Domestic and external environment

by the Research Department

Stock markets across the globe rose markedly during the first five months of 2013 before witnessing sharp sell-offs in June. The sell-offs reflect concerns about the Federal Reserve's near-term exit and heightened volatility in Japan's financial markets. Meanwhile, recovery in major advanced economies remains fragile with extreme downside risks having diminished but not yet fully dissipated. In Europe, the euro area economy is still mired in a protracted recession. In the US, the private sector has been surprisingly resilient but fiscal headwinds will continue to drag on the recovery. In Japan, it remains uncertain if the aggressive reflationary policies can restore growth and overcome deflation in the medium to longer term. In East Asia, regional economies in general expanded at a moderate pace, with notably slower-than-expected growth in Mainland China. In Hong Kong, growth momentum was dragged by the external sector, even with cushion from resilient domestic consumption demand. It is expected that a soft Hong Kong economy will continue for a while unless the global economy sees a more sustained recovery.

External environment

Global stock markets rallied during the first five months of 2013, as major central banks continued to pursue aggressive monetary easing and policymakers defused the near-term threats of a euro break-up and the US "fiscal cliff". However, sentiment took a turn for the worse from the end of May and global stock markets have since experienced sharp declines. The declines reflect concerns about the Federal Reserve's near-term exit and heightened volatility in Japan's financial markets. Meanwhile, recovery in major advanced economies remained fragile with extreme downside risks having diminished but not yet fully dissipated. In Europe, the **euro area** economy remained mired in recession with real GDP contracting for the sixth consecutive quarter, by 0.2% quarter on quarter in the first three months of 2013, following a 0.6% contraction in the fourth quarter of 2012. The unemployment rate also rose to a historical high of 12.2% in April with the youth unemployment rate climbing to 24.4%. The approval of the €10 billion bailout package for Cyprus and the formation of a "grand coalition" government in Italy have eased fears of euro disintegration, but they also highlighted the urgent need of a banking union and the political uncertainties lying ahead on the path of austerity and structural reform. In the **US**, growth prospects look relatively brighter with real GDP growing at 2.4% quarter on quarter (annualised) in the first three months of 2013, up from 0.4% in the previous quarter. In particular, the domestic private sector was surprisingly resilient despite the substantial squeeze from January's income and payroll tax hikes on real disposable income and the continued uncertainty over the budget "sequester". Nevertheless, fiscal consolidation will continue to pose headwinds while employment and income growth will have to accelerate if a stronger recovery is to be sustained. In the **UK**, the economy avoided a triple-dip recession with real GDP growing by 0.3% quarter on quarter in the first three months of 2013, after contracting by 0.3% in the previous quarter. The rebound was mainly driven by strong growth in the service sector and recovery in the North Sea oil and gas output, although slow wage growth and the struggling construction sector do not bode well for stronger growth ahead. In **Japan**, Prime Minister Shinzo Abe launched an aggressive reflationary policy plan consisting of fiscal stimulus, unconventional monetary easing and structural reforms. Financial markets and the real economy appear to have reacted positively so far, with the stock market rising sharply since the end of last year despite its recent consolidation and real GDP growth picking up to 4.1% quarter on quarter (annualised) in the first quarter of 2013, from 1.2% in the fourth quarter of 2012. However, there are important sovereign and banking risks involved and it remains uncertain whether the "Abenomics" can restore growth and overcome deflation in the medium to longer term.

With fragile recovery, slowing inflation and stubbornly high unemployment, central banks across advanced economies continued to ease monetary conditions. In the US, the Federal Reserve decided at the June Federal Open Market Committee meeting to keep its policy unchanged with continued monthly purchase of $40 billion of mortgage-backed securities and $45 billion of longer-term US Treasuries, but hinted that it may start to taper and eventually stop its bond purchase should the unemployment rate continue to drop to about 7%. In Europe, the European Central Bank cut its main refinancing rate by 25 basis points to a historical low of 0.5% in May and hinted at possible further easing ahead. In the UK, the Bank of England extended the Funding for Lending scheme for a year until January 2015 and kept the size of the quantitative easing programme at £375 billion in June. In Japan, the Bank of Japan introduced "Quantitative and Qualitative Monetary Easing" in April, which aims to double its Japanese Government Bond holdings and the size of the monetary base in two years with a 2% inflation target to be achieved by the end of 2014.

