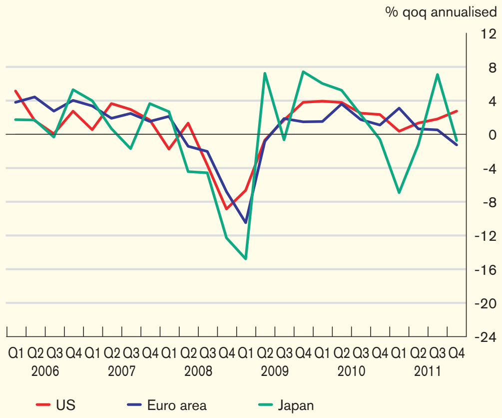
2. Global setting and outlook

External environment

Growth momentum was subdued in major advanced economies amid intensification of the European sovereign debt crisis. While the situation seems to have stabilised temporarily going into 2012, advanced economies will likely be heading for a prolonged period of subdued recovery in the face of structural headwinds. This increases the incentives for major central banks to pursue further quantitative easing, which could add to economic and financial imbalances and render the global economic environment even more uncertain. For most East Asian economies, economic growth moderated distinctly in the second half amid slowing external demand, with future prospects largely depending on the European situation.

2.1 Real activities

Chart 2.1
US, euro area and Japan: real GDP



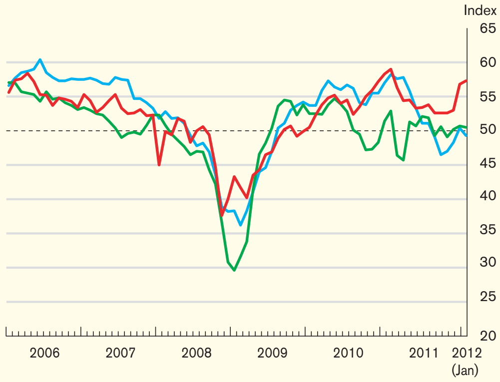
Sources: Bureau of Economic Analysis, Eurostat and Cabinet Office of Japan.

Advanced economies generally grew at a moderate pace during the second half of 2011 with the escalation of the European sovereign debt crisis causing huge economic uncertainties and volatilities in global financial markets. Latest real GDP figures show the US economy grew by 3%, while the Japanese and the euro area economies contracted by 0.7% and 1.3% respectively in 2011 Q4 (Chart 2.1).[1]

With the sovereign debt crisis in Europe remaining unresolved, contagion fears finally engulfed Italy and Spain. Their borrowing costs at one point were pushed to levels that were widely regarded as unsustainable. Heightened fears of sovereign debt defaults have sparked severe volatility on global financial markets. Partly as a result of the impairment of business and consumer sentiments, the euro area economy contracted in Q4. In contrast, recovery in the US remained broadly on track, albeit at a modest pace, with economic activities largely unaffected by the debt crisis. In Japan, growth

[1] For the US, euro area, Japan, and non-Japan Asia (excluding Mainland China), quarterly real GDP percentage changes are on a seasonally adjusted annualised basis, unless otherwise stated.

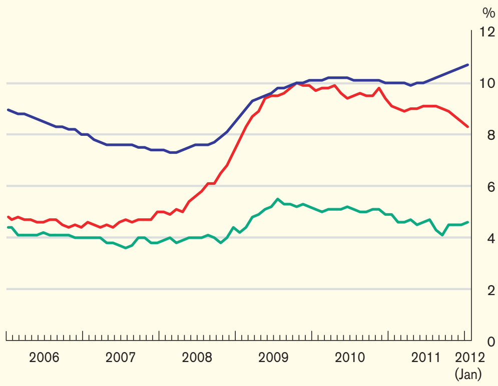
Chart 2.2
US, euro area and Japan: Purchasing Managers' Indices



— Euro area PMI composite
— Japan PMI manufacturing
— US non-manufacturing Institute for Supply Management PMI

Source: Bloomberg.

