DOMESTIC AND EXTERNAL ENVIRONMENT

Domestic financial markets stabilised during the last quarter of 1998 as the external environment improved. Interest rate cuts in the US and other OECD countries, the weakening of the US dollar, and the stabilisation of international financial markets contributed to lower local interest rates as well as more stable asset markets following the rebound in the third quarter. However, bank credit remained weak, despite the improvement in banks' liquidity positions.

Real GDP declined by 7.1% year-on-year in the third quarter, and likely contracted further in the last quarter. Consumer demand remained weak on the back of rising unemployment and increasing downward pressure on wages. Investment was dampened by high real interest rates and the uncertain business outlook. Exports continued to decline, but trade deficit narrowed, as imports contracted even faster on the back of weak domestic demand. The unemployment rate reached a record-high level in the three months to December, while inflation slowed sharply.

The economy is expected to bottom out in the course of 1999, but any recovery later in the year will likely be moderate. Lower interest rates and the partial recovery of the asset markets have improved consumer sentiment. Domestic price adjustments and wage restraint, as well as the recent weakening of the U.S. dollar, should help ease competitiveness concerns. However, the sustainability of these positive factors will in part depend upon developments in the external environment. The immediate spillovers from the Brazilian devaluation to other financial markets have been subdued relative to the experience in 1997-98, but risks remain.

External Environment

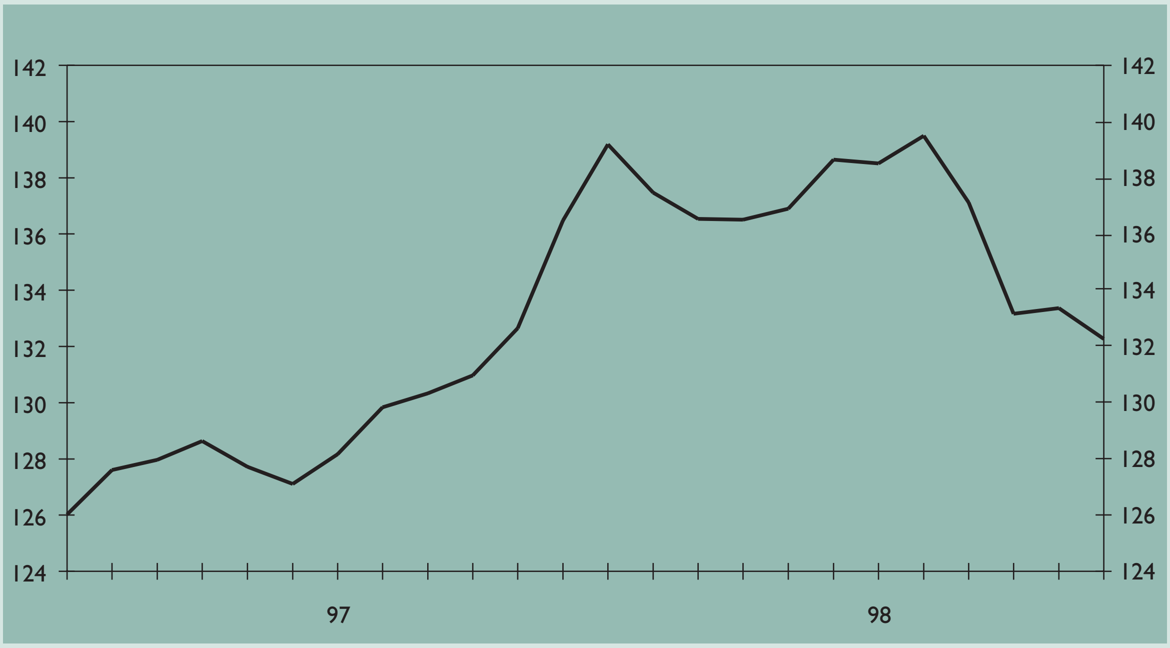
The external environment improved significantly during the last quarter of 1998, as reflected in lower global interest rates, rebounds in most Asian currencies, and reduced volatility in global financial markets. Interest rate cuts in the US and other OECD economies since last September signified an easing in global monetary conditions, and facilitated lower rates in Hong Kong and other crisis-hit countries. Following rate cuts by the Fed in the last quarter of 1998, prime lending rates in Hong Kong fell from 10% in October to 8.75% in January.

