock market

The local stock market experienced sharp fluctuations during 2019. After a market rally in the first four months, the Hang Seng Index plunged in May due in part to concerns about the re-escalation of the US-China trade tensions (Chart 4). While recouping some lost ground in June in response to major central banks' signals of a more accommodative monetary stance, stock prices came under pressure again amid slowing global economic growth and local social incidents. Towards the end of the year, stock prices regained some upward momentum following the announcement of a "phase one" trade agreement between the US and Mainland China. The Hang Seng Index finished the year at 28,190, registering an overall gain of 9.1% for the year. By contrast, the average daily turnover declined by about 19% from a year earlier. The listings of a major Mainland tech company and a leading beer manufacturer helped expand equity funds raised through initial public offerings (IPOs) to HK$314.2 billion in 2019. Hong Kong ranked first globally in terms of funds raised through IPOs for a second straight year in 2019.

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Chart 4 Asset prices

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

Property market

The residential property market staged a strong rebound in the first five months of 2019 but generally softened in the remainder of the year. Market sentiment improved in early 2019 partly because concerns over US-China trade tensions temporarily eased, but the sentiment was dampened afterwards by the re-escalated US-China trade tensions, prolonged social incidents and weakened domestic economic conditions. Overall housing prices moderated by 5% from the peak in May through December, though still recording an annual growth of 5% due to a 10% rebound in the first five months (Chart 4). Transaction volume in 2019 increased by 4% to 59,797 units from a year earlier, reflecting the strong trading activities in the early part of the year. Housing affordability remained stretched, with the price-to-income ratio and the income-gearing ratio staying high at 17.9 and 80.9 respectively, far above their long-term averages.[2] To assist home buyers with immediate housing needs, the Hong Kong Mortgage Corporation (HKMC) in mid-October raised the cap on the value of completed residential properties eligible for a mortgage loan under the Mortgage Insurance Programme.[3] On the other hand, the non-residential property market faced stronger downward pressures in 2019. In particular, both prices and rentals for retail premises registered the largest declines since the global financial crisis in 2008, reflecting the worsening business conditions during the year.

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[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's prudential measures.

[3] The HKMC amended the Mortgage Insurance Programme on 16 October 2019. For details, see "Amendments to the Mortgage Insurance Programme" issued by the HKMC.

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OUTLOOK FOR THE ECONOMY

Economic environment

Hong Kong's economic performance for 2020 is expected to be very challenging, with significant near-term downside risks associated with the coronavirus outbreak. Some sectors, such as retail, accommodation, food services, tourism and transport, which have yet to recover from the disruptions caused by the social incidents, will be doubly hit. However, the countercyclical fiscal measures announced in the 2020/21 Budget, which include a one-off cash handout and a new concessionary low-interest loan under the SFGS with 100% Government guarantee, are expected to provide some support to the economy, especially households and SMEs. On 16 March 2020, the HKMA further reduced the Countercyclical Capital Buffer ratio of banks from 2.0% to 1.0%, which will allow banks to be more supportive to the domestic economy, in particular those sectors and individuals that are expected to experience additional short-term stress due to the impact arising from the coronavirus outbreak. Analysed by GDP component, private consumption and investment are likely to remain weak because of the fragile consumer and business confidence. While government consumption will contribute to economic growth, public investment expenditure is anticipated to be relatively sluggish following the completion of some major infrastructure projects. On the external front, the "phase one" trade deal between the US and Mainland China is assessed to be slightly positive for the local economy in the short term. However, Hong Kong's external trade performance will continue to be weighed down by weak global economic growth and trade flows. In particular, the coronavirus outbreak may lead to regional supply chain disruptions and slower cross-border economic activities, in tourism for example, thereby restraining Hong Kong's exports. The Government forecasts real GDP growth for 2020 in the range of -1.5% to 0.5%, while growth forecasts by international organisations and private-sector analysts averaged -3.3%.

