

# Domestic and external environment

*by the Research Department*

Economic activities in the US and East Asian economies picked up in the second quarter, while growth in Europe and Japan moderated. Overall, global economic growth remained solid, but the recent volatility in the financial markets has created renewed uncertainty about global growth prospects. In Hong Kong, economic growth accelerated in the second quarter following a moderation in the preceding one. The broad-based expansion in domestic demand has further improved labour market conditions, while inflation edged up.

## External environment

In the US, real GDP growth rose to 4% quarter-on-quarter (annualised) in the second quarter of 2007, up from its four-year-low of 0.6% recorded in the first. The strong rebound was supported by a narrowing trade deficit, and business spending picked up steam after weak growth in the past year. While consumer spending was the main driver of GDP growth, it grew by only 1.4% in the second quarter in the face of the housing market downturn, two-fifths of the average quarterly growth in the previous four quarters. Data at the beginning of the third quarter painted a mixed picture. While growth in retail sales was higher than expected in July, housing indicators offered mixed signs for housing demand. Housing starts and building permits dropped to 10-year lows in July, but new home sales increased in the same period. Although a moderate pace of expansion is generally expected in the near future, downside risks clearly increased given the continued housing slump and recent credit-market turmoil. In response to increased financial market volatility and tighter credit conditions, the US Fed cut its discount rate by 50 basis points to 5.75%, while maintaining the Fed funds target rate at 5.25%. Meanwhile, inflationary pressures appeared to have eased in recent months. The year-on-year core PCE inflation

softened to below 2% in June, while the core CPI inflation stood at 2.2% since May. Reflecting lower energy prices, headline CPI inflation fell to 2.4% in July from 2.7% in the first quarter.

In the euro area economic activity slowed more than expected in the second quarter, real GDP growth decelerated from 2.8% quarter on quarter (annualised) in the first quarter to 1.2%, its lowest pace since the fourth quarter of 2004. This is against a backdrop of continued policy-rate increases, an appreciating euro, and higher oil prices, and the slowdown was widespread across major economies except for Spain. Real GDP in Germany and France rose by 1% and 1.3% respectively amid contracting construction activity in Germany and flat business investment growth in France. Supported by improved labour market conditions, private consumption growth increased despite an increase in the value-added tax in the first quarter, while business investment weakened.<sup>1</sup> Survey indicators on balance suggest growth is likely to rebound in the third quarter, although the ongoing financial turmoil and the growth prospects in the US are major sources of uncertainty. The ZEW business confidence index deteriorated significantly in August. Headline HICP inflation in the euro area remained below the European Central Bank's upper inflation limit of 2%

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<sup>1</sup> This is based on the flash estimate, the first of the three GDP releases.

for the 11th straight month in July. The ECB raised its policy rate in March and June by a total of 50 basis points to 4.0%. In the UK, despite two policy-rate increases since May, the economy grew at a higher-than-expected 3.2% quarter on quarter (annualised) in the second quarter. The strong expansion was led by continued robust growth in business services and finance, and manufacturing activities also picked up from a quarter ago. The July retail sales data and the latest survey indicators suggest solid growth is likely to extend into the third quarter. Headline inflation fell unexpectedly to 1.9% year on year in July from 2.4% in June, and core inflation also dropped to 1.7%, from 2.0% during the same period.

In Mainland China, economic growth strengthened in the second quarter. Real GDP increased by a faster-than-expected 11.9% year on year, 0.8 percentage points higher than in the first. The acceleration was mainly propelled by a rebound in growth in fixed-assets investment (FAI) and a strong expansion in net exports. The rebound in FAI was partly a result of strong corporate profits, with large increases of investments in the agriculture, manufacturing, and real estate sectors. The trade surplus continued to surge, totalling US\$136.8 billion for the first seven months of the year. Other than buoyant external demand and the increasing competitiveness of Mainland exports, the strong growth in exports is probably also attributable to the front-loading effect as exporters rushed their orders before the effective date of large adjustments in export tax rebates at the beginning of July. Retail sales, a proxy for private consumption, continued to rise at a steady pace owing to growth in wages and income.

