

THE DOMESTIC ENVIRONMENT

While consumption has weakened, the economy continues to be underpinned by exports and investment with the latter laying the grounds for future growth. With interest rates unchanged, the demand for credit held up in the September quarter. The visible trade deficit is narrowing and inflation is tapering off, but the unemployment rate is high by recent local standards.

Monetary Situation

Total outstanding loans and advances fell by 3.3% in the September quarter, in contrast to the robust growth of 7.5% in the first quarter and 9.8% in the second quarter (Table I). However, the fall should not be regarded as a softening in the demand for loans, and so an indication of a marked slowdown of the economy, because domestic loans actually rose 2.0% during the quarter. Rather, the decrease was mostly attributable to valuation effects arising from exchange rate movements during the quarter (Chart 1). Non-US dollar foreign currency loans fell by 7.9%, which was mainly a reflection of the appreciation of the HK dollar along with the US dollar against most major currencies since July. The HK dollar appreciated 14.9% against the Japanese Yen and 3.1% against the Deutschemark during the September quarter.

Total deposits continued to increase, albeit at a slower pace. Total deposits grew by 2.3% in the third quarter, following increases of 4.8% and 3.9% in the first and second quarters. The increase was due to increases in both HK dollar deposits and

foreign currency deposits during the September quarter; the former rose by 3.6% and the latter by 0.8%.¹

Although the US Federal funds rate was lowered by 0.25% to 5.75% on 6 July, the HKMA did not change the LAF rates. Savings deposit rates and the best lending rate of the major commercial banks remained at 4.25% and 9.0% respectively.

Labour Market

The labour market eased further in the third quarter, with the unemployment rate climbing to 3.5% and underemployment rate to 2.5%, compared to 3.1% and 2.1% in the second quarter respectively. While this unemployment rate is lower than that in virtually all economies with a similar average income, it is the highest rate in Hong Kong for a decade. One cause is an increasing mismatch of skills, reflected in around 52,000 job vacancies co-existing with the 90,600 unemployed in the second quarter. Furthermore, the labour force has grown rapidly recently, being up 4.1% over the year to June, which has been partly attributed to returnees.

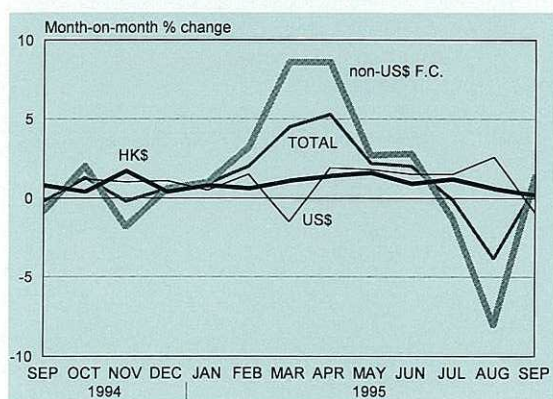
Table I:
Loans by Authorised Institutions

	Total	by usage		by currency			
		Domestic	Other*	HK dollar	Other	of which US dollar	Other
Q1 1994	5.7	5.6	4.7	5.7	5.7	2.0	6.8
Q2	5.5	5.4	3.7	5.0	5.8	4.4	6.2
Q3	0.7	2.9	2.7	2.7	-0.3	1.7	-0.9
Q4	1.8	3.0	0.6	2.6	1.3	3.4	0.7
Q1 1995	7.5	3.3	4.7	2.4	10.2	0.6	13.2
Q2	9.8	3.7	17.1	3.9	12.7	5.3	14.8
Q3	-3.3	2.0	-6.7	2.0	-5.7	3.1	-7.9

* Includes loans for which the place of usage is unknown

1 Figures for HK dollar deposits, those for demand deposits in particular, as of end-August were overstated to the extent that some cheques deposited on 31 August were credited to payees' accounts but were not debited from payers' accounts due to the typhoon on that day. The quarterly figures were not affected.

Chart I
Loans and Advances



Such a surge in the labour force is likely to cause at least a temporary rise in unemployment, even in as flexible a labour market as Hong Kong's, but the recently announced cutbacks in labour importation schemes should moderate the growth in the labour force in the next year. A further cause of increased unemployment has been the weakness in the retail sector and parts of the construction sector.

