

Domestic and external environment

by the Research Department

The geographical pattern of global growth in the final quarter of 2004 remained unbalanced. Real GDP growth continued to be solid in the US, Mainland China and other smaller East Asian economies. But growth declined in the euro area, and was negative in Japan for the third successive quarter. In Hong Kong, economic growth remained healthy in the fourth quarter of 2004, supported by strong external trade and private consumption.

External environment

In the US, real GDP growth remained strong in the fourth quarter of 2004, at 3.8% (quarter-on-quarter annualised), compared to 4.0% in the third. Growth of private consumption and investment spending remained robust, supported by steady increases in real personal income and corporate profits. However, a sharp rise in imports resulted in a negative contribution of net trade to GDP growth of 1.4 percentage points. High frequency indicators suggest a slight moderation in the pace of expansion at the start of 2005. The ISM Purchasing Managers' Indices (PMI) for the manufacturing and service sector declined in January (but remained close to their average levels in the past two years). Retail sales growth declined to 1.8% in the three months to January from 2.4% in December 2004, mainly led by a decline in auto sales.

In the euro area, real GDP growth declined to 0.6% (quarter-on-quarter annualised) in the fourth quarter from 1.0% in the third, mainly due to destocking. Growth in Germany and Italy turned negative, but it increased in France and Spain. The composition of growth indicates a stronger economy. In particular, growth of final domestic demand rose to 2.0% in the fourth quarter, from 0.6% in the third – the highest in two years. More recent indicators suggest stronger growth ahead. The PMI for both the manufacturing and service sectors rose for the second consecutive

month in January. The European Commission's economic sentiment indicator picked up as well (mainly due to improvement in confidence in the service sector), while the German ZEW investor confidence reading rose for the third successive month in February.

In the UK, real GDP growth increased to 2.9% (quarter-on-quarter annualised) in the fourth quarter from 2.1% in the third, reflecting stronger growth of business investment and exports. There are concerns about the resilience of consumer spending to higher interest rates and the downward correction in house prices. Consumption growth slowed, for the fourth consecutive quarter, to below-trend in the fourth quarter, and the January retail sales figures suggest that this weakness continued at the start of 2005.

In Japan, the economy contracted for the third successive quarter in the fourth quarter, with real GDP falling by 0.5% (quarter-on-quarter annualised), following falls of 0.8% in the second and 1.1% in the third quarter. The composition of growth in the third and fourth quarter was similar. Private consumer spending declined for the second consecutive quarter, while business spending continued to grow, albeit modestly. Net trade made a large negative contribution to growth, owing to robust import growth. Strong growth in profits (up 38% in the third quarter compared with a year ago), rising core

machinery orders, and strengthening export growth indicate an improving business climate, but this is yet to translate into higher labour incomes. Continued falls in nominal and real wages and the lack of any sustained rise in employment are restraining household spending. Deflationary pressures persist. The annual rate of core CPI inflation (excluding fresh food) declined to -0.3% in January, and corporate goods price inflation has begun to decline again in recent months.

In Mainland China, real GDP growth picked up to 9.5% (year on year) in the fourth quarter from 9.1% in the third. The composition of growth continued to shift away from investment to exports, a sign of more balanced growth. The pace of expansion in fixed-asset investment continued to ease, but growth in retail sales increased in the final quarter, suggesting that domestic demand remained robust. Nevertheless, the annual rate of headline CPI inflation fell, for the fifth consecutive month, to 1.9% in January from 5.3% in August, owing to lower food price inflation.

Elsewhere in East Asia, estimates of growth in the final quarter are mixed. In Singapore, real GDP growth increased to 7.9% (quarter-on-quarter annualised), but, in The Philippines, it declined to 2.4%. High-frequency indicators suggest that growth is picking up. The growth rate of industrial production and exports increased in a number of economies in November and December. Continued declines in unemployment rates and low interest rates are expected to support an expansion of domestic demand growth. Headline CPI inflation declined in most regional economies toward the end of 2004, partly reflecting lower food price inflation, while core inflation (excluding fresh food and energy) also showed signs of decline or stability. The exception to this pattern was in Indonesia, Malaysia and The Philippines, where inflation continued to accelerate.

