

# Domestic and external environment

*by the Research Department*

The major economies registered better-than-expected GDP growth in the final quarter of 2006. In the US, strong consumption and exports continued to drive growth, despite the slowdown in the housing sector. Meanwhile, various sentiment indicators point to a bright economic outlook in the euro area. In East Asia, economic growth recovered strongly in Japan in the fourth quarter, while Mainland China continued to grow at an elevated pace. In Hong Kong, economic growth moderated in the fourth quarter following a strong rise in the previous quarter. Favourable labour market conditions continued to support consumption spending, while inflation picked up gradually in recent months.

## External environment

In the US real GDP growth rose to 2.2% quarter on quarter (annualised) in the final quarter of 2006 from 2.0% in the third, as strong growth in private consumption and net exports more than offset the continued decline in residential investment and large rundown in inventories. Consumer spending growth increased to 4.2% from 2.8% in the third quarter, as improved labour market conditions, rising equity prices and lower energy prices mitigated the negative impact of the housing slowdown.

Residential construction, however, fell further by 19.1%, taking 1.2 percentage points from the total growth figure for the second quarter in a row. While some tentative signs of stabilisation have appeared, with existing home sales flattening out and mortgage applications picking up, the near-record-high inventories will continue to restrain home construction activities for some time. Leading indicators suggest a moderate expansion in the period ahead. While the ISM non-manufacturing index fell from 59.0 to 54.3 in February, the manufacturing index rose above 50 to 52.3. Reflecting lower oil and energy prices, inflationary pressures appeared to have abated in the past few months. However, core inflation rates have continued to stay above the Fed's comfort zone of 1-2%. The core CPI inflation and the core PCE

inflation edged up to 2.7% year on year and 2.3% year on year respectively in January from 2.6% and 2.2% in the fourth quarter.

In the euro area real GDP expanded at a higher-than-expected rate of 3.6% quarter on quarter (annualised) in the final quarter of 2006 from 2.1% in the third. Germany registered strong growth of 3.5%, while growth in Italy also picked up to 4.6% and in France to 2.6%. The strong expansion was mainly driven by surging exports, which registered an impressive growth of 15.6%. Supported by strengthening labour markets and improving consumer confidence, private consumption remained solid, and business investment continued to grow strongly, reflecting the still favourable financing conditions. Economic prospects are likely to remain positive, as suggested by the elevated survey indicators. While concerns over further interest rate increases and a stronger euro remained, the European Commission economic sentiment indices and the German IFO business climate index stayed at near-record highs in February. The euro area composite PMI also picked up to 57.7, indicating robust growth at the start of 2007. To contain inflationary pressure, the European Central Bank raised its official interest rate for the sixth time in a year to 3.5% in December 2006. While the headline Harmonised Index of Consumer Prices inflation

remained below 2% since last September, the strong pace of growth is likely to add to the inflation risk. In the UK, the economy grew by 3.1% quarter on quarter (annualised) in the fourth quarter of 2006. This was led by robust domestic demand, with growth in private consumption and investment spending more than offsetting the decline in exports. Inflationary pressure remained with rapid growth and limited spare capacity. The headline CPI inflation rose to an 11-year high of 3.0% in December before falling to 2.7% in January this year.

In Japan real GDP growth recovered strongly to 5.5% quarter on quarter (annualised) in the fourth quarter of 2006, from 0.3% in the third. Growth was supported by a strong rebound in consumer spending and fixed investments. Despite a softening in spending in December, strong gains in earlier months led private consumption to increase by 4.4% in the fourth quarter. While the warm weather reduced spending on heating-related items and clothing significantly in December, spending on other items such as consumer durables (excluding heating equipment) increased. On a three-month-on-three-month comparison, core machine orders rose by 2.0% in December, while growth in industrial production fell from 2.6% in December to 1.8% in January. The manufacturing Purchasing Manager Index also fell slightly from 53.4 in January to 53.0 in February, reflecting a slowdown in manufacturing activities. Growth in merchandise exports increased to 4.5% three-month-on-three-month in January, compared with 2.8% in both November and December. Growth in exports to other Asian economies was particularly strong. Inflation in January eased further, with headline CPI inflation falling from 0.3% in December 2006 to 0% in January 2007. The fall was largely attributable to the decline in energy prices, although prices in general also remained soft.

