REGULAR ARTICLE

Domestic and external environment

by the Research Department

The global environment has become more challenging. The spread of the European debt crisis to Italy and Spain has heightened market volatilities and put the global financial system under pressure. In the US, despite pick-up in growth during the third quarter, the labour and housing markets remained depressed. In most of emerging Asia, including the Mainland, growth momentum has eased as exports to the advanced markets slowed. In tandem, growth of the Hong Kong economy has moderated, although solid private consumption has provided some offset. While policymakers in major advanced economies have pledged new measures to maintain confidence and forestall recession, their effectiveness is highly uncertain and downside risks to the global outlook remain significant.

External environment

Global growth and financial stability hang in the balance, depending on how the European sovereign debt crisis unfolds. The crisis has now spread from small peripheral economies to core ones like Italy and Spain, putting the liquidity of European banks under increasing stress. The risk of an adverse feedback loop between the sovereign debt crisis and a banking crisis has increased dramatically. In response, European authorities announced at the EU summit in late October a three-pronged rescue plan to reduce the debt burden of Greece, to recapitalise the European banking system, and to leverage up the European Financial Stability Facility. At the December EU summit, EU leaders also unveiled additional reform measures including in particular the introduction of a new fiscal compact, and acceleration of both the reform and the introduction of the stabilisation funds.

Financial markets initially reacted favourably to both announcements, but the improvements turned out to be short-lived, as there remain concerns about the lack of details and implementation risks. It remains uncertain whether the rescue package can contain the downside risks against the background of rising likelihood of a recession in Europe.

Despite volatile global financial markets, **US** real GDP growth accelerated to 2% quarter on quarter (annualised) in Q3, faster than the 1.3% in Q2. The pick-up in growth was broad-based and mainly driven by the rise in personal consumption expenditure and strong growth in business investment. While the rebound in Q3 has helped calm fears of an imminent recession, there are concerns that the momentum might not be sustained over a longer time, as the growth was mostly driven by household dis-saving rather than by solid income growth. Across the Atlantic, economic activities in **Europe** remained subdued with real GDP rising by 0.2% quarter on quarter in Q3 following the same rate of growth in Q2. Survey data have indicated further weakening ahead not only in the peripherals but also among the core economies. In the **UK**, the economy expanded by 0.5% quarter on quarter in Q3, better than the 0.1% recorded in Q2. The pick-up in growth was partly due to the reversal of many one-off factors. Otherwise, economic conditions remained difficult. In **Japan**, overall economic activities have returned to their pre-earthquake levels and have since stayed on a moderate recovery path. Real GDP growth picked up to 1.4% quarter on quarter in Q3, after contracting for two consecutive quarters.

With growth momentum remaining fragile and the unemployment rate staying stubbornly high in advanced economies, the incentive to pursue further unconventional monetary easing has increased in these economies. In the US, the Federal Open Market Committee (FOMC) announced the "Operation Twist" to buy US$400 billion of longer-term Treasuries by the end of June 2012 through selling an equal amount of short-term Treasuries in the September FOMC meeting. The FOMC also decided to reinvest principal payments from its agency debt and agency mortgage-backed security holdings into agency mortgage-backed securities. In the UK, the Bank of England's Monetary Policy Committee unanimously agreed to another round of quantitative easing worth £75 billion in October. In Japan, the Bank of Japan maintained its extremely loose policy stance and expanded its Asset Purchase Programme in August and October. Separately, in Europe, the European Central Bank (ECB) implemented more non-standard measures to contain the sovereign debt crisis. It reactivated the Security Markets Programme and the Covered Bond Purchase Programme to support bond markets, and introduced US dollar liquidity-providing operations and unlimited longer-term refinancing operations at the fixed rate in response to banks' liquidity shortage. The ECB also cut its policy rate by 25 basis points each in both the November and December meetings. Six major central banks (i.e. the US Federal Reserve, ECB, Bank of Japan, Bank of Canada, Bank of England and Swiss National Bank) also acted in a co-ordinated manner to reduce the price of US dollar liquidity swap arrangements by 50 basis points.

