1. Summary and overview

The global economy is rebounding from its deep recession, but the recovery has been highly uneven, with major advanced economies (AEs) generally outpacing emerging market economies (EMEs), due mainly to differences in the extent of policy support and vaccine uptake. Such asynchronous global recovery and, by extension, monetary policy could pose risks of a premature tightening in monetary conditions in the EMEs.

The Hong Kong dollar remained in the strong side of the Convertibility Zone and continued to trade in a smooth and orderly manner. With total deposits increasing moderately during the review period, there was no sign of significant outflows from the Hong Kong banking system. Bank credit resumed expansion at a notable pace, while the residential property market has regained some upward momentum since the beginning of the year.

Looking ahead, the pace and strength of economic recovery remain uncertain, hinging on the ongoing pandemic development. This issue, together with uncertainties over the future pace and direction of monetary policy in major economies, lingering China-US geopolitical tensions and their potential impacts on business activities, will continue to pose challenges to the Hong Kong banking sector. Banks should stay vigilant and carefully assess the potential effects of these risk factors on the asset quality of their loan portfolios.

The external environment

During the reporting period, the global economy rebounded more strongly than expected, thanks to sustained policy support, increased vaccination rates and stronger-than-expected pent-up demand. The recovery was, however, highly uneven, with major AEs generally outpacing EMEs due to differences in the extent of policy support and vaccine uptake, the development of the pandemic, as well as structural factors such as the degree of reliance on contact-intensive industries, tourism for example.

Amid the economic reopening, strong pent-up demand and pervasive supply chain bottlenecks unleashed inflationary pressures worldwide, particularly in the US. This raises concerns that, in case US inflation turns out to be more persistent than envisaged, the Federal Reserve (Fed) may tighten monetary policy earlier than expected, resulting in adverse spillover effects to the recovering EMEs. Looking ahead, the global outlook hinges on vaccination progress, future development of the pandemic, and whether policymakers have in place a sound “Pandexit” strategy that can avoid “policy cliffs” while mitigating the adverse side effects of prolonged policy accommodation.

In particular, abundant global liquidity amid the accommodative monetary policies may encourage investors to search for yield, which could undermine financial stability. In fact, there has been rapid growth in risky corporate debt assets, including leveraged loans (LLs) and their securitised products, namely Collateralised Loan Obligations. Box 1 finds that open-ended funds which invest heavily in LLs are subject to high liquidity risk and fire-sale pressure in times of stress, calling for close monitoring and policies to address the vulnerabilities in these funds.

In East Asia[1], the pace of economic recovery was highly uneven in the first half of 2021, reflecting the differences in economic structure and the divergence in vaccination progress across regional economies. Apart from uncertainties arising from the vaccination progress, the region is facing multiple headwinds. First, while the region's recovery has been underpinned by strong demand for its goods exports so far, signs have emerged that the import demand in major economies for goods from the region could soon decelerate. Second, as discussed earlier, the rising US inflationary pressures may carry the risk of a sudden spike in long-term US interest rates that could trigger premature financial tightening in some of the regional economies.

In Mainland China, the economy continued to recover amid a strong rebound in consumption and resilient external demand. That said, the economic recovery remained uneven, as some in-person and small businesses were still affected by prevailing anti-virus measures. In response, the authorities continued to roll out accommodative measures to support sectors that were lagging behind, while also containing potential systemic risks by, for example, limiting the exposure of the banking system to risky borrowers such as highly leveraged property developers.

The first half of 2021 witnessed increased defaults of property developers, in part reflecting their worsening financial positions after years of over-borrowing. Looking forward, the debt sustainability of property developers hinges on the performance of the property market. To monitor property market performance, Box 2 introduces a sentiment index based on a textual analysis of Mainland news reports. The analysis shows that both sentiment and economic fundamentals improved after the containment of COVID-19, contributing to the increase in housing prices in the first half of 2021 (see more details in Box 2).

The domestic economy

Overall economic activities in Hong Kong recovered visibly in the first half of 2021, though a return to pre-recession levels has yet to be achieved. Year on year, real gross domestic product (GDP) grew by over 7% in the first and second quarters. On a sequential basis, real GDP also expanded notably by 5.5% in the first quarter, before moderating somewhat in the second quarter against the high base of comparison. The economic rebound was driven by strong merchandise export performance and improving domestic demand. However, the recovery was uneven as social-distancing requirements and travel restrictions continued to weigh on certain economic segments.

Economic recovery is expected to continue for the rest of 2021. In particular, private consumption is set to strengthen further, thanks to improving labour market conditions, the progress of the vaccinations and a boost from the Government's Consumption Voucher Scheme. Better economic prospects may also stimulate investment spending. Externally, the improved global economic conditions should continue to support Hong Kong's export growth in the near term, but inbound tourism is likely to take time to recover. The Government and private-sector analysts have revised upwards their forecasts of

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

real GDP growth for 2021 to 5.5–6.5% and 6.4% respectively. This positive economic outlook is subject to a number of risks and uncertainties as discussed above, especially those stemming from the pandemic (e.g. the Delta variant), China-US tensions and the Fed's monetary policy outlook.

