

Domestic and external environment

by the Research Department

The pace of the global recovery accelerated towards the end of 2003. In the US, economic growth remained robust, with the labour market showing initial signs of improvement. Meanwhile, various sentiment indicators point to a brighter economic outlook in the euro area. In Asia, although exports continued to be a key driver of growth, there were increasing signs of a revival in domestic demand. In the fourth quarter of 2003, the Hong Kong economy continued a broad-based recovery from disruptions caused by the SARS outbreak in the first half of the year. Exports of goods maintained strong momentum, while tourism and private consumption continued to rebound markedly.

External environment

In the US, real GDP increased at an annualised rate of 4.1% in the fourth quarter of 2003, following an exceptionally strong expansion of 8.2% in the third. Personal consumption and capital spending remained the key drivers of growth. Nevertheless, the latest statistics suggest that consumer spending growth moderated somewhat at the start of the year, with retail sales falling for the first time in January since September 2003. With regard to the labour market, the unemployment rate fell from a peak of 6.3% in June 2003 to 5.6% in January, while non-farm payrolls have increased by 366,000 since September 2003. The improving labour market conditions and the recent rally in stock prices have helped boost consumer confidence. On the production side, the continued recovery in capital spending provided support to the industrial sector. The January ISM survey indicates that the manufacturing sector expanded at the fastest pace in two decades, while industrial production rose strongly by 0.8% during the month.

In the euro area, real GDP growth decelerated slightly to 0.3% in the fourth quarter of 2003 from 0.4% in the third, mainly attributable to a slowdown in export growth. Recent data releases show that the unemployment rate stayed high at 8.8% in January.

While the unfavourable labour market conditions continued to weigh on consumer spending, various sentiment indicators suggest that business confidence strengthened further, supported by the reviving global demand. In particular, the ZEW indicator of economic sentiment and the IFO business climate index in Germany have been on a rising trend since early 2003. In the UK, the economy grew at the fastest pace in almost four years in the final quarter of 2003, mainly driven by strong domestic demand.

In Japan, economic growth accelerated to 1.6% in the fourth quarter of 2003 from 0.6% in the third, the fastest pace in more than 13 years. The robust growth was broad-based, with particularly strong expansion in fixed asset investment and exports. The Tankan survey reveals that large manufacturers continued to upgrade their assessment on business conditions, while machine orders rose strongly by 11.3% for the fourth quarter as a whole. There were also initial signs of a gradual recovery in household spending, which grew by 0.9% during the quarter, the biggest gain in a year. This was partly supported by the improving labour market. Recent data releases indicate that the jobless rate dropped from 5.2% to 4.9% in December, the lowest level since June 2001. Nevertheless, prices continued to decline in the fourth quarter, with the GDP deflator

falling by 2.7% from a year ago. Looking forward, capital spending is likely to remain a key driver of growth, while export growth may moderate somewhat given the recent appreciation of the yen.

Elsewhere in Asia, economic performance continued to improve. Real GDP growth on the Mainland accelerated to a year-on-year rate of 9.9% in the fourth quarter, yielding growth of 9.1% for the whole of 2003, the highest since 1996. Singapore, Taiwan, Indonesia, Malaysia and the Philippines also saw robust growth. While exports remained a key growth driver, there were increasing signs of a recovery in domestic demand. Nevertheless, the outbreak of avian flu is seen as a potential threat to the growth prospects in some of the Asian economies.

With regard to monetary policy, the development has been mixed in major economies. In the UK, given rising concerns over price stability, the Bank of England raised the policy interest rate by 25 basis points to 4% in February, the second hike in three months. In contrast, the Bank of Canada lowered the overnight funding rate from 2.75% to 2.5% in January and further to 2.25% on 2 March, while the Bank of Japan raised the current account balance target range to 30-35 trillion yen in January. The Federal Reserve and the European Central Bank maintained their policy interest rates unchanged at 1% and 2% respectively at their latest policy meetings.

