1. Summary and overview

The global economy is on a course of slowing growth and high inflation. Global inflationary pressures continued to build and became more broad-based. As central banks around the world further tightened monetary policy to keep inflation expectations anchored, this is weighing on the global growth outlook, while downside risks to global financial stability have intensified. At the same time, lingering threats of the COVID-19 pandemic and elevated geopolitical risks will continue to cloud the global economic outlook.

The Hong Kong dollar softened during the review period, while continuing to trade in a smooth and orderly manner, and the local monetary environment remained accommodative. With total deposits increasing modestly in the first seven months of 2022, there was no notable sign of outflows from the Hong Kong banking system. Meanwhile, bank credit also recorded modest growth. The residential property market softened recently as market sentiment turned cautious amid rising interest rates.

Looking ahead, heightened economic uncertainties arising from the pace and magnitude of subsequent US interest rate rises, the evolving local epidemic situation and geopolitical risks, could pose challenges to banks' credit risk management. In particular, as the debt repayment abilities of some households and corporates have been weakened since the fifth wave outbreak, banks should carefully assess the potential impacts of sharp rises in interest rates on their loan portfolios.

The external environment

During the review period, global inflationary pressures continued to build and became more broad-based, driven by higher food and energy prices, persistent supply chain bottlenecks and rising wage costs amid tight labour markets. In response, global central banks tightened monetary policy further in a bid to keep inflation expectations anchored, but the rapid tightening of global financial conditions triggered notable financial market corrections and is expected to weigh on the global growth outlook. Accordingly, the International Monetary Fund revised downward its 2022 global growth forecast by 0.4 percentage points to 3.2% in July, compared with 6.1% in 2021. Looking ahead, rising interest rates and slowing growth will likely pose challenges to global debt sustainability and to emerging market economies (EMEs) with weaker fundamentals, heightening downside risks to financial stability.

In emerging Asia, economic recovery continued at a moderated pace in the first half of 2022 amid weakened export growth. Inflationary pressures have also intensified in most economies due to the surge in commodity prices and persistent supply bottlenecks. Many central banks in the

region have tightened their monetary policy accordingly to combat the rising inflationary pressures, but the relatively benign rate hike paths of the region implied narrowing interest rate differentials vis-à-vis the US. This has led to intense bond fund outflows and foreign exchange depreciation in the region, which could, in turn, add debt-servicing difficulties to the heavily indebted firms. Box 1 discusses how US dollar bond funding of emerging Asian corporates would be affected by substantial outflows from open-ended funds in times of tighter financial conditions and the implications for the asset quality of banks' corporate loan portfolios. The possible economic slowdown in Mainland China also clouded the region's economic outlook, especially for those with more reliance on Mainland China for production, exports and final demand.

Amid outbreaks of the Omicron variant, a downturn in property markets and increased global uncertainties, Mainland China's real GDP growth decelerated notably in the second quarter of 2022 following an acceleration in the first quarter. In response, the authorities stepped up policy support to the economy, including through boosting infrastructure investment. While the economy is expected to recover gradually in the second half of the year, there are still strong headwinds from the continuing property market downturn. To facilitate the monitoring of Mainland's economic performance, Box 2 introduces a GDP nowcasting model using both quarterly and monthly macroeconomic indicators. Amid intensified liquidity stress and Omicron outbreaks, defaults by Mainland property developers in the onshore bond market continued to increase in the first half of 2022, although the overall onshore bond default rate still remained low and the risk to the Mainland banking sector remained manageable.

The domestic economy

The Hong Kong economy saw some sequential improvement during the first half of the year, but overall economic activities remained weak compared to a year ago. On a quarter-on-quarter basis, real gross domestic product (GDP) picked up by 1.0% in the second quarter following a broad-based contraction of 2.9% in the first quarter amid the fifth wave of the local epidemic. As the situation stabilised, private consumption and overall investment spending bounced back in the second quarter, driven by improving labour market conditions, recovering business sentiment and various policy support measures. Externally, Hong Kong's merchandise trade performance deteriorated in the first half of the year, due in part to slowing global economic growth, while trade in services continued to stabilise. On a year-on-year comparison, however, real GDP declined by 3.9% in the first quarter, and another 1.3% in the second quarter, mainly reflecting external headwinds.

Looking ahead, Hong Kong's economic outlook will still face considerable challenges. While an improving labour market and the disbursement of Phase II consumption vouchers will support private consumption and hence overall economic recovery, tighter financial conditions could dampen growth. In addition, the worsened global growth prospects may continue to drag on Hong Kong's export performance. Given the worse-than-expected economic performance in the first half of the year, the Government and private-sector analysts have revised downwards their 2022 growth forecasts to -0.5% to 0.5% and 0% respectively. This economic outlook is subject to other risks and uncertainties, including those stemming from the pandemic, the pace of monetary policy normalisation of major central banks and geopolitical concerns (see discussion above).

