



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

The Government released the Third Quarter Economic Report 2008 in mid-November. 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 the most recent period, summarises the updated economic forecasts by the Government for 2008 as a whole, and briefly discusses the various factors which may affect the outlook in 2009.

Economic Analysis Division  
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# Recent Situation and Near-term Outlook For the Hong Kong Economy

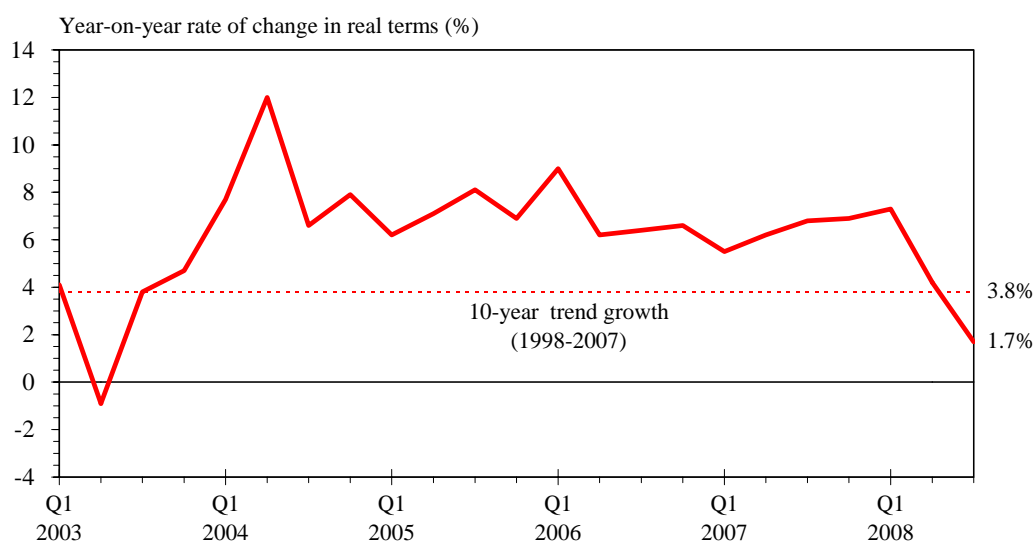
## Introduction

This paper analyses latest developments in the Hong Kong economy and briefly discusses the updated economic forecasts for 2008 as a whole and the economic outlook for 2009.

## Recent economic situation

2. The growth of the Hong Kong economy slowed notably further in the third quarter, as the external sector slackened amid the faltering global demand and as domestic demand towards the end of the quarter was severely hit by the outbreak of the global financial tsunami causing significant jitters in the local asset markets. GDP expanded by 1.7% in the third quarter from a year earlier, down notably further from 4.2% in the second quarter (*Chart 1*). On a seasonally adjusted quarter-to-quarter comparison, GDP fell further by 0.5% in real terms in the third quarter, after a contraction of 1.4% in the second quarter.

**Chart 1 : Economic growth slowed notably further  
in the third quarter**

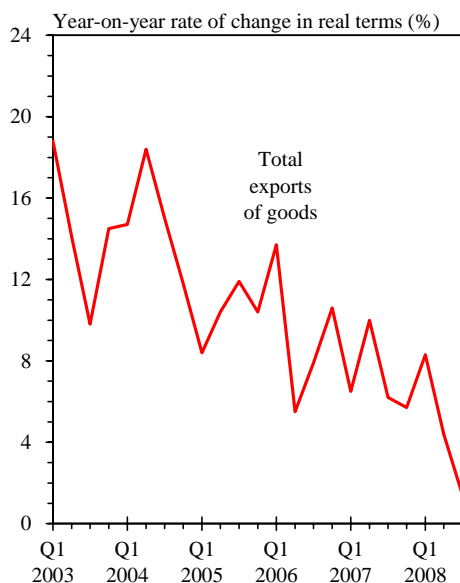


3. Total exports of goods decelerated further to a modest growth of 1.4% in real terms in the third quarter over a year earlier (*Chart 2(a)*), the lowest growth since the first quarter of 2002. The rapidly slowing demand in the

