Economic and Financial Environment

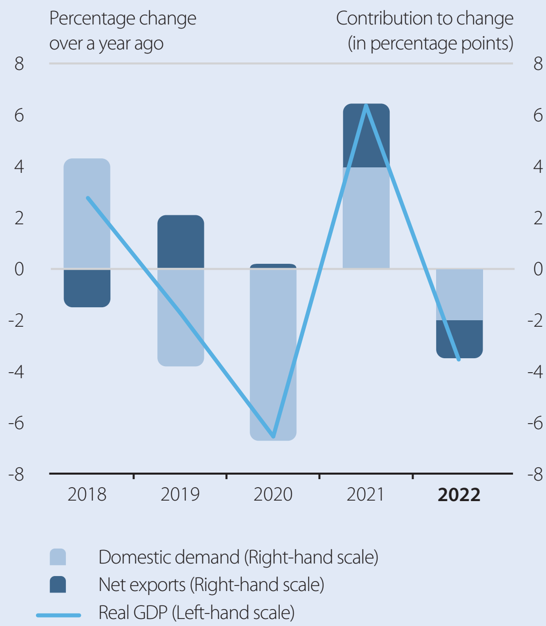
The Hong Kong economy contracted visibly in 2022 alongside the fifth wave of COVID-19, tightened financial conditions and a challenging external environment. The labour market deteriorated for some time before improving, while inflation remained moderate. Asset markets were also under pressure. Economic growth for 2023 is expected to recover from a low base, riding on the re-opening of the Mainland and Hong Kong.

The economy in review

Real activities

The Hong Kong economy contracted by 3.5% in 2022 amid multiple domestic and external headwinds (Table 1 and Chart 1). Domestically, private consumption plunged in the first quarter due to the fifth wave of COVID-19 in Hong Kong, but sequential growth resumed thereafter thanks to the progressive relaxation of social distancing measures and the boosting effect from the Government's Consumption Voucher Scheme[1]. Overall investment expenditure tumbled from 2021 amid soft business sentiment and tightened financial conditions. Externally, Hong Kong's exports of goods plummeted along with weakened external demand and the disruptions to the cross-boundary truck movements between the Mainland and Hong Kong. Partly reflecting the subdued inbound tourism activities, exports of services remained generally weak . However, there was a slight improvement in the fourth quarter after the Government lifted the compulsory quarantine requirements on arrival in Hong Kong in late September.

Chart 1 Real GDP growth by contribution



Source: *Census and Statistics Department*

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

(% Period-over-period, unless otherwise specified)	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2022	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2021
Gross Domestic Product	**(1.8)**	**0.3**	**(2.6)**	**0.0**	**(3.5)**	6.9	(2.3)	0.7	(0.5)	6.4
(year-on-year growth)	**(3.9)**	**(1.2)**	**(4.6)**	**(4.2)**		8.2	7.6	5.5	4.7	
Private consumption expenditure	**(8.9)**	**8.3**	**0.9**	**2.3**	**(1.0)**	1.9	2.2	1.1	0.2	5.6
Government consumption expenditure	**4.7**	**5.4**	**(3.9)**	**2.9**	**8.1**	3.8	(1.1)	2.7	(0.7)	5.9
Gross domestic fixed capital formation	**–**	**–**	**–**	**–**	**(8.5)**	–	–	–	–	8.3
Exports										
Exports of goods	**(6.9)**	**(5.4)**	**(7.6)**	**(7.8)**	**(13.9)**	11.0	(1.2)	(0.1)	3.2	18.7
Exports of services	**1.7**	**(0.7)**	**(3.0)**	**4.0**	**(0.9)**	14.2	(5.9)	3.5	(2.3)	3.4
Imports										
Imports of goods	**(7.4)**	**(0.1)**	**(9.7)**	**(7.8)**	**(13.2)**	8.0	0.2	1.3	(0.2)	17.2
Imports of services	**(2.5)**	**0.6**	**(0.4)**	**5.4**	**(1.0)**	4.1	(1.3)	1.4	(0.6)	2.5

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*

[1] The Government introduced countercyclical measures in the 2022–23 Budget to support the economy, which included the distribution of two phases of electronic consumption vouchers worth HK$10,000 in total to each eligible resident.

