REGULAR ARTICLE

Domestic and external environment

by the Research Department

Uneven economic growth and diverging monetary policy paths in the major economies are posing considerable uncertainties to the global economic outlook. In the US, continued solid growth and labour market improvement point to underlying strength in the recovery and shrinking economic and labour market slack. By contrast, risk of deflation in the euro area has prompted the European Central Bank to introduce further monetary easing measures. Similarly in Japan, as the economy contracted and inflation continued to slow, the Bank of Japan unexpectedly expanded the size of the quantitative and qualitative monetary easing programme and the Japanese government postponed its second consumption tax hike. In East Asia, growth momentum has generally moderated, with GDP growth in Mainland China easing in the third quarter on weakened domestic demand amid a downturn in the property market. In Hong Kong, notwithstanding the recent protests, the local banking system and financial markets continued to function normally without disorderly adjustments. Real economic activities picked up in the third quarter, driven by improving external trade performance and stronger private consumption. Nevertheless, weaker business sentiment points to a moderate economic growth path ahead.

External environment

Global economic growth continued to diverge, with recoveries in the US and the UK continuing to show good underlying strength while economic momentum weakening further in Europe and Japan. The US Federal Reserve is set to normalise its monetary policy but the pace remains uncertain. This, together with further monetary easing in Europe and Japan, is set to complicate the outlook for global monetary conditions. In the US, real GDP grew strongly by 3.9% quarter on quarter (annualised) in the third quarter, following the impressive 4.6% in the previous quarter. The solid momentum looked to have carried over into the fourth quarter with employment posting its tenth consecutive month of above-200,000 job gains in November, its longest run since 1995. As such, labour market slack continued to diminish with the unemployment rate falling to 5.8%, edging closer to the Fed's estimated long-run equilibrium rate of 5.2%-5.5%. Similarly in the UK, the recovery continued with real GDP growing at a solid pace of 0.7% quarter on quarter in the third quarter following the strong 0.9% growth in the previous quarter. In contrast, recovery in the euro area remained weak with real GDP growing slowly at 0.2% quarter on quarter in the third quarter, following a weak 0.1% in the second quarter. The ongoing deleveraging process across the region continues to exert strong disinflationary pressure, which has suppressed inflation well below the European Central Bank's (ECB) 2% target for almost two years and heightens the risk of the region falling into deflation. In Japan, the economy fell into recession with real GDP contracting unexpectedly by 0.5% quarter on quarter in the third quarter, after falling by 1.9% in the previous quarter. Meanwhile, inflation also appears to be slowing with the annual inflation rate (excluding tax increase effects) falling to 0.9% in October from the recent peak of 1.5% in April.

Diverging growth across advanced economies means major central banks are now on very different monetary policy paths. In the US, the Fed ended the asset purchase programme at the October Federal Open Market Committee (FOMC) meeting. The run of robust employment growth and faster-than-expected fall in the unemployment rate prompted the Fed to acknowledge "substantial improvement" in the outlook for the labour market and diminishing underutilisation of labour resources in its policy statement. An overwhelming majority of FOMC members now expect the Fed to raise rates in 2015. Similarly in the UK, the much faster-than-expected fall in the unemployment rate means labour market slack has been shrinking and markets now expect the Bank of England (BoE) to start raising its base rate in 2015. In contrast, to support weakening growth and combat mounting disinflationary pressure, the ECB lowered its key policy interest rates and announced two new asset purchase programmes to buy asset-backed securities and covered bonds in the September Governing Council meeting. It remains uncertain if these measures, together with the Targeted Longer-Term Refinancing Operations programme (TLTRO) announced earlier in June, would help the ECB achieve its €1 trillion balance sheet expansion target, particularly after the disappointingly low take-up of the September and December TLTROs. In Japan, with inflation moving away from target, the Bank of Japan (BoJ) unexpectedly expanded the size of the quantitative and qualitative monetary easing programme (QQE) in October by raising its target increase in monetary base from 60-70 trillion yen to 80 trillion yen per year.

On the fiscal side, progress of fiscal consolidation remains uneven across advanced economies. In the US, as the recovery continues to strengthen, fiscal deficit is expected to fall further to 2.6% of GDP in the current fiscal year (FY2015). The improvement in fiscal health means even with the Republicans gaining control of both houses of the Congress after the mid-term election, the risk of further political stand-off on fiscal consolidation issue has subsided. In the euro area, as a result of weak growth, the pace of fiscal consolidation has slowed with major countries, notably France and Italy, missing their consolidation targets. Similarly in Japan, the government delayed its second consumption tax hike by 18 months in the face of rapidly deteriorating economic conditions.

