4. Monetary and financial conditions

Partly reflecting the strong equity-related demand for Hong Kong dollars, the Hong Kong dollar exchange rate strengthened close to the strong-side Convertibility Undertaking level since April with the strong-side Convertibility Undertaking triggered 50 times between 21 April and 22 September. Along with the lower US dollar interest rates, Hong Kong Interbank Offered Rates softened across the board amid the expansion of the Aggregate Balance. Overall, Hong Kong's foreign exchange and money markets continued to operate in a smooth and orderly manner. While developments in the COVID-19 outbreak, the US-China tensions and evolving geopolitical conflicts may lead to higher fund flow volatility, Hong Kong is able to withstand the fund flow volatility given its ample foreign reserves and robust banking system.

4.1 Exchange rate and capital flows

The Hong Kong foreign exchange and money markets continued to trade in a smooth and orderly manner although worries about global economic impacts of the COVID-19 outbreak heightened volatilities in financial markets around the world, including Hong Kong's equity market. As global investors sought more US dollars under risk-off sentiment, US dollar funding costs tightened in March, affecting Hong Kong dollar interbank interest rates under the Linked Exchange Rate System (LERS). While US dollar funding pressure subsequently eased with the Federal Reserve (Fed)'s liquidity programmes,[30] Hong Kong dollar interest rates stayed tight due to the equity-related demand for the Hong Kong dollar coupled with the quarter-end effect. The strong demand for Hong Kong dollars, together with carry trade activities, spurred by the positive Hong Kong dollar-US dollar interest rate spreads, led to the strengthening of the Hong Kong dollar exchange rate to the strong-side Convertibility Undertaking (CU) level (Chart 4.1). As a result, the strong-side 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 (IPO) activities, the southbound Stock-Connect and dividend payments.

With the strong-side CU being triggered 50 times between 21 April and 22 September, the HKMA sold Hong Kong dollars totalling HK$168.5 billion in accordance with the design of the LERS. In a move to increase market liquidity, the HKMA gradually reduced the issuance of Exchange Fund Bills in late April and early May by a total of HK$20 billion.[31] Taking into account both the triggering of the

[30] Amid considerable volatilities and uncertainties in the global financial markets brought about by the COVID-19 pandemic, the HKMA used the funds obtained through the Fed's temporary repurchase agreement facility for foreign and international monetary authorities (FIMA Repo Facility) to introduce a temporary US Dollar Liquidity Facility (the Facility) to make available US dollar liquidity assistance for licensed banks, with a total of US$10 billion available under the Facility.

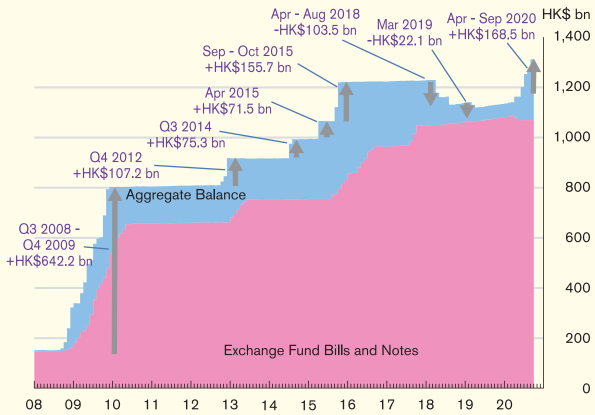
[31] To help ensure continued smooth operation of the Hong Kong dollar interbank market amid a volatile global macro environment stemming from the COVID-19 pandemic, the HKMA made available more Hong Kong dollar liquidity in the banking system by reducing the issue size of 91-day Exchange Fund Bills by HK$5 billion in each of the four regular tenders on 21 April, 28 April, 5 May and 12 May 2020. The issuance of the Bills was reduced by HK$20 billion in total and the AB increased by the same amount.

strong-side CU and the reduced issuance of Exchange Fund Bills, the Aggregate Balance (AB) increased from HK$54.3 billion at the end of February to HK$242.5 billion as at 24 September (Chart 4.2). It is important to note that the reduced issuance of Exchange Fund Bills simply represents a change in the component of the Monetary Base, with a shift from the Exchange Fund Paper to the AB. As the Monetary Base remains fully backed by US dollars, such operations are totally consistent with the Currency Board principles.

Chart 4.1
Hong Kong dollar exchange rate

Source: HKMA.

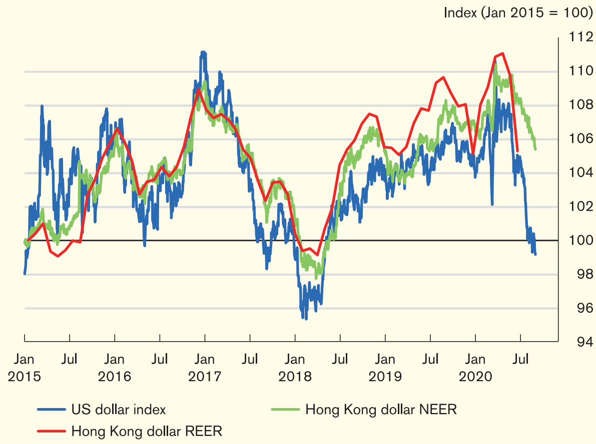
Chart 4.2
Aggregate Balance and Exchange Fund Bills and Notes (EFBNs)



Note: Up to 24 September 2020.
Source: HKMA.

The movement of the Hong Kong dollar nominal effective exchange rate index (NEER) was broadly consistent with the movement of the US dollar. The NEER strengthened in March amid the US dollar funding stress, before moving down more recently along with the weakening of the US dollar (Chart 4.3). The Hong Kong dollar real effective exchange rate index (REER) showed a similar trend as the NEER, because 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.

During the review period, there was an increase of funds flowing to the Hong Kong dollar, as evidenced by the repeated triggering of the strong-side CU. In addition, with total deposits growing in the first seven months of 2020, there were no significant cross-border outflows from the Hong Kong banking system.[32]

Looking ahead, risks of volatile fund flows remain amid uncertainties arising from the COVID-19 outbreak, US-China tensions and evolving geopolitical conflicts. Given the ample foreign reserves position and the robust banking system, Hong Kong is able to withstand the fund flow volatility without compromising its financial stability. Indeed, as the cornerstone of Hong Kong's financial system, the LERS continues to show its strength and resilience to shocks. With free capital mobility and the free convertibility of Hong Kong dollars enshrined in

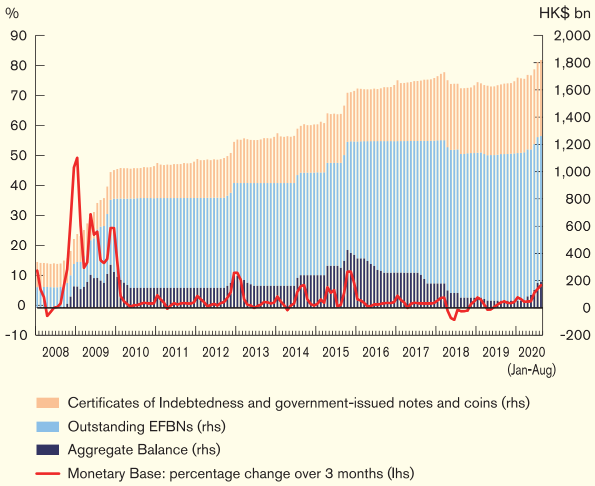
[32] For a detailed analysis of Hong Kong's deposit growth during the review period, see section 4.2.

