



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

The Government released the First Quarter Economic Report 2008 in mid-May. The Economic Report, together with the press release containing the updated economic forecasts for the whole year of 2008, 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 2008 as a whole.

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2 June 2008

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

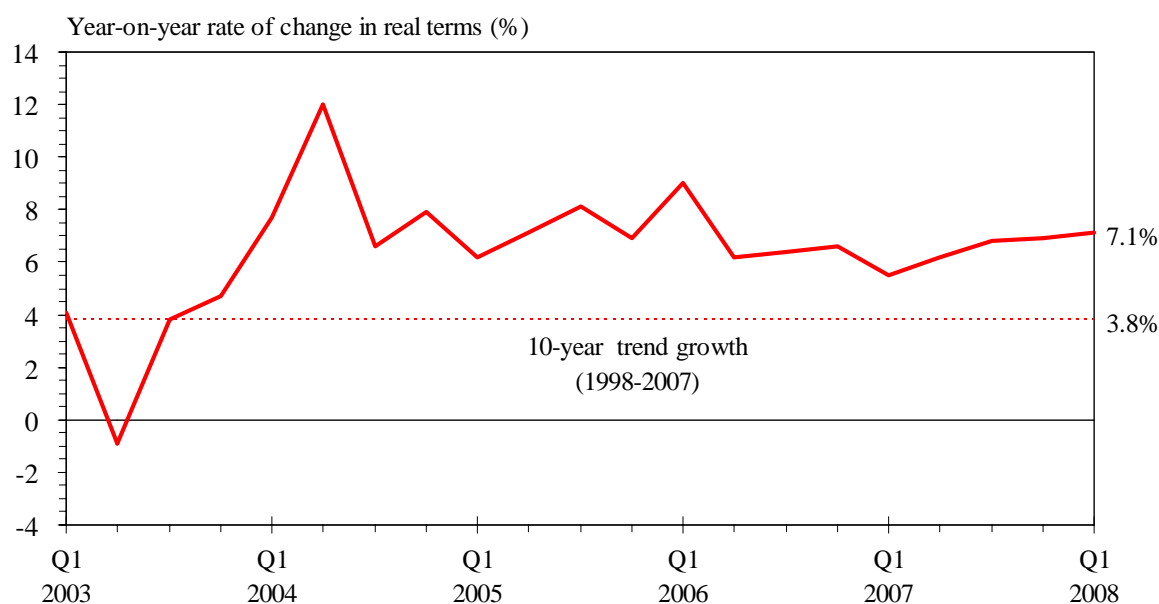
Introduction

This paper analyses latest development in the Hong Kong economy and briefly discusses the updated economic forecasts for 2008 as a whole released in mid-May.

Recent economic situation

2. The Hong Kong economy continued to expand strongly in the first quarter of 2008, despite the growing adversities in the external environment. With real GDP growing by 7.1%, the economy extended the run of distinctly above-trend growth to 18 quarters (*Chart 1*). Exports of goods and services remained strong despite a worsening US economy and the deepening global financial turbulence. Domestic demand also maintained its key role in propelling the economy forward.

Chart 1 : Economy grew strongly further despite growing adversities in the external environment



3. Total exports of goods grew by 8.3% in real terms in the first quarter (*Chart 2(a)*) despite the increasingly challenging trading environment and the still weak US market. Exports to the Mainland and many other emerging markets continued to record good growth. This together with the further solid expansion of the EU market more than offset the weakness of the US market.

4. Exports of services stayed vibrant, growing notably further by 10.8% in real terms in the first quarter (*Chart 2(b)*). Notwithstanding the global financial turbulence, exports of financial services continued to grow strongly, albeit slightly slower than in the preceding quarters. The strong inbound tourism and notable expansion of offshore trade also contributed.

Chart 2(a) : Exports of goods attained further notable growth

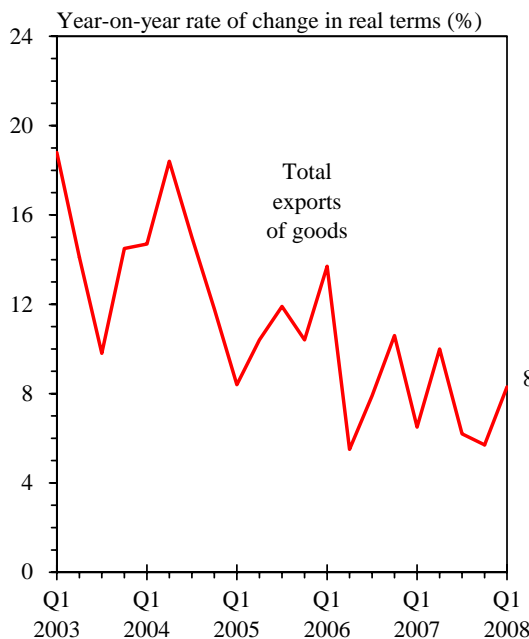
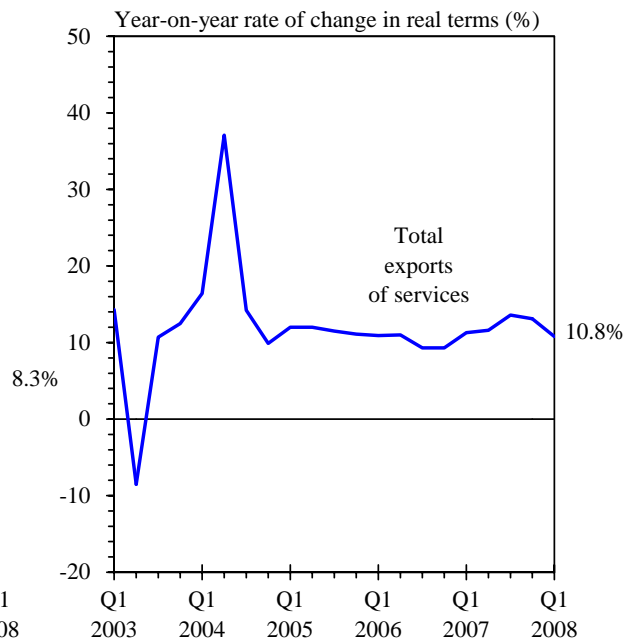


Chart 2(b) : Exports of services stayed vibrant



5. Domestic demand continued to play an important role in driving economic growth. Private consumption expenditure (PCE) rose markedly by 7.9% in real terms in the first quarter (*Chart 3(a)*), with consumer sentiments well supported by firm labour market conditions and rising incomes.

6. Overall investment spending was resilient to the dimmer global economic prospects, expanding by 8.9% in real terms in the first quarter of 2008 (*Chart 3(b)*). Machinery and equipment investment continued to rise notably by 6.0% in the first quarter, along with the continued economic

expansion. Indeed, the results of latest Quarterly Business Tendency Survey conducted by the Census and Statistics Department indicated that large business establishments were generally optimistic about the near-term business situation. Private sector activity in the construction sector rose modestly in the first quarter, while public sector activity rebounded notably from a low base. Taking altogether, overall expenditure on building and construction increased solidly by 5.2% in real terms in the first quarter of 2008. Also, the active property market led to a sharp increase in ownership transfers.

