THE DOMESTIC ENVIRONMENT

The Hong Kong economy continued to contract in the second quarter. While investment expenditure recorded modest growth on a year-on-year basis, consumer spending has weakened considerably and the fall in exports accelerated. However, as imports dropped more rapidly, there was a significant improvement in the merchandise trade balance.

While the economic contraction appears to have continued in the third quarter, since early September there has been a general improvement in market sentiment. In particular, falling interest rates and improved liquidity have helped stabilize asset markets and revive consumer spending. If these favourable developments continue, it is likely that the economy will bottom out next year. However, with weak employment, high real interest rates and a subdued external environment, any recovery is likely to be moderate.

Domestic Activity

Hong Kong's economic adjustment, triggered by the Asian financial turmoil, continued in the second quarter, with real GDP shrinking by 5.2% after a 2.7% decline in the first quarter. For the first half of the year, real GDP has contracted by 4% from the level of the same period last year. Table 1 summarizes the growth in GDP by components.

The economic contraction in the second quarter was mainly due to sluggish consumption and weak export demand. Private consumption expenditure plunged by a sharp 5% in the period after a 2.5% drop in the first quarter, the first-ever

Table 1 : GDP by Components (at constant 1990 market prices)

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

	1996	1997				1998		
	Overall	Q1	Q2	Q3	Q4	Overall	Q1	Q2^P
Private Consumption Expenditure	4.7	4.5	8.6	11.1	3.0	6.7	-2.5	-5.0 (-3.0)
Government Consumption Expenditure	4.0	4.6	5.6	-0.1	-0.4	2.4	2.1	-5.2 (-0.4)
Gross Domestic Fixed Capital Formation	10.8	19.8	16.9	13.9	13.8	16.0	-1.5	1.9 (+0.8)
Change in Inventories	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Domestic Exports of Goods	-8.4	-3.9	-0.1	6.0	5.6	2.1	-4.7	-0.6
Re-exports of Goods	7.5	5.5	7.3	4.2	10.3	6.8	2.5	-0.5
Imports of Goods	4.3	6.4	6.9	7.1	8.2	7.2	-1.7	-1.8
Net Domestic Exports of Goods (HK$ bn)	-302.5	-84.1	-90.8	-80.3	-82.3	-337.5	-75.2	-85.6 (+2.6)
Net Re-exports of Goods (HK$ bn)	194.6	44.8	51.3	55.4	56.3	207.9	45.9	51.0 (-0.1)
Exports of Services	8.5	4.9	2.7	-3.6	-6.0	-0.6	-9.0	-6.9
Imports of Services	2.5	5.3	0.0	6.0	4.7	4.1	2.6	5.0
Net Exports of Services (HK$ bn)	86.6	19.6	22.8	17.8	19.8	80.0	13.8	17.5 (-2.6)
GDP	**4.6**	**5.7**	**6.9**	**6.1**	**2.8**	**5.3**	**-2.7**	**-5.2**

Note: ^{P} : preliminary estimates
( ) : % contribution to growth

consecutive quarterly decline since statistics became available from 1974. Weak private consumption was mainly a result of increased job uncertainty, growing pressure on wage adjustment, and negative wealth effects arising from the sharp fall in asset prices.

Consumer spending is likely to have fallen further in the third quarter, with retail sales in July-August decreasing by 18.5% year-on-year in real terms after a 15.3% fall in the first half. Nevertheless, since September, there has been a general improvement in consumer sentiment, with stock prices rising sharply and property prices reviving somewhat. If favourable market sentiment is sustained, the decline in private consumption expenditure should start to slow in coming months.

