Economic conditions in the major OECD economies are heading towards moderate growth rates and tame inflation, although unemployment remains high. The US economy is slowing to a more sustainable growth rate. Continental Europe is picking up pace. The Japanese economy is improving, but it remains to be seen if recovery has established self-sustaining momentum.

Global inflation remains generally subdued. The rise in oil prices in the wake of the recent tensions in Iraq was relatively small and is unlikely to affect the inflation rate significantly.

With supply and demand developments favourable to maintaining inflation at its current low levels, monetary authorities in the G7 economies made little adjustment to policy rates. Bond yields generally eased back. Exchange rates were fairly stable with some gradual appreciation of the US dollar.

China sustained steady economic growth in the September quarter due to buoyant growth in state sector's fixed asset investment and consumer spending. With lower inflation, the Chinese government made another interest rate cut in August, by more than 100 basis points on average. The debt-ridden state enterprises continue to pose a challenge to policy.

OECD Economies

Activity

The gap between G3 economic growth rates narrowed as output slowed in the US and accelerated in Germany and Japan (Chart 1). In the former, real GDP growth at an annual rate slowed from 4.7% in the June quarter to 2.2% in the September quarter. Employment contracted in September and rose moderately in October with the unemployment rate rising to 5.2% from 5.1% in August. Forward-looking indicators such as the purchasing managers' index and factory orders also imply moderation. Furthermore, US personal bankruptcy filings exceeded a million in the 12 months to June, for the first time in history.

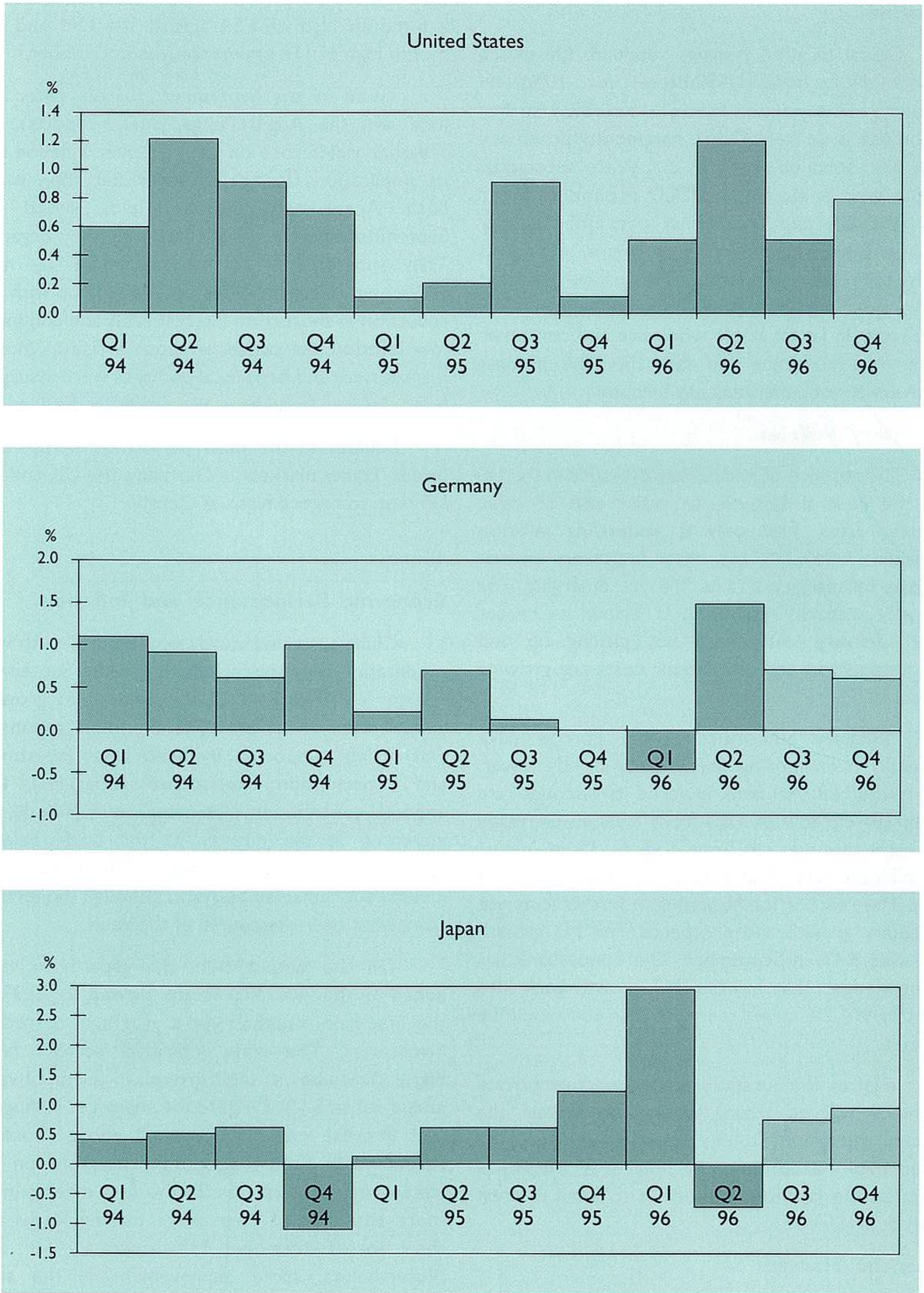
Monetary conditions should exert some restraining influence on the economy. With underlying inflation below 3%, the current level of the Fed funds rate – at 5.25% – in real terms is above the longer term average (around 2%). The same is true for real long bond yields.

