

ECONOMIC GROWTH REMAINED STRONG IN 1995, ALTHOUGH MODERATED SOMEWHAT BY WEAKER CONSUMER SPENDING. EXPORTS CONTINUED TO REGISTER STRONG GROWTH BUT THE TRADE BALANCE MOVED INTO DEFICIT FOR THE FIRST TIME SINCE 1983, LARGELY REFLECTING TEMPORARY FACTORS. INFLATION REMAINED HIGH IN 1995 BUT SHOWED SIGNS OF MODERATION. THE OUTLOOK FOR 1996 IS FOR ONGOING SATISFACTORY OUTPUT GROWTH AND DECLINING INFLATION.

OVERVIEW

Economic growth moderated over the course of 1995. Real GDP grew by 6.1% during the year to the March quarter, but slowed to 5.2% in the June quarter, 4.2% in the September quarter and 3.1% in the December quarter. For 1995 as a whole, growth

was 4.6% (Chart 1). Nonetheless, this was still the fourth fastest growth rate among the 24 “high income” economies as classified by the World Bank.

Analysed by expenditure components, total exports were

buoyant, growing by 12% in real terms. Construction slowed markedly but investment in machinery and equipment remained strong. There was a marked build-up of inventories, believed to be mostly raw materials. The contributions to growth are shown in the following



table. (The corresponding percentage changes are given in Table 1 on page 89).

Consumer spending was subdued, reflecting the lagged effect of the increases in interest rates in 1994 and the wealth effect of subsequent falls in property prices. Furthermore, an increase in unemployment, largely attributable to increased labour supply, and slower growth in real wages dampened consumer confidence.

CONTRIBUTIONS TO GDP GROWTH BY COMPONENTS

	1994	1995P	1996F
Private Consumption Expenditure	3.8	0.8	2.4
Government Consumption Expenditure	0.3	0.3	0.4
Gross Domestic Fixed Capital Formation	3.9	1.9	1.7
Change in Inventories	3.2	3.9	-3.7
Net Domestic Exports of Goods	-7.0	-7.2	-0.2
Net Re-exports	0.8	3.0	2.8
Net Exports of Services	0.4	1.9	1.6
GDP	5.4	4.6	5.0

Note : P : preliminary estimates
F : Government's Budget forecasts

The Government Budget for 1996/97 forecasts a return to surplus after a small deficit in 1995/96 that was largely attributable to spending on the airport project.

Consumer price inflation showed signs of moderation over the course of the year. Whereas asset prices fell for most of 1994, property prices stabilised in 1995 and equity prices advanced steadily through the year.

The transformation of Hong Kong from a manufacturing to a services economy continued in 1995. The strength of Hong Kong as an international financial centre was highlighted by a survey of the foreign exchange and derivatives market (see Box on page 17).



EXTERNAL SECTOR

Hong Kong's external trade grew rapidly last year, although it moderated somewhat later in the year. Re-exports recorded their 13th year of double-digit growth and now constitute 83% of total exports of goods. Domestic exports grew for the first time since 1992. Supported by the weaker real effective exchange rate¹ of the HK dollar since 1994 and the revival of import demand in major trading partners, domestic exports were particularly strong in the March and June quarters. Growth slowed in subsequent quarters as the HK dollar reversed its downtrend. Total exports increased by 14.9% for 1995 as a whole.

Imports, however, rose slightly faster and as a result, the merchandise trade deficit swelled to \$147 bn for the year as a whole.

Nevertheless, the deficit was by and large a temporary phenomenon caused by import requirements for production and investment, notably the new airport project, and the effects of short-lived exchange rate movements on the terms of trade. The deficit was offset to a large extent by the surplus in invisible trade.

