REGULAR ARTICLE

# Domestic and external environment

*by the Research Department*

The recent sovereign bond market sell-offs in advanced economies after an extraordinary period of negative yields highlight the risks of financial market mis-pricing in a policy-driven environment. In the US, markets have pushed back expectations of the first rate hike but risks of earlier and more rapid pace of tightening remain. In the euro area, sovereign quantitative easing by the European Central Bank appears to enjoy some early signs of success but the sustainability of recent economic improvement remains in question given that the deleveraging process and structural reforms have further to run. In Japan, the economy continues to rebound from the recession triggered by the consumption tax hike in April last year but stagnant wage growth remains the key concern. In East Asia, growth momentum remains modest in general, with economic growth in Mainland China softening as weakening property market activities and falling producer prices weigh on capital spending. In Hong Kong, the economy grew slowly in the first quarter amid softer domestic demand and weak export performance. Driven largely by equity-related inflows, the strong-side Convertibility Undertaking was triggered multiple times in April. The property market showed signs of consolidation shortly after the HKMA introduced a fresh round of prudential measures, but market sentiment appears to have improved gradually in the more recent period.

## External environment

Sovereign bond markets in major advanced economies rallied in the early part of 2015, buoyed by market euphoria surrounding the new asset purchase programme by the European Central Bank, continued quantitative easing (QE) by the Bank of Japan and prospects of slower interest rate hikes by the US Federal Reserve (Fed). In the face of continued accommodative monetary policies by major central banks, market participants appeared to have positioned themselves heavily on a seeming one-way bet of strong US dollar, falling euro and surging European sovereign bonds and equities. Some European sovereign bond yields were driven into negative territory while US Treasury yields were also suppressed. The abnormal bond market conditions, however, did not last long before both the US and European sovereign bond markets experienced sharp sell-offs in early May leading to a jump in yields as investors collectively unwound their overdone positions. The latest episode of bond market gyrations highlights the risks of financial market mis-pricing in a policy-driven environment, with changes in bond market structure since the global financial crisis (such as decline in market-making activities and rapid growth of bond Exchange-traded Funds (ETFs)) also likely to have amplified market volatilities.

In the US, lower median interest rate projections by the Fed and the 0.2% quarter on quarter (annualised) contraction in first-quarter real GDP have pushed back market expectations of the first interest rate hike to January 2016[1]. Nevertheless, risks of an earlier and subsequently more rapid pace of monetary tightening remain. In particular, with transitory factors that dragged on first-quarter growth (e.g. the severe winter weather and the West Coast ports labour dispute) likely to stabilise, continued employment growth and cheaper petrol prices are expected to drive robust real consumption growth and lead to a strengthening of the US economy in the remainder of 2015. Meanwhile, consistent with the continued fall in the unemployment rate towards its long-run equilibrium, the Employment Cost Index has shown a notable pickup in private sector wages to 2.8% year-on-year in the first quarter of 2015. Going forward, faster wage growth, together with the persistent slow growth in labour productivity, would drive unit labour cost up from its first-quarter annual growth rate of 1.8%. A notable pickup in unit labour cost could raise concerns over a stronger pass-through of wage growth to price inflation and increase the likelihood of earlier and more rapid US interest rate hikes by the Fed.

In the euro area, sovereign QE has lifted asset prices, boosted economic sentiment and inflation expectations, and helped weaken the euro. Partly as a result, first-quarter real GDP growth picked up slightly to 0.4% quarter on quarter from 0.3% in the prior quarter, raising hope of a long-awaited economic revival. Nevertheless, questions remain over the sustainability of recent economic improvement. In particular, deleveraging in both the public and private sectors as well as structural reforms still have further to run which would continue to restrain growth in the euro area economy. Indeed, experience of the first two rounds of QE in the US suggests they only managed to provide a short-lived boost to the real economy when balance sheet adjustments were still taking place. As such, monetary policy could remain ultra-accommodative in the euro area for quite some time, reinforcing the divergence in monetary policy path from its counterpart across the Atlantic. Similarly in Japan, the economy continues to rebound from the recession triggered by the consumption tax hike in April last year with real GDP growth accelerating to a robust pace of 1% in the first quarter of 2015, faster than the 0.3% in the previous quarter. Nevertheless, Japan's economy still faces many headwinds with stagnant wage growth being the key concern. In the near term, it remains questionable if the expected wage hike in the annual Spring wage negotiation would translate into higher wage growth for the broader economy and help boost private consumption, given that over half of all trade union members involved in the negotiation come from the smaller manufacturing sector and that the negotiated wage hike would come mostly from seniority pay rise rather than base pay rise, with the former likely to have a far smaller boosting effect on consumption. Meanwhile, as potential growth continues to be constrained by an ageing population, labour market reforms would also have to be pushed through if Japan was to achieve a higher sustainable economic growth over the medium to longer term.

