REGULAR ARTICLE

Domestic and External Environment

by the Research Department

There were growing signs of a global recovery in the second quarter. Consumption and production activities increased in the US and Japan, and business sentiment improved in the euro area. In non-Japan Asia, while the outbreak of severe acute respiratory syndrome (SARS) had a negative impact on tourism and the retail sector, the regional economy was starting to recover as concerns about the disease receded. In Hong Kong, real GDP contracted in the second quarter. Nevertheless, the latest statistics point to a gradual recovery in economic activity.

External Environment

In the US, real GDP growth accelerated to an annualised rate of 3.1% in the second quarter from 1.4% in the first. Major components of domestic demand, including personal consumption and capital spending, increased significantly. While the growth figure was partly boosted by a substantial rise in defence expenses, recent economic reports pointed to a gradual revival in general economic activity. The unemployment rate fell from 6.4% to 6.2% in July. Given the recent rally in stock prices and improving labour market conditions, consumer confidence rose in July with a considerable increase in retail sales. On the supply side, although industrial production contracted by 0.9% in the second quarter, July's ISM manufacturing index increased to 51.8, indicating that the manufacturing sector was expanding. Rising productivity and supply capacity continued to contain inflationary pressures with the headline CPI rising by 0.2% month-on-month in July.

In the euro area, preliminary GDP estimates suggested that the economy remained sluggish. Real GDP was flat in the second quarter after growing marginally in the first. The stagnant labour market continued to weigh on household spending, while industrial production contracted in May, partly as a result of the strengthening euro. Nevertheless, there were signs of bottoming in Germany. Retail sales rose by 1.2% month-on-month in June, while the contraction in industrial production narrowed. In addition, the IFO and ZEW surveys indicated that the business climate and economic sentiment improved in July. In the UK, real GDP growth accelerated to 0.3% from 0.1% in the first quarter, with increases in retail sales as well as industrial production.

In Japan, real GDP grew by 0.6% in the second quarter after rising by 0.3% in the first, mainly due to increases in private consumption and capital spending. Although industrial production and retail sales fell moderately month-on-month in June, the latest statistics indicated that the economic environment was improving. In particular, the Tankan survey showed that large manufacturing firms were more optimistic towards future business prospects. However, the high jobless rate may continue to weigh on household spending going forward.

Elsewhere in Asia, output growth decelerated, reflecting the negative impact of the SARS outbreak. In particular, China's real GDP growth slowed to 6.7% year-on-year in the second quarter from 9.9% in the first, largely due to the subdued performance of the services sector. In Singapore, real GDP contracted at an annualised rate of 11.4% in the second quarter. As the concerns over the epidemic gradually faded, there were growing signs of recovery in tourism and the retail sector, while manufacturing and export activities remained robust in the region.

With a dissipating risk of inflation and uncertainty in the strength of the recovery, major central banks eased monetary policy. The Federal Reserve reduced the Fed funds target rate by 25 basis points to 1% at June's FOMC meeting, while the European Central Bank lowered the refinancing rate by 50 basis points to 2% in early June. In July, the Bank of England and the Bank of Canada cut their policy interest rates by 25 basis points to 3.5% and 3% respectively. In Asia, central banks lowered interest rates by varying degrees to alleviate the negative effects of SARS on their economies. In particular, central banks in Malaysia and Thailand cut their policy rates by 50 basis points. In early July, the Monetary Authority of Singapore reduced the midpoint of the nominal effective exchange rate target band of the Singaporean dollar, representing an easing in monetary conditions.

The recent release of favourable economic reports led to market expectations of a stronger recovery in the US, driving up stock prices in major equity markets. The S&P500 index gained 7% in the three months from mid-May to mid-August, while major markets in Europe also advanced. In particular, the German DAX index and the French CAC index rose by 20% and 11% respectively during the same period. Meanwhile, stock markets in Asia rebounded strongly after the containment of SARS, with the NIKKEI 225 index and the MSCI Asia Free ex-Japan index rising by 24% and 22% respectively.

