1. Summary and overview

Global financial markets started the year with a return of volatility triggered by a reappraisal of inflation risk in the US. Equity markets around the world fell sharply from their peaks in late January, wiping out the gains in early 2018, while the benchmark 10-year US Treasury yield rose to a four-year high. The long period of global equity market rallies and low volatility over the past two years was built upon expectations of a continued "Goldilocks" environment of solid growth with low inflation and low interest rates. However, such expectations are subject to risks of tighter global monetary conditions, rising trade protectionist sentiment and geopolitical tensions.

The Hong Kong dollar exchange rate eased and continued to trade in an orderly manner. Total loans continued to expand in the second half of 2017, albeit at a more moderate pace. Both housing price growth and transaction volumes picked up in the fourth quarter of 2017 after some moderation in the middle of the year. That said, going forward, a return of volatility in the global and local financial markets means that fund flows in Hong Kong could become more volatile down the road.

With uncertainties in the financial markets amid the continuing normalisation of US monetary policy and lingering geopolitical risks, banks should remain vigilant against the risks of more volatile interest rates and possible capital outflows. In particular, given the rising levels of corporate leverage and household debt-servicing burdens, banks should assess the possible impacts of sharper-than-expected interest rate rises on their asset quality.

The external environment

Global financial markets started the year with a return of volatility after the Chicago Board Options Exchange Market Volatility Index (VIX) had remained low for more than two years. Equity markets around the world fell sharply from their peaks in late January, with the S&P 500 tumbling by more than 10% at one point, wiping out the gains in early January. The turn in market sentiment was triggered by signs that the global recovery may revive the long-dormant pressure on US wages and prices that could cause the US Federal Reserve (Fed) to quicken the pace of interest rate hikes. The benchmark 10-year US Treasury yield also rose to a four-year high.

The long period of global equity market rallies over the past two years was built upon expectations of a continued "Goldilocks" environment. Global economic growth continued to gain momentum in the second half of 2017, with a synchronised pick-up in economic activities in both advanced and emerging market economies. Towards the end of

the year, the US Congress passed a tax reform bill encompassing tax cuts and sweeping changes to corporate and individual taxation rules, raising expectations that the burgeoning US expansion would receive an additional cyclical boost in the near term. Despite strengthening activity, core inflation remained modest across major advanced economies, fostering expectations of a continuation of the "low-for-long" global interest rate environment. Against this background, global asset markets posted strong gains in 2017, with the US equity markets in particular repeatedly hitting new highs.

Nonetheless, global equity markets experienced a reappraisal of inflation risks on the release of stronger-than-expected US wage growth data for January. Beyond the short-term financial market volatility, the risks of tighter global monetary conditions will likely cloud the global economic outlook. In the US, with the economy operating at full potential, there is a risk that the expected cyclical boost to domestic demand provided by the tax cuts may hasten a rebound in inflation, thereby prompting the Fed to tighten monetary policy at a faster-than-expected pace. At the same time, higher fiscal deficits resulting from tax cuts would likely translate into greater US Treasury issuance going forward, which could amplify upward pressure on longer-term yields as the Fed continues with balance sheet normalisation. Elsewhere, strengthening growth momentum in other major advanced economies has fostered market expectations that their central banks may scale down their quantitative easing programmes. If this materialises, it would point to a synchronised global tightening of monetary conditions.

Policy and event risks arising from international politics and geopolitical tensions may also cloud the global growth outlook. The US administration appears to be increasingly inclined to resort to trade protectionist measures to shield domestic industries from competition, recent examples being the announcements to impose import tariffs on solar panels, washing machines, steel and aluminium, raising fears of retaliatory responses from its trading partners. In addition, any unexpected escalation in geopolitical tensions could affect global trade flows and heighten global financial market volatility.

These uncertainties hanging over the global economic outlook raise questions about the sustainability of the elevated global asset market valuations. More fundamentally, it remains to be seen whether the cyclical upswing in global demand and the expected rise in fiscal deficit due to US tax cuts would drive up the natural rate of interest (R*). This, together with an expected increase in term premia amid the Fed's balance sheet normalisation, could point to higher long-term interest rates and thus pose a headwind to asset market valuations.

