

Third meeting of the Economic and Employment Council

Agenda Item 7 : Latest economic situation and near-term outlook for the Hong Kong economy

Purpose

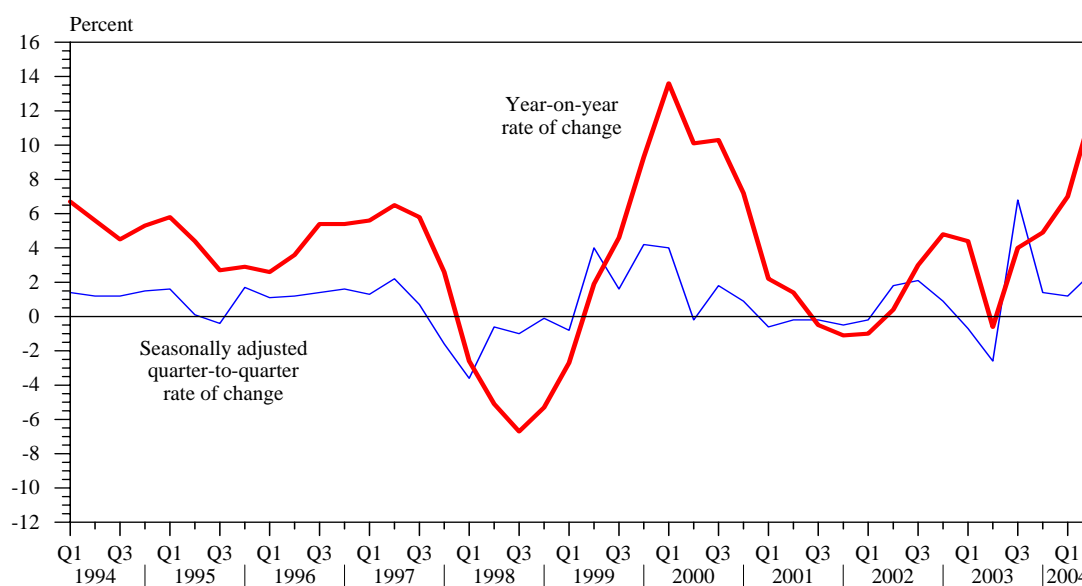
This paper gives an update on the latest economic situation and near-term outlook for the Hong Kong economy⁽¹⁾.

Latest economic situation

2. The recovery of the Hong Kong economy broadened to a full-fledged upturn in the first half of 2004. Both external and domestic demand were buoyant. GDP soared by 12.1% in real terms in Q2 2004, the fastest growth in four years. This was significantly faster than the 7.0% growth in Q1, and was at least partly due to the exceptionally low base of comparison caused by the spreading of SARS a year earlier (*Chart 1*).

3. On a seasonally adjusted quarter-to-quarter comparison, GDP grew by 2.6% in real terms in Q2, also faster than the growth of 1.2% in Q1.

Chart 1 : Gross Domestic Product
(rate of change in real terms (%))



(1) The Half-yearly Economic Report 2004, the GDP estimates for the second quarter of this year, and the updated GDP and inflation forecasts for 2004 have been released on 27 August 2004.

4. With global demand staying firm and benefitting further from the lagged effect of a generally soft US dollar in late 2003 and early 2004, *exports of goods* gathered more vibrancy in Q2 than in Q1. Exports attained an 18% growth in Q2, up from that of 15% in Q1. While exports to the East Asian and European markets continued to register double-digit increase in Q2, those to the US market continued to regain growth impetus. In July, exports grew further, by around 16% (**Chart 2(a)** and **Chart 2(b)**).

Chart 2(a) : Total exports of goods and exports of services

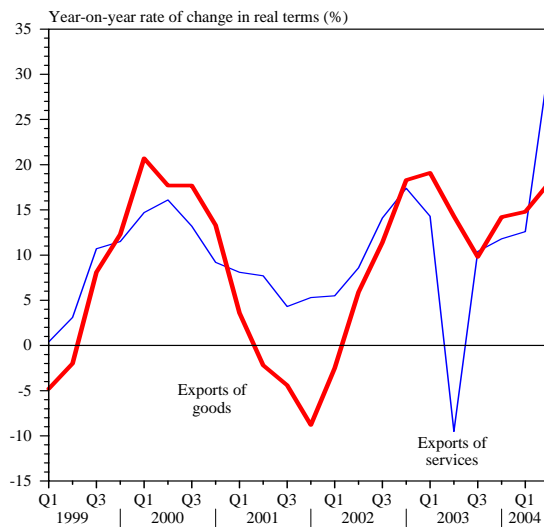
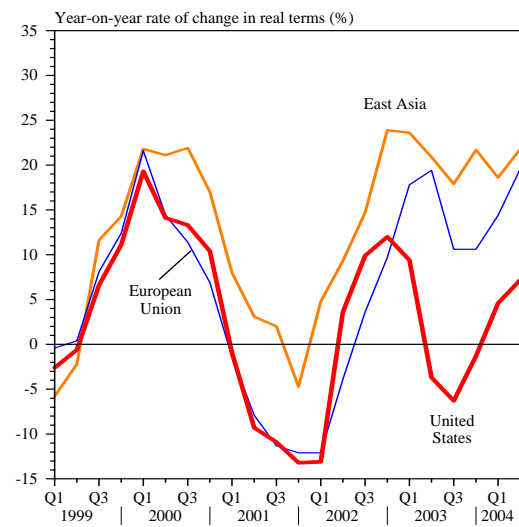


Chart 2(b) : Hong Kong's total exports of goods by major market



5. *Exports of services* grew even more strongly, by 31% in real terms in Q2 2004, significantly up from the 13% growth in Q1 (**Chart 2(a)**). Apart from thriving inbound tourism, offshore trade and exports of transportation services, the surge in Q2 was magnified at least partly by a low base of comparison caused by SARS a year earlier (**Charts 2(c)** and **2(d)**).

