HALF-YEARLY MONETARY AND FINANCIAL STABILITY REPORT

December 2004

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

Summary

Conditions have remained favourable for monetary and financial stability in Hong Kong since the June Report. The outlook is generally positive, although economic growth in Hong Kong is likely to moderate from the unusually high rates in recent quarters. Observers are predicting slower growth in 2005, reflecting mainly external conditions, and a small increase in consumer prices. There are a number of uncertainties and risks concerning the pace of growth, but these are unlikely to derail the recovery.

The continued expansion has been supported by robust global growth and accommodative monetary conditions. Growth in most of Hong Kong's main trading partners has remained strong, although it has slowed in the euro area and Japan. In particular, growth in Mainland China rebounded markedly in the third quarter of 2004, following an investment-led deceleration in the second quarter. Global monetary and financial conditions have remained supportive, despite four consecutive increases in the Federal funds target rate by a total of one percentage point, and interest rate increases in a number of other economies, including Mainland China. In particular, long-term interest rates in the US have eased.

Owing to these favourable external conditions, exports of goods and services from Hong Kong have remained strong, in line with robust trade activity of the Mainland. Tourism earnings in particular have benefited from the rising income of Mainland residents and a widening of the individual visitor scheme. The recovery has continued to broaden to domestic demand, with both private consumption and investment expanding markedly. Property prices have started to increase again in recent months following some moderation over the summer, and consumer prices have been broadly stable. The unemployment rate has continued to drop, although the pace of improvement has moderated. Bank profitability has increased, despite a decline in net interest earnings, alongside a pick-up in credit demand and improvement in asset quality.

There has been renewed inflow of funds since October 2004, and the Hong Kong dollar exchange rate strengthened to a level of around 7.77 in early December, compared with a level very close to 7.8 in late September. The current episode is arguably an

extension of the one that started in September last year, and the main underlying factors seem to be the same – a continued weakening of the US dollar, upward pressures on the renminbi exchange rate, and a recovery of the domestic economy. The HKMA sold Hong Kong dollars to stabilise the exchange rate and, as a result, the Aggregate Balance increased to around HK$14 billion, after declining sharply to just over HK$3 billion earlier in the year.

Reflecting these developments, monetary and financial conditions in Hong Kong have generally eased since the June report. Short-term interest rates have dropped to near zero levels despite higher US interest rates. Together with dissipating deflationary pressures, this has reduced real interest rates. The Hong Kong dollar has depreciated in effective terms together with the US dollar, while equity prices have increased. These developments should support economic recovery in Hong Kong in the face of slower growth in external demand. The latest Consensus Forecasts project real GDP to increase by 4.5% in 2005, compared with growth of 7.5% in 2004, and the Composite CPI to rise by 1.5% following a small decline this year.

The outlook is subject to considerable uncertainty and risks arising mainly from external developments. Oil prices have eased from their high levels earlier in the year, but are likely to remain volatile, given geopolitical uncertainties. There has been renewed focus in the foreign exchange market on the sustainability of the US current account deficit and its implications for the US dollar. An orderly decline in the value of the US dollar, to which the Hong Kong dollar is linked, would help to improve Hong Kong's competitiveness. However, a disorderly adjustment may disrupt global financial markets. In particular, US interest rates may rise by more than currently expected, although the passthrough to Hong Kong dollar interest rates may not be immediate and complete if it is associated with an increased inflow of funds.

On the Mainland, the risk of a sharp slowdown in growth has receded, but pressure on monetary policy arising from capital inflows could increase in the event of a further depreciation of the US dollar against other currencies. Overall, while there are uncertainties about the pace of growth in the period ahead, the recovery is expected to continue, supporting monetary and financial stability in Hong Kong.

Half-Yearly Monetary and Financial Stability Report
December 2004

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1. Global and regional setting

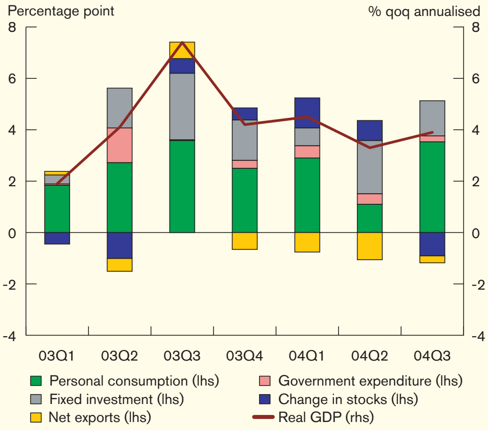
External demand

Growth has slowed in most of the major economies outside of the Asia region since the June Report, including the euro area and, to a lesser extent, the US. This has reduced the momentum behind the export-led expansion in East Asian economies. Higher oil prices and the gradual move to less expansionary monetary policy world-wide have dampened the growth outlook for the coming quarters, although growth is expected to remain reasonably solid.

1.1 United States

US growth rebounded in 2004 Q3, suggesting that the decline in Q2 was temporary.[1] Real GDP growth increased to 3.9%, from 3.3% in Q2, as relatively low US interest rates continued to support domestic demand (Chart 1.1). In particular, growth in consumer spending increased while that of business investment continued at a high rate. The contribution of stocks turned negative, probably reflecting some involuntary inventory accumulation during Q2 owing to weaker-than-expected demand, while that of net exports was less negative reflecting a sharp slowdown in import growth. Monthly leading indicators suggest that growth will remain robust in Q4, close to its current pace of 3.5% to 4.0% (Table 1.A).

Chart 1.1
US: contributions to real GDP growth



Source: Bureau of Economic Analysis.

Table 1.A
US: leading indicators of activity

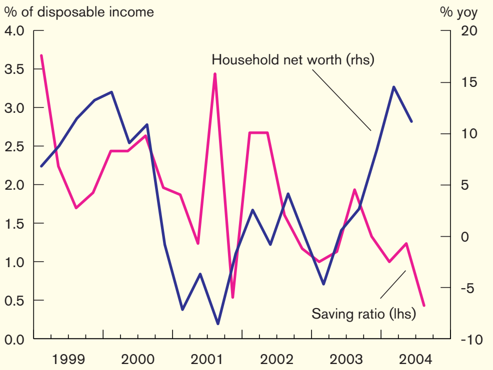
	Jul	Aug	Sep	Oct	Nov
Manufacturing PMI	62.0	59.0	58.5	56.8	57.8
Non-manufacturing PMI	64.8	58.2	56.7	59.8	61.3
Durable goods orders (% 3m-on-3m)	0.6	0.8	2.5	1.5	n.a.
Capital goods orders, nondefense (% 3m-on-3m)	3.8	3.8	5.8	-0.1	n.a.
Retail sales (% 3m-on-3m)	1.5	0.6	1.4	1.3	n.a.
Change in nonfarm payroll (Thousand persons)	85	198	119	303	112
Conference Board					
Consumer confidence index	105.7	98.2	96.7	92.9	90.5
Job prospects[1] (index)	-6.0	-7.6	-11.4	-10.5	-11.3

Note 1: Jobs plentiful less jobs hard to get.

Source: Bloomberg.

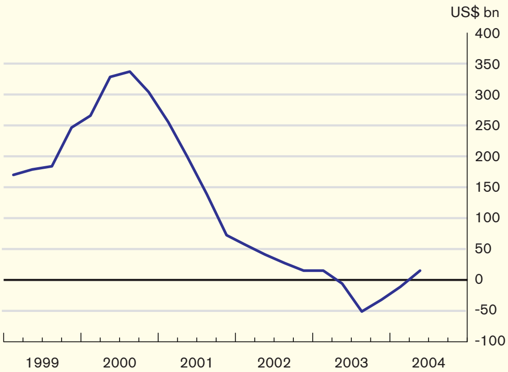
[1] All growth figures are on a seasonally adjusted quarter-on-quarter annualised basis, except where otherwise stated.

Chart 1.2
US: personal saving ratio and net worth



Sources: Flow of Funds Accounts and Federal Reserve.

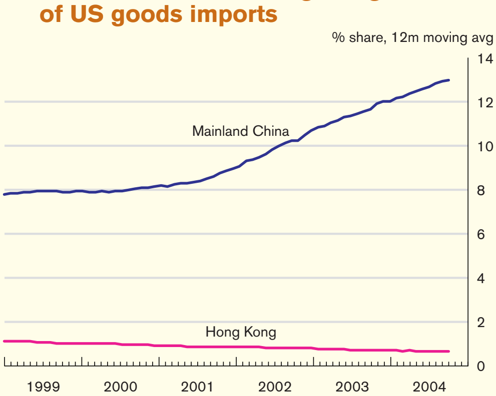
Chart 1.3
US: corporate sector financing gap[1]



Note 1: Capital expenditure less internal funds, where internal funds are the sum of after-tax profits, depreciation allowance and inventory valuation adjustment.

Sources: Flow of Funds Account and Federal Reserve.

Chart 1.4
US: Mainland and Hong Kong's share of US goods imports



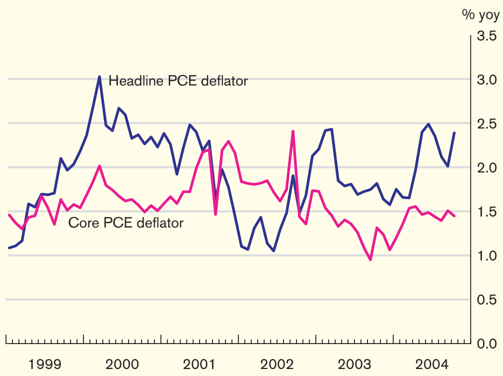
Source: CEIC.

Since the June *Report*, growth in consumer spending has been volatile, possibly reflecting the impact of oil prices on real income and the volatility of employment growth. Taking Q2 and Q3 together, the pace of expansion in consumer spending slowed, reflecting lower growth in real post-tax income, higher interest rates and lower mortgage refinancing. However, the personal sector saving ratio remained on a downward trend, despite a decline in the growth of household net worth (Chart 1.2). This suggests sufficient confidence in a continued expansion in employment – notwithstanding its recent volatility – and real income growth to sustain current spending patterns.

Private investment growth declined to 2.8% in Q3, from its exceptional pace in Q2, owing to lower spending on housing and other structures. Investment in equipment and software continued to grow strongly, at a similar rate to its average over the past five quarters, reflecting a continued high level of profits. Although post-tax profits fell in Q3, partly reflecting a cost squeeze from higher oil prices, they were up by 8.1% on a year earlier, and the share of profits in GDP remains at historical highs. Reflecting these developments, the financing gap – the difference between capital expenditure and internal funds – remained close to zero in Q2 (Chart 1.3). The headline Purchasing Managers' Index (PMI) readings for the manufacturing and non-manufacturing sectors suggest that businesses remain optimistic about near-term prospects for output.

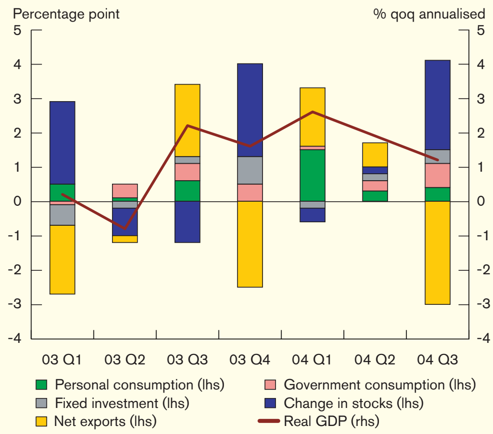
Net exports made a less negative contribution to GDP growth in Q3 than in Q2, as the growth of imports fell more sharply than that of exports. This may reflect expenditure-switching effects arising from a weaker US dollar (i.e. substitution away from imports towards domestically-produced goods as the relative price of imports in US dollar terms rises). In value terms, the trade deficit in goods and services widened, suggesting that the current account deficit may show little improvement in Q3. The share of the Mainland and Hong Kong in US goods imports, by value on a 12-month rolling basis, continued to rise to 13.7% in September 2004, from 12.8% in December 2003 (Chart 1.4).

Chart 1.5
US: headline and core personal consumption expenditure deflator



Source: CEIC.

Chart 1.6
Euro area: contributions to real GDP growth



Source: Eurostat.

Table 1.B
Euro area: leading indicators of activity

(Index)	Jul	Aug	Sep	Oct	Nov
Manufacturing PMI	54.7	53.9	53.1	52.4	50.4
Services PMI	55.3	54.5	53.3	53.5	52.6
Germany IFO (business climate)	95.6	95.3	95.2	95.3	94.1
Industrial confidence[1]	-4	-4	-3	-3	-3
Orders component	-12	-12	-12	-11	-12
Consumer confidence[1]	-14	-14	-13	-14	-13
Consumer credit growth (% yoy)	5.4	6.4	6.2	n.a.	n.a.

Note 1: Survey conducted by the European Commission.

Sources: Bloomberg, European Central Bank and Reuters.

Higher oil prices have resulted in an increase in headline measures of inflation in the past six months, however, core inflation has picked up only moderately. Inflation in intermediate producer prices has risen steadily since Q2, mainly because of higher crude oil prices. While this could suggest rising inflationary pressures, the pass-through to finished goods prices appears to have declined this year.[2] In addition, increases in labour costs remained modest in Q2 and Q3, with continued strong productivity growth helping to restrain unit labour costs. Consequently, core consumer price inflation has been remarkably stable since Q2, with the annual change in the personal consumption expenditure deflator, excluding food and energy, averaging 1.5% in the six months to October (Chart 1.5).

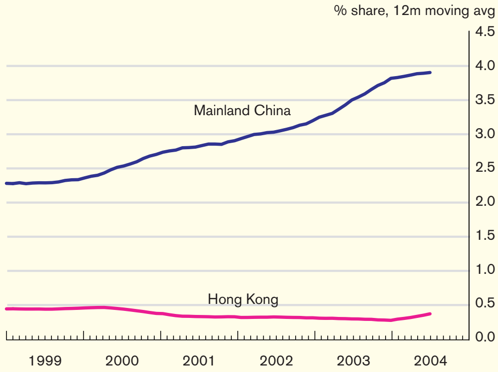
1.2 Euro area and the UK

Real GDP growth in the euro area declined in 2004 Q3, to 1.2% from 1.9% on a quarter-on-quarter annualised basis (Chart 1.6). This reflected a marked slowdown in growth in Germany and France. Private consumption growth in the euro area remained weak, especially in Germany, but there were signs of a gradual recovery in investment spending. The contribution of net trade turned negative owing to a sharp decline in export growth and continued strong import growth.

Concerns remain about the resilience of the modest euro area recovery in the face of slower global growth and continued euro appreciation. The main worry is that private domestic demand will not pick up to fill the gap created by lower export growth. Private consumption growth has been weak in the past two quarters, reflecting rising unemployment, slower real wage growth and lack-lustre consumer confidence. Capital spending has picked up, although increases have been modest so far. Overall, the combination of slow growth, high corporate debt levels, and significant public sector deficits in a number of major euro area economies, continues to hold back both business and consumer confidence (Table 1.B).

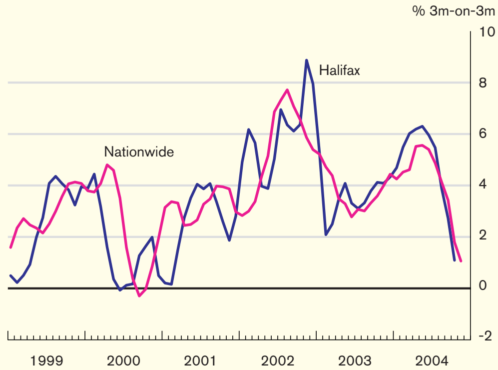
[2] As tentatively suggested by a decline in the 24-month rolling correlation coefficients between crude and intermediate producer price inflation, on the one hand, and finished goods producer price inflation on the other.

Chart 1.7
Euro area: Mainland and Hong Kong share of euro area goods imports



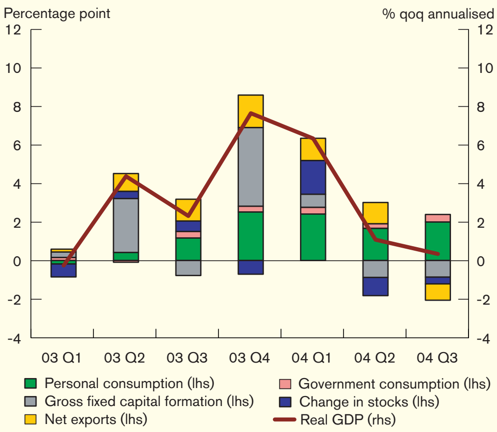
Source: IMF Direction of Trade Statistics.

Chart 1.8
UK: house price inflation



Sources: Halifax and Nationwide Building Society.

Chart 1.9
Japan: contributions to real GDP growth



Source: CEIC.

Net exports made a negative contribution to GDP growth in Q3, reflecting weaker external demand and the lagged effects of the euro appreciation since 2002, especially against the US dollar. Export growth declined sharply, to 4.7% in Q3 from 12.8% in Q2, while the growth of imports rose slightly, to 13.6% from 11.5%. The share of the Mainland and Hong Kong in euro area goods imports, by value on a 12-month rolling basis, was broadly unchanged in June 2004 at 4.3%, from 4.1% in December 2003 (Chart 1.7).

The annual rate of real wage growth was negative in the first half of the year, despite a pick-up in productivity growth, which helped to dampen domestic inflationary pressures. Core consumer price inflation (excluding food, energy, alcohol and tobacco) remained stable, averaging 1.9% in the six months to October, despite increases in headline inflation owing to higher energy prices.

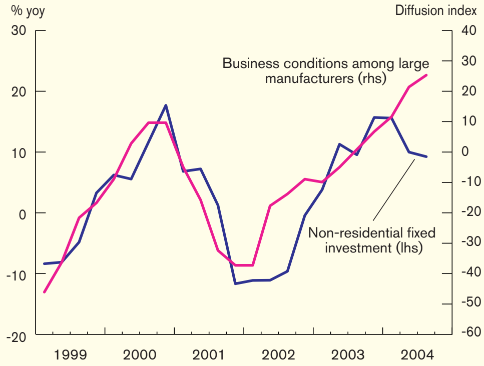
In the UK, real GDP growth declined sharply to 1.8% in Q3, on a quarter-on-quarter annualised basis, following robust average growth of 3.6% in the previous four quarters. This reflected a small fall in capital spending, following three quarters of strong growth, and a large negative contribution from stocks. Consumption growth remained firm, despite higher interest rates and the downward correction underway in the housing market (Chart 1.8). Headline consumer price inflation has moderated since the summer, with the three-month average rate declining to 1.2% in October from 1.5% in July.

1.3 Asia[3]

Growth in the Japanese economy slowed sharply in 2004 Q2 and Q3, to 1.1% and 0.3%, from an average rate of 5.1% in the preceding four quarters (Chart 1.9). These estimates are likely to be revised when Japan publishes chain-weighted GDP figures for the first time in December and, at the same time, incorporates capital spending estimates for Q3 from the latest corporate survey by the Ministry of Finance. The first preliminary

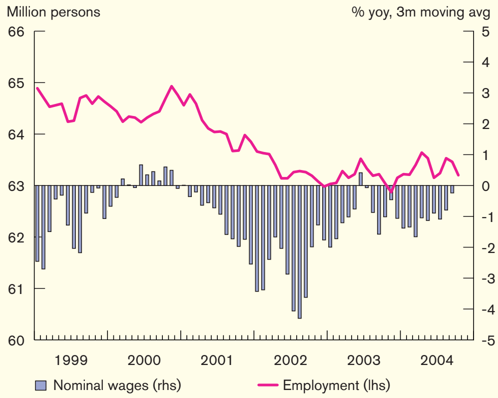
[3] This covers Japan, the Newly Industrialised Economies of Korea, Singapore, Taiwan (hereafter NIE) and the Association of Southeast Asian Nations of Indonesia, Malaysia, the Philippines and Thailand (hereafter ASEAN).

Chart 1.10
Japan: business conditions and investment



Source: CEIC.

Chart 1.11
Japan: employment and nominal wage growth



Source: CEIC.

