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Economic Watch

Asia

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Economic Analysis

Asia

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Hong Kong: Financial resilience

Summary

- In recent years Hong Kong has maintained its roles as a regional business hub and leading international financial centre, despite stiff competition from Singapore and Shanghai. This success can be attributed to strong service sector competitiveness, in finance, business and tourism.
- Moreover, with support from China, Hong Kong has established itself as the world's main offshore RMB centre. Though slowing at present, RMB deposits and related business in Hong Kong have grown rapidly in the past year. More generally, the economy stands to benefit from its increasing integration with China.
- The near-term challenge on the macro front is to navigate the increasingly difficult external environment on which Hong Kong depends heavily for trade and finance. After registering GDP growth of 7.0% in 2010, momentum is now slowing due to lower exports from weaker external demand. We expect full-year GDP growth to register 4.8% in 2011, with the outlook for 2012 clouded by uncertain external prospects.
- Given its peg to the US dollar, Hong Kong has little scope for independent monetary policy, leaving only fiscal policy to smooth economic cycles. Consequently, macro-prudential measures have played a prominent role in slowing lending growth and containing risks of asset prices bubbles, especially in the property market.
- Questions raised earlier in the year about the sustainability of Hong Kong's "linked exchange rate system" to the US dollar have diminished with receding appreciation pressures. However, such questions could eventually re-emerge given the rising international prominence of the RMB. The authorities have repeatedly expressed their commitment to the current framework and, lacking better alternatives at present, any changes in the near term appear unlikely, all the more so given external risks.
- The authorities have been monitoring risks from rapid credit growth over the past year due to mortgage lending and loans extended to mainland companies trying to circumvent tighter credit conditions in China. Credit growth is now slowing, helping to ease concerns of a deterioration of loan quality. Meanwhile, macro-prudential measures have helped to contain, though not yet eliminate, risks of a property bubble.
- Hong Kong is exposed to potential spillovers from the European debt crisis. Deleveraging in Europe could lead to a withdrawal of capital and tighter liquidity conditions. The authorities have conducted stress tests to gauge the risks to financial stability, which appear manageable in view of strong capital adequacy and liquidity ratios. Indeed, Hong Kong continues to enjoy high sovereign ratings, with S&P holding a AAA rating, and Fitch and Moody's reaffirming their ratings at one notch below (AA+).

Background

Hong Kong transitioned rapidly in the 1980s from an export-oriented manufacturing center to a service-based economy, placing it today as one of the world's leading international financial centers and a hub for business activity in Asia. Multinational corporations have been attracted by a business-friendly environment, characterized by low taxation, free trade, minimum government intervention, and a mature legal system, all of which place Hong Kong as second in the World Bank's ease of doing business survey of 183 economies, just behind Singapore.

- The economy's strengths are in financial services, tourism, trade and logistics, and professional services, which together account for around 60% of GDP. As part of its longer-term strategy to foster growth prospects and integration with China, the government is promoting six other services industries: medical, environmental, testing and certification, education, innovation and technology, and cultural and creative.
- Hong Kong has maintained a "linked exchange rate system" to the USD since 1983. The currency is allowed to fluctuate within a tight band of 7.75-7.85 HKD/USD. Currency appreciation pressures—seen in a buildup of international reserves, rising inflation, and the HKD trading toward the stronger end of the band for much of the past year—have led to doubts among some market participants about the sustainability of the current exchange rate regime. However, appreciation pressures have receded, and lacking better alternatives at present—it is not clear that a shift to a basket would be an improvement, and a peg to the (non-convertible) RMB is not yet feasible—we do not foresee any changes in the next few years. Moreover, the authorities have repeatedly expressed their commitment to the framework, which has also been endorsed by the IMF. Over the medium term, however, the Hong Kong Monetary Authority (HKMA, the de facto central bank and banking regulator) may eventually shift the peg to a broader basket of currencies (including the RMB).
- China's "one country, two systems" formula enables Hong Kong to maintain a high degree of political and economic autonomy, while benefitting from increasing economic integration with the Mainland. As part of its efforts to foster long-term growth, the Chinese authorities are actively promoting Hong Kong as the main offshore RMB and international asset centre.
- In March 2012, a new chief executive of Hong Kong will be elected to take place of the incumbent Mr Donald Tsang. Two candidates are in the running: Mr. Henry Tang, who recently resigned as the city's Chief Secretary for Administration, the second-highest government job; and Mr. Leung Chun-ying, a former top member of the cabinet of the current administration. Importantly, both candidates are perceived as having good relations with Beijing, which should contribute to a cooperative policy environment and further economic integration.

