HALF-YEARLY MONETARY AND FINANCIAL STABILITY REPORT

June 2004

This Report relies on statistical information available by end-May 2004.

Summary

Risks to monetary and financial stability in Hong Kong have receded further, as economic conditions continued to improve in the first half of this year. The outlook is generally favourable. Projections for real GDP growth in Hong Kong in 2004 have been revised upwards in recent months, and observers are predicting that deflation, as measured by the annual rate of change of the Composite CPI, is likely to end this year. At the same time, a number of external risks could have an impact on Hong Kong. While economic prospects are brighter now, it is important to guard against excessive optimism.

The improvement in the local economy reflects a combination of global recovery and unusually low interest rates. Growth in most of Hong Kong's main trading partners, particularly Mainland China, the US and Japan, has been stronger than earlier expected. In particular, the expansion in the Mainland economy has accelerated significantly and has become an increasingly important source of growth for regional economies. Global monetary and financial conditions have remained supportive, despite growing expectations that monetary policy in the US and elsewhere will be tightened this year and the policy measures taken to slow growth on the Mainland.

Reflecting these favourable external conditions, the recovery in Hong Kong has become more broad-based. Exports of goods and services have continued to rise strongly, in line with robust trade activity of the Mainland. Tourism has benefited from rising income on the Mainland and a widening of the individual visitor scheme. Property prices have rebounded vigorously from their trough in mid-2003 and domestic demand has shown signs of recovery, with both private consumption and investment increasing in the first quarter of 2004. The level of the Composite CPI has been broadly stable since the middle of 2003, implying reduced deflationary pressures. The unemployment rate has started to decline also.

In line with these developments, monetary and financial conditions in Hong Kong have been stable. In particular, the Hong Kong dollar exchange rate has returned to a level very close to HK$7.8 per US$1, in part reflecting a stronger US dollar and

reduced upward pressure on the renminbi exchange rate. The movements in the Hong Kong dollar were associated with a triggering of the Convertibility Undertaking (CU) on a number of occasions during April and May, which has caused the Aggregate Balance to start declining towards more normal levels.

Short-term interest rates have remained close to zero per cent as a result of low US interest rates and capital inflows. Together with easing deflation, this has reduced real interest rates. The Hong Kong dollar has continued to depreciate in real effective terms. Equity prices have stayed at relatively high levels despite some volatility in recent months. These developments have been associated with increased bank profitability and improved asset quality. The economic recovery in Hong Kong is expected to continue. The latest Consensus Forecasts project real GDP to grow by 6% in 2004 and price deflation to dissipate for the year as a whole.

Of course, forecasts of future economic conditions are subject to considerable uncertainty and there are several risks which, if they materialise, may slow down the growth momentum. In particular, with global recovery pushing up commodity and consumer prices, tighter monetary policy in the US and elsewhere is likely. Unless interest rate increases are significantly larger and more rapid than generally expected, however, it seems unlikely that they will undermine the recovery in Hong Kong. Another potential concern is the risk of a hard landing in the Mainland economy. The measures announced by the authorities in recent months, however, seem appropriate and well-calibrated to the need to control the growth of investment and bank credit. The overall risk of a rapid slowing of the Mainland economy is therefore small. In sum, monetary and financial stability in Hong Kong is likely to be supported by generally favourable macroeconomic conditions in the period ahead, although there are uncertainties surrounding the pace of growth.

Half-Yearly Monetary and Financial Stability Report
June 2004

Table of Contents

1. Global and regional setting

External demand

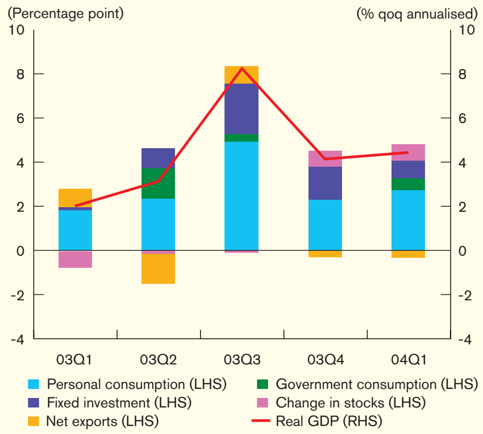
The global recovery has strengthened and broadened in the six months since the December Report. Growth remains solid in the US and has picked up in emerging Asian economies and Japan. The euro area is still lagging behind the global upturn. Monetary policy, in general, remains accommodative, but attention is increasingly shifting to the effect of higher growth on inflation, and its implications for global interest rates.

1.1 United States

Real GDP growth increased to 4.4% (annualised) in 2004 Q1, from 4.1% in 2003 Q4. The growth rate of consumption and investment spending remained high. Government spending and stockbuilding made a positive contribution to growth, while that of net exports remained moderately negative (Chart 1.1). Forward-looking indicators suggest that the growth momentum continued in Q2. In particular, business survey readings and consumer confidence strengthened (Table 1.A).

The rate of consumption growth increased to 3.9% (annualised) in 2004 Q1. Real income is becoming a more important factor supporting consumption growth. The growth of real personal disposable income was 4.9% (annualised) in 2004 Q1, higher than the average of 3.8% during 2003. Within this, real compensation to employees rose by 3.9% (annualised), up from an average of 2.5% in 2003, mainly owing to increases in non-wage benefits. The recent increases in non-farm payrolls have reduced fears about a jobless recovery, and raised the likelihood that higher labour income will help to underpin robust consumption growth. Perhaps reflecting this, consumer confidence measures have picked up.

Chart 1.1
US: contributions to GDP growth



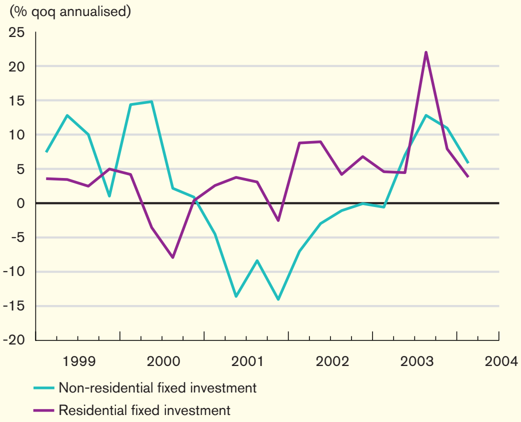
Source: Bureau of Economic Analysis.

Table 1.A
US: leading indicators of activity

		Jan	Feb	Mar	Apr	May
Institute for Supply Management						
Manufacturing PMI	index	63.6	61.4	62.5	62.4	62.8
Non-manufacturing PMI	index	65.7	60.8	65.8	68.4	65.2
Durable goods orders	% mom	-2.6	3.9	5.9	-3.2	n.a.
Retail sales	% mom	0.5	1.0	2.0	-0.5	n.a.
Conference Board						
Consumer confidence	index	97.7	88.5	88.5	93.0	93.2

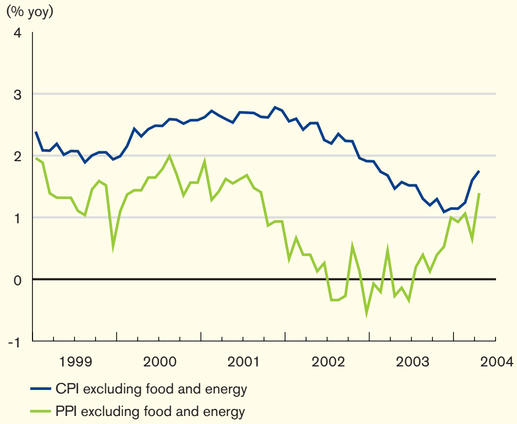
Source: Bloomberg.

Chart 1.2
US: fixed investment breakdown



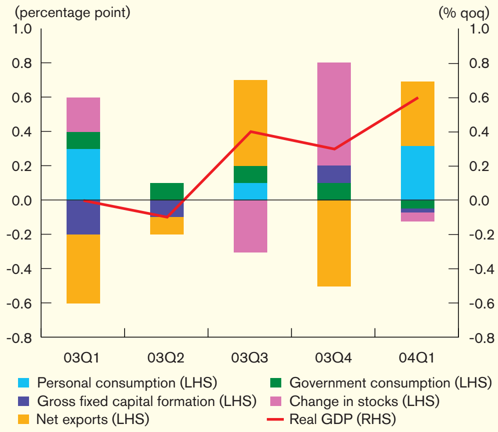
Source: CEIC.

Chart 1.3
US: core consumer and producer price indices



Source: CEIC.

Chart 1.4
Euro area: contributions to GDP growth



Source: Eurostat.

Non-residential investment spending growth remained strong, rising by 5.8% (annualised) in 2004 Q1 (Chart 1.2), mirroring sharp increases in profits. Spending on equipment and software grew by almost 10% following a double-digit pace of expansion in the preceding two quarters. By contrast, residential investment grew at its lowest rate in over two years. Business survey readings indicate that growth remained solid going into Q2. In particular, the headline reading from the manufacturing Purchasing Managers' Index (PMI) stabilised at a high level in April, and rose to a record high in the non-manufacturing survey.

Reflecting stronger growth, core inflation is rising. Annual producer price inflation, excluding food and energy, continued its upward trend, rising to 1.4% in April (Chart 1.3). More importantly for firms' costs, labour compensation rates are rising also. The growth of hourly compensation rose to 4.6% (annualised) in 2004 Q1. Strong productivity growth meant that the growth of unit labour costs was negative during much of 2003, but it turned positive in 2004 Q1. Annual core CPI inflation increased to 1.8% in April, while the headline rate rose to 2.3% from an average of 1.8% in the preceding six months.

US merchandise exports (in real terms) have grown rapidly since the middle of 2003, although the pace of expansion slowed to 6.3% (annualised) in 2004 Q1, from an average of 15% in the preceding two quarters. Similarly, import growth slowed to 6.6% from its high level in 2003 Q4. The share of Mainland China and Hong Kong exports in US imports rose to 12.8% in 2003, from 11.6% in 2002.

1.2 Euro area

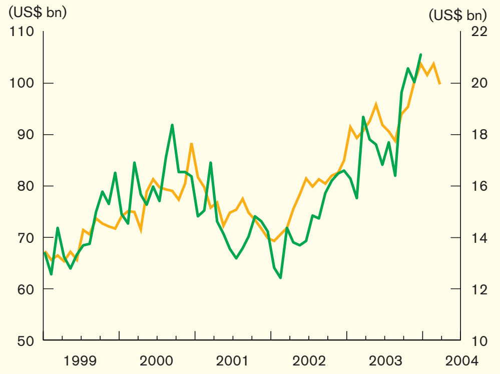
Growth in the euro area is lagging behind the global upturn. Real GDP rose by only 0.6% in 2004 Q1, taking the annual rate to 1.3%. This was driven by higher consumption and net exports (Chart 1.4). Investment spending contracted by 0.1%, the first decline since 2003 Q2. Among the three major economies, growth was the highest in France, at 0.8%, while Germany and Italy grew by 0.4%.

Table 1.B
Euro area: selected high frequency indicators

		Jan	Feb	Mar	Apr	May
Euro area						
Composite PMI	index	56.2	55.4	54.5	54.9	56.1
Manufacturing	index	52.5	52.5	53.3	54.0	54.7
Services	index	57.3	56.2	54.4	54.5	55.8
Industrial confidence	index	-6	-7	-7	-4	-5
Orders component	index	-20	-21	-21	-16	-18
Consumer confidence	index	-15	-14	-14	-14	-16
Unemployment rate	%	8.8	8.8	8.8	9.0	n.a.
Consumer credit growth	% yoy	3.8	4.9	4.8	n.a.	n.a.
National surveys						
Germany IFO (business climate)	index	97.5	96.4	95.4	96.3	96.1
Italy ISAE (business confidence)	index	93.4	92.6	93.4	96.2	94.2

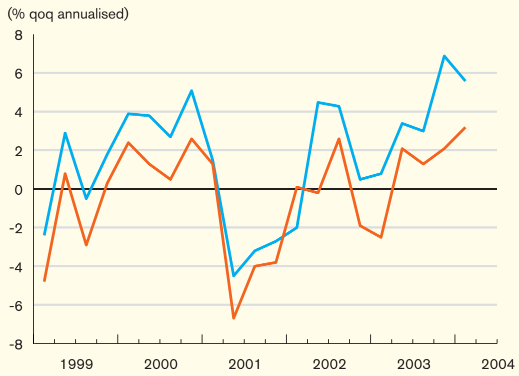
Sources: Bloomberg, Reuters and European Commission.

Chart 1.5
Euro area: Asian merchandise exports to euro area and euro area imports



Note: Asian exports include those of Japan, China, Hong Kong, NIE-3 (Singapore, South Korea and Taiwan), and ASEAN-4 (Indonesia, the Philippines, Malaysia and Thailand).
Source: IMF.

Chart 1.6
Japan: real and nominal GDP growth



Source: CEIC.

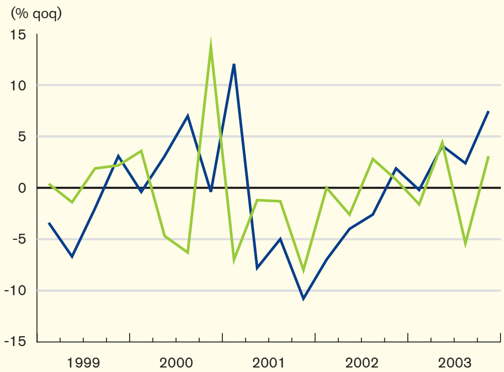
Recent economic indicators suggest some near-term uncertainty about the strength of the recovery (Table 1.B). The pace of growth in industrial production appeared to weaken at the start of this year, but business surveys point to an increase in Q2. The European Commission's industrial confidence indicator rose to its highest level in three years in April (although it fell back slightly in May) and the headline PMI readings also rose. Similarly, for consumer spending, consumer credit growth picked up but retail sales fell in February and March and consumer confidence remained lacklustre. Annual headline CPI inflation declined during 2004 Q1, before picking up to 2.0% in April, while core inflation was stable at 1.8% in the three months to April.

Euro area export growth has picked up since the middle of 2003, suggesting that higher global demand has outweighed the effects of a stronger euro. Merchandise exports grew by 1.7% in 2004 Q1, while imports contracted by 0.6%. Merchandise exports to the euro area from Asia rose by 14.8% in 2003 Q4, from 2.8% in 2003 Q3, taking the annual rate to 25.1% (Chart 1.5). The share of Mainland China and Hong Kong exports in euro area imports increased to 8.1% in 2003, from 7.1% in 2002.

1.3 Asia (ex-Mainland China)

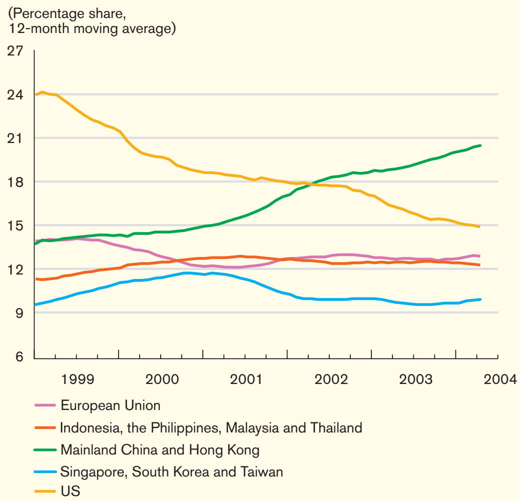
In Japan, the economy maintained its strong growth momentum in the first quarter. Real GDP rose by 5.6% (annualised) in 2004 Q1, compared with 6.9% in 2003 Q4, the eighth successive quarter of expansion (Chart 1.6). Growth was broad-based, with particularly strong expansion in fixed investment and exports. There were also increasing signs of a recovery in household spending.

Chart 1.7
Japan: breakdown of fixed investment



Source: Ministry of Finance.

Chart 1.8
Japan: merchandise imports by origin



Source: CEIC.

Table 1.C
Non-Japan Asia: year-on-year real GDP growth rate

	03Q1	03Q2	03Q3	03Q4	04Q1
NIE-3:					
Singapore	1.7	-3.9	1.7	4.9	7.5
South Korea	3.7	2.2	2.4	3.9	5.3
Taiwan	3.5	-0.1	4.2	5.2	6.3
ASEAN-4:					
Indonesia	5.5	4.8	3.7	4.1	4.5
The Philippines	4.8	4.2	4.8	5.0	6.4
Malaysia	4.6	4.5	5.2	6.6	7.6
Thailand	6.7	5.8	6.6	7.8	6.5

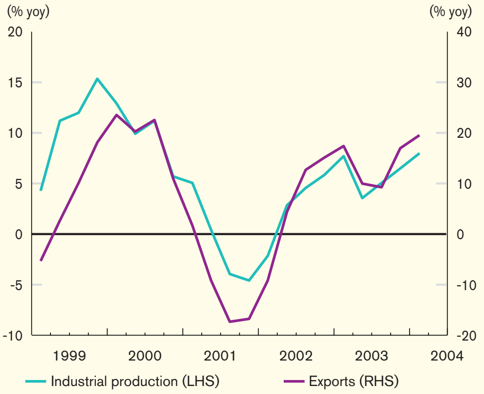
Source: Bloomberg.

