DOMESTIC AND EXTERNAL ENVIRONMENT

The global economic recovery is clouded by a significant deceleration in growth in the US and increased volatility in the financial markets. The weak economic performance in Europe and financial market jitters in Latin America added further uncertainty to the growth outlook. In Hong Kong, exports of goods and services increased strongly in the first half of this year, benefiting from accelerated growth in China's external trade. However, domestic demand remained weak, depressed in particular by the rising unemployment rate and weak asset prices.

External Environment

In the US, real GDP growth fell to an annualised rate of 1.1% in the second quarter, from the downward-revised rate of 5% in the first, largely attributable to moderation in growth of private consumption and investment. Although industrial production continued to increase moderately in the second quarter, the ISM index revealed a contraction in the manufacturing sector in July. The deceleration in production may put further pressure on the sluggish labour market. Despite a drop in the number of initial jobless claims in June, the unemployment rate remained high at 5.9%. The weak labour market and volatile equity markets may continue to weigh on consumer sentiment and spending.

The euro zone economies showed some signs of improvement, but the pace of growth was moderate. Real GDP grew by 0.3% in the first quarter, compared with a decline in the last quarter of 2001. The turnaround was mainly driven by exports, while most components of domestic demand contracted. Meanwhile, the unemployment rate remained high at 8.4% in June. Given muted consumer spending, growth in the headline CPI stayed below 2%, the upper limit of the European Central Bank's definition of price stability. Within the euro area, activity in Germany remained subdued, with factory orders dropping significantly in June. In contrast, the UK economy grew strongly by 0.9% in the second quarter, up from a 0.1% increase in the first. While industrial production and retail sales recorded declines in June, the Jubilee holiday and World Cup complicate interpretation of the data. In Japan, economic activity picked up steadily, with industrial production increasing by 3.7% in the second quarter and machine orders rising by 2.9% month-on-month in June. Various sentiment indicators also pointed to improvement in consumer and business confidence. However, the recent appreciation of the yen could dampen export performance.

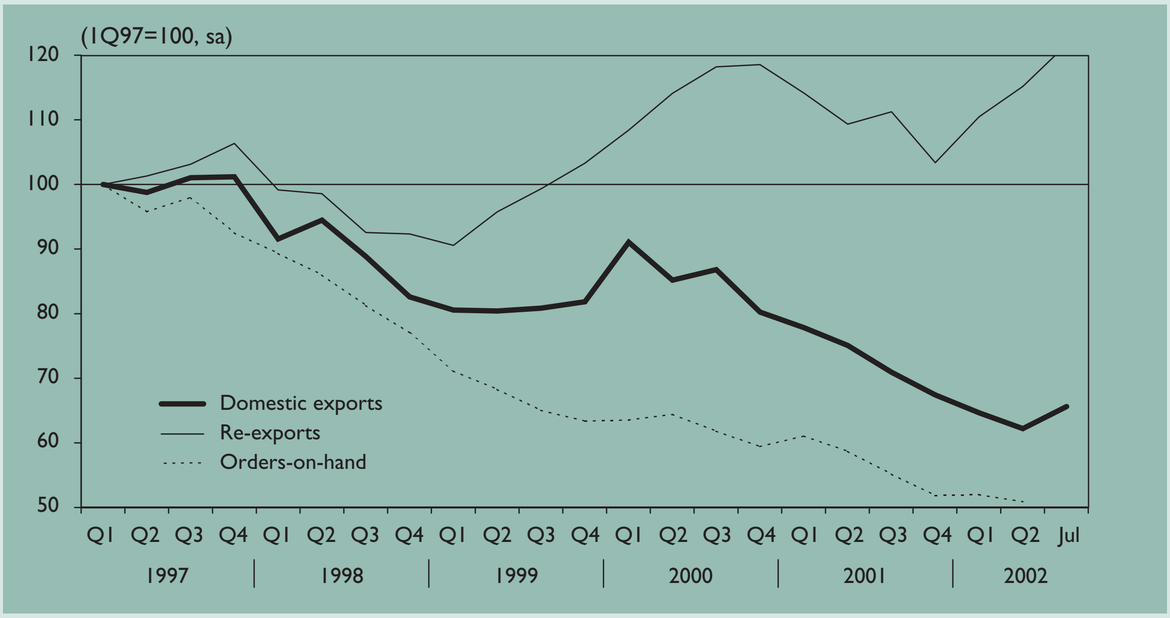
In Latin America, the economic situation in Argentina remained difficult. Real GDP contracted by 16% in the first quarter, after shrinking by 11% in the previous quarter. With industrial production dropping significantly in June and the unemployment rate staying high at 23%, the inflation rate (month-on-month) moderated to 3.6% in June. Meanwhile, the IMF agreed to extend by a year the repayment of a loan of about US$1 billion. Also, a panel of independent advisors designated by the IMF has completed a review of the monetary framework of Argentina. They suggested a number of ways to rectify the fragile financial system, including setting a credible monetary anchor and releasing frozen bank deposits. Separately, the economic situation in Brazil deteriorated, in part reflecting the heightened political uncertainty. The Real depreciated to an all-time-low of 3.46 against the US dollar in July, and the yield spread of Brady bonds over US Treasuries widened significantly.

