1. Summary and overview

The global growth prospect is expected to weaken going into 2023. The stubbornly high inflation rate, the likelihood of a significant growth slowdown in the US and the Euro area amid the cumulated monetary tightening since 2022, and the recent emergence of banking stress in the US and Europe are increasing the uncertainty of economic outcomes and hence financial market volatility.

Hong Kong's exchange rate and interbank market continued to trade in a smooth and orderly manner. Following US policy rate hikes, many banks raised their Best Lending Rates. With total deposits increasing modestly in the seven months since end-June 2022, there was no notable sign of outflows from the Hong Kong banking system. Partly reflecting subdued credit demand, bank credit declined modestly during the same period. The residential property market was under pressure in the second half of 2022, before showing some signs of stabilising in early 2023.

Looking ahead, while the relaxation of COVID-19 restrictions should brighten the outlook for the Hong Kong economy, uncertainties related to future US interest rate adjustments, the growth outlook of major advanced economies, and the lingering geopolitical risks, will pose challenges to the banking sector. Banks should stay vigilant against the impacts of these risk factors on the asset quality of their loan portfolios.

The external environment

During the review period, global inflationary pressures eased but major central banks continued to tighten monetary policy as labour markets remained tight. However, the high interest rate environment coupled with the recent emergence of banking stress in the US and Europe with a failure of a few domestic US banks in March, are increasing uncertainties surrounding the economic outlook and financial markets. As upside risks to inflation cannot be ruled out, there is a possibility that major central banks may have to keep rates higher for longer than market expectations, potentially leading to disruptive repricing of asset valuation ahead.

The materialisation of climate risk could also trigger abrupt repricing of related assets. With the promise of financing projects that bring positive environmental benefits, corporate green bond markets have been developed to mitigate climate risk. Box 1 studies whether the issuers have delivered on their promises and the policy implications for fostering a healthier development of corporate green bond markets.

In emerging Asia, economic growth moderated further in the second half of 2022 as exports' growth fell notably along with the global economic slowdown. Inflationary pressures in some regional economies were at high levels due to the global supply disruptions to food and fuel commodities. As regional central banks accelerated monetary tightening to combat inflation, the region's financial vulnerabilities have been increasingly exposed, particularly, the rising downward pressure on housing valuation along with the rate hikes. Given that housing loans account for a significant share of bank loans, further housing market corrections could have repercussions for their banking systems. The rising borrowing costs will also pose liquidity challenges to indebted firms. Some of these firms are also carrying significant foreign currency debt and hence are susceptible to foreign exchange risk. Box 2 examines whether these corporates have hedged well against the risk, and how the development of foreign exchange derivatives markets in financial centres, such as Hong Kong, has been fostering the use of derivative hedge by corporates in the region.

In Mainland China, after rebounding in the third quarter of 2022, economic growth moderated in the fourth quarter amid COVID-19 outbreaks and weak property market conditions. Looking ahead, Mainland economic growth is likely to accelerate in 2023 on the back of the recovery in private consumption following the easing of COVID-19 restrictions. That said, uncertainties surrounding the near-term growth outlook remain high, depending on how the COVID-19 situation evolves and when the property market stabilises (Box 3 discusses the impacts of the real estate sector on other segments of the economy). To support the economy, the government called for shoring up business confidence by pushing forward structural reforms, such as treating state-owned enterprises (SOEs) and private-owned enterprises (POEs) equally, and boosting domestic demand, especially consumption, through more forceful supportive measures.

The domestic economy

Hong Kong's economy contracted visibly further by over 4% year on year in the second half of 2022. The economic contraction mainly reflected sizeable declines in merchandise exports and aggregate investment along with a weaker global economy and tightened financial conditions. Private consumption was supportive to growth, and exports of services improved slightly following the relaxation of the compulsory quarantine requirements for overseas visitors since late September 2022. For 2022 as a whole, real gross domestic product (GDP) fell by 3.5%, contrasting with the 6.4% growth in 2021.

Riding on the reopening of Mainland China and Hong Kong, economic growth for 2023 is expected to recover from a low base. While the anticipated weaker growth of the advanced economies will continue to weigh on Hong Kong's exports of goods, a recovery in the Mainland's economy and the lifting of restrictions on cross-boundary land transportation with Mainland China could provide some support. The reopening of Mainland China and Hong Kong should also greatly benefit Hong Kong's inbound tourism and other exports of services, as well as local business sentiment and capital spending. Box 4 discusses the recent revival of visitor arrivals into Hong Kong, and provides evidence that the delayed reopening of Hong Kong relative to other regional economies is expected to have only a limited and transitory impact on inbound tourism, with negligible scarring effect. Private consumption will also improve further along with a stronger labour market. The Government forecasts real GDP growth for the whole of 2023 in the range of 3.5% to 5.5%, and the growth estimates by private-sector analysts average 3.7%. However, the growth outlook is fraught with risks and uncertainties, especially those relating to the US Federal Reserve (Fed)'s policy rate path, global growth prospects, lingering geopolitical tensions and the recovery pace of Hong Kong's inbound tourism (see also discussion above).