Nevertheless, there are continuing concerns about the sustainability of the recovery. So far, the pick-up in investment spending has been more evident among manufacturing firms, while a clear upward trend is yet to be established in the non-manufacturing sector (Chart 1.7). Although the Tankan survey suggests that firms are optimistic, several underlying factors continue to hold back investment spending. These include the accumulation of excess capacity during the low-growth 1990s, excess corporate sector debt levels, particularly among smaller firms, and financial sector fragility. In the household sector, private consumption rose by 4.0% (annualised) in 2004 Q1, a similar rate to the previous quarter. This reflects a gradual improvement in labour market conditions, as evidenced by an apparent bottoming-out of the decline in employment since 2002, and a fall in the unemployment rate in March to its lowest level in three years. Deflationary forces have receded somewhat, with the annual CPI inflation rate, excluding fresh food, fluctuating around zero in recent months.

Merchandise exports from Japan remained strong, rising by 17.4% (annualised) in real terms in 2004 Q1, while imports rose by 10.8%. The rise in imports was mainly due to buoyant investment demand, with imports of capital goods (excluding aircraft) and IT-related goods leading overall growth. The share of Mainland China and Hong Kong exports in Japanese imports continued its upward trend, rising to 20% in 2003, from 19% in 2002 (Chart 1.8).

Growth in Singapore, South Korea, Taiwan, Indonesia, the Philippines, Malaysia, and Thailand accelerated further in 2003 Q4 and 2004 Q1 (Table 1.C). The recovery in these economies has been mainly export-led, supported by a combination of low interest rates, competitive currencies, and strong external demand from the US and Mainland China, leading to sharp increases in industrial production and profits (Chart 1.9).

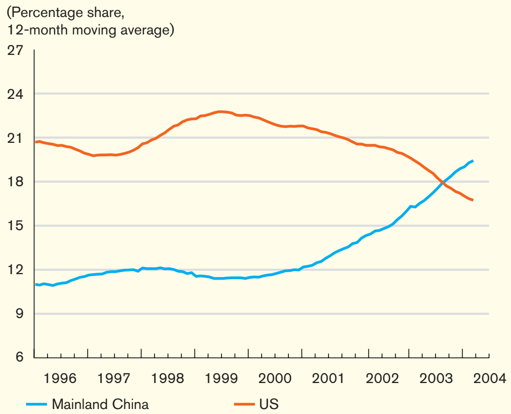
Chart 1.9
Non-Japan Asia: industrial production and merchandise exports



Note: The aggregate data cover Hong Kong, NIE-3 and ASEAN-4, with industrial production growth weighted by their 2003 GDPs valued at PPPs.

Sources: CEIC and World Economic Outlook database.

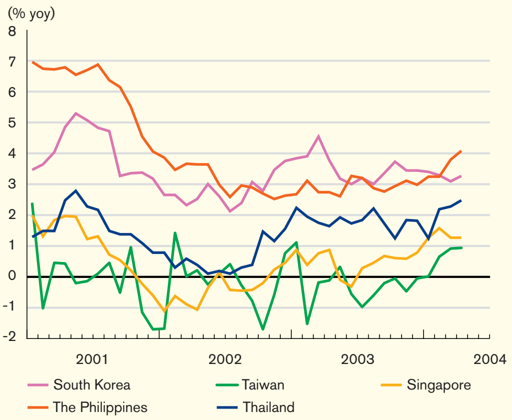
Chart 1.10
Non-Japan Asia: merchandise export shares to the Mainland and the US



Note: The data cover Hong Kong, NIE-3 and ASEAN-4 (excluding Indonesia because of the lack of timely data).

Source: CEIC.

Chart 1.11
Non-Japan Asia: headline CPI inflation



Source: CEIC.

The high degree of openness of the smaller Asian economies means that they have been well-placed to take advantage of the global recovery and associated increases in world trade flows. The increased importance of intra-regional trade, accounting for half of non-Japan Asian exports in 2003, has also created a powerful dynamic for regional expansion. In particular, trade linkages with Mainland China have increased sharply in recent years, as evidenced by a rising share of exports to the Mainland and a declining share to the US (Chart 1.10). The Mainland has emerged as a regional base for final processing and assembly of goods. Nevertheless, there is still high dependence on final demand outside of the region, and particularly the US. The HKMA estimates that around half of non-Japan Asian exports to the Mainland are intermediate inputs to goods exported outside of the region.[1]

There are increasing signs that the export-led recovery is feeding through to higher domestic demand growth, supported by increasing asset prices and expanding bank credit. In the Asian newly-industrialised economies, domestic demand made a larger contribution to GDP growth in the second half of 2003 than in the first half (except for South Korea). In Indonesia, the Philippines and Thailand, domestic demand accounted for over 80% of GDP growth in 2003. The credit cycle has turned in a number of economies. Domestic credit growth picked up in Singapore and Taiwan in the second half of 2003, and continued to grow strongly in Indonesia and Malaysia.

Consumer price inflation has picked up in many regional economies, albeit from low levels (Chart 1.11), while in Taiwan, there are signs that deflation may be coming to an end. These developments have been viewed in a positive way, reflecting stronger external and domestic demand. The sharp rises in commodity and energy prices have put upward pressures on producer prices, although so far the pass-through to consumer prices has been limited given the substantial excess capacity in capital and labour markets in many Asian economies.

[1] See "The impact of a renminbi appreciation on global imbalances and intra-regional trade", *HKMA Quarterly Bulletin*, March 2004.

Mainland China

Growth in Mainland China remains strong, largely driven by higher investment spending. Despite a series of tightening measures implemented by the authorities since mid-2003, broad money and bank credit have continued to expand rapidly. Together with an increase in consumer price inflation, these developments have raised concerns about whether the economy is overheating.

1.4 Output

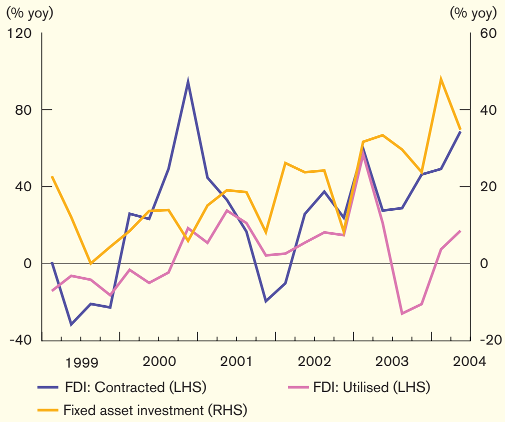
Growth in Mainland China increased to annual rates of close to 10% in 2003 Q4 and 2004 Q1 (Table 1.D). This was mainly driven by higher investment spending. Gross fixed asset investment, in nominal terms, rose strongly in 2004 Q1, before slowing to an annual rate of 34.7% in April (Chart 1.12). The share of investment in GDP has risen in recent years and accounted for almost 50% in 2003. Consumption growth was robust also, with nominal retail sales rising by 13.2% in April on a year earlier. Exports were boosted at the end of 2003 by a rush to ship products ahead of the preannounced reduction in VAT rebates on 1 January. Despite the high base of comparison, export growth slowed only moderately in the first four months of 2004. Imports grew strongly, reflecting higher demand for industrial raw materials and consumer goods.

Table 1.D
Mainland China: key economic indicators

		2003				2004
		Q1	Q2	Q3	Q4	Q1
GDP	real, % yoy	9.9	6.7	9.6	9.9	9.8
Industrial production	real, % yoy	17.2	15.2	16.6	17.7	16.6
Retail sales	% yoy	9.3	6.8	9.7	10.3	10.7
Fixed asset investment	% yoy	31.6	33.3	29.6	23.8	47.8
Exports (US$ terms)	% yoy	33.5	34.3	29.7	40.5	34.1
CPI inflation	% yoy	0.5	0.7	0.8	2.7	2.8

Source: CEIC.

Chart 1.12
Mainland China: investment

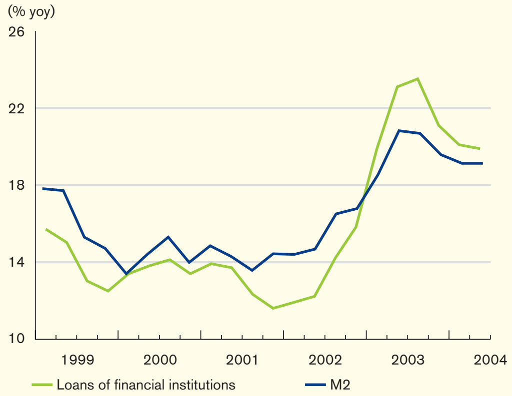


Note: 2004 Q2 figures are based on April data.

Source: CEIC.

Monetary aggregates continued to rise sharply. Broad money grew by 19.1% in April on a year earlier, only marginally slower than the rate of growth of 19.6% at the end of 2003 (Chart 1.13). Credit expanded by 19.9% in April, only slightly lower than its rate of growth of 21.1% in 2003 Q4. The economy continued to attract substantial foreign direct investment (FDI) inflows. Contracted FDI rose sharply by 54.0% in the first four months of 2004 on a year ago, while utilised foreign direct investment grew by 10.1%.

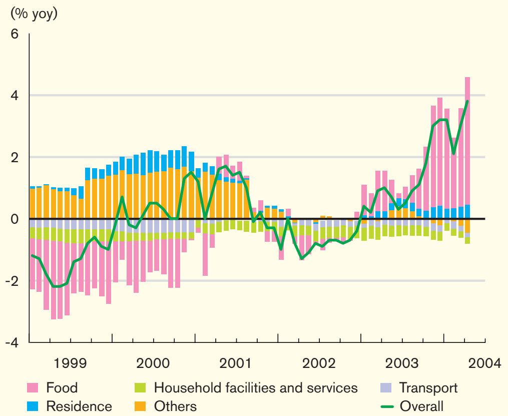
Chart 1.13
Mainland China: broad money and credit



Note: 2004 Q2 figures are based on April data.

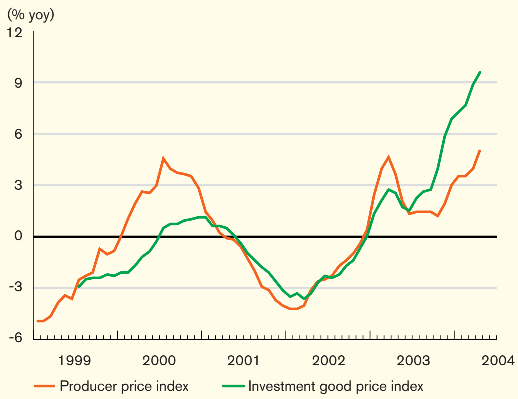
Source: CEIC.

Chart 1.14
Mainland China: contributions to CPI inflation



Source: CEIC.

Chart 1.15
Mainland China: other price indicators



Source: CEIC.

1.5 Price developments

Annual consumer price inflation has picked up in recent months, rising to 3.8% in April. This compares with an average of 1.2% in 2003 (Chart 1.14). The rise in CPI inflation has been largely driven by higher food price inflation, which averaged 7.9% in the first four months of 2004 contributing over two percentage points to the headline inflation rate. Housing costs have risen also, but at a more modest rate. The inflation rate of other consumer items has been lower, while the prices of transport and telecommunications have continued to decline.

Estimates of core inflation in advanced economies often strip out volatile price components, such as food and energy, to gauge movements in underlying inflation. On the Mainland, if food is excluded from the CPI, annual inflation was just 0.4% in April. There are two reasons why this adjustment is controversial in the case of the Mainland. First, food accounts for around one-third of the CPI basket so its exclusion significantly reduces the coverage of the CPI. Secondly, the large share of food in the consumption basket makes it more likely that increases in food prices — even if these are one-off in nature — will have second-round effects on the inflation rate through higher wage pressure, as workers seek compensation for the higher cost of living (although any pass-through is likely to be limited by the current high rate of unemployment).

Other price indicators also show signs of inflationary pressures in the pipeline. The annual rate of producer price inflation rose to 5.0% in April, with prices of some raw materials rising at double-digit rates (Chart 1.15). The rise in commodity prices in the last two years is largely due to strong growth in the Mainland and US economies.

Monetary and financial conditions

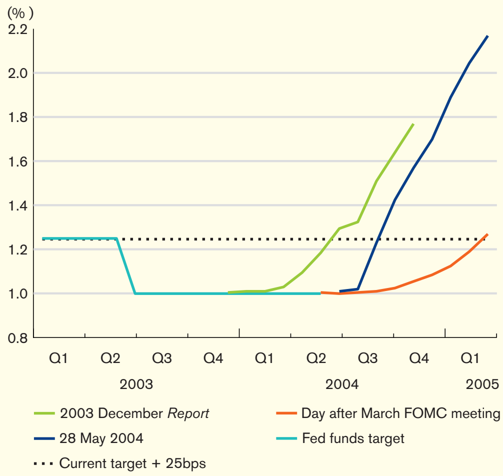
Short-term interest rates in the US, Japan and the euro area have remained unchanged, but markets expect US interest rates to rise this year. In Mainland China, the authorities raised the reserve requirements for financial institutions in April, for the second time in eight months, in an attempt to slow the growth of credit and investment spending. The US dollar rose against the euro, but there is some uncertainty about its future direction stemming from the large US current account deficit.

1.6 Interest rates

Since July 2003 the US Federal Open Market Committee (FOMC) has kept the Federal funds target rate unchanged at 1%. However, the interest rate outlook has been rather unstable. The strong market expectation of an interest rate increase reported in the December *Report* subsided somewhat during the first quarter of 2004 following weaker-than-expected macroeconomic data releases (Chart 1.16). However, against a background of sharp increases in non-farm payrolls in March and April, market participants have priced in a 25 basis point increase in the Fed funds target rate in June with a further 75 basis point increase by end of the year. Yields of 10-year US Treasury bonds have increased sharply (Chart 1.17).

Separately, long-term Japanese government bond (JGB) yields began to rise in mid-March in response to stronger economic data. Rising share prices, improving economic fundamentals and an increased supply of JGBs will continue to put upward pressure on yields. In the current fiscal year, the Japanese Government plans to issue a record ¥117.8 trillion (US$1.1 trillion) of bonds to refinance maturing debt and a budget deficit of ¥82.1 trillion. However, the Bank of Japan has indicated that short-term interest rates will only rise from the current low levels should deflation come to an end.

Chart 1.16
US: Federal funds target and futures rates

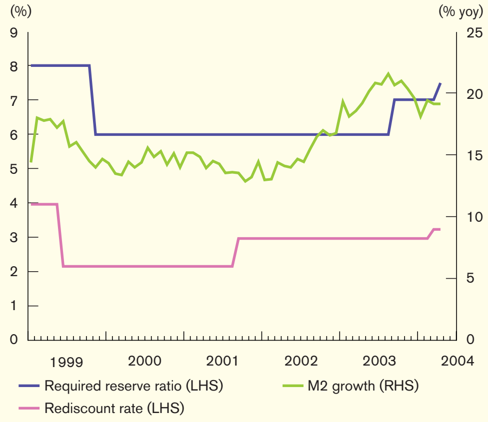


Source: Bloomberg.

Chart 1.17
Long-term government bond yields in the US and Japan

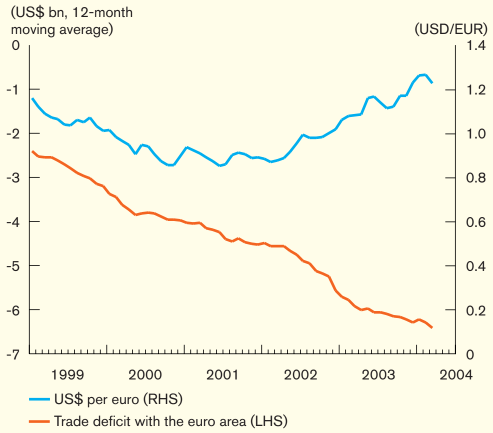
Source: Bloomberg.

Chart 1.18
Mainland China: required reserve ratio, interest rate and money growth



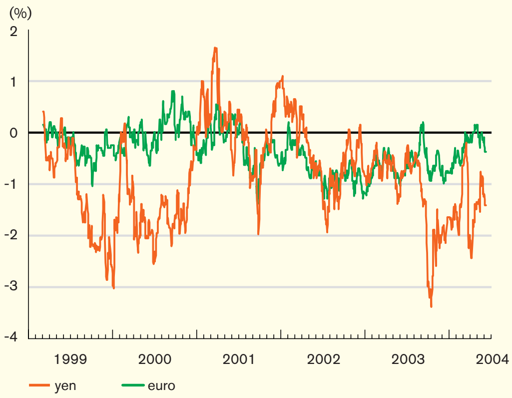
Source: CEIC.

Chart 1.19
US: bilateral exchange rate and trade balance with the euro area



Sources: CEIC and European Central Bank.

Chart 1.20
US dollar risk reversals



Notes: 1. Implied from 3-month option prices.
2. A negative value indicates a risk of yen/euro appreciation against the US dollar.

Source: JP Morgan.

The European Central Bank has kept interest rates unchanged since June 2003. It expects euro area growth to pick up as a result of strong external demand, but the recovery remains fragile and private consumption in some member countries remains weak.

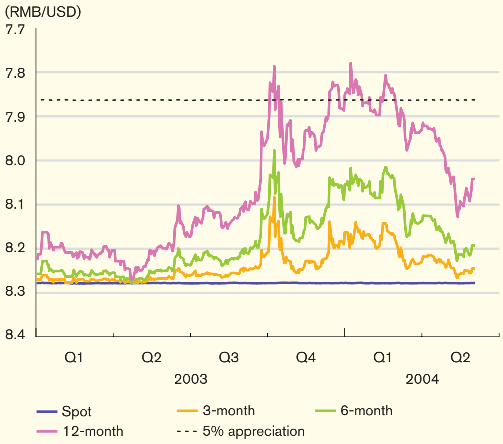
The People's Bank of China raised its re-lending rate (for loans to commercial banks with a maturity of less than one year), and the rediscount rate in March — the first increase since September 2001 (Chart 1.18). It also raised the reserve requirements ratio for financial institution by 50 basis points to 7.5%, the second increase in eight months. For those banks that have not met a standard capital adequacy ratio, the required ratio will be set higher, at 8%. The measures are aimed at slowing the growth of money and credit.

