

Seventh Meeting of the Economic and Employment Council

Agenda Item 4 : Recent Situation of the Overall Economy and the Labour Market and Near-term Outlook

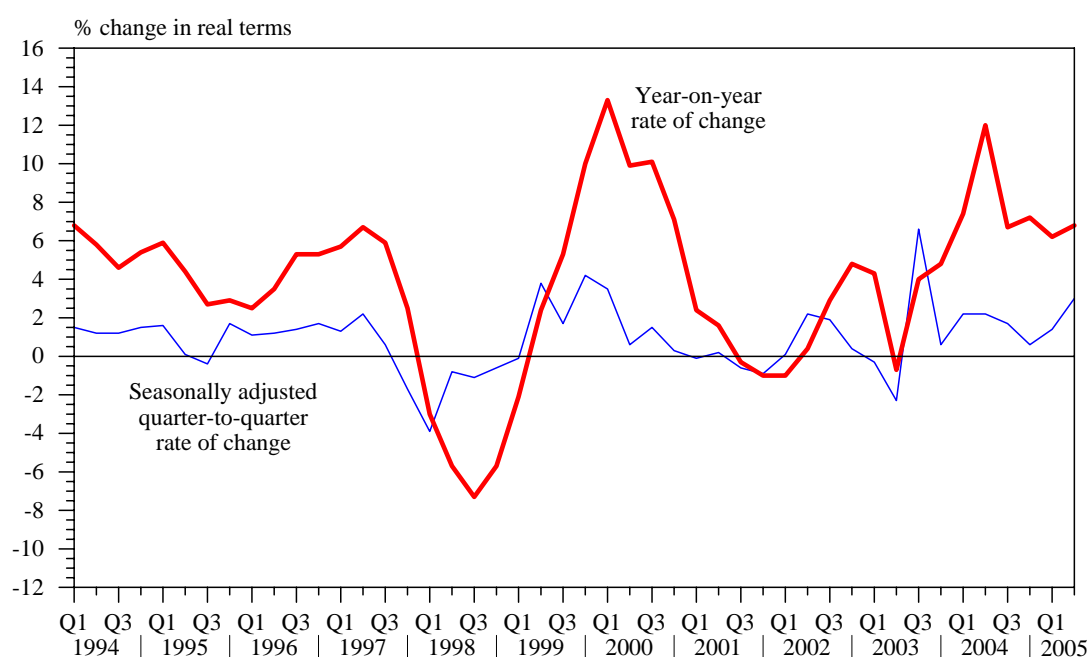
Introduction

This paper presents the recent developments in the local economy and the latest situation in the labour market. It concludes with a broad overview of the economic outlook for the rest of 2005 and a preliminary view on the outlook for 2006.

Recent economic situation

2. The Hong Kong economy continued to expand at a brisk pace in the first half of 2005. The *Gross Domestic Product* (GDP) grew solidly further by 6.5% in real terms in the first half of 2005 over a year earlier, following a strong 8.2% growth for 2004 as a whole (**Chart 1**). Reflecting the more entrenched economic recovery, the growth continued to be broad-based, underpinned by strong growth in merchandise exports and exports of services, pick-up in investment demand as well as steady growth in consumer demand.

Chart 1 : Gross Domestic Product



3. External trade continued to be vibrant in the first half of 2005, thanks to the sustained expansion of the global economy as well as the Mainland's strong trade flows. *Total exports of goods* grew by 10.0% in real terms in the first seven months of 2005 over a year earlier. *Exports of services* grew noticeably further by 8.3% in real terms in the first half of 2005 over a year earlier (**Chart 2**). Of particular note was the continued surge in exports of trade-related services which was supported by the strong trade flows. There was also further increase in exports of travel-related services, underpinned by vibrant inbound tourism (**Chart 3**). The strong performance in exports of goods and services is clearly a manifestation of competitiveness of Hong Kong's trade and logistic sector, as well as a reflection of increasing penetration of Mainland products in the world market.

