

# Domestic and External Environment

*by the Research Department*

The prospect for global recovery is clouded by escalating military tensions in the Middle East. In view of heightened uncertainty and increasing signs of moderation in growth towards the end of 2002, the European Central Bank and the Bank of England eased monetary policy. In Hong Kong, economic recovery accelerated. Benefiting from the robust export performance in the Mainland and a gain in competitiveness resulting from a weaker US dollar, external trade continued to grow strongly. Domestically, local consumption remained subdued while private investment improved.

## External Environment

In the US, real GDP growth slowed considerably to an annualised rate of 0.7% in the fourth quarter of 2002 from 4% in the third, mainly due to slower expansion of consumption and exports. Nevertheless, there were signs of improvement in capital spending, with fixed investment rising by 3% (annualised) after contracting for eight consecutive quarters. Looking ahead, there are two main risk factors to the outlook for 2003. Firstly, the substantial wealth reduction resulting from the declines in equity markets may restrain private consumption growth. The room for home equity withdrawal through refinancing, which has provided support to consumer spending, would be limited should house price inflation moderate. Secondly, the geopolitical tension and the possible disruption to oil production in the Middle East may lead to much higher oil prices, representing a supply shock to the global economy.

In the euro area, real GDP expanded by 0.3% in the third quarter, following an increase of 0.4% in the second. Drivers of growth have shifted away from inventory accumulation and net exports to private consumption. Production growth appeared to moderate further towards the year end, with industrial output contracting by 0.1% in the fourth quarter. The sluggish euro-zone economy is mainly attributed to weak demand in Germany. Although January's IFO Survey showed some signs of improvement in business conditions in Germany, a meaningful recovery is yet to be seen. In the UK, real GDP

growth moderated to 0.4% in the fourth quarter from 0.9% in the third. However, consumer spending remained healthy, with retail sales rising by 1.1% quarter-on-quarter during the period.

In Japan, real GDP growth moderated to 0.5% in the fourth quarter from 0.7% in the third, mainly due to a decline in consumption growth. The weak consumer sentiment and high jobless rate continued to weigh on household spending. On the production side, the latest Tankan survey showed a marginal improvement in business conditions, with the large manufacturers index rising further to minus 9 in the fourth quarter. Meanwhile, consumer prices continued to decline, but at a slower year-on-year rate of 0.4% in the final three months of 2002.

Elsewhere in Asia, preliminary estimates showed that real GDP grew strongly in China by 8.2% year-on-year in the fourth quarter. By contrast, the Singapore economy recorded 0.1% (annualised) growth in the fourth quarter, following a 9.9% contraction in the third. The latest trade statistics suggested that Asian exports remained robust, though the pattern of growth varied across different parts of the region. In particular, export growth in Southeast Asia was mainly driven by intra-regional trade, while North Asia saw strong growth in exports to key markets outside Asia.

In Latin America, the strike in Venezuela starting in early December 2002 remains unresolved. The resultant disruption in oil production and economic activity more broadly have significantly eroded the

country's external position. Reflecting the vulnerable economic conditions and increasing risks of default, Moody's and Fitch downgraded the country's long-term foreign currency sovereign rating to Caa1 and CCC+ respectively in January 2003. The Venezuelan bolivar fell by 31% from end-November to 1,922 per US dollar in January. It rebounded to 1,598 following the imposition of exchange controls in early February.

In view of heightened uncertainty and signs of moderation in growth, major central banks eased monetary policy. The European Central Bank cut its refinancing rate by 50 basis points to 2.75% in December 2002. In the UK, the Bank of England lowered its policy rate by 25 basis points to 3.75% at February's meeting, citing that demand had been weaker than previously anticipated. As for the US, after lowering the Fed funds target rate to 1.25% in November, the Federal Reserve kept the target rate unchanged at its January meeting and maintained a neutral stance between the risks of inflation and sustainable growth.

Meanwhile, concerns over the growing likelihood of military conflict in Iraq and the releases of weaker-than-expected corporate earnings forecast led to a fall of the S&P500 index to 817 in mid-February, representing a loss of 12% from early January. Major markets in Europe and Asia also fell together with the US market. In particular, the German DAX index dropped to a six-year low of 2,555 in mid-February, while NIKKEI index in Japan fell modestly in the same period.

