1. Summary and overview

The twin shocks of a significant strengthening of the US dollar and a sharp plunge in oil prices have heightened volatility in the foreign exchange markets in recent months. While emerging market currencies have experienced increased depreciation pressure, the Hong Kong dollar remained stable.

Loan growth in Hong Kong moderated along with slower economic growth, but renewed buoyancy in the local property market and continued build-up of household indebtedness are adding to financial stability risks. Looking ahead, the strengthening of the US dollar and the imminent US interest rate hike would increase uncertainty in local liquidity conditions and heighten credit risks and interest rate risks. The associated effect on banks' leverage could potentially affect banks' lending capacity and therefore merits closer attention.

The external environment

Global foreign exchange markets have experienced a sharp rise in volatility in recent months amid the twin shocks of a significant US dollar appreciation and a sharp plunge in crude oil prices. In particular, the Swiss franc saw sharp appreciation following the Swiss National Bank's (SNB's) removal of the exchange rate cap of Swiss franc with the euro in January, while the Russian rouble experienced sharp depreciation amid the oil prices plunge late last year.

With the US leading the pack among the advanced economies in terms of economic growth and labour market recovery, the divergence of US monetary policy paths with the rest of the world is likely to continue and drive further strengthening of the US dollar. While the US Federal Reserve (Fed) has already started its process of monetary policy normalisation and will begin its rate hike cycle, the European Central Bank (ECB) announced a quantitative easing programme in January 2015 amid lacklustre growth and rising deflationary risk in the euro area. In Japan, the economy has already entered into a tecÚical recession as a result of the April 2014 consumption tax hike and the Bank of Japan (BoJ) has expanded its Quantitative and Qualitative Easing (QQE) programme since late 2014. In Mainland China, growth momentum softened further amid continued adjustments in the property markets. Capital outflow pressures also emerged, in part reflecting concerns over the economic outlook. The People's Bank of China (PBoC) has taken measures to lower borrowing costs and maintain liquidity conditions stable in the banking system. Box 3 (see Page 27) sheds light on Mainland China's corporate leverage across industries and by firm ownership, and concludes that its rise has been driven mainly by implicit government guarantee.

Continued divergence in the growth and monetary policy paths of the major economies is likely to heighten volatility in the foreign exchange market. In particular, volatility in the foreign exchange market is also amplified by recent volatility in the credit default swap markets especially in emerging market and traditional safe haven economies. Box 1 (see Page 14) examines the interactions between currency risk and sovereign credit risk for major currencies.

While the recent fall in oil prices should benefit economic growth in major oil-importing advanced economies by lowering production costs and stimulating spending on other goods and services, there could be potential negative contagion from increasing credit risks of emerging market oil exporting economies as well as of US energy producers in the US high yield market.

The sharp fall in oil prices is also increasing the uncertainty in the timing and pace of the Fed's interest rate hike. In the near term, the sharp fall in oil prices and concerns over its potential pass-through to core inflation and inflationary expectations have prompted market expectations of a slower pace of Fed's rate hike. However, the good underlying strength of the US recovery and the faster-than-expected narrowing of labour market slack suggest that wage and inflation pressure would eventually pick up some time down the road. The subsequent pace of rate hike by the Fed could be faster than expected if the latter factor eventually dominates.

In East Asia, growth momentum remained modest in the second half of 2014 amid the subdued performance of its external sector. Despite stronger US economic recovery, its contribution to the region's export growth in general is still well below that of the pre-crisis period. Box 2 (see Page 17) examines the reasons behind the weak export demand from the US over the past few years, suggesting that there might be changes in US import pattern since the global financial crisis.

In late 2014, the twin shocks from both a strengthening US dollar and a sharp fall in oil prices have turned investors' sentiment more bearish towards emerging market economies. So far, investors have remained discriminative, as evidenced by less depreciation pressure on the currencies of regional economies with stronger fundamentals. Looking ahead, a stronger US dollar and the expected higher US dollar interest rate could act as a pull factor to induce investors to move away from risk assets in the region, while increasing the debt servicing burden of borrowers of US dollar credit. Meanwhile, central banks in the region would be facing increasing policy dilemma between supporting growth and reining in deflationary pressure on the one hand, and reducing the risk of abrupt capital outflows on the other.