Chart 2 : Exports of goods and services

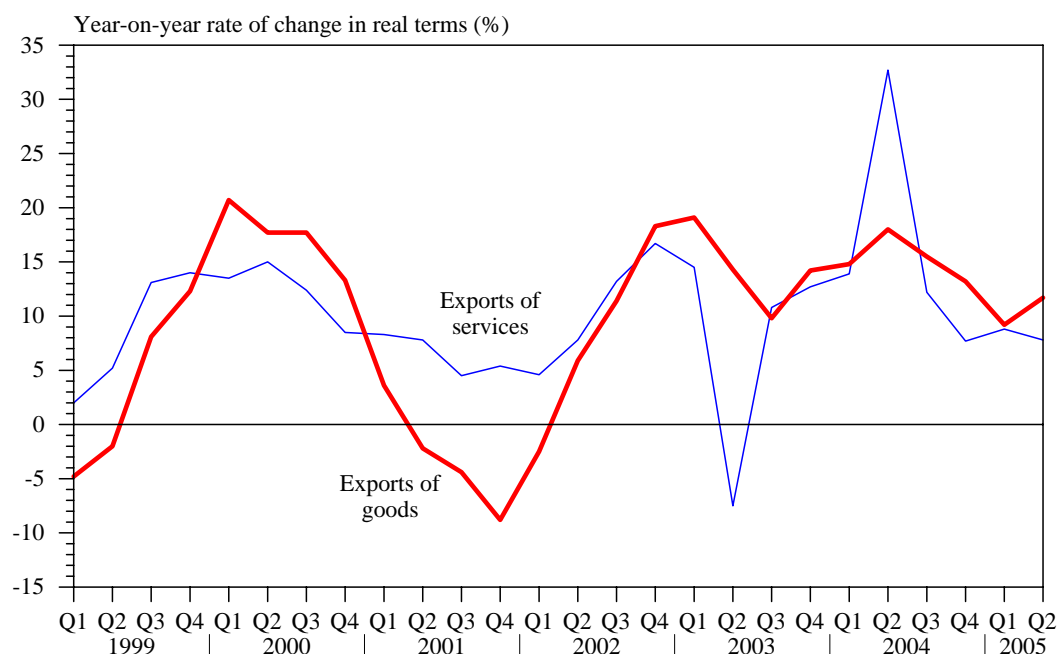
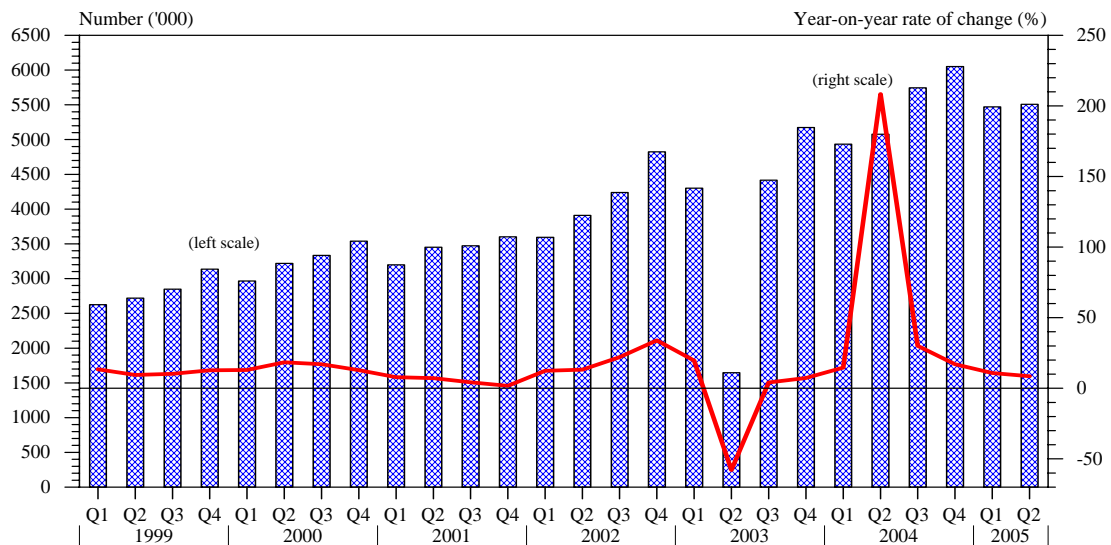


Chart 3 : Visitor arrivals



4. The domestic sector held up firmly. *Private consumption expenditure* grew solidly further by 3.5% in real terms in the first half of 2005 over a year earlier, on the back of improving labour market conditions and positive wealth effect stemming from the cumulative increase in asset prices (**Chart 4(a)**). In tandem with the sanguine economic prospects and the activity upturn, *overall investment spending* picked up to a 2.0% growth in real terms in the first half of 2005 over a year earlier. This was mainly driven by the increase in machinery and equipment investment along with the business expansion. Building and construction activity was still sluggish after the winding down of the major railway projects and the completion of some large-scale non-residential building projects in the private sector, and was further held back by the continuous scale-back of the Public Housing Programme (**Chart 4(b)**).

