REGULAR ARTICLE

Domestic and external environment

by the Research Department

Global financial markets tumbled after the UK voted to leave the European Union in the referendum. The ensuing political and economic uncertainties hanging over Europe, together with lingering concerns about global growth, would cast a shadow over the global economic and financial market outlook. In the US, despite the solid underlying strength of the economy and signs of inflationary pressures building up, markets continue to expect only a very slow pace of interest rate hikes by the US Federal Reserve. In the euro area, despite some improvements in growth, the recovery remains fragile. There are now uncertainties about the fallout from Brexit and continued concerns about the scope and effectiveness for further monetary easing. Similarly, in Japan, growth has rebounded but it remains highly uncertain whether the momentum can be sustained particularly given the strength of the currency. Like their counterparts in Europe, there are also concerns about the potency and side effects of negative interest rate policy. In East Asia, growth momentum generally stayed modest, with economic growth in Mainland China easing slightly on weak domestic and external demand in the first quarter of 2016. In Hong Kong, economic performance deteriorated visibly in the first quarter, dragged down by weaker domestic demand and sluggish export performance. Alongside the subpar economic conditions, the unemployment rate has edged up for the first time since July last year. The residential property market has shown some signs of stabilisation in recent months. Credit demand stayed sluggish amid the domestic economic slowdown and decline in cross-border funding activities.

External environment

Global financial markets tumbled after the UK voted to leave the European Union in the referendum. Europe is now set to face a period of heightened political and economic uncertainties. This, at a time of still-modest recovery in advanced economies and continued slowdown in emerging markets, would likely continue to cast a shadow over the global economic and financial market outlook. In the US, despite a sharp quarter-on-quarter (annualised) slowdown in real GDP growth to 0.8% in the first quarter of 2016, down from 1.4% in the previous quarter, as well as the recent release of weaker than expected job growth figures (averaged +81,000 per month in April and May), the underlying strength of the economy appears to remain solid with real consumption growth so far rebounding strongly in the second quarter. As a result of shrinking economic and labour market slack, annual growth in average hourly earnings remained close to a six-year high of 2.5% with core Consumer Price Index (CPI) inflation (excluding food and energy) trending higher to 2.2% in May. Similarly, in the UK, despite moderating growth momentum with real GDP growth slowing to 0.4% quarter on quarter in the first quarter, down from 0.6% in the previous quarter, the labour market continued to improve with the unemployment rate dropping further to a near 11-year low of 5.0% in the three months to April. Nevertheless, the huge political and economic uncertainties are now set to cloud the outlook of the UK economy. In the euro area, while growth picked up with real GDP advancing by a solid 0.6% quarter on quarter in the first quarter, up from 0.4% in the previous quarter, the recovery remains fragile amid subdued wage growth, continued debt overhang and fading support from the previous fall in commodity prices and depreciation of the euro. There are also uncertainties about the fallout from Brexit. The unemployment rate edged lower but remained high at 10.2% in April. As a result of the still-sizeable economic slack, core CPI inflation stayed subdued at 0.8% in May. Similarly, in Japan, real GDP growth rebounded to 0.5% quarter on quarter in the first quarter, up from the 0.4% contraction in the previous quarter, mainly driven by the strong rebound in private consumption. Nevertheless, with the outcome of pay adjustment in the annual spring wage negotiation expected to be modest, together with the recent strengthening of the yen, it remains highly uncertain if the latest improvement can be sustained. Inflation, as measured by the "new-core" inflation (excluding fresh food and energy), remained subdued at 0.9% in April, down from the recent peak of 1.3% in December 2015.

