

DOMESTIC AND EXTERNAL ENVIRONMENT

After an eighteen-month recession, the Hong Kong economy returned to positive growth in the second quarter of 1999, underpinned by a strong recovery in private consumption and a further improvement in external trade. The latest statistics on retail sales suggest that year-on-year growth in private consumption picked up further in the third quarter. Meanwhile, a weaker US dollar, a broader-based recovery in Asia, and continued growth in the US and Europe should contribute to a further improvement in exports and tourism activity.

External Environment

The growth momentum of industrial economies has strengthened since the early part of this year, with continued robust domestic demand in the US economy, an acceleration of growth in the euro region, and a return to positive growth in Japan. Regionally, growth in Mainland China has continued at a rate of 7-8% p.a., while other East Asian economies have shown broad-based recoveries. The improved health of the global economy should benefit Hong Kong.

By the second quarter of 1999, all major East Asian economies (including Hong Kong) that had dipped into recession during the financial crisis of the past two years had returned to positive growth. Economies that were ahead in the recovery cycle, like South Korea and Singapore, saw strong increases in private consumption, while rebounds in Indonesia and Malaysia were largely driven by the public sector. Despite uneven progress in structural reforms in the banking and corporate sectors, there was further evidence of macroeconomic stabilisation in most East Asian economies, with rising foreign exchange reserves, substantial current account surpluses, improved price stability, and a levelling off of unemployment rates. Liquidity conditions also improved with a general pickup in money supply growth, though loan demand remained subdued due to excess capacity and relatively weak investor confidence.

Supporting East Asia's recovery was a more synchronized upswing in the industrial economies. During the second quarter, the US economy continued to expand, with real GDP growing at a seasonally adjusted annualized growth rate of 1.9%. Growth in the UK accelerated from an annualized

0.9% in the first quarter to 2.6% in the second quarter, while growth in the euro area picked up from 1.7% to 2.0%. Following a strong annualized growth of 8.1% in the first quarter, Japan registered growth of 0.9% in the second quarter. Two consecutive quarters of positive growth have raised hopes that the Japanese economy has finally emerged from its decade-long recession. While restructuring in the labour and corporate sectors has kept unemployment rates in Europe and Japan at relatively high levels, improving industrial output and orders data in Japan and Germany are pointing to a more steady output recovery ahead. Significant improvements in business confidence were also reported by major surveys like the Tankan in Japan and the Ifo in Germany.

Signs of overheating in the US and UK economies, as evidenced by a tightening of labour market conditions and a worsening of current account imbalances, had prompted the US Federal Reserve and the Bank of England to tighten policies further. The US Fed Funds target rate and the UK repo rate were both raised by 25 basis points during the third quarter. In response to the US interest rate hike, the best lending rate quoted by major banks in Hong Kong was raised from 8% to 8.25% in August. While the US Federal Reserve left interest rates unchanged at its 5 October FOMC meeting, it announced a tightening bias in policy. Market expectations of further rises in interest rate were reflected in long bond yields, with the 30-year Treasury yield firming to a 2-year high of 6.38% in late-October. Inflationary expectations have been reinforced by a rebound in oil and gold prices, both of which hit 32-month and 24-month highs respectively. Another area of uncertainty lies in the sustainability of US asset prices and the Fed's response to continued buoyant

sentiment in markets. Following the Fed's repeated warnings, the Dow Jones Industrial Average corrected by around 10% from its peak in August to mid-October, but recovered some lost ground towards the end of the month.

In the currency markets, improved economic prospects in the euro region helped to lift the euro from its record low of US\$1.01 per euro in July to US\$1.09 in mid-October. Meanwhile, the Japanese yen rallied to a 44-month high of 103.2 against the US dollar in September, buoyed by relatively tight monetary conditions and significant capital inflows. An announcement in October by the Bank of Japan indicating that it would increase liquidity by extending its open market operations served to check the yen's strength. Nevertheless, during the third quarter, the yen appreciated by 15% against the US dollar, compared with a 3% rise of the euro. Reflecting these currency movements, Hong Kong's effective exchange rate fell by 1.9%, from 134.8 at end-June to 132.2 at end-September. This should have helped improve Hong Kong's price competitiveness.

Domestic Activity

Following a decline of 3.2% in the first quarter, Hong Kong's real GDP rose by 0.7% (year-on-year) in the second quarter. On a seasonally adjusted quarter-on-quarter basis, real GDP

recorded strong growth of 3.1% in the second quarter, ending six consecutive quarters of decline. The turnaround reflected improvements in both private consumption and external trade, helped by the region's recovery and robust growth in the US.

