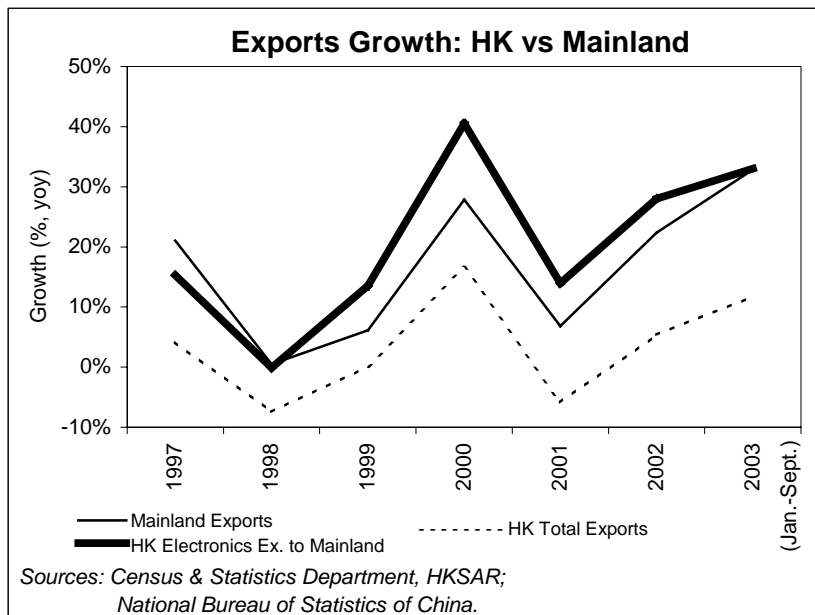


2004: Restoring The Balance

2003 has been a roller-coaster. The local economy started the year with solid growth of 4.5%, but then plunged during the SARS outbreak. In the darkest hour, the Central Government introduced the Individual Visit Scheme and Closer Economic Partnership Arrangement (CEPA), giving Hong Kong a boost. With sentiment vastly improved, the Hong Kong economy will experience more balanced growth in 2004, with stronger domestic demand alongside continued strength in trade and tourism.

External trade remains strong

As in 2002 and 2003, robust export performance will be a major source of growth for the local economy. A closer examination indicates that a large proportion of the increase in export business for Hong Kong has come from electronics exports to the Mainland. In the first nine months of 2003, electronics exports to the Mainland surged by 33%, neck-and-neck with the pace of Mainland export growth and easily outstripping the growth of total Hong Kong exports.



For 2004, we expect Mainland export growth to remain solid, as US consumers, emboldened by a falling jobless rate, continue on their shopping spree. Although Sino-US trade tensions will continue to receive airplay, the public posturing will only have minor impact on the Mainland's export sector, primarily because the US government will not risk damaging the American business interests that are behind a sizable share of the manufacturing operations on the Mainland. The Mainland's export growth will decelerate only slightly in 2004, with electronics exports still a major force. Continued sourcing demand from Mainland electronics manufacturers will translate into continued high business volume for the export sector in Hong Kong, and we project that Hong Kong exports in 2004 will increase by 7% in nominal terms, compared to the 11.5% rise seen in the first 10 months of 2003.

New engines of growth

In the past, the only significant benefit Hong Kong gained from strong growth in its hinterland was a spillover effect from the upsurge in Mainland exports. However, Hong Kong has missed out on the opportunities arising from the increasing affluence of Mainland consumers and the emergence of demand for quality business services. The introduction of policy stimuli such as the Individual Visit Scheme and CEPA is finally succeeding in cracking the glass wall.

The effect of the Individual Visit Scheme is immediately apparent. After the scheme started at the end of July 2003, growth in Mainland tourists surged to 34.3% during August to October, compared to the modest 13.9% increase in the first seven months of the year. Expansion of the Individual Visit Scheme to the whole of Guangdong province will provide continued energy for the tourism industry. We project that the number of Mainland visitors will rise to 11 million in 2004.

