THE EXTERNAL ENVIRONMENT

The global economy has remained volatile over the past three months. Intensified financial turmoil prompted Malaysia to impose capital controls and forced Russia to devalue the rouble as well as to impose a 90-day debt moratorium in August. These events were then followed by devaluation of several Latin American currencies and the revelation of huge losses incurred by Long Term Capital Management and other hedge funds. Heightened risk aversion and large losses reported by major banks in the US and Europe aggravated concern about an impending credit crunch and global recession. The US corporate yield spread was pushed up to exceptional levels and a major unwinding of short yen positions drove up the Japanese yen by 30% against the US dollar in mid-October. In response, the G7 advocated more active steps to contain the global financial crisis and several industrial countries lowered their interest rates. This helped to restore some stability to major financial markets since mid-October.

In Asia, a stronger yen and lower US interest rates offered some relief to the region's currencies and economies. Most economic indicators are still pointing downwards, reflecting lagged adjustment of the real sector to earlier financial turmoil. While signs of sustained recovery remain scarce, there is growing evidence that the region may enjoy broader stability in the coming months.

Domestic activity in the Mainland is gaining momentum, while exports and foreign direct investment remain sluggish. Government policies to stimulate investment started to bear fruit as investment in priority sectors surged substantially. Signals on domestic consumption are mixed. Retail sales volume has held up well in recent months, while sales value remains modest. There are signs that the Mainland economy is starting to recover from deflation pressures as prices rose gradually on a month-on-month basis. Notwithstanding higher growth of domestic activity, the downside risks from deteriorating external demand and other structural impediments continue to pose challenges to the government. In light of the Asian crisis, various measures are being taken to improve capital flow management.

