

## DOMESTIC AND EXTERNAL ENVIRONMENT

*The recovery in the Hong Kong economy, which began in the second quarter of 1999, gathered pace in the third quarter, reflecting a further pick-up in consumer spending and a significant upturn in exports. The latest economic indicators show continued improvements in both the domestic and external sectors. The progress in China's accession to the World Trade Organisation (WTO), the stronger and broader-based recovery in the global economy, and stability in regional financial markets should help reinforce Hong Kong's growth momentum in 2000.*

### External Environment

The global economy maintained its growth momentum in the second half of 1999. The US registered strong GDP growth of 5.8% in the fourth quarter of 1999, up from 5.7% in the previous quarter. Real GDP growth in the euro area also accelerated from 2.1% in the second quarter to 3.9% in the third. While Japan's recovery in the first two quarters of 1999 was interrupted by a 3.9% decline in third quarter GDP, due to waning fiscal stimulus, most other Asian economies reported stronger or broader-based recovery in the third quarter. On the back of a favourable external environment and improved sentiment following the Sino-US agreement on China's accession to the World Trade Organisation (WTO), Hong Kong's recovery also gained further momentum in the latter half of 1999.

Despite a generally benign global inflationary environment, an acceleration of economic activity and signs of economic overheating in selected sectors have prompted monetary tightening in major industrial economies, with the exception of Japan. In response to rising housing prices and a tight labour market, the Bank of England raised its interest rates thrice, by 25 basis points each, between November 1999 and February 2000. The European Central Bank also made a pre-emptive hike of 75 basis points in November and February, more than reversing its 50bps cut in April, 1999. In the US, the Federal Reserve raised the Fed Funds target rate by another 25 basis points in February, following the 75 basis-point hike since last June, amidst a three-decade low unemployment rate and a record-high current account deficit. Reflecting market expectations of a further

tightening in the coming months, the US long-bond yield rose to a 2½-year high of 6.75% in mid-January 2000. Yet, major equity markets continued to scale new highs, despite intermittent corrections.

Notwithstanding higher interest rates in the US and Europe, economic recovery in non-Japan Asia continued. In addition to expansionary monetary and fiscal policies, strong export demand and reviving intra-regional trade helped sustain the pace of recovery. In line with Malaysia, South Korea and Thailand, GDP growth in Hong Kong accelerated during the third quarter of 1999. Growth in Singapore, the Philippines, Taiwan and the Mainland were maintained at levels close to the second quarter, while Indonesia reported a smaller, but still positive, growth rate of 0.5% in the third quarter. The basis of recovery has further broadened, as evidenced by a further improvement in external payment positions, the bottoming out of domestic credit, and further progress in corporate and banking reforms. In Thailand, the non-performing loan ratio declined further to 38.5% in December from the 47.7% peak in May, while Korea announced that its efforts to restructure nine key industries were largely completed. Credit ratings for Malaysia and South Korea were upgraded during the last quarter of 1999.

In the foreign exchange market, the euro weakened below parity to the US dollar, touching a low of \$0.97 in late January. In contrast, the yen stayed firm and at one point strengthened to 101.3 versus the dollar during the fourth quarter, before weakening to about 110 level in February. For the fourth quarter as a whole, the euro weakened by 5%, while the yen appreciated by 3% against the US dollar. The Korean won, the NT

dollar and the Thai baht appreciated by 1-9% against the US dollar, while most other Asian currencies, including the Renminbi, remained broadly stable. Reflecting these currency movements, the

