HONG KONG

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2001: TURBULENT TIMES

The Hong Kong SAR, China experienced one of the biggest growth decelerations in recent history as the local economy expanded by only 0.14 per cent in 2001. Hidden behind this figure were two consecutive quarters (Q3 and Q4) of negative real GDP growth fulfiling the textbook definition of a recession. The disappointing performance came on the back of many factors: a slowdown in the US and Japanese economies, the September 11incident, and rising local unemployment, among other things. The export sector was hardest hit, recording a 2.1 per cent decline from 2000 in real terms amidst a deteriorating external environment. Things would have been even worse had it not been for the relatively buoyant growth of mainland China.

On the domestic front, the economy continued to be plagued by a weak property market which failed to react to lower interest rates. With a view to restructuring their operations, firms held back their investment plans and kept unloading redundant manpower. This contributed to a surge in the jobless rate which, in turn, weighed on the already faltering consumer confidence. Private consumption, the largest component of GDP, recorded growth of just short of 2 per cent compared with 5.4 per cent the year before.

The public sector was the engine of growth, with government consumption chalking up a 3 per cent increase over the year. Gross private investment meanwhile fell by over 4 per cent as the benefits of lower interest rates were largely cancelled out by the higher risks associated with the September 11 incident.

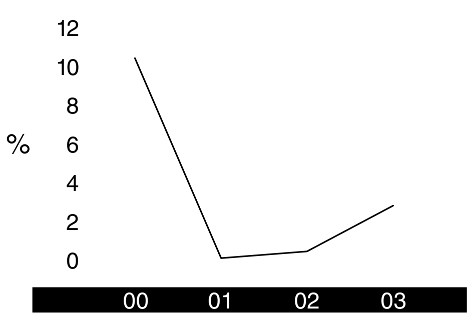
As for the Argentine financial crisis, the perceived contagion effect has been a non-issue and large-scale speculative runs on the local currency were forestalled, thanks to the credibility of the SAR government in maintaining the peg rate.

2002: MILD RECOVERY IN SIGHT

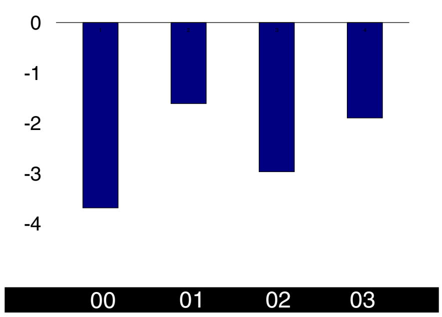
Whether a turnaround from the dismal performance in 2001 will materialise hinges on the much-expected recovery in the US economy. For one thing, nearly 60 per cent of Hong Kong's merchandise re-exports (90 per cent of total exports) are destined for China and the United States. A recovery in the United States would certainly give a boost to the beleaguered economy. We expect real total exports to post a gain of about 1.4 per cent in 2002, versus a 0.2 per cent growth in imports. Thus, whatever the size of growth, it will largely be fuelled by the external sector.

An improvement in economic figures may not necessarily imply that the general public could reap all benefits. In fact, nominal GDP will be pretty much flat, and the growth in real terms will come predominantly from adjustment in the deflator. The majority of the working population has been experiencing wage cuts or wage freezes in the past few years. The SAR government, the largest employer in Hong Kong, has just divulged that there may be a wage cut of 4 per cent on all civil servants' wages. This, coupled with the surging bankruptcy rates and layoff threat, means that consumer

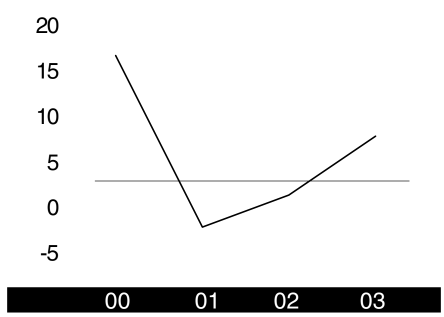
GDP growth



CPI inflation



Export growth



spending has a good chance of remaining sluggish.

The forecast real growth of consumer expenditure is 1.4 per cent. Indeed, we are alarmed by the negative growth in M3 seen lately, a rare phenomenon in recent years, and which we expect to persist for one or two more quarters before things get back to normal.

What is most unsettling is that the government has little leeway in fiscal policy at this critical moment. Due to the slack in the property market, receipts from land sales have fallen short of the targeted levels in 2001, resulting in a burgeoning fiscal deficit. Barring a swift and dramatic resuscitation of the property market, taxes from other sources are going to get higher sooner or later. By the same token, fiscal spending is likely to be more disciplined. We expect government expenditure to pick up by 2.3 per cent in 2001, about half of that seen in the previous year.

Private investment is not likely to stimulate growth in 2002. If the external situation improves as expected, there could be a reversal in the inventory depletion seen lately. It is doubtful, however, that the recent rounds of restructuring and downsizing are over. The relative strength of the HK dollar continues to erode our competitiveness, and outsourcing of lower level operations to mainland China is still evident. The government's stance of reducing the supply of public housing will also affect aggregate performance.

Forecast real GDP growth for 2002 is just above 0.5 per cent. Even this mediocre turnout will be contingent on the economic performance of our trading partners. This projected growth is on the low side of the consensus forecast. Preliminary figures for external trade in January and February indicate that the residual effects of in 2002 global recession are still being felt. Implied in our forecast is a 7 per cent growth in real exports in the last quarter of 2002, but even that will not allow us to shrug off the negative performance in the first half.

Deflation is to persist, rendered in part by the strengthening US dollar. A decline in the CPI(A) of 3 per cent is expected. The unemployment rate will hover above 6 per cent throughout 2002.

Whether there is any real GDP growth depends on the jobless rate. Our forecast downplays the chance of unemployment rate shooting above 7 per cent. If this turns out to be mistaken, growth will be slower than expected.

2003 AND BEYOND

Conditioned on a worldwide economic recovery in 2002, Hong Kong could post better gains in real GDP in 2003–04. We expect GDP growth of 2.9 in 2003 with exports the main contributor. Consumer spending will increase by 3 per cent as sentiment recovers. Investment, however, is expected to lag again. We expect a retreat in the jobless rate back to the 5 per cent plus level. It seems that the 5 per cent average growth rate of the pre 1997 era may not resurface unless the excess manpower can be satisfactorily absorbed by the market.

RISKS IN THE FORECAST

The views outlined above assume a mild recovery in the United States. If that turns out to be stronger than expected, the growth figures are likely to be inflated.

China's accession to the WTO is growth-enhancing in the long term, but there may be adjustment costs in the near term.

Domestically, the biggest uncertainty comes from future fiscal policies. The government predicts that there will be a budget deficit in the next few years, due largely to income shortfalls. Various proposals have been tabled to tackle the problem, including cuts in the civil service and the imposition of a general sales tax. There will be both material and psychological impacts on the public should any of this actually come to pass.

Cycle—unemployment up, loans and retail sales down

Growth in the number of unemployed tends to be accompanied by falls in retail sales and loan demand. Since late 2000 the number of unemployed has shot up, causing retail sales and loan demand in the Hong Kong economy to slump.