REGULAR ARTICLE

Domestic and external environment

by the Research Department

Global economic conditions have deteriorated further. Economic contractions in the major economies accelerated sharply in the fourth quarter of 2008. In the US, while a fiscal-stimulus package was enacted to underpin the economy, high frequency indicators continued to point to further weakness in aggregate demand in 2009. Economic downturns were widespread across major European economies while Japan also witnessed the most severe economic slump in its recent economic history. In Hong Kong, economic activities shrank markedly in the fourth quarter of 2008, attributable to sharp fall in both domestic and external demand. It is generally believed that the global economy will remain in recession in the first half of 2009, and the prospects for a global economic recovery in the second half of 2009 are highly uncertain.

External environment

In the **US**, the recession deepened in the fourth quarter of 2008 as preliminary GDP estimates showed a contraction of 6.2% quarter on quarter (annualised) following a decline of 0.5% in the third quarter. Private consumption fell 4.3% and business investment tumbled 21.1%, while the decline in residential investment accelerated. Net exports also detracted from growth, as the spillover from the financial crisis to the global economy intensified. Monthly economic indicators suggest continued weakness heading into 2009. Retail sales fell 6.7% three months on three months in January, as consumer confidence plunged to a record low of 25 in February from 44.7 three months ago. The contraction in labour demand continued unabated, with non-farm payroll employment falling by almost two million in the three months to January, while the unemployment rate climbed to 8.1% in February from 6.8% three months ago. The housing market has yet to stabilise, as existing home sales fell 8.0% three months on three months in January, and the decline in house prices in 20 US metropolitan areas accelerated to 18.6% year on year in December. Business investment was sluggish, with non-defence capital goods orders excluding aircraft declining 10.0% three months on three months in January, and the ISM manufacturing and non-manufacturing indices both staying well within the contraction territory. Credit conditions remained tight, with the Fed's January Senior Loan Officer Survey showing a large proportion of US banks reporting tightened lending policies over the previous three months. In face of the severe economic downturn, a fiscal-stimulus package of $787 billion was enacted to provide some support to the economy.

On the inflation front, reflecting the continuing decline in energy prices and the sharp contraction in aggregate demand, price pressures eased notably. Headline CPI inflation slowed markedly to flat growth on a year-on-year basis in January from 3.7% three months ago, while core inflation declined to 1.7% from 2.2%. The FOMC maintained its target for the fed funds rate at 0 – 0.25% at its 28 January meeting, and continued to state its intention to keep rates at a low level for some time in its post-meeting statement. It was also noted from the statement that the Fed's balance sheet would be used to support credit markets and economic activity, and that the FOMC was prepared to purchase longer-term Treasury securities if conditions warrant.

In the **Euro area**, the first estimate for the fourth quarter GDP showed that the economy shrank quarter on quarter at an annualised rate of 5.7%, after declining by 1.0% in each of the preceding two quarters. The economies of Germany and France contracted by 8.2% and 4.6% respectively – their worst quarterly performance in more than two decades, while the Italian economy faced a contraction of 7.1%. Other Euro area-wide indicators available for the fourth quarter also had a notably weak tone. Retail sales volume fell at an annualised rate of 3.9% and is likely to weaken as the European Commission's consumer confidence indicator declined further in recent months. Private-sector investment was undercut by the weak prospects, a slump in building activity, and stormy financial market developments. Industrial output dropped by 5.2% quarter on quarter while new orders plummeted by 13.4%. The unemployment rate hit a two-year high of 8.0% in December. Despite some tentative signs of stabilisation, sentiment indicators still suggest a pronounced deterioration ahead. Headline CPI inflation, having reached 4% as recently as last July, fell to 1.1% year on year in January from 1.6% in December. The European Central Bank lowered the benchmark interest rate by 50 basis points to 1.5% at its March meeting, bringing it down by 275 basis points since October. In the UK, real GDP shrank by 6.0% quarter on quarter (annualised) in the fourth quarter, following a decrease of 2.8% in the previous quarter. A range of indicators fell through that quarter to historic lows, and forward-looking surveys suggest that the severity is likely to sharpen. Partly reflecting a temporary reduction in VAT as a countercyclical measure, headline CPI inflation softened to 3.1% year on year in December after reaching a peak of 5.2% in September, while core CPI inflation moderated to 1.1%. Against this background and considering the unsettled financial markets and a sharp contraction in the real sector, the Bank of England reduced policy rates by another 50 basis points to a record low of 0.5% at its March meeting. This takes the total easing to 450 basis points since October.

