2. Global setting and outlook

2.1 External environment

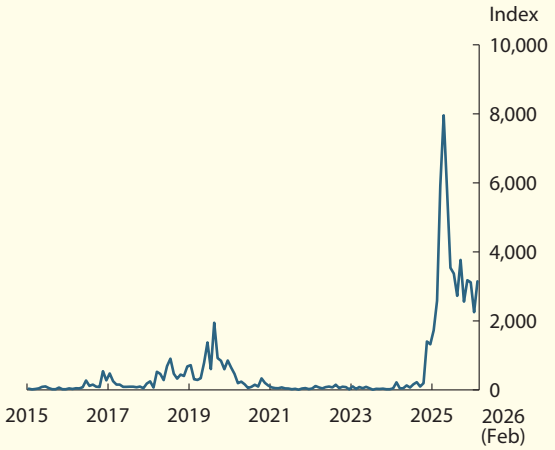
In the US, economic growth remained robust in 2025, though the underlying development was "K-shaped". In particular, consumption was mainly driven by higher-income households benefiting from the equity "wealth effect", while lower-income households faced cost-of-living pressures amid persistent inflation and tariff-induced increases in goods prices. In the corporate sector, A.I.-related tech firms continued to scale up capital expenditures, whereas traditional industries curtailed investment amid heightened policy uncertainty, elevated input costs and uncertain demand.

Across the Atlantic, the Euro area grew at a steady pace in the second half of 2025 underpinned by solid domestic demand, with inflation staying close to the 2% target. Meanwhile, the Japanese economy saw moderated growth with sustained inflationary pressure.

On the monetary policy front, the US Federal Reserve (Fed) delivered a cumulative 75 basis points interest rate cuts during 2025 in response to a weakening labour market, before pausing at the January and March meetings. At the start of 2026, the market had initially expected continued interest rate cuts amid the upcoming transition in US Federal Reserve leadership and a weak labour market. However, the path of US interest rates turned uncertain following the outbreak of military conflict in the Middle East, which cast a cloud on the US inflation outlook.

The China–US trade truce and trade agreements between the US and its other trading partners helped ease market jitters. Yet, US trade policy remained highly uncertain (Chart 2.1), as the US continued to signal other economies with tariffs in pursuit of geoeconomic objectives[1]. Moreover, following the US Supreme Court's ruling on tariffs under the International Emergency Economic Powers Act on 20 February 2026, the US administration swiftly invoked Section 122 as a temporary measure to introduce 10% tariffs[2], while more enduring tariff measures are expected to be implemented under other Sections (e.g. Section 301). Box 1 illustrates how corporate operational flexibility could serve as a crucial buffer to bolster financial health amid heightened uncertainty.

Chart 2.1
US trade policy uncertainty index



Source: Economic Policy Uncertainty.

[1] On 12 January 2026, the US President vowed a 25% tariff on goods from countries "doing business" with Iran immediately. On 17 January 2026, he further threatened to impose 10% tariffs on France, Germany, the United Kingdom, the Netherlands, Denmark, Norway, Sweden and Finland starting from February, unless these countries agree to support his Greenland plan. However, on 21 January 2026, the US President announced to suspend these tariffs after reaching a "framework" agreement with North Atlantic Treaty Organization regarding the territory.

[2] After the US Supreme Court struck down the "reciprocal tariffs" on 20 February 2026, the US administration announced a new flat 10% tariff under Section 122. Tariffs under Section 122 will automatically expire in 150 days unless approved by the US Congress.

The global economic outlook stays cautiously optimistic, yet risks remain two-sided. On the upside, the A.I. boom can be a source of strength for the global trade and financial markets through driving consumption and boosting productivity. In the US, the economy will also benefit from tax cuts and extensive deregulation.

On the downside, beyond trade policy uncertainty, the global economy also faced downside risks from the military conflict in the Middle East, the A.I. investment boom, evolving geopolitical developments, and fiscal sustainability challenges in major advanced economies.

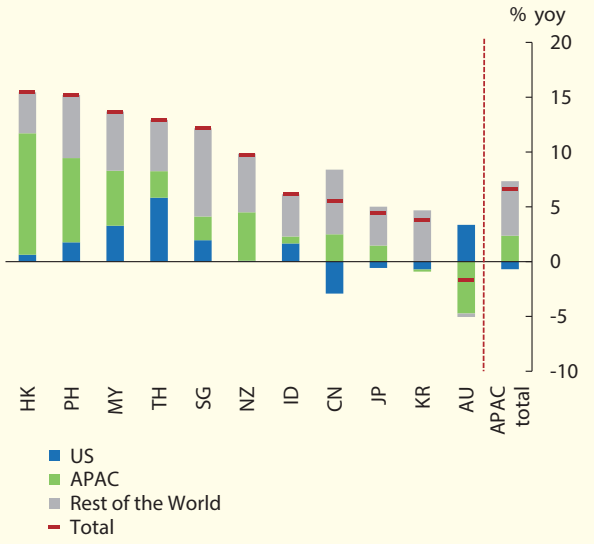
The ongoing A.I. boom has helped lift the global economy, but has also triggered additional concerns. Tech firms have increasingly turned to debt financing instead of relying on cash flows. If expected returns from these investments do not materialise, then some tech firms may encounter financing difficulties given their massive borrowings from the bond markets and private credit markets. There is also a risk of further spillovers to other tech firms due to circular financing within the A.I. ecosystem.

