REGULAR ARTICLE

Domestic and external environment

by the Research Department

The euro area entered into a technical recession in the third quarter as economic fundamentals continued to deteriorate, although the risk of a euro area breakup subsided after the European Central Bank (ECB) announced a new bond purchase programme in September. In the US, fiscal uncertainty continued with signs that businesses have become more reluctant to hire and invest. Growth in East Asia, including Mainland China, generally slowed, but there was a notable divergence across individual economies. In Hong Kong, growth resumed in Q3, albeit at a slow pace, along with some stabilisation in merchandise trade. However, the local economy still faces downside risks stemming from the external environment, while upside risks to inflation and property prices remain amid loose global monetary conditions.

External environment

Growth in major advanced economies remained sluggish during the second half of 2012 with the tail risks of euro disintegration and the "fiscal cliff" in the US continuing to weigh on markets and economic confidence. In Europe, the ECB's new bond purchase programme, known as the Outright Monetary Transactions (OMTs), has so far appeared to have stabilised markets. However, it remains conditional on recipient countries complying with agreed austerity and reform targets, and the risks of failing to meet these targets remain high amid a deepening economic downturn. In fact, the whole **euro area** entered into a technical recession with real GDP contracting by 0.1% quarter on quarter in Q3, following a 0.2% contraction in the previous quarter. The unemployment rate rose to a record high of 11.7% in October with the youth unemployment rate climbing to 23.9%. In the **US**, fiscal uncertainties continued with signs that businesses have become more reluctant to hire and invest. Real GDP grew by 2.7% quarter on quarter (annualised) in Q3, faster than the 1.3% recorded in the previous quarter. However, the improvement was mainly driven by faster-than-expected business inventory accumulation and a surprise and unsustainable jump in government spending. Otherwise, the underlying growth momentum remained weak. While there were tentative signs the recovery was slowly gaining traction into the fourth quarter, supported by continued improvement in the housing sector and the recent fall in the unemployment rate to 7.7% in November, economic activity across much of the East Coast was disrupted by Hurricane Sandy. In the **UK**, the economy emerged from the recession with a 1% quarter-on-quarter growth in Q3, after contracting for three consecutive quarters. Nevertheless, the rebound was mainly driven by one-off factors such as the Olympic Games and relatively favourable comparisons to the reduced activities in Q2 caused by the unusually bad weather and the Queen's Diamond Jubilee Bank Holiday. In **Japan**, the economy slowed significantly with real GDP contracting by 0.9% quarter on quarter in Q3, driven by weak exports and subdued private sector demand.

With sluggish growth, moderate inflation and stubbornly high unemployment, central banks across major advanced economies continued to ease monetary conditions. In the US, the Federal Reserve (the Fed) announced an open-ended quantitative easing (QE3) with the aim of purchasing US$40 billion of mortgage-backed securities a month until the labour market improves "substantially" in September. In December, the Fed further expanded its quantitative easing by purchasing an additional $45 billion per month of Treasury securities when "Operation Twist" expires at the end of 2012. The Fed also changed its low-federal-funds-rate forward guidance of maintaining low interest rate from date-based (previously mid-2015) to threshold-based (unemployment rate remaining above 6.5% and 1 to 2-year ahead projected inflation not exceeding 2.5%). In Europe, the ECB announced the OMTs. While the programme is sterilised, its impact could still be significant in easing monetary conditions among crisis economies. In the UK, the Treasury and the Bank of England launched the Funding for Lending scheme in July, designed to provide incentives to banks to boost lending to households and businesses. In Japan, the Bank of Japan expanded its asset purchase programme twice, in September and October, to 91 trillion yen as deflation persisted in the third quarter.

On the fiscal side, the risk of the US economy falling over the "fiscal cliff" remained. There are signs that growing fiscal uncertainties have led to a continued slump in business investment. The danger is that unless politicians can come to a swift agreement on the future path of fiscal consolidation, more "kicking the can down the road" will only damage economic confidence and may lead to a further downgrade by credit rating agencies, causing volatility on global financial markets. Irrespective of whether the "fiscal cliff" can be avoided in the short term, fiscal consolidation will pose a significant drag on the US recovery over the medium term. Similarly in Europe, large-scale austerity measures and structural reforms have already led to widespread anti-austerity sentiment across the region. As the euro area slides deeper into recession, there are risks that the countries in crisis will continue to fall behind their austerity targets with governments finding it increasingly difficult to push through much-needed structural reforms to regain competitiveness.

