

THE EXTERNAL ENVIRONMENT

The growth momentum in the OECD countries continued in early 1995. The US economy continued to grow strongly, although with some signs of moderation. Most European economic indicators point to continued growth in 1995, although the strong D-mark may slow the German expansion somewhat. The Japanese economy contracted in the December quarter of 1994, and the Kobe earthquake and strength of the yen are slowing the recovery. Meanwhile, inflation in the industrialised countries has remained subdued. Monetary policy remained firm in the US but has been relaxed in Germany and Japan. The US dollar weakened significantly in the first quarter of 1995.

Inflation eased further in China with the dissipation of the effects of floods, droughts and increases in agricultural procurement prices in mid-1994, but the strong balance of payments made tight monetary control more difficult. The promulgation of the central bank law should strengthen monetary control by the People's Bank of China, which should help inflation management in the longer run.

OECD Economies

Economic Growth

Despite the interest rate rises initiated by the US Federal Reserve in 1994, the US economy continued to grow strongly, expanding by 1.2% in real terms in the December quarter. Adding the similar gains in the previous three quarters, the US economy experienced real GDP growth of 4.1% last year, the highest since 1984. The advance estimate for the March quarter showed an increase of 0.7%, mainly attributable to surging investment and a larger accumulation of stocks. Some of the strong demand was met from imports, which again rose strongly, while a sharp fall in exports to Mexico offset stronger exports to other markets.

Continued strong domestic demand is also shown by a number of other indicators. Capacity utilisation reached a 15-year high of 85.6% in January but eased to 84.1% in April (Chart 1). The unemployment rate dropped to a low of 5.4% in December 1994 and again in February 1995 before a slight rise in March and April. Consumer confidence reached its highest level since 1990 in April.

However, some signs of moderation are emerging in the US economy from the strong pace of last year. The housing sector, generally the most interest-sensitive, has shown clear signs of slowdown

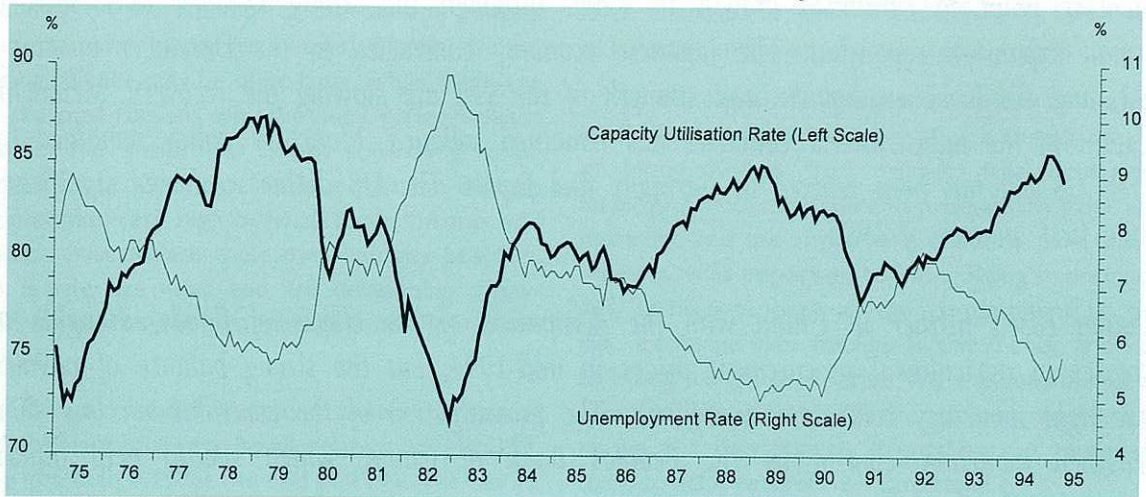
in response to the marked rise in the mortgage rate. Housing starts tumbled in January 1995 by 12% and fell further in February and March. New homes sales slid 13% in February before recovering somewhat in March.

Factory orders have also eased, partly due to substantial inventory build-up over the past year. However, even if domestic demand were to slow more sharply, the US economy has a good chance of achieving a soft landing as high productivity growth and the US dollar depreciation should enhance the competitiveness of US products in overseas markets.

Reflecting stronger global demand, the European economies grew exceptionally well during 1994. This growth momentum continued in early 1995. As a result, unemployment rates in most of Europe have dropped significantly although they remain at high levels.

