REGULAR ARTICLE

Domestic and external environment

by the Research Department

The global economic slowdown has continued and growth concerns have shifted to areas outside the US. In the US, while economic growth in the second quarter was supported by the fiscal stimulus package, activity indicators pointed to continued weakness in the economy. Major European economies contracted in the second quarter, and there are increasing recession fears in the UK and Japan. The Hong Kong economy contracted in the second quarter, attributable to a decline in domestic demand and a moderation in export growth. Growth prospects in the second half will become more challenging in the face of a broad-based global economic slowdown.

External environment

In the **US**, advance estimates show real GDP growing at an annualised 3.3% quarter on quarter in the second quarter of 2008, following the 0.9% growth in the previous quarter. Economic growth in the second quarter was supported by the fiscal stimulus package, which boosted consumer spending growth to 1.7%, and also by a narrowing trade deficit, helped by solid external demand. Growth in business fixed investment however continued to be lacklustre at 2.2%, while inventory adjustments detracted from growth. As expected, residential investment remained a drag on growth, taking 0.6% percentage points from second-quarter GDP growth. Activity data at the start of the third quarter pointed to continued weakness in the economy. Retail sales softened again after the positive effects of the tax rebates faded, weighed down once again by the deterioration in labour-market conditions and the limited access to credit. The unemployment rate rose to 6.1% in August from 5.5% three months ago, while non-farm payroll employment declined by an average of 84,000 every month in the year to August. Credit conditions seem to have tightened further for both consumers and businesses, as indicated by the Fed's senior loan officer survey which showed that lending standards and terms in all major loan categories tightened in July from April. The housing market correction persisted, with house prices in metropolitan areas falling by 15.9% year on year in June, although there seems to be some stabilisation in the demand for existing homes. Both the Institute for Supply Management manufacturing and non-manufacturing indices lingered at low levels, although durable goods orders rebounded to grow by 0.6% three months on three months in July. Prices continued to surge notwithstanding weak economic conditions, with headline Consumer Price Index (CPI) rising by 5.6% year on year in July, the highest since 1990. To the extent that the rise in consumer-price inflation is fuelled by oil price increases, the retreat of oil prices by some $40 a barrel should help alleviate the upward pressure in the coming months. Core CPI rose by 2.5% year on year in July on the back of higher costs for apparel, recreation, airline tickets, and education. The Fed maintained the Fed funds target rate at 2.0% in August, with meeting minutes suggesting that FOMC members saw the next change in interest rates as an increase, although no conclusion was reached on the timing of such a decision.

In the **euro area**, preliminary GDP estimates showed that the economy contracted by 0.8% quarter on quarter (annualised) in the second quarter, the worst quarterly performance since the single currency was launched in 1999. The contraction was mainly driven by Germany, where GDP fell 0.5% from the previous quarter. The weak real GDP performance in the second quarter reflected the high base effect of the strong growth of 2.9% in the first quarter, as well as slower expansion at the global level and dampening effects from high oil and food prices. Weak construction and production output mainly drove the deceleration in growth, while retail sales also remained on a downward trend. In addition, the trade deficit widened further in the second quarter, as the growth momentum in exports declined sharply from the previous quarter due to the adverse impact of past euro appreciation and the US-led slowdown in global demand. Meanwhile, the manufacturing and services Purchasing Managers' Index (PMI) has deteriorated into contraction territory since June, reflecting the ongoing weakening in industrial production and new orders. Headline Harmonised Index of Consumer Prices inflation in the euro area accelerated to 4.0% year on year in July, up from 3.2% six months ago. The European Central Bank (ECB) raised its policy rate by a quarter percentage point at the July meeting, leaving the rate at a seven-year high of 4.25%. The recent fall in oil and other commodity prices has eased inflation pressures in the euro area, as Eurostat's flash inflation estimate dropped to 3.8% in August, implying that inflation is likely to have already peaked in July. Amid increasing signs of the economy heading for a recession and possible second-round-effects of inflation, the ECB maintained its policy rate unchanged in September and is likely to stay in wait-and-see mode in the coming months. In the **UK**, real GDP grew at 0.2% quarter on quarter (annualised) in the second quarter, the lowest rate since 1992, compared with 1.1% in the previous quarter. The weak economic performance was mainly driven by the sharp slowdown of domestic demand, as record fuel and food prices deterred gross fixed capital formation and consumer spending. Headline CPI accelerated to 4.4% year on year in July, from 2.2% at the beginning of 2008. The largest upward effect on CPI inflation came from the food component, leaving core CPI at an annual rate of 1.9%. The Bank of England has maintained its bank rate at 5% for five consecutive months since May, in the face of high inflation, sliding economic growth, and a housing market downturn.