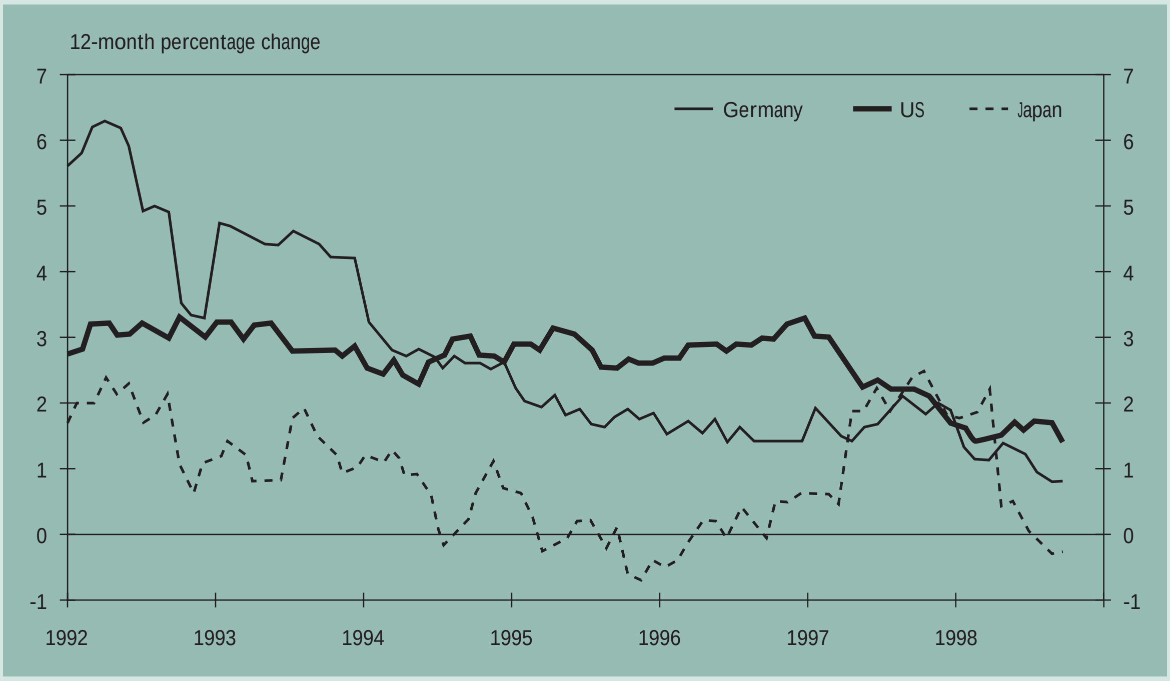
Economic Activity

In late summer and early fall, the Asian financial turmoil spread to other emerging markets and industrialised economies. Volatile market conditions in Hong Kong and Malaysia were aggravated by the Russian default in mid-August and the devaluation of several Latin American currencies in early September. These events were followed by the near-collapse of a highly leveraged US hedge fund and large losses reported by major investment banks in the US and Europe. Intensified risk aversion sharply raised US corporate yield spreads and threatened an impending global credit crunch. In response, the US Federal Reserve Board cut its Fed Funds Target rate by 50 bps in two weeks, prompting some other industrial economies to follow. This helped to restore some stability to the financial markets, but concern remains about further deterioration of the global economy.

During the past quarter, the US economy has shown increasing signs of prospective growth moderation, but current activity remains strong. This is evident from the 3.3% real GDP growth outturn in Q3 1998, up from 1.8% in the second quarter. Consumption continued to provide the main impetus for growth, rising by 3.9% in Q3 1998. This is significantly lower than the 6.1% growth surge in both Q1 and Q2 of 1998 but remains slightly above last year's 3.4% average.

Other economic indicators also pointed to slower but continued growth. While the consumer confidence index fell to a near 2-year low of 117.3 in October after attaining new highs in the second quarter, this remained higher than the annual average of the past 12 years, or double the level of the previous recession. Similarly, retail sales fell 0.1% quarter-on-quarter in Q3, the first decline since the second quarter of 1997. However, on a year-on-year basis, the 4.0% growth in retail sales is substantially higher than the 0.6% cyclical trough recorded in 1991.

Chart 1
Inflation: G3 Economics



After staying above the boom-and-bust 50 line for 22 consecutive months, the National Association of Purchasing Management index has dropped below since June, but remains 9 points higher than the previous trough recorded in January 1991. The capacity utilisation rate also declined from 82.5 and 82.0 in the first and second quarters to an average 81.1 in the third quarter. Yet, this remains almost 2 percentage points higher than the level of 1991. In the labor market, the unemployment rate rebounded to 4.6% in October after falling to a 28-year low of 4.3% in April, but remains well below the 7.8% reached in mid-1992.

In the external sector, the US trade deficit widened to US$123.1 billion in the first nine months of 1998, up 51% from a year ago. In GDP terms, the current account is running at a deficit of about 2.7% in Q2 of 1998, still some distance from the previous peak of 3.6% reached in 1987.

Growth in Europe also appears to be moderating. The European Commission in late October trimmed its 1998 growth forecast for the EU-11 countries from 3.2% to 2.6%. Business confidence appears to have peaked in Germany, France and Belgium. German plant and machinery orders dropped 24% year-on-year in September, while export orders declined 35%, the weakest performance since the early 1980s. The European banking sector is also under pressure, given its role as the top lender to developing Asia, Russia and Latin America. According to the BIS, combined European bank exposures to the above three areas were estimated at 44%, 69% and 55% respectively of all BIS reporting banks at end-1997.

The Japanese economy remained weak. Real GDP growth stayed negative for the third consecutive quarter, contracting by a quarter-on-quarter 0.8% in Q2 1998. Industrial output dropped 8.6% year-on-year and retail sales fell 3.9% over a year ago in Q3. Unemployment rate stayed at record level of 4.3% in September. The trade surplus remained at a high level as the decline in imports continued to outpace the fall in exports. Capital investment stayed weak with machine tool orders slumping 16.2% year-on-year in September. The September Tankan survey indicated that both small and medium-sized companies and large corporations were suffering from deteriorating cash flows.

Inflation

Inflation in most of the developed countries stayed benign (Chart 1). In the US, the CPI rose by an average 1.6% rate in the first ten months of 1998 compared with 2.3% in 1997 as a whole and 3.0% in 1996. Producer prices continued their downward trend in 1998, falling 1.0% in the first ten months.