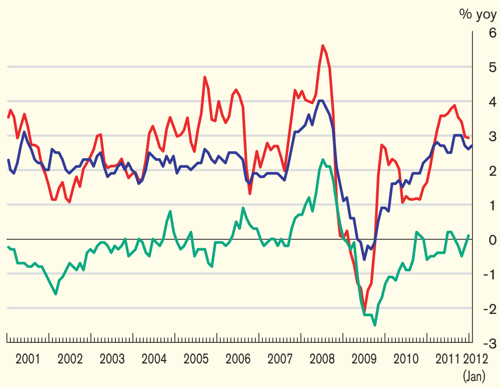
Chart 2.3
US, euro area and Japan: unemployment rate



— US — Euro area — Japan

Source: Bloomberg.

Chart 2.4
US, euro area and Japan: headline inflation



— US — Euro area — Japan

Sources: US Department of Labour, Eurostat and Japan Ministry of Internal Affairs.

rebounded strongly in Q3 as activities recovered from the earthquake disaster in March, but the economy contracted again in Q4. The recent subdued readings in the Purchasing Managers' Indices (PMI) across most advanced economies indicate that growth will likely continue at a moderate pace (Chart 2.2).

As a result of the subdued economic growth, job creation remained slow in most advanced economies, with the unemployment rate staying at stubbornly high levels – around 8.3% in the US, above 10% in the euro area, and 4.6% in Japan (Chart 2.3). The high unemployment rate and excess capacity, together with the fall in global commodity prices, have eased headline CPI inflation in advanced economies with core inflation expected to follow soon over the course of 2012 (Chart 2.4).

Despite the continued efforts by European authorities and the International Monetary Fund (IMF) to resolve the debt crisis, there is a near-term risk that Europe could be sliding into a deeper-than-expected recession which could be prolonged and exacerbated by the tightening of bank credit. Until policy makers can agree on a comprehensive solution that addresses both the short-term refinancing needs and the longer-run competitiveness problems in the euro area, global financial markets will stay susceptible to market jitters and de-stabilising events. Thus, the risk of a global recession remains. Even if a global recession is avoided, advanced economies will likely be heading for a prolonged period of slow recovery in the face of structural headwinds. This, together with widespread and large-scale fiscal consolidations in place, mean there is an increasing likelihood that central banks across advanced economies could soon resort to further quantitative easing measures in an attempt to boost growth and employment. Further financial and macroeconomic imbalances could build up on further quantitative easing, making the global economic environment even more uncertain.

Table 2.A
Asia: Real GDP growth

(% qoq, annualised)	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
NIE-3:[1]	**0.8**	**2.7**	**8.5**	**2.0**	**2.0**	**0.3**
Korea	2.6	2.0	5.4	3.6	3.3	1.4
Singapore	-15.9	6.9	19.7	-3.0	2.0	-2.5
Taiwan	3.7	2.3	10.0	1.0	-0.2	-0.6
ASEAN-4:[1]	**2.2**	**7.5**	**6.3**	**2.8**	**4.4**	**-3.5**
Indonesia[2]	5.5	9.1	5.1	6.1	5.6	8.9
Malaysia[2]	-2.2	8.8	8.0	2.8	3.9	6.2
Philippines	1.0	1.9	8.1	1.1	3.3	3.5
Thailand	0.1	7.2	6.1	-1.9	3.4	-36.4
East Asia:[1]	**1.5**	**5.0**	**7.4**	**2.4**	**3.2**	**-1.5**

Notes:
1. Weighted average (weighted by contribution to world GDP value at Purchasing Power Parity).
2. Seasonal adjustment made by HKMA staff.

Sources: IMF, CEIC and HKMA staff estimates.