Article 112 of the Basic Law, the LERS remains the most appropriate monetary system for a small, open and highly externally-oriented international financial centre like Hong Kong. The HKMA sees no need and has no intention of changing this well-established system.

4.2 Monetary environment and interest rates

Along with the unprecedented easing measures adopted by various central banks, Hong Kong's monetary environment continued to stay accommodative, with the Hong Kong dollar Monetary Base expanding by 9.4% during the first eight months of 2020 (Chart 4.4). Such an increase mainly reflected the rise in the AB due to the triggering of the strong-side CU since April and the reduced issuance of Exchange Fund Bills. Correspondingly, the outstanding EFBNs decreased slightly, due mainly to the reduced issuance of Exchange Fund Bills. On the other hand, Certificates of Indebtedness (CIs) and government-issued notes and coins as a whole continued to pick up.

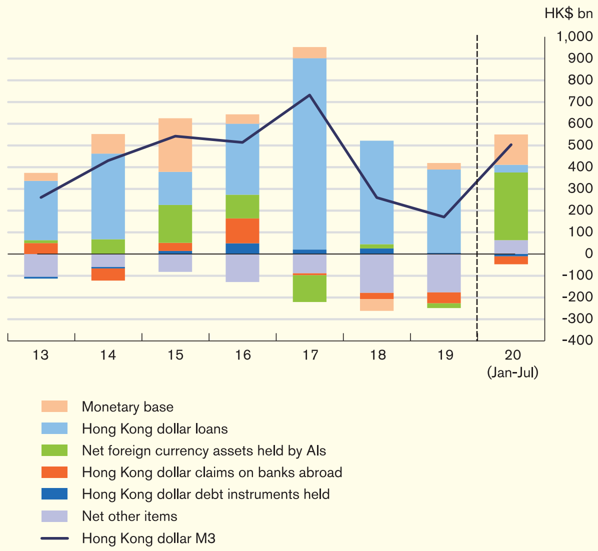
Chart 4.4
Monetary Base components



Source: HKMA.

The Hong Kong dollar monetary aggregate grew at a faster pace alongside the expansion of the Monetary Base. For the first seven months of 2020 as a whole, the Hong Kong dollar broad money (HK$M3) expanded by 6.8% after edging up by 0.2% during the preceding seven-month period (since the end of June 2019). Based on the analysis of asset-side counterparts, the growth of HK$M3 was mainly underpinned by the increase in net foreign currency assets held by banks and the Monetary Base as a result of the triggering of the strong-side CU (Chart 4.5). As a major component of HK$M3, Hong Kong dollar deposits rose by 6.8% during the first seven months. Within Hong Kong dollar deposits, demand deposits posted a notable rise, partly driven by investment demand amid buoyant equity market activities since May.

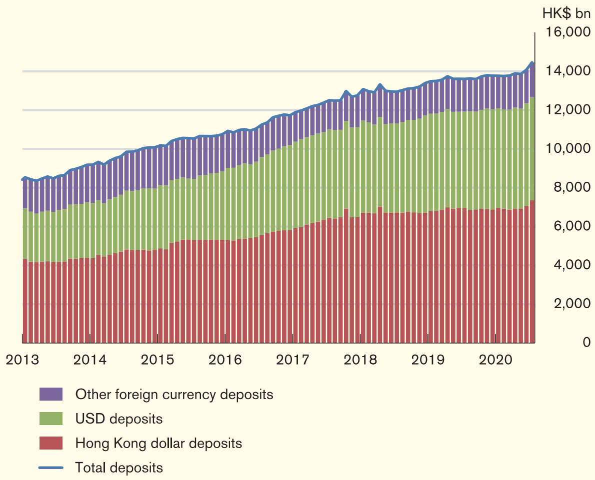
Chart 4.5
Changes in the HK$M3 and the asset-side counterparts



Note: The HK$M3 in the monetary survey has been adjusted to include foreign currency swap deposits.
Source: HKMA staff estimates.

Foreign currency deposits grew at a moderate pace. As a whole, foreign currency deposits increased by 3.1% during the first seven months of 2020, within which US dollar deposits and other foreign currency deposits picked up by 2.9% and 3.8% respectively. Overall, total deposits with authorized institutions (AIs) increased moderately by 5.0% in the first seven months (Chart 4.6).

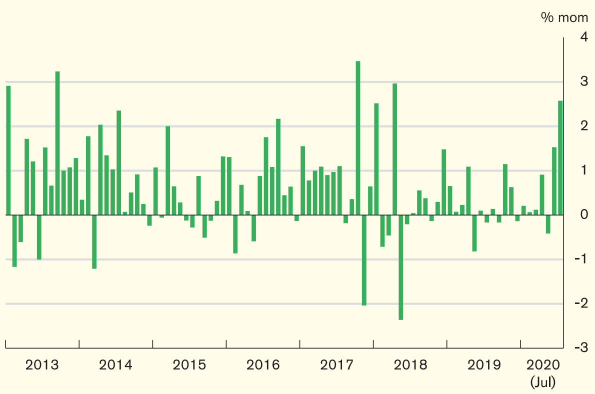
Chart 4.6
Deposits with AIs by currencies



Source: HKMA.

Reflecting the pick-up in total deposits and currency in circulation, total broad money supply grew moderately (Chart 4.7), with total M2 and M3 rising by 5.1% and 5.0% respectively since the end of 2019. However, as monthly monetary statistics are subject to volatilities due to a wide range of transient factors, such as seasonal and IPO-related funding demand as well as business and investment-related activities, caution is required when interpreting the statistics.

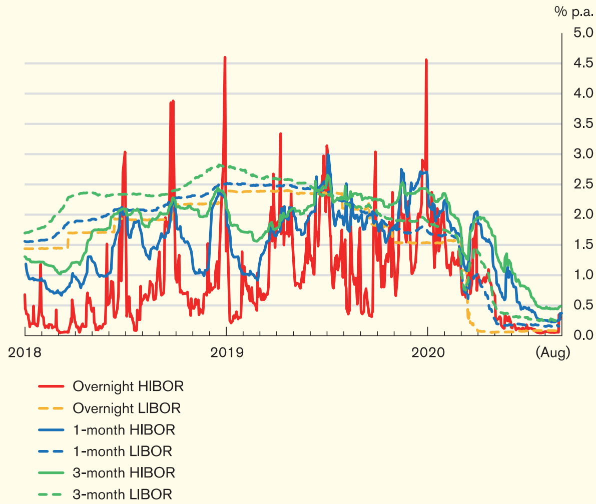
Chart 4.7
Total broad money supply (M2)



Source: HKMA.