Chart 2(c) : Exports of trade-related services and of transportation services

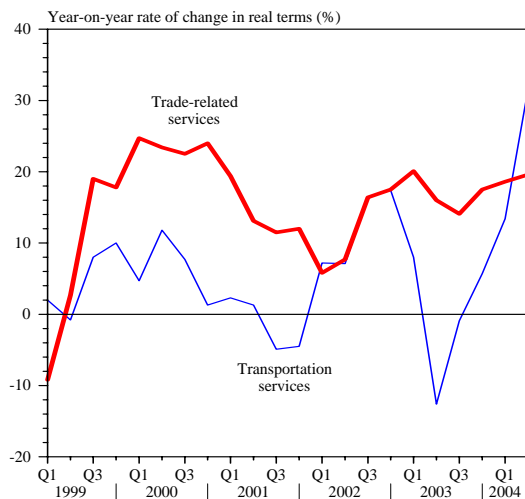
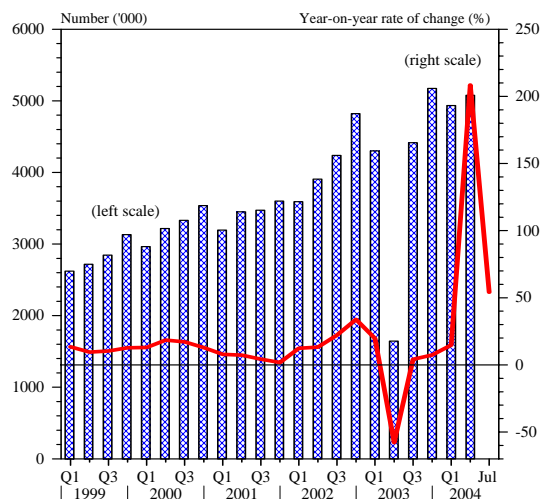
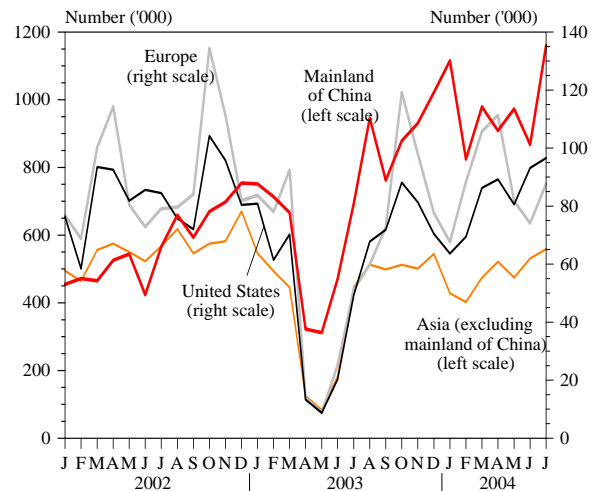


Chart 2(d) : Visitor arrivals



6 On inbound tourism, while visitors from the Mainland remained on a strong uptrend under the boost of the Individual Visit Scheme, visitors from most other major sources had all rebounded and surpassed the pre-SARS level by June 2004 (*Chart 2(e)*). In July, visitor arrivals continued to surge, by 54.1% to a record monthly high of 1.99 million.

Chart 2(e) : Visitor arrivals by sources



7. Locally, consumer spending remained brisk as sentiment returned amid a steadily improving labour market. *Private consumption expenditure* surged by 11% in real terms in Q2, up from the 6% growth in Q1 and was the fastest in almost 13 years (*Chart 3(a)*). Reflecting the vibrancy in local consumption and inbound tourism, retail sales volume rose further in July, by 8% (*Chart 3(b)*).

Chart 3(a) : Private consumption expenditure

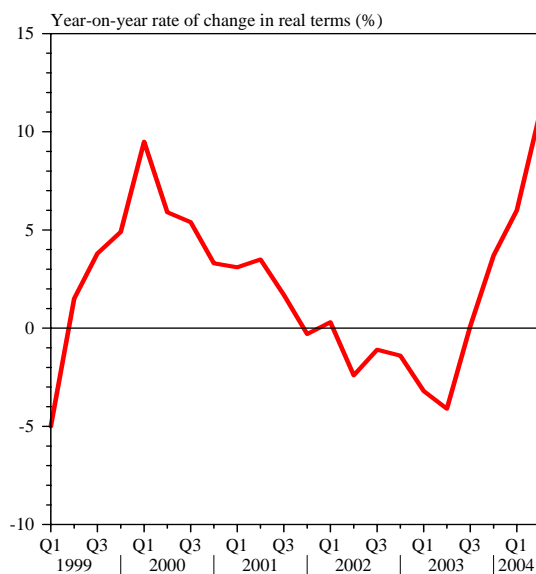
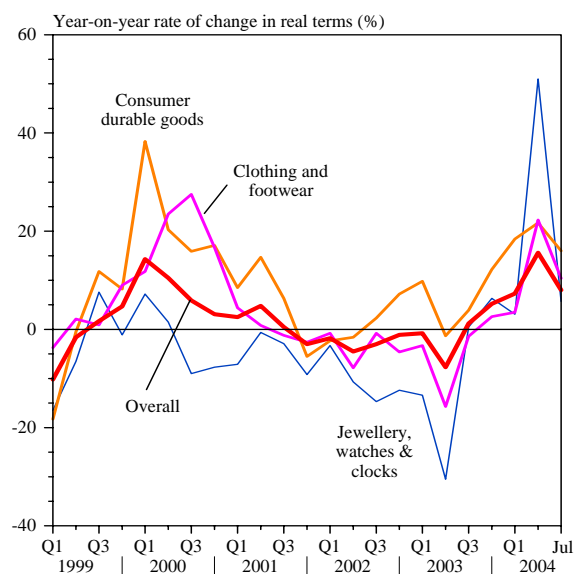


Chart 3(b) : Retail sales



8. Machinery and equipment acquisition picked up substantially as business outlook improved. This more than offset the continued fall-off in construction activity. *Overall investment* expenditure thus increased by 13% in real terms in Q2, further up from the 5% growth in Q1, and was the fastest growth in 3½ years (*Chart 4*).

