



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

The Government has just released the First Quarter Economic Report 2005 at end-May. The Economic Report, together with the press release containing the updated economic forecasts for the whole year of 2005, have been furnished to LegCo Members.

This paper analyses Hong Kong's overall economic growth and the developments in regard to external trade, domestic demand, labour market, asset markets and consumer prices in the most recent period. It then briefly describes the updated economic forecasts by the Government for 2005 as a whole.

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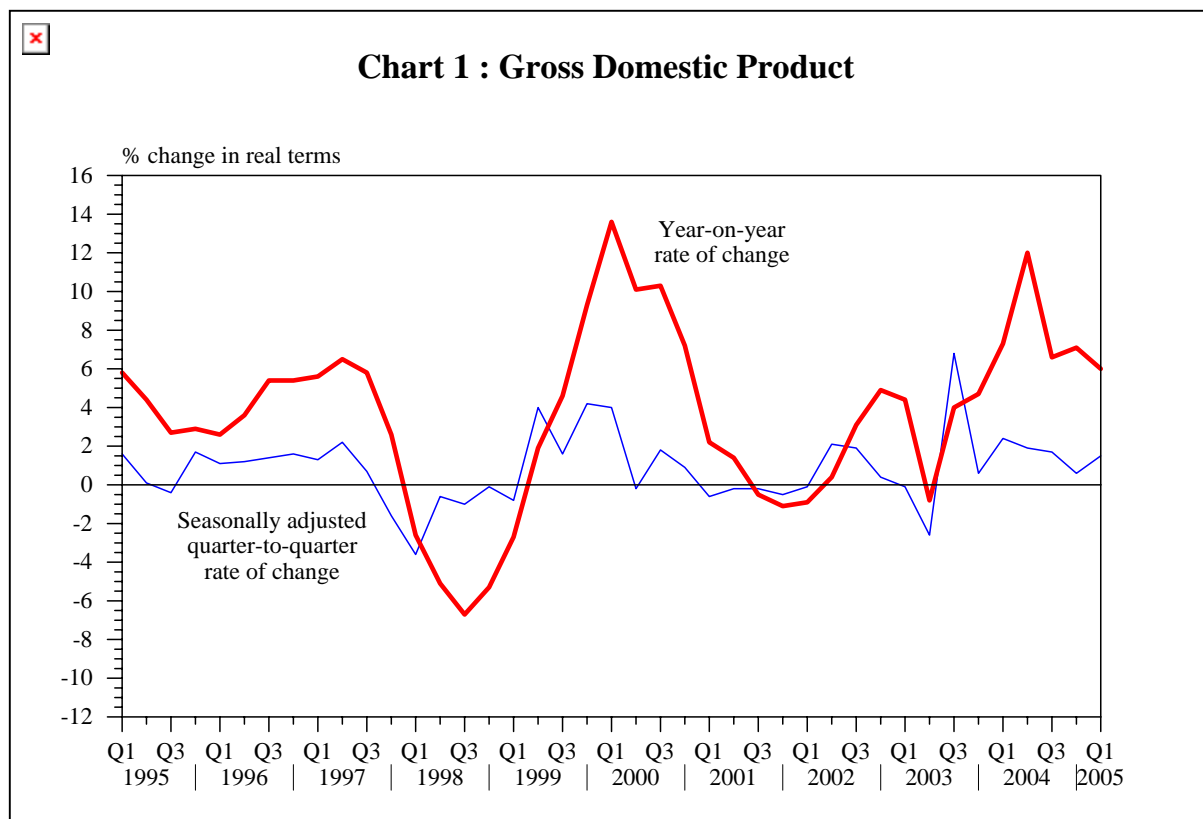
Recent situation and near-term outlook for the Hong Kong economy

Introduction

This paper analyses latest developments in the Hong Kong economy and briefly describes the updated economic forecasts for 2005 as a whole released at end-May.

