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Hong Kong's recent economic situation and short-term outlook

The Government has just released the First Quarter Economic Report 2004 at end-May. The Economic Report, together with the press release containing the updated economic forecasts for the whole year of 2004, have been furnished to LegCo Members.

This paper analyses Hong Kong's overall economic growth, external trade, domestic demand, labour market, consumer prices, asset markets, and so forth in the first quarter. It then discusses the economic outlook in the rest of this year.

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Financial Secretary's Office
7 June 2004

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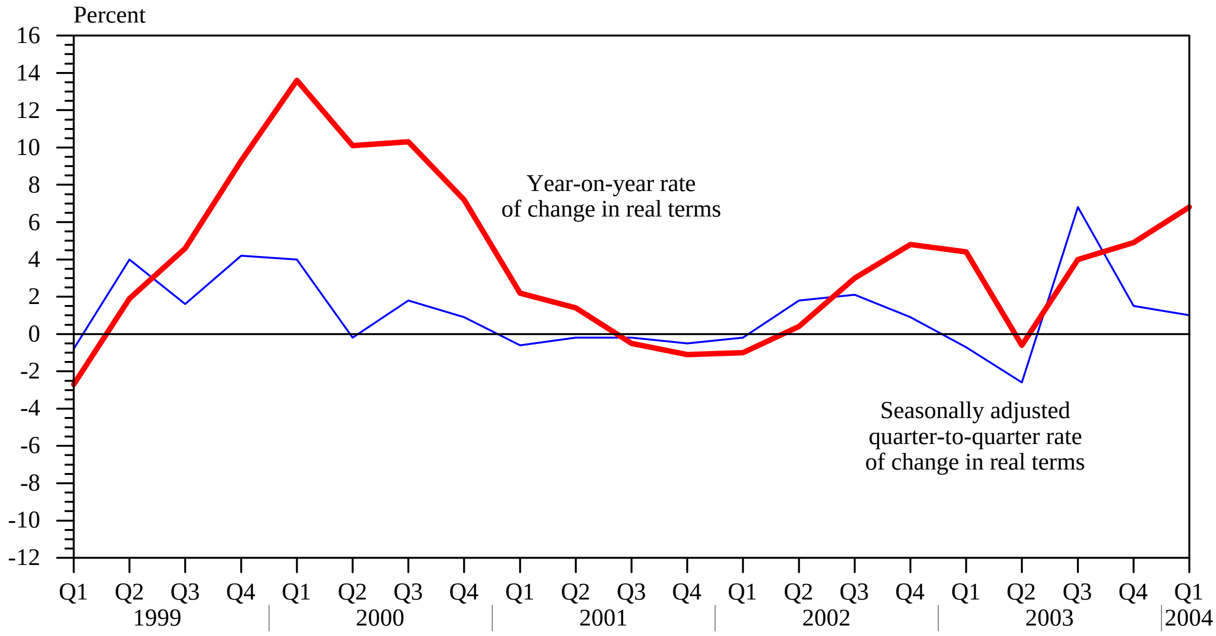
(1) Economic performance in the first quarter of 2004

Chart 1 : Gross Domestic Product

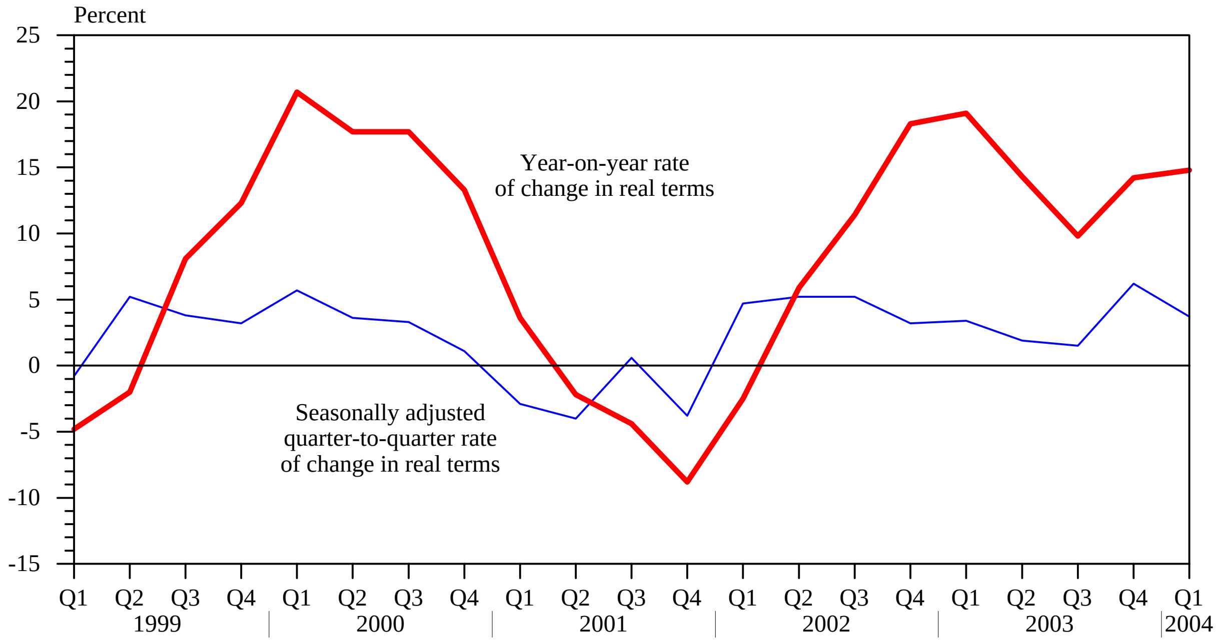


- The Hong Kong economy accelerated in growth in the first quarter of 2004, continuing the broad-based recovery in the second half of 2003.

- On a year-on-year comparison, the Gross Domestic Product (GDP) leaped by 6.8% in real terms in the first quarter of 2004, further up from the 4.9% growth in the fourth quarter of 2003. There was an across-the-board economic upturn in the first quarter, with exports of both goods and services remaining vibrant and overall domestic demand picking up.

- On a seasonally adjusted quarter-to-quarter comparison, GDP grew by 1.0% in real terms in the first quarter of 2004, after a 1.5% growth in the fourth quarter of 2003.

