There was a slowdown in the growth momentum of the industrialised world in the June quarter. The stock cycle caused a marked slowing in the US and monetary policy was eased. The Japanese authorities guided short-term interest rates lower while the German authorities left them unchanged following the cut in April.

The cut in US interest rates underpinned strong performances in US equity and bond markets. After the US dollar was boosted by international intervention at the end of May, the major exchange rates were relatively stable until July, when further intervention again lifted the dollar against the yen.

In China, inflation slowed down in the first five months of 1995. Speculative pressures emerged in bond futures and equity markets, and encouraged fund flows outside the banking sector. Financial reform continued with a new law on commercial banks.

OECD Economies

The outlook for economic growth in the major economies has deteriorated, although the causes differ (Chart 1). The seven rounds of interest rate increases initiated by the Fed from February 1994 to February 1995 appear to have restrained the US economy somewhat more abruptly than past experience would have predicted. Having grown at an average rate of around 1% per quarter during 1994, real GDP increased by 0.7% in the March quarter and a mere 0.1% in the June quarter.

The slowdown in economic growth during the March and June quarters was mainly attributed to lower growth in consumer spending, especially on durables, and exports (primarily due to the decline in exports to Mexico) and falls in housing investment. Production was slowed markedly in the June quarter to reduce the rate of inventory accumulation, particularly in the motor vehicle industry.

Employment has appeared unusually quick to respond to the slower growth. Non-farm payrolls fell by 46,000 in May (initially reported as a fall of 101,000) following almost no change in April. In June employment rebounded by 250,000 but this still left it up by only 0.8% during the first half of 1995, half the pace of the three previous half-years. Employment rose a moderate 55,000 in July. The unemployment rate was 5.7% in July, compared to the five year low of 5.4% recorded in February. The slowdown in the US has already been reflected in a downturn in the Canadian economy, and if sustained is likely to dampen growth elsewhere.

In Europe a divergence is becoming apparent between the core hard currency economies (represented in the solid line in Chart 2 by a weighted average of Germany, France and the Netherlands) and those whose currencies have depreciated (represented by a weighted average of Italy, the United Kingdom and Sweden in the dashed line). The latter economies had shown weaker growth than the former before their devaluations but have since grown faster, led by solid growth in exports. While inflation remains moderate across Europe, prices are now rising faster in the countries with depreciated currencies.

The Japanese recovery is looking ever more tenuous. After falling 1% in the December quarter, Japan's real GDP rose by a mere 0.1% in the March quarter. While the Kobe earthquake affected the March quarter, the large fall in the previous quarter suggests an underlying weakness. Recently released economic data points to the strong yen hurting the manufacturing sector, although the *Tankan* survey showed some improvement in sentiment in the March quarter. The resolution of the trade dispute with the US should boost confidence to some extent.

Most indicators suggest the June quarter was also weak. Industrial production fell in April, May and June by a cumulative 2.2%. Housing starts fell

