4. Monetary and financial conditions

The Hong Kong dollar exchange rate strengthened in September and November, in part reflecting the unwinding of interest carry trade positions as liquidity conditions tightened amid anticipated seasonal funding demand. In early 2019, partly associated with the repatriation of proceeds raised in initial public offerings and some re-building of interest carry positions, the Hong Kong dollar weakened gradually and the weak-side Convertibility Undertaking (CU) was triggered in March. Despite this, the Hong Kong dollar remained traded in a smooth and orderly manner. Reflecting the expectation of US rate hikes and seasonal funding demand, Hong Kong Interbank Offered Rates broadly picked up during the second half of 2018 before easing in January 2019. Fund flows into and out of Hong Kong dollar in the near term may become more volatile amid uncertainties arising from the lingering US-China trade tensions, the Brexit negotiations and the less predictable pace of US monetary policy normalisation. If the large gaps between the Hong Kong dollar and US dollar interest rates remain, carry trade activities will likely keep the Hong Kong dollar weak in the near future and the weak-side CU may be triggered again, consistent with the design of the Linked Exchange Rate System.

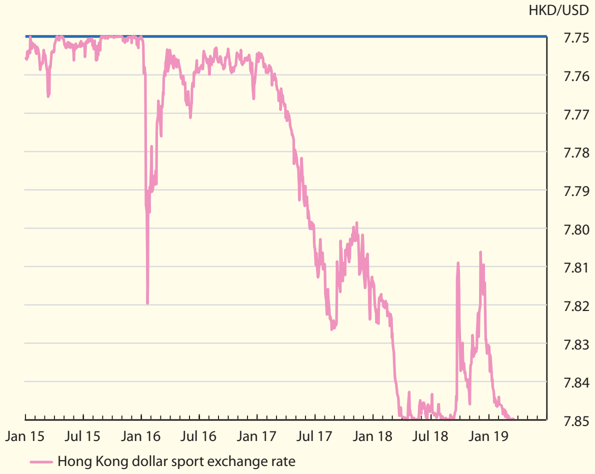
4.1 Exchange rate and capital flows

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) (Chart 4.1).[31] The Hong Kong dollar exchange rate briefly strengthened in September, partly reflecting unwinding of interest carry trade positions amid tightening interbank liquidity, before easing gradually in October. Since November, the Hong Kong dollar firmed again due to the unwinding of interest carry positions as liquidity conditions tightened amid year-end funding demand. Stepping into 2019, the spot rate weakened, partly associated with repatriation of proceeds raised in initial public offerings (IPOs) and some re-building of interest carry positions.

Widened interest rate gaps between the Hong Kong dollar and US dollar after the year-end attracted carry trade activities that sell Hong Kong dollar for US dollar, pushing the Hong Kong dollar exchange rate towards the weak-side. 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. The Aggregate Balance remained unchanged at around HK$76 billion since August (Chart 4.2); it subsequently edged down to HK$70.9 billion (as at March 19) due to the triggering of the weak-side CU in March. The amount of outflows since April 2018 constitutes only a small part of the inflows since 2008, which amounted to around HK$1 trillion.

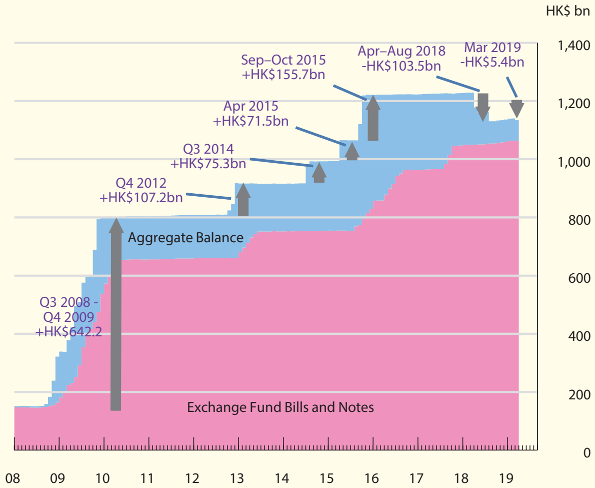
31 Based on the closing rate.

Chart 4.1
Hong Kong dollar exchange rate



Note: Up to 19 March 2019.
Source: HKMA.

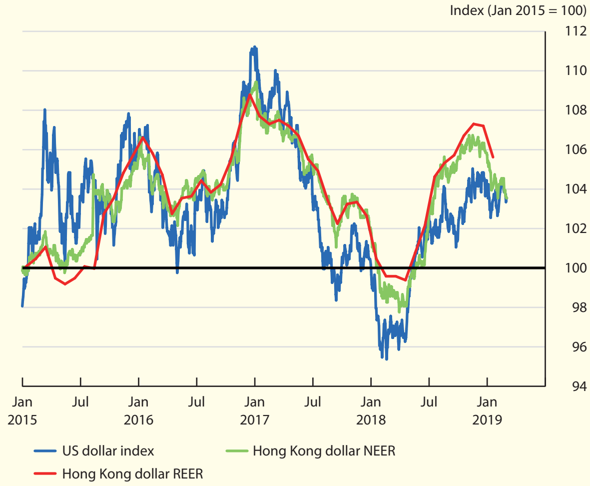
Chart 4.2
Fund flow indicators



Note: Up to 19 March 2019.
Source: HKMA.

Broadly in line with the movements of the US dollar, the Hong Kong dollar nominal effective exchange rate index (NEER) continued to strengthen during the review period (Chart 4.3). The Hong Kong dollar real effective exchange rate index (REER) generally followed the movement of NEER, as the small inflation differential between Hong Kong and its trading partners only had a limited impact on the REER.

Chart 4.3
NEER and REER



Note: REER is seasonally adjusted and only available on a monthly basis.
Sources: C&SD and HKMA staff estimates.

According to the latest Balance of Payments (BoP) statistics, outflows in portfolio investment continued in the third quarter of 2018. Amid weak market sentiment and heightened volatility in the stock markets, the equity portfolio investment outflows by residents accelerated and more-than-offset the inflows by non-residents in the third quarter (Table 4.A).[32] In contrast, there were inflows by both residents and non-residents in debt securities in the third quarter.

Table 4.A
Cross-border portfolio investment flows

	2016	2017	2018		
(HK$ bn)			Q1	Q2	Q3
By Hong Kong residents					
Equity and investment fund shares	-354.7	-109.8	-101.2	-64.6	-134.5
Debt securities	-175.5	54.5	-108.0	-140.7	6.1
By non-residents					
Equity and investment fund shares	19.3	80.4	-77.3	-1.3	31.7
Debt securities	41.3	239.1	40.9	48.5	19.5

Note: A positive value indicates capital inflows.
Source: C&SD.

