

DOMESTIC AND EXTERNAL ENVIRONMENT

The global economy continues to improve, with signs of a recovery most visible in the US, followed by Europe and non-Japan Asia. Nevertheless, uncertainties remain as regards the durability and strength of the upturn. In Hong Kong, the growth outlook has improved in light of a more favourable external environment, although domestic consumption in the near term is likely to be restrained by the rising unemployment rate.

External Environment

The global economy has improved significantly in recent months, though the pace of recovery differs across regions. In the US, real GDP grew at an unexpectedly strong pace of 5.8% (annualised) in the first quarter mainly due to stock building and government spending. Nevertheless, the recent economic statistics provide mixed signals about the momentum of growth. While industrial production rose 0.4% month on month in April, the March figure was revised down significantly. This has raised concerns as to whether the recent acceleration in manufacturing was as strong as earlier expected. Meanwhile, factory orders recorded only modest month-on-month gains in March, with orders on capital goods falling considerably excluding defense and aircraft. On the consumption front, growth of retail sales rebounded to 1.2% in April from 0.1% in the previous month. However, with the still adverse labour market conditions, the durability of the expansion remains a concern. There were also signs that the current account imbalance began to worsen again in the first quarter, further increasing the economy's vulnerability to a reversal of foreign capital inflows.

With increased external demand, growth prospects in the euro zone have improved. The European Commission forecast a resumption of growth in the first quarter of this year, following a slight drop in GDP in the previous quarter. Nevertheless, the outlook in Germany has been dampened by recent economic releases. In particular, wholesale sales fell by 7.2% year on year in March, while industrial production declined by 3.8%. In the UK, although GDP growth slowed to

1% year on year in the first quarter, recent indicators of the manufacturing and service sectors suggest that economic performance is likely to improve in the rest of the year. Meanwhile, the Japanese economy appears set for bottoming this year on the back of a rebound in exports. However, domestic demand will probably remain weak due to sustained increases in corporate bankruptcies and unemployment, and deflationary pressure is likely to persist.

In the emerging markets, the Argentine economy contracted by over 10% year on year in the fourth quarter of 2001. The economic and financial turmoil continued in the first months of 2002. In particular, failure of the attempts to prevent outflow of capital led to a week-long closure of banks and foreign exchange trading in late April. The new president's plan for economic reforms has hinged on obtaining support from the IMF, which has so far withheld new loans and called for further budgetary consolidation and restructuring.

In non-Japan Asia, there are increasing signs that a solid recovery is underway across the region, as stronger US demand has helped increase exports. In particular, the economies with large technology sectors, including Korea, Singapore, Taiwan and Malaysia, benefited from the resurgence in high-tech demand. China continued its strong economic performance, with GDP growing by 7.6% year on year in the first quarter. Growth in industrial production accelerated in April, and recent statistics suggest a strong increase in foreign direct investment in the first four months of the year.

