

Domestic and external environment

by the Research Department

The risks of a US recession have increased and the slowing in economic growth is increasingly being felt by other countries around the world. While the slowdown was widespread across major economies in the euro area, there have been growing concerns that economic growth in Japan may also stall. In Hong Kong, the economy grew strongly in the fourth quarter of 2007, underpinned by the solid expansion in domestic demand. However, the deterioration in the external environment has increased the downside risks to growth.

External environment

In the US, preliminary estimates showed real GDP growing at an annualised rate of 0.6% quarter on quarter in the fourth quarter of 2007, down sharply from the 4.9% observed in the third quarter. The retrenchment in residential investment continued to detract from growth, while heightened caution among consumers and businesses caused consumption spending to slow and inventory accumulation to be scaled down. With exports of goods and services increasing at a faster rate relative to imports, the trade deficit narrowed, so that net exports contributed positively to overall growth. Activity data at the start of the first quarter of 2008 pointed to continued weakness in the economy, suggesting downside risks to growth. The housing sector contraction deepened as house prices in metropolitan areas declined and housing starts stayed at historic low levels. While retail sales surprised on the upside, the outlook may be less positive as the decline in non-farm payrolls in January suggested some deterioration in labour market conditions. Meanwhile tight credit conditions continued to weigh on consumer and business confidence. Partly reflecting the higher uncertainty surrounding the outlook for the economy, the Fed

lowered its target for the federal funds rate by 50 basis points to 3% on 31 January, following an earlier 75 basis-point inter-meeting cut. Meanwhile a \$150 billion fiscal stimulus package consisting of tax rebates and investment tax breaks was enacted to bolster the economy. On inflation, prices remained sticky notwithstanding softening domestic demand, with headline CPI rising by 0.4% month on month and core CPI by 0.3% in January. Inflationary pressure may remain elevated in the near term on higher import prices, especially for energy and food.

In the euro area, real GDP growth decelerated from 0.8% quarter on quarter in the third quarter of 2007 to a preliminary estimate of 0.4% in the fourth quarter. The slowdown was widespread across major economies, with growth in Germany and France both slowing to 0.3% quarter on quarter. Consumer spending moderated and exports weakened as the impact of the US sub-prime mortgage market crisis was felt in the euro area. Both the manufacturing and the service sectors showed signs of weakness, while forward-looking surveys of households and businesses suggested that spending would moderate further, in the face of a tight supply of credit. The headline harmonised index of consumer prices (HICP) inflation in the euro area rose to 3.2%

year on year in January, up from 1.8% six months ago. The European Central Bank kept its policy rate unchanged at 4%, noting the unusually high risks to economic growth. In the UK, economic activity slowed in the fourth quarter of 2007, with real GDP growing by 0.6% quarter on quarter, down from 0.7% in the third quarter. Consumer spending slowed as credit conditions tightened amidst deteriorating financial market conditions, while the housing market showed increasing signs of softening. Headline CPI was 2.2% in January. The Bank of England lowered its Bank rate by 0.25 percentage point each in its December and February meetings to 5.25%.

In Japan, economic growth in the last quarter of 2007 was surprisingly strong. Real GDP grew by 3.7% quarter on quarter (annualised) in the fourth quarter 2007, significantly higher than market expectations of 1.2% to 2%. The upward momentum came mainly from robust business investment and stronger-than-expected net exports. However, such strength is likely to be slashed by the slowdown in other advanced economies and the deceleration of global manufacturing activities in the period ahead. Moreover, private consumption remained lacklustre. The retail trade index, which reflects consumer spending, increased by a mere 0.57% quarter on quarter in the fourth quarter. While the unemployment rate remained at 3.8% in December, average monthly cash income fell in the last quarter of 2007. These unimpressive figures are consistent with the result of the latest national consumer survey conducted by the Economic and Social Research Institute (ESRI), which shows that consumer confidence has continued to fall since the second quarter last year. This suggests that the market is not expecting a significant rebound in consumer spending in the near term. Production and business activities have softened against the background of weak manufacturing confidence. Due to sluggish production in communication equipment, growth in industrial production slowed to 1.3% quarter on quarter in the fourth quarter, from 2.3% in the third

quarter, while machinery orders (excluding vessels and electricity) increased by only 0.9%. Growth in merchandise exports was disappointing, and shipments to the US and Europe are likely to continue their downward trends in the near term. Inflationary pressure rose against the backdrop of rising energy and food prices towards the end of 2007, with headline and core CPI inflation increasing to 0.7% and 0.8% year on year in December respectively. Household confidence is being significantly reduced by realised and expected losses of purchasing power from increasing inflation. Given heightened inflationary pressure and the expected slowing of the economy, the Bank of Japan is likely to face increasing policy challenges in the near term.