As prospects for growth and inflation are brighter in the US but remain more subdued in both the euro area and Japan, the divergence in monetary policy paths of major central banks is still expected to continue. In the US, the Federal Reserve (Fed) kept its monetary policy unchanged in the June FOMC meeting. Meanwhile, despite recent signs of inflationary pressure building up, driven by strengthening domestic demand and fading global and external headwinds, markets continue to expect only a very slow pace of US interest rate hikes. Indeed, the Federal funds futures now imply market expectations of the Federal funds rate to reach 0.4% by end-2016 and 0.5% by end-2017. These remain well below the Fed's latest median projections, which were revised downward in June leaving markets prone to both inflation and interest rate surprises in the US. In the euro area, amid weak growth and subdued inflation, the European Central Bank (ECB) announced a larger and more comprehensive easing package than expected by markets at the March policy meeting. This includes new rounds of cheaper targeted long term refinancing operations (TLTROs), expansion of the asset purchase programme to €80 billion (including non-bank investment grade corporate bonds), and a further reduction of the deposit facility rate to -0.4%. Nevertheless, there are lingering concerns about the scope and effectiveness of further monetary easing given the ECB stressing that the room for further negative rate cut is limited. Similarly, in Japan, the Bank of Japan (BoJ) introduced negative interest rate policy at the January policy meeting. While the effects on stimulating growth and inflation are yet to be seen, markets have so far been critical of its potential side-effects, particularly on bank profitability and the pass-through to lower retail deposit rates and higher lending rates. The extent of these side effects would also likely pose a lower bound for the negative interest rate policy.

On the fiscal side, progress on fiscal consolidation appears to have stalled across major advanced economies. In the US, despite the continued recovery, fiscal deficit is projected by the Congressional Budget Office to rise to 2.9% of GDP in the current fiscal year (FY2016), up from 2.5% in the previous fiscal year. The projected increase is partly due to federal spending, particularly on social security, Medicare and interest payments on the federal debt outpacing growth in revenue. In Europe, while the headline government budget deficit for the euro area continued to decline to 2.1% of GDP in 2015 (from 2.6% in 2014), the appetite for fiscal austerity appears to be waning. According to the European Commission Spring Forecast, some member states, such as Portugal and Spain, are set to miss their budget deficit targets for 2016 and the structural budget deficit for the euro area is projected to deteriorate to 1.3% in 2016 and 1.4% in 2017 (after having remained unchanged at 1.0% in 2015). In Japan, the approved 778 billion yen of supplementary budget for funding reconstruction in the affected area hit by the Kumamoto Earthquake, as well as the postponement of consumption tax hike from April 2017 to October 2019, will add to the fiscal deficit of the Japanese government.

In East Asia[1], growth momentum remained modest, weighed down by falling exports and softer domestic demand amid still-tight financial conditions in many regional economies. The prolonged weakness of commodity prices has also continued to pose a challenge to commodity exporters in the region. In Mainland China, real GDP growth continued to ease slightly to 6.7% year on year in the first quarter of 2016, with accelerated infrastructure spending partly offsetting the negative impact from weak external and domestic demand. For the region as a whole, real GDP expanded by 5.6% year on year in the first quarter of 2016, unchanged from the second half of 2015. On the price front, inflationary pressures remain benign across the region, with headline CPI inflation rates hovering at low or even slightly negative levels in several regional economies, reflecting the combination of soft global commodity prices and moderated domestic growth momentum. In Mainland China, consumer price inflation remained moderate in the first quarter despite picking up slightly from the previous quarter on higher food prices, with CPI inflation rising to 2.2% year on year in the first quarter of 2016 from 1.5% in the fourth quarter of 2015. The average CPI inflation rate in the region also stayed subdued, at 1.6% year on year in the first quarter compared to 1.3% in the second half of 2015. Facing downside risks to growth, a number of regional central banks have eased monetary policies. For example, the central banks of Taiwan and Korea cut their policy interest rates in March and June respectively, while Indonesia's central bank has also lowered its policy rate four times in the first half of this year. Meanwhile, the Monetary Authority of Singapore set the rate of appreciation of the exchange rate policy band at zero percent in April, removing the gradual appreciation path of the band that was previously in place. In Mainland China, the central bank decided to extend its targeted liquidity support for three policy banks, which had played a major role in financing infrastructure projects, through Pledged Supplementary Lending every month starting from May.[2] Meanwhile, regional financial markets have experienced significant fluctuations in recent months. Having experienced capital outflow pressures in January, regional financial markets stabilised in March and April on market expectations of a more gradual pace of US monetary policy tightening and generally supportive economic data in the US and Mainland China. In particular, regional currencies have mostly recovered since mid-February from their troughs in January, while the MSCI Asia (ex-Japan) index has also recouped most of its earlier losses incurred in the January sell-offs. Nonetheless, regional financial markets experienced renewed volatilities in May and early June. Looking ahead, uncertainty about the timing and pace of normalisation of monetary policy in the US will likely remain a risk to financial stability in the region.

