Economic and Financial Environment

The Hong Kong economy contracted for the second consecutive year and by the most severe magnitude on record amid the COVID-19 pandemic in 2020. Consumption and tourism-related sectors were particularly hard-hit, registering much steeper contractions than the overall economy. In tandem, the labour market deteriorated sharply while inflation moderated. In response to the challenging economic environment, the Government and the HKMA rolled out relief measures of unprecedented scale to support the economy. Economic growth is expected to resume in 2021 in the hope of COVID-19 vaccination normalising economic activities, albeit subject to a host of uncertainties that will affect the strength and pace of recovery, especially factors surrounding the pandemic situation and vaccine availability, reach and efficacy.

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THE ECONOMY IN REVIEW

Real activities

Battered by the COVID-19 pandemic, the Hong Kong economy contracted by 6.1% in 2020, marking the second consecutive year of annual contraction and the most severe one on record (Table 1). The steep fall in economic activities was driven mainly by a sharp reduction in domestic demand (Chart 1). Local consumption activities were severely disrupted by the outbreak and the resultant social distancing measures, while overall investment spending retreated noticeably in a worsening business environment. Externally, despite supply chain disruptions and global demand contraction induced by the pandemic, Hong Kong's export of goods saw only a slight decline for the year as a whole, in part supported by a quick resumption of production and economic activities in Mainland China. By contrast, export of services took a big hit as lockdowns, border closures and restricted passenger flows brought global tourism to a standstill. With weak domestic and re-export-induced demand, imports of goods and services also worsened. On net, trade contributed positively to gross domestic product (GDP) (Chart 1) because total imports declined faster than exports. Analysed by economic sector, consumption and tourism-related businesses, such as retail, accommodation and food services, were particularly hard-hit and recorded much steeper contractions than the overall economy, while the financial sector experienced mild growth.

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

	2020					2019				
(% Period-over-period, unless otherwise specified)	**Q1**	**Q2**	**Q3**	**Q4**	**2020**	Q1	Q2	Q3	Q4	2019
Gross Domestic Product	**(5.6)**	**(0.1)**	**2.7**	**0.2**	**(6.1)**	0.8	(0.3)	(3.0)	(0.4)	(1.2)
(year-on-year growth)	**(9.1)**	**(9.0)**	**(3.6)**	**(3.0)**		0.7	0.4	(2.8)	(3.0)	
Private consumption expenditure	**(7.2)**	**(3.9)**	**2.6**	**1.4**	**(10.1)**	0.8	0.2	(4.1)	0.3	(1.1)
Government consumption expenditure	**3.4**	**1.7**	**0.1**	**0.3**	**7.8**	0.9	0.8	2.5	1.7	5.1
Gross domestic fixed capital formation	**–**	**–**	**–**	**–**	**(11.5)**	–	–	–	–	(12.3)
Exports										
Exports of goods	**(8.5)**	**6.2**	**4.9**	**4.1**	**(0.3)**	(1.7)	(1.6)	(1.2)	2.0	(4.6)
Exports of services	**(16.2)**	**(16.1)**	**6.1**	**(4.9)**	**(36.8)**	1.0	(3.6)	(13.1)	(10.6)	(10.2)
Imports										
Imports of goods	**(6.2)**	**1.7**	**7.1**	**5.4**	**(2.1)**	(2.2)	(2.6)	(2.0)	(0.3)	(7.3)
Imports of services	**(20.0)**	**(26.1)**	**8.3**	**0.7**	**(35.1)**	0.3	0.5	(5.9)	(0.3)	(2.4)

Note: 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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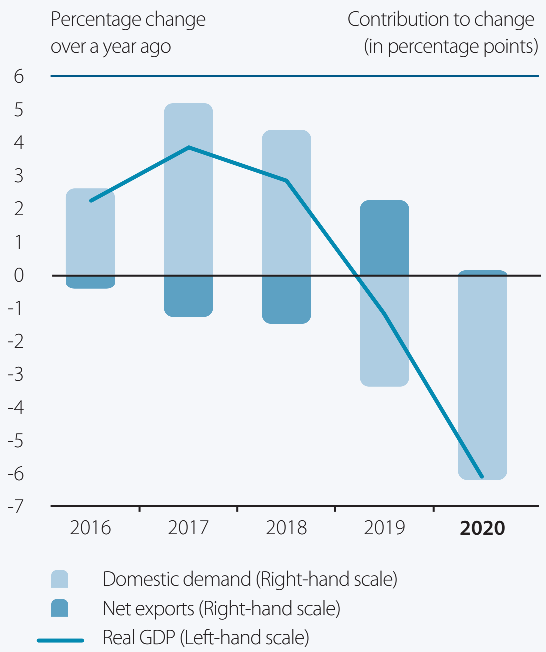
Chart 1 Real GDP growth by contribution



