HALF-YEARLY MONETARY AND FINANCIAL STABILITY REPORT

December 2005

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

Summary

The favourable economic trends described in the June Report continue to characterise Hong Kong's economy. During the third quarter real GDP grew at a remarkably strong rate of 8.2% year on year following the increase of 6.7% in the first six months of the year. Meanwhile the unemployment rate declined to 5.3% of the labour force at the end of October, the lowest in four years. Although inflation continued to edge upwards, the 1.6% year-on-year rate recorded in October is well within a range that can be considered benign.

Several factors have contributed to the strong performance of the economy. The US economy has maintained a strong growth momentum despite high oil prices and tightening monetary policy. Other major trading partners have also recorded solid growth supporting buoyant export performance in Hong Kong. On the domestic front, a rebound in private consumption growth has taken place as a result of increasing employment and household incomes. The performance of the property market has also contributed to increased consumer spending.

The consensus forecast in November points to continued solid growth in 2006, albeit at a more sustainable rate of 4.5%. Inflation is expected to increase somewhat to 2.4% according to the market consensus, reflecting the lagged effect of increases in residential rents in addition to strong aggregate demand.

The movements of the Hong Kong dollar exchange rate and interest rates during the past six months attest to the effectiveness of the three refinements to the Linked Exchange Rate system introduced in May. Local interest rates rapidly converged towards their US dollar counterparts and, as expected, they have generally moved in parallel since. The spot exchange rate has stayed within the Convertibility Zone without any need for market operations by the HKMA, and expectations – measured by the quotes in the forward exchange market – also point to market participants' confidence in the system.

A further indication of the market's confidence in the Linked Exchange Rate came in July when the Mainland authorities modified the renminbi exchange rate system by moving to a managed floating regime with reference to a basket of currencies, and simultaneously announcing a step-appreciation of 2% against the US dollar. This change had virtually no impact on the Hong Kong dollar beyond the first few hours, attesting to the resilience of the Linked Rate.

Reflecting an increase in non-interest income and stabilisation of the net interest margin, profitability in the banking sector increased slightly in the past six months. Asset quality continued to improve as the proportion of classified and overdue loans in total bank loans decreased. In addition, capital adequacy ratios remain well above the minimum international standards.

A new measure of credit risk in the corporate sector indicates that the likelihood of corporate default of publicly listed companies has eased substantially since 2004 to a level that is now quite low by the standards of the past fifteen years.

While the central projections for both the world economy and Hong Kong point to sustained expansion in the coming year, the risks that were noted in the June Report continue to cast shadows on the outlook.

The uncertainty relates mainly to the outlook for interest rates. Under the Linked Exchange Rate system interest rates in Hong Kong generally follow closely those in the United States. While there are signs that the current cycle of tightening by the Fed will end sometime in 2006, it is generally believed that short-term interest rates will still increase by some 50 basis points from current levels. Longer-term rates are expected to move up correspondingly. Higher interest rates will influence the Hong Kong economy directly through the impact on local asset markets and hence on consumption and investment. To the extent higher interest rates also dampen economic growth in the US, our economy will be affected through a reduction in external demand for our goods and services.

Developments in the Mainland economy also constitute a source of uncertainty for Hong Kong. Two areas warrant particular attention – signs of increasing protectionism both in Europe and the United States, and continued pressures on the renminbi. Barring a severe reduction in exports from the Mainland, which is highly unlikely, and given market confidence in our Linked Exchange Rate system, our analysis shows that the Hong Kong economy is quite resilient with respect to these potential developments.

Finally it should be noted that the outlook is not only subject to downside risks. Oil prices could continue to decline and the strength of the recovery underway in Japan may be greater than currently expected. Overall therefore, our assessment is that both the external and internal factors augur well for continued monetary and financial stability in Hong Kong.

Half-Yearly Monetary and Financial Stability Report
December 2005

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1. Global and regional setting

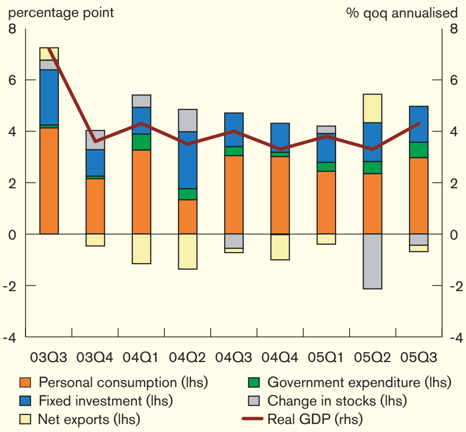
External environment

Overall, the world economy has outperformed expectations over the past six months. The US economy has maintained strong growth momentum despite high oil prices and disruptions caused by hurricanes, and there are increasing signs that economic activity is picking up pace in Europe and Japan. Against this background, exports overtook domestic demand as the prime driver of growth in most East Asian economies, particularly those with a relatively large electronics sector.

1.1 United States

The US remains the growth engine for the global economy, showing resilience to high energy prices and disruptions caused by two severe hurricanes. Real GDP growth increased to 4.3% in 2005 Q3 from 3.3% in Q2 (Chart 1.1).[1] Personal consumption continued to grow strongly, while the contribution of government spending rose to its highest level since 2004 Q1. Contribution of net exports to GDP growth reversed to negative in Q3. Monthly data show that the expansion slowed towards the end of the quarter, with the September figures revealing a slowdown of growth in sales and production (Table 1.A). However, forward-looking indicators, on balance, still point to robust growth in the period ahead.

Chart 1.1
US: contributions to GDP growth



Source: Bureau of Economic Analysis.

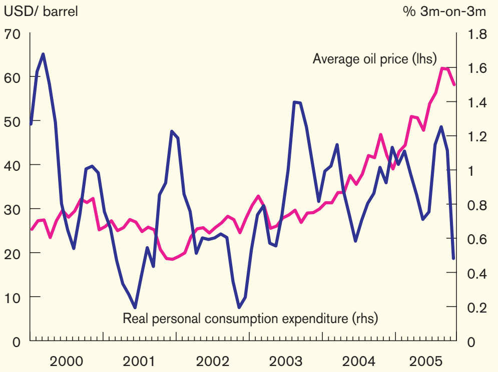
Table 1.A
US: monthly indicators of activity

	Jul	Aug	Sep	Oct	Nov
Manufacturing PMI	56.6	53.6	59.4	59.1	58.1
Non-manufacturing PMI	60.5	65.0	53.3	60.0	58.5
Industrial production (% 3m-on-3m)	0.7	1.0	0.2	-0.2	n.a.
Durable goods orders (% 3m-on-3m)	6.4	4.4	-0.1	0.5	n.a.
Capital goods orders, nondefense (% 3m-on-3m)	15.4	6.6	-4.1	-5.8	n.a.
Retail sales (% 3m-on-3m)	2.8	2.7	1.7	0.1	n.a.
Real personal consumption expenditure (% 3m-on-3m)	1.1	1.2	1.1	0.5	n.a.
Real disposable income (% 3m-on-3m)	0.5	0.1	-0.2	-0.6	n.a.
Change in nonfarm payroll (thousand persons)	277	148	-8.0	56	215
Unemployment rate (%)	5.0	4.9	5.1	5.0	5.0
Consumer confidence (index)					
Conference Board	103.6	105.5	87.5	85.2	98.9
Job prospects[1]	-0.9	0.5	-4.3	-4.6	-2.4
University of Michigan	96.5	89.1	76.9	74.2	81.6

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

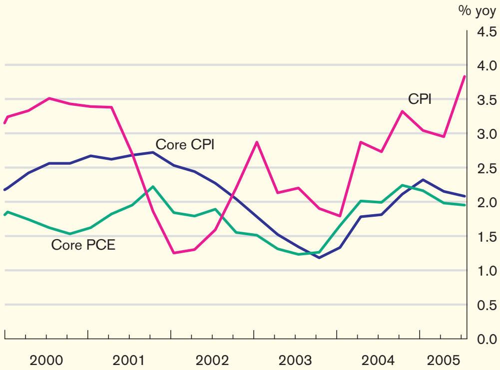
[1] For the US, euro area, Japan and non-Japan Asia (ex-Mainland China), all quarterly percentage changes are on a seasonally adjusted annualised basis, except otherwise stated.

Chart 1.2
US: real personal spending and average oil prices[1]



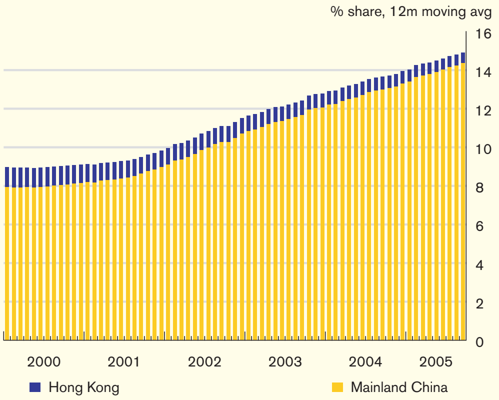
Note 1: Simple average of WTI, Brent and Dubai oil prices.
Sources: Bureau of Economic Analysis and Bloomberg.

Chart 1.3
US: core CPI and PCE[1]



Note 1: Excluding food and energy.
Source: U.S. Dpartment of labour.

Chart 1.4
US: Mainland and Hong Kong's share of US goods imports



Sources: CEIC.

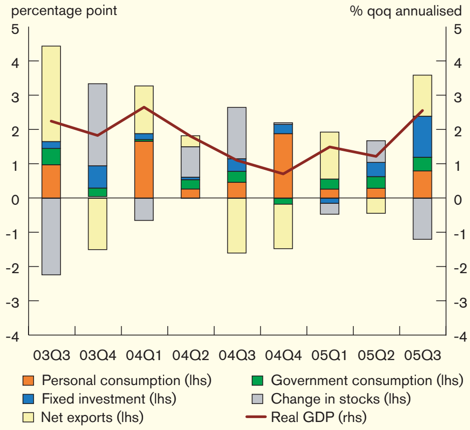
Consumer spending rose by 4.2% in Q3, led by increases in incentive-driven automobile sales at the start of the quarter. However, on a three-month-on-three-month basis, growth in personal consumption declined in the two months to October, partly due to the adverse effect of the surge in energy prices (Chart 1.2). Growth in business fixed investment maintained the solid pace of 8.8%, same as that in Q2. Residential housing construction cooled somewhat, rising by 8.4% in Q3, after growing by an average of 10.2% in the previous two quarters. The latest Purchasing Managers' Indices (PMIs) suggest continued strength in industrial activity, while robust corporate profit growth should support business spending.

High oil prices increased inflationary pressures in Q3, although the pass-through to core inflation has remained limited. Year-on-year headline inflation rose to 3.8% and 3.1% on the CPI and PCE respectively in Q3, but core CPI and PCE inflation remained stable at around 2% (Chart 1.3). However, the prices-paid component (excluding crude oil) of the PMI saw a sharp rise in September, raising concern that higher material costs could squeeze profit margins, forcing producers to pass them on to consumers.

On the external front, the trade deficit widened to 5.8% of GDP in Q3. Notwithstanding some improvements in July, the trade balance deteriorated in August and September, reflecting a widening petroleum deficit and a decline in aircraft exports. The share of Mainland China and Hong Kong in total merchandise imports rose to 14.9% on a 12-month rolling basis in September 2005 (Chart 1.4).

1.2 Euro area and UK

Chart 1.5
Euro area: contributions to GDP growth



Source: Eurostat.

Table 1.B
Euro area: survey indicators of activity

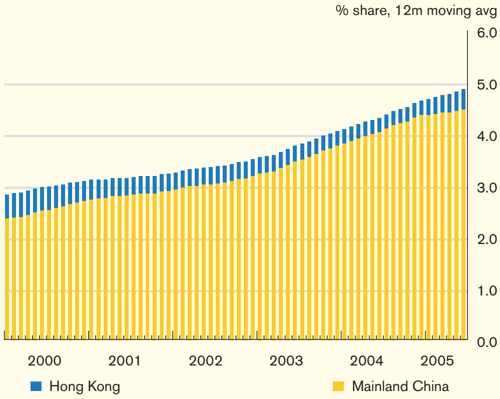
(Index)	2004	Jul	Aug	Sep	Oct	Nov
Composite PMI	54.6	53.2	52.8	54.3	54.7	55.1
Manufacturing PMI	53.1	50.8	50.4	51.7	52.7	52.8
Services PMI	54.6	53.5	53.4	54.7	54.9	55.2
European Commission survey						
Economic sentiment	100.0	97.5	97.8	98.6	100.5	99.9
Industrial confidence	-4.7	-8.0	-8.0	-7.0	-6.0	-6.0
Orders component	-15.5	-18.0	-18.0	-16.0	-16.0	-16.0
Consumer confidence	-13.8	-15.0	-15.0	-14.0	-13.0	-13.0
ZEW economic sentiment (expectation)	52.1	29.0	41.6	31.8	34.7	40.0
Germany IFO (business climate)	95.7	95.1	94.7	96.0	98.8	97.8

Sources: Bloomberg and Reuters.

In the euro area, signs of an improvement in economic activity emerged in 2005 H2. Real GDP grew by 2.6% in Q3, following an increase of 1.2% in Q2. Similar to the previous quarter, growth continued to be driven by business investment. The contribution of net exports also turned positive, reflecting strong growth in exports (Chart 1.5). By region, both Germany and France staged a healthy rebound after their lacklustre performance in Q2, growing at 2.5% and 2.7% in Q3 respectively.

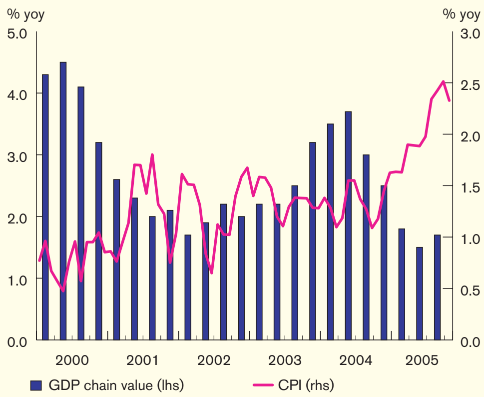
Private domestic demand in the euro area has shown signs of recovery, driven mainly by investment. With the corporate sector supported by the relatively low interest rate environment and robust growth of corporate earnings, investment spending expanded further by 6.6% in Q3 compared with 2.0% in Q2. Recent survey indicators suggest that corporations are leading the recovery (Table 1.B). Both industrial confidence and PMI data improved in recent months, reflecting a rise in new orders and an acceleration of the expansion in the manufacturing and service sectors. Consumer spending also picked up, albeit modestly, by 1.2% in Q3, up from 0.5% in Q2. This reflected a slight improvement in consumer confidence, as households became less pessimistic about employment prospects.

Chart 1.6
Euro area: Mainland and Hong Kong share of euro area goods imports



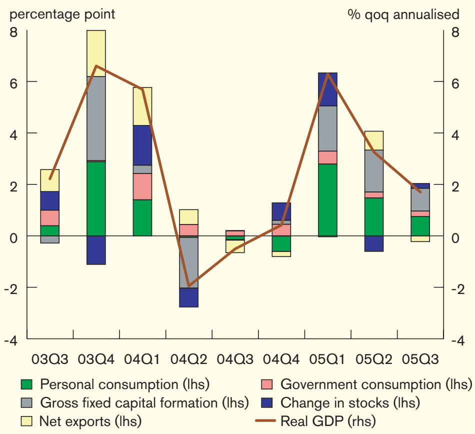
Sources: IMF Direction of Trade Statistics.

Chart 1.7
UK: real GDP growth and CPI inflation



Source: UK National Statistics.

Chart 1.8
Japan: contrbutions to GDP growth



Source: Cabinet Office of Japan.

The external sector saw a significant recovery in Q3, with net exports contributing to 1.2 percentage points of GDP growth in Q3. Exports have registered strong growth since August this year, particularly in Germany, reflecting the robust growth in global demand. Growth in imports also rose to 11.7% in Q3 from 9.4% in Q2. The share of Mainland China and Hong Kong in total euro area goods imports was broadly unchanged in June 2005 at 4.9%, on a 12-month rolling basis, compared with the level at the end of 2004 (Chart 1.6).

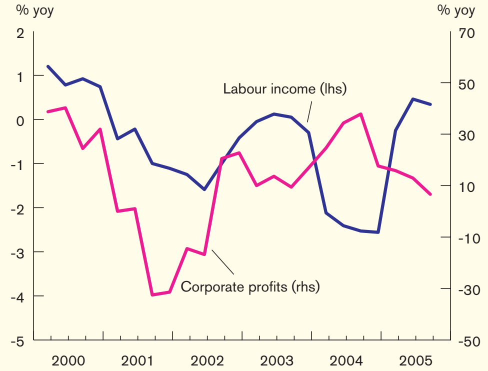
High oil prices are feeding through to consumer prices with headline HICP inflation rising to 2.3% year on year in Q3 from 2.0% in the previous two quarters. In particular, inflation rose significantly to 2.6% year on year in September. However, core CPI inflation (excluding unprocessed food and energy) still hovered at around 1.4% in both Q2 and Q3.

In the UK, real GDP grew by 1.7% year on year in Q3, following an increase of 1.5% in Q2 (Chart 1.7). The sustained weak growth mainly reflected continued sluggishness in domestic demand. Rising energy costs pushed inflation above the Bank of England's (BoE's) 2% inflation target for the fourth month in October to 2.3% year on year (Chart 1.7). However, the BoE cut the policy rate for the first time in two years to 4.5% in August on concerns over weak consumer spending and high household debts.

1.3 Japan

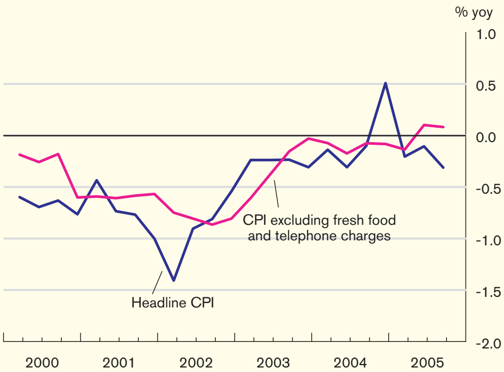
In Japan, growth moderated to 1.7% in Q3 from 3.3% in Q2, as strong export growth was offset by slower growth in domestic demand (Chart 1.8). Following a strong rebound in Q1, growth in private consumption slowed to 2.7% in Q2 and further to 1.4% in Q3. Business investment also grew at a more moderate pace of 3.0% in Q3, compared with double-digit expansion in the previous two quarters. Forward-looking indicators suggest that labour income and corporate profits will continue to rise. Therefore, the moderation of growth in

Chart 1.9
Japan: labour income and corporate profits



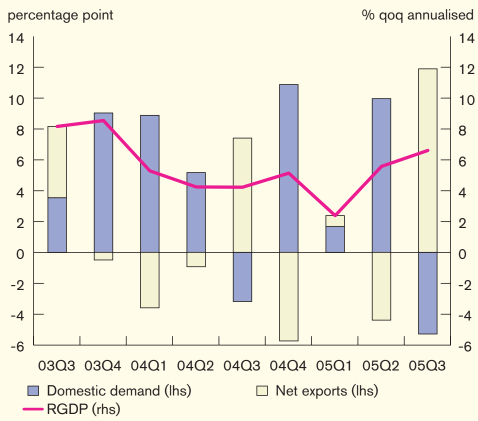
Sources: Ministry of Health, Labour and Welfare and the Ministry of Finance.

