DOMESTIC AND EXTERNAL ENVIRONMENT

Following three quarters of robust performance, economic activity in Hong Kong showed signs of a broad-based moderation in the fourth quarter of 2000. The slowdown reflected in part moderated growth in the major economies. Looking ahead, the deceleration in economic growth is expected to continue into 2001, even though lower interest rates should help offset the negative impact of slower growth in the global economy.

External environment

Economic data reported by the major industrial economies in the beginning of 2001 point to escalated risks of a sharp global economic slowdown. US GDP growth moderated to a quarter-on-quarter annualised 1.4% in the fourth quarter of 2000, the lowest since the second quarter of 1995. Other indicators, including manufacturing output, retail sales and housing, also decelerated sharply. Growth in the EU has also eased, though at a less rapid pace. Having slowed to an annualised 2.7% in the third quarter of 2000, GDP growth is expected to be moderate in the fourth quarter, as industrial output has continued to decelerate while exports have been declining on a year-on-year basis since last September. The economic sentiment index fell to a 15-month low in January. The Japanese economy has remained sluggish, with GDP declining by an annualised 2.4% in the third quarter of 2000. Along with stagnant exports and household spending, growth of industrial production moderated to a quarter-on-quarter annualised 1.3% in the fourth quarter, while deflation persisted in terms of both consumer and wholesale prices.

Central banks of major industrial economies have responded to the threat of sharp economic slowdown by relaxing their monetary policies. The US Federal Reserve cut interest rates twice in January by a total of 100 basis points, and has reiterated its policy bias towards further easing. The Bank of Japan cut its Official Discount Rate by 15 basis points to 0.35% on 9 February, but left the overnight call loan rate unchanged. Likewise, the Bank of Canada, the Reserve Bank of Australia, and the Bank of England have eased their rates, but the ECB has so far kept interest rates on hold.

Lower interest rates have improved liquidity in the international bond markets, which saw marked increases in new issues and declines in high-yield spreads. However, major equity markets remained subdued on the back of deteriorating growth prospects and disappointing corporate earnings. In the foreign exchange market, the rebound of the euro in late 2000 lost momentum in early 2001, despite a narrowing interest rate differential and market perceptions of relatively better growth prospects versus the US. Affected by a deterioration of Japan's economic outlook, the yen dropped against the US dollar to a 18-month low of ¥119 in mid-January. Reflecting the strength of the US dollar, the Hong Kong dollar effective exchange rate has appreciated modestly by 0.7% during the first six weeks of 2001. Nevertheless, monetary conditions have eased considerably as a result of the interest rate cuts that followed the moves in the US.

In Asia, economic sentiment has turned more pessimistic, given the risk of a sharp US slowdown and Japan's return to negative growth. There are growing signs of economic slowdown, both in exports and domestic demand. In response to weakening external demand and lower interest rates globally, many Asian central banks have also moved to ease their monetary policies. Following political changes in Thailand and the Philippines, the baht and the peso staged strong rallies in January. Other Asian currencies have appreciated modestly by 1-5% against the US dollar since end-2000.

Domestic Activity

The pace of economic growth in Hong Kong slowed in the fourth quarter of 2000, following double-digit growth in real GDP for three consecutive quarters (Table 1). Major economic indicators suggest a broad-based moderation in economic activity. Retail sales volume dropped by 2% during the fourth quarter of 2000 on a seasonally adjusted basis. The drop in stock prices and continued weakness in the property market might have affected consumer sentiment, notwithstanding rising employment and improved labour income.

There are also signs of a deceleration in investment growth. Growth in retained imports of capital goods moderated sharply from a year-on-year rate of 51.2% in October to 6.7% in November. Property-related private investment has continued to be restrained by the weak market sentiment. Building and construction output by the public sector is likely to have fallen further as the Public Housing Programme slowed down from its earlier peak. Domestic lending has remained sluggish. While loans have resumed positive year-on-year growth since August 2000, a significant part of the increase reflected those for a major corporate acquisition (Box 1).