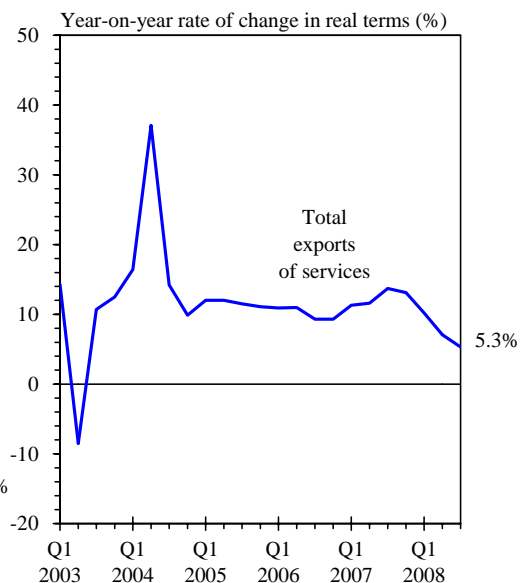
advanced economies had directly hit Hong Kong's exports to these economies, notably the US. Intra-regional trade also slowed as a result, as reflected in different extent of moderation in Hong Kong's exports to many other economies in the Asian region.

4. Exports of services grew by 5.3% in the third quarter, though likewise moderated from the second quarter (*Chart 2(b)*). This partly reflected the influence of a temporary fall-off in inbound tourism during the Olympic Games period, with spillover to exports of transportation services. But more importantly, the slow-down was due to a further deceleration in exports of financial services amid the financial market distress on a global-wide basis. Yet offshore trade continued to grow notably, thanks to the Mainland's still vibrant trade flows.

**Chart 2(a) : Total exports of goods decelerated in the third quarter**



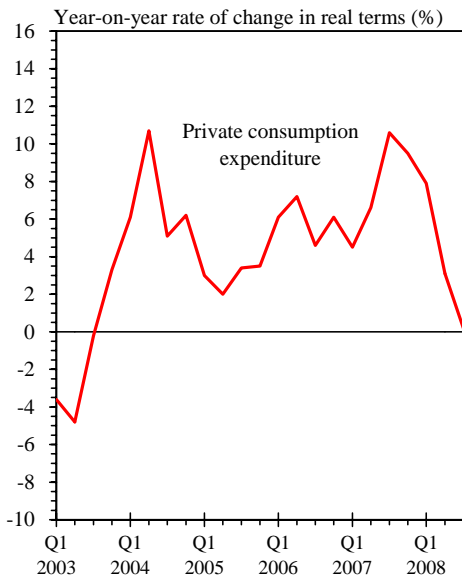
**Chart 2(b) : Exports of services grew solidly in the third quarter**



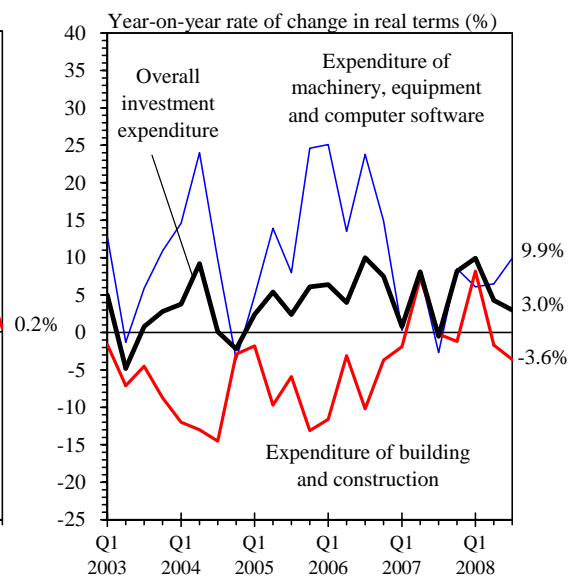
5. Consumer spending still held rather firm in July and August, but slackened distinctly in September in the face of the asset market corrections amidst the financial market jitters and increasing concern over global economic outlook. Private consumption expenditure (PCE) rose marginally by 0.2% in real terms in the third quarter (*Chart 3(a)*), compared with a distinctly high base of comparison a year ago when PCE at that time grew by 10.6%. Yet when compared with the second quarter, consumption still grew by 0.3% on a quarterly seasonally adjusted basis.

