Domestic and external environment

by the Research Department

The slowdown in global growth in the second quarter was greater than expected, particularly in the US and Japan. Forward-looking indicators are not signalling the start of a sustained downturn, and growth is expected to pick up in the third quarter. While expectations about the increase in US interest rates have softened somewhat as a result of the weak second-quarter data, the renewed surge in oil prices has increased the pressure on central banks to raise interest rates to contain the inflationary consequences of the shock. In Hong Kong, economic activity continued to grow strongly in the second quarter. External trade remained robust, while domestic demand continued to pick up.

External environment

In the US, GDP growth decelerated in the second quarter to 2.8% (quarter-on-quarter annualised) from 4.5% in the previous quarter. The drop was mainly attributable to a deceleration in private consumption growth, while capital spending and exports remained strong. In particular, the growth of consumers' expenditure declined to 1.6% (annualised) from 4.1% in the first quarter, partly reflecting the impact of higher energy prices on real income growth and consumer prices. The annual change in Consumer Price Index (CPI) picked up to 2.9% from 1.8% during the same period. However, more up-to-date monthly indicators are not signalling the start of a sustained weak path for the US economy, and growth is expected to pick up in the third quarter. In particular, the ISM Purchasing Managers' Index (PMI) showed continued expansion in the manufacturing and services sectors in July, and consumer confidence reached a two-year high in July according to the Conference Board measure. Nevertheless, the downside risks to activity have probably increased, partly because of the persistency of high oil prices which has led to calls for a more aggressive approach to monetary tightening.

In the euro area, the pace of recovery was modest and uneven. Real GDP grew by 0.5% in the second quarter after rising by 0.6% in the first. Exports continued to be strong but personal consumption was weak. Industrial production remained robust and rose by 0.8% in the second quarter. Business surveys indicate that industrial confidence is improving but employment growth has remained weak. While the manufacturing PMI increased from 52.8 to 54.4 in the second quarter, the employment component remained under the benchmark level of 50. High unemployment and sluggish job creation will continue to act as a drag on household spending growth. In the UK, real GDP growth accelerated from 0.7% to 0.9% in the second quarter. Private consumption continued to show solid growth and business surveys suggest that firms are optimistic about future investment.

In Japan, the pace of recovery appears to be slower than previously expected, as growth decelerated to 0.4% in the second quarter from 1.6% in the previous quarter. Private consumption growth moderated and business capital spending was flat. Nevertheless, with exports continuing to expand, the Tankan survey indicates that business confidence surged to a 13-year high in the second quarter, suggesting further expansion in investment. Consumer spending is recovering gradually, supported by modest increases in employment and nominal wages. On a quarter-on-quarter comparison, spending by workers increased by 2.0% in the second quarter after rising by 2.9% in the first. The revival in domestic demand and higher commodity prices are helping to reflate the economy, with the annual inflation rate of CPI rising to zero in June from -0.5% in May.

The policies adopted to slow the rapid expansion in Mainland China have started to take effect and economic growth slowed down to 9.6% (year-on-year) in the second quarter, from 9.8% in the first quarter. The slowdown was largely concentrated in fixed asset investment, while growth in consumer spending and exports remained firm. On a year-on-year comparison, broad money growth decelerated from 18.9% to 17.7% in the second quarter, the slowest pace of expansion since the fourth quarter of 2002. For the rest of Asia, growth in the first quarter exceeded expectations and remained strong in the second quarter, as the export-led recovery continued to feed through into higher domestic demand.

As widely expected, the Federal Open Market Committee in the US raised the federal funds target rate by 25 basis points to 1.5% in August, the second consecutive increase. Futures prices suggest that interest rates will rise less rapidly than had been expected earlier in the year, reflecting weaker-than-expected growth in the second quarter. The European Central Bank has kept its refinancing rate unchanged while the Bank of England raised the repo rate twice by a cumulative 50 basis points to 4.5% in the second quarter. Elsewhere, the Reserve Bank of New Zealand increased its policy rate by 25 basis points to 6% in July. The Bank of Korea lowered the overnight target rate unexpectedly by 25 basis points to 3.5% in August, while the Bank of Thailand raised the policy rate by 25 basis points to 1.5%, the first increase since June 2001.

Most major stock indices, led by weak US economic reports and higher oil prices, fell in the second quarter. In particular, the S&P500 and NASDAQ Composite indices fell in April and May before rebounding in June. The surge in oil prices drove down equity prices in July and early August but recovered somewhat towards the end of the month. Major European stock indices followed a similar pattern. In Asia, the NIKKEI 225 index declined by 5% between April and August, while the MSCI Asia Free ex-Japan index remained largely stable following a sharp decline in mid-May.