Chart 4 : Investment expenditure by major component

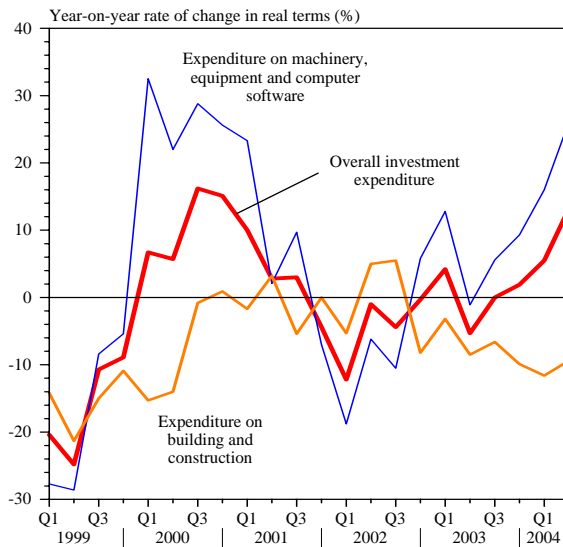
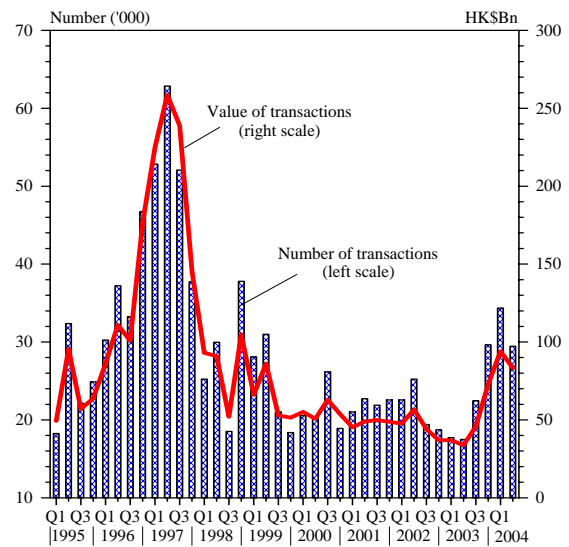


Chart 5 : Number and value of property transactions



9. *Property market* underwent some consolidation over the past few months, after the robust recovery in late 2003 and early 2004. Even so, property transactions were still markedly up by 22% in the first half of 2004 over the second half of 2003 (*Chart 5*).

10. Flat prices likewise eased back in recent months. Yet when compared with the trough in mid-2003, flat prices in July were on average still 26% higher. In general, home purchase affordability has improved significantly over the past few years, along with the fall in flat prices and easing in mortgage interest rate (*Charts 6(a) and 6(b)*).

Chart 6(a) : Prices for residential property

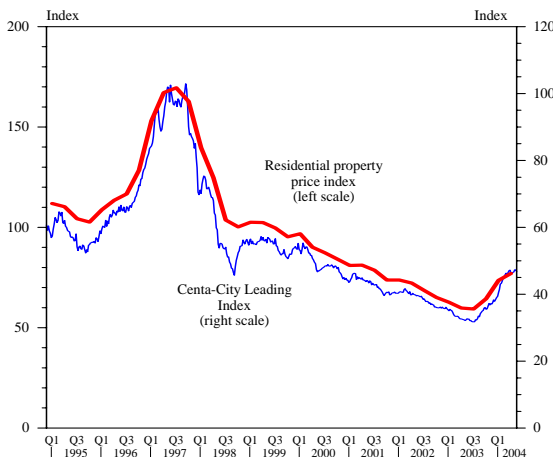
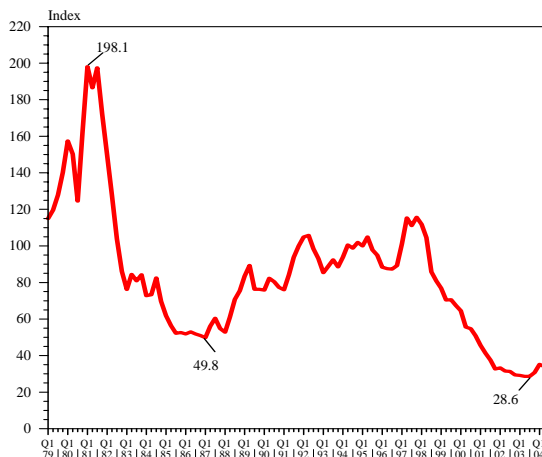
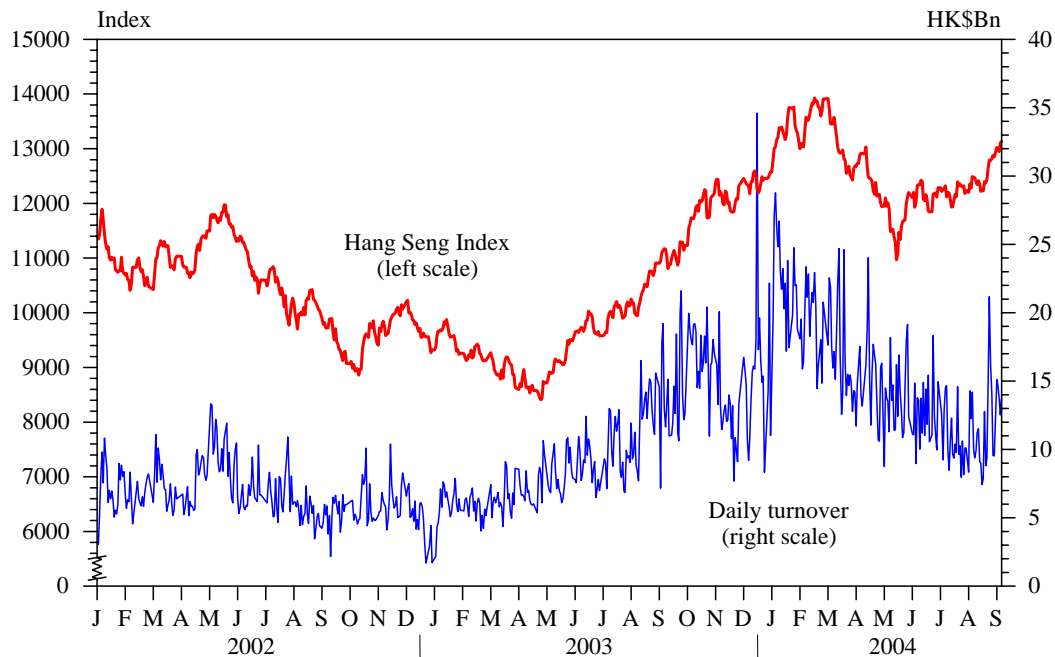


