



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

The Government has just released the First Quarter Economic Report 2006 at end-May. The Economic Report, together with the press release containing the updated economic forecasts for the whole year of 2006, 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 2006 as a whole.

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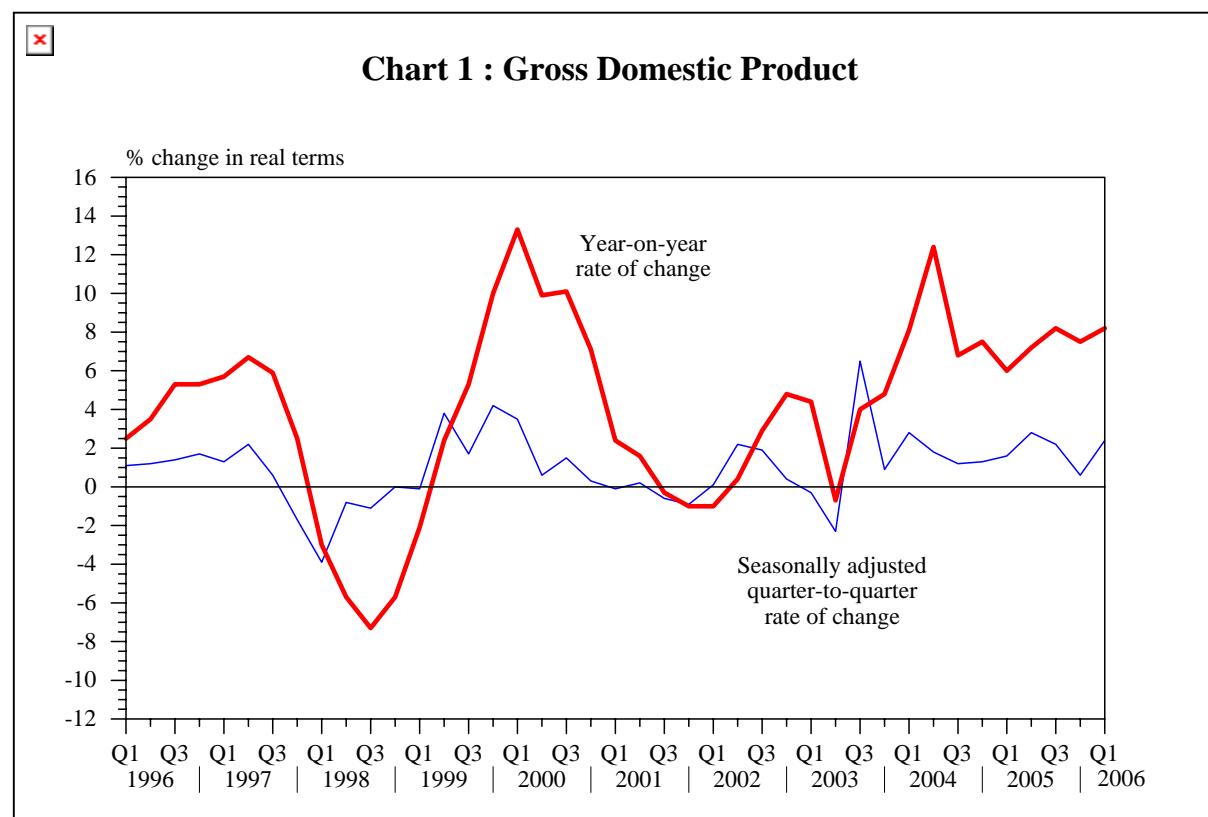
## Recent situation and near-term outlook for the Hong Kong economy

### Introduction

This paper analyses the recent developments in the Hong Kong economy and briefly describes the latest economic forecasts for 2006 as a whole released at end-May.

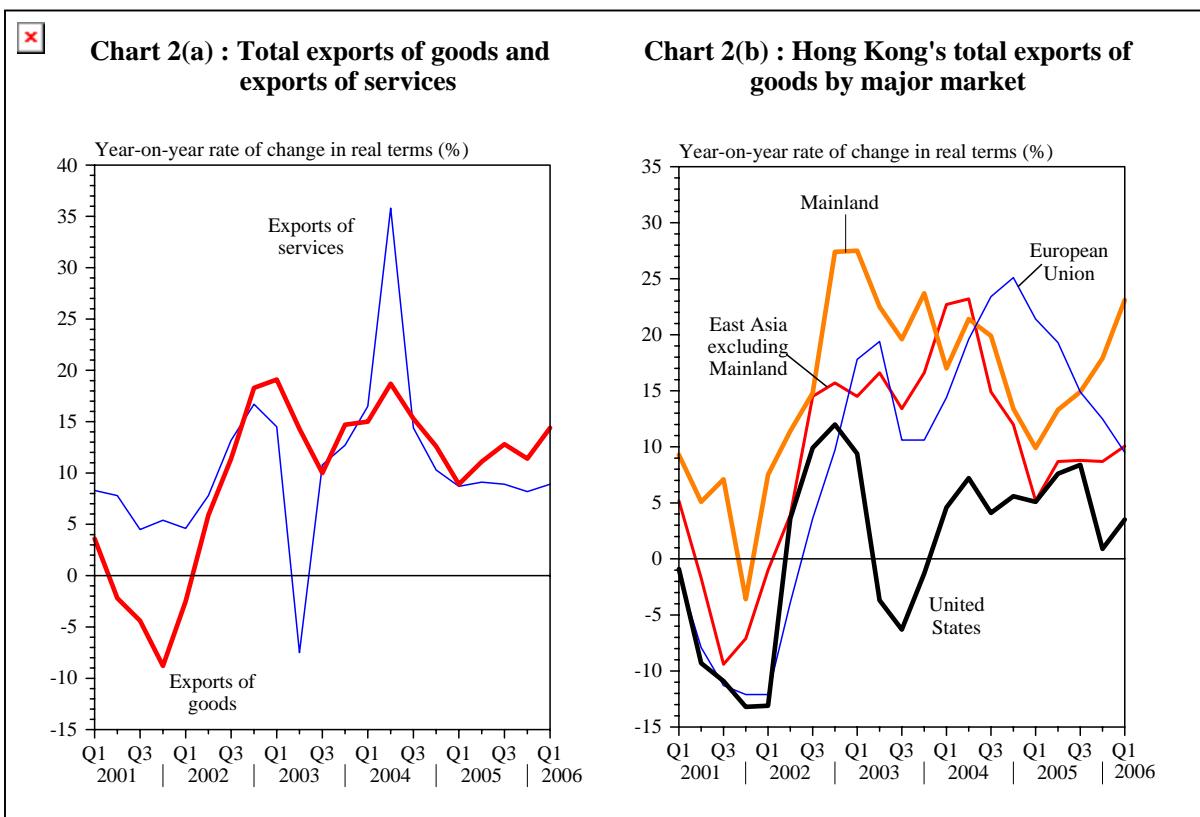
### Recent economic situation

2. The Hong Kong economy continued to register robust and broad-based growth in the first quarter of 2006. Apart from the continued surge in external trade, consumption and investment demand also accentuated further in growth. As the performance in both the external and domestic sectors were better than expected, the *Gross Domestic Product* (GDP) grew notably by 8.2% in real terms in the first quarter over a year earlier, not only faster than that of 7.5% in the fourth quarter of 2005, but also signified the tenth consecutive quarter of above-trend growth. On a seasonally adjusted quarter-to-quarter comparison, GDP expanded markedly for the eleventh quarter in a row, by 2.4% in real terms in the first quarter of 2006 (*Chart 1*).