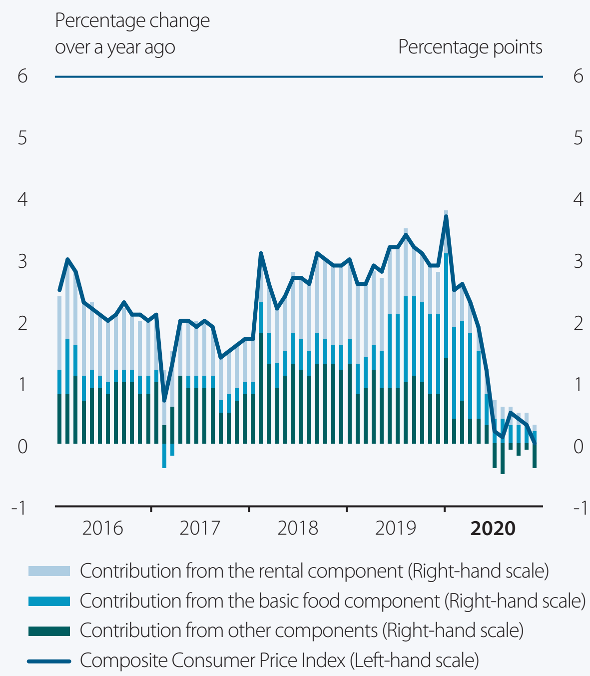
Source: Census and Statistics Department.

In response to the pandemic, the Government swiftly introduced relief measures of unprecedented scale totalling more than HK$300 billion through the 2020–21 Budget and dispensed four rounds of aid from the Anti-Epidemic Fund. These measures included a one-off cash transfer of HK$10,000 to eligible residents, wage subsidies through the Employment Support Scheme (ESS), as well as one-off subsidies, rent concessions and fee waivers for hard-hit sectors. On its part, the HKMA took a three-pronged approach to bolster the banking sector in support of the real economy. The measures comprised proactive coordination with the banking sector to ease cash flow pressures on enterprises and households, releasing buffers to boost the lending capacity of banks and ensuring that banks had abundant liquidity to support domestic economic activities[1].

Inflation

Inflationary pressures subsided notably in 2020. Netting out the effects of the Government's one-off relief measures, the underlying inflation rate decelerated to 1.3%, the slowest since the global financial crisis in 2009[2]. Price pressures on basic foodstuffs, particularly fresh pork, receded notably, and outside of home cooking, meals became cheaper in the second half of the year as restaurants offered deep discounts. The housing component of consumer price inflation also softened along with an earlier decline in fresh-letting private residential rentals (Chart 2). More broadly, domestic business cost pressures eased amid decelerated nominal wage growth and soft commercial rentals, while imported inflation moderated under the subdued global economic conditions.

Chart 2 Underlying consumer price inflation



Source: Census and Statistics Department.

1 As the pandemic lingers, some measures have been refined or extended. For example, the HKMA in March 2021 announced extending the Pre-approved Principal Payment Holiday Scheme to October 2021. These extensions are expected to ease cash flow difficulties faced by some corporate customers.

2 Inclusive of the effects of the Government's relevant one-off relief measures, the year-on-year headline inflation rate was negative between July and December, dragging down the full-year rate to merely 0.3%.

