

DOMESTIC AND EXTERNAL ENVIRONMENT

In line with the strong growth momentum in the global and regional economies, Hong Kong's GDP in the fourth quarter of 1999 was 8.7% higher than a year earlier – the strongest recorded gain since the onset of the Asian crisis in 1997. GDP growth was supported by a broad-based recovery in consumption, exports, and public investment. The downward adjustments in prices and wages moderated, while the unemployment rate declined further. Improved investor confidence supported local asset prices, ameliorating the impact of higher external interest rates. Looking ahead, sustained recoveries in domestic demand and exports are likely to support growth through 2000.

External Environment

Global economic growth gathered further strength at the turn of the millennium. The US economy grew by a quarter-on-quarter annualised 7.3% in the last quarter of 1999, its strongest performance in 16 years. Growth in the euro zone also accelerated from a quarter-on-quarter annualised 2.4% to 3.0% on a further pick up in consumption and exports. The performance of the non-Japan Asian economies in the fourth quarter of 1999 continued to surprise on the upside. Hong Kong, Indonesia, Korea, Malaysia, Singapore and Taiwan all reported their strongest expansions since the Asian crisis. Although Japan technically slipped back into recession with two consecutive quarters of negative growth in the third and fourth quarters of 1999, there were renewed signs of rising corporate investment and private sector demand, and the Economic Planning Agency (EPA) expressed confidence that a self-sustained recovery would emerge in early 2000.

While inflation remained relatively low in most countries, potential price pressures were building in some cases with higher wages and oil prices. The OECD producer price index was 5.4% higher than a year ago in March, while US CPI jumped by an unexpected 3.7% (year-on-year) in March. In response, most OECD countries tightened their monetary policies further in the first quarter of 2000. The US Federal Reserve raised its Fed Funds Target rate by a total of 100 basis points (bp) to 6.50% after the Federal Open Market Committee (FOMC) meetings on 2 February, 21 March and 16 May. The Bank of England raised its repo rate by 50 bp to 6% on 13 January and

10 February, while the European Central Bank also increased its repo rate by 50 bp to 3.75% on 16 March and 4 May.

Most major stock markets consolidated in the first quarter of 2000 after substantial gains in the last two quarters of 1999. Concerns about interest rates and over-valuation of Internet stocks continued to cause jitters in both developed and emerging markets. The Nasdaq composite index retreated 29% to 3,608 at mid-May after breaching the 5,000 level on 9 March. The Dow Jones Industrial Index also lost 5% during the period, finishing at 10,808.

Recoveries in non-Japan Asia gathered further momentum, despite higher interest rates in Europe and the US and renewed weakness in the Japanese economy. The region's export-led recovery gradually broadened its base into domestic demand. Growth of consumption and imports accelerated, while investment showed moderate improvement.

In the foreign exchange markets, the Japanese yen lost 9% against the dollar in January-February to reach a six-month low of 111.1 on the Bank of Japan's intervention. Optimism towards the Japanese economy, however, pushed the yen up again to 102.7 at end-March. The euro briefly rebounded to parity against the dollar in late February, but it quickly lost momentum and dropped to 0.89 against the dollar in early May. In Asia, the regional currencies remained broadly stable. The Korean won and the NT dollar gained 2.8% and 3% against the US dollar respectively during the first quarter, while the Singapore dollar lost 2.6%. Currency movements in Hong Kong's

major trading partners together contributed to a modest 0.8% rise in the nominal effective exchange rate to 132.4 at end-March, compared with 131.5 at end-1999.

Domestic Activity

Helped by a notable pick-up in private consumption and continued robust growth in re-