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

(% yoy)	03Q3	03Q4	04Q1	04Q2	04Q3
NIE:					
Korea[1]	2.4	3.9	5.3	5.5	4.6
	(6.7)	(11.4)	(3.0)	(2.6)	(2.6)
Singapore[1]	1.7	4.9	7.5	12.5	7.5
	(16.1)	(11.0)	(11.1)	(11.9)	(-3.0)
Taiwan	4.2	5.9	6.7	7.9	5.3
ASEAN:					
Indonesia	3.7	4.1	5.1	4.5	5.0
Malaysia	5.3	6.6	7.8	8.2	6.8
Philippines	4.8	5.0	6.5	6.6	6.3
Thailand	6.8	7.7	6.7	6.4	6.0

Note 1: Figures in brackets are official estimates of seasonally adjusted quarter-on-quarter annualised growth rates.

Sources: Bloomberg and CEIC.

estimates for Q3 suggest that growth in private non-residential investment spending stalled, and that export growth declined sharply to deliver a negative net trade contribution for the first time in two years. Growth in consumer spending remained firm. Nevertheless, nominal GDP contracted by an average rate of 0.7% in Q2 and Q3, after increasing by 2.6% in the year to 2004 Q1, and the latest data have rekindled doubts about whether the current recovery will sustain itself.

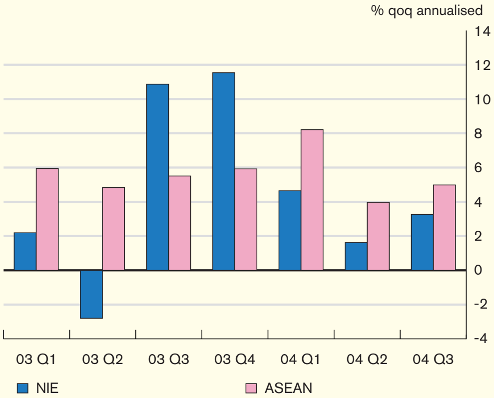
There is particular concern about the weakness of private investment growth in the latest two quarters, following its strong recovery in the year to 2004 Q1. This seems at odds with other indicators, including strong corporate profit growth, import growth, and improving business conditions (according to the Tankan survey (Chart 1.10)). Nevertheless, given the less supportive external environment, it is possible that firms have become more cautious about investment plans. With regard to the household sector, consumption growth remained solid in Q2 and Q3, averaging 3.4% compared with an average rate of 0.7% between 1997 Q1 and 2003 Q2. But there are worries about whether this will be sustained given the apparent failure of strong corporate profit growth to feed through to higher employment and labour incomes in the recovery to date. Employment has increased only modestly since late 2003 and nominal wages are yet to improve (Chart 1.11).

Export growth in Q3 declined sharply, to 1.5%, from double-digit rates of expansion in the preceding four quarters. This reflected lower growth in goods exports, particularly to the US and Mainland China. Import growth remained firm, especially in IT-related and other capital goods and components. The share of the Mainland and Hong Kong in Japanese goods imports, by value on a 12-month rolling basis, rose to 20.9% in October 2004 from 20.0% in December 2003.

Deflation in core consumer prices persisted, with annual changes in the core CPI (excluding fresh food) fluctuating between -0.3% and zero in the six months to October. Domestic corporate goods price inflation, however, almost doubled over the same period, to 1.9% in October, owing to higher commodity prices.

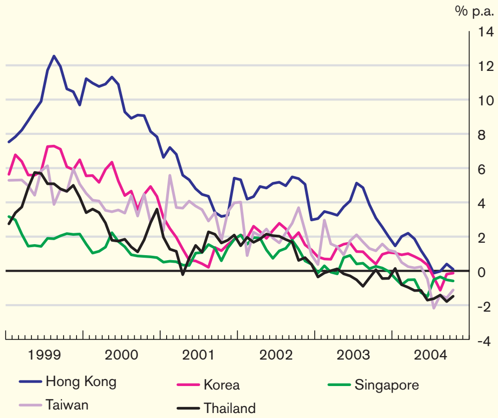
In non-Japan Asia, year-on-year real GDP growth remained high in Q2 but declined in Q3 (Table 1.C).

Chart 1.12
Asia: quarter-on-quarter annualised real GDP growth[1]



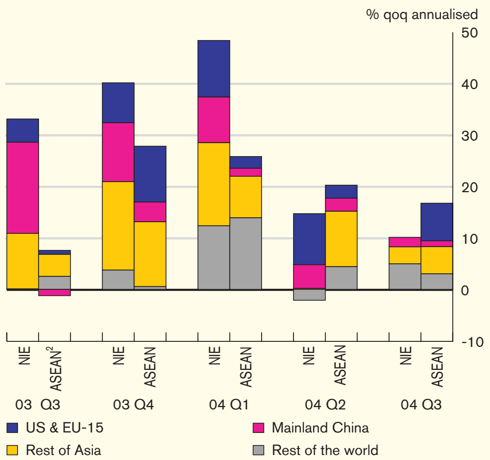
Note 1: Based on official and staff estimates, weighed by 2003 PPP-adjusted GDP.
Sources: CEIC and staff estimates.

Chart 1.13
Asia: real interest rates[1]



Note 1: 3-month interbank interest rates minus annual rates of headline CPI inflation.
Sources: Bloomberg and CEIC.

Chart 1.14
Asia: contributions to export growth[1] by destination (in US$ terms)



Notes : 1. Seasonally adjusted by staff.
2. Excluding Indonesia because of the lack of timely data.
Sources: CEIC and staff estimates.

This pattern reflected base effects from the SARS outbreak last year which boosted 2004 Q2 growth rates, and from strong growth in the second half of 2003. On a seasonally adjusted quarter-on-quarter annualised basis, growth rebounded somewhat in Q3 from Q2, but was still lower than the high rates seen early on in the recovery (Chart 1.12).[4]

Slower growth reflects the impact of higher oil prices and weaker external demand, which has reduced the momentum behind the export-led recovery in the region. The impact of higher oil prices on growth of regional economies varies, with Korea, the Philippines and Thailand likely to be the hardest hit. Slower export growth appears to have fed through to weaker private domestic demand growth, which had been strong at the beginning of this year, but declined in a number of economies in Q2 and Q3. This is despite a highly accommodative monetary policy stance, as evidenced by negative and declining real interest rates in a number of regional economies (Chart 1.13).

Export growth, in value terms, declined in Q2 and Q3, reflecting weaker growth in external demand, from the developed markets of the US and Europe, and in intra-regional trade, particularly to Mainland China (Chart 1.14).[5] Growth in exports slowed more sharply in the Newly Industrialised Economies (NIE), especially Korea and Taiwan, as the global technology cycle turned down. It held up better in the Association of Southeast Asian Nations (ASEAN), which have benefited from strong external demand and higher prices of non-fuel commodities.

Despite slower growth, headline consumer price inflation continued to rise in the six months to October. Across the region, it rose from an average of 3.0% in May to 3.9% in October, reflecting shocks to energy and food prices. Of more concern, however, is the rise in core consumer price inflation in a number of economies. Box 1 looks in more detail at recent developments and prospects for inflation in Asia.

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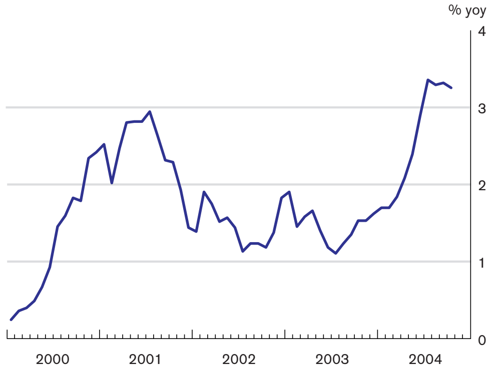
4 See also "East Asia Update", World Bank, November 2004.

5 The impact of a slowdown in growth in Mainland China on Asian economies' exports is examined in more detail in a feature article titled "Intra-regional Trade and the Role of Mainland China" in the *HKMA Quarterly Bulletin*, December 2004.

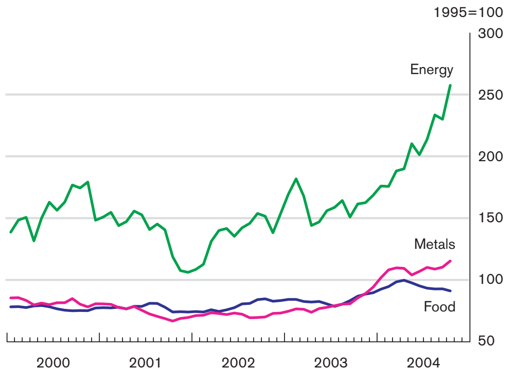
Box 1
Inflation outlook in Asia

Chart B1.1
Headline CPI inflation in Asia



Source: CEIC.

Chart B1.2
Commodity prices



Source: IMF.

Table B1.A
Contribution of food and energy to headline CPI inflation rates in Asia

(% point)	Change in headline CPI inflation (from Jun 03 to Oct 04)	Contribution	
		Food	Energy[1]
Hong Kong	3.3	0.8	0.0
Indonesia	-0.8	0.2	-0.5
Japan	0.9	0.8	0.2
Korea	0.8	0.9	0.4
Mainland China	4.0	3.8	0.1
Malaysia	1.3	1.0	0.2
Philippines	3.9	2.2	1.3
Singapore	2.3	0.7	0.5
Taiwan	2.9	1.8	0.1
Thailand	1.7	-0.5	1.1
Asia	**2.0**	**1.2**	**0.3**

Note 1: Includes motor fuel and petrol. For Indonesia, Korea, Mainland China, Malaysia and the Philippines, this covers private transport, which includes petrol prices. For Singapore, figure is up to Sep 04.

Sources: CEIC and staff estimates.

External price developments, especially in the region, have an important influence on inflation in Hong Kong. This box looks at recent developments and prospects for consumer price inflation in Asia[6], as background to understanding inflation prospects for Hong Kong.

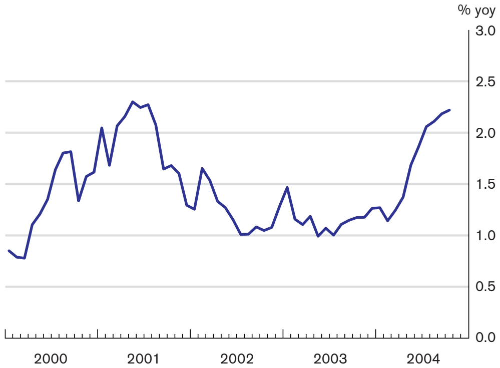
Since the middle of 2003 Asian economies have generally experienced increased rates of inflation. Average headline CPI inflation rose from 1.1% to 3.3% in October 2004 (Chart B1.1). This partly reflects the impact of steep increases in commodity prices (Chart B1.2). After falling for much of 2001 and 2002, non-fuel commodity prices staged a strong recovery in the middle of 2003, with the annual rate of change reaching 25% earlier this year. Both hard (metals) and soft (food) commodity prices have risen, by 46% and 16% respectively since mid-2003. In addition, crude oil prices have been high and volatile during 2004, rising by 39% between January and November, taking the overall increase to 114% since the beginning of 2002.

For most economies, increases in food prices have been the dominant factor behind the rise in headline inflation (Table B1.A). The exceptions are Hong Kong, where changes in rental prices have been an important factor, and Singapore, where the increase in inflation is broad-based. Increases in petrol prices have had a more limited impact (except in Korea, the Philippines, Singapore and Thailand), partly reflecting government price controls and subsidies. In addition, Malaysia and Indonesia are net exporters of crude petroleum products, while, in the case of Hong Kong, a small manufacturing base reduces the oil dependency of the economy.

The outlook for inflation in Asia depends on the persistence of shocks to commodity prices and, more importantly, the extent to which the rise in actual inflation leads to higher expectations about future inflation. With regard to the first issue, the decline in commodity prices, as global growth slows and the effect

6 This covers Japan, NIEs (Hong Kong, Korea, Singapore, Taiwan) and ASEAN-4 economies (Indonesia, Malaysia, the Philippines and Thailand) as well as Mainland China. All aggregate data are simple arithmetic averages except where otherwise stated.

Chart B1.3
Core CPI inflation in Asia



Note: Core CPI inflation excludes fresh food and energy prices.
Sources: CEIC and staff estimates.

Table B1.B
Core CPI inflation rates in individual Asian economies[1]

(% yoy)	2003	2004		
		Q1	Q2	Oct
Hong Kong	-2.5	-2.4	-1.3	-0.2
Indonesia	7.2	5.5	6.4	7.2
Japan	-0.3	-0.1	-0.2	-0.4
Korea	3.1	2.7	2.7	3.4
Mainland China	0.0	0.3	0.5	1.3
Malaysia	0.9	0.9	0.8	1.9
Philippines	3.3	4.2	4.8	6.7
Singapore	0.5	0.9	1.7	0.9
Taiwan	-0.6	0.1	0.7	0.9
Thailand	0.1	0.1	0.4	0.6
Asia	**1.2**	**1.2**	**1.6**	**2.2**

Note 1: Excludes fresh food and energy.
Sources: CEIC and staff estimates.

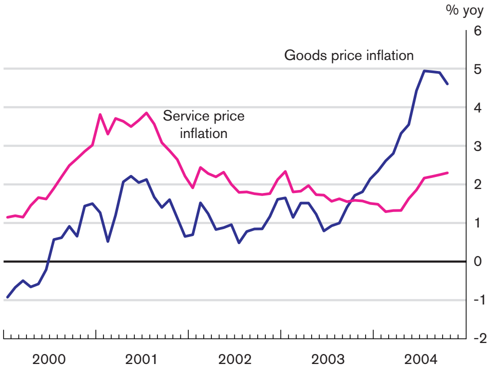
of supply shocks to food prices diminishes, will reduce the upward pressure on headline CPI inflation. Both metals and food prices stabilised during 2004 Q3. Prospects for oil prices are more uncertain, although futures contracts at end-November 2004 for end-2005 delivery suggest that prices will decline from their current high level.

Even if commodity price inflation has peaked, the effect of past shocks on consumer price inflation may be long lasting if there is a high degree of pass-through to other prices and, especially, to wages. Direct evidence on inflation expectations in Asia is sparse. An alternative way to gauge the extent of pass-through is to look at movements in underlying or core inflation. According to staff estimates, the average rate of core inflation, which excludes fresh food and energy, in Asian economies doubled from 1.0% in mid-2003 to 2.2% in October 2004, although this was from a very low base (Chart B1.3).

The increase was widespread across the region (Table B1.B). Core inflation has closely tracked headline inflation in Hong Kong, Indonesia, the Philippines and Singapore. In other Asian economies, once fresh food and energy prices are stripped out, the increase in CPI inflation has been less marked. But it is on a rising trend in Korea, Mainland China, Malaysia, Taiwan and Thailand. The exception is Japan where the rate of decline in the core CPI appears to have increased since the beginning of this year, from close to zero to 0.4% in October.

In addition, historically low nominal interest rates combined with rising inflation has caused real interest rates to turn negative in a number of Asian economies, including Mainland China, the NIEs and Thailand. This is adding to demand and inflation pressures.

Chart B1.4
Goods versus service price inflation in Asia



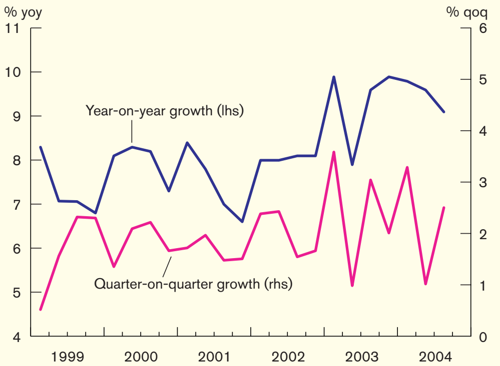
Sources: CEIC and staff estimates.

Against this, however, there is little evidence of cost-push inflation emerging from the labour market. Real wage growth has been subdued despite a recovery in labour demand and productivity growth (except in Thailand, where rising real wages have fed through to core inflation). This reflects a high rate of unemployment, which in many economies is still above its level before the Asian financial crisis. The lack of labour cost pressure is consistent with a stable level of service price inflation, which contrasts with a sharp rise in goods price inflation (Chart B1.4). This suggests that a significant further rise in inflation is unlikely to occur (provided there is no further significant rise in oil prices). Moreover, global growth is expected to moderate in 2005, and a number of Asian central banks have started to tighten monetary policy. In its September World Economic Outlook, the IMF projected CPI inflation in emerging Asia to decline to 3.9% in 2005, from 4.3% this year.

Mainland China

Since the June Report, the risk of a marked slowdown in growth on the Mainland has largely receded. Growth picked up in the third quarter following a sharp deceleration in the second, reflecting a rebound in investment growth. Headline consumer price inflation accelerated in the third quarter, before declining noticeably in October owing to lower food price increases. However, high rates of inflation in producer and investment goods prices, and supply bottlenecks, indicate strong demand pressures. The authorities raised interest rates in October for the first time in nine years and relaxed restrictions on commercial lending rates, marking a shift toward a more market-based approach to macroeconomic management.

Chart 1.15
Mainland China: GDP growth



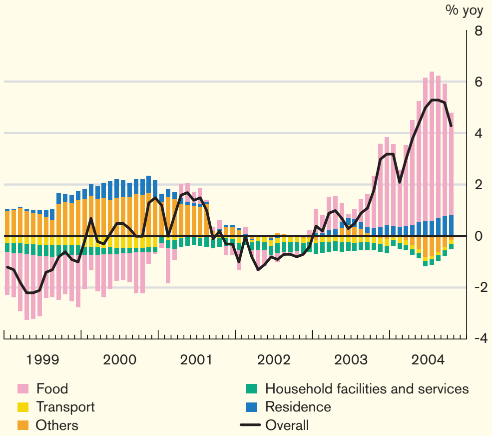
Sources: CEIC and staff estimates.

1.4 Output, growth and inflation

Economic growth rebounded in 2004 Q3, after a sharp slowdown in Q2. The year-on-year growth rate of real GDP declined to 9.1%, from 9.6% in Q2, although the Q2 figure is boosted by the low base of comparison for the same period in 2003, when the economy was severely disrupted by the outbreak of SARS. Unofficial estimates of seasonally adjusted quarter-on-quarter growth rates suggest an acceleration to 2.5% in Q3, from 1.0% in Q2 (Chart 1.15).

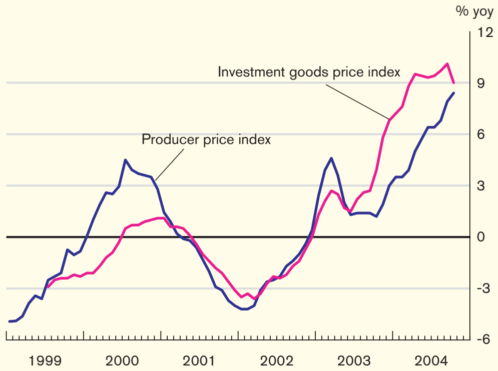
The rise in growth in Q3 mainly reflected a rebound in investment growth, while consumer spending and exports continued to hold up. Nominal fixed asset investment rose by 28.4% year-on-year in Q3, up from 24.3% in Q2, possibly because of a partial scaling back of the administrative measures introduced in the first half of 2004. Industrial production grew at an annualised rate of 10.0% over Q2 (seasonally adjusted). The growth rate of private consumption appears to have decelerated, reflected in a slowdown in the year-on-year growth in retail sales to 14.0% from 18.8% in Q2, although it is running at a high level. Export growth remained strong, at over 30%, while import growth slowed to 30.1%, from 43.6% in Q2, possibly because lending restrictions dampened the demand for raw materials.

Chart 1.16
Mainland China: contributions to CPI inflation



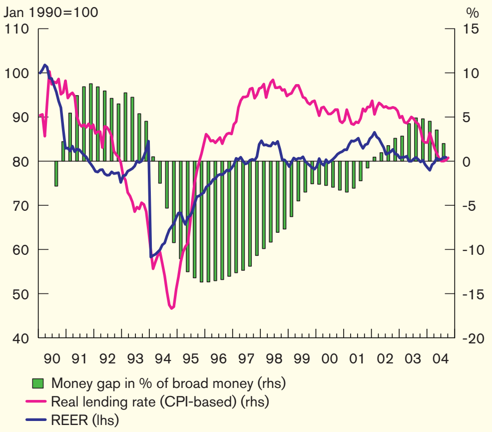
Source: CEIC.