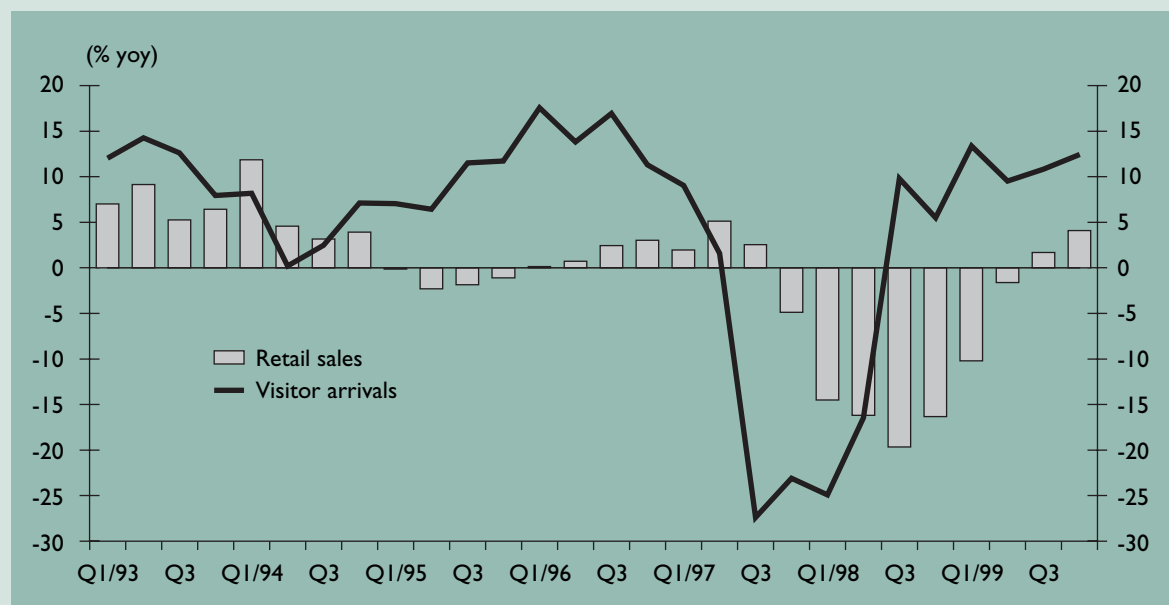
Hong Kong dollar's effective exchange rate fell by 0.5%, from 132.2 at end-September to 131.5 at end-December.

Table I : GDP by Components (at constant 1990 market prices)

	1997	1998	(%yoy, unless stated otherwise)		
			Q1	Q2	Q3
Private Consumption Expenditure	6.2	-6.7	-4.4	1.3	3.0 (+1.7)
Government Consumption Expenditure	2.4	0.6	3.9	3.7	0.8 (+0.1)
Gross Domestic Fixed Capital Formation	12.8	-6.4	-21.2	-26.1	-10.8 (-3.6)
Change in Inventories	n.a.	n.a.	n.a.	n.a.	n.a. (+1.9)
Domestic Exports of Goods	2.1	-7.9	-9.1	-12.6	-7.9
Re-exports of Goods	6.8	-3.7	-4.1	-0.3	10.8
Imports of Goods	7.2	-7.2	-10.3	-7.9	6.8
Net Domestic Exports of Goods (HK\$bn)	-307.8	-251.9	-47.1	-55.2	-54.4 (-0.5)
Net Re-exports of Goods (HK\$bn)	178.2	171.6	37.8	43.6	49.2 (+2.4)
Exports of Services	-0.1	-6.6	0.1	2.4	10.2
Imports of Services	4.0	-0.6	-1.0	-0.3	0.7
Net Exports of Services (HK\$bn)	80.5	66.8	14.2	17.0	21.7 (+2.5)
<b>GDP</b>	<b>5.0</b>	<b>-5.1</b>	<b>-3.0</b>	<b>1.1</b>	<b>4.5 (+4.5)</b>

Note: ( ) : % Contribution to GDP

Chart I  
Retail Sales and Visitor Arrivals



Note: Retail sales volume for the fourth quarter is the average of October and November figures.

## Domestic Activity

Real GDP increased by 4.5% from a year ago in the third quarter, following a rise of 1.1% in the second quarter. On a seasonally adjusted basis, real GDP recorded strong quarterly growth of 3.2% in the second quarter and 1.7% in the third.

Consumer spending picked up further along with the recovery in economic activity and the generally stable labour market situation. Private consumption expenditure increased by a year-on-year rate of 3% in the third quarter of 1999, following 1.3% growth in the second quarter. Recent statistics indicate that retail sales volume grew for the sixth straight month in December, recording year-on-year growth of 5.7%. The pick-up in retail sales also became more broadly based, with sales of supermarkets, clothing, department stores and motor vehicles recording double-digit growth from a year earlier.

