

DOMESTIC AND EXTERNAL ENVIRONMENT

Reflecting in part the sustained weakness in the external environment, economic activity in Hong Kong was sluggish in the fourth quarter of 2001. Along with the continued contraction in trade, domestic demand slowed further amid deteriorating labour market conditions. Looking ahead, while the near-term outlook remains uncertain, the economy would begin to recover should global economic conditions improve later this year.

External Environment

While there are signs that the global economy may have bottomed out, the prospects for growth vary considerably in different parts of the world. In the US, advance estimates showed that real GDP grew at an annualised rate of 0.2% in the fourth quarter, following the 1.3% contraction in the previous quarter, as a sharp decline in private domestic investment was offset by increases in personal consumption and government spending. Business and consumer confidence has strengthened in recent months, while retail sales, excluding motor vehicle and parts, continued to pick up and rose strongly by 1.2% month on month in January. Notwithstanding these initial signs of improvement, there remain risks that any recovery might be muted, as the impetus of growth from household consumption could be restrained by the uncertainty in labour market conditions and the heavy debt-service payment burden of the household sector.

In the euro zone, economic prospects remained weak, with GDP growth decelerating to 1.4% year on year in the third quarter, down from 1.6% in the second, due to contracting fixed capital investment and sluggish consumer spending. In Germany, GDP was estimated to have risen by 0.6% in 2001, the lowest rate since 1993. In contrast, economic performance in the UK was robust, with preliminary estimates reporting that GDP increased by 1.9% in the fourth quarter, only slightly below the 2.2% in the previous quarter, reflecting a buoyant service sector. In Japan, however, the recession deepened further, as industrial production, retail sales and exports all continued to register year-on-year declines in fourth quarter. Moreover, the downward trend in consumer prices persisted, with the rate of deflation

accelerating to 1.2% in December. Reflecting the deteriorating economy, corporate bankruptcies have increased considerably in the past few months, resulting in a higher level of non-performing loans in the already-fragile banking system.

In the emerging economies, the economic crisis in Argentina continued to unfold, and the associated social unrest has left the country in a state of turmoil. In December, the government defaulted on its debts and imposed a partial freeze on bank deposits. Subsequently, the authorities abolished the peg to the US dollar, which was introduced in the early 1990s, with the peso traded in the market alongside an official rate, before being allowed to float freely in February. The partial freeze on bank deposits and exchange controls, combined with the intervention of the central bank, appear to have prevented an excessive depreciation of the peso, which stood at about 1.90 per US dollar by mid-February. As for the banking sector, all US dollar loans are to be converted into peso at par, and US dollar savings will be exchanged into pesos at the rate of 1.40 per US dollar. While it remains to be seen whether these policies could help resolve the present crisis, the default of government bonds earlier on, the rise in bad debts, and the conversion of US dollar loans and deposits into peso at different rates have inflicted heavy losses on the banks, hence threatening the stability of the banking system.

Mirroring the weakness in the global economy, the outlook in Asia remained poor. In Singapore, advance estimates indicated that GDP declined by 7.0% year on year in the fourth quarter, after a 5.5% contraction in the previous quarter. Moreover, there are signs that deflation has increasingly become a regional phenomenon. In

particular, consumer prices in both Singapore and Taiwan recorded year-on-year declines for two months in succession towards the end of 2001. Nonetheless, export performance of most Asian economies appeared to be bottoming in the last quarter of 2001, and could improve further should the key industrial economies recover later this year.

Interest rates in the major industrial countries were stable in the first months of 2002, following significant reductions in 2001. Although the strength of a US recovery remains uncertain, the Federal Reserve seemed to be content with the present stance of monetary policy and left the Fed fund target rate unchanged at the last FOMC meeting on 30 January. Meanwhile, the European Central Bank has kept interest rates unchanged since the reduction in November. Market consensus suggests that further easing is less likely in the near term, given the recent pickup in the inflation rate and the strong growth in money supply in the euro zone. Separately, in the absence of a clear indication of economic weakness in the UK, the Bank of England has maintained its repo target rate at 4.0%.