The trade sector will be a major impetus for growth in the coming months. The main determinants of export performance remain the

macroeconomic conditions in Hong Kong's major export markets. China has successfully navigated its current economic adjustment phase by way of several quarters of slower growth rather than a contraction. The increase in real output moderated to 10% in 1995 from 12% in 1994, while retail price inflation fell to 15% from 22%. For the coming year, China is expected to continue with a moderately tight monetary stance, but with some credit easing for selected pillar industries. Reflecting steady growth prospects for the mainland economy, total exports to China are likely to run at a stable pace in 1996. Re-exports to China will be boosted by cuts in import tariffs and further liberalisation of trade restrictions associated with

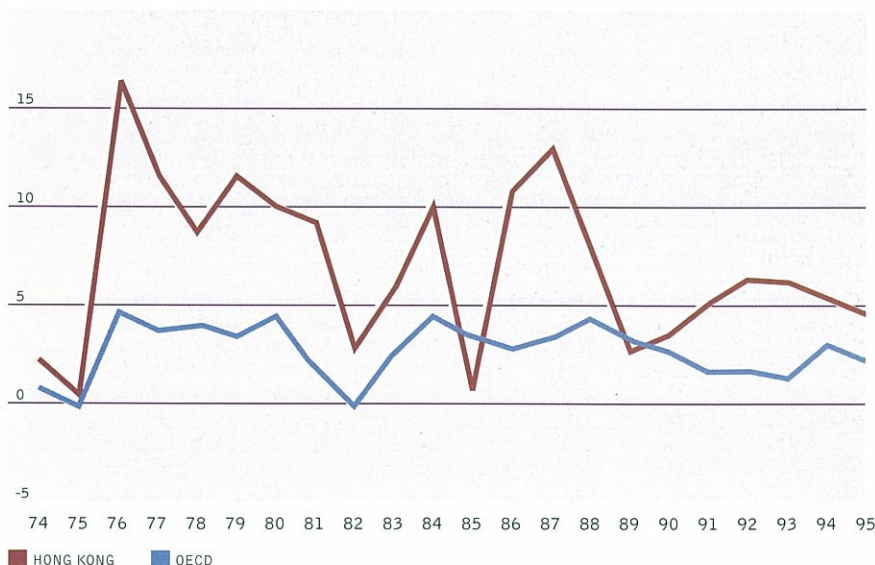
possible entry to the World Trade Organisation, while re-exports to the Western industrialised economies should continue to grow (Chart 2).

Economic activity in other major markets is expected to grow at a steady pace. The IMF and OECD are projecting a real growth rate of about 2.5% for the major Western industrialised economies in 1996, similar to that in 1995. Prospects for Hong Kong's domestic exports should therefore remain favourable, although it may be difficult to achieve a performance comparable to 1995.

INVESTMENT

Investment in machinery and equipment grew strongly in 1995.

CHART 1: GDP GROWTH OF HONG KONG AND OECD
(% change over a year earlier)
PERCENTAGE



The continuous efforts in upgrading production efficiency through mechanisation and office automation underpinned such robust growth (Chart 3). There was also huge demand for machinery associated with the massive infrastructure projects.

Capital spending by both the public and the private sectors will provide support for GDP in 1996. In 1995, China and Britain signed the two Financial Support Agreements on the Airport Authority and the Mass Transit Railway Corporation. These agreements facilitate borrowing by these bodies and would speed up their infrastructure construction.

The December quarter of 1995 witnessed a modest pick-up in property transactions (Chart 4). This was in part accounted for by the introduction of flexible payment methods and attractive mortgage packages by developers and banks. The reversal of the interest rate trend also helped. Credit for the purchase of residential property picked up in the December quarter. Developers are likely to respond to the better market condition by quickening the pace of property development, ensuring some construction follow-through in the coming quarters.

