Economic activity picked up in the US in the September quarter, but Japan remains mired in recession. Weak economic growth in the OECD economies during the first half led to a change in monetary stance. The major industrialised countries, most notably Japan, lowered their interest rates to ensure continued economic growth as inflation risks remained low.

The favourable US economic environment continued to underpin the strong performance of the US equity and bond markets. Meanwhile, boosted by some well-timed central bank interventions and financial deregulation in Japan, the US dollar appreciated strongly through most of the September quarter. However, it slipped back somewhat in late September after the announcement of the Japanese stimulative package disappointed the markets and some disorder occurred within the ERM.

In China output is slowing and inflation continues its downtrend. There were continuing efforts to promote commercial banking, and a plan to liberalise interest rates in a phased manner over the next 7-8 years was announced. The Ninth Five-Year Plan will, in addition to continuing the plan-to-market transition, focus attention on state enterprise reform, reduction in regional disparities and agricultural development.

OECD Economies

The economic outlook for the major countries shows signs of improvement. The policy shifts have inspired demand and production has already picked up in the US (Chart 1). This was also reflected in the views of forecasters who stopped revising down their GDP forecasts for 1995 and in some cases bolstered forecasts for 1996 (Chart 2).

Attributed to the interest rate rises that had succeeded in slowing economic growth, and the build-up of inventories, US real GDP growth took a pause in the first half of 1995 after robust growth in 1994. It grew 0.7% in the March quarter, followed by only 0.3% in the June quarter. However, growth was a strong 1% in the September quarter.

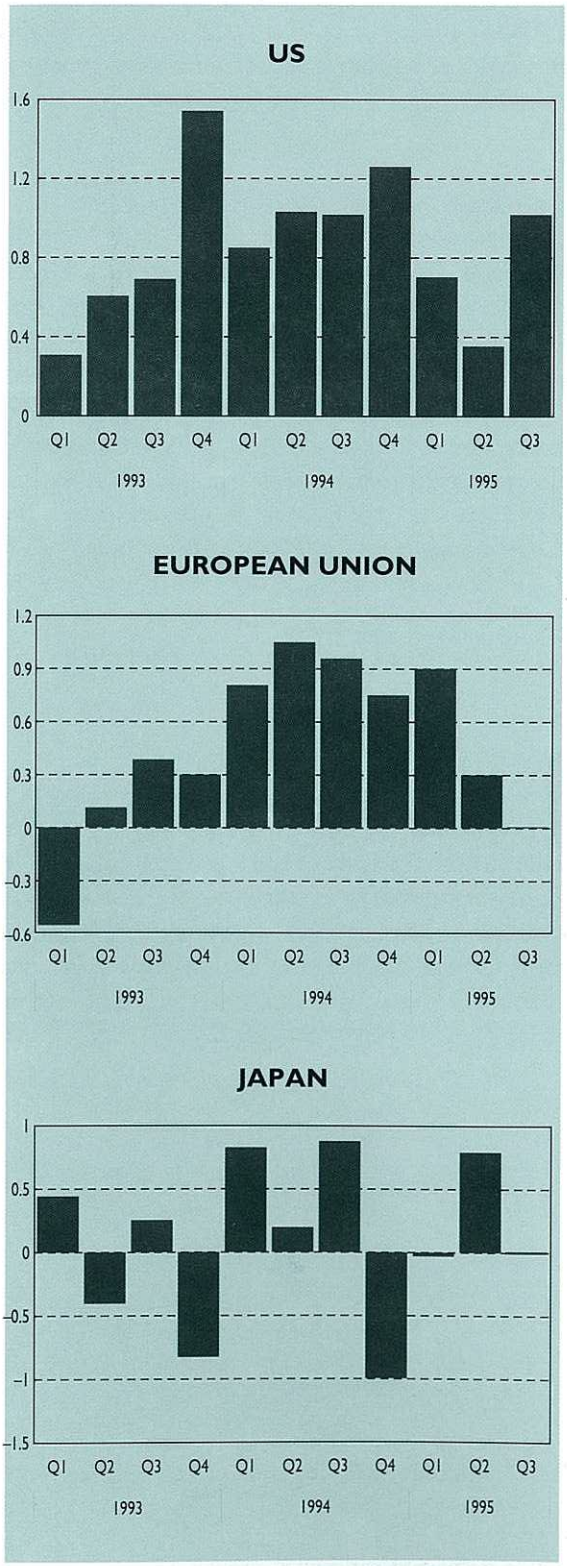
Industrial production leapt by 1.1% in August and held most of this gain in September, when capacity utilisation was at 83.8% compared to an average of 81.9% during the past decade. The unemployment rate slipped to 5.6% in August and September and further to 5.5% in October, from 5.7% in July, as growth accelerated in the service industries and local government. Payrolls have grown at an average monthly rate of 150,000 persons since May, around the long term average. Assisted by cheaper mortgages as long term bond yields decline, continued gains have also been reported in the housing sector.

There are, however, indicators which are much weaker. Retail sales growth is down from annual rates of around 8% last year to 5% recently. This may reflect weaker consumer sentiment. One measure of this fell back in September and October, although it was still above both its recent low in June and its long term average.

As a result of the spillover effect from the US, production in Canada declined early in the year. The resumption of economic growth in the US has seen some recovery although uncertainty over the constitutional status of Quebec has been unsettling financial markets.