Economic and Financial Environment

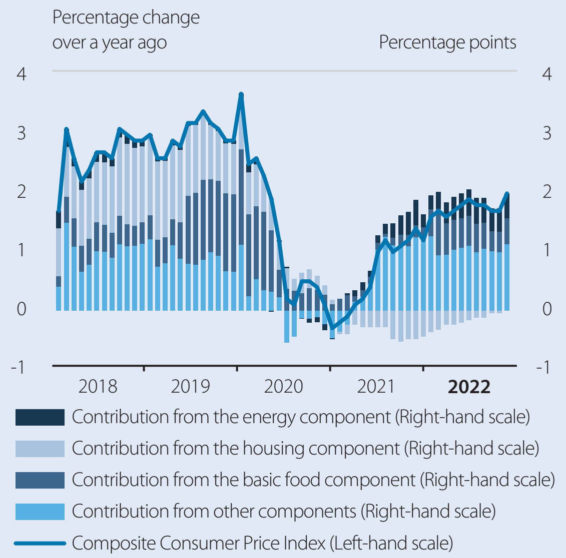
Inflation

Local inflation edged up but remained moderate in 2022. Specifically, the year-on-year underlying inflation rate[2] picked up gradually to a mild 2% in December, as the impact of elevated external energy and food prices was partly offset by the effect of mild domestic cost pressures, especially housing rentals (Chart 2). In addition, nominal wage growth and commercial rentals remained soft alongside weak economic activities, which also helped keep inflation in check. For 2022 as a whole, the underlying and headline inflation rates[3] were 1.7% and 1.9% respectively.

Labour market

Labour market conditions swiftly deteriorated in early 2022 amid the pandemic but improved for the rest of the year. After reaching a peak of 5.4% in April, the unemployment rate fell visibly to 3.5% in December[4] (Chart 3) and the decline was broad-based across most economic sectors. Overall labour demand recovered gradually as reflected by a pick-up in total employment (Chart 3) and private sector vacancies, though total employment was still below the pre-pandemic level. The nominal wage and labour earnings also showed slightly faster year-on-year growth. On the other hand, the labour force shrank slightly by 1.5% in December compared with a year earlier, partly due to a modest decline in the labour force participation rate.

Chart 2 Underlying consumer price inflation



Note: "Energy" items include electricity, town gas, liquefied petroleum gas and other fuel, and motor fuel.

Sources: *Census and Statistics Department and HKMA staff estimates*

Chart 3 Labour market conditions

Source: *Census and Statistics Department*

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[2] The underlying inflation rate is the change in the Composite Consumer Price Index after netting out the effects of the Government's one-off relief measures to reflect the underlying inflation trend.

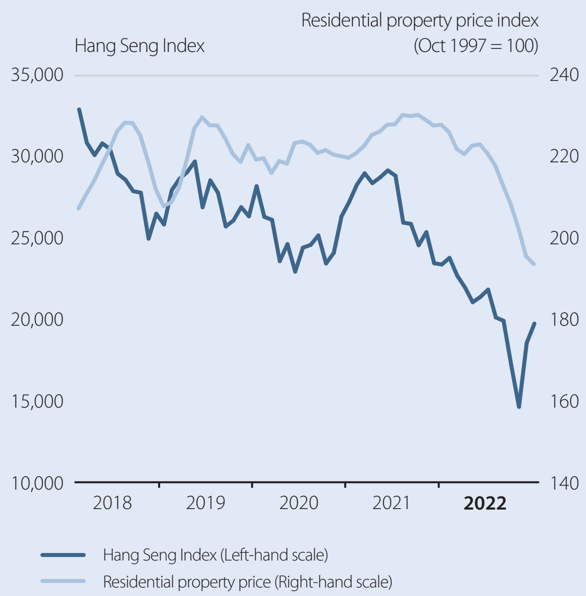
[3] The headline inflation rate is the raw inflation figure calculated from the change in the Composite Consumer Price Index, which includes the effects of the Government's one-off relief measures. It is compiled by the Census and Statistics Department. The year-on-year headline inflation rate gradually increased from 1.5% in the first quarter to 1.8% in the fourth quarter.