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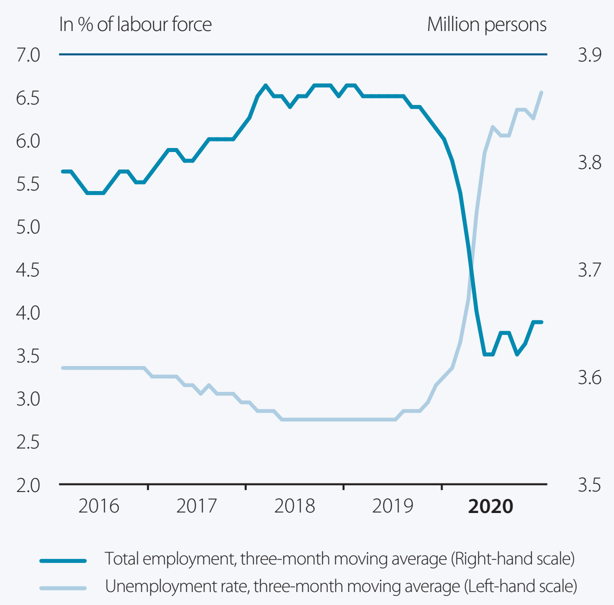
Labour market

The labour market deteriorated sharply in 2020. The seasonally adjusted unemployment rate surged from 3.3% to a 16-year high of 6.6% over the course of the year (Chart 3), with hard-hit sectors such as retail, accommodation and food services experiencing unemployment rates of over 10%. The underemployment rate also rose to a post-SARS high of 3.8% in August. The labour force participation rate edged down, due in part to a cyclical response to the sharp deterioration in economic conditions. Overall labour demand shrank further, as reflected by the steep fall in total employment (Chart 3) and private-sector vacancies. Growth in nominal wage and earnings slowed down further. To provide time-limited financial support to employers to retain employees, the Government launched the ESS, which lent some support to the labour market[3].

Chart 3 Labour market conditions



Source: Census and Statistics Department.

Stock market

The Hang Seng Index plunged to a three-year low during the first quarter alongside the COVID-19 outbreak but stabilised somewhat in the second and third quarters following massive support measures introduced by central banks and governments across the globe (Chart 4). Stock prices regained some upward momentum towards the end of the year on breakthroughs in COVID-19 vaccines. The Hang Seng Index finished the year at 27,231 points, registering an overall loss of 3.4% for the year. Underpinned by Mainland enterprises' secondary listing activities, Hong Kong ranked second globally in terms of the roughly HK$400 billion raised through initial public offerings in 2020.

Chart 4 Asset prices

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

3 Wage subsidies provided to eligible employers under the ESS covered 50% of the actual wage paid to each regular employee in a specified month, with a wage cap of HK$18,000 per month (i.e. the maximum subsidy per employee was HK$9,000 per month). The subsidies were disbursed in two tranches to pay the wages of employees from June to November. Employers participating in the ESS were required to undertake that they will not implement redundancies during the subsidy period and will spend all the wage subsidies on paying wages to their employees.

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Property market

Partly supported by ultra-low interest rates, the residential property market broadly held up in 2020 (Chart 4). Overall, both housing prices and transaction volumes were virtually unchanged compared with a year earlier. However, housing affordability became more stretched as household income declined. Meanwhile, the non-residential property market weakened further, with prices declining by varying degrees and transactions bottoming out. Rentals for office premises and retail spaces registered large declines, reflecting the economic fallout and higher vacancy. Given that the non-residential property market has seen major corrections since 2019 and will likely remain under pressure, and taking into account other factors such as economic fundamentals and the external environment, the HKMA adjusted countercyclical macroprudential measures on non-residential properties in August[4]. In view of the slackening market demand, the Government also abolished the Doubled Ad Valorem Stamp Duty in the purchase of non-residential properties as a demand management measure in November.

OUTLOOK FOR THE ECONOMY

Economic environment

Hong Kong's economy is expected to see positive growth for 2021 as a whole in the hope of COVID-19 vaccination normalising economic activities, albeit subject to a host of uncertainties that will affect the strength and pace of recovery, especially factors surrounding the pandemic situation and vaccine availability, reach and efficacy[5]. In particular, as it takes time for vaccines to be widely adopted, the local economy still faces considerable challenges in the early part of 2021. Externally, the Mainland economy is anticipated to strengthen further and render support to Hong Kong's export of goods and services, but the pace of recovery in other major economies will hinge on the success of their mass vaccination campaigns. The Government forecasts real GDP growth in the range of 3.5–5.5% for the whole of 2021, consistent with the average 4.4% projected by international organisations and private-sector analysts in their latest Hong Kong growth estimates.

