

Output growth in the OECD economies is improving. The US economy has entered its third year of expansion, while Germany, and to a lesser extent Japan, now appear in recovery.

In those economies where the recovery is furthest advanced, central banks have begun to tighten monetary policy. Major financial markets have generally reacted negatively to the reversal of short-term interest rates. Dampened by the deterioration in the US current account and US-Japan trade disputes, the US dollar has weakened significantly against other leading currencies.

In China, despite some slowing in activity, higher food prices have pushed up inflation. The external value of the RMB has stabilised, assisted by an improving trade balance.

OECD Economies

Signs of recovery

Aided by past accommodative economic policies, the OECD economies as a whole have been performing more strongly in 1994 than in the previous three years. The economies of North America, Australia and UK, that entered the recession earlier, have also been the first to expand, while continental Europe is now clearly in recovery and positive signs are emerging in Japan (Chart 1).

The US economy has now been growing for 14 quarters and real GDP is over 10% above its trough in the March quarter of 1991. Real GDP grew by 0.8% in the September quarter of 1994, following 1% in the June quarter, but there were some indications that growth may be moderating. A sharp rise in inventories contributed almost half of the growth in the two quarters and it is unlikely that firms will wish stocks to continue to increase at this rate.

Other indicators suggest that any slowing is only moderate. Sectors such as housing and auto sales, usually the most sensitive to interest rates, have remained strong despite the rate hikes. Over the first three quarters of 1994, more than 2 mn jobs have been added to the country's payrolls, bringing the unemployment rate down from 6.7% in January to 5.9% in September.

The improvement in employment has underpinned higher consumer confidence which in turn has bolstered consumer spending (Chart 2).

The desire to expand capacity has encouraged business investment, as indicated by the surge in non-defense capital orders. In the external sector, faster growth in OECD nations and the depreciation of the US dollar have started to lift US export growth.

The recovery has been similarly consolidated in Canada and Australia. Real GDP is expanding at annual rates of around 4% and unemployment is decreasing in both countries.

The UK, the first major European economy to recover, has been expanding strongly. Real GDP grew about 4% over the year to the June quarter, due to strong gains in exports, inventory building and business investment. Preliminary estimates for the September quarter suggest a slight slowing.

In Germany, the business climate has continued to improve from the trough of the March quarter of 1993 (Chart 3). Although high unemployment has hindered the rebound of domestic sales and consumption, an easier monetary stance and strong export growth have been quite effective in reviving the German economy. Housing investment has particularly benefited from the declining interest rates, especially as population movements from the East to the West have caused a chronic shortage of housing there.

The strong German export performance, despite the appreciation of the D-mark against the US dollar, can be explained by the importance in German exports of capital goods, for which the demand has been strong. In addition, as Japan is the

major competitor to Germany in supplying capital goods, the strong yen has made German products more competitive.

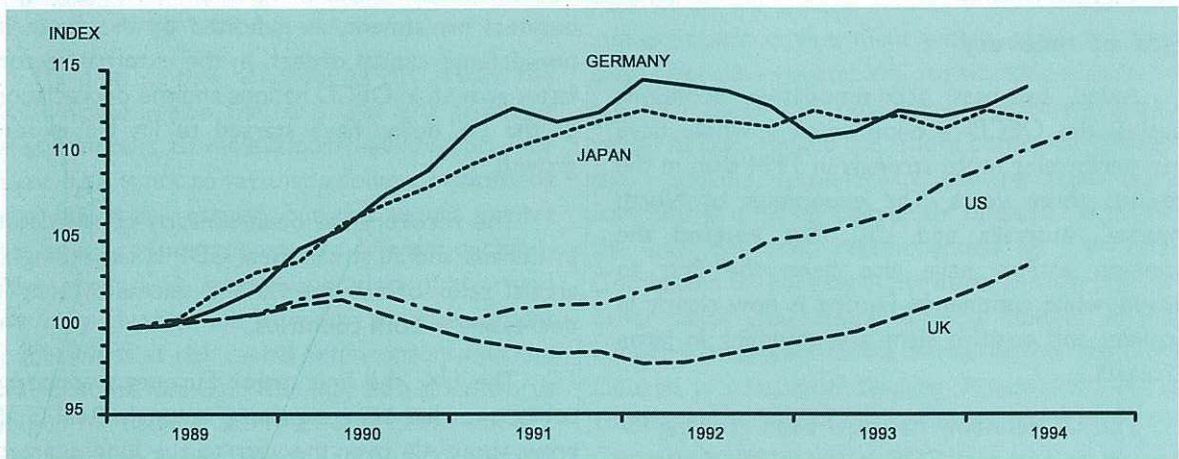
Recovery is also underway in France and Italy. In both countries real GDP in the June quarter was around 2% higher than in the corresponding period last year and investment is picking up.

