With an increase of 25 basis points in the federal funds rate on 25 March, US monetary policy has entered a restrictive phase. The US Fed, however, left the rate unchanged at the May Meeting.

Outside the US, short-term interest rates remained at low levels. The persistence of excess capacity in Europe and Japan and the deflationary corporate restructuring will limit the options of monetary policy. No global monetary squeeze is imminent.

Bond and equity markets declined in response to the Fed's move in March, but rebounded on news of low inflation and a balanced budget agreement in the US. Considerable volatility may be expected in the next few months due to uncertainty about further monetary tightening and the pace of economic growth.

The Chinese economy registered steady growth in the March quarter of 1997. Inflation remained low but could rise again if food prices increased. The PBOC's concern over a sharp rise in equity prices will keep monetary policy "appropriately tight" for the time being.

OECD Economies

Activity

The US economy continued to be strong in the March quarter while inflation remained subdued. Real GDP grew by 5.6% (annual rate), led by consumption and business investment. The capacity utilisation rate remained high at 83.4% in April, after reaching 83.7% in March, suggesting a possibility of higher prices. The labour market remained tight with a lower unemployment rate – of 4.9% – in April.

But the pace of economic expansion is expected to slow in the coming months as the strong dollar is making US exports more expensive and income tax refunds, which seem to be boosting the pace of consumer spending lately, will come to a halt at the end of May. In addition, higher interest rates – real and anticipated alike – could put a brake on the vibrant economy.

The Japanese economy gathered momentum in the March quarter, partly due to the front-loading of business activities ahead of the 1 April consumption tax hikes (from 3% to 5%). While the weaker yen has helped exports, other sectors remain weak. The February Tankan survey indicates a deterioration of non-manufacturers' business sentiment, and expectations of further weakness in the June quarter. Along with the fading impact of past fiscal stimuli, growth is expected to retrench in the June quarter. Continued monetary ease should prevent the economy from sliding back into a recession, however.

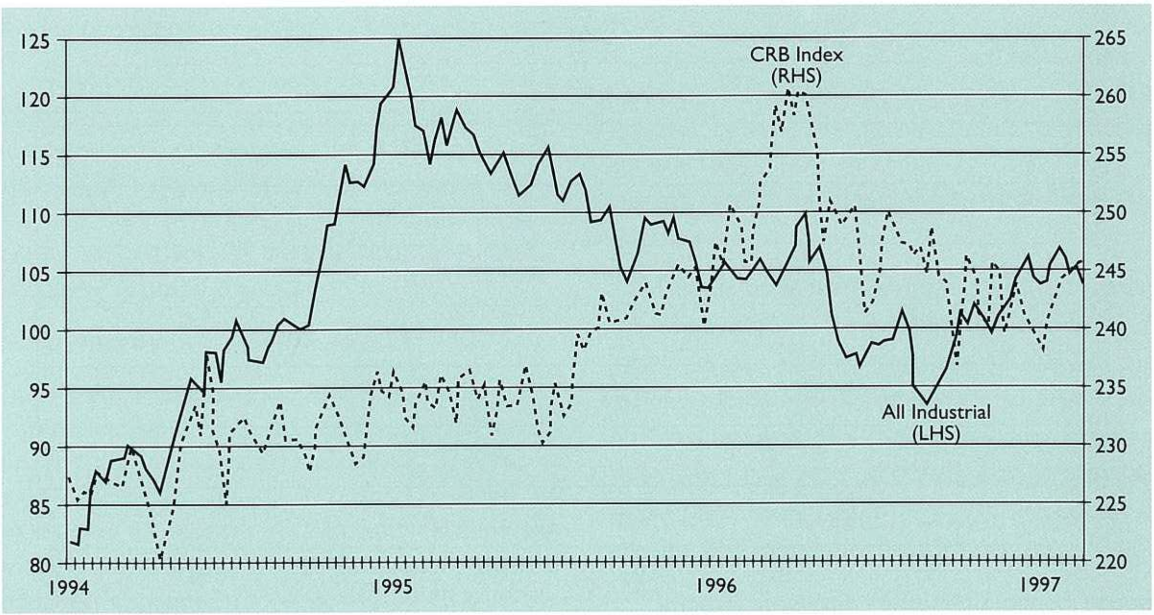
In Germany, latest figures on industrial production and capital goods orders indicate a pickup in economic activity in the early part of the year. Export growth has been impressive and foreign demand for German goods remains strong. Domestic demand remains sluggish, however, with the unemployment rate at record levels.