In East Asia, regional economies are also experiencing solid growth and subdued inflation. This sound economic performance and positive outlook have been accompanied by accelerated capital inflows and financial markets rallies. Nevertheless, the favourable outlook is subject to downside risks stemming from a tightening of global liquidity amid simultaneous monetary policy normalisation by major central banks, more inward-looking US trade policies, geopolitical tensions, and the one-time "deemed repatriation" provision under the US tax reform (which may increase incentives for US corporations to repatriate their profits back to the US which could tighten offshore US dollar liquidity).

In Mainland China, the economy fared well in the second half of 2017, underpinned by solid consumption as well as robust infrastructure and a rebound in industry spending towards the end of the year. Meanwhile, there are increasing signs of the emergence of the "new economy", with strong business expansion in sectors such as high value-added manufacturing and services in the past quarters. Looking ahead, the near-term growth prospects remain positive but

uncertainties remain. In particular, it is unclear to what extent the rapid growth of the "new economy" could help offset the short-term pressure of further structural reforms on growth. Mainland authorities announced to continue to adopt a proactive fiscal policy stance in 2018, which may help cushion adverse economic developments if necessary.

During the review period, some progress has been made on both structural reforms and containment of systemic risks. In particular, Mainland property markets showed signs of cooling down during the review period amid tightening measures, especially in first-tier cities. Meanwhile, the exposure of banks to firms in overcapacity sectors was kept in check thanks to the tightened bank loan underwriting standards, while shadow banking activities also decelerated amid financial deleveraging. In addition to these positive developments, our analyses suggest that capital allocation efficiency in Mainland China appeared to have improved. In particular, the borrowing constraint of state-owned enterprises (SOEs) with weaker repayment abilities has been hardened, likely driven by declined support from local governments (please see more details in Box 2, page 31). On the external front, capital outflow pressures, amid stablised economic conditions and subsided risks, stayed subdued during much of 2017.

The domestic economy

The Hong Kong economy sustained its sequential growth momentum during the second half of 2017. For the year as a whole, real Gross Domestic Product (GDP) grew by 3.8% in 2017, the fastest in 6 years. Growth in private consumption in the second half remained robust alongside favourable employment and earnings conditions as well as booming asset prices. Overall investment spending also rebounded on stronger business capital spending. On the external front, Hong Kong's export performance improved further on the back of better global trade growth and a gradual recovery in inbound tourism. That said, net exports of goods still detracted from GDP growth as imports expanded even faster than exports, while net exports of services contributed positively to GDP growth.

Economic growth for 2018 is expected to remain solid. In particular, private consumption, building and construction, as well as exports are expected to remain growth-supportive. In view of the eventual rises in Hong Kong dollar interest rates, Box 3 examines the effect of a higher mortgage debt service burden on private consumption. The Government and market consensus forecasts of real GDP growth for 2018 are 3–4% and 3.0% respectively. However, this growth outlook is subject to various uncertainties and risks arising from the external environment as discussed above, and those relating to Mainland's economic performance amid financial tightening, and developments in the local asset markets.

Local inflationary pressures were still well contained in the second half of 2017 although the unemployment rate declined lately to a near 20-year low of 2.9%. However, the sequential momentum showed signs of a moderate pick up in inflation rates in recent months, driven by price increases in both tradables and services. Looking ahead, the underlying inflation rate is likely to pick up slightly to a still-moderate level, partly reflecting the gradual feed-through from rising fresh-letting private residential rentals.

Monetary conditions and capital flows

The Hong Kong dollar spot exchange rate strengthened between September and November 2017, alongside an increase in the covering of short Hong Kong dollar positions amid tighter liquidity conditions due to equity-related and seasonal funding demand. As liquidity conditions eased and interest rate arbitrage activities resumed, the Hong Kong dollar exchange rate softened again in December 2017.