On the other hand, CEPA will provide incentive for manufacturers to develop their own brands targeting the Mainland market and present new opportunities for Hong Kong's elite service industries. Moreover, the agreement is not just a one-off boost, but also an ongoing process speeding up economic integration between the Mainland and Hong Kong. Through the provisions of CEPA, a range of Hong Kong companies will enjoy a head start on foreign competition for entry to the Mainland's burgeoning domestic market.

Spending and jobs to pick up

Given the Central Government's explicit and pragmatic support for the Hong Kong economy, the expectations of better times ahead will be a powerful force to rejuvenate consumer demand. The measures have already had a material impact on consumer spending and the property market. Retail sales in October jumped by 3.8%, the highest in three years. Property prices rebounded from a low during the SARS period, edging just above the level at the start of 2003. We anticipate strengthening domestic demand, following the rebound in private consumption that began in the third quarter of 2003. We project private consumption will grow by 4% in 2004.

2004 will be a much better year for the local job market. In particular, we estimate that the rise in Mainland visitors by itself will create 20,000 jobs in the retail, catering, and hotel sectors that together employed 400,000 workers locally, reducing unemployment rate by 0.6 percentage points. At the same time, CEPA will encourage Hong Kong and foreign manufacturers alike to boost their existing or set up new operations in Hong Kong to explore the Mainland domestic market. This should also mitigate the local jobless problem. Furthermore, stronger domestic demand will generate a significant amount of employment, particularly for low skilled workers. With so many constructive influences supporting the employment market, unemployment rate could fall considerably, from 8% in 2003 to 6% to 7% in 2004.

Steady investment, public spending, and prices

The investment picture for 2004 is mixed. Despite the recovery in the property market, depletion of private developers' land banks and the drop in public housing projects imply that construction activity will remain low. On the other hand, investment on capital goods, following years of solid performance in exports and the rebound in economic prospects, will be the major driver for investment demand. Investment is forecast to rise at a modest 2.2% in 2004. For government spending, the mounting budget deficit will force the government to cut its outlays. We project that government expenditure will drop by 1.5%.

With improvement in private consumption, Hong Kong may finally see the end of the destructive deflationary spiral that has haunted the city for more than 5 years. Stronger demand from both local consumers and tourists will enhance retailers' pricing power and ease pressure to offer discounts. Together with technical issues such as the low base of prices in 2003 due to various government concessions and the higher import prices because of the continued weakness in the US dollar, deflation should end some time in mid-2004. Inflation for 2004 is projected to be flat at 0%.

Solid and balanced growth

With the strong showing in private consumption and continued support from the Central Government, GDP growth will rise to 4.5% in 2004, from the 2.8% in 2003. Stable domestic demand will reduce reliance on external trade performance, which can be volatile at times, and lead to a steady trend in economic growth.

The recovery in 2004 will build on the rebound in consumer confidence, stemming from the belief that Hong Kong will be able to profit from the growing Mainland market under the Central Government's support.

The next logical step of our economic restructuring is to explore rising demand on the Mainland, whether it is in form of visitors coming to Hong Kong or new business opportunities under CEPA. 2004 will be a year of investigating and investing into this new direction.

Forecast of Major Indicators (%)		
	Real Growth Rate	
	2003@	2004@
1. Domestic Sector		
Private Consumption Expenditure	0.3	4.0
Government Consumption Expenditure	0.6	-1.5
Gross Domestic Fixed Capital Formation	-0.7	2.2
2. External Sector		
Total Exports of Goods	13.6	8.3
Domestic Exports	-8.7	-7.5
Re-exports	15.7	9.5
Imports of Goods	12.1	9.3
Exports of Services	3.5	14.5
Imports of Services	-6.8	6.0
3. Real Gross Domestic Product	2.8	4.5
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