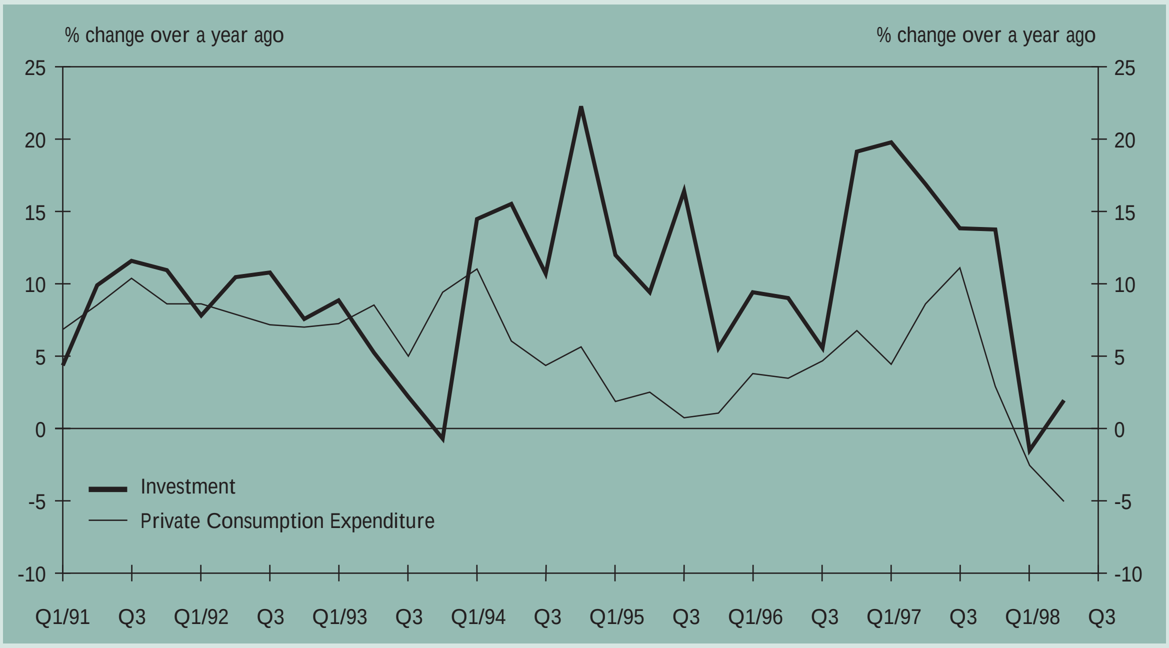
Meanwhile, gross domestic fixed capital formation recorded a modest 1.9% increase in the June quarter. This growth partly reflected the acceleration of existing projects by real estate developers (so that the properties could be sold earlier) in their bid to improve cash flows. The 2.2% growth in private sector construction expenditure was, however, smaller than the 5.3% growth rate observed in the first quarter, as fewer new projects were added to existing building programmes. At the same time, public construction also expanded by 1.2% due to increased public housing activity. Meanwhile, spending on machinery and equipment rose by 5.5% year-on-year in the second quarter, after a 7.5% fall in the first quarter, as the installation of machinery and equipment was speeded up to meet the opening of the new airport in July. With high real interest rates, fixed capital formation is likely to have slid in the third quarter. Building activity in the private sector should have slowed further as property developers refrained from starting new projects, while expenditure on machinery and equipment likely fell as corporate profits were trimmed.

External Trade

Exports declined further in the third quarter due to weak regional demand and disruptions in air cargo transport when the new airport started operation in July. After falling by 2.1% in the first half of the year, total exports dropped sharply by 10.3% in the third quarter, with domestic exports falling by 11.9% and re-exports by 10.1%.

Chart 1

Private Consumption Expenditure and Investment



With weak domestic demand and sluggish re-exports, imports have fallen by a marked 15.5% during the third quarter, after a 5.7% drop in the first half. As the decline in imports was much larger than the fall in total exports, the visible trade deficit improved significantly to HK$6.1 billion in the third quarter, from HK$31.0 billion in the same quarter a year ago.

Due to a weak external sector and continued falls in tourist arrivals, exports of services suffered another setback in the June quarter, falling by 6.9% after a decline of 9% in the first quarter. In the third quarter, the fall in service exports may have moderated as inbound tourism appears to have shown some signs of bottoming out, with visitor arrivals picking up. The performance of other service exports such as transportation, banking, finance, insurance and offshore trade likely remained weak, however.