Growth momentum in Mainland China remained strong in the fourth quarter of 2006, with real GDP rising by 10.4% year on year, marginally lower than in the third. The moderation is attributable to

weakening growth of fixed assets investment (FAI), which declined by more than six percentage points from that in the previous quarter year on year, as a result of the austerity measures taken since mid-2006. Owing to robust growth in household income, retail sales continued to pick up at a firm pace. Growth in exports rose by 28.9% year on year in the fourth quarter of 2006 on favourable external demand. It further accelerated to 33% (year on year) in January 2007, partly due to the Chinese-New-Year effect.<sup>1</sup> Meanwhile, growth in imports continued to lag behind that of exports, albeit with a notable revival in January 2007. As a result, the trade surplus surged in 2006, reaching US\$177.5 billion, with a further surplus of US\$15.9 billion in January.

The year-on-year growth in broad money (M2) in the fourth quarter of 2006 remained the same as in the third, and declined to 15.9% in January 2007, the first time the monthly growth rate was below 16% since June 2005. Growth in narrow money (M1) outpaced M2 in the fourth quarter of 2006 and in January 2007 year on year, deepening the authorities' concerns over liquidity flows from deposits to the booming stock market. Growth in bank loans bounced back to 16.0% year on year in January 2007 after edging down in the fourth quarter of 2006, partly reflecting commercial banks' tendency to over-lend at the beginning of the year. Driven mainly by food prices, CPI inflation increased by 1.9% in the fourth quarter (a seven-quarter high) and by 2.2% in January 2007 year on year. PPI inflation, however, declined in the fourth quarter from that in the third but revived gently in January 2007. Inflationary pressure seems to be rising because of large liquidity overhangs in the banking system, buoyant stock markets and further liberalizations in energy and resource prices.

In the rest of East Asia, real GDP growth moderated slightly in most of the Asian economies in the fourth quarter of 2006. While softness in external demand contributed to slower growth in the region, domestic demand has held up well in most of the region. Real GDP in Korea, Singapore and Taiwan grew by an average of 4%, and the remaining ASEAN

<sup>1</sup> Since the Chinese New Year was in January last year, it lowered the base of comparison.

economies by 5.5%. Export performance weakened significantly towards the end of 2006, although latest data suggests a possible rebound in the external sector. On a three-month-on-three-month comparison, exports from Korea, Singapore and Taiwan rose by an average of 2.4% in US dollar terms in January, while that in Indonesia, Malaysia, the Philippines and Thailand grew by 0.2% in December last year. Inflation in the region continued to remain subdued following a temporary pick-up in December. Headline CPI fell to an average of 1.1% year on year in Korea, Singapore and Taiwan, and to 4.5% in other ASEAN economies, as the rise in food prices was more than offset by the continued decline in energy prices.

On the monetary front, the Federal Open Market Committee kept the federal funds target rate at 5.25% following its January meeting and offered a fairly balanced assessment in a statement released after the meeting, citing both upside and downside risks to the economic outlook. The Fed Chairman broadly adhered to the tone of the statement in his testimony to the Committee on Banking, Housing, and Urban Affairs in the middle of February. However, the downward revision of the fourth quarter GDP data subsequently raised concerns about the economy and heightened expectations of a sooner-rather-than-later monetary easing. On the market close of 28 February, interest rate futures reflected a 28% chance of an interest rate cut by the middle of the year.

In Europe, the Bank of England raised its official interest rate unexpectedly by 25 basis points to 5.25% in January to contain inflation pressure, while the European Central Bank put its rate on hold. In Asia, the Bank of Japan increased the uncollateralised overnight call rate by 25 basis points to 0.5% after its February meeting, the second tightening in this cycle, while the People's Bank of China raised the reserve requirement ratio by a total of 100 basis points to 10% in the first two months of 2007. In contrast, the Bank of Thailand and Bank Indonesia cut their official interest rates by 25 and 50 basis points to 4.75% and 9.25% respectively.

Major equity markets kicked off the new year on a strong note, with lower oil prices, better-than-expected economic performance, and merger and acquisition activities being the main driving forces of the rally. Although the global equity market correction at the end of February reversed part of the gains, the Frankfurt DAX and Tokyo TOPIX rose by 1.8% and 4.3% respectively in the first two months of 2007, while the S&P 500 remained broadly unchanged. Other European and Asian stock markets also posted respectable gains before the sharp fall at the end of February, bringing the MSCI Euro and the MSCI Asia Free ex-Japan back to the level registered at the end of 2006.