[4] The underemployment rate also declined from a high of 3.8% in April to 1.5% in December.

Stock market

The local stock market underwent sharp fluctuations over the course of 2022. Continuing its downtrend in 2021, the Hang Seng Index fell at an accelerated pace to 14,687 on 31 October 2022, the lowest closing level since 2009 (Chart 4). The marked correction was initially driven by growing concerns over the local COVID-19 infections, the US rate hikes and the Russia-Ukraine situation, and the correction widened further later on as a result of a weaker global economic prospect arising from the tightened global financial conditions and Mainland's COVID-19 outbreaks. Stock prices regained some upward momentum in the last two months of the year due in part to Mainland's relaxation of COVID-19 measures. The Hang Seng Index closed the year at 19,781, down notably by 15.5% from the end of 2021 and marking the third consecutive year of decline.

Chart 4 Asset prices



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

Property market

The residential property market was also under pressure amid tightened financial conditions and weak economic activities. Housing prices fell 15% in 2022 (Chart 4) and housing transactions plunged by 39% to 45,050 units, the lowest level on record. Housing affordability remained stretched despite lower housing prices. The effective mortgage interest rates increased from around 1.6% to 3.375%–3.625% during the year, adding to the repayment burden of mortgage borrowers.[5] Likewise, the non-residential property markets turned more sluggish, with prices retreating and rentals remaining soft along with high vacancy rate.

[5] The HKMA lowered the interest rate stress testing requirement on property mortgage lending by banks from three percentage points to two percentage points in September. The move had taken into consideration the changes in banks' risk management needs, the prevailing interest rate environment, the trend of mortgage rates, as well as their long-term historical average. See also the circular *Property Mortgage Lending* issued by the HKMA on 23 September 2022.

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Outlook for the economy

Economic environment

Economic growth for 2023 is expected to recover from a low base riding on the re-opening of the Mainland and Hong Kong. While the expected weaker growth of the advanced economies will continue to weigh on Hong Kong's exports of goods, the recovery of the Mainland economy and the lifting of restrictions on cross-boundary land transportation could provide the local economy with some support. The re-opening of the Mainland and Hong Kong should greatly benefit Hong Kong's inbound tourism and other exports of services, as well as local business sentiment and capital spending. Private consumption will also improve further along with a stronger labour market. The Government forecasts real GDP to grow visibly by 3.5%–5.5% for the whole year of 2023[6]. That said, the growth outlook is fraught with risks and uncertainties, and would largely hinge on the US Federal Reserve's policy rate path, the global growth prospects, the evolving geopolitical tensions, and the recovery pace of Hong Kong's inbound tourism.

Inflation and the labour market

Looking ahead, local inflation is expected to edge up, but shall stay mild amid offsetting forces. While external prices should remain elevated, their upward momentum will likely moderate further alongside weaker economic activities in some major advanced economies and an easing of the upward pressures on commodity prices. Similarly, domestic cost pressures may edge up alongside the recovery of the local economy and the labour market, but the soft housing rentals should continue to provide some offset. For 2023 as a whole, the Government projects the headline and underlying inflation rates to be 2.9% and 2.5% respectively[7]. On the other hand, labour market conditions are likely to improve further as local economic activities resume normalcy.