Unemployment rates in Europe have been slow in adjusting to the rebound in economic activity. Continued uncertainty over employment

prospects has in turn limited the growth of consumption, thereby moderating the pace of economic recovery in those countries.

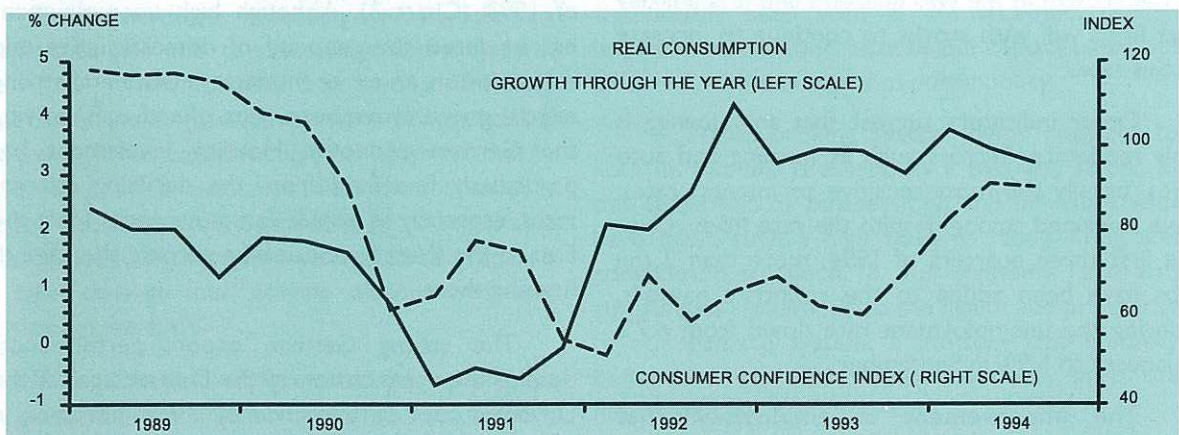
Another factor that may slow the European recovery in the short term is the fiscal tightening announced in recent European budgets. Current fiscal deficits in most European nations are well in excess of the targets set in the Maastricht treaty as a precondition for monetary union. Fiscal tightening is likely to be particularly rigorous in Germany, Italy and Sweden.

Chart 1
Real GDP (March 89 = 100)



Source: DATASTREAM

Chart 2
US Consumer Confidence and Real Consumption



Source: DATASTREAM

Japan remains the slowest growing of major industrialised nations. Real GDP fell by 0.4% in the June quarter after an unexpected 1% rise in the March quarter. Low interest rates and re-structuring have helped enterprises to repair gradually their balance sheets, but the heavy debt burden has continued to restrict corporate activity. However, there are positive signs emerging, notwithstanding the strong yen and the delay in passing the stimulative 1994 fiscal budget. The August 1994 Tankan business survey showed a clear, albeit modest, improvement in business sentiment (Chart 4).

Industrial production has started to rebound after falling for more than two years. The housing sector has been buoyant, reflecting low interest rates, reduced real-estate prices and government stimulus packages. This has in turn boosted some consumer expenditure.

The appreciation of the yen has started to be reflected in the balance of payments, hitherto dominated by cyclical influences. Export volumes have not followed the rise in external demand while import volumes have started to grow despite sluggish domestic demand. Despite some rise in the terms of trade, these volume movements have been associated with a reduction in the trade surplus. Valuation effects mask this when the surplus is calculated in US dollar terms (Chart 5).