Broad money (M2) and financial institution loans kept rising rapidly and well above the People's Bank of China's (PBoC's) targets for 2007. The continued shift of bank deposits to the stock market helped fuel the rapid rise in stock market prices. The Shanghai Stock Exchange Composite Index hit 5,000 in the second half of August, a rise of 85% from early January. Driven mainly by food prices (particularly pork prices), the year-on-year CPI inflation picked up to 3.6% in the second quarter and then to 5.6% in

July. In contrast, the PPI inflation remained subdued, providing mixed signals about the underlying inflation pressure.

The authorities continued to apply a multi-pronged but gradual approach to economic stabilisation. The PBoC raised the benchmark one-year deposit and lending rates further to 3.60% and 7.02% in August, after raising the former by 27 basis points twice and the latter by 18 and 27 basis points in May and July. In the meantime, the reserve requirement ratio has been increased four times since April to 12% in August, one percentage point below the 1988-1998 high. Although the PBoC has so far relied mostly on the reserve requirement ratio to drain liquidity from the banking system, it has also issued more than RMB400 billion yuan worth of three-year central bank bills to target banks with rapid loan growth since March. The tax rate on interest income was also cut from 20% to 5% to make savings more attractive. The State Administration of Foreign Exchange (SAFE) announced on 20 August a pilot scheme for Mainland residents to invest directly in securities listed on the Hong Kong Stock Exchange. The pilot scheme is expected to help fulfil the Mainland's policy objective of allowing orderly outflow of funds and alleviate overheating pressures on the Mainland's asset markets. On the trade policy front, the Ministry of Commerce has moved to discourage further expansion of the processing trade by adding more than 1800 goods to its "restricted list" from 23 August, after export tax rebates were adjusted several weeks earlier. These policy measures may gradually slow the growth momentum in the months ahead.

In Japan the economy continued to expand, albeit at a slower pace. Real GDP growth moderated to 0.5% quarter on quarter (annualised) in the second quarter of 2007, compared with 3.2% in the first. The robust capital expenditure was in part offset by the weak growth in exports and public investments. Private consumption growth slowed to 1.4% in the quarter. However, with the unemployment rate falling to a new nine-year low of 3.7%, and household income rising moderately, spending is expected to rise in the rest

of the year. On the other hand, latest data offered mixed signals on the economy's business environment. Led by electronics products, industrial production growth rose from 0.4% to 0.8% in the second quarter. Core machine orders (excluding vessels and electricity) declined by 2.4% during the same period while the Purchasing Manger Index also fell below 50 in July. Growth in merchandise exports fell slightly to 2.6% in the second quarter, from 3.2% in the first. While exports to the US were soft, those to the EU and East Asia registered solid growth. As widely expected, inflation turned negative in June due to statistical base effects of June last year, with headline CPI inflation falling by 0.2% and core CPI by 0.1%. Looking ahead, inflation is expected to remain close to zero in the near term.

In the rest of East Asia, growth appeared to have regained momentum in the second quarter. Advance estimates show that real GDP growth in Singapore rose to 14% quarter on quarter (annualised) in the second quarter. In Korea, real GDP growth rose to 7% from 3.6% in the first quarter, the fastest pace since the end of 2005. The strong growth in both economies was supported by robust manufacturing activities, and other economies in the region are expected to follow a similar trend. Manufacturing activities have been supported by robust external demand, with export performance improving in most regional economies. Quarter-on-quarter, merchandise exports in Korea, Singapore and Taiwan grew by an average rate of 3.8% in US dollar terms in the second quarter, while those in the other ASEAN economies rose by 4.6%. Inflation remained stable in the region. Headline CPI inflation in Korea, Singapore and Taiwan averaged 1.3% year on year in June, broadly unchanged from the previous quarter, while that in Indonesia, Malaysia, the Philippines and Thailand fell slightly from 3.1% to 2.9%. Meanwhile, food prices increased modestly.

