

CHAPTER 1 : OVERVIEW OF ECONOMIC PERFORMANCE

Summary

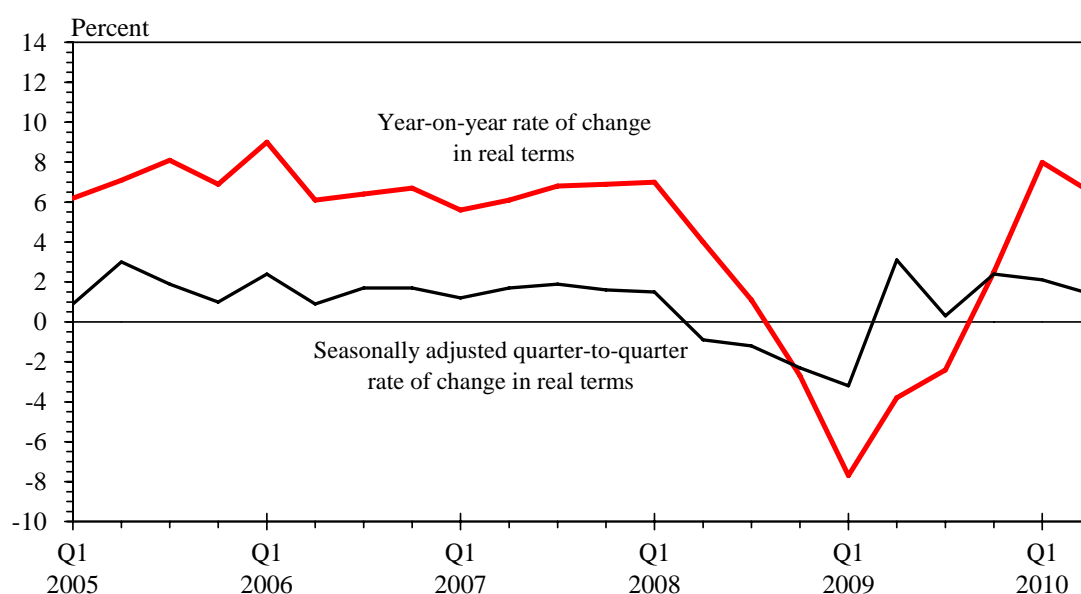
- *The Hong Kong economy continued to show a broadly-based recovery in the second quarter of 2010, benefited mainly from the robust growth momentum in the Mainland and other Asian economies. Real GDP leaped distinctly further by 6.5% over a year earlier, after a growth of 8.0% in the first quarter. On a seasonally adjusted quarter-to-quarter comparison, real GDP expanded by 1.4%.*
- *Merchandise exports remained vibrant in the second quarter, propelled by the strong growth in many Asian markets and the further recovery in import demand in the United States. The European markets continued to lag behind the others, although the sovereign debt problem in Europe had not yet posed a significant drag on global trade flows.*
- *Exports of services likewise maintained strong momentum in overall terms in the second quarter. Inbound tourism continued to benefit from the surge in Mainland visitors and the recovery in regional markets. Exports of trade-related services were buoyant, thanks mainly to the thriving intra-regional trade flows, and this in turn rendered a firm support to exports of transportation services. Exports of financial and business services also grew sizably, despite the intensification of the European sovereign debt problem during the quarter.*
- *Domestic sector stayed resilient. Private consumption expenditure grew solidly, on the back of the general improvement in overall economic situation and hence incomes. Overall investment spending picked up distinctly to a double-digit growth. Construction activity was boosted by the marked surge in public sector works. Machinery and equipment acquisition also maintained strong growth momentum.*
- *Labour market performance was somewhat mixed. Underemployment situation improved further, while job vacancies continued to rise along with a further pick-up in wages and earnings. Yet the seasonally adjusted unemployment rate rose back slightly to 4.6% in the second quarter, conceivably partly due to frictional factors as more workers were in search of employment opportunities with better terms and conditions.*
- *Local stock market saw some retreat in April and May, along with other major overseas stock markets in face of the intensification of the sovereign debt problem in Europe, before stabilising somewhat in June. The local property market also turned slightly quieter in May yet picked up again in June.*