Geopolitical risks remain elevated, given the split of the US society triggered by the fatal actions of US Immigration and Customs Enforcement officers, the US capture of Venezuelan President Nicolas Maduro, the escalated rhetoric surrounding a US takeover of Greenland, and the conflict in the Middle East which has boosted energy prices and thus adding uncertainty to monetary policy paths across multiple regions. Energy-importing economies, particularly in Europe and Asia, faced greater exposure to these shocks. In a downside scenario, adverse developments may trigger market volatility and disrupt fund flows.

Finally, major advanced economies continued to face fiscal sustainability risks, given higher government debt levels and a lack of fiscal consolidation. A sharp repricing of sovereign risk could lead to wider market turbulence. Hedge funds have also increasingly sought leverage from prime brokers for arbitrage trading in sovereign bond markets. Box 2 analyses the potential contagion risks associated with these linkages.

In APAC, regional economies defied earlier expectations of a sharp tariff-induced slowdown, finishing 2025 on a strong note after a year of solid economic growth and buoyant financial markets. Notably, concerted monetary easing supported domestic demand and equity markets. Meanwhile, the A.I. boom and strong performance of tech exports, delayed rollout of US reciprocal tariffs, and efforts to diversify trade, had all combined to lift the region's exports. While repeated tariff postponements alleviated the downward pressure on exports to the US, it was in fact shipments to the rest of the world, including to other Asian markets, that accounted for the majority of export growth for many economies as regional corporates continued to diversify their trading partners (Chart 2.2).

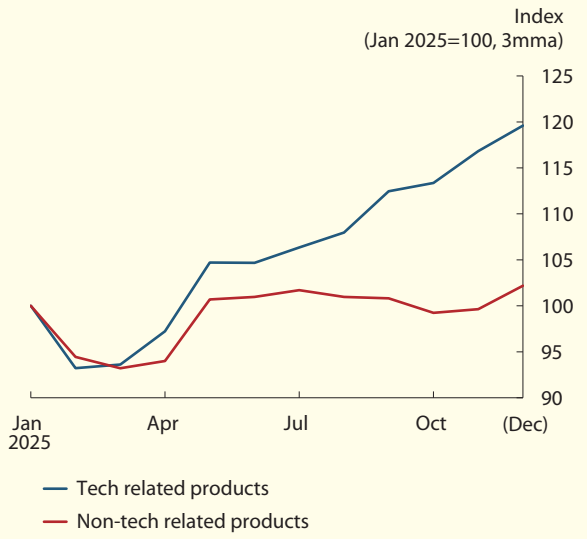
Chart 2.2
Asia Pacific: Exports growth in 2025 by destination



Sources: CEIC and HKMA staff calculation.

The region's external sector strength was particularly evident in the tech industry, where the global A.I. boom fuelled a surge in demand for tech equipment. While both tech and non-tech goods exports grew strongly in the first half of 2025, the former greatly outpaced the latter in the second half of the year (Chart 2.3). This phenomenon was mirrored in regional financial markets, where tech companies have outperformed in regional equity markets in 2025.

Chart 2.3
Asia Pacific: Tech and non-tech exports



Note: "Asia Pacific" includes AU, CN, HK, ID, JP, KR, MY, NZ, PH, SG, and TH. "Tech- related" products refer to products falling under Harmonized System codes 8419, 8470-8473 and 85.

Sources: CEIC, International Trade Center and HKMA staff calculation.

Despite the importance of A.I. as a source of resilience for the region, its long-term sustainability remains subject to significant uncertainty as mentioned in the earlier paragraphs. Furthermore, the region's tech industry features deeply integrated supply chains and a relatively high share of foreign value added, pointing to disproportionate exposure to the US "transshipment tariffs". Taken together with the still heightened uncertainty surrounding US and global trade policy, these factors leave the region vulnerable to a potential deterioration in economic prospects and financial market volatility.