In Mainland China, the economic growth momentum remained strong in the final quarter of 2007, with real GDP rising by 11.2% year on year, though slightly lower than that in the third quarter. The softening is mainly attributed to the moderation in external demand, which has made an immaterial contribution to economic growth, compared with around three percentage points in the previous quarter. Meanwhile, the year-on-year growth in fixed assets investment declined by over two percentage points from the third quarter. Mainly driven by steady growth in income, retail sales (a proxy for private consumption) continued to rise at a robust pace, registering more than 12% year on year in real terms. Growth in exports moderated notably to 22.3% year on year in the fourth quarter of 2007, about four percentage points below that in the third quarter, reflecting the slowdown in the US economy, the accelerating appreciation of the renminbi exchange rate, and various policy measures to rein in the soaring trade balance. Growth in imports, on the other hand, rebounded to a rate about five percentage points above that in the previous quarter on a year-on-year basis. Despite a recovery in January 2008, China's export growth is set to slow further amidst deteriorating global economic conditions, especially in the US, although a significant slowdown is unlikely in the near term.

Year-on-year growth in broad money (M2) declined from 18.5% in the third quarter to 16.7% in the fourth quarter and bounced back to 18.9% in January 2008. In tandem, financial institutional loans rose at a slower pace both year on year and quarter on quarter in the fourth quarter, with a marginal revival in January 2008. The weakening in money and loan growth in the fourth quarter can be largely ascribed to the intensified austerity measures launched in the latter part of 2007 including credit control, window guidance and increases in interest rates as well as reserve requirement ratios (RRR). Headline CPI inflation continued to trend up, reaching 6.7% year on year in the fourth quarter and further picking up to 7.1% in January 2008. As in the previous quarters, food prices remained the major driver of CPI inflation, with the conditions aggravated by the devastating snowstorms around the Chinese New Year. PPI inflation has also been on the rise and hit 6.1% in January 2008 year on year, representing a three-year high. Looking forward, rising global food, energy, and commodity prices, temporary shortages in domestic supply, heightened inflation expectations, and rising labour costs will continue to put upward pressures on Mainland inflation.

In order to stabilise inflation expectations, the People's Bank of China (PBoC) raised the one-year benchmark lending and deposit rates to 7.47% and 4.14% respectively in end-2007 and the RRR on commercial banks to 15% in January 2008, the highest level in recent history. In addition, the PBoC has imposed more stringent credit controls and allowed the renminbi exchange rate to appreciate at a progressively faster pace against the US dollar. Although the negative shock to the economy caused by the snowstorms may have complicated the conduct of monetary policy, the tightening bias is likely to be maintained in the near term in light of growing risk of higher inflation and continued deterioration in external imbalances.