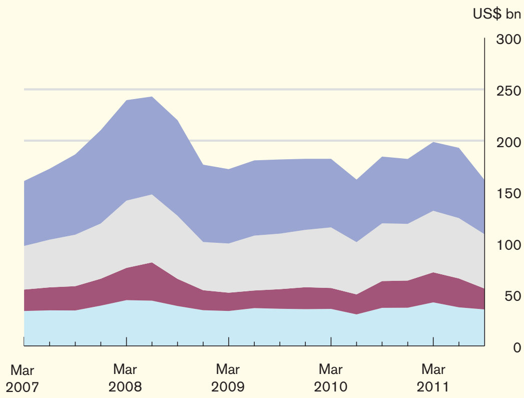
Table 2.B
Asia: Policy interest rates

	Policy interest rate[1]		
	15 Mar 2012 % p.a.	Recent high in 2011 % p.a.	Cumulative rate cut Percentage points
Indonesia	5.750	6.750	1.000
Korea	3.250	3.250	–
Malaysia	3.000	3.000	–
Philippines	4.000	4.500	0.500
Taiwan	1.875	1.875	–
Thailand	3.000	3.500	0.500

Note:
1. Indonesia: BI rate; Korea: base rate; Malaysia: overnight policy rate; The Philippines: overnight reverse repo rate; Taiwan: discount rate; Thailand: policy rate.

Sources: Bloomberg and HKMA staff estimates.

Chart 2.5
Asia: Liabilities to euro zone banks



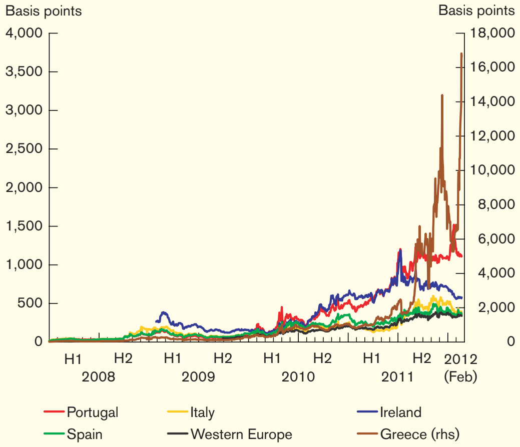
Sources: Bank for International Settlements and HKMA staff estimates.

Most East Asian economies have experienced a distinct weakening in economic growth in Q4, due mainly to a slowdown in external demand (Table 2.A).[2] Inflationary pressures appear to have eased, with average year-on-year CPI inflation for the region having declined to 3.5% in January 2012 from a peak of 4.3% in June 2011. In view of increased downside risks to growth, some central banks in the region loosened their monetary policy during the review period, but such a reversal of policy stance has been rather cautious (Table 2.B). Regional equity prices saw a sharper drop than those in the US when the European debt crisis intensified in September 2011, while many regional currencies registered their largest monthly falls against the US dollar since the collapse of Lehman Brothers. The situation appears to have reversed since the beginning of 2012, with exchange rates and equity prices rebounding markedly.

Solid domestic demand and sufficient scope for policy stimulus will support growth momentum, but the slowing external demand and the potential credit retrenchment stemming from sizable de-leveraging in European banks pose some downside risks. In fact, some European banks have recently pulled back lending from Asia (Chart 2.5), and this might become more apparent when approaching the June 2012 deadline for recapitalisation. However, if the European debt problems stabilise, the two-speed recovery of the global economy could lead to renewed capital inflows into emerging Asia, resuming upward pressures on asset and consumer prices. The consensus forecasts in mid-March suggest the region's GDP growth will moderate marginally from 4.1% in 2011 to 4.0% in 2012, and inflation will be 3.3% compared with 3.9% in 2011.

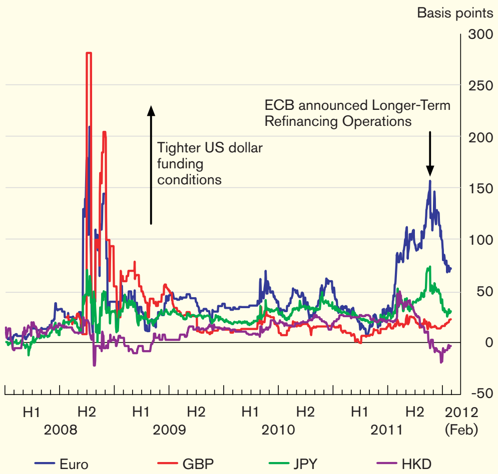
2 The sharp fall in Thailand's GDP in 2011 Q4 was mainly a result of the temporary disruption to manufacturing production and exports due to severe flooding.