On the fiscal side, while the "fiscal cliff" and potential government shutdowns were avoided in the US, politicians have yet to devise a medium-term consolidation plan and raise the debt ceiling. Indeed, although the Congressional Budget Office revised down its fiscal deficit projections in May, which may ease political pressures for more near-term consolidation, the projected budget deterioration towards the end of this decade has highlighted the need for a medium to longer-term plan to deal with pressures from an ageing population, rising health care costs and growing interest payments on federal debt. In any case, the income and payroll tax hikes agreed in January and the budget "sequester" that kicked in from March will continue to drag on the recovery in the near term. Similarly in Europe, while concerns in the financial markets about a euro break-up have eased which have allowed euro area governments to re-address the delicate balance between fiscal consolidation and growth, risks remain that policymakers in Europe may fail to seize the opportunity to push through the necessary structural reforms and closer fiscal, political and banking integration.

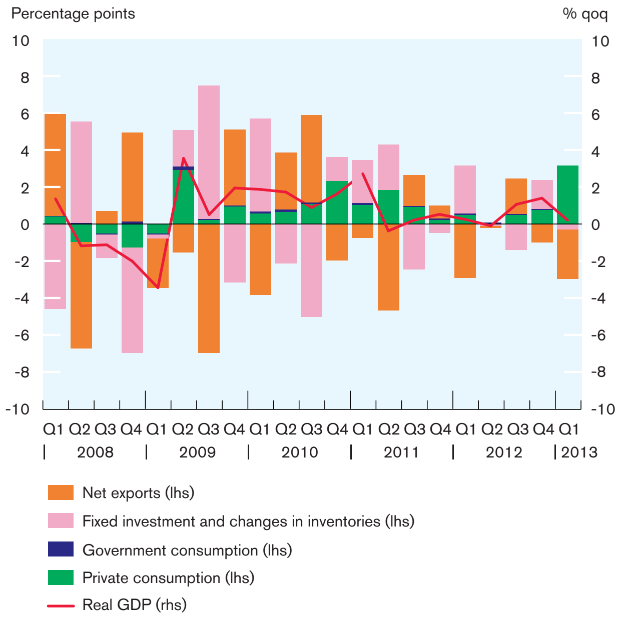
East Asian economies[1] in general expanded at a moderate pace, with notable variation in growth continuing across the region. Newly industrialised economies grew at a below-trend rate, constrained by on-going lacklustre recovery in global economy and a slowdown in domestic household spending. On the other hand, output growth of some other economies in the region was robust, albeit moderating, powered by resilient domestic demand. For the region as a whole, year-on-year real GDP growth moderated to 6.4% in the first quarter of 2013 compared with 7.2% in the previous quarter, with a major drag from Thailand's sharp decline in output growth due to receding base effects associated with flood-related disruptions. GDP growth in Mainland China slowed to 7.7% year on year in the first quarter of 2013 from 7.9% in the previous quarter due to softening domestic and external demand. Inflationary pressure remained contained in the region, with average year-on-year growth easing further by 0.1 percentage points to 2.2% in May, markedly below the five-year average of around 3.5%. In particular, the CPI inflation in Mainland China has largely stayed at around 2% year on year since mid-2012 amid moderate growth momentum, and would likely be contained in the near term. Meanwhile, central banks in the region broadly maintained accommodative monetary policy amid slowing growth and benign inflation, but also stayed cautious on lingering price pressures and increased exchange rate volatility. Both Bank of Korea and the Bank of Thailand cut benchmark rate by 25 basis

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

points to 2.5% in May, whereas Bank Indonesia raised its policy rate by 25 basis points to 6.0% in June. The People's Bank of China would continue its prudent policy stance and manage liquidity in the banking system. Despite Japan's large scale fiscal and monetary easing, signs of massive capital inflows remained muted. Exchange rates were volatile with most currencies in the region appearing to have weakened somewhat against the US dollar after a broad strengthening in April. While the renminbi/US dollar exchange rate has appreciated by about 1% since the end of March amid stronger bank-related capital inflows, the exchange rate has become more stable recently, with emerging signs of a weakening in capital inflow pressure. Looking ahead, the re-emergence of euro area debt crisis and uncertainties surrounding the timing of the Federal Reserve's exit from quantitative easing remain key risks facing the region. Geopolitical tensions and effectiveness of Japan's new policy stimulus to revive the economy pose additional uncertainties. On the other hand, domestic demand would continue to lend some support to regional growth with ample policy space to boost economy if necessary. According to the latest consensus forecast, the East Asian economy as a whole is expected to grow by a solid 6.7% in 2013, compared with 6.6% in 2012.

