HALF-YEARLY MONETARY AND FINANCIAL STABILITY REPORT

June 2005

This Report relies on statistical information available by end-May 2005.

Summary

Hong Kong's economic recovery, which began in 2003, is continuing. Consensus projections point to solid growth in 2005, supported by improving domestic demand, but restrained by sluggish exports. Recently published GDP data for the first quarter confirm these projections. Other indicators are also consistent with improving economic conditions. In April the unemployment rate declined to 5.9%, the lowest since late 2001, and the deflation of the past six years has now definitely ended. Consumer prices increased for the sixth consecutive month on a three-month-on-three-month comparison, and they are projected to increase by 1.5% in 2005 as a whole, relative to last year.

In support of these favourable macroeconomic developments and to ensure the foundation for continued exchange-rate and monetary stability, the Hong Kong Monetary Authority (HKMA) announced on 18 May a series of technical measures to refine the functioning of the Linked Exchange Rate system. The refinements contain three elements: introducing a strong-side Convertibility Undertaking (CU) at 7.75, shifting the existing weak-side CU to 7.85, and creating a Convertibility Zone defined by the levels of the Convertibility Undertakings, within which the HKMA may choose to conduct market operations consistent with Currency Board principles.

The refinements are intended to remove ambiguity about the strong-side potential of the Hong Kong dollar and thereby contribute to timely and smooth adjustments of interest rates and the exchange rate as implied by the Linked Exchange Rate system. Financial markets generally responded favourably to the introduction of the measures, and the differential between Hong Kong dollar interest rates and comparable US dollar interest rates narrowed substantially. Similarly, Hong Kong dollar forward rates, which have been stubbornly indicating an expected appreciation of the Hong Kong dollar during the past 18 months, moved closer to the spot rate. The spot rate stayed near the centre of the Convertibility Zone, closing at 7.783 on 1 June.

The present international environment is uncertain, as global imbalances in goods and asset markets continue, and as commodity prices remain high. While central projections indicate only marginally slower growth in the world economy during 2005, the risks have increased owing to heightened trade tensions and potentially adverse adjustments in asset markets in key economies.

Protectionist pressures have increased in the US and Europe against textile exports from the Mainland. Unless checked, such pressures have the potential to decrease global trade, which has been an important engine for growth in the world economy. Regionally, a slowdown in Mainland exports would have repercussions on the Hong Kong economy by reducing entrepôt activities, and also because of its implications for growth on the Mainland.

Continued pressure on the Mainland authorities to revalue the renminbi constitutes another source of uncertainty for the Hong Kong economy. While the trade and demand effects of a renminbi appreciation are likely to be only moderate due to offsetting influences of direct and entrepôt trade, the impact on asset markets is potentially more significant. In particular, speculative capital flow into the Mainland could spill over into the Hong Kong markets, feeding speculation in the property market and increasing general inflationary pressures.

Despite increases in policy interest rates in the US, the yields on longer-dated securities have remained unusually low. In addition, the spreads between risk-free government securities and corporate and emerging market debt are unusually narrow. While it is possible that these features of financial markets will remain, there are concerns that adjustments to global imbalances will entail increased long-term interest rates and widened credit spreads, with negative consequences for economic growth.

These uncertainties notwithstanding, the recovery of the Hong Kong economy is expected to continue. While external demand may recede, domestic consumption and investment demand are projected to strengthen, supported by recent increases in housing wealth and real estate prices. The service sector is currently the main beneficiary of the economic recovery, but there are indications that the manufacturing and construction sectors are also improving.

Profitability in the banking sector increased last year, supported by continued real economic expansion and a steady improvement in asset quality. Capital adequacy ratios remain high relative to minimum international standards.

Overall, the Hong Kong economy is continuing on the path of sustained recovery. Although the external environment contains elements of concern, the institutions and economic policies in Hong Kong are supportive of continued monetary and financial stability.

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1. Global and regional setting

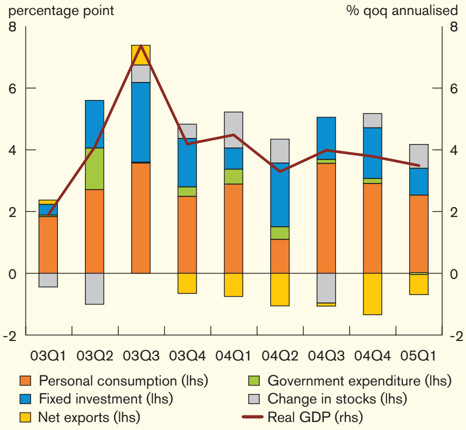
External environment

Global growth appears to be slowing, led by the US, as monetary tightening continues and commodity prices remain high. This has reduced the momentum behind the growth in industrial production and exports in the smaller East Asian economies. In a reversal of growth patterns in the second half of 2004, Japan and the euro area showed stronger-than-expected growth at the start of this year, in contrast with a slowdown elsewhere.

1.1 United States

The pace of expansion in the US economy slowed during 2005 Q1 to 3.5%, from 3.8% in 2004 Q4 (Chart 1.1).[1] Growth in most of the major components of final domestic demand declined, with the sharpest falls occurring in equipment and software spending. Inventories rose sharply. Export growth resumed its annualised pace of 6-7%, following weakness in 2004 Q4. However, with import growth remaining strong, net trade detracted 0.7 percentage points from output growth. It is not clear to what extent the slowdown is due to temporary factors, such as high oil prices, and the expiration of tax incentives for equipment spending at the end of last year. Monthly indicators were mixed at the start of 2005 Q2: employment and retail sales grew strongly, but the Purchasing Managers' Index (PMI) survey results and consumer confidence declined further (Table 1.A).

Chart 1.1
US: contributions to GDP growth



Source: Bureau of Economic Analysis.

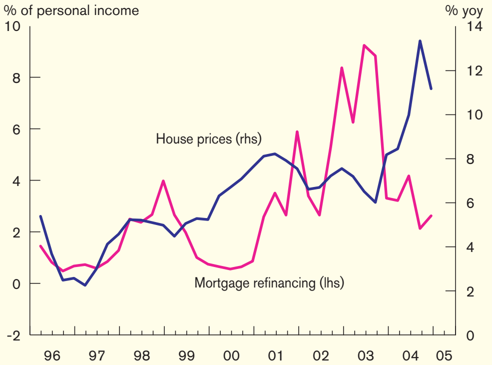
Table 1.A
US: monthly indicators of activity

	Jan	Feb	Mar	Apr	May
Manufacturing PMI	56.4	55.3	55.2	53.3	51.4
Non-manufacturing PMI	59.2	59.8	63.1	61.7	58.5
Industrial production (% 3m-on-3m)	1.2	1.3	0.9	0.7	n.a.
Durable goods orders (% 3m-on-3m)	2.3	1.7	-0.1	-0.8	n.a.
Capital goods orders, nondefense (% 3m-on-3m)	6.4	3.9	1.9	-0.6	n.a.
Retail sales (% 3m-on-3m)	2.1	1.8	1.5	1.8	n.a.
Real personal consumption expenditure (% 3m-on-3m)	1.1	1.2	0.9	0.9	n.a.
Real disposable income (% 3m-on-3m)	3.0	2.9	-0.1	-0.7	n.a.
Change in nonfarm payroll (thousand persons)	124	300	122	274	78
Unemployment rate (%)	5.2	5.4	5.2	5.2	5.1
Consumer confidence (index)					
Conference Board	105.1	104.4	103.0	97.5	102.2
Job prospects[1]	-3.3	-1.3	-2.0	-2.5	-1.6
University of Michigan	95.5	94.1	92.6	87.7	86.9

Note 1: Jobs plentiful less jobs hard to get.
Source: Bloomberg.

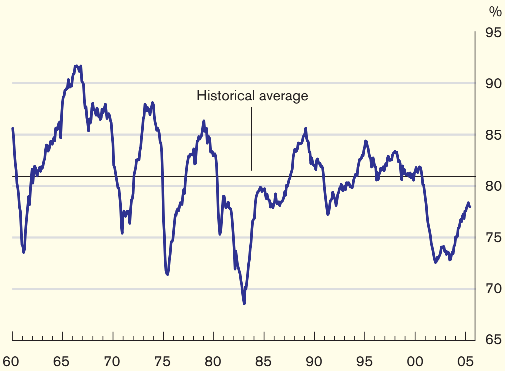
[1] All growth figures are on a seasonally adjusted quarter-on-quarter annualised basis, except where otherwise stated.

Chart 1.2
US: house prices and mortgage refinancing



Sources: Office of Federal Housing Enterprise Oversight and Mortgage Bankers Association.

Chart 1.3
US: capacity utilisation



Source: Federal Reserve Board.

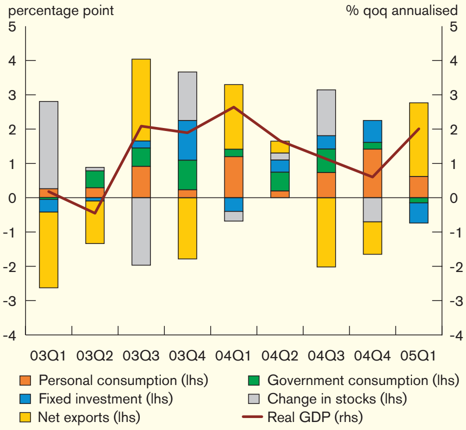
The fundamentals supporting the strong growth in consumer spending and business investment in 2004 remain in place. Despite a gradual increase in US short-term interest rates, long-term interest rates are still at a low level, employment and labour income are growing at a steady pace, housing wealth continues to increase (although mortgage refinancing is lower than its highs in 2003) (Chart 1.2), and profit growth remains solid. However, there is some uncertainty about the effect on growth from persistently high and volatile oil prices. Futures prices for oil have risen over the past six months. Although the effects on growth and inflation have been limited so far, there could be a cumulative effect on consumer spending on durable goods and on business spending should oil prices remain high or increase further.[2]

Another concern is that inflationary pressures are rising in the US, reflecting a weaker US dollar, high commodity prices, and a gradual reduction in the amount of spare capacity in the economy since the middle of 2003 (Chart 1.3). Headline CPI inflation increased to 3.0% in 2005 Q1, from 1.8% a year earlier. Core inflation is rising also, reflecting more pricing power by the corporate sector and rising costs. The growth of unit labour costs, which turned positive last year, rose to an annualised rate of 3.3% in 2005 Q1 as productivity growth slowed.

External imbalances continued to deepen in the two quarters to 2005 Q1. The US trade deficit as a proportion of GDP rose to a historical high of 5.7%. This may partly reflect temporary factors, such as oil prices, which hit new highs during 2005 Q1. Nevertheless, slower but still robust growth in domestic demand and imports in the US is likely to continue to fuel concern about the US current account deficit (the level of US imports is currently around one and a half times that of exports).

[2] For a recent study of non-linear effects of oil price shocks on US GDP growth, see Hamilton, James D. (2000), "What Is An Oil Shock?", *NBER Working Paper No. 7755, June 2000.*

Chart 1.4
Euro area: contributions to GDP growth



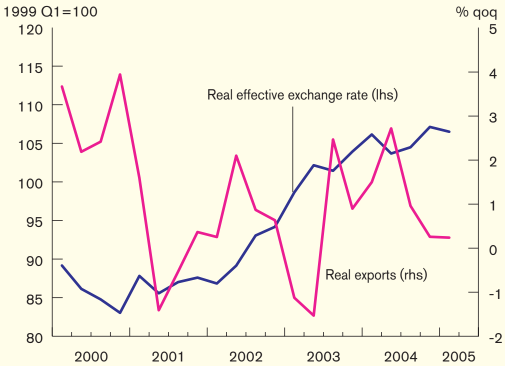
Source: Eurostat.

Table 1.B
Euro area: survey indicators of activity

(Index)	2004	Jan	Feb	Mar	Apr	May
Manufacturing PMI	53.1	51.9	51.9	50.4	49.2	48.7
Services PMI	54.6	53.4	53.0	53.0	52.8	53.5
European Commission survey						
Economic sentiment	100.0	100.8	98.8	97.5	96.5	96.1
Industrial confidence	-4.7	-5.0	-6.0	-8.0	-9.0	-11.0
Orders component	-15.5	-11.0	-15.0	-17.0	-19.0	-21.0
Consumer confidence	-13.8	-13.0	-13.0	-14.0	-13.0	-15.0
ZEW economic sentiment (expectation)	52.1	29.9	36.0	37.3	24.6	14.8
Germany IFO (business climate)	95.7	96.4	95.4	94.0	93.3	92.9

Sources: Bloomberg and Reuters.

Chart 1.5
Euro area: exchange rate and exports



Sources: Eurostat and European Central Bank.

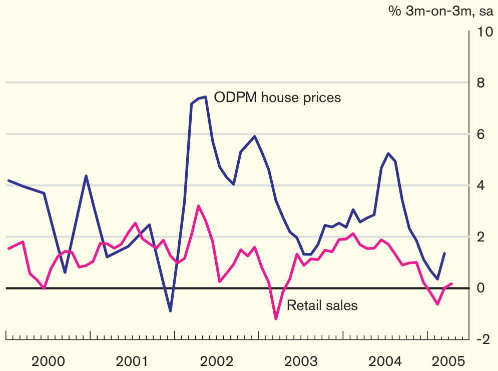
1.2 Euro area and UK

Following unexpected weakness in 2004 Q4, growth in the euro area increased during 2005 Q1 to 2.0% – the highest in a year (Chart 1.4). The contribution of net exports increased, as imports fell, which offset slower final domestic demand growth. By region, the German economy expanded by 4.2% following a contraction in 2004 Q4, while growth in France declined and was negative in Italy for the second consecutive quarter.

Private domestic demand growth in the euro area has shown a modest recovery in recent quarters. Consumer spending growth averaged 1.6% in the three quarters to 2005 Q1, up from close to zero in 2004 Q2. This is supported by higher growth in consumer credit and stable consumer confidence, as employment continued to increase gradually (although real wage growth remained weak). Business investment spending rose steadily during 2004 H2 also, but it declined in 2005 Q1. This is not surprising given the sharp decline in survey indicators of business confidence this year (Table 1.B), suggesting that commodity price increases, and the past strength of the euro, are inhibiting a stronger upturn in business investment spending. Export growth declined sharply in 2004 H2 and remained weak at the beginning of the year (Chart 1.5), although there are signs of a recovery in Germany.

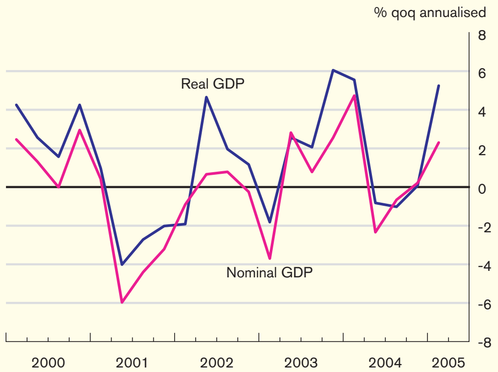
Overall, there is concern about the resilience of the recovery underway in the euro area. In particular, the modest recovery underway in private domestic demand remains vulnerable to external developments. Underlying inflationary pressures remained benign, with core CPI inflation – excluding unprocessed food and energy – falling to 1.7% in 2005 Q1 from 2.0% in 2004.

Chart 1.6
UK: house prices and retail sales



Sources: UK National Statistics, Office of the Deputy Prime Minister and staff estimates.

Chart 1.7
Japan: nominal and real GDP growth



Source: Cabinet Office of Japan.

In the UK real GDP growth slowed to 2.0% in 2005 Q1 from 2.8% in 2004 Q4, mainly attributable to lower growth of business investment and exports. Private consumption growth remained weak, reflecting a tighter monetary policy and lower house price inflation, which declined to near zero (three months on three months) at the beginning of 2005 (Chart 1.6). CPI inflation rose to 1.7% in 2005 Q1 from an average of 1.3% in 2004.

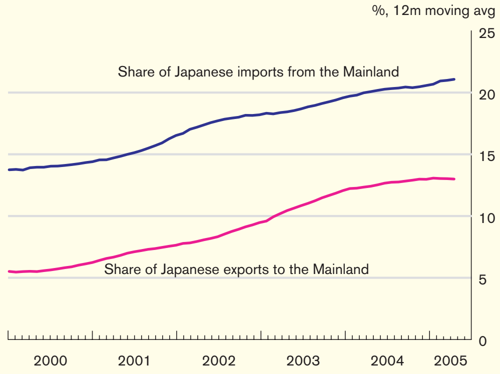
1.3 Asia (ex-Mainland China)

The Japanese economy recovered during the two quarters to 2005 Q1, following a short recession in the middle of 2004. Growth increased to 5.3% in 2005 Q1, from 0.1% in 2004 Q4, following two quarters of contraction (Chart 1.7). In 2004 the economy grew by 2.7%, and by 1.5% in nominal terms – the highest rate in seven years. However, despite stronger-than-expected growth outturns, in May 2005 the Bank of Japan pushed back its forecast for an end to the deflation in the core CPI to FY2006-07, reflecting persistent price falls over the past six months.

There are indications of a more balanced growth path this year, with an increased contribution from domestic demand. After falling in 2004 H2, consumer spending increased in 2005 Q1 as consumer confidence stabilised, and labour market conditions continued to improve. The growth in nominal wages turned positive towards the end of 2004, and the number of people employed has stabilised (but is yet to show a decisive upturn). Business investment grew at an average rate of 3.8% in the two quarters to 2005 Q1, although the March Tankan survey results show a decline in firms' confidence, suggesting that the upturn is still fragile.

Export growth, on the other hand, has been disappointing. It declined during 2004 H2, because of a downturn in global electronics demand and a build-up in inventories, and barely recovered in 2005 Q1. However, within total exports, the share of Japanese exports to Mainland China has continued to increase steadily in recent quarters, providing some support to overall exports. Stronger Mainland China-Japan trade links are driven by a continued restructuring of production chains in East Asia that has seen the Mainland emerge as an

Chart 1.8
Japan: bilateral trade with the Mainland



Source: Ministry of Finance of Japan.

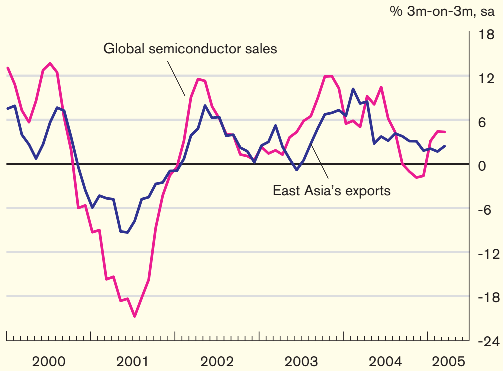
Table 1.C
East Asia: real GDP growth

(% yoy)	2003	04Q1	04Q2	04Q3	04Q4	05Q1
NIE:						
Korea[1]	3.1	5.3	5.5	4.7	3.3	2.7
		(2.6)	(2.4)	(3.3)	(3.8)	(1.4)
Singapore[1]	1.4	7.9	12.3	7.2	6.5	2.5
		(10.1)	(7.5)	(0.7)	(7.9)	(-5.5)
Taiwan	3.3	6.7	7.9	5.3	3.3	2.5
ASEAN:						
Indonesia	4.9	4.4	4.4	5.1	6.7	6.4
Malaysia	5.3	7.8	8.4	6.7	5.8	5.7
Philippines	4.7	6.4	6.4	6.3	5.4	4.6
Thailand	6.9	6.7	6.4	6.1	5.1	3.3
East Asia:	**4.3**	**5.9**	**6.3**	**5.5**	**4.8**	**4.0**

Note 1: Figures in bracket are official estimates of seasonally adjusted quarter-on-quarter annualised growth rates.

