



Hong Kong's Recent Economic Situation and Near-term Outlook

The Government released the Third Quarter Economic Report 2006 at end-November. 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 development in regard to external trade, domestic demand, labour market, asset markets and consumer prices in the most recent period. It then describes the updated economic forecasts by the Government for 2006 as a whole, and briefly discusses the various factors which may affect the outlook in 2007.

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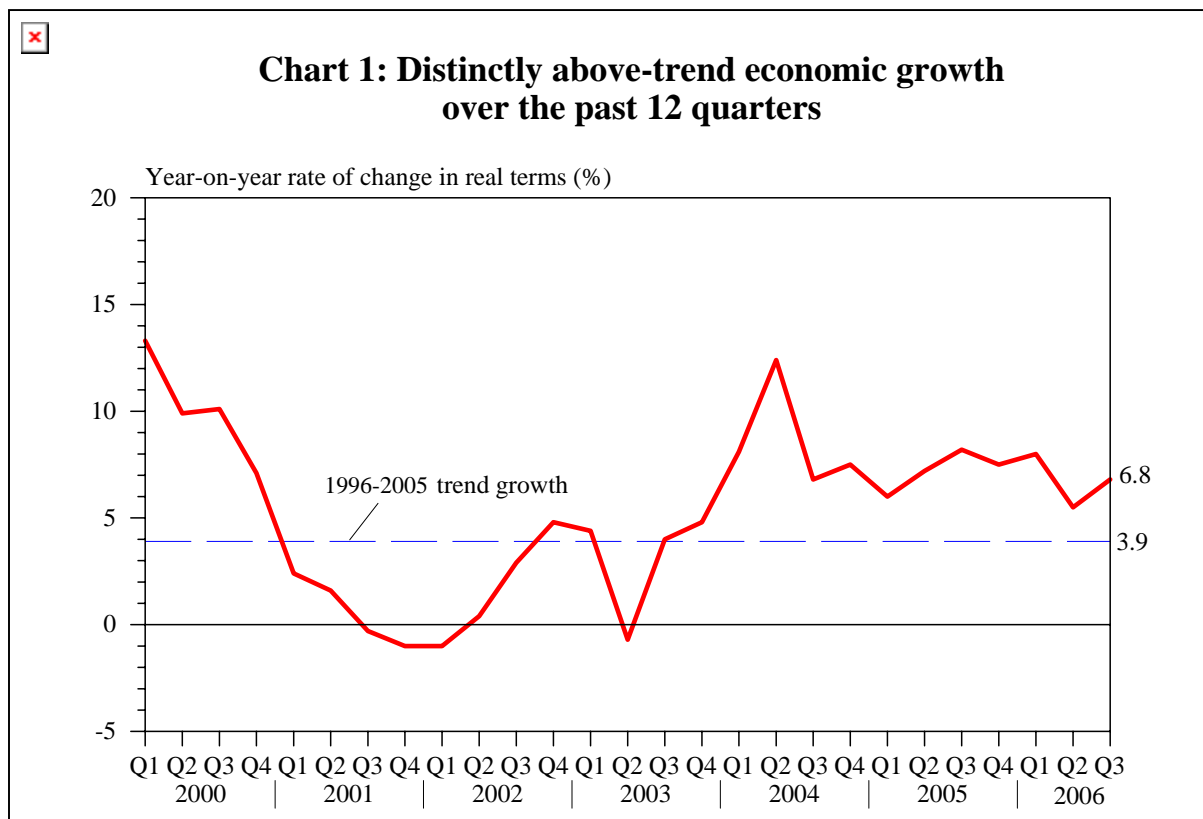
Recent Situation and Near-term Outlook For the Hong Kong Economy

Introduction

This paper analyses latest development in the Hong Kong economy and briefly discusses the updated economic forecasts for 2006 as a whole released at end-November and the economic outlook for 2007.

Recent economic situation

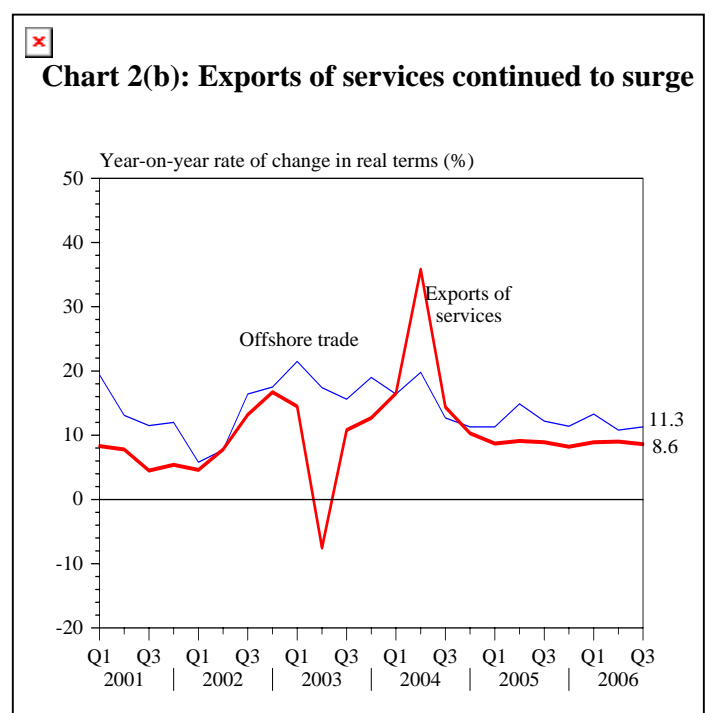
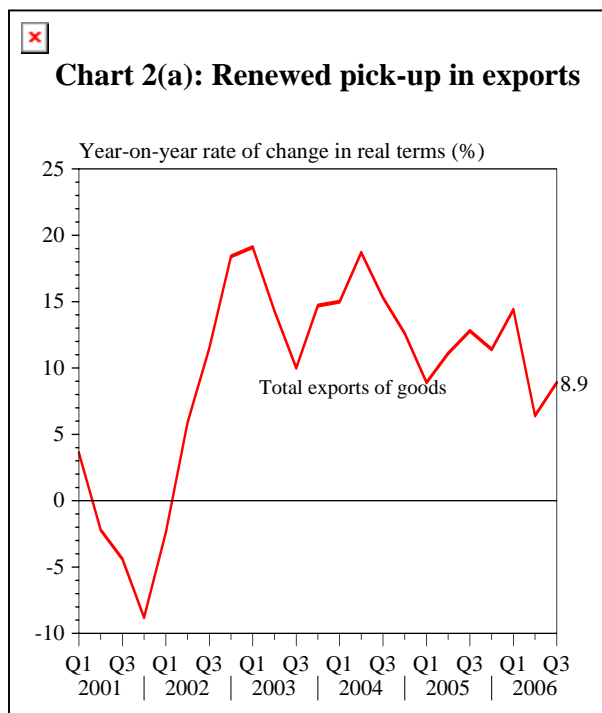
2. The Hong Kong economy gathered strong momentum again in the third quarter of 2006, with real GDP expanding briskly by 6.8% over a year earlier. By now our economy has been on a distinctly above-trend growth for 12 consecutive quarters since the current upturn began in mid-2003 (*Chart 1*). Unlike the pattern in the past few years, a distinct feature of the current economic expansion is that it is a full-fledged upturn, marked by robust growth in external trade as well as strengthening domestic demand.