- *Inflationary pressure climbed up moderately in the second quarter amid the increasingly entrenched economic recovery. Underlying inflation went up to 1.5% in the second quarter.*

Overall situation

1.1 The Hong Kong economy expanded distinctly in the second quarter of 2010, with further improvements on both the domestic and external fronts, thereby consolidating the broadly-based economic recovery that started since the second quarter of last year. Merchandise exports remained vibrant, supported by the stellar performance of Asian markets and a moderate recovery in import demand from the advanced economies. Exports of services likewise expanded strongly, on the back of the brisk expansion of inbound tourism and offshore trade as well as the further growth in financial and commercial activities. In the midst of the economic recovery, consumption demand held firm and investment accelerated further. Although the sovereign debt problem in some of the member economies in the euro area (See *Box 1.1*) had limited impact on the overall economic performance of Hong Kong in the second quarter, it tempered market sentiment to some extent. The marked increase in uncertainty in the external environment also led to some correction in the asset markets, particularly in April and May. Unemployment rate rose back in the quarter, yet the concurrent surge in vacancies suggests that the relapse was in large part frictional, due to more workers in search of better employment opportunities. Inflation, while climbing up further, was still benign.

Diagram 1.1 : The Hong Kong economy expanded distinctly in the second quarter of 2010



1.2 In the second quarter of 2010, the *Gross Domestic Product (GDP)*⁽¹⁾ leaped by 6.5% in real terms over a year earlier, following the 8.0% growth in the first quarter (revised from the earlier estimate of 8.2%). In the first half of 2010, real GDP expanded by 7.2% over a year earlier. On a seasonally adjusted quarter-to-quarter comparison⁽²⁾, GDP grew by 1.4% in real terms in the second quarter, after the 2.1% growth in the first quarter (revised from the earlier estimate of 2.4%). As a result, the seasonally adjusted GDP level in the second quarter surpassed the pre-crisis peak in the first quarter of 2008 by some 1.6%.

The external sector

1.3 *Total exports of goods* continued to fare strongly in the second quarter, amid the sustained global economic recovery⁽³⁾. The Asian markets still outperformed the other markets by a wide margin. Specifically, total exports to the Mainland continued to show a double-digit year-on-year growth even against a higher base of comparison in the second quarter, and those to Taiwan, Japan, Korea and Singapore all recorded double-digit growth in the region of 15-30%. The US market also improved visibly further, as economic recovery there continued at a moderate pace. Although the full impact on global trade flows from the sovereign debt problem in Europe has yet to be seen, the European markets continued to lag markedly behind other markets in the quarter. Hong Kong's total exports of goods surged by 20.1% in real terms in the second quarter over a year earlier, further to the 21.6% growth in the first quarter.

1.4 *Exports of services* maintained strong growth momentum in the second quarter, up 16.9% in real terms over a year earlier, after the 17.9% increase in the first quarter. With the strong influx of incoming visitors, exports of travel services rebounded sharply from the relatively low base due to human swine flu in the same quarter last year. Exports of transportation and trade-related services were also buoyant, helped by the strong intra-regional trade in Asia and normalisation in global trade flows. Exports of financial and business services also grew sizably, even amid the fall-out of the European sovereign debt problem during the quarter.

**Table 1.1 : Gross Domestic Product and its main expenditure components
and the main price indicators
(year-on-year rate of change (%))**