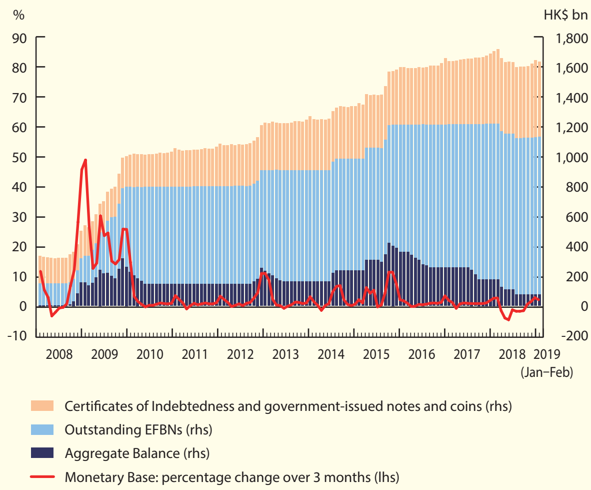
32 At the time of writing, the fourth-quarter BoP statistics were not yet available.

Looking ahead, fund flow volatility may increase amid uncertainties arising from the lingering US-China trade tensions, the Brexit negotiations and the less predictable pace of US monetary policy normalisation. In addition, substantial negative spreads between the Hong Kong dollar and US dollar interest rates may encourage carry trade activities, leading to capital outflows. Under the design of the Linked Exchange Rate System[33], the Hong Kong dollar exchange rate may weaken and the weak-side CU could be triggered again. 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.

4.2 Monetary environment and interest rates

Hong Kong's monetary environment remained accommodative in the second half of 2018 despite the ongoing US interest rate normalisation and the repeated triggering of the weak-side CU during April to August. The Hong Kong dollar Monetary Base decreased slightly by 0.7% in the second half, standing at HK$1,632.9 billion at the end of 2018 (Chart 4.4). The decline in the Monetary Base was mainly led by the fall in the Aggregate Balance from HK$109.5 billion at the end of June 2018 to HK$76.4 billion at the end of 2018 as a result of the triggering of the weak-side CU in August, while there have been modest increases in Certificates of Indebtedness, government-issued notes and coins, and outstanding Exchange Fund Bills and Notes (EFBNs). The Hong Kong dollar Monetary Base remained largely stable in the first two months of 2019, with the Aggregate Balance staying virtually unchanged since August. Due to the triggering of the weak-side CU in March, the Aggregate Balance edged down to around HK$70.9 billion (as at March 19).

Chart 4.4
Monetary Base components

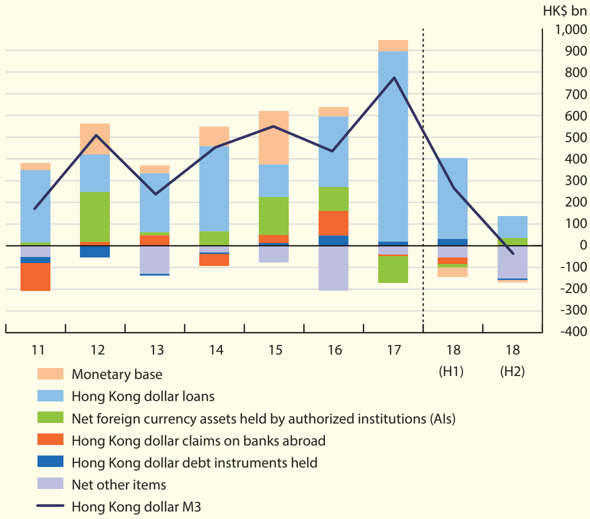


Source: HKMA.

As for broader measures of Hong Kong dollar monetary aggregates, they generally witnessed slower growth during the second half, in part, attributable to heightened uncertainties in the macroeconomic and financial environment. After expanding by 3.6% in the first half, the Hong Kong dollar broad money (HK$M3) edged up only by 0.1% in the second half (Chart 4.5). Hong Kong dollar deposits, a major component of HK$M3, were virtually unchanged compared with the end of June (Chart 4.6). Within Hong Kong dollar deposits, demand and savings deposits declined somewhat, in part due to reduced investment-related transactions moving into the second half. On the other hand, time deposits continued to record strong expansion amid a pick-up in deposit rates. Analysed by the asset-side counterparts, growth deceleration of HK$M3 was due to changes in banks' capital and reserves (which are included in "net other items").

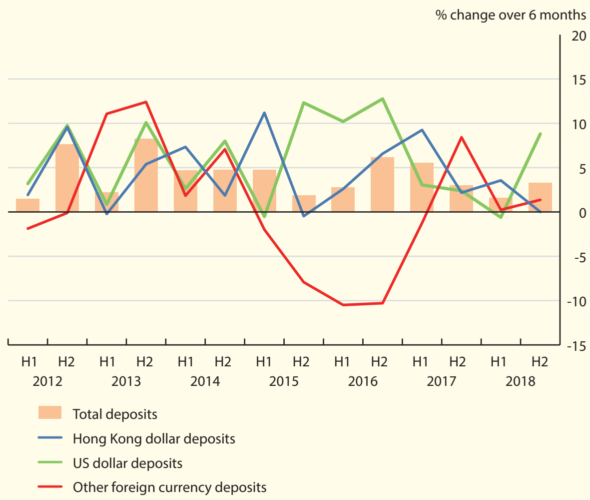
[33] The Linked Exchange Rate System is working according to its design and consistently with the recently developed target zone model, which adequately describes and explains the exchange rate dynamics and the associated interest rate differential in a fully credible convertibility zone. For details, please see "Linked Exchange Rate System operations –mechanism and Theory", *HKMA Quarterly Bulletin*, December 2018 issue, pp.1–10.

Chart 4.5
Changes in the HK$M3 and the asset-side counterparts



Note: The HK$M3 in the monetary survey has been adjusted to include foreign currency swap deposits and to exclude government deposits and Exchange Fund deposits with licensed banks.
Source: HKMA staff estimates.

Chart 4.6
Deposit growth

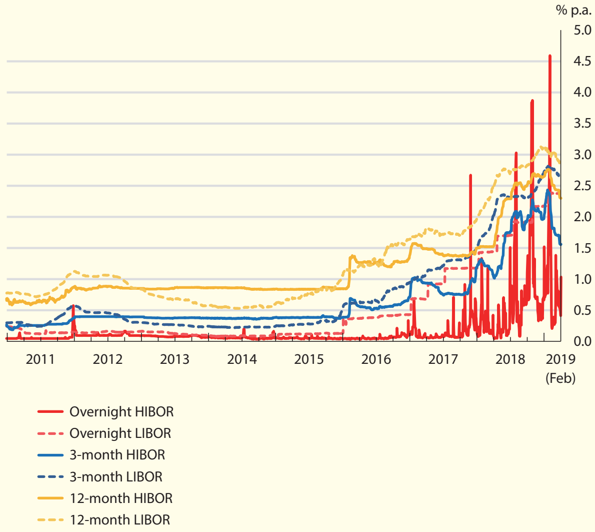


Source: HKMA.

