DOMESTIC AND EXTERNAL ENVIRONMENT

Real GDP growth in Hong Kong moderated further to 2.5% year-on-year in the first quarter of 2001. Weak global demand and a strong US dollar dampened export growth, but domestic demand remained robust on the back of lower interest rates and improved labour income. Looking ahead, prospects remain clouded by the uncertain outlook for the global economy and the recent strength of the US dollar. Accordingly, the government has revised downward its 2001 GDP growth forecast to 3%.

External environment

The global economic outlook remains uncertain, with increasing risk that the US economic slowdown may spread more widely, leading to a synchronised global downturn. In the US, stable consumption demand and a 10% contraction in imports kept GDP growth at an annualised 2% in the first quarter of 2001, up from 1% in the previous quarter. But deteriorating labour market conditions and weak consumer confidence cast doubts on the sustainability of consumer demand. In the EU, while GDP grew at an annualised 2.7% in the fourth quarter of 2000, economic sentiment and business confidence indices have been falling this year. German manufacturing orders and retail sales both declined in March, while export expansion moderated from a year-on-year 23% in January to 7.5% in March. In Japan, the economy grew by an annualised 3% in the fourth quarter of 2000 after a 2.4% contraction in the previous quarter. However, private consumption remained sluggish, and this situation has likely continued into the early part of 2001, given weak household expenditure, declining wages and falling department store sales. Subdued manufacturing and export activity may have also dented investment spending in recent months.

Facing a deterioration in the economic outlook, major central banks have stepped up their monetary easing over the past few months. The US Federal Reserve, after two 50 basis-point interest rate cuts in January, further reduced its Fed Funds target rate on three occasions from March to May, by a total of 150 basis points. The Bank of Japan (BoJ) also cut interest rates twice in February and early March, and introduced a new "Lombard type" lending facility to cap the call rate. In March, it introduced new policy targets for bank reserves and consumer price inflation, de facto returning to the "zero interest rate" policy abandoned last August. Central banks in the UK, Canada, Australia and New Zealand have also cut interest rates recently. Likewise, the European Central Bank ended its 2-year-long tightening cycle and cut its key rates by 25 basis points in May.

Lower interest rates supported a general rebound in the major equity markets over the past two months. Major equity price indices such as the Dow, Nasdaq Composite, Nikkei-225 and FT-100 have recorded rises in the range of 10-27% since March. Meanwhile, liquidity in the international bond markets improved further, with marked increases in new corporate issues but wider credit quality differentiation. Yield curves in the US and Europe steepened following the cuts in short-term rates. In the foreign exchange market, the BoJ's policy shift and Japan's worsening economic outlook drove the yen to a 30-month low of 127 against the US dollar in early April. After official denials of a weak yen policy, the yen rebounded to 122-125. The euro also softened against the US dollar during the period because of concerns that the ECB's overly tight monetary policy might dampen the EU's growth prospect. From its 6-month high of 0.957 in early January, the euro eased by about 8% to below 0.88 in May.

Against the backdrop of slowing world demand, a number of emerging markets experienced increasing economic and financial strains. In Turkey, concerns over the banking sector and political problems triggered a currency crisis in late February and forced the government to abandon its crawling currency peg. This was followed by a sharp depreciation of the Turkish lira of over 45% in less than three months. In mid-April, domestic political problems and a deteriorating economy renewed pressure on Argentina's financial markets. The announcement of a government plan to re-peg the peso to a basket consisting of the US dollar and the euro when the dollar-euro exchange rate reached parity further unsettled the market. The credit spread (between 10-year Argentine sovereign bonds and US treasuries) widened to 1,300 bp. Affected by the contagion effect, the Brazilian real fell to a record low in May.

In Asia, financial markets stayed calm despite the crises in Turkey and Argentina, but export growth in the region moderated further as global demand weakened. In Singapore, GDP growth eased sharply to 4.6% in the first quarter of 2001, from 11% in the previous quarter. Political uncertainties in the Philippines and Indonesia further undermined the growth prospects of Southeast Asia. A weaker yen also led to concerns about renewed "competitive devaluation" and exerted pressure on other currencies in the region. In particular, the Philippine peso and the Singapore dollar have fallen below their troughs reached during the Asian crisis. China has remained a bright spot in the region, recording strong growth of 8.1% in the first quarter of this year. Domestic demand stayed firm while exports continued to grow at a double-digit rate.

