1. Summary and overview

The world economy is experiencing an unprecedented shock amid the novel coronavirus (COVID-19) pandemic. The current recession is the deepest since the Great Depression and the path to recovery is subject to substantial uncertainty. While large-scale fiscal and monetary accommodation has helped mitigate the impact on the economy and financial conditions, the potential longer-term side effects stemming from the debt build-up and "low-for-long" monetary policy remain to be seen.

The Hong Kong foreign exchange and money markets continued to operate in a smooth and orderly manner. With the repeated triggering of the strong-side Convertibility Undertaking and growth in total deposits in the first seven months of 2020, no significant outflows from the Hong Kong dollar or the Hong Kong banking system were observed during the review period. Total loan growth increased slightly during the first half of the year, while activities in the residential property market picked up in the second quarter before moderating again in July and August.

Looking ahead, uncertainties over the path of global and domestic economic recovery amid the pandemic, and rising US-China tensions will continue to pose significant challenges to the Hong Kong banking sector. As these risk factors may continue to linger, banks should carefully assess the longer-term impact on the asset quality of their loan portfolios, particularly as the recession may weaken corporates' and households' repayment ability.

The external environment

The global economy plunged into recession in the first half of 2020, as lockdowns and social distancing measures to contain the COVID-19 pandemic brought real activities to a standstill. Unprecedented fiscal and monetary accommodation was unleashed to mitigate the impact of the recession and forestall disorderly tightening of financial conditions, but it also drove a strong rebound in financial markets that appeared disconnected from the weak underlying economic prospects.

Looking ahead, the global outlook remains clouded by heightened uncertainties. Without medical breakthroughs, the authorities in various jurisdictions will need to strike a delicate balance between reopening the economy and preventing a resurgence of the pandemic. At the same time, global geopolitical uncertainties have increased significantly. Against this background, financial markets may face greater risks of heightened volatilities ahead. In the longer term, policy responses to the pandemic may also risk exacerbating the global debt build-up, and the potential side effects of the "low-for-long" monetary policy remain to be seen.

In East Asia[1], real activities plunged in the first half of 2020. While signs of bottoming out have emerged since June, more data are needed to confirm a sustained recovery. In financial markets, the surge in risk aversion has triggered record-large portfolio outflows from the region, causing significant sell-offs in bond, equity, and exchange traded funds (ETFs). Box 1 found that an equity ETF with a low level of cash holdings is more prone to fire sales when facing substantial redemption pressure and will potentially amplify a financial market downturn. After experiencing abrupt capital outflows and US dollar funding stress during March to April, the regional financial markets have stabilised on improvement in sentiment and aggressive accommodation by central banks. Looking ahead, while regional governments have enacted fiscal and monetary policy support, the capacity and sustainability of this support will become a source of concern as the pandemic drags on. Meanwhile, corporate loan repayment capacity in the region has apparently weakened since the COVID-19 outbreak, raising concerns for corporate financial health further down the road.

In Mainland China, the economy bounced back to growth in the second quarter after a deep slump in the first quarter amid the COVID-19 outbreak. The economic recovery was primarily led by a strong pickup in investment following a gradual resumption of work and production. Whether the recovery continues hinges greatly on future developments of the pandemic as well as the tensions between Mainland China and the US. The latest consensus forecasts expect the Mainland economy will expand by 2.1% in 2020.

In view of the considerable uncertainties surrounding the development of the pandemic and global economic recovery, the government scrapped an annual growth target for this year while putting more emphasis on stabilising the economy and employment. To facilitate better monitoring of economic performance, Box 2 introduces a daily composite economic condition index, which closely tracks Mainland economic activities and has the advantage of being more timely than traditional aggregate-level indicators. Our daily index suggests that the Mainland economy continued to rebound but with increased volatilities. In addition, our index shows that while the economy was recovering, the expansion pace of economic activities had not yet reverted to the 2019 level.