Chart 2.6
Five-year sovereign CDS spreads of European countries



Source: Bloomberg.

Chart 2.7
Basis swap spreads of major currencies against the US dollar



Note: Basis swaps are used in cross-currency transactions, where two parties swap interest rate exposures. The base currency for the above series is the US dollar. An increase in the spread represents a higher cost for raising US dollar funding.

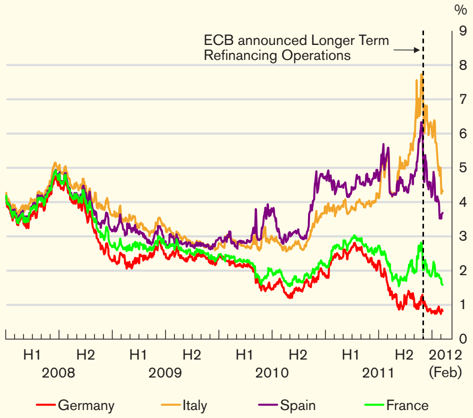
Sources: Bloomberg and HKMA staff calculations.

2.2 Global financial conditions

Global financial markets have remained volatile over the past six months, driven predominately by developments in Europe. A rapid spread of the European sovereign debt crisis – from the small peripherals (Greece, Portugal and Ireland) to the larger ones (Spain and Italy) and eventually to core euro area members (including France) – significantly shook investor confidence late last year. Credit default swap (CDS) spreads and borrowing costs of the peripherals rose sharply to euro-era highs (Chart 2.6), while increased safe-haven demand led German and US bond yields to record lows.

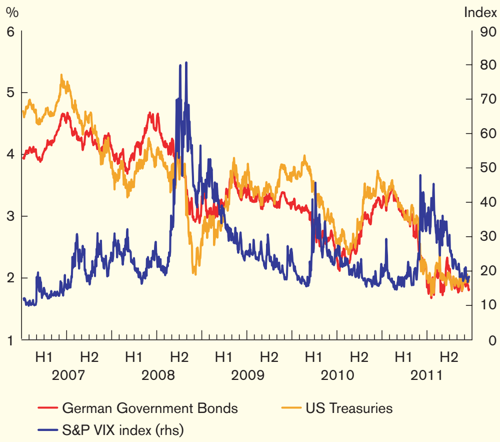
In addition to its influence on sovereign debt markets, the crisis has also had a profound impact on the European banking system. Sharp declines in peripheral bond prices caused concerns about the asset quality of European banks, leading to a significant increase in counterparty risk in the global banking system. US dollar funding spreads for European banks surged in the latter half of last year to levels unseen since the Lehman collapse, as offshore lenders tightened credit conditions and reduced their exposure to European banks (Chart 2.7).

Chart 2.8
Five-year government bond yields of large European countries



Source: Bloomberg.

Chart 2.9
Long-term government bond yields of developed economies and S&P 500 VIX index

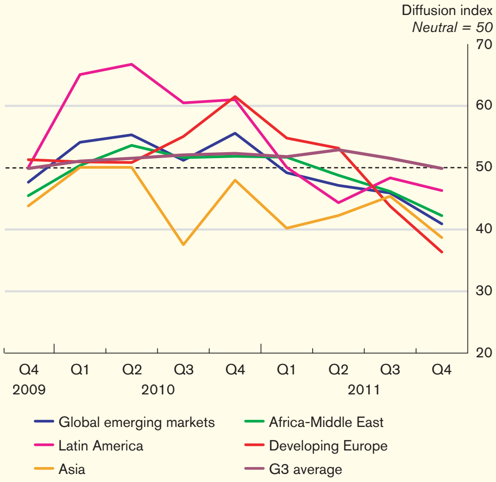


Source: Bloomberg.

