Domestic and external environment

by the Research Department

Global economic conditions remained robust in the second quarter. Growth in the US and Mainland China remained firm, and there are signs of recovery in the euro area economy. The Japanese economy continued to expand, albeit at a slower pace, and growth in other regional economies picked up on stronger domestic demand. The reform of the renminbi exchange rate regime in July was regarded as a positive move by financial market participants. In Hong Kong, economic growth strengthened in the second quarter and was broad-based.

External environment

In the US, real GDP grew at a solid rate of 3.3% in the second quarter (quarter on quarter, annualised), which was lower than the 3.8% in the first quarter but higher than its long-term average of 3.1% over the past two decades. The slower growth mainly reflected an unwinding of inventory accumulation, while final sales of domestic product increased strongly. Private consumption growth remained firm at 3.0% in the second quarter, reflecting improving labour market conditions. The average increase in non-farm payrolls between April and July was well above its 2004 average, and the unemployment rate has stayed at a four-year low of 5% since June. However, the recent rise in oil prices has dampened consumer confidence, adding uncertainty to the consumption outlook. Both business and residential investment showed strong growth at rates of 9-10% in the second quarter, reflecting robust profit growth and strong housing market activity respectively. However, owing to the recent rise in oil prices, the US trade imbalance has worsened, with the trade deficit rising to 5.7% of GDP in June. Higher oil prices and robust GDP growth have not yet translated into higher core CPI inflation (excluding food and energy), which has remained stable at 2.0-2.2% since April.

In the euro area, economic activity remained weak in the second quarter but there are signs of recovery in the second half of the year. Real GDP growth declined to 0.3% (quarter on quarter) from 0.5% in the first quarter, largely reflecting slower growth in Germany and France. Nevertheless, recent survey results point to a recovery in the euro area economy in the coming months. The Purchasing Managers' Indices (PMI) show that the manufacturing sector expanded in July for the first time since April, while the service sector continued to expand at a solid pace. Business confidence in Germany and Italy also rose to five-month highs in July, as a weaker euro is expected to support exports. Inflationary pressures remained subdued, with core CPI inflation (excluding unprocessed food and energy) falling to a four-year low of 1.3% in July. In the UK, real GDP growth declined from 2.1% (year on year) in the first quarter to 1.8% in the second – the slowest pace since the first quarter of 2002 – as growth of private consumption decelerated from 2.5% to 1.5%.

In Japan, the economy expanded for a third straight quarter, led by robust consumer and business spending. Real GDP increased by 1.1% (quarter on quarter, annualised) in the second quarter after rising by 5.4% in the first. The slowdown was mainly attributed to decline in private inventory. Private consumption and business spending continued to grow strongly at 3.0% and 9.0% respectively. Exports increased markedly by over 10% after a contraction in the first quarter, partly benefiting from a weaker yen. Higher wages and employment are expected to support consumer spending, while solid growth in corporate profits and rising machinery orders are expected to boost business spending in the coming months. The Tankan survey shows that business confidence and investment intentions rose in the second quarter, and the manufacturing PMI stayed high at 53.8 in August. Both producer and consumer price inflation rates rose slightly in the second quarter on higher oil prices and stronger economic activities.

In Mainland China, economic growth remained strong in the second quarter with GDP rising by 9.5% (year on year), following an increase of 9.4% in the first. The latest economic indicators suggest that growth moderated slightly across the board though the overall growth momentum stayed solid. While industrial production and fixed asset investment growth eased in July, the composition of investment continued to improve with strong capital spending on "bottleneck" sectors. Private consumption remained robust, with retail sales rising by 15.9% (three-month-on-three-month annualised), the highest pace since last July. Export growth moderated from the previous high levels, with the annual growth rate falling to below 30% for the first time since October 2004. Headline CPI inflation picked up on both year-on-year and three-month-on-three-month rates in July, suggesting that inflationary pressures persist and deflation risk in the near term is low, particularly in the face of strong aggregate demand and potential increase in some government-administered prices.