The US dollar seesawed in a directionless market in most of the period. In January, stronger-than-expected US economic data, which reduced expectations of a near-term easing in monetary policy, lent support to the dollar. The dollar was also aided by renewed pressure on the yen after the release of the G7 ministerial meeting communiqué, which made no mention of the weak yen. However, the US dollar subsequently weakened against other major currencies towards the end of February due to increased concerns over the US economic outlook following the downward revision of the fourth quarter GDP figure and the unwinding of yen carry trades. In the first two months of 2007, the US dollar depreciated against the euro by 0.2% and the yen by 0.4%, while the Federal Reserve Board's broad nominal exchange rate index remained broadly unchanged.

Oil prices fell sharply in the first three weeks of January but rebounded in February. The sharp fall was triggered by an unusually warm winter in the northern hemisphere and higher-than-expected US oil inventories. The average price of UK Brent Crude, Dubai Crude and West Texas Intermediate (WTI) fell from US\$59 per barrel at the end of December to US\$50.6 on 18 January, the lowest since June 2005. Oil prices rebounded subsequently on supply concerns stemming from political instability in Nigeria and implementation of production cuts by the Organisation of the Petroleum Exporting Countries.

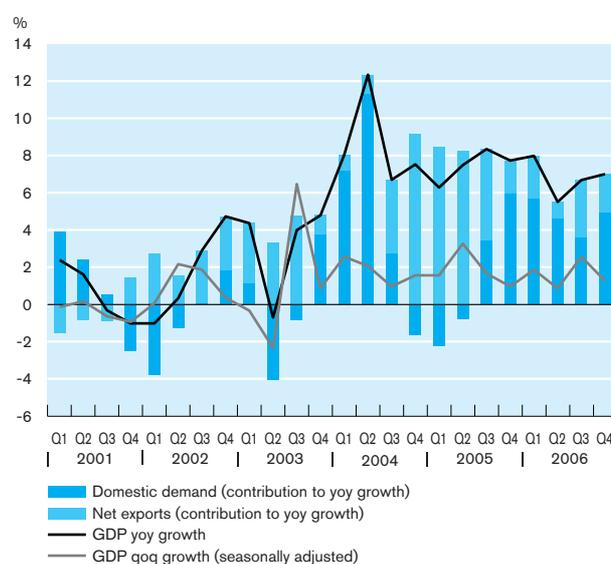
The announcement of a plan to double strategic oil reserves by the US and an upward revision of the 2007 oil demand growth forecast by the International Energy Agency also supported oil prices. The average price of UK Brent Crude, Dubai Crude and WTI settled at US\$60 per barrel at the end of February.

## Domestic activity

Growth of the domestic economy remained solid in the fourth quarter of 2006 following a strong rise in the previous quarter. Seasonally adjusted real GDP growth slowed to 1.3% quarter on quarter from 2.6% in the third quarter, reflecting moderation in the pace of export expansion. Compared with a year ago, real GDP increased by 7.0% after growing by 6.7% in the third quarter (Chart 1 and Table 1).

Nevertheless, domestic demand picked up strongly in the fourth quarter, underpinned by a strong revival in consumer spending and business equipment spending. Growth in merchandise exports remained solid, underpinned by robust external demand from the Mainland. Real GDP increased by 6.8% in 2006 after rising by 7.5% in 2005, marking the third consecutive year of above-trend growth.

**CHART 1**  
Economic activity



Source: Census & Statistics Department

Underpinned by favourable labour market conditions and rising household income, private consumption growth picked up to 1.7% quarter on quarter in the fourth quarter from 1.0% in the preceding one. The year-on-year consumption growth also rose to 5.8% from 4.4% for the period. Growth in private investment remained strong, supported by relatively

**TABLE 1**

Real GDP growth by expenditure component (year on year)

(% yoy)	2005	2006	2006			
			Q1	Q2	Q3	Q4
<b>Gross Domestic Product</b>	<b>7.5</b>	<b>6.8</b>	<b>8.0</b>	<b>5.5</b>	<b>6.7</b>	<b>7.0</b>
(quarter-on-quarter growth)			1.9	0.9	2.6	1.3
Domestic demand	2.1	5.7	6.7	5.4	4.5	6.2
Private consumption expenditure	3.3	5.1	4.8	5.4	4.4	5.8
Government consumption expenditure	-3.1	0.3	1.1	-1.5	-1.1	2.4
Gross domestic fixed capital formation	4.6	7.9	7.3	4.5	10.3	9.5
<i>Of which:</i>						
Building & construction	-8.4	-7.2	-11.4	-4.1	-10.1	-2.6
Machinery & equipment	12.9	17.2	22.4	11.9	20.4	14.9
Change in inventories <sup>1</sup>	-0.8	0.2	1.3	0.7	-0.8	-0.2
Net exports <sup>1</sup>	5.7	2.1	2.3	0.9	3.1	2.1
<i>Of which:</i>						
Exports of goods	11.2	10.2	14.4	6.4	8.9	11.7
Exports of services	11.3	8.7	9.0	9.3	9.3	7.5

<sup>1</sup> Percentage point contribution to annual growth of GDP.