Chart 1

Forecast of Real GDP
Annual % change as reported in successive Economist polls

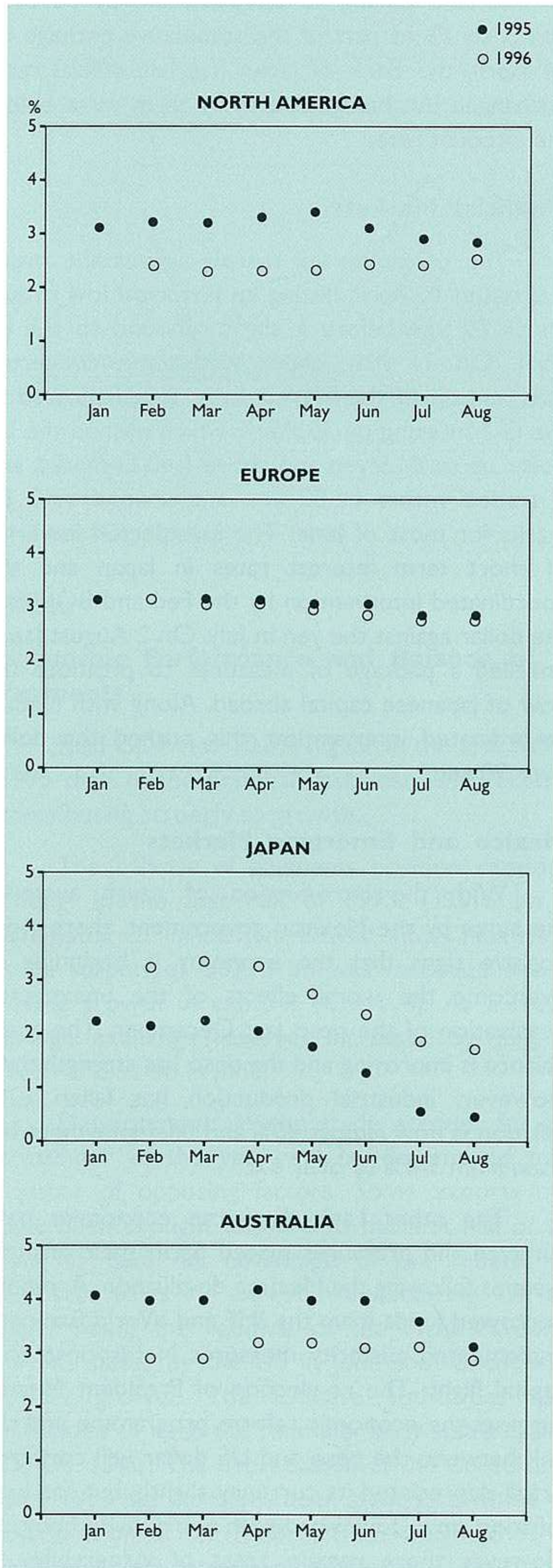
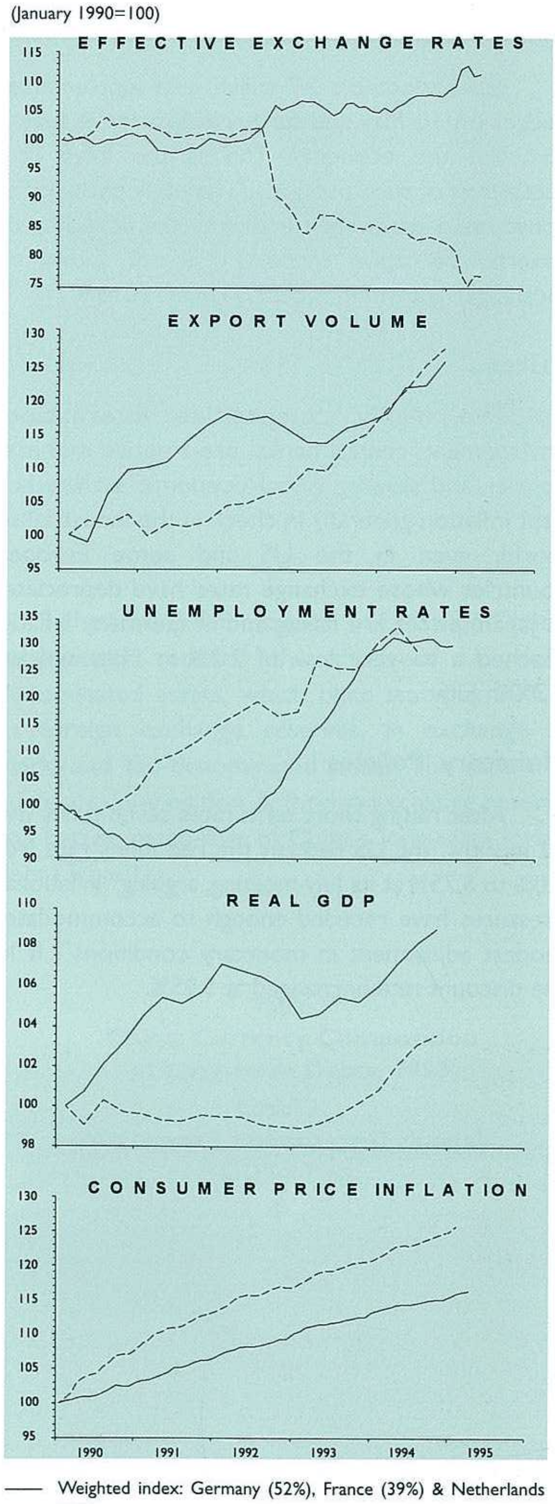


Chart 2

Europe Economies: Hard-vs. Soft-Currencies



—— Weighted index: Germany (52%), France (39%) & Netherlands (9%)

- - - Weighted index: Italy (48%), UK (45%) & Sweden (7%)

Source: Datastream

16% during the year to June despite interest rates falling to an historical low. Retail sales also fell over the year to June. The slowing of economic activity in Japan has resulted in a rise in the unemployment rate. This reached 3.2% in April and again in June with 2 million unemployed, the worst since 1953.

Japan adopted a 2.7 trillion yen supplementary budget on 10 May and further measures in June to stimulate the economy. This is the latest in a succession of such packages. The early packages did constitute a significant stimulus to the economy, but government capital spending has not shown any meaningful growth in recent quarters (Chart 3).

