DOMESTIC AND EXTERNAL ENVIRONMENT

The global economic recovery showed signs of moderation in the third quarter, with decelerating production growth and weakening economic sentiment in major economies. In Hong Kong, signs of economic recovery emerged. Growth in external trade and inbound tourism accelerated, benefiting from the strong economic performance in the Mainland and a weaker US dollar. On the domestic front, the unemployment rate eased for the third consecutive month, while private investment improved.

External Environment

In the US, advance estimates showed that real GDP growth accelerated to an annualised rate of 3.1% in the third quarter from 1.3% in the second. In particular, the low interest rate environment had supported household consumption and capital spending. Nevertheless, economic growth appears to have moderated recently. Industrial production contracted for the third consecutive month in October, while the ISM manufacturing index remained below the neutrality benchmark of 50. On the consumption side, after expanding at an average monthly rate of 1.0% in the preceding three months, retail sales dropped 1.3% in September and were unchanged in October. The volatility in equity prices and sluggish jobs growth continued to weigh on consumer sentiment and restrain spending. In particular, the consumer confidence indices compiled by the Conference Board and the University of Michigan both fell for the fifth consecutive month and reached new lows in October.

In the euro area, the pace of recovery remained slow in the second quarter, with real GDP growing at the same quarterly rate of 0.4% as in the first. As growth of external demand moderated, further signs of weakness emerged in the third quarter. The purchasing managers' manufacturing index fell below the benchmark level of 50 in September and October, albeit in part reflecting the temporary disruptions caused by the flooding in Europe. Germany remained a key drag on the region's recovery, as evidenced by the further declines in industrial production in September and the IFO business climate index in October. Meanwhile, helped by a buoyant property market and strong domestic demand, the UK economy remained robust, with real GDP growing 0.7% in the third quarter.

In Japan, GDP grew by 0.7% in the third quarter, as compared with an increase of 1.0% in the second. While household spending grew steadily, production growth decelerated along with declining exports. The Tankan large manufacturers index rose 4 points to -14 in the third quarter, as compared with a record 20-point increase in the previous quarter. Separately, a new banking reform plan was introduced by the newly appointed Financial Service Agency Minister, in an attempt to improve the banks' capital structure and accelerate the disposal of bad loans.

In the emerging market economies, Brazil's financial market conditions deteriorated in the run-up to October's presidential elections. In particular, Moody's downgraded Brazil's sovereign rating from B1 to B2 in August due to perceived uncertainty about the new government's commitment to reform. Nonetheless, market confidence appeared to improve after the newly elected president proposed financial reform plans and a surplus budget. The Brazilian real strengthened from an all-time low of 3.95 against the US dollar to 3.70 in mid-November, with the sovereign bond spread easing from over 2,000 basis points to around 1,800.

Despite the slowdown in growth in advanced economies, export growth in non-Japan Asia remained strong, with China, Malaysia, Korea, and Taiwan registering double-digit yearly rates of expansion in the third quarter. Industrial output growth in most Asian economies continued to pick up, though the pace of acceleration was not as strong as in the second quarter. Nonetheless, uncertainty about the global outlook continued to pose risks to the region going forward.

