

DOMESTIC AND EXTERNAL ENVIRONMENT

Signs of recovery became more evident in Hong Kong and the regional economies in recent months. Domestically, the unemployment rate levelled off. Retail sales and tourist arrivals picked up. Asset markets stood up well in the face of the increase in US interest rates. Nevertheless, investment activity remained subdued. Barring unexpected external shocks, the economy is expected to register a moderate recovery in the second half of the year.

External Environment

Against robust growth in the US economy and a spike in consumer price inflation in April, the US Federal Reserve raised the Fed Funds Target Rate by 25 basis points to 5% on 30 June. The US and Asian financial markets responded with relative calm, as the interest rate hike had been widely expected. The accompanying announcement by the Federal Reserve that it had shifted from a tightening bias to a neutral monetary policy stance brought some relief to the US bond and stock markets. In Hong Kong, following the rise in US Fed Funds Target Rate, the Base Rate of the Discount Window was automatically adjusted upwards by 25 basis points to 6.5%¹. Nevertheless, given ample liquidity in the banking system, banks left the best lending rate unchanged at 8.25%.

Turning to the regional economies, economic recovery gathered momentum, though the strength of the rebound varies considerably among individual economies. Japan registered a strong seasonally adjusted quarterly GDP growth of 1.9% in real terms in the first quarter, raising hopes that the economy is coming out of its protracted recession. Following four quarters of economic contraction, Korea achieved an impressive quarterly growth of 4.6% in the first quarter. Growth in Thailand has been positive on a quarter-on-quarter basis since the fourth quarter of 1998. On the other hand, the Mainland's economy recorded a mild slowdown during the first half of 1999: real GDP growth decelerated from 8.3% in the first quarter to 7.6% in the second quarter. Benefiting from the recovery in the Asian economies in general, total exports from Hong Kong to Asia (excluding the

Mainland) increased by 0.4% in the April-May period, compared with a decline of 3.4% in the first quarter.

Supported by an improvement in economic prospects, the Japanese yen stayed firm during the second quarter. The euro, on the other hand, depreciated by around 3.5%, as economic activity in Europe remained relatively subdued. With a view to stimulating activity, the European Central Bank cut its repo rate by 50 bps in April, to 2.50%. Reflecting the divergent performance of the Japanese yen and the euro, the overall exchange value of the Hong Kong dollar, as measured by the effective exchange rate index, was almost unchanged comparing end-June with end-March. However, comparing end-June 1999 with a year ago, the index depreciated by 2.9%. It has declined further in July along with a weakening of the US dollar against the Japanese yen and the euro. This should help improve the price competitiveness of Hong Kong's exports.

Further afield, there were renewed uncertainties in Latin America. While the contagion effect of the Brazilian crisis was more limited than originally envisaged, financial markets in Latin America were impacted in mid-May by the expectation of Fed tightening, and were further disturbed by rumours of a possible debt moratorium in Argentina. These uncertainties reversed the declining trend in Brady bond yields and triggered a substantial correction in stock prices. Nevertheless, as economic and financial linkages between Hong Kong and Latin America are quite limited, Hong Kong's financial markets have not been significantly affected by these developments.

¹ The Base Rate is set at the higher of the following: Simple average of the 5-day moving averages of overnight and one-month HIBORs; and US Fed Funds Target Rate plus an adjustment factor (presently set at 150 basis points).

Domestic Activity

While a broad-based recovery in activity has yet to emerge, there are signs that the Hong Kong economy is bottoming out. Following a 5.7% decrease in the last quarter of 1998, real GDP declined at a year-on-year rate of 3.4% in the first quarter of 1999 (Table 1). On a seasonally adjusted quarter-on-quarter basis, the pace of decline in real GDP moderated from 0.6% in the

Asian crisis-hit economies are occurring against the background of deeper and earlier recessions than in Hong Kong.

Having declined by a year-on-year rate of 9.1% in the fourth quarter of 1998, private consumption expenditure fell moderately by 4.8% in the first quarter of 1999. Lower interest rates, coupled with steady recovery in asset markets, lent