The labour market saw some improvement in recent months. The seasonally adjusted unemployment rate declined from a recent high of 7.2% in February to 4.7% in August, along with rising vacancies as evidenced by the number of online job advertisements. Looking ahead, pressures on the labour market should ease further with the continued revival in overall economic activities, although some sectors will still face challenges given the uneven recovery.

Local inflationary pressures edged up recently but remained mild. On a year-on-year comparison, the underlying composite consumer price index declined by 0.2% in the first quarter, and increased slightly by 0.3% in the second quarter and 1.2% in August[2]. Inflation momentum, as measured by the annualised three-month-on-three-month underlying inflation rate, also picked up but remained at a moderate level, due in part to limited upward pressure on housing rentals. Looking ahead, while local inflation will likely pick up further in the near term alongside the economic recovery, overall price pressures should stay mild for 2021 as a whole due to the feed-through of earlier consolidation in fresh-letting residential rentals and restrained local labour costs. The Government projects the underlying and headline inflation rates for 2021 to be 1% and 1.6% respectively, while the latest market consensus forecasts the year's headline inflation rate will hit 1.8%.

Monetary conditions and capital flows

Overall, the Hong Kong dollar remained in the strong side of the Convertibility Zone and continued to trade in a smooth and orderly manner. Due partly to weaker buying interest from the southbound Stock Connects, and partly to the repatriation of initial public offering (IPO) proceeds, the Hong Kong dollar softened slightly against the US dollar in March and early April. The Hong Kong dollar then firmed again in the second quarter, due to the resumption of the southbound inflows and corporates' needs to pay dividends. Stepping into July, the Hong Kong dollar saw some softening due to risk-off sentiment in the local equity market. Nevertheless, the robust IPO pipeline provided support to the Hong Kong dollar.

Hong Kong's interbank market continued to trade in a smooth and orderly manner. With ample interbank liquidity, Hong Kong Interbank Offered Rates remained soft during the review period. Because of low funding costs, the average lending rate for new mortgages dropped to 1.48% in July. The Best Lending Rates of major retail banks remained stable at between 5.00% and 5.50%.

With total deposits increasing moderately during the review period, there was no sign of significant outflows from the Hong Kong banking system. Looking ahead, uncertainties related to the Fed's monetary policy, lingering China-US tensions, the pace of economic recovery along with the development of the COVID-19 pandemic, as well as the equity-market activities may heighten volatility in fund flows. Nonetheless, Hong Kong is able to withstand the volatility, given its ample foreign reserves and robust banking system.

The offshore renminbi banking business witnessed steady growth. The offshore renminbi (CNH) liquidity pool expanded further, with the total outstanding amount of renminbi customer

2 The headline inflation rate was 1.2% and 0.8% in the first and second quarters respectively, higher than the underlying inflation rate. This was attributable to the effect of the Government's one-off relief measures, such as a reduction in subsidies for electricity charges.

deposits and certificates of deposit rising to RMB854.7 billion at the end of July. Meanwhile, renminbi lending and renminbi trade settlement continued to pick up, and the average turnover of the renminbi Real Time Gross Settlement system stayed high at RMB1,531.2 billion during the first seven months. Going forward, Hong Kong's offshore renminbi business is expected to benefit from ongoing liberalisation of Mainland's capital account through the multiple Connect schemes, international investors' rising demand for renminbi assets, as well as deepening regional economic and financial cooperation under the Belt and Road and the Guangdong-Hong Kong-Macao Greater Bay Area initiatives.

Asset market

Major equity markets continued to rally, with the MSCI World Index hitting an all-time high of 3,147 points on 30 August, on the back of accommodative monetary policies and stimuli from fiscal measures, significant progress in the pace of COVID-19 vaccination, as well as upbeat corporate earnings in major economies. Hong Kong's equity market, on the other hand, remained subdued due to sharp declines in tech stocks in the HSI constituents and investors' concerns about the potential impact of virus mutations on the recovery of the global economy. Meanwhile, the blockbuster listings of Mainland enterprises propelled Hong Kong's primary market to its strongest-ever first half-year in terms of IPO proceeds.

Supported by steady issuances, both the Hong Kong dollar and CNH debt markets continued to expand in the first half of 2021. The expansion of the CNH debt market was broadly driven by increased issuance by Hong Kong issuers, private Mainland issuers and overseas issuers. Global bond yields rose at the beginning of 2021 on concerns about rising inflationary pressure, and then consolidated in the second quarter due to rising uncertainties about the sustainability of economic recovery in the US and other developed economies. Rising yields in March dampened investor appetite on bonds, triggering a net outflow of bond funds in the month. Bond fund inflows to Hong Kong picked up again in June after two months of consolidation but registered an outflow in July. Overall, the net bond fund inflows to Hong Kong were moderate in the first seven months of 2021.

