

THE DOMESTIC ENVIRONMENT

The Hong Kong economy grew faster than expected in the first half of the year, driven by strong consumer spending and robust construction activities. Imports also rose rapidly in the first half, outpacing export growth, which remained sluggish. The rate of unemployment fell marginally. Inflation also edged down.

Reflecting the real sector, monetary and credit aggregates expanded at a brisk pace. Much of the credit growth in the first half of the year was due to lending to the property sector, which also contributed to a rise in the domestic loan-to-deposit ratio. Asset markets were buoyant, with share prices reaching record levels. Property markets also surged in the first quarter, but appeared to have stabilised in the second, after the incoming SAR Government expressed an intent to curb property speculation.

Domestic Activity

Hong Kong's real GDP rose by 6.1% in the March quarter, faster than the rate of 4.9% in 1996. Driven by stronger consumer spending and robust private construction activities, the growth momentum appeared to have continued in the June quarter. For 1997 as a whole, GDP growth of 5.5% is expected.

The main impetus of growth came from gross capital formation, which expanded by 18.7% in the March quarter, amid robust private sector construction activities and investment in machinery. Investment spending is expected to remain buoyant, as suggested by rising retained imports of capital goods and an increase in the approval for property projects.

Private consumption expenditure grew by 5% year-on-year in the March quarter, compared with 3.9% a year earlier. Retail sales rose by 2.0% in real terms in the March quarter and grew further by 5.9% in April-May. With improvement in the job market and rising household incomes, consumer spending is expected to remain strong in the coming months.

External Trade

Export growth slowed to 3.2% in the first half of 1997, from 3.7% in the second half of 1996, with re-export growth moderating to 4.4% from 6.3%. Domestic exports declined further, by 3.4% in the first half of 1997, following a drop of 8.7% in the second half of 1996. Exports to Mainland China increased at a slower pace of 4.5% in the first 6

months, compared with a 8.0% growth in the second half of 1996. By contrast, exports to the US grew by 8.0%, up from the 4.8% increase in the latter half of 1996.

Imports continued to outpace exports. In the first six months, imports rose by 4.6%, faster than the 2.8% expansion in the latter half of 1996, due to higher retained imports. As a result, the visible trade deficit widened to \$96bn (12.6% of total imports) in the first half of 1997, from \$84bn (11.4%) in the same period of 1996.

Labour Market

The job market remained steady, with the unemployment rate edging down to 2.4% in the June quarter, from 2.5% in the March quarter. In the three months ending June, total employment and labour supply rose over a year earlier by 3.5% and 2.7% respectively.

Inflation

Inflation eased slightly in the June quarter, with an increase in CPI(A) of 5.5%, compared to 6.2% in the March quarter. For 1997 as a whole, inflation is expected to be kept below the 7% level, reflecting lower import prices and stable residential property prices after the surge in the first quarter.

Monetary Situation

Amid rising economic activities, domestic credit expanded by 7.4% during the June quarter, having grown by 7.9% in the March quarter. Loans for trade financing (including offshore trade) rose

