

DOMESTIC AND EXTERNAL ENVIRONMENT

With the onset of global recession, Hong Kong's economy contracted and unemployment rate rose further in the third quarter. External trade fell for the second quarter in a row, while domestic demand slowed sharply. Looking ahead, the short-term economic outlook is likely to be undermined by the global cyclical weakness, which has been exacerbated by the terrorist attacks in the US on 11 September. Nevertheless, China's accession to the WTO and the stimulative measures announced in the government's policy address would provide some support to the economy in due course.

External Environment

The global economic outlook has been deteriorating rapidly, despite aggressive monetary easing by major central banks around the world. The terrorist attacks in the US on 11 September exacerbated weaknesses in the already-sluggish world economy. In the US, GDP contracted at an annualised 0.4% in the third quarter, reversing a growth rate of 0.3% in the second, the first contraction in the past decade. Industrial production fell for the thirteenth consecutive month in October, while retail sales, boosted by strong automobile sales figures, rebounded by 7.7% in the month, after having fallen by 2.2% in the previous month. However, with labour market conditions worsening rapidly and consumer confidence plunging to record low after the 11 September attacks, private consumption is expected to be less supportive to the ailing economy. In the euro zone, the overall economic climate has been plagued by falling business and consumer confidence. GDP growth slowed to 1.7% year-on-year in the second quarter, down from 2.4% in the first. In Germany, the declines in manufacturing output and orders in September suggested that a notable recovery might be further delayed. In contrast, the UK economy has remained buoyant. Preliminary estimates reported a year-on-year GDP growth rate of 2.2% in the third quarter, similar to the 2.3% registered in the second quarter. However, the beleaguered manufacturing sector continued to be a strain on economic performance ahead. Whereas in Japan, recent economic developments testified a possible deepening of the recession. Industrial production fell on a year-on-year basis for the eighth

consecutive month in September, with the pace of contraction accelerating to 12.7% from 11.7% in the previous month. Against the backdrop of bleak economic outlook and surging unemployment rate, private consumption was equally weak, with retail sales continuing to fall. Exports and imports also declined, by 11.0% and 7.9% respectively from a year ago, reflecting weaknesses both at home and aboard.

In a concerted effort to bolster consumer and investor confidence and to alleviate the adverse economic impact of the terrorist attacks, major central banks in the world eased their monetary policies. On 17 September, when the New York Stock Exchange re-opened, both the Federal Reserve and the European Central Bank (ECB) cut interest rates by 50 basis points, which was then followed by a 25 basis point cut by the Bank of England (BOE). The Bank of Japan also reduced its official discount rate by 0.15 percentage-point to 0.1%. Subsequently, as the pace of economic downturn quickened, the Federal Reserve reduced the Fed Funds target rate twice to 2.0%, implying that the real interest rate became virtually zero. The ECB and BOE also cut their policy rates by a further 50 and 75 basis points respectively, in recognition of the increasing risks of a synchronised downturn in the global economy.

Notwithstanding the mounting uncertainty regarding that of the world economy, major stock markets have mostly recovered from the losses triggered by the terrorist attacks. The currency market has also stabilised, with the US dollar recuperating from post-attack lows, remaining around 120 against the yen and 0.90 against the

euro in most part of October. The weakness of the US dollar against the yen in the weeks after the attacks prompted the Japanese authorities to intervene by actively buying dollars in the market in order to prevent an acute strengthening of the yen. Meanwhile, investors' flight to safety led to a fall in the ten-year US Treasury yield to a three-year low in November.

For the emerging economies, the broader concern has been that the 11 September attacks would lead to a further rise in risk aversion and elicit another round of destabilising capital account adjustments. This apprehension was intensified as Argentina's public debt problem developed into a major financial crisis, with its sovereign spread over comparable US Treasuries soaring over 2000 basis points on default fears. In November, the Argentine government announced plans to restructure its debt, but its offer to bondholders to swap existing bonds for new bonds at a lower interest rate was considered by some rating agencies as an effective default. Nevertheless, the impact of this round of troubles in Argentina on other emerging markets had by far been limited.

These developments aggravated the already dire prospects of non-Japan Asia. Both Korea and Taiwan continued to report double-digit falls in exports. Meanwhile, the recession in Singapore continued in the third quarter, with the decline in GDP worsening to 5.6% on a year-on-year basis from the 0.9% contraction in the second quarter. Yet, Asian currencies remained broadly stable, with exceptions of the Singapore dollar and the Indonesia rupiah, both of which have weakened against the US dollar in recent months. A bright spot in the region is China's accession to the World Trade Organisation and the continued strength in its economy.