CHART 2: TOTAL EXPORTS TO CHINA AND OTHERS
(3-month moving average)
% CHANGE OVER YEAR

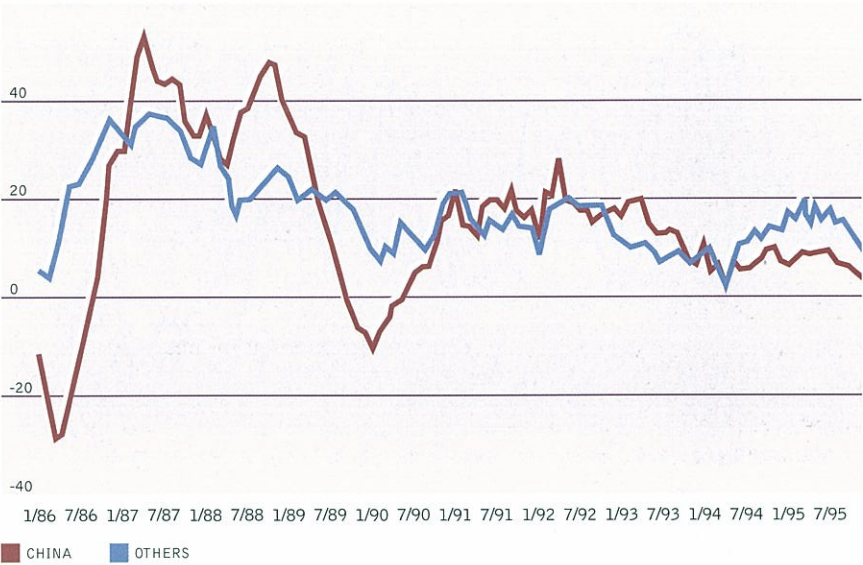


CHART 3: EXPENDITURE ON MACHINERY & EQUIPMENT AND EXPENDITURE ON CONSTRUCTION
(Constant prices, % change over a year ago)
PERCENTAGE

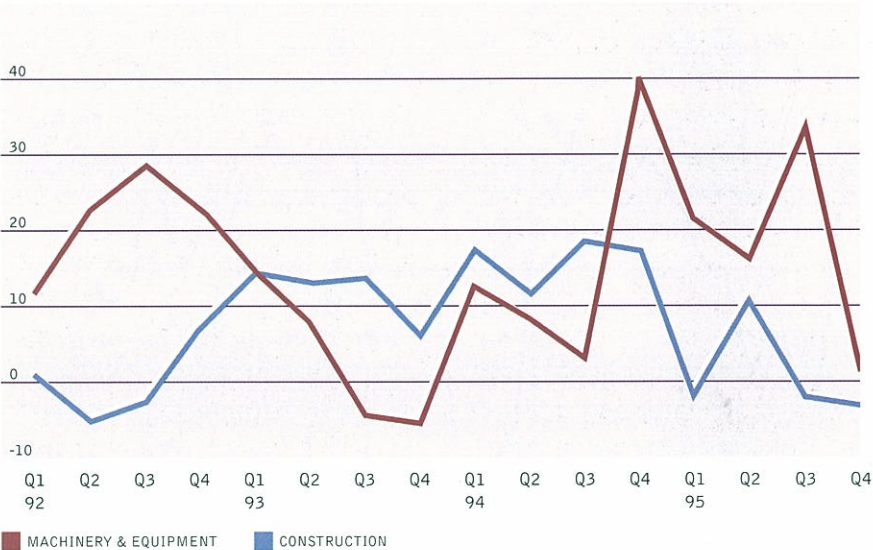


CHART 4: INDICATORS OF PROPERTY TRANSACTIONS
(3-month moving average)