	<u>2008[#]</u>	<u>2009[#]</u>	<u>2009</u>				<u>2010</u>	
			<u>Q1[#]</u>	<u>Q2[#]</u>	<u>Q3[#]</u>	<u>Q4[#]</u>	<u>Q1[#]</u>	<u>Q2⁺</u>
<i>Change in real terms of GDP and its main expenditure components (%)</i>								
Private consumption expenditure	2.4	-0.4	-6.2 (-1.7)	-0.6 (4.1)	0.6 (0.4)	4.8 (2.0)	7.1 (0.6)	4.6 (1.5)
Government consumption expenditure	1.8	2.4	1.5 (-0.3)	2.6 (1.8)	3.4 (0.6)	2.0 (-0.2)	3.4 (1.2)	2.7 (1.0)
Gross domestic fixed capital formation	0.8	-1.8	-10.3	-11.8	3.2	14.1	8.2	15.2
<i>of which :</i>								
Building and construction	6.1	-0.5	-5.6	-2.4	5.4	1.3	-7.2	11.4
Machinery, equipment and computer software	-0.8	-2.6	-4.1	-16.6	-2.1	16.2	11.9	16.2
Total exports of goods	1.9	-12.7	-22.7 (-12.7)	-12.8 (6.0)	-13.2 (-1.3)	-2.9 (7.3)	21.6 (8.4)	20.1 (4.2)
Imports of goods	1.8	-9.5	-20.8 (-10.4)	-12.6 (5.3)	-8.3 (2.5)	3.3 (7.1)	28.0 (10.3)	23.6 (1.6)
Exports of services	5.0	0.3	-5.5 (-1.8)	-3.8 (1.9)	0.8 (3.7)	8.9 (4.8)	17.9 (6.7)	16.9 (0.8)
Imports of services	6.3	-3.7	-9.7 (-3.5)	-5.0 (1.9)	-2.7 (1.6)	2.5 (2.6)	10.9 (4.3)	12.3 (3.3)
Gross Domestic Product	2.2	-2.8	-7.7 (-3.2)	-3.8 (3.1)	-2.4 (0.3)	2.5 (2.4)	8.0 (2.1)	6.5 (1.4)
<i>Change in the main price indicators (%)</i>								
GDP deflator	1.5	0.2	0.7 (0.2)	0.9 (0.2)	-1.0 (-0.6)	0.2 (0.4)	2.0 (2.0)	-0.6 (-2.4)
Composite CPI								
Headline	4.3	0.5	1.7 (0.4)	-0.1 (-0.2)	-0.9 (-1.1)	1.3 (2.2)	1.9 (1.0)	2.6 (0.5)
Underlying[^]	5.6	1.0	3.1 (-0.1)	1.2 (-0.3)	-0.3 (-0.2)	-0.1 (0.5)	0.8 (0.7)	1.5 (0.5)
<u>Change in nominal GDP (%)</u>	3.7	-2.6	-7.0	-2.9	-3.4	2.7	10.1	5.9

Notes : Figures are subject to revision later on as more data become available. Seasonally adjusted quarter-to-quarter rate of change is not applicable to gross domestic fixed capital formation, as no clear seasonal pattern is found for the category due to the presence of considerable short term fluctuations.

(#) Revised figures.

(+) Preliminary figures.

() Seasonally adjusted quarter-to-quarter rate of change.

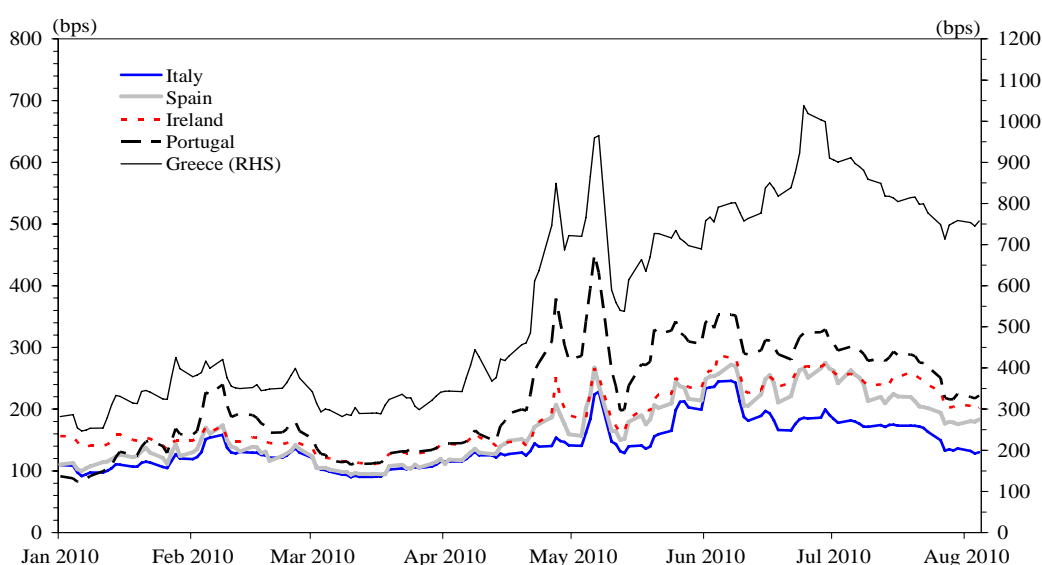
(^) After netting out effects of Government's one-off relief measures.