Foreign currency deposits increased at a faster pace during the second half of 2018. The increase was mainly driven by US dollar deposits, which expanded strongly by 8.8% in the second half as banks attracted more deposits after raising their preferential US dollar deposit rates (Chart 4.6). Other foreign currency deposits grew by a modest 1.4% during the same period, within which renminbi deposits continued to increase. Overall, total deposits with AIs grew moderately by 3.3% in the second half, slightly faster than a 1.6% increase in the preceding half-year period.

Although the Hong Kong dollar Monetary Base and deposits remained sizable, the Hong Kong dollar interbank interest rates faced some upward pressures in the second half of 2018, which primarily reflected US rate hikes. Seasonal liquidity needs also occasionally drove short-term interbank rates higher and resulted in their higher volatility vis-à-vis their long-term counterpart (Chart 4.7). The three-month and 12-month Hong Kong Interbank Offered Rate (HIBOR) fixings averaged, respectively, 2.32% and 2.74% in December, about 30 basis points higher than their averages in June. Stepping into 2019, the Hong Kong dollar interbank interest rates generally eased as seasonal demand faded. The February averages of three-month and 12-month HIBOR fixings eased to 1.65% and 2.39%, respectively.

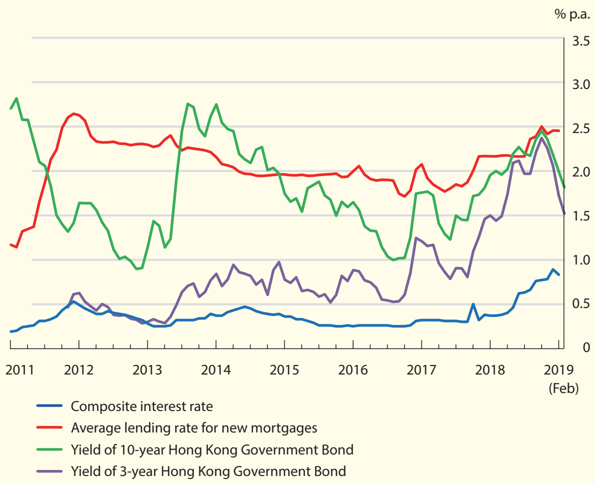
Chart 4.7
Hong Kong dollar and US dollar interbank interest rates



Sources: CEIC and HKMA.

Broadly tracking the movements of the US dollar yield curve, the Hong Kong dollar yield curve shifted downwards during the second half of 2018. The yields of the three-year and ten-year Hong Kong Government Bonds fell, respectively, by 45 basis points and 37 basis points to 1.56% and 1.83% at the end of February 2019 relative to the end of June 2018 (Chart 4.8).

Chart 4.8
Yields of Government Bonds, the composite interest rate, and the average lending rate for new mortgages



Source: HKMA.

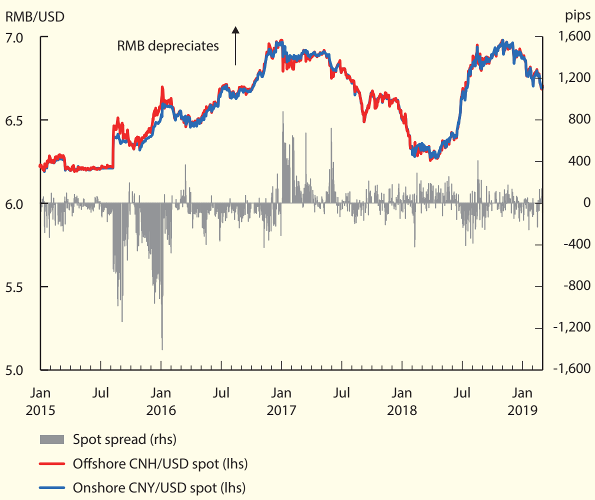
The composite interest rate, which measures the average Hong Kong dollar funding costs of retail banks, edged up during the review period. Underpinned by changes in both interbank and deposit funding costs, the composite interest rate increased from 0.62% at the end of June to 0.89% at the end of December, before easing to 0.83% at the end of January 2019 (Chart 4.8). In view of the tighter funding costs, retail banks raised their Best Lending Rates by 12.5–25.0 basis points following the increase in the target range for the Federal Funds Rate in September. However, retail banks did not adjust the rates again after another increase in the target range for the Federal Funds Rate in December. On the other hand, the average lending rate for new mortgages moved along with the raised Best Lending Rates to around 2.45% at the end of January 2019.

In the period ahead, the path of US dollar interest rates, fund flow patterns and domestic market activities (e.g. IPOs) will continue to be the key drivers of Hong Kong dollar interest rates. Given that the Hong Kong dollar Monetary Base remains sizeable — the banking sector is holding vast amounts of Exchange Fund papers — the pace of Hong Kong dollar interest rate increases should be modest as banks can use the Exchange Fund papers as collateral to obtain Hong Kong dollar liquidity via the discount window.

Offshore renminbi banking business

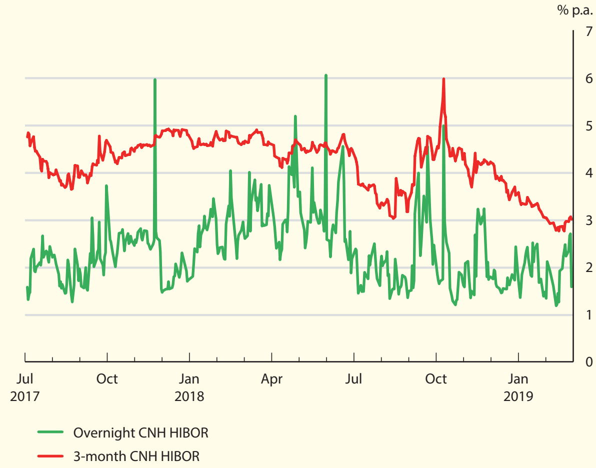
Against the background of an escalation in the US-China trade tensions, the offshore (CNH) and the onshore (CNY) have weakened since early 2018 (Chart 4.9). However, they both stabilised in November on the back of optimism surrounding the news that high-level trade talks between Mainland China and the US had resumed. During the review period, the spread between the CNY and the CNH was largely insignificant.

Chart 4.9
CNY and CNH exchange rates



Source: Bloomberg.