Looking ahead, both the local equity and debt markets would remain susceptible to various global uncertainties, including the development of the pandemic, especially on how the rapid spread of the Delta variant may affect the sustainability of global economic recovery. Meanwhile, the outlook on inflation and interest rates and the uncertainties about the pace of the Fed's tapering moves in its asset purchases, as well as the ongoing China-US tensions, are likely to affect market sentiment in both the equity and debt markets.

The residential property market has regained some upward momentum since the start of this year, underpinned by better economic prospects, improving market sentiment and mortgage interest rates that are still low. In particular, transactions in the secondary market climbed to a nine-year high in the second quarter. Secondary-market housing prices also resumed growth, rising by 4.3% in January–July to just below the historical peak in May 2019. More recent market data indicated that housing prices climbed further in August.

The residential property market outlook is subject to a number of uncertainties and risks mentioned in the previous sections. On the one hand, renewed deterioration in the pandemic situation (due perhaps to a fifth wave of local infections caused by virus mutations) could weigh on housing market sentiment. On the other hand, the current ultra-low interest rates are expected to support asset prices. Over the longer term, the outlook for the housing market will depend on the supply-demand gap. The

Government projects that private housing supply will remain high in the upcoming years[3].

The non-residential property market saw some signs of recovery along with the revival in economic activities. In particular, transactions and prices generally picked up from low levels seen over the past few years. Box 3 studies developments in the non-residential property market using transactional big data and discusses the implications on financial stability. Looking forward, the performance of the non-residential property market will depend on the pandemic developments, as well as the domestic and external economic environments. In particular, the rising vaccination rate, further relaxation in social-distancing measures, eventual border reopening, as well as continued expansion in domestic consumption and external trade would help the commercial and industrial property markets recover further. That said, the emergence of mutant strains and the uncertainties surrounding the Fed's monetary policy and the China-US relations may cloud the non-residential property market outlook.

Banking sector performance

Despite visible economic recovery in the first half of 2021, retail banks registered thinner profits as their net interest margins narrowed further amid the low interest rate environment. The aggregate pre-tax operating profits of retail banks fell by 19.8% in the first half of 2021, compared with the same period in 2020. The fall in profits was mainly driven by a decrease in net interest income, which more than offset the impact of an increase in non-interest income and a notable decrease in loan impairment charges. As a result, the return on assets fell to 0.69% in the first half of 2021 compared with 0.94% in the same period of 2020.

Notwithstanding the fall in profits, the Hong Kong banking sector remained robust and resilient. In particular, the asset quality of the banking sector was stable in the first half of 2021, with classified loan ratios staying low by both historical and international standards.

Capital and liquidity positions of the banking sector also remained robust, providing strong buffers for banks to withstand shocks. The consolidated total capital ratio of locally incorporated authorized institutions (AIs) stood at a high level of 19.8% at the end of the second quarter of 2021. Regarding the liquidity positions, the average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions also maintained at high levels of 154.0% and 58.1% respectively in the second quarter of 2021. In addition, the latest ratios under the Net Stable Funding Ratio requirement stayed at levels well exceeding their statutory minimum requirements.

Bank credit resumed expansion at a notable pace in the first half of 2021, mainly driven by the improved domestic economic environment, coupled with a tangible increase in IPO-related loans straddled at the end of June. On a half-yearly basis, total loans and advances of all AIs increased markedly by 7.2% in the first half of 2021, after declining by 1.8% in the second half of 2020. Excluding IPO-related loans, total loans and advances expanded by 4.4% during the review period. Loan growth was mainly driven by growth in domestic lending (comprising loans for use in Hong Kong and trade financing), while loans for use outside Hong Kong increased mildly in the review period.

Climate change is one of the major emerging risks to financial stability. For instance, a disorderly transition to a low-carbon economy could have a destabilising effect on the financial system. Box 4, based on a sample of syndicated loans in Asia Pacific, finds that banks in the region have started to price-in climate transition

3 According to Government projections, more than 18,000 private residential flats will be completed on average annually in the 2021–2025 period, higher than the annual average of the previous five years.

risk for loans to emission-intensive sectors since the Paris Agreement, suggesting that banks have begun to incorporate climate risk considerations in their existing risk management framework.

Nevertheless, in view of the highly challenging task in managing climate risks given their distinctive nature and data gaps, banks should keep abreast of the latest developments on climate risk management practices when considering their own risk management approach. In this regard, the HKMA has actively engaged with the banking industry to facilitate AIs' inclusion of climate risk management practices in their operations.

Looking ahead, the pace and strength of economic recovery remain uncertain as it will hinge on how the pandemic unfolds further. This, together with uncertainties over the future pace and direction of monetary policy in the major economies, lingering China-US geopolitical tensions and their potential impacts on business activities, will continue to pose challenges to the Hong Kong banking sector. In view of rising indebtedness in the household and corporate sectors, banks should remain vigilant and carefully assess the potential effects of these risk factors on the asset quality of their loan portfolios.

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