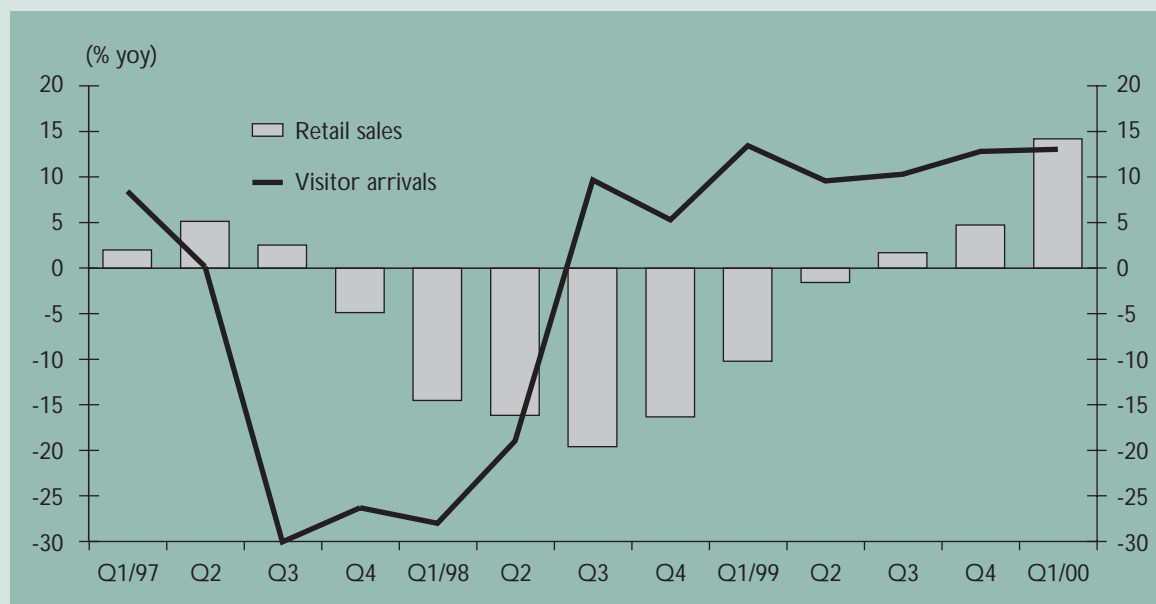
export activity, real GDP growth staged a strong rebound of 8.7% in the fourth quarter of 1999. This added further impetus to the recovery that began in the second quarter of 1999; for the year as a whole, GDP rose by a modest 2.9%, reversing the 5.1% decline of the previous year. On a seasonally adjusted basis, real GDP expanded by 3.4% in the fourth quarter, following a 2.2% increase in the third quarter.

Table 1 : **GDP by Components (at constant 1990 market prices)**
(yoy%, unless stated otherwise)

	1998	1999				
		Overall	Q1	Q2	Q3	Q4
Private Consumption Expenditure	-6.8	1.1	-4.4	1.3	3.0	4.5 (+2.6)
Government Consumption Expenditure	0.7	3.5	3.9	3.7	0.6	5.7 (+0.4)
Gross Domestic Fixed Capital Formation	-6.1	-17.6	-21.2	-26.0	-11.1	-9.9 (-3.2)
Change in Inventories	n.a.	n.a.	n.a.	n.a.	n.a.	n.a. (+5.9)
Domestic Exports of Goods	-7.9	-7.2	-9.1	-12.6	-7.9	0.7
Re-exports of Goods	-3.7	5.4	-4.1	-0.3	10.8	14.1
Imports of Goods	-7.2	0.1	-10.3	-7.9	6.8	11.9
Net Domestic Exports of Goods (HK\$bn)	-251.9	-214.0	-47.1	-55.2	-54.4	-57.3 (-2.8)
Net Re-exports of Goods (HK\$bn)	171.6	180.9	37.8	43.6	49.2	50.4 (+3.1)
Exports of Services	-6.6	5.5	0.1	2.4	10.5	8.2
Imports of Services	-0.6	-0.9	-1.0	-0.3	1.0	-3.3
Net Exports of Services (HK\$bn)	66.8	79.2	14.2	17.0	21.7	26.2 (+2.8)
GDP	-5.1	1.8	-3.2	0.7	4.4	8.7 (+8.7)

Note: () : % Contribution to GDP

Chart 1
Retail Sales and Visitor Arrivals



Note: Retail sales volume for the first quarter is the average of January and February figures.

Along with continued increases in inbound tourism and improved consumer sentiment, consumer spending picked up markedly. Private consumption expenditure increased by a year-on-year rate of 4.5% in the fourth quarter of 1999, following 3% growth in the third quarter. Consumer spending strengthened further during the first quarter of 2000, with retail sales volume growing by 14.2% from a year previously. All major items recorded positive year-on-year sales growth, particularly sales of motor vehicles.

Investment contracted by 17.6% in 1999, following a decline of 6.4% in 1998. However, reflecting the improved business outlook, the decline (year-on-year) in investment spending on machinery and equipment moderated to 7.4% in the second half of 1999, from 29.7% in the first half. With the stepping up of priority infrastructure projects, public-sector building and construction output returned to positive growth in the third quarter, offsetting the slack in private-sector building activity.

