REGULAR ARTICLE

Domestic and external environment

by the Research Department

Economic recovery has continued in the advanced economies, but a number of uncertainties remain. In the US, economic growth slowed in the first quarter, while the high unemployment rate, depressed housing market and large public debt continued to pose uncertainties for growth momentum. In the euro area, strong exports and inventory investment in France and Germany continued to drive growth in the region, but economic conditions among peripheral economies remained difficult. In Japan, the earthquake and nuclear crisis have taken a heavy toll on economic activity. In contrast, growth remained robust in the rest of Asia while inflation pressure intensified, particularly in Mainland China. The Hong Kong economy also expanded briskly in the first quarter, accompanied by low unemployment rate and rising inflation.

External environment

Real GDP growth in the **US** slowed to 1.8% quarter on quarter (annualised) in the first quarter of 2011, down markedly from the 3.1% in the fourth quarter of 2010. The slowdown was due mainly to temporary factors such as the severe weather and high energy prices. In particular, growth in real consumption expenditure was eroded by higher food and energy prices as headline inflation continued to rise, while growth in business investment ground to a halt partly due to the bad weather. Meanwhile, the housing sector remained in the doldrums with sales staying sluggish and house prices, as measured by the S&P/Case-Shiller house price index for 20 metropolitan areas, falling for the ninth consecutive month in March. Unemployment rate remained high at 9.1% in May despite the recent strong growth in private sector employment. On the fiscal side, a Federal government shutdown was averted after a late deal was reached to cut the fiscal deficit by US$38 billion. The Federal Open Market Committee kept its target for the federal funds rate unchanged at its April meeting. The Fed announced its intention to complete the US$600 billion large scale asset purchase programme in June as planned and to maintain its reinvestment strategy for maturing Treasuries and mortgage-backed securities.

Economic growth in the **euro area** picked up speed in the first quarter, with real economic activities in the region growing by 0.8% quarter on quarter, compared with 0.3% in the previous quarter. The faster growth was driven mainly by strong exports and inventory investment in France and Germany, while personal consumption was subdued as evidenced by the moderation in euro-zone retail sales growth in recent months. Huge divergences remained in the euro area with economic conditions among peripheral economies remaining difficult and confidence staying at very low levels amid ongoing fiscal tightening. Concerns over sovereign debt problems heightened again as Portugal became the third euro-zone country to request a bailout after Greece and Ireland, and Greece failed to meet the budget deficit target of its bailout, triggering talks of "soft restructuring" of its debt (which involves creditors extending the maturities of their loans). On prices, headline inflation climbed to 2.8% in April while core inflation rose to 1.6%. In response to higher inflation, the European Central Bank raised the main refinancing rate by 25 basis points to 1.25% at its April meeting.

In the **UK**, economic growth resumed in the first quarter with real GDP growing 0.5% quarter on quarter after an unexpected contraction of 0.5% in the previous quarter. Growth in retail sales remained weak on low consumer confidence, while industrial production and manfacturing continued to be sluggish. Unemployment continued to stay high, while headline CPI inflation rate stayed well above the Bank of England target of 2% for the seventeenth consecutive month.

The devastating earthquake in **Japan** and the ensuing nuclear radiation crisis in March took a toll on the Japanese economy. High frequency indicators in March show that real activity, including industrial production, exports and retail sales, dropped abruptly after the catastrophe. As a result, real GDP dropped by 3.5% quarter on quarter (annualised) in the first three months of 2011. The credit rating agencies Standard & Poor's and Fitch Ratings have revised Japan's sovereign debt rating outlook from "stable" to "negative" recently because of the deterioration in fiscal outlook due to disaster-related outlays. Meanwhile, the Bank of Japan at its latest policy meeting decided to maintain its accommodative monetary policy stance, citing "strong downward pressure" on the economy after the earthquake.

In **Mainland China**, year-on-year real GDP growth edged down to 9.7% in the first quarter from 9.8% in the previous quarter. Growth in real fixed asset investment rebounded year on year, while retail sales growth dropped visibly in real terms, reflecting the impact of rising inflation. Exports grew by 26.5% year on year in the first quarter, and imports expanded at a faster pace, partly reflecting surging commodity prices. The Mainland recorded a trade deficit of US$1.14 billion in the first quarter, its first quarterly deficit since the second quarter of 2004. The trade balance returned to a surplus of US$11.4 billion in April as the growth in exports outpaced imports.

