



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

The Government released the First Quarter Economic Report 2010 in mid-May. The Economic Report, together with the press release containing the updated economic forecasts for the whole year of 2010, 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 2010 as a whole.

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

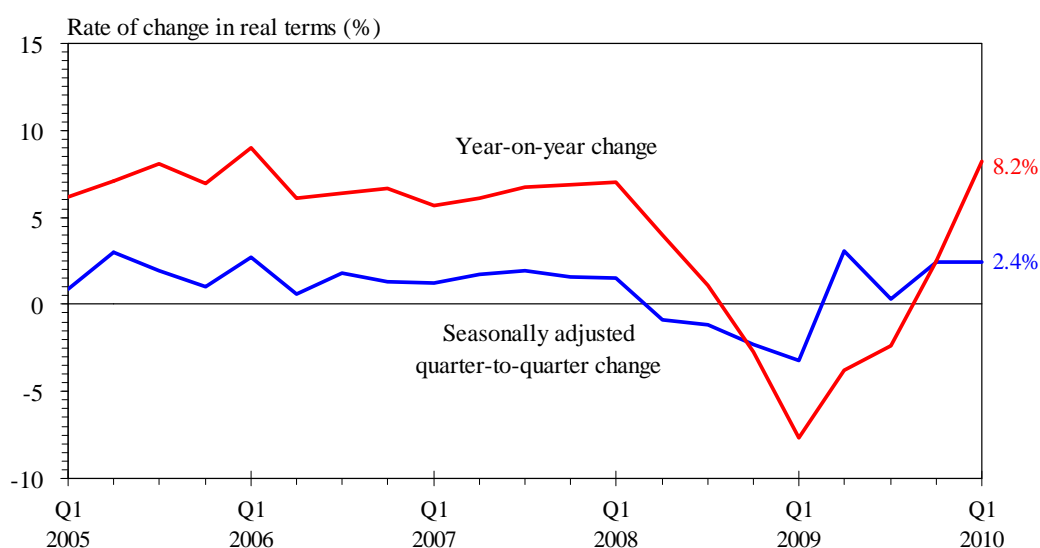
Introduction

This paper analyses latest development in the Hong Kong economy and briefly discusses the updated economic forecasts for 2010 as a whole released in mid-May.

Recent economic situation

2. Economic recovery in Hong Kong became increasingly entrenched in the first quarter of 2010. Having resumed a positive year-on-year growth of 2.5% in the fourth quarter of 2009, GDP grew markedly further by 8.2% in real terms in the first quarter of 2010. On a seasonally adjusted quarter-to-quarter comparison, GDP rose strongly further by 2.4% in real terms in the first quarter, the fourth consecutive quarter-to-quarter expansion (*Chart 1*).

Chart 1 : Economic recovery in Hong Kong became increasingly entrenched



3. The improvement in the first quarter was broadly based. Merchandise exports rebounded strongly by 21.6% from the exceptionally low base in the same quarter last year, in stark contrast with the 2.9% decline in the fourth quarter of 2009 and the 12.7% contraction for 2009 as a whole (*Chart 2(a)*). The strong export performance was mainly led by the sizable growth in exports to the Mainland and other Asian markets. In addition, exports to the US finally resumed modest growth after quarters of significant decline. Exports to Europe were still down despite the already very low base of comparison a year

ago. As a result, the volume of merchandise exports in the first quarter largely returned to levels prior to the outbreak of the global financial tsunami.

4. Exports of services also grew strongly in the first quarter of 2010, by 17.9% year-on-year in real terms, markedly up from the 8.9% increase in the fourth quarter of last year. On a seasonally adjusted basis, the quarter-to-quarter growth was likewise impressive, at 6.6% in the first quarter, versus the 4.8% growth in the preceding quarter (*Chart 2(b)*). All major components turned in sizable growth in the first quarter. Exports of financial and business services grew vibrantly, thanks to the sustained pick-up in financial market and commercial activities. Exports of travel services also expanded rapidly, along with a notable and broad-based growth in visitor arrivals. Exports of trade-related and transportation services, which were severely battered during most of 2009, saw a notable turnaround in the first quarter of 2010 on the back of normalisation in global trade flows.

Chart 2(a) : Exports of goods rebounded strongly on vibrant intra-regional trade

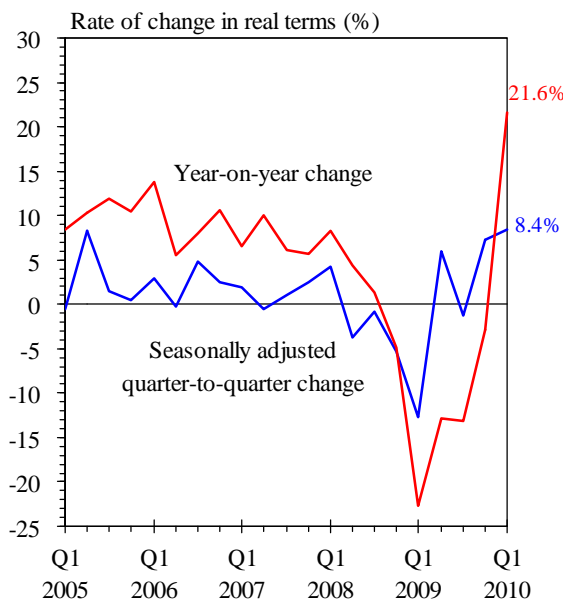
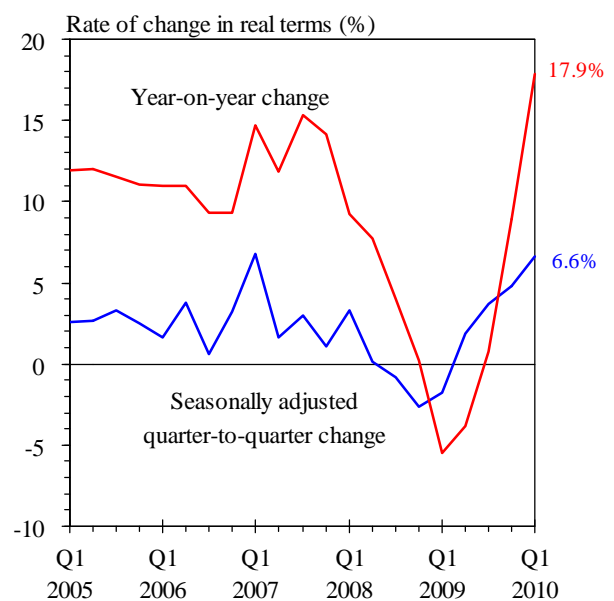