Private consumption expenditure picked up noticeably in the second quarter, recording seasonally adjusted growth of 5.1%, following a 1.3% increase in the first quarter. Consumer sentiment improved on the back of a more stable employment situation, a rebound in asset prices, and lower interest rates. The stimulus packages (including tax concession measures) put in place during the course of the last two years and the prevalence of large price discounts at retail outlets also helped. Recent figures show that retail sales are recovering almost across-the-board, including high-value commodities. Nevertheless, overall sales volume was still about 20% lower than its pre-crisis average level.

Investment, on the other hand, remained weak. Gross domestic fixed capital formation declined by 26.4% in the second quarter of 1999 from a year ago. On a quarter-on-quarter basis, it registered a moderate growth of 5.4%, following a 14.4% decline in the preceding quarter. Output of the building and construction sector was sluggish as existing projects in both the public and private sectors were progressively completed, while the

Table 1 : Retail Sales Volume Index

| Year | Month | Year-on-year change by type of retail outlets, % | | | | | | | | | |
|------|-------|--|---------------|-------------------|------|-------|----------|------------------|------------------------|---------|-------|
| | | All outlets | Super-markets | Department stores | Food | Fuels | Clothing | Jewellery | Consumer durable goods | | |
| | | | | | | | | Vehicles & parts | Others | Overall | |
| 1997 | | 1.1 | -0.3 | -9.2 | 1.7 | 1.4 | -7.6 | 5.9 | 26.3 | 5.2 | 12.3 |
| 1998 | | -16.7 | -2.5 | -26.8 | -3.4 | -12.1 | -27.8 | -16.8 | -29.2 | -10.3 | -17.4 |
| 1999 | Jan | -18.4 | -23.4 | -22.5 | -8.0 | -20.0 | -19.5 | -22.9 | -35.4 | -9.5 | -17.9 |
| | Feb | 0.0 | 18.1 | 6.9 | 24.7 | -20.8 | 18.1 | -9.1 | -36.1 | -13.2 | -20.1 |
| | Mar | -9.4 | -9.0 | -9.8 | 7.2 | -11.5 | 1.6 | -16.4 | -37.4 | -2.5 | -17.3 |
| | Apr | -3.3 | -4.5 | -1.2 | 1.7 | -16.7 | 4.6 | -12.5 | -25.6 | 6.0 | -5.1 |
| | May | -1.3 | -5.5 | 2.9 | 2.7 | -20.9 | 6.4 | -9.5 | -17.9 | 8.9 | 0.3 |
| | Jun | -0.3 | -5.8 | -4.2 | 4.3 | -15.8 | -5.2 | 1.0 | -14.2 | 12.6 | 3.4 |
| | Jul | 0.8 | 0.6 | -5.0 | 1.5 | -8.6 | 1.1 | 8.5 | -8.9 | 18.2 | 9.2 |
| | Aug | 1.9 | 7.3 | -3.8 | -0.1 | -11.6 | 1.0 | 9.6 | 11.4 | 20.1 | 17.3 |

contribution from new sites was relatively small. Investment in machinery and equipment continued to be dampened by banks' cautious lending stance, relatively high interest rates and the uncertain business environment.

External Trade

External trade showed clear signs of improvement. The value of re-exports increased by 6.8% in the third quarter from a year ago, following a 4.3% decline in the previous quarter. This reflected the recovery of the regional economies