In the currency market, investors continued to switch funds out of US dollar-denominated assets. The USD/EUR rate reached a three-year high of 1.09 in early February, while the YEN/USD rate strengthened to 117.8 towards the end of January before easing to around 120 in mid-February. Separately, market anxiety over a possible oil shock drove the spot oil price up to US\$36.8 per barrel in the New York market in mid-February.

## Domestic Activity

Economic growth in Hong Kong rose further in the fourth quarter of 2002, driven by robust external trade. On a year-on-year comparison, real GDP grew

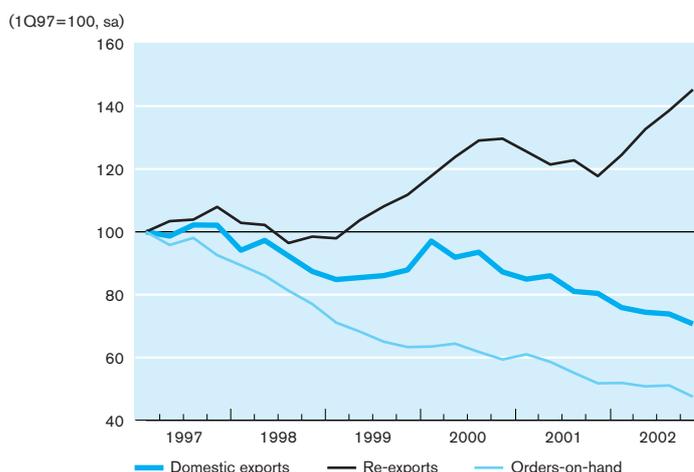
by 5%, to which net exports contributed 4.0 percentage points.

By contrast, domestic demand remained subdued. Although the volume of retail sales increased slightly in the fourth quarter on a seasonally adjusted basis, the rise was likely attributable to a sharp rise in the number of inbound tourists, rather than a recovery in local consumer spending. Private investment recorded a modest growth on a year-on-year comparison after declining for four consecutive quarters.

## External Trade

The strong export performance in the Mainland and a gain in competitiveness as a result of a weaker US dollar continued to support exports of goods and services. Specifically, re-exports rose by 5.9% in real terms on a seasonally adjusted basis in the fourth quarter, compared with an increase of 4.3% in the third (Chart 1). Domestic exports, however, resumed its decline, following a small rise in the previous quarter. Among the major markets, exports to most regional economies and the US continued to grow significantly from a year ago, while those to the EU turned to an increase. Supported by steady rises in tourist inflows and trade-related activities, exports of services also maintained a strong growth momentum.

