REGULAR ARTICLE

Domestic and external environment

by the Research Department

Global economic performance remains solid. Despite a significant slowdown in the US economy in the second quarter, growth has been resilient elsewhere. In particular, the euro area grew at its fastest pace in six years. In East Asia, forward-looking indicators point to continued strength in domestic demand in Japan, while growth in Mainland China accelerated further in the second quarter. In Hong Kong, economic growth moderated noticeably in the second quarter of 2006 from its strong pace earlier this year, while inflation picked up modestly.

External environment

In the US, real GDP growth fell to 2.9% (quarter on quarter, annualised) in the second quarter of 2006, compared with 5.6% in the first. The slowdown reflected a broad-based decline in domestic demand growth on the back of successive increases in interest rates and sustained high energy prices. Private consumption and business investment growth slowed to 2.6% and 4.7% from 4.8% and 13.7% respectively, while the housing market continued to soften, with residential investment falling markedly by 9.8% in the second quarter. Leading indicators suggest continued moderation in the period ahead. The ISM Purchasing Managers' Index (PMI) for the non-manufacturing sector fell for the third consecutive month in July to 54.8, and that for the manufacturing sector rose slightly to 54.7 following a two-month decline. Inflation risks remain. Headline CPI (Consumer Price Index) inflation averaged 4.0% year on year in the second quarter, and core PCE (Personal Consumption Expenditures) inflation rose to a four-year high of 2.6% in June. Nevertheless, inflationary pressures are likely to moderate in the medium term, with the anticipated slowdown in aggregate demand and as previous interest rate increases begin to take effect. Reflecting this, the Federal Open Market Committee (FOMC) kept the federal funds target rate unchanged at 5.25% in August.

The euro area grew at its fastest pace in six years in the second quarter, with real GDP increasing by a higher-than-expected 3.6% (quarter on quarter, annualised), up from 2.5% in the first. Benefiting from the soccer World Cup, private consumption stayed firm during the quarter with retail sales recording its highest growth in eight months in June. Looking forward, survey indicators on balance suggest continued strong performance ahead. The Composite Purchasing Managers' Index reached 58.5 in July, and the German IFO business climate indicator remained strong at 105.6. However, higher oil prices and the expected lower export growth amid concerns about a moderation in the US economy and risks of a stronger euro, affected investors' sentiment. The euro area ZEW investor confidence index fell to a five-year low of 1.3 in August. The recent strong pick-up in economic activity has added to the inflation risk. Headline HICP (Harmonised Index of Consumer Prices) inflation averaged 2.4% in the first half of 2006, and is forecast to stay above 2% in the coming months. The European Central Bank (ECB) raised its policy rates by a quarter of a percentage point to 3% in August, and signalled that further tightening might be needed. In the UK, real GDP grew at an above-historical-average pace of 3.2% (quarter on quarter, annualised) in the second quarter. With a revival in consumer spending and a pick-up in business investment, economic growth is forecast to remain solid. Higher energy and import prices have increased inflationary pressure in recent months. The headline CPI inflation continued to stay above the Bank of England's (BoE's) 2% target, reaching 2.5% in June. Against the backdrop of strong growth and limited spare capacity, the BoE raised the official Bank rate by 25 basis points to 4.75% in August.

In Japan, real GDP growth declined to 1.0% (quarter on quarter, annualised) in the second quarter from 3.3% in the first, due to contractions in government spending and weaker export growth. Growth in industrial production picked up slightly to 0.9% in the same quarter and export volume expanded by 1.3% after rising by 3.4% in the first quarter, largely driven by rising autos and equipment demand from the US and Europe. Forward-looking indicators point to a faster pace of corporate expansion ahead. The June Tankan survey shows that business confidence and investment intentions have strengthened in both the manufacturing and service sectors. The manufacturing PMI rose to 55.7 in July from an average of 55.0 in the second quarter, underpinned by rising new orders. Higher labour income and employment boosted household spending by 0.6% in the second quarter following a contraction of 2.1% in the first. Elevated commodity prices increased inflationary pressure, with headline CPI inflation rising to 0.2% year on year in the second quarter from -0.1% in the first. Excluding fresh food, CPI inflation nudged up from zero in the first quarter to 0.03% in the second, and further to 0.2% in July. In view of the steady rise in consumer prices and revival in domestic demand, the Bank of Japan raised the overnight call rate to 0.25% in July, marking the end of the zero interest rate policy.