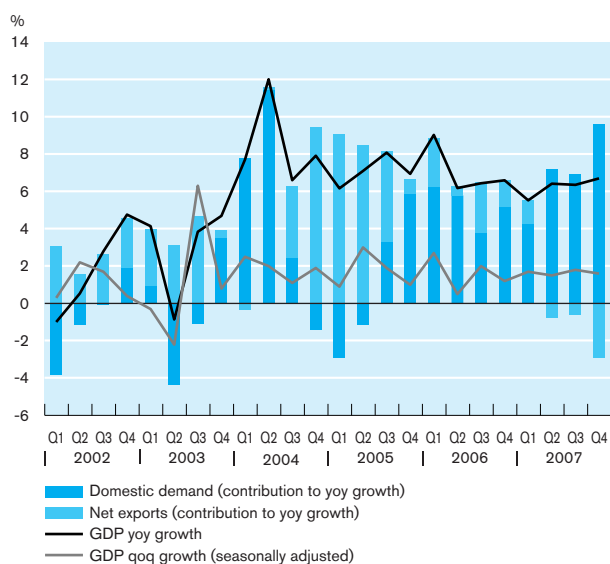
In the rest of East Asia, growth appeared to have maintained its momentum towards the end of 2007, notwithstanding the heightened risks of a US recession. In Korea, Singapore and Taiwan, real GDP growth averaged 3.8% quarter on quarter (annualised) in the fourth quarter. Korea and Taiwan registered positive growth, while the Singapore economy contracted by 4.8% due to sluggish external demand. In the ASEAN-4 economies¹, real GDP growth averaged 7.4%, compared to 7.7% from the third quarter. Looking forward, the market appears to believe that the negative impact from a US recession will gradually be felt in the emerging Asian economies in the year ahead. Manufacturing activities in the region continued to slow. Industrial production in Korea, Singapore and Taiwan grew by an average rate of 1.7% in the fourth quarter, down from 4.7% in the third quarter. In Thailand, growth in industrial production also slowed, while the volume of production even declined in Indonesia. On the other hand, growth in merchandise exports in the region was stronger than expected. In Korea, Singapore and Taiwan, exports grew by an average rate of 4.2% in the fourth quarter, while those in the ASEAN-4 economies grew by an average rate of 11.3% in the same period. Growth in import demand from Mainland China and other emerging markets remained firm, partly offsetting slowing shipments to the US. The sustainability of such robust export growth will depend on the breadth and depth of the impact of a US recession on the regional economies. Inflationary pressure increased in the region due to rising food and energy prices. Headline CPI inflation in Korea, Singapore and Taiwan averaged 3.8% year on year in December, while that in Indonesia, Malaysia, the Philippines and Thailand was 4%. Whether the recent narrowly based inflation would spillover to other sectors (for example, labour and residential housing costs) will be the focus of central banks and authorities in the year ahead.

¹ The ASEAN-4 economies are Malaysia, Thailand, Indonesia and the Philippines.

Domestic activity

Despite increased uncertainty in the external environment, the Hong Kong economy continued to grow strongly during the fourth quarter of 2007. On a quarter-on-quarter comparison, real GDP increased by 1.6% after growing by 1.8% in the third quarter. Comparing with a year earlier, real GDP rose by 6.7% in the fourth quarter following an increase of 6.3% in the previous quarter (Chart 1). Domestic demand remained the key driver of growth, with both consumer and business spending registering double-digit rates of expansion. Contribution from net exports stayed negative, as merchandise imports grew faster than exports due to vibrant domestic demand. Exports of services registered a double-digit growth rate for the third consecutive quarter, resulting in a larger surplus in trade in services in the fourth quarter. For 2007 as a whole, real GDP increased by 6.3% after rising by 7.0% in 2006, the fourth consecutive year of above-trend growth.

CHART 1
Economic activity



Source: Census & Statistics Department.

The broad-based increase in employment and the steady rise in household income continued to boost private consumption, which rose by 10.0% year on year in the fourth quarter after growing by 10.6% in the third quarter. The strong growth was partly driven by increased spending on financial services such as securities trading and investment advisory services, thanks to the buoyant domestic stock market activities. Business equipment spending increased by 11.9%, following a contraction of 0.4% in the third quarter, as corporate owners expanded their businesses in the face of rising economic activity. The contraction in headline residential investment mainly reflected the decline of construction spending in the public sector, while private residential investment expanded by 4.2% after growing by 4.9% in the third quarter (Table 1).

Forward-looking indicators suggest that business activities will continue to expand in the first quarter of 2008. The Quarterly Business Tendency Survey shows that corporate owners remained optimistic about the near-term business prospects, although activities in the communications and the tourism-related sectors such as retail trades, hotel and catering services might grow at a slower pace. The deterioration of the global growth prospects also drove down the Purchasing Managers' Index (PMI) to 50.0 in February from 52.5 in January, reflecting tepid growth in new orders and output. Monthly indicators pointed to a solid expansion in consumer spending in early 2008. On a three-month-on-three-month comparison, retail sales volume rose by 1.5% in January after growing by 2.9% in December last year.