Box 1.1

Recent developments regarding the sovereign debt problem in the euro area

While global economic conditions generally improved further in the second quarter of 2010, the intensification of sovereign risks in some economies in the euro area (notably Portugal, Italy, Ireland, Greece and Spain, now commonly known as PIIGS collectively) had led to renewed financial turbulence in the second quarter of 2010 and increased notably the downside risks to the global economic outlook. Indeed, the macroeconomic vulnerabilities in these economies had been built up for years. Lax fiscal management, easy credit fueled by low interest rate differentials within the euro area, low savings rate, heavy reliance on external financing and housing market bubble all contributed. With the “Great Recession” in 2008-09, these fault lines were exposed, creating pressures on the public finances of these economies as their fiscal balances deteriorated abruptly and conditions for refinancing became more stringent. With the situation in Greece first coming to the fore in late 2009, concern over other PIIGS economies also intensified in the following months, with a string of negative rating actions on Spain, Portugal, and Ireland, on top of Greece. The sovereign credit default swap (CDS) spreads of the PIIGS economies, which measure the cost of insuring against default by the governments of these economies, soared in late April and early May, when market strains were most acute (*Chart 1*).

Chart 1 : 5- year CDS on PIIGS soared and remained higher than the levels in mid-April



In response, massive rescue measures had been rolled out jointly by the European Union (EU) and the International Monetary Fund (IMF) since April 2010. Although a potential contagion has been contained for the time being, financial markets are still skeptical, resulting in sharp gyrations in stock, currency and commodity markets in the second quarter. While strains in the financial markets had lately receded somewhat as compared to the situation in April and May, sovereign CDS spreads for the highly-indebted European nations remained elevated and those on Greek government bonds rose to a new high in late June. The rescue package may be sufficient to relieve the near-term refinancing needs of these heavily indebted economies and prevent an imminent default, but their medium to longer term fiscal sustainability will hinge on the effectiveness of their fiscal consolidation measures, which will be challenging in view of the domestic opposition and expected sluggish growth prospects of these economies.

Box 1.1 (Cont'd)

The situation is still evolving and markets remain skeptical about the long-term resolution of the sovereign debt problem. Indeed, an abrupt worsening of the problem can trigger devastating chain reactions across the banking systems in the euro area and beyond, channelling through cross-border bank exposures to these economies. Based on information from the Bank for International Settlements, banks in France and Germany are the main creditors to banks in PIIGS on an immediate borrower basis (23% and 18% respectively of total claims on PIIGS at end-2009), followed by those in the UK and the US (11% and 5% respectively). Also, for some small economies such as Portugal, the Netherlands and Belgium, the exposures of their banking systems to PIIGS banks are notable (at 9%, 8% and 7% of their respective banking sector assets).

To prevent a further erosion of confidence and a downward spiraling of the debt problem, some European countries have introduced austerity measures to restore fiscal health. The key challenge is how to implement fiscal consolidation without jeopardising the recovery under way. Recovery in Europe is already lagging behind other parts of the world, growing by a mere 0.5% year-on-year in the first quarter of 2010, with unemployment rate still hovering at a high 10% in June. The fiscal tightening would inevitably weigh on the already fragile outlook for Europe. However, resilience in the core European economies such as Germany and France should render some momentum to the euro area, and their exports will also benefit from a weaker euro.

