REGULAR ARTICLE

Domestic and external environment

by the Research Department

The global economy began to recover after going through the deepest recession in the post-war period, helped by extraordinary support from fiscal and monetary policies. Major economies including the US and the euro area rebounded in the third quarter, although unemployment remained high. The momentum of economic recovery has been stronger in emerging Asia than in the rest of the world, and asset prices have risen sharply amid signs of strong capital inflows and a pick-up in domestic credit creation. Underpinned by public investment in infrastructure and a revival in the real estate sector, the Mainland economy recorded faster GDP growth in the third quarter. In Hong Kong, the economy grew further in the third quarter on the back of strong domestic demand, and labour market conditions appeared to have stabilised.

External environment

The **US** economy showed continued signs of a recovery, although the process seemed to be a slow one. The economy emerged from the recession in the third quarter as real GDP rebounded by 2.8% quarter on quarter (annualised) following a 0.7% decline in the previous quarter. Supported by fiscal stimulus, personal consumption contributed 2.1 percentage points to the growth. The de-stocking process also seems to have run its course, with inventory adjustment contributing 0.9 percentage points. More recent monthly indicators suggest that economic activity continued to pick up, although consumer spending dipped as the boost from the "cash-for-clunkers" programme faded. Retail sales rose by 1.5% three months on three months in October, as the Conference Board's measure of consumer confidence fell to 49.5 in November from 54.5 three months ago, partly reflecting weak labour market conditions. The unemployment rate edged up to 10.0% in November from 9.7% three months ago, although the drop in non-farm payrolls narrowed to a total of 261,000 in the three months to November compared with a drop of close to one million in the prior three months. Meanwhile, the outlook for businesses improved, as durable goods orders rose by 1.1% three months on three months in October and orders for non-defence capital goods excluding aircraft, a proxy for business investment, edged up by 0.2%. The more forward-looking surveys such as the Institute for Supply Management indices stayed above the breakeven level of 50 in the past few months. Conditions in the residential housing market stabilised, with the sales of existing homes rising by 12.7% three months on three months in October, reaching the highest level since February 2007. However, in view of the inventory overhang, prices are still under pressure, with the S&P/Case-Shiller Home Price Index for 20 metropolitan areas falling by 9.4% year on year in September. On prices, headline inflation stayed negative at -0.2% year on year in October in the face of substantial spare capacity in the economy, while the core Consumer Price Index (CPI) rose by 1.7%. The Federal Open Market Committee maintained its target for the federal funds rate at 0 - 0.25% at its November meeting, noting again that the exceptionally low levels of the federal funds rate are likely to stay for an extended period.

The **euro area** also ended its recession in the third quarter, as real GDP rose by 1.5% quarter on quarter (annualised). More recent monthly indicators further show the recovery broadening out. Industrial orders rose by 2.2% three months on three months in September, while industrial production fell by 2.2%. Retail sales increased by 1.1% three months on three months in September, although labour market conditions continued to be weak, with the unemployment rate edging up to 9.8% in October from 9.5% three months ago. Sentiment and other forward-looking indicators suggest an improving outlook. Both the European Commission's Economic Confidence Index and the German Ifo Index on business confidence showed a steady improvement from March 2009, while the composite Purchasing Managers' Index (PMI) stayed above the breakeven point of 50. Inflationary pressures eased in view of the excess capacity in the economy, with headline CPI inflation staying negative at -0.1% year on year in October. Core CPI inflation edged lower to 1.2% year on year in October from 1.3% three months ago. The European Central Bank kept the benchmark interest rate unchanged at 1.0% at its December meeting, while noting that the current level of interest rates is appropriate and inflationary expectations are well anchored. In the **UK**, third-quarter GDP fell by 1.2% quarter on quarter (annualised) following a contraction of 2.3% in Q2. Labour markets continued to be weak, with the unemployment rate staying at 7.8% in the three months to September, its highest level since 1996. Inflationary pressures eased with subdued domestic demand. Headline CPI inflation edged down to 1.5% year on year in October from 1.8% in July. The Bank of England maintained the policy rate at 0.5% at its November meeting, and increased the size of its asset purchase programme by £25 billion to £200 billion.