3. In the first three quarters of 2006, Hong Kong's exports of goods, though with some fluctuations from month to month, continued to perform very well in overall terms, up by a further 9.6% in real terms over a year earlier (*Chart 2(a)*).

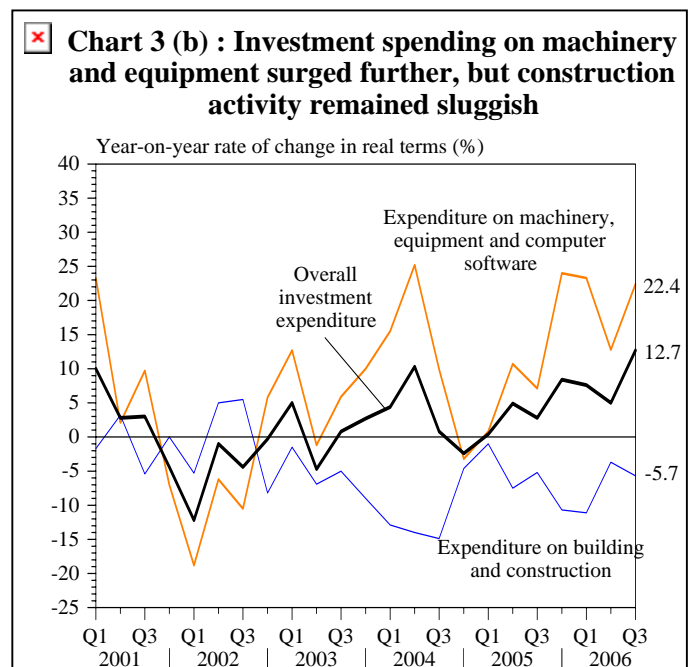
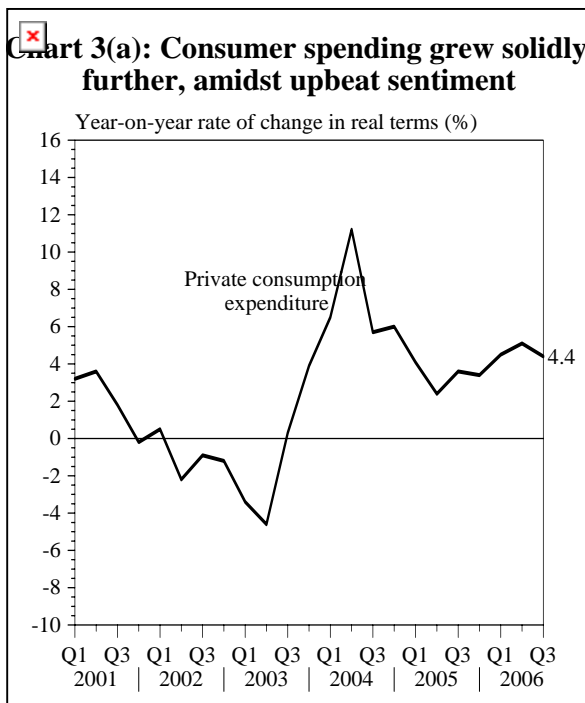
4. For the third quarter in particular, the Mainland market continued to be the key growth spot, under the support of a rapidly growing Mainland economy and its vibrant trade flows. Exports to many other Asian markets such as Taiwan, Singapore and Korea also attained strong growth in tandem with a resurgence in intra-regional trade. Yet exports to Japan slowed down further. Exports to the EU showed only a modest increase, while exports to the US remained weak.

5. With vibrant offshore trade and buoyant financial market activities, exports of services likewise grew strongly, by 8.6% in real terms in the third quarter over a year earlier, cumulating to a growth of 8.8% in the first three quarters as a whole (*Chart 2(b)*).