1.7 Exchange rates

The value of the US dollar, as measured by the Federal Reserve broad effective exchange rate index, rose by 4.0% between January and May. The gain was largely due to its appreciation against the euro. After falling to an all-time low of US$1.29 per euro on 17 February, the US dollar rose to around US$1.20 per euro in late May. Option prices imply that market participants expect the US dollar-euro exchange rate to remain at its current level in the near term. There are two key influences at play. On the one hand, yield differentials favour the US dollar, with the markets expecting an increase in US interest rates and possibly a cut in euro area interest rates. On the other hand, the high US trade deficit continues to weigh against US dollar strength. Despite the sharp depreciation of the US dollar against the euro over the past two years, the US trade deficit against the euro area has continued to widen (Chart 1.19).

Financial markets expect the yen to strengthen in the second half of this year. After heavy intervention in the first quarter, the yen rose sharply at the beginning of April, to 103.7 against the US dollar, on rumours that the authorities plan to scale down foreign exchange interventions. It has since fallen back. However, risk reversals derived from option prices suggest that the markets perceive a stronger probability of a substantial rise in the yen against the US dollar in the coming months (Chart 1.20).

Chart 1.21
Mainland China: renminbi spot and non-deliverable forward exchange rates



Source: Bloomberg.

Upward pressure on the renminbi has eased, reflecting recent statements by Mainland China authorities about the need to maintain a stable exchange rate and remarks by US Fed officials highlighting the potential risks of Mainland China adopting a more flexible exchange rate regime. The rates of renminbi non-deliverable forwards fell, with the 1-year discount narrowing by around 2,000 pips over the first five months of 2004 (Chart 1.21).

1.8 Equity markets

US equity prices rose steadily in 2004 Q1 before declining to the levels seen at the end of 2003, as the market priced in an earlier US interest rate increase. By contrast, share prices in Japan continued to rise on more buoyant economic prospects. The Nikkei 225 index has risen by 5% since the beginning of the year, while the TOPIX has increased by 9% driven by strong gains in the banking and retail sectors. Uncertainty about future stock prices in the US and Europe has continued to moderate, with the exception of a temporary increase in mid-March following the terrorist attacks in Madrid. The implied volatilities of options on the S&P 500 and Frankfurt DAX have declined since the first quarter of 2003 as the earnings outlook has improved.

2. Domestic economy

Output

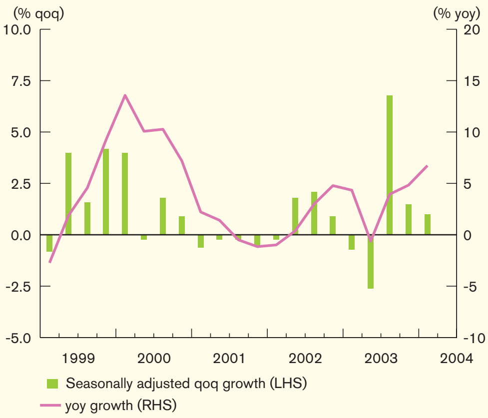
The economic recovery in Hong Kong has become more established in the first half of 2004. Growth of investment spending and consumption increased in 2004 Q1. Export growth remained buoyant, supported by improved competitiveness and strong external demand. Business survey responses indicate that the economic expansion continued in Q2. These macroeconomic developments are conducive to monetary and financial stability.

2.1 GDP growth

Real GDP growth in 2004 Q1, while strong on a year-on-year comparison at 6.8%, slowed slightly to 1% on a seasonally adjusted quarter-on-quarter basis (Chart 2.1). Economic growth continued to be driven mainly by domestic demand and exports. Domestic demand growth increased to 6.8% on a year earlier, as growth of investment spending and consumption accelerated (Table 2.A). Exports have benefited from strong demand from the Mainland and improved competitiveness stemming from a weaker US dollar.

Business survey readings indicated that growth continued into 2004 Q2. In particular, the Purchasing Managers' Index for Hong Kong — a composite index designed to provide an overview of business activity — remained well above its neutral level of 50 (Chart 2.2). This is consistent with the results from the Quarterly Business Tendency Survey, which indicated that all sectors expected their business volume to increase in Q2.

Chart 2.1
Real GDP growth



Source: C&SD

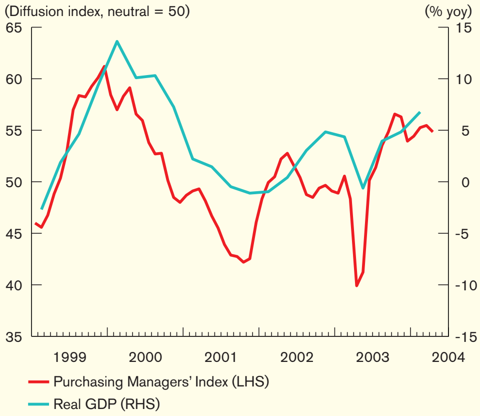
Table 2.A
GDP by expenditure components (year-on-year growth)[1]

			2003				2004
	2002	2003	Q1	Q2	Q3	Q4	Q1
Gross Domestic Product	**1.9**	**3.2**	**4.4**	**-0.6**	**4.0**	**4.9**	**6.8**
Domestic demand	-0.8	0.4	1.4	-3.6	-0.3	4.2	6.8
Consumption							
Private	-1.2	-0.2	-2.5	-3.6	1.5	3.6	5.0
Public	2.5	1.9	1.0	0.5	0.5	5.5	5.1
Gross domestic fixed capital formation	-4.5	0.1	4.2	-5.3	0.0	1.9	5.8
Private	-5.2	0.1	6.7	-5.9	-1.5	2.0	6.8
Public	-1.4	0.3	-4.7	-2.6	8.8	1.4	1.7
Change in inventories[2]	0.9	0.3	1.7	0.0	-1.2	0.8	1.5
Net exports of goods[2]	0.3	0.6	-1.0	3.3	2.1	-1.9	-2.9
Net exports of services[2]	2.3	2.2	4.1	-0.3	2.2	3.0	3.2

Notes: 1. At constant 2000 market prices.
2. Percentage point contribution to annual growth of GDP.

Source: C&SD.

Chart 2.2
Real GDP growth and Purchasing Managers' Index



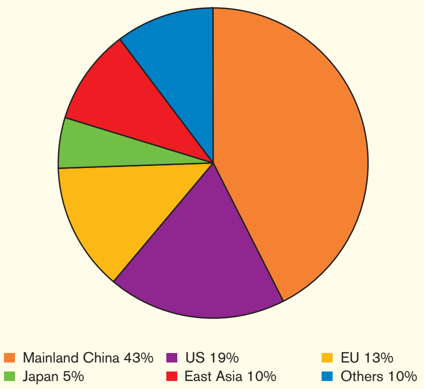
Sources: C&SD and NTC Research.

Table 2.B
Exports to major trading partners

(% yoy)	2002	2003	2003				2004
			Q1	Q2	Q3	Q4	Q1
Mainland China	13.6	18.8	17.8	19.8	16.5	21.2	16.6
US	0.9	-2.6	7.5	-4.9	-6.9	-2.7	3.6
EU	-3.3	11.7	16.1	17.5	7.9	7.5	12.4
Japan	-4.5	12.3	13.5	16.9	11.0	8.8	9.6
East Asia	9.9	12.2	12.7	12.5	9.1	14.8	23.0
Others	-0.6	12.2	51.4	9.1	-1.8	5.7	7.4
Overall	5.4	11.6	17.6	12.2	7.0	11.3	13.0

Note: East Asia refers to Taiwan, Singapore, South Korea, the Philippines, Malaysia and Indonesia.
Source: C&SD.

Chart 2.3
Share of exports to major trading partners (2003)



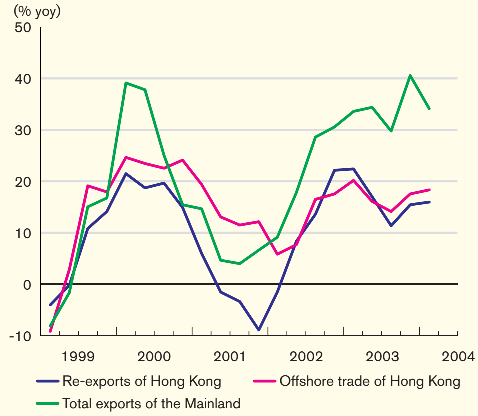
Source: C&SD.

2.2 *External trade*

Net exports were a major driving force for growth last year, accounting for over four-fifths of the increase in real GDP. Of the 3.2% rise in real GDP, net merchandise trade contributed 0.6 percentage point, and net exports of services contributed 2.2 percentage points. In 2004 Q1, however, net exports of goods declined from the high base of 2003, offsetting the continued strong growth of export of services.

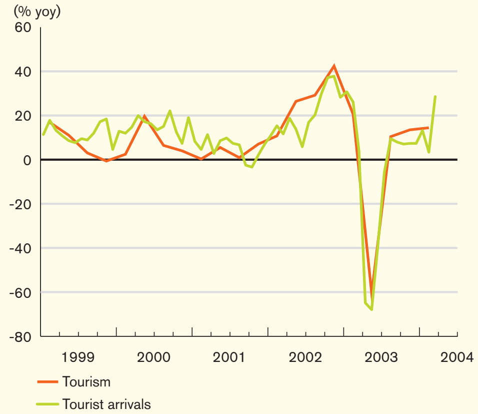
Reflecting closer economic integration with Mainland China, exports to the Mainland have been expanding at a particularly rapid pace over the last two years, with the annual growth rate rising to around 20% in nominal terms (Table 2.B). Together with exports to East Asia, these account for over half of Hong Kong's total merchandise exports (Chart 2.3). The growth of merchandise exports slowed in 2004 Q1 to 3.3% on a seasonally adjusted quarter-on-quarter comparison, although this was from a high level in 2003 Q4. Trade-related exports of services (including offshore trade) rose alongside the fast expansion of merchandise trade (Chart 2.4). In addition, inbound tourism increased. Compared to July 2003, when the individual visitor scheme was initiated, the number of tourist arrivals from Mainland China has risen by around 40% in March 2004 (Chart 2.5).

Chart 2.4
Merchandise exports



Sources: C&SD and CEIC.

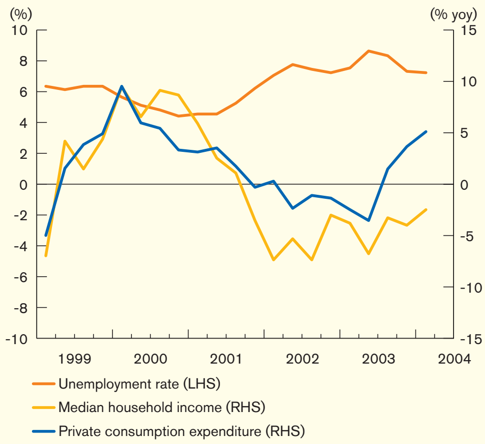
Chart 2.5
Tourism and tourist arrivals



Note: Tourism is defined as travel-related exports of services.

Sources: C&SD and Tourism Board.

Chart 2.6
Income, employment and consumption



Source: C&SD.

2.3 Domestic demand

Domestic demand continued to recover in 2004, and contributed 6.5 percentage points to growth in 2004 Q1, compared with 0.4 percentage point in 2003.

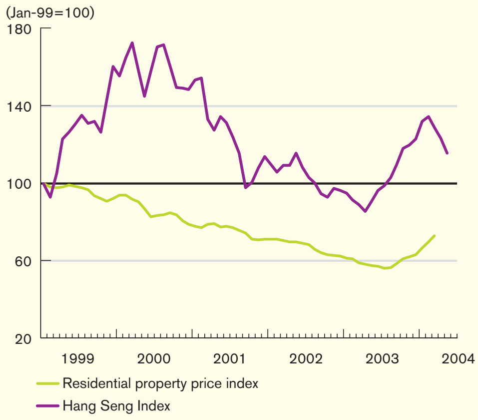
Private consumption

Private consumption expenditure (PCE) continued to recover, rising by 5.0% in 2004 Q1 on a year-on-year basis — the fastest rate of increase in three years. On a seasonally adjusted quarter-on-quarter comparison, however, PCE growth slowed to 0.9% in 2004 Q1, from 1.4% in 2003 Q4. Spending on durable goods has risen faster than that on non-durable and services in recent years, as a downward trend in durable good prices relative to non-durable good prices has probably stimulated demand. Furthermore, there are indications that a recovery in local spending contributed to the strong expansion in consumption of durable goods.[2] Retail sales data show that the fastest-growing categories of spending are furniture, electrical goods and photographic equipment. While the demand for the latter two may come from visitors, growth in sales of furniture should mainly reflect local spending.

The recovery in consumer spending has been supported by more stable household incomes, declining unemployment and rising property prices (Charts 2.6 and 2.7). Median household income, in nominal terms, stabilised in the second half of 2003 after declining in the preceding two years. The unemployment rate has declined since July 2003, and property prices have risen steadily. Reflecting these developments, consumer confidence has picked up since the Autumn.

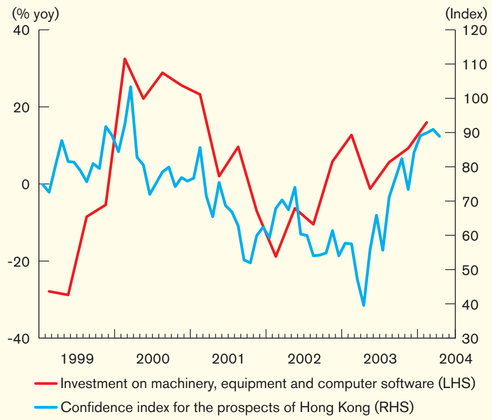
[2] In the National Accounts data, consumption excludes non-residents' spending in Hong Kong and includes residents' spending abroad, but that is not the case for the individual components of consumption (or the retail sales data). Hence, it is difficult to know the relative importance of spending by residents and non-residents in accounting for the strength of durable goods consumption in National Accounts data.

Chart 2.7
Asset prices



Sources: Rating and Valuation Department, C&SD and Reuters.

Chart 2.8
Investment and confidence



Sources: C&SD and Hong Kong Policy Research Institute.

Private investment and stockbuilding

Private investment spending growth turned positive in 2003 Q4, and rose by 6.8% in 2004 Q1 on a year earlier. The rebound in investment was driven by higher spending on machinery, equipment and computer software, which rose by 17.7% on a year earlier in 2004 Q1. This in part reflects stronger profitability as evidenced by the results from the Quarterly Business Tendency Survey, which showed that almost all sectors, with the exception of construction, reported strong profits growth and a healthy financial position in Q1. Firms' expectations about the business outlook improved in Q2, according to the results from the Hong Kong Policy Research Institute's survey, which asks about business prospects for Hong Kong and the Mainland (Chart 2.8).

Investment spending on new building and other construction has, however, lagged behind the recovery in the economy and, more specifically, the property market. In the past, there has been a positive relationship between changes in construction activity and property prices, but it has taken time for this to feed through to an increase in investment spending on new buildings and other construction.

Stockbuilding increased in 2003 Q4 and 2004 Q1, partly reflecting higher imports in anticipation of stronger domestic demand.

Public spending

Government consumption growth slowed in 2004 Q1 to 0.3% on a seasonally adjusted quarter-on-quarter comparison, from 3.0% in 2003 Q4 which was boosted by one-off factors, including compensatory payments made under the Second Voluntary Retirement Scheme. Public investment spending has risen since 2003 Q3 as several new infrastructure projects have come on-stream.

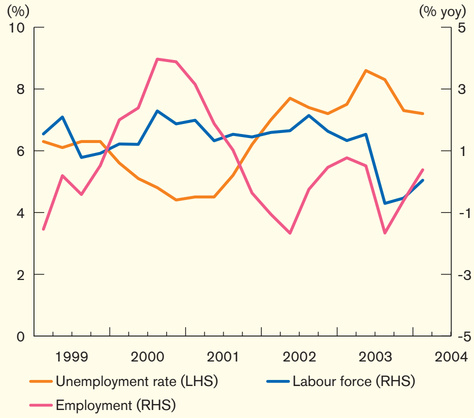
Labour market and prices

The economic recovery has begun to feed through to an improvement in labour market conditions. Employment has risen, unemployment has fallen, and there are signs that the decline in nominal payrolls is bottoming out. The Composite CPI has been broadly stable in recent months, suggesting that the deflation in consumer prices may be coming to an end.

2.4 Employment and unemployment

The economic recovery has fed through to improved labour market conditions. Employment increased by 0.7% in 2004 Q1 (Chart 2.9), as a result of higher labour demand in the service sector. However, the downward trend in manufacturing employment continued, and rising property prices have not yet led to job creation in the building and construction sectors (Table 2.C). The labour force grew by 0.5% in 2004 Q1 compared with 2003 Q4. The unemployment rate continued to decline, to 7.1% in the three months to April, but at a slower pace as the increase in employment was largely offset by an increase in labour market participation (Chart 2.9). The underemployment rate, defined as the proportion of the labour force who involuntarily work for less than 35 hours a week, has also declined since the December *Report*.

Chart 2.9
Unemployment rate



Source: C&SD.