External Trade

Having grown strongly in the first ten months of 2000, merchandise trade recorded a notable slowdown in the last two months (Chart 1). Growth in re-exports decelerated to a year-on-year rate of 9.0% in value terms in November and December, following a 20.1% rise in January-October. Domestic exports fell by 9.5%, after increasing by 9.7% during the earlier period. Growth in imports also decelerated, to 8.8% in the last two months of 2000 from 21.5% in the first ten months. In respect of exports of services, the growth in tourist arrivals slowed from 16.2% year-on-year in the first three quarters of 2000 to 12.9% in the last quarter.

Labour Market and Inflation

The unemployment situation continued to improve. The seasonally adjusted unemployment rate eased to 4.5% in the fourth quarter of 2000, compared with 4.8% in the third quarter and its peak of 6.3% in mid-1999 (Chart 2). Employment

Table 1

GDP by Components (at constant 1990 market prices)

(yoy%, unless stated otherwise)

	1998	1999			2000			
	Overall	H1	H2	Overall	Q1	Q2	Q3	
Private Consumption Expenditure	-7.4	-2.1	3.6	0.8	8.7	5.1	5.6	(+3.1)
Government Consumption Expenditure	0.8	3.8	2.9	3.3	3.7	2.7	2.5	(+0.2)
Gross Domestic Fixed Capital Formation	-7.5	-23.4	-10.4	-17.3	4.8	4.9	13.0	(+3.6)
Change in Inventories (HK$bn)	-14.8	-12.1	1.3	-10.9	5.9	4.8	5.0	(+2.2)
Domestic Exports of Goods	-7.9	-11.0	-3.8	-7.2	16.2	8.3	8.2	
Re-Exports of Goods	-3.7	-2.1	12.5	5.4	21.4	19.1	19.0	
Imports of Goods	-7.2	-9.0	9.3	0.1	22.9	18.8	18.4	
Domestic Exports Minus Retained Imports (HK$bn)	-251.9	-102.3	-111.7	-214.0	-63.5	-69.5	-67.6	(-6.2)
Re-Exports Margin (HK$bn)	171.6	81.4	99.5	180.9	45.8	52.0	58.5	(+4.4)
Exports of Services	-1.8	2.4	12.6	7.8	15.3	18.3	12.6	
Imports of Services	2.8	-0.2	0.5	0.2	-0.2	3.8	3.2	
Net Exports of Services (HK$bn)	72.7	35.0	54.1	89.1	23.9	27.3	30.7	(+3.1)
GDP	**-5.3**	**-0.9**	**6.8**	**3.1**	**14.2**	**10.9**	**10.4**	**(+10.4)**