The year-on-year growth in broad money (M2) trended down to 15.3% in April. Loan growth of financial institutions followed a downward trend but was still visibly higher than the decade average of the pre-crisis period of 1998-2008, while financing through channels other than bank loans also remained solid on aggregate. Inflationary pressures intensified, with food prices and residential costs remaining the major contributors. The People's Bank of China (PBoC) raised the one-year benchmark deposit and lending interest rates by 25 basis points in February and by the same amount again in April, following the two rate increases in the fourth quarter of 2010. The PBoC has also raised the reserve requirement ratio five times this year, by 50 basis points each time, to a record high of 20.5% on aggregate. Property price growth showed signs of moderation recently and property market transactions declined following the reinforcement of tightening measures earlier this year. The renminbi has appreciated by about 2.1% against the US dollar on a cumulative basis since the beginning of this year, and non-deliverable forward rates in late May indicate that markets expect the renminbi to appreciate by about 1.9% in 12 months.

The economies of the **East Asian** region grew by an average quarter-on-quarter annualised rate of 9.0% in the first quarter, with Singapore and Taiwan registering double-digit growth.[1] Exports continued to fuel growth in the region, while private consumption remained robust during the quarter. Nonetheless, the catastrophe in Japan in March has added downside risks to the near-term growth prospects in the region owing to weaker demand from Japan and disruptions of the supply chain. On the price front, headline CPI increased by an average year-on-year rate of 4.0% in April on the back of surging food and fuel prices, compared with 3.8% three months ago. In view of rising inflation risks, central banks in the region continued to normalise

[1] Including Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand; weighted by GDP valued at purchasing power parities.

their monetary policy stances in recent months. For instance, the Monetary Authority of Singapore re-centered the policy band of the nominal effective exchange rate of the Singaporean dollar upwards at its half-yearly meeting in April, and the central banks of Malaysia, the Philippines, South Korea, Taiwan and Thailand have raised their policy rates in the past three months.

Domestic economy

The Hong Kong economy expanded briskly in the first quarter of 2011, with real GDP growth increasing to 2.8% quarter on quarter from 1.5% in the previous quarter. The robust growth momentum was underpinned by solid consumption growth and a strong pick-up in external demand, while aggregate investment spending turned into a drag on economic growth.

Private consumption spending continued to grow at a solid pace quarter on quarter in the first quarter, supported by rising household income, favourable labour market conditions, and the wealth effect from rising asset prices. Government consumption turned around after a temporary drop in the previous quarter. Public investment continued to rise with the ongoing large-scale infrastructure projects, while inventory accumulation increased in anticipation of robust domestic demand. Nevertheless, aggregate investment spending declined as private investment dropped.

External demand strengthened in the first quarter after a weakening in the previous quarter. On a quarter-on-quarter basis, merchandise exports surged on the back of vibrant intra-regional trade and continued recovery in the advanced economies. Exports of services also grew at a rapid pace, with trade-related services expanding in tandem with merchandise exports. Merchandise imports increased briskly, largely driven by a surge in retained imports of goods amid robust consumption growth and inventory accumulation. Meanwhile, imports of services dropped slightly, due in part to a decline in tourism abroad. The overall net exports turned from a drag on output growth in the previous quarter to a significant contributor in the first quarter. The nominal trade balance registered a surplus of HK$27.8 billion (6.2% of GDP) in the first quarter, narrowing slightly from a surplus of HK$33.2 billion (7.0% of GDP) in the previous quarter.

Labour market conditions remained favourable, supported by strong economic growth. The three-month moving average unemployment rate edged up to 3.5% in April after declining to a 30-month low of 3.4% in March, while the underemployment rate also moved up to 1.9% from 1.8% in the previous month. The labour market outlook remains broadly positive on the back of robust domestic demand and upbeat business hiring sentiments.

