Interest rate rises have helped move the money market towards equilibrium as credit expanded at a slower pace while savings held as bank deposits picked up. The adjustment process has led to dampened consumption and a shift from liquid money balances to time deposits, and has assisted the stabilisation of asset prices.

Background

Over the past few years, the low interest rate environment coupled with relatively high inflation had boosted credit demand, which has been the major contributor to the growth in banks' balance sheets (Chart 1). The effect was compounded by the large inflow of funds in the latter part of 1993 which led to an exceptionally high growth in HK$M3 around that time.

The persistently negative real interest rates had also suppressed the demand for currency and bank deposits, as people shifted their asset portfolios towards properties and stocks. At a time when structural factors were pushing up asset prices rapidly, the excess supply of money added to the pressure. By the time asset prices peaked in the first half of 1994, the Hang Seng Index was 290% higher than its end-1990 level. The prices of private residential property and offices had soared by around 120% and 60% respectively during the same period. The sustained rise in residential property prices at rates outpacing wage increases eroded home affordability for the population at large (Charts 2 & 3).

With low real interest rates, consumption demand had also been robust. At the same time, the rising net worth of their assets might have induced property owners (who account for about half of all households) and stocks and share owners to spend more on goods and services, thus adding further pressure on inflation. From 1991 to 1993, private consumption expenditure grew at an average annual real rate of 7.6%, well in excess of the corresponding 5.7% for real GDP.

Interest rate hikes triggered off the adjustment process

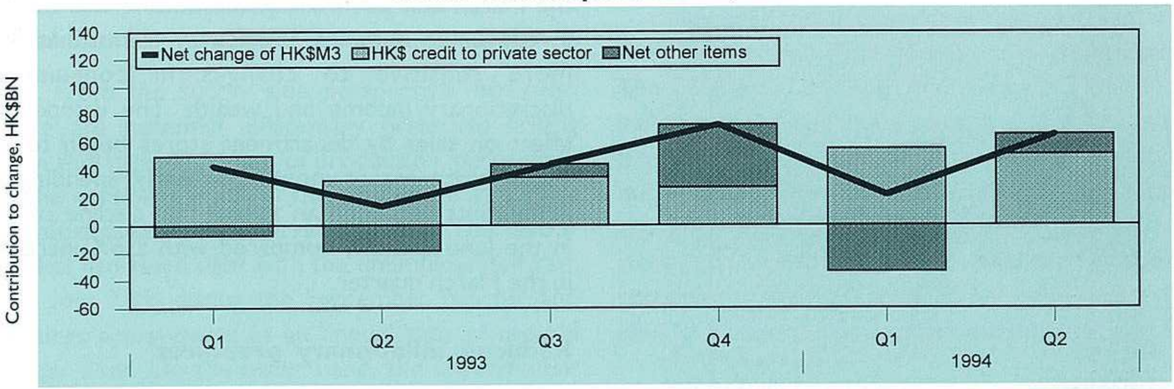
Asset prices peaked in the first half of 1994. The rise in the US Fed funds rate in early February was the major factor prompting the stock market correction this year. In early June the government announced measures to combat speculative activities in the property market.

Following a series of local interest rate rises since March, credit expansion started to moderate with growth in HK dollar loans slowing to an average monthly rate of some 0.9% in the September quarter as compared with 1.7% in the first six months of 1994. In particular, the growth of outstanding mortgage lending moderated to 0.7% in August and September as compared to an average monthly growth of 1.1% in the previous twelve months. This slowdown in credit growth was associated with slower growth in HK$M3, though still at annual rates of 20% to 26%, in recent months.

HK dollar time deposits jumped by 7.4% in the September quarter, contributed largely by the shifting of deposits from savings account and current accounts. As people switched away from their non-interest bearing transaction balances, the velocity of narrow money has seen a gentle rise (Chart 4). Time deposits now account for around 55.5% of broad money, having risen steadily from 50.5% at end February.

This evidence is indicative of firstly, a portfolio shift back from other assets to money balances for holding purposes and secondly, an increased incentive to save by the public. This contributed to a cooling of the overheated asset markets and transaction volumes fell. The average daily stock exchange turnover shrank from the high of HK$9.5 bn in January to HK$6.7 bn in February, and then to a range around HK$3 bn to HK$5 bn in subsequent months. The effect was equally conspicuous in the property market. The value of sale and purchase agreements for building units registered at Land Registries fell from a monthly average of HK$50 bn in the March quarter to