Chart 4.10
The overnight and the three-month CNH HIBOR fixings



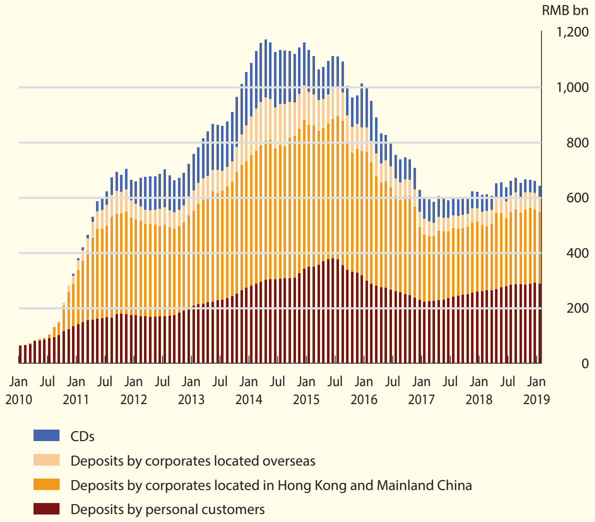
Source: CEIC.

The lingering US-China trade tensions have not so far exerted a significant impact on the funding conditions in the offshore interbank market. As liquidity conditions remained largely stable, the overnight CNH HIBOR mostly traded below 4% during the review period, with only an occasional pick up due to seasonal factors (Chart 4.10). The three-month CNH HIBOR hovered around 4% between September and December 2018, before easing to 3.02% at the end of February 2019, which may reflect the latest monetary easing measures by the People's Bank of China.[34] Nevertheless, it remains to be seen how the development of the US-China trade talks affect the CNH interbank market liquidity in 2019.

Hong Kong's CNH liquidity pool expanded steadily during the second half of 2018. Compared with a 2.6% increase in the first half, the total outstanding amount of renminbi customer deposits and certificates of deposit (CDs) grew slightly faster by 3.7% in the second half to total RMB657.7 billion at the end of 2018 (Chart 4.11 and Table 4.B). This was largely driven by renminbi customer deposits, which picked up by 5.2% in the second half following a 4.5% increase in the first half. In particular, corporate customer deposits expanded faster than personal customer deposits. The outstanding amount of CDs, however, dropped further by 14.1% in the second half, mainly due to a fall in CD issuances and the maturing of a relatively large amount of CDs in October.

[34] For details of the measures, please see the section Fiscal and Monetary policy under chapter 2.2 in this Report.

Chart 4.11
Renminbi deposits and CDs in Hong Kong



Source: HKMA.

Table 4.B
Offshore renminbi banking statistics

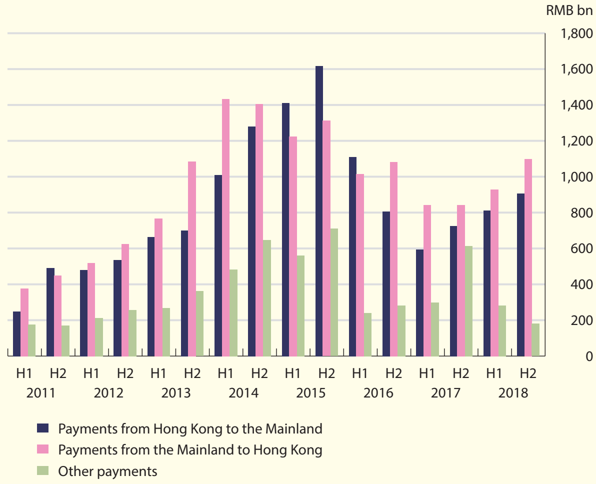
	Dec 2017	Dec 2018
Renminbi deposits & CDs (RMB bn)	618.4	657.7
Of which:		
Renminbi deposits (RMB bn)	559.1	615.0
Share of renminbi deposits in total deposits (%)	5.3	5.2
Renminbi CDs (RMB bn)	59.3	42.7
Renminbi outstanding loans (RMB bn)	144.5	105.6
Number of participating banks in Hong Kong's renminbi clearing platform	203	200
Amount due to overseas banks (RMB bn)	95.4	80.4
Amount due from overseas banks (RMB bn)	131.3	132.8
	2017	**2018**
Renminbi trade settlement in Hong Kong (RMB bn)	3,913.9	4,206.2
Of which:		
Inward remittances to Hong Kong (RMB bn)	1,682.5	2,027.0
Outward remittances to Mainland China (RMB bn)	1,318.3	1,715.3
Turnover in Hong Kong's RMB real time gross settlement (RTGS) system (Daily average during the period; RMB bn)	903.6	1,010.1

Source: HKMA.

Despite a steady expansion in Hong Kong's CNH liquidity pool, renminbi lending activities in Hong Kong continued to be weak. The outstanding amount of renminbi bank loans declined further by 14.3% during the second half to RMB105.6 billion at the end of 2018, albeit at a slower pace than the 14.7% decline in the first half.

Meanwhile, Hong Kong's renminbi trade settlement picked up during the second half. Transactions handled by banks in Hong Kong amounted to RMB2,184.6 billion during the second half of 2018, up by 8.1% compared with the first half (Chart 4.12). For 2018 as a whole, the average daily turnover of the renminbi RTGS system rose to RMB1,010.1 billion from RMB903.6 billion recorded in 2017.

Chart 4.12
Flows of renminbi trade settlement payments



Source: HKMA.

In the near term, the development of the CNH market in Hong Kong will continue to depend on Mainland's macro-financial conditions and the path of the renminbi exchange rate. Despite the lingering US-China trade tensions, Hong Kong's offshore renminbi business is expected to grow alongside continued liberalisation of Mainland's capital account, the development of the Stock and Bond Connect schemes, and more regional economic co-operation under the Belt and Road and Greater Bay Area Initiatives.

Asset markets

Hong Kong equity prices corrected sharply at the beginning of the review period as a result of continued monetary tightening in the US and escalated US-China trade conflict but rallied strongly towards the end with the Federal Reserve's signalling a "patient" approach to monetary policy and increased hopes of a trade deal between Mainland China and the US. The Hong Kong dollar debt market continued to expand on the back of steady growth in issuance last year, while its offshore renminbi debt market contracted. The residential property market slowed in the second half of 2018 amid the trade tensions and tightening financial conditions, before stabilising somewhat in early 2019.

4.3 Equity market

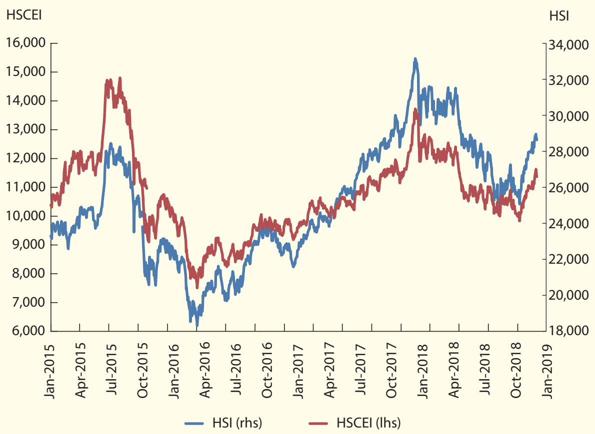
The local equity market took a roller coaster ride in the review period. The Hang Seng Index (HSI) continued to slide at the start and reached a 17-month low in late October amid more rate hikes in the US and elevated US-China trade tensions (Chart 4.13). As the Mainland economy slowed further and its US counterpart began to show its fatigue, a series of worse-than-expected earnings results turned off investors, sending US equity prices sharply lower as well. Sentiment weakened further when the deadlock between the Democrats and Republicans over the financing of the Mexican border wall led to a partial shutdown of the US Government. With the yield curve threatening to invert, uncertainty increasingly loomed over the outlook for the economy.