In the Euro area, consumer prices eased from a year-on-year 1.4% in July to 1.0 % in September. Germany and France, the two largest Euroland countries, saw their consumer price inflation rates fall to 0.8% and 0.5% respectively in September. Throughout Europe, import, wholesale, and producer prices all eased sharply in recent months, with some dipping into negative territory.

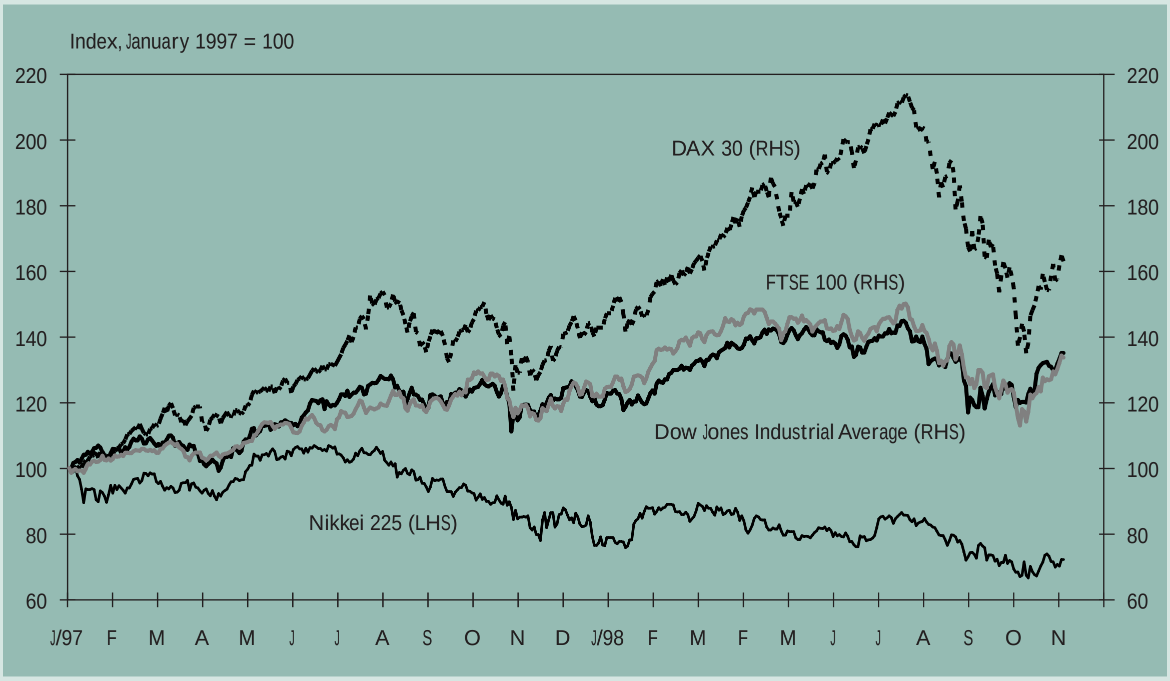
In Japan, the pace of decline in domestic wholesale prices stabilized at a year-on-year rate of 1.9% in Q3, the same as in Q2. Consumer price inflation has turned negative since July, with prices falling by 0.2% in September.

Monetary Policy

On 29 September, the US Federal Reserve Board cut the Fed Funds Target rate by 25 bps at its Open Market Committee (FOMC) meeting, the first cut since January 1996. It then surprised markets by again cutting the Fed Funds Target rate and the discount rate by 25 bps on 15 October, four weeks ahead of the next FOMC meeting.

According to the Fed, the cuts were prompted by growing caution by lenders and unsettling conditions in financial markets, as evidenced by the sharp decline in US stock markets in August, the huge trading losses announced by many financial institutions, and the sharp widening of spreads between US corporate bond yields and Treasuries. Growing signs of an economic slowdown and subdued inflation also supported the Fed's shift to a more expansionary policy.

Chart 2
Stock Market Performance of US, Japan, UK and Germany



In Europe, more than seven countries have reduced their interest rates since October. The Bank of England cut its repo rate twice by a total of 75 bps, reversing the last tightening move just five months ago. However, the Bundesbank held firm to its stance despite mounting domestic pressures and signs of growth moderation. This reinforced the view that interest rates in the Euro-11 region will converge to the 3.3% level (repo rate) of Germany and France.