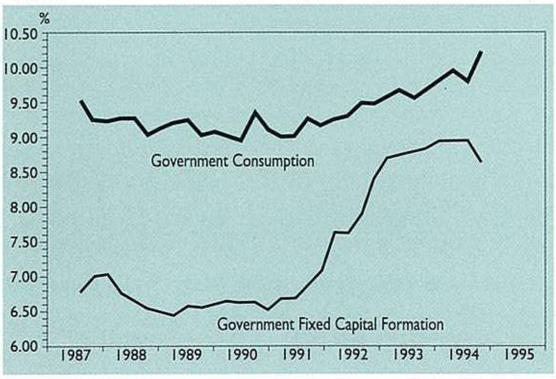
Prices

The highly competitive international environment, central banks' pre-emptive monetary policies and slowing global economic activity have kept inflation generally in check in the industrialised world, even in the US and some European countries whose exchange rates have depreciated. In Japan, prices are falling and in Germany inflation reached a six-year low of 2.2% in May, and was 2.3% in July.

Monetary Policies

After raising short term rates seven times over 12 months, the US Fed cut the Fed funds rate from 6.0% to 5.75% at its July meeting, arguing "inflationary pressures have receded enough to accommodate a modest adjustment in monetary conditions". It left the discount rate unchanged at 5.25%.

Chart 3
Japan's Government Expenditure as % of GDP



Source: DATASTREAM

With the strong D-mark reducing fears of incipient inflation and M3 growth still well below the target range, the Bundesbank left its interest rates unchanged.

Since reducing its discount rate by 75 basis points to 1% as part of the stimulative package on 14 April, the Bank of Japan has left official rates unchanged but has guided short term rates below the discount rate.

Financial Markets

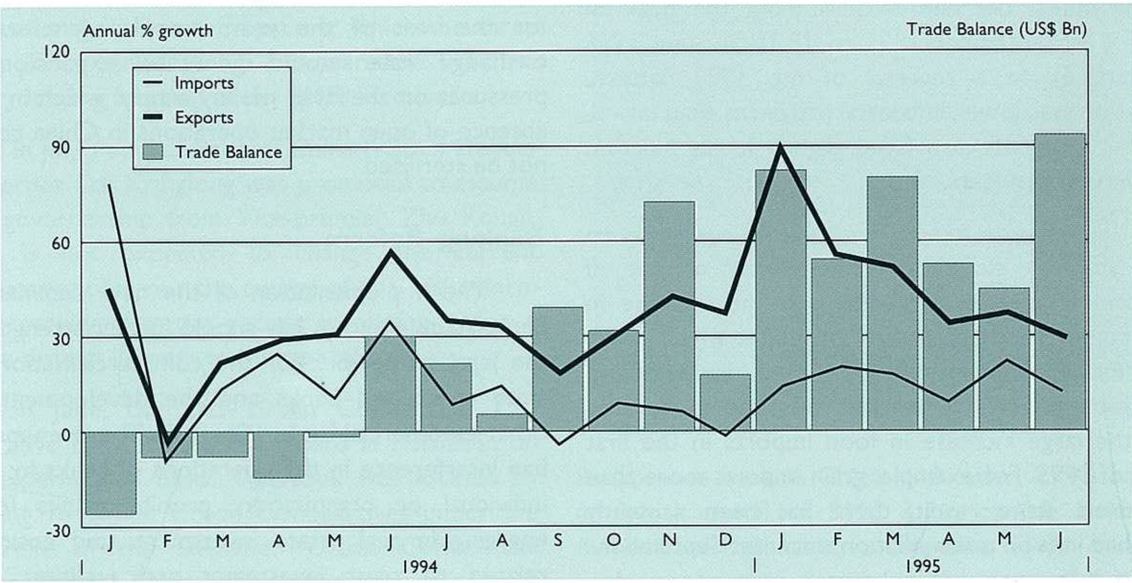
The US dollar fell sharply against the major currencies in April, hitting an historical low of just under 80 yen before a slight rebound to the 83 level. On 31 May, there was some concerted intervention in the FX markets, foreshadowed at the G-7 meeting on 25 April, which pushed the US dollar up to 84.5 yen and above 1.40 D-marks; and it traded within 84-85 yen and around 1.40 D-marks for most of June. The unexpected lowering of short term interest rates in Japan and the coordinated intervention by the Fed and BOJ lifted the dollar against the yen in July. On 2 August Japan unveiled a package of measures to promote the flow of Japanese capital abroad. Along with further co-ordinated intervention, this pushed the dollar over 90 yen.

Mexico and Emerging Markets

With the introduction of tough austerity measures by the Mexican government, there were positive signs that the economy is beginning to overcome the worst effects of the unexpected devaluation of the peso last December. The trade balance is improving and the peso has strengthened. However, industrial production has fallen 12%, inflation is now almost 40% and unemployment has risen from 3-4% to over 6%.