In **Japan**, real GDP contracted by 2.4% quarter on quarter (annualised) in the second quarter, after a solid expansion of 3.2% in the first quarter, bringing the country to the threshold of its first recession in six years. Exports fell by 9.0% quarter on quarter (annualised), the most since the 2001-2002 recession, robbing Japan's growth engine of its longest postwar expansion, while record fuel and food prices deterred consumer spending and fixed-capital formation. Consumer spending, which accounts for more than half of the economy, decreased 0.5% from the previous quarter, while fixed-capital formation contracted sharply by 1.5%. Both activity and survey indicators reinforced a rising risk that the economy may be heading towards a recession, as industrial production contracted by 0.8% and the retail trade index declined by 0.2% from the first quarter, while manufacturers' sentiment deteriorated into contraction territory. The Tankan index of manufacturers' sentiment has declined for three quarters in a row, reflecting the sharpest deterioration in operating conditions. Meanwhile, the labour market remained weak, as the unemployment rate lingered around 4.0% in July for four consecutive months, with average monthly cash income declining. Headline CPI inflation accelerated to 2.3% year on year in July, from 1.0% in the first quarter. Soaring food and energy prices remained the main contributors to inflation, leaving core CPI inflation (excluding food and energy) hovering at around zero. The Bank of Japan maintained its benchmark interest rate at 0.5% at its August meeting, citing more evidence of a slowdown in the real economy, despite rising inflationary pressure.

In **Mainland China**, the year-on-year economic growth continued to inch down to 10.1% in the second quarter, half a percentage point lower than in Q1. The slowdown was mainly attributable to weaker net exports, whereas domestic demand grew at a steady pace. Although exports registered healthy growth of around 22% in Q2 and 27% in July year on year, growth in imports surged by almost four percentage points on a year-on-year basis in the second quarter to over 32% and further to about 34% in July. While the stabilisation of exports over the past few quarters has been mainly led by worsening external conditions, the upturn in imports can largely be ascribed to higher international energy and commodity prices. On the domestic demand side, fixed-asset investment maintained the same growth momentum as in the previous quarter and rose by about 16% year on year in real terms in Q2, partly due to impressive investment in the primary industry and reconstruction following the major earthquake in the Sichuan Province. Retail sales, a proxy for private consumption, also registered robust growth of about 15% and 17% in real terms in Q2 and July respectively owing to steady growth in income. Going forward, economic growth is likely to moderate further in the light of the broadening deterioration in the demand of China's major trade partners and possible adverse wealth impacts of stock markets at home.

The year-on-year growth in broad money (M2) rose by more than one percentage point from that in Q1 to 17.3% in the second quarter and moderated to 16.4% in July. In addition, the growth of M2 in Q2 outpaced that of narrow money (M1) for the first time since 2006 Q4, partly reflecting reversing flows from the stock markets to banks as a result of plunging stock prices. Meanwhile, growth in financial institutional loans continued to trend down and registered a 14.1% year-on-year growth in Q2, 0.7 percentage points below that in Q1, mainly reflecting authorities' tightening bias. Dragged down in large part by falling food-price inflation (for pork and poultry in particular), headline CPI inflation edged down to 7.9% in Q2 and further softened to 6.3% in July on a year-on-year basis. In contrast, Producer Price Index (PPI) inflation continued to trend up year on year on the back of rising commodity and energy prices, exceeding 8% in Q2 and surging to above 10% in July. The widening divergence between CPI and PPI inflation may further squeeze the narrowing profit margins of firms and casts a shadow over near-term growth prospect. Looking ahead, inflation pressure remains tilted to the upside as the possibility of upstream inflation translating into downstream prices cannot be ruled out.