6. Overall investment spending saw some further growth of 3.0% in the third quarter of 2008 over a year earlier (*Chart 3(b)*). Machinery and equipment investment rose notably by 9.9% in the third quarter. But overall expenditure on building and construction continued to decrease moderately, by 3.6% in the third quarter. As the property market became more subdued, ownership transfer activity also trended downward. In view of the highly uncertain global financial and economic environment and strains in the credit market amid the global credit crunch, companies have also recently become more cautious in making investments and hiring new hands.

**Chart 3(a) : Asset market corrections and gloomier economic prospects dragged down consumer sentiment**

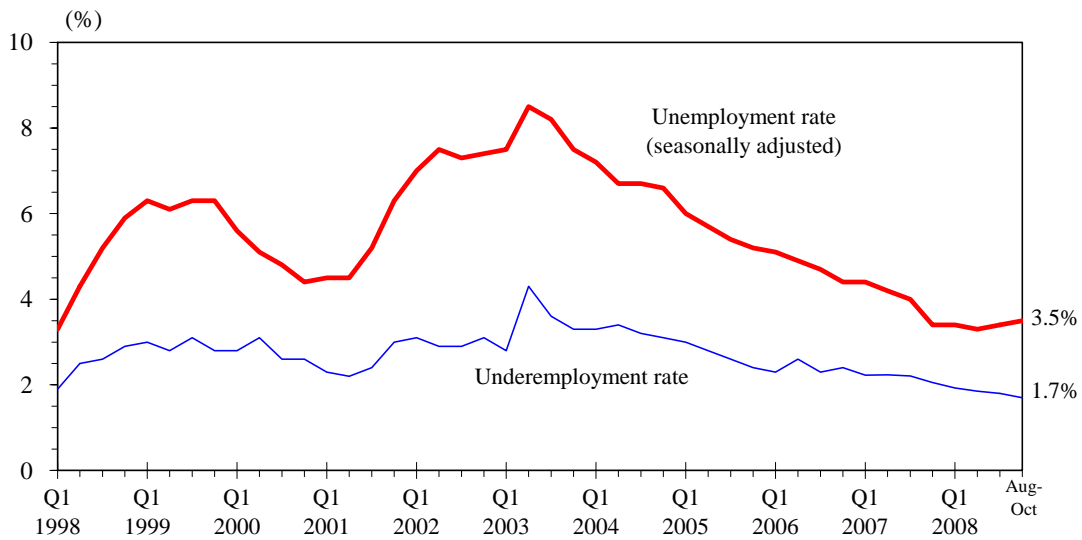


**Chart 3(b) : Investment grew further**



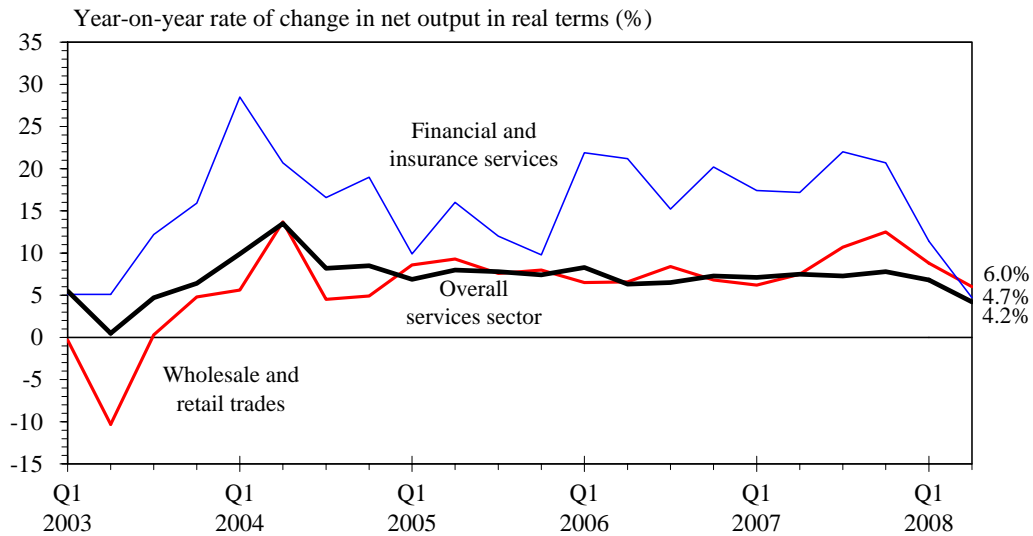
7. Along with the economic slowdown, the seasonally adjusted unemployment rate bottomed out at 3.2% in May-July and crept up to 3.5% in the 3-month period ending October 2008. Over the same period, the underemployment rate remained relatively low at 1.7% (*Chart 4*). The prospects of labour market have inevitably dimmed as the near term outlook was clouded by the unsettled global financial market situation.

