THE EXTERNAL ENVIRONMENT

As the second half of 1997 begins, major world economies are poised for moderate growth with little inflation. The prospect for price stability has been enhanced by growing international competition, excess capacity in plant and resource supply, and low raw materials costs, including relatively low crude oil prices.

With the current slowdown and lower inflation in the US, there is no imminent need for monetary tightening. The Fed left interest rates unchanged in its July FOMC meeting. Mr Alan Greenspan also reaffirmed the current policy stance in his Humphrey-Hawkins testimony on 22 July. In Germany and Japan, where the current economic recovery is still fragile, the authorities have also chosen to defer monetary restraint.

The recent spate of currency attacks in South-east Asia reflects weaknesses in the economies as well as a difficult external environment characterised by volatile capital movements. It has also highlighted the vulnerability of regional currencies and stock markets to the contagion effect.

After a successful soft landing in 1996, the Mainland's economy grew steadily in the first half of 1997, with real GDP expanding by 9.5% year-on-year, comparable to the rate of 9.7% observed in 1996. Growth has been driven by a surge in exports, while domestic demand has slowed somewhat. Inflation has moderated to an annual rate of less than 3% so far this year.

The benign economic environment has provided new impetus to asset markets. Equity prices, which had risen by more than 200% in 1996, showed further sharp gains in the first quarter of this year. In May, the authorities imposed tough new measures to curb excessive speculation.

Economic Growth

The June quarter GDP report, due out in mid-August, is expected to show the **US** economy growing at a modest 2% real rate. The slowdown reflects subdued consumer spending. Retail sales dropped for the third consecutive month in May. The larger-than-expected 0.5% rebound in June was offset by a downward revision of the May decline.

The weak US retail sales are surprising in the context of a surge in consumer confidence to a 28-year high in July, the buoyancy of consumer incomes, or the strength of asset prices. One explanation rests on temporary factors, including, first, bad weather which disrupted consumers' shopping activity and second, a change in the seasonal pattern of tax refunds this year. Taxpayers got their money back earlier this year and may have spent much of it in the strong first quarter.

The rise in March quarter spending and the sudden drop in the June quarter caught many businesses and retailers unprepared. They were running out of stocks in March and are now building up inventories. This unplanned inventory accumulation is one of the key points in the latest Fed "Beige Book". Reducing inventories could restrain production growth and imports in the near future. Slower demand and higher inventories have limited retailers' ability to raise prices.

In Europe, the **German** economy is beginning to show signs of life. Real GDP grew by 0.4% quarter-on-quarter in the March quarter after near-stagnation in the December quarter of 1996. The recent uptrend in manufacturing orders and