Inflation and the labour market

Inflationary pressures are expected to moderate in 2020 because of the sub-par economic conditions, the consolidation of private residential rentals and mild imported inflation. Market consensus forecasts a headline inflation rate for 2020 of 1.8%, and the Government projects the headline and underlying inflation rates to be 1.7% and 2.5% respectively. In the labour market, the unemployment rate is likely to rise further in the near term, given the weakened economic prospects and the coronavirus outbreak. Private-sector analysts expect the unemployment rate to rise to about 4.0% in 2020.

Uncertainties and risks

The subdued economic outlook for 2020 is subject to a number of uncertainties and risks, including those stemming from the slowing global economy, US-China trade relations, Mainland's economic performance, local social incidents and the persistence of the coronavirus outbreak. In particular, a prolonged coronavirus outbreak could trigger a more visible global economic slowdown and a repricing of assets, with the resulting unfavourable macroeconomic environment and tighter financial conditions posing further downward pressures on domestic real activities. However, the more concerted effort by major central banks to ease their monetary policies may provide a cushion against the negative economic impact inflicted by the outbreak.

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PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector was resilient in 2019 despite the challenging environment with the global economic slowdown, US-China trade tensions and local social incidents. Bank balance sheet trends were stable, as both loans and deposits grew moderately. The capital and liquidity positions of the banking sector remained solid and asset quality held up well. The banking sector remained profitable with stable average return on asset.

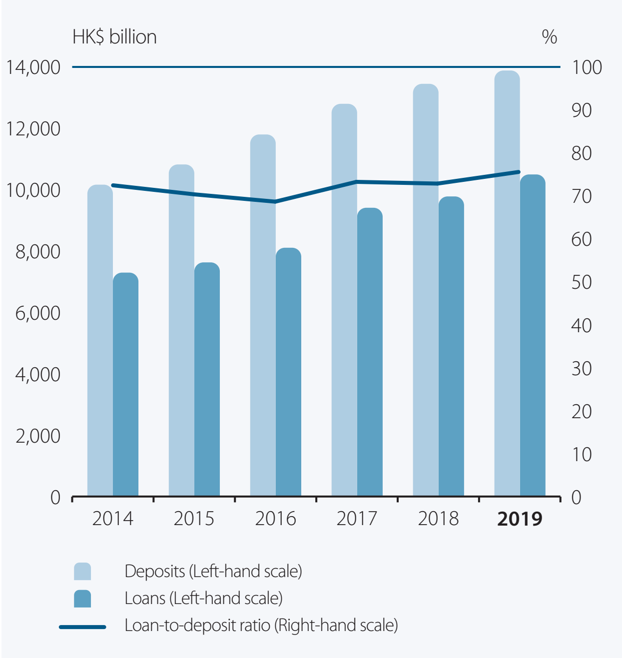
Balance sheet trends

The banking sector's balance sheet grew by 1.7% in 2019. While local and global headwinds weighed on consumer and investment sentiments, total loans increased modestly by 6.7% during the year, compared with 4.4% in 2018. Among the total, loans for use in Hong Kong grew by 7.7%, loans for use outside Hong Kong grew by 5.8%, while trade finance decreased by 0.7%. Growth in Mainland-related lending accelerated to 7.4% in 2019, from 1.5% in 2018.

Debt securities holdings accounted for 23% of total assets at the end of 2019, compared with 22% at the end of 2018. The credit risk associated with these holdings remains low as they are mostly investment-grade debt securities issued by sovereigns and banks.

On the liabilities side of bank balance sheets, total deposits increased by 2.9% in 2019, compared with 5.0% in 2018. Deposit fluctuations during the year were within historical norms and were driven by a wide range of transient factors, such as seasonal and initial public offering-related funding demand as well as business and investment-related activities. As total deposits increased at a slower pace than total loans, the overall loan-to-deposit ratio rose to 75.3% at the end of 2019 from 72.6% a year ago (Chart 5).

Chart 5 Loans and deposits of the banking sector



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Capital adequacy

The capital positions of the banking sector strengthened further in 2019, providing banks with a strong buffer to withstand potential shocks. The consolidated total capital ratio of locally incorporated authorized institutions (AIs) improved to 20.7% at the end of 2019 from 20.3% at the end of 2018 (Chart 6), while the Tier 1 capital ratio was at 18.5%, up from 17.9% in 2018.

