

Eighth Meeting of the Economic and Employment Council

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

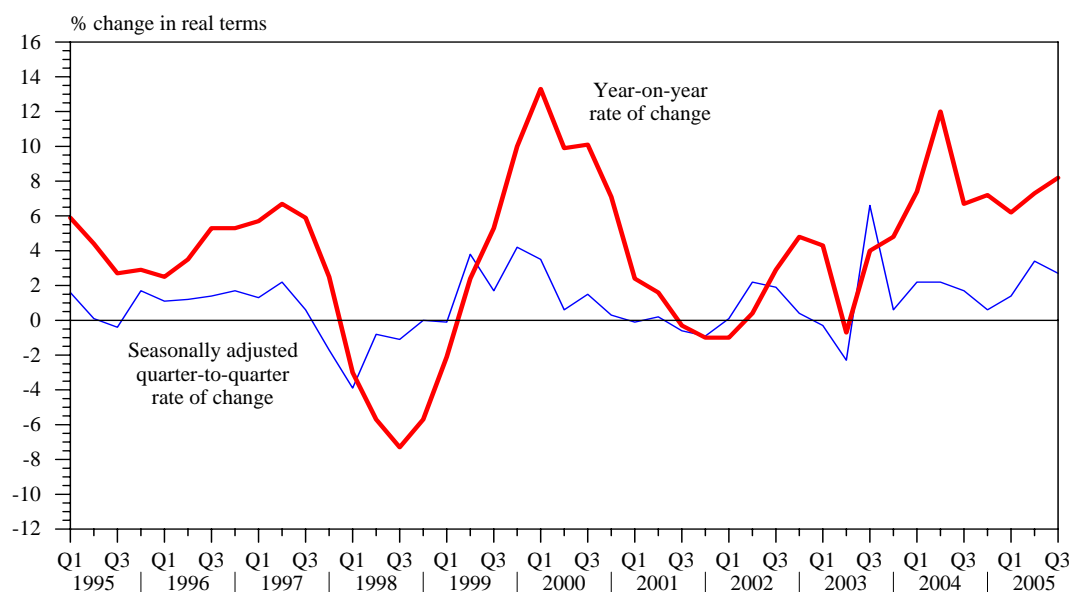
Introduction

This paper presents the recent overall situation in the Hong Kong economy and the labour market, and broadly discusses the outlook for 2006.

Recent economic situation

2. The Hong Kong economy turned out an even more spectacular performance in the third quarter of 2005. While the external sector remained highly robust, consumer demand re-accelerated to a solid growth and investment demand rose further. With both the external and domestic fronts exceeding expectations, the *Gross Domestic Product (GDP)* leaped by 8.2% in real terms in the third quarter over a year earlier. This was not only up from the 6.7% growth in the first half of 2005, but also marked the eighth consecutive quarter that the economy has attained above-trend growth. On a seasonally adjusted quarter-to-quarter comparison, GDP also expanded notably further, for the ninth straight quarter, by 2.7% in real terms in the third quarter of 2005. (*Chart 1*).

Chart 1 : Gross Domestic Product



3. A distinct feature in the current economic recovery is the sustained strong growth in our external trade, both in goods and services. Our strong trade performance, and along with it, the massive size of our current account surplus, is a clear manifestation of the strength of Hong Kong's competitiveness as a trading and logistics hub in the region. *Total exports of goods* continued to surge, by 12.8% year-on-year in real terms in the third quarter, reflecting the fairly strong performance of the major overseas markets as well as the Mainland's buoyant trade flows, and also the strength of Hong Kong as the trade conduit for the Mainland economy (**Chart 2(a)**).

4. Exports to all major markets recorded notable growth in the third quarter of 2005. Exports to the Mainland continued to record double-digit growth. The stellar performance was underscored by the Mainland's strong trade flows as well as its robust domestic demand. Exports to the EU were also strong, mainly reflecting the increasing penetration of Mainland's products into this market. Exports to the US maintained solid growth amidst the still firm domestic demand there. Export performance to other major East Asian markets, such as Japan, Taiwan, South Korea and Malaysia, also fared strongly (**Chart 2(b)**). Merchandise exports continued to record double-digit and broad-based increase in October 2005, by 11.6% in value terms year-on-year.

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

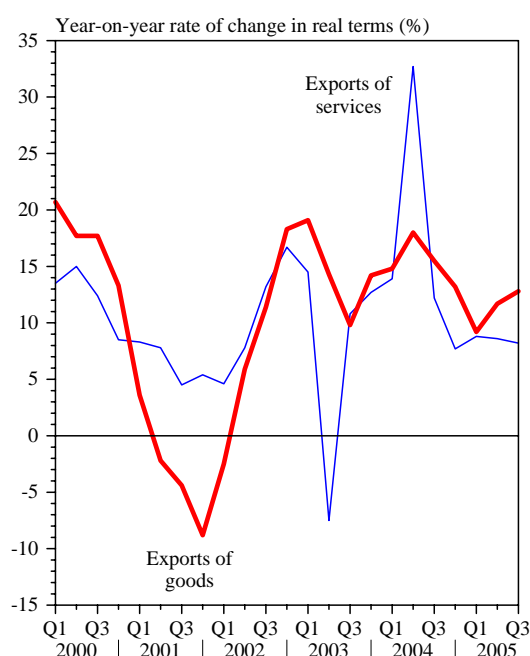
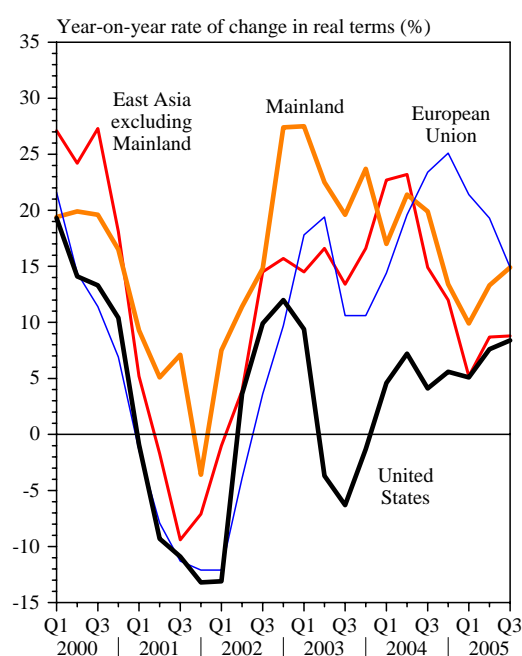


