

Domestic and External Environment

by the Research Department

Global growth slowed moderately in the first quarter partly due to the uncertainty arising from the war in Iraq. Nonetheless, as the military conflict ended, the war-related premium in oil prices and financial markets has largely dissipated, providing an environment more conducive to a recovery in the second half of 2003. In Hong Kong, economic growth moderated in the first quarter, and activity in April slowed sharply due to the outbreak of severe acute respiratory syndrome (SARS).

External Environment

In the US, economic growth remained slow in the first quarter. Real GDP grew at an annualised rate of 1.9%, compared with 1.4% in the previous quarter. Key components of domestic demand were sluggish, with a slower growth in personal consumption and a decline in fixed capital spending. The latest statistics suggested that activity remained subdued in the early part of the second quarter. Industrial production contracted by 0.5% in April from March, while the ISM manufacturing index declined further below the neutrality benchmark of 50. Meanwhile, retail sales decreased slightly after a rebound in March. There were also signs of deterioration in the labour market, with the unemployment rate rising to 6.0% in April. Nevertheless, consumer confidence has improved considerably with the end of the war. Looking ahead, the lower oil prices, improvement in consumer and business sentiments and dissipation of the war-related risk premium in financial markets will likely contribute to a more conducive economic environment in the remainder of the year.

In the euro area, real GDP growth decelerated to 0.1% in the fourth quarter of 2002 from 0.3% in the third. The recent releases indicated that the broad-based weakness was extended to 2003. Manufacturing activity weakened, with industrial production falling 1.2% month-on-month in March. On the consumption side, retail sales decreased by

0.8% month-on-month in February. In Germany, real GDP contracted by 0.2% in the first quarter of 2003 over the previous quarter. The latest IFO Survey showed the business climate had deteriorated considerably in April. Meanwhile, the unemployment rate edged up further to 10.7%. In the UK, economic growth moderated to 0.2% in the first quarter of 2003 from 0.4% in the previous quarter.

In Japan, real GDP was flat in the first quarter of 2003, compared with a 0.5% growth in the previous quarter. Inflation as measured by the GDP deflator posted a record low of -3.5% year-on-year (y-o-y), indicating heightened deflationary pressures. The industrial sector appeared to be adversely affected by the moderation of growth in the global economy, with the expansion of manufacturing output showing signs of peaking along with export growth. In addition, the latest Tankan survey showed a downgraded assessment on business conditions by large manufacturers during the first quarter. On the household side, although consumer confidence rebounded moderately in April after reaching a recent low in the first quarter, the high jobless rate and declining real household income are likely to restrain consumption growth going forward.

Elsewhere in Asia, the latest statistics showed that real GDP grew strongly in China by 9.9% y-o-y in the first quarter of 2003. Although export growth remained robust, the outbreak of SARS represents a

significant threat to the region's growth prospects in the near term. Economies affected most directly by the disease include Hong Kong, Singapore, Taiwan, Vietnam, and China. While the impact of the epidemic was felt mainly in tourism-related sectors, general consumer and business sentiments were undermined to varying degrees. In view of the severity of the potential damage to the economy, the authorities of some of these jurisdictions have introduced special relief measures.

Notwithstanding signs of moderating growth in the global economy at the beginning of 2003, most major central banks kept interest rates unchanged in anticipation of improving economic conditions in the latter part of the year. In the US, the Federal Reserve kept the Fed funds target rate unchanged at 1.25% at its May policy meeting, although its risk assessment was shifted towards economic weakness. The European Central Bank also maintained its refinancing rate following a 25 basis points cut to 2.5% in March. In the UK, the Bank of England held its policy rate unchanged at 3.75% at May's meeting. Nevertheless, in view of rising inflation risks, the Bank of Canada raised the overnight funding rate by 25 basis points to 3.25% in April.

World equity markets have rebounded considerably since mid-March as the war in Iraq ended. The S&P500 index rose by 17% to 945 by mid-May, while major markets in Europe also advanced strongly in tandem. However, the Japanese stock market continued to be weak due to increasing concerns over the stability of the banking sector. Elsewhere in Asia, the outbreak of SARS led most markets to perform poorly in April before rebounding in May.

