HALF-YEARLY MONETARY AND FINANCIAL STABILITY REPORT

December 2003

This Report relies on statistical information available by end-November 2003.

Summary

Economic conditions in Hong Kong have improved distinctly in the second half of 2003, and have become more conducive to monetary and financial stability. The upswing is supported in part by a revival of demand in our main trading partners. There are increasing signs of an accelerated and more balanced recovery in the major economies, while the Mainland economy also appears to be entering an upturn in its growth cycle. The combined market share of the Mainland and Hong Kong in the major economies has continued to increase, and the easing of global monetary and financial conditions has also been supportive of growth. Domestically, market sentiment has been boosted by a number of factors, including policy initiatives aimed at strengthening economic integration between Hong Kong and the Mainland, and the Government's clarification of its role in the property market.

Reflecting these developments, exports of goods and services from Hong Kong grew strongly, in line with the rapid expansion of external trade on the Mainland, although the pace of growth has moderated from a high base. Tourist arrivals from the Mainland have increased sharply following the decision by the Mainland authorities to relax restrictions on individual visitors. Domestic demand has also shown signs of a recovery. Private consumption rose considerably in the third quarter to the same level as in mid-2001 after declining for four consecutive quarters, while the fall in investment moderated. The unemployment rate has declined to 8% from a peak of 8.7% in the three months ending in July, and the number of bankruptcy filings has also fallen.

The change in sentiment is reflected in a sharp fall in the forward premium of the Hong Kong dollar since late September, and a rally in equity prices, including those of a number of listed banks. On 16 October, Moody's upgraded Hong Kong's foreign currency rating by two notches to a level above that of the Mainland. This points to an increasing recognition of the distinct position and strengths of Hong Kong under the "one country, two systems" arrangement, and to growing confidence that the recovery is likely to prove lasting. The profitability of retail banks rose modestly in the third quarter of 2003, owing much to an improvement in asset quality. The banking sector remains fundamentally sound, with a strong capital position and abundant liquidity.

A notable recent development has been the strengthening of the Hong Kong dollar. The HKD/USD exchange rate appreciated to 7.70 in late September from a level close to 7.80. The HKMA sold a cumulative HK$11 billion of Hong Kong dollars before the end of November, which contributed to a fall in interbank interest rates to levels below US dollar rates, and an easing of the exchange rate to 7.76-7.77. The sudden shift in market sentiment reflects improved fundamentals in Hong Kong, as well as the recent weakness of the US dollar and market speculation about an appreciation of the renminbi. The small appreciation of the Hong Kong dollar against the US dollar has no material macroeconomic implications.

Looking ahead, the pace of the economic recovery in Hong Kong is expected to accelerate, barring unexpected shocks in the external and domestic environment. Private institutions and multilateral organisations have raised their growth forecasts markedly. The latest Consensus Forecasts project real GDP to grow by over 4% in 2004 and price deflation to ease considerably. With more favourable macroeconomic conditions, banking performance is expected to improve. Overall, these factors should support monetary and financial stability in the period ahead.

Half-Yearly Monetary and Financial Stability Report
December 2003

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1. Global and regional setting

External demand

Global growth has become more balanced during the course of 2003. The US and Japanese economies strengthened markedly in the second and third quarters, and recent statistics suggest that the recovery has continued in the remainder of the year. The euro area economy was weak in the earlier part of 2003, but improved moderately in the second half. Reflecting accelerated growth, demand for imports in the major economies continued to rise. There are also signs that the combined market share of the Mainland and Hong Kong in these markets has increased.

1.1 United States

Growth picked up significantly in 2003 Q3, with real GDP increasing by 8.2% on an annualised quarter-on-quarter basis, compared with a rise of 3.3% in Q2. The acceleration was supported by a broad-based recovery in both private consumption and fixed-capital investment, which rose by 6.4% and 18.2% respectively during the third quarter. High-frequency indicators suggest that economic growth remained robust at the beginning of Q4 (Table 1.A).

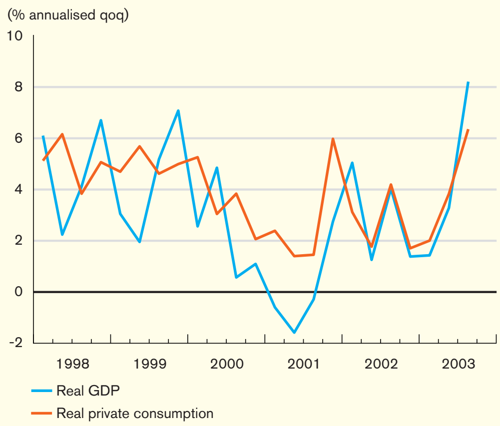
Table 1.A
US: selected high frequency indicators

		Jun	Jul	Aug	Sep	Oct	Nov
Industrial production	% mom	0.0	0.8	0.2	0.5	0.2	n.a.
ISM manufacturing PMI	index	49.8	51.8	54.7	53.7	57.0	62.8
Durable goods orders	% mom	2.5	1.6	-0.1	2.1	3.3	n.a.
Retail sales	% mom	0.9	1.4	1.0	-0.4	-0.3	n.a.
Consumer confidence	index	83.5	77.0	81.7	77.0	81.7	91.7
Unemployment rate	%	6.4	6.2	6.1	6.1	6.0	n.a.

Source: CEIC.

Whether the current recovery is sustainable depends largely on the development of household consumption and corporate investment. Private consumption served as a major cushion to overall economic performance throughout the downturn that started in 2000 Q1 (Chart 1.1). Growth in household spending has been partly fuelled by home equity withdrawals via mortgage re-financing, made possible by rises in house prices and declining interest rates. However, since longer-term interest rates appear to have reached a bottom in June 2003, and house price inflation has moderated, home equity withdrawals may become less pronounced. Thus, other factors, such as income growth and labour market conditions, are likely to become more critical to the outlook.

Chart 1.1
US: private consumption and GDP growth



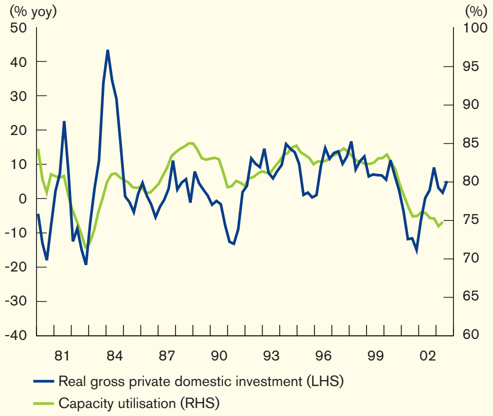
Source: CEIC.

With regard to corporate investment, companies are still digesting the excess capacity that emerged following the boom in the late 1990s. In particular, the industrial capacity utilisation rate has remained substantially below the long-term average (Chart 1.2). As a result, investment in industrial equipment has stayed weak. Nevertheless, investment in information technology (IT) equipment and software picked up notably in Q2 and Q3, bringing a rebound in overall fixed capital investment. The recovery in IT-related investment might be attributable to the buoyant activity in the service sector, which grew more strongly than did the industrial sector.

Another crucial determinant of private investment is profitability, which can be seen as a leading indicator of the corporate sector's propensity to expand (Chart 1.3). National account data indicate that corporate profits rebounded markedly in 2003 Q2 and Q3, while recent results of listed companies also show a similar improvement, suggesting that private capital expenditure will probably remain robust towards the end of 2003. Nonetheless, it should be noted that company earnings are typically volatile, and it is unclear whether the current increase represents the beginning of an uptrend.

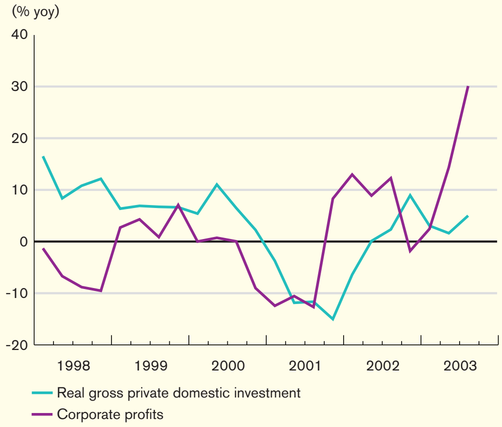
Although GDP growth accelerated in Q3, growth in demand for imported goods moderated. Year on year, real import growth has fallen significantly since the beginning of the year, probably reflecting the weakening of the US dollar. In terms of origins of imports, the combined market share of Mainland China and Hong Kong in US imports increased further in 2003, while that of Japan and other major Asian economies declined (Chart 1.4).

Chart 1.2
US: capacity utilisation and investment



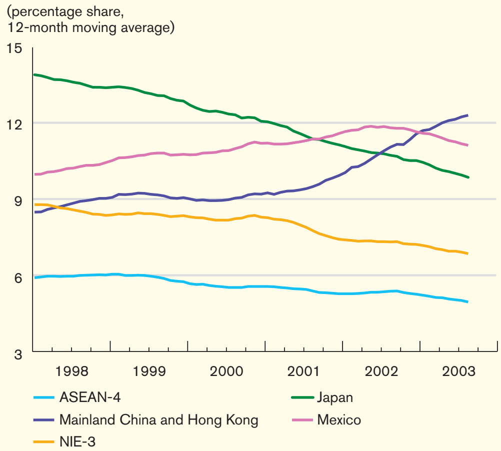
Source: CEIC.

Chart 1.3
US: corporate profits and investment



Source: CEIC.

Chart 1.4
US: imports by origins



Note: NIE-3 refers to three Newly-Industrialised Economies: South Korea, Singapore and Taiwan. ASEAN-4 refers to four selected members of Association of Southeast Asian Nations: Indonesia, Malaysia, the Philippines and Thailand.

Source: CEIC.

1.2 Euro area

Economic activity in the euro area improved moderately in 2003 Q3. The latest flash estimate indicates that real GDP rose by 0.4% quarter on quarter in Q3, after contracting by 0.1% in Q2. The improvement reflected in part a stronger external demand. National statistics from Germany, France and Italy suggest a stronger expansion in exports, while growth in domestic demand remained sluggish.

High frequency forward-looking indicators point to further improvement in the rest of 2003 (Table 1.B). Purchasing managers' indices for the major economies continued to rise in October and November, while most business and consumer confidence indicators also improved slightly. However, it is unclear whether a sustained recovery is emerging. In the near term, the appreciation of the euro will not support exports, and longer-term growth could be restrained by structural problems and difficult fiscal positions in some key economies.

Despite the economic weakness, demand for imports picked up slightly. Chart 1.5 shows that real imports continued to grow despite the fall in the Purchasing Managers' Index in the first half of 2003, probably because of the strengthening of the euro. In terms of origins, the combined share of Mainland China and Hong Kong in the euro area imports rose markedly in 2003, while that of other major Asian economies also increased but at a slower pace (Chart 1.6).

Table 1.B
Euro area: selected high frequency indicators

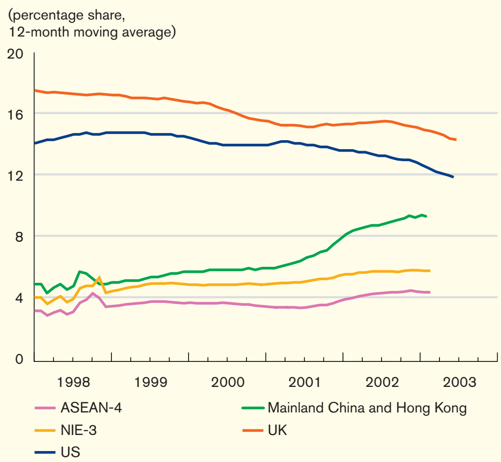
		Jun	Jul	Aug	Sep	Oct	Nov
Euro area							
Composite Purchasing							
Managers' Index	index	48.1	49.8	51.2	52.8	54.9	56.2
Manufacturing	index	46.7	48.0	49.1	50.1	51.3	52.2
Services	index	48.2	50.2	52.0	53.6	56.0	57.5
Industrial confidence	index	-12	-14	-11	-9	-8	-7
Consumer confidence	index	-19	-18	-17	-17	-17	-16
Unemployment rate	%	8.8	8.8	8.8	8.8	8.8	n.a.
National surveys							
Germany IFO							
(business climate)	index	88.9	89.4	90.9	92.0	94.3	95.7
Italy ISAE							
(business confidence)	index	91.7	86.7	95.2	94.7	94.3	94.4

Source: Bloomberg and JP Morgan.

Chart 1.5
Euro area: Purchasing Managers' Index and real import growth

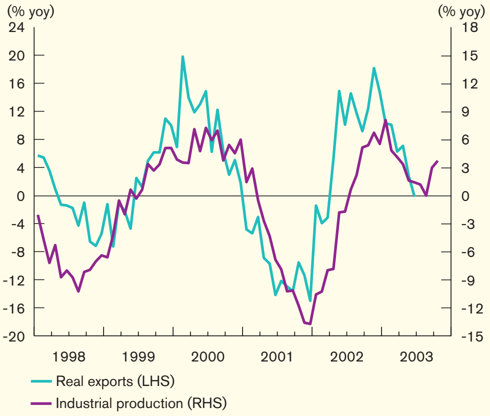
Source: Reuters and CEIC.

Chart 1.6
Euro area: imports by major origins



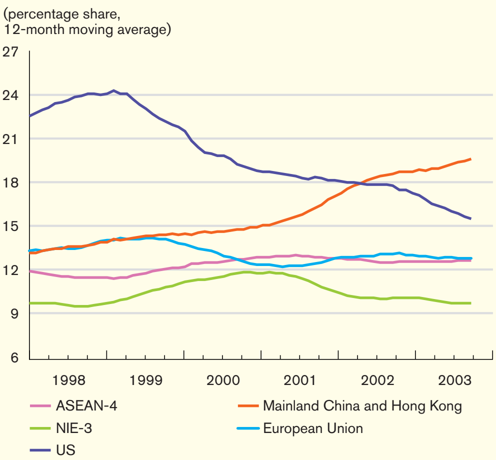
Source: Datastream and UNCTAD data.

Chart 1.7
Japan: exports and industrial production



Source: CEIC and IMF.

Chart 1.8
Japan: imports by major origins



Source: CEIC

Table 1.C
Asia: year-on-year real GDP growth rate

	02Q3	02Q4	03Q1	03Q2	03Q3
South Korea	5.8	6.8	3.7	1.9	2.3
Singapore	3.8	3.0	1.6	-3.8	1.7
Taiwan	5.2	4.5	3.5	-0.1	4.2
Indonesia	4.3	3.8	3.4	3.8	3.9
Malaysia	5.8	5.4	4.6	4.5	5.1
The Philippines	3.8	5.8	4.5	4.0	4.4
Thailand	5.8	6.1	6.7	5.8	n.a.

Source: CEIC.

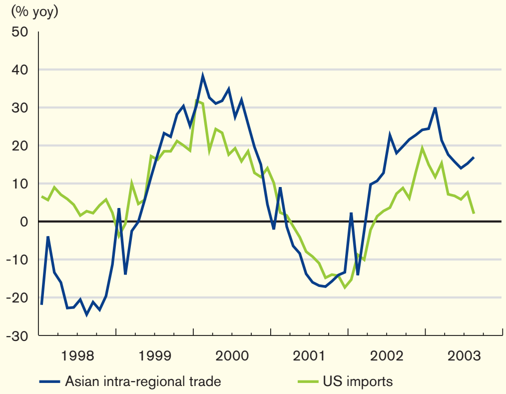
1.3 Asia (ex-Mainland China)

In Japan, real GDP growth moderated to 2.2% on an annualised quarter-on-quarter basis in 2003 Q3, from an exceptionally strong 3.5% in Q2. The recovery that began in early 2002 was mainly led by external demand (Chart 1.7). The buoyant performance of the trade sector in 2002 subsequently translated into an improvement in corporate profits and hence a rebound in private fixed investment. The latter rose strongly in 2003 Q2 and Q3, supporting the expansion in GDP, while export growth slowed. Labour market conditions remained difficult as structural adjustments in the corporate sector continued. Thus, the spill-over effects of the recovery on the household sector have been limited.

Given improved economic conditions, import growth in Japan continued to be robust, rising in real terms by 7% during the first nine months of 2003 over a year ago, compared with 2% for the whole of 2002. The stronger expansion in imports was mainly due to buoyant investment demand, with imports of industrial supplies and capital goods leading the overall growth. In terms of origins, the share of Mainland China and Hong Kong rose steadily, while that of the US and several Asian economies declined (Chart 1.8).