Elsewhere in the world, while countries such as Poland and the Czech Republic are now growing

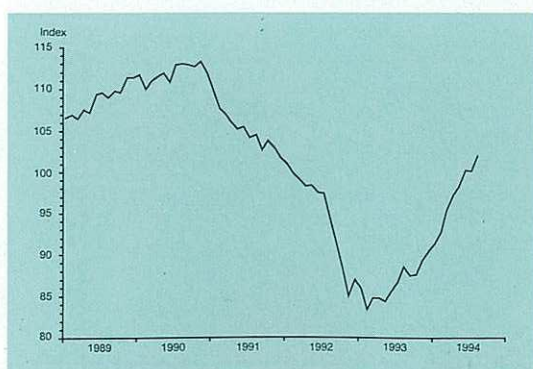
strongly, much of Eastern Europe remains weak with the Russian and Ukrainian economies continuing to contract. More positively, the Latin American countries are experiencing reasonable growth and the East Asian economies remain strong. Overall the IMF expects the developing economies to grow by 5.6% in 1994.

Prices

So far, the economic recovery in the OECD countries has not exerted any significant impact on current inflation rates (Chart 6). Thanks to strong growth in productivity and relatively mild increases in compensation, unit labour costs in the US have registered only modest growth despite an unemployment rate now down to what in the past has been associated with accelerating inflation. As labour costs account for two-thirds of total output, this has made an important contribution to containing inflationary pressure. The increasing global "outsourcing" of US producers has also provided a safety valve when capacity is under short-term pressure.

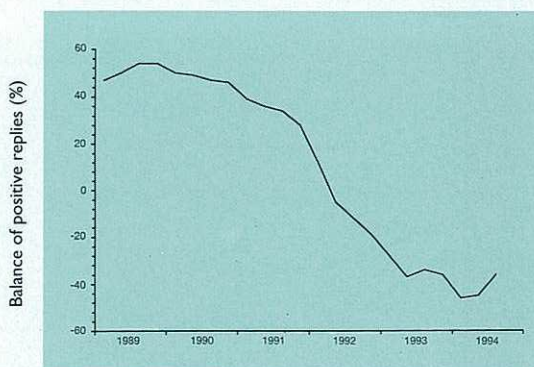
However, in marked contrast to the other G7 economies, output in the US is near capacity. With most estimates of potential output growth in the US around 2-3%, inflationary pressures are likely to emerge if growth does not moderate soon. Capacity utilisation (the ratio of the industrial production index to plant and equipment capacity) was 84.6 in September, a level widely regarded as close to effective full use of capacity.

