

DOMESTIC AND EXTERNAL ENVIRONMENT

With further deterioration in economic conditions worldwide, Hong Kong's economic growth continued to slow in the second quarter. The deceleration reflected mainly a contraction in external trade, and to a lesser extent, a moderation in growth of domestic demand. Looking ahead, economic activity will likely to be constrained by the unfavourable external environment. On the domestic front, consumer sentiment would be undermined by the renewed weakness in the asset and labour markets.

External Environment

The near-term prospects of the global economy have remained weak. What started as a reversal in the technology boom in the US last year has transformed into strong headwinds affecting the US economy and the rest of the world, gaining strength through feeding on the weaknesses and vulnerabilities in other economies. In the US, despite the Federal Reserve's aggressive monetary easing, GDP growth slowed further to an annualised 0.7% in the second quarter from 1.3% in the previous quarter. Meanwhile, industrial output fell for the tenth consecutive month in July – the longest period of decline since 1983. Although a relatively healthy consumer demand provides some cushion to US growth, continued decline in fixed capital spending, weak exports, and poor business sentiment prompt most forecasters to believe that the US is unlikely to rebound strongly towards the end of the year. In the euro zone, GDP grew by an annualised 2% in the first quarter of this year, while industrial output fell in July to its lowest level over two years. Germany, the biggest economy in the euro zone, has notably weakened with unemployment rising, business confidence plummeting, and manufacturing slipping into recession. In Japan, business and consumer confidence also deteriorated as growth continued to slow. Revised figures show that Japan's GDP grew by an annualised 0.5% in the first quarter of the year. Growth in both private consumption and government spending were stagnant, while business investment, the biggest source of economic growth over the past two years, plunged by 3.7% on an annualised basis. Exports also fell sharply as a result of slower global demands.

With economic outlook deteriorating, and inflationary pressure subsiding due to falling energy prices, most major central banks have stepped up their monetary easing in the past few months. The Federal Reserve has reduced the Fed Funds target rate by 25 bp to 3.5% on 21 August, the seventh cut in 2001, bringing a total reduction of 300 bp. Responding to widespread global weaknesses, the Bank of England cut its base lending rate by a quarter percentage point to 5% in early August. The Bank of Japan (BoJ) also announced further quantitative monetary easing in mid-August, aiming at boosting bank reserves and increasing the BoJ's monthly purchase of government bonds, in an effort to stop a downward spiral of demand and prices. In the euro zone, although the European Central Bank (ECB) has left its policy rate unchanged since the 25 bp reduction in May, inflation in the euro area appears to have eventually set on a downward trend, raising the prospects of the ECB adopting a more accommodating stance going forward.

Clouded by the gloomy outlook, the 10-year US Treasury yield fell to a 4-month low in mid-August, and equity markets continued to decline. In Japan, apart from the brief rally in early August, the Nikkei 225 was generally on a downward trend in the past few months. In currency markets, the US dollar weakened notably against the euro since June. The fall in the US dollar against the euro was exacerbated by concerns expressed by the International Monetary Fund (IMF) on 14 August about the sustainability of US current account deficit. Meanwhile, the yen also strengthened to about 120 against the dollar.

In emerging markets, concerns over Argentina's fiscal stability reached crisis proportions in mid-July. Rising default fear caused overnight interest rates to reach 300% at one point and triggered a capital outflow that depleted the foreign reserves by US\$ 3 billion in a week, while bank liquidity has been drying up quickly in August. On 21 August, after 10 days of negotiations with the Argentine government, the IMF announced that it would offer about US\$ 5 billion in the form of standby credit to Argentina, and a further US\$ 3 billion if Argentina engages in voluntary negotiations to restructure its outstanding debt. Whether the new package would suffice to restore confidence in Argentina remained to be seen. Nonetheless, the crisis in Argentina had already adversely affected Brazil and Chile, the currencies of which both fell to new lows against the US dollar.

The economic outlook facing Asia remained bleak as the electronics-sector-led export slump continued. In Singapore, GDP contracted by an annualised 10.1% in the second quarter, after the decline of 10.9% in first quarter. Taiwan, another major exporter of electronics products in the

region, also saw its GDP fall by 2.4% from a year ago in the second quarter, the worst performance in twenty-five years. While the Indonesia rupiah rebounded after the appointment of a new president, currencies of the Philippines, Singapore and Taiwan all hit new lows. Nevertheless, China continued to be the only economy in the region that maintained healthy growth in the first half of 2001. Supported by robust domestic demand, the economy grew 7.8% in the second quarter.