Chart 2 : Total exports of goods

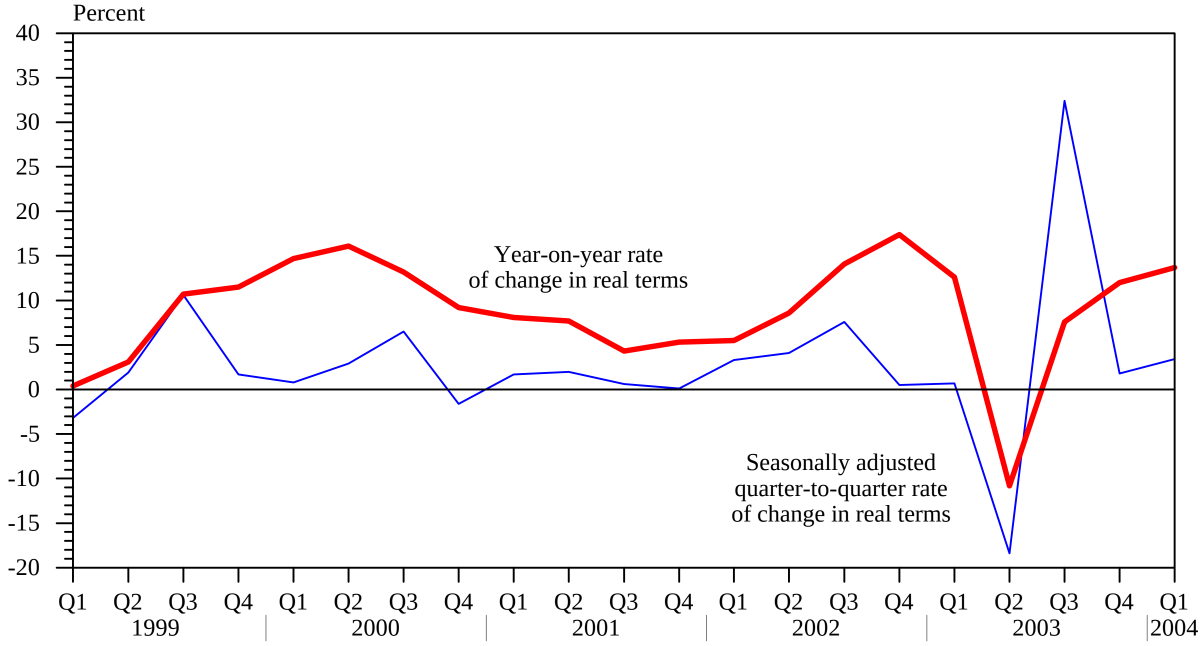


- Exports of goods remained robust in the first quarter of 2004, buoyed mainly by a revival in global demand. The generally soft US dollar also gave additional support.

- On a year-on-year comparison, total exports of goods leaped by 14.8% in real terms in the first quarter of 2004, up even further from the 14.2% increase in the fourth quarter of 2003.

- Analysed by export region, exports of goods to East Asia registered an across-the-board surge alongside the export boom in the region in the first quarter of 2004. Exports to the European Union recorded a further double-digit growth amidst a strong euro and firmer demand there. Exports to North America also resumed growth. But compared to East Asia and the European Union, the growth in exports to North America was much less distinct, conceivably weighed down by the on-going shift from re-exports to offshore trade.

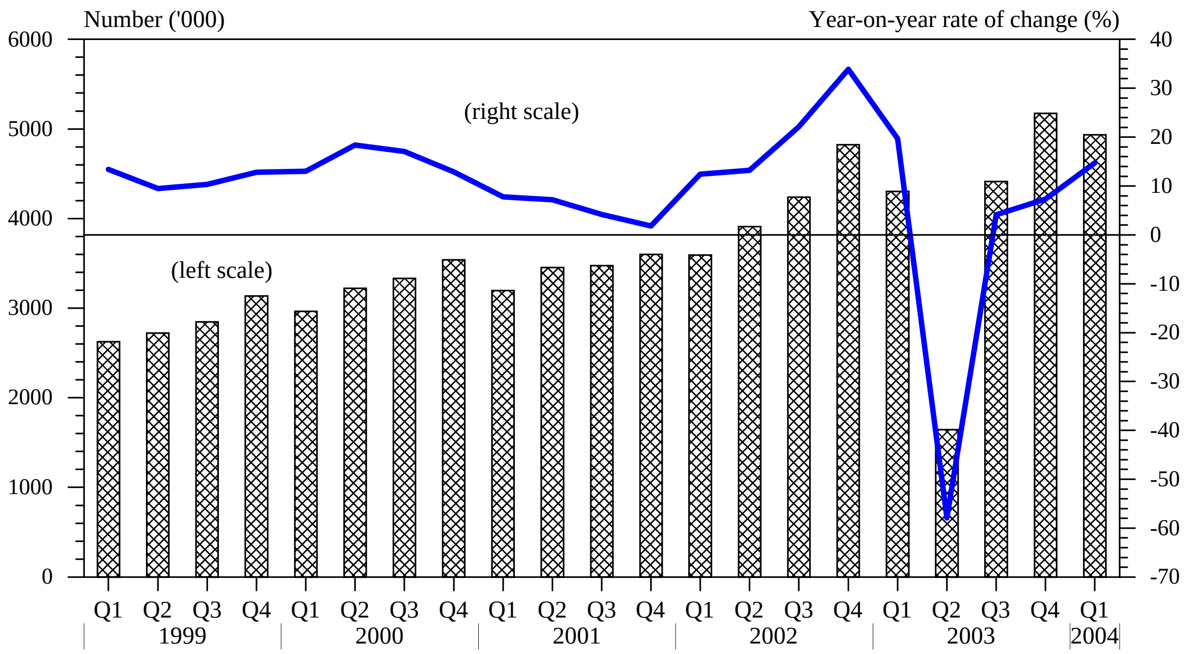
Chart 3 : Exports of services



- On invisible trade, exports of services attained a distinct growth of 13.7% in real terms in the first quarter of 2004 over a year earlier, up from the 12.0% increase in the fourth quarter of 2003.

- All major components within exports of services registered marked increases in the first quarter. While offshore trade remained on an uptrend, inbound tourism continued to prosper on the back of surging visitor arrivals from the mainland of China (the Mainland). Also, exports of transportation services accelerated in growth, in tandem with the vibrant tourism and strong export performance.

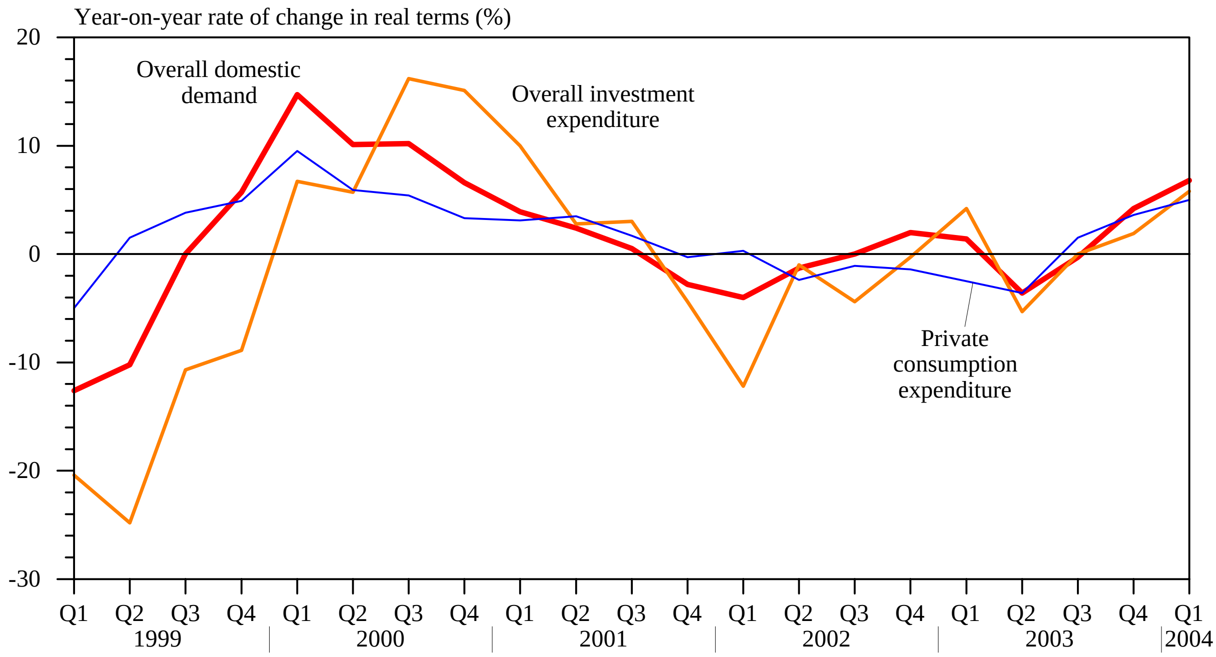
Chart 4 : Visitor arrivals



- ➢ On a year-on-year comparison, the number of incoming visitors showed accelerated growth of 15% in the first quarter of this year, compare with 7% in the fourth quarter last year.