Note:( ) : % Contribution to GDP Growth

Chart 1

External Trade

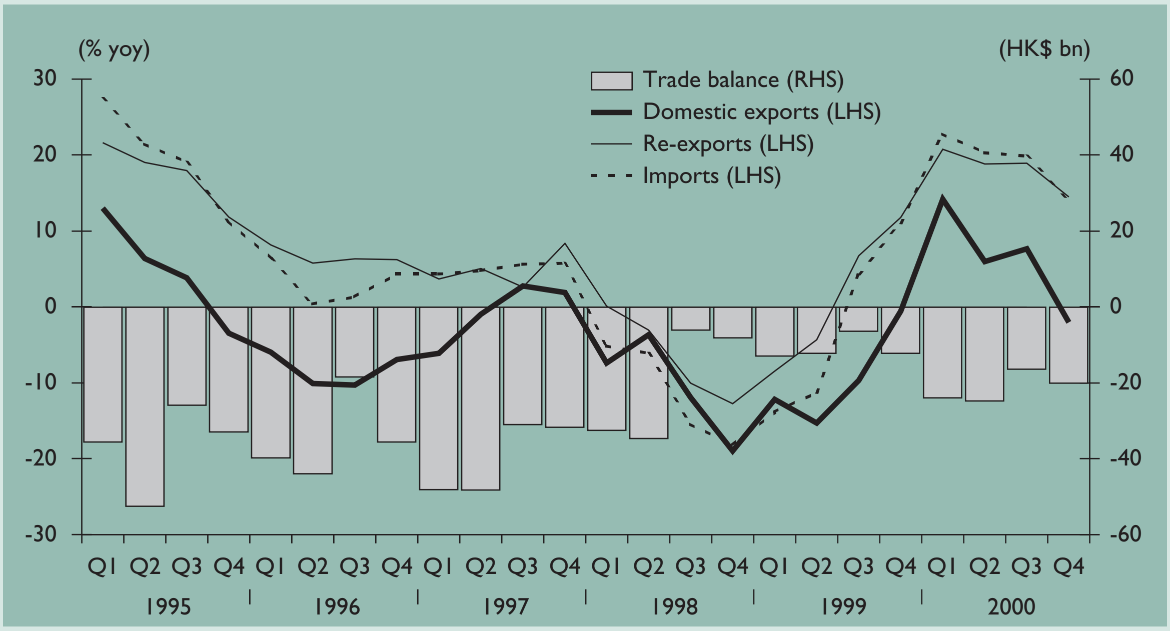
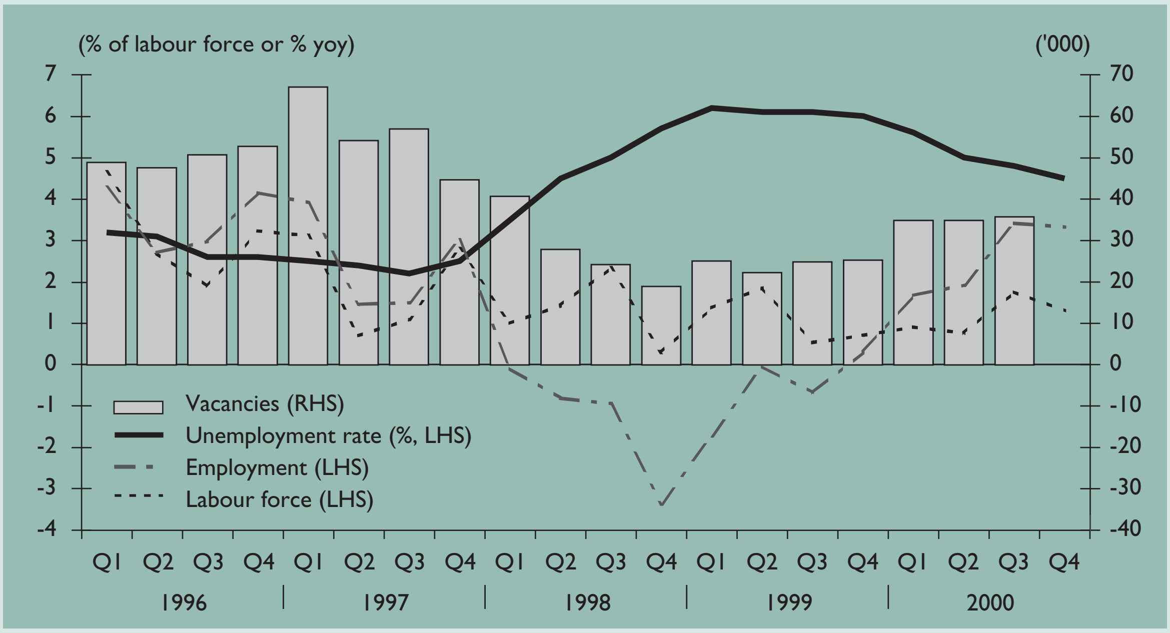


Chart 2

Unemployment Rate



Note: Unemployment rates prior to the second quarter of 1996 and year-on-year % changes of employment and labour force prior to the second quarter of 1997 are under old definition.

