Box 2.1

The US housing boom

The current upswing of the US housing market began in the mid-1990s and continued through most part of 2005, along with the strong income growth in the US. The accommodative monetary policy pursued by the US Federal Reserve following the burst of the IT bubble in late 2000, which led to a very low interest rate environment until recently, has often been blamed as the key factor sustaining the buoyant housing market conditions and causing possible over-valuation of US house prices. In particular, the rapid increases in house prices in 2004 and the first three quarters of 2005 were unprecedented in the recent history of the US economy.

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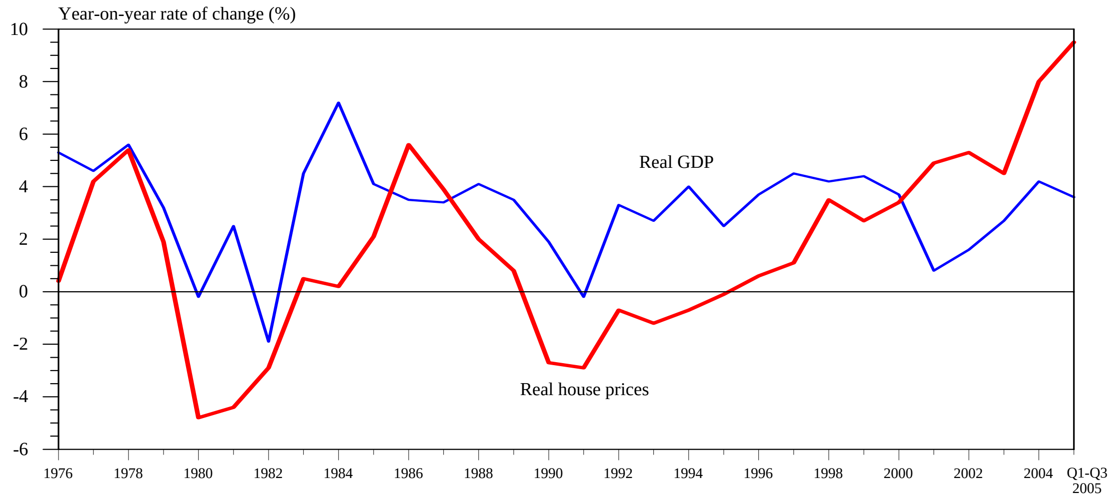
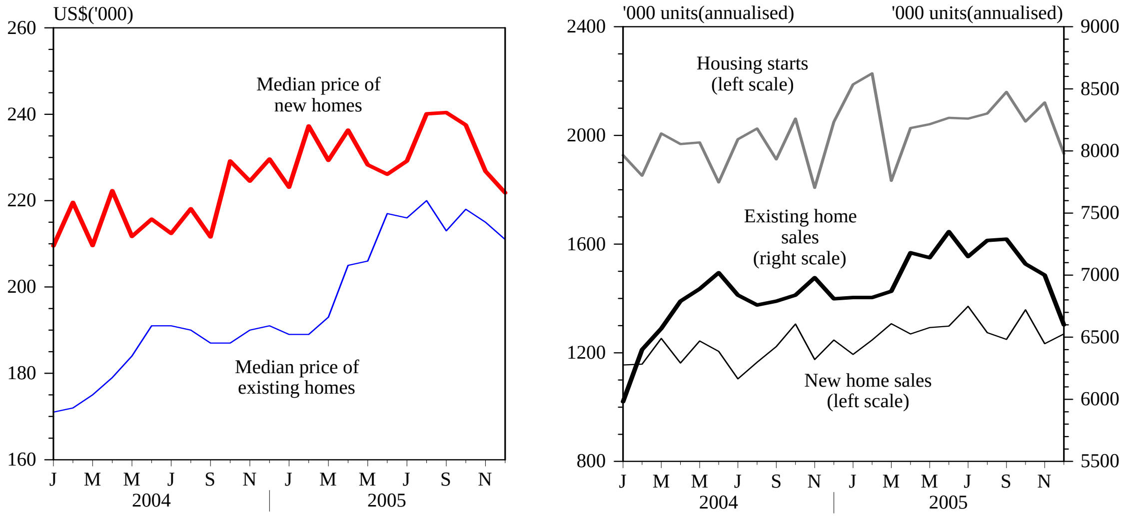
US real house prices rising distinctly faster than real GDP in recent years



There are mixed views as to whether the current housing boom is a bubble at all, and whether there will be a marked correction down the road. There are also disagreements over whether the bubble, if it exists at all, is only regional or indeed nationwide. Yet cooling of the US housing market seems to be already underway. The latest US housing market indicators showed that median prices of both new and existing homes eased somewhat since the latter part of last year. Meanwhile, the pace of sales activity and housing starts also slowed.