Encouraged by better-than-expected economic reports and improved corporate profitability, major stock markets continued to rise. The S&P 500 index advanced to a two-year high of 1,158 in mid-February, and the Nikkei 225 index climbed to a high of 11,537 in early March. Major European markets also rose, with the German DAX and the French CAC 40 indices edging up by 5% and 7% respectively in the three months ending February. In non-Japan Asia, worries about the outbreak of avian flu led most markets to perform poorly in late January before rebounding in February.

In the currency market, the US dollar continued to depreciate against other major currencies between mid-November 2003 and mid-February 2004, given concerns about the persistent current account deficit in the US. While the euro strengthened to a record

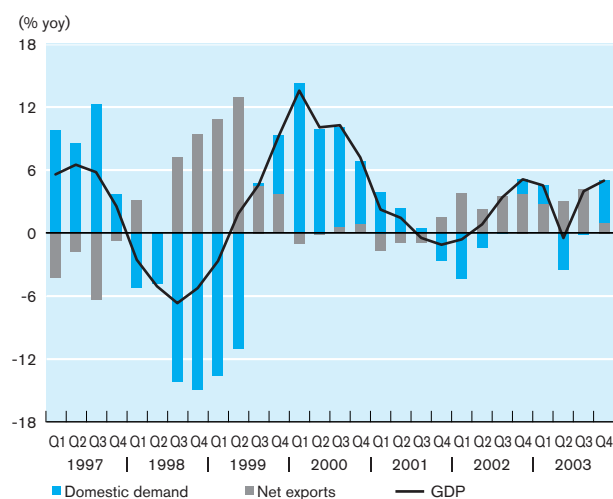
high of 1.284 USD/EUR in mid-February, the yen appreciated to a 41-month high of 105.37 JPY/USD. Meanwhile, most floating Asian currencies strengthened to varying degrees against the US dollar. Separately, crude oil prices rose rapidly in recent months, with the UK Brent crude oil prices increasing to above US\$33 per barrel at end-February.

Domestic activity

The Hong Kong economy continued a broad-based recovery in the fourth quarter of 2003. Real GDP rose by 5.0% compared to a year earlier, further up from the 4.0% increase in the third quarter. Exports of goods maintained strong growth momentum, while tourism and private consumption continued to rebound markedly. Spending on machinery, equipment and computer software started to pick up in the second half, but that on building and construction remained weak (Chart 1).

The latest economic indicators point to a sustained recovery. The Purchasing Managers' Index — a composite index designed to provide an overview of the business activity in Hong Kong — stayed above the neutral level of 50 in January, signalling a continued expansion in economic activity. Tourist arrivals from the Mainland increased by 48.5% in January compared with a year ago. Although growth of retail sales appeared to slow somewhat in January, it could be distorted by the timing of the Lunar New Year which fell in January in 2004, but in February last year.

CHART 1
Sources of growth



External trade

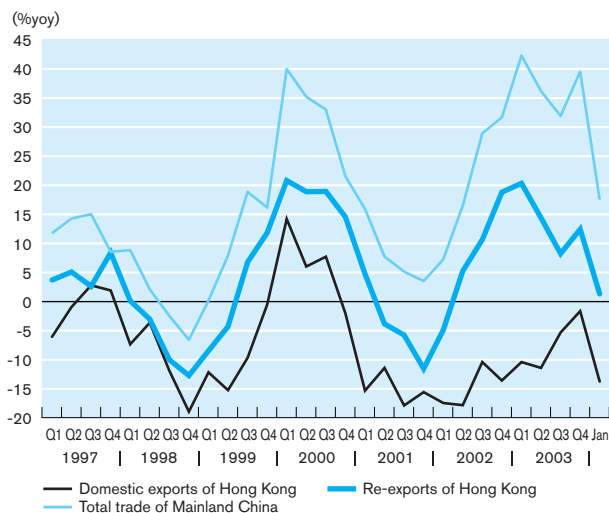
Growth in merchandise exports slowed from a year-on-year increase of 11.4% in the fourth quarter of 2003 to 0.2% in January of 2004 (Chart 2). The slowdown was partly attributable to reductions of VAT rebates implemented on the Mainland in January which led to a rush by exporters to ship products by the end of 2003. The year-on-year comparison may also be distorted by the different timing of the Lunar new year. Among the major markets, exports to East Asia and to the European Union grew strongly, while export performance to the United States was somewhat weak.