The US dollar weakened during the fourth quarter, particularly vis-à-vis the Japanese yen and other Asian currencies. As a result, Hong Kong's nominal effective exchange rate depreciated (Chart 1), easing somewhat pressures on export competitiveness. Rebounds in other Asian currencies also helped improve market sentiment and reduce speculative pressures on the Hong Kong dollar.

Other factors which contributed to the stabilisation of international financial markets in the last quarter of 1998 included progress in replenishing IMF resources, the assembling of the

Chart 1

Hong Kong's Nominal Effective Exchange Rate



$41.5 billion Brazil rescue package, and the building of a consensus on the need to improve the international financial architecture.

More recently, however, the devaluation of the Brazilian real has raised concerns over possible spillover effects on other Latin American countries — particularly Argentina — and the United States. Market sentiment toward the renminbi and the Hong Kong dollar was also negatively affected. Immediate contagion effects were muted compared with previous periods of turbulence, however.

Monetary Conditions

Following the introduction of the package of technical measures to strengthen the currency board arrangements in Hong Kong in early September, market sentiment improved. Hong Kong dollar interest rates moved on a downward trend and the spreads between Hong Kong dollar interest rates and their US dollar counterparts generally narrowed.[1]

Total deposits continued to pick up in the fourth quarter — with a notable shift to demand and savings deposits from time deposits — but lending activities of banks remained sluggish. Total deposits grew by 2.8% in the December quarter, compared with the 6.1% increase in the previous quarter. Hong Kong dollar time deposits declined by 5.3%, while demand and savings deposits grew by 8.1% and 33.4%, respectively. Total loans and advances fell by 1.6% in the fourth quarter, following a 6.5% decrease in the previous quarter. Domestic loans declined further by 2.3% in the December quarter. Trade financing dropped by 8.9%, following a 7.3% decline in the previous quarter. Lending to most other sectors continued to fall, with the exception of residential mortgage loans, which grew by 3.2% as property market activity recovered. Offshore lending also recorded a decline of 0.5% due to continued weakness in the regional economies.

1 For details on the movement of the Hong Kong dollar interest rates, please refer to the article on 'Operation of Monetary Policy' in this bulletin.

Domestic Activity

The Hong Kong economy continued to contract in the third quarter of 1998, with real GDP declining by 7.1% following negative growth of 2.6% and 5.1% in the first and second quarters, respectively. The contraction reflected mainly weak domestic demand, while the external trade balance improved further. GDP is likely to have contracted again in the fourth quarter. Growth in GDP by major components is summarised in Table 1.

Table 1 : GDP by Components (at constant 1990 market prices)

(% y-o-y, unless stated otherwise)

	1996 Overall	1997 Q1	Q2	Q3	Q4	1998 Overall	Q1	Q2	Q3^P
Private Consumption Expenditure	4.7	4.5	8.6	11.1	2.9	6.7	-2.6	-5.1	-10.0 (-5.9)
Government Consumption Expenditure	4.0	4.6	5.6	-0.1	-0.4	2.4	2.1	-5.3	3.7 (+0.3)
Gross Domestic Fixed Capital Formation	10.8	19.7	15.8	13.7	13.7	15.6	-1.2	5.6	-9.1 (-3.1)
Change in Inventories	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a. (-4.8)
Domestic Exports of Goods	-8.4	-3.9	-0.1	6.0	5.6	2.1	-4.7	-0.6	-9.4
Re-exports of Goods	7.5	5.5	7.3	4.2	10.3	6.8	2.5	-0.5	-6.6
Imports of Goods	4.3	6.4	6.9	7.1	8.2	7.2	-1.7	-1.8	-10.5
Net Domestic Exports of Goods (HK$ bn)	-302.5	-84.1	-90.8	-80.3	-82.3	-337.5	-75.2	-85.6	-60.8 (+8.9)
Net Re-exports of Goods (HK$ bn)	194.6	44.8	51.3	55.4	56.3	207.9	45.9	51.0	51.8 (-1.7)
Exports of Services	8.5	4.9	2.7	-3.6	-6.0	-0.6	-9.0	-11.0	-3.7
Imports of Services	2.5	5.3	0.0	6.0	4.7	4.1	1.9	3.0	-1.2
Net Exports of Services (HK$ bn)	86.6	19.6	22.8	17.8	19.8	80.0	14.0	15.9	16.3 (-0.7)
GDP	**4.6**	**5.7**	**6.9**	**6.1**	**2.8**	**5.3**	**-2.6**	**-5.1**	**-7.1 (-7.1)**