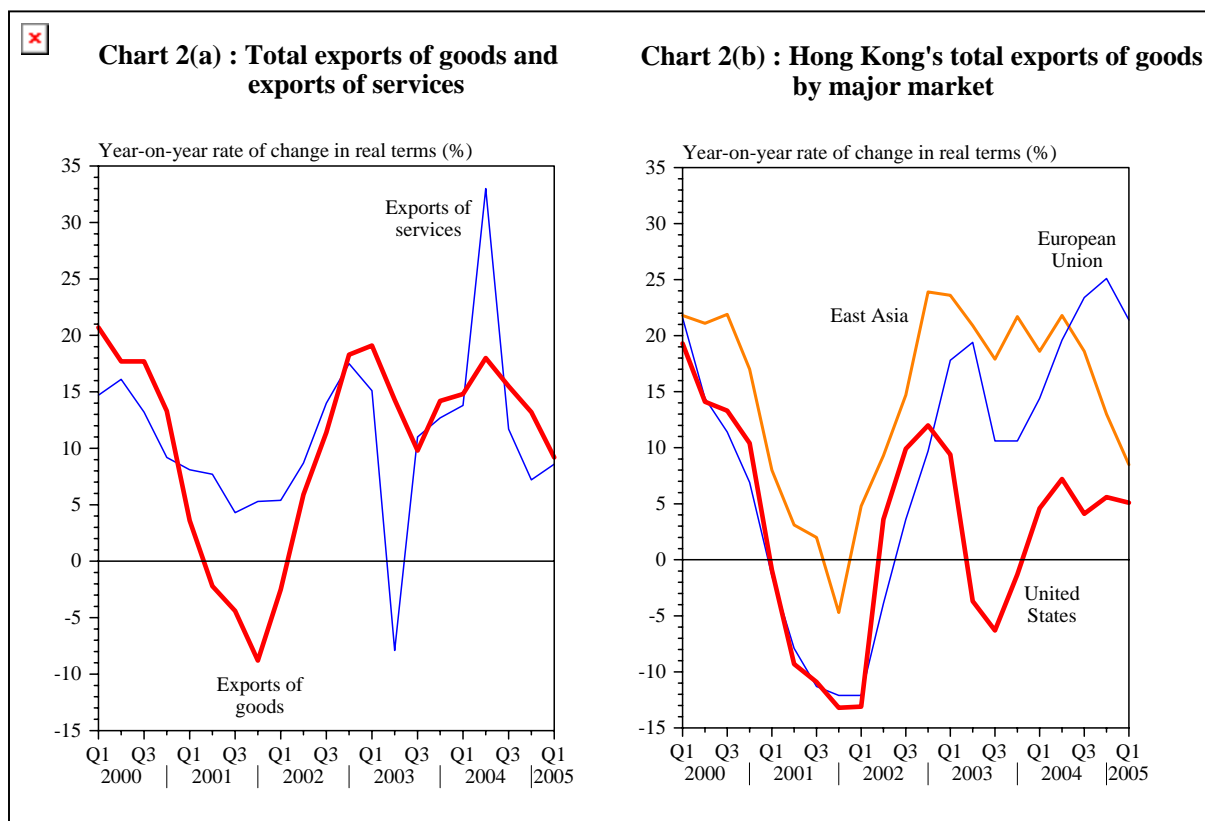
Recent economic situation

2. The solid growth momentum of the Hong Kong economy continued into the first quarter of 2005, marked by sustained notable growth in consumer demand, renewed increase in investment, and a generally brisk export performance. The *Gross Domestic Product* (GDP) grew solidly further by 6.0% in real terms in the first quarter over a year earlier, following a 7.1% growth in the fourth quarter of 2004 and an 8.1% growth for 2004 as a whole. On a seasonally adjusted quarter-to-quarter comparison, GDP expanded for the seventh straight quarter, by 1.5% in real terms in the first quarter of 2005 (*Chart 1*).