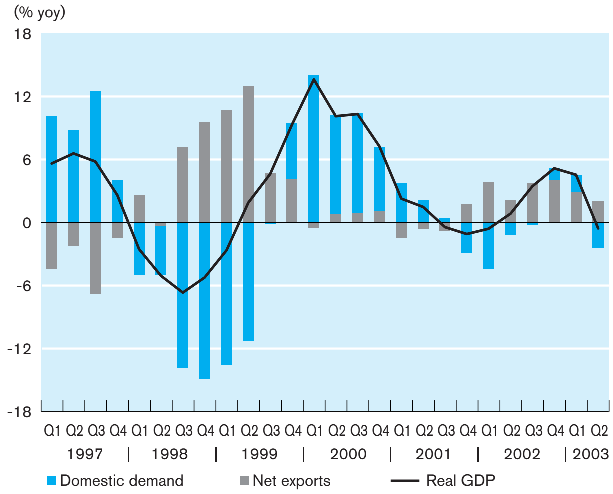
In the currency market, the US dollar strengthened against other major currencies, partly reflecting the better-than-expected growth prospects of the economy. The US dollar appreciated by 7% against the Euro to 1.11 from end-May to mid-August and by 2% against the Yen to 120. Nonetheless, major floating Asian currencies had mixed performances against the US dollar. While the currencies of Indonesia, the Philippines and Singapore weakened against the dollar, those of Korea, Taiwan and Thailand strengthened.

Domestic Activity

In Hong Kong, economic activity slowed in the second quarter, beset by the adverse impact of SARS. Real GDP contracted by 0.5% on a year-on-year basis compared with an increase of 4.5% in the first quarter. On a seasonally adjusted quarter-on-quarter basis, real GDP fell by 3.7%. While merchandise exports continued to grow at a double-digit year-on-year rate, domestic activity and exports of travel-related services declined (Chart 1).

The latest economic indicators point to signs of a gradual recovery in domestic activity. In particular, the volume of retail sales in July almost returned to the pre-SARS level.

CHART 1
Sources of Growth



External Trade

Growth in Hong Kong's merchandised exports moderated in July following the strong performance in the first half of the year (Chart 2). Re-export growth slowed from 14.4% year-on-year in the second quarter to 9.1% in July, while domestic exports continued to contract over a year ago. Both imports and exports of services were affected significantly by the outbreak of SARS in the second quarter, mainly due to the marked contraction of travel-related business. However, there were signs of a rebound in inbound tourism in the more recent period. In particular, tourist arrivals rose appreciably by 78% in July to slightly below the pre-SARS level. The rebound reflects the swift return of Mainland visitors and business travellers as the SARS threat receded.

Labour Market and Inflation

Labour market conditions showed signs of stabilising. The seasonally adjusted unemployment rate rose modestly from 8.6% in the second quarter to 8.7% in the three months ending July, the smallest increase since the outbreak of SARS (Chart 3).