The domestic economy

Hong Kong's economic recession deepened in the first half of 2020 amid the COVID-19 outbreak. Compared with a year ago, real gross domestic product (GDP) dropped by about 9% in the first half of the year, the steepest decline on record. The trade, retail and tourism-related sectors were particularly hard hit, recording a double-digit decline in activities. On a sequential basis, real GDP also declined at a record rate of 5.5% in the first quarter and roughly stayed at that subdued level in the second quarter. The outbreak had an adverse impact on almost all components of GDP – disrupting consumption, investment and external trade, and bringing tourism to a standstill. That said, trade in goods picked up slightly in the second quarter as production activities in Mainland China largely resumed.

In response to the pandemic, the Government swiftly launched relief measures of unprecedented scale to support enterprises and individuals and to safeguard jobs, including the HK$10,000 Cash Payout Scheme and the provision of wage subsidies through the Employment Support Scheme. The HKMA has also taken a three-pronged approach to bolster the banking sector in support of the real economy. The measures comprise proactive coordination with the banking sector to ease cash-flow pressures on enterprises and households, releasing buffers to boost the lending capacity of banks and ensuring that

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

banks have abundant liquidity to meet their needs and support domestic economic activities.

Local economic performance for the rest of 2020 is still highly challenging given the lingering pandemic. Nonetheless, increased public demand (e.g. government consumption) and the massive relief measures introduced by the authorities are anticipated to provide some support to the domestic economy. Taking into account the multiple headwinds, the Government and private-sector analysts revised downward their forecasts of real GDP growth for the whole of 2020 to a range between -6% and -8% and a mean of -6.8% respectively. This subdued economic outlook is subject to a number of risks and uncertainties as discussed above.

The labour market has come under significant pressure in the first seven months of 2020. The unemployment rate rose to 6.1% in July, surpassing the peak of 5.5% in the aftermath of the 2008 global financial crisis. The underemployment rate also climbed. On the demand side, Box 3 analyses the recent changes in labour demand using a timely big dataset of online job advertisements, and the results reveal that vacancies stayed low recently. Looking ahead, the Employment Support Scheme introduced by the Government should help retain jobs, but the labour market will continue to face challenges given the sluggish economic outlook.

Local inflationary pressures softened further alongside the deepened economic recession. In particular, the year-on-year underlying inflation rate decelerated from 2.9% in the first quarter to 1.8% in the second quarter, and moderated further to 0.2% in July. Domestic inflation is expected to recede further in the near term due to weak local economic conditions, the earlier decline in fresh-letting residential rentals and mild imported inflation amid the sluggish global demand. The Government has adjusted downward its projections of underlying and headline inflation rates for 2020 to 1.8% and 0.8% respectively. The latest market consensus forecasts the headline inflation rate for 2020 to be 0.9%.

Monetary conditions and capital flows

The Hong Kong dollar exchange rate has strengthened since March. Underpinned by equity-related Hong Kong dollar demand and carry trade activities as induced by the positive Hong Kong dollar-US dollar interest rate spreads, the Hong Kong dollar exchange rate strengthened to 7.7500 in April. The strong-side Convertibility Undertaking (CU) was triggered six times between 21 April and 27 April. Thereafter, the Hong Kong dollar exchange rate stayed strong at near the 7.75 levels and the strong-side CU was further triggered 44 times between 4 June and 22 September, underpinned by equity-related demand including initial public offering activities, the southbound Stock-Connect and dividend payments. Despite market volatilities arising from the COVID-19 outbreak, the Hong Kong dollar continued to trade in a smooth and orderly manner.

Hong Kong dollar interbank interest rates broadly declined along with their US dollar counterparts amid the increase in the Aggregate Balance from HK$54.3 billion at the end of February to HK$242.5 billion as at 24 September due to the triggering of the strong-side CU and the reduced issuance of Exchange Fund Bills. The composite interest rate decreased from 1.09% at the end of 2019 to 0.41% at the end of August, reflecting both the drop in retail banks' wholesale funding costs and the lowered time deposit interest rates offered by major retail banks. The average lending rate for new mortgages also decreased from 2.53% to 1.79% during the first seven months, mainly driven by the fall in the one-month Hong Kong interbank offered rate. Although the Federal Reserve lowered the target range for the US federal funds rate in March, the Best Lending Rates of major retail banks remained unchanged in the range

from 5.00% to 5.50% throughout the review period.