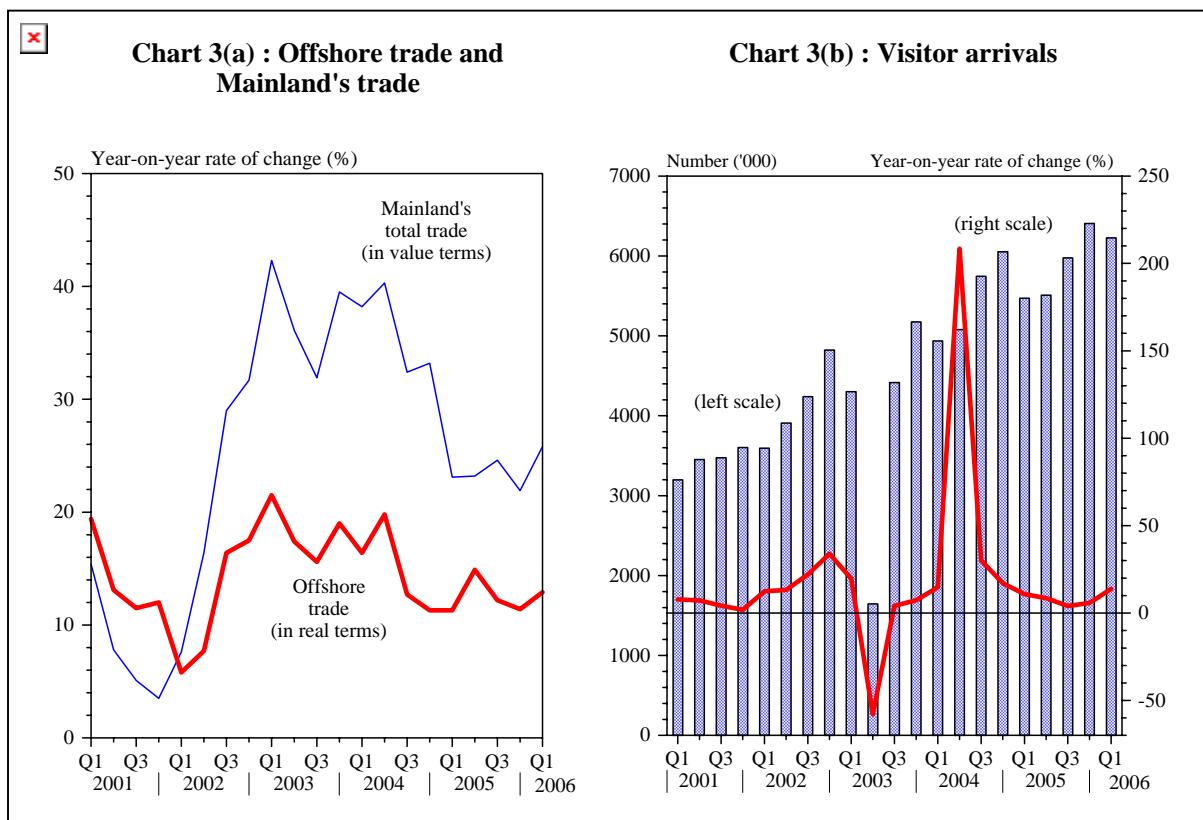


3. External trade remained vibrant in the first quarter and remained a key growth driver. *Total exports of goods* leaped by 14.4% in real terms in the first quarter over a year earlier. This mainly reflected the generally sanguine external environment and thriving Mainland's trade flows, which helped offset the dampening effects of high oil prices, rising interest rates worldwide and the earlier strength of the US dollar (**Chart 2(a)**).

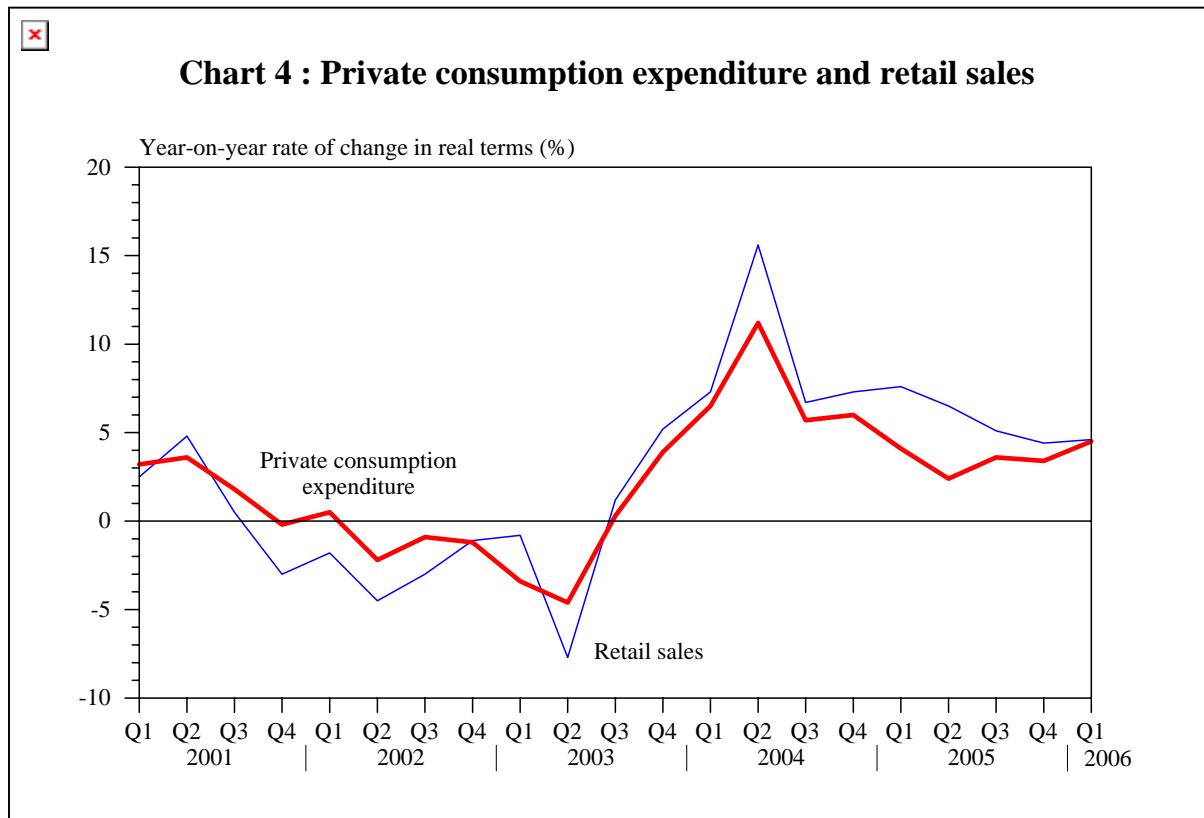
4. Notwithstanding the strong overall growth, performance in individual markets was diverse. Exports to the Mainland accelerated further, bolstered by the Mainland's persistently strong industrial activity and robust domestic demand. Exports to most East Asian markets likewise grew strongly, in tandem with the surge in intra-regional trade, thanks to the export boom throughout Asia and also the recovery in global demand for IT products. Exports to the EU market as a whole still fared quite well, albeit moderating from the strong growth last year. The deceleration was partly due to the feed-through of weaker euro and pound sterling, but there was also some distortion to the base effect caused by an exceptional surge in T&C exports a year ago. Likewise, exports to the US market were also largely distorted by a distinctly high base of comparison. Exports other than T&C items to the United States actually held up well, in line with the pick-up in US import demand in the first quarter (**Chart 2(b)**).