Elsewhere in Asia economic performance was adversely affected by the outbreak of SARS (Severe Acute Respiratory Syndrome) in 2003 Q2, particularly in Singapore and Taiwan (Table 1.C). In general, the impact was larger in those economies directly affected by the epidemic and having a relatively high exposure to the tourism sector. When the disease was successfully contained and the fear of further outbreaks dissipated towards the end of June, a recovery began in the tourism and retail sectors.

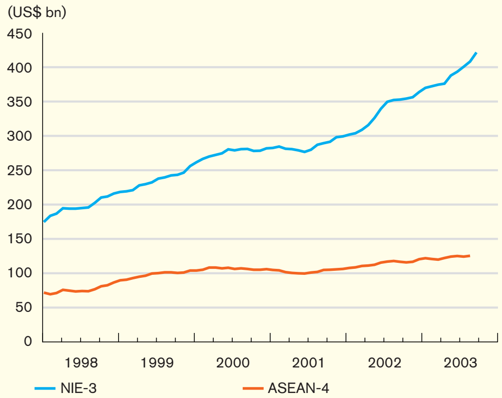
Chart 1.9
Asia: intra-regional trade and US imports (in US dollar terms)



Note: Intra-regional trade is defined as exports of Japan, Mainland China, Hong Kong, NIE-3 and ASEAN-4 (excluding Indonesia because of the lack of timely data) to the economies within these groups.

Source: CEIC.

Chart 1.10
Asia: foreign exchange reserves



Source: CEIC.

Manufacturing and external trade were largely unaffected by the outbreak of SARS. Nevertheless, export growth in most Asian economies decelerated during the first half of the year as demand in the US moderated. While intra-regional trade represents over 50% of total Asian exports, it is highly correlated with import demand from the US (Chart 1.9). This suggests that trade within the region is dominated by semi-finished goods, and is largely driven by final demand in the major economies.

Over the longer term the Asian economies have good potential for a sustainable growth in domestic demand. Following the Asian financial crisis in 1997-98, both corporate and household sectors underwent a period of de-leveraging. Thus domestic demand growth has largely been lagging behind income growth in the region. Higher savings rates in conjunction with the economic recovery have led to substantial increases in savings and hence to a rapid rise in foreign reserves (Chart 1.10). Against this background, the US dollar weakened against most Asian currencies (except the Philippine peso) in 2003 Q3, while Asian stock markets also outperformed US equity markets. These factors should be conducive to a recovery in domestic demand.

Mainland China

Economic growth on the Mainland slowed temporarily in 2003 Q2 because of the outbreak of SARS. However, there was a strong rebound in Q3, as domestic demand recovered rapidly. On the external side, continued relocation of foreign-owned manufacturing facilities into the Mainland helped maintain an exceptionally strong expansion in exports. Hong Kong has been benefiting from the buoyant trade growth on the Mainland.

1.4 Output and inflation

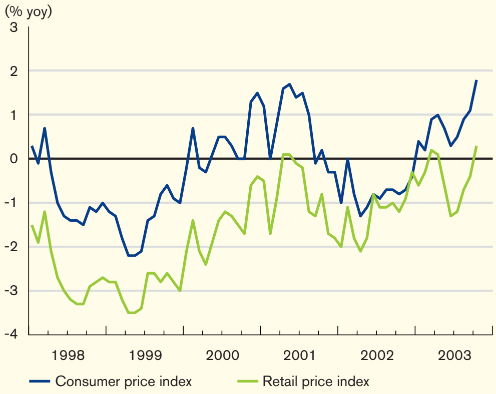
Table 1.D
Mainland China: key economic indicators

		Q1	Q2	Q3	Oct
GDP	real, % yoy	9.9	6.7	9.1	n.a.
Industrial production	real, % yoy	17.2	15.2	16.6	17.2
Retail sales	% yoy	9.2	6.8	9.8	10.2
Fixed asset investment	% yoy	31.6	33.3	29.6	22.7
Exports (US$ terms)	% yoy	33.2	34.4	29.7	36.7
CPI inflation	% yoy	0.5	0.7	0.8	1.8

Source: CEIC.

Economic growth on the Mainland slowed in Q2 as the outbreak of SARS caused a slump in the tourism and retail sectors (Table 1.D). As a result, real GDP growth declined from a high level of 9.9% year on year in Q1 to 6.7% in Q2. However, with the recovery in consumption demand and the still-buoyant expansion in fixed investment, economic growth rebounded strongly to 9.1% in Q3.

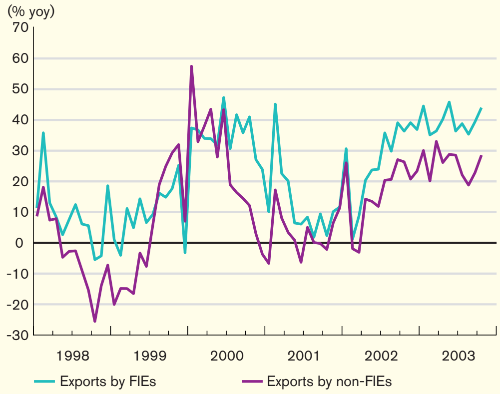
Chart 1.11
Mainland China: inflation rates



Source: CEIC.

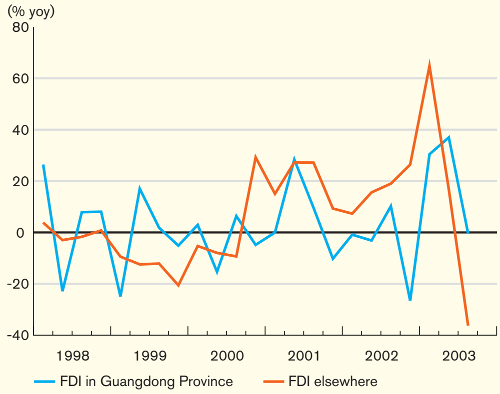
Reflecting the rapid pace of growth, concerns about deflation have eased considerably. Year on year, the CPI inflation rate rose from -0.4% at the end of 2002 to +1.8% in October 2003. Meanwhile, the retail price index (RPI) rose by 0.3% in October after declining for five consecutive months (Chart 1.11). While prices of most tradable items remained weak, prices of services and housing recorded modest increases in the first 10 months of the year.

Chart 1.12
Mainland China: exports by FIEs and non-FIEs (in US dollar terms)



Source: CEIC.

Chart 1.13
Mainland China: FDI in Guangdong Province and elsewhere on the Mainland



Source: CEIC.

1.5 External trade

Export growth remained strong on the Mainland, but slowed slightly to 30% year on year in Q3, from 34% in Q2. The buoyant trade performance has been partly boosted by foreign investment. Foreign-invested enterprises (FIEs) accounted for more than 50% of the total exports in 2002, and have been outpacing local firms in export growth (Chart 1.12). Although the US has remained the largest market (absorbing 22% of the Mainland's exports in 2002), the strengthening of the euro appears to have significantly boosted exports to the European Union (EU) (absorbing 15%). In the first 10 months of 2003, exports to the EU rose sharply by 46% year on year, while those to the US rose by 33%.

Since Hong Kong is the key trade hub of southern China, the export performance of Guangdong Province is important to Hong Kong's indirect trade flows and to offshore trade activity. In the first 10 months of 2003, exports from Guangdong rose by 26% year on year: this was slower than the 37% registered by the rest of the Mainland, which suggests that the other regions have been expanding their share in external trade. Growth of foreign direct investment (FDI) in Guangdong, which is associated with export capacity, has generally been lower than that in the rest of the Mainland over most of the past several years (Chart 1.13). However, it should be noted that export growth in Guangdong has still been rapid in absolute terms, and has remained substantially higher than that of many of the other Asian economies.

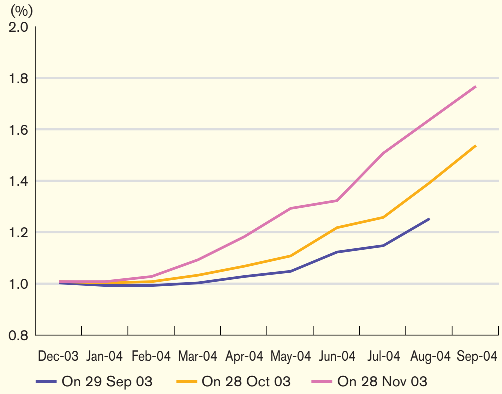
Monetary and financial conditions

Global monetary conditions eased further during the first three quarters of 2003. Interest rates in major economies are now at record lows. Money supply growth also showed signs of acceleration in the second half of 2003. Under the Linked Exchange Rate system, low US interest rates and the weakening of the US dollar against other major currencies have resulted in an easing in monetary conditions in Hong Kong.

1.6 Interest rates

In the US the federal funds target rate was lowered further by 25 basis points in June to 1%, the lowest level in 45 years. This was the thirteenth consecutive cut in interest rates since January 2001, leading to a total reduction of 5.5 percentage points. Although the Federal Reserve kept the policy rate unchanged at 1% at its November meeting, longer-term interest rates rose considerably between mid-June and mid-August, as the risk of weak economic activity and deflation was perceived to be lower than previously expected. The 10-year Treasury yield climbed by about 150 basis points during the period. Following statements by the Federal Reserve that it intended to maintain low interest rates for an extended period, the yield on the 10-year Treasury note eased by some 50 basis points in September. With recent economic data pointing to a significant acceleration in growth, long-term rates started to climb once again after reaching a low at the end of September. Short-term interest rates are anticipated to rise more rapidly than previously expected, as implied by the federal funds futures market (Chart 1.14).

Chart 1.14
US: expectations of the federal funds rate (derived from the federal funds futures market)



Source: Bloomberg.

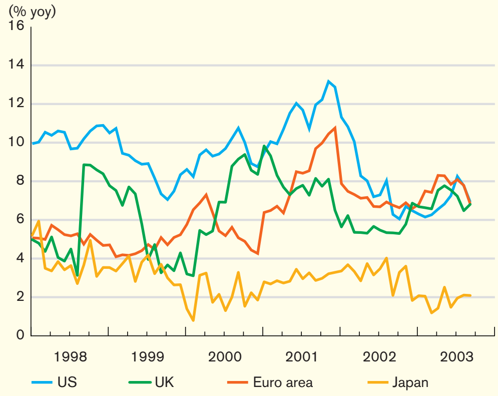
The Bank of England raised the repo rate by 25 basis points to 3.75% at its November MPC meeting, citing the strengthening of demand and the depreciation of sterling as main sources of underlying inflationary pressure. Interest rates in other major economies moved roughly in line with those for the US, given weak growth and the absence of imminent inflation concerns (Table 1.E). The European Central Bank reduced the benchmark refinance rate by 50 basis points to 2% at its meeting in June. The

Table 1.E
Changes in policy rates in major economies

	Policy rate	Current rate	Date of last change	Previous rate
		%		%
US	Fed funds target rate	1.00	25-Jun-03	1.25
Euro area	Refinancing rate	2.00	05-Jun-03	2.50
UK	Repo rate	3.75	06-Nov-03	3.50
Canada	Overnight funding rate	2.75	03-Sep-03	3.00

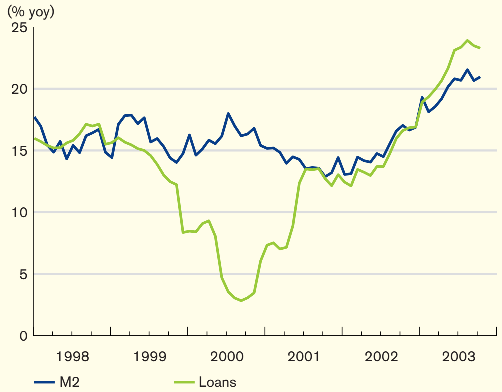
Source: Various central banks.

Chart 1.15
Broad money supply growth



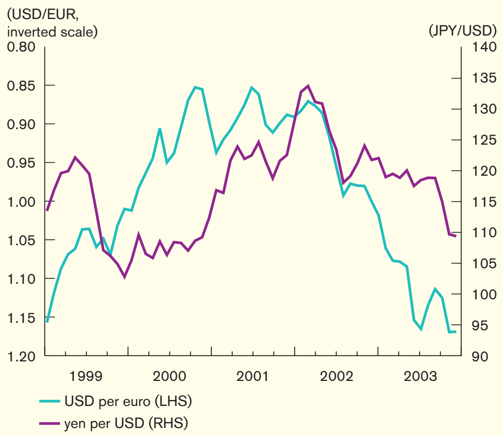
Source: CEIC.

Chart 1.16
Mainland China: monetary aggregates and loans



Source: CEIC.

Chart 1.17
US dollar against the euro and yen



Source: CEIC.

Bank of Canada cut the policy rate by 25 basis points in September. Monetary easing in these economies seems to have led to an acceleration of growth in broad money (Chart 1.15).

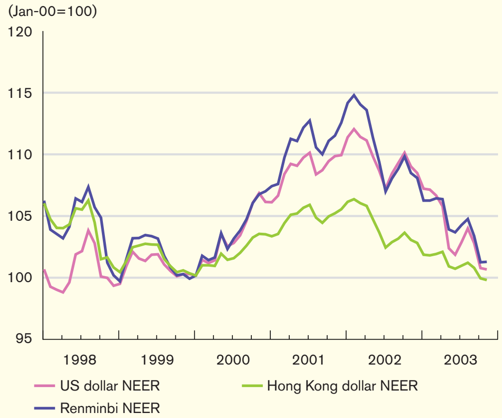
Monetary conditions in Mainland China eased in the first 10 months of 2003. Growth in broad money (M2) accelerated from 17% year on year at the end of 2002 to 21% in October 2003 (Chart 1.16). This was largely attributable to the robust expansion in bank credit, which rose 23% year on year in October, compared with an increase of 17% at the end of 2002. Increases in net foreign assets of the central bank arising mainly from sizeable FDI and other inflows have contributed to base money growth and hence to the capacity of the banking sector to extend credit. Interest rates remained unchanged at record-low levels, with the one-year time deposit and working capital lending rates staying at 2% and 5.3% respectively, following the reduction in February 2002.

The current rapid expansion of credit is accompanied by buoyant growth in residential property investment, which is supported by housing reforms. Nonetheless, there have been growing concerns about whether the housing market is becoming overheated and banks over-exposed to real estate lending. Against this background, the People's Bank of China (PBoC) introduced a number of prudential measures in mid-June to better regulate property-related lending and managing the associated risks. In late August the PBoC raised the required reserve ratio from 6% to 7%, effective from late September. The PBoC estimated that this move would freeze RMB150 billion in excess reserves, and thus limit the room for excessive credit growth.

1.7 Exchange rates

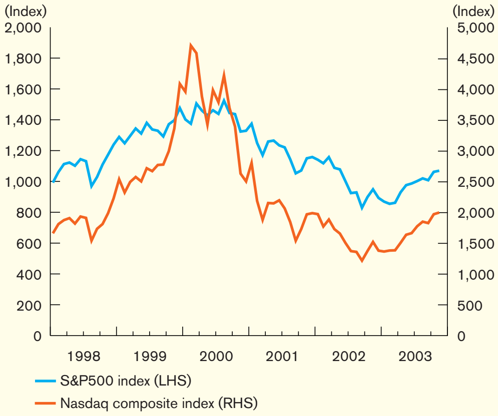
The US dollar depreciated owing to concerns over the sizeable current account (CA) deficit, which reached 5.1% of GDP in 2003 Q2. During the first eleven months of 2003, the US dollar declined by 13% against the euro and 8% against the yen, and by 7% in nominal effective terms (Chart 1.17).

Chart 1.18
Nominal effective exchange rates of the US dollar, renminbi and Hong Kong dollar



Source: CEIC, JP Morgan and HKMA.

Chart 1.19
US: S&P500 and NASDAQ indices



Source: CEIC.

