

## DOMESTIC ENVIRONMENT

*The Hong Kong economy experienced a sharp slowdown in the first quarter, beset by a deteriorating external environment, weak domestic demand and tight liquidity. Prospects for the rest of the year would continue to be affected by the volatile external environment and slackening domestic demand. The reduction in air cargo business due to the airport problems would also affect third-quarter performance.*

*Nevertheless, the Hong Kong economy is adjusting rapidly to restore competitiveness. Property prices and rents have fallen sharply from last October's peak. Real wages in the manufacturing sector and some services sectors such as retail, hotel and catering are declining. To relieve the pain, the HKSAR Government has launched a series of supply side and fiscal measures that aim at improving employment, stabilizing the property market and easing the credit crunch. While the external environment remains volatile, these stimulative measures would help stabilize the domestic economy in its adjustment process.*

### Domestic Activity

The Hong Kong economy slowed sharply in the first half, beset by adverse external environment and fall in local asset prices. Local consumer spending weakened considerably while overall investment spending shrank. Inbound tourism has further weakened in the first quarter. These adverse developments were initially triggered by external shocks but they have by now generated their own momentum, bringing the economy to a sharp slowdown. Real GDP contracted by 2.8% in the first quarter.

The economic contraction was broad-based. Private consumption, which used to be the mainstay of economic growth and accounted for about 60% of 1997 GDP, fell by 2.5% during the first quarter. It continued to shrink in the face of weak external environment and higher real interest rates, although at a more moderate pace in recent months despite aggressive price cuts by retailers. During April to May, retail sales fell by 16.1% year-on-year, compared with a 14.5% drop in the first quarter. Consumer sentiment was depressed by fallen income, rising unemployment and depleted wealth amid a slump in asset prices.

Gross domestic fixed capital formation, the second largest component in GDP, also fell by 2.2% year-on-year in the March quarter. The fall was mainly attributable to the unfavorable business environment and uncertainty over the developments in the region. Expenditure on machinery and equipment fell by 7.5%. Although building activities in the private sector registered a robust 15.4% growth in the first quarter, such activities are expected to slow significantly in the near future when developers finish their existing projects. Consents to commence building work have already declined sharply. Moreover, as the new airport related projects were near completion and major infrastructure projects have not started yet, investment spending is unlikely to see significant recovery. This will also slow the rate of growth of imports.

### External Trade

Hong Kong's export performance moderated sharply in the first quarter, but the pace of moderation slowed down in the second quarter. During the first quarter, total exports fell by 0.9% year-on-year compared with a 7.4% growth in the fourth quarter of 1997. Exports fell by 3.1% in the

## GDP by Components ( at constant 1990 market prices)

(% y-o-y, unless stated otherwise)

	1996		1997				1998	
	Overall	Q1	Q2	Q3	Q4	Overall	1Q <sup>P</sup>	
Private Consumption Expenditure	4.7	4.5	8.6	11.1	3.0	6.7	-2.5(-1.5)	
Government Consumption Expenditure	4.0	4.6	5.6	-0.1	-0.4	2.4	2.5(+0.2)	
Gross Domestic Fixed Capital Formation	10.8	19.8	16.9	13.9	13.8	16.0	-2.2(-0.8)	
Change in Inventories	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.(-2.8)	
Domestic Exports of Goods	-8.4	-3.9	-0.1	6.0	5.6	2.1	-4.7	
Re-exports of Goods	7.5	5.5	7.3	4.2	10.3	6.8	2.5	
Imports of Goods	4.3	6.4	6.9	7.1	8.2	7.2	-1.7	
Net Domestic Export of Goods (HK\$bn)	-302.5	-84.1	-90.8	-80.3	-82.3	-337.5	-75.2(+4.6)	
Net Re-exports of Goods (HK\$bn)	194.6	44.8	51.3	55.4	56.3	207.9	45.9(+0.6)	
Exports of Services	8.5	4.9	2.7	-3.6	-6.0	-0.6	-9.2	
Imports of Services	2.5	5.5	0.3	6.2	4.9	4.3	2.7	
Net Exports of Services (HK\$bn)	86.6	19.5	22.8	17.7	19.8	79.7	13.6(-3.0)	
<b>GDP</b>	<b>4.6</b>	<b>5.7</b>	<b>6.9</b>	<b>6.0</b>	<b>2.7</b>	<b>5.3</b>	<b>-2.8(-2.8)</b>	

Note: <sup>P</sup> : Preliminary estimates

( ) : % Contribution to growth

second quarter compared with a year earlier. Exports to Japan and crisis countries in Asia registered the largest decline while intake from the mainland, our major market, also fell. However, total exports to such other markets as the US and

the UK continued to register respectable growth of 4.7% and 11.4% respectively.