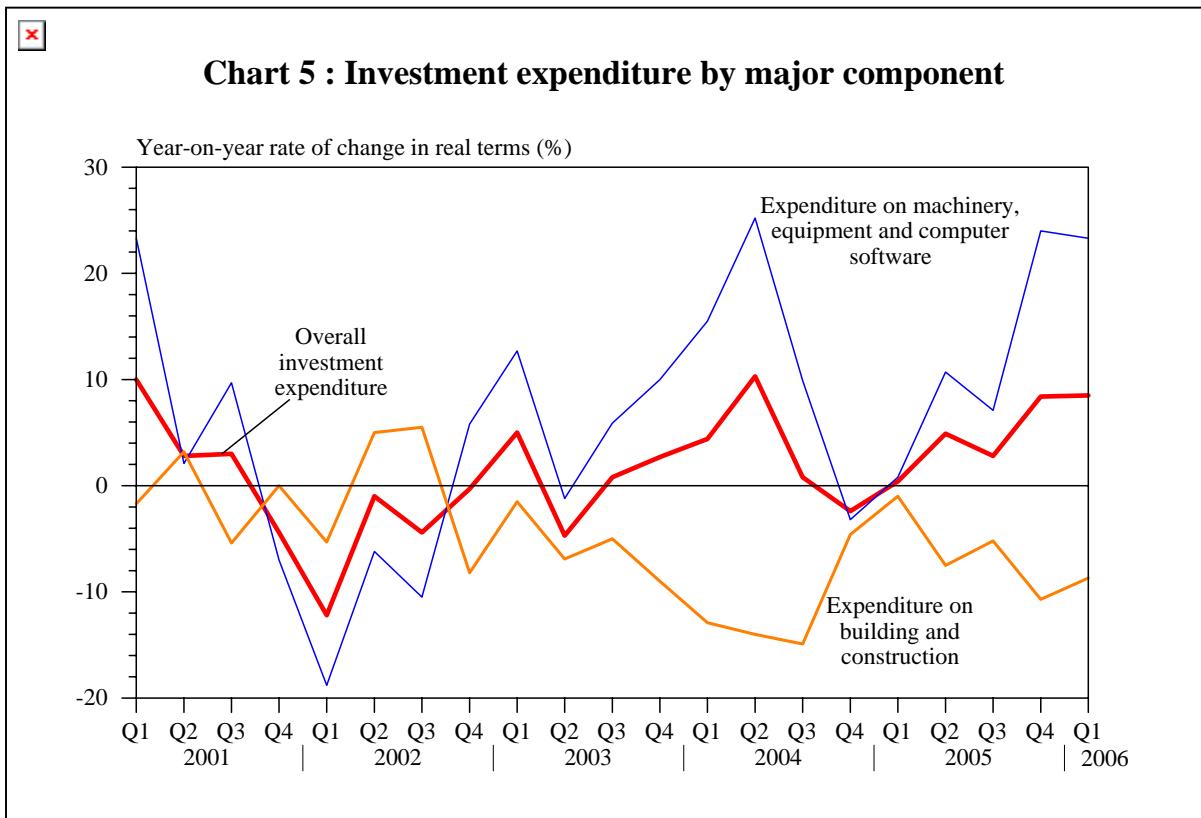
5. On invisible trade, *exports of services* expanded distinctly further, by 8.9% in real terms in the first quarter over a year earlier, following growth at 8.9% and 8.2% in the third and fourth quarter of 2005 respectively. Exports of trade-related services (including notably the offshore trade) continued to soar, underpinned by the Mainland's robust trade flows and the vibrant growth in Hong Kong's merchandise trade (**Chart 3(a)**). Exports of travel services also grew solidly, supported by the vibrant inbound tourism. The robust external trade coupled with the notable growth in inbound tourism likewise boosted exports of transportation services.



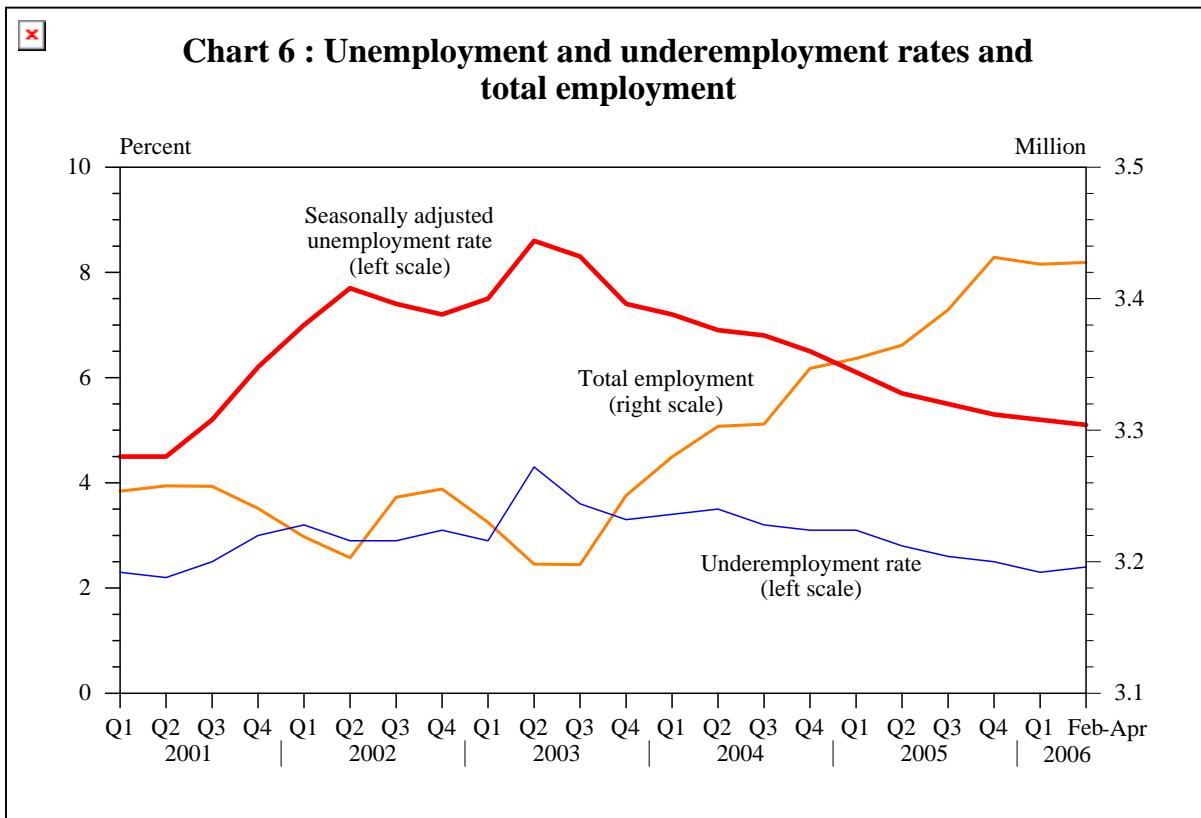
6. On the domestic front, on the back of rising labour income and the better performance of the property and stock markets, local consumer spending attained solid growth in the first quarter and played an increasing role in the current economic upturn. With generally sanguine consumer sentiment, *private consumption expenditure (PCE)* grew by 4.5% in real terms in the first quarter of 2005 over a year earlier, notably faster than the 3.4% growth in the fourth quarter of 2005 (**Chart 4**).