Economic developments and outlook

As a free trade hub and an international financial centre, Hong Kong's economy is particularly exposed to variations in global growth trends. GDP growth has been moderating since the second quarter of the year amidst the escalation of the European debt crisis, economic slowdown in US, and moderating momentum in China. Until now, Hong Kong's growth moderation has been healthy by helping to ease overheating pressures. The slowdown, together with the implementation of various macro-prudential measures over the past year, has helped ease inflationary pressures and contain rising property prices, both of which have been key policy challenges for the past two years.

- After stronger-than-expected GDP growth in the first quarter of 2011, growth momentum has slowed since Q2 due to slowing exports on weaker external demand. Growth contracted by -0.4% q/q, seasonally adjusted (non-annualized) in the second quarter, and narrowly avoided a technical recession by expanding by 0.1% q/q in the third quarter. Nevertheless, domestic demand has been resilient, especially private consumption and retail sales, buoyed by low unemployment and strong tourism inflows. This has helped offset weakening external demand.

Table 1
Hong Kong economic outlook (Baseline scenario)

	2008	2009	2010	2011F	2012F
Real GDP growth (YoY%)	2.3	-2.7	7.0	4.8	3.9
Private consumption (YoY%)	2.4	0.7	6.2	7.9	5.0
Public consumption (YoY%)	1.8	2.3	2.7	2.2	2.1
Investment (YoY%)	1.0	-3.9	7.8	6.0	10.4
Inflation (YoY%, avg)	4.3	0.5	2.4	5.3	4.5
Foreign exchange rate (HKD/USD, eop)	7.75	7.75	7.75	7.80	7.80
Policy rate (%, eop)	0.50	0.50	0.50	0.50	0.50
Fiscal balance (% of GDP)	0.2	0.8	4.1	0.1	3.0
Current account (% of GDP)	13.7	8.6	6.2	6.0	7.0

Source: BBVA Research

- Inflation has been a major policy concern. Though pressures are now easing, headline inflation remains high in year-on-year terms, at 5.7% as of November, due to rising food prices and high housing costs (rents alone have a weight of almost 30% in Hong Kong's CPI basket). Contributing to inflation trends has been a strong labour market and upward wage pressures--the unemployment rate has been relatively stable in recent months at 3.4%, well below the long-term average of 4.5%. Importantly, the pegged exchange rate system contributes to high inflation during periods of appreciation pressures.

- Under the baseline scenario published in our Asia Outlook in early November, we project full-year GDP growth of 4.8% in 2011 and 3.9% in 2012. However, there is considerable downside risk to the projection for 2012 given Hong Kong's exposure to global growth and developments in China. Under a scenario of persisting financial strains in Europe and slower global growth, Hong's Kong's GDP could easily contract, by 2-3%. (GDP growth was -2.7% in 2009).

- Property prices have been moderating in recent months, after a rapid rise beginning in 2009 that brought prices to above their previous historic peaks of 1997. In addition to creating financial stability risks, the housing bubble has become a social concern by stretching affordability ratios. In response, a series of macro-prudential measures were implemented which, together with the dimming growth outlook and falling financial asset prices have worked to slow the appreciation momentum in the property market. Key measures to cool the market include imposition of higher down payment requirements and stamp duties on speculative transactions (reselling within two years). The authorities have also stepped efforts to increase land supply and a resumption of the Housing Ownership Scheme (HOS) for low and middle-income families, along with plans to construct more than 17,000 low-income flats over four years from 2016/17 onwards.

- Public finances are sound, enabling the government to implement fiscal stimulus measures if needed. The fiscal outturn for 2011 is likely to register a significant surplus, once again outperforming the budget targets.

