REGULAR ARTICLE

Domestic and external environment

by the Research Department

Despite some stabilisation of the European sovereign debt crisis early this year, concerns over renewed instability have re-emerged amid fears of a possible disorderly exit of Greece from the euro area and the deteriorating financial conditions in Spain. In the US, there were signs the recent pick-up in economic recovery might be losing steam. Growth in Mainland China has slowed. And, the economic performance in the rest of East Asia has become more diverse. In Hong Kong, the economy saw modest growth and moderating inflation in the first quarter. The highly uncertain external environment will continue to pose downside risks to growth, but the risk of overheating in the local property market remains, in light of a highly accommodative global monetary environment.

External environment

At the start of the year, global financial markets were cheered by diminished tail risk from the European sovereign debt crisis and tantalising signs of a stronger recovery in the US economy. However, market optimism has recently faded as sovereign debt concerns resurface in Europe and improvements in the US labour market stall. The policy measures introduced in the euro area, in particular the €1 trillion liquidity injection through the three-year Longer-Term Refinancing Operations (LTROs) and the Fiscal Compact, initially appeared to have calmed global financial markets. However, the euphoria soon gave way to concerns over crisis economies becoming trapped in a vicious circle of deeper recession, more austerity measures and further losses in the banking sector. Anti-austerity sentiment has been spreading across Europe and was clearly reflected in the recent election results in Greece, France and Germany. Indeed, the Greek post-election impasse now poses a significant risk of a possible Greek default and exit from the euro area. Separately, the vulnerability of the financial sector in Spain has become more evident. The Spanish Government found it difficult to restore public confidence in its banks even after it nationalised one of the country's largest banks and tightened banks' provision requirements. As a result, the Spanish Government sought a European Union bailout in the Meeting of Economic and Financial Affairs Council in June to recapitalise its banking sector. These lingering concerns over the debt crisis sent the euro exchange rate against the US dollar to its lowest level in three months in late May, while the sovereign bond spreads of the peripheral countries rebounded sharply.

In the **US**, real GDP growth continued at a moderate pace of 1.9% quarter on quarter (annualised) in Q1, slower than the 3% recorded in the previous quarter. Economic momentum appeared to have moderated towards the end of Q1. Housing activities looked to have stabilised, while employment growth slowed sharply for three consecutive months in March – May. Across the Atlantic, economic activities in the **euro area** remained weak with real GDP registering no growth quarter on quarter in Q1, following a 0.3% contraction in the previous quarter. Industrial production fell by 0.3% month on month in March, while the unemployment rate also rose to a record high of 11%, accompanied by extremely high youth unemployment rates in Spain (51.5%) and Greece (52.7% in February). The **UK** economy returned to a recession with a 0.3% quarter-on-quarter contraction in Q1, following a 0.3% contraction in the previous quarter. The economic weakness was driven mainly by a sharp fall in construction output. In **Japan**, domestic demand was solid on the back of strong consumption spending and post-earthquake reconstruction, with real GDP rising by 1.2% quarter on quarter in Q1 after registering zero growth in 2011 Q4.

With weakening growth momentum in the US, renewed recessions in much of Europe and the stubbornly high unemployment rates, monetary stances remained accommodative in major advanced economies. However, as core inflation remains broadly in line with, or above, targets in many advanced economies, major central banks have been keeping further easing measures on hold. In the US, "Operation Twist" is due to expire at the end of June with no clear indications yet from the Federal Open Market Committee on whether the programme will be extended or followed by other easing measures. In Europe, the European Central Bank has also indicated that it has no plans to conduct a third round of LTROs. In the UK, the Bank of England's Monetary Policy Committee voted to keep its asset purchase programme unchanged at £325 billion in its June meeting. In Japan, while deflationary pressure slightly subsided with year-on-year CPI inflation moving up to around zero per cent, the Bank of Japan decided to expand its asset purchase programme by a further ¥5 trillion to ¥70 trillion in April.