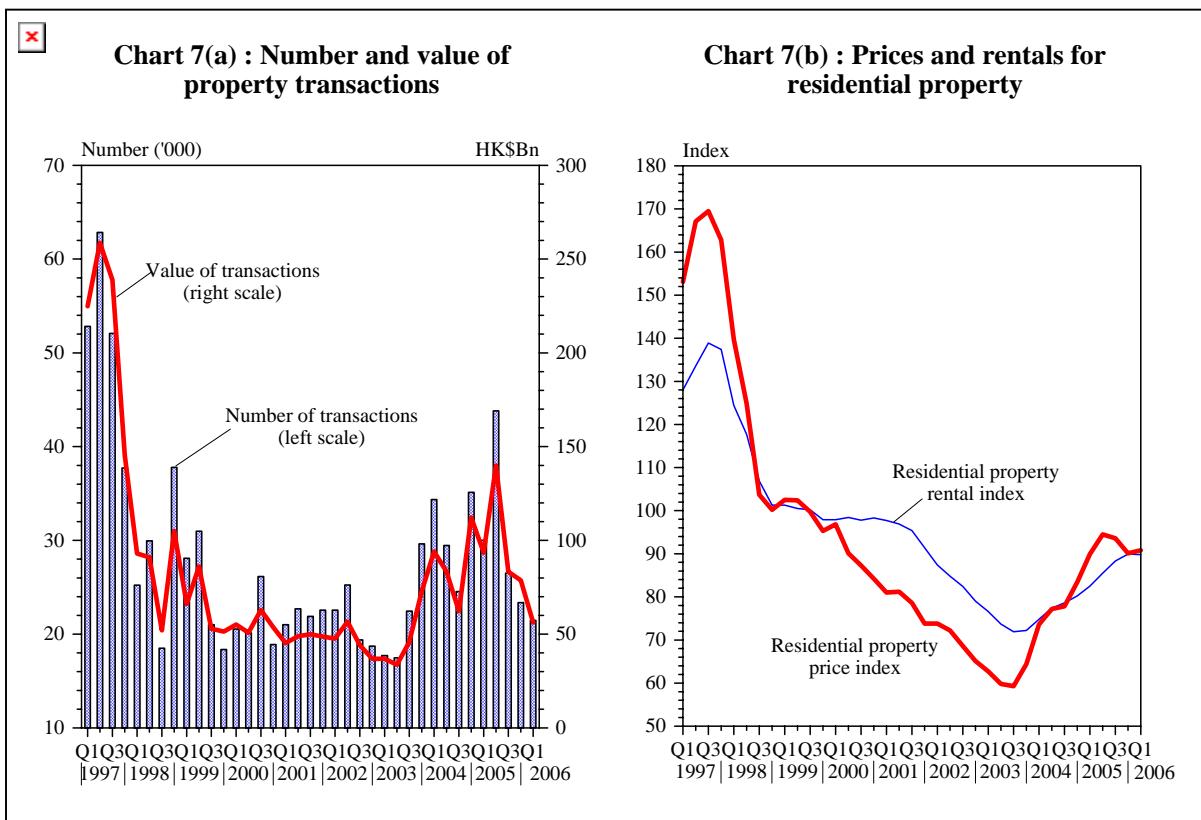
7. Overall investment spending in terms of *gross domestic fixed capital formation* sustained a distinct growth at 8.5% in real terms in the first quarter over a year earlier, after the 8.4% growth in the fourth quarter of last year. Expenditure on machinery and equipment remained the key driver of overall investment growth (up 23.3%), reflecting on one hand the strong investor confidence on business outlook, and on the other hand the need to expand capacity to capture the sustained increase in business opportunities. Building and construction activity was however still sluggish, registering an 8.7% decline in the first quarter, dragged mainly by the 20% fall-off in public sector construction (**Chart 5**).



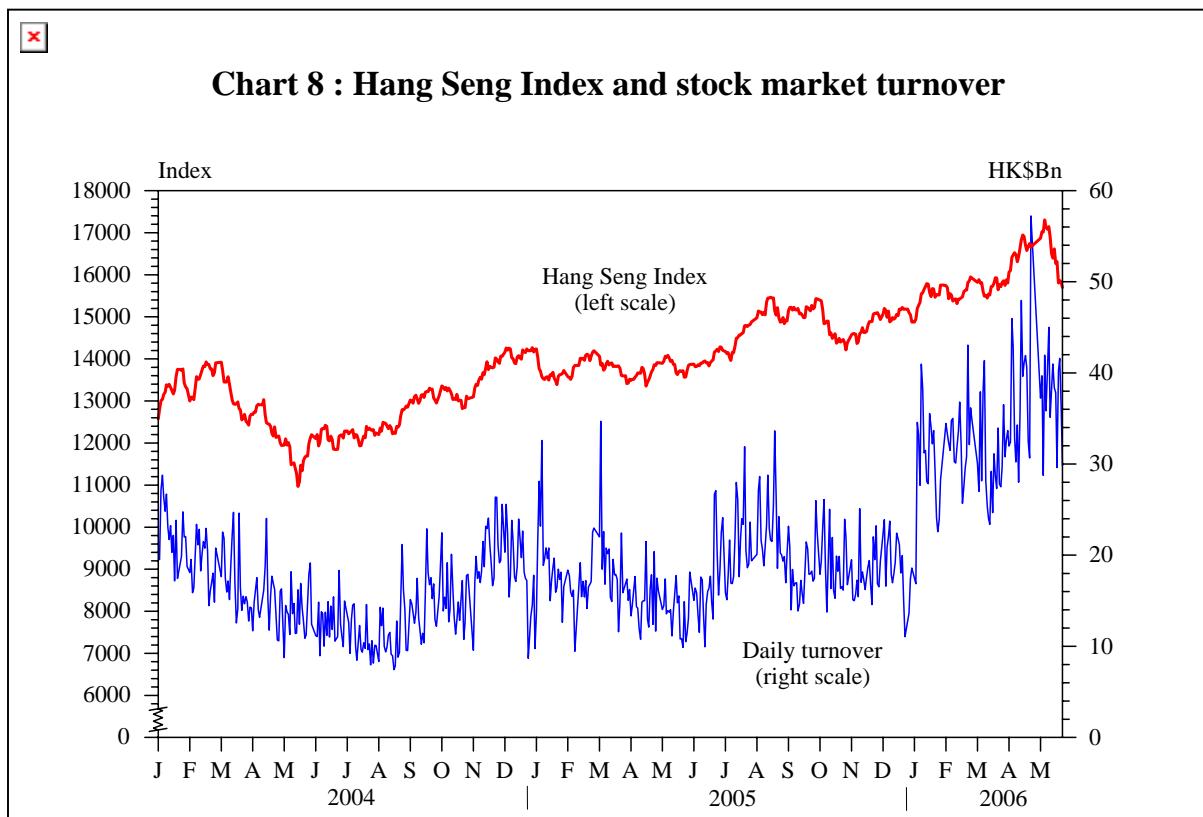
8. The labour market continued to show improvement. The *seasonally adjusted unemployment rate* fell to a 56-month low of 5.1% in February – April 2006, whilst the *underemployment rate* was 2.4% in the same period (**Chart 6**). *Total employment* was 3.43 million in February – April 2006, representing a net creation of 238 000 jobs since the trough in mid-2003. The employment conditions of lower-skilled workers also improved along with the more entrenched economic recovery, with their unemployment rate falling gradually from the peak of 10.0% to the current level of 6.2%. Moreover, the number of long-term unemployed persons came down markedly further, from the peak of 93 000 in 2003 to about 46 000 in February – April 2006. This phenomenon reflected that as and when the economic revival becomes more widespread and with the support of a broad-based expansion in overall economic activity, those among the unemployed who have long faced difficulties in finding jobs can also be re-absorbed into the labour market. Meanwhile, labour income also picked up further in tandem with the improvement in labour market conditions. Payroll per person engaged in the private sector establishments rose by 3.5% in money terms for 2005 as a whole, having fallen for three consecutive years.