6 The growth estimates by private sector analysts average 3.7%.

7 Market consensus forecasts a headline inflation rate of 2.4% in 2023.

Performance of the banking sector

The Hong Kong banking sector was confronted with a challenging macroeconomic environment in 2022, characterised by the fifth wave of COVID-19 infections in the early part of the year, heightened geopolitical tensions, and aggressive interest rate hikes by major central banks globally to tame rising inflation. Banks in Hong Kong overcame these challenges well, continuing to maintain strong capital and liquidity positions. The credit risk facing the banking sector increased during the year, but the overall asset quality of the banks remained at a healthy level. Meanwhile, while the net interest income of banks increased amid rising interest rates, the positive effect was partly offset by the rising bad debt provisions and declining income from fees and commissions. Overall, the profitability of retail banks improved over the level in 2021.

Asset quality

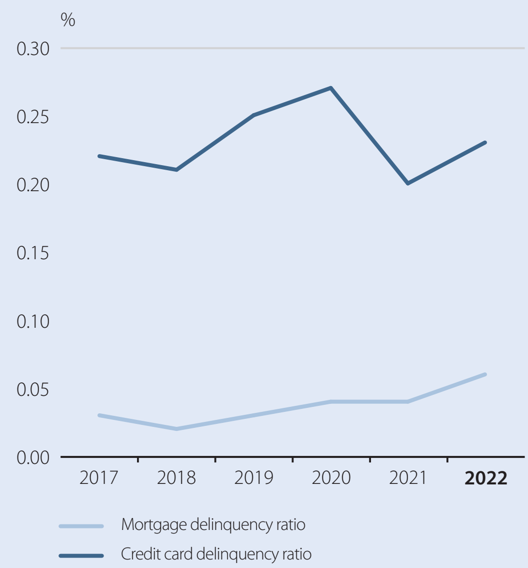
The classified loan ratio of the banking sector increased to 1.38% at the end of 2022 from 0.89% at the end of 2021, with the overdue and rescheduled loan ratio edging up to 0.85% from 0.56% during the same period (Chart 5). The classified loan ratio for Mainland-related lending also increased to 2.21% at the end of 2022 from 0.89% a year before. The increase in the classified loan ratio was mainly due to downgrades of exposures to some Mainland property developers. That said, provisions set aside by the banks remained sufficient. The provision coverage ratio (i.e. total provisions to classified loans) stayed at around 80% at the end of 2022. If taking also into account the market value of collateral held against the classified loans, the adjusted provision coverage ratio would reach around 140%. In the meantime, the delinquency ratios of residential mortgage lending and credit card lending remained low at 0.06% and 0.23% respectively at the end of 2022 (Chart 6).

Chart 5 Asset quality of the banking sector

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

Source: HKMA

Chart 6 Delinquency ratios of residential mortgages and credit card lending



Source: HKMA

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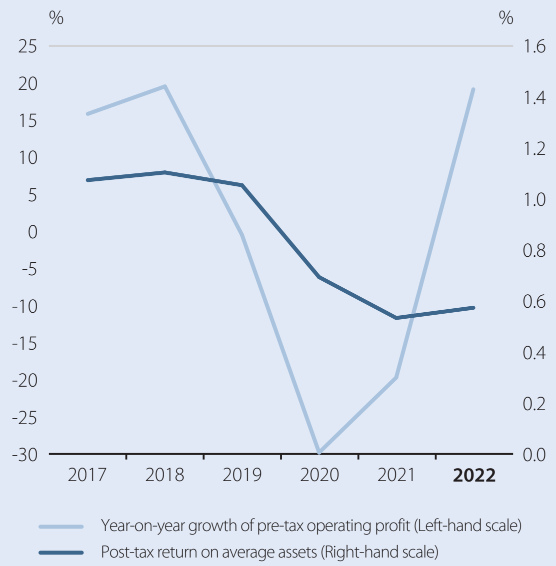
Profitability trends