CHART 2

External Trade

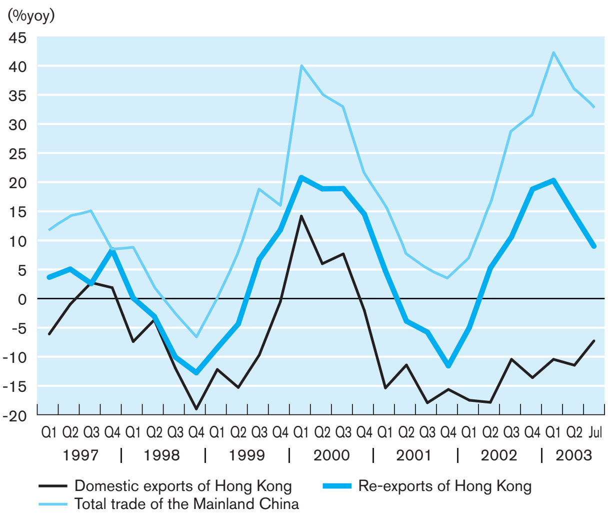
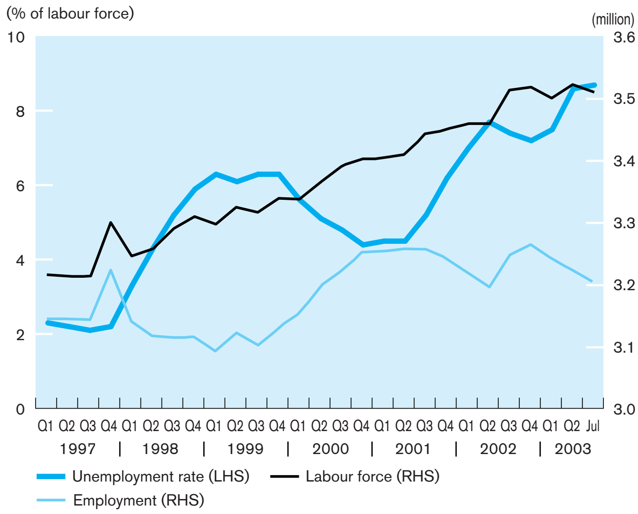


CHART 3

Labour Market

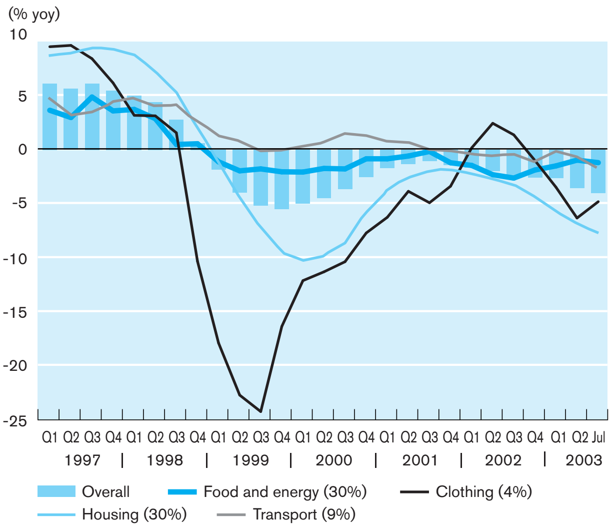


Meanwhile, the underemployment rate fell from 4.3% to 4.2%, reflecting a reduced number of employees taking no-pay leave as the impact of SARS receded. [1]

Price deflation continued. The Composite Consumer Price Index (CCPI) fell by 4.0% in July from a year earlier (after adjusting for the government relief measures), following a drop of 3.5% in the second quarter (Chart 4). On a seasonally adjusted month-on-month basis, the CCPI declined by 0.2% in July, slower than the average rate of decline of 0.6% in

CHART 4

Inflation (Adjusted for Special Relief Measures)

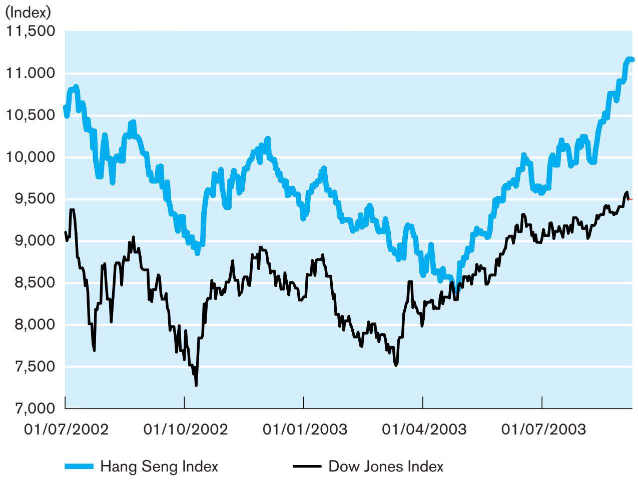


Note: The figures in the parenthese are the weights of the components in CCPI basket.

[1] Underemployed persons are those involuntarily working for less than 35 hours a week.