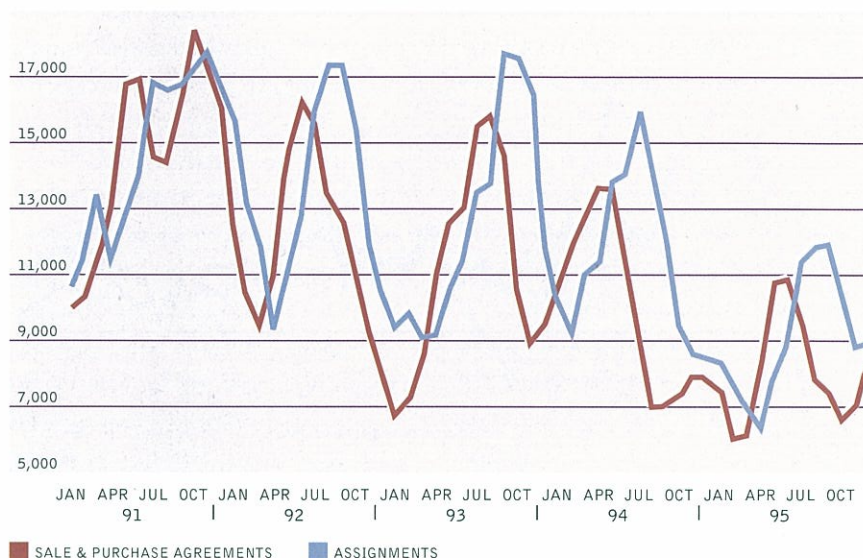
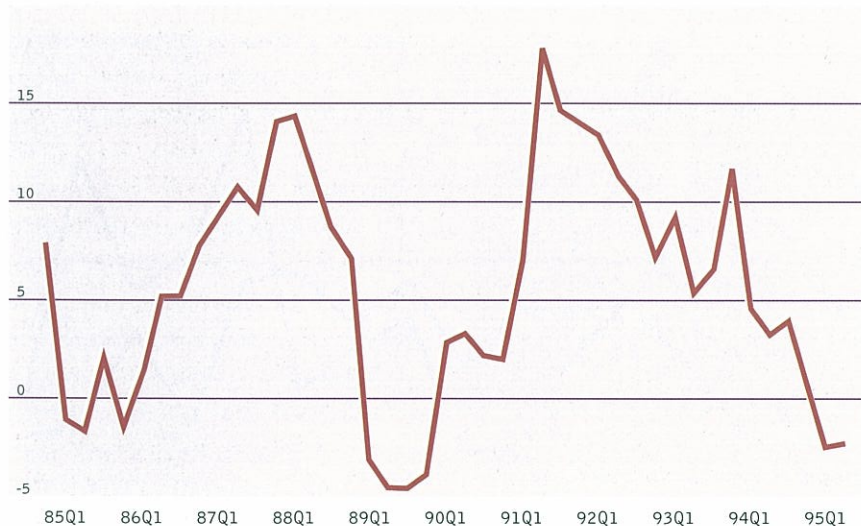


CHART 5: RETAIL SALES
(Volume terms, % change over a year ago)
PERCENTAGE



CONSUMER SPENDING

Consumer spending in 1995 was weak; from February onwards retail sales volumes were lower than in the corresponding month in 1994, leading to a real drop of 1.3% for 1995 as a whole (Chart 5). The sluggish performance was attributable to:

(a) slower growth in real wages

Real wages of workers, which had been growing at an average annual rate of around 5% between 1984 and 1994, slowed in 1995 to around 1% only.

(b) rising interest rates

Between March 1994 and February 1995, the best lending rate in Hong

Kong was raised by 250 basis points(bp). This raised the cost of borrowing and reduced consumer spending, particularly on durables². Estimates indicate that sales of non-durables still increased.

(c) negative wealth effects resulting from falling property prices

The desire to spend was further eroded by developments in the property market. Having reached its peak in April 1994, residential property prices have, on average, fallen back by about 25%. Falling equity prices through much of 1994 would also have had an impact on household wealth.

(d) fragile consumer sentiment

Consumer confidence fell to a record low level, according to surveys conducted by the Social Sciences Research Centre of the University of Hong Kong. Higher unemployment, low wage growth, relocation of businesses and continuing austerity measures in China were the main factors contributing to the bearish sentiment.

