REGULAR ARTICLE

Domestic and external environment

by the Research Department

Global financial markets have been volatile since the end of May. Despite the sharp swings in equity prices and the steep rise in global bond yields, recovery in major advanced economies has generally proceeded at a steady albeit moderate pace. In the US, growth prospects look brighter relative to other advanced economies notwithstanding the still-moderate underlying growth momentum. In Europe, the euro area economy has emerged from an 18-month recession although the recovery remains fragile. In Japan, "Abenomics" has had some positive impact on near-term growth and expected inflation, though sustainability of the growth momentum remains to be seen. In East Asia, while overall growth momentum remained moderate, economic performances continued to be mixed across the region, with GDP growth in Mainland China picking up somewhat in the third quarter. In Hong Kong, growth momentum stayed moderate amid weaker domestic demand. The residential property market saw more signs of softening, but property valuation remained highly stretched. Looking ahead, growth of the Hong Kong economy is expected to remain moderate in the near term.

External environment

Global financial markets have been volatile since the end of May as market expectations over the timing and the pace of the US Federal Reserve's near-term policy exit were constantly unsettled by incoming economic data, monetary policy development and fiscal events in the US. Despite the sharp swings in equity prices and the steep rise in global bond yields, recovery in major advanced economies has generally proceeded at a steady albeit moderate pace. In the **US**, growth prospects continue to look brighter relative to other advanced economies although the underlying growth momentum remains moderate. Stripping out inventory accumulation, the final sales of domestic product grew by 1.9% in the third quarter, a touch slower than the 2.1% recorded in the previous quarter. The unemployment rate fell to 7% in November from 7.8% a year earlier, although much of the improvement was driven by a fall in labour force participation. In Europe, the **euro area** economy has emerged from an 18-month recession although the ongoing balance sheet adjustment means the recovery remains fragile. Real GDP grew by 0.1% quarter on quarter in the third quarter, following a 0.3% growth in the previous quarter. As a result of the prolonged economic slowdown, the unemployment rate remained at its record high of 12.1% in October with the youth unemployment rate climbing to 24.4%. In the **UK**, there are signs of the recovery gathering strength, with real GDP growing at its fastest pace in three years, by 0.8% quarter on quarter in the third quarter following a solid 0.7% growth in the previous quarter, mainly driven by strong growth in the services and construction sectors. Nevertheless, the pick-up has yet to be translated into sustained and stronger employment growth. In **Japan**, there are early signs of "Abenomics" having a positive impact on the economy with growth momentum remaining solid and both actual and expected inflation rates steadily rising. Real GDP grew by 1.1% quarter on quarter (annualised) in the third quarter, following a strong 3.6% growth in the second quarter. Nevertheless, weak wage growth, upcoming fiscal consolidation and mounting public debt could soon pose a serious challenge to the sustainability of the growth momentum.

With moderate recovery in the US, and slowing inflation and stubbornly high unemployment in Europe, central banks across advanced economies have continued to pursue aggressive monetary easing. In the US, the Fed defied market expectations by not tapering Quantitative Easing (QE) in the September Federal Open Market Committee meeting, and also appeared to be backing away from the "tapering roadmap" outlined in June. All of these helped to keep long term interest rates down. In Europe, the European Central Bank (ECB) cut its main refinancing rate by 25 basis points to a historical low of 0.25% in November in an attempt to guard against the rising deflation risk. The ECB also maintained its forward guidance introduced in July by stating that it expected the key interest rates to remain at present or lower levels for an extended period. Similarly in the UK, the Bank of England continued to follow its explicit forward guidance introduced in July in which it pre-committed to neither raising the bank rate from 0.5% nor reducing the £375 billion QE programme at least until the unemployment rate falls to 7%, subject to the conditions of projected medium-term inflation staying below 2.5%, inflation expectations remaining sufficiently anchored, and financial stability risks being well contained. In Japan, the Bank of Japan continued with Quantitative and Qualitative Easing (QQE) and appears on track to double its JGB holdings and the size of the monetary base in two years and to achieve a 2% inflation target by the end of 2014.

On the fiscal side, although the US Congress seems on track to approve a bipartisan budget deal in December to provide fiscal stability for the next two years, political differences between the Democrats and the Republicans over healthcare reform and other longer-term budgetary issues remain. Meanwhile, in Europe, fiscal consolidation would continue to drag on the region's recovery. While policymakers have already taken some difficult fiscal decisions and made progress in establishing a banking union, more still needs to be done to address the region's problems of high public debts and structural rigidities in the labour market.