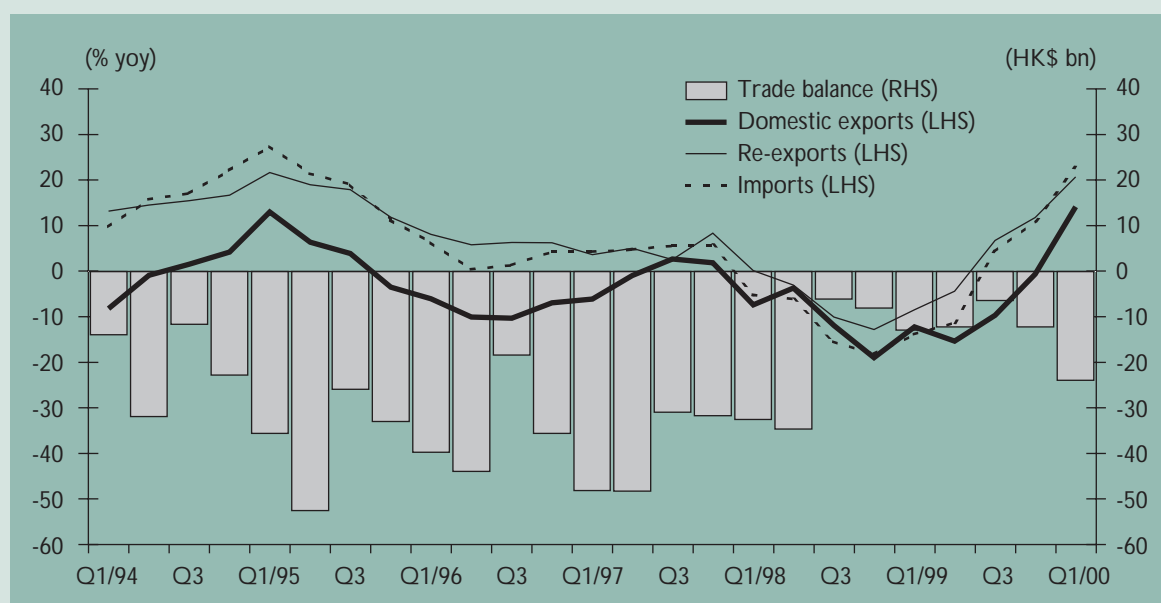
External Trade

External trade continued its strong growth in the first quarter of 2000, with the expansion in

merchandise exports continuing across all major markets. Exports to the Mainland, the US, Japan and the ASEAN economies all registered double-digit rates of growth in the first quarter, following robust increases in the fourth quarter of 1999. Re-exports grew further by 20.8% from a year ago in the first quarter, up from 11.8% in the fourth quarter of 1999. Domestic exports also rebounded strongly, increasing by 14.2% year-on-year in the first quarter, following a 0.5% decline in the last quarter of 1999. In line with the pick-up in re-exports and the recovery in consumer spending, growth in imports accelerated to 22.8% in the first quarter, following 11.1% growth in the preceding quarter. As imports grew faster than exports, the visible trade deficit widened to HK\$24.0 billion in the first quarter of 2000, compared with HK\$12.9 billion in the same period last year.

On invisible trade, along with the continued improvement in inbound tourism, exports of services grew by 8.2% from a year earlier in the fourth quarter of 1999, resulting in a 5.5% rise for the year as a whole. Tourist arrivals continued to trend up, increasing by a year-on-year rate of 13.0% in the first quarter of 2000, following an increase of 12.8% in the preceding quarter. On the other

Chart 2
External Trade



hand, imports of services declined by 3.3% in the fourth quarter of 1999, falling by 0.9% for the year as a whole. Taking visible and invisible trade together, there was an overall trade surplus of HK\$54 billion, or 4.4% of GDP, in 1999, compared with a surplus of HK\$6 billion, or 0.5% of GDP in 1998.

