1. Summary and overview

The outbreak of the novel coronavirus (COVID-19) since early 2020, by manifesting itself in a shock to both demand and supply, presented the global economy with challenges unlike past crises. While major central banks and several governments have rolled out stimulus measures since early March to contain the economic fallout of this health crisis, financial markets remained volatile and global financial conditions have tightened.

Despite uncertainties in the external and domestic environment, both Hong Kong foreign exchange and money markets continued to operate in a smooth and orderly manner. With the Hong Kong dollar remaining firm, the Aggregate Balance being stable and total deposits growing modestly, no significant outflows from the Hong Kong dollar or Hong Kong's banking system were observed during the review period. Total loan growth decelerated in the second half of 2019 after a moderate rebound in the first half. The residential property market has generally softened since mid-2019, albeit showing some fluctuations.

Looking ahead, the Hong Kong banking sector will continue to be challenged by a number of downside risk factors arising from the uncertainties over the extent of the coronavirus outbreak, future US-China trade relations, geopolitical tensions and domestic social incidents. Banks should carefully assess how the possible intensification of these risk factors could impact the asset quality of their loan portfolios particularly when the levels of corporate leverage and household debt-servicing burdens have been rising.

The external environment

Since the fourth quarter of 2019, tentative signs of global growth stabilisation emerged amid increased monetary accommodation by major central banks, de-escalating US-China trade tensions and receding risks of a "no-deal" Brexit. Since late January, however, concerns over the rising worldwide cases of the coronavirus infection resulted in sharp gyrations in global financial markets. In response to the evolving risks posed by the outbreak, several major central banks aggressively lowered their policy rates and stepped up liquidity provision measures, while a number of governments also rolled out targeted measures to assist the real economy. Nonetheless, global financial conditions have tightened amid widening credit spreads and plunging equity markets.

Looking ahead, downside risks to the global outlook have increased. The coronavirus outbreak would dampen global activities, and the scale of the economic fallouts would depend on the severity and duration of the outbreak. Further down the road, trade tensions between the US and its major trading partners may re-emerge, and the post-Brexit European Union-UK trade negotiations could be bumpy.

Weak global demand continued to weigh on growth in East Asia[1]. The region's exports to all major destinations, including the US, European economies and Mainland China, stayed weak in the second half of 2019. Some major telecommunication equipment exporters in the region reported improved earnings recently, but whether this marks a broad-based tech cycle rebound is yet to be seen. The financial market responded positively to the "phase one" US-China trade deal announced in December 2019 as it partly reduced global trade uncertainties. Nonetheless, the region will continue to face headwinds from weakening corporate earnings, and high private sector leverage. The coronavirus outbreak has also raised concerns that the region's economy may be facing further pressure on top of the ongoing weakness in growth. Travel restrictions imposed by many regional economies will likely hit the tourism sector in Asia, especially those which rely more on travel service exports. The outbreak could also affect the region's manufacturing sector given its closely integrated supply chain with Mainland China.

In Mainland China, economic growth continued to decelerate in the second half of 2019 amid sluggish domestic and external demand. While the signing of the "phase one" trade deal with the US helps to temporarily reduce external uncertainties facing the Mainland economy, downward pressure remains amid the coronavirus outbreak, the ongoing economic rebalancing and the slowdown in the global economy. The Central Economic Work Conference held in December 2019 made stabilising the economy a top priority for 2020, and containing financial risks is also a focus. The latest consensus forecasts suggest that Mainland China's economic growth will ease to 5.2% in 2020.

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

During the review period, Mainland authorities continued to announce targeted monetary and fiscal policies to support the private sector, especially smaller private business owners. Despite the efforts, some media reports and market analysts pointed out that private industrial firms might have suffered equity declines in recent years, which was seen as a sign of "retreat of the private sector". Box 2 examines the drivers for equity changes of Mainland industrial firms using listed firm data from 2018, and finds that privately-owned enterprises or small firms were not intrinsically more likely to suffer shrinkage in size or "retreat". While negative profits were found to be the biggest contributing factor, other factors especially structural factors are worth noting (see more details in Box 2).

