Domestic and external environment

by the Research Department

The global economy has bottomed out from the worst crisis since the Great Depression but the pace of recovery is slow, with signs of weakness lingering. In the US, GDP contracted in the second quarter but at a much slower speed compared with the first quarter, and the housing market showed further signs of stabilisation. In the euro area, sentiment indicators show the corporate sector is gaining more confidence in the economic outlook, but real economic indicators remain weak. Meanwhile, the Asian economies emerged from recession. While the Japanese economy expanded in the second quarter after a year of contraction, Mainland China saw a strong recovery as fiscal stimulus was transmitted to the real economy and the property market started to show signs of recovery. In Hong Kong, the economy rebounded more than expected in the second quarter, as exports normalised after the sharp downturn since the fourth quarter of 2008.

External environment

In the **US**, the recession moderated in the second quarter of 2009 with the preliminary estimate of real GDP contracting by 1.0% quarter on quarter (annualised) following a 6.4% decline in the first quarter. Private consumption fell by 1.0% and fixed investment by 13.5%. Inventories detracted from growth for the third consecutive quarter, taking 0.8 percentage points off real GDP growth while net exports contributed 1.4 percentage points as the trade deficit narrowed. This better-than-expected economic performance suggests that the economy could be bottoming out. However, a broad-based recovery is less likely in the near term given the fading of the boost from fiscal stimulus, the ongoing repair of household balance sheets, high unemployment, the overhang of housing supply and tight credit conditions.

Indeed, more recent data show continued economic weakness amid signs of stabilisation. In July consumer confidence remained weak although it had steadily improved since the beginning of the year. Non-farm payroll dropped by almost one million in the three months to July although the rate of decline is moderating, while the unemployment rate edged higher to 9.4% in July from 8.9% three months ago. The housing market downturn continued albeit at a slower pace, as existing and new home sales rose 3.8% and 5.2% three months on three months respectively in June, and the fall in house prices in 20 US metropolitan areas decelerated to 15.4% year on year in June from 18.7% three months ago. Business investment revealed signs of bottoming, with non-defence capital goods orders excluding aircraft rising 0.5% three months on three months in June, and the ISM manufacturing and non-manufacturing indices both edging closer to expansion territory in July than three months earlier. On the other hand, capacity utilisation lingered at low levels.

On the inflation front, price pressure continued to ease on high excess capacity and continued weakness in aggregate demand. Headline CPI inflation fell further on a year-on-year basis to -2.1% in July from -0.7% three months ago, while core CPI inflation edged lower to 1.6% from 1.9%. Credit conditions remained tight, with the Fed's July Senior

Loan Officer Survey showing the majority of US banks reporting tighter lending standards and weakened demand for loans. The Federal Open Market Committee maintained its target for the Federal Funds Target Rate at 0-0.25% at its 12 August meeting, and reiterated that low policy rates are likely to stay for some time. Quantitative easing remains in the pipeline, as the Fed would continue with its plan to purchase $1.25 trillion of agency mortgage-backed securities, $200 billion of agency debt, and $300 billion of Treasury securities.

In the **euro area**, the economy is slowly edging out of the recession. A flash estimate shows that real GDP declined by a smaller-than-expected 0.4% quarter on quarter (annualised) in the second quarter after shrinking by 9.7% in the first, attributable to a rebound in activity in Germany and France with both posting growth. Euro-area retail sales rose by 4.6% quarter on quarter in Q2 after a decline of 16.5% in Q1. Labour market conditions remained weak, with the unemployment rate rising to 9.4% in June from 9.0% in March. Industrial production fell 1.4% quarter on quarter in the second quarter, while industrial orders declined by 0.9% three months on three months in June. On sentiment indicators, the Purchasing Managers' Index (PMI) surveys showed some improvement, with the composite index rising to 47.0 in July from 41.1 three months ago, while the European Commission's economic sentiment indicator rose to 76.0 in July from 67.3 three months ago. The German ZEW and IFO indices both suggest rising optimism among businesses. Price pressures remained benign. The Harmonised Index of Consumer Prices inflation rate fell to -0.7% year on year in July, while the core price index rose 1.3%. The European Central Bank kept its refinancing rate unchanged at 1.0% at its August meeting, but reiterated its intention to continue with the programme to purchase a total of EUR60 billion of covered bonds.