The **Japanese** economy expanded at a stronger-than-expected pace, growing by 4.8% quarter on quarter (annualised) in Q3 after registering a decent 2.7% increase in Q2. The growth was driven by private consumption and capital expenditure. On a quarter-on-quarter (annualised) basis, consumption increased by 2.8% and capital expenditure by 6.6%. Against a backdrop of strengthened economic conditions, the Consumer Confidence Index compiled by the Cabinet Office rose to its highest level in two years in October, while the latest Tankan survey conducted by the Bank of Japan indicated a more optimistic outlook for the corporate sector. On the external front, the volume of exports continued to increase in Q3 due to a resurgence in demand from other Asian economies. Meanwhile, labour market conditions have improved, with the unemployment rate decreasing to 5.1% in October. The headline CPI fell by 2.5% year on year in October, mainly driven by weak consumer demand. While the retreat from last year's spike in energy costs has continued to weigh on the general price level, the core index excluding energy and food prices showed that deflationary pressure gathered pace. The core CPI (excluding energy and food costs) fell by 1.1% year on year in October. Equity prices were little changed during the quarter, while the value of yen rallied to about 87 JPY/USD in late November.

The **Mainland** economy continued its strong recovery supported by public investment in infrastructure and a turnaround in the real estate sector. Real GDP growth climbed from 7.9% in Q2 to 8.9% year on year in Q3, but sequential growth moderated somewhat quarter on quarter. Fixed-asset investment (FAI) grew by 32.9% year on year in Q3, with the main contributions from the infrastructure and real estate sectors. While infrastructure investment has been strong since Q1, the contribution from the real estate sector to FAI growth almost tripled its level in Q1, as booming housing prices led to an increase in new construction projects. In the external sector, the fall in exports eased to 20.5% and imports to 11.8% year on year in Q3. On a quarter-on-quarter basis, both exports and imports continued to grow strongly, though growth in the latter moderated following its sharp rebound in Q2. The share of exports from China in the major markets remained broadly unchanged, with the share of US non-oil imports from the Mainland being stable at around 22% since 2008 Q3. As imports recovered faster than exports in the past two quarters, the trade surplus narrowed from US$62.5 billion in Q1 to US$39.3 billion in Q3.

Investors are generally optimistic about the Mainland's economic outlook, but there are concerns over the risk of inflation given strong growth in bank loans and monetary aggregates, as both CPI and Producer Price Index inflation rates have been positive on a three-month-on-three-month basis since July. Nevertheless, some market analysts argue that the relation between money and inflation on the Mainland has not been stable, and over-capacity in many industries is likely to mitigate inflationary pressure. On asset prices, the Mainland stock markets have consolidated somewhat in the past few months following a steady revival earlier in the year. The Shanghai Stock Exchange Composite Index has hovered around 3,000 after hitting a recent high of close to 3,500 in early August. On the other hand, the property market has gained momentum. The year-on-year growth in the overall housing price index, after staying negative for six consecutive months, turned positive in June and rose steadily during the reporting period. Meanwhile, growth in monthly new floor space sold continued to increase and posted a three-year high in October on a year-on-year basis. The RMB/USD spot rate has remained largely stable since the latter part of 2008. In effective terms, the renminbi has continued to depreciate in the past few months but its value is broadly unchanged compared with the pre-crisis level.

In the **NIE-3** economies, latest available data show that the economic momentum held up strongly in Q3. In Korea, the economy expanded by 13.4% quarter on quarter (annualised) in Q3. In particular, private consumption rose for three quarters in a row and investment two quarters in a row, suggesting that the underlying momentum is strong. In Singapore, real GDP grew by 14.2% quarter on quarter (annualised) in Q3, with the manufacturing sector being a major contributor to the growth. Benefiting from a rebound in external demand, the Taiwanese economy expanded by 8.3% quarter on quarter (annualised). On the external front, the recovery in the NIE-3 economies was also supported by a pick-up in demand across major markets, including China, Japan and the US. Meanwhile, inflationary pressure was generally subdued. Increasing concerns over potential asset bubbles have however made central banks in general more cautious in setting monetary policy, with the Bank of Korea widely expected to raise interest rates soon.

