

THE DOMESTIC ENVIRONMENT

The domestic economy shows signs of recovery, with most sectors which were weak in 1995 beginning to pick up. Export growth slowed further but a stronger performance is expected for the coming months. The property market further rebounded. Whilst HK\$M3 has been slowing, its growth remains largely in line with that of nominal GDP.

Domestic Activity

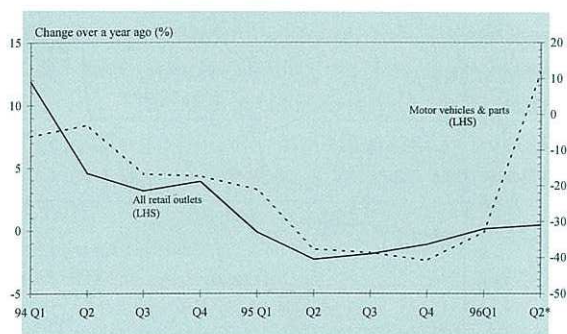
Most of the domestic sectors which were weak in 1995 have begun to recover in recent months. In particular, retail sales in the June quarter were higher than a year ago (Chart I). In earlier months, retail sales of most consumer goods and services registered some increases while the fall continued to concentrate in 'big-ticket' items, such as motor vehicles and other consumer durables, in part an adjustment to the high level of spending on these items in the previous few years. Since March, however, the sales of motor vehicles have improved. The moderate recovery in consumer spending is expected to continue in the latter part of 1996, underpinned by the recent pick-up of property prices and a stable labour market.

Private sector building has picked up along with the reviving property market while public sector construction and investment in capital equipment remained strong, supported by infrastructural projects. With more buoyant growth expected in the domestic sectors in the second half, economic growth this year will be more broadly based than last year.

External Trade

Growth in external trade slowed further in the June quarter, with exports up by 3.1% in value terms compared with a year ago. Similar to the trends in recent months, the value of re-exports rose by 5.8%, but that of domestic exports fell by 10.1%. Export growth has been weaker so far this year than last year, partly due to slower demand from the US market. As over half of Hong Kong's re-exports originate from China, the slow-down in China's exports due to the cut in value-added tax rebates was also significant. The strengthening of the HK dollar since mid-1995 against major non-US dollar currencies has hampered Hong Kong's export competitiveness. However, the adverse impact may not be as severe as the changes in nominal exchange rates indicate. The real effective

Chart I
Retail Sales Volume



* based on April and May data.

exchange rate index constructed by using prices of tradables (see Box) has remained largely steady, reflecting productivity gains and slower rises in production costs as well as a possible reduction of export margins.

Trade should, however, pick up in the second half of this year on more buoyant overseas demand stemming from sustained economic expansion in the US and a continued recovery in European and Japanese economies. In addition, China's progressive reduction of import tariffs, as well as a revival of China-Taiwan trade – the bulk of which passes through Hong Kong – should also contribute.

During the June quarter, import growth slowed further to 0.4% in value terms. The marked deceleration was largely due to a large fall in retained imports of 7.5%. Due to the slow-down in import growth, the visible trade deficit narrowed to \$84 bn (11.4% of total imports) in the first half of 1996, from \$88 bn (12.4%) in the first half of 1995.

Labour Market

The labour market improved slightly in the June quarter, with the unemployment rate edging down to 3.1%. A healthy gain of 2.9% was

Chart 2
Real Effective Exchange Rate Index

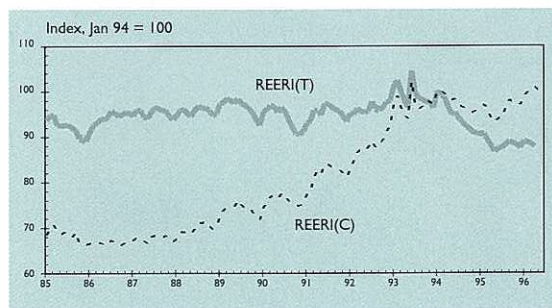
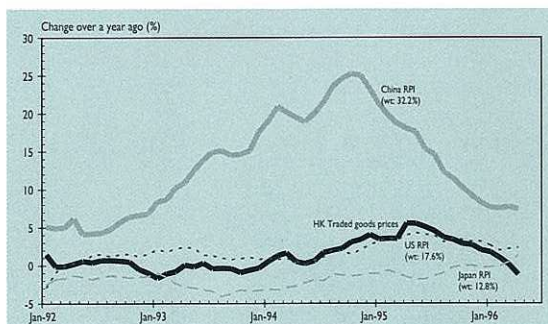


Chart 3
Traded goods Prices



registered in total employment in the year to the May quarter, against a 3.3% rise in total labour supply. With the expected pick-up in economic activity during the year, employment should rise faster, allowing the unemployment rate to drop further (Chart 4).