Moving into early 2018, despite increased volatility in the global financial markets, in particular the stock markets, the Hong Kong dollar remained broadly stable. The Hong Kong dollar eased further in early March but the Convertibility Undertaking was not triggered.

The Hong Kong dollar interbank interest rates saw more upward pressure between September and December 2017, largely driven by initial public offering (IPO)-related funding demand and banks' prudent stance on liquidity management towards year-end. Comparing with six months ago, the overnight and three-month Hong Kong Interbank Offered Rate (HIBOR) fixings picked up by 14 and 50 basis points to 0.25% and 1.26% respectively in December (in monthly average terms). After easing slightly in early January 2018, the HIBOR stayed largely steady despite recent global financial market corrections. Along with the rise in the short-term HIBOR, banks' average lending rate for new mortgages also increased to 2.16% in December, regardless of the keen competition in the mortgage lending business. On the other hand, while there was a brief pick-up in October due to IPO-related funding demand, retail banks' funding costs generally remained low, with the composite interest rate closing at 0.38% in December.

In the near term, the Hong Kong dollar interest rate is likely to face more upward pressure amid ongoing US monetary policy normalisation, while fund flows could be subject to more volatility should global market sentiment swing sharply.

Banks' total loans expanded solidly by 16.1% in 2017 as a whole, but grew at a decelerated pace of 5.3% in the second half following a strong 10.2% expansion in the preceding half-year period. In particular, domestic loans in most business sectors and loans for use outside Hong Kong witnessed slower expansion. Foreign currency loans recorded much slower increases due in part to a rise in US dollar funding costs, while Hong Kong dollar loans continued to register fast growth on the back of the favourable domestic economic environment and relatively lower Hong Kong dollar funding costs.

As Hong Kong dollar loans grew faster than Hong Kong dollar deposits, the Hong Kong dollar loan-to-deposit (LTD) ratio rose in the second half to 82.7% at the end of 2017, the highest since March 2015. On the other hand, the foreign currency LTD ratio declined to 63.1% at the end of the year due to the relatively slow expansion in foreign currency loans.

After showing some signs of stabilisation between September and November, both the onshore and the offshore renminbi exchange rates strengthened somewhat against the US dollar from December alongside a noticeable weakening of the US dollar against most major currencies. Largely reflecting the shift in the renminbi exchange rate expectation, Hong Kong's offshore renminbi liquidity pool (including outstanding customer deposits and certificates of deposit) recovered moderately in the second half after a slight decline in the preceding half-year period. In other offshore renminbi business, while renminbi loans continued to decline, the renminbi trade settlements handled by banks in Hong Kong rebounded in the second half, with the average daily turnover of the renminbi real time gross settlement system remaining high. Looking ahead, Hong Kong's offshore renminbi business is expected to benefit from the further development of the Belt and Road Initiative and continuing internationalisation of the renminbi.

Asset markets

The Hong Kong equity market extended its rally before taking a sharp downward adjustment towards the end of the review period. Over the past six months, the global economy has strengthened markedly. This, coupled with the

passing of the tax cuts in the US, kept market sentiment buoyant with corporate performance expectations rising globally. In addition, more investors are pinning their optimism on another IT boom, this time through vigorous application of data technology and artificial intelligence across a wide spectrum of economic activities. The local equity market also benefited from a considerable increase in southbound investment through its Stock Connect with the two exchanges in Mainland China. Nevertheless, local equities corrected sharply towards the end of the review period amid heightened concerns about rising bond yields.

Indeed, significant uncertainties remain over the market outlook, not the least being whether monetary policies in major economies will tighten more sharply than anticipated, and whether the concepts that investors have bought into can be realised. For example, can the current IT boom deliver the expected productivity growth? Box 4 (see page 55) examines the potential impact on the Asia Pacific equity markets, including Hong Kong, of shocks originating from both within and outside the region.