Chart 1.17
Mainland China: other price indicators



Source: CEIC.

Chart 1.18
Mainland China: monetary conditions



Note: The money gap is defined as the difference between the nominal broad money supply and an estimated demand determined by economic growth and inflation.

Sources: CEIC and staff estimates.

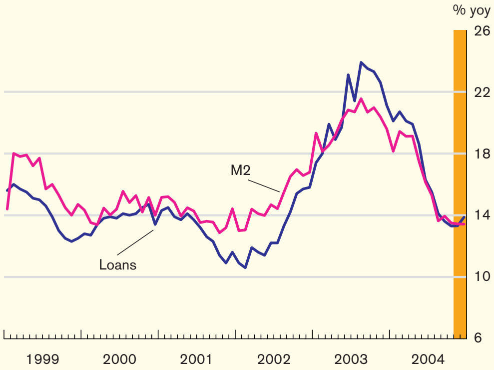
Growth appears to have remained solid in Q4. Industrial production rose by 15.2% in October on a seasonally adjusted three-month-over-three-month basis, up from 10.0% in September. Fixed-asset investment and retail sales also rose strongly.

Consumer price inflation declined to 4.3% in October, after remaining above 5% in the previous four months. This reflects lower food price inflation (Chart 1.16), although food price inflation continues to be the single largest factor behind the high headline inflation rate, contributing around 3.5 percentage points. Inflationary pressures remained high along the supply chain, reflecting continued strong demand, although these are yet to show up in headline consumer price inflation. In particular, the investment goods prices rose by 9.0% in October, compared with 10.1% in September, and the inflation rate of producer prices increased to 8.4% from 7.9% (Chart 1.17).

1.5 Monetary conditions and asset prices

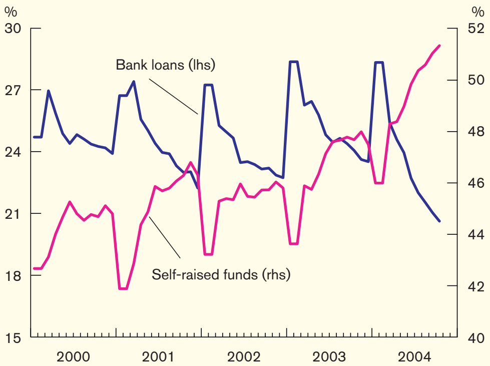
Monetary conditions tightened, reflecting the impact of administrative measures in reducing credit growth, and increases in benchmark lending and deposit rates in late October. Real interest rates began to rise in recent months, although they remained negative (Chart 1.18). The impact of higher interest rates on overall monetary conditions was, however, partly offset by a depreciation of the RMB in real effective terms as the US dollar weakened. Broad money (M2) and credit growth slowed, following strong expansion in the first few months of 2004, indicating tighter financial conditions from a credit availability perspective. M2 and credit grew at annualised rates of 13.3% and 10.4% respectively in October on a seasonally adjusted three-month-on-three-month comparison. At the current pace, M2 and credit year-on-year growth rates look set to decline to around

Chart 1.19
Mainland China: money and credit



Note: The shaded area indicates estimates.
Sources: CEIC and staff estimates.

Chart 1.20
Mainland China: sources of investment funds



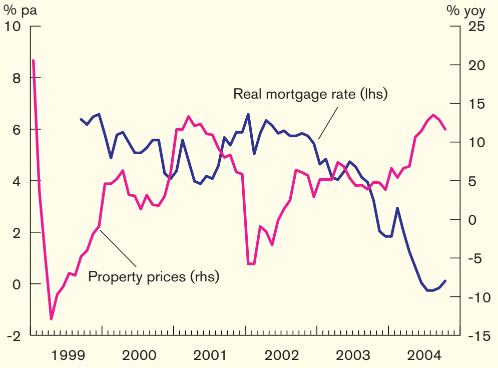
Note: Figures are on a year-to-date basis.
Source: CEIC.

14% by end-2004, below the range of 16-17% desired by the People's Bank of China (PBoC) (Chart 1.19). HKMA estimates suggest that the positive money gap, which indicates excess money supply relative to demand, narrowed significantly.

The sharp slowdown in money and credit growth probably overstates the extent of tightening in credit availability. Restricted access to credit in the formal sector has caused investors to seek alternative sources of funding. The fraction of self-funded investment by enterprises has been increasing, and there is anecdotal evidence that activity in the informal credit market has increased, supported by negative real interest rates, which have caused a diversion of deposits to alternative investment channels (Chart 1.20). Growth in RMB deposits has fallen since late last year, reflected in both year-on-year (from 22.6% in October 2003 to 15.6% in October 2004) and annualised three-month-on-three-month growth rates (from 19.3% to 10.9% during the same period). Nevertheless, there are some signs of stabilisation in RMB deposits, as their rate of decline has slowed. In addition, foreign financing appears to have increased, as indicated by a rise in short-term foreign debt, part of which does not involve credit expansion by the banking sector. This financial disintermediation has reduced the effectiveness of restricting credit supply of the banking sector for macroeconomic control, and raised potential risks associated with the unregulated informal credit market. These concerns are probably part of the motivation behind the increase in interest rates by the PBoC in late October.

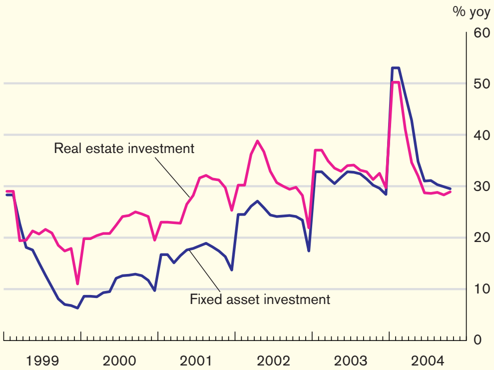
In the meantime, strong inflows of capital have continued to put pressures on reserve money growth as foreign exchange reserves more than doubled between 2001 and 2003, and rose by 27.6% in the first nine months of this year. This led the PBoC to carry out sterilisation operations in order to limit the impact on domestic monetary conditions. As a result, growth in base money has been restrained within the range of 10-14% year-on-year in the last few months despite the fast expansion of foreign exchange reserves.

Chart 1.21
Mainland China: real mortgage rates and property prices



Sources: PBoC and CEIC.

Chart 1.22
Mainland China: investment



Note: Figures are on a year-to-date basis.
Source: CEIC.

Relatively easy monetary conditions have contributed to strong increases in property prices, which in turn have fuelled investment growth and aggravated the overheating problem. The low real mortgage rates have probably stimulated the demand for residential properties (Chart 1.21). Property prices have risen rapidly in some metropolitan areas since 2001, increasing by over 20% in the first nine months of 2004. Nation-wide, prices increased by 12% year-on-year in October 2004 – a high rate of increase by historical standards. Spending on real estate development appears to be a key driver of overall fixed asset investment. The growth rates of the two have been closely correlated in the past few years (Chart 1.22). In the first ten months of 2004, investment in real estate rose by 28.9% year on year, compared with an increase of 29.5% in total fixed asset investment.

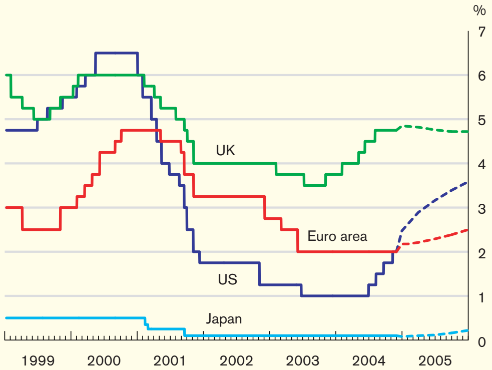
Monetary and financial conditions

The much expected US interest rate-tightening cycle began in late June 2004. By the end of November, the US Federal Open Market Committee had raised its target rate by a total of one percentage point in four consecutive meetings and stated that it would continue to remove monetary stimulus at a measured pace. The People's Bank of China also raised key interest rates to help maintain a stable growth path. The value of the US dollar weakened sharply in early November and the large US current account deficit continues to pose a risk for further depreciation of the US dollar.

1.6 Interest rates

As expected by the markets, the US Federal Reserve ("the Fed") began tightening its monetary stance in late June 2004. By the end of November, the Federal Open Market Committee (FOMC) had raised its Federal funds target rate by a total of one percentage point in four consecutive meetings to 2%. Despite some mixed macroeconomic data releases, the Fed maintains that the monetary stimulus will be removed at a "measured" pace. At 30 November, the price of fed funds futures contracts indicated that market participants expected the target rate to reach 3.0% in June 2005. Among the major economies, Canada and the United Kingdom also raised their policy rates over the period. The European Central Bank and the Bank of Japan kept interest rates unchanged, but prices of futures contracts imply that market participants expect these to rise steadily in 2005 (Chart 1.23).

Chart 1.23
Official spot and forward interest rates in major economies

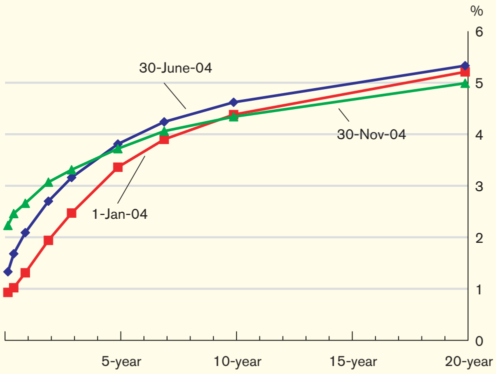


Note: Solid lines are official spot interest rates, while broken lines are three-month interbank rates implied by futures contracts on 30 November 2004.

Sources: Bloomberg and CEIC.

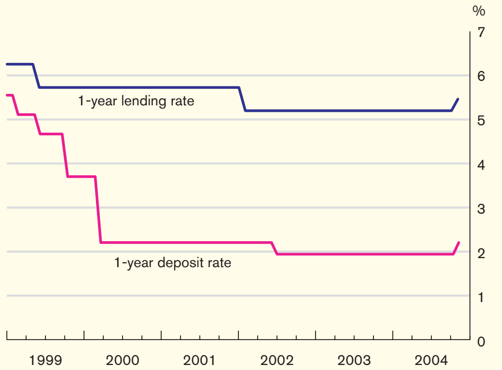
The US Treasury yield curve has flattened since June 2004 (Chart 1.24). Expectations of further US rate increases in 2005 have pushed short-term yields higher, while the risk of slowing growth momentum, together with a benign inflation outlook, have driven yields at the long end of the maturity spectrum lower. At the end of November, the spread of 10-year over 1-year US treasury yields had fallen to around 170 basis points – the lowest in three years. In Europe, long-term government bond yields were also influenced by a lack of inflationary pressures. The 10-year German government bond yield fell from a peak of around 4.4% in mid-June to just below 3.8% on 30 November.

Chart 1.24
US Treasury yield curve



Source: Federal Reserve Board.

Chart 1.25
Mainland China: key lending and deposit rates

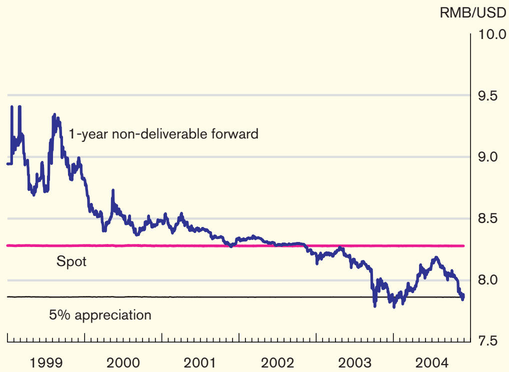


Source: CEIC.

Chart 1.26
US dollar: bilateral exchange rates

Source: Bloomberg.

Chart 1.27
Renminbi non-deliverable forward rates



Source: Bloomberg.

Against the background of rising consumer prices, pushing *realised* real interest rates to below zero, the PBoC raised its key interest rates in late October to help maintain a stable growth path. This was the first time in nine years that the PBoC had increased interest rates: both the benchmark one-year lending and one-year deposit rates were increased by 27 basis points to 5.58% and 2.25% respectively (Chart 1.25).[7] To help improve risk management in the banking sector, the PBoC also widened the range in which commercial banks are allowed to set interest rates by abolishing the upper limit on lending rates and the lower limit on deposit rates. Prior to the announcement, lending rates were set at an upper limit of 2.3 times the benchmark rate. But the lower limit on lending rates and the upper limit on deposit rates were kept unchanged.

1.7 Exchange rates

The value of the US dollar was broadly stable in 2004 Q3 but fell sharply in November (Chart 1.26). Against the euro, the US dollar was traded within a range of US$1.2 to US$1.25 per euro between June and October before weakening to a record low of around US$1.33 per euro in late November. A similar pattern of yen-US dollar exchange rate movements appeared over the same period. In the medium term, however, most commentators expect the US dollar to weaken further to help reduce the large US current account deficit (see Box 2).

Market expectations of a renminbi appreciation have strengthened substantially since October (Chart 1.27). In the run up to the meeting between finance ministers and central bank governors of the G7 and Mainland China on 1 October, market speculation of a renminbi appreciation intensified, pushing the one-year renminbi non-deliverable forward (NDF) rate to around RMB 7.9 per US dollar from a year-low of RMB 8.2 per US dollar in mid-July.

[7] Financial institutions are required to set their deposit and lending rates either at or within a narrow range of a benchmark rate announced by the PBoC.

Chart 1.28
Selected major equity indices (local currency)

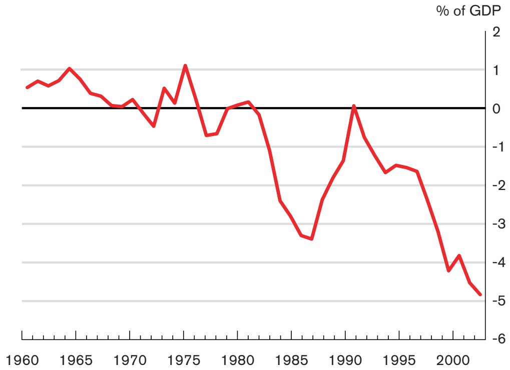
Source: Bloomberg.

1.8 Equity markets

Given that uncertainty in equity markets (as measured by the implied volatility of option prices) remained subdued, share price movements over the past six months may have been influenced more by fundamentals than by market dynamics. Concerns about corporate earnings growth contributed to weaknesses in most major equity markets in the summer of 2004 (Chart 1.28). In particular, share prices of information technology firms fell sharply in July after several large corporations issued warnings of lower-than-expected profit margins in the second half of the year. Share prices rebounded strongly in early November after the US presidential election, and oil prices declined from their all-time highs.

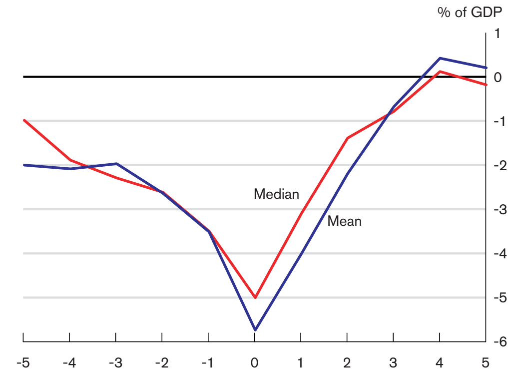
Box 2
US current account deficit and the value of the dollar

Chart B2.1
US current account balance



Source: Bureau of Economic Analysis.

Chart B2.2
Current account reversal in industrialised countries



Note: 0 denotes the year when current account deficit reaches its trough. See Freund (2000) for more details.

Sources: IMF IFS and WEO.

The large US current account imbalance has attracted much attention in recent policy discussions. Some commentators argue that at the level of around 5% of GDP (Chart B2.1), the US current account deficit is not sustainable. This perhaps signals that the value of the US dollar could continue to depreciate.[8] This box examines the arguments more closely.

At what level should the current account deficit be of concern? There is no definite answer to this question. However, Freund (2000), based on an event study of 25 episodes of current account reversals among industrialised countries, finds that a typical current account reversal begins when the deficit is about 5% of GDP and takes three to four years to return to balance (Chart B2.2).[9]

Sustainability depends on both the decisions of borrowers in the deficit country and foreign lenders. The deficit position is sustainable only when the borrower (in this case the US) finds it beneficial to continue borrowing while the lenders (the rest of the world) are willing to extend more loans. From the point of view of the US, the deficit will thus not be sustainable when it becomes so large that the repayment has an adverse effect on domestic economic activity. Furthermore, the rest of the world will analyse the risk-return profile of the US to see if it is profitable to invest further in the country.

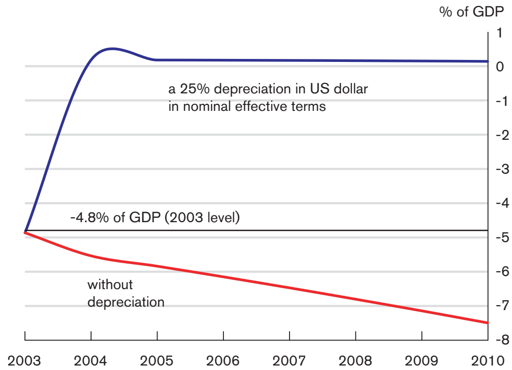
In accounting terms, the current account balance is simply the sum of trade balance and net income payments on foreign assets. Based on this accounting framework, Mann (1999) evaluates the level of depreciation needed for the US current account to return to balance.[10] Assuming a nominal world interest rate of 4%, and that the US and the rest of the world to grow by

[8] A contrary view is that higher current account deficits simply reflect new investment opportunities, thus there is no reason to be concerned about them. The so-called Lawson Doctrine maintains that higher current account deficits are of no policy concern unless they are driven by higher public borrowing.

[9] Freund, C. (2000), "Current account adjustment in industrialised countries," Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 692.

[10] Mann, C. (1999), "Is the US trade deficit sustainable?" Institute for International Economics.

Chart B2.3
Projections of US current account balance



Sources: Mann (1999) and staff calculations.

2.1% and 3.2% respectively, she projects a deterioration in the US current account deficit from 4.8% of GDP in 2003 to 7.5% by 2010 in the absence of any exchange rate adjustment (Chart B2.3). However, with a 25% depreciation of the US dollar exchange rate in nominal effective terms, the current account will almost return to a balanced position in the following year.

Obstfeld and Rogoff (2004) argue that while the current account deficit may be small at 5% of GDP, it could account for 20% or more of US traded goods production. A small change in the current account balance in terms of GDP could, therefore, have a more significant impact on the relative price of US and foreign products and hence the US dollar nominal exchange rate.[11] Using a model that differentiates between home and foreign traded goods, and non-traded goods, Obstfeld and Rogoff assess the requisite change in the long-run real exchange rate associated with a return of a 5% current account deficit to balance. They calculate that in the event of a sudden reversal, caused by, say, a demand shock, the real exchange rate might have to depreciate by more than 30% in effective terms.

While these calculations suggest that a large depreciation of the US dollar may be necessary to restore external balance, there are other factors that could affect the sustainability analysis.[12] For example, an orderly return to US current account balance could be achieved through faster economic growth and hence stronger import demand in Japan and the euro area. If these increases in demand are met by US products, the trade and current account balances of the US will improve. The current account deficit could also be improved by higher US public and private savings. In addition, the special status of the US dollar as a reserve currency is expected to continue to provide a strong incentive for international investors, especially central banks, to hold US dollar assets.

[11] Obstfeld, M. and K. Rogoff (2004), "The unsustainable US current account position revisited," UC Berkeley, mimeo.

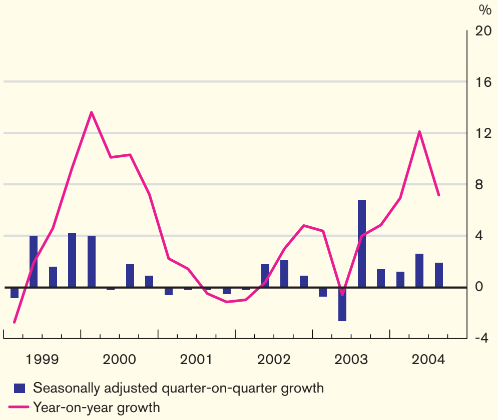
[12] Mussa, M. in "Global Economic Forecasts, April 2004", presented at the Institute for Economics, argues that the real effective foreign exchange value of the US dollar needs to decline by around 30% from its peak in 2000/01 to narrow the US trade deficit by US$250-300 billion. In 2003, the trade deficit in the US reached almost US$500 billion. Given the US real effective exchange rate has declined by 14% since the end of 2001, another 15% depreciation is implied by Mussa's calculations.