The domestic economy

Economic activities contracted markedly during the second half of 2019. In particular, the economy has entered a recession as real Gross Domestic Product (GDP) declined consecutively over the past three quarters. This dragged down the full-year growth rate for 2019 to -1.2%, compared with a 2.9% expansion a year earlier, marking the first annual decline since 2009.

Moderating domestic demand, especially private consumption, was the main drag on GDP in the second half of 2019 as local social incidents caused major disruptions to consumption-related activities and the resultant weaker economic outlook lowered consumer and business confidence. Hong Kong's external trade performance continued to be subdued amid the renewed US-China trade tensions, weaker global economic growth and a severe setback in inbound tourism.

In view of the strong economic headwinds, the Government introduced several rounds of measures between August and December 2019 to support the economy. To allow banks to be more supportive to the domestic economy and help mitigate the economic cycle, the HKMA announced on 14 October a reduction in the Countercyclical Capital Buffer (CCyB) ratio of banks from 2.5% to 2.0%, thereby allowing banks to have an expected additional headroom of HK$200–300 billion to lend to enterprises, especially small and medium-sized enterprises (SMEs).

The economic performance for 2020 is expected to be very challenging, with significant near-term downside risks associated with the coronavirus outbreak. Some sectors, such as retail, accommodation, food services, tourism and transport, which have yet to recover from the disruptions caused by the social incidents, will be doubly hit. However, the countercyclical fiscal measures announced in the 2020/21 Budget, which include a one-off cash handout and a new concessionary low-interest loan under the SME Financing Guarantee Scheme with 100% Government guarantee, are expected to provide some support to households and enterprises (especially SMEs).[2] On 16 March 2020, the HKMA further reduced the CCyB ratio of banks from 2.0% to 1.0%, which will allow banks to be more supportive to the domestic economy, in particular those sectors and individuals that are expected to experience additional short-term stress due to the impact arising from the outbreak. Analysed by GDP components, private consumption and investment will likely remain weak because of the fragile consumer and business confidence. While government consumption will contribute to economic growth, public investment expenditure is anticipated to be relatively sluggish following the completion of some major infrastructure projects. On the external front, the "phase one" trade deal between the US and Mainland China is assessed to be slightly positive for the local economy in the short term.[3] However, Hong Kong's external trade performance will continue to be weighed down by weak global economic growth and trade flows. In particular, the coronavirus outbreak may lead to regional supply chain disruptions and slower cross-border economic activities (e.g. tourism), thereby restraining Hong Kong's exports. The Government forecasts real GDP growth for 2020 in the range between -1.5% and 0.5%, and the growth estimates by international organisations and private sector analysts averaged -1.5%. This subdued economic outlook is subject to a number of uncertainties and risks, including those stemming from the slowing global economy, the US-China trade relations, Mainland's economic performance and local social incidents.

The labour market faced increasing pressures in the second half of 2019 and early 2020, with total employment moderating, the unemployment rate rising and the real payroll index showing a year-on-year decline. Specifically, the unemployment rate rose from a multi-year low of 2.8% in June 2019 to 3.7% in February 2020, partly reflecting the impact of the social incidents and the coronavirus outbreak on the retail, accommodation and food services sectors. Looking ahead, the unemployment rate will likely rise further given the weakened economic prospects and the coronavirus outbreak. Box 3 discusses in more detail the recent developments in the labour market and its near-term outlook.

Local inflationary pressures continued to accumulate up to the third quarter of 2019 mainly due to elevated fresh pork prices, but the sequential momentum of inflation gradually eased thereafter along with weakened economic activities. In the near term, inflation is expected

[2] Other relief measures in the Budget include reducing salaries tax and profits tax by 100%, subject to a ceiling, as well as waiving rates of domestic properties and registration fees for businesses. Meanwhile, some banks have also implemented short-term relief measures such as interest-only repayments for mortgage loans and relief loans for SMEs.

[3] Our in-house analysis suggests that the trade deal will have a small net positive impact on Hong Kong's nominal GDP in the short term, although the actual outcome will be subject to high uncertainty. The impact is likely to come mainly from a reduction in uncertainty which increases consumption and investment, while the potential impact on trade is estimated to be limited given the offsetting effects from the tariff rollback and possible trade diversion (away from Hong Kong).

to moderate because of the sub-par economic conditions, the consolidation of private residential rentals and mild imported inflation. Market consensus forecasts the headline inflation rate for 2020 to be between 0.6% and 3.7%, and the Government projects the underlying inflation rate to be 2.5%.