In order to bring inflation under control, the People's Bank of China (PBoC) maintained its tightening bias in the second quarter and raised the reserve requirement ratio (RRR) for commercial banks further to 17.5%. The authorities' hawkish policy stance has recently, however, shifted subtly to a more pro-growth tone in view of the decline in CPI inflation, deteriorating external economic environment and discouraging assets markets. In the latest Monetary Policy Implementation Report, for example, the PBoC emphasised lending support to the agricultural sector, small and medium-sized enterprises and earthquake-affected areas. Nevertheless, it is still too early to tell to what extent the tightening bias may be relaxed given the uncertainty of inflation pressure.

In the rest of **East Asia**, the economic momentum in the newly industrialised economies appeared to have slowed from the first quarter, reflecting the slowdown of export-led growth due to sluggish global demand. In Korea, Singapore and Taiwan, real GDP growth averaged 0.4% quarter on quarter (annualised), slowing from 4.4% in the first quarter. Although Korea registered firm growth of 3.4% in the second quarter, the contribution of net exports declined from 3 percentage points in the first quarter to 1.9 percentage points in the second quarter. In the ASEAN-4 economies[1], real GDP growth averaged at 5.7% quarter on quarter (annualised), compared to 2.9% in the first quarter. In Indonesia, the economy grew unexpectedly by 6.7% quarter on quarter (annualised), mainly driven by the rising prices and demand for the nation's coal, palm oil and rubber exports. However, economic growth in Malaysia and Thailand appeared to have decelerated from the robust pace in Q1. In the face of slowing external demand, tighter monetary policy, high inflationary

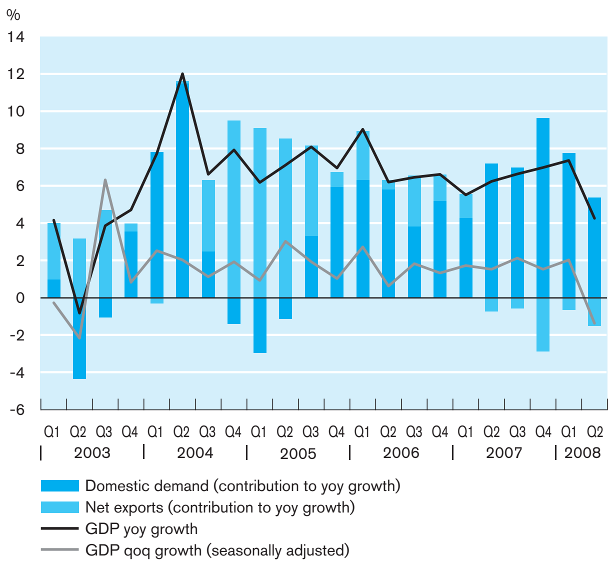
[1] The ASEAN-4 economies comprises Malaysia, Thailand, Indonesia and the Philippines.