Labour Market and Inflation

The labour market continued to show signs of improvement. The seasonally adjusted unemployment rate declined from 6.0% in the fourth quarter of 1999 to 5.5% in the first quarter of 2000, and stayed at the same level in the three months to April. This was significantly lower than its peak of 6.3% in March - May 1999. Employment rose markedly by a year-on-year rate of 4.1% in the three months to April, the highest increase since the three months to January 1998, outpacing the 3.1% rise in the labour force. The improvement in the employment situation was broad-based, with employment in most major sectors registering positive growth. Adjustments in wages and salaries continued, with the payroll index falling by 0.7% year-on-year in nominal terms in the fourth quarter of 1999, following a decline of 1.1% in the preceding

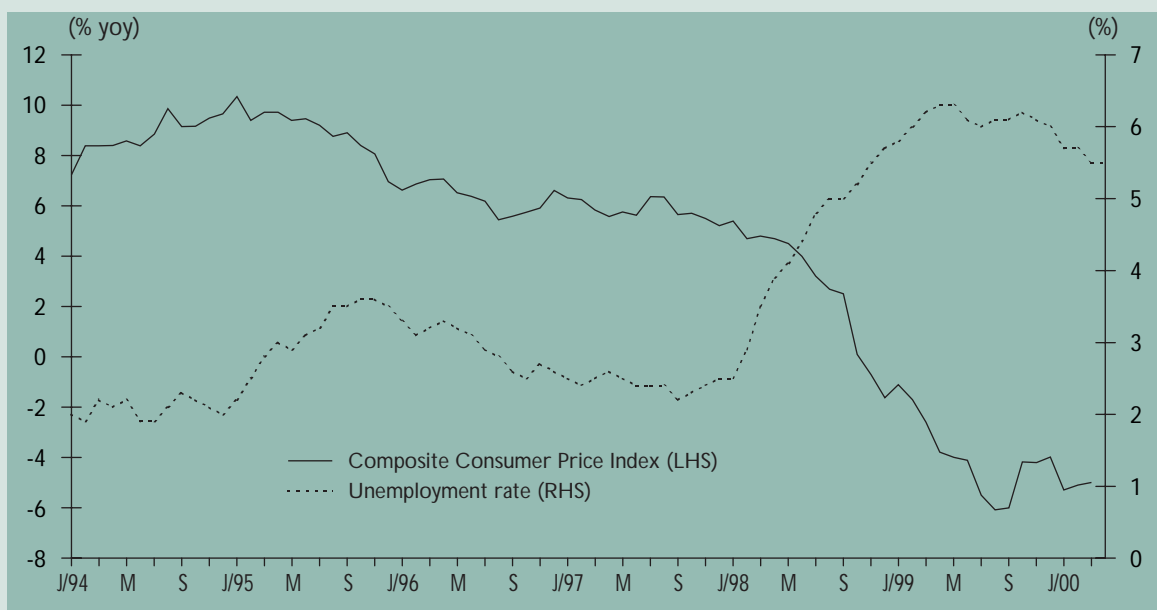
quarter. Adjusting for the decline in the consumer price index, the payroll index increased by 3.6% year-on-year in real terms in the fourth quarter.

Consumer prices declined by 5.1% from a year ago in the first quarter of 2000, compared with a fall of 5.5% in the fourth quarter of 1999 (after adjusting for the effect of the rates rebate granted for the fourth quarter of 1998). On a seasonally adjusted quarter-on-quarter basis, the CCPI fell by 1.3% during the first quarter, following a decline of 0.7% in the preceding quarter. Retailers continued to offer substantial price discounts amidst keen competition in the retail market. Lower consumer prices have been conducive to the revival in retail sales volumes in recent months.

Asset Markets

After some consolidations in January, the stock market rallied in February and March, with the Hang Seng Index (HSI) reaching a record high of 18,302 on 28 March, on the back of buoyant share flotation activity and easing tensions across the Taiwan Straits. However, declines in the US technology share prices and US interest rate hike

Chart 3
Unemployment Rate and Inflation



led to a correction in the stock market, with the HSI plunging to 14,323 in May — 21% below its recent peak.

Along with China's expected accession to the WTO and positive news on the Disneyland Theme Park, residential property prices continued to increase moderately by 2.1% during the first quarter of 2000, after returning to positive growth in December 1999. The number of sales and purchase agreements also increased from 6,711 in December to 9,138 in April. Notwithstanding expectations of further interest rate hikes in the US, keen competition in mortgage rates among banks should help mitigate the negative effect of the rise in interest rates.

Export growth is expected to pick up further, supported by the strong recovery in the regional economies and the turnaround in the Mainland's trade performance. Nonetheless, import growth is also likely to accelerate in response to strong domestic demand and to replenish depleted inventories.