Chart 4(a) : Private consumption expenditure and retail sales

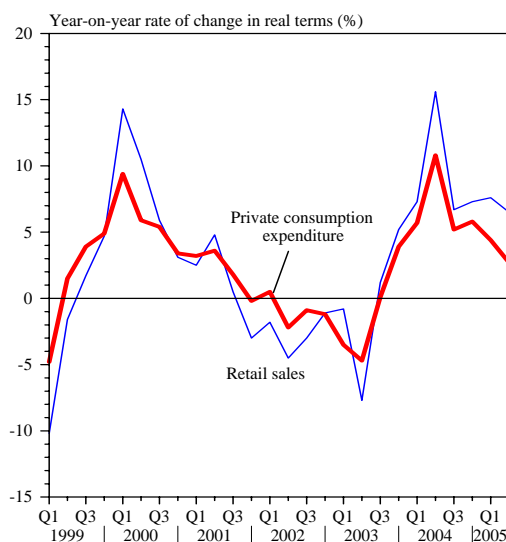
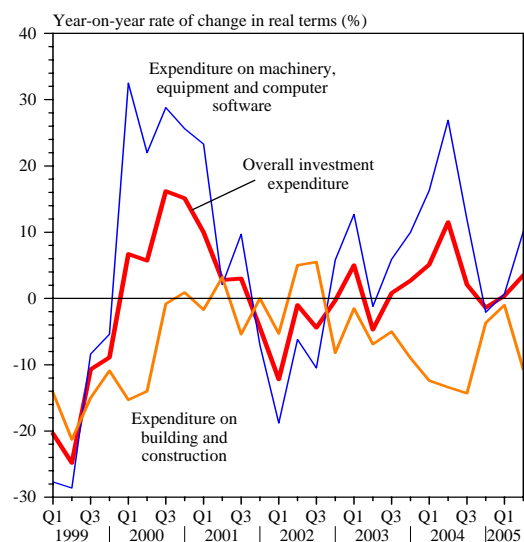
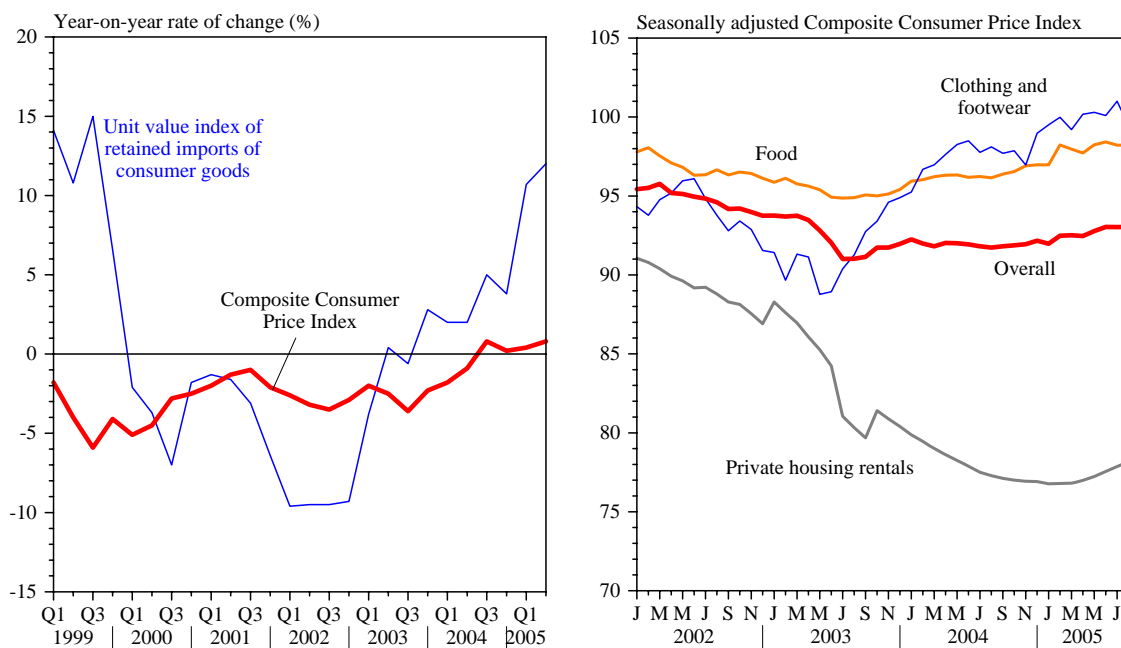