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

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

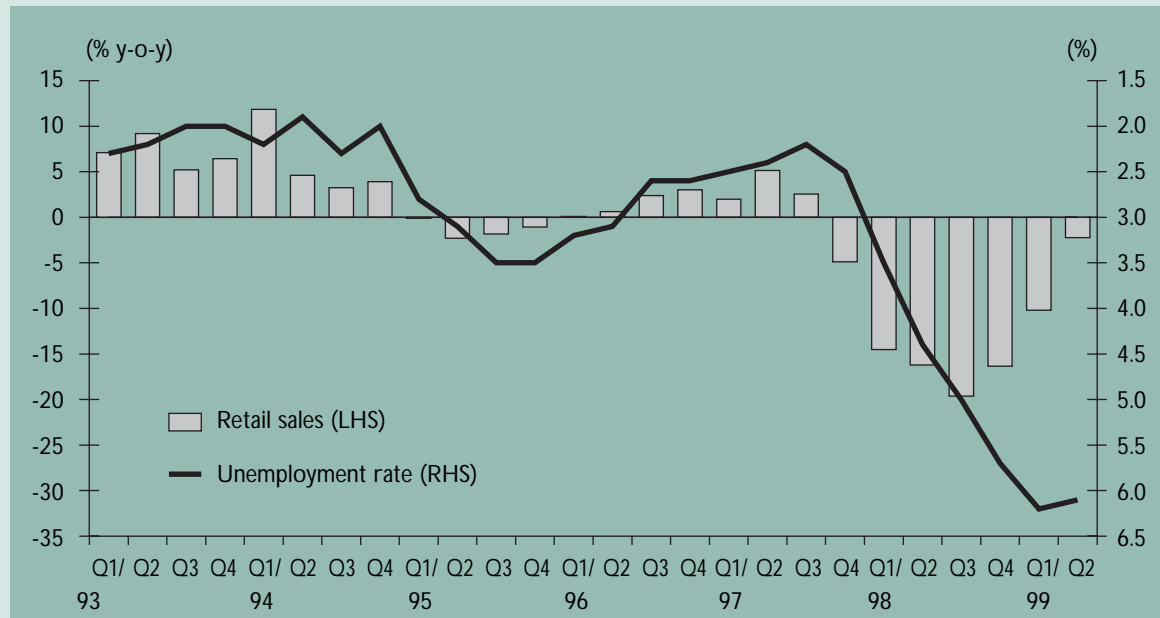
	1997	1998					1999
	Overall	Q1	Q2	Q3	Q4	Overall	Q1
Private Consumption Expenditure	6.7	-2.5	-5.0	-10.0	-9.1	-6.7	-4.8 (-3.0)
Government Consumption Expenditure	2.4	2.1	-5.3	3.8	2.5	0.7	4.4 (+0.4)
Gross Domestic Fixed Capital Formation	15.6	-1.2	5.6	-9.1	-20.5	-6.6	-24.4 (-9.5)
Change in Inventories	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a. (-2.1)
Domestic Exports of Goods	2.1	-4.7	-0.6	-9.4	-15.5	-7.9	-9.1
Re-exports of Goods	6.8	2.5	-0.5	-6.6	-8.6	-3.7	-4.1
Imports of Goods	7.2	-1.7	-1.8	-10.5	-13.5	-7.2	-10.3
Net Domestic Exports of Goods (HK\$ bn)	-307.8	-68.6	-78.3	-53.4	-51.6	-251.9	-47.1 (+11.3)
Net Re-exports of Goods (HK\$ bn)	178.2	39.4	43.8	44.4	44.1	171.6	37.8 (-0.9)
Exports of Services	-1.0	-10.1	-11.4	-4.4	-0.2	-6.5	1.4
Imports of Services	3.6	1.1	1.6	-2.6	-2.0	-0.6	-0.2
Net Exports of Services (HK\$ bn)	79.0	13.4	15.5	16.4	20.4	65.7	14.1 (+0.4)
GDP	5.3	-2.6	-5.1	-6.8	-5.7	-5.1	-3.4 (-3.4)

Note: () : Contribution to % change in GDP

fourth quarter of 1998 to 0.3% in the first quarter of 1999. Set against positive quarterly growth in some other regional economies, the continued contraction in real GDP, though moderating, painted an unfavourable picture of Hong Kong's relative cyclical performance. Nevertheless, recoveries in

support to consumer demand. The latest statistics on retail sales suggested that consumption demand continued to improve in the second quarter. The year-on-year decline in the volume of retail sales moderated notably to 3.3% and 1.2% respectively in April and May, compared with a decline of 10% in

Chart 1
Retail Sales and Unemployment Rate



Note: Retail sales volume for the second quarter is the average of April and May figures.

the first quarter (Chart 1). On a month-on-month basis, retail sales started to register positive growth in March 1999.

Private sector investment activity remained sluggish, however. Following a year-on-year decline of 20.7% in the fourth quarter of 1998, private investment fell by 27.6% in the first quarter of 1999. Building and construction activity continued to be weak, reflecting the impact of the earlier setback in the property market. Investment in machinery and equipment fell substantially as the uncertain business outlook continued to impede new investment.

