

THE DOMESTIC ENVIRONMENT

Economic growth remained vigorous in the March quarter of 1997, supported by continued growth in consumer spending and investment expenditure. Export performance, however, remained sluggish. Asset markets were active, with share and property prices rising to new highs, before consolidating towards the end of March. The unemployment rate remained steady. Inflation edged up slightly.

Domestic Activity

The Hong Kong economy was strong in the fourth quarter of 1996, with real GDP growth accelerating to 5.5%, from 3.5% in the first half and 5.0% in the third quarter. The growth momentum appeared to have continued in the March quarter of 1997, driven by stronger consumer spending and robust private construction activities. For 1996 as a whole, real GDP is estimated to have expanded by 4.7%, the same as in 1995. Given the prospect of sustained growth in private consumption, continued buoyant fixed capital formation and the favourable trade outlook, real GDP is forecast to grow by 5.5% in 1997 (Table I).

Domestic economic activities are expected to rebound further. Private consumption expenditure grew strongly by 6.4% in the fourth quarter of 1996, compared with a year ago. Having resumed their uptrend in the June quarter of 1996, retail sales rose by 2.7% in real terms in the second half of 1996 and further expanded by 2.5% in January-February 1997 (Chart 1). Although the interest rate rise in late March may slow the pace of further rebound, consumer spending is expected to remain buoyant, underpinned by continued improvement in the job market, increased household

incomes and the positive wealth effect stemming from rising stock and property prices. Recent sharp rises in consents to commence work on property projects and in retained imports of capital goods suggest that fixed capital formation would remain strong in the coming months. Provided interest rates do not rise further substantially, investment spending should continue to grow.

External Trade

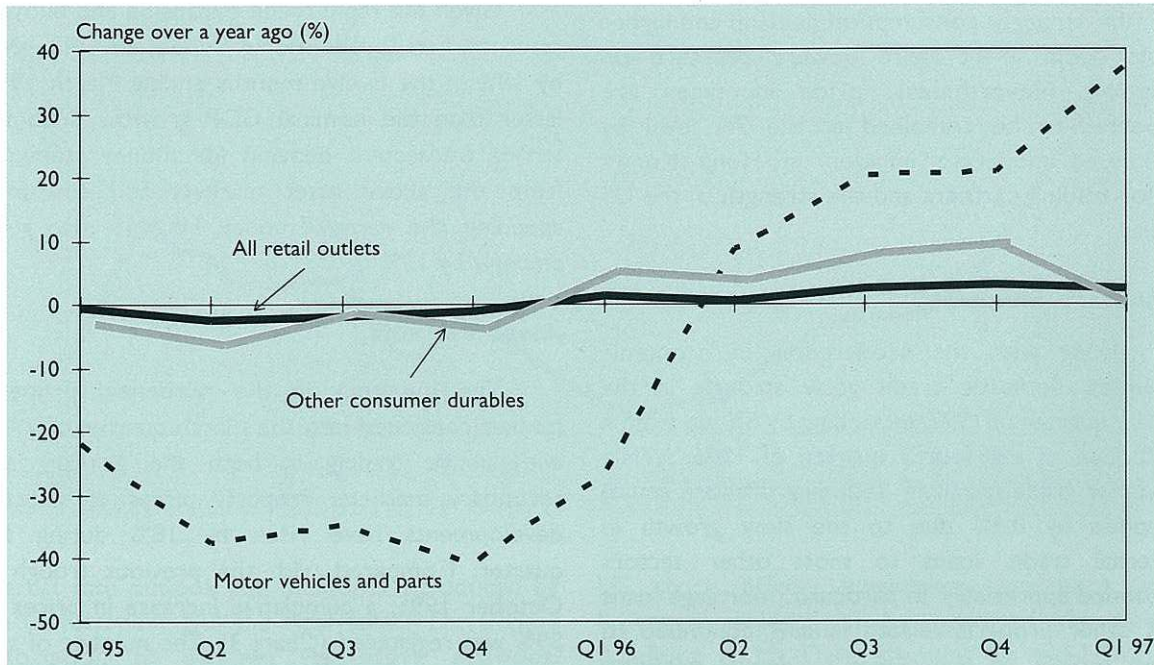
Export growth remained modest in the March quarter of 1997, rising by 2.2% in value terms. Earlier disputes between Hong Kong and the US over textile and clothing quotas continued to depress Hong Kong's export performance. The strength of the US dollar also weakened the competitiveness of Hong Kong's exports. As a result, domestic exports fell by 6.1% in value terms in the March quarter, having dropped by 6.9% in the previous quarter, while the growth in re-exports slowed to 3.7%, from 6.3%. In the March quarter, Hong Kong's re-exports to China increased at a slower pace of 2.1%, compared with a 11.9% growth in the previous quarter, partly due to China's shift in sourcing from imports to domestic supplies. Re-exports to the US, on the contrary,