The evolving sovereign debt situation in Europe has emerged as a key risk factor to the global economic outlook, considering the sheer weight of Europe in the global economy (the EU accounted for about 28% of world GDP in 2009, even larger than the United States). Europe is also closely knit to world trade, being an important market for Asian exports of goods and services. Specifically, the EU market accounts for about 12% and 19% respectively of total merchandise exports and service exports of Hong Kong. Prolonged sluggishness in the EU economy will likely put a drag on the prevailing strong growth momentum in Asia. While the sovereign debt problem in Europe had not caused any significant dampening effect on global trade flows so far, the evolving situation needs to be closely monitored, as its negative impact on global demand may become more discernible later this year. Hong Kong's export outlook in the latter part of this year and in 2011 will also likely be affected to some extent.

More notable developments regarding the sovereign debt problem in the euro area

December 2009	Fitch Ratings cut Greece's sovereign credit rating to BBB+ with outlook negative on deteriorating public finance, the lowest in the eurozone and the first sub-A rating for Greece, triggering a flight from Greek assets. Greek government outlined plans to cut deficit but faced resistance.
January 2010	The European Commission (EC) condemned Greece for falsifying public accounts.
End-February	Fitch downgraded Greece's four largest banks from BBB+ to BBB.
Early March	The Greek government announced new austerity measures to reduce the deficit by €4.8 billion (about 2% of GDP).

Box 1.1 (Cont'd)

Late March	Leaders of the eurozone backed a joint bailout deal with the IMF should Greece's debt troubles intensify. Fitch cut Portugal's sovereign debt rating from AA to AA- with outlook negative.
Mid-April	After much bickering, eurozone members agreed to provide Greece with €30 billion of three-year loans at below market interest rates upon formal request for financial assistance from the nation. The IMF agreed to provide another €15 billion loan in parallel. This, however, did not stop the yield on Greek government bonds from rising. Moody's downgraded Greece's debt rating after the country's fiscal deficit in 2009 was found to be underreported.
23 April	Greece announced that it would draw on emergency aid to tide it over for the rest of the year.
27 April	Standard & Poor's (S&P) downgraded Greece's rating to junk status (BB+) and cut Portugal's rating by two notches to A- with outlook negative on "weak macroeconomic structure."
28 April	S&P downgraded Spain's rating from AA+ to AA with outlook negative on "protracted economic adjustment and risks to budgetary position." The IMF said the aid package for Greece could be topped up to €100-120 billion over three years, more than double the amount pledged in mid-April.
2 May	A €10 billion package of emergency loans was jointly provided by the eurozone governments and the IMF in an attempt to avert a Greek default and prevent contagion. In return, Greece would adopt fiscal austerity package to cut its deficit over the next three years. The European Central Bank (ECB) also dropped the minimum credit requirement for Greek government debt collateral in the euro-system's credit operations.
10 May	The EU and IMF introduced further stabilisation measures of €750 billion, comprising €60 billion of EU-backed bonds, a €440 billion fund guaranteed by eurozone countries and up to €250 billion of IMF money, supplemented by the ECB's purchase of government and corporate debt, the reactivation of unlimited fixed rate offerings of three-month loans and US dollar swap lines with the Federal Reserve. CDS of the PIIGS countries retreated as a result, but the euro accelerated its downtrend, subsequently reaching a four-year low against the US dollar.
Mid-May	Following Greece and Ireland, a number of European economies, including Spain, Portugal, Italy, Hungary, Germany and the UK, successively began to introduce austerity plans with a view to restoring fiscal health.
17 May	In a backlash against opaque financial operations, EU finance ministers passed a draft Alternative Investment Fund Management Directive (AIFMD) to rein in hedge funds and private equity.

