

The monetary situation has been stable during the June quarter. The lowering of the US Federal funds target rate in July had no direct impact on domestic rates but the move suggests that the period of rising interest rates which started in early 1994 may have come to an end. The visible trade deficit continued to swell but closer examination of trade figures reveals a number of encouraging developments.

Monetary Situation

Domestic interest rates were generally stable after the last round of increases in February. Credit expanded slightly faster during the June quarter while deposit migration moderated.

The savings deposit rate and the best lending rate remained at 4.25% and 9% respectively. Although the US Federal Reserve lowered the Federal funds target rate by 25 basis points in July, they left the discount rate unchanged. As on past occasions, with the US discount rate steady, the HKMA did not move its Liquidity Adjustment Facility rates and there was no direct impact on domestic rates. However, the Fed move confirmed a gradual change in domestic sentiment towards the view that the monetary tightening cycle started in early 1994 had come to an end and that therefore both US and domestic interest rates had peaked.

This change in sentiment led to domestic credit demand picking up in the June quarter. Total HK dollar loans extended by authorised institutions grew by 3.9% during the quarter, up from a 2.4% rise in the March quarter. Loan demand from trading firms was strong as trading conditions were buoyant during the quarter. Residential mortgage loans, which had been quite weak since mid 1994, also recorded faster growth in the June quarter to be 12% higher than a year ago. Loan demand from the construction industry, however, remained subdued. Loans to financial concerns (other than authorised institutions) fell by 3% in the quarter.

Reflecting the acceleration in credit, the broad money supply, HK\$M3, also registered faster growth. On the other hand, narrow money, HK\$M1, fell by 2.6%. The divergence in the growth of the two definitions was partly related to weak private consumption.

The deposit migration resulting from the earlier interest rate rises and the partial removal of

the interest rate cap on time deposits moderated. Savings deposits began to trend upwards again in the last few months while the decline in swap deposits eased (Chart 1). Given the apparent peaking of US interest rates and hence their local counterparts, the migration is likely to slow further in the coming months. Beyond that, developments will reflect the decision to be taken later in the year on further deregulation.

Asset Markets

Performance in the asset markets was mixed. The local stock market was boosted by the changed sentiment on interest rates, the bullish performance of the US stock markets and improved Sino-British co-operation shown in the agreement on the Court of Final Appeal and the finalising of the financing arrangements for the new airport programmes. The Hang Seng Index has stayed above the 9 000 level since early May.

The property market became quiet again after a brief rebound immediately following the Chinese New Year. Transactions in the second hand market were sluggish. In some popular areas, flat prices reportedly fell up to 10% to 15% during the year to the June quarter (Chart 2). In the primary market, developers sold their flats at very attractive prices and favourable payment terms such as providing additional mortgage finance up to 90% of the selling prices. In a number of large projects, the sales were boosted by intensive marketing and promotion campaigns.

Inflation

Consumer inflation moderated slightly in the June quarter. Consumer prices rose by 9.2% over a year earlier compared to the 9.5% increase in the March quarter. Inflation in the September quarter is likely to slow down further as the exchange rate of the US dollar, and hence the HK dollar, against other major currencies has become more stable. In

