THE DOMESTIC ENVIRONMENT

Following a strong growth of over 6% in the first half, the Hong Kong economy appeared to have slowed somewhat in the third quarter, as the pace of consumer spending and tourism revenues slowed and exports remained weak. Visible trade deficits were still at high levels in recent months. However, the invisible trade balance should remain in surplus and offset a large part of the deficit on the visible trade.

The Hong Kong dollar came under pressure several times during the third quarter and in October, as the regional currency turmoil spread. Domestic interest rates rose significantly as markets perceived greater risks. Share prices in Hong Kong experienced a downward correction in volatile trading as most Asian stock markets fell. Property prices also consolidated. The Hong Kong dollar, however, remained firm on the strong side of the link.

Meanwhile, the Hong Kong dollar money supply continued to grow steadily. As the Hong Kong dollar strengthened along with the strong US dollar, inflation eased somewhat.

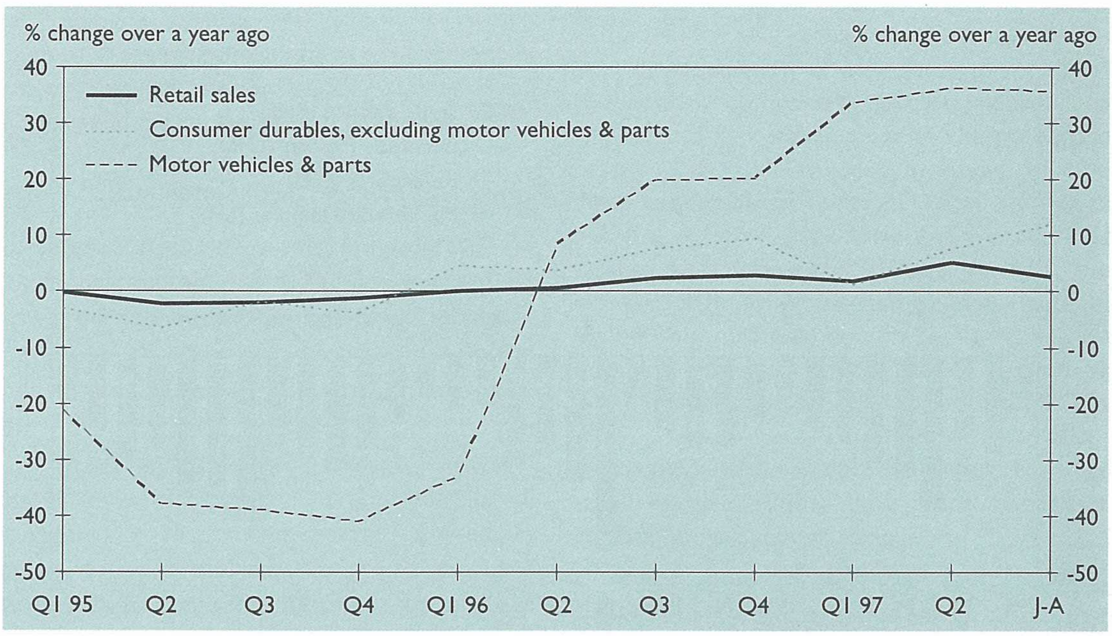
Domestic Activity

Hong Kong's economy gained momentum in the second quarter of 1997, with real GDP growing by 6.4%, compared with 6.1% in the first and 5.8% in the fourth quarter of 1996. Robust private construction activities continued, but consumer spending slowed somewhat. Tourism revenues fell and export growth remained subdued. Given the regional currency turmoil and higher interest rates in Hong Kong, the overall economic growth may have moderated somewhat since the third quarter. (For more on interest-rate development, see the article "Operation of Monetary Policy".) Nevertheless, the government's forecast of a 5.5% real GDP growth for 1997, which implies about 5% growth in the second half of the year, should be achievable.