CHART 1

Contributions to quarter-on-quarter percentage change in real GDP



Sources: Census and Statistics Department (C&SD) and HKMA staff estimates.

Domestic economy

Growth momentum of the **Hong Kong** economy has weakened. On a seasonally adjusted quarter-on-quarter basis, real GDP edged up by 0.2% in the first quarter of 2013, slower than the 1.4% growth in the previous quarter (Chart 1). While private consumption increased briskly by 4.9% on the back of rising income, resilient labour market conditions and positive wealth effects, overall investment spending was dragged by weaker private-sector building activity and capital investment. Public infrastructure works also moderated after growing at a robust pace for several years. Net exports weakened further, with slight improvement in exports being outstripped by much stronger retained imports. Along with the largely muted sequential momentum, year-on-year real GDP growth reached 2.8% in the first quarter of 2013, same as in the fourth quarter of 2012.

Labour market conditions were broadly tight in overall terms, with total employment growing at a firm pace amid robust domestic-oriented economic activities and vibrant inbound tourism. In the meantime, more people re-entered the labour market, leading to a faster increase in the labour force participation rate. However, employment growth failed to absorb all the increases in the labour force, and the unemployment rate edged up to 3.5% in the first quarter of 2013 from 3.3% in the fourth quarter of 2012 as a result. Moreover, the average monthly employment earnings of full-time employees grew more slowly by 2.5% from a year ago in nominal terms in the first quarter, which translated into a 1.2% decrease in real terms.

Inflation

Despite softer GDP growth, inflationary pressure has increased in recent months. On a year-on-year comparison, the underlying inflation rate edged up to 3.9% in April from 3.8% in late 2012. There was indeed a sharper sequential pick-up, with the annualised three-month-on-three-month underlying inflation rate reaching a 15-month high of 5.3% in April. This mainly reflected rising food prices and the pass-through of the earlier increases in housing rentals.

Asset markets

The Hong Kong stock market has been volatile so far in the year. Stock prices made a strong start in January and early February but then experienced a correction amid renewed concerns over the euro area debt crisis. Stock prices ticked up in mid-April and most of May along with some stabilisation in the euro area and signs of broader improvement in the US economy. More recently, however, market sentiment has been weighed down along with sell-offs in emerging markets triggered by uncertainties about the timing and scope of the Federal Reserve's policy exit, heightened volatility in Japan's financial markets as well as signals of slowdown in the Mainland economy. Overall, the Hang Seng Index dropped by 1.6% during the first quarter of 2013 and a further 8.6% to close at 20,383 on 20 June. The daily turnover fell from an average of HK$74.4 billion in the first quarter of 2013 to HK$59.5 billion in April and May and remained sluggish in early June. Total funds raised from the equity market were little changed from a year ago, amounting to HK$114.6 billion in the year to May.

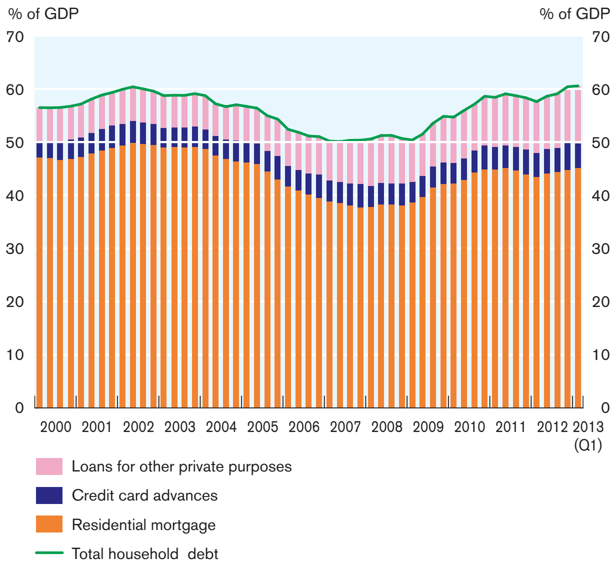
Property market sentiment remained fairly upbeat in early 2013 but cooled after the HKMA and the Administration introduced prudential and stamp duty measures in late February. Housing prices softened as a result, with the Centa-City leading index falling by 3.0% from its March peak. Meanwhile, property transactions dropped by more than 40% according to the Land Registry. Still, there continues to be some risk of misalignment between housing prices and economic fundamentals. Housing affordability has deteriorated further, with the price-to-income ratio just slightly below its 1997 peak of 14.6 and the income-gearing ratio rising to a 13-year high of around 63%. The currently low rental yield also signals risk of housing prices running ahead of fundamentals, either from a user-cost or asset-pricing perspective.