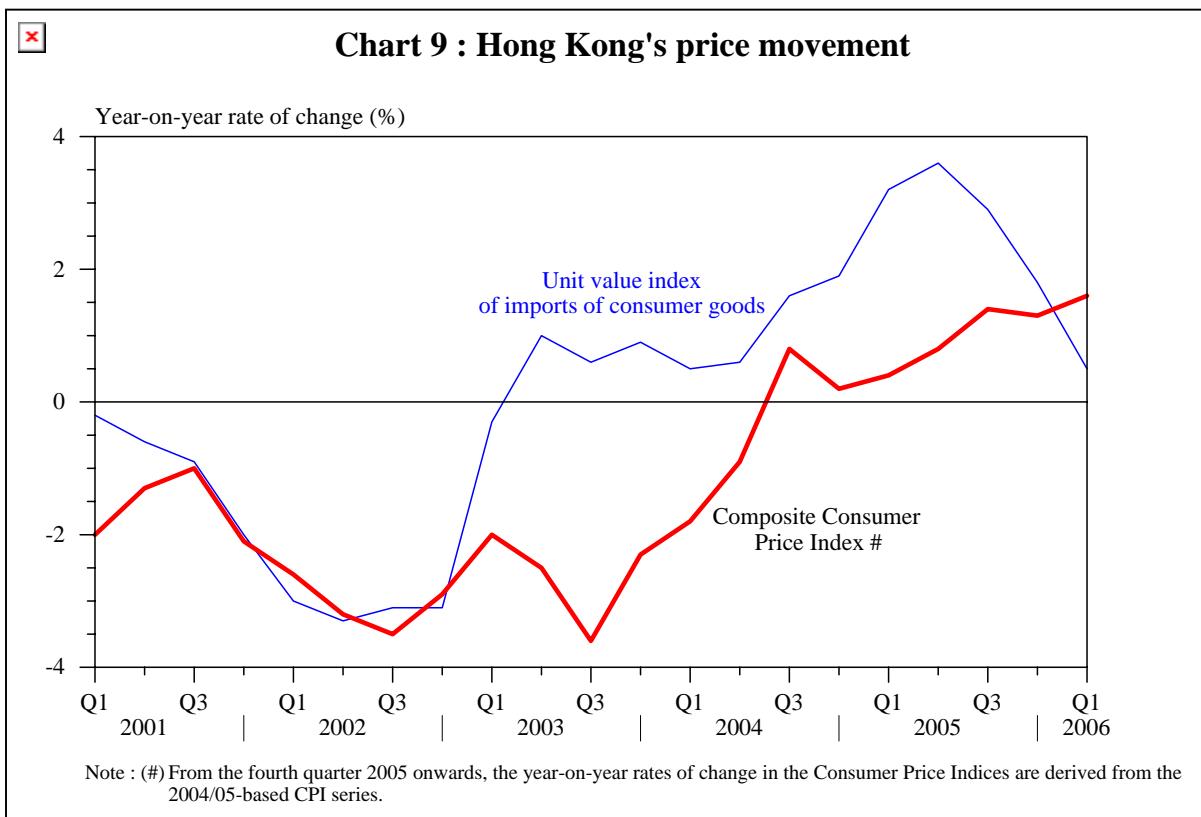
9. The *property market* on the whole turned slightly more active in recent months. The monthly transaction volume of residential property rebounded to around 7 000 in March and April 2006, from the trough of 4 426 in December 2005. The increase was mainly led by secondary sales, although the primary market also became somewhat more active recently. There was some release of pent-up demand as more potential buyers anticipated that the interest rate rise would come to a pause soon. Also contributed was a new round of mortgage concessions by the banks, which cushioned the impact of a further hike in the prime lending rate by 0.25 percentage point to 8-8.25% in late March. Flat prices rose back by around 3% in March 2006 from the recent low in November 2005 (*Chart 7(a)*). Concurrently, flat rentals edged up mildly by 1% during the first quarter, with activities being relatively quiet around the Lunar New Year (*Chart 7(b)*).



10. *The local stock market* was buoyant in the first quarter of 2006 amidst abundant liquidity. Market sentiment was boosted by the buoyant performance in other major stock markets notably those in the US and Japan, as well as the enthusiastic response to the IPO of new listings. The generally strong corporate earnings and an optimistic outlook for both the Hong Kong and the Mainland economies also rendered support. The Hang Seng Index surged by 6% over end-December 2005 to close at 15 805 at end-March 2006. Average daily turnover expanded markedly to a record high of \$31.2 billion in the first quarter, up by 66.6% over the preceding quarter. On entering the second quarter, the local stock market extended its rise with persistently vibrant turnover, fuelled by market expectations about a sooner end of the US interest rate upcycle and the further expansion of the QDII Scheme by the Mainland authorities as from 1 May. The Hang Seng Index rose to a 5 1/2-year high of 17 302 on 8 May, pushing up the total market capitalisation to above \$1 trillion. However, the local stock market has since undergone a distinct correction alongside the fall-back in overseas markets, with the Hang Seng Index easing back to below the 16 000 level lately (**Chart 8**).



11. Continuing the moderate rising trend in 2005, consumer price inflation climbed up slightly further in the first quarter of 2006, alongside brisk economic growth. The successive rises in rentals over the past two years have begun to creep into consumer prices to a greater extent. Yet concurrently, the easing in imported inflation brought about by the fall in prices of foodstuffs imported from the Mainland and the earlier appreciation of the Hong Kong dollar along with the US dollar, as well as the sustained improvement in productivity, have both helped consumer price inflation to remain at a moderate and healthy level. The *Composite Consumer Price Index* rose by 1.6% in the first quarter of 2006 over a year earlier (by reference to the new 2004/05-based series), and crept up further to a 1.9% increase in April. For the first four months of 2006 as a whole, the average increase was 1.7% (**Chart 9**).