Chart 2(b) : Hong Kong's total exports of goods by major market



5. On invisible trade, *exports of services* expanded noticeably further, by 8.2% in real terms in the third quarter, following increases of 8.8% and 8.6% in the first and second quarters respectively. Offshore trade and exports of transportation services surged further, mainly benefited by buoyant trade flows involving the Mainland (**Chart 3(a)**). The further growth in inbound tourism

provided additional support, although the momentum was not as fast as in the past few quarters. But this has to be seen in conjunction with the very rapid growth in inbound tourism over the past year or so. Also, there was possibly some postponement of leisure trips by Mainland visitors to match the opening of the new Disney theme park in mid-September (*Chart 3(b)*). In addition, the continued upturn in business activities also gave a boost to exports of finance, business and other services.

Chart 3(a) : Offshore trade and Mainland's trade

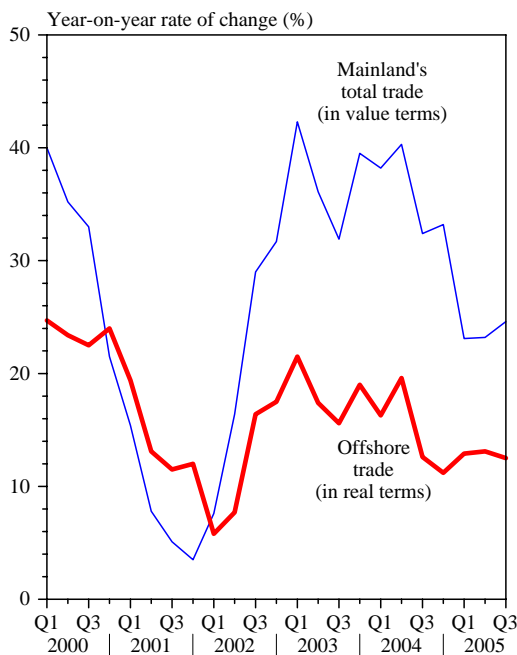
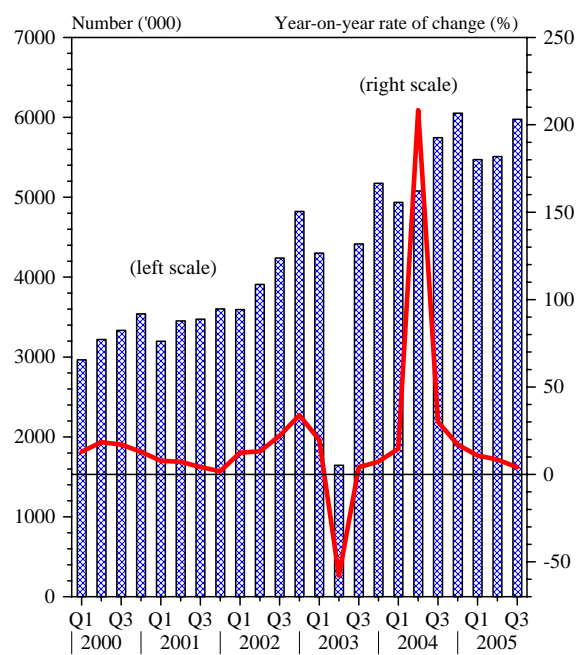
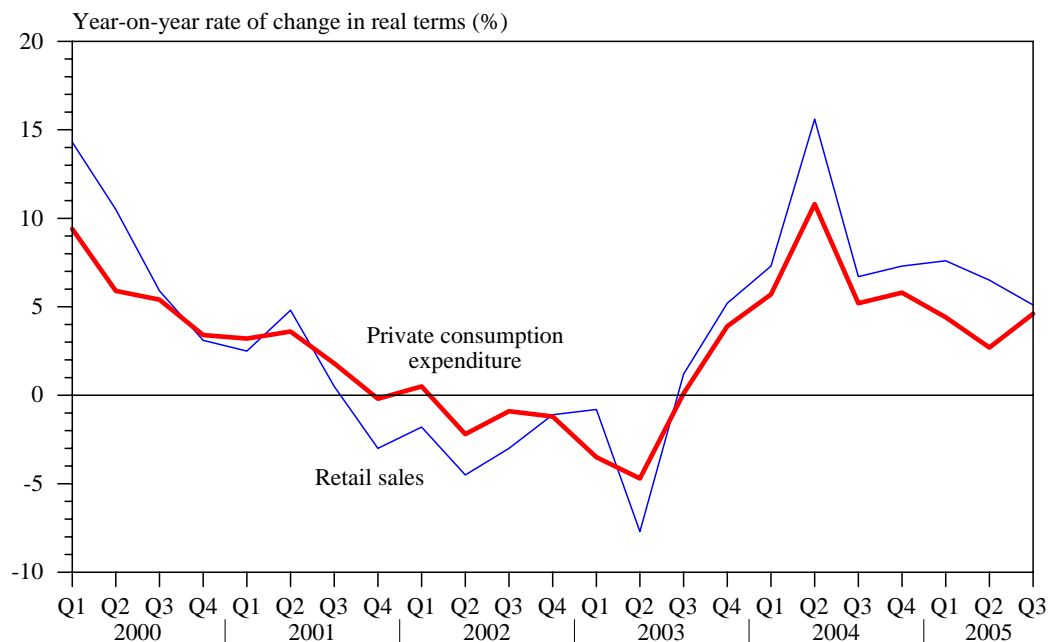