Chart 2(b) : Exports of services thrived on all fronts



5. The local segment was highly resilient in the first quarter. Private consumption expenditure grew further by 6.5% year-on-year in real terms over a year earlier, up from the 4.8% growth in the fourth quarter of last year (*Chart 3(a)*). Consumer confidence was firmly supported by the continued improvement in labour market and more optimistic economic outlook. The Government's relief measures and the distinctly low base of comparison in the same quarter last year were also relevant.

6. Business sentiment continued to strengthen, with investment spending rising notably by 10.5% in real terms in the first quarter of 2010 over a year earlier, after a rebound of 14.1% in the preceding quarter (*Chart 3(b)*). Machinery and equipment acquisition surged by 12.1%, with a greater contribution coming from the private sector component. Businesses became more willing to invest in capacity building in view of the improved business situation and outlook. The results of the latest Quarterly Business Tendency Survey also indicated a general increase in optimism among the large enterprises surveyed. Expenditure on building and construction declined modestly by 2.1% in the first quarter of 2010. Public sector works continued to grow rapidly, as the Government expedited small-scale works and as some large-scale infrastructure projects started. However, private sector construction activity remained slack.

Chart 3(a) : Consumer sentiments stayed firm

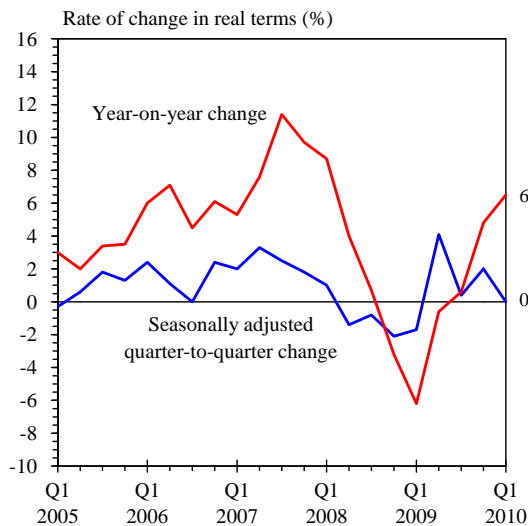
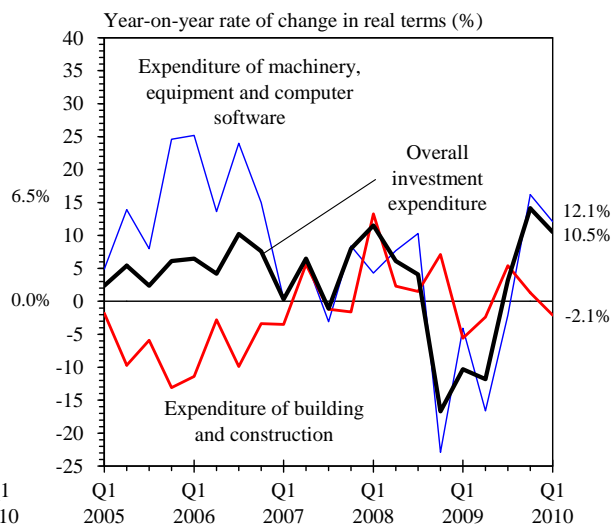
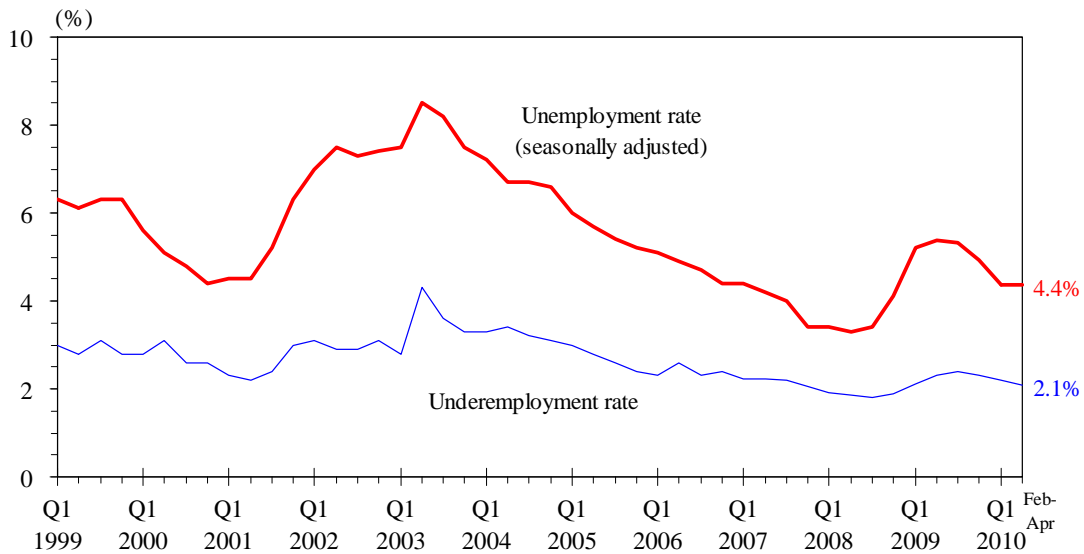


Chart 3(b) : Investment spending recorded double-digit growth for two quarters in a row



