Domestic and external environment

by the Research Department

Expectations of further monetary policy divergence in major advanced economies, together with risks of a negative feedback loop from emerging markets, continue to cloud the global economic and financial market outlook. In the US, the strengthening recovery finally persuaded the US Federal Reserve to raise the federal funds target rate for the first time in almost a decade. By contrast, the continued sluggish recovery and subdued inflation in the euro area prompted the European Central Bank to ease monetary policy further. Similarly in Japan, the modest economic recovery and weak underlying wage and inflationary pressures mean market expectations of further monetary easing by the Bank of Japan continued to linger. In East Asia, growth momentum has remained subdued, with GDP growth in Mainland China moderating slightly in the third quarter on weakened external demand and subdued private investment. In Hong Kong, the underlying economic growth momentum weakened in the third quarter, dragged by moderating domestic demand and lacklustre export performance. Meanwhile, the Hong Kong dollar continued to stay close to the 7.75 level against the US dollar, with the strong-side Convertibility Undertaking being triggered intermittently in September and October mainly due to conversions of the offshore renminbi into the Hong Kong dollar. Nevertheless, credit growth slowed further amid softer corporate credit demand. The local stock market stabilised and recovered some grounds from the sell-off in the third quarter, while the residential property market shows signs of consolidation more recently.

External environment

Expectations for further monetary policy divergence in major advanced economies have re-emerged as the US Federal Reserve (Fed) has finally raised interest rates for the first time in nine and a half years, marking the start of an interest rate upcycle while the European Central Bank (ECB) has eased monetary policy further with markets still expecting the Bank of Japan (BoJ) to follow the ECB in the foreseeable future. These, together with risks of a negative feedback loop from emerging markets as highlighted in recent financial market sell-offs in August, continue to cloud the global economic and financial market outlook. In the US, despite weakening global growth, strengthening of the US dollar and the recent financial market turmoil, the underlying domestic demand remained strong with final sales to domestic purchasers (excluding inventories and net exports) growing by 2.8% quarter on quarter (annualised) in the third quarter. Employment continued to grow solidly by +211,000 jobs in November with the unemployment rate edging down to a near-8-year low of 5%, close to the Fed's estimated long run equilibrium rate of 4.9%. As a result, wage growth as measured by annual growth in average hourly earnings briefly touched a 6-year high of 2.5% in October with core CPI inflation (excluding food and energy) also edging higher to 2% in November. Similarly in the UK, the steady recovery continued with real GDP growing at a decent pace of 0.5% quarter on quarter in the third quarter after growing by a robust 0.7% in the previous quarter. The UK unemployment rate dropped to a 7-year low of 5.2% in the three months to October. In contrast, the recovery in the euro area remained sluggish with real GDP growth slowing to 0.3% quarter on quarter in the third quarter, following the 0.4% growth in the second quarter. The economic boosts from the earlier fall in oil prices and weaker euro look set to fade. This, together with the unemployment rate standing high at 10.7% in October and domestic demand continuing to be restrained by private sector deleveraging, mean there remain concerns that the ECB could struggle to achieve its 2% inflation target in the medium term with core CPI inflation remaining subdued at 0.9% in November. Similarly in Japan, although real GDP growth rebounded to 0.3% quarter on quarter in the third quarter, up from the upwardly-revised 0.1% contraction in the second quarter, the pace of recovery remained modest. The muted wage growth as measured by hourly cash earnings at 0.1% year on year in the third quarter remains a key concern despite the tight labour market as indicated by the job-to-applicant ratio hitting a 23-year high of 1.24 in October. The annual growth in the "new-core" inflation (excluding fresh food and energy) also remained subdued at 1.2% in October.