- Hong Kong's position as the main offshore RMB centre has been strengthened through additional support initiatives from China designed to enhance the usefulness of holding offshore RMB (a key limitation to faster RMB internationalization has been the limited range of permissible activities for using RMB, especially in remitting RMB proceeds back to China). In July 2011 steps were announced to allow foreign enterprises in Hong Kong to remit offshore RMB to the Mainland in the form of FDI on a more regular basis, and to invest in Mainland securities on a limited basis. The authorities also recently approved the pilot program of R-QFII, allowing offshore RMB to be invested in China's domestic stock market subject to a quota of RMB 20 billion. At the same time, the bilateral swap arrangement between the PBoC and HKMA was doubled to RMB 400 billion ($56.6 billion), which should reduce the risk of insufficient RMB liquidity, and ensure a smooth functioning of the offshore RMB market.

- In the meantime, RMB deposits in Hong Kong, an often-used measure of the pace of RMB internationalization, have increased by 135% year-over-year, to 10% of total deposits. However, given reduced appreciation expectations, such deposits began declining in October on a month-on-month basis, revealing headwinds to the further growth of the market. Indeed, for a time, the offshore rate (CNH) became more depreciated than the onshore (CNY) rate, as investors' sought to sell RMB assets amidst lower appreciation expectations and an increasingly uncertain global outlook.
- More generally, Hong Kong stands to benefit from increasing integration with China. China's 12th five-year development plan (2011-2015) elaborates on strategies for fostering Hong Kong's future development. Hong Kong is targeted to become an overseas service centre, with positive spillovers to the development of China's own service sector, and a premier offshore RMB business centre. Hong Kong and China are working to expand an existing "Close Economic Partnership Arrangement" (CEPA), which further opens China's service sector to Hong Kong incorporated enterprises.

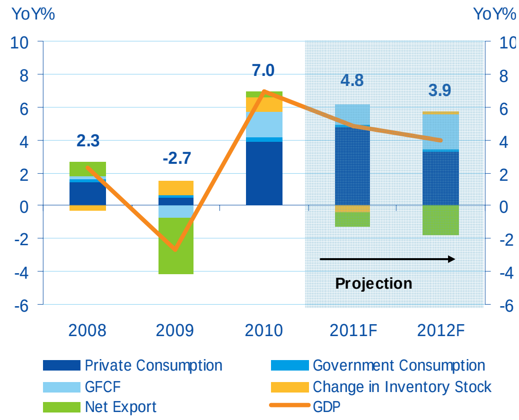
Banking prospects

Hong Kong's banking sector is well capitalized and continues to post strong profitability. That said, recent rapid credit growth, uncertain external prospects, and the rise of RMB deposits have created challenges to liquidity in the system.

- The banking sector registered high profit growth through the first half of the year, at 22.4% y/y. The results were due to rapid credit growth, as net interest margins narrowed. As elsewhere, slowing economic activity and less favourable financing conditions are likely to weigh on the profit outlook for the second half of the year and into 2012.
- Overall loan growth registered 21.9% y/y in October, down from a peak of 30.9% in March. In the meantime, the component of offshore loans rose by 47.5% y/y, mainly due to loan growth to Mainland companies in China. The HKMA has expressed concern about prospects for deteriorating credit quality, especially due to a possible overextension of loans to Mainland companies as growth and the property sector there slow down.
- Rapid credit growth has also led to tighter liquidity conditions, and the average loan-to-deposit ratio for HKD denominated loans rose to 86.6% in September from 77.6% a year ago. Nevertheless, the ratio is still within a healthy range.
- In addition to rapid credit growth, spillovers from the European debt crisis could create liquidity pressures in the banking system. According to BIS data, about one-third of Hong Kong bank liabilities are from European countries, so that deleveraging in Europe could lead to large capital outflows and funding pressures.
- Recognizing these risks, the HKMA ordered banks to conduct stress tests last May under a scenario of large-scale capital outflows. The stress tests, as well as other macro-prudential measures including imposition of lower loan-to-value ratio requirements on mortgage loans, encouraging banks to increase reserve buffers, and strengthening the monitoring of cross-board RMB trade finance should enhance banks' capacity to manage these risks.
- Hong Kong should be able to weather outflows from deterioration in external conditions, as it did during the 2008-2009 global financial crisis. In particular, no banks at that time required government assistance, although profitability was undermined due to losses on overseas investments. Given the low asset exposure to Europe (less than one percent, and Hong Kong's traditional status as a safe haven, we believe the banking system should remain resilient.