Domestic Activity

While the external environment has turned less favourable, monetary and financial market conditions in Hong Kong have remained broadly stable.[1] In the real sector, year-on-year growth of GDP slowed to 2.5% in the first quarter of 2001, from 6.9% in the preceding quarter (Table 1). On a seasonally adjusted quarter-on-quarter basis, it expanded by 0.3%, after a similar increase of 0.3% in the fourth quarter of 2000. The deceleration in year-on-year growth reflected a marked slowdown in exports, while growth of domestic demand remained steady.

Private consumption expenditure grew by 2.8% from a year ago, following a 2.5% year-on-year increase in the previous quarter. Household consumption expenditure was helped by long holidays, lower interest rates and rising labour income.

Table 1

GDP by Components (at constant 1990 market prices)

(yoy%, unless stated otherwise)

	2000					2001
	Q1	Q2	Q3	Q4	Overall	Q1
Private Consumption Expenditure	8.7	5.1	5.6	2.5	5.4	2.8 (+1.6)
Government Consumption Expenditure	3.7	2.7	2.5	-0.6	2.1	4.0 (+0.3)
Gross Domestic Fixed Capital Formation	5.7	5.4	14.8	13.0	9.8	13.8 (+3.9)
Change in Inventories (HK$bn)	5.2	4.4	3.7	1.6	14.9	1.3 (-1.8)
Domestic Exports of Goods	16.2	8.3	8.2	-0.8	7.5	-12.8
Re-exports of Goods	21.4	19.1	19.0	15.2	18.5	6.5
Imports of Goods	22.9	18.8	18.4	13.4	18.1	5.3
Domestic Exports minus Retained Imports (HK$bn)	-63.5	-69.5	-67.6	-66.5	-267.0	-71.4 (-3.8)
Re-exports Margin (HK$bn)	45.8	52.0	58.5	58.0	214.3	48.8 (+1.4)
Exports of Services	15.8	18.2	14.0	9.5	14.1	6.4
Imports of Services	-0.9	3.3	3.4	2.7	2.1	5.5
Net Exports of Services (HK$bn)	24.5	27.6	31.2	35.0	118.2	26.3 (+0.9)
GDP	**14.1**	**10.7**	**10.8**	**6.9**	**10.5**	**2.5 (+2.5)**

Note:( ) : % Contribution to GDP growth

1 See "Operation of Monetary Policy" on p.87.

There were also signs of broad-based improvement in fixed capital investment in the first quarter of 2001. Having declined for ten consecutive quarters, private construction output recorded a year-on-year rise of 3.1%, while output by the public sector also grew by 2.2%, after having fallen by 8.4% in 2000. Private investment in machinery and equipment continued to grow strongly by 24.2% in the first quarter, while that of the public sector recorded a modest growth of 1.1% following declines of 25% and 30% in the third and fourth quarters of 2000 respectively.

External Trade

Along with weaker global demand, export growth slowed further during the first quarter of 2001 (Chart 1). Growth in the volume of re-exports eased to 6.5% year-on-year, compared with double-digit growth in the preceding six quarters. The decline in the volume of domestic exports accelerated to -12.8% in the first quarter of 2001 from 0.8% in the previous quarter. The moderation in export growth was rather broad-based. Exports to the US, for instance, recorded a year-on-year decline of 0.8% in the first quarter, compared with double-digit growth in the preceding quarters. Given a slower pace of inventory accumulation, growth in retained imports moderated, from 8.4% in the fourth quarter of 2000, to 2.2% in the first quarter this year. Growth in service exports likewise slowed to 6.4% in real terms from 9.5% in the preceding quarter, but a continuing increase in overseas travel by Hong Kong residents raised service imports by 5.5%. As export growth moderated faster than that of imports, the total trade surplus narrowed to HK$2.3 billion in the first quarter from HK$5.2 billion in the same period last year.