Inflation

Inflation, as measured by CPI(A), averaged 6.6% in the June quarter, with an underlying decline continuing⁽¹⁾. Prices of tradable goods were largely contained by moderate consumer spending, a stronger HK dollar, and lower inflation in China,

Box:

Real Effective Exchange Rate Indices⁽²⁾

One measure of an economy's trade competitiveness is the real effective exchange rate index (REERI). The index is constructed by taking the weighted average of the percentage changes in real exchange rates of the HK dollar vis-à-vis the currencies of its major trading partners⁽³⁾. A rise in the REERI could be due to a nominal appreciation of the HK dollar or more rapid inflation in Hong Kong than in its trading partners.

Chart 2 shows two series of REERIs, which differ from each other in the choice of price indices. The REERI(C), which is based on the consumer price index, exhibited an uptrend over the past decade and continued to rise so far this year. This was attributable to the faster growth in consumer prices in Hong Kong than in other major trading partners. However, it is inappropriate to conclude that the increase in REERI(C) represents a loss of competitiveness in international markets. The higher consumer price inflation in Hong Kong was largely fueled by higher prices of non-tradables⁽⁴⁾.

The other series, REERI(T), makes use of traded goods prices instead, and is considered to be a more relevant measure of the competitiveness of domestic exports. Since mid-1995, the nominal effective exchange rate index rose along with the appreciation of the US dollar (and hence the HK dollar) against other major currencies. The REERI(T) remained rather stable, however, as this appreciation was largely offset by less rapid rises in prices of tradables in Hong Kong than in China and the US, and also lately than in Japan (Chart 3).

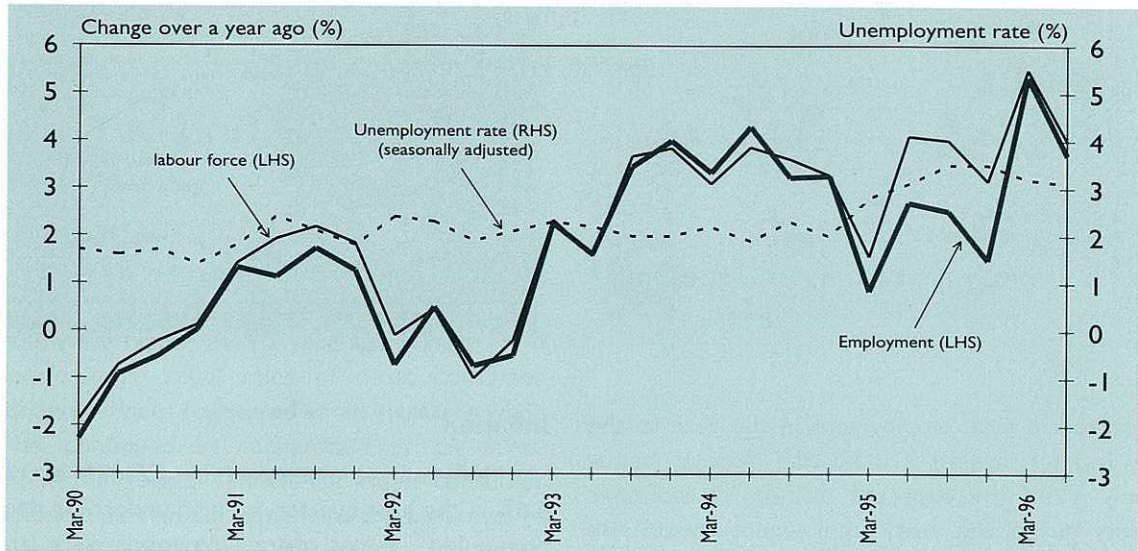
(1) For a more detailed discussion, see "Analysis of Inflation in Hong Kong" in this issue of the *Quarterly Bulletin*.

(2) These indices are constructed by the HKMA and are not official government figures. From October 1996 they will be published regularly in the *HKMA Monthly Statistical Bulletin*.

(3) For a more detailed discussion, see "Real and Effective Exchange Rates" in the November 1995 issue of the *Quarterly Bulletin*.

(4) Please see footnote (1).