While monetary policies remain extremely accommodative in advanced economies, fiscal tightening has generally become a drag on growth. In the US, a last-minute deal was struck to extend the debt ceiling by at least US$2.1 trillion over the next 10 years. Nevertheless, the political brinkmanship during the negotiations prompted the Standard & Poor's (S&P's) to downgrade the US sovereign credit rating in August. The agreed size of the deficit reduction would soon become a drag on US economic growth, and there are concerns that the package may not strike the appropriate balance between supporting growth and achieving fiscal sustainability. In Europe, fiscal conditions have not seen much improvement and have actually worsened in a number of crisis economies, particularly in Greece. While fiscal consolidation is necessary for economic rebalancing, overly hasty and draconian fiscal tightening could induce a negative feedback loop, leading to slower economic growth and offsetting the deficit reduction efforts.

The growth momentum in the **East Asian** economies, including Mainland China, showed further signs of moderating, with real GDP growth registering an average quarter-on-quarter annualised rate of 7.2% in Q3, down from 7.6% in Q2.[1] In Mainland China, real GDP growth declined to 9.1% year on year in Q3 from 9.5% in the previous quarter, while sequential growth also edged down. The moderation in export growth has been a common factor in the slowdown in many regional economies, while domestic demand, particularly household consumption, has generally held up well. Inflationary pressures have eased on moderating commodity prices and aggregate demand pressures. The headline CPI for the region increased by an average year-on-year rate of 4.2% in October, compared with the recent high of 4.5% in June. On the Mainland, headline CPI inflation dropped to 4.2% in November from its peak of 6.5% in July. While most central banks in the region have taken a pause in raising interest rates in view of the increased risks to growth, Bank Indonesia and the Bank of Thailand have lowered their policy rates in the October-November period. The Monetary Authority of Singapore reduced the slope of the policy band of the Singaporean dollar's nominal effective exchange rate in October. The People's Bank of China reduced the reserve requirement ratio by 50 basis points in December. The renminbi continued to strengthen against the US dollar before November but showed signs of weakening recently, whereas currencies of other

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

regional economies have weakened since August 2011, driven in large part by the worsening eurozone sovereign debt crisis. Benchmark equity indices in many regional markets have also declined markedly over the same period. Looking ahead, the subdued growth prospects in advanced economies and increased volatility in global financial markets will continue to weigh on the economic outlook for the region, while domestic demand will likely remain relatively resilient.

Domestic economy

The Hong Kong economy expanded modestly in Q3. On a quarter-on-quarter comparison, real GDP edged up by 0.1% after having declined by 0.4% in Q2. The marginal pick-up in real GDP was mainly supported by private consumption and net exports. In tandem with the weak sequential momentum, the year-on-year GDP growth rate moderated from 5.3% in Q2 to 4.3% in Q3.

On the domestic demand front, private consumption spending continued to increase at a solid pace (1.1% quarter on quarter in Q3), with favourable income and labour market conditions providing key support. Private investment spending on machinery and equipment increased further after a notable rise in Q2. Demand from the public sector stayed firm, with government consumption and infrastructure investment still on the upswing. On the other hand, significant inventory de-stocking, together with the continued downward trend of private investment on building and construction, has created a sizeable drag on GDP growth.

External demand improved slightly in Q3 following a sharp decline in Q2. In particular, exports of services were the main growth impetus, rising steadily by 1.1% from Q2 thanks to vibrant inbound tourism. After an 11.1% drop in Q2, exports of goods were flat sequentially in Q3, with the temporary lift from the post-Japanese earthquake recovery of the Asian supply chains offsetting the lull in demand from advanced markets. With imports of goods and services dropping by 1.0% and 0.1%, respectively, overall net exports contributed 2.5 percentage points to GDP growth in Q3. The nominal trade balance reverted to positive, recording a surplus of HK$36.0 billion (7.4% of GDP) in Q3, compared with a deficit of HK$12.9 billion (2.9% of GDP) in Q2.

The labour market remained tight despite the mild pace of economic expansion. The three-month moving average unemployment rate dropped further from 3.4% in July to a post-1998 low of 3.2% in September, before edging up to 3.3% in October, while the underemployment rate hovered at a low level of 1.6% in October. However, the near-term labour market outlook has deteriorated, with various official and private-sector surveys all pointing to less optimistic corporate hiring sentiment amid increased concerns over global growth and business prospects.