Source: Bloomberg.

Chart 1.9
East Asia: the global IT cycle and export growth (in US$ terms)



Sources: CEIC and staff estimates.

important low-wage base for processing and assembly operations in the region, importing hi-tech components from Japan, Taiwan and Korea.[3] Chinese trade data show that imports from Japan accounted for a larger share of Mainland China's total imports, by value, than those from the US last year. The export of final goods back to Japan has led to a steady increase in the share of imports from the Mainland in total Japanese imports, which rose to 21% in 2005 Q1 (Chart 1.8).

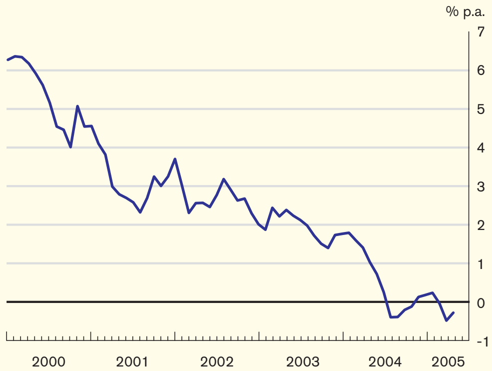
In the rest of East Asia (outside Mainland China)[4], annual growth rates have declined from their highs last year, to an estimated 4.0% in 2005 Q1 from 4.8% in 2004 Q4 (Table 1.C). This partly reflected the base effects from a high level of growth at the start of 2004, which helped to take the average growth rate in regional economies to 5.6% in 2004 as a whole – the best performance since 2000. But it also reflected a loss of the growth momentum behind industrial production and exports, as external demand weakened.

Annual export growth declined in most of the smaller East Asian economies in the two quarters to 2005 Q1. Seasonally adjusted, three-month-on-three-month growth rates also suggest weakness, with some economies showing a fall in the level of exports, in nominal terms, during the period. This reflected slower growth in exports to both the Mainland and the US. One factor explaining slower export growth is the global IT cycle, which turned down sharply in 2004 H2 (Chart 1.9). Singapore, Korea and Taiwan were hard hit, as electronics account for more than a third of their total exports. This may prove temporary as there are signs of a recovery in IT demand this year.

[3] See Cutler J. et al (2004), "Intra-regional Trade and the Role of Mainland China", *HKMA Quarterly Bulletin*, December 2004.

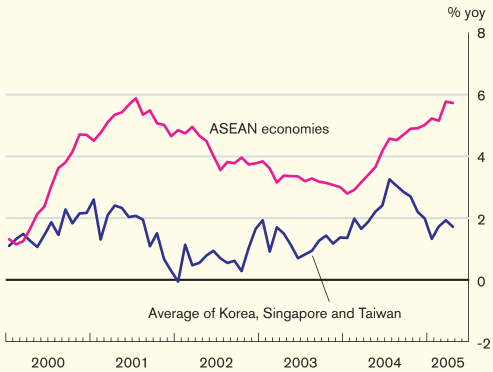
[4] This covers Korea, Singapore, Taiwan, and the ASEAN economies of Indonesia, the Philippines, Malaysia and Thailand. Note that aggregates for these economies are weighted by 2003 PPP-adjusted GDP, except where otherwise stated.

Chart 1.10
East Asia: real interest rate[1]



Note 1: 3-month interbank interest rates minus annual rates of headline CPI inflation.
Sources: Bloomberg and CEIC.

Chart 1.11
East Asia: headline CPI inflation[1]



Note 1: Simple average.
Source: CEIC.

Indicators of domestic demand growth show a mixed picture across the region. Annual consumer spending growth was robust in a majority of economies in the two quarters to 2005 Q1, supported by low or, in some economies, negative real interest rates (Chart 1.10), increased availability of consumer credit and gradually improving labour market conditions. In Korea, consumer spending growth increased to its highest level since the bursting of the credit bubble in 2003. A notable exception was Singapore, where consumption growth declined sharply during 2005 Q1. Annual fixed investment growth has been strong in recent quarters in Taiwan, Thailand and Indonesia, but has weakened in Korea, the Philippines and Singapore.

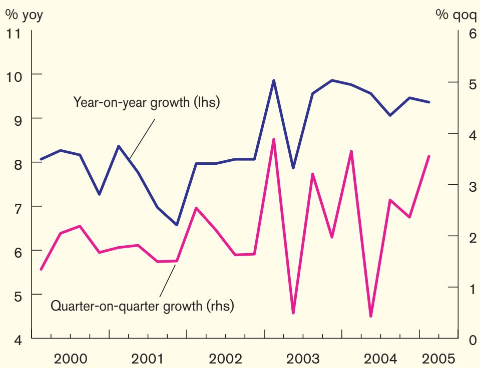
The persistent strength of commodity prices is putting upward pressure on inflation rates. Although food price inflation has declined from its highs last year, energy and metal price inflation shows a renewed pick-up. Headline CPI inflation picked up earlier this year in Korea, Singapore and Taiwan, and remained on a rising trend in the ASEAN economies, notably in Indonesia and the Philippines (Chart 1.11).

Mainland China

Since the December Report, the Mainland's rapid economic growth has continued, largely driven by high investment spending and a strong export performance. Both consumer price inflation and producer price inflation slowed markedly. The growth rates of M2 and financial institution loans declined in the first four months of this year, after picking up in late 2004.

1.4 Output, growth, and inflation

Chart 1.12
Mainland China: GDP growth

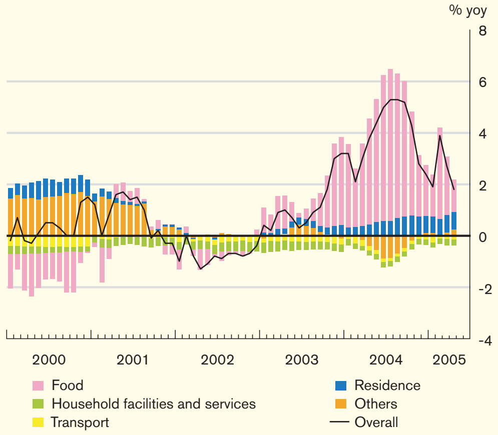


Sources: CEIC and staff estimates.

Economic growth continued to be strong, with a year-on-year rate of 9.5% in 2004 Q4 and 9.4% in 2005 Q1. The relatively high base of 2004 Q1 suggests a pick-up in growth momentum in 2005 Q1. Unofficial estimates of seasonally adjusted quarter-on-quarter growth rates increased markedly, from 2.4% in Q4 to 3.6% in Q1, the highest since 2004 Q1 (Chart 1.12).

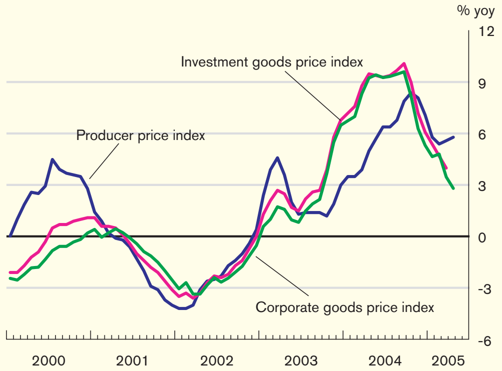
Strong investment and exports were the main drivers of the rapid growth, while private consumption continued to hold up. Recent data on investment and industrial production point to risks of renewed overheating pressures in the economy. The annualised quarterly seasonally adjusted growth rate of industrial production rose to around 16% in the first four months of 2005, from 14.9% in Q4. Despite the high base in early 2004, urban fixed asset investment rose by 25.7% year on year in the first four months of 2005, compared with 23.6% in 2004 Q4. Consumer spending remained robust, growing by over 12% year on year in the past two quarters. Export growth remained strong at an annual rate of 34% in the first four months of 2005, compared to 35.6% in Q4, while import growth slowed significantly from 30.4% to 13.3% over the same period. Unofficial estimates of seasonally adjusted three-month-on-three-month growth rates showed a different picture for exports and imports. The growth rates of exports declined rather sharply for the fourth consecutive month to -0.2% in April. Together with some recent trade frictions (particularly for textiles) with the EU and the US, it suggests that export growth may moderate somewhat in the periods ahead. On the other hand, the

Chart 1.13
Mainland China: contributions to CPI inflation



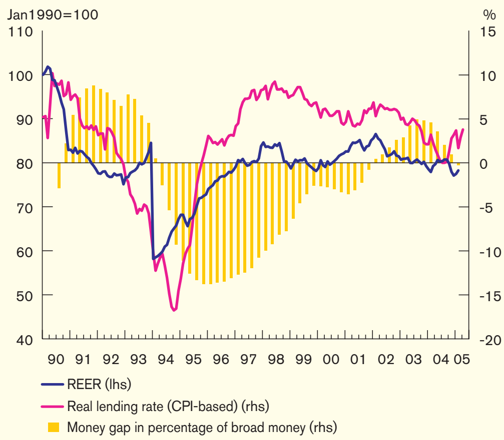
Sources: CEIC and staff estimates.

Chart 1.14
Mainland China: other price indicators



Source: CEIC.

Chart 1.15
Mainland China: monetary conditions



Note: The money gap is defined as the difference between the actual nominal M2 and an estimated demand determined by economic growth and inflation.
Sources: CEIC and staff estimates.

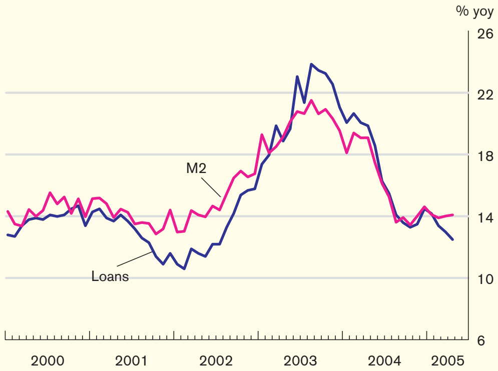
sharp slowdown in the annual growth rates of imports might be largely attributable to the high base effect.

The headline inflation rate continued to decline, to 1.8% year on year in April, mainly reflecting a decrease in food price inflation – the dominant factor behind recent consumer price inflation (Chart 1.13). Upstream inflation also eased. Producer price inflation fell to a recent low of 5.4% in February 2005, before rebounding to 5.6% in March and 5.8% in April (Chart 1.14). Both investment goods price inflation and corporate goods price inflation continued to fall. Nevertheless, the effects of high oil prices and supply bottlenecks in some key sectors are yet to feed into the pipeline inflation.

1.5 Monetary conditions and asset prices

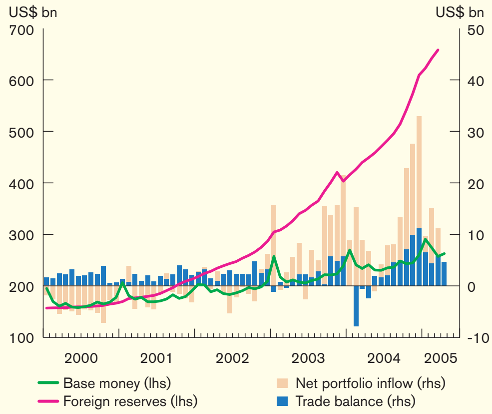
Monetary conditions tightened in the first few months of 2005, following a relatively easy environment in 2004 Q4. Real interest rates have risen and stayed above zero (Chart 1.15), reflecting the combined effect of increased lending rates and lower consumer price inflation. The renminbi real effective exchange rate (REER) has appreciated since December 2004, after depreciating between September and December 2004, mainly reflecting corresponding movements in the US dollar. Broad money (M2) and financial institution loans' expansion remained below the desired annual rates of 16-17% set by the People's Bank of China (PBoC)

Chart 1.16
Mainland China: money and credit



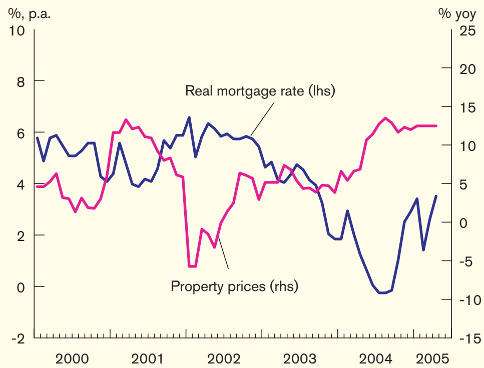
Sources: CEIC and staff estimates.

Chart 1.17
Mainland China: external capital inflows



Note: Net portfolio inflow is defined as the difference between the changes in foreign exchange reserves and the sum of trade surplus and foreign direct investment.
Sources: CEIC and staff estimates.

Chart 1.18
Mainland China: real mortgage rates and property prices



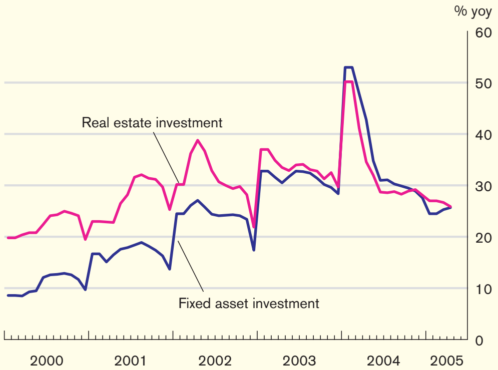
Sources: PBoC and CEIC.

(Chart 1.16). In addition, unofficial estimates show that the money gap, a measure of excess money supply relative to demand, continued to narrow to about zero.

Short-term capital inflows remained strong and posed challenges to monetary policy management, mainly as a result of speculation on a revaluation of the renminbi. Net portfolio inflows have added up to US$133 billion since January 2004, accounting for more than half of the rise in foreign exchange reserves over the same period (Chart 1.17). This prompted the State Administration of Foreign Exchange to set caps for short-term offshore borrowings by local and foreign banks on 10 May. As the PBoC continued to carry out sterilisation operations to limit the impact of reserve increases on domestic monetary conditions, growth in base money has been contained.

Despite somewhat tightened financial conditions, the property market continued to boom in the first four months of 2005. Property prices rose by 12.5%, a high rate of appreciation by historical standards (Chart 1.18). In Shanghai, property prices increased by 19% in 2005 Q1. Strong increases in property prices have

Chart 1.19
Mainland China: investment



Source: CEIC.

contributed to higher investment growth, particularly real estate investment (Chart 1.19). The authorities have implemented a series of measures to reduce speculative activities, including raising mortgage interest rates and down-payment requirements in March and additional steps in May. Initial signs indicate the latest measures may have started to take effect, particularly in large cities like Shanghai, where increases in property prices have been higher than in other parts of the country. However, it remains to be seen whether these new measures are sufficient to achieve a sustained consolidation in the property market.

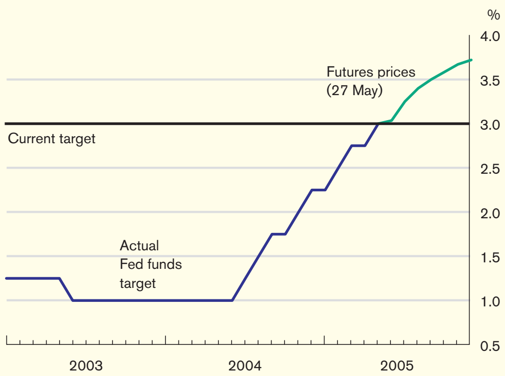
Monetary and financial conditions

The US Federal Open Market Committee continued to tighten its monetary policy stance. With short-term bond yields rising and longer-term rates remaining at low levels, the US Treasury yield curve flattened further. Some central banks in emerging Asia raised their policy rates amid a pick-up in inflationary pressures on higher oil prices. The US dollar has been volatile against other major currencies.

1.6 Interest rates

The US Federal Reserve continued to tighten its monetary policy stance in the first half of 2005. Since June 2004, the Federal Open Market Committee has raised its federal funds target rate by a total of two percentage points to 3% in eight consecutive meetings. In its May meeting, the Committee noticed a pick-up in inflationary pressures but added that longer-term inflation expectations remain well contained. Against this background, the Committee maintains that the monetary stimulus will be removed at a "measured" pace. At the end of May, the price of Fed funds futures contracts indicated that market participants expected the target rate to reach 3.75% by the end of 2005 (Chart 1.20). Apart from the US, all major central banks kept their key policy rates unchanged so far this year.

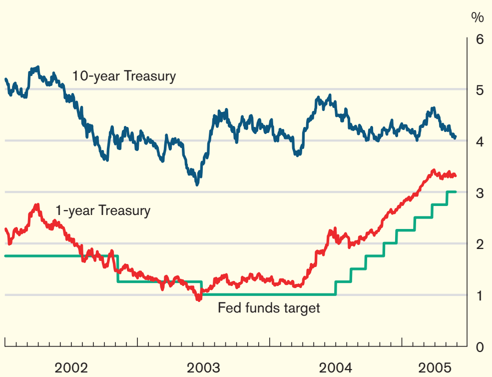
Chart 1.20
US federal funds target rate



Sources: Federal Reserve Board and Bloomberg.

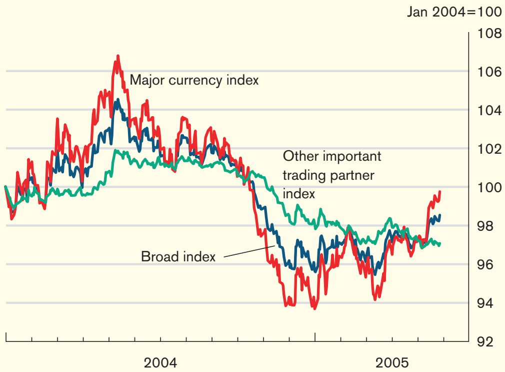
The US Treasury yield curve continued to flatten. Short-term bond yields rose further with the Fed funds target rate, but the 10-year US Treasury bond yield fell to around 4% at the end of May – the levels seen in December 2004 (see Section 4.3). The spread of 10-year over one-year US treasury yields had fallen from 173 basis points at the end of November 2004 to slightly less than 80 basis points at the end of May (Chart 1.21). The long-term European Government bond yields tracked the US Treasury yields to stay at low levels, partly reflecting the increasingly globalised world capital markets and the subdued inflationary pressures.

Chart 1.21
US Treasury yield curve



Source: Federal Reserve Board.

Chart 1.22
US dollar exchange rate indices



Source: Federal Reserve Board.

Chart 1.23
Renminbi non-deliverable forward rates

Source: Bloomberg.

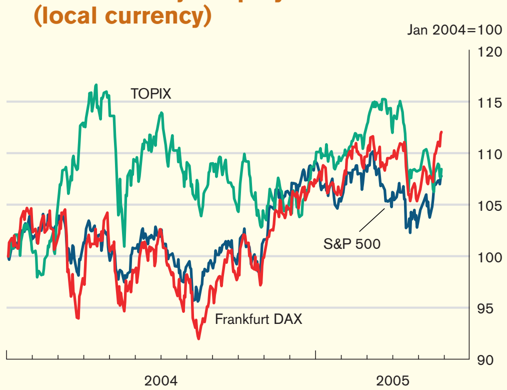
Both the Philippine and Thai central banks raised their policy rates by 25 basis points during the first half of 2005, as higher energy prices pushed up consumer price inflation. The Bank of Korea kept its overnight call rate target unchanged, but warned of increasing inflationary pressures from higher oil and property prices. On the Mainland, the PBoC kept the benchmark one-year renminbi lending and deposit rates stable, but increased slightly the upper limits on rates that commercial banks can offer for onshore US dollar and Hong Kong dollar deposits of less than US$3 million.