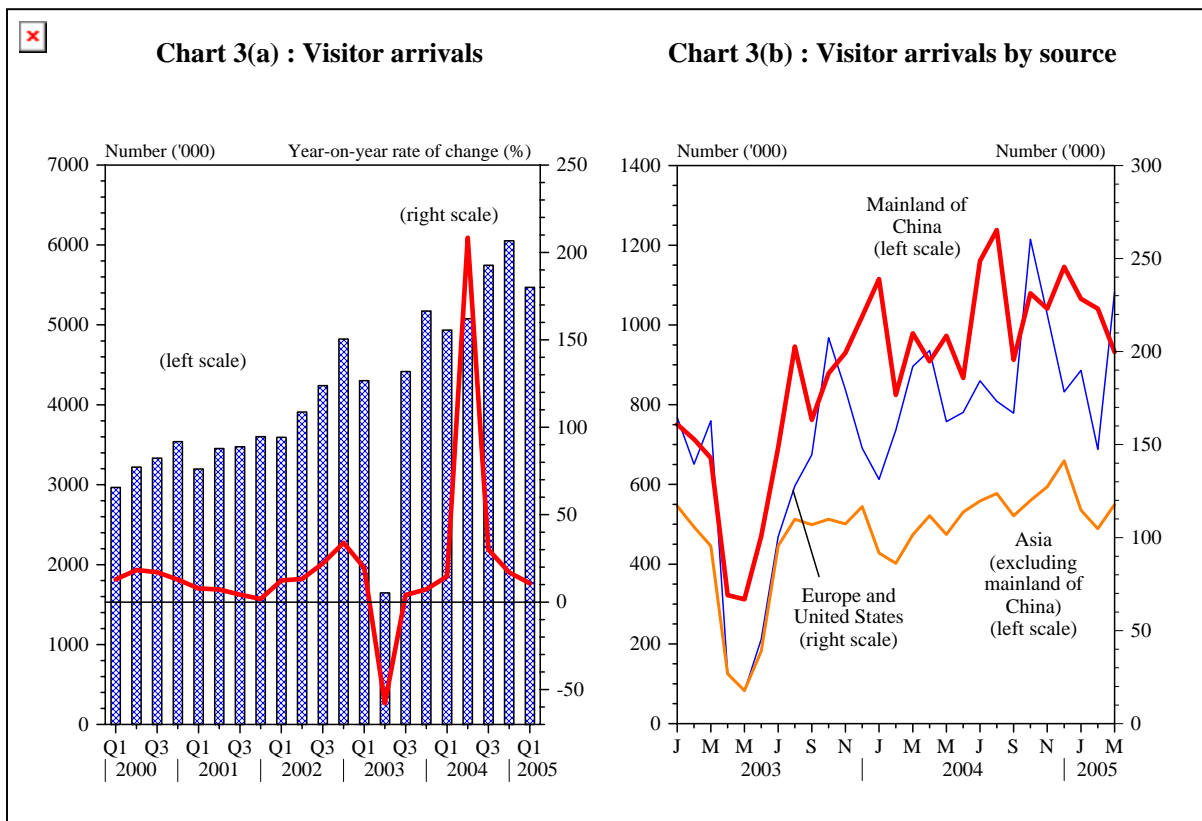


3. Merchandise exports were strong in the first two months of 2005, but moderated in March as exports to quite a number of East Asian economies slackened along with the more noticeable slow-down in intra-regional trade. For the first quarter of 2005 as a whole, *total exports of goods* still attained notable growth at 9.2% in real terms, following a 13.2% increase in the fourth quarter of 2004 and a 15.3% surge for 2004 as a whole (**Chart 2(a)**). After the abrupt slow-down in March, total exports of goods nevertheless gathered some strength again in April, rising by 7.8% in value terms over a year earlier.

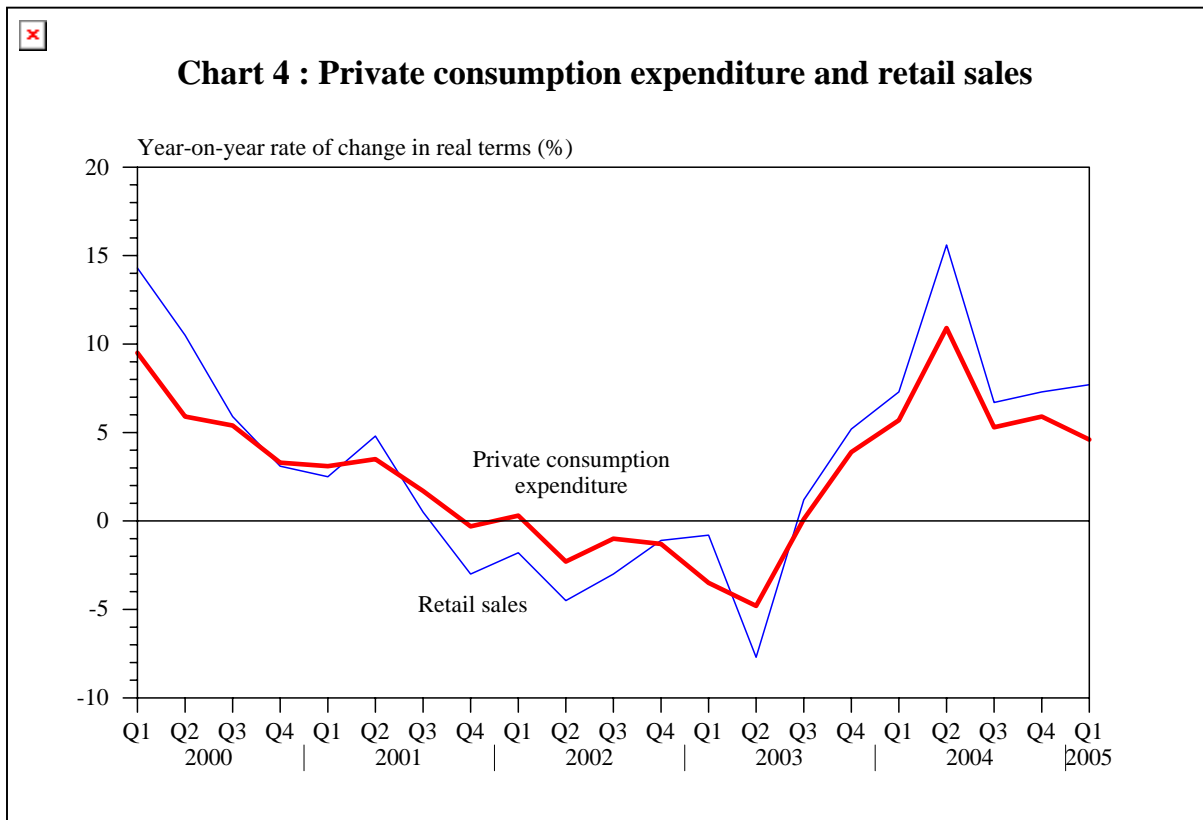
4. The export performance in the first quarter varied widely amongst individual markets. Exports to the Mainland, Japan and Singapore still maintained rather strong growth in the quarter. But exports to other East Asian markets like the Republic of Korea, Malaysia and Taiwan slowed down more markedly in the quarter, especially so in March, as their demand for semi-manufactures, particularly for electronic parts and components, eased back considerably along with the turn in the global electronic product cycle. As to the conventional markets, exports to the US likewise lost steam in March after growing briskly in the first two months. This was also generally in line with the fall-off in US import intake lately. Yet exports to the EU maintained double-digit growth in the first quarter, supported by the earlier strength of the euro and boosted also partly by the surge in textile and clothing items sourced from the Mainland (**Chart 2(b)**).