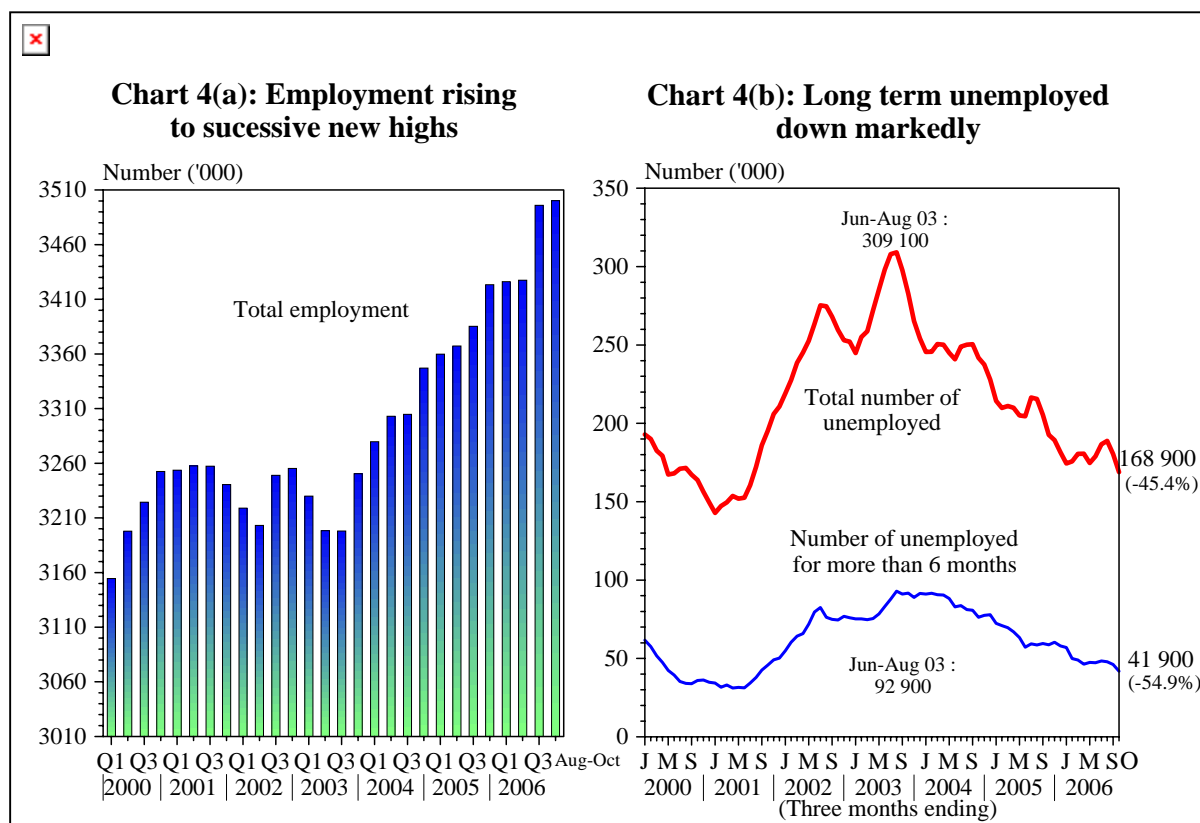


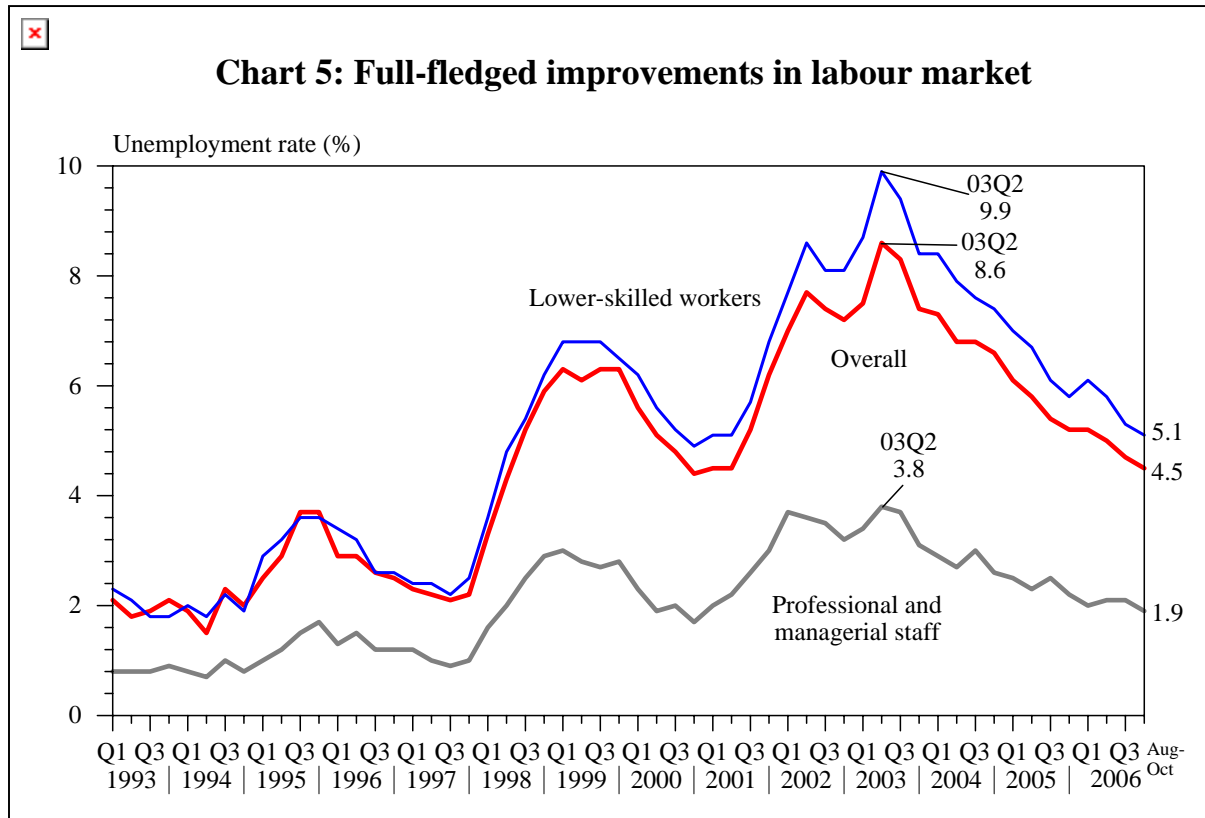
6. Domestic sector has been playing an increasingly important role in driving economic growth. Private consumption expenditure rose solidly further by 4.4% in real terms in the third quarter over a year earlier, on the back of upbeat consumer sentiment and an improving labour market. For the first three quarters as a whole, there was a notable growth of 4.7% (**Chart 3(a)**). While consumption growth in the third quarter was broad-based, consumption on durable items such as motor vehicles, electrical goods and photographic equipment were particularly strong.

7. Overall investment expenditure surged by 12.7% in real terms in the third quarter over a year earlier, the fastest since the fourth quarter of 2000. Machinery and equipment investment, which surged by 22.4%, was the key driver of overall investment growth, underlining the strength of business confidence and also sustained business expansion in the corporate sector. The increases were again across-the-board, but more markedly in the acquisition of office equipment, telecommunications equipment and aircraft. Meanwhile, overall building and construction activity remained slack, although private sector output seemed to have stabilized over the past two quarters (**Chart 3(b)**).