In East Asia[2], growth momentum remained modest in general, as external sector continued to grapple with the sluggish global demand while domestic demand growth remained mediocre. Growth is particularly weak for commodity exporting countries in the region amid weak global demand for commodities. In Mainland China, GDP growth slowed to 7.0% year on year in the first quarter as subdued activities in the property market and falling producer prices weighed on capital spending. For the region as a whole, the year-on-year real GDP growth slowed further to 5.9% in the first quarter of 2015 from 6.2% in the previous two quarters. On the price front, the region has seen disinflationary pressure since late 2014, with the average Consumer Price Index (CPI) inflation rate decreasing to 1.2% year on year in the first quarter this year, compared to an average of 2.3% in the

[1] As implied by the Fed funds futures probability of over 50% on 23 June 2015.

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

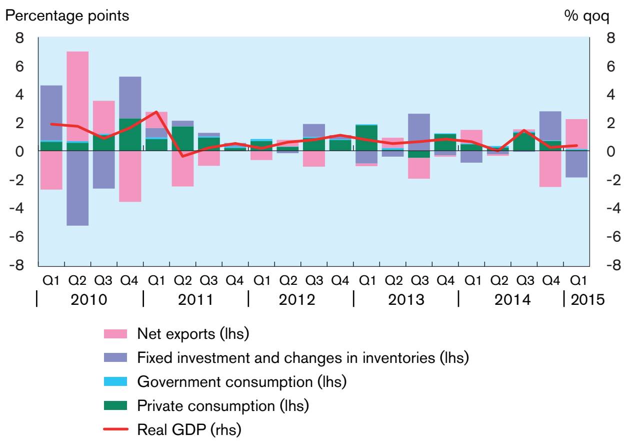
second half of 2014. While the drop in headline inflation was largely due to the decline in global commodity prices, core inflation in some regional economies has also started to ease. The decline in consumer price inflation seems to have stabilised in Mainland China, with CPI inflation standing at 1.2% year on year in May after registering a five-year low of 0.8% in January. In response to the weak growth momentum and low inflation, some regional central banks have eased their monetary policy. For example, central banks in Indonesia, South Korea and Thailand cut their policy interest rates in recent months, while the Monetary Authority of Singapore reduced the slope of the policy band on its exchange rate in January. In Mainland China, the People's Bank of China lowered the reserve requirement ratio for all depository institutions by 100 basis points in April to shore up broad money growth. To keep real borrowing cost stable in the face of softening inflation, the central bank cut benchmark lending and deposit rates by 25 basis points in May, the third rate cut in six months. It also raised the ceiling on deposit rates offered by banks from 1.3 to 1.5 times of the benchmark rates. Meanwhile, financial markets in the region appeared to have stabilised in recent months after facing capital outflow pressure in late 2014 and earlier months this year. In particular, most currencies in the region have strengthened since April from the low level recorded in the first quarter, and the MSCI Asia (ex-Japan) index has also risen in recent months. Looking ahead, uncertainty about the timing and pace of normalisation of monetary policy in the US and risks related to the Greek debt problem remain potential triggers for another bout of market volatility in emerging Asian economies.

## Domestic economy

In Hong Kong, sequential growth momentum remained weak in the first quarter of 2015. The seasonally adjusted real GDP increased by a mild 0.4% quarter on quarter, compared with the 0.2% growth in the fourth quarter of 2014 (Chart 1). Domestic demand moderated amid subdued overall investment activities and lacklustre growth in private consumption. Exports of goods contracted reflecting the still-sluggish global demand conditions, while exports of services grew at a slower pace dragged by weaker inbound tourism. Total imports of goods and services declined quite visibly along with moderating domestic and export-induced demand. As a result, net exports made a positive contribution to GDP growth. On a year-on-year comparison, real GDP growth slowed slightly to 2.1% in the first quarter from 2.4% in the prior quarter.