Local labour market conditions continued to improve in recent months, with the unemployment rate declining to 3.3% in February 2023. Total employment also rebounded from a recent low in May 2022, albeit still below its pre-pandemic level. Looking ahead, the labour market is likely to improve further as local economic activities return to normal.

On the price front, the underlying inflation rate remained moderate at 1.8% in both the third and fourth quarters of 2022, and 2.1% in January and February 2023 combined.[1] In the near term, local inflation is expected to edge up, but should stay mild reflecting offsetting forces. While external prices should remain elevated, their upward momentum will likely moderate further alongside weaker economic activities in some major economies and easing upward pressures on commodity prices. Domestic cost pressures may edge up alongside the recovery in the economy and the labour market, but the soft housing rentals should provide some offset. The Government projection of underlying and headline inflation rates for 2023 is at 2.5% and 2.9% respectively, and the latest market consensus forecasts the headline inflation rate for 2023 to be 2.4%.

Monetary conditions and capital flows

The Hong Kong dollar stayed close to the weak-side Convertibility Undertaking (CU) from September to early November 2022, driven by the correction of the local stock market, market expectation of further US interest rate hikes, and continued carry trade activities. It regained some strength from mid-November to the end of 2022, amid stronger local equity market activities and year-end funding demand. Moving into 2023, the Hong Kong dollar exchange rate softened to close to the weak-side CU again as the seasonal demand faded. From the first weak-side CU triggering in May 2022 to February 2023, the weak-side CU was triggered 43 times in total, and the HKMA purchased a total of HK$261.2 billion at the request of banks in accordance with the design of the Linked Exchange Rate System (LERS).

Overall, Hong Kong's interbank market continued to trade in a smooth and orderly manner. The Hong Kong Interbank Offered Rate (HIBOR) gradually increased from September to December 2022 alongside US rate hikes, and receded in the beginning of 2023 as the seasonal demand for Hong Kong dollar funding faded. On the retail front, following US policy rate hikes, many banks raised their Best Lending Rates three times or by 62.5 basis points in total from September to December 2022. Some major banks further increased the cap on HIBOR-based mortgage rates of newly approved mortgage loans in late November and December 2022. Accordingly, the average lending rate for new mortgages increased from 2.31% in July 2022 to 3.50% in January 2023.

Hong Kong's offshore renminbi (CNH) liquidity pool expanded during the review period, with the total outstanding amount of renminbi customer deposits and certificates of deposit increasing to RMB985.6 billion at the end of January 2023. Both the outstanding amount of renminbi loans and renminbi trade settlement continued to grow steadily. The average daily turnover of the renminbi Real Time Gross Settlement system stayed high at RMB1,654.0 billion in 2022.

Looking ahead, the continuing development of Hong Kong's offshore renminbi ecosystem will further reinforce its leading role in offshore renminbi business. The enhanced Currency

[1] Inclusive of the effects of the Government's relevant one-off relief measures, the year-on-year headline inflation rate was 2.7% and 1.8% in the third and fourth quarters of 2022, and 2.1% in January and February 2023 combined.

Swap Agreement with the People's Bank of China (PBoC), as well as the enhancements to the HKMA's renminbi liquidity facility, will further support and deepen Hong Kong's renminbi liquidity pool. At the same time, the continuous efforts in strengthening connectivity with the Mainland through various schemes, including the Swap Connect, the two-way Stock, Bond, and Cross-boundary Wealth Management Connects will provide a more diverse range of renminbi-denominated products in Hong Kong. In relation to financial infrastructure, the planned upgrading of the Central Moneymarkets Unit (CMU) into a major international central securities depository (ICSD) in Asia will also add to a robust and secure channel for overseas investors to efficiently trade renminbi assets. With these initiatives, Hong Kong will be in a position to capture further opportunities brought by the continuing liberalisation of Mainland's capital account and the deepening regional economic and financial co-operation under the Belt and Road and the Guangdong-Hong Kong-Macao Greater Bay Area initiatives.

Asset market

Amid monetary tightening by major central banks, global equity prices underwent a sharp correction in September and October 2022. The weak market sentiment pushed the Hang Seng Index to a thirteen and a half-year low of 14,687 points on 31 October. The local equity market rebounded afterwards, led by the prospects of a slowdown in US interest rate hikes and re-opening of the Mainland and Hong Kong economies, before declining in February 2023. Overall, the Hang Sang Index declined slightly by 0.8% from the end of August 2022 to the end of February 2023.

Along with the monetary tightening in the US, yields of US 10-year Treasury and Hong Kong dollar 10-year Government Bond surged and reached the peak in late October 2022. The yields eased afterwards, before going up in February 2023. Despite the rising interest rates, the Hong Kong debt market continued to grow in 2022.

