



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

The Government has just released the Third Quarter Economic Report 2005 at end-November. 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 discusses the updated economic forecasts for 2005 as a whole and gives a broad assessment of the economic outlook for 2006.

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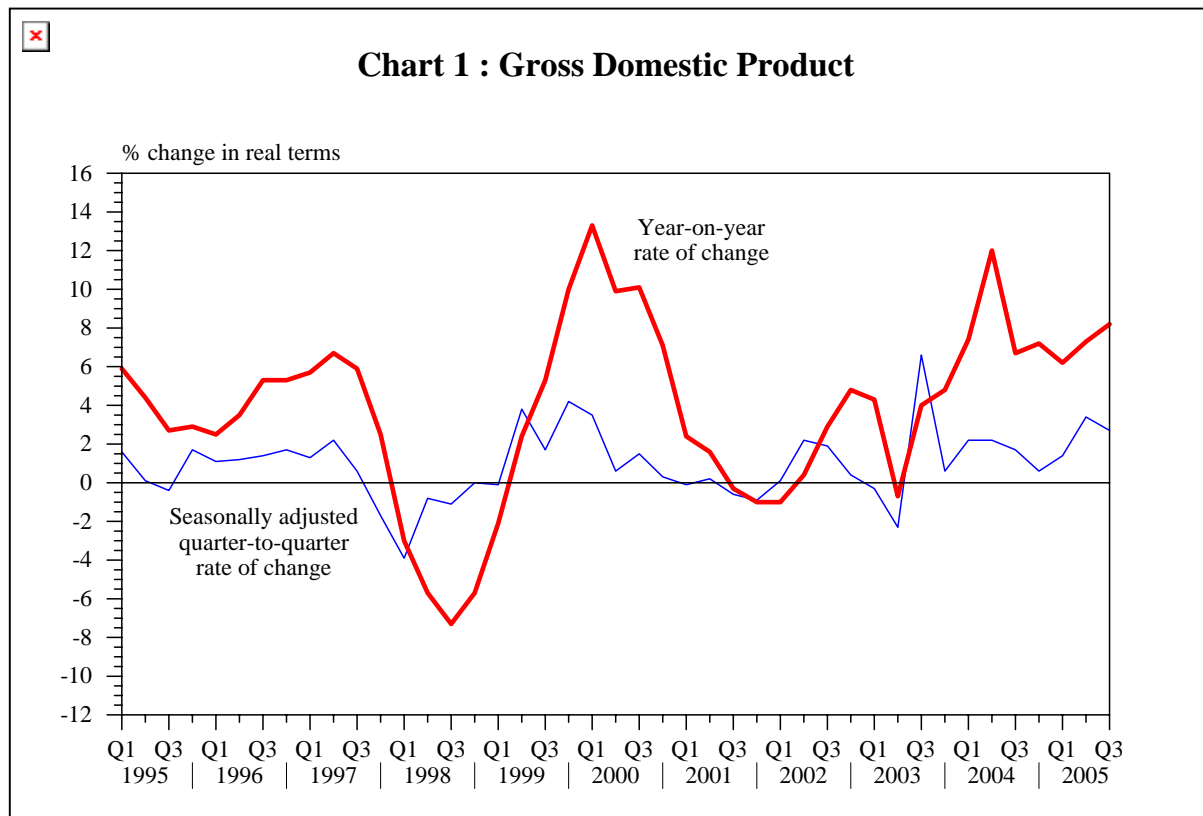
# Recent situation and near-term outlook for the Hong Kong economy

## Introduction

This paper analyses latest developments in the Hong Kong economy and briefly discusses the updated economic forecasts for 2005 as a whole released at end-November and the economic outlook for 2006.

