

THE DOMESTIC ENVIRONMENT

As a consequence of slackening demand of major trading partners and a stronger Hong Kong dollar since the second half last year, growth momentum of exports slowed in the December quarter. Domestically, retail sales remain weak reflecting high unemployment and fragile consumer confidence. However, as property prices have stabilised in the December quarter and interest rates were cut, consumer sentiment may strengthen somewhat. Inflation receded during the course of 1995.

Monetary Situation

The best lending rate of major commercial banks, and the savings deposits rate set by the Hong Kong Association of Banks, were reduced by 0.25% on 27 December 1995 and again on 5 February 1996. They now stand at 8.50% and 3.75% respectively. This followed the successive cuts in the US Federal funds rate of the same magnitude.

Total deposits rose by 2.1% in the December quarter, moderating slightly from the 2.3% growth in the September quarter. The moderation was accounted for by the slowdown in the growth of HK dollar deposits; there was an acceleration in foreign currency deposits (Chart 1). Total loans rebounded slightly by 0.3% in the December quarter after the 3.3% fall in the September quarter. (For details, see "Developments in the Banking Sector").

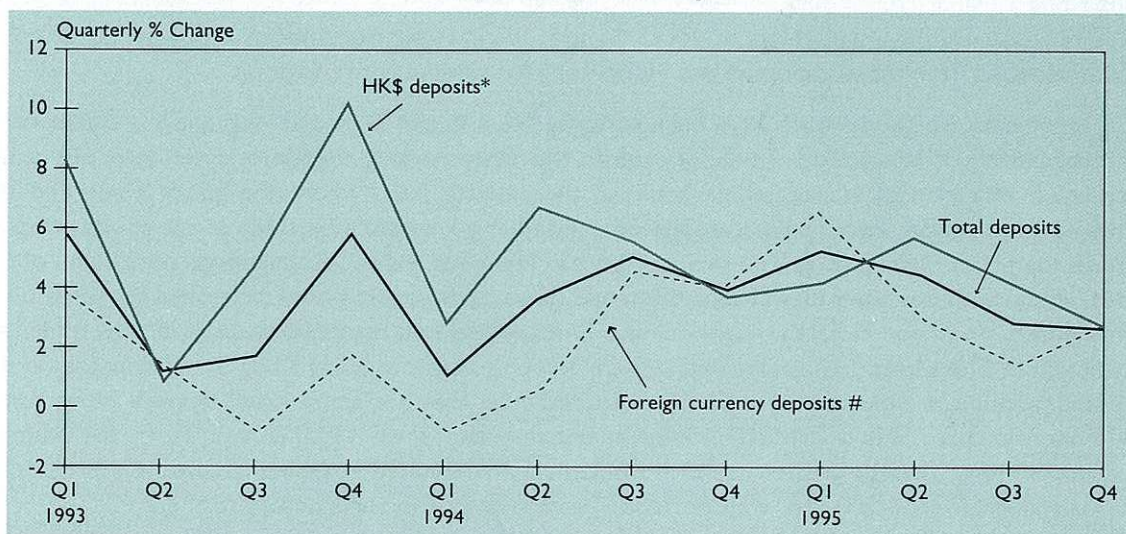
Economic Activity

Real GDP grew by 4.2% during the year to the September quarter of 1995, a slower rate of growth than in previous quarters, with consumer spending and construction expenditure relatively weak. Nevertheless, output in the first nine months of the year was 5.1% higher than in the corresponding period of 1994, supporting the government's estimate of around 5% growth for the year as a whole.

External Trade

Growth in external trade moderated in the December quarter, attributable to the weaker import demand of major trading partners and a stronger HK dollar since July last year. In the December quarter, the total value of exports was only 8.9% higher than a year ago. Domestic exports fell by 3.4% and the growth in re-exports

Chart 1
Deposits by Currency



Notes: 1. * - adjusted to include foreign currency swap deposits
2. # - adjusted to exclude foreign currency swap deposits

was down from 18.0% to 11.9% as transshipments played an increasing role (see Box).