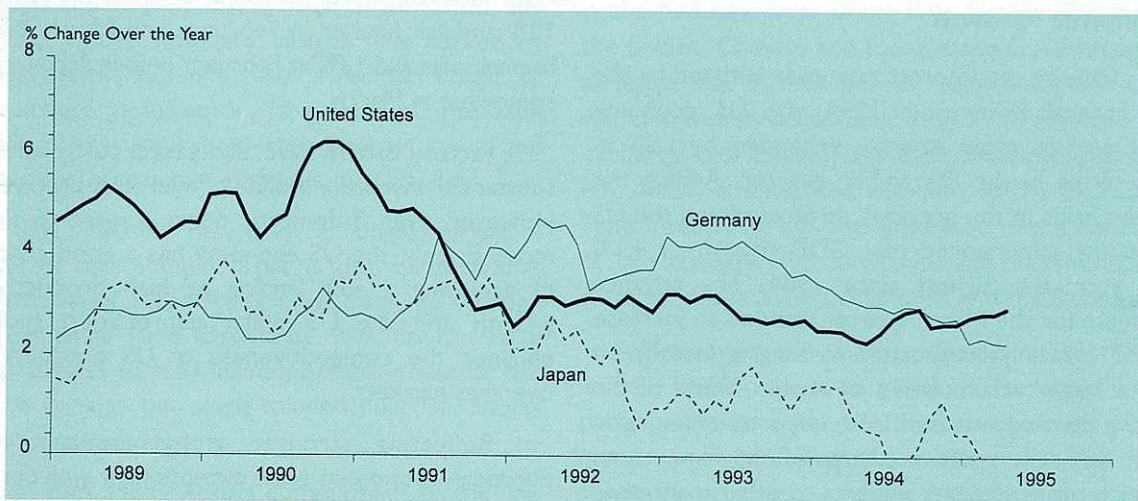
Driven by vigorous industrial activity and strong export demand, economic growth in Germany fared better than expected in 1994, growing by 2.4% following a recession in the previous year. Most indicators point to a continued pickup in activity in 1995. New orders in the manufacturing sector have maintained rapid growth, partly due to the strong demand for German capital goods from other continental European countries.

Chart 1
United States Capacity Utilisation and Unemployment Rates



Source: DATASTREAM

Chart 2
Consumer Prices



Source: DATASTREAM

However, despite the strong growth, domestic consumption has remained sluggish. The reimposition of the solidarity tax surcharge at the beginning of this year and the modest improvement in employment are likely to limit the purchasing power of German households. Therefore, domestic consumption is unlikely to grow strongly in the near future. Meanwhile, higher wage deals and the strengthening of the D-mark present risks of higher costs to industry and problems for exporters.

Reflecting the booming export sector, the UK economy grew strongly in 1994 and early 1995. UK unemployment fell for the fourteenth consecutive month in March to reach 8.6%, compared with 10.3% in January 1994.

Although Japan appeared to emerge from recession in the second half of 1994, real GDP contracted by 0.9% in the December quarter. The downturn was caused by the fall in consumer

spending and housing investment, which outweighed the continued growth in exports.

The Kobe earthquake in mid-January has brought greater uncertainty to this slow economic recovery. The devastating earthquake that hit Japan's sixth largest city, and busiest port, may disrupt some economic activity for much of 1995. Personal consumption, which had been sluggish anyway, is likely to have been dampened (particularly in the earthquake area). Meanwhile, the sharp appreciation of the yen is also placing pressure on exports and the unemployment rate of 3.0%, high by Japanese historical standards, continues to weigh on the growth of consumption.

Despite these adverse factors, Japan's quarterly *Tankan* survey in February showed a further improvement in business confidence in manufacturing. While firms still expect to cut investment, the planned reduction was less than in the previous survey.

The stance of fiscal policy within the OECD (except Japan) is likely to remain restrictive for the near future to correct the excessive size of government deficits and the concomitant rise in ratios of public sector debt to GDP. This will exert a restraining effect on economic growth.

Prices

The highly competitive international environment, substantial excess capacity in many economies and central banks' pro-active tightening of monetary policies have so far put a lid on inflation in the industrialised world (Chart 2). However, inflation fears are looming in some countries, fanned by rising commodity and producer prices and sharp falls in exchange rates.