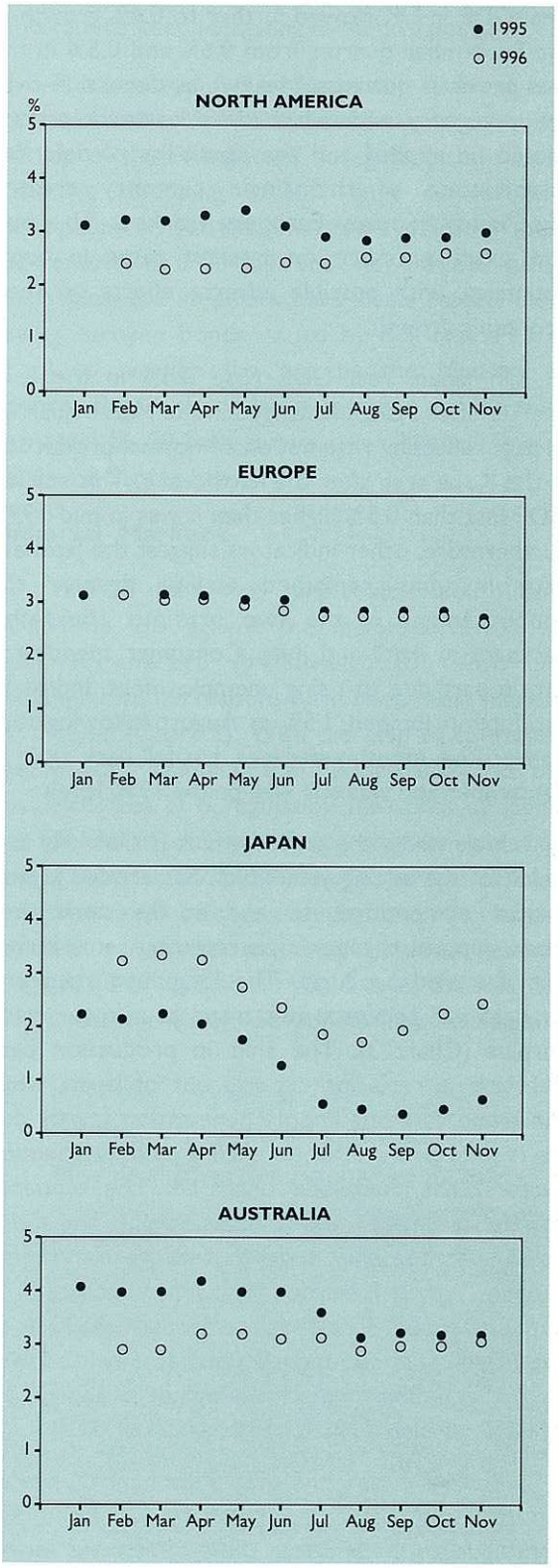
Meanwhile, the long-awaited German GDP figures showed Pan-German GDP fell by 0.7% in the March quarter before rebounding by 0.9% in the June quarter. The economic setback was mainly attributed to a slowdown in global economic activity, the strong Deutschemark damaging German's export competitiveness and the building boom that hit Germany after the unification in 1990 tapering off. This adds extra pressure to the already high unemployment.

Chart 1
Real GDP (Quarterly % Change)



Source: Datastream

Chart 2
Forecast of Real GDP
Annual % change as reported in successive Economist polls



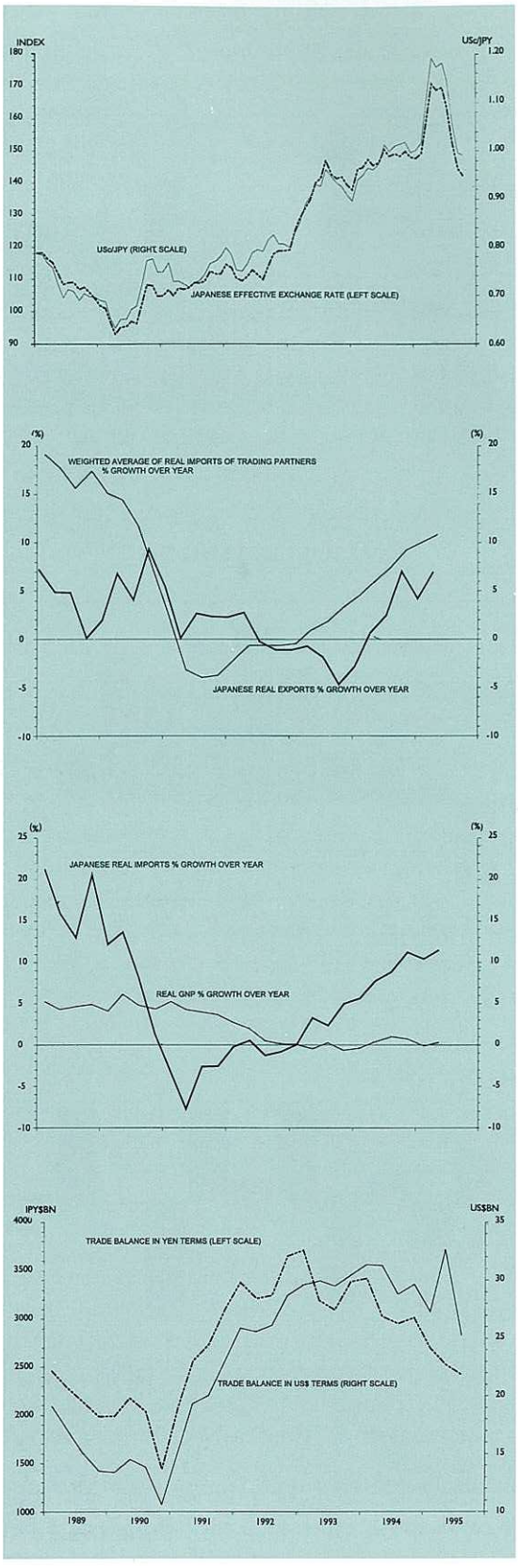
The French economy grew 0.4% in the June quarter, down from the March quarter's 0.7%. The drag on growth came from huge destocking and a sharp fall in investment. Destocking was also large in Italy, leading to a fall in GDP in the June quarter. Real GDP in UK slowed further to 0.4% growth in the September quarter from 0.6% and 0.5% in the two previous quarters. Meanwhile, discussion over the stringency with which the Maastricht criteria should be applied and the possibility of deferring introduction of the single currency created uncertainty in many European markets. This may add extra pressure on interest rates in some countries, with possible adverse effects on their economic growth.