Chart 1
HK\$ Loan-to-deposit Ratio

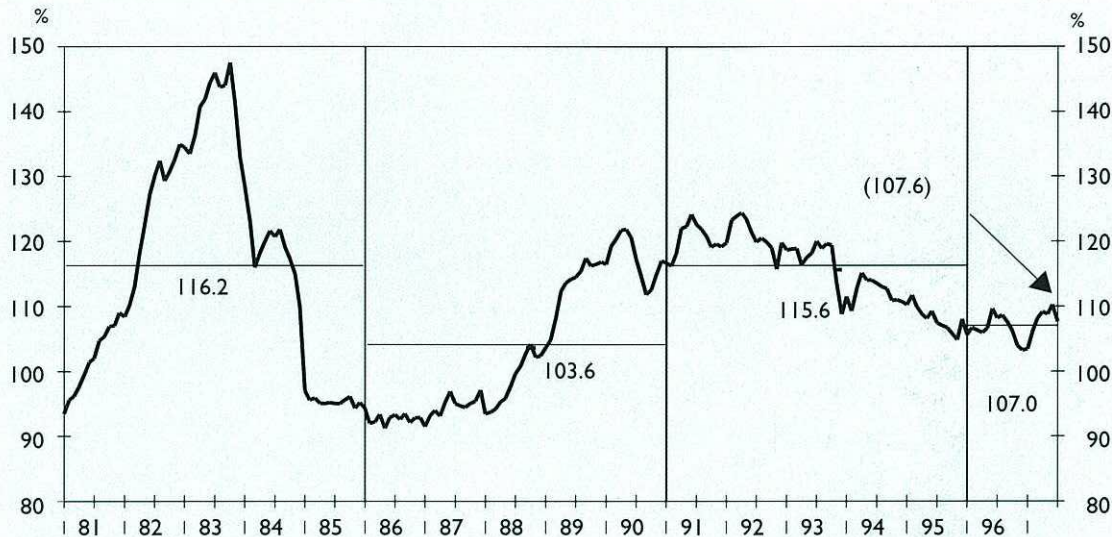
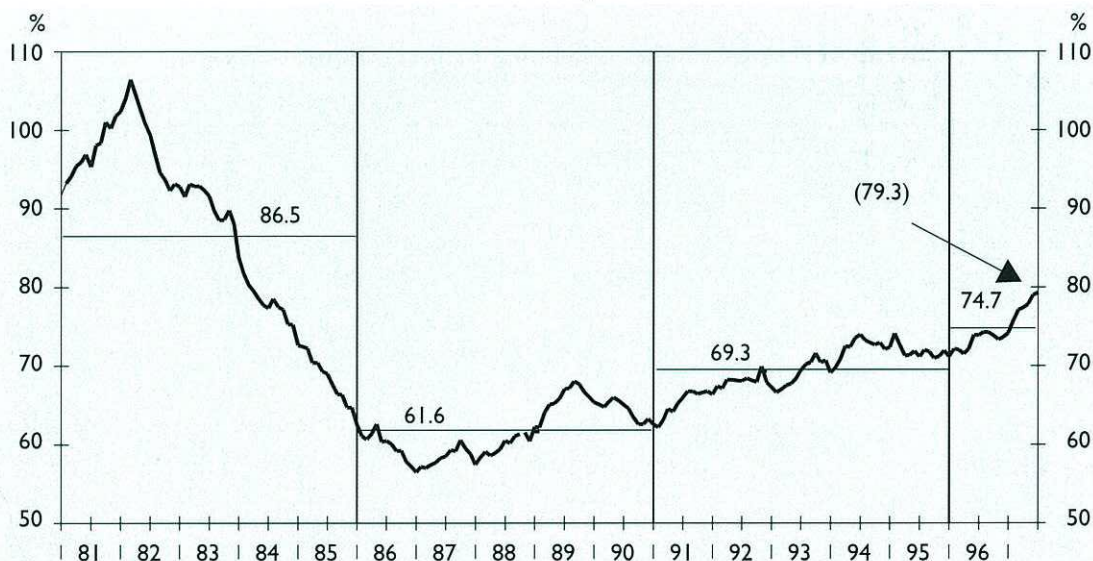


Chart 2
Domestic Loan-to-deposit Ratio



Note: Domestic loans refer to loans for trade financing and other loans for use in Hong Kong while deposits refer to the sum of HK\$ and foreign currency deposits.

by 6.5%, reversing the 0.5% contraction in the preceding quarter. Reflecting the buoyancy in the property market and intense competition among banks for market share, residential mortgage loans surged 8.8%, following a 7.1% increase during the March quarter. Other property-related loans rose by 11.5% and 10.2% in the June and March quarters respectively. Loans to stockbrokers and other financial institutions also showed strong growth.

Credit extended to wholesalers and retailers increased by 6.2%, reflecting the strong consumer spending.