While the economic prospects in the near-term have been overshadowed by the unsettled state of financial markets in the region, given the strong fundamentals of the Hong Kong economy, the adverse impact of the present financial market volatility is expected to be relatively modest and short-lived. After an International Monetary Fund (IMF) visit to Hong Kong for Article IV consultation on Hong Kong's exchange rate arrangements and economic policies, the IMF mission endorsed the Government's commitment to a rules-based and noninterventionist approach, as it should enhance the economy's ability to withstand the recent financial market turmoil. Hong Kong's steadfast adherence to the existing policy framework — which includes the linked exchange rate system, a prudent fiscal policy, the careful supervision of the financial sector, and a noninterventionist approach to factor markets — would provide an environment that facilitates the flexible adjustment of costs and prices to external shocks, and help minimise the adverse impact. Nevertheless, in view of the likelihood of a persistence of somewhat higher interest rates, the drop in stock prices, and turbulence within the region, the IMF projects that Hong Kong's economic growth could slow to about 4.25% in 1998, which is slightly below the Government's medium range forecast of 5%.

Meanwhile, early signs of a slow-down are emerging, initially from a slack in consumer spending. While investment spending has so far remained strong, consumption expenditure has slowed, with retail sales in July-August growing at a pace of 2.6% in real terms, well below the growth of more than 3% in the first half (Chart 1). Market sources suggest that retail sales have been weak in September and October, partly due to higher interest rates. Recent corrections of asset prices were also a contributing factor.

Chart 1
Retail Sales



External Trade

Export growth has remained sluggish so far this year, partly as a result of weak import demand in several major overseas markets and the strength of the US dollar. In the first nine months of 1997, re-exports grew by 3.7% in value terms, while domestic exports fell by 1.2%. Total exports grew by 3%, compared with 4% in 1996.

On the other hand, import growth continued to outpace exports, accelerating to 5% in value terms in the first nine months, from 3% in 1996. While the visible trade deficit narrowed in August and September (Chart 2), it widened to HK$127.5 billion (10.7% of imports) for the first nine months of this year, compared with $102.2 billion (9% of imports) during the same period last year. However, since a major part of the imports is capital goods, which will help expand the economy's capacity and output, the trade deficit should not be a major concern. Furthermore, the slow-down in exports is partly due to a change in the trade pattern between China and Hong Kong, with a shift from re-exports to transhipments and offshore trade. As a result, the current account balance benefits from rising external service and investment incomes.

On invisible trade, there are also indications that exports of services may have slowed. The number of visitors to Hong Kong fell by 11.9% in the April-August period over a year earlier, whereas the number of Hong Kong residents traveling abroad rose by 7.5% (Chart 3). Nevertheless, exports of services, particularly trade-related services, should show strong growth this year, as reflected by a large increase in airborne and seaborne cargo movements, including transhipments.

While Hong Kong's merchandise exports are expected to benefit from China's further liberalisation of trade, the pace of growth is likely to be constrained by the strength of the Hong Kong dollar and the sharp currency depreciation of most Asian countries which compete with China in the world market. Nonetheless, the invisible trade account should remain in surplus and continue to offset a large part of the visible trade deficit. Offshore trade, exports of professional and business services as well as external factor income should continue to expand.

Labour Market

The job market has tightened somewhat in recent months. As total employment rose faster