Economic recovery is continuing in Germany. Real GDP rebounded by 1.5% in the June quarter after falling 0.5% in the March quarter. Industrial production, new orders, and surveys of the business climate all suggest that the economy continued to expand in the September quarter. Fuelled by some easing in the DM, further growth should be export driven – data on foreign orders suggest this is already occurring.

In Japan, a 3% annualised decline in June quarter real GDP followed the sharp 13% increase in the March quarter. Abstracting from this volatility, a recovery is evident but is still vulnerable. Consumer spending remains sluggish, although the rise in machinery orders indicates private investment is expanding. The August *Tankan* survey showed a relapse in business conditions for the manufacturing sector, unusual for this index, and sounding a cautionary note. Non-manufacturers have taken over as the key drivers of business investment.

Unemployment remains a blight on the economic landscape. While the rate of around 5% in the US is low by historical standards, it is still in excess of "full employment". In Japan, while the rate appears low, it is still a historical high for Japan and many commentators believe there is much

Chart 1
Quarterly Percentage Change in GDP



Note: Q396 and Q496 figures are forecasts "hidden" unemployment in the economy. European rates are high by any criterion; they have averaged over 10% since 1994.

Inflation

Global inflation remains subdued. Oil prices jumped by around US$2/barrel (or 10%) on renewed military action in Iraq. However, a further major rise is unlikely. Other commodity prices are generally subdued (Chart 2). With substantial output gaps in the major OECD economies other than the US, and uncertainty over job security holding down wage growth even there, inflation is likely to remain moderate. Maastricht-mandated fiscal rigour adds a further disinflationary impetus in Europe. In Japan, stable wholesale and consumer price data underline the fact that the modest recovery is not generating any inflation.

Monetary Policies

The absence of inflationary pressure in the US led the Federal Reserve to resist calls to raise interest rates. Not only is underlying inflation remaining below 3% but other indicators do not suggest inflationary strains are yet emerging. For example, capacity utilisation is below its recent peak, delivery delays are not picking up and producer prices and unit labour costs are growing moderately.

Monetary authorities across Europe have generally been moving policy rates slightly lower. The Swiss National Bank lowered its discount rate to an 18-year low of 1.0% from 1.5%. In Germany the repo rate was cut from 3.3% to 3% in August as inflation was clearly low and unemployment high. The reasons for hesitating in further cuts are monetary growth and prospects. The M3 growth rate was 8.4% in September. The Bundesbank has acknowledged that bringing M3 growth back into the target 4-7% target range by year-end would be difficult.

In Japan, the question remains whether private spending will be strong enough to sustain the nascent recovery. Doubts on this question, the absence of inflation and the fragility of the banks have led the Japanese authorities to keep interest rates at low levels.

Financial Markets

The ebbs and flows of sentiment on the economic outlook for the major economies and possible central bank decisions on interest rates dominated foreign exchange trading in recent months but conditions remained much less volatile than in 1995 (Chart 3). The US dollar advanced to a 5-month high of 1.54 against the DM and 42-month high of 115 against the yen in October.