Chart 6(b) : Affordability index



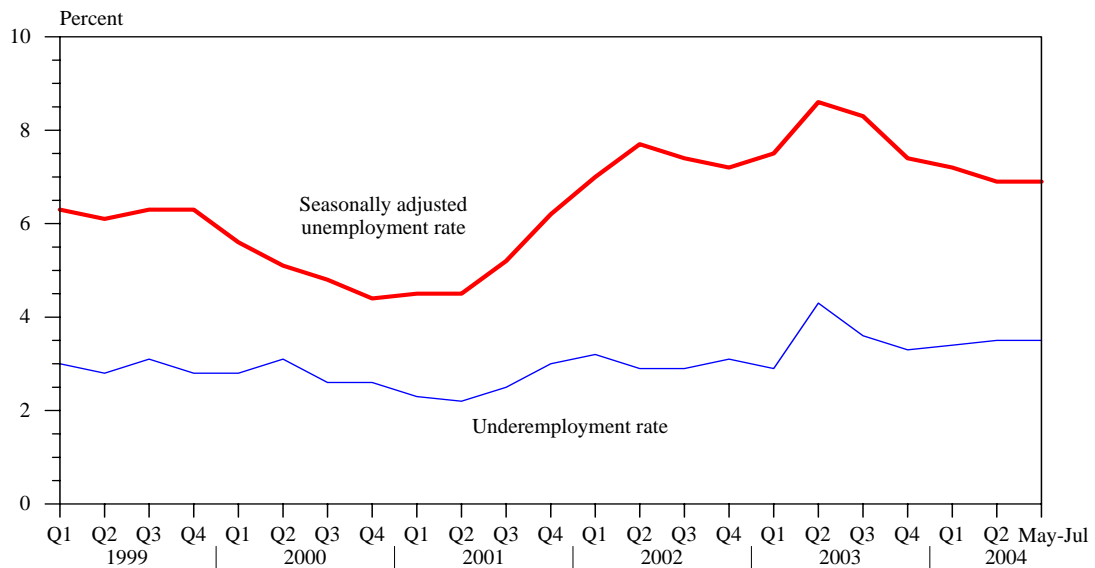
11. The local *stock market* also consolidated in tandem with the overseas stock markets during Q2, as sentiment worldwide was weighed down by concerns about an imminent rise in US interest rates, hike in international oil price, and the stepping up of economic tightening measures in the Mainland. The Hang Seng Index plummeted to a near 8-month low at 10 968 on 17 May, but rebounded to above the 12 000 level in the latter part of June. The Index hovered within a narrow range in July, before bouncing up strongly in late August as sentiment was successively buoyed by favourable corporate results, easing world oil prices, and the release of upbeat GDP and CCPI data. The Hang Seng Index glided higher to end August at 12 850, and further to a near six-month high of 13 104 on 6 September (*Chart 7*).

Chart 7 : Hang Seng Index and Hong Kong's stock market turnover



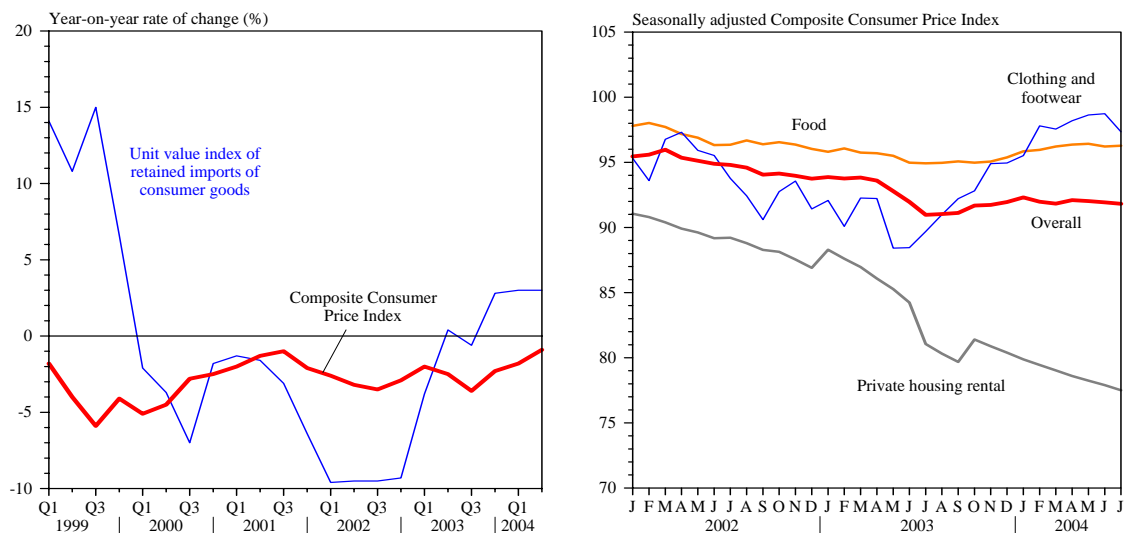
12. In parallel with a broad-based strengthening in labour demand in the *labour market*, total employment picked up further to a 2.6% growth in Q2, up from the 0.8% growth in Q1. Vacancies also surged across all the major economic sectors. The seasonally adjusted unemployment rate thus fell to a 28-month low of 6.9% in Q2 (and stayed at this level in May - July). The underemployment rate hovered around 3.5% between these two periods (*Chart 8*).

