1. Summary and overview

Global economic expansion continued, but is losing momentum amid rising uncertainties due to lingering trade tensions, tighter financial conditions, and other idiosyncratic and cyclical headwinds. While investors have priced out another interest rate hike in the US as the Federal Reserve adjusted its stance on monetary policy to emphasise "data dependence" and the need for "patience", financial markets could become more sensitive to incoming data, particularly those warranting a tighter monetary policy, such as higher readings of US inflation.

Despite the triggering of the weak-side Convertibility Undertaking (CU) in March, the Hong Kong dollar continued to trade in a smooth and orderly manner. Total loan growth contracted slightly in the second half of 2018, reflecting subdued credit demand amid headwinds including lingering US-China trade conflicts and weaker global economic growth. The housing market also cooled down in the second half, with a visible fall in transactions and a decline in housing prices, before stabilising somewhat in early 2019.

Looking ahead, the Hong Kong banking sector will face multiple headwinds amid rising uncertainties in the external environment. Should these uncertainties intensify and persist into the longer term, they could significantly dampen business confidence and credit demand, thereby posing downward pressure on banks' profitability. With rising corporate leverage, banks should carefully assess how the possible deterioration in the external environment would affect the credit risk of their corporate exposure.

The external environment

The global economy continued to expand in the second half of 2018. However, while the US economy grew solidly, growth momentum elsewhere shifted down a gear. Among advanced economies, Japan and a number of major euro area countries experienced slower growth, and inflation was tepid. Slowing global trade flows and a plunge in oil prices posed cyclical headwinds to emerging market economies (EMEs). In January, in recognition of the softer global growth momentum, the International Monetary Fund revised downward its global growth projections for 2019 and 2020 by 0.2 and 0.1 percentage points, respectively, relative to October 2018.

As the growth outlook became less optimistic and with trade tensions taking hold, global equity market volatility surged in late 2018. The US Treasury yield curve flattened to levels not seen since the global financial crisis, sparking concerns among market participants of an imminent US recession. However, with US economic fundamentals still solid, a near-term recession remains a low-probability scenario.

Nevertheless, the global economic outlook is fraught with uncertainties. In the US, while benign inflation has allowed the Federal Reserve (Fed) leeway to put the rate hike cycle on pause, a more data-dependent Fed also suggests that financial markets will likely become more sensitive to incoming economic data, especially those warranting a tighter monetary policy, such as higher readings of inflation. At the same time, the outcomes of trade negotiations between the US and Mainland China, as well as those between the US and the European Union, remain uncertain. In the UK, it remains to be seen whether solutions to prevent a "hard" Brexit can be achieved.

In East Asia[1], while financial markets have stabilised on the back of a moderating US dollar and expectations of a pause in Fed rate hikes, a deteriorating external environment could weigh on the region's economic growth. Indeed, the weakening global trade momentum has already weighed on gross domestic product (GDP) growth in many East Asian economies and inflationary pressures have moderated. While this may alleviate the growth-inflation policy dilemma faced by the region's central banks, financial imbalances, such as high private sector indebtedness in some countries in the region, remain a challenge. Another challenge, as detailed in Box 1 (page 16), is that shocks emanating from Fed monetary policies — if they materialise — tend to have large spillover effects on EME sovereign bonds, including those issued by East Asian economies.

In Mainland China, growth slowed further in the second half of 2018, amid increased uncertainties in the external environment and some moderation in domestic demand. Looking ahead, the economic outlook remains uncertain as the outcome of the US-China trade talk remains unknown. Rising financing difficulties faced by private business owners especially small firms in the past few quarters that resulted from the notable contraction of shadow financing activities, coupled with weaker economic confidence, could also exert pressures on business activities. In this challenging economic environment, policymakers would have to continue to strike a balance between stabilising the economy and containing potential systemic risks, by adopting accommodative but targeted measures such as targeted required reserve ratio cuts. Meanwhile, the authorities also stepped up supply-side measures to enhance productivity growth, such as promoting competition among firms with different ownership structure and providing better social safety nets for individuals. The official growth target for 2019 was also tuned lower to the range of 6.0–6.5% from around 6.5% in 2018.

Risk-off sentiment prevailed in the Mainland financial market in 2018. Banks' asset quality also deteriorated somewhat over the review period, while leverage of listed non-financial corporate firms edged higher. Nevertheless, banks' loan loss provision increased further in the second half and their exposure to off-balance sheet wealth management products continued to decline; both developments help protect the banking system against potential deterioration in credit quality. Another bright spot is that the leverage of listed firms in overcapacity sectors, one of the major sources of banks' credit risks, declined further in the first three quarters of 2018. Box 2 (page 32) provides a more in-depth analysis of the factors leading to the recent improvement in the business performance of the overcapacity sectors.

The domestic economy

Compared with the first half of 2018, economic activities in Hong Kong softened in the second half. Sequential growth was muted and year-on-year growth also slowed. This dragged the full-year growth rate down to 3.0%, against 3.8% a year earlier.