In line with weak domestic consumption and investment, imports fell by 5.1% and 6.1% year-on-

Chart 1  
External Trade

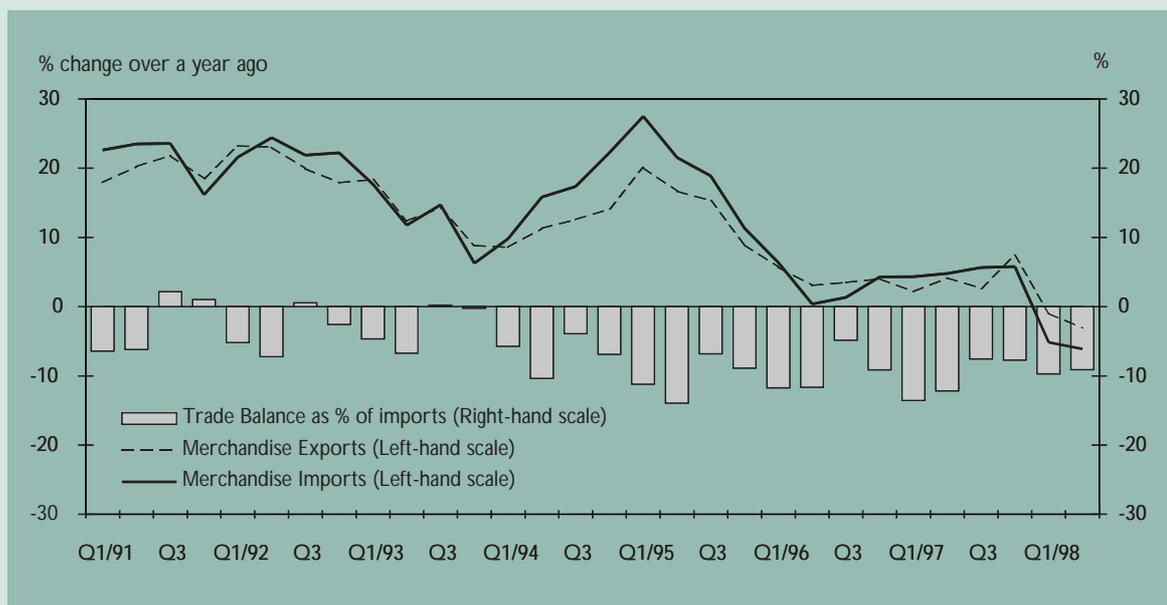
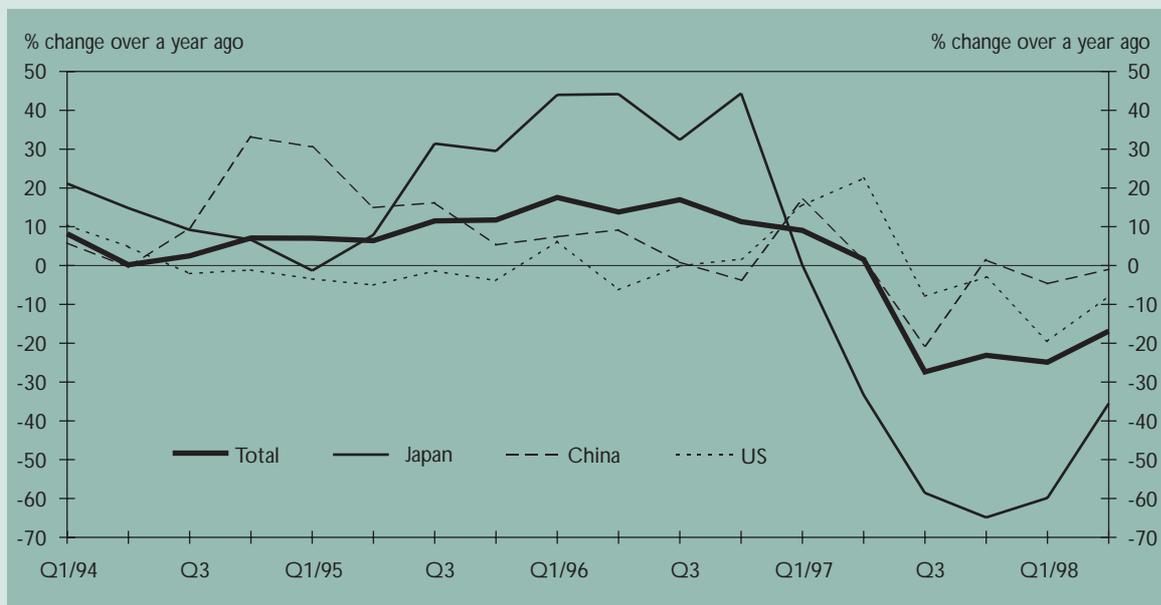