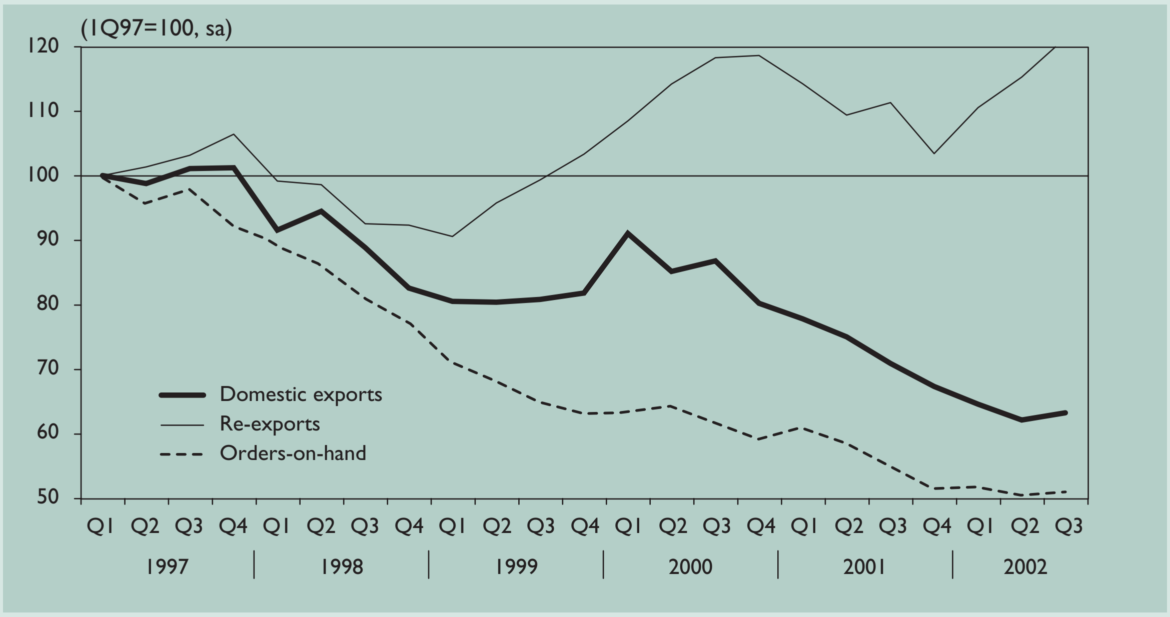
In view of heightened risks to growth, the Federal Reserve lowered the Fed funds target rate by 50 basis points to 1.25% at November's FOMC meeting. Accompanied by the move was a shift of its risk assessment from a bias towards weakness to a neutral stance. Meanwhile, monetary policies have been generally stable in other major economies. The European Central Bank kept its policy interest rate unchanged at 3.25% at its latest policy meeting. While market consensus pointed to expectations of monetary easing by the end of the year, the fact that inflation stayed above the 2% level in recent months may thwart such a policy move. In the UK, the Bank of England maintained its repo target rate at 4%.

Major equity markets in the US and Europe rebounded strongly in October following sharp declines in September, when market sentiment was undermined by disappointing corporate results. The S&P500 index rose from a 5-year low of 777 in early October to 920 in early November. Nevertheless, Japan's NIKKEI index has largely been on a downward trend in the second half of the year. Reflecting market concerns about the impact of the new banking reform plan, the index dropped to a 19-year low of 8,300 in mid-November, representing a drop of over 20% since July. In the currency market, the US dollar has displayed renewed weakness against the euro and the Japanese yen since mid-October. After staying around the 0.98 level for over two months, the Euro started to appreciate in mid-October and reached 1.01 against the US dollar in early November. Meanwhile, the Japanese yen strengthened to around 120 per US dollar. Similar patterns were also observed in other major floating Asian currencies.

Domestic Activity

There were signs of an increase in economic growth in the third quarter, underpinned by vibrant external trade. Growth of exports of goods and services accelerated due to a strong export performance in the Mainland and improved competitiveness brought about by a weaker US dollar.

Chart 1
External Trade



However, private consumption remained generally subdued. The volume of retail sales fell in the third quarter on a seasonally adjusted basis. This drop in retail sales, despite a significant increase in inbound tourists, suggests that local consumer demand remained sluggish. Despite weak household demand, the latest statistics on retained imports of consumer goods indicate strong growth in July-August, reflecting a building up of inventory. Private investment showed signs of improvement, with the volume of retained imports of raw materials and semi-manufactures increasing sharply in recent months on a year-on-year basis, although those of capital goods continued to decline.

