DOMESTIC AND EXTERNAL ENVIRONMENT

Despite signs of moderating growth in major economies, economic activity in Hong Kong remained buoyant in the third quarter, with real GDP recording a year-on-year increase of 10.4%, following growth of 12.5% in the first half of 2000. Domestic demand, particularly investment spending on machinery and equipment, picked up strongly, while exports continued to perform well. Looking ahead, the broad-based economic upturn is expected to continue, but the pace of recovery is likely to slow, in part reflecting a higher base of comparison.

External Environment

There are increasing signs of moderating growth in major industrialised economies. US real GDP growth slowed to 2.7% (seasonally adjusted annualised rate) in the third quarter, from 5.6% in the second. While higher oil prices raised headline CPI inflation to 3.5% (year-on-year) in the third quarter, core inflation remained largely stable, at 2.6%, allowing the US Federal Reserve to keep interest rates steady. In Europe, economic growth in the EU-11 eased slightly from 3.6% in the first quarter to 3.3% in the second. Key indicators, including industrial output and the German IFO index, have pointed to further moderation in the pace of expansion in the third quarter. Nevertheless, high oil prices and a weak euro pushed inflation to a year-on-year 2.8% in September, exceeding the European Central Bank's target. In response, the ECB raised its repo rate by another 25 basis points in October, the seventh interest rate hike since November 1999.

In Asia, Japan's recovery has continued at an uneven pace. GDP growth moderated from a seasonally adjusted annualised 10.3% in the first quarter to 4.2% in the second. The latest statistics on industrial output and export growth suggest that positive growth continued into the third quarter. But consumer spending has remained sluggish. Against a continued decline in retail sales, the year-on-year change in the CPI has remained negative. The Bank of Japan terminated its zero interest rate policy in August as the economic upturn became more established. Nevertheless, weak consumption and continued deflation are likely to delay any further tightening. In other parts of Asia, the growth momentum has remained strong. China, Malaysia, Singapore and South Korea registered real GDP growth of 8-10% in the second quarter (on a year-on-year basis), while Indonesia, the Philippines, Taiwan and Thailand recorded growth of 4-6%. However, as the recovery becomes more mature, growth in regional economies, including Hong Kong, is likely to moderate. The expected slowdown in US and European activity, and softness in global electronics markets, will also reduce demand for the region's exports. On the other hand, the moderation in US growth will reduce pressure for further interest rate hikes. Correspondingly, the interest rate environment in Hong Kong is likely to remain stable.

In currency markets, while growth rates in the US and European economies are showing signs of convergence, the euro has remained weak, and at one time touched a low of 0.826 against the dollar. On 22 September, G-7 central banks launched a round of concerted intervention to support the currency. This was followed by several rounds of unilateral intervention by the European Central Bank in November, partly in response to which the euro settled in a slightly higher range of 0.84-0.87. The Japanese yen has been relatively stable this year, trading within a narrow range of ¥105 to ¥110 since July. Largely reflecting weakness in the euro, the effective exchange rate index of the Hong Kong dollar rose from 132.7 at end-June to around 136 in mid-November. Nevertheless, continued adjustment in domestic prices, although at a more moderate pace, helped to maintain Hong Kong's price competitiveness.

Regional financial markets have exhibited considerable volatility in recent months. The Philippine peso, Indonesian rupiah and Thai baht have depreciated by 15-25% since January. Stock markets in these countries, as well as bourses in

South Korea and Taiwan, fell by 30-45% in the first ten months of this year. In many of these cases, the sharp declines were due to political instability and growing concerns about slow progress in bank and corporate reforms. Helped by improved fundamentals in the post-crisis period, and reduced leverage of global speculators, disruptions in these financial markets have had limited contagion effects on other markets. Hong Kong's foreign exchange and money markets have remained very stable, and

Table 1

GDP by Components (at constant 1990 market prices)