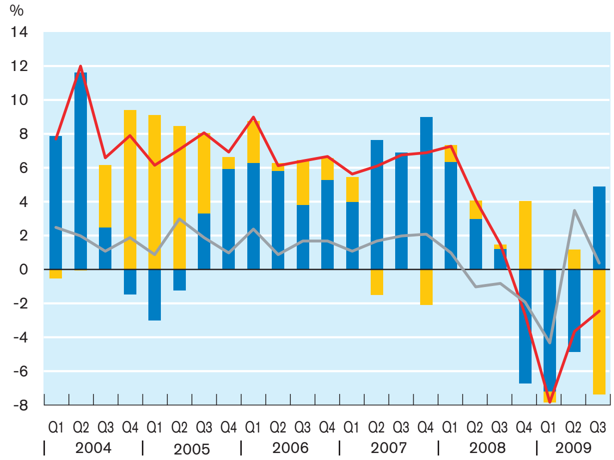
The **ASEAN-4** economies continued to see a moderate pick-up in the third quarter after a strong rebound in the previous quarter.[1] Aggregate GDP expanded by 6.1% quarter on quarter (annualised) after growing by 7.8% in the second quarter. Domestic demand has been underpinned by fiscal stimulus, rising confidence and the positive wealth effect of equity market rallies. On the external front, exports have rebounded markedly since the second quarter, attributable to a surge in intra-regional trade and a global inventory re-stocking. Meanwhile, inflation generally remained subdued, but there were initial signs of increased upward pressure in some economies. The year-on-year increase in consumer prices edged up to 1.6% in October from 0.2% three months ago in the Philippines, while annual inflation in Thailand turned positive for the first time this year in October. In the financial markets, equity prices have continued to rise appreciably and regional currencies have appreciated further against the US dollar on persistent capital inflows. Central banks in the region have all kept their policy interest rates unchanged at their recent monetary policy meetings.

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

Domestic activity

Hong Kong's overall economic situation showed clearer signs of improvement in the third quarter of 2009. After bouncing up by 3.5% quarter on quarter in the second quarter, the seasonally adjusted real GDP rose further in the third quarter, though at a more moderate rate of 0.4%. Meanwhile, the year-on-year decline in real GDP narrowed successively to 2.4% from 3.6% in the second quarter and the outsized 7.8% in the first quarter (Chart 1 and Table 1). The waning of recessionary forces was most evident in domestic demand, as it resumed year-on-year growth after three quarters of contraction, reflecting the modest pick-up in private consumption and fixed investment, a sizeable increase in government spending and massive inventory re-stocking. Altogether, domestic demand made a positive contribution of 4.9 percentage points to the year-on-year rate of change in real GDP in the third quarter.

CHART 1
Economic activity



Source: Census and Statistics Department.

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

			2008	2009		
(% yoy)	2007	2008	Q4	Q1	Q2	Q3
Gross Domestic Product	**6.4**	**2.4**	**-2.6**	**-7.8**	**-3.6**	**-2.4**
(quarter-on-quarter growth)			-1.9	-4.3	3.5	0.4
Domestic demand	7.9	0.8	-7.5	-8.1	-5.2	5.7
Private consumption expenditure	8.5	1.5	-4.1	-6.0	-1.1	0.2
Government consumption expenditure	3.0	1.7	1.8	1.4	1.7	3.3
Gross domestic fixed capital formation	3.4	-0.5	-17.8	-13.7	-13.6	1.4
of which						
Building and construction	-0.3	1.6	0.1	-10.9	-4.7	3.4
Machinery and equipment	3.0	-0.3	-21.1	-6.6	-18.0	-4.0
Change in inventories[1]	1.0	-0.2	-0.8	-0.9	-1.3	4.3
Net exports[1]	-0.6	1.6	4.0	-0.6	1.2	-7.3
of which						
Exports of goods	7.0	1.9	-4.9	-22.7	-12.4	13.2
Exports of services	14.1	5.7	0.4	-6.3	-5.2	-0.9

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

Source: Census and Statistics Department.