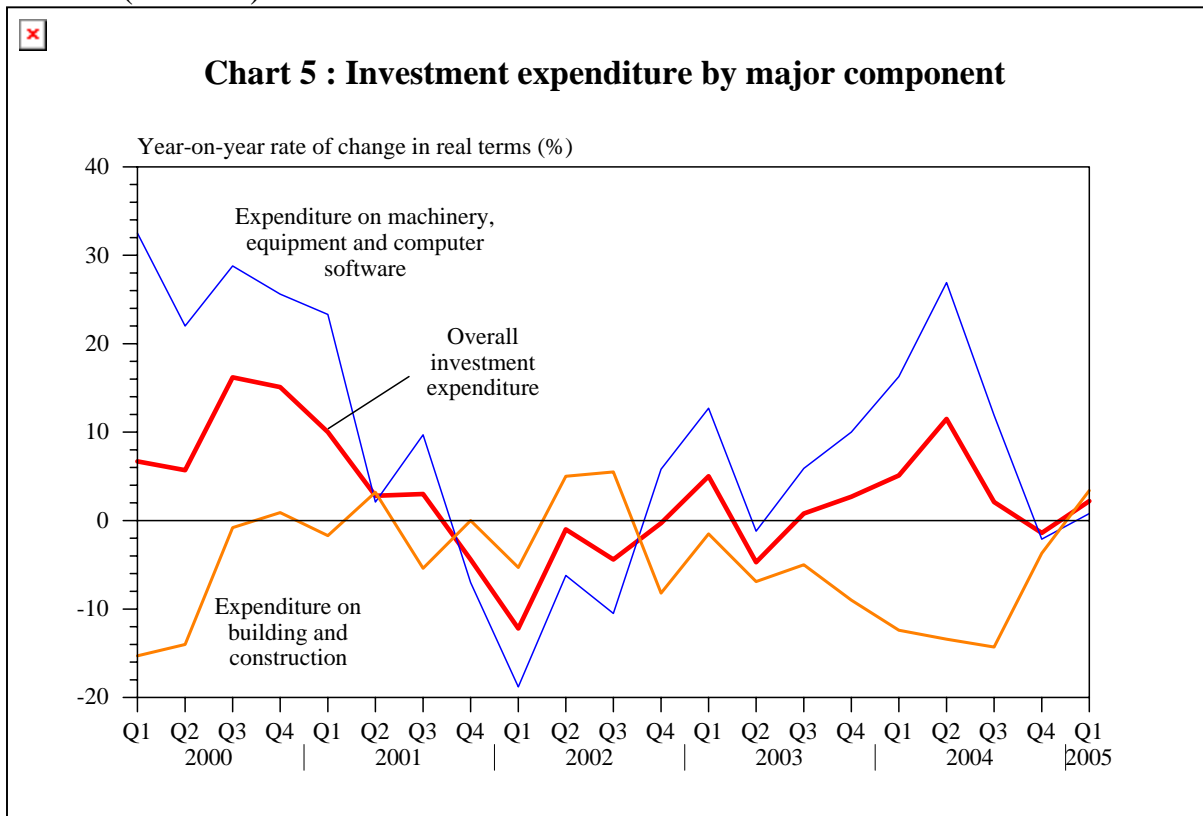
5. On invisible trade, inbound tourism continued to show solid and broad-based growth. The government's strenuous effort in publicity and promotion, enhancement in tourist facilities, together with the general weakness of the US dollar, all helped increase the attractiveness of Hong Kong to overseas visitors (*Chart 3(a)*). Not only did Mainland visitors continue to increase in the first quarter under the support of Individual Visit Scheme, visitors from almost all of the other major sources also surged. Total visitor arrivals stood at a high level of 5.47 million in the quarter, of which 3.04 million were Mainland visitors (*Chart 3(b)*). Also with continued surge in offshore trade brought forth particularly by the generally buoyant intra-regional trade, *exports of services* attained a further notable growth at 8.6% in the first quarter of 2005, faster than the 7.2% increase in the fourth quarter of 2004 and following a remarkable 15.0% growth for 2004 as a whole (*Chart 2(a)*).