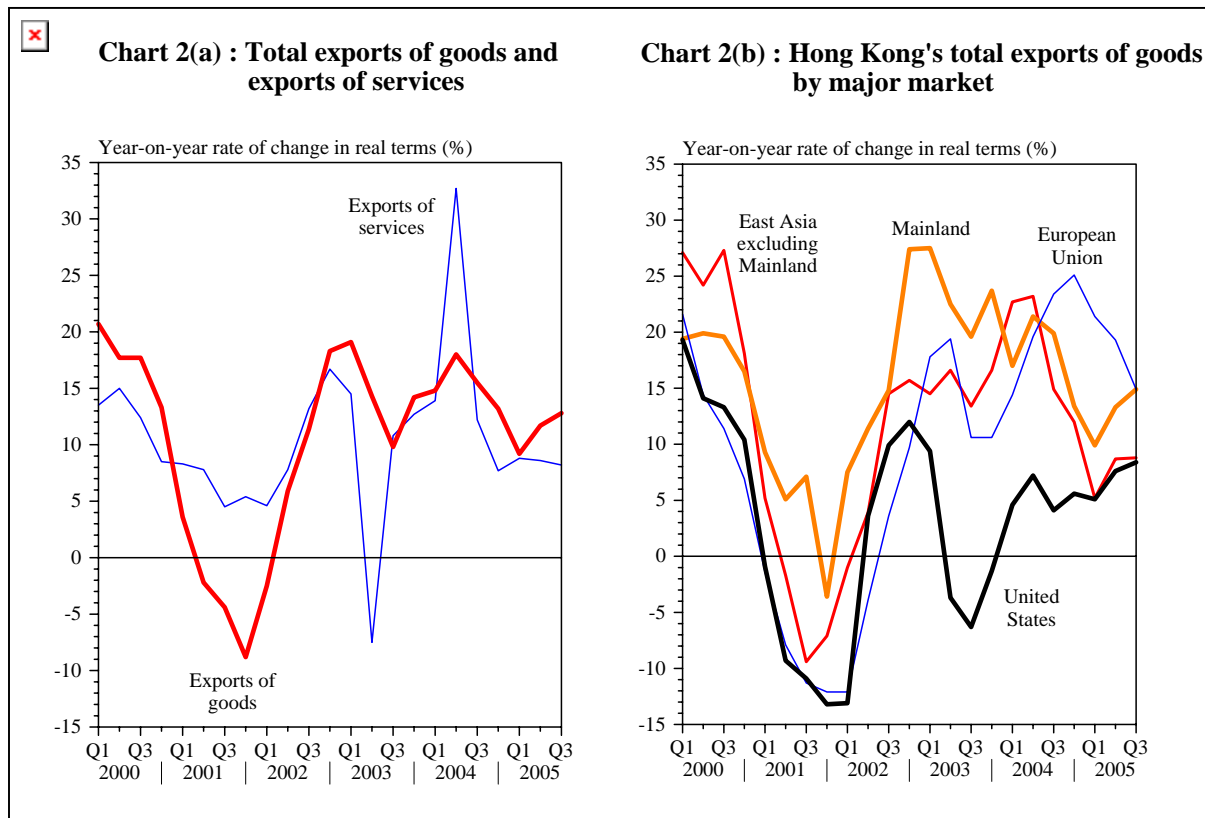
## Recent economic situation

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*).