Domestic economy

In Hong Kong, economic performance deteriorated in the first quarter of 2016. The seasonally adjusted real GDP contracted by 0.4% quarter on quarter, after growing by a meagre 0.2% in the final quarter of 2015 (Table 1). Domestic demand was the main drag on real GDP in the first quarter (Chart 1) with private consumption declining further amid decreases in local asset prices and overall investment activities falling markedly amid weak business sentiment and delay in funding approvals of public infrastructure projects. Externally, exports of services continued to shrink alongside weaker inbound tourism, while imports of services recorded slower growth. Exports of goods also contracted amid sluggish global demand but, with imports of goods declining at a faster rate, net exports of goods made a positive contribution to real GDP growth. Compared to a year ago, real GDP grew by just 0.8% in the first quarter, down from 1.9% in the previous quarter.

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

[2] The amount of Pledged Supplementary Lending granted each month would depend on the size of infrastructure loans made by these policy banks in the previous month.

TABLE 1

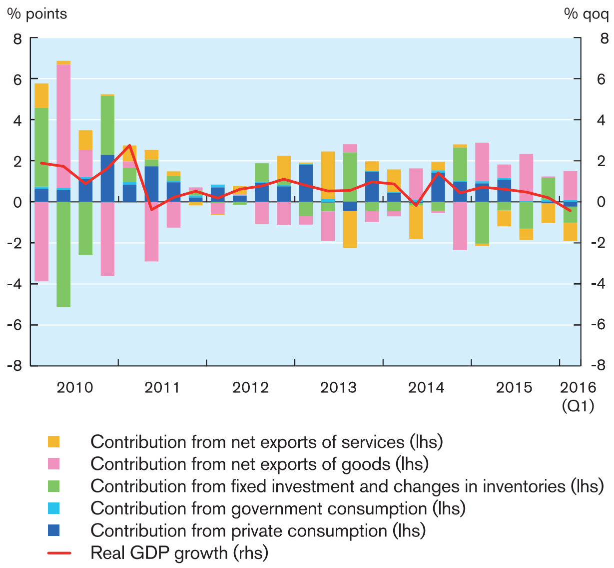
Real GDP by components

	2014	2015	2015 Q4	2016 Q1	2015 Q4	2016 Q1
	change (%)		year-on-year change (%)		Seasonally adjusted quarter-on-quarter change (%)	
Real GDP	2.7	2.4	1.9	0.8	0.2	-0.4
Private consumption	3.3	4.7	2.7	1.1	-0.1	-0.4
Government consumption	3.0	3.4	3.3	3.2	1.0	0.9
Gross domestic fixed capital formation	-0.1	-2.0	-9.4	-10.1	n.a.	n.a.
Buildings and construction	9.3	2.9	-0.9	-0.8	n.a.	n.a.
Machinery and equipment	-8.6	-5.8	-12.9	-11.9	n.a.	n.a.
Exports: Goods	0.8	-1.9	-0.5	-3.6	2.3	-3.9
Exports: Services	1.1	-0.2	-2.7	-4.9	-1.4	-1.8
Imports: Goods	0.9	-2.7	-2.8	-5.4	2.0	-4.2
Imports: Services	1.8	5.7	5.4	3.8	1.4	0.3

Source: Census and Statistics Department (C&SD).

CHART 1

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



Sources: C&SD and HKMA staff estimates.

Incoming data point to continued weak economic momentum. On a seasonally adjusted three-month-on-three-month basis, merchandise exports fell further in April, while retail sales volume continued to contract amid waning domestic demand and inbound tourism. The Purchasing Managers' Index (PMI) and the latest Quarterly Business Tendency Survey indicate that the business sector is still pessimistic about the near-term prospects, while the Chinese University of Hong Kong survey suggests consumer confidence has weakened further. Our in-house composite index of leading indicators points to sluggish economic momentum in the period ahead through the third quarter.

