# 1. Summary and overview

*Tapering of asset purchases by the US Federal Reserve has led to a new bout of volatility affecting emerging market economies. Against this stormy external environment, the Hong Kong dollar exchange rate has been broadly stable and local financial markets have remained orderly.*

*As the authorities in Mainland China aim to steer the economy toward a slower but more sustainable growth path and achieve a gradual reduction in corporate and local government leverage, local banks need to be alert to and be prepared for possible increases in the credit risks of their Mainland exposures. At the same time, they need to brace themselves for risks associated with possible fund outflows and property market adjustments.*

### *The external environment*

The US Federal Reserve began tapering its large-scale asset purchase programme in January. The move signalled the start of what could be a prolonged and complex monetary normalisation process. Global financial markets initially reacted calmly, helped by improved prospects for advanced economies and expectations that major central banks would maintain loose monetary conditions for a prolonged period. However, a new bout of market volatility soon resurfaced as markets assessed how well emerging markets economies would withstand the withdrawal of US monetary stimulus.

The beginning of the US Federal Reserve's monetary policy normalisation process may reflect improved growth momentum in the US economy, but there are still some concerns about the US economy. Continued decline in the labour participation rate and subdued capital investment may indicate lower potential output growth, which could complicate the judgment about inflation risks and the conduct of monetary policy. Indeed, the path of exit is not necessarily smooth, and interest rate volatility could be higher than currently anticipated. In the euro area, while the recovery has steadied, continued financial fragmentation and the debt overhang in both the private and public sectors make a stronger recovery difficult to attain. In Japan, growth and inflation have both improved but the outlook remains uncertain amid sluggish wage growth and current account deficits. High public debt and limited fiscal room to manoeuvre also mean if growth falters or government bond yields jump, sovereign debt dynamics may worsen in Japan.

In East Asia, some capital outflow pressures were felt in a number of economies after the announcement of tapering of asset purchases by the US Federal Reserve late last year, but financial markets have in general reacted more calmly compared to the heavy sell-off in the summer last year. Looking ahead, capital flows may have become more sensitive to shocks or events that could trigger risk aversion, and market volatility is likely to remain high as concerns over emerging markets linger amid the normalisation of monetary policy in the US. On a more positive note, most governments in the region have room to adopt counter-cyclical policies to cushion the impact of capital flow reversals.

Capital flow volatility in the region may also reflect market concerns for slower growth in Mainland China. As growth slows, concerns for excess leverage in local governments and in the corporate sector could also cause market volatility. The authorities in Mainland China have indicated their determination to steer the economy toward a slower but more sustainable growth path, and given their experiences in the 1990s, are in a position to manage an orderly process of deleveraging.

The property market on the Mainland is central to both macroeconomic and financial stability. Box 1 (see Page 19) explores the linkages between real estate and other sectors. The analysis suggests that the real estate sector's linkages with others have strengthened in the past several years, and credit risks of the real estate sector could potentially generate spillover effects on other sectors in the Mainland economy.

## *The domestic economy*

Real GDP growth in Hong Kong accelerated to a quarter-on-quarter rate of 0.7% in the third quarter and 1.1% in the fourth quarter of 2013 on the back of stronger domestic demand and gradual recovery in external demand. Private consumption held up well, while investment strengthened due to robust machinery and equipment acquisition. Export performance improved with the gradual recovery of the advanced economies and the Mainland economy, but net exports remained a drag on growth due to much stronger retained imports.

For the whole of 2013, real GDP growth picked up to 2.9% from 1.5% a year ago but remained below the annual average of 4.5% in the past 10 years. Labour market conditions however remained broadly stable, with the unemployment rate edging down to 3.2% in the fourth quarter and total employment growing at a robust pace. Box 2 (see Page 25) discusses some possible reasons behind the stable labour market conditions in spite of the relatively slower GDP growth in recent years.

Local inflation pressure eased from the first half of 2013, with the annualised three-month-on-three-month underlying inflation rate declining to 4.0% in January 2014 from an average rate of 4.6% in the first six months of 2013. Such easing momentum will likely continue, as gentler residential property rental increases should continue to restrain inflationary pressures.