Inflation

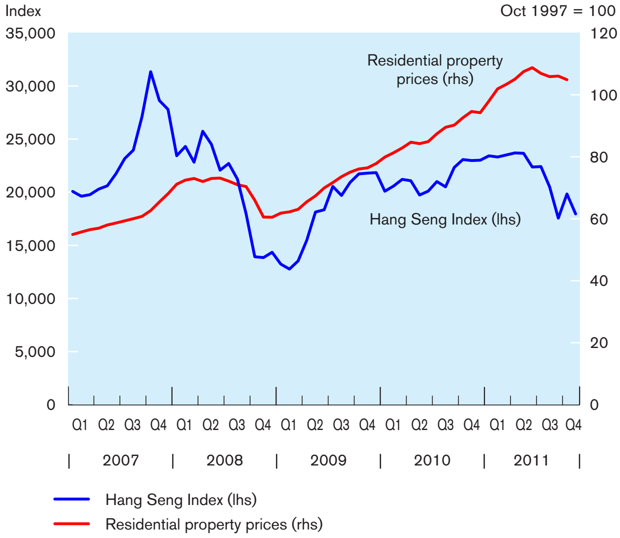
Inflationary pressure remained elevated in recent months, with the year-on-year underlying inflation rate climbing to 6.4% in October from 5.5% in June, driven mainly by the food and housing rental components. The inflation momentum, however, showed some signs of moderation. On an annualised three-month-on-three-month comparison, the underlying inflation rate dipped to 5.8% in October from its peak of 8.0% in April, partly reflecting a slight easing in domestic food price pressure after the surge in global food prices halted earlier this year. However, residential rental feed-throughs continued unabated, while the inflationary pressure from rising labour and commercial rental costs also remained.

Asset markets

The Hong Kong stock market experienced an extended period of volatility in the second half of 2011. Stock prices were weighed down by a sharp upward global re-pricing of risks, as concerns grew over the uncertain global economic outlook and financial market contagion from the worsening European debt crisis. The downgrade of the US sovereign rating by the S&P's in early August also contributed to the market gyrations. The Hang Seng Index lost 21.5% (4,806 points) in Q3 before moving modestly higher by 2.3% (397 points) to close November at 17,989 (Chart 1). The downbeat performance was broadly in line with movements in the major European and emerging Asian indices in US dollar terms. Stock market turnover also moderated, despite a surge in short-selling trade. At the same time, total funds raised in the stock market dropped notably from a monthly average of HK$50.7 billion in the first half of the year to HK$20.2 billion in the four months to October.

The residential property market cooled down in the second half, reflecting the combined impact of a weaker global growth outlook, rising mortgage interest rates, and the multiple rounds of stabilising policy measures. Overall, residential property prices declined by a modest 3.6% between June and October. The Centa-City leading index pointed to continued price declines in November and more recently. Transaction volume in the period from July - November dropped by nearly 60% from a year ago and, according to the Midland volume index, remained sluggish in recent weeks. Confirmor transactions and flipping trade (selling within 12 months of holding) also decreased significantly. Flat rentals, however, remained in an upward trend, nudging up market rental yields (for example, from 3.2% in Q2 to 3.4% in October for typical 40 - 69.9 sq. m. flats). The debt servicing burden for new mortgages has increased, as major banks have been adjusting upwards their mortgage interest rates since early this year.

CHART 1
Asset prices



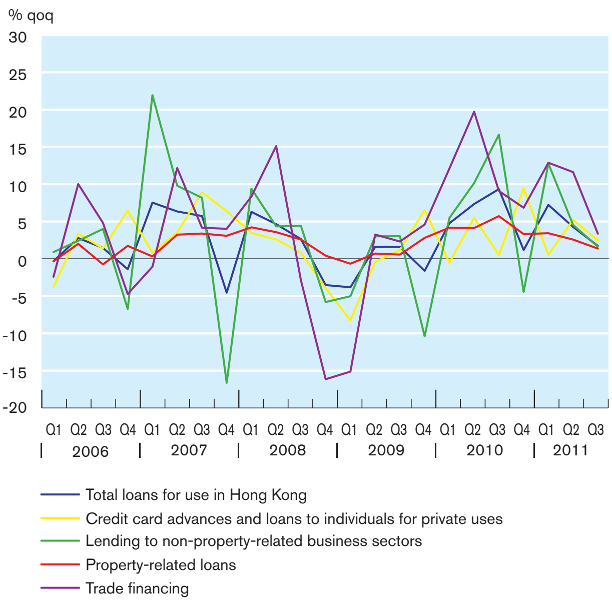
Sources: Rating and Valuation Department, and Hang Seng Indexes Company Limited.