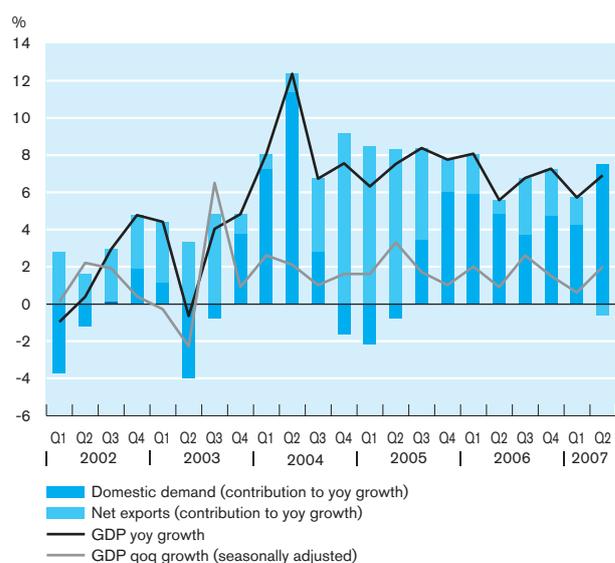
## Domestic activity

Growth of the domestic economy accelerated in the second quarter of 2007 following a moderation in the first. Seasonally-adjusted real GDP growth picked up

to 2.0% quarter on quarter from 0.6% in the first quarter, reflecting strong expansion in both private consumption and business investment. Growth in merchandise exports remained buoyant, underpinned by solid growth in re-exports. Compared with a year ago, real GDP increased by 6.9% after growing by 5.7% in the first quarter (Chart 1 and Table 1). For the first half of 2007, real GDP grew by 6.3% year on year.

Private consumption continued to be a key driver of growth, rising 6.6% year on year in the second quarter from 5.3% in the previous one, supported by the steady rise in household income and favourable labour market conditions. Growth in private investment also gathered momentum, reflecting the solid growth in exports and relatively accommodating monetary conditions. Compared with a year ago, business equipment spending increased by a strong 13.1% in the second quarter after rising by 6.8% in the first. Residential investment posted its first positive year-on-year growth in nearly five years, expanding by 5.3% in the quarter, reflecting improving sentiment among homebuyers and developers.

**CHART 1**  
Economic activity



Source: Census & Statistics Department

TABLE 1

## Real GDP growth by expenditure component (year on year)

(% yoy)	2005	2006	2006		2007	
			Q3	Q4	Q1	Q2
<b>Gross Domestic Product</b>	<b>7.5</b>	<b>6.8</b>	<b>6.8</b>	<b>7.3</b>	<b>5.7</b>	<b>6.9</b>
(quarter-on-quarter growth)			2.6	1.5	0.6	2.0
Domestic demand	2.1	5.7	4.6	5.9	5.0	8.7
Private consumption expenditure	3.3	5.1	4.6	5.4	5.3	6.6
Government consumption expenditure	-3.1	0.3	-1.1	2.3	2.4	2.8
Gross domestic fixed capital formation	4.6	7.9	10.3	9.4	4.7	11.1
<i>Of which:</i>						
Building & construction	-8.4	-7.2	-10.1	-2.8	-2.6	5.3
Machinery & equipment	12.9	17.2	20.4	14.9	6.8	13.1
Change in inventories <sup>1</sup>	-0.8	0.2	-0.8	-0.2	0.2	1.0
Net exports <sup>1</sup>	5.7	2.1	3.0	2.5	1.5	-0.6
<i>Of which:</i>						
Exports of goods	11.2	10.2	8.9	11.7	8.2	11.3
Exports of services	11.3	8.7	8.9	9.0	8.9	10.9

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

Source: Census & Statistics Department.