There was an increase of funds flowing to the Hong Kong dollar during the review period, as evidenced by the repeated triggering of the strong-side CU. Moreover, with total deposits growing in the first seven months of 2020, there were no significant cross-border outflows from the Hong Kong banking system. While continuing developments in the COVID-19 outbreak, US-China tensions and evolving geopolitical conflicts may heighten fund flow volatility, Hong Kong is able to withstand this volatility given its ample foreign reserves and robust banking system.

The offshore (CNH) and the onshore (CNY) renminbi depreciated from March and at one stage tested the decade low of 7.19 against the US dollar in late May amid the COVID-19 outbreak and the US dollar funding stress. Thereafter, both the CNY and CNH strengthened along with the broad weakness in the US dollar and positive sentiment on Mainland economic recovery. Overall, the spread between CNY and CNH remained moderate by historical standards, with the CNY-CNH spread turning from a discount to a slight premium as the renminbi depreciation pressure abated. The CNH liquidity pool in Hong Kong continued to expand during the review period. The total outstanding amounts of renminbi customer deposits and certificates of deposit picked up to RMB699.2 billion at the end of July. As for other renminbi businesses, both Hong Kong's renminbi bank loans and renminbi trade settlement expanded further, and the average daily turnover of the renminbi real time gross settlement system continued to stay high at RMB1,201.1 billion during the first seven months of 2020. Hong Kong's offshore renminbi business is expected to gain further momentum, supported by the ongoing liberalisation of Mainland's capital account, the rising demand for renminbi assets from international investors, and more 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 been on a roller coaster ride over the past six months. In tandem with global stock markets, the Hong Kong equity market was initially driven down by the COVID-19 outbreak. Lockdowns of economic activities sparked fear of an unprecedented global recession, at one stage in late March sending the Hang Seng Index (HSI) to its lowest level in more than three years. It has since recovered along with other equity markets amid proactive measures by leading central banks and unprecedented fiscal stimuli by governments globally, despite that the pandemic has yet to be brought under control. Since late-March, most global equities have recouped their losses, with the MSCI World Index reaching a record high by the end of the review period. Nevertheless, the HSI, while witnessing rebound from its year-low in March, was down by 4.2% during the review period.

The local debt market expanded mildly in the first half of 2020 on the back of steady growth in issuance compared to the second half of 2019. Amid massive monetary easing by leading central banks in response to the COVID-19 pandemic, yields of both sovereign and non-sovereign Hong Kong dollar bonds fell sharply to record lows in March, in tandem with the decline in US Treasury yields. As global equity markets rebounded in the second quarter, bond yields stabilised amid optimism that the policy responses of global governments to the pandemic might support an economic recovery.

Looking ahead, however, considerable uncertainties remain in both local equity and debt markets. Uncertainties over the path of global and domestic economic activities amid the pandemic, as well as the rising tensions between the US and Mainland China and its potential

implications for Hong Kong, could undermine operational activities, earnings, and the credit quality of corporates. This could dampen the sentiment in both the stock and debt markets for the rest of 2020.

After a quiet first quarter, the housing market picked up in the second quarter, partly supported by the low interest rate environment and a temporary stabilisation of the local COVID-19 situation. Housing transactions increased considerably towards mid-year and the secondary-market housing prices picked up by around 2.2% in March – June after falling by 4.7% from the peak in May 2019. As local infection cases rose again in July, housing market activities softened in July and August.

The outlook for the residential property market is subject to a number of uncertainties and risks as discussed above. The lingering COVID-19 outbreak, coupled with the deepened economic recession and the rising unemployment rate, will weigh on housing demand. Other external risk and uncertainty factors such as the intensified US-China tensions may also affect the residential property market sentiment. However, the prolonged ultra-low interest rates will continue to be a supporting factor for asset prices. Over the longer term, the outlook for the housing market will depend on the housing supply-demand gap. According to the latest completion figures, the private housing supply has not been disrupted by the pandemic. More than 11,000 units were completed by end-July, which met more than a half of the Government's projection for 2020.