With rapid domestic credit expansion, the Hong Kong dollar loan-to-deposit ratio rose steadily this year until June when it dipped slightly to 107.6% (Chart 1). A higher loan-to-deposit ratio means that a greater portion of bank lending is financed by funds other than customer deposits,

Chart 3
Total Loan-to-deposit ratio

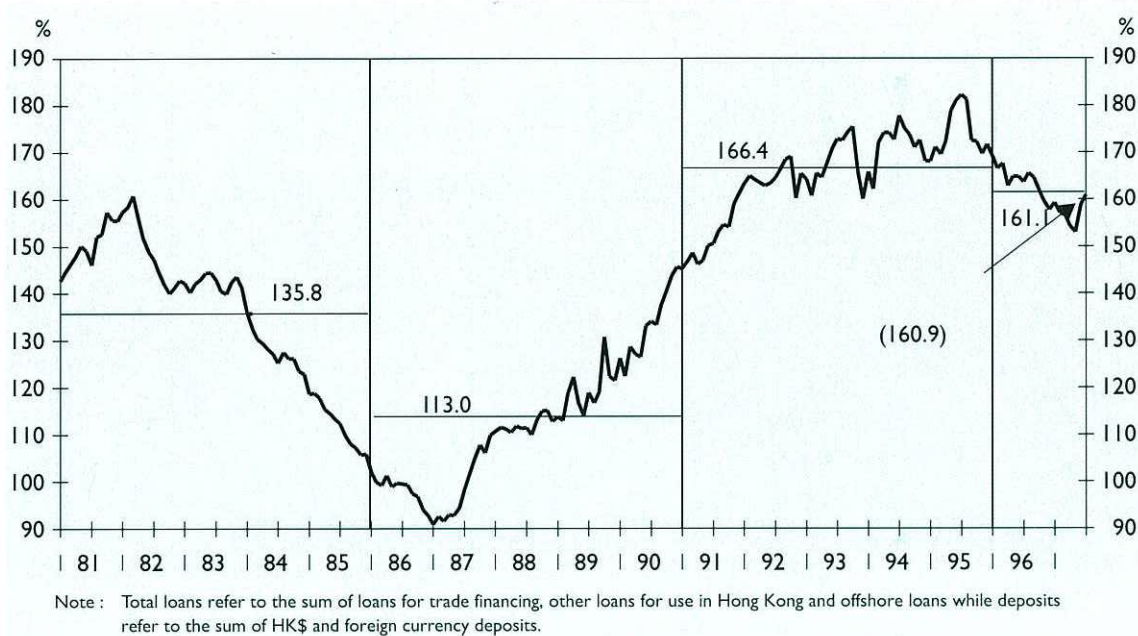
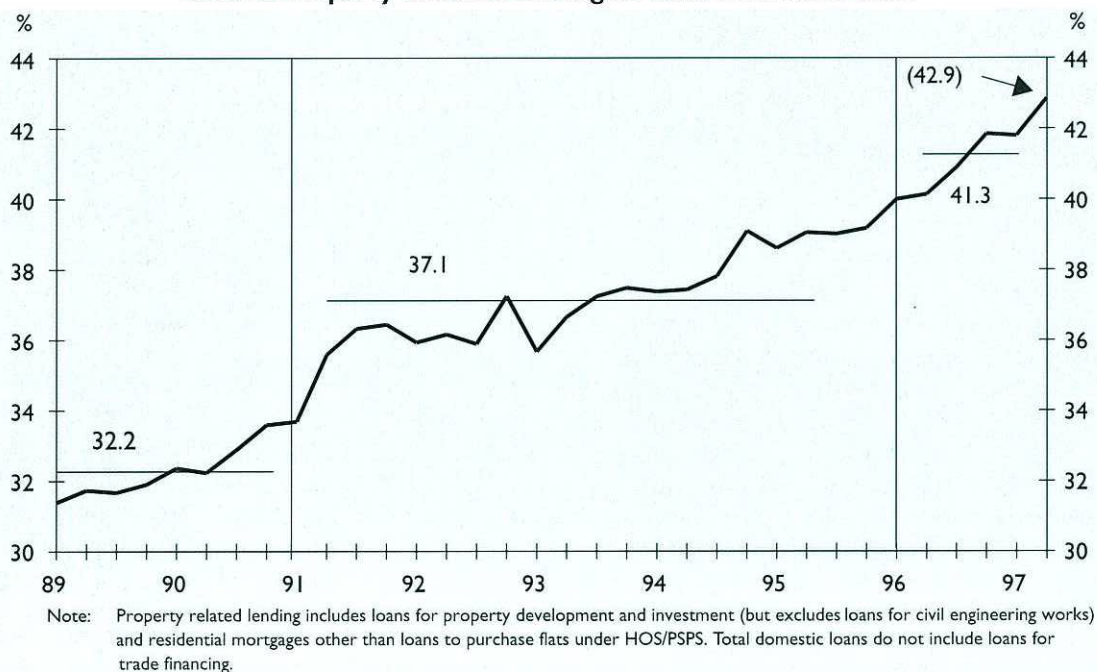