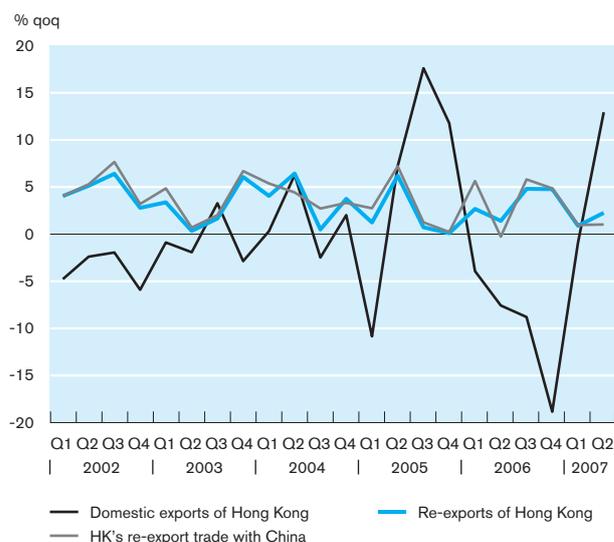
Forward-looking indicators pointed to continued business expansion in the third quarter of 2007. The Quarterly Business Tendency Survey for the third quarter suggested buoyant corporate sentiment in such components as business volume and hiring decisions. The PMI rose to 54.5 in August from 53.9 in July, as the new orders component remained strong. Consumer spending remained robust, with the volume of retail sales rising by 5.9% in July on a three-month-on-three-month basis after increasing by 2.5% in June, reflecting a sustained rise in the sales of consumer durables and in valuables.

## External trade

Growth in merchandise exports remained firm, benefiting from strong external demand and the robust trade performance of the Mainland. Quarter on quarter, seasonally-adjusted merchandise exports rose 2.8% in the second quarter following a rise of 0.9% in the first, as the growth of both re-exports and domestic exports gathered pace (Chart 2). The Mainland continued to be the key contributor to

export growth, while the US remained another major export destination. Following the strong revival in domestic demand, retained imports also expanded in the second quarter, reflecting a broad-based increase in the import of raw materials, food, and

CHART 2  
External trade



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

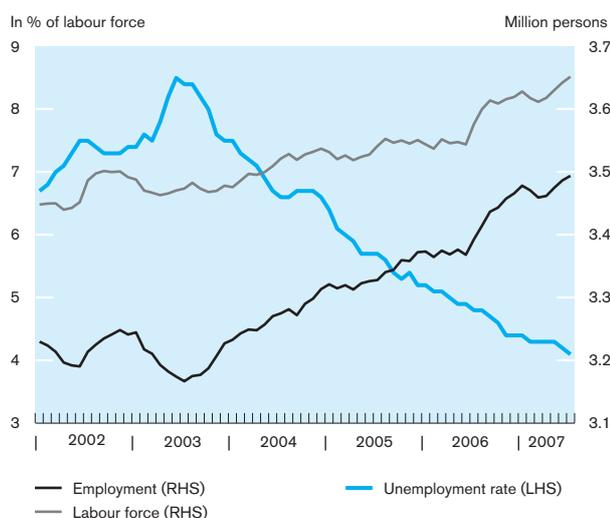
consumer goods. As imports grew faster than exports, the merchandise trade deficit widened to HK\$54 billion (15% of GDP) in the second quarter from HK\$40 billion (11% of GDP) in the first. The overall trade balance remained in surplus but fell to HK\$25 billion (7% of GDP) in the second quarter from HK\$41 billion (11% of GDP) in the previous one.

## Labour market and inflation

Labour market conditions continued to improve. The unemployment rate declined to a nine-year low of 4.2% in the second quarter from 4.3% in the first. Employment expanded at a robust pace, despite the entry of fresh graduates to the labour market in the summer (Chart 3). The rise in employment was most notable in financial and business services, and in the trade and tourism sector. The stronger labour market conditions have boosted labour earnings. Nominal wages increased by 0.7% quarter on quarter in the first quarter after growing by 0.5% in the fourth quarter of 2006. The nominal payroll per worker, which includes wages and other non-regular allowances and bonuses, declined by 0.8% in the first quarter after growing by 1.8% in the previous one.