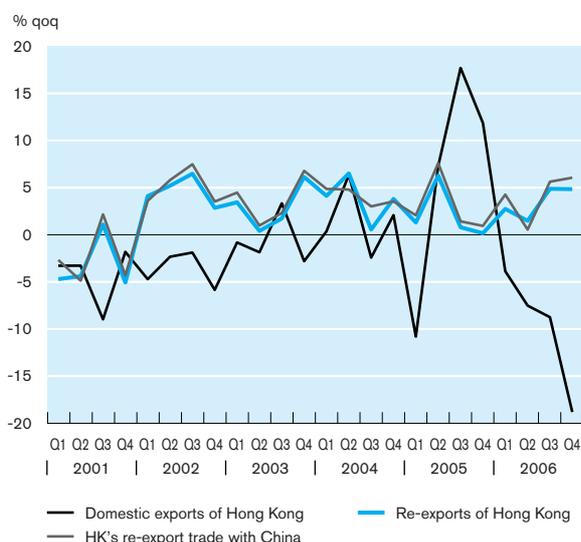
Source: Census & Statistics Department

loose monetary conditions and solid growth in exports. Compared with a year ago, business equipment spending increased by 14.9% after rising by 20.4% in the third quarter, the fifth straight quarter of double-digit growth. However, residential investment remained weak due to subdued construction spending in both the private and public sectors.

## External trade

Growth in merchandise exports remained solid, as the strong economic performance of the Mainland continued to boost the re-export trade of Hong Kong. Quarter on quarter, exports of goods grew by 3.6% in the fourth quarter after rising by 4.1% in the third, largely driven by the expansion in re-exports as domestic exports declined (Chart 2). The Mainland remained the key contributor to growth in re-export trade in Hong Kong, while external demand from the US and the EU remained robust. Reflecting a strong revival in domestic demand, retained imports picked up in the fourth quarter in particular for raw materials and food. As imports grew faster than exports, the merchandise trade deficit widened to HK\$32 billion (8% of GDP) in the fourth quarter from HK\$26 billion (7% of GDP) in the third. The overall trade balance remained in surplus but decreased to HK\$54 billion (14% of GDP) from HK\$56 billion (15% of GDP) in the previous quarter.

**CHART 2**  
External trade



Sources: Census & Statistics Department, CEIC database and staff estimates.

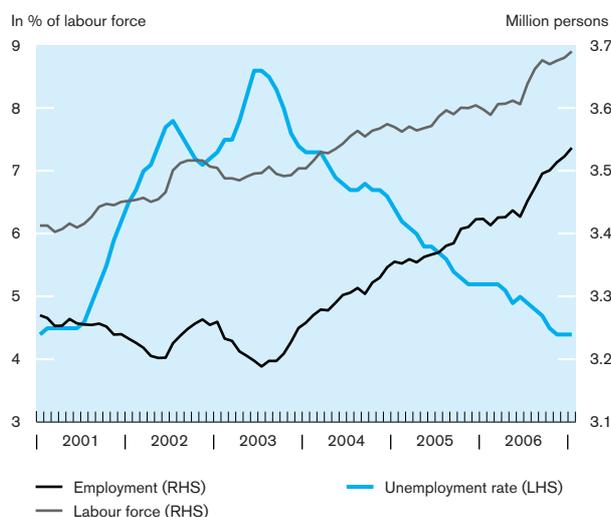
Forward-looking indicators point to continued business expansion in the first quarter of 2007 albeit at a slower pace. The Quarterly Business Survey shows that corporate owners remained optimistic about the business outlook in the first quarter. Their willingness to continue business expansion is positive to investment and employment growth. The PMI decreased slightly to 55.2 in February from 55.9 in January, but the employment component remained strong. Consumer spending remained robust, with the volume of retail sales rising by 2.9% in January after growing by 2.2% in December on a three-month-on-three-month basis. However, growth in merchandise exports slowed to 2.2% from 3.6% during the period, as growth in re-exports moderated while domestic exports continued to decline.