In Japan, the Bank of Japan reduced its target overnight call rate by 25 bps to 0.25% on 9 September. Given near-zero interest rates, the room for further cuts is very limited.

Financial Markets

In foreign exchange markets, volatility increased with the effective devaluation of the Russian rouble and the currencies of Venezuela, Colombia and Ecuador between mid-August and mid-September. This was followed by a sharp 30% strengthening of the Japanese yen against the US dollar in early October, partly due to short-covering activities triggered by tightened credit to hedge funds. The Japanese government's proposal and subsequent approval of a Y60-trillion bank restructuring package also contributed to the rebound of the yen. At the same time the US dollar weakened to a 21-month low against the Deutschemark and French Franc on concerns of a credit crunch and a slowing US economy.

In securities markets, US and European equities fell sharply after reaching peaks in July, and rebounded only after the second US interest rate cut in mid-October (Chart 2). Meanwhile, the Japanese stock market also fell to a near 13-year low in early October. In early September, the Federal Reserve Bank of New York coordinated an unprecedented US$3.6-billion arrangement with 14 financial institutions to rescue a highly leveraged hedge fund, Long Term Capital Management. This was followed by reports of large losses suffered by many hedge funds, securities firms and major investment banks, raising concerns about growing instability of the global financial system. In response, consensus among the industrial economies increased regarding the need to avert an impending

Table 1
Real GDP Growth of Selected Asian Economies in Q2 1998[1]

	Real GDP growth (% yoy)
Indonesia	-16.8[2]
Malaysia	-6.8
Philippines	-1.2
Singapore	1.6[3]
South Korea	-6.7

[1] For Thailand, only yearly GDP figures are available.
[2] -17.4% for the third quarter.
[3] On a quarter-on-quarter basis, real GDP fell 1.7% in the quarter.

credit crunch and to stabilise and revamp the global financial system. This, together with lower interest rates in major industrial economies, helped to reduce volatility in major financial markets from mid-October.

Asia

In Asia, the release of GDP figures confirmed that real activity took another deep dive in Q2 1998 (Table 1). The poor macroeconomic performance of most Asian countries was characterised by weak domestic demand, attributed to sharp falls in consumer spending and business investment. Unemployment continued to rise throughout the region, while bank credit contracted. This overall picture generally remained intact in Q3, although the slowdown in activity appeared to be losing momentum.

Subdued domestic demand has contained inflation, despite the sharp depreciation in most Asian exchange rates. Even for economies that experienced sharp falls in their currencies during the most turbulent times of the turmoil, the pass-through effect of exchange rate depreciation has generally turned out to be much milder than expected. This is reflected in the decline in the consensus forecasts of inflation for the region. (Table 2)

To some extent, the favourable inflation outcomes have enabled the crisis-hit countries to consolidate part of the gains in competitiveness

Table 2
Consensus Forecasts of Growth and Inflation for 1998

	Real GDP (% yoy)		Consumer Prices (% yoy)	
Survey Date	13 July	12 Oct	13 July	12 Oct
Indonesia	-15.1	-16.5	73.4	65.1
Malaysia	-2.6	-4.8	7.6	6.3
Philippines	2.1	-0.6	10.0	9.8
Singapore	0.4	0.0	1.3	0.4
South Korea	-4.3	-6.7	9.2	7.9
Thailand	-7.2	-7.9	10.4	8.8

Source: *Asia Pacific Consensus Forecasts, July and October issues.*

reaped through earlier currency falls. However, it will take time for the increased competitiveness to be translated into sustained gains in export performance. Many exporters and producers have lost financing during the turmoil and are still finding it hard to get credit lines from financial institutions. At the moment, improvements in merchandise trade surpluses are impressive, but that is more of a result of import compression, rather than export expansion. There is thus the danger that, if and when demand picks up, imports would increase while exports might not have regained market share and the trade surplus could be pared considerably.