Chart 4(b) : Investment expenditure by major component



5. Consumer price inflation has been gradually edging up over the past few months, along with the increasingly entrenched economic recovery. This essentially was the natural phenomenon of an economic upturn. Private housing rentals finally reversed to increase in July, having fallen by more than six years. Yet for the first eight months as a whole, overall *consumer price inflation* was still very moderate, averaging at only 0.8% (**Chart 5**).

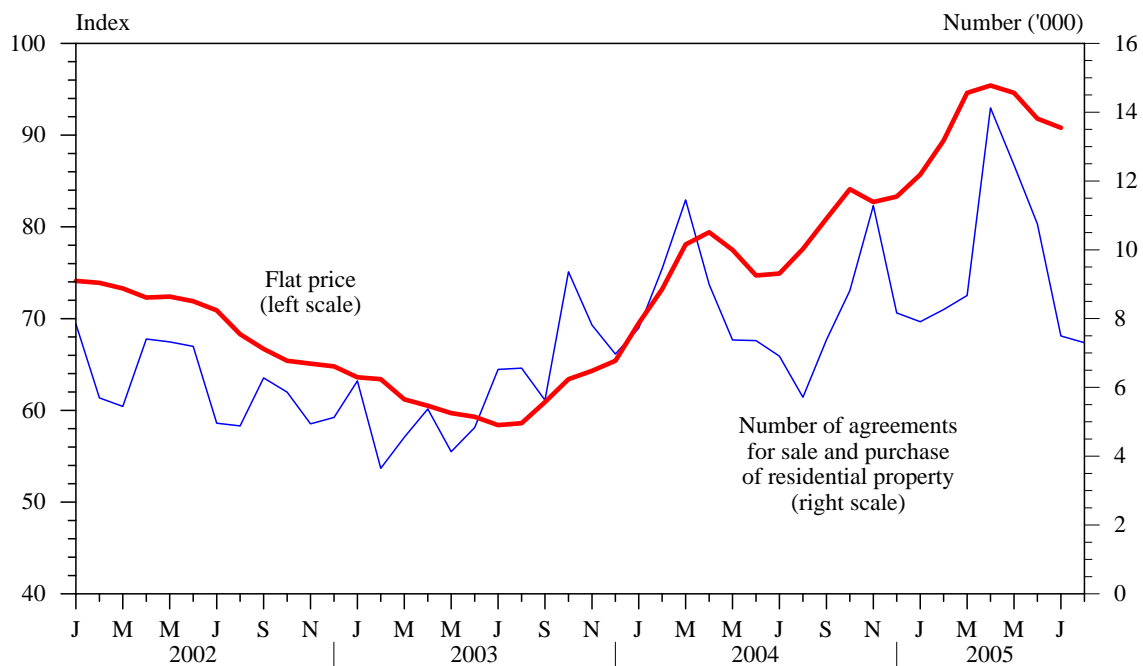
Chart 5 : Hong Kong's price movement



The property market

6. The residential property market surged further in the first quarter of 2005 but began to cool off somewhat since the second quarter of 2005, mainly reflecting the adjustment to the successive interest rate increases and the earlier hectic situation. Flat prices eased back mildly by 4.8% between April and July, but they still rose by 9.0% during the first seven months of 2005. By July 2005, prices for residential flats have rebounded by a cumulative 55% from the trough in mid-2003, yet they are still 47% below the peak in 1997 (**Chart 6**). Primary sales of flats continued to receive favourable response. Market sentiment remained generally positive, as supported by strong economic fundamentals such as improved employment income, steady rise in flat rentals, and that housing affordability still remained favourable. As such, the mild consolidation should help underscore a healthy development of the property market.