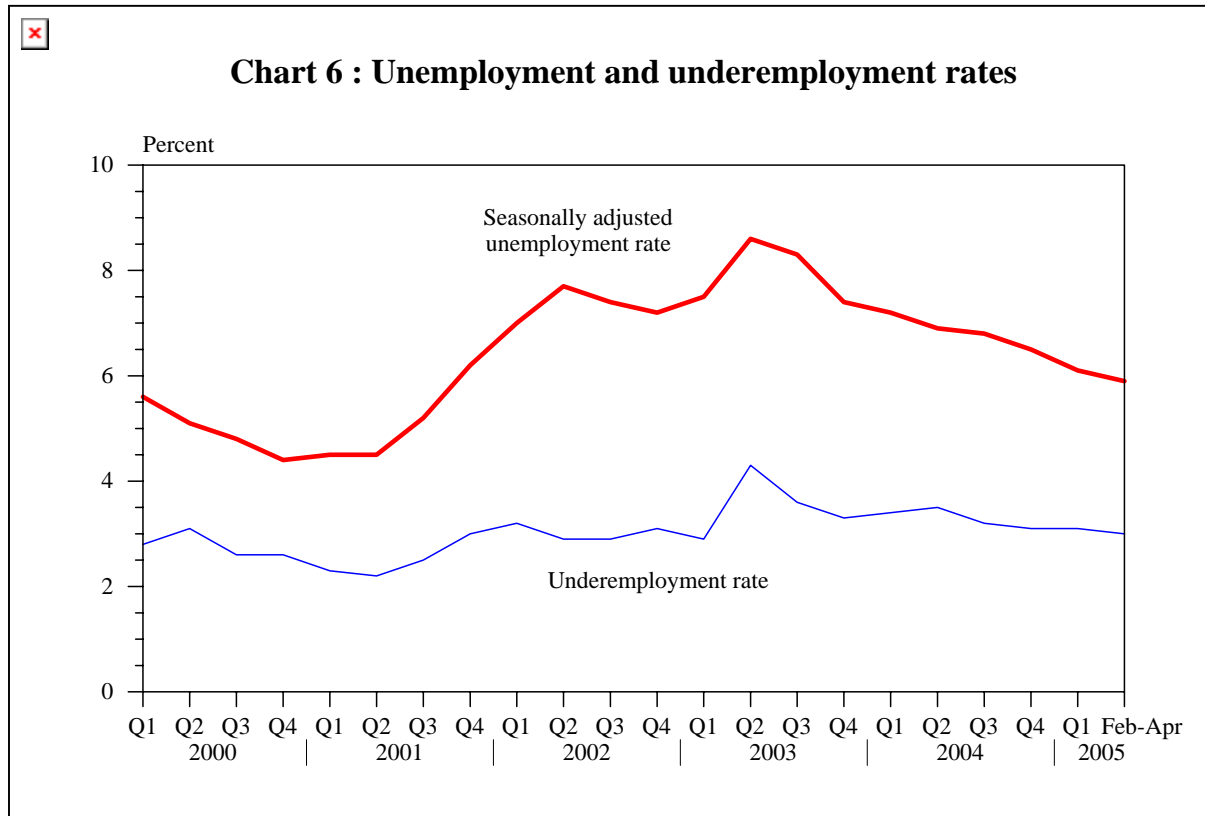
6. In the domestic sector, local consumer spending sustained solid growth in the first quarter, as consumer confidence held up well amidst the improvements in the job market. The positive wealth effect from an active property market also rendered an additional boost to consumers' propensity to spend. *Private consumption expenditure* went up further by 4.6% in real terms in the first quarter of 2005 over a year earlier, compared with the 5.9% growth in the fourth quarter of 2004 and after a 6.9% growth for 2004 as a whole (*Chart 4*).



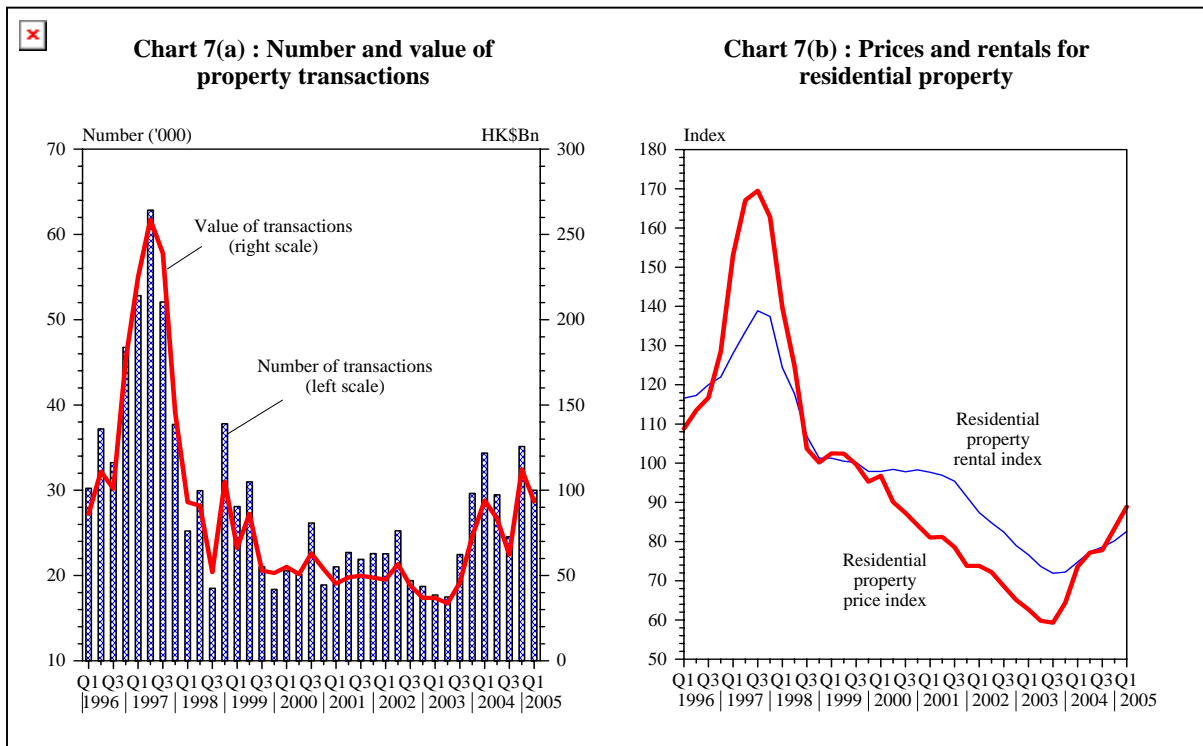
7. Overall investment spending reverted to a 2.2% increase in real terms in the first quarter of 2005, having temporarily suffered a 1.4% drop in the fourth quarter of 2004. Not only that investment in machinery, equipment and software resumed positive growth in the quarter, building and construction activities also turned around to a modest increase after nine straight quarters of fall-off (*Chart 5*).