Chart 3(b) : Visitor arrivals



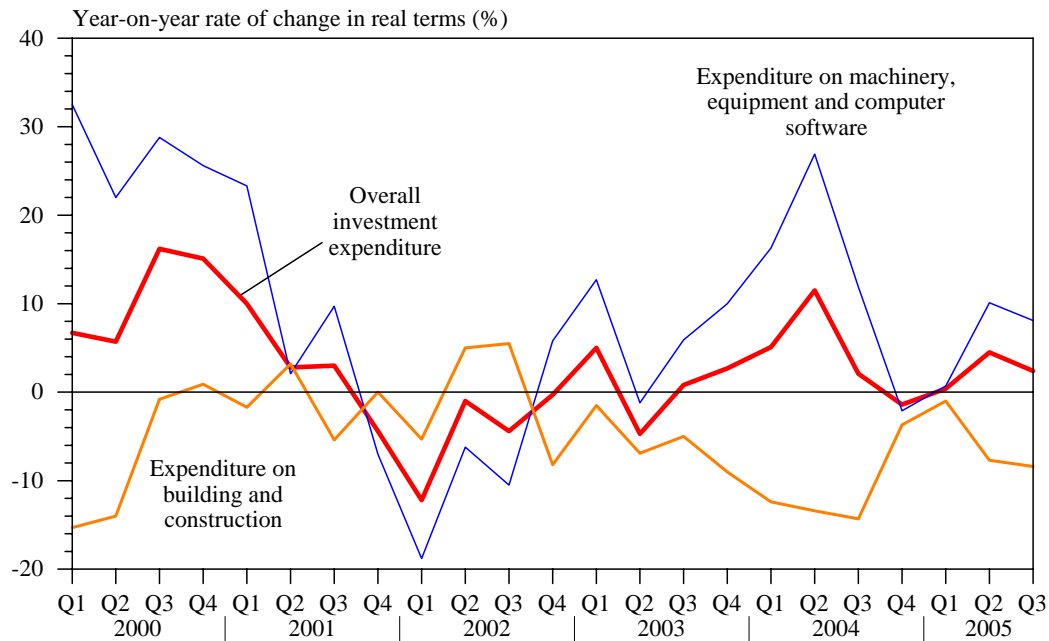
6. Another distinct feature in the current economic recovery is a more balanced growth pattern, with impetus to growth coming from both the external and domestic sectors. In the third quarter, amidst improving employment incomes and generally upbeat sentiment, *private consumption expenditure (PCE)* re-accelerated to grow at 4.6% in real terms in the third quarter over a year earlier, distinctly up from the 3.5% growth in the first half (*Chart 4*).

Chart 4 : Private consumption expenditure and retail sales



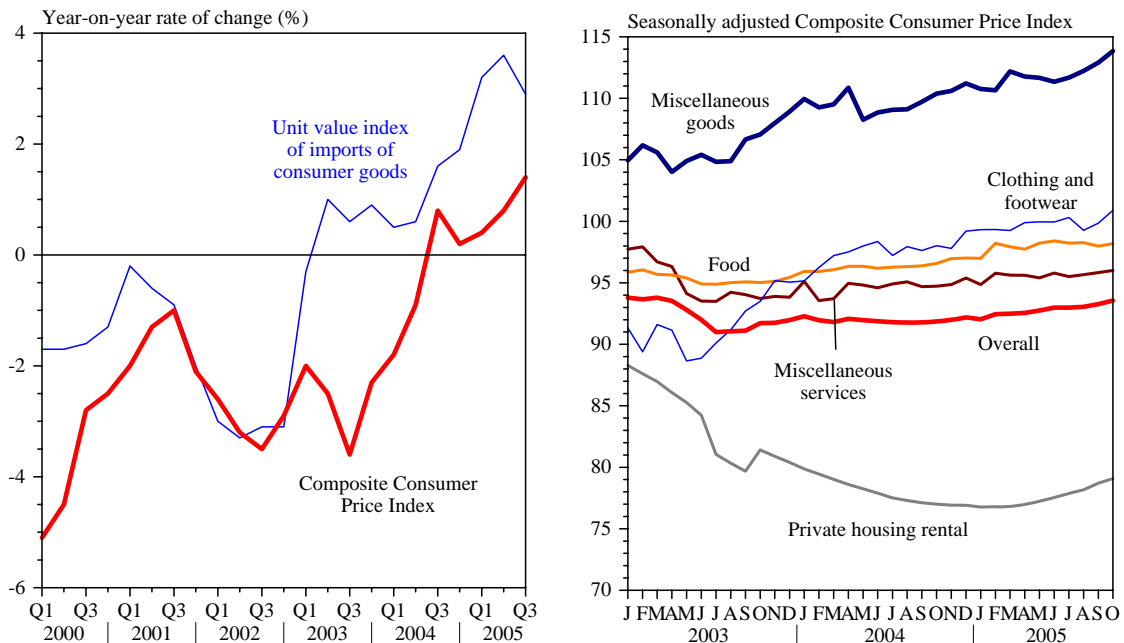
7. Overall investment spending in terms of *gross domestic fixed capital formation* grew further, though only modestly by 2.4% in real terms in the third quarter over a year earlier, after a 2.5% growth in the first half of the year. Business sentiment remained generally upbeat, against the background of the brisk pace of economic expansion. This, together with the need to expand capacity to cope with the increased business volume, led to a further visible increase in investment in machinery, equipment and computer software in the third quarter (up by 8.1%). However, the weak building and construction activity continued to hold back the pace of upturn in overall investment. Expenditure on building and construction fell off further in the third quarter, by 8.4%, as there were still relatively few large-scale building and infrastructure projects in progress (*Chart 5*).

