REGULAR ARTICLE

Domestic and external environment

by the Research Department

The global economic recovery accelerated further in the first quarter, albeit increasingly at uneven speeds across major continents. The US economy has been growing faster than Europe where the outlook is clouded by uncertainties over the sovereign debt problems. Growth in the Japanese economy also gathered momentum in the first quarter but deflation remains a concern. In contrast, signs of inflation are emerging amid strong growth in the rest of Asia. The Mainland economy expanded further in the past few months, while inflationary pressures and uncertainties surrounding the property market may pose challenges ahead. The Hong Kong economy also continued to grow strongly in the first quarter, accompanied by incipient inflationary pressures and moderating unemployment rate.

External environment

The **US** economic recovery was sustained with a broadening expansion of 3.2% in the first quarter, following a stronger-than-expected 5.6% quarter-on-quarter annualised real GDP growth in the final quarter of 2009. Despite the slower momentum, the first quarter saw a significant pick-up in domestic final demand and a more broadly-based economic expansion driven by consumer spending and business investment (equipment purchase), as opposed to the previous quarter during which growth was mainly propelled by restocking. Consumer spending, business investment and the housing market continued to improve, and the more forward-looking surveys and sentiment indicators suggest that confidence among consumers and businesses has reached a post-crisis high. In particular, consumer spending continued to defy the gravity of weak labour market, modest income growth and lower housing equity, with retail sales rising faster than expected by 2.4% three month on three month in April and the Conference Board's measure of consumer confidence also rose strongly in the second straight month to 57.9 in April. Meanwhile, despite an increase in the unemployment rate to 9.9% in April from 9.7% in January, non-farm payrolls saw widespread and stronger-than-expected gains of 559,000 jobs in the three months to April, compared with the loss of 31,000 jobs in the prior three months. The increase in the unemployment rate actually reflected the renewed optimism on the part of workers, where more people were starting to look for work again. The business outlook continued to improve, as durable goods orders rose by 5.8% three month on three month in March and orders for non-defence capital goods excluding aircraft, a proxy for business investment, rose by 1.9%. On the more forward-looking surveys, the ISM manufacturing index rose to 60.4 in April from 58.4 in January, while the ISM non-manufacturing index rose to 55.4 in April from 50.5 three months ago.

The housing sector also showed signs of bottoming out. House prices as measured by the S&P/Case-Shiller house price index for 20 metropolitan areas increased by 0.6% in February, the first year-on-year increase since December 2006. Although sales of existing homes fell by 1.7% compared with three months ago, sales actually rebounded strongly by 6.8% month on month in March. The surge in sales reflects a rush for homebuyers to qualify for first-time or repeat tax credits, low mortgage rates and falling house prices, which have now returned to the 2003 levels. On prices, US inflation remained subdued. The headline

CPI rose by 2.2% year on year in April, while the core CPI rose by 1.0%. The Federal Open Market Committee maintained its target for the fed funds rate at 0 - 0.25% at its April meeting, reiterating that the exceptionally low levels of federal funds rate are likely to stay for an extended period.

In the **euro area**, the economy grew at a modest quarter-on-quarter annualised 0.2%, in the first quarter after the downward adjustment of the 2009 Q4 real GDP growth to a stagnant 0.04%, suggesting that the recovery remained fragile and the economy still faced considerable headwinds. Retail sales stayed flat with a 0.03% three-month-on-three-month increase in March, amid weak labour market conditions as the unemployment rate rose to 10% in March from 9.9% three months ago, the highest since 1998. Industrial production rose by 3.8% three month on three month in March with industrial orders registering a 4.0% increase. Despite the weak economic data and growing concerns over the European sovereign debt problems, sentiment and other forward-looking indicators continued to suggest an improving outlook. Both the European Commission's economic confidence index and the German IFO index on business confidence rose to their highest levels since May 2008, while the composite Purchasing Managers' Index (PMI) rose to 57.3 in April, the highest since August 2007. Inflationary pressures stayed mild in view of the excess capacity in the economy. While the headline Consumer Price Index (CPI) rose by 1.5% year-on-year in April, core CPI inflation stayed subdued at 0.8%. The European Central Bank kept the benchmark interest rate at 1.0% at its April meeting, noting that price developments are expected to stay subdued and that inflation expectations remained anchored.

