Following a sharp economic downturn last year, there are growing signs that the economy is bottoming out, and is on track for a broader-based recovery later this year. A stabilisation of global financial conditions and lower domestic interest rates have supported a recovery in the local equity and property markets, contributing to improved sentiment among consumers and investors. In the real sector, adjustments have continued, with rising unemployment and declining wages. It may take some time to see a clear reversal in these indicators, which tend to lag behind economic cycles.

External Environment

The year 1999 had an eventful start, as the financial turmoil re-emerged in Latin America. The Brazilian real came under heavy selling pressure in mid-January, culminating in the abandonment of the crawling peg system. Nevertheless, helped by more proactive policy responses and greater sophistication on the part of the investors in differentiating between fundamentals in different markets, the contagion effect of the Brazilian crisis has been more moderate than expected. After a short period of volatility in late January, Asian currency and stock markets soon regained their stability and moved steadily out of the doldrums. For the first four months of 1999, most Asian currencies fluctuated within a 3% range against the US dollar, while regional bourses registered strong gains of 15-35%.

Contributing to improved sentiment in Asian financial markets has been an easing of monetary conditions, made possible by a further easing of monetary policy in developed economies. The Bank of Japan and the European Central Bank cut their benchmark interest rates by 15 and 50 basis points respectively during the first quarter. Notwithstanding continued strong growth in the US, subdued inflation has kept monetary policy on hold. Under this benign environment, interest rates in most Asian economies, including Hong Kong, have fallen below their pre-crisis levels.

There are also growing signs of recovery in the real sectors of selected Asian economies. Industrial output in four of the crisis-hit economies has rebounded over the past few months; declines in retail sales moderated in Singapore and reversed in South Korea, while export growth in Malaysia has turned positive since last October. While brighter economic prospects in the regional economies may help to improve the outlook for Hong Kong's external trade, the strengthening of the US dollar in the first quarter of 1999 may have partly eroded the recovery of Hong Kong's price competitiveness. During the first quarter, the US dollar strengthened by 4.8% against the Japanese yen and 8.8% against the Euro, resulting in a 2.2% increase in Hong Kong's effective exchange rate, from 131.8 at end-1998 to 134.8 at end-March 1999.

Domestic Activity

In the real sector, GDP dropped 5.1% in 1998, the worst recession on record since official GDP data started in 1962. Similar to most other crisis-hit economies in Asia, the main contraction came from domestic demand, which shrank by 8.9%. Part of the decline was offset by an improvement in the external sector, which contributed 4.3% to

Table 1: Real GDP for Hong Kong
(Annual growth rate unless otherwise specified)

	1996	1997	1998	1999 (Official forecast)
Overall GDP	**4.5**	**5.3**	**-5.1**	**0.5**
Total domestic demand	**2.5**	**8.7**	**-8.9**	**3.3**
Final domestic demand	6.6	9.4	-6.1	0.3
Consumption	4.6	6.2	-6.0	2.7
Private	4.7	6.7	-6.8	2.5
Public	4.0	2.4	0.7	4.0
Investment	10.8	15.6	-6.1	-4.0
Private	9.6	20.0	-5.4	-5.6
Public	17.1	-5.5	-10.8	6.6
Change in inventories	(-4.0)	(-0.6)	(-3.1)	(3.0)
Net trade balance	**(1.9)**	**(-3.6)**	**(4.3)**	**(-2.8)**
Goods	(0.2)	(-2.7)	(5.9)	(-3.2)
Services	(1.7)	(-0.9)	(-1.6)	(0.4)

Note: Figures in the brackets refer to contribution to GDP growth.

growth in GDP, largely as a result of faster decline in imports than exports. Growth in GDP by major components is summarised in Table 1.

Having fallen significantly in 1998, private consumption seems to have stabilised. On a seasonally adjusted basis, retail sales volume recorded a drop of 2% in the first two months of 1999, compared with the last two months of 1998.[1] This was an improvement from the quarter-on-quarter declines of 5% and 2¼% in the third and fourth quarters of 1998, respectively.[1] Reflecting lower interest rates abroad and improved market sentiment, local interest rates eased further during the past four months. The banks' prime lending rate dropped twice by a combined 50 basis points (bps) to a four year low of 8.25%. The average 3-month HIBOR decreased from 6.2% in the fourth quarter of 1998 to 5.9% in the first quarter and further to 5.2% in April. While rising unemployment and job uncertainties continued to restrain household spending, the partial recovery in asset prices and lower interest rates appeared to have arrested a further deterioration in consumer confidence.

Investment remained weak in early 1999, restrained by an uncertain business outlook and cautious bank lending. Retained imports of capital goods declined by over 15% during the first two months of 1999, compared with the last two months of 1998.[1] This followed a quarter-on-quarter drop of 8¼% in the last quarter of 1998.[1] Bank loans for property investment and development fell by 3.0% during the first quarter. However, the recent recovery in the property market and a bottoming out of leading indicators, such as buildings with consent to commence work, may signal a pick up in construction activities later this year. Government initiatives to speed up a number of large-scale civil engineering projects may add further impetus to overall investment expenditure.

External Trade

The export sector remained sluggish in the first quarter of 1999. Total exports of goods were flat in the first quarter of 1999, following a quarter-on-quarter drop of 3% in the preceding quarter.[1]

[1] Based on seasonally adjusted data estimated by the Research Department of the Hong Kong Monetary Authority.

