1. Summary and overview

Hong Kong's financial system withstood the severe market volatilities in the second half of 2011. The Hong Kong dollar exchange rate was not subjected to any great pressures. Credit growth slowed and the property market consolidated. The offshore renminbi market adjusted to expectations of slower exchange rate appreciation, and banks' renminbi balance sheets became more diversified.

The external environment is likely to remain volatile in 2012. Materialisation of downside risks to growth in the region could put the credit quality of bank assets under pressure. On the other hand, risk build-up in the local property market could resume as interest rates remain lower than consumer price inflation. Banks will face the challenge of managing these risks prudently while preparing for the implementation of the new capital and liquidity standards under Basel III.

The external environment

The intensification of the euro zone sovereign debt crisis in the second half of 2011 brought the global financial system to the brink of another crisis of systemic proportions. Although the risk has now receded somewhat, de-leveraging by European banks will cast a long shadow on recovery of the global economy. Recovery in major advanced economies will also be constrained by on-going fiscal consolidation and household balance sheet repair. Weak growth and low resource utilisation could prompt major central banks to continue with further quantitative easing, which could exacerbate financial imbalances in the faster-growing emerging market economies.

Growth has slowed in most East Asian economies, including Mainland China, amid subdued external demand. While the weak global backdrop will continue to weigh on exports across the Asian region, solid domestic demand and sufficient scope for policy stimulus suggest that growth will not deviate far from the trend. Some central banks in the region have started to loosen monetary policy, but a significant reversal in the policy stance is not expected unless there is a sharp deterioration in the near-term economic outlook.

The domestic economy

The Hong Kong economy failed to regain much momentum in the second half of 2011, with the difficult external environment restraining exports and also casting a shadow on domestic demand. On a quarter-on-quarter basis, the economy grew at a meagre 0.1% and 0.4% in Q3 and Q4, respectively. While net exports edged up from the deep slump in Q2, domestic demand, particularly inventory investment, turned weaker.

The weakened growth momentum in the local economy has yet to have any visible impact on labour market conditions. The seasonally adjusted three-month moving-average unemployment rate remained at low levels of about 3.3% during the second half of 2011, while total employment reached an historical high of 3.63 million in January. With growth momentum slowing, the output gap was estimated to have been largely closed in the second half of 2011.

Inflationary pressures have been gradually receding. On an annualised three-month-on-three-month basis, the underlying inflation rate declined from 6.8% in July to 5.3% in January. The slowdown in the sequential momentum has been mainly driven by a slower pace of increase in the housing component of the CCPI and stabilised commodity prices. However, upside risks, such as the implementation of a new round of quantitative easing in the US, and supply-side shocks on oil prices triggered by geopolitical tensions, could reverse the expected moderation of inflationary pressures.

Incoming news has generally pointed to a gradual revival in growth impetus in the second half of 2012. Box 1 of the Report discusses our in-house composite leading and coincident economic indicators, which seek to take the pulse of the economy based on high-frequency data. However, the underlying global backdrop remains highly uncertain. On the one hand, the downside risks arising from the European sovereign debt crisis persist. On the other hand, the risk of renewed exuberance in asset markets should not be discounted given the expectations of the persistence of very expansionary monetary policies in the advanced economies. The latest consensus forecast for 2012 growth is 3.0%, but bracketed by a wide spectrum of views. The Government, meanwhile, has forecast growth also at a wide range of 1.0 - 3.0%.

Monetary conditions and capital flows

In the second half of 2011 the Hong Kong dollar spot exchange rate continued to trade within a narrow range. The exchange rate generally weakened in the third quarter, albeit mostly remaining in the stronger side of the Convertibility Zone. The downward pressures on the Hong Kong dollar were milder than the situation across much of the region, where local currencies were heavily sold off amid heightened global risk aversion.

The fourth quarter of 2011 saw larger fluctuations in the Hong Kong dollar exchange rate, mainly driven by the evolving market sentiments and banks' year-end funding demand. The exchange rate strengthened alongside a stock market rally in October, before weakening in November amid a higher safe-haven demand for the US dollar. Approaching the end of 2011, demand for the Hong Kong dollar rose again in response to banks' year-end liquidity needs.

Movements in the Hong Kong dollar interest rates in the second half of 2011 varied across market segments and tenor. In the money market, HIBORs rose slightly in November and December, broadly tracking their US dollar counterparts, after having been largely flat earlier in 2011. In contrast, yields of longer-term Exchange Fund papers declined alongside a fall in the corresponding US Treasury yields, albeit by a lesser magnitude. At the retail level, banks raised both their mortgage interest rates and deposit interest rates in response to higher funding pressures.

Reflecting weaker credit demand and enhanced supervisory measures, loan extension has decelerated visibly since mid-2011. In particular, growth in external loans – the sum of all foreign currency loans and those Hong Kong dollar loans that are for use outside Hong Kong – slowed more sharply than that of

Hong Kong dollar loans for use in Hong Kong. It should be noted, however, that renminbi-denominated loans have been growing at a fast rate, albeit from a very low base. Indeed, over the past few years, the external loan component has generally displayed more procyclical movement than the domestic loan counterpart, thus magnifying the swing of credit cycles in Hong Kong. Box 2 seeks to add to our understanding of the determinants of external loan growth, particularly by highlighting the role of the Mainland's monetary conditions in driving demand for credits from Hong Kong.