Chart 1.10
Japan: consumer price inflation



Sources: Ministry of Internal Affairs and Communications and staff estimates.

Chart 1.11
East Asia: contributions to GDP growth



Sources: CEIC and staff estimates.

Q3 is likely to be temporary (Chart 1.9). The September Tankan survey suggests that business confidence has increased, and enterprises are planning to invest more in fixed assets and hire more workers. The manufacturing PMI also rose to a 18-month high in November on rising new orders and employment. Machine orders (excluding vessels and electric power) expanded by 2.1% quarter on quarter in Q3 after rising by 0.8% in Q2, suggesting that manufacturing activity will pick up in the coming months.

On the external front, exports picked up strongly in Q3, benefiting from a weaker yen and a revival in external demand. Export volume increased by 3.3% after rising by 1.5% in Q2. Among major export destinations, Mainland China registered the fastest growth, attributable to rising demand for capital goods and parts. The recent pickup in US electronics demand also helped Japanese exports. However, high oil prices increased the import bill substantially, cutting the trade surplus to a four-year low of 1.4% of GDP in Q3.

Inflation remained subdued, despite high oil prices. Headline consumer price inflation stayed negative at -0.3% (year on year) in Q3, as rising fuel costs were offset by declines in fresh food prices and telephone charges. Excluding fresh food and telephone charges, consumer prices rose by 0.1% in Q3 (Chart 1.10). In view of the gradual pick up in economic activity and rising fuel costs, the Bank of Japan has revised its forecast for core CPI inflation (excluding fresh food) to 0.1% for fiscal year 2005 from a previous estimate of -0.1%, revealing its optimism that the 8-year long deflation may end next year.

1.4 Other Asia (ex-Mainland China)

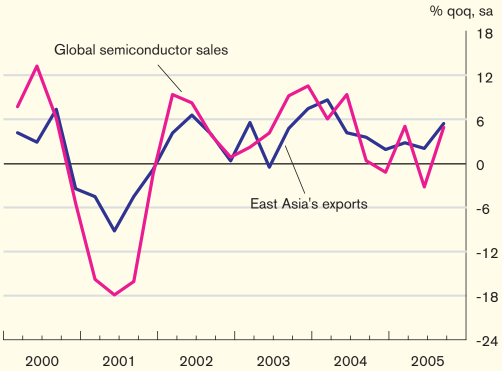
In the rest of East Asia (outside Mainland China), economic growth has remained robust while inflation has risen. With rising interest rates, exports have generally overtaken domestic demand as the main driving force of growth in the region (Chart 1.11). Economic activity gathered stronger momentum in the newly industrialised economies than in their less developed neighbours in Q3. Real GDP in Korea, Singapore and Taiwan grew by an average of 7.5%

Table 1.C
East Asia: real GDP growth

(% qoq, annualised)	04Q2	04Q3	04Q4	05Q1	05Q2	05Q3
NIE:	**3.2**	**2.5**	**2.5**	**2.5**	**6.3**	**7.5**
Korea	2.7	3.0	3.8	1.5	5.0	8.0
Singapore	7.5	0.7	7.9	-4.6	19.0	7.1
Taiwan[1]	3.2	2.0	-0.7	5.3	5.9	6.9
ASEAN:	**5.1**	**5.7**	**7.4**	**2.2**	**5.1**	**5.8**
Indonesia[1]	5.2	6.2	9.9	3.4	2.7	5.4
Malaysia[1]	8.0	2.8	5.0	9.1	0.9	6.3
Philippines	4.4	6.3	4.1	3.1	7.1	2.3
Thailand	4.0	5.9	7.1	-3.7	9.3	9.0
East Asia:	**4.2**	**4.2**	**5.1**	**2.4**	**5.6**	**6.6**

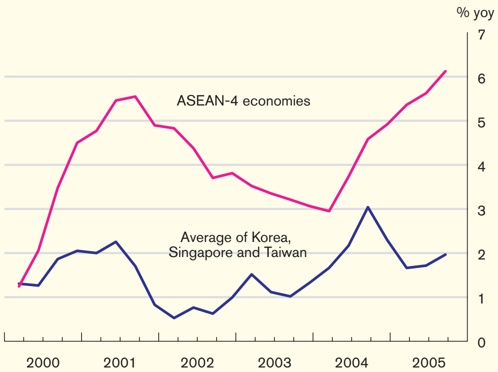
Note 1: Staff estimates.
Sources: CEIC and staff estimates.

Chart 1.12
East Asia: the global IT cycle and export growth (in US$ terms)



Sources: CEIC and staff estimates.

Chart 1.13
East Asia: headline CPI inflation[1]



Note 1: Simple average.
Source: CEIC.

compared with 6.3% in Q2 and 2.5% in Q1, while Indonesia, Malaysia, the Philippines and Thailand together registered a 5.8% growth compared with 5.1% in Q2 (Table 1.C).

Domestic demand growth has weakened in East Asia, as business spending growth turned negative. Business investment contracted by 10.9% quarter on quarter (annualised) in Q3 after rising by 29.5% in Q2. Nevertheless, consumer spending rebounded in Q3, with private consumption increasing by 7.8% after contracting by 2.7% in Q2. Growth in merchandise exports in the region accelerated to 5.4% quarter on quarter in Q3 from 2.0% in Q2, the highest since 2004 Q1. The pickup was across the region except for the Philippines. This is attributable to a host of positive factors, including a rise in global IT demand, robust growth in the US and Mainland China, and weaker currencies vis-à-vis the US dollar (Chart 1.12).

High oil prices have increased inflationary pressures in the region. Headline CPI inflation rose to an average rate of 2.0% in Q3 from 1.7% in Q2 in Korea, Singapore and Taiwan, and to an average of 6.1% from 5.6% in Indonesia, Malaysia, the Philippines and Thailand (Chart 1.13). As a result, a number of central banks have tightened monetary policy. In particular, Bank Indonesia raised its policy rate six times from 8.5% in August to 12.75% in December, as the outlook for inflation deteriorated sharply in view of the reform of oil subsidy measures. Elsewhere in the region, the situation is not as severe, but increased inflationary pressure may lead to a further tightening of monetary policy.

Mainland China

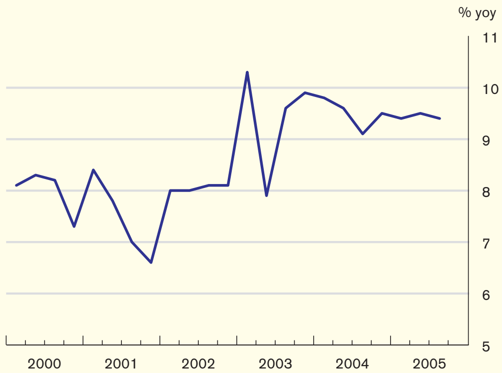
The Mainland economy continued to grow strongly, while inflationary pressures remained subdued. Despite faster growth in M2 resulting from a rapid build-up of foreign exchange reserves, bank loans grew modestly, well within the targeted policy range. Low interest rates relative to those in the US may have slowed speculative capital inflows, somewhat lessening pressure on the renminbi.

1.5 Output, growth, and inflation

The Mainland economy continued to grow at a rapid pace, registering a year-on-year rate of 9.5% and 9.4% in Q2 and Q3, respectively (Chart 1.14).

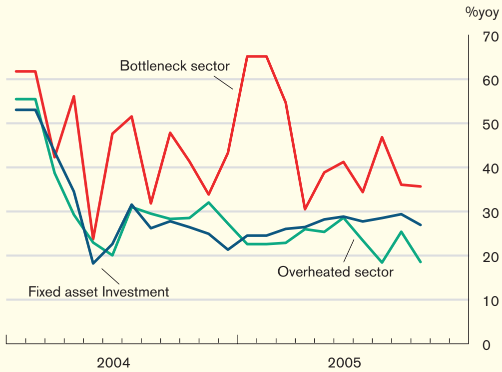
On a year-on-year comparison, fixed asset investment rose by over 28% in Q2 and Q3, compared with an increase of 25.3% in Q1. Growth in investment in "bottleneck" sectors, such as coal mining, gas, electricity, and transportation, was stronger than in the formerly "overheated" sectors like steel, construction, and real estate (Chart 1.15). Growth in industrial production also increased from 14.6% in Q1 to over 16% in Q2 and Q3. The strong growth in investment and industrial production has raised concerns about over capacity in some sectors.

Chart 1.14
Mainland China: year-on-year GDP growth



Source: CEIC.

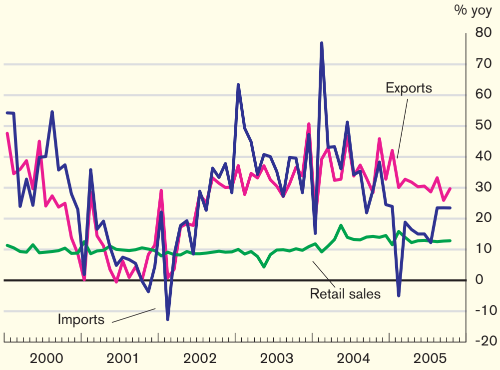
Chart 1.15
Mainland China: fixed asset investment



Note: Bottleneck sectors refer to coal mining, gas, electricity, and transportation. Overheated sectors refer to steel, construction, and real estate.

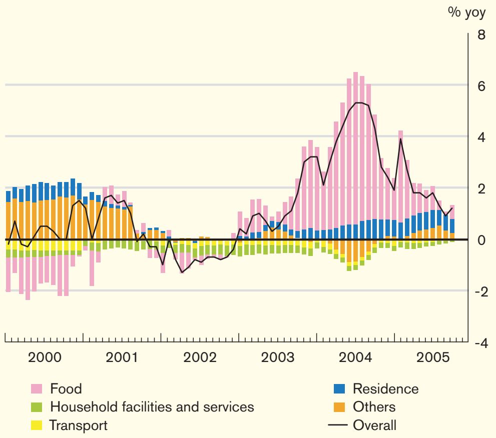
Sources: CEIC and staff estimates.

Chart 1.16
Mainland China: retail sales and external trade



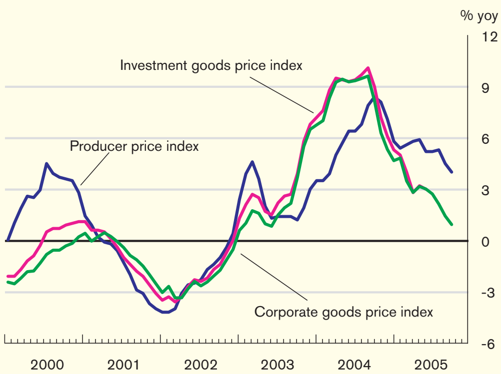
Source: CEIC.

Chart 1.17
Mainland China: contributions to CPI inflation



Sources: CEIC and staff estimates.

Chart 1.18
Mainland China: other price indicators



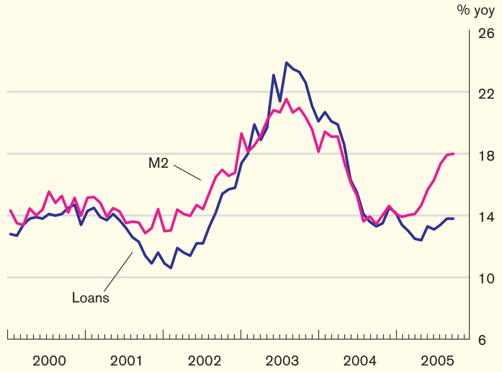
Source: CEIC.

Rising personal income continued to support private consumption, with retail sales increasing by 12.6% in the past two quarters (Chart 1.16). External trade continued to be a major driver of growth, although the most recent data suggest export growth may have moderated somewhat. A stronger renminbi (RMB) and increased trade tensions with the EU and the US may partly explain the decline in year-on-year growth to a three-year low of 29.2% in Q3. By contrast, import growth rebounded steadily in the past two quarters, partly due to delayed imports in earlier periods on expectations of the RMB revaluation and increased spending on oil imports.

Inflationary pressures remained subdued. Falling grain prices have contributed to a marked decline in the headline inflation rates, to a two-year low of 0.9% year on year in September before rebounding to 1.2% in October (Chart 1.17). PPI inflation also eased to 4% in October, the lowest level since March 2004, partly due to capacity expansion and rising productivity (Chart 1.18). Declining inflation raised concerns of a possible return to deflation. However, the near-term deflation risk remains low in light of strong aggregate demand, expanding money supply, and possible pass-throughs of high raw material and crude oil prices.

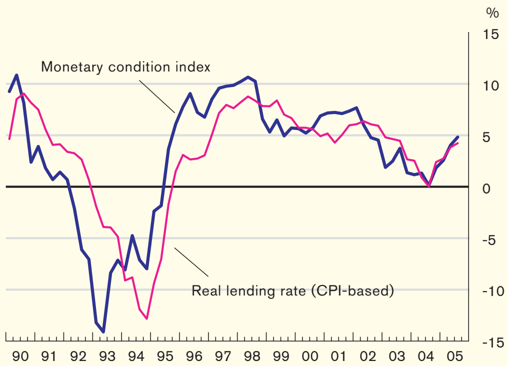
1.6 Monetary conditions and asset prices

Chart 1.19
Mainland China: money and credit



Source: CEIC.

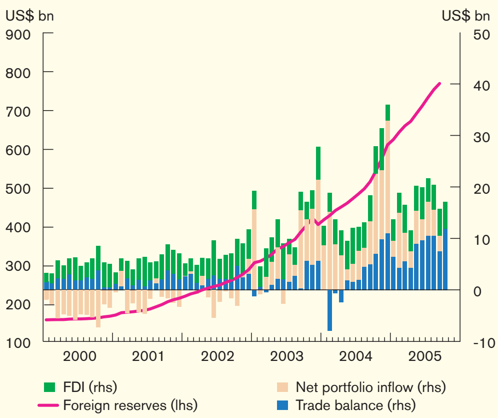
Chart 1.20
Mainland China: monetary conditions



Note: The monetary condition index is defined as a weighted sum of real interest rate, real exchange rate and real credit growth. A rise in the index indicates a tightening of monetary conditions.

Sources: CEIC and staff estimates.

Chart 1.21
Mainland China: external capital inflows



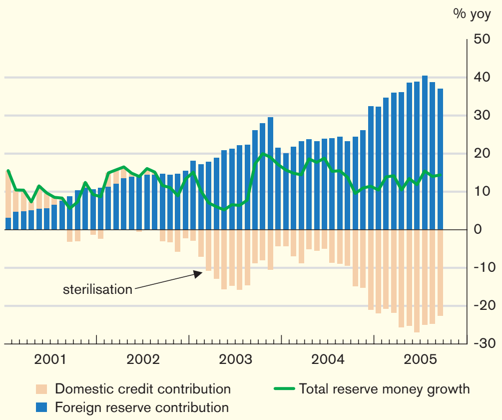
Note: Net portfolio inflow is defined as the difference between the changes in FX reserves and the sum of trade surplus and FDI.

Sources: CEIC and staff estimates.

Both broad money (M2) and bank credit continued to expand, but at diverging rates. M2 growth accelerated from 14.0% (year on year) in Q1 to 17.9% in Q3, well above the official target rate of 15% (Chart 1.19). Its annualised three-month-on-three-month rate also rose from 16.7% to 19.5% over the same period. On the other hand, bank loans expanded modestly by 13.4% (year on year) for the past three quarters, within the official target. Rapid accumulation of foreign exchange reserves in the absence of fully offsetting sterilisation resulted in a rise in liquidity in the banking system. This possibly reflects the authorities' intention to keep money market interest rates low, to reduce the strong side pressure on the RMB exchange rate and to cushion the impact of a stronger RMB on the economy, rather than to stimulate credit growth. Indeed, overall monetary conditions have tightened since the June Report. Our estimates show that the monetary condition index - a weighted sum of real interest rate, real exchange rate, and real credit growth - continued to rise (Chart 1.20).

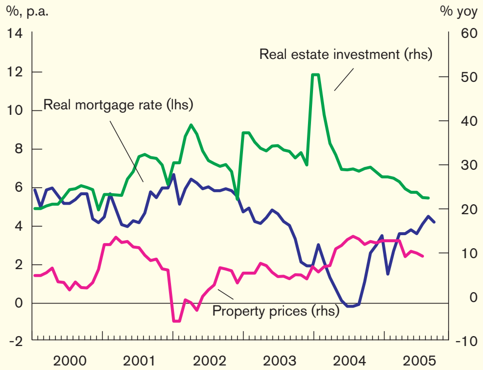
Foreign exchange reserves rose by US$110 billion since the June Report to US$769 billion, making Mainland China the second largest official holder of foreign exchange reserves after Japan (Chart 1.21). Sustained trade surpluses contributed to half of the increase in foreign reserves, while foreign direct investment and other capital inflows each accounted for about one quarter of the rise. As the People's Bank of China (PBoC) continued to carry out sterilisation operations to limit the impact of reserve increases on domestic monetary

Chart 1.22
Mainland China: contribution to reserve money growth



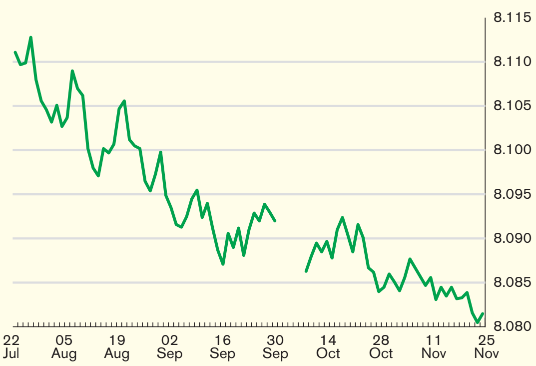
Source: CEIC.

Chart 1.23
Mainland China: real mortgage rates and property prices



Sources: PBoC, CEIC, and staff estimates.

Chart 1.24
Mainland China: market RMB/USD exchange rate



Note: The break in the chart represents the missing data due to the Chinese National Holidays.

