1. Summary and overview

Global growth momentum moderated further in the first half of 2019, reflecting weaker business investment in major advanced economies and the disruptive impact of US import tariffs on global trade and supply chains. The Hong Kong economy also recorded its slowest year-on-year growth in ten years over the same period.

Despite some fluctuations, particularly amid seasonal funding demand and sizable initial public offerings in May and June, the Hong Kong dollar market traded in a smooth and orderly manner. Both Hong Kong dollar and total broad money supply recorded steady growth, while bank credit resumed expansion in the first half of 2019 following a contraction in the second half of 2018. The residential property market has softened somewhat since June after a strong rebound in the first five months of the year.

Looking ahead, the Hong Kong banking sector will face multiple headwinds, including the worsening of the US-China trade tensions, increased downside risks to the global economy, rising uncertainty over the timing and magnitude of monetary accommodation by some major central banks, and increased geopolitical risks. In particular, in view of the rising corporate leverage and household debt burden, banks should stay alert to the credit risk of their corporate and household exposures to any further deterioration in the external environment.

The external environment

Global growth momentum moderated further in the first half of 2019, reflecting weaker business investment in major advanced economies and the disruptive impact of US import tariffs on global trade and supply chains. In July, in recognition of the weaker global growth momentum, the International Monetary Fund revised downward its growth projections for the global economy for 2019 and 2020.

Adding to the headwinds faced by the global economy, trade tensions and the continual technology rivalry between the US and Mainland China intensified since May, triggering episodic financial market sell-offs. Nonetheless, global equity markets generally remained supported by market expectations of a more accommodative global monetary policy, although slower economic growth and downbeat earnings outlook call into question the levels of valuation.

Looking ahead, the global economic outlook will hinge on various factors, especially how the US-China trade tensions evolve, as well as the future monetary policy direction of major central banks. In the US, while the economy continued to perform well in the first half of 2019, the US Federal Reserve (Fed) delivered a "risk management" rate cut in July in the face of growing external headwinds, although Chairman Powell's speech at the Jackson Hole Symposium in August did not provide new hints on the future monetary policy direction. In the euro area, against the background of subdued growth and inflation outlook, the European Central Bank at its September monetary policy committee meeting responded with more monetary easing, as well as indicating its intention to keep policy rates at their current or lower levels until the inflation outlook converges robustly to target. It remains to be seen whether the increased monetary accommodation by major central banks will be effective in rekindling faltering global growth. Importantly, inflation developments will continue to heavily influence the direction of monetary policy at major central banks. At the same time, a number of geopolitical developments, including Brexit, the US-Iran tensions and uncertainties surrounding the denuclearisation progress on the Korean Peninsula, will also cloud the global economic outlook.

In East Asia[1], export performance softened against the backdrop of a synchronised slowdown in global growth and demand for consumer electronics. Uncertain prospects on trade and less confident business conditions have clouded the investment environment and hindered the region's gross domestic product (GDP) growth. As inflation has also remained subdued in many East Asian economies, central banks in the region have signalled a more accommodative stance to fuel growth momentum in the near term. Such monetary accommodation will also be needed to temper the effects of trade war-inflicted strains in manufacturing activities and, more broadly, the global value chain. If the economic slowdown deepens and uncertainty remains elevated, financial markets in the region may continue to face bouts of volatility. Indeed, Box 1 shows that investment flows to emerging market economy local currency bond funds are quite sensitive to changes in exchange rate volatility, particularly during market distress. In addition, indebted sectors in the region could face challenges to their debt servicing capabilities, especially given the substantial refinancing needs of the region's corporate sector in the next several years.

[1] East Asia refers to the following seven economies: Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand.