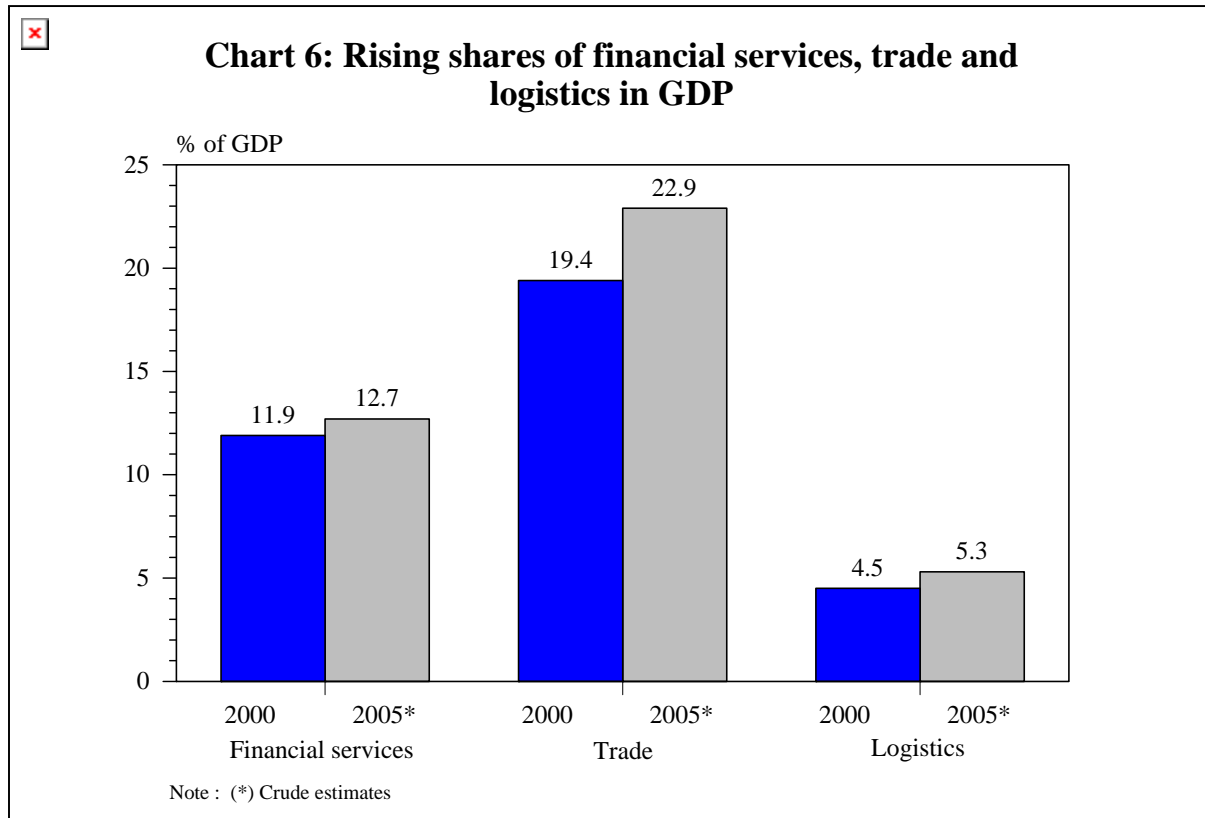


8. Another distinct feature of the current recovery is the extensive job creation process brought about by economic expansion. An impressive total of some 311 000 additional jobs have been created since the trough in mid-2003, bringing total employment to successive record highs over the past year and thus leading to significant improvements in employment conditions in all segments of the labour market (*Chart 4(a)*). As a result, the seasonally adjusted unemployment rate is down to a 64-month low of 4.5% in the three months ending October, an improvement of more than four percentage points as compared to the high of 8.6% in mid-2003 (*Chart 5*). The number of long-term unemployed also fell markedly, by 55% over the same period (*Chart 4(b)*). Labour incomes and job vacancies are on the rise. Broad-based improvements in the labour market in turn have helped to instill confidence back into the economy, a key factor underpinning the sustained upturn in domestic demand.