In East Asia[1], growth momentum has moderated in general, as domestic demand softened in many economies while export growth remained modest. In particular, real GDP growth in Mainland China eased to 7.3% year on year in the third quarter from 7.5% in the previous quarter, as domestic demand weakened amid the property market downturn. For the region as a whole, the year-on-year real GDP growth slowed slightly to 6.1% in the third quarter of 2014 from 6.4% in the previous quarter. Inflationary pressure appeared to be easing in the region, driven largely by the decline in global commodity prices. In Mainland China, inflationary pressures remained subdued, with the headline CPI inflation staying low at 1.6% year on year in October. Overall, the average CPI inflation rate in the region decreased to 2.2% in October, compared to an average of 2.8% in the first three quarters of 2014. In response to moderating growth and receding inflationary pressure, most central banks in the region have maintained accommodative monetary policy stance, with the Bank of Korea cutting its policy interest rate by 25 basis points at each of the two meetings in August and October to 2%. In Mainland China, the People's Bank of China cut the benchmark lending and deposit rates for the first time since July 2012 by 40 and 25 basis points respectively. The central bank also pushed ahead with interest rate liberalisation by lifting the ceiling of deposit rates from 10% above the benchmark rates to 20% in November. The Philippines and Indonesia were exceptions in the region. The Central Bank of the Philippines raised its policy interest rate by 50 basis points in two meetings in the third quarter to rein in inflation expectations, while Bank Indonesia also increased its policy interest rate by 25 basis points in an unscheduled meeting in November in order to anchor inflation expectations and to ensure that inflationary pressures remain under control after the

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

subsidised-fuel price hike. Following a period of unusual calm in the middle of the year, financial markets in the region experienced a bout of volatility in September and October reflecting mainly worries about the deteriorating global growth prospects. While the renminbi remained largely stable against the US dollar in recent months, most regional currencies have depreciated against the US dollar since September, and the MSCI Asia (ex-Japan) Index also receded from the multi-year high level in early September. Looking ahead, the uncertainties surrounding the timing and pace of normalisation of monetary policy in the US will continue to dominate the near-term growth prospect of the region. In particular, the significant strengthening of the US dollar, together with expectations of higher US interest rates and weakening regional growth outlook have heightened the risk of capital flow reversal in the region. Meanwhile, the possibility of slower-than-expected growth in Mainland China could also pose adverse impact on the region's growth outlook. The latest consensus forecasts project the region to grow by 6.4% in 2014 and 6.3% in 2015, slightly lower than that in 2013.

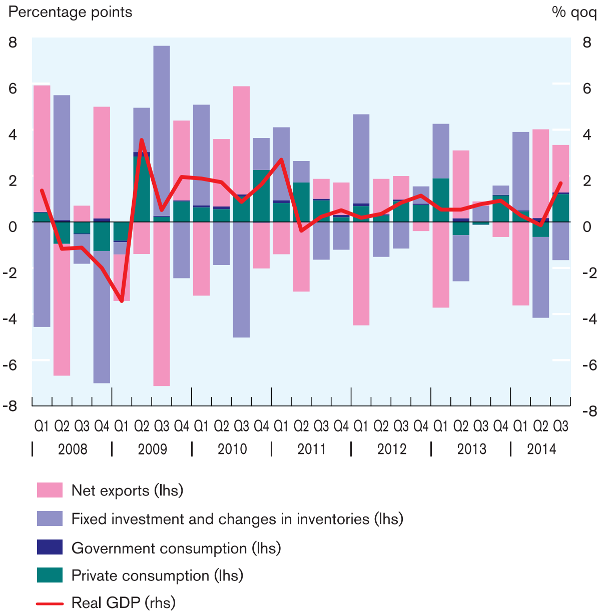
Domestic economy

In **Hong Kong**, economic activities improved in the third quarter, with the seasonally adjusted real GDP bouncing up by 1.7% following a slight decrease of 0.1% in the second quarter (Chart 1). The growth pick-up was partly due to continued improvement in Hong Kong's external trade performance. Exports of goods increased further amid robust regional processing trade flows, while services exports resumed positive growth partly due to vibrant financial market activities. Domestic spending remained a slight drag on GDP growth, with stronger pick-up in private consumption being offset by the continued decline in investment spending. On a year-on-year basis, real GDP growth increased to 2.7% in the third quarter from 1.8% in the second quarter.