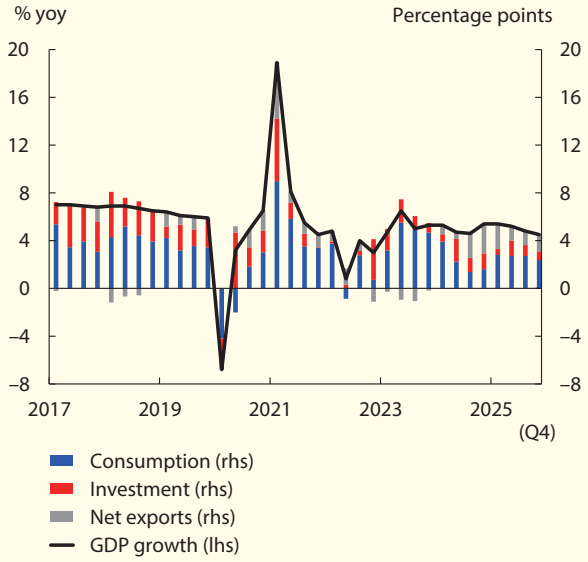
Additionally, the energy shock stemming from the military conflict in the Middle East would weigh on regional economies, as most are net energy importers with significant reliance on oil supplies from the Middle East via the Strait of Hormuz. However, given the region's relatively benign starting points on inflation and oil consumption burdens, the direct impact on inflation and economic growth appears manageable so far. That said, the ultimate severity would depend critically on the duration and the scope of the conflict, the magnitude and persistence of the energy price spike, as well as the policy responses and structural characteristics of individual economies. Meanwhile, the high trade exposure of Asia also leaves the region vulnerable to the indirect effect of potential trade disruptions and a broader slowdown in global growth.

2.2 Chinese Mainland

Economic performance and policy responses

The Chinese Mainland's year-on-year real gross domestic product (GDP) growth moderated to 4.5% in the fourth quarter of 2025 from 4.8% in the third quarter (Chart 2.4), as domestic demand growth weakened due to fading consumption trade-in programme support, continued housing market weakness and anti-involution push. In particular, the decline in fixed investment widened in the second half of 2025, not only due to a contraction in real estate investment but also remarkable decreases in manufacturing and infrastructure investments. However, merchandise exports remained resilient amid the China-US trade truce, the tech up-cycle, increased competitiveness of Mainland's products, and Mainland's market diversification efforts. In particular, increased exports to non-US economies effectively offset the decline in the US market. For 2025 as a whole, real economic growth remained at 5.0%, meeting the official growth target. With strong exports and stable imports, merchandise trade surplus reached a record high of almost US dollar (USD) 1.2 trillion in 2025.

Chart 2.4
Chinese Mainland: Contribution to GDP growth by demand component



Sources: National Bureau of Statistics of China (NBS), CEIC, and HKMA staff estimates.

Looking ahead, the Mainland economy is expected to maintain relatively stable growth momentum in 2026 alongside continued policy support.[3] The contraction in fixed investment, especially in manufacturing and infrastructure investments, will likely be reversed. The new economy sectors will continue to outperform, and the outlook of exports is cautiously optimistic amid China-US tariff truce.

Under the 15th Five-Year Plan, the authorities will prioritise building a modern industrial system, advancing technological self-reliance and new quality productive forces, expanding domestic demand (especially consumption) and building a robust domestic market[4]. Key challenges include a profoundly complex external environment, and the domestic imbalance between strong supply and relatively weak demand. Indeed, this year's economic outlook faces both upside and downside risks stemming from geopolitics (for example, the military conflict in the Middle East) and trade, A.I. and technology, the domestic property market and macro policy. At the Two Sessions held in March 2026[5], the authorities set the growth target at 4.5–5.0%, while the latest market consensus forecasts predict a 4.6% expansion for the year.

Inflation dynamics improved somewhat between July 2025 and February 2026, though deflation pressure remained. The headline consumer price index (CPI) inflation edged up, driven, in part, by higher food prices. The pickup in core CPI inflation, which excludes food and energy prices, was supported by higher prices in gold, jewellery and selected services (e.g. medical). That said, declines in producer price index and GDP deflator continued, albeit at a narrower pace, partly due to some improvement in anti-involution-focused sectors[6]. The headline unemployment rate edged up to 5.3% in February 2026, with the youth unemployment rates for 16–24 and 25–29 age groups standing at 16.1% and 7.2%, respectively.

[3] Recent policies include enhanced implementation of large-scale equipment renewal and consumer goods trade-in programme, and interest rate cuts on structural monetary policy tools.

[4] In particular, the Chinese Mainland will keep its economic growth within an appropriate range, notably increase household consumption share in GDP and ensure labour remuneration keeps pace with labour productivity growth. On anti-involution, China will advance the development of a unified national market. Over the longer run, the Chinese Mainland reaffirms the 2035 modernisation goal, which aims to lift GDP per capita to the level of mid-level developed (or moderately advanced) economies. The Central Economic Work Conference in December 2025 also emphasised that expanding domestic demand will be the top priority in 2026. Policies will be rolled out to boost consumption through both the supply and demand sides.

