

## Domestic demand is the key

The year 2002 has been a schizophrenic year for the Hong Kong economy. The external sector has performed very well, led by a robust trade sector and strong tourism receipts from Mainland visitors. On the other hand, the domestic economy remains sluggish, with persistent deflation and weak retail sales. We expect this divide to continue for the near future, and stronger consumer confidence is required before we will be in a position to declare a full recovery.

### Revival of the external sector

Despite the weakness in the global economy since the terrorist attacks in 2001, the Mainland economy continues to post strong gains. In particular, export growth in the third quarter of 2002 was 28.6%, a substantial rise following increases of 9.1% and 17.8% in the first two quarters of the year. Hong Kong's trade performance, as usual, benefited from this strength. After dropping 4.4% in the first half of 2002, exports have rallied to double-digit increases since September. As a result, we expect real growth of 7.3% in exports for 2002 as a whole. At the same time, trade and tourism services exports in the first 3 quarters in 2002 have also been favourably influenced by the Mainland economy, growing by 11.1% and 15.7% respectively.

For 2003, China should witness another year of strong export growth, although it will be difficult to maintain a blistering pace of more than 20% as in 2002. Meanwhile, we project that Hong Kong's export growth for 2003 will remain solid, slowing marginally to 5.9%.

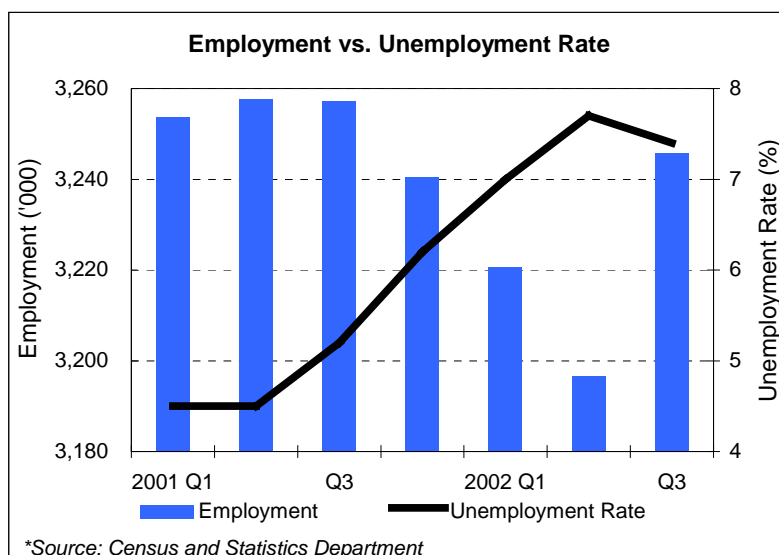
### Domestic demand lags behind

In the domestic sector, consumer confidence will be the key for 2003. The weak property market has had a major bearing on confidence in recent years, driving sentiment steadily downward. However, we may finally be set for a turnaround. As mortgage interest rates fall to all time lows, mortgage payments for many flats are actually lower than rental payments. In 2002, end-users have shown renewed interest in buying flats, as reflected in the good response to quality projects in prime locations.

On the down side, an excess of supply continues to dog the market. Completion of private residential flats averaged almost 30,000 units a year during 1999 to 2001, compared to around 20,000 per year between 1996 and 1998. Since not all the new flats are being taken up by buyers, the vacancy rate of residential flats jumped from 3.8% in 1997 to 5.7% in 2001. The pressure from property inventory forces developers to slash prices to clear their stocks.

The housing policy initiatives recently announced by the SAR Government, suspending home ownership scheme projects and restricting land sales, are aimed at tackling the supply problem. Over the medium-to long-term, we expect the measures to slowly rebuild buyers' confidence. We project a stable property market with increased transactions and steady prices in 2003. Stemming the freefall in property values will help to alleviate the negative wealth effect and improve sentiment.