TABLE 1

Real GDP growth by expenditure component (year on year)

(% yoy)	2006	2007	2007			
			Q1	Q2	Q3	Q4
Gross Domestic Product	7.0	6.3	5.5	6.4	6.3	6.7
(quarter-on-quarter growth)			1.7	1.5	1.8	1.6
Domestic demand	5.9	8.2	4.8	7.9	8.3	11.4
Private consumption expenditure	6.0	7.8	4.5	5.8	10.6	10.0
Government consumption expenditure	0.1	2.3	2.3	2.9	1.5	2.3
Gross domestic fixed capital formation	7.0	6.0	2.8	10.0	1.0	10.4
<i>Of which:</i>						
Building & construction	-7.3	0.2	-2.2	6.5	-0.9	-2.3
Machinery & equipment	19.1	6.6	3.6	11.2	-0.4	11.9
Change in inventories ¹	0.2	1.2	0.8	1.2	0.8	1.7
Net exports ¹	1.8	-0.8	1.3	-0.8	-0.6	-2.9
<i>Of which:</i>						
Exports of goods	9.3	7.2	6.6	10.1	6.4	5.9
Exports of services	10.1	11.2	10.0	11.6	12.6	10.5

¹ Percentage point contribution to annual growth of GDP.

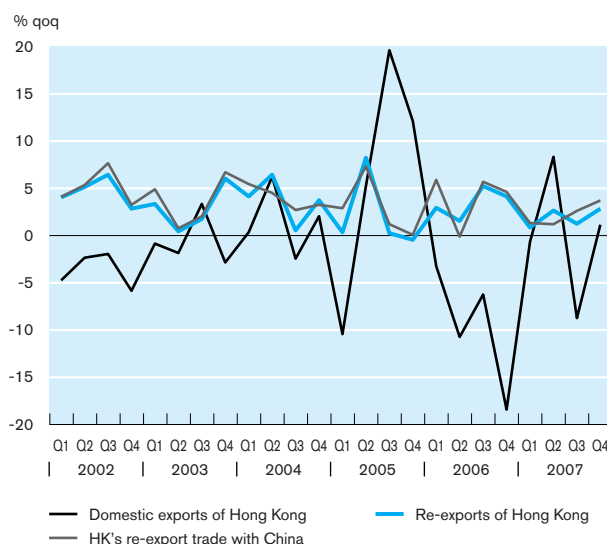
Source: Census & Statistics Department.

External trade

Growth of merchandise exports picked up in the fourth quarter of 2007, reflecting the robust re-export trade to Mainland China and other Asian economies (Chart 2). On a quarter-on-quarter basis, merchandise exports increased by 2.8% in the fourth quarter after growing by 0.9% in the third quarter. However, weaker external demand from the US and the euro area is expected to weigh on merchandise exports in the coming months, as a significant portion of re-export trade in Hong Kong will ultimately be shipped to the US and other developed economies for final consumption. That said, the robust expansion in service exports, particularly in trade and financial related services, should offset the expected widening of the deficit in merchandise trade, which increased to HK\$51 billion (11% of GDP) in the fourth quarter from HK\$35 billion (8% of GDP) in the third quarter.

CHART 2

External trade



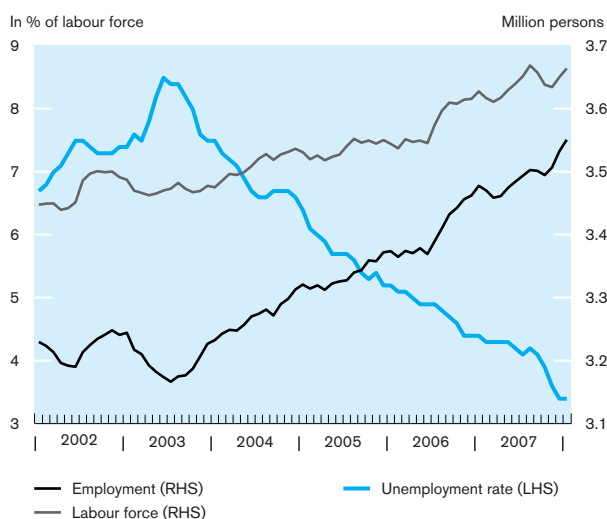
Sources: Census & Statistics Department, CEIC database and staff estimates.

Labour market and inflation

The continued expansion in economic activities has resulted in a broad-based expansion in domestic employment. During the fourth quarter of 2007, total employment increased to a record level of 3.53 million from 3.50 million in the third quarter, while the labour force declined slightly. As a result, the unemployment rate fell to 3.4% in the fourth quarter from 4.1% in the previous quarter, with the number of unemployed persons declining to a near-ten-year low of 0.12 million (Chart 3). While the demand for professional and managerial staff remained strong, the employment situation has also improved in the lower skill segment. Labour income has increased across different sectors, with nominal payroll per persons rising notably in financial-related services and the transport and communications sector.