Chart 5 : Investment expenditure by major component



8. Consumer price inflation climbed up slightly further during the third quarter, reflecting the buoyant economic upturn, progressive feed-through from the earlier rental rebound and also some modest impact from higher fuel cost. Yet on the whole, price pressures remained well contained so far, as the strengthened demand was largely matched by expansion in productive capacity coupled with continued productivity enhancement. The *Composite Consumer Price Index* rose by 1.4% in the third quarter of 2005 over a year earlier, and further by 1.8% in October, giving an average increase of only 1.0% for the first ten months of 2005 as a whole (**Chart 6**).

Chart 6 : Hong Kong's price movement



9. The property market as a whole turned quieter in recent months, representing a consolidation from the hectic situation earlier this year. The consolidation was particularly apparent in the sales market for residential property, as acquisition interest was curbed by the cumulative hike of 2.5 - 2.75 percentage points in the best lending rate since March this year as well as by the moves of some banks to claw back more attractive mortgage packages. Overall property prices met with moderation pressure, though the adjustment was mild as the longer-term market outlook stayed positive. On a quarter-to-quarter comparison, flat prices reverted to decline by 2% in the third quarter of 2005 (*Chart 7(a)*). The leasing market nevertheless improved steadily in overall terms, underpinned by progressive pick-up in end-user demand. Flat rentals moved up moderately by 3% in the third quarter (*Chart 7(b)*).

Chart 7(a) : Number and value of property transactions

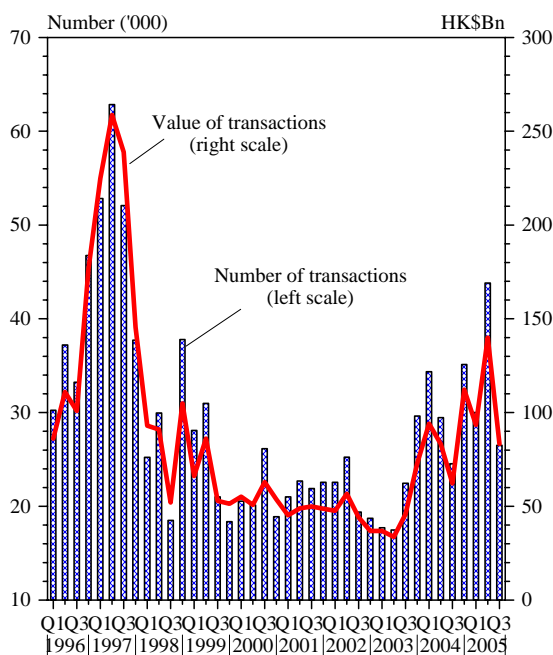
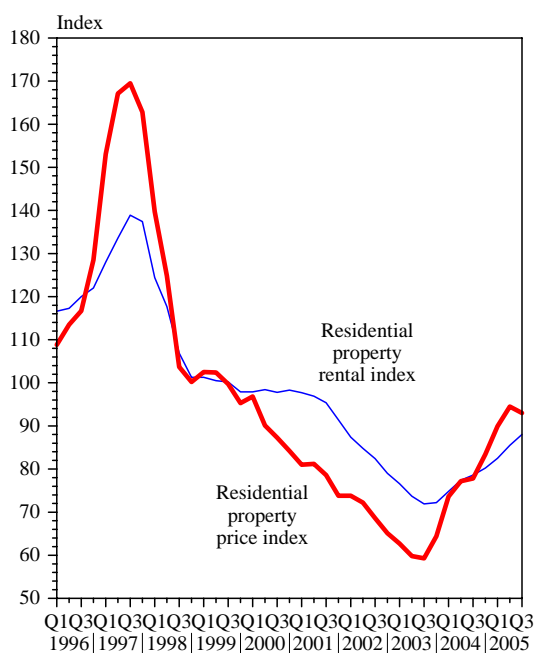
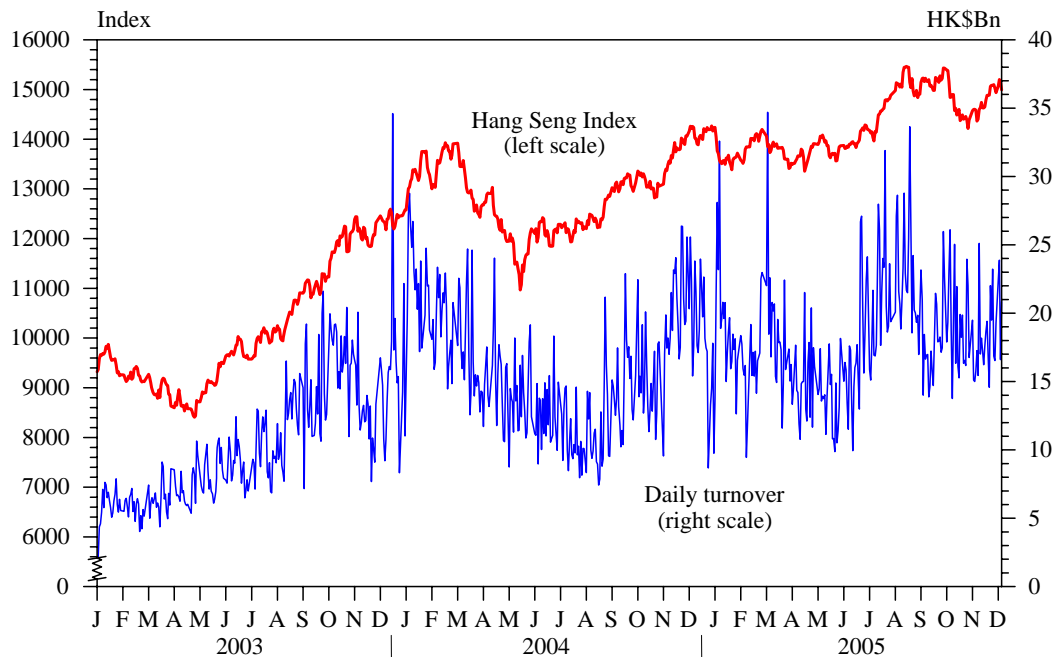