On the fiscal side, the lack of political consensus continued to delay fiscal consolidation in the US. While this has so far allowed the recovery to continue, albeit at a moderate pace, deficit reductions could soon come to a head in the form of a fiscal cliff worth up to 5% of GDP starting in January 2013. Therefore, the outcome of the upcoming presidential and congressional elections will be highly critical in determining the US fiscal consolidation and growth path. In contrast, large-scale austerity measures and structural reforms have already swept across countries in Europe with many economies falling back into recession or growing at a modest pace. Economic conditions will likely become increasingly difficult and the threat of further political backlash leading to changes in governments could pose significant challenges to policymakers, not only on following through the agreed fiscal compact, but also on closer co-ordination of crisis-fighting measures and the issues of long-term fiscal integration.

Economic growth in **East Asia**[1] remained generally moderate, but the performance has become more diverse across economies. While some economies experienced a slowdown in growth due mainly to a moderation in domestic demand, economic activities in others appear to have been cushioned by the recent pick up in the US economy and diminished tail risk in Europe earlier in the year. In Mainland China, real GDP growth slowed further to 8.1% year on year in 2012 Q1 from 8.9% in 2011 Q4, and quarter-on-quarter growth also softened. In contrast, quarter-on-quarter real GDP growth in Singapore and Thailand rebounded markedly in Q1 from the low rates in the previous quarter. For the region as a whole, real GDP expanded by an average quarter-on-quarter annualised rate of 8.4% in Q1, up from 4.7% in the previous quarter, mainly reflecting the rebound of the Thai economy after the floods. Inflationary pressures have eased further, with the headline CPI for the region increasing by an average rate of 3.1% year on year in April 2012, compared with 3.6% three months ago. In particular, headline CPI inflation in Mainland China trended downwards from 4.5% year on year in January to 3.0% in May, due mainly to an easing in food price inflation. Central banks in the region have generally maintained a loosening bias since March, but the policy stance has remained cautious, reflecting lingering concerns over inflation risks, particularly in view of the elevated oil price. The Central Bank of the Philippines lowered its policy interest rate again by 25 basis points in March while the People's Bank of China (PBoC) reduced the reserve requirement ratio, for the second time this year, by 50 basis points in May and lowered the benchmark interest rates by 25 basis points in June. On the other hand, the Monetary Authority of

[1] East Asia includes China, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand.

Singapore tightened its policy stance by increasing the slope of the policy band of the Singaporean dollar's nominal effective exchange rate in April. Amid renewed uncertainties surrounding the European debt crisis, benchmark equity indices in many regional markets have dropped distinctly since March, reversing some of the strong rally seen in the first two months of the year. Regional currencies have also generally weakened against the US dollar. The RMB/USD exchange rate has seen some two-way movements since March and weakened modestly against the US dollar on a cumulative basis over the review period. Meanwhile, the PBoC widened the daily trading band for the RMB/USD exchange rate from ±0.5% to ±1.0% around the central parity in April to increase the flexibility of the renminbi exchange rates. Looking ahead, risks to growth in the region continue to tilt to the downside, stemming mainly from the unresolved European sovereign debt crisis, subdued global economic prospects, and elevated global oil prices.

Domestic economy

The Hong Kong economy experienced another quarter of modest growth in Q1. On a seasonally adjusted quarter-on-quarter comparison, real GDP expanded by 0.4% for a second consecutive quarter. The modest support from net exports was partially offset by softer domestic demand. In line with the weak sequential momentum, the year-on-year GDP growth rate declined to 0.4% in Q1 from 3.0% in the previous quarter.

Domestic demand showed some signs of losing steam, although public spending remained solid. Private consumption contracted mildly in Q1, after growing briskly last year on the back of rising household income and favourable labour market conditions. There were also slight drags from private investment and inventory changes. Government consumption increased steadily, providing some support to sequential GDP growth. On-going large-scale infrastructure projects also continued to lift public investment in building and construction, which is likely to induce more public investment in machinery and equipment in the coming quarters.

Despite a steady rebound from the steep fall in the second quarter of last year, exports of goods still faced strong headwinds. The slack in the advanced economies led to weak production and reduced trade flows in major Asian economies during the quarter, which in turn resulted in a notable deceleration in Hong Kong's exports of raw materials and intermediate goods to all major Asian markets. Exports of services, however, remained resilient and rose successively on the back of vibrant inbound tourism. Alongside a slight deterioration in terms of trade, the nominal overall trade surplus contracted to HK$1.3 billion (0.3% of GDP) in Q1, compared with a surplus of HK$24.6 billion (5.4% of GDP) in the same quarter last year.