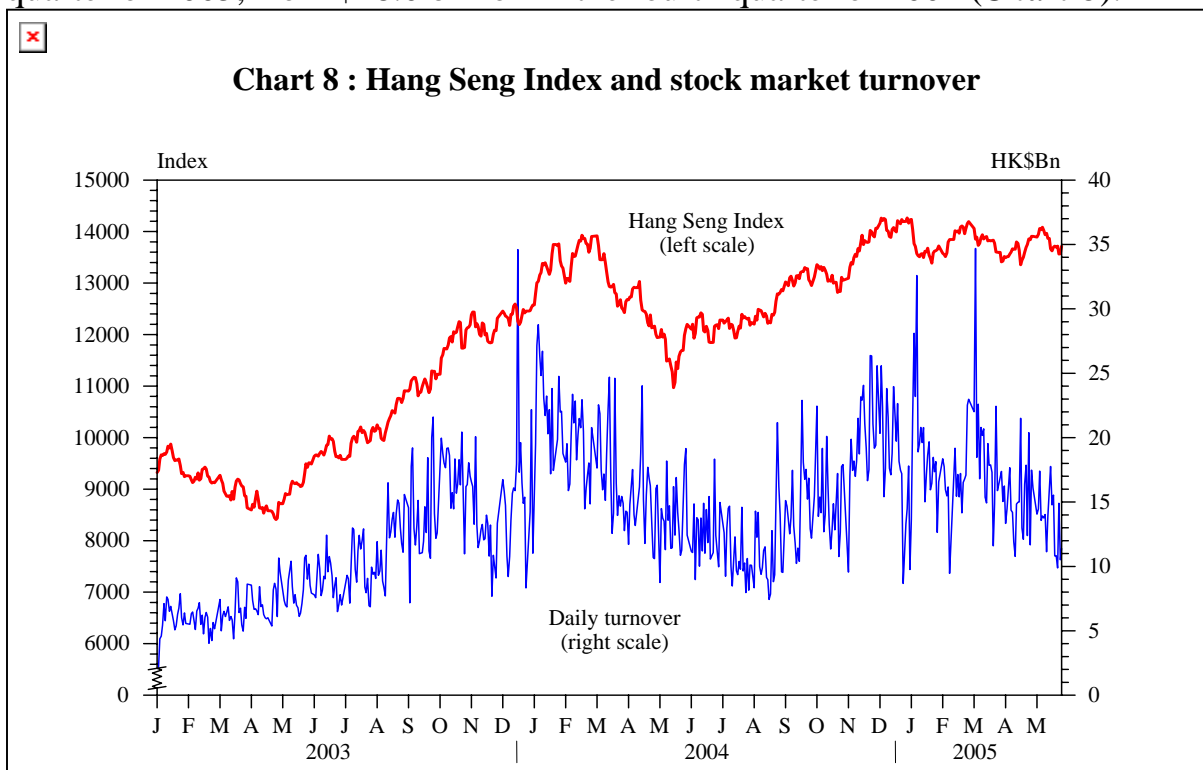
8. The labour market improved notably further along with the economic upturn, with total employment rising to an all-time high of 3.35 million in the first quarter of 2005. The *seasonally adjusted unemployment rate* fell to 6.1% in the first quarter, and further to a 41-month low of 5.9% in the three months ending April 2005 (**Chart 6**). The *underemployment rate* held steady at 3.1% in the first quarter, before falling slightly to 3.0% in the three months ending April. Meanwhile, overall labour earnings remained soft in the fourth quarter of 2004, down by 0.6% in money terms (0.9% in real terms) over a year earlier.