Source: Reuters

conditions, growth in base money has been largely contained (Chart 1.22). However, the rapid build-up of foreign exchange reserves continued to put pressure on the RMB exchange rate. Meanwhile, the increasing stock of sterilisation bills will pose challenges to the conduct of monetary policy in the future.

The property market appears to have consolidated following a series of administrative measures implemented by the authorities earlier this year, including raising mortgage interest rates, tightening down-payment requirements, and imposing real estate transaction taxes. Increases in property prices moderated from 13% between January and April to 9.5% during the May-to-August period (Chart 1.23). Real estate investment growth has slowed markedly.

1.7 The renminbi exchange rate

Reform of the RMB exchange rate regime announced by the PBoC on July 21 was the most significant development on the Mainland since the June Report. The reform consisted of a 2% up-front revaluation of the RMB and a shift from the US dollar peg to a managed float with reference to a basket of currencies, including the US dollar, the euro, the Japanese yen, the Korean won, and other major trading partners' currencies. The transition to the new exchange rate mechanism has been relatively smooth and the authorities have managed market expectations well (Chart 1.24). Market views have converged to a gradual and moderate appreciation

Chart 1.25
Renminbi non-deliverable forward rates

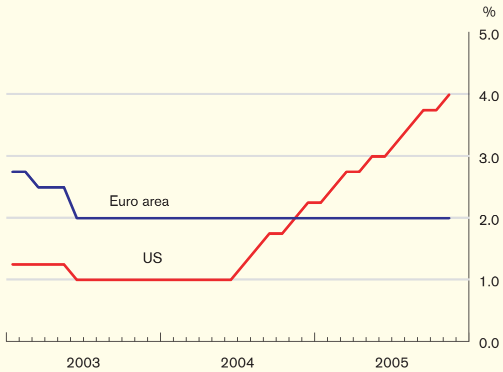
Source: Bloomberg.

path since the reform. The latest RMB non-deliverable forward rates suggest that market participants expect the RMB to appreciate by 1% in three months and 4% in 12 months (Chart 1.25). Given the modest change in the exchange rate, the impact on the economy has been limited.

Monetary and financial conditions

Against the background of robust economic growth and increased concerns over inflation, the US Federal Reserve further tightened monetary policy in the second half of 2005. US Treasury yields rose across the maturity spectrum. As a result, interest differentials continued to widen in favour of the US dollar, which appreciated against other major currencies.

Chart 1.26
Policy rates in the US and euro area



Sources: US Federal Reserve and European Central Bank.

Chart 1.27
US Treasury yields

Source: US Federal Reserve.

1.8 Interest rates

The US Federal Reserve has continued to tighten its monetary policy stance. The Federal Open Market Committee (FOMC) raised the federal funds target rate by 25 basis points following each of the four policy meetings since June this year, bringing the rate to 4% in November (Chart 1.26). Despite the disruptions caused by hurricanes Katrina and Rita in August and September, the FOMC, in a statement released following its policy meeting in November, maintained that monetary accommodation would be removed at a "measured" pace. In particular, the Committee expressed concern that rising energy prices might add to inflationary pressures. At the end of November, the price of federal funds futures contracts indicated that market participants expected the target rate to reach 4.7% by May 2006. Meanwhile, the ECB and the Bank of Japan kept their policy rates unchanged, while the Bank of England reduced its repo rate by 25 basis points to 4.5% in August.

Against this backdrop, US Treasury yields have risen across the maturity spectrum and the yield curve has flattened. Short-term yields increased in line with the federal funds rate, while the long end of the yield curve was driven more by concerns over rising energy prices and increased inflation expectations. At the end of November, the spread of 10-year over 1-year US Treasury yields fell to 15 basis points from 68 basis points at the end of May (Chart 1.27). In Europe, government bond yields have been pushed up over concerns that rising inflation might prompt an earlier-than-expected monetary tightening by the ECB. The yield on the 10-year Bund rose to a seven-month high of 3.59% in mid-November, before easing to 3.46% at the end of November.

In Asia, a number of central banks have raised interest rates during the past six months. Since June, Bank Indonesia has raised its policy rate by a total of 4.3 percentage points to 12.25% as the reform of oil subsidy measures put considerable upward pressure on inflation. In Mainland China, the People's Bank of China kept the benchmark one-year renminbi lending and deposit rates stable, but raised the upper limit of the onshore US dollar and Hong Kong dollar small value deposit rates to 2.5% and 2.375% respectively.

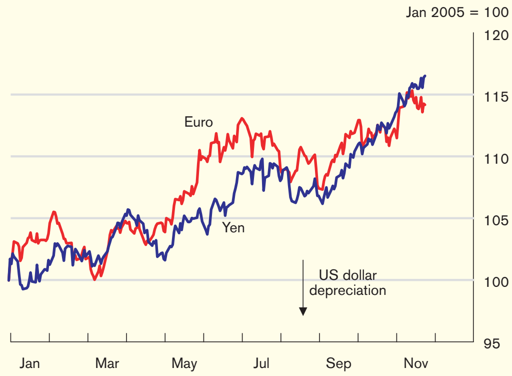
1.9 Exchange rates

The US dollar strengthened against other major currencies in the past six months (Chart 1.28), rising by 3.3% and 10.2% against the euro and the yen respectively. This appeared to reflect the widening of interest differentials in favour of the dollar and the strong economic growth in the US.

1.10 Equity markets

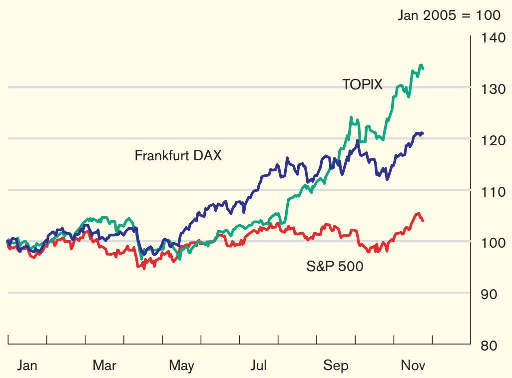
The performance of global equity markets was mixed over the past six months. The S&P 500 was locked within a narrow trading range from 1,170 to 1,270, with the rise in bond yields lowering valuations. Sentiment was also adversely affected by the severe hurricanes and the bankruptcies filed by two major airlines in September. The European and Japanese markets, on the other hand, were supported by lower exchange rates and improved business confidence, and advanced markedly during the same period. Since June the TOPIX and Frankfurt DAX recorded gains of 34% and 15% respectively (Chart 1.29).

Chart 1.28
Bilateral US dollar exchange rates



Source: Bloomberg.

Chart 1.29
Selected major equity indices (local currency)



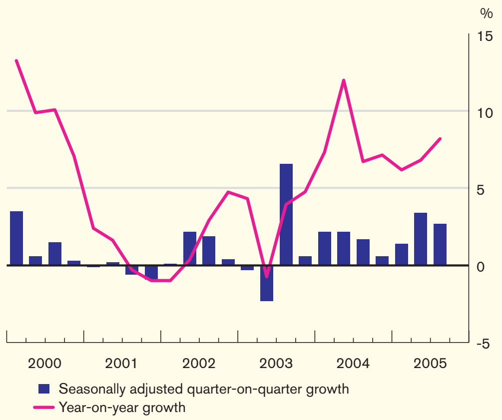
Source: Bloomberg.

2. Domestic economy

Demand

Real GDP growth in Hong Kong continued to gather momentum in the third quarter of 2005, following strong expansion in the first half. The remarkable economic performance has been broadly based. Despite higher interest rates and a moderation in the property market, private consumption growth picked up in the third quarter and private investment increased further. Exports remained buoyant, supported by solid growth in Hong Kong's major trading partners.

Chart 2.1
GDP at constant market prices



Source: C&SD.

2.1 Aggregate demand

The Hong Kong economy has fared well in a period of high oil prices and increases in interest rates.[2] Real GDP growth gathered momentum in 2005 Q3, rising by 8.2% from a year ago, following an increase of 6.7% in H1 (Chart 2.1). Private consumption growth picked up in Q3, while private investment growth moderated. The latter reflects a decline in construction output and a slower increase in capital goods investment. Export performance in Q3 remained robust, supported by solid growth in Hong Kong's major trading partners. On a seasonally adjusted quarter-on-quarter basis, real GDP registered its ninth straight quarter of growth in Q3, rising by 2.7%, compared with a high rate of 3.4% in Q2.

[2] Box 1 discusses the implications of high oil prices on the Hong Kong economy.

Box 1
Potential impact of oil prices on Hong Kong

This box considers the potential consequences of high oil prices on the Hong Kong economy. First, it assesses how oil prices could impact Hong Kong via their adverse effects on the global economy. This will be discussed in the context of the results of a simulation based on the HKMA macro-econometric model. Secondly, it analyses the marked rise in oil consumption in Hong Kong in recent years, which may have implications for the Hong Kong economy over time.

Indirect impact of oil prices

Oil prices have tripled over the past four years. The direct effect of higher oil prices on Hong Kong is likely to be limited because of the economy's low oil intensity.[3] However, the indirect effect of higher oil prices, which would come via changes in global growth, inflation and monetary conditions, could be significant. Here the downside risks to Hong Kong are assessed using the HKMA macro-econometric model in a simulation study.

We consider two scenarios that differ mainly in the monetary policy response of the US Federal Reserve. In both scenarios, oil prices are assumed to rise to an average of US$80 per barrel in 2006. However, in scenario 1, the federal funds target rate is assumed to reach 4.25% by the end of 2006. Monetary tightening is more aggressive in scenario 2 with the federal funds target rate raised to 5.25% by the end of next year.[4]

[3] Oil intensity can be defined as the amount of oil used in producing one unit of output or GDP.

[4] Scenario 1 reflects that high oil prices have a greater impact on real income, while in scenario 2 there is a stronger pass-through of oil prices to inflation, triggering more aggressive monetary tightening.

Table B1.A
Estimated impact on the Hong Kong economy in 2006

	Scenario 1	Scenario 2
	(Percentage point deviation from baseline)	
GDP	-0.9	-2.4
Consumer price inflation	0.0	-0.5
Unemployment rate	+0.3	+0.7

Source: Staff estimates.

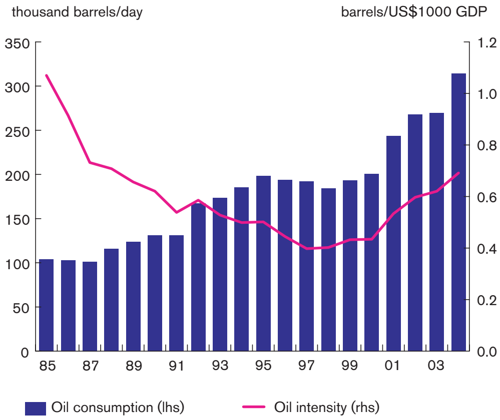
The simulation results are presented in Table B1.A. In both cases, the performance of the Hong Kong economy is adversely affected by a change in global growth and inflation due to higher oil prices. However, working through the effects on consumer spending, investment and asset prices, higher interest rates in scenario 2 cut GDP growth more sharply by 2.4 percentage points, compared with 0.9 percentage points in scenario 1. The effect on the CPI appears smaller, with zero impact in the first scenario and half a percentage point decline in the second. The unemployment rate would increase by 0.3 and 0.7 percentage points in scenarios 1 and 2 respectively.

Rising oil intensity

Oil intensity in Hong Kong is among the lowest in the world, which is often attributed to the high service orientation of the economy. Interestingly, despite the fact that factories remain sparsely located in Hong Kong, oil demand has increased rapidly in recent years. Between 2000 and 2004, oil consumption increased from 201,000 barrels per day to 314,000 barrels, representing a 56% increase (Chart B1.1). A closer look at the statistics suggests that this trend may well continue for some time.

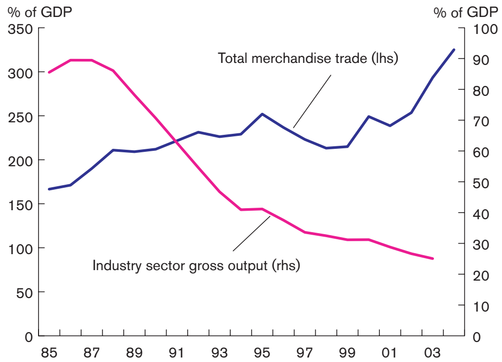
It appears there are two opposite forces at work in determining the oil intensity of the economy. On the one hand, the relocation of manufacturing industries across the border, starting from the mid-1980s, has reduced Hong Kong's oil consumption. The ratio of total gross output of the industry sector (including mining and quarrying, manufacturing, electricity, gas and water, and construction sectors) to GDP fell from about 90% in the mid-1980s to 25% in 2003 (Chart B1.2).

Chart B1.1
Oil consumption and intensity in Hong Kong



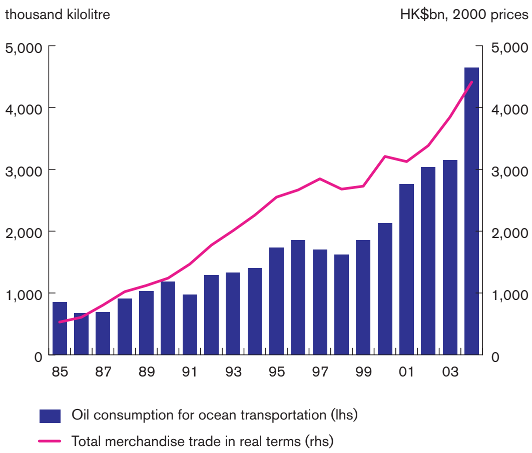
Sources: CEIC, BP and staff estimates.

Chart B1.2
Merchandise trade and industry sectors



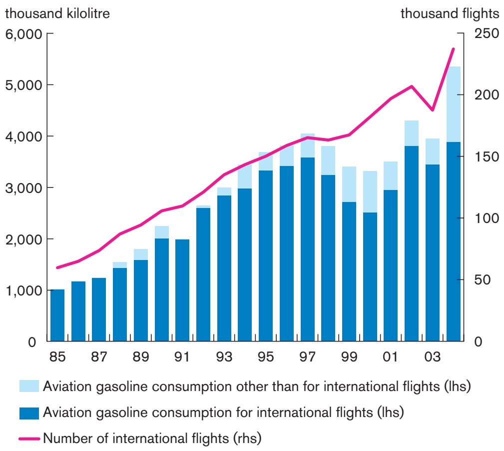
Sources: C&SD and staff estimates.

Chart B1.3
Oil consumption and merchandise trade



Sources: C&SD, CEIC and staff estimates.

Chart B1.4
Fuel consumption and air traffic



Sources: CEIC and staff estimates.

On the other hand, the growth of external trade and air travel has raised oil consumption considerably. During the past two decades, total merchandise trade increased from 167% of GDP in 1985 to 320% of GDP in 2004. Fuel sales statistics show that the increase went hand-in-hand with oil consumption for ocean transportation (Chart B1.3). At the same time, aviation gasoline consumption moved closely in tandem with the number of international flights and, in the past decade, also other flights (mainly domestic and cross-boundary flights by private helicopter operators) (Chart B1.4).

As suggested by the trend in oil intensity, before 1997 the relocation of industries had a greater impact on oil demand. After 1997, the effect of the growth of trade and air travel has become more significant. The resulting increase in oil intensity is unlikely to abate in the foreseeable future in view of the momentum of growth in manufacturing industries in Mainland China, the increasing integration of the Mainland with the global economy, and the rapid growth of the tourism industry locally.

In summary, oil intensity in Hong Kong is still low by world standards. However, it is rising rapidly and it is possible that oil prices could have a more significant direct effect on the domestic economy in the future.

2.2 Domestic demand

Domestic demand picked up in 2005 Q3 after falling for three consecutive quarters (Table 2.A). Private consumption and gross domestic fixed capital formation continued to increase in Q3, while the decline in public sector spending slowed. The pick-up in domestic demand also reflected a rebuilding of depleted inventories, which decreased markedly in the previous four quarters.

Table 2.A
Real GDP growth by expenditure component

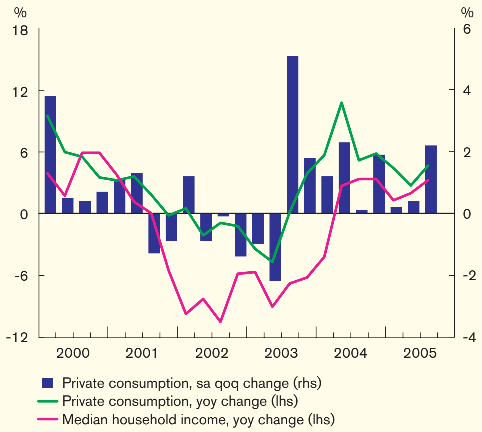
(% yoy)	2003	2004	2004 Q4	2005 Q1	2005 Q2	2005 Q3
Gross Domestic Product	**3.1**	**8.2**	**7.2**	**6.2**	**7.3**	**8.2**
Domestic demand	0.1	4.9	-1.9	-2.3	-0.8	4.4
Consumption						
Private	-1.0	6.8	5.8	4.4	2.7	4.6
Public	1.9	0.7	-1.7	-4.8	-2.3	-1.8
Gross domestic fixed capital formation	0.9	4.1	-1.4	0.4	4.5	2.4
Private	0.8	6.2	-0.8	2.0	8.3	5.1
Public	1.4	-6.0	-4.3	-6.4	-19.9	-14.9
Change in inventories[1]	0.3	-0.4	-4.4	-4.3	-3.2	0.8
Net exports of goods[1]	0.6	0.9	7.4	6.5	5.5	2.5
Net exports of services[1]	2.5	2.9	1.5	1.9	2.5	2.0

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

Consumption

Growth in consumer spending picked up in 2005 Q3, owing to a continued improvement in the labour market and household income (Chart 2.2).[5] In addition, the wealth effect stemming from the strong recovery in the asset markets over the past two years continued to support consumer spending. Private consumption expenditure rose by 4.6% in 2005 Q3 from a year earlier, after increasing by 3.5% in H1. On a seasonally adjusted quarter-on-quarter basis, consumer spending rose markedly by 2.2% in Q3, following a mild increase of 0.4% in Q2.

Chart 2.2
Private consumption and household income



Source: C&SD.

However, the consumption statistics in Q3 have probably not fully reflected the negative effects of the recent increase in interest rates. Higher interest rates tend to increase households' debt-servicing burden and reduce the amount of income available to save or to spend on other goods and services, particularly for households with high mortgage loans. Since March 2005, the best lending rate – a typical benchmark for mortgage interest rate pricing – has increased by 2.5 to 2.75 percentage points from 5% to 7.5%-7.75%. This implies that total monthly repayments of residential mortgage loans could increase by HK$0.8 billion compared with that in March, by assuming an average remaining contractual life of 15 years. This amounts to an equivalent of 1.2% of the monthly private consumption expenditure in Q3.[6]

5 Box 2 reviews the factors contributing to the recovery of private consumption growth in the past two years, and discusses the near-term outlook for consumption growth.