In the **UK**, recent data suggest that the outlook for the economy is improving, with consumer confidence rising for the fourth consecutive month in July and retail sales rising 2.6% year on year in July. The service sector PMI broke above the breakeven 50 level and reached 53.2 in July. On inflation, headline CPI rose 1.7% year on year in July, down from 2.3% three months ago. The Bank of England kept the Bank Rate at 0.5% at its August meeting but expanded its Asset Purchase Facility by GBP50 billion to GBP175 billion, higher than the ceiling of GBP150 billion authorised by the Treasury in March.

The **Japanese** economy expanded in the second quarter after one whole year of contraction. Real GDP grew by 3.7% quarter on quarter (annualised), compared with a decline of 11.8% in Q1. The recovery was attributable to an improvement in consumer spending and exports. On a quarter-on-quarter (annualised) basis, consumer spending increased by 3.1%, adding 1.8 percentage points to the real GDP expansion. The increase reflected partly the effect of the JPY25 trillion fiscal-stimulus package and partly a rebound in consumer confidence. According to the Economic Watchers Survey conducted by the Cabinet Office, household confidence level rose to a 22-month high in June and remained strong in July. On the external front, exports increased by 12.3% quarter on quarter in volume terms, attributed substantially to a resurgence in demand from China. Latest business surveys also reflect an improvement in business conditions, with the PMI increasing to above the neutral 50 threshold in July for the first time since February 2008. Meanwhile, labour market conditions continued to worsen, with the unemployment rate rising to a six-year high at 5.4% in June. As excess capacity remained high, inflation pressure continued to be well contained, with the headline and core (excluding food and energy) CPIs declining in June by 1.8% and 0.7% year on year respectively. This downward trend is expected to continue in view of the strong yen and the large output gap. Equity price rose along with the revival of global financial markets. Further advances, however, will depend on the next round of corporate earnings results.

In **Mainland China**, economic recovery has been strong, mainly supported by public investments financed by the fiscal-stimulus package. Real GDP growth rebounded from 6.1% in Q1 to 7.9% in Q2 year on year. On a quarter-on-quarter basis, our estimate shows the annualised real GDP growth rate reached 17%. Growth was driven by the expansion in fixed-asset investment, which in Q2 reached RMB5.5 trillion, 35.9% higher than the same time last year. Strong growth in investment pushed up industrial production which expanded by 10.8% in July and 12.3% in August year on year. Fixed-asset investment growth moderated slightly to 30.0% in July and 33.6% in August, but market analysts expect the recovery in the property market will keep investment strong in the coming months. Retail sales remained stable and grew by 15.2% in July and 15.4% in August year on year, comparable to the rates in the previous two months. The strong growth momentum has led to stronger confidence in the corporate sector, as the PMI edged up to 54.0 in August from 53.3 in July, the sixth consecutive month that the Index showed expansionary signals. External demand remained weak, as exports contracted by 23.0% in July and 23.4% in August year on year, narrowing the trade surpluses. Nevertheless, the PMI export orders sub-index continued to improve in July and August, which indicates exports might recover somewhat in the coming months as the global economy improves.

Some early signs of inflationary pressure emerged in the Producer Price Index (PPI), while CPI inflation remained stable on a sequential basis. While the PPI inflation dropped by 7.9% in August year on year, the seasonally adjusted month-on-month PPI inflation turned positive, up by 0.9% in July and 0.4% in August, as commodity prices rebounded. The headline CPI inflation has been declining since March 2009 on a year-on-year basis, and fell by 1.2% in August. On a sequential basis, CPI inflation declined slightly in Q2 and rose by 0.4% in August. Monetary aggregates remained at high levels as the Mainland authorities maintained accommodative policy, but investors are concerned about the potential decline of liquidity going forward as new loans dropped from RMB1.5 trillion in June to RMB355.9 billion in July and RMB410.4 billion in August, heightening the uncertainty on credit supply in the coming months. The equity market rallied in Q2 but has undergone a sharp correction since early August as concerns on credit supply loomed. In line with strong domestic economic growth, net capital inflows of US$177.9 billion were recorded in Q2. Foreign reserves reached US$2.1 trillion in June. The RMB/US$ exchange rate has been broadly stable since the first quarter of 2009.