Box 1.1 (Cont'd)

- 22 May The Bank of Spain took over a small savings bank, CajaSur, fanning fears of spillover to the interbank market, where three-month LIBOR had gradually climbed higher to levels back in July 2009.
- 4 June A Hungarian official's remark that Hungary might face risks of a Greek-style crisis stirred a renewed bout of market jitters.
- 7 June Eurozone finance ministers approved details of the €440 billion rescue package introduced in early May. A special purpose vehicle, European Financial Stability Facility (EFSF), was established to raise money in the markets backed by members' guarantees in proportion to their shares in the ECB, and the funds raised will be provided as loans to members in difficulty.
- 16 June Spain announced that it will publish bank stress test results to improve market transparency.
- 17 June The EU agreed to do the same by the second half of July. An interim review by the European Commission, ECB and IMF reported that fiscal developments in Greece were positive and austerity measures were being implemented as agreed.
- 30 June Demand for the ECB's offer of three-month funds fell short of expectations, relieving fears over banks' reliance on the ECB lifeline to stay afloat.
- 7 July German Cabinet approved a plan to reduce fiscal deficit by about €80 billion by 2014.
- 17 July The IMF and EU suspended talks with Hungary in reviewing its €20 billion stabilisation programme, indicating that more measures should be taken to shrink its budget deficit.
- 19 July Moody's downgraded Ireland's sovereign credit rating to Aa2 from Aa1 with outlook stable, on "government's gradual but significant loss of financial strength" and "weakened growth prospects."
- 23 July The results of the EU-wide stress-testing exercise were released. Only 7 out of 91 banks put under the test (comprising 5 Spanish savings banks, Hypo Real Estate in Germany and ATEbank in Greece) fell short of the required 6% Tier 1 capital ratio under the adverse scenario with additional sovereign shock. The amount of under-capitalisation was at €3.5 billion. While the results were better than expected in the financial markets, some doubts remained about the rigour of the tests.

The domestic sector

1.5 The domestic sector held firm in the second quarter on the back of rising incomes and generally upbeat economic sentiment. *Private consumption expenditure* grew solidly by 4.6% year-on-year in real terms over a year earlier, further to the 7.1% growth in the first quarter. Despite the correction in the stock market and concerns about the European debt problem, local consumer confidence remained rather sanguine, as evidenced by sustained increase in spending on big-ticket items, including motor vehicles and other consumer durables. Meanwhile, *government consumption expenditure* grew steadily further in the second quarter.

**Table 1.2 : Consumer spending by major components^(a)
(year-on-year rate of change in real terms (%))**

Of which :

		Total consumer spending in the domestic market ^(a)	Food	Durables	Non- durables	Services	Residents' expenditure abroad	Visitor spending	Private consumption expenditure ^(b)
2009	Annual	0.4	-2.0	0.7	-0.1	1.0	1.9	7.8	-0.4
	H1	-2.7	-3.0	-6.9	-5.8	-1.0	1.4	6.7	-3.4
	H2	3.5	-1.0	7.7	5.6	3.1	2.3	8.8	2.7
	Q1	-4.1	-3.7	-5.8	-5.7	-3.1	-3.8	14.3	-6.2
	Q2	-1.4	-2.4	-8.2	-5.9	1.0	7.2	-1.6	-0.6
	Q3	0.7	-1.3	-2.4	-1.4	2.5	0.3	1.7	0.6
	Q4	6.1	-0.8	18.3	11.8	3.7	4.5	15.3	4.8
2010	H1	8.3	3.3	28.3	13.6	4.8	4.3	26.2	5.8
	Q1	9.1	3.9	29.9	14.6	5.1	4.0	19.9	7.1
	Q2	7.5	2.8	26.5	12.7	4.5	4.6	34.3	4.6

Notes : (a) Consumer spending in the domestic market comprises both local consumer and visitor spending, which are not separable from the survey data.

(b) Private consumption expenditure is obtained by deducting visitor spending from the total consumer spending in the domestic market, and adding back residents' expenditure abroad.