Domestic Activity

While the external environment has deteriorated further in the past few months, monetary and financial conditions in Hong Kong have remained broadly stable. In the real sector, economic growth slowed further in the second quarter, reflecting contraction in external trade, and to a lesser extent, a moderation in growth of domestic demand.

Consumer spending was constrained by the continued weakness in the asset markets as well as worsening labour market conditions. Adjusted for

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

	2000					2001
	Q1	Q2	Q3	Q4	Overall	Q1
Private Consumption Expenditure	8.7	5.1	5.6	2.5	5.4	2.8 (+1.6)
Government Consumption Expenditure	3.7	2.7	2.5	-0.6	2.1	4.0 (+0.3)
Gross Domestic Fixed Capital Formation	5.7	5.4	14.8	13.0	9.8	13.8 (+3.9)
Change in Inventories (HK\$bn)	5.2	4.4	3.7	1.6	14.9	1.3 (-1.8)
Domestic Exports of Goods	16.2	8.3	8.2	-0.8	7.5	-12.8
Re-exports of Goods	21.4	19.1	19.0	15.2	18.5	6.5
Imports of Goods	22.9	18.8	18.4	13.4	18.1	5.3
Domestic Exports minus Retained Imports (HK\$bn)	-63.5	-69.5	-67.6	-66.5	-267.0	-71.4 (-3.8)
Re-exports Margin (HK\$bn)	45.8	52.0	58.5	58.0	214.3	48.8 (+1.4)
Exports of Services	15.8	18.2	14.0	9.5	14.1	6.4
Imports of Services	-0.9	3.3	3.4	2.7	2.1	5.5
Net Exports of Services (HK\$bn)	24.5	27.6	31.2	35.0	118.2	26.3 (+0.9)
GDP	14.1	10.7	10.8	6.9	10.5	2.5 (+2.5)

Note: () : % Contribution to GDP growth

seasonal factors, growth of retail sales volume slowed to 2.3% in the second quarter from 4.1% in the preceding quarter, pointing to a moderated quarter-on-quarter growth in private consumption expenditure in the second quarter.¹

As for fixed capital investment, there were also signs of deterioration in the second quarter, since business outlook was clouded by the worsening of the external environment. In particular, trade data suggest a significant slowdown in growth of machinery and equipment acquisition – value of retained imports of capital goods declined by 2.1% in the second quarter from a year ago, reversing a strong increase of 19.3% in the first quarter.

External Trade

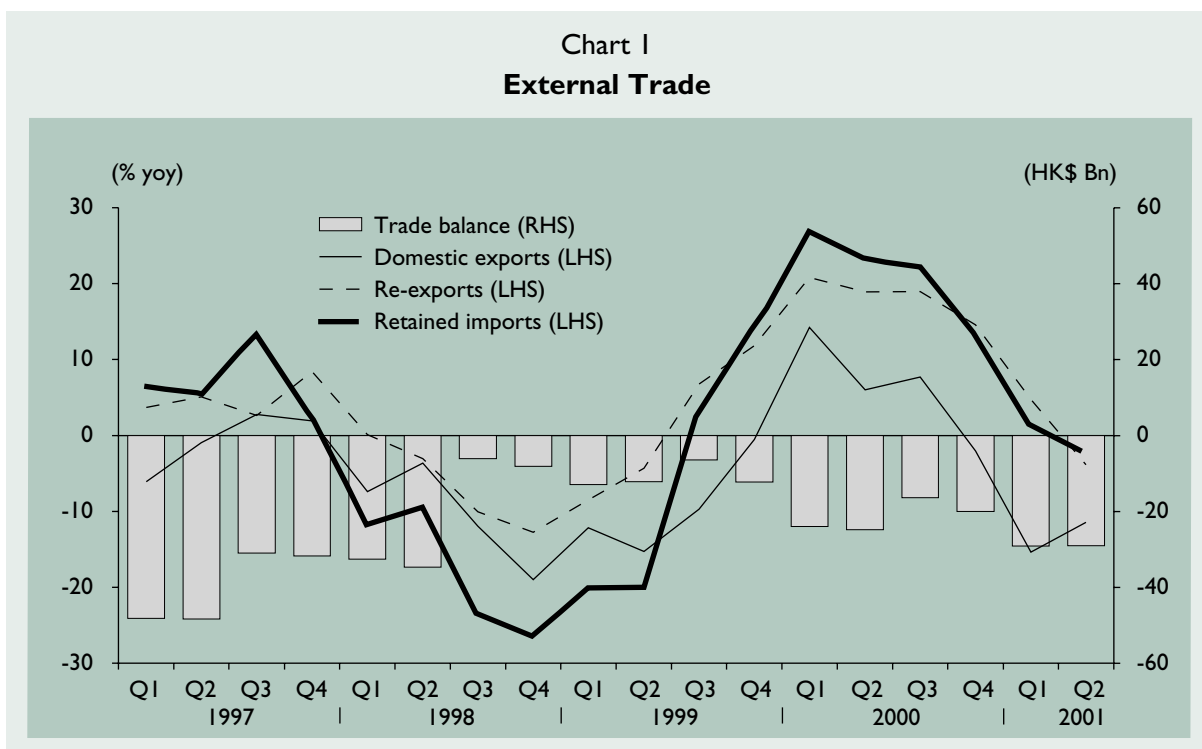
Along with the deceleration of global growth, external trade contracted in the second quarter (Chart 1). Value of re-exports declined by 3.9% from a year ago, compared with an increase of 4.8% in the previous quarter. Domestic exports continued to decline, albeit at a slightly more