However, these negative developments appear to have had a positive side: they brought considerable incentives for the two economic superpowers to return to the negotiation table. During the trade truce, both sides showed friendly gestures and demonstrated willingness to make compromises. In particular, Mainland China purchased large amounts of agricultural products to help narrow the bilateral trade gap, and stepped up its legal reforms to help foreign direct investment. This was despite the complication created by the US indictment of a major Mainland telecoms company. With the Federal Reserve (Fed) indicating a switch to a more "patient" monetary policy, the market staged a cautious rebound towards the end of the review period with early signs that fund flows might once again head in a favourable direction (Chart 4.15).

Overall, the HSI and Hang Seng China Enterprises Index, also known as the H-share index, edged up by 3.32% and 5.12%, respectively from September 2018 to February 2019, due mainly to the rally in the last two months. Option-implied volatilities initially surged towards the end of last year, but have since subsided as calm returned to the market (Chart 4.14). The SKEW Index also declined markedly during the period, suggesting that downside protection was not valued as much as before.[35]

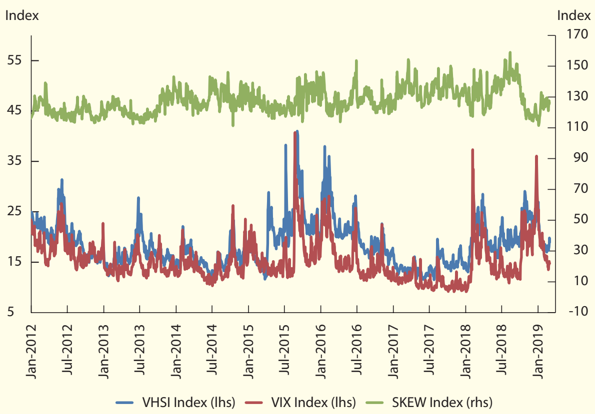
[35] The SKEW Index is calculated by the Chicago Board Options Exchange from the prices of the S&P 500 out-of-the-money options. A SKEW value of 100 means that the probability of outlier negative returns at a 30-day horizon is negligible. As SKEW rises above 100, the left tail of the S&P 500 returns distribution acquires more weight, suggesting that the probability of outlier negative returns become more significant. For details, see https://www.cboe.com/products/vix-index-volatility/volatility-indicators/skew.

Chart 4.13
Equity prices in Hong Kong



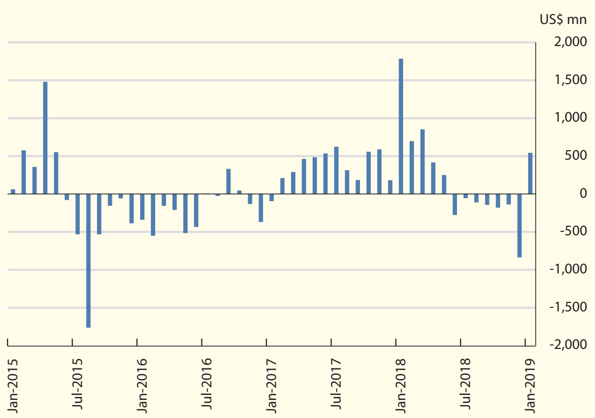
Source: Bloomberg.

Chart 4.14
Option-implied volatilities of the HSI and S&P 500, and the SKEW index



Sources: Bloomberg.

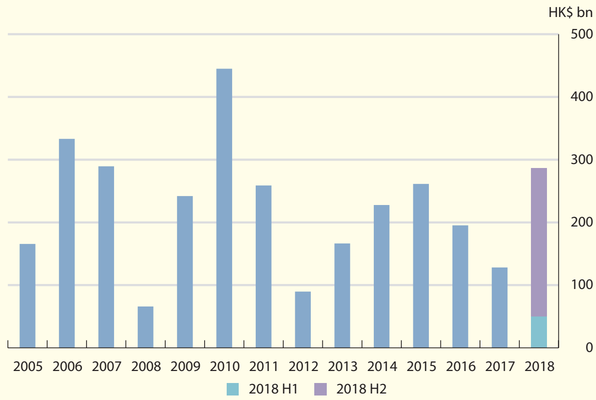
Chart 4.15
Equity market net fund flows into Hong Kong



Source: EPFR Global.

Contrary to the lacklustre performance of share prices, the primary market in Hong Kong recorded significant growth in 2018. To a certain extent this was attributable to the listing rules reform last April, which allowed companies with dual-class shareholding structures and pre-revenue biotech firms to list on the Hong Kong Stock Exchange. In 2018, funds raised from IPOs increased by 125% to HK$286.5 billion, putting Hong Kong once again at the top of the league table for IPOs globally (Chart 4.16).

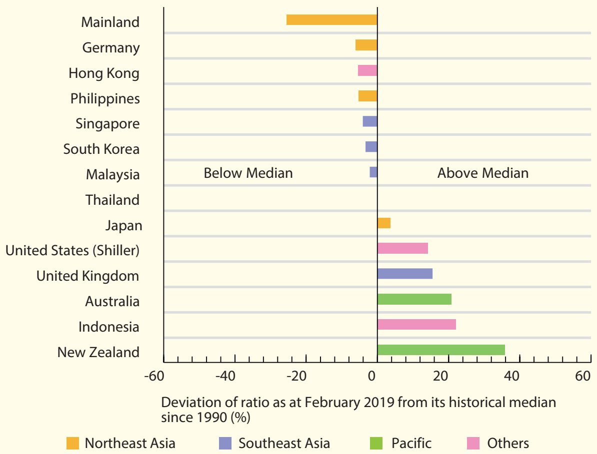
Chart 4.16
The IPO market in Hong Kong



Sources: CEIC and HKEx.