In Japan, real GDP rose 0.8% in the June quarter after being unchanged in the March quarter, in part reflecting resumption of normal production in the Kobe area after the earthquake. This still left GDP less than 0.5% higher than it was in mid-1992. Furthermore, other indicators suggest the Japanese economy has remained stalled despite the announcement of the two previous stimulative packages in April and June. Consumer spending is flat, in part due to rising unemployment. Industrial production jumped 2.5% in August following four consecutive monthly declines, but fell back again in September and was still well below 1990 levels.

Meanwhile, the trade surplus is shrinking as a result of the strong yen, which has eroded Japan's export competitiveness, and at the same time made imports cheaper, thus replacing some home-manufactured products. The long-term structural changes will reinforce this trend of a lower trade surplus (Chart 3). The shift in production base overseas is replacing exports out of Japan, while the trend to rising import penetration (partly due to restructuring in the retailing and distribution sectors) has continued unabated. The tendency towards a smaller visible trade surplus and rising invisible trade deficit suggests that Japan's current account surplus is headed for further declines. The current account surplus fell to around US$30 bn in the March and June quarters and somewhat lower in the September quarter, equivalent to around 2% of GDP; in early 1993 it had been 3% of GDP.

Besides cutting the official discount rate to an historic low of 0.5%, the Bank of Japan has continued to guide other short-term rates lower, hoping to revive the weak economy. To provide

Chart 3
Japan's Balance of Payments



further impetus, a third stimulus package this year totalling 14.2 trillion yen was announced on 20 September. Coupled with the yen's recent depreciation, the package should induce some improvement in Japan's economic situation although problems within the banking system will remain a drag on growth.

Prices

The weather-induced rise in agricultural commodity prices did not push up overall inflation (Chart 4). Producers were reluctant to pass the price rise onto consumers given the slowdown in global economic activity. Inflation has thus generally remained subdued in the industrialised countries. Inflation in the US has remained tame, the headline CPI falling to 2.5% in September from its recent peak of 3.2% in May, while the rate excluding food and energy has stayed around 3% for over a year. In Germany, weakness in the economy has led to inflation falling to 1.6% in October, the lowest in almost 7 years. In Japan many measures of prices are still declining.

Monetary Policies

The Fed trimmed its fed funds rate for the first time in nearly three years in July as the US economy showed signs of a slowdown in the second quarter. The Fed has then held interest rates unchanged as a brightening economic outlook emerged, which made the "slightly restrictive" stance of real interest rates (see Box 1) seem appropriate. The Fed funds rate and the discount rate stand unchanged at 5.75% and 5.25% respectively.

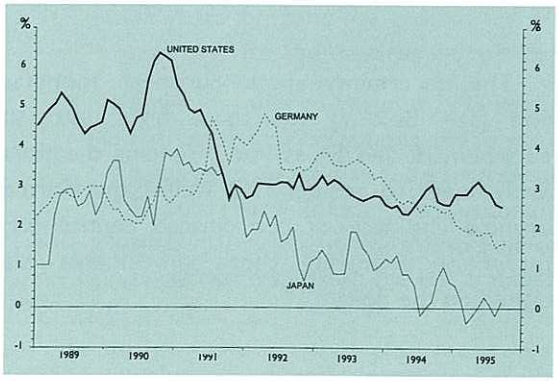
On the back of weak M3 growth and falling inflation, the Bundesbank lowered its lombard and discount rate by 50 basis points to 5.5% and 3.5%, respectively, on 24 August. Since the rate cut, the Bundesbank has continued to nudge down the repo rate to keep loosening monetary policy.

The past stimulus packages and discount rate cut have failed to resuscitate the Japanese economy. On top of the unexpected deregulation measures (including scrapping a 50% limit on insurers' participation in yen-denominated syndicated loans and removal of a 90-day "lock-up" period, during which Japanese investors have been barred from buying euroyen bonds issued by non-residents of Japan) to weaken the yen by the Ministry of Finance, the Bank of Japan lowered its discount rate again by 50 basis points to an historic low of 0.5% on 8 September.