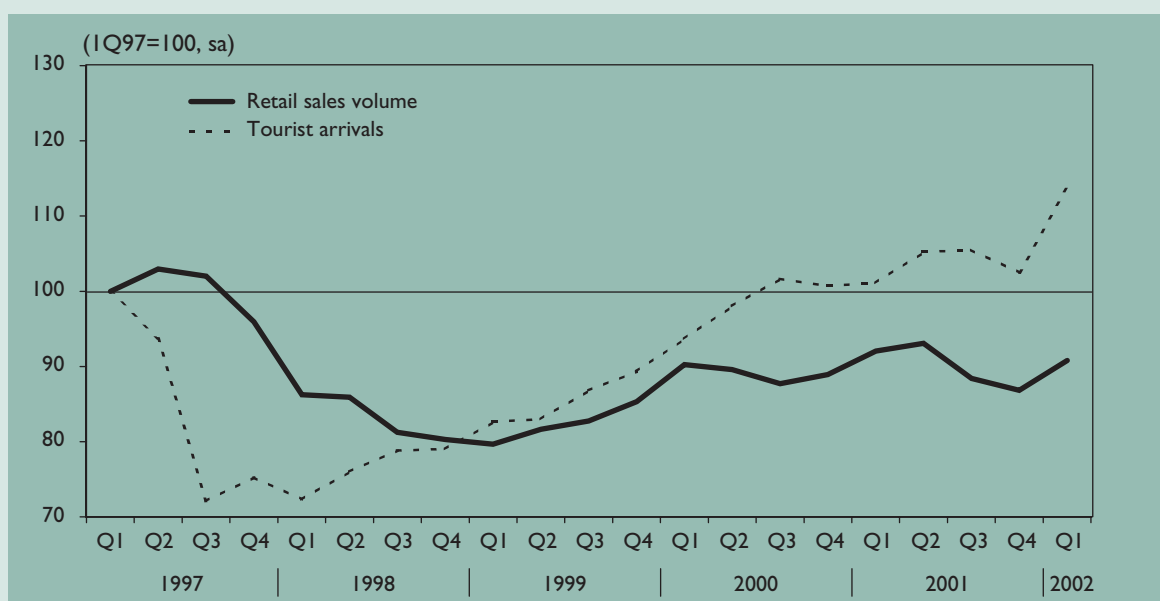
Global monetary conditions have been generally stable in recent months. Central banks in Canada, Korea, New Zealand and Australia raised their policy rates by 25 basis points between late March and early May due to increasing inflation concerns. In the US, the Federal Reserve kept interest rates unchanged at its 7 May FOMC meeting, and market expectations suggest that the Federal Reserve is unlikely to raise interest rates before the third quarter. The latest reading on US productivity growth indicates that there is yet to be any material wage inflation pressure. With lingering deflationary concerns and the banking sector's fragility, the Japanese government introduced an anti-deflation package in late February, which included a call for the Bank of Japan to provide ample liquidity should financial institutions encounter problems. As for Europe, the inflation rate in the euro zone has remained stubbornly above 2%, the upper limit of the European Central Bank's definition of price stability, prompting market expectations that the bank may raise rates during the third quarter. The Bank of England kept its repo target rate unchanged at 4.0% at its 9 May MPC meeting.

On the financial market front, major stock markets turned bearish in April as investors became less optimistic about the global economic and corporate earnings prospects. In particular, the S&P500 index fell by over 6% in April, but recovered part of the loss by mid-May, while indices of the key European markets demonstrated a similar pattern. However, Japan's TOPIX index was largely directionless and hovered around the 1,080 level during the same period. In the currency market, the US dollar weakened markedly against the euro and Japanese yen. The USD/JPY exchange rate fell to 128 in late April, down from 133 when the month started, while the USD/EUR rate rose to above 0.90 from 0.88. Against the weakened US dollar, the six floating Asian currencies, including the Indonesian Rupiah, Thai Baht, Singaporean Dollar, Korean Won, New Taiwan dollar and Philippine Peso, have gained an average of 3.4% in the first four months of this year.

Domestic Activity

Economic activity in Hong Kong has picked up somewhat, along with the gradual revival in the global economy. The latest statistics on retail sales

Chart I
Retail Sales and Tourist Arrivals



suggest that consumption demand might have increased moderately in the first quarter. On a seasonally adjusted quarter-on-quarter basis, the volume of retail sales rose notably by 4.6%, compared with drops of 5.1% and 1.8% in the third and fourth quarter of 2001 respectively (Chart 1). The rise was in part attributable to an increase in inbound tourists, particularly a year-on-year upsurge of 40% in visitors from the Mainland in the first three months, following the abolition in January of the quota system for Mainland visitors.

However, fixed-capital investment remained sluggish. The scale-back of the Public Housing Program continued to offset the sustained work on some civil engineering projects. Private spending on machinery and equipment might have declined substantially, as suggested by a year-on-year drop of about 28% in the value of retained imports of capital goods.