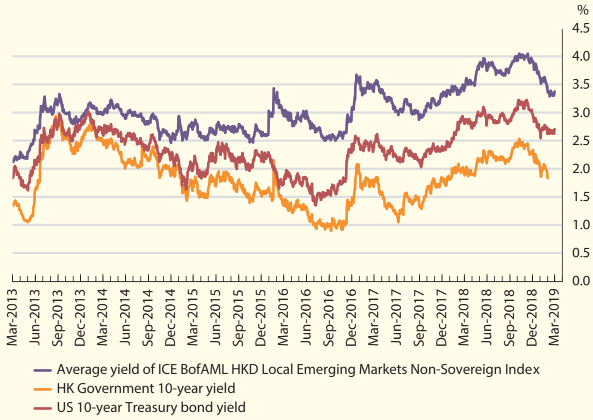
For 2019, the local equity market is expected to remain susceptible to the external environment. The outlook for US monetary policy may turn out to be a bright spot. However, apart from that, the outcome of the current trade talks remains highly uncertain, as Mainland China and the US are yet to finalise the implementation and structural details of a trade deal, if any. This is especially so in the difficult high-tech sphere with further developments likely in the highly politicised indictment case complicating the scene. Apart from this, there are several other wild cards, particularly the UK's hard Brexit risk, Italy's fiscal turmoil and Venezuela's political crisis. Valuation wise, Hong Kong is undoubtedly among the lowest globally, but it is unlikely to provide enough cushion should events unfold in an adverse and turbulent manner (Chart 4.17).

Chart 4.17
Cyclically-adjusted price-earnings (CAPE) ratios of Asia Pacific and other major markets



Sources: Bloomberg, CEIC and HKMA staff estimates.

Chart 4.18
Hong Kong dollar sovereign and non-sovereign bond yields and US 10-year Treasury yield

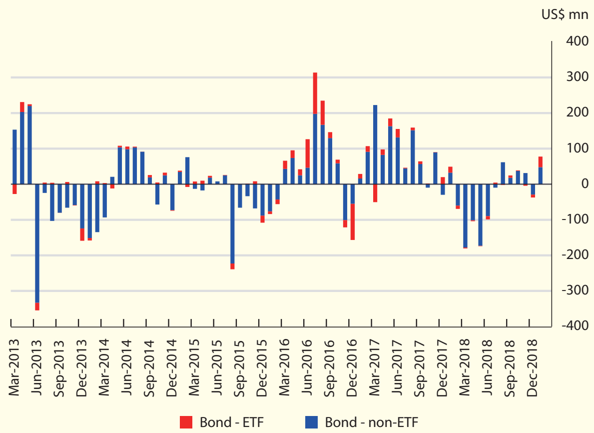


Sources: HKMA and ICE Data Indices.

4.4 Debt market

The Hong Kong dollar debt market continued to expand in 2018 on the back of steady growth in issuance, with the yields of both sovereign and non-sovereign bonds easing since the fourth quarter, after rising for an extended period (Chart 4.18). The easing went in tandem with the decline in US Treasury yields amid growing market expectations that the Fed would take a more patient and flexible approach to adjusting its target policy rate. Against the backdrop of a more moderate pace of monetary normalisation in the US, capital outflow pressure faced by East Asian economies has also eased, with international investors gradually returning from the sidelines. As a result, there appears to be an improved appetite for Hong Kong dollar debt, which is reflected in the net bond fund flows rebounding to positive territory since last August (Chart 4.19).

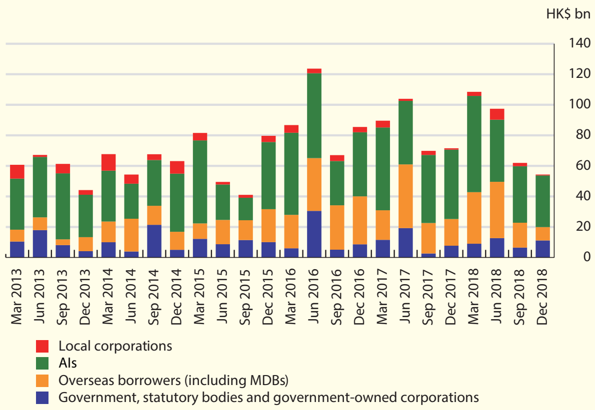
Chart 4.19
Exchange traded fund (ETF) and non-ETF bond fund flows into Hong Kong



Source: EPFR Global.

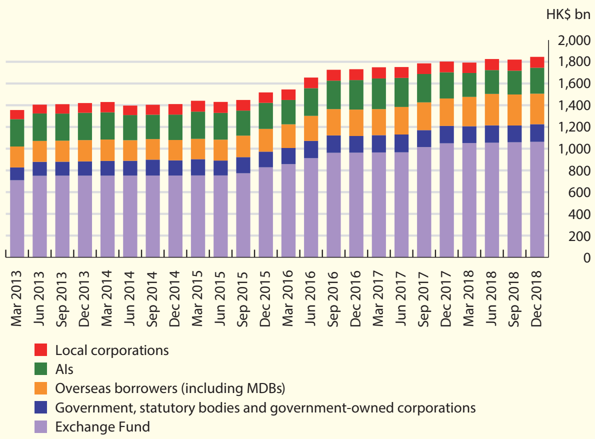
The total issuance of Hong Kong dollar debt increased by 6.6% to HK$3,555.1 billion in 2018 from the preceding year, mainly driven by the Exchange Fund's strong issuance that more than offset the decline of debts issued by the private sector (Chart 4.20). As a result, the outstanding amount of Hong Kong dollar debt rose by 2.4% year on year to HK$1,844.5 billion at the end of December (Chart 4.21). The amount was equivalent to 25.3% of HK$M3 or 20.8% of Hong Kong dollar-denominated assets of the banking sector. Within the total, overseas borrowers including multilateral development banks (MDBs) saw their debt outstanding increase by 11.0% from a year ago to HK$281.5 billion, more than offsetting the 0.5% year-on-year decline in outstanding debt of the local private sector.

Chart 4.20
New issuance of non- EFBNs Hong Kong dollar debt



Source: HKMA.

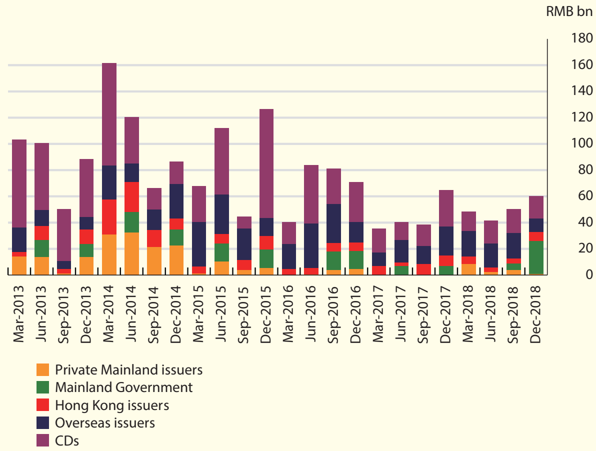
Chart 4.21
Outstanding Hong Kong dollar debt



Source: HKMA.