1.7 Exchange rates

The US dollar exchange rate has been volatile over the past six months. Since November 2004, the value of the US dollar, as measured by the Federal Reserve Broad Dollar Index, strengthened on rising US short-term interest rates and signs of strong economic activity. However, it weakened in mid-February before rebounding in mid-March. While the US dollar was volatile against other major currencies, it remained broadly stable against the currencies of other important trading partners, including the Mainland (Chart 1.22).

Market expectations of a renminbi revaluation peaked at the beginning of 2005 before subsiding. However, more recently, the pressure on the Mainland Government to adopt a more flexible currency regime intensified as the Mainland recorded large trade surpluses with its trading partners in the US and the euro area. In April, US Senators proposed a 27.5% tariff on all Mainland imports unless the Mainland Government revalued its currency. The discounts of the renminbi non-deliverable forwards (NDFs) – a market measure of expected appreciation – widened. At the end of May, the one-year NDF rate implied a 5.5% appreciation of the renminbi against the US dollar in a year's time (Chart 1.23).

Chart 1.24
Selected major equity indices (local currency)



Source: Bloomberg.

1.8 Equity markets

Global equity markets were volatile in the first half of 2005. After strong gains late last year, equity prices in major economies strengthened further in the first quarter of 2005 on positive corporate earnings' growth. However, equity prices have started to weaken since April (Chart 1.24). In the first five months of 2005, the Frankfurt DAX registered a growth of 4.4%, both the TOPIX and the S&P 500 recorded slight losses. Several factors contributed to the weak performance of equities in the US, including the prospect of rising interest rates, slowing corporate earnings, and the impact of higher commodity prices on inflation.

2. Domestic economy

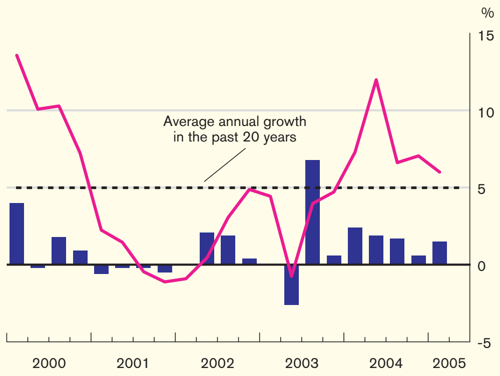
Demand

Real GDP growth in Hong Kong eased in 2005 Q1 from its high level in 2004, but continued to remain robust by historical standards. The moderation in growth mainly reflects a decline in export growth against the backdrop of slower global expansion. By contrast, private consumption growth remained robust, supported by rising housing wealth and improving labour market conditions.

2.1 Aggregate demand

Economic growth eased in 2005 Q1 from its high level in 2004, but remained at an above-average pace (Chart 2.1). Real GDP grew at an annual rate of 7.1% in the final quarter of 2004, finishing the year with remarkable growth of 8.1% – the fastest since 2000. In 2005 Q1, growth declined to an annual rate of 6.0%, mainly reflecting a decline in export growth against the backdrop of slower global expansion. However, on a seasonally adjusted quarter-on-quarter basis, growth in 2005 Q1 increased to 1.5%, from 0.6% in 2004 Q4. This suggests that the underlying growth momentum remained robust.

Chart 2.1
GDP at constant market prices



Source: C&SD.

2.2 Domestic demand

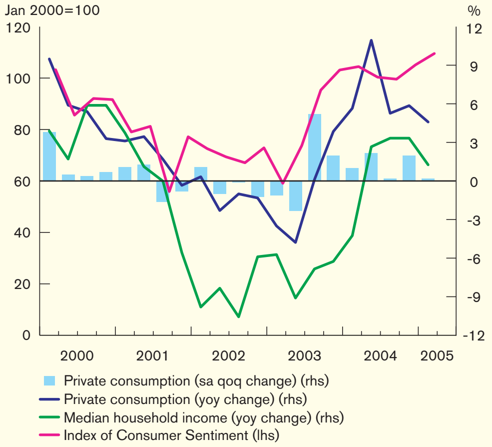
Domestic demand decreased in 2005 Q1, at an annual rate of 2.5%, compared with a 2.0% decline in 2004 Q4 (Table 2.A). The decline was mainly due to a further fall in inventories, while private consumption growth remained robust and investment growth turned positive. The fall in inventories in 2005 Q1 was due to an increase in consumption and investment together with a decline in retained imports.

Table 2.A
Real GDP growth by expenditure component

(% yoy)	2003	2004	2004			2005
			Q2	Q3	Q4	Q1
Gross Domestic Product	**3.1**	**8.1**	**12.0**	**6.6**	**7.1**	**6.0**
Domestic demand	0.1	5.0	12.1	3.4	-2.0	-2.5
Consumption						
Private	-1.1	6.9	10.9	5.3	5.9	4.6
Public	1.9	0.7	0.0	-1.3	-1.7	-4.2
Gross domestic fixed capital formation	0.9	4.1	11.5	2.1	-1.4	2.2
Private	0.8	6.2	15.3	4.9	-0.8	4.1
Public	1.4	-6.0	-8.4	-12.6	-4.3	-5.8
Change in inventories[1]	0.3	-0.4	2.1	-0.3	-4.5	-5.1
Net exports of goods[1]	0.6	0.9	-3.5	1.2	7.5	6.6
Net exports of services[1]	2.5	2.7	4.1	2.4	1.3	1.8

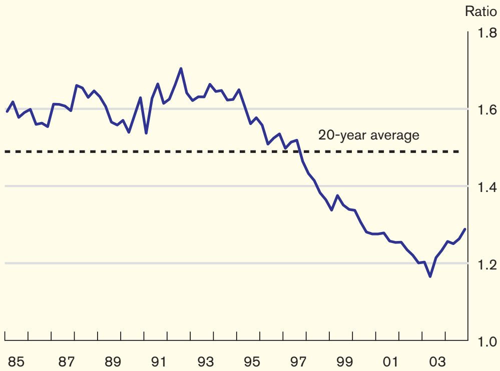
Note 1 : Percentage-point contribution to annual growth of GDP.
Source: C&SD.

Chart 2.2
Private consumption, consumer sentiment and household income



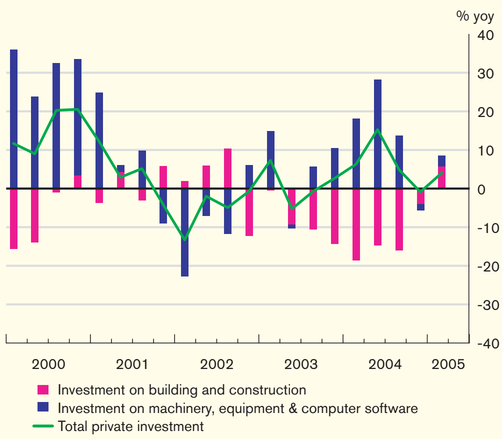
Sources: C&SD, the Chinese University of Hong Kong, and CEIC.

Chart 2.3
Consumption-to-labour-income ratio



Sources: C&SD and staff estimates.

Chart 2.4
Private investment by component



Source: C&SD.

Private consumption

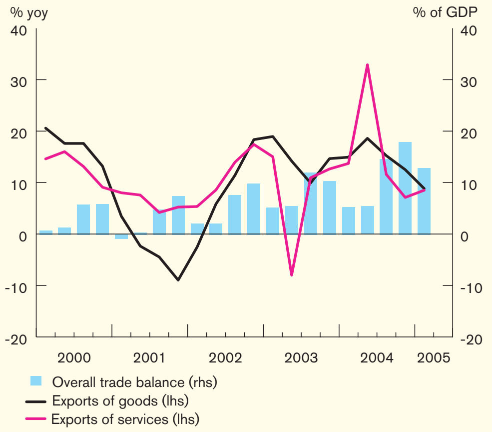
Growth in private consumption has remained strong since the December *Report*, supported by an increase in consumer sentiment (Chart 2.2). The latter may reflect further increases in housing wealth, a decline in the unemployment rate, and an increase in household income. Annual growth of private consumption slowed to 4.6% in 2005 Q1, from 5.9% in 2004 Q4. On a seasonally adjusted quarter-on-quarter comparison, private consumption growth in Q1 declined also, to 0.2%, from 2.0% in the previous quarter.

Stable wages and an increase in consumption suggest that the household sector saving ratio may have fallen. This is supported by a continued increase in the ratio of consumption-to-labour-income, although in 2004 Q4 it was still well below its average level over the past 20 years (Chart 2.3). The decline in households' propensity to save could reflect an increase in household wealth as a result of higher housing prices and optimism about future income growth as the recovery continues.

Investment

Private investment reverted to positive annual growth in 2005 Q1 (Chart 2.4). Spending on machinery, equipment and computer software grew by 2.8% in 2005 Q1, after a short-lived decline in 2004 Q4. However, the growth rate has slowed considerably compared with the earlier quarters in 2004, as the business outlook has been clouded by slower global growth expectations. The sustained recovery in the property market has led to an increase in spending on building and construction, which grew by 5.8% in 2005 Q1, after declining for more than two years. Historically, there has been a positive relationship between changes in construction activity and property prices, but it has taken time for higher property prices to feed through to an increase in investment spending on new buildings and other construction. Reduced land supply in earlier years, because of the suspension of land sales, may have also contributed to the slow response of construction activity to property prices.

Chart 2.5
Export growth and trade balance (in real terms)



Source: C&SD.

The year-on-year decline in public sector investment increased in 2005 Q1 to 5.8%, compared with 4.3% in 2004 Q4. This reflected the further decline in works under the Public Housing Programme and the completion of several large railway projects.

2.3 External trade

Growth in goods exports declined to a zero quarter-on-quarter rate in 2005 Q1 – the lowest in three years – from 2.9% in 2004 Q4, as a sharp fall in domestic exports offset a small increase in re-exports. Annual growth declined in 2005 Q1, but continued to be robust (Chart 2.5). The slowdown was across the board to most major markets, but was particularly marked for intra-regional exports (Table 2.B). Annual growth of goods imports also declined in 2005 Q1 because of slower growth in re-exports and a further decline in retained imports.

Table 2.B
Merchandise exports by major market

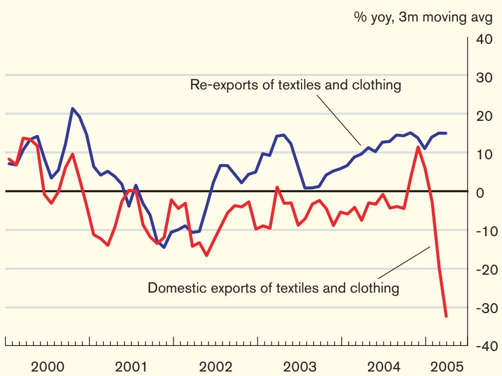
(% yoy)	Share[1] %	2003	2004	2004 Q2	2004 Q3	2004 Q4	2005 Q1
Mainland China	44	21	20	22	23	17	12
United States	17	-3	5	6	4	7	6
European Union	14	12	18	16	20	22	16
ASEAN5[2] + Korea	8	9	19	23	17	13	6
Japan	5	12	14	17	14	16	12
Taiwan	2	22	16	25	14	7	-3
Others	10	5	9	17	11	12	5
Total	**100**	**12**	**16**	**18**	**17**	**15**	**11**

Notes: 1. Share in 2004.
2. ASEAN5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand.

Sources: C&SD and CEIC.

The decline in domestic exports in 2005 Q1 was largely due to a sharp fall in exports of textiles and clothing. Some firms have reduced their processing of textiles and clothing in Hong Kong following the abolition of quotas on imports of textiles and clothing into Hong Kong's major markets in January 2005. The ending of the quota restrictions means Hong Kong manufacturers have more flexibility in relocating production to low-cost manufacturing bases, including the Mainland, to improve their competitiveness. The value of domestic exports of textiles and clothing, which accounted for over half of Hong Kong's total domestic exports in 2004, fell by 32% in 2005 Q1 from a year earlier (Chart 2.6). On the other hand, growth in re-exports of textiles and clothing increased in 2005 Q1.

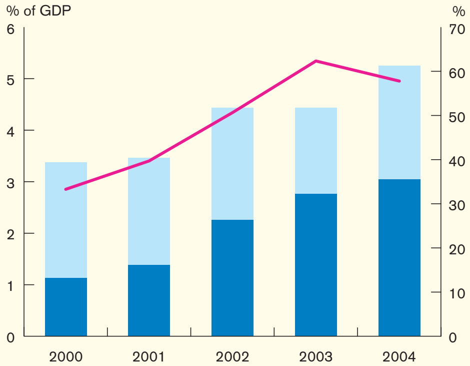
Chart 2.6
Exports of textiles and clothing



Sources: C&SD and CEIC.

By contrast, the value of domestic exports to the Mainland recorded annual growth for the fourth consecutive quarter in 2005 Q1, following falls in the previous three years. This partly reflected the effects of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), which grants Hong Kong products tariff-free access to the Mainland market.

Chart 2.7
Visitor spending



Mainland visitors' spending (lhs)
Other visitors' spending (lhs)
Mainland visitors' spending in percentage of total visitors' spending (rhs)

Sources: Hong Kong Tourism Board, C&SD, and staff estimates.

In 2005 Q1 exports of services increased by 2.4% on a seasonally adjusted quarter-on-quarter basis, compared with a decline of 1.0% in 2004 Q4. Annual growth also increased, reflecting mainly faster growth in travel-related services. Boosted by a further extension of the Mainland's Individual Visit Scheme and a recovery in the number of visitors from other economies, the number of incoming tourists hit a record high in December 2004, before decreasing slightly in 2005 Q1. Mainland China continued to be the largest source of tourist receipts, with its share accounting for over half the total (Chart 2.7). By contrast, annual growth in imports of services moderated in 2005 Q1, consistent with slower growth in goods imports.

Overall, the trade surplus declined in 2005 Q1 compared with the previous quarter, mainly reflecting a widening in visible trade deficit, which was due to slower export growth.

Output and supply

The service sector continued to be the key driver of growth, particularly in services related to external trade. Closer integration with the Mainland has led to a strong revival in output in tourism-related sectors and in manufacturing. Labour market conditions improved further, with the unemployment rate declining in April 2005 to its lowest level since late 2001.

2.4 Output

The service sector continued to be the main driving force of growth in 2004 H2, although its annual rate of growth was lower than in 2004 H1 (Table 2.C).[5] Closer integration with the Mainland has continued to support Hong Kong's trade in goods and services. While trade-related services continued to record double-digit growth, owing to buoyant trade growth on the Mainland, output of the consumption and tourism-related sectors also grew markedly. Inbound tourism, in particular, benefited from a further extension of the Individual Visit Scheme in May and July 2004 to cover more Mainland cities. A notable development since the December *Report* is an increase in manufacturing output growth to 5% in the year to 2004 Q4 – the fastest growth rate since the inception of the statistics for 2001 Q1. This may reflect the introduction of tariff exemptions in January 2004 for goods produced in Hong Kong and exported to the Mainland under CEPA.

In terms of contributions to growth, services related to external trade accounted for almost half of annual output growth in 2004 H2 (Table 2.D). The financial services industry was the second largest contributor with more than 20%. The contribution from the manufacturing sector turned positive for 2004 as a whole.

Table 2.C
Real GDP growth by major economic sector

(% yoy)	2003	2004	2004			
			Q1	Q2	Q3	Q4
GDP at factor cost	**3.3**	**7.6**	**7.1**	**10.7**	**6.1**	**6.7**
Industrial sector	-4.6	-1.9	-2.4	-3.4	-2.8	1.2
Of which:						
Manufacturing	-9.1	2.9	1.8	1.1	3.4	5.0
Construction	-4.6	-8.5	-9.2	-10.7	-12.0	-2.3
Service sector	4.5	8.8	8.3	12.7	7.4	7.4
Of which:						
Wholesale, retail, restaurant and hotel	-5.9	10.1	6.7	23.6	6.2	6.5
Import and export	13.5	14.0	13.6	19.2	13.8	10.7
Transport and storage	-1.1	18.2	12.0	29.0	16.6	16.6
Financing, insurance and business services	7.7	11.7	17.9	13.4	7.7	8.6

Source: C&SD.

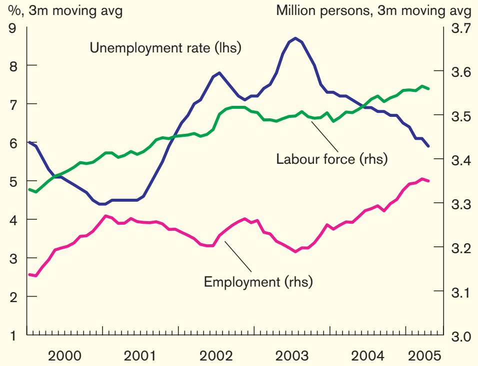
Table 2.D
Contribution to real GDP growth by major economic sector (year on year)

(% point)	2003	2004	2004			
			Q1	Q2	Q3	Q4
GDP at factor cost	**3.3**	**7.6**	**7.1**	**10.7**	**6.1**	**6.7**
Industrial sector	-0.6	-0.2	-0.3	-0.4	-0.3	0.1
Of which:						
Manufacturing	-0.4	0.1	0.1	0.0	0.1	0.2
Construction	-0.2	-0.4	-0.4	-0.5	-0.5	-0.1
Service sector	3.9	7.8	7.3	11.1	6.5	6.6
Of which:						
Wholesale, retail, restaurant and hotel	-0.4	0.6	0.4	1.2	0.3	0.4
Import and export	2.8	3.2	2.9	4.1	3.3	2.6
Transport and storage	-0.1	1.4	1.0	2.1	1.3	1.3
Financing, insurance and business services	1.3	2.1	3.1	2.5	1.3	1.5

Source: C&SD.

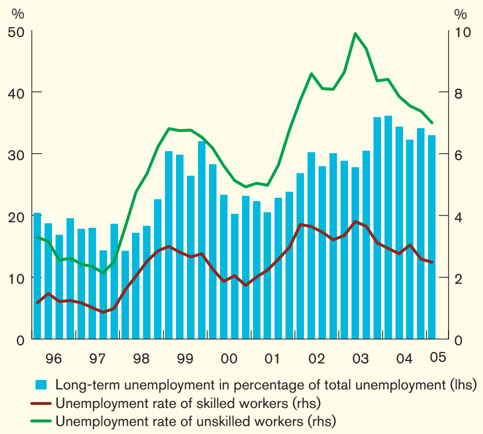
5 GDP by economic sector for 2005 Q1 was not available at the time of the publication of this *Report*.

Chart 2.8
Labour market conditions



Source: C&SD.

Chart 2.9
Long-term unemployment and unemployment rate by skilled and unskilled workers



Sources: C&SD, CEIC and staff estimates.

2.5 Labour and productivity

The sustained economic recovery has resulted in an increase in employment growth. While the annual growth rate of labour productivity declined in 2005 Q1, it was still higher than its long-term growth rate of 2.2%.

Labour market conditions

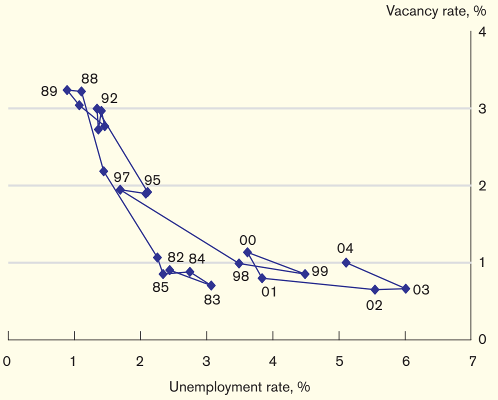
Labour market conditions have continued to improve since the December *Report*. The pace of expansion in employment increased in recent months, leading to a slightly faster decline in the unemployment rate, which eased to 5.9% in the three months ending April, down from 6.7% in the six months before (Chart 2.8). The labour force has also risen steadily due to an increase in the working-age population, although the labour force participation rate declined marginally. The fall in the unemployment rate has been broadly based. The largest falls were in the external trade and the consumption and tourism-related sectors.