moderate pace of 11.4%. The slowdown in exports was broad-based, with exports to all major markets recording declines or much slower growth. In particular, exports to the US and EU recorded year-on-year declines of 10% in the second quarter. In line with the decelerating domestic demand, value of retained imports also dropped by 2.3% from a year ago, following an increase of 1.3% in the first quarter.

Labour Market and Inflation

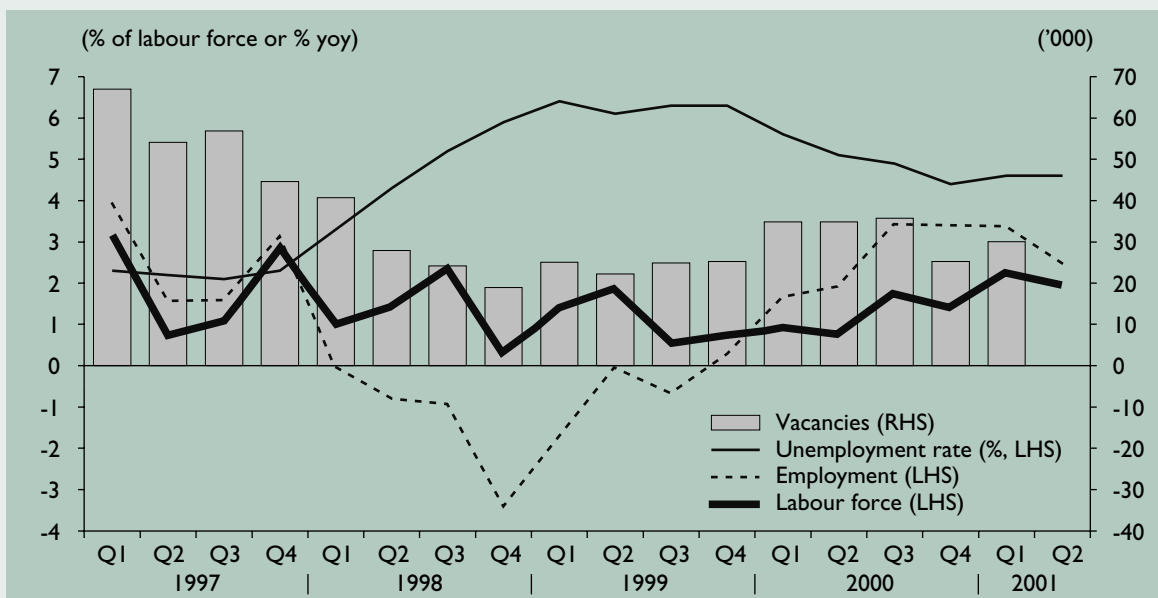
Labour market conditions showed signs of deterioration amid the sluggish economic activities. The seasonally adjusted unemployment rate rose slightly to 4.7% in the three months ending July 2001 from 4.6% in the second quarter, compared with 4.4% in the last quarter of 2000 (Chart 2). The increase in the unemployment rate was mainly due to a deceleration in employment growth, as labour force continued to record stable growth. On the other hand, the underemployment rate improved slightly from 2.3% in the second quarter to 2.2% in the three months ending July.