Labour Market and Inflation

Labour market conditions have deteriorated slightly in recent months. The seasonally adjusted unemployment rate rose to 4.6% in the three months ending April 2001, from 4.4% in the last quarter of 2000 (Chart 2). During the same period, the underemployment rate fell from 2.7% to 2.3%. The increase in the unemployment rate was mainly due to an acceleration in growth of the labour force, from 1% (year-on-year) in mid-2000 to around 2% recently. Employment growth has remained

Chart 1
External Trade

Chart 2
Labour Market: Major Indicators

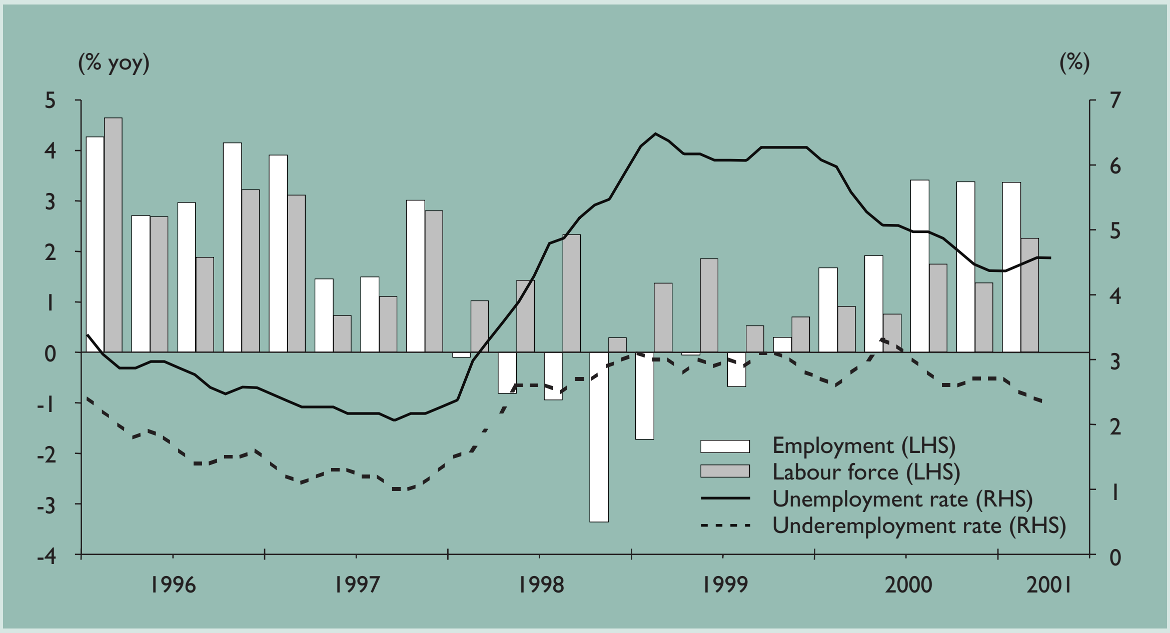
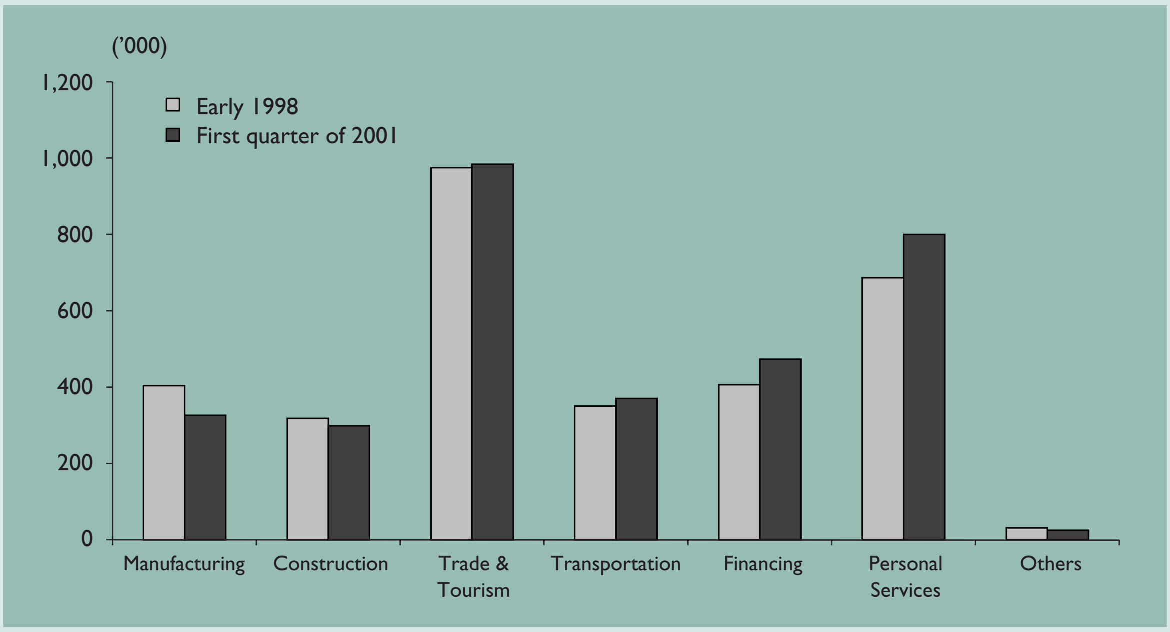


Chart 3
Employment by Major Sectors



steady, at around 3%. Employment levels in most sectors have risen above their previous highs, but that in the construction sector remained about 5% below its peak in early 1998, reflecting continued weakness in the property market (Chart 3).