Table 2.C
Unemployment rates of major sectors

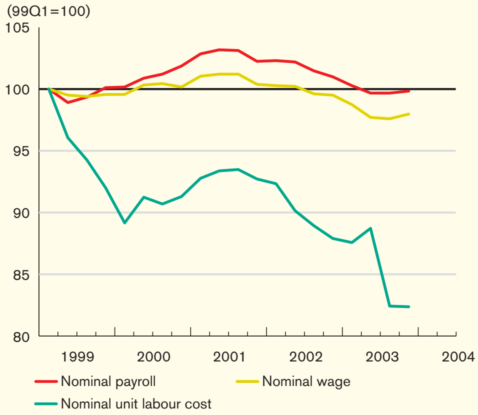
(%)	2002	2003	2003 Q1	2003 Q2	2003 Q3	2003 Q4	2004 Q1
Manufacturing	7.3	7.6	7.3	8.4	7.3	7.5	7.1
Construction	15.8	19.0	18.9	19.7	19.6	17.7	17.9
Trade and tourism	7.8	8.2	7.9	9.1	8.7	7.0	7.0
Transport	5.4	6.5	6.1	7.6	6.2	6.1	6.1
Financing	4.7	5.2	4.5	5.6	5.4	5.2	4.9
Personal services	3.2	3.5	2.9	3.7	3.7	3.5	3.5
Others	2.4	2.8	3.5	3.2	3.2	1.5	2.0
Overall	**7.3**	**7.9**	**7.4**	**8.5**	**8.5**	**7.3**	**7.1**

Source: C&SD.

2.5 Labour costs

The latest available data on labour costs indicate that average earnings stabilised at the end of 2003. In particular, average payrolls, which include remuneration as well as overtime payments, back-pay and other irregular allowances and bonuses, rose by 0.2% on a seasonally adjusted basis in 2003 Q4 (Chart 2.10). However, in real terms, average payrolls declined marginally from 2003 Q3 to Q4. This is because the Composite CPI actually increased from 2003 Q3 to Q4, by more than the increase in nominal payrolls. Unit labour costs, calculated using the payroll data, declined in the second half of 2003 as productivity growth outpaced average payroll growth (Chart 2.10).

Chart 2.10
Wage & payroll indices and unit labour cost

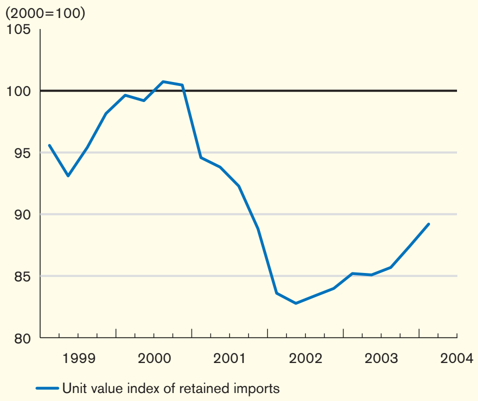


Sources: C&SD and Staff estimates.

2.6 Commodity and import prices

Import prices have risen in recent quarters, reflecting a weaker Hong Kong dollar effective exchange rate and higher world commodity prices. The unit value index of retained imports rose by 4.7% in 2004 Q1 on a year earlier, up from 4.1% in 2003 Q4 (Chart 2.11). The sharpest increases were for consumer goods, raw materials and fuel, while the prices of capital goods continued to decline.

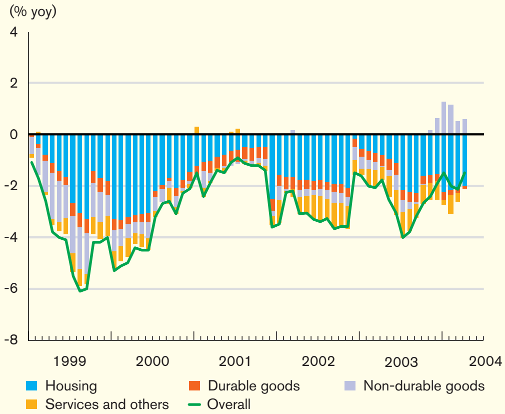
Chart 2.11
Import prices



Source: C&SD.

2.7 Consumer prices

Chart 2.12
Consumer prices, by component



Source: C&SD.

The deflation in consumer prices has lessened since the December *Report*. The annual deflation rate of the Composite CPI fell to 1.5% in April, from 2.1% in March (Chart 2.12). However, year-on-year changes alone do not provide a timely description of price movements, as they are affected by price changes in both the previous year and the current year. Therefore, monthly changes are more useful in analysing the latest developments in inflation. Adjusted for seasonal and special temporary factors, the Composite CPI has been broadly stable since August 2003, and recorded a small rise in recent months, suggesting that deflation may have come to an end. The prices of clothing and footwear have shown a marked increase, while food prices have started to rise also. However, the rental component, which reflects the impact of both new and existing contracts, continued to decline and is lagging the upturn in property prices and market rents. Research by the HKMA on estimating core inflation suggests that underlying consumer price inflation has been broadly stable since September 2003.[3]

[3] See Gerlach S. and M. Yiu, (2004), "A simple measure of underlying inflation: estimates for Hong Kong and the Mainland", *HKMA Research Memorandum*, http://www.info.gov.hk/hkma/eng/research/RM02-2004.pdf.

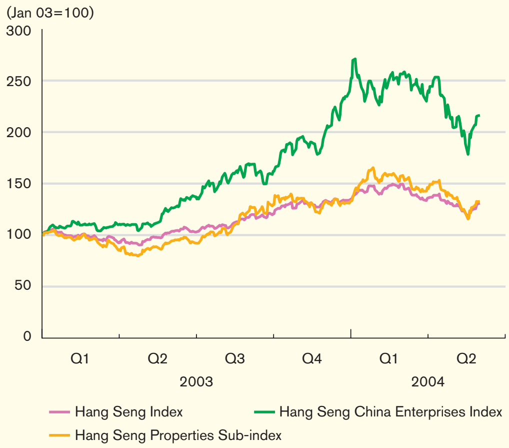
Asset markets

Equity prices have been volatile in recent months, rising in the early part of 2004 before declining on expectations of an earlier start to US monetary tightening. Residential property prices have rebounded sharply, with increases at the high end of the market particularly pronounced.

2.8 Equity market

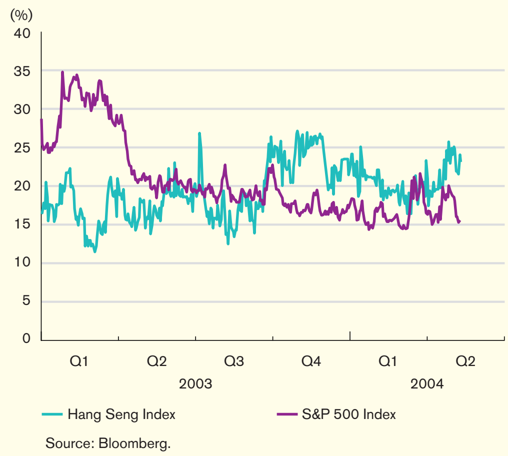
Equity prices in Hong Kong have been volatile since the December *Report*. After gaining 35% in 2003, the benchmark Hang Seng Index continued to rise by a further 11% to 13,928 points by mid-February (Chart 2.13). The performance of property stocks was particularly strong on account of the recovery in property prices, as was interest in initial public offerings (IPOs) for shares of Mainland enterprises (H-shares). However, investors' confidence subsequently declined on market expectations of an increase in US interest rates and a further monetary tightening on the Mainland. In sharp contrast to the experience in February, the first trading-day closing prices of several newly-listed shares fell below their respective IPO prices in March. The benchmark Hang Seng Index fell to around 12,000 in late May. Mainland-related shares were particularly affected, with the prices of the H-shares and Red-chips declining by 14% and 6% since the end of 2003. Uncertainty about future stock prices, as measured by the implied volatility of options on the Hang Seng Index, remains higher than in the US (Chart 2.14).

Chart 2.13
Equity prices



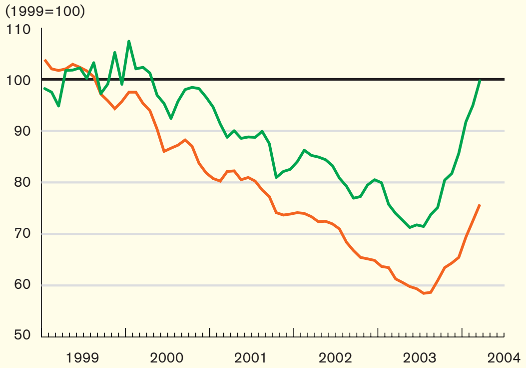
Source: Bloomberg.

Chart 2.14
Implied volatility



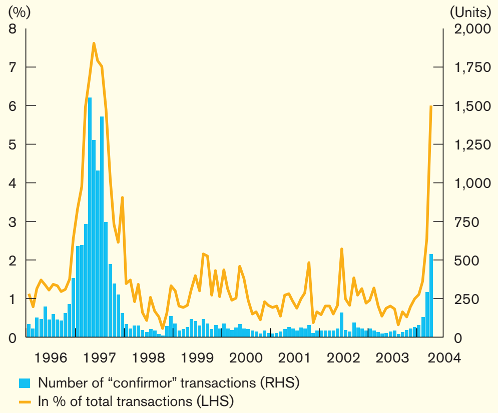
Source: Bloomberg.

Chart 2.15
Residential property prices



Source: Rating and Valuation Department.

Chart 2.16
Number of "confirmor" transactions



Note: If a flat is re-sold to sub-purchasers before the legal completion of the original sale, all sub-vendors sign as "confirmors" in the Assignment.

Sources: Land Registry and Centaline Property Agency Ltd.

2.9 Property market

In contrast to developments in the equity market, the recovery in the property market remains solid. The Rating and Valuation Department's residential property price index rose sharply by 30% in March from its trough in July 2003. The average price of large flats rose by 40% over the same period (Chart 2.15). The Centa-City Leading Index — a weekly residential price index constructed by a private real estate agent — suggests that the prices of flats continued to rise in April. Private rents have risen less sharply, by 3.3% since last July, leading to a decline in rental yields.

The number of residential property transactions has also risen markedly since the latter part of 2003 (although it fell slightly in April). The number of "confirmor" transactions, which is sometimes taken by analysts as an indicator of speculative activity, rose sharply from below 50 at the beginning of 2003 to above 500 in April (Chart 2.16). While this is much lower than during the mid-1990s boom in property prices, the share of confirmor transactions in total transactions has risen sharply.

Public finances

Government projections show a progressive decline in the fiscal deficit to a balanced budget by 2007/08. Long-term fiscal sustainability will be supported by the large amount of financial assets held by the Government, and the announced expenditure reductions and revenue measures.

2.10 Public finances

The Government has lowered its estimate of the budget deficit in 2003/04 to 3.3% of GDP, from 4.0% in the 2004/05 Budget Statement. The latest estimate is significantly smaller than the projection released in March 2003 (5.3% of GDP) and in October 2003 which incorporated the cost of the SARS-relief package (6.3% of GDP). The improvement reflects higher than expected investment income and revenues from profit taxes and stamp duties (Table 2.D).

Table 2.D
Analytical presentation of fiscal account

Fiscal year	00/01	01/02	02/03	03/04[1]	03/04[2]	04/05[2]
			(In percent of GDP)			
Revenue	17.5	13.8	14.1	15.1	16.5	15.5
Tax	9.8	9.8	9.0	9.6	10.1	10.4
Direct tax	5.9	6.3	5.9	6.1	6.4	6.6
Indirect tax	3.9	3.6	3.1	3.5	3.6	3.8
Non-tax	7.7	4.0	5.1	5.5	6.4	5.1
Expenditure	18.1	18.8	19.0	20.4	20.5	20.9
Recurrent	14.3	15.4	15.7	16.1	16.3	16.4
Capital	3.8	3.4	3.3	4.2	4.2	4.5
Overall balance[3]	-0.6	-5.0	-4.9	-5.3	-4.0	-5.4
Operating balance[4]	-1.2	-3.7	-3.7	-3.9	-2.9	-3.7
Government borrowing						
Securitisation notes						0.5
Government bonds						1.6
Fiscal reserves	33.4	29.3	24.7	18.6	21.6	17.6
Net fiscal reserves	33.4	29.3	24.7	18.6	21.6	15.6

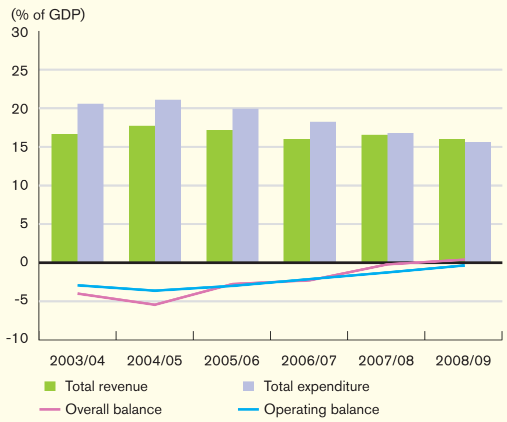
Notes: 1. Based on the 2003/04 Budget.
2. Based on the 2004/05 Budget.
3. Before government borrowing.
4. Operating balance comprises mainly recurrent revenue and expenditure.

Sources: Financial Services and the Treasury Bureau and Staff estimates.

For the current financial year, the 2004/05 Budget projects a budget deficit of 3.4% of GDP. This includes HK$20 billion of planned bond issuance proceeds and HK$6 billion of securitisation receipts as part of revenues. If these items are excluded, the projected deficit would be 5.4% of GDP.

Two initiatives were announced in the 2004/05 Budget that should help strengthen the Government's medium-term fiscal management. First, the planned issuance of government bonds will increase the Government's flexibility in managing its fiscal account. Secondly, the Financial Secretary endorsed the need to introduce a Goods and Services Tax (GST), which would broaden Hong Kong's tax base. If the expenditure reduction and revenue measures projected over the medium term are realised, fiscal sustainability should not be of major concern (Chart 2.17). In particular, the HKSAR Government's financial strength is supported by the large amount of financial assets that has been accumulated over the years.

Chart 2.17
Medium-term projections



Source: The 2004/05 Budget.

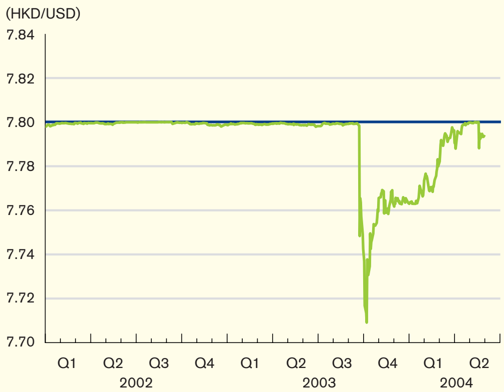
3. Monetary and financial stability

Exchange rate, interest rates and monetary developments

After depreciating towards the linked rate of HK$7.8 per US$1 during the first four months of 2004, the Hong Kong dollar exchange rate strengthened briefly during the second half of May as stock prices rebounded. The Convertibility Undertaking was triggered repeatedly between 30 April and 18 May. Nevertheless, interbank liquidity remains high, helping to keep Hong Kong dollar interest rates below US dollar rates. Narrow money grew briskly, partly as a result of buoyant stock market activity, while broad money rose moderately reflecting higher economic growth.

3.1 Exchange rate and interest rates

Chart 3.1
Hong Kong dollar exchange rate

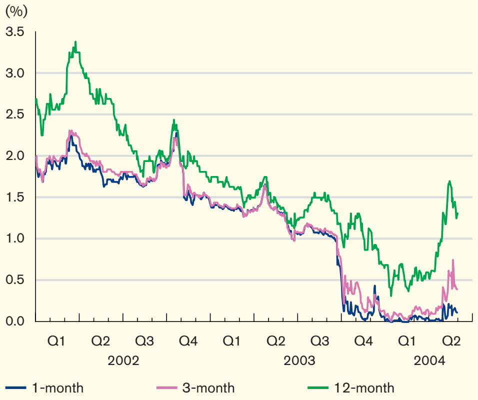


Source: HKMA.

After depreciating towards the linked rate of HK$7.8 per US$1 during the first four months of 2004, the Hong Kong dollar exchange rate strengthened briefly during the second half of May along with a rebound in the stock market (Chart 3.1). Prior to that, the Convertibility Undertaking was triggered repeatedly between late April and mid-May. This episode followed a significant appreciation of the Hong Kong dollar against the US dollar, to HK$7.70 per US$1 at one point last October, reflecting several influences, including stronger growth in the Hong Kong economy, weakening sentiment towards the US dollar, and international pressure on the Mainland authorities to appreciate the renminbi.

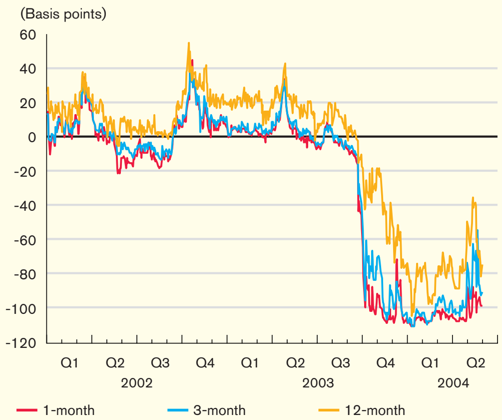
The return of the exchange rate towards the linked rate was facilitated by the operation of the Currency Board arrangements, under which the HKMA passively responds to bank bids for Hong Kong dollars at the market exchange rate. A total of HK$54.2 billion of Hong Kong dollars was sold to banks between September 2003 and February 2004, resulting in a corresponding increase in the Aggregate Balance and foreign exchange reserves. Thereafter, the HKMA purchased HK$19.2 billion of Hong Kong dollars under the

Chart 3.2
Hong Hong dollar interbank interest rates



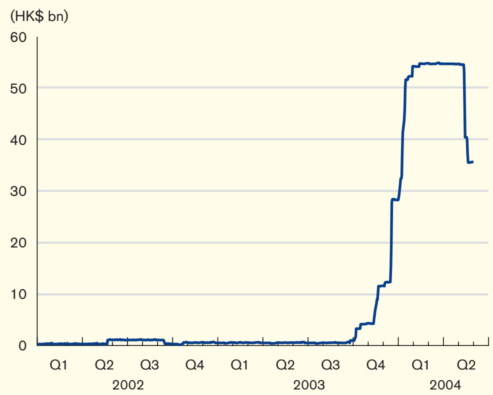
Source: HKMA.