The other Latin American economies have survived the pressures placed upon their financial systems following the Mexican devaluation. Argentina borrowed funds from the IMF and World Bank and implemented austerity measures in response to a capital flight. The re-election of President Menem suggests the economic reform programme and the link between the peso and US dollar will continue. Brazil depreciated its currency slightly but has kept inflation on a downward path and activity buoyant. However there remain areas of vulnerability in both economies.

Chart 4
China: External Trade



Source: China Monthly Statistics, Reuters

China

Economic Performance and Balance of Payments

Real GDP was 10.3% higher in the first half of 1995 than in the first half last year, with exports contributing strongly to growth.

The balance of payments position remained strong. In the first half of 1995, US$16 bn of foreign direct investment flowed into China and a trade surplus of US$13 bn was recorded due to strong growth in exports (Chart 4). As a result, foreign exchange reserves increased by 21% to reach US$63 bn in June.

Developments in the trade account for the remainder of the year will be determined by a number of opposing factors. Some exports may have been brought forward to the first half of the year to take full advantage of tax rebates on imported parts for export manufacturing. On the other hand, the renewal of the Most Favoured Nation status by the US in June should underpin export growth. The Chinese authorities have continued to keep the renminbi fairly stable against the US dollar. The depreciation of the US dollar in early 1995 has therefore been associated with a 4% depreciation of the RMB in trade-weighted terms in the first six months of this year (Chart 5) and this should boost China's exports.

The State Administration of Exchange Control substantially reduced the share of US dollar denominated assets, which once stood at 90%, in its foreign exchange reserves, in exchange for Mark- and Yen-denominated assets. This meant the currency composition of foreign exchange reserves will better match that of China's long-term foreign debt (Table 1).

Table 1
China: Currency Composition of Long-term Debts, 1993

Currencies	Percent
U.S. Dollars	54.2
Japanese Yen	21.0
Deutsche Mark	1.0
Pound Sterling	0.3
French Franc	0.3
Multiple Currency	20.6
Special Drawing Rights	0.2
All Other Currencies	2.4
	100.0

Source: World Bank, World Debt Tables, 1994-95

Inflation and Money

Inflation, as measured by the 35 cities cost-of-living index, declined steadily from the peak of 27.5% in September 1994 to 18.1% in June 1995 (Chart 6). In a reversal of the 1993 pattern, inflation was lower in coastal provinces than inland. Urban residents also faced slightly lower inflation than rural residents.

Supply-side factors contributed the most to the inflation slowdown. The effects of one-off factors like floods, droughts and the increase in procurement prices of farm products, which drove up food prices in mid-1994, had dissipated. In addition, food price inflation was also moderated by the large increase in food imports in the first half of 1995. For example, grain imports more than doubled. As a result, there has been a steady decline in food price inflation since last September.

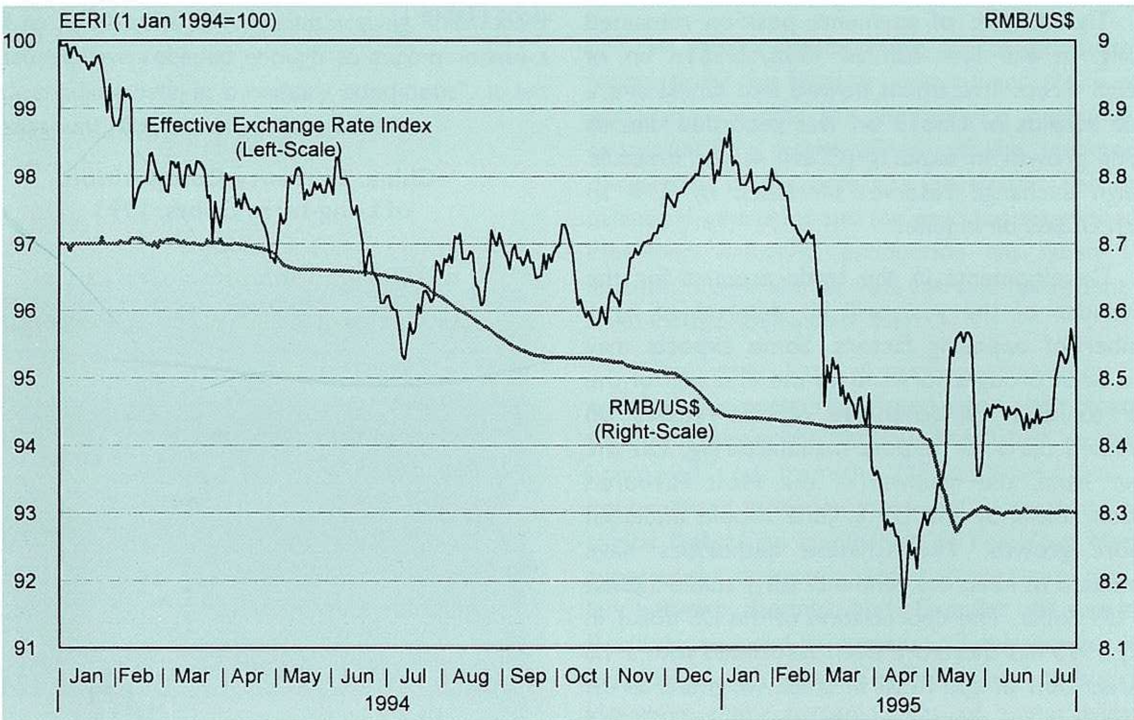
The M2 measure of the money supply grew by 33% over the year to June. Continued restrictive monetary policy is probably needed to bring inflation down to the 1995 official target of 15%, but there are entrenched difficulties. There is a continuing need for policy loans to keep the loss-ridden state-owned enterprises afloat. Furthermore, if the balance of payments position remains strong for the rest of the year, maintaining a stable exchange rate would generate expansionary pressures on the RMB money supply, which in the absence of open market operations in China could not be sterilised.