Chart 3(a) : Consumer spending remained strong

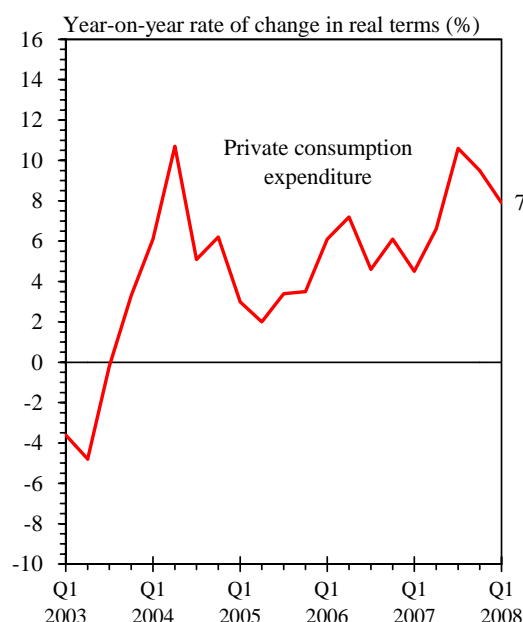
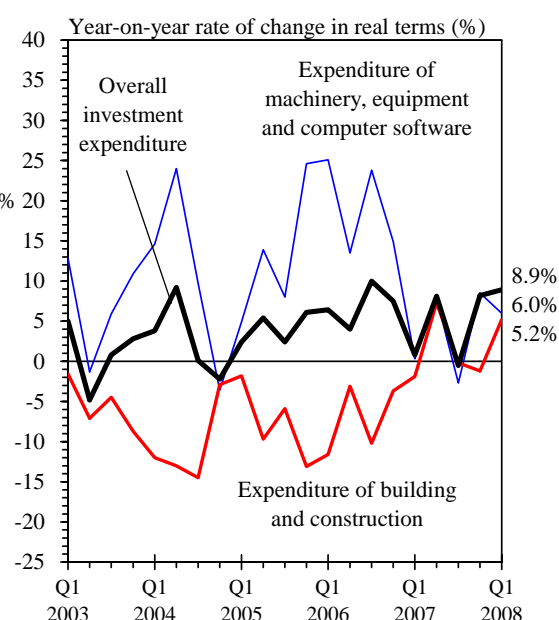


Chart 3(b) : Overall investment was resilient to the dimmer global economic prospect



7. The labour market stayed firm in the first quarter of 2008. The seasonally adjusted unemployment rate remained stable at 3.4% in the first quarter and edged slightly lower back to the ten-year low of 3.3% in the three months ending April. The underemployment situation showed more visible improvement in early 2008, with the underemployment rate falling further to 1.9% in the first quarter and to 1.8% in the three months ending April (*Chart 4*). Sustained vibrant economic growth continued to underpin job creation. On a year-on-year basis, there was an appreciable 2.2% increase in total employment in the first quarter, out-pacing the concurrent year-on-year increase of 1.1% in the total labour force (*Charts 5(a)*). According to the latest available data, the number of job vacancies in the private sector continued to increase strongly towards the end of 2007. Labour earnings, as measured by payroll per person

engaged in the private sector, also accelerated to a notable growth of 5.9% in money terms in the fourth quarter of 2007 (*Charts 5(b)*).

Chart 4 : Firm labour market in the first quarter of 2008 after considerable improvement towards the end of 2007

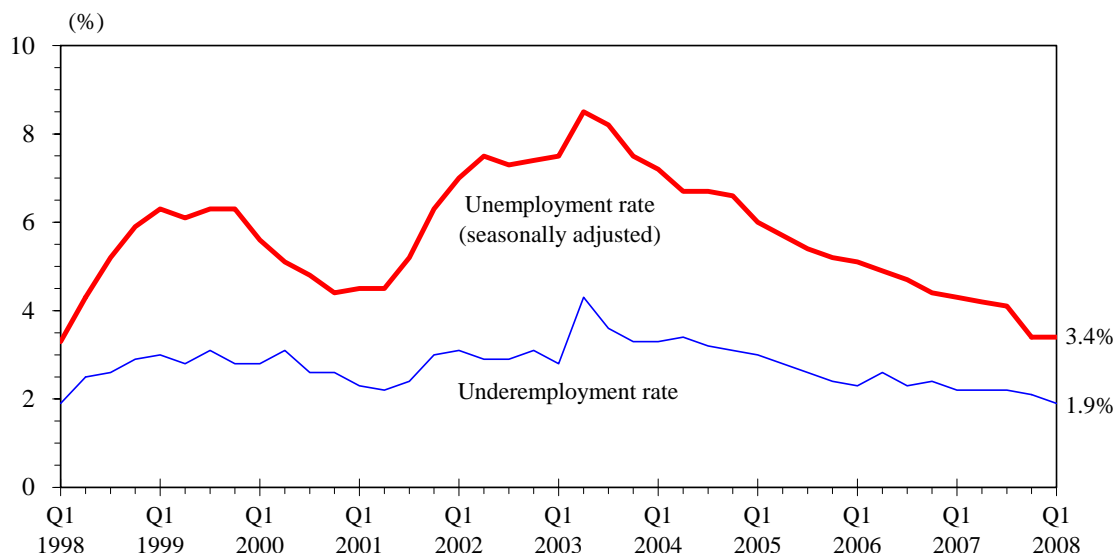


Chart 5(a) : Job creation is underpinned by sustained vibrant economic growth

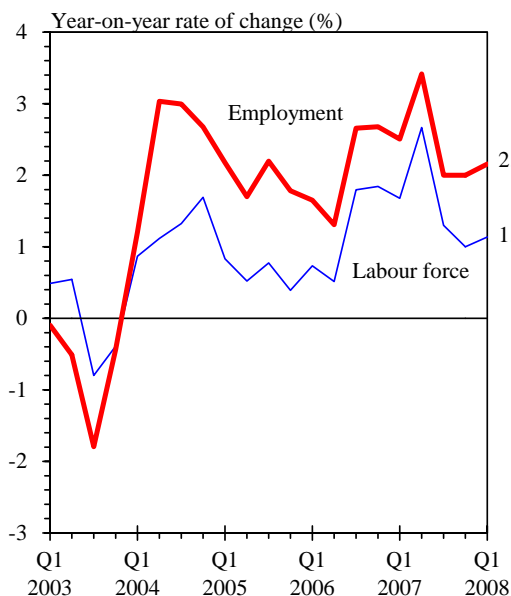
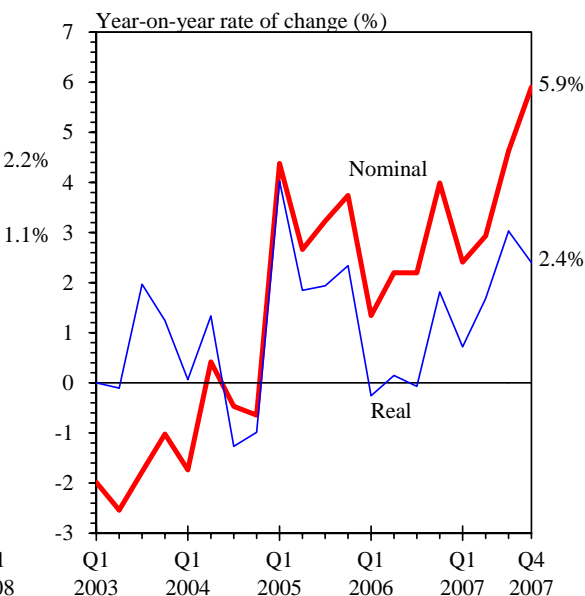


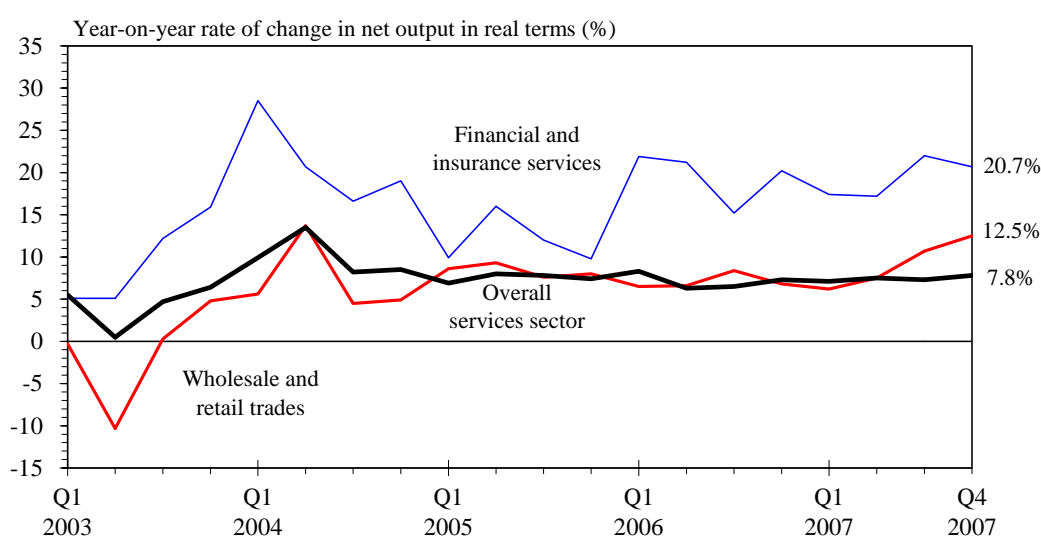
Chart 5(b) : Labour earnings accelerated towards the end of 2007