Moving into the fourth quarter, there are some signs of moderation in economic activities, with growth in merchandise exports and retail sales slowing and the Purchasing Managers' Index staying below the 50-point threshold. Moreover, the local protests may have posed some drag on certain business sectors such as retail trade, restaurants and transportation services in the affected areas, although other major sectors such as financial services and import/export trade should have been largely unaffected.

CHART 1

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



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

The labour market remained relatively tight, though with some signs of easing recently. While labour force participation has picked up visibly, total employment rose at a slower pace, leading to a slight increase in the unemployment rate to 3.3% in the third quarter from 3.2% in the second quarter and 3.1% in the first quarter. Hiring sentiment, while still positive, has weakened somewhat according to the latest Quarterly Business Tendency Survey and other similar surveys. The median household income increased by a modest 0.6% in real terms from a year ago in the third quarter.

Inflation

Hong Kong's inflationary pressures stayed moderate in the third quarter, reflecting mild growth in food prices, rentals and wages. Imported inflation also softened along with the strengthening of the US dollar and the recent fall in oil prices. Consequently, the underlying inflation rate edged down to an annualised quarter-on-quarter rate of 2.7% in the third quarter, from 2.8% in the second quarter.[2] The year-on-year underlying inflation also moderated gradually to 3.3% in the third quarter from 3.5% in the second quarter.

Asset markets

The local equity market showed some swings in recent months, attributable to a host of global and local macro-financial factors. The Hang Seng Index (HSI) reached a six-year high in early September, supported by better-than-expected earnings results from blue-chip corporates and robust equity fund flows. However, worries about weaker global growth prospects, intensified geopolitical tensions and the local protests sent the HSI visibly down to a low in early October. Later, the HSI recovered some grounds, closing at 23,987 at the end of November. As an important milestone in Mainland China's capital account liberalisation process, the Shanghai-Hong Kong Stock Connect was officially launched on 17 November to allow investors in Hong Kong and on the Mainland to trade and settle shares listed on the other market via the exchange and clearing house in their local market. The average daily turnover of the equity market increased in recent months, particularly after the launch of the Shanghai-Hong Kong Stock Connect. Equity fund-raising and merger and acquisition activities remained vibrant in the third quarter and recently.

The residential property market remained active, supported by the low interest rate environment and a relatively tight housing supply condition. Housing prices in the secondary market increased further by 6.3% in the third quarter after rising by 2.7% in the second quarter, with prices of small and medium sized flats advancing at a relatively faster pace. The Centa-City leading index showed that housing prices remained firm in more recent months. Led by primary market transactions, total transaction volume climbed by 25% from the second quarter to reach a monthly average of 6,654 units. Housing affordability remained stretched, as the price-to-income ratio picked up to 14.8 in the third quarter, a level slightly above its 1997 peak. The income-gearing ratio increased to 65.9%, compared with its long-term average of 50%.[3]

Money supply and domestic credit

Hong Kong's monetary conditions remained broadly accommodative in the third quarter and recent months. Moreover, notwithstanding the local protests, Hong Kong's banking system and financial markets continued to function normally without disorderly adjustments. The overnight and three-month Hong Kong Interbank Offered Rate (HIBOR) fixings stayed low at 0.05% and 0.37% respectively, though with occasional upward pressures driven by seasonal and quarter-end liquidity demands. The Hong Kong dollar yield curve shifted downward and flattened along with their US counterparts. The composite interest rate, which indicates the average cost of funds for retail banks, declined to 0.39% in October from 0.47% in June. On the lending side, the average interest rate for new mortgage loans edged down to 1.95% in October.

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

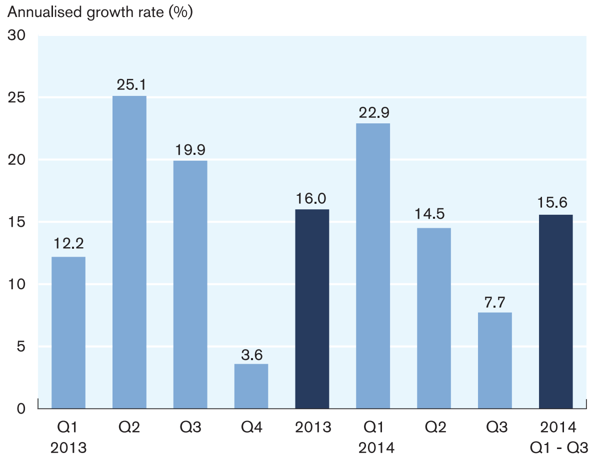
3 The price-to-income ratio measures the average price of a typical 50 square-metre flat relative to the median annual income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio compares the amount of mortgage payment for a typical flat of 50 square 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.