- ➢ Bolstered by the launch of the Individual Visit Scheme, the surge in the number of incoming visitors from the Mainland was particularly distinct, by 37% in the first quarter of 2004 over a year earlier. Concurrently, visitor arrivals from the United States, Europe and Southeast Asia also resumed modest increases in the first quarter. But the number of incoming visitors from Japan continued to record double-digit declines in recent months.

Chart 5 : Domestic demand

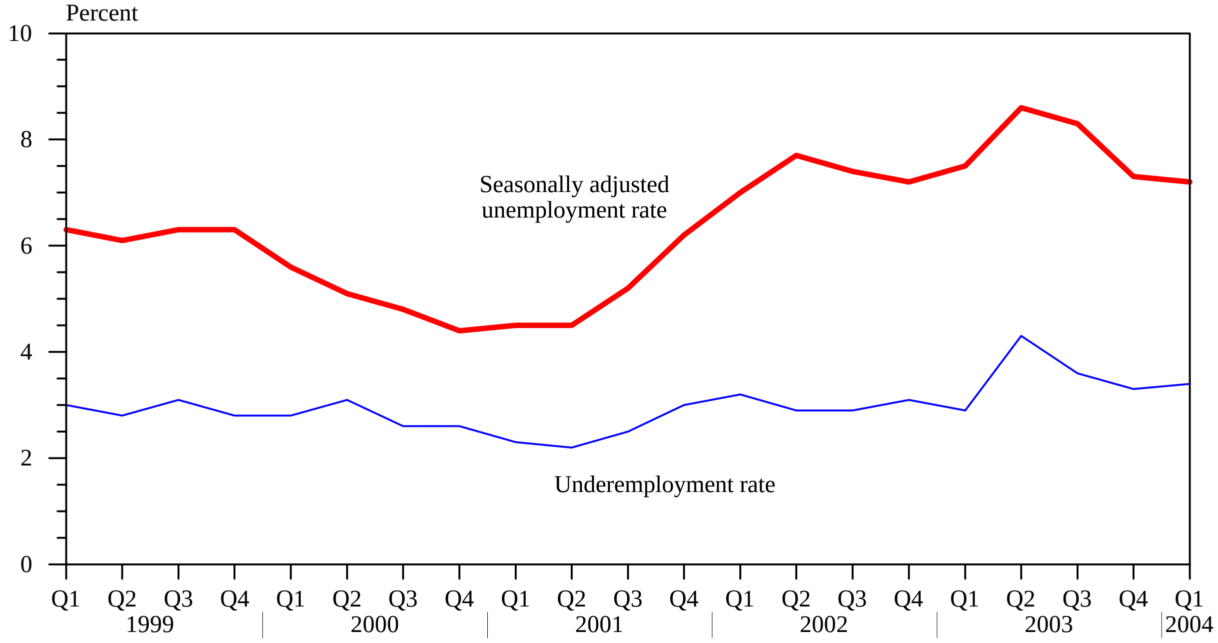


➢ Amidst a brighter economic outlook, improved employment and a steadily reviving property market, overall domestic demand also continued to pick up in the first quarter of 2004.

➢ Private consumption expenditure accelerated to a 5.0% growth in real terms in the first quarter of 2004 over a year earlier, after a 3.6% increase in the fourth quarter of 2003. This was the fastest quarterly growth since the third quarter of 2000. The increase was seen in almost all the broad categories of consumer spending, with a particularly distinct rise in spending on consumer durable goods.

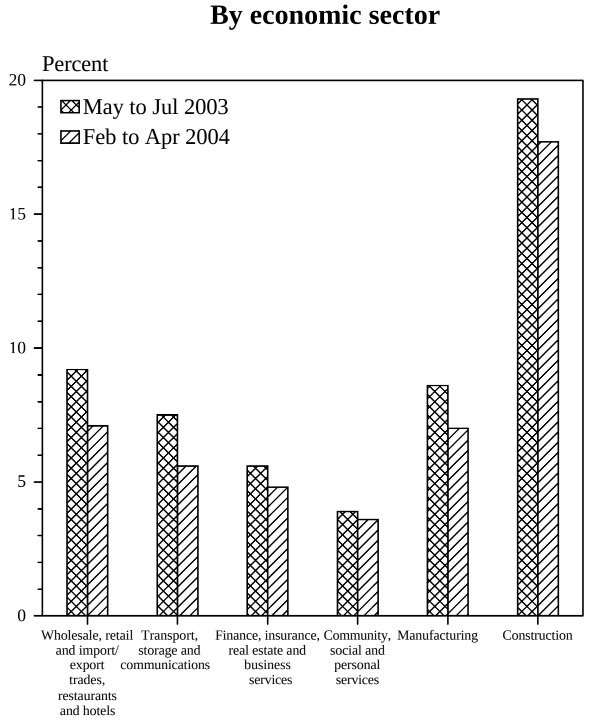
➢ Intake of machinery, equipment and computer software likewise rose sharply, yet building and construction output remained slack. Taken together, overall investment spending rose by 5.8% in real terms in the first quarter of 2004 over a year earlier, improved significantly further from the 1.9% increase in the fourth quarter of 2003.

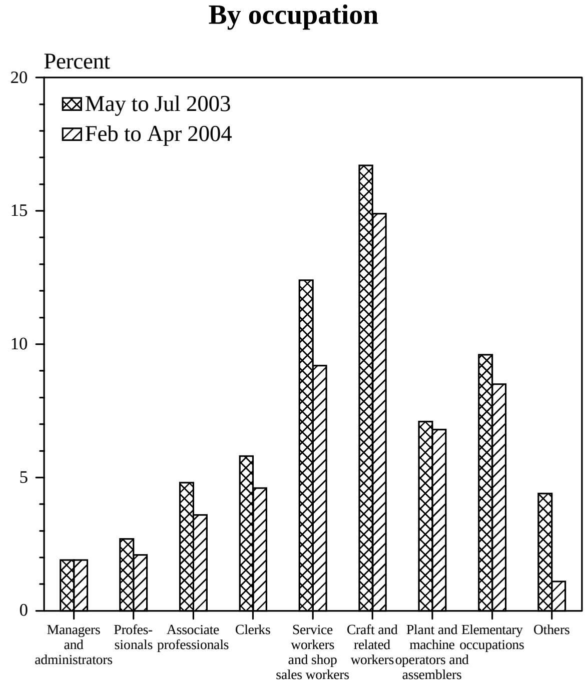
Chart 6 : Unemployment and underemployment rates



- Along with the upturn in economic activity, overall labour market conditions continued to improve. The seasonally adjusted unemployment rate fell distinctly to 7.1% in February - April 2004, from the peak of 8.7% in May - July 2003. The underemployment rate likewise declined, from 4.2% to 3.4% between these two periods.