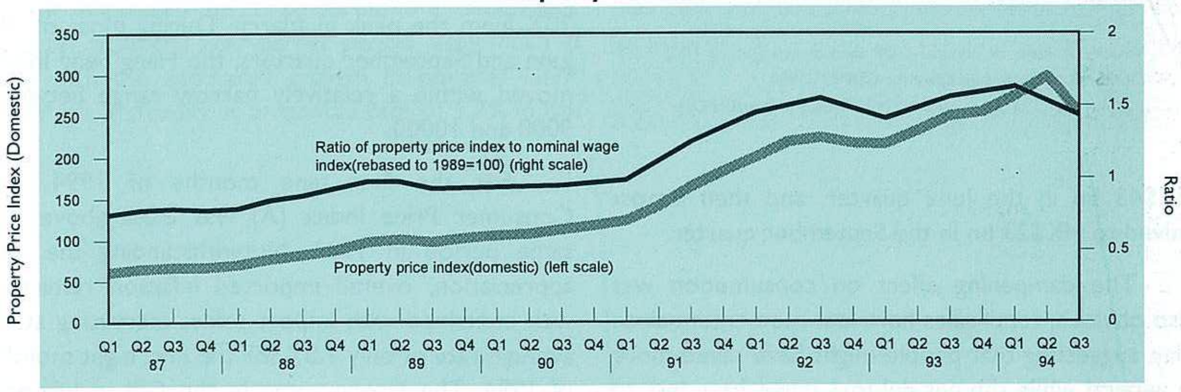
Chart 1
Credit Counterparts of HK$M3*



* HK$M3 has been adjusted to include foreign currency swap deposits (from 1984 onwards) and to exclude government deposits and Exchange Fund deposits with licensed banks.

Source: HKMA

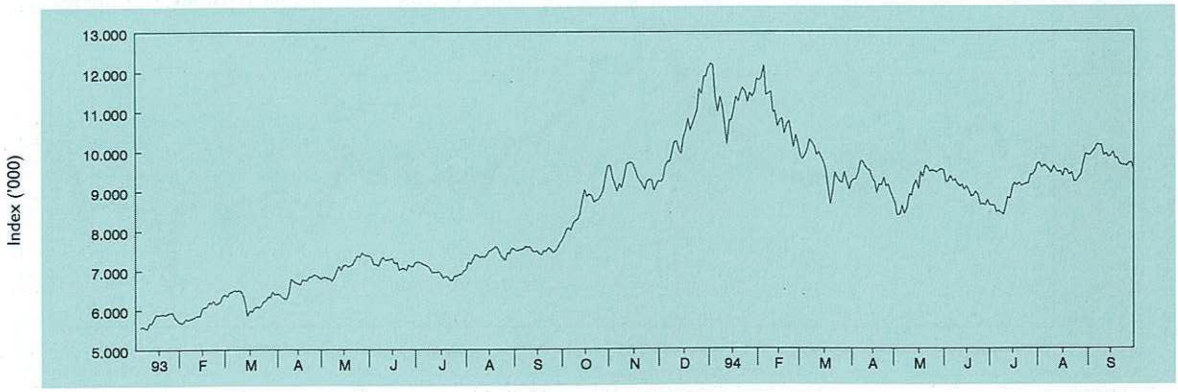
Chart 2
Property Prices



Estimated figures for Q3/1994.

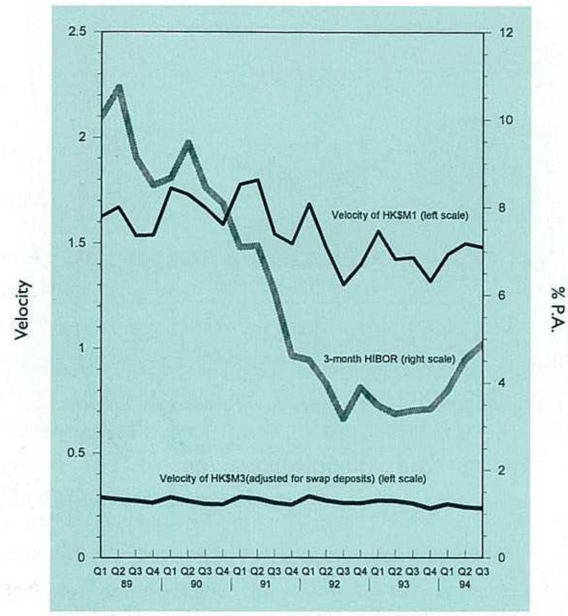
Source: Census & Statistics Dept., Rating & Valuation Dept.

Chart 3
Equity Prices (Hang Seng Index) (Jan 93 – Sep 94)



Source: HSI Services Ltd.

Chart 4
Velocity & Interest Rates



Velocity = ratio of nominal GDP (annual average) to HK$ money supply. Estimated figure for GDP Q3/1994.