**Chart 4 : Unemployment rate reversed the downtrend but underemployment edged further down**



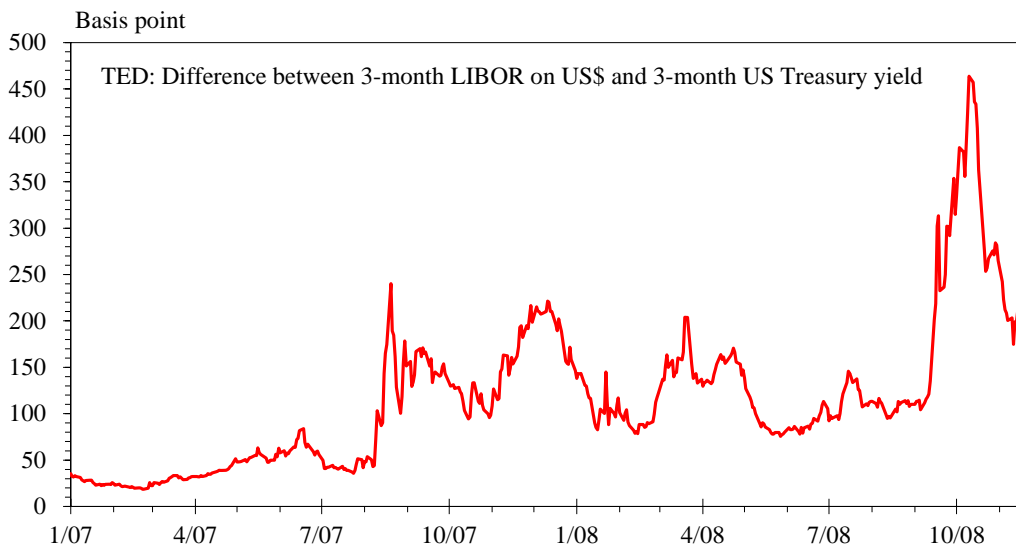
8. The services sector accounts for over 90% of the Hong Kong economy. Latest available figures indicate that the net output of the services sector rose moderately further by 4.2% in real terms in the second quarter of 2008 after a long period of rapid expansion. Wholesale and retail trade held up well alongside the consumer spending in the local market in that quarter. Amidst the less vibrant trade flows in the Asian region, import and export trade, as well as transport and storage both showed some moderation. The financing, insurance, real estate and business services decelerated notably in the second quarter, reflecting mainly the decline in asset market transactions in the face of an increasingly uncertain economic outlook. The net output of the construction sector reverted to a decline in the second quarter, and the manufacturing sector also continued to fall (*Chart 5*).