Chart 7 : Unemployment rate by economic sector and by occupation

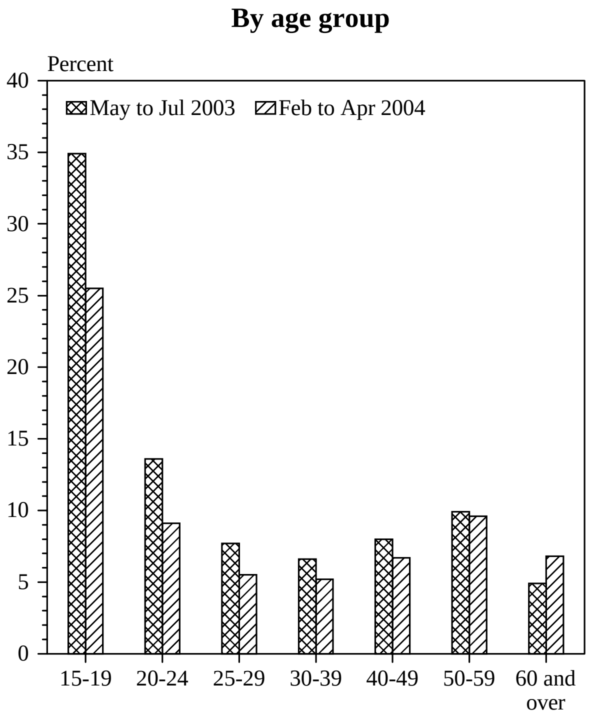


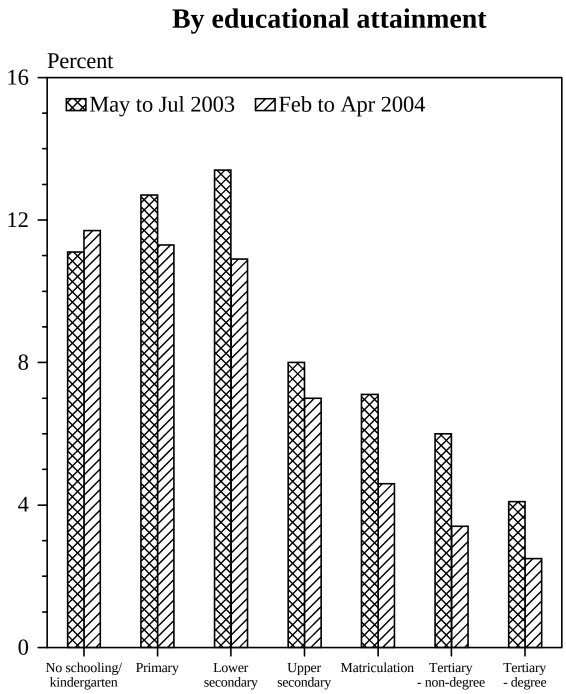


- Analysed by economic sector, the decrease in unemployment rate was broadly based in February - April 2004 compared with the peak in May - July 2003.

- The improvement in employment situation for the major occupation categories was also widespread.

Chart 8 : Unemployment rate by age group and by educational attainment

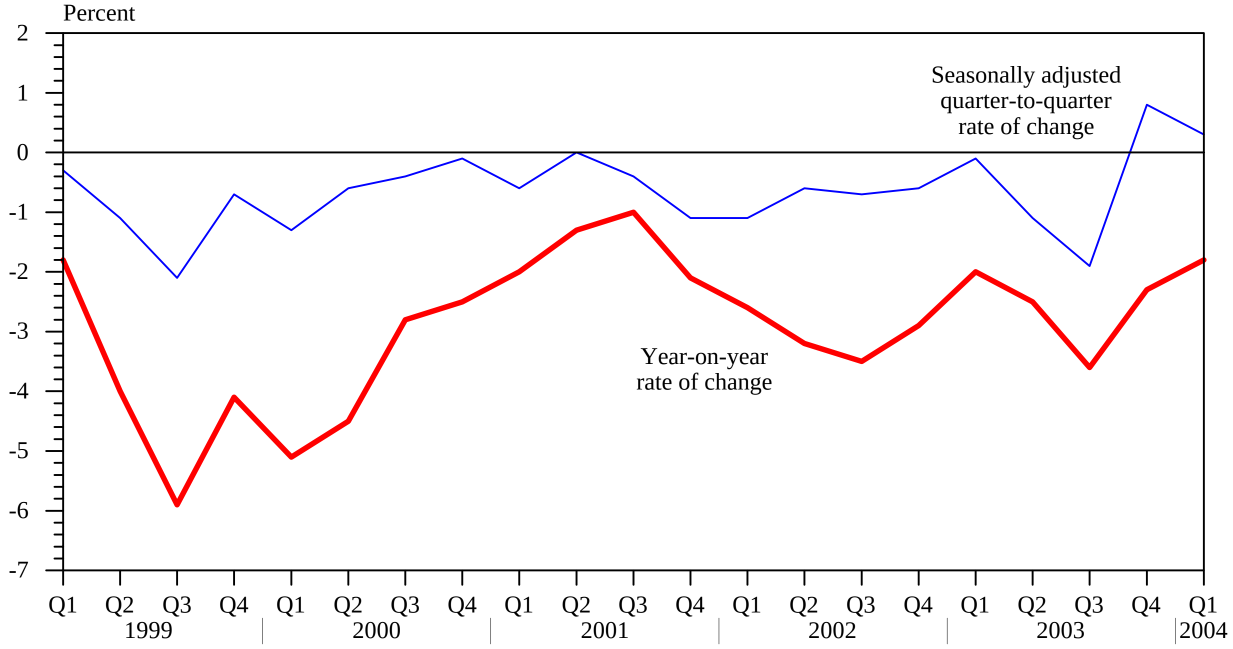




- Analysed by age, comparing the unemployment rate in February - April 2004 with the peak in May - July 2003, the decrease in unemployment rate was the most distinct for persons aged 15-19 and 20-24. However, employment situation for persons aged 60 or above had yet to improve.

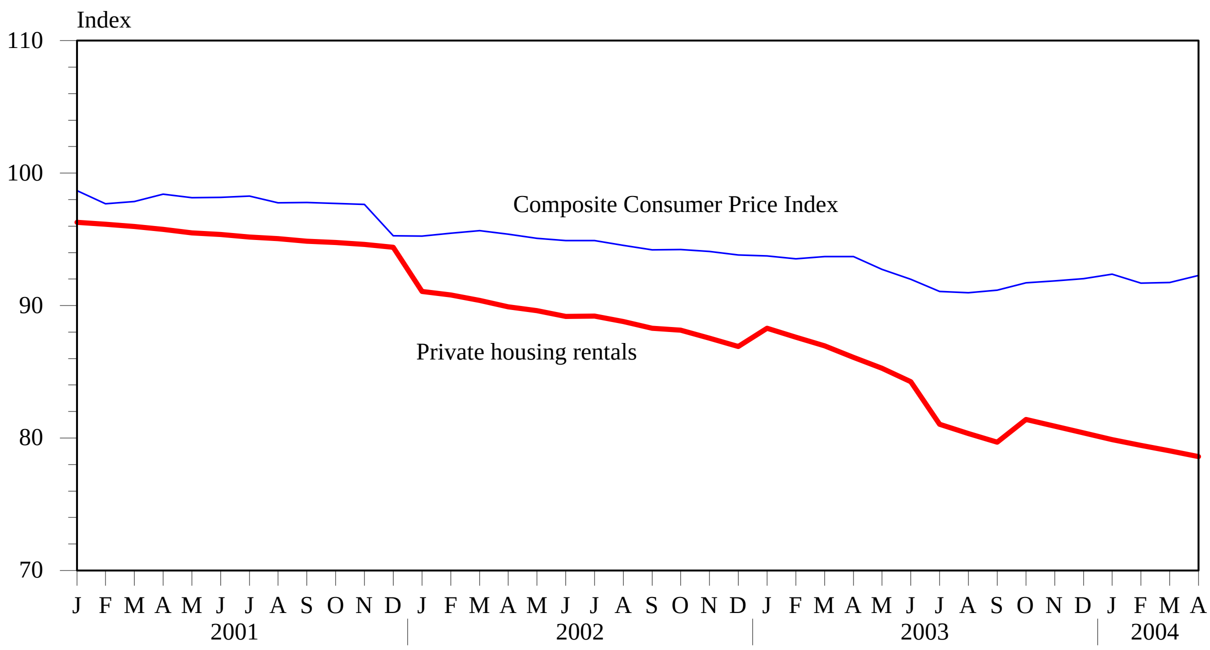
- Analysed by educational attainment, except for persons with low education, employment situation for all other groups showed improvement over the period.