The non-residential property markets saw a further moderation in the first half of the year. With the pandemic and escalating geopolitical tensions continuing to weigh on business confidence, the non-residential property markets are likely to remain under pressure. Taking into account factors such as the price trends of non-residential properties, transaction volumes, economic fundamentals, and the external environment, the HKMA considers it appropriate to adjust the countercyclical macroprudential measures on non-residential properties. Effective from 20 August 2020, the applicable loan-to-value ratio caps for mortgage loans on non-residential properties are adjusted upward by 10 percentage points.[2]

Banking sector performance

Due to the deterioration in the global economic environment amid the COVID-19 pandemic, the banking sector recorded thinner profits in the first half of 2020. The pre-tax operating profits declined by 20.0% in the first half of 2020 compared with the same period in 2019. The reduction in profits was mainly driven by a decrease in net interest income and an increase in loan impairment charges, which more than offset the mild increase in non-interest income. As a result, the return on assets dropped to 0.95% in the first half of 2020 compared with 1.27% in the same period of 2019.

Despite a slight deterioration in the asset quality of the banking sector amid the deepening economic recession, it remained sound by historical and international standards. In view of the huge uncertainty over the development of the COVID-19 pandemic, asset quality may see a further deterioration ahead if the threats of further outbreaks continue to stress borrowers' repayment ability.

Capital and liquidity positions of the banking sector remained robust, providing strong buffers for banks to withstand any deterioration in asset quality. The consolidated total capital ratio of locally incorporated authorized institutions (AIs) stood at a high level of 20.7% at the end of June 2020. Regarding the liquidity positions, the average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity

[2] For more details, see the circular "Prudential Measures for Mortgage Loans on Non-residential Properties" issued by the HKMA on 19 August 2020.

Maintenance Ratio of category 2 institutions stayed at high levels of 156.5% and 57.2% respectively in the second quarter of 2020. 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.

Despite the worsening global environment in the first half of 2020, total loan growth increased slightly. On a half-yearly basis, growth in total loans and advances of all AIs edged up to 3.0% in the first half, after increasing by 2.4% in the second half of 2019. Loan growth was broad-based, with growth in loans for use outside Hong Kong accelerating to 4.2% in the same period from 2.2% in the preceding six months, and growth in domestic loans (comprising loans for use in Hong Kong and trade financing) being broadly stable at 2.6%. Foreign currency loans grew sharply during the same period, partly driven by strong demand from corporates for US dollar loans amid a sharp global dollar liquidity stress around mid-March.

Liquidity conditions of the Hong Kong dollar and banking sector remained sound in the first half. With total loan growth marginally outpacing deposit growth during the review period, the average all-currency loan-to-deposit (LTD) ratios of all AIs edged up to 76.0% at the end of June 2020 from 75.3% six months ago. The average Hong Kong dollar LTD ratio of all AIs declined, driven by an increase in Hong Kong dollar deposits and a mild decline in loans.

The outbreak of COVID-19 and related containment measures have exerted significant cash-flow pressures on corporates, as their revenue declined sharply. Worsening funding positions among corporates could adversely affect firms' debt servicing ability, putting their solvency under the test. Based on accounting data of local non-financial corporates listed in Hong Kong, Box 4 analyses corporates' funding and default risks under a recession scenario with a sharp drop in corporate revenue. The analysis shows that while corporates in Hong Kong may see higher default risks due to declines in revenue and thus net cash buffers amid the COVID-19 pandemic, the severity of the impact would vary across sectors. The analysis also finds that how far firms can roll over their short-term debt under the revenue shock is a key determinant of the funding and default risks, suggesting that maintaining stable credit flows to support the real economy is critically important in such a difficult situation. Therefore, the relief measures taken by the HKMA and the banking sector should help corporates, particularly small and medium-sized enterprises, to ride through this difficult period.

The uncertainties over the path of global and domestic economic recovery amid the COVID-19 pandemic and rising US-China tensions will continue to pose significant challenges to the Hong Kong banking sector. As these risk factors may continue to linger, banks should carefully assess the longer term impact on the asset quality of their loan portfolios, particularly as the recession may weaken corporates' and households' repayment ability.

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