**Chart 5 : Services sector rose moderately further in the second quarter**



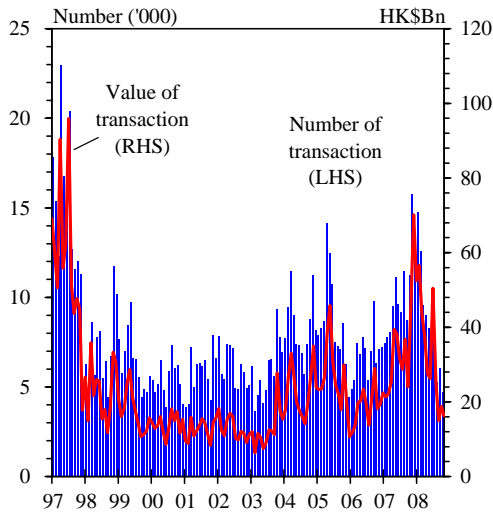
9. The global financial crisis escalated rapidly in September, following the collapse of Lehman Brothers, the US's fourth largest investment bank. The serious concerns about insolvency of financial institutions clogged credit markets in the advanced economies. This triggered a wave of deleveraging activities among global financial institutions and sent stock markets worldwide in a nose-dive. As an indication, the rate that banks charge each other, the London Interbank Offered Rate (LIBOR) on the US dollar, was traded so high above three-month US Treasury-bill rates during a large part of October (on 10 October it was 4.82% vs. 0.25%, giving a TED spread of 457 basis points) that lending among banks virtually came to a halt. This so-called TED spread signals the health of credit markets and has rarely been over 100 basis points. Following a series of unprecedented measures taken by various governments and central banks in the advanced economies, there are signs that stability is gradually returning to the global financial markets (the TED spread eased back to around 200 basis points in mid-November) (**Chart 6**). However, the credit markets remain tight and would take time to return to more normal functioning. The risk of a more prolonged and protracted global economic downturn has increased.

**Chart 6 : TED spread surged to the largest in decades in October and eased back more recently**

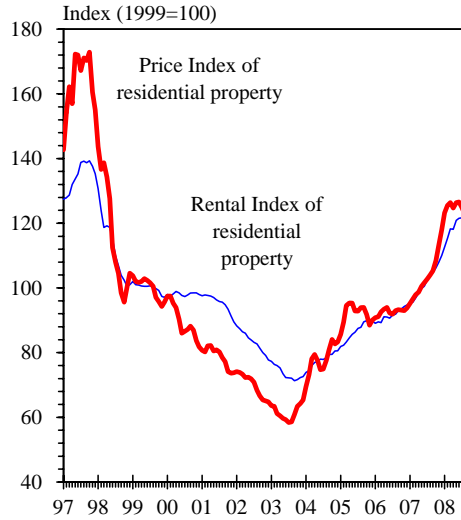


10. Buyers' enthusiasm in the local property market has also been hard hit by the global financial crisis and uncertain economic outlook. As a result, the number of sale and purchase agreements for residential property received by the Land Registry fell by 36% year-on-year, in the third quarter of 2008 and further by 58% year-on-year, in October. Total consideration of these agreements, were also 34% and 63% lower than a year earlier in third quarter and October respectively (*Chart 7(a)*). In tandem with the fall-off in transactions, overall residential flat prices fell by 5% between June and September 2008. With the gain recorded in the early part of the year largely wiped off by the recent fall, residential flat prices in September were only 2% higher than in December 2007. The leasing market also started to feel the pinch, though performance was not as bad as the sales market. Overall rentals declined by 2% between June and September 2008. This reduced the cumulative increase over December 2007 to 8% (*Chart 7(b)*). The markets for commercial and industrial properties also turned sluggish in the face of a more difficult business environment.