A significant recent development on the Mainland was the reform of the renminbi exchange rate regime announced by the People's Bank of China (PBoC) on July 21. The reform mainly consists of a 2% up-front appreciation of the renminbi and a shift from the peg to the US dollar to a managed float with reference to a basket of currencies including the US dollar, euro, Japanese yen, Korean won and currencies of other major trading partners. The appreciation of the renminbi is expected to affect the Mainland economy through a number of channels, such as affecting exports adversely because of reduced external competitiveness, supporting domestic demand due to lower import prices, and elevating asset prices on expectations of further renminbi revaluation. However, some of these effects tend to offset each other, and given the modest recent appreciation of the renminbi, the impact on the Mainland's near-term growth is likely to be limited.

In the rest of East Asia, growth in the more advanced economies increased in the second quarter, and inflationary pressures remained subdued. In Singapore, real GDP expanded by 18.0% (quarter on quarter, annualised) following a contraction of 4.6% in the first quarter. Exports were the main driver of growth, while growth of private consumption and business fixed investment picked up. In Korea, real GDP growth accelerated to 5.0% (quarter on quarter, annualised) from 1.5% in the first quarter, with growth in consumer and business spending offsetting a contraction in exports. In Taiwan, the economy expanded by 3.0% (year on year) after rising by 2.5% in the first quarter, reflecting stronger growth in domestic demand. The above data suggest a more balanced growth path in the region as export growth has been slowing since the fourth quarter of last year. Headline CPI inflation remained low in Korea, Singapore and Taiwan, at an average rate of 1.7% (year on year) in the second quarter. However, CPI inflation stayed high in Indonesia and the Philippines at 7.6% and 8.2% respectively.

As widely expected, the Federal Open Market Committee in the US raised the federal funds target rate by 25 basis points to 3.5% in August. Futures prices imply that interest rates will rise to 3.75% by the end of this year. Long-term interest rates, measured by yields of 10-year Treasury bonds, rose from 3.91% at the end of June to 4.28% in mid-August, reflecting concern about higher oil prices and robust growth in the US economy which may increase inflationary pressures in the medium term. Interest rate differentials between the US and Europe continued to widen in favour of the US, as the European Central Bank kept the policy rate unchanged at 2.0%, and the Bank of England lowered the repo rate by 25 basis points to 4.5% in August. In East Asia, the Central Bank of China (Taiwan's central bank) raised the discount rate by

12.5 basis points to 2.0% in July and the Bank of Thailand increased the repo rate by 25 basis points to 2.75%.

In the foreign exchange markets, the PBoC announced a revaluation of the renminbi to 8.11 from 8.28 against the US dollar in July. Although the news triggered a wave of buying of Asian currencies initially, it subsided quickly. The major Asian currencies appreciated by no more than 2% against the US dollar between 20 and 31 July. The RMB/USD spot rate has also remained largely stable since the revaluation, moving within a narrow range between 8.095 and 8.113 from 21 July to 31 August, a fluctuation of about 0.2%. The one-year renminbi non-deliverable forward rate at the end of August implied that market participants expect the currency to appreciate by another 3% against the US dollar in 12 months' time. Partly reflecting the appreciation of most Asian currencies, the US dollar has weakened, with the Federal Reserve Board's broad nominal effective exchange rate index decreasing by 1.9% between 5 July and 31 August, and the index against major currencies declining by 3.1%.

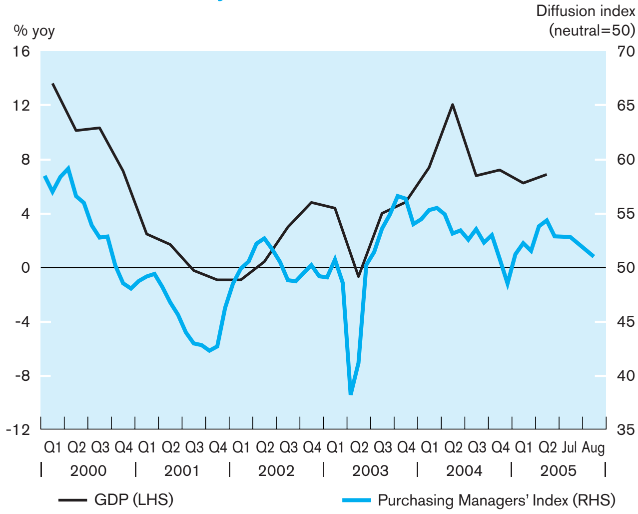
Global equity markets declined in August, partly reflecting higher crude oil prices. The average price of Dubai, Brent and WTI crude oil rose to a historical high of US$65 per barrel at the end of August from US$58 at the end of July. In the US, the S&P500 and NASDAQ Composite indices decreased by 1.1% and 1.5% respectively in August. The bomb attacks in London led to a temporary sell-off of stocks in the UK and other European markets in mid-July, but major stock indices rebounded in late July before easing towards the end of August. Equity markets in Japan increased, reflecting market expectations of stronger economic recovery ahead. The NIKKEI 225 index rose by 4.3% in August. Other Asian stock indices moved mostly in tandem with the US's, with the MSCI Asia free ex-Japan index (in local currency terms) decreasing by 2.1%.

