1. Summary and overview

The risks of sustained trade tensions and global monetary policy divergence are likely to represent two of the biggest threats to the global economic outlook. While trade tensions could take a toll on business confidence, investment and production efficiency, prolonged global monetary policy divergence could fuel sustained US dollar strength, posing risks to the financial stability of emerging market economies. In East Asia, while the impact of trade tensions has yet to be reflected in the growth figures, capital outflow and currency depreciation pressures have become visible.

The Hong Kong dollar exchange rate has eased gradually since March, with the weak-side Convertibility Undertaking being triggered 27 times in April, May and August. Despite this, the Hong Kong dollar remained traded in a smooth and orderly manner near the weak side Convertibility Undertaking rate of 7.85. Total loans continued to grow steadily in the first half of 2018, while property prices increased further and the volume of transactions remained robust.

In view of the increasing uncertainties arising from the US-China trade conflict, the pace of US interest rate hikes and geopolitical risks, banks should remain vigilant against the risks of more volatile capital outflows and the associated impact on local interest rates. In particular, given rising corporate leverage, banks should carefully assess how these risk factors could affect the credit risk of their corporate exposures.

The external environment

Global growth remained strong in the first half of 2018, but has become less even across countries. The US economy continued to expand at a solid pace on the back of procyclical fiscal policies and buoyant sentiments. However, activity in the euro area and Japan surprised on the downside early this year and, despite some improvements in the second quarter, growth performance was still weaker than in 2017. Signs of more divergent growth among the advanced economies (AEs) raised concerns that the cyclical upturn over the past two years has peaked outside the US. Adding to such concerns, political uncertainty in Italy and the UK has also clouded the near-term growth outlook in Europe.

Against a background of less synchronised global growth, there are increasing risks that escalating trade tensions between the US and major trading partners could derail the global recovery. Since early this year, the US administration has imposed, or threatened to impose, tariffs on a wide range of imports, prompting retaliatory measures from the rest of the world. At the same time, the Federal Reserve (Fed)'s continued normalisation of its balance sheet and interest rate policies has driven longer-term US Treasury yields and the US dollar higher, raising investor concerns about the spillover effects on emerging market economies (EMEs). These concerns have resulted in increased financial market volatility in major EMEs since mid-April, characterised by declines in EME equity market indices and, for some of those with weaker fundamentals or higher political risks, increased capital outflow and currency depreciation pressures.

Looking ahead, the risks of sustained trade tensions and global monetary policy divergence are likely to represent two of the biggest threats to the global economic outlook. Negative trade developments could take a toll on business confidence, investment and production efficiency. At the same time, prolonged global monetary policy divergence could fuel sustained US dollar strength to the detriment of EMEs' financial stability.

In East Asia, the impact of the escalating trade conflict between Mainland China and the US has yet to be reflected in growth figures. However, capital outflow and currency depreciation pressures have become visible in the region, especially in those economies which have closer ties with Mainland's production chains. The ongoing trade conflict will pose multiple challenges to the region's outlook. While the direct impact on the region's exports due to increased tariffs is expected to be manageable, the trade war's damage to investor confidence could be much more disruptive to the economy. In the event of a slowdown in growth, central banks will need to strike a delicate balance between supporting growth by easing monetary policy and curbing capital outflows by tightening. With rising downside risks and uncertainties, East Asian economies are likely to face higher market volatility and weaker economic momentum in the near-term. Economies with stronger fundamentals, healthier external positions and larger fiscal policy space are more likely to withstand the headwinds.

In Mainland China, economic growth remained largely stable in the first quarter of 2018, but showed moderation in the second quarter as infrastructure investment growth slowed notably amid tightening measures on local government financing activities. Consumption growth, however, remained vibrant, underpinned by solid labour market conditions and buoyant consumer sentiment. In the near-term, while the robust growth in higher value-added manufacturing and services industries should continue to support the growth outlook, increasing uncertainty amid the escalating trade conflict between the US and China could make it more challenging for Mainland authorities who are trying push ahead with structural reforms while maintaining financial stability and decent economic growth.