Twice in the September quarter (after the June and the August employment reports), US Treasury yields rose on worries over inflation and its implications for policy rates but then eased back. Accordingly, 10-year yields ended the September quarter around the 6.7% they began it. They subsequently fell back to 6.2% by mid-November. German yields declined in line with the reduction in short-term interest rates and continued low inflation. As concerns about a rise in money market rates and large fiscal packages were assuaged, bond yields in Japan have also gradually declined.

Equities in the main performed better than bonds. Equity markets in Germany, the UK and the US rose to record highs in October.

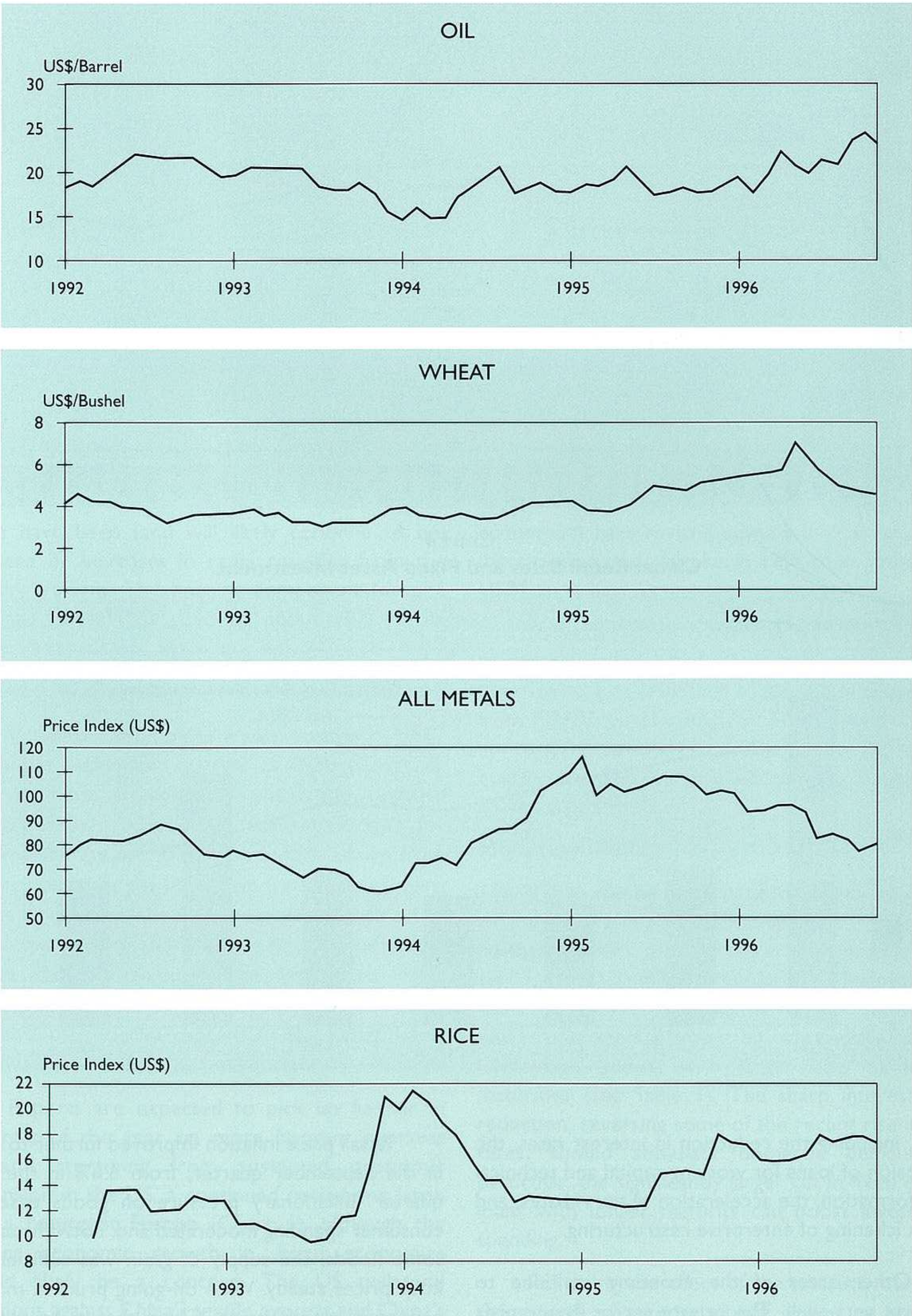
China

Economic Performance and Inflation

China sustained steady economic growth with moderating retail price inflation in the September quarter of 1996. Real GDP continues to grow at annual rates of almost 10%. Economic expansion was mainly supported by fixed asset investment and consumption expenditure (Chart 4). Net exports' contribution, albeit small in magnitude, has increased in the quarter as the trade balance improved. Both retail sales and fixed asset investment remained buoyant, although moderating somewhat over the course of the year.