The Federal Open Market Committee in the US raised the federal funds target rate by 25 basis

points to 2.5% in February, the sixth consecutive increase since June last year. Futures prices suggest that interest rates will rise to around 3.75% by the end of this year. Long-term interest rates rose from 4.21% at the beginning of January to 4.38% at end-February. The European Central Bank and the Bank of England kept policy rates unchanged at 2.0% and 4.75% respectively in January and February. In Asia, the Bank of Thailand raised the repo rate by 25 basis points to 2.25% in March, and the policy rate in Taiwan was also raised by 12.5 basis points to 1.75% in December last year.

Stock prices in the US declined in January before recovering in February, partly reflecting volatility in oil prices. By end-February, the S&P500 index had returned to its level at the end of last year, while the NASDAQ Composite index was down 5.7%. Equity markets in Europe and Asia have outperformed those in the US so far this year, with the MSCI Euro index rising by 4.3%. During the same period, the NIKKEI 225 index edged up by 2.2% and the MSCI Asia Free ex-Japan index rose by 4.7%.

In the foreign exchange markets, the US dollar strengthened during January, supported by expectations of higher US interest rates, before falling back toward the end of February. The Federal Reserve Board's broad nominal effective exchange rate index declined by 1.1% during February, while the index against major currencies fell by a similar amount. These indices are 17% and 28% lower than their peaks in February 2002. Most Asian floating currencies experienced a modest appreciation relative to their levels at the end of 2004.

Oil prices increased notably in January and February. The average price of UK Brent, Dubai and West Texas Intermediate (WTI) crude oil was US\$48 per barrel at end-February, compared with US\$39 at the end of 2004, partly due to stronger oil demand in the US. Futures prices suggest that oil prices would remain high this year. The WTI crude for delivery in December was priced at US\$51 at end-February, as compared with spot WTI price of US\$52.

Domestic activity

In Hong Kong, economic recovery continued in the fourth quarter of 2004. Real GDP rose at about the same pace as in the third quarter on a year-on-year comparison. On a seasonally adjusted quarter-on-quarter comparison, growth moderated slightly in the fourth quarter. The expansion was broad-based, with most of the major components recording increases over the preceding quarter. In particular, merchandise exports and private consumption picked up, after declining in the third quarter. Building and construction investment, however, remained sluggish.

The latest economic indicators point to solid growth at the start of 2005. 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 January – February 2005 after falling temporarily below 50 in December 2004, suggesting a return to expansion in economic activity (Chart 1). Supported by higher asset prices, declining unemployment rate and further growth in inbound tourism, retail sales of most of the consumer durables continued to grow at a double-digit yearly rate in January. Retained imports, having declined for two consecutive months, rose markedly in January (seasonally adjusted, month on month). While this

may suggest strong domestic demand in the months ahead, the strong growth reflects in part the distortions in seasonal adjustments due to the different timing of the Lunar new year, which fell in February this year, but in January last year.

External trade

Exports of goods and services grew strongly in the fourth quarter of 2004 on expansions in Mainland China's external trade (Chart 2). The latest statistics suggest that growth in exports remained strong at the start of 2005, despite signs of slower growth of the global economy. In particular, the total value of exports of goods increased by 9.6% in January on a seasonally adjusted month-on-month basis, compared with a rise of 3.2% in the fourth quarter of 2004. On a year-on-year comparison, growth in merchandise exports was exceptionally strong at 34.8% in January. This distinct performance in part reflects the different timing of the Lunar new year. Growth in exports of trade-related services has been supported by the strength in merchandise exports. However, increases in tourism-related earnings eased off from a high level. Growth in the number of inbound tourists slowed from a year-on-year rate of 17% in the fourth quarter of 2004 to 8.3% in January this year.