Chart 9 : Composite Consumer Price Index



- On the price front, compared with the trough in July 2003, the seasonally adjusted Composite CPI in April 2004 had risen back by 1.2%. However, when compared with the same quarter last year, the Composite CPI still registered a decline of 1.8% in the first quarter of 2004, though much tapered from the corresponding decrease of 2.3% in the fourth quarter of 2003. This trend continued into April, with a year-on-year decline of 1.5% being recorded.

Chart 10 : Overall Consumer Price Index and private housing rentals

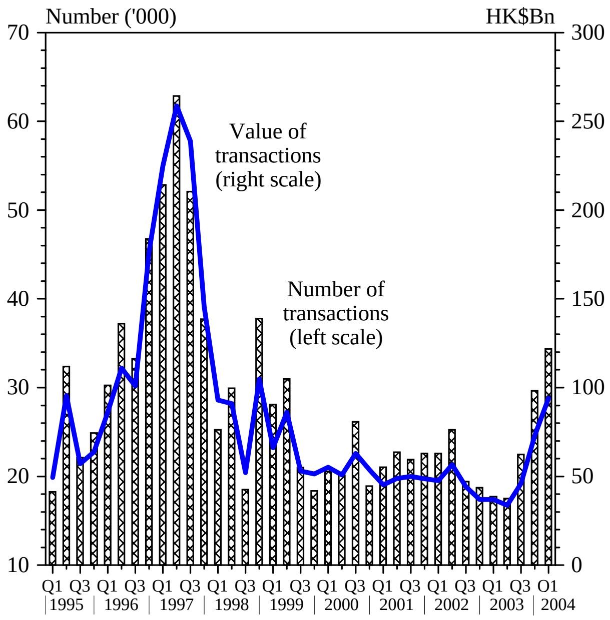


- The main drag on the current consumer price level came from the earlier falls in housing rentals. With the revival in property demand, private residential rentals have shown signs of bottoming out in recent months.

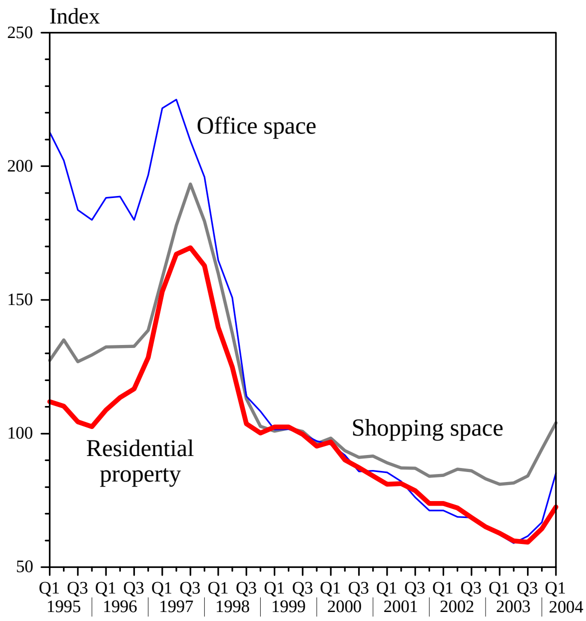
- In addition, amidst the upturn in local demand, there were generally lesser price discounts and other concessions on consumer items in the retail market in recent months. The prices of some consumer items such as foodstuffs, clothing and footwear, and home appliances recorded increases of various magnitude. A weaker US dollar and a sharp escalation in world commodity prices also contributed in part to the rise in retained import prices.

Chart 11 : Property transactions and prices

Number and value of property transactions



Prices for residential property, office space and shopping space



- Property market picked up distinctly further in the first quarter of 2004.

- Property transactions rose by 16% in number in the first quarter of 2004 over the fourth quarter of 2003, marking the third consecutive quarter of increase. In terms of total value, the uptrend in property transactions was even more distinct, posting a quarterly increase of 29% over the same period.

- On residential property, there was strong buying interest in both the primary and secondary markets, particularly for property at the luxury end. By March 2004, flat prices have already risen for eight consecutive months. Though with some ease-back in April, flat prices still had a cumulative increase of 32% over the trough in July 2003. Flat rentals also increased, by 6% over the same period.

- Likewise, both investment and leasing demand for office space strengthened distinctly amidst improved business environment. Prices for office space surged by a cumulative 54% in March 2004 over the trough in May 2003. Office rentals resumed some increase in late 2003, reversing the downtrend since early 2001. By March 2004, office rentals have risen back by 5% over the trough in September 2003.

- The market for shopping space also turned more active, as inbound tourism remained buoyant and as local consumer spending picked up further. Comparing March 2004 with the trough in July 2003, prices for shopping space rose by 36%. Rentals for shopping space increased by 6% over the same period.

Chart 12 : Prices for residential property by class

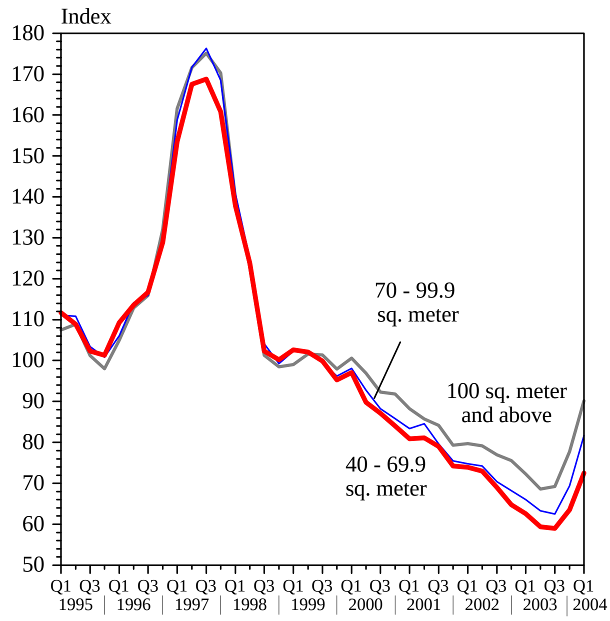
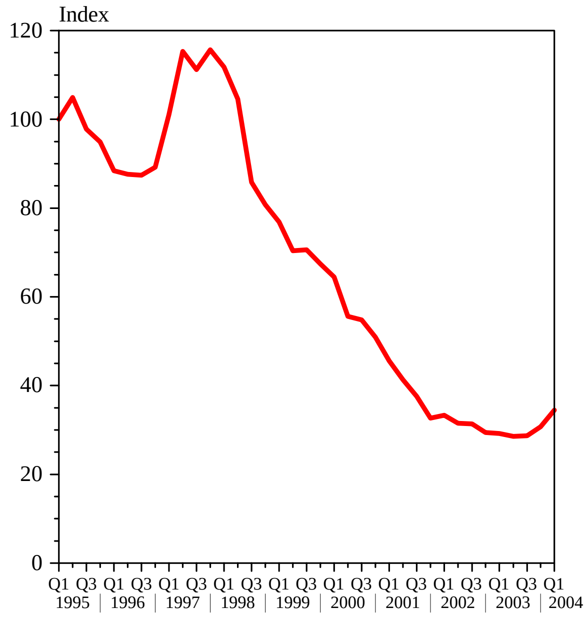


