

5 HONG KONG, CHINA

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2004: STRONG GROWTH

Underpinned by solid export growth and a robust recovery of domestic demand, Hong Kong's economy experienced strong economic growth in 2004, with real GDP growing by 8.1%. A major contributor to GDP growth was net exports of goods and services which accounted for 3.5 percentage points to the overall 8.1% growth. Following 12.7% growth in 2003, the export of goods and services grew by 15.2% last year. This stellar performance was a result of strong regional trade, robust import demand in Europe, as well as the high growth in the Mainland. The weakening US dollar also helped Hong Kong's external competitiveness.

In 2003, private consumption spending, ravaged by SARS, shrank by 0.3%. The rebound started in the 3rd quarter of 2003, and the growth momentum picked up considerably in the 2nd quarter of 2004 when private consumption grew by 2.5% on a seasonally adjusted quarter-on-quarter basis. For the year as a whole, it went up by 6.7% – the highest rate since 1993. The strong growth in consumption reflected improvements in labour earnings as well as employment prospects, with the unemployment rate dropping by more than two percentage points to a three-year low of 6.5% by year-end, and more than 100,000 new jobs created during the year.

Another factor in the strong growth in

consumption spending was the wealth and balance sheet effects brought on by improvements in stock and property markets. The stock market had recovered significantly since mid-2003. The benchmark Hang Seng Index (HSI) of share prices surged by 35% in 2003 and went up further by 13% in 2004. HSI climbed to 14,230 points, the highest level in almost four years. The property market had experienced a prolonged slump since 1998. However, property prices increased significantly at the beginning of 2004, consolidated in mid-year and then rallied again after land sales in October 2004 recorded higher than market-expected prices. Residential property prices on average increased by 27% by the end of 2004. As a result the number of homeowners with negative equity fell to about 19,215 by year-end, accounting for only 4% of all mortgage borrowers. This represents a big improvement over the peak of about 105,697 cases in mid-2003.

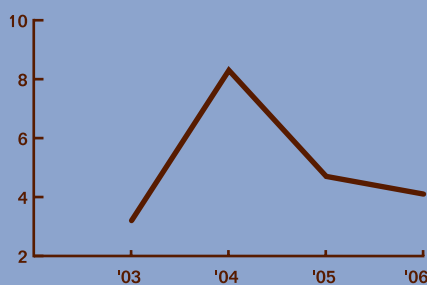
Strong growth in private consumption spending was reflected in the retail and catering sectors. For 2004 as a whole, retail sales surged by 10.8% in value and by 9.1% in volume, while spending at restaurants increased by 10.1% in value and 10% in volume. On top of the reviving local demand, the influx of Mainland visitors was another major growth driver. As part of the Closer Economic Partnership Agreement between the Mainland and Hong

Kong, travel restrictions on mainlanders to Hong Kong had been lifted in phases since July 2003 under the Individual Visit Scheme. By July 2004, an estimated total of 150 million residents from Guangdong and 11 other Mainland cities were eligible to visit Hong Kong on an individual basis. This scheme quickened the revival of tourism and related sectors. In 2004, 34.6% of the visitors from the Mainland, amounting to 4.24 million arrivals, visited Hong Kong under the Individual Visit Scheme. Overall hotel occupancy rate reached 88% for 2004 as a whole, a significant increase compared to the rates of 84% and 70% recorded in 2002 and 2003, respectively.

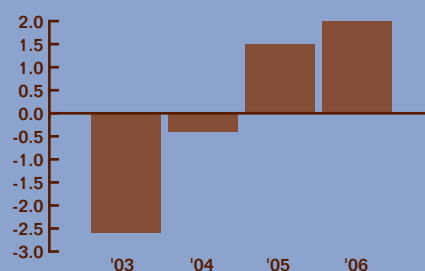
Stimulated by the positive economic outlook, investment in machinery and equipment shot up 12.2% in 2004. On the other hand, the recovery in the property market had not filtered into an increase in construction activities. Investment in land and construction shrank by 5.1% in 2004. Overall gross investment in fixed assets grew by 4.5% in 2004, a substantial increase over the 0.1% growth recorded in 2003.

