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

The Government released the First Quarter Economic Report 2007 in mid-May. The Economic Report, together with the press release containing the updated economic forecasts for the whole year of 2007, 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 2007 as a whole.

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29 May 2007

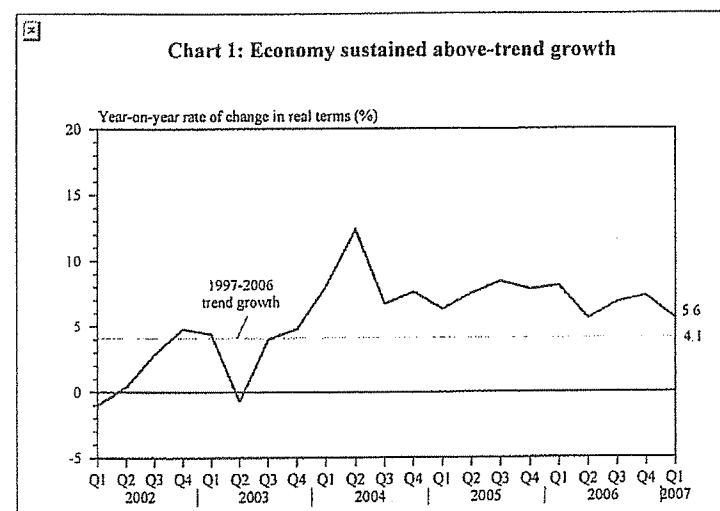
## Recent Situation and Near-term Outlook For the Hong Kong Economy

### Introduction

This paper analyses latest development in the Hong Kong economy and briefly discusses the updated economic forecasts for 2007 as a whole released in mid-May.

### Recent economic situation

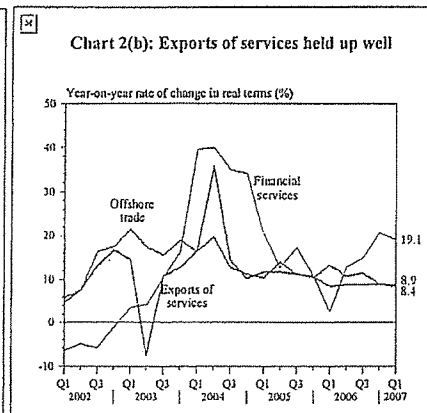
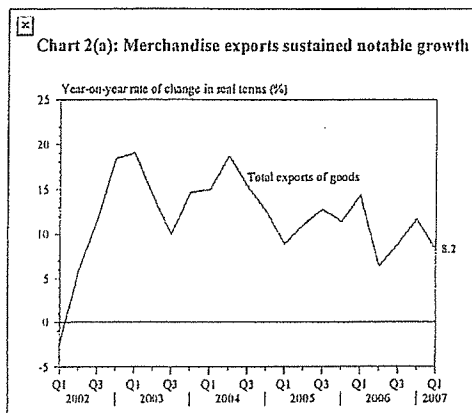
2. The Hong Kong economy continued to show broad-based expansion in the first quarter of 2007, with GDP growing solidly by 5.6% in real terms over a year earlier. Since the upturn in mid-2003, the economy has been growing at above-trend pace for 14 quarters in a row (*Chart 1*). Growth remained broad-based, with domestic demand sustaining strong momentum and export performance staying resilient.



3. External demand held up well on entering 2007. Merchandise exports recorded a further notable growth at 8.2% in real terms in the first quarter over a year earlier, even when set against an exceptionally high base a year earlier. Trade flows involving the Mainland remained vibrant, thereby largely cushioning overall export performance against the weakness in the US market (*Chart 2(a)*).

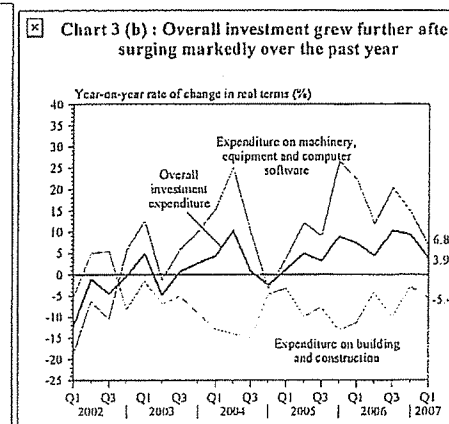
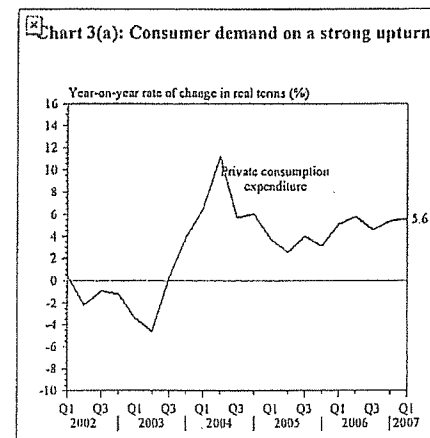
4. Analysed by market, exports to the Mainland continued to show double-digit growth in the first quarter, thanks to the strength of the domestic economy and also vibrant trade flows. Exports to the European Union showed only modest growth. Despite the improving domestic demand there, the scope for a sharper pick-up was somewhat restrained by reduced intake of raw materials amidst a weakening export sector. Exports to the US were still lackluster, owing to its weak import demand. Exports to other Asian economies showed mixed performance, with those to Thailand, Malaysia and Indonesia outperforming others.

5. Exports of services leaped by 8.4% in real terms in the first quarter over a year earlier, led by the surge in exports of financial and business services amidst the buoyant financial markets, as well as the brisk expansion of both offshore trade and inbound tourism (*Chart 2(b)*).

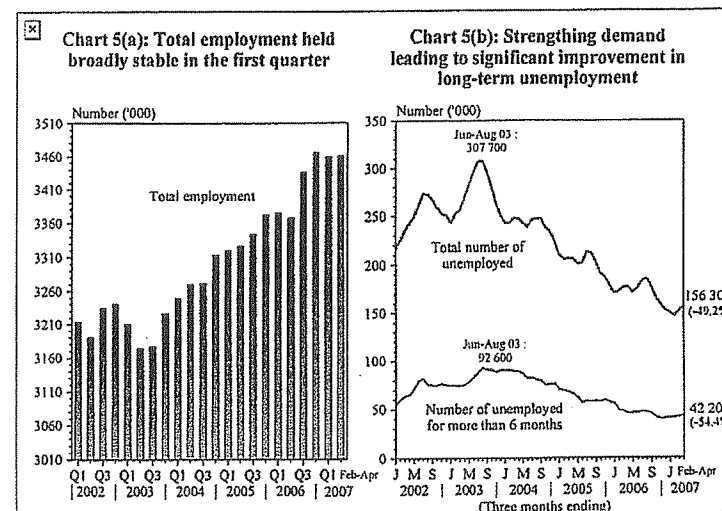
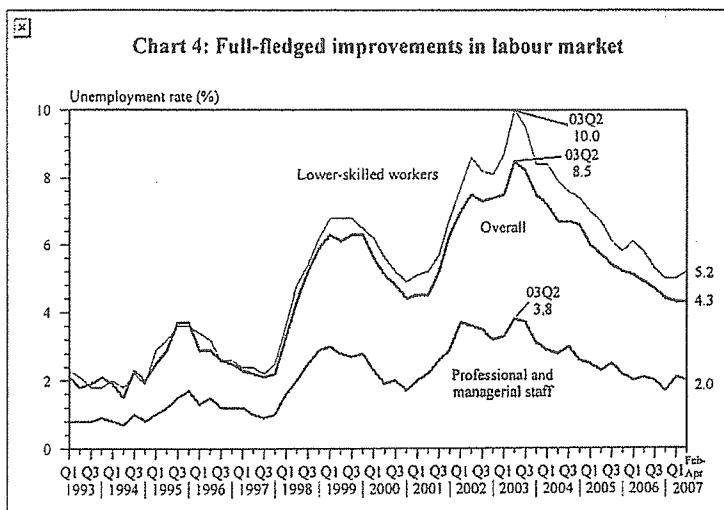


6. Domestically, consumption demand continued to display strength. With rising labour income and the wealth effect stemming from the buoyant performance of the stock market during most of the first quarter, private consumption expenditure (PCE) leaped by 5.6% in real terms in the first quarter over a year earlier, extending the strong growth momentum in the latter part of 2006 (*Chart 3(a)*).

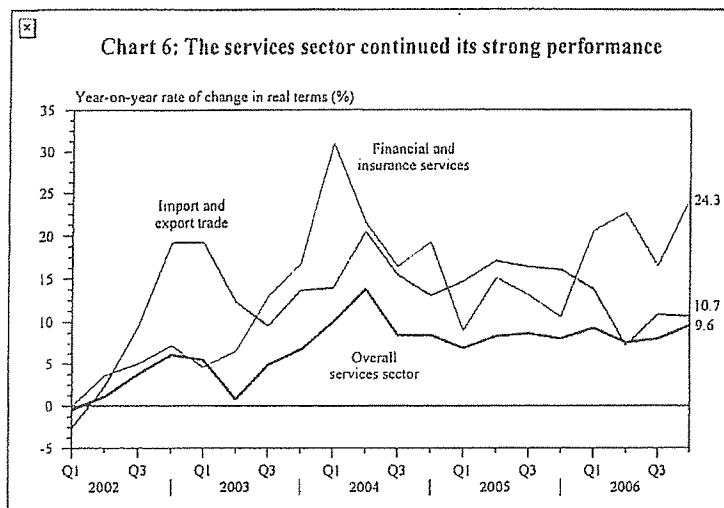
7. Overall investment spending grew further by 3.9% in real terms in the first quarter over a year earlier. The somewhat more moderate growth in overall investment in the first quarter was caused by the less rapid increase in expenditure on machinery and equipment. It has to be noted, however, that investment expenditures can be volatile at times, especially after a rather long period of continuous upsurge. The results of the latest Quarterly Business Tendency Survey conducted by the Census and Statistics Department actually indicated that large business establishments were still optimistic on business outlook. Meanwhile, overall building and construction activity was still slack, yet construction activity in the private sector held largely stable (*Chart 3(b)*).