In the currency market, the US dollar continued to depreciate against other major currencies after a brief rebound in mid-March, partly due to concerns over the persistent current account deficit of the US. The USD/EUR rate rose to 1.17 in mid-May, the highest level since January 1999. Meanwhile, the yen also strengthened to a two-year low of 115.4 against the dollar. Separately, spot oil prices eased

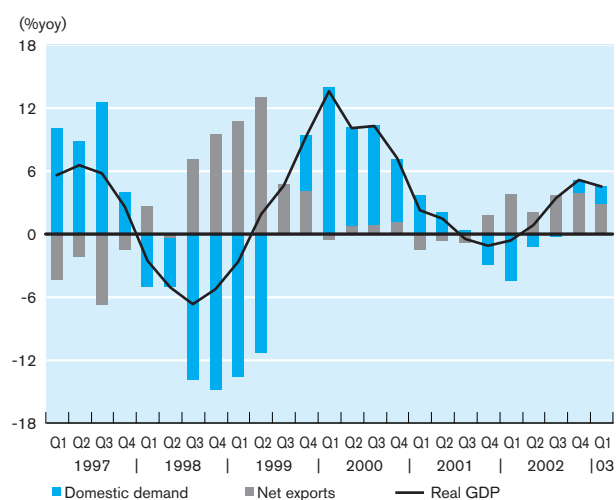
considerably to below US\$30 per barrel from a high of US\$38 registered prior to the outbreak of war in mid-March.

Domestic Activity

In Hong Kong, economic growth moderated in the first quarter of 2003, with real GDP growing by 4.5% y-o-y compared with 5.1% in the fourth quarter of 2002. On a seasonally adjusted quarter-on-quarter basis, real GDP declined by 0.3%. Supported by robust trade performance in the Mainland and a gain in competitiveness arising from the depreciation of the US dollar, exports continued to provide strong impetus to growth in Hong Kong (Chart 1). By contrast, domestic demand remained weak. Private consumption has contracted for six consecutive quarters and property-related investment further declined in the first quarter, despite an increase in investment in machinery and equipment.

The latest economic indicators point to a further weakening of domestic activity due to the outbreak of SARS in mid-March. In particular, retail sales fell by 12.2% in April from a year earlier, the largest decline since the fourth quarter of 1998. This reflected reduced domestic spending brought on by a fear of being infected in public areas as well as the decline in inbound tourists due to the travel warnings issued by the World Health Organisation (WHO).

CHART 1
Sources of Growth



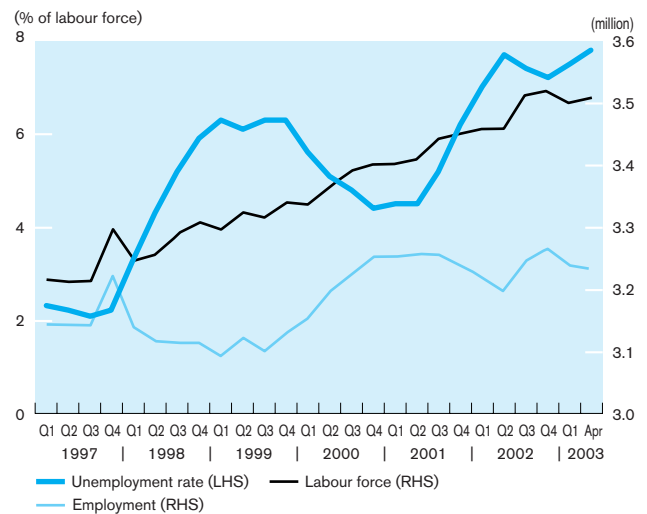
External Trade

Growth in merchandise exports moderated in April (Chart 2). Re-export growth slowed from 20.3% in the first quarter to 11.3% in April, while domestic exports continued to contract at a double-digit rate. Exports of services have been significantly affected by SARS. While expansion of merchandise trade continued to support exports of trade-related services, the sharp decline of 65% in tourist arrivals in April pointed to a considerable contraction in tourism-related earnings. Likewise, imports of tourism-related services shrank appreciably because of the travel restrictions imposed by some countries on visitors from Hong Kong. The number of Hong Kong residents travelling abroad fell by 29.2% y-o-y in April.

Labour Market and Inflation

Labour market conditions worsened, with the seasonally adjusted unemployment rate rising back to the record high of 7.8% during the three months ending April, the same level as in May-July 2002 (Chart 3). The deterioration was attributable to a decline in total employment coupled with an increase in the total labour force. Meanwhile, the underemployment rate rose to 3.2%, as an increasing