Chart 3
German Business Sentiment



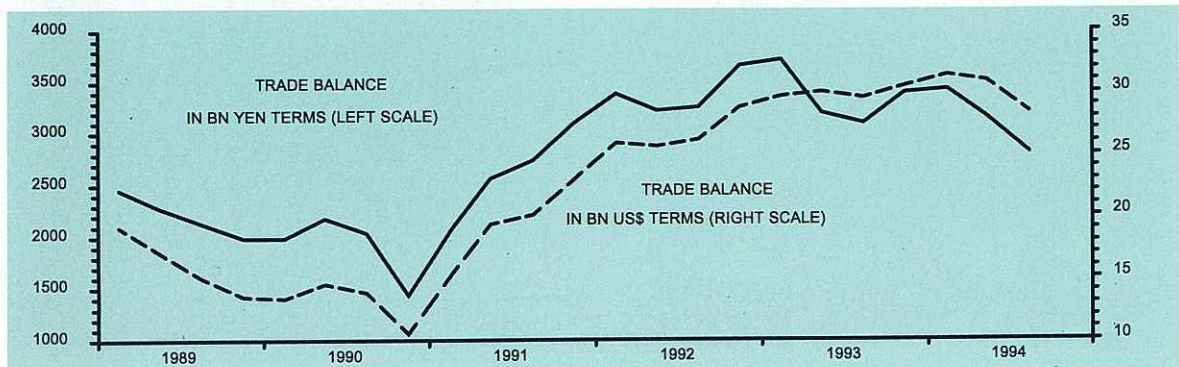
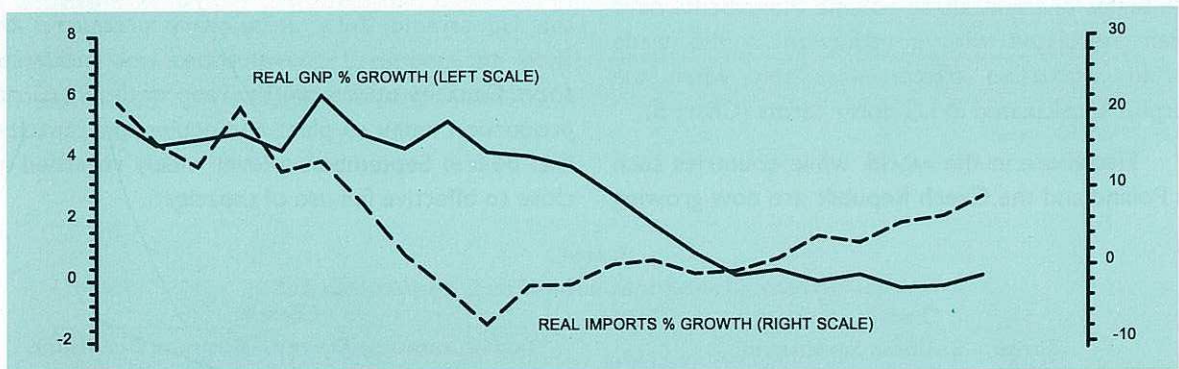
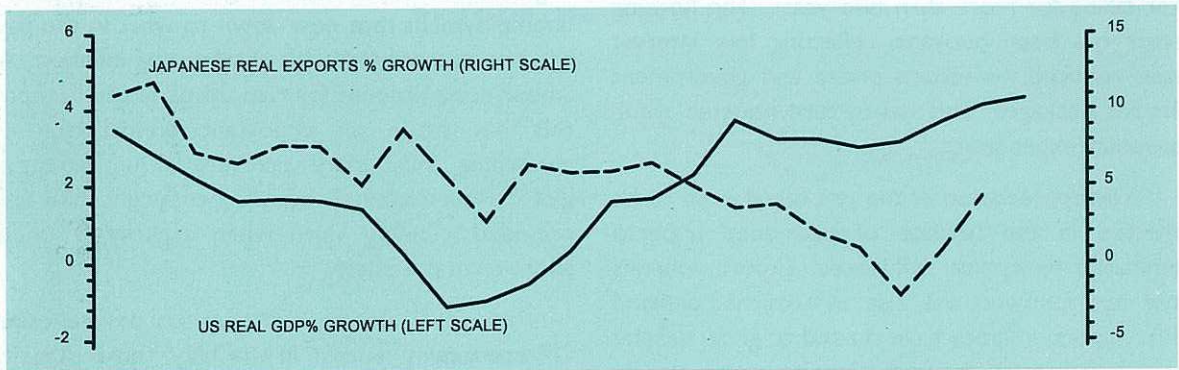
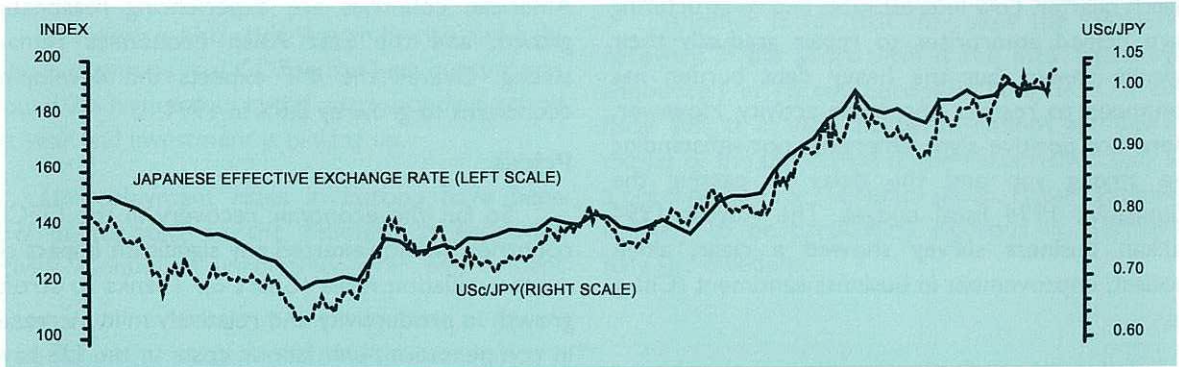
Source: DATASTREAM

Chart 4
Tankan Business Survey – Business Conditions



Source: DATASTREAM

Chart 5
Japanese Balance of Payments



Source: DATASTREAM

Inflation in Europe has remained subdued due to ample spare capacity. German inflation has continued to fall, reflecting the mild wage increases accepted by the trade unions early in the year and the strong effective exchange rate. However, given a prospective rise in economic activity and the upsurge in commodity prices, there have been some inflation fears across Europe. By contrast in Japan, the sluggish economy and the strong yen have seen consumer prices fall slightly over the past year. Until there is a solid pickup in domestic demand, inflation will not be a concern in Japan.