Chart 8 : Unemployment and underemployment rates



13. The *Composite CPI* reverted to a 0.9% increase in July, signifying the end of a 68-month long deflation (**Chart 9**). Improved economic conditions, revived consumer demand and higher import prices have prompted many retailers to reduce price discounts or even to raise the prices of some consumer items.

Chart 9 : Hong Kong's price movement



Near-term outlook for the Hong Kong economy

(a) Risk factors in the external environment

14. The external environment remains overshadowed by high oil prices, rising US interest rates, and the macroeconomic adjustment in the Mainland. Yet so far, these risk factors have not reversed or severely dampened the global growth momentum. Accordingly, their impact on the Hong Kong economy has not been large in overall terms, and is not expected to undermine our overall growth momentum in the rest of 2004.

- *Recent hike in international crude oil prices* : international oil prices have actually eased back visibly from the peak-levels in recent weeks, as concerns over global oil supply waned upon the increase in oil exports from Iraq and Russia (*Chart 10*). More importantly, the decline in oil dependency over the past decades should have rendered the industrialised economies less vulnerable to the oil price hike now than in the 1970s (*Chart 11*).

Chart 10 : International crude oil prices (Brent)

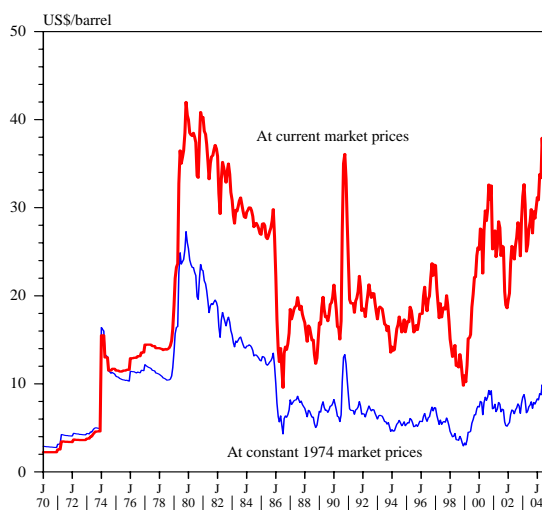
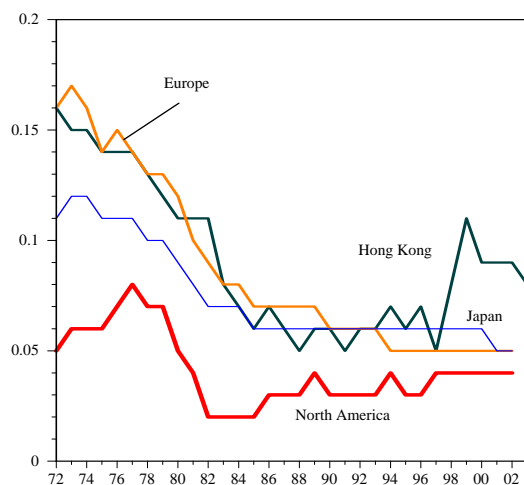
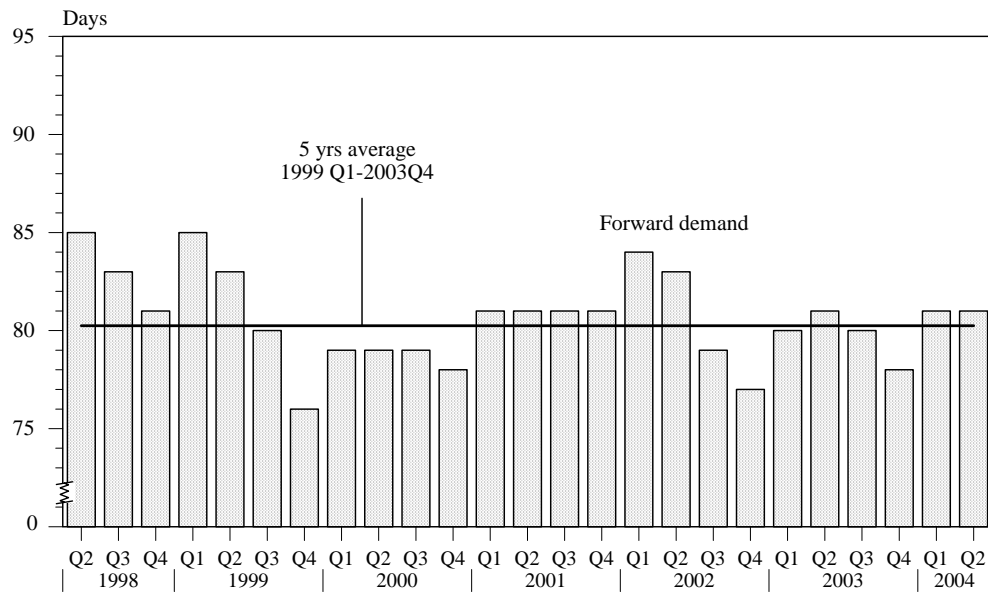