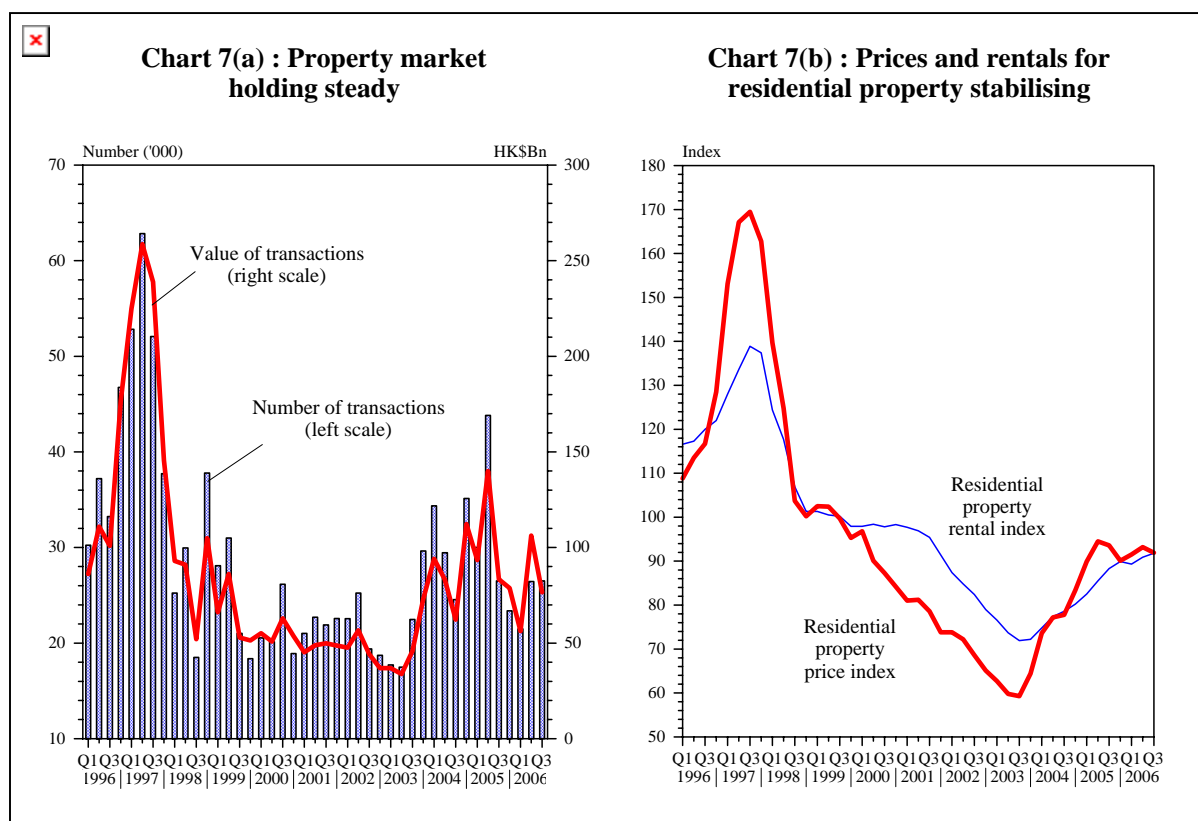




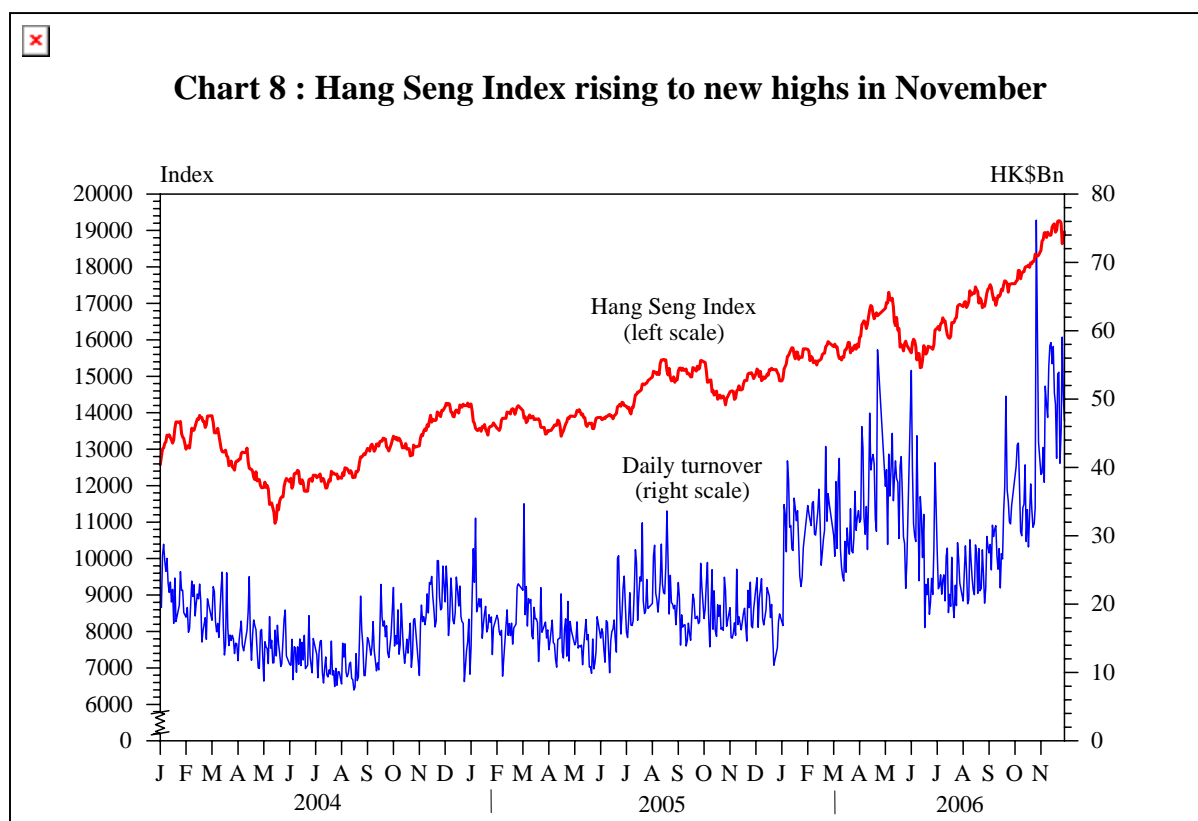
9. Driven by the forces of globalization and closer integration with the Mainland economy, the Hong Kong economy has been restructuring itself and gone up the value chain quite successfully. Over the past three years of economic expansion (comparing the first half of 2006 over the same period in 2003) when overall GDP grew by 25.5%, output in the financial and insurance services has expanded markedly by a cumulative total of 70%, while output in the trading and in transport and storage have both risen by over 40%, signifying the strength and also the continued growth of Hong Kong as a premier international centre for financial, trade, logistics and shipping services serving the Mainland and the region (*Chart 6*).



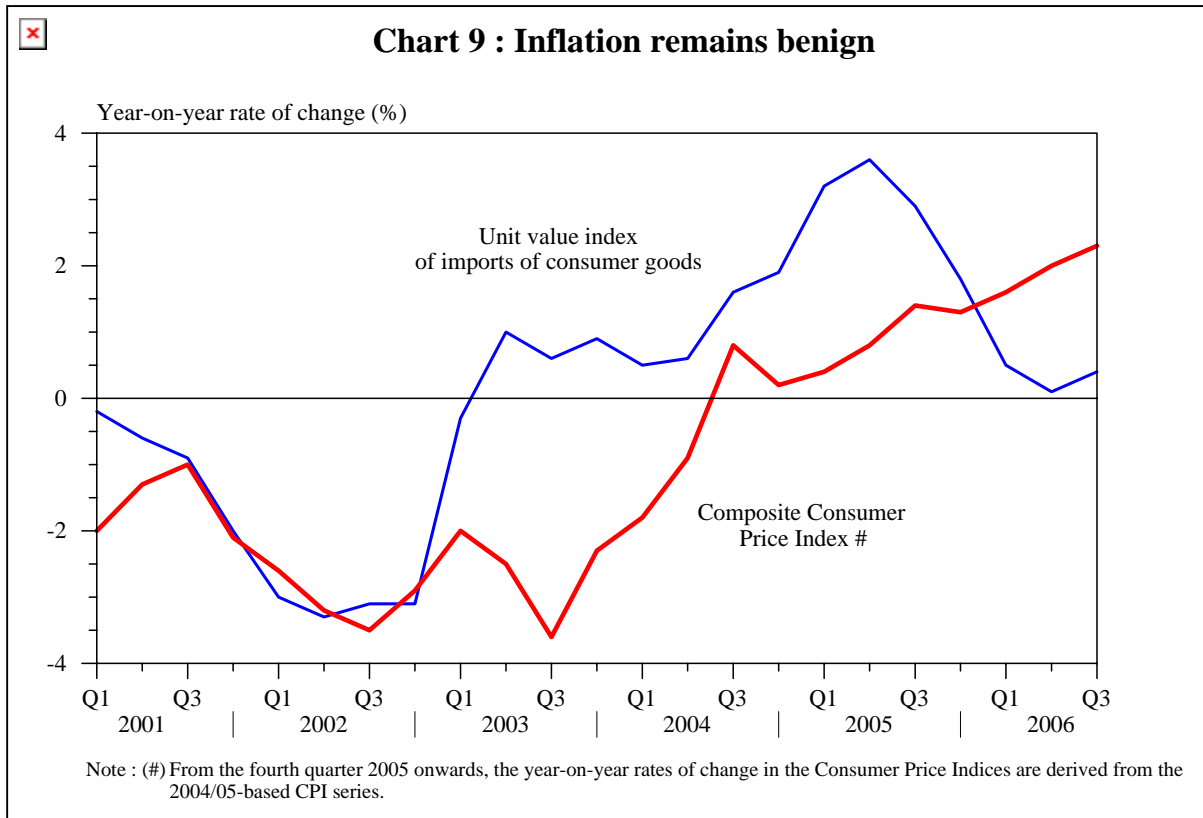
10. The property market on the whole continued to develop healthily in the third quarter of 2006. The residential property market has stabilized in the more recent months, as sentiment turned better upon the recent pause in US interest rate hikes and intensified mortgage competition amongst the banks. Flat prices in September 2006 were virtually unchanged from June, though modestly higher by 2% over end-2005. Compared with the trough in 2003, flat prices in September 2006 were 58% higher, but still 47% lower than the peak in 1997. Concomitantly, flat rentals edged up slightly by 1% during the third quarter. The non-residential segment largely performed well in tandem with continued business upturn (*Chart 7*).