Banking Reform

The implementation of the new *Commercial Banking Law* (box) in July should further strengthen the legal framework for the commercialisation of state specialised banks and the development of other commercial banks (Chart 7). The law aims to ban interference in the operations of banks by any individual or organisation; prohibit banks from engaging in real estate investment, and business related to trust investment and equities; and stipulates an 8% capital adequacy ratio and a ceiling for loans of 75% of deposits.

Even after the new law is in place, the development of commercial banks will still depend

Chart 5
China: Exchange Rates



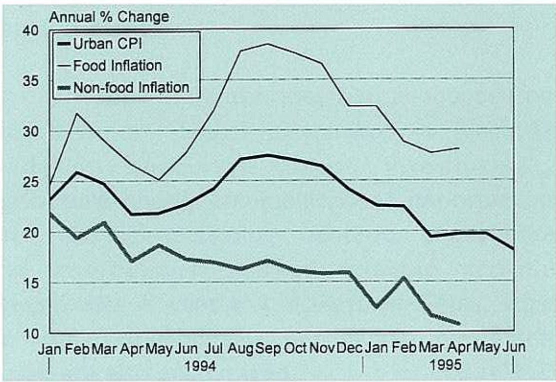
Source: HKMA calculations based on data from Datastream on the settlement of bad debts accumulated by the state specialised banks, the establishment of management structures and the acquisition of professional staff and the pace at which the three state policy banks[1] set up last year take over the policy lending function of the specialised banks.

In July, Peoples' Bank of China (PBoC) Deputy Governor Dai Xianglong was promoted to assume the governorship from Vice-premier Zhu Rongji. This is not expected to change the current monetary policy nor the course of financial reform but complements the recent legislation giving a more distinct identity to the central bank.

In June, the first Urban Commercial Co-operative Bank started operations in Shenzhen on an experimental basis. The bank was formed by putting 16 Urban Credit Cooperatives under the umbrella of the Shenzhen Urban Commercial Cooperative Bank. Governed by the new Commercial Banking Law and headed by a central bank official, the new bank will be subject to interest rate regulations from which the Urban Credit Cooperatives are exempt. The formation of this new class of banks should make loans more accessible to smaller enterprises and non-state enterprises which do not have good access to large state banks. In addition, their larger capital base should make them an alternative fund-raising channel for large state-owned enterprises which have been confined mainly to large state banks.

A further stimulus to competition in the banking industry came from the prospective establishment of the People's Livelihood Bank, the first private bank in China in decades. It will have an initial capital of RMB 3 bn coming from a number of non-state enterprises. This bank's performance may determine the pace of future development of China's private banking sector.

Chart 6
China: Inflation



Source: China Monthly Statistics, Reuters

Other Financial Developments

China recently took steps to strengthen further the market orientation and widen the market coverage of its foreign exchange system. *First*, foreign-invested enterprises which are so far confined to the swap market will be allowed to trade in the inter-bank market. This should enhance these enterprises' foreign exchange trading through the provision of a much larger market and more predictable exchange rates. *Second*, the Japanese Yen has been introduced as the third trading currency in March 1995 (the US dollar and HK