8. The services sector accounts for over 90% of the economy. Latest available figures indicate that net output in the services sector as a whole rose markedly by 7.5% in real terms in 2007. Financial services sector was again the star performer, growing at a double-digit rate throughout the year, on the

back of the rapid growth in the financial services industry as well as in the level of market activities. Real estate and business services also saw notable growth amidst the increasingly active property market and general business expansion. The rapid growth in net output of wholesale and retail trades as well as restaurants and hotels was supported by the strength in consumer spending and vibrant inbound tourism. However, the net output of the construction sector and manufacturing both declined (*Chart 6*).

Chart 6 : Financial services remained the star performer



9. The property market remained very active for most of the first quarter of 2008, but trading became quieter more recently, as market sentiment turned more cautious upon heightened uncertainties about global economic prospects and after property prices had increased considerably. Both the total number and value of sale and purchase agreements were significantly higher on a year-on-year comparison in the first quarter of 2008. But they were somewhat reduced as compared to their respective levels in the previous quarter (*Chart 7(a)*). Residential flat prices went up by an average of 6% during the first quarter of 2008. Home purchase affordability continued to improve during the quarter, along with rising incomes and lower mortgage rates. On the leasing front, the climb in flat rentals at 7% during the first quarter of 2008 was broadly similar to the increase in flat prices (*Chart 7(b)*). The rental yield for residential flats in March averaged at 4.1%. As for commercial and industrial premises, acquisition and leasing demand stayed firm in overall terms, underpinned by continued expansion in overall economic activity.

Chart 7(a) : Property market remained active in the first quarter, but with some cooling off more recently

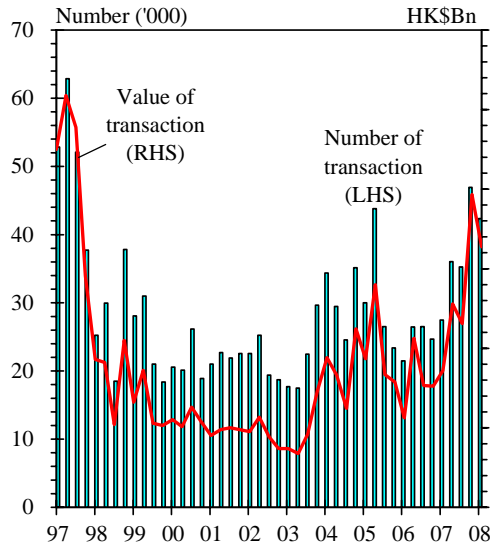
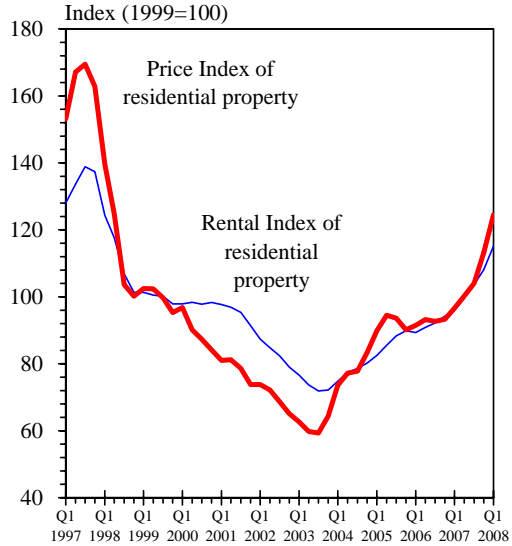
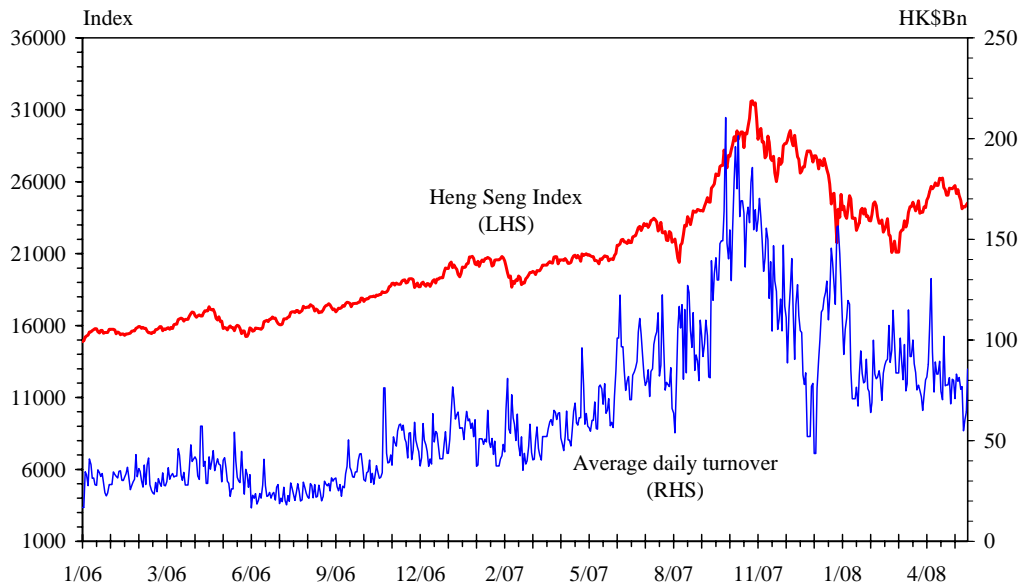


Chart 7(b) : Both flat prices and rentals went up further during the first quarter



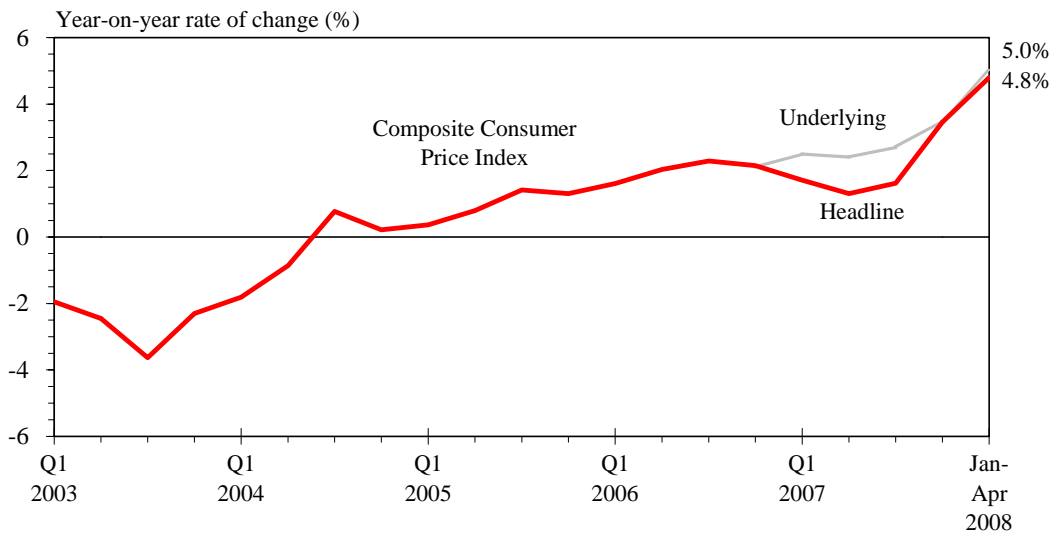
10. The local stock market showed a further downward correction during the first quarter of 2008, along with other major overseas equity markets, as investment confidence was shaken by the global credit crisis and the dimmer global economic prospects. The Hang Seng Index (HSI) closed the quarter at 22 849, 17.8% below the end-2007 level, though still higher by 15.4% over a year earlier. Average daily turnover shrank from \$130 billion in the fourth quarter of 2007 to \$98.7 billion in the first quarter of 2008, which was still higher than the \$88.1 billion recorded for the whole of 2007 (*Chart 8*). The local stock market rebounded in recent months, as concerns about the global financial market turbulence eased somewhat. The HSI rose back to 24 533 at end-May 2008.