Chart 4
Ratio of Property Related Lending to Total Domestic Loans



which are generally more expensive. The upward trend is even more pronounced when total domestic loans are compared with total deposits (Chart 2). On the other hand, the ratio of total loans to total deposits (in HK dollar and foreign currencies) has declined (Chart 3). This reflects the slower growth

in loans for trade financing and offshore loans relative to property loans.

The increasing concentration of bank lending in the property sector is illustrated in Chart 4, which shows that the share of property lending has been rising from about 30% in 1989 to over 40% in

Chart 5
Growth of HK\$M3, Loans for Use in Hong Kong and Nominal GDP

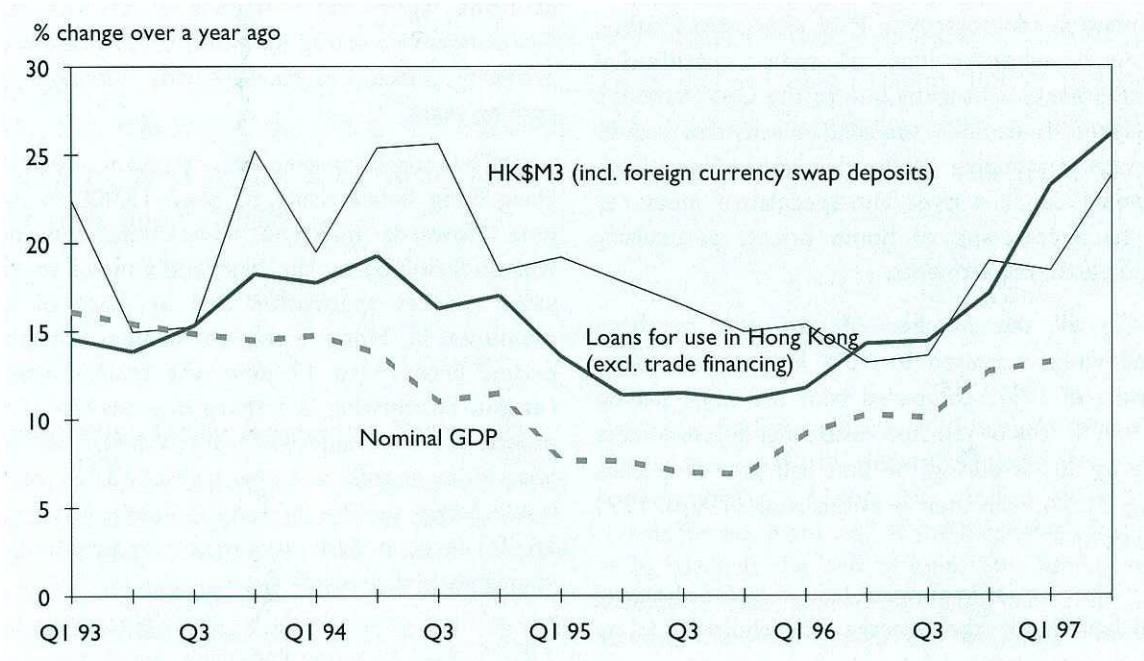
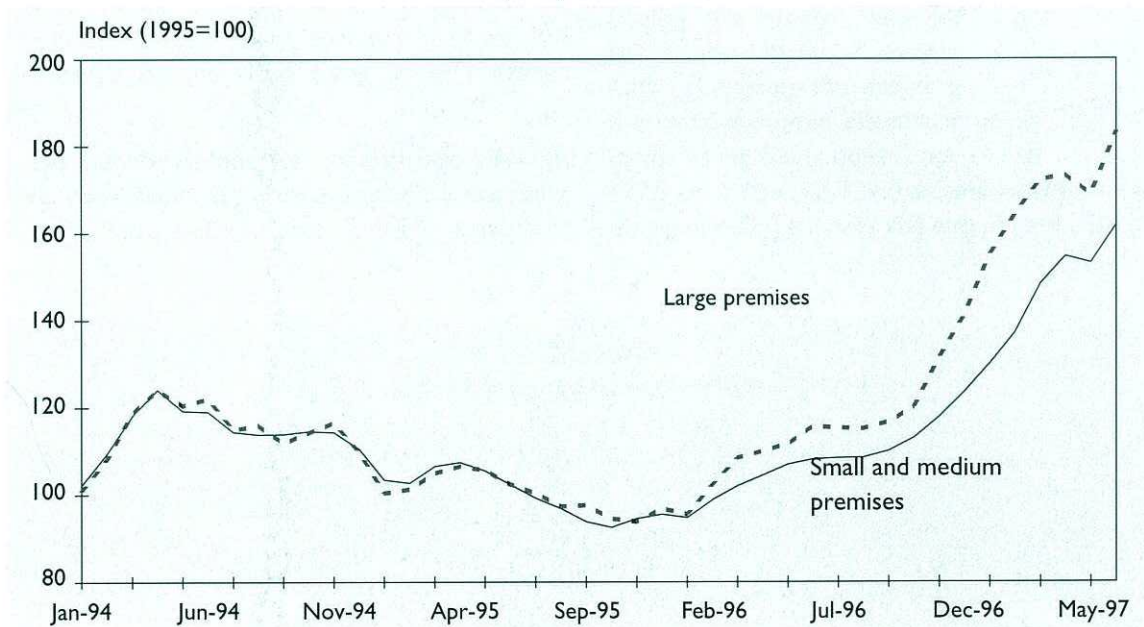