Diverging growth and inflation prospects in advanced economies mean monetary policy paths of major central banks are expected to diverge. In the US, the strengthening recovery finally persuaded the Fed to raise the target range for the federal funds rate for the first time in nine and a half years to 0.25% to 0.5% at the December Federal Open Market Committee (FOMC) meeting. While the Fed expects the subsequent increase in the federal funds rate to be gradual, the actual path would depend on the economic outlook, particularly with respect to inflation. Similarly in the UK, the steady recovery and drop in the unemployment rate mean the Bank of England continued to move gradually toward monetary normalisation although the timing is less certain. In contrast, the ECB eased monetary policy further in December by extending its asset purchase programme by 6 months until March 2017 and broadening the programme to include regional and local government debts. The ECB also lowered the negative deposit facility rate by 10 basis points to -0.3%. In Japan, although the BoJ kept its monetary policy unchanged at the November meeting, weak economic prospects and subdued inflation mean market expectations of further monetary easing by the BoJ continued to linger.

On the fiscal side, major advanced economies have continued to make progress with fiscal consolidation. In the US, as the recovery continues to strengthen, fiscal deficit is projected by the Congressional Budget Office to fall further to 2.4% of GDP in the current fiscal year (FY2015), the lowest since FY2007. Meanwhile, the new budget deal agreed by the US Congress in mid-December has also averted another political stand-off. In the euro area, the fiscal position continues to improve albeit only gradually along with the sluggish recovery. The general government deficit is projected by the European Commission to fall to 2.0% of GDP in FY2015, down from 2.6% in FY2014. Similarly in Japan, the fiscal deficit has been gradually declining since the consumption tax hike was introduced in April 2014 with the International Monetary Fund (IMF) projecting the fiscal deficit to fall to 5.9% of GDP this fiscal year, down from 7.3% in FY2014.

In East Asia[1], growth momentum remained subdued, as domestic demand growth was mediocre and export growth stayed soft. Commodity exporters were the hardest hit against the backdrop of fragile global demand and tumbling commodity prices. In Mainland China, real GDP growth moderated slightly to 6.9% year on year in the third quarter from 7.0% in the previous quarter, the lowest in six-and-a-half years, on weakened external demand and subdued private investment. For the region as a whole, the year-on-year real GDP growth slowed to 5.6% in the third quarter from 5.8% in the previous two quarters.

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

On the price front, while the region was in general under disinflationary pressure due to lacklustre global demand and weak commodity prices, there were signs of inflation bottoming out in recent months as the disinflationary effect from last year's collapse in oil prices gradually started to fade out. In the third quarter, the average CPI inflation rate for the region edged up to 1.4% year on year from an average of 1.3% in the first half of this year. Consumer price inflation in Mainland China also climbed to 1.7% year on year from 1.3% during the same period, driven in part by rising pork prices. In response to slowing growth, several regional economies have taken steps to ease their monetary policy stance. For example, the People's Bank of China (PBoC) reduced the benchmark interest rates and reserve requirement ratio further by 25 basis points and 50 basis points respectively in October, with an additional 50 basis-point cut in reserve requirement ratio for financial institutions providing lending support to SMEs and the agricultural sector.[2] Monetary easing was also conducted by the central banks in Singapore and Taiwan lately.[3] On the other hand, other central banks in the region have kept their policy interest rates on hold in the face of an increasingly difficult monetary policy trade-off between supporting growth and mitigating capital outflows. Meanwhile, financial markets in the region appeared to have stabilised after seeing turbulent times in the summer, as decisions by the Fed to leave policy interest rates unchanged in September and October have given some relief to the region in the face of capital outflow pressure. In particular, many currencies and equities in the region have stabilised, despite remaining weak, after massive sell-offs between May and September. Looking ahead, the outlook for the region still hinges largely on the pace and timing of US monetary policy normalisation. Any tightening in monetary conditions along with US monetary policy normalisation and capital outflow pressure could have a significant impact on the already weakened economy.