Following a deterioration in early 2022, the labour market improved in recent months, partly supported by the gradual relaxation of social distancing measures and various policy initiatives, including the 2022 Employment Support Scheme. The seasonally adjusted unemployment rate declined from a recent high of 5.4% in April to 4.1% in August. Total employment and the labour force participation rate have also picked up since June, though still below their pre-pandemic levels. In the near term, pressures on the labour market are likely to ease further alongside a pick-up in local economic activities.

Local inflationary pressures remained moderate, albeit edging up recently. The year-on-year underlying inflation rate was 1.6% and 1.7% in the first and second quarters respectively, and 1.8% in August.[1] Inflation momentum, as measured by the annualised three-month-on-three-month underlying inflation rate, also picked up, but remained mild due in part to soft housing rentals. While external price pressures are expected to remain elevated in the near term, local inflation should stay mild due to soft domestic cost pressures. The Government projections for underlying and headline inflation rates for 2022 are maintained at 2.0% and 2.1% respectively, while the latest market consensus forecast is that the headline inflation rate for the year will hit 2.1%.

Monetary conditions and capital flows

The Hong Kong dollar softened during the review period, driven by increased interest rate carry trade activities amid the widening of the negative HIBOR-LIBOR spreads in the first half of 2022 and the lacklustre performance of the local stock market. The weak-side Convertibility Undertaking (CU) was triggered 31 times from May to August, and the HKMA has purchased a total of HK$213.1 billion (at the end of August) at the request of banks in accordance with the design of the Linked Exchange Rate System. As a result of these purchases, the Aggregate Balance of the banking system declined from HK$337.6 billion at end-February to HK$125.0 billion at end-August.

Despite the triggering of the weak-side CU and increase in HIBORs, Hong Kong's monetary environment remained accommodative during the review period. The average lending rate for new mortgages increased from 1.56% in January 2022 to 2.31% in July 2022, mainly reflecting the increase in HIBOR. After the US Federal Reserve (Fed) hiked its policy rate in September, some banks raised their Best Lending Rates by 12.5 basis points, marking the first increase since 2018. Some banks also increased the cap on HIBOR-based mortgage rates of newly approved mortgage loans in recent months.

Hong Kong's offshore renminbi (CNH) liquidity pool consolidated during the review period, with the total outstanding amount of renminbi customer deposits and certificates of deposit decreasing to RMB919.9 billion at the end of July 2022. On the other hand, other aspects of the offshore renminbi banking business continued to grow. Both the outstanding amount of renminbi loans and renminbi trade settlement continued to expand steadily in the first seven months of 2022. The average daily turnover of the renminbi Real Time Gross Settlement system stayed high at RMB1,669.5 billion during the same period.

Going forward, the enhanced Currency Swap Agreement with the People's Bank of China, as well as the enhancement to the HKMA's renminbi liquidity facility, will further support and deepen Hong Kong's renminbi liquidity pool. The continuous enhancement to the mutual market access schemes with the Mainland (including the recently announced Swap Connect and the two-way Stock, Bond, and

[1] Inclusive of the effects of the Government's relevant one-off relief measures, the year-on-year headline inflation rate was 1.9% in August and 1.5% in both the first and second quarters of 2022.

Cross-boundary Wealth Management Connects), as well as the planned modernisation of the Central Moneymarkets Unit (CMU) into a major international central securities depository (ICSD) in Asia, will provide a convenient and secure channel for overseas investors to trade renminbi assets through a connection between infrastructure institutions in both Hong Kong and the Mainland. With these initiatives, Hong Kong stands ready to capture opportunities brought by the ongoing liberalisation of Mainland's capital account as well as deepening regional economic and financial co-operation under the Belt and Road and the Guangdong-Hong Kong-Macao Greater Bay Area initiatives.

Asset market

Along with the decline in global equity markets, the Hong Kong equity market dropped to a six-year low in March 2022. Major and local equity markets remained volatile throughout the review period amid lingering threats of the pandemic, front-loaded monetary tightening in the US, and impacts of the Russia-Ukraine conflict on the global economy. Overall, the Hang Sang Index dropped by 12.1% from the end of February to the end of August 2022. Despite the heightened volatility in the Hong Kong equity market, buying interest through the southbound Stock Connects stayed relatively stable.

The Hong Kong dollar debt market grew mildly in the first half of 2022. In tandem with the movements in the US 10-year Treasury yield, the yield of the Hong Kong dollar 10-year Government Bond rose to an all-time high in June and remained volatile afterwards. Driven by a surge in the CNH certificate of deposits issuance, the new issuance of CNH debt securities increased by 16.4% year on year in the first half of 2022. At the end of June, total outstanding CNH debt securities in Hong Kong increased by 29.4% compared with a year ago.

Looking ahead, both the local equity and debt markets will remain susceptible to headwinds in the external environment, including lingering geopolitical tensions, concerns over global economic growth slowdown and inflationary pressure, as well as the tightening monetary policies of major central banks. On the other hand, monetary and fiscal policy support to the Mainland economy may help lift market sentiment. To foster the development of Hong Kong's bond market, policy initiatives were introduced during the review period, including the HKMA's three-year enhancement programme plan to develop the CMU into a major international central securities depository in Asia and the expansion of green bond products in Hong Kong.