Financial Markets

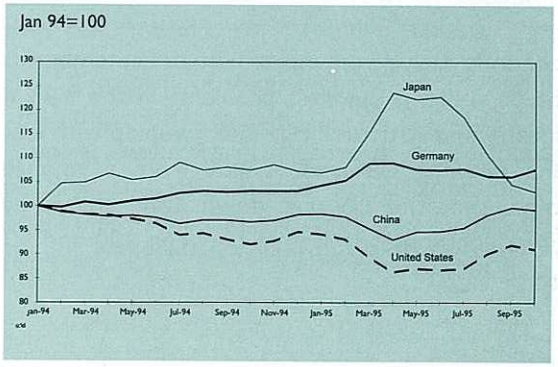
The US dollar was very volatile after hitting an all-time low against the major currencies in April. In effective (trade-weighted) terms the exchange rate fluctuations have been most marked for the yen (Chart 5). With the help of concerted intervention, including the Bundesbank, and the announcement of deregulation measures by Japan, the US dollar climbed sharply higher. It rallied further after the endorsement of dollar appreciation by some key officials in the world's largest economic powers. At one time, the dollar reached a high of 104.7 against the yen, a level not seen for 15 months. However, disappointment that Japan's

Chart 4
Consumer Prices (% growth over year)



Source: Datastream

Chart 5
Four Largest Economies: Nominal Effective Exchange Rates



Source: Datastream, HKMA estimates

Box 1: Real Rate Reality

An important element in assessing the stance of US monetary policy is the real fed funds rate. (The real funds rate is simply the nominal funds rate less expected inflation.) For example, the minutes of the 22 August FOMC meeting recorded that some members characterised monetary policy as "slightly to the restrictive side at least in terms of the inflation-adjusted federal funds rate".

While this concept sounds simple enough, there is the problem of just what constitutes expected inflation. Most economists use past inflation – often the consumer price increase over the past year – as a proxy for expected inflation. There are few alternatives to this approach when analysing the history of the real funds rate, as there are no measures of inflation expectations which have been recorded for the past several decades. Over the more recent past, however, measures of inflation expectations do exist and offer an interesting comparison to the usual method of using past inflation as a proxy for inflation expectations.

Looking back at the past 30 years, the average real funds rate using the previous year's rise in the Consumer Price Index (CPI) as a measure of inflation is 2.0%. This average is arguably a fair measure of the "neutral" real funds rate as inflation was at similar rates in 1965 as now and neither year was a recession nor boom.

To compare this "neutral" rate to the current real rate, one must decide on a measure of inflation expectations. The popular measure – the past year's CPI change – is currently 2.6%. Using the current nominal funds rate target of 5.75%, one will thus come up with a 3.15% real funds rate, 115 basis points above the presumed "neutral" real rate. (Whether the economy is currently at a stage when it is appropriate for the real rate to be tighter than neutral is another question.)

There are, however, other possible measures of inflation expectations. If one looks at only the core CPI, which rose 2.9% over the year to September, the real rate falls to 2.8%. If instead one were to use the 3.2% inflation forecast for 1996 by the IMF, the implied real funds rate dips further to 2.55%.

Finally, there are inflation expectations themselves. The Conference Board has been measuring inflation expectations for the year ahead since 1987. These expectations have been surprisingly stubborn. Despite an inflation rate which has averaged 3.2% since the beginning of 1991, consumer expectations for the next year's inflation seldom drop below 4.0%. Using these expectations to measure the real funds rate, one will now have a 1.75% real rate – below the presumed "neutral" rate!

economic package announced on 20 September did not do more to address problems in the banking industry and structural rigidities, coupled with fears of a growing US trade deficit from a stronger dollar, sent the US unit down again and it has subsequently mostly traded between 100 and 104 yen.

The uncertainty about European monetary union (see Box 2) led to a flight into the Deutschemark and Swiss franc, sending the dollar sharply lower to around 1.42 against the German currency. The lack of coordinated central bank intervention following these movements also weighed on the dollar.

Box 2: European Monetary Union

European monetary union (EMU) is a major financial, and hence economic, issue in Europe given the difficulties for the member countries in meeting the criteria set under the Maastricht Treaty.

A key component of the journey towards monetary union is to have price stability within the European Monetary System. The core feature is the *Exchange Rate Mechanism* which was implemented in 1979 to limit exchange rate volatility between member states' currencies. The initial fluctuation band was +/– 2.25% around fixed central parities, with a 6% band for weaker currencies. In 1992 Sterling and Lira, being casualties of speculative attacks, were withdrawn from the system. Further turmoil in 1993 caused the widening of the fluctuation band to +/– 15%.

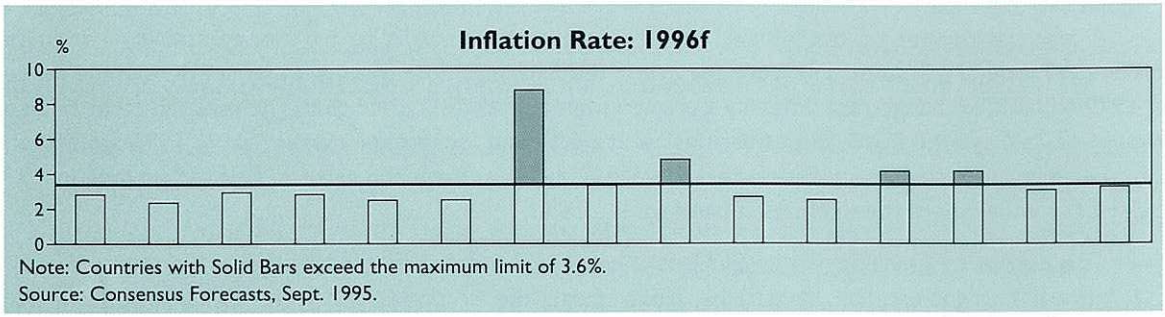
The European Currency Unit (ECU) is a basket of currencies containing fixed amounts of most EU national currencies. The Maastricht Treaty froze the composition of the ECU basket in 1989. Weights of each currency in the ECU are as follows:–

	Composition	Weight as at end-October 1995 (%)
Belgian Franc	3.301	8.6
Danish Krone	0.1976	2.7
Deutsche Mark	0.6242	33.1
Greek Drachma	1.440	0.5
Portuguese Escudo	1.393	0.7
French Franc	1.332	21.0
Dutch Guilder	0.2198	10.4
Irish Pound	0.008552	1.0
Luxembourg Franc	0.130	0.3
Italian Lira	151.8	7.0
Spanish Peseta	6.885	4.1
Pound Sterling	0.08784	10.6
		100.0

