

## DOMESTIC AND EXTERNAL ENVIRONMENT

*Following a strong increase of 14.3% in the first quarter of 2000 over a year ago, real GDP growth remained robust at 10.8% in the second quarter. The strong upturn of economic activity eased the unemployment rate, and moderated the downward adjustments in consumer prices. Looking ahead, growth is expected to moderate in the second half of the year, while the downward drift in consumer prices should decelerate further.*

### External Environment

Recovery of the Asian economies continued to benefit from strong and more synchronised growth in the major industrial countries. In the first quarter of 2000, Japan registered a strong 10% quarter-on-quarter annualised GDP growth, ending its two-quarter economic contraction with rising exports and corporate investment. GDP growth in the euro zone also accelerated from 3.5% to 3.6% in the first quarter, while US economic growth eased from a 16-year high of 8.3% in the fourth quarter of 1999 to 5.2% in the second quarter of 2000. In non-Japan Asia, notwithstanding higher interest rates in the US and Europe, the economies of Mainland China, Malaysia, Singapore, South Korea, and Taiwan grew at new or near post-crisis highs, ranging from 8% to 13% on a year-on-year basis.

As recovery in the non-Japan Asia region entered a more mature stage, the growth impetus also broadened from exports to the domestic sectors. Most economies saw a rebound in domestic demand, led by private consumption. This resulted in a general rebound in imports, a trend that has accelerated in recent months and led to a narrowing of trade surpluses.

Higher oil prices have raised the year-on-year changes of the OECD producer price index to over 5% since February. In the US, the headline consumer price index jumped by 3.7% (year-on-year) in June, up from just above 3.0% in the previous two months. As such, monetary policies of the major central banks turned tighter in the second quarter. The US Federal Reserve raised its Fed Funds target rate by 50 basis points to 6.5% on 16 May. The European Central Bank also increased its repo rate by 50 basis points to 4.25% on 7 June. However, signs of a moderating US

economy started to emerge towards the end of the second quarter, and the Federal Reserve kept rates unchanged in its 28 June and 22 August Federal Open Market Committee meetings. Similarly, the Bank of England has kept its base rate unchanged at 6% since its last tightening on 10 February. The Bank of Japan, however, terminated its zero-interest rate policy by raising the overnight call rate by 25 basis points on 11 August, despite uneven signs of recovery and strong government objection.

As fears for immediate further monetary tightening receded towards the end of the second quarter, most major stock markets in the US and Europe recovered from their downturn since March. The Nasdaq Composite Index has rebounded to the 4,000-mark since mid-July from its 6-month low of 3,164 in late-May. The Dow Jones Industrial Average Index recovered from about 10,300 to around 11,000. The FTSE 100 also picked up from 6,000 to 6,500. However, sustainability of the market gains remains uncertain as investors turned more cautious with strong US economic indicators toward end-July.

During the period from May to mid-August, the US dollar first weakened against other major currencies, but then strengthened. The euro climbed to 0.96 against the US dollar in early-June, but since slid back to 0.91 at mid-August. Similarly, the Japanese yen moved back to 108 to the dollar, after reaching a 3-month high of 104.5 on 22 June. In Asia, most major Asian currencies weakened slightly against the US dollar during the second quarter. However, the Indonesian rupiah depreciated by 13.5% against the US dollar due to concerns about political instability, while the Philippine peso fell by 4% on worsening budget deficit.

## Domestic Activity

Real GDP growth accelerated significantly to 14.3% in the first quarter of 2000, the fastest rate of growth recorded since the third quarter of 1987 (Table I). Growth continued at a double-digit rate of 10.8% in the second quarter, as domestic

demand and merchandise exports remained robust. On a seasonally adjusted quarter-on-quarter basis, real GDP declined by 0.8% in the second quarter, after strong growth of 5.3% in the first quarter.