CHART 3

Labour market conditions

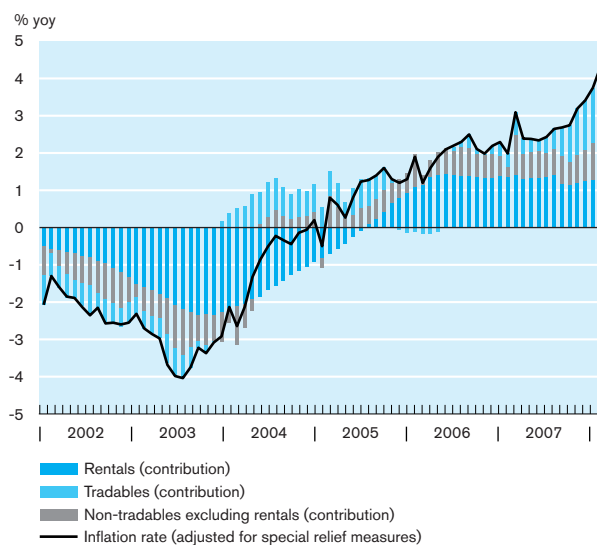


Source: Census & Statistics Department.

Rising imported food prices and housing rents continued to feed through to higher consumer prices. After removing the one-off effect from property rates rebates, the Composite Consumer Price Index (CCPI) increased by 4.3% year on year in January after growing by 3.8% in December 2007, the fastest pace of increase in almost ten years (Chart 4). On a three-month-on-three-month annualised basis, consumer price inflation accelerated to 5.9% in January from 4.7% in December and 3.4% in November last year. There are a number of factors driving the recent rise in consumer price inflation, including the vibrant expansion in domestic demand, sustained increases in global food prices and higher cost pressures from the supply side. Although CCPI inflation is expected to edge up further in the coming months, the economic slowdown in our major trading partners is expected to result in a moderation of growth in the domestic economy, which will help contain inflation expectations.

CHART 4

Consumer price inflation



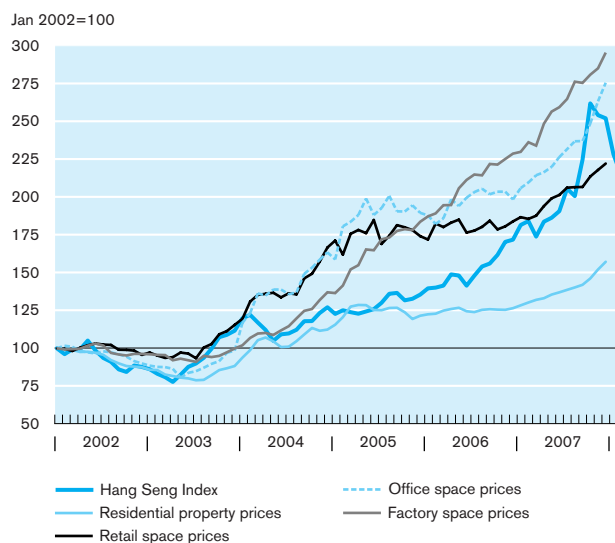
Sources: Census & Statistics Department and staff estimates.

Asset markets

The domestic equity market declined notably during the first two months of 2008, reflecting increased worries over the recession risks in the US economy and more stringent macroeconomic control measures imposed by the Chinese authorities. After reaching a record high of 31,638 on 30 October, the Hang Seng Index fell by 12% to close at 27,813 at the end of 2007. The two policy rate cuts by the US Fed in January only provided a brief relief to the global stock markets, which resumed a downward trend as market sentiment turned negative following the sizable write-off by financial institutions in the US and Europe. The Hang Seng Index fell in tandem, falling by 16% to 23,456 in January before rising to 24,332 by the end of February. The average daily turnover value also contracted from HK\$134 billion in the fourth quarter of 2007 to HK\$103 billion during the first two months of 2008.