In the foreign exchange markets, the US dollar strengthened against the euro in April but weakened over the rest of the second quarter. It continued to weaken to 1.24 per euro in mid-July before strengthening to 1.21 towards the end of August, a 2% appreciation from the end of March. Most Asian floating currencies depreciated against the US dollar in the second quarter. In particular, the Yen/USD rate rose from 104.2 at the end of March to 109.2 at the end of August, while the Philippines peso depreciated by 0.8% in the second half of the month following the remarks made by the President on the country's fiscal deficit problem.

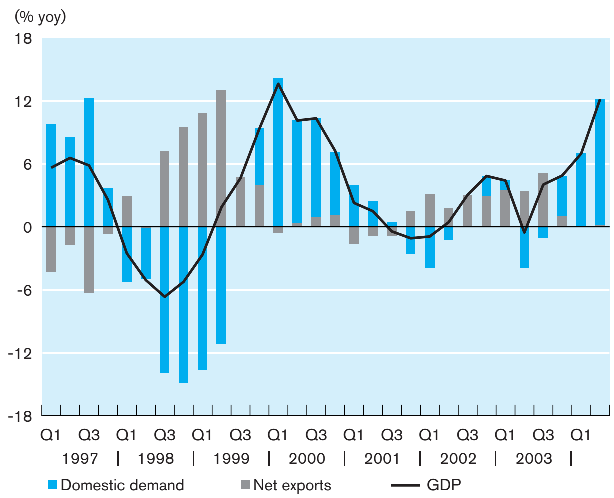
The renewed surge in oil prices during July and August has raised concerns about the impact on growth and inflation. The average price of West Texas, Brent and Dubai crude rose from US$34 per barrel at the end of June to US$43 in late August, reflecting concerns about escalating violence in Iraq and possible supply interruptions. If oil prices stabilise at their current level, they will average around $38 per barrel in 2004 compared with an assumption of $30 in the April IMF World Economic Outlook. This will knock half a percentage point off the IMF projection of global growth in 2004, reducing it to 4.1%.

Domestic activity

The Hong Kong economy continued to recover strongly in the second quarter of 2004. Real GDP rose by 2.6% on a seasonally adjusted basis, further up from the 1.2% increase in the first quarter. Compared with a year earlier, it grew by a distinct 12.1%, partly due to the low base of comparison in the same period last year when the domestic economic activity was severely disrupted by the outbreak of Severe Acute Respiratory Syndrome (SARS). Merchandise exports maintained strong growth momentum, while private consumption and spending on machinery, equipment and computer software continued to rebound markedly. However, building and construction investment remained weak (Chart 1).

CHART 1

Sources of growth



The latest economic indicators point to a continued recovery in the third quarter. The PMI – a composite index designed to provide an overview of the business activity in Hong Kong – stayed above the neutral level of 50 in July and August, despite declining slightly from the second quarter. This suggests a continued expansion in economic activity. Tourist arrivals remained strong in July. All major markets (except Taiwan) continued to rise notably on a year-on-year comparison. Retained imports increased markedly across the board, pointing to a broad-based increase in domestic demand.

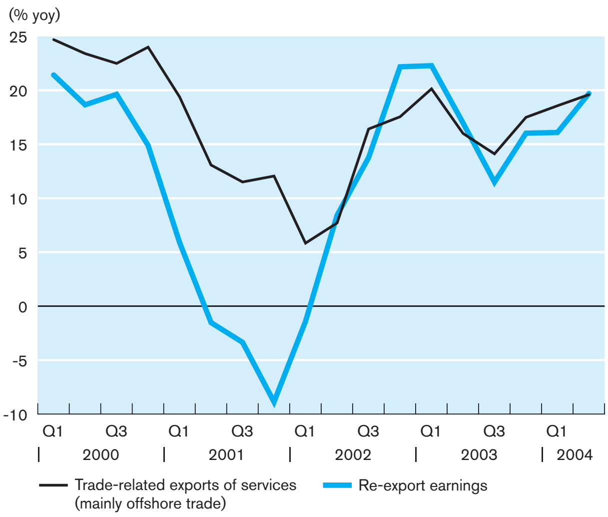
External trade

Merchandise trade remained robust. On a year-on-year comparison, total exports of goods grew by 16.5% in July, following an increase of 17.8% in the second quarter. Exports to the Mainland, East Asia and the EU remained vibrant, and those to the US grew at a relatively modest pace.