Inflation

The overall commodity price index, which suggests a benign inflation outlook, disguises the fact that there has been a shift in the sources of inflation (Chart 1). Oil prices fell back to below US$22 per barrel due to a combination of demand and supply factors[1]. But industrial material prices, after softening last year, have strengthened by

1 On the demand side, seasonal weather-related factors which drove prices up early in the year have now moderated. On the supply side, non-Opec output capacity has been expanded, particularly from the North Sea. In addition, the resumption of Iraqi exports has boosted Opec supply while Opec producers have raised output to around 27 million barrels per day – 2 million barrels per day in excess of Opec quota.

Chart 1
Commodity Price Index



Source: Datastream

about 10% in the past six months. The extent to which industrial commodity prices will put pressure on import costs bears a close watch.

Inflation remains subdued in most industrialised economies. In the US, the key issue in coming months is whether stronger growth exacerbates inflation. Most likely, overheating in labour markets will remain the primary threat, with hourly earnings accelerating to 4.0% growth year-on-year in March – the highest in seven years – before easing back to 3.6% in April. In Japan and Germany, where the currencies have been weak, the inflation outlook will depend largely on import prices (Chart 2).

Monetary Policy

The US Federal Reserve raised the fed funds rate by 25 basis points on March 25 to 5.5%. In Fed chairman Greenspan's words, "this action was taken in light of persisting strength in demand, which is progressively increasing the risk of inflationary imbalances in the economy that would eventually undermine the long expansion." This pre-emptive move to nip inflation in the bud will help improve the prospect of an extended period of non-inflationary economic growth.

There are two differences between the current condition and those that existed during 1994 which may impact the Fed's response in the current tightening cycle. The first is that the real fed funds rate was about 2.25% when the Fed tightened in March 1997, much higher than in February 1994 when it was about zero. The other difference is that inflation pressure in the manufacturing sector – evidenced by the NAPM price and delivery indices (Table 1) – is much smaller now than when the Fed started tightening in 1994[2]. These suggest that the current interest rate upcycle may be shorter and smaller in magnitude.

The Bundesbank and the Bank of Japan left interest rates unchanged in the first four months of the year. In Japan, the fragility of the economic recovery and the financial system makes it difficult for the BoJ to raise interest rates. In Germany,

2 In 1994, the NAPM price index was 12 points higher than current levels while the NAPM delivery index was 3 points higher. While capacity utilisation is higher now than it was during 1994, the operating rate in fact reached a peak in December 1994 at an alarming 84.9%, which was 0.8% higher than the surge in March 1997.