Chart 13 : Index of owner affordability*

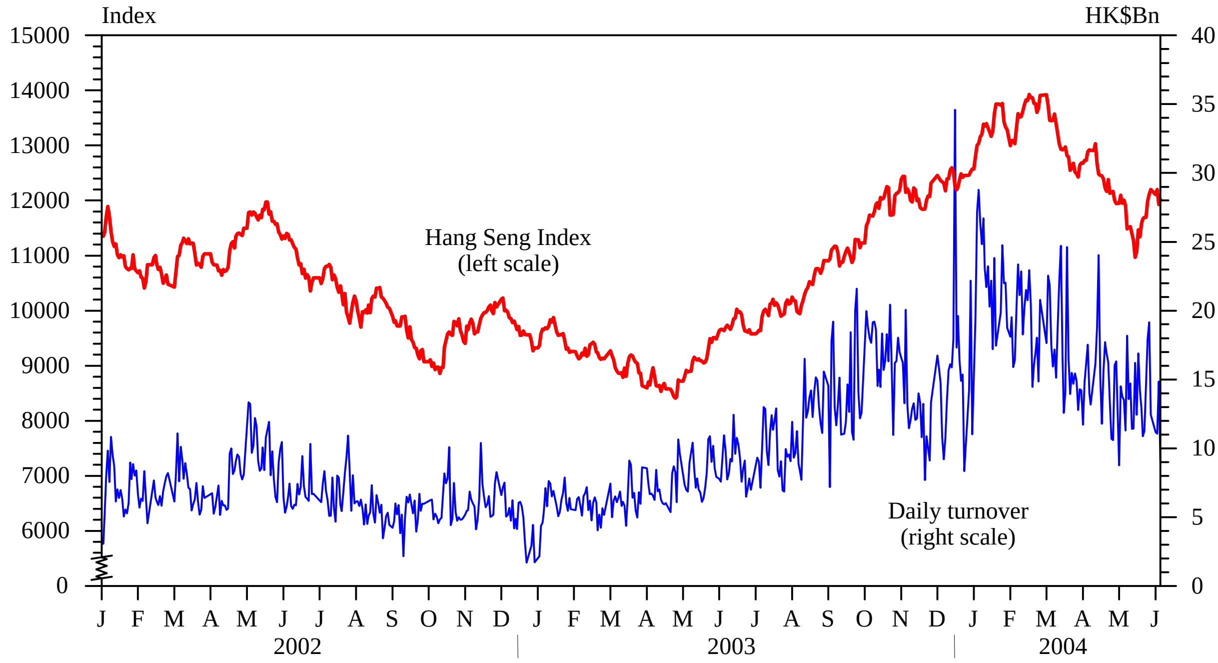


(*) An increase in the index represents a decline in owner affordability; a decrease in the index represents a rise in owner affordability.

- The turnaround in flat prices was the most distinct for the residential property with floor area of 70 m^2 and above, which had a cumulative increase of over 40% in April 2004 over the trough in mid-2003. The increase for the smaller residential units was also pronounced, with a cumulative rise of around 25-30% over the same period. Yet compared with the peak level, the prices for the various classes of residential property were still around 50-60% lower.

- While flat prices have picked up in recent months, the index of owner affordability is still 70% lower than the peak level in the fourth quarter of 1997, owing to the prevailing low mortgage interest rates.

Chart 14 : Hang Seng Index and Hong Kong's stock market turnover



- The local stock market continued on a strong rally at the beginning of 2004. Share prices were bolstered by continued inflow of funds, promising near-term outlook for the Hong Kong economy, and a more active property market.

- The Hang Seng Index reached a 35-month high on 18 February 2004, closing at 13 928. But market sentiment turned less bullish thereafter, amidst increasing concern about a sooner rise in US interest rates, mounting geo-political tension, hike in international oil prices, and stepping up of economic tightening measures in the Mainland. The Hang Seng Index fell back to a seven-month low of 10 968 on 17 May. It then rebounded to 12 023 on 4 June, though it was still 4% lower than 12 576 at the end of last year.

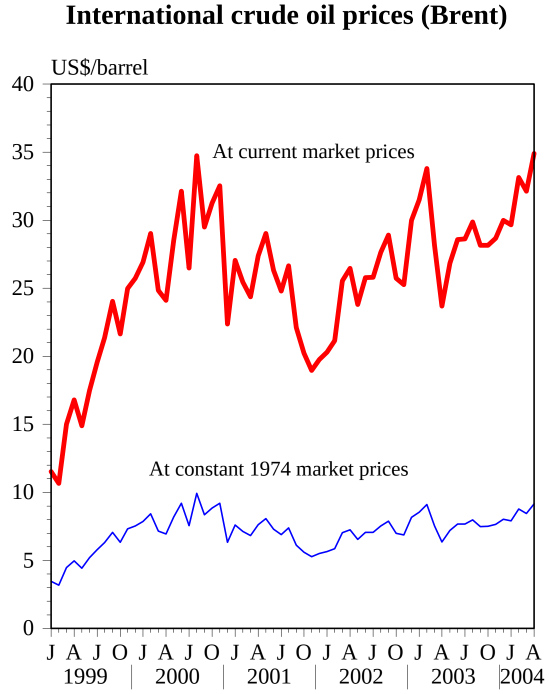
- The average daily turnover in the local stock market posted a six-year high in the first quarter of 2004, at $19.7 billion, up by 29% over the fourth quarter of last year. But as market sentiment turned weaker, the average daily turnover declined visibly in recent months.