Chart 7(b) : Prices and rentals for residential property



10. The local *stock market* was buoyant for most of the time in the third quarter of 2005, underpinned by progressive improvement in the local economy and good corporate earnings. The Hang Seng Index hit 15 466 on 15 August, the highest level in 2005, before closing at 15 429 at end-September, up by 8.6% over end-June. Yet, between early October and mid-November 2005, the Hang Seng Index fell to a low of 14 400, due partly to renewed concerns over an extension of up-cycle in US dollar interest rates. The index moved within the 14 800-15 200 range during mid-November to early December. In general, the local stock market has been rather resilient on the back of an improving economy (*Chart 8*).

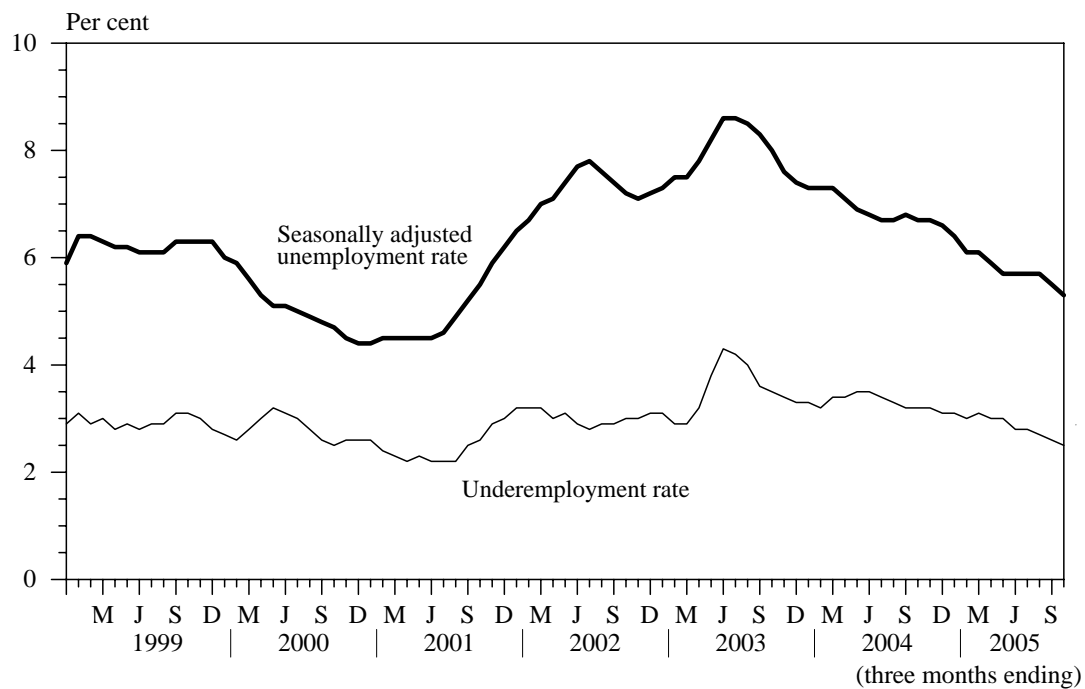
Chart 8 : Hang Seng Index and stock market turnover



Recent developments in the labour market

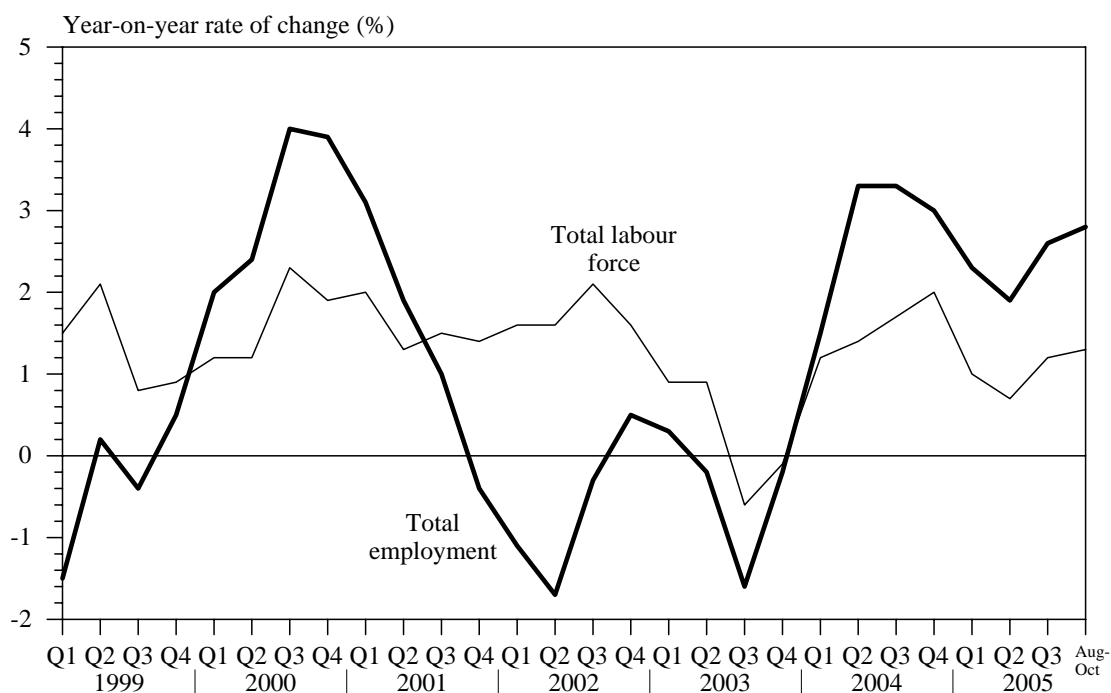
11. A third salient feature in the current recovery is that it has readily translated into a broad-based improvement in the labour market. By August-October 2005, the seasonally adjusted unemployment rate fell to 5.3% and the underemployment rate to 2.5%, which were both at their lowest levels since July - September 2001 (*Chart 9*). Meanwhile, the numbers unemployed dropped to 193 000, for the first time below the 200 000 mark in four years. The reduction in unemployment was extensive across many different economic sectors, occupations and educational levels. The number of long-term unemployed persons also came down markedly, from the peak of 93 000 in mid-2003 to about 59 000 in August-October 2005.