Chart 2
Import Prices: G3 Economies

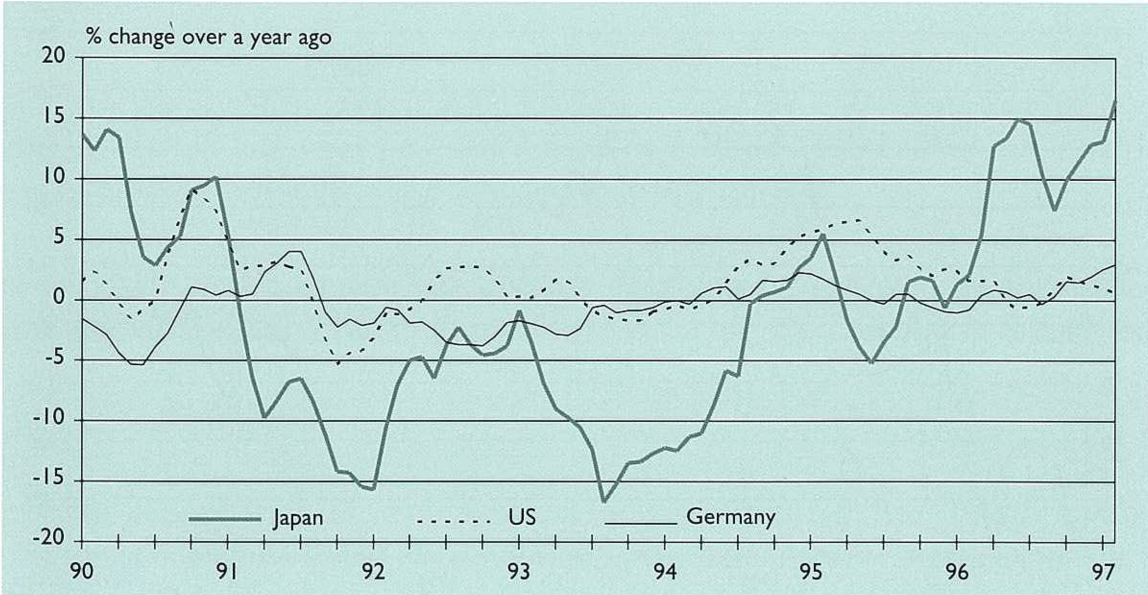


Table 1
Manufacturing conditions: February 1994 versus March 1997

	February 1994	March 1997
CPI, yr%	2.5	2.8
Core CPI, yr%	2.8	2.4
NAPM index	56.4	55.0
NAPM price index	63.0	50.9
NAPM delivery index	56.7	53.6
Capacity utilisation	82.8	83.7

despite signs of improvement in the economy, unemployment remains high and inflation low.

Financial Markets

The US dollar posted a 56-month high of 1.75 against DM and a 37-month high of 127 against yen in the March quarter. Strength was underpinned by widening interest rate differentials in favour of the US and the relatively strong US fundamentals. However, expectations of narrowing interest rate differentials and comments by officials about the dollar's strength triggered a sharp sell-off in mid-May, by as much as 10% against the yen (112.6) and around 5% against DM (1.68).

The rise in the fed funds rate triggered a sharp decline in the US bond market in March. The ripple effect was also felt in Germany, as bond yields rose sharply. Compared to bonds, the decline in global equities was more modest. However, unchanged Fed policy in May owing to softer economic data in April drove the US Dow Index to a new high by mid-May.

China

Inflation

Inflation in China continued to decelerate. The rise in retail price index moderated to a year-on-year rate of 1.7% in March 1997 while that of consumer price index slowed to 4%. Much of the slowdown was due to the fall in agricultural prices following two consecutive years of bumper harvests.

However, core or non-food price inflation remained firm at the high single digit level. Core consumer-price inflation was at 6.3% in March. Rentals seem to have bottomed at around the 10% level, and service prices remained high. This is likely to set a floor for further drop in inflation, especially when food prices begin to rise.

The Economy

The government eased credit policy last year on soft inflation trends by relaxing credit quota limits and cutting interest rates twice[3]. The easing helped relieve the liquidity constraints faced by state-owned enterprises (SOEs) and enhance the interest rate margins of state banks. Industrial production expanded more slowly by 13% in the March quarter, as inventories remained at high levels. The stagnating SOEs have revived (Chart 3). The rebound should add momentum to growth in the coming quarters.

Real GDP grew 9.4% in the March quarter of 1997 following an expansion of 9.7% for the whole of 1996. Growth was underpinned by private consumption expenditure and exports. Retail sales of consumer goods remained robust. Soaring stock markets and steady income growth continued to provide support for consumer spending. Consumers could turn more cautious if job security were to be threatened by the ongoing reform of SOEs. However, given the government's gradual and cautious approach in handling the issue, the reform's impact on unemployment is likely to be moderate.