The domestic economy

In Hong Kong, economic growth continued at a below-trend rate in the second half of 2014, with the real GDP growth rate easing back to 0.4% on a quarter-on-quarter basis in the fourth quarter from 1.4% in the third quarter amid a weaker external trade environment. In particular, net exports turned to a notable drag on growth in the fourth quarter as overseas demand weakened. On the other hand, domestic spending strengthened compared with the first half. Private consumption remained supported by the stable labour market conditions, while overall investment spending improved slightly, with vibrant building and construction activities being partly offset by weak capital investment.

Domestic inflation momentum picked up somewhat in the second half of 2014 before softening in early 2015. The annualised three-month-on-three-month underlying inflation rate increased to 4.3% in November from 2.4% in August, and fell to 1.3% in February on the back of weaker housing rental and service inflation. Looking ahead, the expected softening in import prices and moderate domestic growth momentum would keep inflationary pressure in check.

Hong Kong's economic growth is expected to remain moderate in 2015. While stronger US growth should provide some support, a sharp turnaround in Hong Kong's export performance is not likely given that demand from the euro area and Japan remains weak and growth in Mainland China and other emerging market economies is slowing. On the domestic front, private consumption should remain broadly supported by the stable labour market conditions. Large-scale public infrastructure works and private building activities should also hold up quite well, although a mixed business outlook, together with the imminent increase in interest rates ahead, will continue to weigh on capital investment. Private analysts project real GDP growth at an average of 2.6% in 2015, and the Government forecasts growth in the range of 1-3%. The HKMA in-house composite index of leading indicators also points to moderate growth momentum in the first half of 2015.

This growth outlook is subject to a number of uncertainties and risks. In particular, when the interest rate up-cycle starts, monetary conditions in Hong Kong would inevitably tighten and this in turn could weigh on real economic activities. In addition, persistent strengthening of the US dollar, together with higher US interest rates, could increase the risk of a sudden re-pricing of risk assets and capital outflow pressures, as well as a rise in the debt-servicing burden of borrowers of US dollar credit.

Monetary conditions and capital flows

Following sizeable Hong Kong dollar inflows in July and early August amid buoyant equity fund-raising activities and strong commercial demand, the Hong Kong dollar buying interest has subsided since the fourth quarter, as shown by small changes in banks' net spot foreign currency positions. Despite heightened volatility in the international currency markets and depreciation pressures on the emerging-market currencies, the Hong Kong dollar remained stable and continued to trade in an orderly manner.

Over the past decade, Hong Kong's bilateral capital flows with Mainland China have increased considerably amid growing economic integration. Box 4 (see Page 53) analyses these bilateral capital flows under the balance of payments framework and explains how they translate into economic activities in Hong Kong.

The monetary and credit conditions in Hong Kong remained accommodative, with ample liquidity in the banking system. Money market operated smoothly including at times of volatile external environment. The Monetary Base expanded in the second half after staying flat for a year or so, mainly attributable to a rise in the Aggregate Balance following the triggering of the strong-side Convertibility Undertaking (CU) in July and early August. The wholesale funding costs continued to stay low, with the overnight and three-month HIBOR fixings hovering well below the Base Rate of 0.5%. Broadly tracking the

US counterparts, the Hong Kong dollar yields picked up in the medium tenors but declined in the long end. On the retail front, the composite interest rate and the mortgage interest rate were largely steady at low levels.

Loan growth slowed in the second half, reflecting weaker credit demand and in part also the effects of the HKMA prudential measures in place. This brought the full-year loan growth to 12.7% in 2014, down from 16.0% in 2013. Growth in domestic credit decelerated in the second half, reflecting a marked decline in trade finance. On the other hand, loans for use outside Hong Kong continued to expand at a relatively fast pace. Meanwhile, household debt climbed to 65.3% of GDP at the end of 2014 due to faster growth in both mortgage loans and personal loans. In general, banks' funding conditions remained largely stable, as the Hong Kong dollar loan-to-deposit ratio held largely steady and the US dollar loan-to-deposit ratio levelled off.