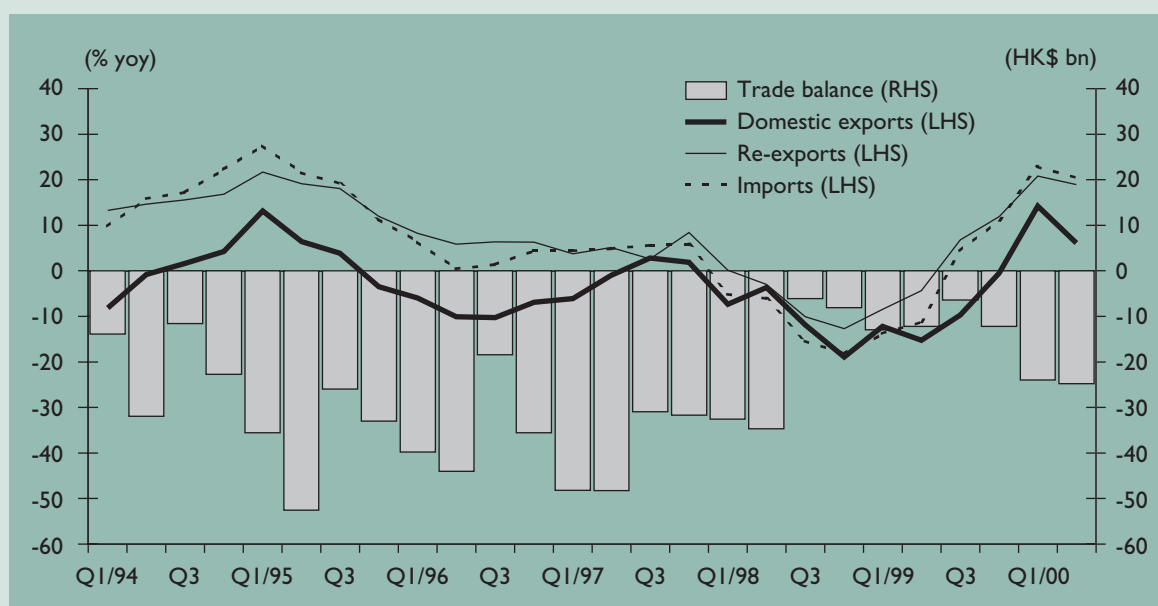
After recording a strong year-on-year increase of 8.8% in the first quarter, private consumption

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

	1998	1999				2000		
	Overall	Q1	Q2	Q3	Q4	Overall	Q1	Q2
Private Consumption Expenditure	-7.4	-5.0	1.0	2.8	4.5	0.8	8.8	5.2 (+3.1)
Government Consumption Expenditure	0.6	3.9	3.7	0.6	5.4	3.4	3.6	2.5 (+0.2)
Gross Domestic Fixed Capital Formation	-7.5	-20.9	-25.6	-10.8	-10.0	-17.3	5.0	5.1 (+1.6)
Change in Inventories	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a. (+5.1)
Domestic Exports of Goods	-7.9	-9.1	-12.6	-7.9	0.7	-7.2	16.2	8.3
Re-Exports of Goods	-3.7	-4.1	-0.3	10.8	14.1	5.4	21.4	19.1
Imports of Goods	-7.2	-10.3	-7.9	6.8	11.9	0.1	22.9	18.8
Net Domestic Exports of Goods (HK\$bn)	-251.9	-47.1	-55.2	-54.4	-57.3	-214.0	-63.5	-69.5 (-7.4)
Net Re-Exports of Goods (HK\$bn)	171.6	37.8	43.6	49.2	50.4	180.9	45.8	52.0 (+4.3)
Exports of Services	-1.8	0.9	3.8	12.3	13.0	7.8	15.3	16.3
Imports of Services	2.8	-0.8	0.4	2.0	-0.9	0.2	-0.2	3.1
Net Exports of Services (HK\$bn)	72.7	16.0	19.0	24.2	29.9	89.1	23.9	26.6 (+3.9)
<b>GDP</b>	<b>-5.3</b>	<b>-2.9</b>	<b>1.2</b>	<b>4.4</b>	<b>9.2</b>	<b>3.1</b>	<b>14.3</b>	<b>10.8 (+10.8)</b>

Note: ( ) : % Contribution to GDP

Chart I  
External Trade



expenditure continued to grow by 5.2% in the second quarter. While continued improvement in labour market conditions supported consumer spending, growth was moderated in part due to a consolidation in asset markets during the second quarter. On a seasonally adjusted quarter-on-quarter basis, private consumption expenditure declined by 0.1% in the second quarter, following a significant pick-up of 5.0% in the first.

Investment accelerated marginally from 5.0% in the first quarter to 5.1% in the second quarter. The decline in building and construction spending moderated from 13.9% in the first quarter to 10.6% in the second quarter. But this was largely offset by a slowdown in growth of machinery and equipment spending, from 29.7% to 19.6% during the same period. Stock re-building - which intensified in the first quarter of 2000 - decelerated slightly in the second quarter.