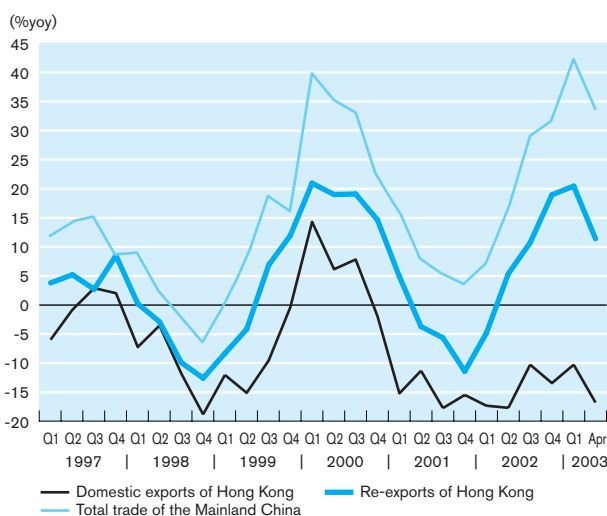
CHART 3
Labour Market



number of employees had to take no-pay leave amid the SARS outbreak.¹ Preliminary statistics on sectoral developments indicate a broad-based increase in the unemployment rate, particularly in the construction, restaurants and hotels, and wholesale/retail sectors.

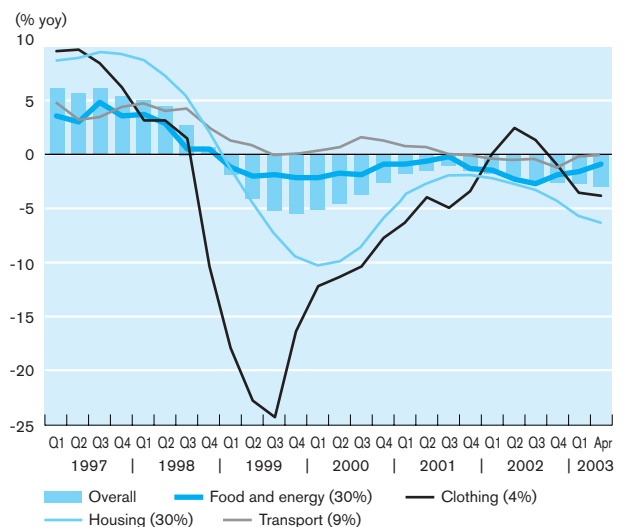
Price deflation continued. The Composite Consumer Price Index (CCPI) fell by 3.0% y-o-y (after adjusting for the government relief measures) in April, following a drop of 2.6% in the first quarter (Chart 4). The

CHART 2
External Trade



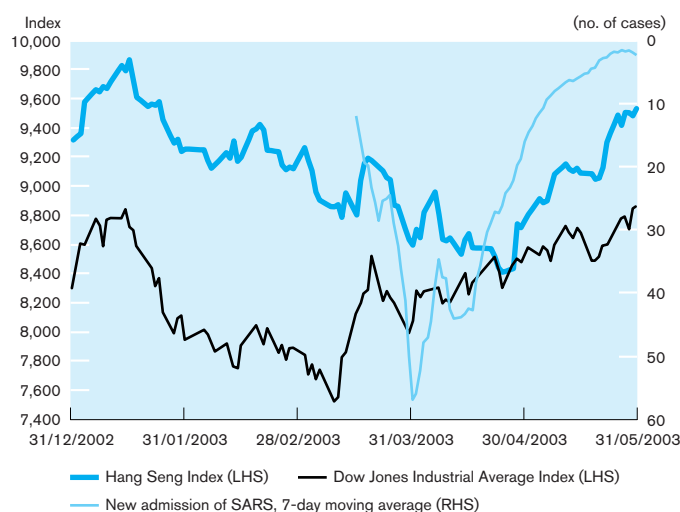
¹ Underemployed persons are those involuntarily working for less than 35 hours a week.

CHART 4
Inflation (Adjusted for Special Relief Measures)



Note: The figures in the parentheses are the weights of the components in CCPI basket.

CHART 5
Equity Market



intensified price deflation reflected weaker domestic demand and sharper declines in rental prices, both were in part related to the outbreak of SARS. In particular, the y-o-y decline in the housing component accelerated to 6.3% in April 2003 from 2.6% in the same period last year.

Asset Markets

Notwithstanding the recovery in the US and European stock markets, Hong Kong's equity prices fell on the outbreak of SARS (Chart 5). The Hang Seng Index weakened to a four-and-a-half-year low of around 8,400 in late April, before recovering in May on a reduced number of newly confirmed cases of SARS and the lifting of WHO's travel advisory against Hong Kong. At the end of May, the Hang Seng Index was 1.8% above the closing level at the end of 2002, compared with a rise of 6.1% in the Dow Jones Industrial Index during the same period.

The property market has further weakened in recent months. Residential property prices fell by 7% in the first quarter of 2003, following a fall of 3.4% in the last quarter of 2002. The transaction volume stayed at around 6,000 per month during January to April, down by 22% from the corresponding period last year.