The Basel III leverage ratio, a "backstop" to the risk-based capital adequacy ratio that helps restrict the build-up of excessive leverage in the banking sector, rose to 8.2% at the end of 2019 from 8.0% in 2018, well above the statutory minimum requirement of 3% (Chart 7).

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

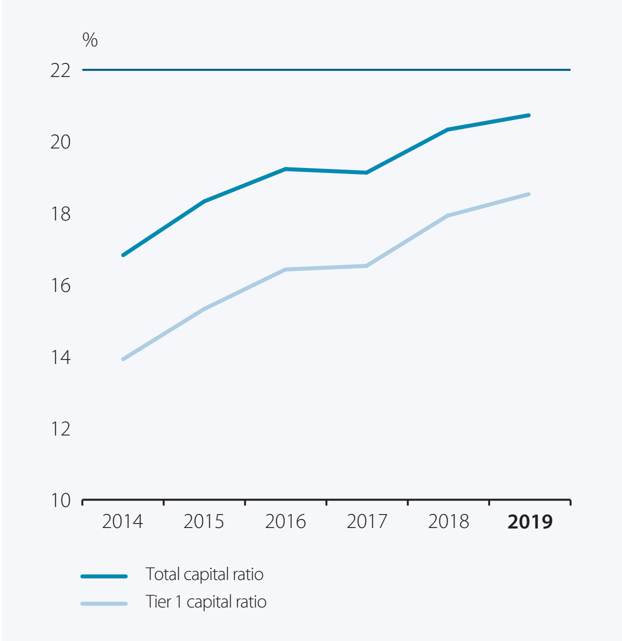

Chart 7 **Consolidated leverage ratio of locally incorporated AIs**

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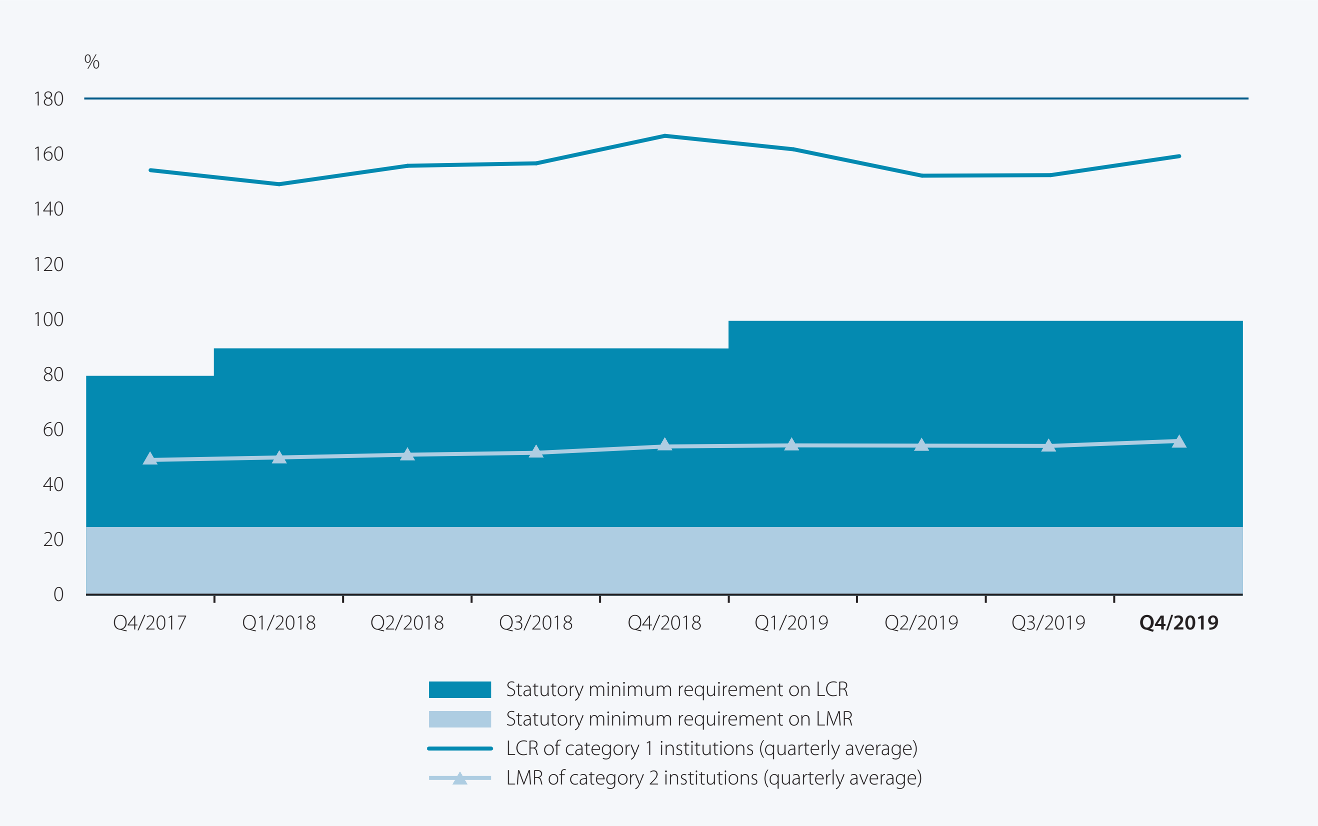
Liquidity