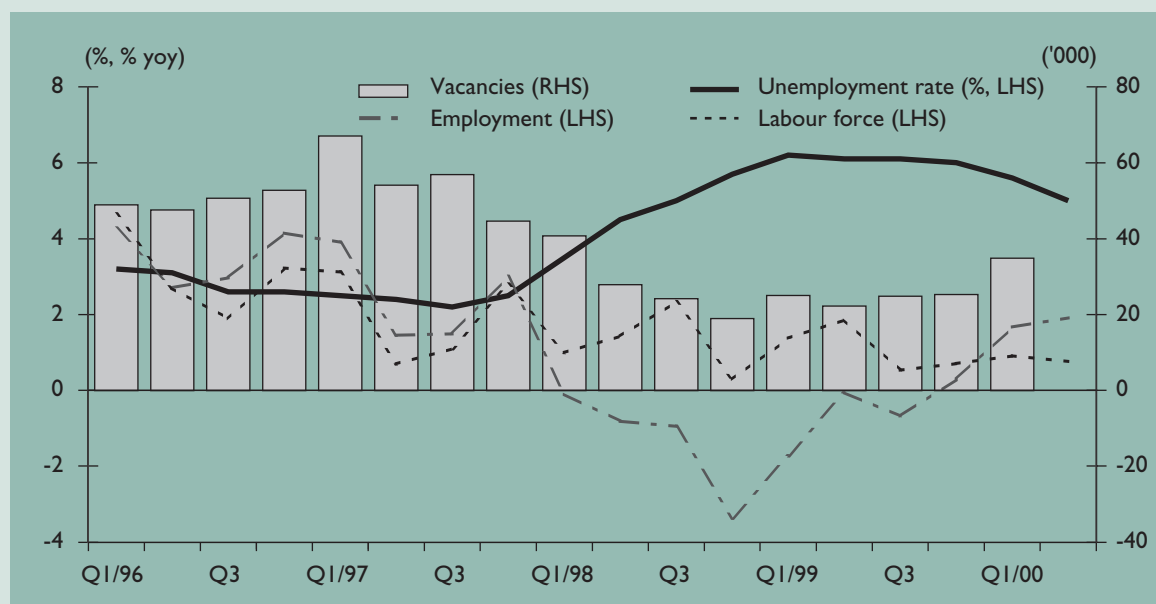
### External Trade

Merchandise trade continued to record a notable increase in the second quarter, following strong performance in the first (Chart 1).

Specifically, re-export growth continued to increase by a year-on-year rate of 18.9% in value terms in the second quarter, from 20.8% in the first, while growth in domestic exports moderated to 6.0% from 14.2% during the same period. Exports to the Mainland, the US, Japan and the ASEAN economies continued to record double-digit rates of growth. In line with the strong re-export growth and consumer spending, growth in imports rose by 20.4% in the second quarter, from 22.8% in the first. As imports grew faster than exports, the visible trade deficit widened for the fourth straight quarter.

On invisible trade, growth of exports of services accelerated to a year-on-year rate of 16.3% in real terms in the second quarter, from 15.3% in the first quarter, reflecting mainly stronger inbound tourism. Meanwhile, imports of services registered a significant rebound of 3.1% in the second quarter, following a decline of 0.2% in the first quarter. Taking visible and invisible trade together, there was an overall trade surplus of HK\$12 billion, or 2.0% of GDP in the first half of 2000, compared with a surplus of HK\$18 billion, or 3.0% of GDP in the same period last year.

Chart 2  
Unemployment Rate



Note: Unemployment rates prior to 2Q97, year-on-year % changes of employment prior to 2Q98 and year-on-year % changes of labour force prior to 2Q97 are under old definition.

## Labour Market and Inflation

The labour market continued to show signs of improvement. The unemployment rate eased to 5% in the second quarter and remained at the same level in the three months ending July, off from its peak of 6.3% recorded in the three months to May 1999 (Chart 2). Employment increased by 2.0% during the May-July period from a year ago, outpacing an increase of 0.8% in labour force. The number of vacancies in almost all sectors recorded double-digit year-on-year growth in March 2000, although it remained 35.6% lower than the pre-crisis level in the second quarter of 1997. Adjustments in wages and salaries seem to have moderated, with the payroll index showing virtually no change in nominal terms in the first quarter of 2000, following a decline of 0.7% in the preceding quarter. Adjusting for the decline in the consumer price index, the payroll index increased by 5.5% year-on-year in real terms in the first quarter.