Table 1.F
Selected equity markets

Index	% change until end-Nov-03			
	Since end-2002	Since end-03Q1	Since end-03Q2	Since end-03Q3
Major economies				
France, CAC40	11.8	26.3	11.1	9.5
Germany, DAX	29.5	45.7	18.2	16.9
Japan, TOPIX	18.6	25.1	11.4	-2.3
UK, FT all shares	13.4	21.7	9.3	6.3
Asia Pacific				
Australia, All Ordinaries	7.4	11.7	6.6	0.7
Hong Kong, Hang Seng	32.1	39.5	29.4	11.7
South Korea, Composite price	26.9	41.5	20.1	15.7
Malaysia, Composite	20.6	22.2	13.5	7.1
The Philippines, Composite	29.0	26.9	8.9	1.6
Singapore, All shares	33.1	35.4	20.6	5.5
Taiwan, Capitalisation weighted	29.6	32.6	20.2	3.6
Thailand, SET	81.2	79.0	51.7	18.8

Source: CEIC.

Under the Linked Exchange Rate system, the Hong Kong dollar weakened along with the US dollar. The renminbi also depreciated against most non-US-dollar currencies. The decline in the nominal effective exchange rate of the Hong Kong dollar was less significant than that of the US dollar, reflecting the fact that the renminbi, the currency of Hong Kong's biggest trade partner, was stable against the US dollar (Chart 1.18). Overall, these developments represent easier monetary conditions for Hong Kong.

1.8 Equity markets

Having bottomed out in March 2003, the S&P500 index gained over 30% by end-November in response to the economic upturn in the US (Chart 1.19). In particular, during the latter part of Q3, fund managers were reportedly re-balancing their portfolio weightings towards equities in anticipation of a global economic recovery.

Stock markets elsewhere also rebounded. Notably, the Japanese markets have risen sharply since the end of May, supported by better-than-expected economic performance. Between June and November, the TOPIX index rose by 22%, substantially higher than the corresponding figure of 10% for the S&P500 index. Table 1.F, which illustrates the performance of key developed markets and selected Asian markets, shows that markets in non-Japan Asia rose more than the developed markets. In particular, the Thai market rose by 81% since the end of 2002, significantly outperforming all others.

The rally in global equity markets, which apparently reflected in part an increase of investors' appetite for risk, has led to a worldwide reduction in costs of funds for the corporate sector, notwithstanding the recent rise in longer-term interest rates. This should be conducive to growth in business spending.

2. Hong Kong economy

Output

The Hong Kong economy rebounded markedly in the third quarter after having been severely disrupted by the outbreak of SARS in the second quarter. Exports of goods and services maintained a strong growth momentum, supported by a robust trade performance in Mainland China and an improvement in competitiveness brought about by the weakening of the US dollar. Domestic demand showed signs of a revival, with a significant increase in private consumption.

2.1 GDP growth

Economic activity in Hong Kong was severely disrupted in 2003 Q2 by the outbreak of SARS, but it rebounded strongly in Q3 (Table 2.A).

Real GDP fell by 3.7% in Q2 over Q1 on a seasonally adjusted basis. The contractionary impact of SARS was concentrated in the wholesale and retail trades, transport, and other tourism-related sectors. Merchandise trade, however, continued to register double-digit year-on-year growth, supported by the strong expansion in both exports and imports in Mainland China.

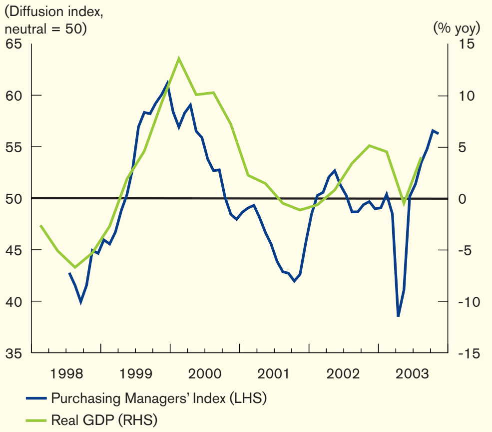
Real GDP rebounded markedly by 6.4% in Q3, seasonally adjusted. While the strong growth reflected in part the low base in Q2, it clearly indicates a turning point. Year on year, real GDP fell by 0.5% in Q2, but rose by 4.0% in Q3. The latest indicators suggest a continuing recovery in Q4. In particular, the Purchasing Managers' Index — a composite index designed to provide an overview of business activity in Hong Kong — rose to 56.3 in November, well above the neutral level of 50 (Chart 2.1).

Table 2.A
Real GDP by expenditure component (year-on-year growth)[1]

(% yoy)			2003		
	2001	2002	Q1	Q2	Q3
Gross Domestic Product	**0.5**	**2.3**	**4.5**	**-0.5**	**4.0**
Domestic demand	1.0	-1.1	1.8	-3.0	0.1
Consumption					
Private	2.0	-1.2	-1.7	-2.6	2.0
Public	6.1	2.4	1.3	0.4	0.5
Gross domestic fixed capital formation	2.7	-4.3	3.5	-5.7	-0.4
Private	3.7	-4.8	5.8	-6.3	-2.3
Public	-2.3	-2.0	-4.9	-2.4	11.0
Change in inventories[2]	-1.5	0.6	1.8	0.1	-1.0
Net exports of goods[2]	-1.6	0.3	-1.0	3.3	2.1
Net exports of services[2]	1.2	3.0	3.8	-0.8	1.8

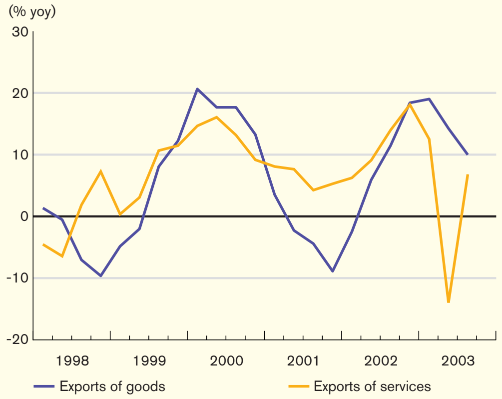
Notes: 1. At constant 2000 market prices.
2. Percentage point contribution to annual growth of GDP.
Source: C&SD.

Chart 2.1
Real GDP growth and Purchasing Managers' Index



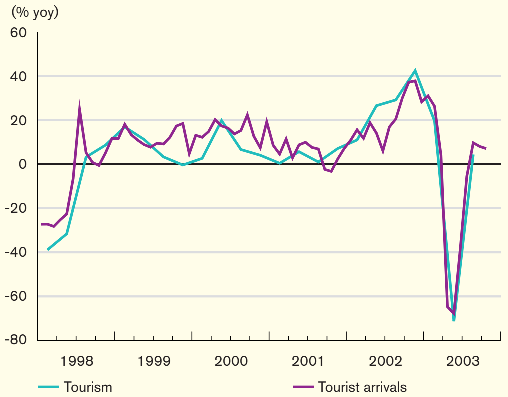
Source: C&SD and NTC Research.

Chart 2.2
Exports of goods and services (in real terms)



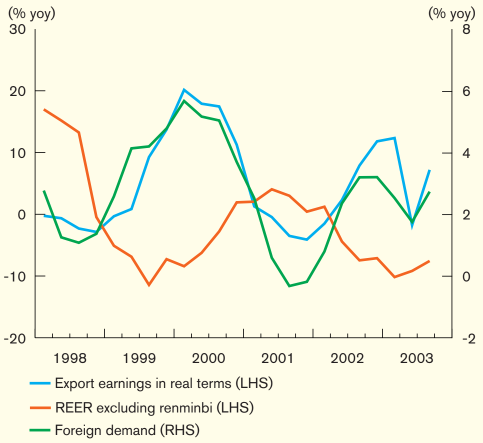
Source: C&SD

Chart 2.3
Tourism and tourist arrivals



Note: Tourism is defined as travel-related exports of services (in real terms).
Source: C&SD and Tourism Board.

Chart 2.4
Export earnings, external demand and REER



Source: C&SD and Staff estimates.

2.2 External trade

Merchandise exports in Hong Kong rose strongly in the first three quarters (Chart 2.2). Exports of services recorded a temporary setback in Q2, owing to the abrupt fall in tourism-related earnings. Tourism started to revive after the WHO lifted its travel advisory on Hong Kong in May; it was further helped by the relaxation of travel restrictions on Mainland visitors (Chart 2.3). The remaining part of exports of services is mainly trade-related, and has held up well.

Export earnings — defined as the sum of domestic exports, re-export margins and exports of services — are more useful for analysing the contribution of external trade to the economy. These rose by 6.3% in real terms in Q3 from a year earlier, following a temporary slowdown in growth in Q2 (Chart 2.4). Growth in export earnings has followed external demand closely, measured by a weighted average of GDP in the main trading partners of both the Mainland and Hong Kong. Increases in competitiveness brought about by the weakening of the US dollar also helped export performance. While exports of goods to East Asia and to the EU remained strong, those to the US declined in Q2 and Q3 (Table 2.B).

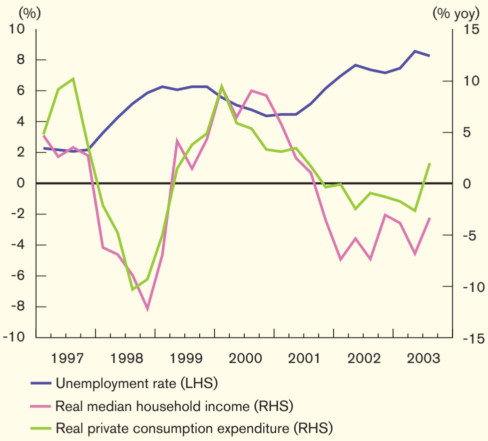
Table 2.B
Exports to major trading partners (in Hong Kong dollar terms)

(% yoy)	2001	2002	2002	2003			Share
			Q4	Q1	Q2	Q3	(2002)
Mainland China	1.8	13.6	31.1	17.8	19.8	16.5	40
US	-9.9	0.9	8.8	7.5	-4.9	-6.9	21
EU	-10.8	-3.3	7.2	16.1	17.5	7.9	13
Japan	0.6	-4.5	6.8	13.5	16.9	11.0	5
East Asia	-11.0	9.9	15.4	12.7	12.5	9.1	10
Others	-12.4	-0.6	-2.0	51.3	9.1	-1.8	10
Overall	-5.8	5.4	15.5	17.6	12.2	7.0	100

Note: East Asia refers to Taiwan, Singapore, South Korea, the Philippines, Thailand, Malaysia and Indonesia.

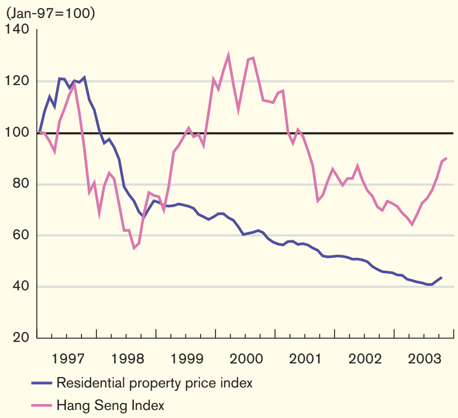
Source: C&SD.

Chart 2.5
Income, employment and consumption



Source: C&SD.

Chart 2.6
Asset prices



Source: Rating and Valuation Department and Reuters.

2.3 Domestic demand

Domestic demand weakened considerably after the outbreak of SARS, but started to recover in Q3.

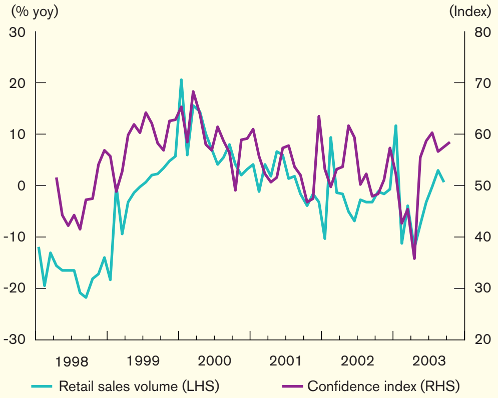
Private consumption

Private consumption expenditure (PCE) rebounded sharply by 4.6% in Q3 in real terms on a seasonally adjusted basis, after falling for five consecutive quarters. Year on year, it also improved from a decline of 2.6% in Q2 to an increase of 2.0% in Q3.

While the decline in Q2 in part reflected the impact of SARS, the general weakness of private consumption in the earlier periods was attributable to a combination of factors, including falling income and rising unemployment, as well as the negative wealth effects associated with the continued decline of property prices. In particular, real household income declined between 2001 Q2 and 2003 Q2, in part reflecting falls in employment (Chart 2.5).

The revival in PCE in Q3 reflected improvements in some of these factors. First, real household income appears to have stabilised. Specifically, median household income, after discounting the fall in consumer prices, rose moderately in Q3, although it was still lower than a year earlier. The improvement was in part associated with a decline in the unemployment rate in recent months. Secondly, stock prices rose strongly since May. There were also emerging signs of a recovery in the property market (Chart 2.6; and see Section 2.9 for details).

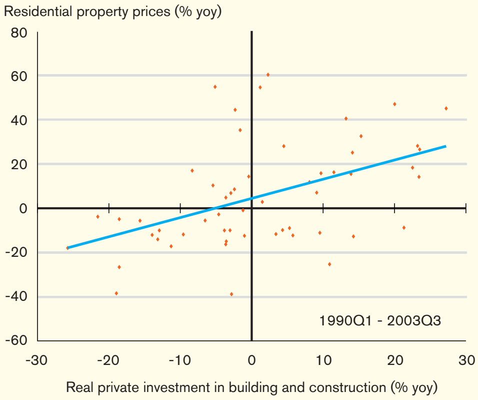
Chart 2.7
Retail sales and consumer confidence



Note: The confidence index refers to the index on major consumption decisions, which is a sub-index of the Economic Confidence Index compiled by the Hong Kong Policy Research Institute.

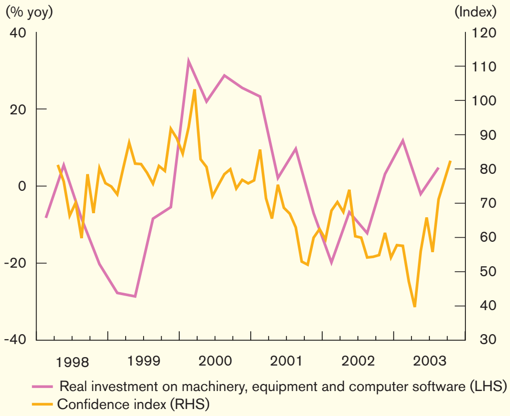
Source: C&SD and Hong Kong Policy Research Institute.

Chart 2.8
Property prices and private investment in building and construction



Source: C&SD and Rating and Valuation Department.

Chart 2.9
Investment and confidence



Note: The confidence index pertains to the prospect of Hong Kong, and is a component of the Economic Confidence Index compiled by the Hong Kong Policy Research Institute.

Source: C&SD and Hong Kong Policy Research Institute.

Finally, the improved economic outlook and policy initiatives intended to facilitate economic integration between Hong Kong and the Mainland have boosted consumer confidence (Chart 2.7).

Private investment

Private investment remained sluggish in 2003, affected by a cutback in building activity and relatively high real interest rates. Private investment increased by 5.8% year on year in Q1 in real terms, following five consecutive quarters of contraction, but declined again in the following two quarters. Among the major components, private expenditure on building and construction fell in the first three quarters of 2003. Nevertheless, expenditure on machinery, equipment and computer software picked up in Q3, rising by 4.9% from a year ago.

The decline in private sector expenditure on building and construction reflected several developments. Building activity tends to be positively related to property price movements, but responds to market conditions with a lag (Chart 2.8). Driven by falling property prices before the recent stabilisation, building activity had been continuously cut back. Moreover, output under the Home Ownership Scheme and Private Sector Participation Scheme, which is classified as private sector building output in the GDP estimates, fell substantially.

The increased spending on machinery, equipment and computer software reflected in part the improved business outlook. In recent months the Hong Kong Policy Research Institute survey of economic confidence has recorded a steady rebound in the confidence indices for the prospects of both Hong Kong and the Mainland from their low readings in April (Chart 2.9).

Inventories

Inventories rose in real terms in the first half of the year. This probably reflected involuntary stock accumulation due to weak domestic demand and the fall in inbound tourism. Inventories fell in Q3, as growth in retained imports was outpaced by that of consumer spending.