CHART 1
Economic activity

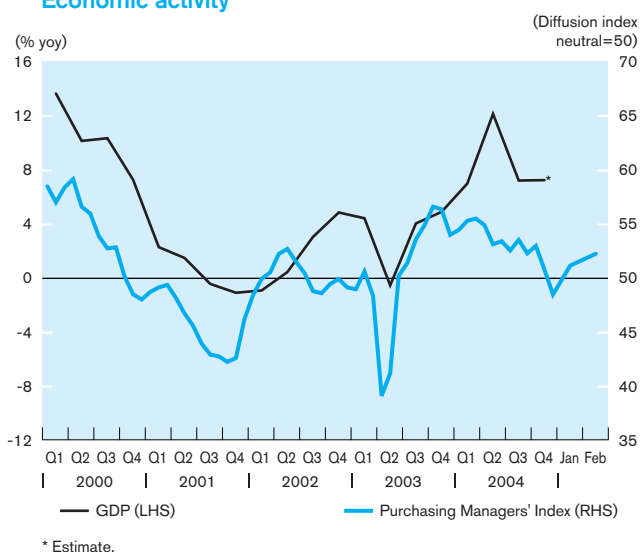
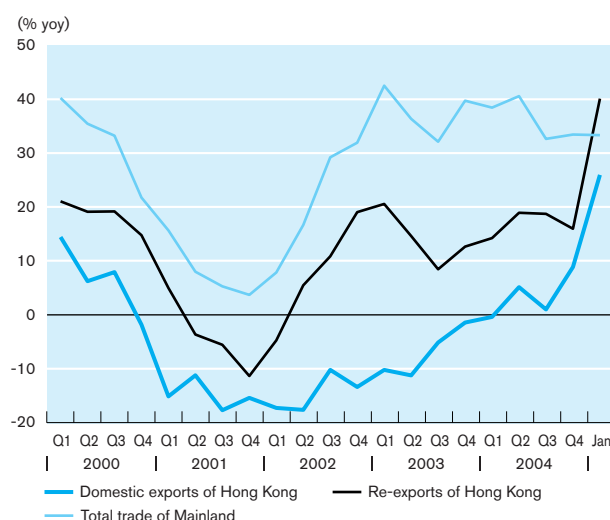


CHART 2
External trade

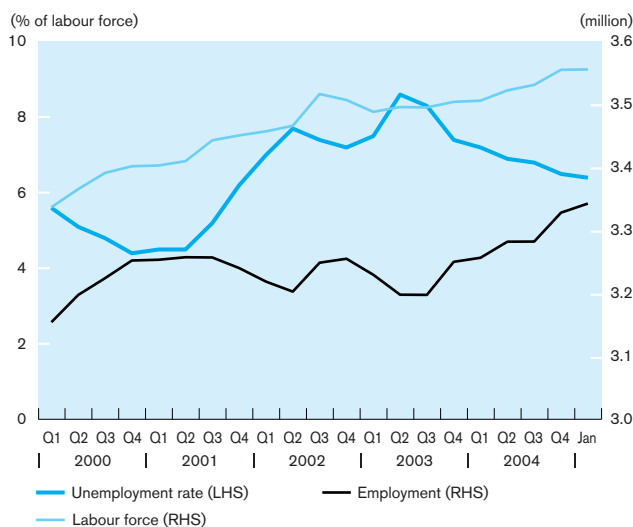


Labour market and inflation

Labour market conditions continued to improve. The economic recovery has led to a sustained increase in employment, which helped bring down the seasonally adjusted unemployment rate to 6.4% in the three months to January 2005, from a record high of 8.6% in May-July 2003 (Chart 3). While increased employment has led to a rise in household income, labour earnings remained broadly flat, as the relatively high rate of unemployment restrained wage increases. Average nominal payroll, which includes remuneration, overtime payments, back-pay, and other irregular allowances and bonuses, decreased modestly by 0.7% (year on year) in the first three quarters of 2004, compared with a decline of 1.8% in 2003.

