

THE DOMESTIC ENVIRONMENT

Earlier increases in domestic interest rates continue to affect monetary conditions and real activity in Hong Kong. The inflation rate for the March quarter was 9.5%. While the depreciation of the HK dollar will add to inflationary pressures, this should not be exaggerated. Fiscal policy is expected to be mildly stimulatory in 1995/96, providing some offset to weaker private consumption, before returning to surplus in subsequent years. Export performance continued to improve in the March quarter.

Monetary situation

There were no significant changes in domestic interest rates in March and April. The best lending rate has stayed at 9% since early February 1995 when key local interest rates followed their US counterparts to move half a percentage point higher.

Earlier increases in domestic interest rates continue to affect monetary conditions and real activity in Hong Kong. Along with the removal of the interest rate cap on longer term time deposits, the higher rates have induced depositors to shift their demand and savings deposits to time deposits. In March 1995, HK dollar time deposits accounted for 65.1% of the HK dollar deposits, the highest proportion in ten years.

The higher interest rates have had both direct and indirect effects on the demand for credit. Retail sales have slowed and equity and property transactions have remained at subdued levels. HK dollar loans grew by 2.4% in the March quarter 1995. Reflecting the moderation in credit expansion, the broad money supply, HK\$M3, grew by 3.7% in the same quarter.

The HK dollar was steady against the US dollar. However, both have depreciated markedly relative to some other currencies. Although the US dollar has depreciated by 17% against the yen and 8% against the D-mark over the past six months until end-April, it has fallen by less than 6% on a trade-weighted basis. Similarly, the HK dollar has depreciated only 4% against its trade-weighted index over the same period.

Asset markets

Asset markets generally stabilised over recent months, following some skittishness in January associated with uncertainties in Mexico.

The Hang Seng Index has experienced a significant rebound since February 1995, encouraged by signs of an improved demand for residential properties and easing interest rate worries. The sharp rise in US stock prices also improved sentiment towards the local stock market. Overall, the Index increased by 4.8% during the March quarter. The number of initial public offers slowed significantly to four in the March quarter, compared with 14 in the December quarter of 1994.

Anecdotal evidence suggests that the decline in residential property prices observed in late 1994 has paused in early 1995. The number of mortgage loans drawn in March jumped almost 60%. In the same month, the amount of new mortgage loans approved but not yet drawn surged by 260% or HK\$6.6 billion to HK\$9.2 billion (Chart 1). These figures reflect the resurgence of activity in the property market after the Chinese New Year and suggest that the growth rate of outstanding loans will be much higher in April. On the other hand, the average monthly value of sale and purchase agreements for building units registered at Land Registries continued to drop, from HK\$26 bn in the December quarter of 1994 to HK\$16 bn in the March quarter of 1995.

Inflation

There was the usual surge in prices around Chinese New Year. The March quarter average CPI(A), which abstracts from this effect, was up by 9.5% from a year ago. Within this, the major sources of inflation remained higher rents (a lagged effect of higher property prices in recent years) and domestic services; the housing and miscellaneous services components rose by 13% and 12% respectively.

The depreciation of the HK dollar will add somewhat to inflationary pressures during 1995,

although much will depend on the volatile state of the foreign exchange markets in the major currencies. However, even if the depreciation is not reversed, the inflationary consequences of this for Hong Kong are likely to be much less than some commentators have suggested. Firstly, many countries in the region, from which Hong Kong takes much of its imports, have formal or informal ties to the US dollar themselves and so there has been little movement in their currencies vis-à-vis the HK dollar. For example, China is a very important source of Hong Kong's imports and the

RMB has been steady against the HK dollar since early 1994. The most relevant measure in this context is the import-weighted effective exchange rate index, which has fallen by 5% from the beginning of the year until end-April.

