REGULAR ARTICLE

Domestic and external environment

by the Research Department

Economic recovery in the advanced economies has been losing steam. The growth momentum in both the US and Europe continued to fall short of what is needed to bring down high unemployment. In Japan, the strength of the yen and persistent deflation has continued to be a drag on the economy. In contrast, in the rest of Asia growth has remained robust and inflationary pressures are building up, particularly in Mainland China. In Hong Kong, economic growth slowed sequentially in the third quarter, accompanied by low unemployment and still moderate inflation. However, the continued divergence in growth performances and policy conditions between East Asia and the major economies will attract capital inflows and put pressure on inflation and asset prices in the region.

External environment

The **US** economic recovery continued at a slow pace. Real GDP growth expanded by 2.5% quarter on quarter (annualised) in the third quarter, up from 1.7% the previous quarter. While growth was driven by rising consumption, this might not be sustainable as it was only supported by a drop in the personal savings rate. Growth in real disposable personal income actually slowed to 0.9% (annualised) from 5.6% during the period. The pace of growth in business investment also slowed sharply, as businesses have now worked through much of their previously delayed capital investment during the recession. The housing sector remained depressed with sluggish sales. House prices, as measured by the S&P/Case-Shiller Home Price Index for 20 metropolitan areas, continued their downward trend and the depressed housing market looks set to remain a drag on household spending. In addition, the US economy is still not growing fast enough to create sufficient number of jobs to reduce the high unemployment rate, which rose to 9.8% in November. Employment growth in the private sector was also sluggish. Inflationary pressures remained subdued and prices continued to edge downwards. In response to higher unemployment and the risk of deflation, the Federal Open Market Committee announced it would expand the Federal Reserve's holdings of securities by purchasing an additional US$600 billion of longer-term Treasury securities by the end of the second quarter of 2011.

Economic recovery in the **euro area** also slowed markedly in the third quarter, with real economic activities in the region growing by a modest 0.4% quarter on quarter, compared with the 1% growth in Q2. The slowdown in the third quarter was an inevitable retreat after some exceptionally strong industrial and export performances among the core economies in the second quarter, particularly in France and Germany, amid a weak euro. Huge divergences still existed between Europe's core and peripheral economies. Economic conditions in peripheral economies continued to deteriorate with confidence remaining at very low levels. Sovereign debt problems and fiscal tightening heightened concerns within the debt-ridden peripheral countries in Europe, as countries such as Ireland and Portugal continued to fall behind their deficit-reduction targets. Discussions over how private investors should bear the costs for an orderly sovereign debt restructuring also caused unease among investors. Nevertheless, with excess capacity in the economy, inflationary pressures remained mild. Although the headline CPI inflation rate reached 1.9% year on year in October, which was close to the European Central Bank's 2% price stability ceiling, this should not cause concern as it was most likely due to the temporary effects of the rise in food and energy prices.

In the **UK**, economic recovery continued at a steady pace with the economy growing by 0.8% quarter on quarter in Q3 following a 1.2% growth quarter on quarter in Q2. Labour market conditions remained weak, while headline CPI inflation stayed above the Bank of England target of 2% for the eleventh consecutive month in October.

In **Japan**, real GDP grew by 4.5% quarter on quarter (annualised) in Q3. Growth was mainly driven by an increase in private consumption, which was boosted by last-minute purchases of automobiles and tobacco prior to the end of the government stimulus package and an increase in the tobacco tax. Reflecting the impact of the appreciation of the Japanese yen, exports decreased by 5.0% quarter on quarter in Q3 (in Japanese yen terms), while industrial production also registered a decline. In the hope of halting its strengthening currency, the Japanese Government intervened in the foreign exchange market in September. However, the impact of the intervention appeared to be short-lived as the currency strengthened again several days after the action. Although the unemployment rate edged down from 5.3% in June to 5.1% in October, it was still about one percentage point above the pre-crisis level in the third quarter of 2008. Consumer price inflation remained subdued. While the headline CPI inflation returned to positive territory in October (0.2% year on year), the core CPI (excluding food and energy costs) remained on a downward trend. In light of the subdued consumer prices and in response to the further quantitative easing conducted by the US Federal Reserve, the Bank of Japan also recently announced its quantitative easing measures.