For 1995 as a whole, domestic exports rebounded in value terms by 4.3%, rising for the first time since 1992. Growth of re-exports was 17.4%, the 13th consecutive year of double-digit growth. As a result, total exports rose by 14.9% in 1995, compared with the 11.8% increase in 1994. However, as imports grew by 19.2% in 1995 (16.6% in 1994), the merchandise trade deficit swelled from HK\$81 bn in 1994 to HK\$147 bn in 1995. Nevertheless, it should be substantially offset by the surplus in services trade.¹

Consumer Spending

Consumer spending in 1995 has been weak; from February retail sales volumes were lower than in the corresponding month in 1994, leading to a real drop of 1.3% for the first eleven months. The sluggish performance was attributable to:

- slower growth in real wages. Real wages of workers, which had been growing at an average annual rate of around 5% between 1984 and 1994, barely grew in 1995.
- rising interest rates. Between March 1994 and February 1995, the best lending rate in Hong Kong was raised by 2.5%. This raised the cost of borrowing and reduced consumer spending, particularly on durables. Sales of consumer durables fell by 15% in real terms in the first eleven months of 1995. More remarkably, sales of motor vehicles and parts fell by 34% over the same period. However, car sales were affected by forward purchases in 1994 when a government report on traffic congestion recommended raising the First Registration Tax. Estimates indicate that sales of non-durables still increased.
- negative wealth effects resulting from falling property prices. Having reached a peak in April 1994, property prices have, on average, fallen back by about 25%. Although there was a modest pickup in the December quarter, transactions remained thin and were confined to the primary market.
- fragile consumer sentiment. Consumer confidence fell to a record low level,

Box: Transshipments

The fact that re-exports did not grow as rapidly as in late 1980s and early 1990s was attributable to a shift in trading method from re-exports to transshipment. Re-exports are products which have previously been imported into Hong Kong and which are re-exported without having undergone in Hong Kong a manufacturing process which has changed permanently the shape, nature, form or utility of the product. Transshipment refers to goods transhipped in Hong Kong under a through bill of lading (as distinguished from those imported into Hong Kong for subsequent re-export).

Re-exports are goods which have been consigned to a trader in Hong Kong, and the trader takes legal possession of the goods. Re-exports clear the customs and therefore enter into our trade statistics. It is a kind of indirect trade between the country from where the goods come and the country of destination. Transshipment, on the other hand, is a kind of direct trade as the goods just pass through the port of Hong Kong. The shipping agent in Hong Kong does not take legal possession of the goods, although these goods may change the mode of transport or may even be stored for some time. Transshipment does not clear the customs and is therefore not regarded as part of our trade. As production in China becomes mature and as many shipping agents in Hong Kong start businesses in the Mainland, goods are exported from China direct, although they are transhipped through Hong Kong. Consequently, there was a marked pick-up in transshipment since 1994 (Chart 2). In the national accounts, a move towards greater use of transshipments is reflected in slower growth in merchandise exports and faster growth in the "transportation" component of exports of services.

¹ For more information, see "The Domestic Environment" in the August 1995 issue of the *Quarterly Bulletin*.

Chart 2
Re-exports at constant prices and Transhipment Volumes
 (% change over year ago)