In the **NIE-3 economies**, latest available data show a strong rebound in activity. In Korea, real GDP grew by 9.7% quarter on quarter (annualised) in the second quarter. Private consumption, fixed investment and net exports all saw clear signs of improvement. In Singapore, real GDP rebounded by 20.7% quarter on quarter (annualised), thanks to a sharp spike in growth in the biochemical manufacturing cluster and, to a lesser extent, also in the electronics sector. The Taiwan economy expanded by 20.7% quarter on quarter (annualised), benefiting from a resurgence of merchandise exports. Overall, economic performance in terms of production and trade in the region has been impressive in the past few months, attributable to some extent to the sustained growth in demand from China. Inflation pressure was generally subdued with year-on-year headline CPI inflation remaining in the negative territory in Singapore and Taiwan, making a sharp reversal of the current accommodative monetary policy stance less likely in the rest of the year. Equities in the region staged a strong rally in June and July before the consolidation in August, while currencies have been relatively stable since June following a period of appreciation from March to May.

The **ASEAN-4 economies** also appear to be pulling out of the recession, with aggregate GDP expanding distinctly by 8.3% quarter on quarter (annualised) in the second quarter of 2009, after contracting for two consecutive quarters.[1] Exports rebounded strongly from low levels recorded in the first quarter, while industrial production also picked up. Consumer and investment spending have shown some signs of recovery, supported by fiscal stimuli, a return of confidence and positive wealth effect brought about by equity market rallies. Meanwhile, inflation

[1] The ASEAN-4 economies are Indonesia, Malaysia, the Philippines and Thailand.

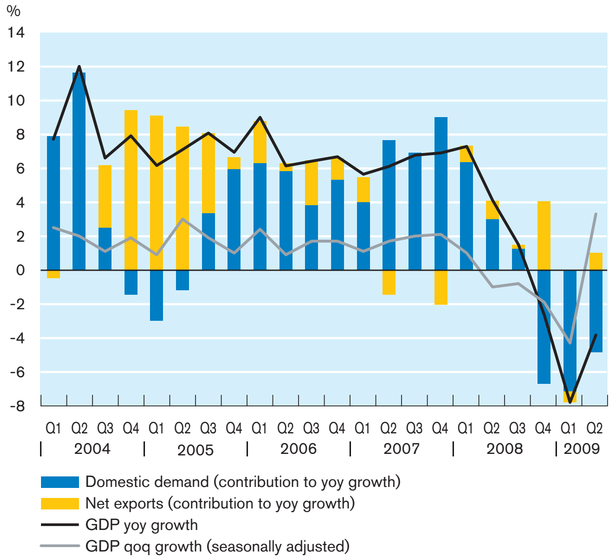
continued to subside in the region, with consumer prices recording year-on-year declines in Thailand and Malaysia. However, against the backdrop of continued quantitative easing by the large economies, some central banks in the region were wary of the longer-term outlook for inflation, prompting a more cautious stance in setting monetary policy. Indeed, central banks of Malaysia, the Philippines and Thailand have kept their policy interest rate unchanged at their recent monetary policy meetings. Bank Indonesia, which also noted growing price pressure, is the only central bank among the ASEAN-4 economies which eased monetary policy in August. In financial markets, the emergence of green shoots in the region has been fuelling rallies in the equity markets and underpinning regional currencies since March 2009.

Domestic activity

The domestic economy rebounded in the second quarter of 2009, probably marking an end to the worst recession since the Asian financial crisis. The seasonally adjusted real GDP grew by a surprisingly strong 3.3% quarter on quarter, after registering negative growth in the previous four quarters. On a year-on-year comparison, the contraction in real GDP also narrowed to 3.8% in Q2 from 7.8% in Q1 (Chart 1 and Table 1). A closer look at the second-quarter figures indicates that weak domestic demand accounted for the majority of the decline in the year-on-year real output growth rate, while net exports' contribution to the growth rate turned positive amid improving external environment.

CHART 1

Economic activity



Source: Census and Statistics Department.