Growth in **East Asia**[1] has, in general slowed, but there was a notable divergence across individual economies. Sluggish demand from the advanced economies remained a major drag on growth, whereas consumption stayed resilient in most regional economies amid tight labour markets. Investment growth has been strong in economies where governments are committed to long-term infrastructure investment plans (for example, Indonesia and Malaysia), but it was moderate in Mainland China, partly reflecting the authorities' efforts to reduce the risk of overheating in the property market and to maintain a sustainable growth path. GDP growth in Mainland China softened further from 7.6% year on year in Q2 to 7.4% in Q3, while growth in Indonesia, Malaysia and the Philippines remained largely stable. For the region as a whole, GDP growth decreased from an average year-on-year rate of 6.3% in Q2 to 6.1% in Q3. Overall inflationary pressures eased, with average year-on-year inflation rate declining from 2.9% in Q2 to 2.7% in Q3 amid slower growth, but they have been sticky in those economies with solid domestic demand (for example, Indonesia and the Philippines). Some central banks in the region loosened their monetary policy in October in response to slowing growth[2], while the People's Bank of China maintained a prudent policy stance and continued to use reverse repos actively to manage short-term fluctuations in interbank liquidity. The new round of quantitative easing in the US has created some capital inflow pressures for the region. Most regional currencies have strengthened against the US dollar on a cumulative basis since late August. Partly reflecting the improved investor confidence in Mainland China's economic outlook, the renminbi/US dollar exchange rate has reversed its weakening trend and appreciated accumulatively by about 2% since the end of August. While weak external demand continues to challenge the outlook for the region in the near term, the accommodative monetary policy stance, together with the implementation of long-term infrastructure investment plans in some regional economies, will support domestic demand. The latest consensus forecasts project real GDP for the region to grow by 6.5% in 2012 and by 6.9% next year.

1 East Asia includes Mainland China, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand.

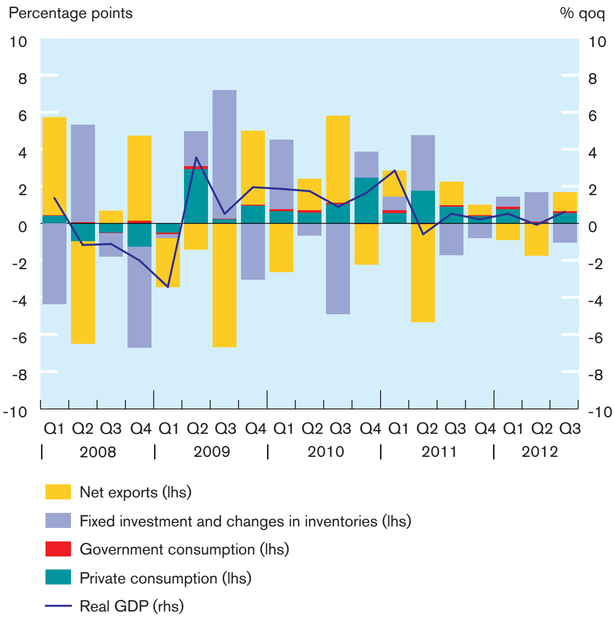
2 Bank of Korea, the Central Bank of the Philippines, and Bank of Thailand lowered policy interest rates by 25 basis points in October.

Domestic economy

The Hong Kong economy continued to grow at a below-trend rate. On a seasonally adjusted quarter-on-quarter comparison, real GDP expanded by 0.6% in Q3 after edging down a little by 0.1% in Q2 (Chart 1). The modest pick up was mainly underpinned by net exports, which showed some stabilisation after two quarters of significant drags. However, aside from an increase in merchandise shipments, growth in services exports actually softened quite visibly, partly due to weaker demand for transportation as well as moderation in inbound tourism spending. Nevertheless, net exports together contributed around one percentage point to GDP growth in Q3. Domestic demand remained soft, with only steady growth in private consumption and fixed investment, but offset by inventory destocking. In tandem with the rather weak sequential momentum, the year-on-year GDP growth reached 1.3% in Q3, marginally higher than the 1.2% in Q2.

CHART 1

Contributions to quarter-on-quarter percentage change in real GDP



Sources: Census and Statistics Department, and HKMA staff estimates.

The labour market held up rather well, with the unemployment rate sitting at 3.4% in October and still very close to the cyclical low. While turning more cautious, corporate hiring sentiment also remained broadly positive. However, some signs of weakening in the labour market emerged towards the end of Q3, as shown in slower job growth and wage increases. Despite some support to the labour demand from year-end festive spending, continued uncertainty in the external environment will restrain economic growth and weigh on the labour market, thereby exerting some upward pressure on the unemployment rate.

Inflation

Inflationary pressure eased further, as the underlying inflation rate tapered to a year-on-year 3.8% in October from 4.5% in June. The sequential pressure moderated slightly to an annualised 3.1% on a three-month-on-three-month comparison. This reflected waning food price inflation and moderation in price increases for other major CPI components. Overall, it is expected the slow-growing economy will continue to restrain inflationary pressure in the near term. However, pressure from the rental component is likely to increase further amid the gradual pass-through of rising property prices and rentals for fresh leases. Risks to inflation have also increased with additional quantitative easing in the US, through its potential impact on global commodity prices and local property prices.