Chart 1
HK dollar Deposits Growth

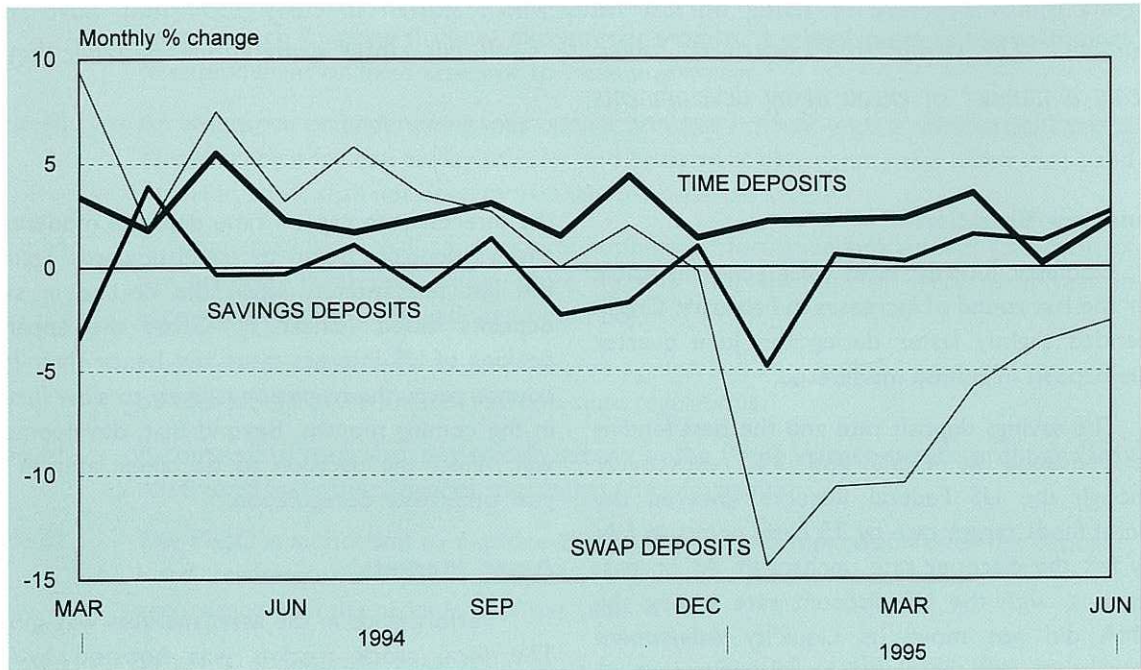
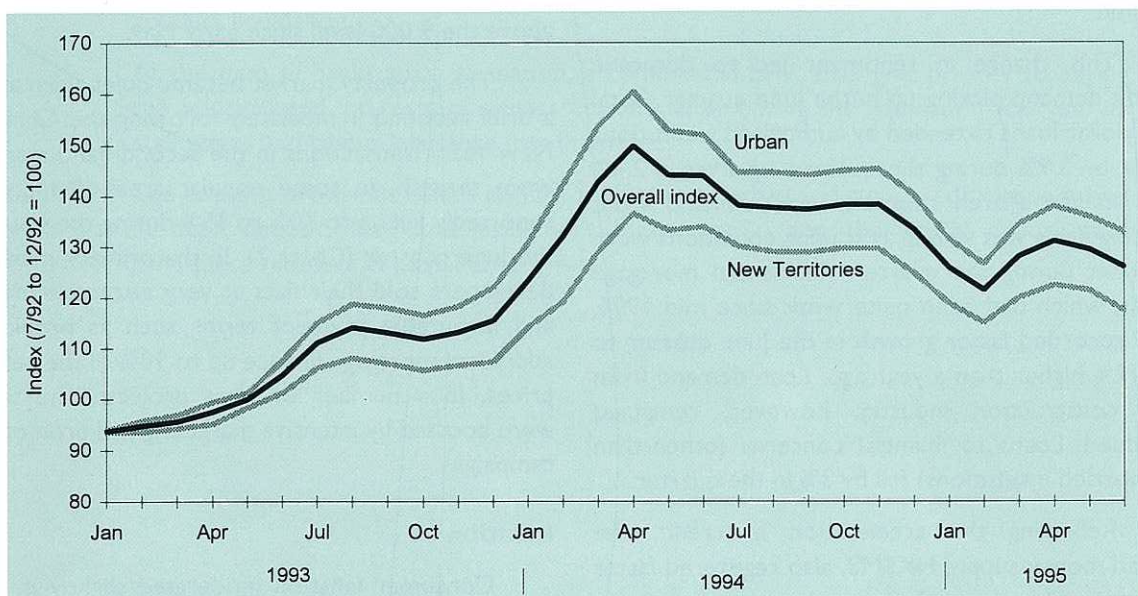


Chart 2
Price Indices for Major Residential Units



Source: Rating & Valuation Department

addition, locally generated inflation will be constrained by the weaker labour market and the modest consumption demand.

External Trade

The strong export performance, which started in the second half of 1994, continued into the June quarter of 1995. The rapid growth in exports was however accompanied by an even faster growth in imports. As a result, the visible trade deficit during the first half of 1995 accumulated to HK\$88 bn, almost double the figure for the same period of 1994. The swelling deficit has raised concerns about the trade account. A closer examination of the trade figures revealed that there are a number of encouraging developments and the situation is far from pessimistic. First, the performance of both domestic exports and re-exports has been very good. Domestic exports in the first half of 1995 were 9% higher than the same period in 1994, whereas re-exports were 20% higher. This represents a much better performance than in 1994 when the corresponding growth rates were -0.4% and 15% respectively.

Second, the recent weakening of the US dollar, and hence the HK dollar, should further improve the price competitiveness of Hong Kong's exports in the coming months. The HK dollar depreciated by 13% against the Yen during the first seven months of 1995. Past experience suggests that HK's exports respond to exchange rate movements with a lag of one to two quarters. The exchange rate effect should stimulate exports and help moderate the visible trade deficit in the second half of the year.

Third, the acceleration in imports has been mostly for production rather than for consumption. The latest statistics showed that the growth of retained imports of raw materials and capital goods in the March quarter of 1995 was exceptionally strong compared to the previous quarters. The rapid increase in imports is in part due to the new airport project which would only have a one-off

effect in contributing to the visible trade deficit during the course of its construction and would not lead to a deteriorating trend in the deficit. The completion of the new airport will greatly enhance Hong Kong's economic efficiency and sustain future export growth. Apart from the airport project, the strong import growth in raw materials and capital goods also reflect more intensive private sector investment and production. On the other hand, the real growth of imported consumer goods for domestic use was more moderate, consistent with the subdued retail sales.

Fourth, the structural transformation of Hong Kong from a manufacturing-based to a service-oriented economy, with the relocation of labour-intensive activities to the mainland, implies a concurrent shift from manufacturing to service exports. The large increase in the shift from re-exports to transshipment in 1994 is one sign of such a structural change. However, the negative impact of such a trend on Hong Kong's visible trade balance should be offset both by increases in the exports of trade related services and through higher factor income from Hong Kong's investments in the mainland. A clearer assessment of the situation will be possible when the first set of GNP data is published by the Census and Statistics Department later this year.

Labour Market

The labour market has eased with unemployment standing at around 3%. While ongoing structural change is causing some skill mismatches in the market, the slow-down in domestic consumption and the rapid increase in the labour force last year also contributed to the rise in unemployment. During the three months to May 1995, total employment rose by 3.6% over a year earlier while total labour supply increased by 4.4%. The fast increase in labour supply is partly due to the growing number of returning migrants. ☉

– Prepared by the External Department