

# Domestic and external environment

*by the Research Department*

The global economy continued to record a solid expansion in the final quarter of 2005, notwithstanding high energy prices. Despite slowing down in the fourth quarter, forward-looking indicators point to a rebound in growth in both the US and the euro area in the coming months. In East Asia, the economic recovery in Japan is gathering momentum while the Mainland economy continued to register growth of close to 10% in 2005. In Hong Kong, the economy showed broad-based expansion in the fourth quarter, albeit at a more moderate pace.

## External environment

In the US, real GDP growth slowed in the fourth quarter of 2005, to 1.6% (quarter on quarter, annualised) from 4.1% in the third. The slowdown reflected mainly slower personal consumption and business investment growth, a sharp rise in imports and a decline in government spending. Nevertheless, monthly and forward-looking indicators, on balance, point to a rebound in economic growth at the start of the year. On a three-month-on-three-month basis, growth in both retail sales and industrial production picked up further in January by 2.2% and 1.9% respectively. The Purchasing Managers' Index (PMI) for the manufacturing and service sectors also increased in February. Year-on-year headline CPI inflation fell for the third consecutive month to 3.4% in December, before rising to 4.0% in January. Core PCE (Personal Consumption Expenditures) inflation eased to 1.8%, which is within the Fed's 1.0%-2.0% "comfort zone". Nevertheless, high oil prices, falling unemployment rate (to a four-year low of 4.7% in January) and a rising capacity utilisation rate point to increased risks of inflation.

In the euro area, real GDP growth moderated to 1.0% (quarter on quarter, annualised) in the final

quarter of 2005 from 2.7% in the third, as growth stagnated in Germany and slowed in France. Growth in industrial production fell for the fourth straight month in December to 0.4% (three months on three months). Survey indicators suggest improved economic prospects in the first quarter of 2006. The January PMI report showed continued expansion in both manufacturing and service-sector activities, while the February euro area ZEW economic sentiment index remained at a high level of 66.0. In Germany, the IFO business confidence index rose to 103.3 in February, its highest level since 1991. Inflation appeared to remain benign. Headline HICP (Harmonised Index of Consumer Prices) inflation was stable in the fourth quarter of 2005, and stayed at 2.4% in January. In the UK, real GDP growth increased to 2.6% (quarter on quarter, annualised) in the fourth quarter from 1.5% in the third, driven by stronger service-sector growth. Economic activity appears to have regained momentum in recent months, although the pace of recovery remains uncertain. Retail sales continued to grow at a robust pace of 1.2% in the three months to January, while industrial production contracted further by 0.8% (three months on three months) in December. Headline consumer price inflation eased to 1.9%, which is below Bank of England's 2% target.

In Japan, real GDP growth picked up to 5.5% (quarter on quarter, annualised) in the fourth quarter of 2005 from 1.4% in the third, driven by stronger growth in private consumption and exports. The contribution of net exports rose markedly as imports declined, adding 2.4% percentage points to overall growth. Industrial production increased by 2.6% (quarter on quarter) in the fourth quarter after contracting by 0.2% in the third. Forward-looking indicators point to continued expansion in the manufacturing sector. Machinery orders (excluding vessels and electricity) increased by 4.1% in the fourth quarter after rising by 2.1% in the previous quarter, while the manufacturing PMI climbed to a record-high in January 2006. Improved labour market conditions supported household spending, which grew by 1.8% in the fourth quarter after contracting by 3.0% in the third, while the consumer confidence index also strengthened to a 14-year high of 48.2. Inflation picked up notably, as fresh food prices stopped declining. Headline CPI inflation picked up to 0.5% year on year in January from -0.1% in December 2005. Excluding fresh food, core CPI inflation rose to an eight-year high of 0.5% from 0.1% during the same period.