On the financial market front, the rise of the major stock markets in late 2001 did not continue.

In particular, in the wake of the collapse of Enron, market sentiment in the US has been affected by concerns about the quality of corporate financial reporting. In Japan, amid the deterioration in the economy, the NIKKEI index fell sharply to 9,421 in February, the lowest level since 1983. Likewise, in the currency market, the Japanese yen fell to a low of 134.7 against the US dollar in early February. The depreciation of the yen that began towards the end of last year has caused downward pressure on several Asian currencies, with the Singapore dollar and New Taiwan dollar both reaching new lows in December. In Europe, euro notes and coins were officially launched on 1 January 2002 in the member countries of the European Monetary Union and the changeover has been successful. However, notwithstanding the positive sentiment resulting from the smooth changeover, the euro weakened to a low of 0.86 towards the end of January, some 3% lower than the level at end-2001, partly because of recent worries about Germany's fiscal position.

Domestic Activity

Notwithstanding an unfavourable external environment, monetary and financial market conditions in Hong Kong were broadly stable in the recent months. Economic activity was weak in the

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

	2000					2001		
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3
Private Consumption Expenditure	8.7	5.1	5.6	2.6	5.5	3.0	3.6	1.3 (+0.7)
Government Consumption Expenditure	3.7	2.7	2.5	-0.6	2.1	3.9	4.1	6.2 (+0.4)
Gross Domestic Fixed Capital Formation	5.7	5.4	14.8	13.1	9.8	11.5	1.3	3.7 (+1.1)
Change in Inventories (HK\$bn)	5.2	4.4	3.7	1.5	14.8	1.1	1.3	-1.3 (-2.1)
Domestic Exports of Goods	16.2	8.3	8.2	-0.8	7.5	-12.8	-8.5	-12.4
Re-exports of Goods	21.4	19.1	19.0	15.2	18.5	6.5	-1.0	-3.0
Imports of Goods	22.9	18.8	18.4	13.4	18.1	5.3	-0.7	-3.4
Domestic exports minus retained imports (HK\$bn)	-63.5	-69.5	-67.6	-66.5	-267.0	-71.4	-73.5	-68.3 (-0.3)
Re-exports margin (HK\$bn)	45.8	52.0	58.5	58.0	214.3	48.8	51.4	56.8 (-0.7)
Exports of Services	15.8	18.2	14.0	9.5	14.1	6.2	6.3	1.5
Imports of Services	-0.9	3.3	3.4	2.7	2.1	3.9	1.0	-2.0
Net Exports of Services (HK\$bn)	24.5	27.6	31.2	35.0	118.2	26.8	31.1	32.9 (+0.8)
GDP	14.1	10.7	10.8	7.0	10.5	2.2	0.8	-0.3 (-0.3)

Note: () : % Contribution to GDP growth

fourth quarter of 2001, however, reflecting continuing contraction in external trade and slowdown in domestic demand.

On a seasonally adjusted basis, the retail sales volume fell by 2.8% in the quarter, suggesting a possible quarter-on-quarter decline in private consumption expenditure. Fixed capital investment was also subdued. The reduction of the Public Housing Programmes continued to offset the work on some infrastructure projects. Private spending on machinery and equipment grew by 9.8% in the third quarter partly due to the purchase of aircraft, but there are mixed signs as to whether the growth could be sustained. Recent trade statistics show that the value of retained imports of capital goods fell by 15.6% in October from a year ago, but grew by 9.2% in November.

External Trade

External trade continued to contract with the value of total merchandise exports declining by 12.0% in the fourth quarter from a year ago (Chart 1). After falling by 3.9% and 5.8% in the second and third quarter respectively, re-exports shrank more markedly by 11.6% in the fourth, while the decline

in domestic exports moderated slightly. The contraction was broad-based, with exports to most industrial economies recording double-digit rates of decline. In line with weaker re-exports and domestic demand, total imports shrank by 13.5% from the same period of 2000.