During the review period, Mainland authorities continued to contain financial risks through tightening measures. Reflecting these efforts, property prices stabilised, especially in first-tier cities, which is important for financial stability as drastic changes in property prices could have a significant impact on corporate default risks (see more details in Box 1, page 28). Amid government efforts to deleverage, the number of bond defaults increased, although the share of these bonds to overall non-financial debt securities remained small. In both equity and forex markets, investor sentiment deteriorated somewhat in recent months, reflecting concerns about the trade conflict. However, capital outflows were limited during the period, likely supported by stable economic conditions.

The domestic economy

Compared with the second half of 2017, economic growth in Hong Kong remained robust for the first half of 2018 as a whole. Real Gross Domestic Product (GDP) for the first half grew at an above-par rate of 2.4% over the preceding half year. The year-on-year real GDP growth fluctuated from the extraordinary growth of 4.6% in the first quarter to a slower 3.5% in the second quarter, in sharp contrast to the roughly stable growth in the second half of 2017. More specifically, private consumption posed an outsized increase in the first quarter, but slowed in the second. After a strong recovery, the external trade performance also slowed, along with the deteriorating market sentiment amid the worsening trade conflict.

Economic growth is expected to continue for the remainder of 2018, but at a more moderate pace compared with the first half. While the escalating trade tensions, especially between the US and Mainland China, could weigh on Hong Kong's export performance, other components of the GDP, including private consumption, building and construction, as well as other exports of services are anticipated to be growth-supportive. For 2018 as a whole, the Government forecasts real GDP growth in the range of 3–4%, while the latest growth forecasts by private-sector analysts averaged 3.6%.

With the growing intensity of the US-China trade conflict, the downside risk to growth has risen compared with several months ago. While the short-term impact on Hong Kong is estimated to be limited through conventional trade channels, the local economy could be affected through other channels, which would result in a much more substantial negative impact for the overall economy. For example, increased economic uncertainty could affect macro-financial conditions (see Box 2). Besides trade protectionism, other major uncertainties or risks concerning the baseline economic outlook include those arising from major central banks' monetary policy normalisation, Mainland's economic performance amid its continued financial deleveraging, and potential volatility in international capital flows.

Local inflation edged up to a still-moderate level in the first half of 2018, with a slight uptick in inflation momentum reflecting both external and domestic price pressures. At the same time, the labour market tightened further along with a decline in the unemployment rate to 2.8%, the lowest level in more than 20 years. In the remainder of 2018, local inflationary pressures are expected to increase slightly, further reflecting higher global inflation and continued feed-through of earlier rises in fresh-letting private residential rentals.

Monetary conditions and capital flows

Mainly driven by increased interest carry trade activities, the Hong Kong dollar spot exchange rate eased gradually since March, with the weak-side Convertibility Undertaking (CU) being triggered 27 times in April, May and August. Since the first triggering on 12 April, the HKMA purchased a total of HK$103.5 billion (as at the end of August) on request from banks under the weak-side CU. As a result of these purchases, the Aggregate Balance of the banking system declined from HK$179.7 billion at end-March to HK$76.4 billion at end-August. Despite this, the Hong Kong dollar remained traded in a smooth and orderly manner near the weak side CU rate of 7.85.

Hong Kong Interbank Offered Rates (HIBORs) broadly picked up since the second quarter, reflecting the growing market expectation of US interest rate hikes, the reduced interbank liquidity following the triggering of the weak-side CU, Initial Public Offering (IPO)-related funding demand and seasonal liquidity needs. The overnight HIBOR fixing rose notably to 3.0% during the IPO subscription period at the end of the first half. It once eased back to a recent low of 0.08% in mid-July before picking up to around 0.9% at the end of August. Alongside the pick-up in HIBORs, retail banks' funding costs saw more upward pressure since the second quarter, with the composite interest rate increasing to 0.63% at the end of July from 0.38% at the end of March. On the other hand, the average lending rate for new mortgages hovered around the prevailing Prime-based cap of 2.15% in the second half despite the pick-up in HIBORs.