The Mainland economy grew by 9.9% (year on year) in real terms in the fourth quarter of 2005. For the year as a whole, the economy expanded at the same rate. Fixed asset investment registered a robust increase of 26.3% (year on year) in the final quarter, led by strong capital spending in the less-developed regions and some "bottleneck" sectors. However, on a three-month-on-three-month basis, fixed asset investment growth declined for the third consecutive month in December. Private consumption growth was well maintained, with retail sales growing by 12.6% (year on year) for the third straight quarter. Export growth slowed significantly on both a year-on-year and a quarter-on-quarter basis, partly due to a stronger renminbi, lower export tax rebates and other export-restraining government policies. On the other hand, import growth continued to recover steadily. The National Bureau of Statistics revised the Mainland's 2004 real GDP growth upwards to 10.1%. The revision suggests that growth on the Mainland is less imbalanced and therefore more

sustainable than previously expected. Headline CPI inflation edged up by 0.1 percentage point to a modest 1.4% in the fourth quarter on a year-on-year basis. On a three-month-on-three-month comparison, however, consumer prices declined slightly in November and December, while producer price index and corporate good prices inflation eased.

Elsewhere in East Asia, growth picked up in the fourth quarter of 2005, while inflation increased in some economies. In Singapore, real GDP growth accelerated to 12.5% (quarter on quarter, annualised) in the fourth quarter from 9.6% in the third, driven by stronger export growth in electronics and pharmaceuticals. In Korea, real GDP grew by 1.7% (quarter on quarter) after rising by 1.9% in the third quarter, led by strong expansion in business investment. In the Philippines, growth picked up to 2.7% (quarter on quarter) from 0.9% due to a marked increase in private consumption. Benefiting from rising global electronics demand, export growth increased in Korea, Singapore and Taiwan, but moderated in Indonesia, Malaysia, the Philippines and Thailand. Industrial production continued to expand in most economies on the back of rising exports, while consumer spending increased in Korea and Singapore amid improving labour market conditions. Looking ahead, higher oil prices and interest rates might dampen domestic demand growth in the region. Rising energy and metal prices have increased inflations in Indonesia, Malaysia, the Philippines and Thailand, with the average rate of headline CPI inflation rising to 8.5% year on year in the fourth quarter from 6.1% in the third. On the other hand, inflation remained stable at an average rate of 2.0% in Korea, Singapore and Taiwan.

The US Federal Open Market Committee (FOMC) raised the federal funds target rate by 25 basis points to 4.5% in January. In its latest statement the FOMC stated that some further policy firming might be needed but it dropped the word "measured". The June 2006 federal funds futures contract was traded at 4.94% at the end of February, suggesting that most market participants expect that there will be another 50-basis-point rise in the policy rate by

mid-2006. As widely expected, the European Central Bank raised interest rate by 25 basis points to 2.5% following its March policy meeting. In Asia, Thailand raised the official interest rate by 25 basis points to 4.25% in January, while Korea raised its overnight call rate by 25 basis points to 4.0% in February.

The equity market has been volatile in the US, reflecting mixed earnings results, fluctuations of oil prices and uncertainties surrounding the interest rate outlook. By the end of February, the S&P 500 index had risen by 2.5% from the end of last year. The Japanese market extended its rally into 2006 on the back of a stronger-than-expected economy before plummeting in mid-January on news of an insider-trading investigation of Livedoor, a major technology company. The market subsequently recovered part of the losses, the TOPIX was little changed from the end of 2005. Stock markets in Europe and emerging Asia started the year on a strong note, with the MSCI Euro and MSCI Asia Free ex-Japan increasing by 6.4% and 4.9% respectively.