TABLE 1

Real GDP growth by expenditure component (year on year)

(% yoy)	2007	2008	2008 Q3	2008 Q4	2009 Q1	2009 Q2
Gross Domestic Product	**6.4**	**2.4**	**1.5**	**-2.6**	**-7.8**	**-3.8**
(quarter-on-quarter growth)			-0.8	-1.9	-4.3	3.3
Domestic demand	7.9	0.8	1.5	-7.5	-8.1	-5.2
Private consumption expenditure	8.5	1.5	-0.2	-4.1	-6.0	-1.0
Government consumption expenditure	3.0	1.7	1.6	1.8	1.4	1.6
Gross domestic fixed capital formation	3.4	-0.5	2.9	-17.8	-13.7	-14.0
of which						
Building and construction	-0.3	1.6	-2.8	0.1	-10.9	-5.9
Machinery and equipment	3.0	-0.3	10.7	-21.1	-6.6	-18.0
Change in inventories[1]	1.0	-0.2	0.7	-0.8	-0.9	-1.3
Net exports[1]	-0.6	1.6	0.2	4.0	-0.6	1.0
of which						
Exports of goods	7.0	1.9	1.3	-4.9	-22.7	-12.4
Exports of services	14.1	5.7	4.8	0.4	-6.3	-5.7

[1] Percentage-point contribution to annual growth of GDP.

Source: Census and Statistics Department.

Following declines of 7.5% and 8.1% in the previous two quarters, domestic demand contracted less by 5.2% year on year in the second quarter. In particular, there was a turnaround in private consumption expenditure, which registered an increase of 4.0% on a seasonally adjusted quarter-on-quarter basis amid buoyant housing and equity markets. The year-on-year decline also narrowed significantly to 1.0% in the second quarter from 6.0% in the first quarter. Notwithstanding the advance in asset markets, private investment activities remained lacklustre, as business owners were still cautious under an uncertain business outlook, causing private spending on construction and equipment to fall by 10.6% and 19.0% respectively on a year-on-year basis. As a result, overall investment registered a 14.0% contraction, a magnitude similar to the 13.7% drop recorded in the previous quarter, despite a strong pickup in public investment spending.

Recent releases of economic indicators pointed to continuing improvement in the near-term economic conditions. In particular, the PMI rose above 50 in August, after staying inside the contraction zone for 13 consecutive months. Despite a decline in the number of inbound tourists, retail sales volume also increased by 1.6% in July on a three-month-on-three-month basis, reflecting the strengthening of consumption demand. The latest Quarterly Business Tendency Survey, on the other hand, indicates that surveyed respondents have turned less pessimistic towards the third quarter.

External trade

Merchandise trade stabilised somewhat in the second quarter as the external environment began to normalise with emerging signs of recovery in several economies, particularly China. Against this backdrop, total exports of goods fell in value terms at a slower pace of 12.9% year on year in Q2 after a marked drop of 21.9% in Q1, due to narrower declines of 12.0% in re-exports and 39.6% in domestic exports. On a seasonally adjusted quarter-on-quarter comparison, total exports of goods partly reversed its previous decline by rebounding 11.0% in Q2. A breakdown by export destination suggests that the turnaround in exports in Q2 was mainly attributable to China (Table 2). Meanwhile, decline in exports of services narrowed slightly in value terms to 12.1% year on year in Q2 from 13.1% in Q1, due to stabilising external demand for financial and trade-related services. With imports of goods and services growing faster than their export counterparts, the surplus in the overall trade account declined to HK$30.4 billion (7.7% of GDP) in Q2 from HK$40.4 billion (10.6% of GDP) in Q1.

TABLE 2

Merchandise exports in value terms by major market[1]

(% yoy)	Share[2] (%)	2007	2008	2008		2009	
				Q3	Q4	Q1	Q2
Mainland China	48	13	5	4	-2	-24	-5
United States	13	-1	-2	1	-7	-21	-21
European Union	14	6	6	10	-1	-18	-22
ASEAN5[3] + Korea	7	9	9	3	11	-32	-25
Japan	4	-1	1	3	4	-13	-18
Taiwan	2	2	4	5	0	-26	-6
Others	12	18	14	17	-9	-17	-18
Total	**100**	**9**	**5**	**6**	**-2**	**-22**	**-13**

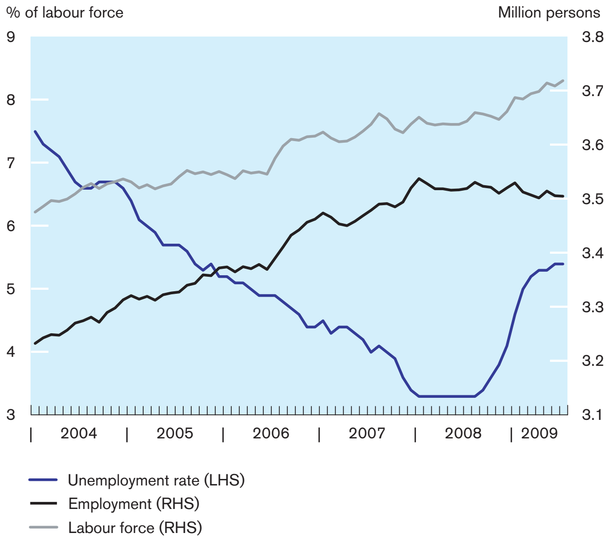
[1] Within the total, re-exports accounted for 97% in 2008.
[2] Share in 2008.
[3] ASEAN5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand.