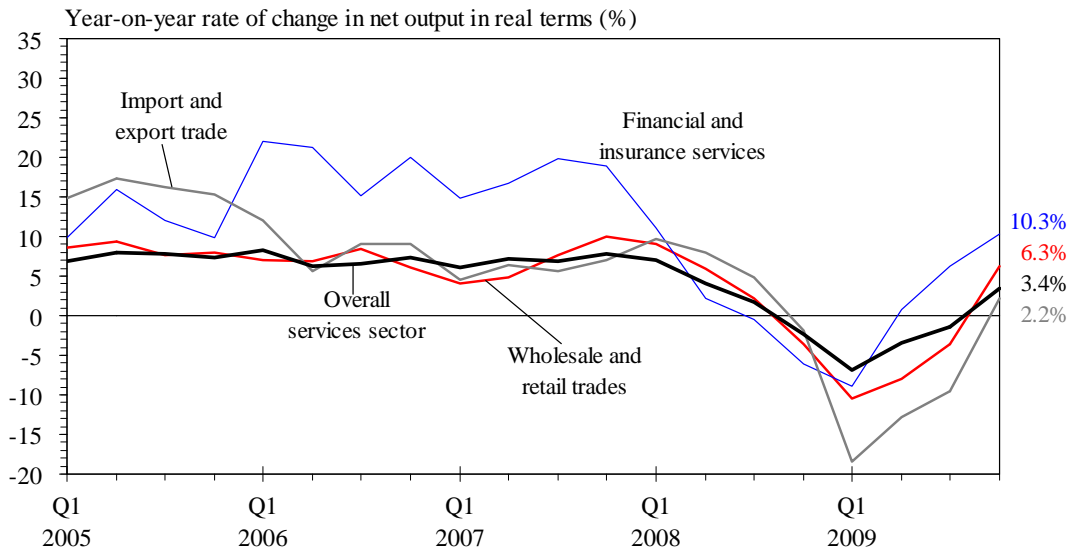
7. Labour market improved further in the first quarter of 2010 alongside the strong rebound in overall economic activities. The seasonally adjusted unemployment rate came down successively by one percentage point since mid-2009, reaching 4.4% in February-April 2010 (*Chart 4*). Downward pressure on labour wages and earnings that once prevailed in the aftermath of the financial tsunami by and large disappeared by the end of last year. Companies also showed stronger intention to reactivate their hiring plans.

Chart 4 : Labour market improved further with unemployment rate successively down



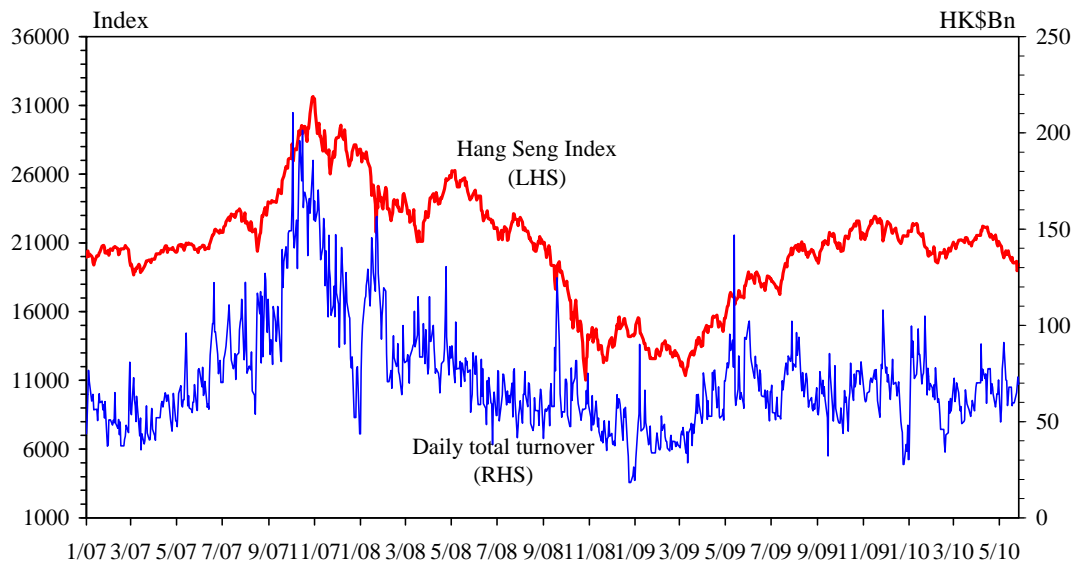
8. The services sector accounts for over 90% of the economy. Latest available figures indicate that net output of the services sector as a whole contracted by 2.0% in real terms in 2009, after a growth of 2.5% in 2008. Nevertheless, a notable improvement was seen by the fourth quarter of 2009, the net output of the services sector reverted to a year-on-year growth of 3.4% after four consecutive quarters of contraction. Financing and insurance saw the quickest revival, followed by wholesale and retail trades, and real estate. However, the net output of transport and storage, and restaurants and hotels still declined modestly in the fourth quarter of last year (*Chart 5*). As to the manufacturing sector, net output declined significantly by 9.2% in 2009. Construction sector output resumed growth since the third quarter of last year, leading to a 1.6% increase in 2009 as a whole.

Chart 5 : Services sector showed notable improvement by the fourth quarter of 2009



9. The local stock market, having staged a strong rebound during last year, turned more volatile on entering 2010, as market sentiment was particularly sensitive to news on exit strategies worldwide and the global economic outlook. Concerns over the deterioration of the debt crisis in Greece and the eurozone intensified on entering the second quarter, causing gyrations in the global financial, foreign exchange and commodity markets. The Hang Seng Index (HSI) plunged alongside major stock markets around the world. Lately, the takeover of a small Spanish savings bank by its government and heightened geopolitical tensions in North Asia have sent shockwaves across stock markets. The HSI fell below 19 000 on 25 May, the lowest since last July. As of 28 May, the HSI closed at 19 767, down 9.6% from end-2009. The weaker market sentiment also led to fewer fund-raising activities in the stock market. The daily turnover of the local stock market averaged at \$67.4 billion in the first five months of 2010, similar to that of \$65.4 billion in the fourth quarter of 2009 (*Chart 6*).