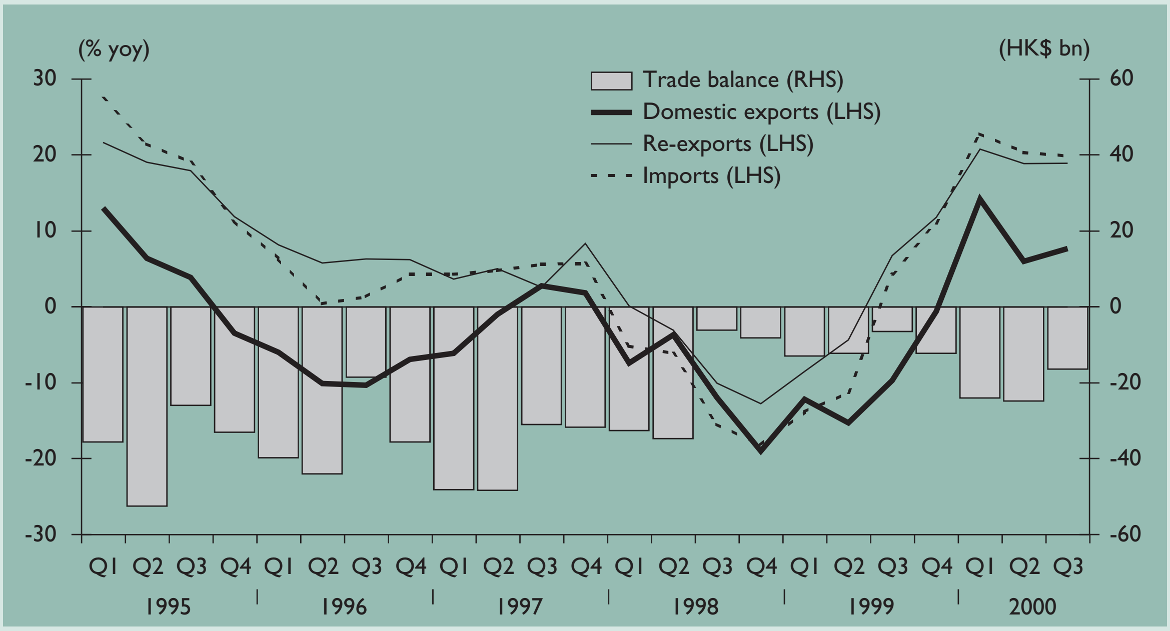
(yoy%, unless stated otherwise)

	1998	1999			2000			
	Overall	H1	H2	Overall	Q1	Q2	Q3	
Private Consumption Expenditure	-7.4	-2.1	3.6	0.8	8.7	5.1	5.6	(+3.1)
Government Consumption Expenditure	0.8	3.8	2.9	3.3	3.7	2.7	2.5	(+0.2)
Gross Domestic Fixed Capital Formation	-7.5	-23.4	-10.4	-17.3	4.8	4.9	13.0	(+3.6)
Change in Inventories (HK$bn)	-14.8	-12.1	1.3	-10.9	5.9	4.8	5.0	(+2.2)
Domestic Exports of Goods	-7.9	-11.0	-3.8	-7.2	16.2	8.3	8.2	
Re-Exports of Goods	-3.7	-2.1	12.5	5.4	21.4	19.1	19.0	
Imports of Goods	-7.2	-9.0	9.3	0.1	22.9	18.8	18.4	
Domestic Exports Minus Retained Imports (HK$bn)	-251.9	-102.3	-111.7	-214.0	-63.5	-69.5	-67.6	(-6.2)
Re-Exports Margin (HK$bn)	171.6	81.4	99.5	180.9	45.8	52.0	58.5	(+4.4)
Exports of Services	-1.8	2.4	12.6	7.8	15.3	18.3	12.6	
Imports of Services	2.8	-0.2	0.5	0.2	-0.2	3.8	3.2	
Net Exports of Services (HK$bn)	72.7	35.0	54.1	89.1	23.9	27.3	30.7	(+3.1)
GDP	**-5.3**	**-0.9**	**6.8**	**3.1**	**14.2**	**10.9**	**10.4**	**(+10.4)**

Note:( ) : % Contribution to GDP Growth

Chart 1

External Trade



its equity market has probably received some safe-haven flows from other regional economies. So far this year, Hong Kong's equity market has fared better than most other markets in the region[1].

Domestic Activity

In Hong Kong, momentum of the recovery remained strong in the third quarter, with real GDP registering a year-on-year increase of 10.4%, following double-digit growth of 14.2% and 10.9% in the first and second quarters respectively (Table 1). On a seasonally adjusted quarter-on-quarter basis, real GDP increased by 1.7%, compared with a modest decline of 0.6% in the second quarter and strong growth of 5.1% in the first. The growth in the third quarter reflected a broad-based pick-up in economic activity.