Sources: Census and Statistics Department, and CEIC database.

Labour market and inflation

Domestic labour market conditions remained unfavourable in general, despite the pickup in the broader economy. In particular, the number of unemployed persons rose by 15,800 from Q1 to 203,000 in Q2, as the pace of job creation lagged behind the expansion in the labour force. As such, the seasonally adjusted unemployment rate edged up to 5.4% in Q2 from 5.2% in Q1 (Chart 2). Sectoral data also indicate that, with the exception of the transport sector, the unemployment rate increased among all sectors moving into the second quarter. That said, the rise in the overall unemployment rate since the outbreak of the current financial crisis has been less severe than the downturn in 2001-2003. This in part reflects that employers have resorted to compulsory no-pay leave as an alternative to layoffs. On the other hand, labour income moderated amid worsened labour market conditions, with the nominal payroll per person dropping by 0.2% year on year in Q1 after falling by 2.1% in the previous quarter.

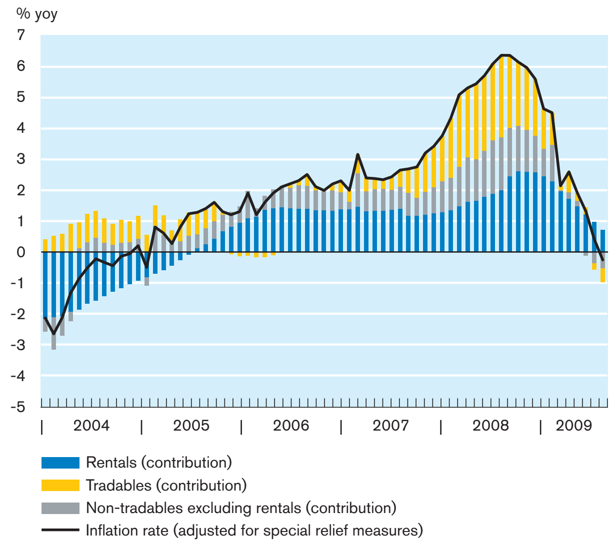
CHART 2
Labour market conditions



Source: Census and Statistics Department.

Weak domestic demand and soft import prices have translated into easing inflationary pressure. After netting out the effects of government relief measures, the year-on-year underlying inflation rate moderated to 1.2% in the second quarter from 3.1% in the first quarter, which can be attributed to lower food and rental-cost inflation (Chart 3). On a quarter-on-quarter annualised comparison, underlying inflation rate fell further to -1.2% in the second quarter from -0.9% in the first quarter. Excluding basic food and energy, the core inflation rate also dropped to -1.0% in the second quarter from -0.2% in the first quarter.

CHART 3
Consumer-price inflation



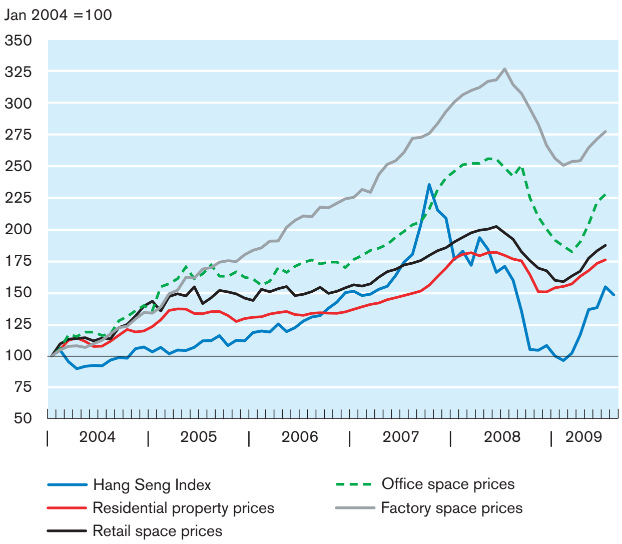
Sources: Census and Statistics Department, and staff estimates.