Domestic credit and money supply

Total loan growth slowed in the third quarter, reflecting sluggish merchandise exports, a weaker growth outlook and the ongoing consolidation of the local residential property market. With both Hong Kong dollar and foreign currency loans showing slower growth momentum, total loans and advances expanded by 4.4% in Q3, following rises of 7.4% in Q1 and 6.1% in Q2. While loans for use outside Hong Kong continued to increase robustly, most types of domestic loans recorded slower growth in Q3 (Chart 2). Analysed by economic use, trade finance, residential mortgage loans, property investment and loans to wholesale and retail trade were the major contributors to slower quarterly growth in domestic loans. In October, total loan growth moderated further, with loans for use in Hong Kong expanding by 1.0% compared with three months ago.

CHART 2

Loan growth



Source: HKMA.

Growth in total deposits also declined and lagged behind the rise in loans. Expansion of deposits decelerated to 1.2% in Q3, driven by slower growth in foreign currency deposits and a slight contraction in Hong Kong dollar deposits. The slower increase in foreign currency deposits partly reflected a similar trend in foreign currency loans. During the quarter, renminbi deposits were still the main engine of foreign currency deposit growth, reaching RMB622.2 billion at the end of September, representing about 10% of total deposits. The total renminbi remittance for cross-border trade settlement expanded to RMB525.4 billion in Q3 from RMB492.7 billion in Q2, and there was an increase in net renminbi receipts, which further boosted corporate renminbi deposits. On the other hand, Hong Kong dollar deposits registered a quarterly decline. The share of Hong Kong dollar deposits in total deposits also edged down to 49% at the end of September. In October, Hong Kong dollar deposits rebounded somewhat, growing by 0.1% from three months ago. Between July and October, Hong Kong dollar broad money increased and narrow money grew in response to increased currency demand.

The Hong Kong dollar loan-to-deposit ratio rose to 86.6% at the end of September, from 84.2% at the end of June. The US dollar loan-to-deposit ratio also increased at a brisk pace. Higher loan-to-deposit ratios continued to exert upward funding pressure on banks, which pushed up their effective deposit and lending interest rates in response. The composite interest rate, which reflects the average cost of funds for banks, picked up further from 0.31% at the end of June to 0.36% at the end of September, although still at a very low level by historical standards. Some banks were reported to have been offering new customers particularly favourable deposit rates in stepped-up competition for deposits. On the lending side, there were also signs that effective lending interest rates at the retail level had risen despite stable Best Lending Rates and HIBORs. In particular, HIBOR-based mortgage interest rates for newly approved loans have risen to 2 – 3%, making the HIBOR-based mortgage plans less attractive. Indeed, survey data show that the proportion of newly approved loans priced with reference to HIBOR dropped to 46% at the end of September from 80% three months earlier. The latest data show slower growth in loans relative to deposits in October, reversing the upward trend in the loan-to-deposit ratios.

Short-term outlook

The near-term growth outlook has turned a lot less positive for Hong Kong. The stiff headwinds from the external environment – owing to sluggish growth prospects in advanced economies, a deepening European debt crisis and the ensuing global market volatilities – will likely remain a significant drag on Hong Kong's exports. Domestic demand, mainly driven by private consumption, is expected to fare relatively well and provide some cushion against the potential setback to exports. In the coming quarters, Hong Kong's real GDP is expected to grow at a pace somewhat below its trend rate. The Government now forecasts the economy to grow in 2011 by 5%, hitting the lower end of its earlier range forecast of 5 - 6%, whereas private sector analysts on average expect a 5.0% growth. For 2012, the International Monetary Fund expects that Hong Kong's growth will ease to 4.0%, while private sector analysts see growth at 3.4%.

On the price front, inflation is likely to edge up slightly in the near term due to the delayed pass-through of the earlier surge in market rentals. But further ahead, inflation is expected to gradually recede, reflecting the recent ease-back in global food prices and the moderating growth momentum of the economy.

In the baseline outlook, where the euro area will manage to muddle through the debt problem, growth in major advanced economies will remain subdued in the face of fiscal consolidation and continued de-leveraging. In such a case, the impact of the external headwinds on the domestic economy is expected to mainly work through the trade channel. However, in the adverse scenario where the European sovereign debt crisis worsens and degenerates into a global financial crisis, significant financial distress could arise in Hong Kong and knock the economy into a much deeper downturn. The feature article "Assessing the potential impact of a shock from the US and the euro zone on the Hong Kong economy" in this issue of the Quarterly Bulletin discusses in greater detail how external shocks may affect Hong Kong in the baseline and adverse scenarios through the trade and possibly also financial channels.