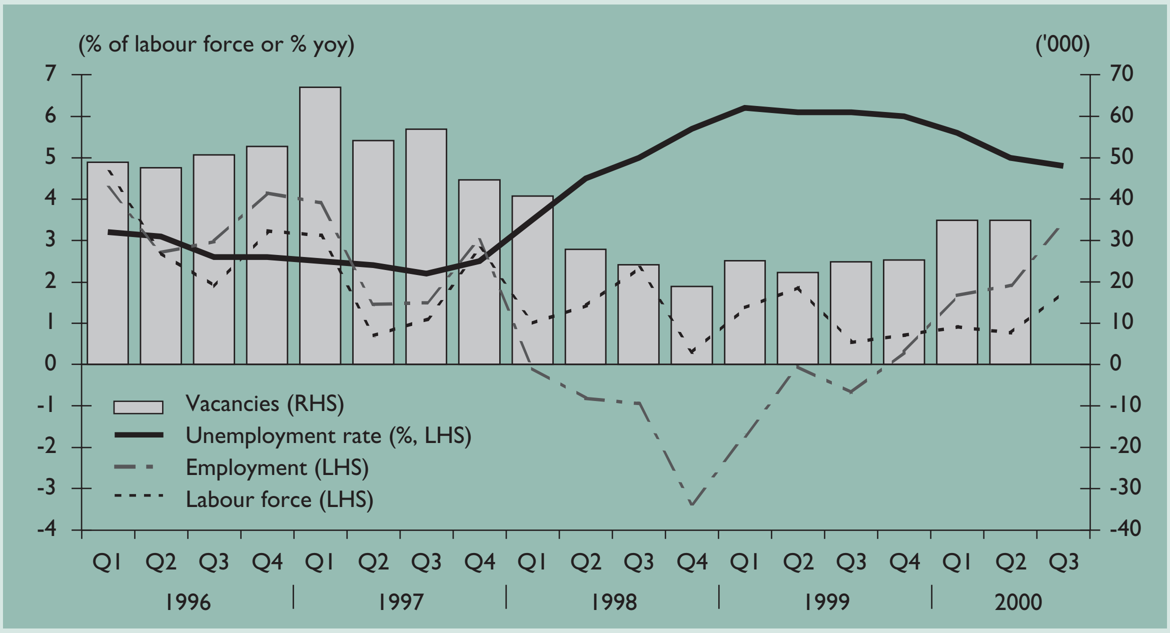
Private consumption expenditure (PCE) increased by 5.6% in the third quarter from a year earlier, following an increase of 5.1% in the second. On a seasonally adjusted quarter-on-quarter basis, PCE rose moderately, by 0.5%, following a modest decline of 0.2% in the previous quarter. The increase reflected mainly a pick-up in the consumption of services, which more than offset a decline in the consumption of goods.

Growth in fixed-capital investment accelerated to a year-on-year rate of 13% in the third quarter, from 4.8% in the first half. This pick-up reflected the continued strong recovery in machinery and equipment investment, and a significant moderation of the decline in building and construction output. Specifically, spending on machinery and equipment grew by 27.8% in the third quarter from a year ago, following an increase of 24% in the first half. Meanwhile, the decline in building and construction output moderated from 12.4% to 3.5%. Along with the increase in final domestic demand, inventory accumulation continued into the third quarter, albeit at a slightly slower pace.

External Trade

Growth in merchandise trade remained strong in the third quarter (Chart 2). Re-exports increased by a year-on-year rate of 19.0% in value terms in the quarter, following a 19.8% rise in the

Chart 2
Unemployment Rate



Note: Unemployment rates prior to the second quarter of 1996 and year-on-year % changes of employment and labour force prior to the second quarter of 1997 are under old definition.

1 Between January and mid-November 2000, the Hang Seng Index fell by 10.7%. This compared with a fall of 21% in the Singapore Straits Time Industrial Index, and declines of 31-46% in the benchmark stock indices in the Philippines, Taiwan, Indonesia, Thailand and South Korea.