The Hong Kong dollar Monetary Base climbed by 6.7% in the third quarter following the triggering of the strong-side Convertibility Undertaking in July and August, with the HKMA purchasing a total of US$9.7 billion in response to banks' offer. This led to a corresponding increase in the Aggregate Balance by HK$75.3 billion. Still, growth in the Hong Kong dollar broad money supply (HK$M3) decelerated to 1.4% in the third quarter from 5.7% in the second quarter. Analysis by the asset-side counterparts of the HK$M3 reveals that there were considerable drags from a decline in banks' net foreign currency assets in September, signalling net Hong Kong dollar outflows from the non-bank private sector alongside correction in the local stock market. In the third quarter, Hong Kong dollar deposits rose by a moderated 1.5% while foreign currency deposits increased by a robust 4.8%, spearheaded by US dollar deposits. Taken together, total deposits with the banks expanded by a milder 3.2% in the third quarter.

Total loan growth moderated in recent months but remained at a relatively fast pace. The quarterly growth rate slowed to 1.9% (or an annualised 7.7%) in the third quarter, mainly reflecting slowdown in domestic credit (including trade finance) (Chart 2). This brought the total loan growth to a slower 15.6% (annualised) in the year to September, compared with 16.0% in 2013. Within domestic credit, loans to manufacturing and wholesale and retail trade continued to post robust growth, while trade finance and loans to other major business sectors rose at a decelerated pace. As residential mortgage loans advanced slightly faster, household debt as a whole edged up to 64.2% of GDP. With slower growth in loans relative to deposits, the Hong Kong dollar and the foreign currency loan-to-deposit ratios decreased slightly to 81.8% and 64.2% respectively in the third quarter. In November, the HKMA announced some refinements of the Stable Funding Requirements, which among others, change the loan growth threshold and the frequency of review and report submission with effect from January 2015.

CHART 2

Total loan growth



Source: HKMA.

Hong Kong's offshore renminbi business continued to grow at a robust pace. The sum of renminbi deposits and certificates of deposits picked up to RMB1,127.6 billion at the end of September from RMB1,124.9 billion at the end of June. Renminbi trade settlement handled by banks in Hong Kong expanded further to RMB1,609.3 billion in the third quarter from RMB1,437.3 billion in the second quarter. The Shanghai-Hong Kong Stock Connect came into operation on 17 November, and the renminbi daily conversion limit for Hong Kong residents was removed on the same day. To facilitate banks' management of renminbi liquidity, from 10 November, the HKMA offers intraday renminbi funds of up to RMB10 billion to banks participating in renminbi business in Hong Kong. The HKMA also designated 7 banks as Primary Liquidity Providers for the offshore renminbi market in Hong Kong and started to provide a dedicated repo facility to each of them. All these developments will help further strengthen Hong Kong's role as a premier offshore renminbi business centre.

Short-term outlook

While real economic activities improved in the third quarter, overall growth momentum is expected to be moderate in the short term. Softer global growth prospects would weigh on Hong Kong's merchandise export performance, although robust regional trade flows would continue to provide some support. The latest survey results (including the Quarterly Business Tendency Survey for the trading sector and the HKTDC Export Index) actually point to weaker export confidence going forward. While Hong Kong's trade in financial services stands to gain with the implementation of the Shanghai-Hong Kong Stock Connect, headwinds to inbound tourism will likely persist amid a trend of reduced per capita spending of tourists.

As for domestic demand, private consumption is expected to increase steadily on the back of the still-supportive job market conditions. Overall fixed investment would be weighed down by weaker capital spending amid more cautious business sentiment, though ongoing infrastructure projects and private-sector building and construction activities would be a partial offset. Overall, the HKMA composite index of leading indicators suggests growth momentum of the Hong Kong economy will remain moderate in the near term. The Government has revised the 2014 GDP growth forecast to 2.2%, near the lower end of its earlier range forecast of 2-3%. Private sector analysts have also lowered their GDP growth forecasts for 2014 and 2015 to an average of 2.2% and 2.7% respectively.

Inflationary pressure is expected to remain contained amid soft economic growth momentum, modest wage growth, and restrained external price pressures. The Government has adjusted downward its forecast of the underlying inflation rate for 2014 to 3.4%. It is likely that labour market conditions will ease further in the coming months, with the unemployment rate and income growth facing some pressures.