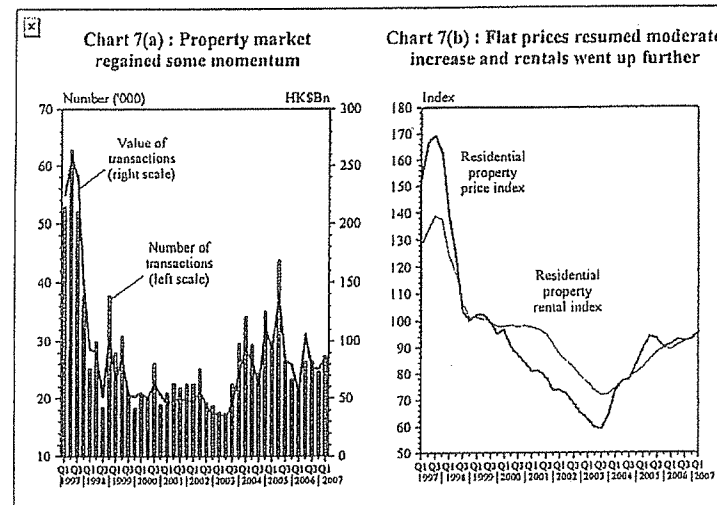
8. As demand for labour continued to rise in tandem with the economic upturn, the seasonally adjusted unemployment rate fell further to 4.3% in the first quarter (and stayed unchanged in the three months ending April), the lowest in more than 8½ years (*Chart 4*). The improvement in the labour market conditions continued to be broad-based. Since the trough in mid-2003, a total of nearly 300 000 net additional jobs have been created, benefiting workers at different skill levels across different sectors (*Charts 5(a) and 5(b)*). The number of long-term unemployed fell by more than half over the past 3½ years or so, and the number of lower-skilled unemployed workers also declined by nearly half. The total number of job vacancies in the private sector continued to rise, while wages and earnings also picked up more notably in the fourth quarter of 2006.



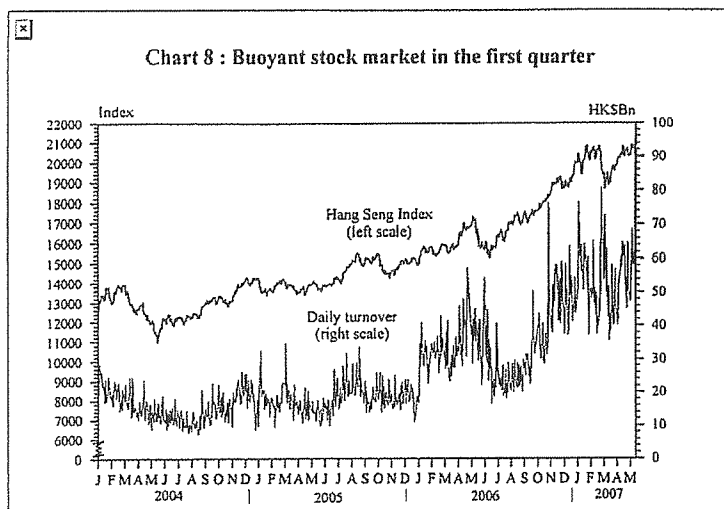
9. Hong Kong's overall economic growth has been propelled by the continued strong performance of the services sector. Latest available figures for 2006 indicate that the value added of the services sector as a whole grew robustly by 8.7% in real terms. Reflecting the buoyancy of financial market activities, financing and insurance showed the fastest growth among the constituent service sectors in 2006. This was followed by communications and import and export trade. The strengthening consumption demand and further expansion of inbound tourism also led to a vibrant growth in the value added of restaurants and hotels. On the other hand, the manufacturing sector only showed a small increase in value added and the construction sector remained slack (*Chart 6*).



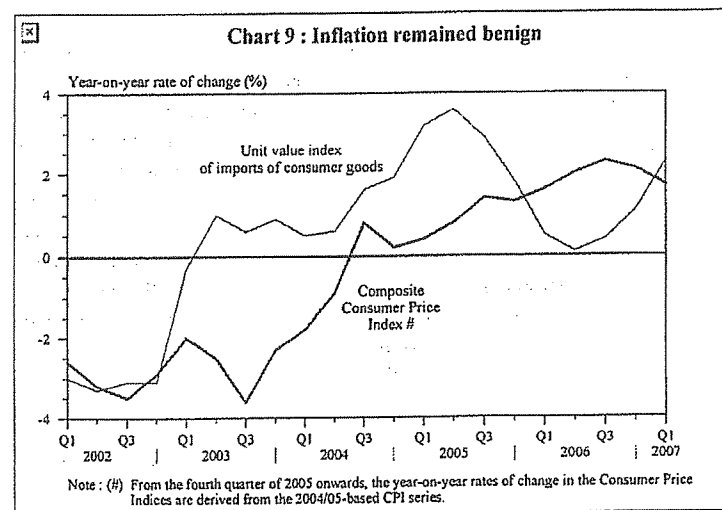
10. The residential property market regained some momentum in the first quarter of 2007. Sentiment was boosted by sanguine economic outlook, stable local interest rate environment and increased mortgage concessions by the banks. Acquisition interest for smaller flats more recently was also stimulated by the reduction in stamp duty for property transactions worth between \$1 million and \$2 million as announced in the 2007/08 Budget. Flat prices resumed a moderate increase of around 3% during the quarter, having moved narrowly for five months. Compared with the trough in 2003, flat prices in March 2007 were 66% higher, but still 44% lower than the peak in 1997. Concomitantly, flat rentals went up further by about 3% during the first quarter. As for the non-residential segment, it maintained an upturn. In particular, the strong demand for quality office space was sustained, as the economy continued to move up the value chain (*Chart 7*).



11. The local stock market held up well at the beginning of 2007, but the fall in the Mainland market together with the ensuing jitters in other overseas markets saw a rather sharp correction in late February and early March. The Hang Seng Index retreated from a high of over 20 800 in late January to below the 19 000 mark in early March. The local stock market however rebounded swiftly, backed by the rise-back in other markets, and more importantly, the favourable corporate earnings results and positive market sentiment about the economic outlook. The Hang Seng Index closed the first quarter at 19 801, not much lower than that of 19 965 at end-December 2006. Trading has been buoyant throughout the first quarter, with average daily turnover expanding sizably to a record high of \$52.9 billion, 18.4% higher than the fourth quarter in 2006 (*Chart 8*). The recent announcement to extend the scope of Mainland's QDII scheme has boosted market sentiment further. The Hang Seng Index reached successive new highs and broke the 21 000 mark for the first time in mid-May amidst hectic trading.



12. Consumer price inflation stayed moderate. The year-on-year rate of increase in Composite Consumer Price Index (CCPI) averaged at only 1.7% in the first quarter, down from the 2.1% rise in the preceding quarter, due to the waiving of public housing rentals in February. Excluding the influence of this one-off measure, the underlying inflationary pressures actually crept up, yet only slightly, mainly reflecting the feed-through of higher imported inflation due to the depreciation of the Hong Kong dollar along with the US dollar, as well as the gradual appreciation of the renminbi (*Chart 9*).



#### Updated short-term economic forecasts for 2007

13. The near-term outlook for the rest of 2007 is affected by a number of uncertainties arising from the external front. Although the global economy remained largely resilient so far this year, the evolving development of the US housing market and related issues of sub-prime mortgages and fall-off in construction investment continue to attract considerable concern, in particular whether the housing segment problems will eventually filter through to the wider segments of the economy and lead to a sharper-than-expected US economic slow-down, with negative spill-overs to the rest of the global economy. Along with an uncertain US outlook, there may also come more volatility in global financial markets, especially given the lingering structural weakness of global imbalances.

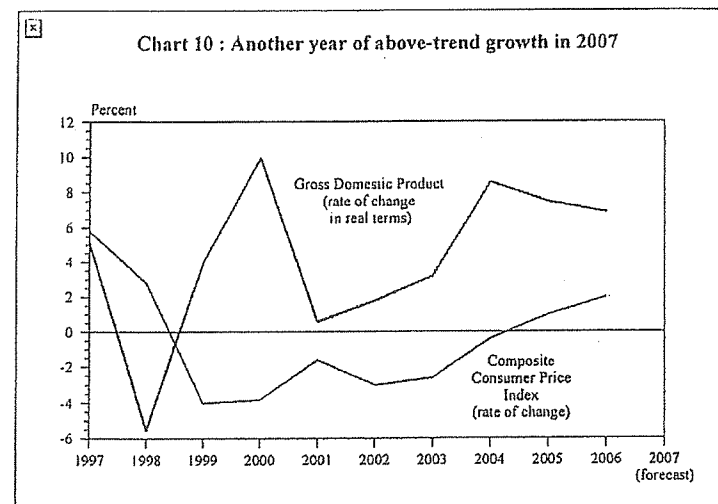
14. Yet there are also a number of positive factors which should render support to the Hong Kong economy. The European and Japan economies have finally embarked on a sustainable growth path, a much welcomed development for the global economy, at a time when the US economy is slowing. The Mainland's economy has remained vibrant, and continues to be a plus factor for Hong Kong. Even though there is concern about further macro tightening measures, these measures are intended to forestall the risk of overheating and steer the Mainland economy towards a steady and more sustainable high growth track. On the exchange rate front, the weakness of the dollar particularly against the Asian currencies would continue to aid our export competitiveness. Abundant liquidity in our banking system is another positive factor for business expansion. Moreover, after the distinct upturn over the past few years, the Hong Kong economy is now on a sounder footing to cope with external shocks.