CHART 5

Equity Market



the second quarter. The moderation in the rate of deflation, in part, reflected the improved consumer sentiment as the impact of SARS receded.

Asset Markets

In line with the rally on global stock markets, the Hang Seng Index rose to a nearly 15-month high of 11,171 in early September, while the average daily transaction surged to a 3-year high (Chart 5). In contrast, the property market has weakened further in recent months. Residential property prices fell by 1.7% in July, following drops of 5.7% and 4.4% in the first and second quarter respectively. Reflecting this, the number of residential mortgage loans in negative equity increased to about 106,000 at end-June from 83,000 at end-March.

Money Supply and Domestic Credit

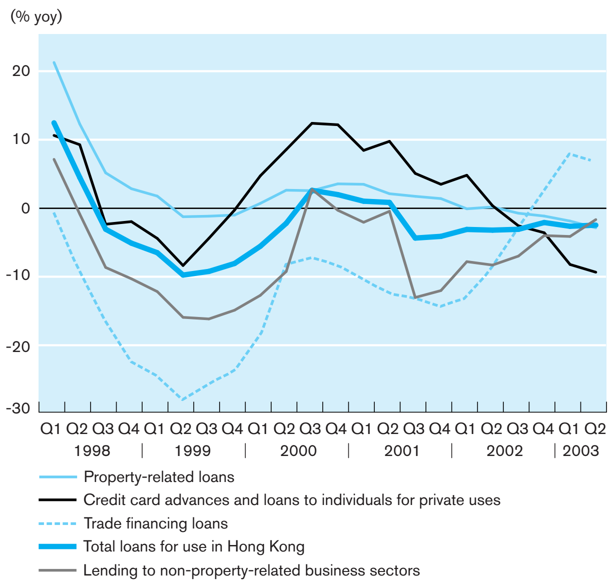
Narrow money increased strongly while that of broad money remained sluggish. Narrow money (seasonally adjusted) rose by 18.8% in the year to end-June, while broad money grew by only 0.5%. The rise in narrow money was in part attributable to a notable increase in demand deposits, which was likely associated with the buoyant stock market activity. The low opportunity cost of holding non-interest-bearing monetary assets was another contributing factor. The subdued growth in broad money was in line with weak economic conditions.

Foreign currency deposits rose slightly in the second quarter compared with the first quarter, reflecting a rise in US dollar deposits, which more than offset a fall in other foreign currency deposits. As Hong Kong dollar deposits grew faster than foreign currency deposits during the second quarter, the share of foreign currency deposits in total deposits declined modestly to 45%.

Domestic credit expansion remained sluggish. Specifically, loans for use in Hong Kong fell by 0.3% during the second quarter, or by 2.8% from a year ago. The contraction was broad-based, except for trade financing, which rose significantly alongside strong growth in external trade (Chart 6). In other sectors, credit card advances and personal loans continued to decline, although their share in total domestic lending was small. This mainly reflected weak consumer spending, increased charged-offs and a tightening of the issuance of new cards and lending policies by banks.

CHART 6

Loans for Use in Hong Kong



Note: Non-property business lending is defined as loans for use in Hong Kong other than property-related loans, lending to individuals for private purposes, credit card advances and trade financing loans.

Short-term Outlook

Looking ahead, a gradual recovery is expected to take hold in the second half of the year because of a number of factors. First, market sentiment has improved generally following the removal of Hong Kong from the list of SARS-affected areas on 23 June and the announcement of a number of policy initiatives, including the signing of the Closer Economic Partnership Arrangement (CEPA) between Hong Kong and the Mainland. In particular, the Mainland's further relaxation of travel restrictions should provide an immediate boost to the tourism industry. The rebound in tourism will filter through to retail and entertainment industries. Secondly, the buoyant trade performance in the Mainland and the expected global rebound will continue to support Hong Kong's exports of goods and services. Nevertheless, the strength and durability of the recovery in domestic demand remains uncertain in view of high unemployment and weak property prices.