Downward drift in consumer prices showed distinct moderation, with the year-on-year decline in the Composite Consumer Price Index (CCPI) moderating to 3.2% in July, following a drop of

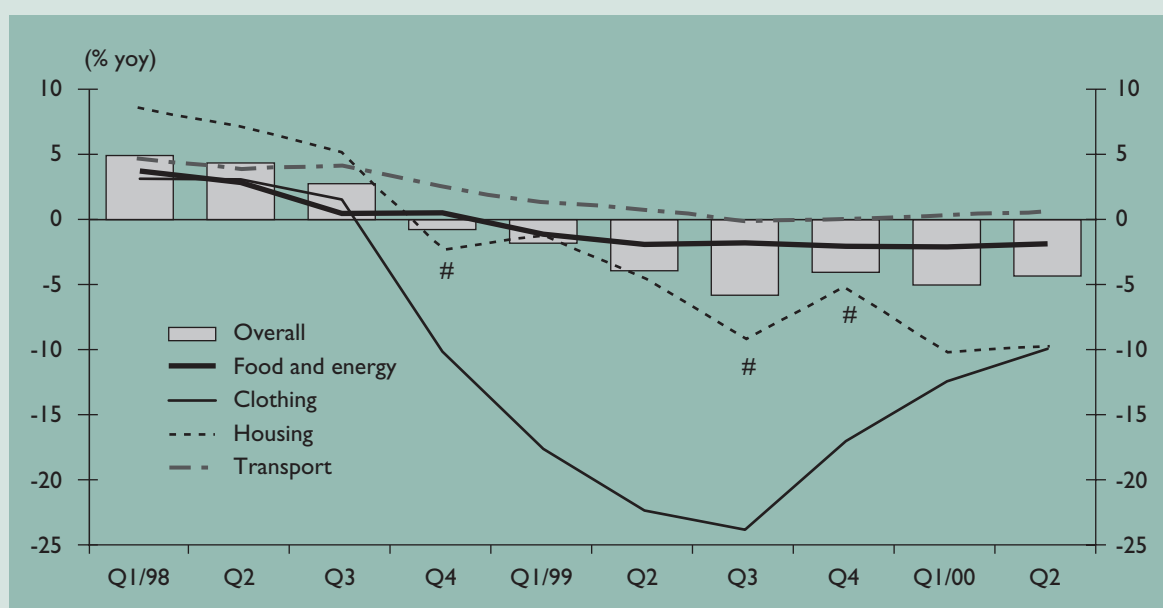
4.5% in the second quarter of 2000 (Chart 3). The smaller decline was in part attributable to a lower base, due to a 50% rates concession granted in the third quarter of 1999. Adjusted for this factor, the CCPI fell by about 4.0% in July, still smaller than the decline in the second quarter.

## Asset Markets

The stock market was highly volatile in the second quarter, mostly echoing the movements in US markets (Chart 4). After surging to a historical high of 18,302 in late March, the Hang Seng Index (HSI) plunged by 25% to 13,723 in late May. The correction was attributable to the declines in the US technology share prices and higher-than-expected US inflation. Subsequently, as moderate economic indicators in the US reduced pressure for aggressive interest rate hikes, the HSI surged strongly to over 17,000 in late August.

In line with the consolidation in equity markets, residential property prices declined by 12.5% during the second quarter, following a modest increase of 1.7% in the first. The number of sales and purchase agreements dropped to 4,873 in June 2000, the lowest since February 1998.

Chart 3  
Inflation



# Being affected by the rates rebate and the 50% rates concession granted in 4Q98 and 3Q99 respectively.

Nevertheless, market sentiment has improved recently, following the announcement of adjustments to the Home Ownership programmes and the clarification of the Government's housing policy. Partly reflecting this, the number of sales and purchase agreements increased to 7,827 in July 2000.

### Short-Term Outlook

Looking ahead, growth is expected to moderate in the second half of the year. The government has revised upward its forecast of real GDP growth in 2000 from 6% to 8.5%, implying a quarterly average decline of 1% in the remaining two quarters. While private consumption would be supported by the continued improvement in labour market conditions and the recent recovery in the stock market, growth is likely to decelerate after the strong pick-up in the first half of the year. Investment is expected to continue to recover from the depressed cyclical troughs in 1998-99. Growth in exports could moderate further, due to both moderating growth in the global economy and a high base of comparison. Likewise, import growth would decelerate along with the expected

moderation in domestic demand and re-export growth.

Given the larger-than-expected decline in the CCPI in the first half, the official forecast of CPI inflation was revised to -3.5% in August, from -2.5% in May. Nevertheless, as economic recovery continues and the remaining lagged effect of the rental component diminishes, the downward drift in prices should decelerate further. ☸

- Prepared by the Research Department

Chart 4  
Asset Prices