In the **UK**, first-quarter GDP grew at a slower pace of 0.2% quarter-on-quarter annualised compared with 0.4% in the previous quarter. The recovery remains fragile with the growth in retail sales dropping to a moderate 0.2% three month on three month in April from 0.7% three months ago. Labour market conditions remained weak, with the unemployment rate rising to 8% in the three months to March, its highest level since 1996. On prices, the headline CPI inflation climbed to 3.7% year-on-year in April from 3.4% in January. At its April meeting, the Bank of England kept the bank rate at 0.5% and maintained the now-completed programme of asset purchases at £200 billion.

Recovery has gathered stronger momentum and become more broadly-based in **Japan**. Real GDP grew by 4.9% quarter-on-quarter annualised in the first quarter after registering a 4.2% growth in the previous quarter. While strong demand from rapidly rebounding Asian neighbours stimulated Japan's exports, domestic consumption and investment also picked up during the quarter. Robust external demand also boosted the production sector, leading to a moderate increase in demand for labour. The unemployment rate edged slightly lower to 5.1% in April from 5.2% in December 2009. Against the backdrop of improved labour market conditions, latest private consumption indicators such as household spending and retail sales have registered solid growth. Sentiment indicator readings suggest that businesses have also become less pessimistic, reflecting stronger confidence in the sustainability of the economic recovery. Meanwhile, prices continued to decline, with headline and core (excluding food and energy) CPIs decreasing by 1.2% and 1.6% year on year in April respectively, prompting the Bank of Japan to reaffirm its fight against deflation in its recent policy statements. Nonetheless, since the output gap is not expected to narrow significantly in the near term, deflation may continue for some time. The Japanese yen traded between 88 and 93 JPY/USD in the first quarter, weakening slightly from the previous quarter. Looking forward, the strong yen, coupled with the uncertainties of the momentum and duration of deflation, will continue to slow recovery.

The **Mainland** economy expanded further in the past few months. Real GDP growth accelerated to 11.9% year on year in the first quarter, partly reflecting the base effect. Private fixed-asset investment grew by over 30% year on year in the same period, about nine percentage points above the investment growth by the state-owned sector. External trade continued to improve, with exports rising by 28.7% year on year in the first quarter, compared with an even stronger increase in imports of 64.6% owing to the strengthening domestic demand and the rising import prices. As a result, the trade balance narrowed substantially to US$14.5 billion in the first quarter from US$61.4 billion in the previous quarter.

The year-on-year growth in both broad money (M2) and financial institution loans continued to decline in the past few months, but remained high by historical standards, registering 21.5% and 22.0% respectively in April. Year-on-year headline CPI inflation touched 2.2% in the first quarter partly owing to the base effect, and rose to 2.8% in April. In the meantime, the Producer Price Index inflation has been trending up year on year and posted 6.8% in April, mainly driven by rising commodity prices. Strong economic growth, accommodative monetary conditions and increasing upstream prices point to upward pressures on inflation in the period ahead. In order to mop up abundant liquidity in the banking system, the People's Bank of China has been actively engaging in open market operations and raised the reserve requirement ratio further by 50 basis points effective 10 May after two hikes earlier this year. Meanwhile, the persistent rise in property prices raised concerns over potential asset price bubbles and triggered a series of new policy measures to rein in speculative activities in the property market in mid-April. Property turnovers in major cities plummeted after the announcement of these measures, but it remains to be seen to what extent property prices can be stabilised. Given the strong linkages between the real estate sector and other industries, abrupt corrections in property prices could cloud the prospect of investment growth.

The rest of **East Asian** economies continued to steam ahead, with growth strengthening in the first quarter. For the region as a whole[1], real GDP registered an 11.0% quarter-on-quarter annualised growth, up from 7.8% in the final quarter of 2009. In Korea, real GDP grew by 8.8% quarter-on-quarter annualised, after taking a breather in the previous quarter. Manufacturing production was the main driver, fuelled by robust external demand. In Singapore, real GDP expanded remarkably by 38.6% quarter-on-quarter annualised, backed by a sharp revival of the manufacturing sector which was in turn supported by external demand for electronics and pharmaceuticals. In Taiwan, real GDP increased by 11.3% quarter-on-quarter annualised, led by strong growth in private investment. In Thailand, real GDP increased by 16% quarter-on-quarter annualised. It appears that the effects of anti-government protests on the economy have yet to show up in the first quarter figures, but are expected to take a toll on the economy in the second quarter. For the rest of the region, exports increased appreciably in the first quarter, accompanied by solid growth in production and consumer spending. Robust real activity has spurred labour demand in Korea and Singapore, with the unemployment rate declining to 3.7% in April for Korea and 2.2% in March for Singapore. Going forward, it is widely expected that the global inventory restocking will remain supportive of the region's exporters in the near term, though at a diminishing rate. Meanwhile, the stimulatory effect of fiscal measures will also subside.