Inflation

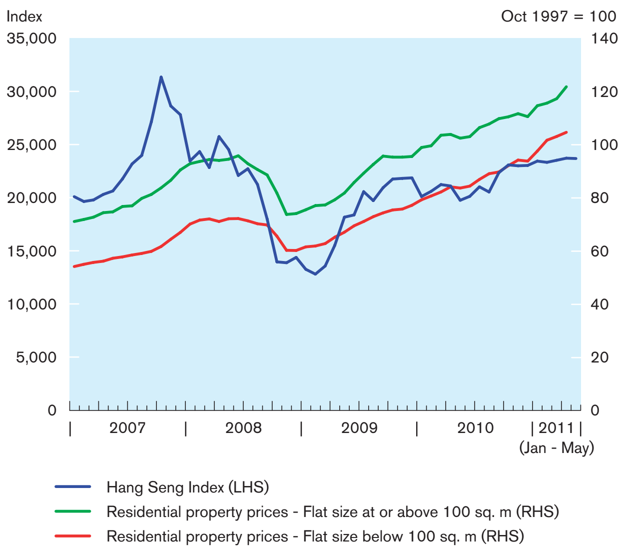
Inflationary pressures intensified further, with the year-on-year underlying inflation rate reaching 4.4% in April. The three-month-on-three-month annualised underlying inflation rate also increased to 8.1% in April from 7.3% in March. Prices have risen across most CCPI components over the past few months, with housing rentals and food components contributing notably to the rise in the inflation rate. Inflationary pressures are expected to increase in the months ahead as higher rental costs continue to feed through and global food and commodity prices remain elevated.

Asset markets

The Hong Kong stock market was volatile in the first five months of 2011. Share prices were buoyed by optimistic outlook for corporate earnings and signs of a stronger global economic recovery at the beginning of the year, but the earthquake and nuclear crisis in Japan then caused a sharp decline in the global and Hong Kong stock markets. Stock prices traded up again in early April with the support of strong earnings of Mainland enterprises but zigzagged downwards thereafter due to renewed worries over the European debt crisis and a potential slowdown in the advanced economies. Stock prices however bounced up temporarily towards the end of May. The Hang Seng Index closed at 23,684 at the end of May, 2.8% higher than at the end of 2010 (Chart 1). The price-earnings ratio nevertheless dropped from 17.1 to 12.7 during the period due to a faster increase in earnings. Stock trading remained generally active. The average daily turnover, though having declined somewhat from the latter part of 2010, rose by 12.3% from a year earlier to HK$74.3 billion in the first five months. On the other hand, fund raising activities cooled after the robust performance late last year.

CHART 1

Asset prices



Sources: Rating and Valuation Department, and Hang Seng Indexes Company Limited.

The property market remained broadly buoyant over the past few months. Overall residential property prices increased 11.5% during the first four months of 2011, with prices of small and medium-sized flats rising slightly faster than those of larger flats. Property trading moderated following the announcement of a new round of macro-prudential measures and the Special Stamp Duty late last year. Speculative activities waned, as reflected in the recent plunge in confirmor transactions and short-term trading. Growth in outstanding mortgage loans also somewhat moderated. More recently, residential property prices appeared to be experiencing some consolidation, while trading activities weakened further amidst tighter mortgage terms and rising interest rates. As property price increase continued to outpace income growth, housing affordability deteriorated further. In the leasing market, overall flat rentals rose 3.8% during the first four months. The market rental yields for residential properties hovered around record low levels (3.3% for flats between 40 and 69.9 square metres in April, for example). The debt servicing burden for new mortgages increased with major banks having raised the margin for the HIBOR-based mortgage loans by as much as one percentage point since March. Upward pressure on banks' lending rates is likely to continue as a result of the strong loan demand from various sectors. Meanwhile, the risk of over-stretching in the commercial and industrial property markets remained, as evidenced by the sharp run-ups in prices, active trading and intensive speculative activities.

