REGULAR ARTICLE

Domestic and external environment

by the Research Department

Global financial markets have remained calm as the US Federal Reserve continued the reduction of its large-scale asset purchase programme. Monetary policy paths of major advanced economies look set to diverge in the face of varying domestic economic conditions. In the US, growth has been halted temporarily by the severe winter weather and inventory reduction but the underlying momentum of the recovery remains intact. In the euro area, the recovery has remained subdued with disinflationary pressure continuing to persist. In Japan, strong growth has been driven by the frontloading of domestic demand and the economy faces the risk of a sharp reversal. In East Asia, growth momentum of many economies has generally moderated, with real GDP growth in Mainland China receding in the first quarter on deceleration of both external and domestic demand. In Hong Kong, the economy grew slowly in the first quarter largely due to sluggish trade performance, while high-frequency data continue to suggest modest growth momentum more recently. Loan growth has moderated in recent months, but the credit situation continues to warrant close monitoring and supervision, particularly in terms of banks' funding risks and credit risks.

External environment

Global financial markets have remained calm amid expectation of a prolonged period of accommodative monetary policy and improved growth momentum in advanced economies. Monetary policy paths of major advanced economies look set to diverge with strengthening recoveries in the US and the UK bringing forward expectations of interest rate hikes while risks of weakening growth in Japan and persistently low inflation in the euro area have prompted expectations of further unconventional monetary easing. In the US, growth was halted temporarily by the severe winter weather and inventory destocking but the underlying momentum of the recovery remains intact. Excluding inventories and net exports, final sales to domestic purchasers grew by 1.6% in the first quarter, the same pace as in the previous quarter. The unemployment rate fell to 6.3% in May, down sharply from 7.5% a year earlier, although much of the improvement was driven by a fall in labour force participation. The recent rebound in activity indicators and the run of robust employment growth suggest the economy should improve vastly in the second quarter. Similarly in the UK, the economy continued to strengthen with real GDP growing by 0.8% quarter on quarter in the first quarter following a solid 0.7% growth in the previous quarter. The recovery has broadened out with production, construction and services all expanding in the quarter. The number of people in work also hit a record high with the unemployment rate falling to a 5-year low of 6.6% in the three months to April. In contrast, economic recovery in the euro area has remained subdued with real GDP growing slowly by 0.2% quarter on quarter in the first quarter, down from 0.3% in the previous quarter. The ongoing balance sheet adjustment and the stubbornly high unemployment rate continue to weigh on the recovery. As a result, disinflationary pressure persisted with the annual inflation rate falling to 0.5% in May and many peripheral countries sliding into deflation which exacerbated their debt problems. In Japan, the economy grew strongly by 1.5% quarter on quarter in the first quarter, driven by the frontloading of domestic demand to beat the tax increase in April. The economy now faces the risk of a sharp reversal of the frontloading demand in the second quarter, and the strength and sustainability of the subsequent recovery in the second half of the year remains uncertain.

Major central banks look set to embark on diverging monetary policy paths in the face of varying domestic economic conditions. In the US, the solid recovery means the Fed continued to reduce its large-scale asset purchase programme by another $10 billion to $35 billion per month in the June Federal Open Market Committee meeting. The Fed previously hinted that the asset purchase programme could end in autumn with the possibility that it could be followed by the first rate hike in around 6 months. As the unemployment rate has been falling faster toward its numerical policy threshold than projected, the Fed has switched from quantitative to qualitative forward guidance and widened the metrics in their "dashboard" of economic and labour market data. Similarly in the UK, the faster-than-expected fall in the unemployment rate means the Bank of England (BoE) has switched from a numerical-threshold based forward guidance to a qualitative guidance that is based on a wide range of economic indicators. Both the Fed and the BoE have stated that interest rates will likely be kept below their longer run levels even when employment and inflation get close to their targets. In Europe, the European Central Bank (ECB) announced a package of monetary easing measures in the June Governing Council meeting, including in particular cuts in key policy interest rates and the introduction of Targeted Longer-Term Refinancing Operation (TLTRO). At the same time, the ECB Governor Mario Draghi emphasized the ECB has not exhausted monetary easing options by saying that "if needed, within our mandate, we aren't finished here". In Japan, the Bank of Japan (BoJ) has so far stuck firmly to its Quantitative and Qualitative Easing programme (QQE) by doubling its JGB holdings and meeting its base money target during the first year of implementation. The BoJ Governor Haruhiko Kuroda has said repeatedly that the central bank is ready to strengthen the QQE programme if the economy slows more than expected after the tax hike in April.