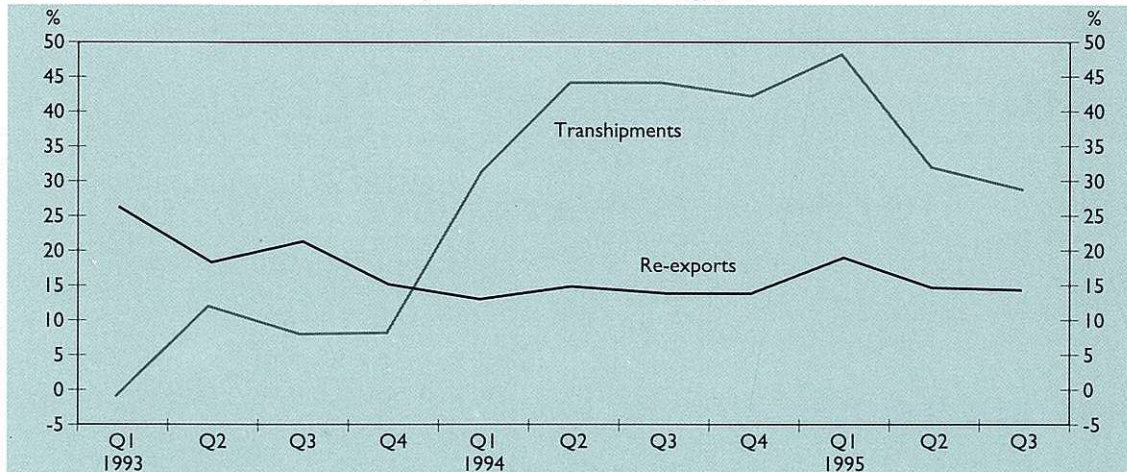
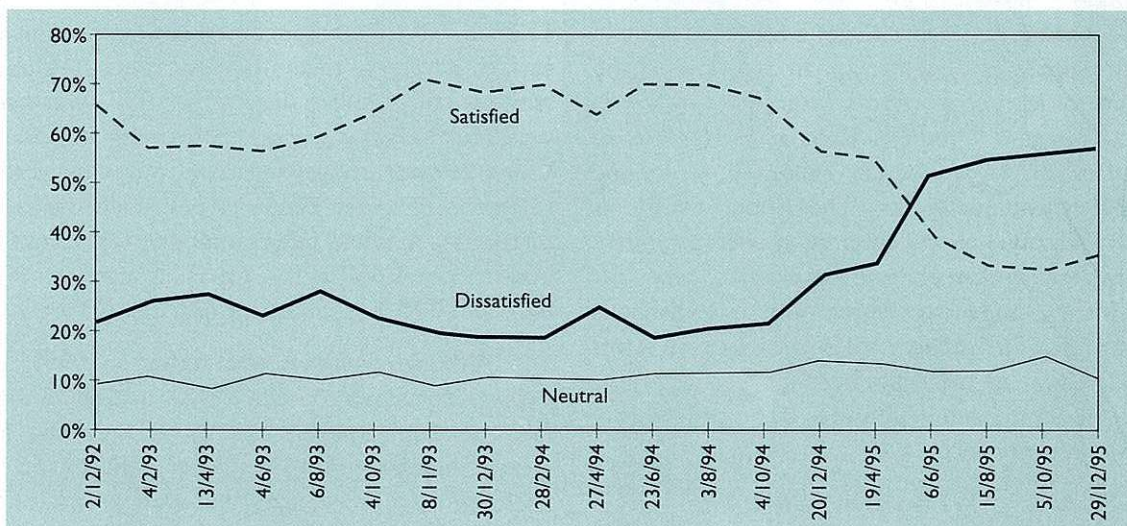


Chart 3
Consumer Sentiment (% of respondents)



according to surveys conducted by the Social Sciences Research Centre, Hong Kong University (Chart 3). High unemployment, low wages growth, relocation of businesses and continuing austerity measures in China were the main factors contributing to the bearish sentiment.