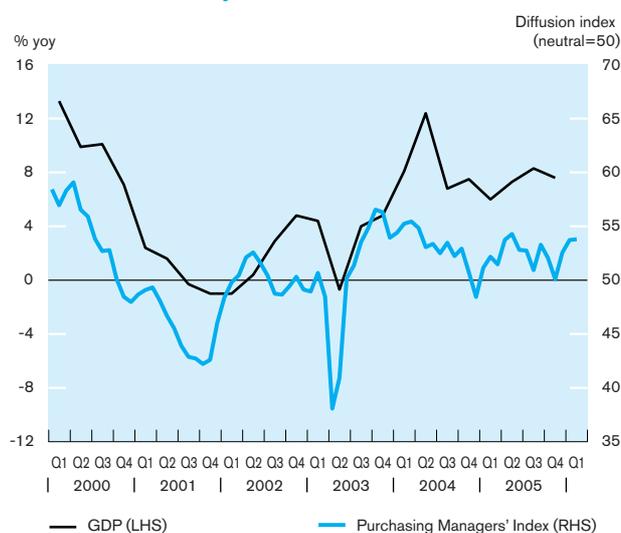
The US dollar weakened in the first two months of the year, despite a widening of interest differentials in favour of the US against other major economies. The Federal Reserve Board's broad nominal exchange rate index decreased by 1.7% from the end of 2005 to the end of February 2006. The People's Bank of China introduced further reforms to the exchange rate system at the beginning of the year. Instead of using the previous day's closing rate, the China Foreign Exchange Trading System now computes and announces a central parity rate in the morning of each trading day, based on prices submitted by market-makers weighted by their transaction volumes. In addition, over-the-counter foreign exchange transactions in the interbank market were introduced in parallel with the existing automatic price-matching system. The renminbi appreciated slightly from 8.07 per US dollar at the end of 2005 to 8.04 at the end of February.

Oil prices fluctuated considerably around the beginning of the year. The average price of the UK Brent, Dubai and West Texas Intermediate (WTI) crude oil rose from US\$58 per barrel at the end of 2005 to a peak of US\$67 per barrel on 30 January due to supply concern in Nigeria and Iran, before easing to US\$59 per barrel at the end of February following news of higher-than-expected US oil inventories. WTI crude futures for delivery in December 2006 were traded at US\$67 per barrel at the end of February, suggesting that market participants generally expect oil prices to stay high in the rest of the year.

## Domestic activity

The Hong Kong economy has fared well in an environment of rising interest rates and high oil prices. Real GDP registered its tenth straight quarter of expansion in the fourth quarter of 2005, rising by 0.6% on a quarter-on-quarter basis and 7.6% on a year-on-year basis (Chart 1). The expansion in the fourth quarter was broadly based, with most of the major components recording increases over the previous quarter. For 2005 as a whole, real GDP grew considerably by 7.3%, following a remarkable increase of 8.6% in 2004.

CHART 1  
Economic activity



Sources: Census & Statistics Department and NTC Economics Ltd.

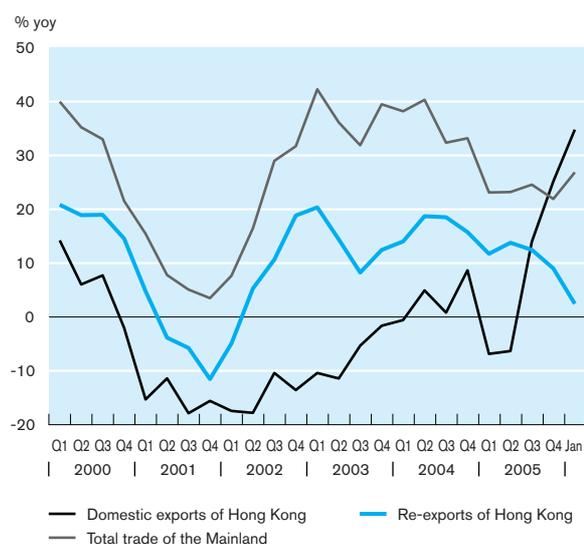
Private consumption spending held firm in the final quarter of 2005, rising by 0.8% over a quarter ago and 3.7% over a year earlier, supported by increased household income and an improved employment environment. Despite rises in interest rates and moderation in property prices, consumer confidence remained strong, as suggested by a slight increase in the Index of Consumer Confidence compiled by the Chinese University of Hong Kong. Reflecting the generally optimistic business sentiment, capital goods investment increased sharply in the fourth quarter, which more than offset a larger decline in building and construction activity. As a result, year-on-year growth in overall investment spending picked up to 7.5%.