Offshore renminbi business has expanded further in Hong Kong. The liquidity pool expanded moderately, with robust growth in customer deposits recorded in the second half in part driven by the removal of the daily conversion limit of RMB20,000 for Hong Kong residents in November, which was announced along with the official launch of the Shanghai-Hong Kong Stock Connect (SHKSC) to allow mutual stock market access. The amount of outstanding certificates of deposit (CD) however declined as major Chinese banks reduced CD issuance. During the second half, the HKMA also introduced several measures to facilitate banks' management of renminbi liquidity and strengthen infrastructure of Hong Kong's offshore renminbi market.

Tracking closely the onshore exchange rate (CNY), the offshore renminbi exchange rate (CNH) weakened in late 2014 and early 2015 amid the broad strengthening of the US dollar. The CNH interbank liquidity tightened further, with the three-month CNH HIBOR rising from around 3% in June 2014 to 4.2% in February in part due to increased funding demand along with the expansion in renminbi transactions as well as seasonal liquidity needs.

Asset markets

The Hong Kong equity market has experienced large swings over the past six months. Shortly after last summer, prices plummeted sharply on renewed concerns over the US monetary normalisation process and weaker-than-expected macroeconomic performance of Mainland China. The market subsequently came under further pressure when the rest of the global economy, especially in continental Europe, showed increasing signs of fatigue. Fund raising activities were probably the only bright spot, with initial public offerings amounting to the second highest in the world last year. The market recouped much of the lost ground early this year in view of the Fed's "patient" approach to a rate hike and a new round of quantitative easing by the ECB. Nonetheless, the prospect of monetary tightening in the US and a weaker global economic outlook are likely to keep the market highly uncertain and volatile in the period ahead.

Hong Kong dollar debt outstanding fell marginally last year. Domestic bond yields declined alongside their US counterparts as the US Treasuries market advanced on the back of strong safe-haven demand and lower-than-expected outturn on inflation. This stimulated primary market activities, as issuers from both the private and public sectors were incentivised to take advantage of the bullish sentiment to lock in lower borrowing costs. However, the increase in issuance still ran short of matured debt, causing a slight decline in the total outstanding amount of debt. Meanwhile, last year continued to see strong growth in offshore renminbi debt. New issuance remained by and large well-received despite a weaker macroeconomic outlook. The market is also becoming more mature as evident by increased product diversity. From market development perspectives, there is still much room for the market to grow in the foreseeable future.

The residential property market has turned more active since the second quarter of 2014 and remained buoyant for the rest of the year and recent months with the support of the ongoing low interest rate environment and a tight demand-supply balance. Transactions bounced up, while housing prices soared by 13.5% in 2014, with most of the gains recorded in the second half. Property valuation has become a lot more stretched relative to household income and economic fundamentals, with the price-to-income ratio rising to a record level and the income-gearing ratio well above its long-term average.

Banking sector performance

Despite a less sanguine external environment, the banking sector recorded healthy growth, characterised by sound asset quality, favourable liquidity conditions, and strong capital positions. Although retail banks' profitability edged down during the second half of 2014 because of lower non-interest income, it remained more favourable for full year 2014 than the previous year, with their pre-tax operating profits registering annual growth of 3.6%. Meanwhile, the net income margin of retail banks hovered around 1.4%.

The average liquidity ratio improved further to 41.1% in the fourth quarter of 2014, well above the 25% regulatory minimum. With the favourable liquidity condition, the market information has so far shown no sign of notable impact associated with the phase-in of the Basel III Liquidity Coverage Ratio (LCR) requirement, which has taken effect from 1 January 2015. 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.

Partly reflecting the policy effect of the Stable Funding Requirement, the overall loan-to-deposits ratio for all AIs declined slightly to 72.2% at the end of 2014. Liquidity conditions, however, remained highly uncertain amid the divergence of monetary policies in the advanced economies. Specifically, our assessment indicates that the liquidity risk associated with the flow of international US dollar credit remained high, particularly when there is serious disruption in the foreign exchange swap market. Box 5 (see Page 72), which studies the dynamics of banks' leverage, further finds that any initial contraction in global liquidity could be amplified, as banks would react to the liquidity shock by reducing their leverage and thus lending capacity. The implications for liquidity risk and funding costs merit close attention.

Looking forward, banks should continue to be attentive to credit risks associated with rising debt-servicing burdens in both the household and corporate sectors. Meanwhile, the implication of slower economic growth in Mainland China on the credit risk of rising Mainland-related lending should also warrant continued vigilance.

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