On the fiscal side, advanced economies look to have made some progress with fiscal consolidation. In the US, the Congressional Budget Office has revised down its forecast for current year (FY2014) fiscal deficit, to 2.8% of GDP in April, down from 3% in February and below the past 40-year average of 3.1%. In the euro area, countries have continued their fiscal consolidation effort although the pace has started to slow and there is still a long way to go. In Japan, the government has finally started fiscal consolidation in FY2014 to meet its long-term goal of achieving a primary fiscal balance by FY2020. Consumption tax was raised from 5% to 8% in April 2014, and the Japanese government is planning to increase it further to 10% in October 2015.

In East Asia[1], growth momentum of many economies had moderated following stable growth in the second half of 2013. Reflecting the softening in both external and domestic demand, growth momentum in Mainland China slowed in the first quarter, with real GDP growth slipping to 7.4% year on year from 7.7% in the previous quarter. Elsewhere, growth momentum in many economies also appeared to have slowed down in the first quarter, as the performance of their external sector weakened along with the slowdown in the US and Mainland China. For the region as a whole, the year-on-year real GDP growth edged down to 6.3% in the first quarter from 6.5% in the previous quarter. Meanwhile, price pressure remained weak in the region, but there are emerging signs of inflation picking up in some economies amid rises in domestic costs such as for utilities and housing. In Mainland China, inflationary pressure remained contained, with the May CPI inflation being 2.5% year on year. Separately, the average CPI inflation rate in the region edged up slightly to 3.1% year on year in April from 2.9% a month earlier. With the inflation threat generally under control, most central banks in the region have maintained accommodative monetary policies. In Thailand, the central bank cut its policy interest rate

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

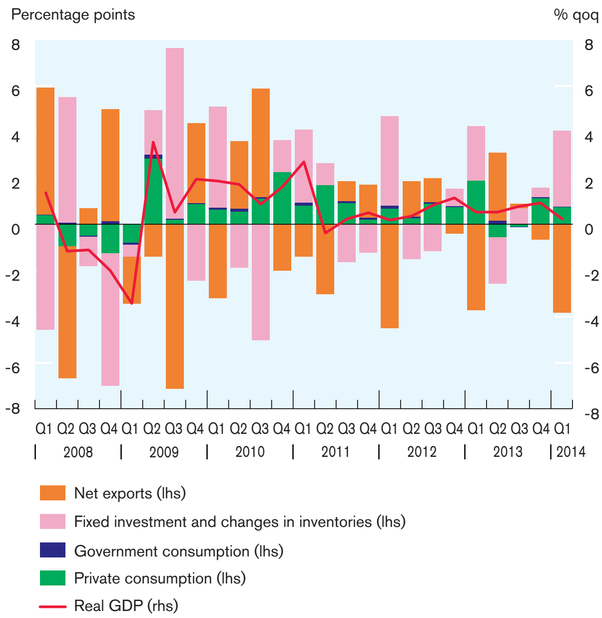
by 25 basis points in March to support growth as the nation's prolonged political tension has taken a toll on its economy. In Mainland China, the People's Bank of China maintained a prudent policy stance while using targeted measures to support real economic activities, such as lowering the required reserve ratios of commercial banks with significant lending to small and micro-sized enterprises and agricultural sector. The renminbi weakened further against the US dollar in April, but has been largely stable in recent weeks. Meanwhile, financial markets in the region had remained calm despite some volatility following the announcement of the Fed's QE tapering in December last year and the tumble of Argentine peso early this year. Exchange rates of most regional currencies have strengthened against the US dollar since February after enduring some selling pressure in the previous months, with capital inflows returning to the region after the sell-off last summer. Looking ahead, it remains uncertain to what extent the pick-up in growth momentum of the US and other major advanced markets should help support the region's exports. At the same time, the region's outlook may also have become more sensitive to potential volatilities in the growth of the Mainland China economy, which has recently become a more important source of final demand for regional exports, particularly commodities. In the latest consensus forecasts, the East Asian economy is projected to grow by 6.3% on aggregate in 2014, slightly down from 6.6% in 2013.