Weakening economic activities occurred as the impact of the US-China trade conflict, either directly or indirectly, weighed on consumption and exports. Private consumption grew more slowly, probably due to heightened economic uncertainty and some negative wealth effects

[1] In this report, East Asia refers to a group of seven economies: Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand.

associated with local asset price corrections. Externally, Hong Kong's export performance also worsened, particularly in the fourth quarter following the actual imposition of additional tariffs. Box 3 takes a closer look at the impact of the US-China trade conflict on Hong Kong's merchandise trade performance and discusses its near-term outlook and the associated risks.

Economic growth for 2019 is expected to slow further, mainly reflecting a slowdown in global growth. In the face of a number of cross-currents, Hong Kong's export performance is expected to continue to struggle. Domestically, private consumption will likely remain growth-supportive amid the low unemployment rate and rising household income, but the outlook for overall investment spending may become more uncertain. For 2019 as a whole, the Government forecasts real GDP growth in the range of 2–3%, while the latest growth forecasts by private-sector analysts averaged 2.3%; these forecasts are subject to a number of uncertainties and risks as discussed above.

Local inflation increased slightly to a still moderate level in the second half of 2018, due in part to the effect of earlier rises in fresh-letting private residential rentals. At the same time, the unemployment rate stayed low at 2.8%, the lowest level in more than 20 years, although growth in total employment showed initial signs of slowing. For 2019 as a whole, local inflationary pressures will likely stay mild, along with softer domestic growth momentum.

Monetary conditions and capital flows

After the triggering of the weak-side Convertibility Undertaking (CU) in the latter part of August, the Hong Kong dollar moved away from 7.8500 to trade between 7.8062 and 7.8499 until the weak-side CU was triggered again 4 times in March 2019 (up to 19 March 2019)[2]. The Hong Kong dollar exchange rate strengthened in September and November, partly reflecting the unwinding of interest carry trade positions as liquidity tightened. Stepping into 2019, the Hong Kong dollar softened against the US dollar with some rebuilding of interest carry positions. The weak-side CU was triggered again in March. Despite the triggering of the weak-side CU, the Hong Kong dollar continued to trade in a smooth and orderly manner. Due to the triggering of the weak-side CU, the Aggregate Balance edged down to HK$70.9 billion (as at March 19).

The Hong Kong dollar interbank interest rates broadly trended upwards during the second half, primarily reflecting expectations of US rate hikes. Compared to the first half of 2018, the three-month and 12-month Hong Kong Interbank Offered Rate (HIBOR) fixings moved up by about 30 basis points to 2.32% and 2.74% (monthly average term) respectively in December. Moving into 2019, the Hong Kong dollar interbank interest rates generally eased as seasonal demand faded. The composite interest rate, which measures the average Hong Kong dollar funding costs of retail banks, increased from 0.62% at the end of June 2018 to 0.83% at the end of January 2019. In view of the higher funding costs, retail banks raised their Best Lending Rates by 12.5–25.0 basis points after the rise in the target range for the US Federal Funds Rate in late September. The average lending rate for new mortgages moved along with the Best Lending Rates to around 2.45% at the end of January 2019.

Amid the uncertainties arising from the US-China trade tensions and Brexit negotiations, fund flow volatility may increase. In addition, substantial negative spreads between the Hong Kong dollar and the US dollar interest rates may encourage carry trade activities, leading to capital outflows. In such circumstances, the outflow and possible triggering of the weak-side CU is a natural process to be expected under the Linked Exchange Rate System.

[2] Based on the closing rate.

The offshore (CNH) and onshore (CNY) renminbi have experienced weakening pressure since early 2018, due to the fear of an escalation in trade tensions between Mainland China and the US. However, both stabilised in November amid optimism surrounding news that high-level trade talks between Mainland China and the US had resumed. The lingering trade tensions have so far not exerted significant impact on funding conditions in the offshore interbank market. The overnight CNH HIBOR mostly traded below 4% and the three-month CNH HIBOR hovered around 4%. Hong Kong's CNH liquidity pool expanded steadily during the second half, with renminbi customer deposits picking up by 5.2% in the second half of 2018. The average daily turnover of the renminbi real time gross settlement system continued to stay high, picking up further to RMB1,010.1 billion in 2018. Despite concerns over the US-China trade tensions, it is expected Hong Kong's offshore renminbi business will grow along with the progress of Mainland's capital account liberalisation, the development of the Stock and Bond Connect schemes, and increasing regional economic co-operation under the Belt and Road and Greater Bay Area Initiatives.