In contrast to the relatively less-pronounced market swings in major advanced economies, many emerging market economies (EMEs), notably Brazil, India and Indonesia, have experienced heavy market sell-offs and substantial capital outflows, on fears over the potential unwinding of their large economic and financial imbalances in the event of the Fed QE tapering. Financial markets and investors' confidence in the EMEs eventually stabilised, helped by better-than-expected data releases from Mainland China, the roll-out of a number of policy measures in the EMEs and the postponement of QE tapering by the Fed. While market movements appeared to have shown some discrimination across economies during the crisis, even EMEs with relatively strong macro-fundamentals were affected to some extent. As such, going forward, the risks remain that common vulnerabilities shared across EMEs could yet be exposed simultaneously by the normalisation of monetary policy in the US.

In the **East Asian** economies[1], the overall growth momentum remained moderate, but economic performances continued to be mixed across the region. GDP growth in Mainland China rose to 7.8% year on year in the third quarter from 7.5% in the previous quarter on the back of an improvement in domestic demand, while newly industrialised economies grew at a robust pace, supported by resilient consumption growth. On the other hand, growth in some other economies in the region such as Thailand followed a moderating trend as domestic demand slowed down. For the region as a whole, the year-on-year real GDP growth increased to 6.6% in the third quarter from 6.3% in the previous quarter. Inflationary pressure remained largely contained in the region, with the exception of Indonesia where inflation surged since July mainly as a result of a cut in fuel subsidies. The CPI inflation in Mainland China has been trending upwards on a year-on-year basis in recent months but stayed lower than the official target of 3.5%, and would likely be contained in the

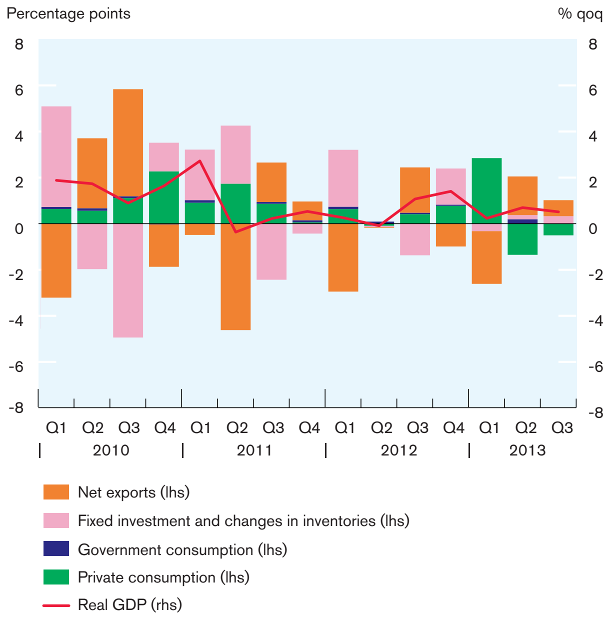
[1] East Asia includes Mainland China, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand.

near term amid moderate growth momentum. Overall, the average CPI inflation rate in the region edged up to 2.7% year on year in October from 2.3% in June. Most central banks in the region have maintained accommodative monetary policies, while paying close attention to external risk factors and financial market volatility. The Bank of Thailand reduced its policy rate by 25 basis points to 2.25% in November in view of the downside risks to growth, while Bank Indonesia raised its policy rate by 25 basis points to 7.5% in November, partly in an effort to combat inflationary pressure. The People's Bank of China continued to keep a prudent policy stance, with overall monetary conditions having tightened slightly in the third quarter. Meanwhile, East Asia had witnessed market sell-offs and a reversal of capital flows between May and mid-September amid heightened market expectations of the Fed QE tapering. The sell-offs had been more pronounced in those economies that suffered from weaker fundamentals and more vulnerable external positions. Financial markets in the region have stabilised recently, with signs of capital flows returning to the region's equity markets. Most regional currencies have appreciated against the US dollar since September after having depreciated in the previous months, while the renminbi/US dollar exchange rate has stayed on a mild strengthening path since June and appreciated cumulatively by 1.0%. Going forward, the modest recovery in the advanced economies may support the region's external demand, but it is unclear to what extent this could lift the region's growth, given the uncertainties surrounding the unwinding of QE and the fiscal situation in the US, which could increase financial market volatility and drag on domestic demand. Potentially slower growth in Japan due to the upcoming fiscal consolidation could also have adverse impact on the region's growth outlook. The latest consensus forecasts project the East Asian economy to grow by 6.5% on aggregate in 2013, the same as in 2012, and by 6.6% in 2014.