2. Domestic economy

Demand

Output growth in Hong Kong slowed somewhat in the third quarter of 2004 following exceptionally strong performance in the second quarter, as growth in both domestic and external demand moderated. Nevertheless, domestic demand remained robust, supported by rising asset prices, an improved labour market, and growing household income. Closer integration with the Mainland has continued to support Hong Kong's external trade.

Chart 2.1
GDP at constant market prices



Source: C&SD.

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

	2002	2003	2003		2004		
			Q3	Q4	Q1	Q2	Q3
Gross Domestic Product	**1.9**	**3.2**	**4.0**	**4.9**	**7.0**	**12.1**	**7.2**
Domestic demand	-0.8	0.0	-1.1	4.2	7.3	12.7	4.3
Consumption							
Private	-1.2	-0.9	0.1	3.7	6.0	11.2	5.1
Public	2.5	1.9	0.5	5.5	5.4	-0.2	-1.5
Gross domestic fixed capital formation	-4.5	0.1	0.0	1.9	5.5	12.7	4.9
Private	-5.2	0.1	-1.5	2.0	6.8	16.8	8.5
Public	-1.4	0.3	8.8	1.4	0.3	-8.6	-14.5
Change in inventories[2]	0.9	0.3	-1.2	0.8	1.5	2.2	-0.1
Net exports of goods[2]	0.3	0.6	2.1	-1.9	-2.9	-3.5	1.2
Net exports of services[2]	2.3	2.6	3.0	2.9	2.9	3.6	2.2

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

Source: C&SD.

2.1 *Aggregate demand*

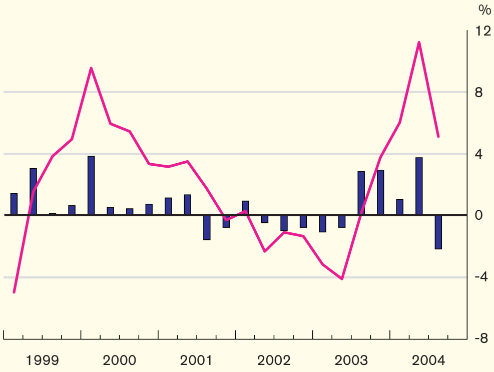
Since the June *Report*, growth in aggregate demand has remained robust, but moderated slightly in 2004 Q3 (Chart 2.1). Reflecting the strong demand, GDP at constant (2000) market prices grew by 1.9% in Q3 on a seasonally adjusted quarter-on-quarter basis, following a rise of 2.6% in Q2. Year on year, growth slowed to 7.2% in Q3 from 12.1% in Q2, although the latter was distorted by the impact of SARS in the same period of 2003 (Table 2.A). Growth in domestic demand, which continues to be a key contributor, slowed to 4.3% from a year earlier.

2.2 *Domestic demand*

Private consumption

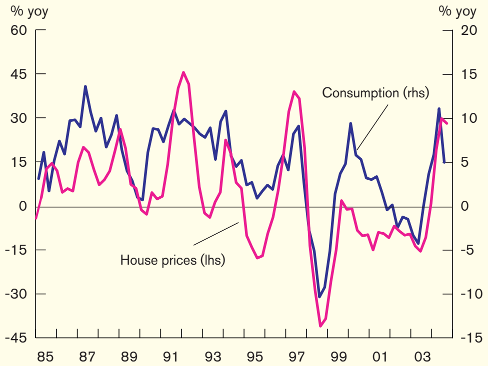
Private consumption has been strong since the June *Report*, although it has declined somewhat in recent months. On a seasonally adjusted quarter-on-quarter basis, consumption grew by 3.7% in Q2 – the highest

Chart 2.2
Real private consumption



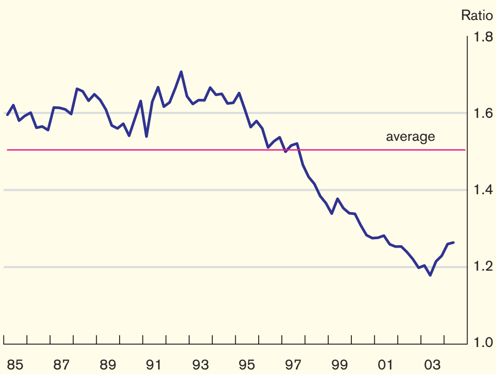
Source: C&SD.

Chart 2.3
Private consumption and house prices (in real terms)



Note: Real house prices are obtained by deflating the residential property price index by the Composite CPI.
Sources: C&SD and Rating & Valuation Department.

Chart 2.4
Consumption-to-labour-income ratio



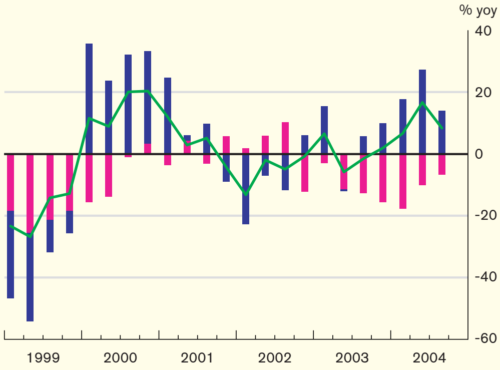
Source: Staff estimates.

quarterly growth rate for over four years – but declined by 2.2% in Q3 from the high level in Q2 (Chart 2.2). Private consumption contributed 6.5 and 2.7 percentage points to year-on-year GDP growth in Q2 and Q3 respectively. Both spending on goods and services grew at double-digit rates in Q2 but slowed in Q3 year on year. However, the latest data show a decline in retail sales on a seasonally adjusted three-month-on-three-month basis in October. With an increase in tourist arrivals, the fall in retail sales indicates a possible further moderation in local consumption in Q4.

The strong pick-up in consumption in the earlier part of the year was supported by a turnaround in the asset markets, improved labour market conditions, higher consumer confidence, and rising household income (Chart 2.3). In line with strong consumption growth, there are signs of a decline in the household saving ratio, following a considerable rise in recent years.[13] Chart 2.4 shows that the consumption-to-labour-income ratio has risen in recent quarters, although it remains well below its average level over the past 20 years. Should the ratio return rapidly to the average level since 1985, this could mean a sharp increase in consumption growth as the economy recovers, which could pose inflationary risks.

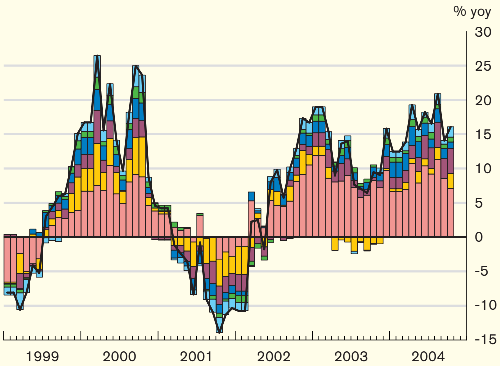
[13] Official estimates of the household sector saving ratio are not published; however, HKMA staff has constructed estimates of labour income (see "The relationship between consumption, income and wealth in Hong Kong", HKIMR Working Paper No. 1/2004.). The inverse of the ratio of consumption to labour income provides a guide to movements in the household saving ratio, although it is not a good proxy of the level of the saving ratio since labour income is only part of household income.

Chart 2.5
Private investment by component



Source: C&SD.

Chart 2.6
Merchandise export value to major trading partners



Source: C&SD.

Investment

Private investment remained firm, and rose by 16.8% and 8.5% year on year in Q2 and Q3, reflecting strong profitability and continued optimism in the business outlook. Spending on machinery, equipment and computer software continued to drive overall investment, while the rate of decline in spending on building and construction has slowed since Q2 (Chart 2.5).

Public investment declined year on year in Q2 and Q3 after increasing in the previous three quarters. This reduction reflected a winding-down of several railway projects, which more than offset increased spending on a number of major civil engineering projects.

2.3 External trade

As domestic demand started showing signs of a deceleration, growth in external demand for Hong Kong's goods and services also lost some momentum, because of slower growth in the economies of major trading partners in recent months. However, offshore trade and inbound tourism, especially from the Mainland, remained strong.

Merchandise exports declined by 0.9% quarter on quarter in Q3, after increasing by 5.8% in Q2. Recent data suggest the decline may have continued, as total value of exports of goods increased by 0.6% in October on a seasonally adjusted three-month-over-three-month basis, while export deflator has been rising at about the same rate. In particular, year-on-year growth in total value of exports of goods to Mainland China and East Asia was weaker in September-October following strong performances in the previous five months (Chart 2.6).

Imports of goods fell more than exports in Q3, by 2.9% quarter on quarter, after increasing by 5.5% in Q2. Latest data indicate that imports continued to fall, as the value of merchandise imports fell in October on a seasonally adjusted three-month-over-three-month basis by 0.3%, when import prices continued to rise. The decline mainly reflected a fall in retained imports, although imports for re-exports also declined.

Table 2.B
Tourism receipts

	Tourism receipts[1]		
	Total	Mainland	Others
		% of GDP	
2002	4.6	2.3	2.4
2003	4.6	2.9	1.7
2004 Q1	4.9	3.2	1.7
Q2	4.6	2.7	1.9
Q3	5.1	3.3	1.8

Note: 1. Tourism receipts include visitors' consumption expenditure only.
Sources: C&SD, Tourism Board, and staff estimates.

Despite the slowdown in merchandise trade, exports of services, including offshore trade increased in Q3 by 7.6% quarter on quarter. This reflected the continuous structural shift in export composition from exports of goods to offshore trade. In addition, inbound tourism continued to increase. The number of visitor arrivals rose by 30% in Q3 from a year earlier, with visitors from the Mainland accounting for two-thirds of the rise. The Individual Visit Scheme has strengthened the role of the Mainland as the biggest source of tourism receipts for Hong Kong. It is estimated that total tourism receipts from the Mainland have accounted for 3.1% of GDP so far this year, compared with 2.3% in 2002 and 2.9% in 2003 respectively (Table 2.B). However, this increase in contribution may slow, since there are signs of a possible decline in per capita spending by Mainland tourists.

Output and supply

From the supply side perspective, the service sector has been the main contributor to recent output growth. Labour market conditions continued to improve with the economic recovery. However, the decline in the unemployment rate slowed in recent months, as an increase in labour force partly offset the expansion of employment.

2.4 Output

Real GDP at factor cost by economic sector, which measures the income paid to factors of production, offers a view on the development of the supply side of the economy. Sectoral analysis of output growth suggests that service sector output, which accounts for almost 90% of total output, expanded by 12.6% in 2004 Q2 over a year earlier (Table 2.C). While output declined in the industrial sector, manufacturing sector output increased by 1.4% in 2004 H1, after declining at an average annual rate of 9.2% in the previous three years. The increase in manufacturing sector output occurred alongside a rise in domestic exports, which increased in Q1 and Q2 year on year, after having declined for 13 consecutive quarters. This probably reflects the positive impact from the implementation of the Closer Economic Partnership Arrangement (CEPA) since the beginning of 2004.

In terms of contributions to growth, the import-export sector, including trade-related services, is a key driver of the recent recovery, and contributed about 40% to the increase of output in 2004 Q2 (Table 2.D). The financial services industry also contributed over 20% of the growth. The industrial sector contributed negatively to growth, indicating a continuous structural shift to a service-based economy.

Table 2.C
Real GDP growth by major economic sector (year-on-year)

	2001	2002	2003	2003		2004	
				H1	H2	Q1	Q2
GDP at factor cost	**0.9**	**2.1**	**3.4**	**2.1**	**4.5**	**7.1**	**10.8**
Industrial sector	-3.7	-3.7	-4.6	-5.7	-3.6	-2.1	-2.3
Of which:							
Manufacturing	-8.6	-9.8	-9.1	-10.7	-7.7	1.8	1.1
Construction	-2.0	-1.5	-5.0	-5.0	-5.0	-8.3	-8.0
Service sector	1.6	3.0	4.5	3.2	5.7	8.4	12.6
Of which:							
Wholesale, retail, restaurant and hotel	-4.1	-5.6	-5.3	-10.7	-0.2	6.7	23.2
Import and export	1.6	7.5	14.4	17.2	12.3	14.3	19.3
Transport and storage	0.3	5.0	-0.7	-2.8	1.1	12.0	28.9
Financing, insurance and business services	-0.9	1.4	7.5	4.1	10.7	17.0	12.5

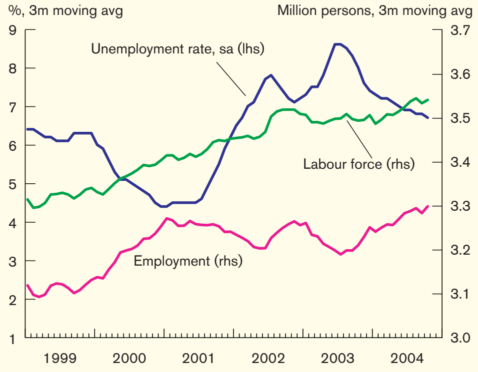
Source: C&SD.

Table 2.D
Contribution to real GDP growth by major economic sector (year-on-year)

	2001	2002	2003	2003		2004	
				H1	H2	Q1	Q2
GDP at factor cost	**0.9**	**2.1**	**3.4**	**2.1**	**4.5**	**7.1**	**10.8**
Industrial sector	-0.5	-0.5	-0.6	-0.7	-0.5	-0.2	-0.3
Of which:							
Manufacturing	-0.5	-0.5	-0.4	-0.5	-0.4	0.1	0.0
Construction	-0.1	-0.1	-0.2	-0.3	-0.2	-0.4	-0.4
Service sector	1.4	2.6	4.0	2.8	5.0	7.4	11.0
Of which:							
Wholesale, retail, restaurant and hotel	-0.3	-0.4	-0.3	-0.7	0.0	0.4	1.2
Import and export	0.3	1.5	3.0	3.2	2.8	3.1	4.1
Transport and storage	0.0	0.4	-0.1	-0.2	0.1	1.0	2.1
Financing, insurance and business services	-0.2	0.2	1.3	0.7	1.8	2.9	2.3

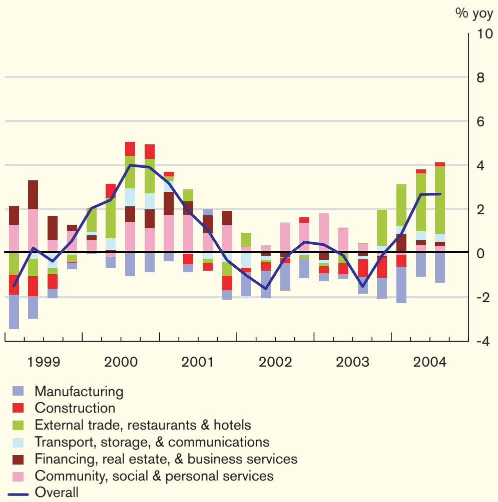
Source: C&SD.

Chart 2.7
Labour market conditions



Source: C&SD.

Chart 2.8
Contribution to employment growth by sector (year-on-year)



Source: C&SD.

Leading indicators suggest that growth in Q4 could moderate further, following a slowdown in Q3.[14] According to the Quarterly Business Tendency Survey conducted by the Census and Statistics Department (C&SD) for 2004 Q4, although most of the sectors covered expect an increase in the volume of business/output in Q4 over Q3, businesses are less optimistic about the outlook than in the previous survey.

2.5 *Labour and productivity*

The economic recovery has been accompanied by a pick-up in employment and higher labour productivity. At this stage, the unemployment rate is still high by historical standards but could fall further as the recovery continues.

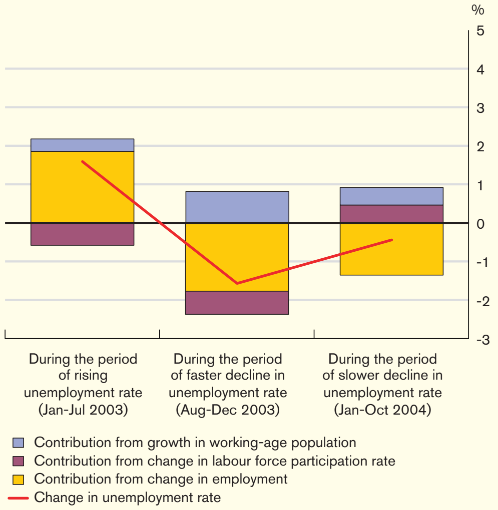
Labour market conditions

Labour supply has continued to increase since the June *Report*, owing to rises in the working-age population and labour force participation (Chart 2.7). Improved employment prospects may have attracted more people to enter the job market.

Reflecting the recovery in output growth, employment has been expanding steadily. Consistent with the earlier analysis of output by sector, the fastest growing sectors – trade, restaurants, and hotels – created more jobs, while manufacturing employment continued to fall (Chart 2.8). The Quarterly Business Tendency Survey suggests most sectors expect a slight increase in employment, or a broadly stable situation, in 2004 Q4. The Labour Department statistics on vacancies point to sustained demand for workers in the private sector.

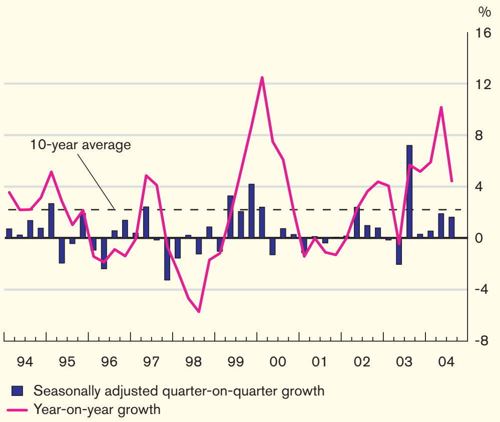
[14] GDP by economic activity for Q3 was not available at the time of the publication of this report. The slowdown in Q3 is therefore calculated based on GDP by expenditure components.

Chart 2.9
Determinants of the unemployment rate



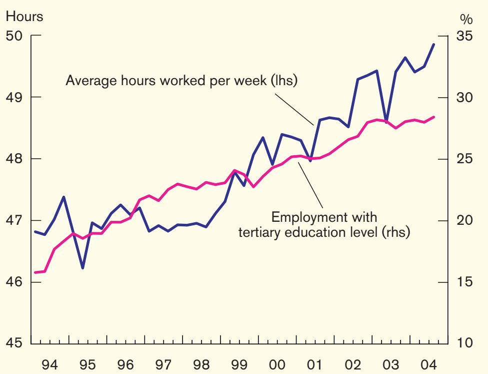
Source: Staff estimates.

Chart 2.10
Output per worker



Source: Staff estimates.

Chart 2.11
Average hours worked and share of workers with higher educational attainment



Sources: C&SD and staff estimates.

As mentioned in the June *Report*, a faster expansion in employment than in the labour force resulted in a rapid fall in the unemployment rate. However, in recent months, the decline in the unemployment rate has slowed: the unemployment rate was 6.7% in the three months ending October (Chart 2.7). This is because the increase in employment was in large part offset by a rise in the labour force (Chart 2.9).[15] Underemployment is still prevalent in some sectors, in particular construction. Uncertain business prospects have led to increases in part-time jobs as employers take a cautious approach to hiring workers.

The slowdown in the decline in the unemployment rate has raised concerns about the role of structural factors. While the natural rate of unemployment has likely risen following the Asian financial crisis, estimates suggest that it is significantly below the current unemployment rate.[16]

Productivity

The growth in labour productivity, as measured by output per worker, on a year-on-year basis has been above its 10-year average in the past three years, except for 2003 Q2, when output was severely disrupted by the SARS outbreak (Chart 2.10). Part of the faster growth in the measured labour productivity is due to longer working hours. Average hours worked per week rose from around 47 hours in 1994-98 to over 49 hours in 2004 Q3 (Chart 2.11). The steady improvement in educational attainment and occupation profile of the workforce has probably also helped. The share of those with tertiary education in total employment increased from below 17% in 1994 to above 28% in 2004 Q3 (Chart 2.11). The share of middle and senior positions in the total workforce increased from about 30% in mid-1990s to 33% in 2004 Q3.[17]

15 A framework of decomposing changes in the unemployment rate into contributions from various factors is presented in Peng, W. et al. (2001), "Sources of Unemployment: Recent Developments and Prospects", *HKMA Quarterly Bulletin*, November 2001.