Chart 8 : The stock market fell notably in the first quarter before regaining some lost ground



11. Consumer price inflation picked up further in recent months, mostly due to the surge in food prices amidst the global food inflation. The sustained strong economic growth also added to inflationary pressure from the demand side. Headline Composite CPI inflation averaged at 4.8% in the first four months of 2008. After netting out the effects of rates concession and public housing rental waiver, underlying Composite CPI inflation in the first four months was 5.0% (*Chart 9*).

Chart 9 : Inflation went up further in the first quarter amidst global food inflation



Updated short-term economic forecasts for 2008

12. Looking ahead, the external environment will remain uncertain and challenging. The US economy is likely to remain weak as the effects of the housing market downturn spread into the wider economy, while global financial markets are likely to remain unsettled. Economic activities in other major advanced economies have also showed signs of deceleration.

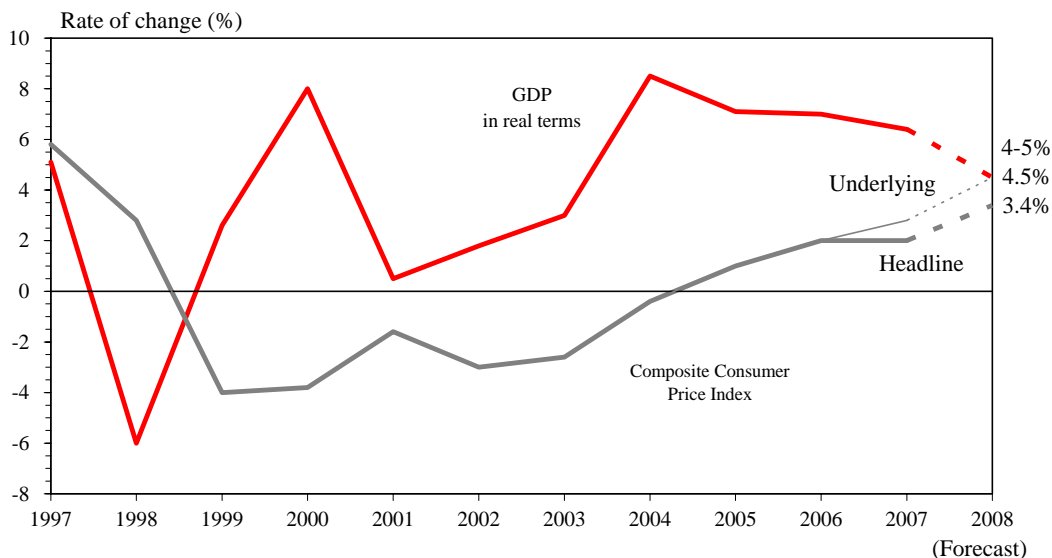
13. Nevertheless, the growth momentum in the emerging and developing economies, including the Mainland economy, is expected to remain vibrant, although there should unavoidably be some mild moderation in growth due to the weaker demand from the advanced economies. Yet this should still provide some cushioning effect to the impact of the slowdown of the major advanced economies on Hong Kong in the coming quarters. However, the effects of the macro-tightening measures in the Mainland need to be watched closely.

14. Domestic demand is expected to grow solidly further and remain a key driver in economic growth going forward. Firm labour market conditions and rising incomes should continue to give support to private consumption. As business confidence holds up well and interest rates remain low, there should also be further growth in investment spending in the rest of the year.

15. Overall, given the uncertainties prevailing in the external environment and dimmer global economic prospects, the GDP forecast at 4-5% as announced in the Budget round in February is kept unchanged (*Chart 10*). Yet with the strong GDP growth in the first quarter, and barring any abrupt external shocks, it is likely that GDP growth in 2008 should be close to the upper end of the forecast range. As a reference, private sector analysts are also projecting the Hong Kong economy to expand further at a solid pace, with prevailing forecasts averaging at around 4.7%.

16. The inflation outlook is rather uncertain as global food and crude oil prices, as well as exchange rates are volatile. But high commodity prices as well as the strength of the local economy are likely to continue to exert inflationary pressure in the coming months. Nevertheless, the sustained increase in labour productivity will provide some cushioning effect. In view of the high degree of uncertainties in the external environment, the forecast rate of increase in the underlying Composite CPI for 2008 is maintained at 4.5%. The corresponding forecast headline inflation rate is also kept unchanged at 3.4%. The risks to these forecasts are on the upside. The Government will review the inflation forecast as more incoming data become available.

Chart 10 : Barring any abrupt external shocks, 2008 should see another year of above-trend economic growth



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2 June 2008

Recent situation of household income⁽¹⁾

Background

This Annex provides a regular update on the movement of household income both in overall terms and with respect to households with monthly household income below \$4,000.

Latest situation

2. Supported by further growth in jobs and labour earnings, household income continued to increase generally over the past few months. Average monthly household income in Q1 2008, at \$28,900, was 7.0% higher in money terms than a year earlier. After discounting price changes, the gain was 2.3% in real terms. Also worth noting is that the share of households with monthly income between \$4,000 and \$16,000 (at current prices) decreased over the past year, while the share of households with less than \$4,000 and those with \$16,000 or above rose (*Table 1*).

Table 1: Distribution of domestic households by monthly household income

	<u>Q1 2005</u>	<u>Q1 2007</u>	<u>Q1 2008</u>
	<u>(%)</u>	<u>(%)</u>	<u>(%)</u>
Less than \$4,000	8.4	7.9	8.3
\$4,000 - \$7,999	13.8	12.9	11.7
\$8,000 - \$11,999	14.3	13.4	12.5
\$12,000 - \$15,999	12.5	12.0	11.4
\$16,000 - \$23,999	16.5	16.7	17.1
\$24,000 - \$39,999	17.5	18.5	18.9
\$40,000 - \$99,999	14.0	15.5	16.3
\$100,000 or above	2.8	3.0	3.7

Note : The purchasing power of the income (as measured by the Composite CPI) in Q1 2005 and Q1 2007 were 108% and 105% of that in Q1 2008 respectively.

(1) Foreign domestic helpers are not included in this analysis.

Households with monthly household income below \$4,000

3. In Q1 2008, the number of households with monthly household income below \$4,000 (“low-income households”) increased by 10 700 (or 6.1%) over a year earlier to 187 300. Increases were observed among two types of low-income households: the elderly households (i.e. with all members aged 60 or above) and the economically inactive households (i.e. with all members being economically inactive), by 11 200 and 1 800 respectively. Meanwhile, the number of economically active (i.e. with at least one economically active household members) low-income households continued to decline, conceivably due to the sustained improvement in labour market conditions which enabled more households with working members to move up the income ladder.

4. On top of analyzing the recent trends, comparison of the number and share of low-income households over a longer time horizon also reflects the significant change in Hong Kong’s demographics. Comparing Q1 2008 with Q1 1998, the rise in the low-income households in both absolute and proportional terms was mainly driven by a significant increase in the number of retired elderly households and a decline in the average household size (*Table 2*).

