1. Summary and overview

The rollout of COVID-19 vaccines has raised hopes of economies reopening and brightened the global growth outlook. Together with sustained fiscal and monetary easing, financial markets rallied to new heights. Nevertheless, the global outlook remains clouded by uncertainties and the recovery is likely to be uneven. Over the medium term, the disconnect between financial markets and the real economy, as well as the elevated indebtedness and the economic scarring brought by the pandemic, will be a challenge to policymakers down the road.

The Hong Kong foreign exchange and money markets continued to operate in a smooth and orderly manner during the review period. The Hong Kong dollar traded close to the strong-side Convertibility Undertaking, driven mainly by equity-related demand. There was also no sign of significant cross-border outflows from the Hong Kong banking system as total deposits increased. In part reflecting lower demand for credit amid weaker economic activities due to the resurgence of virus outbreaks, total loans declined modestly in the second half, albeit recording a mild expansion for 2020 as a whole. Meanwhile, the residential property market broadly held up.

Looking ahead, uncertainty in the pace of economic recovery together with lingering geopolitical risks will continue to pose challenges to the Hong Kong banking sector. Banks should remain vigilant to the implications of these downside risk factors for their asset quality, particularly in view of the weakening ability of corporates and households to repay debt amid the pandemic.

The external environment

After a rebound in the third quarter of 2020 along with various economies reopening, global growth has slowed again since the fourth quarter amid resurging COVID-19 infections. Nonetheless, breakthroughs in vaccine development in late 2020 raised hopes that the pandemic would eventually be brought to an end, thereby allowing the return of normalcy and faster global growth ahead. Coupled with sustained fiscal and monetary easing, global financial markets rallied to new heights in early 2021, albeit with signs of disconnecting from the real economy.

Against this background, the global outlook remains clouded by elevated uncertainties. It remains to be seen whether COVID-19 vaccines can be made widely available. At the same time, potential upside surprises to inflation due to supply-side bottlenecks and earlier aggressive easing measures might require central banks to reduce monetary accommodation sooner than expected, upending financial markets' expectations of a "low for even longer" monetary policy. In the longer term, policymakers will have to assess the costs and benefits of extending relief measures, and contend with a multitude of economic legacies created by the pandemic, including elevated global indebtedness and economic scarring.

In East Asia[1], growth of gross domestic product (GDP) improved in the second half of 2020, supported by revived demand for its exports. Portfolio inflows into the region resumed along with a return of searching-for-yield activities amid risk-on sentiment. Despite these positive developments, the region still has to face lingering uncertainties from the pandemic. First, in the global race to procure vaccines, less-developed economies in the region may lag behind advanced economies in achieving population immunity, leading to a delay in the recovery of their tourism and service sectors. Second, downside surprises in the availability, reach or efficacy of vaccines, coupled with a deterioration of government finance in the region, could turn market sentiment and trigger capital flow reversals.

In Mainland China, the economy recovered at a faster pace in the second half of 2020 compared with the first half, along with a gradual normalisation of consumption activities. For 2020 as a whole, the Mainland economy grew by 2.3% and was the only major economy in the world registering positive growth. Looking forward, the economic outlook depends much on the development of the pandemic and the China-US tensions. The latest consensus forecasts expect the Mainland economy to expand by 8.4% in 2021. After months of depreciation in early 2020, the renminbi strengthened in the rest of the year amid faster economic recovery, the weakening US dollar, and strong bond inflows into the economy. A closer examination showed that fundamental factors rather than market sentiment played an important role in driving renminbi exchange rate volatility amid the COVID-19 outbreak (see more details in Box 1).

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

The domestic economy

Hong Kong's economy saw some improvement in the second half of 2020, although real GDP remained well below pre-pandemic levels. With domestic demand edging up and exports of goods expanding further, seasonally adjusted real GDP has picked up sequentially since the third quarter, ending successive declines in the preceding five quarters. Year on year, the contraction in real GDP also narrowed visibly from 9% in the first half of 2020 to about 3% in the second half. However, for 2020 as a whole, real GDP declined by a record rate of 6.1%, marking an unprecedented consecutive annual decline following the 1.2% contraction in 2019. The latest sectoral GDP data also indicated that consumption and tourism-related sectors continued to contract more steeply than the overall economy amid the pandemic.