On the output side, the growth in value added by the industrial sector slowed to 12.9% in the first nine months over a year ago, to reduce inventories. The state industrial sectors faced bigger difficulties as their growth in terms of value added fell to 5.5%. Despite the sharp cut in August, real interest rates remain well above those in recent years (Chart 5), putting pressure on the state-owned enterprises. In the first nine months, more than half of them were making losses and their losses rose by 23% over a year ago. Nevertheless, some improvement in the state enterprises sector can be expected as the State Council has adopted a number of measures to help

Chart 2
Commodity Prices



Source: Datastream

Chart 3

Large Economies: Nominal Effective Exchange Rates

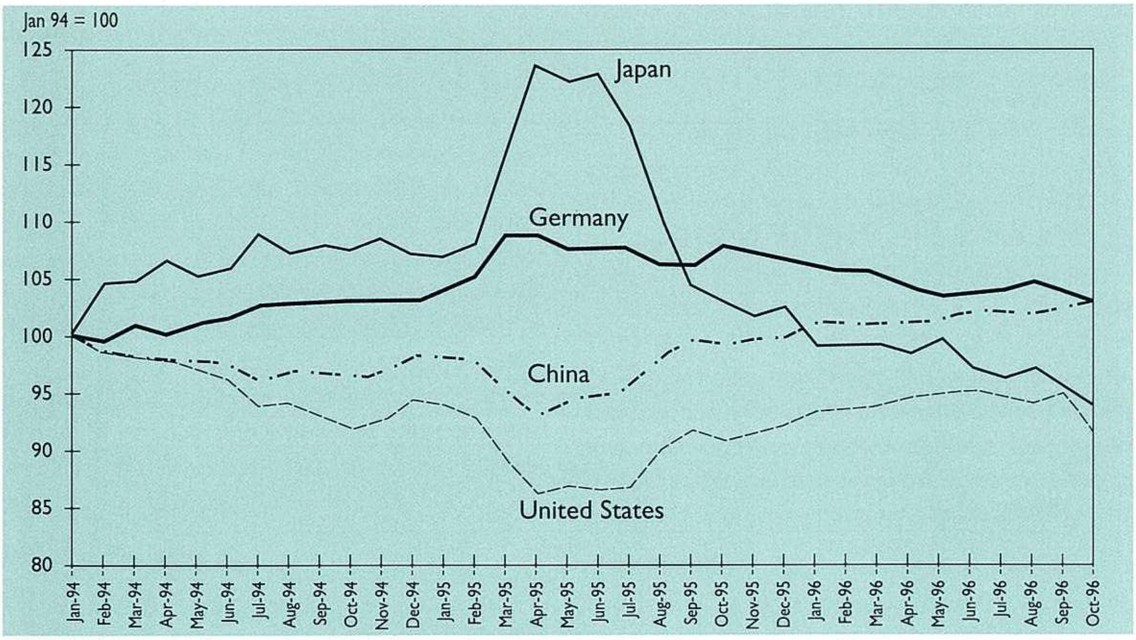
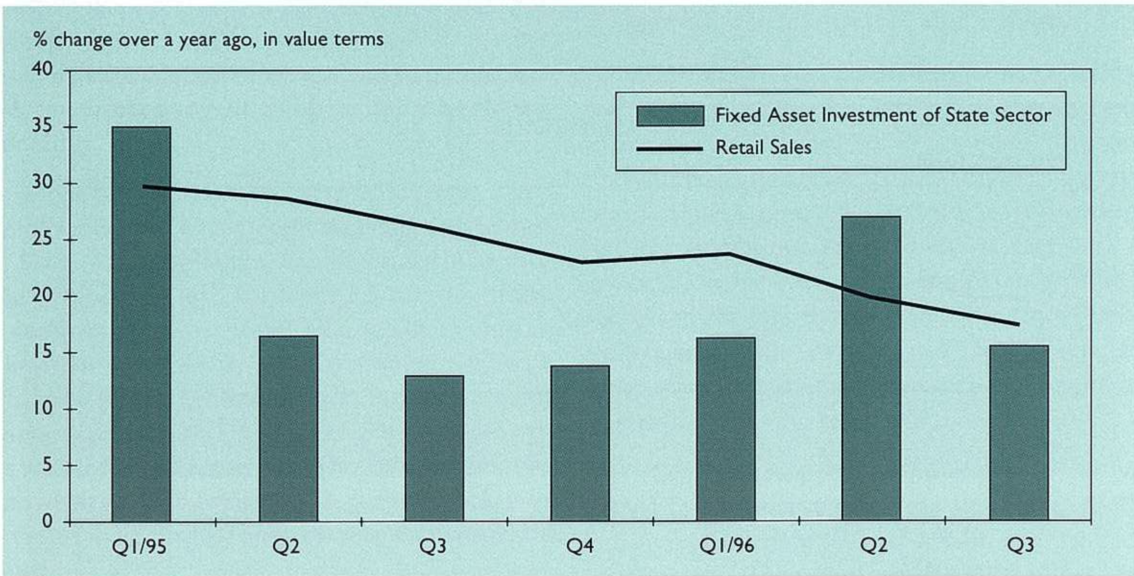