Table 2: Number and breakdown of low-income* households

	<u>Elderly households</u>	<u>Economically inactive households</u>	<u>Economically active households</u>	<u>Total</u>
Q1 1998	89 300 (4.6)	26 000 (1.3)	21 600 (1.1)	136 900 (7.1)
Q1 2005	119 600 (5.5)	30 900 (1.4)	33 200 (1.5)	183 700 (8.4)
Q1 2006	114 200 (5.2)	33 000 (1.5)	28 500 (1.3)	175 600 (8.0)
Q1 2007	114 000 (5.1)	36 600 (1.6)	26 000 (1.2)	176 600 (7.9)
Q1 2008	125 200 (5.6)	38 400 (1.7)	23 600 (1.0)	187 300 (8.3)

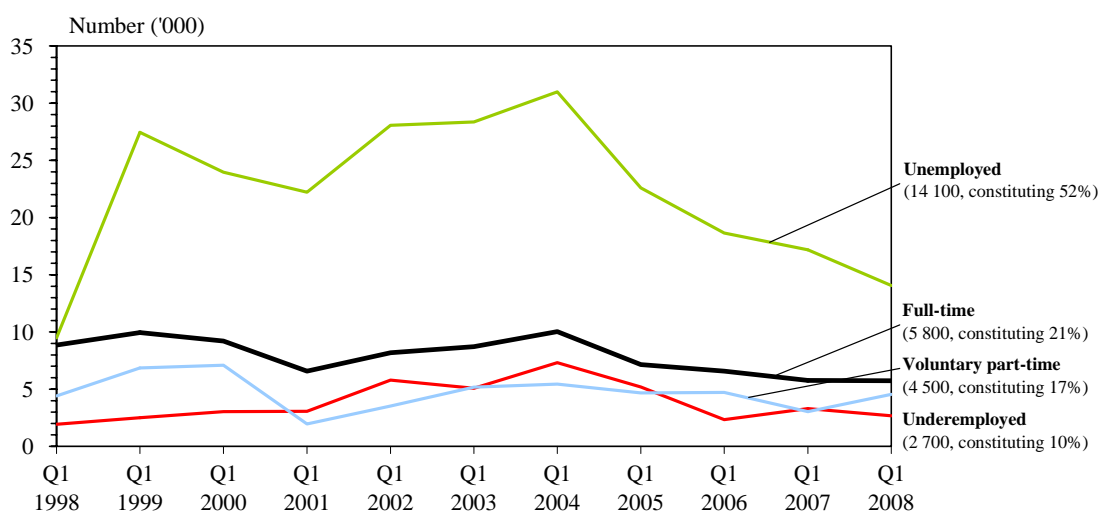
Notes : () Share in all domestic households.

* Low-income households refer to households with a monthly household income of \$4,000 or below.

5. A further breakdown of the low-income households yielded the following observations:

- Two-thirds of the low-income households in Q1 2008 were 1-person households, the majority of which (67%) were elderly persons aged 60 or above.
- There were 69 600 household members living in economically inactive low-income households. More than one-third (37%) of them were aged below 20 and aged 60 or above (mainly students and retirees). The bulk of the remaining 44 000 persons aged 20-59 were home-makers (22%), persons suffering prolonged illness (22%) and retirees (19%).
- Of the 27 100 economically active persons living in economically active low-income households, 52% were unemployed, 27% were part-time workers (working voluntarily for less than 35 hours per week, or involuntarily, i.e. underemployed), and the remaining 21% were full-time workers. (*Chart 1*).

Chart 1 : Composition of economically active persons in the low-income households*

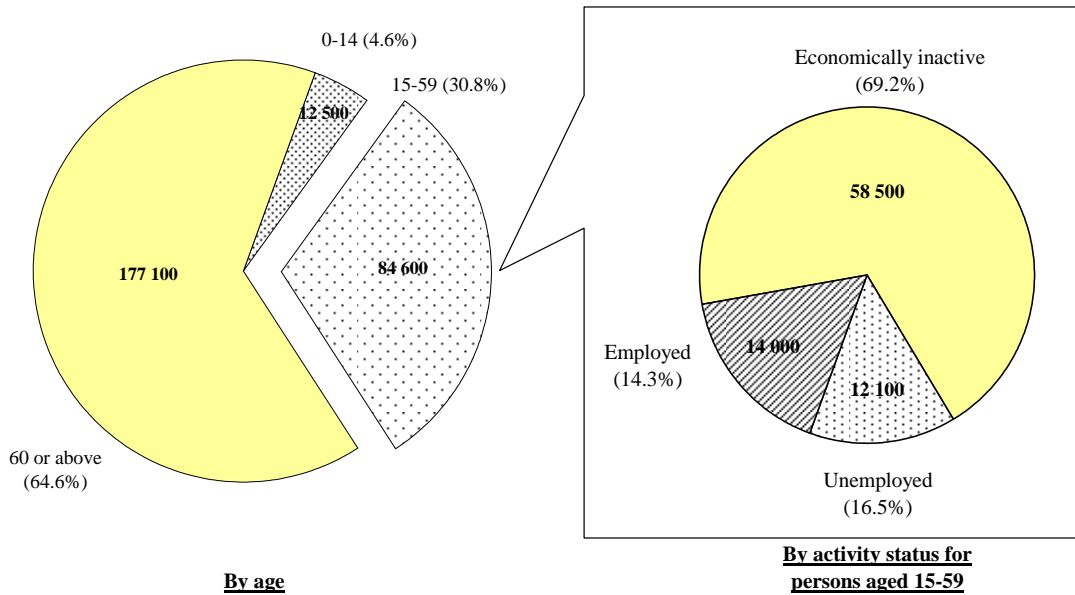


Notes : (*) This does not include economically active persons in the low-income households with elderly members only, but the numbers involved are insignificant.
 Figures in brackets represent the number of economically active persons in Q1 2008.

- 274 200 persons lived in low-income households in Q1 2008. A significant portion (64.6%) was elderly persons aged 60 or over. 31% of

them were aged 15-59, of whom nearly 70% were economically inactive (*Chart 2*).

**Chart 2 : Persons living in low-income households
by age and activity status, Q1 2008**



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2 June 2008

The Administration's response to the list of inflation-related issues attached to Clerk to Panel's letter dated 6 May 2008

This Annex gives the Administration's response to the list of inflation-related issues attached to Clerk to Panel's letter dated 6 May 2008.

Issue (a)

Background and factors leading to the current level of inflation in Hong Kong, the latest development of the inflationary trend and the forecast growth, if any, of inflation in Hong Kong

Response to Issue (a)

Inflationary pressures are building up around the world and, being an open economy, Hong Kong is not immune to this development. Hong Kong's consumer price inflation, in terms of the headline Composite CPI on a year-on-year comparison, averaged at 4.8% in the first four months of 2008. This was higher than the average of 2.0% in 2007. The underlying inflation rate, which nets out the effects of the one-off measures, including the public housing rental waiver for February 2007 and the rates concession, averaged at 5.0% in the first four months of 2008, up from 2.8% in 2007. The recent movements of the Composite CPI and the price indices for its major commodity/service groups are given in Table 1.

2. Inflation is closely related to the state of the economy. The strong global economic expansion over the past four years or so has been one of the important factors leading to higher global inflationary pressures. Similarly, by the first quarter of 2008 Hong Kong's economy has expanded at a distinctly above-trend pace for 18 months. Over the past four years, economic growth averaged at 7.2%. This represented one of the longest and strongest expansions in decades. In consequence, the unemployment rate has fallen to a more than ten-year low, the financial positions of most families have improved significantly, investor and consumer confidence stay upbeat, and wages and

rentals are on the rise. With the strengthening demand conditions, inflationary pressures in Hong Kong have been building up over the past few years.

3. Yet the more distinct pick-up in inflation in Hong Kong over the past two quarters or so has much to do with the global food inflation. Excluding the food items, headline consumer price inflation was notably lower at 2.8% in the first four months of 2008.