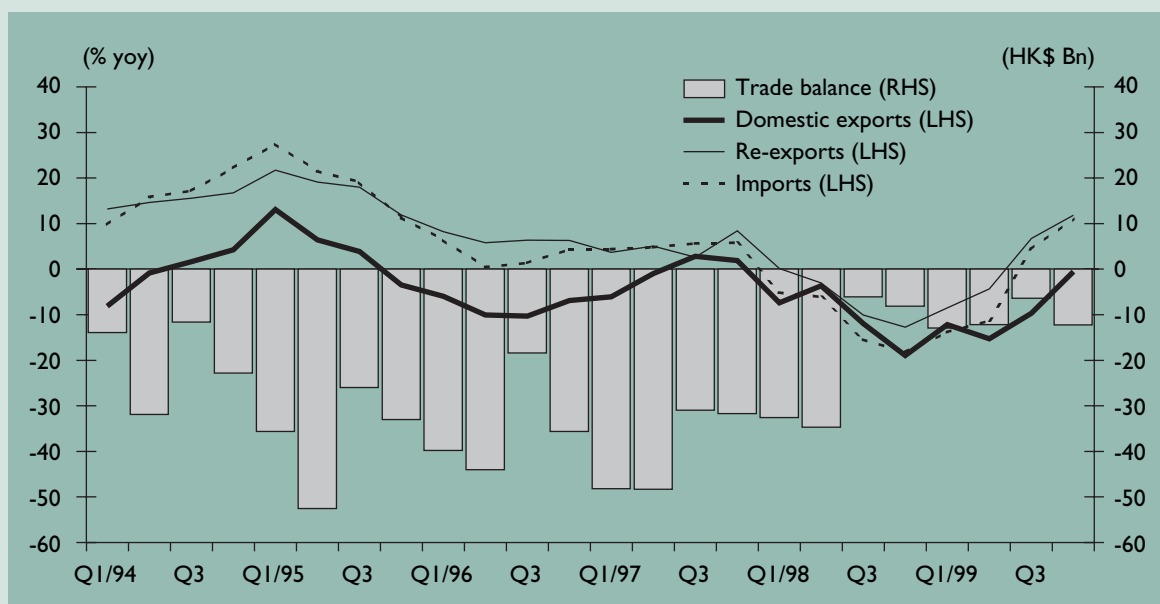
Investment declined by 10.8% in the third quarter from a year earlier, moderating from a decline of 26.1% in the previous quarter. On a quarter-on-quarter basis, it increased by 1.4% in the third quarter, following 4.5% growth in the

preceding quarter. The decline in investment spending on machinery and equipment showed signs of tapering off. Partially offsetting the continued slack in private sector building activity, public sector building and construction output returned to positive growth, reflecting the stepping up of priority infrastructure projects.

## External Trade

External trade continued to improve, reflecting the rebound in Mainland exports, a general pick-up in demand in the East Asian economies, as well as a broad strengthening in import absorption in the US and Europe. Re-exports increased by 11.8% in the fourth quarter, following 6.8% growth in the third quarter. Meanwhile, domestic exports returned to positive growth in November and December, reversing declines for 22 consecutive months. Reflecting renewed intake of goods along with the recovery in consumer spending, imports grew by 11.1% in the fourth quarter, following 4.4% growth in the preceding quarter. As exports grew faster than imports, the visible trade deficit narrowed to HK\$43.7 billion in 1999, compared with HK\$81.4 billion in 1998.

Chart 2  
External Trade



On invisible trade, along with the continued improvement in inbound tourism, exports of services registered year-on-year (yoy) growth of 10.2% in the third quarter, following a 2.4% increase in the second quarter. Tourist arrivals increased further by a year-on-year rate of 12.4% in the fourth quarter, following an increase of 10.8% in the third quarter. Imports of services returned to a positive growth of 0.7% in the third quarter of 1999, reversing the downtrend since the third quarter of 1998. Taking visible and invisible trade together, there was an overall trade surplus of HK\$21 billion, or 7% of GDP in the third quarter of 1999, following a surplus of HK\$9 billion, or 3% of GDP in the second.

### Labour Market and Inflation

The labour market showed signs of stabilisation. The seasonally adjusted unemployment rate eased lower to 6.0% in the fourth quarter of 1999, from 6.1% in the third quarter, compared with the peak of 6.3% in the three months to May. For 1999 as a whole, the unemployment rate averaged 6.1%, the highest since 1976. Employment in all the service sectors increased in September 1999 over a year earlier, while there was an