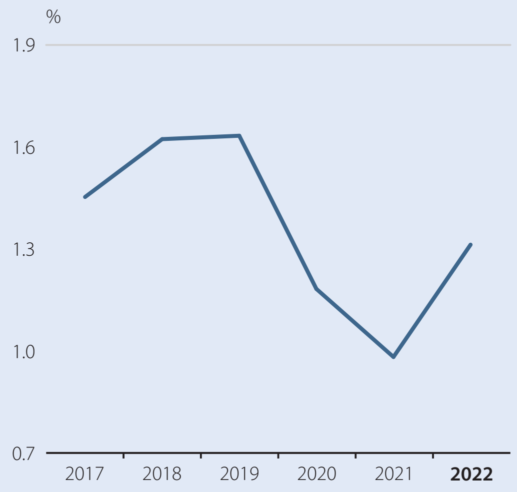
The banking sector continued to be profitable in 2022. The aggregate pre-tax operating profit of retail banks increased by 19.0% in the year (Chart 7). The improvement in profit was attributable to increases in net interest income (+34%) and income from foreign exchange and derivatives (+72%), which were partly offset by an increase in bad debt provisions (+151%) and a reduction in income from fees and commissions (-19%). Against the backdrop of rising interest rates, net interest margin widened to 1.31% in 2022 from 0.98% a year before (Chart 8). Banks also recorded higher income from foreign exchange and derivatives business as a result of higher market volatility during the year. Bad debt provisions increased as specific provisions were set aside for new classified loans, while income from fees and commissions decreased amid lacklustre performance of the financial markets. Retail banks' cost-to-income ratio fell to 48.0% in 2022 from 54.7% in 2021 (Chart 9).

Chart 7 Retail banks' performance



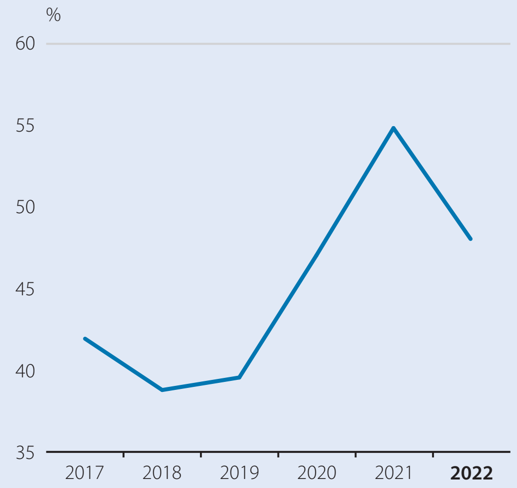
Source: HKMA

Chart 8 Retail banks' net interest margin



Source: HKMA

Chart 9 Retail banks' cost-to-income ratio



Source: HKMA

Economic and Financial Environment

Balance sheet trends

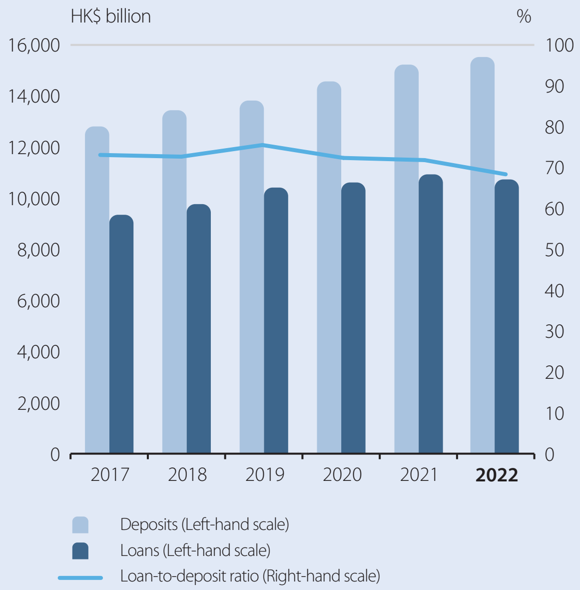
The banking sector's balance sheet grew by 2.5% in 2022. The increase in total assets was attributable to larger mark-to-market foreign exchange and derivatives positions. Given the uncertainties in the external environment and rising interest rates, loan demand weakened during the year. Total loans fell by 3.0% in 2022, compared with a growth of 3.8% in 2021. Among the total, loans for use outside Hong Kong decreased by 10.2% and trade finance decreased by 13.5%, while loans for use in Hong Kong increased slightly by 0.9%. Mainland-related lending fell by 4.4% in 2022, after expanding by 3.7% a year before.