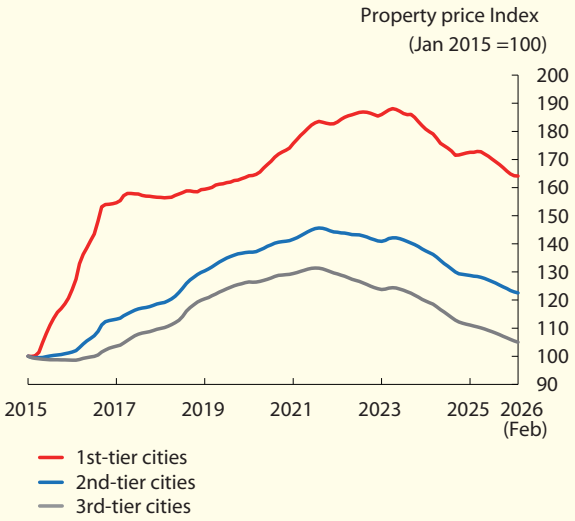
[5] In the Government Work Report for 2026, the official budget deficit target is kept at an elevated 4% of GDP. Additional supportive measures include (i) a RMB100 billion special fiscal–financial coordination fund to facilitate domestic demand expansion, and (ii) an expansion of funding for new policy-backed financing tools to RMB800 billion to support investment.

[6] The People's Bank of China also reiterated that promoting a modest increase in prices remains a key monetary policy objective.

Property and credit markets

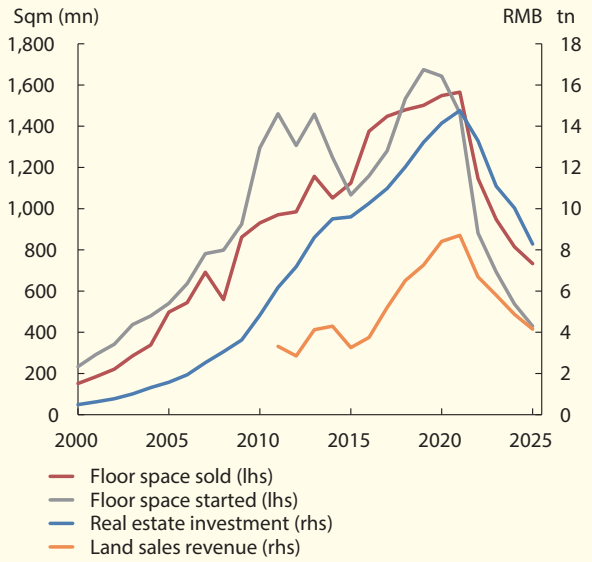
The Mainland housing market remained weak in the second half of 2025 and early 2026. Housing prices continued to decline sequentially across all city tiers (Chart 2.5), and property market activities such as sales, investment and construction remained depressed (Chart 2.6). In response, the authorities maintained a supportive policy stance[7] and continued to stress property market stabilisation, with a strategy of controlling new supply, reducing housing inventory, and optimising the supply structure. The government has also promoted the high-quality development of the real estate sector from the perspective of improving people's livelihood, encompassing initiatives such as high-quality urban renewal, quality houses and affordable housing.

Chart 2.5
Chinese Mainland: Residential property prices by tier of cities



Sources: CEIC and HKMA staff estimates.

Chart 2.6
Chinese Mainland: Property market activities



Sources: CEIC and HKMA staff calculations.

In the near term, the housing market is likely to remain soft, although the market expects the drag on GDP growth to be smaller for 2026. The stabilisation of the property market will hinge on the overall economic situation and the authorities' policy response.

On the credit front, both outstanding loans and total aggregate financing generally recorded slower growth towards the end of 2025 compared with a year ago, in part owing to weak private credit demand. Overall risk in the Mainland banking sector remained under control in the second half of 2025, with non-performing loan ratios hovering at low levels.

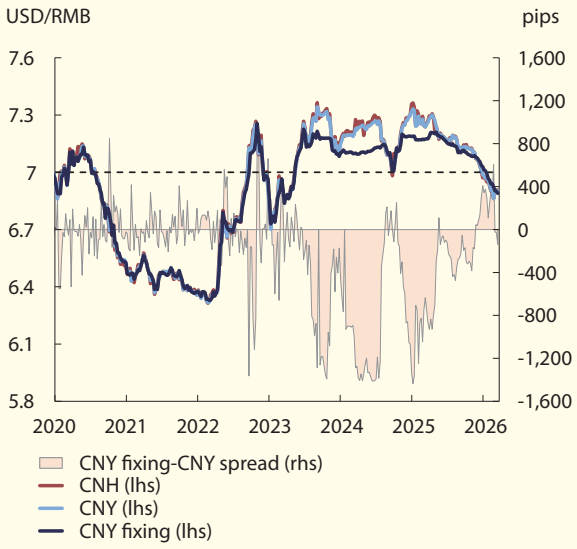
Exchange rate and bond flow indicators

Both the official fixing and market renminbi (RMB) exchange rates strengthened further against the USD in recent months, and broke the 7 per USD threshold (Chart 2.7). The strengthening trend partly reflected broad USD weakness, easing China-US trade tensions, the Mainland's record-high trade surplus, and seasonal demand for foreign exchange settlements. With the fixing rate turning slightly weaker than the spot rate since late November

[7] Specific policies include facilitating property purchases by overseas individuals, lowering housing transaction costs, and reducing the minimum down payment ratio for commercial property mortgages. At the local level, city-specific measures include destocking and supply control, housing purchase subsidies, housing voucher-based resettlement schemes and increased policy support for housing provident funds. Top-tier cities such as Beijing and Shanghai also further relaxed their home purchase restrictions.