Policymakers responded to the worsening situation by introducing a number of supportive measures, including leveraging the European Financial Stability Facility, lifting the bank capital ratios and establishing a fiscal compact. However, none of them was able to provide sustained relief to markets, until the Longer-Term Refinancing Operations of the European Central Bank (ECB), which provided banks three-year euro funding at well below market interest rates. Since the December operation, funding conditions have improved substantially, with money market spreads narrowing and bank issuance activity picking up. Sovereign bond yields of Italy and Spain have also declined following the liquidity injection, due to purchases by banks to profit from the wide interest rate differentials (Chart 2.8). In currency markets, the euro has rebounded strongly against the US dollar since the start of this year, with other risk-sensitive currencies also benefiting from the recovery in risk appetite.

Encouraged by the improved European situation, global equity markets have rebounded strongly since late December. Adding to the positive sentiment were continued improvement in US economic data and increased prospects of easy monetary policy in both developed and developing countries. In particular, the pledge by the US Federal Reserve to keep interest rates low until late 2014 has kept US Treasury bond yields at close to historical lows, despite the strong recovery in risk appetite (Chart 2.9).

Chart 2.10
Bank credit conditions for G3 economies and emerging markets



Notes:
1. G3 economies refer to the US, euro zone and Japan.
2. A reading above (below) 50 indicates easier (tighter) credit conditions.

Sources: Institute of International Finance and HKMA staff calculations.

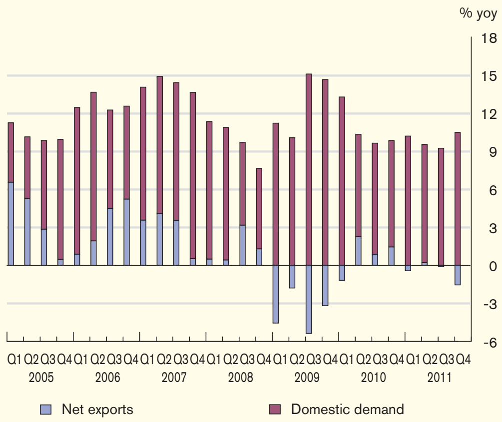
Notwithstanding the improvement seen over the past few months, the outlook for global financial markets remains highly uncertain. While the support measures from the ECB have significantly reduced the risk of a major liquidity crisis in the near term, the deep-rooted structural problems, stemming from the excessive debts of the peripheral sovereigns, remain unsolved. Meanwhile, faced with the challenge of meeting capital requirements, European banks may go through a period of de-leveraging, threatening to continue to tighten credit conditions globally. Recent experience suggests that emerging markets might again take the brunt of it (Chart 2.10). As the uncertainties over the global economic outlook continue, financial markets are likely to remain volatile in the period ahead.

Mainland China

Reflecting a moderation in external demand, growth has trended down and inflationary pressures have eased. Trade surplus declined significantly in part responding to a notable strengthening of the real exchange rate. Amid increased global risk aversion, signs of capital outflows and depreciation pressures on the RMB/USD exchange rate emerged in the last quarter of 2011. Market concerns about a hard landing of the economy have eased as the authorities actively manage risks associated with local government debts, informal lending and the property market. Domestic demand is expected to remain solid, but subject to some downside risks of a deceleration in property-related investment spending.

2.3 Output growth and inflation

Chart 2.11
Mainland China: contributions by domestic demand and net exports to GDP growth

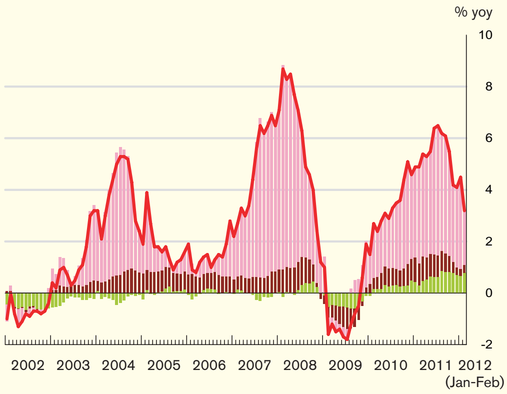


Sources: CEIC, National Bureau of Statistics and HKMA staff estimates.