## External trade

Overall export growth remained brisk, underpinned by buoyant external trade on the Mainland and robust growth in Hong Kong's other major trading partners. In the fourth quarter, exports of goods increased by 2.2% on a quarter-on-quarter basis and 11.4% on a year-on-year basis. The strong export performance reflected increases in both domestic exports and re-exports (Chart 2). Among Hong Kong's major markets, exports to the Mainland and the European Union continued to increase noticeably. However, growth in exports of services slowed markedly to 0.8% quarter on quarter, and the year-on-year increase also moderated slightly to 7.7%. While exports of trade-related services continued to increase at a solid pace, growth in tourism-related earnings was relatively weak, reflecting moderated growth in the number of incoming tourists. Retained imports rose markedly in the fourth quarter along with the increase in domestic demand. Net exports contributed 1.6 percentage points to the year-on-year growth of real GDP in the fourth quarter, compared with 4.7 percentage points in the third.

The latest economic indicators point to a continued expansion in the first quarter of 2006. The Brunswick Purchasing Managers' Index stayed well above the no-change mark of 50 in January and February, suggesting sustained solid growth in private sector activity. Business sentiment remained generally optimistic with the Quarterly Business Tendency Survey, showing all business sectors, except the construction sector and the restaurants and hotels sector, anticipating an increase in output in the first quarter of 2006. In January 2006, the volume of retail sales rose markedly over a year ago but declined slightly on a seasonally adjusted month-on-month basis, reflecting robust growth in consumer spending during the Lunar New Year season. Meanwhile, the value of merchandise exports increased noticeably on a monthly basis.

**CHART 2**  
External trade



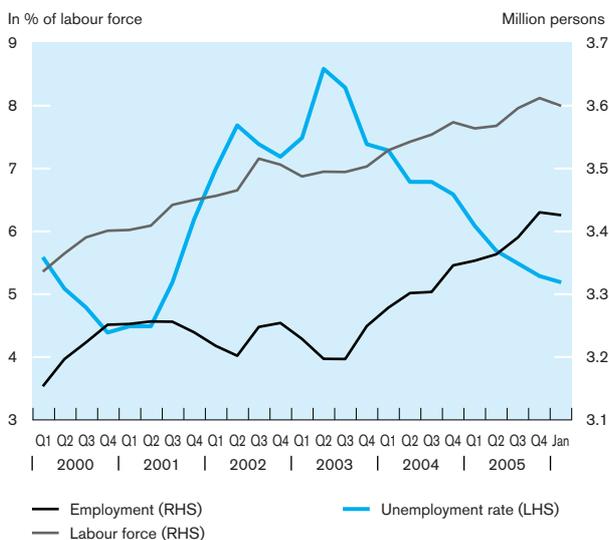
Sources: Census & Statistics Department and CEIC database.

## Labour market and inflation

Labour market conditions continued to be favourable. Bolstered by broad-based growth in economic activities, total employment rose to an all-time high in the last quarter of 2005. However, the increase in employment was largely offset by an expansion of the labour force. As a result, the unemployment rate declined only moderately from 5.5% in the third quarter to 5.3% in the fourth quarter (Chart 3). The favourable labour market conditions continued in January 2006, with the three-month moving average unemployment rate falling to 5.2%. Increased employment has led to rises in labour earnings. The nominal payroll per worker, which includes remuneration, overtime payments, back-pay and other irregular allowances and bonuses, increased by 3.2% in the third quarter of 2005 over a year ago.

CHART 3

### Labour market conditions

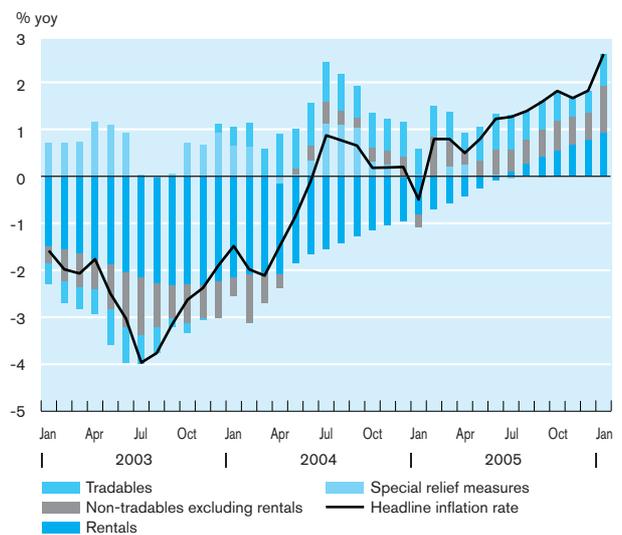


Source: Census & Statistics Department.