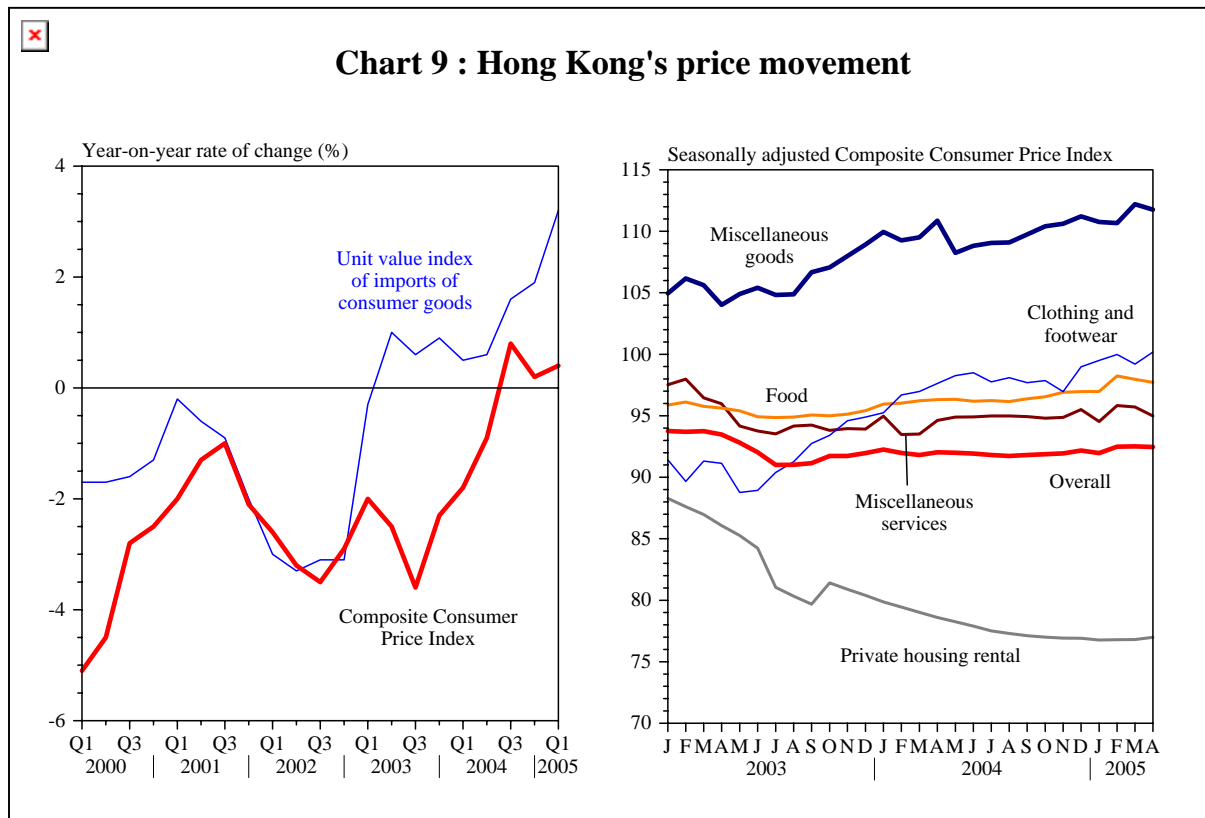
9. The *property market* remained buoyant in early 2005, marked by a further gain in flat prices and active trading (**Chart 7(a)**). The buoyant market sentiment was lifted by an optimistic economic outlook, improved labour market conditions, favourable land auction results, and the enthusiastic response to the primary sales of residential developments particularly those at the luxurious end of the market. Notwithstanding the cutting of preferential mortgage loan terms by banks since late February and the kick-start of increase in local interest rates in late March, market sentiment remained generally positive in the rest of the first quarter. Flat prices rose further by an average of 7% in the first quarter of 2005. Flat rentals edged up steadily, by an average of 3% over the same period, following an average 6% increase in 2004 (**Chart 7(b)**).



10. After a strong start at the beginning of the year, the local *stock market* soon drifted lower, as market sentiment was weighed down by concerns over rising interest rates and the upsurge in crude oil prices, and also by the reversal of earlier fund inflows as speculative pressures for renminbi revaluation died down. The Hang Seng Index closed the first quarter at 13 517, 5% lower than the closing of 14 230 at end-2004. Market sentiment then was mostly affected by speculative activities in relation to renminbi revaluation in the subsequent period, with the Hang Seng Index rising to above 14 000 in early May before falling back in the latter part of the month. The Index closed at 13 715 on May 27. The average daily turnover rose slightly further to \$18.4 billion in the first quarter of 2005, from \$18.0 billion in the fourth quarter of 2004 (*Chart 8*).



11. Consumer price inflation has been running at a moderate pace in recent months. From a business cost perspective, rents have been rising but labour costs remain generally soft. The pace of upturn in the CPI continued to be kept down by the low housing cost due to the earlier fall-off in private housing rentals. The *Composite Consumer Price Index* edged up by 0.4% in the first quarter of 2005 over a year earlier, following a 0.2% increase in the fourth quarter of 2004. Consumer price inflation remained modest in April, at 0.5% (*Chart 9*).