**Chart 7(a) : Transaction in property market shrank markedly in recent months**



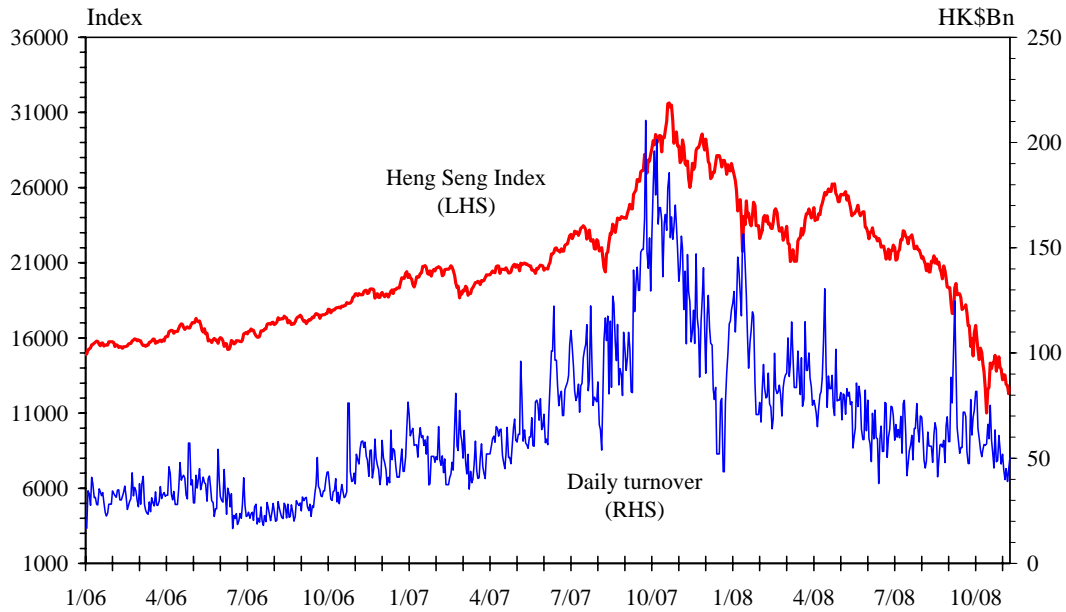
**Chart 7(b) : Flat prices returned to a level similar to that in early 2008**



11. The local stock market fell further in the second half of 2008 so far, in tandem with the sharp fall observed in the major bourses overseas and in the Mainland. The Hang Seng Index (HSI) stood at 18 016 at end-September 2008, 18.5% lower than at end-June, and fell sharply further to the lowest of around 11 000 in the latter part of October before showing some recovery more recently. Daily turnover shrank further from an average of \$76.1 billion in the second quarter to \$63.6 billion in the third quarter and \$61.7 billion in October (*Chart 8*).