In response to the lingering pandemic, the Government launched two additional rounds of the Anti-Epidemic Fund (i.e. AEF 3.0 and 4.0) in the latter part of 2020 to assist industries and people affected by the pandemic and enhance Hong Kong's anti-epidemic capabilities. More recently, the Government also announced additional countercyclical fiscal measures in the 2021/22 Budget to revive the economy, including a one-off provision of electronic consumption vouchers worth HK$5,000 and a Special 100% Loan Guarantee for unemployed individuals. Together with the Banking Sector SME Lending Coordination Mechanism, the HKMA announced in March 2021 the extension of the Pre-approved Principal Payment Holiday Scheme (PPPHS) to October 2021, and repayment deferment for trade facilities under the PPPHS. These extensions are expected to help ease cash-flow difficulties faced by some corporate customers.

The local economy is expected to see positive growth for 2021 as a whole in the hope of COVID-19 vaccination normalising economic activities, but the strength and pace of recovery is subject to a host of uncertainties, especially those surrounding the pandemic situation and vaccine rollout and efficacy. In particular, as vaccines take time to be widely adopted, the local economy still faces considerable challenges in the early part of 2021. Externally, the Mainland economy is anticipated to strengthen further and render support to Hong Kong's export of goods and services, but the pace of recovery in other major economies will hinge on the success of their mass vaccination campaigns. The Government forecasts real GDP growth for 2021 in the range of 3.5–5.5%. Growth estimates by international organisations and private-sector analysts average 4.4%.

The labour market continued to deteriorate in the second half of 2020 and in early 2021. The unemployment rate climbed further to a 17-year high of 7.2% in February 2021, while the underemployment rate rose to a post-SARS high of 4.0%. In response to the deteriorating labour market conditions, the Government launched the Employment Support Scheme (ESS) under AEF 2.0 to provide time-limited (i.e. June–November 2020) wage subsidies for employers to retain employees. After the ESS ended, other targeted measures, such as one-off subsidies, were provided under AEF 3.0 and 4.0 to further support hard-hit sectors. In the near term, the labour market is expected to remain under pressure given the lacklustre economic conditions. Box 2 sheds light on the potential impacts of Hong Kong's inbound tourism boom and bust on the local labour market.

Local inflationary pressures continued to subside in the eight months leading up to February 2021. Year on year, the underlying consumer price inflation rate decelerated notably to 0.3% and 0.2% in the third and fourth quarters of 2020 respectively, and even declined to -0.5% in January and -0.1% in February 2021[2]. Inflation momentum, as measured by the annualised three-month-on-three-month underlying inflation rate, also stayed mild in recent months, albeit with some fluctuations. Local inflationary pressures will likely remain subdued in the near term as global and local economic conditions are still challenging. In particular, the feed-through of an earlier decline in fresh-letting residential rentals will continue to restrain local inflation. Market consensus forecasts that the headline inflation rate for 2021 will be at a moderate level of 1.4%, while the Government projects the underlying and headline inflation rates to be 1% and 1.6% respectively in 2021.

[2] Inclusive of the effects of the Government's relevant one-off relief measures, the year-on-year headline inflation rate also turned negative between July and December 2020.

Monetary conditions and capital flows

The Hong Kong dollar traded close to the strong-side Convertibility Undertaking (CU), driven mainly by equity-related demand arising from vibrant initial public offering (IPO) activities and the southbound Stock Connects. With equity fund-raising activities staying strong in the first two months of 2021, the Hong Kong dollar has remained firm. During the review period, the strong-side CU was triggered 47 times in September and October 2020 with inflows of HK$263.3 billion into the Hong Kong dollar. For 2020 as a whole, the strong-side CU was triggered 85 times, with accumulated inflows of HK$383.5 billion. Overall, the Hong Kong dollar continued to trade in a smooth and orderly manner.

From a geographical perspective, there was also no sign of significant cross-border outflows from the Hong Kong banking system as total deposits increased during the review period. While the uncertainties related to the development of the pandemic, pace of economic recovery and lingering China-US tensions may heighten fund-flow volatility, Hong Kong is able to withstand such volatility given its ample foreign reserves and robust banking system.