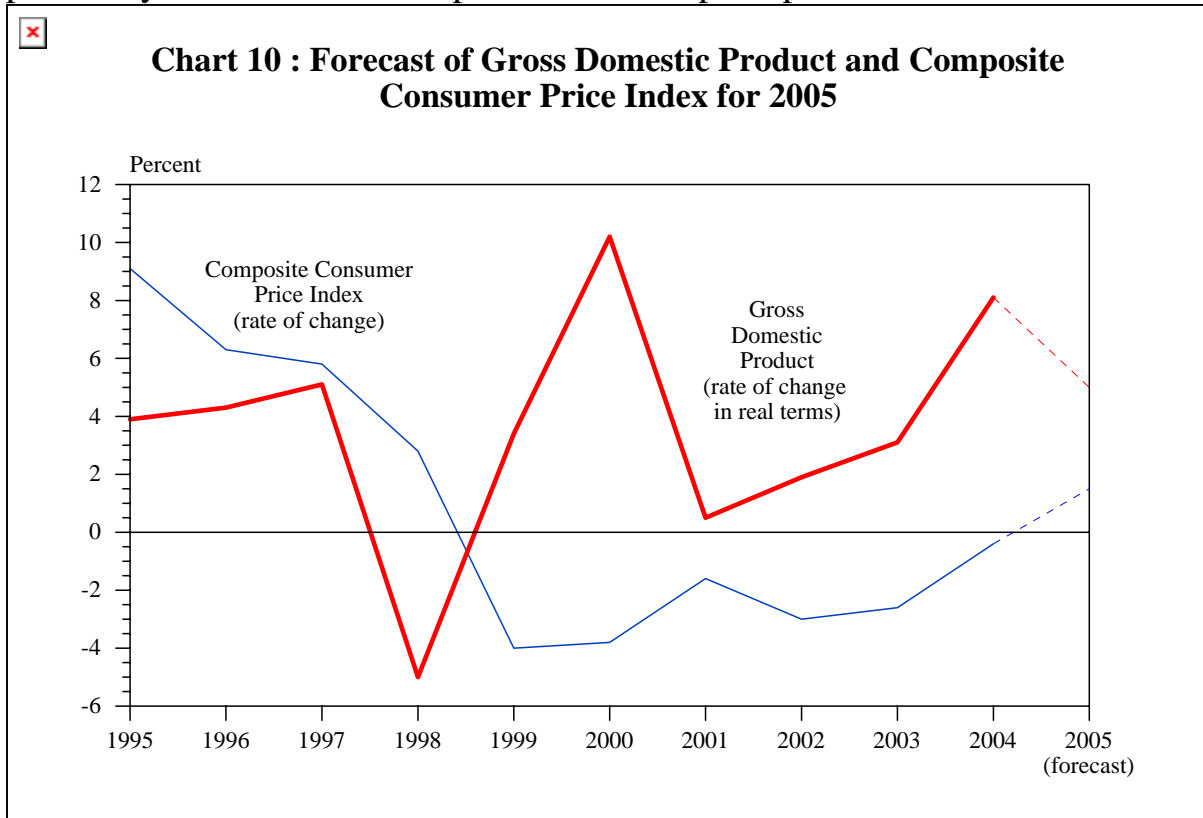
Updated short-term economic forecasts for 2005

12. While the economy has performed well in the first quarter, the trade outlook is increasingly overshadowed by a number of risks in the external environment. Crude oil prices, whilst easing back somewhat after reaching a new high in early April, remained high and hovered at US\$45-50 per barrel lately. The surge in oil prices last year seems to be taking a toll on global demand gradually. Signs of a regional slow-down have become more evident, leading to a general moderation in their import intake. The Mainland economy, though still having strong growth in the first quarter, may settle back to a more moderate growth pace later in the year, in the light of the government's recent tightening measures to cool down the overheated property market. Also, if the US dollar continues to strengthen, it would entail a relative loss in Hong Kong's export competitiveness. On top of these, lately the US has taken steps to institute safeguard measures against seven categories of textile imports from China, and there is a risk that the EU will do the same. All in all, compared to two months ago, the trade prospect has dimmed somewhat. It is thus likely to see the negative impact on Hong Kong's export growth emerging more visibly in the coming months.

13. While external demand seems to have slowed recently, domestic demand has so far performed better than expected. Along with the improvement in the labour market and a still generally upbeat sentiment, local consumption can be expected to hold up well in the year. The recovery in overall investment demand should gain further ground. In addition to the envisaged solid growth in machinery and equipment investment, there would be additional impetus from construction investment, if private sector building activity can sustain its reviving trend, now that it has finally turned around. Overall, despite a somewhat weaker trade outlook, there should be cushion from the domestic sector, stemming from a reviving property market and improving employment conditions. Furthermore, the opening of the Hong Kong Disneyland later this year should give a strong boost to inbound tourism and lift consumer sentiment further.

14. With the downside risks from the external front broadly balanced by the upsides from the domestic sector, the forecast *GDP* growth in real terms for 2005 is maintained at 4.5-5.5% in the current update, same as that put up in the Budget Speech in March (*Chart 10*).

15. As to the forecast consumer price inflation, the outturn so far is broadly in line with the earlier expectations. The forecast rate of change in the *Composite CPI* for 2005 is thus maintained at 1.5% (**Chart 10**). While there may be some modest price pressures from the external front stemming from high oil prices and the earlier weakness of the US dollar, local price pressures in overall terms are expected to remain mild over the coming few months. The expansion in supply capacity brought by the hefty capital investment over the past two years should also help alleviate local price pressures.



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