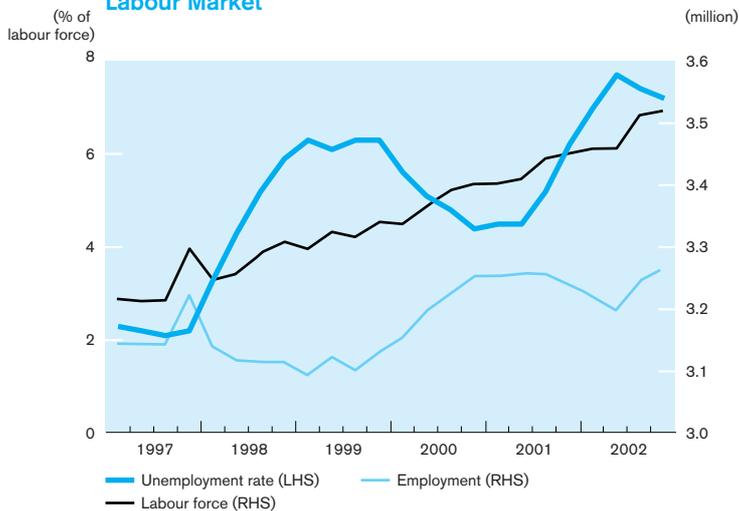
CHART 1  
External Trade



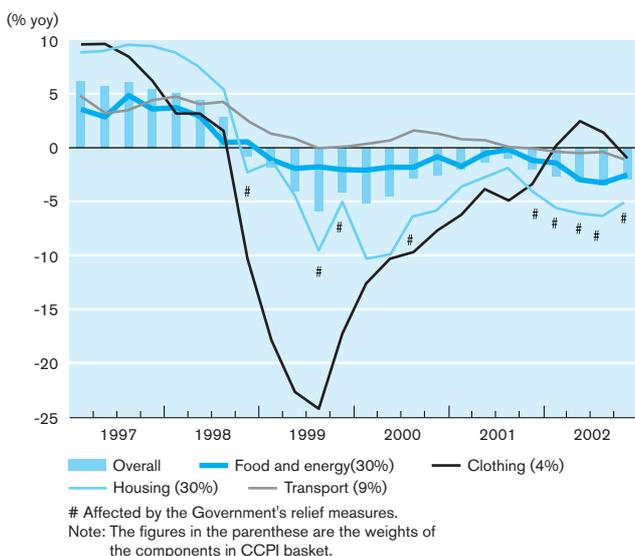
## Labour Market and Inflation

Labour market conditions improved in recent months. The seasonally adjusted unemployment rate fell from a peak of 7.8% in May-July to 7.2% in the three months to January, as growth of employment outpaced that of total labour force (Chart 2). The gains in employment were most significant in the construction, financing, and community, social and personal services sectors. Nominal payroll per person engaged fell by 0.3% in the third quarter, the same pace of decline as in the second.

**CHART 2**  
Labour Market



**CHART 3**  
Inflation



Price deflation persisted. On a year-on-year basis, the decline in the Composite Consumer Price Index (CCPI) in January narrowed significantly compared to the third quarter, largely due to a low base of comparison in January 2002 when there was the rates concession. Separately, the government relief measures on water and sewage charges, and a rebate of electricity charges exerted a downward pressure on the CCPI. After adjusting for these special factors and seasonal effects, the CCPI fell by 0.6% in the three months to January, compared to 0.7% in the third quarter (Chart 3).

## Asset Markets

Reflecting developments in the US and European stock markets, volatility in the Hong Kong stock market continued. Equity prices weakened in December following a rebound in November. The Hang Seng Index rose slightly in early January, but drifted lower to around 9,400 in mid-February.

The residential property market remained weak with prices and rentals falling further (Chart 4). However, transaction volumes increased in December-January, as the market responded positively to the announcement by the Government of a set of measures aimed at reviving confidence in the property market.

**CHART 4**  
Property Market



## Money Supply and Domestic Credit

Narrow and broad money supply growth continued to diverge in the fourth quarter of 2002. Narrow money grew considerably, by 3.4% in the fourth quarter compared with the third, and by 12.9% from a year ago.<sup>1</sup> This was attributable to the low opportunity cost of holding non-interest-bearing monetary assets as well as an increase in cash demand associated with a rising number of inbound tourists from the Mainland. Broad money rose slightly during the quarter, but was lower than the level a year ago, reflecting in part portfolio shifts in search for higher return in the face of record-low deposit rates against yields on alternative financial assets.

Following a decline in the third quarter, foreign currency deposits increased moderately in the fourth, as a rise in US dollar deposits exceeded a decline in other foreign currency deposits. On a year-on-year comparison, foreign currency deposits contracted in 2002, with non-US dollar foreign currency deposits declining more notably.

Domestic lending remained sluggish, as lacklustre economic conditions and uncertain business prospects continued to depress the demand for credit. Loans for use in Hong Kong shrank marginally during the quarter, and were about 2.4% lower than a year ago. The contraction was broad-based, with lending to non-property business sectors registering the largest rate of decline in the twelve months to December 2002 (Chart 5).<sup>2</sup> Alongside strong growth of external trade, loans for trade financing recorded an increase in 2002, but their share in total loans for use in Hong Kong was small (at 5%).

<sup>1</sup> The quarter-on-quarter narrow money growth was seasonally adjusted.

<sup>2</sup> 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

Economic conditions are generally expected to improve in 2003. Benefiting from strong trade performance in the Mainland, robust inbound tourism, and a weaker US dollar, exports of goods and services is expected to continue to be the driving force for growth. Domestic demand is likely to recover as the rebound of external trade in 2002 and its sustained growth in 2003 filter through to investment and local consumption. However, the short-term growth outlook is subject to considerable uncertainty, with the balance of risks tilting towards the downside. Notably, a possible US-led military action in Iraq, especially in the event of a prolonged war, could significantly weaken the global economy and cause greater volatility in financial markets. Labour market conditions may further improve along with a sustained recovery. Any progress, however, is likely to be gradual as firms tend to postpone decisions on purchasing and company expansion in the current uncertain political and economic climate. Price deflation is expected to moderate, reflecting the acceleration in economic growth, a rise in import prices brought about by the weakening of the US dollar, and increases in oil prices.

**CHART 5**  
Loans for Use in Hong Kong