Chart 6 : HSI retreated in recent months mainly on concerns over the European sovereign-debt problem



10. The residential property market went up further in the first quarter of 2010, after a sustained climb in 2009. Abundant liquidity, ongoing accommodative interest rate environment and tight supply relative to demand were the three key factors driving the property market. The number of sale and purchase (S&P) agreements for residential property received by the Land Registry rose to 33 249 in the first quarter, up by 20% over the preceding quarter or 102% over the low base a year earlier (*Chart 7(a)*). With the launch of a number of large-scale projects, primary market transactions in the first quarter jumped by 38% over the preceding quarter, while secondary market transactions also grew by a rapid 19%. In April, the number of S&P agreements for residential property stayed at 12 236.

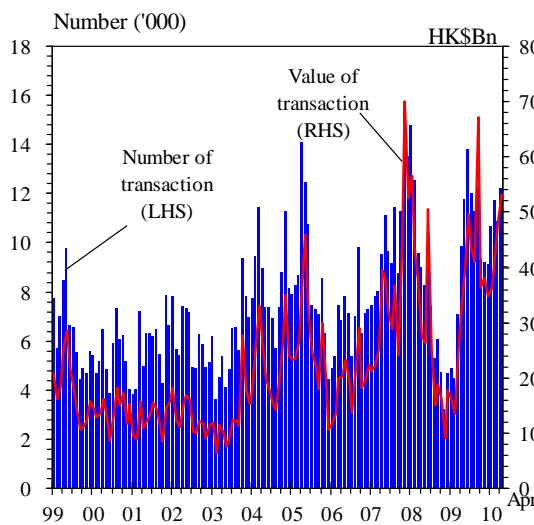
11. Overall flat prices in the secondary market in March 2010 increased sharply further by 5% over December 2009, and have surpassed the pre-crisis peak in 2008 by 12% (*Chart 7(b)*). Analysed by size of properties, prices of large flats surged by 9% between December 2009 and March 2010, faster than the 5% increase in prices of small/medium-sized flats. In March 2010, prices of large flats have surpassed the historic high in 1997 by 4%, but prices of small/medium-sized flats were still 19% lower than the 1997 peak.

12. As reflected by the small share of confirmor cases in total transactions and the large portion of the secondary market transactions involved flats in the mass market (i.e. flats smaller than 70 square metres), the residential property market remained largely end-user led. Yet with the persistent surge in flat prices over the past year or so, the risk of a property market bubble remains. To ensure a healthy and stable development of the property market, the Government announced a series of measures in February 2010 to increase the flat supply via fine-tuning the land supply arrangements, discourage property

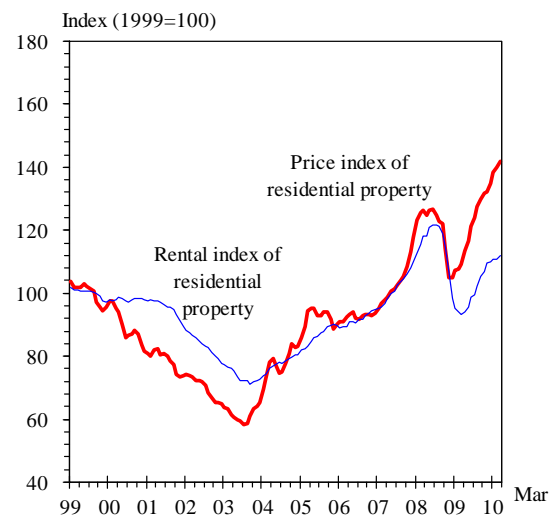
speculation, improve transparency in property transactions and transaction prices, and prevent excessive expansion in mortgage lending. Further measures were rolled out along the same directions in April. Anecdotal evidences suggest that the property market has turned somewhat steadier over the past month or so. According to the latest data from the Hong Kong Monetary Authority, the number of residential mortgage applications fell by 7.7% in April. The Government will continue to closely monitor the situation, and introduce further measures when necessary.

Chart 7 : The residential property market firmed up during the first quarter but turned quieter more recently