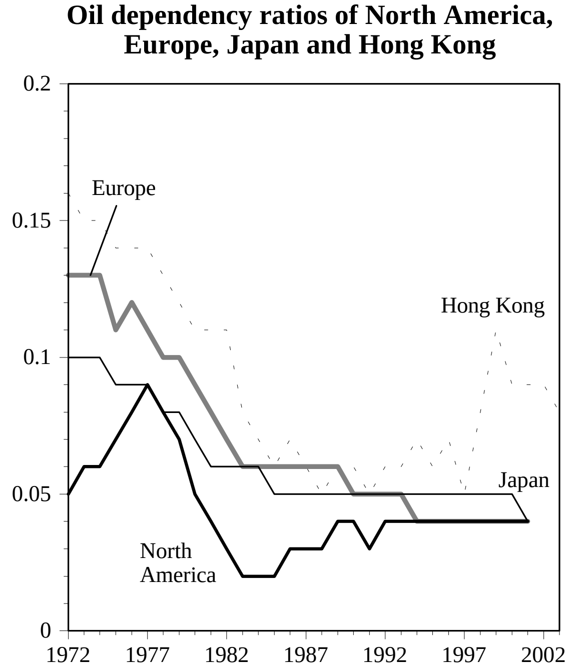
(2) External uncertainties

➢ Compared with two months ago, there are now more concerns about the latest developments in the external economic environment. The more prominent issues include :

(i) Recent hike in international crude oil prices

Chart 15 : International crude oil prices and oil dependency ratio





➢ The prices of Brent crude oil has continued to surge since early April 2004, reaching a 13½-year high of US$39.5 per barrel on 1 June. This has aroused market concern about whether the upsurge in international crude oil prices would hamper the recovery process in the global economy and the Hong Kong economy.

➢ As Hong Kong's oil dependency ratio is not high (fuel cost accounting for less than 5% of the overall business operating cost), the direct curtailing impact of oil price hike on overall domestic demand should be rather insignificant, even though the impact on specific sectors would be larger.

➢ The indirect impact would depend mainly on whether the rise in oil prices would dampen demand of Hong Kong's trading partners, thereby curtailing Hong Kong's export performance. At this juncture, it is believed that such impact should not be very significant. The reason is that the oil dependency ratios of the industrialised economies have been declining over the past three decades. As such, an upsurge in crude oil prices should have less damaging effect on the global economic performance now than before.

(ii) Possible imminent rise in US interest rates

Chart 16 : US economic growth and interest rate

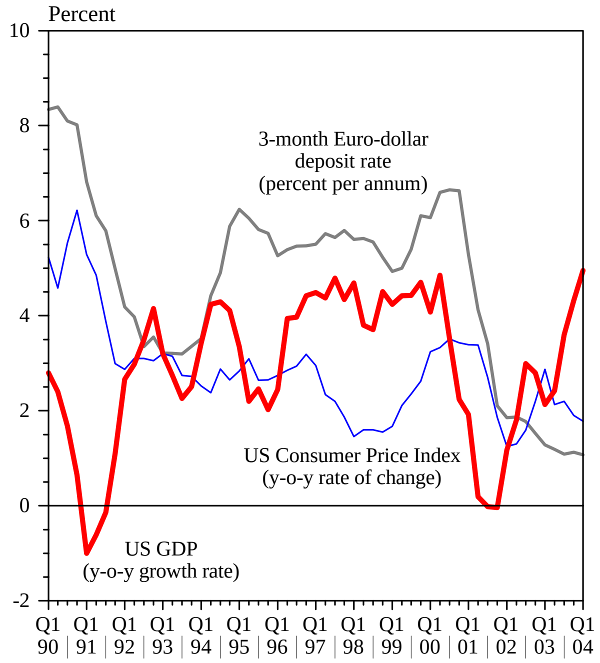
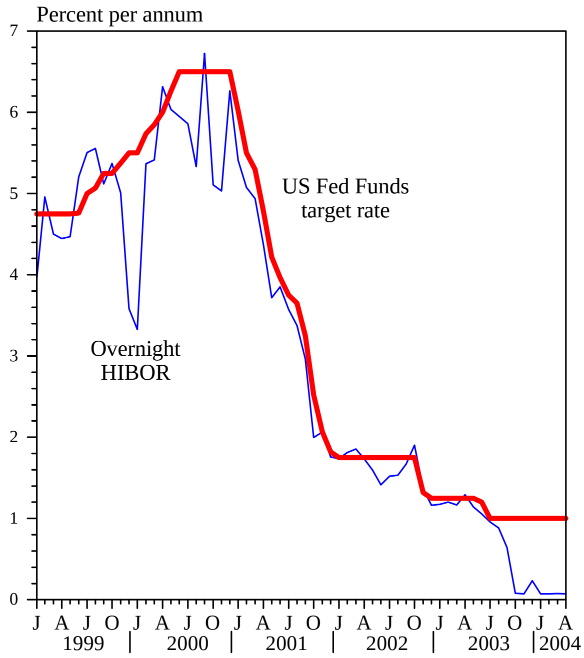


Chart 17 : US and Hong Kong interest rates (monthly average)



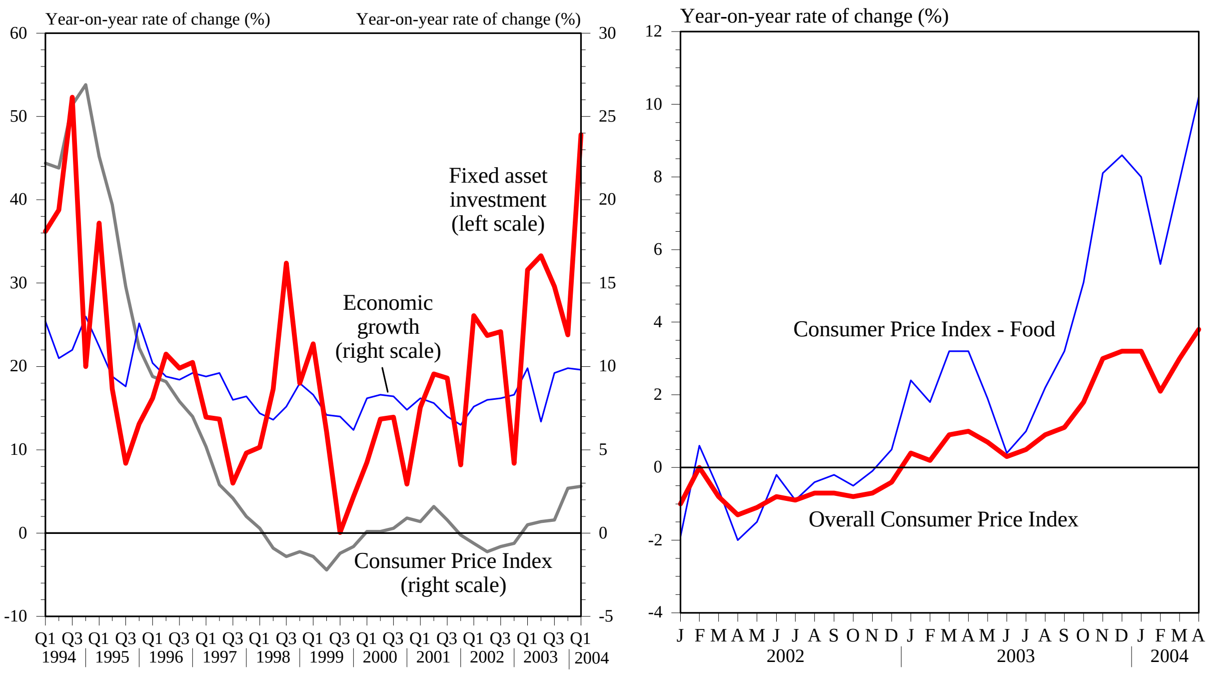
- Latest US economic data indicate that growth momentum in the US economy is still strong, raising market expectations for an imminent rise in interest rates by the US Federal Reserve in order to forestall the re-emergence of inflationary pressures.

- Nevertheless, as US inflation rate is still low, any interest rate rise in the United States is likely to be only gradual and at a measured pace. Also, the current US Fed Funds target rate is only 1%, which is a 46-year low. As such, a modest increase in interest rate from such a low level is not expected to pose a severe threat to the global economy and hence to the Hong Kong economy.