Public spending

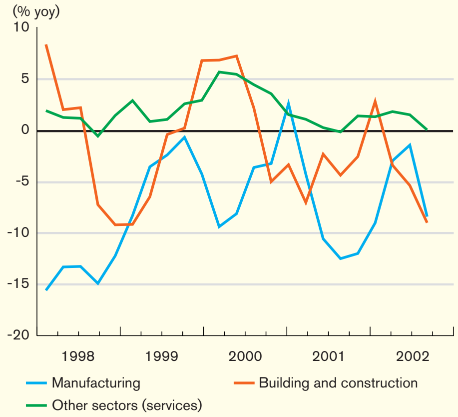
Government consumption expenditure rose modestly in real terms in the first three quarters from a year before, while capital expenditure rose by 11.0% in Q3, after a contraction in the first half of 2003. This increase was particularly marked in spending on building and construction.

Labour market and prices

Labour market conditions have improved in recent months, with a fall in the unemployment rate. Consumer price deflation has persisted, but there have been some tentative signs of stabilisation.

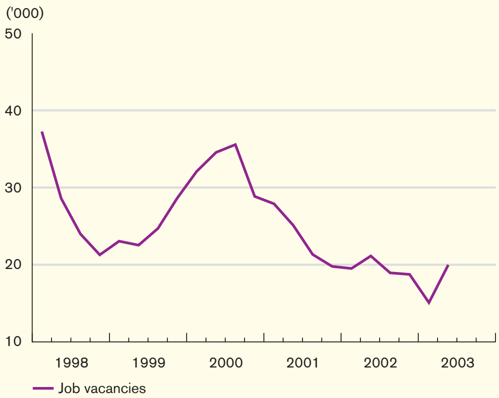
2.4 Labour demand and unemployment

Chart 2.10
Growth of sectoral employment



Source: C&SD.

Chart 2.11
Job vacancies

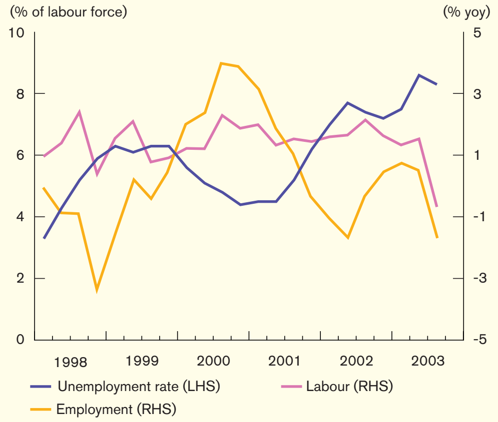


Source: C&SD.

Employment growth has been weak in recent years, reflecting the cyclical downturn as well as structural changes in the economy. In particular, the shift from domestic exports to re-exports and, more recently, to offshore trade has reduced labour demand in the manufacturing and trade-related sectors (Chart 2.10). Employment in the building and construction sector has also fallen, owing to reductions in the Public Housing Programme and the sluggish property market. By contrast, employment in other sectors (mostly services) has continued to increase.

The employment situation deteriorated in the first three quarters of 2003, but has shown signs of stabilisation more recently. Total employment contracted in the first nine months before rising in October. Employment in restaurants, hotels, retail and wholesale trade and the personal services sector was particularly affected by the outbreak of SARS. Employment in the Civil Service fell following the Government's decision to reduce operating costs. Weak labour demand was also reflected in job vacancies (Chart 2.11), which fell substantially in Q1 on a seasonally adjusted basis, before rebounding modestly in Q2.

Chart 2.12
Unemployment rate



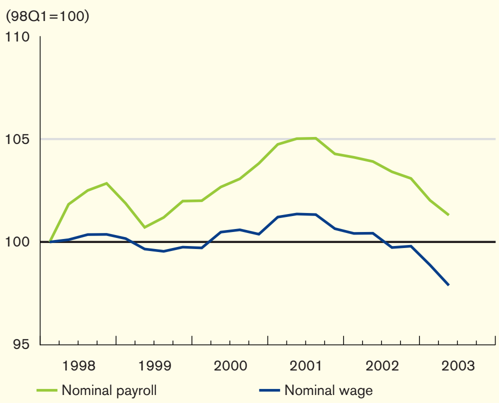
Source: C&SD.

Table 2.C
Sectoral unemployment rate

(%)	2001	2002	2003		
			Q1	Q2	Q3
Manufacturing	5.3	7.3	7.3	8.4	7.3
Construction	10.7	15.8	18.9	19.7	19.6
Trade and tourism	5.5	7.8	7.9	9.1	8.7
Transport	4.4	5.4	6.1	7.6	6.2
Financing	3.0	4.7	4.5	5.6	5.4
Personal services	2.0	3.2	2.9	3.7	3.7
Others	1.6	2.4	3.5	3.2	3.2
Overall	5.1	7.3	7.4	8.5	8.5

Source: C&SD.

Chart 2.13
Wage and payroll indices



Source: C&SD.

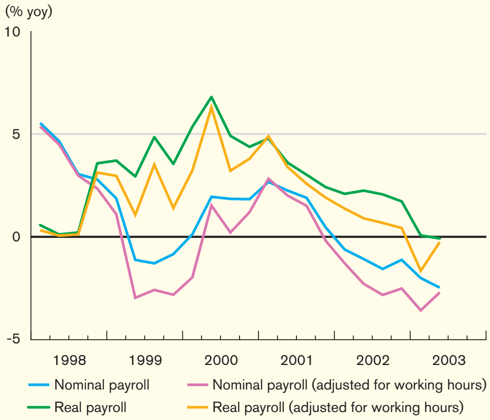
The labour force recorded moderate growth of below 2% in the first half of 2003 from a year before, before falling in recent months. The differential growth between employment and the labour force led to a substantial increase in the unemployment rate, which reached a record high of 8.7% in the three months ending July this year (Chart 2.12). The deterioration was broad based, but was more marked in the tourism and consumption-related sectors (Table 2.C).

Subsequently, the unemployment rate declined to 8.0% in the three months to October: this was attributable to an increase in employment as well as a decline in the labour force. Given the revival of economic activity, the unemployment rate is likely to fall further, as the demand for labour typically lags behind output developments.

2.5 Labour costs

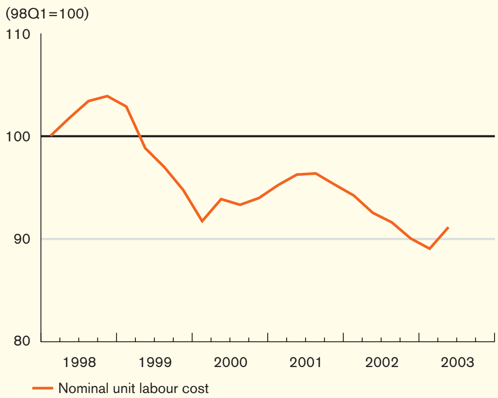
Data on labour costs are available with a long lag. The latest release shows that the decline in labour costs accelerated in the first half of 2003 as the unemployment situation deteriorated upon the impact of SARS. Both the wage and payroll indices saw the biggest decline in over two years (Chart 2.13). The decline in labour earnings was broad based, but was most marked in the restaurant and hotel sector. After taking into account price developments, the wage and payroll indices were virtually unchanged in real terms in the first half of 2003 compared with a year before.

Chart 2.14
Nominal and real labour income



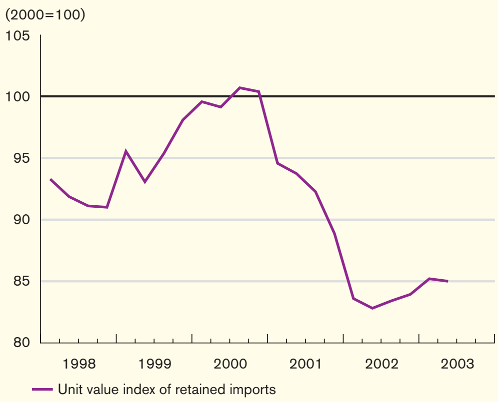
Source: C&SD and Staff estimates.

Chart 2.15
Unit labour cost



Source: C&SD and Staff estimates.

Chart 2.16
Prices of retained imports



Source: C&SD.

However, these indicators of labour earnings may not provide an accurate measure of underlying developments, since they do not take into account changes in working hours.[1] The estimated average hours worked per week were two hours longer in 2003 Q2 than in 1998. After adjusting for the increase in working hours, both nominal and real payroll indices show larger declines (Chart 2.14).

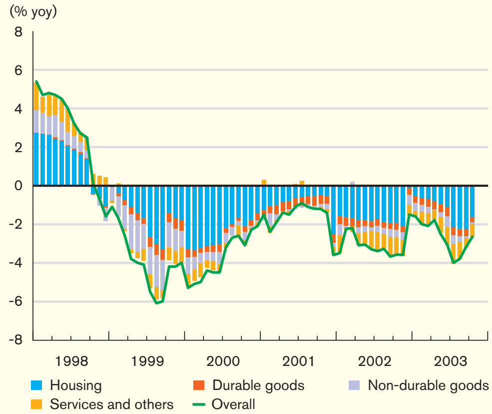
Furthermore, labour costs faced by firms are better captured by unit labour costs, which also take into account productivity growth. Unit labour costs based on payroll data had been declining in recent years, before a modest rise in the second quarter of 2003, which was mainly related to the fall in output (Chart 2.15).

2.6 Commodity and import prices

The unit value index of retained imports rose by 2.4% in the first nine months from a year before (Chart 2.16). The rise reflected a weaker effective exchange rate due to the depreciation of the US dollar as well as higher world commodity prices. Specifically, prices of retained consumer goods and raw materials increased in the first three quarters, while those of capital goods and food declined. Prices of retained imports of fuels also rose in line with developments in the world market.

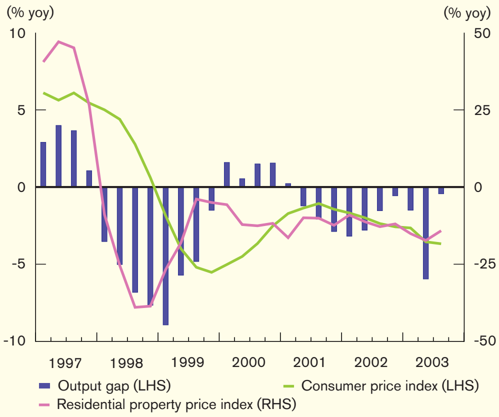
1 See Fan, K. (2003), "Recent Developments in Labour Earnings in Hong Kong", *HKMA Quarterly Bulletin*, December 2003, (Page 17).

Chart 2.17
Consumer prices



Source: C&SD.

Chart 2.18
Residential property prices, the output gap and consumer prices



Note: The output gap is measured as deviations of actual GDP from potential GDP as a percentage of potential GDP.

Source: C&SD, Rating and Valuation Department and Staff estimates.

2.7 Consumer prices

Consumer price deflation continued. The Composite Consumer Price Index (CCPI) declined by 2.7% in the first 10 months of 2003 (Chart 2.17). The sharpest declines occurred in May and June, reflecting the impact of SARS. Deflation has shown signs of moderation since August, with the decline in the CCPI (adjusted for the effects of seasonal factors and government relief measures) narrowing somewhat.

Persistent deflation has been the result of a combination of cyclical and structural factors. In particular, the decline in property prices has contributed to deflation through falls in housing rentals as well as the negative wealth effect on domestic demand (Chart 2.18). The latter has also been affected by high unemployment and reduced income. Reflecting weak domestic demand, output gaps have been negative since the Asian financial crisis, except in 2000.

While import prices increased in the first three quarters, the pass-through to retail prices appears to be limited, probably reflecting the low pricing power of importers and retailers in the environment of weak demand.

Price convergence with the Mainland generally, and with the nearby Guangdong Province in particular, constitutes a structural factor in the downward adjustment of prices in Hong Kong, although it is difficult to assess the importance of this factor. Studies by the HKMA and the IMF suggest that price convergence has contributed only moderately to the overall price decline.[2] Nevertheless, this factor may gain in significance should more items in the consumer basket become tradable between Hong Kong and the Mainland as a consequence of increasing economic integration.

[2] See Ha, J. and K. Fan, (2002), "Price Convergence between Hong Kong and the Mainland", *HKMA Research Memorandum,* June 2002, http://www.info.gov.hk/hkma/eng/research/RM8-2002.pdf; Schellekens, P. (2003), "Deflation in Hong Kong SAR", *IMF Working Paper No. 03/77*, April 2003, http://www.imf.org/external/pubs/ft/wp/2003/wp0377.pdf.

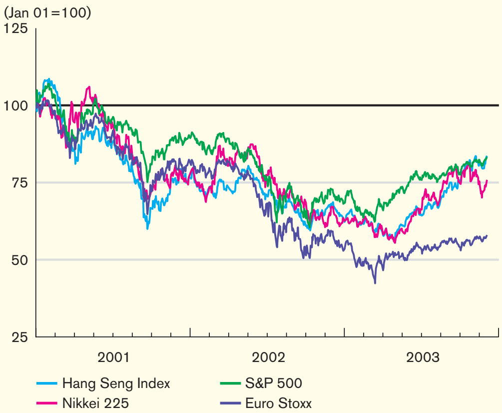
Asset markets

Rising uncertainty arising from the war in Iraq and the outbreak of SARS led to a decline in equity prices in early 2003. Stock prices subsequently rebounded strongly as the economic outlook improved. Property prices continued to decline in the early part of the year, but have shown signs of a recovery in recent months.

2.8 Equity market

The Hong Kong equity market closely followed movements in global markets at the beginning of the year (Chart 2.19). However, developments in local and global equity prices subsequently diverged. The Hang Seng Index weakened to a low of around 8,400 in late April following the outbreak of SARS, despite the recovery of the US and European markets. Stocks of property, retail and travel-related sectors were particularly under strain.

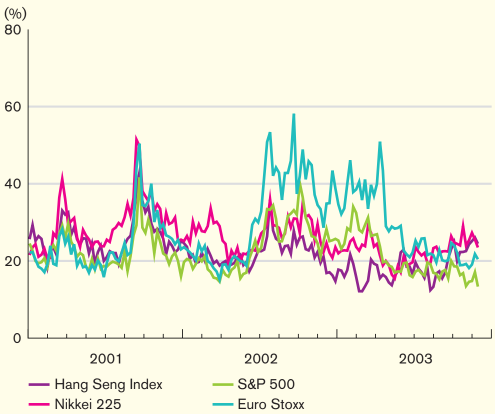
Chart 2.19
Hang Seng Index and global equity prices



Source: Reuters.

Market sentiment started to improve in May as SARS was progressively brought under control. In the following months the local equity market again tended to follow movements in the global markets, but was also supported by encouraging interim profit announcements by major corporates and increasing optimism about economic prospects in Hong Kong. There have been signs of increased capital inflows in recent months, and the Hang Seng Index rose to a recent high of 12,457 in early December. In particular, the sharp increase in tourist arrivals from the Mainland led to substantial rallies in retail shares while the Closer Economic Partnership Arrangement (CEPA) boosted demand for banking stocks.

Chart 2.20
Implied volatility



Source: Bloomberg.

The demand for equity is affected by the perceived riskiness of the stock market compared with other forms of investment. The implied six-month ahead volatility of the major stock price indices derived from options contracts provides a measure of market uncertainty (Chart 2.20). Following global developments, the implied volatility of the local equity market declined in 2003 compared with 2002. This suggests that the recent gains in the Hang Seng Index may be partly explained by a reduction in investors' risk perceptions.

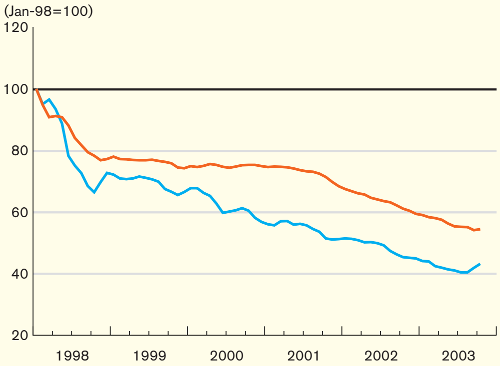
2.9 Property market

The residential property market remained weak at the beginning of the year, but transaction volumes increased in January as the market responded positively to the announcement by the Government of a set of measures aimed at reviving confidence in the market. SARS weighed heavily on residential property prices, which fell by 3.5% in March (Chart 2.21). As the impact of SARS started to fade, sentiment began to improve, lifting demand in the primary market in particular. The number of transactions started to increase in June, and rose to a two-year high in October (Chart 2.22). Signs of improvement were more visible at the high end of the market, stimulated in part by the Government's policy measure to attract investment immigrants to Hong Kong. Under this measure, eligible persons who make capital investments, including real estate, of over HK$6.5 million may apply under the Capital Investment Entrant Scheme.