In non-Japan Asia, there were increasing signs that a recovery was under way. Year-on-year real GDP growth accelerated to 3.5% in Indonesia, and about 4% in Malaysia, Singapore and Taiwan respectively in the second quarter. The improvement reflected continued increases in exports as well as stronger domestic demand. In particular, those economies with strengths in high-tech products — such as Korea and Taiwan — gained from the export-led recovery. However, the moderation of growth in the global demand for semi-conductor products and the recent weakening of the US dollar may undermine the growth prospects in the region.

Interest rates in the major industrial countries were generally stable. The Federal Reserve kept the Fed funds target rate unchanged at 1.75% at its FOMC meeting on 13 August. Nevertheless, it changed the policy bias from neutral to easing in view of signs of a softening in aggregate demand. Fed funds futures prices in July indicated market expectations of a modest rate cut towards the end of this year. Meanwhile, the European Central Bank and Bank of England maintained their target interest rates steady at 4.25% and 4% respectively, given stable consumer prices. However, other central banks started raising policy rates in the face of rising inflation. In particular, the Bank of Canada raised its overnight rate target from 2.5% to 2.75% in July, and the Reserve Bank of Australia tightened its cash rate target from 4.5% to 4.75% in June.

Financial markets experienced increased volatility, reflecting investors' concerns on the sustainability of growth and corporate governance problems in the US. The major stock market indices recorded significant declines in July before making a moderate recovery in August. In particular, the S&P500 index lost 8% in July after touching a 5-year low of 798 on the 23rd. While similar trading patterns were witnessed in Europe, markets in Asia declined less significantly, with most indices losing 2% to 6% during the month. In the currency market, the US dollar weakened considerably against the euro and the yen in July, before stabilising in August. Most other Asian currencies also recorded gains against the US dollar, but the Philippine peso weakened significantly on concerns about the increased budget deficit and the government's debt problem.

Chart 1
External Trade



Domestic Activity

Economic activity in Hong Kong remained generally weak in the second quarter. However, exports of goods and services continued to grow strongly following the turnaround in the first quarter, supported by the accelerated growth in China's external trade.

Domestic demand was weak, as the unemployment rate rose to a historically high level and asset prices continued to be depressed. The latest statistics on retail sales suggest that private consumption might have declined in the second quarter. Specifically, the volume of retail sales fell by 2.4% on a quarter-on-quarter basis (seasonally adjusted), compared with a 4.6% increase in the first quarter. Fixed-capital investment remained sluggish. The value of retained imports of capital goods declined by double-digit year-on-year rates in the recent months, suggesting weak spending on machinery, equipment and software. Nevertheless, property-related investment may increase from the low level recorded last year, in part due to intensification in the construction of the Disneyland Theme Park and the Science Park.