External Trade

External trade improved markedly in the first quarter of 2002. On a seasonally-adjusted quarter-on-quarter basis, the value of merchandise re-

exports grew by 6.9%, having contracted by 7.1% in the fourth quarter of 2001 (Chart 2). Domestic exports continued to decline, but the value of orders-on-hand recorded a modest increase, reversing the declining trend of the preceding three quarters. Having consolidated moderately in the last quarter of 2001, exports of services are estimated to have increased, along with the rise in inbound tourists and trade-related activities.

Labour Market and Inflation

Labour market conditions remained weak, reflecting continued corporate restructuring and downsizing. The seasonally-adjusted unemployment rate reached a record high of 7.1% in the three months to April, while nominal payroll per person engaged dropped by 0.5% in the last quarter of 2001 (Chart 3).

Price deflation persisted, with the Composite Consumer Price Index (CCPI) in April falling by 3.1% year-on-year, compared with a decline of 2.6% in the first quarter (Chart 4). The price declines so far this year reflected a combination of factors including weak cyclical conditions, declines in import

Chart 2
External Trade

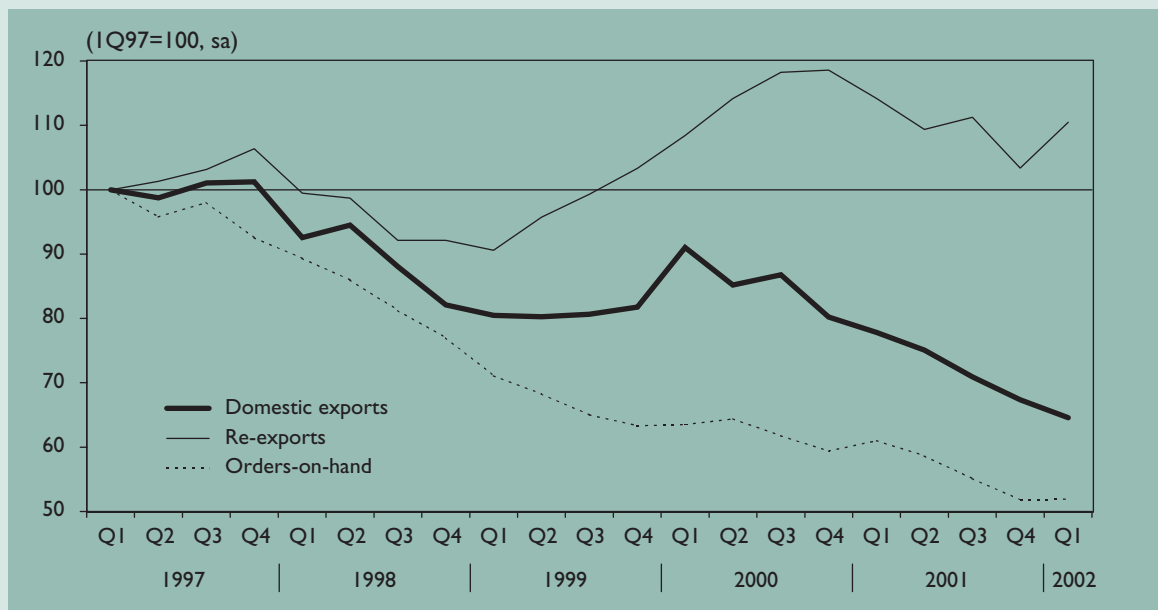


Chart 3
Labour Market

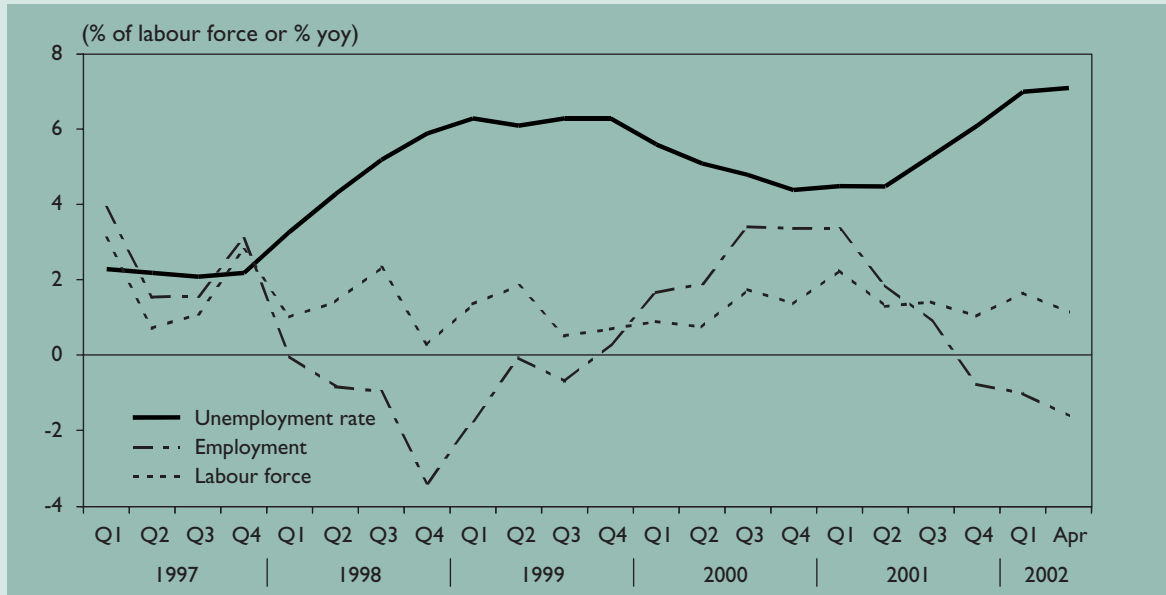
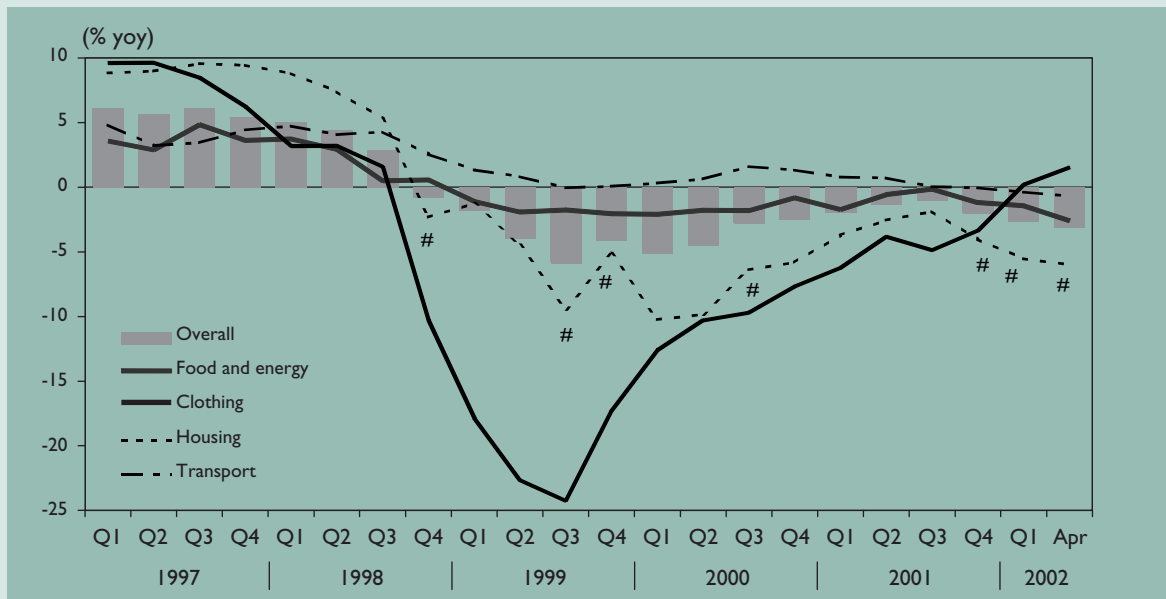


Chart 4
Consumer Prices



Affected by the Government relief measures.

prices, and special measures of rates concessions, waiver of water and sewage charges and the rebate of electricity charges. Of the major components, prices of consumer durables recorded the largest decline.