Chart 9 : Unemployment and underemployment rates



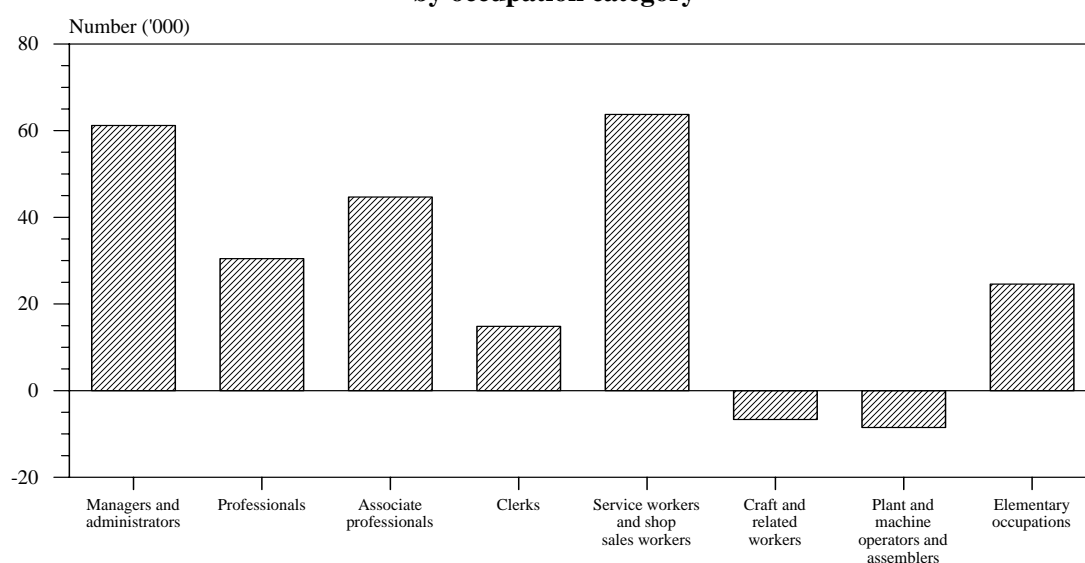
12. Total employment went up to another historic high of 3.42 million in August - October 2005. Employment growth, at 2.8% year-on-year, continued to outstrip the labour supply growth, at 1.3%, as the corporate sector became increasingly confident in their recruitment drive amid the sustained pick-up in business activity (*Chart 10*). This was manifested partly by the relative shift in employment composition from part-time to full-time workers and also from self-employed persons to employees in recent quarters.

Chart 10 : Total labour force and total employment

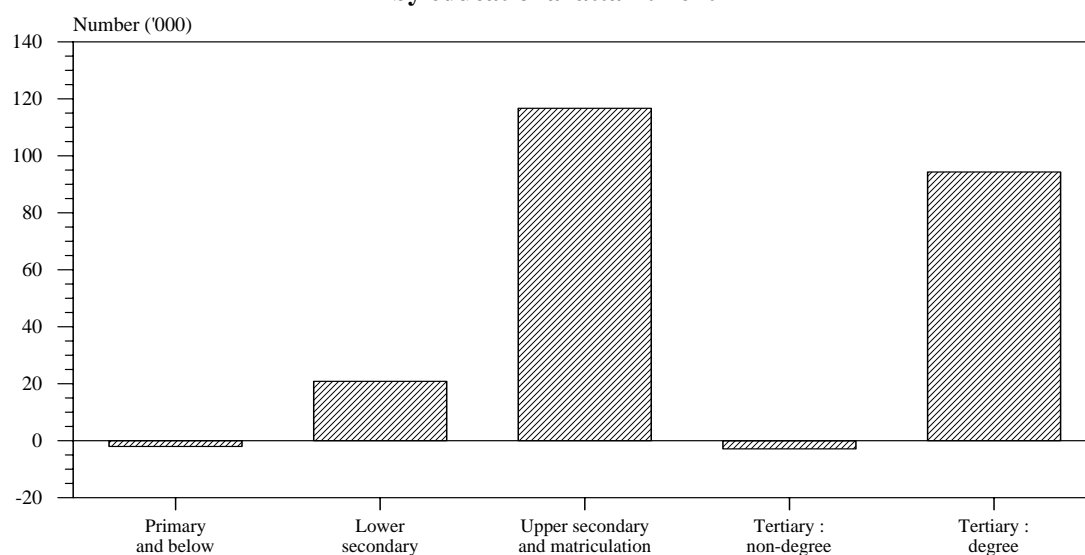


13. When compared with the trough in mid-2003, employment in August - October 2005 showed an impressive gain of 227 000. Within this total, some 91 000 comprised new jobs at the lower-skilled level, which had mainly been taken up by persons with upper secondary education or below, or those aged 40 – 59 (*Charts 11-13*). The majority (over 60 000) of these new jobs belonged to the service workers and shop sales workers category, for which labour demand was boosted by the improved consumer spending and vibrant inbound tourism. Yet for the longer term, it remains imperative to continue to upgrade the quality of local workforce for improved labour productivity and better competitiveness of the Hong Kong economy.