Chart 1
Steady Commodity Prices

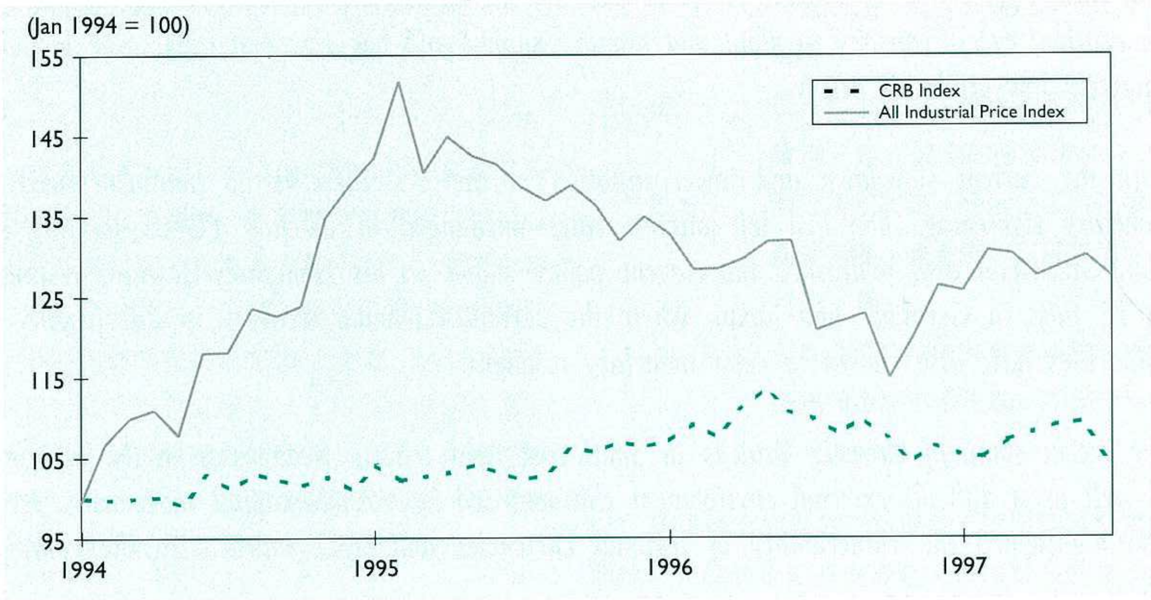
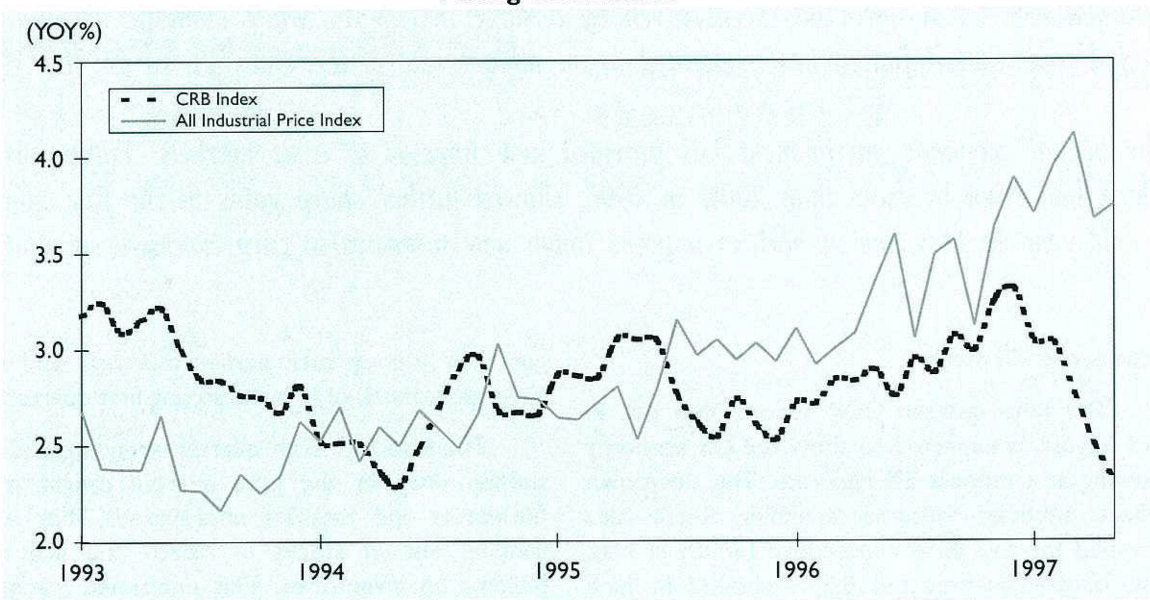


Chart 2
Falling US Inflation



industrial output suggests further improvement in the economy. Exports and capital spending are the main drivers of growth, while consumer spending is sluggish.

The **Japanese** economy, however, remains weak. Irrespective of renewed business optimism as suggested by the latest *Tankan* report, major statistics do not show an increase in the real sector activity. Housing starts, car registrations and Tokyo department store sales all registered a decline in their year-on-year growth in recent months. The sluggishness is attributed to Tokyo's decision to raise the consumption tax from 3% to

5% on 1 April. The government's determination to reduce its budget deficit not just this year but over the medium term does not bode well for growth either. One effect of the slowdown is the dramatic expansion of Japan's trade surplus in May and June, which has already made the yen stronger relative to the US dollar.

Inflation

Current commodity prices, a leading indicator of consumer inflation, do not suggest any imminent risk. The Commodity Research Bureau index, which rose early in the year as a result of higher oil and coffee prices, has steadied of late. By June, oil prices have fallen back to US$17/barrel, compared with around US$25/barrel in January. Steady base metal prices should also help subdue global inflation (Chart 1).