In **Japan**, the downturn in economic activity continued to deepen in the fourth quarter. Real GDP fell quarter on quarter at an annual rate of 12.1%, accelerating from 1.4% in the third quarter and 4.5% in the second quarter. The decline was attributable to the sharp contraction in private non-residential investment (-19.8%) and the negative contribution from net exports. Overall household consumption decreased by 1.8% and durable goods purchases by 14.3%. Merchandise exports tumbled by 20.6%, showing across-the-board decreases in all major markets amid sluggish global demand. Factory activity throttled back as industrial output fell by a record 12.0% in the fourth quarter, with significant declines in the automotives, electronics and machinery sectors. Reflecting the worsening economic conditions, the unemployment rate climbed to a three-year high of 4.3% in December. Forward-looking indicators remain unanimously weak, with business sentiment and consumer confidence all falling to or near record low levels. In the course of declining domestic demand and lower oil prices, inflationary pressure continued to ease. The headline annual CPI inflation rate moderated to 0.4% in December, while core CPI inflation (excluding fresh food and energy) was a tepid year-on-year rate of 0.2%. Noting that deflation risks have increased, the Bank of Japan reduced the policy rate to 0.1% in mid-December and decided to step up monetary easing through outright purchases of Japanese government bonds and corporate financial instruments.

In **Mainland China**, the growth momentum continued to decelerate. Real GDP growth in the fourth quarter of 2008 declined to 6.8% year on year, which is a seven-year low. Real GDP growth for the whole year of 2008 was 9.0%, four percentage points less than that in 2007. The decline was mainly driven by tumbling exports and a plunge in industrial production. Growth in exports dropped sharply from 23% in the third quarter to 4.3% in the fourth quarter of 2008 due to weakening external demand, and growth in imports plummeted from 25.8% to -8.9% as a result of contraction in processing trade in China. The slowdown in exports and imports continued in January 2009, with exports dropping by

17.5% year on year and imports by 43.1%. The year-on-year growth in fixed-asset investment declined from 28.7% in the third quarter to 23.1% in the fourth quarter of 2008, and electricity production contracted by 6.0% in the fourth quarter. Some economic indicators showed positive signals in January 2009 presumably due to recent fiscal-stimulus package and dramatic monetary expansions. The Purchasing Managers' Index (PMI) rebounded in January to 45.3 from 41.2 a month ago, and new loans in January 2009 increased sharply to RMB1.62 trillion, more than double the figure in January 2008. The year-on-year growth in broad money (M2) rose from 15.3% in the third quarter to 17.8% in the fourth quarter of 2008, and grew further to 18.8% in January 2009. The growth in outstanding loans year on year accelerated from 14.5% in the third quarter to 18.8% in the fourth quarter of 2008, and rose further by 21.3% in January 2009. Nonetheless, it remains to be seen how quickly and strongly the credit expansion will be transmitted to investments and consumption, as some observers noticed that a large part of credit expansion is due to increase in short-term commercial papers, implying that bankers are still cautious in extending new loans in light of the highly uncertain economic outlook.

The headline CPI inflation rate dropped quickly from 5.3% in the third quarter to 2.6% in the fourth quarter of 2008. Deflation emerged in February as the CPI dropped by 1.6% year on year. PPI inflation dropped sharply from 9.7% in the third quarter to 2.5% in the fourth quarter of 2008 as commodity prices declined, and recorded a contraction of 4.5% in February 2009. Looking forward, risk of persistent deflation could be a major concern to policy makers in Mainland China if aggregate demand continues to deteriorate due to the gloomy global economy. Mainland authorities continued to implement expansionary monetary and fiscal policies to fight against the slowdown of the economy. The supply of credit has been eased in last several months to encourage domestic investment and production, and specific policies have been announced to alleviate the pressure on selected industries, under the umbrella of the fiscal-stimulus package. The renminbi has been kept largely stable in recent months despite depreciations in other emerging economies and the decline in exports. The Mainland authorities have made it clear that they will not use exchange rate policy to help exports.