The liquidity position of the banking sector remains sound, indicating its strong ability to withstand liquidity shocks arising from financial and economic stress. For short-term liquidity needs of one month, the quarterly average Liquidity Coverage Ratio (LCR) of category 1 institutions was 159.9% in the fourth quarter, well above the statutory minimum requirement of 100% applicable for the year. The quarterly average Liquidity Maintenance Ratio (LMR) of category 2 institutions was 56.3%, also well above the statutory minimum requirement of 25% (Chart 8).

Chart 8 Liquidity ratios of designated AIs



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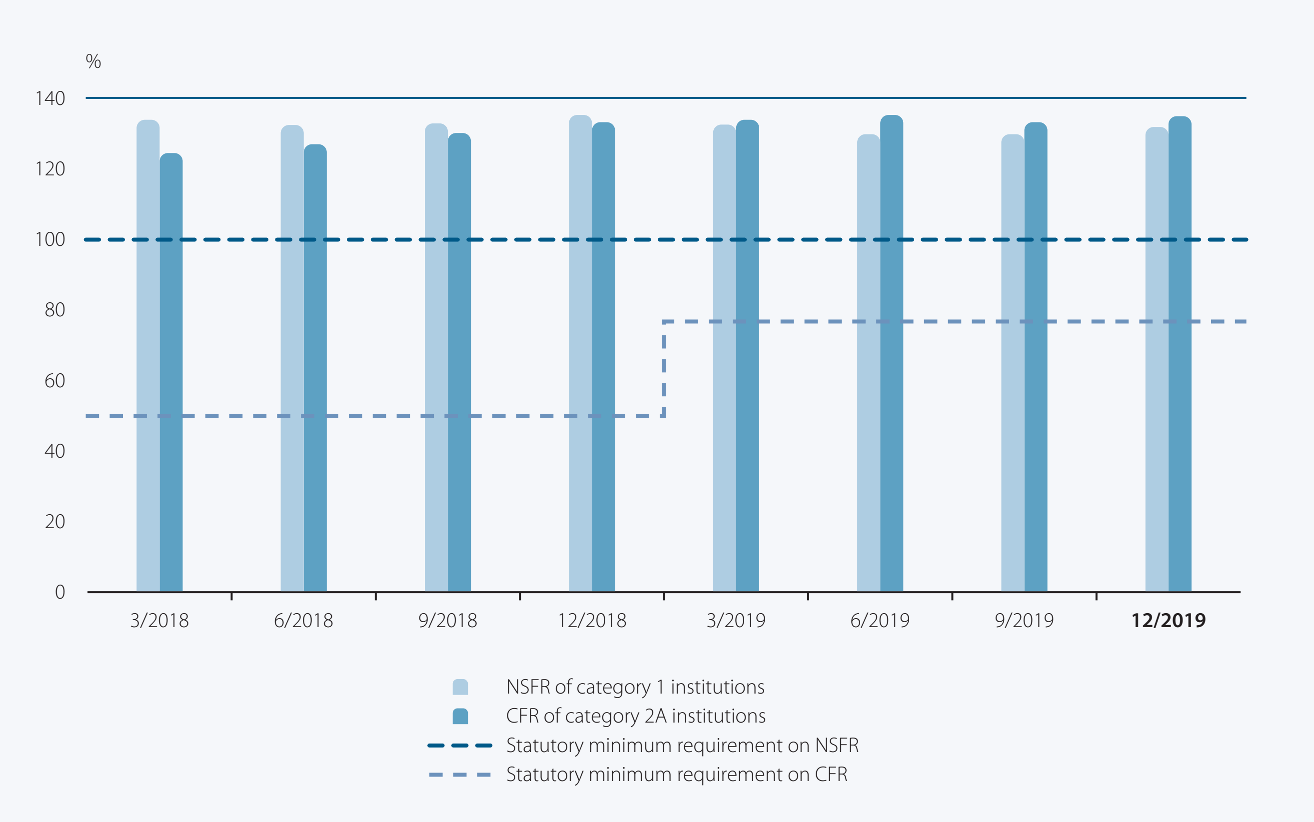
Assets held by the banking sector continue to be supported by stable sources of funding. The Net Stable Funding Ratio (NSFR) of category 1 institutions was 131.7% at the end of 2019, well above the statutory minimum requirement of 100%. The Core Funding Ratio (CFR) of category 2A institutions was 134.5%, also well above the statutory minimum requirement of 75% applicable for 2019 (Chart 9).