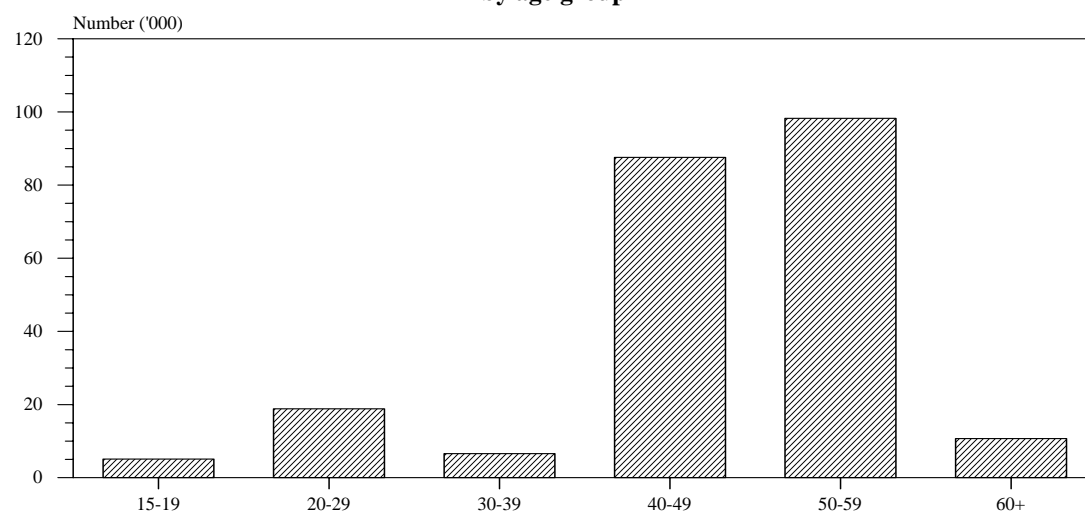
**Chart 11 : Employment growth c.f. the trough in mid-2003
by occupation category**



**Chart 12 : Employment growth c.f. the trough in mid-2003
by educational attainment**

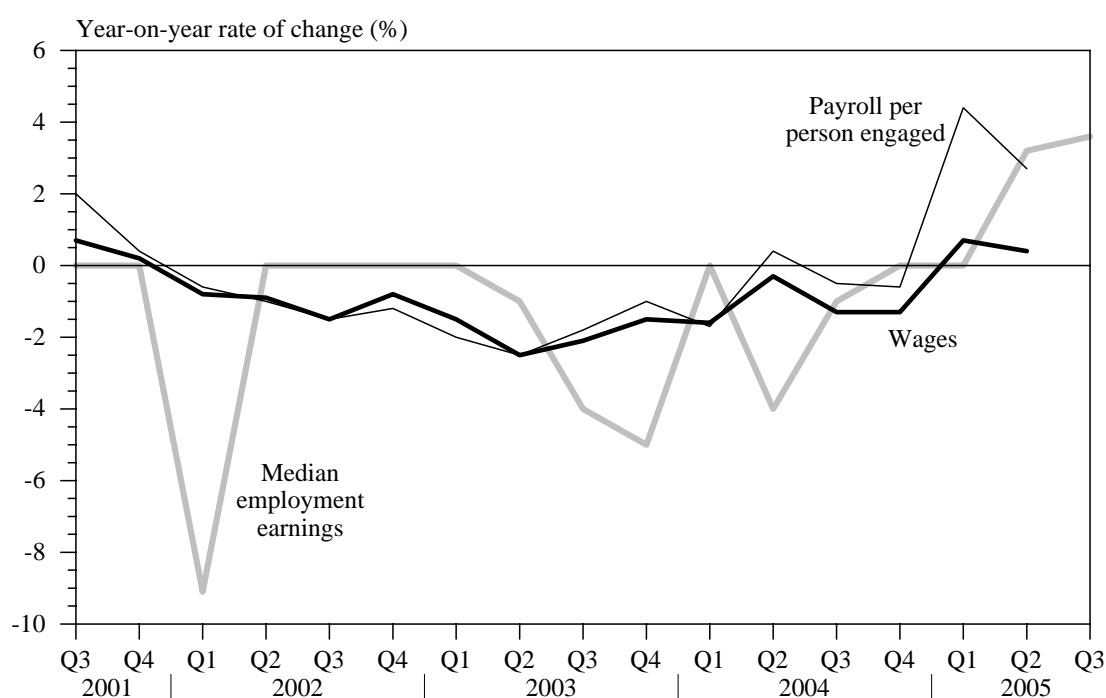


**Chart 13 : Employment growth c.f. the trough in mid-2003
by age group**



14. Labour earnings and wages sustained their upward trend. More specifically, labour earnings, measured in terms of payroll per person engaged in private sector establishments, moved up by 2.7% in money terms in the second quarter of 2005 over a year earlier. In terms of wages, the increase was more modest, at 0.4% in June 2005 (*Chart 14*). But this was largely related to the narrower coverage of the wage index, which included *regular* rewards to workers up to the supervisory level only. Also partly contributed was the relatively loose manpower resource balance still prevalent at the lower segment of the labour market, as well as the further shift in the emphasis of employees' remuneration from fixed wages towards variable or performance-linked pay. More recently, labour earnings should have continued to rise. This was borne out partly by the 3.6% rise in the median monthly employment earnings in the third quarter of 2005 over a year earlier, according to the data enumerated from the General Household Survey.