Growth momentum of the Mainland economy softened in the second half of 2011 due mainly to a moderation in external demand, with net exports turning into a bigger drag (Chart 2.11). Consumption rose at a faster pace year on year, and investment growth remained largely stable. The trade surplus continued to drop as a share of GDP from 3.9% in 2010 to 2.6% last year. The narrowed trade surplus may be sustained beyond the next year or two, with a significant appreciation in the renminbi real exchange rate in the second half of 2011, as well as a sluggish external demand going forward.

While a further slowdown in exports and the property market will dampen investment activities, the economy is expected to grow at a rate close to the trend, which is somewhat slower than in the past decade, but still significantly faster than the major trading partners of Mainland China. The latest consensus forecasts suggest output will rise by 8.4% in 2012. Uncertainties over the euro area debt crisis remain a major risk to the broadly favourable outlook. Although the relative importance of the US and euro area markets for the Mainland's total exports has been declining in the past decade, exports to the two economies remain as important for the Mainland's growth. This is in large part because ordinary exports, whose contributions to Mainland's value-added are much larger than processing exports, have been increasing as a share of total exports and are still sensitive to growth in the US and euro area.

Chart 2.12
Mainland China: contributions to CPI inflation



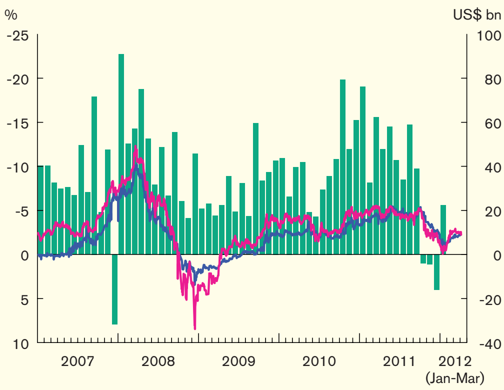
Sources: CEIC and HKMA staff estimates.

Inflationary pressures eased over the review period and are expected to be broadly contained in the near term. The headline CPI inflation rate trended downwards from a peak of 6.5% year on year in July 2011 to 3.2% in February 2012 (Chart 2.12). Looking ahead, global oil and commodity prices may rise with increased geopolitical risks in the Middle East and further quantitative easing in the advanced economies, while food prices are subject to potential supply-side shocks, such as bad weather conditions. However, the moderating demand pressures amid a prudent monetary policy stance and receding residence cost inflation will help reduce upward pressures. The latest consensus forecasts suggest the headline CPI inflation rate will be 3.3% in 2012, compared with 5.4% in 2011.

2.4 Monetary conditions, asset markets and banking risks

Market concerns over a sharp slowdown in the Mainland economy, together with increased risk-aversion among international investors during an intensification of the euro area debt crisis, generated some capital outflow pressure and downward pressure on the RMB/USD exchange rate. For instance, financial institutions' foreign exchange purchases reversed in Q4, while the foreign exchange reserves saw the first quarterly drop since the Asian financial crisis. The RMB/USD exchange rate experienced more significant two-way movements in Q4. Reflecting to some extent different perceptions about economic fundamentals among domestic and international investors, the spreads between the onshore and offshore RMB/USD exchange rates widened in Q4, but narrowed in January and February. Alongside the noticeable strengthening of the US dollar against other major currencies, the renminbi has appreciated distinctly in nominal and real effective terms by 6.6% and 5.1% respectively during September 2011 – January 2012.

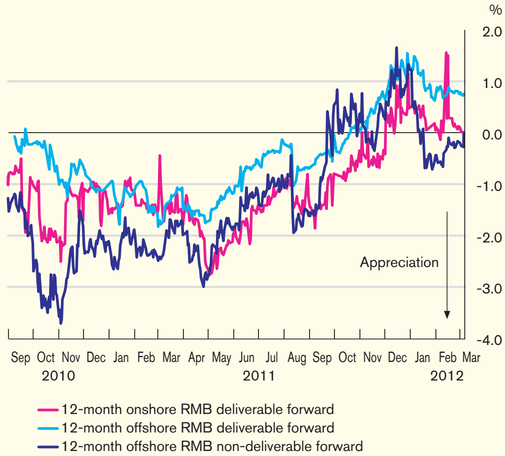
Chart 2.13
Mainland China: financial institutions' foreign exchange purchases and deviations from covered interest parity



Note: Negative deviation from the CIP indicates incentives for capital inflows, and vice versa.
Sources: CEIC and HKMA staff estimates.