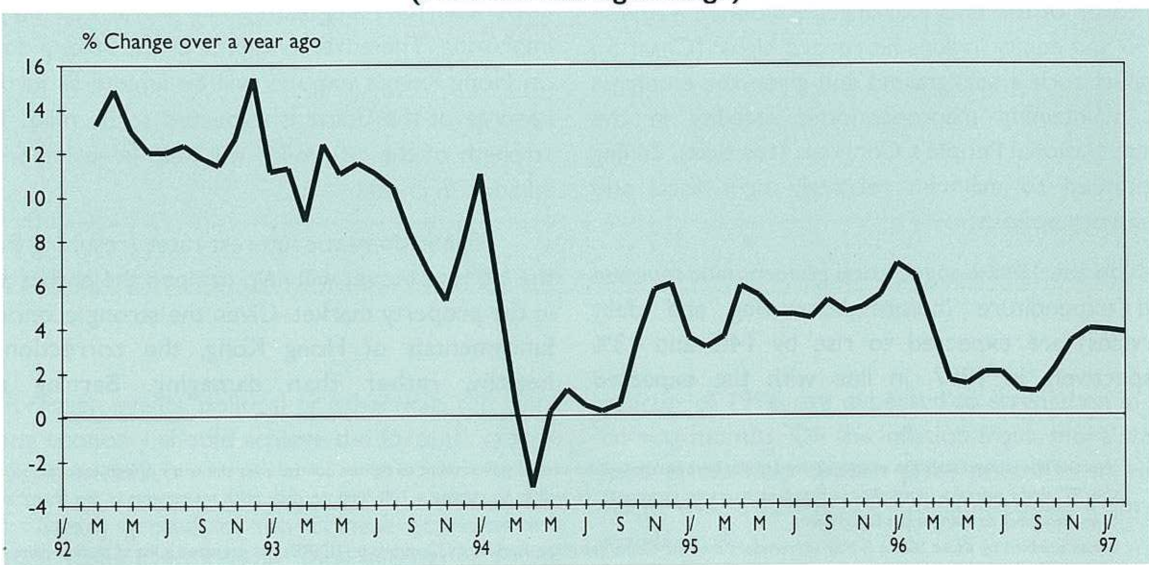
On the trade front, export growth accelerated. This was partly due to stronger import demand of China's major trading partners (Table 2); more working capital for exporters due to credit easing and faster rebates of VAT since the June quarter of 1996; and a low base of comparison for the same period last year, when exports dropped with reduced VAT rebates for exporters.

Imports, however, remained subdued, dropping by 1.8% in the March quarter. This was partly a result of an earlier inventory buildup and the abundant supply of food in the domestic market.

External accounts and the renminbi

The divergent trends of export and import growth since the second half of 1996 led to a sharp

Chart 3
China: Industrial Output of SOEs
(3-month moving average)



3 The authorities reduced the one-year working capital rate by 1.08% from 12.06% to 10.98% in May and by a further 0.9% in August to 10.08%.

Table 2

Growth of China's Exports by Country, year-on-year %

	Total exports	The US	Europe	Japan	Hong Kong	Asia (excluding Japan, HK)
Q1 96	-8.7	-5.7	3.8	9.1	-33.1	-0.6
Q2 96	-7.9	-2.0	-2.1	8.2	-27.0	-4.5
Q3 96	7.3	10.0	5.3	5.7	6.4	7.8
Q4 96	12.8	25.5	7.8	10.9	24.3	-2.3

rise in the trade surplus in the final three months of 1996; the trade surplus ended 1996 at US$12.1 billion, and a surplus of US$6.7 billion was recorded for the March quarter of 1997.

Coupled with continued capital inflows, the trade account surplus helped raise China's foreign exchange reserves to US$112 billion by end-March 1997. The renminbi continued to advance, despite the strength of the US dollar (Chart 4). The currency traded at US$1=RMB8.296 at end-March, compared with RMB8.298 at end-December 1996.