External Trade

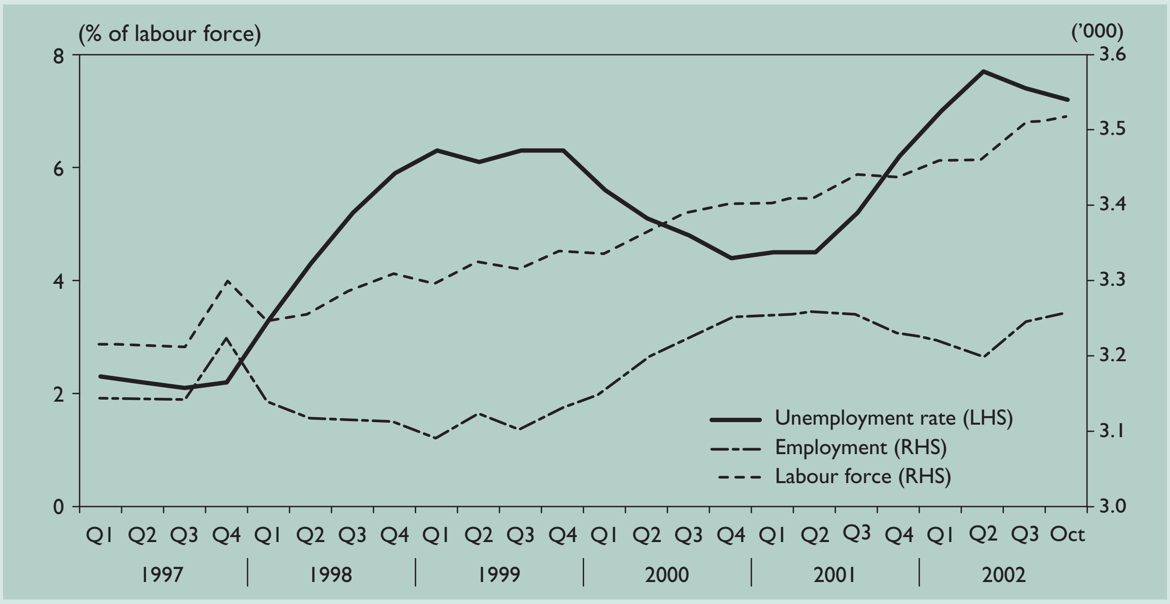
Export performance remained robust. On the seasonally adjusted basis, growth in the value of re-exports accelerated to 5.2% in the third quarter from 4.3% in the second (Chart 1). Domestic exports reverted to a quarterly increase of 1.8%, after declining for seven consecutive quarters. Among the major markets, exports to China and the rest of the region (except Japan) have grown at a double-digit year-on-year rate since June. Exports of services were buoyant, helped by a strong increase in inbound tourists and trade-related activities.

Labour Market and Inflation

Labour market conditions have improved somewhat in recent months. The seasonally adjusted unemployment rate recorded three consecutive declines to 7.2% in the three months ending October, from a peak of 7.8% in May-July (Chart 2). The decline was due to a continued increase in employment, which exceeded a rise in total labour force. Across the major sectors, the decoration and maintenance, wholesale/retail trades, and community, social and personal services sectors recorded the largest declines in unemployment. The latest statistics indicate that nominal payroll per person engaged decreased by 0.2% in the second quarter of 2002, the same pace of decline as in the first.

Price deflation eased slightly in October. On a seasonally adjusted month-on-month basis, the Composite Consumer Price Index (CCPI) rose marginally, after declining for six consecutive months. On a year-on-year comparison, the CCPI dropped by 3.6%, compared with a fall of 3.7% in September (Chart 3). While private housing rentals, prices of durable goods and transportation costs remained on a downtrend, prices of other consumer goods and food saw a moderate increase in October.