pressure and sluggish financial markets, market observers believe that signs of further slowdown in the region will become more evident in the second half of the year. While growth in merchandise exports in the region remained firm, manufacturing activities in the region are already slowing. In the external sector, growth in export demand from the Asian economies continued to offset the decline in demand from the US. In Korea, Singapore and Taiwan, exports grew by an average rate of 7.4% quarter on quarter in the second quarter, while those in ASEAN-4 economies increased by 8.6% during the same period. On the other hand, industrial production in Korea, Singapore and Taiwan contracted by an average of 0.8% quarter on quarter in the second quarter, while that in Indonesia, Malaysia and Thailand decreased by 0.3%, 0.1% and 0.2% respectively during the same period. Manufacturing production also contracted in the Philippines according to the May data. The downside risks to production are expected to increase in the quarters ahead against the background of deteriorating global economic conditions. Consumer-price inflation continued to hit record highs in the region. In Korea, Singapore and Taiwan, headline CPI inflation averaged 6.1% year on year in July, the highest rate since the first quarter of 1991, while that in ASEAN-4 economies increased to double digits during the same period. Nevertheless, market observers believe that inflation will peak soon in the region. The food commodity price index compiled by the IMF decreased for the first time in July since April last year and is expected to slow further. The drop in oil prices is also likely to ease inflationary pressure. Central banks in the region are expected to focus more on the downside risks to growth. In the face of the sluggish economic outlook and increasing risks to growth, Asian currencies continued to depreciate against the US dollar. For example, the Korean won hit a 45-month low of 1,076 won to the dollar on 25 August, despite active intervention by the government. The Philippine peso also depreciated to 45.6 pesos to the dollar on 25 August, from about 43 in early August. Central banks in the region are expected to continue to closely monitor their currencies and intervene in due course.

Domestic activity

The domestic economy contracted in the second quarter following an extended period of solid expansion over the past few years. On a seasonally-adjusted quarter-to-quarter comparison, real GDP decreased by 1.4% after growing by 2.0% in the first quarter, reflecting a decline in domestic demand and a moderation in export growth. Compared with a year ago, real GDP growth slowed to 4.2% from 7.3% in the first quarter, dragged down by weaker growth in private consumption and exports (Chart 1 and Table 1). The slowdown in export growth was partly due to the flooding in the southern part of Mainland China, which caused significant disruption to manufacturing activities. The moderation in the number of inbound tourists and ongoing turbulence in the global financial markets weighed on services exports, which increased by 7.1% year on year in the second quarter after growing at a double-digit rate in the past five quarters. Net exports contributed 0.8 percentage points to the year-on-year GDP growth, compared with a contribution of 1.0 percentage point in Q1. For the first half of 2008, real GDP increased by 5.8% year on year after growing by 6.8% in the second half of 2007.

CHART 1
Economic activity



Source: Census & Statistics Department.

TABLE 1

Real GDP growth by expenditure component (year-on-year)

(% yoy)	2006	2007	2007 Q3	2007 Q4	2008 Q1	2008 Q2
Gross Domestic Product	**7.0**	**6.4**	**6.8**	**6.9**	**7.3**	**4.2**
(quarter-on-quarter growth)			2.1	1.5	2.0	-1.4
Domestic demand	5.9	7.8	8.2	10.3	7.1	3.7
Private consumption expenditure	6.0	7.8	10.6	9.5	7.9	3.1
Government consumption expenditure	0.1	2.3	1.5	2.3	0.3	3.5
Gross domestic fixed capital formation	7.0	4.2	-0.5	8.2	9.9	4.3
Of which:						
Building & construction	-7.3	1.0	-0.2	-1.2	8.2	-1.7
Machinery & equipment	19.1	3.5	-2.7	8.5	6.1	6.5
Change in inventories[1]	0.2	1.2	0.9	1.6	-0.4	0.3
Net exports[1]	1.7	-0.5	-0.1	-2.0	1.0	0.8
Of which:						
Exports of goods	9.3	7.0	6.2	5.7	8.3	4.4
Exports of services	10.1	12.5	13.7	13.1	10.2	7.1