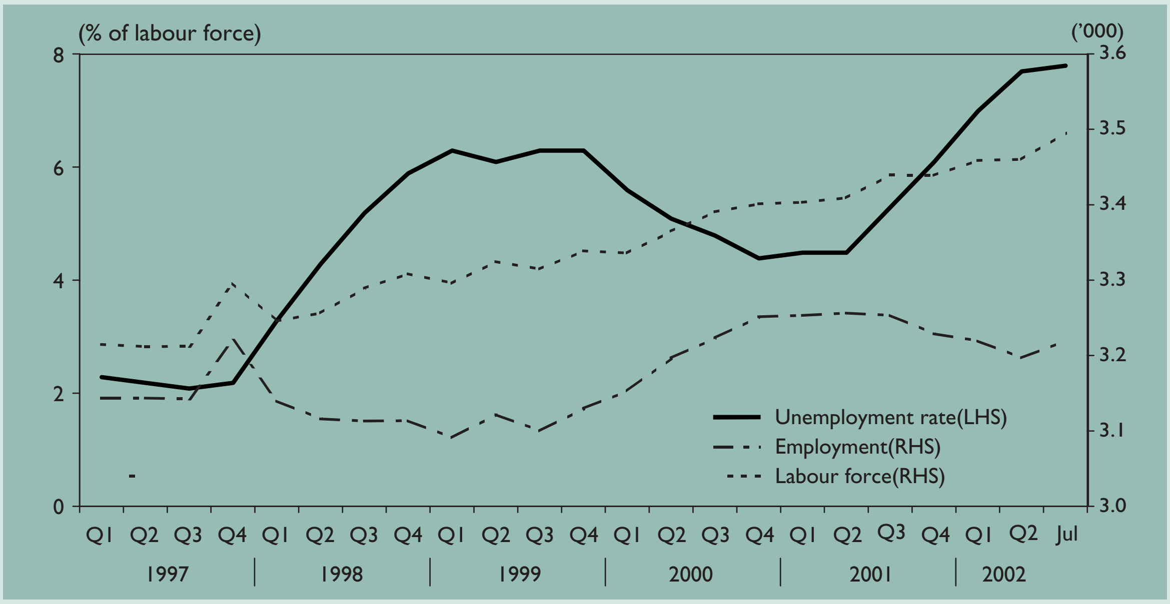
External Trade

Exports continued to grow strongly. Having increased by 4.3% in the second quarter (seasonally-adjusted, quarter-on-quarter), the value of merchandise re-exports expanded further by 5.6% in July over the average level in the second quarter (Chart 1). Domestic exports also showed signs of bottoming out. In addition, the value of orders-on-hand appears to have stabilised, suggesting an improved outlook in the period ahead. Exports of services continued to improve, supported by a rise in inbound tourism and trade-related activities.

Labour Market and Inflation

Labour market conditions remained weak, with the seasonally-adjusted unemployment rate reaching a record high of 7.8% in the three months to July (Chart 2). Although total employment reverted to a slight increase from declines in the previous quarters, the rise was outpaced by that of labour force. Across the major sectors, the manufacturing and construction sectors recorded the largest increases in unemployment during the