Chart 4
Labour Market



* Growth rates of employment and labour force are for the May quarter

while the easing of inflationary pressure from wages and rents also kept prices of services in check. For the second half of this year, the rebound in property prices and a further recovery in consumption demand may start to exert some upward pressure, but steady inflation in Hong Kong's trading partners should continue to help restrain prices.

Asset Markets

The rebound in the residential property market, which started late last year, continued into the June quarter with further improved market sentiment. Buoyed by the more competitive mortgage rates and attractive payment terms offered by banks and developers, the response to primary sales of flats has been favourable, and trading activity in the secondary market picked up, with the number of sale and purchase agreements surging by 23% during the quarter. The growth of residential mortgage loans also accelerated from an annual rate of less than 10% in October 1995, to over 16% in June 1996. Property prices rose further in the June quarter, to around 20% above their recent trough in October 1995. Nevertheless, they were still about 11% lower than the peak in April 1994.

The renewal of China's Most Favoured Nation trading status and the conclusion of the agreement

with the US on intellectual property rights in June boosted investors' sentiment, with the Hang Seng Index (HSI) rising to 11226 in early June. Also, new share flotations during the quarter were largely well received, with one of the issues oversubscribed by as much as 100 times. Market sentiment was, however, somewhat dampened in July and early August by uncertainties over the direction of US interest rates and the weakness in US share prices. The HSI eased to the 10700 level in mid-July, but recovered to hover around 11100 by mid-August.

Monetary Situation

Total deposits rose more slowly in the June quarter (Table 1). However, as the slow-down in non-US dollar foreign currency deposits reflects to a large extent exchange rate valuation effects, the underlying trend was a more moderate slow-down. The growth in HK dollar deposits during the year to June was broadly in line with that in nominal GDP and domestic credit expansion.

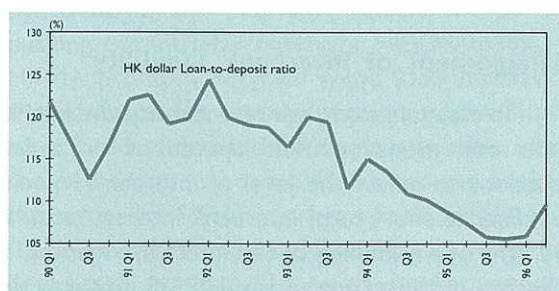
Total loans picked up during the June quarter, primarily due to a more rapid expansion in loans for use in Hong Kong, underpinned by buoyant residential mortgage loans and other property- and construction-related lending. Loans to most other sectors also rose strongly. In particular, spurred by two share flotations close to the end of June, loans to stockbrokers rose sharply, while loans for

Table I:
Financial Aggregates

Growth during period	Deposits				Domestic Loans				Offshore Loans	Total Loans	HK\$ Loan-to-deposit ratio (%)
	HK\$	US\$	non-US\$ F.C.	Total	Trade financing	Purchase residential property	Other property and construction-related lending	Other			
(% share of total*)	(55)	(22)	(23)	(100)	(5)	(10)	(8)	(22)	(55)	(100)	
1995 Q1	3.7	4.3	8.1	4.8	8.1	1.4	2.1	3.6	10.7	7.5	108.8
Q2	5.2	-1.9	7.6	3.9	12.2	5.8	1.0	2.0	14.1	9.8	107.4
Q3	3.6	0.7	0.8	2.3	-2.4	4.3	1.5	2.3	-6.7	-3.3	105.8
Q4	2.0	3.2	1.3	2.1	1.0	4.1	-0.4	2.9	-1.2	0.3	105.6
1996 Q1	3.8	0.3	3.3	2.9	3.1	4.2	6.5	2.0	-4.2	-1.0	105.9
Q2	2.9	-3.0	0.2	0.9	6.2	5.2	4.7	5.0	0.0	2.3	108.2

* as of end-June 1996

Chart 5
HK dollar Loan-to-deposit Ratio



Note: HK dollar deposits are adjusted to include foreign currency swap deposits.

wholesale and retail trade increased further in line with the gradual pick-up in consumer spending. On the other hand, while loans for trade financing registered a strong rise during the June quarter, they continued to decelerate in terms of annual growth, reflecting the slowdown in external trade. The value of offshore loans, meanwhile, contracted further, largely due to the weaker Yen as the bulk of these loans were booked by Japanese banks in Hong Kong.

The recent slow-down in HK dollar deposits, against the more rapid domestic credit expansion, has caused the HK dollar loan to deposit ratio to rise to 108.2 at end-June (Chart 5). ☺

— Prepared by the External Department