Macroeconomic policy

Capital inflows buoyed the Shanghai and Shenzhen stock markets and alerted the authorities to the risk of asset price inflation[4]. The stock turnover of the two exchanges ballooned 429% in 1996 and equity indices hit record highs[5] (Chart 5). Against such a background and given the emphasis on maintaining macroeconomic stability in the latest National People's Congress (see Box), Beijing continued to maintain relatively tight fiscal and monetary policies.

In the 1997 budget, total government revenue and expenditure (before borrowing and debt services) are expected to rise by 14% and 13% respectively in 1997, in line with the expected growth of nominal GDP – real GDP growth target of 8% and inflation of 6%. Budget deficit before debt services is expected to improve from 0.8% of GDP in 1996 to 0.7% in 1997[6].

On the monetary side, although real interest rates rose and broad money (M3) moderated in the March quarter, the central bank seemed reluctant to go for another interest rate reduction. The Governor of People's Bank of China Dai Xianglong indicated that China's monetary policy will remain "appropriately tight", and dismissed the possibility of any rate cut this year.

Implications for Hong Kong

The global economic climate remains favourable for Hong Kong. The world economy is improving. The adverse impact of the strong dollar on Hong Kong's exports will be limited as further upsurge of the dollar is expected to be mild. The strength of the US dollar will help keep imported inflation in check.

Higher domestic interest rates (resulting from the US rate move) will help dampen the enthusiasm in the property market. Given the strong economic fundamentals of Hong Kong, the correction is healthy, rather than damaging. Barring any

4 Worries about the escalation of speculative activity have prompted the central government to tighten control over the entry of domestic investors to the "B" share markets (normally restricted to overseas investors), as well as to impose a 10% limit on daily price movements at the Shanghai and Shenzhen stock exchanges last December.

5 Prices tumbled by about 5% on 8 May on rumours that the China Securities Regulatory Commission (CSRC) has prepared a list of market-dampening measures to discourage speculation. These include, among other things, raising the stamp duty for share transactions and the introduction of a capital gains tax. The CSRC announced subsequently on 9 May that the stamp duty would increase from 0.3% to 0.5%.

6 Including debt services, government expenditure is budgeted to rise by 18.4% and the fiscal shortfall could increase from 2.8% of GDP in 1996 to 3.3% in 1997.