In the housing market, as the fifth wave of the local epidemic receded, transaction volume picked up in the second quarter on pent-up demand. Flat prices also edged up by 0.2% in the second quarter, after a 3.2% decline in the first quarter. However, the residential property market softened recently as market sentiment turned cautious amid rising interest rates. Housing rentals moderated in the seven months through April, but zigzagged upwards during May–August.

With an uptick in the one-month HIBOR, local mortgage interest rates have picked up since June, and some banks also raised the cap on their HIBOR-based mortgage rates in recent months and their Best Lending Rates in September. However, the public should carefully assess and manage the relevant risks when buying property, arranging mortgages or making other relevant decisions.[2] That said, the macroprudential measures implemented by the HKMA since 2009 have helped contain household leverage and

[2] The HKMA has reminded homebuyers to be aware of property price or interest rate adjustment risks when buying first-hand, incomplete flats via stage payment schemes. In particular, when these buyers arrange mortgage later on, they may face more conservative property valuations or may not pass the stress test amid rising interest rates.

strengthen banks' risk management for mortgage loans, thereby improving their resilience to interest rate and property market shocks. Box 3 explores the use of machine learning techniques to predict credit deterioration in residential mortgage loans (RMLs) in view of the upward pressures on mortgage rates.

The residential property market outlook is subject to a number of uncertainties and risks as discussed previously. In particular, a prolonged local epidemic, coupled with higher mortgage interest rates, could suppress housing demand, while concerns about the global economic prospects and the uncertainty over the pace of US rate hikes will continue to cloud housing market sentiment. 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 coming years.

The non-residential property market consolidated in the first half of the year, partly reflecting a challenging business environment. Along with reduced transactions, the prices of commercial and industrial properties either declined or zigzagged sideways, while rentals were also generally soft. The outlook for the non-residential property market remains challenging in the near term. For example, while the disbursement of the government's consumption vouchers should stimulate local consumption and thereby provide some support to the retail segment, subdued inbound tourism continues to be a drag. The rental and capital values of office spaces may remain under pressure due to the high vacancy rate and more new supply in upcoming years.

Banking sector performance

Against the backdrop of the fifth wave of the local epidemic in the first half of 2022, retail banks' profits declined due to lower non-interest incomes and rises in loan impairment charges. The aggregate pre-tax operating profits of retail banks fell by 19.5% in the first half of 2022, compared with the same period in 2021. Accordingly, the return on assets fell to 0.54% in the first half of 2022 compared with 0.69% in the same period of 2021. Classified loan ratios also slightly increased during the same review period, but remained at a healthy level by both historical and international standards.

Reflecting upward pressure on the Hong Kong dollar interbank interest rates amid the US interest rate hikes, the Hong Kong dollar funding costs of retail banks increased, albeit still staying at an accommodative level.

Nevertheless, the Hong Kong banking sector remained resilient, as underpinned by the robust capital and liquidity positions. The consolidated total capital ratio of locally incorporated authorized institutions (AIs) was high at 19.8% at the end of June 2022, well above the minimum international standard. The average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions were 154.9% and 58.4% respectively in the second quarter of 2022, well above their statutory minimum requirements. Meanwhile, the latest Net Stable Funding Ratio of banks also stayed at levels well exceeding their statutory minimum requirements.

Partly reflecting the adverse impacts of the fifth wave of local infections and the global supply chain disruptions, bank credit growth was sluggish during the first half of 2022. On a half-yearly basis, total loans and advances of all AIs increased by 0.8%, following a mild decline of 0.6% (excluding initial public offering (IPO) loans straddling the end of June 2021) in the second half of 2021. The sluggish growth was due to a moderate decline in loans for use outside Hong Kong during the first half of 2022, which partially offset a modest growth in domestic credit (comprising loans for use in Hong Kong and trade financing) in the same period.

Since the outbreak of COVID-19, the HKMA, together with the banking sector, has introduced various support measures with the aim of maintaining a stable flow of bank credits to support corporates (especially small and medium-sized enterprises (SMEs)) and individuals in need. Box 4 analyses whether, and to what extent, bank lending in Hong Kong has been supported by these measures, with a particular focus on the two major measures: (i) the release of the Countercyclical Capital Buffer (CCyB) and (ii) the SME Financing Guarantee Scheme (SFGS). The findings suggest that not only are these measures effective in supporting lending in times of stress, the complementary roles between measures that are broad-based (e.g. CCyB release) and targeted (e.g. SFGS) can also enhance the overall effectiveness of policy measures.

Looking ahead, heightened economic uncertainties arising from the pace and magnitude of subsequent US interest rate rises, the evolving local epidemic, and geopolitical risks, could pose challenges to banks' credit risk management. Particularly, as the debt repayment abilities of some households and corporates have been weakened since the fifth wave outbreak, banks should carefully assess the potential impacts of sharp rises in interest rates on 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