Monetary conditions and capital flows

The Hong Kong dollar exchange rate started to strengthen gradually from mid-October 2019, underpinned by equity-related Hong Kong dollar demand including initial public offerings (IPOs). Since December, the strengthening of the Hong Kong dollar gained further momentum, partly due to some buoyant IPO activities and partly to the unwinding of short Hong Kong dollar positions amid tightened liquidity towards the end of the year. As liquidity eased after the Lunar New Year holiday, the Hong Kong dollar exchange rate slightly softened at the end of February. Overall, the Hong Kong dollar continued to trade in a smooth and orderly manner without triggering the Convertibility Undertaking during the review period. The Aggregate Balance remained unchanged at around HK$54 billion.

The short-term Hong Kong dollar interbank interest rates witnessed fluctuations, reflecting seasonal liquidity demand as well as more capital market activities, such as IPOs, since the fourth quarter of 2019. Box 4 studies how market attention to future IPO activities could affect three-month HIBOR. Meanwhile, the composite interest rate picked up gradually from 0.94% at the end of July 2019 to 1.01% at the end of January 2020. This reflected that banks continued to raise their preferential deposit rates in attracting deposit funds. With the increase in the prime-based cap by some banks, the average lending rate for new mortgages moved up to around 2.6% in October, but declined slightly to around 2.5% in January 2020 amid the lower Best Lending Rates in the market since November.

With the Hong Kong dollar staying firm, the Aggregate Balance remaining stable and total deposits growing modestly, no significant outflows from the Hong Kong dollar or Hong Kong's banking system were observed during the review period. Nonetheless, we will need to monitor the impact arising from any worsening of the coronavirus outbreak amid the uncertain external environment. Given the ample foreign reserves and robust banking system, the HKMA has the capability, resources and commitment to withstand capital outflows and safeguard Hong Kong's monetary and financial stability.

During the review period, the offshore (CNH) and the onshore (CNY) renminbi exchange rates strengthened with optimism over the US-China trade deal, before facing weakening pressure since late January 2020 amid the coronavirus outbreak. The CNH traded roughly at a premium against the CNY in the latter part of 2019, but saw widened discount briefly in late January 2020. The spread in general remained moderate by historical standards. The CNH liquidity pool in Hong Kong expanded moderately following a modest decline in the last review period, with the total outstanding amount of renminbi customer deposits and certificates of deposit increasing to RMB637.4 billion at the end of January 2020. Other renminbi business in Hong Kong also gathered strength, with renminbi bank lending and renminbi trade settlement in Hong Kong recording strong gains. The average daily turnover of the renminbi real time gross settlement system stayed high at RMB1,133.9 billion for the whole of 2019. Despite uncertainties surrounding the external environment, Hong Kong's offshore renminbi business is expected to benefit from the ongoing liberalisation of Mainland's capital account, more allocation into renminbi assets by international investors, and deepened regional economic and financial co-operation under the Belt and Road and Guangdong-Hong Kong-Macao Greater Bay Area initiatives.

Asset market

The local stock market has gone on a roller coaster ride over the past six months. Following a sharp correction last summer, it regained lost ground significantly at first, before tumbling again on the outbreak of the coronavirus towards the end of the review period. The initial rebound was attributed to a much improved investor sentiment following a major rally in equity markets worldwide, triggered by markedly reduced risks of a global recession. The global economic outlook brightened up, due in part to signs that global growth began to stabilise, aided by the lagged effects of the monetary accommodation of leading central banks, and partly to the two largest global economies being able to find a way to avoid a full-blown trade war. Looking ahead, however, considerable uncertainties remain, especially regarding how Mainland's macroeconomy will perform in the face of the current global health crisis, and with the US-China trade negotiations entering the tough second phase.

The Hong Kong dollar debt market continued to expand last year with issuance growing steadily. A steeper rebound in local currency yields relative to those of the US dollar in the second half of the year helped reverse the flow of bond funds in favour of Hong Kong. The offshore renminbi debt market grew rapidly on the back of a large jump in public sector issuance. As the funding cost difference between onshore and offshore markets narrowed, private sector issuance also registered a considerable increase. However, the near term outlook for the domestic debt market development, including both Hong Kong dollar and renminbi debts, will undoubtedly face formidable challenges in view of the great uncertainties surrounding the next phase of the US-China trade negotiations and the effects of the outbreak.

