HONG KONG, CHINA

1999: SWIFT RECOVERY

Second quarter growth in 1999 was positive, following 5 consecutive quarters of contraction. The rebound has been so strong that year-on-year growth in Hong Kong Special Administrative Region of the People's Republic of China (referred to hereafter as Hong Kong) soared from –3 per cent in the first quarter of 1999 to 8.7 per cent in the fourth, with growth for the whole year of 2.9 per cent. In 1998, the economy shrank by 5.1 per cent.

1999's V-shaped rebound drew strength from the swift recovery in regional trade and sustained import demand from industrial countries. Hong Kong, as the major re-export centre in the region, in particular for mainland China, relies heavily on external trade flows for trade expansion. The strengthening of the Japanese yen, together with falling domestic factor costs, helped to lift substantially the competitiveness of Hong Kong products (including those made in mainland China). Lagging growth in retained imports also played an important role.

Substantial internal cost adjustments have been achieved in Hong Kong over the past 2 years (see chart). With such severe downward adjustment, deflation was inevitable—consumer prices fell by 4 per cent in 1999, compared with 2.9 per cent for 1998.

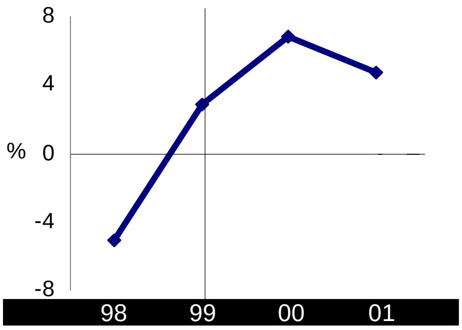
DOMESTIC DEMAND LAGGING

The stockmarket was not strong enough to boost private consumption—indeed, the soaring stock index reflected exceptional gains in only a handful of technology-related stocks. Without rebound over a wider spectrum of stocks and in the absence of a notable recovery in property prices, the wealth effect was not sufficient to fuel private consumption growth. High US interest rates, to which Hong Kong's interest rates are tied, also suppressed domestic demand. This is in contrast to Hong Kong's neighbours who could engineer interest rate reductions to spur domestic demand. Real interest rates rose even higher as a result of deepening deflation, discouraging fixed capital formation. Private consumption also suffered from restraint in wage growth and high unemployment, in addition to the huge indebtedness of mortgagees. Signs of a domestic recovery were finally emerging late in 1999, as the effect of the exceptional trade performance started to spill over to other sectors. A pick up in retail sales, albeit mild, was noted and retailers became keener to rebuild inventories in the expectation of better sales in 2000.

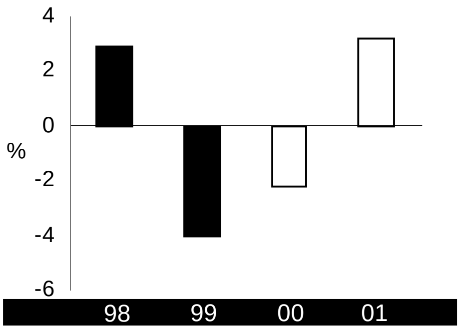
2000: BROAD-BASED RECOVERY

Broad-based recovery will be seen in 2000 as domestic demand picks up and external trade maintains its strong growth momentum. Hong Kong's real GDP in 2000 is expected to grow by 6.8 per cent. The higher growth figure is, to a certain extent, boosted by the residual low base effect from 1999. Strong growth figures will be seen mainly in the first half of 2000, and a marked slowdown in growth should then follow

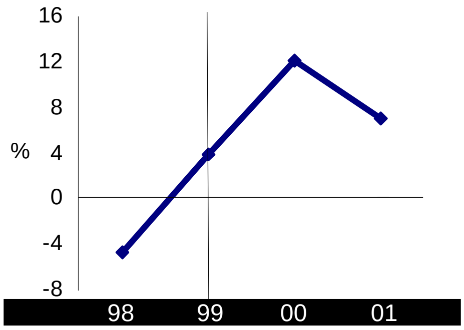
GDP growth



CPI inflation



Export growth



in the second half, as the low-base effect dissipates and the impact of higher nominal interest rates set in.

Robust activity in the Asia Pacific region and strong import demand from industrial economies are not expected to cool significantly in 2000, although the rapid pace of expansion may not be sustainable in the latter part of the year because of the relatively high base of comparison in the second half of 1999. Exports to the United States are expected to slow slightly in view of the anticipated slowdown in the US economy, but the pick-up in the Japanese and European markets is likely to offset the drop. Due to restocking, import growth will outstrip exports, resulting in a widening trade deficit, though this will be largely offset by a growing surplus in the services account.

A revival of domestic consumption is already underway and will be spurred further by better employment prospects. The near-completion of corporate restructuring in late 1999 should mean an end to downsizing, although wage growth is not expected to recover swiftly as there is still an ample supply of labour. Falling real interest rates and more moderate deflation will provide incentives to invest, particularly in the ongoing e-commerce revolution. Private construction is likely to remain subdued because of the stagnant property market, while the commencement of several large-scale public infrastructure projects will lend some support to fixed investment.

2000 should mark the end of a rare deflationary cycle in Hong Kong's economic history—deflation is forecast to lessen to –2.2 per cent due to reviving domestic demand. The base effect will also play a part in producing a higher inflation figure.

US SLOWDOWN

One development that could affect Hong Kong's economic prospects for 2000–01 is a more aggressive tightening of US monetary policy, as Hong Kong is forced to follow US actions by the present fixed exchange rate arrangement. A significant slowdown in the US economy would also have an adverse impact on Hong Kong's export growth.

LOOKING TO 2001

Economic growth in 2001 will be slower than in 2000, partly due to interest rate hikes in 2000 and partly due to the higher base for comparison. Interest rates are expected to fall again in 2001, facilitating a pick-up in the domestic economy. External trade will stay strong despite a slowdown of shipments to the United States. The revival of import demand from the Japanese and European markets will largely offset the anticipated decrease in the US market, while the world's increased trade flow with China as a result of the opening up of the market will benefit Hong Kong significantly. Rising investment to China will also generate substantial financial services income. The economy is projected to expand at 4.7 per cent in real terms in 2001, accompanied by mild inflation of 3.2 per cent. From 2001 on, the effects of the East Asian crisis will finally dissipate, and the economy will revert to its normal growth cycle, with the effects of China's accession to the WTO taking over as the prime factor in determining domestic growth.

Falling factor costs help maintain Hong Kong's competitiveness

While other regional economies were aided in adjusting to the turbulent global economy of 1998–99 by currency depreciations, Hong Kong's competitiveness could only be maintained through domestic cost cutting. Labour costs were held and property costs fell, providing the necessary edge Hong Kong needed to ride out the crisis.