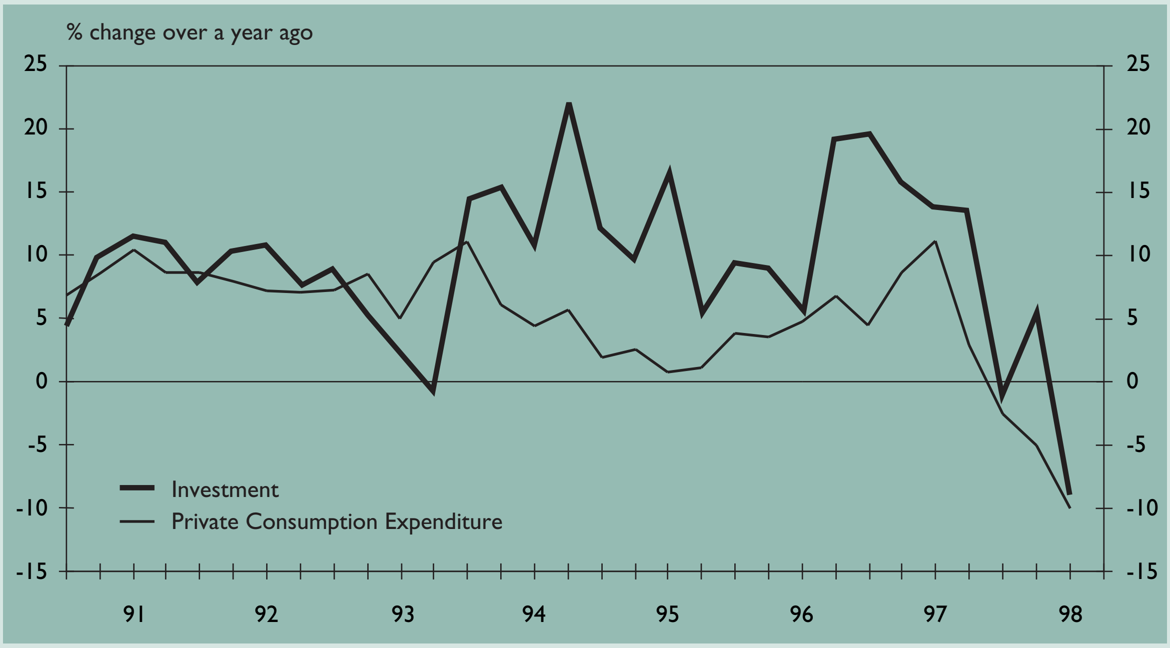
Note: ^{P} : *preliminary estimates*

( ) : *% contribution to growth*

In addition to negative wealth effects arising from the fall in asset prices, rising unemployment and growing downward pressure on wages have affected consumer behaviour. Private consumption expenditure dropped by 10% in the third quarter, after sliding by 2.6% and 5.1% in the previous two quarters. (Chart 2) Retail sales showed signs of a rebound in October, recording a seasonally adjusted month-on-month growth of 0.8%, following negative growth in the previous 5 months. The month-on-month (seasonally adjusted) growth turned into negative (-0.7%) again in November. Nevertheless, there were indications that Christmas sales were less weak than feared.

Gross domestic fixed capital formation recorded a year-on-year decline of 9.1% in the third quarter of 1998, after a moderate rebound in the previous quarter. Private sector building activity lost momentum, as existing projects reached completion and new projects were held back in a sluggish property market. Public sector civil engineering output was also weak, upon the completion of the Airport Core Programme. In addition, expenditure on machinery and equipment dropped in the third quarter, after a temporary rebound in the second quarter. As new building projects were deferred and demand for machinery and equipment were dampened by high real interest rates and the uncertain business outlook in the near term, investment spending is likely to have further declined in the last quarter of 1998.

Chart 2
Private Consumption Expenditure and Investment



External Trade

Following a significant setback in the third quarter, further large declines in exports were recorded in the last quarter (Chart 3). For 1998 as a whole, the values of domestic exports and re-exports dropped by 10.9% and 6.9%, respectively. In addition to weak demand from the rest of East Asia, exports to the US and the Mainland also slackened.

Imports declined at an even larger rate than exports on the back of weak domestic demand and sluggish re-exports, dropping by 11.5% in 1998. As a result, the merchandise trade deficit contracted sharply to HK$81.4 billion, compared with a deficit of HK$159.1 billion in 1997.