For the **rest of East Asia**, the latest available economic indicators continued to point south, reflecting that the contraction in economic activity in the region may have accelerated in recent months. In Korea, Singapore and Taiwan, the economies contracted by an average rate of 22.5% quarter on quarter (annualised) in the fourth quarter of 2008, the second quarter of contraction since the third quarter, and the worst performance since the Asian financial crisis in 1997/1998. In the ASEAN-4 economies, real GDP contracted by an average of 5.9%. The sharp decline in export demand from all the advanced economies as well as China continued to take a toll on economies in the region. The rapid decline in export-led production slashed job opportunities in the region, with the latest available unemployment rate in Korea, Singapore and Taiwan showing an accelerated uptrend. Along with sluggish domestic demand, the worsening labour market will be a drag on the regional economies in the coming quarters. In Korea, Singapore and Taiwan, industrial production fell sharply by 14.7% quarter on quarter in the fourth quarter, with a broad-based contraction in both hi-tech and non-hi-tech industries. Other economies in the region also recorded negative growth in production activity in the last quarter of 2008. The decline in production largely reflected the significant drop in exports amid the global downturn. Both NIE-3 and ASEAN-4 have recorded a double-digit fall in exports (quarter on quarter) in the fourth quarter. Inflationary pressure in the region continued to ease in the face of sluggish economic activities, while core CPI inflation remained steady. In Korea, Singapore and Taiwan, headline CPI inflation decreased to an average rate of 2.7% year on year in January 2009, compared to the peak of 6.1% in July 2008. In the ASEAN-4 economies, headline CPI inflation also decreased to 4.9% during the same period. The alleviation of inflationary pressure in recent months has provided more room for policy makers to ease monetary conditions to support growth. Central banks in Indonesia, Malaysia, the

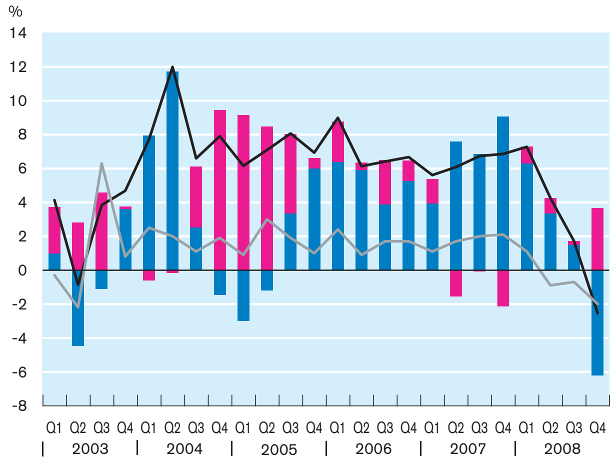
Philippines and Taiwan cut their policy interest rates substantially by a range of 0.5% to 0.75% in January. It is widely believed that rate cuts will continue in the region amid the sharp deterioration in economic activity.

Domestic activity

The domestic economy contracted in the second half of 2008, the first time in six years, as the global economic downturn took its toll on domestic economic activities through the trade and financial channels. Real GDP decreased by 0.5% year on year in the second half of 2008, amidst much weaker performance in private demand (Chart 1 and Table 1). This contrasted with the 5.8% growth in the first half when the economy remained fairly resilient. On a seasonally-adjusted quarter-to-quarter comparison, real GDP fell by 2.0% in the fourth quarter after the 0.9% and 0.7% decline in the second and third quarters of 2008, signifying that the recession was deepening.

CHART 1

Economic activity



Source: Census and Statistics Department.