US inflation has been lower than expected. CPI moderated to 2.2% year-on-year in June, the lowest increase in this business cycle. It stood at 3.3% at end-1996. Furthermore, wage growth, which accelerated in the early months of the year, stabilised in the June quarter (Chart 2). This was in spite of the steady decline in the jobless rate to 5.0% in June, the lowest level in $4^1/_2$ years.

In Europe, high unemployment and low consumer demand will limit price increases. **Germany's** cost of living index rose 1.5% in May and the pace is expected to continue for the remainder of the year. Unemployment rose to 11.4% in May, suggesting a weak labour market. Thus, domestic demand is unlikely to reignite inflation soon.

In **Japan**, the VAT increase is depressing domestic demand. Companies are reluctant to raise prices beyond the 2% tax increase for fear of losing business. Consumer prices rose 1.9% year-on-year in May due to the tax effect, but they are expected to remain under 1% for 1997 as a whole.

Monetary Policy

The **Fed** has indicated that monetary policy will be conducted in a proactive manner, meaning that they would tighten policy before inflation rises. But the recent moderation in inflation suggests that even proactive tightening is not necessary at the moment. Accordingly, the Fed left interest rates unchanged at the July FOMC meeting.

In Europe, tight fiscal policy at a time of structurally high unemployment calls for a correspondingly easy monetary policy. The **Bundesbank** has held its repo rate – the securities repurchase rate – at 3.0% for ten months now, and the discount/Lombard rates were last changed on 18 April 1996.

Similarly, the **Bank of Japan** left interest rates unchanged in the June quarter. Business failures had highlighted the sluggish domestic economy and ruled out an interest rate hike.

Financial Markets

The three G7 meetings (February, April and June) this year led to a significant dollar-yen realignment. Since peaking at 127.5 at the start of May, the yen fell to a low of 110.5 by mid-June, before rebounding to the current 118 level. The DM was initially very strong against the US dollar, at a low of 1.668 in early May, but it has weakened to the 1.88 area since then on concerns about the credibility and stability of the euro.

With favourable economic and inflation data, Treasury yields fell in July to levels not seen since last December. German and Japanese bond yields fell in sympathy with the US. With steady growth, low inflation and stable interest rates, equity markets rose to record highs in July.

Asia

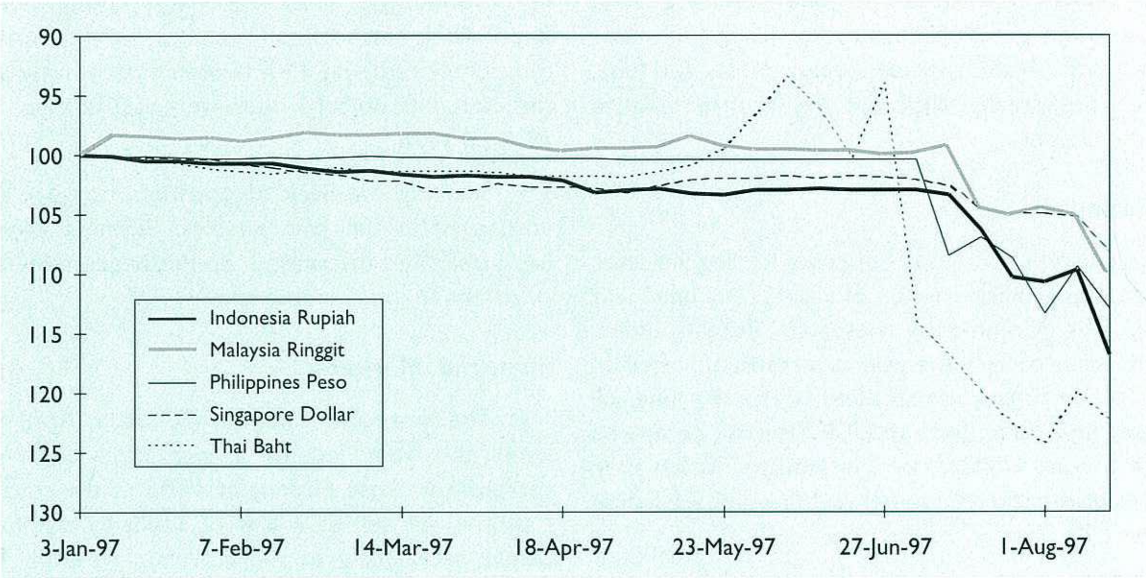
In response to heavy currency attacks, Thailand and the Philippines abandoned fixed exchange rates in July in favour of a managed float, while Indonesia abandoned the currency intervention band. The baht, the peso and the rupiah depreciated after the move. The contagion effect also spilled over to other regional currencies and stock markets (Chart 3).