15. Moreover, locally, domestic demand is expected to hold firm and take up a bigger role as a growth contributor, at a time when the trade prospects are subject to more uncertainties. Improving employment incomes and the positive economic prospects would continue to render support to private consumption. Vibrant business activity and the prevailing upbeat business sentiment should augur well for continued investment growth in the coming quarters.

16. Overall, the Hong Kong economy is likely to have another year of above-trend growth in 2007. With the actual GDP outturn of a 5.6% growth in the first quarter largely in line with expectations, the GDP forecast at 4.5-5.5% for 2007 announced in the Budget round in late February is kept unchanged (*Chart 10*). As a reference, the IMF lately forecasts that the Hong Kong economy would grow by 5.5% in 2007. The prevailing private sector analysts are also upbeat about further expansion of the Hong Kong economy at a solid pace, with prevailing forecasts averaging at around 5.3%.

17. As to the inflation outlook, tighter labour market conditions, weakness of the US dollar and renminbi appreciation would see cost pressure creeping up further. Yet the upturn in CCPI is likely to proceed still at a rather modest pace, being cushioned by a concurrent notable growth in labour productivity. Moreover, various one-off factors including the rates waiver for two quarters, the public housing rental cut to be implemented later this year, and the implementation of the Pre-primary Education Voucher Scheme would also

bring down the CCPI level. With the actual outturn of consumer price inflation so far in line with expectations, the forecast rate of increase in the CCPI for 2007 is also maintained at 1.5%.



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29 May 2007

## Annex

### Recent situation of household income<sup>(1)</sup>

#### Background

This Annex provides a regular update on the movement of household income both in overall terms and in respect of households with monthly household income below \$4,000, in response to the earlier request from the Hon Emily Lau at the 5 December 2005 meeting<sup>(2)</sup>.

#### Latest situation

2. In overall terms, household income continued to improve in the past few months, underpinned by further increases in job opportunities and labour earnings. The average monthly household income in Q1 2007, at \$27,000, was 2.9% higher in money terms than a year earlier and also 8.0% higher over Q1 2004. After discounting the price changes, the respective gains were 1.2% and 4.1% in real terms. Furthermore, it is worth noting that over the past three years, the proportion of households with monthly income less than \$16,000 at current prices fell, whereas that for households with \$16,000 or above rose (*Table 1*).

Table 1: Share of domestic households by monthly household income

	<u>Q1 2004</u>	<u>Q1 2006</u> (Percent)	<u>Q1 2007</u>
Less than \$4,000	9.0	8.0	7.9
\$4,000 - \$7,999	13.6	12.8	12.9
\$8,000 - \$11,999	14.5	13.7	13.4
\$12,000 - \$15,999	12.5	12.2	12.0
\$16,000 - \$23,999	16.4	17.0	16.7
\$24,000 - \$39,999	17.3	18.3	18.5
\$40,000 - \$99,999	13.9	15.1	15.5
\$100,000 or above	2.8	3.0	3.0

Note : The purchasing power of the income (as measured by the Composite CPI) in Q1 2004 and Q1 2006 were 104% and 102% of that in Q1 2007 respectively.

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

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

### Households with monthly household income below \$4,000

3. In Q1 2007, the number of households with monthly household income below \$4,000 (hereafter referred to as "low-income households") rose slightly by 1 000 or 0.6% over a year earlier to 176 600. This was primarily due to the rise in the number of economically inactive low-income households (i.e. with all of their members being economically inactive). The number of economically active low-income households (i.e. with at least one economically active household members) actually fell further, thanks to a significant improvement in the employment situation for the lower-skilled workers (as manifested by a drop in the overall unemployment rate of these workers from 6.1% in Q1 2006 to 5.0% in Q1 2007). Concurrently, the number of elderly low-income households (i.e. with all members aged 60 or above) edged down slightly. As a proportion of all domestic households, the low-income households decreased further over the past year, from 8.0% to 7.9%.

4. Comparing Q1 2007 with Q1 1997, while there was still a surge in the low-income households in both absolute and proportionate terms, it was mainly attributable to a significant increase in the number of retired elderly households as well as a decline in average household size during the period (*Table 2*).

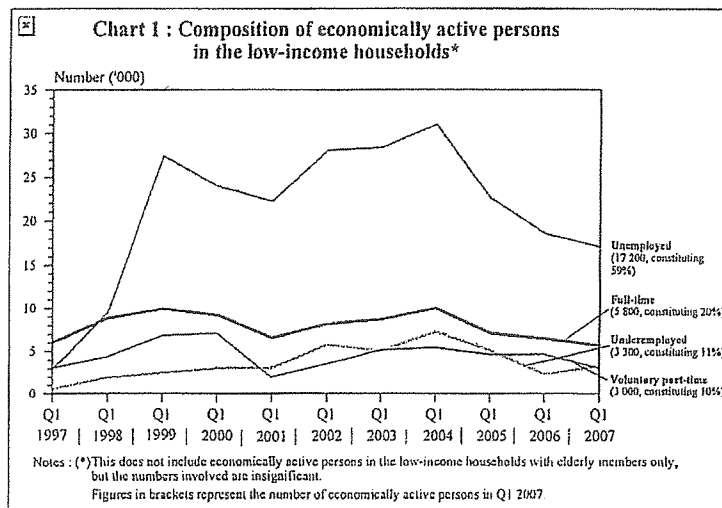
Table 2: Number and share of low-income households

	<u>Elderly households</u>	<u>Economically inactive households</u>	<u>Economically active households</u>	<u>Total</u>
Q1 1997	62 700 (3.3)	18 400 (1.0)	11 200 (0.6)	92 300 (4.8)
Q1 2004	119 300 (5.6)	29 600 (1.4)	44 300 (2.1)	193 200 (9.0)
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)

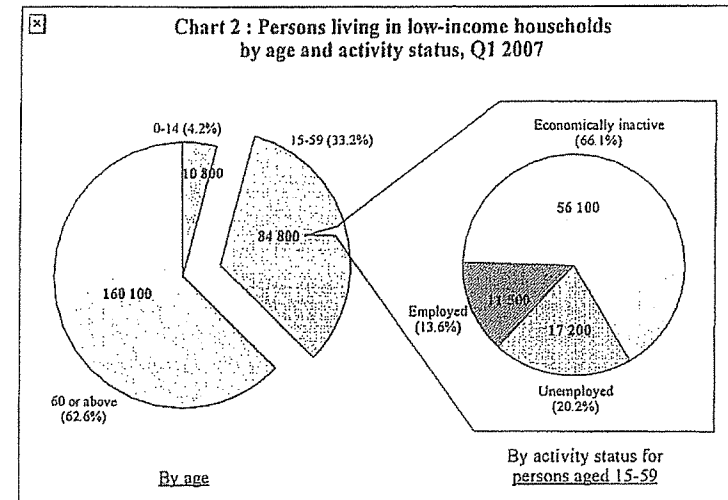
Note : ( ) Share in all domestic households.

5. A further breakdown of these low-income households gave the following major observations:

- More than two-thirds of the low-income households in Q1 2007 were 1-person households, within which elderly persons aged 60 or above constituted the majority share.
- There were 65 900 household members living in economically inactive low-income households. More than one-third (36%) of them were aged below 20 and aged 60 or above (primarily consisting of students and retirees). The remaining 42 200 persons aged 20-59 comprised mainly home-makers (22%), persons suffering prolonged illness (19%), and retirees (19%).
- Of the 29 300 economically active persons living in economically active low-income households, 59% were unemployed, 22% were part-time workers (working voluntarily for less than 35 hours per week, or involuntarily so, i.e. underemployed), and 20% were full-time workers. The noticeable decline in the number of these household members over the past three years suggested that many of them had actually regained employment or else had earned higher income, thereby moving away from the group of low-income households (*Chart 1*).



- For all the 255 800 persons living in low-income households in Q1 2007, the great majority (62.6%) were elderly persons aged 60 or over. About one-third of them were aged 15-59, of whom a predominant proportion was economically inactive (*Chart 2*).



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This paper analyses Hong Kong's overall economic development in the most recent period, summarises the updated economic forecasts by the Government for 2007 as a whole, and briefly discusses the various factors which may affect the outlook in 2008.