6 A sensitivity analysis based on different remaining contractual life from five years to 25 years indicates that the increases in monthly repayments vary from 1.1% to 1.3% of monthly private consumption expenditure.

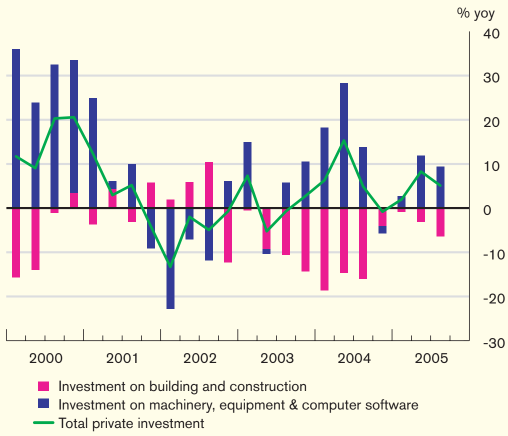
Government consumption expenditure has continued to decline on a year-on-year basis in recent quarters, reflecting the Government's cost saving efforts (Table 2.A).

Investment

Growth in private investment spending slowed to 5.1% year on year in 2005 Q3, from 8.3% in Q2 (Chart 2.3). Spending on machinery, equipment and computer software recorded a slower growth of 9.4% in Q3, compared with 11.8% in Q2, as business sentiment was affected by expectations of further interest rate hikes. Despite a strong recovery in the property market over the past two years, spending on building and construction continued to decline, by 6.3% year on year in Q3. The fall in construction activity was in part due to a sharp reduction in land supply in recent years, particularly the suspension of land sales in 2003 (Chart 2.4).

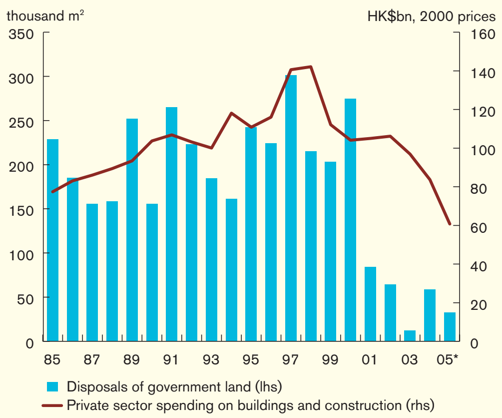
Public sector investment spending continued to decline in 2005 Q3, falling by 14.9% from a year ago. This reflects the scaling down of the Public Housing Programme and the completion of several large railway projects.

Chart 2.3
Private investment by component



Source: C&SD.

Chart 2.4
Spending on buildings and construction and government land disposals[1]

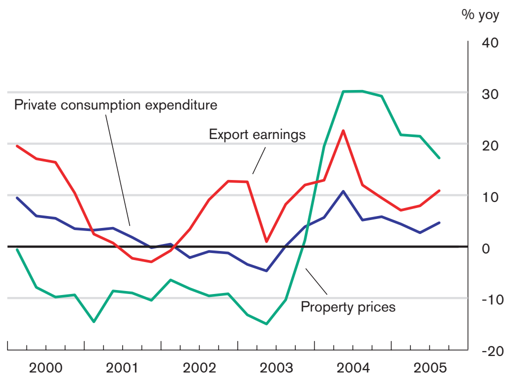


Note: 1. Include sales of land for residential, commercial, and industrial property developments through public auctions and tenders.
2. *2005 Q1-Q3.

Sources: C&SD, Lands Department, and CEIC.

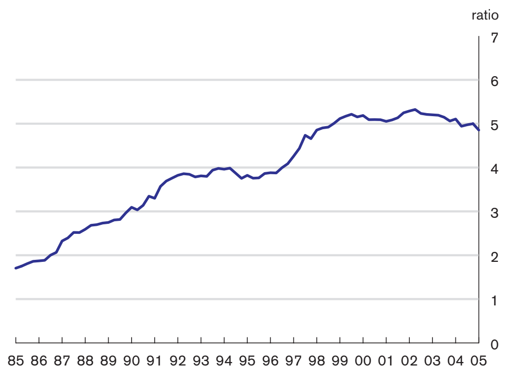
Box 2
Durability of consumption growth

Chart B2.1
PCE, export earnings and property prices



Sources: HKMA, C&SD and Rating & Valuation Department.

Chart B2.2
Debt-to-labour income ratio



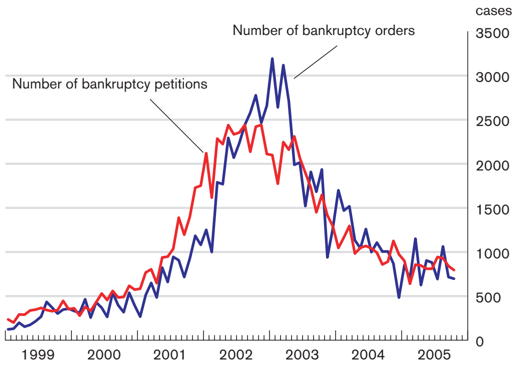
Note: Debt refers to the sum of loans for purchasing residential properties, credit card advances and loans for other private purposes.
Source: CEIC.

Private consumption expenditure (PCE) began to recover in mid-2003, supported by strong export earnings growth and the bottoming-out of property prices (Chart B2.1). In 2004, real PCE rose by 6.8%, the highest yearly growth rate since 1993. However, quarterly statistics suggest that PCE growth has moderated somewhat since the end of 2004. Seasonally adjusted figures indicate a growth rate of 0.9% per quarter during the first three quarters of 2005, implying an annualised rate of only 3.8%, a marked deceleration from 2004. This raises concerns as to whether the recovery of PCE is sustainable.

Since mid-2003, the recovery of PCE has been mainly due to three factors: (1) robust growth in export earnings; (2) the improved financial position of the household sector because of a rebound in property prices; and (3) a low interest rate environment.

The 66%-fall in property prices from their peak between mid-1997 and mid-2003 eroded a substantial part of household wealth, leading to a persistent negative wealth effect on PCE in the post-Asian-financial-crisis period. The rebound in residential property prices by over 50% since July 2003 has turned the situation around. Apart from the rise in property prices, a number of indicators also point to more healthy household sector balance sheets: the debt-to-labour income ratio has declined (Chart B2.2), the number of bankruptcies and of negative

Chart B2.3
Number of bankruptcies



Source: CEIC.

Table B2.A
Decomposition of private consumption growth

	Change			Contribution to change in PCE		
	PCE	Property prices	Interest rates	Property prices	Interest rates	Others
	(per cent)			(percentage point)		
2003 Q3 – 2004 Q4	12.8	39.3	0.1	3.4	-0.2	9.6
2005 Q1 – Q3	2.9	11.0	1.5	1.9	-3.4	4.4

Source: HKMA.

equity cases for mortgage has fallen (Chart B2.3 and Chart 3.17), and the gearing ratio of housing capital has dropped (Chart 3.16).

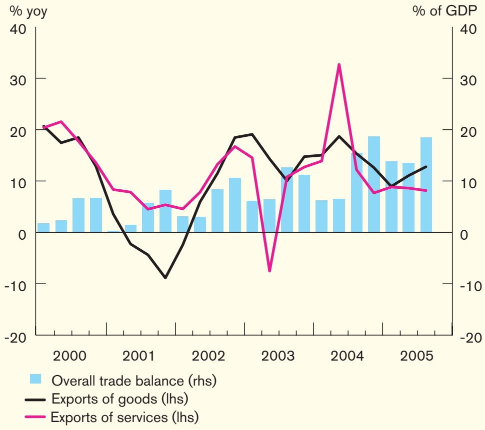
To quantify the contribution of each of the three factors to PCE growth, we utilise the consumption equation of our in-house econometric model. Specifically, private consumption is modelled as a function of income, interest rates, property prices, and equity prices, with the last two variables capturing the wealth effects. Table B2.A shows a decomposition of the contributions of these factors to PCE growth in two different periods - from 2003 Q3 to 2004 Q4 (from recent trough to end-2004), and the first three quarters of 2005.

The table shows that PCE increased by some 12.8% between 2003 Q3 and 2004 Q4, with property prices contributing 3.4 percentage points to the rise, and interest rates -0.2 percentage points. The residual term, "others", representing the effects of income growth and equity price rises as well as the variations unexplained by the model, contributed 9.6 percentage points. In summary, income growth and increases in financial asset prices played the key role in explaining the rebound in PCE during this period.

For the more recent period, 2005 Q1-Q3, as interest rates rose, their negative contribution became larger. However, this was partly offset by a further increase in property prices. The net effect is a much moderated growth in private consumption spending.

PCE is generally expected to continue to increase, albeit at a slower pace than in 2004. Looking ahead, a temporary decline in PCE for one or two quarters cannot be ruled out, depending on external conditions, particularly interest rate changes. However, the risk of a sharp fall or a prolonged slump in PCE is small. The much improved financial position of the household sector should provide support to private consumption.

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



Source: C&SD.

Table 2.B
Total exports of goods by major market[1]

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

Notes: 1. Within the total, re-exports accounted for 94% in 2004.
2. Share in 2004.
3. ASEAN5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand.

Sources: C&SD and CEIC.

2.3 External trade

Exports of goods increased by 2.0% in Q3, on a seasonally adjusted quarter-on-quarter basis, compared with a rise of 6.7% in Q2. While growth in re-exports slowed in Q3, that of domestic exports increased noticeably. The year-on-year growth rate remained robust in Q3, with exports to most major markets recording strong increases (Chart 2.5 and Table 2.B). The recent surge in exports was in part due to an upswing in the electronics demand cycle, which led to an increase in regional electronics trade. Imports of goods rose markedly in Q3 from a year ago, supported by a continuous increase in re-exports and retained imports, although the growth rate moderated somewhat on a quarter-on-quarter basis.

Exports of services increased by 5.7% in 2005 Q3 over the previous quarter (seasonally adjusted), following an increase of 0.9% in Q2. The year-on-year growth rate also remained robust. The strong performance mainly reflected growth in trade-related services, underpinned by buoyant trade flows involving the Mainland. The increase in travel services has slowed in recent quarters. Statistics on incoming tourists indicate that the slowdown was more distinct in visitors from Asia, particularly the Mainland. This was probably due to the deferral of leisure trips to Hong Kong in anticipation of the opening of Hong Kong Disneyland in September. In October, the number of Mainland visitors increased by 3.3% from a year earlier, compared with a decline of 0.5% in Q3. Year-on-year growth in imports of services also picked up in Q3, reflecting mainly increases in trade-related and transport services.

Overall, the trade surplus increased in 2005 Q3 compared with the previous quarter, reflecting increases in both merchandise and service trade balances.

Output and supply

The service sector remained the driver of output growth, particularly in areas related to external trade. The sustained economic recovery has led to an increase in labour demand, resulting in a further decline in the unemployment rate.

2.4 Output

The service sector, which accounts for 90% of GDP, remained the driver of growth in 2005 H1 (Table 2.C).[7] Increasing integration with the Mainland continued to support Hong Kong's trade in goods and services. In 2005 Q2, trade-related services recorded double-digit growth, and the consumption and tourism-related sectors also increased markedly. Output in the manufacturing sector declined in 2005 H1, following a moderate increase in 2004 H2. The construction sector continued to contract.

In terms of contribution to growth, services related to external trade accounted for more than 40% of output growth in 2005 H1 (Table 2.D). The financial and business services industry was the second largest contributor, accounting for about 20% of the total increase.

Table 2.C
Real GDP growth by major economic sector (year on year)

(% yoy)	2003	2004	2004		2005	
			Q3	Q4	Q1	Q2
GDP at factor cost	**3.4**	**7.7**	**6.3**	**6.8**	**5.9**	**6.6**
Industrial sector	-5.1	-2.2	-3.1	1.0	0.3	-1.6
Of which:						
Manufacturing	-10.3	1.7	2.3	3.8	-2.3	-0.1
Construction	-4.9	-8.4	-12.0	-2.0	-0.7	-8.3
Service sector	4.5	8.9	7.5	7.4	6.5	7.5
Of which:						
Wholesale, retail, restaurant and hotel	-6.5	11.0	6.7	6.8	6.3	6.6
Import and export	13.3	13.9	13.7	10.5	12.2	12.8
Transport and storage	-1.6	19.0	17.6	17.3	14.0	13.0
Financing, insurance and business services	6.9	11.1	7.4	9.2	4.5	8.2

Source: C&SD.

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

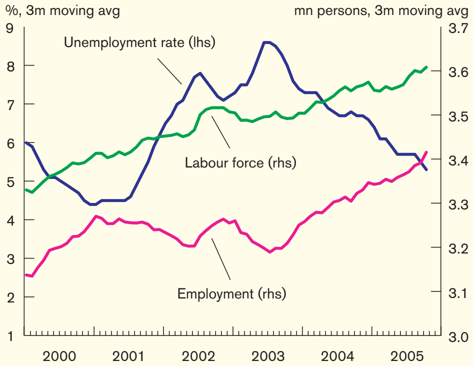
(% point)	2003	2004	2004		2005	
			Q3	Q4	Q1	Q2
GDP at factor cost	**3.4**	**7.7**	**6.3**	**6.8**	**5.9**	**6.6**
Industrial sector	-0.6	-0.2	-0.4	0.1	0.0	-0.2
Of which:						
Manufacturing	-0.4	0.1	0.1	0.1	-0.1	0.0
Construction	-0.2	-0.4	-0.5	-0.1	0.0	-0.3
Service sector	4.0	7.9	6.6	6.7	5.9	6.7
Of which:						
Wholesale, retail, restaurant and hotel	-0.4	0.5	0.3	0.4	0.3	0.3
Import and export	2.6	3.0	3.1	2.4	2.6	2.7
Transport and storage	-0.1	1.4	1.3	1.3	1.1	1.0
Financing, insurance and business services	1.1	1.9	1.2	1.6	0.8	1.5

Source: C&SD.

[7] GDP by economic sector for 2005 Q3 was not available at the time of the publication of this Report.

2.5 Labour and productivity

Chart 2.6
Labour market conditions



Source: C&SD.

The sustained economic recovery further boosted labour demand, resulting in a continued decline in the unemployment rate. Labour productivity again increased in 2005 Q3 reflecting faster growth in output than employment.

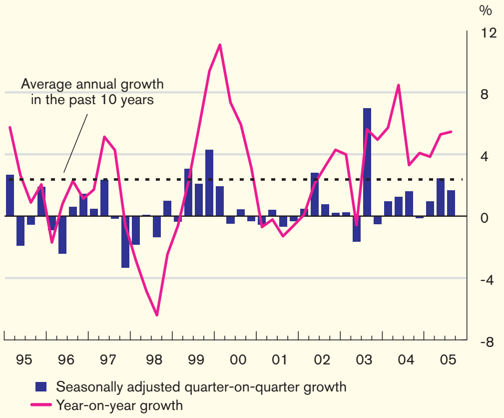
Labour market conditions

Labour market conditions have continued to improve since the June Report. The pace of expansion in employment has picked up in recent months. However, the effect of employment growth on the unemployment rate was partly offset by a rise in the labour force. As a result, the unemployment rate declined to 5.3% in the three months ending October, from 5.9% in the previous six months (Chart 2.6). The relatively stable participation rate suggests that the increase in the labour force was due largely to an expansion in the working-age population during the period. The fall in the unemployment rate was broadly based, with the construction sector recording the largest decline. However, employment in the construction sector was little changed, suggesting a decline in the labour force of this sector.

The Closer Economic Partnership Arrangement (CEPA) between Hong Kong and the Mainland has benefited the labour market. The increasing business opportunities on the Mainland and the Individual Visit Scheme (IVS) have led companies to hire more workers. The Government estimated that about 19,500 new jobs were created under CEPA in 2004.[8] These new jobs, mostly from the IVS, account for one-fifth of the total increase in employment during 2004. In 2005, an additional 9,500 new jobs in the goods and services trade sectors were expected to be created.

[8] Based on a study by the Commerce, Industry and Technology Bureau for information to the Legislative Council's Panel on Commerce and Industry in April 2005 (http://www.legco.gov.hk/yr04-05/english/panels/ci/papers/ci0419cb1-1259-3e.pdf)

Chart 2.7
Output per worker



Sources: C&SD and staff estimates.

The underemployment rate declined to 2.5% in the three months to October, from 3.0% in the six months earlier, as more full-time jobs were created to replace part-time and temporary jobs.[9] The decline was particularly noticeable in the construction, transport, and wholesale and retail sectors.

Productivity

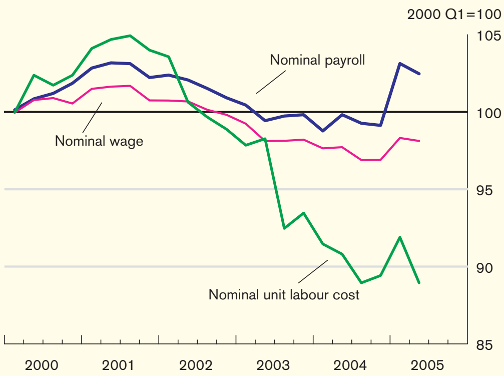
The year-on-year increase in the output per worker – an indication of labour productivity growth – picked up in recent quarters (Chart 2.7). It appears that productivity growth has shown signs of trending up in recent years, following a sharp swing between 1997 and 2000.

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

Prices and wages

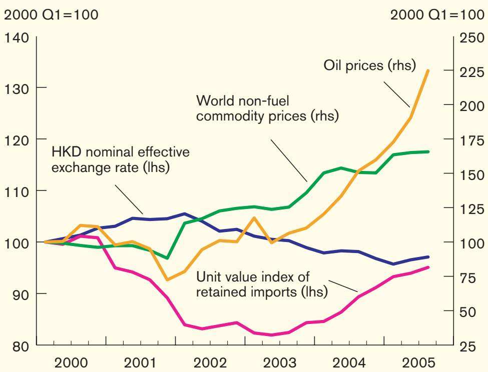
Rises in residential rents have started to feed through into the consumer price index, together with price increases in other goods and services, resulting in a steady rise in inflation since the June Report. Nevertheless, inflationary pressure arising from wage increases remained limited, as labour productivity rose.

Chart 2.8
Wage and payroll indices and unit labour cost



Sources: C&SD and staff estimates.