While retail sales will probably not pick up sharply, any further slowdown is unlikely as these negative factors have begun to subside. There was a modest recovery in both the prices and volume of transactions in residential property since November, and the Hang Seng Index of equity prices was 23% higher at end 1995 than end 1994. Besides, interest rates were cut by 25 bp in December, and consumer sentiment has also picked up somewhat towards the end of 1995. Looking at the three largest

sources of tourists, the Chinese economy should remain robust due to a slightly easier monetary policy stance, the Taiwanese economy remains resilient while the Japanese economy is gradually recovering. Tourist arrivals should lend additional support to the retail market.

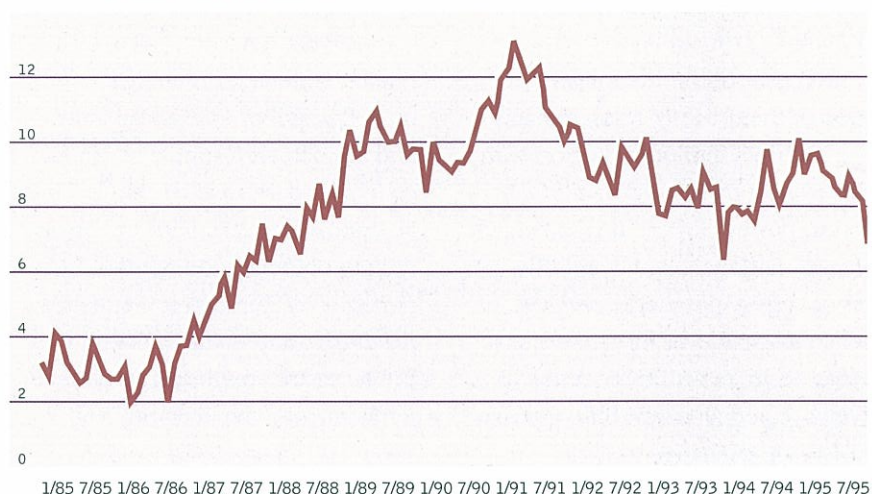
UNEMPLOYMENT

The labour market eased in 1995, with the unemployment rate at 3.5% in the September and December quarters, up from 2.8% and 3.1% in the March and June quarters respectively. These rises were partly the result of a faster increase in labour supply attributable to an increase in the number of emigrants returning. There was also an increase in job mismatch, as the number of vacancies in major sectors remained at around 51,000 at end September. The labour market is already adjusting to this upsurge in unemployment. Wages for craftsmen and operatives, and for supervisory, technical, clerical and miscellaneous non-production workers fell slightly in real terms over the year to the September quarter. Real wage increases were moderate, and well below trend productivity growth in other sectors.

INFLATION

Inflation, as measured by CPI(A), rose by 8.7% in 1995, higher than the 8.1% recorded for 1994 (Chart 6). Nonetheless, most of the factors responsible for price increases in the first half year, such as the HK dollar depreciation and service sector inflation (rent and services prices)

CHART 6: CONSUMER PRICE INDEX (A)
(% change over a year earlier)



moderated somewhat in the second half. Inflation fell from 9.5% in the March quarter to 9.2%, 8.6% and 7.7% in subsequent quarters. As in previous years, there were significant differences in price movements between traded goods and non-tradeables (mostly services). Price movements in traded goods mainly reflected exchange rate movements.

Both internal and external factors argue against a significant build-up of inflationary pressures in the near term. Domestically, the sluggish consumer demand will prevent local businesses from passing all their cost increases onto consumers. There is also less pressure from wage inflation. Lower property prices have been reflected in falls in residential and commercial rentals. At the same time, the strengthening of the HK dollar should abate imported inflation. An easing of price growth in China should help contain import costs, given that China is Hong Kong's largest supplier. Inflation is

forecast to be 7.5% in 1996.

MONETARY SITUATION

Retail interest rates were adjusted twice in 1995; in February and December. Following the rise in US interest rates, local savings and best lending rate were raised by 50 bp in February, to 4.25% and 9% respectively. In December, interest rates were adjusted downward by 25 bp.