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

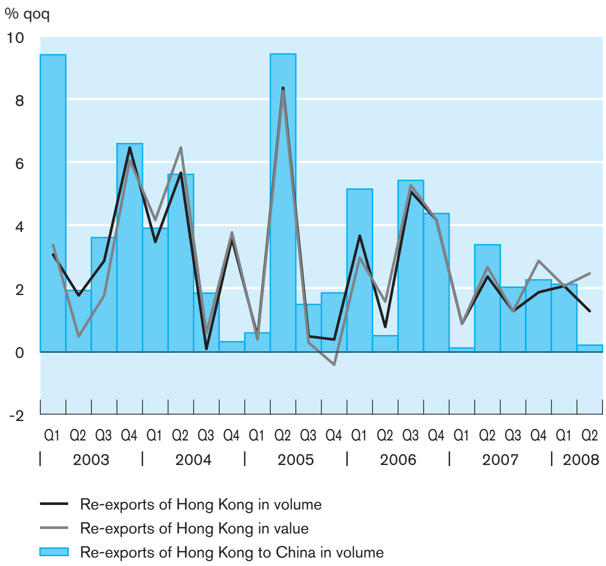
Growth in domestic demand slowed notably to 3.7% year on year in the second quarter from 7.1% in the first quarter. Private consumption growth declined to 3.1% from 7.9% over the same period, as the volatile stock market reduced consumer spending on financial services and rising inflation eroded the purchasing power of households. Business equipment spending remained strong, growing by 6.5% following an expansion of 6.1% in the first quarter, underpinned by the low-interest-rate environment. However, deterioration in the external environment has undermined business confidence, which is likely to affect the investment decisions of corporate owners. Residential investment contracted by 1.7% year on year following an expansion of 8.2% in the first quarter, with construction spending declining in both the private and public sectors.

Forward-looking indicators point to a slowdown in the pace of business expansion in the third quarter. Compared with the second quarter, the Quarterly Business Tendency Survey for the third quarter shows that corporate owners were generally less optimistic about the business conditions, and became more cautious about hiring. The PMI decreased to a three-year low of 48.5 in August after falling to 49.4 in July, dragged down by weaker output and new orders. Growth in consumer spending remained subdued. On a three-month-on-three-month basis, retail sales volume declined by 1.8% in July following a contraction of 1.7% in June, reflecting weaker spending on valuables and consumer goods by tourists and households.

External trade

Growth in merchandise exports declined to 7.8% year on year in the second quarter from 10.5% in the first quarter, reflecting a more broad-based moderation in external demand from our major trading partners. In particular, growth in re-exports to Mainland China decelerated to a single-digit rate of 8.5% in the second quarter from 11.4% in the first quarter, the slowest expansion in six years. On a seasonally-adjusted quarter-on-quarter comparison, merchandise exports rose by 2.1% in the second quarter after growing by 2.0% in the previous quarter. In volume terms, merchandise exports increased at a slower pace of 1.0% in the second quarter (versus 1.8% in the first quarter), as rising global commodity prices fed through to higher export prices. The slowdown in trade flows was mainly due to a moderation in re-exports to Mainland China, which grew at a tepid rate of 0.2% in the second quarter (Chart 2). Reflecting weaker export performance, the merchandise trade deficit widened to HK$68 billion (17% of GDP) in the second quarter from HK$51 billion (13% of GDP) in the first quarter.

CHART 2
External trade

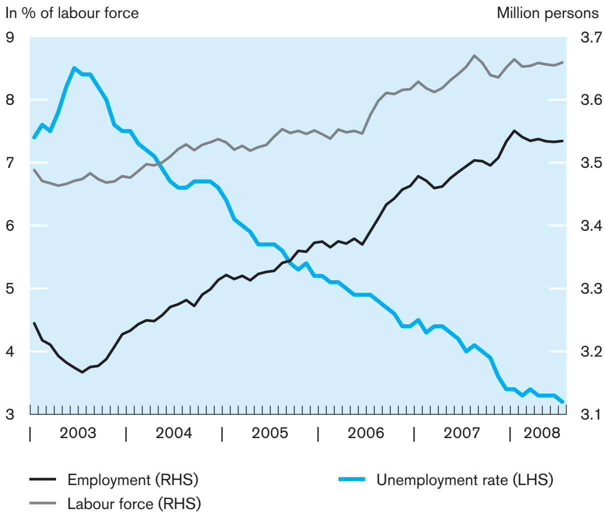


Sources: Census & Statistics Department, CEIC database and staff estimates.