Domestic Activity

Despite the further deterioration in the external environment in the past few months,

monetary and financial conditions in Hong Kong have remained broadly stable. In contrast, in the real sector, economic activity declined in the third quarter from a year ago, reflecting a contraction in external trade and a sharp slowdown in the growth of domestic demand.

Reflecting fragile consumer sentiment and slowdown in inbound tourists, consumer spending dropped significantly in the third quarter. Adjusted for seasonal factors, the volume of retail sales shrank by 6% in the third quarter from the preceding quarter, suggesting a similar decline in private consumption expenditure.¹

Building activity remained slack. The sustained work on some civil engineering projects, including Cyberport, Disney Theme Park and Container Terminal 9, was offset by the continued decline in the output from Public Housing Programme. Nevertheless, recent trade statistics showed that value of retained imports of capital goods increased by 7.8% in the third quarter from a year ago, reversing the decline of 2.1% in the second, suggesting a possible increase in the investment in machinery and equipment.

External Trade

Along with the deceleration of global growth, external trade contracted further in recent months (Chart 1). The value of re-exports declined by 13.5% in October from a year ago, following a drop of 5.8% in the third quarter, while domestic exports shrank by 17.9% in the third quarter and 18.1% in October. The recent slump in exports was broad-based, with exports to most industrial economies recording double-digit rates of decline, and exports to the Mainland registering a moderate contraction. Reflecting the weakness in domestic demand, the value of retained imports fell by 17.9% in October, from a year ago, following a decline of 8.3% in the third quarter.

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

Chart 1
External Trade

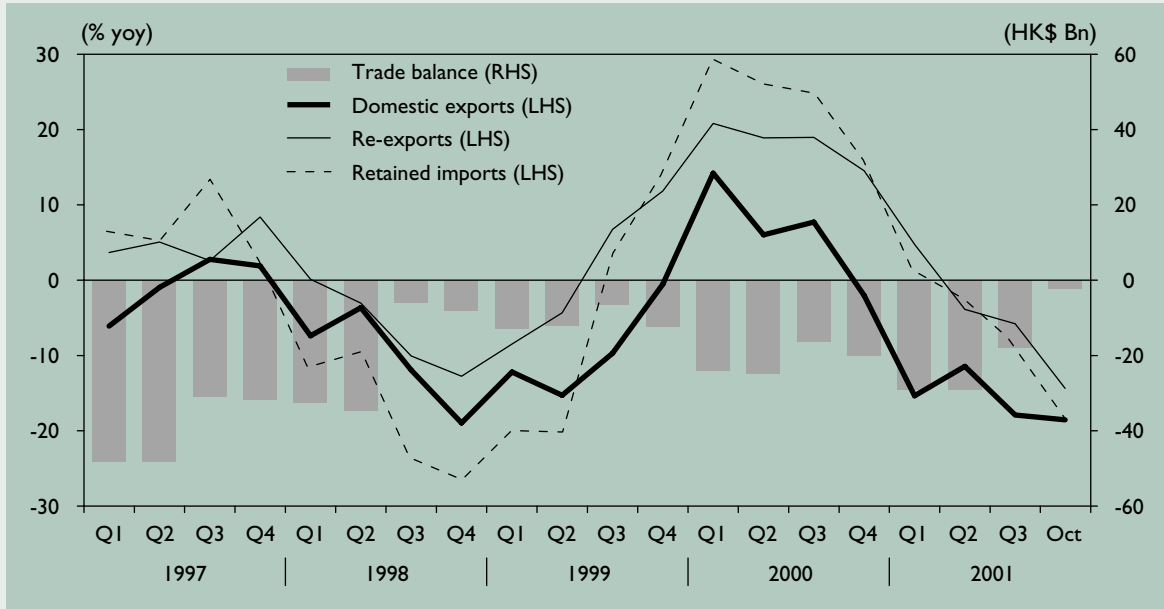
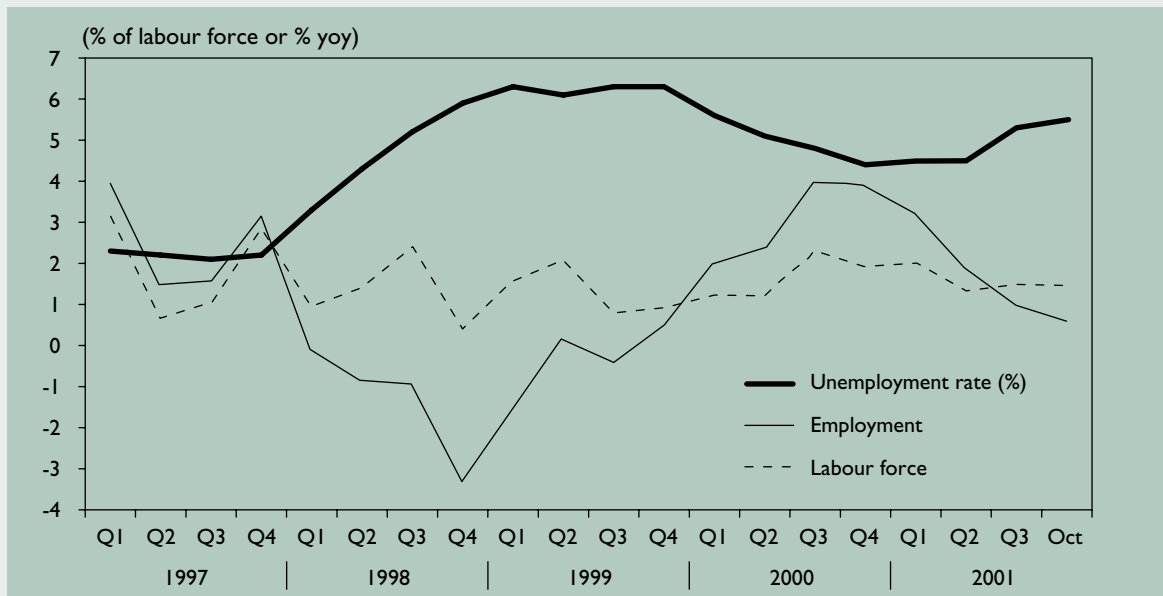