Overall, the IMF expects inflation in the industrial countries to be 2.4% in 1994, rising slightly to 2.6% in 1995. Inflation rates are somewhat higher in the Asian economies but mostly in single-digit levels. Inflation continues to be much higher in many former communist countries.

Prices of major commodities started to rise at the beginning of this year. For the first eight months, the Non-fuel Commodity Price Index, compiled by the IMF, rose about 10% compared with the same period last year in line with a gradual pickup in economic activity in the industrialised world. In the September quarter, gold prices remained rather stable, with an average gain of about 1%. Meanwhile, supply control in oil-exporting countries has further supported petroleum prices, which registered an average increase of about 5%.

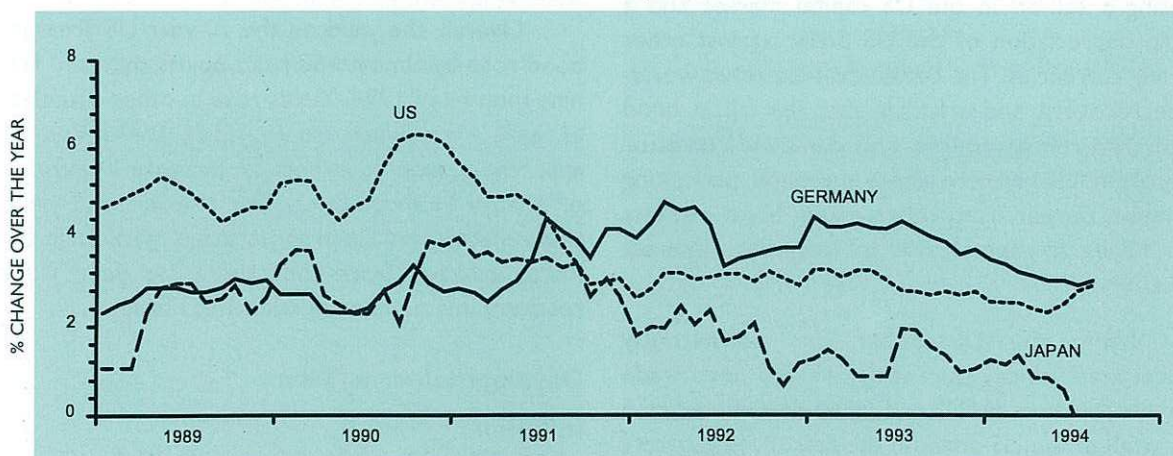
Monetary Policy

Concerns about potential inflation have led the US to remove the stimulus from low real interest rates. Starting on 4 February 1994, the US Federal Open Market Committee has raised the Fed funds target rate five times by a total of 175 basis points to 4.75%. The discount rate has also been increased by 100 basis points to 4% over the period.

Whilst the US and some European countries have already started tightening their monetary policies, Germany and Japan have kept their monetary stance largely unchanged.

Following three rounds of interest rate cuts in the first five months of 1994, the German Lombard rate and discount rate are now at their lowest levels, 6.0% and 4.5% respectively, in five years. The growth of M3, while falling, has continued to exceed the official target range of 4.0-6.0%. However, the fast growth of monetary aggregates is attributable to portfolio shifts rather than a pick-up in nominal expenditures. In particular, tax reforms that closed loopholes for offshore funds have distorted the money supply figures. In its August 1994 report, the Bundesbank said that its recent freeze on interest rates was intended to boost confidence in financial markets, with a view to attracting funds into the longer end of the bond

Chart 6
Consumer Prices



Source: DATASTREAM

Table I
Financial Markets Performance

Equity Markets	End-Dec 93	End-Mar 94	End-June 94	End-Sept 94
US(DJ)	3,754	3,636	3,625	3,843
UK (FTSE 30)	2,560	2,439	2,277	2,350
Japan (Nikkei)	17,417	19,112	20,644	19,564
Germany (DAX)	2,267	2,133	2,025	2,012
Bond Market (10 Year Bond Yields)				
US	5.79	6.76	7.33	7.61
UK	6.10	7.51	8.64	8.81
Japan	3.18	3.97	4.28	4.50
Germany	5.54	6.36	6.92	7.57

market (which will also have the effect of bringing M3 down closer to the target levels).