Chart 2.9
Import prices



Sources: C&SD and Datastream

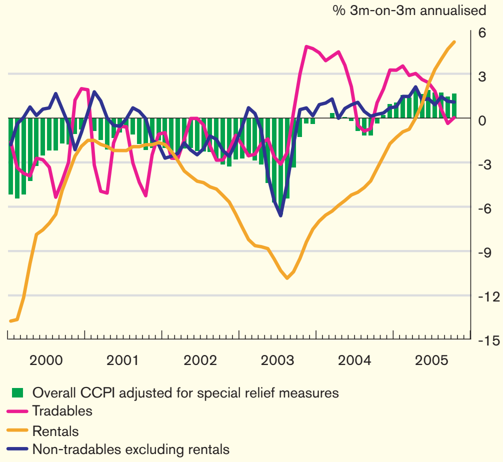
2.6 Labour costs

Increased labour demand has led to rises in wages. The nominal payroll per worker – which includes remuneration and overtime payments, back-pay, and other irregular allowances and bonuses – rose markedly by 4.0% during 2005 Q1, before declining slightly by 0.6% in Q2 (Chart 2.8). On a year-on-year comparison, per worker payroll in Q2 was 2.7% higher than a year earlier, the second straight quarter of increase. The increase was particularly strong in the wholesale, retail, trade, and hotel sectors. However, unit labour costs remained low, suggesting that inflationary pressure stemming from the labour market was still modest.

2.7 Commodity and import prices

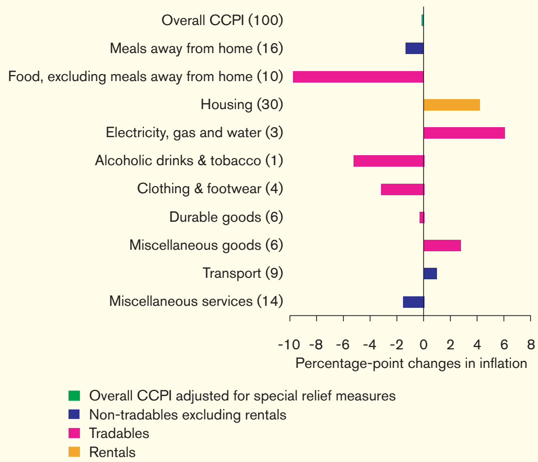
Import prices have risen further since the June Report, but at a more moderate rate. The year-on-year increase in the unit value index of retained imports eased markedly from 10.3% in 2005 Q1 to 6.4% in Q3, despite the rise in oil prices. This reflects a low level of oil intensity in Hong Kong, a much slower increase in non-fuel commodity prices, and an appreciation of the Hong Kong dollar nominal effective exchange rate (Chart 2.9).

Chart 2.10
Consumer price inflation by broad component



Sources: C&SD and staff estimates.

Chart 2.11
Change in 3-month-on-3-month annualised CCPI inflation between April and October 2005



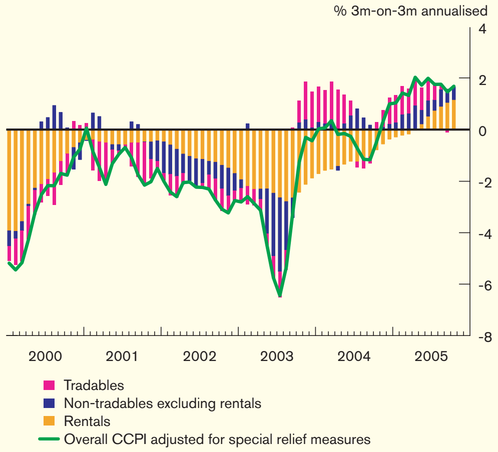
Note: Figures in brackets are the weights in the CCPI.
Sources: C&SD and staff estimates.

2.8 Consumer prices

The headline inflation rate has risen since the June Report, as increases in residential rents have started to feed through into the Composite CPI (CCPI) and prices of other goods and services have continued to rise. The year-on-year increase in the CCPI rose to 1.8% in October, from 0.5% in the previous six months. During the same period, the year-on-year change in the rental component increased from -1.9% to 2.4%.

However, the underlying pressures are likely to have eased. On a seasonally adjusted three-month-on-three-month basis, the annualised inflation rate declined from 1.9% in April to 1.7% in October (Chart 2.10). The rate of change in tradable goods prices has declined markedly in recent months while increases in prices of non-tradables excluding rentals have been broadly stable. At a more dis-aggregated level, the rates of increases in most categories have eased over the past six months, particularly food prices (Chart 2.11). Energy price increases have so far had little effect on overall inflation owing to their low weights in the CCPI.

Chart 2.12
Contribution to consumer price inflation by broad component



Sources: C&SD and staff estimates.

In terms of contribution to overall inflation, the rental component accounted for almost 70% of the total increase in the CCPI in October, and non-tradables excluding rentals made up another 30% (Chart 2.12).

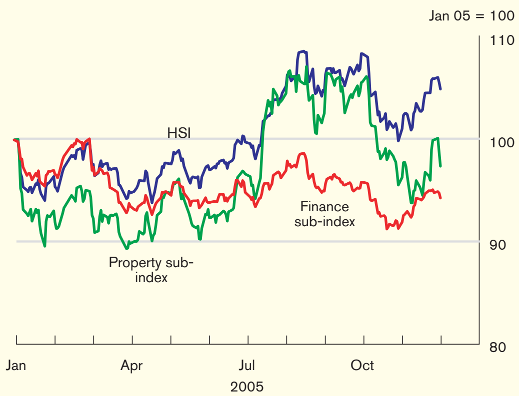
Asset markets

Equity prices increased sharply in the third quarter, but have since declined on expectations of further interest rate rises. Property prices have stabilised in recent months, following a strong recovery in the past two years. Reflecting the increase in mortgage interest rates, housing affordability has worsened in recent quarters and the costs of owner-occupation have exceeded that of house-leasing.

2.9 Equity market

Equity prices increased sharply in 2005 Q3, with the Hang Seng Index advancing by almost 9%. The rally was driven by a number of positive factors including better-than-expected corporate interim reports, the revaluation of the renminbi, and a stronger overall performance of major equity markets abroad. The Index has since declined by 3.2% amid expectations of further interest rate rises in the US. Property stocks suffered the most with the property sub-index declining by 7.8% (Chart 2.13).

Chart 2.13
Hong Kong equity prices

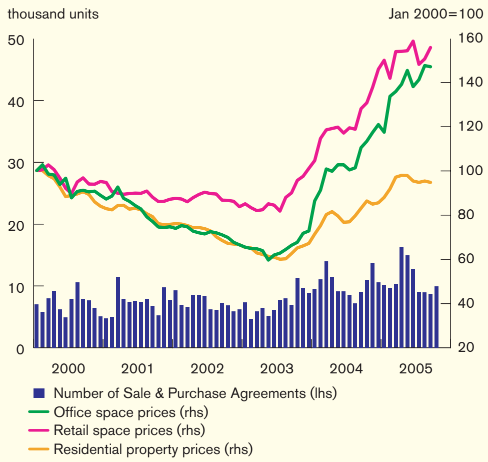


Source: Bloomberg.

2.10 Property market

Higher interest rates have dampened property market activities, as indicated by a moderation in prices and transaction volumes in recent months. Private residential property prices declined by 2.4% during the six months to September, but were still 58% higher than the trough in 2003 (Chart 2.14). Prices of large flats (saleable area of 160m^2 or more) have increased more sharply than indicated by the overall price index, rising by 92% from the trough, with some luxurious flats exceeding the high prices recorded in 1997. For non-residential properties, the recovery has been even more pronounced, with prices of private office and retail space surging from their troughs by about 150% and 90% respectively.

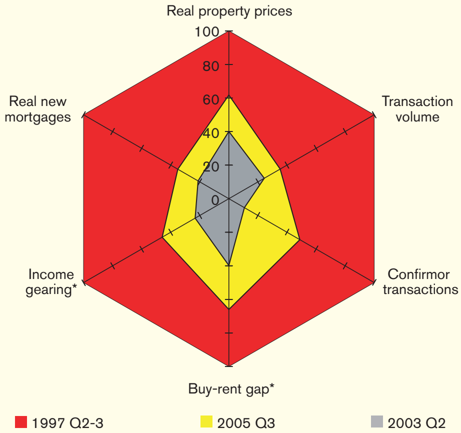
Chart 2.14
Property prices and transactions



Sources: Rating & Valuation Department and Land Registry.

Property transaction volumes – measured by the number of Sale and Purchase Agreements – declined sharply by 39% in Q3 from the previous quarter, but recovered somewhat in October (Chart 2.14). Speculative activity also fell in recent months, as indicated by a decline in the number of confirmor transactions.

Chart 2.15
Graphical analysis



Note:* Based on mortgage interest rates in November 2005, and prices, rents, and household incomes in Q3.

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

An updated graphical presentation, which summarises six key real estate indicators in the form of a hexagon, shows that, by 2005 Q3, conditions in the private housing market remained benign compared with that in 1997 (Chart 2.15).[10] Specifically, real property prices were still 38% below the average level between April and September 1997, although those of large flats (saleable area of 160m^2 or more) have risen to levels below the 1997 peak by 16% on average. However, the risk of an over-extension in the market cannot be discarded, as the 1997 peak was an extreme situation when market conditions were clearly out of line with fundamentals.

Because of rises in mortgage rates and a faster increase in property prices than those in household income and property rentals, housing affordability has worsened in recent quarters and the costs of owner-occupation have exceeded that of renting. The income-gearing ratio (measured as the ratio of mortgage repayment to household income) surged to 29% from 15% in 2003 Q2.[11] The buy-rent gap (measured as the ratio of mortgage repayment to rental) also increased to 133% from 80% during the same period.

On the supply side, the fall in construction activity in the past six years (as noted in Section 2.2) could lead to a reduction in new supply in coming years. However, a supply shortage is unlikely in the near term, as the number of vacant properties remained high. The vacancy rates of private residential properties and office space were 6.2% and 12.7%, respectively, at the end of 2004, compared with averages of 4.5% and 9.8% over the past two decades.

[10] 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.

[11] The mortgage repayment is estimated by assuming a 20-year mortgage on 70% of the purchase price of a representative 50 m^2 flat. The 75th percentile household income, instead of the median household income, is used in the calculation because it better reflects the income level of private housing owners.

Public finances

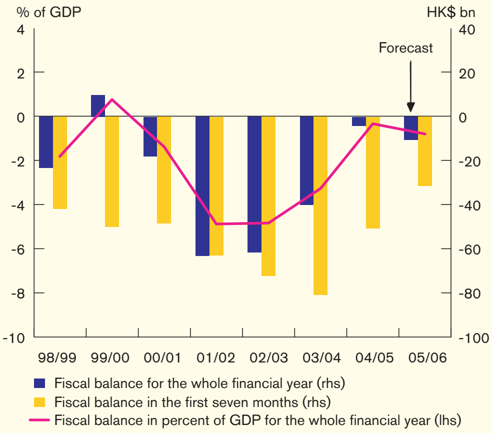
The latest data on the Government's consolidated account suggest that the fiscal position continued to improve, helped by its cost-saving efforts and increase in revenue.

2.11 Public finances

The deficit in the first seven months of the current financial year amounted to HK$31 billion, well below the HK$63 billion average in the same period of the past five years (Chart 2.16). The improvement came mainly from the revenue side, with total revenue increasing by HK$15 billion over the same period in the previous fiscal year. Reflecting the Government's cost-saving efforts, total expenditure declined by HK$4 billion during the same period.

The International Monetary Fund recently projected that, based on current economic trends and the Government's restraint on spending, the budget could return to balance in 2005/06. This is two years ahead of the Government's schedule, which projects a balanced budget by 2007/08.

Chart 2.16
Fiscal performance in the first seven months of the financial year



Note: 1. The 2000/01 balance excludes MTR privatisation proceeds; the 2004/05 balance excludes proceeds from the issuance of government notes and bonds.
2. The 2005/06 whole year balance is the Budget forecast; the balance for the first seven months is the actual outturn.
3. Hong Kong's fiscal year starts in April each year.

Sources: 2005/06 Budget Speech, the Treasury, and staff estimates.

3. Monetary and financial sector

Exchange rate, interest rates and monetary developments

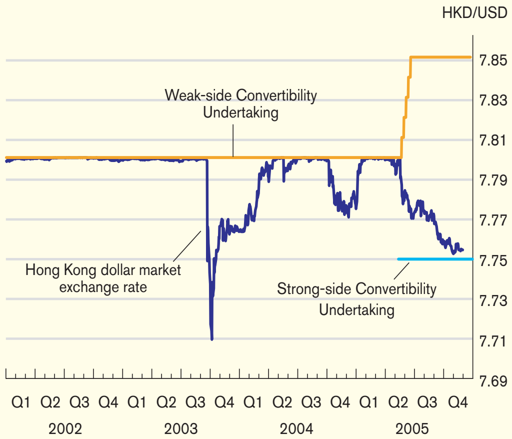
The Hong Kong dollar exchange rate strengthened in recent months, reaching levels close to the strong-side Convertibility Undertaking of HK$7.75 to US$1. Hong Kong dollar interest rates were largely in line with their US dollar counterparts, reflecting the effectiveness of the three refinements to the operation of the Linked Exchange Rate system introduced in May 2005. As the federal funds target rate was raised further by 100 basis points between June and November, Hong Kong dollar interbank interest rates generally rose.

3.1 Exchange rate and interest rates

The Hong Kong dollar exchange rate strengthened steadily against the US dollar between June and November, reaching levels close to the strong-side Convertibility Undertaking (CU) of 7.75 towards the end of November (Chart 3.1). Recent developments continued to be affected by the flow of funds, including that associated with initial public offerings (IPOs). Despite the announcement of a change in the renminbi exchange rate regime by the Mainland authorities in July, the Hong Kong dollar exchange rate was generally stable and did not appear to be affected by the announcement. This suggests that the three refinements to the Linked Exchange Rate system introduced in May are effective in anchoring exchange rate expectations on the strong side.

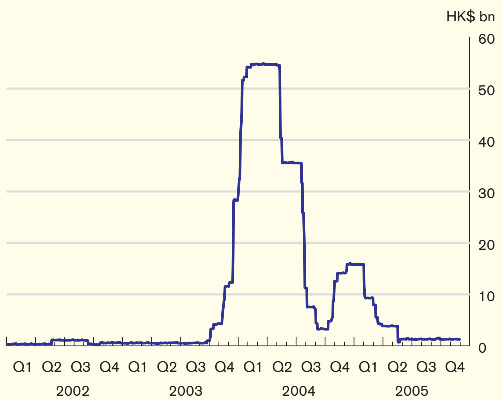
Since the June Report, the Convertibility Undertakings have not been triggered, and the HKMA has not carried out any market operations within the Convertibility Zone. Against this backdrop, the Aggregate Balance stayed around HK$1.3 billion, with small fluctuations due to interest payments on Exchange Fund paper (Chart 3.2).

Chart 3.1
Hong Kong dollar exchange rate



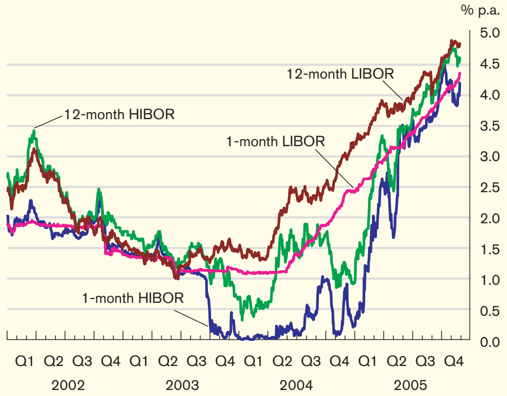
Source: HKMA.

Chart 3.2
Aggregate Balance (before Discount Window Activity)



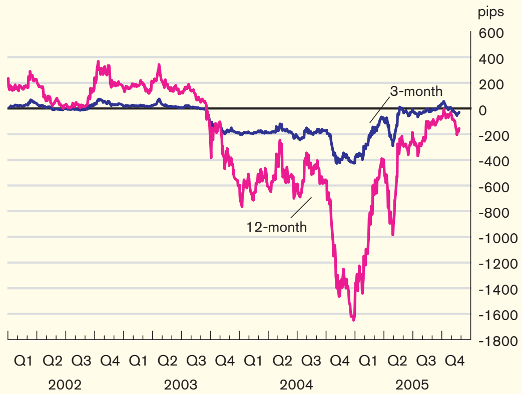
Source: HKMA.

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



Source: HKMA.

Chart 3.4
Hong Kong dollar forward points

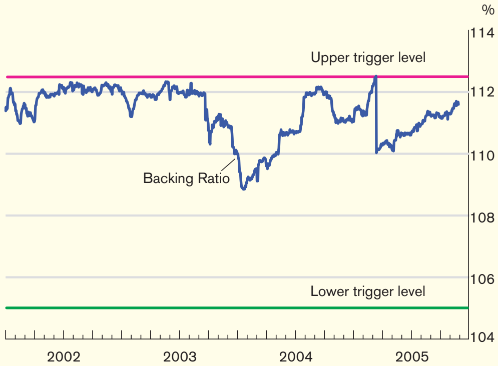


Source: HKMA.

Hong Kong dollar interbank interest rates largely tracked the US dollar interest rates during the period. Between June and November, the US federal funds target rate was raised four times by a total of 100 basis points to 4%. Given the rise in US dollar rates, one-month and 12-month Hong Kong dollar rates generally rose. The interest rate spread between 12-month HIBOR and LIBOR narrowed further towards the latter part of the period, while the one-month Hong Kong dollar rate largely stayed in line with its US dollar counterpart (Chart 3.3). However, during the first half of October and late November, the spreads between HIBORs and LIBORs widened temporarily due to tightened liquidity conditions arising from IPOs. Overnight HIBOR also increased, from 2.75% at the end of May to 4.0% on 30 November.

Reflecting the movements in interest rate spreads, the Hong Kong dollar 12-month forward discount narrowed further (Chart 3.4). With the three refinements, volatility of Hong Kong dollar forward points declined considerably, suggesting that the interest rate adjustment mechanism had become more effective. The Hong Kong dollar 12-month forward discount closed at 155 pips on 30 November.