GDP Growth and Consumer Spending

The government's real GDP growth forecast for 1995 has been revised down from 5.5% to 5.0%, in accordance with the sluggish consumer spending. Compared to the same period last year, private consumption expenditure rose by 0.8% in the first quarter and 1.4% in the second quarter of 1995. The volume of retail sales fell by 1.5% over the year to August. This reflects poor consumer sentiment; more than half of the respondents to a survey conducted by the Social Sciences Research Centre² were dissatisfied with the economic environment. This gloomy sentiment may itself be influenced by the attention given to the rise in unemployment but it is also likely to reflect wealth effects from the declines in equity and property prices which followed the rises in interest rates in 1994 and early 1995. The property market has adjusted downward by around 25% on average from the peak in April last year, which would

reduce the wealth of many households. The slowdown in the Chinese economy would also have reduced income from investments there for some Hong Kong residents.

Looking forward, some of these negative influences should abate. Interest rates are probably at or near their peak, while property prices have stabilised. Equity prices, which fell sharply in late 1994, turned around in early 1995 and were 38% above their trough at end September. At the same time, economic conditions in the Mainland are looking more favourable than many commentators expected, with latest indicators suggesting that the economy is achieving the desired soft landing. All these are positive signs that should over time support consumer spending.

External Trade

The value of total exports rose by 17.1% over the year to the September quarter. However, as imports increased by 22.2% over the same period, the merchandise trade deficit swelled from HK\$11.6 billion in the September quarter of 1994 to HK\$25.9 billion in the September quarter of 1995. However, this was an improvement from the second quarter when the deficit was HK\$52.5 billion. Notwithstanding the temporary surge in imports associated with the airport project, the surplus in invisible trade should substantially offset the deficit in merchandise trade for the year.

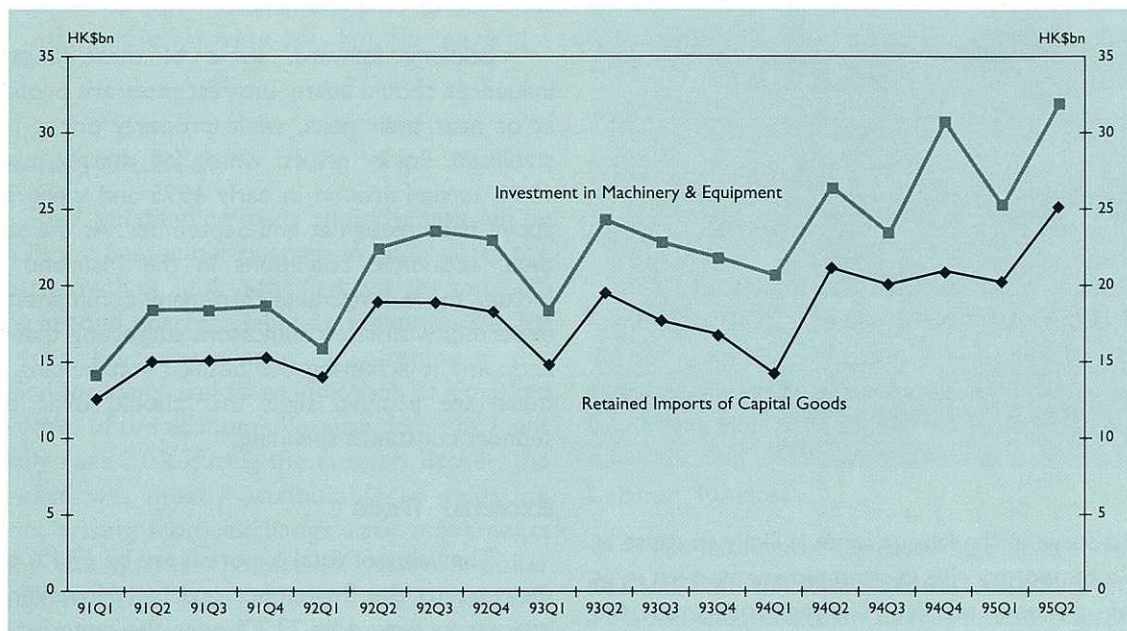
Investment

Machinery & Equipment

A positive aspect of the import surge was that, in line with the weak consumer spending, a large proportion of imports was for production rather than consumption. Retained imports of capital goods rose by 29% in real terms in the first half of 1995, in contrast to the 12% increase for consumer goods. Retained imports of capital goods are a very important component of capital formation; between 1991 and 1994, they amounted to 80% of total investment in machinery and equipment (Chart 2). Spending on machinery and equipment expands productive capacity, and enhances labour productivity.²