CHART 3

Labour market conditions

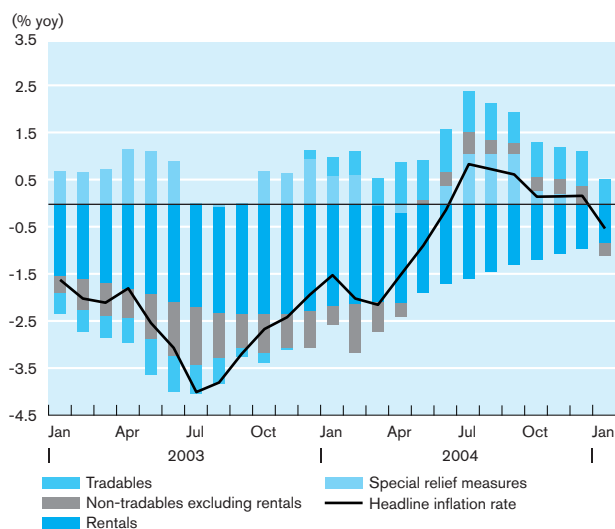


Deflationary pressures have eased significantly and, by some measures, dissipated. The headline Composite Consumer Price Index (CCPI) declined by 0.4% in 2004, following a decrease of 2.6% in 2003. The CCPI recorded modest year-on-year increases since July 2004, but the rises mainly reflect a low base of comparison due to the government

relief measures implemented in July-November 2003 (Chart 4). On a seasonally adjusted month-on-month comparison, the CCPI increased by an average monthly rate of 0.1% during September-December 2004, before declining by 0.2% in January 2005. The latter may in part reflect distortions in seasonal adjustments due to the different timing of the Lunar new year.

CHART 4

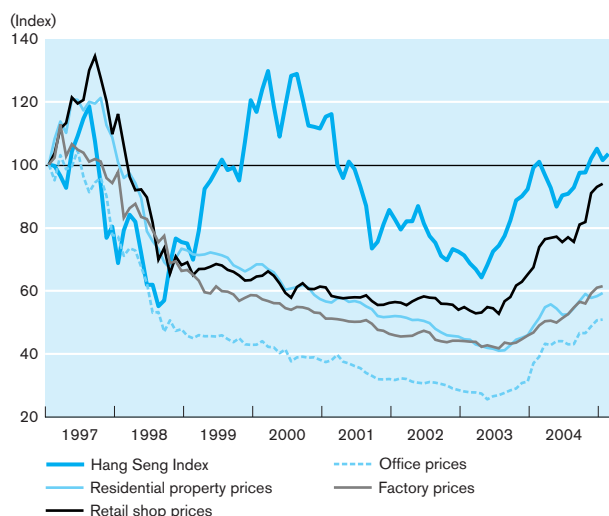
Headline inflation



Asset markets

The recovery in property market has continued, after a temporary pause in May-July 2004. Prices for most types of properties have increased substantially from their troughs in mid-2003 (Chart 5). The residential property price index compiled by Rating and Valuation Department continued to rise in January 2005, having surged by 27% in 2004 and a cumulative 42% from its trough in July 2003. The rise in prices has been accompanied with increases in transactions, particularly at the high end of the market. The number of Sale and Purchase Agreements increased to a seven-year high in 2004, but was still 40% lower than that in 1997.

CHART 5
Asset prices



Local stock prices also increased, but were more volatile than property prices. After a sharp decline in the second quarter of 2004 on concerns about the impact of monetary tightening in Mainland China and increases in US interest rates, share prices in Hong Kong rebounded strongly in the second half of 2004. The Hang Seng Index closed the year 13.2% higher than that in the end of 2003. The increase was mainly supported by shares of property developers as property prices continued to recover in 2004. Share prices of Mainland companies (H-shares), however, fell by 5% in the year on concerns about a possible hard landing of the Mainland economy. At the start of 2005, the Hang Seng Index fell by about 5% as investment sentiment was undermined by concerns about the Hong Kong shares being overvalued. The index has rebounded in February to the levels in late 2004 upon the better-than-expected profit announcements of major listing companies. IPO applications, especially from Mainland companies, increased against the background of a booming market. During the fourth quarter of 2004, 17 companies raised HK\$38 billion through IPOs in the main board in Hong Kong, of which over 70% were Mainland-related (red chip or H-shares) companies.