Chart 2  
Tourism



year respectively in the first and second quarter. The faster decline in imports vis-a-vis exports has resulted in an improvement in trade balance. In the first half of 1998, trade deficit shrank by 30% compared with the same period last year to HK\$67.2 billion. The reduction in domestic absorption reflected that the economy is highly flexible and able to adjust quickly to changes in the external trade environment.

Meanwhile, exports of services fell for the third straight quarter, mainly attributable to the continued weakness in inbound tourism. Nonetheless, the slump in tourist arrivals appeared to have stabilized, as visitor arrivals declined at a less rapid pace during the second quarter (Chart 2). The falls in visitors from Japan, the US and the Mainland, which together account for nearly half of Hong Kong's tourist arrivals, have moderated. Imports of services continued to rise in the first quarter despite the economic downturn. The services account balance might deteriorate further in the second quarter as outbound trips by Hong Kong residents rose markedly, taking advantage of weaker currencies in neighbouring countries.

## Labor Market and Inflation

The unemployment rate climbed to a 15-year high of 4.8% in the three months ending July from 3.5% in the first quarter. Many employers are reducing their outlay by downsizing their workforce or cutting wages in view of the uncertain business outlook. This will continue to put pressure on the unemployment level. Wage growth also softened to 0.3% in real terms in the first quarter compared with the same period last year. Real wages in the manufacturing sector and such services sectors as retail, hotel and catering registered some decline.

Rising unemployment, coupled with asset deflation and flagging domestic demand have constrained consumer price inflation. Composite CPI rose by 4.0% by June, the lowest increase in 11 years. The easing in inflation was found in all components of the Composite CPI. Prices of durable goods and clothing and footwear were flat compared to a year earlier. The moderation in the prices of services components and rent was also notable. In line with the decline in asset prices, we expect inflation to moderate further in the months ahead.

## Monetary Situation

Having risen by 1.4% during the first quarter, broad money supply, HK\$M3, was flat in growth 0.2% during the second quarter. The moderation in domestic credit contributed to the flat growth in HK\$M3. Owing to slowing economic activity and a cautious lending attitude adopted by banks, domestic credit contracted by 0.2% during the June quarter, having shrunk by 1.2% in the March quarter. Whilst lending to most business sectors continued to fall, property-related loans, which account for 45.8% of domestic loans, increased during the second quarter. Most of this was attributable to the increase in residential mortgages.

Towards the end of the second quarter, liquidity started to ease. In June, HK\$M3 rose by 0.8% over the preceding month. The rise in HK\$M3 during June was largely due to the 22 June announcement of the exemption of the profits tax on interest income derived from corporate deposits. The measure has encouraged repatriation of offshore funds, thereby improving liquidity in the banking sector. Meanwhile, the narrow money supply, HK\$M1, fell for four quarters in a row, down by 8.3% in the second quarter. This reflected the continued weakness in consumption and other economic activities, lower transaction demand for money and the impact of higher interest rates on fixed deposits relative to current account and savings deposits.

## Asset Markets

Following a brief period of stabilization in March and April, the stock market adjusted further between June and August. Growing concerns over the deteriorating external environment as well as poor earnings results announced by domestic corporations exerted downward pressure on the stock market. Market sentiment was further depressed by the heavy selling of the HK dollar amid rumors about the stability of RMB exchange rate. The HSI plunged below 7,000 level in mid-August.