Deposits in both the Hong Kong dollar and foreign currencies grew solidly in the second half of 2011. Growth in renminbi deposits was slower in the third quarter than in the first half of the year, largely due to more balanced two-way renminbi remittance flows between Hong Kong and the Mainland in relation to trade settlement. Renminbi deposits have contracted in recent months, in part reflecting global market factors that weakened market participants' demand for the offshore renminbi. Amid heightened global risk aversion and flight to safe-haven currencies, most currencies in the region experienced heavy sell-offs. In this context, the offshore renminbi in Hong Kong traded at a visible discount to the onshore renminbi, reversing the previous pattern of a more expensive renminbi in the offshore market. Box 3 studies the price dynamics in onshore and offshore renminbi financial markets. The downward pressures and volatility in the CNH market, however, were much milder than those encountered in most other regional currency markets during the period.

In the year ahead, Hong Kong dollar interbank interest rates will likely remain at very low levels, given the US Federal Reserve's indication that current economic conditions warrant exceptionally low levels for the federal funds rate at least through late 2014. However, fund flows and longer-term Hong Kong dollar interest rates could see more volatilities as global economic and financial conditions evolve. As discussed above, a key risk relates to the likelihood of further rounds of quantitative easing in the advanced economies, which could lead to renewed inflows and push the long-term interest rates down. On the downside, an escalation in the euro zone sovereign debt situation could lead to significant outflows and put upward pressures on long-term interest rates.

Asset markets

Equities have been on a roller coaster ride – a major sell-off at the beginning of the review period was followed by a rebound towards the end. As the euro zone sovereign debt crisis deteriorated sharply after summer, investors sought safe havens and fled risky assets, sending the local equity market into a tailspin and implied volatility to the highest levels since the global credit crisis. Risk appetite subsequently returned as funding conditions eased in the euro zone and the US Federal Reserve indicated its intention to retain its highly accommodative policy stance at least through late 2014. The immediate future is likely to remain turbulent as a more accommodative monetary environment wrestles with weakening global demand and the de-leveraging of European banks.

The domestic debt market was also subject to the influence of the external environment. As investors turned more risk-averse globally, especially in their assessment of credit risk and in view of the deepening euro zone debt crisis, the accessibility of private sector issuers to international capital markets was generally reduced. The resulting reduction in issuance of Hong Kong dollar debt by overseas private issuers has slowed the expansion of the market. In contrast, the offshore renminbi bond market held up well amid rising yields and reduced expectations of an appreciation in the renminbi exchange rate. As the movement of the renminbi exchange rate becomes more flexible, the offshore renminbi bond market in Hong Kong is expected to grow steadily.

The residential property market has been gradually consolidating. Housing prices fell 4.4% in the second half, albeit still standing at some 40% above the previous peak in mid-2008. While official data showed the transaction volume had dropped sharply, provisional records suggest a rebound in trading activity more recently. The non-residential property market has also seen similar signs of consolidation.

The scale of the market correction has so far seemed mild, particularly in light of the strong surge in housing prices over the preceding two years. The previous buoyant market activity resulted in a considerable divergence between house price inflation and household income growth. Despite the recent price adjustment, the price-to-income ratio, as a measure of housing affordability, still stands at 11, significantly higher than its 10-year average of eight. As interest rates remain lower than consumer price inflation and supply is still tight, a further build-up of risks in the housing market cannot be ruled out. The balance of risks, therefore, warrants maintaining the existing prudential requirements on residential mortgage lending by the HKMA.

Banking sector performance

The local banking sector remained robust despite the lingering euro zone sovereign debt crisis and heightened uncertainties in the external environment. However, the aggregate pre-tax profits of retail banks decreased by 13.7% in the second half of 2011 from the first half. The net interest margin (NIM) of banks was up in the second half to average 1.28%, from 1.21% in the first half, partly reflecting banks' move to raise their HIBOR-based mortgage interest rates. But the increase of NIM was offset by lower non-interest income and higher operating costs. As a result, the return on assets edged down to 1% from 1.2% in the first half of the year. As some banks have recently moved to reverse their previous action in raising mortgage interest rates, how the NIM may be affected is yet to be seen.

Liquidity in the local banking system tightened somewhat in the review period, although lately it appears to have eased slightly. During the second half, while the pace of credit growth moderated further, from a 4.4% increase in 2011 Q3 to 1% in 2011 Q4, total deposits grew slightly faster by 3.6%, having slowed to only 1.2% in the third quarter. Still, the Hong Kong dollar and all currency loan-to-deposit ratios stayed at relatively high levels of about 84.5% and 66.9% respectively at the end of 2011.

The domestic banking environment will continue to be affected by the volatile external environment. Box 4 shows that if a euro zone crisis-led recession occurred, Hong Kong would inevitably be affected by higher credit losses in the local banking sector. In addition, the de-leveraging pressures for European banks could also affect credit availability. In particular, the growth of foreign currency lending in Hong Kong would decelerate in the event of any drastic outflows of interbank funding by European banks. However, results of the stress tests show that the loan loss severity, even in extreme cases, would remain much lower than the actual loss registered after the Asian financial crisis. The impact on liquidity would also be significantly less severe than what happened during the global financial crisis of 2008-09, with credit supply remaining adequately supported by domestic funding. Nevertheless, banks face the challenges of continuing to manage their credit and liquidity risks prudently while positioning themselves to meet the new capital and liquidity standards under Basel III.

The Half-Yearly Report on Monetary and Financial Stability is prepared by the staff of the Research Department of the Hong Kong Monetary Authority.