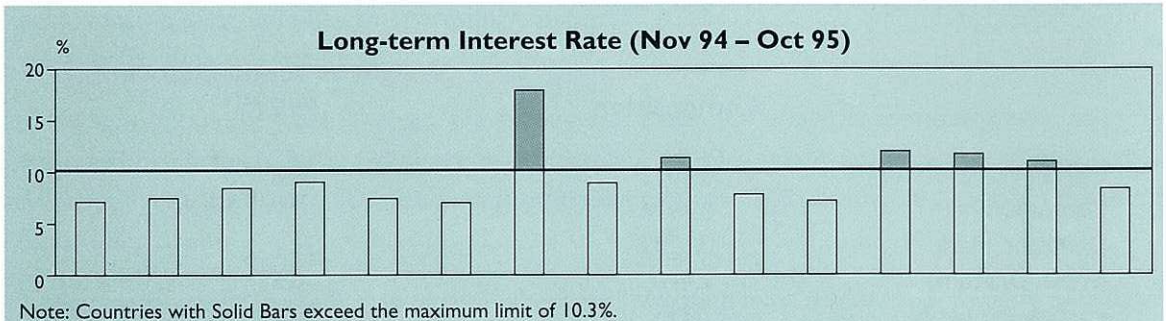
The Maastricht Treaty contemplates a staged approach, with convergence of national economies preceding monetary union;

- Stage I – involved principally the liberalisation of capital flows, and was largely completed by the time of the Maastricht Treaty.
- Stage II – involved the creation of European Monetary Institute (EMI) in Frankfurt in early 1994, to prepare the ground for EMU. Member states were to move towards economic convergence and towards independence of their central banks.
- Stage III – was to begin in 1997 at the earliest, if a majority of states met the criteria, and by the latest in 1999 among those states that met the criteria as at July 1998. It includes the establishment of the European System of Central Banks which consists of the European Central Bank (ECB), the successor to the EMI, and the national central banks of all participating countries, irrevocable fixing of exchange rates, and the rapid introduction of a single currency. Both the UK and Denmark have opt-outs from automatic entry into EMU.

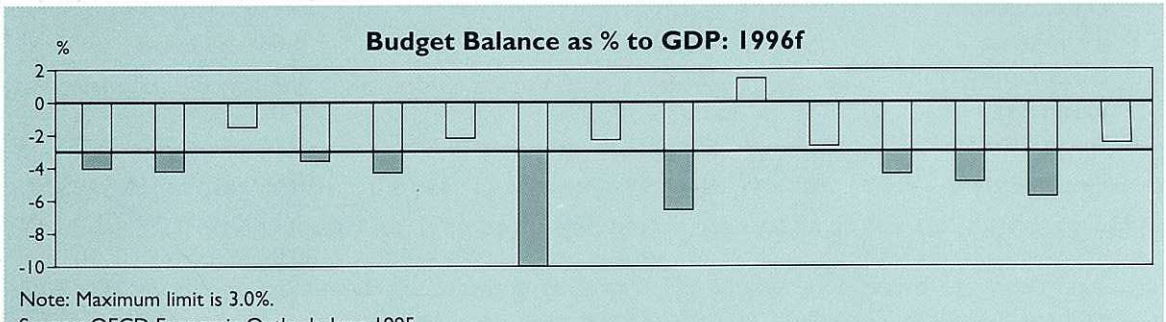
Convergence Situation of Potential EMU Members



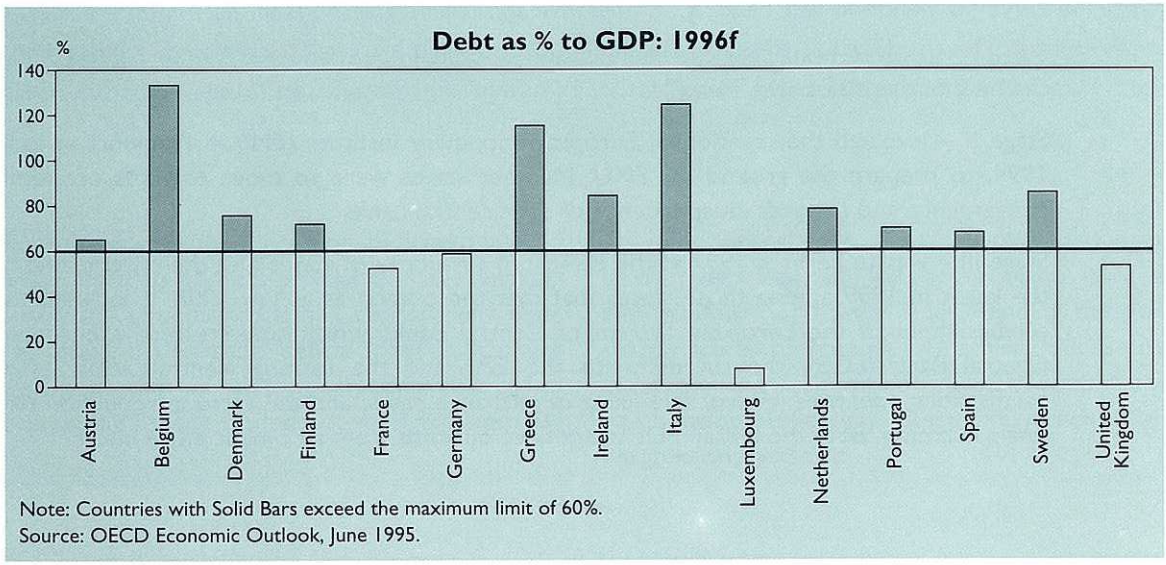
Note: Countries with Solid Bars exceed the maximum limit of 3.6%.
Source: Consensus Forecasts, Sept. 1995.