Hong Kong interbank offered rates (HIBORs) declined alongside their US dollar counterparts during the review period (Chart 4.8). Although HIBORs were elevated in March as influenced by the US dollar funding stress and local factors, such as IPO-related and quarter-end funding demand, HIBORs declined noticeably stepping into April along with improved liquidity due to the expansion of the AB. Thereafter, volatilities of HIBORs were rather small, with only modest fluctuations stemming from IPO-related funding demand. HIBORs continued to remain steadily low stepping into the third quarter, with the one-month HIBOR averaging around 0.25% in August.

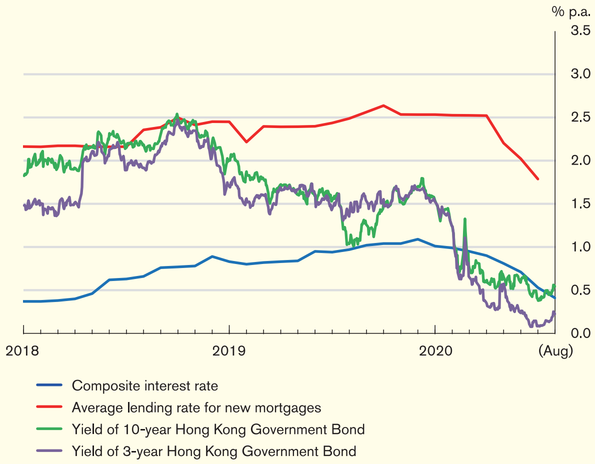
Chart 4.8
Hong Kong dollar and US dollar interbank interest rates



Sources: CEIC and HKMA.

Broadly following movements of the US dollar yield curve, which dropped markedly amid the aggressive monetary easing in the US, the Hong Kong dollar yield curve also declined noticeably during the review period (Chart 4.9). In particular, yields for the short tenors decreased more than those for the long tenors. Compared with the end of 2019, the yield of the 10-year Hong Kong Government Bond declined by 125 basis points to 0.54% at the end of August, while the yield of the three-year Hong Kong Government Bond dropped by 145 basis points to 0.22% during the same period.

Chart 4.9
Yields of Government Bonds, the composite interest rate, and the average lending rate for new mortgages



Sources: HKMA and staff estimates.

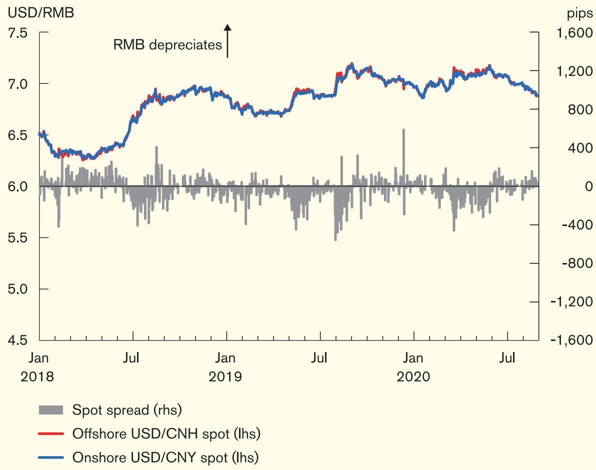
For retail-level interest rates, the composite interest rate, which measures the average Hong Kong dollar funding cost of retail banks, decreased from 1.09% at the end of 2019 to 0.41% at the end of August (Chart 4.9). The decline reflected both the drop in retail banks' wholesale funding costs and the 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 HIBOR. On the other hand, the Best Lending Rates of major retail banks remained unchanged, ranging from 5.00% to 5.50% throughout the review period, despite the cut in the US federal funds target rate in March.

Overall, the Hong Kong dollar money market continued to function in an orderly manner during the review period. The abundant liquidity in the banking system, together with the sizeable EFBNs held by banks (amounting to around HK$1 trillion), provide a strong liquidity backstop for Hong Kong's monetary and financial stability.

Offshore renminbi banking business

Against the backdrop of the COVID-19 outbreak and the US dollar funding stress, both the offshore (CNH) and the onshore (CNY) renminbi faced depreciation pressure from March (Chart 4.10). As the US-China tensions intensified, the CNH and CNY tested the decade low of 7.19 against the US dollar in late May. Thereafter, the renminbi regained some strength, due partly to the weakness of the US dollar and partly to the positive sentiment on Mainland's economic recovery. Despite turbulent economic and financial market conditions, the spread between CNY and CNH remained moderate by historical standards, turning from a discount to a slight premium since late May as renminbi depreciation pressure eased.

Chart 4.10
CNY and CNH exchange rates



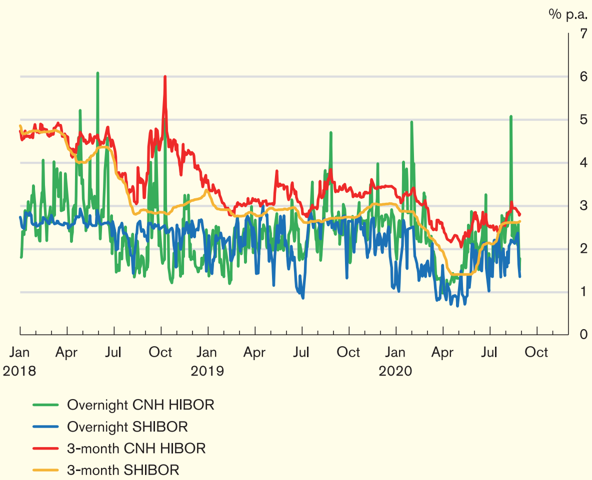
Source: Bloomberg.

Despite the uncertainties arising from the COVID-19 and the escalation of US-China tensions, liquidity conditions in the offshore CNH interbank market remained largely stable. During the review period, the overnight and three-month CNH HIBORs mostly traded below 3% and softened in March and April following the People Bank of China (PBoC)'s monetary easing (Chart 4.11).[33] Moderate fluctuations were

[33] See Chapter 2.2 for a summary of the PBoC's monetary easing measures.

seen in June, in part driven by funding needs for northbound remittances and seasonal liquidity demand near the half-year end.

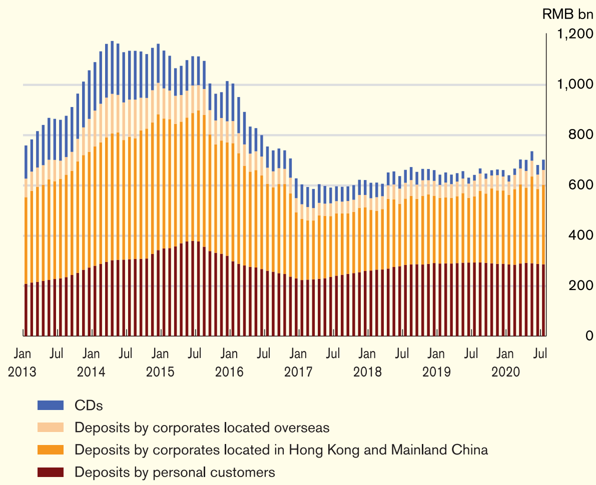
Chart 4.11
The overnight and the three-month CNH HIBOR fixings



Source: CEIC.