**CHART 1**

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




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

Incoming data point to continued weak growth momentum in recent months. Business prospects remained somewhat cautious, as the Purchasing Managers' Index (PMI) fell below the 50-point mark in April and May and the latest Quarterly Business Tendency Survey suggested less sanguine prospects. Moreover, both the Chinese University of Hong Kong consumer confidence index and the employment confidence index weakened considerably. The HKMA composite index of leading indicators suggests moderate growth momentum in the period ahead through the third quarter.

Despite soft economic activities, labour market conditions continued to be broadly solid. After staying flat at 3.3% for some time, the seasonally adjusted unemployment rate edged down to 3.2% in April and May. Overall labour demand remained strong, with private-sector job vacancies staying high. However, employment earnings increased at a moderating pace in the lower-skilled segment in recent quarters partly due to the softness in the retail and tourism-related sectors.

## Inflation

Inflationary pressures continued to moderate in Hong Kong, mainly reflecting some easing in domestic cost pressures and a milder increase in import prices. The feed-through of fresh-letting residential rentals to consumer price inflation has moderated recently, while service inflation continued to stay low. Softer international food and commodity prices, easing inflation in the major import sources and to a lesser extent a stronger US dollar against many other currencies have helped contain external cost pressures. The year-on-year underlying consumer price inflation rate eased to 2.6% in May from 3.1% in last December, and the sequential momentum further moderated to an annualised three-month-on-three-month rate of 2.3% in May.[3]

## Asset markets

The local stock market has turned buoyant since early 2015, with sentiments supported by expectation of continued low domestic interest rates in the near term, further monetary easing in the euro area and supportive measures rolled out in Mainland China. More importantly, surging equity demand through the Shanghai-Hong Kong Stock Connect (SHKSC) and renewed equity inflows provided strong support to the local stock market in April and May. The Hang Seng Index hit an eight-year high of 28,443 on 28 April and gained over 15% in the first five months, though the stock market showed signs of consolidation in June. Also, the average daily turnover in the equity market more than doubled to HK$177.7 billion in April and May from HK$86.4 billion in the first quarter. Equity fund-raising activities picked up again in recent months after weak performance in the first quarter.

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

The residential property market showed some signs of consolidation shortly after the HKMA announced the seventh round of prudential measures in late February and early March[4], but market sentiment appears to have improved gradually in the more recent period. On the back of strong primary-market sales and signs of pick-up in secondary-market transactions, transaction volume rose to 5,168 units in May after declining to a monthly average of 4,439 units in March and April from that of 6,220 units in January and February. Housing prices rose by 6.8% cumulatively in the first four months, with a moderating pace in March and April. However, the Centa-City leading index shows tentative signs of renewed upward momentum in recent weeks. Given the latest market developments, housing affordability remained highly stretched, with the housing price-to-income ratio rising to a record high of 15.4 in the first quarter of 2015 and the income-gearing ratio climbing higher to 68.7%.[5] On the other hand, following the latest round of prudential tightening, the average loan-to-value ratio for new mortgages decreased to 52.6% in March and April, and the average debt-servicing ratio declined to 34.8%.

## Money supply and domestic credit

Hong Kong's monetary environment remained broadly accommodative in early 2015. In particular, driven by a surge in equity-related demand and to a lesser extent by ordinary commercial activities such as dividend pay-out and mergers and acquisitions, the strong-side Convertibility Undertaking was triggered multiple times in April. This involved inflows of HK$71.5 billion and has led to a corresponding increase in the Aggregate Balance. Mainly as a result of this, the Hong Kong dollar Monetary Base grew by a cumulative 6.0% in the first four months of 2015. Meanwhile, the Hong Kong dollar broad money (HK$M3) picked up by 8.6%, with the Hong Kong dollar deposits component rising by 9.1%. However, total deposits only increased by 4.3% as foreign currency deposits decreased slightly.