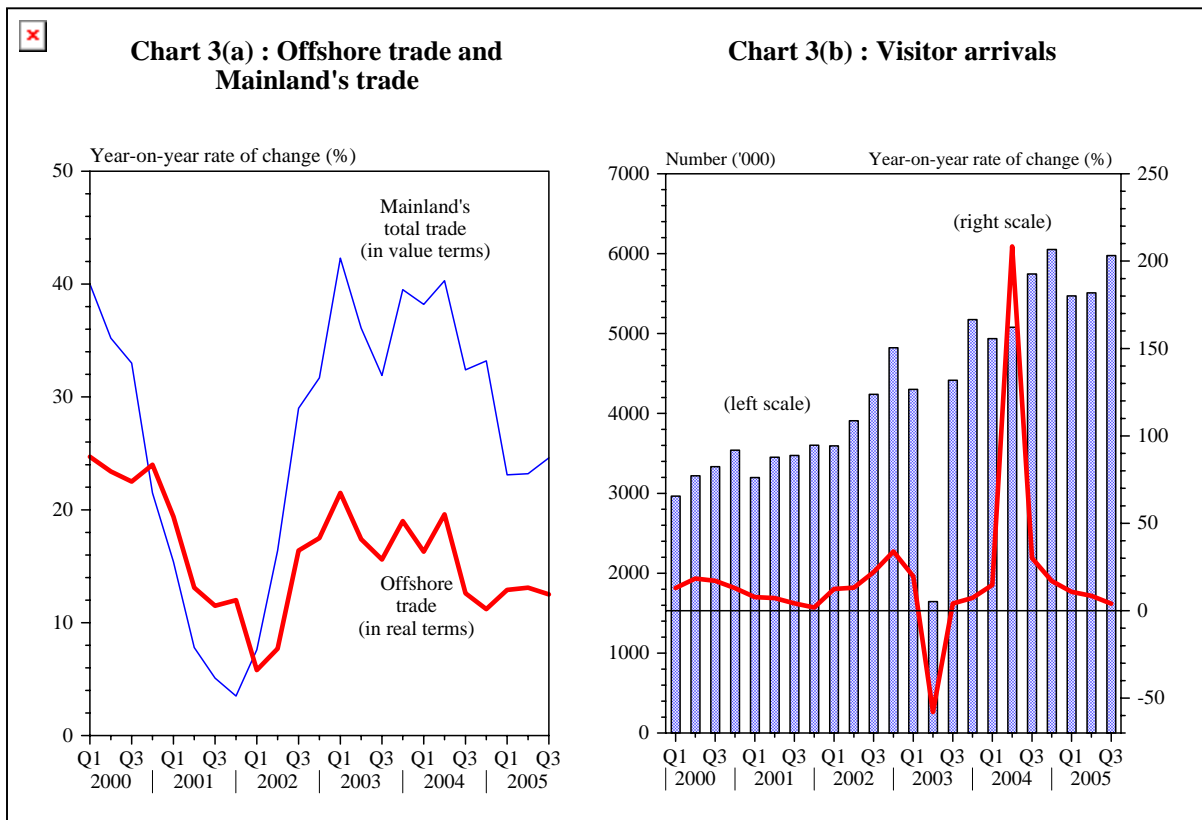


3. While the economic expansion had become more broad-based in the third quarter, the external sector with its robust performance was still the dominant driving force. *Total exports of goods* continued to grow significantly, by 12.8% year-on-year in real terms in the third quarter, reflecting the fairly 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)**).

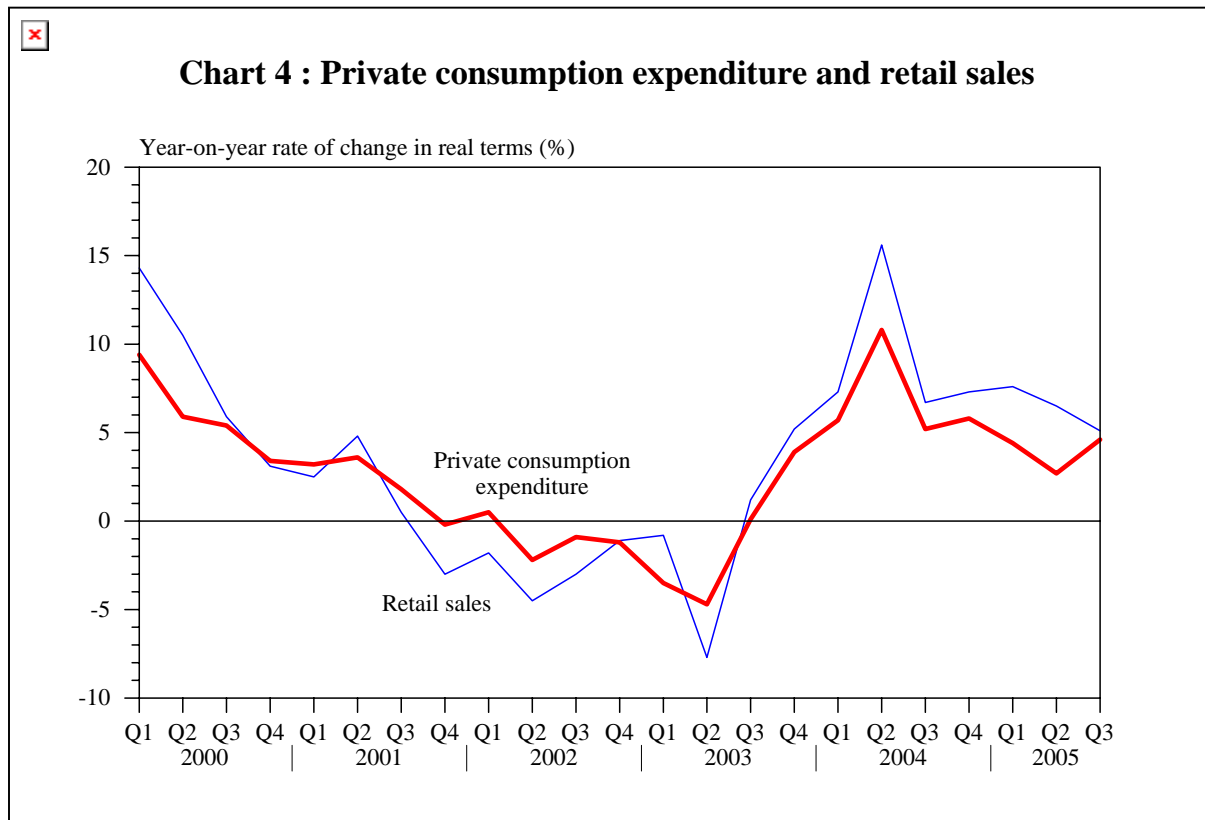
4. Exports to all major markets recorded notable growth in the third quarter of 2005. Exports to the Mainland continued to record double-digit growth. The stellar performance was underscored by the Mainland's strong trade flows as well as its robust domestic demand. Exports to the EU were also strong, 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, offsetting the slackening in the Singapore market (**Chart 2(b)**).