In Japan, the sluggish job market, dis-inflation and the strong yen have meant there is no pressure to raise rates. Since September 1993, the Bank of Japan has left its official discount rate at 1.75%, although sliding inflation has caused a rise in real interest rates.

Bond Markets and Exchange Rates

Major financial markets have undergone rapid adjustments in 1994. The appetite of international investors for US dollar-denominated assets lessened, causing a sell-off in the US capital market and a sharp depreciation of the US dollar against other leading currencies. The better-than-expected worldwide recovery, and a feeling that the fall in bond yields had run its course, also dampened investor interest in fixed income assets in general, prompting a similar retreat from other major bond markets and hence a general rise in long-term interest rates.

While the US dollar has consistently depreciated since the early 1990s, the trade dispute between the US and Japan contributed to a sharp fall of the US dollar in the first three quarters of 1994. The breakdown of US-Japan trade negotiations in mid-February 1994 intensified market

speculation that the US would like a stronger yen to correct the growing trade imbalance. Although talks resumed in May, lack of substantial progress continued to add pressure to the US dollar until a partial agreement was reached at the end of September.

Concerns about US inflation, and a deteriorating current account, led international investors to unload their long positions in US financial assets. This trend has been exacerbated by the cut-loss selling of highly leveraged so-called 'hedge funds'. The loss in confidence in US financial markets has also spread to other major financial markets around the world.

Overall, the yield on the 10-year US Treasury bond rose by almost 180 basis points over the first nine months of 1994. Yields rose in other countries as well, even when, as in Japan, there was no apparent reason to expect an increase in inflation or change in short rates. The rise in bond yields was reflected in falls in most share markets in the March quarter. Since then there has been some recovery in a number of countries (Table I).

Developments in China

Inflation

The most important recent development in the Chinese economy was that, after a moderate

decline in the June quarter, the national retail price index (RPI) picked up again to an annual rate of 21.4% in July and further increased to 23.5% in August and 24.6% in September (Chart 7). In a meeting of branch presidents of the People's Bank of China (PBoC) held in mid-August, inflation was named the No.1 economic enemy. Public policy is committed to bringing economic growth and inflation down to single digit rates at a gradual pace.

The recent rise in inflation has somewhat dampened the optimistic mood in the June quarter when it was reported that the central government was convinced that inflation was under control, and as a consequence credits were eased to help loss-ridden state-owned enterprises (SOEs).

A surge in food prices, which carry about half of the weight in the national cost-of-living index, was the major contributor to inflation. Food inflation has been edging up continuously since May while non-food inflation, or core inflation, has been moving on a downtrend since March (Chart 8).

Three factors may contribute to a moderation in food prices in coming months. First, the current inflation seems to be the result of one-off factors such as the government's price liberalisation on grain and other foodstuffs, as well as the floods and drought in China recently. Second, by late September, the Agriculture Ministry announced that China's grain output in 1994 would be the second highest on record despite natural disasters and a drop in acreage. Third, in the very unlikely

case of a shortage of food, the increase in foreign exchange reserves put the country in a better position to purchase food from overseas.

Banking reforms

In January 1994, the Chinese government launched a bold financial reform programme. It included abolition of the official exchange rate (leaving the market-determined rate in the 'swap centres' as the only exchange rate), establishment of three policy banks to take over non-commercial loans for policy purposes and transforming the four specialised banks (the Bank of China, the Agricultural Bank of China, the People's Construction Bank of China, the Industrial and Commercial Bank of China) into state-owned commercial banks, discontinuation of the foreign exchange retention system for Chinese enterprises, and improvement of the effectiveness of the PBoC as a regulator of macro-economic activities.