Private consumption expenditure, which accounted for about 60% of GDP, increased modestly by 0.5% from the second quarter on a seasonally adjusted basis. The year-on-year rate of change in private consumption expenditure also reverted to a 0.2% increase after four quarters in decline. Consumption of services picked up gradually but spending on food and goods remained on a moderate decline. Government consumption increased by 3.3% year on year in the third quarter, reflecting the expansionary fiscal-stimulus programmes. Overall investment spending rebounded by 1.4% year on year in the third quarter, after falling conspicuously at double-digit rates in the previous three quarters. Public investment was the source of strength, while private investment remained subdued due to slack capacity and cautious business sentiment.

Recent releases of economic indicators suggested that domestic activity continued to thrive moving into the fourth quarter. Retail sales volume expanded strongly by 6.9% three months on three months in October, and The Chinese University of Hong Kong's Consumer Sentiment Index rose further amid improvements in the household financial position and economic outlook. Business sentiment also turned more upbeat according to the latest Quarterly Business Tendency Survey conducted by the Census and Statistics Department in September and early October. Moreover, the bellwether PMI increased above 50 – the cutoff line between growth and contraction for the fourth straight month in November along with distinct upticks in output and new orders.

External trade

External demand remained weak with the world economy still in recession (on a year-on-year basis). Merchandise exports continued to fall, by 13.2% year on year in real terms in the third quarter, at about the same rate as in the second quarter after narrowing from the 22.7% decrease in the first quarter. Meanwhile, the sequential momentum of merchandise exports weakened to show a 2.8% seasonally adjusted quarter-on-quarter decrease after the strong rebound in the second quarter. Analysed by major markets, merchandise exports to the US and the EU continued to fall sharply in value terms in the third quarter and at much steeper rates than those to the Mainland, Japan and the rest of Asia (Table 2). On the other hand, with the Mainland economy gaining further strength, industrial activity in Asia has been broadly picking up, lending support to Hong Kong as a conduit for intra-regional trade.

TABLE 2

Merchandise exports in value terms by major market[1]

(% yoy)	Share[2] (%)	2007	2008	2008 Q4	2009 Q1	2009 Q2	2009 Q3
Mainland China	48	13	5	-2	-24	-5	-8
United States	13	-1	-2	-7	-21	-21	-24
European Union	14	6	6	-1	-18	-22	-26
ASEAN5[3] + Korea	7	9	4	-8	-32	-25	-18
Japan	4	-1	1	4	-13	-18	-8
Taiwan	2	2	4	0	-26	-6	3
Others	12	18	18	4	-17	-18	-18
Total	**100**	**9**	**5**	**-2**	**-22**	**-13**	**-14**

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

[2] Share in 2008.

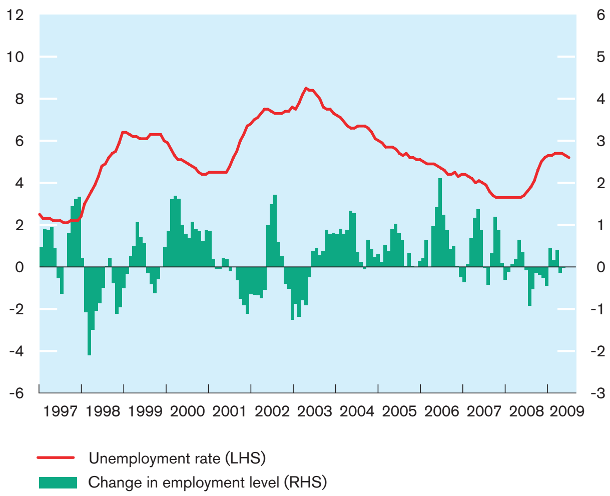
[3] ASEAN5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand.

Sources: Census and Statistics Department, and CEIC database.