Chart 4

China: Retail Sales and Fixed Asset Investment

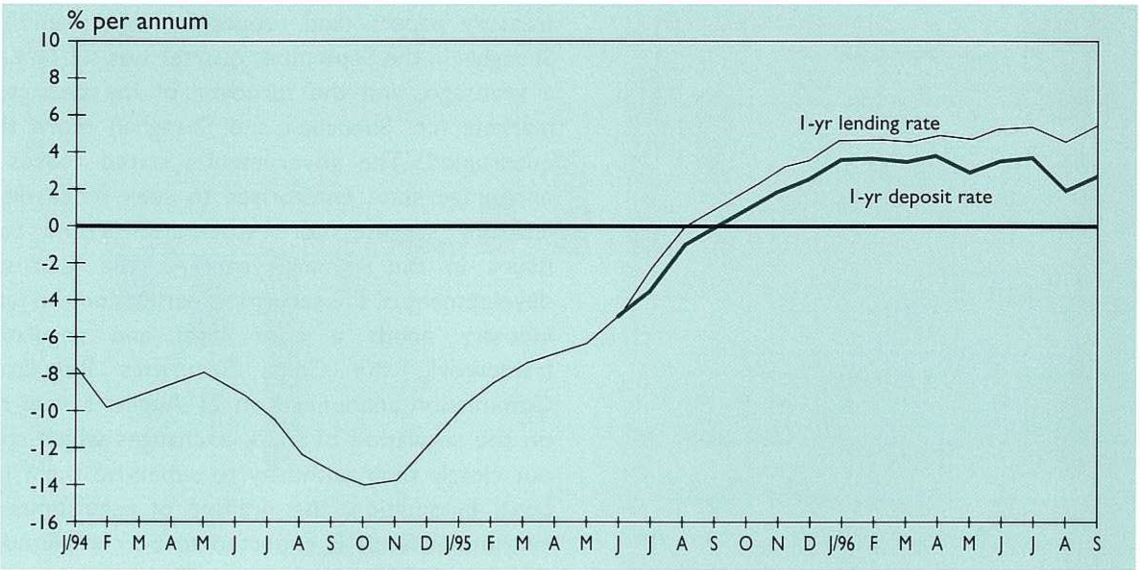


them, including the reduction in interest rates, the expansion of loans for working capital and technical transformation, the acceleration of tax rebates, and the quickening of enterprise restructuring.

Other areas of the economy continue to perform very well. The private sector economists had revised upward their forecast for GDP growth to 9.7% (Chart 6).

Retail price inflation improved further to 5.5% in the September quarter, from 6.6% in the June quarter. Inflationary pressure on goods eased as consumer spending moderated and, notwithstanding some floods, the supply of grain was sufficient to keep prices steady. With on-going prudent macro-economic management, China should be able to achieve the new target of 7% retail price inflation for 1996. However, consumer prices in major

Chart 5
China: Real Deposit and Lending Rates



Note: Retail price index is used to derive the real interest rates.

cities have been (and will likely continue to be) boosted by increases in rents resulting from the housing reform. The housing component (despite its small share) has risen by about 20% in the September quarter over a year ago.