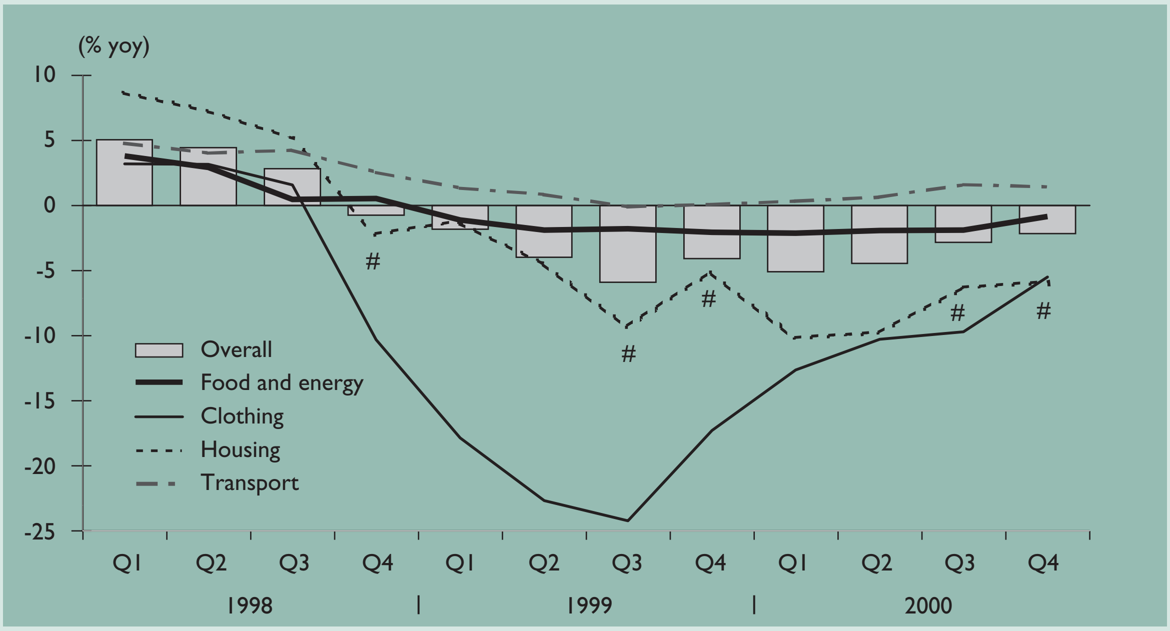
has continued to pick up, increasing by 3.3% year-on-year in the fourth quarter of 2000, outpacing an increase of 1.3% in the labour force. Along with improved labour market conditions, workers' earnings and household income have also increased. The payroll per person engaged registered a small year-on-year increase of 1.7% in the second and third quarters of 2000, following a zero increase in the first. Median household income grew by 3.5% from a year ago in the third quarter, following growth of 1.2% in the second.

The downward drift in consumer prices showed further signs of moderation. The Composite Consumer Price Index (CCPI) fell by 2.2% in the fourth quarter from a year ago, following declines of 4.5% and 2.8% in the second and third quarters respectively (Chart 3). The continued moderation in the fall in the CCPI was attributable to the dissipation of the lagged effect of the rental decline, as well as the pick up in economic activity, which has reduced downward pressures on general prices of goods and services.

Asset Markets

From a narrow range of 14500-15500 during the fourth quarter of 2000, the Hang Seng Index edged up to a slightly range of 15700-16000 in early 2001, supported by interest rate cuts and expectations of further monetary easing in the US (Chart 4). There are also signs that activity in the property market has revived somewhat in recent weeks following the interest rate cuts. In the fourth quarter of 2000, residential property prices dropped by 6%, and the number of transactions fell by 28%, as compared with the third quarter.