The turmoil experienced by South-east Asian currencies stems from a variety of sources, including:

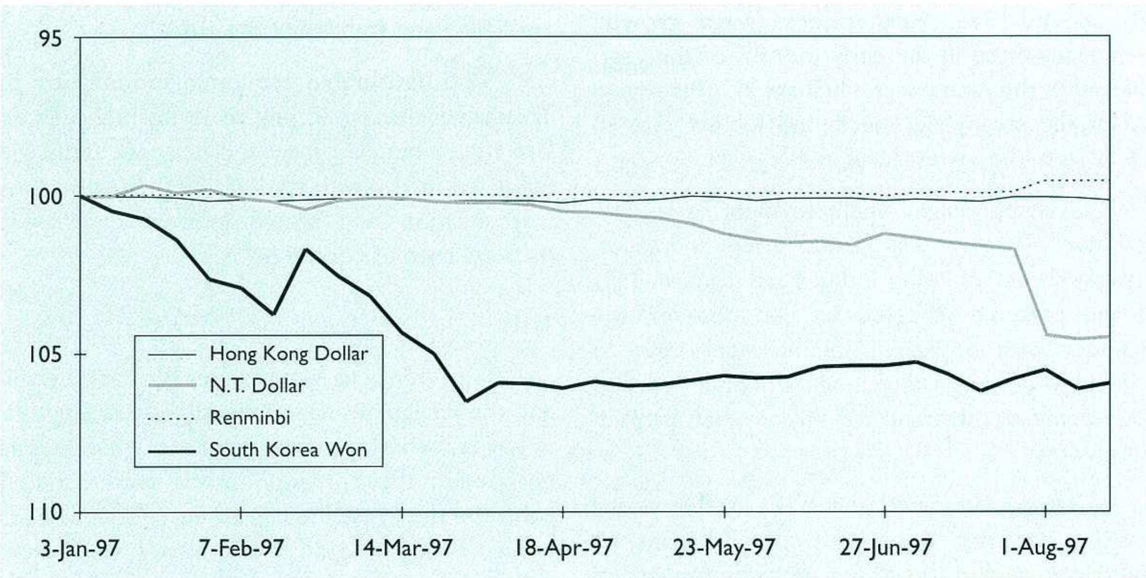
First, there has been much greater capital mobility in the region. Funds flow to emerging markets where interest rates are relatively high from mature markets. In particular, the "carry trade", which involves borrowing in yen and lending in Asian emerging markets, has grown significantly. This trade is, however, highly vulnerable

Chart 3

Exchange Rates of South-east Asian Currencies



Exchange Rates of North-east Asian Currencies



to movements in currencies and interest rates. In addition, low interest rates in the industrialised world have encouraged the banking sector in emerging economies to borrow offshore. The currency risk that arises is seldom hedged and becomes a major burden to the borrowers when the home currency depreciates.

Second, the currency turmoil reflects areas in domestic economies that require strengthening. In the case of Thailand, the authorities have undertaken strong measures in financial sector reforms and economic adjustments as a result of the currency turmoil.

Third, there has been considerable regional contagion effect. Following the floating of the baht at the beginning of July, it fell 30% to the dollar as of 15 August. During the same period, other Asian currencies, notably the peso, also came under attack. In spite of the Philippines' strong export growth this year and its small current account deficit, the peso fell 12.2% against the US dollar. The Malaysian ringgit also fell 10% to the dollar under sustained speculative attack. The Indonesian rupiah depreciated by 14.5% during the same period.

Even the Singapore dollar, normally viewed as a safe haven in times of currency crisis, depreciated against the dollar by 6%. The Hong Kong dollar has been stable.

In an unprecedented move, eight economies in the region joined hands in a broad-based financing package of more than US$16 bn organised by the International Monetary Fund. The policy package by IMF is positively viewed by market participants as a reflection of Thailand's determination to steer the country back on the right track.