16 An empirical analysis suggests that the natural rate of unemployment stood at $3^1/_2$-$4^1/_2$% in recent years. For details, see Fan, K. (2004), "Sources of Unemployment", *HKMA Quarterly Bulletin*, June 2004.

17 Middle and senior positions refer to associate professionals (for examples, technicians, nurses, and accounting supervisors), professionals, and managers and above.

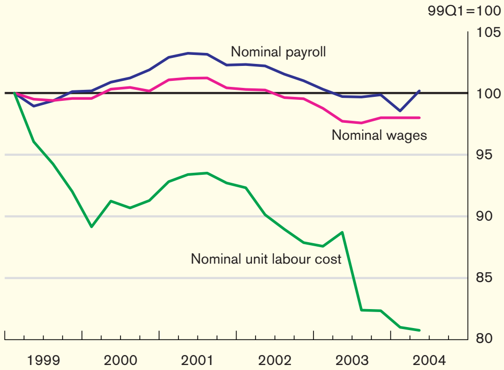
Prices

While deflationary pressures have eased rapidly and, by some measures, dissipated, there are few signs of inflation yet. However, a positive output gap, rising import prices and wages, a recovering property market, and strong demand could lead to increased inflationary pressures. Against this, upward pressures from wage increases are likely to be modest, as productivity growth continues to exceed wage growth.

2.6 Labour costs

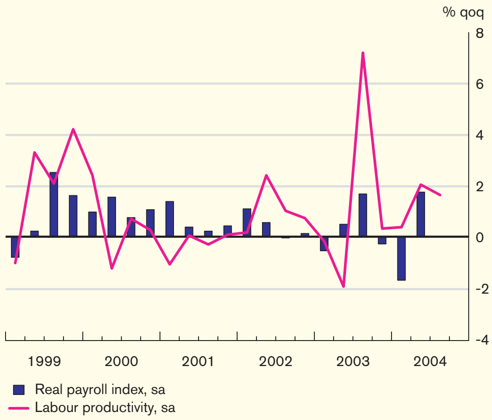
Cost-push inflationary pressures have remained low. The latest data on labour costs indicate that the average nominal wage remained stable in 2004 H1. Average nominal payroll, which includes remuneration as well as overtime payments, back-pay and other irregular allowances and bonuses, rose by 0.3% on a seasonally adjusted basis during 2004 H1 (Chart 2.12). Despite the increase in payroll, unit labour cost continued to decline in 2004 H1 as productivity growth outpaced average payroll growth (Chart 2.13).

Chart 2.12
Wage & payroll indices and unit labour cost



Sources: C&SD and staff estimates.

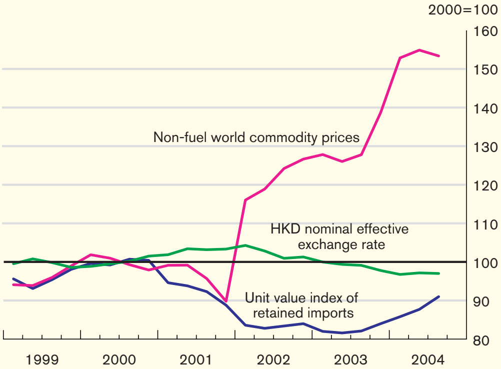
Chart 2.13
Labour productivity and real wages



Note: Labour productivity is measured as output per worker.

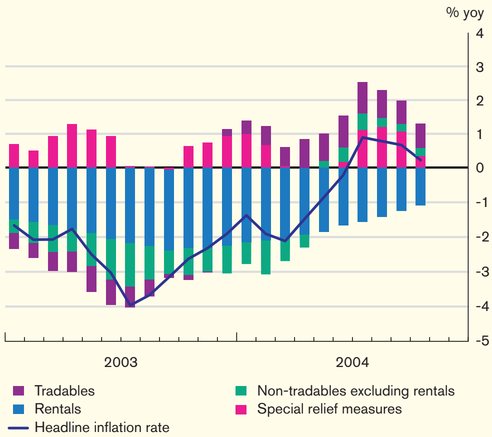
Sources: C&SD and staff estimates.

Chart 2.14
Import prices



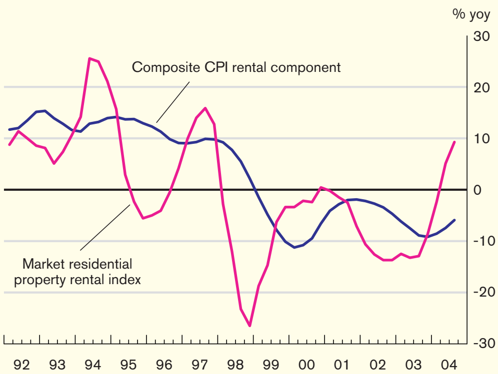
Sources: C&SD and Datastream.

Chart 2.15
Headline inflation



Sources: C&SD and staff estimates.

Chart 2.16
Rental indices



Sources: C&SD and Rating & Valuation Department.

2.7 Commodity and import prices

Import prices have risen further in Q2 and Q3, reflecting a weak Hong Kong dollar effective exchange rate and high world commodity prices: the sharpest rises were in the prices of raw materials and fuel (Chart 2.14). The unit value index of retained imports, which increased by 2.2% in Q2, rose further by 3.8% in Q3 quarter on quarter (Chart 2.14). While non-fuel commodity prices declined in Q3, oil prices have remained high and volatile.

2.8 Consumer prices

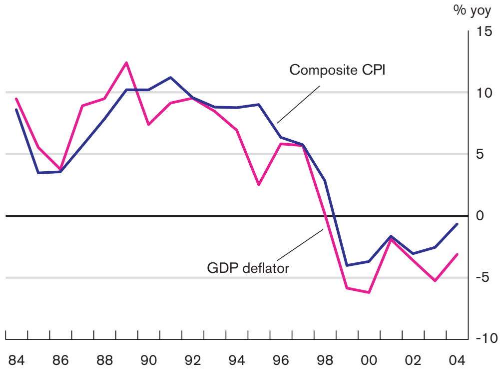
The Composite CPI recorded year-on-year increases between July and October, which have led to concerns about a return of inflation. However, the rises are mainly due to the effect of special relief measures adopted by the Government in the same period of 2003 (Chart 2.15). Adjusting for the effect of these measures, consumer prices declined year on year. Month on month, the Composite CPI rose by 0.1% in September and October, after declining by about the same rate in each of the previous three months. This suggests that while deflationary pressures have eased rapidly and, by some measures, dissipated, there are few signs of a significant pick-up in inflation yet.

The broad stability in the Composite CPI masks divergent movements in its main components. The synchronised recovery in global growth and a revival in domestic economic activity have led to increases in prices of tradable and non-tradable goods and services, excluding rent, since late 2003. The rental component of the Composite CPI has continued to decline, despite the recovery in property prices, exerting downward pressures on the aggregate index throughout the period. The decline in the rental component is in contrast to developments in market rents, which show a rise of about 10% since their trough in 2003 (Chart 2.16). Changes in the rental component lag movements in market rents partly because of fixed-term rental contracts, typically by 1-2 years. So far in 2004, petrol price increases have had little discernible effect on inflation owing to their low weight in the consumer price index.

While deflation measured by changes in consumer prices has largely ended, the GDP deflator, a broader measure of prices, has continued to decline. Box 3 finds that the discrepancy between these two indices in recent years is mainly accounted for by differences in coverage. Specifically, the sharper decline in the GDP deflator than in the Composite CPI in recent years mainly reflects a larger fall in investment goods prices than in the prices of consumer goods and services, as well as a deterioration in terms of trade. Overall, both measures suggest subdued inflationary pressures at present.

Box 3
The GDP deflator and the consumer price index

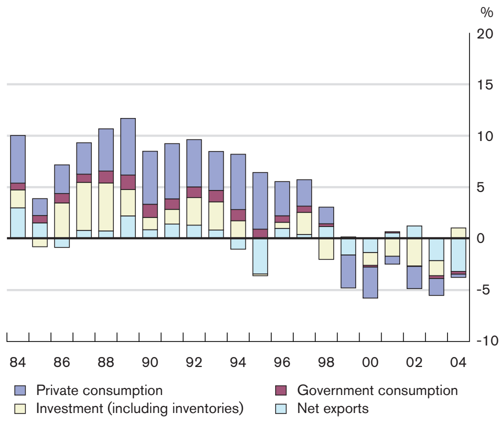
Chart B3.1
GDP deflator and consumer prices



Note: 2004 figures are the averages of the first three quarters.

Source: C&SD.

Chart B3.2
Contributions of broad components to change in the GDP deflator



Note: 2004 figures are the averages of the first three quarters.

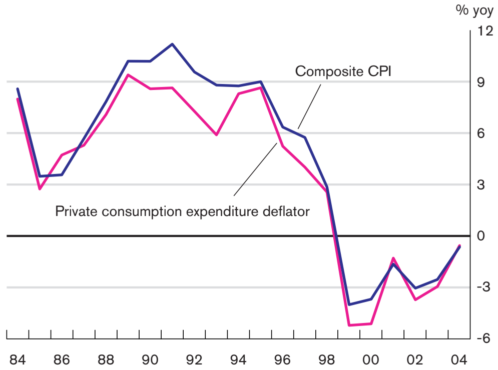
Sources: C&SD and staff estimates.

The GDP deflator has declined at a faster rate than the Composite CPI (CCPI) in recent years (Chart B3.1). In particular, while deflation measured in terms of changes in consumer prices has come to an end, a broader definition based on the GDP deflator suggests that prices continue to decline. This box considers the sources of the difference and their significance.

An earlier HKMA study suggests that the larger decline in the GDP deflator in the past few years is mainly due to differences in coverage.[18] The CCPI has roughly the same coverage as the private consumption expenditure component of the GDP deflator, but the latter also includes prices of investment goods, the cost of government services, and prices of traded goods and services. A decomposition suggests that the fall in the GDP deflator in recent years was mainly attributable to declines in the private consumption expenditure and investment deflators (Chart B3.2). In particular, price declines in the investment components were larger than those in private consumption in 2001-03. In addition, the deterioration in the terms of trade contributed to the fall in the GDP deflator in 2003 and 2004.

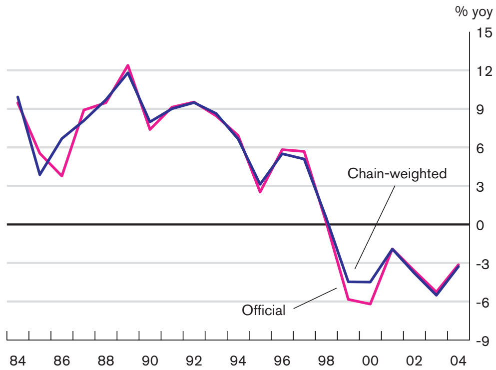
[18] See Peng, W. and K. Fan (2004), "Key Price Indicators and Inflation in Hong Kong", HKMA Research Memorandum, http://www.info.gov.hk/hkma/eng/research/RM06-2004.pdf.

Chart B3.3
Private consumption expenditure deflator and the Composite CPI



Note: 2004 figures are the averages of the first three quarters.
Source: C&SD.

Chart B3.4
Official and chain-weighted GDP deflator



Note: 2004 figures are the averages of the first three quarters.
Sources: C&SD and staff estimates.

Apart from the difference in coverage, the discrepancy can also arise from the methods for calculating the indices, which give rise to biases in measuring price changes. This bias is referred to as the substitution bias, and results from shifts in consumption baskets as consumers substitute cheaper goods and services for relatively more expensive ones. An indication is that while the private consumption expenditure deflator has roughly the same coverage as the CCPI, its rate of change is lower than that of the CCPI for most of the last two decades (Chart B3.3).

The CCPI is a Laspeyres index aggregated from price indices of individual commodities and services using the weights fixed at the base year. A decline in the relative price of a commodity or service tends to stimulate demand for that commodity or service. The CCPI therefore may overstate the rate of increase in the aggregate price level by giving higher-than-actual weights to commodities and services with relatively high prices.

By contrast, the GDP deflator is a Paasche index compiled as an average of the sub-components of deflator using their current relative shares in GDP as weights. Thus, as consumers tend to shift their purchases of goods and services with relatively high prices to those with relatively low prices, the weights of lower priced goods and services increase over time. As a result, the GDP deflator may understate the rate of increase in prices.

The bias can be largely eliminated by adopting the chain-weighted index, in which the base year is changed on a rolling basis. A chain-weighed GDP price index was computed, for illustration purpose, to assess the potential significance of the downward bias in the GDP deflator. Comparison of the rates of changes in the official and estimated chain-weighted GDP deflators suggests that the effect of compositional shifts in the GDP deflator is immaterial in recent years, although they were more significant in the earlier periods (Chart B3.4).

In sum, while the CPI is widely used to measure inflation, the GDP deflator, which has a larger coverage, can be used as a supplement to gauge price developments in the overall economy. By both measures, inflationary pressures remain low.

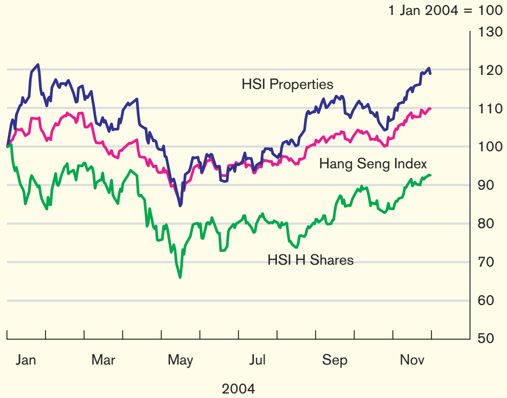
Asset markets

After declining in the second quarter, equity and property prices rebounded in the second half of 2004. Share prices in the property sector gained strongly. There are signs of a moderation in speculative activity in the property market.

2.9 Equity market

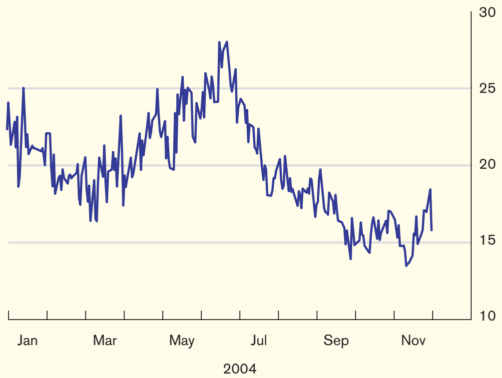
After a sharp decline in the second quarter, share prices in Hong Kong rebounded in the second half of 2004 (Chart 2.17). Equity prices for property developers in particular gained strongly on rising property prices. Share prices of Mainland-related companies (H shares) also rose sharply on reduced concerns about a sharp slowdown in the growth of the Mainland economy. Market participants suggested that capital inflows into Asia, including Hong Kong, since August have also contributed to the strong performance in the regional equity markets. By the end of November 2004, stock markets in all Asian economies except the Mainland, Taiwan, and Thailand had registered strong growth for the year. In line with other major equity markets, the implied volatility of the Hang Seng Index suggests that there was no apparent increase in short-term uncertainty in the equity market (Chart 2.18).

Chart 2.17
Hong Kong equity prices



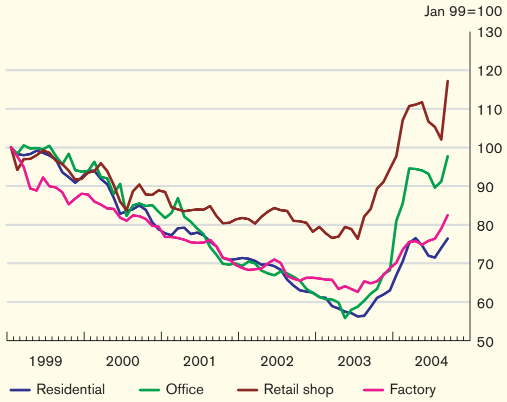
Source: CEIC.

Chart 2.18
Implied volatility of the Hang Seng Index



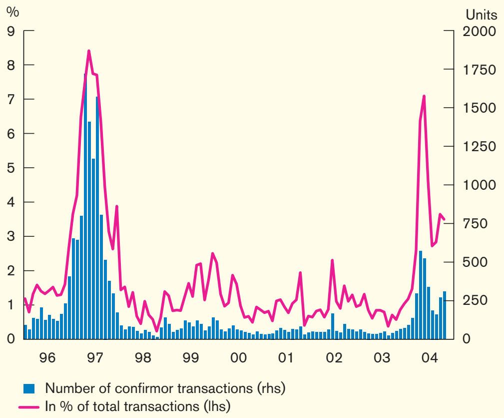
Source: Bloomberg.

Chart 2.19
Property prices by type



Source: Rating & Valuation Department.

Chart 2.20
Number of confirmor transactions



Note: Confirmor transactions are transactions in which a buyer resells the flat to a sub-purchaser before the legal completion of the original sale.

Sources: Land Registry and Centaline Property Agency Ltd.

2.10 Property market

The recovery in the property market has continued since the June *Report*. After a temporary pause in May-July, prices for most types of properties increased in August-September. The increase in commercial property prices was particularly pronounced, climbing by a cumulative 75% by September from their trough in May 2003 (Chart 2.19). Residential property prices increased by 36% in September from their trough in July 2003. The Centa-City Leading Index – a weekly residential price index constructed by a private real estate agent – continued to rise in October and November.

Market transactions have also picked up in recent months. The number of Sale and Purchase Agreements for residential properties increased between September and November, after falling from a five-year high in March. A notable development is a sharp decline in the number of confirmor transactions since the June *Report*. Their share in total transactions decreased from 7% in May to below 3% in July-August, before rising slightly to about 3.5% in September-October, with greater increase in the higher end of the market (Chart 2.20). This may point to a decline in speculative activity in the market.

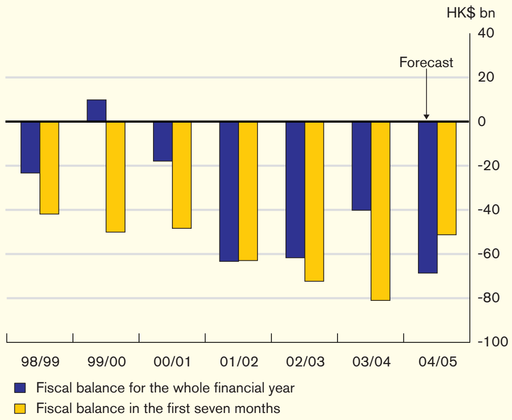
Public finances

The latest government consolidated account data suggest that the fiscal position has improved, helped by stronger revenue performance resulting from the economic recovery.

2.11 Public finances

The deficit in the first seven months of the current financial year amounted to HK$51 billion (after excluding proceeds from sales of government notes and bonds), well below the HK$72 billion average in the same period in the past three years (Chart 2.21). The improvement came largely from the revenue side. Stamp duties and land premia (including receipts from land sales and modification of existing leases) increased markedly. In particular, receipts from land auctions amounted to HK$18 billion during April-October, which exceeded the budget forecast of HK$12 billion for the whole financial year.

Chart 2.21
Fiscal performance in the first seven months of the financial year



Notes: 1. The 2000/01 balance excludes MTR privatisation proceeds; the 2004/05 balance excludes proceeds from the issuance of government notes and bonds
2. The 2004/05 whole year balance is the Budget forecast; the balance for the first seven months is actual outturn.

Sources: 2004/05 Budget Speech, the Treasury, and staff estimates.