Chart 3.3
Interest rate differentials between Hong Kong dollar and US dollar



Source: HKMA.

Chart 3.4
Aggregate Balance (before Discount Window)



Source: HKMA.

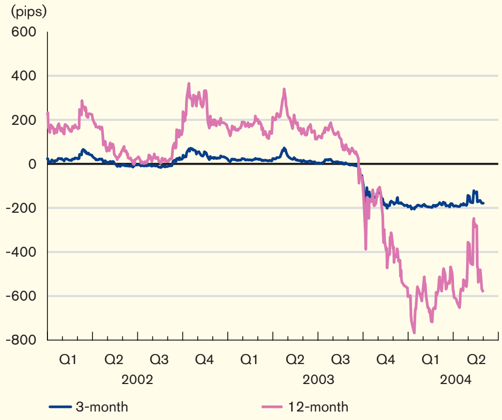
Convertibility Undertaking between 30 April and 18 May. Nevertheless, given ample interbank liquidity, interest rates climbed only marginally and remained low, with short-term rates close to zero, and below US dollar rates (Charts 3.2 and 3.3). On 31 May, the Aggregate Balance stood at HK$35.6 billion, significantly above its average level of around HK$0.5 billion before the Hong Kong dollar appreciation in 2003 Q4 (Chart 3.4).

The Sub-Committee on Currency Board Operations of the Exchange Fund Advisory Committee has recently considered whether additional Exchange Fund paper should be issued to absorb interbank liquidity. As Exchange Fund paper forms part of the Monetary Base, the issuance of additional paper will change the composition of the Monetary Base but not its size, and would therefore be consistent with Currency Board principles. Nevertheless, the Sub-Committee expressed doubts about the need and effectiveness of such a measure.[4] Since the end of April, the high level of interbank liquidity has become less of an issue as there have been net capital outflows.

The Aggregate Balance has started to decline towards more normal levels. The negative interest rate spreads against the US dollar are expected to induce further outflows, though robust current account surpluses and the large international investment position, coupled with an improved domestic outlook, may support the demand for Hong Kong dollars. Meanwhile, the present monetary conditions remain conducive to the economic recovery underway, and there is no sign of a significant pick-up in inflationary pressures (see Section 2.7).

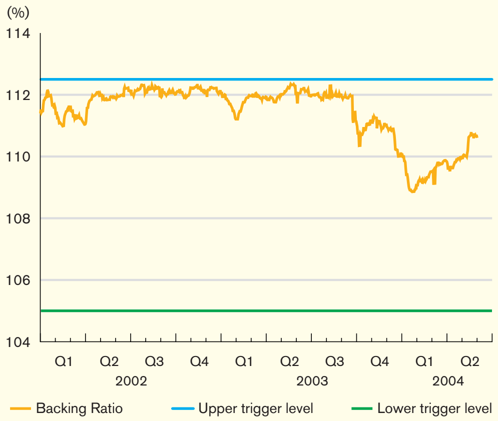
[4] See Record of Discussion of the Meeting of the Exchange Fund Advisory Committee Sub-Committee on Currency Board Operations held on 5 March 2004, available on the HKMA website http://www.hkma.gov.hk.

Chart 3.5
Hong Kong dollar forward points



Source: HKMA.

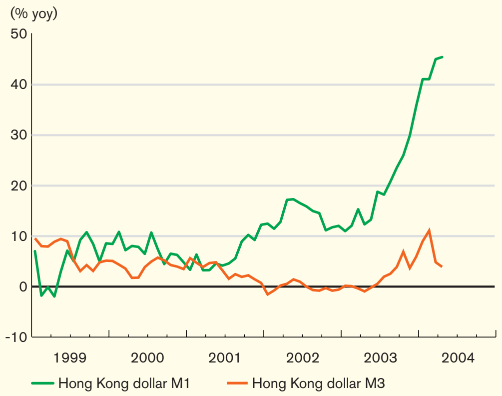
Chart 3.6
Backing Ratio



Note: The Backing Ratio is the ratio of Backing Assets to the Monetary Base. Under the arrangements for transferring assets between the backing portfolio and the investment portfolio of the Exchange Fund, when the backing ratio reaches 112.5% (the upper trigger level), sufficient assets will be transferred from the backing portfolio to the investment portfolio to reduce the ratio to 110%. Should the backing ratio drop to 105% (the lower trigger level), assets will be transferred from the investment portfolio to the backing portfolio to restore the ratio to 107.5%.

Source: HKMA.

Chart 3.7
Monetary aggregates



Note: Hong Kong dollar M1 is seasonally adjusted.

Source: HKMA.

The pressure on the Hong Kong dollar to appreciate receded in 2004 Q1, as shown by a reduction of the discount in the 12-month forward exchange rate (Chart 3.5). This may reflect the recent strengthening of the US dollar as well as a decline in the portfolio demand for Hong Kong dollar assets associated with volatile equity prices. Nevertheless, any renewed speculation on the exchange rate policy of the Mainland authorities or a weaker US dollar may affect market sentiment towards the Hong Kong dollar.

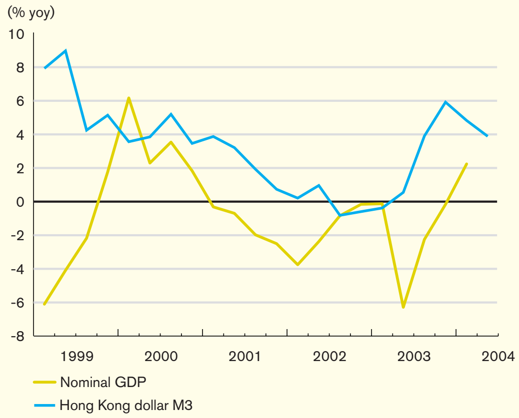
3.2 Monetary Base and Backing Ratio

The Backing Ratio declined considerably between September 2003 and January 2004, reaching a low of 108.9%, before rising to 110.6% at the end of May (Chart 3.6). The decline was because of net capital inflows. The HKMA met the increase in the demand for Hong Kong dollars by purchasing US dollars in exchange, leading to matched increases in the Monetary Base and the Backing Assets. Because the Backing Assets are larger in value than the Monetary Base, matched increases in the two will arithmetically reduce the Backing Ratio (See Box 1). However, the Backing Ratio has remained well above the lower trigger level, at which point assets would be transferred from the investment portfolio of the Exchange Fund assets to increase the Backing Ratio to 107.5%.

3.3 Monetary aggregates

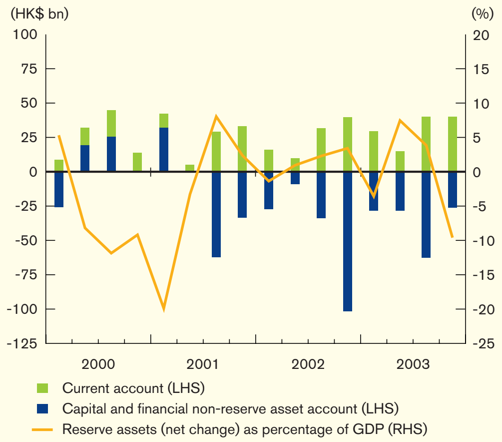
Hong Kong dollar narrow and broad money growth rose in the first four months of 2004 (Chart 3.7). Narrow money (seasonally adjusted) increased sharply in April by 46% on a year earlier, largely because of an increase in demand deposits. This partly reflected an increase in fund-raising activity, associated with initial public offerings, and high turnover in the equity market. The low opportunity cost of holding cash and demand deposits was also a contributory factor. Broad money also rose, though by a lesser degree, reflecting an increase in economic activity and a decline in deflation (Chart 3.8).

Chart 3.8
Broad money growth and nominal GDP



Note: 2004 Q2 figure for M3 is based on April data.
Sources: HKMA and C&SD.

Chart 3.9
Balance of payments



Note: A negative sign in the net change in reserve assets represents an increase.
Source: C&SD.

Table 3.A
Balance of payments account by standard components

In percent of GDP	2002	2003	2003 Q1	Q2	Q3	Q4
Current Account	7.9	10.3	10.1	5.4	12.9	12.3
Capital and Financial Account	-12.1	-12.4	-13.0	-2.2	-15.9	-17.5
Capital transfers	-1.3	-0.6	-0.7	-1.0	-0.4	-0.6
Financial non-reserve assets (net change)	-12.3	-11.1	-8.8	-8.9	-19.5	-7.2
Direct investment	-4.9	6.3	1.0	12.3	6.5	5.5
Portfolio investment	-24.2	-19.4	-18.6	-9.1	-25.8	-23.1
Financial derivatives	4.1	6.5	4.1	7.8	12.1	2.3
Other investment	12.6	-4.5	4.6	-19.8	-12.2	8.0
Reserve assets (net change)	1.5	-0.6	-3.5	7.7	4.0	-9.6
Net errors and omissions	4.2	2.1	2.9	-3.2	3.0	5.1

Note: A negative sign in the net change in reserve assets represents an increase.
Source: C&SD.

3.4 Capital flows

Latest available balance of payments (BoP) statistics show an increase in reserve assets in 2003 Q4 (Chart 3.9 and Table 3.A). This is because of purchases of US dollars under the Currency Board arrangements. The current account continued to record a large surplus, reflecting an increase in exports as a result of the global recovery, and an improvement in competitiveness.

The (non-reserve) capital and financial account recorded net outflows, arising largely from portfolio investment flows. Since the middle of 2003, non-residents' investment in domestic equities has increased, but has been more than offset by residents' investment in foreign equities.[5] Part of the portfolio outflows are related to the purchase of shares of Mainland companies traded on the HKEx, which are treated as foreign equities for the purpose of the BOP statistics.

The "Other Investment" account, which includes mainly the offshore loans and deposits of the bank and non-bank sectors, recorded net inflows in 2003 Q4, compared with net outflows in Q3. The inflows were mainly because of a reduction of placements abroad by non-bank residents, perhaps reflecting a stronger domestic economy, and, to a lesser extent, a net placements of deposits into banks in Hong Kong.

The information available so far indicates a further increase in reserve assets in the early part of 2004, mainly attributable to purchases of US dollars as a result of net capital inflows in January. The strength of the portfolio demand for Hong Kong dollar assets, however, appears to have subsided since February. This is evidenced by a narrower (negative) spread against longer-term US dollar rates.

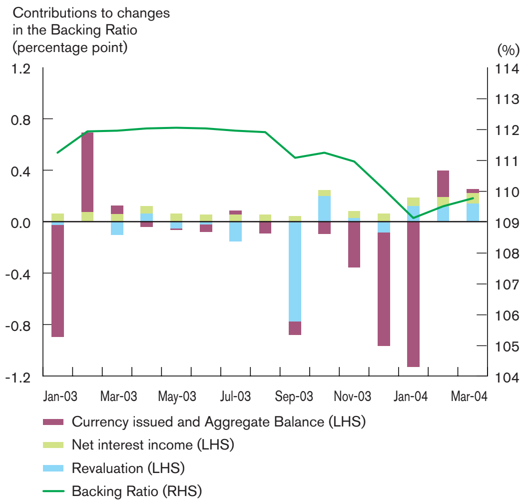
[5] The BoP accounts are compiled based on the concept of residence, which depends on the centre of economic interest of individuals and organisations. For example, while a H-share company is listed on the HKEx, it is classified as a non-resident company since its business activity is not based in Hong Kong.

Box 1
Recent developments in the Backing Ratio

Chart B1.1
Movement of the Backing Ratio

Source: HKMA.

Chart B1.2
Contributions of individual factors to changes in the Backing Ratio



Source: HKMA.

The Backing Ratio, defined as the ratio of the Backing Assets to the Monetary Base, declined from around 112% in late September 2003 to 110% at end-March 2004 (Chart B1.1). This box examines the reasons behind this decline.

Since all the Backing Assets earn interest income while only 40% of the Monetary Base (specifically Exchange Fund paper) is remunerated, there is a tendency for the Backing Ratio to rise over time. However, the Backing Ratio may decline for a number of reasons. First, if Hong Kong dollar interest rates decline relative to US dollar rates, the marked-to-market value of the Monetary Base will increase relative to the Backing Assets, reducing the ratio. Secondly, if the Hong Kong dollar exchange rate strengthens against the US dollar, the value of Backing Assets will decrease in Hong Kong dollar terms, decreasing the ratio. Thirdly, if there is an autonomous expansion in the Monetary Base, the Backing Assets will rise less proportionately than the Monetary Base (since the former are larger in value), thereby reducing the ratio.[6]

All three of these factors have contributed to the decline in the Backing Ratio since late 2003. Reflecting persistent net capital inflows, local interest rates dropped significantly below US dollar rates, the Hong Kong dollar exchange rate strengthened markedly against the US dollar, and the Aggregate Balance (as part of the Monetary Base) expanded.

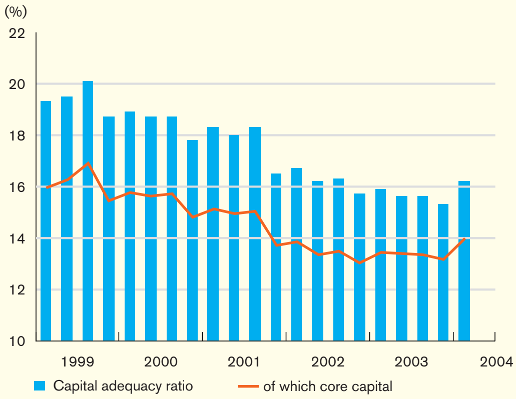
Chart B1.2 shows the relative importance of these factors. The decline in the Backing Ratio in September 2003 was largely due to revaluation losses arising from the Hong Kong dollar appreciation. Thereafter, the decline was mainly due to autonomous Monetary Base expansion, as the HKMA sold Hong Kong dollars in response to persistent net capital inflows, and a rise in currency issued around the Christmas and Chinese New Year holidays. These factors more than offset the positive impact of net interest income.

[6] To see this, let R denote the Backing Ratio, A the Backing Assets, and B the Monetary Base. Then $R = A/B$, which implies that $dR = 1/B * dA - A/B^2 * dB$. Since a change in the Monetary Base would be matched by a change in the Backing Assets, $dA = dB$, $dR/dA = 1/B\ (1-A/B)$, which is negative as A > B.

Banking sector performance

The banking sector has benefited from increased economic activity and a rebound in asset prices. The profitability of retail banks has increased, reflecting an improvement in asset quality, and a continued rise in non-interest income owing to banks' successful diversification into new business areas in recent years. Net interest margins, on the other hand, have continued to decline as loan growth has been subdued and competition for residential mortgage loans has remained intense.

Chart 3.10
Capitalisation of local AIs



Source: HKMA.

Table 3.B
Consolidated capital adequacy ratio of local AIs

(HK$ mn)	Mar-04
Total capital base after deductions	330,110
of which core capital	285,312
Total risk-weighted exposures	2,040,163
Capital adequacy ratio	16.2%

Notes: 1. Total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance.
2. Core capital primarily consists of common equity and certain preferred capital, excluding goodwill.

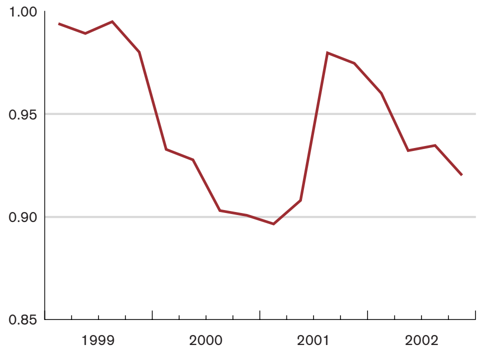
Source: HKMA.

3.5 Profitability and capitalisation

The soundness of the banking system is a key factor supporting currency stability, which is the primary objective of monetary policy in Hong Kong. In particular, a well-capitalised and profitable banking sector is better able to withstand adverse shocks. The operating environment faced by the banking sector has become more competitive over the past decade (see Box 2). Nevertheless, local Authorized Institutions (AIs) remain well-capitalised. The latest statistics show that the average consolidated capital adequacy ratio was 16.2% at end-March 2004, which is well above the minimum international standard of 8% (Chart 3.10). Core capital accounted for around 86% of the capital base (Table 3.B). The ratio to risk-weighted assets was high, at 14%, considerably above that of many advanced economies.

Box 2
Banking sector competition in Hong Kong

Chart B2.1
Estimates of H statistic



Note: The H statistic is the sum of the recursive estimates of the coefficients of input prices.

Competitive conditions in the banking industry are of interest to policymakers responsible for monetary and financial stability. While competition lowers financial intermediation costs and contributes to improvements in economic efficiency, it reduces market power affecting the profitability of banks and, potentially, their ability to withstand adverse shocks.