Money supply and domestic credit[2]

On the credit front, total loans grew at an annualised rate of 12.3% in the first quarter of 2013, slightly faster than the 9.6% increase in 2012 as a whole. However, along with slower economic activities, growth in domestic lending remained soft in general, with Hong Kong dollar loans and loans for use in Hong Kong excluding trade finance only increasing by an annualised 3.1% and 4.7% respectively. In particular, growth in mortgage lending and other property-related loans has moderated after the introduction of prudential and tax measures. Consumer credit[3] also grew modestly, although its accumulated increase over the past few years has helped lift the aggregate household debt-to-GDP ratio to a record 61% by the first quarter of 2013 (Chart 2). As regards external-oriented lending, trade finance bounced up after a sharp decrease in the fourth quarter of 2012, while foreign currency lending and loans for use outside Hong Kong continued to rise at a robust pace. This broad picture of the credit market remained largely unchanged moving into the second quarter, albeit with signs of a pick-up in domestic lending.

CHART 2

Household debt-to-GDP ratio



Note: Only borrowings from authorized institutions are included.

Sources: HKMA and C&SD.

[2] All annualised rates of change in this section are prorated based on the year-to-March rate.

[3] Consumer credit refers to the sum of credit card advances and loans for other private purposes.

By contrast, growth in annualised total deposits moderated from 9.3% in 2012 to just 2.7% in the first quarter of 2013. In particular, Hong Kong dollar deposits declined by an annualised 1.0% in the first quarter of 2013, in part reflecting some outflows of funds from Hong Kong dollar alongside the local stock market correction. Foreign currency deposits rose by an annualised 6.6%, roughly the same pace as in 2012. Renminbi deposits in Hong Kong increased by RMB65.1 billion to RMB668.1 billion during the quarter, while total remittances for renminbi cross-border trade settlement rose by RMB128.5 billion to RMB831.0 billion. As for monetary aggregates, the Hong Kong dollar broad money only edged up by 0.1% in the first quarter of 2013 (0.3% annualised), while the seasonally adjusted Hong Kong dollar narrow money supply (HK$M1) grew steadily by 3.8% (15.3% annualised). In April, Hong Kong dollar deposits and the monetary aggregates picked up again, while growth in foreign currency deposits accelerated. Renminbi deposits also increased further to RMB677.2 billion in April.

The Hong Kong dollar interest rates remained steadily low amid the on-going accommodative monetary environment in the US. During the first four months of 2013, both the overnight HIBOR and the three-month HIBOR fixings edged down by two basis points, to 0.08% and 0.38% respectively. The composite interest rate, which reflects the average cost of funds for banks, also decreased to 0.25% in April from 0.32% in December 2012. On the other hand, the average mortgage interest rate ticked up to 2.35% in April from 2.30% in December 2012, in part reflecting the impact of the regulatory increase in the risk-weight floor for residential mortgages. On the whole, the Hong Kong dollar liquidity conditions remained relatively stable, with the Hong Kong dollar loan-to-deposit ratio hovering around 80%, compared with an average of 82% in 2012.

Short-term outlook

Despite softer sequential momentum in the first quarter of 2013, it is expected that the Hong Kong economy will grow slightly faster in the remainder of the year. Still, the overall growth will remain soft and below-trend. The drags from external demand should subside gradually, albeit at a more moderate pace than earlier expected as the global economy remains fragile and struggles to achieve a sustained recovery. On the domestic front, thanks to resilient labour market conditions and rising household income, private consumption will continue to act as a major growth driver. After sluggish performance in the first quarter, large-scale infrastructure works and private building activity are anticipated to show steady growth momentum going forward. However, the outlook for capital investment and inventory stocking remains less certain amid relatively fragile business sentiment. In view of the sluggish first quarter performance, private sector analysts have adjusted downwards their 2013 GDP growth forecast to 3.2% on average, from 3.5% earlier this year. Our in-house composite index of leading indicators also points to moderate growth in the coming months.

Inflationary pressure is expected to persist in the near term but moderate further ahead. In the coming months, the lagged effects of the surge in housing rentals over the past year will progressively feed through to the CPI inflation. There will also be spill-over effects from the rise in the statutory minimum wage rate since May. But going forward, the still below-trend economic growth, recent softening in fresh-letting housing rentals and softer import and commodity prices should help contain the upward pressure on inflation, with their moderating effect becoming more visible next year.