The underemployment rate declined, albeit less markedly, to 3.0% in the three months to April, from 3.2% in the six months earlier. The decline was concentrated in the manufacturing and restaurant and hotel sectors, as more full-time jobs were created to replace part-time and temporary jobs.

However, the unemployment rate is still high by historical standards, raising concerns about prospects for the labour market. Our research suggests that the relatively high unemployment rate in recent years was mainly associated with cyclical factors; although there are signs, backed by supporting evidence, that the natural rate of unemployment may have risen as a result of structural shifts towards a more knowledge-based and higher value-added economy.[6] First, the share of long-term unemployment (that is, individuals unemployed for six months or more) remains high (Chart 2.9). The duration of unemployment in the manufacturing sector has been the longest, at 167 days in 2005 Q1, according to median duration. Secondly, the gap between the

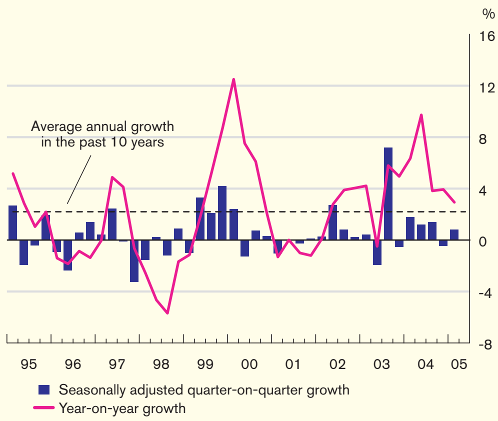
[6] See Fan, K. (2004), "Sources of unemployment", *HKMA Quarterly Bulletin*, June 2004.

Chart 2.10
Unemployment and vacancy rates for the service sector



Note: Service sectors include the trade & tourism, transport & communications, financing & business services and personal services.
Sources: C&SD, CEIC and staff estimates.

Chart 2.11
Output per worker



Sources: C&SD and staff estimates.

unemployment rate of skilled and unskilled workers has widened in recent years, owing to a weak demand for lower-skilled workers (Chart 2.9).[7] Thirdly, Chart 2.10 shows that the unemployment rate for the service sector is higher in the past decade than in the 1980s for any given level of vacancies. For example, a vacancy rate of about 1% was associated with an unemployment rate of 4-6% in recent years, but 2-3% in the early 1980s. This suggests that the skills mismatch may have increased. Nevertheless, our estimates indicate that the natural rate of unemployment is still significantly below the current rate of unemployment. Thus, the unemployment rate is expected to decline further as economic recovery continues.

Productivity

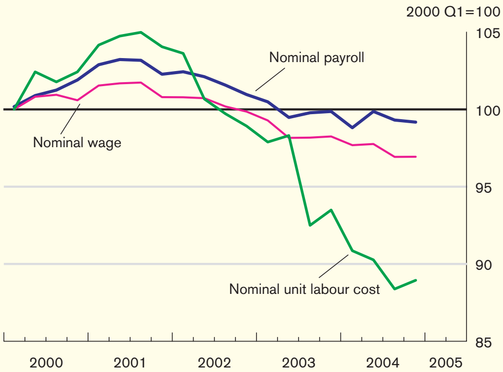
Growth in labour productivity – as measured by output per worker – turned positive in 2005 Q1, following a quarter-on-quarter decline in 2004 Q4 (Chart 2.11). The latter was due to a faster expansion in employment than output. Annual growth of labour productivity declined in recent quarters, but remained above its long-term growth rate. While faster expansion in employment has led to slower labour productivity growth, the slowdown could be a temporary phenomenon, as workers take time to pick up the skills required for their new jobs. Should labour productivity growth continue, higher employment levels could generate more output in the future, improving growth prospects in the longer term.

[7] Skilled workers include managers and administrators, professionals and associate professionals, while unskilled workers include clerks, service workers and shop sales workers, craft and related workers, plant and machine operators and assemblers and elementary occupations.

Prices and wages

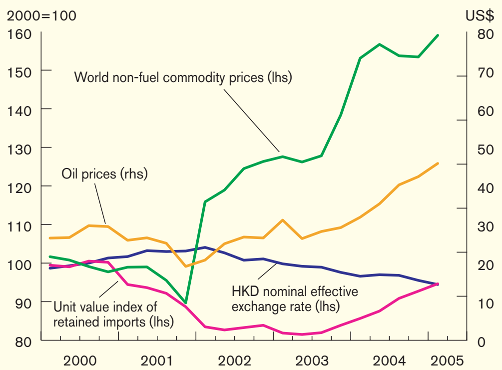
There has been a steady pick-up in consumer price inflation since the December Report. A positive output gap, a recovering property market, and a weak effective exchange rate have led to increased inflationary pressures. Upward pressure from wage increases has remained low.

Chart 2.12
Wage and payroll indices and unit labour cost



Sources: C&SD and staff estimates.

Chart 2.13
Import prices



Sources: C&SD and Datastream.

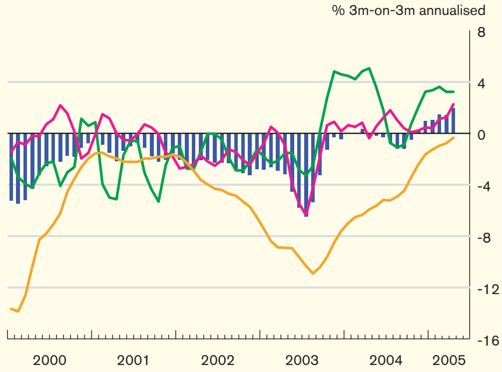
2.6 Labour costs

Inflationary pressures stemming from the labour market have remained low. Despite a declining unemployment rate in recent quarters, average nominal payroll – which includes remuneration and overtime payments, back-pay and other irregular allowances and bonuses – in 2004 Q4 was 0.1% lower than in the previous quarter, and 0.6% lower than a year earlier (Chart 2.12). The payroll declined in most major sectors with the exception of the manufacturing and the wholesale, retail, trade, restaurant, and hotel sectors. While the manufacturing sector has benefited from the implementation of CEPA, the wholesale, retail, trade, restaurant, and hotel sector is one of the fastest-growing sectors in the economy, as discussed in Section 2.4.

2.7 Commodity and import prices

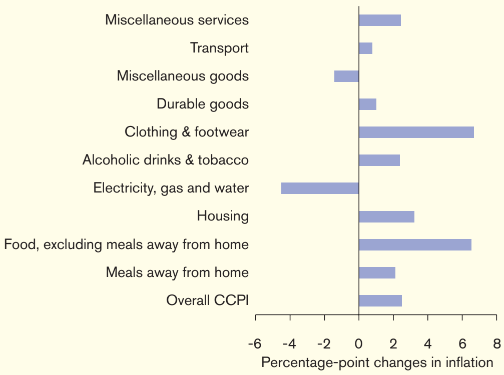
Since the December *Report*, import prices have risen further, reflecting a depreciation of the US dollar, the strength of world non-fuel commodity prices, and persistently high oil prices (Chart 2.13). However, the rate of import price inflation slowed in response to the decline in commodity price inflation during 2004 H2. On a three-month-on-three-month comparison, the unit value index of retained imports increased at an annualised rate of 8.4% in March, compared with 12.3% in 2004 H2. The annual rate of import price inflation remained high at around 10.5% in the three quarters to 2005 Q1.

Chart 2.14
Consumer price inflation by component



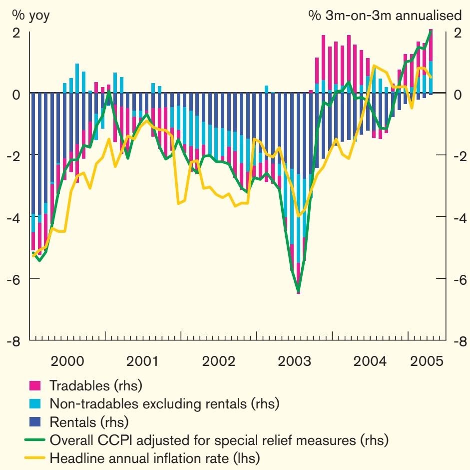
Sources: C&SD and staff estimates.

Chart 2.15
Change in 3m-on-3m annualised CCPI inflation between October 2004 and April 2005



Sources: C&SD and staff estimates.

Chart 2.16
Contribution to consumer price inflation by broad component



Sources: C&SD and staff estimates.

2.8 Consumer prices

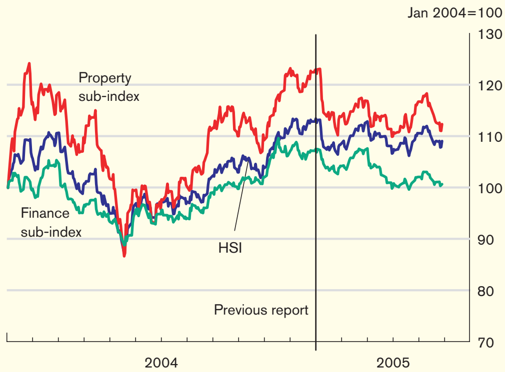
There has been a steady pick-up in consumer price inflation since the December *Report*, despite a decline in import price inflation and stable wages. The seasonally adjusted three-month-on-three-month annualised inflation rate rose to 2.0% in April – its fastest pace since July 1998 (Chart 2.14). The increase in the inflation rate of the price of tradable goods was faster than that of non-tradable goods and services. At a more dis-aggregated level, inflation increased in almost all categories with the exception of electricity, gas and water – most of these prices are regulated by the Government – and miscellaneous goods (Chart 2.15). Reflecting a lagged response to the recovery in property prices, deflation in the rental component ended in February. During February and April, the rental component of the Composite CPI (CCPI) increased modestly by 0.3%. However, the increase in inflation was from a very low level and the annual rate of CCPI inflation was 0.4% in the first four months of 2005, compared with an average of -0.4% in 2004 (Chart 2.16).

The increase in CCPI inflation suggests that firms have regained some pricing power as the economy has recovered, after a significant erosion of profit margins during the economic downturn between 1998 and 2003. It could also partly reflect higher costs, particularly from rising rents. The rental indices of both retail and residential premises have rebounded by 14% and 17% respectively from their troughs in 2003. The rise in property prices was even stronger, at 76% and 60% respectively.

Asset markets

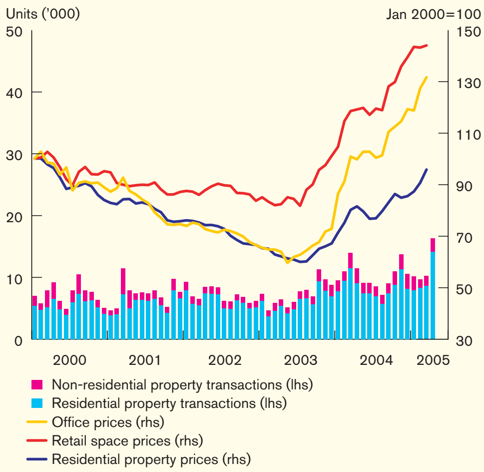
Equity prices in Hong Kong have been volatile since the December Report. However, residential property prices continued to increase strongly over the past six months. Although key real estate indicators suggest the housing market is still a long way off its previous high in 1997, there has been a marked increase in speculative activity.

Chart 2.17
Hong Kong equity prices



Source: Bloomberg.

Chart 2.18
Property prices and transactions



Sources: Rating & Valuation Department and Land Registry.

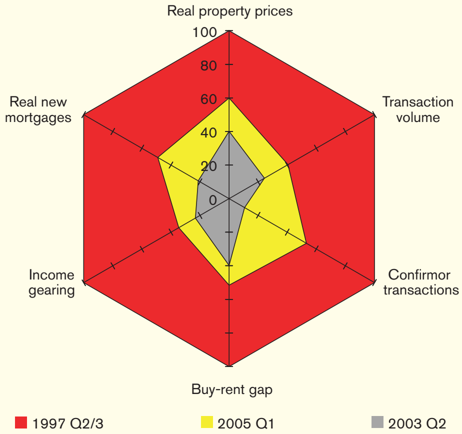
2.9 Equity market

Equity prices in Hong Kong have been volatile over the past six months (Chart 2.17). After registering a gain of 13% in 2004, the benchmark Hang Seng Index fell sharply in January 2005, partly due to some research reports by international investment houses suggesting that Hong Kong shares were overvalued. Since then, the movements in equity prices have been affected by the volatile capital flows and energy prices, and the interest rate outlook.

2.10 Property market

The property market has continued to recover. Residential property prices increased sharply, by 15% between September 2004 and March 2005, taking the cumulative increase to 60% relative to the trough in July 2003 (Chart 2.18). Increases in the prices of commercial properties have been even sharper, rising by 19% in March over the past six months, and by 121% since mid-2003. There has been a slightly lower increase in retail space prices – 12% in the six months to March 2005, and 76% from the trough in 2003. The Centa-City Leading Index, a weekly residential property price index, continued to rise in April, but the pace of increase moderated in the latter part of May in response to a half percentage point increase in interest rates on 23 May.

Chart 2.19
Graphical analysis



Sources: Rating & Valuation Department, Land Registry, C&SD, Centaline Property Agency Limited, and staff estimates.

Property transaction volumes – measured by the number of Sale and Purchase Agreements – declined during 2005 Q1 from a high level in late 2004, but then rose sharply in April 2005 to its highest level since July 1997 (Chart 2.18). Speculative activity has risen, as measured by an increase in the number of confirmor transactions, which climbed to above 500 in April, from around 300 in the previous three months, although its share in total transactions was little changed at slightly below 4%. Preliminary information suggests that total transactions declined slightly in May.

Chart 2.19 summarises six key real estate indicators in the form of a hexagon. A larger size of the hexagon suggests a greater risk of overheating in the market.[8] The size of the hexagon representing the state of the residential property market in 2005 Q1 is substantially smaller than that for 1997 Q2/3, when market conditions were clearly out of line with the fundamentals. However, compared with the trough in 2003 Q2, property prices, transaction volumes (particularly confirmor transactions) and new mortgage loans have risen markedly, although income-gearing and the buy-rent gap have increased only modestly. Thus, despite a strong recovery since mid-2003, the housing market remains a long way off its previous high in 1997. Nevertheless, the increase in the speculative demand for housing is of concern.

[8] See Chan, N., W. Peng and K. Fan (2005), “A graphical framework for monitoring the property market in Hong Kong”, *HKMA Quarterly Bulletin*, March 2005.

Public finances

The fiscal position has improved considerably, helped by stronger revenues as a result of sustained growth. The consolidated government account is projected to be in balance by 2007/08, a year ahead of the Government's previous projections.

2.11 Public finances

The Government revised upwards its estimate of the budget surplus in 2004/05 to 1.7% of GDP recently, from 0.9% in the 2005/06 Budget Statement (Table 2.E). This compares with a previous projection of a deficit of 3.3% of GDP made in March 2004. The turnaround from a budget deficit in the previous four years to a surplus in 2004/05 reflects the inclusion of proceeds from the issuance of government notes and bonds. However, even if these proceeds are not included, the estimates show a much reduced deficit for 2004/05, at 0.3% of GDP, compared with 3.2% in 2003/04.

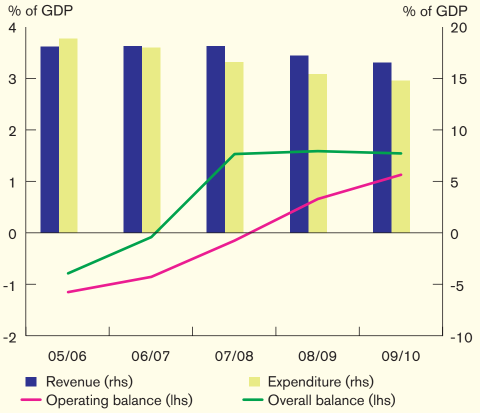
Table 2.E
Analytical presentation of fiscal account

Fiscal year	2002/03	2003/04	Budget[1] 2004/05	Forecast[2] 2004/05	Provisional[3] 2004/05	Budget[2] 2005/06
			(% of GDP)			
Revenue	14.1	16.7	15.4	18.2	18.4	18.0
Tax	9.0	10.3	10.3	11.6	n.a.	11.5
Direct tax	5.9	6.6	6.5	7.6	n.a.	7.5
Indirect tax	3.1	3.7	3.7	4.1	n.a.	4.1
Non- tax	5.1	6.4	5.1	6.6	n.a.	6.5
Expenditure	19.0	20.0	20.7	19.3	18.7	18.8
Recurrent	15.7	15.9	16.2	15.2	n.a.	15.2
Capital	3.3	4.0	4.5	4.1	n.a.	3.5
Overall balance[4]						
Before borrowing	-4.9	-3.2	-5.4	-1.0	-0.3	-0.8
After borrowing	-4.9	-3.2	-3.3	0.9	1.7	-0.8
Fiscal reserves	24.7	22.2	17.5	22.2	22.9	20.5
Outstanding debts	–	–	2.0	2.0	2.0	1.8
Net fiscal reserves	24.7	22.2	15.4	20.2	20.9	18.7

Notes: 1. Based on the 2004/05 Budget released in early March 2004.
2. Based on the 2005/06 Budget released in early March 2005.
3. Based on the release of monthly financial results at the end of April 2005.
4. Borrowing refers to issuance of government bonds and notes.
Sources: Budget Speech, the Treasury and staff estimates.

The improvement in the fiscal position mainly came from the revenue side. Receipts from land sales were much higher than expected in 2004/05, at HK$31.3 billion, and more than $5^1/_2$ times their value in 2003/04. Direct tax receipts and stamp duty income increased by around 20% and 40% respectively. The strong rebound in revenues reflects a combination of factors, including higher economic activity, booming property and stock markets and higher tax rates on salaries and profits. Operating expenditure recorded its first decline in over 50 years, reflecting the Government's cost-saving efforts. These include reductions in the number of civil servants, adjustments to civil service pay, reprioritisation of service provision, structural reorganisation, and streamlining procedures. During the past year, some government departments have been merged, and more services have been outsourced.

Chart 2.20
Medium-term projections



Source: The 2005/06 Budget Speech.

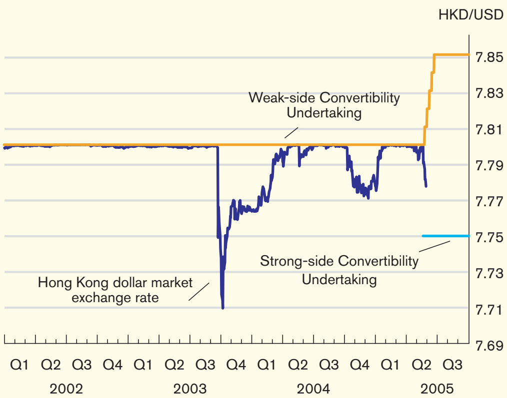
For the current financial year, the Budget projects a deficit of 0.8% of GDP. The Budget includes a proposal to begin public consultation on broadening the tax base through a goods and services tax (GST). The aim is to secure a steadier source of revenue. Assuming that real output expands at an annual trend rate of 4% over the medium term, and with no GST, the Consolidated Account is expected to be in balance in 2007/08, a year earlier than the previous target set in October 2003 (Chart 2.20). Balance in the Operating Account will be restored in 2008/09 as scheduled.