Hong Kong's CNH liquidity pool expanded further during the first seven months of 2020. The total outstanding amount of renminbi customer deposits and certificates of deposit (CDs) grew moderately by 6.2% to RMB699.2 billion at the end of July (Chart 4.12 and Table 4.A). Renminbi customer deposits witnessed a 4.1% increase, driven by a moderate increase in deposits by corporate customers. Personal customer deposits, however, decreased slightly, partly reflecting residents' northbound renminbi transfers for investment in the onshore market. On the other hand, outstanding CDs picked up strongly by 58.2% along with the rise in renminbi CD issuance during the first half.

Chart 4.12
Renminbi deposits and CDs in Hong Kong



Source: HKMA.

Table 4.A
Offshore renminbi banking statistics

	Dec 2019	Jul 2020
Renminbi deposits & CDs (RMB bn)	658.0	699.2
Of which:		
Renminbi deposits (RMB bn)	632.2	658.3
Share of renminbi deposits in total deposits (%)	5.1	5.0
Renminbi CDs (RMB bn)	25.8	40.9
Renminbi outstanding loans (RMB bn)	153.7	162.0
Number of participating banks in Hong Kong's renminbi clearing platform	204	206
Amount due to overseas banks (RMB bn)	76.3	98.0
Amount due from overseas banks (RMB bn)	95.4	101.7

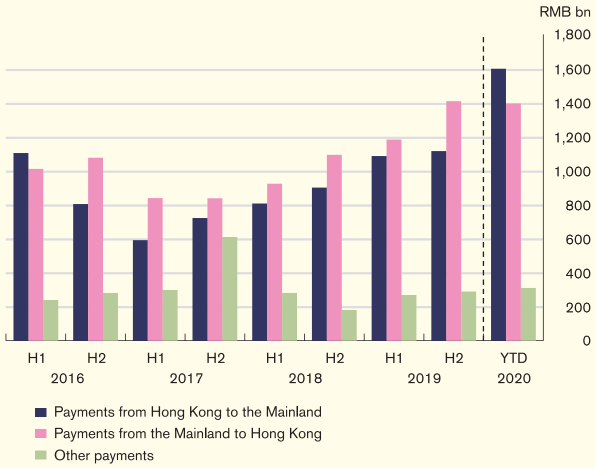
	Jan – Jul 2020
Renminbi trade settlement in Hong Kong (RMB bn)	3,724.4
Of which:	
Inward remittances to Hong Kong (RMB bn)	1,602.1
Outward remittances to Mainland China (RMB bn)	1,768.3
Turnover in Hong Kong's RMB real time gross settlement (RTGS) system (Daily average during the period; RMB bn)	1,201.1

Source: HKMA.

Renminbi bank lending in Hong Kong continued to maintain steady growth. During the first seven months of 2020, the outstanding amount of renminbi loans rose by 5.4% to RMB162.0 billion. Hong Kong's renminbi trade settlement also continued to expand. Transactions handled by banks in Hong Kong amounted to RMB3,724.4 billion during the first seven months of 2020, picking up by 23.9% compared with the same period last year. The increase was mainly driven by a rise in outward remittances to Mainland China (Chart 4.13). Overall, the renminbi liquidity pool in Hong

Kong continued to provide adequate support to a large amount of renminbi payments and financing intermediation activities. During the first seven months, the average daily turnover of the renminbi Real Time Gross Settlement (RTGS) system stayed high at RMB1,201.1 billion, compared with RMB1,121.3 billion in the same period in 2019.

Chart 4.13
Flows of renminbi trade settlement payments



Source: HKMA.

Looking ahead, the development of Hong Kong's offshore renminbi business will continue to be affected by the changing macro-financial and geopolitical environment. Although the outlook remains clouded by the uncertainties arising from the COVID-19 outbreak as well as the US-China tensions, Hong Kong's offshore renminbi business is expected to gain momentum along with the ongoing liberalisation of Mainland's capital account, rising demand for renminbi assets from international investors, and more regional economic and financial co-operation under the Belt and Road and the Guangdong-Hong Kong-Macao Greater Bay Area initiatives[34].

[34] On 29 June, the PBoC, the HKMA and the Monetary Authority of Macao jointly announced the launch of a cross-boundary wealth management connect pilot scheme (Wealth Management Connect) in the Guangdong-Hong Kong-Macao Greater Bay Area, which facilitates cross-boundary investment by individual residents in the Guangdong-Hong Kong-Macao Greater Bay Area.

Asset markets

In line with global stock markets, the Hong Kong equity market was initially driven down by the COVID-19 outbreak, and then recovered amid optimism that global policy responses to the pandemic could support an economic recovery, even though the pandemic was still not fully under control. Nevertheless, both the Hong Kong dollar debt market and the offshore renminbi debt market in Hong Kong expanded marginally in the first half of 2020. With COVID-19 lingering in the background, activities in the residential property market moderated again in July and August after picking up in the second quarter.

4.3 Equity market

The Hong Kong equity market took a roller coaster ride in the review period. The Hang Sang Index (HSI) dropped sharply in the first quarter of 2020 amid the COVID-19 outbreak and the economic uncertainties surrounding it. The lockdown of economic activities, coupled with the fear of a widespread recession worldwide, wreaked havoc on the global economy. The Hong Kong stock market, as with other global equity markets, plummeted under heavy selling pressure. At one stage in late March, the Hong Kong market hit its lowest level in more than three years.

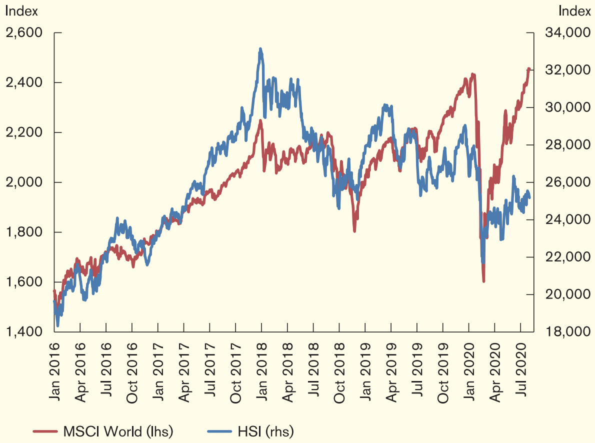
Spurred by the optimism that economic activities may be recovering amid global policy supports, the local stock market rebounded quickly in tandem with other major equity markets. Proactive moves by leading central banks, including unlimited asset purchase schemes, have flooded financial markets with massive liquidity support. These actions by central banks, together with significant fiscal stimuli by government authorities globally, signalled policymakers' determination to combat the unprecedented global recession.