Labour market and inflation

Labour market conditions remained firm during the second quarter. Total employment and the labour force remained largely stable at 3.53 million and 3.65 million respectively (Chart 3). The seasonally adjusted unemployment rate declined to 3.3% in the second quarter from 3.4% in the first quarter, the lowest level since early 1998. Despite the current low unemployment rate, the pace of job creation appeared to have lost momentum, with year-on-year employment growth declining to 1.4% in the second quarter from 2.2% in the first quarter. Disaggregate data show increased job losses in the import/export sector, as business owners were more cautious about hiring due to weaker export earnings. Labour income continued to rise, with the nominal payroll per person growing by 3.1% year on year in the first quarter following an increase of 5.9% in the previous quarter, with the largest increment in labour earnings in the financial and business services sector.

CHART 3
Labour market conditions

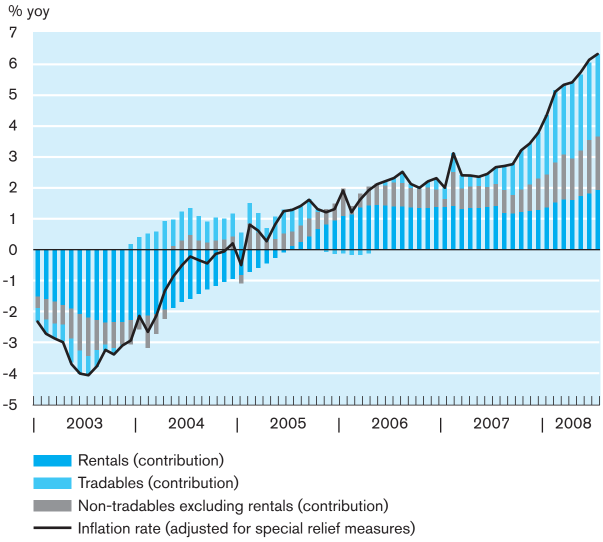


Source: Census & Statistics Department.

Consumer-price inflation rose in the second quarter, reflecting a faster pace of increase in residential rents and food costs. After adjusting for the effects of the property rates concession and other one-off relief measures, the Composite Consumer Price Index (CCPI) increased by 5.7% year on year in the second quarter after rising by 4.9% in the first quarter (Chart 4). On a quarter-on-quarter comparison, the annualised rate of CCPI inflation eased to 5.8% from 8.9% over the same period, reflecting a moderation in food-price inflation. Excluding basic food and energy, core CCPI inflation declined to 5.1% in the second quarter from 5.8% in the first quarter. Looking ahead, the stabilisation of food prices on the Mainland is expected to alleviate the rise in the prices of foodstuffs in Hong Kong. Moderation in domestic demand and employment growth will also help contain the domestic cost pressure. That said, higher house prices will continue to exert upward pressure on rental costs, which account for nearly 30% of the consumption basket of the CCPI.

CHART 4

Consumer-price inflation



Sources: Census & Statistics Department and staff estimates.