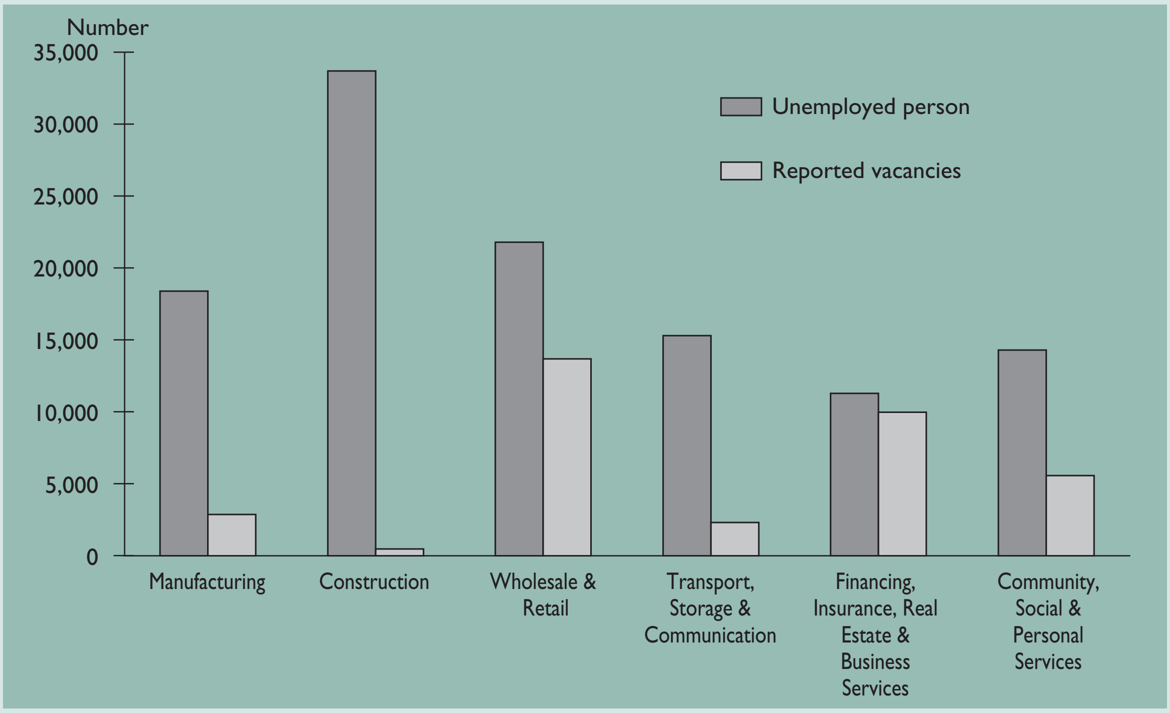
first half, while growth in domestic exports moderated slightly to 7.7% from 9.8% during the same period. The slight moderation of growth in exports was across major markets, particularly to European economies. Growth in imports also decelerated modestly to 19.9% in the third quarter, from 21.5% in the first half. As imports grew faster than exports, the visible trade deficit widened to HK$65.2 billion in the first three quarters of the year from HK$31.5 billion in the same period last year.

On invisible trade, exports of services grew by 12.6% in real terms in the third quarter over a year earlier, compared with a 16.8% increase in the first half. Offshore trading and trade-related services rose significantly along with strong merchandise trade activities, while exports of business services continued to improve amid the regional recovery. Meanwhile, imports of services grew by 3.2% in the third quarter, following an increase of 1.7% in the first half. Taking visible and invisible trade together, there was an overall trade surplus of HK$37.7 billion (5.7% of GDP) during the first three quarters, compared with a surplus of HK$33.0 billion (or 5.6% of GDP) during the same period last year.

Labour Market and Inflation

The employment situation continued to improve, with the seasonally adjusted unemployment rate easing to 4.8% in the third quarter, compared with its peak of 6.3% recorded in mid-1999 (Chart 2). Employment continued to pick up, increasing by 3.4% year-on-year in the third quarter, outpacing an increase of 1.8% in the labour force. The numbers of vacancies rose significantly in almost all sectors compared with a year earlier. Skill mismatches between job-seekers and vacancies (Chart 3) may impede a rapid take-up of these positions. Looking ahead, the labour market should continue to be helped by the sustained economic recovery. The Chief Executive's Policy Address announced the creation of around 15,000 new jobs next year, which will provide employment for around 0.4% of the total labour force, particularly for unskilled workers.

Chart 3
Vacancies and Unemployment by Sector (Q2/2000)



Along with improved labour market conditions, workers' earnings and household income also increased. Payroll per person engaged registered a small year-on-year increase of 1.7% in the second quarter of 2000, after a zero increase in the previous quarter. Median household income grew by 1.2% from a year ago in the second quarter, following growth of 3.3% in the first.

The downward drift in consumer prices showed further signs of moderation. The Composite Consumer Price Index (CCPI) fell by 2.8% in the third quarter from a year ago, following a drop of 4.5% in the second quarter (Chart 4). The smaller decline in the third quarter was in part attributable to a lower base due to a 50% property rates concession granted in the same period of 1999. Nevertheless, adjusted for this factor, the decline, at about 3.6%, was still smaller than that in the previous quarter.

