1. Summary and overview

Global and regional financial markets have experienced very low level of volatility and appear to be underpricing the risks associated with the exit from unconventional monetary policies by the US Fed.

The Hong Kong dollar has been under inflow pressures, reflecting a range of global, regional and local factors. As a result, local monetary conditions will remain loose but can tighten abruptly along with a rise in the US dollar interest rates.

Income growth has been sluggish in Hong Kong. As incentives for borrowing continue to be unabated, credit, liquidity and interest rate risks may increase further in the financial system in the period ahead.

The external environment

Global financial markets have experienced low volatility in recent months. However, there appears to be growing disconnect between the performance of the financial markets and the real economy, as indicated by the significant divergence between strong asset price inflation and sluggish credit growth in the major advanced economies. Investors are justifying their bets on continued accommodative global monetary environment and strengthening global growth, but they may be underestimating hidden economic and policy risks that could cause dislocations in the markets.

One major swing factor is the timing and pace of monetary policy normalisation in the US. The unemployment and inflation rates are already approaching the long-run policy targets faster than the Fed had expected, posing risks of a stronger-than-expected monetary tightening. In the euro area, the effectiveness of the European Central Bank (ECB)'s latest monetary easing on combating disinflation is still unclear. In Japan, the strength and sustainability of the economic rebound after the April tax increase remain uncertain and there is a risk that "Abenomics" may fail to stimulate long-term growth if the government cannot deliver the structural reforms it has promised.

In East Asia, growth momentum has moderated in the first half of 2014 due to the weak external performance alongside slowdown in the US and China. But financial markets in the region have been buoyed by the unusually calm investor sentiment. As incentives for borrowing remain strong, leverage in the region could increase further before the Fed eventually exits its unconventional monetary policy. This would exacerbate the risk of a boom-bust cycle that leads to an abrupt unwinding of the currently compressed risk premia and fund flow reversal. Box 1 (see Page 14) discusses the potential impact of the Fed's monetary normalisation by examining the relationship between US Treasury yields and sovereign bond yields in the Asia Pacific, especially when the markets come under severe stress.

The degree of financial market adjustment and capital flow reversal in the region would be sensitive to the growth prospect of the Mainland China economy. Growth momentum of the Mainland economy has improved and is expected to be largely stable in the near-term amid gradually improving external demand and fine-tuning of economic policies. Nevertheless, the property market downturn and its impact on industries with overcapacity and local government debt would continue to put pressure on banks' asset quality. Our analysis in Box 2 (see Page 22) suggests that entrusted lending, a major component of shadow banking on the Mainland, has mainly been conducted by state-owned enterprises (SOEs) and big firms in industries with overcapacity as well as real estate developers. This Box seeks to provide a better understanding of entrusted lending on the Mainland using firm-level data.

The domestic economy

In Hong Kong, economic growth has been sluggish in the first half of 2014, with real GDP declining marginally by 0.1% on a quarter-on-quarter basis in the second quarter, following the mundane growth of 0.3% in the first quarter. Domestic spending used to be the main growth engine but has weakened noticeably, particularly in the second quarter. Investment spending was the main drag, while private consumption also declined due to weaker growth prospects and receding housing wealth effects. Meanwhile, services exports were weighed down by weaker tourist spending and, to a lesser extent, softer financial market activities. A brighter spot was moderate improvement in exports of goods on the back of stronger external demand.

Domestic inflation moderated during the first seven months of 2014, with the annualised three-month-on-three-month underlying inflation rate declining to 2.5% in July from 4.0% in January. This was driven mainly by the easing in services inflation. Going forward, moderate inflation will likely continue as mild rental increase and tepid labour cost pressures are expected to contain inflationary pressure.

Despite sluggish economic activity in the first half, a pick-up in sequential growth momentum is expected, though likely at a moderate below-trend rate. Export performance would improve further with the recovery of the US economy continuing to take hold and the Mainland China economy showing signs of stabilisation. Box 3 (see Page 30) studies the relative importance of Mainland China and the US in driving Hong Kong's economic cycle and trend growth. While weaker Mainland tourist spending could well remain a drag, there will be some support from exports of trade-related services and financial services, the latter buoyed in part by the soon-to-be-launched Shanghai-Hong Kong Stock Connect pilot scheme.

Regarding domestic spending, private consumption is anticipated to improve modestly, supported by a relatively stable yet easing labour market. Overall fixed investment would continue to be supported by infrastructure projects and other building and construction activities, although capital spending tends to fluctuate.

The Government has revised downward its range forecast of 2014 real GDP growth to 2-3% from 3-4% as announced earlier in May. Private-sector analysts also adjusted downward their growth forecasts recently to an average of 2.4%. The HKMA in-house composite index of leading indicators points to a modest increase in economic activities in the second half. However, downside risks to the economic outlook remain amid uncertainties surrounding the global economic and financial environment as well as heightened geopolitical tensions.

Monetary conditions and capital flows

Despite some softening in the first quarter, the Hong Kong dollar has faced stronger buying pressure. The Hong Kong dollar exchange rate strengthened towards 7.75 in the second quarter and the following months, while the net spot foreign currency positions of the Authorized Institutions (AIs) increased considerably, suggesting strong net inflows into the non-bank private sector alongside revived stock market activities and investors' risk appetite. The inflow pressure remained persistently strong in recent months, which culminated into repeated triggering of the strong-side Convertibility Undertaking (CU) in July and August. In response, the HKMA purchased a total of US$9.7 billion from banks, thereby creating HK$75.3 billion and leading to a corresponding increase in the Aggregate Balance. The net inflows were driven by a range of global, regional and local factors, including improved confidence in the Mainland China economy, and active commercial activities such as dividend distributions, cross-border merger and acquisition transactions and initial public offerings.