The residential property price index stopped falling in August on a month-on-month comparison, and rose in September-October. The latest Centa-City Leading Index suggests that property prices increased further in November. The Hong Kong Policy Research Institute's survey shows that market confidence in the property market has been improving in recent months.

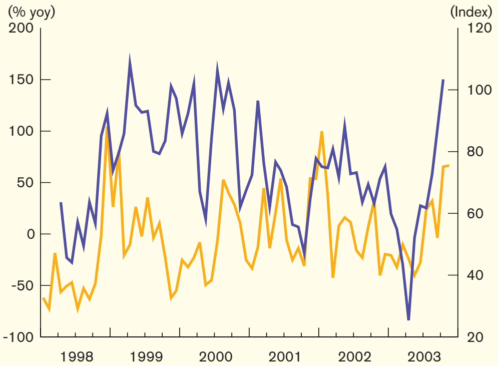
Nevertheless, the strength and durability of the rebound in the property market remains to be seen. Housing demand is affected by factors such as income, property yield, funding costs and expectations about future capital gains/losses. Given the low level of interest rates, the average rental yield has been higher than the funding cost since 2001 (Chart 2.23). The incentive to purchase houses provided by the negative buy-rental gap, together with stabilisation of income and improved labour market conditions, should support housing demand. On the other hand, the strength of investment demand remains to be seen.

Chart 2.21
Residential property prices and rentals



Source: Rating and Valuation Department.

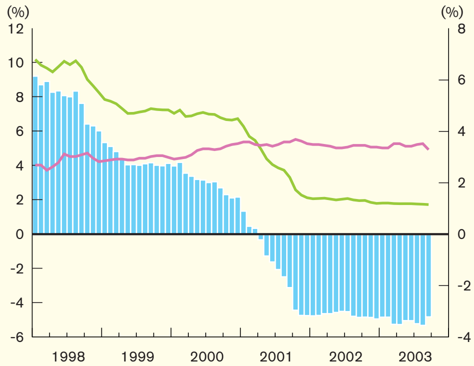
Chart 2.22
Transaction volume and confidence



Note: The confidence index refers to the index for the property market.

Source: Land Registry and Hong Kong Policy Research Institute.

Chart 2.23
Buy-rental gap



Note: The buy rental gap is calculated as: [(1 - downpayment ratio) x mortgage rate + downpayment ratio x 1-month time deposit rate] - rental yield. The term in the square brackets represents the effective funding rate. To compute this rate, the downpayment ratio is taken as 30%, and the mortgage rate is a weighted average for new loans approved. The 1-month time deposit rate is used to represent the opportunity cost of interest earnings on downpayments.

Source: Staff estimates.

Public finances

The fiscal deficit for 2003/04 has been revised upwards since the Budget forecast, in part reflecting increased spending on health care services and relief measures in response to the impact of SARS.

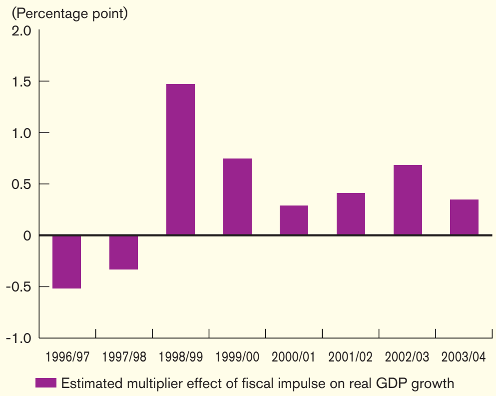
Table 2.D
Fiscal accounts

Fiscal year	98/99	99/00	00/01	01/02	02/03	03/04[1]
	(In percent of GDP)					
Revenue	16.9	18.7	17.5	13.8	14.1	15.1
Tax	9.0	9.0	9.8	9.8	9.0	9.6
Non-tax	7.9	9.7	7.7	4.0	5.1	5.5
Expenditure	18.7	17.9	18.1	18.8	19.0	20.4
Operating	13.9	14.1	14.5	15.6	15.5	16.6
Capital	4.8	3.8	3.6	3.2	3.5	3.7
Overall balance	-1.8	0.8	-0.6	-5.0	-4.9	-5.3
Operating balance	0.0	-0.1	-1.2	-3.7	-4.1	-4.2

Note: 1. Based on the 2003/04 Budget.
2. The operating balance is defined as the difference between operating revenue and operating expenditure. Operating revenue comprises all receipts credited to the General Revenue Account (GRA) except those classified as capital revenue. Operating expenditure is all expenditure from the GRA charged under "Recurrent Account" plus "Other Non-recurrent" expenditure.

Sources: Financial Services and the Treasury Bureau and Staff estimates.

Chart 2.24
Multiplier effect of fiscal impulse



Note: The estimate for 2003/04 is made based on figures in the Budget forecast.

Source: Staff estimates.

The consolidated government fiscal position has been in deficit since 2001/02. Following a shortfall of 4.9% of GDP in 2002/03, the 2003/04 Budget projected a deficit of HK$68 billion or 5.3% of GDP (Table 2.D). To reflect increased spending on health care services and relief measures in response of the impact of SARS, the Government has revised upwards the projected deficit for 2003/04 to around HK$78 billion. Fiscal deterioration in recent years has been associated with an increase in recurrent expenditure and sharp declines in the land premium and other asset-related income. While these partly reflect cyclical conditions in the economy, a study by the Government concludes that the deficit is also of a structural nature.[3]

The fiscal deficits in the past few years have provided moderate stimulus to aggregate demand. Estimates suggest that the policy stance has been expansionary since 1998/99, although the strength of the stimulus moderated in recent years (Chart 2.24).[4]

The Government has set a target of achieving budget balance by 2008/09, and has committed itself to reducing public expenditure to at most 20% of GDP. Given the substantial fiscal reserves and the absence of government debt, a continuing deficit in the next few years does not necessarily pose a threat to monetary stability. Indeed, given the improved growth outlook and consolidation measures, fiscal deficits are expected to decline.

[3] See Task Force on Review of Public Finances (2002), *Final Report to the Financial Secretary*, February 2002, Hong Kong SAR Government, http://www.info.gov.hk/fstb/tb/budget/budget02-03/tfr/english/e_tfr.htm.

[4] The framework for estimating the multiplier effect of fiscal impulse on real GDP growth was discussed in "Hong Kong: Macroeconomic Impact of Recent Fiscal Measures", *HKMA Quarterly Bulletin,* February 2000, http://www.info.gov.hk/hkma/eng/public/qb200002/fa01.pdf.

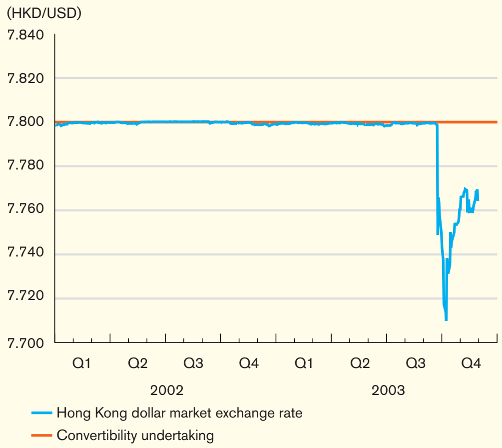
3. Monetary and financial stability

Exchange rate, interest rates and monetary developments

Over the course of 2003 market sentiment has changed markedly from pessimism to optimism about the Hong Kong economy. Fund flows reversed abruptly in late September and early October, with one-month Hong Kong dollar interbank interest rates falling to around 100 basis points below US dollar rates, and the exchange rate appreciating by around 1% at its peak. The sale of Hong Kong dollars by the HKMA has helped to stabilise the exchange rate.

Broad money growth picked up moderately in the third quarter, reflecting the recovery in economic activity. Narrow money expansion was brisk in the face of increased stock market activity.

Chart 3.1
Hong Kong dollar exchange rate



Source: HKMA.

3.1 Exchange rate and interest rates

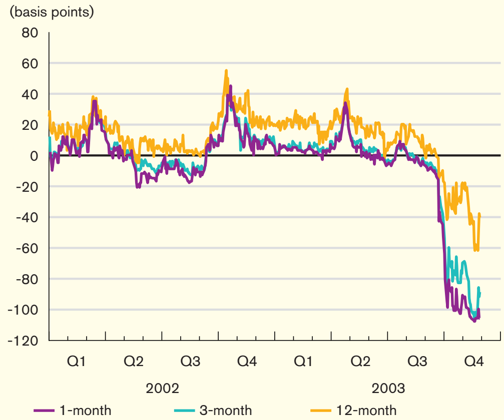
The exchange rate remained close to the Linked Rate of 7.8 during the first three quarters of 2003, but strengthened significantly at the end of September (Chart 3.1). The HKD/USD rate appreciated at one time to 7.70 in early October. The HKMA sold a cumulative HK$11 billion of Hong Kong dollars to banks between late September and the end of November, contributing to a further decline in interest rates and a modest easing of the exchange rate to 7.76-7.77 (Chart 3.2) (see Box 1 for a discussion of the episode).

The abrupt shift in sentiment in late September arose largely from greater recognition by investors of the improved prospects of an economic recovery, robust current account surpluses, and large international investment position. The shift took place against a background of the recent weakness of the US dollar and international pressure for an appreciation of the renminbi.

Chart 3.2
Hong Kong dollar interbank interest rates

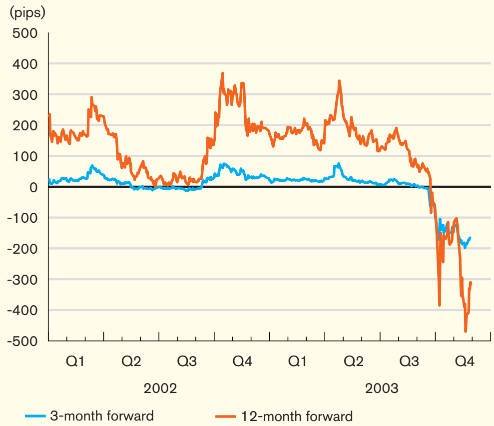
Source: HKMA.

Chart 3.3
Interest rate differentials between Hong Kong dollar and US dollar



Source: HKMA.

Chart 3.4
Hong Kong dollar forward points



Source: HKMA.

The improvement in market confidence came after a period of subdued sentiment during April – July. Interest rate differentials between the Hong Kong and US dollar increased briefly in April – July upon the impact of SARS and uncertainty associated with the resignation of Principal Government Officials (Charts 3.3 and 3.4). Since August, domestic interest rates have fallen below US dollar rates, reflecting improved market sentiment. This has in part been supported by the announcement of a number of policy initiatives, in particular, a relaxation of travel restrictions on Mainland visitors to Hong Kong and the conclusion of CEPA. Moody's upgraded Hong Kong's long-term foreign currency rating by two notches, to a level above that of the Mainland, in October. Anecdotal evidence suggests that equity-related inflows have increased considerably since August.

The strengthening of the spot rate from the Linked Rate reached a maximum of 1.2% in October: this had minimal macroeconomic implications. It does not appear that the absence of a convertibility undertaking on the strong side of the Link has had any effect on the credibility and effectiveness of the Currency Board System.[5]

Despite the improved economic outlook, the strength and durability of recovery in major economies, domestic fiscal situation, developments regarding the renminbi exchange rate, and the possibility of a re-emergence of SARS still warrant attention. In particular, investors are likely to remain watchful of fiscal deficits and the policy strategy adopted by the Government to address the imbalance. While the Mainland authorities have reaffirmed their policy of a stable renminbi exchange rate, the continuing speculation about exchange rate policy on the Mainland may raise the volatility of fund flows.

[5] See Yam, J. "Viewpoint" Articles on 2 and 16 October 2003, http://www.info.gov.hk/hkma/eng/viewpt/index.htm.

Box 1
Recent developments in the Hong Kong dollar exchange and money markets

Chart B1.1
HKD/USD and RMB/USD forward points

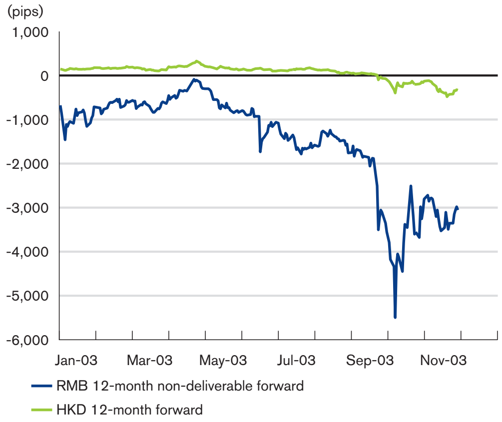


Chart B1.2
Exchange rates of Hong Kong dollar and Asian currencies against US dollar

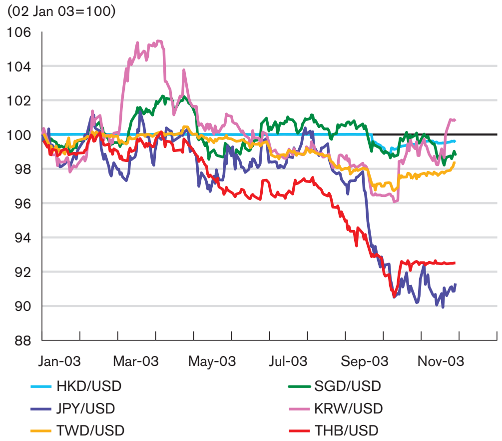
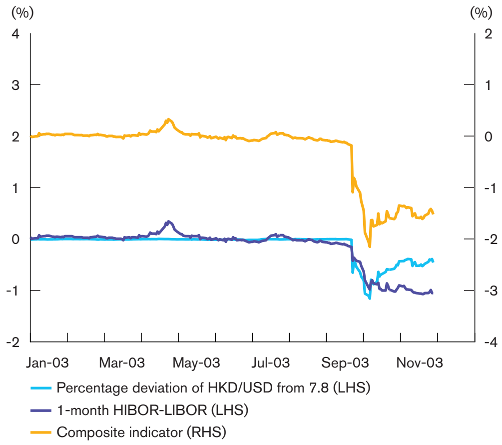


Chart B1.3
Composite indicator of exchange rate and interest rate differentials

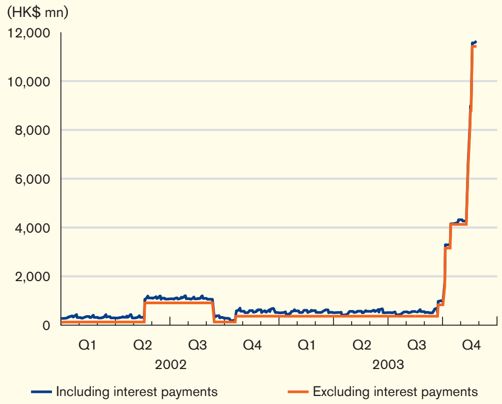


The appreciation of the Hong Kong dollar in late September is explained mainly by the improved prospects for the economy, helped by a rebound from pessimism following the onset of SARS, and policy measures that facilitate further economic integration between Hong Kong and the Mainland. Speculation about a revaluation of the renminbi, and market dynamics, particularly the unwinding of short Hong Kong dollar positions, played a role in triggering and exacerbating the movement of the Hong Kong dollar (Chart B1.1 and Chart B1.2).

The adjustment of the exchange rate has probably also been affected by the limited room for falls in interest rates, which were already at a low level. A composite indicator, formed by adding the interest rate differentials and the deviation of HKD/USD from the convertibility rate (both in percentage terms), suggests that the spot exchange rate and interest rate differentials each underestimate the pressure on the Hong Kong dollar (Chart B1.3). Should the spot rate be kept close to 7.8, interest rates would have to decline much more. This composite indicator does not fully capture the market pressure either, because it fails to reflect the sale of Hong Kong dollars by the HKMA after the short-term rates fell to near zero. It is, however, difficult to assess the effect of such sales on the exchange rate.