Chart 2
Merchandise Trade

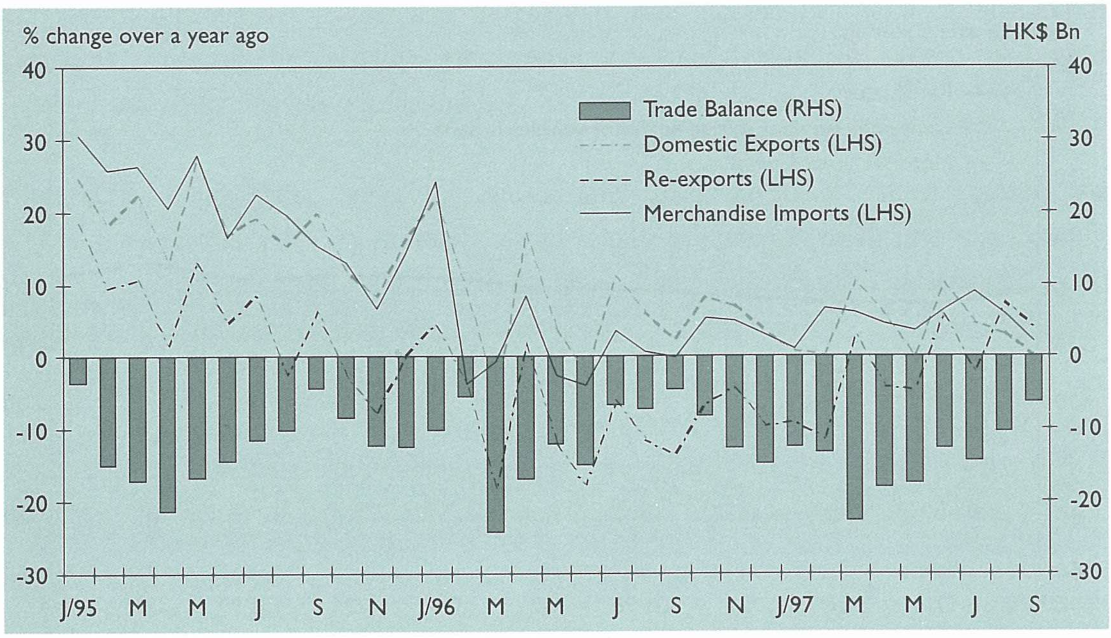
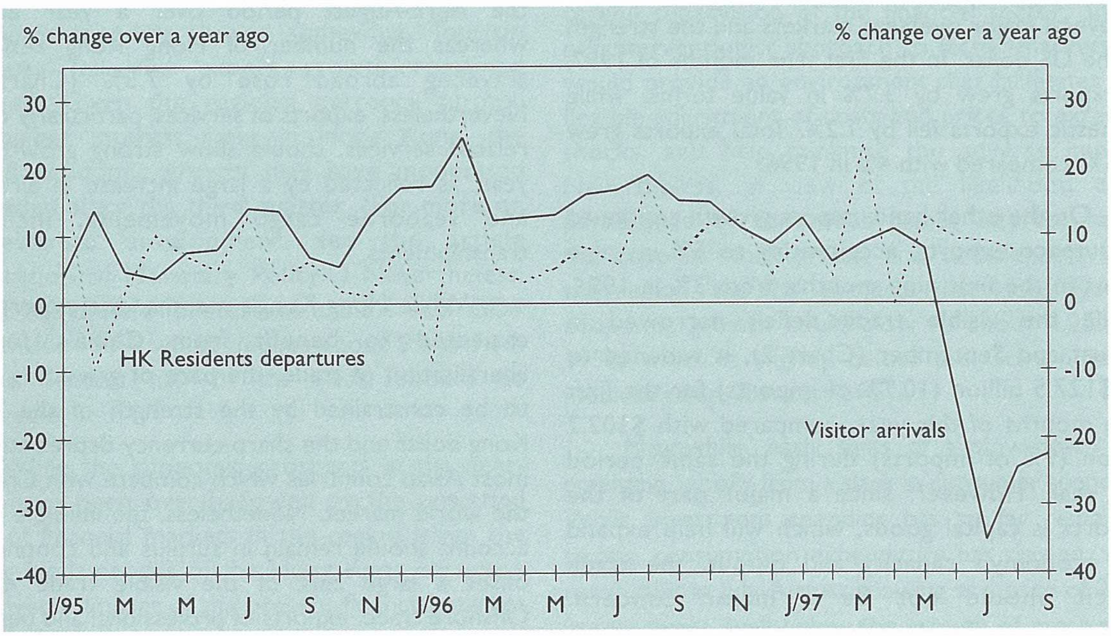


Chart 3
Tourist Industry



than labor supply, the unemployment rate edged down from 2.5% in the first quarter to 2.4% in the second quarter, and fell further to 2.2% in the third quarter.