Source: HKMA, Census & Statistics Dept.

HK$43 bn in the June quarter, and then almost halved to HK$23 bn in the September quarter.

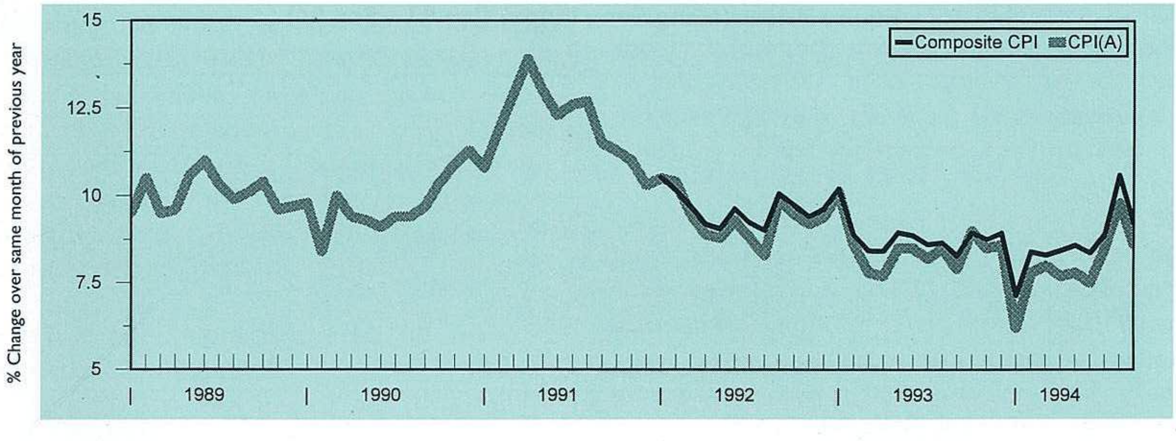
The dampening effect on consumption was also obvious; retail sales have lost momentum since May, suggesting that people might have saved more in general while the net debtors might have less to spend. The annual growth in retail sales in July slipped to 3.3% in volume terms, down from an average of 4.7% in the June quarter and 12.1% in the March quarter. Initially, the decline was mainly in consumer durables and luxury items that are more sensitive to changes in consumers' discretionary income and wealth. The dampening effect on sales by department stores began to be felt in more recent months. Similarly, spending in restaurants recorded an annual real decline of 1% in the June quarter, compared with a 6% increase in the March quarter.

Reduced inflationary pressures

With easing demand in both the assets and goods markets, stock prices and property prices have basically stabilised while overall consumer prices have stayed on a moderating trend. By September, prices of residential flats had fallen, according to market information, by some 10% to 20% from the peak in March. During most of the June and September quarters, the Hang Seng Index moved within a relatively narrow range between 9000 and 10000.

For the first nine months of 1994, the Consumer Price Index (A) was 8.0% above the same period in 1993. Notwithstanding the Yen appreciation, overall imported inflation remained well contained with import prices increasing at an average rate of only 1.8% for the first eight months of 1994. The strong surge in the CPI in July and August reflected primarily the sharp increase in

Chart 5
Inflation (Jan 89 – Sept 94)



Source: Census & Statistics Dept.

food prices due to the summer flooding in southern China. This effect began to taper off in September and should have little bearing on the core inflationary pressure.

From the supply side perspective, however, there are potential inflationary pressures arising from shortages in factors of production, particularly as the economy is still in the process of structural transformation into a services centre. The labour market remained tight with the unemployment rate at a low 2.3% during the September quarter and earnings are growing at an annual rate of around 10 per cent. On the other hand, the Government has been actively pursuing various measures in relieving shortages in land supply, including the speeding up of re-development in the urban areas.

The money market adjustment process has, so far, not affected the real economy. HK dollar credit expanded by 17% during the September quarter from the year-earlier period, very much in line with the estimated growth in nominal GDP. GDP grew steadily at an annual rate of 5.7% in the March quarter and 5.4% in the June quarter, around the rate recorded in recent years.

All along the adjustment process, HK$ interest rates have stayed close to their US$ counterparts. The differential between the 3-month Hong Kong Interbank Offered Rate and the corresponding Euro dollar rate was less than 25 basis points during the September quarter. At the same time, the HK$ exchange rate remained stable on the strong side of the link. The visible trade deficit narrowed from HK$32 bn in the June quarter to HK$12.1 bn in the September quarter.

Given the expectation of further rises in interest rates in the U.S., and hence the local counterparts, the HK dollar money market should continue heading towards equilibrium as credit expands at a slower pace while savings held as bank deposits pick up. The adjustment process has assisted the easing of domestic inflationary pressures.

– Prepared by the External Department