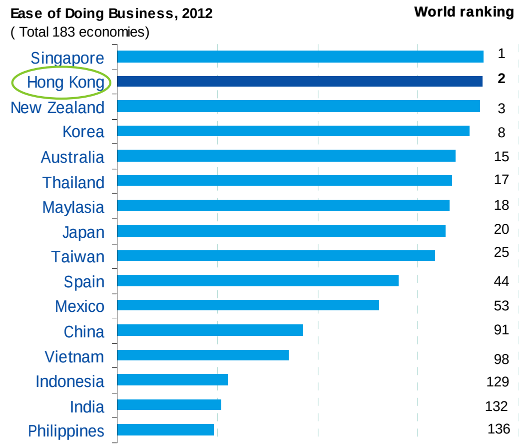
Figure 1: Recent economic developments

Contribution to GDP growth



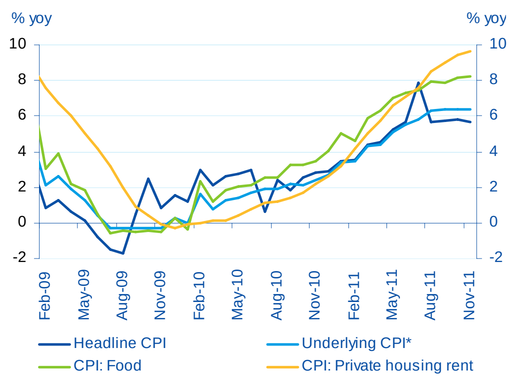
Source: CEIC and BBVA Research

Excellent business environment



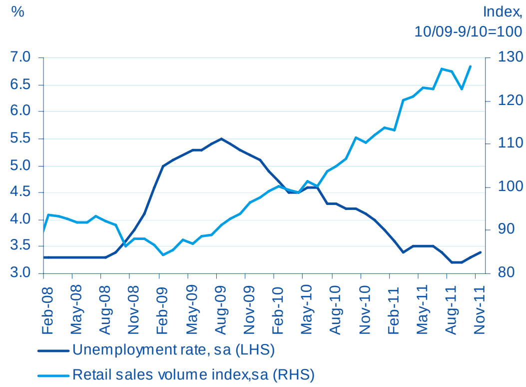
Source: World Bank (EDB2012) and BBVA Research

Inflation has picked up



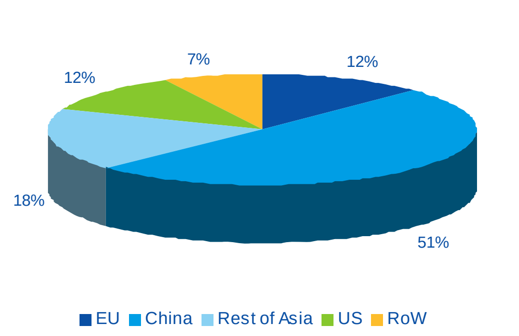
Source: CEIC and BBVA Research
* Netting out Effect of Government One-off Relief Measure