Chart 11 : Oil dependency ratios of North America, Europe, Japan and Hong Kong



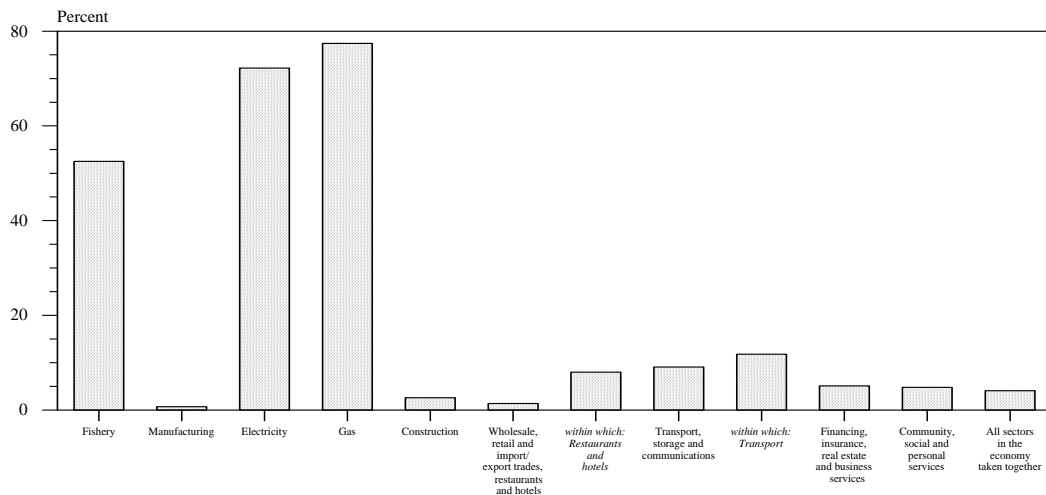
World oil inventory has already returned to a more comfortable level lately. Reportedly, the number of days of forward demand recovered by OECD stock in the first and second quarters of 2004 was slightly above the 5-year average (*Chart 12*). Some analysts reckoned that the current crude oil prices might have included a US\$10-15 premium stemming from the geo-political risk factor.

Chart 12 : Days of forward demand covered by OECD stock



*The direct impact of oil price surge on the Hong Kong economy as a whole is also likely to be rather insignificant, as Hong Kong is a service-oriented economy with fuel cost accounting for less than 5% of non-labour business cost, even though the impact on individual sectors may vary according to their intensity of oil usage (**Chart 13**).*

Chart 13 : Fuel cost as a proportion of overall business operating cost (excluding labour cost) in the Hong Kong economy by economic sector



- *Further rise in US interest rates* : Notwithstanding hikes by a total of 50 basis points on 30 June and 10 August, the overall *monetary* stance in the US is still accommodative, with the current Fed funds target rate at only 1.5% (**Chart 14**). Moreover, the US core inflation rate is still modest, at 1.8% in July 2004, well below the trend rate of 2.4% over the past ten years. Thus, if US interest rates were to be raised from

the current low level only gradually and at a measured pace, as the Fed repeatedly assured the public, it should not pose a severe threat to the global and the regional economy, and hence to Hong Kong's trade sector. Indeed, notwithstanding the concern over rising interest rates, domestic demand in the US economy held firm, with its import intake still on a strong uptrend lately (**Chart 15**).