The downward drift in consumer prices showed further signs of moderation in the first quarter of 2001, with the Composite Consumer Price Index (CCPI) falling by 1.9% from a year earlier, compared with a decline of 2.5% in the preceding quarter (Chart 4). This was partly due to the dissipation of the lagged effects of pronounced rental declines in the earlier period.

Asset Markets

In line with the movements in the US stock market, the Hang Seng Index dropped to a 23-month low of around 12,000 in early April, before rebounding to above 13,000 in the latter part of the month. Activity in the property market revived somewhat in the first quarter, helped by lower interest rates and the announcement of a reduction in the supply of land and Home Ownership Scheme flats.

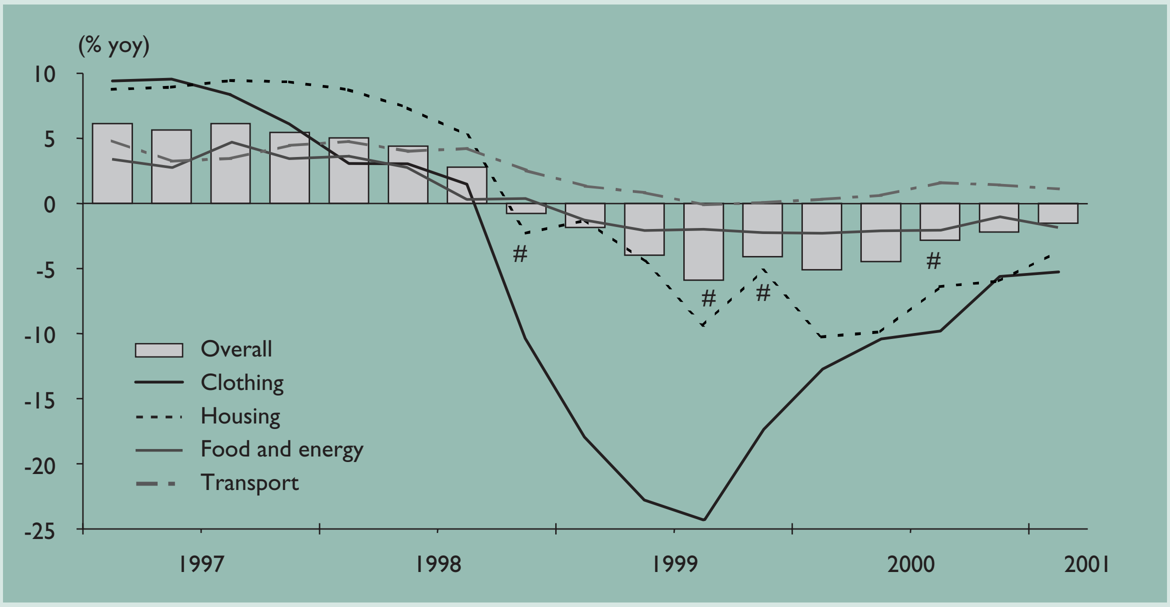
Short-term Outlook

The worsening of the external environment and the correction of local stock prices in the first quarter of 2001 have clouded the outlook of the Hong Kong economy. The government revised its forecast of real GDP growth for 2001 to 3% from the earlier projection of 4% in March. Notwithstanding lower interest rates, private consumption growth is expected to moderate, as consumer sentiment may be negatively affected by conditions in the labour market and asset price movements. Weak global demand and the recent strength of the US dollar may also affect Hong Kong's exports adversely. On the other hand, the strong investment in machinery and equipment and the bottoming out of property-related investment is expected to continue in the remainder of the year, partly offsetting the moderation in exports and consumption.

Consumer price inflation is expected to remain in negative territory for the remainder of 2001. For 2001 as a whole, the official forecast for CCPI inflation has been revised downward from zero to -1%, partly due to expectations of slower growth for both Hong Kong and the global economy.

- Prepared by the Research Department

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.