Along with the expansion of the Aggregate Balance due to the triggering of the strong-side CU, Hong Kong dollar interbank interest rates generally stayed at very low levels. The composite interest rate, which measures the average Hong Kong dollar funding cost of retail banks, dropped further from 0.71% at the end of June 2020 to 0.23% at end-February 2021. As a result of lower funding costs, the average lending rate for new mortgages also decreased from 2.02% in June to 1.56% in January. On the other hand, the Best Lending Rates of major retail banks stayed unchanged at between 5.00% and 5.50% during the review period.

Along with the strengthening onshore renminbi (CNY), the offshore counterpart (CNH) has appreciated against the US dollar since late May 2020. In most of the review period, the CNH traded at a premium over the CNY, with the premium averaging at around 100 pips during the fourth quarter, which was moderate by historical standards. Hong Kong's CNH liquidity pool continued to grow during the second half of 2020, with the total outstanding amount of renminbi customer deposits and certificates of deposit picking up to RMB826.3 billion at the end of January 2021. As for other renminbi businesses, Hong Kong's renminbi bank lending declined while renminbi trade settlement increased, and average daily turnover of the renminbi Real Time Gross Settlement system stayed high at RMB1,191.5 billion for 2020 as a whole. With efficient financial infrastructure and multiple access channels for cross-border portfolio investment vis-à-vis the Mainland, Hong Kong's offshore renminbi business is expected to benefit from ongoing liberalisation of Mainland's capital account, increasing demand for renminbi assets from international investors, and deepening regional economic and financial cooperation under the Belt and Road and the Guangdong-Hong Kong-Macao Greater Bay Area initiatives.

Asset market

On the back of rising global equity prices and strong buying flows from Mainland investors via the southbound Stock Connects, the local stock market rebounded after a sharp correction at the beginning of the review period. Global equity markets rose, supported by unprecedented monetary easing measures in major economies, optimism that positive vaccine developments might speed up the recovery of economic activities, as well as a reduction in some geopolitical uncertainties. Against this backdrop, the Hang Seng Index recouped its earlier losses in 2020 and recorded a 15.1% gain over the review period after hitting a fresh new high of over 31,000 points in 32 months in mid-February 2021.

Supported by steady issuances, both the Hong Kong dollar and offshore renminbi debt markets continued to expand in the second half of 2020. Bond fund flows to the local market rebounded after a sharp net outflow in the first half as unprecedented stimulus measures around the world quickly restored confidence. Despite the modest rebounds, global bond yields including those of Hong Kong were still hovering around their historical low levels.

Looking ahead, considerable uncertainties remain in both local equity and debt markets. In particular, the path of global economic recovery from the pandemic is still highly uncertain, hinging on the pace and efficacy of vaccine rollouts. Meanwhile, the development of the China-US relationship, especially in terms of lingering concerns about continued US policy restrictions by the new administration on investment in some Mainland entities, is likely to weigh on market sentiment in both the equity and debt markets in the foreseeable future.

In the medium term, local debt market development is expected to be boosted by a number of policy initiatives in the Government Bond Programme, particularly on green finance.

In January 2021, the Government announced the successful offering of US$2.5 billion of green bonds. The positive market response is in line with the market trend that environmental, social and governance (ESG) factors are playing an increasing role in investment. Relatedly, the HKMA's recent research findings (Box 3) suggest that the ESG disclosures of firms could effectively reduce uncertainties in stock valuations due to ESG-related risks.

Despite new waves of local COVID-19 infections, the residential property market broadly held up. In the second half of 2020, transaction activities were partly boosted by new launches after the third wave of local infections faded, while flat prices had consolidated only slightly since mid-2020. For 2020 as a whole, housing transactions and prices were broadly similar to those in 2019. Stepping into early 2021, market activities remained robust. Meanwhile, housing affordability became more stretched mainly due to a decline in household income.

The residential property market outlook is subject to a number of the uncertainties and risks discussed above. On the one hand, the high unemployment rate and the fall in household income will weigh on housing demand. On the other hand, prolonged ultra-low interest rates are expected to provide support for asset prices. Over the longer term, the outlook for the housing market will depend on the supply-demand gap. Actual completions reached 20,900 units in 2020, the second highest in the recent decade, and the Government projects that private housing supply will remain high in the upcoming years.