On the liability side, the banking sector continued to record a moderate growth of deposits. Total deposits rose by 1.7% in 2022, compared with a growth of 4.6% in 2021. As total loans decreased while total deposits increased, the overall loan-to-deposit ratio edged down to 68.5% at the end of 2022 from 71.8% a year before (Chart 10).

Capital adequacy

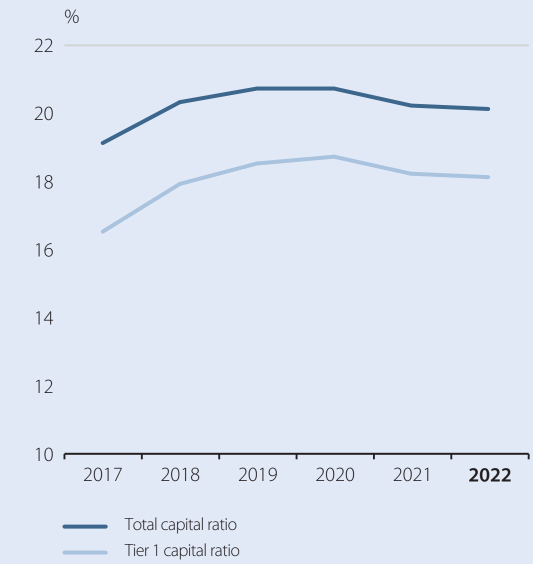
The capital positions of the banks remained strong in 2022. The consolidated total capital ratio of locally incorporated authorized institutions (AIs) stood at 20.1% at the end of 2022, compared with 20.2% a year before. The Tier 1 capital ratio was 18.1% (Chart 11). Both ratios were well above their respective international minimum requirements. The Basel III leverage ratio was 7.9% at the end of 2022 (Chart 12).

Chart 10 Loans and deposits of the banking sector



Source: HKMA

Chart 11 Consolidated capital ratios of locally incorporated AIs



Source: HKMA

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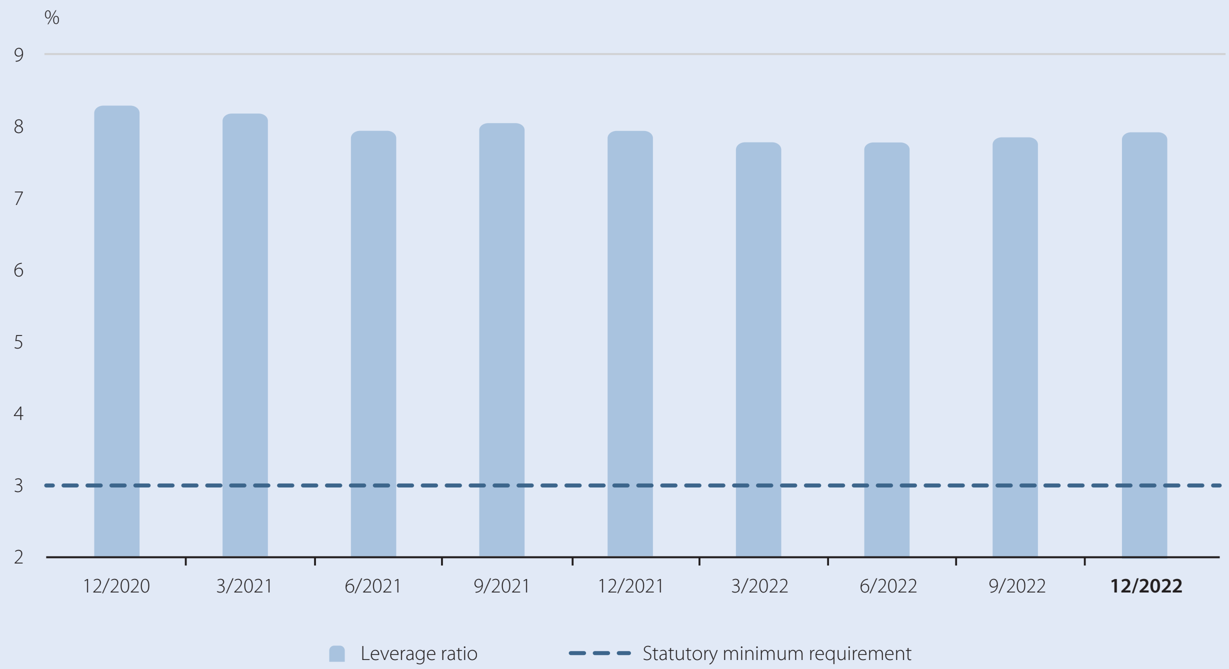
Chart 12 Consolidated leverage ratio of locally incorporated AIs