Chart 3
Inflation



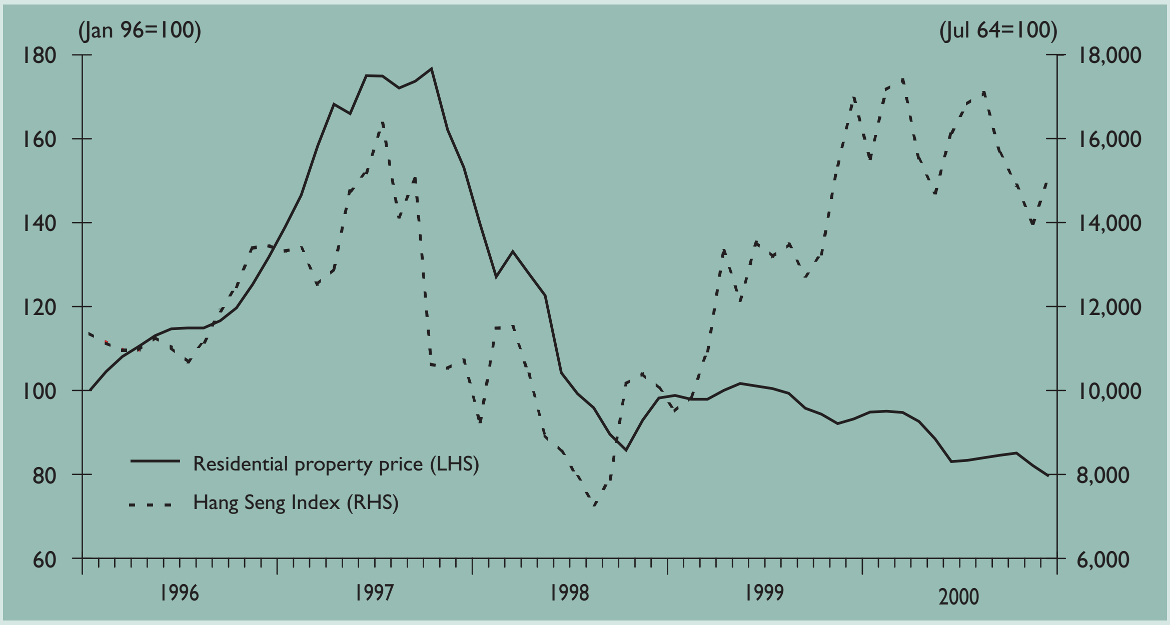
 # Affected by the rates rebate and the 50% rates concession granted in fourth quarter of 1998 and the third quarter of 1999 respectively.

Short-term Outlook

Following an exceedingly strong performance in 2000, economic growth is likely to slow in 2001. Apart from the higher base of comparison, a combination of factors points to moderation in growth. Domestically, while lower interest rates, higher employment and better income should support consumer spending, sentiment may be affected by the uncertain prospects of asset markets and the implementation of the Mandatory Provident Fund. Investment is expected to slow, following the strong rebound in 2000. Growth in exports may moderate further, due to slower growth in the global economy. Likewise, import growth may decelerate along with the expected moderation in domestic demand and re-export activity. The CCPI is likely to show modest year-on-year increases in the latter part of 2001, as the economic recovery continues - though at a slower pace - and the remaining lagged effect of the rental component diminishes.

Chart 4

Asset Prices



Box 1.

Domestic Lending

While the Hong Kong economy has seen a strong V-shaped recovery since the second quarter of 1999, domestic bank lending has remained sluggish, and has only resumed mild positive year-on-year growth since August 2000 (Chart B1). This is a puzzling phenomenon because in previous economic cycles growth in domestic lending lagged behind the rebound in economic activity by only one to two quarters. With a view to obtaining a better understanding of the reasons behind weak loan growth, we have informally consulted several large and medium-sized banks active in the domestic lending market.

Discussions with banks suggest that subdued demand has been the predominant factor behind sluggish loan growth. This is, in turn, associated with the downturn in the property market, which has traditionally been a main driver for both corporate and personal lending. First, in view of the uncertain prospects for the property market, some property developers have refrained from embarking on new large-scale building projects. Much of their funding demand in the past year was for re-financing purpose, taking advantage of favourable interest rates offered by banks. Second, loans for residential mortgages have moderated along with much lower property values and a significant decline in property market transactions (Chart B2). Third, some lending to corporations outside the property sector has similarly been affected because of the decline in collateral value (Chart B3).

Most of the banks appear to have relaxed their lending policies as the general improvement in economic performance has eased concerns about credit risks. Against weak demand, lending rates have declined, most notably in respect of lending to large conglomerates and for residential mortgages. Nevertheless, banks seem to have mixed views on lending to small- and medium-sized enterprises (SMEs), and mainland-related entities. Some have remained cautious, while others are actively building up SME lending, and introducing more systematic credit assessment based on a wider range of criteria in addition to the collateral value.