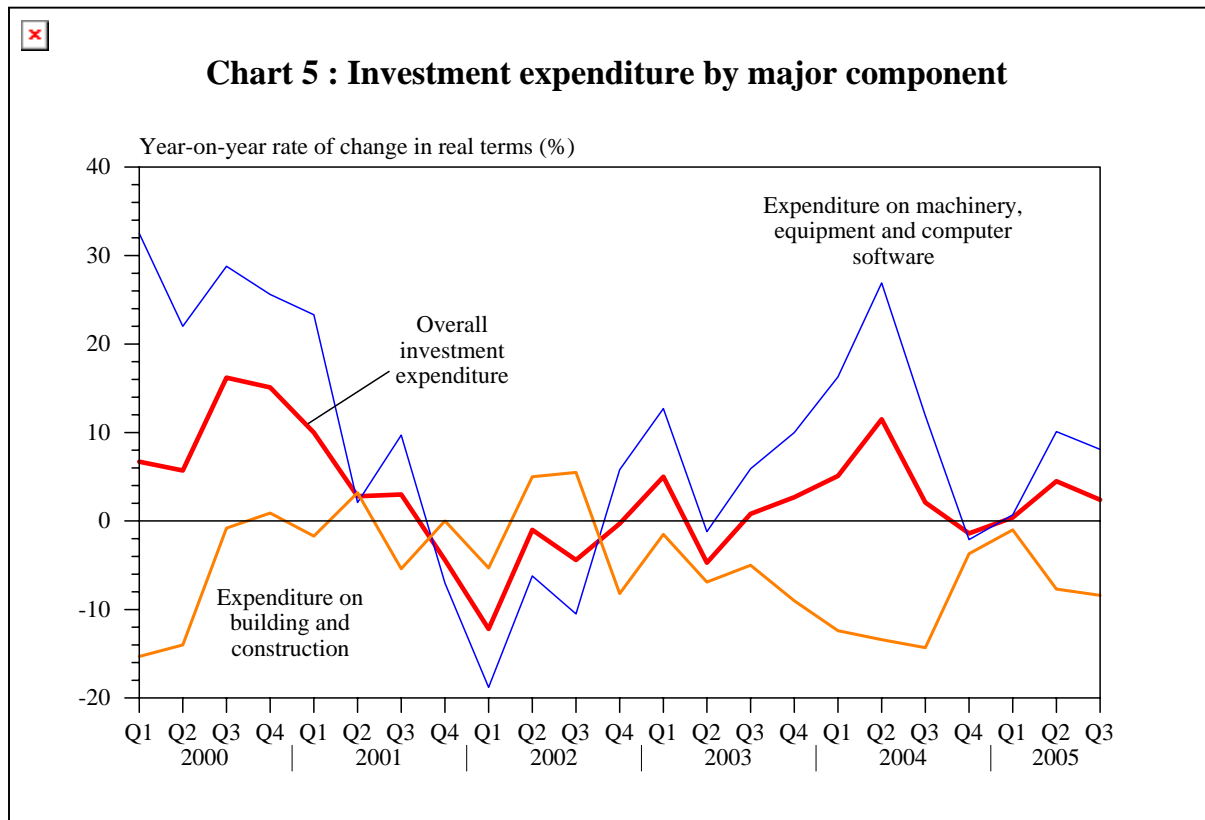
5. On invisible trade, *exports of services* expanded noticeably further, by 8.2% in real terms in the third quarter, following increases of 8.8% and 8.6% in the first and second quarters respectively. Offshore trade and exports of transportation services surged further, mainly benefited by buoyant trade 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.