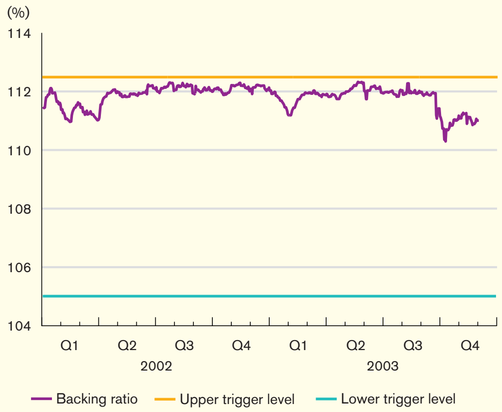
While the Linked Exchange Rate system anchors exchange rate expectations, in the short run, forces such as speculation about a renminbi revaluation may continue to influence market views about the Hong Kong dollar.

Chart 3.5
Aggregate Balance (before Discount Window)



Source: HKMA.

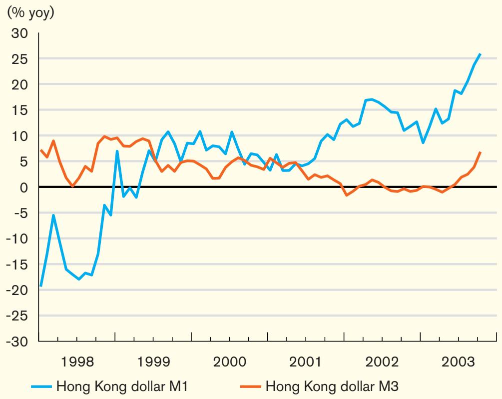
Chart 3.6
Backing ratio



Note: Under the arrangements for transferring assets between the backing portfolio and the investment portfolio of the Exchange Fund, when the backing ratio reaches 112.5% (the upper trigger level), sufficient assets will be transferred from the backing portfolio to the investment portfolio to reduce the ratio to 110%. Should the backing ratio drop to 105% (the lower trigger level), assets will be transferred from the investment portfolio to the backing portfolio to restore the ratio to 107.5%.

Source: HKMA.

Chart 3.7
Monetary aggregates



Note: Hong Kong dollar M1 is seasonally adjusted.

Source: HKMA.

3.2 Monetary Base and Backing Ratio

The Aggregate Balance was broadly stable until a notable expansion in late September following sales of Hong Kong dollars by the HKMA in response to the strengthening of the Hong Kong dollar from the Linked Rate (Chart 3.5).

The Monetary Base — which comprises the Certificates of Indebtedness (CIs, which back the issue of banknote), currency and coins issued by the Government, the Aggregate Balance, and Exchange Fund paper — expanded. This was largely due to increases in CIs and the Aggregate Balance. The rise in currency demand and thus CIs was in part attributable to low interest rates.

The ratio of backing assets to the Monetary Base declined in late September, but remained well above the lower trigger level (Chart 3.6). Although the increase in the Monetary Base was matched by a corresponding rise in backing assets, the increase in the latter was partly offset by valuation changes associated with the appreciation of the Hong Kong dollar against the US dollar.

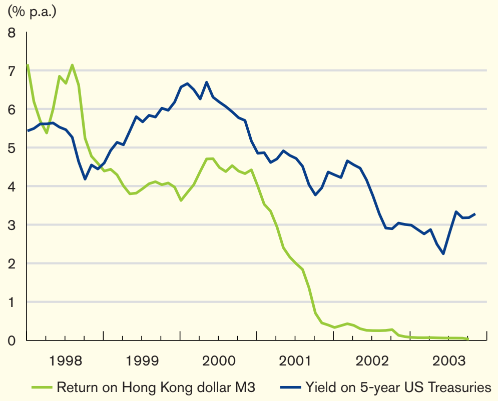
3.3 Monetary aggregates

Growth in narrow and broad money has diverged since mid-2001 (Chart 3.7). Narrow money expanded strongly, mainly reflecting the declining opportunity cost of holding non-interest-bearing monetary assets, while broad money recorded sluggish growth due to subdued economic conditions. Past studies suggest that broad money depends positively on economic activity but negatively on the spread between yields on alternative assets and deposits.[6]

The expansion of narrow money has accelerated in recent months: this is attributable to a significant increase in demand deposits and to a smaller extent a rise in currency held by the public. The former was related to the rebound in stock market activity.

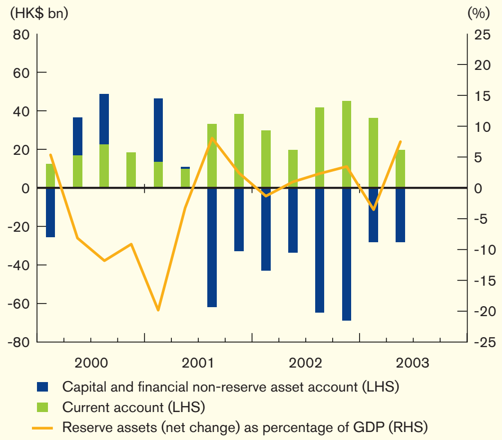
[6] See Lai, K. and J. Shi, (2002), "The Slowdown of Hong Kong Dollar Broad Money Growth", *HKMA Research Memorandum*, June 2002, http://www.info.gov.hk/hkma/eng/research/RM-2002_broad_money.pdf.

Chart 3.8
Rates of return on assets



Source: Staff estimates and CEIC.

Chart 3.9
Balance of payments



Note: A negative sign in the net change in reserve assets represents an increase.

Source: C&SD.

Table 3.A
Balance of payments account by standard components

	2002				2003	
In percent of GDP	Q1	Q2	Q3	Q4	Q1	Q2
Current account	10.1	6.5	12.9	13.7	12.3	6.9
Capital and financial account	-15.7	-9.9	-17.6	-17.3	-12.9	-2.2
Capital transfers	-1.0	-2.5	-0.6	-1.0	-0.7	-1.0
Financial non-reserve assets (net change)	-13.4	-8.5	-19.4	-19.8	-8.7	-8.8
Direct investment	-3.4	5.0	-10.1	-1.0	1.0	12.1
Portfolio investment	2.4	-38.5	-25.4	-29.5	-18.4	-9.0
Financial derivatives	4.1	2.0	-1.8	-0.6	4.1	7.7
Other investment	-16.5	23.0	17.9	11.3	4.6	-19.5
Reserve assets (net change)	-1.3	1.0	2.4	3.5	-3.5	7.6
Net errors and omissions	5.6	3.4	4.6	3.6	0.6	-4.7

Note: A negative sign in the net change in reserve assets represents an increase.

Sources: C&SD.

Broad money growth has also picked up moderately since June, indicating a revival in economic activity. Nevertheless, broad money growth was still restrained by record-low deposit rates. For example, the estimated return on Hong Kong dollar M3, which is a weighted average of the yields of its components, was close to zero, and much lower than yields on longer-term US Treasuries (Chart 3.8).

3.4 Capital flows

The balance of payment (BoP) accounts offer information useful for analysing cross-border fund flows. Nevertheless, the statistics do not necessarily reflect *ex ante* demand. It is important to examine forces driving changes in the BoP components and the role of financial variables, particularly interest rates, in equilibrating the flows. Box 2 outlines a framework for interpreting the BoP statistics.

The BoP accounts show a decline in reserve assets in Q2, the most recent period for which statistics are available (Chart 3.9 & Table 3.A). This was mainly attributable to a conversion of foreign currency assets to Hong Kong dollars in response to fiscal drawdowns, rather than changes in the non-government sector's portfolio demand for the domestic currency. Among the BoP components, a strong current account surplus was accompanied by a large net outflow in the (non-reserve) capital and financial account. The current account surplus reflects in part an improvement in competitiveness due to the depreciation of the real effective exchange rate, as well as weak domestic demand.

The net outflow in the (non-reserve) capital and financial account, particularly for portfolio investment, reflects a portfolio re-balancing in search of higher rates of return on foreign assets. The other investment (OI) account, which includes mainly offshore loans and deposits of the banking and non-bank sectors, also recorded a net outflow. This was partly associated with a reduction in deposits of Mainland banks, probably reflecting reduced demand for Hong Kong dollar assets in Mainland China in light of higher deposit rates for the renminbi relative to foreign currencies and speculation about a revaluation of the renminbi.

Available information suggests a decline in reserve assets and a continued robust surplus in the current account, which together imply a net outflow in the (non-reserve) capital and financial account in Q3.[7] This appears to be in contrast with the notably stronger equity-related inflows witnessed in August and September. However, the pressure from inflows was partly borne by interest rates, which declined to close to zero for short maturities, and partly by the exchange rate. This might have induced some portfolio outflows, resulting in a net outflow in the capital and financial accounts. The fall in foreign reserves was due to fiscal drawdowns, which more than offset the expansion of the backing portfolio associated with the increase in the Monetary Base during the quarter.

[7] Foreign reserves declined by about HK$18 billion during Q3 in value terms, which have to be adjusted for valuation changes in the BoP accounts.

Box 2
Analysing the balance of payments

BoP statistics provide important information about an economy's external payment transactions with the rest of the world. The main features of the statistics are:

- They comprise two main accounts: (i) the current account (CA), which covers transactions involving goods, services, investment and other factor income, and current transfers; and (ii) the financial and capital account, which covers transactions involving financial claims and liabilities, as well as capital transfers. The financial and capital account is further decomposed into the official reserves and the non-reserve account, with the latter representing private capital flows. The change in official reserves is often called the BoP position.

- The BoP is an accounting identity, with the sum of the two accounts being zero. For example, in the event of net import of goods, this involves external payment, which has to be financed by a drawdown of net foreign assets (or increased foreign borrowing). A CA deficit is financed by inflows to the financial and capital account.

Caution is called for in interpreting the statistics, because they capture external transactions in an ex-post sense. The data reflect the interaction of: (i) autonomous or exogenous changes in individual components; and (ii) changes in response to interest rate and exchange rate developments, emanating from changes in other BoP components. Some common misperceptions in analysing the BoP in Hong Kong are highlighted below.

First, in the past few years, the BoP in Hong Kong has been characterised by large CA surpluses, matched by net capital outflows. This leads to the question whether these outflows constitute a concern. An analysis suggests that there were some autonomous net portfolio and foreign direct investment outflows, which were financed in part by the CA surplus. However, this net outflow was compatible with economic fundamentals, reflecting particularly a portfolio re-balancing in seeking higher rates of return on foreign assets. The adjustment in the real exchange rate helped to bring about the CA surplus and the accumulation of foreign assets.

Secondly, changes in reserve assets (or the so-called overall BoP position) do not necessarily reflect the autonomous demand for Hong Kong dollars. This is because reserve assets are influenced by a host of factors in addition to the public's portfolio demand for Hong Kong dollars. These include the public's demand for cash, banks' liquidity demand for clearing balances, and fiscal transfers.

In sum, the BoP accounts should be carefully interpreted with due regard to the underlying forces that drive changes in individual components. To better ascertain the nature of these shocks, it is useful to examine the factors driving changes in reserve assets, as well as movements in financial variables, such as interest rates, the exchange rate, and asset prices.

Banking sector performance

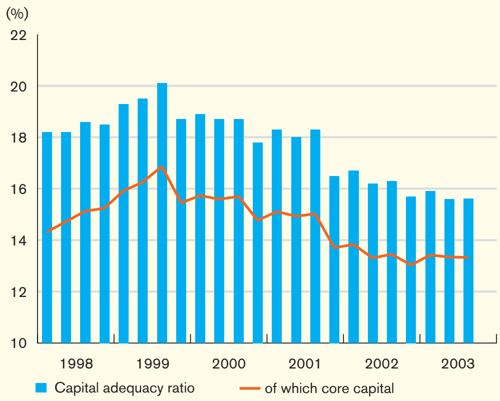
Retail bank profitability increased modestly in the third quarter of 2003, owing largely to a reduction in loss provisions. The net interest margin, however, declined, reflecting mainly narrowed lending spreads and sluggish loan demand. Asset quality should improve further given the recent declines in unemployment rate, a pick-up in residential property prices, and brighter economic outlook.

3.5 Profitability and capitalisation

The soundness of the banking system is critical to the maintenance of the Linked Exchange Rate system in Hong Kong. In particular, a well-capitalised and profitable banking sector is better able to withstand adverse shocks. The consolidated capital adequacy ratio of the locally incorporated Authorized Institutions (AIs) stood at 15.6% at end-September, well above the minimum international standard of 8% (Chart 3.10). Core capital accounted for 85% of the capital base (Table 3.B). Its ratio to risk-weighted assets was high, at 13.3%, compared with about 10% in the US and the UK.

Box 3 outlines the linkages between the performance of the banking sector and macro-economic conditions. Reflecting the weak economy, the bursting of the property bubble, and increased competition in the banking sector, bank profitability has declined since the

Chart 3.10
Capitalisation of local AIs



Source: HKMA.

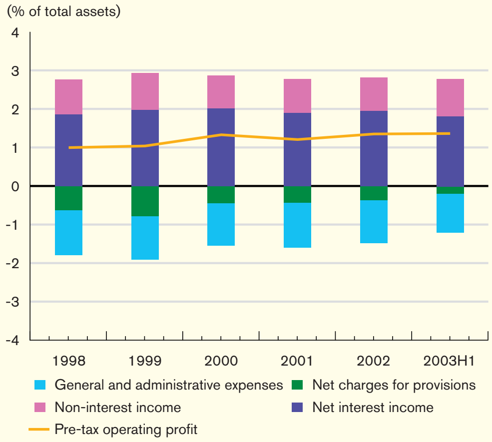
Table 3.B
Consolidated capital adequacy ratio of local AIs

(HK$ mn)	Sep-03
Total capital base after deductions	311,965
of which core capital	266,483
Total risk-weighted exposures	1,998,476
Capital adequacy ratio	15.6%

Note: 1. Total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance.
2. Core capital primarily consists of common equity and certain preferred capital, excluding goodwill.

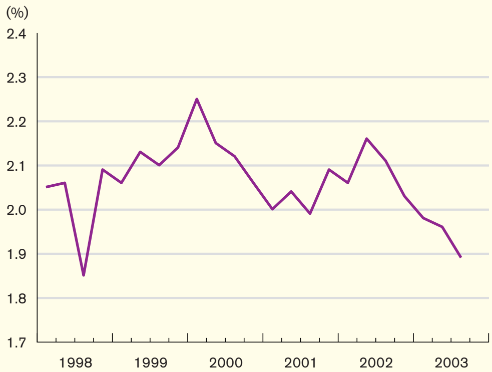
Source: HKMA.

Chart 3.11
Profitability of retail banks



Source: HKMA.

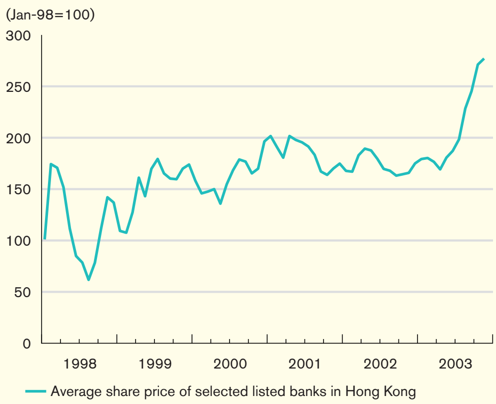
Chart 3.12
Net interest margin of retail banks



Note: Net interest margin is measured by the ratio of net interest income to interest-bearing assets.

Source: HKMA.

Chart 3.13
Stock prices of selected listed banks



Note: The listed banks include Hang Seng Bank, Bank of East Asia, Dah Sing Bank, International Bank of Asia, ICBC (Asia), Wing Hang Bank, Wing Lung Bank and Liu Chong Hing Bank. They account for 25-30% of Hong Kong dollar assets of all (listed and non-listed) retail banks in Hong Kong. The three largest listed banks are excluded.

Source: HKMA.

Asian financial crisis, notwithstanding a modest rebound from the low level in 1998-99 (Chart 3.11). In particular, weak loan demand and increased competition have reduced banks' pricing power and have thus contributed to narrowed lending margins. Net charges for loss provisions also increased following the Asian financial crisis, owing to a deterioration in asset quality. Asset quality has improved steadily in the past few years, but has remained below that in the pre-crisis period.

The recent developments suggest that retail bank profitability, as measured by pre-tax returns as a percentage of total assets, rose slightly in Q3, attributable mainly to a reduction in provisioning charges. Nevertheless, the net interest margin declined, reflecting weak loan demand associated with high unemployment and persistent declines in property prices, as well as intense competition in the mortgage market (Chart 3.12).

The improved economic outlook should be helpful to the banking sector. The recent rise in stock prices of listed banks indicates market expectations of a revival in bank profits (Chart 3.13). Box 4 considers the use of stock prices as a market-based indicator of banking performance.