4. There are a number of factors contributing to the current tight situation in international food markets. *Firstly*, the strong economic growth in developing economies, coupled with their faster population growth, has led to stronger demand for food. *Secondly*, the weather conditions and other special supply-side factors have not been accommodating over the recent past. The disruption to pig supply due to blue-ear disease in the Mainland last year, the severe snowstorms that affected the Mainland in early 2008, the cyclone in early May that devastated the southern part of Myanmar, a rice producing region, and the recent mega earthquake in Sichuan are the recent examples. *Thirdly*, the increasing demand for bio-fuels, partly due to the energy policies of some advanced countries, has led to more food crops being used in bio-fuel production. This has also resulted in higher costs of feedstock, pushing up prices of meat and dairy products. *Fourthly*, industrialization and urbanization in developing economies have led to less agricultural land. According to the world food price index compiled by the IMF, world food prices on average rose by 41% in the first four months of 2008 over a year earlier. As Hong Kong relies much on imports for meeting its food consumption, our food prices have inevitably been affected by these external developments.

5. Although Hong Kong is not an oil dependent economy, the recent sustained surge in oil prices in the international markets also added to inflationary pressures. For example, the Brent crude oil saw an increase of 65% of its price in the first four months of 2008 over a year earlier. In tandem, Hong Kong's import prices of fuels rose markedly by 42% in the first quarter of 2008 over a year earlier. The increase in energy prices directly contributed about 0.3 percentage point to the 4.8% headline inflation rate in the first four months of 2008.

6. Rising private housing rentals are the largest domestic source of inflationary pressures. This reflects the stronger demand for housing amidst

rising income and brisk economic expansion. If the food and housing components are taken out, consumer price inflation was only 1.6% in the first four months of 2008. This indicates that the productivity growth in the local economy has helped to contain the rise in business costs in many sectors, thus providing some cushioning effect to inflation.

7. The near-term outlook for inflation depends much on food prices in the international markets, which are expected to be rather volatile. Apart from food prices, the elevated oil and other commodity prices, the weakness of the US dollar, the renminbi appreciation, as well as the strength of the local economy will all continue to exert inflationary pressures going forward. The underlying inflation rate for 2008 as a whole is forecast at 4.5%. Taking into account the various relief measures announced by the Government, which would help to lower the Composite CPI, the headline inflation rate in 2008 is forecast at 3.4%. The risks to these forecasts are on the upside. The Government will continue to monitor closely the situation and review the forecast when more incoming data are available.

8. Over the medium term, inflation is likely to remain an issue. However, we need not be overly pessimistic. Inflation in Hong Kong will be influenced by the future development of global inflation as well as by domestic developments.

9. On the global front, price stability in the medium term remains the prime objective of the central banks in the US and Europe. The Mainland is also stepping up efforts to keep inflation under control. With the incentives provided by higher food prices, world food supply will gradually improve. Moreover, the expected slower pace of expansion of global economic activity over the coming year or so will also take some steam off global inflationary pressures and contain the increases in commodity prices. As evidenced by the prevailing levels of medium and long-term interest rates in the US and Europe, expected inflation in the coming years remains relatively mild in the advanced economies.

10. Domestically, rising wages and rentals will exert upward pressure on prices. This will nevertheless be cushioned by the sustained growth in labour productivity. Over the past four years, Hong Kong's labour productivity

growth averaged at 4.9%, which fared much better than in many other places and had helped to contain the rise in unit labour cost and hence inflationary pressure. In addition, Hong Kong's economic growth is expected to moderate to a more sustainable level over the medium term, this will also reduce some inflationary pressure. Moreover, the efforts made by the Government to invest in education, training and re-training and infrastructure projects will enhance productivity and enlarge the productive capacity of the economy, thereby helping to reduce inflationary pressures as well.

Issue (b)

To what extent is the current inflation attributable to the Linked Exchange Rate system; and whether the inflationary pressure on Hong Kong can be alleviated if a more flexible exchange rate policy is adopted

Response to Issue (b)

11. As discussed under the response to Issue (a) above, the recent pick-up in inflation in Hong Kong has been mainly driven by the surge in global food and energy prices on the external front and the sustained above-trend economic expansion on the domestic front. The increase in such prices in Hong Kong largely reflected the surge in prices in the import sources. By comparison, the impact of the weakening of the Hong Kong dollar, along with the US dollar under the Linked Exchange Rate System (LERS), is of a lesser importance in explaining the recent inflation situation.

12. In terms of the Trade-weighted Nominal Effective Exchange Rate Index, the Hong Kong dollar depreciated by an average of 6.9% in the first quarter of 2008 from a year earlier. Over the same period, the increase in Hong Kong's overall import prices was much smaller, at 3.6%, which reflected not only the effect of exchange rate changes but also inflation in the import sources. Specifically, import prices of consumer goods rose by 3.7%. By comparison, excluding food and housing items, the Composite CPI rose by only 1.6% in the first quarter of 2008 over the same quarter last year.

13. The above observations are consistent with the results of a recent research by the Hong Kong Monetary Authority, which show that a 10% depreciation of the US dollar against all currencies except for the Hong Kong

dollar would lead domestic prices to increase by 0.8% in the short run and 1.6% in the medium run. These findings about the relative low pass-through of exchange rate changes to consumer prices are also broadly in line with the experiences of other advanced economies in recent decades.

14. In fact, the building up of inflationary pressures is a global phenomenon. Many other economies, despite their more flexible exchange rate regimes and the strengthening of their currencies against the US dollar, are also experiencing sustained inflationary pressures. Figures on the consumer price inflation and exchange rate movements in selected economies are given in Table 2. Hong Kong's inflation rate in the first quarter of 2008 was lower than those in a number of economies, and not much higher than in the US and the EU. This suggests that the exchange rate system is not an important factor in accounting for the current round of inflation, and hence changing the LERS is not the solution to the current inflation issues facing Hong Kong.

15. Monetary policy objective in Hong Kong is exchange rate stability, rather than to target inflation rate. The effectiveness of LERS should be judged based on its ability to deliver monetary and financial stability through economic cycles, and should not depend on the cyclical conditions at a particular juncture. Although Hong Kong does not pursue a discretionary monetary policy to reduce inflationary pressures, the Hong Kong Monetary Authority has stepped up prudential supervision to ensure that financial institutions behave prudently in an environment of rising inflation and volatile asset prices.

16. The LERS is the cornerstone of Hong Kong financial system and provides Hong Kong with a firm monetary anchor which, among other things, reduces the foreign exchange risk faced by importers, exporters and investors. The LERS has served Hong Kong well since its establishment, helping Hong Kong to weather numerous external shocks. It is important for facilitating Hong Kong economic development and for maintaining the status of Hong Kong as an international financial centre. The LERS is an immutable policy and there is no intention or plan to change or abandon it.

Issue (c)

The consequences of inflation; notably the general rise in prices, the soaring

cost of living, and the impact on people's livelihood and on Hong Kong's economic development

Response to Issue (c)

17. The trend of inflation is closely related to the state of the economy. During 1998-2003, Hong Kong's economic growth averaged only 1.6% per annum, way below its trend growth rate. It was a period when the Hong Kong economy experienced significant difficulties after being hit by a series of external shocks. It was also a period when Hong Kong experienced protracted deflation, seeing falling prices, rentals and incomes. Falling prices on a large scale are often a reflection of the weakness of, or inadequate demand in, the economy. Thus, a low rate of inflation is not necessarily bad for the economy. Indeed, moderate inflation allows prices to change to balance the demand and supply conditions more effectively, and is part and parcel of the normal adjustment mechanism of a market economy.

18. Living standards of the people would not decline if the increase in their income is on par or faster than inflation. The latest earnings statistics indicate that labour income, in terms of payroll per person engaged, rose by an average of 5.9% in the fourth quarter of 2007, which was faster than the inflation rate. More recent data from the General Household Survey indicated that the overall average monthly employment earnings (excluding foreign domestic helpers) accelerated to a year-on-year growth rate of 7.1% in money terms in the first quarter of 2008. Further analysis shows that this increase was mainly driven by surging earnings of the higher skilled workers. While earnings growth for workers at the lower end of the skills spectrum also picked up in recent few months, it still remained moderate and lagged behind inflation. Thus in general the higher-skilled workers should have been able to maintain or improve their living standards despite the higher inflation. However, incomes for some lower-skilled workers may not have increased as fast and therefore could have suffered from a deterioration of living standards.