Exports of services, whose rate of decline narrowed to 0.9% year on year in real terms in the third quarter from 5.2% in the second quarter, remained inhibited by falling offshore trading activity and transportation services. Exports of other services categories however increased with notable pick-ups in inbound tourism and financial activities. Driven by the decline in transportation services, imports of services as a whole dropped in real terms by 3.8% in the third quarter, though moderately improving from the 5.6% decrease in the second quarter. Taken together, there was a surplus of HK$24.8 billion (5.9% of GDP) in the nominal overall trade account in the third quarter, narrowing from a surplus of HK$56.8 billion (13.2% of GDP) in the same quarter a year earlier. In terms of growth contribution, net exports detracted 7.3 percentage points from the year-on-year rate of change in real GDP in the third quarter.

CHART 2

Labour market conditions



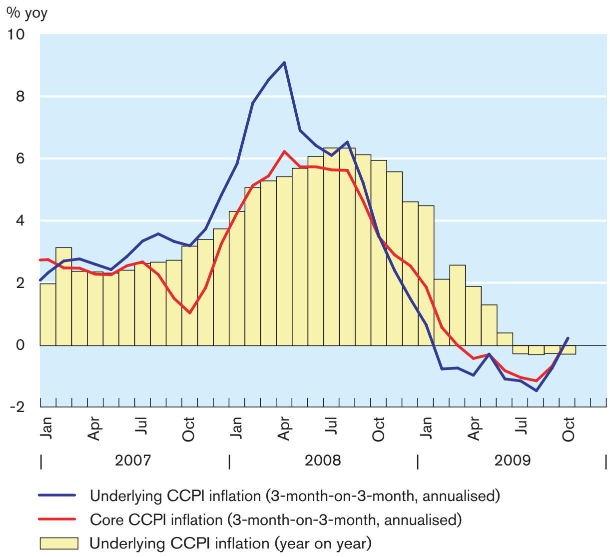
Source: Census and Statistics Department, and staff estimates.

Labour market and inflation

The labour market showed encouraging developments in the second half of 2009 (Chart 2). The seasonally adjusted three-month moving average unemployment rate edged down to 5.2% in October from 5.3% in September and the three-year high of 5.4% in August. Meanwhile, the unemployment rate for the higher-skilled held stable at 3.1% and that for the lower-skilled declined to 5.8% in the third quarter. Sectoral breakdown showed broad-based moderations in the unemployment rates, particularly a notable decrease in the construction sector following the Government's efforts to boost public construction works. Total employment remained on a decline, both on a year-on-year and seasonally adjusted quarter-on-quarter basis. Labour earnings continued to be restrained by the weak economic environment and the slack labour market, with the nominal payroll per person decreasing by 0.7% year on year in the second quarter.

CHART 3

Consumer-price inflation



Sources: Census and Statistics Department, and staff estimates.

Inflationary pressure remained largely subdued following successive quarters of moderation. In particular, the year-on-year underlying inflation rate moderated to -0.3% for four months from July to October, mainly attributable to the tapering of food and rental cost pressures (Chart 3). The downward price pressure nonetheless moderated towards the end of the third quarter on a seasonally adjusted basis. In fact, after being in negative territory for eight months, the three-month-on-three-month underlying inflation rate turned positive at an annualised 0.2% in October. Excluding basic food and energy, the core inflation rate also rose to an annualised 0.2%. The underlying price pressure is expected to be contained in the coming months given moderate local costs pressure and modest import price inflation. However, the down-drag from housing rentals brought forward by the lettings agreed during the past twelve months will wane, thereby renewing the upward pressure on rentals and thus inflation at some point in the future.