Exports of trade-related services grew along with the expansion of merchandise trade. Owing to an increasing number of Mainland visitors taking advantage of the "individual travel" scheme, tourism-related earnings continued to increase strongly by 13.4% year-on-year in the fourth quarter. Imports of tourism-related services also recovered, but at a more moderate pace.

Labour market and inflation

Labour market conditions improved further in recent months. The seasonally adjusted unemployment rate fell from the peak of 8.7% in July 2003 to 7.3% in the three months to January 2004 (Chart 3). The improvement was broad-based, but consumption and tourism-related sectors particularly benefited.

CHART 2
External trade



Deflationary pressures eased noticeably. The decline in the Composite Consumer Price Index (CCPI) narrowed to 1.5% year-on-year in January, while the monthly changes of prices (after adjusted for seasonal and special factors) have moved around zero in recent months (Chart 4). Within the components of the CCPI, food and clothing prices increased. The housing component, which reflects both new and existing rental contracts, continued to decline, although the market rental turned to increase in the last few months of 2003.

CHART 3
Labour market

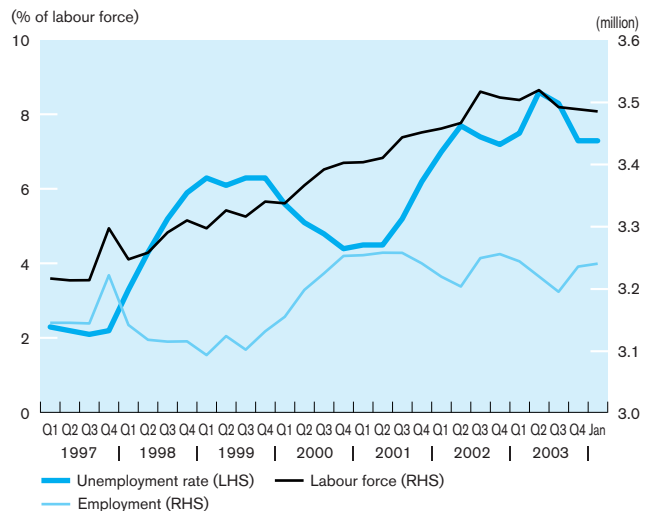


CHART 4
Inflation (adjusted for Special Relief Measures)

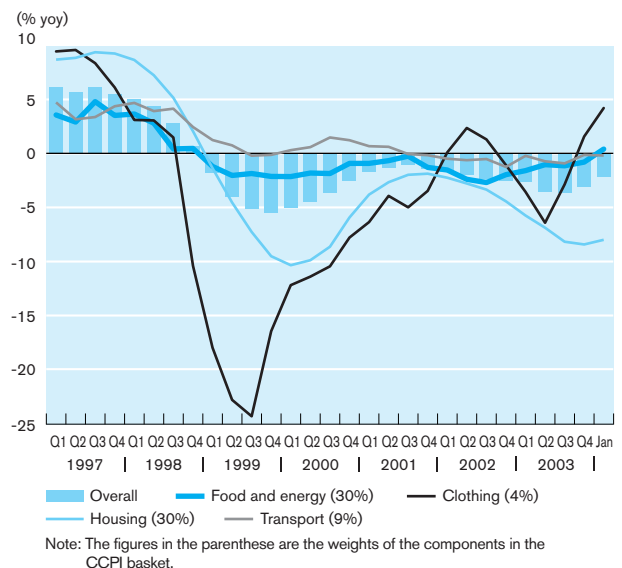
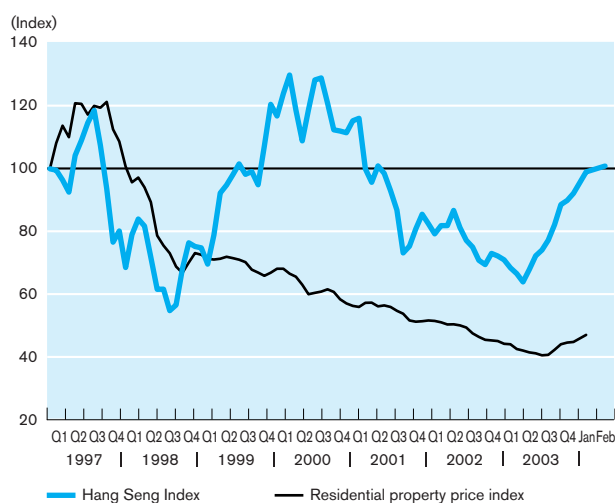