3. Monetary and financial sector

Exchange rate, interest rates and monetary developments

The HKMA announced three refinements to the operation of the Linked Exchange Rate system on 18 May 2005, including the introduction of a two-way Convertibility Undertaking. Following the announcement, the negative spreads between Hong Kong dollar interest rates and US dollar rates narrowed markedly. The Hong Kong dollar exchange rate stayed close to the Linked Rate of HK$7.8 to US$1 in the first few months of 2005, and strengthened in late April and May.

Chart 3.1
Hong Kong dollar exchange rate



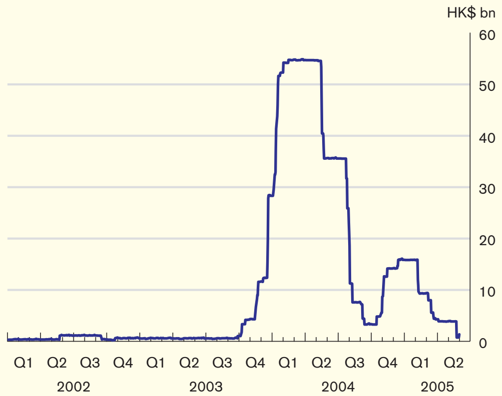
Source: HKMA.

3.1 Exchange rate and interest rates

In order to make the interest rate adjustment mechanism more effective, the HKMA announced three refinements to the operations of the Linked Exchange Rate system on 18 May: introducing a strong-side Convertibility Undertaking (CU) at 7.75, shifting the existing weak-side CU to 7.85, and creating a Convertibility Zone defined by the levels of the Convertibility Undertakings, within which the HKMA may choose to conduct market operations consistent with Currency Board principles (see Box 1). The Hong Kong dollar exchange rate stayed close to the Linked Rate of 7.8 in the first few months of 2005, but strengthened during late April and May. Prior to this, the exchange rate appreciated moderately against the US dollar during 2004 Q4 (Chart 3.1). These recent movements in the exchange rate continued to be affected by the flow of funds, including those associated with initial public offerings and changes in market sentiment towards the renminbi. Against this backdrop, the HKMA purchased and sold Hong Kong dollars on a number of occasions.

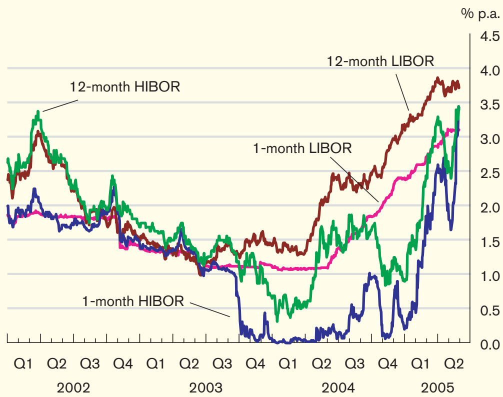
In response to bank bids, the HKMA sold some HK$3.2 billion between 8 November and 8 December 2004. As the Hong Kong dollar drifted back to the Linked Rate, the CU (equivalent to the weak-side CU

Chart 3.2
Aggregate Balance (before Discount Window Activity)



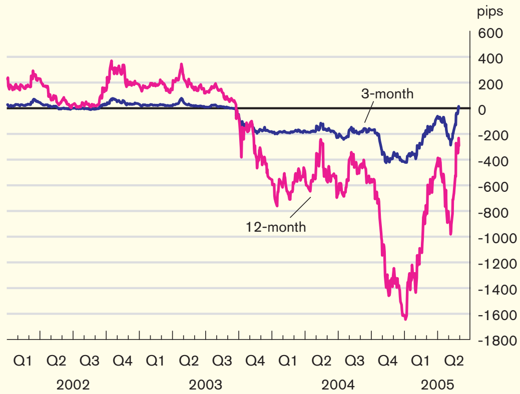
Source: HKMA.

Chart 3.3
Interest rates of the Hong Kong dollar and US dollar



Source: HKMA.

Chart 3.4
Hong Kong dollar forward points



Source: HKMA.

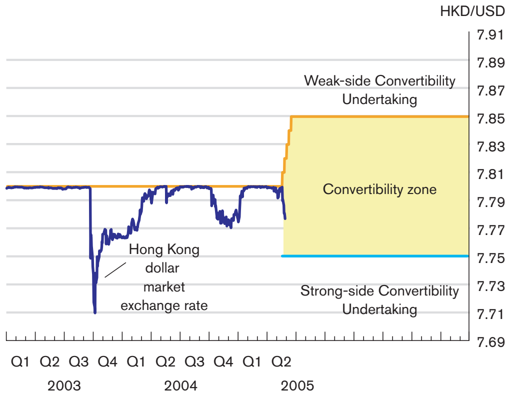
after the three refinements) was triggered 10 times from 31 January to 29 March, in response to an outflow of funds. During this period, the HKMA purchased HK$12 billion Hong Kong dollars under the CU. With the introduction of the refinements on 18 May, the weak-side CU was triggered, and the HKMA further purchased HK$3.1 billion Hong Kong dollars. Subsequently, as the Hong Kong dollar strengthened, the HKMA sold some HK$0.5 billion on 25 May. Under the Currency Board arrangements, these operations were matched by corresponding changes in the Aggregate Balance, which rose to HK$15.9 billion on 13 December 2004, and subsequently declined to HK$1.3 billion on 27 May (Chart 3.2). As the Aggregate Balance declined, Hong Kong dollar interbank interest rates rose markedly.

Between December 2004 and May 2005 the US federal funds target rate was raised four times by a total of 100 basis points to 3%. Given the rise in US dollar rates, one-month and 12-month Hong Kong dollar rates all generally rose. The negative interest rate spread between 12-month HIBOR and LIBOR was significantly narrowed, and the one-month Hong Kong dollar rate even exceeded its US dollar counterpart towards the end of May (Chart 3.3). Overnight HIBOR also increased, from levels near zero at the beginning of 2005 to above 2% in late March and early April, and fell moderately afterwards. Following the introduction of the three refinements, the negative spreads narrowed further, and the overnight rate rose, reaching 2.75% on 27 May.

Reflecting the movements in interest rate spreads, the Hong Kong dollar 12-month forward discount was narrowed substantially (Chart 3.4). However, the discount widened slightly, but only briefly, in late April and early May, owing to renewed speculation about the exchange rate policy of the Mainland authorities. With the three refinements, the 12-month forward discount narrowed considerably. The Hong Kong dollar 12-month forward discount closed at 295 pips on 27 May.

Box 1
Refinements to the operation of the Linked Exchange Rate system

Chart B1.1
HKD spot exchange rate and the Convertibility Zone



Source: HKMA.

The HKMA announced on 18 May 2005 three refinements to the operation of the Linked Exchange Rate system:

(1) a strong-side Convertibility Undertaking is immediately introduced, under which the HKMA undertakes to buy US dollars from licensed banks at 7.75;

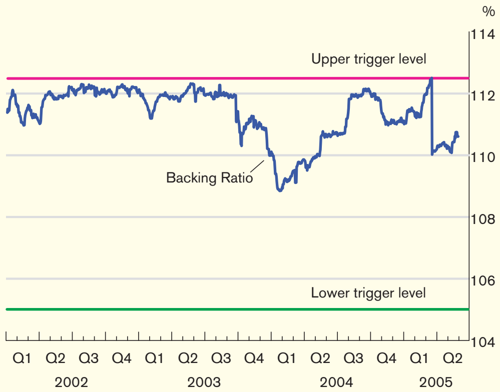
(2) the weak-side Convertibility Undertaking by the HKMA to sell US dollars to licensed banks will be gradually shifted from 7.80 to 7.85 (by 100 pips per week from 23 May 2005 to 20 June 2005) to make 7.80 the mid-point of the Convertibility Zone;

(3) the HKMA may conduct market operations (in a manner consistent with Currency Board principles) within the Convertibility Zone.

These measures are intended to remove uncertainty about the strong-side potential of the Hong Kong dollar. By anchoring exchange rate expectations on the strong side, these refinements are expected to make the interest rate adjustment mechanism more effective, thus bringing Hong Kong dollar interest rates closer to their US dollar counterparts. These measures should help promote the smooth functioning of the Linked Exchange Rate system in accordance with the Currency Board principles.

The initial response of the foreign exchange and money markets suggested that the new measures were effective. On the announcement of the refinements, the HKMA bought HK$3.12 billion Hong Kong dollars in response to banks' offers under the weak-side Convertibility Undertaking of 7.8. Subsequently, as the Hong Kong dollar strengthened, the HKMA sold some HK$0.5 billion on 25 May. As a result of these operations, the Aggregate Balance dropped from HK$3.86 billion on 17 May 2005 to HK$1.32 billion on 27 May 2005. The one-month and three-month HIBORs rose markedly, with their negative spreads over the US dollar counterparts turning into small premiums of 32 basis points and 1 basis point respectively. The rise in HIBORs resulted in major banks raising their best lending rates by 50 basis points on 23 May 2005.

Chart 3.5
Backing Ratio

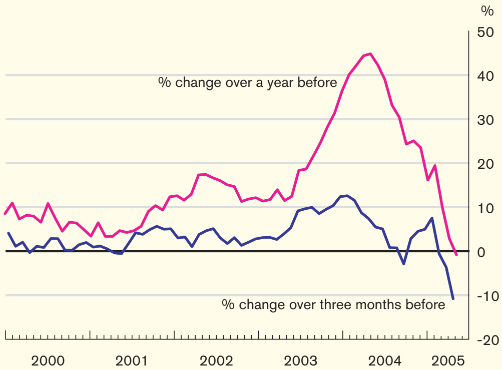


Note: See, *Half-yearly Monetary and Financial Stability Report June 2004*, page 53, *HKMA Quarterly Bulletin, June 2004*, for the definition of the Backing Ratio.
Source: HKMA.

3.2 Monetary Base and the Backing Ratio

The Backing Ratio declined in 2004 Q4, reaching a low of 110.98% on 15 November (Chart 3.5). The decline was mainly due to an expansion in the Monetary Base, particularly the increase in the Aggregate Balance arising from the sale of Hong Kong dollars by the HKMA during this period.[9] Nonetheless, as the Monetary Base contracted along with the Aggregate Balance in 2005 Q1, the Backing Ratio climbed to 112.52% on 15 March, breaking the Upper Trigger Level of 112.5%. Under the arrangements approved by the Financial Secretary in January 2000, assets were transferred out of the backing portfolio to the investment portfolio of the Exchange Fund assets to reduce the ratio to 110% on 16 March. The Backing Ratio closed at 110.61% on 27 May.

Chart 3.6
Hong Kong dollar narrow money M1



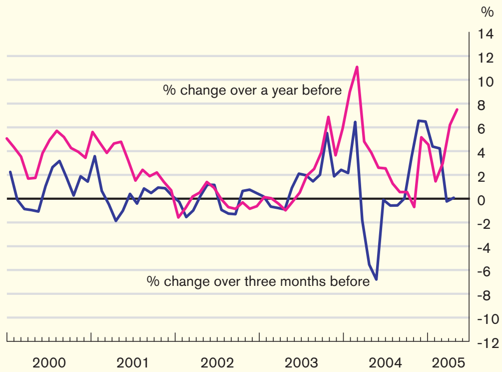
Note: Hong Kong dollar M1 is seasonally adjusted.
Source: HKMA.

3.3 Money and credit aggregates

Monetary conditions tightened slightly in 2005 Q1, as indicated by higher interest rates and a slowdown in money growth. Hong Kong dollar narrow money (M1) declined during the quarter, although it still registered some increases compared with a year earlier. The fall was mainly due to a decline in demand deposits, probably associated with reduced transaction demand for money arising from lower stock market turnover (Chart 3.6). The decline in growth of M1 continued in April 2005.

Hong Kong dollar broad money (M3) decreased slightly during the quarter, but appeared to stabilise in April. On a year-on-year basis, M3 growth picked up to 7.5% in April mainly because of a low comparison base (Chart 3.7). The growth of loans for use in Hong Kong

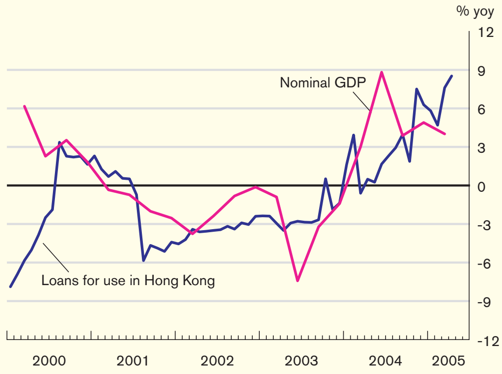
Chart 3.7
Hong Kong dollar broad money M3



Source: HKMA.

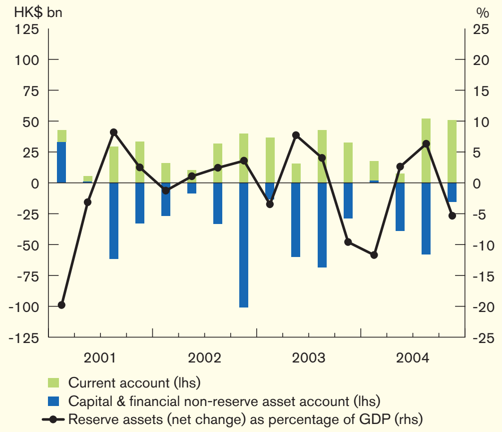
[9] Because the Backing Assets are larger in value than the Monetary Base, matched increases in the two will arithmetically reduce the Backing Ratio.

Chart 3.8
Loans for use in Hong Kong and nominal GDP



Sources: HKMA and C&SD.

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

In percent of GDP	2003	2004	2004 Q1	Q2	Q3	Q4
Current Account	10.6	10.0	5.5	2.6	16.2	15.0
Capital and Financial Account	-14.8	-10.7	-11.1	-10.2	-11.6	-10.1
Capital transfers	-0.7	-0.2	0.1	0.0	-0.4	-0.2
Financial non-reserve assets (net change)	-13.5	-8.6	0.6	-12.8	-17.5	-4.4
Direct investment	5.2	-3.5	-34.4	8.9	-1.7	11.1
Portfolio investment	-21.9	-19.8	-51.8	-34.9	-12.8	15.6
Financial derivatives	6.5	3.8	4.0	3.7	2.0	5.6
Other investment	-3.3	10.9	82.8	9.5	-5.0	-36.8
Reserve assets (net change)	-0.6	-2.0	-11.8	2.6	6.3	-5.4
Net errors and omissions	4.2	0.7	5.6	7.7	-4.6	-4.9

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

Source: C&SD.

has risen further on increased credit demand (Chart 3.8). Growth in domestic credit picked up notably to 8.5% year on year at the end of April, from 4.0% in September 2004 (see Section 3.7 for a sectoral breakdown of domestic loans). The growth rates of broad money and domestic credit were broadly consistent with the pace of economic recovery.

3.4 Capital flows

Since the December *Report*, the balance of payments has remained volatile. There was a strong inflow into the Hong Kong dollar in 2004 Q4, following an outflow in the previous two quarters. The Balance of Payments (BoP) statistics show a rise in reserve assets in 2004 Q4, the most recent period for which complete BoP data are available (Chart 3.9 and Table 3.A). The inflow was partly brought about by the ongoing domestic economic recovery and heightened market expectations of a possible revaluation of the renminbi.

Among the BoP components, the current account continued to record a large surplus in 2004 Q4, underpinned by strong growth in exports of goods and trade-related services, and sustained growth in tourism-related sectors. For 2004 as a whole, the current account surplus was equivalent to 10% of GDP.

The (non-reserve) capital and financial account continued to record a net outflow in 2004 Q4, although the flow was much smaller than in the previous two quarters. This was due to an outflow in other investments, which more than offset inflows in net direct investment and portfolio investment. The inflow in portfolio investment – the first net inflow since 2000 Q4 – was partly due to increased non-residents' investment in domestic equity, reflecting investors' optimism in the prospects for Hong Kong-listed companies. However, for 2004 as a whole, there was an outflow in the portfolio investment account. This was possibly due to a portfolio re-allocation away from Hong Kong dollar assets, prompted by a rise in local property and equity prices, and low local interest rates.

The "Other Investment" account, which includes mainly offshore loans and deposits of the banking and non-bank sectors, recorded a significant net outflow in 2004 Q4, as a marked expansion in claims exceeded a large increase in external liabilities. The large gross flows reflect the role of Hong Kong as an international banking centre.

The information available so far indicates a decline in reserve assets in 2005 Q1. However, there were signs showing that the fund flows were temporarily reversed to an inflow between mid-April and May, given renewed speculation about a renminbi revaluation. (See Box 2 for a discussion of recent developments in Hong Kong dollar fund flows).

Box 2
Recent developments in Hong Kong dollar fund flows

Table B2.A
Changes in Hong Kong dollar positions of banks and the non-bank sector

HK$ bn	Change in the Monetary Base	Change in HKD position of banks	Change in HKD position of non-bank sector[1]
Quarterly			
1Q03	4.7	1.7	3.0
2Q03	3.2	-7.8	11.0
3Q03	3.8	17.8	-14.0
4Q03	34.8	4.3	30.4
1Q04	29.7	16.3	13.4
2Q04	-17.1	9.1	-26.2
3Q04	-26.4	-5.6	-20.8
4Q04	16.2	25.1	-8.9
1Q05	-8.7	14.8	-23.4
Annual			
2001	14.4	-24.0	38.3
2002	16.6	-11.5	28.1
2003	46.5	16.0	30.5
2004	2.4	44.8	-42.4

[1] Including changes in Hong Kong dollar positions related to fiscal needs of the official sector and changes of the non-official, non-bank sector.

Sources: HKMA and staff estimates.

This analysis of Hong Kong dollar fund flows is based on the accounting identity that a decline (rise) in the net Hong Kong dollar position of the banking and non-bank sectors has to be matched by a corresponding decrease (increase) in the Monetary Base.

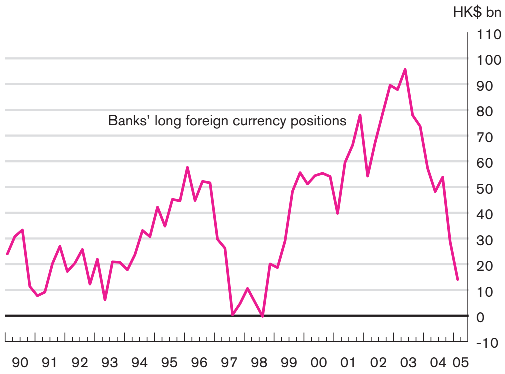
A change in the Monetary Base can occur through two main channels: (i) a change in private-sector liquidity demand for Hong Kong dollars that affects banknotes in circulation or the Aggregate Balance, and (ii) a change in portfolio demand for Hong Kong dollars by the private sector that may necessitate the purchase or sale of Hong Kong dollars by the HKMA to ensure exchange rate stability. From a wider perspective, the liquidity and portfolio demand for the Hong Kong dollar reflect Balance of Payments developments that relate to transactions between Hong Kong residents and the rest of the world. Specifically, flows of Hong Kong dollar funds are not only influenced by current account balances, but also by saving decisions and portfolio choices regarding domestic and foreign assets.

For analytical purposes, it is noted that changes in Hong Kong dollar positions of the non-bank sector are related to either financing needs of the Government or transaction demand and portfolio allocations of residents and non-residents.[10] As data on the Monetary Base, banks' net Hong Kong dollar position and transactions related to fiscal needs are available, change in the net position of non-official, non-bank sector is derived as a residual.