Diagram 1.2 : Private consumption expenditure held firm

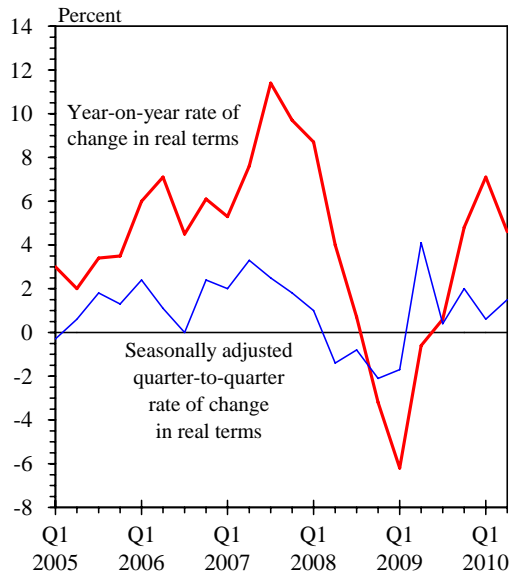
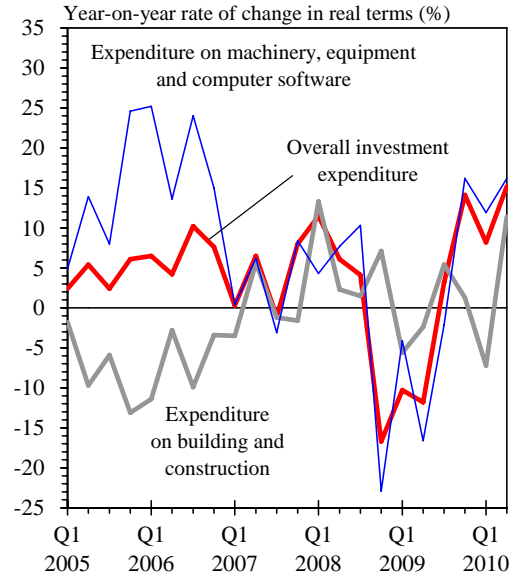


Diagram 1.3 : Overall investment spending picked up markedly in the second quarter



1.6 Overall investment spending in terms of *gross domestic fixed capital formation* surged by 15.2% in real terms in the second quarter of 2010 over a year earlier, accelerating sharply from the 8.2% growth in the first quarter. Investment in machinery and equipment picked up notably further, expanding by 16.2% in the second quarter. The growth impetus came from a sharp increase in spending by the private sector, reflecting the prevailing positive business sentiment despite the near-term business outlook in the latter part of this year being somewhat overshadowed by increased uncertainty in the global economic environment (See **Box 1.2** for the latest business situation of small and medium enterprises). Indeed, the extent of optimism among the large enterprises held up rather well, as indicated by the results of the latest Quarterly Business Tendency Survey conducted by the Census and Statistics Department in June and early July. Expenditure on building and construction resumed a marked increase of 11.4% in the second quarter, mainly contributed by the surge in public sector works. Private sector construction activity saw some relative improvement, but had yet to turn around into a year-on-year increase.

Box 1.2

Impact of financial tsunami on small and medium-sized enterprises (an update)

To gain a better understanding of the impact of the financial tsunami on business receipts, employment and credit access situations of small and medium-sized enterprises (SMEs)⁽¹⁾, an ad-hoc consultation exercise has been conducted by the Census and Statistics Department on behalf of the Economic Analysis and Business Facilitation Unit since late November 2008 on a sample panel of around 500 SMEs to solicit their feedback. This note provides a further update of the results reported in *Box 1.2* in the *First Quarter Economic Report 2010*.

From June 2010 onwards, the SMEs surveyed were asked to compare their business and employment situation with that *in the previous month* instead of that *under normal situation*, to improve the relevance of the survey. A set of diffusion indices is thus compiled to indicate the general directions of change in the respondents' views on business receipts and employment compared with the prior month. Given the change in questions, the results regarding their views on business receipts and employment in the latest two rounds of the exercise cannot be compared with those in the preceding rounds. It should be noted that the findings should be interpreted with considerable caution given the coverage and nature of the consultation exercise. Nevertheless, they can serve as a rough indicator to enable high frequency monitoring of SMEs' situation.