Domestic economy

In **Hong Kong**, the pace of growth remained moderate amid weaker domestic demand. On a seasonally adjusted quarter-on-quarter basis, real GDP increased only modestly by 0.5% in the third quarter, slightly slower than the 0.7% growth in the second quarter (Chart 1). Private consumption has declined for two consecutive quarters amid a smaller housing wealth effect. Overall investment spending also weakened, mainly reflecting a retreat in private-sector construction activities and capital spending. On the other hand, net exports have provided the main support to real GDP growth, led by a relatively stronger revival in exports of goods. Exports of services however deteriorated, partly due to softer inbound tourist spending. Along with the moderate sequential growth path, the year-on-year real GDP growth rate slowed to 2.9% in the third quarter from 3.2% in the second quarter.

CHART 1
Contributions to quarter-on-quarter percentage change in real GDP



Sources: Census and Statistics Department (C&SD) and HKMA staff estimates.

Despite moderation in economic activities, labour market conditions have been largely stable on the back of still-positive hiring sentiment. Total employment grew steadily in the third quarter and was able to keep pace with rising labour supply. After discounting for seasonal factors, the unemployment rate remained at a low level of 3.3%. The median monthly employment earnings increased slightly in nominal terms in the third quarter, in part due to a rise in the statutory minimum wage rate with effect from May.

Inflation

On a three-month-on-three-month comparison, inflationary pressure has softened slightly in the third quarter amid subdued imported inflation and slower increases in fresh-letting housing rentals. Food prices, however, fluctuated due to bad weather conditions but showed signs of stabilisation more recently. Overall, the seasonally-adjusted underlying inflation rate eased to an annualised 3.4% in the third quarter from 4.6% in the second quarter. The year-on-year underlying inflation rate continued to hover at around the 4% level.

Asset markets

The local equity market has shown much volatility since the end of May. After the sharp sell-off in May and most of June, local equity prices rebounded briefly on signs of improvement in the Mainland China economy. But there were sharp fluctuations again in August amid the financial market turmoil in the emerging markets. In September, local equity prices rallied as risk appetite increased following the Fed's decision not to begin tapering. There was another bout of volatility in November due to renewed concerns about Mainland China's macro-financial risks. Despite the volatility, the Hang Seng Index has on the whole risen by about 15%, while the average daily turnover increased mildly. Equity fund-raising activity was relatively quiet in July and August but became buoyant since September, bringing the total funds raised from the equity market to HK$132.9 billion in the five months to November.

The residential property market has remained quiet since the third quarter. After falling sharply in the second quarter, trading activities remained at a subdued level of some 3,600 transactions a month, compared with the monthly average of 6,800 in 2012. Within this, primary-market transactions saw some pick-ups recently but on the whole remained weak relative to last year. Speculative activities also continued to be muted with confirmor transactions and short-term flipping trade having almost vanished. Growth in overall flat prices fell to a modest 0.9% in the third quarter from 5.4% and 1.4% in the first two quarters respectively, while the Centa-City leading index has been virtually flat in recent months. Nevertheless, property valuation remained highly stretched. In particular, the price-to-income ratio reached 14.6 in the third quarter, a level comparable to the 1997 peak, while the income-gearing ratio stayed well above its long-term average of 50%.[2] The gap between rental yield and interest rate also shrank considerably, making property investment less attractive.

Money supply and domestic credit

Total loans increased sequentially by 5.0% in the third quarter, following growth of 3.0% and 6.3% in the first two quarters respectively. This brought the annualised growth rate of total loans to 19.9% in the year-to-September, faster than the 9.6% increase in 2012 as a whole. Growth in loans for use outside Hong Kong accelerated in the third quarter while growth in foreign currency loans remained fast, in part reflecting stronger global demand for the US dollar liquidity. By contrast, along with the slowdown of the Hong Kong economy, both domestic lending and Hong Kong dollar loans grew at a moderating pace of 3.6% and 3.0% respectively. In particular, growth in trade finance decelerated sharply, and loans to most other economic sectors also saw slower increases. Household debt in Hong Kong that comprises residential mortgage loans and consumer credits increased very slowly in the third quarter, but its ratio to the GDP still hovered at a high level of 61%.