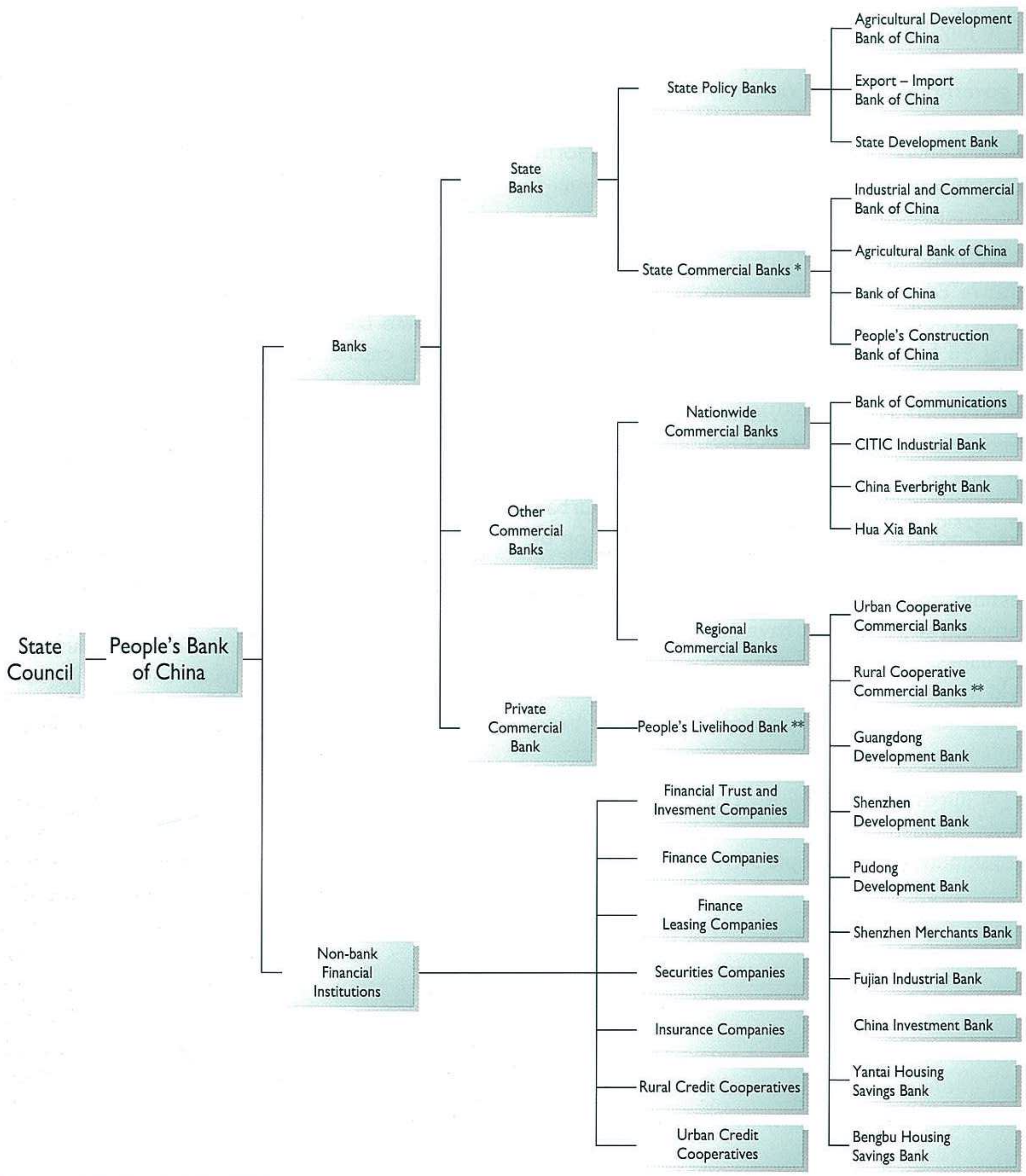
Table 2
China: Total Assets of Financial Institutions (RMB bn)

	1986	1988	1990	1992	1993	1994
Total Assets	1027	1465	2225	3421	4164	4902
(% to GDP)	(106)	(104)	(126)	(143)	(133)	(112)
Banks	889	1213	1851	2725	3462	4148
NBFIs*	138	252	374	696	702	754
Urban credit cooperatives	3	20	37	111	117	134
Rural credit cooperatives	106	149	219	354	339	417
Trust and investment companies	29	83	118	231	246	203

* Excluding finance and securities companies
Source: World Bank, People's Bank of China

1 Agricultural Development Bank of China, Export-Import Bank of China, and State Development Bank.

Chart 7
China: Financial Institutions, 1995



** State specialised banks before 1994.*

*** To be formed.*

Source: Various. Mainly from China Financial Outlook '95 dollar being the other two). More foreign currencies are expected to be added later. *Third*, the national inter-bank trading network was expanded to 25 cities in April 1995. Trading volume has been increasing steadily.

High inflation, and low fixed deposit and loan interest rates in the banking sector, helped channel investment as well as speculative funding into treasury bond futures and equities, resulting in volatility in these markets.[2] Irregularities in the trading of treasury bond futures led to trading suspensions in February and May. Funding has also been diverted from the interest rate-regulated banking sector to the less regulated non-bank financial institutions (NBFIs).

The suspension of treasury bond futures trading in May shifted investment funds into the equity market. As a result, stock market indices shot up by more than 50% during 18-22 May before most of the gain was dissipated in June and July.