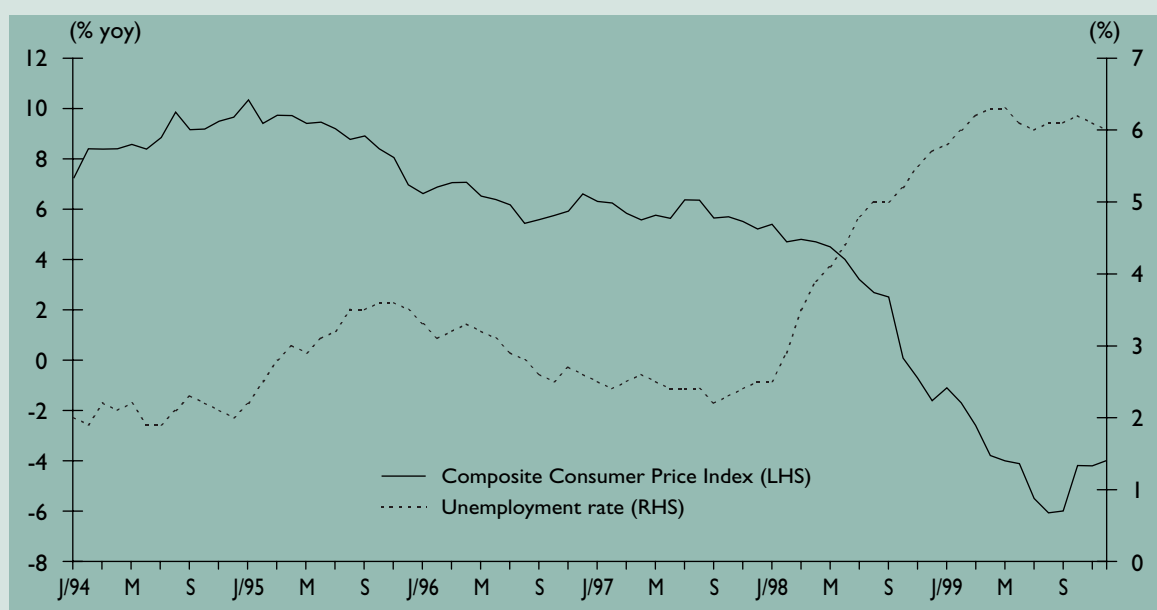
increase in the total number of vacancies in most major sectors, reversing the downtrend in the preceding quarters. Adjustments in wages and salaries continued, with the payroll index falling by 1.1% year-on-year in nominal terms in the third quarter, following a decline of 1.2% in the preceding quarter. Adjusting for the decline in the consumer price index, the payroll index increased by 5% year-on-year in real terms in the third quarter.

Consumer prices declined by 4.1% in the fourth quarter of 1999 from a year ago, following a 5.9% drop in the third quarter. On a seasonally adjusted quarter-on-quarter basis, the Composite CPI fell by 0.7% during the fourth quarter, following a decline of 2.1% in the third. For 1999 as a whole, the CCPI declined by 4%. Signs of stabilisation were evident across-the-board. As new items have been imported to replenish depleted stocks, the room for deep discounts in many of the consumer items has been reduced.

### Asset Markets

Helped by improved sentiment owing to the expected accession of China to the WTO, the over-

Chart 3  
Unemployment Rate and Inflation



subscription of the Tracker Fund, and strong GDP growth in the third quarter, there had been significant inflows of funds into Hong Kong's stock market since late October. The Hang Seng Index closed 1999 at a year-high level of 16,962. However, concerns over possible U.S. interest rate hikes and the sell-off in overseas markets led to a significant correction in the HSI. It fell to 15,103 on 25 January, before recovering to 15,532 at end-January.

Sentiment in the property market improved towards the end of the year, helped by the rally in the stock market. Residential property prices, having eased for six months, recorded a modest increase of 1.3% in December 1999. The number of sales and purchase agreements increased from 5,640 in September to 6,955 in January 2000. Meanwhile, both the sales and rental markets for commercial properties remained sluggish amid an abundant supply of office premises.

### Short-Term Outlook

Looking ahead, the momentum of growth is expected to continue into 2000. Private consumption is expected to be supported by improved sentiment and stabilising labour market

conditions. Private investment, though remaining weak, is expected to rebound from a low base. Public building and construction activity should be boosted by the work on the Priority Railway Projects and the Public Housing Programme.

Externally, the Hong Kong economy should benefit from the expected accession of China to the WTO. Together with the favourable external growth environment, both domestic exports and re-exports are expected to strengthen further. Exports of services will be supported by the strong performance in inbound tourism. Meanwhile, growth in the imports of goods is likely to accelerate, along with the pick-up in domestic demand and the replenishment of inventories.

In view of the lagged effect of the earlier rental declines, the CPI may continue to fall, on a year-on-year basis, in the early part of this year. But the downward pressure in consumer prices is expected to ease over the course of the year, as increased demand, the gradual dissipation of the rental effect, and possible increases in government fees and charges in next year's Budget would raise the CPI. ☺

- Prepared by the Research Department

Chart 4  
Asset Prices