Our estimate of the deviation from the covered interest parity (CIP) suggests that the incentives for capital outflows did increase in the latter part of 2011, but were much weaker than during the 2008-2009 global financial crisis, and have eased recently (Chart 2.13). Over the

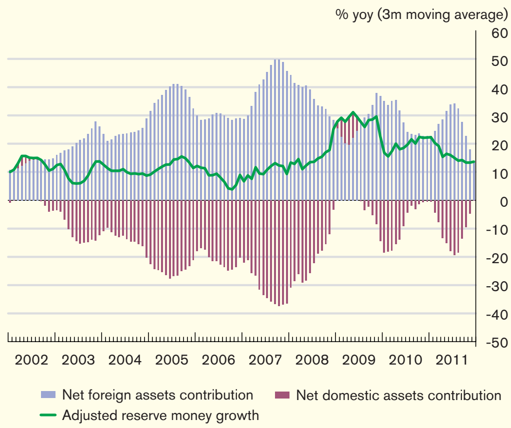
Chart 2.14
Mainland China: expected appreciation of the renminbi against the US dollar



Note: The expected rate of appreciation of the renminbi is calculated as the percentage difference between the spot rate and the forward rates. A negative number implies an appreciation of the renminbi against the US dollar.

Sources: Bloomberg and HKMA staff estimates.

Chart 2.15
Mainland China: contributions to reserve money growth



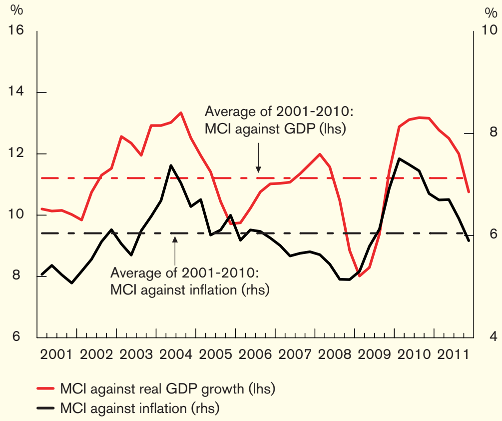
Note: Total reserve money is adjusted for the changes in the reserve requirement ratio.

Sources: CEIC and HKMA staff estimates.

medium term, international capital flows will be more balanced along with the deepening of domestic financial markets and gradual liberalisation of the Mainland's capital account restrictions. The forward exchange rates imply that the RMB/USD exchange rate still faces some downward pressure (Chart 2.14). From a medium-term perspective, however, there is unlikely to be sustained depreciation pressure on the renminbi exchange rate. The Mainland's relatively strong growth potential and expected stable path of its net foreign asset positions will continue to support the renminbi.

Following a largely tightening bias in the second half of 2011, the People's Bank of China (PBoC) started to fine-tune the policy stance towards the end of the year in view of the moderation in inflation, slowdown in growth momentum, and drops in net capital inflows. Reserve money growth continued to decelerate (Chart 2.15), and broad money and loan growth followed a similar trend year on year. The reserve requirement ratio (RRR) was cut twice by a total of 100 basis points in December 2011 and February 2012. Our analysis suggests that overall monetary conditions tightened further due partly to the appreciation in the real effective exchange rate (REER) of

Chart 2.16
Mainland China: Monetary Conditions Indices



Note: The Monetary Conditions Indices (MCIs) are compiled based on real money growth, the real interest rate and the real effective exchange rate. The GDP-based MCI measures the extent to which monetary conditions support growth, and the inflation-based MCI measures the extent to which monetary conditions support inflation. A rise (decline) in the MCI indicates a loosening (tightening) in monetary conditions.

Sources: CEIC and HKMA staff estimates.

the renminbi, but have remained broadly supportive of growth. As shown in Chart 2.16, current monetary conditions are consistent with an output growth rate of about 11% year on year (compared with the implied 10-year average of 11.2%) and a CPI inflation rate of about 6% (close to the implied 10-year average of 6.1%). Further easing in inflationary pressures will provide more room for policy loosening, if needed, but a significant reversal in the policy stance is not expected unless the economic outlook deteriorates sharply.