Labour Market and Inflation

Labour market conditions continued to deteriorate amidst sluggish economic activity. The seasonally adjusted unemployment rate reached a high of 6.1% in the three months to December as businesses stepped up corporate restructuring and downsizing (Chart 2).

The downward pressure on consumer prices intensified. The Composite Consumer Price Index (CCPI) fell by 2.1% in the fourth quarter from a year ago (Chart 3), compared with a decline of 1.0% in the third. The accelerated decline reflected a combination of factors including sluggish domestic demand, weakening import prices, and the waiver of public housing rentals in December. In particular, the CCPI declined by 3.6% in December, or 1.6% after excluding the effect of the waiver of public housing rentals.

Chart 1
External Trade

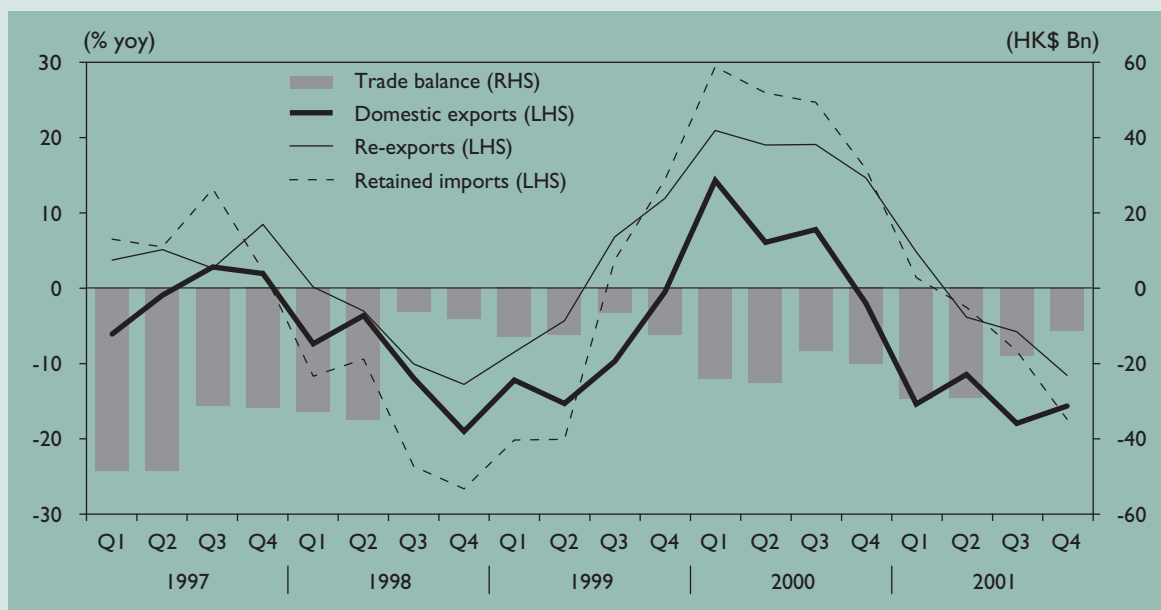
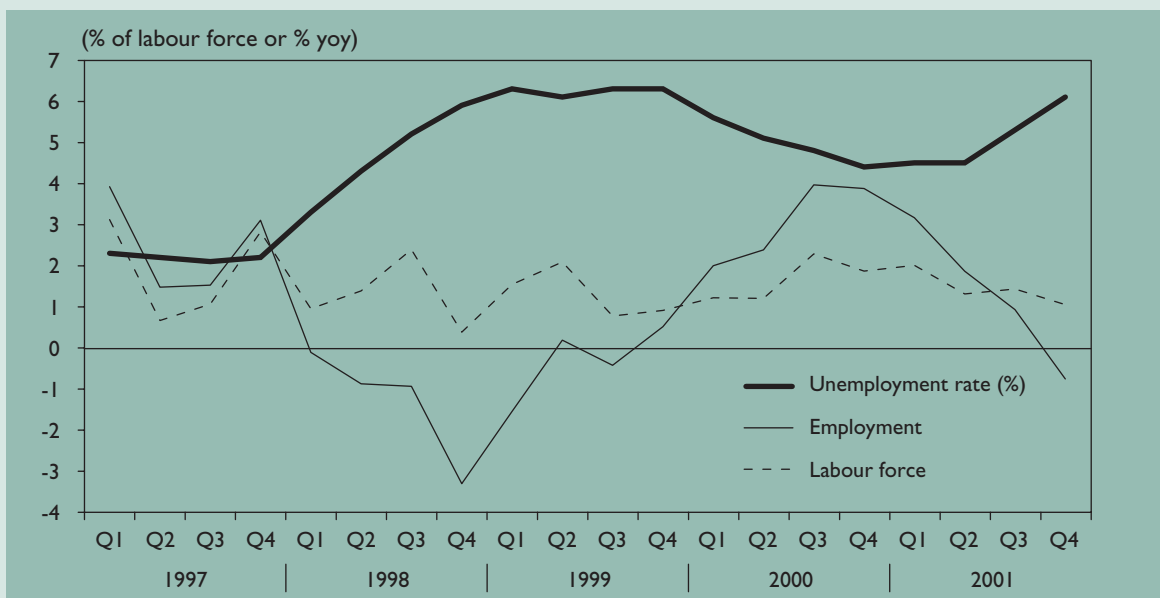
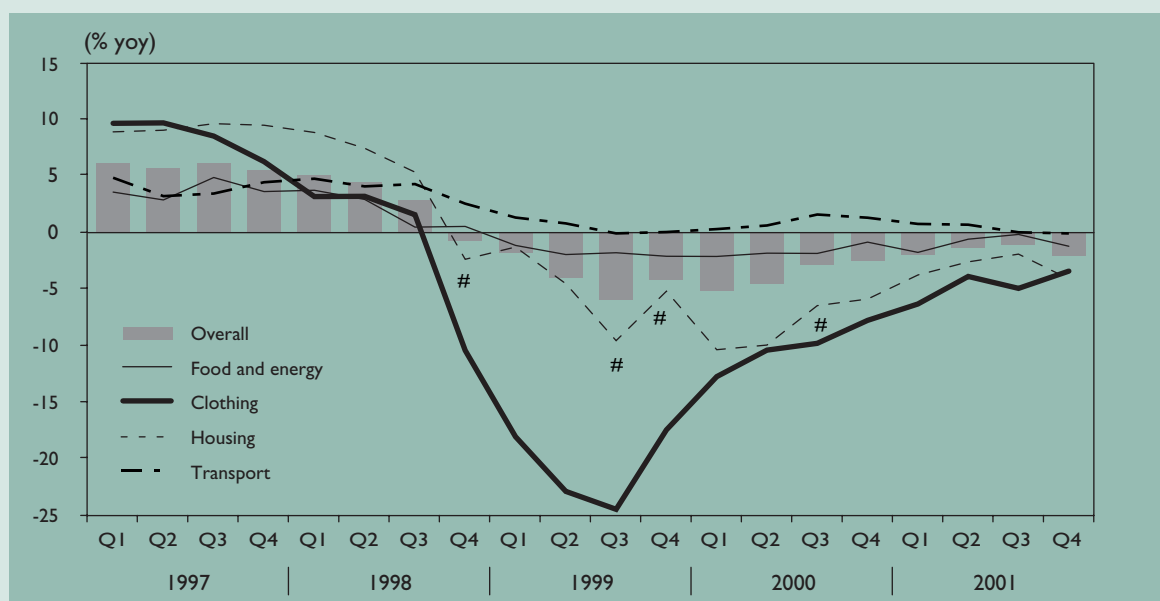