Secondly, Hong Kong has a very competitive marketplace. For instance, Chart 2 shows that movements in the prices of imports from Japan across the docks are much smaller than the movements in the exchange rate. This suggests that many importers of Japanese goods are absorbing

Chart 1
New Residential Mortgage Loans Approved But Not Yet Drawn*

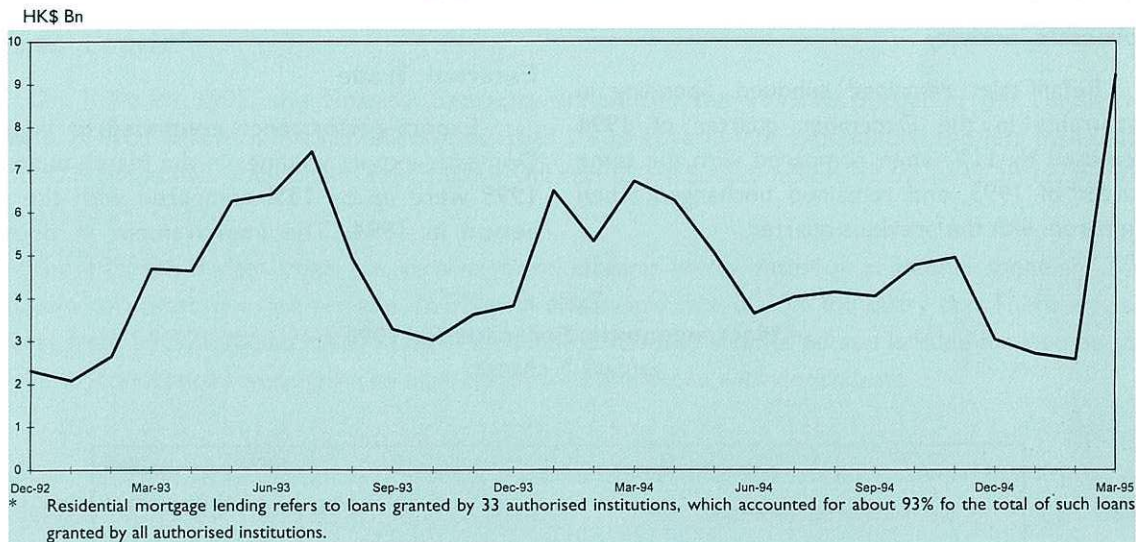
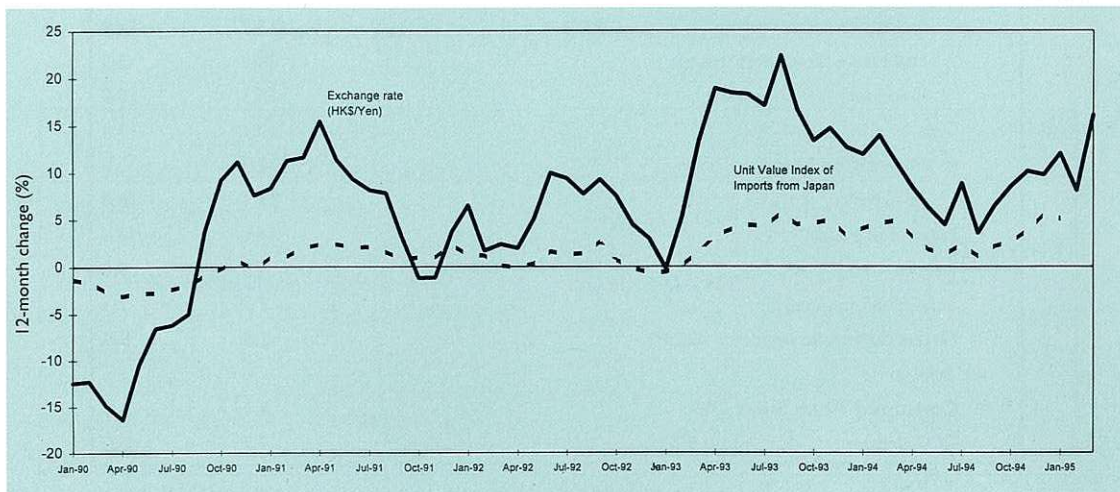


Chart 2
Prices of Imports from Japan and Exchange Rates of Yen



some of the impact of the strong Yen to maintain their market shares.

Thirdly, the retail prices of imported goods reflect more than just the prices across the docks. They also incorporate local transport, staff costs, shop rents and profit margins. The shelf prices of imported goods should therefore rise by less than the prices across the docks in response to exchange rate movements. This is especially likely at a time when retail sales have been slowing.

It should also be borne in mind that the overall impact on the cost of living should be less than the average increase in prices. Consumers can substitute goods whose prices have not risen as much.