Equity markets remained subdued amid the slowing growth momentum. Having under-performed most of the major stock markets in the second half, the benchmark indices rebounded in early 2012 amid speculation of a relaxation in credit controls and reduced concerns over European debt problems. The aggregate price-earnings ratio of Shanghai A shares had trended downwards before rising slightly to about 15 in February, still much lower than the past 10-year average of about 30. Equity prices are expected to remain volatile in the near term, as market sentiment will continue to be clouded by potential downside risks associated with the property market and uncertainties in global financial markets.

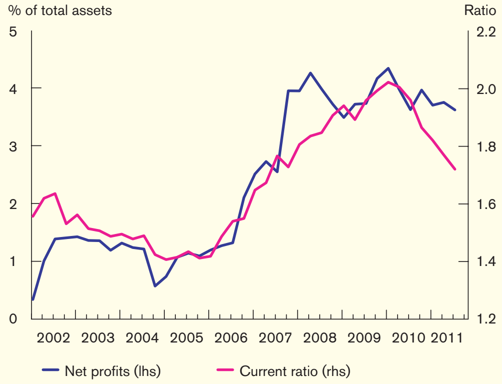
The housing market continued to moderate over the review period, with first- and second-tier cities having generally seen a larger price drop than third-tier cities. Transaction volumes in major cities have also trended downwards since mid-2011. This has continued to raise market concerns about the possibility of a sharp correction in the Mainland housing market.

It is likely the housing market will weaken further in the near term. In particular, downside risks could be more significant for major cities that have seen stronger symptoms of overheating. Continued administrative controls could weaken the financial condition of property developers and hence their pricing power, which would in turn add downward pressure on the market. According to a PBoC survey conducted in 2011 Q4, 20.8% of depositors expected property prices to drop in the next couple of quarters, up from 8% in Q3. In particular, the proportion of depositors who expect property prices to decline increased more significantly in major cities, such as Beijing and Shanghai.

Chart 2.17
Mainland China: average house price changes across cities between June 2011 and January 2012

Sources: CEIC and HKMA staff estimates.

Chart 2.18
Mainland China: liquidity conditions of large real estate developers



Notes:

1. Average of 112 companies listed on the stock exchanges in Shanghai and Shenzhen.
2. Net profits are the 4-quarter moving sum and total assets are quarter-end figures.

Sources: WIND and HKMA staff estimates.

That said, the probability of a sharp correction in the housing market remains relatively low. In fact, the current slowdown in the housing market could be partly attributed to the administrative controls, including purchase restrictions and credit tightening, as cities with less stringent implementation of these measures have generally recorded smaller house price declines (Chart 2.17).

Structural factors, including on-going urbanisation, remain supportive of the property market. Despite some weakening in the financial condition of property developers, large developers, which account for a majority of market share, generally have good liquidity due to strong profitability over the past few years. Their current ratio (the ratio of current assets to current liabilities) and net-profit-to-asset ratio have remained high by historical standards (Chart 2.18). This suggests that the risk of a large-scale fire-sale of properties should not be overestimated.

While the banking sector of the Mainland has been healthy in recent years with high liquidity, sound asset quality, and strong capital, market concerns over a sharp worsening in the banking sector's asset quality remain. This is due partly to the fact that a deterioration in the property market would continue to weigh on land prices and in turn worsen local governments' ability to repay loans. However, the authorities have been actively managing the related risks.[3] Local government debts are mainly used to fund infrastructure projects which may have difficulty in generating cash flow in the early stages of developments, but can usually yield relatively good returns in the medium term. As such, local government debts present mainly a liquidity risk rather than a solvency risk. Meanwhile, the generally strong asset and sound fiscal positions should provide the central government the capacity to prevent any liquidity problems of local governments from escalating into a systemic banking crisis.

[3] It has been reported recently that major banks are being asked to roll over their loans to local governments.