Meanwhile, the surge of the yen and cuts in US interest rates have greatly reduced the likelihood of another round of competitive devaluation, providing breathing space for Asia. Most countries in the region are now seeing their interest rates fall and their currencies rebound in varying degrees. Sentiment has thus become more favourable than a few months ago, as evidenced by the return of some overseas funds and stock market rallies. Nonetheless, while there appears to be some early signs of a bottoming out of activity, the road to recovery still looks bumpy against the background of many unresolved structural problems. The prospects for sustained recovery remain critically dependent on how well these economies proceed on their reform paths or, more specifically, how committed they are to reforming their banking sectors and to formulating credible and prudent economic policies.

Mainland Chinese economy

Economic Developments

The Mainland's domestic spending is gathering pace amid slowing export and foreign direct investment growth. Real GDP growth picked up significantly from 6.8% in the second quarter to 7.6% in the third quarter of 1998, bringing the year-to-date growth rate to 7.2%. Higher growth in the third quarter was mainly attributed to an acceleration of fixed investment and a slight improvement in private consumption and industrial output.

Underpinning the upward trend in economic activity in the third quarter was a government-driven investment surge that offset the drag from weakening exports and foreign direct investment. In September, fixed investment by state-owned enterprises leapt 33.8% year-on-year, up from 26.9% in August and 13.8% in the first half of 1998. On the other hand, actual FDI dropped by 1.0% in the first nine months of 1998, while contracted FDI rose 2.5%. The Asian financial turmoil and slowing global economic growth are likely to further contain foreign investment flows to the Mainland in the short term.

Nevertheless, infrastructure investment is expected to remain as the primary growth impetus in coming months, particularly given simplifications in the approval process and additional funding for new projects. The issuance of an additional RMB100-billion in treasury bonds should support further infrastructure investment. At the same time, the authorities encouraged banks to increase lending by RMB100 billion to support investment in agricultural infrastructure, railway and telecommunications projects.

Industrial production data provided further evidence that domestic activity is gaining momentum. Industrial value-added rose by 10.6% in October after growing by 8.6% and 7.7% in the third and second quarters respectively. The growth of industrial output in the third quarter was due mainly to faster growth in sectors related to infrastructure investment, such as building materials. Output of chemical fibres surged 17.5% in 3Q98 from 12.0% in 2Q98, cement production increased by 4.1% from a fall of 3.9%, and glass output rose 4.7% from a contraction of 3.1%. On the other hand, the sales/output ratio suggested that inventories were building up at a slower pace. The sales/output ratio improved to 97.8% in September from 97.6% and 96.3% in August and July respectively. The recent acceleration in the growth of electricity production was another sign of rebound in domestic activity.

Consumption growth is picking up, but it is not yet clear if the uptrend can be sustained. Consumption, which accounts for 60% of GDP, seems to have accelerated in August and July. Retail sales value grew by 9.3% in August and 8.1% in July, but the rise might be the result of a one-off flood-induced demand. In September, retail sales growth slowed to 7.0%. Adjusted for price changes, sales volume grew by 10.3% in Q3 compared with 10% in Q2 1998 (Chart 3).