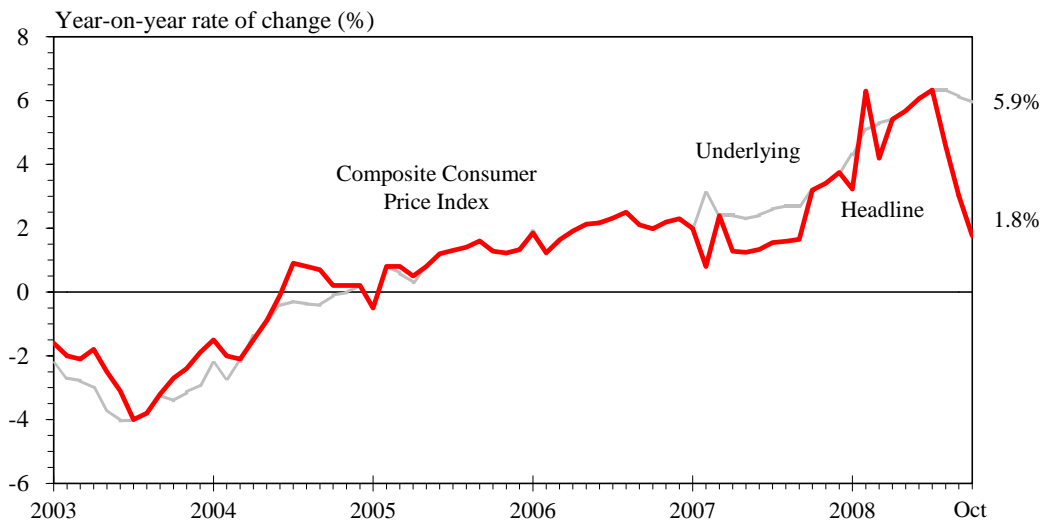


**Chart 8 : Stock market saw a significant correction alongside global stock market plunge**



12. Headline consumer price inflation fell notably in the third quarter to 4.6%, largely reflecting the favourable effects of the one-off relief measures, particularly those of the Government's payment of public housing rentals on behalf of lower income families for three months starting from August and the electricity subsidy for residential accounts from September 2008. With the additional effect of the rates concession which was not in place in the fourth quarter last year, headline inflation went lower further to 1.8% in October. Underlying consumer price inflation has tended to ease after July, as the tapering in food inflation provides an offset to the enlarged increase in private housing costs, a result of the continued pass-through of the earlier surges in rentals. The underlying consumer price inflation notched down from 6.3% in the third quarter to 5.9% in October (*Chart 9*).

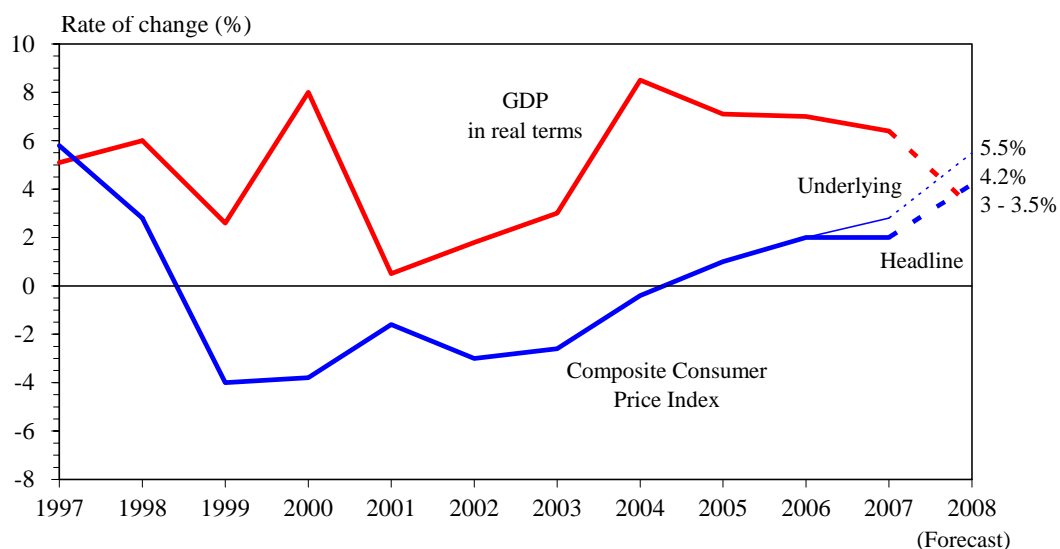
**Chart 9 : Headline consumer price inflation went down notably in recent months, mainly reflecting the effect of Government's relief measures**



### Updated short-term economic forecasts for 2008

13. Taking into account the GDP growth of 4.3% in the first three quarters of the year, economic growth for the year of 2008 as a whole is forecast at 3-3.5%, revised down from the earlier range forecast of 4-5% (*Chart 10*). The economy in the rest of this year is likely to be rather subdued, as the adverse impacts of the global economic downturn increasingly set in.