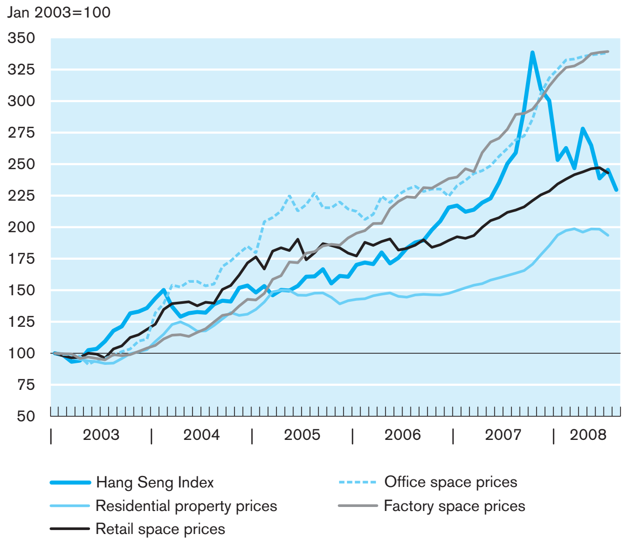
Asset markets

The domestic equity market resumed its downward trend in August, following a decline of 3.3% in the second quarter, weighed by the extended weakness in the stock market on the Mainland and renewed concerns over the sizable write-downs of sub-prime-related investments by financial institutions in the US. The fall in crude oil prices from a record high of US$146 per barrel to US$124 in July boosted global equity prices during the month.[2] The Hang Seng index rose in tandem by 2.8% in one month to close at 22,731 at the end of July (Chart 5). However, the rise in solvency risk of Freddie Mac and Fannie Mae, the extended credit losses in sub-prime-related investments by financial institutions in the US, and the weak stock market performance on the Mainland undermined investor confidence in the domestic market. The Hang Seng index fell by 6.5% in August to close at 21,262 at the end of the month. The average daily turnover contracted by 5.9% in one month to HK$59 billion in August, declining from HK$63 billion in July and HK$76 billion in the second quarter.

Activity in the residential property market contracted further in July following a marked decline of 25.4% in the second quarter, as potential home buyers turned cautious in the face of the uncertain economic outlook and poor performance of the equity market. Average house price fell by 2.5% month on month in July following a decline of 0.1% in June. Reflecting limited new supply in the primary market and subdued activity in the secondary market, the transaction volume of residential property shrank by 27% in July after rising by 23% in June. While deterioration in economic prospects will continue to weigh on property market activity, a healthy level of housing affordability and a negative buy-rent gap suggest a broadly stable picture in the housing market. In the commercial segment, growth in the average price of office space appeared to have levelled off, as corporate owners scaled back their expansion plans in the face of weakening business conditions (Chart 5). However, monthly rentals of quality office premises located in prime locations hit a record high of HK$926 per square metre in the second quarter. Prices of retail premises and factory space continued to increase, albeit at a moderate pace.

CHART 5

Asset prices



Sources: Rating and Valuation Department, and Reuters.

[2] The spot crude oil price of US West Texas Intermediate (WTI).

Money supply and domestic credit

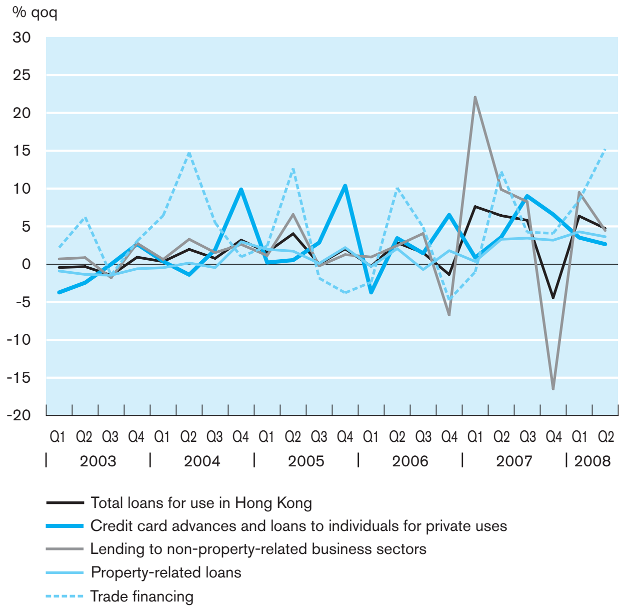
Hong Kong-dollar narrow money increased in the second quarter while broad money continued to decline. Seasonally adjusted narrow money rose by 1.0% during the quarter and grew by 14.0% from a year earlier, as the opportunity cost of holding liquid deposits remained low. But broad money contracted by 3.4% in the second quarter, partly because of a shift away from time deposits in a low-interest-rate environment. Compared with a year ago, broad money decreased by 3.8%, in part reflecting a high base of comparison associated with heavily-subscribed IPOs at the end of June 2007.