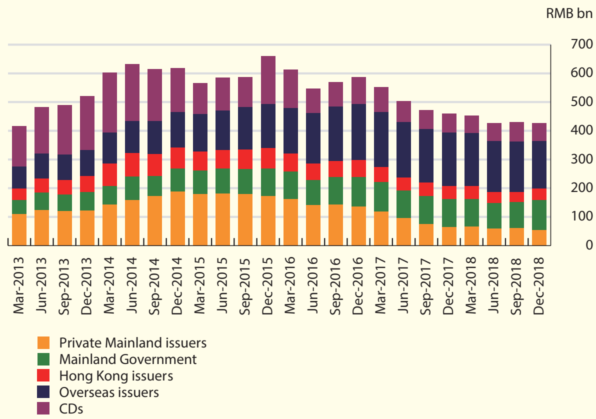
The sentiment underlying the primary offshore renminbi debt market in Hong Kong is mixed. New issuance showed tentative signs of recovery in 2018, after contracting for three years in a row. Total issuance increased by 11.5% year on year to RMB200 billion in 2018, driven by a rebound in issuance by private Mainland issuers, the Mainland government and overseas issuers (Chart 4.22). However, as the increase in issuance was more than offset by maturing debt, the total outstanding amount of offshore renminbi debt securities in Hong Kong registered a year-on-year decline of 7% to RMB427 billion at the end of December 2018, partly reflecting the continued deleveraging of the corporate sector and partly a more tarnished business outlook (Chart 4.23). The gap between onshore and offshore funding costs widened during the review period, which further underscored the disincentive for borrowers to roll over their debt offshore (Chart 4.24).

Chart 4.22
New issuance of offshore renminbi debt securities



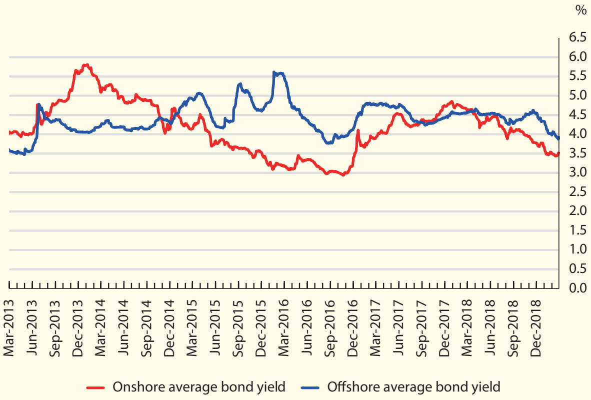
Sources: Newswires and HKMA staff estimates.

Chart 4.23
Outstanding amount of offshore renminbi debt securities and renminbi deposits in Hong Kong



Sources: Newswires and HKMA staff estimates.

Chart 4.24
Average yields of onshore vs. offshore renminbi bond indices



Sources: Bloomberg, Hang Seng Indexes Company Ltd, and China Central Depository & Clearing Co., Ltd.

Looking ahead, despite expectations of a more gradual US monetary tightening, the near-term prospect for the local debt market remains challenging. In particular, in the wake of the US-China trade conflict and concerns about the global economic slowdown, corporates will be more cautious in launching new investment, thus dampening their incentives to issue Hong Kong dollar and offshore renminbi debt. However, a bright spot is emerging in the fast-growing green bond market. As an international financial centre and global renminbi business hub, Hong Kong is well-positioned to capitalise on the rising demand for green finance products, and serve as a financing platform for green projects on the Mainland and overseas. The supportive measures of the Government will also facilitate the development of this market segment.[36]

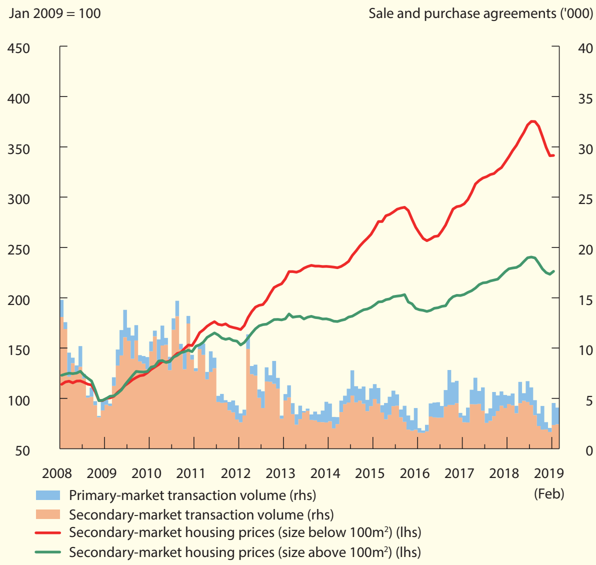
4.5 Property markets

Residential property market

The residential property market cooled down in the second half of 2018 amid the US-China trade tensions, stock market corrections, the rise in local Best Lending Rates and weakening domestic economic activities. Compared with the first half, average monthly housing transactions fell by more than 30% to 3,892 units (Chart 4.25). Housing prices also declined by 9.0% from the peak in July through December. In particular, the price of small and medium-sized flats (with a saleable area of less than 100m²) decreased at a faster pace than that of large flats (with a saleable area of at least 100m²). For 2018 as a whole, overall flat prices increased by just 1.8%, the slowest growth since 2009.

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

Chart 4.25
Residential property prices and transaction volume

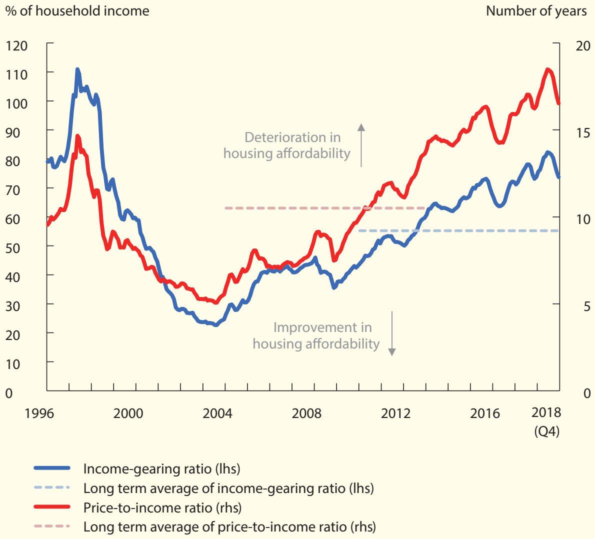


Sources: Rating and Valuation Department (R&VD) and Land Registry.