On the price front, growing demand has led to a rise in inflation across the region. Economies that experienced year-on-year declines in their consumer prices during 2009 have all seen price increases since late 2009 or earlier 2010. In April the year-on-year increase of consumer prices of the regional economies averaged at 2.8%, with that of Indonesia and the Philippines staying above 3.5%. The recent increases in global food and commodity prices are likely to add to the upside risk of inflation in the region, putting pressure on central banks to normalise their monetary and fiscal policies. Bank Negara Malaysia raised its policy rate twice in March and May. The Monetary Authority of Singapore also tightened monetary by allowing its currency to appreciate in April. Meanwhile, other central banks in

[1] Including Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand; weighted by GDP valued at purchasing power parities.

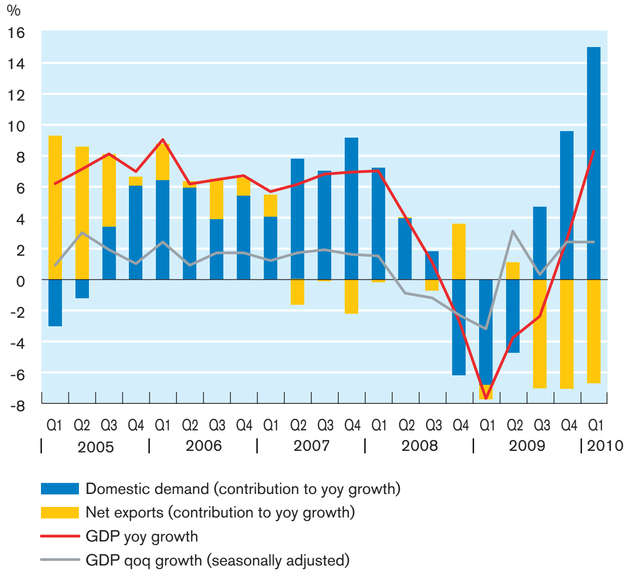
the region are gradually withdrawing their extraordinary liquidity measures introduced during the global financial crisis. In the foreign exchange market, Asian currencies generally strengthened against the US dollar in the earlier months before settling back in recent weeks, while equity markets saw investors moving back to the sideline amid the intensified sovereign debt problems in Europe.

Domestic activity

The Hong Kong economy recorded another quarter of strong economic growth. The seasonally adjusted real GDP grew at a decent quarterly rate of 2.4% in the first quarter, maintaining the growth pace of the previous quarter. On a year-on-year basis, the growth momentum accelerated considerably to 8.2% in Q1 from 2.5% in 2009 Q4 and -2.4% in 2009 Q3 (Chart 1 and Table 1), with strong domestic demand continuing to be the main driver of economic growth. In particular, domestic demand contributed a sizable 14.9 percentage points to the year-on-year real GDP growth rate in Q1, driven by vibrant private consumption, inventory accumulation, strong pick-up in fixed capital formation and increased government consumption. On the external front, net exports of goods remained a drag on economic growth, offsetting the boost from services trade. Consequently, overall net exports reduced the year-on-year real GDP growth by 6.7 percentage points in Q1.

CHART 1

Economic activity



Source: Census and Statistics Department (C&SD).

TABLE 1

Real GDP growth by expenditure component (year on year)

			2009			2010
(% yoy)	**2008**	**2009**	**Q2**	**Q3**	**Q4**	**Q1**
Gross Domestic Product	**2.2**	**-2.8**	**-3.8**	**-2.4**	**2.5**	**8.2**
(quarter-on-quarter growth)			3.1	0.3	2.4	2.4
Domestic demand	1.6	0.9	-5.0	5.3	11.1	16.4
Private consumption expenditure	2.4	-0.4	-0.6	0.6	4.8	6.5
Government consumption expenditure	1.8	2.4	2.6	3.4	2.0	3.5
Gross domestic fixed capital formation	0.8	-1.8	-11.8	3.2	14.1	10.5
of which						
Building and construction	6.1	-0.5	-2.4	5.4	1.3	-2.1
Machinery and equipment	-0.8	-2.6	-16.6	-2.1	16.2	12.1
Change in inventories[1]	-0.3	1.2	-2.1	3.4	4.2	8.4
Net exports[1]	0.7	-3.6	1.1	-7.0	-7.0	-6.7
of which						
Exports of goods	1.9	-12.7	-12.8	-13.2	-2.9	21.6
Exports of services	5.0	0.3	-3.8	0.8	8.9	17.9

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

Source: C&SD.