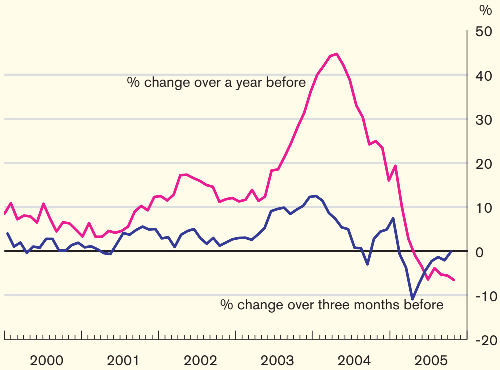
Chart 3.5
Backing Ratio



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

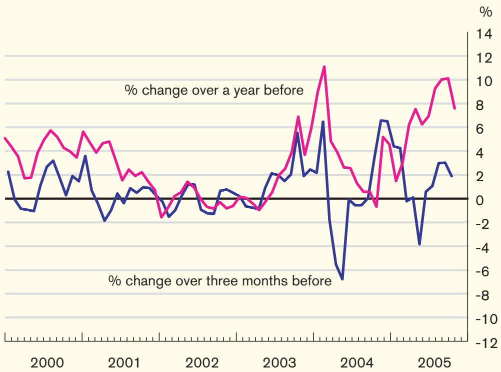
Source: HKMA.

Chart 3.6
Hong Kong dollar narrow money M1



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

Chart 3.7
Hong Kong dollar broad money M3



Source: HKMA.

3.2 Monetary Base and the Backing Ratio

The Monetary Base decreased during the past six months. The market value of outstanding Exchange Fund paper and the Aggregate Balance remained stable, while the outstanding amount of Certificates of Indebtedness and government-issued currency notes and coins declined. The Backing Ratio increased from 110.58% at the end of May to 111.60% on 30 November (Chart 3.5).[12]

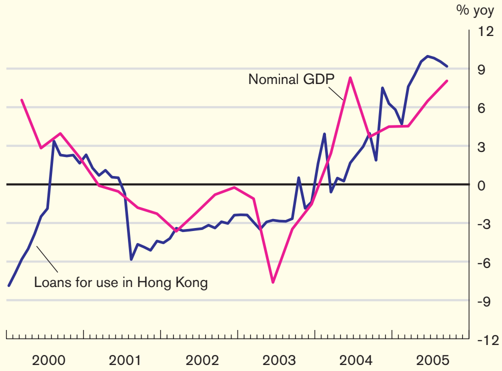
3.3 Money and credit aggregates

Narrow and broad money growth continued to diverge, reflecting in part a shift away from liquid monetary assets to term deposits. In 2005 Q3, Hong Kong dollar narrow money (M1) declined on both a quarter-on-quarter and a year-on-year comparison, attributable mainly to a decline in demand deposits. M1 declined further in October 2005. This is probably a result of the increased opportunity cost of holding non-interest-bearing monetary assets (Chart 3.6).

Hong Kong dollar broad money (M3) increased further during the quarter, registering a rise of 10.1% in the 12 months to September 2005 (Chart 3.7). Strong growth in time deposits, which was associated mainly with higher deposit rates, accounted for a significant part of the increase in M3. Nevertheless, growth in M3 showed some signs of moderation in October.

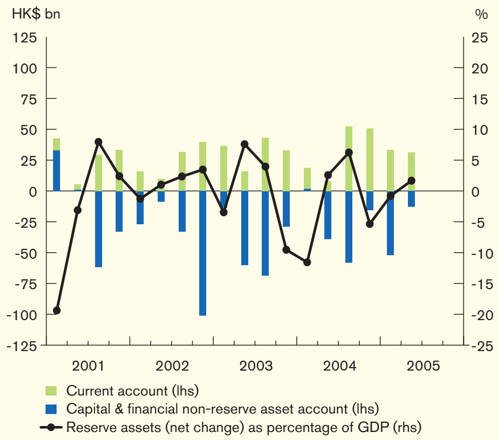
[12] Because the Backing Assets are larger in value than the Monetary Base, matched declines in the two will arithmetically increase the Backing Ratio.

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 Q3	2004 Q4	2005 Q1	2005 Q2
Current Account	10.4	9.9	15.9	14.7	10.4	9.4
Capital and Financial Account	-14.5	-10.6	-11.4	-9.9	-17.0	-2.2
Capital transfers	-0.7	-0.2	-0.4	-0.2	-0.8	-0.5
Financial non-reserve assets (net change)	-13.2	-8.4	-17.2	-4.3	-15.3	-3.5
Direct investment	5.1	-3.4	-1.7	10.9	0.3	1.2
Portfolio investment	-21.5	-19.5	-12.6	15.4	-22.1	-27.5
Financial derivatives	6.3	3.8	2.0	5.5	1.3	1.7
Other investment	-3.3	10.7	-4.9	-36.2	5.1	21.2
Reserve assets (net change)	-0.6	-2.0	6.2	-5.4	-0.8	1.7
Net errors and omissions	4.1	0.7	-4.5	-4.8	6.5	-7.2

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

Source: C&SD.

Loans for use in Hong Kong were virtually unchanged in 2005 Q3 compared with Q2, although the year-on-year rate of growth remained strong at 9.2%, generally in line with the pace of nominal GDP growth (Chart 3.8). The recent increases in interest rates raised the costs of borrowing and debt-servicing burden, possibly suppressing the demand for credit. The subdued quarterly growth also reflected a high comparison base as a result of increases in the earlier periods (see Section 3.7 for a sectoral breakdown of domestic loans).

3.4 Capital flows

Following capital inflows into the Hong Kong dollar in 2004 Q4 and 2005 Q1, the direction of fund flows reversed in 2005 Q2. The Balance of Payments (BoP) statistics show a decline in reserve assets in 2005 Q2, the most recent period for which complete BoP data are available (Chart 3.9 and Table 3.A). The reduction in reserve assets was related to the sale of US dollars for Hong Kong dollars through the Convertibility Undertaking in May 2005, when the three refinements were introduced.

Among the BoP components, the current account remained in surplus in 2005 Q2, underpinned by strong growth in exports of goods and trade-related services, and sustained growth in tourism-related sectors. The current account surplus was equivalent to about 10% of GDP in the first half of 2005.

The (non-reserve) capital and financial account continued to record a net outflow in 2005 Q2, although the volume was much smaller than in Q1. This was due to an outflow in portfolio investment, while there were net inflows in net direct investment and other investment. Within portfolio investment, non-residents' investment in domestic equities increased from 2004 Q3, but was more than offset by residents' investment in foreign equities. The latter was mainly related to increased holdings of non-resident debt securities by banks in Hong Kong.

The "Other Investment" account, which includes mainly offshore loans and deposits of the banking and non-bank sectors, recorded a significant net inflow in 2005 Q2, as placements of deposits into banks in Hong Kong increased, and local residents' placements abroad fell. It should be noted that fund flows related to the other investment account have always been volatile, and the flows reflect the role of Hong Kong as an international banking centre.

The information available so far indicates a rise in reserve assets in 2005 Q3, mainly attributable to inflows related to investment income of the Exchange Fund.

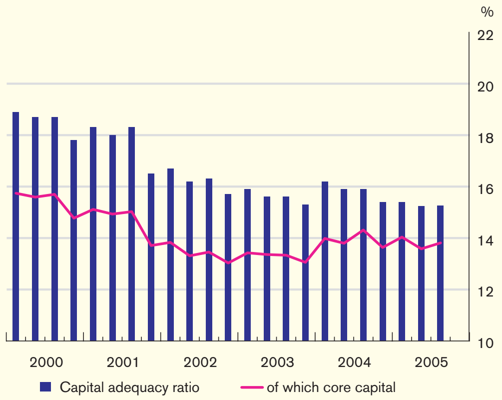
Banking sector performance

Retail banks recorded respectable profit growth in the first three quarters of 2005, due largely to an increase in non-interest income and stabilisation of the net interest margin. Although operating costs have started to rise, the overall cost pressure remains benign. Increases in domestic interest rates have not yet posed significant difficulties to banks, but the associated risk of a slowdown in loan growth remains a concern.

3.5 Profitability and capitalisation

The average consolidated capital adequacy ratio of locally incorporated authorized institutions (AIs) decreased modestly from 15.4% in the June Report to 15.3% at the end of September 2005, reflecting a slightly faster pace of expansion of risk-weighted assets than the capital base (Chart 3.10). Despite the decline, the consolidated capital adequacy ratio still far exceeded the minimum international standard of 8%. Core capital comprised 91% of the capital base and the ratio of core capital to risk-weighted assets was at a high level of 13.8%.

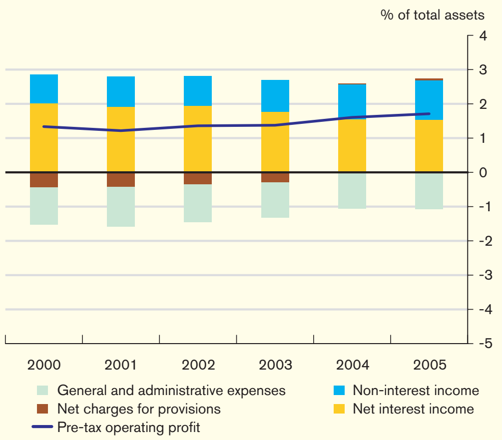
Chart 3.10
Capitalisation of locally incorporated AIs



Source: HKMA.

Retail bank profitability, measured by pre-tax operating profit as a percentage of total assets, increased slightly on an annualised basis in the first three quarters of 2005 (Chart 3.11). Profitability was bolstered by robust growth in non-interest income and stabilisation of the net interest margin, which more than offset higher general and administrative expenses.

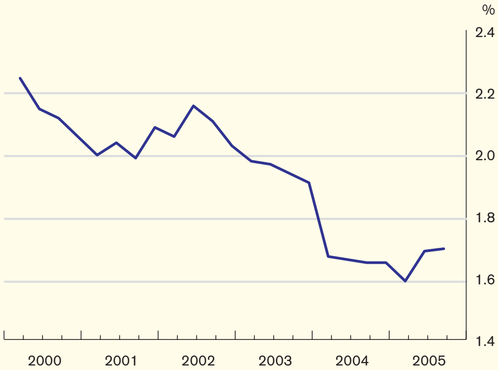
Chart 3.11
Profitability of retail banks



Note: 2005 figure is the annualised figure up to 2005 Q3.
Source: HKMA.

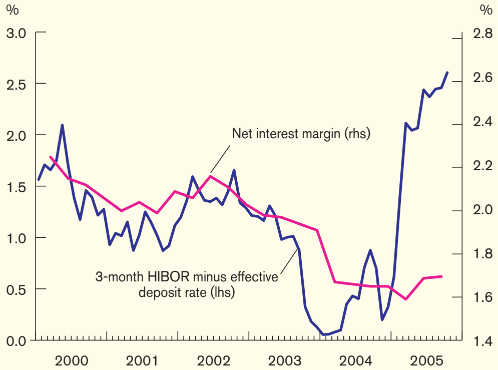
General and administrative expenses (as a ratio of total assets) increased in the first three quarters of 2005, due to higher staff costs arising from salary increases and new hirings, and increases in operating expenses to finance business expansion. Despite the rise, cost pressure does not appear to be a serious concern at this stage.

Chart 3.12
Net interest margin of retail banks



Source: HKMA.

Chart 3.13
Spreads between HIBOR and deposit rate



Source: HKMA.

The decrease in the net interest margin has stabilised since the second half of 2004 (Chart 3.12). A buoyant property market in part helped alleviate competition in the residential mortgage market and eased the pressure on the margin on new mortgage lending. The rise in HIBORs has also improved the yield on free funds (see section 3.6 for details).

3.6 Interest rate risk

Given that the pricing of a sizeable part of interest-bearing assets of banks is on a floating-rate basis, intermediation spreads should remain relatively stable in the face of volatility in interest rates. However, banks have increased their portfolio allocation to fixed-income securities over the past few years, subjecting them to re-pricing risk.

Changes in interbank rates affect interest income directly through HIBOR-based lending. Because retail banks as a whole are net lenders in the interbank market, the rise in HIBORs relative to the effective deposit rate over the past few quarters has raised margins on HIBOR-based lending, thus improving returns on free funds (Chart 3.13). Following the three refinements to the operations of the Linked Exchange Rate system on 18 May, the catch-up of HIBORs to LIBORs and the adjustments of domestic best lending rates to reflect rate hikes in the US have proceeded more quickly, supporting the net interest margin.

Although the rises in domestic interest rates seem to be favourable to the net interest margin, the risk of sharp increases in the domestic interest rate hindering domestic loan growth remains a cause for concern.

3.7 Credit risk

Credit exposures

Loans for use in Hong Kong were little changed in 2005 Q3, but grew strongly by 9.2% compared with a year ago. Loans analysed by economic uses were mixed on a quarter-on-quarter comparison (Table 3.B). Within property-related loans, credit for building, construction, property development and investment expanded for the fourth consecutive quarter, underpinned by increased residential development and commercial property investment. However, the outstanding stock of residential mortgage loans fell slightly during the quarter, as repayments on existing mortgage loans more than offset new loans. Reflecting a moderation in property prices and transaction volumes, the amount of new mortgage loans has declined markedly since the June Report (Chart 3.14). Overall, the share of property-related loans in total domestic lending remained at around 51% in Q3.

Within the other sectors, loans for information technology registered the biggest quarter-on-quarter increase, followed by credit card advances and lending to financial concerns. There was a decline in lending to stockbrokers, the wholesale and retail trade and the manufacturing sector.

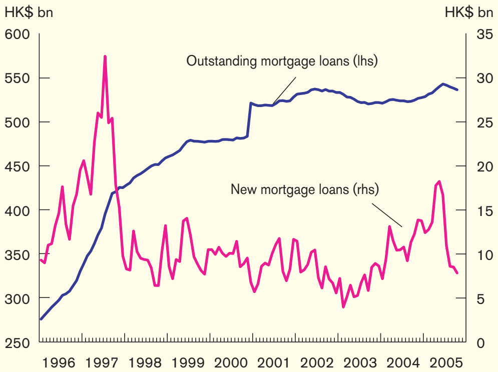
Table 3.B
Loans for use in Hong Kong

	Quarter-on-quarter change (%)				Share of total (%)
	Dec-04	Mar-05	Jun-05	Sep-05	Sep-05
Loans for use in Hong Kong[1]	3.2	1.6	4.2	0.0	
Of which:					
Trade financing	1.0	2.4	12.2	-1.4	7.2
Mortgages[2]	0.2	0.6	1.1	-1.1	30.2
Manufacturing	6.4	8.1	10.1	-2.1	5.8
Transport and transport equipment	-0.1	-0.5	1.2	0.9	5.9
Electricity and gas[3]	-3.6	4.1	37.9	-5.3	1.4
Information technology[3]	-7.7	0.1	20.2	38.6	1.3
Building, construction, property development and investment	7.6	4.3	2.7	2.1	20.7
Wholesale and retail trade	0.4	-0.6	6.7	-2.3	5.0
Financial concerns[4]	6.5	-0.8	3.4	2.2	8.6
Stockbrokers	5.7	5.8	10.9	-7.8	0.5
Credit card advances	9.6	-2.0	0.0	5.6	2.6

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

Source: HKMA.

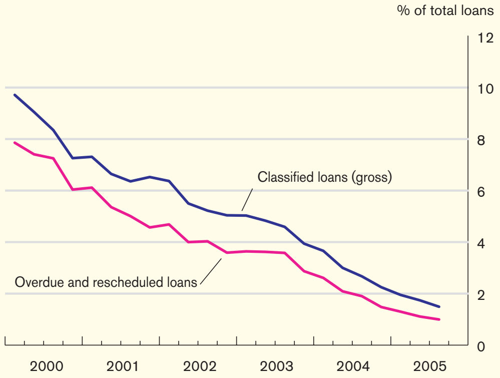
Chart 3.14
Outstanding and new mortgage loans of surveyed AIs



Note: The marked jump in the outstanding mortgage loans in late-2000 reflected a change in the coverage of banks in the survey.

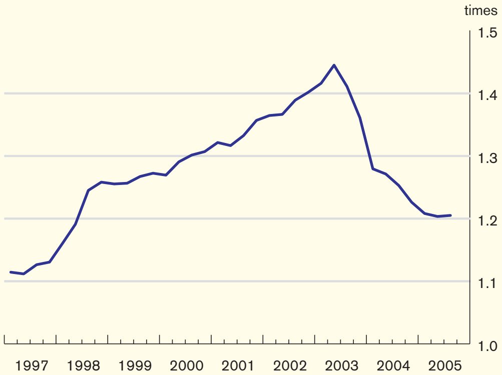
Source: Monthly Survey of Residential Mortgage Lending.

Chart 3.15
Asset quality measures of retail banks



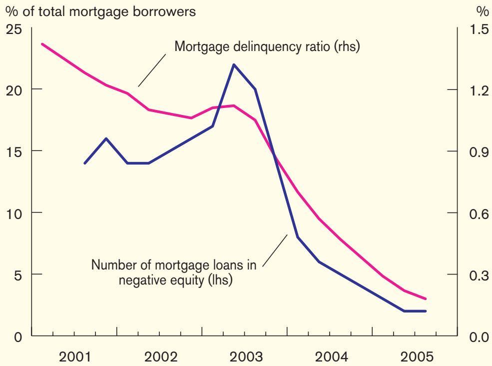
Source: HKMA.

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.

Asset quality

Asset quality continued to improve amid stable conditions in the domestic economy and the property market. Box 3 provides an assessment of credit risks based on data of listed companies. The proportion of classified loans and that of overdue and rescheduled loans in total loans decreased further in 2005 Q3 (Chart 3.15). Separately, the charge-off ratio for credit card receivables dropped from an annualised rate of 3.18% in the June Report to 2.95% in 2005 Q3.

The rebound in property prices in recent years has strengthened the balance sheets of households, thereby improving the quality of banks' mortgage portfolio. The effective housing capital gearing, defined as the ratio of market value of total housing stocks to their net asset value (i.e. the market value subtracted by outstanding mortgage lending from banks), has decreased substantially since 2003 (Chart 3.16). The percentage of residential mortgage loans in negative equity in the total number of mortgage borrowers has continued to decline since the June Report. The mortgage delinquency ratio dropped to 0.18% in September 2005 (Chart 3.17).

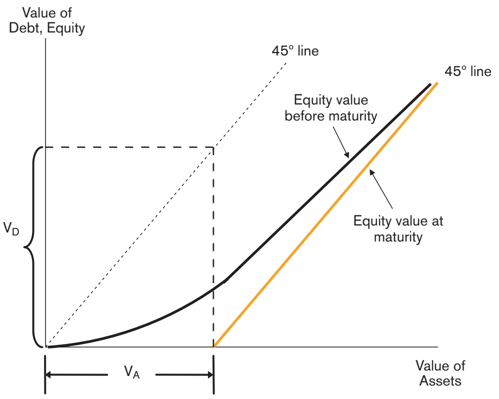
Box 3
A structural approach to assessing the credit risk of Hong Kong's corporate sector

The assessment of the credit risk of the non-financial corporate sector has become part of a broad financial stability monitoring and surveillance framework adopted by central banks in recent years. Among different methods for measuring the default risk of corporations, the Merton's structural approach has gained popularity with central banks and international organisations.