Against this backdrop, despite that the pandemic has yet to be brought under control, most global equities recouped their losses in the second quarter, 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, underperformed when compared with other major equity markets.

During the review period, there was much "noise" stemming from the geopolitical front, including the re-emergence of tensions on the Korean Peninsula, the rising tension between the US and Mainland China and its potential implications for Hong Kong. However, the impact on the local equity market has so far been short-lived.

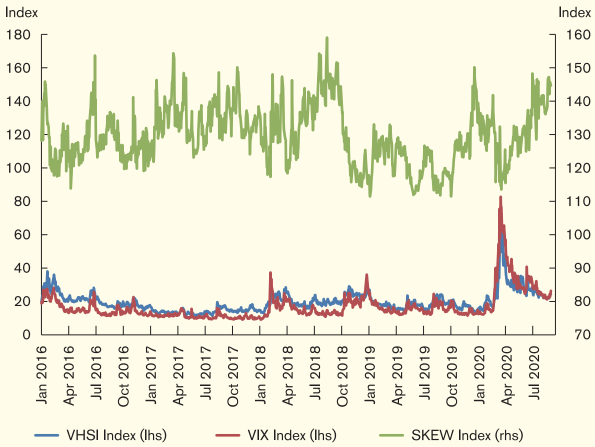
Overall, the HSI declined by 4.2% from March 2020 to Aug 2020, while the MSCI World Index edged up by 11.0% in the same period (Chart 4.14). Option-implied volatilities initially surged to a peak in mid-March, and have retreated somewhat since then. However, it was still higher than its historical average, as the market may see further uncertainty ahead. The rebound of the SKEW index towards the end of the review period reflected that investors were once again concerned with a heightened tail risk, hence they were willing to pay more for downside protection (Chart 4.15).[35]

Chart 4.14
Equity prices and the MSCI World Index



Source: Bloomberg.

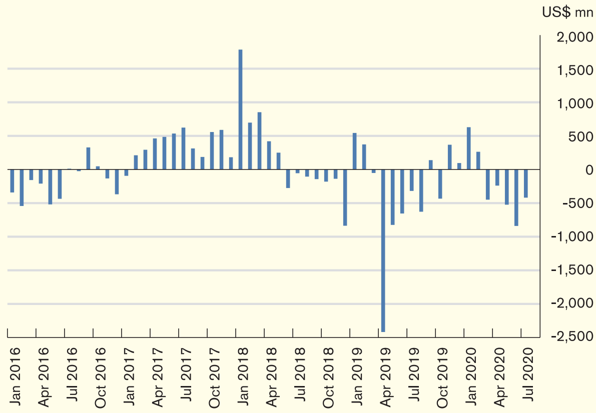
Chart 4.15
Option-implied volatilities of the HSI and S&P500, and the SKEW index



Source: Bloomberg.

With the uncertainties built up around the outbreak of the COVID-19, as well as risks of heightening tensions between the US and Mainland China, investors' appetite for Hong Kong stocks has been dampened. Against this backdrop, international investors have been cautious, as reflected by a mild net outflow in the Hong Kong equity funds during the review period (Chart 4.16).

Chart 4.16
Equity market fund flows into Hong Kong

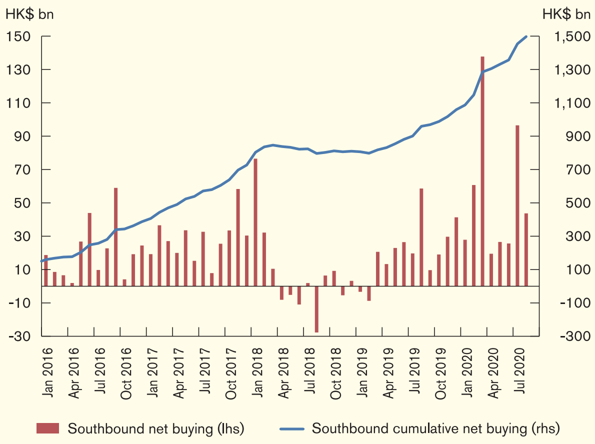


Source: EPFR Global.

Nevertheless, the Hong Kong stock market registered substantial inflows from Mainland investors. The cumulative southbound net buying through the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect since their introduction got a boost and stood at HK$1,497.3 billion at the end of August, a 56% increase over a year earlier (Chart 4.17).

[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&P500 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 4.17
Net flows through Stock Connects

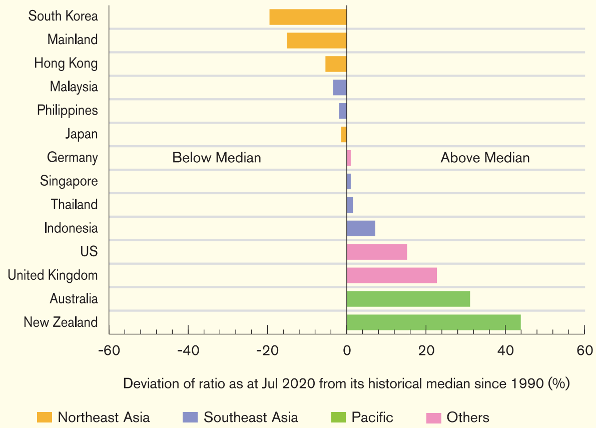


Note: The southbound net buying represents the sum of the southbound net buying from the Shanghai-Hong Kong Stock Connect and that of the Shenzhen-Hong Kong Stock Connect.
Sources: CEIC, HKEX and HKMA staff estimates.

The primary market in Hong Kong recorded significant growth. Funds raised through IPOs in the first half of 2020 increased by 22% year on year, with a total of 64 new listings and total proceeds reaching HK$87.5 billion. More Mainland information technology (IT) firms have sought a secondary listing in Hong Kong, with two large-scale US listed Mainland companies raising a total value of over HK$54.3 billion.

Looking ahead, the local equity market remains highly sensitive to both local and external market conditions, particularly the surging risk of the spread of COVID-19, the uncertainty over the pace of worldwide economic recovery, and whether central banks and government authorities globally still have sufficient policy spaces to respond to future shocks. In addition, geopolitical risks, such as the deterioration in the US-China relationship, will further weigh on the market sentiment of stock investors in Hong Kong. As such, while the local equity market remains relatively attractive in terms of valuation, it is likely to head for more volatility in the near future (Chart 4.18).