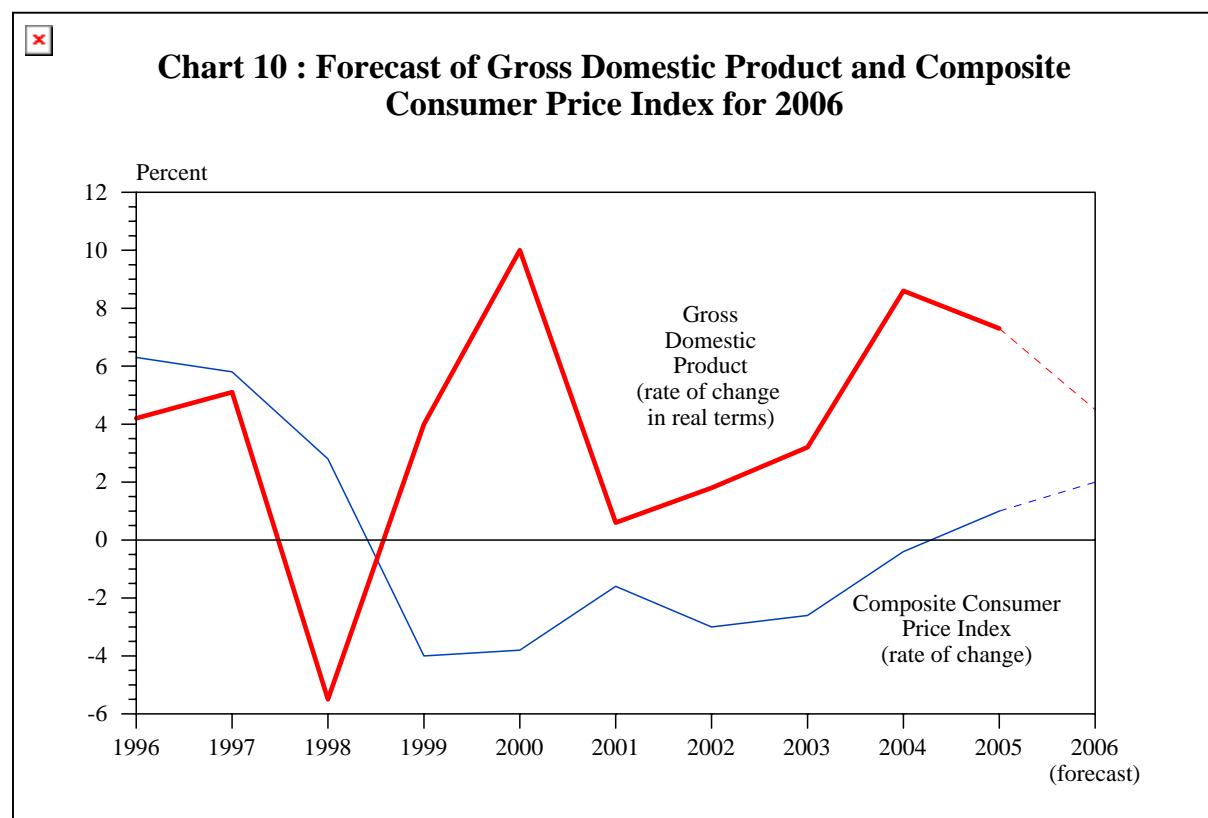
## Updated short-term economic forecasts for 2006

12. Notwithstanding the increase in oil prices and higher interest rates, the global economy continued to show a fairly strong performance in the first quarter of 2006, providing significant growth impetus to Hong Kong's external trade. The US economy grew at an above-trend rate in the first quarter; the Japanese economy was on track to a sustained recovery; and the EU economies were also improving. The Mainland economy was particularly buoyant. The trade boom throughout the region had also resulted in solid growth in most other Asian economies.

13. Although the performance of the global economy in the first quarter was unexpectedly strong, the external environment is still much clouded by various downside risks viz. recent hike in oil prices to around US\$70/barrel; uncertainties about US interest rate movement leading to the recent fluctuations in financial markets; avian flu; persistent global trade imbalances; and lately, the tightening measures in the Mainland. Some of these risks in fact have intensified recently from the situation a few months earlier. How these various risk factors will play out is critical to Hong Kong's trade performance and hence Hong Kong's overall economic growth in the coming quarters. Locally, consumption looks set to hold up rather well, in tandem with better job prospects and rising employment incomes. Investment in plant and equipment seems likely to surge further in tandem with the much improved corporate profits, the still sanguine business outlook, and also the further expansion in business activity. But construction activity is likely to remain weak in the near term, thereby to a certain extent capping the upside of overall investment.

14. Given the exceptionally strong GDP outturn of an 8.2% growth in the first quarter of 2006, the Hong Kong economy should have little difficulty in attaining the forecast GDP growth of 4-5% as released in the Budget round. Indeed, as the prospects for the global economy are still largely positive, there could be some upsides from the external side. However, in view of the wide range of uncertainties still prevailing in the external environment as well as the recent volatilities in the international financial markets, it is more prudent to maintain the forecast GDP growth for 2006 unchanged at 4-5% in the present round, pending a full update in the next round three months from now (*Chart 10*).

15. As to outlook for consumer price inflation, the actual outturn of consumer price inflation so far was in line with the earlier expectations. Consumer price inflation, though creeping up progressively along with the brisk pace of economic expansion, is likely to be still moderate and healthy for 2006 as a whole. To take on board the release of the new 2004/05-based Composite CPI series, which is on average about 0.4 percentage point lower than the old 1999/00 series, the forecast rate of increase in the *Composite CPI* for 2006 as a whole is revised slightly down, from 2.3% to 2% (*Chart 10*).



**Recent situation of household income<sup>(1)</sup>****Latest situation**

The labour market continued to show improvement along with the deepening in economic recovery. Apart from a substantial increase in employment opportunities, overall labour earnings also arrested the downtrend and rose back in 2005. As the growth momentum remained very robust, labour earnings look set to improve further and are likely to attain faster growth in 2006.

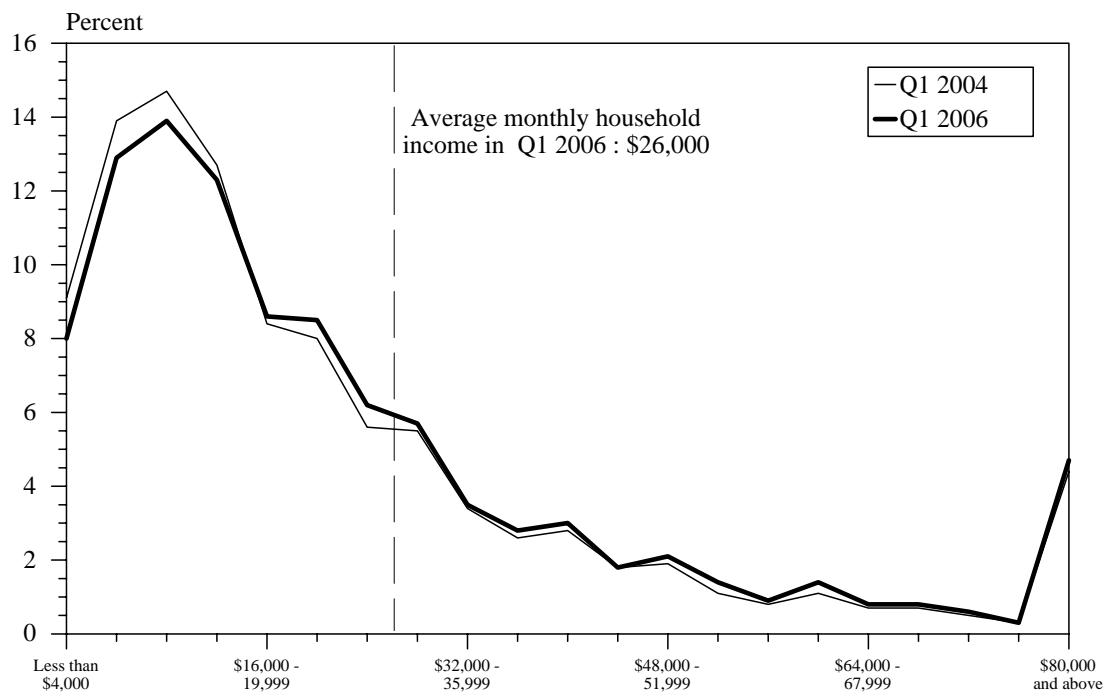
2. Analysed by household income, according to the latest results of the General Household Survey, the overall average monthly household income rose back somewhat over the past two years, from \$24,600 in Q1 2004 to \$26,000 in Q1 2006, representing an increase of 5.8% in money terms. After adjusting for price movements, the increase was 3.7% in real terms.