36 For more details, see Section 4.4 of *HKMA Half Yearly Monetary and Financial Stability Report* (September 2018).

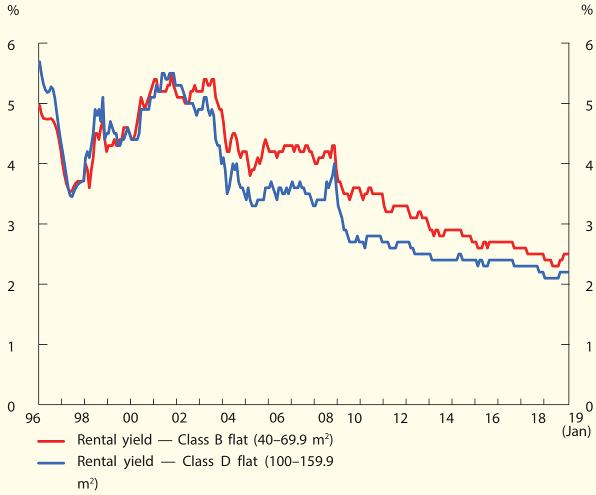
Housing affordability remained stretched despite the recent declines in housing prices. The house price-to-income ratio stayed high at 17.0 in the fourth quarter of 2018 compared with the 1997 peak of 14.7, while the income-gearing ratio was 75.7%, still much higher than the long-term average (Chart 4.26).[37] Mainly reflecting the decline in flat prices, the residential rental yields for both small and large flats picked up in recent months (Chart 4.27). As a result, the buy-rent gap, a measure of relative costs between buying and renting a typical housing unit[38], narrowed in the second half of 2018, but was still at a high level of 180.9% in the fourth quarter.

Chart 4.26
Indicators of housing affordability



Sources: R&VD, C&SD and HKMA staff estimates.

Chart 4.27
Rental yields



Source: R&VD.

Although the residential property market saw some downward pressure, the eight rounds of macroprudential measures implemented by the HKMA over the past several years have helped strengthen the risk management of banks and the resilience of the banking sector to cope with housing price adjustments. In particular, the average LTV ratio for newly approved mortgages declined to 46% in January 2019 from 64% before the measures were first introduced in 2009. And, the DSR also decreased to 35.1%.

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 (Chart 4.28) and the

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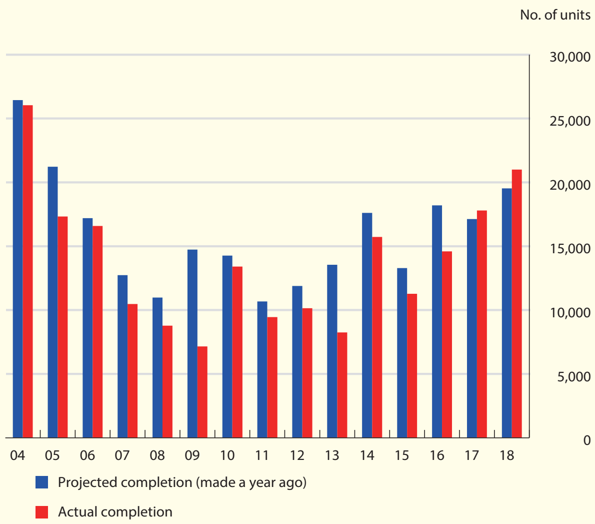
37 The price-to-income ratio measures the average price of a typical 50m² flat relative to the median income of households living in private housing. Alternately, the income-gearing ratio compares the amount of mortgage payment for a typical 50m² flat (under a 20-year mortgage scheme with a 70% loan-to-value (LTV) ratio) to the median income of households living in private housing. The income-gearing ratio is not the same as a borrower's actual debt-servicing ratio (DSR), which is subject to a maximum cap by the HKMA's prudential measures.

38 The buy-rent gap estimates the cost of owner-occupied housing (under a 20-year mortgage scheme with a 70% LTV ratio) relative to rentals.

Government's effort to increase land and housing supply.

Chart 4.28
Projected and actual private flat completion

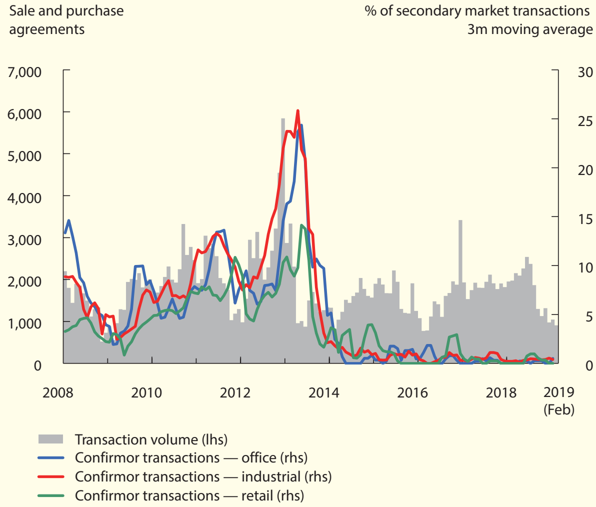


Sources: Transport and Housing Bureau and R&VD.

Non-residential property market

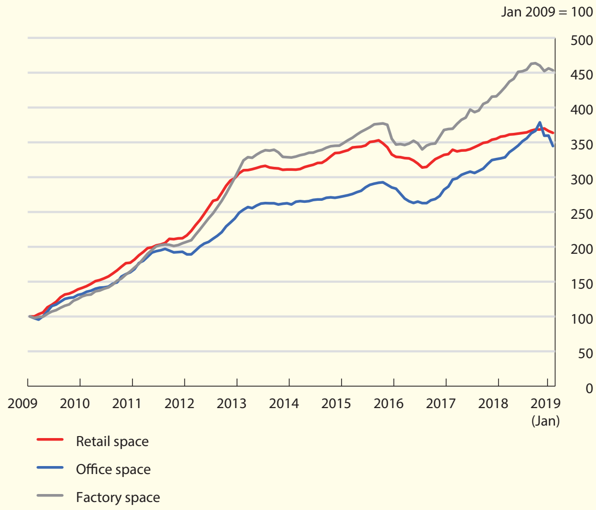
The non-residential property market also softened in the second half of 2018 as business prospects weakened. Transaction volume dropped to a monthly average of 1,495 units, and speculative activities remained inactive as indicated by low confirmor transactions (Chart 4.29). The price growth of office space, retail premises and flatted factories turned negative near the end of 2018 (Chart 4.30), and the leasing market also showed signs of moderation. Overall rental yields across segments continued to stay at a low range of 2.3–2.7% in January 2019.

Chart 4.29
Transactions in non-residential properties



Sources: Land Registry and Centaline Property Agency Limited.

Chart 4.30
Non-residential property price indices



Source: R&VD.

In the near term, the non-residential property market may face headwinds from the lingering trade protectionism, weakening global economic expansion and potential financial market volatility. In addition, the outlook for retail premises will also depend on business prospects in the sector. In that regard, a boost to inbound tourism arising from the new cross-border infrastructure projects could provide some support to the rental and capital values of retail space, even though they may face headwinds from softening local economic growth.