As the monetary policy normalisation continues in the US, Hong Kong dollar interest rates will inevitably maintain a rising trend. The spreads between the Hong Kong dollar and US dollar interest rates may continue to encourage interest carry trade activities and lead to capital outflows. The outflow of funds from Hong Kong dollar is a normal and inevitable process for Hong Kong dollar interest rate normalisation under the Linked Exchange Rate System. The banking sector is holding a vast amount of Exchange Fund papers, which can be used by banks to obtain HKD liquidity via the discount window, serving as an effective cushion against any excessive volatility in interest rates. The HKMA also stands ready to calibrate the issuance of Exchange Fund papers to release liquidity in order to deal with possible sharp outflow from the Hong Kong dollar.

As trade tensions between the US and Mainland China intensified, the offshore (CNH) and onshore (CNY) renminbi depreciated sharply against the US dollar from the middle of June. This interrupted the stable relationships of the CNH and CNY with the US dollar as observed during the first five months of 2018. The exchange rate stabilised again in August after the counter-cyclical factor was re-instated gradually in the daily fixing of the CNY. The depreciation pressure from mid-June also saw CNH being mostly traded at a discount against its onshore counterpart, although the spread remained moderate by historical standards. Despite the sharp movement in the spot exchange rate market, the US-China trade tensions have not had an adverse impact on the funding condition in the offshore interbank market, as the overnight CNH HIBOR mostly traded below 4% in the first eight months of 2018. Meanwhile, Hong Kong's CNH liquidity pool continued to increase during the review period, led by renminbi deposits from both personal and corporate customers. The average daily turnover of the renminbi real time gross settlement system continued to stay high. Looking ahead, the development of the CNH market in Hong Kong will depend on the market expectation of the renminbi exchange rate amid the US-China trade tensions and Mainland's macro-financial conditions. Nevertheless, Hong Kong's offshore renminbi business is expected to benefit from the progress in the Mainland's capital account liberalisation, the development of the Stock and Bond Connect schemes, and enhanced regional economic co-operation under the Belt and Road and Guangdong-Hong Kong-Macao Bay Area initiatives.

Asset markets

The Hong Kong equity market progressively came under pressure during the review period as trade conflicts escalated and monetary normalisation picked up further pace. Although geopolitical tensions eased on the Korean Peninsula following the US-North Korean summit in Singapore, the focus of the market quickly shifted to the heightened tensions between the US and China on the trade front. Meanwhile, as the global economy continued to gather momentum, major central banks quickened their pace of normalising monetary conditions, putting upward pressure on interest rates across the yield curve worldwide. The combined negative impact of the unfavourable trade and monetary developments has caused local equity prices to spiral down sharply. However, looking ahead, although the outlook remains highly uncertain, attractive valuations may trigger bargain hunting activities, especially if the market corrects further from current levels. Box 3 looks at the effects of the value trading strategy of long-term institutional investors on the domestic stock market.

The Hong Kong dollar debt market grew markedly in the first half of the year. This is despite the fact that outflows from bond funds continued during the period, due to their lacklustre performance amid an increase in yields in both the sovereign and non-sovereign sectors. The growth was fairly broad-based except for the AIs. In the near term, the introduction of a number of government initiatives such as the three-year Pilot Bond Grant Scheme and the Government Green Bond Programme are expected to stimulate local debt issuance. In contrast, the offshore renminbi debt market contracted for six successive quarters through to the second quarter of 2018. Although there was a pickup in primary market activity recently, the medium-term development outlook is subject to considerable uncertainties, including changes in the exchange rate expectations for the renminbi, discrepancies between onshore and offshore funding costs, and the current drive of Mainland authorities to deleverage the economy. The US-China trade war adds to the headwinds.

The residential property market in Hong Kong remained buoyant in the first half of the year. Amid robust economic conditions and the low mortgage rate environment, property prices increased further and the volume of transactions remained robust. But signs of moderation emerged stepping into the third quarter. As housing price growth outpaced that of household income during the review period, housing affordability deteriorated further.