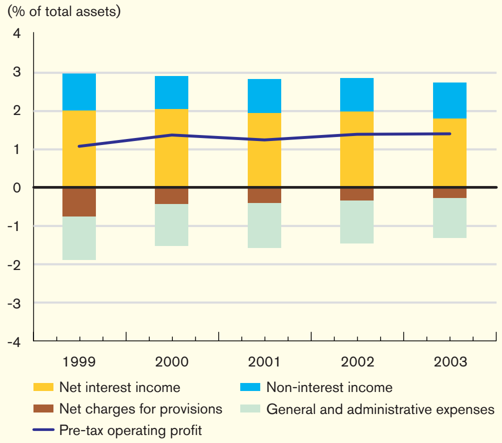
There have been major changes in the competitive environment for banks operating in Hong Kong in recent years. First, in response to the recommendations of a study of the banking sector in 1998, the HKMA gradually removed several barriers to competition, including regulated interest rates, branching restrictions for foreign banks, and certain market entry criteria. Secondly, technological innovations have helped to overcome geographical barriers and to facilitate product innovations. Thirdly, consolidation in the sector has resulted in an increase in market concentration. The effects of the Asian financial crisis, consolidation among international banks, weak credit demand, and a sharp decline in property prices have created pressures for mergers and acquisitions in the sector.

The relaxation of regulatory restrictions and technological developments should enhance competition in the banking sector. The effect of consolidation, however, is more ambiguous, and likely to depend on prevailing market conditions such as the initial level of market concentration. Some studies[7] find that bank consolidation reduces competition at low levels of market concentration, but increases it in highly concentrated markets. The HKMA has undertaken research on competitive conditions in the banking sector using an empirical approach suggested by Panzar and Rosse.[8] This assesses the relationship between input costs and output prices in an industry and constructs a summary statistic known as the H statistic, which ranges between negative infinity and one. A value closer to one suggests a more competitive market structure. Applying this approach to the Hong Kong banking sector gives an H statistic of close to one over the years 1992 and 2002 (Chart B2.1), suggesting a competitive environment.

[7] For example, Jackson, W., (1992), “The Price-concentration Relationship in Banking: A Comment,” *Review of Economics and Statistics*, Vol. 74, May, pp. 373-376.

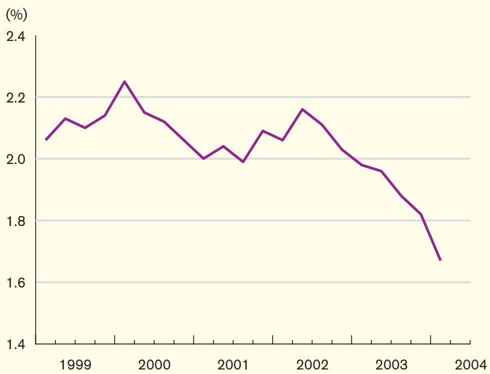
[8] For details, see Jiang et al. (2004), “Banking Sector Competition in Hong Kong – Measurement and Evolution Over Time”, *HKMA Research Memorandum*, http://www.info.gov.hk/hkma/eng/research/RM04-2004.pdf.

Chart 3.11
Profitability of retail banks



Source: HKMA.

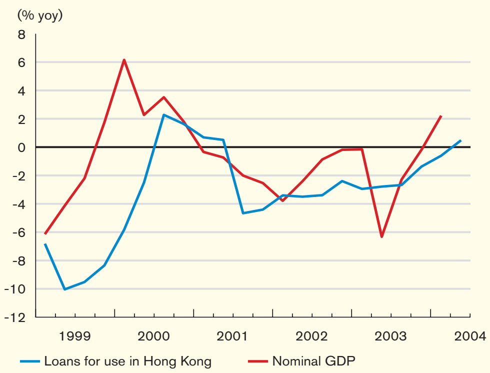
Chart 3.12
Net interest margin of retail banks



Note: Net interest margin is measured by the ratio of net interest income to interest-bearing assets.

Source: HKMA.

Chart 3.13
Growth of domestic loans and nominal GDP



Note: 2004 Q2 figure for domestic loans is based on April data.

Source: HKMA.

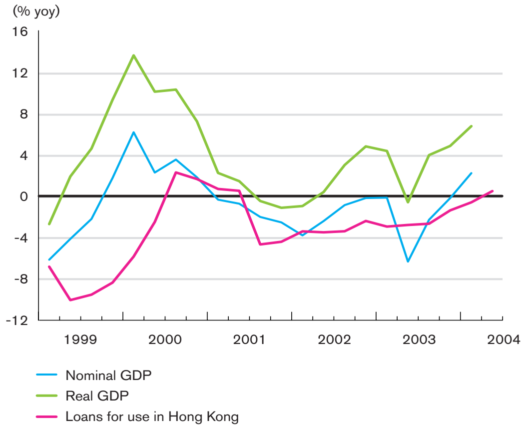
Recent developments suggest that the improvement in retail banks' profitability, which began in the second half of 2003, continued in 2004 Q1, as measured by pre-tax returns as a percentage of total assets (Chart 3.11). Although net interest margins declined, this was more than offset by lower provisioning charges and an increase in non-interest income. The decrease in net interest margins reflects intense competition in the mortgage market, weak demand for credit, and ample liquidity in the banking system (Chart 3.12).

The growth in bank lending has remained sluggish despite the economic recovery underway in Hong Kong. This is explained by weak investment spending and slow growth in nominal income (Chart 3.13) (See Box 3 for a more detailed discussion).

Non-interest income has increased in terms of both its share in total income and total assets. This reflects banks' efforts over the past few years to diversify into new business lines to increase revenue. Robust stock market activity, in particular, has contributed to an increase in revenue from fees and commissions.

Box 3
Recent developments in domestic lending

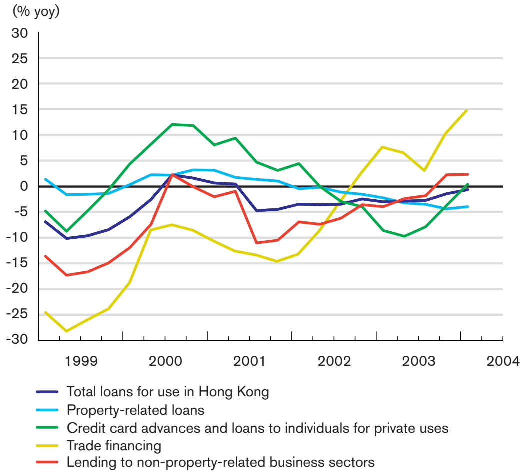
Chart B3.1
GDP and domestic lending



Note: 2004 Q2 figure for domestic loans is based on April data.

Sources: HKMA and C&SD.

Chart B3.2
Domestic loans by sectors



Note: Non-property business lending refers to domestic loans other than property-loans, lending to individuals for private purposes, credit card advances and trade financing.

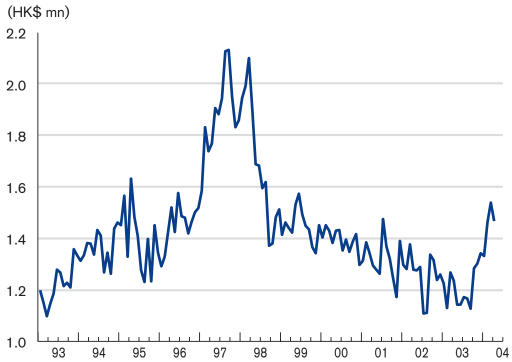
Source: HKMA.

Domestic lending growth has remained sluggish, despite the economic recovery underway in Hong Kong. Two factors help explain this. First, nominal income growth has not rebounded as sharply as has real growth, reflecting continued deflation in whole economy prices. Secondly, property-related lending growth has remained subdued despite the sharp increase in housing prices.

Chart B3.1 suggests a close relationship between nominal income growth and domestic credit growth. Despite a strong rise in real GDP since the second half of 2003, nominal GDP growth has remained low, as the overall price level continued to decline on a year-on-year comparison.

Slow growth in property-related lending, which constitutes over half of all lending, has also played an important role (Chart B3.2). Specifically, weak investment in building and construction contributed to a further decline in loans for building, construction, property development and investment. Private sector building programmes have been constrained by a large number of unsold housing units in earlier periods, the postponed property development plans of the railway companies, and a suspension of land sales in 2003.

Chart B3.3
Average size of new mortgages



Note: The average size of new mortgages is measured by the ratio of new mortgage loans to the number of new loans.

Source: HKMA's Monthly Survey on Residential Mortgage Lending.

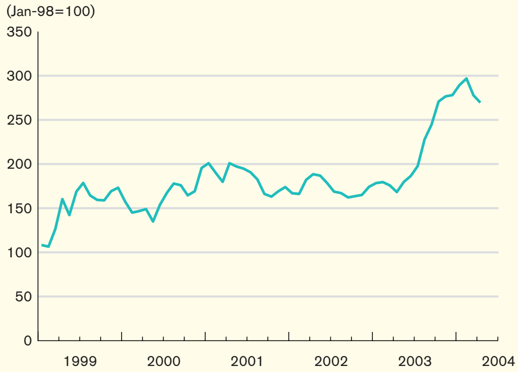
Although new mortgage lending has increased markedly in recent months alongside the pick-up in the housing market, the growth of the outstanding stock of mortgage loans remains sluggish.[9] This is because of repayments on existing loans, which have largely offset the increase in new mortgage lending. The average size of new mortgage loans has increased in recent months but remains substantially lower than in 1996-98 as a result of lower housing prices[10] (Chart B3.3).

Lending to other business sectors and trade financing grew strongly, especially to stockbroking and other financial intermediaries, reflecting buoyant stock market activity (Chart B3.2).

[9] According to statistics of the Rating and Valuation Department, residential property prices rose by around 30% in March from their trough last summer. Property transactions doubled in Q1 on a year earlier.

[10] Despite the recent rebound, property prices are still around 60% lower than the peak in mid-1997.

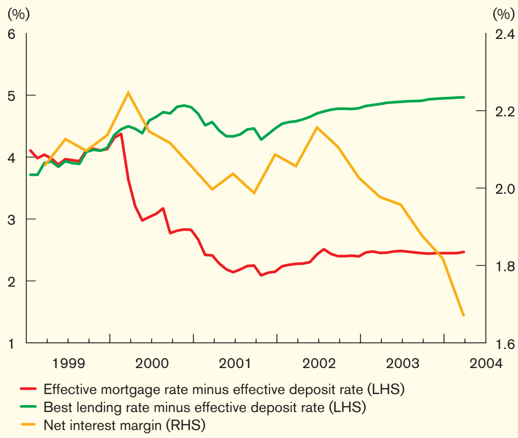
Chart 3.14
Stock prices of selected listed banks



Note: The listed banks include Hang Seng Bank, Bank of East Asia, Dah Sing Bank, International Bank of Asia, ICBC (Asia), Wing Hang Bank, Wing Lung Bank and Liu Chong Hing Bank. They account for 25-30% of Hong Kong dollar assets of all (listed and non-listed) retail banks in Hong Kong. The three largest listed banks are excluded.

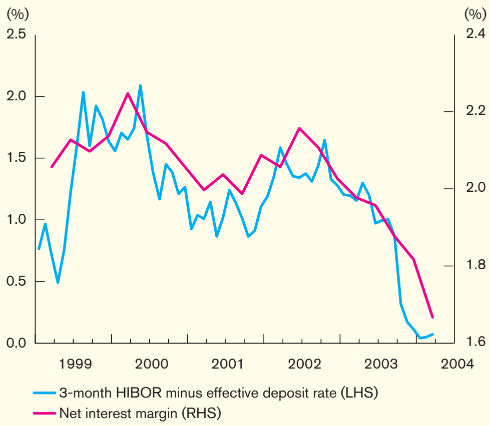
Source: HKMA.

Chart 3.15
Intermediation spreads



Source: HKMA.

Chart 3.16
Spreads between HIBOR and deposit rate



Source: HKMA.

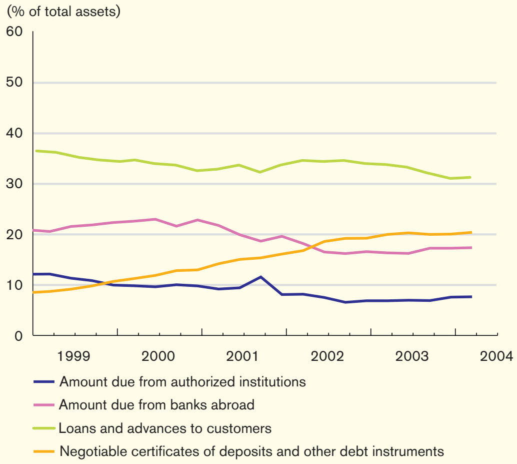
Prospects for the banking sector depend on the pace of economic growth and a sustained recovery in the property market as well as the outlook for interest rates (see Section 4). The stock prices of listed banks declined between March and May, but remained substantially higher than at their trough in the middle of last year, reflecting market expectations of stable bank profits (Chart 3.14).

3.6 Interest rate risk

The majority of banks' interest-bearing assets are on floating-rate terms, limiting their exposure to changes in interest rates. There is, however, a basis risk arising from the use of different reference rates. Residential mortgages and personal loans are mostly priced with reference to the best lending rate (BLR). The spread of the BLR over the effective deposit rate, a measure of intermediation spreads, has widened as a result of a swifter decline in funding cost (Chart 3.15), which is expected to lead to a widening of the net interest margin. However, interest rates for new mortgages have declined further below the BLR, owing to the intense competition in the residential mortgage market. This has a negative impact on the net interest margin, and it tends to build up gradually, as the share of such recently contracted loans in banks' portfolios increases over time.

Banks are also susceptible to movements in interbank interest rates. Changes in these rates may affect interest income directly through HIBOR-based lending, including inter bank lending. Given a large deposit base, most retail banks are net lenders in the interbank market. The difference between three-month HIBOR and the effective deposit rate has declined to a very low level since 2003 Q4, and may have contributed to a contraction of the net interest margin (Chart 3.16).

Chart 3.17
Asset composition of retail banks



Source: HKMA.

In search of higher returns, banks have increasingly invested in debt securities (Chart 3.17). While this provides some support to interest income, banks may be more exposed to volatility in bond markets, which has increased in recent months because of uncertainty about the interest rate outlook.

3.7 Credit risk

Credit exposures

Property-related loans accounted for about 54% of domestic lending (Table 3.C). Residential mortgage loans increased slightly in 2004 Q1. Even though new residential mortgage lending rose considerably, it is still small relative to the outstanding stock of loans (Chart 3.18). This reflects in part a valuation effect associated with lower property prices.[11] Loans for building, construction, property development and investment declined, resulting from the slow recovery in investment spending and construction. Growth of trade financing has rebounded markedly since 2003 Q4, following a brief decline in 2003 Q3. Lending to stockbrokers and financial concerns, particularly loans related to share subscription, also expanded, owing to robust stock market activity.

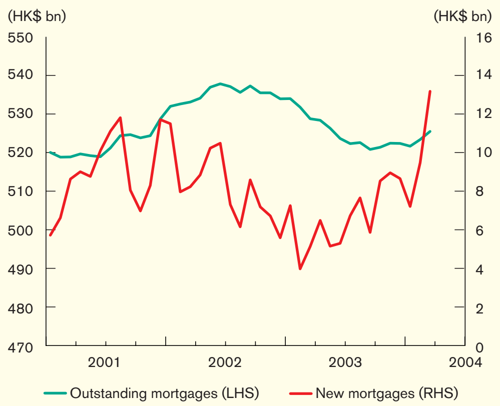
Table 3.C
Loans by economic use

	Quarter-on-quarter change (%)				Share of total (%)
	Jun-03	Sep-03	Dec-03	Mar-04	Mar-04
Loans for domestic use[1]	-0.3	-1.5	0.9	0.3	
Of which:					
Trade financing	6.2	-1.5	3.0	6.4	5.9
Mortgages[2]	-1.4	-1.0	-0.3	0.1	34.0
Manufacturing	4.9	3.1	3.1	5.4	4.7
Transport and transport equipment	1.7	2.8	3.8	-3.3	5.9
Electricity, gas and telecommunications[3]	2.7	-26.1	9.9	n.a.	n.a.
Electricity and gas[3]				n.a.	1.2
Information technology[3]				n.a.	1.1
Building, construction, property development and investment	-1.3	-2.2	-1.1	-1.5	19.6
Wholesale and retail trade	-0.5	-5.4	-3.1	2.5	5.4
Financial concerns[4]	2.8	7.3	5.8	4.3	8.5
Stockbrokers	-5.5	10.0	12.3	6.0	0.6
Credit card advances	-1.3	1.0	4.7	-4.8	2.6

Notes: 1. Including trade financing loans.
2. Mortgage loans include loans for Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme.
3. Some categories of loans have been reclassified as from March 2004.
4. Loans for financial concerns include loans to investment and insurance companies, futures brokers and finance companies.

Source: HKMA.

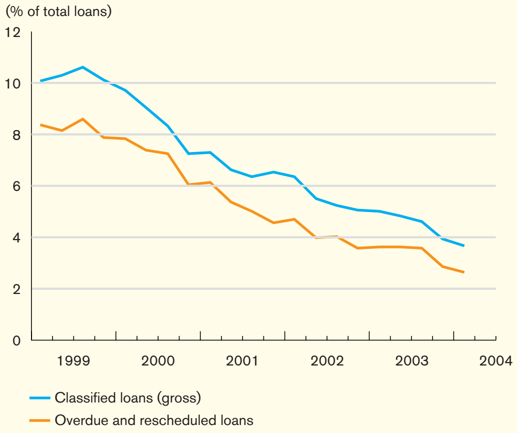
Chart 3.18
Residential mortgages: new lending and outstanding amount



Source: HKMA.