The Mainland Chinese Economy

Domestic demand and growth

Investment in fixed assets grew by 14.3% in the first half of the year, compared with 18.6% in the corresponding period in 1996. The slowdown in capital formation was attributable to rising real interest rates and the phasing out of import subsidies on capital goods. In addition, the inventory level remained high, particularly among state-owned enterprises (SOEs). Consumer demand also grew at a slower pace, rising by 13% in the second quarter compared to 15.5% in the first.

For the first half of this year, growth in real GDP was 9.5% year-on-year, marginally below the 9.7% rate observed in 1996. Similarly, the expansion of industrial output moderated to 11.6% in the first half of 1997, compared with 13.2% in the same period of 1996. The unemployment rate is reported to have risen, as SOEs begin to reduce the work force.

Foreign trade

Exports, however, have taken up the slack in domestic demand. As Chart 4 below shows, growth in exports has risen significantly, after a protracted slowdown in the past two years. Import growth, however, has been restrained by slowing domestic demand and by last year's bumper wheat harvest which has reduced imported grains. As a result, the trade balance has improved dramatically, with the surplus rising from less than US$1 billion in the first half of 1996 to US$17.8 billion in the first half of this year. A large trade surplus is also expected for the second half.

Chart 4
China Foreign Trade

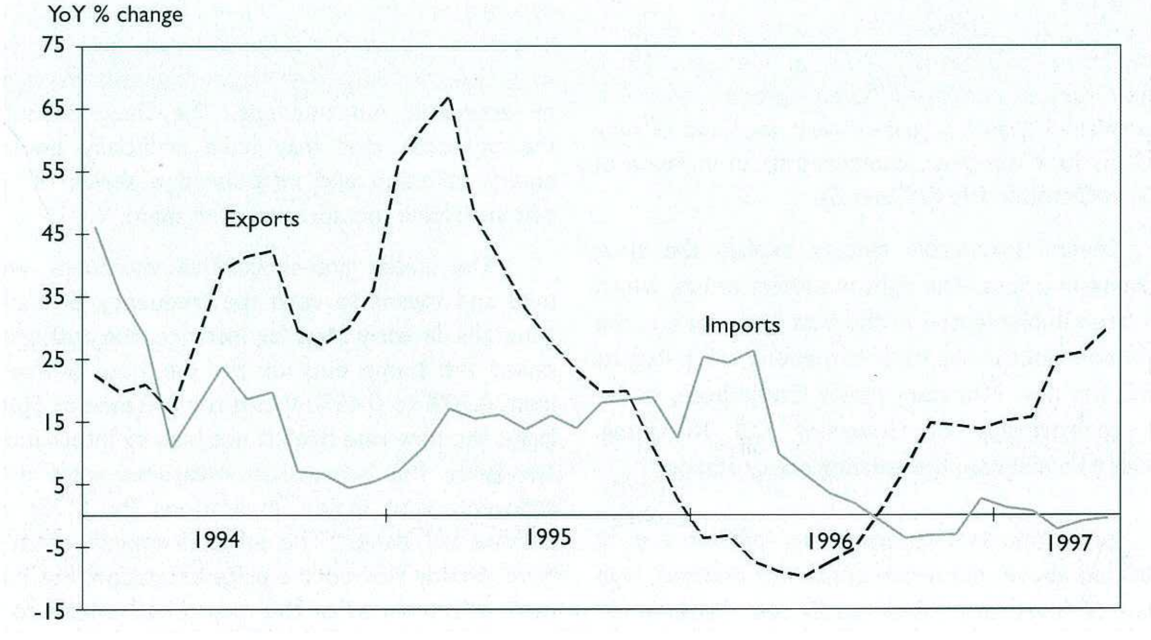
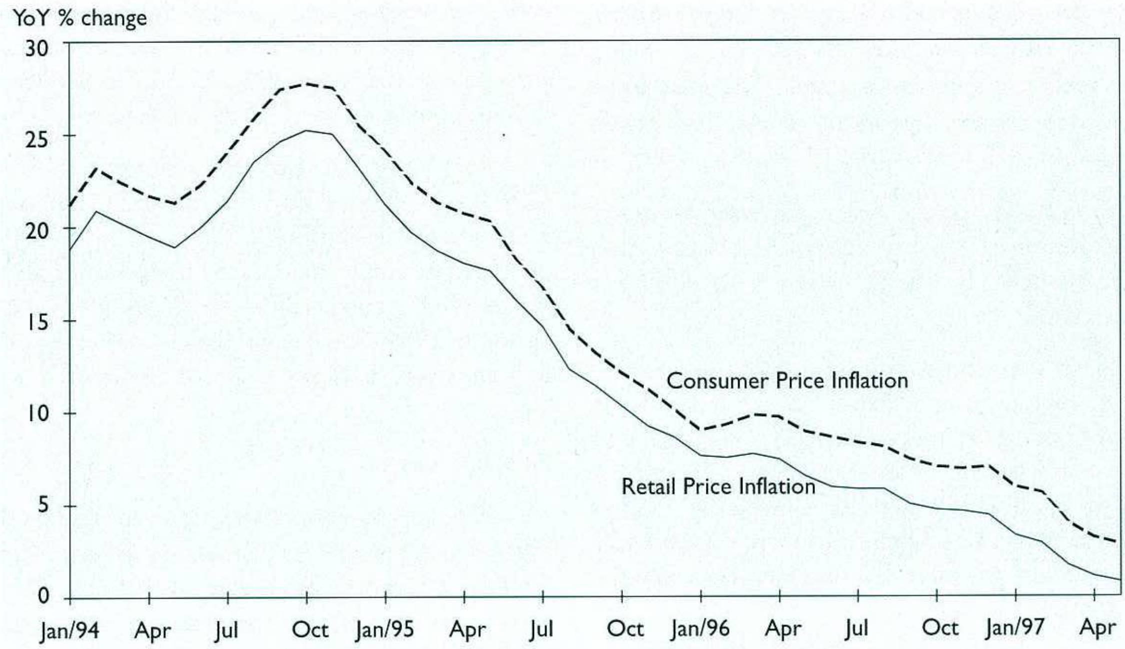