Asset markets

The local equity market started the third quarter on a weak note but then rallied on hopes of global economic recovery, particularly with the release of better-than-expected economic data. After falling to a six-week low of 17,255 on 13 July, the Hang Seng Index bounced up again and hovered above the 20,000 level for most of August. Capital inflows remained strong while equity initial public offering (IPO) activities somewhat revived. However, the bullish market trend was hindered by the relatively high price-earnings valuations of most stocks. Concerns over monetary tightening on the Mainland and the pace of recovery of the industrialised economies also weighed down the local equity market. As a result, the Hang Seng Index fell in the second half of August to close the month at 19,724, albeit 7.3% higher than that at the end of June. The average daily turnover fell slightly to HK$69 billion in July-August from HK$71 billion in the second quarter.

Property prices broadly picked up in the second quarter of 2009 amid the low interest rate environment and an improvement in local economic outlook. For the second quarter as a whole, residential property prices rose by 8.1% quarter on quarter (Chart 4). Transaction volume also surged markedly by 115% in the second quarter after growing by 30.0% in the first quarter, in part due to an increased supply in the primary market and a vibrant secondary market. Strong demand from Mainland buyers also contributed to the buoyant housing market activity. Despite the elevated house prices and a rapid growth in transaction volume, housing affordability remained at a healthy level, while the negative buy-rent gap was little changed. In the commercial property market, underpinned by a rebound of rents and improved business conditions, prices of office space rose sharply by 9.8% quarter on quarter in the second quarter, while prices of retail premises and factory space increased by 9.5% and 3.9% respectively over the same period.

CHART 4
Asset prices



Sources: Rating and Valuation Department, and Reuters.

Money supply and domestic credit

Growth in Hong Kong-dollar narrow and broad monetary aggregates accelerated in the second quarter alongside a rebound in economic activity and an inflow of funds. Seasonally adjusted narrow money increased by 13.9% during the quarter, higher than the 9.4% expansion in Q1. Faster growth in narrow money partly reflected stronger transaction demand that was associated with stock market trading and increased activity in equity IPOs. Broad money grew further by 6.0% in Q2, following a rise of 1.3% in Q1. Larger inflows of funds into the Hong Kong dollar and a revival of lending activity were major reasons for the acceleration in broad money growth.

Total deposits bounced back during the second quarter as Hong Kong-dollar deposits continued to climb and foreign-currency deposits rebounded. Reflecting the inflow of funds and an increase in Hong Kong-dollar loans, Hong Kong-dollar deposits grew by 6.6% in the second quarter, after a 1.4% rise in Q1. The shift from time deposits to liquid deposits continued as time-deposit interest rates were near zero. Some depositors might also maintain sufficient liquidity to take advantage of investment opportunities in the local stock market. Renminbi deposits in Hong Kong picked up to RMB54.4 billion at the end of June from an 11-month low of RMB53.0 billion at the end of April, partly because some investors reportedly positioned for renminbi bond investment in June and July.

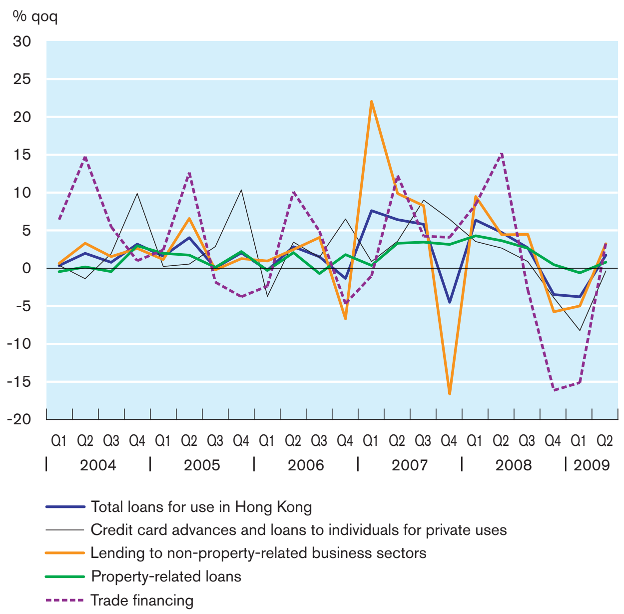
After contracting in the previous two quarters, total loans and advances recovered in the second quarter of 2009. In line with a positive quarter-on-quarter increase in nominal GDP, loans for use in Hong Kong[2] rebounded by 1.7% during the quarter. Analysed by economic use, growth in trade-financing