External Trade

Along with steady growth in the US and a gradual recovery in Asian economies, the year-on-

year decline in Hong Kong's exports in the second quarter, of 5.9%, was more moderate than the fall of 9.0% in the preceding quarter (Chart 2). Exports to the US registered a positive year-on-year growth rate of 0.2% in the April-May period, reversing three consecutive quarters of decline, while exports to Japan and China recorded smaller declines. Partly reflecting subdued private investment activity, imports contracted by 11.3% year-on-year in the second quarter, compared with 13.8% in the previous quarter. As the decline in imports outpaced that of exports, the merchandise trade deficit narrowed to HK\$12.2 bn in the second quarter of 1999, compared with a deficit of HK\$12.9 bn in the preceding quarter and HK\$34.7 bn in the same quarter of last year.

On invisible trade, exports of services recovered further, along with the pick-up in inbound tourism. Tourist arrivals rose by a year-on-year rate of 9.5% in the second quarter, following an increase of 13.4% in the first quarter (Chart 3).

Increases were reported in arrivals from the Mainland, Taiwan, and South East Asia. On the other hand, imports of services fell marginally by 0.2% in the first quarter of 1999.

Chart 2
External Trade

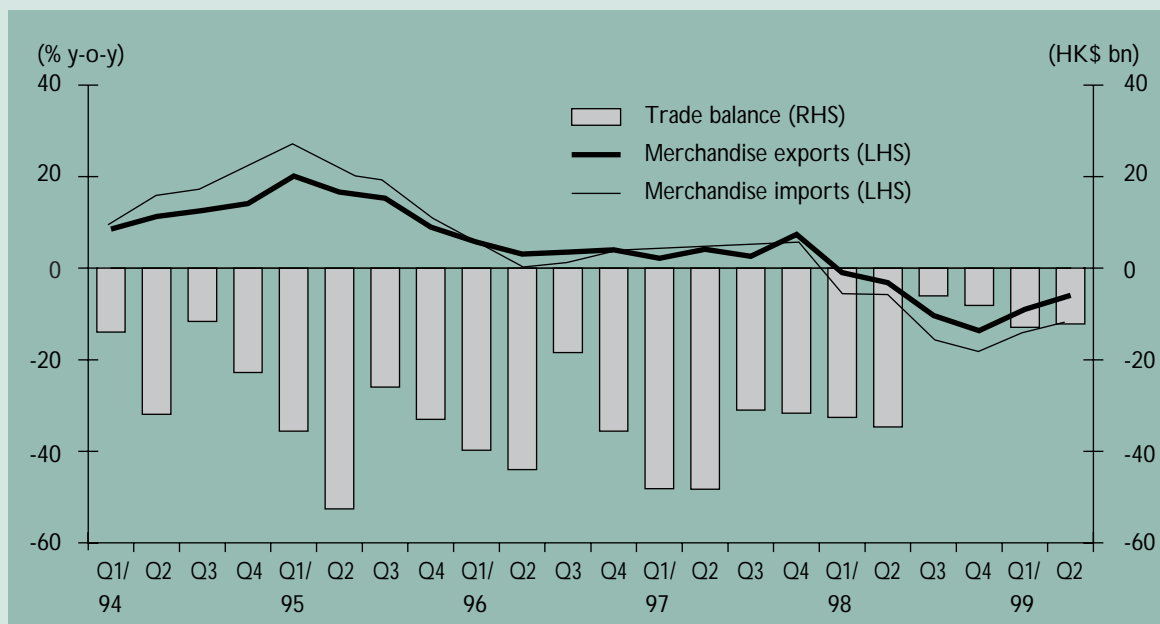
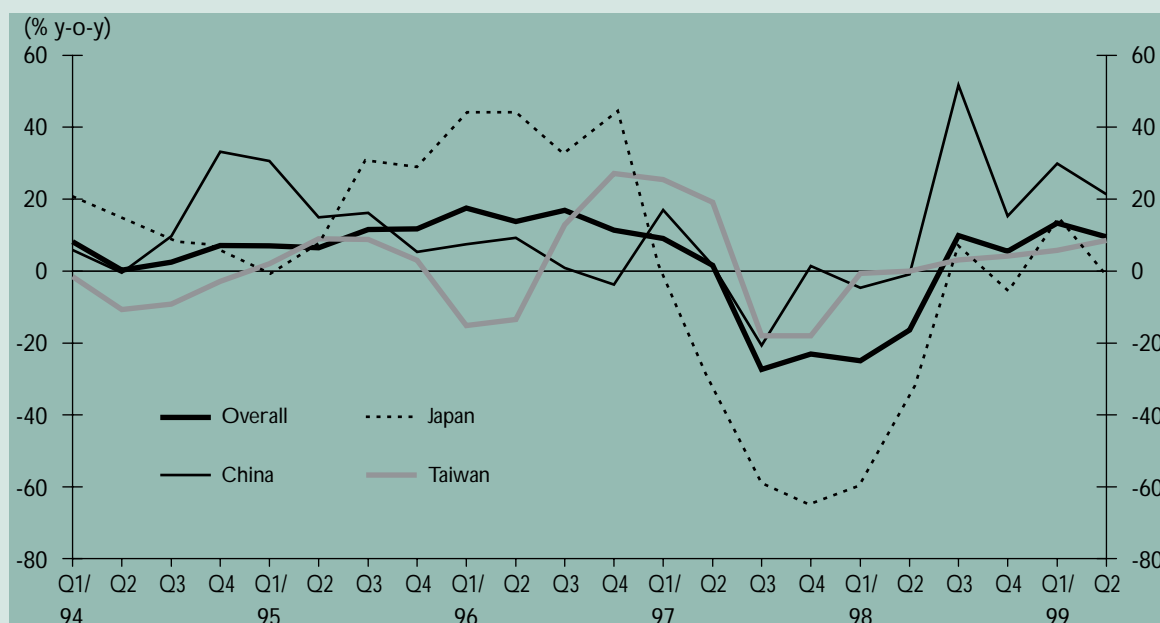