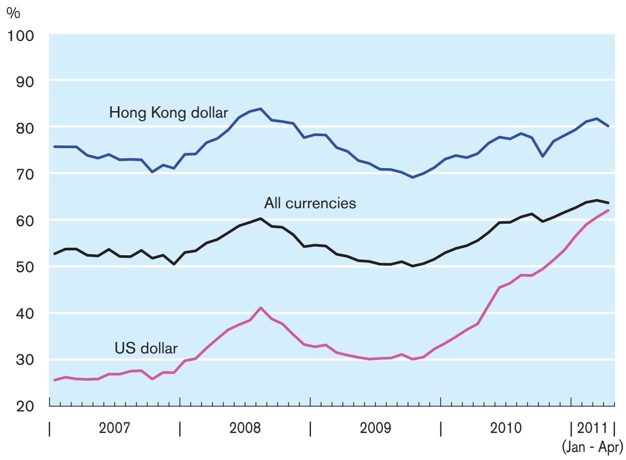
Domestic credit and money supply

Strong growth in loans continued in the first quarter of 2011, supported by robust economic growth, vibrant activity in the property market and Mainland-related credit demand. After growing by 28.6% in 2010, total loans and advances at the end of March 2011 increased at an annualised rate of 29.6%. Partly reflecting the expansion in Mainland-related loans which were mostly denominated in the US dollar, foreign currency loans rose faster than Hong Kong-dollar loans. On a year-on-year basis, loans for use outside Hong Kong climbed by 42.7% and loans for use in Hong Kong grew by 27.9%. Analysed by economic use, property lending, trade finance and loans to wholesale and retail trade continued to be the major contributors to growth in loans for use in Hong Kong. On the mortgage front, survey data indicate that both new loans approved and new loans drawn down rebounded markedly in March. HIBOR-based mortgage plans remained popular and the proportion of newly approved loans priced with reference to HIBOR was little changed at around 92% during the first quarter. In April, total loans grew further but loan growth showed initial signs of slowing down.

Total deposits increased by 11.0% from a year ago at the end of March and reached $7,073.5 billion, with foreign currency deposits rising at a faster rate than Hong Kong-dollar deposits. Within Hong Kong-dollar deposits, the share of time deposits expanded slightly. Meanwhile, the proportion of time deposits with maturities longer than one month also increased. This partly reflected the impact of reported upticks in effective time deposit interest rates, especially for large deposits with long maturities. Representing about 7.6% of total deposits, renminbi deposits surged to RMB451.4 billion at the end of March, mainly driven by the receipts from renminbi trade settlement. The total renminbi remittance for cross-border trade settlement expanded further to RMB310.8 billion in the first quarter of 2011, compared with RMB263.2 billion in the previous quarter. Monetary aggregates at the end of March also rose, with Hong Kong-dollar broad money growing by 7.1% from a year ago and foreign currency broad money by 17.1%. In line with the pattern of loan growth, money supply and deposits continued their upward trends in April, with renminbi deposits rising to RMB510.7 billion.

As loans grew faster than deposits, both Hong Kong-dollar and US-dollar loan-to-deposit ratios increased (Chart 2). Higher loan-to-deposit ratios have raised the funding cost pressures of banks and pushed up their effective lending and deposit interest rates. In February, a major retail bank was reported to have largely suspended offering HIBOR-based mortgage plans to new customers. In the following months, major retail banks were also reported to have raised their HIBOR-based mortgage interest rates. While global liquidity is still ample, local interest rates may increase faster than expected given the strong loan demand. In view of the fast credit growth, the HKMA issued a circular on 11 April requiring banks to reassess and submit their business plans and funding strategies for the rest of the year.

CHART 2
Loan-to-deposit ratios



Source: HKMA.

Short-term outlook

The domestic economic outlook is expected to remain favourable in the second half of 2011. Private consumption growth is set to hold up well on the back of positive income and job prospects, while government consumption is expected to grow at a firm pace as set out in the Government's Budget plans. Public building and construction investment will continue to support gross fixed investment, while private capital spending may pick up owing to positive business sentiments. Externally, vibrant economic conditions in emerging Asia are expected to support Hong Kong's external trade. However, export growth is likely to moderate as the regional supply chain has been apparently disrupted by the earthquake and nuclear crisis in Japan, while the global inventory re-building cycle may have run its course.

The economic outlook is subject to a number of risks and uncertainties. Externally, the impacts stemming from the earthquake and nuclear crisis in Japan, the geopolitical tensions in the Middle East and North African region, together with the prospective cut in the US government spending, point to some downside risks in the global recovery. The sovereign debt crisis in Europe continues to challenge global financial market stability despite progress in resolving issues surrounding the debt-ridden countries. The normalisation of monetary policy stance in Europe amid rising inflationary pressures, coupled with the end of the US quantitative easing in June, will add uncertainties to the direction of Hong Kong-dollar fund flows.

Domestically, risks of an overheating in the property market remain a concern. While residential property prices stay elevated, the buoyant non-residential property markets continue to see brisk speculative activities. Meanwhile, rising rentals for fresh leases, together with increasing food prices and local costs, will continue to add to inflationary pressures in the economy. The strong momentum in credit demand persisted in the first quarter, and against this background, the HKMA continues to closely monitor local banking business development, strengthen onsite examinations, and maintain close communications with banks to minimise the risks of excessive credit growth.