11. The local stock market enjoyed a stellar performance in the third quarter following some consolidation in May and early June. The Hang Seng Index (HSI) closed at 17 543 at end-September 2006, up by 8% over end-June. The stock market rally continued into October and November, with HSI surging to successive new highs in November, reaching a new high of 19 265 on 23 November, before closing the month at 18 960. Market capitalization broke the \$12 trillion mark and stood at \$12.1 trillion on 30 November. The stock market's stellar performance to a large extent reflects the strength of our economic fundamentals and also the prevailing favourable macro conditions, including sanguine economic outlook; improved corporate profitability; abundant liquidity in the banking sector leading to lower interest rates; a thriving Mainland economy; and easing in oil prices thus removing some of the earlier worries overshadowing the global economy and resulting in global-wide stock market rally. IPO activity has regained much vigor and attracted much interest from international investors. This attests to our strength as the IPO centre for the Mainland, underscoring our position as Asia's premier international financial centre (*Chart 8*).

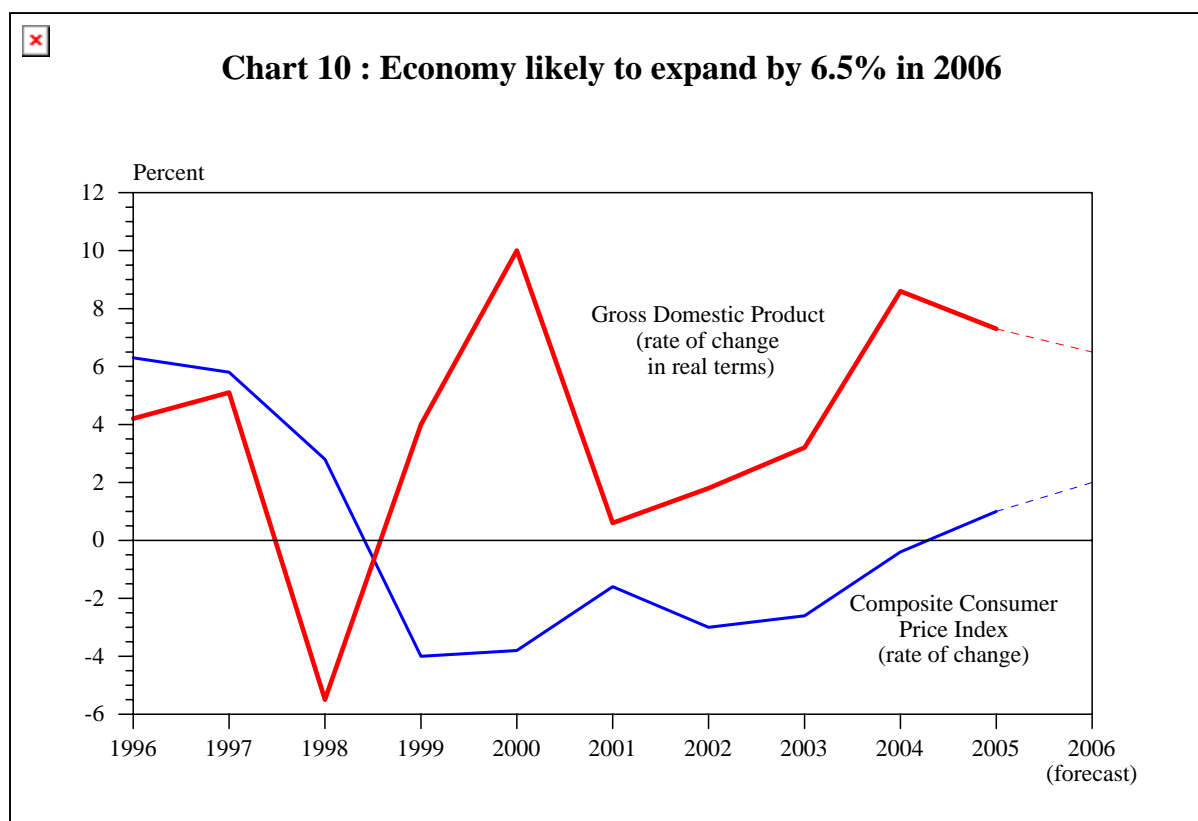


12. Inflation has remained benign even after three years of very strong economic expansion. The Composite Consumer Price Index (CCPI) notched up by 2.0% in the first ten months of 2006, following a 1.0% increase in 2005 (*Chart 9*). On the domestic front, upward pressures on local business costs have remained largely in check, with unit labour cost being capped by rising productivity, and unit rental cost increases also stabilizing in tandem with some softening in shop rentals lately. External cost pressures are likewise muted, especially with the recent substantial fall-off in oil prices.



Updated short-term economic forecasts for 2006

13. On the back of an exceptionally strong GDP outturn of 6.8% growth for the first three quarters of 2006, and even after allowing for some possible moderation in external trade in the fourth quarter, the forecast GDP growth for 2006 as a whole is revised upward from 4 - 5% to 6.5%. This represents the third consecutive year of very high growth, the best performance in 20 years (*Chart 10*).



14. With sustained strong growth in labour productivity keeping down the pressure on local costs, the benign inflation environment can be expected to continue, which is a factor conducive to sustained economic expansion. CCPI inflation for 2006 as a whole is expected to be a modest 2%.