Hong Kong's real GDP growth will likely pick up moderately faster towards the trend rate in 2014. Export performance is expected to improve further amid stronger recovery in the advanced economies and the broadly resilient Mainland economy. Domestic demand will likely remain robust with solid growth in private consumption and investment. The housing wealth effect, however, could weaken or even turn to a drag on consumption amid the cooling of the property market. Moreover, the fiscal stance has become slightly contractionary due to cutbacks in the size and scope of relief measures.

Private-sector analysts now project Hong Kong's real GDP growth to average around 3.5% in 2014, while the Government sees growth strengthening to the range of 3.0-4.0%. The HKMA in-house composite index of leading indicators also points to moderately faster growth ahead. This relatively more favourable outlook is however subject to a number of uncertainties and risks, particularly those associated with volatile capital flows in the region.

## *Monetary conditions and capital flows*

The Hong Kong dollar spot exchange rate continued to move within a tight range near the strong-side convertibility rate of 7.75 in the second half of 2013 despite a sell-off in some emerging market currencies during the period. Indeed, alongside a pickup in local stock market activities, there were mild inflow pressures in the non-bank private sector between July and November. In December, when the US Federal Reserve announced its tapering plan, the Hong Kong dollar spot exchange rate softened only slightly. But on the whole, fund flow pressures were modest and the Linked Exchange Rate system continued to enjoy a high degree of market credibility.

Monetary conditions remained accommodative, with interest rates still hovering at low levels and the money supply growing faster. The wholesale funding costs of the banking sector continued to stay at low levels, with the overnight and 3-month HIBOR fixing rate moving around 0.08% and 0.38% respectively. Retail interest rates have also remained stable at low levels. Nevertheless, the long-dated Hong Kong dollar yields increased gradually along with the US dollar counterparts amid concerns about the US Federal Reserve's plan to reduce asset purchases. Meanwhile, reflecting a stronger increase in bank customers' deposits and negotiable certificates of deposits held by the non-bank sector, the Hong Kong-dollar broad money supply (HK$M3) rose at a faster pace of 5.5% in the second half.

On the asset side, despite signs of moderation in the fourth quarter, total loan growth reached 16.0% in 2013, compared with 9.6% in 2012. There was a sharp increase in foreign currency lending and loans for use outside Hong Kong, and the US dollar loan-to-deposit ratio reached 85.4% at the end of 2013. To prevent further build-up of funding vulnerability, the HKMA introduced the Stable Funding Requirement which came into effect from January 2014, under which Authorized Institutions (AIs) with total loan growth exceeding 20% are required to maintain specific level of stable funds.

Hong Kong dollar lending and domestic credit also grew faster. While growth in residential mortgage lending has already slowed due to sluggish property market activities and the dampening impact of prudential measures, personal loans increased by 16.8%, bringing the household debt-to-GDP ratio to a record 62%. In view of these developments, the HKMA issued a circular in January 2014 to require the AIs to review the underwriting standards for their personal lending business and enhance their risk management practices.

The development of Hong Kong as an offshore renminbi business centre gained further momentum. Total renminbi deposits and certificates of deposit (CDs) rose significantly by 46.2% in 2013, largely driven by the rise in renminbi trade settlement, and to a lesser extent, stronger renminbi demand due to higher interest rates against other currencies and expectations for currency appreciation. Renminbi loans also grew notably by 46.3% from a year ago. Despite tightened liquidity conditions on the Mainland leading to sizeable fluctuations in the onshore interbank interest rates, the offshore interbank rates remained relatively stable. But forward-implied yields moved closely with those onshore. Box 3 (see Page 38) highlights the key findings of a study on the interactions between CNY and CNH deliverable forward markets. On average, spillovers from the onshore to the offshore market were larger than spillovers in the opposite direction, and both markets were found to contribute to the price discovery process for renminbi forward exchange rates.

### *Asset markets*

Hong Kong equities have underperformed global equities over the past six months. Concerns about the spillover effects of US tapering and slowdown of the Mainland China economy cast a shadow over the local market. The brighter spot was probably the primary market which saw a sharp increase in the initial public offerings of Mainland firms in the second half of the year. Looking ahead, while downside risks appear to be limited at the current level of valuations, trading is likely to be volatile as the US Federal Reserve goes further down its tapering path.