Chart 2
Unemployment Rate



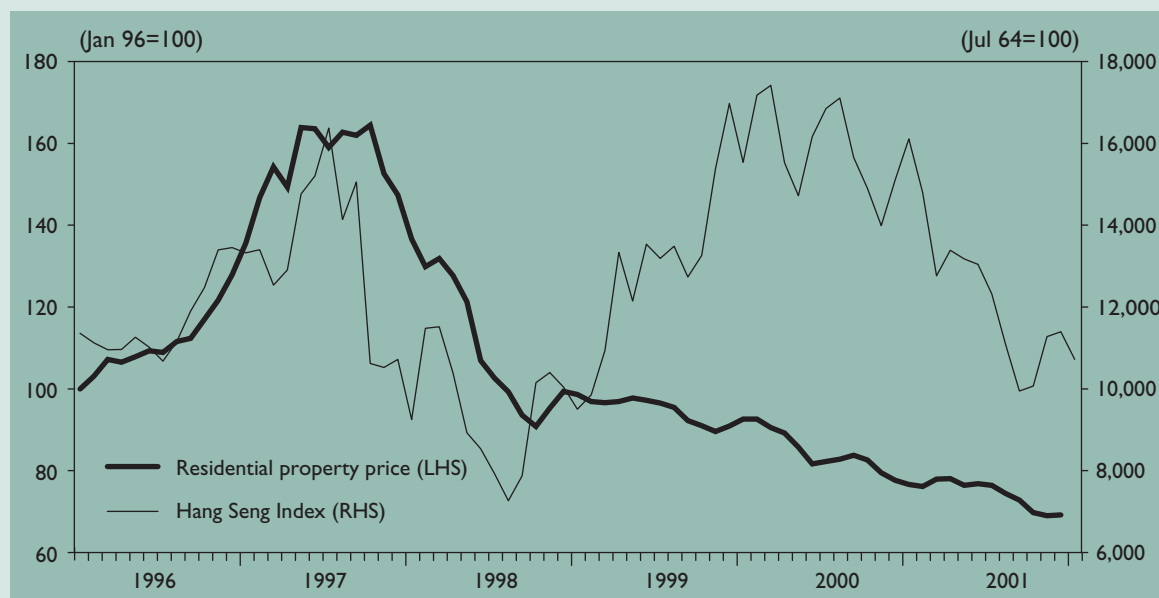
Note: Year-on-year % changes of employment and labour force prior to the second quarter of 1997 are under old definition.

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



Asset Markets

The stock markets recovered from the September low towards the end of 2001, but consolidated somewhat in the first two months of this year. The Hang Seng Index closed 2001 at 11,397, representing a loss of 25% from a year earlier but a gain of 28% from the low recorded in September. However, the index fell below 11,000 by mid-February, in line with developments in global stock markets (Chart 4).

The property market has shown some signs of stabilising in recent months. Although still 10.9% lower than a year ago, residential property prices registered a modest rise in December from the previous month. The transaction volume increased markedly in January as heavier discounts on prices and more flexible financing arrangements stimulated sales in the primary market.

Short-term Outlook

The near term outlook crucially hinges on global economic developments. Economic activity

would start to recover should the world economy begin to improve later this year as generally expected by the market. Exports are expected to lead the recovery, while consumption and investment may remain subdued in the near term, as the rise in unemployment and an uncertain economic outlook weigh on consumer and business sentiment. Domestic demand should revive gradually, benefiting from increased export earnings and the lagged effects of low interest rates.

Prices are likely to adjust further downward, in part reflecting the lagged effects of declines in housing rentals in 2001, and weak import prices. Lifting of restrictions on some frozen food items imported from the Mainland in 2002 may also place some downward pressure on consumer prices. The labour market may remain weak in the near future, but should improve as the economy recovers and the government's job creation initiatives start to take effect. 🌸

- Prepared by the Research Department