Table I:
Contributions to GDP Growth by Components (%)

	1995	1996 ^P	1997 ^F
Private Consumption Expenditure	0.5	2.7	3.2
Government Consumption Expenditure	0.3	0.4	0.4
Gross Domestic Fixed Capital Formation	2.9	3.8	2.5
Change in Inventories	3.2	-3.7	0.0
Net Domestic Exports of goods	-6.9	-1.5	-4.2
Net Re-exports of Goods	2.7	1.7	2.3
Net Exports of Services	1.9	1.4	1.2
GDP	4.7	4.7	5.5

Note: P: preliminary estimates
F: Government Budget forecasts

Chart I
Retail Sales Volume



expanded by an impressive 13.4%, as US import demand recovered.

Imports grew by 4.3% in value terms in the March quarter, the same as in the fourth quarter of 1996. Reflecting the pick-up in domestic demand, growth in retained imports quickened, with notable increases in foodstuff, as well as raw materials and semi-manufactures and capital goods. As a result of faster growth in imports than exports, the visible trade deficit widened to \$48 bn (13.3% of total imports) in the March quarter of 1997, from \$40 bn (11.5%) in the same period of 1996.

Looking ahead, exports are expected to benefit from China's further liberalisation of trade and should grow more buoyantly on stronger import demand from the OECD countries and within the region. The recent move by the mainland to issue permits to six Taiwanese shipping firms to sail directly across the Taiwan Strait, following Taiwan's earlier approval for five mainland shipping firms to sail between Kaohsiung and Xiamen/Fuzhou, is not expected to have a severe adverse impact on Hong Kong, as cross-strait trade accounts for only about 7% of Hong Kong's re-exports. Moreover, direct cargo exchange is still not allowed. Taiwan opens up Kaohsiung only as an

"offshore transshipment centre" where incoming mainland cargoes can be processed for onward international shipment, but are not allowed to pass through Taiwan's customs. Likewise, Taiwan's cargoes cannot be loaded on ships planning to go directly to the mainland. As these shipping deals are still far from truly direct shipping, the impact on Hong Kong's role as an entrepôt should therefore be limited.

Labour Market

The job market was steady, with the unemployment rate edging up slightly to 2.6% in the three months ending April 1997, from 2.5% in the three months to January. In the three months ending March 1997, total employment rose by 3.9% over a year earlier, while total labour supply expanded by a less rapid 3.1%.

Inflation

Inflation, as measured by CPI(A), eased lately, from 6.6% in January to 6.5% in February and 5.7% in March (Chart 2). However, on a quarterly basis, it edged up to 6.2% in the March quarter of 1997, from 5.4% and 6% in the third and fourth quarters of 1996 respectively. The rise

inflation was mainly due to domestic factors, reflecting the recovery in consumer spending and a moderate rise in residential rents. In the coming months, stronger consumption demand and higher rents could exert more upward pressure on inflation. Nevertheless, price increases are expected to be contained at the 7% level by continued moderate inflation in Hong Kong's major trading partners and the strength of the US dollar.