Chart 6 : Flat prices and agreements for sale and purchase



Impact of high oil prices on the economy

7. Though with some slight easing back lately, high and volatile oil prices remain a key downside risk to the economy in the near term. Although the direct impacts of surging oil prices on our service-oriented economy should not be significant, the indirect impact stemming from the trade front and the potential financial market volatility are of much more concern to us, if the oil price surge were to eventually dent the growth momentum of the global economy. Any consequential slow-down in external demand would inevitably

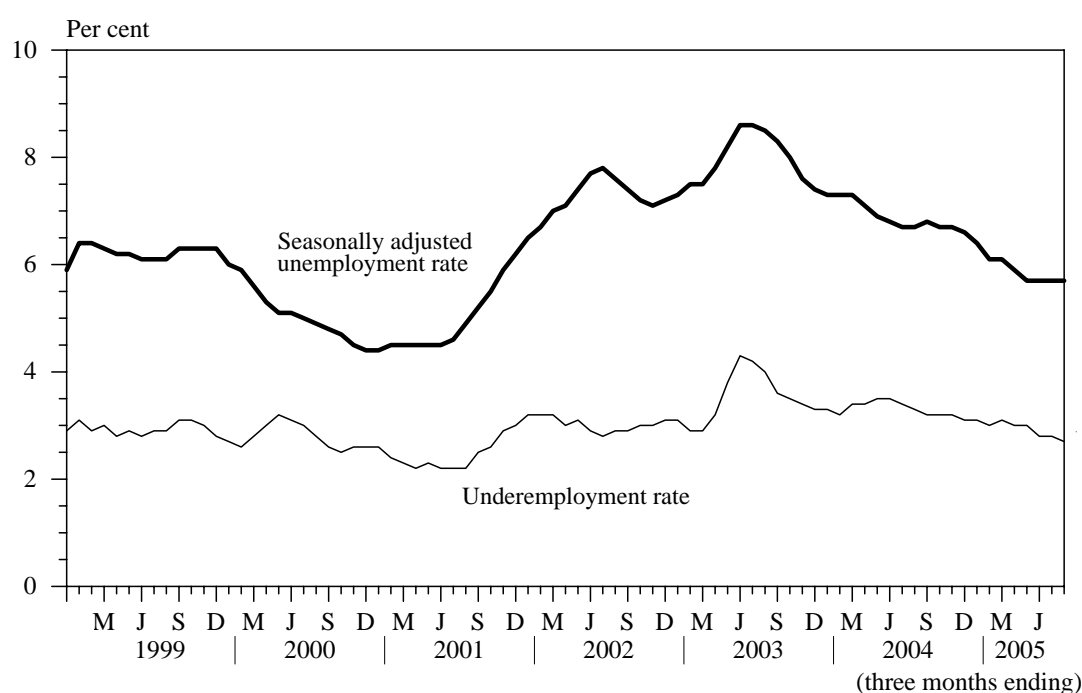
impinge on Hong Kong's trade growth. The cut-back in income stemming from the trade front would in turn have spill-over effect on local consumer and investment spending. The EABFU estimates that a US\$10/barrel permanent increase in oil prices will knock down Hong Kong's GDP growth by 0.6 of a percentage point in the first year of incidence.

8. As to the impact of high oil prices on inflation, it is estimated that the direct impact of high oil prices contributed only 0.14 percentage point to the increase in Composite CPI in the first eight months of 2005. The pass-through of higher oil prices to the consumer price level so far has been limited, as Hong Kong is not an oil-dependent economy. Also, part of the cost increases stemming from oil price have been absorbed in the profit margin of the business operators. The EABFU estimates that a permanent increase in international oil prices by US\$10 per barrel would lift the Composite CPI by 0.2 of a percentage point in the year of incidence.

Recent developments in the labour market

9. The labour market improved visibly further in the first eight months of 2005, in tandem with continued revival in economic activity. In June - August, the seasonally adjusted unemployment rate fell to a near 4-year low of 5.7%, while the numbers unemployed decreased to 216 000 despite the entry of fresh graduates and school leavers into the labour market during the period. The reduction in unemployment occurred fairly extensively across many different sectors, occupations and educational levels. Meanwhile, the underemployment rate also declined to an almost 4-year low of 2.7% (*Chart 7*).