The headline inflation, which represents year-on-year change in the Composite Consumer Price Index (CCPI), rose to 1.1% in 2005 from -0.4% in 2004. The increase was driven by rises in rents and strong consumer demand. The increases in commodity prices, including energy prices, had limited effect on overall inflation, reflecting Hong Kong's high service orientation and low oil intensity. Having stayed at 1.7-1.8% in the fourth quarter of 2005, the CCPI inflation picked up to 2.6% year on year in January 2006 (Chart 4). However, this reflected mainly the distortion caused by the different timing of the Chinese New Year holidays, which fell in January in 2006 but February in 2005. The underlying inflationary pressure appeared to pick up in recent months, with the annualised three-month-on-three-month increase in the CCPI climbing from 2.0% in November to 2.5% in December, before stabilising at 2.6% in January.

CHART 4

### Headline inflation



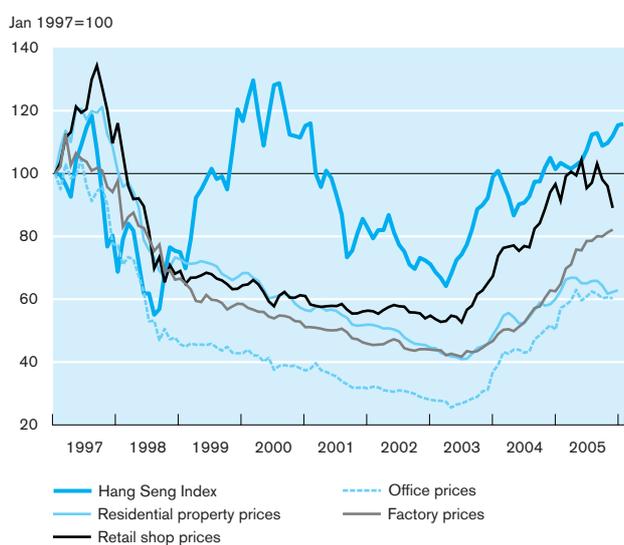
Source: Census & Statistics Department and staff estimates.

## Asset markets

The increases in interest rates since March 2005 have dampened property market activities. Following the interest rate hikes in the US, banks in Hong Kong have raised their best lending rates – a typical benchmark for setting mortgage interest rates – by 2.75-3 percentage points to the current levels of 7.75-8%. Residential property prices fell by 7.7% in November compared with their recent high seven months earlier, but have shown signs of stabilising since December (Chart 5). Prices of office and retail space also suffered from higher interest rates while prices of factory space continued to increase. Notwithstanding the recent declines, prices of various types of premises remained significantly higher than their troughs in 2003. The decline in residential property prices has been accompanied by sharp decreases in transaction volumes, with the number of Sale and Purchase Agreements declining by 64% in January 2006 from its previous high in April 2005.

CHART 5

Asset prices



Sources: Rating & Valuation Department and Reuters.

Local stock prices fluctuated significantly over the past three quarters. Having risen to a four-and-a-half-year high in the third quarter of 2005, the Hang Seng Index fell sharply in October owing to renewed concerns about an extension of the interest-rate-hike cycle in the US. Since then, equity prices have been affected by volatile energy prices, interest rate outlook, and concerns on corporate earnings. Stock prices rebounded strongly in November, with those of locally-listed Mainland enterprises (H-shares) recording remarkable gains. The Hang Seng Index reached its highest level since early 2001 in February 2006, while the China Enterprises Index hit a post-1997 high in the same month. By the end of February, the Hang Seng Index and the China Enterprises Index have risen by 7.0% and 22.1% from the end of 2005.