The persistent large differences between official loan rates and "free market" rates have led to the phenomenon of "extra-body loans" whereby some domestic and foreign funds are channelled outside the regulated banking sector and loaned at rates far above the official ones. This phenomenon, which emerged in 1993 and has continued up to 1995, has weakened the central bank's monetary control. In response, the State Administration of Exchange Control launched in March 1995 the first nation-wide inspection of the foreign exchange positions of foreign-funded enterprises to control the inflow of speculative capital into China.

NBFIs, which have grown rapidly in recent years as a result of government policy to reduce the dominance of state banks, have played an important role in making these "extra-body loans" based on both domestic and foreign funding. From 1986 to 1994, while total assets of financial institutions rose 366% (Table 2), those of trust and investment companies rose 7 times and those of Urban Credit Cooperatives expanded by a phenomenal 41 times due to the higher interest rates they offered and the rapid increase of incomes of urban residents. However, the NBFIs are neither constrained by the state credit plan nor subjected to the interest rate restrictions which apply to banks.

The Chinese authorities also announced new guidelines on foreign investment in June. The guidelines encourage foreign investments in agriculture, energy, communications, important raw materials, high technology, utilisation of resources, and international market oriented activities. Investments in central and western China, where economic development lags behind the eastern coast, are also encouraged.

Impact on Hong Kong

As the Fed left the discount rate unchanged when it cut the Fed funds rate on 6 July, the HKMA decided to keep the LAF rates unchanged and there was little change in interest rates set by domestic banks. The weak US dollar continued to weigh on the effective exchange rate of the HK dollar and has caused some rise in imported inflation.[3] However, it has enhanced the competitiveness of Hong Kong exports.

In addition to the bullish US stock market, the expectation of a rate cut in the US as a result of a slowing US economy has led to a rebound in the Hong Kong stock market and helped stabilise the falling property prices.

On the trade front, the strong export performance in China has contributed to the recovery in Hong Kong's exports, in line with the trend in recent years. On the financial front, China has made increasing use of Hong Kong's financial markets to finance its rapid economic development. 17 major state-owned enterprises have tapped Hong Kong's equity market as of July 1995 through the issuance of H-shares and raised some HK$19 bn. At the national level, Chen Yuan, PBoC's Deputy Governor, suggested recently[4] that China will make increasing use of Hong Kong's debt market for fund raising. ❀

– Prepared by the External Department

2 An "interest subsidy" is paid on bonds of maturity three years or longer to compensate for the erosion of their value by inflation. Uncertainty about the magnitude of this adjustment also fuelled speculative activity in bond futures.

3 For reasons why this effect is likely to be relatively modest, see "The Domestic Environment" in the May 1995 issue of the *Quarterly Bulletin*.

4 In a speech reproduced in this issue of the *Quarterly Bulletin*.

Some Important Provisions of the "Commercial Banking Law of the People's Republic of China"

Article 1 — This law is formulated to protect the legitimate rights and interests of commercial banks, depositors and other clients, standardise the behaviour of commercial banks, improve the quality of funds, strengthen supervision and administration, ensure safety and soundness of commercial banking, maintain a normal financial order and promote the development of the socialist market economy.

Article 3 — The business scope of a commercial bank is defined by the statute thereof and reported to the People's Bank of China (PBoC) for approval.

Article 10 — A commercial bank shall be subject to supervision and administration by the PBoC in pursuance of the law.

Article 11 — The establishment of a commercial bank shall require the examination and approval by the PBoC.

No organisation or individual shall receive money deposits from the public or do any other businesses of a commercial bank or use the title of "bank" without the approval of the PBoC.

Article 12 — The PBoC in examining the application for the establishment of a commercial bank should take into account the need for economic growth and the competition of the banking industry.

Article 13 — The minimum registered capital for the establishment of a commercial bank shall be RMB one billion. Of the commercial banks, an urban cooperative commercial bank shall need a minimum registered capital of RMB 100 million and a rural cooperative commercial bank shall need a minimum registered capital of RMB 50 million. Registered capital herein referred to should be paid-up capital.

The PBoC may readjust the floor amount of the registered capital necessary for the establishment of a commercial bank in the light of economic development, but the amount shall not be lower than those specified in the previous paragraph.

Article 18 — A commercial bank solely owned by the state shall have a board of supervisors ... composed of representatives of the PBoC and governmental departments, experts from other relevant departments and representative of the staff of the bank.

The Board of Supervisors shall exercise control of the solely state-owned commercial banks over the quality of credit funds, the ratio of assets and liabilities, the hedging and appreciation of the state-owned assets and other relevant matters of the bank and the behaviour of its high ranking managerial personnel violating the law, administrative decrees and regulations or statute or acts damaging the interests of the bank.