In Mainland China, growth momentum accelerated in the second quarter, with real GDP growth recording an 11-year high of 11.3% (year on year). Rapid economic growth was driven mainly by strong expansion in fixed assets investment (FAI) and record trade surpluses, raising fears of renewed economic overheating and heightening the expectation of further appreciation of the renminbi. Rapid accumulation of foreign exchange reserves continued to complicate the conduct of monetary policy, leading to elevated growth in M2 and brisk growth in bank loans. Headline CPI inflation edged up to 1.7% in the second quarter and PPI (Producer Price Index) inflation has been trending up since April, suggesting that the balance of risks of inflation has tilted to the upside.

Amid renewed economic overheating, the People's Bank of China (PBoC) tightened credit by raising the reserve requirement ratio twice, each by a half percentage point, to 8.5%. It also raised the one-year benchmark lending rate in late April, and both the one-year benchmark lending and deposit rates in August. In addition, the PBoC intensified its sterilisation operations by issuing RMB250-billion-worth of one-year bills from May to July to banks with relatively fast loan growth. Other than these monetary tightening measures, the authorities have also resorted to various administrative controls that aimed at reining in FAI at the level of local governments and decelerating the rise in property prices. Although a soft-landing is far from certain, it appears that these tightening measures may have started to have some impact on the economy. This is evidenced by a softening in the monthly growth of both industrial production and FAI in July. Looking ahead, growth of the Mainland economy is expected to moderate in the second half of the year amid the cumulative policy effect and a slowing US economy.

In the rest of East Asia, growth moderated in the more advanced economies, mainly due to weaker growth in domestic demand. Real GDP growth declined to an average rate of 1.6% (quarter on quarter, annualised) in the second quarter from 4.9% in the first in Korea, Singapore and Taiwan, as higher commodity prices and interest rates weighed on consumer and business spending.[1] In Indonesia, the economy expanded by 6.2% in the second quarter after growing by 1.2% in the first, reflecting stronger growth in private consumption and business

[1] Aggregate real GDP growth is weighted by GDP of the respective economy in 2005 valued at PPP (Purchasing Power Parity) exchange rates.

investment. Industrial production growth slowed in most regional economies in the second quarter. Nevertheless, the upswing in the global IT cycle and strong external demand are expected to support export growth, which rose to an average of 4.6% in the second quarter from 4.2% in Korea, Singapore and Taiwan, and remained solid in Indonesia, Malaysia, the Philippines and Thailand. Inflationary pressure eased somewhat in Asia on tighter monetary conditions. While the year-on-year headline CPI inflation remained in double digits in Indonesia, it declined in most regional economies during the second quarter. However, higher producer prices appear to have fed through to consumer prices in Korea and Thailand.

After 17 consecutive interest rate hikes since June 2004, the FOMC has decided to put its tightening policy on hold. The Fed funds target rate was maintained at 5.25% following the August meeting and, at the end of August, prices of Fed funds future contracts suggested that market participants expected only a 10% chance of another rate rise by the end of the year. The 10-year Treasury bond yield fell from 5.15% on 30 June to 4.74% at the end of August, as latest data revealed that inflationary pressure is moderating. However, outside the US, monetary tightening has continued. As mentioned earlier, in Europe, both the ECB and BoE raised their policy rates. So did the Reserve Bank of Australia and the Bank of Korea in Asia Pacific. Bank Indonesia is the only central bank that bucked the trend, lowering its policy rate by 75 basis points to 11.75% in the last two months as inflationary pressure receded.

Foreign exchange markets have been volatile since the end of June. On the one hand, increasing expectations of a pause in the interest rate rise in the US and continued tightening of monetary policy elsewhere put pressure on the US dollar, especially in July. On the other hand, news of escalating geopolitical tensions in the Middle East and the uncovering of terrorist plots appeared to have increased the safe-haven role of the dollar. The US dollar has depreciated against the euro by 0.2% while appreciating against the yen by 2.5%. It has weakened against most Southeast Asian currencies. Overall, the dollar has declined by 0.5% on the Federal Reserve Board's broad nominal effective exchange rate index.