Overall labour market conditions eased along with the weaker economic momentum. As total employment grew at a slower pace than the labour force, the seasonally adjusted unemployment rate increased slightly to 3.4% in March - May after staying at 3.3% or below for more than two years. Sectoral breakdown reveals that labour demand has deteriorated in the retail, accommodation and food services sector and the construction sector, while it remains largely stable in other business sectors.

Inflation

Inflationary pressure remained contained in the first five months of 2016. The year-on-year underlying consumer price inflation increased to 2.8% in the first quarter from 2.3% in the fourth quarter of 2015[3], mainly due to the rise in food prices amid the unusually cold weather. As food price inflation moderated, the underlying consumer price inflation dropped to 2.2% in May. That said, import price inflation remained generally muted along with benign global inflation. Domestic cost pressures also remained contained amid weak retail sector performance and slow economic growth momentum, while housing rental inflation had been moderating along with declining fresh lease rentals.

Asset markets

Along with heightened global financial market volatility and general weakness across Asian currencies and commodity prices, the Hang Seng Index (HSI) dropped by 16.4% from end-2015 to a three-year low of 18,320 in February. With market sentiment subsequently stabilising, along with expectations of a slower pace of US interest rate hikes and easing concern over hard landing risks of the Mainland economy, the HSI increased by 8.9% between end-February and May. Market was volatile in June amid concerns about Brexit. Meanwhile, the average daily turnover in the equity market declined to HK$68.6 billion in the first five months, compared with HK$105.6 billion in 2015. Equity fund-raising activities have also moderated in recent months after the robust performance of late last year.

The residential property market has shown signs of stabilisation in recent months after further softening in the first two months of 2016. The average monthly transaction volume fell to a record low of 1,926 units in January-February amid weak property market sentiment and volatile financial markets. As conditions in the secondary market improved and new launches in the primary market picked up after the Lunar New Year holidays, the monthly transaction volume increased to 3,816 units on average between March and May. As indicated by the Centa-City leading index, housing prices in the secondary market have also been moving sideways since mid-March, after declining by 13.2% from their peak in September last year. Nevertheless, housing affordability remained stretched, with the housing price-to-income ratio and the income-gearing ratio remaining high at 14.7 and 65.5% respectively in the first quarter. The average loan-to-value ratio and debt-servicing ratio for new mortgages stayed low at 52.3% and 33.9% respectively in April.

Money supply and domestic credit

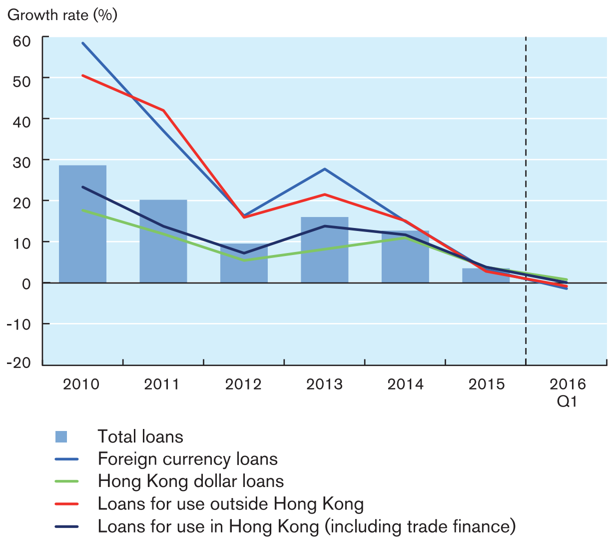
Despite volatile financial market conditions and the US interest rate lift-off, the domestic money and foreign exchange market continued to function normally, with the domestic monetary environment remaining accommodative. The Hong Kong dollar Monetary Base remained sizeable, increasing slightly by 0.6% in the first four months of 2016. The Hong Kong dollar broad money (HK$M3) also picked up by 1.1% in the first four months of 2016, with Hong Kong dollar deposits growing by 1.3%. Meanwhile, foreign currency deposits rose strongly by 3.5%, largely underpinned by the strong expansion in US dollar deposits.