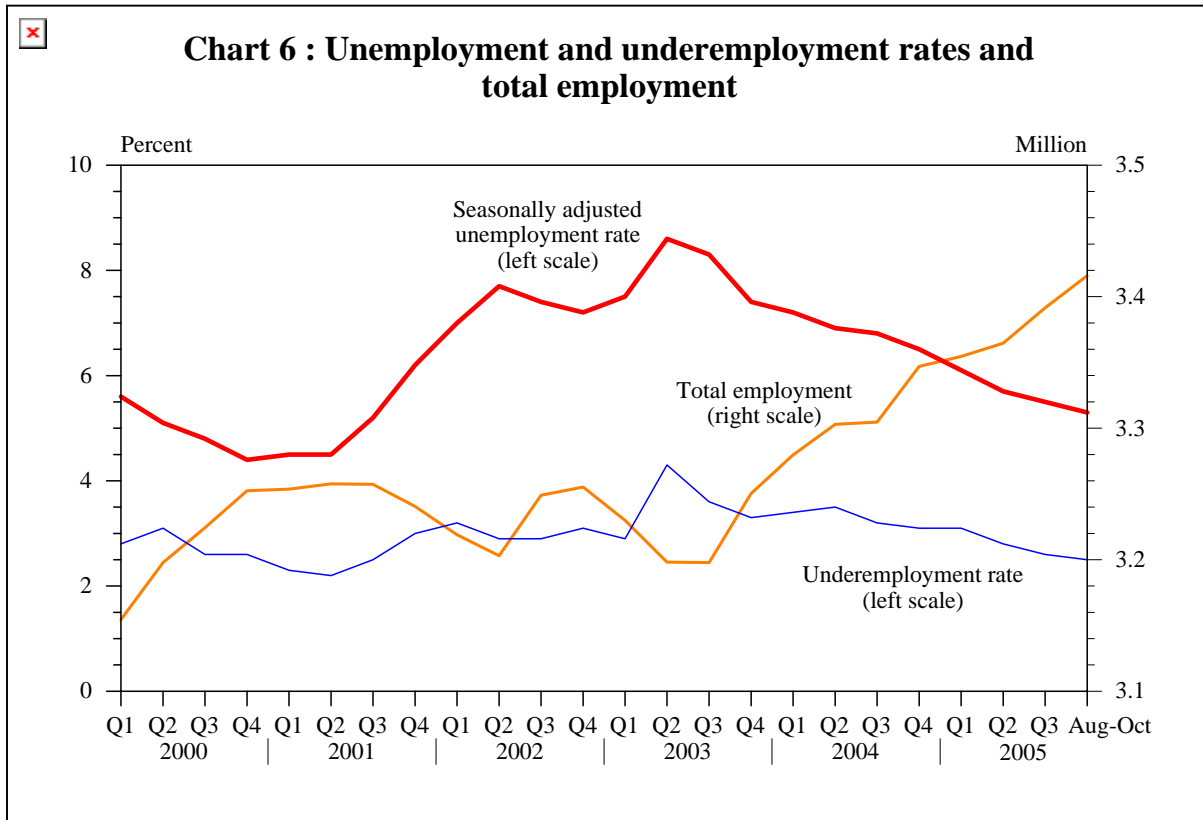
6. On the domestic front, local consumer spending held firm in the third quarter, supported by improving employment incomes. Amidst the generally upbeat sentiment, *private consumption expenditure (PCE)* re-accelerated to grow at 4.6% in real terms in the third quarter over a year earlier, distinctly up from the 3.5% growth in the first half (**Chart 4**).



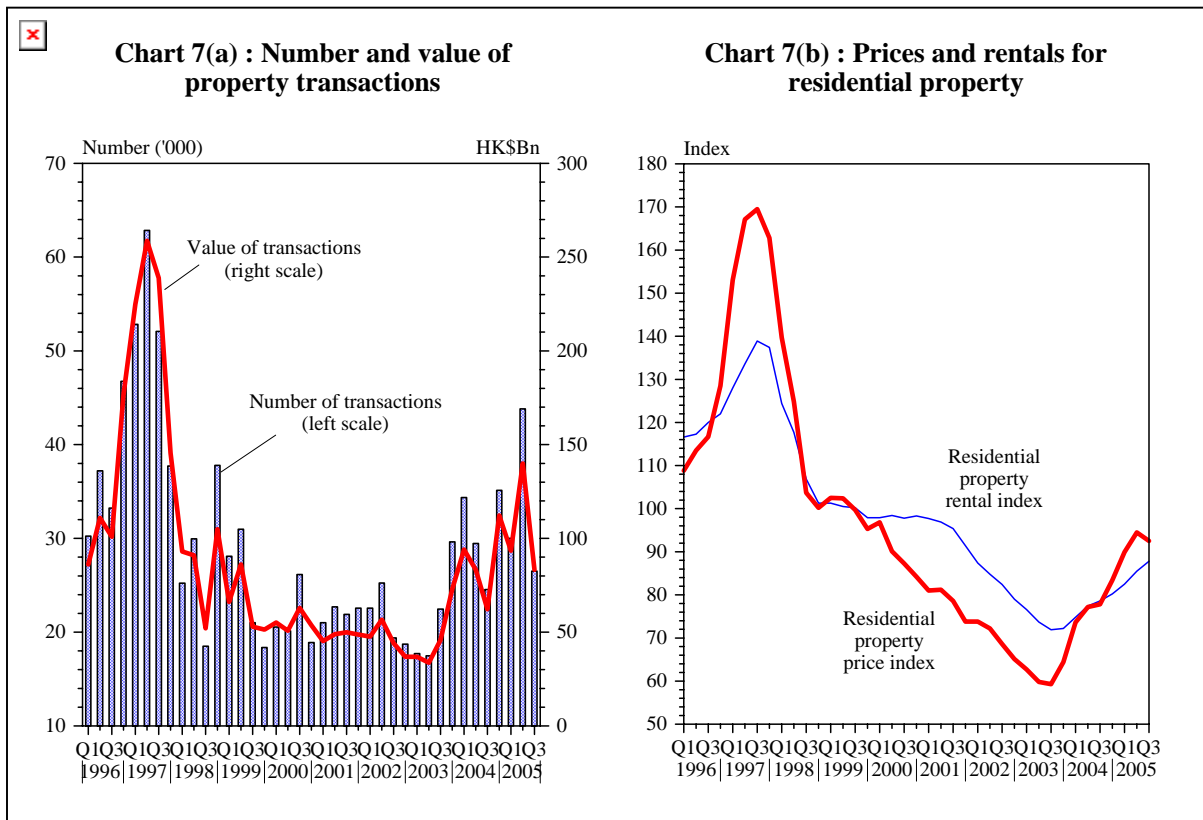
7. Overall investment spending in terms of *gross domestic fixed capital formation* grew further, though only modestly by 2.4% in real terms in the third quarter over a year earlier, after a 2.5% growth in the first half of the year. Business sentiment remained generally upbeat, against the background 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*).