Labour market conditions continued to be tight, thanks partly to support from vibrant inbound tourism which benefited some labour-intensive sectors such as retail trade and personal services. Total employment reached a record high of 3.65 million in Q1. The three-month moving average unemployment rate was still low at 3.4% in Q1 and 3.3% in April, similar to the levels in the second half of 2011. However, the challenging external environment and modest domestic growth momentum may dampen hiring sentiment, and pose upward pressure on the unemployment rate.

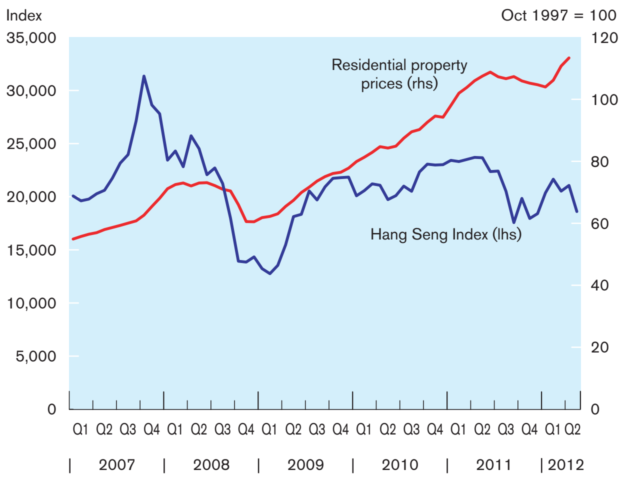
Inflation

Inflationary pressures moderated, with the year-on-year underlying inflation rate softened to 5.9% in Q1 from 6.4% in the previous quarter. Major CPI components recorded slower increases and the rental component remained a key contributor to inflation. In the short term, inflation is likely to recede further due to high base effects, slower growth momentum and the waning effect of last year's higher rentals, although the recent increase in rents, if sustained, could slow the ongoing moderation in inflation.

Asset markets

Following a rebound in January and February, local stock prices began to lose momentum in March and April, largely reflecting an unfavourable global outlook amid the lingering European debt crisis. The Hang Seng Index reached a recent high of 21,680 in late February, but levelled off in March and April (Chart 1). Towards May, an expectation of slower growth in Mainland China, together with negative sentiment stemming from the election results in Europe, created significant downward pressure on stock markets. The Hang Seng Index trended downwards along with regional stock markets to close at 18,630 at the end of May. The average daily turnover of the Hong Kong stock market decreased to HK$58.4 billion in January – May from HK$66.0 billion in the second half of 2011. Total funds raised declined to a monthly average of HK$22.7 billion in January – May from HK$31.0 billion in the second half of last year.

CHART 1
Asset prices



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

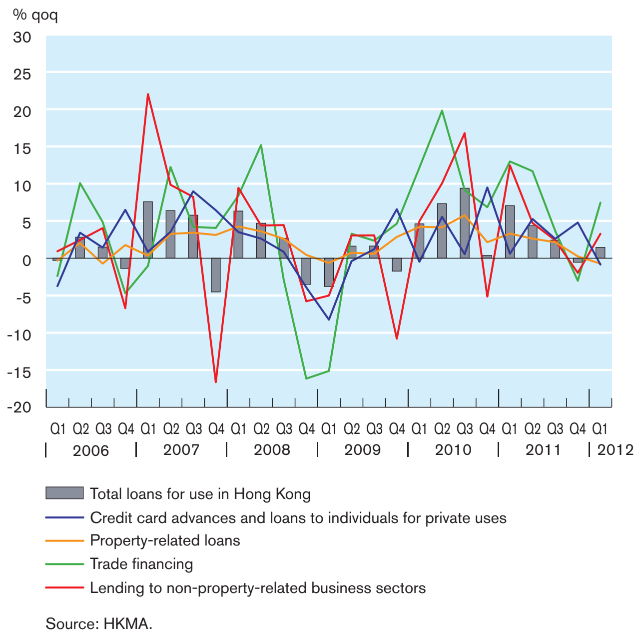
Buoyancy returned to the local residential property market after the Chinese New Year holidays, with housing prices rising by 9.0% from January to April. The Centa-City Leading Index also pointed to a continued price increase towards May and early June. Analysed by market segments, housing prices for the mass market rose somewhat faster than those for the large flat market (with saleable area over 100 square metres). Transaction volume climbed to a 16-month high of 11,358 units in March before moderating to a still-robust level in April and May. On the other hand, confirmor transactions and flipping trade (selling within 12 months of holding) remained thin by historical standards. Housing rentals also increased recently, but at a relatively slower pace compared with housing prices, thus leaving the rental yields at a low level. As a result of the elevated property prices, housing affordability, measured by the income-gearing ratio and price-to-income ratio, deteriorated further in recent months.