Economic outlook for 2007

15. The 2007 outlook for the export-dependent Hong Kong necessarily hinges crucially on how the global economy would fare. While currently the global economic environment is still largely positive, there are uncertainties down the road for the coming year. The key risk is whether the US economy would show a sharper-than-expected downturn, which would inevitably have repercussions on Europe, Japan and Asia. At this present juncture, the mainstream view is for another year of notable growth in the world economy, as can be seen from the upbeat forecast of around 5% global economic growth by the International Monetary Fund (IMF) lately. But clearly, there is a need to watch out for potentially bigger shocks stemming from the US economy and also the lingering downside from the large and growing global trade imbalances.

16. Barring an unexpectedly sharp downturn in the US, there are a number of positive factors which should help to underpin Hong Kong's trade to weather the negative impact of weaker US demand. First, growth in the Mainland economy is likely to maintain reasonably strong momentum. Secondly, economic recovery in both Europe and Japan should also continue to cruise ahead steadily. Thirdly, the weakness of the US dollar against many of the Asian currencies should continue to boost Hong Kong's export competitiveness and offset the effects from renminbi appreciation. Fourthly, the ease-back in oil prices lately should be a welcome development, to the extent that it would help to reduce production costs and also lift the households' disposable income in the industrialized economies, and also remove a potentially impeding force on global economic growth momentum.

17. Moreover, the past three years of strong growth has placed Hong Kong on a much sounder footing than before. In particular, with the support of improving employment conditions, rising household incomes as well as more favourable monetary conditions, the domestic sector can be expected to gain further strength and take up an even bigger role in driving economic growth for next year, at a time when the trade outlook is subject to more uncertainties.

18. Overall, the Hong Kong economy is likely to have another year of solid and balanced growth in 2007, although the growth pace may not be as fast as the exceptionally high levels achieved over the past three years. We will take into account the above factors when preparing the economic forecast for 2007, which will be announced along with the Budget Speech in February next year. As a reference, the IMF lately forecasts that the Hong Kong economy would grow by 5% in 2007. The prevailing private sector analysts are also upbeat about further expansion of the Hong Kong economy at a solid pace, with prevailing forecasts averaging at around 4.5%.

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Recent situation of household income⁽¹⁾

Background

This Annex updates Panel Members on the movement of household income both in overall terms and in respect of households with monthly household income below \$4,000, in response to the earlier request made by the Hon Emily Lau at the 5 December 2005 meeting⁽²⁾.

Latest situation

2. The improving trend of household income continued over the past few months, against the backdrop of widespread job creation and rising labour earnings. The overall average monthly household income bounced up from \$22,500 in Q3 2004 to \$24,000 in Q3 2006, representing a gain of 6.6% in money terms or 2.9% in real terms. It is worth noting that the proportion of households with monthly income less than \$16,000 fell while that for households with \$16,000 or above rose (*Table 1*).

Table 1: Share of domestic households by monthly household income

	<u>Q3 2004</u>	<u>Q3 2005</u> (Percent)	<u>Q3 2006</u>
Less than \$4,000	8.7	8.4	8.1
\$4,000 - \$7,999	14.3	13.7	13.2
\$8,000 - \$11,999	15.0	15.1	14.3
\$12,000 - \$15,999	13.3	13.0	12.7
\$16,000 - \$23,999	17.1	18.2	18.2
\$24,000 - \$39,999	17.7	17.6	18.7
\$40,000 - \$99,999	12.0	11.9	12.6
\$100,000 or above	1.9	2.0	2.3

Note : The purchasing power of the income (as measured by the Composite CPI) in Q3 2004 and Q3 2005 were 104% and 102% of that in Q3 2006 respectively.

(1) Foreign domestic helpers are excluded from this analysis.

(2) Previous updates were submitted to the Panel in March and June 2006.

Households with monthly household income below \$4,000

3. The number of households with monthly household income below \$4,000 (hereafter referred to as “low-income households”) came down by 5 100 or 3% to 187 100 in Q3 2006 from a year earlier. Such a modest decline was however largely due to the visible increase in the number of economically inactive low-income households (i.e. with all of their members being economically inactive). The number of economically active low-income households (i.e. with at least one economically active household members) actually fell notably, thanks to a significant improvement in the employment situation for the lower-skilled workers (as manifested by a drop in the overall unemployment rate of these workers from 6.1% in Q3 2005 to 5.3% in Q3 2006). Concurrently, the number of elderly low-income households also dropped. As for the surge in the number of low-income households still observed over the past 10 years, this was mainly attributable to a surge in the number of retired elderly households (with all members aged 60 or above) as well as a contraction in average household size during the period (*Table 2*).

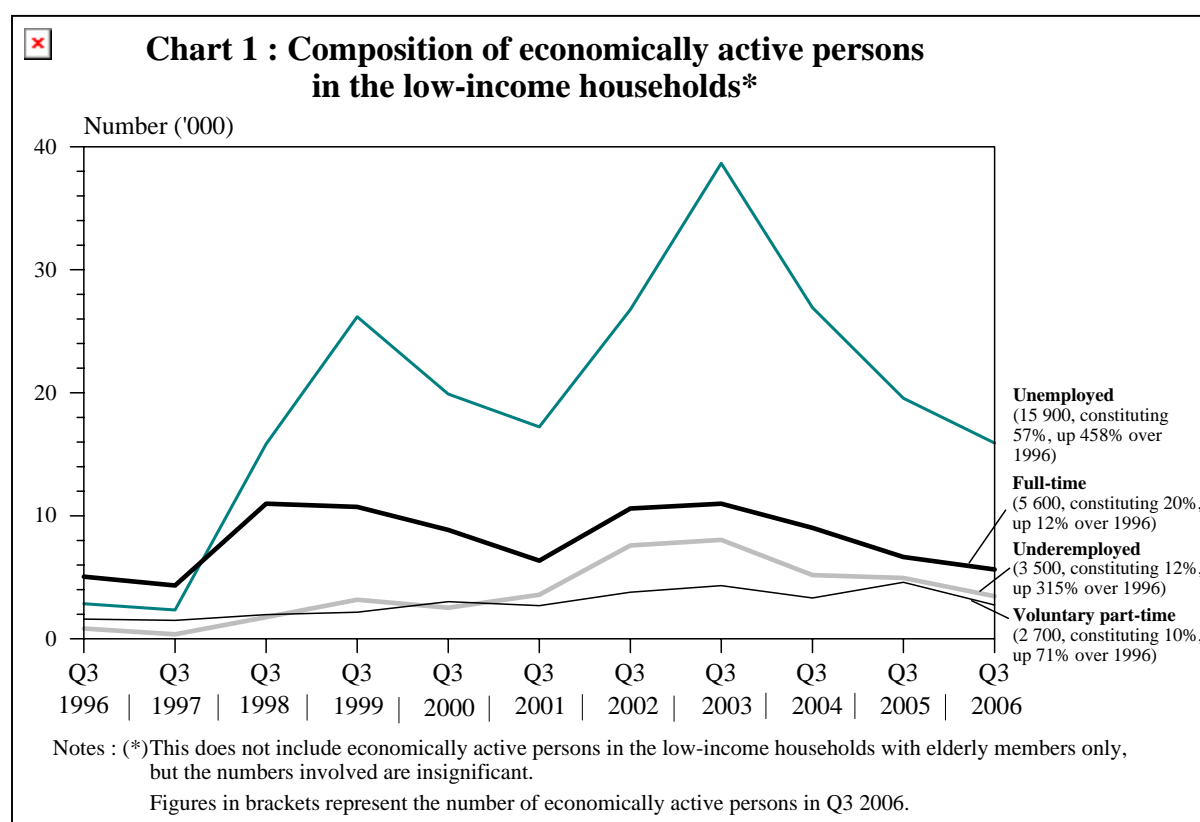
Table 2: Number and share of low-income households