Reflecting the Government's efforts in addressing land and housing supply issues, the government-appointed Task Force on Land Supply has invited stakeholders to offer views on land supply options and other land supply-related issues. The Government also announced six new housing initiatives in late June. These include revising the pricing policy for subsidised sale flats, reallocating private housing land for public housing and proposing "special-rates" on vacant first-hand private residential units.

A variety of factors make the outlook for the residential property market uncertain. On the one hand, the current favourable employment and income conditions might provide some support for the demand for property. On the other hand, the property market is likely to face a number of headwinds. In particular, if the US-China trade tensions persist or intensify, the positive market sentiments could turn quickly.

Furthermore, as the US monetary policy normalisation process continues, domestic mortgage rates are set to increase along with the rising funding costs of the banks. Indeed, banks increased their effective mortgage rates by raising the cap for newly approved HIBOR-based mortgages in August. In addition, the supply-demand gap is expected to narrow in the longer term, as the supply of residential property increases on the back of the Government's effort to address land and housing shortages.

Banking sector performance

The profitability of retail banks continued to improve in the first half of 2018, with pre-tax operating profit increasing substantially by 24.8% year on year. The improvement was mainly driven by a significant increase in net interest income (boosted by higher net interest margins), and a reduction in loan impairment charges. Asset quality remained healthy by historical standards during the review period.

Banks continued to maintain strong capital positions, with the consolidated total capital ratios of locally incorporated AIs edging up to 19.4% at the end of June 2018. 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 its current 1.875%.

Liquidity conditions within the banking system remained sound in the first half of 2018. Despite tangible rises in the short-term HIBORs following the triggering of the weak-side CU and IPO-related demand, the Hong Kong dollar funding cost of retail banks remained low by historical standards, largely underpinned by the still relatively low retail deposit rates. The liquidity positions of AIs were generally sound by Basel III standards, as the average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions increased to 156.6% and 51.3%

respectively, in the second quarter of 2018 and were well above their statutory minimum requirements. In addition, the implementation of the Net Stable Funding Ratio as part of the Basel III liquidity requirements has helped to strengthen banks' ability to fund their activities with sufficiently stable sources of funding and reduce their funding risk over a longer time horizon.

Despite rising uncertainties in the global economic environment, bank lending continued to grow steadily in the first half of 2018. Both domestic loans (comprising loans for use in Hong Kong and trade financing) and loans for use outside Hong Kong, grew by 5.4% and 5.1%, respectively, compared with 5.6% and 4.6% in the preceding six months. As a result, total loans and advances of all AIs continued to grow steadily by 5.3% in the first half of 2018, the same pace as in the second half of 2017. With total loan growth outpacing deposit growth during the review period, the loan-to-deposit ratios of all AIs rose to 75.7% in the first half of 2018 from 73.0% six months ago.

Within domestic loans, corporate loans continued to grow steadily by 5.4% on a half-yearly basis in the first half of 2018, while growth in household debt moderated to 5.3% in the first half of 2018 compared to 6.5% six months ago. Despite the slower growth in household debt, the household debt-to-GDP ratio edged up to 71.2% in the second quarter of 2018 from 70.3% in the fourth quarter last year. That said, our assessment finds that Hong Kong has a strong household balance sheet with high net-worth-to-liability and safe-asset-to-liability ratios. This suggests that the household sector as a whole has a strong buffer to cushion potential financial and economic shocks.

Based on data of banks in Hong Kong, Box 4 (see page 77) provides an empirical analysis to examine the net effect of loan concentration on the credit risk of banks' loan portfolios. Overall, the empirical results suggest that there are gains of improved screening and monitoring abilities for banks, which buffer the associated concentration risks, by focusing lending to certain loan sectors. A key implication is that the potential specialisation gains from higher loan concentration should be taken into consideration in order to have a more balanced assessment of banks' credit exposures.

In view of rising uncertainties arising from the US-China trade conflict, the pace of US interest rate hikes and geopolitical risks, banks should remain vigilant against the risks of more volatile capital outflows and the associated impact on local interest rates. In particular, given rising corporate leverage, banks should carefully assess how these risk factors could affect the credit risk of their corporate exposures.

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