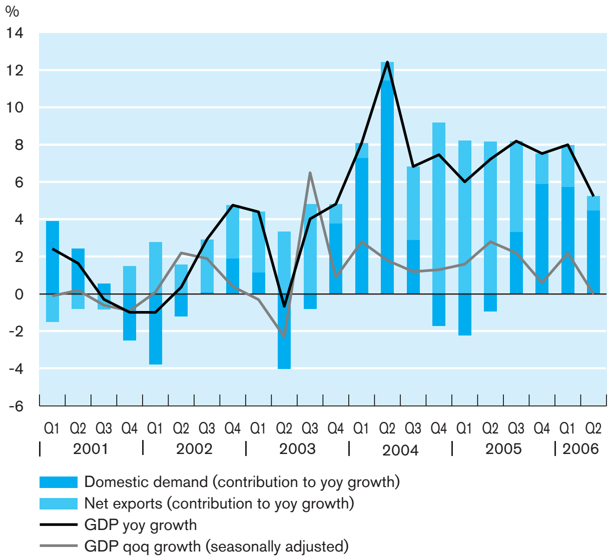
Global equity prices were fairly directionless in the summer months, following a strong rebound in the second half of June. The US market was weighed down by a surge in oil prices in July. However, better-than-expected interim earning results and reduced concerns of interest rate hikes – in view of data releases in August reflecting contained inflation and weaker-than-expected economic activity – subsequently led to more bullish sentiment. The S&P 500 index advanced by 2.6% between the end of June and the end of August. Share prices in Europe also came under pressure as oil prices tested new highs and central banks tightened their grips further. At the same time, reports of terrorist plots renewed concerns of potential spillovers from the Middle East despite the UN resolution on the Israel-Lebanon ceasefire. However, better-than-expected corporate earnings have supported stock prices. The Frankfurt DAX index gained 3.1% during the period. The Japanese market continued to ride on the economic recovery. Bank loans in July registered the largest growth in a decade, while machinery orders in June rose much more than expected. The NIKKEI 225 index rose by 4.1% from the end of June to the end of August. Other Asian stock markets also advanced slightly during the period, with the MSCI Asia free ex-Japan index rising (in local currency terms) by 3.5%. Oil was traded in jittery markets against a background of escalating conflicts in the Middle East and the news of the shutdown of a major US oilfield. The average price of Dubai, Brent and WTI crude oil rose to a record high of US$76 per barrel on 7 August before retreating to US$69 per barrel towards the end of August.

Domestic activity

Economic growth in Hong Kong moderated noticeably in the second quarter of 2006 from its strong pace earlier in the year. On a year-on-year comparison, real GDP growth slowed markedly to 5.2% in the second quarter from 8.0% in the first quarter (Chart 1 and Table 1). On a quarter-on-quarter basis, real GDP recorded zero growth after expanding for 11 straight quarters. The moderation in the year-on-year growth in the second quarter was mainly attributable to slower growth of merchandise exports and capital goods investment, while exports of services and private consumption expenditure continued to grow at a solid pace and the rate of decline in construction output narrowed.

Private consumption expenditure held up well during the second quarter, increasing by 1.0% over the previous quarter and 5.0% over a year earlier. Notwithstanding higher interest rates and sluggish asset markets, consumer sentiment continued to be buoyant with improving labour market conditions and rising household income. Investment spending, in terms of gross domestic fixed capital formation, remained firm, although the year-on-year growth abated to 4.3% in the second quarter. While the rate of decline in construction activity narrowed somewhat, the increase in machinery and equipment investment slowed noticeably.

CHART 1
Economic activity



Source: Census & Statistics Department

TABLE 1
Real GDP growth by expenditure component (year on year)

(% yoy)	2004	2005	2005 Q3	2005 Q4	2006 Q1	2006 Q2
Gross Domestic Product	**8.6**	**7.3**	**8.2**	**7.5**	**8.0**	**5.2**
Domestic demand	5.1	1.9	4.0	7.3	6.7	5.2
Private consumption expenditure	7.3	3.4	3.6	3.4	4.5	5.0
Government consumption expenditure	0.7	-3.1	-1.6	-3.8	1.2	-1.3
Gross domestic fixed capital formation	3.0	4.1	2.8	8.4	7.6	4.3
Of which:						
Building & construction	-11.7	-6.1	-5.2	-10.7	-11.1	-6.4
Machinery & equipment	11.0	10.6	7.1	24.0	23.3	12.8
Change in inventories[1]	-0.2	-0.8	0.9	2.6	1.4	0.8
Net exports[1]	3.9	5.6	4.9	1.6	2.3	0.8
Of which:						
Exports of goods	15.3	11.2	12.8	11.4	14.4	6.4
Exports of services	17.9	8.7	8.9	8.2	8.9	8.6