CHART 5

Asset prices



Asset markets

In the local equity market, investment sentiment was briefly affected by the outbreak of avian flu in the region in January, but the strong rally subsequently resumed upon the improved economic outlook. The Hang Seng Index rose to over 13,300 in early March, around 7% higher than at the end of 2003 and 60% up from its trough in last April (Chart 5).

Optimism over Hong Kong's economic prospects had a particularly noticeable impact on the property market, which has posted a marked rebound in recent months. The transaction volume was more than doubled in February compared with a year ago. Residential property prices rose by 15.8% in January from the low in July, and the latest Centa-City leading index points to a continuing upward trend (Chart 5).

Money supply and domestic credit

Hong Kong dollar broad money expanded significantly, while growth of narrow money accelerated in the fourth quarter. Broad money rose by 2.4% during the quarter, yielding a 5.9% rise in the twelve months to December, reflecting the revival in economic activity and reduced deflationary pressures. Narrow money (seasonally adjusted) continued to rise markedly, by 12.8% in the quarter

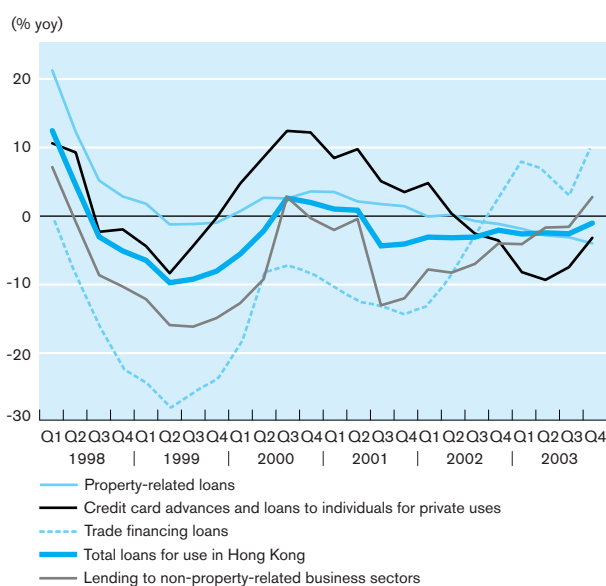
and by 35.8% in the year to end-December. The strong growth of narrow money was mainly attributable to the buoyant stock market activity, which led to a continued increase in demand deposits, as well as the record-low interest rates.

Foreign currency deposits expanded for the third consecutive quarter, owing to a notable rise in US dollar deposits and, to a lesser extent, an increase in other foreign currency deposits. As Hong Kong dollar deposits rose less than foreign currency deposits, the share of foreign currency deposits in total deposits edged up modestly to 45.9% in the fourth quarter.

Domestic credit showed some signs of improvement alongside the economic recovery. Specifically, loans for use in Hong Kong grew moderately by 0.9% during the fourth quarter, and registered a smaller rate of decline of 1.4% on a year-on-year comparison (Chart 6). The expansion was attributable to a rise in trade financing and lending to non-property-related sectors. Property-related loans continued to decline, owing in part to reduced lending for residential property development.

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.

Short-term outlook

The economic recovery in Hong Kong is expected to gain strength in 2004. It is difficult to project the effect of cuts in tax rebates on exports on the Mainland, but merchandise trade is likely to remain robust given the strong recovery in the global economy. With more areas to be included in the “individual visit” scheme and rising income on the Mainland, growth in tourism should accelerate, particularly in the light of a low base of comparison in 2003 owing to the impact of SARS. Private consumption is expected to continue to recover, supported by rising consumer confidence brought about by falling unemployment, increasing asset prices and opportunities arising from closer integration with the Mainland. The expected robust economic recovery in Hong Kong and a return of inflation in the Mainland should further ease deflationary pressures.