Chart 1
External Trade



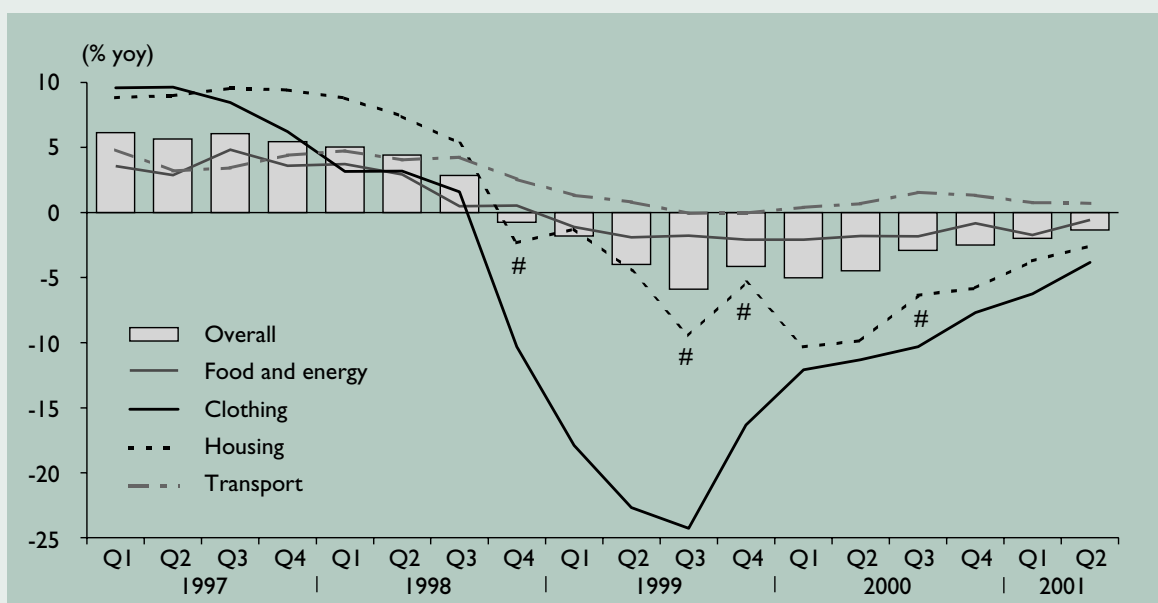
¹ Due to differences in coverage, caution is warranted in comparing the statistics on retail sales and private consumption expenditure. Retail sales include spending in goods by residents and non-residents in Hong Kong, while private consumption expenditure also includes spending in services as well as residents' spending abroad, but excludes non-residents' spending in Hong Kong.

Chart 2
Unemployment Rate



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

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.

The downward drift in consumer prices continued to moderate in the second quarter of 2001, with the Composite Consumer Price Index (CCPI) falling by 1.3% on a year-on-year basis, compared with a decline of 2.0% in the preceding quarter (Chart 3). The moderation in price declines was partly due to the dissipation of the lagged effects of the rental declines in the earlier period.

Asset Markets

Stock prices declined significantly in recent months, in line with the movements in the global markets. The Hang Seng Index fell to a 28-month low to below 11,500 in late August, while the market turnover also dropped significantly (Chart 4). Property market activity remained sluggish, with both prices and transaction volume declining moderately during the second quarter. The correction in the stock market has adversely affected the sentiment in the property market, which was further dampened by unexpectedly weak land sales in August.

Short-term Outlook

Economic growth in Hong Kong will likely continue to be constrained by the unfavourable external environment for the remaining part of 2001. Exports are expected to continue to decline in the near term, as external demand weakens further. However, the pace of contraction in exports may moderate because of the recent weakening of the US dollar, to which the Hong Kong dollar is linked. On the domestic front, despite the lower interest rates, consumer sentiment would be undermined by the renewed weakness in the asset and labour markets. In particular, with the announced plans of large corporations to relocate their back offices to the Mainland and increasing signs for business consolidation, the unemployment rate is likely to rise further. The downward pressure on prices is also likely to persist in the near term amid the sluggish domestic demand, although import prices may rise due to the recent weakening of the US dollar. 🌀

- Prepared by the Research Department

Chart 4
Asset Prices