2 To push ahead with interest rate liberalisation, the PBoC also removed the ceiling of banks' deposit rates.

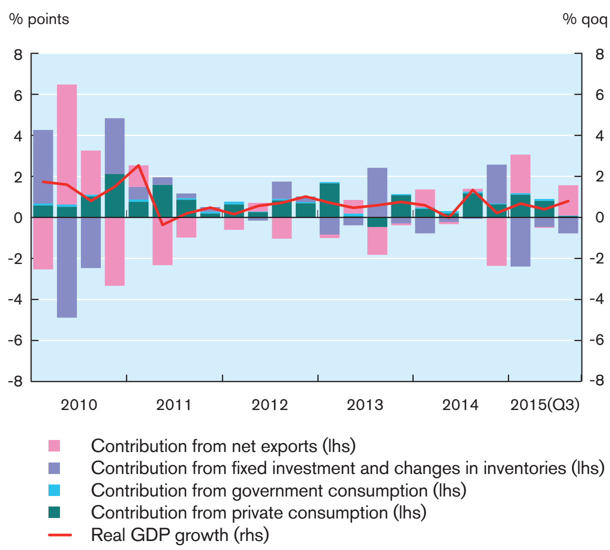
3 The Monetary Authority of Singapore reduced the slope of its SGD NEER policy band slightly in October and the central bank of Taiwan also cut its policy interest rate by a total of 25 basis points in September and December.

Domestic economy

In Hong Kong, the seasonally adjusted real GDP grew by 0.9% quarter on quarter in the third quarter of 2015, compared with the 0.4% growth in the second quarter (Chart 1). While real GDP growth picked up in sequential terms, the underlying growth momentum actually weakened with most of the GDP components showing little growth or even contraction (Table 1). Private consumption flat-lined while overall fixed investment remained weak. Export performance was also lacklustre amid sluggish global and regional trade flows, as well as continued weakness in inbound tourism. Imports of goods and services also declined partly due to weaker domestic demand. However, as total exports fell less than total imports, net exports turned out to have provided moderate support to real GDP growth. Meanwhile, a slower pace of destocking also helped lift real GDP growth. But on a year-on-year basis, real GDP growth slowed to 2.3% in the third quarter from 2.8% 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.

TABLE 1
Real GDP by components

	2014 annual change (%)*	2015 Q1	2015 Q2	2015 Q3	2015 Q1	2015 Q2	2015 Q3
		year-on-year change (%)*			quarter-on-quarter change (%)*		
Real GDP	+2.5	+2.4	+2.8	+2.3	+0.7	+0.4	+0.9
Private consumption	+3.2	+5.3	+6.1	+4.3	+1.8	+1.3	+0.1
Government consumption	+3.0	+3.4	+3.3	+2.6	+0.8	+1.1	+0.2
Gross domestic fixed capital formation	-0.2	+7.5	+5.2	-6.5	n.a.	n.a.	n.a.
Buildings and construction	+6.5	-3.3	+13.4	+4.2	n.a.	n.a.	n.a.
Machinery and equipment	-6.5	+14.4	-1.3	-10.5	n.a.	n.a.	n.a.
Change in inventory (in HK$ bn)	+7.9	-6.6	-9.0	-5.5	n.a.	n.a.	n.a.
Exports: Goods	+0.8	+0.4	-3.6	-3.2	-1.4	-3.2	+0.5
Exports: Services	+0.9	+0.0	+0.9	-1.3	+0.9	-0.8	-1.9
Imports: Goods	+0.9	+0.1	-3.2	-4.1	-2.1	-3.1	-0.9
Imports: Services	+1.9	+6.1	+3.6	+4.1	+0.8	+1.5	-0.3

* Unless otherwise stated.

Source: C&SD.

Incoming higher-frequency indicators also point to continued softness in the growth momentum of the Hong Kong economy. Both merchandise trade and retail performance remained sluggish in October. The Purchasing Managers' Index (PMI) stayed below the 50 mark for the ninth consecutive month in November, while the latest Quarterly Business Tendency Survey indicates more cautious business sentiment. Meanwhile, the HKMA in-house composite index of leading indicators suggests that the weak growth momentum would likely continue through early next year.

Overall labour market conditions remained stable in the third quarter, with the unemployment rate continuing to stay low at 3.3%. There were, however, early signs of softening in labour demand, as total employment levelled off along with the weaker economic growth momentum. The main drag came from the import/export trade sector and the retail, accommodation and food services sector, which have cut employment for two straight quarters, while the pace of hiring remained stable in other business sectors.