TABLE 1

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

(% yoy)	2007	2008	2008 Q1	2008 Q2	2008 Q3	2008 Q4
Gross Domestic Product	**6.4**	**2.5**	**7.3**	**4.3**	**1.7**	**-2.5**
(quarter-on-quarter growth)			1.1	-0.9	-0.7	-2.0
Domestic demand	7.9	1.1	7.0	3.5	1.7	-6.9
Private consumption expenditure	8.5	1.8	7.6	3.5	0.0	-3.2
Government consumption expenditure	3.0	2.0	0.6	3.2	2.0	2.6
Gross domestic fixed capital formation	3.4	-0.3	10.1	4.9	3.2	-17.3
of which						
Building and construction	-0.2	0.3	9.1	-0.4	-4.1	-3.6
Machinery and equipment	3.0	0.6	5.9	6.9	10.6	-18.7
Change in inventories[1]	1.0	-0.2	-0.4	-0.2	0.7	-0.9
Net exports[1]	-0.6	1.5	1.0	0.9	0.2	3.7
of which						
Exports of goods	7.0	2.0	8.3	4.4	1.4	-4.9
Exports of services	14.1	5.6	10.2	8.2	5.1	-0.2

[1] Percentage point contribution to annual growth of GDP.

Source: Census and Statistics Department.

Domestic demand dropped considerably by 6.9% in the fourth quarter compared with a year earlier, after a modest 1.7% increase in the third quarter. As the global financial crisis intensified and local labour-market conditions deteriorated, private consumption expenditure fell by 3.2% year on year in the fourth quarter, after staying flat in the third quarter. Undermined by a sharp reduction in spending on financial services and big-ticket items, this was the first decline recorded since the third quarter of 2003. Held back by credit stringency and an uncertain business outlook, overall investment spending declined conspicuously by 17.3% year on year in the fourth quarter, compared with the 3.2% growth in the prior quarter. Although public investment held up well against the down-cycle, there was a sharp fall in private-sector construction activity and equipment spending.

Recent news and economic releases remain generally downbeat and point to further weakening in near-term economic conditions. In particular, the latest Quarterly Business Tendency Survey shows that corporate owners' assessment of their business situation deteriorated rapidly in the first quarter of 2009. Meanwhile, the PMI has fallen below 50 (the cutoff line between growth and contraction) since July 2008, largely reflecting a significant drag from weaker output and new orders. The decline in retail sales stabilised in January 2009 as the headline figure picked up by 0.2% on a three-month-on-three-month basis, but it still failed to offset the outsized 2.9% drop in December 2008.

External trade

The fourth quarter export performance of Hong Kong was buffeted by reduced external demand of our major trading partners amidst the global slowdown. After rising by 5.5% in the third quarter, merchandise exports fell in value terms by 2.1% in the fourth quarter, the first year-on-year decline in more than six years (Table 2). The subdued performance comprised a 31.1% decrease in domestic exports and a fall of 0.9% in re-exports, with broad-based weaknesses across the major destinations including the Mainland, US and other industrialised economies. The flagging momentum in exports was evident in the rollover of the quarter-on-quarter declines in both the third and the fourth quarters at an accelerating seasonally-adjusted pace of 0.5% and 4.2% respectively. Exports of services rose in value terms by 0.7% year on year as the external demand for financial services weakened distinctly and the vibrant growth in inbound tourism came to a halt. Meanwhile, imports of goods and services fell by 3.5% in the fourth quarter. Taken together, there was a surplus of HK$69.1 billion in the overall trade account in the fourth quarter, equivalent to 15.8% of GDP, as against a surplus of HK$49.9 billion (11.1% of GDP) in the year-earlier quarter.

TABLE 2

Merchandise exports by major market[1]

(% yoy)	Share[2] (%)	2007	2008	2008 Q1	2008 Q2	2008 Q3	2008 Q4
Mainland China	48	13	5	11	8	4	-2
United States	13	-1	-2	-1	-1	1	-7
European Union	14	6	6	8	8	10	-1
ASEAN5[3] + Korea	7	9	9	15	9	3	11
Japan	4	-1	1	-2	-1	3	4
Taiwan	2	2	4	3	7	5	0
Others	12	18	14	30	24	17	-9
Total	**100**	**9**	**5**	**10**	**8**	**6**	**-2**

[1] Within the total, re-exports accounted for 97% in 2008.

[2] Share in 2008.

[3] ASEAN5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand.