3. Apart from lifting overall household income, the economic recovery has also led to a decline in the proportion of low-income households. *Chart 1* compares the distribution of household income in Q1 2004 and Q1 2006. During this period, the proportion of households with monthly household income less than \$4,000 fell from 9.1% to 8.0%, while the share of households with income above \$16,000 increased. This reflected that the spectacular economic growth over the past couple of years has resulted in a general rebound in household income, through creating more jobs and lifting labour earnings.

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(1) Foreign domestic helpers are excluded from this analysis, as the income paid by an employer to a foreign domestic helper represents only transfer among members within the same household. It should not be allowed to lift the household income unnecessarily in detailed analysis about household income.

**Chart 1 : Share of domestic households by monthly household income**



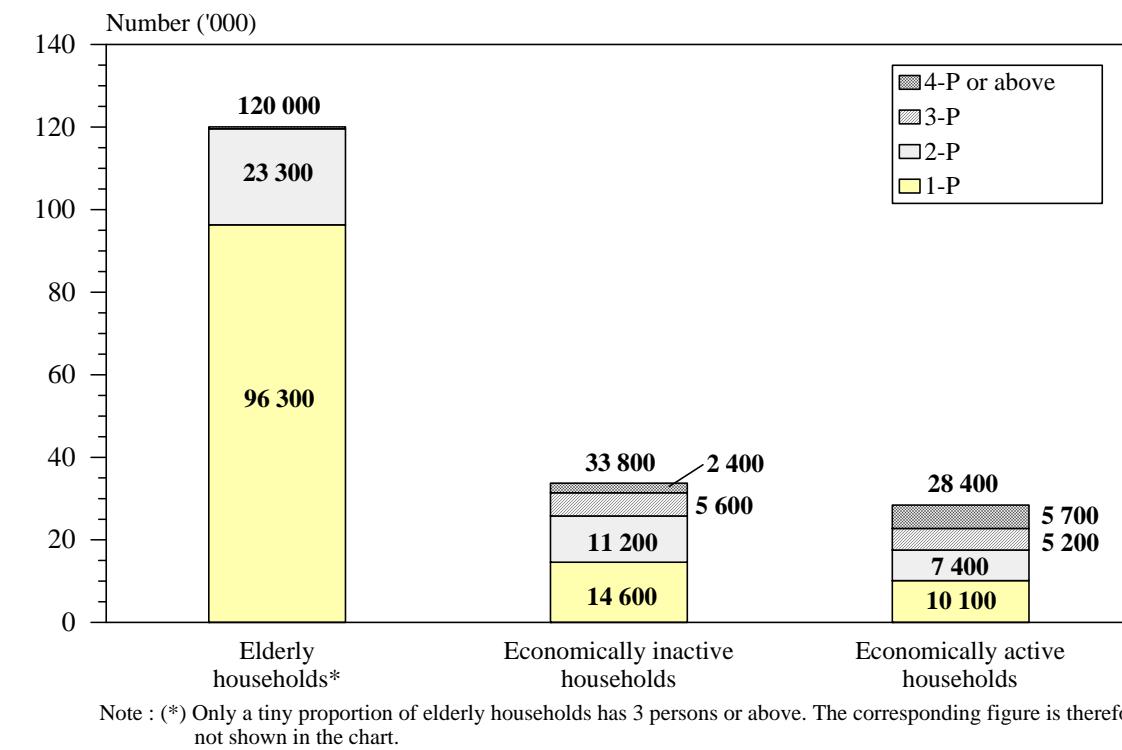
### **Households with monthly household income below \$4,000**

4. The number of households with monthly household income below \$4,000 (hereafter refer to as “low-income households”) was 182 200 in Q1 2006, down 9 800 or 5% from 192 000 in the same quarter in 2005, reflecting a decline in low-income households in tandem with the economic recovery. As regards the rise in the number of low-income households by nearly 100 000 over the past decade, statistics indicate that it is mainly attributable to a surge in the number of retired elderly households (with all members aged 60 or above), i.e. a manifestation of “population ageing”, and also the fall in average household size in recent years.

5. **Chart 2** depicts the distribution of low-income households by both household type and household size in Q1 2006. There were 120 000 low-income elderly households, constituting 66% of all low-income households. Among them, a predominant proportion (80%) was 1-person household. In Q1 2006, the average monthly household income for the 1-person households was \$14,000 (46% below the overall average), and over 30% of these households had monthly income less than \$4,000.



**Chart 2 : Composition of low-income households in Q1 2006**



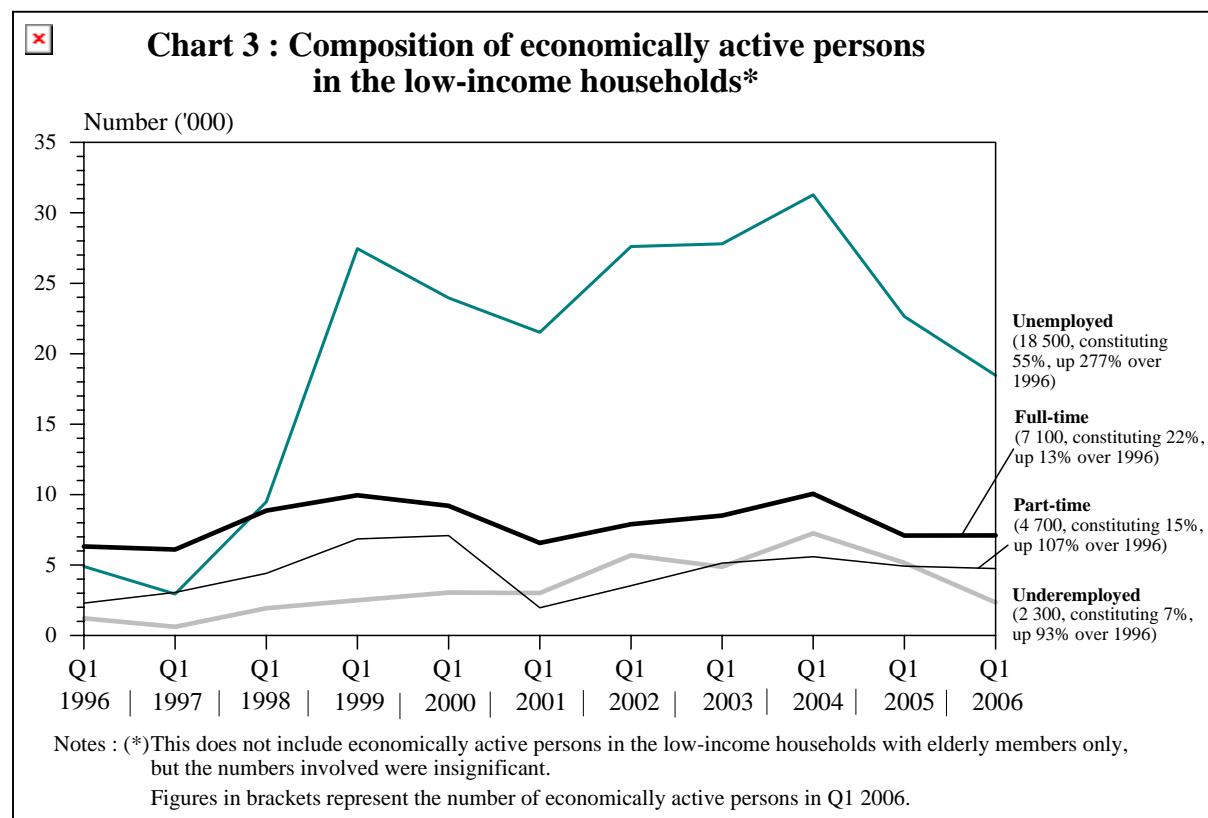
6. Meanwhile, there were 33 800 or 19% low-income households with all of their 64 100 members being economically inactive in Q1 2006 (i.e. economically inactive household). Among these household members, 15% aged below 20 and almost all of them were students, and 23% aged 60 or above and a predominant proportion of them were retirees. The remaining 62% or 39 600 working age persons were outside the labour force for various reasons, consisting of 27% home-makers, 15% who were suffering prolonged illness, and 20% who claimed to have retired.