Box 3
Macroeconomic conditions and the banking sector

There are important two-way linkages between macroeconomic conditions and banking sector performance (Figure 1). A strong and profitable banking system promotes broader financial stability and increases the economy's resilience to adverse macroeconomic shocks. At the same time, changes in macroeconomic conditions affect banks' performance and financial health.

Banks' performance is affected by shocks to the macroeconomy through risk factors such as interest risk, exchange rate risk, credit risk and liquidity risk. ***Interest rate risk*** is incurred by the mismatch of the interest rate sensitivity of a bank's assets and liabilities, as well as other interest sensitive components of the balance-sheet. Interest rate risk can emerge in a variety of forms, including repricing risk, yield curve risk and basis risk. ***Exchange rate risk*** arises because exchange rate changes can impact directly on a bank if it holds foreign currency positions, or indirectly if its borrowers or counter-parties are affected. ***Credit risk*** is the risk that a borrower or counter-party defaults on contractual obligations. Credit risk may increase with slow economic growth, rising interest rates, high unemployment and falling asset prices. ***Liquidity risk*** may exist on both the asset and funding sides. Asset liquidity risk refers to the inability to conduct a transaction at market prices because of the size of the transaction, *e.g.* in the event of a 'fire sale'. Funding liquidity risk arises in the situation in which a bank does not have access to sufficient funds to meet payment obligations in a timely manner.

To assess how vulnerable individual banks are to changes in economic conditions, bank supervisors can carry out stress tests as well as monitor bank profits and asset quality. There are three approaches to undertaking stress testing to evaluate systemic vulnerabilities — bottom-up, aggregative, and macroeconomic.[8] The bottom-up approach makes a judgement on banking soundness by summarising results from stress tests of individual banks' balance-sheets. The aggregative method applies shocks to risk factors such as exchange and interest rate risks to the sector's aggregate balance-sheet. The macroeconomic approach seeks to directly establish the relationships between macroeconomic variables and indicators of banking sector performance and health.

There have been a number of studies of the linkages between the macroeconomy and banking sector in Hong Kong: see for example Shu (2002), Peng *et al.* (2003), Gerlach and Peng (2003), Jiang *et al.* (2003) and Gerlach *et al.* (forthcoming).[9] These studies show that profitability — a key indicator of banking performance — fell in recent years in the face of difficult macroeconomic conditions and increased competition:

- The two major economic downturns in recent years raised loan default rates, and thus contributed to a rise in loss provisions. Weak loan demand, combined with increased competition, also reduced banks' pricing power, resulting in a narrowing of net interest margins. Although nominal interest rates

[8] See Lindgren, C., Garcia, G. and M. I. Saal, (1996), "Bank Soundness and Macroeconomic Policy", Washington, DC: IMF.

[9] Shu, C. (2002), "The Impact of Macroeconomic Environment on the Asset Quality of Hong Kong's Banking Sector", *HKMA Research Memorandum,* December 2002, http://www.info.gov.hk/hkma/eng/research/RM20-2002.pdf; Peng, W., Lai K., Leung F. and C. Shu, (2003), "The Impact of Interest Rate Shocks on the Performance of the Banking Sector", *HKMA Quarterly Bulletin,* June 2003, http://www.info.gov.hk/hkma/eng/public/qb200306/fa2.pdf; Gerlach, S. and W. Peng, (2003), "Bank Lending and Property Prices in Hong Kong", *HKIMR Working Paper No. 12/2003,* June 2003, http://www.hkimr.org/search/pdf/wp200312_text.pdf; Jiang, G. *et al.* (2003), "Determinants of Bank Profitability in Hong Kong", *HKMA Research Memorandum,* September 2003, http://www.info.gov.hk/hkma/eng/research/RM_on_Banz_Profitability.pdf; and Gerlach, S., Peng W. and C. Shu, (forthcoming), "Macroeconomic Conditions and Banking Performance in Hong Kong: A Panel Study".

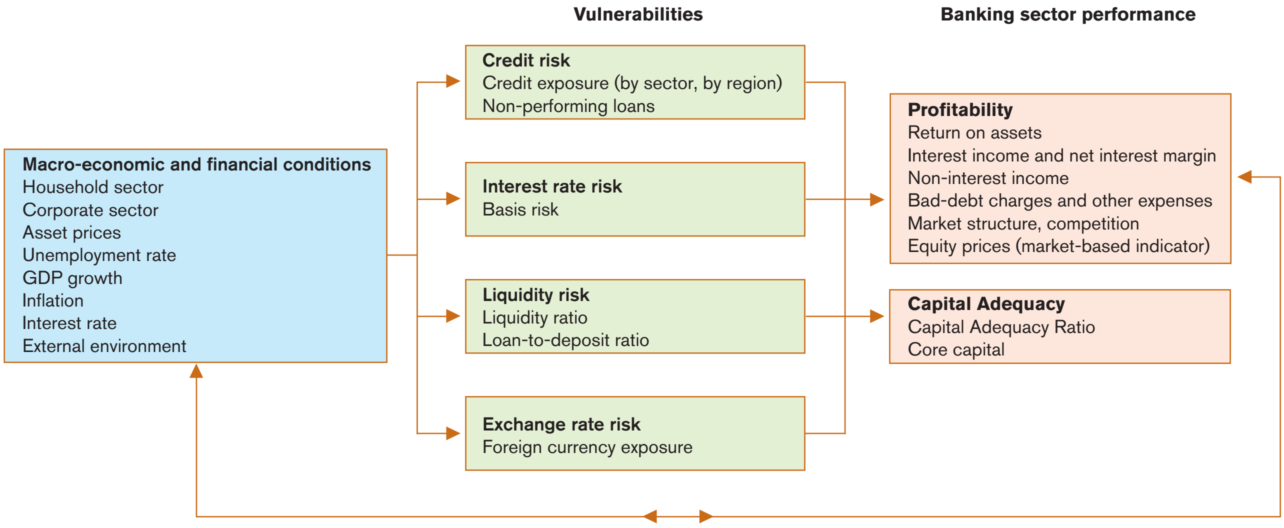
have been low in the last two years, real interest rates have remained at relatively high levels by pre-crisis standards because of deflation. This has increased the real value of the debt burden.

- Property price declines have affected bank profitability through reduced loan demand and increased credit risk. It should be noted, however, that the quality of property-related lending appears to be less sensitive to macroeconomic conditions than other loans, as evidenced by the relatively low delinquency rate of residential mortgages.

- Smaller banks have experienced a larger decline in profitability since the Asian financial crisis. This is mainly attributable to a larger fall in net interest income of smaller banks. Furthermore, smaller banks have not been able to raise non-interest income and reduce operating costs as larger banks have done in recent years to stabilise profits in the face of declining net interest income and increasing loss provisions.

Despite the decline in profitability in recent years relative to the boom period before the Asian financial crisis, the banking system as a whole remains fundamentally sound.

Figure 1
Linkages between the banking sector and macro-economic conditions



Box 4
Market-based indicators of bank performance

Chart B4.1
Stock price and profitability of selected listed banks

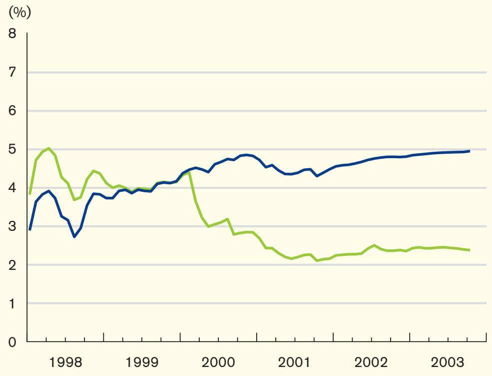
Note: Return on assets and stock price are averages calculated for eight listed banks in Hong Kong, namely Hang Seng Bank, Bank of East Asia, Dah Sing Bank, International Bank of Asia, ICBC (Asia), Wing Hang Bank, Wing Lung Bank and Liu Chong Hing Bank. Data are collected from Bankscope, Primark, and Datastream.

While financial ratios provide comprehensive information about bank performance, data are released with a time lag. In contrast, market-based indicators are more up to date, and thus are useful supplements to financial statistics. Both stock prices and subordinated bond spreads are commonly used market indicators. In Hong Kong stock prices are readily available information but few banks issue subordinated debt. In recent years, changes in stock prices of listed banks tend to be associated with movements in profitability (Chart B4.1).

Stock prices and related statistics (e.g. returns and market capitalisation) provide leading information about bank performance. This report uses average stock prices of retail banks listed in Hong Kong, excluding the three largest ones (HSBC, Standard Chartered Bank and Bank of China). They account for 25-30% of Hong Kong dollar assets of all (listed and non-listed) retail banks in Hong Kong. The exclusion of the three largest banks leaves the remaining ones more representative of small to medium-sized banks with operations mainly in Hong Kong.

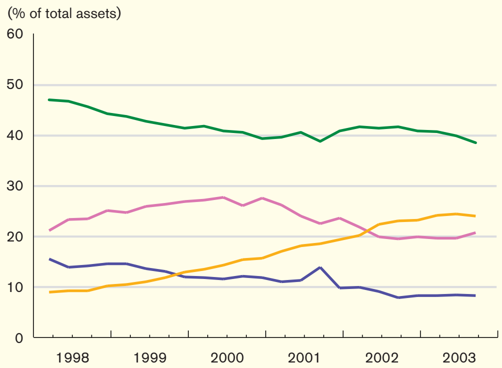
It should be noted that stock price-based indicators usually place emphasis on profitability, which can be achieved either by excessive risk-taking or an improvement in managerial performance. The balance of risk and return may be more tilted towards the former than a bank regulator would prefer.

Chart 3.14
Intermediation spreads



Source: Staff estimates.

Chart 3.15
Asset composition of retail banks



Source: HKMA.

Table 3.C
Loans by economic use

	Year-on-year change (%)				Share of total (%)
	Dec-02	Mar-03	Jun-03	Sep-03	Sep-03
Loans for domestic use	-2.4	-2.9	-2.8	-2.9	
Of which:					
Trade financing	2.8	7.6	6.5	3.1	5.4
Mortgages[1]	-0.8	-2.1	-4.1	-4.4	34.6
Manufacturing	-1.3	-0.9	2.6	11.3	4.3
Transport and transport equipment	1.2	-2.2	-0.3	3.3	5.9
Electricity, gas and telecommunications	-4.0	0.6	1.7	-24.5	2.4
Building, construction, property development and investment	-3.8	-3.6	-2.9	-2.8	20.4
Wholesale and retail trade	-2.5	-1.3	-1.7	-6.2	5.4
Financial concerns[2]	-10.1	-10.8	-0.1	7.0	7.5
Stockbrokers	-6.9	-4.9	-27.5	2.6	0.5
Credit card advances	-6.4	-11.0	-11.4	-8.5	2.6

Note: 1. Mortgage loans include loans for the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme.
2. Loans for financial concerns refer to loans to investment and insurance companies, futures brokers and finance companies.

Source: HKMA.

3.6 Interest rate risk

The majority of banks' interest-bearing assets are on floating rate terms, hence limiting banks' exposure to changes in interest rates. There is, however, a basis risk arising from the use of different reference rates. Mortgages and personal loans are mostly priced with reference to the best lending rate (BLR). The spread of the BLR over the effective deposit rate, a measure of intermediation spreads, has widened as a result of a swifter decline in funding cost (Chart 3.14). However, the decline of mortgage rates relative to the BLR, driven by the competition in the residential mortgage market, has led to a further contraction of the lending margin.

In search of higher returns, banks have increasingly invested in debt securities (Chart 3.15). While this provides some support to interest income, banks may have become more susceptible to volatility in bond markets.

3.7 Credit risk

Credit exposures

Property-related loans accounted for about 55% of domestic lending (Table 3.C). Such lending declined in the third quarter of 2003, as the weak property market and concerns about employment prospects continued to depress credit demand. There was also a valuation effect associated with lower property prices. Trade financing grew strongly in Q2, but moderated somewhat in Q3, owing in part to the slowdown in growth of external trade. Nevertheless, the share of trade financing in total domestic lending was small (around 5% at the end of September).

Outstanding credit card advances fell on a year-on-year comparison in Q2, but the rate of decline slowed in Q3. The decline in credit card receivables was probably because of a tightening of credit card issuance and lending policies by banks, the transfer of restructured receivables out of the card portfolio, and charge-offs. Lending to stockbrokers and financial concerns expanded in Q3 alongside the sharp rebound in the stock market.

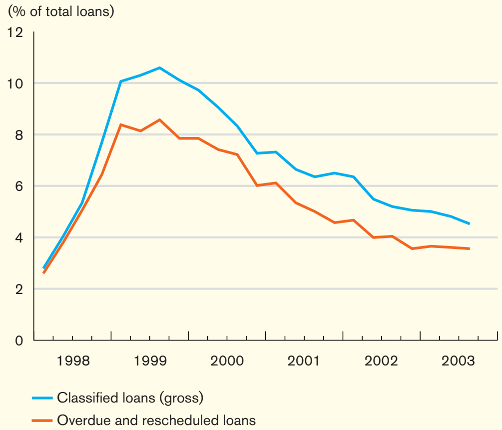
Asset quality

Asset quality, as measured by the proportion of classified loans, has improved (Chart 3.16). Bad debt charges decreased in 2003 Q3 after a notable rise in Q2. The situation is expected to improve further, as indicators of asset quality tend to lag behind developments in the economy and financial markets.

The mortgage delinquency ratio declined to 1.05% at end-September (Chart 3.17). Helped by a pick-up in property prices, the number of residential mortgage loans in negative equity decreased to about 99,800, with a value of HK$155 billion at the end of September and an unsecured portion of about HK$33 billion.

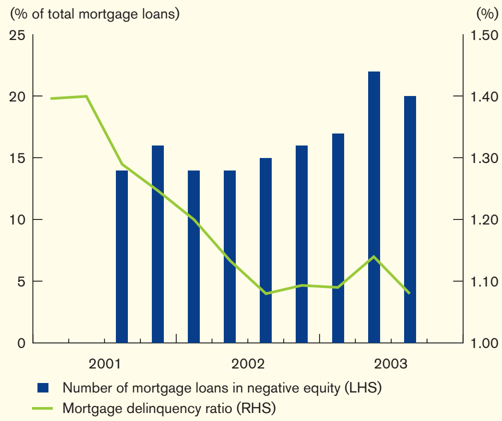
The quality of banks' credit card portfolios appears to be stabilising (Chart 3.18). The charge-off ratio declined further in Q3. This was due in part to banks' tightening of credit card lending and to on-going restructuring efforts. The improvement in labour market conditions also helped.

Chart 3.16
Asset quality measures of retail banks



Source: HKMA.

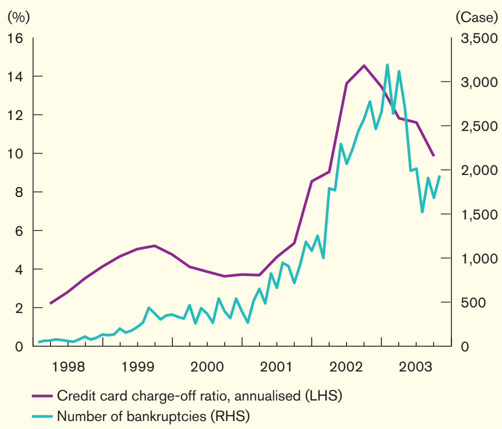
Chart 3.17
Negative equity and mortgage delinquency ratio of surveyed AIs



Note: The number of mortgage loans in negative equity are available from September 2001.

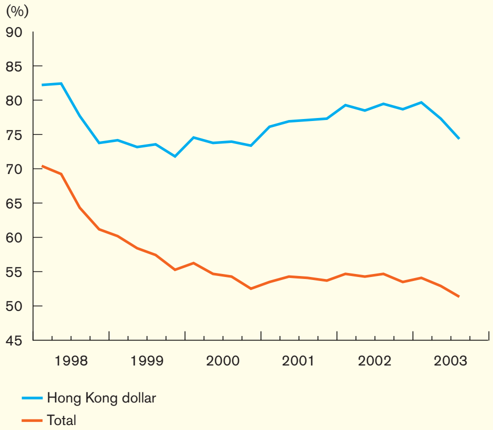
Source: HKMA.