19. The Government is very concerned about the impact of inflation on the livelihood of the disadvantaged and the lower-income groups. As expenses on food usually account for a larger share of a lower-income household than a higher-income one, the recent surge in food prices should have affected them more. In the Policy Address last year and the Budget this year, the

Government announced a series of measures with a view to assisting these people. More details are given in the response to Issue (d).

20. Specifically on the impact of inflation on the lower-income groups, it should be noted that public housing rentals also account for a large share of their expenditures. Based on the data from the Census and Statistics Department, for the 10% of households in the lowest household expenditure range (excluding households receiving Comprehensive Social Security Assistance (CSSA)), about 35% of their household expenditures are spent on food (including meals bought away from home) and about 19% on public housing rentals. Therefore, the 11.6% reduction in public housing rentals since August last year has helped these people to cushion against the faster rise in food prices. Likewise, the Government's one-month public housing rent payment proposal to be implemented later this year will also help to alleviate their hardship. On the basis of the expenditure pattern of these 10% of households in the lowest expenditure range, the rate of consumer price inflation applicable to them can be broadly estimated. The comparison with the movements of the Composite CPI is given below. Generally speaking, the inflation rates facing these households (especially for those living in public rental housing) over the recent past were on average lower than those facing an average household in Hong Kong.

Year-on-year rate of change

	<u>Composite CPI</u>	CPI for households in the lowest <u>expenditure range[#]</u>
	(%)	(%)
2006	2.0	1.4
2007	2.0	-1.0
2008 Jan	3.2	1.2
Feb	6.3*	23.8*
Mar	4.2	2.0
Apr	5.4	4.9

Notes: (#) Based on the expenditure pattern of the 10% of households in the lowest expenditure range, excluding those receiving CSSA.

(*) The sharp increase in February 2008 reflected the very low base in February 2007 due to the public housing rental waiver in that month.

21. Inflation may have an impact on economic development as it could undermine the competitiveness of the economy. But in Hong Kong's current circumstances, inflation is more a consequence of brisk economic expansion. The Hong Kong economy continued to grow strongly by 7.1% in the first quarter of 2008, despite the higher inflation rate. In fact, the current inflation rate would not cause noticeable disruptions to economic growth.

22. The Hong Kong economy's competitiveness could be negatively affected if our inflation rate is sustained at a much higher level than our competitors in the world market. But as shown in Table 2, the current rate of inflation in Hong Kong is still comparable to those prevailing in most of our trading partners. Moreover, exchange rate movements are also of critical importance in determining the external competitiveness of Hong Kong's exports of goods and services. Over the past year or so, the weakness of the Hong Kong dollar, along with the US dollar, has actually helped to increase our price competitiveness.

23. A common measure of the relative price competitiveness of an economy is its real effective exchange rate index, which takes into account the combined effects of nominal exchange rate movements and the differences in price movements between the economy concerned and its major trading partners. The Trade-weighted Real Effective Exchange Rate Index fell by 7.4% in the first quarter of 2008 from the same period last year, which is even slightly larger than the corresponding change of 6.9% in the Trade-weighted Nominal Effective Exchange Rate Index. In other words, the price competitiveness of Hong Kong's goods and services has increased over the period, mainly due to the depreciation of the Hong Kong dollar and also helped by the fact that inflation in Hong Kong is comparable or even lower than its major trading partners. This is also one of the factors underlying the vibrant performance of Hong Kong's external sector in recent periods, notwithstanding the increasingly challenging trading environment.

24. Amidst an inflationary environment, companies may face a faster increase in business costs. There may also be greater upward pressures on wages. Yet it is worth noting that labour productivity growth in Hong Kong has been strong, averaging at 4.9% per year over the past four years. A similar rate of increase was attained in the first quarter of 2008. As a result, the

upward pressure on unit labour cost is rather moderate. In fact, wage increases which are commensurate with productivity improvements need not be inflationary. By improving productivity and efficiency, companies would be in a better position to maintain its competitiveness.

25. A high rate of inflation could also lead to faster increases in asset prices, particularly if interest rates are low and the economy is strong. Given the Linked Exchange Rate System, interest rates in Hong Kong are determined to a large extent by interest rates in the US dollar. But the Government will provide adequate land to the market to meet demand to ease the upward pressure on property prices and rentals.

Issue (d)

The policy stance adopted by the Government to deal with inflation, the strategies and action plans, if any, to alleviate the hardship resulting from inflationary pressure on the public; as well as the effectiveness or otherwise of such measures

Response to Issue (d)

26. As discussed above, inflation in Hong Kong is driven by developments in the external environment and the state of the domestic economy. Given the small and open nature of the economy, and that Hong Kong is a free market economy, changes in prices are part and parcel of the adjustment mechanism to balance demand and supply, and to enable the economy to adapt quickly to changes in the external environment. Administrative interventions in the free market price setting process are generally undesirable and have many unintended consequences. Yet the Government will do its best to reduce inflationary pressures in general and mitigate the impact of inflation on the community.

27. To contain inflationary pressures, it is important to ensure the supply of goods, especially food supply in the present circumstances, to ensure open and free competition, and to enhance the efficiency and productivity of the economy. The Government has been pursuing the following measures and will continue to

- enhance communications with the Mainland authorities and other import sources to ensure a stable supply of food for Hong Kong;
- ensure effective market competition at the import and retail levels so that consumers can enjoy a wider range of product choices at competitive prices;
- provide adequate land to meet market demand through an efficient land disposal and modification of land use system in order to ease the upward pressure on property rentals and prices;
- progressively liberalizing the regime on the admission of talents and professionals so as to enhance the overall productivity of the labour force; and
- enhance the productivity of the labour force through investment in education, training and re-training, as well as enlarge the productive capacity of the economy through investment in infrastructure projects. When the ten major infrastructure projects announced in last year's Policy Address are completed, they will raise the efficiency and enlarge the capacity of the Hong Kong economy significantly.

28. The Government is very concerned about the impact of inflation on the disadvantaged and the lower-income groups. Apart from promoting economic development and hence generating more employment opportunities for the lower skilled, a wide range of social support efforts is in place to help the needy, in areas such as social security, medical and health, public housing, education and promoting community support networks. The Government has also been adopting actively a multi-pronged approach to alleviate the hardship of the less well-off community, including the various relief measures announced in the Budget, as well as such other measures as the pilot Transport Support Scheme, promotion of social enterprises to facilitate job creation, and Wage Protection Movement for cleaning workers and security guards.

29. Specifically, in the 2008/09 Budget, the Government announced various measures to relieve the hardship of the disadvantaged and lower-income groups. These measures include:

- providing one additional month of the standard rate CSSA payments for CSSA recipients, one additional month of allowance for recipients of Disability Allowances and a one-off grant of \$3,000 to Old Age Allowance recipients;
- advancing the adjustment of the CSSA standard payment rates ahead of the normal schedule in accordance with the existing mechanism around the middle of this year;
- paying one-month's rent on behalf of lower income families living in the rental units of the Hong Kong Housing Authority and the Hong Kong Housing Society;
- relaxing the pilot Transport Support Scheme; and
- granting of electricity charge subsidy of \$1,800 for each residential electricity account.

30. It is estimated that the measures of paying one month's rent on behalf of lower income public housing tenants and electricity charge subsidy, together with the rates concession, will directly lower the headline Composite CPI by about 1.1 percentage points in 2008. The Government will continue to monitor closely the inflation trend and its impact on households especially those at the grassroot level.

Issue (e)

How inflation in Hong Kong compares with that in other jurisdictions, the approaches taken by other governments to curb inflation and ease inflationary pressure on people's livelihood, and how far overseas experience can serve as reference for Hong Kong

Response to Issue (e)

31. The creeping up of inflation over the recent past is a worldwide phenomenon. Consumer price inflation in Hong Kong, averaging at 4.6% in the first quarter of 2008 on a year-on-year comparison, was lower than or broadly comparable to those in the economies in the region, and not much

higher than those in such advanced economies as the US and the euro zone, while the economic performance of Hong Kong is relatively strong among these economies. A comparison of inflation in Hong Kong with other selected economies is given in Table 2.