Balance of Payments and Exchange Rate

External trade posted a solid surplus of US$7 bn in the September quarter of 1996 (Chart 7). Exports have strengthened since the negative effects of the reduction in the rebate rate for value-added tax and the uncertainties arising from negotiations over the Most Favoured Nation trading status diminished. The Chinese government's move to accelerate the payment of rebates for value-added tax and increase bank lending to viable trading enterprises may have helped exporters to improve their performance. On the other hand, imports slowed since the June quarter.

Exports are expected to pick up further in the rest of the year on more buoyant overseas demand stemming from sustained economic expansion in the US, a continued recovering Japan and a resurgent Europe (Chart 1), although the slower economic growth in Asian economies would likely be a concern. The US unilateral sanctions against China's textile exports and China's possible retaliation also cast doubts over the prospects for Sino-US trade. Private sector economists have revised upward their forecast for merchandise trade surplus in 1996 to an average of US$7 bn (Chart 6).

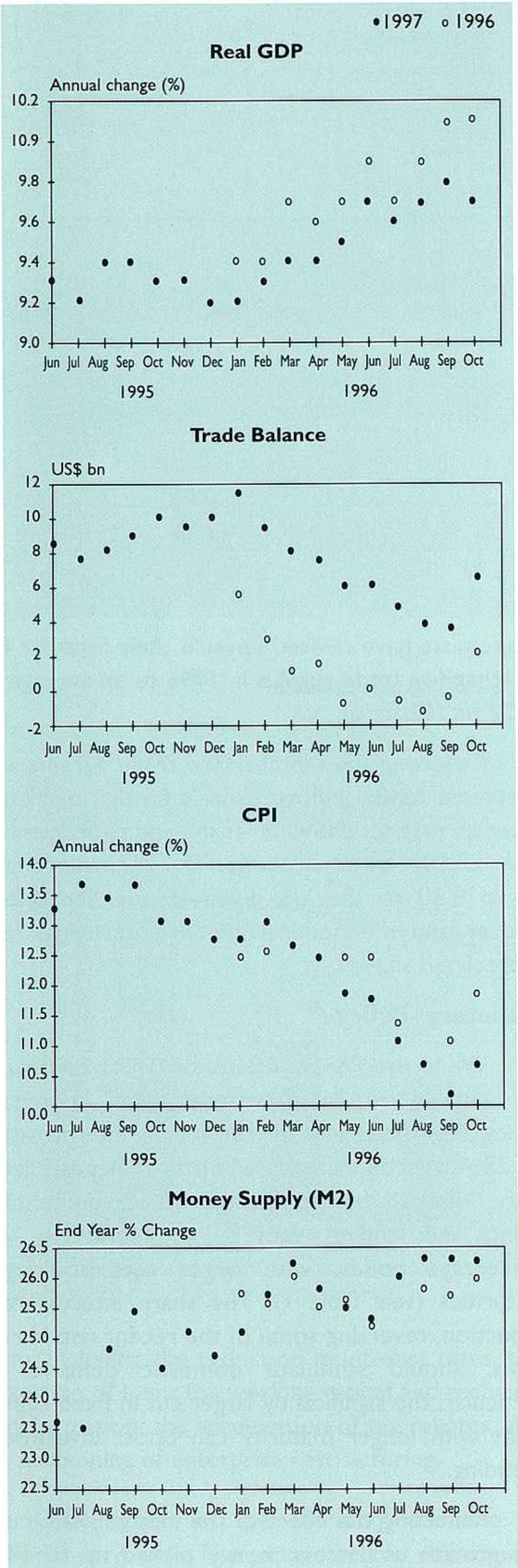
Reflecting the merchandise trade surplus and continued capital inflow, China's foreign exchange reserves rose to US$95 bn at the end of September from US$87 bn at end June. The renminbi edged up to 8.30 to the US dollar in the September quarter and the nominal effective exchange rate appreciated slightly.

Monetary Policy

While the People's Bank of China continued to maintain an "appropriately tight" monetary policy, they made another cut in bank interest rates on 23 August as inflation fell further. Deposit rates were lowered by an average of 1.5 percentage points and lending rates by an average of 1.2 percentage points, with larger cuts at longer maturities (see Table 1). The sharp interest rate reduction, reversing some of the recent rise in real rates, should stimulate domestic demand. In particular, the significantly larger cut in fixed capital loans with longer maturity can boost investment spending.