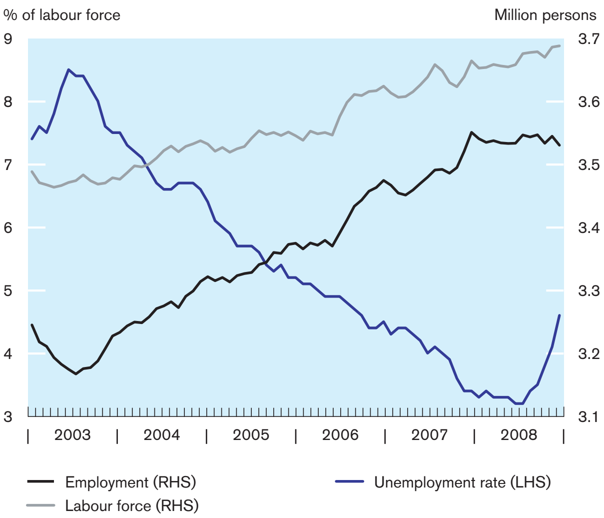
Sources: Census and Statistics Department, and CEIC database.

Labour market and inflation

The slowdown in economic activities has resulted in a notable slackening of labour-market conditions. While the total labour force continued to expand at a solid year-on-year rate of 1.3% in the fourth quarter of 2008, job creation moderated to the slowest pace in about five years with total employment increasing only by 0.7%. As a result, the seasonally-adjusted unemployment rate climbed to 4.1% in the fourth quarter from 3.4% in the earlier quarter (Chart 2). Disaggregate data further indicate that job losses were broad-based, with the construction, retail, import/export trade, and transport sectors being the hardest hit. On the other hand, labour income continued to pick up as the nominal payroll per person rose by 5.2% year on year in the third quarter following an increase of 4.6% in the preceding quarter. Yet after adjusting for inflation, there was only a modest increase of 0.5% in the real payroll.

CHART 2

Labour market conditions

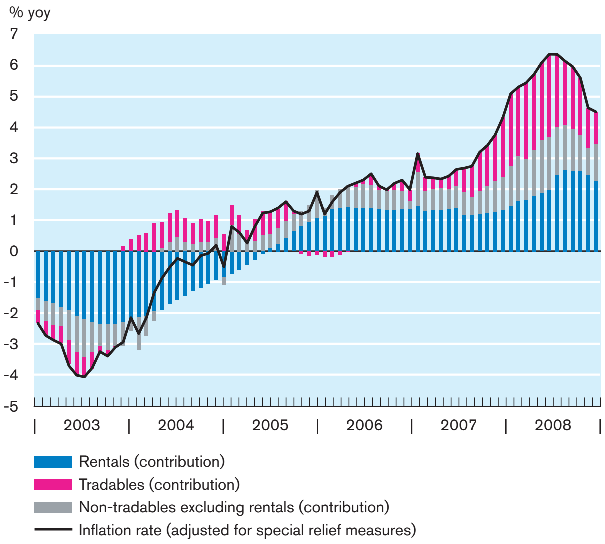


Source: Census and Statistics Department.

Meanwhile, inflationary pressures receded in the fourth quarter, largely reflecting the tapering of food-price inflation, the decline in residential rents and weaker domestic demand. After removing the effects of various government relief measures, the Composite Consumer Price Index (CCPI) increased by 5.4% year on year in the fourth quarter after rising by 6.3% in the third quarter (Chart 3). Indeed, inflation momentum has visibly slowed down on a quarter-on-quarter basis, with the annualised rate of CCPI inflation easing to 1.8% from 5.3% over the same period. On the same comparison basis, core inflation excluding basic food and energy edged down to an annualised rate of 2.8%, compared with 4.7% in the third quarter.