2025, markets now generally expect measured RMB appreciation by the end of 2026. However, the People's Bank of China (PBoC) reiterated its commitment to keeping the RMB basically stable[8], while also noting that corporates have lower sensitivity to exchange rate volatility. As to bond flows, amid improved equity market sentiment, the onshore Mainland bond market recorded more moderate combined net inflows under different schemes in the second half of 2025 (Table 2.A).

Chart 2.7
Chinese Mainland: Onshore and offshore RMB exchange rates against the USD



Sources: Bloomberg and HKMA staff estimates.

Table 2.A
Chinese Mainland: Cross-border bond flow indicators

(RMB bn)	H1 2025	H2 2025	Sep 25	Oct 25	Nov 25	Dec 25	Jan 26
Northbound Bond Connect	296	–63	–5	14	–1	7	–13
CIBM Direct and QFI	853	199	64	58	24	29	35
Change in foreign holdings in the interbank market	71	–770	–45	–54	–117	–151	–108

Notes: Bond flows are measured by net buying flows for the Northbound Bond Connect and the China Interbank Bond Market Direct Scheme (CIBM Direct) and Qualified Foreign Investor Scheme (QFI).

Sources: Wind, CFETS and HKMA staff estimates.

[8] The PBoC announced a cut in the foreign exchange (FX) risk reserve ratio for forward FX sales to 0% from 20%, effective on 2 March 2026, supporting enterprises in managing exchange rate risks.

Box 1
Corporate operational flexibility as a buffer against economic policy uncertainty: Global evidence and policy implications

Introduction[9]

Global economic policy uncertainty can undermine firms' financial performance via two main channels: (1) Inducing a "wait-and-see" mindset that delays investment and innovation, thereby compressing profitability; and (2) tightening financing conditions by raising perceived risk, widening credit spreads, and increasing borrowing costs.

Firms with limited operational flexibility may be more vulnerable to uncertainty, as rigid cost structures and funding constraints can hinder timely adjustment. However, there is limited evidence on the extent to which flexibility can mitigate these effects. This study addresses this gap by utilising broad firm-level data to quantify the impacts, analyse the determinants of operational flexibility, and explore the associated policy implications.

Data and measurement

1) Global economic policy uncertainty

We measure economic policy uncertainty using the Global Economic Policy Uncertainty (GEPU) index (Davis, 2016), a widely used indicator of global policy-related uncertainty[10].

2) Corporate financial health

Corporate financial performance is proxied by Altman's Z-score (Altman, 1968), constructed as a weighted sum of standard profitability, liquidity, leverage and activity ratios (including working capital, retained earnings, EBIT and sales, scaled by assets, plus market capitalisation scaled by liabilities)[11]. A lower Z-score indicates weaker financial performance and a higher likelihood of distress.

3) Operational flexibility

Operational flexibility is proxied by a firm-level index following Gu et al. (2018), intended to capture a firm's inability to adjust operating costs in response to profitability shocks[12]. The index is constructed as the historical range of a firm's operating costs-to-sales ratio, scaled by the volatility of its sales growth over the same window. A higher value of the index indicates lower operational flexibility, in that it is harder to realign operating costs with its sales performance.

Although the operational inflexibility index is based on the notion of cost "stickiness", it can also reflect the underlying managerial and operational adaptability. For example, firms with more adaptable operations may reconfigure activities or shift geographical focus to flexibly adjust their production to match fluctuations in cost and demand, resulting in a lower value of the inflexibility index.

Non-financial listed firms across 10 sectors[13] and 72 economies are included in the index compilation, starting from the fourth quarter of 2002 to the first quarter of 2025. The analysis of

[9] For details, please refer to Tam and Wong (forthcoming): "Corporate operational flexibility as a buffer against economic policy uncertainty: Global evidence and policy implications", *HKMA Research Memorandum*.

[10] Davis, S. J. (2016). An index of global economic policy uncertainty. *NBER Working Paper No. 22740*. The updated GEPU index is downloaded from the website of Economic Policy Uncertainty.