Inflation and the labour market

Inflationary pressures are expected to remain muted in 2021 as global and local economic conditions are still challenging. In addition, the feed-through of the earlier decline in fresh-letting residential rentals will continue to restrain local inflation. Market consensus forecasts a headline inflation rate of 1.5% in 2021, while the Government projects the headline and underlying inflation rates to be 1.6% and 1% respectively. The labour market will remain under pressure in the near term, given the challenging outlook in the early part of 2021 and in view of expectations by private-sector analysts for the unemployment rate to remain high at about 5.9% for 2021 as a whole.

4 See the circular "Prudential Measures for Mortgage Loans on Non-residential Properties" issued by the HKMA on 19 August.

5 The economic outlook is subject to other uncertainties and risks, including those stemming from China-US relations under the new US administration, global geopolitics, rising debts worldwide and lofty valuations of global equity markets with signs of disconnecting from the real economy.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained resilient in 2020, underpinned by the solid financial positions of banks. Despite the challenges posed by the COVID-19 pandemic, bank balance sheets continued to grow, along with an expansion in deposit funding. The capital and liquidity positions of the banking sector continued to be strong. Asset quality deteriorated modestly but remained at a healthy level.

Balance sheet trends

The banking sector's balance sheet grew by 5.7% in 2020. As the economic downturn took hold, credit growth slowed to 1.2% during the year, compared with 6.7% in 2019. Loans for use in Hong Kong grew by 2.2% and loans for use outside Hong Kong grew marginally by 0.1%, while trade finance decreased by 6.2%. Mainland-related lending edged down by 0.2% in 2020, compared to a 7.4% growth in 2019.

On the liabilities side of bank balance sheets, total deposits increased by 5.4% in 2020, compared with 2.9% in 2019. As total deposits increased at a faster pace than total loans, the overall loan-to-deposit ratio decreased to 72.3% at the end of 2020 from 75.3% 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 remained robust in 2020, providing banks with a strong buffer to withstand potential shocks. The consolidated total capital ratio of locally incorporated authorized institutions (AIs) remained stable at 20.7% at the end of 2020 as compared to the end of 2019. The Tier 1 capital ratio increased slightly to 18.7% from 18.5% during the same period (Chart 6).

The Basel III leverage ratio remained steady at 8.2% at the end of 2020 as compared to the end of 2019, well above the statutory minimum requirement of 3% (Chart 7).