Inflation

Inflation performance has been somewhat better than expected. Consumer price inflation turned up slightly, from 5.9% in the first half to

6.1% in the third quarter as a result of rising food prices. In the first nine months of the year, the increase in CPI(A) averaged 5.9%. The government's forecast of 6.5% for this year should be within reach, given the benign inflationary environment in our major supplier economies, the strong Hong Kong dollar and moderate consumer spending.

Monetary Situation

Domestic credit grew more moderately in the third quarter, rising by 5.9%, below the 7.4% increase in the second quarter. Residential mortgage loans grew by 9%, after expanding by 9.2% in the second quarter. Lending to stockbrokers and finance concerns also recorded strong growth, boosted by the extremely active stock markets and by new share subscriptions. On the other hand, credit growth in most other sectors slowed. In particular, loans for the manufacturing sector and the wholesale and retail trades fell, while other property-related loans and loans for trade financing moderated.

The growth of broad money, HK\$M3, also moderated somewhat to 21.6% in the twelve months ending September, from an expansion of 23.8% in the twelve months ending June. Likewise, the expansion of narrow money supply, HK\$M1, also slowed to 9.2%, from 15.5% during the corresponding periods.

Asset Markets

In anticipation of new government measures, the residential property market consolidated in August and September prior to the policy address of the SAR Chief Executive. Prices of selected developments were up by 33.3% in the first seven months of 1997, but down by a modest 1% in August and September (Chart 4). The average number of monthly sale and purchase agreements for buildings dropped notably by 43.1% in the third quarter. Following a brief period of renewed vigour in the market after the policy speech on 8 October 1997, sentiment turned negative with the depreciation of Asian currencies and the decline of stock markets. Prices have since fallen and the volume of transactions shrunk.

The stock market was extremely volatile, with the Hang Seng Index rising to over 16,000 in early August and then falling below 9,000 in late October, before recovering somewhat in early November. Market sentiment was highly negative as interest rates rose sharply. The turnover decreased, along with a weakening of investors' interest.

