1. Summary and overview

Despite a volatile external environment, the Hong Kong dollar has not been subjected to any significant inflow or outflow pressures. Credit growth has been subdued amid slowing economic activities in both the local and regional economies. And, banks' profitability has strengthened despite slower growth of their balance sheets.

The local property market continues to be a major source of risk to financial stability in Hong Kong. Tight supply conditions and low interest rates may exert persistent upward pressure on housing prices, but this upward trend could be abruptly reversed by unexpected shocks. It is critical that both banks and their borrowers maintain large cushions of capital on their balance sheets.

The external environment

The global growth momentum faltered in the first half of 2012. As the stabilising effect of the European Central Bank's three-year Longer-Term Refinancing Operations waned, concerns about the European sovereign debt crisis renewed. With many crisis countries in the euro area plunging deeper into recession, there are growing signs that a vicious circle of recession and banking and sovereign debt problems is in the making in these countries. In the US, subdued economic growth and the slow pace of job creation increase the vulnerability of the economy to shocks emanating externally from Europe and locally from the political debate on fiscal consolidation. Major central banks therefore have stepped up easing and supportive measures.

Given the weaknesses in the external environment, growth momentum in the East Asian emerging economies, including Mainland China also moderated in the first half of 2012. Inflationary pressures have generally moderated and should continue to ease, leaving policymakers more room for supporting economic growth. Signs of capital outflows from the region have also emerged, exerting some downward pressures on regional currencies. Box 1 discusses the long-run performance of the stock market in Mainland China, and addresses the question whether investors should expect a tight relationship between stock market performance and economic growth.

The domestic economy

The Hong Kong economy has advanced at a pace well below its trend rate for more than a year, with the difficult external environment weighing heavily on exports and holding back somewhat on domestic demand. The down cycle became even more evident in the first half of 2012, as real GDP grew by 0.5% in Q1 and then contracted a little by 0.1% in Q2.

Despite the lacklustre economic performance, labour market conditions remained tight. The seasonally adjusted three-month moving-average unemployment rate hovered between 3.2% and 3.4% in the first seven months of 2012, while total employment continued to edge up to a record high. Box 2 examines in more detail the tightness of the labour market conditions, and addresses the question whether the market is likely to remain resilient.

Inflationary pressure continued to recede, although the speed of the deceleration in price pressures has been slower than expected due to the continued strength of the rental component. On an annualised three-month-on-three-month basis, the underlying inflation rate edged down to 3.1% in July from 5.3% in January. All major CCPI components, including rental, tradables and services, have registered some moderation. With increasing downside risks to the domestic economy and strong global headwinds, inflationary pressure is likely to recede further in the near term.

For the rest of the year, the Hong Kong economy is not likely to regain much momentum, given the lull in external demand and global financial volatility. With private sector sentiment and income prospects already turning weaker, domestic demand could only provide a limited offset against the continued weakness in exports. As a result, market analysts have revised their forecasts for annual GDP growth down to a consensus average of 1.8%. The Government also sees growth weakening to the 1 - 2% range.

Monetary conditions and capital flows

Despite heightened uncertainty in the global macro-financial environment, the Hong Kong dollar spot exchange rate has only moved within a tight band so far during the year. At the beginning of 2012, the Hong Kong dollar exchange rate strengthened slightly amid a respite from the euro area crisis. However, the rate softened through mid-May on renewed concerns over the crisis and the weaker global growth prospects. More recently, the demand for the Hong Kong dollar strengthened again on signs of progress in addressing the European sovereign debt crisis. Overall, the strength of the Hong Kong dollar in the past several years, to some extent, reflects its perception as a "safe-haven" currency by investors, a finding discussed in Box 3, which investigates the risk assessment of currencies by international investors in times of financial turmoil.

The low interest rate environment has continued. In the money market, while the overnight Hong Kong dollar interbank offered rate (HIBOR) fixing edged down, interbank rates for maturities of three months and beyond increased slightly, in line with movements in the US dollar interbank rates. The yield curve of Exchange Fund Papers shifted downward across the term structure, reflecting increased demand for high-quality Hong Kong dollar assets and the flattening of the US Treasuries yield curve. The average cost of funds for banks, as reflected by the composite interest rate, has declined slightly as a result of easing deposit interest rates. Mortgage interest rates have also seen a slight decline.

Along with weakening economic growth momentum, both bank lending and deposits have been growing at a moderating pace during the first half of 2012. The growth in bank lending has continued to be driven, to a large extent, by foreign currency loans and loans for use outside Hong Kong. In contrast, Hong Kong dollar loans and domestic credit increased only slightly at low single-digit rates. Both Hong Kong dollar and foreign currency deposits grew at a modest pace.