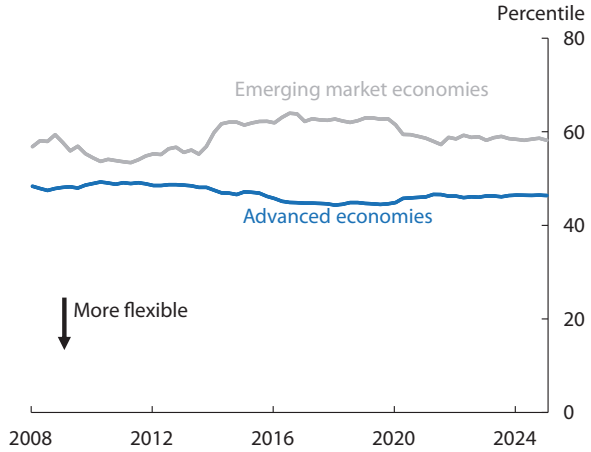
[11] Altman, E. I. (1968). Financial ratios, discriminant analysis and the prediction of corporate bankruptcy. *The Journal of Finance*, 23(4), 589–609.

[12] Gu, L., Hackbarth, D., & Johnson, T. (2018). Inflexibility and stock returns. *The Review of Financial Studies*, 31(1), 278–321.

[13] These non-financial firms are divided into 10 sectors according to the Global Industry Classification Standard, including energy, materials, industrials, consumer discretionary, consumer staples, health care, information technology, communication services, utilities and real estate.

the determinants of operational flexibility uses an annual panel from 2004 to 2024. To ensure comparability across business sectors, we compute each firm's percentile rank within its sector and quarter. Notably, firms in advanced economies generally exhibit greater flexibility than their peers in emerging markets (Chart B1.1).

Chart B1.1 Sector-adjusted inflexibility index



Source: HKMA staff estimates.

Empirical analysis

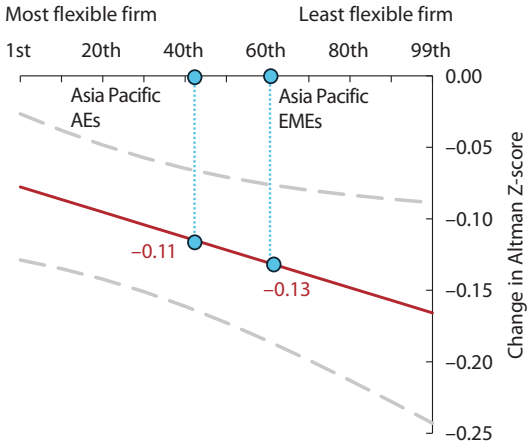
We first examine how the economic policy uncertainty affects firms' financial performance and whether operational flexibility can mitigate the impact. Then we explore which firms' characteristics are associated with greater operational flexibility, and how these links vary with financial market stress.

1) *GEPU, operational flexibility and corporate financial performance*

We estimate a firm-level fixed effects regression. Our model uses Altman's Z-score as the measure of financial health and examines how it is influenced by the GEPU index from the previous quarter, while allowing this effect to vary based on a firm's degree of operational inflexibility.

The estimation results indicate that a higher GEPU index is associated with weaker corporate financial performance, consistent with uncertainty weighing on firms through softer activity and tighter financing conditions. However, operational flexibility can significantly alleviate this effect: the analysis shows that the negative impact of rising uncertainty is amplified by inflexibility, which experiences a larger decline in Z-scores. Conversely, flexible firms exhibit a smaller deterioration in financial performance as the GEPU index increases. This suggests that firms' operational flexibility can serve as a buffer during periods of uncertainty (Chart B1.2).

Chart B1.2 Marginal effects of GEPU index on Altman Z-score with respect to operational flexibility ranking



Note: The blue dot lines mark the median flexibility ranking and the corresponding marginal effects on firms in Asia Pacific advanced economies (AEs) and emerging market economies (EMEs), respectively. The red line shows the estimated marginal effect (full sample period) of one standard deviation increase in the GEPU index (about 80 units) on firms' Altman Z-score. The dashed lines represent the 95% confidence interval of the marginal effect of the GEPU index.

Source: HKMA staff estimates.

2) *Determinants of operational flexibility*

To understand the determinants of a firm's operational flexibility, we estimate another firm-level fixed effects regression in which the dependent variable is the firm's operational inflexibility measure. The regression model relates inflexibility to a set of the firms' lagged characteristics, including the debt-to-capital ratio, the short-term debt-to-total debt ratio, the cash-to-assets ratio, the intangibles-to-assets ratio and the raw materials-to-inventory ratio, and also controls for the broader financial

environment using the Financial Stress Index (FSI)[14]. The estimation results suggest that operational flexibility is driven by a few factors:

(1) *Capital structure:* Firms with higher leverage and a greater reliance on short-term debt tend to be more inflexible, consistent with debt servicing and refinancing pressures limiting the room for cost adjustment; and

(2) *Buffers and asset structure:* Firms with larger cash buffers are generally more flexible, suggesting that internal liquidity could support adjustment. Firms with a higher share of intangible assets also tend to be more flexible, consistent with more reconfigurable business models.