CHART 3

### Labour market conditions

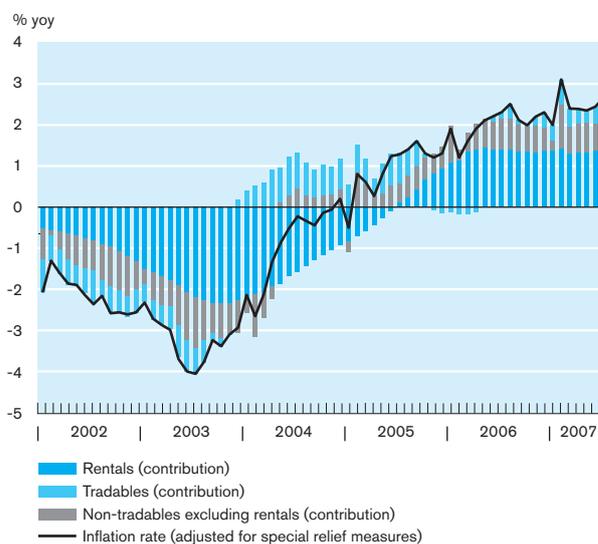


Source: Census & Statistics Department.

Consumer-price inflation edged up in recent months, reflecting a faster pace of increase in the price of imported foodstuffs and in residential rents. After adjusting for the waiver of public housing rents and the government rate concession, the Composite Consumer Price Index (CCPI) increased by 3.4% three months on three months (annualised) in July from 2.6% in June, led by a marked increase in the price of basic foods and in housing costs. The Mainland's meat and poultry prices have registered sharp increases in recent months and this is likely to have been passed through to Hong Kong. Compared with a year ago, CCPI inflation rose to 2.6% in July from 2.4% in June, as the increase in the prices of both tradables and non-tradables including rentals picked up (Chart 4). Overall, the underlying inflationary pressure remained contained. Excluding the rental component, core consumer price inflation rose to 1.6% three months on three months (annualised) in July from 0.9% in June.

CHART 4

### Consumer price inflation



Source: Census & Statistics Department and staff estimates.

## Asset markets

Local share prices staged a strong rally in the first half of 2007 but entered a volatile phase from the middle of July as global stock markets underwent a correction. Renewed concerns over problems in the US sub-prime mortgage market, including worries about a liquidity crunch in major credit markets and the unwinding of the yen carry trade, shook investor confidence and led to increased risk aversion. The Hang Seng Index fell to 19,386 on 17 August after having climbed to a high of 23,557 on 26 July. The index subsequently more than retraced its losses to reach 24,089 on 31 August, as global stock markets steadied somewhat. More importantly, domestic market sentiment was boosted by the announcement of a pilot scheme allowing Mainland individuals to invest directly in Hong Kong-listed stocks. In the face of rising market volatility, transaction volumes increased significantly. The average daily turnover in August was \$94 billion, 48% higher than that in the first seven months in 2007. Market capitalisation of the main board was \$17.6 trillion at the end of August.

The property market remained buoyant in the first half of 2007. Prices for all types of properties rose markedly during the period. Residential property prices increased by 10.6% year on year to an eight-year high in July, underpinned by a steady rise in household income and favourable labour market conditions (Chart 5). In the commercial property market, the prices of office and retail space also picked up to a nine-year high while the prices of factory space continued to increase steadily. The rise in property prices was accompanied by an increase in market activity, with the number of Sales and Purchase Agreements increasing by 31% in the second quarter.

CHART 5  
Asset prices



Source: Rating and Valuation Department and Reuters.