Money supply and domestic credit

Monetary aggregates and bank loans continued to expand. Hong Kong dollar narrow money rose notably in the fourth quarter of 2004, due largely to the low level of interest rates and increased transaction demand for money arising from robust economic and stock market activities. Broad money growth accelerated in the fourth quarter, after registering moderate rates in the previous three quarters, reflecting the sustained economic recovery and dissipated deflationary pressures. Compared with the end of 2003, narrow money and broad money expanded by 16.3% and 4.6% respectively.

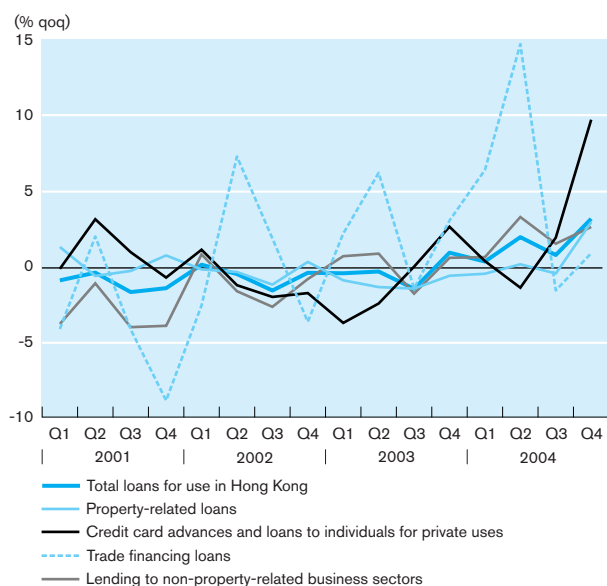
Foreign currency deposits rose markedly in the fourth quarter. Of the total, US dollar deposits grew significantly despite the weakening of the US dollar, while other foreign currency deposits declined moderately. As growth of Hong Kong dollar deposits was higher than that of foreign currency deposits, the share of foreign currency deposits in total deposits declined slightly to 47.8% at the end of December from three months ago, despite the ratio was still higher than that at the end of 2003.

Domestic credit increased alongside the revival in economic activity. In particular, loans for use in Hong Kong recorded higher growth in the fourth quarter than in the previous quarters. Analysed by economic uses, the rise in lending was broad-based, with credit card advances increasing markedly on a quarter-on-quarter comparison (Chart 6).¹ Within property-related loans, loans for building, construction, property development and investment rose notably, while the outstanding stock of residential mortgage loans registered a small increase.

¹ Data on loans for use by economic sectors are available only quarterly.

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 economic recovery is expected to continue in 2005, but the pace of expansion is likely to be slower than that in 2004. Easy monetary conditions, including low real interest rates and a weak Hong Kong dollar in effective terms, are expected to support growth. Although export growth is expected to decline on slower global growth, the increasing integration between the Mainland and Hong Kong economies and the anticipated opening of Hong Kong Disneyland should help bolster Hong Kong's export earnings. Local consumer spending should be supported by recent increases in asset prices, improved labour market conditions and income growth. Consumer prices are expected to rise moderately in 2005, supported by a positive output gap, higher import prices (in part associated with the weak US dollar), and rises in market rentals in 2004 which tend to have a lagged effect on the rental component of the CCPI. On the other hand, with the unemployment rate still at a relatively high level, upward pressures on labour costs are likely to be modest. A gradual deceleration of growth and inflation in Mainland China is also expected to help contain inflationary pressures in Hong Kong.