Conclusion and policy implications

Our empirical analysis highlights that heightened global economic policy uncertainty is associated with weaker corporate financial performance, and that operational flexibility could help mitigate this adverse effect. These findings carry several policy implications for financial stability. First, maintaining clear and consistent policy communication can reduce uncertainty and its impact on corporate investments and funding conditions. Secondly, uncertainty indicators, including the GEPU index, may inform macro stress testing and financial stability monitoring. Finally, policies that enhance liquidity or support investment in intangibles (e.g. intellectual property, digital and knowledge-based capacity) can strengthen corporate longer-term operational agility and resilience.

[14] The FSI is downloaded from the US Office of Financial Research.

Box 2
Assessing the linkages between hedge funds and prime brokers in sovereign bond markets: Evidence from commercial data

Introduction[15]

In recent years, hedge funds have increasingly sought leverage from prime brokers for arbitrage trading in sovereign bond markets[16]. While this may enhance market liquidity under normal conditions, a shock could trigger hedge funds' rapid unwinding of their leveraged positions, potentially amplifying market stress in sovereign bond markets. Hedge funds' losses could also lead to large counterparty losses for their prime brokers, propagating the risks to the broader financial system.

This leverage is primarily provided by prime brokers, either locally or across borders[17]. The latter presents particularly significant challenges for effective global oversight, as such cross-border linkages often fall outside the regulatory purview of individual jurisdictions. In principle, more comprehensive data sharing across jurisdictions can facilitate the surveillance of these linkages. In practice, however, such data sharing is often hindered by legal and operational constraints, creating substantial blind spots for monitoring the potential contagion risks at the global level. In an attempt to address these data gaps, this analysis draws on commercial databases to map these interconnections and evaluate the underlying contagion risks.

Overview of commercial databases

Our data on hedge funds are sourced and consolidated from Preqin Pro, Morningstar Direct[18] and Bloomberg Finance, L.P. We selected only those hedge funds that are more likely to employ leveraged trading strategies in sovereign bond markets[19], resulting in a sample of 2,024 hedge funds.

These datasets contain information on each hedge fund's domicile and prime brokers. A total of 134 prime brokers are identified serving the sampled funds. The domicile of each broker is determined by cross-referencing with information from S&P Capital IQ. In this study, a linkage between a fund and a broker is classified as domestic if both entities share the same domicile, and cross-border otherwise.

It is important to note that our databases provide limited visibility into the amount of funding provided by individual prime brokers to specific hedge funds. Nevertheless, they still provide adequate information that allows us to conduct a network analysis between the funds and brokers.

Network analysis

Using this sample, our network analysis reveals three risk areas in the linkages between hedge funds and prime brokers.

1) Prevalent use of foreign prime brokerage services by hedge funds

First, hedge funds prevalently employ prime brokers domiciled abroad. Around 60% of hedge

[15] For details, please refer to Leung et al. (2025) "Assessing the linkages between hedge funds and prime brokers in sovereign bond markets: Evidence from commercial data", *HKMA Research Memorandum – 2025/10*.

[16] Please refer to Bassi et al. (2024) "Financial stability risks from basis trades in the US Treasury and euro area government bond markets" for euro area government bonds and Glicoes et al. (2024) "Quantifying Treasury cash-futures basis trades" for US Treasuries.

[17] For instance, nearly half of the US-registered hedge funds' secured leverage was prime brokerage borrowing, based on the US Securities and Exchange Commission.

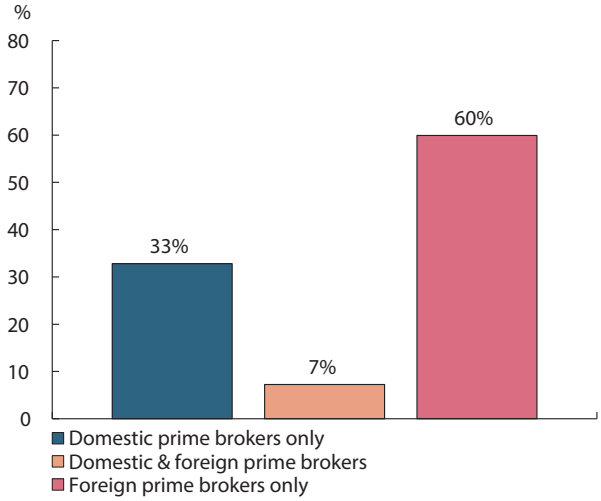
[18] Morningstar Direct's data providers do not guarantee the accuracy, completeness or timeliness of any information provided by them and shall have no liability for their use.

[19] Our sample includes hedge funds whose primary investment strategies are either relative value or fixed income. This sample selection largely mirrors the approach of Kruttli et al. (2021) "Hedge fund Treasury trading and funding fragility: Evidence from the COVID-19 crisis" in identifying hedge funds that are likely to trade in the US Treasury market.

funds in our sample rely entirely on foreign prime brokers; and 7% employ both domestic and foreign brokers (Chart B2.1).