Asset markets

Local stock prices gathered traction in July and August amid some alleviation of stress in European market conditions, and have risen further since mid-September with the announcement of additional quantitative easing by the US and a better-than-expected performance of the Mainland economy. The optimistic investment sentiment was also partly fuelled by expectations of more policy stimulus in Mainland China. Compared with early July, the Hang Seng Index surged by 14.5% to 22,606 on 14 December notwithstanding concerns about the US "fiscal cliff". The average daily turnover of the equity market stayed low at HK$49.2 billion in July - November compared with HK$56.7 billion in the first half of 2012. Total funds raised in the equity market declined to HK$228.7 billion in the year to November from HK$417.2 billion over the same period last year.

In the property market, the disconnect between housing prices and economic fundamentals appeared to have become more acute. In contrast to tepid income growth, housing prices surged by a cumulative 23.2% in the year to October. Housing affordability deteriorated as a result, with both the price-to-income ratio and the mortgage payment-to-income ratio rising to their post-1997 highs. Against this background, after the HKMA implemented its prudential measures in mid-September, the Government raised the Special Stamp Duty rates from 5 - 15% to 10 - 20% and extended the restriction period from two years to three on 26 October. The Government also introduced a Buyer's Stamp Duty of 15% on residential properties acquired by companies and non-locals. Market information suggests that housing prices and transaction activity have moderated as a result.

Money supply and domestic credit

On the credit front, loan growth slowed from double-digit rates last year to an annualised rate of 8.8% in the first nine months of 2012. Sequential growth remained weak at 1.9% in Q3, with only slight increases in domestic credit, but somewhat faster expansion in loans for use outside Hong Kong. Within domestic credit, the performance was rather mixed across loans to different major economic sectors (Chart 2). Trade financing, loans to wholesale and retail trade, and loans for purchase of residential property and other property-related loans grew steadily, while growth in credit card advances and loans to individuals for private use moderated slightly. However, loans to financial concerns, stockbrokers and other economic sectors declined. This broad picture of the credit market remained unchanged moving into Q4, with total loans increasing by a modest 0.4% from the previous month in October.

CHART 2
Loan growth

Source: HKMA.

Growth in total deposits accelerated to 3.0% in Q3 from 0.5% in Q2, within which Hong Kong dollar deposits and foreign currency deposits picked up by 4.5% and 1.6% respectively. Renminbi deposits in Hong Kong decreased by RMB12.0 billion to RMB545.7 billion during Q3, while total remittances for renminbi cross-border trade settlement increased by RMB75.0 billion to RMB716.9 billion. As for monetary aggregates, the Hong Kong dollar broad money expanded by 4.6% in Q3 after decreasing slightly by 0.3% in Q2. The seasonally adjusted Hong Kong dollar narrow money supply (HK$M1) also increased steadily by 2.9%. In October, total deposits and broad money continued to expand at a solid pace, while renminbi deposits picked up to RMB554.8 billion.

The low interest rate environment in Hong Kong continued amid the ongoing accommodative monetary policy in the US. The Hong Kong dollar interbank interest rates hovered at low levels, with the overnight HIBOR and three-month HIBOR fixings standing at 0.13% and 0.40% respectively in October. The composite interest rate, which reflects the average cost of funds for banks, edged down by six basis points from June to 0.36% in October. On the lending side, the average mortgage interest rate also stayed low at 2.29% in October, in part reflecting keen competition in the mortgage market. The easing of Hong Kong dollar liquidity conditions was supported by a lower Hong Kong dollar loan-to-deposit ratio, which declined to 80.4% at the end of October from 84.0% at the end of June. On the other hand, the foreign currency loan-to-deposit ratio stayed high at 54.0% due to solid expansion in foreign currency lending.

Short-term outlook

The near-term outlook for the Hong Kong economy continues to be relatively weak. On the external front, while there are signs of stabilisation, weak foreign demand will continue to restrain Hong Kong's export performance for a time. Indeed, the latest Quarterly Business Tendency Survey and the TDC Export Index all indicate that the trade-related sectors are still cautious about business in the near term. Domestically, consumer spending will continue to lend modest support to growth in real activity, owing to the sustained strength of the labour market and higher incomes over the past few years. Large-scale infrastructure works and private building activity are also expected to hold up quite well, but the outlook for capital investment and inventory stocking is less certain. The latest reading of our in-house composite index of leading indicators also points to continued soft growth in the months ahead. The Government now forecasts the economy to grow in 2012 by 1.2%, whereas private sector analysts on average expect a 1.4% growth. For 2013, the International Monetary Fund expects that Hong Kong's growth will recover to 3% as the drag from net exports further abates, while private sector analysts see growth at 3.4%.

The Hong Kong economy is still faced with downside risks, particularly for the external environment. A severe global downturn resulting from a further escalation of the euro area crisis or a fiscal shock in the US could exert considerable pressure on Hong Kong's exports and throw the broader economy into recession. Domestically, the overheating property market carries macro-financial risks to the economy. The loose global monetary conditions and the expectation of a protracted period of negative real interest rates could provide incentives for households to take up excessive mortgage leverage and pose upside risks on property prices, which in turn could further intensify the disconnect between property prices and economic fundamentals. The extremely low interest rate environment also means the mortgage burden could rise substantially in the future and put mortgagors in distress when the interest rate returns to a more normal level.