In Mainland China, growth momentum showed signs of stabilisation in the first quarter following government economic supportive measures and the temporary trade truce between the US and Mainland China, but then softened again in the second quarter as trade tensions resurfaced after May. As the trade situation deteriorates, the economic outlook for the Mainland remains highly uncertain as it has to grapple with pressures on both the external sector and on domestic demand. Growth prospects hinge also on how policy-makers would weigh the efforts to support the economy in the near-term against the containment of systemic risks that may be harmful over the longer term. The latest consensus forecasts for Mainland economic growth eased to 6.2% for 2019 as a whole, notably down from the 6.6% actual growth in 2018.

In order to support business expansion amid recent economic slowdown, the Mainland government has rolled out several rounds of cuts in business taxes and fees. Many of these tax cuts aim to lower the tax burden for small private firms, which are the key driver of growth and employment in the economy. By focusing on Mainland-listed non-financial firms, Box 2 finds that the recent tax cuts seem, indeed, to have reduced the tax burden of small private firms. In addition, detailed tax rate breakdowns (e.g., the turnover tax rate and income tax rate) lend little support to the argument that smaller private firms have faced a greater tax burden than the average Mainland privately-owned enterprises.

The domestic economy

The Hong Kong economy grew at a sluggish pace in the first half of 2019. The year-on-year growth rate of real GDP declined to 0.6% in the first quarter and hit a ten-year low of 0.5% in the second quarter. On a quarter-on-quarter basis, private domestic consumption growth weakened and aggregate investment spending contracted. Externally, Hong Kong's trade performance also worsened significantly amid lingering US-China trade tensions and weaker global economic growth. As imports of goods declined at a faster rate than exports, net exports still contributed positively to GDP growth in the first quarter, but its contribution turned negative in the second quarter. Box 3 examines in more detail the recent performance of Hong Kong's merchandise exports and their relation to Mainland's export patterns so far this year.

The economic performance for the rest of 2019 is expected to remain subdued. Externally, the US-China trade tensions and slowing global economic growth will continue to weigh down Hong Kong's trade performance. Domestically, private consumption will likely be growth-supportive, but its growth rate is expected to be tepid, in part, due to more cautious consumer sentiment. As for fixed capital formation, heightened economic uncertainty and fragile business confidence could dampen capital expenditure, as well as building and construction activities. Taking into account the weaker-than-expected GDP outturn, the Government revised downwards its forecast of real GDP growth for 2019 from 2–3% earlier to 0–1%.

This tepid growth outlook is subject to a number of uncertainties and downside risks that have arisen in recent months. The slowing global economic growth, the ongoing US-China trade dispute, the future direction of monetary policy in the US, the economic performance of Mainland China, the impending Brexit, and the recent social incidents in Hong Kong constitute the core of a myriad of factors that may have an impact on the Hong Kong economy.

The labour market in Hong Kong has so far remained resilient, as the unemployment rate fluctuated little in the first seven months of the year. As at July 2019, the unemployment rate is at the low level of 2.9%. That said, the labour market outlook is overshadowed by weakened economic prospects.

Local inflation edged up to a still-moderate level in the first half of 2019. In particular, there was an uptick in inflation momentum, reflecting price increases in fresh pork amid a disrupted supply situation, while inflationary pressures on other non-food items remained moderate. Looking ahead, while local inflationary pressures are expected to remain moderate due to low global inflation, earlier moderation in fresh-letting residential rentals and sluggish domestic growth momentum, the inflation rate in the near term may depend on the extent of supply disruption and the resultant price of fresh pork. In August, the Government revised upward its projection of the underlying and headline inflation rates for 2019 to 2.7% and 2.6% respectively, from 2.5% earlier.

Monetary conditions and capital flows

In the early part of this year, carry trade activities pushed the Hong Kong dollar exchange rate towards the weak side of the Convertibility Zone and triggered the weak-side Convertibility Undertaking (CU) eight times between 8 and 29 March. Since late May, the Hong Kong dollar exchange rate rebounded significantly, supported in part by funding demand as market participants prepared for sizable initial public offerings (IPOs) and partly by seasonal factors, such as corporate demand for Hong Kong dollars to pay dividends near the half-year end. In July and August, the Hong Kong dollar weakened somewhat against the US dollar as liquidity conditions improved after the half-year end. As a result of the triggering of the weak-side CU in March, the Aggregate Balance declined from HK$76.3 billion at the end of February to HK$54.4 billion at the end of August. Despite this, the Hong Kong dollar continued to trade in a smooth and orderly manner. Meanwhile, Hong Kong dollar broad money (HK$M3) has expanded by a moderate 3.3% so far this year.