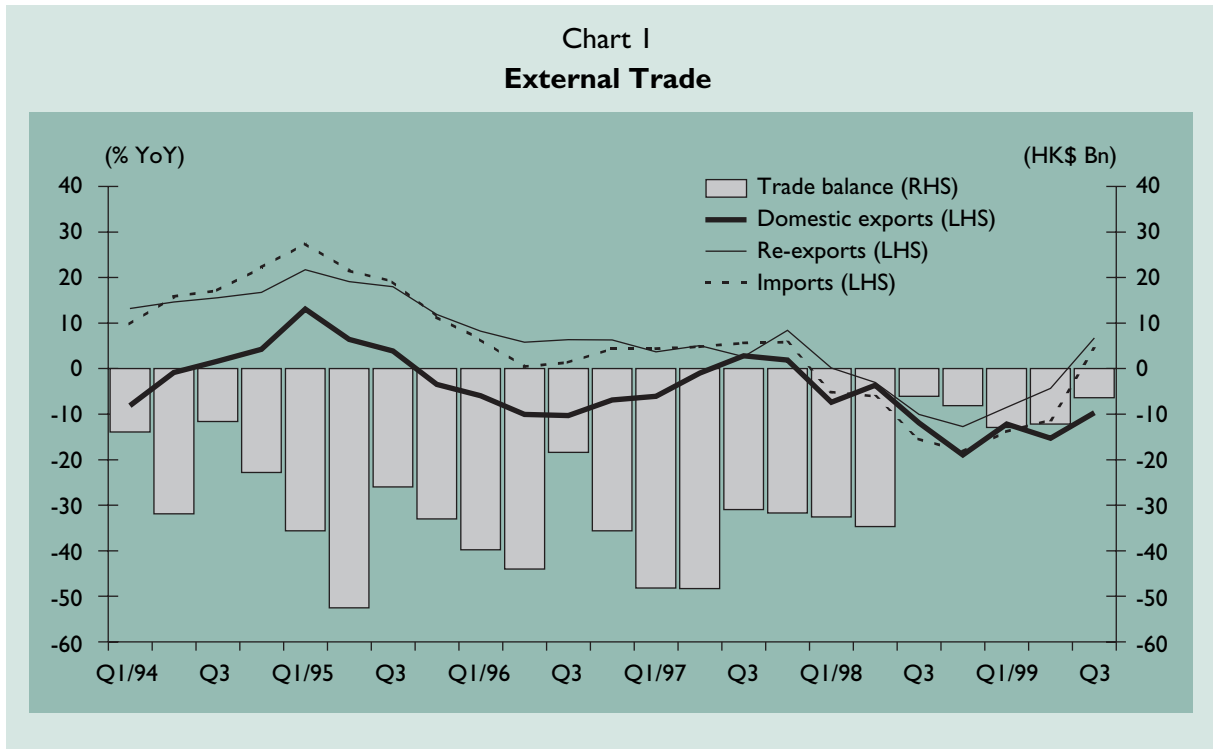


Table 2 : Value of Re-exports

| Year | Month | Year-on-year change by destinations, % | | | | | | Total |
|------|------------------|--|-------|-------|-------|-----------------|--------|-------|
| | | China | USA | Japan | EU | ASEAN and Korea | Others | |
| 1997 | | 6.3 | 7.9 | -3.0 | 4.0 | 3.2 | 3.5 | 5.0 |
| 1998 | | -8.2 | -0.6 | -17.4 | -0.6 | -22.8 | -5.7 | -6.9 |
| 1999 | Jan | -2.0 | -10.5 | -10.5 | -9.0 | 19.3 | -13.7 | -6.3 |
| | Feb | -34.9 | 13.3 | 1.7 | 20.0 | -3.8 | -3.3 | -10.1 |
| | Mar | -5.9 | -12.6 | -7.0 | -15.0 | 10.1 | -18.2 | -9.5 |
| | Apr | -12.0 | 0.6 | -2.0 | -3.4 | 5.5 | -13.2 | -6.7 |
| | May | -10.2 | 5.4 | 0.3 | -0.3 | 16.4 | -5.0 | -2.3 |
| | Jun | -8.4 | -4.9 | 3.3 | -0.2 | 18.8 | -5.6 | -3.7 |
| | Jul | 1.4 | 7.8 | 7.1 | 4.5 | 37.8 | -0.6 | 5.5 |
| | Aug | 6.5 | 6.9 | 6.7 | 11.2 | 23.0 | -3.7 | 6.7 |
| | Sep | 11.0 | 7.0 | 12.2 | 9.3 | 23.5 | -3.5 | 8.3 |
| | Percentage share | 34 | 23 | 6 | 16 | 7 | 14 | 100 |

and continued robust demand from the US. The increase in China's external trade also played a part. Re-exports to the Mainland, which account for about one-third of Hong Kong's re-exports, grew by 6.1% in the third quarter from a year ago, reversing the downtrend since April last year. The decline in domestic exports moderated to 9.7% year-on-year in the third quarter. Imports grew by 4.4% after an 11.3% decline in the previous quarter. This was largely due to a pick-up in re-exports and the recovery in consumer spending. Retained imports of consumer goods registered a 10.2% year-on-year in the third quarter, having declined by 21.3% in the previous quarter. As exports increased faster than imports, the visible trade deficit narrowed further to HK\$6.4 billion, down from HK\$12.2 billion in the second quarter.