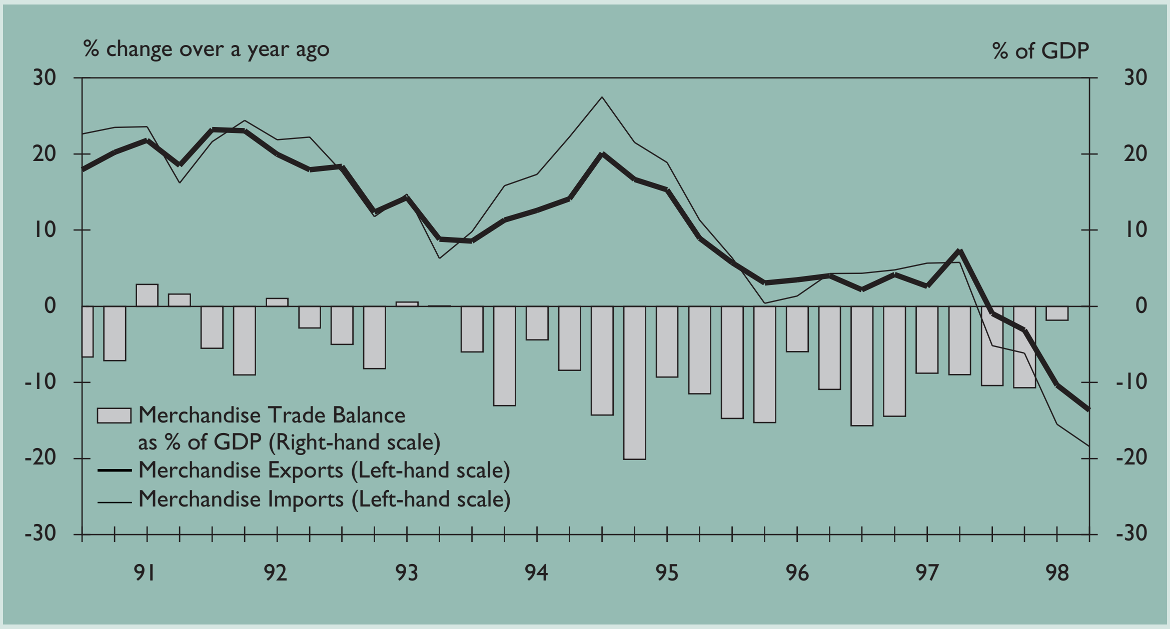
With regard to exports of services, tourist arrivals rebounded, with a year-on-year growth of 9.8% in the third quarter followed by a 5.5% increase in the fourth quarter. However, exports of other services, including transportation, banking, finance, insurance and offshore trade, likely remained weak, given weak domestic activity and slower external trade.

Labour Market and Inflation

The unemployment rate rose to 5.8% in the three months to December, with the construction, import/export trade, and transport sectors being the hardest hit. The surge in unemployment in the construction sector was mainly due to the slowdown in building and renovation activities while the marked rise in unemployment in the catering and trade-related sectors reflected sluggish external trade and weak consumer demand. The rise in unemployment in part also reflected a continued expansion in labour force, boosted by housewives re-entering the labour market, returnees of former emigrants and new arrivals from the Mainland. As the adjustment process continues, and with the unemployment rate usually being a lagging indicator of the business cycle, the unemployment rate is expected to rise further in coming months.

Deteriorating labour market conditions were reflected in wages. The nominal wage index recorded a year-on-year increase of 2% in September, compared with a rise of 7% in the same period of the previous year. The real wage index declined by 0.1%, year-on-year, in September. Meanwhile, prices have been

Chart 3
External Trade



responding quickly to the decline in domestic demand. The composite CPI recorded a year-on-year decline of 1.6% in December, following a 0.7% fall in November. The CPI in December was 3.3% lower than its peak level reached in May 1998. Weak domestic demand and a decline in import prices contributed to the price decline. Some special factors also played a role — including the freezing in government fees and utility charges as well as the one-off government rates rebate in the fourth quarter that trimmed rental charges.

Asset Markets

Following a sharp rebound toward the end of the third quarter, the stock market remained stable in the last quarter of 1998, with the Hang Seng Index trading at around the 10,000 level. Stock market turnover increased to over HK$14 billion in mid-October compared with around HK$3.4 billion in early August. Residential property prices recorded a month-on-month rise of 8.5% in November and 5.8% in December, reversing the downward trend in the previous seven months. Property transactions also revived substantially, with the number of transactions in both November and December nearly double that in October.