(a) S&P agreements for residential property

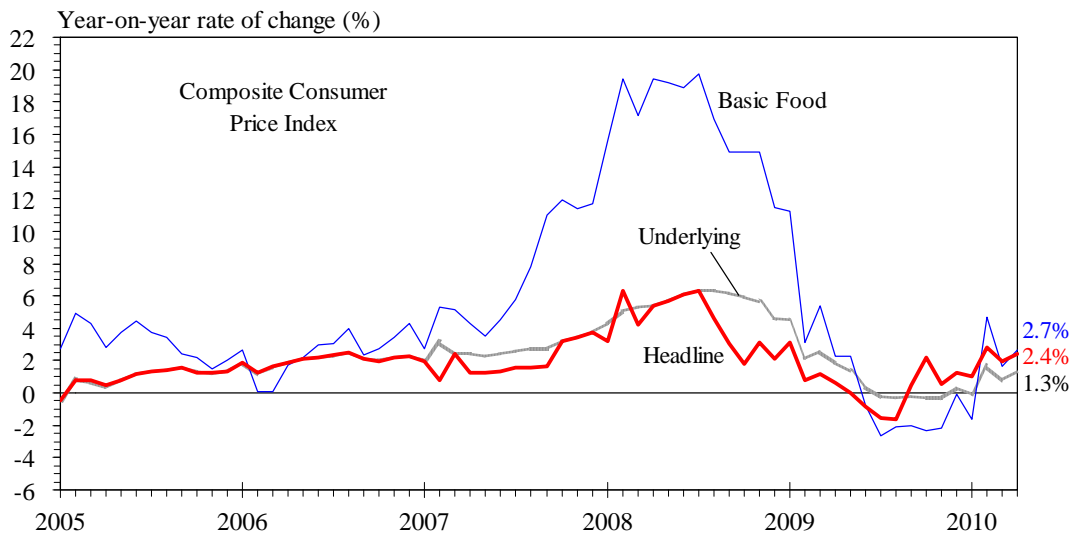


(b) Flat prices



13. Inflationary pressure increased slightly in the first quarter of 2010 as the economic recovery gathered momentum. Headline consumer price inflation, in terms of the year-on-year rate of change in the headline Composite Consumer Price Index (CCPI), was higher at 1.9% in the first quarter, mainly due to the low base of comparison in the same quarter last year as a result of the one-off electricity charge subsidy. Netting out the effect of the Government's one-off relief measures, underlying consumer price inflation, in terms of the year-on-year rate of change in the underlying CCPI, edged up to 0.8% in the first quarter, from -0.1% in the preceding quarter. In April 2010, headline and underlying consumer price inflation went up somewhat further to 2.4% and 1.3% respectively (*Chart 8*). The gradual increase in inflation was part of the reflationary process as the economic recovery proceeds.

Chart 8 : Inflationary pressure crept up as economic recovery became more entrenched



Updated short-term economic forecasts for 2010

14. Locally, the results of the latest Quarterly Business Tendency Survey conducted in March and early April 2010 confirmed a broad-based rise in optimism among the large enterprises surveyed, and an increasing number of firms have indicated their intention to reactivate hiring plans. Investment as a whole should show further growth, with private sector investment recovering further in addition to the expected pick-up in public sector works. Better job and income prospects should also render the key driver for consumption growth in the quarters ahead.

15. Externally, the global recovery has proceeded quite well in the first quarter of 2010, with Asia taking the lead while the US economy also churning out a better-than-expected performance. But the European economies are still sluggish under the drag of high unemployment and huge fiscal deficits. The Greek sovereign-debt problem and the need for some European economies to implement austerity measures will pose a drag to the recovery in Europe and increase financial market volatility. Given the latest developments in the external environment, and the already fragile nature of the global recovery, the export outlook for Hong Kong has turned somewhat more uncertain, more so in the latter part of the year upon the waning of the exceptional fiscal boosts in the advanced economies.

16. The Greek sovereign-debt problem has emerged as the most imminent threat to the external environment lately, and the global economic recovery is still wrought with uncertainties. Although the massive stabilization measures jointly introduced in early May by the European Union (EU), the European

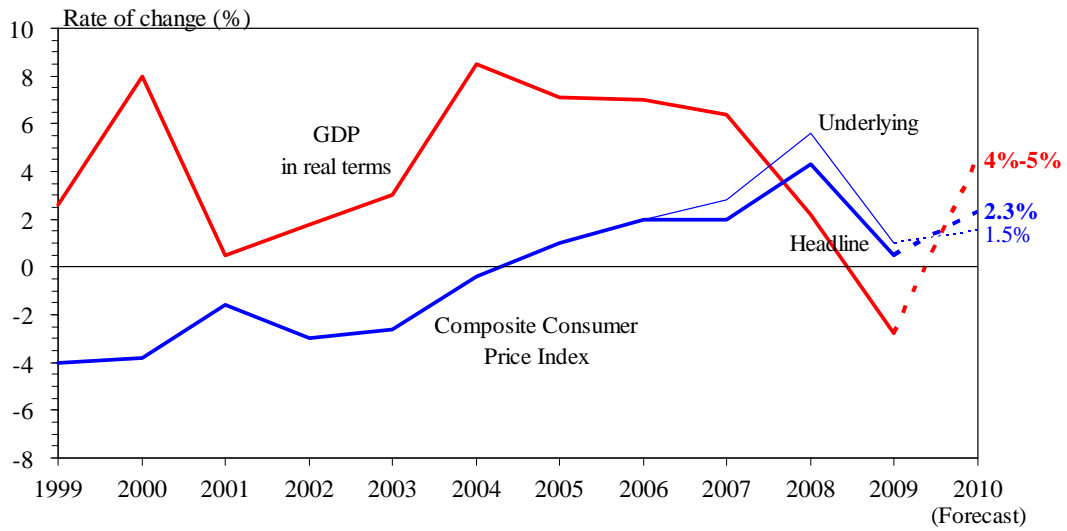
Central Bank and the International Monetary Fund (IMF) have to some extent relieved the concerns about the contagion of the problem to other European countries with fragile fiscal positions, the effectiveness of these measures will hinge on whether Greece and other countries can successfully redress their fiscal problems. Judging from the recent market reactions, the market remained concerned about the drag posed by austerity measures to be taken in the indebted European countries on the already fragile economic recovery in Europe. Overall, market sentiment remains weak.

17. While Hong Kong's economic links with Greece are rather insignificant, those with the EU are notable. The EU as a market accounted for some 12% of Hong Kong's total exports of goods and 19% of Hong Kong's exports of services. Around 5% of visitors to Hong Kong come from the EU. If the pace of recovery in the EU weakens in the period ahead, it will inevitably affect Hong Kong's exports of goods and services to this market. It is also worth noting that the EU accounted for about 28% of the World's GDP in 2009, even slightly larger than that of the US. Persistent slack in the EU economy will inevitably weigh on the global recovery, thereby also affecting the prevailing strong growth momentum in Asia.

18. With the Hong Kong economy bouncing back for four quarters in a row, by the first quarter of 2010, GDP has largely returned to the peak in early 2008, recouping all the lost ground in the 2009 Great Recession. Given the current strong growth momentum in Hong Kong and in the region, and if no major external shocks occur, real GDP growth for 2010 as a whole would very likely exceed the forecast of 4-5% as announced in the 2010-11 Budget (*Chart 9*). However, recognising the prevailing uncertainties in the external environment, in the May round of review the Government maintained the forecast GDP growth at 4-5%. A further review will be conducted in the August round when more incoming data from both the global and Hong Kong economy are available. For reference, in April the IMF projected Hong Kong's economic growth for this year at 5%, whereas most private sector analysts are currently projecting the economy to expand by 4-7%, averaging at around 5.2%.