**Chart 14 : US and Hong Kong interest rates
(monthly average)**

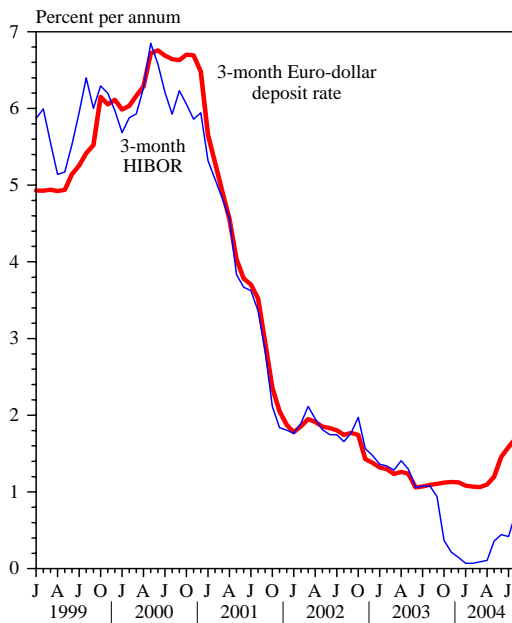
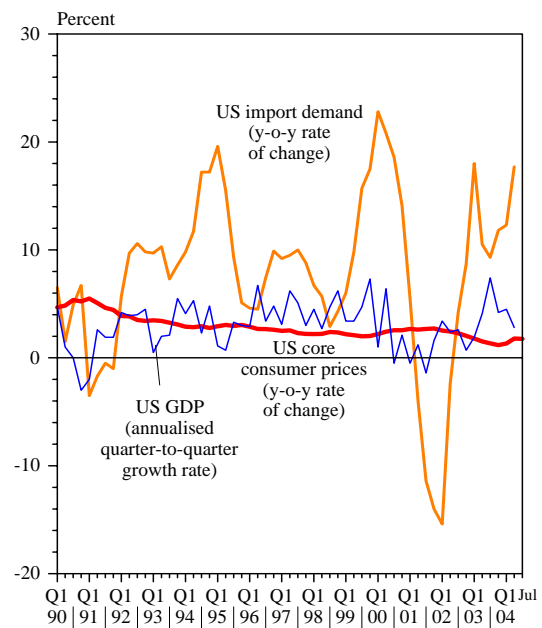
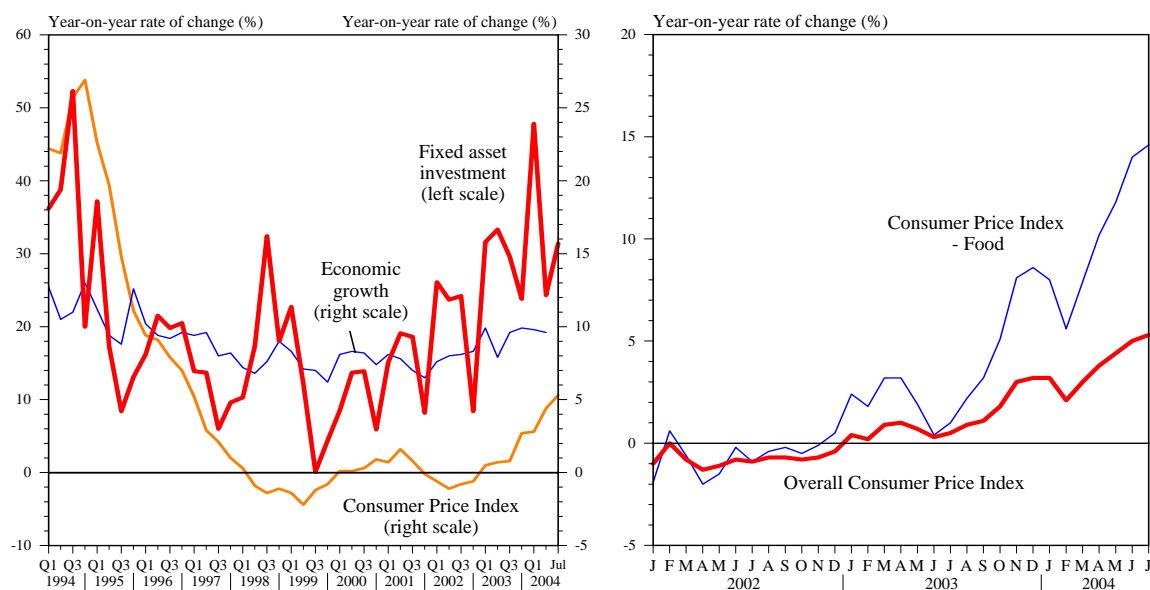


Chart 15 : US economic growth, consumer prices and import demand



- *Macroeconomic adjustment measures in the Mainland* : the tightening measures so far are largely confined to those sectors with signs of overheating and excessive investment. The Mainland economy still maintained a strong growth of 9.6% in Q2 (and on average a growth of 9.7% in the first half of the year), as trade surged ahead notwithstanding the concurrent slow-down in overall investment (**Chart 16**). On the price front, while producer prices in the Mainland went up visibly amidst higher material and energy cost in recent months, so far it has not been transmitted to the retail price level. The pick-up in consumer prices was mainly due to an upsurge in food prices, by 14.6% in July. Prices of non-food items edged up by only 0.8%.

Chart 16 : Key economic indicators for the mainland of China



As to the impact on the Hong Kong economy, so far the impact has been relatively contained. While the Mainland's economic growth is likely to ease back somewhat in the second half of 2004, growth for 2004 as a whole is still likely to be above 8%. Also, it is worth noting that a sizeable proportion of Hong Kong's exports to Mainland is related to export processing. Thus, so long as the Mainland can sustain buoyant trade growth, the impact on Hong Kong is likely to be cushioned to a large extent.

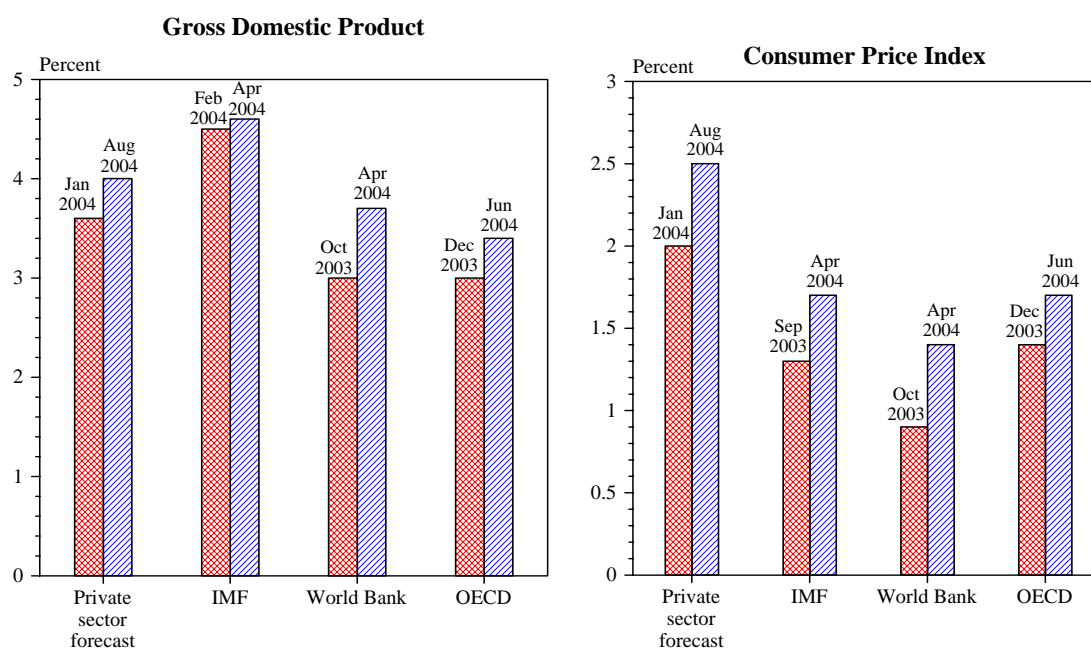
15. Hence, despite the on-going uncertainties, *the overall tone for the global economy* in the rest of this year is still cautiously optimistic. The major forecasters including IMF and OECD have actually revised up their forecasts for global economic growth over the past few months (**Table 1** and **Chart 17**). The widely held view is that even allowing for some moderation in global demand in the latter part of 2004 upon rising interest rates and surging oil price, global economic growth for the year as a whole is still likely to stay healthy and will be the fastest since 2000. If this is so, the export-dependent Asian economies including Hong Kong should continue to benefit from the sturdy demand in the industrialised economies in the rest of the year, albeit at a more moderated pace.