On a year-on-year basis, exports of goods declined by 9% in Q1 1999, compared with a drop of 13.5% in Q4 1998. Exports to China continued to register a significant drop, but exports to the US, Europe, Japan and the rest of the Asia recorded smaller declines. Total imports of goods decreased by 2% on a quarter-on-quarter basis during the first quarter, down from 2% in the fourth quarter of 1998.[1] On a year-on-year basis, the drop was 13.8% in Q1 1999, down from 18.2% in Q4 1998. As the decline in imports outpaced that of exports, the merchandise trade deficit shrank by 60% from a year ago, to HK$12.9 billion.

Tourism reported a stronger and broader recovery. Tourist arrivals rose by 13.4% year-on-year during the first quarter, the strongest growth since arrivals rebounded in mid-1998. Increases were reported in arrivals from all four major markets – the Mainland, Taiwan, Japan and Southeast Asia. Other service exports, especially transportation and offshore trading, were more sluggish, in part reflecting weak external activity.

Labour Market and Inflation

The unemployment rate continued to rise, reaching a post-1975 high of 6.2% in the three months ending in March 1999. Construction, wholesale/retail trade and restaurants/hotels sectors were the hardest hit. The rise was in part attributed to a continued expansion in the labour force, boosted by an increase of housewives entering the labour market, returnees of former emigrants and new arrivals from the Mainland.

Consumer prices continued to fall, by a year-on-year rate of 1.8% during the first quarter. On a seasonally adjusted month-on-month basis, and after discounting the effect of property rates rebate in Q4 1998, prices of clothing and footwear saw the greatest drop, followed by housing, durable goods and miscellaneous services. Apart from weak domestic demand and lower import prices, lower inflation reflected the lagged effect of the drop in housing rentals last year and the freeze in government fees and utility charges.

Asset Markets

Local asset markets recovered along with the stabilisation of the external environment and rallies in overseas stock markets. Domestically, lower interest rates and the fiscal stimulus announced in the March Budget (box) have also improved investors' sentiment. The Hang Seng Index broke through 13,000 on 19 April, the highest level since October 1997, and hovered around this level for the rest of the month. Stock market turnover increased to over HK$10 billion per day. Property prices remained stable, having rebounded by 15% during the last quarter of 1998. Property trading activity, measured by the number of sale and purchase agreements, stayed high at over 10,000 in March 1999.

Short-Term Outlook

Barring unexpected external shocks, the Hong Kong economy is likely to bottom out in the course of 1999, with a modest recovery expected in the later part of the year. Private investment may remain weak, but public investment is likely to rise with increased spending in infrastructure projects. The easing in local interest rates, recent rebound in share and property prices, and measures announced in the latest budget should provide support to consumer demand. However, the unemployment rate – being a lagging indicator of cyclical conditions – may remain high in the near term. Inflation may also stay negative on a year-on-year basis for the coming months, though further decline of the CPI on a month-on-month basis is likely to be limited.

- Prepared by the Economic Research Division

Highlights of the 1999/2000 Budget

The 1999/2000 Budget projects a 1.4% drop in government expenditure[2] and a 3.6% decline in government revenue, leading to a fiscal deficit of HK$36.5 billion, equivalent to 2.8% of projected GDP. This follows a HK$32.2 billion deficit, or 2.5% of GDP, estimated for the fiscal year 1998/1999.

Against sizeable fiscal reserves, the running of a temporary budget deficit during economic downturns does not represent a departure from the principle of fiscal prudence. Moreover, the budget is expected to return to surplus by 2001/02. Fiscal reserves are projected to fall from a peak of HK$458 billion on 1 April 1998 to HK$383 billion at end-March 2001, but pick up again in the fiscal year 2001/2002.

The 1999/2000 budget proposed several relief measures, including a 10% rebate of 1997/98 salaries, profits and property taxes and a 50% discount on property rates for the third quarter of 1999. The measures are one-off and, therefore, should have no adverse impact on the tax base. Revenue-raising measures were carefully designed to avoid adverse impact on businesses and individuals. These included the sale of a minority stake in the MTRC, adjusting stamp duty rates, reverting property rates to 5% of assessed rental value, and increasing the betting duty and tunnel toll charges.

The 1999/2000 budget also laid out some proposals that aim at strengthening Hong Kong's competitiveness and increasing employment. They include:

- *A Cyberport* in the western part of the Hong Kong island designed to promote high-tech industries and upgrade Hong Kong as an international information services hub.

- *A capital market reform programme to* strengthen the competitiveness of Hong Kong as a regional and international financial centre. The programme calls for a merger of the local stock and futures exchanges and their associated clearing-houses into a single market operator, upgrading of market infrastructure to facilitate scripless and internet securities trading, and undertaking a comprehensive reform of existing capital market regulations to strengthen supervision and streamline market operations.

- *A theme park project* at north Lantau island aimed at attracting regional and international visitors, which is now under negotiation.

[2] In terms of total public expenditure that comprises spending by statutory bodies and subvention to private and quasi-private institutions, public expenditure is budgeted to grow by a nominal 5.5% (or a real 4.3%) in fiscal 1999/2000.