The Hong Kong dollar interest rates continued to stay at relatively low levels. After experiencing some upward pressures in January, the three-month Hong Kong dollar interbank interest rate edged down gradually on improved market sentiment, closing at a low level of 0.55% at the end of April. The overnight Hong Kong dollar interbank interest rate also stayed low at around 0.05% during the first four months of 2016, only seeing small fluctuations towards the end of the first quarter due to banks' funding demand. Meanwhile, the Hong Kong dollar yield curve flattened, with the yield of the 10-year Hong Kong Government Bond decreasing by 34 basis points to 1.32% at the end of April. At the retail level, the composite interest rate, which measures the average Hong Kong dollar funding cost of retail banks, remained steady at 0.26% at the end of April. Amid keen competition for mortgage lending business, the average mortgage interest rate for new loans continued to stay low at around 2%.

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

Credit demand remained weak amid the domestic economic slowdown and contraction in cross-border funding activities following the renminbi depreciation. Total loans decreased slightly by 0.2% during the first quarter of 2016 (Chart 2), marking the third consecutive quarter of decline. Loans for use in Hong Kong grew by a modest 0.1% within which, trade finance continued to decline amid sluggish trade flows, while loans to wholesale and retail trade contracted at a sharper pace along with the lacklustre retail sales performance. Growth of residential mortgage loans and personal loans also slowed, reducing the household debt-to-GDP ratio to 66.0% in the first quarter. With Mainland firms continuing to cut back their foreign currency borrowings, loans for use outside Hong Kong declined further by 0.8%, while foreign currency loans fell by 1.4% driven by the contraction of US dollar loans. Reflecting the relative movements of loans and deposits, the Hong Kong dollar and the foreign currency loan-to-deposit ratios dropped to 78.2% and 59.4%, respectively, in March. Moving into the second quarter, total loans increased slightly by 0.3% from a month earlier in April along with improved market sentiment.

CHART 2
Loan growth



Source: HKMA.

Hong Kong's offshore renminbi business continued to consolidate amid changes in market expectation of the renminbi exchange rate movements. The renminbi liquidity pool contracted further in the first four months of 2016, with the total outstanding amount of renminbi deposits and certificates of deposits declining by 17.8% from the end of 2015 to RMB830.3 billion at the end of April. Meanwhile, the outstanding amount of renminbi bank loans decreased by 5.2% to RMB282.0 billion at the end of April. Renminbi trade settlement transactions handled by banks in Hong Kong declined by 30.5% year on year to RMB1,130.6 billion in the first quarter. The daily average turnover of Hong Kong's renminbi Real Time Gross Settlement (RTGS) system also dropped to RMB776.5 billion in April from RMB962.7 billion in December 2015.

Short-term outlook

Hong Kong's economic momentum is expected to remain sluggish in the near term. Private consumption may remain subdued owing to local asset price adjustments and potential headwinds facing the labour market. While private building and construction activities may hold up in light of the increase in housing units under construction, private capital expenditure may continue to remain subdued in the face of an uncertain economic environment. On the external front, exports of goods and services are likely to remain soft due to subpar global economic and trade growth and a downturn in inbound tourism. For 2016 as a whole, the Government forecasts real GDP growth to be in the range of 1-2%, while private-sector analysts project the economy to grow by 1.3% on average.

Risks to Hong Kong's economic outlook remain tilted to the downside. In particular, any adverse development in US interest rate hikes, Brexit, and global economic prospects may lead to renewed financial market turbulence and capital flow reversals, resulting in negative spillovers to the domestic real economy through trade and financial channels. These, together with the resultant dampening of market sentiments, could trigger more significant correction in the local housing market and have further repercussions on the domestic economy. That said, the introduction of counter-cyclical macro-prudential measures and other supervisory measures over the past few years have significantly enhanced the resilience of Hong Kong's banking system.