Table 1: Real GDP growth and inflation of selected economies

	Real GDP growth (%)				Inflation (%)			
	2003	2004 ^f		2005 ^f	2003	2004 ^f		2005 ^f
Global economy	3.9	4.6		4.4	1.8*	1.7*		1.7*
US	3.0	4.6	(4 - 4.75)	3.9	2.3	2.3	(1.5 - 2)	2.2
EU	0.9	2.0	(1.4 - 2) [#]	2.4	1.9	1.7	(1.9 - 2.3) [#]	1.7
Japan	2.5	4.5	(3.5) ⁺	2.4	-0.2	-0.1	(-0.1) ⁺	0
China	9.1	9.0	(8.7)	8.0	1.2	3.5	(3.0 - 3.5)	3.0
South Korea	3.1	5.5	(5.4)	5.3	3.5	3.7	(3.6)	3.4
Singapore	1.1	5.0	(8 - 9)	4.0	0.5	1.2	(N.A.)	1.5
Taiwan	3.3	4.9	(5.87)	4.9	-0.3	0.7	(1.5)	1.5
Thailand	6.8	7.0	(6 - 7)	6.7	1.8	2.2	(N.A.)	1.3
Hong Kong	3.2	5.5	(7.5)	4.5	-2.6	-0.5	(0)	0.8

- Notes: (f) IMF forecasts as put out in April and August 2004.
 (*) For the advanced economies only.
 () Figures in parenthesis denote official forecasts of the economies.
 (#) For the euro area only.
 (+) On fiscal year basis.

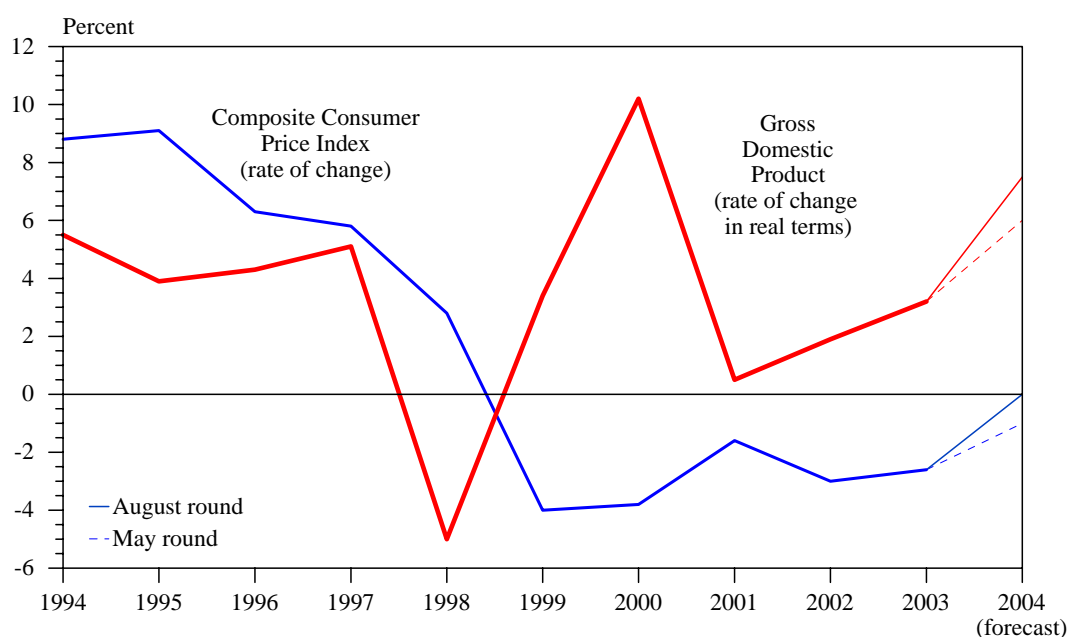
Chart 17 : Global growth and inflation forecasts for 2004



(b) Updated short-term forecast for the Hong Kong economy

16. With better-than expected outturn so far this year, and with both external and local demand likely to hold up well throughout the rest of the year, *GDP* for 2004 as a whole is now forecast to grow by 7.5%, 1.5 percentage points up from 6% in the May round (*Chart 18*).

Chart 18 : Forecast of Gross Domestic Product and Composite Consumer Price Index for 2004



17. The forecast rate of change in the Composite CPI for 2004 is likewise revised upwards to zero change in the August update, from -1% in the May round. As domestic demand strengthens further, and as the uptrend in world commodity prices and higher inflation in the major supplier economies including the Mainland filter their impact through, consumer price inflation is expected to remain positive in the rest of 2004 (*Chart 18*).

18. Most private sector analysts have revised upwards their forecasts for Hong Kong's GDP and price forecasts for 2004 further, after the release of GDP data for the second quarter and Composite CPI data for July signalling the end of deflation. Their latest GDP growth forecasts are mostly in the range of 7% and 8%.