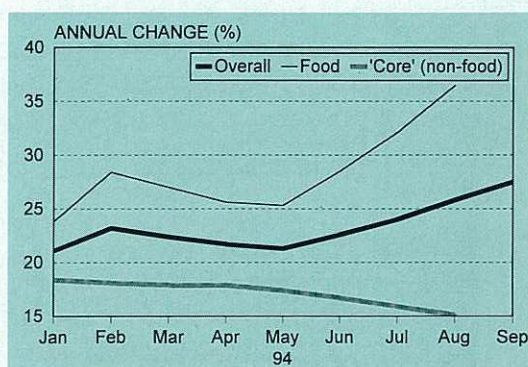
Three-pronged measures are being adopted to strengthen the PBoC's effectiveness as a regulator of macro-economic activity. First, the PBoC is trying to phase in the use of market tools such as reserve requirements, discount rates and open market operations in its monetary management. Second, the PBoC is striving to centralise credit control, part of which was decentralised to local branches of the PBoC and local governments, back to its Beijing headquarters. Third, the intended discontinuation of PBoC's monetisation of fiscal deficits should rein in a potential source of

Chart 7
China: National Retail Price Index



Source: China Monthly Statistics; Reuters

Chart 8
China Inflation: National Cost-of-living Index



Source: China Monthly Statistics

inflation. The issuance of RMB 102 billion of treasury bonds, most of which went to the general public, to finance the fiscal deficit reflects the central government's desire to separate monetary policy from fiscal policy.

Although returns on bank deposits still fall slightly short of the inflation rate, repeated increases in deposit interest rates as well as interest subsidies have made them more attractive. Bank savings deposits in the first half of 1994 rose by RMB 315 bn, up from the increase of RMB 180 bn in the same period of 1993.

External balance

On the external front, after a sharp depreciation in 1993, the PBoC has successfully stabilised the external value of RMB since its adoption of the highly centralised managed floating exchange rate regime at the beginning of the year. The currency traded within a relatively narrow band of 8.5-8.7 RMB/US\$ in the first three quarters of 1994 (Chart 9).

After 16 months of deficits, trade surpluses have been recorded since June. Compared with the same period last year, exports in the first nine months of 1994 rose by 30% to US\$79 bn, while imports grew by 15% to US\$78 bn, resulting in a small trade surplus (Chart 10).

The trade position is likely to remain favourable. The effective depreciation of the RMB at the time of exchange rate unification should

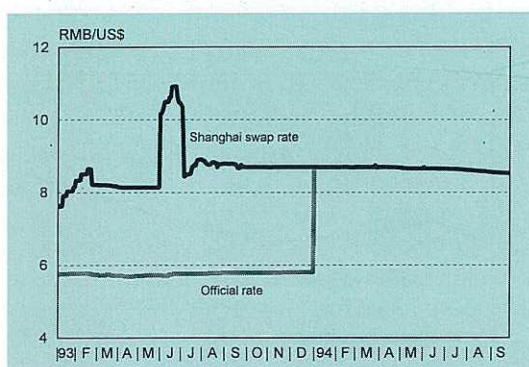
continue to boost exports and discourage imports. Unconditional renewal of the Most Favoured Nation status by the US and the improving economic performance of the OECD economies, which take about half of China's exports, should strengthen exports while some slowing in the domestic economy as a result of the tight credit policy should moderate growth in imports.

Exchange rate stability has also been maintained by a sustained inflow of foreign investment. In the first nine months of 1994, despite a fall in the pledged foreign investment inflow, the realised value, at US\$22.7 bn, was 49% up from the level during the same period of 1993 (Chart 11). (If left unsterilised, this rate of inflow would add 8 percentage points to the annual growth rate of the money supply).

China's foreign exchange reserves increased by a substantial 90% in the first nine months of 1994 to US\$40 bn (Chart 12). In addition to improvement in the trade balance, the discontinuation of the foreign exchange retention system has helped the rapid growth in foreign exchange reserves by redistributing foreign exchange holdings from domestic enterprises to the PBoC.