Exports of trade-related services continued to grow strongly, reflecting the on-going structural shift in export composition from exports of goods to offshore trade (Chart 2). Tourism-related earnings grew significantly by 126% yearly in the second quarter, reflecting in part a low base of comparison in the same period last year when Hong Kong was listed as a SARS-affected area.

CHART 2

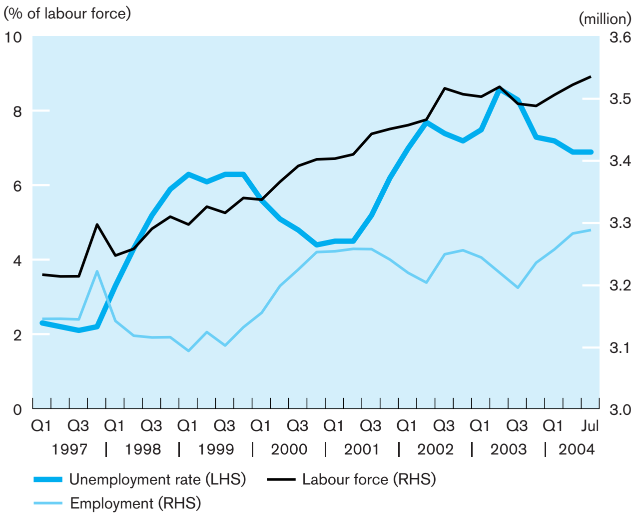
External trade



Labour market and inflation

The economic recovery has resulted in improved labour market conditions. Owing to sustained growth in employment, the seasonally adjusted unemployment rate eased to 6.9% in the three months to July, from 8.6% in the same period last year (Chart 3). While there was an across-the-board improvement, the unemployment rate in the construction sector remained high notwithstanding the rebound of property market in the earlier months.

CHART 3
Labour market



Consumer prices were broadly stable. Adjusted for seasonal and special factors, the month-on-month changes in the Composite Consumer Price Index (CCPI) have been fluctuating around zero since August 2003. On a year-on-year comparison, the headline CCPI recorded its first increase of 0.9% in July since October 1998. This, however, was mainly attributable to a low base of comparison brought about by a rebate of electricity charge and rates concession in the same period last year. Adjusted for these special effects, the CCPI registered a modest decline of 0.2% in July from a year ago (Chart 4). Prices of all key components, except for the rental component and prices of durable goods, alcoholic drinks and tobacco, reported a year-on-year increase during the period. The noticeable ease in deflationary pressures in Hong Kong was attributable to the strong rebound in domestic demand, a generally weak US dollar, rising world commodity prices and an emergence of inflationary pressures on the Mainland.

Asset markets

In the local equity market, investment sentiment was undermined by the impact of monetary tightening on the Mainland and in the US and the escalating oil prices, but improved since late August upon the better-than-expected profit announcements of major listed companies and the stronger-than-expected GDP growth in the second quarter. The Hang Seng Index, having moved within a narrow range of 12,000-12,500 from June to mid-August, rose to above 13,000 in early September, about 20% up from its recent low in mid-May (Chart 5).

The property market consolidated after experiencing a strong rally in earlier months. The residential property price index, having increased by a cumulative 36% in the nine months from July 2003, declined by a total of 7% between May and July. The transaction volume has also dropped in recent months, after registering a five-year high in March (Chart 5).

CHART 4
CCPI inflation (adjusted for Special Relief Measures)

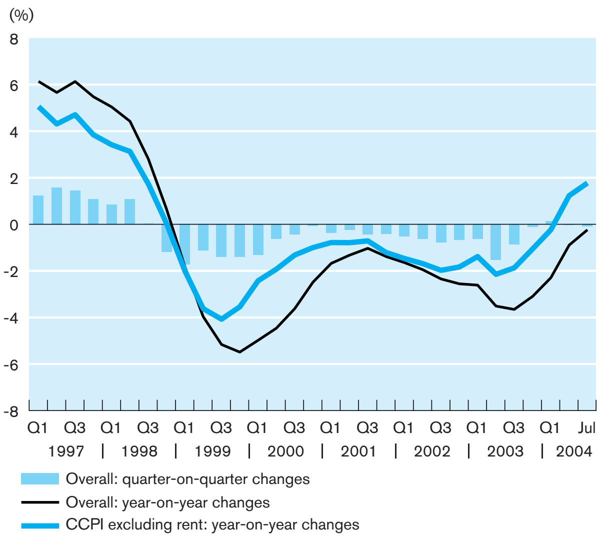
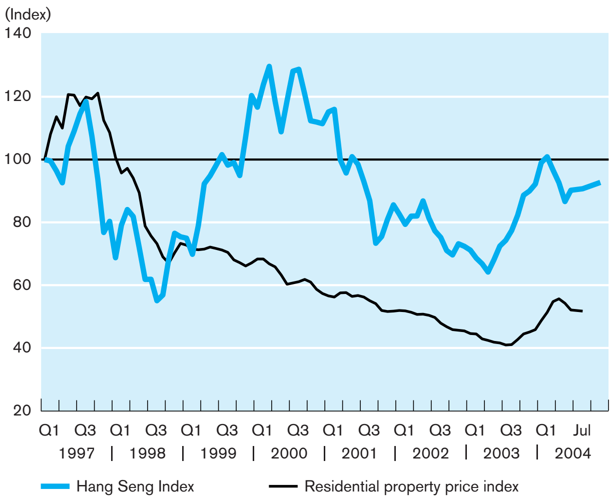