32. The approaches adopted by economies at a stage of development comparable to Hong Kong to curb inflation and to ease inflationary pressure on people's livelihood can be broadly divided into the following: (i) macroeconomic management policies, particularly discretionary monetary policy, (ii) administrative or fiscal measures to control/regulate prices, (iii) measures to facilitate supply and enhance efficiency and competitiveness, and (iv) financial assistance to the needy.

33. The use of discretionary monetary policy is the major policy tools used by advanced economies such as the US, the UK and the euro zone to fight inflation. However, many of them have to balance the upside risks to inflation with the downside risks to economic growth when they exercising their monetary policies. For a small open economy, there is always the question of whether the monetary policy is effective in curbing inflation given its limited power in controlling interest rates in view of the large capital inflows and outflows. For instance, in the case of Singapore the major macroeconomic policy instrument is the exchange rate. The Singapore dollar has been appreciating against the US dollar, but consumer price inflation has remained elevated in recent months, at over 6%. For reasons explained in response to Issue (b) above, the use of discretionary monetary policy is deemed not appropriate in the case of Hong Kong.

34. In the advanced economies, with a mature market system, the use of price controls in the form of freezing price changes as a means to curb inflation is rare. Discretionary administrative measures to control prices are more frequently used in economies where the public sector is an important supplier of public utility and transport services or where the government is traditionally influential in private business operations. For examples, Korea has frozen electricity rates and other public utility fees such as transportation and water charges, and would also reduce import tariffs on fuels and exempt import tariffs on agriculture products. Taiwan has reduced tariff rates on several agriculture products such as wheat and wheat flour until August 2008, and maintained a freeze on the prices of utilities such as water, electricity, liquefied petroleum gas

and fuel oil. In the case of Hong Kong, which is already a free port, the reduction of import tariffs is not applicable. Direct interventions into the price adjustment mechanism are generally not desirable. As to the fee/fare adjustment applications by the public utility and transport operators, the Government considers a range of factors when examining these applications, including the cost pressures on the operator concerned as well as the affordability of the public, according to the established procedures.

35. Some governments in the region also emphasized the need to meet the housing needs of the people in the face of higher inflationary pressure. For example, in Singapore, a policy measure is to provide subsidized housing for lower-income individuals to rent or own. In Korea, the government announced that it will make sure that 500 000 homes be built nationwide. In Hong Kong, the Government will ensure that public rental housing is provided for families which cannot afford rental accommodation in the private sector and that there is adequate supply of land to meet market demand.

36. In its Budget announced in February 2008, the Singapore government also emphasized the need to diversify food sources and to keep the economy competitive as the means to contain inflation. These are broadly similar to our own efforts.

37. Providing additional financial assistance to the disadvantaged and the lower-income groups to help them to weather the impact of inflation is also common in the economies in the region. As detailed in the response to (d), in Hong Kong the Government has also pursued this approach to help the needy.

38. It is worth noting that different economies, given their own economic and social characteristics, would pursue different combinations of policy approaches to deal with the problem of inflation. In Hong Kong, the Government has pursued a mix of policy measures deemed appropriate to Hong Kong's own unique circumstances to deal with the problem, and will continue to monitor closely the developments with a view to relieving the inflationary impacts on the community, particularly those at the grassroots.

Table 1 : Composite Consumer Price Index by component
(year-on-year rate of change (%))

<u>Expenditure component</u>	<u>Weight (%)</u>	<u>2007</u>	<u>2007</u>				<u>2008</u>	
			<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>	<u>Q1</u>	<u>Apr</u>
Food	26.94	4.3	2.9	2.8	4.8	6.7	10.0	11.1
<i>Meals bought away from home</i>	16.86	2.5	1.8	2.0	2.6	3.7	5.4	6.0
<i>Other foodstuffs</i>	10.08	7.1	4.4	4.1	8.2	11.6	17.4	19.4
Housing ^(a)	29.17	2.0	2.2	1.0	0.7	4.2	3.9	5.5
<i>Private dwellings</i>	23.93	4.0	5.6	2.0	2.3	5.9	3.5	7.5
<i>Public dwellings</i>	2.49	-17.7	-31.7	-10.5	-17.8	-10.8	14.4	-13.0
Electricity, gas and water	3.59	-0.7	-1.3	-2.2	-2.7	3.4	7.2	8.7
Alcoholic drinks and tobacco	0.87	-1.2	-3.9	-0.1	-1.1	0.5	0.5	0.2
Clothing and footwear	3.91	4.1	7.2	3.9	3.7	2.0	1.6	1.4
Durable goods	5.50	-4.7	-5.8	-4.6	-4.2	-4.0	-3.5	-3.1
Miscellaneous goods	4.78	2.5	2.8	1.8	2.1	3.4	4.6	5.2
Transport	9.09	-0.1	-0.6	-0.5	-0.1	0.7	1.3	2.0
Miscellaneous services	16.15	1.7	2.2	2.2	1.3	1.0	1.3	0.6
All items	100.00	2.0	1.7	1.3	1.6	3.5	4.6	5.4
		(2.8)	(2.5)	(2.4)	(2.7)	(3.5)	(4.9)	(5.4)
All items excluding food	73.06	1.2	1.3	0.7	0.5	2.3	2.6	3.3
		(2.2)	(2.4)	(2.2)	(1.9)	(2.3)	(3.0)	(3.3)
All items excluding food and housing	43.89	0.6	0.8	0.6	0.3	0.9	1.6	1.7

Notes : (a) The housing component covers rents, rates, Government rent, maintenance costs and other housing charges. Its sub-components on private and public dwellings as presented here, however, cover rents, rates and Government rent only. Hence, the combined weighting of private and public dwellings is slightly less than the weighting of the entire housing component.

() Figures in brackets are the underlying inflation rates, which net out the effect of all relevant one-off measures, specifically, the lower base effect of public rental waiver in February 2007, and the rates concession in the second and third quarters of 2007 and the first quarter of 2008.

Table 2: Inflation and exchange rate developments in selected economies
(year-on-year rate of change)

	Consumer price inflation								Currency appreciation (Against the US dollar)
	2007						2008		2008
	2006	2007	Q1	Q2	Q3	Q4	Q1	Apr	Q1
<i>Selected industrialised economies</i>									
US	3.2	2.9	2.4	2.7	2.4	4.0	4.1	3.9	--
EU	2.3	2.4	2.2	2.2	2.1	3.0	3.5	3.6	14.3%
Euro area	2.2	2.1	1.9	1.9	1.9	2.9	3.4	3.3	14.3%
Japan	0.2	0.1	-0.1	-0.1	-0.1	0.5	1.0	0.8	15.5%
<i>Major Emerging economies</i>									
Mainland of China	1.5	4.8	2.7	3.6	6.1	6.6	8.0	8.5	8.3%
Russia	9.7	9.0	7.7	7.9	8.9	11.4	12.9	14.3	8.5%
India	6.3	6.4	7.0	6.3	6.7	5.5	6.3	n.a.	10.9%
<i>Selected Asian economies</i>									
Hong Kong	2.0	2.0	1.7	1.3	1.6	3.5	4.6	5.4	--
Singapore	1.0	2.1	0.5	1.0	2.7	4.1	6.6	7.5	8.7%
Korea	2.2	2.5	2.0	2.4	2.3	3.4	3.8	4.1	-1.8%
Taiwan	0.6	1.8	1.0	0.3	1.5	4.5	3.6	3.9	4.3%
Indonesia	13.1	6.4	6.4	6.0	6.5	6.7	7.6	9.0	-1.6%
Malaysia	3.6	2.0	2.6	1.5	1.8	2.2	2.6	3.0	8.4%
Thailand	4.6	2.2	2.5	1.9	1.6	2.9	5.0	6.2	5.9%
Macau	5.2	5.6	4.6	4.9	6.1	6.7	9.1	8.7	--
<i>World (IMF data)</i>	3.5	3.8	3.4	3.5	3.8	4.7	n.a.	n.a.	n.a.

Notes: n.a. Not available.
-- Not applicable.