CHART 3

Consumer-price inflation



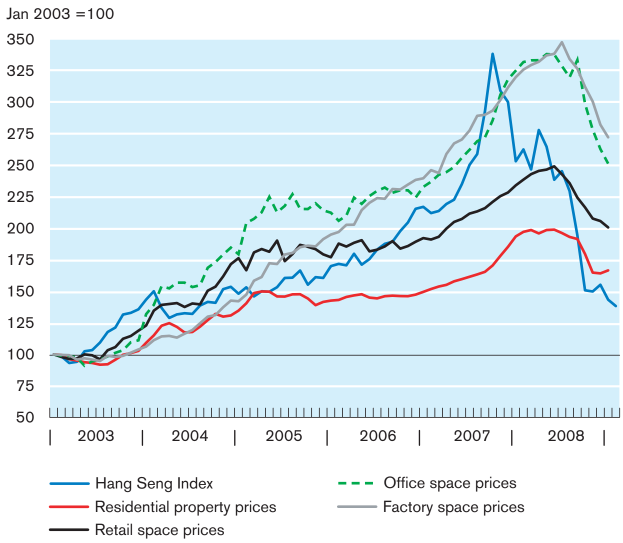
Sources: Census and Statistics Department, and staff estimates.

Asset markets

The local equity market remained lacklustre amid the tightened credit-market conditions and global economic downturn in recent months (Chart 4).

CHART 4

Asset prices



Sources: Rating and Valuation Department, and Reuters.

Following the collapse of Lehman Brothers and the contagious sell-offs of global financial assets in the third quarter of 2008, the HKSAR Government announced temporary measures on liquidity assistance and a deposit guarantee, while Mainland China announced an RMB4 trillion fiscal package. There was a rebound in the local equity market during the fourth quarter, with the Hang Seng Index rising by 35% from the bottom in October 2008 to close at 14,387 at the end of December. Nevertheless, growing concerns about the economic outlook and the continued strains in financial markets resulted in the resumption of the downward trend of the Hang Seng Index, which fell 11% to close at 12,812 at the end of February. The average daily turnover contracted further to HK$44 billion in the first two months of 2009 from HK$51 billion in the fourth quarter of 2008.

Property prices also experienced significant downward pressure during the fourth quarter of 2008, as market sentiment was restrained by the global financial crisis and rapidly deteriorating economic conditions. Residential property prices fell by 12.4% in the fourth quarter after declining by 2.1% in the preceding quarter. Transaction volume shrank by 30.8% in November following a contraction of 22.3% in October, as tightened credit approval and worsening labour-market conditions weighed on residential property demand. Following the improvement of credit-market conditions towards the end of 2008, activity in the residential property market expanded again, with residential property prices remaining stable and transaction volume surging by 44.2% in December. This was partly supported by a healthy level of housing affordability and a negative buy-rent gap. In the commercial property market, prices of office space declined sharply by 14.5% quarter on quarter in the fourth quarter, reflecting a slowdown of expansion in business operations and a rapid sell-off of illiquid assets amid tightened credit-market conditions. Prices of retail premises and factory space also registered double-digit declines over the same period.

Money supply and domestic credit

Both Hong Kong-dollar narrow and broad monetary aggregates increased in the fourth quarter. With both demand deposits and currency held by the public rising, seasonally-adjusted narrow money rebounded by 4.5% during the quarter, after declining by 1.3% in the previous one. The rebound was partly due to decreases in term deposit interest rates, which lowered the opportunity cost of holding non-interest-bearing monetary assets. Following a 2.6% increase in the third quarter, broad money expanded further by 2.9% in the fourth quarter, possibly driven by some inflows of funds into Hong Kong dollars. Indeed, market reports suggest that some domestic corporations repatriated their funds into Hong Kong dollars due to business or liquidity needs after the global financial crisis worsened in mid-September. Broad money contracted by 1.2% in 2008, which was in line with weaker economic activity and subdued trading in the stock market.