² Labour productivity, as measured by real value added per person engaged, increased at an average annual rate of 3.9% between 1991 and 1994. Real wages, on the other hand, increased at a rate of 2.6% per year over the same period. Real unit labour costs have therefore declined, implying this aspect of the competitiveness of the economy has improved.

Chart 2
Investment in Machinery & Equipment and Retained Imports of Capital Goods
(At constant 1990 prices)



In 1994, expenditure on machinery and equipment constituted 13.8% of GDP and made a significant contribution to economic growth. Once the associated multiplier effects are taken into account, the total impact on GDP will be substantial. Expansion in investment in machinery and equipment precedes output growth by around six quarters according to some econometric estimates. As investment in machinery and equipment started to grow significantly from the fourth quarter of 1994³, this stimulative effect should be felt in 1996.

Infrastructure

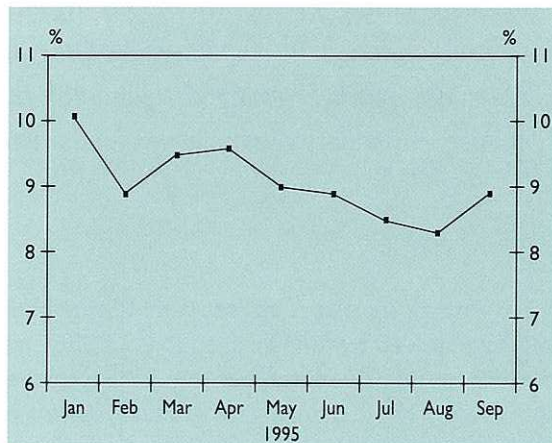
Apart from investment in machinery and equipment, the territory is embarking on an ambitious programme of infrastructure projects. Of these, the largest and most important is the Airport Core Programme (ACP). Total spending on the entire ACP is forecast to reach HK\$158 bn, which is spread within a spectrum of eight years beginning 1991. Spending accelerates each year before leveling off in 1997.

The new Airport removes bottlenecks and will raise the efficiency of the transport network of the territory. In particular, the Kai Tak Airport is already operating beyond its optimal capacity in terms of both the number of passengers handled and air cargo throughput. There exists no room for further expansion due to land limitation and noise accompanying the aircraft has also reached the tolerance limit of the residents nearby.

Apart from facilitating commercial transactions, the new Airport will enable our tourist industry to flourish. Tourist spending totaled HK\$62.5 bn or around 6% of GDP in 1994, and has the potential for much more growth as a gateway to China. Last year, 3 million foreign tourists passed through Hong Kong destined for China, equivalent to a third of total tourist arrivals in the year. Alongside this development is the blossoming of the convention and exhibition industry. Hong Kong has become in recent years a large centre for hosting conferences, meetings and exhibitions.

³ Spending on machinery and equipment grew by 40.3% in real terms in the fourth quarter of 1994 and 21.8% in the first quarter of 1995 over the same period of the previous year. The corresponding growth rate in the third quarter of 1994 had been only 2.6%.

Chart 3
CPI(A) – % change over a year ago



Inflation

Domestically, weaker consumer spending and an easing labour market both lessened the pressure on prices. Rentals are also consolidating, but with contracts only being negotiated every 1-2 years, the main impact of this will not be reflected in the CPI until 1996. The appreciation of the US dollar, and hence the HK dollar, against many other currencies should also somewhat abate import prices. Consumer price inflation – on the CPI(A) basis – moderated from 9.5% in the first quarter to 9.2% in the second quarter, and further to 8.6% in the third quarter. For the first nine months of the year, inflation averaged 9.1%, in line with the forecast for the whole year (Chart 3). Ⓢ

– Prepared by the External Department