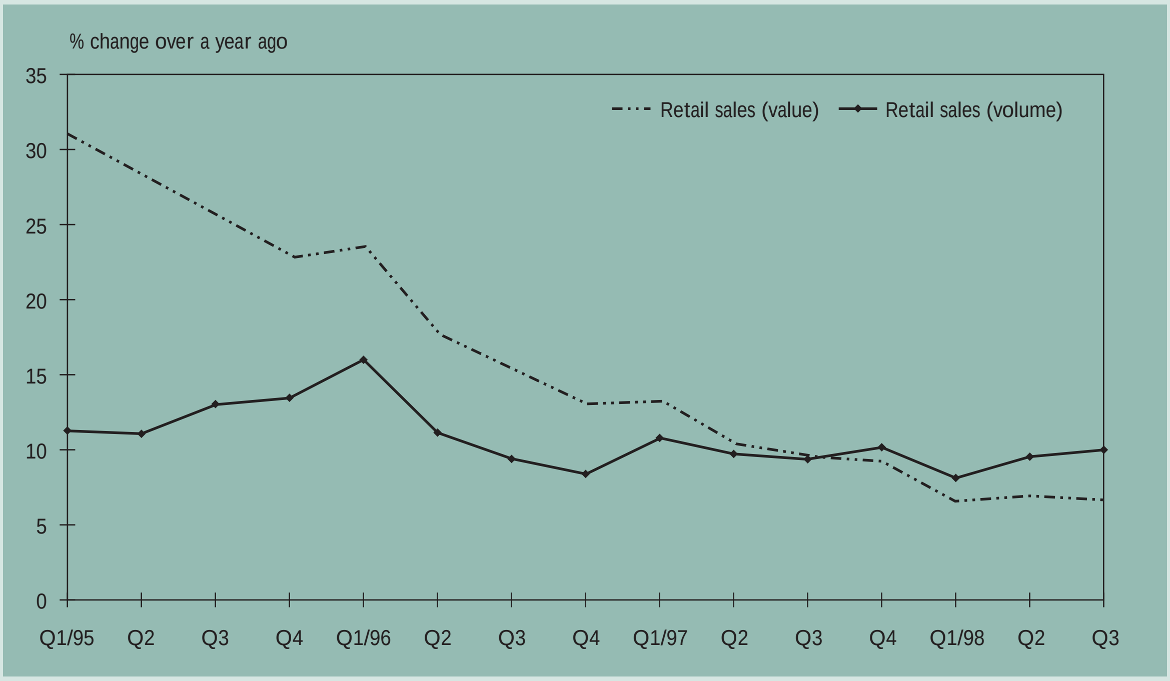
External Sector

A weak Japanese economy and the Asian crisis continued to hit the Mainland's external sector. In addition, export growth to the US and Europe has slowed since June 1998. Exports weakened further in September, down 6.7% after a 2.9% fall in August, leading to a 2.2% decline in Q3 compared with a 2.6% increase in Q298. Exports to Japan and Korea dropped by 11.1% and 30.3% year-on-year in September 1998 respectively. Export growth to the US, the country's largest export market, moderated to 11.2% in September compared with 12.8% in August and 17.8% in July. Looking forward, the Asian crisis and the likely slowdown in the OECD countries may continue to cloud China's export prospects.

Import growth remains weak despite a 0.6% rise in September, reversing the downtrend of the previous two months. Import demand may turn stronger as investment and consumption accelerate. Nevertheless, weak import demand has contributed to a sizeable trade surplus of US$12.8 billion in the third quarter, raising the total trade surplus by 15% to US$35.3 billion in the first three quarters of 1998.

In October, both exports and imports plunged markedly by 17.3% and 9.2% respectively in US dollar terms, leading to an aggregate 0.7% fall in imports and a marginal 1.3% rise in exports during the first ten months of 1998. The decline in exports mainly reflected sluggish external demand. However, China's export competitiveness appears to be holding up well when compared with other Asian countries whose exports have declined even faster (except the Philippines). In US dollar terms, South Korea's exports fell by 2.7% in the first ten months, while exports of Malaysia dropped by 10.3% in the first nine months of 1998.

Chart 3
China's Retail sales



Inflation

There are signs that consumer prices are bottoming out. On a year-on-year basis, retail prices (RPI) and consumer prices (CPI) fell by 3.3% and 1.4% respectively in the third quarter and another 2.9% and 1.1% in October, but they actually rose modestly on a month-on-month basis (m-o-m). On a m-o-m basis, the RPI and CPI rose by 0.6% and 0.8% respectively in August, and then accelerated to 1.0% and 1.6% respectively in September. Indeed, the RPI has risen month-on-month since June. The moderate revival of prices reflects factors such as higher growth of fixed asset investment, increased demand driven by reconstruction of flood-affected areas, and crack down on price wars, dumping and smuggling.