8. The labour market kept turning better on a broad front during the third quarter of 2005, and improved further in October. The *seasonally adjusted unemployment rate* fell to 5.3% and the *underemployment rate* to 2.5% in August - October, both representing their lowest levels since July - September 2001 (**Chart 6**). *Total employment* surged to an all-time high of 3.42 million in August - October 2005. Compared to the trough in mid-2003, there was a net creation of 226 900 jobs, of which 60% belonged to the higher-skilled categories, including managers and administrators, professionals and associate professionals. On the other hand, the increase in the share for lower-skilled jobs, at 40%, indicated that the entrenched economic recovery has also benefited the low-skilled segment of the workforce. The number of long-term unemployed persons also came down markedly, from the peak of 93 000 in 2003 to about 59 000 in August-October 2005. Thus even the hard core of the unemployed was able to benefit from economic revival once the recovery broadened to a full-fledged upturn. Meanwhile, labour income also improved moderately, with payroll per person engaged in the private sector establishments rising by 3.6% in money terms in the first half of 2005 over a year earlier.

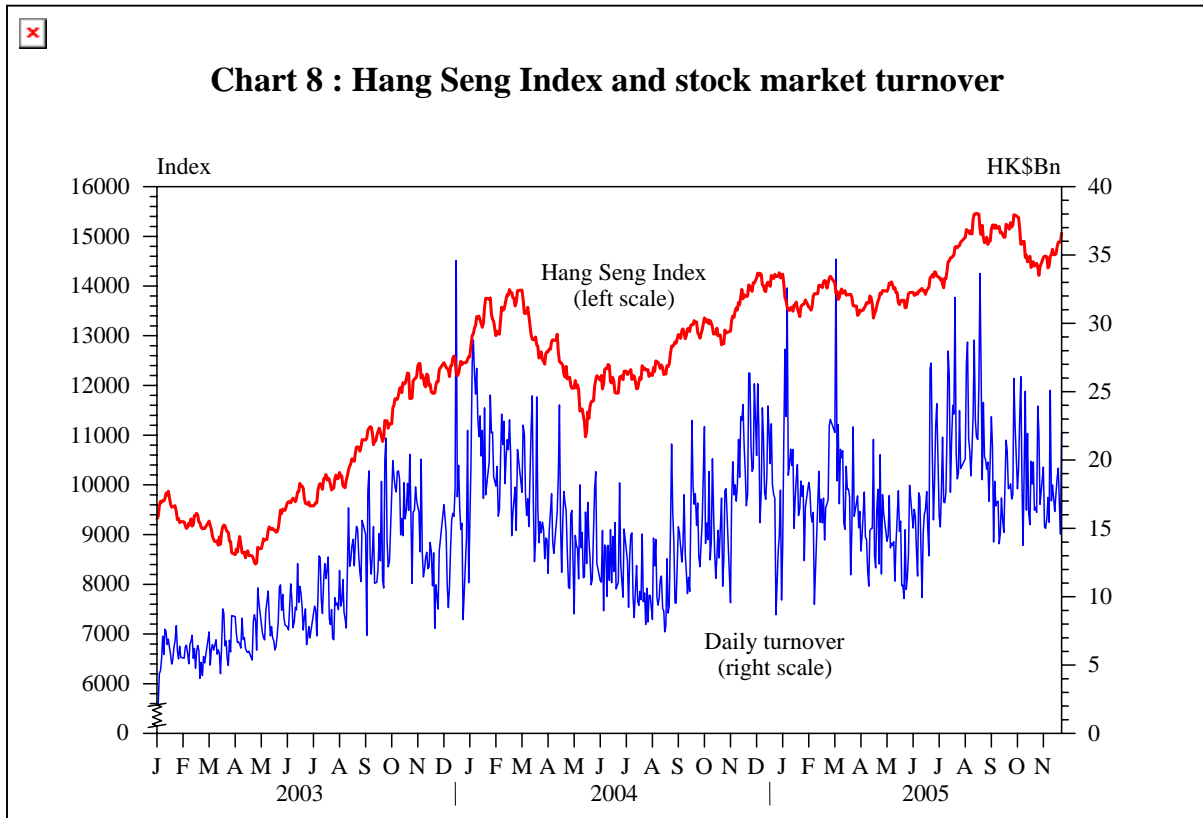


9. The property market as a whole turned quieter in recent months, representing a consolidation from the hectic situation earlier this year. The consolidation was particularly apparent in the sales market for residential property, as acquisition interest was curbed by the cumulative hike of 2.5 - 2.75 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)*).