Money supply and domestic credit

Along with the slowdown in domestic economic activity, loans for use in Hong Kong increased only modestly by 1.5% in Q1, following a 0.5% decline in 2011 Q4 (Chart 2). Within this, trade financing and lending to non-property related business sectors rebounded, while there were some offsets from property-related loans amid the consolidation of the property market in late 2011. Credit card advances and loans to individuals for private use edged down as private consumption weakened. However, the robust demand for loans for use outside Hong Kong continued, rising by 4.5% in Q1. In terms of currency denomination, Hong Kong dollar loans declined by 0.2%, while foreign currency loans rose faster by 6.3%. Total loans as a whole increased by 2.3% in Q1, up from the 1.0% the previous quarter. The broad picture remained largely unchanged moving into the second quarter, with total loans increasing by 2.4% in April from three months earlier. Property-related loans may have picked up again as survey data suggest new mortgage loans approved surged in recent months associated with a rise in property trading activity.

CHART 2

Loan growth



Source: HKMA.

Growth in total deposits moderated to 1.0% in Q1 from 3.7% in 2011 Q4, driven by slower growth in Hong Kong dollar deposits and a slight decline in foreign currency deposits. The latter mainly reflected a decline in renminbi deposits in Hong Kong, from RMB588.5 billion at the end of 2011 to RMB554.3 billion at the end of March, although the outstanding amount of renminbi certificates of deposit rose to RMB118.0 billion from RMB73.0 billion three months ago. During the quarter, the total remittance of renminbi for cross-border trade settlement fell by RMB11.7 billion to RMB227.3 billion. Monetary aggregates increased only moderately, with Hong Kong dollar broad money growing by 2.7% as restrained by sluggish Hong Kong dollar lending. Narrow money increased by just 1.1% in Q1, in part reflecting subdued equity IPO activities. In April, total deposits and monetary aggregates continued to increase at a moderate pace, while renminbi deposits decreased slightly to RMB552.4 billion.

Banks' funding pressure for the Hong Kong dollar has eased somewhat since early 2012, with the loan-to-deposit ratio declining to 82.4% at the end of April from 84.5% at the end of 2011. At the same time, the composite interest rate, which reflects the average cost of Hong Kong dollar funds for banks, dropped 14 basis points from the end of 2011 to 0.39% in April. On the lending side, there were signs that banks have lowered the effective lending interest rates at the retail level. For instance, prime-based mortgage interest rates are estimated to have eased on average by 32 basis points since early this year to around 2.34% currently, while reportedly the HIBOR-based mortgage interest rates have also edged down. However, as foreign currency lending remained robust, the corresponding loan-to-deposit ratio climbed further to a decade-high of 53.1% at the end of April.

Short-term outlook

The global outlook remains highly uncertain and the near term prospects for the Hong Kong economy will continue to be subject to binary risks. First, the renewed flare-up in Europe's sovereign debt crisis and weaker growth on the Mainland could subject financial market conditions and fund flows to substantial volatilities, and will cast a cloud over the growth outlook in the near term. Export growth will likely continue to be restrained by subdued global growth. Signs of softening in private consumption could also become more visible, especially if the labour market conditions start turning from the current cyclical highs. The Government now forecasts real GDP growth at 1 - 3% for 2012. Private sector analysts expect a 2.7% growth on average, with a wide dispersion reflecting the considerable uncertainties around the outlook.

Secondly, despite the potential downside, risks of overheating in the local property market remain, in light of the highly accommodative global monetary environment. Any further quantitative easing in the advanced economies, which is still possible given their fragile growth, could exacerbate such risks.