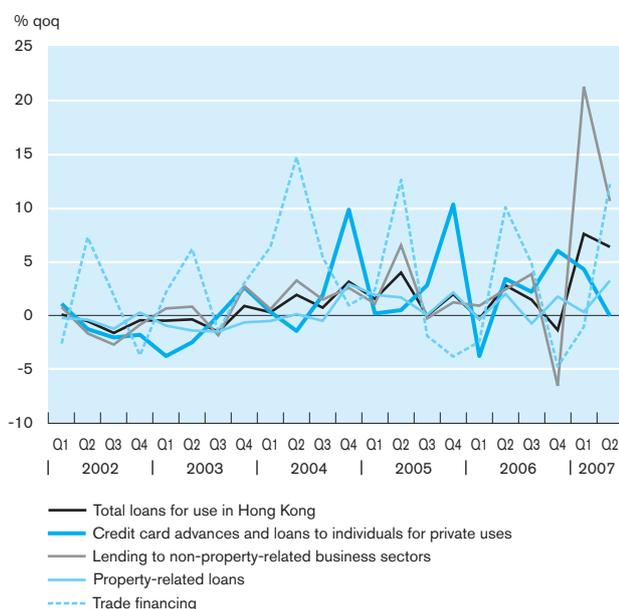
## Money supply and domestic credit

Both Hong Kong dollar narrow and broad monetary aggregates continued to expand in the second quarter, thanks to solid economic growth and buoyant stock market activities. Quarter on quarter, narrow money rose by 3.6% after growing by 6.3% in the first quarter. The moderation in M1 growth mainly reflected a high base of comparison associated with IPO activities at the end of the first quarter. Broad money also expanded by 8.3% after rising by 6.1% in the first quarter. Compared with a year ago, growth in broad money increased to 27.3%, up from 20.1% in the first quarter.

Growth in total deposits expanded to 7.3% quarter on quarter from 4.3% in the first quarter, as both Hong Kong dollar and foreign currency deposits increased at a faster pace. For Hong Kong dollar deposits, the expansion of liquid deposits (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 44% at the end of the second quarter. For foreign currency deposits, renminbi deposits increased notably by 9.4% in the second quarter, compared with 7.8% in the previous one. This in part reflected the issuance of the first renminbi-denominated bonds in Hong Kong.

Quarter on quarter, loans for use in Hong Kong grew by 6.4% in the second quarter after rising by 7.6% in the previous one. Analysed by economic uses, most types of loans increased quarter on quarter (Chart 6).<sup>2</sup> Lending to non-property-related business sectors grew at a faster pace than property-related lending. The former was mainly driven by strong growth in trade financing and lending to stockbrokers and financial concerns. Residential mortgages and loans to building, construction, property development and investment also rose. Compared with three months ago, the outstanding residential mortgage loans of authorized institutions rose by 1.2% after contracting by 0.1% in the first quarter. New loans drawn down grew by 35%, reflecting increased residential property transactions in the secondary market. Meanwhile, the average size of a newly approved mortgage loan was about HK\$1.8 million in the second quarter, slightly higher than the HK\$1.7 million in the first.

**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.

## Short-term outlook

The near-term outlook for the Hong Kong economy remains favourable, as the broad-based expansion is expected to continue in 2007. The Government revised upwards its projection for real GDP growth in 2007 to 5-6%, compared with the market consensus of 5.5%, in view of the strong first-half growth. Domestic demand is expected to be the key contributor to growth, supported by continued solid consumer and business spending. However, heightened uncertainty surrounding US economic growth could dampen the external demand for Hong Kong's exports.

Consumer price inflation is likely to pick up modestly in 2007, as higher food prices could continue to exert cost pressure, while robust domestic demand and strong labour market conditions may also add to upside risks. The Government's forecast for headline CCPI inflation in 2007 is maintained at 1.5%, lower than the market consensus of 2.0%. The benign inflation outlook takes into account the effect of the various one-off factors including the rates concession for two quarters and the public housing rental cut, and reflects the sustained increase in labour productivity and expansion in productive capacity.

The positive economic outlook is subject to a number of risks, mainly related to the recent resurgence of financial market volatility. There is a risk that heightened global financial market volatility could further weigh on domestic financial markets and weaken consumer sentiment, which could negatively affect private consumption. The broadening issues arising from US sub-prime mortgage difficulties have increased the uncertainty about near-term economic prospects in the US, which in turn could pose a downside risk to the external demand for Hong Kong's domestic exports and re-exports. The strength of further policy tightening in the Mainland in the face of a vigorous economy is also a risk factor, although the incremental nature of previous tightening efforts has not posed any stability issues for the real economy.

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