**Chart 10 : Forecast economic growth marked down to 3-3.5%**



14. Inflationary pressures from the external front are receding, on the back of retreating global commodity prices, especially those of food and oil, and the rebound in the US dollar since July. The slowdown in the Hong Kong economy will also alleviate the price pressures from the domestic front. With the favourable effects of the Government's relief measures continuing in the rest of the year, the forecast headline consumer price inflation for 2008 as a whole remains unchanged at 4.2%. Netting out the effects of Government measures, the forecast underlying inflation rate for 2008 is also maintained at 5.5%.

### **Economic outlook for 2009**

15. The global economy is facing the most dangerous crisis since the Great Depression in the 1930s. Being an open economy, the economic outlook for Hong Kong in 2009 is bound to be affected. The financial tsunami has resulted in a credit crunch on a worldwide scale that has added woes to the already rapidly faltering global economy. Although concern on financial meltdown appeared to have receded somewhat following a series of unprecedented measures taken by various governments and central banks in the advanced economies, the ongoing deleveraging process as a necessary part of the balance sheet adjustments of financial institutions is likely to continue for some time and, coupled with the depressed consumer and investor sentiments,

will continue to put a severe drag on the global economy. The risk of a more prolonged and protracted global economic downturn has increased.

16. Recession is already under way in many advanced economies, including the US and EU. The IMF last month predicted a contraction in the advanced economies in 2009, the first annual recession in the post-Second World War era. With global trade flows to be hampered by the slowdown in demand from the advanced economies, the export-dependent economies in Asia would all be affected by different extents. Amid such an uncertain and difficult external environment, Hong Kong's export performance is likely to remain rather lacklustre.

17. Domestic demand would likewise slow going forward, as the labour market looks set to weaken further. The substantial fall-off in stock market triggered by the global-wide stock market crash and its potential spillover effect to the property market should continue to restrain consumers' propensity to spend. Businesses are also likely to turn more cautious in making machinery and equipment acquisitions given the dimmer economic outlook.

18. The inflation prospects for 2009 will depend on the developments in international commodity prices and exchange rate, the extent of the global downturn as well as the performance of the domestic economy. Receding external inflationary pressures, together with the lesser pressures from the domestic economy in the face of expected slowdown in the Hong Kong economy, should provide the conditions for CPI inflation to ease more visibly during the course of the year.

19. Overall, with the global economic downturn now underway, the risk of recession in the Hong Kong economy in 2009 has increased. Economic conditions are likely to be difficult in early 2009, and the prospect of a turnaround in the latter part of 2009 remains highly uncertain. The Government will closely monitor the developments in the coming months and announce the economic forecast for 2009 along with the Budget Speech in February next year. As a reference, the IMF's latest 2009 economic growth forecast for Hong Kong is 2%. In face of the high degree of uncertainty in the period ahead, the private sector analysts' forecast growth rates of the Hong Kong economy in 2009 vary greatly, with prevailing forecasts averaging at around 1%.

20. In the face of the global economic crisis, it is important for the Government to proactively take measures to minimise the impact on the economy. The Government will speed up public sector works to create jobs. To ease the problem of tight credit facing SMEs, a number of support measures have been introduced, including augmenting the existing export credit insurance scheme, enhancing the existing funding schemes and introducing a time-limited "Special SME Loan Guarantee Scheme". The Hong Kong Monetary Authority has also urged banks to be more accommodating in lending to SMEs within the bounds of prudent risk management, and injected a large amount of liquidity into the banking system to create the conditions for banks to cut interest rates. Separately, the Government will continue to strengthen communication with the Mainland authorities at various levels through different channels to provide appropriate assistance to the Hong Kong businessmen, SMEs in particular, operating in the Mainland. The Government will continue to listen views on ways to tackle the crisis and turn it into opportunities.

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