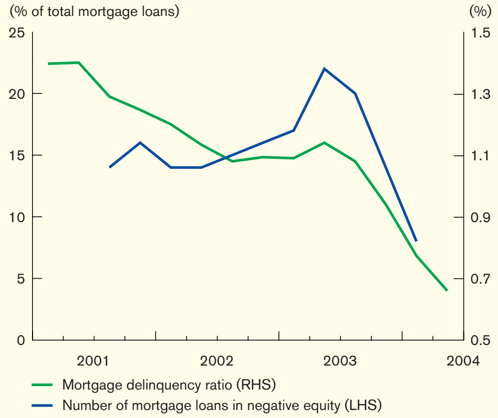
[11] This reflects, in part, the increase in secondary market transactions, which involve repayment of mortgage loans originated in earlier periods when property prices were, on average, higher. Such repayments provide an offset to the corresponding newly-extended mortgage loans which are made at a lower valuation.

Chart 3.19
Asset quality measures of retail banks



Source: HKMA.

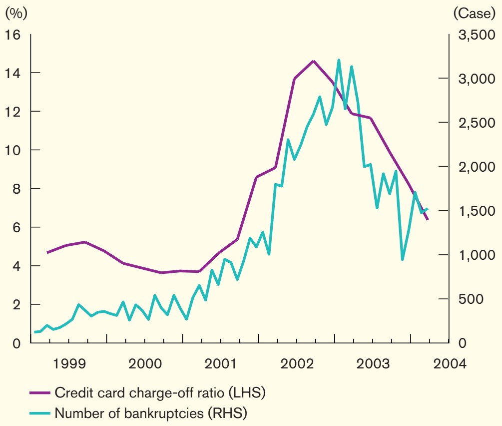
Chart 3.20
Negative equity and mortgage delinquency ratio of surveyed AIs



Note: The number of mortgage loans in negative equity is available from September 2001.

Source: HKMA.

Chart 3.21
Bankruptcies and credit card charge-off ratio of surveyed AIs



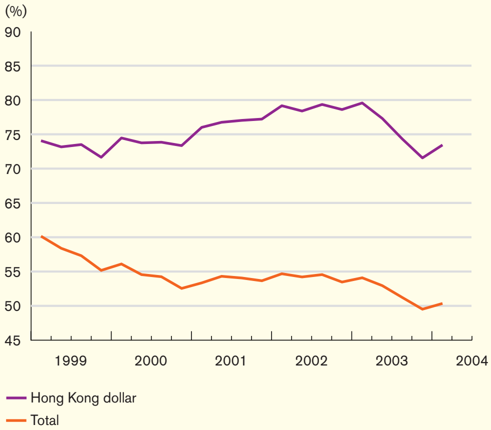
Sources: CEIC and HKMA.

Asset quality

Asset quality has benefited from the improvement in economic conditions and the recovery in property prices. As a percentage share in total loans, classified loans and overdue and rescheduled loans continued to decline in 2004 Q1 (Chart 3.19).

Credit risks related to household sector lending have probably declined. In particular, the increase in property prices will have had a positive effect on household sector balance sheets. The number of residential mortgage loans in negative equity has declined and is less than half of the peak level registered at the beginning of 2003. Bankruptcies have also declined markedly. Higher employment is expected to raise the quality of consumer loans, even though nominal wages have remained stagnant. The mortgage delinquency ratio fell to 0.66% at the end of April 2004 (Chart 3.20) and the charge-off ratio for credit card receivables declined further in 2004 Q1 (Chart 3.21).

Chart 3.22
Loan-to-deposit ratios of retail banks



Source: HKMA.

3.8 Liquidity

The average liquidity ratio of retail banks stood at 44.8% in 2004 Q1, far exceeding the minimum requirement of 25%. Net placements to banks abroad and debt securities holdings, which are relatively liquid, accounted for 13% and 25% of retail banks' total assets. The abundance of liquidity is also reflected in a low Hong Kong dollar loan-to-deposit ratio, which was 73% at 2004 Q1 (Chart 3.22).

3.9 Foreign currency position

The overall foreign currency position, including both spot and forward, for all Authorized Institutions remained high, at HK$57 billion at end-March 2004, although it has declined from its high of HK$98 billion at end-May 2003.

Key performance indicators of the banking sector are provided in Table 3.D.

Table 3.D
Banking sector performance indicators[1] (%)

	Mar-03	Dec-03	Mar-04
Interest rate[2]			
1-month HIBOR	1.31	0.12	0.07
3-month HIBOR	1.33	0.24	0.08
BLR and 1-month HIBOR spread	3.69	4.88	4.93
BLR and 3-month HIBOR spread	3.67	4.76	4.92
		Retail banks	
Balance sheet developments[3]			
Total deposits	-0.9	4.2[r]	-1.1
Hong Kong dollar	-1.1	3.9	-2.6
Foreign currency	-0.5	4.5	1.3
Total loans	0.3	0.7	0.6
Loans to customers inside Hong Kong[4]	0.2	0.5	0.3
Loans to customers outside Hong Kong[5]	4.3	6.5	12.4
Negotiable instruments			
Negotiable debt certificates issued	8.5	5.1	-3.3
Negotiable debt instruments held	4.1	5.0	2.8
Asset quality[6]			
As % of total loans			
Pass loans	88.49	89.53[r]	90.07
Special mention loans	6.47	6.53[r]	6.26
Classified loans (gross)[7]	5.03	3.94[r]	3.66
Classified loans (net)[8]	3.52	2.78[r]	2.62
Overdue > 3 months and rescheduled loans	3.64	2.87[r]	2.62
Non-performing loans[9]	4.03	3.17	2.92
Profitability[10]			
Bad debt charge as % of average total assets	0.27	0.28[r]	0.01
Net interest margin	1.98	1.91	1.67
Cost income ratio	37.5	38.6[r]	38.0
Liquidity ratio[11]	45.7	46.1	44.8
		Surveyed institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	1.11	0.86	0.70
Credit card receivables			
Delinquency ratio	1.25	0.92	0.78
Charge-off ratio — quarterly annualised (adjusted)[12]	11.82	8.19	6.34
— year-to-date annualised	12.35	10.02	6.34
		All locally incorporated AIs	
Capital adequacy ratio (consolidated)	15.9	15.3[r]	16.2

Notes:

1 Figures related to Hong Kong office(s) only except where otherwise stated.
2 Quarterly average.
3 Quarterly change.
4 Loans for use in Hong Kong plus trade financing loans.
5 Includes "others" (i.e. unallocated).
6 Figures relate to retail banks' Hong Kong office(s) and overseas branches.
7 Classified loans are those loans graded as "substandard", "doubtful" or "loss".
8 Net of specific provisions.
9 Loans on which interest has been placed in suspense or on which interest accrual has ceased.
10 Year-to-date annualised.
11 Quarterly average.
12 Excluding certain charge-offs which will not be repeated in subsequent quarters and which it would not therefore be appropriate to annualise. The year-to-date figures are not similarly adjusted.

r Revised figures due to late adjustments.

4. Outlook, risks and uncertainties

Outlook, risks and uncertainties

World growth is expected to accelerate this year, led mainly by the US, Mainland China, and Japan. Inflation is projected to remain low, partly as global interest rates start to move back up to more neutral levels. Against this backdrop, the recovery underway in Hong Kong is expected to continue as export growth and a recovery in local property prices underpin the revival in domestic demand. There are, however, a number of risks to the outlook: these relate to the effects of monetary tightening in the US and on the Mainland, rising oil prices and sentiment towards the US dollar.

4.1 Global outlook

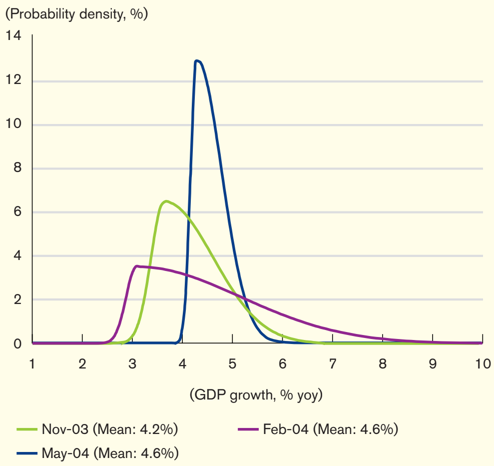
The stronger-than-expected growth performance in the US, Mainland China and Japan has led to upward revisions of forecasts made by multilateral and private institutions for the global economy in 2004. In its April 2004 forecast, the IMF projects global growth to increase from 3.9% in 2003 to 4.6% in 2004, and 4.4% in 2005. US growth is forecast to accelerate from 3.1% in 2003 to 4.6% in 2004, before slowing to 3.9% in 2005 (Table 4.A). In Japan, growth is projected to rise to 3.4% in 2004, while, on the Mainland, it is expected to slow moderately (but remain at a high level) to 8.5% in 2004. The slowest growing region is expected to be the euro area, where growth is projected to rise to 1.7% in 2004, from 0.5% in 2003. According to the latest Consensus Forecasts, risks in the US and Japan have become more balanced (Charts 4.1 and 4.2).

Table 4.A
Forecasts of economic growth in major economies

	Consensus Forecasts		IMF		OECD	
	2004	2005	2004	2005	2004	2005
US	4.6	3.8	4.6	3.9	4.7	3.7
Euro area	1.6	2.0	1.7	2.3	1.6	2.4
Japan	3.1	1.8	3.4	1.9	3.0	2.8

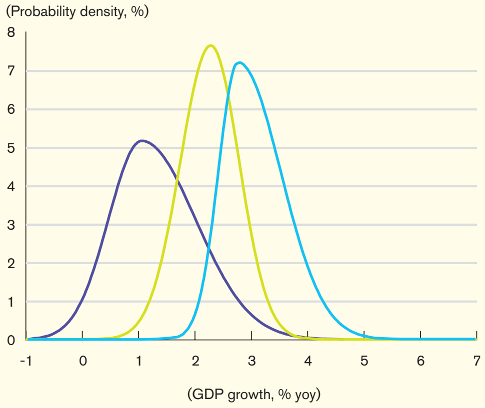
Sources: Consensus Forecasts (May-04), IMF (Apr-04) and OECD (May-04).

Chart 4.1
US: Probability distribution of growth forecasts for 2004



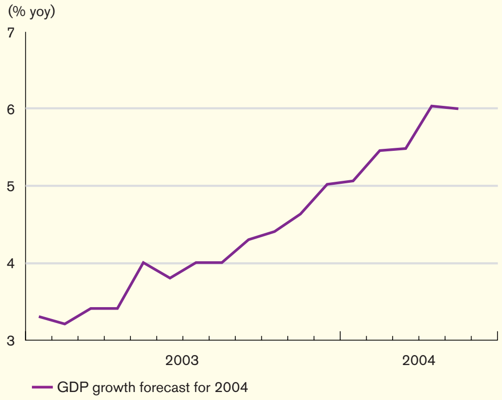
Source: Staff calculations based on Consensus Forecasts.

Chart 4.2
Japan: Probability distribution of growth forecasts for 2004



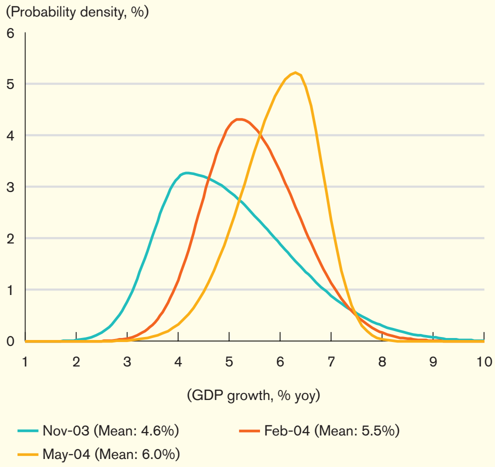
Source: Staff calculations based on Consensus Forecasts.

Chart 4.3
Hong Kong: Consensus Forecasts for economic growth



Source: Consensus Forecasts.

Chart 4.4
Hong Kong: Probability distribution of growth forecasts for 2004



Source: Staff calculations based on Consensus Forecasts.

The primary drivers of the global recovery are expected to be monetary stimulus still in the pipeline, and the widespread rebound in equity prices. The latter benefits both the corporate sector, by lowering the cost of finance, and the consumer sector through wealth gains. As in the second half of 2003, investment spending is projected to grow rapidly, especially in equipment and software. For the small open economies of Asia, while exports are expected to continue to expand at a robust pace, domestic demand is projected to make an increasingly important contribution to growth.

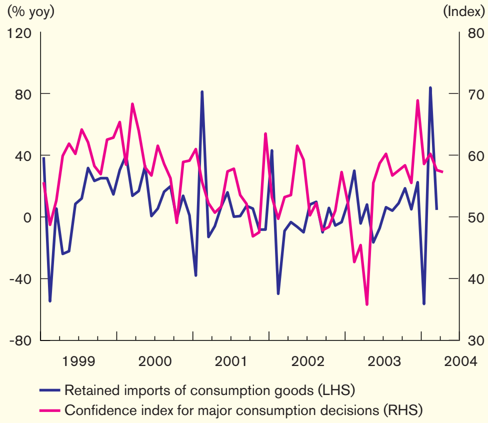
Global consumer price inflation is expected to rise but not sharply. This partly reflects increases in energy and other commodity prices during 2002 and 2003 as a result of strong global demand and, in the oil market, geo-political risk. Futures contracts suggest that the price of oil will fall back but remain at high levels in the near future (see Box 4). The latest IMF forecast expects CPI inflation in the US to increase to 2.7% by 2004 Q4, before declining to 2.1% in 2005 Q4. In Mainland China, CPI inflation is projected to rise to 3.5% this year before declining to 3.0% next year, while in Japan, consumer price changes are projected to be close to zero by the end of 2005.

Financial markets increasingly expect interest rates to rise in a number of major economies this year, including the US, the UK and the Mainland. Long-term interest rates have risen in the US by around 100 bps since mid-March, and the US dollar has appreciated by around 3.5% on a trade-weighted basis since mid-February. Thus, there has already been some tightening in US monetary conditions.

4.2 Domestic outlook

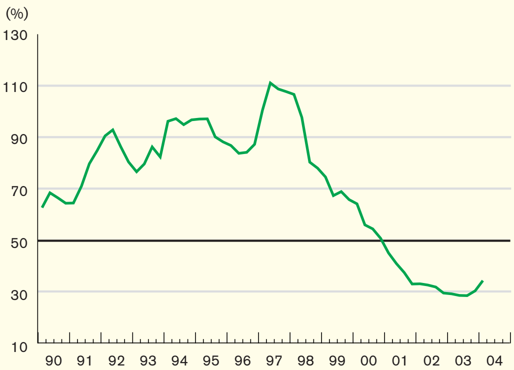
The outlook for the Hong Kong economy is positive (Charts 4.3 and 4.4). The projected increase in global growth and trade flows should support exports. In particular, continued strong expansion of exports from Mainland China should benefit Hong Kong's re-exports and offshore trade. Domestic exports will likely continue to benefit from the Closer Economic Partnership Arrangement (CEPA). Growth in tourist revenues is expected to remain robust.

Chart 4.5
Retained imports of consumption goods and consumer confidence (major purchases)



Sources: C&SD and Hong Kong Policy Research Institute.

Chart 4.6
Housing affordability in Hong Kong



Note: The mortgage repayment is estimated by assuming a 20-year mortgage on 70% of the purchase price of a representative 50 sq. m flat.

Source: Staff estimates.

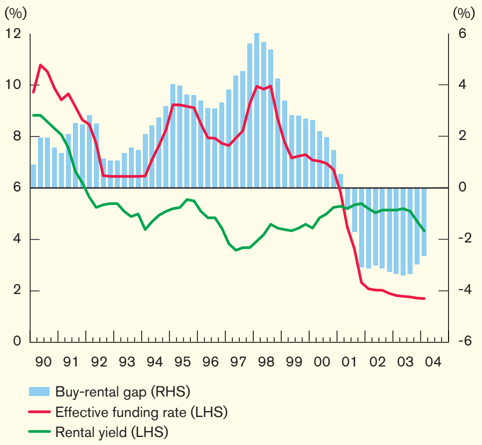
Domestic demand is expected to continue to recover. Consumer confidence has remained high according to responses to the survey by the Hong Kong Policy Research Institute, following the recovery last autumn. This has been underpinned by an impressive rally in property prices and share prices. Retained imports of consumption goods rose by 5.4% in 2004 Q1 compared with a year earlier, suggesting that consumption growth remained robust (Chart 4.5). Leading indicators of investment spending have picked up also. Retained imports of raw materials and capital goods have been rising strongly since November 2003, and increased by 33.4% and 18.6% respectively in 2004 Q1 on a year earlier.

Improved labour market conditions have helped to underpin the rise in consumer confidence. The Quarterly Business Tendency Survey suggests that all sectors, except for construction, expected to increase employment levels during Q2. The Labour Department statistics on vacancies showed a sharp increase to 27,572 at the end of the first quarter, 61.5% higher than at the end of 2003. Most of these are in the private sector.

The recovery in Hong Kong property prices has been pronounced since July of last year. The sustainability of the increases in property prices is difficult to assess since asset prices are forward-looking in nature and reflect market expectations about future macroeconomic and financial developments. Nevertheless, a number of indicators suggest that recent increases are broadly in line with fundamentals. First, debt servicing costs remain low. The ratio of mortgage repayments to median household income rose to 35% in 2004 Q1 but is still well below its average of around 65% in the past two decades and the 50% ceiling observed by banks when making residential mortgage loans (Chart 4.6).[12] This reflects a fall in housing prices relative to median household income since 1997, and low mortgage interest rates. Secondly, the cost of purchasing and maintaining

[12] Moreover, housing affordability may be understated since this measure is based on median household income for the population as a whole and therefore includes low-income households unable to afford home ownership.