Chart 6 Consolidated capital ratios of locally incorporated AIs

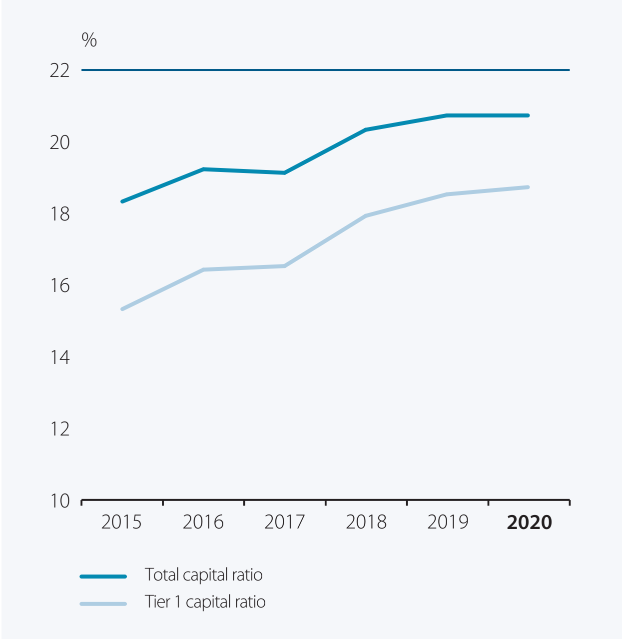
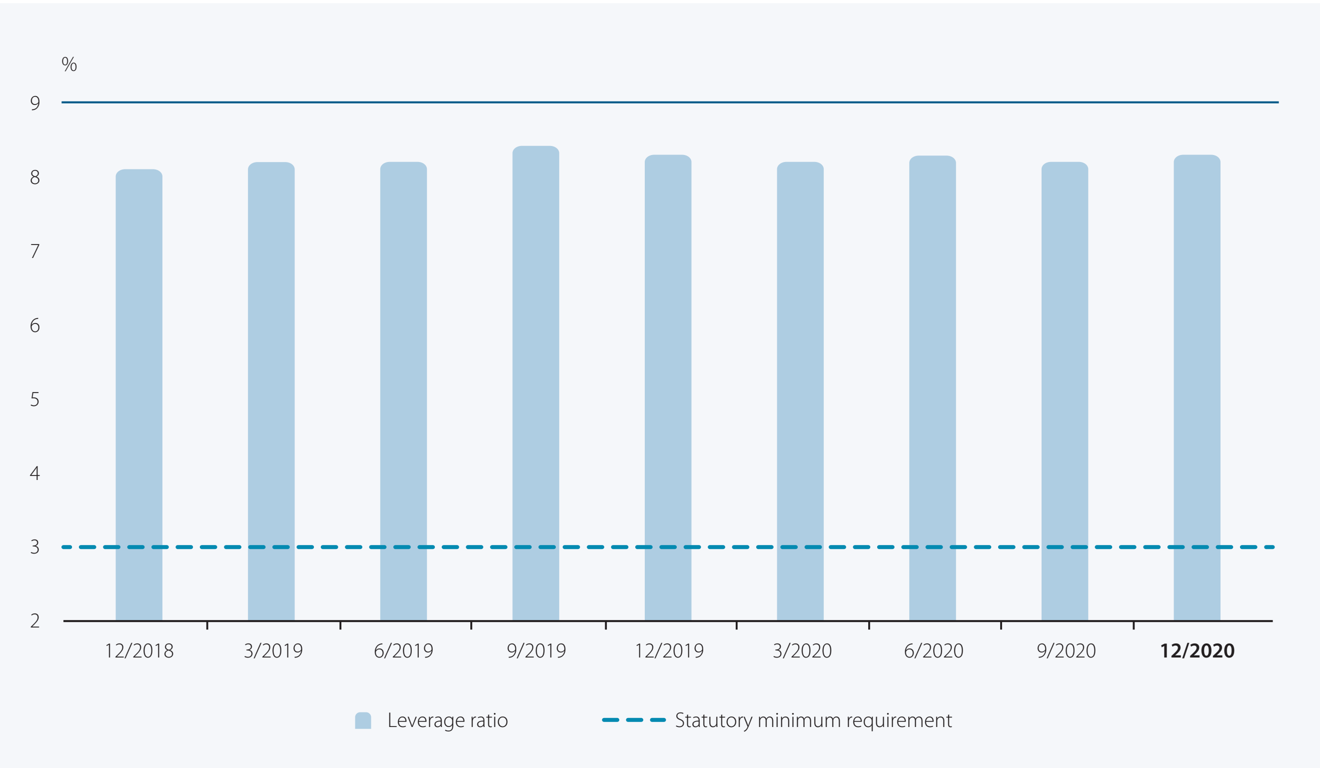