Chart 3.18
Bankruptcies and credit card charge-off ratio of surveyed AIs



Source: CEIC and HKMA.

Chart 3.19
Loan-to-deposit ratios of retail banks



Source: HKMA.

3.8 Liquidity

The average liquidity ratio of retail banks stood at 46% in 2003 Q3, far exceeding the minimum requirement of 25%. Net placements to banks abroad and debt securities holdings, which are relatively liquid, accounted respectively for 13% and 22% of retail banks' total assets. The Hong Kong dollar loan-to-deposit ratio of all retail banks declined to 74% at the end of September (Chart 3.19).

3.9 Foreign currency position

Authorized Institutions (AIs) have accumulated net foreign currency assets in recent years, reflecting partly the diversion of Hong Kong dollar funds in the face of weak domestic lending. Alongside the strengthening of the Hong Kong dollar against the US dollar, the aggregate net foreign currency position (including both spot and forward) of AIs fell considerably by HK$18 billion from the end of June to about HK$79 billion at the end of September.

Key performance indicators of the banking sector are provided in Table 3.D.

Table 3.D
Banking sector performance indicators[1] (%)

	Sep-02	Jun-03	Sep-03
Interest rate[2]			
1-month HIBOR	1.70	1.26	0.99
3-month HIBOR	1.72	1.26	1.03
BLR and 1-month HIBOR spread	3.43	3.74	4.01
BLR and 3-month HIBOR spread	3.41	3.74	3.97
		Retail Banks	
Balance sheet developments[3]			
Total deposits	-0.9	2.2	1.8
Hong Kong Dollar	-1.4	2.3	2.1
Foreign currency	-0.1	2.0	1.2
Total loans	-0.3	0.0	-1.5
Loans to customers inside Hong Kong[4]	-0.5	0.0	-1.7
Loans to customers outside Hong Kong[5]	9.9	0.6	5.7
Negotiable instruments			
Negotiable debt certificates issued	6.4	0.4	2.3
Negotiable debt instruments held	2.7	3.4	0.2
Asset quality[6]			
As % of total loans			
Pass loans	89.02	88.55[r]	88.39
Special mention loans	5.76	6.63[r]	7.08
Classified loans (gross)[7]	5.22	4.83[r]	4.53
Classified loans (net)[8]	3.52	3.31[r]	3.11
Overdue > 3 months and rescheduled loans	4.03	3.62[r]	3.58
Non-performing loans[9]	4.17	3.92[r]	3.59
Profitability[10]			
Bad debt charge as % of average total assets	0.32	0.38[r]	0.33
Net interest margin	2.11	1.97	1.94
Cost income ratio	39.2	36.8[r]	37.6
Liquidity ratio[11]	46.9	46.1	46.2
		Surveyed Institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	1.08	1.12	1.05
Credit card receivables			
Delinquency ratio	1.32	1.27	1.23
Charge-off ratio — quarterly annualised (adjusted)[12]	14.55	11.60	9.85
— year-to-date annualised	12.75	11.77	10.98
		All Locally Incorporated AIs	
Capital adequacy ratio (consolidated)	16.3	15.6	15.6

Notes:

1 Figures related to Hong Kong office(s) only except where otherwise stated.
2 Quarterly average.
3 Quarterly change.
4 Loans for use in Hong Kong plus trade financing loans.
5 Includes "others" (i.e. unallocated).
6 Figures relate to retail banks' Hong Kong office(s) and overseas branches.
7 Classified loans are those loans graded as "substandard", "doubtful" or "loss".
8 Net of specific provisions.
9 Loans on which interest has been placed in suspense or on which interest accrual has ceased.
10 Year-to-date annualised.
11 Quarterly average.
12 Excluding certain charge-offs which will not be repeated in subsequent quarters and which it would not therefore be appropriate to annualise. The year-to-date figures are not similarly adjusted.

r Revised figures due to late adjustments.

Outlook, risks and uncertainties

Economic recovery in Hong Kong is expected to accelerate in 2004, supported by faster and more balanced growth in the global economy, and policy measures that help facilitate further economic integration between Hong Kong and the Mainland. Banking performance is expected to improve along with the rebound in economic activity. All of this bodes well for monetary and financial stability in Hong Kong. The main uncertainties and concerns include the strength and durability of the global recovery and, within Hong Kong, the outlook for property prices and the fiscal deficit.

3.10 Global outlook

It is generally expected that growth will accelerate markedly in 2004 in the major economies (Table 3.E). Consensus Forecasts project an acceleration of US GDP growth from 2.9% in 2003 to 4.2% in 2004. Growth in the euro area is also expected to increase from 0.5% to 1.7%. The latest OECD and IMF forecasts are similar to those by private-sector analysts. On the other hand, the pace of recovery in Japan is expected to moderate in 2004, as the outlook is still clouded by deflation and banking system weaknesses.[10]

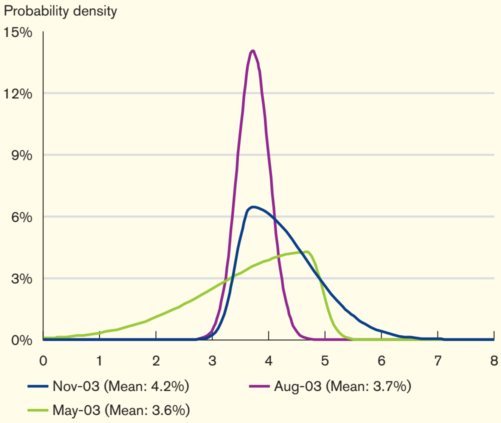
Table 3.E
Forecasts of economic growth in major economies

	Consensus Forecasts		IMF		OECD	
	2003	2004	2003	2004	2003	2004
US	2.9	4.2	2.6	3.9	2.9	4.2
Euro area	0.5	1.7	0.5	1.9	0.5	1.8
Japan	2.4	1.3	2.0	1.4	2.7	1.8

Source: Consensus Forecasts (Nov-03), IMF (Sep-03) and OECD (Nov-03).

Forecasters turned more positive towards the 2004 outlook for the US in November 2003 (Chart 3.20). The dispersion of their forecasts increased slightly, suggesting that the level of perceived uncertainty has risen. For the euro area, the growth assessments for 2004 were revised downwards during the earlier part of 2003 (Chart 3.21), mainly reflecting disappointing economic data releases, but have stabilised towards the year-end. In contrast, better-than-expected growth in Japan prompted some upward revisions (Chart 3.22).

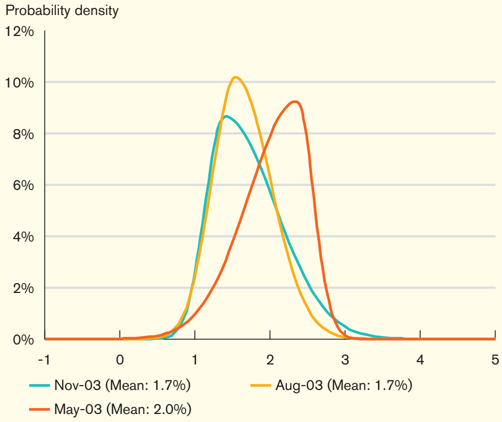
Chart 3.20
US: probability distribution of growth forecasts for 2004



Source: Staff calculations based on Consensus Forecasts.

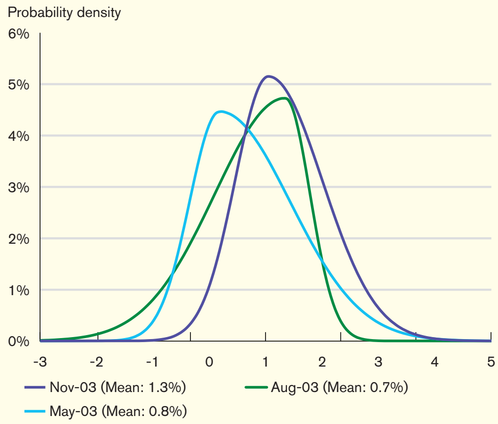
[10] See IMF (2003), "World Economic Outlook", September 2003, http://www.imf.org/external/pubs/ft/weo/2003/02/index.htm.

Chart 3.21
Euro area: probability distribution of growth forecasts for 2004



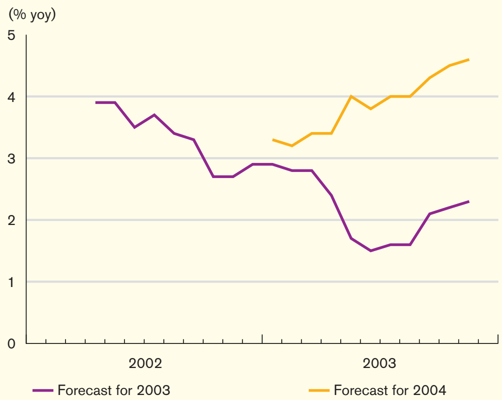
Source: Staff calculations based on Consensus Forecasts.

Chart 3.22
Japan: probability distribution of growth forecasts for 2004



Source: Staff calculations based on Consensus Forecasts.

Chart 3.23
Consensus Forecasts for economic growth in Hong Kong



Source: Consensus Forecasts.

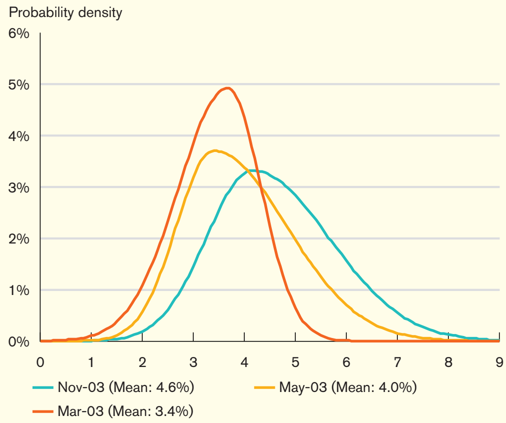
Stronger global growth in 2004 is expected to be boosted by a recovery in business investment. Recent indicators of corporate profitability in the US, and surveys on business confidence in the euro area suggest that business investment may recover markedly in the coming year. The recent rally in global equity markets also reflects such expectations.

3.11 Domestic outlook

The growth outlook in Hong Kong has improved significantly. This is supported by a number of favourable developments in the external and domestic environment. Stronger and more balanced growth in the global economy and the weakening of the US dollar should continue to support Hong Kong's exports. The strong upturn in the Mainland economy and a number of policy initiatives, including CEPA, have shifted the balance of views about the economic integration between Hong Kong and Mainland China. While only a few months ago, the market tended to focus more on the competitive aspect of the relationship, there is now more recognition of the benefits arising from being close to a large and rapidly growing economy and further integration with the Mainland. Domestically, the property market has shown signs of stabilisation, supported by improved sentiment and by policy measures rationalising the Government's role in the property market.

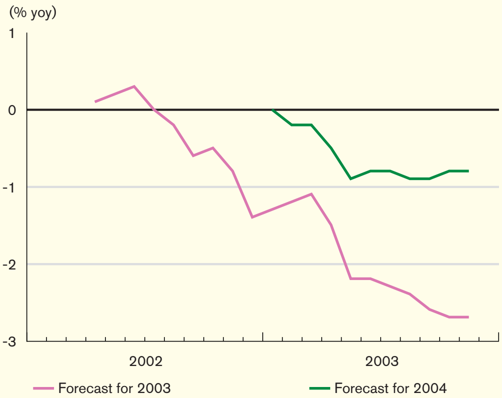
Reflecting these developments, the Government revised its growth projection for 2003 to 3% in November, from 2% in its August forecast. Forecasters in the private sector have also revised upwards their growth projections for Hong Kong in recent months (Chart 3.23). The latest Consensus Forecasts expect the Hong Kong economy to grow by 2.3% in 2003, and 4.6% in 2004. The balance of risks, as indicated by the probability distribution function of the forecasts, tilts towards the upside (Chart 3.24).

Chart 3.24
Probability distribution of growth forecasts for 2004



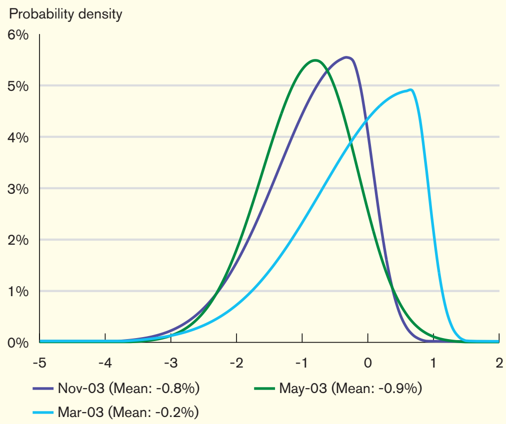
Source: Staff calculations based on Consensus Forecasts.

Chart 3.25F
Consensus Forecasts for CPI inflation in Hong Kong



Source: Consensus Forecasts.

Chart 3.26
Probability distribution of inflation forecasts for 2004



Source: Staff calculations based on Consensus Forecasts.

Deflationary pressures are expected to ease substantially, supported by external developments including continued increases in world commodity prices, emerging inflationary pressures on the Mainland, and the weakening of the US dollar. Domestically, the negative output gap is expected to narrow significantly. Housing rentals are also expected to stabilise should the recent improvement in the property market prove sustainable. Nevertheless, housing rentals affect the CPI only after a considerable lag, as rental contracts usually last for one to two years. The latest Consensus Forecasts project that the composite CPI will fall by 0.8% in 2004, much lower than the projected drop of 2.7% for 2003 (Charts 3.25-26).

The banking system remains fundamentally sound, notwithstanding the bursting of the property bubble and the economic downturn in recent years. With faster economic growth, banking performance is expected to improve. This will support monetary and financial stability in Hong Kong.

3.12 Uncertainties and risks

While considerable uncertainties surround the strength and durability of the recovery, the balance of risks has improved. In particular, geopolitical risks have eased somewhat. Although SARS might return, the improved understanding of the epidemic and the institutional arrangements that have been put in place to deal with such situations should prevent it from disrupting the economy to the same extent as in 2003.

Nevertheless, downside risks remain on both the external and the domestic fronts.

First, concerns remain over the large US current account deficit and the associated issue of over-reliance by the global economy on US growth. Despite the recent depreciation of the US dollar, the US current account deficit remains high. This suggests the possibility of an adjustment in the exchange rates among major currencies. Any disorderly adjustment would be highly disruptive to the US and the global economy.[11]

Secondly, mortgage refinancing, which has been supporting the robust consumption growth in the US and UK over the past few years, has declined along with the recent increase in long-term interest rates. Should growth in property prices slow down or change direction, household spending could be restrained.

Domestically, a major uncertainty is the outlook for property prices. Given the improved affordability brought about by sharp declines in prices in recent years and the other developments conducive to housing demand, there seems to be a fundamental support to the property market. Nevertheless, the improvement in sentiment remains subject to global and domestic shocks.

In the banking sector, subdued loan demand remains a factor restraining bank profitability. A revival in property market activity may provide some support. Nevertheless, growth in loans to business depends crucially on a strong rebound in investment, which is yet to be seen. Personal lending is likely to be restrained in the light of the high unemployment rate.

Finally, the fiscal deficit should decline as the economy recovers. However, to the extent that a considerable part of the deficit is related to structural factors, market concerns about fiscal sustainability are likely to remain.

[11] See IMF (2003), "World Economic Outlook", September 2003, http://www.imf.org/external/pubs/ft/weo/2003/02/index.htm.

Abbreviations

AI	Authorized Institution
BLR	Best Lending Rate
BoP	Balance of Payments
CA	Current Account
CEPA	Closer Economic Partnership Arrangement
CI	Certificates of Indebtedness
C&SD	Census and Statistics Department
CPI	Consumer Price Index
EU	European Union
FDI	Foreign Direct Investment
FIE	Foreign-Invested Enterprise
GRA	General Revenue Account
HIBOR	Hong Kong Interbank Offered Rate
HKMA	Hong Kong Monetary Authority
IMF	International Monetary Fund
IT	Information Technology
mom	month-on-month
MPC	Monetary Policy Committee
NEER	Nominal Effective Exchange Rate
OECD	Organisation for Economic Cooperation and Development
OI	Other Investment
PCE	Private Consumption Expenditure
qoq	quarter-on-quarter
REER	Real Effective Exchange Rate
RPI	Retail Price Index
S&P	Standard and Poor's
WHO	World Health Organisation
yoy	year-on-year