Short-Term Outlook

Notwithstanding the Brazilian crisis and the GITIC problems in January, market sentiment has remained relatively stable since the last quarter of 1998. Lower interest rates and improved liquidity helped stabilise financial markets and should have some positive impact on domestic demand. Moreover, price declines and wage restraint, as well as the sharp fall in asset prices, have reduced domestic costs, while the weakening of the US dollar — to which the Hong Kong dollar is linked — also improved Hong Kong's competitiveness. Provided these favourable factors are sustained, the economy is expected to bottom out during the course of 1999. However, in view of high real interest rates and rising unemployment, any recovery is likely to be modest. The pace of the recovery would also depend critically on the external environment. In this respect, there have been significant improvements, but risks remain.

While there were significant reductions in the OECD countries' interest rates during the last quarter of 1998, asset market exuberance and strong domestic demand in the US, as well as the desire to maintain a strong Euro in Europe, may delay further rate cuts.

The strengthening of the yen has reduced pressure on Asian currencies, including the Hong Kong dollar. However, the sharp rebound of Japan Government Bond (JGB) yields since late November could aggravate Japan's banking sector problems and delay Japan's recovery.

There has been no imminent impact on global markets from the introduction of the Euro. In the longer run, the Euro may offer another anchor for global exchange rates and help to reduce the dependence of the world economy on the US dollar. It may also provide a new source of growth and funding for Asia through a more integrated and deeper Euro market, both onshore and offshore (Box 1).

China's moves to improve its external sector management — including anti-smuggling restrictions, tightening of foreign exchange controls, and the

The Euro and its Implications for Hong Kong

The Euro started trading on 4 January 1999. The irrevocable conversion rates of the members' currencies[2] against the Euro were fixed on 31 December 1998. Compared with the initial fixing of US$1.1685 per Euro, the first tradable price reached US$1.1745, amid a favorable response by the Asian foreign exchange markets. Euro notes and coins will come into circulation on 1 January 2002, and will replace national notes and coins by mid-2002 at the latest. During the transition period from 1 January 1999 to 31 December 2001, trading in money market, foreign exchange market, equity and bond markets will be re-denominated in the Euro.

Hong Kong may benefit from the Euro's successful launch in several ways. The rise of the Euro may reduce exchange risk (particularly among Euro-member countries) and enhance global currency market stability. The growing importance of the Euro as a reserve currency will also provide local and international investors with new alternatives to diversify their investment portfolios.

In the longer term, Hong Kong could benefit from increasing trade, investment and financial flows between Europe and Asia if a more integrated Europe offers increased business opportunities for Asia. The elimination of intra-member exchange rate risk and financial integration among EU members should foster the development of Euroland capital markets, which have a combined size (equity market capitalisation and bonds outstanding) of about 140% of GDP, only half the size of the US. Hong Kong's unique financial infrastructure, including its pioneering connections with CEDEL and Euroclear, could facilitate the linkage between local and European capital markets, providing a new source of funding for Hong Kong companies and new investment opportunities to local investors.

As an active offshore financial center with the largest concentration of European banks in Asia, Hong Kong could also benefit from the likely emergence of an offshore Euro market in Asia (or Asia-Euro market). In contrast, there are concerns that Hong Kong could suffer from any major retreat of European banks and capital from Asia triggered by Asia's current economic difficulties and new financial opportunities in Europe.

2 The 11 Euro-states are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

liquidation of GITIC — should help reduce external payment risks in the long run. However, these may aggravate short-term pressures on local financing for ITICs and other red-chip companies, and also pose a temporary risk to trade growth.

Meanwhile, underlying gains in domestic demand remain uncertain in China, while exports are expected to face continuing pressures in 1999. (Chart 4) In addition, as the fiscal stimulus measures are mainly in the form of spending on infrastructure investment, the benefit to Hong Kong through increased trade would be limited.

With improved stability in Asian financial markets as well as the region's increasing efforts to reflate demand, the crisis-hit economies are expected to turn around in 1999. Nevertheless, recovery of the region is likely to be uneven, and some countries may still face serious challenges ahead. Finally, the Brazilian devaluation has so far had a limited immediate impact on Asian financial markets. However, since the events in Brazil are still developing, the full impact on Asia is yet to be assessed.

- Prepared by the Economic Research Division

Chart 4
China's GDP Growth