19. On inflation outlook, inflation may creep up modestly further in the rest of the year, being part of the reflationary process as the economic recovery proceeds. The forecast rates of the headline and underlying consumer price inflation in 2010 as a whole were at 2.3% and 1.5% respectively, same as in the Budget round. For reference, in April the IMF forecast Hong Kong's headline consumer price inflation in 2010 at 2%, whereas the forecasts by most private sector analysts are currently at 2-3%, averaging at around 2.5%.

Chart 9 : Economy is forecast to expand by 4%-5% in 2010



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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. Thanks to the progressive improvement in the economic and labour market conditions, the average monthly household income went up by 5.5% in the first quarter of 2010 over a year earlier. After discounting price change, the gain was 3.5% in real terms. When compared with the pre-crisis level in the first quarter of 2008, average monthly household income was also higher by 1.7% in nominal terms. The declining trend prevalent for most of the period since end-2008 was thus reversed. Labour wages and earnings across a wide spectrum of the workforce saw different degrees of improvement. Specifically, labour wages, as a measure of regular payments to employees at the supervisory level or below, having trended downward in most of last year, reverted to a year-on-year increase of 0.8% in December 2009. Labour earnings, as measured by payroll per person engaged in private sector, likewise rose by 0.9% year-on-year in the fourth quarter of 2009 (*Table 1*).

**Table 1: Average monthly household income,
labour wages and labour earnings
(year-on-year rate of change in nominal terms (%))**

<u>Year</u>	<u>Average monthly household income (%)</u>	<u>Labour wages (%)</u>	<u>Labour earnings (%)</u>
2008 Q1	6.9	4.0	3.1
2008 Q2	5.3	4.1	4.6
2008 Q3	4.7	4.6	5.2
2008 Q4	0.1	0.9	-2.1
2009 Q1	-3.7	-0.9	-0.2
2009 Q2	-0.4	-1.9	-0.7
2009 Q3	1.1	-1.8	2.1
2009 Q4	-3.3	0.8	0.9
2010 Q1	5.5	n.a.	n.a.

Note : n.a. Not yet available.

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

Households with monthly household income below \$4,000

3. In the first quarter of 2010, the number of households with monthly household income below \$4,000 (“low-income households”) totalled 190 600, up by 13 400 (or 7.6%) over a year earlier. In proportionate terms, the respective share in total domestic households also increased slightly, from 7.8% to 8.2% (*Table 2*). The increase of low-income households over this period was attributable entirely to a rise in the relevant economically inactive households (i.e. with all members being economically inactive) and elderly households (i.e. with all members aged 60 or above), which in turn was due to the change in population structure and the emergence of many retired elderly households over the past ten years or so. Over the same period, the number of economically active households (i.e. with at least one economically active household member) decreased somewhat. This reduction was consistent with the declining unemployment rate observed for lower-skilled workers from 5.9% to 5.0% over the past year.

Table 2: Distribution of domestic households by monthly household income

	<u>Q1 2005</u> (5 years ago) (%)	<u>Q1 2008</u> (pre-crisis) (%)	<u>Q1 2009</u> (1 year ago) (%)	<u>Q1 2010</u> (%)
Less than \$4,000	8.4	8.3	7.8	8.2
\$4,000 - \$7,999	13.8	11.8	12.9	12.8
\$8,000 - \$11,999	14.3	12.5	12.7	12.7
\$12,000 - \$15,999	12.5	11.4	11.4	11.2
\$16,000 - \$23,999	16.5	17.1	16.9	17.0
\$24,000 - \$39,999	17.5	18.9	18.5	18.4
\$40,000 - \$99,999	14.0	16.3	16.4	16.3
\$100,000 or above	2.8	3.7	3.4	3.3

Note : The purchasing power of the income (as measured by the Composite CPI) in Q1 2005, Q1 2008 and Q1 2009 were 112%, 104% and 102% of that in Q1 2010 respectively.

4. When compared with 10 years ago (i.e. first quarter of 2000), the proportion of low-income households in all the domestic households showed some decrease from 8.5% to 8.2%. A compositional analysis indicated that within this household group, the numbers of elderly households and economically inactive households were on the uptrend during the past ten years (*Chart 1*), which was likewise due to the secular trend towards population ageing and reduced household size over the period. However, the proportion of economically active low-income households moved broadly in line with the economic ups and downs. During 2000 and 2008 when the economy performed persistently rather well for most of the

period, the proportion of economically active households decreased successively from 1.9% in the first quarter of 2000 to 1.0% in the first quarter of 2008. After the outbreak of global financial tsunami in late 2008, the Hong Kong economy mired into recession, thereby leading to a rise in the proportion of economically active households, to 1.3% in the first quarter of 2009. As the economic recovery gradually took hold afterwards, the proportion fell back to 1.2% in the first quarter of 2010 (*Table 3*).