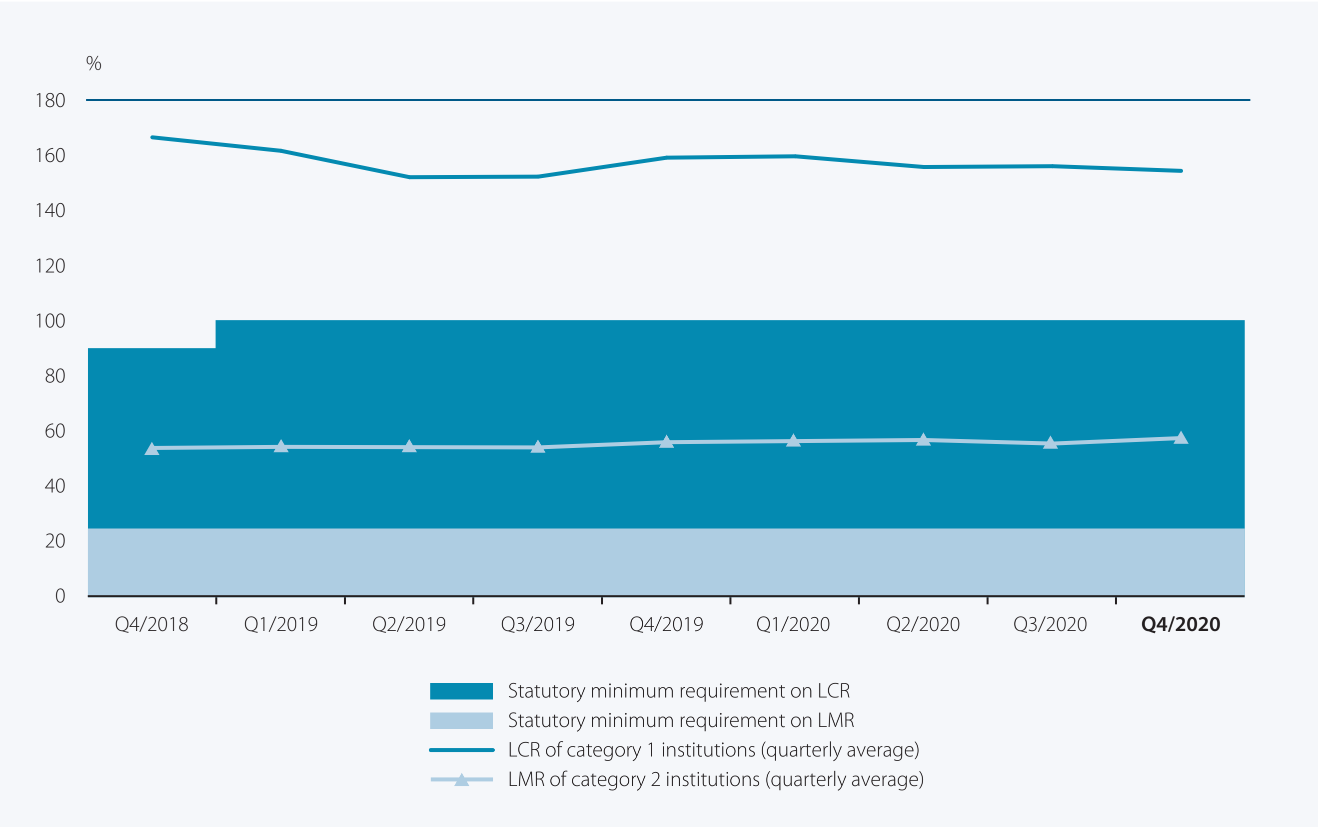
Chart 7 Consolidated leverage ratio of locally incorporated AIs



Liquidity

The liquidity position of the banking sector remained sound, indicating its ability to withstand liquidity shocks in times of stress. The quarterly average Liquidity Coverage Ratio (LCR) of category 1 institutions was 155.1% in the fourth quarter, well above the statutory minimum requirement of 100%. The quarterly average Liquidity Maintenance Ratio (LMR) of category 2 institutions was 57.9%, also well above the statutory minimum requirement of 25% (Chart 8).