Real GDP growth on the **Mainland** declined to 9.6% in the third quarter from 10.3% in Q2 year on year. Sequential growth, however, edged up according to the People's Bank of China's estimate. The year-on-year fixed asset investment (FAI) growth decelerated to 23.1% in Q3, mainly owing to the decline in public sector investment. However, real estate FAI remained solid on the back of robust activity in affordable housing investment. Private consumption also held up well in the third quarter underpinned by steady income growth. Exports rose at a slower pace both year on year and quarter on quarter in Q3 due mainly to a softening in demand from the advanced economies, while imports also slowed because of weaker expansion in domestic demand. The trade balance reached US$65.5 billion in the third quarter compared with US$41.0 billion in Q2, partly reflecting an improvement in the terms of trade.

The year-on-year growth in broad money (M2) turned around in August after declining for eight consecutive months and hovered around 19% from August to October, while loans from financial institutions also showed signs of rebounding in October. Inflationary pressures intensified in the past few months, with year-on-year CPI inflation trending up from 2.9% in the second quarter to 3.5% in Q3 and jumping further to 4.4% in October. Food price and residential costs continued to be the major contributors to aggregate inflation. PPI inflation also reversed its downward trend in September and rose to 5.0% in October on a year-on-year comparison. Despite the more stringent measures launched in late September to stabilise the property market, property prices rose further with the average prices of 70 major cities rising by 0.5% and 0.2% month on month in September and October respectively. In order to drain abundant liquidity in the banking system and contain inflationary pressures, the People's Bank of China raised the one-year benchmark interest rates by 25 basis points effective from 20 October, and raised the required reserve ratio (RRR) for all commercial banks twice by 50 basis points each in mid- and late November. This came on top of a temporary two-month rise in the RRR in mid-October for the six largest domestic commercial banks by 50 basis points. Since the resumption of the exchange rate reform in June, the renminbi has appreciated by about 3% against the US dollar on a cumulative basis, with the daily volatility in the RMB/USD exchange rate increasing in tandem. Non-deliverable forward (NDF) rates in late November indicate that markets expect the renminbi to appreciate by about 2% in 12 months.

The rest of the East Asian economies continued to expand in the third quarter, albeit at a much slower pace. For the region as a whole[1], real GDP gained by 0.5% quarter on quarter (annualised), down from 5.4% in the second quarter, dragged down largely by the decline in Singapore's GDP. Growth in industrial production and exports appeared to have lost momentum. Labour market conditions continued to improve at a gradual pace, with most economies in the region registering a slight decline in the unemployment rate during the third quarter. Consumer price inflation continued to gain momentum in the region, driven mainly by the rise in fresh food prices in many economies. Most regional currencies have appreciated markedly against the US dollar since May 2010. Concerned about the increasing risks of asset bubbles and overheating amid ample global liquidity, central banks in the region have introduced various regulatory measures to maintain economic stability. For instance, the Government of Singapore strengthened its administrative measures in August to cool down the property market, while authorities in Korea, Indonesia and Thailand imposed control measures on the capital account to cushion the impact of large capital inflows.

Domestic economy

Real GDP growth in Hong Kong declined to 0.7% quarter on quarter in Q3 after registering 2.1% and 1.4% in the first two quarters respectively. The deceleration was due mainly to the fading domestic inventory cycle, with domestic demand and net exports still experiencing steady growth.

Private consumption growth strengthened further quarter on quarter on the back of strong economic recovery, rising household income and improved labour market conditions. Government consumption also saw broad-based growth. Gross fixed investment declined in the third quarter after improving notably in the first half of 2010. While public investment increased substantially, reflecting large-scale infrastructure projects in the pipeline, growth in private investment reversed its course in the third quarter due in large part to a decline in private machinery and equipment acquisitions, as well as slower building and construction activities. Concurrently, the domestic inventory cycle has run its course and dropped in the third quarter. Taken together, overall investment spending dragged heavily on GDP growth in Q3.

After a strong recovery in the first half of the year, external demand expanded at a slower pace in the third quarter as demand from the Asian economies softened and the US recovery remained sluggish. Growth in merchandise exports decelerated markedly quarter on quarter, and growth in exports of services also edged downwards. Merchandise imports contracted, due in large part to a decline in retained imports of consumer goods and intermediate products, as inventory de-stocking took place. Imports of services also eased sequentially owing to a decline in transportation service imports, which are highly connected to merchandise imports. Overall, net exports turned into a strong contributor to output growth in the past two quarters. The nominal trade balance recorded a surplus of HK$57.1 billion (12.6% of GDP) in Q3 after a deficit of HK$2.7 billion (0.6% of GDP) in Q2.