The Hong Kong dollar debt market expanded slightly last year, with yields climbing gradually amid continued monetary normalisation in the US. Higher borrowing cost reduced incentives to issue debt in Hong Kong dollar in the review period, leading to a small reduction in non-Exchange Fund Bills and Notes issuance. On the demand side, there was a decline in net bond fund inflows, reflecting diminishing attractiveness of local currency debt. Meanwhile, the offshore renminbi debt market in Hong Kong contracted further in 2017 as primary market activity remained in the doldrums. While the relative onshore-offshore yield has moved in favour of offshore issuance, the outlook critically depends on a wide range of other forces at work such as exchange rate expectations for the renminbi and the current drive of the Mainland authorities to deleverage the economy.

Amid an improvement in economic conditions and market sentiment, transactions in the residential property market picked up again after a brief moderation in mid-2017, following the eighth round of macro-prudential measures implemented in May. Housing price growth has also accelerated since the fourth quarter, causing housing affordability to stretch further.

The outlook for the residential property market remains uncertain. In the near term, the current favourable domestic economic conditions, perceived housing shortage, low mortgage rates and alternative sources of home financing will continue to support the demand for property, but the recent sell-offs in global financial markets may dampen property market sentiments. Over the longer term, the property market will continue to face a number of headwinds. In particular, as the US monetary policy normalisation process continues, domestic mortgage rates will rise eventually, and the increase in Hong Kong dollar interest rates could quicken should sizeable capital outflows from Hong Kong occur amid heightened global financial market volatility. In addition, on the back of the Government's effort to increase the supply of land and residential properties, the housing demand-supply gap is expected to narrow gradually, which will ease the upward pressure on property prices in the longer term.

Banking sector performance

The profitability of retail banks continued to improve, with the return on assets rising to 1.15% in the second half of 2017 compared with 1.11% in the same period of 2016. The improvement was mainly due to the increase in net interest income and a reduction in loan impairment charges.

Banks have maintained strong capital positions, with the consolidated total capital ratios of locally incorporated authorized institutions (AIs) increased to 19.1%. To enhance banks' resilience to systemic risks, the countercyclical capital buffer ratio for Hong Kong will rise to 2.5% with effect from 1 January 2019 from the current 1.875%. In addition, the HKMA has recently published a consultation paper on prescribing loss-absorbing capacity (LAC) requirements for AIs as envisaged by the Financial Institutions (Resolution) Ordinance. Box 5 (see page 77) provides a cost-benefit assessment of the potential impact of LAC requirements on Hong Kong. Our assessment suggests that the implementation of LAC requirements is likely to bring net benefits to the Hong Kong economy.

Partly due to IPO-related funding demand and the two US rate hikes in June and December, the Hong Kong dollar interbank interest rates increased notably in the second half of 2017. Nonetheless, the Hong Kong dollar funding costs of retail banks, as reflected by the composite interest rate, remained low and stable supported by the low retail deposit interest rate. The liquidity positions of AIs were generally sound by Basel III standards. Both the average Liquidity Coverage Ratio for category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions remained high at 155.1% and 49.4% respectively in the fourth quarter of 2017 and were well above their regulatory minimums. To strengthen banks' ability to fund their activities with sufficiently stable sources of funding, the HKMA introduced the Net Stable Funding Ratio as part of the Basel III liquidity requirements on 1 January 2018. The implementation of the new requirement by AIs will reduce their funding risk over a longer time horizon.

Credit growth moderated to 5.3% in the second half of 2017 after growing rapidly by 10.2% in the first half of 2017. The asset quality remained sound by historical standards and improved further during the review period. As banks' asset quality could be more sensitive to the external environment given the rapid rise in loans for use outside Hong Kong in recent years, the credit risk of these loans should warrant close monitoring. Banks should also remain vigilant against the risks of more volatile interest rates, possible abrupt capital outflows amid further US rate hikes and the ongoing reduction in the Fed's balance sheet, and geopolitical risks. In particular, banks should assess the possible impacts of sharper-than-expected interest rate rise on their asset quality, given the rising levels of corporate leverage and household debt-servicing burdens.