Chart 4
China: RMB Exchange Rate

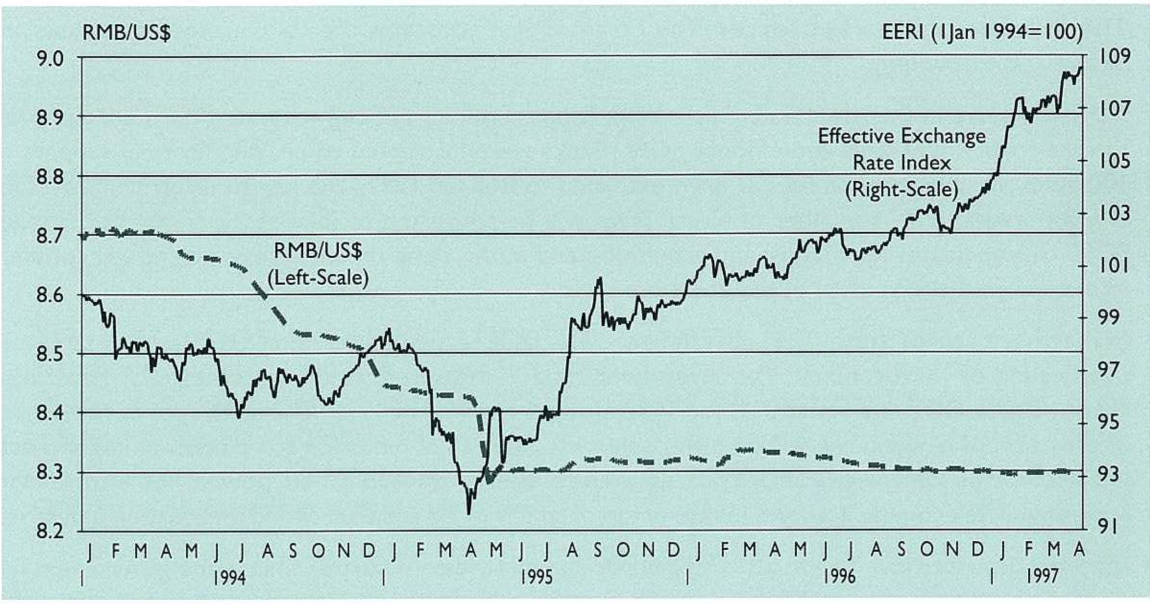
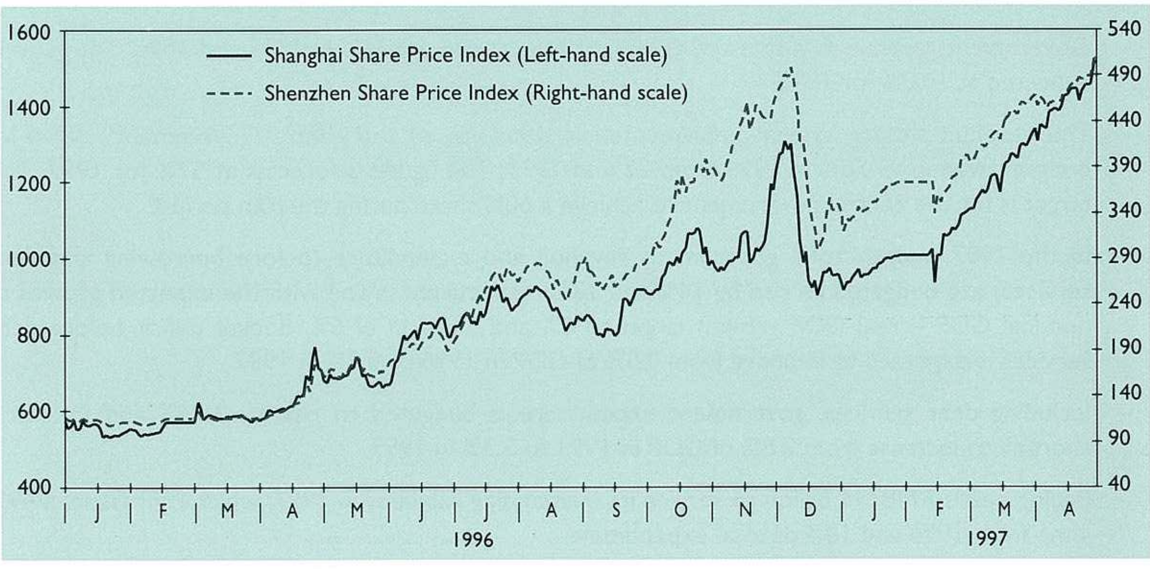


Chart 5
China: Stock Market Index Movements in Shanghai and Shenzhen



unforeseen events, political or otherwise, the Hong Kong economy should achieve the forecast growth of 5.5% in 1997.

Steady growth of the Chinese economy will benefit Hong Kong's trade. Total exports to China, which have been edging higher since the December quarter of 1996, are expected to strengthen in the coming months. On the inflation front, more stable food prices help contain price pressures in Hong Kong, where 22% of the foodstuff comes from the mainland.