Asset Markets

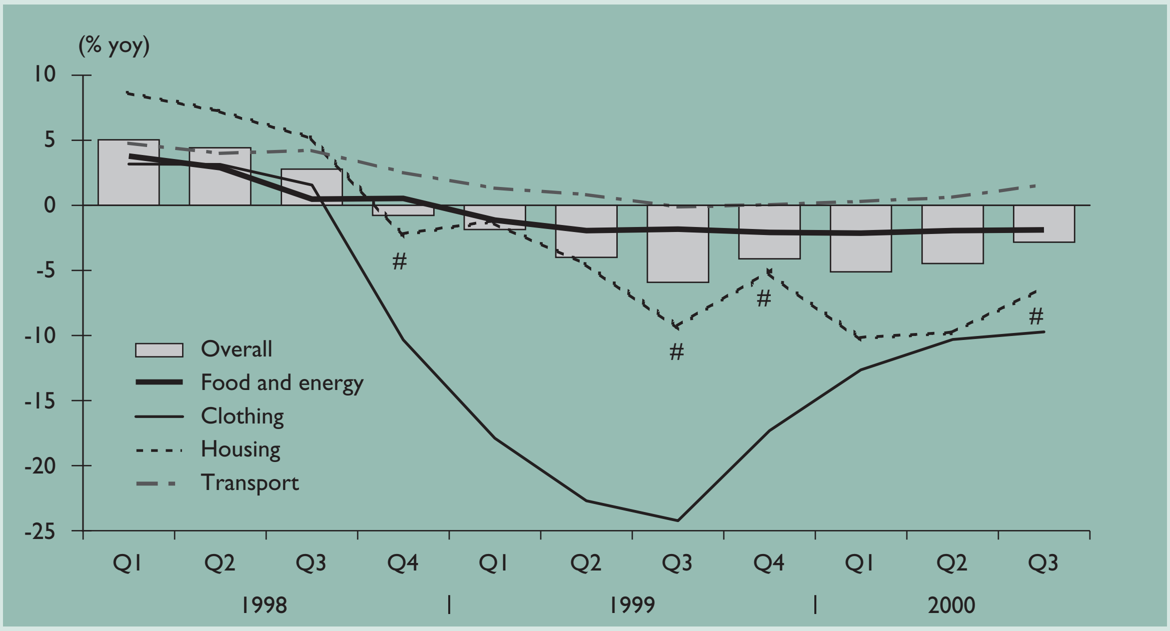
The stock market has been volatile in recent months, mostly echoing movements in US markets. Having plunged from a historical peak of 18,302 in March to 13,723 in May, the Hang Seng Index (HSI) rebounded strongly to 17,921 in July, as pressure for further US interest rate hikes subsided. Subsequently, the HSI traded within a range of 16,800 to 17,800, before falling to below 15,000 in late September, along with the consolidation of global stock markets on the back of concerns about oil price increases. In the first half of November, the index fluctuated within a range of 14,800 to 15,800. (Chart 5)

The residential property market was broadly stable. Having consolidated during March-June, residential property prices picked up slightly, by 2.0%, during the third quarter, following the announcement of adjustments to the Home Ownership programmes, and the clarification of the government's housing policy. The number of transactions also rose from 4,873 in June to a 15-month high of 10,473 in August, before easing back to below 8,000 in September and October. (Chart 6)

Short-term Outlook

Reflecting the stronger-than-expected performance in the third quarter, the government has revised the forecast of real GDP growth for

Chart 4
Inflation



 # Affected by the rates rebate and the 50% rates concession granted in fourth quarter of 1998 and the third quarter of 1999 respectively.

2000 upwards to 10% from the earlier projection of 8.5% in August. Looking ahead, while private consumption should continue to be supported by the improvement in labour market conditions, its growth is likely to decelerate after the strong pick-up in the earlier part of the year. On the other hand, the recovery in investment from the depressed cyclical troughs in 1998-99 is expected to continue. Growth in exports may moderate further, due to slower growth in the global economy. Likewise, import growth may decelerate along with the expected moderation in domestic demand and re-export activity.

The official forecast for CCPI inflation in 2000 has further been revised from -3.5% to -3.7%, taking into account the 4.0% year-on-year decline in the first ten months of this year. Nevertheless, the downward drift in the CCPI should decelerate further next year, as economic recovery continues and the remaining lagged effect of the rental component diminishes.

- Prepared by the Research Department

Chart 5

Asset Prices