Labour market conditions continued to improve into the second half of 2010 on the back of firm economic growth. Following a temporary rise in the second quarter amid increased uncertainties in the external environment due to the European sovereign debt crisis, the three-month moving average unemployment rate dropped and then stayed at 4.2% in October for three consecutive months. The underemployment rate also continued to decline in the third quarter and was unchanged at 1.9% in October.

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

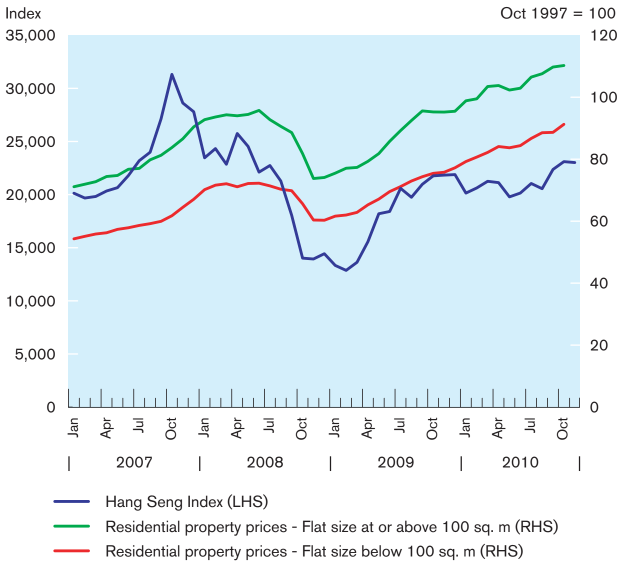
Inflation

Inflationary pressures have been building up gradually in the economy. The year-on-year underlying inflation rate edged up to 2.3% in October from 2.2% a month earlier. Progressive increases in rental costs and basic food prices over the past few months contributed to the rise, while contributions from non-tradable goods prices, excluding rentals, sustained over the same period. The three-month-on-three-month annualised rate of underlying inflation rose to 2.1% in October from 1.5% in September, due in large part to surging food prices. Looking ahead, indicators suggest that rising private housing rentals and food prices will add further risks to inflationary pressures in Hong Kong.

Asset markets

Following an extended period of consolidation in the earlier part of 2010, the local equity market regained momentum in September alongside other major markets. Investor sentiment improved progressively because of the expected appreciation in the renminbi exchange rate, the stabilisation of macro-financial conditions in the euro area, further quantitative easing in the US and solid corporate earnings of local blue chip companies. The Hang Seng Index (HSI) rose by 12.5% from the end of August to 23,096 at the end of October (Chart 1), and then went through a volatile period in November and edged down slightly to 23,008 at the end of November due to the uncertain prospects of the domestic residential property market, tensions between North and South Korea, renewed concerns over the European sovereign debt problems, and worries about further monetary tightening in Mainland China. The price-earnings ratio of HSI constituent stocks increased notably from 15.8 in August to 16.9 in November, higher than the long-term average of 14.9. The average daily turnover of the equity market rose from HK$61.8 billion in the third quarter to HK$98.5 billion in October and November. Fund raising and equity initial public offerings (IPOs) were vibrant as total equity capital raised on the Main Board and the Growth Enterprise Market increased from HK$80.8 billion in Q2 to HK$167.9 billion in Q3 and HK$340.7 billion in October and November combined.

CHART 1
Asset prices



Sources: Census and Statistics Department, and staff estimates.

The residential property market boom continued as housing prices rose further and transactions remained robust in the past few months. In the secondary housing market, for instance, prices picked up sequentially by 5.0% in the third quarter, leading to a 15.3% cumulative increase in the year through September. New mortgage loans made also rose notably in Q3. The Government and the HKMA introduced a range of measures in mid-August to ensure a healthy and stable development of the property market. As a result, housing prices increased at a slower pace, while transactions moderated but remained high by historical standards (about 9,500 recorded in October). From mid-October, the property market had picked up again, as data from some major real estate agencies showed stronger growth in transactions and housing prices. Speculative activities also appeared to be surfacing as evidenced by the rise in short-term re-sale activities (i.e. with a buy-hold-and-sale period of less than 12 months). Housing affordability further deteriorated as growth in household income failed to keep pace with that of housing prices. Against this background, the authorities introduced a new round of measures in mid-November to curb speculative activities and prevent excessive mortgage lending. Initial signs of a cooling off in market momentum emerged after the announcement. The authorities are mindful of any new developments in the residential property market and have pledged to introduce further measures to safeguard banking and financial stability when necessary.