The residential property market has generally softened since mid-2019, albeit showing some fluctuations. Market sentiment was dampened initially by the renewed US-China trade tensions, the local social incidents, weakened domestic economic activities, and later the coronavirus outbreak. Official data showed that average monthly transactions and secondary-market housing prices generally softened from the recent peak in May 2019. However, market data from real estate agencies suggest secondary-market transactions picked up in recent weeks. Despite the slight decline in flat prices, 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 is subject to a host of uncertainties and risks as discussed above. For example, the outbreak of the coronavirus, coupled with the current economic recession and the rising unemployment rate, will dampen housing demand and new project launches. Some external risk and uncertainty factors, such as the pace of global economic growth and the international financial market volatility, may also affect housing market sentiment. On the other hand, the very low interest rates may provide some support to asset markets, while market activity could rebound when the outbreak fades out, as suggested by the experience of the post–SARS period in 2003. Over the longer term, the outlook for the housing market will depend on the housing supply-demand gap. Although actual completions in 2019 saw a shortfall compared with projections, the Government expects private housing completions will remain high in the forthcoming years.[4]

Banking sector performance

Given increasing uncertainties in both the global and domestic economic environments, retail banks in Hong Kong registered a slight decrease in their profits in the second half of 2019, with pre-tax operating profits declining moderately by 1.5% compared with the same period in 2018. Although the net interest income registered a mild increase during the review period, profits were constrained by increases in loan impairment charges and operating expenses. As

[4] The Rating and Valuation Department forecasts gross completions at around 20,000 units per year in 2020 and 2021, compared with the average of 13,500 units per annum in the past ten years (2010–2019).

a result, the return on assets reduced slightly to 1.13% in the second half of 2019 compared with 1.23% in the same period of 2018.

The consolidated total capital ratio of locally incorporated authorized institutions (AIs) increased further to 20.7% at the end of 2019. To provide greater flexibility for banks to support businesses (especially SMEs) amid the significant deterioration in the domestic economic environment since the second quarter of 2019, the Countercyclical Capital Buffer rate for Hong Kong was lowered from 2.5% to 2% in October 2019 and further to 1% in March 2020. 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 159.9% and 56.3% respectively in the fourth 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.

After a moderate rebound in the first half of 2019, growth in bank credits receded again in the second half against the backdrop of increasing uncertainties in both global and domestic economic environments. On a half-yearly basis, growth in total loans and advances of all AIs decelerated to 2.4% in the second half of 2019, after increased moderately by 4.2% in the first half. Growth in domestic loans (comprising loans for use in Hong Kong and trade financing) and loans for use outside Hong Kong decelerated to 2.5% and 2.2% in the second half of 2019, compared with 4.5% and 3.5% growth, respectively, in the preceding six months. Nonetheless, for 2019 as a whole, the total loan growth accelerated to 6.7% in 2019 from 4.4% in 2018.

Meanwhile, 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 75.4% at the end of 2019 from 74.5% six months earlier. The average Hong Kong dollar LTD ratio of all AIs also edged up due to a slight decline in Hong Kong dollar deposits in the second half of 2019. Nevertheless, the liquidity conditions of the Hong Kong dollar and the banking sector remained sound, underpinned by the stable Aggregate Balance and the broadly stable level of deposits. In addition, no significant outflow of funds from the Hong Kong dollar or from the banking system was observed during the review period.

On the overall development of the market, the Hong Kong banking sector is witnessing the launch of the virtual bank. This follows the HKMA's granting of eight licences for these new banks. As virtual banks are expected to attract new customers, initially through more convenient products and attractive deposit rates, the keener competition for deposits may pose upward pressures on the funding cost of incumbent banks. While the near term impact is likely to be mild, in view of the limited business scale of virtual banks, the longer- term impact may depend on how far incumbent banks seek to accelerate their adoption of financial technologies (fintech) to stay competitive. As suggested by the results in Box 5 (see page 81), a bank with a higher level of fintech adoption is statistically associated with larger improvements in its cost efficiency and profitability.

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