## Labour market and inflation

Labour market conditions continued to improve along with solid expansion of domestic demand. The unemployment rate declined to a six-year low of 4.4% in the fourth quarter from 4.7% in the third, as employment growth outpaced the expansion in labour force (Chart 3). The rise in employment is broad-based, with the external trade sector, financial and business services, and social and personal services registering the largest increments in 2006. The stronger labour demand has boosted labour earnings. Nominal wages increased by 0.4% quarter on quarter in the third quarter after growing by 0.3% in the second. The nominal payroll per worker, which includes wages and other non-regular allowances and bonuses, rose by 0.3% in the third quarter after growing by 0.6% in the second.

Consumer price inflation picked up gradually in recent months, reflecting larger increases in food prices and higher residential rents. The Composite Consumer Price Index (CCPI) inflation rose to 2.4% (three months on three months, annualised) in January 2007 from 1.6% in December 2006. Compared with a year ago, however, CCPI inflation eased to 2.0% from 2.3%, mainly due to a higher base of comparison with the Lunar New Year falling in January in 2006. While the rental component remained the major contributor to the rise in

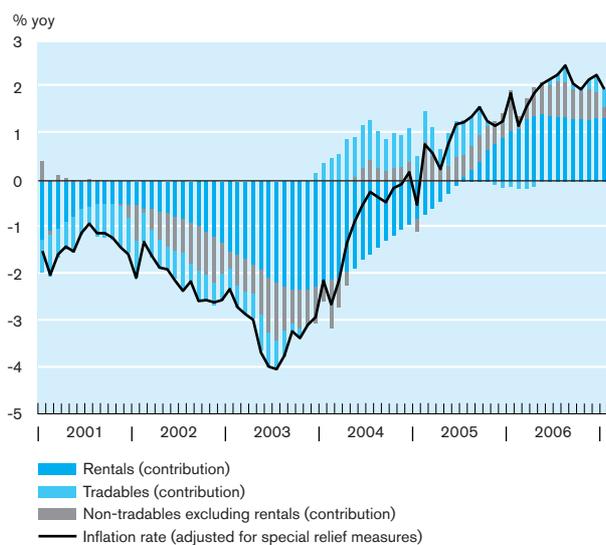
**CHART 3**  
Labour market conditions



Source: Census & Statistics Department.

consumer price inflation in 2006, higher prices in basic food have pushed up headline inflation recently (Chart 4). Overall, the underlying inflationary pressure remained contained. Excluding the rental component, core consumer price inflation stayed low at 1.4% (three months on three months, annualised) in January.

**CHART 4**  
Consumer price inflation



Sources: Census & Statistics Department and staff estimates.

## Asset markets

Local stock prices increased markedly at the start of this year following the strong rally in the second half of 2006. The Hang Seng Index climbed to a record high of 20,821 on 24 January before easing to 19,652 at the end of February. Selling pressures emerged in early March, reflecting rising concerns about potentially more stringent tightening measures in Mainland China, the reversal of yen carry trades and uncertain prospects of the US economy, leading to increased risk aversion of investors. In 2006, the stock market increased by 34%, the largest annual gain since 2003. This partly reflected stronger demand for H-shares given the high growth potential on the Mainland and a gradual appreciation of the renminbi. Increased stock market activities boosted the market capitalisation of the Main Board to a historic high of HK\$13.2 trillion at the end of 2006, 63% higher than the level at the end of 2005. The average daily turnover also expanded to HK\$34 billion in 2006 from HK\$18 billion in 2005.

The property market remained largely stable in the fourth quarter, as the uncertain interest rate outlook continued to suppress demand. Residential property prices stayed flat in the fourth quarter, while house rents rose by 2.3% after growing by 1.4% in the third quarter (Chart 5). The number of Sale and Purchase Agreements for property decreased by 6.9% in the

**CHART 5**  
Asset prices



Sources: Rating and Valuation Department and Reuters.