Unemployment rate remains low



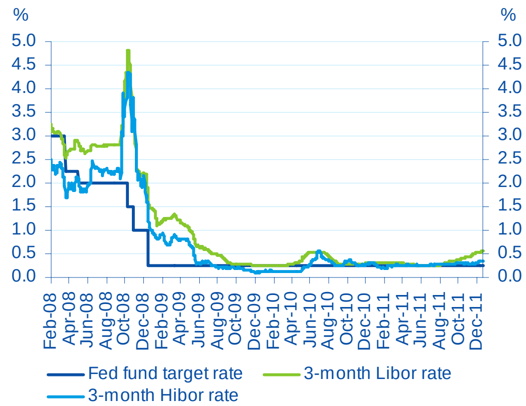
Source: CEIC and BBVA Research

Asia: Hong Kong's major export markets



Source: CEIC and BBVA Research

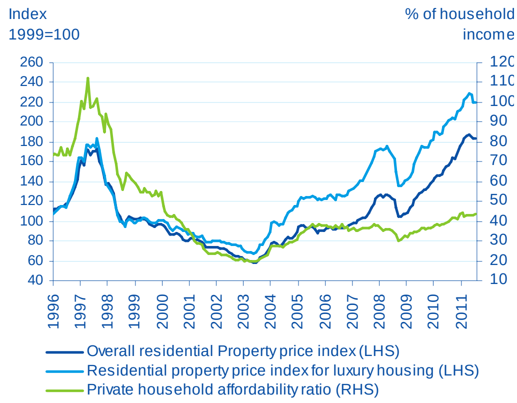
Low interest rate policy imported from the US



Source: Bloomberg and BBVA Research

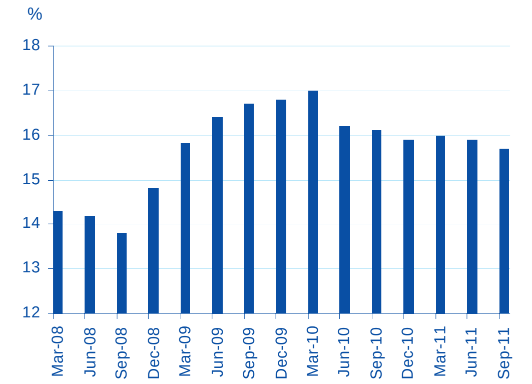
Figure 2: Banking prospects

Property prices have begun to moderate



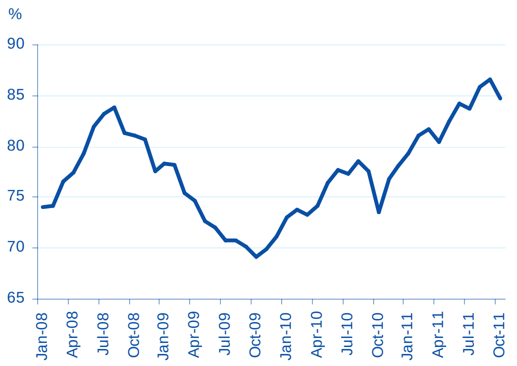
Source: CEIC and BBVA Research

Banks are well capitalized (CARs)



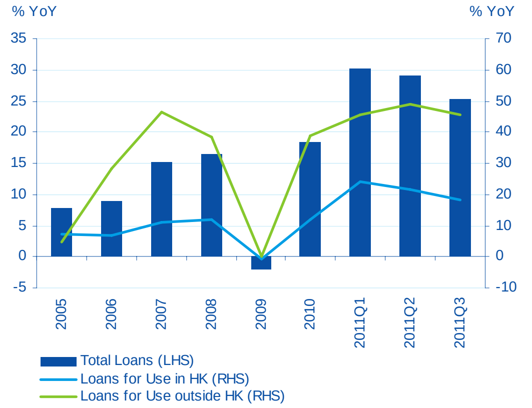
Source: CEIC and BBVA Research

Loan-to-Deposit ratio have risen...