Chart 2
Unemployment Rate



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

Labour Market and Inflation

Labour market conditions deteriorated further amid sluggish economic activity. The seasonally adjusted unemployment rate edged up to 5.5% in the three months ending October 2001, from 4.5% and 5.3% in the second and third quarter respectively (Chart 2). The recent increase in the unemployment rate was mainly due to the sharp slowdown in employment growth, owing to accelerated corporate restructuring and a worsening business outlook following the terrorist attacks in the US.

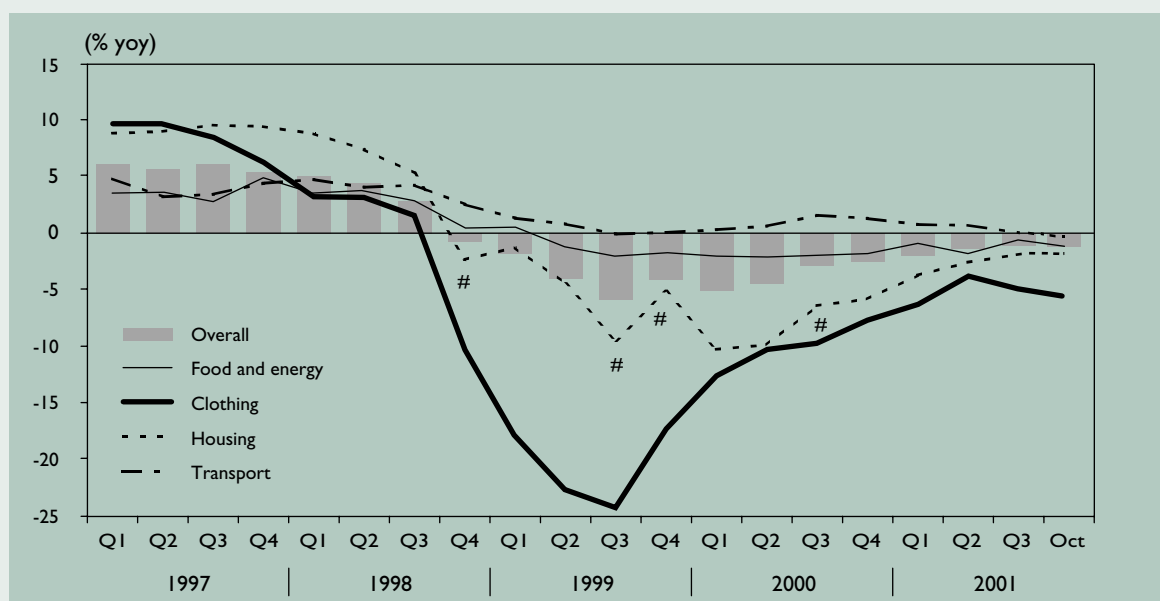
Having eased considerably already during the first half of this year, the downward drift in consumer prices gathered pace in recent months as consumer sentiment further weakened and import prices kept declining amid a global slowdown in growth. The Composite Consumer Price Index (CCPI) fell by 1.2% in October from a year ago (Chart 3), compared with a decline of 1.0% in the third quarter. The CCPI could fall more sharply in the immediate future given the widening output gap and declining import prices. Also, the waiver of one-month rent for the public rental housing and