Monetary Situation

Along with the acceleration of economic activities, domestic credit grew strongly in the March quarter of 1997, expanding by 8%, up from a 4.6% rise in the fourth quarter of 1996. While loans for trade financing (including offshore trade) dropped by 0.4% due to the slow growth in external trade, loans to most other sectors expanded appreciably. In particular, mortgage loans and other property-related lending continued to grow rapidly on the active residential property market, while loans to stockbrokers and financial concerns registered double-digit growths, reflecting the buoyant stock market. Meanwhile, credit extended to wholesalers and retailers increased by

6.7%, in line with the recovery in consumer spending.

Given the rapid credit expansion and buoyant asset markets, broad money supply, HK\$M3, grew by 18% in the twelve months ending March 1997, faster than the nominal GDP growth. With the strong transaction demand for money stemming from the active asset markets and consumer spending, the narrow money, HK\$M1, also grew strongly by 13%.

Asset Markets

The buoyancy in the residential property market continued into the March quarter of 1997, with active trading in both the primary and secondary markets. Property prices of selected developments have risen by 18% during the quarter. Compared with the previous trough in October 1995, a cumulative increase in prices of 59% was registered (Chart 3). The number of sale and purchase agreements rose by 75% in the March quarter of 1997 from a year earlier.

Nevertheless, the market has consolidated somewhat since late March due to the change in

Chart 2
CPI(A) – Tradable and Non-tradable Components

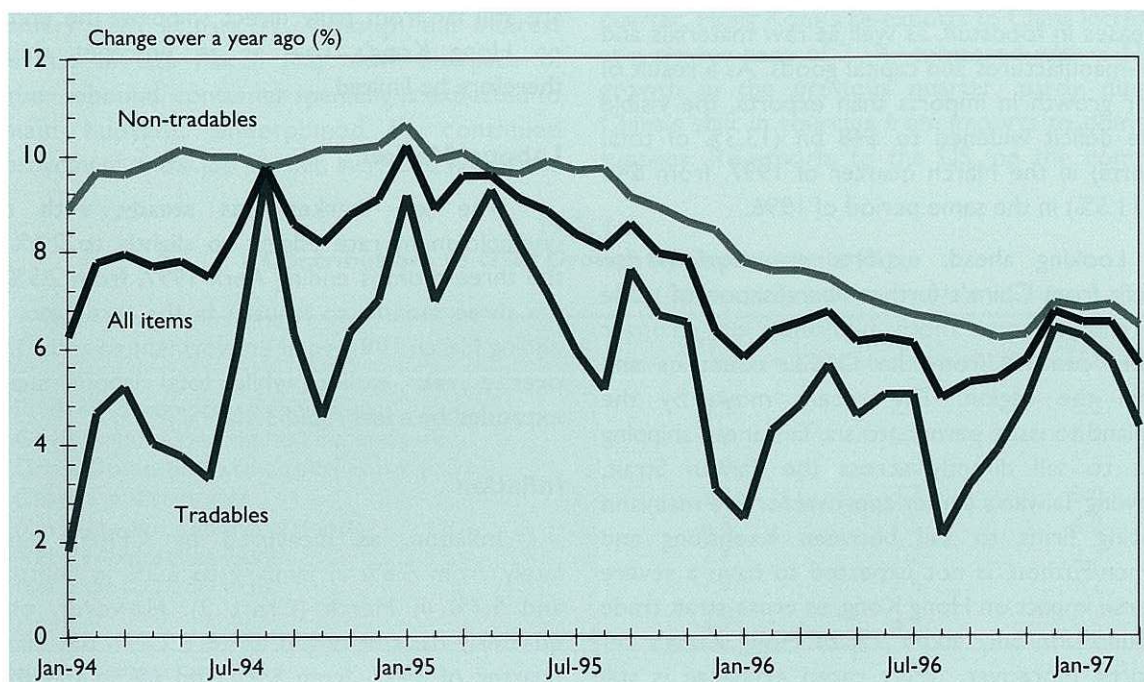
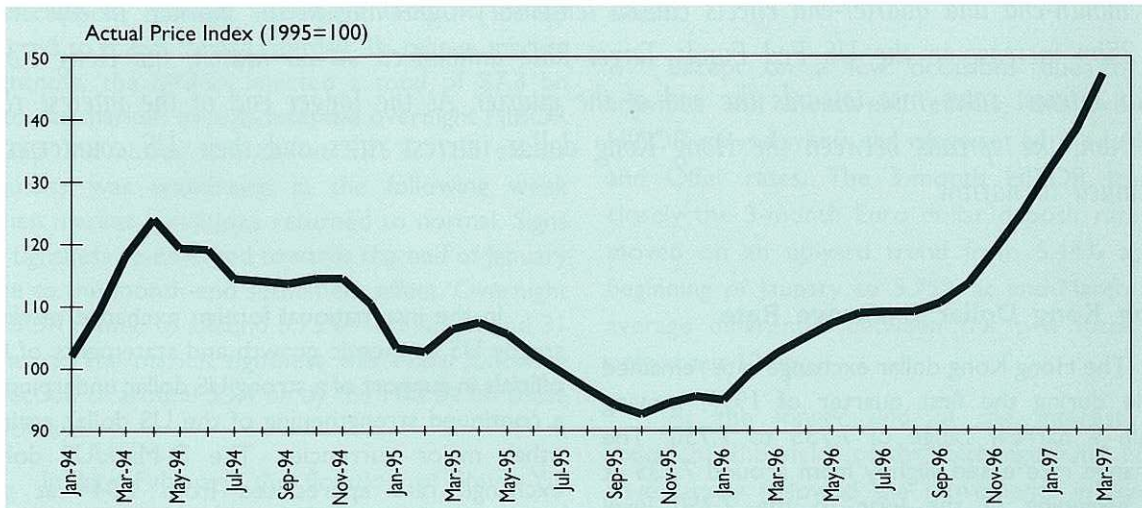