– Prepared by the External Department

Box: The *Government Work Report*, the *Budget* and the *Economic Plan* presented to the National People's Congress in March 1997

- **The influence of market forces**: The *Economic Plan* advocates the continuation of markets for managing the economy.
- **SOEs reform**: In the latest *Government Work Report*, Premier Li Peng reiterated the state's priority to rejuvenate 1,000 large and efficient SOEs. Banks were instructed to provide financial support to 300 SOEs in 1996, and the list has been extended to 511 for 1997. The key to reforming the SOEs is "corporatisation". A number of bigger SOEs will be converted to joint-stock companies. Smaller SOEs are candidates for merger and acquisition and at the same time the government will continue to encourage the expansion of the non-state sector.
- **Investment priorities**: The government will limit expenditures on fixed assets to avoid overheating of the economy. The investment ratio – measured as the percentage of total fixed investment to GDP – is set at 32% for 1997, down from 35% in 1996. The state's support in terms of provision of new funding will be highly selective. The use of funds for completion of key projects under construction will give priority to: agriculture, energy, transportation, power, home-ownership programme, telecommunications, infrastructure, and advanced electronics and information industries.
- **Income distribution**: The focus is to develop the mid-western part of China. The government has made Chongqing a municipal level city with greater policy autonomy. It is hoped that like Shanghai and Shenzhen, the growth and prosperity of Chongqing will stimulate the development of its neighbouring areas. The government will strengthen agricultural development by increasing state investment in agricultural infrastructure and other measures[7].
- **The fiscal system**: The 1996 budget confirms some success in revenue collection:
  - Government revenue as a share of GDP stabilised at around 11% in 1995 and 1996. The ratio is expected at 10.8% for 1997.
  - The revenue sharing system implemented in 1994 raised the central government's share of budget revenue to 58% in 1996 from 22% in 1993. The figure is forecast at 57% for 1997. The target is for the central government to achieve a 60% share during the plan period[8].
  - In the 1997 budget, total government revenue and expenditure (before borrowing and debt services) are budgeted to rise by 14% and 13% respectively, in line with the expected growth of nominal GDP – real GDP growth target of 8% and inflation of 6%. Budget deficit before debt services is expected to improve from 0.8% of GDP in 1996 to 0.7% in 1997.
  - Including debt services, government expenditure is budgeted to rise by 18.4% and the fiscal shortfall to increase from 2.8% of GDP in 1996 to 3.3% in 1997.
  - Beijing needs RMB196 billion to service its outstanding liabilities in 1997, which represents a 49% jump from 1996 and 18% of total expenditure.

7 The government will step up investment in roads and farm and water facilities, provide more financial assistance to the fertilizer industry, further the development of township and village industries (to absorb the surplus farm labour), and increase arable land (through slowing the conversion of land for non-agricultural purposes).

8 The government is implementing new initiatives to strengthen central government's share of revenue. The decision to remove foreign investment tax concessions and to reduce VAT rebates for exports in 1996 has helped broaden the tax base (although they have undermined foreign investment and export growth). One significant tax change in the 1997 budget is the reduction of income tax for state-owned financial institutions from 55% to 33% – the same level as other domestic enterprises. This will improve revenue collection by reducing tax evasion and levelling the playing field for different taxpayers.

A glance of China's 1997 Budget (RMB bn)

	1996	1997 Forecasts	% change
Revenue	736.7	839.8	14.0
Expenditure	922.9	1092.7	18.4
– Transfer	271.6	290.5	6.9
– Debt services	131.4	195.9	49.1
Deficit	186.2	252.9	35.8
(% of GDP)	2.8	3.3	–

Source: Ministry of Finance

- **The 1997 growth and inflation targets**: The *Economic Plan* emphasises a continuation of "appropriately tight" fiscal and monetary policies to combat inflation. The goals of 1997 are to achieve a 6% inflation rate and a real GDP growth rate of 8%. The target for the growth of money supply (M2) for 1997 is 23-25%.

Official targets versus actual outcomes

	1997 target	1996 target	1996 actual
Real GDP, % growth	8	8-9	9.7
Retail price index, % change	6	<15	6.1
Fixed asset investment, % of GDP	32	35	32
Money supply (M2), % change	23-25	25	25.3
Currency issued, % growth	14	14	–
Exports, US$ bn	155	120	151
Imports, US$ bn	155	120	139
Population growth, %	11.4	–	10.4
Urban unemployment rate, %	3	–	3