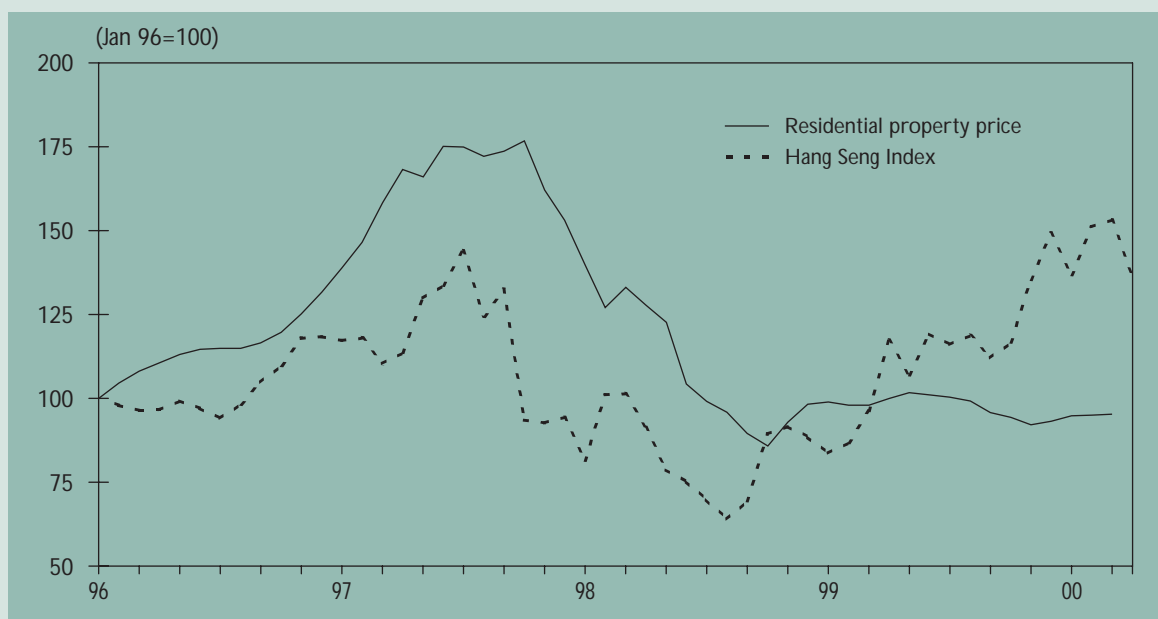
The lagged effect of the earlier rental declines will continue to contribute to a fall in the CPI on a year-on-year basis. Nevertheless, as economic recovery continues and the remaining lagged effect of the rental component diminishes, the downward drift in prices should decelerate. ☉

- Prepared by the Research Department

Short-Term Outlook

Looking ahead, the growth impetus is expected to come mainly from domestic demand. In particular, private consumption expenditure should benefit from more stable asset markets and improved labour market conditions. Investment spending is also expected to rebound from the low level in 1999, as business prospects improve and public sector investment in infrastructure gathers pace.

Chart 4
Asset Prices



Highlights of the 2000/2001 Budget

The 2000/2001 Budget forecasts a deficit of HK\$6.2 billion or 0.5% of GDP in FY2000, the third successive year of deficit. The budget is expected to return to a small surplus in FY2001. Fiscal reserves are projected to drop to HK\$432.7 billion and HK\$426.4 billion at the end of March 2000 and 2001 respectively.

The Budget did not propose revenue-raising measures, contrary to earlier speculation of the introduction of a sales tax or a land departure levy. To deal with a possible loss in revenue amid the structural changes in the economy, an independent committee comprising tax experts, professionals and academics will be set up to study the feasibility and desirability of introducing new types of broad-based taxes.

The Budget also laid out broad strategies to reinvent Hong Kong as a knowledge-based and technology-intensive economy in the 21st century. These include:

- Consolidating existing strengths, including dynamic and free markets, a robust telecommunications and internet infrastructure, and experience, contacts and expertise in doing business with China.
- Harnessing the forces of globalisation by enhancing the financial infrastructure; developing a multi-currency clearing system; building a leading debt market in the region; reforming the banking sector; enhancing the regulatory regime and corporate governance; attracting more foreign investment; providing better services to business; and strengthening support for innovation and technology.
- Making the most of the relationship with China to benefit from the opportunities arising from China's impending accession to the WTO.
- Upgrading human capital in order to cope with the transformation into a knowledge-based economy.
- Invigorating the public sector by the Enhanced Productivity Programme and civil service reform.