Labour Market and Inflation

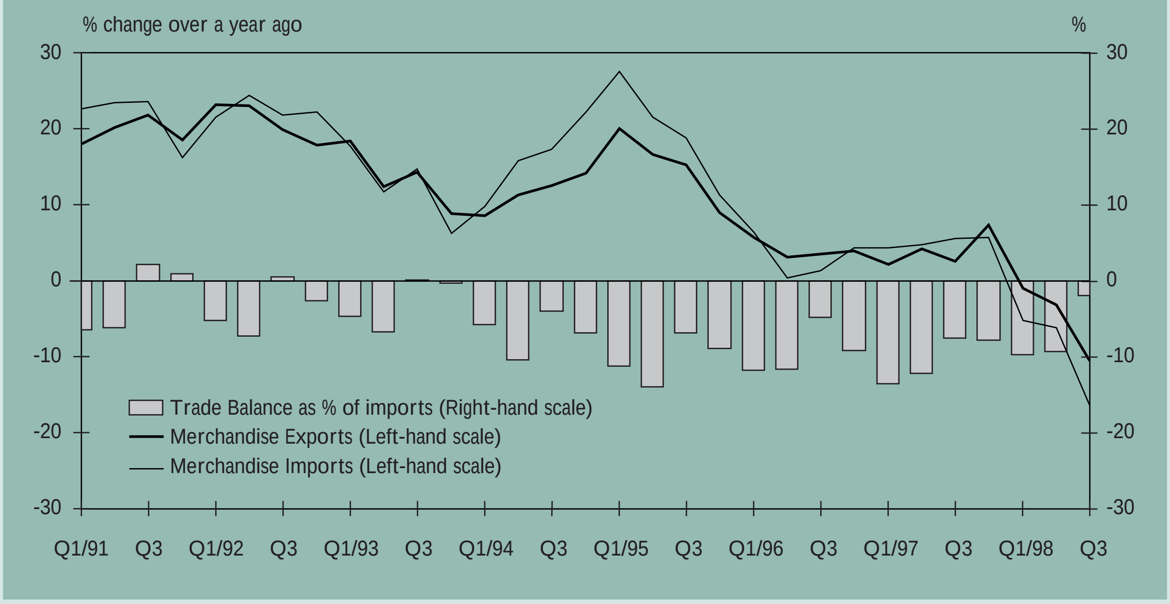
As corporates streamlined their operations to cope with the current economic downturn, the unemployment situation has been deteriorating since February, with the unemployment rate rising to 5.3% in the three months ending in October. The increase in unemployment was concentrated in such sectors as construction, manufacturing, retail, restaurants and hotels. As Hong Kong is experiencing ongoing economic adjustments, it is possible that the unemployment rate may rise further in the coming months. In view of deteriorating labour market conditions, wages are likely to face more downward pressure.

Prices have been responding quickly to the shrinkage in domestic demand. The Composite CPI, a broad measure of consumer price inflation, increased by a year-on-year 2.5% in September, much slower than rises of 4.4% and 2.9% in the second quarter and July-August respectively. The easing in consumer price inflation was across the board, with notable moderations in service charges and rents. With domestic demand remaining weak, inflation is expected to ease further.

Monetary Conditions

After registering 0.2% growth in the second quarter, HK$M3 rose by a strong 5.2% during the third quarter, partly due to a drawdown of the fiscal surplus from the Exchange Fund. In contrast

Chart 2
External Trade



to the growth in HK$M3, domestic loans contracted further by 1.9% in the September quarter, after a drop of 0.2% in the previous quarter, as banks remained cautious in lending and credit demand weakened. Lending to most sectors continued to decline, with the exception of residential mortgage loans which grew by 1.7% in the third quarter, having increased by 2.8% in the June quarter. Meanwhile, offshore lending dropped sharply by 13.7% in the September quarter, largely due to a further fall in Euroyen Impact Loans, which account for more than 30% of total loans in the banking system. The contraction in Euroyen Impact Loans should have little impact on Hong Kong's economic activity and credit situation, as Hong Kong serves mainly as a booking centre for these loans.

Since the latter part of the September quarter, the liquidity of the banking sector has improved, with strong growth in HK$ deposits, partly due to the repatriation of offshore funds by corporates following the exemption from the profits tax on interest income derived from these deposits. The introduction of the HKMA's seven technical measures in September to strengthen the currency board arrangement and reduce interest rate volatility have also helped improve liquidity. As HK$ deposits rose but HK$ loans fell, the HK$ loan-to-deposit ratio improved from 111.5% at end-June to 104.0% at end-September.

Asset Markets

Stock prices have been on an uptrend since mid-August, boosted by falling interbank interest rates, as the "risk premium" of Hong Kong's interest rates fell considerably. This followed the government's intervention to counteract speculators' double-play in the markets and the introduction of seven technical measures to strengthen the currency board system. Local interest rates have also softened on recent cuts in US interest rates. Having fallen to a trough of 6,660 on 13 August, the HSI rebounded by 57.8% to 10,508 on 4 November, and has since traded around the 10,000 level. Meanwhile, market turnover also increased, rising from HK$4.0 billion per day in July (prior to Government's intervention in the stock market) to over HK$12 billion in early November; but it has since fallen to just over HK$6 billion in the week of 9 November.

Recent housing measures, in particular the suspension of land sales until April next year, have helped alleviate markets' fears over an oversupply of housing in the near to medium term. This, coupled with the fall in interest rates and improved liquidity in the financial system, has supported a moderate revival in the housing market in October, with residential property prices rising slightly and the number of transactions up by almost 50%.

Short-term Outlook

There has been a general improvement in market sentiment since September, underpinned by lower interest rates and improved liquidity. These factors have helped stabilize asset markets and should have some positive impact on domestic demand. Provided these favourable factors are sustained and barring any major unexpected shocks, there is a reasonable chance that the economy will bottom out early next year. Nevertheless, with weak employment, high real interest rates and less sanguine external environments, any recovery is likely to be moderate.

- Prepared by the Research Department