3. Monetary and financial sector

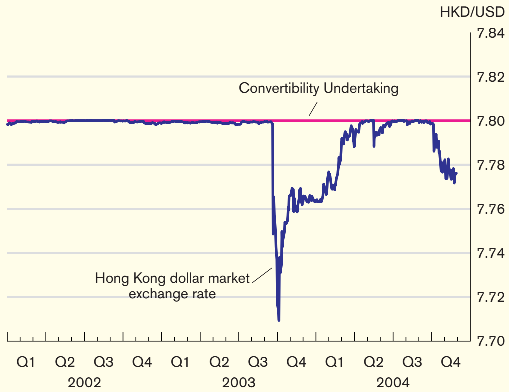
Exchange rate, interest rates and monetary developments

After remaining close to the linked rate of HK$7.8 to US$1 during the second and third quarters, the Hong Kong dollar exchange rate began to strengthen in October. The HKMA sold a total of HK$10.9 billion during October and November in response to bank bids. Despite a cumulative increase of 100 basis points in the US Federal funds target rate between 30 June and 10 November, Hong Kong dollar interbank interest rates remained low, because of the ample liquidity. Annual growth in both narrow and broad money has declined since the June Report.

3.1 Exchange rate and interest rates

The Hong Kong dollar exchange rate remained close to the linked rate of 7.8 during 2004 Q2 and Q3, but began to appreciate at the beginning of October, reaching a level of 7.7761 on 30 November (Chart 3.1). This period followed a significant appreciation of the Hong Kong dollar in late 2003 and early 2004, reflecting several factors, including the weakening sentiments towards the US dollar, international pressures on the Mainland to revalue the renminbi, and stronger growth in the Hong Kong economy.

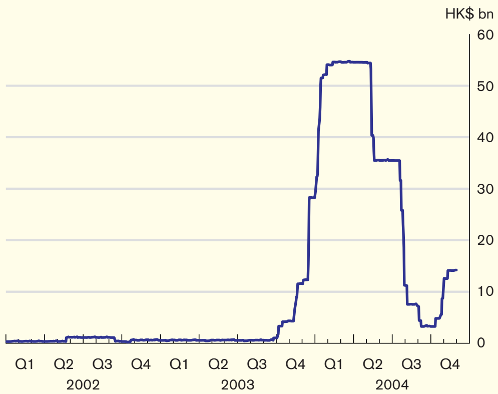
Chart 3.1
Hong Kong dollar exchange rate



Source: HKMA.

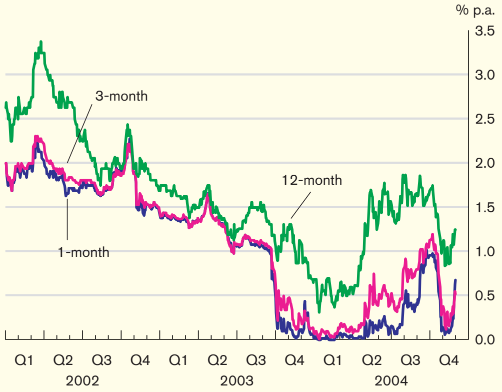
Since the June *Report*, the Convertibility Undertaking (CU) has been triggered 30 times between 16 July and 6 September, in response to an outflow of funds. During this period, the HKMA purchased HK$32.3 billion Hong Kong dollars under the CU. With the Hong Kong dollar strengthening since early October, the HKMA subsequently sold a total of HK$10.9 billion during the first two months of Q4, in response to bank bids. Under the Currency Board arrangements, these operations led to corresponding changes in the Aggregate Balance, which rose to HK$14.2 billion as of end-November, after reaching a recent low of HK$3.2 billion on 8 September (Chart 3.2).

Chart 3.2
Aggregate Balance (before Discount Window)



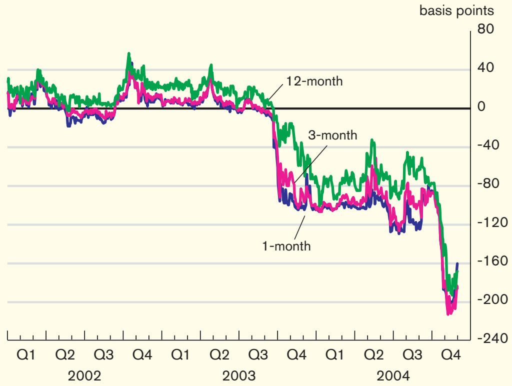
Source: HKMA.

Chart 3.3
Hong Kong dollar interbank interest rates



Source: HKMA.

Chart 3.4
Interest rate differentials between Hong Kong dollar and US dollar



Source: HKMA.

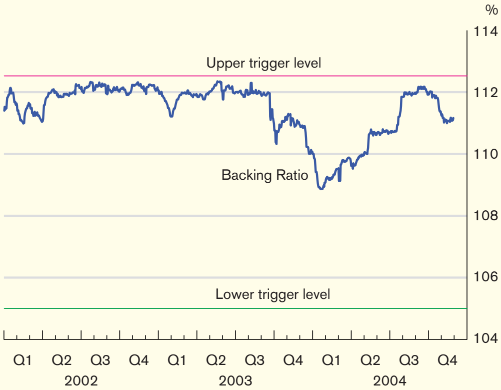
Chart 3.5
Hong Kong dollar forward points

Source: HKMA.

Following a cumulative increase of 100 basis points in the US Federal funds target rate between 30 June and 10 November, Hong Kong dollar interbank interest rates rose in Q2 and Q3, but eased in early Q4 on increased liquidity. Short-term interest rates fell to levels near zero in early November (Chart 3.3), before edging up slightly towards the end of November. The negative spreads against US dollar rates widened substantially (Chart 3.4). Nonetheless, the 12-month interbank interest rate at end-November remained higher than its trough in January 2004.

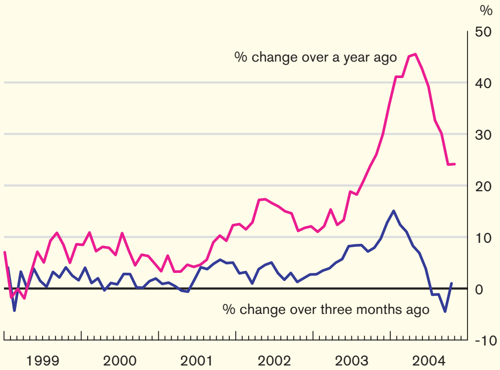
Reflecting the movements in interest rate spreads, the Hong Kong dollar 12-month forward discount was increased substantially since the June *Report*, closing at 1270 pips on 30 November (Chart 3.5), owing to the recent weakening of the US dollar and renewed speculation about the exchange rate policy of the Mainland authorities.

Chart 3.6
Backing Ratio



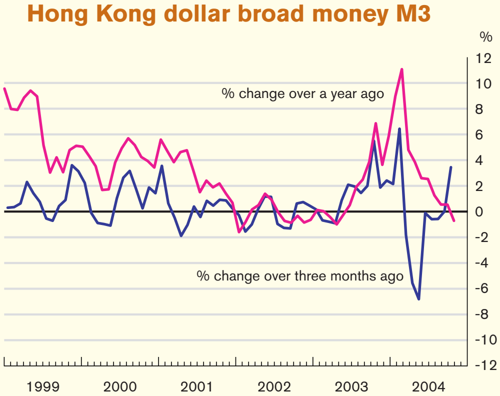
Note: See Half-yearly Monetary and Financial Stability Report June 2004, page 53, *HKMA Quarterly Bulletin*, June 2004, for the definition of the Backing Ratio.
Source: HKMA.

Chart 3.7
Hong Kong dollar narrow money M1



Note: Hong Kong dollar M1 is seasonally adjusted.
Source: HKMA.

Chart 3.8
Hong Kong dollar broad money M3



Source: HKMA.

3.2 Monetary Base and the Backing Ratio

The Backing Ratio climbed steadily in Q2 and Q3, reaching a high of 112.17% on 14 September (Chart 3.6). The increase was mainly attributable to a continuous reduction in the Monetary Base, particularly the decline in the Aggregate Balance arising from the triggering of the CU during this period. However, following the sale of Hong Kong dollars by the HKMA in October and November, the Aggregate Balance rose accordingly and the Backing Ratio returned to 111.15% on 30 November.

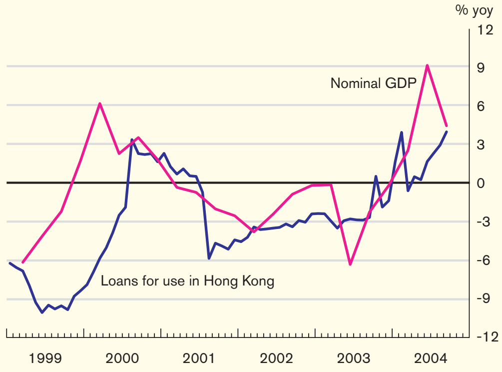
3.3 Money and credit aggregates

Despite the recovery in the domestic economy, the pace of expansion in both Hong Kong dollar narrow money (M1) and broad money (M3) moderated notably from early 2004 to September, but showed some signs of rebound in October.

The annual growth of M1 declined from a high of about 45.6% in April to 24.1% in September, but appeared to stabilise in October (Chart 3.7). This was attributable to a moderation in the relatively high rate of increase in demand deposits associated with lower equity market turnover, which, in part, probably arose from a reversal of fund flows out of Hong Kong. Despite the moderation, the rate of growth in M1 remained high by historical standards, reflecting a low opportunity cost of holding liquid assets (see Box 4 for a discussion of recent developments in the composition of deposits). However, reflecting renewed inflows of funds into the Hong Kong dollar, M1 rose slightly from three months ago in October.

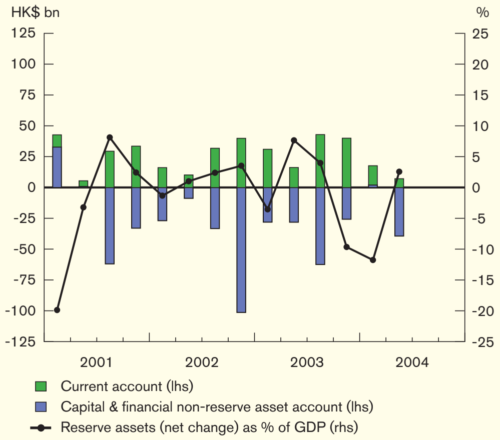
Annual M3 growth also slowed, from a high of 11.1% in early 2004 to –0.7% in October (Chart 3.8). While this was partly due to the slowdown in M1 growth discussed above, the impact of a transfer of funds raised in the equity market out of the Hong Kong dollar might also have played a role. The sharp increase in broad money during late 2003 and early 2004 was partly due to buoyant fund-raising activity in the equity market. Anecdotal reports suggest that the funds raised by the

Chart 3.9
Loans for use in Hong Kong and nominal GDP



Sources: HKMA and C&SD.

Chart 3.10
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 Q3	Q4	2004 Q1	Q2
Current Account	**7.9**	**10.7**	**13.7**	**12.2**	**5.2**	**2.3**
Capital and Financial Account	**-12.1**	**-12.4**	**-15.9**	**-17.5**	**-11.0**	**-10.1**
Capital transfers	-1.3	-0.6	-0.4	-0.6	0.1	0.0
Financial non-reserve assets (net change)	**-12.3**	**-11.1**	**-19.5**	**-7.2**	**0.6**	**-12.6**
Direct investment	-4.9	6.2	6.5	5.5	-34.3	8.8
Portfolio investment	-24.2	-19.4	-25.8	-23.1	-51.6	-34.4
Financial derivatives	4.1	6.5	12.1	2.3	4.0	3.6
Other investment	12.6	-4.5	-12.2	8.0	82.5	9.4
Reserve assets (net change)	**1.5**	**-0.6**	**4.0**	**-9.6**	**-11.7**	**2.6**
Net errors and omissions	**4.2**	**1.7**	**2.2**	**5.2**	**5.9**	**7.8**

Note: A negative sign in the net change in reserve assets represents an increase.

Source: C&SD.

newly listed companies (especially H-share companies)[19] started to flow out of the Hong Kong dollar from the latter part of Q1 onwards. Despite the moderation in M3 growth, ample liquidity remains in the banking system and the Hong Kong dollar loan-to-deposit ratio is still low (at 85.4% at end-Q3). Nonetheless, owing to the renewed inflow of funds, M3 rose in October compared with three months ago, although annual growth registered a decline.

Loans for use in Hong Kong registered a broad-based increase in Q3, supported by the revival in economic activity (Chart 3.9). In particular, the end of deflation has helped improve consumer and business sentiment (see Section 3.7).

3.4 Capital flows

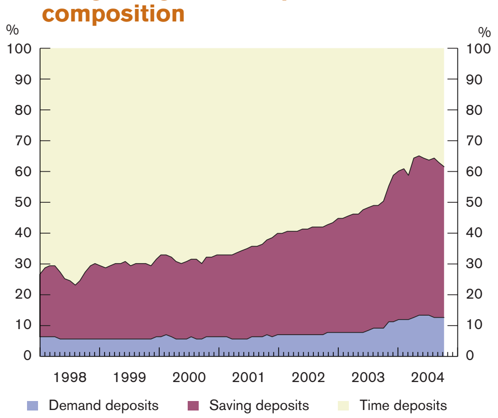
Following strong capital inflows into the Hong Kong dollar in 2003 Q4 and 2004 Q1, the fund flows reversed in 2004 Q2. The Balance of Payments (BoP) statistics show a decline in reserve assets in Q2, the most recent period for which complete BoP data are available (Chart 3.10 and Table 3.A). The reduction in reserve assets was related to sales of US dollars for Hong Kong dollars by the HKMA through the CU. This was in part attributable to interest rate arbitrage as investors took advantage of higher US dollar interest rates.

Among the BoP components, the current account remained in surplus in Q2, but the surplus was much smaller than in the previous quarters. This was partly due to seasonal factors, and partly attributable to the robust growth in imports arising from the increase in domestic demand.

19 For example, the retail tranche of the initial public offering of a company in late February 2004 was over-subscribed 720 times, involving an estimated amount of HK$139 billion. The amount was temporarily placed as deposits with banks in Hong Kong.

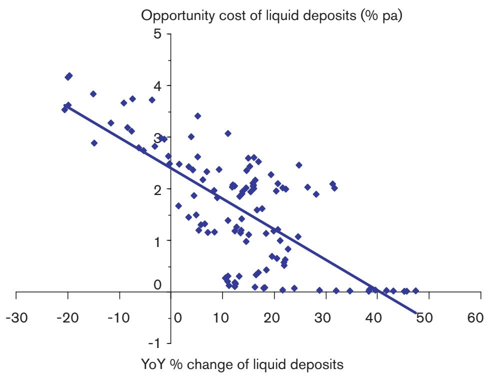
Box 4
The composition of Hong Kong dollar deposits

Chart B4.1
Hong Kong dollar deposit composition



Source: HKMA.

Chart B4.2
Liquid deposits and the opportunity cost (January 1995 — September 2004)



Source: HKMA.

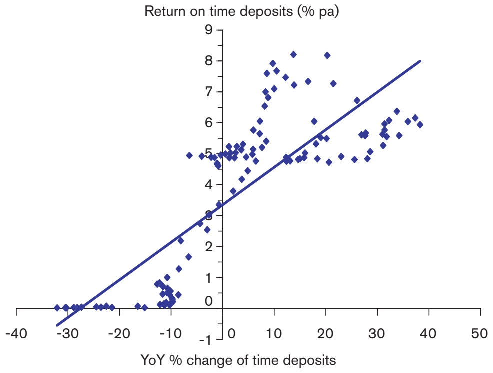
The composition of Hong Kong dollar deposits has changed considerably since early 2001. In particular, the share of liquid deposits (defined as demand and savings deposits) in total Hong Kong dollar deposits has risen from less than 35% in early 2001 to 61% at end-September 2004 (Chart B4.1). This box examines the factors behind the phenomenon, and explores whether this trend could be reversed if Hong Kong dollar interest rates were to rise along with US interest rates.

One incentive for depositors to place funds in time deposits is that their yields are higher than those for liquid deposits. Thus, low interest rates might be a factor behind the changing composition of deposits. Indeed, Hong Kong dollar deposit rates generally declined in the past several years due to a combination of external and domestic factors. The US Federal funds target rate has declined since early 2001, reached a record low of 1% in mid-2003, and remained at this level until end-June 2004. Sluggish loan growth in Hong Kong in recent years led to a continued reduction in the loan-to-deposit ratio. Given the ample supply of funds, banks have not competed actively for deposits, thus further depressing time deposit rates. In fact, despite a cumulative 100-basis-point increase in the US Federal funds target rate between June and November 2004, deposit rates in Hong Kong remain close to zero.

The low interest rate environment has affected the composition of deposits in two ways. First, demand for liquid deposits has been boosted by the low opportunity costs, as captured by the near zero time deposit rates. Chart B4.2 shows that growth of liquid deposits is negatively correlated with the opportunity cost.[20]

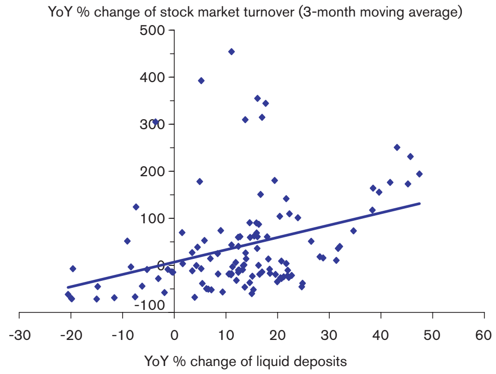
[20] The opportunity cost of liquid deposits was measured by the difference between the effective time deposit rate and the interest rate on liquid deposits. The effective time deposit rate refers to the weighted average of the interest rates on time deposits by maturity.

Chart B4.3
Time deposits and return on time deposits (January 1995 – September 2004)



Sources: HKMA and staff estimates.

Chart B4.4
Liquid deposits and stock market turnover (January 1995 – September 2004)



Sources: CEIC and HKMA.

Secondly, there has been a shift of funds out of time deposits given the low return of monetary assets. Chart B4.3 illustrates that growth of time deposits is strongly correlated with the interest paid. The effective time deposit rate fell markedly from around 5% at end-2000 to less than 1% in early 2002. It has decreased further to near zero in 2004. As a result, the yield spread against alternative assets, for example, 5-year US Treasury bills, widened substantially. This has provided incentives for depositors to shift to assets with higher return. This portfolio re-allocation is evidenced by increased retail interest in bonds and guaranteed funds. The Balance of Payments statistics also indicate increased net portfolio investment on non-resident assets in recent years, accounting for around 20-25% of GDP during 2001-2003.

In addition, the revival of economic activity and asset prices since the second half of 2003 has increased the transactions demand for money. In particular, demand for liquid money has risen together with equity market turnover (Chart B4.4).

In sum, the rise in the share of liquid deposits in total deposits stemmed from the low interest rate environment and increased transaction demand. Looking forward, Hong Kong dollar interest rates are expected to gradually rise along with US rates. Moreover, a stronger credit demand arising from economic recovery will also push up the loan-to-deposit ratio, and may contribute to higher Hong Kong dollar interest rates. Thus, the trend in the composition of deposits in recent years may be reversed, at least partially, in the coming quarters, with the share of liquid deposits declining.

The (non-reserve) capital and financial account recorded net outflows in Q2, resulting mostly from portfolio investment flows. Part of the portfolio outflows were 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.[21] This reflects investors' optimism about the prospects of these Mainland companies, and is evidence of a further portfolio re-allocation induced by the low deposit rates in Hong Kong.

The "Other Investment" account, which includes mainly offshore loans and deposits of the bank and non-bank sectors, recorded a small net inflow in Q2, as a marked expansion in liabilities exceeded a large increase in external claims. The large gross flows reflect the role of Hong Kong as an international banking centre.

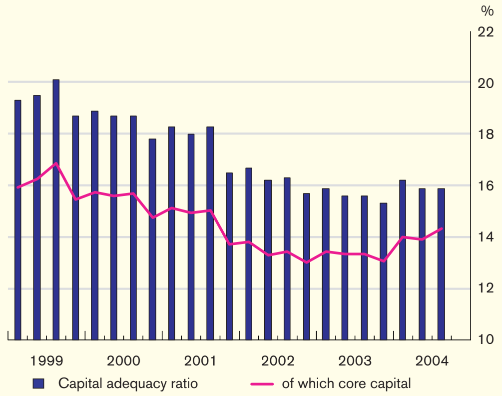
The information available so far indicates a further decline in reserve assets in Q3, as interest rate arbitrage continued, with the CU being triggered on a number of occasions. Nonetheless, there was a renewed inflow of funds at the beginning of 2004 Q4, and reserve assets were on the rise again in October.