Table B2.A provides an overview of changes in the Monetary Base and the Hong Kong dollar position of the banking sector and the non-bank sector. During 2004 and 2005 Q1, the Government's demand for the Hong Kong dollar declined substantially, as the fiscal position turned to a surplus in 2004/05, following deficits in the previous four fiscal years. Thus, the official sector barely changed its Hong Kong dollar position during this

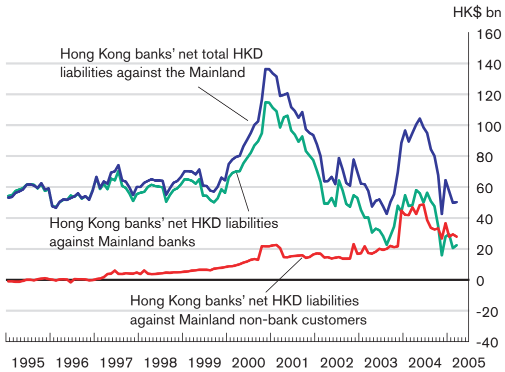
[10] As fiscal reserves are mainly held in the form of foreign currency assets, financing needs of the Government may necessitate the sale of such foreign currency assets for Hong Kong dollar, which can lead to an increase in the Hong Kong dollar position for the official sector.

Chart B2.1
Banks' long foreign currency positions



Source: HKMA.

Chart B2.2
Hong Kong banks' net external liabilities vis-à-vis the Mainland



Source: HKMA.

period, suggesting that the banking and the non-bank sectors combined can be used as a proxy of the private sector.

For 2004 as a whole, the Hong Kong dollar position of the private sector rose, as an increase in banks' position more than offset a reduction in the position of the non-bank sector. The position of the private sector declined in the first quarter of 2005, as the non-bank sector continued to record a sizeable outflow. It is worth noting that banks have largely been increasing Hong Kong dollar positions since mid-2003. Such increase reflects the unwinding of their long foreign currency position that was accumulated in the years following the Asian financial crisis (Chart B2.1).

There are a number of possible explanations for the outflow of Hong Kong dollars by the non-bank sector in recent quarters. First, low deposit rates have discouraged holdings of Hong Kong dollar deposits. Secondly, sharp rises in housing and equity prices in Hong Kong since mid-2003 have led to an increase in the share of Hong Kong dollar assets in the private sector's wealth holdings, possibly prompting a diversification by the private sector into non-Hong Kong dollar assets. Thirdly, activities of non-residents, such as H-share companies, may also have played a role. For example, the repatriation of funds raised by H-share companies out of Hong Kong may be reflected as an outflow.

More generally, there were signs of reduced demand for Hong Kong dollars in the past few quarters by Mainland entities (both banks and non-banks), probably reflecting expectations of a revaluation of the renminbi. Data on banks' external claims and liabilities vis-à-vis the Mainland indicate a decline in Hong Kong banks' net liabilities against Mainland entities (Chart B2.2).

Against this backdrop, the switching out of Hong Kong dollars by the non-bank sector should not be seen as a sign of reduced confidence in the currency. Indeed, the Hong Kong dollar market exchange rate has been mostly under strong-side pressures.

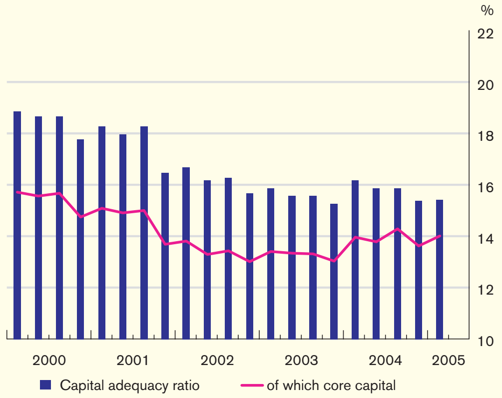
Banking sector performance

Retail banks continued to register strong profit growth in 2004, resulting from improvements in asset quality and, to a lesser extent, an increase in non-interest income. After a sustained period of decline, net interest margin has shown some signs of stabilisation. Despite the favourable banking environment, the recent rise in interest rates may pose a risk management challenge to banks.

3.5 Profitability and capitalisation

As the rise in risk-weighted assets outpaced that in the capital base, the average consolidated capital adequacy ratio of locally-incorporated authorized institutions (AIs) decreased from 15.9% in the December *Report* to 15.4% at the end of March 2005 (Chart 3.10). Nevertheless, the consolidated capital adequacy ratio was still considerably higher than the minimum international standard of 8%. Core capital accounted for 91% of the capital base and the ratio of core capital to risk-weighted assets was at a high level of 14.0%.

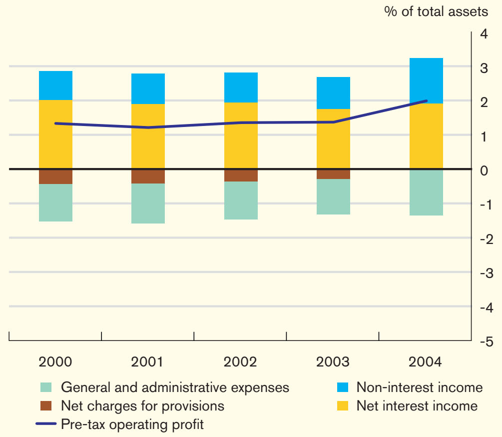
Chart 3.10
Capitalisation of locally-incorporated AIs



Source: HKMA.

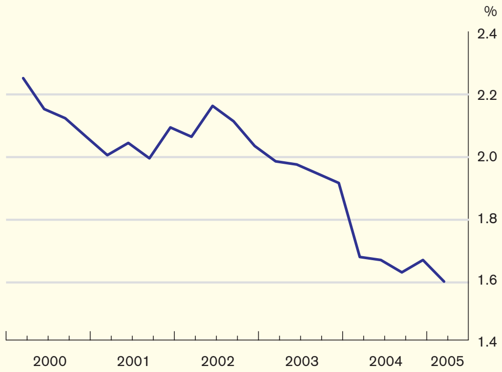
Retail bank profitability, in terms of pre-tax operating profit as a percentage of total assets, increased in 2004 (Chart 3.11). The rise was underpinned by steady improvement in asset quality, which was shown by the declines in bad debt charges and write-backs of provision. Non-interest income also increased, alleviating the effect of the compression in net interest margin in the face of fierce competition in the mortgage market and a low yield on free funds. Growth in non-interest income was due to rises in fees and commissions income from wealth management and trade financing, and increased income from treasury operations.

Chart 3.11
Profitability of retail banks



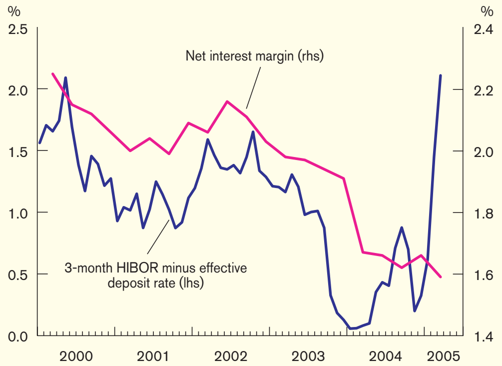
Source: HKMA.

Chart 3.12
Net interest margin of retail banks



Source: HKMA.

Chart 3.13
Spreads between HIBOR and deposit rate



Source: HKMA.

The decline in net interest margin since mid-2002 has shown some tentative signs of stabilisation since the second half of 2004 (Chart 3.12). The pick-up in property transactions may help ease competition in the residential mortgage market. In addition, the rise in HIBORs in recent periods has probably improved the yield on free funds (see section 3.6 for details). The latter factor is likely to play an important role in stabilising the net interest margin.

The recovery in the domestic economy and the property market continued to support credit demand, providing a favourable environment to increase banks' net interest earnings through volume growth. As such, the risk to banking sector profitability may largely come from a slowdown in the growth of lending business, given the recent rises in interest rates. Short-term domestic interbank rates have already risen from near zero to about 3% in the first five months of 2005, a factor that has yet to be fully reflected in commercial lending and deposit rates. This may hinder growth in lending.

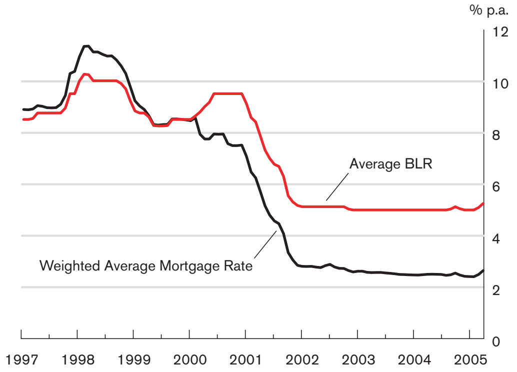
3.6 Interest rate risk

Since a substantial portion of banks' interest-bearing assets is priced on a floating rate basis, intermediation spreads are less sensitive to volatility in interest rates. However, banks have increased their exposure to debt securities over the past few years to improve returns, making them more vulnerable to re-pricing risk. A rise in interbank interest rates may also affect the spread of the mortgage lending rates over funding costs, posing risks to margins for mortgage loans (see Box 3).

Changes in interbank rates affect interest income directly through HIBOR-based lending, including interbank lending. Most retail banks, sitting on a large base of deposits, are net lenders in the interbank market. The rise in HIBORs relative to the effective deposit rate over the past few quarters has probably started to push up margins on HIBOR-based lending, thereby enhancing returns on free funds (Chart 3.13). The convergence of HIBOR and LIBOR, following the introduction of the three refinements to the operations of the Linked Exchange Rate system on 18 May, may provide further support to margins on such lending. This should be useful in mitigating the decline in the overall net interest margin.

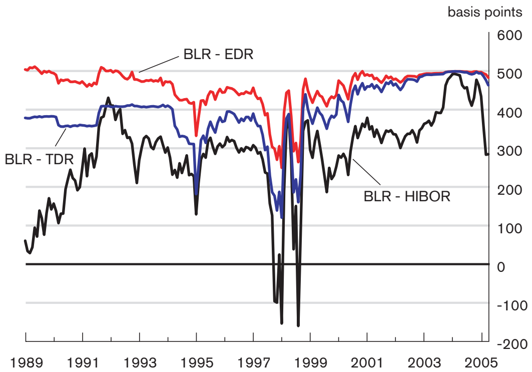
Box 3
Interest rate risk in the pricing of banks' mortgage lending

Chart B3.1
Average mortgage rate and BLR



Sources: CEIC and staff estimates.

Chart B3.2
Spreads of BLR and cost of funds



Note: The EDR is the average interest rates on demand, savings and time deposits weighted by the deposit composition of the entire banking sector. The TDR is the average rate of time deposits weighted by different maturity composition.
Source: HKMA.

Residential mortgage rates in Hong Kong have fallen to an historic low since late 2004, along with the general easing of interest rates and with intense competition driving down the mark-ups of mortgage rates over the best lending rate (BLR) (Chart B3.1).[11] One key reason why banks have been able to offer such low rates is their extraordinarily low funding cost. Until recently, the Hong Kong interbank offered rate (HIBOR) had been at a deep discount relative to LIBOR for almost 18 months, reflecting the abundance of liquidity in the banking system. In January 2005 the discount was about 200 basis points. The spread of the BLR over the three-month HIBOR had been maintained at around 460 basis points.

The keen competition and high liquidity have benefited residential mortgage borrowers. However, as Hong Kong's mortgage rates are largely priced with reference to the BLR, given that the movement in this rate can, at times, deviate significantly from banks' cost of funds, there are risks of a reduction of the interest rate margin for mortgage loans made under the prevailing monetary conditions (Chart B3.2). Such risks could arise from a narrowing of the spread between the BLR and the cost of funds during the current tightening phase of US interest rates, and a shift in the risk premium of the Hong Kong dollar over the US dollar to a more normal level.

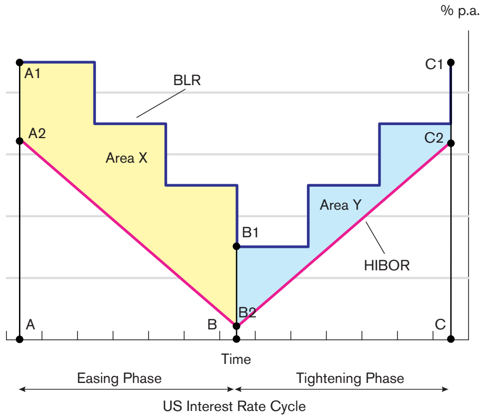
Spread narrowing in the current phase of interest rates

The average BLR – HIBOR spread in the past 16 years was 300 basis points.[12] In the easing phases of the interest rate cycles, the average spread was 310 basis points. By contrast, in the tightening phases it was 250 basis points.

[11] In Hong Kong, mortgage loans are commonly referenced to BLR with a mark-up. The average mortgage rate has come down from around BLR plus 1% in mid-1998 to BLR minus 2.75% since early December 2004. Taking into account the cash rebate offered by banks, the effective mortgage rate is estimated at around BLR minus 3% in January 2005.

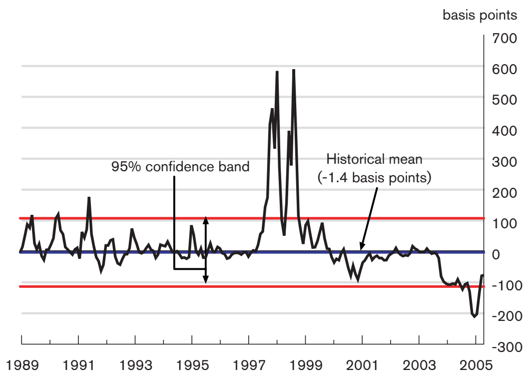
[12] January 1989 to December 2004.

Chart B3.3
Asymmetric pattern of spread between BLR and HIBOR during an interest rate cycle



Note: The average interest spread of BLR – HIBOR during the up cycle of US interest rates represented by Area Y is smaller than the average interest spread during the easing cycle represented by Area X

Chart B3.4
Risk premium



Note: To illustrate the potential size of the HIBOR-LIBOR differential, a long-term mean level is established by taking the average of the differential over the past 16 years. This mean level is estimated to be near zero. At 95% confidence level, the upper bound of the risk premium is at +109 basis points and the lower bound is at -112 basis points. This 95% confidence band provides a simple illustration of the historical dispersion of the risk premium.

Sources: CEIC and staff estimates.

One hypothesis for such an asymmetric pattern is that Hong Kong's interbank lending rates tend to incorporate expected BLR increases ahead of actual BLR adjustments. To examine this hypothesis, econometric tests have been carried out.[13] The results confirm that the observed narrowing of the spread during the tightening phase of interest rates was partly due to the lead-lag relationship between HIBOR and BLR in their responses to US interest rate adjustments. A graphical illustration is given in Chart B3.3.

Shift in risk premium

Under the Linked Exchange Rate system, interest rates in Hong Kong normally track closely their US counterparts. Until recently, HIBOR had been at a deep discount relative to LIBOR since September 2003 (Chart B3.4). However, this is not expected to be permanent. Indeed, on a monthly average basis, it was narrowed to 72 basis points in May 2005.[14] This highlights vividly the risk of a shift in the risk premium, which could result in a significant rise in HIBOR, and thus banks' cost of funds, even if US market interest rates remain unchanged.

Reduction in the interest rate margin

To evaluate the interest rate risk, an error correction model was constructed. For analytical purposes, loans are classified into three groups: HIBOR-financed loans, TDR-financed (TDR: the average rate of time deposits weighted by different maturity composition) loans and EDR-financed (EDR: the average interest rates on demand, savings and time deposits weighted by the deposit composition of the entire banking sector) loans. Simulation results showed that, because of the lead-lag relationship of local interest rates, and their different responses to the shocks, if HIBOR converges with LIBOR, and US interest rates increase by 120 basis points in the next 12 months, the resulting margin reduction on loans priced on the currently very low funding cost could be tangible. How the margin of the mortgage portfolio of

[13] For details, see Wong et al. (2005), "Interest Rate Risk in the Pricing of Banks' Mortgage Lending", *HKMA Research Memorandum*, http://www.info.gov.hk/hkma/eng/research/RM05-2005.pdf.

[14] Using daily data, the three-month HIBOR was in fact at par with LIBOR by the end of May 2005.

Table B3.A
Simulated impact on the interest margin of currently priced loans[1, 2]

	basis points
Average Mortgage Pricing as of January 2005	200
HIBOR-financed loans	
Funding Cost	-70
Current Net Mortgage Margin[3]	90
Estimated Reduction of Mortgage Margin	-168
Simulated Net Mortgage Margin After Impact	*-78*
TDR-financed loans	
Funding Cost	-37
Current Net Mortgage Margin[3]	123
Estimated Reduction of Mortgage Margin	-92
Simulated Net Mortgage Margin After Impact	*31*
EDR-financed loans	
Funding Cost	-33
Current Net Mortgage Margin[3]	127
Estimated Reduction of Mortgage Margin	-47
Simulated Net Mortgage Margin After Impact	*80*

Notes: 1. The simulation is for the twelve months ending January 2006. It is based on the market situation up to January 2005, and uses monthly average data up to that month.

2. Under the scenario of an increase in 120 basis points in US interest rates and a shift of risk premium level to the historical mean level.

3. Current net mortgage margin is derived by subtracting the funding cost as well as the operating and credit costs from the average mortgage pricing. The operating and credit costs are estimated to be 30 basis points and 10 basis points respectively. For a detailed description, please refer to the HKMA Research Memorandum 05-2005 "Interest Rate Risk in the Pricing of Banks' Mortgage Lending".

individual banks may be affected depends largely on the structure of their own funding sources and actual operating and credit costs. As shown in Table B3.A, TDR-financed and EDR-financed loans would be less affected when compared with HIBOR-financed loans.

The reduction in interest rate margins has been taking place since January 2005, with three-month HIBOR rising by 190 basis points on a monthly average basis, but the BLR only up by 45 to 70 basis points. For the mortgage portfolios acquired by banks in January 2005, the margins for HIBOR-financed, TDR-financed and EDR-financed loans have been reduced by about 125 basis points, 17 basis points and 7 basis points respectively. Further reductions can be expected if the above scenario continues to materialise.

The expected tightening of the mortgage spread is likely to exert pressure on the earnings of the banking industry. It is noted that banks active in the residential mortgage business generally have a sizable retail deposit base. However, the banks should take into account such interest rate risks in the pricing and management of their mortgage portfolios.

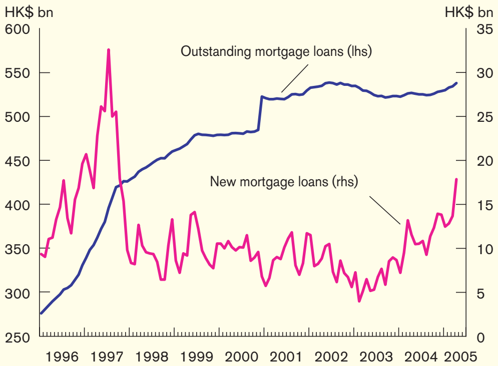
Table 3.B
Loans for use in Hong Kong

	Quarter-on-quarter change (%)				Share of total (%)
	Jun-04	Sep-04	Dec-04	Mar-05	Mar-05
Loans for use in Hong Kong[1]	**1.9**	**0.8**	**3.2**	**1.6**	
Of which:					
Trade financing	14.7	5.5	1.0	2.4	6.8
Mortgages[2]	-0.7	-0.5	0.2	0.6	31.5
Manufacturing	8.7	4.9	6.4	8.0	5.6
Transport and transport equipment	6.0	6.8	-0.1	-0.5	6.1
Electricity and gas[3]	15.7	-8.1	-3.6	4.1	1.2
Information technology[3]	-10.4	1.7	-7.7	0.1	0.8
Building, construction, property development and investment	1.5	-0.3	7.6	4.5	20.6
Wholesale and retail trade	0.2	5.8	0.4	-1.0	5.0
Financial concerns[4]	2.1	0.8	6.5	-1.2	8.6
Stockbrokers	-5.9	-8.8	5.7	5.8	0.5
Credit card advances	0.1	0.5	9.6	-2.0	2.6

Notes: 1. Including trade financing loans.
2. Mortgage loans include loans for Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme.
3. Some categories of loans have been reclassified since March 2004.
4. Loans for financial concerns include loans to investment and insurance companies, futures brokers and finance companies.