The funding structure of renminbi business in Hong Kong banks has continued to evolve. Although renminbi deposits decreased modestly from six months ago, the outstanding amount of renminbi certificates of deposit rose markedly from January to June. Along with the growth of renminbi funds, outstanding renminbi loans climbed further from a low base by over 70% during the same period. Cross-border use of the renminbi has continued to grow despite lower expectations of renminbi appreciation. Box 4 studies the determinants of the distribution of eurodollar deposits among different offshore banking centres and draws lessons for further development of offshore renminbi business in Hong Kong.

Asset markets

Equities came under tremendous pressure amid the deteriorating external economic environment. The manifestation of the European sovereign debt crisis in the form of troubled banks sent global equity markets into a tailspin, while the US and Mainland economies displayed further weakness. The combination of financial and economic woes led to a significant increase in risk aversion, causing local stock prices to fall sharply and implied volatilities to surge. This kept more investors on the sideline in a market where trading was already subdued. In the primary market, fund raising activity was also reduced significantly amid the risk re-appraisal. While the relatively low market valuations may render the market more receptive to positive news, the period ahead is likely to continue to see a volatile market given considerable policy uncertainties in the US, Europe and the Mainland.

The domestic debt market has been dominated by issuances by the public sector and local banks. The European sovereign debt crisis continued to limit the accessibility of private sector issuers to international capital markets, including Hong Kong, especially for longer-term funding. In contrast, the growth of the offshore renminbi debt market continued at a brisk pace, accompanied by a rise in yields. Primary market activity was buoyant, especially at the longer end of the yield curve, attributable in part to issuances by the Mainland Government and state-owned banks. This should provide useful benchmarks for private issuers, hence benefiting the long-term development of the offshore market.

The residential property market has shown a sharp revival since February this year from a mild consolidation during the latter part of 2011. Housing prices have bounced up 13.1% so far this year, while the number of transactions increased by some 40%. Behind the revival was improving home-buying sentiment that helped release the pent-up demand from the earlier consolidation period.

Nevertheless, it is still uncertain how the residential property market will evolve, as it has been caught in a tug-of-war between two opposing forces. On the one hand, upward pressure on housing prices could persist with continued tight supply conditions and low interest rates. On the other, a weaker global outlook would weigh down housing prices. The recent rise in residential property prices has already eroded housing affordability further, with the income-gearing and price-to-income ratios soaring towards their 1997 peaks. It is therefore critical that both banks and their borrowers maintain large cushions of capital on their balance sheets to be resilient against potential shocks from a downward adjustment in housing prices. In view of this, the HKMA introduced on 14 September a new round of measures to further strengthen risk management in property mortgage lending business, including tightened underwriting criteria for loans to borrowers with multiple property mortgages and a newly introduced ceiling for loan tenors.

Banking sector performance

The local banking sector continued to record healthy growth despite the unfavourable external environment. As the European sovereign debt and banking crisis intensified, banks in Hong

Kong have been prudent in managing their exposure to Europe. With the Mainland economy slowing, banks' credit risk in their Mainland exposure could also be rising, but the banks should be well positioned to manage such risks.

Banks' growth was characterised by strong capital positions by international standards and sound liquidity, as well as a general improvement in asset quality. Notwithstanding the prolonged European sovereign debt crisis and a slowdown in the Mainland economy, retail banks registered a noticeable improvement in earnings, with aggregate pre-tax profits growing strongly by 26.9% in the first half of 2012, from the second half of 2011, and the return on assets rising to 1.25% from 1%. The improvement reflected higher net interest and non-interest income as well as lower operating costs and lower net charges for provisions. Although competition in the loan market, particularly in mortgage lending, continued to be keen, the net interest margin of banks improved further to 1.35% in 2012 H1, from 1.27% in 2011 H2, as funding costs as a whole softened.

Domestic liquidity conditions remained steady, with the average liquidity ratio sustaining at well above the regulatory minimum requirement. The pace of credit growth slowed further to 4.7% in the first half of 2012 from 5.4% in the second half of 2011, while total deposits increased by an even more moderate rate of 1.5%, compared with a rise of 4.9% in the previous period. The overall loan-to-deposit (LTD) ratio increased to 69% in June 2012, but the Hong Kong dollar LTD ratio edged down to 84%. Given the less sanguine economic outlook, more banks expect the loan demand to slow further rather than pick up in the near term.

The Financial Stability Board has recently identified shadow banking as a potential source of systemic risk. Box 5 assesses the situation in Hong Kong and finds that the scale of shadow banking is small, with no material concerns on the participants' leverage, funding structure and interconnectedness with the local banking sector. Nevertheless, continuous monitoring is required since the situation may evolve amid rapid regulatory changes in the global financial system.

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