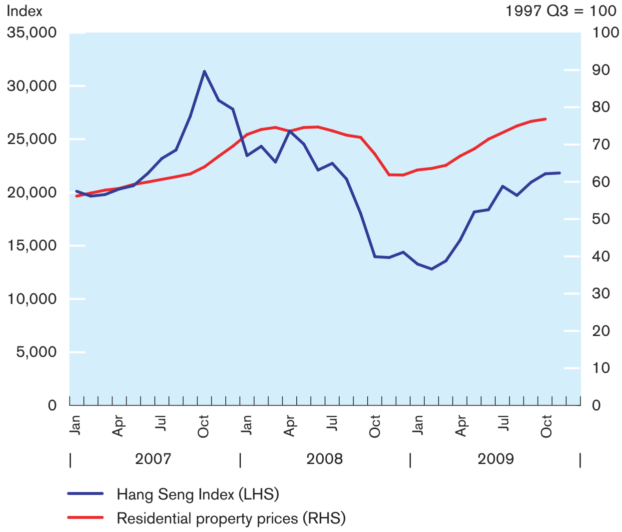
Asset markets

The local equity market remained upbeat with the Hang Seng Index hovering around a 15-month high since the collapse of the Lehman Brothers. After passing the 20,000 level in late July, the Hang Seng Index ran further ahead to close at 21,822 on 30 November (Chart 4). The average daily turnover however fell to HK$66.0 billion in October, slightly below that in the third quarter, while equity initial public offering (IPO) activities manifestly revived. The strong equity rally was fuelled by strong capital inflows and increased risk appetite of market participants amid improving economic outlook for Hong Kong and the Mainland.

The residential property market has turned buoyant with both prices and transaction volume returning to pre-crisis levels within a year. Having reached a low in December 2008, overall flat prices rose for ten consecutive months to October, culminating in a 24.2% gain year-to-date. The run-up in flat prices has been most distinct in the luxury segment (flats with saleable area of 100m² and above) with prices surging by 29.4% over the same period. Suggestive of market buoyancy, total transaction volume rose robustly above 10,000 units for five straight months to September. However, activities cooled moving into October amid market concerns about the surging flat prices. Market sentiment also became more cautious after the HKMA tightened the guideline on loan-to-value (LTV) ratios for residential mortgages on high-value flats.[2] Total transaction volume dropped in October, while the average transacted price held steady in the mass market segment (flats with saleable area below 100m²) but fell modestly in the luxury segment. This trend continued in November and December according to the Centa-City Leading Index and the Midland Property Price Chart.

CHART 4

Asset prices



Sources: Rating and Valuation Department, and Reuters.

Money supply and domestic credit

Hong Kong-dollar monetary aggregates continued to expand in the third quarter, underpinned by a gradual economic recovery and inflows into the Hong Kong dollar. Growth in Hong Kong-dollar M1 accelerated to 19.2% in Q3, compared with 13.9% in Q2. Strong growth in narrow money partly reflected increased transaction demand that was associated with a buoyant stock market and vibrant activity in equity IPOs. Depositors were also more willing to hold demand deposits because term-deposit interest rates were extremely low. Hong Kong-dollar M3 grew by 3.3% in Q3, smaller than the 6.0% increase in Q2. The expansion in broad money was largely driven by inflows of funds instead of credit.

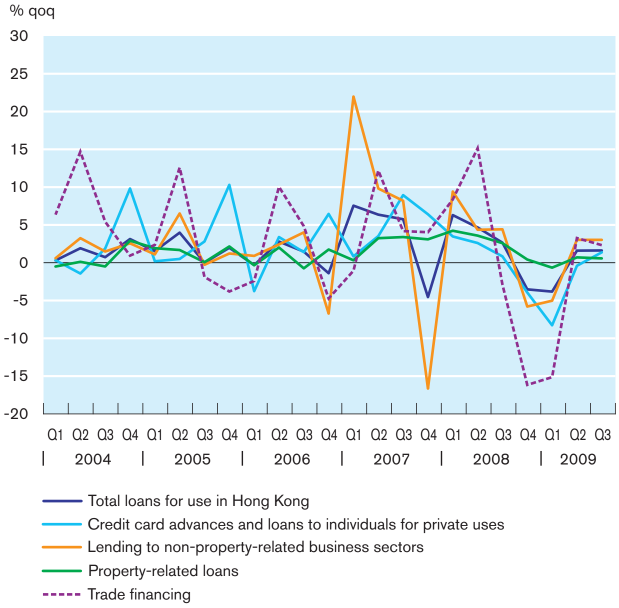
2 The HKMA issued a circular to authorized institutions on 23 October 2009 requiring them to lower the maximum LTV ratio for properties with a value of HK$20 million or more to 60%, and to maintain the 70% LTV ratio for properties valued at below $20 million but cap the maximum loan amount at $12 million.