[1] Percentage point contribution to annual growth of GDP.
Source: Census & Statistics Department

External trade

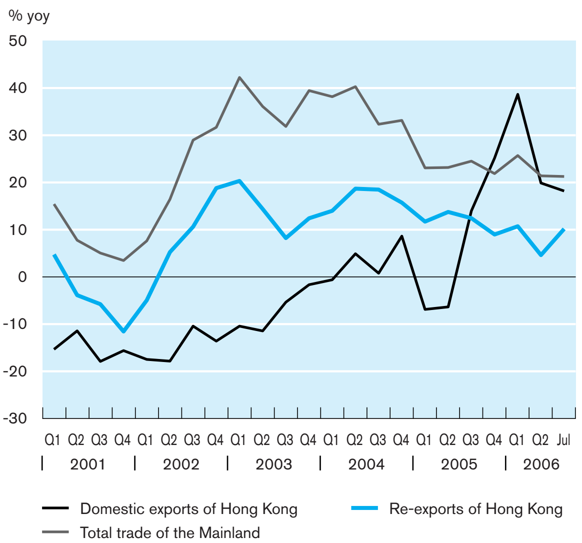
Merchandise exports moderated markedly in the second quarter, with the year-on-year increase slowing to 6.4% and the quarter-on-quarter growth turning negative for the first time in 18 quarters. The moderation in growth was mainly attributable to an across-the-board slowdown in re-exports, which was in turn due to diminished import demand of Hong Kong's major export markets (Chart 2). Specifically, re-exports of goods to the US and the European Union declined year on year, while the year-on-year growth of re-exports to the Mainland decreased distinctly. By contrast, exports of services held up well in the second quarter, rising by 8.6% from a year ago and 1.8% from the previous quarter. The year-on-year increase in exports of trade-related services moderated somewhat along with sluggish export growth. Meanwhile, exports of travel services remained firm on the sustained increase in inbound tourists. Reflecting the widened merchandise trade deficit and narrowed service trade surplus, the overall trade surplus in the second quarter declined to 13.8% of GDP in real terms, from 14.8% in the first quarter.

Recent data point to a continued expansion of the economy in the third quarter, but at a more moderated pace. The Brunswick Purchasing Managers' Index declined to 51.8 in July and 51.6 in August, suggesting that growth in private sector activity has moderated. The volume of retail sales increased by 2.6% in July on a seasonally adjusted month-on-month basis. Meanwhile, the value of merchandise exports also increased strongly during the month. Nevertheless, business sentiment remained generally optimistic. The Quarterly Business Tendency Survey, which was conducted between 12 June and 6 July, shows that all covered business sectors expect the volume of business to expand in the third quarter. For all sectors, the difference between the proportions of respondents expecting the business situation to be better over those expecting it to be worse increased slightly to 32 percentage points in the third quarter, from 30 percentage points in the second.

Labour market and inflation

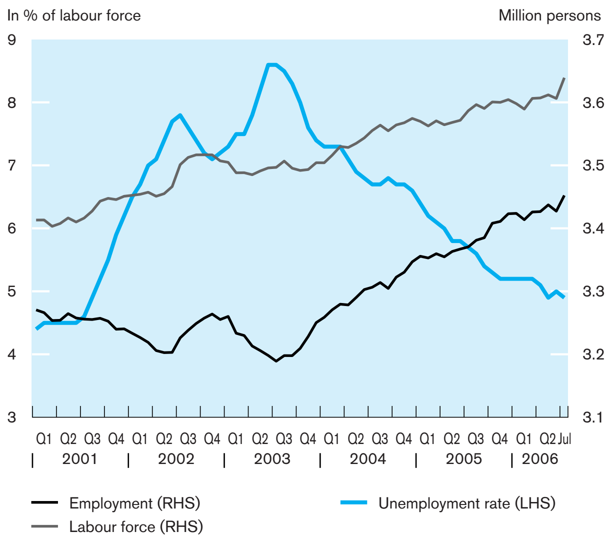
Labour market conditions remained favourable, with the total employment rising to an all-time high in May-July 2006. However, the effect of employment growth on the unemployment rate was partly offset by a larger labour force. As a result, the seasonally adjusted unemployment rate declined only modestly from 5.2% in the first quarter of 2006 to 4.9% in the three months ending July (Chart 3). Despite robust employment creation, labour earnings rose only

CHART 2
External trade



Sources: Census & Statistics Department and CEIC database.