On invisible trade, exports of services registered year-on-year growth of 1.7% in the second quarter of 1999. Statistics on tourist arrivals suggested continued strong growth into the third quarter. Compared with the same period last year, tourist arrivals increased by 10.8% in the third quarter, following growth of 9.5% in the previous quarter. On the other hand, imports of services fell marginally by 0.6% in the second quarter of

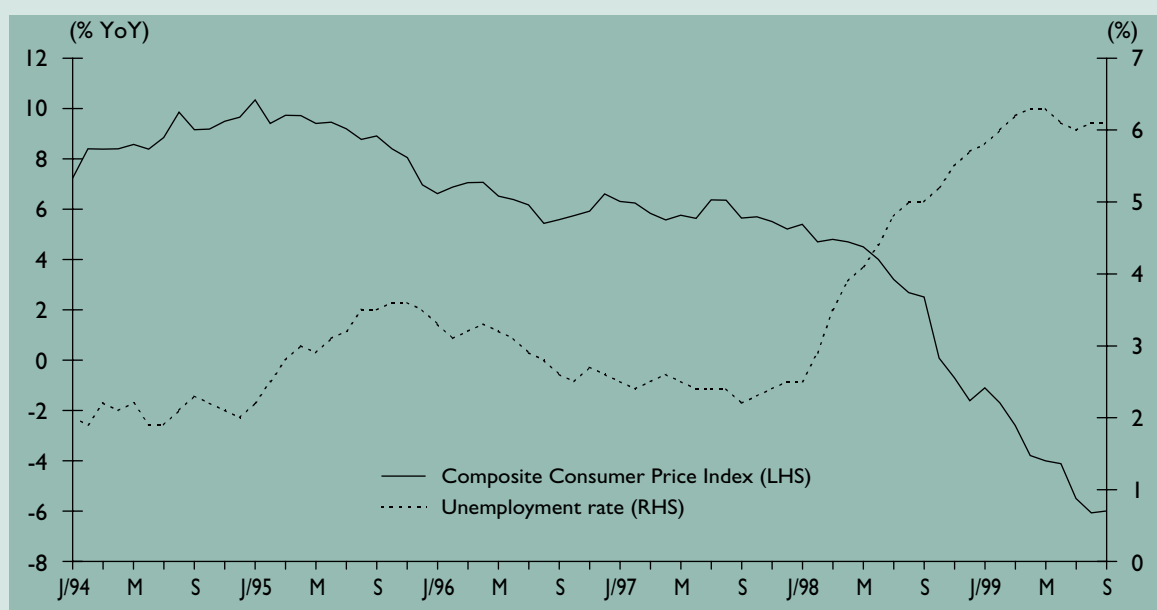
1999. Taking visible and invisible trade together, there was an overall trade surplus of HK\$9.0 billion, or 3.0% of GDP, in the second quarter of 1999, following a surplus of HK\$4.4 billion, or 1.5% of GDP, in the first.

Labour Market and Inflation

The labour market showed signs of stabilisation. The seasonally adjusted unemployment rate was 6.1% in the three months to September 1999, down from the peak of 6.3% in the three months to April. Employment in all service sectors increased in June over a year ago, while declines in vacancies in almost all major economic sectors and occupation categories moderated. Adjustments in salaries continued, with the payroll index falling by 1.2% year-on-year in nominal terms in the second quarter, after increases of 3.2% in the last quarter of 1998 and 1.7% in the first quarter of 1999. Adjusting for the decline in the consumer price index, salaries rose by 2.9% in real terms in the second quarter.

Consumer prices fell by a year-on-year rate of 5.9% in the third quarter, following a 4% drop in the second. On a seasonally-adjusted quarter-on-

Chart 2
Unemployment Rate and Inflation



quarter basis, the CPI declined by 2.1% during the third quarter, following a decline of 1.1% in the second. The continued weakness in the CPI reflected a combination of factors, including a 50% reduction in government property rates for the third quarter, the lagged effect of a sharp fall in property rentals in 1998, and price discounts offered by supermarkets.