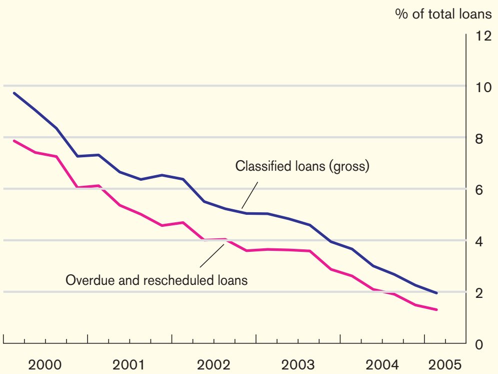
Source: HKMA.

Chart 3.14
Outstanding and new mortgage loans of surveyed AIs



Note: The marked jump in the outstanding mortgage loans in late-2000 reflected a change in the coverage of banks in the survey.
Source: HKMA Monthly Survey of Residential Mortgage Lending.

Chart 3.15
Asset quality measures of retail banks



Source: HKMA.

3.7 Credit risk

Credit exposures

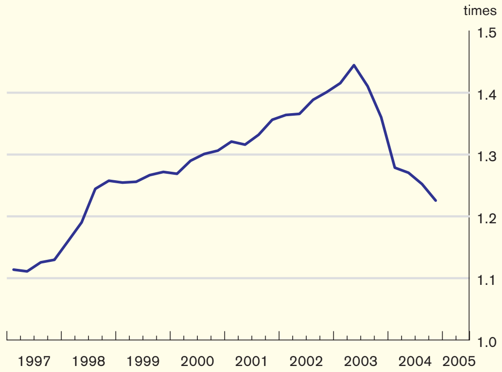
Loans for use in Hong Kong increased across most sectors in 2005 Q1 (Table 3.B). Within property-related loans, credit for building, construction, property development and investment rose for the second consecutive quarter, underpinned by increased residential and commercial property investment. The outstanding stock of residential mortgage loans grew only modestly, despite continued growth in property market activity and higher property values. This is because repayments on existing mortgage loans largely offset the expansion in new mortgage lending. The amount of new mortgage loans increased, although it remained lower than the levels in 1996-98, when property values were relatively high (Chart 3.14).

Within the other sectors, lending to manufacturing registered the biggest quarter-on-quarter increase, followed by loans for stockbrokers and the utility sector. Nevertheless, there was a decline in credit card advances, and lending to financial concerns, and the wholesale and retail trade sectors. The fall in credit card receivables was partly due to seasonal effects. On balance, as both property-related and non-property-related lending increased at a similar pace, the share of property-related loans in total domestic loans was little changed at around 52% in Q1.

Asset quality

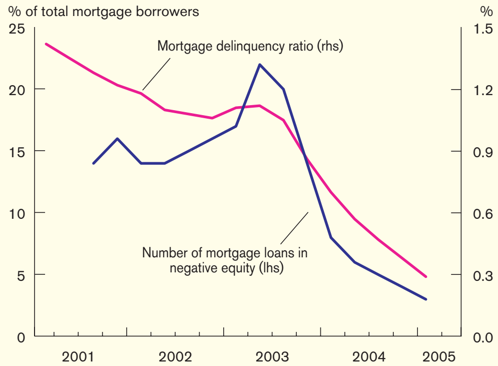
Asset quality continued to improve alongside the robust economic recovery. The proportion of classified loans and that of overdue and rescheduled loans in total loans decreased further in 2005 Q1 (Chart 3.15). Separately, the charge-off ratio for credit card receivables dropped to an annualised rate of 3.18% in 2005 Q1 (the lowest level since 1998 Q3).

Chart 3.16
Effective housing capital gearing ratio



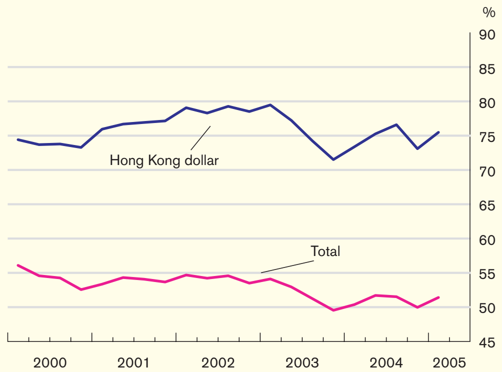
Source: Staff estimates.

Chart 3.17
Negative equity and mortgage delinquency ratio of surveyed AIs



Note: The number of mortgage loans in negative equity is available from September 2001.
Source: HKMA.

Chart 3.18
Loan-to-deposit ratios of retail banks



Source: HKMA.

It is worth-noting that the rise in property prices has helped strengthen the balance sheets of households. The effective housing capital gearing ratio, defined as the ratio of market value of total housing stocks to their net asset value (that is, the market value subtracted by outstanding mortgage lending from banks), has decreased markedly since 2003 (Chart 3.16). The number of residential mortgage loans in negative equity has continued to fall from its peak level in 2003 Q2. These developments suggest an improved quality of mortgage lending. The mortgage delinquency ratio decreased to 0.26% in April 2005 (Chart 3.17).

3.8 Liquidity

The average liquidity ratio of retail banks was 45.8% in Q1, well above the statutory requirement of 25%. Net placements to banks abroad and debt securities holdings, which are relatively liquid, accounted for 15% and 24% of retail banks' total assets respectively. Liquidity remains ample in the banking system, and the Hong Kong dollar loan-to-deposit ratio was still low at the end of March at 84.8% for the banking sector as a whole, and at 75.6% for retail banks (Chart 3.18).

3.9 Foreign currency position

The overall foreign currency position, including both spot and forward, for all AIs declined further to HK$14.2 billion at the end of March 2005 from a recent high of HK$98 billion at the end of May 2003. This mainly reflects the unwinding of the sizeable foreign currency positions that were built up following the Asian financial crisis in 1997 and 1998. The present level of the foreign currency position, as a percentage of total assets of banks, appears to be consistent with the long-term average.

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

Table 3.C
Key performance indicators of the banking sector[1] (%)

	Mar-04	Dec-04	Mar-05
Interest rate[2]			
1-month HIBOR	0.07	0.41	1.22
3-month HIBOR	0.08	0.48	1.45
BLR and 1-month HIBOR spread	4.93	4.65	3.81
BLR and 3-month HIBOR spread	4.92	4.57	3.58
		Retail banks	
Balance sheet developments[3]			
Total deposits	-1.1	6.5	-1.3
Hong Kong dollar	-2.6	7.9	-1.1
Foreign currency	1.3	4.4	-1.4
Total loans	0.6	3.7	1.6
Loans to customers inside Hong Kong[4]	0.3	3.1	1.6
Loans to customers outside Hong Kong[5]	12.4	24.5[r]	1.9
Negotiable instruments			
Negotiable debt certificates issued	-3.3	4.7	3.5
Negotiable debt instruments held	2.8	-1.7	1.7
Asset quality[6]			
As percentage of total loans			
Pass loans	90.07	93.76	94.30
Special mention loans	6.26	3.99[r]	3.75
Classified loans (gross)[7]	3.66	2.25[r]	1.95
Classified loans (net)[8]	2.62	1.59[r]	1.40
Overdue > 3 months and rescheduled loans	2.61	1.48	1.30
Non-performing loans[9]	2.92	1.63[r]	N.A.
Profitability[10]			
Bad debt charge as percentage of average total assets	0.01	-0.02	-0.03
Net interest margin	1.67	1.65	1.59
Cost income ratio	38.0	41.6	42.5
Liquidity ratio[2]	44.8	45.9	45.8
		Surveyed institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	0.70	0.38	0.29
Credit card receivables			
Delinquency ratio	0.78	0.44	0.45
Charge-off ratio — quarterly annualised (adjusted)	6.34	3.76	3.18
— year-to-date annualised	6.34	4.73	3.18
		All locally incorporated AIs	
Capital adequacy ratio (consolidated)	16.2	15.4	15.4

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 Information of loans on which interest has been placed in suspense or on which interest accrual has ceased are not available from January 2005 following adoption of the new Hong Kong Accounting Standard 39.
10 Year-to-date annualised.

r Revised figures due to late adjustments.

4. Outlook, risks and uncertainties

The pace of global growth is expected to moderate this year from its high level in 2004, while consumer price inflation is likely to remain subdued. In Hong Kong, growth is expected to continue, albeit at a more moderate pace. Inflation is expected to rise, in part reflecting the gradual pass-through of changes in market rents to the rental component of the Consumer Price Index. There are a number of uncertainties and risks to the outlook, relating to global imbalances, high oil prices and macroeconomic and financial conditions in Mainland China. Overall, the risks to Hong Kong's monetary and financial stability appear limited.

4.1 Global outlook

The latest forecasts by the IMF and World Bank show a decline in global growth in 2005 to around $4^1/_4$%, which is still solid by past standards. This should be viewed in the context of a high rate of growth in 2004 estimated to be around 5% (Table 4.A).

Table 4.A
Global growth and inflation 2004-06

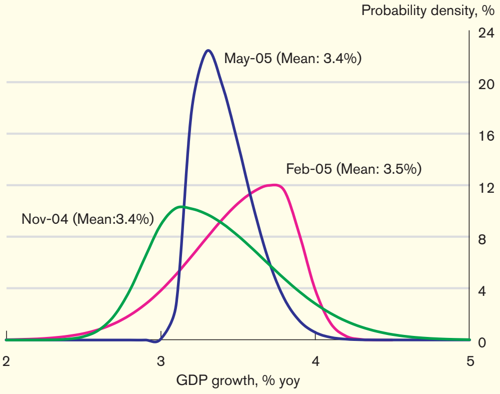
(% yoy)	IMF			World Bank[1]		
	2004	2005	2006	2004	2005	2006
Global growth[2]	**5.1** (5.0)	**4.3** (4.3)	**4.4**	**4.9** (3.9)	**4.2** (3.8)	**4.1**
US	4.4	3.6	3.6	4.3	3.2	3.3
Euro area	2.0	1.6	2.3	1.8	2.1	2.3
Japan	2.6	0.8	1.9	4.3	1.8	1.6
Emerging Asia	7.8	7.0	6.9	7.8	7.1	6.6
Global consumer price inflation	**3.7**	**3.6**	**3.1**	n.a.	n.a.	n.a.
G-7 economies	2.0	1.9	1.8	1.7	1.4	1.2
Emerging Asia	4.0	3.7	3.2	n.a.	n.a.	n.a.

Note 1: Growth in emerging Asia covers developing countries in East Asia and the Pacific region.
2: Weighted by GDP at PPP exchange rates. Figures in bracket are previous forecasts.

Sources: IMF World Economic Outlook (Apr-05) and World Bank Global Economic Prospects 2005.

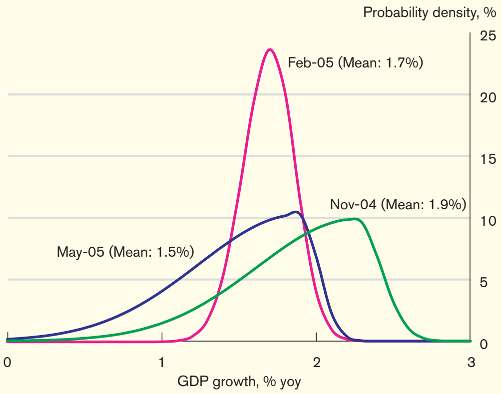
The moderate slowdown in global growth reflects a combination of factors. First, US monetary tightening is expected to continue as short-term interest rates are gradually increased to more neutral levels. Financial markets expect monetary conditions to be tightened this year in a number of other major economies, including the euro area. Secondly, the level of oil and non-oil commodity prices remains high, reflecting the strength of global growth last year. This is still working through the supply chain in many economies, and is likely to reduce income, leading to more moderate demand growth this year. Thirdly, a slowdown in growth in the Mainland Chinese and US economies will reduce the momentum behind the growth of world trade flows. World trade grew at an unprecedented pace of around 10% during 2004, boosting income in many developing economies.

Chart 4.1
US: probability distribution of growth forecasts for 2005



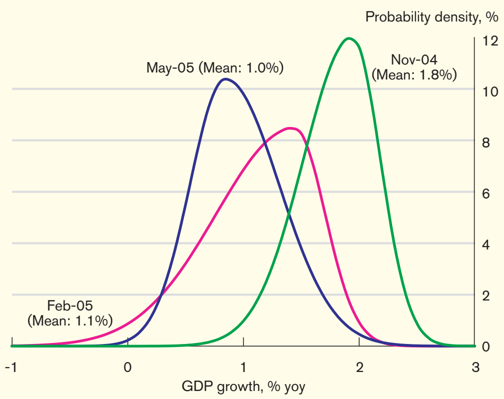
Source: Staff calculations based on Consensus Forecasts.

Chart 4.2
Euro area: probability distribution of growth forecasts for 2005



Source: Staff calculations based on Consensus Forecasts.

Chart 4.3
Japan: probability distribution of growth forecasts for 2005

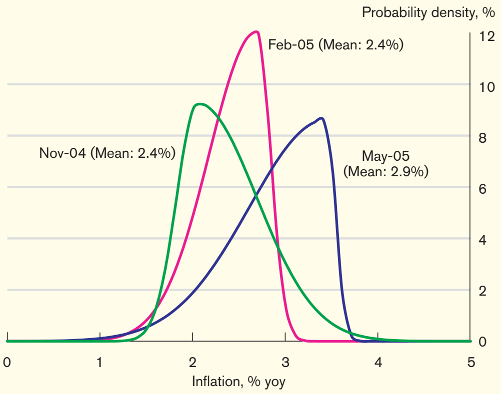


Source: Staff calculations based on Consensus Forecasts.

In the US, higher interest rates and a less expansionary fiscal policy should reduce the growth rate of domestic demand to more sustainable levels this year and next. The World Bank is projecting a slightly sharper slowdown in US growth in 2005 than the IMF, to 3.2% compared with 3.6%. The mean of Consensus Forecasts for US growth is little changed since the December 2004 *Report*, but the distribution of forecasts is less skewed to the upside (Chart 4.1). The mean forecast for euro area growth has been revised down since last November, but the distribution is more balanced (Chart 4.2). In Japan, the Consensus Forecasts suggest lower growth than had been expected last November (Chart 4.3).

In emerging Asian economies, the IMF is projecting a moderate slowdown in growth, to 7.0% in 2005 from an estimated 7.8% last year, but still higher than the average growth rate of 5.9% since the Asian financial crisis in 1997. In particular, the growth of industrial production and goods exports is expected to decline, from its high rate in the first half of 2004, reflecting, among other factors, lower growth of import demand from the US and Mainland China. While the contribution of domestic demand to overall growth increased in 2004 in most regional economies, there is scope for it to expand, as further falls in regional unemployment rates support consumer spending, and business investment continues to grow.

Chart 4.4
US: probability distribution of inflation forecasts for 2005



Source: Staff calculations based on Consensus Forecasts.

The IMF projections show that global consumer price inflation in 2005 will be broadly similar to the rate in 2004. Inflation is forecast to decline in 2006, as lower global growth this year feeds through to lessen price pressures. In the US, the mean forecast of CPI inflation has been revised up, to 2.9% from 2.4% (Chart 4.4).

The renewed increase in oil and non-oil commodity prices in recent months may pose an upside risk to current forecasts of consumer price inflation, especially in Asian economies. A feature article in the June 2005 *HKMA Quarterly Bulletin* reports the results of an empirical study by staff on the relationship between changes in commodity prices and consumer price inflation in Hong Kong and Mainland China.[15] It finds that increases in commodity prices are associated with a sharper increase in future consumer price inflation in these economies than typically found in other studies, for example, on the US. The implication is that if commodity prices stay high, or increase further, consumer price inflation may turn out higher than currently forecast by a number of outside organisations.

Financial markets expect monetary tightening in the US and some emerging Asian economies to continue this year. At the end of May, the futures market was pricing in an increase in the federal funds target rate to 3.75% by the end of 2005. Despite the rise in actual and expected US short-term interest rates, the yield on 10-year US Treasuries is broadly unchanged relative to the December 2004 *Report*. Long-term interest rates in the euro area have tracked closely those in the US, reflecting subdued inflation expectations and increased integration between the euro area and global financial markets. In Japan, there has been no change in short-term interest rates, while long-term interest rates have fallen over the past six months. For emerging Asian economies, increases in US short rates are likely to result in tighter credit spreads, and this already appears to be happening.

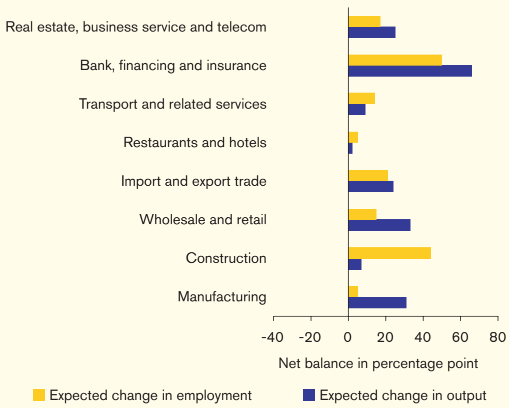
The US dollar exchange rate has been volatile against other major currencies over the past six months, as financial market participants flit between concern about

[15] See cutler et al (2005), "The relationship between commodity and consumer prices in Mainland China and Hong Kong", *HKMA Quarterly Bulletin*, June 2005.

the widening US current account deficit, on the one hand, and more attractive US growth and interest rate differentials relative to other major economies on the other. High and volatile energy prices, together with rising interest rates and lower growth in corporate earnings, are the key factors affecting the global equity outlook.

4.2 Domestic outlook

Chart 4.5
Results of Business Tendency Survey: views on expected changes in volume of output and employment in Q2 over Q1



Note: Net balance refers to the difference between the percentage of respondents expecting a rise over those expecting a decline.

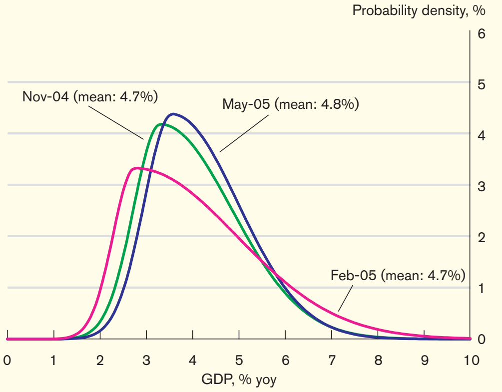
Source: C&SD.