Note: Countries with Solid Bars exceed the maximum limit of 10.3%.
Source: Bloomberg



Note: Maximum limit is 3.0%.
Source: OECD Economic Outlook, June 1995.



Note: Countries with Solid Bars exceed the maximum limit of 60%.
Source: OECD Economic Outlook, June 1995.

According to the Convergence criteria (Article 109F),

- Annual CPI over the past year must not be more than 1.5% above the average of the 3 lowest inflation countries in the EU.
- Long term interest rates over the past year should not be more than 2% above the average of the 3 countries with the lowest inflation rates.
- General government deficit should not exceed 3% of GDP unless the ratio has been declining and is close to 3% or any excess is only temporary.
- General government debt should not exceed 60% of GDP unless the ratio is declining and is close to 60%.
- Exchange rates should be kept within normal fluctuation bands without severe tensions for 2 years prior to joining EMU.

As seen from the charts on the preceding page, the countries most likely to meet a strict interpretation of the EMU criteria by the end of 1996 are Germany, Luxembourg and the UK. On a flexible interpretation of the convergence criteria, Austria, Denmark, Finland, France, Ireland, and the Netherlands are likely to qualify.

The primary objective of the ECB shall be to *maintain price stability*. Monetary policy would be decided by the ECB, with national central banks executing aspects of this policy. The ECB would have control over authorising single currency note issuance by the central banks of the member countries.

The Treaty provides no plans to centralise control over the member countries within the EMU. However, it has provided for an excessive deficit procedure to deter member countries from undermining the EMU's price stability with fiscal malaise. The ECB may impose sanctions if a member country's deficit is excessive. Such sanctions include fines, non-interest bearing deposits to be made with the ECB, and publication of additional information before further government debt may be issued.

The irrevocable fixing of exchange rates in Stage III, now generally conceded to be in 1999 rather than 1997, will see the emergence of a European bond market with a uniform currency, leaving credit rating and liquidity as the main factors contributing to spreads between the member countries. Therefore, the rates at which the national currencies will be converted to the single currency are an important question for the financial markets. The EMI's Preliminary Convergence Report is scheduled for publication in November 1995. The EU Summit to be held in Madrid on 15/16 December 1995 will decide on the transition strategy and the name of the future Euro currency.

China

Economic Performance and Inflation

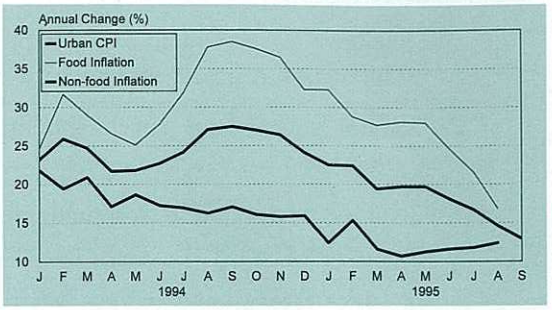
Economic growth and inflation continue to moderate. Real GDP in the first three quarters of 1995 was 9.8% above the corresponding period in 1994, a slower growth than the 11.8% for 1994 as a whole. The corresponding figures for fixed asset investment show a more marked slowdown from 28% to 18%.

Inflation, as measured by the annual change of the 35 cities cost-of-living index, declined steadily from the peak of 27.5% in September 1994 to 12.9% in September 1995, helped by the freeze in all price reform measures, a good summer harvest despite the floods, and a ban on grain exports and 140% increase in imports of grain (Chart 6).

Inflation is unlikely to resurge in the rest of the year because of supply-side factors, as the 1995 grain output target now looks likely to be met. On the demand side, the M2 measure of the money supply has slowed somewhat, from 36% during the year to March to 31% during the year to September.

The Ninth Five-Year Plan (1996-2000) (see below) has set an annual average inflation target of less than 10%. Achievement of this target together with the economic growth target of an annual average of 8-9% may require greater progress in state enterprise reforms.

Chart 6
China: Inflation
(35 Cities Cost-of-living)