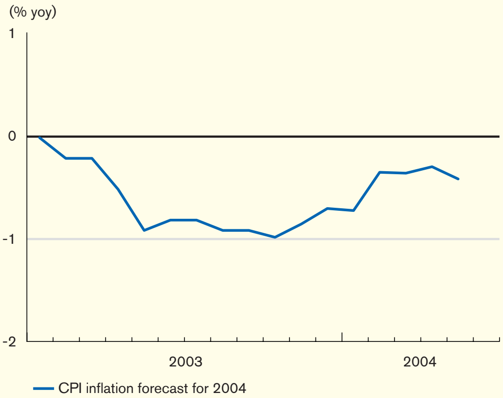
Chart 4.7
Buy-rental gap



Note: The buy-rental gap is calculated as: [(1 – downpayment ratio) x mortgage rate + downpayment ratio x 1-month time deposit rate] – rental yield. The term in the square brackets represents the effective funding rate, based on a downpayment of 30% and a representative mortgage rate.

Source: Staff estimates.

Chart 4.8
Consensus Forecasts for CPI inflation in Hong Kong



Source: Consensus Forecasts.

a flat remains lower than the cost of renting it. The 'buy-rental gap', which measures the difference between effective funding costs and rental yields, remains in favour of buying, although it has narrowed slightly in recent quarters (Chart 4.7).

Reflecting recent economic developments, the Government maintained its forecast for growth in 2004 at 6.0% in May. The latest Consensus Forecasts project the Hong Kong economy to grow by 6.0% in 2004, with the balance of risks tilted to the downside (Chart 4.4). In May, Fitch and Standard and Poor's reaffirmed their credit ratings on Hong Kong, while Fitch raised its outlook to stable from negative.

Deflationary pressures are expected to ease substantially this year. This reflects the recovery in domestic demand, as well as increases in import prices arising from a weaker Hong Kong dollar, higher world commodity prices and higher inflation in Mainland China. In particular, a narrowing of the negative output gap will start to exert some upward pressure on prices. In addition, the recovery in property prices should help to ease the decline in rental costs. Assuming the headline Composite CPI stabilises at its April level, the annual change would be above zero by June 2004 (giving an annual rate of -0.2% for the year as a whole). The latest Consensus Forecasts projection is for the Composite CPI to decline by 0.4% in 2004, compared with a decline of 2.6% in 2003 (Chart 4.8).

4.3 Uncertainties and risks

Despite the overall positive outlook, there are a number of risks to the external and domestic outlook. In terms of global conditions, US interest rates may rise more quickly and to a greater extent than expected, the persistence of upward pressures on oil prices may unseat the global recovery (see Box 4), the US dollar may fall sharply, and, in Mainland China, efforts to cool the economy could result in a hard landing. The risk of a hard landing is judged to be small, but its regional impact would be significant. Domestically, the speed of the turnaround in Hong Kong property prices — albeit from a very low level — may start to raise concern.

It is widely expected that US short-term interest rates will rise to more neutral levels in the coming quarters. At the moment, short-term real interest rates are negative but, with growth running at 4% to 5% and inflation picking up, there is a perceived need to move back to a less expansionary monetary stance. Strong US data releases over the past few months have caused financial markets to bring forward their expectations about the timing of the first rise. The Fed funds futures rate is pricing in a 25 basis points increase in June with a further 75 basis points before the end of the year. However, there are uncertainties about the scope and speed of US monetary tightening. During previous episodes of monetary tightening and loosening the Federal Open Market Committee moved interest rates more quickly than financial markets expected. However, the current situation is different because global inflation is much lower, US unemployment has fallen without concomitant inflationary pressures, and improvements in US productivity growth since the mid-1990s make it difficult to assess the neutral rate of interest.

Increases in US interest rates are generally transmitted to higher interest rates in Hong Kong under the Linked Exchange Rate system, suggesting that local consumption and investment may be adversely affected. However, there are a number of reasons to expect the impact of higher US interest rates on Hong Kong, and the region more broadly, to be limited. First, some increase in interest rates is widely expected by financial markets, and is from a low level. Secondly, cyclical conditions in Hong Kong and Asia are more similar to those in the US than in the previous episode of monetary tightening at the end of the 1990s. Higher interest rates would be more appropriate to regional economic conditions this time, and may help to contain inflationary pressures (and, in some Asian economies, the run-up in property prices). Thirdly, even if the increase in US interest rates is sharper than expected, to the extent that this reflects stronger US growth, higher external demand for regional exports should offset at least part of the negative effect on growth.[13]

[13] See Ha, J. and Leung, C (2002) "Macroeconomic Implications of US Interest Rates for Hong Kong", *HKMA Research Memorandum*, May 2002, http://www.info.gov.hk/hkma/eng/research/RM05-2002.pdf.

For the banking sector, higher interest rates would affect profitability through three channels. First, banks' asset quality may be affected, as higher rates would tend to raise borrowers' debt servicing burden and hence the risk of loan default, given the fact that most loans are priced on a floating rate basis. Secondly, loan demand would be lower, affecting banks' interest income. However, net interest earnings may be supported by an increase in the spread between lending and deposit rates, given ample liquidity in the banking system.[14] Thirdly, an increased holding of debt securities has made banks more susceptible to bond market volatility, though the impact would likely be limited given better tools for managing interest rate risk. On the whole, while the profitability of some banks may be affected more than that of others, the banking system should be resilient to an increase in interest rates, even if this is larger than expected.

For the non-bank financial sector, which has benefited from strong capital inflows since last year, higher global interest rates will make emerging market assets less attractive based on relative values, and could also lead to a re-pricing of the risks inherent in investing in emerging markets. This could lead to adjustments in international investors' portfolios leading to capital outflows. However, the development of deeper regional capital markets since the Asian financial crisis should help to insulate the local economy to some extent from volatile external capital flows.

Turning to prospects for the US dollar, in the near term, growth and yield differentials are likely to be favourable. In recent months the US dollar has strengthened, reversing the decline since mid-2002, which will tend to worsen the current account deficit. In the medium term, continued concern about the US current account deficit and sharply higher fiscal deficits since 2002 are likely to affect sentiment about the US dollar. The sustainability of the twin-deficits will depend on the desire of foreigners to continue to purchase US assets, in the context of the US dollar's position as a reserve currency.

[14] Although research by the HKMA suggests that in the long run there is full pass-through to both deposit and lending rates. See Peng et al. (2003), "The impact of interest rate shocks on the performance of the banking sector", *HKMA Research Memorandum*, http://www.info.gov.hk/hkma/eng/research/RM07-2003.pdf.

Although there seems little evidence of stress in financing requirements for the moment, the longer the current account deficit stays high, the more vulnerable is the US dollar to a sudden reversal of investor sentiment.

A gradual fall in the US dollar would cause the Hong Kong dollar to depreciate against other currencies through the Linked Exchange Rate system. It would also lead to a renminbi depreciation (which is linked to the US dollar as well) which would tend to benefit Hong Kong through higher re-exports. However, any positive effect on Hong Kong exports from gains in competitiveness may be offset partially by negative effects from slower growth in neighbouring economies that experienced a loss in competitiveness vis-à-vis the US. If US interest rates were raised to curb inflationary pressures, Hong Kong's interest rates would rise with a negative effect on domestic demand. An abrupt fall in the US dollar would be more damaging for Hong Kong. Directly, it would increase the likelihood of a sharp increase in US interest rates, and slower global growth. Indirectly, it could have significant effects on the banking and finance sectors through an increase in asset price volatility.

Perhaps a more important risk for Hong Kong and other regional economies is the possibility of a hard landing in Mainland China, characterised by a significant tightening in financial conditions, a sharp slowdown in economic growth and renewed deflation. There are increasing concerns that overheating in certain sectors of the economy may spill over to more generalised inflationary pressures.

An important issue for the Mainland authorities is to determine the pace of monetary tightening. On the one hand, too sharp a monetary tightening will stifle growth. On the other, a slow and inadequate response to excessive credit growth and the build-up of debt may cause a pronounced slowdown later on in the event that interest rates need to be raised sharply to curb inflationary pressures. This is of particular concern because the current high rate of investment may exert downward pressure on prices in the future by raising productive capacity. An additional consideration is that, to the extent that some of the current investment being undertaken reflects too optimistic a view about profitability, it will exacerbate the existing problem of large non-performing loan portfolios in the banking sector.

Tighter monetary conditions and a slowdown in growth on the Mainland would affect Hong Kong through a variety of channels, including close trade links, revenues from Mainland tourists, investment earnings and possibly renewed deflationary pressures arising from price convergence with the Mainland. In the financial sector, Hong Kong banks' profitability and asset quality may be affected, although their direct exposure to Mainland entities is small.

However, the risk of a hard landing is judged to be small. Compared with the previous episode of monetary tightening in the early 1990s, growth and inflation is much lower, there is more confidence in the renminbi, and the expansion of bank credit is not as rapid. In sum, tightening measures undertaken by the Mainland authorities are expected to be successful in delivering a soft landing and more balanced growth. This would benefit Hong Kong by limiting macroeconomic volatility and helping to sustain the recovery.

Turning to domestic risks, the sharp rebound in Hong Kong property prices since July of last year has raised concerns about whether this is warranted and, if not, the extent to which the banking sector is exposed to any reversal in prices. It is difficult to estimate the fair value of housing prices. However, a number of indicators suggest that housing affordability remains at historically high levels and that, if anything, the increases in property prices since the middle of last year represent a rebound from low levels that likely resulted from an overshooting during the downturn.

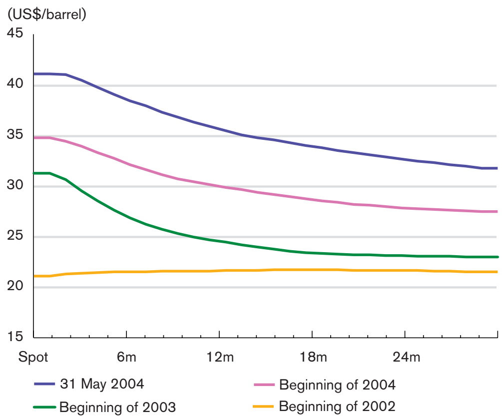
From a banking sector perspective, the increases in property prices have helped to reduce the number of mortgage loans in negative equity, thereby raising banks' asset quality. Moreover, there is little evidence of over exposure to the property market at present. Property-related lending — including both residential mortgage loans and loans for property development and investment — increased only modestly during 2004 Q1 and its share in total lending is little changed at slightly above 50%. Nevertheless, experience suggests that housing prices are prone to overshooting. If they continue to grow at a high rate and become delinked from economic fundamentals, there could be a risk of another property cycle occurring with implications for the profitability and asset quality of the banking sector.

While economic fundamentals remain generally favourable, there is a risk that financial markets in Hong Kong could over-react to external developments, such as a stronger-than-expected monetary tightening in the US and macro-economic adjustments in Mainland China. Although this risk seems small, under extreme market conditions, short-term volatility in financial markets could have a bearing on monetary and financial stability in Hong Kong. This could turn the discount of Hong Kong interest rates over US rates into a premium.

In summary, since the December *Monetary and Financial Stability Report*, economic conditions in Hong Kong and the Asian region have improved and deflationary pressures have receded. Although the recovery has been export-led, there are increasing signs that this is feeding through to a revival in domestic demand growth. While the region is still highly dependent on external demand and exposed to a slowdown in the US or the Mainland, the risk of an abrupt slowdown in either economy is judged to be small. Thus, the risks to Hong Kong's monetary and financial stability seem limited.

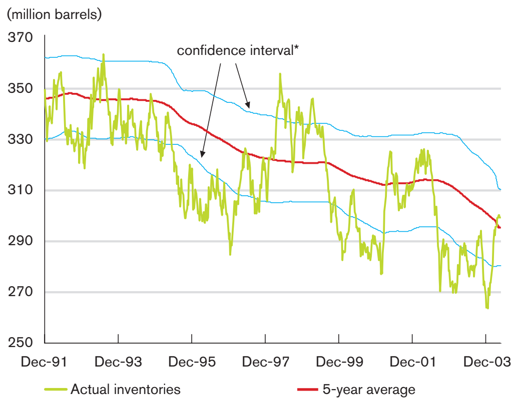
Box 4
The effect of higher oil prices on Hong Kong

Chart B4.1
West Texas Intermediate crude oil spot and futures prices



Source: Bloomberg.

Chart B4.2
US crude oil inventories



* 5-year average +/– one standard deviation.

Sources: US Dept. of Energy and HKMA Staff calculations.

Table B4.A
Global oil demand (million barrels per day)

	Demand	Annual change		
	2004*	2002	2003	2004*
North America	25.0	0.15	0.48	0.39
Europe	15.5	-0.15	0.14	0.24
Asia	23.0	0.35	0.86	1.01
o/w China	6.2	0.27	0.55	0.75
Others	17.1	-0.16	0.17	0.31
World	**80.6**	**0.19**	**1.65**	**1.95**

* Forecast.

Source: International Energy Agency.

Over the past two years, oil prices have risen markedly from around US$19 a barrel in January 2002 to US$38 a barrel in May 2004.[15] Futures contracts suggest that oil prices will fall, but remain over the US$30 a barrel level (Chart B4.1). The sharp increase in prices is due to demand and supply factors. First, strong growth in the global economy and especially in the US and Mainland China, which have high energy usage, has increased demand. Growth in global oil demand accelerated to 1.7 million barrels per day (mbpd) in 2003, from 0.2 mbpd in 2002, according to the International Energy Agency (IEA), while global oil inventories declined to low levels (see Chart B4.2 for the US). The IEA forecasts global demand to increase by 1.9 mbpd this year (Table B4.A). Secondly, continuing geo-political tensions have disrupted world oil supplies and caused many countries, notably the United States, to increase their strategic petroleum reserves. Thirdly, the Organisation of Petroleum Exporting Countries (OPEC) cut its production target in early 2004 in anticipation of lower seasonal demand this summer.

The effect of higher oil prices on Hong Kong works through several channels: a terms-of-trade impact on supply and demand, and inflation. Hong Kong is a net oil importer so real incomes and spending will be reduced by a negative terms-of-trade impact. Supply effects are likely to be reasonably small reflecting the fact that Hong Kong is largely a service-based economy with a small manufacturing sector. Import demand will fall reflecting the decline in domestic demand, but exports are likely to fall by more, as a result of slower regional and global growth,[16] leading to lower net exports. Inflation will rise, through direct effects on the energy components of the CPI and, possibly, indirect effects on labour earnings as consumers seek compensation for cost-of-living increases. Other effects include a deterioration in the nominal trade balance, because of

[15] Based on an arithmetic average of UK Brent, Dubei and West Texas intermediate spot prices.

[16] According to IMF estimates, a sustained US$5 per barrel increase in oil prices reduces the level of global output by 0.3 percentage points relative to base in the following two years assuming monetary policy is tightened in response to higher inflation. Thus, the doubling in prices between 2002 and May 2004 could have knocked around 1.0% off the level of global output. If there is no monetary policy response, the effect is halved. See Robinson, D. and others (2000), "The impact of higher oil prices on the global economy," IMF.

higher spending on oil, and perhaps lower equity prices, particularly if monetary policy is tightened in the US and elsewhere.

The HKMA estimates that the increase in oil prices between 2002 and 2004 may reduce the level of real GDP by about 1%. Of course, a large part of the increase in oil prices reflects stronger global demand, so there will be offsetting effects from improving labour incomes and exports in Hong Kong. The direct effect on the Composite CPI is estimated to be around 0.4 percentage point reflecting the low share of energy (less than 1%); indirect effects are likely to be small given high unemployment. Some of these effects will have come through last year, but growth this year is likely to be affected also. Overall, however, higher oil prices are unlikely to derail the economic recovery underway in Hong Kong.

Abbreviations

AIs	Authorized Institutions
ASEAN	Association of Southeast Asian Nations
BLR	Best Lending Rate
BoP	Balance of Payments
C&SD	Census and Statistics Department
CA	Current Account
CEPA	Closer Economic Partnership Arrangement
CPI	Consumer Price Index
CU	Convertibility Undertaking
EMBI	Emerging Market Bond Index
FDI	Foreign Direct Investment
FOMC	US Federal Open Market Committee
GDP	Gross Domestic Product
GST	Goods and Services Tax
HIBOR	Hong Kong Interbank Offered Rate
HKD	Hong Kong dollar
HKEx	Hong Kong Exchanges and Clearing Limited
HKMA	Hong Kong Monetary Authority
HKSAR	Hong Kong Special Administrative Region of the People's Republic of China
IEA	International Energy Agency
IMF	International Monetary Fund
IPOs	Initial Public Offerings
JGB	Japanese Government Bond
mbpd	Million barrels per day
mom	Month-on-month
NDFs	Non-deliverable Forwards
NIE	Newly Industrialised Economies
OECD	Organisation for Economic Cooperation and Development
OI	Other Investment
OPEC	Organisation of Petroleum Exporting Countries
PCE	Private Consumption Expenditure
PMI	Purchasing Managers' Index
PPI	Producer Price Index
PPP	Purchasing Power Parity
qoq	Quarter-on-quarter
REER	Real Effective Exchange Rate
RMB	Renminbi
S&P	Standard and Poor's
SARS	Severe Acute Respiratory Syndrome
USD	US dollar
VAT	Value Added Tax
yoy	Year-on-year