Lower mortgage rates and rising household income have increased property market activities recently. During the fourth quarter of 2007, residential property prices grew by 10.7% following an increase of 3.6% in the third quarter. The volume of transactions increased even faster by 37.8% in the fourth quarter, reflecting the strong expansion in secondary market transactions. For 2007 as a whole, house prices appreciated by 24.3% after growing by 4.1% in 2006. While prices of luxury flats reached record highs in the fourth quarter, house prices in the mass market remained one-third below the peak levels in mid-1997. In the commercial property market, prices of office space rose notably by 16.3% during the fourth quarter, much faster than the 7.0-7.5% growth in prices of retail premises and factory space (Chart 5). Reflecting the limited supply of office space in prime locations, prices and rents of first-class office space are expected to grow further on the back of buoyant business activities.

CHART 5
Asset prices



Sources: Rating and Valuation Department and Reuters.

Money supply and domestic credit

Hong Kong-dollar narrow and broad monetary aggregates declined in the fourth quarter, in part reflecting a high base of comparison associated with heavily subscribed IPOs at the end of the third quarter. On a quarter-on-quarter basis, narrow money decreased by 6.0% after shrinking by 4.3% in the third quarter. Broad money also declined by 3.6%, reversing the 6.6% growth in the third quarter. Compared with a year ago, growth in broad money decreased to 18.1%, down from 28.3% in the previous quarter.

Growth in total deposits moderated to 3.1% quarter on quarter from 6.9% in the third quarter, with the increase in foreign currency deposits more than offsetting the decline in Hong Kong-dollar deposits. US-dollar deposits rose by 11.8% in the fourth quarter. Renminbi deposits also increased notably by 21.4% in the fourth quarter after declining by 0.4% in the previous quarter. This in part reflected expectations of faster renminbi appreciation due to a further strengthening of the currency against the Hong Kong dollar. For Hong Kong-dollar deposits, liquid deposits (demand and savings deposits) expanded while term deposits declined. As a result, the share of liquid deposits in total Hong Kong-dollar deposits rose to 46% in the fourth quarter from 41% in the third quarter.

On a quarter-on-quarter comparison, loans for use in Hong Kong contracted by 4.4% in the fourth quarter after rising by 5.8% in the previous one. The contraction was driven by a large decline in lending to non-property-related business sectors, particularly loans to stockbrokers (Chart 6)². The demand for loans by stockbrokers declined because fund-raising activities in the stock market subsided towards the end of the fourth quarter. In contrast, demand for property-related loans remained strong, growing by 3.2% compared with three months ago. In the housing loan market, the outstanding stock of mortgage loans increased by 2.2% in the fourth quarter after growing by 1.8% in the previous quarter. New loans drawn down grew by 42.8%, supported by increased residential property transactions in the secondary market. Newly approved mortgage loans averaged around HK\$2.03 million in the fourth quarter, higher than HK\$1.78 million in the previous 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

While the domestic economy is expected to grow at a solid pace this year, the downside risk has increased given the deterioration of the growth prospects for the US and other developed economies. The Government projects real GDP growth to moderate to 4-5% in 2008 from 6.3% in 2007, in part reflecting weaker export performance and a slowdown in the growth of consumer and business spending. The robust economic expansion in Mainland China will continue to support import/export and financial sector activities in Hong Kong. That said, if the slowdown in the US economy is more protracted and severe than expected, the Hong Kong economy will be affected through weaker external demand from the developed and regional economies.

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

Inflation pressure is likely to rise, as the sustained increase in global food prices and the steady growth in rental costs push up consumer prices. The official forecast is that the underlying CCPI inflation will rise to 4.5% in 2008 from 2.8% in 2007. Lower domestic interest rates and higher consumer price inflation will drive down interest rates in real terms, which could be stimulative to private consumption and asset prices. However, the deterioration in the external environment may undermine consumer and investor confidence. The determination of the Chinese authorities to curb inflation pressures on the Mainland suggests that more macroeconomic control measures might be implemented, which should help contain the pace of increase in domestic consumer price inflation.

Other downside risks to the growth prospects of the domestic economy include a sizable reversal of capital flows to Hong Kong if tighter global financial market conditions force international investors to liquidate their portfolio investment in Asia and other emerging markets. Increased volatility in the global financial markets would also heighten risk aversion, which might increase business borrowing costs. Finally, a protracted decline of the US dollar would push up global commodity prices, which could feed into consumer prices through higher import prices. Given the externally oriented nature of the Hong Kong economy, the above risk factors, if realised, would have a material impact on output growth and consumer price inflation.