After softening in the first two months of 2019, the Hong Kong dollar interbank interest rates experienced renewed upward pressure between March and June, driven by seasonal funding needs and increases in liquidity demand ahead of large anticipated IPOs in the second half. The composite interest rate remained largely stable at around 0.82% in the first five months of 2019, but picked up to 0.95% at the end of June as banks raised their preferential deposit rates amid the rise in funding demand, before edging down to 0.94% at the end of July. The average lending rate for new mortgages remained steady at around 2.4% in most of the first half, but increased slightly heading into July, with major banks raising the level of the prime-based caps for some of their new mortgage lending. While reduction in the Aggregate Balance since April last year may have increased the sensitivity of the Hong Kong dollar interbank rates to changes in supply and demand for the Hong Kong dollar, the interbank market has operated in an orderly fashion so far this year.

Movements in the Hong Kong dollar interest rates will continue to be influenced by the US dollar counterparts. More fluctuations are expected around periods with strong funding demand. In case of short-term liquidity tightness due to large scale capital market activities, banks can make use of the HKMA liquidity facilities.

With the escalation of the US-China trade conflict, the offshore (CNH) and the onshore (CNY) renminbi faced depreciation pressure since early May and in early August, the CNY exchange rate fell past 7 against the US dollar. The spread between CNY and CNH widened occasionally over this period, but remained moderate by historical standards. The total outstanding amount of renminbi customer deposits and certificates of deposit declined slightly from RMB657.7 billion at the end of 2018 to RMB638.8 billion at the end of July. Despite the weakening pressure of the renminbi exchange rate, renminbi customer deposits went up slightly in the first seven months as a whole. The average daily turnover of the renminbi real time gross settlement system remained high at RMB1,121.3 billion in the first seven months. Although the development of the offshore renminbi market will continue to be affected by the external headwinds, particularly the lingering US-China trade conflict, the progress of the Mainland's capital account liberalisation, the increase of renminbi assets allocation by international investors, and enhanced regional economic and financial co-operation under the Belt and Road and Guangdong-Hong Kong-Macao Greater Bay Area initiatives are expected to offer continued support to the offshore renminbi business.

Asset markets

The local stock market has fluctuated widely so far this year, driven to a considerable extent by the ebb and flow in the US-China trade tensions. The global economy has weakened, but major stock markets, especially the US market, appear to have focused more on the increased prospects that leading central banks now stand ready to ease monetary policy. Local equities have benefited from this improved global sentiment. However, the outlook for the market remains highly uncertain. Although Mainland China and the US returned to the negotiation table following the Osaka Summit, the negotiations are likely to be a long drawn-out process, as it is increasingly clear that conflicts on a number of structural issues will take time to resolve. This has put increasing pressure on the renminbi. Box 4 studies whether such pressure has affected the equity flows through Stock Connect. In addition to trade, there are also numerous wild cards in the background, for example, Brexit, and the geopolitical tensions in the UK/US row with Iran.

The review period has also seen the Hong Kong dollar bond market continue to ride on the back of US Treasury securities, with both sovereign (EFBNs) and non-sovereign yields declining significantly. The strong performance is attributable mainly to the build-up of expectations that the Fed will ease monetary policy. There have been consecutive months of net bond fund inflows to Hong Kong from January, which is also consistent with the general picture of rising non-resident portfolio inflows to emerging markets globally. From the perspective of market development, total debt outstanding increased mildly in the first six months of this year. Offshore renminbi debt recently saw a rebound in primary market activities after several quarters of tepid performance, but it was mainly due to a sharp increase in issuance by both overseas issuers and Mainland authorities. The appetite of the private sector remained weak, as uncertainties grew over the outlook for the Mainland economy.