Domestic activity

In Hong Kong, economic growth strengthened in the second quarter of 2005. Real GDP rose by 3.0% on a seasonally adjusted quarter-on-quarter basis, following an increase of 1.4% in the first quarter. The year-on-year GDP growth accelerated to 6.8% from 6.2% in the previous quarter (Chart 1). The growth was broad-based, with most of the major components recording quarterly and annual increases. Both machinery investment and merchandised exports registered double-digit year-on-year increases in the second quarter.

CHART 1

Economic activity

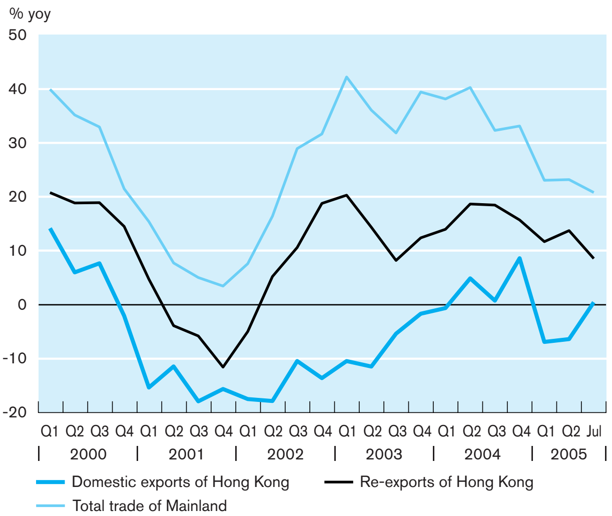


The latest economic indicators suggest that economic expansion continued, but the pace of growth is moderating. The PMI remained above the no-change mark of 50 for the eighth consecutive month in August, suggesting sustained solid growth in private sector spending (Chart 1). Nevertheless, the pace of expansion has eased to a eight-month low, pointing to a possible slow-down in growth in the periods ahead. In particular, the volume of retail sales fell distinctly in June, possibly showing the damping effect of rising mortgage interest rates on private consumption. However, the volume of retail sales rebounded in July. Values of retained imports declined slightly in the second quarter over the previous quarter, indicating moderation in the growth of domestic demand.

External trade

Growth in merchandise exports accelerated in the second quarter of 2005. Total exports of goods grew by 7.0% on a seasonally adjusted quarter-on-quarter basis, compared with -0.3% in the first quarter. On a year-on-year comparison, growth in merchandise exports was 12.5% in the second quarter and 8.1% in July. The strong overall export performance reflected robust re-exports as a result of expansion in Mainland China's external trade (Chart 2). Growth in exports of trade-related services remained firm. Annual growth of tourism-related earnings slowed to 6.6% in the second quarter from 9.9% in the first, alongside a slowdown in the year-on-year growth in the number of inbound tourists.