As interest rates were relatively steady, the main influence on the monetary aggregates was the slower growth in spending, particularly by consumers. This effect was most evident in the narrow definition of money, HK\$M1, which only grew by 2.1% during 1995. The broad definition of money, HK\$M3, grew by 14.9%, compared with 18.4% in 1994.

CONCLUSION

Taken altogether, the signs are that the modest economic slowdown in

1995 is unlikely to intensify. Real GDP is forecast to accelerate to 5% growth in 1996, in line with the official estimate of the longer-term growth trend. Hong Kong remains the business hub of the region with the world's busiest port and the fourth busiest airport. It is the eighth largest trading economy and the tenth largest exporter of services. As an international financial centre, Hong Kong ranks fifth in terms of banks' external assets, fifth in terms of foreign exchange turnover, seventh as a foreign exchange and interest rate derivatives market and eighth for the size of the stock market. Major rating agencies rank Hong Kong at levels comparable with, and in some cases even superior than, that of the other Asian economies.

With sound economic fundamentals, Hong Kong is better protected from the vicissitudes of the Western economic cycles, and the territory is strongly anchored within a region of strong and solid growth. With stable

interest rates, easing inflation, moderating wage increases, consolidated property prices and rentals, softening of the tight monetary policy in the Mainland, and an increased supply of labour, economic performance should be favourable in 1996. With the private sector continuing to improve productivity³ through investment in machinery and equipment and the public sector continuing to invest in infrastructure, the economy will continue to grow satisfactorily.

¹ For a detailed explanation of this measure, see "Real and Effective Exchange Rates" in the November 1995 issue of the *Quarterly Bulletin*, published by the HKMA.

² For more information on the sales of durables (motor vehicles in particular), see "The Domestic Environment" in the February 1996 issue of the *Quarterly Bulletin*.

³ For more information on productivity growth, see "The Best of Times, The Worst of Times: Developments in Productivity" in the August 1995 issue of the *Quarterly Bulletin*.

THE FOREIGN EXCHANGE AND DERIVATIVES MARKETS IN HONG KONG

The HKMA conducted a survey of the foreign exchange and derivatives markets in March/April 1995. The results were published in the November 1995 and February 1996 issues of the HKMA *Quarterly Bulletin* respectively. The main conclusions are summarised below -

- Hong Kong has become the fifth largest foreign exchange trading centre in the world, up from sixth in 1992. The average foreign exchange turnover was US\$91 bn per day in April 1995, including spot, forward, options and futures trading. This represented a 49% increase over 1992.
- Hong Kong was the seventh largest trading centre for foreign exchange and interest rate derivatives in the world, with an average daily turnover of US\$74 bn.
- The outstanding derivatives contracts amounted to US\$1.6 trillion in notional amount at end-March 1995. However, the market value, which is a more meaningful measure of risk exposure, was very small as compared to the notional amount.
- The detailed breakdown is shown below -

(US\$ bn)

TYPE OF DERIVATIVES	AVERAGE DAILY TURNOVER DURING APRIL 1995	OUTSTANDING AMOUNT AT END-MARCH 1995		
		NOTIONAL AMOUNT ALL	OTC* ONLY	MARKET VALUE OTC ONLY
Foreign exchange	56	970	966	60
Interest rate	18	666	477	6
Equity and stock index	N.A.	6	5	1
Commodity	N.A.	2	1	0
TOTAL	74	1,644	1,450	67

* OTC - Over-the-counter derivatives refer to custom-tailored contracts traded off organised exchanges.

- As shown from the table, foreign exchange and interest rate derivatives were used on a much larger scale than derivatives on equities, stock indices and commodities.
- The most common currency pairs for foreign exchange trading (including both spot and derivatives) were US dollar/yen, US dollar/DM and US dollar/HK dollar. As for interest rate derivatives, US dollar and Japanese yen interest rates were the most common. The majority of equity and stock index derivatives had Hong Kong equities and the Hang Seng Index as the underlying assets while gold was the most common underlying asset for commodity derivatives.