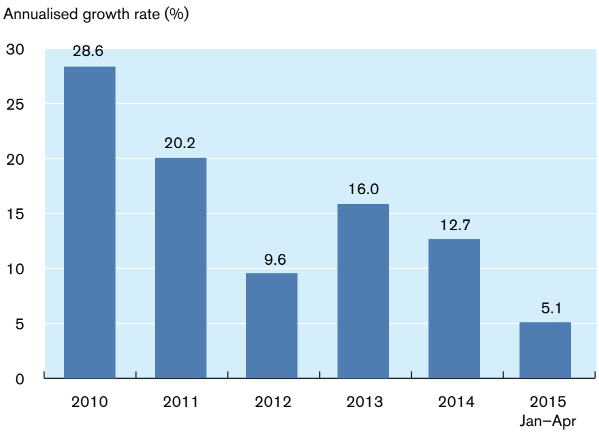
Reflecting the abundant liquidity conditions, Hong Kong dollar interest rates continued to stay at low levels. The overnight and three-month Hong Kong Interbank Offered Rate fixings hovered around 0.06% and 0.39% respectively in the first five months, only with occasional fluctuations due to initial public offerings and equity trading activities. During the same period, the Hong Kong dollar yield curve flattened, with the 10-year Government Bond yield decreasing by 35 basis points to 1.70% at the end of May. As an indicator of the average cost of funds for retail banks, the composite interest rate decreased to 0.31% in May from 0.39% last December. On the lending side, the average interest rate for new mortgage loans remained steadily low at 1.95% amid keen competition among banks for mortgage business.

[4] The HKMA provided further guidance to Authorized Institutions (AIs) on 2 March 2015 to tighten the caps on debt servicing ratio for mortgages that require mortgage co-financing or insurance schemes and to put AIs under more stringent supervisory requirements if they lend to money lenders that engage in the business of mortgage finance.

[5] 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.

Loan growth slowed to an annualised rate of 5.1% in the first four months of 2015 from 12.7% in the full-year of 2014 amid softening in credit demand and the effect of HKMA prudential oversight (Chart 2). Loans for use in Hong Kong grew at a slow pace, within which trade finance saw a visible decline. Yet loans for use outside Hong Kong continued to increase at a relatively fast pace. As for household indebtedness, mortgage lending increased steadily but other personal loans picked up visibly faster, lifting the household debt-to-GDP ratio higher to 65.8% in the first quarter. Banks' funding conditions remained largely stable, with the Hong Kong dollar loan-to-deposit (LTD) ratio declining to 78.1% in April and the foreign currency LTD ratio staying steady at around 63%.

**CHART 2**
**Total loan growth**




Source: HKMA.

As regards Hong Kong's offshore renminbi business, renminbi trade settlement transactions handled by banks in Hong Kong decreased to RMB1,626.1 billion in the first quarter of 2015 from RMB1,722.9 billion in the final quarter of 2014. The total outstanding amount of renminbi deposits and certificates of deposits fell by 8.4% to RMB1,061.2 billion at the end of March in part due to net payment outflows under trade settlement transactions. On renminbi financing activities in the first quarter, renminbi bank lending remained strong, with outstanding renminbi bank loans surging by 19.0% to RMB223.7 billion. Entering into the second quarter, renminbi trade settlement transactions declined in April, while renminbi deposits and certificates of deposits picked up. More recently, a mutual recognition of funds arrangement between Mainland China and Hong Kong by the China Securities Regulatory Commission and the Hong Kong Securities and Futures Commission was announced on 22 May. The arrangement is expected to enrich the types of fund products offered in the two places and facilitate cross-border investment between Mainland China and the rest of the world through Hong Kong.

## Short-term outlook

Growth momentum of the Hong Kong economy is expected to remain moderate in the near term. Trade performance in real terms is not likely to see a sharp turnaround as demand from the euro area and Japan remains subdued, while growth in Mainland China and other emerging market economies is slowing. Moreover, support from a firmer US recovery has been modest. More vibrant cross-border financial activities should bode well for exports of financial services, although inbound tourism is facing headwinds from the slowdown of growth of the Mainland China economy and a stronger US dollar. Domestically, private consumption should be moderately supported by the still-favourable labour market conditions and modest boosts from fiscal stimulus. Large-scale public infrastructure works and private building activities are expected to gather pace later in the year, but less positive business outlook and possible rises in future interest rates will likely weigh on business capital investment. Overall for 2015, private-sector analysts have revised downward their GDP growth forecasts for Hong Kong to an average of 2.4% while the Government maintains its growth projection in the range of 1-3%.

Inflationary pressures are anticipated to remain contained in the rest of the year given benign global inflation, lower energy prices, a stronger US dollar and moderate domestic growth momentum. Taking into account the lower-than-expected inflation rate in the first quarter, the Government has adjusted downward its forecasts of the headline and underlying inflation rates for 2015 to 3.2% and 2.7% respectively.