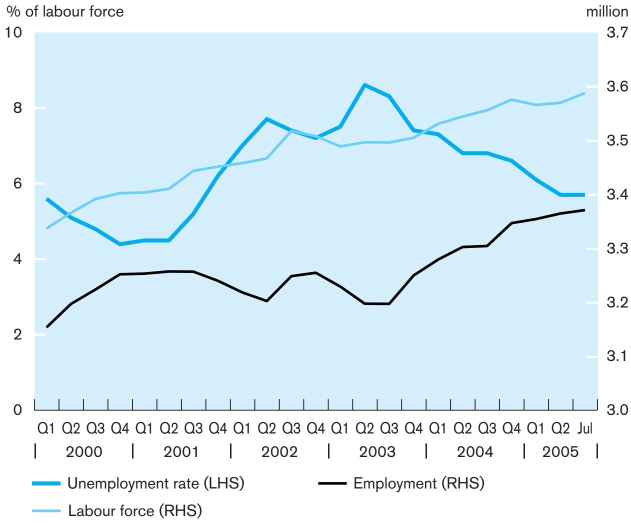
CHART 2
External trade



Labour market and inflation

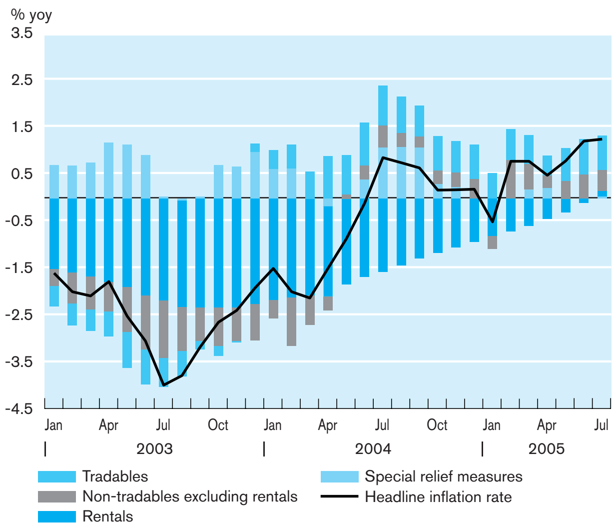
Labour market conditions continued to improve, although the pace of decrease in the unemployment rate has slowed in recent months. The seasonally adjusted unemployment rate remained unchanged at 5.7% in July as the rise in labour force offset the expansion in employment (Chart 3). The underemployment rate also held steady at 2.8%. Employment increased mainly in the trade, tourism, transport, and financial sectors.

CHART 3
Labour market conditions



Consumer prices continued to increase. Adjusted for seasonal and special factors, the annualised three-month-on-three-month rate of increase in the Composite Consumer Price Index (CCPI) rose to 2.0% in July from 1.4% and 1.9% in the first and second quarters respectively. On a year-on-year comparison, the headline CCPI increased by 1.3% in July, the highest since September 1998 (Chart 4). The recent pick-up in inflation reflects strengthening consumer demand, rising wages, and increases in the rent component as it increasingly captures rises in housing rents in the earlier periods. In addition, the recent appreciation of the renminbi and other

CHART 4
Headline inflation

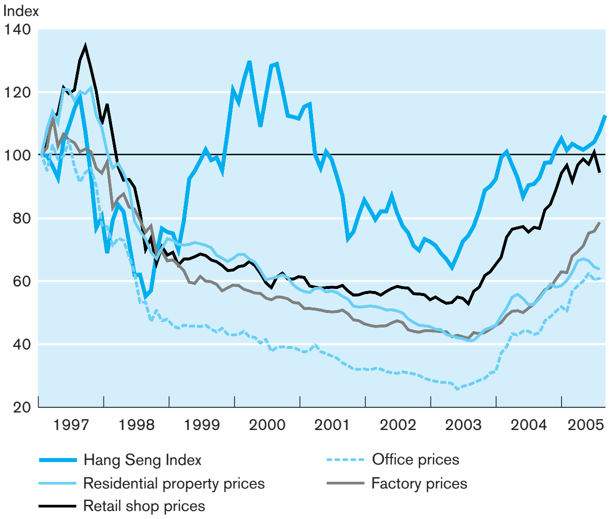


Asian currencies may raise import prices. However, the risk of a sharp acceleration in inflation remains small.

Asset markets

Property prices moderated in recent months after experiencing a sustained across-the-board rally since late 2003 (Chart 5). Despite the continuous rise in factory prices, prices of residential properties, retail shops and offices dropped in the past few months, mainly driven by the rising interest rates. The fall in property prices has been accompanied with sharp decreases in transaction volumes. The number of Sale and Purchase Agreements declined by 45% from the recent high of 16,280 in April to 8,933 in July.