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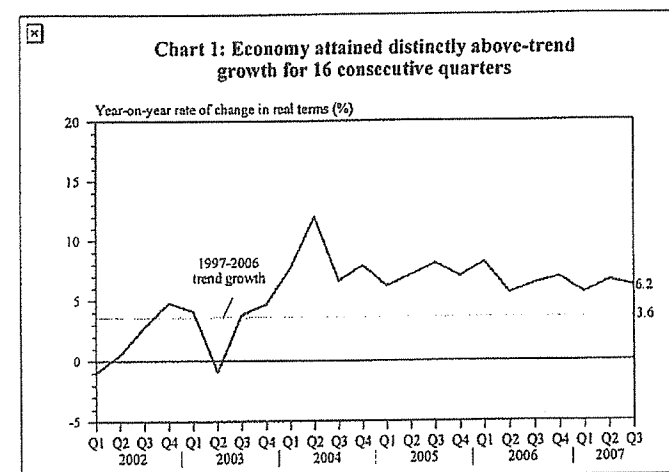
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### Introduction

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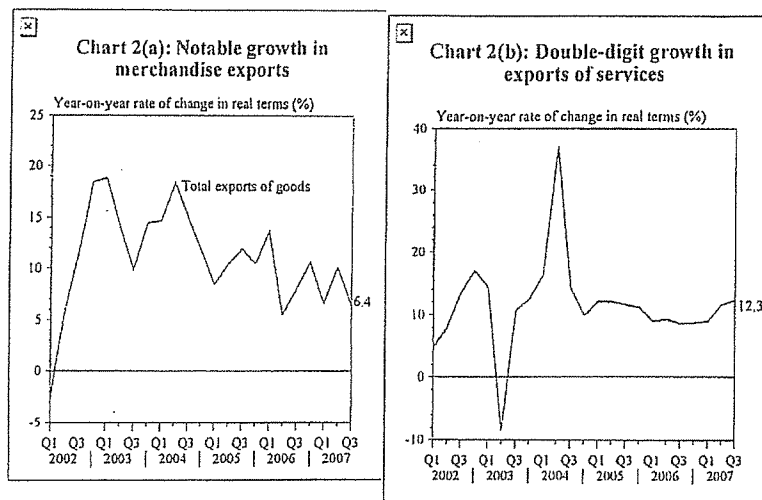
### Recent economic situation

2. The Hong Kong economy continued to be vibrant in the third quarter of 2007, with real GDP leaping by 6.2% over a year earlier. This followed a robust 6.1% growth in the first half of the year. By now our economy has attained distinctly above-trend growth for 16 consecutive quarters (*Chart 1*). Despite the global financial market turbulence in August and September, external trade grew notably further and domestic demand continued to display strength in the third quarter.



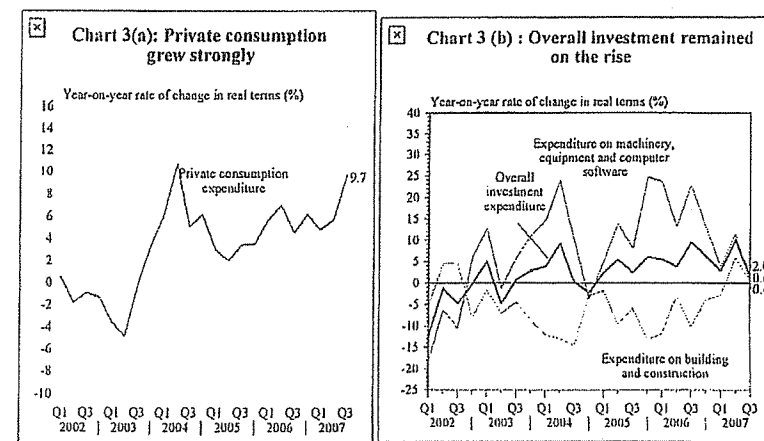
3. In the third quarter, merchandise exports still held firm, with a 6.4% growth (*Chart 2(a)*). The Mainland market continued to be the main growth driver. Exports to many other emerging Asian markets such as India, Malaysia, Thailand, Vietnam and Indonesia also fared strongly. These together with the continued expansion in exports to the EU market compensated for the weak exports to the US. Presumably the sluggish US economy also contributed to the weak raw material intakes in Taiwan, Singapore and Korea, which in turn led to the rather soft performance in Hong Kong's exports to these economies. Exports to Japan reverted to a decline, given the weak Japanese yen and the rather soft domestic demand there.

4. Exports of services continued to surge distinctly. With strong inbound tourism, vibrant financial market activities, and rapid growth in offshore trade, exports of services accelerated further to a 12.3% growth in real terms in the third quarter over a year earlier, cumulating to a growth of 11.0% in the first three quarters as a whole (*Chart 2(b)*).

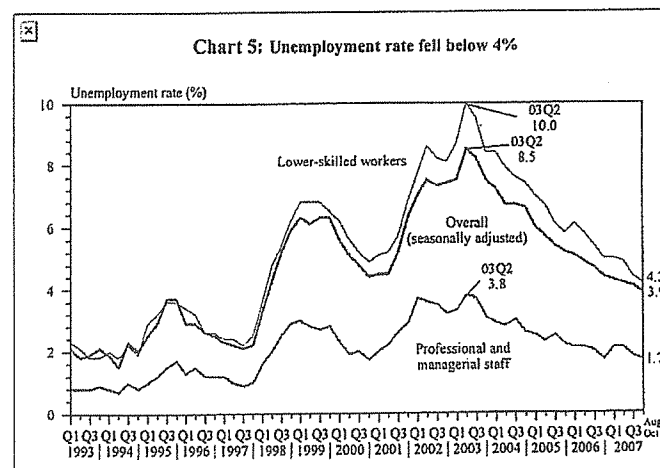
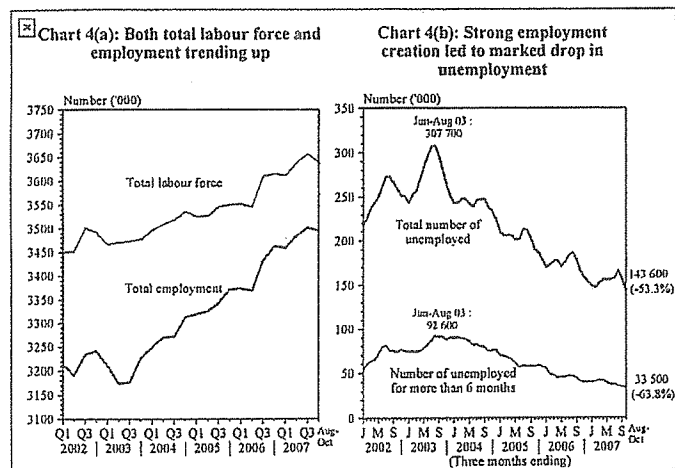


5. Domestic demand has been playing a key role in driving overall economic growth. Private consumption expenditure grew strongly by 9.7% in real terms in the third quarter over a year earlier, supported by an improving job market, and rising household income and wealth, but the year-on-year comparison was also partly boosted by a relatively low base of comparison in the third quarter last year. For the first three quarters as a whole, there was a notable growth of 6.7% (*Chart 3(a)*).

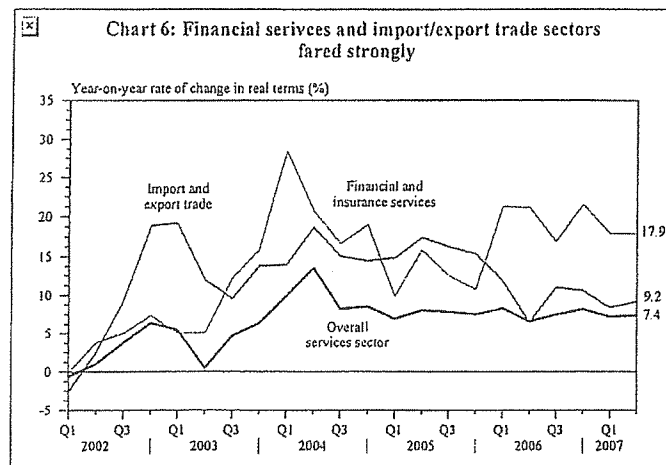
6. Overall investment expenditure expanded further by 4.9% in real terms in the first three quarters of 2007 after the notable growth of 6.3% recorded last year. Machinery and equipment investment increased by 5.2% in real terms in the first three quarters, providing the major impetus to the growth in overall investment. The slower increase of 2.0% in real terms in overall investment in the third quarter was due mainly to a high base of comparison in the same quarter last year. Confidence in near-term business outlook remained strong, as indicated by the results of the latest Quarterly Business Tendency Survey. Meanwhile, private sector output in building and construction showed a notable rebound in the first three quarters of 2007, yet the overall building and construction activity rose only mildly, as public sector activities remained on a decline (*Chart 3(b)*).



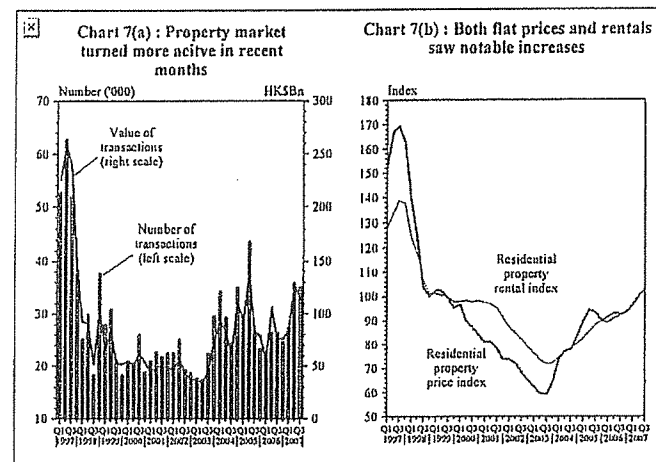
7. The sustained strength of the local economy continued to translate into job opportunities and benefit a wide spectrum of the labour sector (*Chart 4(a)*). Since the economic trough in mid-2003, a total of some 330 000 net additional jobs had been created. With the strong employment creation, the number of long-term unemployed also fell markedly, by 64% as compared to the peak in mid-2003 (*Chart 4(b)*). The seasonally adjusted unemployment rate went further down to 3.9% in the three months ending October, the lowest in nine and a half years (*Chart 5*). Workers at the lower end of the labour market also saw a significant improvement in employment situation. Wages and earnings picked up further in June 2007 over a year earlier, representing increases in real terms after netting out inflation. Job vacancies continued to surge.