Chart 4.18
Cyclically-adjusted price-earnings ratios of Asia Pacific and other major markets

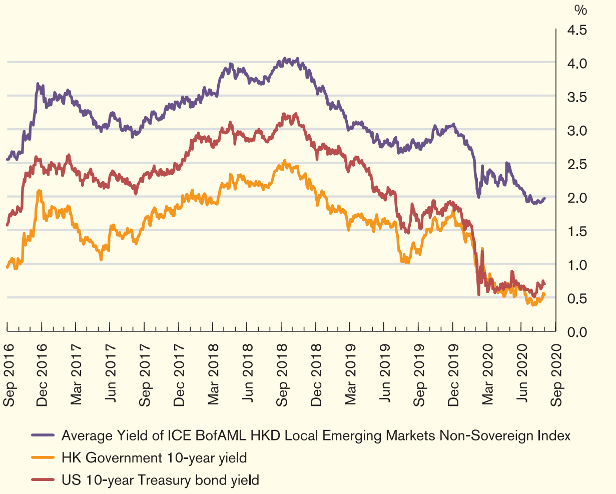


Sources: Bloomberg, CEIC and HKMA staff estimates.

4.4 Debt market

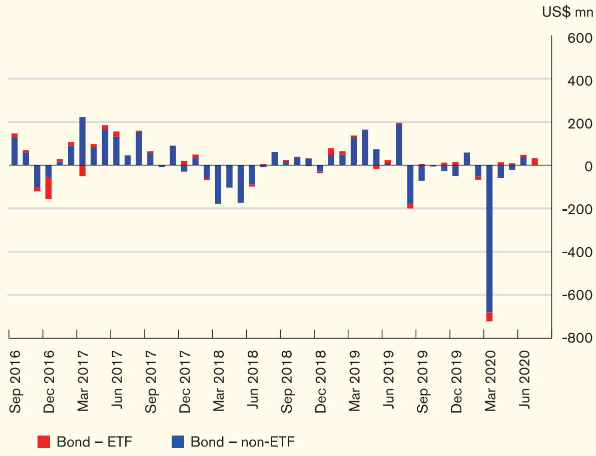
The Hong Kong dollar debt market expanded mildly in the first half of 2020 on the back of steady growth in issuance, with yields of both Hong Kong dollar sovereign and non-sovereign bonds falling sharply to a record low in early March amid massive monetary easing by leading central banks. The decline in Hong Kong dollar bond yields in the first quarter was in tandem with the decrease in US Treasury yields and sharp falls in bond yields in developed economies. These yields, however, have been hovering around low levels since March. Market optimism that economic activities may be recovering with the unprecedented global government policy supports, lured investors back to bonds and other risky assets after the first quarter, despite the spread of the pandemic has yet been fully under control (Chart 4.19).

Chart 4.19
Hong Kong dollar sovereign and non-sovereign bond yields and US ten-year Treasury yield



Sources: ICE Data Indices and HKMA.

Chart 4.20
Exchange traded fund (ETF) and non-ETF bond fund flows into Hong Kong

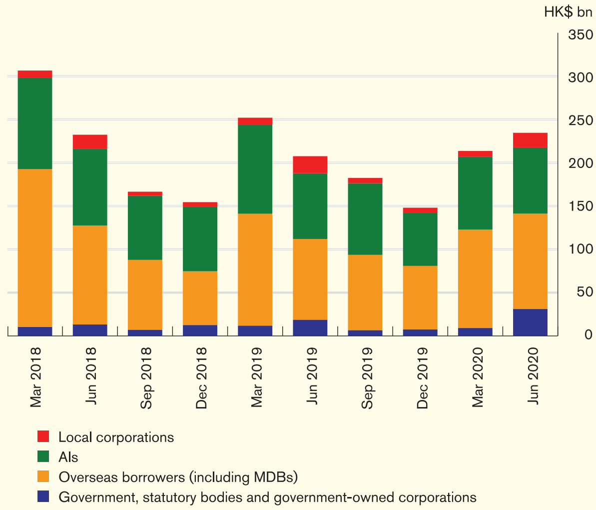


Source: EPFR Global.

The COVID-19 outbreak in Europe in late February and the US in mid-March triggered widespread outflows of bond funds globally as fear of the pandemic then drove investors to hold more cash. Hong Kong was no exception, with bond funds reaching the highest monthly net redemptions on record at US$722 million in March 2020. The fund redemptions were primarily driven by non-exchange traded fund bond funds. Since then, outflows of bond funds from Hong Kong and other emerging markets have stabilised somewhat as the global economic outlook slightly improved with the unprecedented stimulus measures by leading central banks and governments (Chart 4.20).

The total issuance of Hong Kong dollar debt in the first six months of 2020 decreased by 3.2% year on year to HK$2,031.3 billion, mainly driven by a 3.3% decrease in the issuance of the Exchange Fund papers, which more than offset the increase in debt issued by the government sector and overseas borrowers (Chart 4.21).

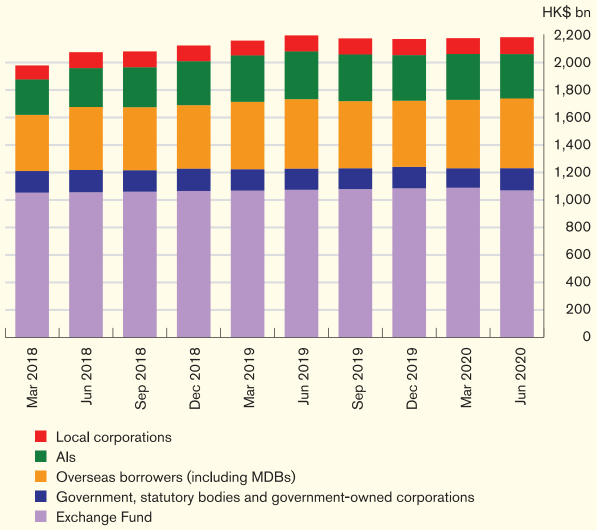
Chart 4.21
New issuance of non-EFBNs Hong Kong dollar debt



Source: HKMA.

The outstanding amount of Hong Kong dollar debt shrank marginally by 0.6% year on year to HK$2,179.0 billion at the end of June 2020 (Chart 4.22). The amount was equivalent to 28.5% of HK$M3 or 23.2% of Hong Kong dollar-denominated assets of the banking sector. Within the total, the local private sector saw its debt outstanding decline by 4.1% from a year ago to HK$444.5 billion, due mainly to a decrease in the outstanding debt of AIs. The outstanding debt of the Exchange Fund papers also decreased by 0.3% year on year to HK$1,067.7 billion.

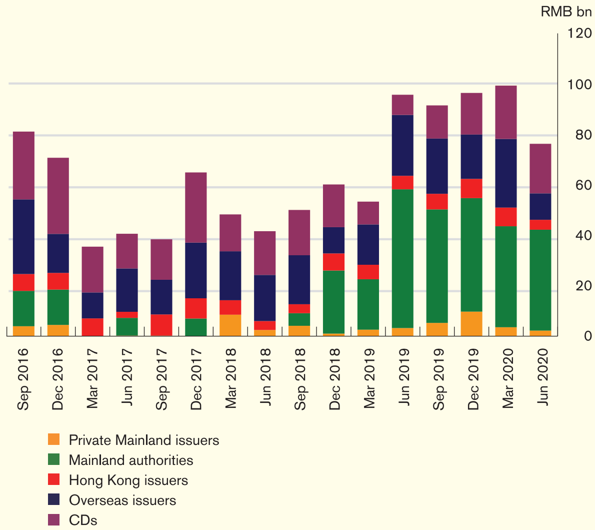
Chart 4.22
Outstanding Hong Kong dollar debt



Source: HKMA.