The domestic debt market expanded steadily amid increased volatility in global bond markets. As tapering talks kept investors on the sideline, debt issued by the private sector declined considerably. This, however, was more than offset by a marked increase in public debt issuance. Meanwhile, the offshore renminbi market registered another year of fast growth in 2013. Primary market activity grew remarkably and featured an increasingly diversified issuer and product mix. Looking forward, the market is likely to see steady growth in the coming year, in view of an increase in refinancing need and strong demand from private Mainland issuers. Swap-based issuance by overseas firms, whose recent strong growth is analysed in Box 4 (see Page 45), is also expected to gain further popularity, adding to the vigour of the market.

Property market activities remained weak in the second half of 2013 and recent months, with transaction volume shrinking considerably and housing prices facing some downward pressure amid rising expectation of future interest rate hikes and the dampening effect of the counter-cyclical measures. Primary-market transactions revived more recently as developers offered discounts and concessions. At the same time, there are signs that more home owners are willing to lower their asking prices and banks become relatively more conservative on home appraisal. While analysts generally envisage further consolidation this year, there are no strong signs of a definitive turn in the property cycle. Property valuation remains highly stretched, with the price-to-income ratio and the income gearing ratio staying at elevated levels.

### *Banking sector performance*

The banking sector continued to record healthy growth, characterised by sound asset quality, favourable liquidity conditions, and strong capital positions by international standards. While the sector's profitability moderated somewhat during the second half of 2013, from the very strong results of the first half, it remained more favourable than the same period of the previous year, with retail banks registering a pre-tax return on assets of 1.2%, compared with 1.4% in the first half of the year and 1.1% in the second half of 2012. For 2013 as a whole, the aggregate pre-tax operating profits of retail banks recorded an increase of 22.1%, with the average return on assets rising to 1.3%, from 1.2% in 2012.

In the second half of 2013, liquidity conditions continued to be favourable, and domestic interest rates were generally steady. As the growth of deposits outpaced credit expansion, the overall loan-to-deposit (LTD) ratio for all AIs fell to 70.4% in December 2013, from 71.9% in June 2013. Box 5 (see Page 63) assesses the liquidity risk of the Hong Kong banking sector. In short, the liquidity stress test shows that the systemic liquidity risk of Hong Kong banking sector would be contained in the face of severe economic and financial shocks. While the sensitivity test points to the same conclusion, it highlights that banks' liquidity risks are sensitive to interest rate movements. Banks should therefore be vigilant for the potential effect and pace of normalisation of interest rates.

Given the strong presence of global banks in Hong Kong, the liquidity and funding conditions of the banking sector cannot be immune to inward spillovers of shocks from global banks' home countries. Box 6 (see Page 67) examines factors determining the extent of shock transmissions through intra-group funding activities of global banks and the associated impact on the operation of foreign bank branches in Hong Kong. The findings suggest that while funding shocks of parent banks could exert significant pressure on the credit availability and loan pricing in host countries, the ongoing regulatory reforms should help reduce the adverse effect.

Looking forward, as global monetary conditions continue to normalise, the possible impacts on banks' balance sheets should be closely monitored. In particular, in view of the recent rise in the level of household indebtedness and corporate leverage, the debt servicing abilities of borrowers could be under test should interest rates increase markedly or a significant correction in the local property market take place. To prevent further build-up of funding vulnerability in banks' balance sheets, the HKMA introduced a Stable Funding Requirement with effect from January 2014. Following the announcement, credit growth in late 2013 somewhat slowed down. Meanwhile, the expansion of the sector's credit exposure to Mainland China-related business remains a challenge, and banks should continue to manage conservatively the credit risks on their Mainland China-related exposure. To step up surveillance of such activities, the HKMA required all banks to report more granular information on their non-bank Mainland exposures by introducing a new quarterly Return of Mainland Activities. In addition, the HKMA required banks active in such activities to conduct thematic review on their risk management and internal controls.

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