Chart 14 : Growth in labour earnings and wages in money terms



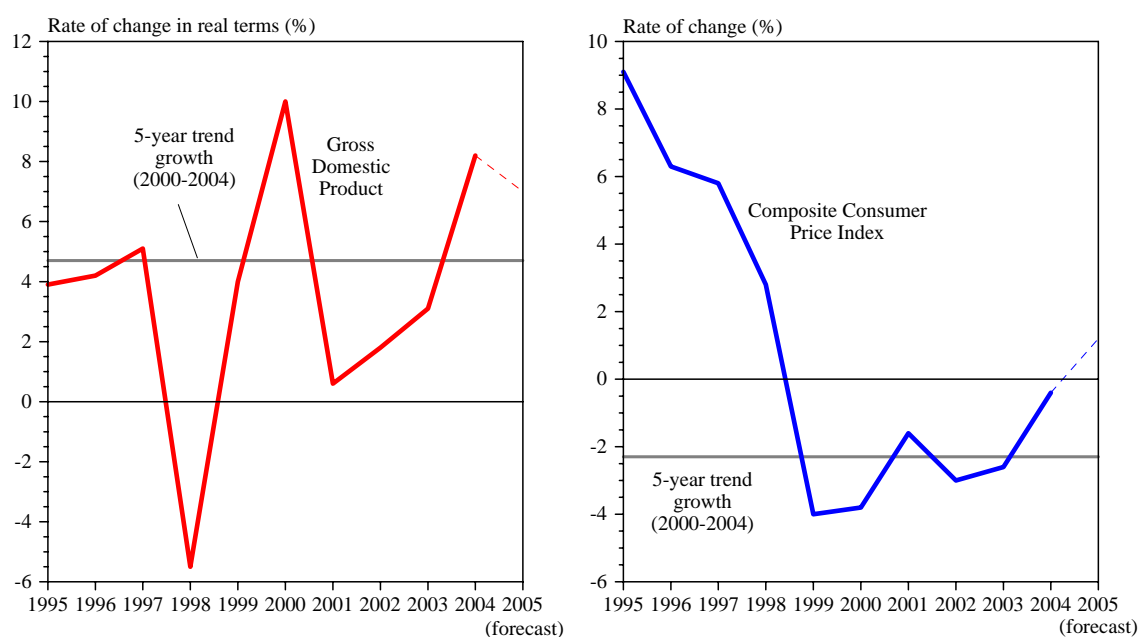
15. The employment outlook for the next couple of months will depend very much on the strength of business activity in the run-up to Christmas and New Year holidays. Looking further ahead, the overall economic performance and job creation capacity in the corporate sector will however be the more relevant factors.

Economic outlook for the rest of 2005 and 2006

16. On the back of the highly robust growth of 7.3% attained in the first three quarters of 2005, the forecast GDP growth for 2005 as a whole is raised from 4.5-5.5% to 7% in the current round of forecast update. This has given due allowance for some moderation in the global and regional demand in the fourth quarter, and has also taken into account the dent in domestic demand from successive interest rate hikes (*Chart 15*).

17. The inflation environment remains benign, as both unit labour cost and unit rental cost continue to show modest increases in recent period. Given the lower-than-expected actual outturn so far, and with the pace of rise-back in CPI inflation likely to remain gradual in the remaining months of the year, the forecast Composite CPI inflation for 2005 as a whole is revised slightly downward to 1.2% from the earlier forecast of 1.5%.

Chart 15 : Forecast of Gross Domestic Product and Composite Consumer Price Index for 2005



18. Trade outlook in 2006 is still beset with a range of uncertainties, including whether the global economy is able to sustain reasonably solid growth momentum; to what extent avian flu would impact on global economy and international trade; whether Mainland's trade can maintain strong growth as in this year; whether US dollar will continue to strengthen; by how much more the impact of the earlier oil price surge will show up in 2006, etc. In addition, in the international financial markets, there are lingering concerns about the possible corrections of the US housing market and the persistent huge US current account deficit. With the impact of the successive interest rate

hikes showing up more fully in 2006, it is not unlikely, indeed natural, for economic growth to ease back in 2006, after attaining two consecutive years of very rapid growth. Much depends on how well the global economy can extend the current pace of economic expansion into 2006.

19. Against the lingering uncertainties and downside risks, however, the implementation of the three phases of CEPA, as well as the strengthening co-operation with Guangdong and the Pan-PRD region, will continue to render support to Hong Kong's economic growth. It should be noted that the economic fundamentals of Hong Kong have strengthened up significantly after the substantial corporate downsizing and downward adjustments in cost structure since 1998, which should enable Hong Kong to weather external shocks better than before.

20. We will take into account the above factors when preparing the economic forecast for 2006, which will be announced along with the Budget Speech in February 2006. As a reference, the International Monetary Fund lately forecasts that the Hong Kong economy would grow by 4.5-5% in 2006, and the forecasts put out by private sector analysts are mostly in the range of 4-5%. These forecasts essentially expect GDP growth to ease back to a level which is more commensurate with the trend GDP growth in the past.

Economic Analysis Division
Economic Analysis and Business Facilitation Unit
Financial Secretary's Office
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