[21] 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 an H-share company is listed on the HKEx, it is classified as a non-resident company since its business activity is not in Hong Kong.

Banking sector performance

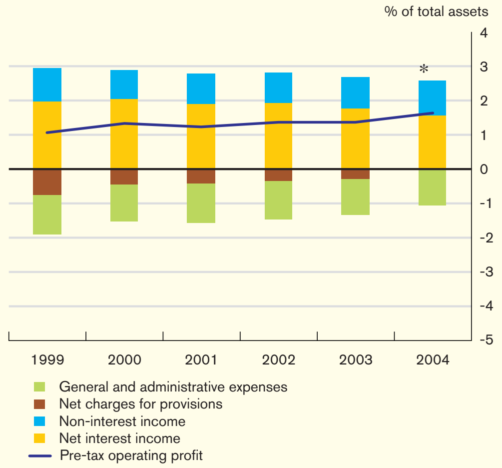
The operating environment of the banking sector continued to improve along with favourable conditions in the domestic economy and the property market. The profitability of retail banks increased further, reflecting higher asset quality and a rise in non-interest income. Despite a revival in loan growth, the net interest margin continued to decline, reflecting a low loan-to-deposit ratio.

Chart 3.11
Capitalisation of locally-incorporated AIs



Source: HKMA.

Chart 3.12
Profitability of retail banks



Note: *2004 figures are only up to the first half of the year.
Source: HKMA.

3.5 Profitability and capitalisation

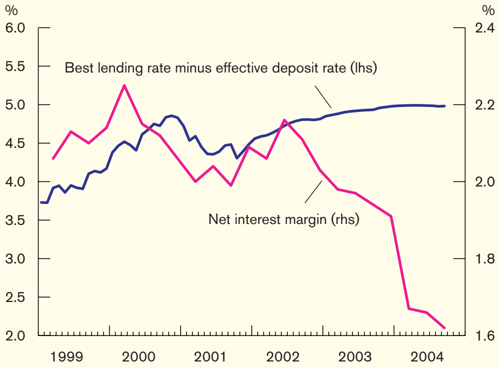
The latest data show that locally-incorporated Authorized Institutions (AIs) are well capitalised, with an average consolidated capital adequacy ratio of 15.9% at end-September, well above the minimum international standard of 8% (Chart 3.11). Core capital constituted about 90% of the capital base. The ratio of core capital to risk-weighted assets was high, at 14.3%.

Retail bank profitability, as measured by pre-tax returns as a percentage of total assets, continued to increase from the June *Report* (Chart 3.12). The rise was largely attributable to an improvement in asset quality, which led to a sharp reduction in bad debt charges or write-back of provisions, and to a lesser extent, an increase in non-interest income. However, net interest margin continued to contract, mainly due to intense competition in the mortgage market and a lower yield on free funds.

Non-interest income continued to increase, reflecting banks' endeavours to diversify their revenue base. The rise in non-interest income was mainly due to increases in fees and commissions on wealth management and trade financing. This helped offset the decline in interest income, providing some support to banks' profits.

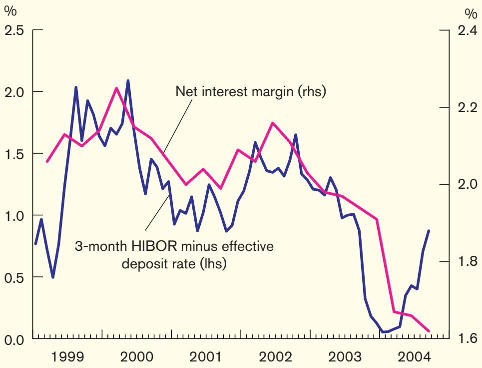
The outlook for banking sector profitability depends on the sustainability of the recovery in the domestic economy and in the property market, and the outlook for US interest rates. In particular, the pick-up in credit demand, if it continues, should support banks' profitability. Stock prices of listed banks were higher than the recent trough in 2003 Q2, reflecting market expectations of increases in bank profits.

Chart 3.13
Intermediation spreads



Source: Staff estimates.

Chart 3.14
Spreads between HIBOR and deposit rate



Source: HKMA.

Table 3.B
Loans for use in Hong Kong

	Quarter-on-quarter change (%)				Share of total (%)
	Dec-03	Mar-04	Jun-04	Sep-04	Sep-04
Loans for use in Hong Kong[1]	**0.9**	**0.3**	**1.9**	**0.8**	
Of which:					
Trade financing	3.0	6.4	14.7	5.5	6.9
Mortgages[2]	-0.3	0.1	-0.7	-0.5	32.7
Manufacturing	3.1	5.4	8.7	4.9	5.0
Transport and transport equipment	3.8	-3.3	6.0	6.8	6.5
Electricity, gas and telecommunications[3]	9.9	n.a.	n.a.	n.a.	n.a.
Electricity and gas[3]	n.a.	n.a.	15.7	-8.1	1.3
Information technology[3]	n.a.	n.a.	-10.4	1.7	0.9
Building, construction, property development and investment	-1.1	-1.5	1.5	-0.3	19.3
Wholesale and retail trade	-3.1	2.5	0.2	5.8	5.3
Financial concerns[4]	5.8	4.3	2.1	0.6	8.4
Stockbrokers	12.3	6.0	-5.9	-8.8	0.5
Credit card advances	4.7	-4.8	0.1	0.5	2.5

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.

3.6 Interest rate risk

A large part of banks' interest-bearing assets are priced on a floating rate basis, limiting banking sector exposure to interest rate changes. However, a basis risk arises 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 relatively rapid decline in funding costs (Chart 3.13). However, interest rates for new mortgages have dropped further below the BLR, because of competition in the residential mortgage market.

Banks are also affected by movements in interbank interest rates. Changes in interbank rates impact on interest income directly through HIBOR-based lending, including interbank lending. With a large deposit base, most retail banks are net lenders in the interbank market. The rise in three-month HIBOR relative to the effective deposit rate this year has probably cushioned the decline in the net interest margin owing to the influence of other factors (Chart 3.14).

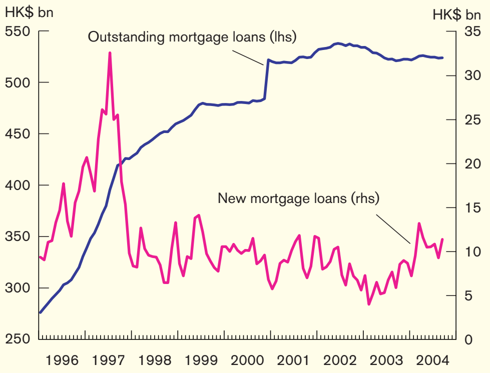
In search of higher returns, banks have increasingly invested in debt securities. While this provides some support to interest income, banks may have become more exposed to volatility in bond markets.

3.7 Credit risk

Credit exposures

Analysed by economic uses, credit grew in most sectors quarter on quarter in Q3 (Table 3.B). Loans to the transport sector and to wholesale and retail trade, and trade financing registered notable increases during the quarter. The exception was in property-related loans, which declined. Reflecting relatively strong growth in non-property-related lending, the share of property-related loans in total domestic credit, although remaining high, declined slightly to 52.0%.

Chart 3.15
Outstanding and new mortgage loans of surveyed AIs



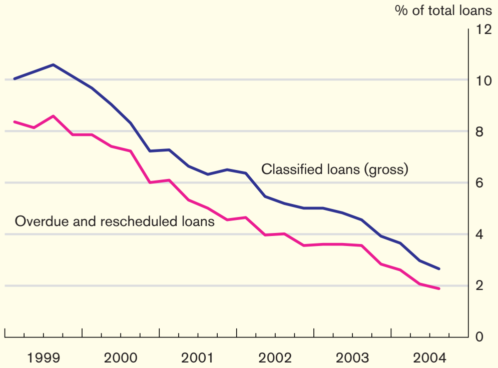
Note: The marked jump in the outstanding mortgage loans in late-2000 reflected a change in the coverage of banks in the survey.
Source: Monthly Survey of Residential Mortgage Lending.

Caution is required in interpreting the decline in residential mortgage loans. While growth in outstanding mortgage loans remained sluggish, new mortgage lending increased notably owing to the pick-up in property market activity. This is because repayments on existing mortgage loans largely offset the expansion in new mortgage lending. The amount of new mortgage loans increased, although it remained substantially lower than the level in 1996-98 as a result of lower property values (Chart 3.15).

Asset quality

Asset quality continued to improve with the recovery in the economy, and rises in property prices. The proportion of classified loans and that of overdue and rescheduled loans in total loans decreased further in Q3 (Chart 3.16).

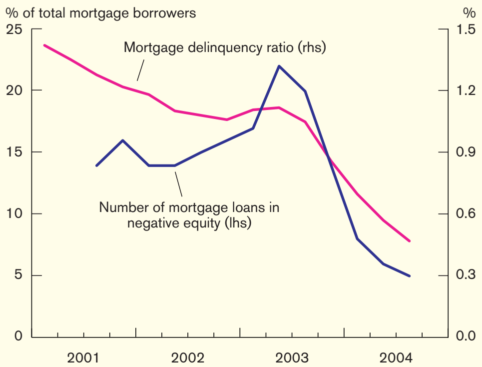
Chart 3.16
Asset quality measures of retail banks



Source: HKMA.

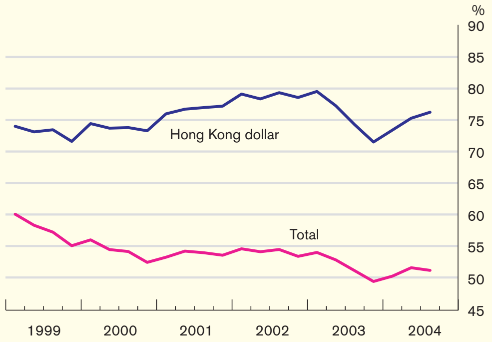
The increase in property prices improved household sector balance sheets: this tended to lower the credit risk associated with household sector borrowing. The number of residential mortgage loans in negative equity fell to a quarter of the peak level registered in 2003 Q2. Bankruptcies declined markedly as well, and the mortgage delinquency ratio fell to 0.47% in September 2004 (Chart 3.17). Separately, the charge-off ratio for credit card receivables decreased further, to an annualised rate of 4.51% in Q3.

Chart 3.17
Negative equity and mortgage delinquency ratio of surveyed AIs



Note: The data of mortgage loans in negative equity are available from September 2001.
Source: HKMA.

Chart 3.18
Loan-to-deposit ratios of retail banks



Source: HKMA.

3.8 Liquidity

The average liquidity ratio of retail banks stood at 43.7% in Q3, exceeding the minimum requirement of 25%. Net placements to banks abroad and debt securities holdings, which are relatively liquid, accounted for 14% and 25% of retail banks' total assets respectively. The abundance of liquidity was also reflected in the low Hong Kong dollar loan-to-deposit ratio of 76% at the end of September for retail banks (Chart 3.18).

3.9 Foreign currency position

The overall foreign currency position, including both spot and forward, for all AIs dropped to HK$54 billion at end-September, compared to a recent high of HK$98 billion at end-May 2003.

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

TABLE 3.C
Key performance indicators of the banking sector[1] (%)

	Sep-03	Jun-04	Sep-04
Interest rate[2]			
1-month HIBOR	0.99	0.10	0.42
3-month HIBOR	1.03	0.30	0.69
BLR and 1-month HIBOR spread	4.01	4.90	4.59
BLR and 3-month HIBOR spread	3.97	4.70	4.32
		Retail banks	
Balance sheet developments[3]			
Total deposits	1.8	0.0	1.9
Hong Kong Dollar	2.1	-0.3	0.1
Foreign currency	1.2	0.5	4.7
Total loans	-1.5	2.7	1.1
Loans to customers inside Hong Kong[4]	-1.7	2.4	1.3
Loans to customers outside Hong Kong[5]	5.7	10.7	-3.5
Negotiable instruments			
Negotiable debt certificates issued	2.3	1.9	7.1
Negotiable debt instruments held	0.2	-0.5	6.2
Asset quality[6]			
As % of total loans			
Pass loans	88.39	91.41	92.35
Special mention loans	7.01	5.59	4.98
Classified loans (gross)[7]	4.59	3.00[r]	2.67
Classified loans (net)[8]	3.17	2.16	1.95
Overdue > 3 months and rescheduled loans	3.58	2.09	1.90
Non-performing loans[9]	3.61	2.28	2.02
Profitability[10]			
Bad debt charge as % of average total assets	0.33	-0.02	-0.02
Net interest margin	1.94	1.66	1.65
Cost income ratio	37.6	40.0	41.6
Liquidity ratio[11]	46.2	43.2	43.7
		Surveyed institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	1.05	0.57	0.47
Credit card receivables			
Delinquency ratio	1.23	0.64	0.55
Charge-off ratio — quarterly annualised	9.85	5.37	4.51
— year-to-date annualised	10.98	5.79	5.31
		All locally incorporated AIs	
Capital adequacy ratio (consolidated)	15.6	15.9	15.9

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.

r Revised figures due to late adjustments.

4. Outlook, risks and uncertainties

The pace of global growth is expected to moderate over the coming quarters, but to remain solid by historical standards. Global consumer price inflation has turned out higher than expected this year, mainly because of higher oil prices, but is anticipated to moderate in 2005. Against this background, growth in Hong Kong is expected to slow in 2005 from a high rate in 2004. There are a number of uncertainties and risks to the outlook, relating to sentiment towards the US dollar, the volatility of oil prices, and macroeconomic and financial conditions in Mainland China.

4.1 Global outlook

Global growth has been stronger than had been expected six months ago, despite some slowdown in Q2. Forecasts for 2004 have been revised upwards (Table 4.A). However, the pace of growth is expected to slow in 2005, with further monetary policy tightening, led by the US. The IMF September World Economic Outlook projects a decline in global growth to 4.3% in 2005, from 5.0% in 2004.

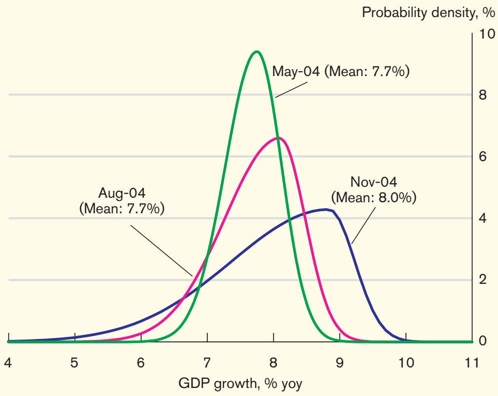
Table 4.A
Forecasts for global growth and inflation

(% yoy)	IMF		World Bank	
	2004	2005	2004	2005
Global growth[1]	**5.0 (4.6)**	**4.3 (4.4)**	**4.9 (3.9)**	**4.2 (3.8)**
US	4.3	3.5	4.3	3.2
Euro area	2.2	2.2	1.8	2.1
Japan	4.4	2.3	4.3	1.8
Emerging Asia	7.3	6.5	n.a.	n.a.
Global consumer price inflation	**3.8**	**3.6**	n.a.	n.a.
G-7 economies	2.1	2.1	1.7	1.4
Emerging Asia	4.3	3.9	n.a.	n.a.

Note 1: Weighted by GDP at PPP exchange rates. For other aggregates, the IMF weights by GDP at PPP exchange rates, while the World Bank uses market exchange rates. Figures in brackets are previous forecasts.

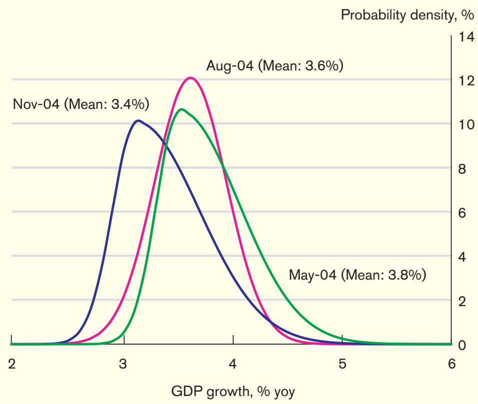
Sources: IMF World Economic Outlook September 2004 and World Bank Global Economic Prospects 2005.

Chart 4.1
Mainland China: probability distribution of growth forecasts for 2005



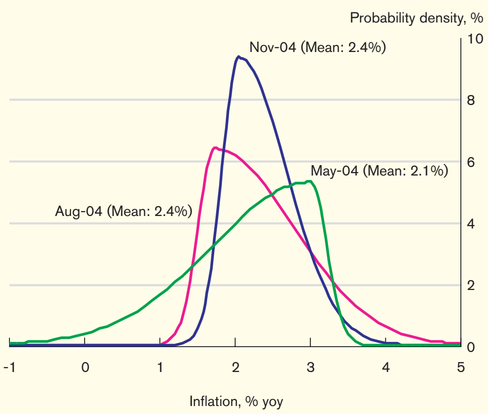
Source: Staff calculations based on Consensus Forecasts.

Chart 4.2
US: probability distribution of growth forecasts for 2005



Source: Staff calculations based on Consensus Forecasts.

Chart 4.3
US: probability distribution of inflation forecasts for 2005



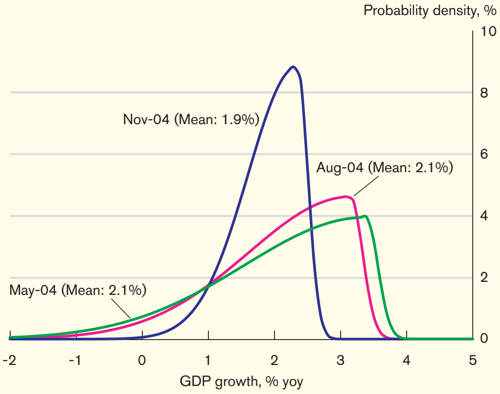
Source: Staff calculations based on Consensus Forecasts.

In the industrialised economies, growth is expected to slow, led by the US and Japan. In the euro area, where the recovery has lagged behind that in the other major economies, it is projected to remain broadly at its current pace in 2005, higher than in recent years. In emerging Asian economies, some slowdown in growth is expected from the high rates this year. In particular, growth in Mainland China is forecast to decline to around 8% in 2005, from 9.2% in 2004, reflecting expectations that policy measures will successfully achieve a measured slowdown (Chart 4.1). According to the latest Consensus Forecasts, the risks to both growth and inflation in the US have become more skewed to the downside since May of this year, while growth expectations for the euro area have become more balanced (Charts 4.2–4.4).

The main drivers of growth in 2005 are expected to be broadly similar to those in 2004. However, further monetary tightening, as real interest rates return to more neutral levels, and slower growth in asset prices are likely to remove some of the momentum. In particular, slower growth – and perhaps falls – in housing prices in a number of industrialised economies, including the US, UK and Australia, is expected to lead to more moderate growth in consumer borrowing and spending. Nevertheless, solid output and profit growth generally, and a continued expansion in employment, should support final domestic demand, which is projected to remain strong, especially in the US. For East Asian economies, exports are expected to remain a key growth driver, but there is scope for the contribution of private domestic demand to increase, particularly as unemployment rates continue to decline.

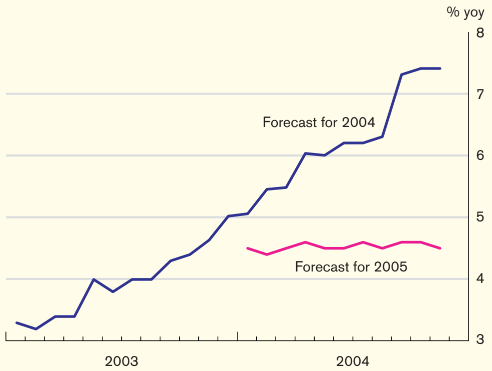
Global consumer price inflation is expected to moderate in 2005, as growth slows and commodity prices fall. The IMF September World Economic Outlook projects a decline to 3.6% in 2005, from 3.8% this year. Among the major economies, inflation is expected to stabilise in the US and in Mainland China, while deflation in Japan is projected to come to an end during 2005.