Chart 9 Funding ratios of designated AIs



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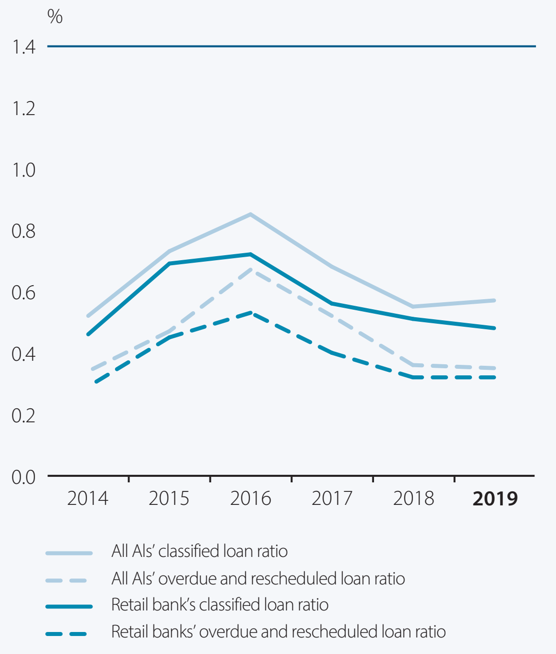
Asset quality

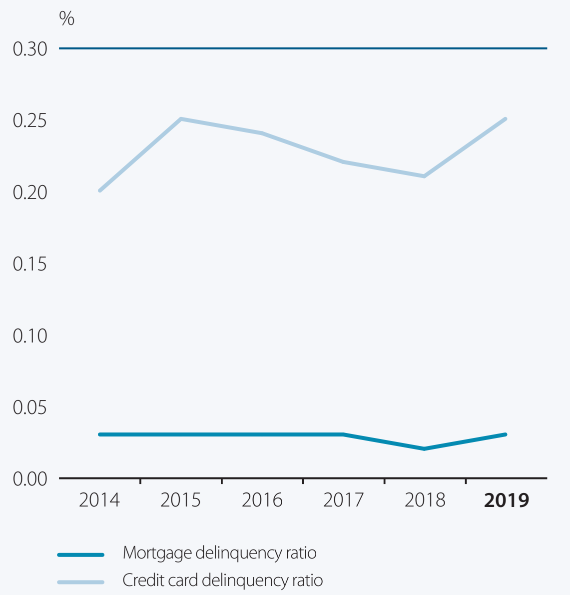
Despite the headwinds faced by the banking sector, asset quality remained good in 2019. The classified loan ratio remained low at 0.57% at the end of 2019 compared with 0.55% at the end of 2018, while the overdue and rescheduled loan ratio edged down to 0.35% from 0.36% (Chart 10). As for Mainland-related lending, the banking sector's classified loan ratio increased to 0.75% at the end of 2019 from 0.55% at the end of 2018, mainly driven up by several idiosyncratic credit events. The delinquency ratios of residential mortgage lending and credit card lending remained low at 0.03% and 0.25% 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 