The Merton approach

The Merton model combines the elements of a company's (a) asset value, (b) leverage, and (c) business risk (or asset volatility) to form a measure of default risk. For a company whose capital structure only comprises debt and equity, the equity component can be regarded as a call option written on its underlying assets with the strike price being the book value of its debt. Chart B3.1 provides an example. At the time when the debt matures, the value of the equity, like an option, depends on the final value of the asset.[13] When the value of the asset (V_A) is less than the value of the debt (V_D), the option becomes worthless and the company is considered to be in default. Before the debt matures, the equity still has value (shown as the curve in Chart B3.1) even if the value of the asset is below that of the debt.[14] The company's equity price thus contains information about the probability of the value of its assets falling below the book value of its debt at the end of a specific period of time, which is equal to the default risk of the company. Using market data of equity values and accounting data, the default probability at the end of a period of time t (PD_t) is, according to the Merton model, given by:

Chart B3.1
Value of assets, equity and debt

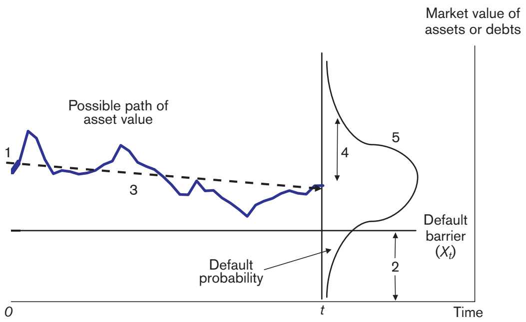


$$PD_t = N\left[- \frac{\ln \frac{V_A}{X_t} + \left(\mu - \frac{\sigma_A^2}{2}\right)t}{\sigma_A \sqrt{t}} \right] \quad (1)$$

[13] The payoffs to the shareholders of a company are similar to those they would have received from a purchased call option on the value of the company with a strike price given by the amount of debt outstanding.

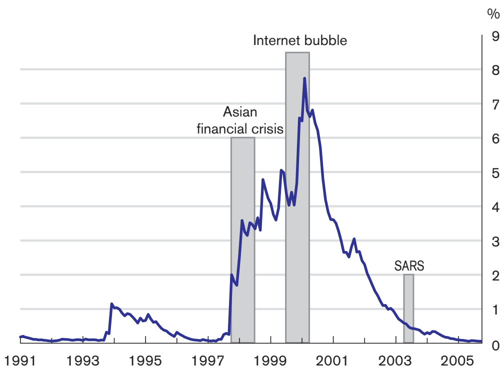
[14] This is similar to the time value of an option before its expiry date.

Chart B3.2
Asset value, default barrier and default probability



Notes: 1. The current market value of assets (V_A).
2. The level of default barrier, i.e. the book value of debts due at time t (X_t).
3. The expected rate of growth in the asset value (μ).
4. The volatility of asset (σ_A).
5. The distribution of asset value (N(0.1)).

Chart B3.3
Aggregate default probability of HSI non-financial constituent companies



Note: Shaded areas represent major events or crises.
Source: HKMA staff estimates.

where V_A is the current market value of the company's assets, μ and σ_A are the drift rate and volatility of V_A respectively, X_t is the book value of its debt due at time t (the default barrier), and N is the standard cumulative normal distribution (N(0,1)).[15] See Chart B3.2 for an illustration.

Aggregate default probabilities of Hong Kong companies

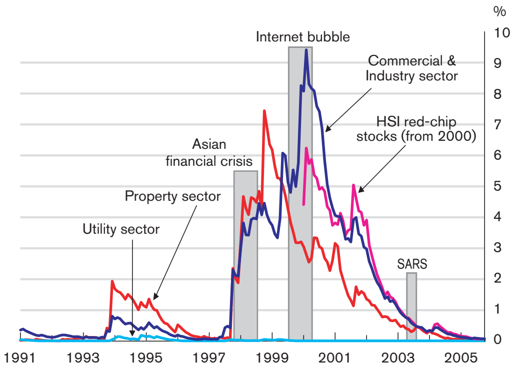
To apply the Merton model for monitoring the Hong Kong corporate sector, PDs in the coming 12 months of publicly listed non-financial companies of the Hang Seng Index (HSI) are estimated. The aggregate PD of the HSI non-financial constituent companies and its three constituent sectors are constructed by summing up the PDs of individual companies, weighted by their market capitalisations.

The aggregate PD of the HSI non-financial constituent companies is depicted in Chart B3.3. It shows that the aggregate PD started to climb in mid-1997, jumping from 0.25% to about 5% during the Asian financial crisis. In the few months before the internet bubble burst in late February 2000, the PD rose sharply from 4% in October 1999 to a high of 7.7% in February 2000.[16] The sharp rise prior to the bursting of the bubble suggests that the PD may serve as an early warning signal for monitoring potential vulnerability in the corporate sector. Since 2004, the likelihood of corporate default has eased substantially.

[15] For details, see Yu and Fung (2005), "A Structural Approach to Assessing the Credit Risk of Hong Kong's Corporate Sector", *HKMA Research Memorandum*, http://www.info.gov.hk/hkma/eng/research/RM24-2005.pdf.

[16] The market capitalisation of the Internet Stock Index, an authoritative and widely cited index for publicly traded internet stocks in the US, fell in value by approximately 45% from February to May 2000, signalling the bursting of the internet bubble.

Chart B3.4
Aggregate default probabilities of HSI constituent sectors

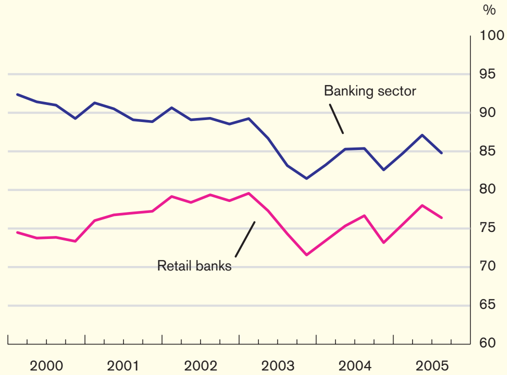


Note: Shaded areas represent major events or crises.
Source: HKMA staff estimates.

To reveal areas of vulnerability within the HSI constituent sectors, similar PDs are derived for the HSI red-chip constituent stocks, as well as the property sector, the commercial & industry sector, and the utility sector.[17] Chart B3.4 presents their aggregate PDs. The first observation from the chart is the resilience of the utility sector in terms of its financial health and soundness. Its PD consistently stays at a low level throughout the period 1991 - 2005. PDs of the property sector and the commercial & industry sector rose sharply during the Asian financial crisis. The further increase in default risk of the property sector after the crisis might reflect the continuous slump in the property market and the relatively high leverage of property developers' balance sheets. In early 2000, the default risk of the commercial & industry sector rose substantially to as high as 9.4%. In fact, the rise in its default risk outweighed the credit improvement in the property sector, leading to the sharp increase in the default risk of the aggregate HSI companies during the internet-bubble period. The PDs of the red-chip companies were consistently higher than those of the other HSI constituent sectors. However, the differences have narrowed since 2003.

[17] Note that the finance sector of the HSI is excluded in this study. Red-chip stocks represent claims on companies that are incorporated in Hong Kong, listed on the Hong Kong Stock Exchange and have at least 35% of their shareholdings held, directly or indirectly, by state-owned organisations or provincial or municipal authorities in the Mainland. The data series used here starts from 2000 as there was only a small number of red-chip companies included in the HSI before 2000.

Chart 3.18
Hong Kong dollar loan-to-deposit ratios



Source: HKMA.

3.8 Liquidity

The average liquidity ratio of retail banks was 45.9% in Q3, substantially higher than 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 abundant in the banking sector, and the Hong Kong dollar loan-to-deposit ratio was still low at the end of September at 84.8% for the banking sector as a whole, and at 76.4% for retail banks (Chart 3.18).

3.9 Foreign currency position

The overall foreign currency position, including both spot and forward, for all AIs increased slightly from the June Report to HK$14.8 billion at the end of September 2005, but remained on a downward trend from a recent high of HK$98.5 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 the total assets of banks, seems 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] (%)

	Sep-04	Jun-05	Sep-05
Interest rate[2]			
1-month HIBOR	0.42	2.66	3.46
3-month HIBOR	0.69	2.73	3.62
BLR and 1-month HIBOR spread	4.59	2.80	3.12
BLR and 3-month HIBOR spread	4.32	2.73	2.96
		Retail banks	
Balance sheet developments[3]			
Total deposits	1.9	-0.3	1.9
Hong Kong Dollar	0.1	-0.2	2.2
Foreign currency	4.7	-0.5	1.5
Total loans	1.1	3.4[r]	0.2
Loans to customers inside Hong Kong[4]	1.3	3.7	-0.5
Loans to customers outside Hong Kong[5]	-3.5	-3.8	19.7
Negotiable instruments			
Negotiable certificates of deposit issued	7.1	0.4[r]	0.4
Negotiable debt instruments held	6.2	3.8	0.6
Asset quality[6]			
As percentage of total loans			
Pass loans	92.35	95.05[r]	95.26
Special mention loans	4.98	3.21	3.25
Classified loans (gross)[7]	2.67	1.74[r]	1.49
Classified loans (net)[8]	1.95	1.20[r]	1.06
Overdue > 3 months and rescheduled loans	1.90	1.11[r]	1.00
Non-performing loans[9]	2.02	N.A.	N.A.
Profitability[10]			
Bad debt charge as percentage of average total assets	-0.03[r]	-0.02	-0.05
Net interest margin	1.65	1.64[r]	1.66
Cost income ratio	41.6	40.9[r]	41.1
Liquidity ratio[2]	43.7	45.8	45.9
		Surveyed institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	0.47	0.22	0.18
Credit card receivables			
Delinquency ratio	0.55	0.40	0.39
Charge-off ratio — quarterly annualised (adjusted)	4.51	3.27	2.95
— year-to-date annualised	5.31	3.19	3.05
		All locally incorporated AIs	
Capital adequacy ratio (consolidated)	15.9	15.2[r]	15.3

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

Markets generally expect global growth to remain robust and inflationary pressure to be contained in 2006. In Hong Kong, growth is expected to continue, albeit at a slower pace, and inflation is likely to rise moderately, in part reflecting continued pass-through of increases in market rents to the Consumer Price Index. There are a number of uncertainties and risks to the outlook. These relate to high oil prices, monetary tightening in the US, global imbalances, trade protectionism against Mainland China, and the possibility of an avian flu pandemic. Overall, the risks to Hong Kong's monetary and financial stability remain limited.

4.1 Global outlook

Global growth is expected to remain robust, despite moderation from the buoyant levels of 2004 in the wake of high oil prices and rising inflationary pressures. In its September World Economic Outlook, the International Monetary Fund (IMF) maintained its forecast of global growth at 4.3% for 2005, compared with 5.1% in 2004 and the historical average of 3.5% over the past two decades. The World Bank has revised upwards its forecast for global growth to 4.4% in 2005 from a previous estimate of 4.2% (Table 4.A). Growth is expected to be maintained at a somewhat steady pace in 2006. Both the IMF and the World bank project global growth of 4.3% for the year, similar to the level for 2005. The Consensus Forecasts also project real GDP in 2006 to grow at a similar rate as that in 2005.

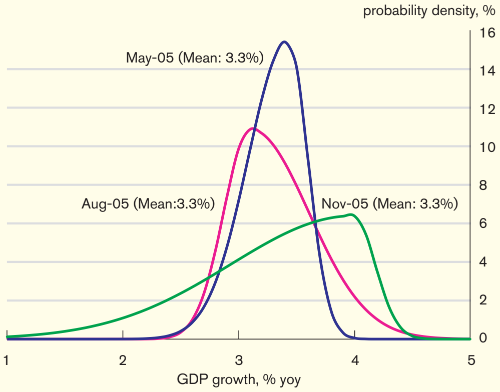
Table 4.A
Global growth and inflation 2004-06

(% yoy)	IMF			World Bank[1]		
	2004	2005F	2006F	2004	2005F	2006F
Global growth[2]	**5.1**	**4.3**	**4.3**	**5.0**	**4.4**	**4.3**
	(5.1)	**(4.3)**	**(4.4)**	**(4.9)**	**(4.2)**	**(4.1)**
US	4.2	3.5	3.3	4.2	3.5	3.5
Euro area	2.0	1.2	1.8	1.7	1.1	1.4
Japan	2.7	2.0	2.0	2.6	2.3	1.8
Emerging Asia	7.9	7.3	6.9	8.3	7.8	7.6
Global inflation	**3.7**	**3.9**	**3.7**	n.a.	n.a.	n.a.
G-7 economies	2.0	2.1	2.1	1.7	2.2	2.0
Emerging Asia	4.0	3.9	4.4	n.a.	n.a.	n.a.

Note 1: Growth in emerging Asia covers developing countries in East Asia and the Pacific region.
2: Global gowth is weighted by GDP at PPP exchange rates. For other aggregates and countries, the IMF uses PPP exchange rates, while the World Bank uses market exchange rates. Figures in brackets are previous forecasts.

Sources: IMF World Economic Outlook (Sep-05) and World Bank Global Economic Prospects 2006.

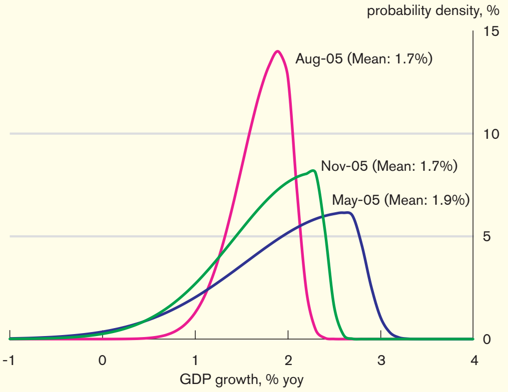
Chart 4.1
US: probability distribution of growth forecasts for 2006



Source: Staff calculations based on Consensus Forecasts.

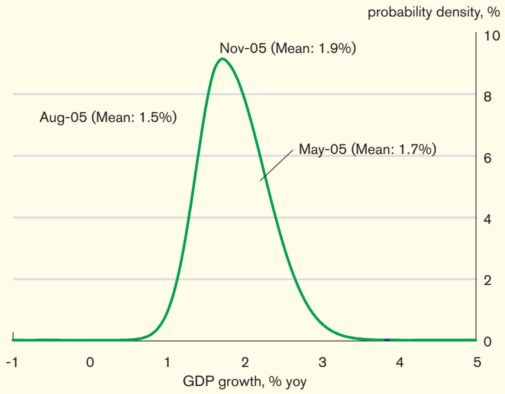
In the US, higher interest rates are expected to reduce consumption and investment growth. The IMF projects real GDP growth to slow to 3.5% this year and further to 3.3% in 2006. The mean of Consensus Forecasts for US growth in 2006 has remained unchanged at 3.3% since May this year, but the distribution of forecasts has tilted to the upside in its latest survey (Chart 4.1). While high debt levels together with rising interest rates will continue to put a strain on household budgets, the recent decline in energy prices has increased the chance of a rebound in consumer confidence in the coming quarters.

Chart 4.2
Euro area: probability distribution of growth forecasts for 2006



Source: Staff calculations based on Consensus Forecasts.

Chart 4.3
Japan: probability distribution of growth forecasts for 2006



Source: Staff calculations based on Consensus Forecasts.

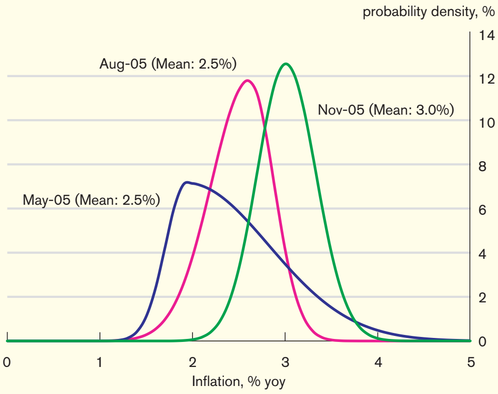
While the mean of Consensus Forecasts for euro area growth in 2006 has remained unchanged at 1.7% since August this year, the distribution of forecasts has tilted slightly to the upside in its latest survey (Chart 4.2). Although private consumption will continue to be affected by weakness in the labour market, the economic recovery appears to have picked up momentum in recent months, as suggested by the stronger-than-expected growth in Q3.

In Japan, the mean forecast for growth in 2006 has been revised upwards to 1.9% from 1.5% in August, and the distribution has become less dispersed (Chart 4.3). Retail sales have been holding up so far, and the recovery in the labour market, together with expectations that Japan is close to ending its long struggle with deflation, will continue to support consumer spending. Investment growth is expected to be underpinned by high corporate profits and improvements in business sentiment. At the same time, continued strong growth in Mainland China should bode well for Japanese exports.

The Consensus Forecasts in November suggest that the real GDP growth on the Mainland will slow to 8.4% in 2006 from 9.4% this year. Growth in fixed asset investment is also expected to moderate in 2006, declining from 24% to 18.3% over the same period, mainly due to over capacity and shrinking profit margins in formerly “overheated” sectors and easing shortage in “bottleneck” sectors. Export growth may face some downward pressure as well, due to factors such as a stronger renminbi (RMB), a capped growth in textile exports to the EU and the US, and other trade protectionist measures against Chinese exports. On the positive side, consumer spending is expected to be supported by a set of policy measures that will be implemented from next year to stimulate domestic demand, as outlined in the 2006-2010 five-year plan. These policy measures include raising the threshold of exemption of personal income taxes, eliminating the agriculture tax, raising minimum wages, strengthening the social security system, and increasing fiscal spending on education and health in the rural sector. They represent a gradual policy shift from the previous over reliance on exports and investment to more dependence on private consumption and domestic demand. The effort should also help resolve the current global economic imbalances.

In other emerging Asian economies, the IMF and the World Bank expect growth to decelerate to 7.3% and 7.8% respectively in 2005, from around 8% in 2004, and to slow further in 2006. This partly reflects an expected slowdown in growth in the US and Mainland China, which will reduce export growth in the region. Nevertheless, the likely slowdown in regional export growth could be mitigated by the strength of the economic recovery in Japan, which is an important market for many Asian economies.

Chart 4.4
US: probability distribution of inflation forecasts for 2006



Source: Staff calculations based on Consensus Forecasts.

Global consumer price inflation is projected by the IMF to rise to 3.9% in 2005 from 3.7% in 2004, reflecting mainly higher oil prices. For the US, the mean of Consensus Forecasts for CPI inflation in 2006 has been revised upwards to 3.0% from a previous forecast of 2.5% (Chart 4.4). However, inflation is expected to remain benign in 2006, compared with the level in 2005. The IMF forecasts global consumer price inflation to ease back to 3.7% in 2006, while the Consensus Forecasts project inflation to stay relatively flat for the same year.