- Moreover, the need for a rise in US interest rates primarily reflects the robust growth in the US economy. This means that the rest of the world, including the Mainland and Hong Kong, should be able to sell more to the United States, thereby offsetting in part the adverse impact of the interest rate rise.

(iii) Stepping up of macroeconomic tightening measures in the mainland of China

Chart 18 : Key economic indicators for the mainland of China



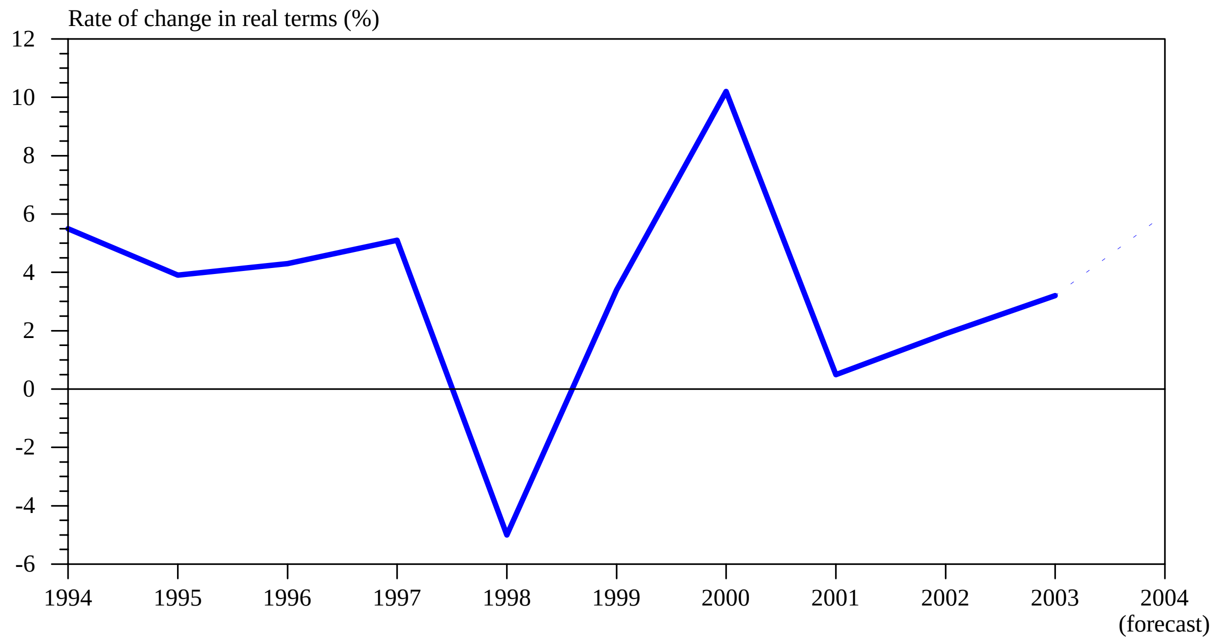
- So far, the Mainland's economic tightening measures are mainly targetted at specific sectors with signs of overheating, including real estates, automobile, steel, cement and aluminium. Latest indicators suggest that these measures have begun to take effect.

- As imports related to these overheated sectors account for only a minor share of Hong Kong's total exports of goods to the Mainland, the Mainland's economic tightening policy should not have a serious damaging effect on Hong Kong's overall export performance.

- Currently, the market generally believes that the risk of a hard landing in the Mainland economy is not large. As such, the impact of the Mainland's economic tightening measures on the Hong Kong economy is not reckoned to be too significant. Indeed, a more steady and sustained growth in the Mainland economy should be beneficial to the Hong Kong economy in the longer term.

(3) Economic outlook and forecasts for this year

Chart 19 : Forecast of Gross Domestic Product for 2004



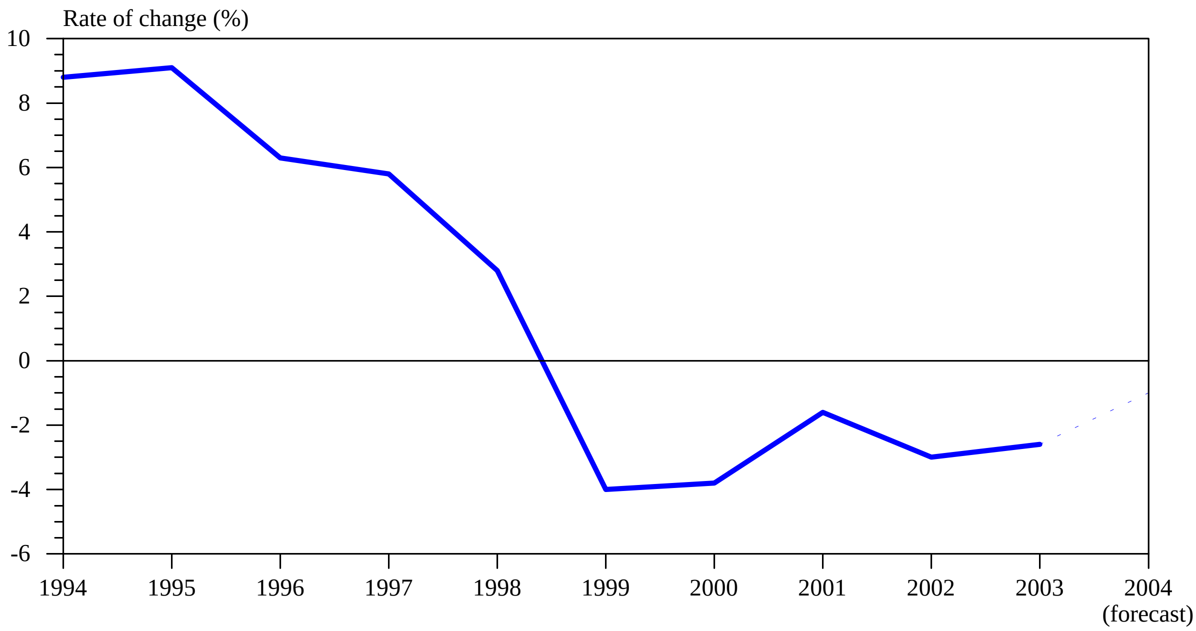
- Although there are more uncertainties emerging in the external environment lately, the general tone for the economy is still very positive for this year.

- On the outlook for the rest of this year, exports of goods and services should continue to hold up well, on the back of strong global and regional demand and thriving inbound tourism.

- Overall domestic demand should also pick up further, amidst continued improvement in employment situation and business environment.

- On weighing the afore-mentioned external risks against the upside potential from the robust growth momentum of external trade and inbound tourism, and even allowing for a possible moderation in GDP growth in the latter part of the year, the earlier forecast of a 6% growth for the year is still considered reasonable and attainable. Hence, the forecast growth rate in real terms of GDP for 2004 is kept unchanged at 6% in the May update, same as the forecast first released in March.

Chart 20 : Forecast of Composite Consumer Price Index for 2004



- The Composite CPI registered a smaller-than-expected average decline of 1.7% in the first four months of 2004 over a year earlier. Looking ahead, as domestic demand strengthens further and as the uptrend in world commodity prices and higher inflation in the Mainland feed through, the rate of change in consumer prices can be expected to return to positive later in the year.

- For 2004 as a whole, the forecast rate of change in the Composite CPI is kept unchanged at -1%.