US inflation remains low on all measures although there are signs of some increase. While the rise in the consumer price index in 1994, at 2.6%, was slightly lower than the 3.0% in 1993, during the March quarter consumer prices rose by 0.8%, compared with 0.5% during the previous quarter. The 3-year-old economic upswing in the US has simultaneously closed the US output gap and generated a tight labour market (Chart 1). At 5.8% in April US unemployment is below rates that have in the past been associated with rising inflation. Nevertheless, it has not so far caused any 'wage-push' inflation; average real earnings were

0.4% lower in April than a year earlier. With solid growth in labour productivity, the very slow growth in unit labour costs is helping to restrain inflation.

In both Germany and Japan, spare capacity, sluggish domestic demand and the strong currencies continue to check inflation. Wage settlements in Germany, which have been higher than the 3% to 3.5% level accepted by the employers and the Bundesbank, raises some concern of a 'wage-push' inflation in the longer run.

Meanwhile, inflation in most other industrialised countries has remained subdued. According to *The Economist's* May survey of forecasters, inflation will remain below 3% in 1995 and 1996 in a majority of these economies.

Monetary Policy

The US Federal Reserve raised its Fed Funds target rate from 3% to 6% between February 1994 and February 1995, but has since left its key interest rates unchanged. The recently released economic data suggest a moderation of US economic growth from the 4% pace of 1994. It is less clear whether, on current policy settings, the economy will slow to 2.5% in the next few quarters, which is generally regarded as its longer term potential growth rate.

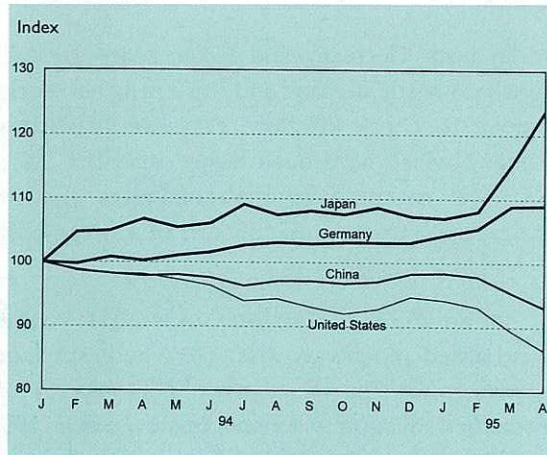
West German inflation has been generally steady during the early months of 1995 after declining to an annual rate of 3.0% in 1994 from 4.2% in 1993. Consumer prices rose 2.3% during the year to April. The Bundesbank unexpectedly cut its discount rate by 50 basis points on 30 March to 4%, the first reduction since last May. The Bundesbank judged that the strong currency was reducing pressure on prices and noted that the money supply had contracted in early 1995.

Interest rates have been drifting down in Japan over recent months. The absence of inflationary pressure in Japan, the tepid recovery and the very strong exchange rate of the yen against the dollar, led the Bank of Japan to cut its discount rate from 1.75% to an historical low of 1%, the first change since September 1993.

Financial Markets

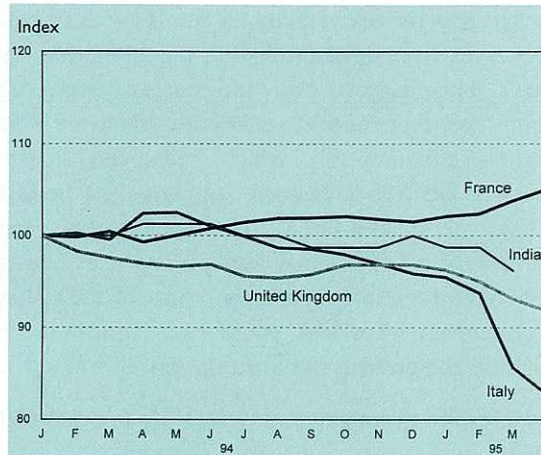
After settling down in the latter part of 1994, the financial markets have undergone drastic

Chart 3
**Four Largest Economies:
 Nominal Effective Exchange Rates**



Source: Datastream, HKMA estimates

Chart 4
**Four Next Largest Economies:
 Nominal Effective Exchange Rates**



Source: Datastream, J.P. Morgan

movements since the beginning of this year. Bond yields have come down significantly and the major currencies have moved sharply (Chart 3).