the Rates concession of up to \$2000 for each rateable tenement would exert additional downward pressure on overall consumer price index.

Asset Markets

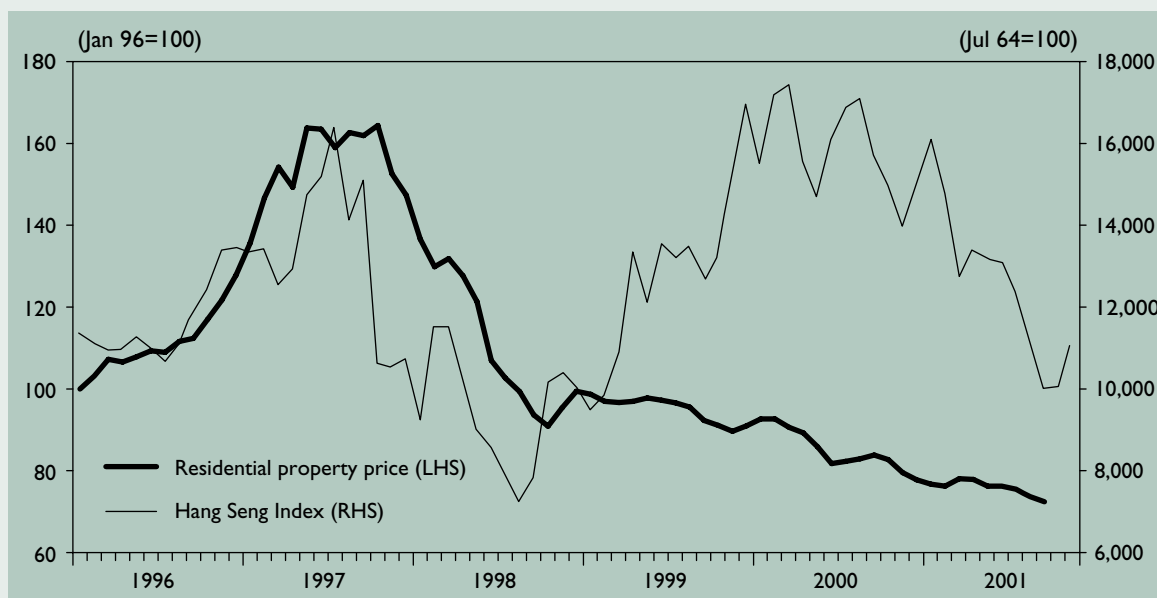
Stock prices have declined significantly so far this year, in line with the movements in the global markets. The Hang Seng Index fell sharply to a three-year low of 8,934 shortly after the terrorist attacks in the US, but returned to the pre-attack level in early November. The index rebounded to around 11,300 in late November, representing a loss of 25% from end-2000 but a gain of 26% from the post-attack low. Property market activity remained sluggish, with both prices and transaction volume declining in the third quarter (Chart 4). Nevertheless, anecdotal information indicated some improvements in market sentiment, in particular, in the primary market, following the aggressive interest rate cuts so far this year and the concessions offered by the real estate developers.

Chart 3
Inflation



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

Chart 4
Asset Prices



Short-term Outlook

In view of the global cyclical weakness that was exacerbated by the 11 September attacks, the near-term economic outlook for the Hong Kong economy has worsened. Economic activity in Hong Kong is likely to be sluggish in the near term. Specifically, exports are expected to shrink further alongside weakening external demand. Despite the lower interest rates, domestic demand remains weak. Consumer sentiment is undermined by the deteriorating labour market conditions. The downward pressure on prices is also likely to persist amid the sluggish external and domestic demand.

China's accession to the WTO, together with the government's stimulative measures announced in the policy address, should help provide some support to the economy. Nevertheless, it would take time for the effects of the government's initiatives, including fiscal and employment policies, to fully materialise. 🌸

- Prepared by the Research Department