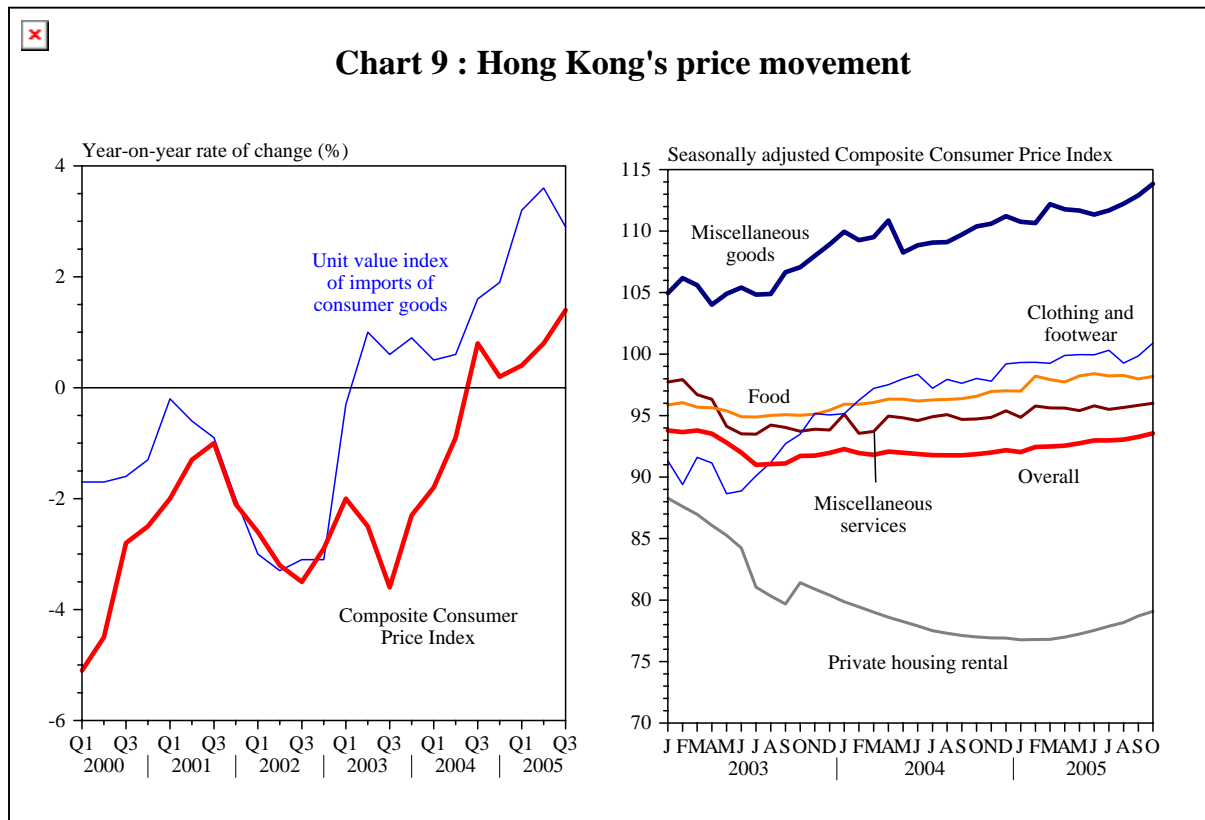


10. The local *stock market* was buoyant for most of the time in the third quarter of 2005, underpinned by progressive improvement in the local economy and good corporate earnings. The Hang Seng Index hit 15 466 on 15 August, the highest level in 2005. The index closed at 15 429 at end-September, up by 8.6% over end-June. Yet, between early October 2005 and mid-November, the Hang Seng Index dipped below 15 000, due partly to renewed concerns over an extension of up-cycle in US dollar interest rates. But lately the index moved up again to level of above 15 000. In general, the local stock market has been rather resilient on the back of an improving economy (*Chart 8*).





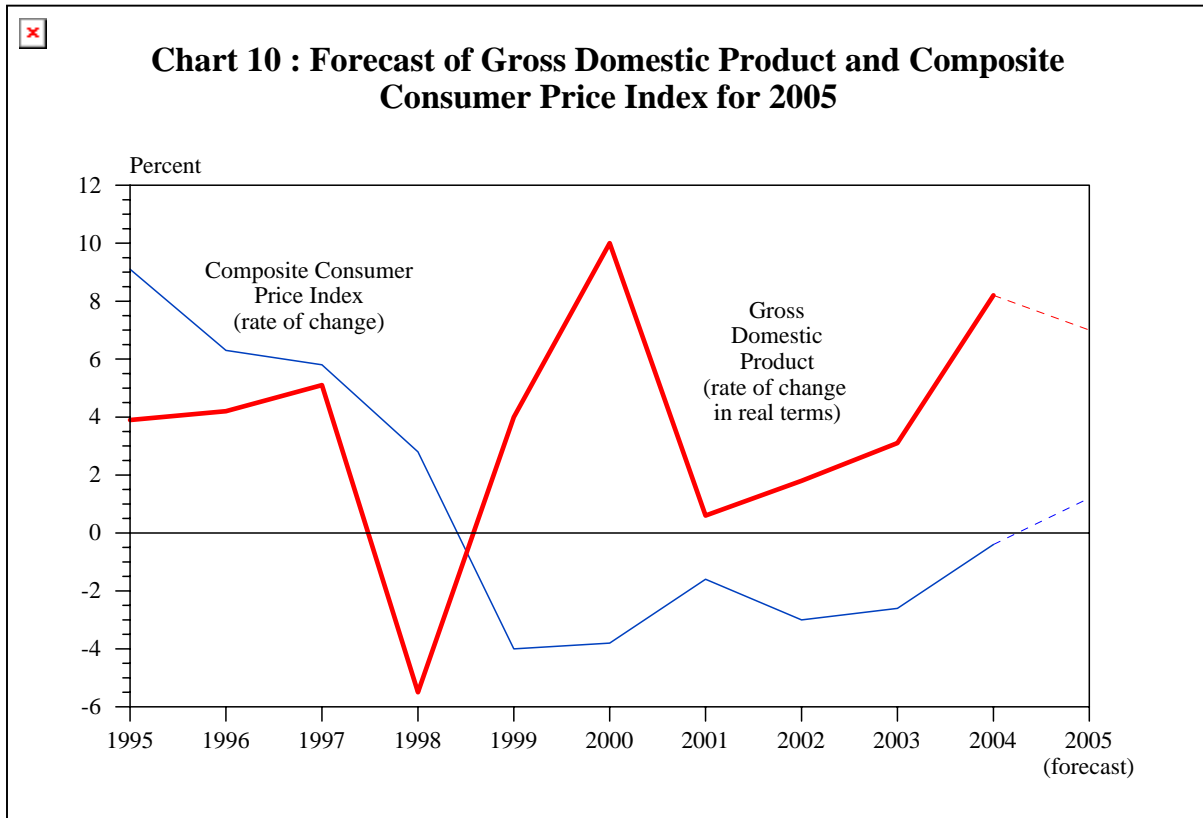
11. Consumer price inflation climbed up slightly further during the third quarter, reflecting the buoyant economic upturn, progressive feed-through from the earlier rental rebound and also some modest impact from higher fuel cost. Yet on the whole, price pressures remained well contained so far, as the 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 moderately 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 9*).



### Updated short-term economic forecasts for 2005

12. 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 10*).

13. 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%.



### **Economic outlook for 2006**

14. 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.

15. 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.

16. 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.

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