Since peaking in mid-November 1994, US yields have come down by around 100 basis points as economic data and statements by Federal Reserve officials, notably Chairman Greenspan, seemed to assure market participants that the Federal Reserve has taken sufficient action to prevent a revival of inflation. Meanwhile, notwithstanding possible extra bond issues to fund reconstruction in Kobe, the Japanese long bond yield has declined below 4.0%.

The US dollar has been under further attack after a short period of stability. On top of the unexpected devaluation of the Mexico peso, the repatriation of funds to Japan and the continued trade deficit sent the US dollar sharply lower against the major foreign currencies in the March quarter of 1995. The 'flight to quality' as a result of the spillover effect from the Mexican crisis sent the US dollar to a new post World War II low against the D-mark and the yen. The movements in other currencies were generally less marked (Chart 4 shows the exchange rates of the four next largest economies).

The G7 meeting in Washington DC on 26 April did not announce any specific policy coordinating initiatives or other measures to address

the turbulence caused by recent exchange rate movements. Nonetheless the US dollar strengthened in early May.

China

1994 Economic Performance

At the National People's Congress (NPC) held in March 1995, various government reports portrayed an economy with strong growth in 1994. The 11.8% growth in real GDP in 1994 was the third year in a row of double-digit growth. Secondary (industrial) production was the dominant source of growth (Chart 5). Trade performance improved dramatically; the US\$12.2 bn trade deficit of 1993 was reversed to a US\$5.3 bn trade surplus in 1994 due to strong export growth of 32% and low import growth of 11%. The sizable trade surplus together with a 31% increase in foreign direct investment more than doubled foreign exchange reserves to US\$51.6 bn, the sixth highest in the world. This strong balance of payments performance has contributed to a stable exchange rate of the RMB, which appreciated by 3% against the US dollar during the course of 1994.

On the other hand, the 21.7% retail price inflation, the highest reached in the last four decades, clearly indicated that the Chinese economy was overheated. Premier Li Peng mentioned

increases in the procurement prices of many agricultural products, inadequate investment in agriculture and monetary expansion as among the causes of high inflation.

The Chinese government aims to slow economic growth to 8-9% and trim inflation to 15% in 1995.

Money and Inflation

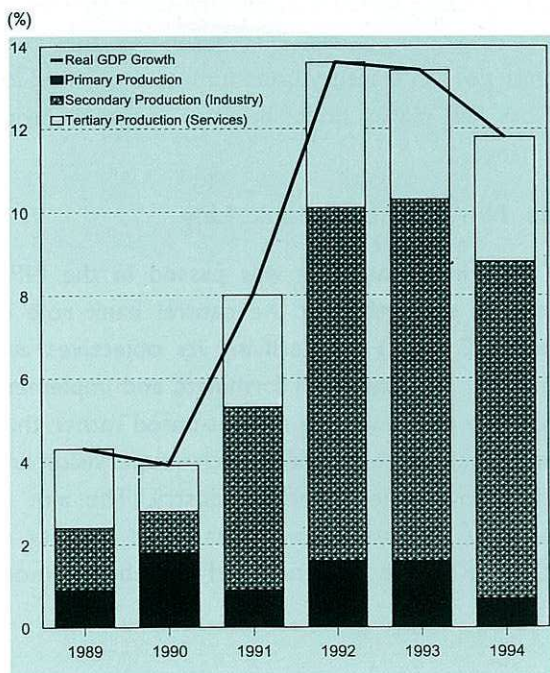
The prospect of a “soft landing” emerged in the December quarter of 1994, with inflation and retail sales peaking and monetary growth stabilising (Chart 6). Inflation continued its downtrend into the first three months of 1995. National retail price inflation was 18.7% in March 1995, the lowest since 1993. The effects of one-off factors including floods, droughts and the increase in procurement prices of agricultural products which pushed inflation up in the September quarter had apparently dissipated. This should continue to reduce inflationary pressure given that three-fifths of last year’s 21.7% retail price inflation was accounted for by higher food prices.

The estimated growth of broad money supply (M2 plus foreign exchange deposits plus financial bonds) was 34% in 1994. Based on our estimated monetary survey for 1994 (Chart 7), loans made the largest contribution to the increase in broad money supply. The accumulation of foreign assets also played an important role in the money creation process. While increasing monetary growth fueled inflation in 1994, the recent stabilisation may help ease inflationary pressures somewhat (Chart 6).