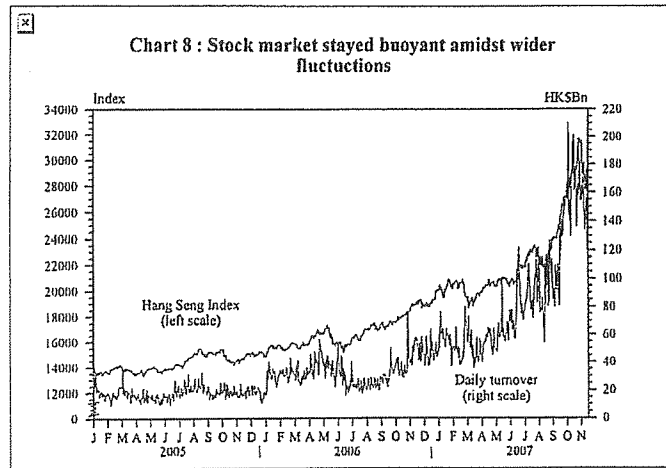
8. In recent years, Hong Kong has been successful in enhancing its role as an international financial centre and maintaining its position as a leading trading hub in the region. Output in the financial services sector surged at an average annual rate of 17.7% in real terms over the past three years, and further by 17.9% in the first half of 2007. Output in import and export trade also attained a robust average annual growth of 13.7% during 2004 to 2006, and grew notably further by 8.8% in the first half of 2007 (*Chart 6*). Wholesale and retail trades, and restaurants and hotels also performed well in recent quarters, on the back of strong consumption demand and thriving inbound tourism.



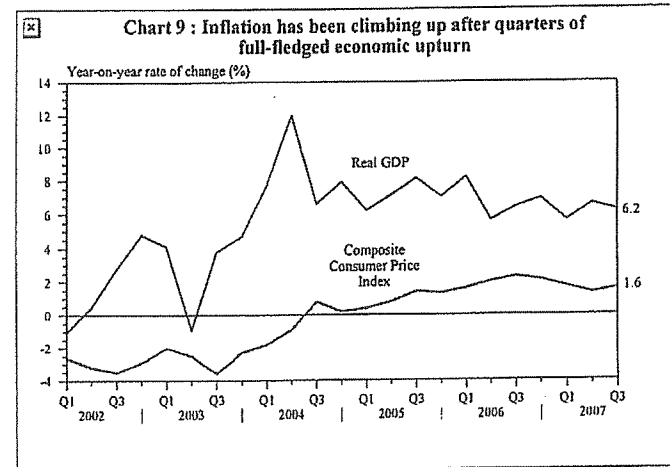
9. The residential property market continued to gain momentum. Trading in the residential property market turned more active in recent months (*Chart 7(a)*), with more notable increases in both prices and rentals (*Chart 7(b)*), as the households' financial positions became stronger, confidence in economic prospects increased, and expectations of interest rate cuts prevailed. Residential flat prices in September 2007 were 2.2% higher as compared with June, and 11.3% higher than in September 2006. Compared with the trough in 2003, residential flat prices in September 2007 rebounded substantially but were still 40% lower than the peak in 1997. Flat rentals also went up distinctly by 3.7% during the third quarter, reflecting strong leasing demand. The markets for commercial properties, i.e. retail premises and offices, also fared strongly given businesses' expansion plans amidst sustained economic upturn.



10. Amidst the global financial market turbulence and the uncertain outlook for the US economy, the local stock market, along with other major overseas stock markets, showed much greater volatility in recent months. The Hang Seng Index (HSI) was on an uptrend in July, then fell to an intra-day low of 19 387 in mid-August upon the global equity market adjustment, and again went on surging starting from the second half of August on the prospects for more fund inflows, as well as the resurgence of the global equity markets. The rising momentum of the stock market, in terms of both prices and turnover, extended into October, with the HSI attaining successive new highs in the month and closed above the 30 000-mark for the first time. However, as concerns about the adverse effects of global credit market turbulence re-emerged, the HSI fell to 26 005 on 22 November 2007, 18 % lower than the record closing high of 31 638 on 30 October (*Chart 8*). The local stock market capitalisation stood at \$23.1 trillion at end-October, up 73% from end-December 2006. IPO activities stayed robust in recent months, although the amount of capital raised fell short of the distinctly high level in 2006. In terms of IPO funds raised during the first three quarters of 2007, Hong Kong was ranked fourth in the world.

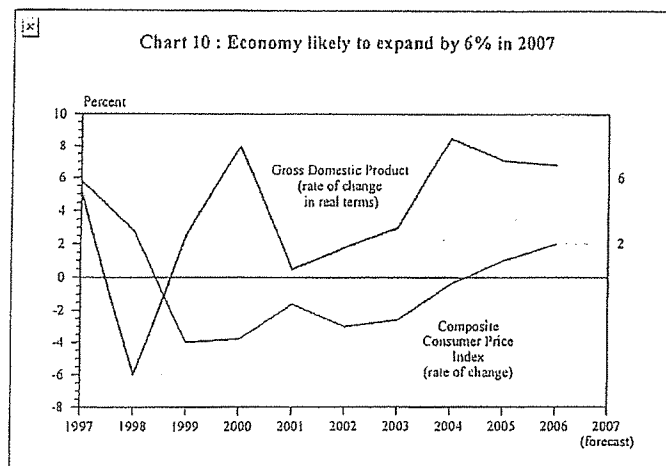


11. With a sustained strong economic upturn, inflation has been climbing up gradually. In the first ten months of 2007, the headline CPI inflation averaged at 1.7% year-on-year, and the underlying inflation at 2.6% after netting out the effects of the rates concession and public rental waiver in February (*Chart 9*). External cost pressures are increasing, with the pick-up in food inflation globally, the weak US dollar and the accompanying appreciation of RMB, as well as the resurgence of oil prices. The upward price pressures from the increases in wages and rentals on local business costs, however, have remained largely in check, with unit labour cost being tamed by sustained increases in productivity, and unit rental cost also being contained by solid expansion in business volume.



Updated short-term economic forecasts for 2007

12. With the strong outturn of a 6.1% GDP growth in the first three quarters of 2007 and given the prevailing strength in domestic demand, the Hong Kong economy should be able to attain a 6% growth in real terms for 2007 as a whole (*Chart 10*). Barring any abrupt adverse changes in the external environment, the economy looks set for further strong growth in the fourth quarter.



13. The headline inflation rate is expected to go higher in the fourth quarter, due to the dissipation of the favourable effect of the rates concession after September, the persistent rapid increase in food prices, and the factors mentioned in paragraph 11 above. For 2007 as a whole, Composite CPI inflation is forecast at 2%. The corresponding forecast underlying inflation rate, which discounts the effects of rates concession and public housing rental waiver for February, would be 2.7% for 2007 as a whole.

#### Economic outlook for 2008

14. The 2008 economic outlook for Hong Kong, given its openness, necessarily hinges crucially on how the global economy would fare. While the global credit market turbulence left the Hong Kong economy relatively unscathed so far, the external trading environment has turned more uncertain. The repercussions of the credit market turbulence have yet to be fully played out. Also, the US economy, which is being overshadowed by the housing market slump, sub-prime mortgage problem and tightening credit, poses as the main downside risk to global economic growth in the coming months.

15. Barring an unexpectedly steep recession in the US, there

are still certain important positive developments which would render some support to Hong Kong's external trade. The strong growth momentum in the Mainland economy is likely to continue. Currently the Mainland market accounts for almost half of Hong Kong's total exports. Many other emerging Asian markets have been doing well, and the economic prospects in Europe have also remained positive. The depreciation of the HK dollar against many of the Asian currencies should continue to help Hong Kong's export competitiveness.

16. Moreover, the sustained economic upturn locally has placed Hong Kong on a much sounder footing than before. Consumer demand is well underpinned by better labour market, rising incomes and strong household financial positions. Business sentiment also stays strong, against the backdrop of a successful economic integration between Hong Kong and the Mainland. Domestic demand can be expected to provide support to overall economic growth in 2008, at a time when the trade outlook is subject to more uncertainties.

17. Inflationary pressures are likely to build up further in the near term, particularly if the economic upturn continues to proceed at an above-trend pace. The inflation prospects for 2008 will also depend on whether the weakness in US dollar and the accompanying renminbi appreciation would continue, and whether the recent rapid increases in global food and oil prices would persist. More attention should also be paid to local wage and rental increases, and how far such increases could be absorbed by sustained labour productivity growth thus reducing the risk of a significant pick-up in inflation. The rates concession for the first quarter of 2008 announced in the Policy Address would help lower the Composite CPI inflation in 2008 by 0.3 percentage point. The Government will continue to stay alert to the upside risks to inflation, particularly in view of the impact of escalating costs on people in the lower economic strata of the community.