Domestic demand continued to be a bright spot of the economy in the first quarter, with the year-on-year growth rate accelerating further to a strong 16.4% from 11.1% and 5.3% in the previous two quarters (Table 1). A closer look at the figures suggests that the strengthening of domestic demand was broad-based. In particular, private consumption expenditure bounced up markedly by 6.5% in Q1 from 4.8% in 2009 Q4, amid improved labour market conditions and firmer consumer sentiment. Nevertheless, on a seasonally adjusted quarter-on-quarter comparison, private consumer expenditure did not grow in Q1. On fixed capital formation, private sector investment rose by 8.4% year-on-year in the first quarter of 2010, benefiting from the improved economic outlook and business sentiment. Meanwhile, public investment increased strongly by 22.7% year on year as several infrastructure projects started. Strong government spending on investment, coupled with a 3.5% increase in government consumption over the year, manifests Government's continued efforts in supporting economic growth.

Moving into the second quarter, the domestic economic environment remained upbeat according to recent releases of economic indicators. The PMI stayed above 50 for 10 consecutive months, signalling expansionary domestic economic activity in the near term. Private sector sentiment also remained positive, with the latest Quarterly Business Tendency Survey indicating a more optimistic business outlook in Q2 compared with Q1 for all surveyed sectors. Retail sales volume increased by 0.1% three month on three month in April, driven by strengthened consumer sentiment and inbound tourism.

External trade

The continued improvement in the global economic environment has been translated into sequential improvement in merchandise trade. After staying in negative territory for five quarters, the year-on-year growth rate of merchandise exports (in real terms) reverted to a positive 21.6% in the first quarter. The seasonally adjusted quarter-on-quarter growth momentum also strengthened to 8.4% in Q1 from 7.3% in the previous quarter. Analysed by export destinations, strong intra-Asia trade was an important driver of exports growth in Q1, with exports to Mainland, Taiwan, and ASEAN and Korea combined growing at materially faster paces than those to the US and the European Union (Table 2). That said, underpinned by vibrant domestic demand, the strong growth in merchandise exports in Q1 was still outpaced by their imports counterpart, with the year-on-year and the seasonally adjusted quarter-on-quarter growth rates in merchandise imports being higher at 28.0% and 10.3% respectively in Q1.

TABLE 2

Merchandise exports in value terms by major market[1]

(% yoy)	Share[2] (%)	2008	2009	2009 Q2	2009 Q3	2009 Q4	2010 Q1
Mainland China	51	5	-8	-5	-8	4	40
United States	12	-2	-21	-21	-24	-16	4
European Union	12	6	-20	-22	-26	-15	-1
ASEAN5[3] + Korea	7	4	-20	-25	-18	-3	33
Japan	4	1	-10	-18	-8	-2	13
Taiwan	2	4	-1	-6	3	25	72
Others	12	18	-13	-18	-18	0	19
Total	**100**	**5**	**-13**	**-13**	**-14**	**-2**	**26**

[1] Within the total, re-exports accounted for 98% in 2009.
[2] Share in 2009.
[3] ASEAN5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand.

Sources: C&SD and CEIC database.

The improved external environment has also benefited services exports. Following a 8.9% year-on-year increase in the final quarter of 2009, exports of services grew further at an accelerated pace of 17.9% in Q1, helped by double-digit growth in all major components. In particular, exports of merchanting and trade-related services rose by 18.8% in Q1, on the back of reviving world trade in goods. Likewise, exports of transportation services rose by 15.8% in Q1. Exports of travel services also rose remarkably by 20.0%, owing to thriving inbound tourism. On the other hand, exports of financial, business and other services increased by 17.8% year-on-year, as global financial market activities picked up alongside improving economic fundamentals and outlook. Similar development was observed in the imports of services account in Q1, but with the overall and all major components of imports of services growing at lower paces than the corresponding export counterpart.