Asset markets

Over the past six months, the local equity market has been on a roller coaster ride. The market fell sharply at the beginning of the review period amid continued monetary tightening in the US, the considerable divide between the two sides in the US-China trade negotiations, and increased signs of weakness in the Mainland economy. Subsequently, the Fed switched to a "patient" monetary stance amid a weaker and more uncertain economic outlook, while Mainland China stepped up its efforts to reduce its bilateral trade surplus with the US and open its markets to foreign investors during the trade truce. Despite the highly politicised US indictment against a Mainland telecoms company, both sides showed friendly gestures and demonstrated determination to reach a deal. This set the backdrop for the sharp rebound in local equities at the beginning of 2019. Nonetheless, uncertainty still looms large in the period ahead as the two sides get into the details of the deal, if any. This is especially so in the difficult high-tech sphere with the impending US federal indictment case complicating the scene.

The Hong Kong dollar debt market grew slightly last year. Yields declined and performance improved towards year-end amid increased expectations of a more moderate pace of monetary normalisation in the US. As a result, the flow of bond funds reversed its direction and registered a mild increase in the second half of 2018. Hong Kong's offshore renminbi market saw a considerable rebound in issuance, ending a three-consecutive-year decline. However, total issuance was still outsized by maturing debt, as corporate deleveraging continued on the Mainland. The prospects for the local debt market in the year ahead will be challenging, depending on the global economic outlook, especially for the Mainland.

The residential property market moderated in the second half of 2018 amid the US-China trade tensions, global stock market corrections and higher local prime rates. Housing transactions dropped visibly and flat prices declined by 9.0% from the peak in July through December. However, housing affordability remained stretched, with both the price-to-income ratio and the income gearing ratio staying at high levels. During the same period, the non-residential property market showed tentative signs of softening, as suggested by lower transactions and some price consolidation.

In early 2019, secondary-market housing prices stabilised somewhat, and overall transactions picked up in part because more property developers pushed out new launches, with more attractive pricing than previously to lure buyers.

A host of external and domestic factors make the outlook for the housing market uncertain. On the external front, the uncertainty over the US-China trade tensions will continue to cloud Hong Kong's property market outlook, possibly through changes in market sentiment, economic prospects and financial conditions. On the domestic front, economic growth is softening, but employment conditions and income growth have remained largely stable which could provide some support for property demand. The trajectory for domestic interest rates partly hinges on the future path of the US policy rate, which in itself is uncertain. Over the longer term, the supply-demand gap is expected to narrow given increased flat completions during the past few years and the Government's effort to increase land and housing supply.

Banking sector performance

Notwithstanding an uncertain external environment, retail banks registered higher profits in the second half of 2018, with pre-tax operating profits rising by 14.3% compared with the same period in 2017. The increase in profits was mainly due to a significant growth in net interest income, which more than offset the increase in impairment charges and operating expenses. As a result, the return on assets rose to 1.23% in the second half of 2018 compared with 1.14% in the same period last year.

Banks' capital positions, as measured by Basel III standards, were structurally robust and strengthened further in the review period. The consolidated capital ratio of locally incorporated authorized institutions (AIs) rose to 20.3% at the end of December 2018. The countercyclical capital buffer rate for Hong Kong has been set to 2.5% to enhance banks' resilience to systemic risk. The liquidity positions of AIs were generally sound, as the average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions increased to 167.6% and 54.3% respectively in the fourth quarter of 2018. In addition, the average Net Stable Funding Ratio of category 1 institutions and the average Core Funding Ratio of category 2A institutions both stayed at levels well above the statutory minimum.

Reflecting subdued credit demand amid the lingering US-China trade conflict and weaker global economic growth, the full-year loan growth slowed notably to 4.4% in 2018 from 16.1% in 2017. On a half-yearly basis, total loans and advances contracted slightly by 0.9% in the second half of 2018, driven by a 3% drop in loans for use outside Hong Kong, while growth in domestic loans (comprising loans for use in Hong Kong and trade financing) decelerated notably to 0.1%. However, there were signs of stabilisation in loan growth since November 2018. The asset quality of banks' loan portfolios remained healthy by historical standards.

To broaden our understanding of the credit risk of Mainland-related lending by banks in Hong Kong, Box 4 (see page 73) provides a macro assessment of the credit risk for Mainland corporates based on locally-listed non-financial Mainland corporates that have borrowed syndicated loans from banks in Hong Kong. By assessing a broader set of key financial characteristics of Mainland corporates, the findings suggest that the Hong Kong banking sector, at least for the syndicated loan portfolio, is less exposed to riskier Mainland corporates. However, in view of concerns over Mainland's growth outlook and the uncertainty surrounding the US-China trade negotiations, banks should remain alert to the credit risk management of their Mainland-related exposure.

In the near term, the Hong Kong banking sector will face multiple headwinds, including the unresolved US-China trade tensions, weaker global economic growth, uncertainty over the pace of the US tightening cycle, and geopolitical risks. Should these uncertainties intensify and persist into the longer term, these could significantly dampen business confidence and credit demand, thereby posing downward pressure on banks' profitability. In view of the rising corporate leverage, banks should also carefully assess how the possible deterioration in the external environment could affect the credit risk of their corporate exposure.

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