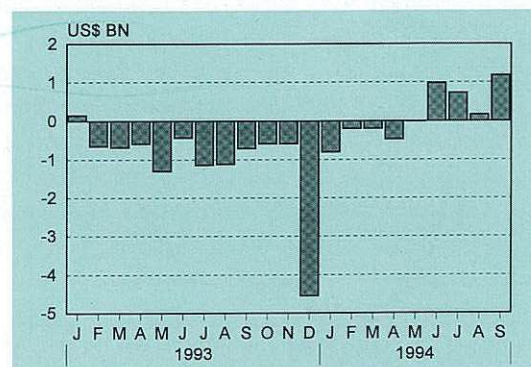
In sum, the recent stability of RMB has been, and probably will be, sustained by an improvement in the trade balance, continuous inflow of capital and rapid accumulation of foreign exchange reserves. In the longer run, lowering inflation would assist in the task of maintaining exchange rate stability.

Chart 9
China: Exchange Rate Movements



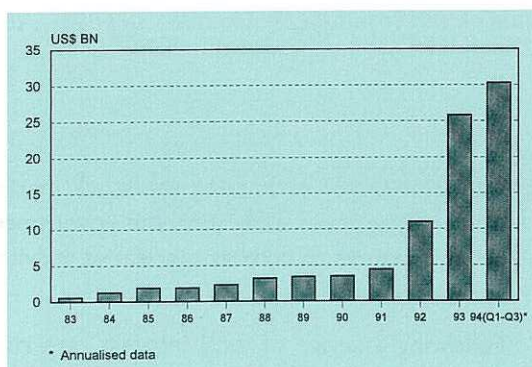
Source: Reuters; Hong Kong Economic Journal

Chart 10
China: External Trade Balance



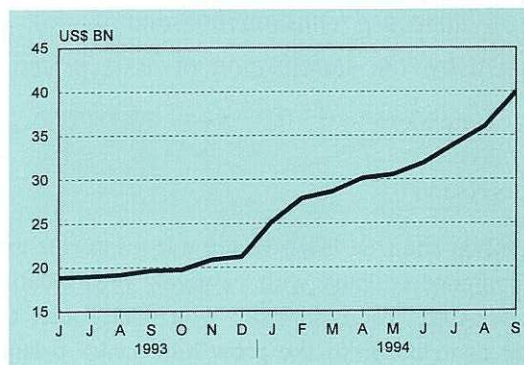
Source: China's Customs Statistics, Economic Information & Agency, Reuters

Chart 11
China: Foreign Direct Investments



Source: Statistical Year Book of China 1993; Reuters

Chart 12
China: Foreign Exchange Reserves



Source: IMF International Financial Statistics, People's Bank of China

Impact on Hong Kong

The growing strength of the OECD economies, which take about half of Hong Kong's exports, should bolster activity here. Reflecting the global economic recovery, commodity prices are rising. In time, other prices in the OECD countries are likely to rise somewhat faster too. The weakening of the US dollar has brought the Hong Kong nominal effective exchange rate down by 6% from end-93. These factors will all act to increase imported inflation in Hong Kong, but only by a small amount. An offset will be provided by lower prices for food imported from southern China as the effects of the recent flooding pass.

The rise in US interest rates has resulted in a corresponding increase in local interest rates given the link between the US dollar and the HK dollar. The Hong Kong one-month interbank rate has risen by around 130 basis points since the beginning of the year, and rates charged by banks to their customers have also risen. This should help dampen speculative activity and assist in winding back domestic inflation.

The RMB's devaluation and subsequent stability are good for both traders and investors in Hong

Kong. A weaker RMB should help boost China's exports, which is good news for Hong Kong traders engaged in re-export trading. For investors, a stable RMB means lower exchange rate risk for investments in China.

When the Chinese government announced its financial reforms in January, it was expected that a large sum of HK dollar then circulating in China might return to Hong Kong. There is no official estimate of HK dollars circulating in China. However, market guesstimates put it at HK\$15-20 bn, which amounts to less than 30% of the total currency in circulation or some 5% of the foreign currency assets held by the Exchange Fund. The HKMA would therefore have no difficulty in meeting the demand for redemption of these HK dollar notes for US dollars. But so far any inflow of HK dollars back to Hong Kong has been quite modest. In fact, HK dollars in circulation has only increased by 3%, which is unusually low, in the first nine months of this year, possibly due to the rise in interest rates that suppressed demand for non-interest bearing liquid money balances. ☺

— Prepared by the External Department