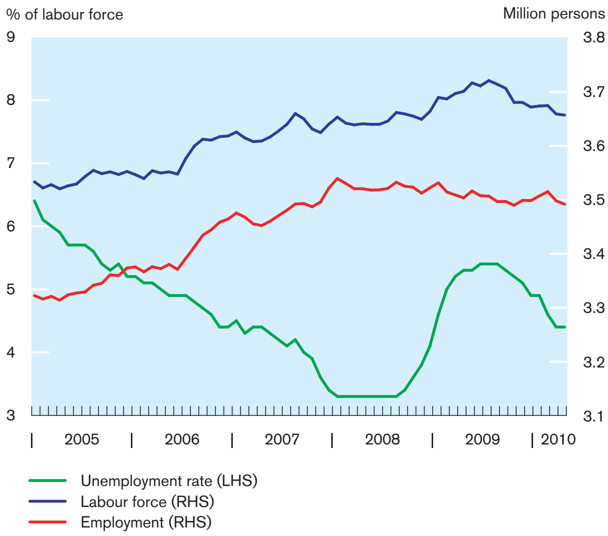
Overall, the nominal trade balance registered a surplus of HK$7.2 billion (1.7% of GDP) in the first quarter, narrowing from a surplus of HK$32.3 billion (7.3% of GDP) in the previous quarter.

Labour market and inflation

Recent development in the labour market was favourable in general. After peaking at 5.4% in June 2009, the seasonally adjusted three-month moving average unemployment rate lowered progressively, reaching 4.4% in April (Chart 2). Hiring sentiment also improved further moving into Q2 according to the latest Manpower Survey, while vacancies in the private sector also increased by 7.5% year on year in the last quarter of 2009 according to the Quarterly Survey of Employment and Vacancies. That said, the pace of job growth was somewhat lacklustre in recent months, with total employment (non-seasonally adjusted) registering some declines alongside the labour force after February. On the other hand, improved labour market conditions have led to some rises in labour income, with the nominal payroll per person edging up moderately by 0.9% year on year in 2009 Q4, following an increase of 2.1% in the previous quarter.

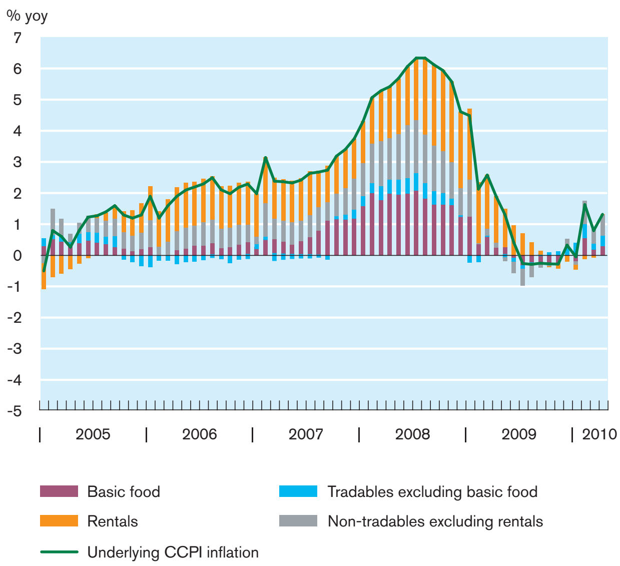
Inflationary pressures in the economy have resurfaced, alongside upbeat economic activity and improving labour market conditions. The year-on-year underlying inflation rate zigzagged upward to 1.3% in April from a trough of -0.3% recorded in July to November 2009 (Chart 3). An uptrend was also observed in the three-month-on-three-month annualised underlying inflation rate, which rose to 3.1% in April from a recent-low of -1.4% in August 2009. Analysed by

CHART 2
Labour market conditions



Source: C&SD.

CHART 3
Consumer price inflation



Sources: C&SD and staff estimates.