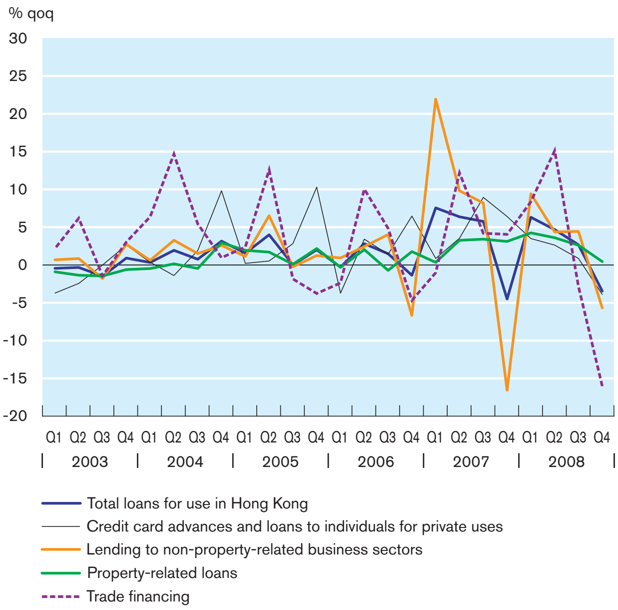
Growth in total deposits accelerated during the fourth quarter, with both Hong Kong-dollar and foreign-currency deposits recording faster growth rates. For Hong Kong-dollar deposits, liquid deposits (demand and savings deposits) expanded while term deposits declined. As a result, the share of liquid deposits in total Hong Kong-dollar deposits rose to 52% at the end of December from 46% three months ago. For foreign-currency deposits, US-dollar deposits increased markedly by 9.2% in the fourth quarter. However, renminbi deposits in Hong Kong contracted further, dropping by 19.9% in the fourth quarter after declining by 9.9% in the previous one.[1] The demand for such deposits contracted partly because of decreases in renminbi deposit interest rates and increased uncertainty about the short-term direction of the renminbi exchange rate.

[1] In terms of renminbi.

Domestic credit decreased in the fourth quarter alongside a deepened economic downturn. Loans for use in Hong Kong[2] contracted by 3.5% in the fourth quarter, following increases in the previous three quarters. Analysed by economic uses, lending to trade financing fell by 16.1% on the back of shrinking trade flows (Chart 5).[3] Credit-card advances and loans to individuals for private use declined by 3.9%, and lending to non-property-related business sectors showed a broad-based contraction. Property-related loans grew slightly, with an increase in lending to residential and commercial property investment exceeding a decline in the outstanding stock of residential mortgage loans. As Hong Kong-dollar loans decreased while deposits climbed, the Hong Kong-dollar loan-to-deposit ratio declined further to 77.6% at the end of December.

CHART 5

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

The domestic economy is expected to remain lacklustre under the drag of falling export demand, continued strains in the financial markets and reduced domestic spending. Re-export trade and exports of services may recede further given the rapidly worsening economic conditions in our major trading partners. Domestic demand may further weaken as rising unemployment and worsening business conditions will hold back both household and business spending. Against this background, the Government projects the economy to contract by 2% to 3% in 2009, which is roughly in line with the consensus market estimate of a 2% decline. The prospects for a turnaround however hinge critically on the developments in the US and other developed economies and how the global financial crisis will play out.

Consumer-price inflation is expected to ease further as domestic cost pressures will moderate due to weaker aggregate demand. Lower energy prices and more stable food costs will keep import-price inflation in check. Residential rents, which were a key driver of inflation before the current downturn, will be on a downward trend in 2009 following the sharp decline in property prices in 2008. The official forecast is that the underlying CCPI inflation will moderate to 1.5% in 2009 as a whole, down from 5.6% in 2008.

[2] Including trade-financing loans.

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

Downside risks to the near-term economic outlook continue to dominate as the impact of the global financial crisis on the domestic real sector is still unfolding, while the depth and length of recessions in major industrialised economies remain highly uncertain. Factors like sharper-than-expected recessions in the US and Europe and on-going strains in the global financial markets may deepen and prolong the economic downturn in Hong Kong. Despite the highly uncertain external environment, the domestic economy may weather the current global financial crisis better than during the Asian financial crisis because: (1) the Asia region, particularly Mainland China, has much stronger economic fundamentals than a decade ago, and the policy makers have room for policy manoeuvre, as demonstrated by the RMB4 trillion fiscal package announced by the Mainland authorities; (2) the ultra-loose monetary policy in the US cushioned the Hong Kong economy under the Linked Exchange Rate system in the current economic downturn; and (3) policy measures unveiled in the 2008/09 Budget and the supplementary relief measures announced by the Chief Executive in July 2008 have provided timely fiscal stimulus to the real economy. Policy stimulus in the 2009/10 budget will provide some renewed impetus for local demand in 2009.