With ample liquidity in the banking system and interest rates hovering at low levels, the monetary and credit conditions in Hong Kong remained highly accommodative. While the Hong Kong-dollar broad money supply (HK$M3) has expanded at a robust pace, the wholesale funding costs of banks remained low, with the overnight and three-month Hong Kong dollar interbank interest rates moving around 0.06% and 0.37% respectively. The Hong Kong dollar yield curve has flattened along with the US dollar yield curve by about 20 basis points for the yield of the 10-year Exchange Fund Notes. On the other hand, given a moderate increase in the deposit rates, the composite interest rate, which reflects the average funding cost of retail banks in Hong Kong, rose to 0.47% in June from 0.39% last December. However, the average lending rate for new mortgage loans declined to around 2% recently, probably reflecting slight easing in banks' credit stance towards mortgage lending.

Total bank loans grew faster at an annualised 19.1% in the first half of 2014 following a 16.0% increase in 2013. Reflecting strong cross-border demand and increased Mainland-related exposure, foreign currency loans and loans for use outside Hong Kong continued to grow at a fast pace, though moderating slightly compared with last year. Meanwhile, Hong Kong dollar loans and loans for use in Hong Kong (including trade finance) also rose faster. Household debt edged up to 63.6% of GDP in the second quarter alongside strong growth in personal loans. The loan-to-deposit ratio for Hong Kong dollar was largely stable while the ratio for foreign currency (particularly US dollar) increased, albeit levelling off more recently.

Offshore renminbi business in Hong Kong maintained a solid growth momentum. Total renminbi deposits and certificates of deposit (CDs) increased by 6.8% (not annualised) in the first half, while renminbi trade settlement picked up by 36.4% (not annualised). Meanwhile, renminbi financing activities in Hong Kong grew at a robust pace, with outstanding loans increasing by 20.6% (not annualised) and renminbi bond issuance recording strong growth. Largely due to increased funding demand for renminbi bond investments and liquidity needs around the half-year end, interbank liquidity for offshore renminbi tightened slightly in May and June, as the three-month CNH interbank rate rose by about 60 basis points to 3% at the end of June. The offshore exchange rate (CNH) has tracked closely the onshore rate (CNY), without any persistent positive or negative spreads between the two rates.

Asset markets

Hong Kong equities have rebounded over the past six months, following a sell-off in the beginning of the year. International investors regained appetite for risky assets as the Fed indicated to keep interest rates low for the foreseeable future. Against this backdrop, a series of "mini-stimulus" measures unveiled by the Mainland authorities and a pilot programme to link the local and Shanghai stock markets fuelled a rally in the local market, sending the HSI to a 6-year high. However, in view of the current low volatility in global financial markets, a rebound in interest rates may prompt a major risk re-appraisal globally. Hence, the medium-term outlook for local equities is still largely uncertain.

In the local bond market, the total amount of bonds outstanding registered a small decline in the first half of this year. Following a sell-off in Asian bonds early in the year, improved economic conditions in the region provided a favourable environment for the private sector to raise more funds in the debt market. Public sector issuance also increased, though only marginally. However, the increase in issuance was not enough to offset matured bonds. Box 4 (see Page 46) reviews recent developments in the corporate bond market in the region and discusses potential risks associated with rising leverage of the issuers. The offshore renminbi debt market in Hong Kong continued its rapid expansion and overseas despite some concerns over the credit quality of a few issuers. Looking forward, the market is likely to see steady growth in view of strong refinancing needs. Investor risk appetite would also increase if the outlook for the Mainland economy improves further.

After some consolidation in the past year or so, the residential property market has turned more active in recent months on the back of pent-up demand and improving sentiment, with transaction volume picking up from recent lows and housing prices resuming moderate growth. But property valuation remains highly stretched relative to household income and economic fundamentals, with the price-to-income ratio and the income gearing ratio staying high. Box 5 (see Page 53) discusses the impact of counter-cyclical prudential and demand-management measures on housing market activities.

Banking sector performance

Retail banks maintained solid earnings growth, sound asset quality and a strong capital position. In the first half of 2014, their pre-tax operating profits grew by 7.3% from the second half of the previous year, and their return on assets edged up to 1.22%. The increase in profitability was mainly driven by a 7.6% growth in net interest income. Meanwhile the net interest margin of retail banks held at 1.4%.

The average liquidity ratio stood at 40.8% in the second quarter, well above the 25% regulatory minimum. The Liquidity Coverage Ratio under the Basel III liquidity standards, which aim at strengthening banks' resilience to liquidity stress, is scheduled to phase in from 1 January 2015 with a view to completing the implementation on 1 January 2019. Banks in Hong Kong are not expected on the whole to encounter major difficulties in complying with the new liquidity standards over the transitional period.

The overall loan-to-deposit ratio for all AIs went up to 73.6% at the end of June, largely reflecting a faster increase in foreign currency loans that outpaced the moderate growth of foreign currency deposits. In this regard, the prospective exit from unconventional monetary policy (UMP) by the US Fed may potentially lead to a disruption of the supply of international US dollar credit. Box 6 (see Page 68) studies this issue and finds that although the contractionary effect on global liquidity brought by Fed's exit from UMP could be partly offset by the expansionary effect of UMPs of other central banks, the net effect is crucially dependent on whether the normalisation of liquidity in the US would coincide with a general flight to safety from risky assets. Liquidity risks associated with the flow of international US dollar credit can be high in such stressful scenario, posing significant challenges for policymakers.

Looking forward, banks should remain vigilant to risks associated with rising corporate leverage and household indebtedness. Debt-servicing burdens have increased in both the household and the corporate sectors in recent years, and could worsen significantly if income growth continues to be sluggish.

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