## Money supply and domestic credit

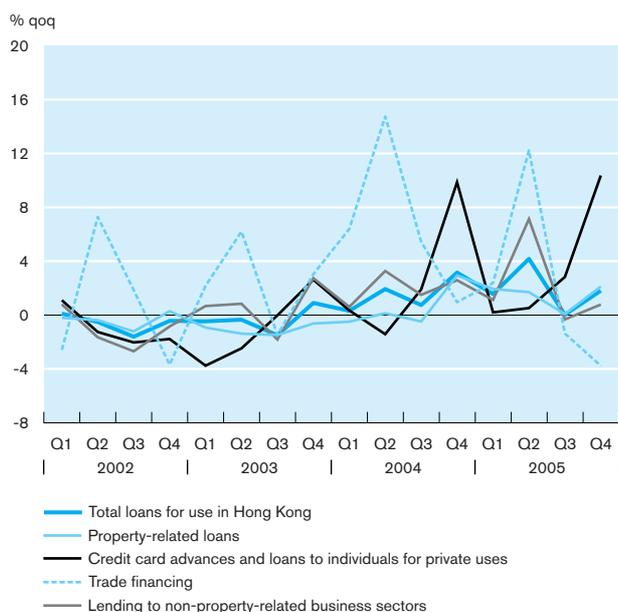
Hong Kong dollar narrow money and broad money growth continued to diverge. Narrow money fell further in the fourth quarter of 2005 from the previous quarter, as both demand deposits and currency held by the public declined. The drop in narrow money was partly due to higher deposit rates, which increased the opportunity cost of holding non-interest-bearing monetary assets. Despite the fall in narrow money, broad money rose moderately during the quarter, leading to a year-on-year growth of 5.7% in December. The expansion in broad money was generally in line with economic activity.

Foreign currency deposits expanded considerably in the fourth quarter, reflecting mainly an increase in non-US dollar foreign currency deposits, and to a lesser extent, a rise in US dollar deposits. As growth of Hong Kong dollar deposits was slower than that of foreign currency deposits, the share of foreign currency deposits in total deposits increased moderately to 47.6% at the end of 2005 from three months ago, although the ratio was still lower than that at the end of 2004.

Loans for use in Hong Kong grew moderately by 1.8% during the quarter, and by 7.8% from a year earlier due to increased credit demand associated with buoyant economic activity. Analysed by economic use,<sup>1</sup> growth in domestic credit showed a mixed picture (Chart 6). Credit card advances expanded markedly on a quarter-on-quarter comparison. Lending to property-related sectors grew moderately, as a rise in loans for residential and commercial property investment more than offset a decline in the outstanding stock of residential mortgage loans. On the other hand, lending to non-property-related business sectors increased only slightly while trade financing registered some declines.

CHART 6

## Loans for use in Hong Kong



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

Source: HKMA.

## Short-term outlook

Hong Kong's near-term economic outlook continues to be positive, although the rate of growth is expected to moderate and inflation is likely to increase. The Government projects economic growth to slow to 4-5% and inflation to edge up to 2.3% in 2006. Export growth is likely to fall, on the back of a high base of comparison and protectionist measures in the US and EU against the Mainland's exports. However, the third phase of the Closer Economic Partnership Arrangement between Hong Kong and the Mainland, which came into effect on 1 January 2006, should benefit Hong Kong's domestic exports and exports of financial and other business services. Higher interest rates and slower export earnings growth will restrain growth of domestic demand, although private consumption will be supported by improved labour market conditions. Inflation is expected to increase, as the aggregate demand continues to pick up and with the further pass-through of higher rents into the consumer price index. However, the probability of a substantial increase in inflation remains low, given the generally benign core inflation in our major trading partners. Notwithstanding the positive near-term prospects, there are a number of risks, which are mostly related to external factors. These include sustained high and volatile oil prices, further monetary policy tightening in the US, global imbalances, trade protectionism against the Mainland, and the possibility of an avian flu pandemic.

<sup>1</sup> Data on loans for use by economic sectors are available only on a quarterly basis.