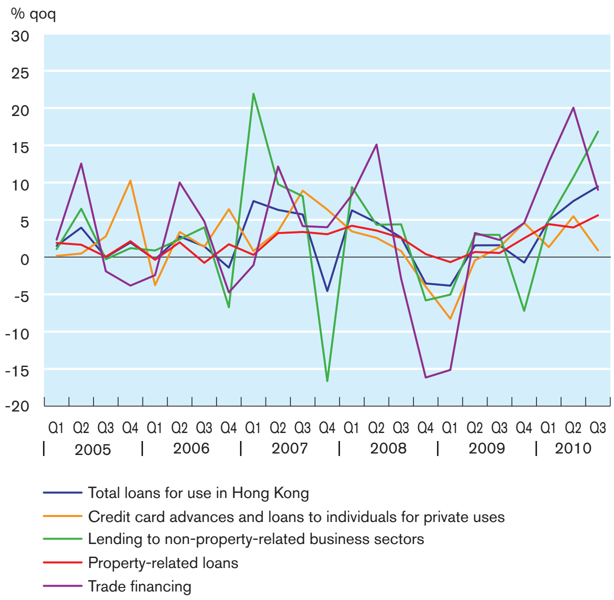
Money supply and domestic credit

Hong Kong-dollar monetary aggregates expanded in the third quarter, driven by entrenched economic recovery. Narrow money rose sharply due mainly to a surge in credit demand arising from IPO activity at the end of September, while broad money increased by 8.9% following a zigzag but an essentially flat path in the first half.

Total deposits increased in the third quarter with Hong Kong-dollar deposits up by 9.2%, although foreign-currency deposits grew at a much slower pace of 2.5%. The growth in Hong Kong-dollar deposits was mainly due to liquid (demand and savings) deposits, reflecting a stronger demand from fund raising activity in the equity market. Renminbi deposits in Hong Kong increased markedly to RMB217.1 billion at the end of October from RMB89.7 billion in June. The demand for these deposits was boosted by the rapid development of renminbi businesses in Hong Kong and appreciation pressures on the currency.

Demand for loans was robust in the third quarter because of low interest rates and favourable growth prospects for the local economy. Total loans and advances expanded, with both Hong Kong-dollar and foreign-currency loans increasing at a brisk pace. Loans for use in Hong Kong rose by 9.5% in Q3, compared with 7.6% in Q2 (Chart 2).[2] Analysed by economic use, loans to stockbrokers contributed 2.7 percentage points to the third-quarter growth in domestic loans, underpinned by a surge in margin lending associated with new share subscriptions.[3] Property-related loans were another major contributor, with their quarterly growth accelerating to 5.7% in Q3 from 4.0% in the previous quarter. Households continued to prefer HIBOR-based mortgage products because of low interbank interest rates. Survey data suggested the proportion of newly approved mortgage loans priced with reference to HIBOR increased to a record high of 90.5% in September from 83.9% three months earlier. As Hong Kong-dollar loans and deposits increased at roughly the same rate, the Hong Kong-dollar loan-to-deposit ratio was little changed, closing at 77.6% at the end of September.

CHART 2
Loans for use in Hong Kong



Source: HKMA.

2 Including trade-financing loans.

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

Short-term outlook

The Hong Kong economy is expected to grow at a firm pace through the rest of the fourth quarter and in 2011. Private consumption will continue to be supported by improving labour market conditions and robust consumer confidence. Public investment will hold up well, while private investment may moderate and inventory de-stocking may continue. Externally, the trade balance is facing downward pressures due mainly to lacklustre growth in the advanced economies, while intra-regional trade is expected to remain supportive of Hong Kong's exports.

Nevertheless, the near-term economic outlook is subject to risks and uncertainties. With the impact of the second round of quantitative easing in the US remaining uncertain, and the vulnerabilities in the global economy and financial system staying elevated, any deviation in economic outcomes from expectations could lead to large volatilities in global financial markets. In Hong Kong, the risk of overheating in the property market remains a concern. While the measures launched by the authorities over the past few months have had some impact, factors conducive to an overheating in the property market remain given the current low interest-rate environment. In particular, the new round of quantitative easing announced by the US Federal Reserve may lead to a resumption of capital inflows, adding risks to the already brisk credit growth and booming asset markets in Hong Kong. The rise in property prices and rentals for fresh leases together with increasing food prices may eventually feed through to inflationary pressures in the economy.