18. Overall, the Hong Kong economy is likely to expand further in 2008, although the growth pace should be slower than that achieved over the past four years. The economic forecast for 2008 will be announced along with the Budget Speech in February next year. As a reference, the IMF's latest 2008 economic growth forecast for Hong

Kong is 4.7%. Most private sector analysts also expect the Hong Kong economy to show further solid growth in 2008, with prevailing forecasts averaging at around 5.1%.

Economic Analysis Division  
Economic Analysis and Business Facilitation Unit  
Financial Secretary's Office  
26 November 2007

## Annex

### Recent situation of household income<sup>(1)</sup>

#### Background

This Annex provides regular updates 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 Q3 2007, at \$25,700, was 6.0% higher in money terms than a year earlier. After discounting price changes, the gain was 4.3% in real terms. Also worth noting is that the share of households with monthly income less than \$24,000 (at current prices) decreased over the past year, while the share of households with \$24,000 or above rose (*Table 1*).

Table 1: Distribution of domestic households by monthly household income

	Q3 2004	Q3 2006	Q3 2007
	(%)	(%)	(%)
Less than \$4,000	8.6	8.0	7.7
\$4,000 - \$7,999	14.1	13.0	12.6
\$8,000 - \$11,999	14.8	14.2	13.5
\$12,000 - \$15,999	13.2	12.6	12.4
\$16,000 - \$23,999	17.1	18.2	17.7
\$24,000 - \$39,999	17.8	18.7	19.0
\$40,000 - \$99,999	12.3	12.9	14.4
\$100,000 or above	2.0	2.4	2.7

Note : The purchasing power of the income (as measured by the Composite CPI) in Q3 2004 and Q3 2006 were 105% and 102% of that in Q3 2007 respectively.

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

### Households with monthly household income below \$4,000

3. In Q3 2007, the number of households with monthly household income below \$4,000 ("low-income households") dropped by 4 300 (or 2.4%) over a year earlier to 173 600. Decreases were observed across different types of low-income households. In particular, the number of economically inactive low-income households (i.e. with all members being economically inactive) posted a more notable decline, after rising for five consecutive years. This is likely a reflection of an increase in labour force participation rate alongside the further improvement in unemployment situation especially among lower-skilled workers (their overall unemployment rate dropped from 5.4% in Q3 2006 to 4.4% in Q3 2007). The number of elderly (i.e. with all members aged 60 or above) and economically active (i.e. with at least one economically active household members) low-income households also continued to fall. Taken together, the proportion of low-income households in all domestic households edged down from 8.0% in Q3 2006 to 7.7% in Q3 2007.

4. Comparing Q3 2007 with Q3 1997, although there was still a rise in the low-income households in both absolute and proportional terms, it was mainly driven by a significant increase in the number of retired elderly households and a decline in the average household size (*Table 2*).

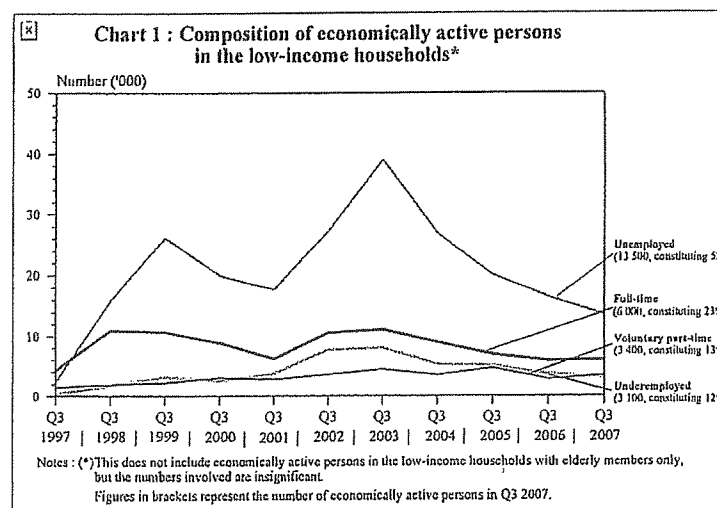
**Table 2: Number and share of low-income households**

	Elderly households	Economically inactive households	Economically active households	Total
Q3 1997	62 700 (3.3)	15 300 (0.8)	7 500 (0.4)	85 600 (4.4)
Q3 2004	115 700 (5.3)	32 700 (1.5)	38 000 (1.7)	186 400 (8.6)
Q3 2005	119 700 (5.5)	34 500 (1.6)	31 900 (1.5)	186 100 (8.5)
Q3 2006	115 000 (5.2)	37 900 (1.7)	25 000 (1.1)	177 900 (8.0)
Q3 2007	114 800 (5.1)	35 100 (1.6)	23 700 (1.1)	173 600 (7.7)

Note: ( ) Share in all domestic households.

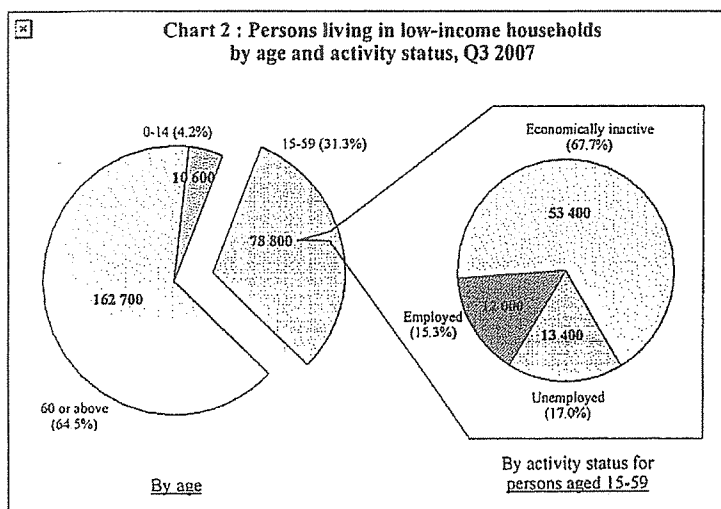
5. A further breakdown of the low-income households yielded the following salient observations:

- Two-thirds of the low-income households in Q3 2007 were 1-person households, the majority of which (78%) were elderly persons aged 60 or above.
- There were 64 300 household members living in economically inactive low-income households. More than one-third (35%) of them were aged below 20 and aged 60 or above (mainly students and retirees). The bulk of the remaining 41 500 persons aged 20-59 were home-makers (26%), persons suffering prolonged illness (17%) and retirees (23%).
- Of the 26 000 economically active persons living in economically active low-income households, 52% were unemployed, 25% were part-time workers (working voluntarily for less than 35 hours per week, or involuntarily, i.e. underemployed), and the remaining 23% were full-time workers. The notable decline in the number of these household members over the past few years suggested that some of them had earned higher income, thus moving up to household groups of higher income (*Chart 1*).





- With regard to the 252 100 persons living in low-income households in Q3 2007, a significant portion (64.5%) were elderly persons aged 60 or over. Nearly one-third of them were aged 15-59, of whom over two-thirds were economically inactive (*Chart 2*).



Economic Analysis Division  
 Economic Analysis and Business Facilitation Unit  
 Financial Secretary's Office  
 26 November 2007



## 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.

Economic Analysis Division  
Economic Analysis and Business Facilitation Unit  
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2 June 2008

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

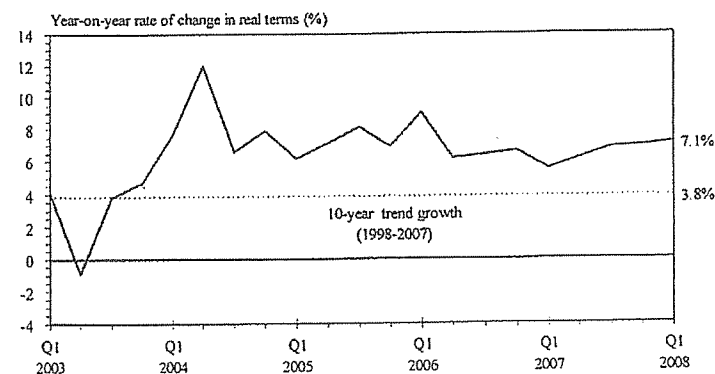
### Introduction

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

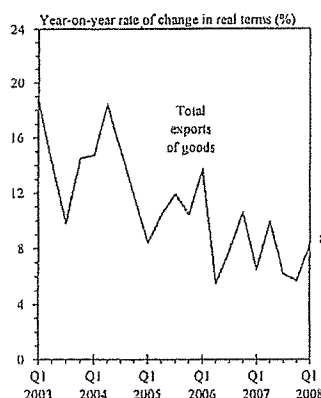
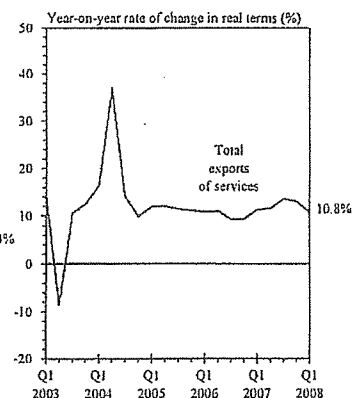