In Hong Kong, growth is expected to continue to moderate from its high level in 2004, although the pace is still strong by past standards. According to the Quarterly Business Tendency Survey, all sectors of the economy expect an increase in the volume of business and output in 2005 Q2 compared with the previous quarter (Chart 4.5). This suggests that companies in Hong Kong are feeling more optimistic about their near-term economic prospects. The survey results also suggest a continued improvement in labour market conditions, with all sectors expecting an increase in hiring, especially in construction and financial services.

The contribution of domestic demand to growth is likely to increase over the coming quarters. Consumption growth will likely remain robust, supported by rising household income growth, improving labour market conditions, and continued gains in property prices. Property-related investment is likely to recover following a strong revival in the property market since the middle of 2003. However, retained imports of capital goods recorded a year-on-year decline for the second consecutive quarter in 2005 Q1, suggesting that investment spending on industrial machinery may weaken in the near term.

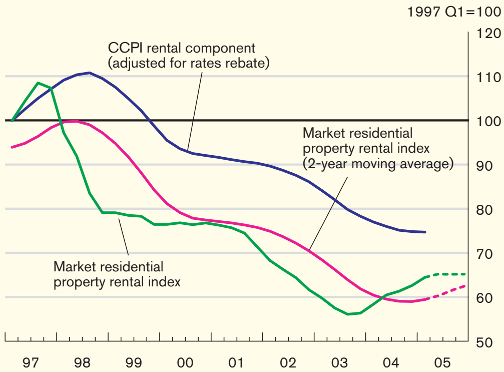
Export growth is expected to slow, reflecting a decline in global growth. Domestic exports will likely continue to fall in the near term, as a result of reduced production of textiles and garments in Hong Kong after the removal of quotas on these products in January 2005 (see Section 2.3). Growth of re-exports and offshore trade is likely to moderate towards a more sustainable level from its high base in 2004 alongside slower trade growth on the Mainland. Some economies have taken or considered taking safeguard measures on certain textile and garment

Chart 4.6
Hong Kong: probability distribution of growth forecasts for 2005



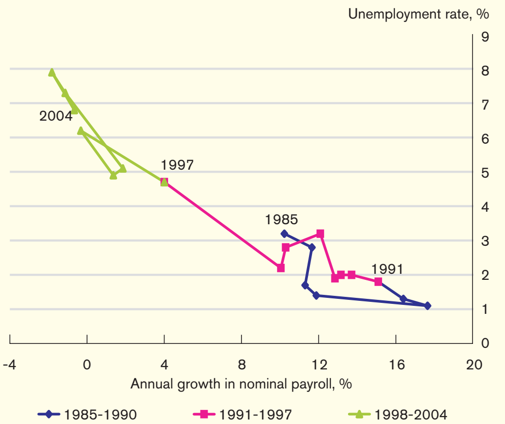
Sources: Staff estimates based on market consensus.

Chart 4.7
Rental component of CCPI and market rent



Sources: Rating & Valuation Department, C&SD and staff estimates.

Chart 4.8
Earnings and unemployment rate



Source: C&SD.

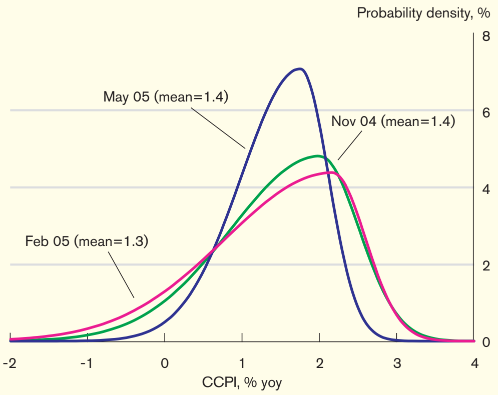
imports from the Mainland to counteract the increased imports following the removal of quotas. Despite projected weaker exports of goods and trade-related services, the Individual Visit Scheme and the opening of Hong Kong Disneyland in September 2005 are expected to support growth in tourism-related exports of services.

Reflecting recent economic developments, the Government maintained its forecast for growth in 2005 at 4.5%-5.5% in May. The latest forecasts by international organisations and private institutions project growth of 4.8% in 2005, with the balance of views tilted to the upside (Chart 4.6). In May, Standard & Poor's raised its outlook on Hong Kong's sovereign credit rating to positive from stable, owing to better public finances and solid economic growth.

Inflation is expected to continue to pick up during 2005 as output increases relative to potential. The output gap turned positive in 2004 and growth is expected to continue to exceed potential in 2005. In addition, rising market rents are likely to exert upward pressure on the CCPI because of the gradual pass-through to the rental component. Chart 4.7 shows that a 24-month moving average of market rent correlates closely with movements in the rental component of the consumer price index. The dotted lines suggest that, even if the market residential property rental index stabilises at its current level, the rental component of the CCPI will continue to adjust upwards. In addition, rising rents for commercial property, especially retail space, will exert upward pressure on firms' costs, which may be passed on to consumer prices in the coming period.

On the other hand, import price inflation is likely to decline as a result of slower global growth, and inflationary pressures from the labour market are expected to remain low. Chart 4.8 shows the historical relationship between the unemployment rate and wage growth in Hong Kong. The succession of lines sloping downwards from left to right indicates that increases in unemployment tend to generate weaker wage growth (and vice versa). Given the current relatively high unemployment rate, it suggests that wage pressures are likely to be modest by past standards.

Chart 4.9
Hong Kong: probability distribution of inflation forecasts for 2005



Sources: Staff estimates based on market consensus.

The latest market consensus for CCPI inflation in 2005 is 1.4%, compared with -0.4% in 2004 (Chart 4.9). The projection is largely in line with the Government's forecast of 1.5%. The overall balance of views on inflation is still on the downside, but at a lesser extent than shown by forecasts made in late 2004. Assuming a gradual rise in inflation, the latest market consensus implies the annual rate could be over 2% by 2005 Q4, compared with 0.4% in Q1.

4.3 Uncertainties and risks

In summary, the economic recovery is expected to remain on track in Hong Kong for the remainder of 2005, and conditions continue to be favourable to monetary and financial stability. However, there are a number of uncertainties and risks to the growth outlook, arising from both external and domestic developments. The main external factors include global imbalances, persistently high oil prices, and the possibility of substantially tighter financial conditions and their effect on long-term interest rates and housing prices. Developments in the Mainland economy will continue to have an important bearing on Hong Kong, such as increased trade protectionism in the US and Europe against the Mainland, and speculation on a change in the renminbi exchange rate regime. Locally, the strong recovery in the property market and relatively easy monetary conditions have raised concerns about inflationary pressures.

Global imbalances have deepened, with the US current account deficit generally expected to increase further in 2005 from an already high level in 2004. The adjustment to a more sustainable level in the US external payment position is likely to involve a combination of a further US dollar depreciation, increases in long-term interest rates, and slower growth in the US than its main trading partners. Despite the recent strengthening of the US dollar because of the relatively high US growth and interest rates, a sharp depreciation of the dollar and its associated impact on financial markets remain an important risk for the global economy. The December *Report* analysed how a US dollar depreciation may affect the Hong Kong economy. The main risk is a disorderly adjustment with financial market volatility that could lead to slower growth in the global economy and in Hong Kong.

A related concern is the possibility of a sharp reversal of global financial conditions. Despite considerable increases in US short-term interest rates, long-term US treasury yields have remained low. There is a risk of a sharp rise in US long-term bond yields, which could be triggered by higher-than-expected inflation or reduced demand for US dollar securities on concerns about the large US current account deficit. Hong Kong could be affected by this through a number of channels (Box 4). A tightening of global financing conditions could lead to a synchronised decline in housing markets, which could have a material effect on global growth as housing prices are at very high levels in most major economies and household balance sheets are most exposed to rising interest rates. More directly, some investors in Hong Kong, including banks that hold a large portfolio of US securities, could suffer from substantial mark-to-market losses in the event of a sharp rise in US long-term interest rates.

The price of oil remains a concern. In recent months, prices have fluctuated considerably, but have generally stayed at high levels. Changes in oil prices affect Hong Kong mainly through their impact on global growth reflecting the relatively low energy intensity of the local economy. The impact so far has been moderate, but further sharp increases could be more detrimental by affecting inflationary expectations and hurting the supply-side of the global economy in the longer term.

Another source of uncertainty continues to be developments in the Mainland economy. Consumer price inflation has dropped markedly in the past six months, and recent stronger measures to rein in the booming property market are starting to reduce speculative demand. However, strong investment growth and supply bottlenecks in key sectors continue to be of concern. Nevertheless, the overall risk of a sharp slowdown in growth remains low.

From Hong Kong's perspective, there are two important areas of concern – signs of increased trade protectionism in the US and Europe against the Mainland, and heightened pressure on the renminbi exchange rate regime. Recent strong growth in China's exports, particularly textile exports to the US and Europe, have increased protectionist sentiment in the Mainland's two largest trading partners. The US Senate endorsed on 6 April 2005 a proposal to impose a 27.5% tariff on all Chinese products sold in the US if the Mainland did not agree to raise the value of its currency within 180 days. While the probability of a trade war is small, frictions between these main trading powers would affect smaller economies in Asia, including Hong Kong, given the importance of the Mainland in intra-regional trade. There could also be spill-over effects on financial markets should the dispute affect market sentiment towards the US dollar and the demand for US securities.

The pressure for a change in the renminbi exchange rate regime has intensified, and the market increasingly seems to take the view that reform is only a matter of time. Because of the close economic links, Hong Kong will be affected by changes in the Mainland's policy framework, including the exchange rate regime. A change in the value of the renminbi against the US dollar – to which the Hong Kong dollar is linked – would affect Hong Kong's output growth, inflation, and external payment position through a number of channels, including trade, import prices, and investment income. These effects are likely to be mixed, reflecting Hong Kong's role as an entrepôt for the Mainland. For example, re-exports originating from the Mainland through Hong Kong to the rest of the world could be affected by an appreciation of the renminbi should the latter reduce the Mainland's trade competitiveness. As the bulk of Hong Kong's food and basic necessities are imported from the Mainland, a stronger renminbi would raise import prices, implying a terms of trade deterioration, which could lead to higher consumer prices and lower domestic demand through a negative income effect. On the other hand, a stronger renminbi helps Hong Kong's domestic exports and tourism, and re-exports via Hong Kong from the rest of the world to the Mainland. The substantial asset holdings on the

Mainland, accumulated by Hong Kong residents over the years, and income deriving from these assets, will benefit from the currency valuation effect (although investment income in renminbi terms could decline should output growth on the Mainland be affected by the currency appreciation). As these effects tend to offset each other, the net impact is unlikely to be large.

Potentially of more significance is the indirect impact on Hong Kong through financial channels. The speculation on the value of the renminbi has probably contributed to the capital inflows and easy monetary conditions in Hong Kong in the past few quarters. A revaluation of the renminbi could lead to a renewed inflow of funds, raising concerns about its impact on local monetary conditions and inflationary pressures, particularly on asset prices. In this context, the recently introduced refinements to the operation of the Linked Exchange Rate system should be of help. The two-way Convertibility Undertaking should better anchor exchange rate expectations on the strong side, reducing the amount of speculative inflows. Noticeable developments after the introduction of the refinements point to an initial success in "normalising" monetary conditions.

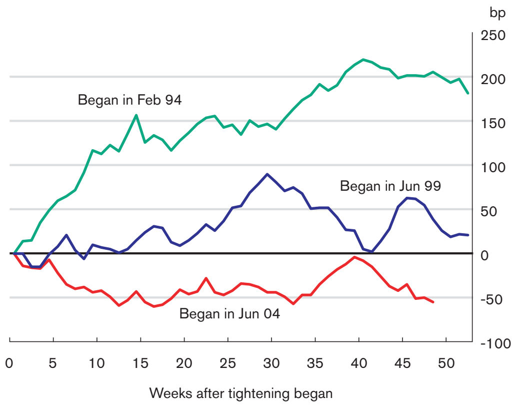
Locally, increases in property prices, supported by low interest rates, have raised concerns about whether the rise has gone beyond that justified by the fundamentals. It is extremely difficult to assess the fair value of asset prices. As noted in Section 2.10, the latest graphical framework for monitoring property market conditions suggests that the risk of a bubble in the mass market remains low, compared with the situation in 1997. Recent increases in interest rates have helped restrain buoyant activity in the property market. However, real mortgage interest rates remain at a low level, supporting property prices. Even so, there is a risk of a sharp tightening of financial conditions, as noted above. The resulting swings in housing prices could exacerbate economic cycles as shown by experience. Some households have become more vulnerable to property price falls because they have acquired mortgage loans on a loan-to-value ratio that is substantially higher than the generally accepted prudent level of 70%.

The easy monetary conditions have so far had a limited effect on consumer price inflation. However, underlying pressures are likely to be higher than suggested by the headline figures, because the rental component of the CPI has continued to contribute negatively to overall inflation despite considerable rises in market rents. Along with a gradual pass-through of increases in market rents to the rental component, the headline inflation rate is expected to pick up in the period ahead. This could feed into higher inflationary expectations, and put further pressure on the housing market. Nevertheless, the probability of a sharp increase in consumer price inflation remains low, considering the generally low inflation rates in Hong Kong's main trading partners. The deceleration in Mainland China's CPI inflation, particularly food price inflation, is helpful.

In summary, economic and financial conditions in Hong Kong and the Asian region remain generally favourable. The Hong Kong economy is expected to recover further, although the rate of expansion may moderate along with slower global growth. The banking sector will continue to benefit from the ongoing recovery in economic activity. Banks' asset quality and credit demand will be supported by robust income growth, low real interest rates and the booming property market. Looking ahead, the main concern is how changes in financial conditions affect asset prices and the wider economy. Overall, however, the risks to Hong Kong's monetary and financial stability seem to be limited.

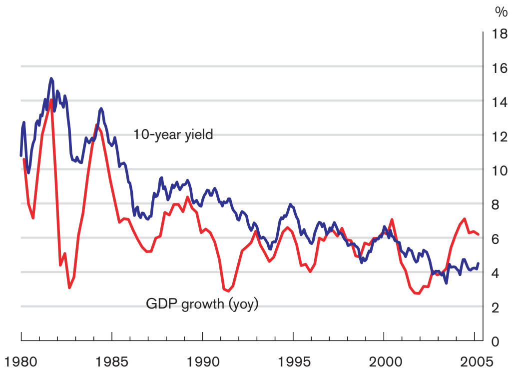
Box 4
Potential impact on Hong Kong of a sharp rise in longer-term US Treasury yields

Chart B4.1
US: Movements in 10-year US Treasury yield during interest rate tightening cycles



Source: Federal Reserve Board.

Chart B4.2
US nominal GDP growth and 10-year Treasury yield



Sources: Federal Reserve Board and Bureau of Economic Analysis.

The risk of a sharp rebound in long-term US Treasury bond yields has attracted much attention in recent international policy discussions.[16] Some commentators maintain the view that longer-term Treasury yields are currently "too low".[17] For example, in contrast to experience, yields on long-term US Treasury notes have fallen during the current US interest-rate tightening cycle that began in June 2004 (Chart B4.1). Nominal US GDP growth also moved broadly in line with longer-term Treasury yields, up until late 2003. However, since then, a gap of some 200 basis points has emerged between the two (Chart B4.2). Given the market expectations of more US rate increases in the coming months, the likelihood of a sharp rise in long-term bond yields should not be underestimated.

A sharp correction in long-term Treasury yields could affect Hong Kong in several ways. First, investors, including banks, that hold a large portfolio of such US securities would incur a heavy mark-to-market loss and hence a deterioration in their balance-sheet positions. According to US Treasury statistics, Hong Kong, which held some US$38.2 billion in long-term Treasury and Agency bonds at June 2004, was the world's twelfth largest holder of these securities (Table B4.A). Assuming the bond holdings have an average remaining maturity of four to five years, a one-percentage-point increase in yield could lead to an almost 4% decrease in prices and a loss of US$1.5 billion (or 0.9% of GDP) in the market value.

Secondly, yields on the Exchange Fund Notes (EFNs) have closely tracked their US counterparts, given the Linked Exchange Rate system and the fact that world capital markets have become increasingly integrated. This would mean that EFN holders would also suffer from capital loss if the US Treasury yields increased. However, despite the fact that around 85% of EFNs are

[16] See, for example, the 2005 April issue of the *IMF Global Financial Stability Report*.

[17] To examine whether the bond yield is below its long-run equilibrium value requires a more detailed analysis using standard growth models and is beyond the scope of this note.

Table B4.A
Long-term US bond holdings
(as of June 2004, US$, bn)

(US$ bn)	Treasury	Agency	Total
Japan	735.7	552.1	652.0
Mainland China	320.3	189.2	304.1
Taiwan	112.5	65.0	104.0
Cayman Islands	229.5	56.4	89.8
Korea	80.8	43.1	77.0
UK	221.4	45.8	69.1
Luxembourg	230.2	35.0	66.6
Belgium	284.6	14.0	65.3
Germany	107.2	42.1	62.7
Bermuda	113.1	24.3	47.8
Switzerland	68.5	32.8	45.2
Hong Kong	43.5	27.6	38.2
World Total	**3,514.6**	**1,462.4**	**2,088.9**

Source: US Treasury.

held by banks, they represent only a small proportion of bank assets. Thus the risk to the banking sector balance sheet remains small.

Thirdly, the low interest rate environment in recent times has encouraged investors to "search for yield", pushing down corporate bond spreads in both the mature and emerging economies. A rapid rise in long-term Treasury bond yields could potentially result in a more than proportionate increase in corporate bond yields when the overall liquidity condition tightens. In such an event, firms in Hong Kong would face higher borrowing costs. However, as equity and bank financing remain the key fund-raising channels for local firms, the increased borrowing costs for new projects should be limited, even though the credit spreads on existing debts would widen.

Hong Kong could also be affected indirectly as a sharp rise in longer-term Treasury yields could affect global financial stability. Rising short-term rates coupled with falling long-term yields have flattened the US Treasury yield curve considerably since June 2004 (Chart 1.21). A flattened yield curve means that the profit margin for leveraged investors who are engaging in carry trades (for example, borrowing short-term to invest in higher yield longer-term assets) has decreased. To achieve the previous profit levels, these investors would have to take on more leverage. In the event of market distress caused by rising long-term yields, the highly-leveraged investors might be forced to sell their assets and spread the credit losses to their counter-parties, resulting in a much wider disruption to global financial markets.

Abbreviations

3m moving avg	Three-month Moving Average
3m-on-3m	Three-month-on-three-month
12m	Twelve-month
ASEAN	Association of Southeast Asian Nations
AIs	Authorized Institutions
Avg	Average
BLR	Best Lending Rate
BoP	Balance of Payments
CCPI	Composite Consumer Price Index
CEPA	Closer Economic Partnership Arrangement
C&SD	Census and Statistics Department
CPI	Consumer Price Index
CU	Convertibility Undertaking
EFNs	Exchange Fund Notes
FDI	Foreign Direct Investment
FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GST	Goods and Services Tax
HIBOR	Hong Kong Interbank Offered Rate
Hi-tech	High Technology
HKD	Hong Kong Dollar
HKMA	Hong Kong Monetary Authority
HSI	Hang Seng Index
IMF	International Monetary Fund
IT	Information Technology
lhs	Left-hand Scale
LIBOR	London Interbank Offered Rate
mom	Month-on-month
NDFs	Non-deliverable Forwards
NIE	Newly Industrialised Economies
p.a.	Per Annum
PBoC	People's Bank of China
PCE	Private Consumption Expenditure
PMI	Purchasing Managers' Index
PPP	Purchasing Power Parity
qoq	Quarter-on-quarter
REER	Real Effective Exchange Rate
rhs	Right-hand Scale
RMB	Renminbi
sa	Seasonally Adjusted
yoy	Year-on-year