CHART 3
Labour market conditions

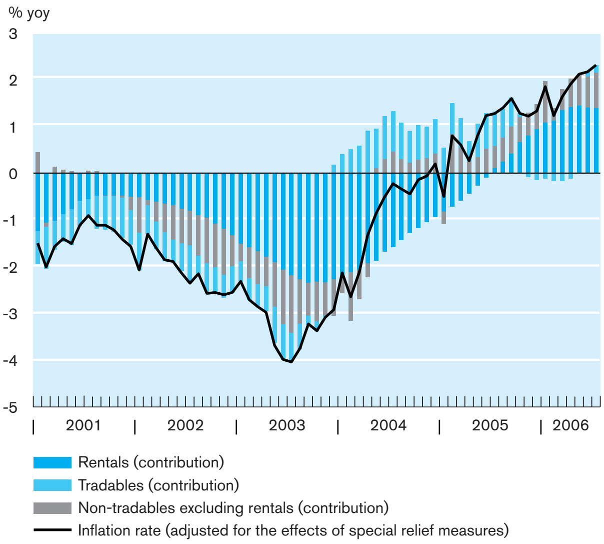


Source: Census & Statistics Department.

modestly. The nominal payroll per worker, which includes basic wage, overtime payment, back-pay and other irregular allowances and bonuses, increased by 1.3% in the first quarter of 2006 over a year ago, following an increase of 3.5% in 2005.

The headline inflation, measured in terms of the year-on-year change in the Composite Consumer Price Index (CCPI), increased gradually to 2.3% in July. The increase in the CCPI was led by the rise in the rental component due to the pass-through of higher private housing rentals as rental contracts were renewed. While the rental component continued to drive the CCPI upward, its contribution to the overall increase has been levelling off in recent months (Chart 4). Contribution from prices of other consumer goods and services, on the other hand, is picking up. Although the pace of the increase in the year-on-year inflation rate appeared to have moderated since April, the annualised three-month-on-three-month rate increased more noticeably in recent months, rising from 1.6% in April to 3.6% in July.

CHART 4
Consumer price inflation



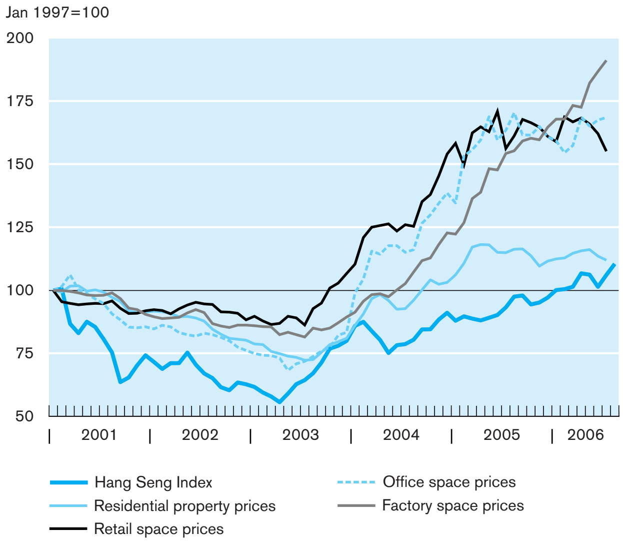
Sources: Census & Statistics Department and staff estimates.

Asset markets

Local share prices have been very volatile in recent months. After rising strongly during the early part of 2006, the Hang Seng Index fell markedly in May on heavy profit-taking pressure triggered by renewed concerns of inflation and thus an extension of the monetary tightening cycle in the US. From the high on 8 May, the Hang Seng Index dropped by a total of 11.9% to a recent low on 13 June. The index has recovered strongly since then and surpassed its previous high in August. However, transaction volumes have declined significantly compared with the earlier months of 2006. By the end of August, the Hang Seng Index has risen by 16.9% from the end of 2005.

The property market has also been affected by the uncertainty over the interest rate outlook. Having moderated somewhat during 2005, residential property prices and transaction volume recovered slightly in the early part of 2006 on expectations that interest rates had nearly peaked (Chart 5). However, sentiment turned more cautious in recent months in view of increased uncertainty over the monetary policy stance of the US. In July, residential property prices were still 5.2% below the high in April 2005. Prices of office and retail space also suffered from higher interest rates, but prices of factory space

CHART 5
Asset prices



Sources: Rating and Valuation Department and Reuters.

continued to surge on increased demand from the manufacturing and logistics sectors.