Chart 5
China Inflation



With the rising trade surplus, the Mainland's foreign exchange reserves rose to US$120.9 billion at end-June. The renminbi remains stable at RMB8.29/US$ in July, little changed from the level at the start of the year.

Inflation

A major achievement of the Mainland's economic policy has been the maintenance of strong growth while lowering inflation substantially. Consumer price inflation slowed to 2.8% in June, down from a peak of 27.7% in October 1994. Retail prices showed even more dramatic improvement, with a year-on-year increase of only 0.8% by June this year, compared to an increase of 25% in October 1994 (Chart 5).

Several favourable factors explain the slow increase in prices. The tight monetary policy, which has been implemented in the past few years, is the main contributor. At its first meeting on 1 August 1997, the new Monetary Policy Committee, under the chairmanship of Governor Dai Xianglong, decided to maintain the existing policy stance.

Also important in restraining inflation are, as indicated above, moderate consumer demand, high levels of inventory, lower tariffs and better-than-expected grain harvests in the past two years, all of which have served to reduce producers' pricing power. In the absence of supply shocks, inflation is expected to remain low for the rest of the year.

Financial market developments

With stable growth and low inflation, as in the case of the Mainland, it is not surprising to see major advances in the stock market. The Mainland's authorities, however, have been increasingly concerned about the surge in equity prices (Chart 6), which may have gone beyond what is warranted by economic fundamentals. They have identified the practices that may have artificially boosted equity valuation and introduced a series of new administrative measures to curb them.