	<u>Elderly households</u>	<u>Economically inactive households</u>	<u>Economically active households</u>	<u>Total</u>
Q3 1996	61 000 (3.3)	14 800 (0.8)	9 400 (0.5)	85 300 (4.5)
Q3 2003	121 400 (5.6)	32 600 (1.5)	52 700 (2.4)	206 700 (9.5)
Q3 2004	123 300 (5.5)	33 300 (1.5)	38 000 (1.7)	194 600 (8.7)
Q3 2005	126 200 (5.5)	34 600 (1.5)	31 400 (1.4)	192 200 (8.4)
Q3 2006	124 400 (5.4)	38 100 (1.6)	24 600 (1.1)	187 100 (8.1)

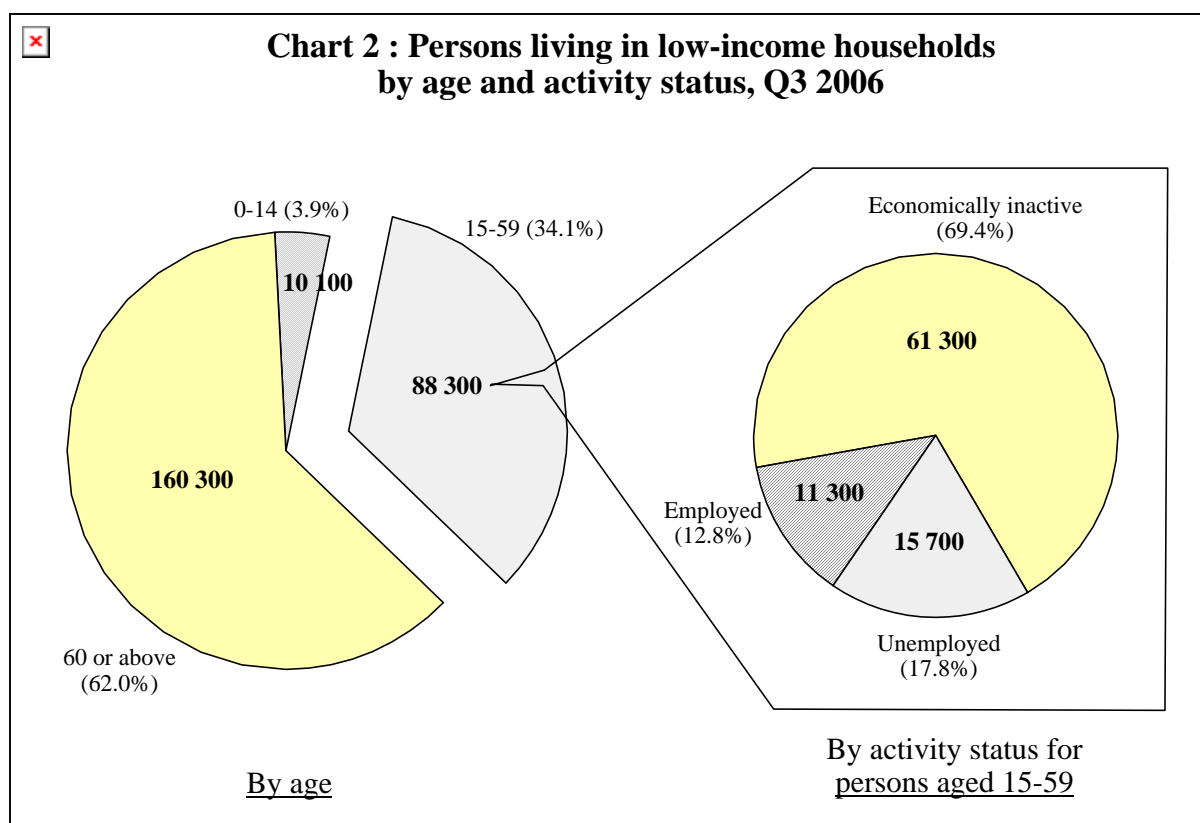
Note : () Share in all domestic households.

4. Further analyses into the composition of these low-income households indicated the following :

- More than two-thirds of low-income households in Q3 2006 were 1-person households, among which elderly persons aged 60 or above constituted the majority group.
- There were 66 700 household members living in economically inactive low-income households. Around one-third of them were aged below 20 and aged 60 or above (primarily students and retirees). The remaining 44 600 working-age persons comprised home-makers (27%), those suffering prolonged illness (22%), and retirees (21%) etc.
- Of the 27 800 economically active persons living in economically active households in Q3 2006, 57% were unemployed, 22% were part-time workers (comprising underemployed persons and those working voluntarily less than 35 hours per week), and only 20% were full-time workers. The across-the-board decline in the number of these household members regardless of employment status over the past two years suggested that many of them had regained employment or had earned higher income, thereby moving away from the group of low-income households (*Chart 1*).



- Among all the 258 700 persons living in low-income households in Q3 2006, only about one-third were persons aged 15-59, among whom a predominant proportion were economically inactive. For the remaining economically active members, they had a much higher unemployment rate (58.2% vs. 5.3%) as well as underemployment rate (12.2% vs. 2.5%) relative to the economy-wide average (*Chart 2*).



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