Article 19 — A commercial bank may set up its branches within and outside the territory of the PBoC in keeping with its business needs. A branch thereof shall be set up with the approval of the PBoC.

Article 28 — Any organisation or individual intending to buy more than ten percent of the shares of a commercial bank shall have to obtain the approval from the PBoC.

Article 29 — A commercial bank in its savings deposit business shall abide by the principle of voluntariness in depositing, freedom of withdrawal, interest on every deposit and keeping secret for the depositor.

Article 31/38 A commercial bank shall fix its interest rates for deposits/loans pursuant to the ceiling and floor of interest rates defined by the PBoC.

Article 32 A commercial bank shall place a required reserve with the PBoC and keep adequate standby reserve in accordance with the stipulations by the PBoC.

Article 34 A commercial bank shall conduct its loan business in accordance with the need for the development of the national economy and social progress and under the guidance of the state industrial policy.

Article 36 A commercial bank shall extend a loan against a security, and conduct strict examination of the repaying capability, the ownership and value of the mortgage or pledge, and the feasibility of the realisation of the mortgage or pledge.

A borrower may be exempted from securities after the commercial bank has conducted examination and found it to have a high credit rating and to have the capability of repayment.

Article 37 A commercial bank shall sign a written contract with its borrower on the extending of a loan. The contract shall specify the category, usage, amount, rate of interest, date and form of repayment, default liabilities and other matters deemed as necessary by the two parties.

Article 39 A commercial bank in its loan business shall abide by the regulations on the ratios of assets and liabilities listed below:

(1) the capital adequacy rate shall not fall short of eight percent;
(2) the ratio of the outstanding balance of loans to that of deposits shall not exceed seventy-five percent;
(3) the ratio of liquid assets to liquid liabilities shall not fall short of twenty-five percent;
(4) the ratio of loans to one borrower to the capital of the bank shall not exceed ten percent;
(5) other stipulations by the PBoC on asset and liability management.

When a commercial bank which was established prior to the promulgation of this law is found to have its ratios of assets and liability at variance with the stipulations hereinbefore, it is required to conform to the stipulations within a designated time limit.

Article 40 A commercial bank shall not extend unsecured loans to related persons; and shall not provide related persons with secured loans on conditions more favourable than those to a borrower of a similar loan.

Article 41 No organisation or individual may force a commercial bank to extend a loan or provide guarantee for a loan. A commercial bank shall have the right to refuse any organisation's or individual's demand for a loan or guarantee.

A commercial bank owned solely by the state should provide loans for special projects approved by the State Council. Losses resulting from such loans shall be compensated with appropriate measures taken by the State Council.

Article 43 A commercial bank shall not engage in trust investment or stock business, or invest in real estate not for its own use.

A commercial bank shall not invest in non-bank financial institutions or enterprises within the PBoC. A commercial bank which has made investment in non-bank financial institutions or enterprises prior to the promulgation of this law shall be subject to other provisions stipulated by the State Council.

Article 45	A commercial bank shall apply for approval for issuing financial bonds or seeking loans outside China in accordance with the law and administration decrees.
Article 46	Inter-bank loan shall be subject to the time limit defined by the PBoC and the maximum time for such financing shall not exceed four months. It is prohibited to use call money to extend loans on fixed assets or to make investment.
Article 48	An enterprise or undertaking may open a principal account with a commercial bank of its own choice for day to day transfer and settlement of accounts and cash receipt and payment, but it shall not open more than one principal account.
Article 56	A commercial bank shall announce its business performance and audited statement of the previous fiscal year within three months after the end of every fiscal year in accordance with the stipulations of the PBoC.
Article 57	A commercial bank shall retain a reserve against bad and doubtful accounts and write off bad debts in pursuance of relevant state regulations.
Article 61	A commercial bank shall periodically submit to the PBoC balance sheets, profit and loss statements and other financial statements and information.
Article 62	The PBoC is authorised to exercise examination of and supervision over the deposits, loans, settlements and bad and doubtful accounts of a commercial bank at any time in accordance with the provisions of this Law.
Article 64	When a commercial bank is in or is liable to be in a credit crisis thus seriously threatening the interests of the depositors, the PBoC may take over the said bank.
Article 71	When a commercial bank is incapable of repaying its mature debts, it may, with the consent of the PBoC, be declared bankrupt by the People's Court. When a commercial bank is declared bankrupt in accordance with the law, the People's Court may organise the PBoC and other relevant departments and personnel to form a liquidation group to conduct liquidation. At the time of bankruptcy liquidation, a commercial bank shall give priority to paying the principal and interests of savings deposits after paying the liquidation fees and its staff wages and labour insurance fees in arrears.
Article 89/90	The relevant provisions of this law are applicable to urban and rural credit cooperatives in their deposit, loan and settlement businesses ... and the postal deposit and remittance business of postal enterprises.