Money supply and domestic credit

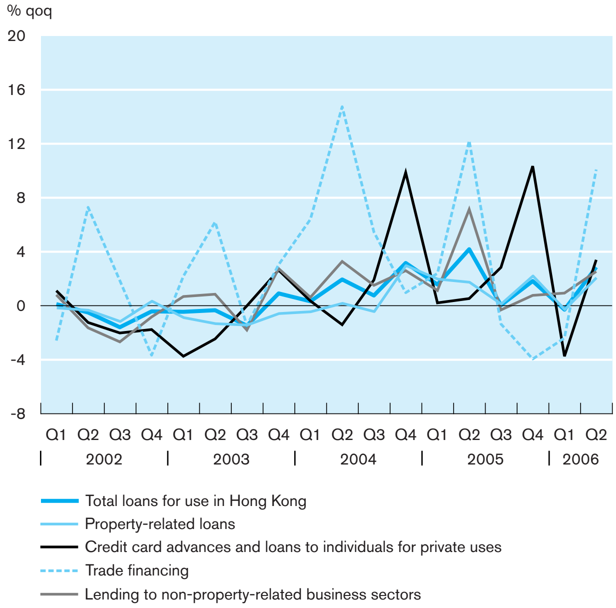
Hong Kong dollar narrow and broad monies increased in the second quarter of 2006. Narrow money rose by 1.1% during the quarter, but recorded an annual decline of 2.2% at the end of June. The quarter-on-quarter growth was partly attributable to a large scale fund-raising activity in the equity market. Broad money expanded by 2.2% during the quarter and grew by 13.3% compared with a year ago.

Total deposits increased by 2.9% during the second quarter, with notable growth in foreign currency deposits and, to a lesser extent, in Hong Kong dollar deposits. Within Hong Kong dollar deposits, as growth in time deposits outpaced the increase in liquid deposits (i.e. demand and savings deposits), the share of liquid deposits in total Hong Kong dollar deposits fell slightly to 43% at the end of June. Within foreign currency deposits, the second-quarter renminbi deposits rose slightly. The share of renminbi deposits in total foreign currency deposits remained small at around 1% at the end of June.

Loans for use in Hong Kong increased by 2.8% in the second quarter and by 4.4% from a year earlier. Analysed by economic uses,[2] growth in domestic credit was broad-based on a quarter-on-quarter basis (Chart 6). Trade-financing loans rose by 10.1%. Credit card advances expanded by 3.4%. Loans for non-property-related business sectors increased more than property-related lending. The former was mainly driven by strong growth in trade financing and lending to electricity and gas businesses. As the residential property market remained generally quiet, the outstanding stock of residential mortgage loans of all authorized institutions fell modestly in the second quarter of 2006, and registered a decline of 3% compared with a year ago. This was because repayments on existing mortgage loans exceeded the expansion in new mortgage credit. Separately, reflecting firm property values, the average size of newly approved mortgage loans edged up to around HK$1.7 million in the second quarter.

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

Despite a noticeable slowdown in the second quarter, the near-term outlook for Hong Kong remains largely positive. The Government maintained its growth forecast for 2006 at 4-5%, implying a further slowdown in the growth rate to 1.7-3.6% in the second half. Exports are expected to grow at a slower pace compared with the first half, reflecting a high base of comparison and slower growth in some of Hong Kong's major trading partners. Nevertheless, domestic demand is expected to continue to register solid growth. The improvement in labour market conditions should continue to support consumer spending, although higher interest rates and slower growth in export earnings may restrain growth in domestic demand.

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

Consumer price inflation is expected to increase modestly, reflecting a continuous pass-through effect of higher residential rentals and import prices into consumer prices. However, the relatively slow growth of unit labour cost brought about by productivity gains in the past quarters and the moderation in the growth of aggregate demand should help contain inflationary pressures. The Government maintained its inflation forecast for 2006 at 2.0%, suggesting that inflation would increase to an average annual rate of 2.2% in the remainder of the year.

Notwithstanding the generally positive near-term prospects, there are a number of risks, mostly related to external factors. These include high and volatile oil prices, a possible slowdown of the US economy, worsening global imbalances, macroeconomic overheating and tightening on the Mainland, trade protectionism against the Mainland, and the possibility of an avian flu pandemic.