Inflation

Inflation stayed on an easing trend, as local cost pressures were largely contained and imported inflation stayed benign. Domestically, wage pressure was steady, while the price pressures from the retail segment and other services sectors weakened amid growth slowdown of the domestic economy. Externally, imported inflation was restrained by the easing price pressures in Hong Kong's major import sources and lower international commodity prices. Taken together, the year-on-year underlying consumer price inflation softened to 2.4% in the third quarter from 2.5% in the second quarter and 2.6% in the first quarter.[4]

Asset markets

The local stock market was hit by a host of global financial market events during the third quarter. The Hang Seng Index (HSI) dropped by 28% from an eight-year high in April to a low of 20,557 in September amid the sell-off in the Mainland A-share market, heightened volatility in the global foreign exchange market, as well as weakness in global commodity prices. Afterwards, global and Mainland financial markets stabilised, and the HSI recovered some grounds, rising to 21,996 at the end of November. However, the average daily turnover of the equity market continued to decline, down from HK$101.5 billion in the third quarter to HK$77.4 billion in October and November. On the other hand, equity fund-raising activities picked up in recent months after a subpar performance in the third quarter.

[4] The underlying inflation rate refers to the CPI inflation rate after netting out the effects of all Government's one-off relief measures.

The residential property market shows signs of consolidation since August amid increased stock market volatility and softening economic growth. Housing transaction volume declined to a monthly average of 3,571 units between August and November from 5,379 units in the first seven months of the year as secondary-market activities weakened noticeably. Although primary-market transactions remained robust, the pace of sales has slowed in recent months. Meanwhile, following a modest increase in the third quarter, housing prices in the secondary market decreased in October, and the downward adjustments continued in November and December as indicated by the Centa-City leading index. Yet, housing affordability remained stretched, with the housing price-to-income ratio staying high at 15.8 in the third quarter and the income-gearing ratio climbing higher to 70.9%. On the other hand, after seven rounds of prudential tightening, the average loan-to-value ratio declined to 49.3% in October, and the average debt-servicing ratio fell to below 35%.

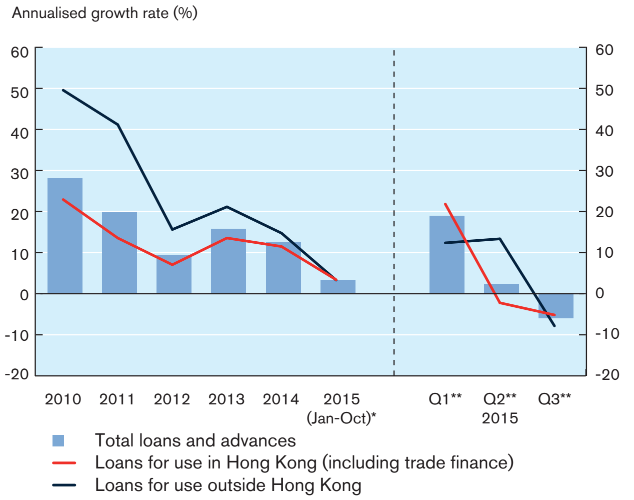
Money supply and domestic credit

Hong Kong's interbank liquidity remained ample during the third quarter and in recent months, with interest rates staying at low levels notwithstanding worsening financial market conditions. The strong-side Convertibility Undertaking was triggered intermittently between 1 September and 30 October, driven by conversions of the offshore renminbi (CNH) into the Hong Kong dollar and ordinary business demand for the Hong Kong dollar. This led to further expansion of the Aggregate Balance, and as a result, the Hong Kong dollar Monetary Base rose by 10.8% between the end of June and the end of October. Despite some fluctuations in August, overnight and three-month Hong Kong Interbank Offered Rate (HIBOR) fixings stayed low at around 0.05% and 0.39%, respectively, between July and October. During the same period, the Hong Kong dollar yield curve flattened at the longer end, with the 10-year yield of the Hong Kong dollar Government Bond falling by 26 basis points to 1.53% at the end of October. Meanwhile, the composite interest rate, which reflects retail banks' funding costs, edged down to a recent low of 0.25%. The average interest rate for new mortgage loans also remained low at around 2%.