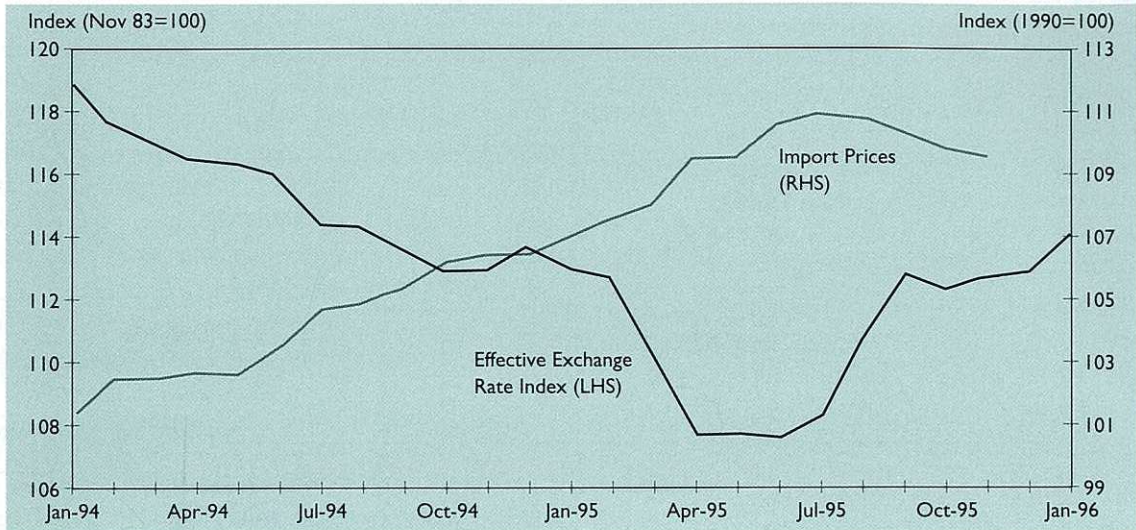
Although a sharp pickup is unrealistic, further slowdown in retail sales in 1996 is also unlikely as negative factors begin to subside. Property prices have stabilised and the Hang Seng Index was 23% higher at year-end 1995 than year-end 1994. Interest rates were cut by 0.25% in December and

a further 0.25% in February. Furthermore, as the Taiwanese economy looks strong in 1996 while the Japanese economy is expected to recover, tourists from the second and third largest sources with the highest per capita spending will give additional support to the retail market.

Unemployment & Inflation

The labour market eased in 1995, with the unemployment rate at 3.5% in the September and December quarters, up from 2.8% and 3.1% in the March and June quarters. In the September quarter, the average unemployed person had been without a job for 77 days; a year earlier this was 61 days.

Chart 4
Effective Exchange Rate Index and Import Prices



These were partly the result of a faster increase in labour supply attributable to an increase in the number of former emigrants returning. There was also an increase in job mismatch, as the number of vacancies of major sectors remained at around 51,000 at end-September. The labour market is already adjusting to this upsurge in unemployment. Wages for craftsmen and operatives, and for supervisory, technical, clerical and miscellaneous non-production workers fell slightly in real terms over the year to the September quarter. Increases were moderate, and well below trend productivity growth in other sectors.

Inflation as indicated by CPI(A), was 8.7% in 1995, higher than the 8.1% recorded in 1994. The higher rate was due in part to higher import prices following the depreciation of the HK dollar in the early months of 1995 (Chart 4) and in part to the high inflation rate in China and higher world commodity prices in the first half of 1995 which affect food import prices. At the same time, non-tradable items such as housing and miscellaneous services continue to rise at double-digit rates of

12.2% and 11.4% respectively. Lately, inflation has abated, reflecting several factors. These include a stronger HK dollar since July 1995, weakening world commodity prices, moderating inflation in China, slower wage inflation and the gradual reflection of lower property prices on the rental market. As a result, inflation moderated across the board from 9.5% in the March quarter to 9.2%, 8.6% and 7.7% in subsequent quarters (Chart 5).

Although inflation was higher in 1995, our exports remain competitive. The unit value index for domestic exports rose by 2.5% in the first eleven months of 1995. After adjustment for exchange rate movements, the growth rate of the index was still lower than the growth of import prices in the United States, Germany and Japan over the same period, implying that Hong Kong products remain competitive in these three markets. Furthermore, after making adjustments for exchange rate fluctuations, our export price increases were lower than those in Taiwan, Singapore and South Korea, further demonstrating Hong Kong's continued export competitiveness. ⊕

— Prepared by the External Department

Chart 5
Consumer Prices (% change over the same quarter of 1994)