Asset Markets

Equity prices in Hong Kong recovered along with the regional stock markets. The Hang Seng Index rose by about 10% during early April and mid-May to the 12,000 level, while daily turnover nearly doubled over the period. The residential property market was generally weak, with prices staying on a downward trend. Having dropped for two consecutive months, the transaction volume increased in April, in part bolstered by more attractive purchase terms and more flexible financing arrangements in the primary market.

Money Supply and Domestic Credit

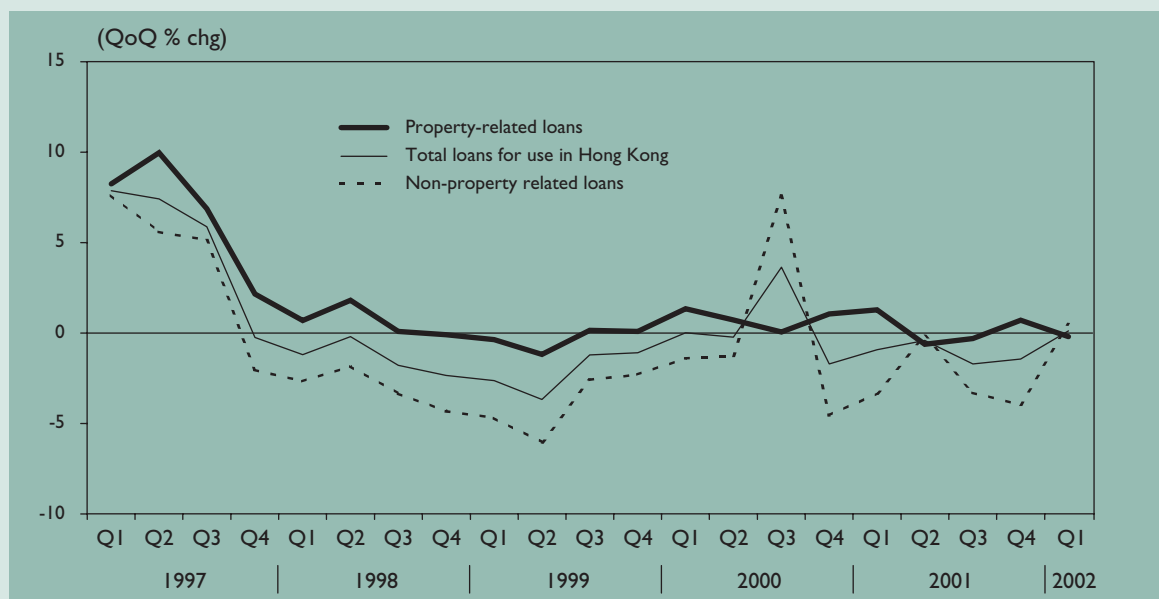
Growth of narrow money diverged further from that of broad money in the first quarter.

Compared with a year ago, HK\$MI rose by nearly 14% (seasonally adjusted), significantly outpacing growth of the value of retail sales. This in part reflected low opportunity cost of holding money as a result of interest rate reductions and increased cash demand associated with a rise in in-bound tourists and cross-boundary spending by Hong Kong residents (see detailed analysis in Box A). In contrast, broad money (HK\$M3) contracted modestly, and was only marginally higher (0.2%) than a year ago. Nevertheless, the changes in broad money were generally in line with the weak economic conditions.

Foreign currency deposits continued to shrink, largely attributable to a decline in non-US dollar deposits. The latter was mainly due to a reduction in connected deposits with Japanese banks, associated in part with the merger of some banks and maturing of some of these placements.¹

Loans for use in Hong Kong reversed to a small quarter-on-quarter rise, following declines in the previous quarters (Chart 5). The increase


Chart 5
Loans for Use in Hong Kong



¹ Connected deposits refer to placements from a connected company within the same bank group.

largely reflected a rise in lending to some non-property-related sectors, while loans for the property sector remained subdued.² Compared with a year ago, domestic loans fell by 3.4% in March 2002.