Chart 3
Price Index for Selected Residential Developments



interest rate outlook and measures introduced by the Government and the Real Estate Developers Association to dampen speculative activities, including measures to increase short-term flat supply. As a result, some developers have priced their primary sales 5 to 10% below prevailing secondary market prices, and asking prices in the secondary market have also adjusted downward.

The stock market continued to be active. The Hang Seng Index rose to over 14,000 in mid-January on bullish land auction results and surging

US stock prices. Investment sentiment was, however, undermined by news of the health condition of Mr Deng Xiaoping by mid-February, with the Hang Seng Index falling to around 13,000. The market recovered subsequently to about 13,600, before retreating to the 12,000 level on the change in interest rate outlook and Government's measures to combat property speculation. It rebounded to over 14,000 by early May on the benign inflation trend in the US. ☉

— Prepared by the External Department

Box: The 1997-98 Budget

The 1997-98 budget features increases of 16% in government revenue and 14% in expenditure. The real increase in recurrent public expenditure is budgeted at around 5%, in line with the medium-range forecast of 5% growth in real GDP. Non-recurrent expenditure will rise by 11%, driven partly by the growth in capital spending for providing public rental housing and subsidised flats.

On the revenue side, the corporate profits tax rate and the standard rate of salaries tax are kept unchanged at 16.5% and 15% respectively. Salary tax allowances and deductions are adjusted slightly upward to help the lower income group, and the marginal tax bands are revamped to reduce the burden of the middle-income group. Stamp duties for property transactions are lowered for flats not more than HK\$4 million. The percentage charge of rates is also cut from 5.5% to 5%. However, homeowners are expected to pay higher rates as a result of the revaluation of ratable values (an increase of about 17%) and the additional rents to be paid from July 1997.

A budget surplus of HK\$31.7 billion is projected, up from HK\$15.1 billion in 1996-97. This will lift Hong Kong's fiscal reserves to an estimated HK\$189.7 billion by 31 March quarter 1998 (excluding the Land Fund of HK\$169.6 billion and the Mandatory Provident Fund). The large projected surplus this year reflects partly additional rents collectible and full proceeds from land transactions, and partly the result of restrained public expenditure.