Chart 2
Labour Market



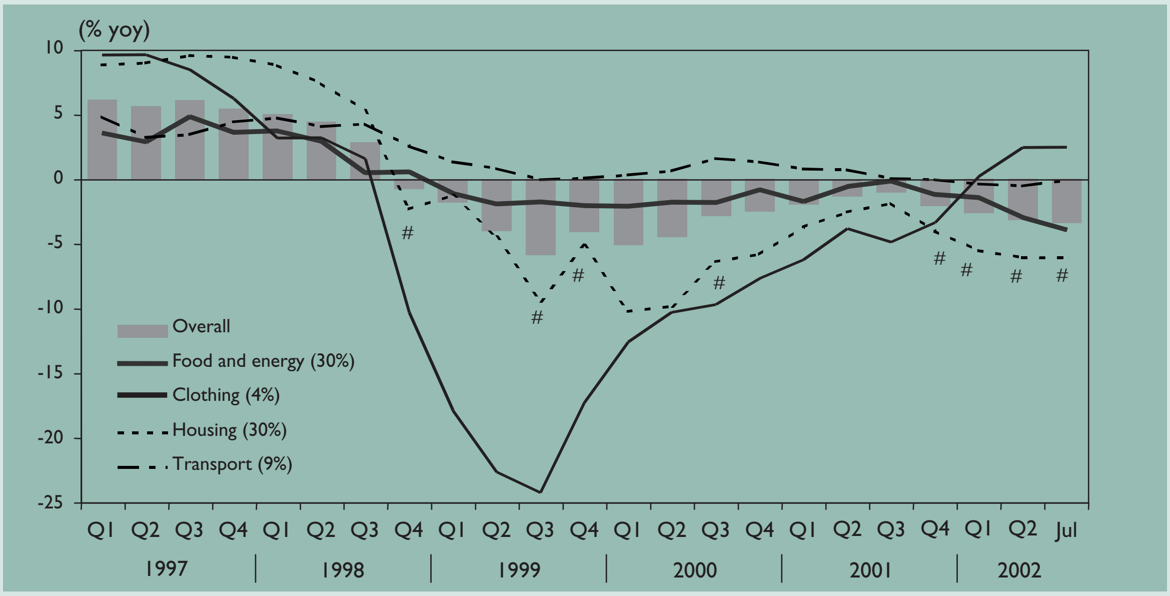
second quarter. Nominal payroll per person engaged, having dropped by 0.6% in the fourth quarter of 2001, fell further by 0.1% in the first quarter of 2002.

Price deflation persisted, with the Composite Consumer Price Index (CCPI) in July falling by 3.4% year-on-year, compared with a decline of 3.2% in the second quarter (Chart 3). The price declines in part reflected special relief measures including rates concessions, waiver of water and sewage charges, and the rebate of electricity charges. Adjusted for the special effects, the fall in the CCPI was 2.3% in July, compared with 2.0% in the second quarter.

Asset Markets

Equity prices in Hong Kong declined in the recent months, in line with developments in the US and European stock markets. Having tested a nine-month high of about 12,000 in mid-May, the Hang Seng Index recorded significant drops in June - July, before rebounding moderately in August. The residential property market was generally weak, with prices continuing to decline (Chart 4).

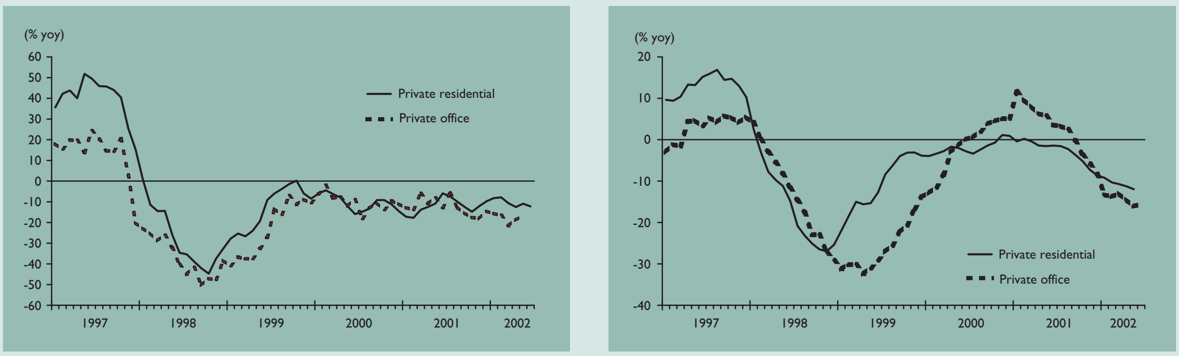
Chart 3
Inflation



Affected by the Government relief measures.

Chart 4
Property Market

(a) Price Indices **(b) Rental Indices**



Nevertheless, the transactions volume held up reasonably well, in part supported by the more attractive purchase terms and more flexible financing arrangements in the primary market. Residential and office rentals continued to decline in the second quarter.