– Prepared by the External Department

Chart 4
Property Prices and Turnover

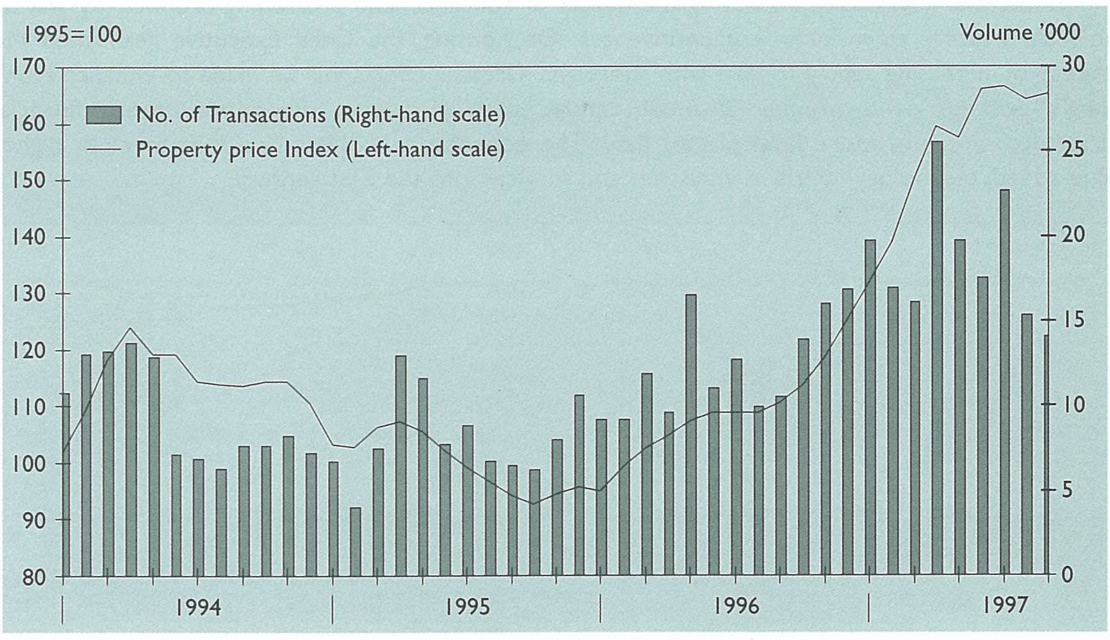
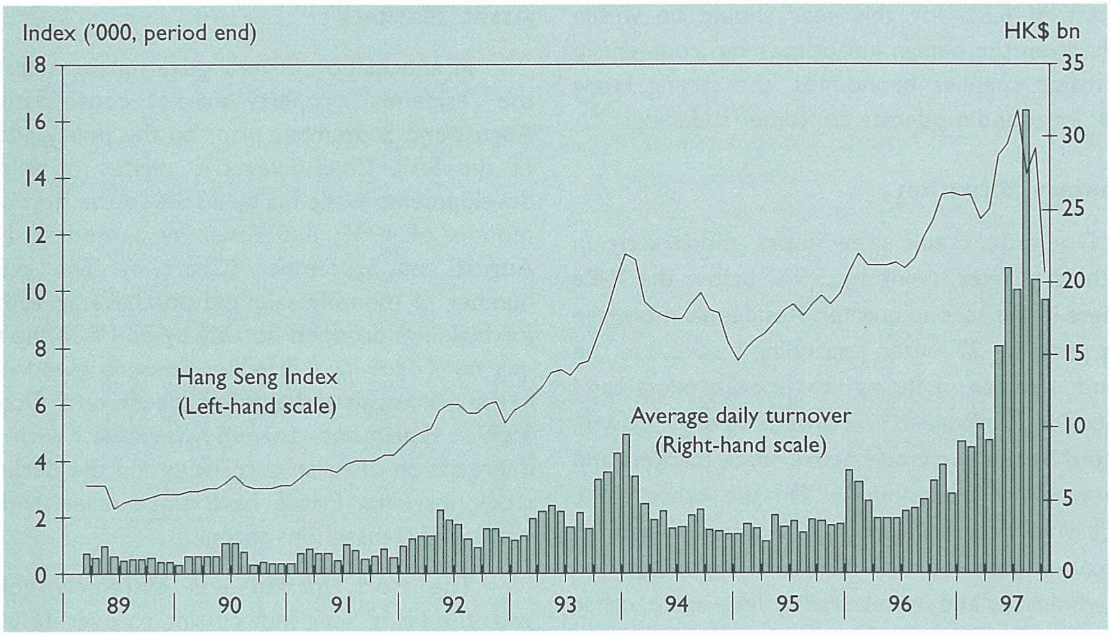


Chart 5
Hang Seng Index and Stock Turnover



The First Policy Speech of the SAR Chief Executive

In his maiden policy speech on 8 October, the SAR Chief Executive unveiled a blueprint for Hong Kong's future direction. The policy address is comprehensive, covering all major aspects of the economy, including housing, industry, services, labour, infrastructure, social welfare and education. He put considerable emphasis on continuity, business friendliness and Hong Kong's competitiveness. In particular, the pledge to maintain a free market economy and keep the tax regime simple and predictable was welcomed by the market.

Under the new policy, improving the quality of education and promoting productivity will be the main strategy to maintain competitiveness. On housing, the Chief Executive reaffirmed the strategy of increasing supply to deal with shortages. Greater efforts will be made to enhance Hong Kong's position as a premier financial centre, through better supervision, more financial infrastructure, and a more level playing field. The economy is expected to shift towards higher value-added, technology-intensive industries and services into the 21st century.