Money Supply and Domestic Credit

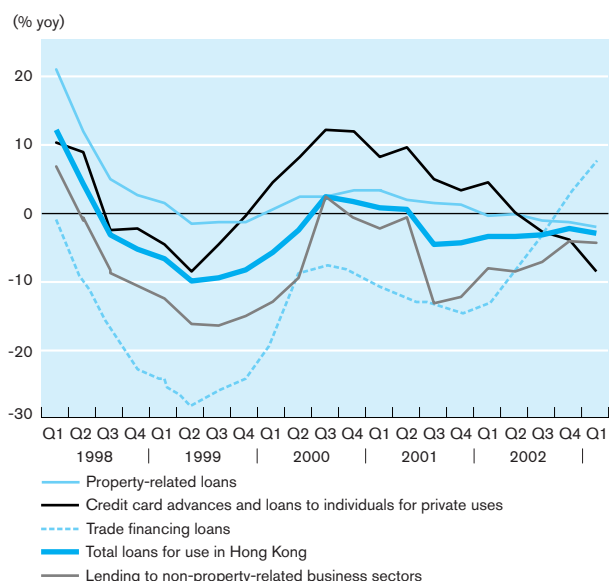
Notwithstanding a further increase in Hong Kong dollar narrow money, broad money registered a small

decline. Narrow money (seasonally adjusted) grew considerably, by 2.7% in the first quarter and by 15.2% in the year to end-March, compared with the contraction in broad money of 0.8% and 0.5% respectively. The modest fall in broad money was attributable to a decline in time deposits, which was in part associated with portfolio shifts in search of higher returns in the face of record-low deposit rates against yields on alternative financial assets. This was in line with the Balance of Payments statistics that showed a notable net outflow in the capital and financial account (see Appendix for details).

Foreign currency deposits declined in the first quarter, reflecting a drop in US dollar deposits, which more than offset an increase in other foreign currency deposits. The latter was partly attributable to valuation effects as the Hong Kong dollar weakened against other major currencies along with the US dollar.

Domestic credit remained subdued, in line with the weak economic conditions. Specifically, loans for use in Hong Kong fell by 0.5% during the first quarter, or by 2.9% from a year ago. The contraction was broad-based, except for trade financing, which rose significantly alongside strong growth in external trade (Chart 6). In other sectors, credit card

CHART 6
Loans for Use in Hong Kong



Note: Non-property business lending is defined as loans for use in Hong Kong other than property-related loans, lending to individuals for private purposes, credit card advances and trade financing loans.

advances and personal loans registered the largest rate of decline on a y-o-y comparison, although their share in total domestic lending was small. This reflected mainly a tightening of the issuance of new cards and lending polices, increased charge-offs as well as weakened consumer spending (mainly in March) following the SARS outbreak.

Short-term Outlook

The near-term economic outlook has weakened in part due to the outbreak of SARS. First, the already sluggish local demand is further undermined. Despite the recent improvement in consumer sentiment as a result of fewer confirmed cases of SARS, consumer spending is likely to be constrained by the higher unemployment rate and lower asset prices. Secondly, external trade will continue to be affected. Exports of tourism-related services are unlikely to resume significant growth until Hong Kong is removed from the list of areas with recent local transmission of SARS. Merchandise trade may also be affected to the extent that some countries imposed restrictions on business travel to and from the region. Thirdly, deflationary pressures are expected to intensify along with weaker domestic demand and lower property prices.

Nevertheless, the recent depreciation of the US dollar will help to improve the competitiveness of Hong Kong's exports. The US monetary policy is expected to continue to support a low interest rate environment. Moreover, the Government has proposed a set of relief measures to alleviate the impact of SARS. Against this background, a recovery, led by external trade, is likely to take hold in the latter part of the year along with an expected improvement in the global economy.

APPENDIX

AN ANALYSIS OF BALANCE OF PAYMENTS DEVELOPMENTS IN 2002

The recently released Balance of Payments (BoP) statistics indicate a strong current account surplus in 2002, accompanied by a large net outflow in the portfolio and direct investment account (Table A1). This Appendix reviews the BoP developments from a macroeconomic perspective and considers, in particular, if the net capital outflow reflected reduced confidence in the currency or the banking system (see *HKMA Research Memorandum: "An Analysis of Balance of Payments Developments in 2002"*, April 2003, available on the HKMA website).