After a strong rebound in the first five months of the year, the residential property market has softened somewhat since June. Between January and May, housing transactions surged along with improved market sentiment, and flat prices fully recovered from the losses recorded in the second half of 2018. Since June, however, the transaction volume and housing prices have levelled off. Housing affordability remained stretched, with the price-to-income ratio and the income gearing ratio staying high by historical standards.

The outlook for the residential property market has become more uncertain. While the currently low unemployment rate could provide some support for property demand, the weakening economy could lead to deterioration in labour market conditions. Other risk factors including the US-China trade conflict and slowing global economic growth may weigh on housing market sentiment in the near term. In addition, while the Fed cut its policy rate in July, the trajectory for domestic mortgage interest rates is still uncertain and will depend on other factors such as local interbank liquidity conditions. Over the longer term, the outlook for the housing market will hinge on the housing supply-demand gap. The Government projects the private housing completion will remain high in the years ahead, which should help narrow the housing supply-demand gap over time.

Banking sector performance

Despite subdued economic growth, retail banks in Hong Kong still registered a steady level of profit in the first half of 2019, with pre-tax operating profits rising modestly by 0.6% compared with the same period in 2018. During the review period, profits were constrained by a reduction in non-interest income and increases in impairment charges and operating expenses, which almost offset the growth in net interest income. With retail banks' profit growing slower than assets, the return on assets reduced slightly to 1.27% in the first half of 2019 compared with 1.31% in the same period last year.

Banks' capital positions, as measured by Basel III standards, continued to stay strong in the review period. The consolidated capital ratio of locally incorporated authorized institutions (AIs) rose to 20.6% at the end of June 2019. 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 stayed at high levels of 152.8% and 54.6% respectively in the second quarter of 2019. 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 exceeding their statutory minimum requirements. The asset quality of banks' loan portfolios also remained healthy by historical standards during the review period.

Despite slower global economic growth, bank credit resumed expansion in the first half of 2019 following a contraction in the second half of 2018. Domestic loans and loans for use outside Hong Kong rose by 4.5% and 3.5% respectively, after growing only modestly by 0.1% for the former and contracting by 3.0% for the latter, in the preceding six months. As a result, total loans and advances of all AIs expanded by 4.2% in the first half of 2019.

With total loan growth outpacing deposit growth during the review period, the average all-currency loan-to-deposit (LTD) ratios of all AIs rose to 74.5% at the end of June 2019 from 72.6% six months earlier. The average Hong Kong dollar LTD ratio of all AIs also increased to 89.3% from 86.9%. Nevertheless, the liquidity conditions for the Hong Kong dollar remained ample, underpinned by the broadly stable level of deposits, and with no noticeable outflow of funds from the Hong Kong dollar or from the banking system in the second quarter.

Given that Basel III regulatory reforms and the Hong Kong Mortgage Corporation's SME Financing Guarantee Scheme may affect credit conditions for small and medium-sized enterprises (SMEs) in Hong Kong, Box 5 empirically assesses their effects on the supply of bank loans to SMEs in Hong Kong. The assessment finds that despite more stringent regulatory requirements under Basel III, there has not been a persistent negative effect on the supply of SME loans by banks in Hong Kong, probably due to their strong capital and liquidity positions. The assessment also finds that public sector loan guarantee schemes can effectively reduce funding difficulties facing SMEs.

Looking ahead, the Hong Kong banking sector will face multiple headwinds, including the worsening of the US-China trade dispute, increased downside risks to the global economy, the recent social incidents in Hong Kong, rising uncertainty over the timing and magnitude of monetary accommodation by some major central banks, and increased geopolitical risks. In particular, in view of the rising corporate leverage and household debt burden, banks should stay alert to the credit risk of their corporate and household exposures to any further deterioration in the external environment.

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