banking sector remained profitable although profitability was slightly lower than last year. The aggregate pre-tax operating profit of retail banks declined slightly by 0.4% in 2019 (Chart 12). An increase in total operating income (+2.9%) driven by net interest income (+6.2%) was offset by increases in total operating expenses (+4.9%) and loan impairment charges (+72.1%). The net interest margin widened slightly to 1.63% in 2019 from 1.62% in 2018 (Chart 13).

Retail banks generally maintained their efficiency. Their cost-to-income ratio edged up to 39.5% in 2019 from 38.7% in 2018 (Chart 14).

Chart 12 Retail banks' performance

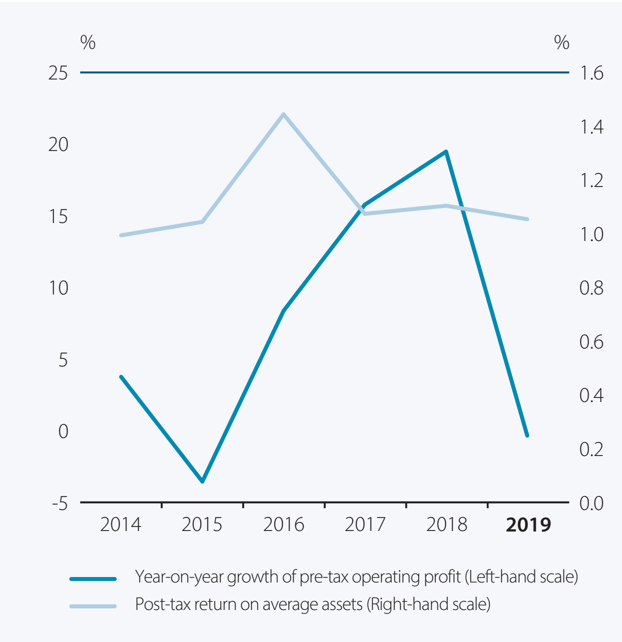

Chart 13 Retail banks' net interest margin

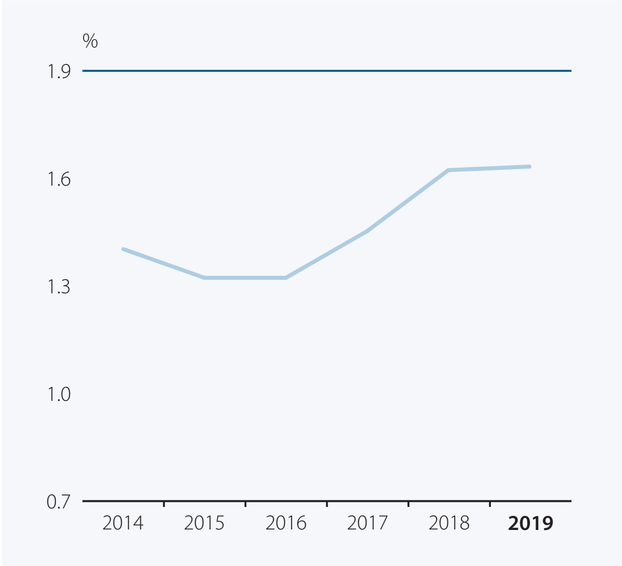

Chart 14 Retail banks' cost-to-income ratio