Chart 3
Tourist Arrivals



Labour Market and Inflation

The labour market also showed signs of improvement. The unemployment rate fell from 6.3% in the March-May period to 6.1% in the April-June period. Decreases in the unemployment rate were recorded in a wide range of sectors including construction, manufacturing, import/export trades, hotels, transport, real estate and insurance.

Consumer prices fell by a year-on-year rate of 4.1% in June 1999, following a drop of 4.0% in May. On a seasonally adjusted basis, the CPI fell by 0.3% in the second quarter, following a decline of 0.1% in the first quarter. The continued fall in the CPI reflected a combination of factors, including weak domestic demand, the lagged effect of a sharp fall in property rentals in 1998, a fall in import prices, and the freezing of government fees and utility charges.

Asset Markets

The stock market was generally on an uptrend during the second quarter. With improved prospects for Asian economies and favourable market reaction to the proposed share disposal programme by the Exchange Fund Investment Limited (EFIL), the Hang Seng Index rose to a post-crisis high of 14,531 in early July. Thereafter, amid the Federal Reserve's concerns over the emergence of inflation, tension between Taiwan and the Mainland, as well as concerns over a possible devaluation of the renminbi, the Hong Kong stock market consolidated and closed at around 13,120 at end-July.

Prices in the residential property market have also stabilised, helped partly by lower mortgage rates. The year-on-year declines in April and May, of 21.8% and 17.5% respectively, were more moderate than the decline of 26.3% in the first quarter. On a month-on-month basis, April and May registered positive growth of 2.2% and 1.3% respectively. The trading volume of property, measured by the number of sale and purchase agreements, increased by 10.3% in the second quarter over the previous quarter, and by 3.5% over the same quarter last year.

Short-term Outlook

Barring unexpected external shocks, the economy is expected to record a moderate recovery in the second half of 1999. The turnaround in economic growth is expected to be underpinned by a renewed growth in domestic demand. Tax concessions granted in FY1998/99, more stable asset markets, lower interest rates and improvement in the labour market should support domestic demand. Private investment, however, will likely remain weak, amid high interest rates, banks' cautious stance towards business lending, and continued consolidation in the corporate sector.

Developments in recent months suggest that exports – both domestic and re-exports – will likely record a better-than-expected performance, in part helped by economic recovery in the region. But imports of goods are also likely to pick up in the second half, on the back of the rebound in domestic demand and the replenishment of inventories. Exports of services are expected to resume positive growth in 1999, helped by a recovery in inbound tourism.

Inflation may remain negative on a year-on-year basis in the second half of 1999, partly due to the lagged impact of the substantial fall in rentals in 1998 and the early part of 1999. Nevertheless, in an open economy operating a fixed exchange rate regime, such as Hong Kong, worries of a deflationary spiral are unwarranted, as falling prices should help improve competitiveness that would boost economic activity. ☺

- Prepared by the Economic Research Division