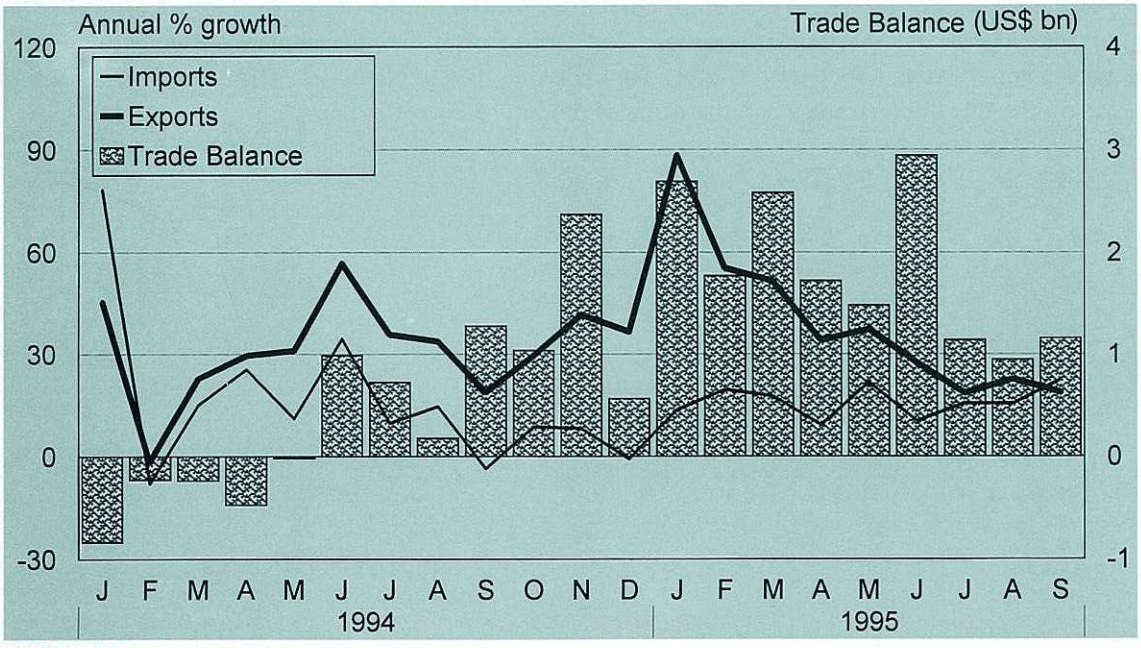


Source: China Monthly Statistics, Reuters

Balance of Payments and Exchange Rate

The balance of payments remained strong. A US$16 bn trade surplus was recorded in the first nine months due mostly to strong growth in exports (Chart 7). On the capital account side, US$23 bn of foreign direct investment was recorded in the first eight months.

Chart 7
China: External Trade



Source: China Monthly Statistics, Reuters

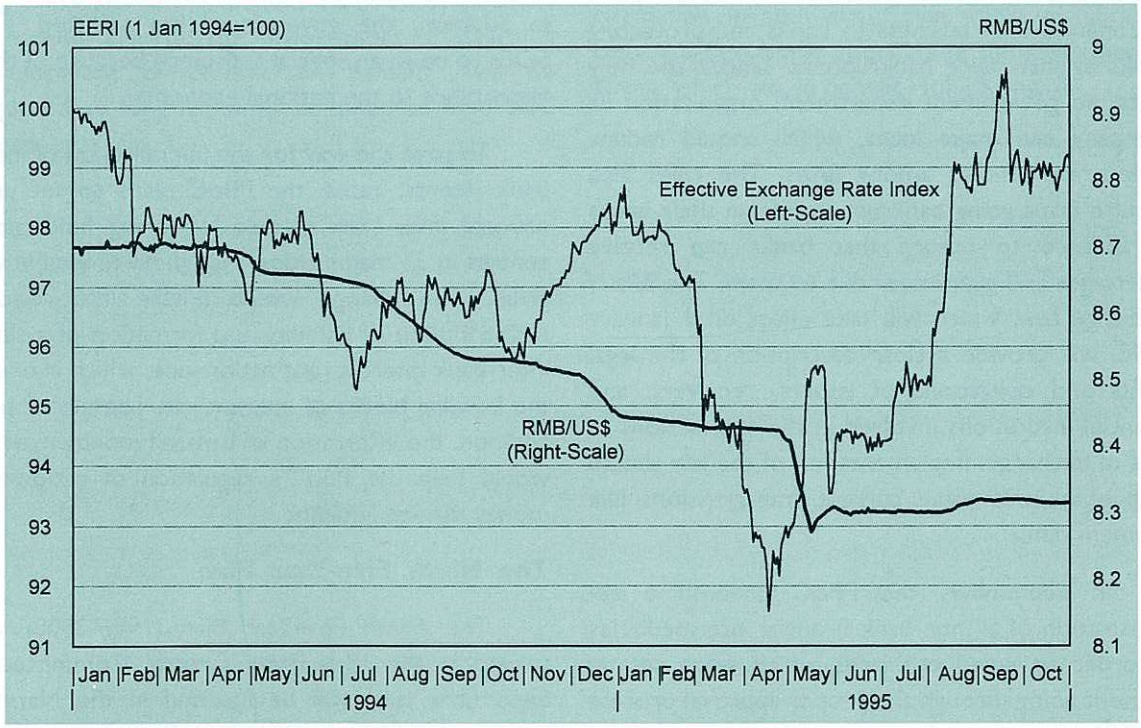
The strong balance of payments had led to a rapid accumulation of foreign exchange reserves which reached some US$70 bn by end September 1995, more than triple the amount at end 1993. This underpinned the 1.4% appreciation of the RMB against the US dollar in the first nine months of 1995. In trade-weighted terms the RMB exchange rate underwent greater fluctuations as the US dollar first weakened in early 1995 then strengthened since July (Chart 8). However, China's effective exchange rate was still less volatile than that of countries such as the USA and Japan (Chart 5).

Current Account Convertibility

In October, the People's Bank of China (PBoC) reaffirmed that the RMB would be made convertible on the current account no later than 2000. In the past few years, China has introduced a number of measures which have paved the way towards convertibility. In 1993, residents of China were allowed to take with them up to RMB 6,000 on trips abroad. In 1994, the dual exchange rates were unified, and domestic exporters were required to sell all their foreign exchange earnings to designated banks which would then on-sell them to the PBoC. This significantly sped up the PBoC's accumulation of foreign exchange reserves, which is important for convertibility. In addition, the domestic foreign exchange market was integrated in 1994 with the establishment of a national inter-bank electronic trading network. More recently, in June 1995, the PBoC announced plans to abolish the swap market and to open the inter-bank market to foreign-funded enterprises, which should help deepen the foreign exchange market and reduce its volatility.