Chart 2
Labour Market

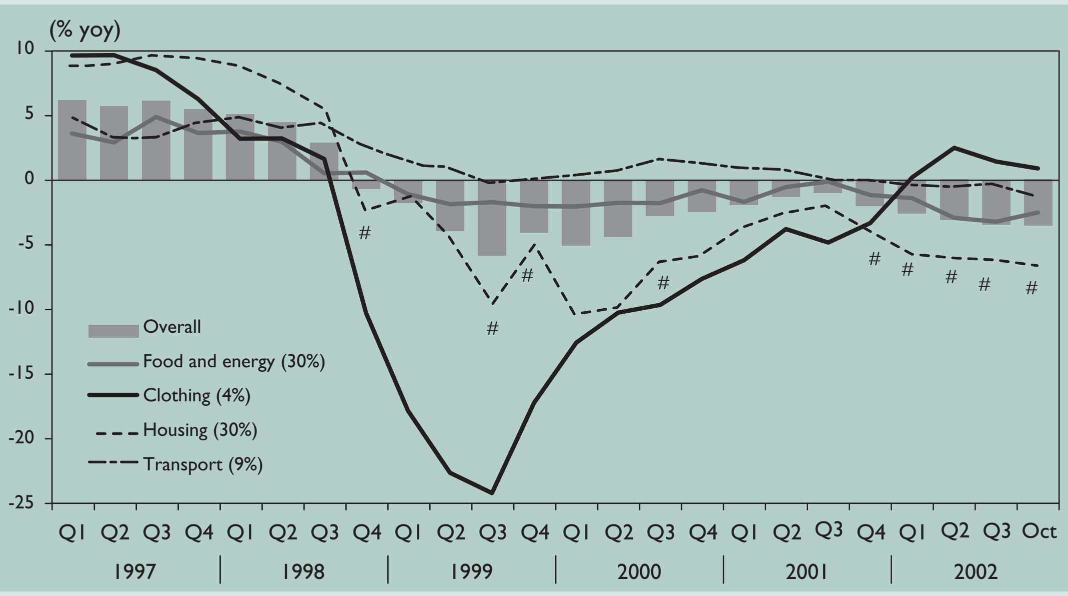


Asset Markets

Equity prices in Hong Kong rebounded after falling to a four-year low of below 9,000 in early October. Thereafter, the Hang Seng Index first traced the rises in the US and European stock markets in anticipation of the rate cut by the Federal Reserve, and then was supported by the improved market sentiment following the Government announcement of new housing policies. The index surged to near 10,000 in mid-November, and daily turnover increased.

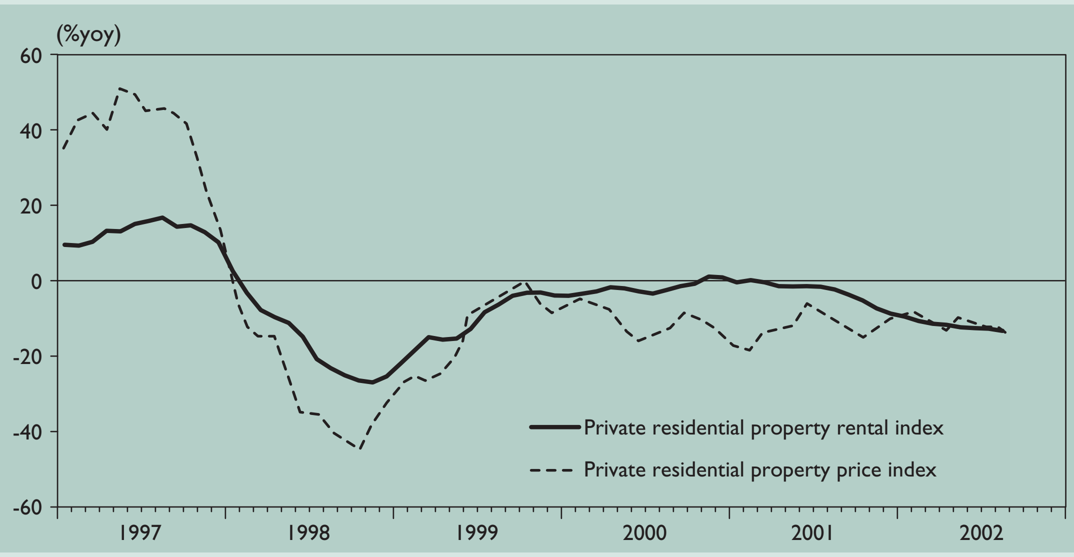
The residential property market was generally weak. Prices and rentals continued to decline, while the transaction volume dropped by 23% over the preceding quarter (Chart 4). In an effort to revive public confidence in the property market,

Chart 3
Inflation



 # Affected by the Government relief measures.

Chart 4
Property Market



the Government announced on 13 November a package of nine measures related mainly to land supply, the public housing programme and the mode of housing subsidies. The property market responded positively to the announcement, with signs of increased transactions. Nevertheless, it remains to be seen how durable and strong the effects are.