Asset Markets

The stock market was broadly stable in the third quarter. After reaching a post-crisis high of 14,507 in early July, the Hang Seng Index retreated in early August amid rising political tensions between the Mainland and Taiwan and concerns over a possible devaluation of the renminbi. In mid-September, the Hang Seng Index surged to the 13,800 level again supported by a combination of favourable factors, including higher US stock prices, an improved outlook for the Japanese economy, and renewed expectations of funds flowing into Japan and Asia. However, concerns over further rate hikes in the US and a strong yen pushed the HSI back towards the 12,000 level in mid-October.

Residential property prices consolidated after a rebound in late 1998 and early 1999. Having surged

by a total of 19% from November last year to a post-crisis high in May this year, residential property prices eased slightly by an average monthly rate of 1.4% during June to September. Market activities also slowed. The number of sales and purchase agreements declined to below 6,000 in September, after surging to around 15,000 in late 1998 and 10,000 in early 1999. Both the sales and rental markets for commercial properties remained sluggish amidst an abundant supply of office premises.

Short-Term Outlook

The base of recovery in the economy is broadening and, barring unexpected external shocks, should continue into the remainder of 1999 and 2000. Tax concessions granted in FY 1998/99, rebounds in asset prices and a more stable employment situation should support private consumption. In respect of investment activity, works related to KCR West Rail and MTR Tseung Kwan O Extension and other priority capital projects are expected to gather momentum in the coming months. However, private investment is likely to remain weak given prevailing levels of interest rates, the cautious lending stance of the banks and some continuing uncertainties in the business outlook.

Chart 3a
Stock Market

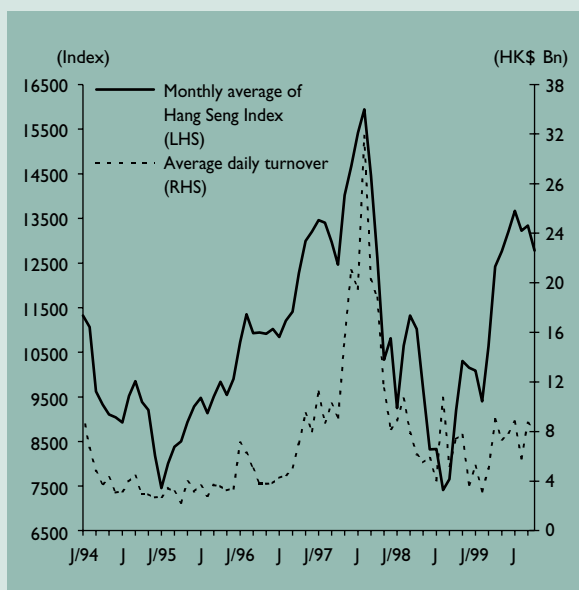
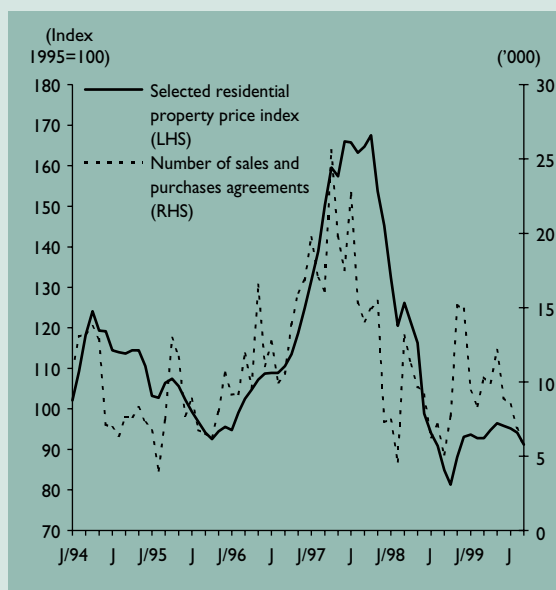


Chart 3b
Property Market



Both domestic exports and re-exports are expected to improve further, helped in part by the economic recovery in the region. Imports of goods are also likely to pick up, in line with the rebound in domestic demand and the replenishment of inventories. Exports of services should grow further with the rebound in inbound tourism and expected growth in trade-related services, alongside the pick-up in merchandise trade.

Given that the decline in housing rentals in 1998 will continue to be reflected in the housing component of the CPI, inflation is likely to remain negative on a year-on-year basis in the remaining months of 1999. However, the decline in core CPI (i.e. excluding food, energy and housing components) was much smaller than in the headline CPI in the third quarter. Furthermore, the recent pick-up in exports and private sector consumption - in part reflecting improved competitiveness of Hong Kong due to falling costs and prices - suggests that the fear for a deflationary spiral seems not justified. ☹