Monetary developments

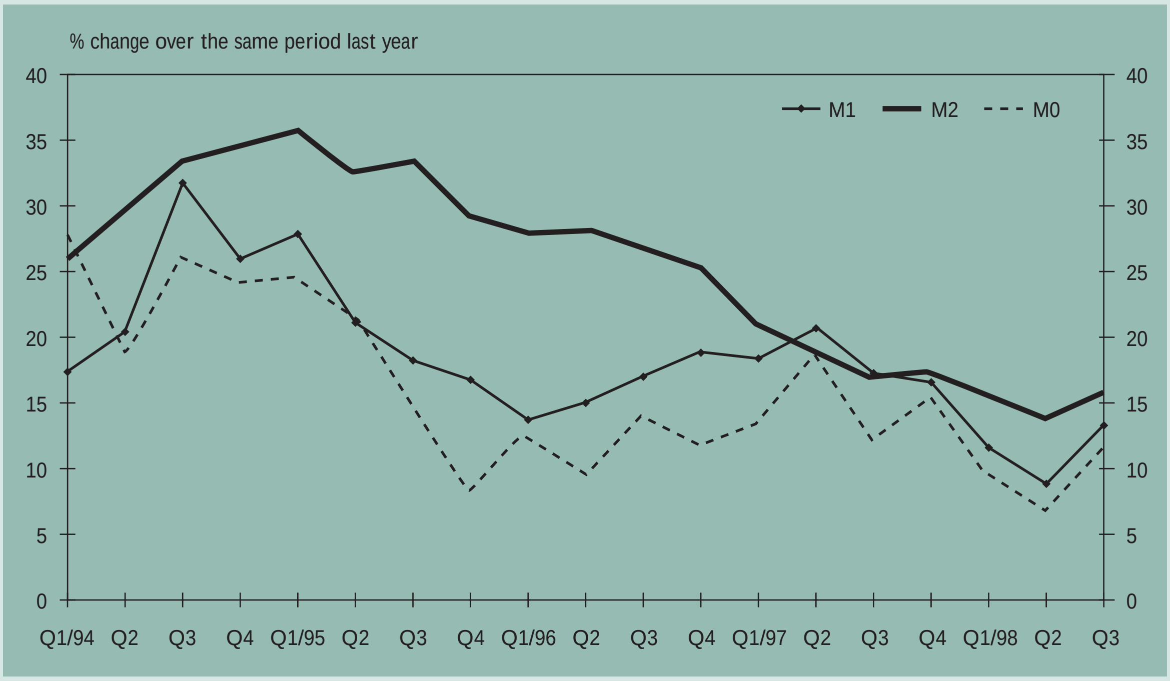
Monetary indicators have recovered during the third quarter after hitting cyclical lows in June. At end-September 1998, the narrow money supply M1 rose by 13.2% y-o-y, up from 10.9% and 8.7% at end-August and end-June respectively (Chart 4). M2 growth also picked up to 16.0% at end-September compared with 15.0% in August. Money supply accelerated further in October with M1 rising by 13.5% and M2 by 16.3%.

After the July domestic interest rate cut, the PBoC had lowered US$ deposit and lending rates twice[1] but domestic rates were kept unchanged. This puts 1-year US$ deposit rate at 3.75% p.a. (against 4.77% for the corresponding RMB deposit). With the continued decline in prices, real interest rates have remained at high levels. Adjusted for consumer price inflation, the real six-month RMB lending and deposit rates stood at 8.1% and 5.5% respectively in September.

Foreign exchange reserves

The Mainland's foreign exchange reserves remained huge but the amount has increased very little so far this year. Foreign exchange reserves only increased by US$1.2 billion in the first nine months of 1998 to US$141.1 billion. The reasons for the slow increase in foreign exchange reserves are twofold. *First*, enterprises are allowed to retain

Chart 4
China's Money Supply



[1] Interest rates on US$ deposits were lowered twice - once in September 1998 and again in late October.

15% of their export earnings instead of selling all of them to the state. *Second*, there may have been an increase in illegal transactions and capital outflows. This has prompted the government to intensify its combat against smuggling and illegal forex transactions. Other measures were also taken to ensure repatriation of forex earnings, tighten the issuance of foreign debt or guarantees by central government agencies and local governments, prohibit advance debt repayment, and close all regional swap centres on 1 December 1998. In September, foreign reserves increased by US$900 million to US$141.1 billion, hinting at some initial success of these measures.

Implications for Hong Kong

Sustained real GDP growth of the Mainland should benefit Hong Kong positively, while the recent pick up in prices may only have minor impact on Hong Kong's inflation given generally weak price pressures in the SAR. Nevertheless, the Mainland's weak export growth is likely to affect negatively Hong Kong's re-export trade.

- Prepared by the Research Department