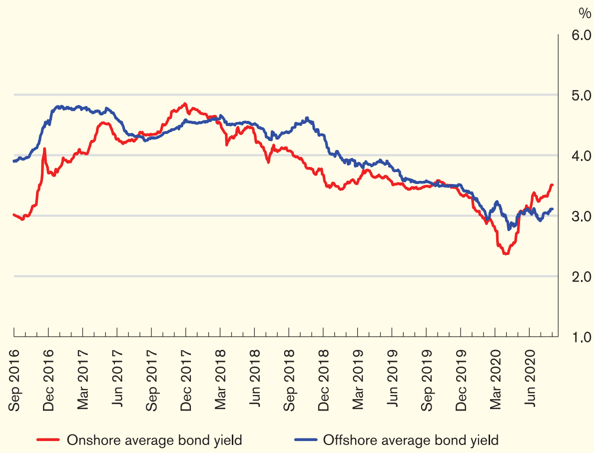
The offshore renminbi debt market in Hong Kong, however, continued to expand steadily. New issuance jumped by 17.8% year on year to RMB175.5 billion in the first half of 2020. This increase was mainly driven by a 139% increase in the issuance of CDs, with local financial institutions being the major contributors. The increase in CD issuance more than offset the 5.4% decrease in debt issued by the overseas issuers and private Mainland issuers (Chart 4.23). As the onshore renminbi debt market was strongly supported by monetary measures of the PBoC to lower borrowing costs for corporates, the gap between onshore and offshore funding costs widened to a high of 68 basis points in early April. The yield difference, however, has reversed towards the end of the review period, as the average funding cost became higher in the onshore market (Chart 4.24).

Chart 4.23
New issuance of offshore renminbi debt in Hong Kong



Sources: Newswires and HKMA staff estimates.

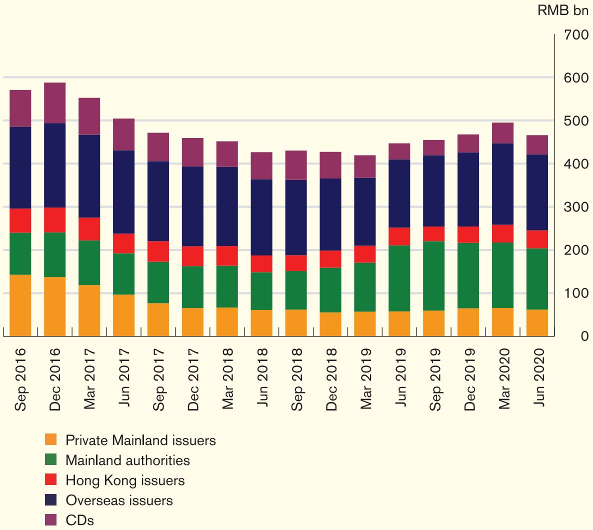
Chart 4.24
Average yields of onshore vs. offshore renminbi bond indices



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

Due to the growth in new issuance, the total outstanding amount of offshore renminbi debt securities recorded a 4% year-on-year increase to RMB465.7 billion at the end of June 2020 (Chart 4.25).

Chart 4.25
Outstanding amount of offshore renminbi debt in Hong Kong



Sources: Newswires and HKMA staff estimates.

The near-term prospect for the local debt market, including the offshore renminbi debt market, remains challenging due to the jitters across global markets dominated by the fear of new waves of COVID-19 infections, the global economic slowdown, and a deterioration in the US-China relationship. In the past few months, global economic activities in both the service and manufacturing sectors were almost at a standstill amid the pandemic, and there is no clear sign of a full recovery in the near future. Corporates will be more cautious in launching new investment and engaging in long-term projects, hence dampening their demand for long-term funds. On the other hand, while accommodative fiscal and monetary policy responses to the pandemic have restored some stability and liquidity to bond markets, bond investors may become more prudent in view of the rising credit risk amid heightened economic uncertainty.

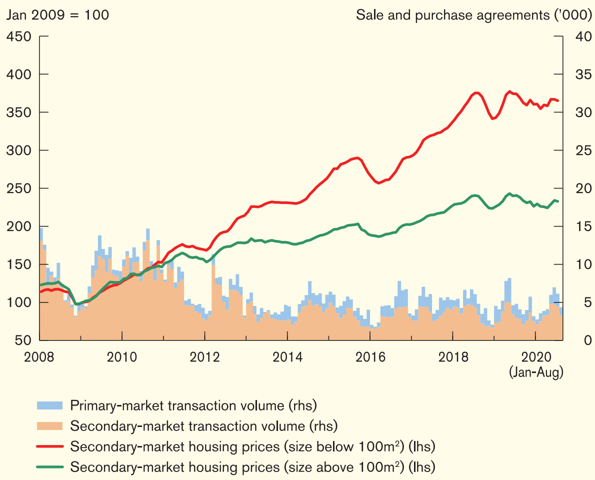
4.5 Property markets

Residential property market

After a quiet first quarter, the residential property market picked up in the second quarter, partly supported by a low interest rate environment and a temporary stabilisation of the local COVID-19 situation. In particular, more property developers resumed or launched new project sales when the restrictions on public gatherings were gradually relaxed in May. Potential buyers also resumed their flat-viewing activities in the secondary market. As a result, the overall housing transactions increased by 67% in the second quarter compared with the first quarter (Chart 4.26). Thereafter, market activities slowed again amid the rise in local COVID-19 infections. The average monthly transactions in July – August eased to around 5,250 units.

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. In particular, prices of large flats (with a saleable area of at least 100m^2) increased faster than the prices of small and medium-sized flats (with a saleable area of less than 100m^2). More recent market data indicated that housing prices eased in July and August.

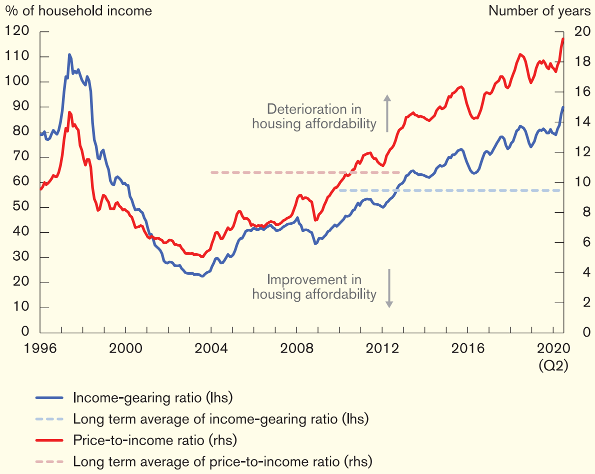
Chart 4.26
Residential property prices and transaction volume



Sources: R&VD and Land Registry.