Chart 8 Liquidity ratios of designated AIs



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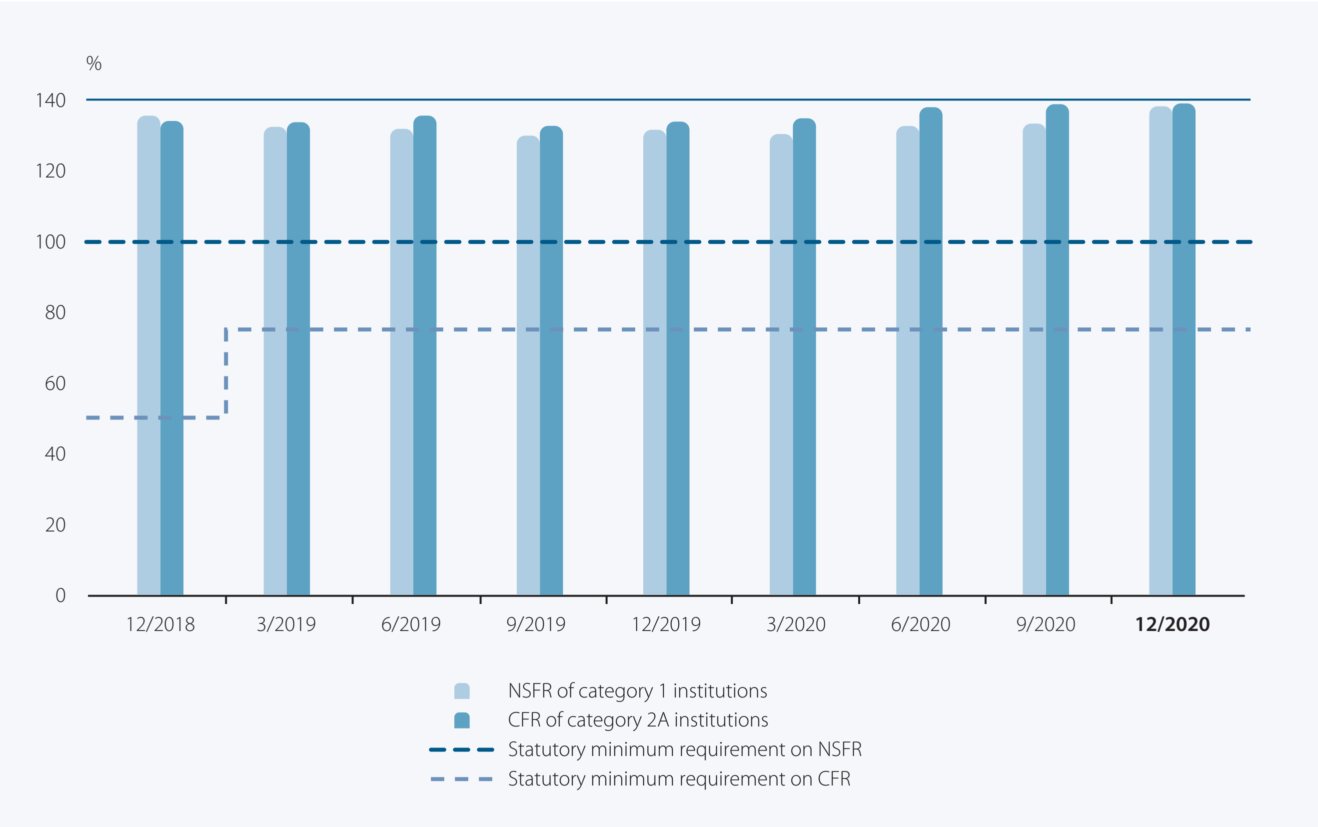
The sources of funding of the banking sector remained stable. The Net Stable Funding Ratio (NSFR) of category 1 institutions was 138.6% at the end of 2020, well above the statutory minimum requirement of 100%. The Core Funding Ratio (CFR) of category 2A institutions was 139.5% at the end of 2020, also well above the statutory minimum requirement of 75% (Chart 9).

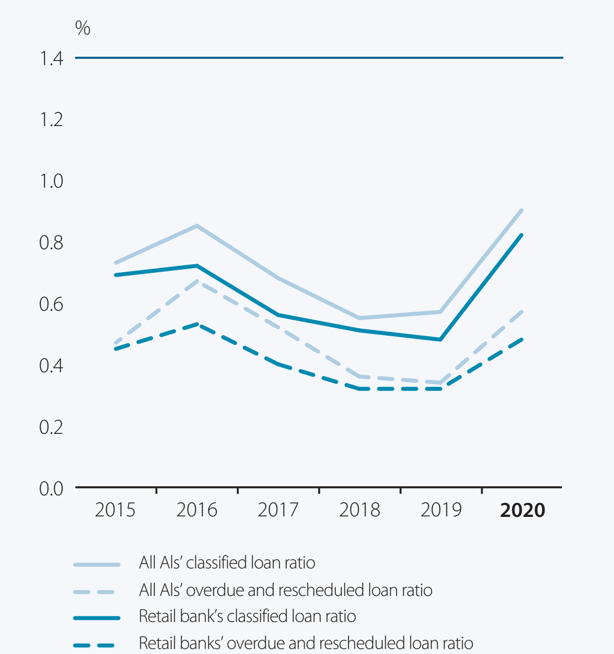
Chart 9 Funding ratios of designated AIs



Asset quality

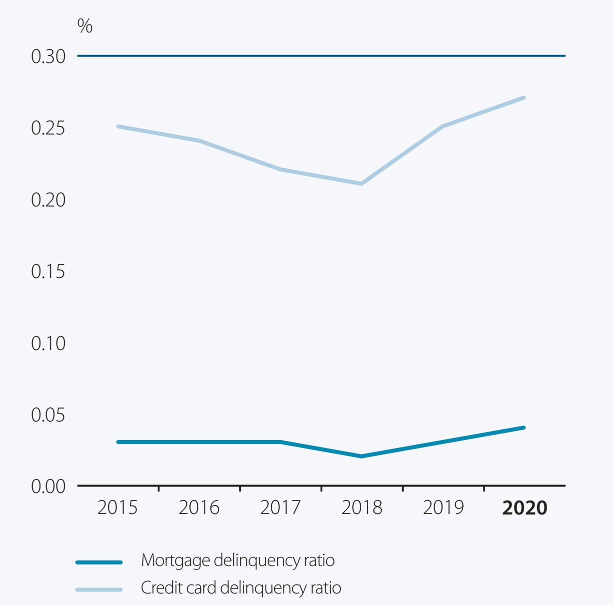
Reflecting the impact of the COVID-19 pandemic, asset quality deteriorated modestly during the year, but remained at a healthy level by historical and international standards. The classified loan ratio increased to 0.90% at the end of 2020, compared with 0.57% at the end of 2019, while the overdue and rescheduled loan ratio increased to 0.57% from 0.34% during the same period (Chart 10). As for Mainland-related lending, the banking sector's classified loan ratio increased to 0.96% at the end of 2020 from 0.75% at the end of 2019. The delinquency ratios of residential mortgage lending and credit card lending remained low at 0.04% and 0.27% respectively (Chart 11).