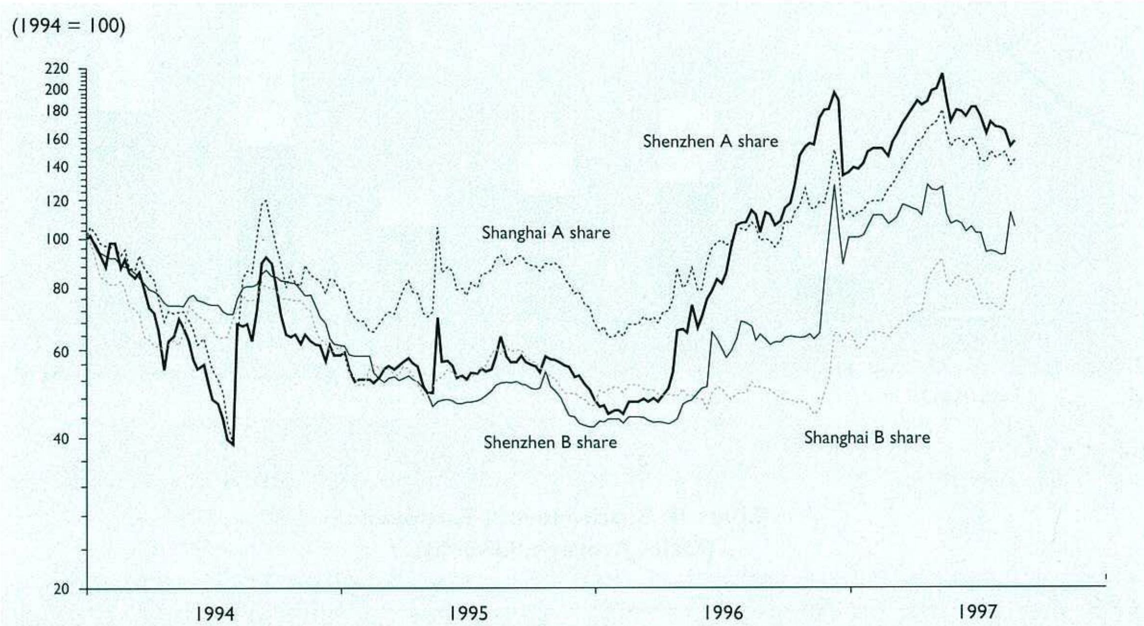
The initial anti-speculative measures were mild and meant to curb the frequency of trading generally. In early May, for instance, the authorities raised the stamp duty on the purchase of shares, from 0.30% to 0.45%. While the increase of 50% is large, the new rate itself is not high by international standards. But subsequent measures were more stringent, with major implications for SOEs and commercial banks. The announcements seem to have already slowed the price escalation, but long-term effectiveness of the measures remains to be seen.

One of the practices that the authorities wish to discourage is the use of leverage in share purchases. On 30 May, the authorities introduced a policy package, which prohibits banks from lending to sharebuyers and engaging in repurchase agreements. Brokerage houses are no longer allowed to provide margin loans. In addition, commercial banks are also prohibited from doing investment and securities business. Severe penalties have been imposed for any breach of the new rules.

Another move by the authorities is to deal with abuses associated with "asset injections", including below-market pricing practices. On 20 June, the State Council issued new directives restricting the transfer of assets into foreign-incorporated firms, including both unlisted and listed companies, such as "red-chip" companies in Hong Kong. Explicit approval by designated domestic regulators and government ministries is now required. Furthermore, the requirements for overseas listing have also been tightened to improve regulatory oversight over the listing process.