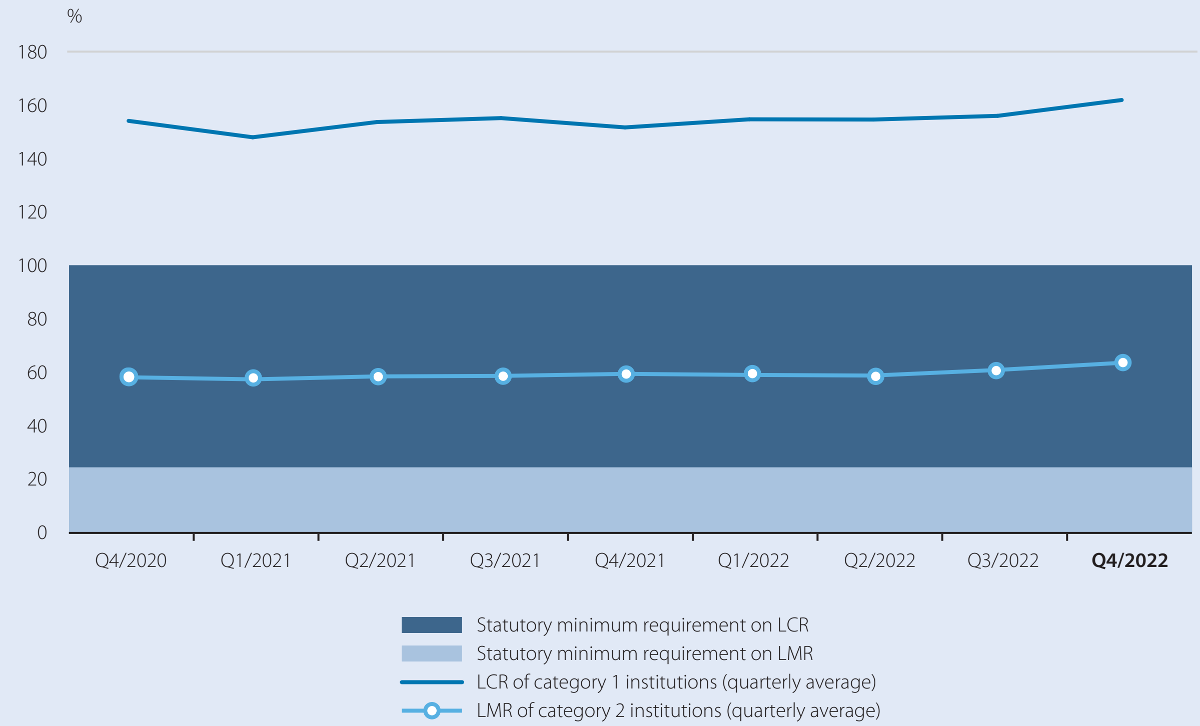


Source: HKMA

Liquidity conditions

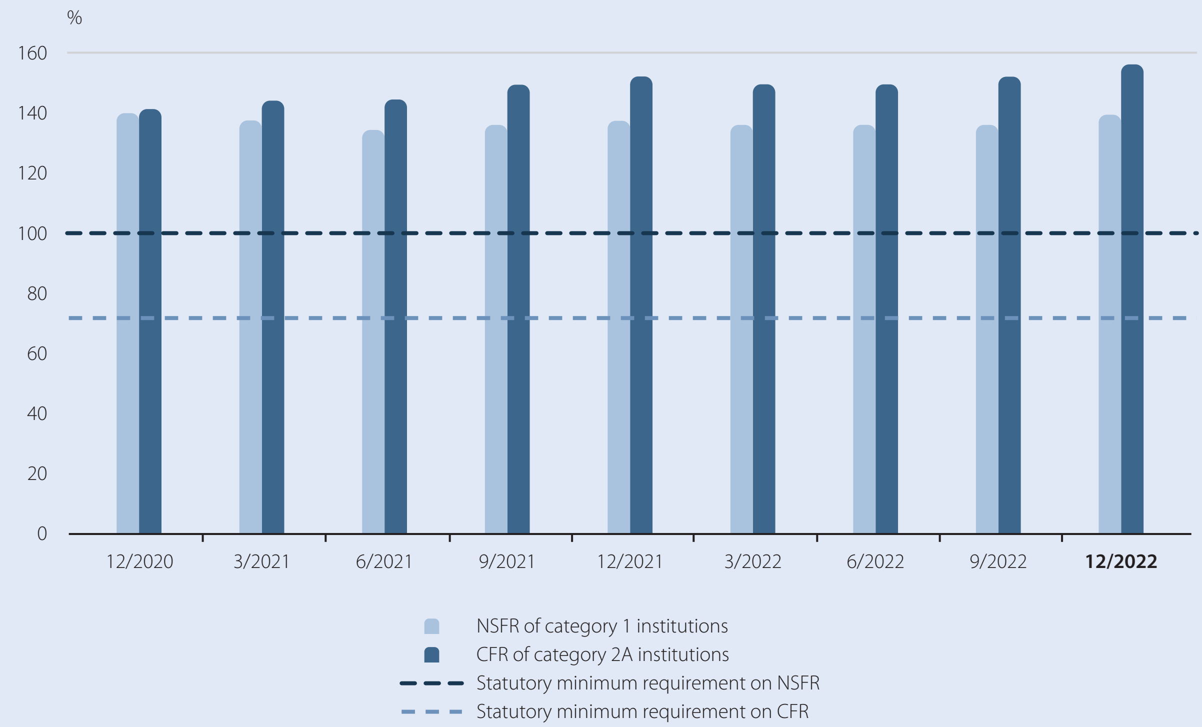
The banking sector continued to maintain robust liquidity position, providing a key source of strength in the face of heightened uncertainties in the macroeconomic environment. The quarterly average Liquidity Coverage Ratio (LCR) of category 1 institutions was 162.3% in the fourth quarter of 2022, and the quarterly average Liquidity Maintenance Ratio (LMR) of category 2 institutions was 63.2% (Chart 13). The main source of funding of the banking sector continued to be customer deposits. The Net Stable Funding Ratio (NSFR) of category 1 institutions and the Core Funding Ratio (CFR) of category 2A institutions were 137.7% and 155.7% at the end of 2022 respectively (Chart 14). All the four ratios were well above the statutory minimum requirements.

Chart 13 Liquidity ratios of designated AIs



Source: HKMA

Chart 14 Funding ratios of designated AIs



Source: HKMA