CHART 5
Asset prices



Money supply and domestic credit

Hong Kong dollar broad money was almost unchanged during the second quarter, probably reflecting capital outflows associated with expectations of a sharper-than-expected monetary tightening in the US. Nevertheless, year-on-year growth of broad money remained positive, generally in line with the revival of domestic economic activity. Annual growth of narrow money (seasonally adjusted) remained strong, although the pace of expansion slowed somewhat in the second quarter. The robust growth was attributable to the record-low level of interest rates and a strong transaction demand for money related partly to a high level of stock market turnover. In particular, the total value of the stock market turnover was significantly higher (about 70%) than the same quarter in 2003.

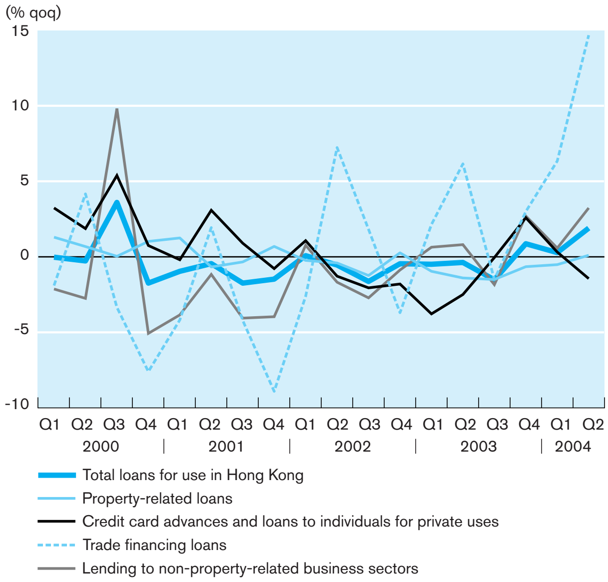
Foreign currency deposits continued to expand in the second quarter. US dollar deposits rose notably, which more than offset a fall in other foreign currency placements that were partly due to valuation effects arising from exchange rate movements. As Hong Kong dollar deposits registered a small decline while foreign currency deposits increased, the share of foreign currency deposits in total deposits edged up to 47.2% at the end of June.

Domestic credit increased alongside the economic recovery. Specifically, following an expansion in the preceding two quarters, loans for use in Hong Kong grew further in the second quarter. Analysed by economic uses, the rise in lending was broad-based, with trade financing and loans for non-property-related business sectors registering notable quarterly increases (Chart 6).[1] Meanwhile, the increase in lending to property-related sectors mainly came from loans for residential and commercial property investment, which more than offset the decline in the outstanding stock of residential mortgage loans. Residential mortgages decreased as repayments on existing loans outweighed the increase in new mortgage lending.

[1] Data on loans for use by economic sectors are available only on a quarterly basis.

CHART 6

Loans for use in Hong Kong



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

Short-term outlook

The near-term economic outlook for Hong Kong remains positive. Although growth in the Mainland economy is expected to slow down due to the implementation of macro-economic adjustment measures, merchandise exports and offshore trade are likely to remain relatively strong given the synchronised recovery in the global economy. Tourism receipts and retail sales should continue to benefit from the Individual Visit Scheme for Mainland Visitors and the rising income on the Mainland. Local consumer spending is expected to be supported by improved labour market conditions. The sustained recovery, and a generally soft US dollar, and inflationary pressure on the Mainland should further ease deflationary concerns in Hong Kong.

While the near-term outlook is generally positive, there are risks relating to the pace of increase in US interest rates, higher oil prices, and the growth outlook for the Mainland and US economies. While these factors are unlikely to derail the recovery in 2004, the impact on the growth in 2005 could be more significant.