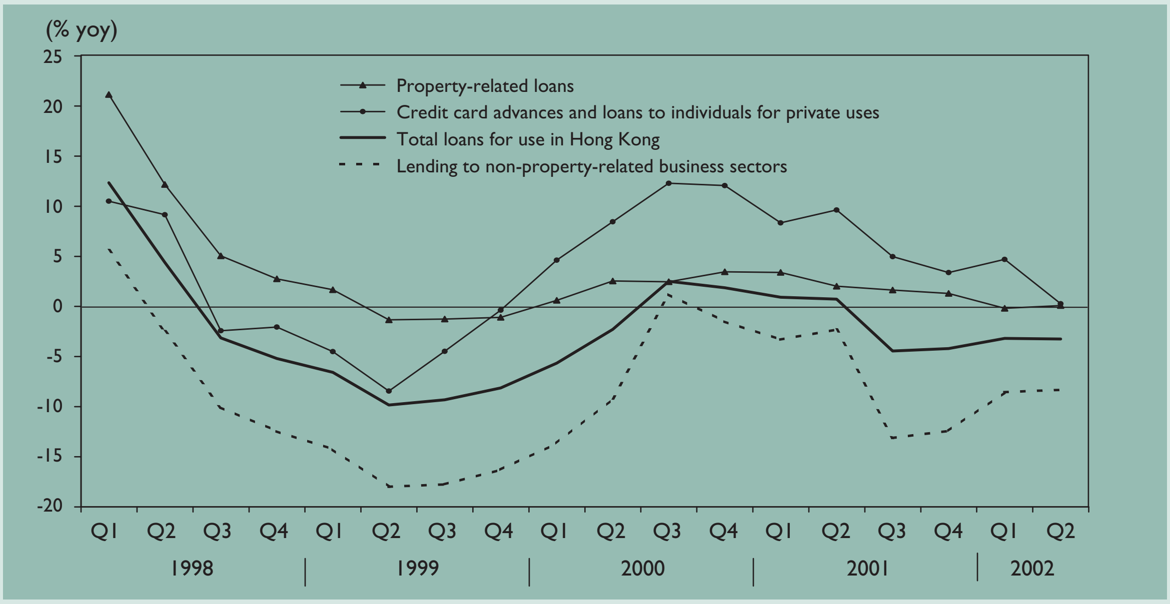
Money Supply and Domestic Credit

Growth of narrow money (Hong Kong dollar M1) continued to pick up in the second quarter, diverging further from that of broad money (Hong Kong dollar M3). Compared with a year ago, Hong Kong dollar M1 increased by nearly 16% in June, while Hong Kong dollar M3 rose by only 1%. The former reflected a low opportunity cost of holding narrow money and increased cash demand associated with rising inbound tourists from the Mainland. The behaviour of broad money was more a reflection of the generally weak economic conditions, as well as relatively low return against yields on alternative financial assets, in particular debt securities.

Foreign currency deposits recorded a quarter-on-quarter rise in the second quarter, following a decline in the first. The rise was attributable to increases in both US dollar and other foreign currency deposits. The latter was in part due to the valuation effect arising from the depreciation of the US dollar.

Domestic credit remained sluggish in the second quarter, reflecting the weak economic activity (Chart 5). Specifically, loans for use in Hong Kong declined by 3.5% in the twelve months to June, attributable largely to a notable drop in lending to non-property-related business sectors as well as a moderation in growth of credit card advances. The latter in part reflected a tightening of credit card lending by some banks, alongside an increase in credit card charge-offs.

Chart 5
Loans for Use in Hong Kong



Note: Property-related loans include loans for building, construction, property development and investment, and residential mortgage loans. Lending to non-property-related business sectors are defined as loans for use in Hong Kong other than property-related loans, lending to individuals for private purposes and credit card advances.

Short-term Outlook

Looking ahead, exports are expected to benefit from the weakening of the US dollar and the strong export performance in the Mainland, while the contraction in domestic demand should moderate when the improvement in the external sector filters through. Nevertheless, the short-term outlook remains subject to considerable uncertainties, relating mainly to the volatility in global financial markets and the moderation of growth in the US. Domestically, concerns over unemployment and future income growth may continue to dampen consumer sentiment. The unemployment rate is likely to stay high, and deflationary pressures to persist in the near term. Although the recent weakening of the US dollar against other major currencies might exert an upward pressure on Hong Kong's import prices, the extent of pass-through to consumer prices is likely to be restrained by the weak domestic demand.