The achievement of convertibility on the current account should enhance international trade in China, and particularly if accompanied by further import liberalisation should promote investment, efficiency and growth. It should help the development of domestic financial centres like Shanghai, although the transformation of these centres into truly international financial centres would require also convertibility on the capital account, and no time table has yet been announced in this regard.

Chart 8
China: Exchange Rates



Source: HKMA calculations based on data from Datastream

Financial Reforms

The government is introducing competition into the banking sector through the promotion of new commercial banks. The first two urban commercial cooperative banks were established in Shenzhen and Shanghai in June and August, respectively, and the first joint-venture bank, the China International Capital Corporation, started operations in August 1995. The performance of these banks may determine the future pace of development of these two types of banking institutions in China. Their success would also provide competition to the four major banks[1].

The Chinese government is planning to restructure the People's Construction Bank with the aid of a US$250 mn loan from the World Bank. The objective is to improve the bank's profitability by revamping its organisational structure, financial operations and information systems to conform with international banking standards.

To enhance further the development of commercial banking in China, two sets of rules were promulgated recently to strengthen the legal framework for bank business and transactions of bills of exchange. In August, the first set of standard rules on bank loans was introduced aimed at confining loan business to banks and protecting banks against rising bankruptcies. Under the new rules, no government department, organisation or company can make loans, which should reduce widespread lending among firms. The rules also require firms going bankrupt to inform their banks in advance to ensure that banks can receive mortgages and guarantees due to them. The *Bills of Exchange Law*, which will take effect on 1 January 1996, will provide a clear description of the legal rights and obligations of issuers, receivers, and financial institutions involved in the transactions of bills of exchange. Implementation of the law should help phase out some current transgressions like payment denial.

In September, the PBoC ordered a re-registration of all non-bank financial intermediaries in order to weed out ones which were set up without going through the proper approval process and to strengthen supervision of those operating beyond their registered line of business.

Monetary Management and State Enterprise Reforms

The government announced recently a plan to liberalise interest rates in a three-stage process over the next 7-8 years. First, inter-bank interest rates will be liberalised. Second, bank lending rates will be liberalised, with the PBoC setting a ceiling and a floor for rates and banks being allowed to set their own rates within that range. Finally, banks will be allowed to set deposit rates except for one-year term deposits for which rates will continue to be set by the PBoC as a benchmark. The pace of liberalisation will depend on the progress of state enterprise reform, as many of them are reliant on access to cheap loans.

The Chinese government announced recently that state-owned enterprise (SOE) reform would be conducted under the guiding principle of "more mergers, less bankruptcies" in order to avoid massive unemployment. To encourage mergers, the government would offer incentives like debt-to-equity conversion for key enterprises, and preferential treatments for bank loan repayments and interest payments for enterprises which merge. In addition, the government has selected 1000 SOEs to be given special assistance because of their importance to the national economy.

To pave the way for the liberalisation of inter-bank interest rates, the PBoC plans to set up a national inter-bank market by linking fund-raising centres in 35 major cities, though no timetable was given. This change would enable inter-regional redistribution of liquidity and formation of a single inter-bank interest rate nationwide, which is one of the building blocks of interest rate liberalisation. In addition, the integration of isolated money markets would help the PBoC's regulation of nationwide money market liquidity.

The Ninth Five-Year Plan

The Ninth Five-Year Plan (1996-2000) was passed in the 14th Party Central Committee in September, and will be finalised in the National

1 Bank of China, People's Construction Bank, Agricultural Bank, and Industrial and Commercial Bank.

People's Congress next March. Aside from inflation and growth targets, the plan also sets out the following major areas of economic development in the next five years:

- continuation of the plan-to-market transition;
- reduction in regional disparities;
- acceleration of state enterprise reform; and
- promotion of agricultural development.

The first area is a continuation of the reforms launched since the late seventies while the other three refer to the major problem areas currently facing China.

The government intends to promote development of the inland through the use of preferential fiscal and credit policies. The objective is to narrow coastal-inland economic disparities which, according to a World Bank study, have worsened since 1985. Greater regional balance in economic development will not only help alleviate potential social friction, but will also enhance overall economic growth for the country.

Successful SOE reform will reduce the government's fiscal burden and speed up banking reform. Some studies suggest fiscal subsidies to SOEs may amount to around 4% of GDP. Progress in banking reform, the major tenet of which is development of commercial banking, will be hindered so long as banks continue to fund SOE losses.

Provision of adequate food supply has long been a challenge for China, which has 22% of the world's population but only 7% of its arable land. The fast increasing income in recent years coupled with a 0.6% annual acreage shrinkage since 1978 have raised the nation's import demand for grains. Recent research has indicated that unless China takes measures to raise production it will face a major shortfall in grains of around 25 mn tonnes by the year 2000 and approaching 140 mn tonnes by the year 2010 (in comparison a total of around 15m tonnes of grains would be imported in 1995 representing around 3% of domestic supply). Such large shortfalls will either greatly raise domestic grain prices or imports or both. The focus on promoting agricultural development in the Ninth Five-Year Plan should help address this problem.

Economic Issues Affecting Hong Kong

The convertibility of the RMB on the current account might weaken the demand for HK dollars in southern China and lead to some repatriation. However, this should not create any problems for Hong Kong's monetary management as the repatriated HK dollars can be absorbed readily by the Exchange Fund, whose foreign assets are a large multiple of the amount of HK dollars in circulation in southern China. More significantly, convertibility should boost trade and investment in China, which would benefit Hong Kong.

– Prepared by the External Department