The non-residential property market remained generally weak. Overall transactions were at a record low for the year as a whole, although transactions picked up in late 2020. Prices and rentals of non-residential properties also remained soft during the second half.

The non-residential property market may continue to face headwinds in the near term, as economic activities will take time to recover even with the new vaccines. In particular, prices and rentals of office space and retail premises may remain under pressure given higher vacancies. Over the longer term, some post-pandemic behavioural changes may have long-lasting effects on the commercial property market. For example, the rise of remote working may reduce demand for office space in the future.

In view of slackening market demand over the past two years, the Government considered it appropriate to abolish the Doubled Ad Valorem Stamp Duty (DSD) for non-residential property as a demand management measure, effective on 26 November 2020. The abolition of DSD could facilitate the selling of non-residential property by companies that are encountering financial difficulties or liquidity needs due to the economic downturn. Earlier in August 2020, the HKMA adjusted countercyclical macroprudential measures on non-residential property, raising the applicable LTV ratio caps for mortgage loans on non-residential property by 10 percentage points. The HKMA will continue to monitor developments closely and introduce appropriate measures in response to changes in the property market cycle to safeguard banking stability.

Banking sector performance

Against the backdrop of the prolonged domestic recession amid the COVID-19 pandemic and low interest rate environment, retail banks' profits declined further in the second half of 2020. Pre-tax operating profits fell by 38.5% in the second half compared with the same period in 2019. The reduction in profits was driven mainly by a significant decrease in net interest income, which more than offset the mild increase in non-interest income. Reflecting these declines, the return on assets fell to 0.62% in the second half of 2020 compared with 1.13% in the same period of 2019.

As the debt repayment ability of corporates and households were adversely affected by the prolonged pandemic, the classified loan ratio of all authorized institutions (AIs) increased modestly, but there were signs of a slower pace of deterioration during the second half of 2020. Asset quality remained sound by historical and international standards.

The robust capital and liquidity positions of the banking sector continue to provide strong buffers for banks to withstand shocks. The consolidated total capital ratio of locally incorporated AIs stood at a high level of 20.7% at the end of the fourth quarter of 2020. On liquidity positions, the average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions were also maintained at the high levels of 155.1% and 57.9% respectively in the last quarter of 2020. In addition, the latest ratios under the Net Stable Funding Ratio requirement stayed at levels well exceeding their statutory minimum requirements.

Liquidity conditions of the Hong Kong banking sector also improved in the review period. As total deposits increased and loans declined, the average all-currency loan-to-deposit ratio of all AIs decreased moderately to 72.3% at the end of 2020 from 76.0% six months ago.

In part reflecting lower demand for credit amid weaker economic activities due to the resurgence of COVID-19 outbreaks, bank credit contracted modestly in the second half, albeit recording a mild expansion for 2020 as a whole. On a half-yearly basis, growth in total loans and advances of all AIs declined by 1.8% in the second half of 2020, after increasing by 3.0% in the first half. The decline was driven by a slight decrease of 0.9% in domestic loans (comprising loans for use in Hong Kong and trade financing) and a 3.9% reduction in loans for use outside Hong Kong during the same period.

Leverage for firms listed in Hong Kong has been rising since the global financial crisis in 2008, driven mainly by non-local corporates listed in Hong Kong, particularly Mainland firms. Box 4 provides a comprehensive assessment which finds that rising investment activities amid the low interest rate environment are a key driver for the rising leverage of Mainland firms listed in Hong Kong. Importantly, compared to local firms, Mainland firms' investment on average is found to be more responsive to productive investment opportunities and their return on equity also improved more in the "low-for-long" interest rate environment.

Looking ahead, although the rollout of vaccines may raise hopes of containing the pandemic and reopening economic activities globally, the pace of economic recovery remains uncertain. This, together with lingering geopolitical risks, will continue to pose challenges to the Hong Kong banking sector. Banks should remain vigilant to the implications of these downside risk factors for asset quality, particularly in view of the weakening ability of corporates and households to repay debt amid the pandemic.

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