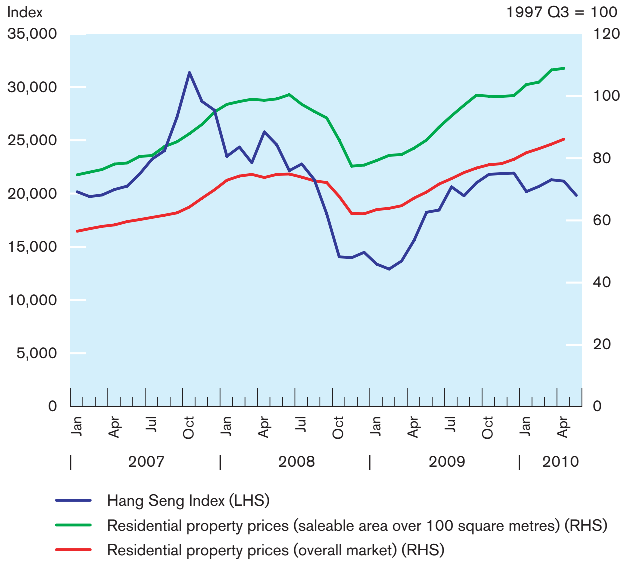
component, rental costs increased in recent months, but the magnitude was modest compared with other CCPI components such as food costs. Nevertheless, the rental components are expected to increase more notably in the rest of 2010, given that market rentals for new leases have bounced up materially since the second quarter of 2009.

Asset markets

Stock market volatility heightened over the last few months. After some adjustments in early 2010, local share prices were briefly buoyed in March and early April by the upbeat US economic data and the expectation of a possible appreciation of the renminbi, with the Hang Seng Index reaching a four-month high of 22,208 on 9 April (Chart 4). Thereafter, risk appetite of equity investors steadily lost steam due to rounds of new policy measures on Hong Kong and Mainland property markets, and the news of fraud charges against Goldman Sachs. Investor confidence was further hammered by the worsened Greece's fiscal crisis. Consequently, the Hang Seng Index fell to 19,765 at the end of May. On the other hand, the average daily turnover increased to $67.7 billion in April and May from $64.2 billion in the first quarter of 2010.

The property market stayed buoyant in general. To foster healthy development of the residential property market, the Government unveiled in the 2010/11 Budget a new series of measures on the property market. Nevertheless, the property market showed few signs of cooling down after then, with residential property prices rising by 5.8% quarter on quarter in Q1. In particular, prices in the upper-middle and luxury segment (flats with a saleable area over 100 square metres) continued to climb and reached new highs. Transaction volume also expanded by 20.0% quarter on quarter in Q1. In view of the still-buoyant property market, the Government announced further measures in April and May to promote transparency in the sale of first-hand flats. It was reported that transaction volume declined quite materially following the announcement of the new guidelines, while the Centa-City Leading Index indicated some consolidation of property prices in May.

CHART 4
Asset prices



Sources: Rating and Valuation Department, and CEIC database.

Money supply and domestic credit

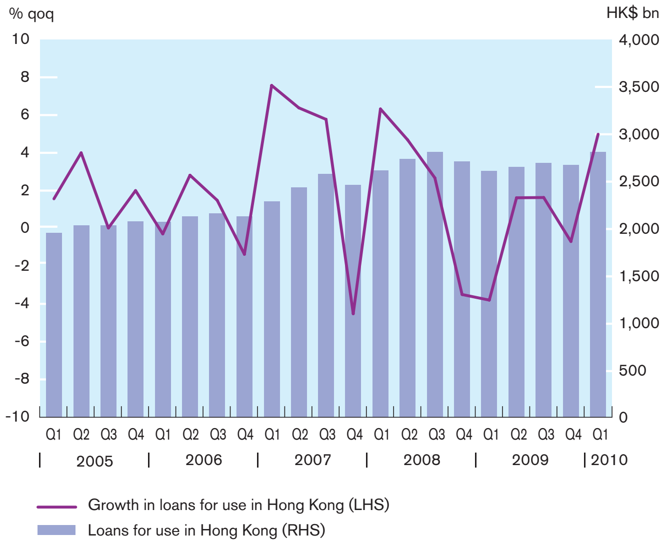
Hong Kong-dollar monetary aggregates expanded in the first quarter, underpinned by improving economic activity and a rebound in loans. Broad money grew by 0.5% after declining by 0.3% in the previous quarter. Analysed by the asset-side counterparts of Hong Kong-dollar M3, the increase in broad money was mainly driven by domestic credit. Narrow money rose at a much faster rate, by 4.8% in Q1. Because term-deposit interest rates were extremely low, depositors were more willing to hold demand deposits, a main component in the narrow money.