Chart 6
Property Price Indices



June 1997. On 28 July, HKMA issued a letter to all authorised institutions warning them the risks of increasing exposure to the property sector and reminding them to strictly apply existing criteria, including loan to valuation ratios and debt servicing ability.

Fueled by credit expansion and strong transactions demand for money, broad money supply, HK\$M3, grew by 23.8% in June 1997, faster than the nominal GDP growth (Chart 5). The narrow money supply, HK\$M1, grew by 15.5%.

Asset Markets

The residential property market regained momentum temporarily in May, after consolidating in April when prices of major residential developments fell slightly due to the Government's measures to dampen speculative activities and to increase the supply of housing units. Since June, renewed concern over anti-speculative measures led to a softening of home prices, particularly among luxury apartments.

In all the number of sale and purchase agreements increased by 73% in the first seven months of 1997, compared with the same period of 1996. Prices of selected residential developments rose by 30.7% during the first half year and were up by 31.5% from their previous peak in April 1994 (Chart 6).

The surge in prices has reduced housing affordability for the average household in Hong

Kong, despite lower mortgage interest rates and higher incomes. Market sentiment has turned cautious again since late-June as the SAR Government re-stated its intent to curb escalating property prices and increase land supply in the coming years.

The stock market was buoyant, with the Hang Seng Index rising to over 15,000 in early June. Towards mid-June, investment sentiment was undermined by the Mainland's move to curb stock market speculation and by fears of new measures in Hong Kong to dampen property prices. From 4 to 12 June, the market was in retreat, culminating in a sharp one-day fall of 497 points. As the Handover approached, the Hang Seng Index soared to a new high of 15,197 on the last trading session in June. It rose further to 16,400 level in early August on expectations of strong earning growth. ☺

– Prepared by the External Department