[2] Including trade-financing loans.

loans turned positive on the back of improving external trade performance (Chart 5).[3] Lending to non-property-related business sectors also picked up, partly attributed to a marked increase in loans for stockbrokers alongside a buoyant stock market and increased activity in equity IPOs. As the residential property market continued to recover and banks lowered their effective mortgage interest rates for newly approved loans, property-related loans also grew. Survey data also suggest that more customers chose HIBOR-based mortgage products to take advantage of low interbank interest rates. The proportion of new mortgage loans priced with reference to rates other than the best lending rate (mostly HIBOR) increased to 39.8% in June from 29.5% in March. As Hong Kong-dollar loans increased at a slower rate than deposits, the Hong Kong-dollar loan-to-deposit ratio declined further to 72.1% at the end of June, down from 75.5% three months ago.

CHART 5

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.

[3] Data on loans for use by economic sector are available only on a quarterly basis.

Short-term outlook

The near-term economic prospect has improved following the upbeat outturn in the second quarter, and a moderate recovery will probably take hold for the second half of the year. In particular, external demand may gather some momentum as "green shoots" is becoming more apparent in many economies, to a large extent due to the timely and sizable stimulus measures implemented. Domestic demand, on the other hand, will benefit from the improvement in the outlook and advance in asset prices amid accommodative monetary environment, although the extent of improvement will be restrained by the still-rising unemployment. Against this backdrop, the Government revised upward the real output growth forecast for 2009 to -3.5 to -4.5%, which is in line with the latest market consensus of -4.0%, and represents a two-percentage-point increase from their previous projection.

Domestic inflationary pressure is likely to remain subdued, and consumer-price inflation may stay in the negative territory for a while. In particular, worsened labour market conditions will hold down nominal wages and payroll, easing cost pressure from the supply side. Stabilising food and commodity prices together with excess capacity worldwide will also contain import-price inflation. The official forecast is that the underlying inflation will remain weak at 0.9%, while the corresponding figure for the headline inflation is 0.5%.

A number of risks and uncertainties relating to the external and domestic environment deserve attention:

Externally, recent real economic indicators still point to a relatively tepid path of global recovery, and the risk of a double-dip in developed economies cannot be ruled out. In particular, the recent rebound was partly driven by restocking after massive destocking process in 2009 Q1, and it is still unclear how persistent the recovery can be as unemployment remained at high levels in major economies. Yet global equity markets have already made significant advances since March 2009 and are now ahead of economic fundamentals. If market expectations were correct, the current policy environment could turn out to be too accommodative that fuel inflationary pressures. However, if market expectations were wrong, then there is a risk of another major correction and loss of confidence, dragging down economic growth.

In addition, financial markets and economic commentaries have become increasingly concerned about the expanded central bank balance sheets, and the deterioration of fiscal balances resulting from the adoptions of unconventional quantitative easing and aggressive fiscal-stimulus packages in major economies. If the subsequent exit strategies of the authorities turned out to be ill-timed, unfavourable market reactions might be triggered and the recovery processes could be disrupted.

Domestically, the repeated triggering of the strong-side Convertibility Undertaking and the ensuing sharp expansion in the Aggregate Balance signal strong inflows into the Hong Kong dollar. The resultant loose monetary environment may heighten the risks of asset-price and consumer-price inflation through the expectation and credit channels. At present, the accommodative monetary environment is conducive to recovery when the economy is still in the early stage of rebound and credit growth remains weak. However, inflation risks may rise if Hong Kong recovers sooner than the US on the back of a strong recovery of the Mainland economy, and the Fed's monetary policy remains loose for an extended period of time.

There is also risk of a sudden and disorderly reversal of fund flows in the future, leading to volatilities in the asset markets and the real economy. Possible catalysts for reversal of fund flows include (a) a sell-off in the Hong Kong stock market amid investors' disappointment on corporate earnings or pace of recovery in Hong Kong or the Mainland; (b) increased global risk aversion leading to a flight from risky assets; and (c) a revival in carry trades if the US economy recovers and the Fed starts tightening to dampen inflationary pressure. Judging by the relatively strong performance of the financial markets in both Hong Kong and the Mainland, the probability of materialising the risk is expected to be low. But vigilance is still warranted given the fickle external environment.