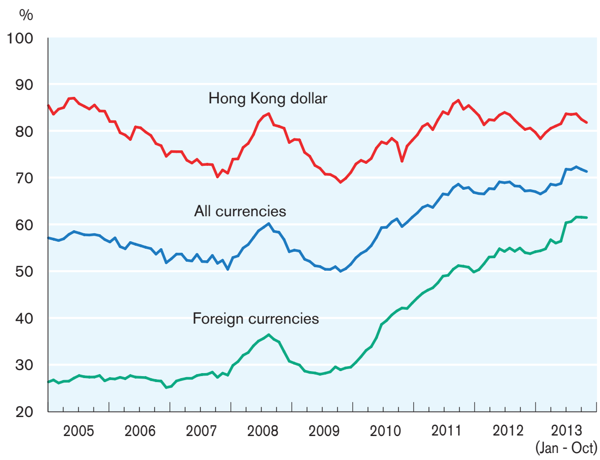
Following two quarters of modest growth, total deposits with the authorized institutions (AIs) increased notably faster by 5.0% in the third quarter. Within this, Hong Kong dollar deposits and foreign

[2] The price-to-income ratio measures the average price of a typical 50 square-metre flat relative to the median annual income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio compares the amount of mortgage payment for a typical flat of 50 square metres (under a 20-year mortgage scheme with a 70% loan-to-value ratio) with the median income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio is not the same as a borrower's actual debt-servicing ratio, which is subject to a maximum cap by the HKMA prudential measures.

currency deposits expanded by 4.5% and 5.5% respectively. Accordingly, the Hong Kong dollar broad money supply (HK$M3) grew by 4.6% in the third quarter, after staying virtually flat for two quarters. Analysed by the asset-side counterparts, growth in the broad money supply broadly reflected increases in Hong Kong dollar loans and fund flows into the non-bank private sector. As regards the offshore renminbi business, the outstanding renminbi deposits in Hong Kong rose to RMB730.0 billion in September from RMB698.0 billion in June, while total remittances for renminbi cross-border trade settlement increased to RMB921.3 billion from RMB864.4 billion during the same three-month period.

CHART 2

Loan-to-deposit ratio



Source: HKMA.

The low interest rate environment continued in Hong Kong. The overnight and three-month HIBOR fixings were largely stable at around 0.09% and 0.38% respectively, though moving up momentarily in late September in part due to intensive equity fund-raising activities. The composite interest rate, which indicates the average cost of funds for retail banks, edged up to 0.34% in October after staying flat at 0.32% during the third quarter. On the lending side, the average mortgage interest rate also stayed low at 2.24%. However, the Hong Kong dollar and the foreign currency loan-to-deposit ratios remained high, at 82.6% and 61.6% respectively at the end of September, which could suggest an increase in banks' potential funding risks (Chart 2).

In mid-October, the HKMA announced a plan to introduce the Stable Funding Requirement starting from 2014 to ensure the AIs have a stable source of funds to sustain their loan businesses.

Short-term outlook

Growth of the Hong Kong economy is expected to remain moderate in the near term. External demand would continue to lend support to Hong Kong's export performance, as the advanced economies gradually regain ground and the Mainland China economy remains broadly resilient. However, downside risks to global growth remain considerable and would hold back export growth from switching to a higher gear. This cautious view is evidenced in the latest results of the Quarterly Business Tendency Survey for the trading sector and the HKTDC Export Index. As for domestic demand, private consumption would likely bottom out after two quarters of decline and grow again at a modest pace with the support of still-positive consumer confidence, resilient labour market conditions and the spillover of global trade recovery. The housing wealth effect, however, would weaken or even turn to a drag amid the cooling of the property market. Ongoing large-scale infrastructure works and a pick-up in private-sector building and construction activities would sustain moderate growth, but the outlook for capital investment and inventory stocking remains weak due to concerns about future interest rate hikes and increased uncertainties in business prospects. The HKMA composite index of leading indicators points to a moderately faster growth path for the Hong Kong economy as a whole in the period ahead through early 2014. Private-sector analysts in December forecast real GDP growth at 3.0% for 2013 and 3.5% for 2014.

Inflationary pressure is anticipated to remain in the near term and then moderate early next year. In particular, subdued imported inflation and slower increases in fresh-letting housing rentals would help contain the upward pressure on consumer prices further into the future.