Total deposits rose by 2.4% during the third quarter as both Hong Kong-dollar and foreign-currency deposits registered increases. Reflecting the inflow of funds, Hong Kong-dollar deposits grew by 3.4% in Q3, after rising by 6.6% in Q2. A shift from time deposits to liquid (demand and savings) deposits continued in a low interest-rate environment. Liquid deposits accounted for 66.0% of Hong Kong-dollar deposits at the end of September 2009, a record high since 1981. Renminbi deposits in Hong Kong also picked up by 7.0% in Q3, amounting to RMB58.2 billion at the end of September. The demand for such deposits was partly boosted by the pilot scheme for renminbi trade settlement launched in July.

Total loans and advances continued to increase in the third quarter. In line with positive growth in GDP, loans for use in Hong Kong[3] expanded by 1.6% for the second consecutive quarter in Q3. Analysed by economic use, trade-financing loans climbed by 2.3%, reflecting a gradual improvement in external trade performance (Chart 5).[4] Mortgage loans also rose as banks were more aggressive in extending new loans. Survey data also suggest that more customers chose HIBOR-based mortgage products to take advantage of the low interbank interest rates. The proportion of newly-approved mortgage loans priced with reference to rates other than the best lending rate (mostly HIBOR) increased to 54.5% in September from 39.8% in June. As Hong Kong-dollar loans increased at a slower rate than deposits, the Hong Kong-dollar loan-to-deposit ratio declined further to 70.2% at the end of September from 72.1% at the end of June.

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

Both domestic and external sectors are expected to show further improvement in the fourth quarter and next year. Stabilising labour market conditions, advance in asset prices, and to some extent the Government relief measures, should help support consumption spending. Private capital spending is likely to stay weak for some time with companies still saddled with excess capacity, whereas public building works will accelerate due to the Government's continued efforts in supporting the economy. Meanwhile, external demand is expected to pick up gradually alongside the normalising external environment. There are indications that orders are coming back in recent months as part of the re-stocking process of overseas buyers. Regional trade flows are also likely to gain strength with the onset of a modest global recovery and the rapid rebound of the Mainland economy.

[3] Including trade-financing loans.

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

Market analysts have upgraded their growth outlook. The latest market consensus forecast points to real GDP growth of 4.2% in 2010 following a 2.8% contraction in 2009. Separately, the IMF revised its forecast for the Hong Kong economy upward to -2% for 2009 and 5% for 2010.

On the price front, the underlying inflationary pressure is expected to be subdued in 2010 in view of global excess capacity. Property prices and private housing rentals for new lettings have rebounded sharply in 2009, and their increases will eventually feed through to the rental component of the Composite Consumer Price Index (CCPI). On the other hand, the non-rental component of the CCPI inflation is likely to remain moderate in the near future. Overall, consumer-price inflation is expected to remain anchored in the first half of 2010 and pick up more notably afterwards. The latest market consensus predicts headline CCPI inflation to rise by 1.7% on average in 2010.

The near-term economic prospect is subject to a number of risk factors. Recent real economic indicators still point to a relatively tepid pace of global recovery, which has been heavily reliant on the massive fiscal boost provided by governments around the world. However, ill-timed exit from monetary and fiscal stimulus could trigger unfavourable market reactions, disrupting the recovery. Furthermore, the risk of a re-intensification of the adverse feedback between the real and financial sectors cannot be ruled out. Domestically, the repeated triggering of the strong-side Convertibility Undertaking and the ensuing sharp expansion in the Aggregate Balance signal strong inflows into the Hong Kong dollar. The resultant loose monetary environment may heighten the risks of asset-price and consumer-price inflation through the expectation and credit channels. A reversal of fund flows in the future could lead to sharp corrections in the asset markets and volatilities in the real economy. Given the volatile nature of capital flows, the HKMA will maintain close monitoring of the fund-flow situation and its risks to monetary and financial stability.