While the Monetary Base picked up noticeably, the Hong Kong dollar broad money (HK$M3) decreased moderately by 0.7% quarter on quarter in the third quarter. This was mainly due to a 0.6% decrease in Hong Kong dollar deposits. As for foreign currency deposits, US dollar deposits rose by a noticeable 6.5% in the third quarter, but other foreign currency deposits contracted by 3.0%, mainly reflecting a drop in renminbi deposits. Overall, total deposits with banks increased steadily by 1.0% in the third quarter.

Credit growth decelerated further reflecting weaker corporate credit demand. For the first ten months as a whole, the annualised growth rate of total bank loans slowed to 3.4% compared with 12.7% for the full year of 2014 (Chart 2). On a quarterly comparison, total loans posted the first decline since 2009, down 1.5% (6.0% annualised) in the third quarter after a modest increase of 0.6% (2.5% annualised) in the second quarter. Loans for use outside Hong Kong dropped by 2.0% (7.9% annualised) after several quarters of strong increases, while loans for use in Hong Kong including trade finance declined further by 1.3% (5.2% annualised), with trade finance, loans to stockbrokers, and loans to the wholesale and retail trade sector being the main drags. As for the household sector, the debt-to-GDP ratio edged up to 66.3% in the third quarter, reflecting a faster increase in residential mortgage loans which offset a slight decline in personal loans. As Hong Kong dollar loans decreased while deposits increased, the Hong Kong dollar loan-to-deposit (LTD) ratio fell to 77.4% in October, and the foreign currency LTD ratio also declined to 63.1%.

CHART 2
Loan growth



Notes: *Annualised growth rate for the period between January and October

**Annualised quarter-on-quarter growth rate

Source: Hong Kong Monetary Authority.

The renminbi liquidity pool in Hong Kong contracted in the third quarter, in part reflecting a decline in customer deposits amid market expectation of renminbi depreciation and net payment outflows in trade settlement transactions. The total of renminbi customer deposits and outstanding certificates of deposit fell by 13.4% from the end of June, to RMB960.4 billion at the end of October. But on the whole, renminbi banking business continued to see solid growth in Hong Kong. For example, the outstanding amount of renminbi bank loans expanded by 24.3% from four months earlier to RMB293.6 billion at the end of October. Renminbi trade settlement transactions handled by banks in Hong Kong rose to RMB2,050.1 billion in the third quarter, up 30.6% from RMB1,569.7 billion in the second quarter. The average daily turnover of renminbi real time gross settlement (RTGS) system also increased further to RMB1,066.7 billion in October, compared with RMB732.7 billion in the whole of 2014. On 30 November, the IMF decided at its Executive Board meeting to include renminbi in the Special Drawing Rights (SDR) basket, effective from 1 October 2016. Going forward, Hong Kong will continue to play a pivotal role in promoting the internationalisation of renminbi, and benefit from the ongoing process of Mainland's capital account liberalisation.

Short-term outlook

Growth momentum of the Hong Kong economy is expected to stay moderate in the near term. Given the still-challenging global economic outlook, Hong Kong's external trade performance is likely to remain constrained by sluggish global trade flows, continued weakness in inbound tourism and some softening in financial services exports in the face of increased market volatility. On the domestic front, growth in private consumption will moderate somewhat due to loosening of labour market conditions and possible negative wealth effects stemming from asset price volatility. Moreover, weaker business sentiment and expected rises in interest rates would continue to weigh on capital investment, while building and construction activities should hold up well. Based on the latest consensus forecast, private-sector analysts project real GDP growth at 2.4% in 2015 and 2.0% in 2016.

However, the macroeconomic outlook is subject to downside risks including weaker-than-expected global growth prospects, unexpected shocks stemming from the US interest rate normalisation particularly with the divergence of monetary policies in the euro area and Japan, as well as possible escalation of geopolitical risks. These risk factors could lead to more volatile international capital flows and global financial conditions, with potential negative spillovers to the Hong Kong economy through financial and credit channels. Domestically, valuation of the property market is stretched, and downward pressures on property prices could increase amid upcoming rises in US interest rates and the gradual narrowing of the housing demand-supply gap.