7. The remaining 28 400 or 16% of low-income households had at least one economically active household members (i.e. economically active households). In Q1 2006, these low-income households consisted of 32 700 economically active persons. Among them, 71% were aged 40 or above, and 49% had attained lower secondary education or below.

8. Among these 32 700 economically active persons, 57% of them were unemployed, 7% were underemployed, and 15% were part-time workers (i.e. voluntarily working less than 35 hours per week). That means out of these 32 700 persons, only 7 100 or 22% were full-time workers (**Chart 3**). This composition of employment status explained in part why the monthly household income of such households were below \$4,000, even though they had at least one economically active household members, as most of them were either without a job, underemployed, or working part-time voluntarily.

9. Regarding the 14 200 employed persons in the low-income households (including full-time, part-time and underemployed workers), 28% of them were engaged in elementary occupations, among which a significant proportion were employed in the community, social and personal services sector (60%). Meanwhile, 23% were service workers and shop sales workers, mostly belonged to the wholesale, retail and import/export trades, restaurants and hotels sector (81%).

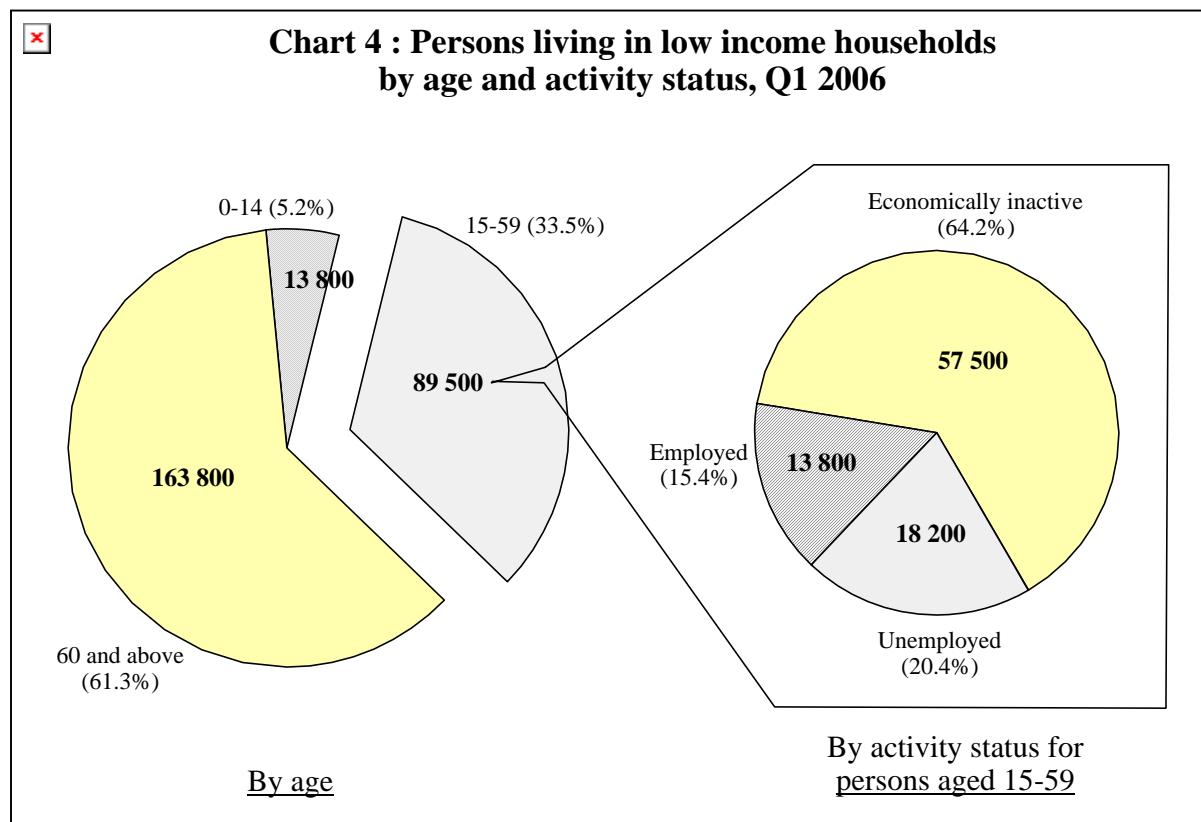
10. As indicated by ***Chart 3***, the group of unemployed among the economically active low-income households had increased at the fastest pace over the past decade, followed by the part-time and underemployed workers. It is not hard to explain, as the unemployment rate in Q1 2006 (5.2%, and edged down to 5.1% in February – April) was still higher than the level in the 1990s<sup>(2)</sup>.



(2) For consistency with the figures widely published, no adjustment has been made to the unemployment rate to exclude foreign domestic helpers.

11. Nevertheless, the current economic upturn has contributed to a marked decline of 28% in the total number of unemployed persons over the past two years, from over 250 000 in Q1 2004 to 180 500 in Q1 2006. Over the same period, the number of economically active persons in low-income households also fell noticeably by 40% from 54 200 to 32 700, with the extent of improvement even greater than that in overall unemployment. Apparently, most of these people had secured employment again or had earned higher income, thereby moving upward to the group of households with monthly household income above \$4,000. As shown in **Chart 3**, the number of full-time, underemployed, part-time and unemployed workers within these low-income households all came down from the levels in Q1 2004.

12. Taking the above three types of low-income households (i.e. elderly, economically inactive and economically active) together, there were 267 100 persons living in such households in Q1 2006. Among them, nearly two-thirds were either elderly persons aged 60 or above, or young persons aged below 15 (**Chart 4**). Of the remaining one-third aged between 15 and 59, a predominant proportion (64%) of them were economically inactive, i.e. outside the labour force. The remaining 36% or 32 000 persons were either unemployed or with low-income. Compared to the average for all persons aged 15-59 in Hong Kong, those in the low-income households had a much higher unemployment rate (57.0% vs. 5.4%), as well as underemployment rate (7.3% vs. 2.4%), indicating that the major problems faced by low-income households were unemployment and underemployment, consistent with the situation as described in Paragraph 10.



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