The outlook for global financial markets in 2006 will likely be characterised by higher interest rates and exchange rate volatility. In the US, the next Federal Reserve Chairman, Ben Bernanke has indicated that he will continue to build on the course set by Alan Greenspan in formulating monetary policy. Futures prices suggest that the federal funds target rate will rise to 4.25% in December this year, and increase further to 4.75% by 2006 Q2. Long-term interest rates, as measured by the yield on 10-year Treasury bonds, also climbed to 4.48% at the end of November, the highest since June 2004. In the euro area, there is increasing likelihood the ECB will tighten monetary policy next year. There is also increased speculation over the ending of the quantitative easing policy by the Bank of Japan in 2006 if core CPI inflation rises above zero. In the rest of East Asia, central banks are expected to tighten monetary policy further next year amid generally rising inflation.

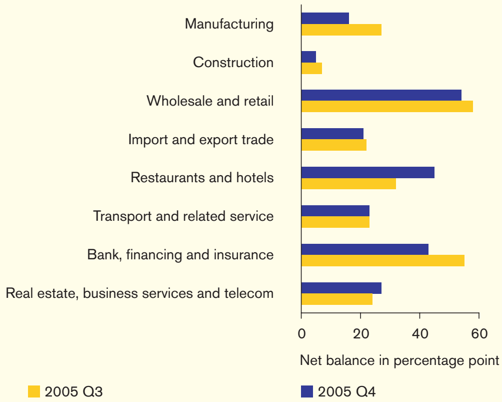
The US dollar has strengthened since September this year, supported by the widening of growth and interest rate differentials in favour of the US. It appreciated by 1.4% in nominal effective terms in the three months ending November. However, high oil prices and a stronger US dollar may worsen the US current account deficit, increasing the risk of exchange rate re-alignment should market sentiment reverse.

4.2 Domestic outlook

The near-term outlook for the Hong Kong economy remains positive. According to the Quarterly Business Tendency Survey, all sectors of the economy expect the volume of business and output to expand in 2005 Q4 (Chart 4.5). However, except for two sectors (the restaurants and hotels sector and the real estate, business services and telecom sector), the balance of respondents with positive views outweighing the negative ones declined compared with that in Q3. This suggests that companies in Hong Kong have become more cautious about their near-term business prospects. Consistent with the Business Tendency Survey, the Purchasing Managers' Index also fell to 50.1 in November (Chart 4.6).

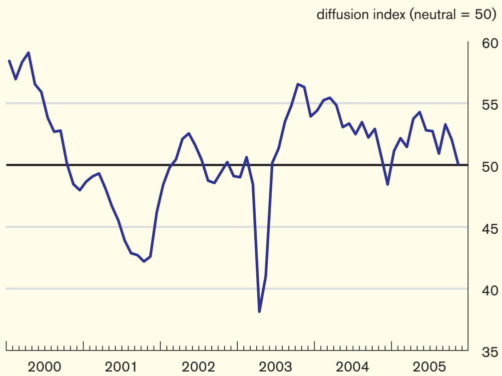
Reflecting the solid performance in 2005 Q3, the Government revised upwards its growth forecast for 2005 to 7.0% in November, from 4.5%-5.5% in August. However, the latest official forecast implies a moderation in growth in the final quarter, to 6.2% year on year. For consumer price inflation, the Government revised downwards its forecast to 1.2% from 1.5%.

Chart 4.5
Results of Business Tendency Survey: Views on expected changes in volume of output in 2005 Q3 and Q4



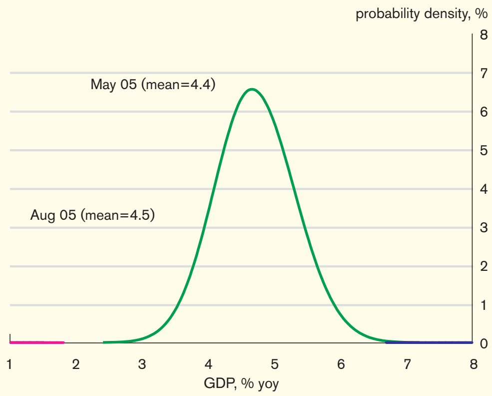
Note: Net balance refers to the difference between the percentage of respondents expecting a rise over those expecting a decline.
Source: C&SD.

Chart 4.6
Purchasing Managers' Index



Source: NTC Research.

Chart 4.7
Hong Kong: probability distribution of growth forecasts for 2006



Source: Staff estimates based on market consensus.

Growth is expected to continue in 2006, although at a more moderate rate. The forecasts by international organisations and private institutions averaged at 4.7% in November 2005 (Chart 4.7).

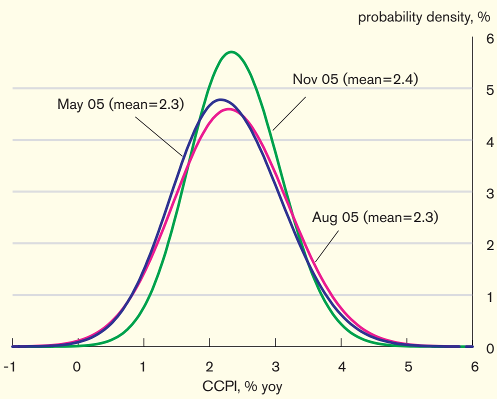
The expected slowdown in growth reflects mainly increases in interest rates and slower growth in Hong Kong's major trading partners. Interest rate increases will raise funding costs and debt-service burdens and affect consumer and business sentiments. Export growth is expected to moderate on slower growth in the US and Mainland China.

However, the Hong Kong economy will continue to be supported by some positive factors. First, the improved trade competitiveness brought about by the depreciation in the real effective exchange rate over the past three years will support Hong Kong's export growth.

Secondly, the third phase of CEPA, which broadens the scope of the liberalisation measures to cover all Hong Kong products under the tariff exemption and to further relax the market access conditions for some service suppliers, will take effect on 1 January 2006. It will help Hong Kong's domestic exports and exports of financial and business services.

Thirdly, the opening of Hong Kong Disneyland in September 2005 and the further broadening of the Individual Visit Scheme to include more provinces and cities on the Mainland should support growth in tourism-related exports of services. Finally, the improvement in labour market conditions should support consumer spending.

Chart 4.8
Hong Kong: probability distribution of inflation forecasts for 2006



Source: Staff estimates based on market consensus.

Inflation is expected to increase moderately in 2006, with the latest market consensus predicting consumer price inflation to edge up to 2.4% (Chart 4.8). This reflects a continued pick-up in aggregate demand and a further pass-through of increases in residential rents to the headline CPI. In addition, rising rents for commercial properties, especially retail space, continue to exert upward pressure on firms' operating costs. External factors, such as high oil prices and the appreciation of the renminbi, could also feed into higher import prices.

The Government recently proposed a new bus fare adjustment mechanism, which allows franchised bus operators to adjust fares based on a set of variables, including inflation, staff costs, productivity, household income and the average cost of capital. The proposal also involves several fare reduction initiatives on implementation of the proposed mechanism, which will help contain the rise in the CCPI in 2006. The new fare adjustment mechanism may trigger a faster and fuller pass-through of future cost increases into bus fares and thus inflation in the longer term. Nevertheless, the overall impact on inflation should be limited, as the weight of bus transport in the CCPI is only 1.9%.

4.3 Uncertainties and risks

The Hong Kong economy is expected to continue to grow in 2006, although the pace of expansion is likely to moderate. The generally favourable macroeconomic conditions should support 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 high oil prices, increased inflation and possibly sharper-than-expected tightening of monetary policy in the major advanced economies, and global imbalances. Developments in the Mainland economy will continue to have an important bearing on Hong Kong. From Hong Kong's perspective, the rise of trade protectionism in the US and Europe against the Mainland and pressure on the RMB exchange rate continue to be of particular significance. Locally, increases in interest rates and the associated dampening effect on the property market raises concerns about the durability of private consumption growth. Finally, there is the danger of a flu pandemic due to human-to-human transmission of avian influenza. The probability of this event is low, but the economic impact would potentially be large.

First, the price of oil remains a key concern for the global economy. Notwithstanding some moderation in recent months, oil prices have generally stayed high. The rise in oil prices in the past few years has had limited impact on global growth because (a) it is mainly demand driven; (b) prices are still well below their historical peaks in real terms; (c) global oil intensity of production has fallen considerably; and (d) the pass-through to core inflation and hence monetary policy response has been limited. However, if oil prices stay persistently high or rise further, the impact on the global economy could be larger. In particular, a stronger feeding through to core inflation may trigger more aggressive monetary tightening by major central banks than currently anticipated. Also, the terms of trade shock could worsen the global imbalance that has already been an important concern (see below). It is noted that some emerging market economies in Asia are especially vulnerable to the persistence of high oil prices owing to their relatively high oil intensity of production and subsidies for energy consumption. The latter has strained the fiscal position of a number of economies and led to sporadic pressures on the foreign exchange markets.

Changes in oil prices affect Hong Kong mainly through their impact on global growth, inflation and monetary conditions. The direct impact on Hong Kong is generally considered to be small given the economy's high service orientation. However, there are signs that the oil intensity of production in the local economy has risen in recent years (Box 1). Oil consumption has increased sharply since 2000 due to higher demand from aviation and transportation industries. If this trend continues, future oil price rises will have an increased effect on production costs in Hong Kong.

Second, there are risks related to a significant tightening of global financial conditions. Despite considerable increases in US short-term interest rates, there is uncertainty as to when the current tightening cycle by the Fed will end. And, notwithstanding some increases in recent months, long-term US treasury yields have remained low relative to the growth and inflation outlook. A marked increase in inflationary pressure would lead to a larger-than-currently-expected rise in the federal funds target rate, and could trigger a sharp rise in

US long-term bond yields. In Japan, given increasing signs of a sustained rebound in economic activity, the authorities face the challenge of avoiding a premature monetary tightening that could derail the recovery as well as a delayed but more drastic action that could trigger sharp adjustments in the financial markets.

Hong Kong could be affected by a tightening of global financial conditions through a number of channels. Under the Linked Exchange Rate system, interest rates in Hong Kong generally follow those in the US. A marked rise in interest rates from their current levels would hurt asset markets and in turn private consumption and investment through the wealth and balance-sheet effects. If the Fed tightening is triggered by inflationary pressure rather than increased growth, then growth of the US demand for our goods and services may slow. This will be emphasised if the rise in US interest rates leads to a sharp correction in the US housing market. More directly, some investors in Hong Kong, including banks that hold a large portfolio of US and Japanese securities, could suffer from substantial mark-to-market losses in the event of a sharp rise in the long-term interest rates.

Third, global imbalances have increased, with the US current account deficit continuing to grow in 2005. In the short term, growth and interest rate differentials in favour of the US, and consequently private sectors' appetite for US dollar assets, facilitate a smooth financing of the US deficit. However, these benign forces have also led to a further build-up of external indebtedness of the US, increasing the risk for a substantial adjustment of investor preferences for asset classes and currencies in the medium term. Such adjustments may trigger a sharp fall in the US dollar, a steep rise in US long-term interest rates and a US recession.

Another source of uncertainty continues to be developments in the Mainland economy. Some commentators have raised concerns on the marked fall in consumer price inflation during the course of 2005. However, various indicators, including a rebound in investment growth and strong expansion in broad money, suggest that the risk of a sharp slowdown in economic growth and a return to deflation should be small. On the other hand, the continued increase in trade surpluses has brought to fore the concern about over-reliance on exports and the need to have more balanced growth. A change in the composition of the Mainland's growth could have implications for Hong Kong. In the long term, Hong Kong should benefit from a more balanced and thus more sustainable growth of the Mainland economy. Nevertheless, a sharp adjustment in the Mainland's exports over a short period would be detrimental to economic growth in Hong Kong, reflecting its role as an entrepôt for the Mainland.

In this context, two areas of concern warrant attention - signs of increasing trade protectionism in the US and Europe against the Mainland, and continued pressure on the RMB exchange rate after the reform of the regime in July. While the recent bilateral trade agreements that China signed with the European Union (EU) and the US represent significant progress in reducing trade tensions between the countries, trade protectionist sentiment against China's exports continues.[18] The possibility of future trade disputes remains along with growing integration of the Mainland into the global economy. This is particularly so over exports of the Mainland's other light manufacturing goods that are competing head-on with the US and European manufacturers. Disputes between the Mainland and the major trading powers have not only involved merchandise trade, but also intellectual property rights protection in China. 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.

[18] Following an accord with the EU in June, China reached an agreement with the US in November that will limit growth of the Mainland's textile and clothing exports to the US for the next three years. The deal covers 34 product lines and will take effect on January 1, 2006.

While there have been signs of easing market pressure on the RMB exchange rate in recent months, the political pressure remains, partly fuelled by the rising trade surpluses of Mainland China. Inflows of funds into the Mainland could again increase if there is renewed weakness in the US dollar against other major currencies. Because of the close economic links, Hong Kong will be affected by movements in the RMB exchange rate through changes in trade, import prices and investment income. So far, the strengthening of the RMB exchange rate against the US dollar has had a limited effect on Hong Kong. This is because the size of the appreciation has been moderate. Also, the various effects tend to offset each other.[19]

Potentially of more significance is the indirect impact on Hong Kong through financial channels. Speculation on the value of the RMB reportedly contributed to the capital inflows and easy monetary conditions in Hong Kong earlier in the year. However, the three refinements to the operation of the Linked Exchange Rate system introduced in May helped to "normalise" monetary conditions in Hong Kong. In particular, the two-way Convertibility Undertaking better anchors exchange rate expectations on the strong side. As a result, market reactions to the announcement of the RMB reforms in July did not lead to any significant inflow of funds into the Hong Kong dollar. Nevertheless, if there is any sharp appreciation of the RMB (although this probability is small), increased pressure on the Hong Kong dollar on the strong side, and hence easy monetary conditions in Hong Kong, can not be ruled out.

[19] This reflects 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 RMB should the latter reduce the Mainland's trade competitiveness. On the other hand, a stronger RMB 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 RMB terms could decline should output growth on the Mainland be affected by the currency appreciation).

Locally, there is concern over the durability of consumption growth, which decelerated markedly in 2005. Trend growth in domestic demand tends to be driven by changes in export earnings and investment income from abroad. However, cyclical movements can be affected in a significant way by changes in interest rates and asset prices. Our estimates suggest that the rebound in private consumption from the third quarter of 2003 to the last quarter of 2004 reflected strong income growth as well as the recovery in property prices; while the slowed growth in consumer spending in the first three quarters of 2005 was mainly attributable to the rise in interest rates (Box 2). An important uncertainty for the future is related to movements in property prices. The increase in interest rates has had a moderate dampening effect on the property market. However, as noted above, there is a risk of much further tightening by the Fed. In that event, the corresponding increase in interest rates in Hong Kong could have a marked impact on asset prices, which in turn would affect household spending.

Finally, an avian flu pandemic represents a shock that has a low probability of materialising, but has a potentially large effect on the global economy. The economic impact of an infectious disease could take place through a number of channels. Foremost, it represents a demand shock. The need to contain the disease could lead to a sharp fall in international travel and domestic consumption. A subsequent loss of consumer and business confidence would exert a more broad-based contraction in domestic demand. The severity of the impact would depend on the number of human casualties and the duration of the shock. In the event of widespread loss of life, the long-term growth potential could also be affected by the decline in human capital.

It is difficult to conjecture about the size of the impact, but the SARS (Severe Acute Respiratory Syndrome) outbreak in 2003 provides a useful basis for comparison. SARS turned out to be a temporary demand shock that affected mostly tourism and consumption-related activities. It did not cause any significant disruption to manufacturing activity and long-term capital flows. Real GDP growth in Hong Kong, Singapore and Taiwan (the worst hit areas), fell by 4-7 percentage points during Q2-Q3 2003. However, a significant part of this represented postponed consumption, and the economy recorded a sharp rebound as concerns over the disease receded. Compared with SARS, two factors suggest that an avian flu pandemic could have a larger impact. The threat is global, not confined to Asia, and the loss of human life could be larger. Hong Kong, given its dependence on international trade, would be affected by any associated slowdown in growth in our main trading partners. Any panic on major financial markets could also have contagious effects on Hong Kong. On the other hand, Asian governments seem to be better prepared than before the SARS outbreak, and the monetary authorities have more room to ease policy stance to support the economy, given the tightening in the US and most Asian economies in the past two years.

While the economy is subject to the various uncertainties and risks noted above, there is a potential upside. Oil prices could continue to fall substantially below the current levels, particularly if part of the increase in recent years was due to speculative demand. As the recovery in Japan continues, global growth could become more balanced and thus more durable than currently anticipated. In addition, the resilience of Hong Kong's economy to negative shocks seems to have increased in the past few years, as the financial positions of the household and corporate sectors have improved and retail banks' profitability has recovered to levels last seen before the Asian financial crisis.

In brief, economic and financial conditions in Hong Kong and the Asian region remain generally favourable. The Hong Kong economy is expected to continue to grow in 2006, although the rate of expansion is likely to moderate. The banking sector will continue to benefit from the ongoing recovery in economic activity; in particular, banks' asset quality and credit demand will be supported by sustained income growth. Overall, the risks to Hong Kong's monetary and financial stability continue to be limited.

Abbreviations

3m moving avg	Three-month Moving Average
3m-on-3m	Three-month-on-three-month
ASEAN	Association of Southeast Asian Nations
AIs	Authorized Institutions
bn	Billion
BoE	Bank of England
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
ECB	European Central Bank
EU	European Union
FDI	Foreign Direct Investment
FOMC	Federal Open Market Committee
FX	Foreign Exchange
GDP	Gross Domestic Product
HIBOR	Hong Kong Interbank Offered Rate
HICP	Harmonised Index of Consumer Prices
HKMA	Hong Kong Monetary Authority
HSI	Hang Seng Index
IMF	International Monetary Fund
IPOs	Initial Public Offerings
IT	Information Technology
lhs	Left-hand Scale
IVS	Individual Visit Scheme
LIBOR	London Interbank Offered Rate
mn	Million
PBoC	People's Bank of China
PCE	Private Consumption Expenditure
PD	Default Probability
PMI	Purchasing Managers' Index
PPP	Purchasing Power Parity
qoq	Quarter-on-quarter
rhs	Right-hand Scale
RMB	Renminbi
sa	Seasonally Adjusted
SARS	Severe Acute Respiratory Syndrome
USD	US dollar
WTI	West Texas Intermediate
yoy	Year-on-year