The persistent deflation since November 1998 came to an end in July 2004. The 68-month long deflation was arrested mainly by the strengthening of local consumer demand. Rising import prices resulting from the weak US dollar and high world commodity prices, as well as increasing rentals, also put upward pressure on the general price level. In 2004,

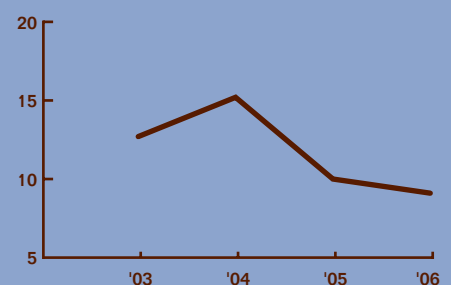
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)





the Composite CPI is estimated to have decreased by only 0.4%, a sharp turnaround from the 2.6% drop in 2003.

Resulting from the economic recovery, the fiscal balance in the 2004-05 financial year turned out to be a surplus of \$12 billion, much better than the shortfall of \$42.6 billion originally projected. The improvement in the fiscal position was largely due to an increase in revenue from land sales and profit taxes.

Hong Kong's external position continued to be very strong in 2004, with the current account estimated at about 9.7% of GDP, and the net international investment position to be more than two times GDP.

OUTLOOK FOR 2005

Global economic growth is expected to decelerate from the high level achieved in 2004, with further monetary tightening. The US and Japan are both projected to slow down. Of particular importance to Hong Kong, growth in Mainland China is forecast to slow to around 8.5% from 9.5% in 2004 as investment is projected to continue to decline, but its exports growth is expected to remain strong at around 20%. Given a weaker external environment, Hong Kong's exports of goods and services are expected to grow more slowly in 2005, at 10%, compared with the estimated 15.3% in 2004. Concomitant with the

deceleration in export growth, the import of goods and services is forecast to grow by 9.8% in 2005, dropping from the estimated 13.8% growth in 2004. Tourism-related sectors are expected to continue to do well in 2005. The opening of the Disneyland theme park in September will draw in a record number of visitors from the region, particularly from the Mainland. The thriving tourism industry will continue to provide stimulus to the domestic economy.

Developments in the property market will be crucial in providing support to domestic demand. Recent strong land sales reflected expectations of a sustained property market recovery. The further weakening of the US dollar will continue to make Hong Kong's assets more attractive to foreign investors. The increase in nominal interest rates is expected to be around 2%. On the other hand, consumer prices are expected to increase further, together with rising rentals. The Composite CPI is forecast to rise by 1.5% in 2005. Hence, real interest rates would remain low in Hong Kong. Further appreciation in property values will help underpin continued growth in private domestic demand. Private consumption spending is forecast to grow by 4.7% and investment by 2.8% in 2005.

Led by strong growth in domestic demand and supported by robust growth in the net export of goods and services, real GDP is forecast to

grow by 4.7% in 2005 and moderate to 4.1% in 2006. The employment situation will keep on improving, albeit at a slow rate, with the unemployment rate projected to be around 6% by the end of 2005.

UNCERTAINTIES

Given the huge current-account deficit of the US, the dollar is set to continue to weaken. While a slow and orderly depreciation of the US dollar tends to enhance Hong Kong's external competitiveness, given Hong Kong's Linked Exchange Rate System, a sharp depreciation could lower growth by unsettling the global financial markets, and by dragging interest rates to a higher level than currently expected in the market.

US interest rates are expected to increase further in 2005, and Hong Kong interest rates are expected to follow suit. In 2004, the spread between Hong Kong and US interest rates widened, as substantial fund inflows in the latter part of the year drove local interest rates substantially below those of the US. The divergence between the Hong Kong and US interest rates last year is highly unusual. Given the Linked Exchange Rate System, interest rate arbitrage will work to close the gap over the long term. Whether the gap would be closed this year depends on the uncertain fund flows. There is a risk that sharp hikes in local interest rates would lower growth.

HONG KONG PROPERTY PRICE INDICES