Inflationary expectations have apparently declined in the March quarter of 1995. According to a survey conducted by the People’s Bank of China (PBoC) in February 1995, 45% of respondents believed that prices would increase quickly, down from 55% in November 1994.

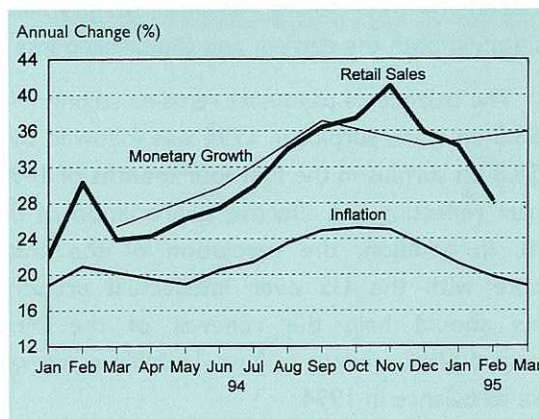
Despite the encouraging trend, reduction of retail price inflation to the 1995 official target of 15% may require greater monetary restraint than in 1994. The planned issuance of RMB150 bn in treasury bonds in 1995 (compared with RMB102 bn in 1994), part of which would help finance the RMB67 bn fiscal deficit projected for 1995, should assist this process. Finally, the policies of increasing agricultural investment and food production should also help lower inflation.

Chart 5
China: Sources of Growth, 1989 – 94



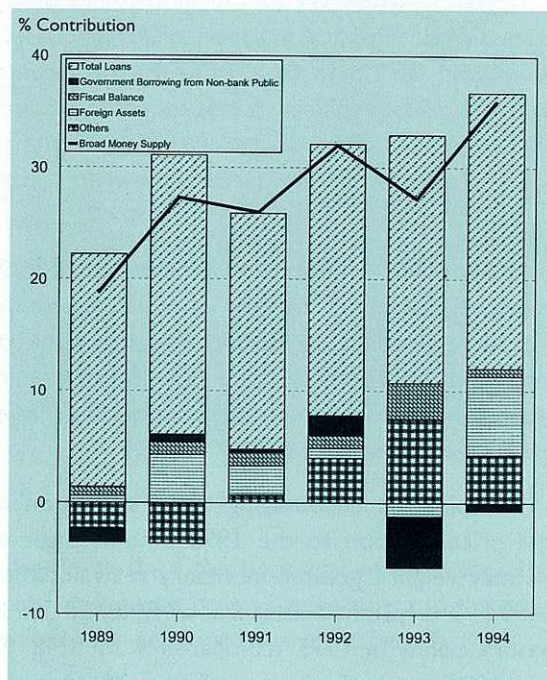
Source: Statistical Yearbook of China; Reuters

Chart 6
China: Monetary (M2) Growth, National Retail Price Inflation and Consumer Goods Retail Sales



Source: China’s Latest Economic Statistics
China Monthly Statistics
People’s Bank of China

Chart 7
**Credit Counterparts of
 Broad Money Supply of RMB**
 (% Contribution)



Balance of Payments and Exchange Rate

Despite the high inflation, the RMB exchange rate has remained relatively stable. It has appreciated 4% against the US dollar from the beginning of the year until end-April. Over the same period, our calculations suggest that the RMB has lost 8% in trade-weighted terms due to the weakening of the US dollar (Chart 3). This relative stability has been sustained by the strong balance of payments position, in both the current and capital accounts.

The balance of payments remains strong. The US\$5.3 bn trade surplus in 1994 was followed by a US\$8.8 bn surplus in the first four months of 1995, in part reflecting the effective depreciation of the RMB. In addition, the resolution of the trade dispute with the US over intellectual property rights should help the renewal of the Most Favoured Nation status in June. Invisible trade was close to balance in 1994.

The capital account was also strong in 1994 with a net inflow of US\$29 bn in foreign capital. Foreign direct investment, at US\$34 bn, was up by a third in 1994. According to the PBoC, foreign capital inflows in 1994 had expanded money supply by RMB284 bn which in turn fueled inflation. The PBoC also stated that there was an inflow of US\$1-2 bn of speculative funds for interest arbitrage as China's interest rates were higher than abroad and the US\$/RMB exchange rate has been very stable since the unification of exchange rates in January 1994. Some of the capital was invested in securities markets while some may have been loaned through underground finance companies at high interest rates.