Total deposits decreased by 1.0% during the second quarter, as the decline in Hong Kong-dollar deposits exceeded the rise in foreign currency deposits. For Hong Kong-dollar deposits, both liquid deposits (demand and savings deposits) and term deposits contracted during the second quarter, possibly due to a portfolio shift towards foreign currency. The share of liquid deposits in total Hong Kong-dollar deposits rose slightly to 48% at the end of the second quarter. For foreign-currency deposits, renminbi deposits in Hong Kong increased notably in April because of low interest rates in Hong Kong-dollar deposits and expected valuation gains arising from the currency's appreciating trend. Growth in renminbi deposits dropped in May and turned negative in June, partly reflecting the Mainland's policy to increase the transaction cost associated with converting Hong Kong-dollar deposits into renminbi deposits. At the end of June, renminbi deposits in Hong Kong totalled RMB77.6 billion, accounting for around 3.1% of total foreign-currency deposits in Hong Kong.

Growth in domestic credit moderated in the second quarter alongside a slowdown in economic growth. Loans for use in Hong Kong rose by 4.7% during the quarter, after growing by 6.3% in the previous one. Analysed by economic uses, most types of loans recorded lower quarterly growth compared with three months ago, except those for trade financing (Chart 6).[3] In line with lower private consumption expenditure, growth in credit card advances slowed to 1.6% at the end of the second quarter. Growth in property-related loans also moderated to 3.6% in the face of a quiet property market. Loans in Hong Kong dollars continued to grow at a slower pace than loans in foreign currency in the second quarter. As Hong Kong-dollar loans continued to climb while deposits declined, the Hong Kong-dollar loan-to-deposit ratio rose further to 81.9% at the end of June, from 76.5% at the end of March.

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.

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

Short-term outlook

Growth in the domestic economy is expected to slow in the second half of this year. The Government maintained its projection of real GDP growth of 4-5% for 2008, compared with the market consensus of 4.4%. A more broad-based economic slowdown in our major trading partners will weigh on the export performance of Hong Kong. In particular, the European and emerging Asian economies have started to worsen, while external demand remained weak in the US and Japan. That said, the robust consumption and manufacturing activities on the Mainland will provide support to the re-export trade in Hong Kong. Increased uncertainty and volatility in the global financial markets will have a negative impact on domestic asset prices and financial sector activities, which will affect economic growth and exports of financial services negatively. Despite the less favourable economic outlook, the strong balance sheet position of the household and corporate sectors and the low interest-rate environment are expected to underpin consumer and business spending.

Consumer-price inflation is expected to remain elevated in the second half of the year but will eventually level off due to weaker domestic demand. The Government revised upward its forecast of headline CCPI inflation from 3.4% to 4.2% for 2008, reflecting higher global food prices and rental costs. The recent stabilisation of food prices on the Mainland will help contain food-price inflation in Hong Kong. However, house prices will continue to feed through to residential rents, which will be a key driver of inflation in the second half.

The downside risk to the near-term economic outlook has increased, mainly reflecting deterioration in the external environment. The decline in the US housing market has not yet bottomed out, which will have a protracted impact on consumption and growth in the world's largest economy. The credit problems triggered by the collapse of the US subprime mortgage market has deepened, and its spill-over effect on other financial markets has posed threats to global financial stability. Given the externally oriented nature of the Hong Kong economy, any adverse developments in these risk factors will affect the domestic economy through the trade and financial channels. With the closer economic and financial ties with the Mainland, any changes in the policy stance of the Mainland authorities will also have a significant influence on the Hong Kong economy.