Short-term Outlook

The growth outlook for 2002 has improved due to a more favourable external environment, but considerable uncertainties remain. In particular, possible increases in US interest rates would exert an upward pressure on local interest rates. On the other hand, the Hong Kong economy should benefit from a turnaround of the global economy and the recent depreciation of the US dollar.³ While exports have already shown signs of recovery, domestic demand is expected to revive more gradually given the high rate of unemployment and weak consumer and business sentiment. Prices may adjust further downwards, and the labour market condition would remain weak in the near term. However, the situation should improve as the economy recovers and the Government's job creation initiatives start to take effect. 

- Prepared by the Research Department

2 Including loans for trade financing.

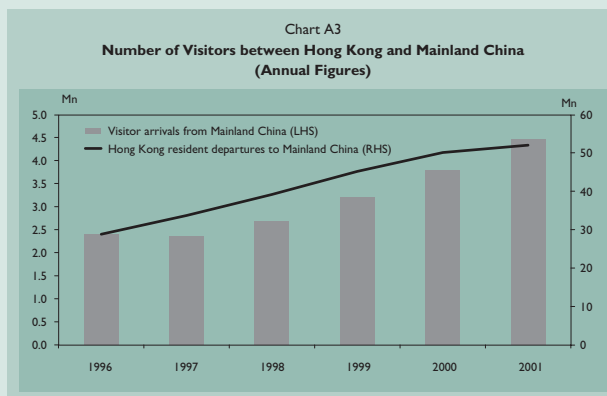
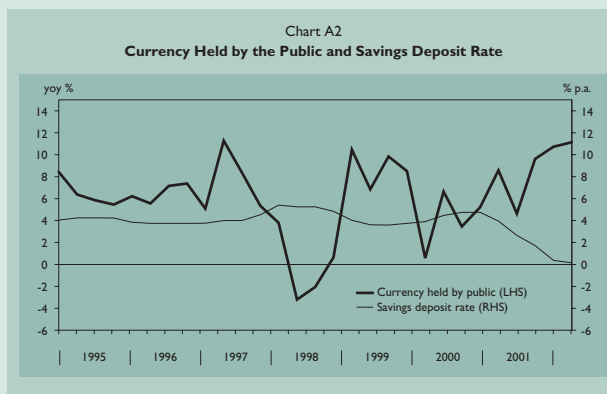
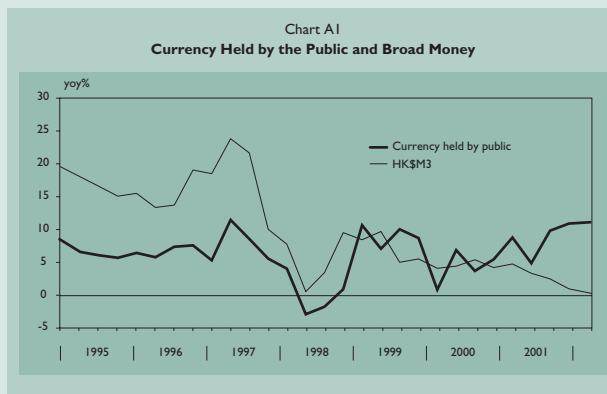
3 The consensus forecast and IMF projection of US growth for 2002 have been revised significantly upwards recently. Increases - if any - in US interest rates are most likely to be associated with a strong rebound of the economy.

Box A An Analysis of Demand for Cash

The public's cash holdings (seasonally adjusted) increased steadily from early 2000, recording a double-digit rise of around 11% in March 2002 from a year ago, while broad money (HK\$M3) moderated notably (Chart A1). The significant rise in cash holdings was somewhat puzzling, in view of the recent economic downturn and increasing use of non-cash payment means, including credit cards and electronic payment system such as Octopus cards.¹ The preliminary analysis discussed below suggests that a combination of factors may have contributed to the marked rise in currency held by the public.

First, alongside the reduction in interest rate, the opportunity cost of holding cash has declined sharply. Savings deposit rate, for example, fell from 4.8 % at end-2000 to around 0.2% at end-March 2002 (Chart A2).