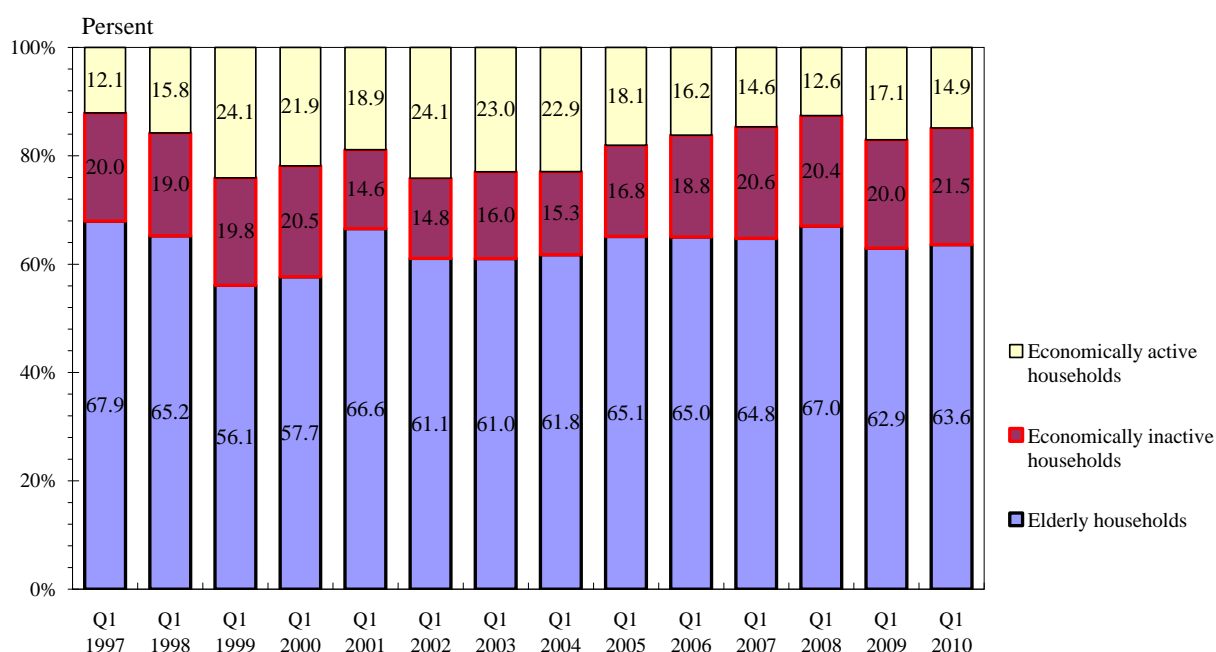
Table 3: Number and breakdown of low-income households*

	<u>Elderly households</u>	<u>Economically inactive households</u>	<u>Economically active households</u>	<u>Total</u>
Q1 1997	62 700 (3.3)	18 400 (1.0)	11 200 (0.6)	92 300 (4.8)
Q1 2000	99 200 (4.9)	35 200 (1.7)	37 600 (1.9)	172 100 (8.5)
Q1 2005	119 600 (5.5)	30 900 (1.4)	33 200 (1.5)	183 700 (8.4)
Q1 2008	125 900 (5.6)	38 300 (1.7)	23 600 (1.0)	187 900 (8.3)
Q1 2009	111 500 (4.9)	35 400 (1.6)	30 200 (1.3)	177 200 (7.8)
Q1 2010	121 200 (5.2)	41 000 (1.8)	28 300 (1.2)	190 600 (8.2)

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

() Share in all domestic households.

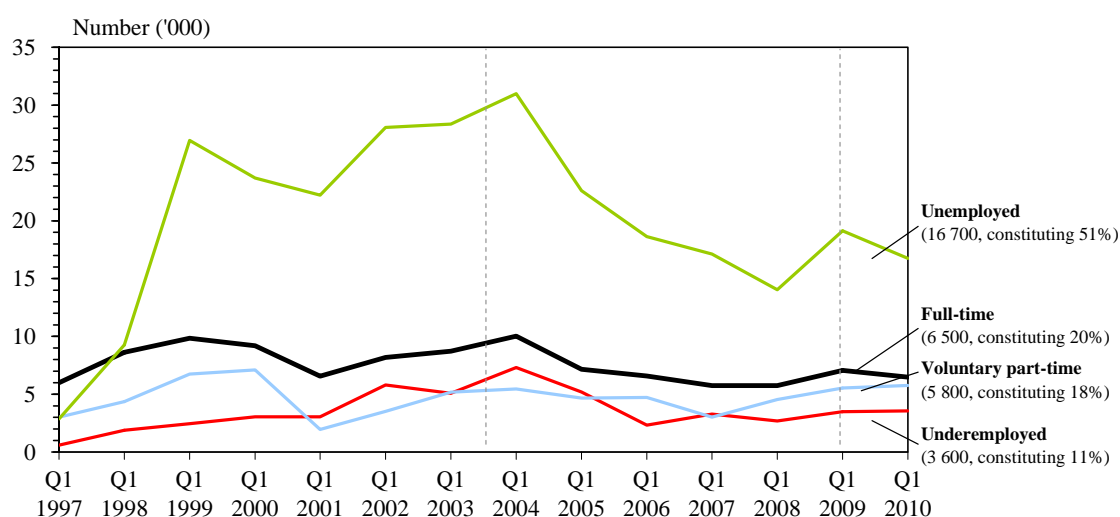
Chart 1 : Composition of lower income households



5. Further analysis of the low-income households in the first quarter of 2010 yields the following observations:

- 63% of them comprised 1-person households, in which the majority (76%) were elderly persons aged 60 or above.
- As to the economically active low-income households, there were 32 600 economically active persons living there in the first quarter of this year, less than the 35 200 persons a year earlier. Among them, the number of unemployed persons in such households decreased notably from 19 100 to 16 700 (or 12.5%) over the period, which was in line with the decrease of 14.2% in the number of overall unemployed persons, a manifestation that the economic recovery can indeed lead to a general improvement in unemployment situation of low-income households. Likewise, the number of full-time employees declined from 7 100 to 6 500 (or 8.3%), likewise suggesting that these employees were also able to benefit from the economic upturn, and can therefore successfully move out of the group of low-income household. A breakdown by employment status revealed that 51% of these economically active persons were unemployed, 29% were employed part-time workers (working voluntarily for less than 35 hours per week, or involuntarily for the same amount of time, i.e. underemployed), and the remaining 20% were in full-time employment (*Chart 2*).