Reflecting the effect of the interest rate cuts, the growth of narrow money picked up to 14%, while the growth of broad money remained stable (Chart 8). Residents' deposits rose less rapidly, as

Chart 6
Consensus Forecasts of China Economy



Source: Asia Pacific Consensus Forecasts

some of them may have been channelled into securities markets. Domestic credit maintained rapid but volatile growth rates. The trading of treasury papers (and repurchase agreements) in Shanghai in the September quarter was six times of a year ago, and the turnover of the two stock markets (i.e. Shenzhen and Shanghai) more than quadrupled. The government's stated moves to encourage state enterprises to seek more direct financing suggest more stock listings and bond issues in the coming year. As the successful development of the securities market and the funds industry needs a clear legal and regulatory framework, the China Securities Regulatory Commission announced on 21 August a new rule on the regulation of stock exchanges which spells out clearly their authority to supervise them (see box). In addition, the drafting of regulations on investment funds is expected to be completed by the end of 1996.

Effect on Hong Kong

The favourable outlook for activity in the OECD and Chinese economies bodes well for Hong Kong's exports. China announced on 20 August rules allowing direct shipping links across the strait for carriers from wholly owned mainland Chinese or Taiwanese companies or those involving either as partners. Xiamen and Fuzhou are the first two ports under the trial scheme. The Taiwanese government also revealed that proposals to allow foreign-flagged ships to sail directly between the mainland and Taiwan are being considered. How these developments are to impact on Hong Kong's re-export trade is yet to be seen.

The modest retail price inflation in the OECD economies and China should help contain the prices of tradables in Hong Kong.

As China accelerates infrastructural developments and state enterprise reform, some of the funding needs can be met through Hong Kong's stock market. More state enterprises are expected to come to list in Hong Kong and, so far, about ten have revealed such plans.

– Prepared by the External Department

Chart 7
China: External Trade

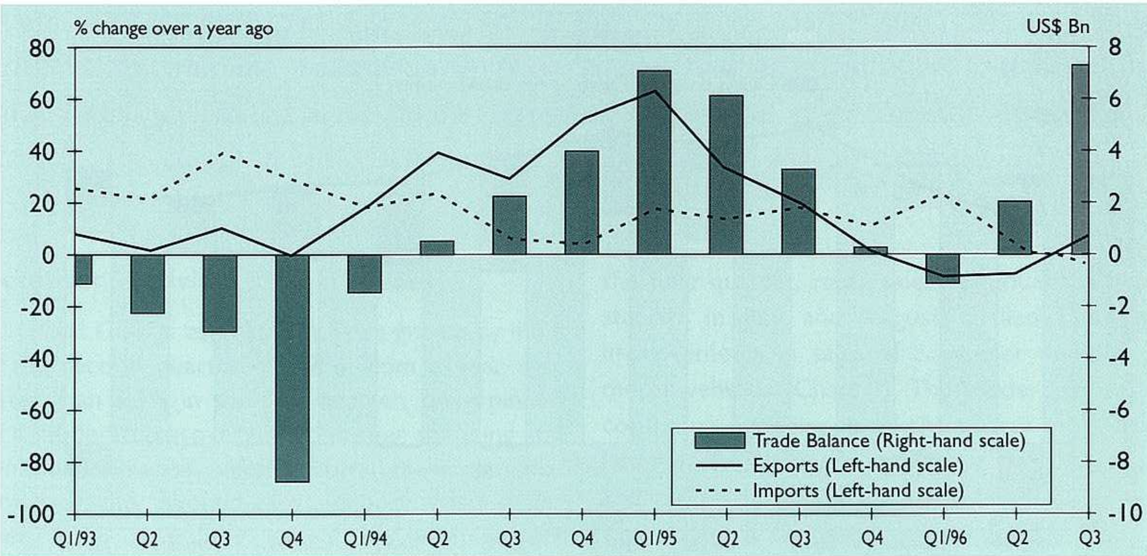
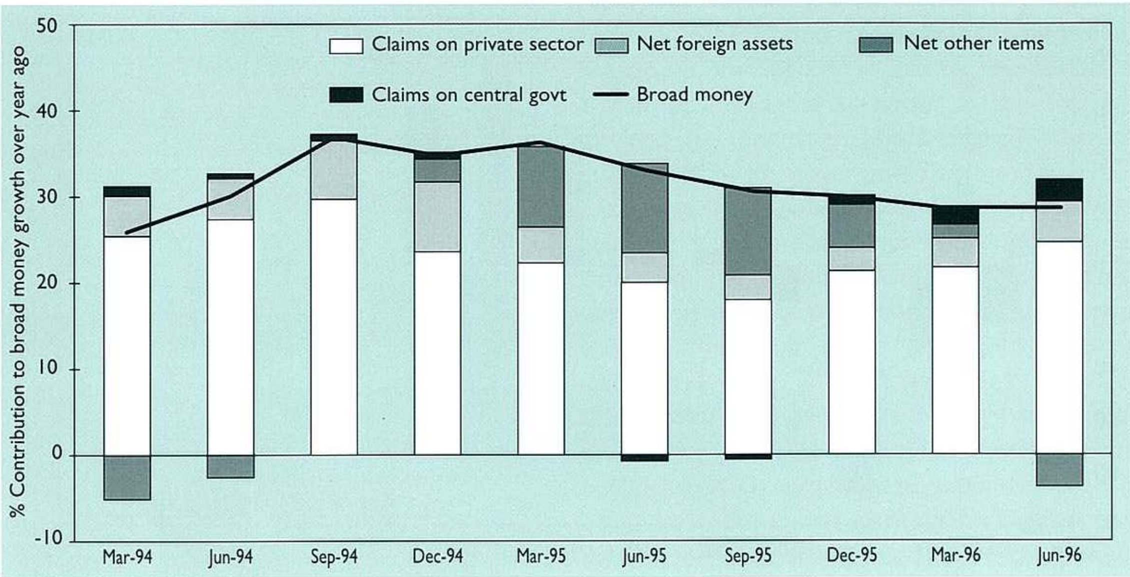