Money Supply and Domestic Credit

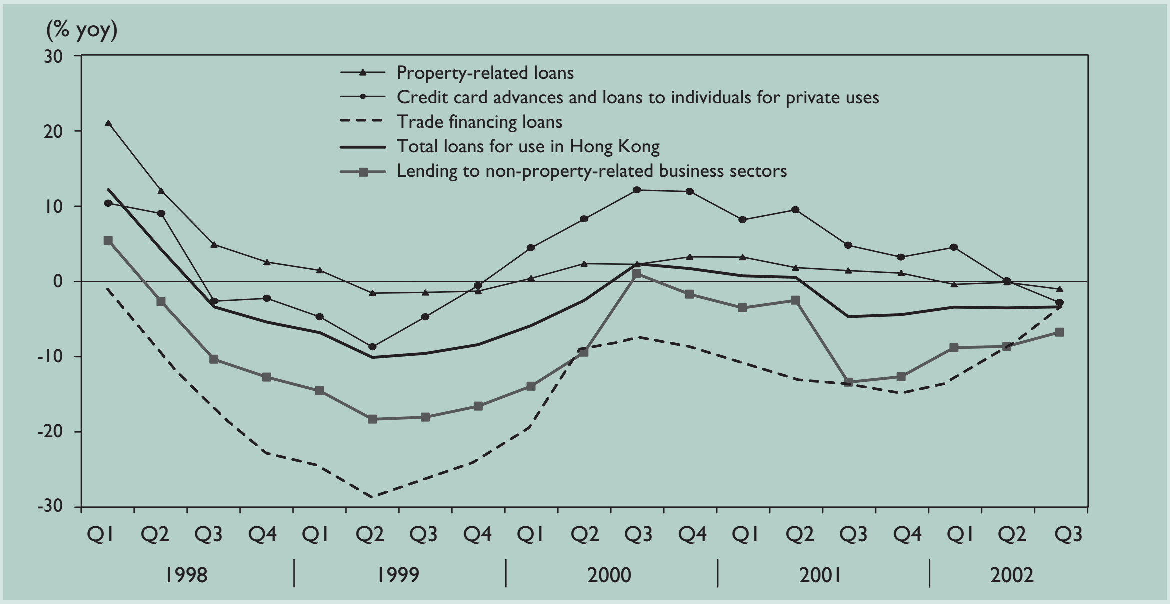
Narrow and broad money growth continued to diverge. Notwithstanding a further increase in narrow money (HK$M1), broad money (HK$M3) registered a small decline in the third quarter. As a result, HK$M1 rose by nearly 15% in the twelve months to September, while HK$M3 dropped by 1%. The notable rise in HK$M1 reflected a low opportunity cost of holding non-interest bearing monetary assets as well as an increase in cash demand associated with rising inbound tourists from the Mainland. The moderate fall in broad money was attributable to a decline in time deposits, which was in part associated with portfolio shifts in search for higher returns in the face of record-low deposit rates relative to yields on alternative financial assets.

Foreign currency deposits recorded a modest quarter-on-quarter decline in the third quarter, following a rise in the second. The drop was attributable to a fall in US dollar deposits, which exceeded an increase in other foreign currency deposits. The former in part reflected higher US dollar deposit rates offered by banks in the US than in Hong Kong.

Domestic credit expansion remained subdued due to the generally weak economic conditions. Specifically, loans for use in Hong Kong shrank slightly during the quarter, and were about 3.4% lower than a year ago. The contraction was broad-based, with lending to non-property business sectors registering the largest rate of decline on a year-on-year comparison (Chart 5).[1] Alongside strong growth of external trade, loans for trade financing grew for two consecutive quarters, but were still lower than a year ago.

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, credit card advances and trade financing loans.

1 Non-property business lending is defined as loans for use in Hong Kong other than property-related loans, lending to individuals for private purposes, credit card advances and trade financing loans.

Short-term Outlook

Looking ahead, exports in Hong Kong would continue to benefit from the strong trade performance in the Mainland and the weakening of the US dollar. The contraction in domestic demand should also moderate as the increase in export earnings starts to filter through to local consumption and investment. The employment situation may further improve, provided that the strong export performance and the improvement of private investment are sustained. Nevertheless, the short-term growth outlook remains subject to considerable uncertainty, relating mainly to global economic prospects and the volatility of financial markets. Domestically, concerns over a possible increase in the fiscal deficit may continue to affect the market sentiment. Deflationary pressure is expected to persist in the near term. Although the recent weakening of the US dollar against other major currencies may exert upward pressure on import prices, the extent of pass-through to consumer prices is likely to be restrained by the generally weak domestic demand.

- Prepared by the Research Department