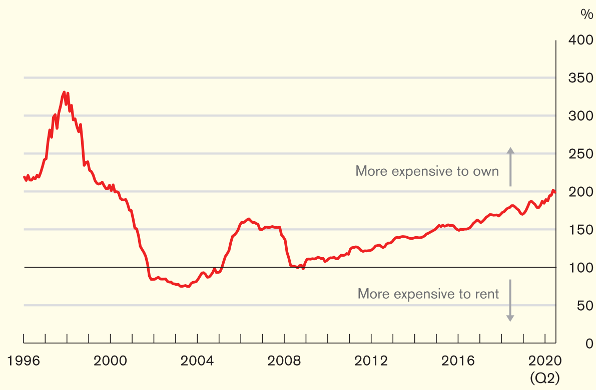
Housing affordability became more stretched in the first half of the year along with a pick-up in housing prices and easing household income. The housing price-to-income ratio climbed to 18.8 in the second quarter, compared with the 1997 peak of 14.6. The income-gearing ratio also reached 86.6%, well above the long-term average (Chart 4.27).[36] In addition, as housing rentals declined, the buy-rent gap also climbed in the first half of the year (Chart 4.28).[37] In tandem, residential rental yields softened to a low range of 1.8–2.4% in July.

Chart 4.27
Indicators of housing affordability



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

Chart 4.28
Buy-rent gap



Note: This indicator is calculated as the ratio of the cost of purchasing and maintaining a 50m² flat with that of renting it.
Sources: R&VD, C&SD and HKMA staff estimates.

The average interest rates for new mortgages fell to a low of about 1.8% in July, mainly reflecting the decline in HIBORs in recent months (see also section 4.2). Several banks have tightened their mortgage offers by cutting the cash rebates for new mortgages, but a few of them reintroduced the rebates in late August because of keen market competition.

While the pandemic and the deepening economic recession pose downside risks to the housing market, the macroprudential measures implemented by the HKMA since 2009 have strengthened banks' resilience to property market shocks. The debt-servicing ratio for new mortgages was stable at a low level of about 36% in January–July. The average LTV ratio for new mortgages was 58% in July, which is still below the 64% level before the measures were first introduced.

The outlook for the residential property market is subject to a number of uncertainties and risks as discussed in previous chapters. The lingering COVID-19 outbreak, coupled with the deep 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 residential property market sentiment. However, the prolonged

[36] 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. Alternatively, 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, which is subject to a maximum cap by the HKMA prudential measures.

[37] 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.

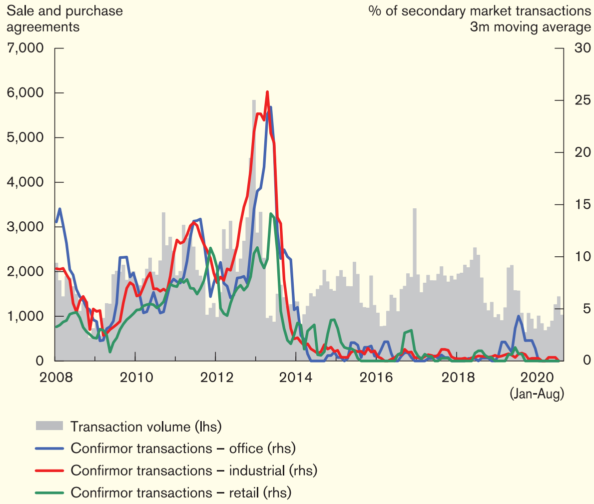
ultra-low interest rates will continue to be a supporting factor for asset prices. Over the longer term, the outlook for the housing market will depend on the housing supply-demand gap. According to the latest completion figures, the private housing supply has not been disrupted by the pandemic. More than 11,000 units were completed by end-July, which met more than a half of the Government's projection for 2020.

Non-residential property market

Reflecting the decline in economic activities, the non-residential property market saw a further moderation in the first half of 2020. The average monthly transaction volume fell to a record low of 912 units between January and June (Chart 4.29). Speculative activities remained inactive as indicated by confirmor transactions. On the price front, prices of commercial and industrial properties exhibited differential movements within the first half of the year. In particular, prices of office space declined further, while prices of retail premises picked up slightly after a sharp fall in the second half of 2019 (Chart 4.30). The commercial leasing market stayed lacklustre. Rentals of office space and retail premises remained soft, partly because landlords were willing to cut rents in response to increased vacancy rates (Chart 4.31). Rental yields across segments remained low at 2.6–2.9%.

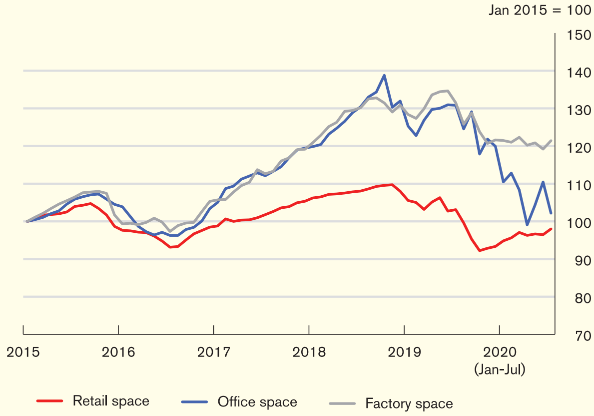
The outlook for the non-residential property market remains challenging in the near term. Should the pandemic linger on, the local economy might deteriorate further and inbound tourism will remain in the doldrums, thereby dampening rental earnings and capital values of office space and retail premises. Other factors such as the intensified US-China tensions might also add uncertainties to the business environment, which could in turn weigh on business confidence and dampen the demand for commercial and industrial properties.

Chart 4.29
Transactions in non-residential properties



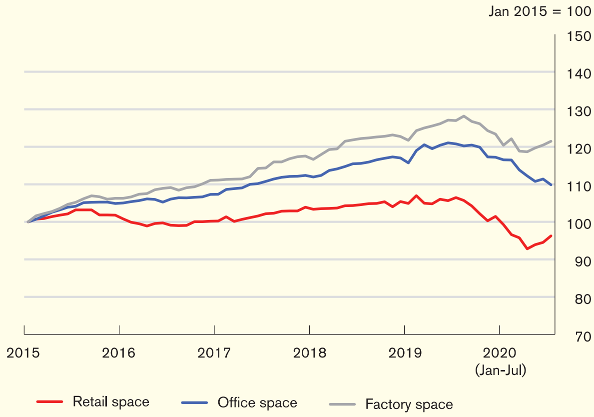
Sources: Land Registry and Centaline Property Agency Limited.

Chart 4.30
Non-residential property price indices



Source: R&VD.

Chart 4.31
Non-residential property rental indices



Source: R&VD.

Given that the non-residential property markets have seen major corrections since last year and will likely remain under pressure, and taking into account other factors such as 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.[38]

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