Chart 10 Asset quality of the banking sector



Note: Figures covered Hong Kong offices, overseas branches and major overseas subsidiaries.

Chart 11 Delinquency ratios of residential mortgages and credit card lending



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Profitability trends

The low interest rate environment, together with a modest deterioration in asset quality, compressed the profits of the banking sector. The aggregate pre-tax operating profit of retail banks declined by 29.4% in 2020 (Chart 12), mostly attributable to a contraction in net interest income (-21.9%) and a surge in loan impairment charges (+61.3%). The net interest margin narrowed to 1.18% in 2020 from 1.63% in 2019 (Chart 13).

Driven by the decrease in income, retail banks' cost-to-income ratio increased to 46.8% in 2020 from 39.5% in 2019 (Chart 14).

Chart 12 Retail banks' performance

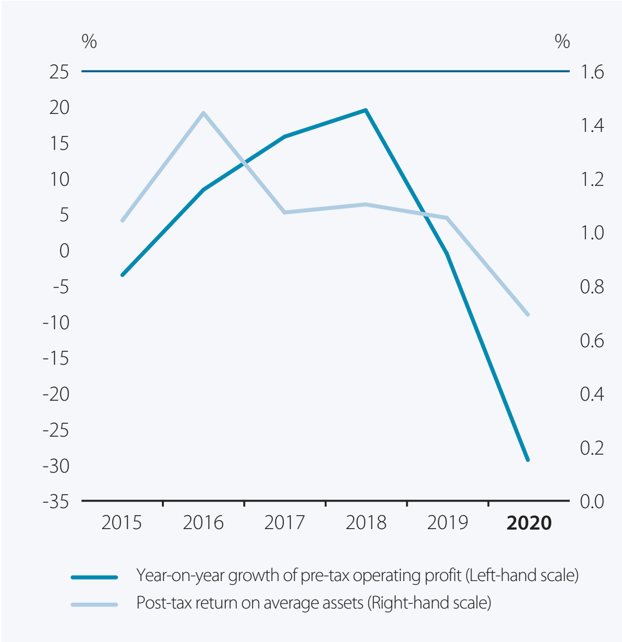

Chart 13 Retail banks' net interest margin

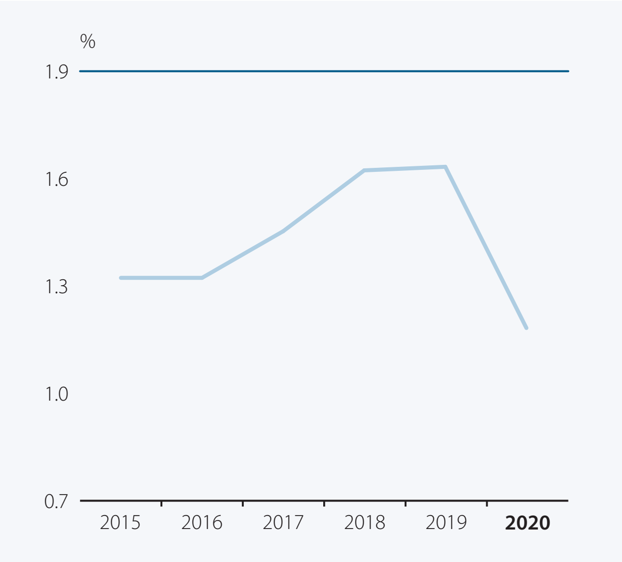

Chart 14 Retail banks' cost-to-income ratio