Chart 7 : Unemployment and underemployment rates



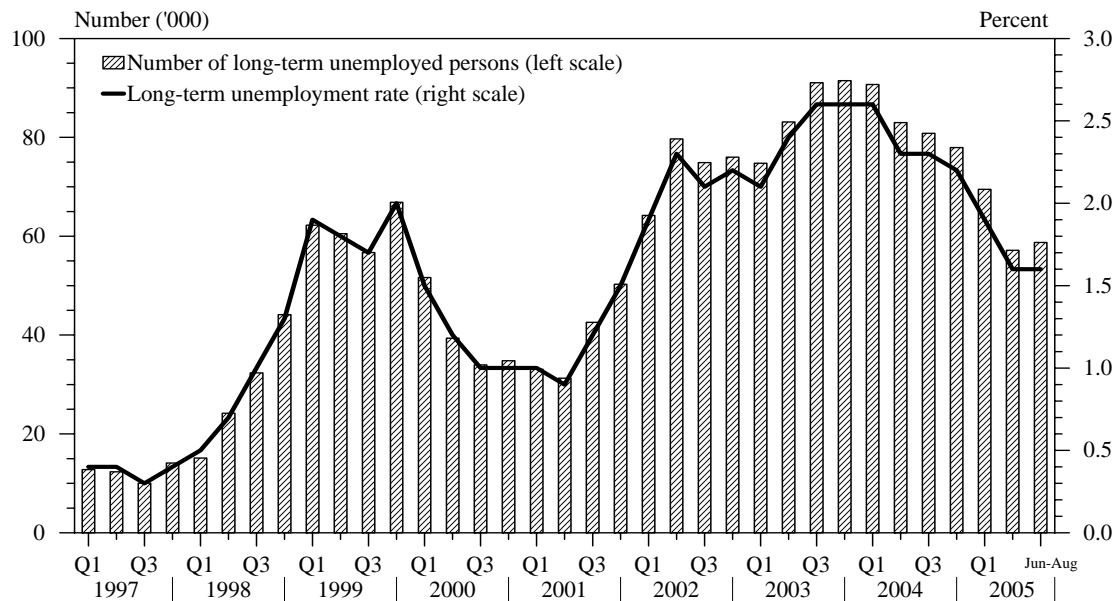
10. In tandem with the vibrant economy, employment continued to rise at a pace faster than in the labour force, by 2.2% as against 1.1% year-on-year. As at June - August 2005, total employment reached a record high of 3.39 million, which was up by 72 000 over a year earlier or even more by 197 000 from the trough in mid-2003 (*Chart 8*).

Chart 8 : Total labour force and total employment



11. Meanwhile, long-term unemployment also fell noticeably both in absolute and proportionate terms. Specifically, the number of long-term unemployed workers (i.e. those unemployed for six months or more) dropped to 59 000 in June - August 2005, way below the peak of 92 900 in June - August 2003 and 81 200 a year earlier. The corresponding proportion of long-term unemployed to total unemployed likewise shrank to 27.2%, from 30.1% and 32.5% over the same periods (*Chart 9*).