In addition to demand and supply side factors, domestic lending has also been affected by some structural factors. In particular, the availability of renminbi funding from banks in Mainland China has reduced the need for corporations to borrow from banks in Hong Kong to finance their operations in the mainland. Another major development has been an increase in open account trading, which has reduced demand for traditional trade financing loans.[1] While some banks have introduced alternative forms of financing under open account trading, such as, factoring, they represent a rather small proportion of total trade financing.[2]

The increased fund-raising activities in the equity and bond markets over the past two years raise a question of whether disintermediation reduces demand for bank lending. Most banks did not consider equity market financing as a substitute for bank financing, as the IPOs have mostly been launched by Chinese enterprises or young technology firms that lack a track record to apply for bank loans. Debt market financing is perceived as a closer substitute to traditional bank lending. Banks, nevertheless, are indirectly providing funds to corporates through increased holdings of such paper.

1 Under an open account arrangement, importers pay directly to the account of exporters, rather than using letters of credit.

2 Factoring refers to a financing arrangement under which exporters discount the receivables with a bank. The bank will then assume all the risks associated with the order. It will need to arrange an overseas company to collect payments from the importer.

Chart B1

Domestic Loans and Economic Growth

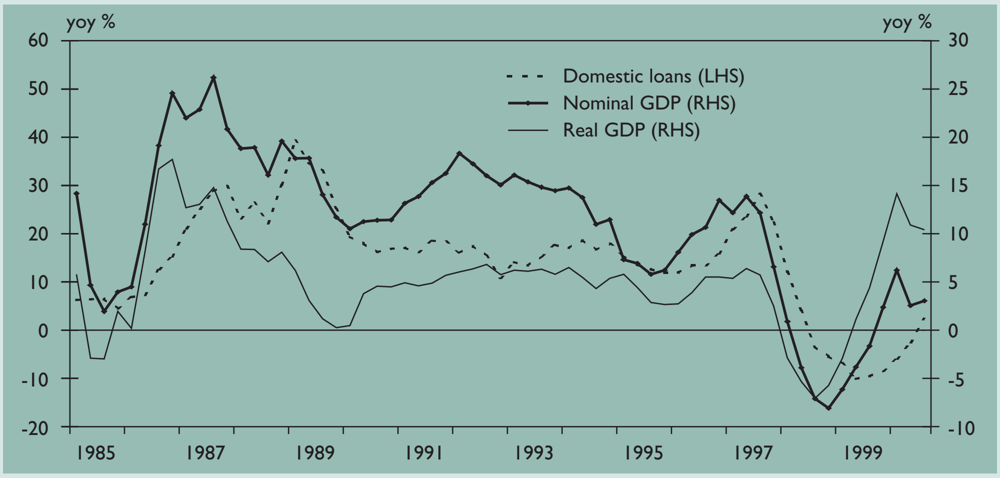


Chart B2

Residential Mortgage Loans

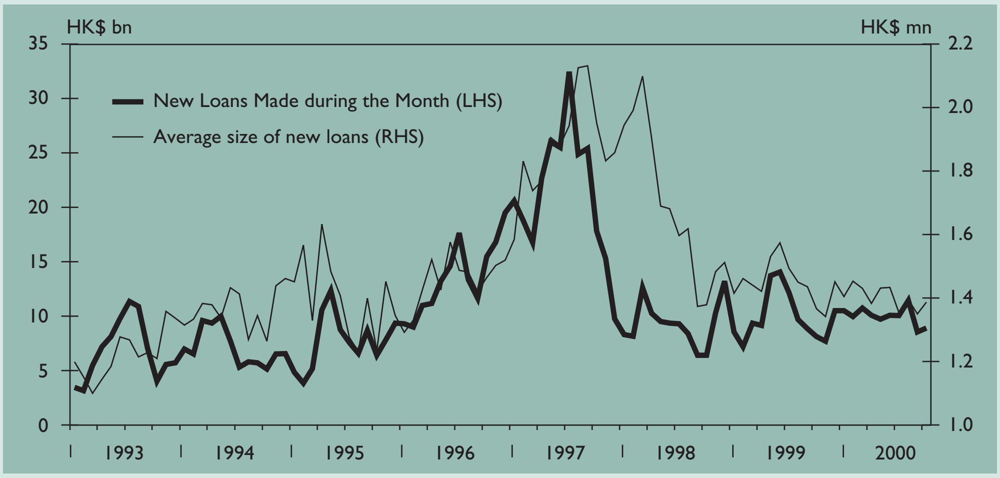


Chart B3

Property Prices and Lending to Non-property Related Sectors