Secondly, an increase in in-bound tourists from the Mainland has probably raised demand for cash, the main means of payments for these visitors (Chart A3). Tourist receipts from Mainland visitors registered strong increases in the past two years, by around 25% in 2001 in particular.



¹ Octopus cards were introduced in Hong Kong in 1997.

Box A (cont'd)
An Analysis of Demand for Cash

Thirdly, a steady rise in Hong Kong people's cross-boundary spending may have also led to an increase in cash holdings, to the extent that a significant portion of expenses by these visitors in the Mainland continues to be made in Hong Kong dollars.²

Regression analysis was conducted to quantify the relationship between currency held by the public and the possible explanatory variables. An error correction model approach (ECM) was employed to specify the currency demand function. First, a long run demand for currency was modelled as a function of price, real retail sales, an opportunity cost variable (savings deposit rate), and a trend variable. The latter was intended to capture possible structural factors that lead to an upward trend in the

demand for Hong Kong dollar cash. In the earlier years, a significant amount of Hong Kong dollar cash was reportedly circulated in the Mainland because of high inflation and concern of a devaluation of the RMB. In more recent years, the increasing flows of people across the boundary would lead to higher demand for Hong Kong dollars, as noted above.³

All data except the savings deposit rate and the time trend were in logarithm, and were de-seasonalised. Quarterly data, which span from 1991:4 to 2002:1, were used in the estimation. Augmented Dickey-Fuller unit root and co-integration tests suggest that variables are integrated of order one (I(1)), but are co-integrated with a stationary linear relationship. The estimated equation is as follows.

(1) Long-run relationship

$$c_t = 6.387 + 0.563p_t + 0.363s_t - 2.127i_t + 0.014T_t$$

(17.7)** (6.0)** (4.6)** (-3.9)** (15.3)**

Adjusted R² = 0.98 ADF = -4.1**

DW = 1.09

** denotes significance at the 1% level. Numbers in parentheses are t-ratios.

where

c_t = Currency held by the public;
 p_t = composite consumer price index;
 s_t = retail sales in volume terms;
 i_t = savings deposit rate; and
 T_t = time trend.

2 According to estimates from the Census and Statistics Department, Hong Kong residents' expenditure incurred during personal travels (excluding business travels) in the Mainland rose steadily from mid-1990s to around HK\$29 billion in 2000 before moderating slightly to HK\$27.6 billion in 2001. The amount accounted for around 33% of the total Hong Kong residents' expenditure abroad.

3 It was estimated that the amount of Hong Kong dollar circulating in the Guangdong and Macau region was around 11% of the total amount issued in Hong Kong. (For details, see "Currency Substitution between Hong Kong Dollar and Renminbi in South China", Hong Kong Institute for Monetary Research Working Paper No. 2/2001, Kenneth S. Chan, March 2001.)

Box A (cont'd)
An Analysis of Demand for Cash

All variables are of correct signs and statistically significant. In particular, the results confirm a significant negative effect of interest rate on the demand for cash. Taking the estimates literally, a decline of one percentage point in the savings deposit rate would raise cash holdings by around 2%. The time trend variables is also highly significant.

The short-run demand function was estimated by including tourist arrivals from the Mainland and Hong Kong residents' departure for the Mainland in the error-correction model. Following a general-to-specific approach, the following is obtained. Diagnostic tests do not find evidence of serial correlation in the residuals.

(2) *Short-run relationship*

$$\Delta c_t = 0.016 + 0.265\Delta s_t + 0.125\Delta \text{visit}_t - 0.480u_{t-1}$$

(3.6)** (2.3)* (2.4)* (-3.3)**

Adjusted R² = 0.36

DW = 2.29

** and * denote significance at the 1% and 5% levels. Numbers in parentheses are t-ratios.

where

Visit_t = Number of tourist arrivals from the Mainland (in logarithm);

Δ is the first difference operator; and

u_{t-1} the error correction term.

The results indicate a positive relationship between growth in tourist arrivals from the Mainland and that in the demand for cash.