Chart 2(b) : Exports of services stayed vibrant



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

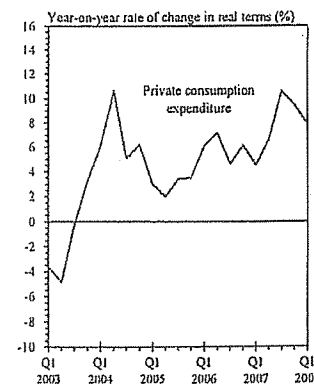
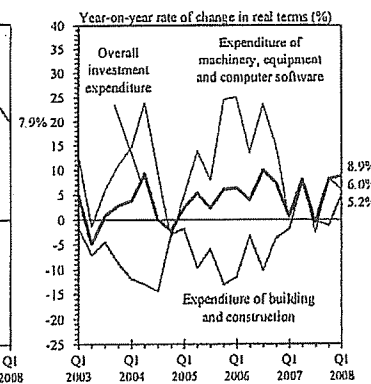


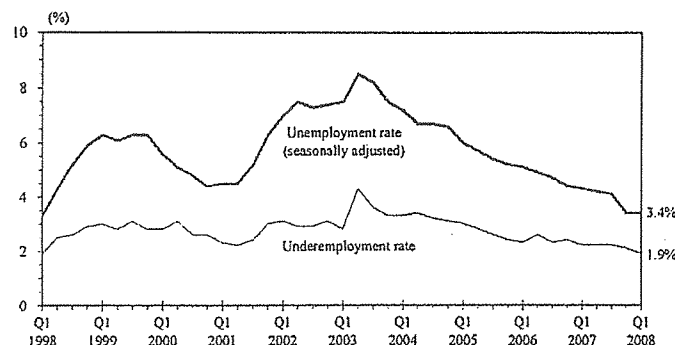
Chart 3(b) : Overall investment was resilient to the dimmer global economic prospect



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)*).

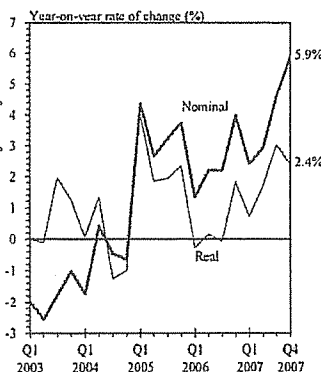
**Chart 4 : Firm labour market in the first quarter of 2008 after considerable improvement towards the end of 2007**



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



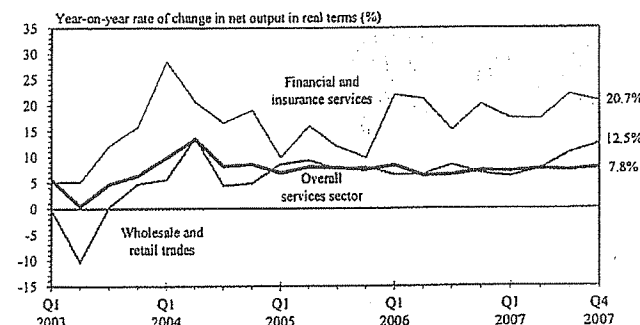
**Chart 5(b) : Labour earnings accelerated towards the end of 2007**



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

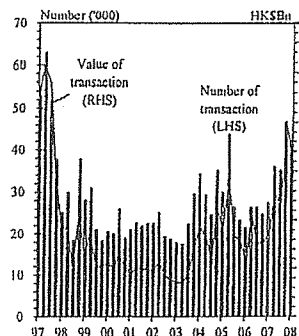
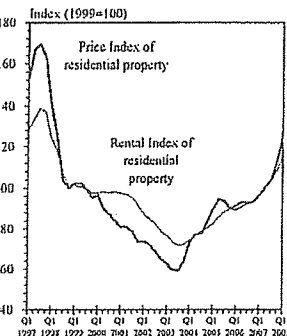
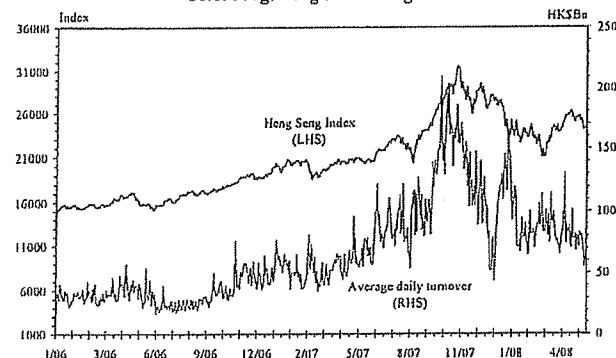


Chart 7(b) : Both flat prices and rentals went up further during the first quarter



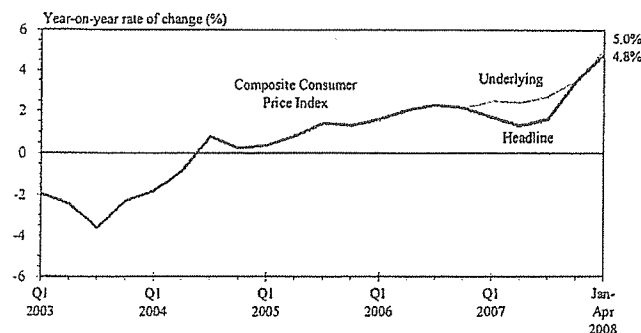
10. The local stock market showed a further downward correction during the first quarter of 2008, along with other major overseas equity markets, as investment confidence was shaken by the global credit crisis and the dimmer global economic prospects. The Hang Seng Index (HSI) closed the quarter at 22 849, 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.

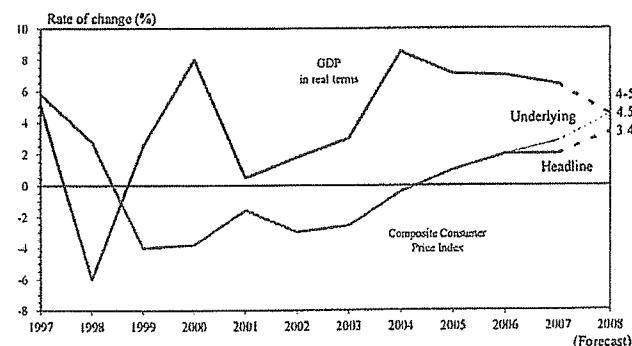
13. Nevertheless, the growth momentum in the emerging and developing economies, including the Mainland economy, is expected to remain vibrant, although there should unavoidably be some mild moderation in growth due to the weaker demand from the advanced economies. Yet this should still provide some cushioning 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**



Economic Analysis Division  
Economic Analysis and Business Facilitation Unit  
Financial Secretary's Office  
2 June 2008

## Recent situation of household income<sup>(1)</sup>

### Annex A

#### 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

	Q1 2005	Q1 2007	Q1 2008
	(%)	(%)	(%)
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

	Elderly households	Economically inactive households	Economically active households	Total
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)

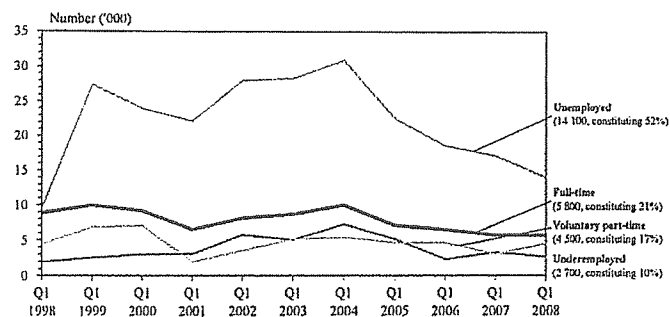
Notes: ( ) Share in all domestic households.

\* 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\*

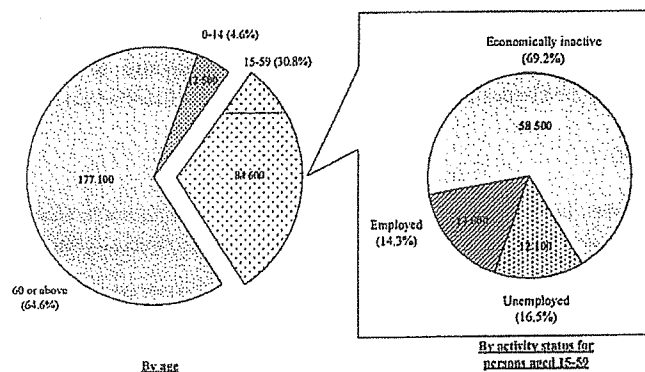


Notes : (\*) This does not include economically active persons in the low-income households with elderly members only, but the numbers involved are insignificant.  
Figures in brackets represent the number of economically active persons in Q1 2008

- 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



Economic Analysis Division  
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Financial Secretary's Office  
2 June 2008



## Annex B

### 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>	<u>CPI for households in the lowest expenditure range<sup>#</sup></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 (%))

Expenditure component	Weight (%)	2007					2008	
		2007	Q1	Q2	Q3	Q4	Q1	Apr
Food	26.94	4.3	2.9	2.8	4.8	6.7	10.0	11.1
Meals bought away from home	16.86	2.5	1.8	2.0	2.6	3.7	5.4	6.0
Other foodstuffs	10.08	7.1	4.4	4.1	8.2	11.6	17.4	19.4
Housing <sup>(a)</sup>	29.17	2.0	2.2	1.0	0.7	4.2	3.9	5.5
Private dwellings	23.93	4.0	5.6	2.0	2.3	5.9	3.5	7.5
Public dwellings	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 (2.8)	1.7 (2.5)	1.3 (2.4)	1.6 (2.7)	3.5 (3.5)	4.6 (4.9)	5.4 (5.4)
All items excluding food	73.06	1.2 (2.2)	1.3 (2.4)	0.7 (2.2)	0.5 (1.9)	2.3 (2.3)	2.6 (3.0)	3.3 (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.