Prime brokers are a key source of leverage for hedge funds. If prime brokers provide sizable leverage to offshore hedge funds, such cross-border linkages may add to contagion risks across jurisdictions, as investment losses from hedge funds in one jurisdiction could transmit to prime brokers in another via these linkages.

Chart B2.1
Proportion of hedge funds using domestic and foreign prime brokerage services



Note: Figures are expressed in percentages of the total number of hedge funds in our sample.
Source: HKMA staff estimates.

2) *Higher risks of contagion between North America and Europe*

Secondly, cross-border linkages are highly concentrated in North America and Europe. Specifically, over 90% of cross-border connections involve hedge funds and prime brokers domiciled in North America or Europe (Table B2.1).

This geographic concentration implies comparatively higher spillover risks from hedge funds to prime brokers in these regions. By contrast, contagion risks involving the APAC region remain relatively contained.

Table B2.1
Proportion of cross-border linkages by hedge fund and prime broker domiciles

		Prime broker domicile			
		North America	Europe	Asia Pacific	Others
Hedge fund domicile	North America	41.6%	27.2%	2.1%	0.8%
	Europe	11.8%	12.7%	0%	0.4%
	Asia Pacific	1.3%	0.5%	0.05%	0%
	Others	0.9%	0.6%	0.2%	0%

Note: Figures are expressed in percentages of the total number of cross-border linkages between hedge funds and prime brokers in our sample. The sum of these figures does not equal 1 due to rounding.
Source: HKMA staff estimates.

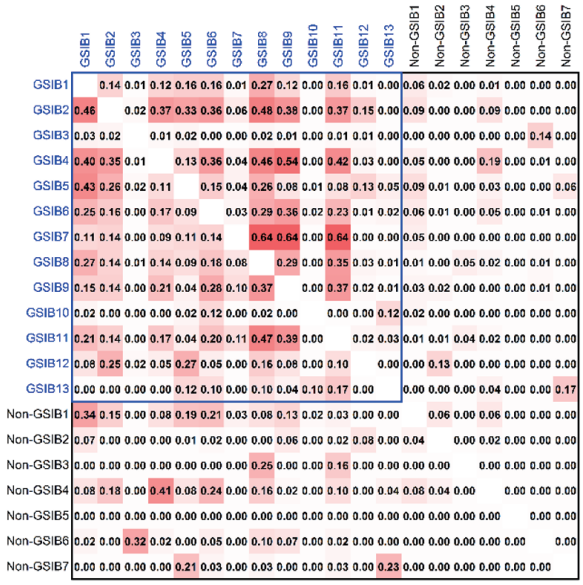
3) *Concentrated exposures among global systematically important banks*

Third, a handful of prime brokers dominate the provision of prime brokerage services, with the 20 major prime brokers collectively serving 77% of hedge funds in our sample. Of these, 13 are found to be global systematically important banks (G-SIBs), which together serve 66% of the funds.

Furthermore, G-SIBs exhibit substantially higher common exposure to the same hedge funds than non-G-SIB brokers. For each pair of major prime brokers, common exposure is quantified as the number of funds jointly served by the paired brokers divided by the number of funds served by one of the brokers. Chart B2.2 presents these ratios for each broker pair, with G-SIB pairs highlighted by blue borders. This heatmap shows generally higher ratios (i.e. darker red cells) among G-SIB pairs compared to non-G-SIB pairs.

This pattern suggests that investment losses at hedge funds could simultaneously propagate stress to a multiple of G-SIB prime brokers through their common exposures, thereby amplifying contagion risks across the G-SIB prime brokers.

Chart B2.2
Common exposures of the 20 major prime brokers to hedge funds



Note: For illustration, the figure in the row for G-SIB4 and the column for G-SIB9 shows a value of 0.54, suggesting that 54% of the hedge funds served by G-SIB4 are also served by G-SIB9. Diagonal values are equal to one and hidden for brevity.

Source: HKMA staff estimates.

Conclusion and policy implications

In conclusion, this network analysis identifies three key risk areas: (1) prevalent use of foreign prime brokerage services by hedge funds, which heightens the potential for cross-jurisdictional contagion; (2) higher risks of contagion between North America and Europe; and (3) concentrated exposures among G-SIBs to hedge funds.

These findings carry two key policy implications for financial stability. First, stronger international co-operation is needed to address the regulatory blind spot. While full-scale regulatory data sharing remains constrained by legal or operational barriers, a mechanism to facilitate the sharing of "red flags" should be developed to monitor this contagion risk. Secondly, regulators may consider collecting more frequent and granular information from G-SIBs on counterparties to which they hold sizable exposure. In this regard, the International Data Hub may serve as a platform to facilitate effective global monitoring of such exposure.