Domestic activity

Retail sales remained subdued. Spending in restaurants in the December quarter of 1994 decreased by 11% when compared with the same quarter of 1993, and remained unchanged when compared with the previous quarter.

Given the strong 3% growth in the labour force, the weaker consumption expenditure is being reflected in a rise in unemployment. The seasonally adjusted unemployment rate rose to 3% during the 3 months to April 1995. The impact of weaker consumption on employment is however being moderated by the continued strength of investment expenditure, particularly in projects associated with the new airport. Fiscal policy is expected to be mildly stimulatory in 1995/96 before returning to surplus in subsequent years. (see Box)

Budget forecasts for 1995 foresee continued robust growth in real GDP, but with a greater contribution from net exports, and more stable inflation. (Table I)

External Trade

Export performance continued to improve. Domestic export volumes in the March quarter of 1995 were up by 13% compared with the same period in 1994. The improvement in domestic

Table I:
Macroeconomic Forecasts for 1995
(annual % change)

	1994	1995
(i) <i>Constant price national accounts</i>		
Private consumption expenditure	7.8	6.0
Government consumption expenditure	3.9	4.0
Gross Domestic fixed capital formation	13.1	10.2
transfer costs of land and buildings	-10.1	0.0
building and construction	15.3	14.9
real estate developers' margin	14.9	3.0
machinery and equipment	14.3	10.0
Total exports of goods	10.4	13.4
domestic exports	-2.3	2.0
re-exports	13.9	16.0
Imports of goods	14.1	13.4
Exports of services	7.5	9.0
Imports of services	7.7	7.5
Gross domestic product (GDP)	5.5	5.5
(ii) <i>Inflation</i>		
Consumer Price Index (A)	8.1	8.5
GDP deflator	7.7	8.0

Source: Hong Kong Government, 1995 Economic Prospects and 1995/96 Budget.

export performance was found in all major markets. Re-exports, especially to Japan, rose strongly also.

Total imports accelerated, rising by 27.5% in volume terms, in the March quarter, reflecting strong demand for both re-export and use for domestic production (imports of capital goods, raw materials and semi-manufactures were particularly strong).

The terms of trade continued to deteriorate as the HK dollar weakened in trade weighted terms.

Tourist arrivals reached a record high of 9.33 million in 1994. Arrivals in the first two months of this year grew 8.5% compared to the same period of last year. Japanese and European tourists together account for over a quarter of the market and their numbers are expected to increase as the strengthening of their currencies makes holidays here cheaper for them. ☺

— Prepared by the External Department

1995/96 Budget

On 1 March 1995, the Financial Secretary announced the 1995/96 Budget in the Legislative Council. A fiscal deficit of HK\$2.6 billion (less than 2% of government expenditure and less than 0.3% of GDP) is projected. Total public expenditure will rise to HK\$203.9 billion, 17.6% of GDP, up slightly from last year's 16.8%.

The 1995/96 Budget does not involve major changes in tax rates or additional spending. The maximum corporate tax rate remains 16.5% with a standard rate of 15% for salary tax. There was an increase from HK\$72,000 to HK\$79,000 in the income at which a single person is liable for income tax and similar concessions were given to married persons and those with dependants.

Hong Kong fiscal reserves will fall to HK\$145 billion in March 1996 because of the projected deficit in 1995/96, but are expected to rise with the budget surplus in the subsequent years to an estimated HK\$151 bn in early 1997.

Table 2:
Government Budget Estimates for 94/95 and Forecasts for 95/96 to 98/99

		94/95	95/96	96/97	97/98	HK\$ bn 98/99
Operating Statement	Revenue	150.6	159.0	177.8	206.6	241.3
	Expenditure	-109.2	-126.2	-145.3	-166.6	-191.0
Capital Financing Statement	Revenue	23.0	30.0	28.7	50.4	51.4
	Expenditure	-56.6	-65.4	-55.2	-57.1	-68.5
Surplus/deficits		7.7	-2.6	6.0	33.3	33.2
Consolidated	Fiscal Reserves	147.9	145.3	151.3	184.6	
Reserves	SARG Land Fund				142.9	
Total		147.9	145.3	151.3	327.5	360.7