Domestic economy

Hong Kong's real GDP growth receded to a quarter-on-quarter rate of 0.2% in the first quarter of 2014 from 0.9% in the fourth quarter of 2013 (Chart 1). Domestic demand continued to lend support to real GDP growth, led by a surge in construction work and inventory build-up. But private investment in machinery and equipment seemed to have weakened, while growth in private consumption expenditure also softened slightly. On the other hand, the drag from net exports has largely offset the gain in domestic demand. Exports of goods reverted to a decline in the first quarter amid sluggish demand from the advanced economies and weak processing trade flows in Asia, while exports of services were losing momentum, battered by much slower growth in tourist spending and subdued performance in trade-related services. The year-on-year real GDP growth rate also slowed to 2.5% in the first quarter of 2014 from 2.9% in the fourth quarter of 2013.

CHART 1

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



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

Labour market conditions, while still broadly buoyant, eased slightly along with the growth slowdown of the domestic economy. Labour demand softened with total employment levelling off. On the other hand, as the labour force participation rate also declined, the unemployment rate stayed at a 16-year low of 3.1% in recent months. Further breakdown of the data however shows that the unemployment rate of the lower-skilled segment rose while that of the higher-skilled segment remained at a steadily low level.

Inflation

Against the backdrop of softer GDP growth, inflationary pressures have been broadly contained so far this year with slower increases in housing rentals and miscellaneous service costs offsetting the upswings in food price inflation. The underlying inflation rate, after staying around 3.9% during the first quarter, fell to an annualised three-month-on-three-month rate of 3.4% in April.[2] The year-on-year underlying inflation also moderated gradually to 3.5% in April.

Asset markets

The local equity market has shown much volatility so far this year amid concerns over the normalisation process of the US monetary policy and the macro-financial prospects of the Mainland China economy. Fluctuations in the technology shares and merger and acquisition activities have also amplified market volatility. The authorities announced on 10 April the launch of a direct share-dealing scheme between Hong Kong and Shanghai called the "Shanghai-Hong Kong Stock Connect" in six months' time. This pilot scheme is an important step forward for the opening of Mainland China's capital account, and it is expected to strengthen Hong Kong's status as an international financial centre. In the first five months of 2014, the Hang Seng Index fluctuated in a wide band between 21,182 and 23,340. The average daily turnover of the equity market decreased moderately, while equity fund-raising activity also weakened.

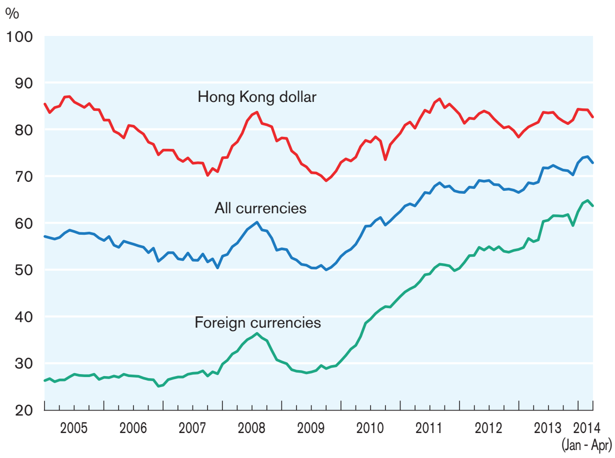
In the property market, overall housing prices have changed little, while the number of residential transactions increased moderately from a monthly average of 3,600 units in the first quarter to an average of around 5,000 units in April and May. Incoming data from real estate agencies showed that housing prices appeared to have picked up more recently. Nevertheless, housing affordability remained stretched in the first quarter, with the price-to-income ratio staying elevated at 14.2, a level just slightly below the 1997 peak, and the income-gearing ratio still hovering around 62.2% and above its long-term average of 50%.[3] Also, property investment has become less attractive amid moderation in rentals, higher stamp duties, and expectation of interest rate hikes. On the whole, risks in the property market remain a concern for Hong Kong's macro-financial stability.

Money supply and domestic credit

Total loan growth was relatively fast in the first two months of 2014 but has moderated noticeably since then. Nevertheless, for the first four months as a whole, the growth rate still reached an annualised 18.4%, slightly higher than the full-year growth of 16.0% in 2013. This was largely underpinned by US dollar loans which were partly associated with a rise in Mainland-related lending.[4] Trade finance and loans for use outside Hong Kong also saw notable growth. Meanwhile, domestic loans excluding trade finance increased at a solid pace, mainly driven by loan demand from the corporate sector. Personal loans also grew somewhat faster, pushing the household indebtedness to a high of 63% of GDP. The Hong Kong dollar and the foreign currency loan-to-deposit

CHART 2

Loan-to-deposit ratio



Source: HKMA.