## 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  
Economic Analysis and Business Facilitation Unit  
Financial Secretary's Office  
24 November 2008

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

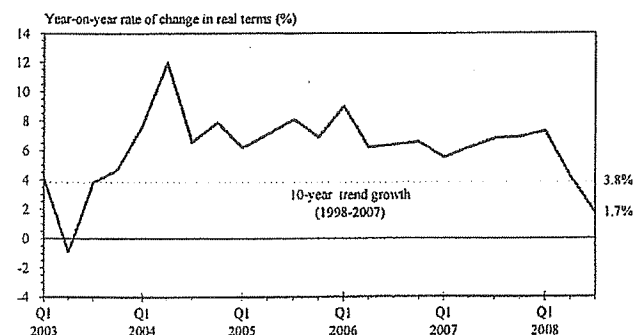
### Introduction

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.

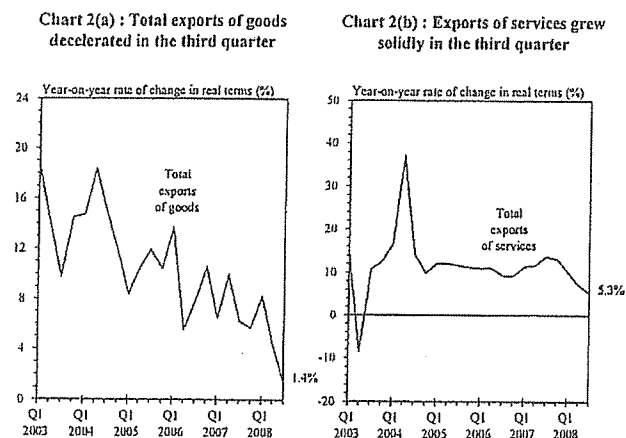
Chart 1 : Economic growth slowed notably further  
in the third quarter



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.

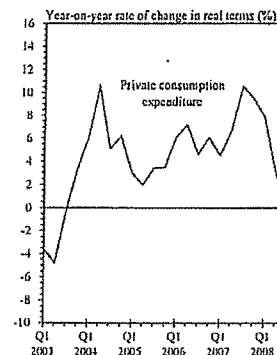
4. Exports of services grew by 5.3% in the third quarter, though likewise moderated from the second quarter (*Chart 2(b)*). This partly reflected the influence of a temporary fall-off in inbound tourism during the Olympic Games period, with spillover to exports of transportation services. But more importantly, 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.



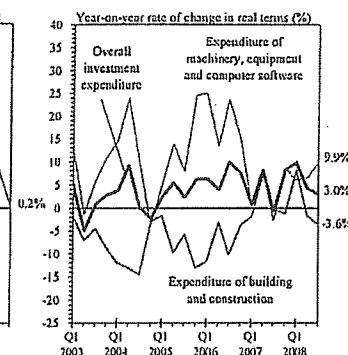
5. Consumer spending still held rather firm in July and August, but slackened distinctly in September in the face of the asset market corrections amidst the financial market jitters and increasing concern over global economic outlook. Private consumption expenditure (PCE) rose marginally by 0.2% in real 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**

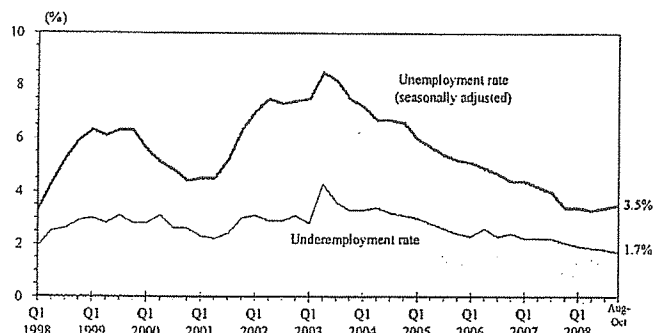


**Chart 3(b) : Investment grew further**



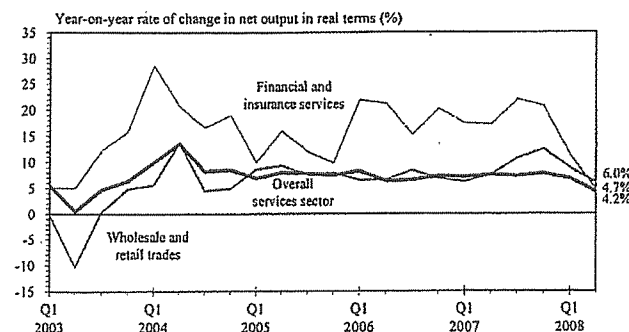
7. Along with the economic slowdown, the seasonally adjusted unemployment rate bottomed out at 3.2% in May-July and crept up to 3.5% in the 3-month period ending October 2008. Over the same period, the underemployment rate remained relatively low at 1.7% (*Chart 4*). The prospects of labour market have 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



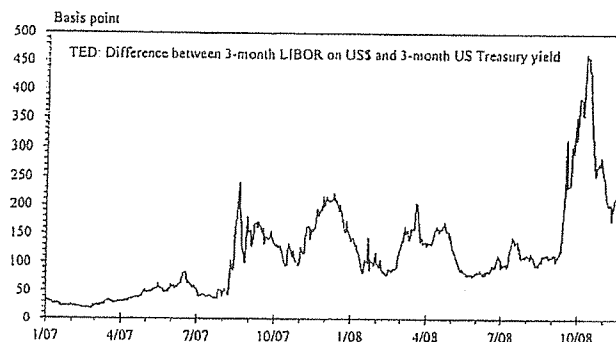
8. The services sector accounts for over 90% of the Hong Kong economy. Latest available figures indicate that the net output of the services sector rose moderately further by 4.2% in real terms in the second quarter of 2008 after a long period of rapid expansion. Wholesale and retail trade held up well 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

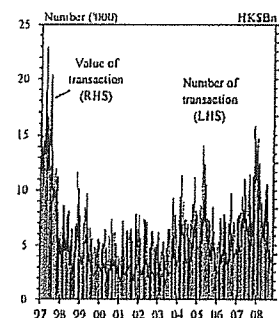
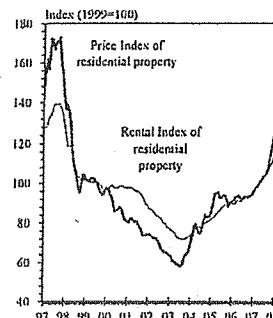
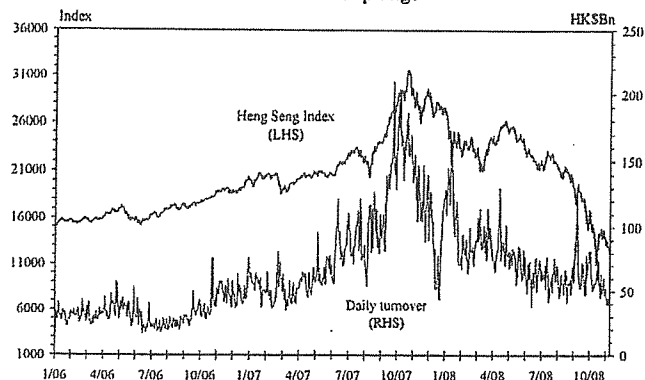


Chart 7(b) : Flat prices returned to a level similar to that in early 2008



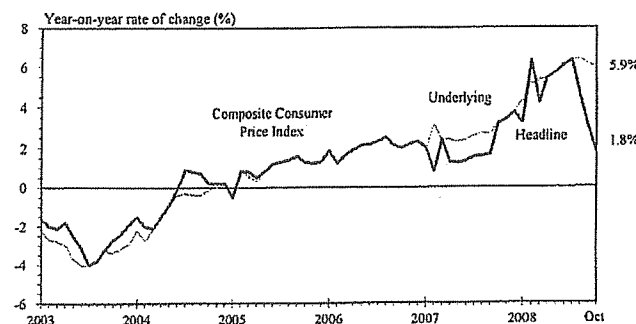
11. The local stock market fell further in the second half of 2008 so far, in tandem with the sharp fall observed in the major bourses overseas and in the Mainland. The Hang Seng Index (HSI) stood at 18 016 at end-September 2008, 18.5% lower than at end-June, and fell sharply further to the lowest of 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*).

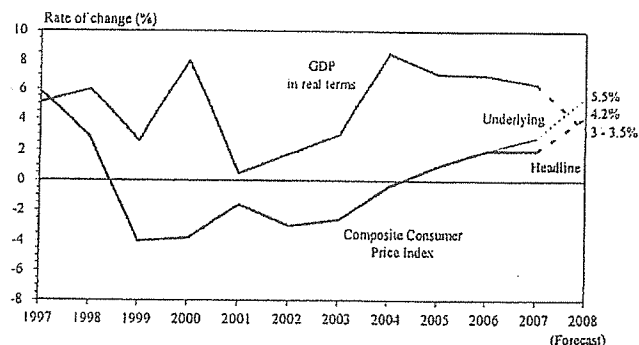
**Chart 9 : Headline consumer price inflation went down notably in recent months, mainly reflecting the effect of Government's relief measures**



#### 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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