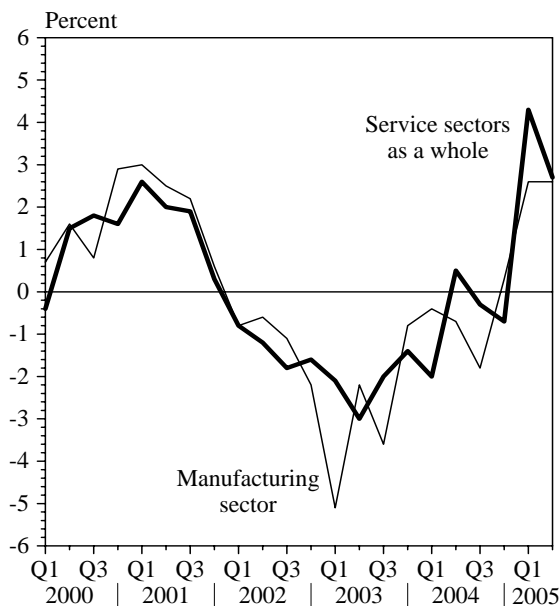
Chart 9 : Long-term unemployment



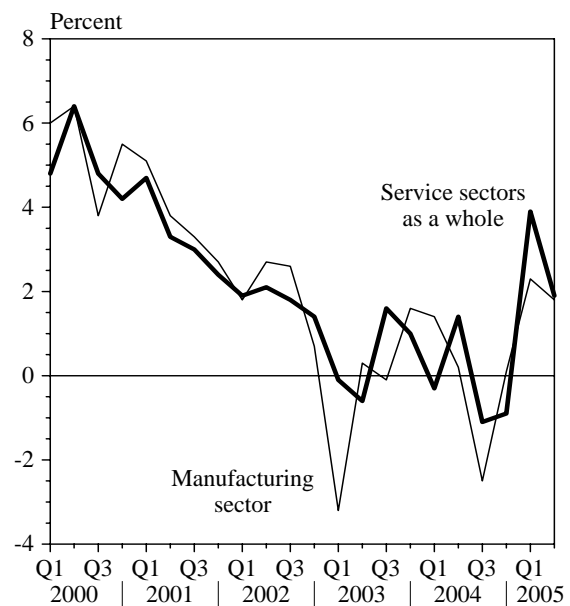
12. As the manpower resource balance turned relatively tighter, this had led to renewed rise in wages. Reflecting this, overall labour earnings in the private sector, as measured by payroll per person engaged, rose by 3.6% in money terms or 3.0% in real terms in the first half of 2005 over a year earlier, reversing the general downtrend seen over the preceding three years. Workers in the service sectors generally faced an increase in earnings averaging 3.6% in money terms or 3.0% in real terms, while those in the manufacturing sector had a smaller rise averaging 2.6% and 2.1% respectively (*Chart 10*).

Chart 10 : Earnings by broad economic sector

(a) Year-on-year rate of change in money terms



(b) Year-on-year rate of change in real terms



Near-term economic outlook

13. The outlook for the Hong Kong economy in the rest of this year remains favourable. So far, the global economy continues to cruise ahead well and the impact of the surge in oil prices has been rather contained. The US economy is still in good shape even after the damages caused by Hurricane Katrina in late August. The Mainland economy continues to display strength, particularly in exports despite the moderation in investment growth. The Japanese economy showed further noticeable improvement recently, as reflected by the surge in optimism in the Japanese stock market. Most of the other Asian economies are also growing at a reasonable pace lately. These developments should underpin a sanguine external environment in the rest of this year, thereby providing solid support to Hong Kong's merchandise exports. In addition, the opening of the Hong Kong Disneyland in September should render a boost to inbound tourism in the rest of this year and in 2006. Moreover, further market liberalisation is expecting to come in the third phase of CEPA helps to boost confidence further. The recent surge in oil prices and the rise in interest rates have not dampened consumer spending to any significant extent.

14. The outlook for the labour market will hinge on the overall economic performance and in particular job creation capacity in the corporate sector. On current indications, the continued strong growth expected for the Mainland economy, coupled with the continued growth in local consumer spending and the buoyant tourism industry particularly upon the opening of the Hongkong Disneyland, should help sustain economic growth in Hong Kong. A further increase in employment therefore seems highly likely in the near term, with perhaps more notable gains in the import/export trade, financial services and such consumption and tourism-related sectors as the retail trade, restaurants and hotels.

15. Yet a number of downside risks on the external front deserve close monitoring. Sustained surge in crude oil prices might heighten inflationary pressure worldwide and eventually dampen global economic growth. The pace of interest rate upturn in the US may affect the momentum in the asset markets. Possible relapse in the US housing market may undermine consumption and investment demand in the US, adding to global financial market volatility.

16. On the price front, consumer price inflation is expected to climb up further towards the end of this year, as the earlier fall-off in private housing rentals is finally reversed and local business costs are expected to rise back in the natural course of an increasingly entrenched economic recovery. Still, on the whole, local price pressures are expected to be well contained through the end of 2005.

17. While the favourable factors underpinning the robust growth of the Hong Kong economy are expected to carry through into 2006, the economic outlook for 2006 would hinge on how the developments mentioned in paragraph 15 above unfold. The administration will produce the growth forecast for 2006 in February next year.

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