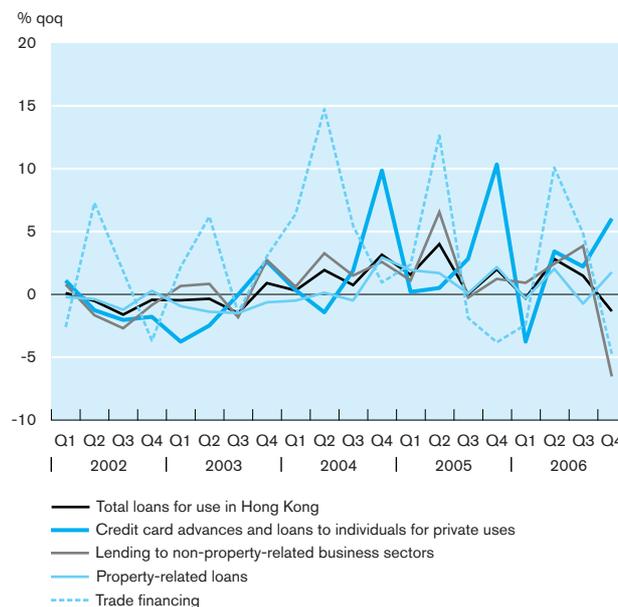
fourth quarter, mainly due to a contraction in residential property transactions in the primary market. The recent stabilisation in house prices and lower mortgage interest rates have increased housing affordability, while higher rents should also increase incentives for home purchase. In the commercial property market, prices of office and retail space moved within a narrow range in the fourth quarter. However, prices of factory space continued to rise steadily throughout 2006.

## Money supply and domestic credit

Hong Kong dollar narrow and broad monetary aggregates continued to expand in the fourth quarter of 2006. Quarter on quarter, narrow money rose by 1.6% after growing by 4.2% in the third quarter. The swing in M1 growth mainly reflected equity-related fund flows due to a number of sizable IPOs. Broad money also expanded by 4.7% after rising by 5.8% in the third quarter. Compared with a year ago, growth in broad money increased to 19.2% in the fourth quarter, from 16.3% in the previous one.

Growth in total deposits slowed to 4.7% quarter on quarter from 5.1% in the third quarter, as growth in Hong Kong dollar deposits moderated. For Hong Kong dollar deposits, the expansion of liquid deposits (i.e. demand and savings deposits) outpaced the increase in term deposits. As a result, the share of liquid deposits in total Hong Kong dollar deposits rose to 46% in the fourth quarter from 43% in the third. For foreign currency deposits, US dollar deposits rose by 6.7% quarter on quarter in the fourth quarter, while renminbi deposits grew at a slower pace.

**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, credit card advances and trade financing loans.

Source: HKMA.

Quarter on quarter, loans for use in Hong Kong contracted by 1.3% in the fourth quarter after rising by 1.5% in the previous one. Domestic credit growth was mixed across economic sectors (Chart 6).<sup>2</sup> Lending to stockbrokers, the information technology sector and trade financing registered the largest declines. In contrast, credit card advances picked up notably, partly reflecting the domestic consumption boom during Christmas. In the housing loan market, the outstanding residential mortgage loans of authorized institutions increased by 0.3% in the fourth quarter after contracting in the previous five. New loans drawn down grew by 20%, reflecting increased residential property transactions in the secondary market. Newly approved mortgage loans averaged around HK\$1.8 million in the fourth quarter, slightly higher than HK\$1.7 million in the third.

<sup>2</sup> Data on loans for use by economic sector are available only on a quarterly basis.

## Short-term outlook

The near-term economic outlook remains favourable, as the strong revival in domestic demand and solid growth in exports are expected to support economic expansion in 2007. The Government's latest projection of real GDP growth in 2007 is 4.5-5.5%, compared with the market consensus of 5.2%. The moderation in growth reflects an expected slowdown in the US economy, which will weigh on domestic exports and re-exports in Hong Kong. However, the robust growth in cross-border trade between Hong Kong and the Mainland and a weaker Hong Kong dollar effective exchange rate should mitigate part of the negative impact. Given that export growth would moderate somewhat in 2007, domestic demand is expected to be the key contributor to growth.

Consumer price inflation is likely to pick up modestly in 2007, reflecting rising domestic demand and higher import prices. The Government's forecast for headline CCPI inflation is 1.5% in 2007, lower than the market consensus of 2.5%. The benign inflation outlook reflects the expected stabilisation in rental price inflation, which has a weight of more than a quarter in the CCPI basket. The pass-through from higher import prices to consumer prices will also be limited. On the supply side, there has been little upward pressure on unit labour costs as increased productivity offset higher wages. Overall, the risk of a substantial increase in consumer price inflation remains low.

The positive economic outlook is subject to a number of risks, mainly related to external factors. These include a sharper-than-expected slowdown in growth of the US economy, a tighter monetary policy in the US in response to persistent underlying inflationary pressures, a disorderly unwinding of the global imbalances, and the disruption to financial markets caused by a sharp reversal in international capital flows. These risk factors, if realised, would have a significant impact on the Hong Kong economy through trade and financial channels.