US housing market showing some signs of cooling

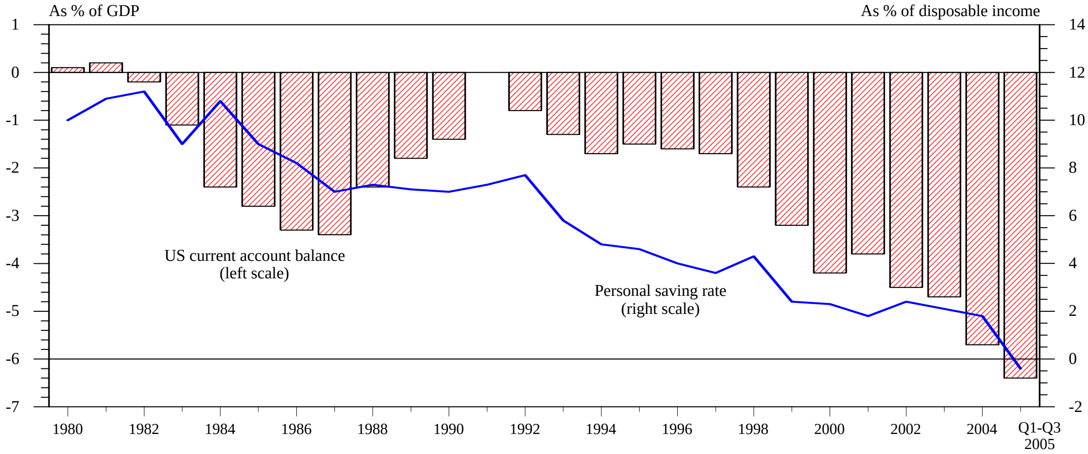


Box 2.1 (cont'd)

The prevailing mainstream views are for a continuation of a mild correction in the US housing market. In the near term, the risk of a major correction should not be very significant, especially with the US economy still holding up rather well lately.

Yet there are certain pitfalls. *First*, although US mortgage rates are still low by historical standards, they have crept up gradually since the latter part of last year. Any unexpected upsurge in the mortgage rates may trigger a more abrupt adjustment in the housing market. *Second*, housing affordability of US households has worsened to its lowest level in the 1990s and their debt service ratio has been on the rise, reducing their ability to cope with larger house price corrections. *Third*, US consumption, a key driver of growth in the US economy in recent years, has been led mainly by rising house prices to support consumption, by means of increased trading activity and mortgage re-financing. This could have been the major factor accounting for the decline in personal saving rate over the past decade to negative level in 2005, which has in turn contributed to the rise in the US current account deficit to a historic high. Thus, there is risk that a large correction of the US housing market, if occurred, may also trigger a faster-than-desirable adjustment in US external imbalances, causing significant disruptions to the stability of the international foreign exchange and financial markets.

US personal saving rate turning negative and current account deficit increasingly alarming



The impact on the Hong Kong economy will depend much on the extent of the correction in the US housing market and how it will transpire to slow the demand in the US and to dim the US as well as the global growth prospects.

In general, if the US housing market correction is gradual and orderly, the impact on Hong Kong economy should be quite moderate. There would likely be some slow-down in trade growth due to weaker US demand. Domestic demand may also be moderately down as income from trade is reduced, and as there would be some mild negative wealth effect from the asset market spill-overs. However, in the event of a more abrupt and drastic downturn in the US housing market, the repercussions on the Hong Kong economy would be distinctly larger and more damaging, as there would likely be excessive volatility in the international financial and foreign exchange markets, dampening consumption and investment sentiment worldwide. Thus it is important to monitor the downside risks arising from any adverse developments in the US housing market.

It is also imperative for the Hong Kong economy to continue to build up its capability and flexibility to weather external shocks as they come. Our banking sector needs to remain prudent in lending. The Government should also stay vigilant in fiscal spending, strive to maintain high flexibility in the labour market, continue to invest in education and infrastructure, and uphold the aspects where Hong Kong has competitive edge.