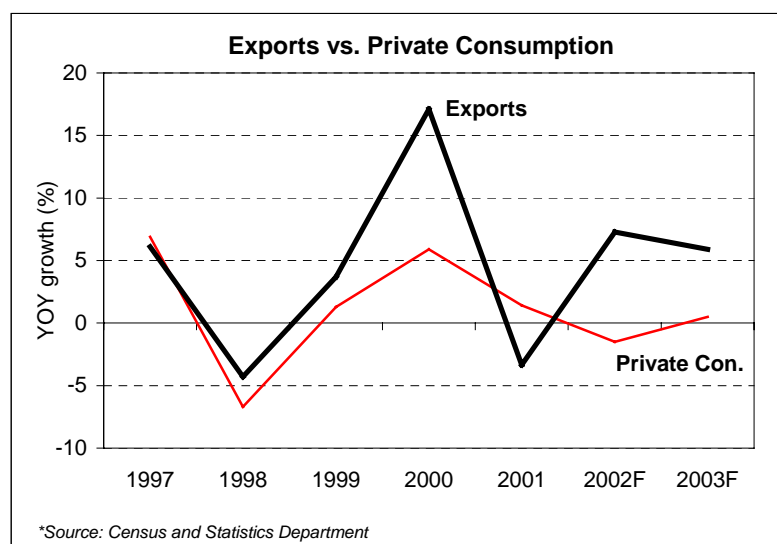
Meanwhile, strong export growth in the second half of 2002 has boosted employment by 60,000 during the third quarter, and total jobs available is back to levels last seen in 2001, prior to the recession. Jobless rates in manufacturing and trade services dropped from 8.2% and 5.5% in June, to 7.1% and 5.0%, respectively, in September. Even so, the overall unemployment rate remains above 7%, much higher than the 4.5% trough seen in early 2001. The higher jobless rate is caused by the steady rise in the number of people in the labour force – more than 100,000 people have joined the labour force during the past 2 years.



While the robust external sector will create more opportunities for local workers, unemployment is likely to retreat only slowly to 6.0-6.5% by 2003 year-end. Competition in the job market, due to the labour surplus, will continue to linger in the short term, constraining a recovery in confidence. Combined with a stabilized property market, private consumption is projected to grow slightly by 0.5% in 2003, improving from a 1.5% decrease in 2002.

### Outlook for 2003

The weakness in private consumption represents a different response to what we have seen in the past, when a rebound in trade would invariably result in solid local spending and a strong recovery. When exports rebounded from a 4.3% contraction to a 17.1% increase between 1998 and 2000, private consumption growth also shot up, from negative 6.7% to plus 5.9% during the same period. This time around, however, growth in private consumption is still below the level before the recession, even though growth in external trade has recovered strongly.



With Hong Kong's fiscal deficit projected at over 5% of GDP for the current fiscal year, it is widely acknowledged that we risk economic instability if the shortfall continues at such high levels. Government expenditure must slow, and people in Hong Kong know that we have to share the burden together in order to eliminate the imbalance in public finances. As the export picture in 2003 is likely to be rather similar to 2002, and the modest improvement in private consumption will be diluted by a less

expansionary fiscal policy, we expect that GDP growth will be 2.0% in 2003, similar to our projection for 2002.

### Trends to watch

Only a recovery in both the job and property markets can truly boost the confidence of consumers, and help pull the performance of the domestic and external sectors into alignment. The rising trend for Mainland exports to bypass our ports has led to fears that Hong Kong will share fewer and fewer benefits from a prosperous Mainland economy. These fears are unfounded. There is much demand for Hong Kong's unique offering of high living standards and a modern financial system. The influx of Mainland tourists and private enterprises lining up to list on Hong Kong's stock market are just some of the evidence. A development to watch is the flow of capital and talent to Hong Kong, which is now being blocked artificially.

Keen attention is now focused on a review of population policy, now being conducted by the Government. An announcement regarding population policy could be made in the Chief Executive's Policy Address, scheduled for 8<sup>th</sup> January. Will there be new measures to attract business immigrants, especially those from the Mainland? By moving in this direction, the additional capital inflow brought by Mainland entrepreneurs would bolster the domestic economy and support the property market. Their investments would generate new job opportunities. Furthermore, their presence would strengthen the ties between the Mainland and Hong Kong, and pave the way for more Mainland companies to take advantage of our high quality professional services. The end result: a more energetic economy that will boost the confidence of Hong Kong people and help restore a sense of vibrancy to our city.

Forecast of Major Indicators (%)		
	Real Growth Rate	
	2002@	2003@
1. Domestic Sector		
Private Consumption Expenditure	-1.5	0.5
Government Consumption Expenditure	2.0	1.0
Gross Domestic Fixed Capital Formation	-6.0	1.0
2. External Sector		
Total Exports of Goods	7.3	5.9
Domestic Exports	-7.0	-8.0
Re-exports	9.0	7.3
Imports of Goods	6.3	6.4
Exports of Services	10.0	9.3
Imports of Services	-1.5	3.0
3. Real Gross Domestic Product	2.0	2.0
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