Table 1:
Interest rates in China (% p.a.)

	Effective 1 Jul 1995	Effective 1 May 1996		Effective 23 Aug 1996	
Deposits					
Savings deposits	3.15	2.97	(0.18)	1.98	(0.99)
Time deposits					
3-month	6.66	4.86	(1.80)	3.33	(1.53)
6-month	9.00	7.20	(1.80)	5.40	(1.80)
1-year	10.98	9.18	(1.80)	7.47	(1.71)
2-year	11.70	9.90	(1.80)	7.92	(1.98)
3-year	12.24	10.80	(1.44)	8.28	(2.52)
5-year	13.86	12.06	(1.80)	9.00	(3.06)
Loans					
Working capital					
6-month	10.08	9.72	(0.36)	9.18	(0.54)
1-year	12.06	10.98	(1.08)	10.08	(0.90)
Fixed capital					
1-year or below	12.24	11.52	(0.72)	10.08	(1.44)
1-3 years	13.50	13.14	(0.36)	10.98	(2.16)
3-5 years	15.12	14.94	(0.18)	11.70	(3.24)
Over 5 years	15.30	15.12	(0.18)	12.42	(2.70)

Note: Bracketed figures represent the magnitude of the cut.

Chart 8
China: Banking Survey



Box: Regulations on Stock Exchanges

The China Securities and Regulatory Commission (CSRC) announced on 21 August new regulations on stock exchanges, which replace the provisional ones issued in July 1993.

The major changes in the new regulations are as follows-

- Stock exchanges are under the supervision of the CSRC while the local governments will no longer have the authority to manage the stock exchanges.
- The chairman and the vice-chairman of the Board of Directors, and the general manager and the assistant general manager of stock exchanges are nominated by the CSRC, instead of by both the CSRC and local governments.
- Stock exchanges are required to establish and supervise a securities registration and clearing organisation.
- Stock exchanges are forbidden to engage in profit-making activities and in the media industry, release information on stock price forecasts, provide guarantees and engage in other business without prior approval by the CSRC.
- It is specified that the senior staff of stock exchanges should not leak any insider information. The general manager and the assistant general manager cannot take up any position in other profit-making bodies. The staff are also forbidden to take up posts in the member companies of the exchanges.
- The regulations also detail stock exchanges' duties in supervising the activities of members and listed companies. For example, listed companies are required to disclose information in case of unusual price fluctuations.