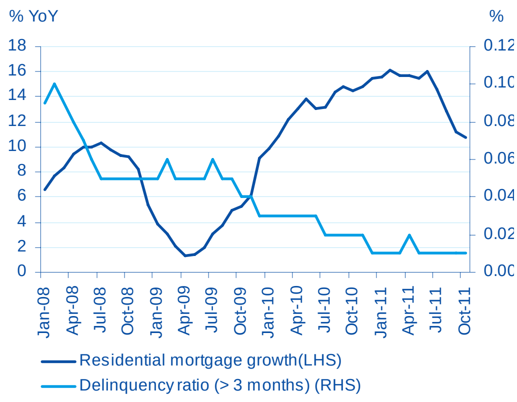
Source: CEIC and BBVA Research

...Credit growth remains high in 2011



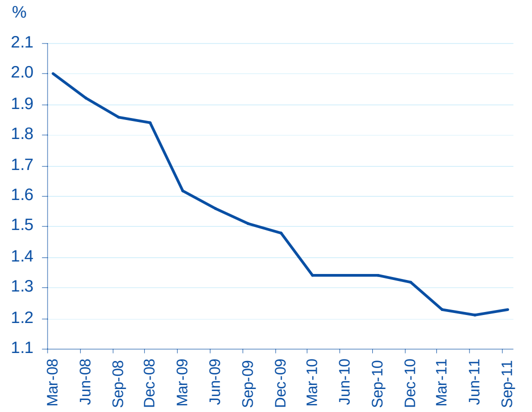
Source: CEIC and BBVA Research

Rapid mortgage loan growth is slowing



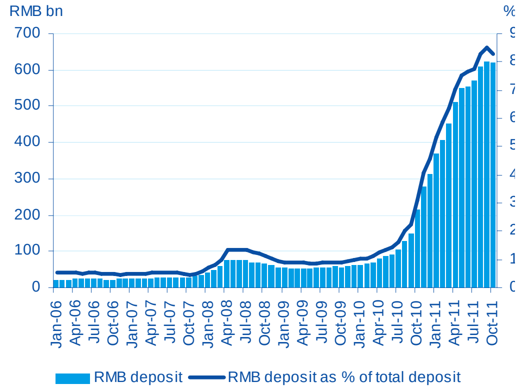
Source: CEIC and BBVA Research

NIMs in the banking sector are low



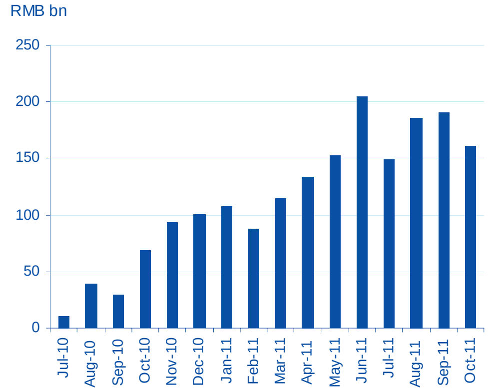
Source: CEIC and BBVA Research

Off shore RMB deposits in HK have grown



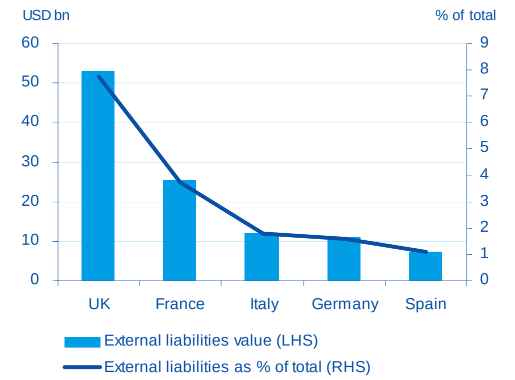
Source: CEIC and BBVA Research

But RMB trade settlement volumes are flat



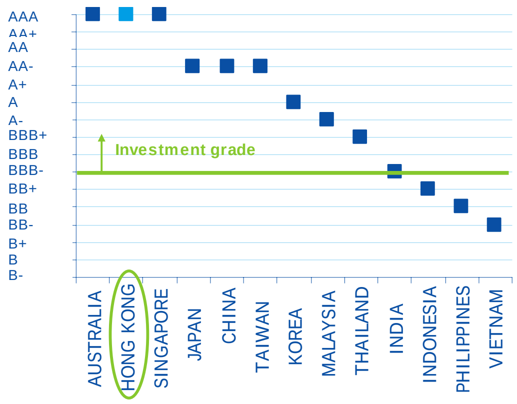
Source: CEIC and BBVA Research

Exposure to EU credit (as of 2011H1)



Source: HKMA and BBVA Research

Hong Kong holds S&P's top sovereign rating



Source: S&P rating
Hong Kong: Moody's AA1, Fitch AA+

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