Chart 4.4
Euro area: probability distribution of growth forecasts for 2005



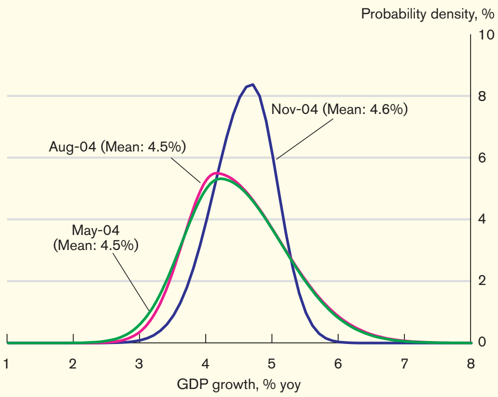
Source: Staff calculations based on Consensus Forecasts.

Chart 4.5
Consensus Forecasts for economic growth



Source: Consensus Forecasts.

Chart 4.6
Probability distribution of growth forecasts for 2005



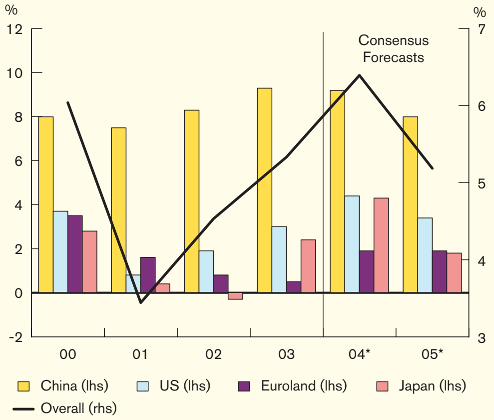
Source: Staff calculations based on Consensus Forecasts.

Financial markets expect global short-term interest rates to continue to increase during 2005, led by the US. At the end of November, the Federal funds futures market was pricing in an increase in the Federal funds target rate to 2.5% by June 2005. The Mainland authorities may raise benchmark interest rates, should demand and inflationary pressures continue. Long-term interest rates in the US and the euro area have fallen, reflecting a benign inflation outlook. In the currency markets, there is a growing consensus that the US dollar will depreciate further as part of the adjustment towards a smaller, more sustainable current account deficit. The implied volatilities of Hong Kong and other major equity markets declined to low levels, suggesting that share prices over the past six months may have been influenced more by expectations of earnings growth, oil prices and the real interest rate outlook than market dynamics.

4.2 Domestic outlook

The outlook for the Hong Kong economy remains positive, but the rate of growth is expected to moderate in 2005 against a backdrop of slower global growth (Charts 4.5 and 4.6). The Purchasing Managers' Index has declined since July but remains above its neutral level of 50, signalling continued expansion, though at a slower pace. In particular, the volume of new orders rose for the seventeenth successive month in October, although the rate of increase has slowed.

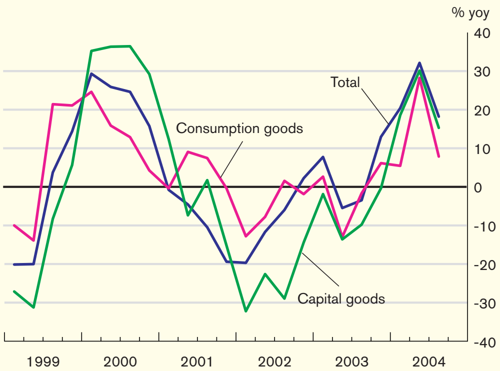
Chart 4.7
GDP growth of Hong Kong's major trading partners



Note: *refers to Consensus Forecasts in November 2004.

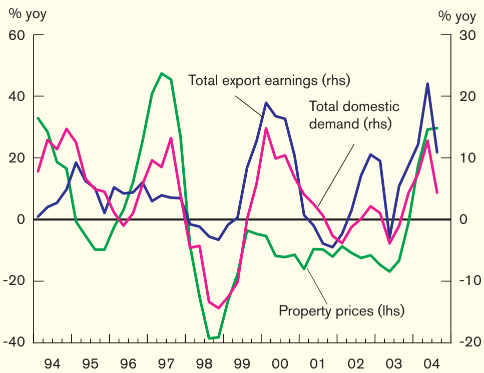
Sources: Consensus Forecasts, CEIC, Bureau of Economic Analysis, European Central Bank, Japan' s Cabinet Office and staff estimates.

Chart 4.8
Retained imports



Source: C&SD.

Chart 4.9
Domestic demand, export earnings, and property prices



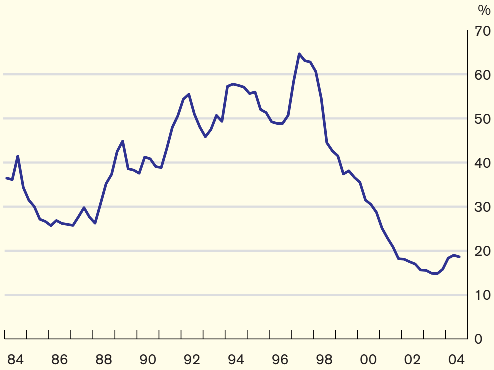
Sources: C&SD and staff estimates.

Growth in Hong Kong's exports of goods and services is expected to decline in 2005, owing to slower growth in trade-weighted external demand to around 5% in 2005 from 6.4% in 2004, according to the latest Consensus Forecasts (Chart 4.7). The implementation of CEPA starting from January 2004 and a broadening of the Individual Visit Scheme may counter some of the impact from weaker external demand.

Domestic demand growth is expected to moderate, in part reflecting a slower increase in export earnings. Indeed, growth in retained imports of consumer goods moderated on a year-on-year basis in Q3, pointing to slower growth in private consumption (Chart 4.8). Retained imports of capital goods also increased at a slower rate, perhaps suggesting weaker investment growth ahead.

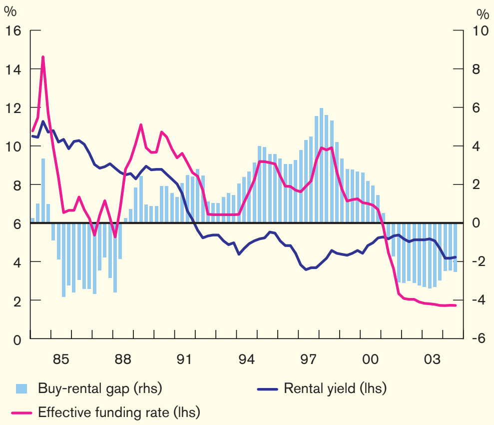
While growth of domestic demand tends to follow that of export earnings, experience suggests that the two can deviate as a result of asset price movements (Chart 4.9). Thus, developments in the property market may provide support to domestic demand in the face of slower external demand growth. Recent strong land sales may reflect expectations of a sustained property market recovery, although it is uncertain how quickly this will translate into higher spending on building and construction. Further appreciation in housing prices may stimulate consumption and investment through wealth and balance sheet effects.

Chart 4.10
Income-gearing ratio



Source: Staff estimates.

Chart 4.11
Buy-rental gap



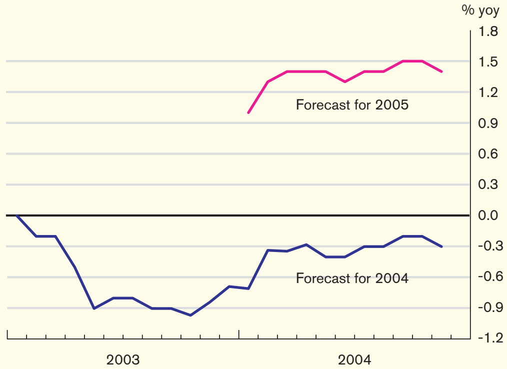
Source: Staff estimates.

However, the outlook for the property sector is difficult to assess, as asset prices are forward-looking in nature and reflect market expectations about future macroeconomic and financial developments. The previous *Report* discussed a number of indicators to gauge the fundamental values of residential properties. The income-gearing ratio and the buy-rental gap suggest that recent increases in property prices are supported by fundamentals (Charts 4.10 and 4.11).[22] In particular, housing affordability remains at a historically high level, as indicated by a low income-gearing ratio. Furthermore, the buy-rental gap suggests that the funding cost of home purchase remains lower than the rental yield.

While employment should continue to expand, a cautious attitude towards hiring in the light of uncertain external developments and expectations of a slowdown in growth might imply a more modest reduction in the unemployment rate.

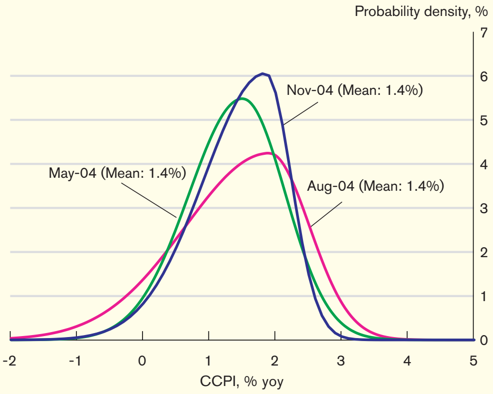
[22] See the previous *Report* and Peng, W. and K. Fan (2004), "Real Estate Indicators in Hong Kong", *HKMA Quarterly Bulletin*, March 2004.

Chart 4.12
Consensus Forecasts for inflation



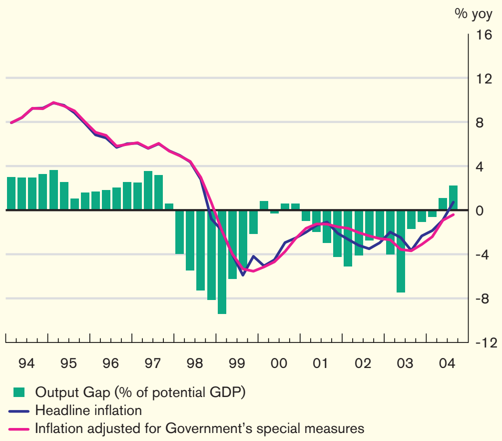
Source: Consensus Forecasts.

Chart 4.13
Probability distribution of inflation forecasts for 2005



Source: Staff calculations based on Consensus Forecasts.

Chart 4.14
Output gap and inflation



Note: Output gap is measured as the difference between the actual and potential GDP.

Sources: C&SD and staff estimates.

Consumer prices are expected to rise moderately in 2005, following a small decline in 2004 (Charts 4.12 and 4.13). Research by the HKMA suggests that the output gap, measured as the difference between the actual and potential output, turned positive in 2004 Q2 (Chart 4.14).[23] Since growth is expected to be above potential over the coming quarters, the output gap is likely to widen. Together with rising import prices and robust consumer demand, this will exert upward pressures on consumer prices. In addition, the rental component of the Composite CPI is likely to pick up gradually in 2005, in part reflecting the lagged effect of rising market rentals since 2003 Q3. According to the PMI survey, total input costs – including both staff and purchasing costs – continue to rise. Higher input costs may be passed on to consumer prices in the coming periods. However, with the unemployment rate still at a relatively high level, any wage pressures are likely to be modest. Moreover, other factors are likely to act to contain inflationary pressures, including weaker global growth, and a gradual deceleration of growth and inflation on the Mainland.

4.3 Uncertainties and risks

There are a number of uncertainties and risks to the outlook, arising from both external and domestic developments. The main external factors include prospects for the US dollar and US interest rates, volatility in oil prices, and macroeconomic and financial conditions on the Mainland. Domestically, there are concerns that inflation may rise faster than currently expected and, in particular, that loose monetary conditions, if sustained, may further boost property prices, which have recovered strongly since mid-2003.

23 In Hong Kong, studies using different approaches have estimated the potential output growth to be 3%-4% in recent years. See Gerlach, S. and M. Yiu (2002), "Unobservable-Component Estimates of Output Gaps in Five Asian Economies", *HKIMR Working Paper*, and Ha, J. and C. Leung (2001), "Estimating Hong Kong's Output Gap and Its Impact on Inflation", *HKMA Research Memorandum*, November 2001.

The US dollar has been influenced by two potentially offsetting forces: concerns about the sustainability of the current account deficit, and growth and interest rate differentials between the US and the euro area and Japan, the latter has supported the US currency. Recent developments suggest a renewed focus in the foreign exchange market on the US current account and fiscal deficits. With US merchandise imports being almost twice as large as exports, the adjustment required in the US dollar to achieve a meaningful reduction in the current account deficit could potentially be large. The impact on Hong Kong of a depreciation of the US dollar would depend in part on the nature of adjustment. An orderly decline in the value of the US dollar would help Hong Kong's external competitiveness through the Linked Exchange Rate system. As the RMB is implicitly tied to the US dollar, Hong Kong would also benefit from any increase in re-exports and offshore trade originating in the Mainland. While US interest rates may rise, to the extent that a weaker US dollar against Asian currencies leads to inflows of funds into Hong Kong, Hong Kong dollar interest rates may remain below US rates.

However, a disorderly adjustment could lead to slower growth in the global economy, which in turn would affect Hong Kong. A sharp dollar depreciation could also be associated with increased volatility in global financial markets, and a reduced demand for US dollar-denominated financial instruments. Moreover, any resulting increase in US inflation could lead the Federal Reserve to raise interest rates faster and by a greater magnitude than currently expected.

A related concern is the high level of oil prices, which tend to increase the US current account deficit and hence put pressure on the US dollar. The combination of historically low oil inventories, continued geo-political risks, and evidence of speculative activities in the oil market, has made prices sensitive to news about demand and supply. As a result, oil prices are likely to remain volatile and may well remain high for some considerable time, given expected strong demand in the near term. Estimates suggest that a sustained $5 rise in oil prices would reduce GDP growth in Hong Kong by 1/4 percentage point in the following year, somewhat less than the IMF estimate of the impact on the other Asian economies. This reflects a low share of manufacturing in the economy. Furthermore, the impact of slower global growth could be partly offset by a lower effective exchange rate of the Hong Kong dollar, to the extent that higher oil prices are associated with a weaker US dollar.

Another source of uncertainty arises from developments in the Mainland economy. In the near term, the main concern is likely to continue to be demand and inflationary pressures. Monetary and financial conditions remain relatively loose, as evidenced by low and (by some measures) negative real interest rates and a depreciation of the RMB in effective terms alongside a weaker US dollar. Despite the moderation in headline CPI inflation in October, strong rises in producer prices and continued bottlenecks in the energy and transportation sectors suggest upward pressures on consumer prices in the period ahead. While the risk of a sharp slowdown in growth has receded significantly since 2004 Q2, recent developments point to challenges to the management of macroeconomic and financial policy.

Two difficulties are notable. The first is related to the lack of a well-defined monetary transmission mechanism, as a weak banking sector and still under-developed capital markets reduce the efficiency of financial intermediation, and structural changes and ongoing economic reforms render traditional monetary relationships unstable. In particular, increased financial disintermediation may have reduced the usefulness of broad money and credit aggregates as intermediate targets for monetary policy. As a result, it is difficult to assess macroeconomic and financial conditions and the effectiveness of measures to tighten the stance of policy. It is therefore natural for the authorities to be cautious in managing the pace of macroeconomic adjustment.

The second difficulty is posed by strong capital inflows, which have resulted in sharp increases in foreign reserves and have led the PBoC to sterilise the impact on domestic monetary conditions. Some of the inflows are of a short-term nature, in light of widespread speculation that the RMB may appreciate. There are also signs of an increase in short-term foreign indebtedness that finances domestic investment but does not involve a switch into RMB funds. In addition to the difficulty posed for monetary policy, the build-up of short-term foreign liabilities risks increasing the vulnerability of the financial sector to an abrupt reversal of capital flows. Looking forward, while strong growth and rising property prices on the Mainland would continue to attract inflows in the near term, further increases in US interest rates may help to reduce these pressures. Nevertheless, a major uncertainty is related to the possibility of a further decline in the exchange value of the US dollar, which would increase the upward pressure on the RMB.

Overall, compared with the brisk pace in 2004 Q1, the macroeconomic control measures introduced by the authorities have helped to achieve a measured slowdown in economic growth. A more balanced and sustainable growth path would benefit Hong Kong, given increasing integration between the two economies. Thus, the impact of any slowdown in growth of the Mainland economy on Hong Kong is expected to be limited, at least in the next six months, in part because the moderation is likely to be concentrated in domestic demand on the Mainland.

In Hong Kong, a notable concern relates to easy monetary conditions and their potential impact on domestic inflation and property prices. Expected short-term real interest rates have probably already become negative, considering expectations of a moderate increase in consumer prices over the next year. A further monetary tightening in the US should facilitate interest rate arbitrage, which has been limited by low US rates and a zero bound in Hong Kong dollar interest rates. However, the size of inflows could potentially be large, depending upon the pressures on the US dollar and the RMB. The situation is complicated by substantial net foreign assets accumulated by the private sector, part of which reflects increased savings and limited investment opportunities in Hong Kong during the economic downturn. Improving sentiment regarding the Hong Kong dollar has already led to substantial inflows, and this process may well continue. Thus, it is possible that negative interest rate spreads against the US dollar will persist for some time.

Easy monetary conditions, if sustained, would underpin domestic demand in the face of the expected slowdown in global growth, in part by supporting asset prices. Considering the weakness of the US dollar and possibly continued inflationary pressures on the Mainland in this scenario, it is possible that inflation will be higher than indicated by the Consensus Forecasts. However, the risk of a sharp acceleration in inflation remains small, considering the still high rate of unemployment.

The banking sector is likely to continue to benefit from the ongoing economic recovery, moderate inflation, and the relatively low interest rate environment. Banks' asset quality is likely to improve further, supported by robust income growth and low real interest rates, which reduce borrowers' debt service burden and hence the risk of loan defaults. Credit demand is set to be supported by an increase in domestic investment and property market developments. While higher credit demand would increase banks' net interest earnings, the spread between lending and deposit rates may be depressed by ample liquidity in the banking system. As mortgage loans have been growing more slowly than the rest of domestic credit, which is still at an early stage of recovery, the risk of over-exposure to the property market remains small. Furthermore, despite the sharp rebound, property prices do not appear to be misaligned with economic fundamentals, as housing affordability remains high by historical standards. Nevertheless, movements in property prices tend to be volatile, and experience suggests that property prices and bank credit tend to move together. Thus, the risk of another property cycle raising volatility in the profitability and asset quality of the banking sector should not be ignored.

In summary, economic and financial conditions in Hong Kong and the Asia region remain generally favourable. While the expected slowdown in global growth would affect external demand for Hong Kong-produced goods and services, domestic demand is likely to be supported by generally easy monetary conditions, reflecting a weak US dollar and upward pressures on the RMB exchange rate. The probability of a sharp slowdown in growth on the Mainland is small. While the global economy may be affected by a depreciation of the US dollar, the Linked Exchange Rate system would provide a buffer for Hong Kong, since it implies a weakening of the Hong Kong dollar against other currencies and hence improved competitiveness. Overall, at the current juncture, the risks to Hong Kong's monetary and financial stability seem to be limited.

Abbreviations

3m-on-3m	Three-month-on-three-month
ASEAN	Association of Southeast Asian Nations
AIs	Authorized Institutions
BLR	Best Lending Rate
BoP	Balance of Payments
CEPA	Closer Economic Partnership Arrangement
C&SD	Census and Statistics Department
CPI	Consumer Price Index
CU	Convertibility Undertaking
FOMC	US Federal Open Market Committee
GDP	Gross Domestic Product
HIBOR	Hong Kong Interbank Offered Rate
HKD	Hong Kong Dollar
HKEX	Hong Kong Exchanges and Clearing Limited
HKMA	Hong Kong Monetary Authority
HSI	Hang Seng Index
IFO	Institute for Economic Research
IMF	International Monetary Fund
IPOs	Initial Public Offerings
IT	Information Technology
mom	Month-on-month
NDFs	Non-deliverable Forwards
NIE	Newly Industrialised Economies
PBoC	People's Bank of China
PCE	Personal Consumption Expenditure
PMI	Purchasing Managers' index
PPP	Purchasing Power Parity
qoq	Quarter-on-quarter
REER	Real Effective Exchange Rate
RMB	Renminbi
sa	Seasonally adjusted
SARS	Severe Acute Respiratory Syndrome
USD	US Dollar
VAT	Value Added Tax
yoy	Year-on-year