From a macroeconomic perspective, the BoP figures reflect the interaction of: (i) autonomous or exogenous changes in individual components; and (ii) changes in response to interest rate and exchange rate developments, emanating from changes in other BoP components.¹ In other words, the current account is not only influenced by the determinants (such as changes in competitiveness) of trade in goods and services, but also by savings decisions and portfolio choices regarding domestic and foreign assets.

TABLE A1

Hong Kong's Balance of Payments Account

Standard Components	1998	1999	2000	2001	2002
<i>In % of GDP</i>					
Current Account	2.7	7.5	5.5	7.5	10.7
Capital and Financial Account	-2.5	-6.7	-4.5	-7.6	-15.1
Capital transfers	-1.4	-1.1	-0.9	-0.7	-1.2
Financial non-reserve assets (net change)	-5.1	0.7	2.5	-4.0	-15.3
Direct investment	-1.3	3.3	1.6	7.6	-2.4
Portfolio investment	13.4	20.6	14.8	-25.2	-22.9
Financial derivatives	2.0	6.4	0.1	3.1	0.8
Other investment	-19.1	-29.6	-14.0	10.5	9.2
Reserve assets (net change)⁽¹⁾	4.1	-6.2	-6.1	-2.9	1.5
Net error and omissions	-0.2	-0.8	-1.0	0.1	4.3
Overall Balance of Payments⁽¹⁾	-4.1	6.2	6.1	2.9	-1.5

⁽¹⁾ The overall BoP balance mirrors the net change in reserve assets, for which a positive sign indicates a decline.

¹ A comprehensive review of considerations in analysing BoP statistics was provided in another HKMA Research Memorandum, "Balance of Payments Statistics: Examining Some Received Wisdom", December 2000. For full text, see *HKMA Quarterly Bulletin*, February 2001.

In Hong Kong, there were some autonomous net portfolio and foreign direct investment outflows in 2002, which were financed in part by the current account surplus. However, empirical analysis confirmed that the net outflow of capital was in line with economic fundamentals, reflecting particularly a portfolio re-balancing in seeking higher rates of return on foreign assets. Specifically, the 3-month Hong Kong dollar deposit rate declined to a record-low level of 0.1% as of end-2002, compared with a yield of around 3% for 5-year US Treasury bills (Chart A1). On the other hand, notwithstanding the notable net capital outflow, the interest rate differentials between the Hong Kong dollar and the US dollar — an indicator of the Hong Kong dollar risk premium — remained generally stable in recent years (Chart A2).² Thus, there was no significant evidence of a capital flight triggered by reduced confidence.

The strong current account surplus reflected an improvement in competitiveness due to the depreciation of the real effective exchange rate (REER). Partly as a result of a weakening of the US dollar against other major currencies, the REER index depreciated by 4% during 2002. This was also likely related to weak domestic demand, due in part to increased household savings in response to declining property prices.

CHART A1
Hong Kong Dollar Deposit Rates and Yields on US Treasury Bills

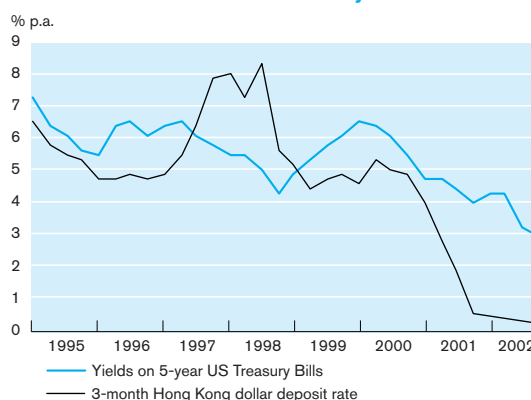
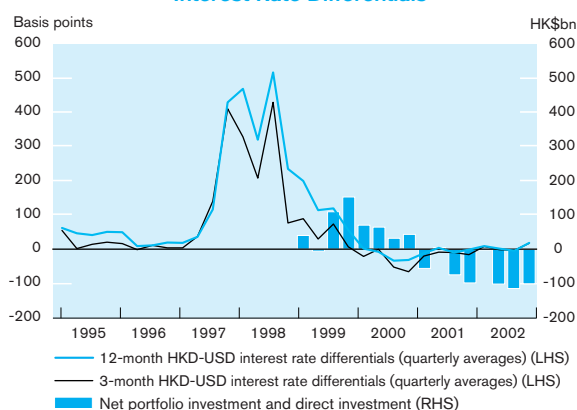


CHART A2
Net Portfolio and Direct Investment and Interest Rate Differentials



² Under the Linked Exchange Rate system, an increase in the Hong Kong dollar risk premium is usually associated with an increase in domestic interest rates relative to their US dollar counterparts.