Total deposits contracted slightly by 0.2% during the first quarter as the decline in foreign-currency deposits exceeded the increase in Hong Kong-dollar deposits. Hong Kong-dollar deposits rose slightly by 0.2% after shrinking by 0.5% in the previous quarter. In a low-interest-rate environment, liquid (demand and savings) deposits accounted for 66.7% of Hong Kong-dollar deposits at the end of March. Despite the contraction in foreign-currency deposits, renminbi deposits in Hong Kong increased markedly by 12.8% in Q1, totalling RMB 70.8 billion at the end of March. The demand for such deposits was partly boosted by renewed speculation about renminbi appreciation and the expanding scope of renminbi business in Hong Kong.

Total loans and advances continued to increase in the first quarter. In line with the faster growth in nominal GDP, loans for use in Hong Kong[2] expanded briskly by 5.0% in Q1 (Chart 5). The level of domestic loans also recovered to the pre-crisis peak of around $2,800 billion. Analysed by economic use, the rise in the loans for use in Hong Kong was across the board, led by building, construction, property development and investment.[3] Mortgage loans continued their upward trend and more customers chose HIBOR-based mortgage products to take advantage of low interbank interest rates. The effective mortgage interest rates for new loans could be as low as one-month HIBOR plus 0.65%, with a cap of best lending rate minus 2.5%. Survey data also suggest that the proportion of newly approved mortgage loans priced with reference to HIBOR increased markedly to a record high of 76.5% in March from 61.6% three months earlier. Indeed, property-related loans were the main contributor to the credit recovery in Hong Kong. As Hong Kong-dollar loans increased at a faster rate than deposits, the Hong Kong-dollar loan-to-deposit ratio climbed to 73.3% at the end of March 2010 from 71.2% at the end of December 2009.

CHART 5

Loans for use in Hong Kong



Source: HKMA.

Short-term outlook

The near term economic outlook remains positive. Private consumption demand will benefit from the Government relief measures, improving labour market conditions and better income prospects. Private investment is likely to pick up with better business situations, while public investment will stay strong due to the implementation of some infrastructure projects. Meanwhile, external demand will be underpinned by the decent global economic and trade prospects (the International Monetary Fund (IMF) forecasts world output growth and trade volume growth to be 4.2% and 7.0% respectively in 2010), in particular the strengthened intra-regional trade among Asian countries.

A strong output growth is expected for the Hong Kong economy in 2010. In particular, the latest market consensus forecasts a real output growth of 5.2% in 2010, same as that of the Asian Development Bank (ADB) and slightly higher than the IMF's 5.0%. The Government also maintained its previous projection of the real output growth to be 4 - 5% in 2010. On the price front, the market consensus points to a headline inflation of 2.5% in 2010, close to the projections of the ADB (2.2%), the IMF (2.0%) and the Government (2.3%).

The following risks to Hong Kong's near-term economic prospects deserve attention:

Externally, the fiscal crisis in Greece has caused sharpened volatilities in the international financial and currency markets. Contagion from the crisis brought about sharp rises in yield spreads as well as sovereign debt rating downgrades for other euro area member countries with weak fiscal positions. Despite the implementation of the sizable European Financial

[2] Including trade-financing loans.
[3] Data on loans for use by economic sector are available only on a quarterly basis.

Stabilisation Mechanism, and the European Central Bank's unprecedented pledge to buy member countries' government bonds, market jitters continued and the effectiveness of these measures remained uncertain. On the Mainland, the authorities have taken a range of policy tightening actions, such as raising the reserve requirement ratio for three times, and implementing stringent measures on the property market, to prevent domestic economic environment from overheating. Nevertheless, with inflationary pressures still on the rise and a still-buoyant economic activity, the Mainland authorities may continue to normalise their policy stance, notwithstanding the fallout from the Greece crisis. The policy tightening on the Mainland could affect the financial and asset market sentiment in Hong Kong.

Domestically, the risk of overheating in the residential property market remains. While some signs of cooling down have emerged from the property market, following the announcement of new measures by the Government and the Urban Renewal Authority on 21 April and 3 May, the expansionary monetary environment and strong domestic economic activity will continue to provide an environment conducive to the formation of bubbles. Upside risks to the inflation outlook have also increased. In particular, the expected strong economic growth will likely eliminate any excess capacity in the economy. This coupled with the marked increase in market rentals for new leases since the second quarter of 2009, means that inflationary pressures in the economy may continue to rise, possibly to notable levels by year end.