CHART 5
Asset prices



Local stock prices have risen strongly since late May after consolidating in the earlier months. The Hang Seng Index rose by about 7% in June and July. Since then, a stronger renminbi has led to market expectation of improved earning prospects of some Mainland-related companies, boosting share prices of these companies. Share prices have increased by around 3% since the reform of the renminbi exchange rate regime announced on July 21.

Meanwhile, Mainland-related initial public offerings dominated the activities of the main board in Hong Kong. In the first seven months of 2005, HK$67 billion was raised through initial public offerings, of which around 90% was raised by Mainland companies (H shares and Red chips).

Money supply and domestic credit

Hong Kong dollar narrow money and broad money growth continued to diverge. Narrow money decreased further in the second quarter of 2005 from the previous quarter, reflecting a decrease in demand deposits, and to a lesser extent, a decline in currency held by the public. The decline in narrow money was partly attributable to increase in opportunity cost of holding non-interest-bearing monetary assets as a result of rising deposit rates. However, broad money rose moderately during the quarter, leading to a year-on-year growth of 6.9% in June. The expansion in broad money was generally in line with the trend of the economy.

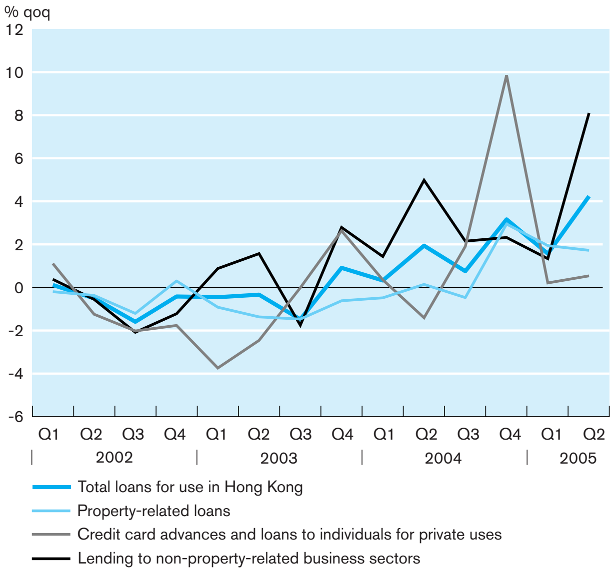
Foreign currency deposits declined slightly in the second quarter, as the decrease in US dollar deposits outweighed the rise in non-US dollar foreign currency deposits. As Hong Kong dollar deposits rose while foreign currency deposits declined, the share of foreign currency deposits in total deposits decreased modestly from 48.0% at the end of March to 47.7% at the end of June.

Loans for use in Hong Kong expanded markedly by 4.2% from the previous quarter, and 10% in the twelve months to June 2005, as a result of increased credit demand associated with buoyant economic activity. Analysed by economic uses,[1] lending grew in almost all sectors on a quarter-on-quarter comparison (Chart 6). Loans for non-property-related business sectors rose more than property-related lending (Chart 6). The former was largely driven by strong growth in trade financing and loans for the manufacturing sector. Separately, reflecting higher property values, the amount of new mortgage

[1] Data on *loans for use by economic sectors* are available only quarterly.

CHART 6

Loans for use in Hong Kong



Note: Non-property business lending is defined as loans for use in Hong Kong other than property-related loans, lending to individuals for private purposes and credit card advances.

loans increased noticeably in the second quarter compared with the first. However, the outstanding stock of mortgage loans expanded only moderately, as repayments on existing mortgage loans offset most of the expansion in new mortgage credit.

Short-term outlook

The domestic economic expansion is expected to continue in the second half of 2005, but the growth momentum is likely to moderate. While local consumer spending is expected to be supported by recent increases in asset prices, improved labour market conditions and income growth, rising interest rates may have a dampening effect. The impact of the recent revaluation of the renminbi on Hong Kong's near-term growth and inflation outlook is likely to be limited. While re-exports originating from the Mainland to the rest of the world could be adversely affected, a stronger renminbi would help Hong Kong's exports to the Mainland and in-bound tourism. In addition, the opening of Hong Kong Disneyland is expected to help bolster Hong Kong's export earnings. Consumer prices are expected to continue to rise because of increased demand, higher import prices, and pass-through of higher market rents to the rental component of the CCPI. However, the risk of a sharp acceleration in inflation remains small.