Chart 2 : Composition of economically active persons in low-income households*



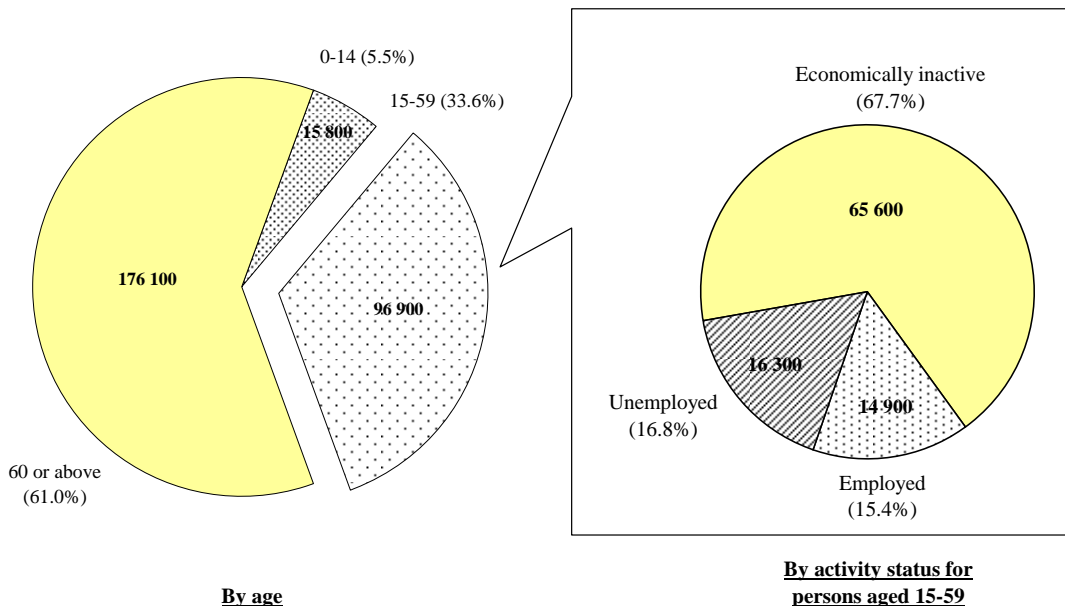
Notes : (*) This does not include economically active persons in the low-income households with elderly members only, but the numbers involved are insignificant.
 Figures in brackets represent the number of economically active persons in Q1 2010.

- As for the 75 700 persons living in economically inactive low-income households, 36% of them comprised elderly persons at 60 and above (91% being retirees) or teenagers below 20 (mainly students). The remaining 64% or 48 100 persons were aged 20-59. Among them, 23% were homemakers,

22% were persons suffering prolonged illness, 18% were retirees and 7% were students.

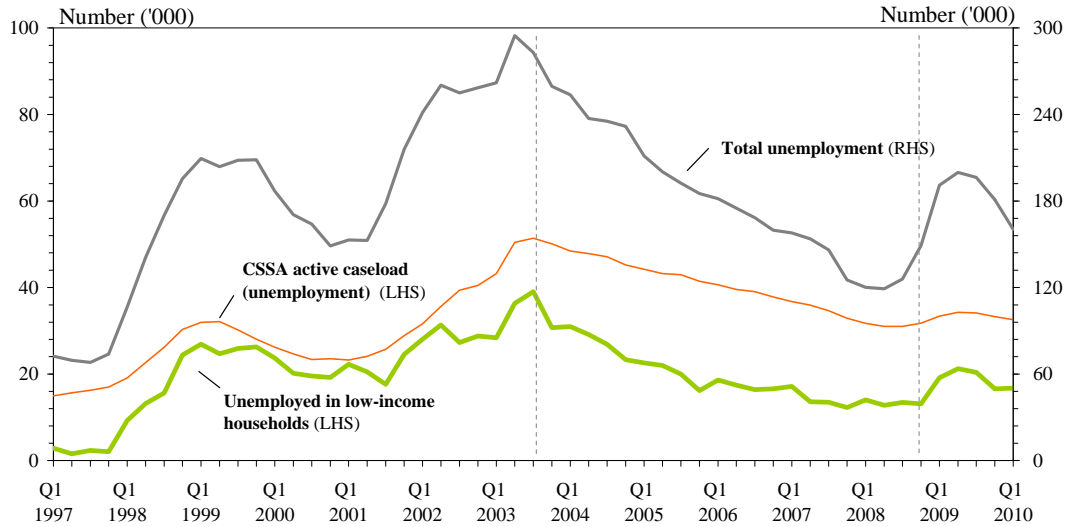
- Taken together, there were thus 288 800 persons living in low-income households. Of this total, 61% (or 176 100 persons) comprised elderly persons aged 60 or over. As to the 96 900 persons aged 15-59, over two-thirds (68%) of them were economically inactive, while the remaining 17%, 9% and 6% were unemployed, part-time and full-time workers respectively (*Chart 3*). In proportionate terms, those who were unemployed and full-time workers actually witnessed a noticeable decrease over the past year, again reflecting that the employment condition of the low-income households have gradually improved in tandem with the economic revival.

**Chart 3 : Persons living in low-income households
by age and activity status, Q1 2010**



- In fact, during the current economic recovery, the unemployment rate for lower-skilled workers fell successively from a high of 6.1% in mid-2009 to 5.1% in February – April 2010, making a cumulative fall of 1.0 percentage point. This was comparable with the decrease in the overall unemployment rate over the same period. Concurrently, the number of CSSA cases was also steadily on the decrease. At 287 094 in April 2010, the number of CSSA cases was down by 3 148 (or 1.1%) from the high of 290 242 in August 2009. The unemployment caseload witnessed a more notable improvement, the number fell cumulatively by 2 041 (or 6.0%) to 32 225 (*Chart 4*).

Chart 4 : The relationship between the unemployed in low-income households*, CSSA active caseload (unemployment)^, and total unemployment in the economy



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

(^) Monthly period-end figures.

- Despite the recent improvements in economic and labour market conditions, the Government will not let up on its efforts to assist the low-income households. Indeed, the Government has all along been adopting a pragmatic and multi-pronged approach through the social safety net, and the provision of a wide range of free or highly subsidised services in various areas, including housing and health care, etc to help alleviate the difficulties of such households. Moreover, the Government will continue to invest heavily in education and training and strengthen employment support services, such as the “Employment Programme for the Middle-aged” and the two-year “Pilot Employment Navigator Programme”, etc to enhance social mobility and reduce inter-generational poverty. In the longer term, the fundamental solution to improve the livelihood of people living in low-income households is to promote overall economic growth so as to provide more employment and income opportunities for this vulnerable group.

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