Financial Markets

Abolition of same day buying and selling, and concerns over the health of Mr. Deng Xiao-ping, had a major dampening effect on stock market activities. As a result, the uptrend and active trading in stock markets in the September quarter of 1994 came to an abrupt end (Chart 8). Since October 1994, trading became very thin. Stock trading was also affected by the re-introduction of the inflation-compensating interest subsidy, the rate of which has been adjusted upward on almost a monthly basis, which induced investors to shift to treasury bonds. In the March quarter this year, transactions in treasury bond futures accounted for almost all transactions in the Shanghai Stock Exchange.

The New Central Bank Law

An important law was passed in the NPC aimed at strengthening the central bank role of the PBoC (Box) by clarifying its objectives and functions. The Bank will formulate and implement monetary policies using market-based rather than administrative means and exercise supervision and control over the financial industry. The aim of monetary policies is to maintain the stability of the value of the currency and thereby promote growth.

The PBoC may no longer lend to the State or local governments. This gives PBoC greater independence than before.


Implications for Hong Kong

Higher US interest rates, which translated directly into higher rates in Hong Kong, will continue to play a role in stabilising the local asset markets, as well as inflation.

Meanwhile, the depreciation of the US dollar has led to a fall in the import-weighted effective exchange rate for the HK dollar of around 6% since the beginning of the year. However, the

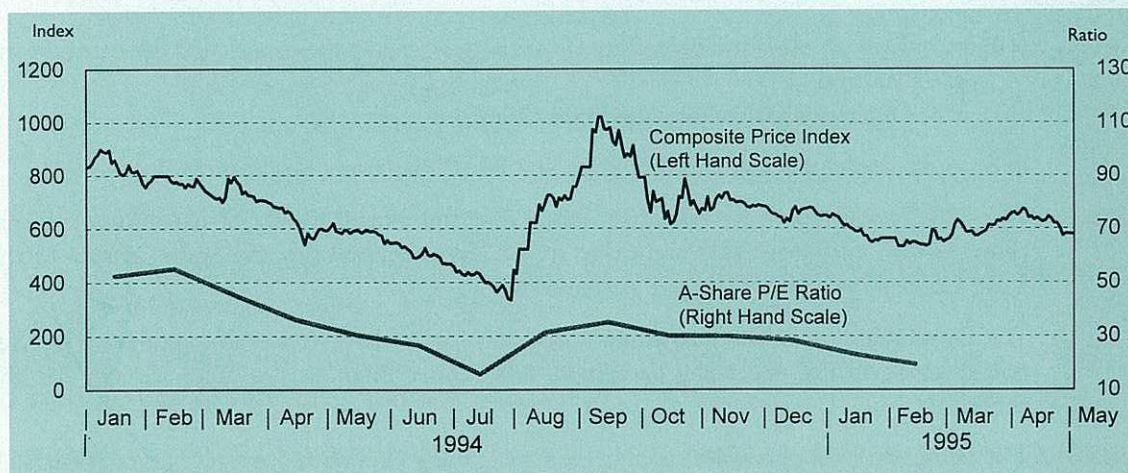
inflationary implications of this should not be overstated.¹

Furthermore the weaker HK dollar against the D-mark and the yen has made Hong Kong exporters, and Chinese firms who export via Hong Kong, more competitive in these markets. This has the potential to add to Hong Kong's growth in 1995.

The economic recovery in major overseas markets in 1995 is likely to raise Hong Kong's raw materials and capital equipment exports to China for outward processing, and boost re-exports of China-manufactured products. 

– Prepared by the External Department

Chart 8
China: Shanghai Stock Exchange Composite Price Index and A-Share P/E Ratio



Source: Datastream and Smith New Court – Asia Stats

¹ See the discussion in the following article on the domestic environment.

Some Important Provisions of the “Law of the People’s Republic of China on the People’s Bank of China”

Article 2 The People’s Bank of China (PBoC) is the Central Bank of the People’s Republic of China. The PBoC shall formulate and implement monetary policies and exercise supervision and control over the financial industry under the leadership of the State Council.

Article 3 The aim of monetary policies is to maintain the stability of the value of currency and thereby promote economic growth.