The near-term outlook of the local equity market would be clouded by risks of higher for longer interest rates and significant growth slowdown in advanced economies, as well as escalating geopolitical tensions such as the Russia-Ukraine conflict, while the rapid re-opening of the Mainland economy may help boost the prospects of the Hong Kong equity market. For the local debt market, policy supports to the Mainland economy could help lift the demand for CNH debt securities.

During the review period, the local debt market continued to attract Mainland entities to issue offshore renminbi bonds. This, together with the successful offering by the Hong Kong Government of green bonds worth US$5.75 billion and the inaugural tokenised green bond of HK$800 million, strengthened Hong Kong's status as a global offshore renminbi centre, and a premier green and sustainable finance hub in Asia.

Amid tightened financial conditions and weak economic activities, the residential property market was under pressure in the second half of 2022, with moderating trading activities, more selling price cuts and a softening in transacted prices. For 2022 as a whole, the total transaction volume dropped to a record-low of 45,050 units, down 39% from 2021, while housing prices recorded an orderly adjustment of 15%. In early 2023, the housing market showed signs of stabilisation as market sentiment revived alongside the resumption of travel between Mainland China and Hong Kong.

Following the US Fed's successive policy rate hikes, major banks have raised their effective mortgage interest rates, putting an additional burden on borrowers' mortgage repayments. The estimated number of residential mortgage loans (RMLs) in negative equity increased to 12,164 cases at end-December 2022 as housing prices softened. These cases were related to bank staff housing loans or RMLs under the Mortgage Insurance Programme (MIP), which generally have a higher loan-to-value (LTV) ratio. It should be noted that the MIP has strict requirements on the applicant's repayment ability. In fact, the delinquency ratio of RMLs under the MIP was 0.01% at end-December 2022, which is even lower than the 0.06% delinquency ratio of RMLs for the whole banking sector, suggesting that the loan quality under the MIP is very high. Looking ahead, the continued recovery of the labour market is expected to help households meet their mortgage obligation and thus contain any upward pressures on the delinquency ratio of the RML. As such, the risks relating to banks' RMLs are considered to be manageable.

More broadly, the macro-prudential measures introduced by the HKMA since 2009 have helped contain household leverage and strengthen banks' risk management for mortgage loans, thereby improving their resilience to interest rate and property market shocks. However, the public should be prepared for the likelihood that banks' lending rates may increase further, and should carefully assess and manage the relevant risks when making property purchases and mortgage decisions.

The residential property market outlook is subject to a number of uncertainties and risks as discussed previously. In particular, higher mortgage interest rates and greater short-term private housing supply may continue to cloud the housing market outlook, while the normalisation of cross-boundary travel between Mainland China and Hong Kong may release pent-up demand and revitalise 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 turned more sluggish in the second half of 2022. Along with reduced transactions, the prices of commercial and industrial properties retreated, while rentals generally stayed soft. The outlook for the non-residential property market will hinge on a number of offsetting factors. For instance, the reopening of Mainland China and Hong Kong is expected to drive the recovery of inbound tourism and therefore provide some support to the retail segment. On the other hand, the prevailing high vacancy rate, coupled with additional new supply in the near term, may continue to weigh on the rental and capital values of commercial properties.

Banking sector performance

Against the rising interest rate environment, retail banks' profit improved notably in the second half of 2022 as increases in net-interest income and income from foreign exchange and derivatives more than offset an increase in bad debt provisions and a decline in income from fees and commissions. The aggregate pre-tax operating profit of retail banks rose by 74.0% in the second half of 2022 compared with the same period in 2021. Accordingly, the return on assets rose to 0.80% in the second half of 2022 compared with 0.48% in the same period last year.

Partly reflecting the subdued credit demand amid higher borrowing costs and soft economic activities, total loans and advances of all authorized institutions (AIs) declined modestly by 3.8% in the second half of 2022. The decline was driven by a contraction of both domestic credit (comprising loans for use in Hong Kong and trade financing) and loans for use outside

Hong Kong during the review period. Meanwhile, classified loan ratios of all AIs increased in the second half of 2022, but remained at a healthy level.

Overall, the Hong Kong banking sector remained resilient, underpinned by sound and robust capital and liquidity positions. The consolidated total capital ratio of locally incorporated AIs stood high at 20.1% at the end of 2022, well above the minimum international standards. The average Liquidity Coverage Ratio of category 1 institutions and the average Liquidity Maintenance Ratio of category 2 institutions were 162.3% and 63.2% respectively in the fourth quarter of 2022, well above their statutory minimum requirements. The latest Net Stable Funding Ratio of banks also stayed at levels well exceeding their statutory minimum requirements.

Looking ahead, while the relaxation of COVID-19 restrictions should brighten the outlook for the Hong Kong economy, uncertainties related to future US interest rate adjustments, the growth outlook of major advanced economies, and the lingering geopolitical risks, will pose challenges to the banking sector. Banks should stay vigilant against the impacts 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.