Meanwhile, residential property prices continued to adjust downward, falling by 40% from the October 1997 high. Current property prices were just 8% above their previous trough in

October 1995. Rents for residential premises likewise declined by more than 10% from the peak. However, the actual decline in rents could be more pronounced than the reported rent cuts. Landlords are beginning to offer rent-free period to cutting nominal rents. This practice is very common in new contracts for office premises.

## Short-term Outlook

The short-term outlook would continue to be clouded by a number of factors. Externally, the regional financial crisis does not appear to have fully run its course. Uncertainty over the yen exchange rate and worries about the ailing Japanese economy continue to overhang regional currencies and financial markets. Despite its buoyancy, the US economy, one of our major markets, is also likely to ease in growth in the second half. Domestically, the third quarter performance would be impeded by the temporary cargo disruption at the new airport, which is officially estimated to result in a loss amounting to 0.35% of GDP. Furthermore, the negative wealth effect stemming from the current compression in asset prices would continue to dampen consumption and investment. The situation would be compounded by problems such as growing unemployment, high real interest rates and tight liquidity.

The HKSAR government has already implemented a series of relief measures to stimulate the economy (see box). These would help ease the pains arising from the downward economic adjustment and boost the economy by promoting tourism, stabilizing property prices, easing liquidity tightness and reducing unemployment. The impact of some of these measures is gradually filtering through the economy. ☎

### Measures Introduced on May 29, 1998

#### **Credit and Liquidity**

1. Develop the **Hong Kong Dollar Repurchase market** by making use of high quality debt securities held by banks as collateral for repo transactions. This can facilitate more active interbank lending at the longer end.
2. Streamline the mortgage purchase programme of the Hong Kong Mortgage Corporation and introduce a **Forward Commitment Facility** to purchase mortgages from commercial banks. This can help banks manage their cash flow and new loan business more effectively.

#### **Property Market**

3. Extend the pre-sale period of uncompleted flats from the present 15 months to 20 months and suspend anti-speculative measures implemented earlier. This can help developers' liquidity and achieve a soft landing in the adjustment process.

#### **Tourism**

4. Simplify the entry requirements and procedures to facilitate Taiwanese travellers visiting Hong Kong.
5. Increase the quota for visitors from the Mainland under the 'Hong Kong Travel' Group tour scheme by 30%.
6. Develop new tourist attractions such as the construction of a cable-car to the giant Buddha statue.

### Measures Unveiled on June 3, 1998

#### **Job Creation**

1. Hasten spending on minor maintenance works.
2. Advance public works projects.
3. Expand and speed up district environmental improvement projects.

#### **Improve employment and job matching services provided by the Labor Department**

4. Strengthen job-matching programmes.
5. Provide a phone job-matching and vacancy-processing service.
6. Provide more touch-screen computers to facilitate job seekers to access vacancy information.
7. Launch an employment information and promotion programme to canvass vacancies.

#### **Enhance vocational training and employees retraining**

8. Create a "one-stop" service unit to help employers and the unemployed at the Employees' Retraining Board.
9. Provide a 9-month training for 1,000 unemployed.

#### **Promote further education**

10. Increase capacity of postgraduate courses at universities by up to 1,000.
11. Extend loan scheme to benefit more tertiary students.

#### **Combat illegal employment**

12. Amend Immigration Ordinance to hold construction site controllers liable for illegal workers.

**Measures Announced on June 22, 1998**

**Credit and Liquidity**

1. Exempt interest earned locally from profit tax, aiming to provide some \$200 billion in liquidity for the banking sector through repatriation of offshore deposits.
2. Set up a \$2 billion capital to help non-export related small and medium enterprises obtain loans.

**Property Market**

3. Suspend land sales until end-March 1999 and freeze Private Treaty Grants for sandwich class housing sites.
4. Provide \$3.6 billion to double the number of households eligible for the Home Starter Loan to 12,000.
5. Increase the quota for the Home Purchase Loan Scheme from 4,500 to 10,000.

**Families and Business**

6. Rebate rates of \$3.88 billion.
7. Cut duty on diesel by 30% up to end-March 1999.
8. Reduce declaration charges for by importers and exports.

**Salary Freeze for Senior Government Officials**

9. Freeze 1998/99 pay adjustment for about 330 directorate officials at D3 level or above.