-Prepared by the External Department

Chart 6
China Stock Markets Indices

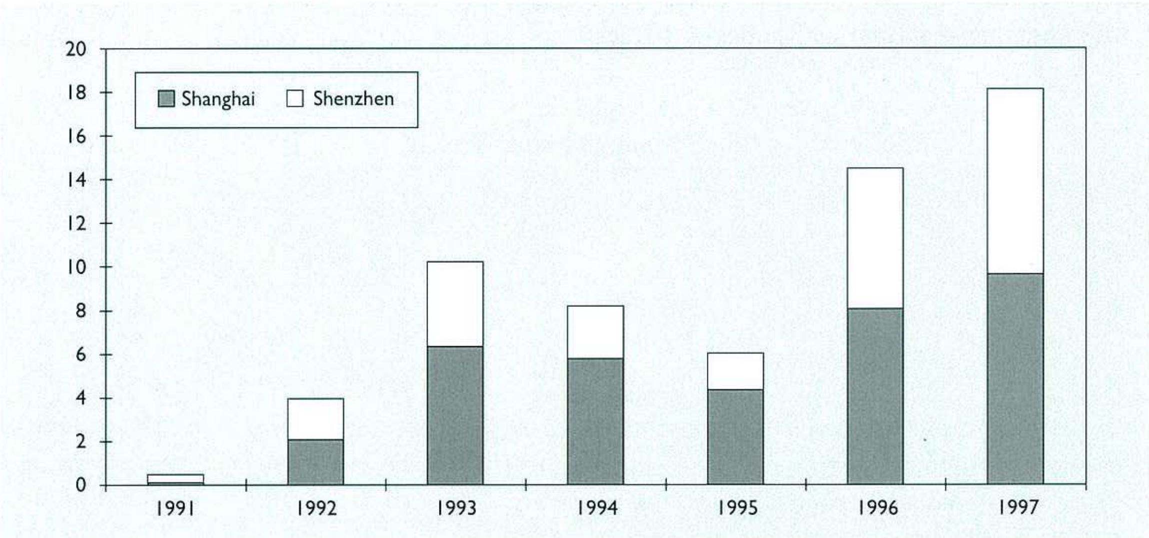


Source: DATASTREAM

Box: Stock Markets in Mainland China

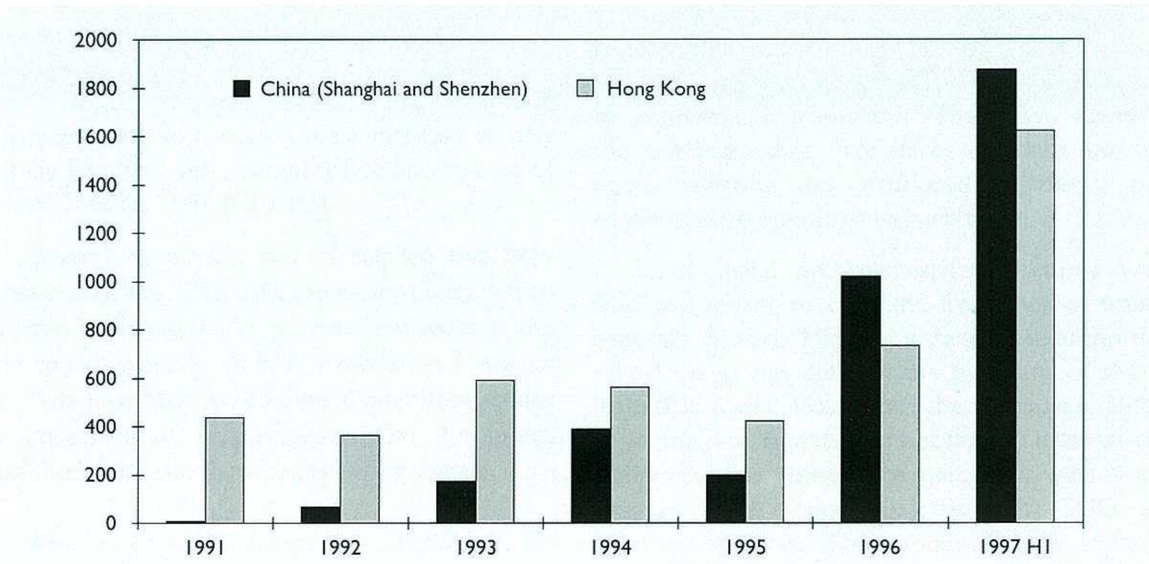
Mainland China's dramatic economic growth of the past decades is well known. Not as well known, however, is the equally dramatic expansion of the markets and the use of equity financing. Unlike other Asian markets, "A" shares, which are reserved for the Mainland's nationals, trade at a significant premium to "B" shares, which may be purchased by foreigners (Chart 6). Elsewhere in the region, the relative prices are reversed, with the shares that are open to foreigners trading at much higher prices.

Chart A: Stock Market Capitalisation
(As a % of GDP)



* Forecasts.

Chart B: Stock Market Turnover
(Daily Average, US$Mn)



As Charts A and B show, equity markets have grown considerably in recent years. Market capitalisation of shares, for instance, has risen from a negligible percentage of GDP in 1991 to nearly 20% today (including both the Shanghai and Shenzhen stock exchanges). Although this percentage share remains small by regional standards, the growth is among the fastest.

The turnover of shares in the Mainland show the same trend. As Chart B shows, the average turnover of the Mainland's stock exchanges have risen from close to nil in 1991 to approximately US$1.8 billion a day. The volume of equity trading in Mainland China has now exceeded that of Hong Kong.

One reason the stock markets have grown so fast is the lack of alternative investment instruments to absorb the Mainland's extremely high savings. So far the principal outlet has been bank deposits. At the end of June 1997, savings deposits with China's banking system amounted to RMB4,277 billion (about 63% of GDP). The performance of stocks in recent years have convinced more than 22 million people to become shareholders.