[2] The underlying inflation rate refers to the CPI inflation rate after netting out the effects of all Government's one-off relief measures.

[3] The price-to-income ratio measures the average price of a typical 50 square-metre flat relative to the median annual income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio compares the amount of mortgage payment for a typical flat of 50 square metres (under a 20-year mortgage scheme with a 70% loan-to-value ratio) with the median income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio is not the same as a borrower's actual debt-servicing ratio, which is subject to a maximum cap by the HKMA prudential measures.

[4] For more details, please refer to the inSight article on "Mainland-related exposures" (15 April 2014), available at http://www.hkma.gov.hk/eng/key-information/insight/20140415.shtml.

ratios stayed high, at 82.7% and 63.8% respectively at the end of April (Chart 2). Against the background of rapid loan growth, the HKMA has reviewed the Stable Funding Requirement (SFR) earlier, now using the end-March 2014 position instead of the end-June 2014 position to determine the SFR applicable to individual banks. The SFR obliges banks with significant loan growth to maintain longer term stable funds to support their lending business. This measure also helps ensure that banks will have sufficient capacity to address potential risks arising from possible significant fund outflows from Hong Kong.

Total deposits showed little change in the first quarter but picked up visibly in April, resulting in a 6.9% annualised growth for this four-month period as a whole. While there was a contraction in US dollar deposits, Hong Kong dollar deposits actually rose faster by an annualised 10.8%. As such, the Hong Kong dollar monetary aggregates recorded strong growth, with the narrow money (HK$M1) and broad money (HK$M3) rising by an annualised 13.3% and 10.8% respectively. Analysed by the asset-side counterparts, growth in the HK$M3 mainly reflected increases in Hong Kong dollar loans as well as mild inflows of funds into the non-bank private sector in Hong Kong. Offshore renminbi business continued to expand solidly, with the outstanding renminbi deposits in Hong Kong rising to RMB959.9 billion at the end of April from RMB860.5 billion at the end of 2013. Remittances for renminbi cross-border settlement also increased further to RMB1,488.8 billion during the first quarter, compared with RMB1,224.3 billion in the fourth quarter of 2013.

The Hong Kong dollar interest rates continued to stay low amid the ongoing accommodative monetary environment in the US. The overnight and three-month HIBOR fixings hovered around 0.06% and 0.38% respectively in the first four months of the year. Meanwhile, the Hong Kong dollar yield curve flattened slightly along with the US dollar yield curve, with the yield of the 10-year Exchange Fund Notes edging down to around 2% more recently. The composite interest rate, which indicates the average cost of funds for retail banks, however increased by a few basis points to 0.45% in May. On the lending side, amid keener competition in the mortgage lending business, the average mortgage interest rate for new loans decreased to 2.06% in April from 2.21% last December.

Short-term outlook

The Hong Kong economy is expected to grow moderately in the short term but downside risks to growth have increased. Domestic demand will likely continue to be supported by steady growth in private consumption and fixed investment. Performance of merchandise exports is expected to improve gradually alongside the recovery of the advanced economies. However, exports of tourism-related services look set to moderate from a high-growth path due to softening in tourist spending. The increased downside risks to growth mainly reflected the uncertain growth prospects of the US and Mainland China, lingering worries about US monetary policy normalisation and heightened geopolitical tensions. Cooling of the property market could also weaken the housing wealth effect on consumption. Increased uncertainty about Hong Kong's growth prospects is also evidenced in the sentiment indicators and private-sector analysts' economic forecasts. The latest Quarterly Business Tendency Survey showed only little improvement in the near-term business prospects of the major sectors, while both the PMI and HKTDC export index stayed slightly below the expansionary/contractionary threshold. The HKMA composite index of leading indicators, which keeps track of the local monetary and financial conditions, housing starts, sentiment indicators and growth prospects, also suggests the economic growth momentum will likely remain tepid in the near term. Meanwhile, private-sector analysts revised down their forecasts for 2014 real GDP growth from 3.5% in March to 3.3% in June and the Government indicates that it is considering revising its range forecast of 3-4% downward .

Inflationary pressure is anticipated to remain contained in the short term given mild imported inflation and slower increases in housing rentals. While the unemployment rate is expected to hover at a low level, mild upward pressures may emerge as a result of slowing retail sales and increased uncertainty about the economic prospects.