Article 4 The PBoC shall perform the following functions:

- (1) to formulate and implement monetary policies in accordance with the law;
- (2) to issue Renminbi and control its circulation;
- (3) to approve, supervise and administer financial institutions in accordance with regulations;
- (4) to supervise and control the financial market in accordance with regulations;
- (5) to promulgate ordinances and rules concerning financial administration and business;
- (6) to hold, administer and manage the state foreign exchange reserve and bullion reserve;
- (7) to act as fiscal agent for the State;
- (8) to maintain the normal operation of payment, clearing and settlement systems;
- (9) to be responsible for statistics, investigation, analysis and forecasting for the financial industry;
- (10) to engage in relevant international financial activities in the capacity of the central bank of China; and
- (11) other functions assigned by the State Council.

In order to implement monetary policies, the PBoC may carry out financial businesses.

Article 5 The PBoC shall report its decisions concerning the annual supply of banknotes, interest rates, foreign exchange rates and other major issues specified by the State Council to the State Council for approval before implementation.

The PBoC shall immediately implement decisions on matters concerning monetary policies not specified in the preceding paragraph, and report them to the State Council for the record.

Article 6 The PBoC shall submit work reports to the Standing Committee of the National People’s Congress (NPC) on matters concerning monetary policies and its work of supervision and control over the financial industry.

Article 7 The PBoC shall, under the leadership of the State Council, independently implement monetary policies, exercise its functions and carry on its operation according to the law and be free from intervention by local governments, or other administrative organs at all levels, public organisations or individuals.

Article 8 The entire paid-up capital of the PBoC is allocated by the State and owned solely by the State.

Article 9 The PBoC shall have a governor and a number of deputy governors.

The person for the Governor of the PBoC shall, on the basis of nomination by the Premier of the State Council, be decided upon by the NPC; and when the NPC is not in session, determined by the NPC Standing Committee and appointed or removed by the President of the People’s Republic of China. The deputy governors of the PBoC shall be appointed and removed by the Premier of the State Council.

Article 11 The PBoC shall establish a monetary policy committee whose functions, organisation and working procedure shall be prescribed by the State Council and reported to the Standing Committee of the NPC for the record.

Article 12 The PBoC shall, as necessitated by the performance of its functions, establish its branches as its representative organs. The PBoC shall exercise centralised and unified leadership and control over its branches.

The branches of the PBoC shall, as authorised by the PBoC, be responsible for the supervision and control over the financial operations and for handling relevant business operations in areas under their respective jurisdiction.

Article 15 The legal tender of the People's Republic of China is Renminbi. The Renminbi shall be used for repaying all public or private debts according to its face value within the territory of the People's Republic of China, which may not be rejected by any organisation or individual.

Article 22 The PBoC may, for the purpose of implementing monetary policies, apply the following monetary policy instruments:

- (1) to require a financial institution to place a deposits reserve fund at a required ratio;
- (2) to fix the base interest rates;
- (3) to provide rediscount business for financial institutions having current accounts in the PBoC;
- (4) to provide loans for commercial banks;
- (5) to buy and sell state bonds and other government bonds and foreign exchange in the open market operations; and
- (6) other monetary policy instruments defined by the State Council.

The PBoC may work out specific conditions and procedure when applying the monetary policy instruments set forth in the preceding paragraph to implement monetary policies.

Article 23 The PBoC shall act as fiscal agent for the State in accordance with the Law and administrative degrees and regulations.

Article 25 The PBoC may open accounts for financial institutions as needed, but may not provide the financial institutions with overdraft facilities.

Article 28 The PBoC may not provide the State with overdraft facilities, and may not directly subscribe and underwrite State bonds and other government bonds.

Article 29 The PBoC may not provide loans to local governments or governmental departments at all levels, or to financial institutions other than banks, other organisations or individuals, however the special financial institutions other than banks to which the PBoC may provide loans as determined by the State Council shall be excepted.

The PBoC may not act as financial guarantor for any organisation or individual.

Article 30 The PBoC shall, in accordance with the law, exercise supervision over financial institutions and their business operations to maintain the legitimate, stable and sound operation of the financial industry.

Article 32 The PBoC shall have the power to audit, check and supervise at any time the deposits, credits, settlements, bad loans and other business affairs of financial institutions.

The PBoC shall have the power to check and supervise the raising or lowering of interest rates on deposits or loans by financial institutions in violation of regulations.