Business receipts of the SMEs surveyed, as depicted by the new set of diffusion indices, showed some slight tapering in June but held largely stable in July compared with the preceding months (*Table 1*). In July, a larger proportion of SMEs in five out of ten sectors surveyed reported stable or some improvement in business receipts versus those reporting otherwise. Among the various sectors, SMEs in the logistics, financing institutions and insurance sectors reported the least favourable results, while a larger proportion of SMEs in the real estate and travel sectors reported increases in business receipts. The results of the consultation also indicated that SMEs' employment situation held largely stable, with more notable improvement recorded in the business services and financing institutions sectors. On the other hand, employment situation saw some slight relapse in the logistics, real estate, restaurants and retail trade sectors.

Specifically for import and export firms, from the June round onwards, their views on new export orders were sought, at weekly intervals, in order to better gauge the impact of the European debt problem on export performance. The diffusion index on new export orders stood at 49.6 in both June and July, marginally below the boom-bust dividing line of 50. Indeed, those import and export firms dealing with the European markets fared slightly worse than the others in terms of new orders received in June, yet the gap closed up in July.

(1) Manufacturing enterprises with fewer than 100 employees and non-manufacturing enterprises with fewer than 50 employees are regarded as SMEs in Hong Kong.

Box 1.2 (Cont'd)

Credit access situation improved further in recent months. The proportion of SMEs reporting very tight/tighter-than-normal credit access came down successively to 3.4% in July 2010 from above 12% in late November 2008, the lowest since the consultation exercise started (*Chart 1*). Moreover, the proportion of SMEs expecting tighter credit access in the coming month fell to zero for the first time in June 2010 since the global financial crisis took hold, while credit pricing continued to hold broadly stable over the past few months, thanks to the accommodative monetary conditions and also to the Government's efforts to relieve credit strains through the enhanced and special loan guarantee schemes. As at the end of July, some 19 400 companies benefited under these schemes, involving approved loan amount of over \$92 billion. This also indirectly helped to secure the jobs of those employed by these companies, totaling over 320 000.

Table 1: Diffusion indices[^] on business and employment situations

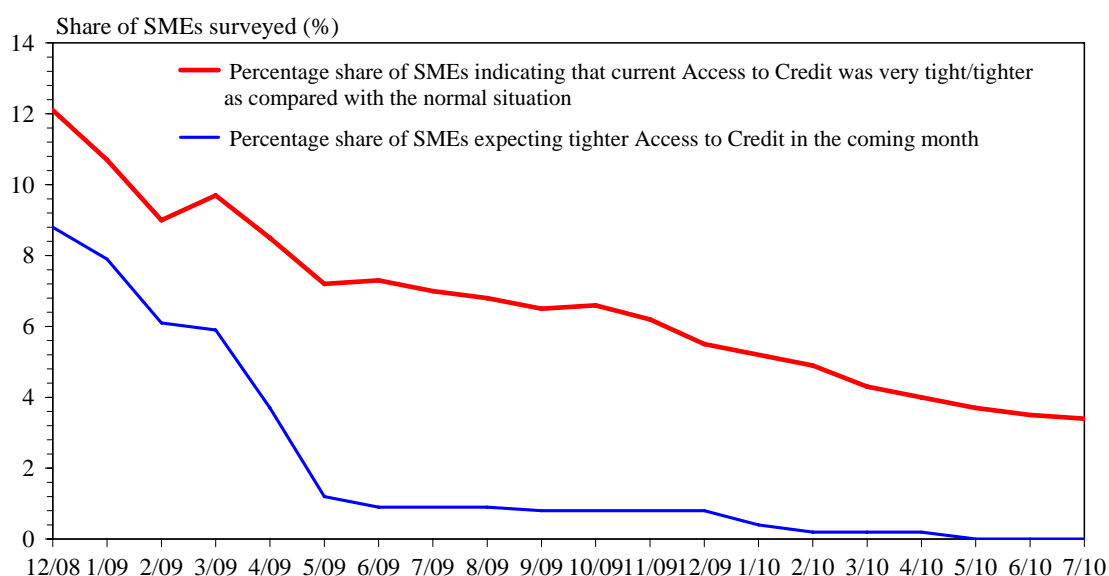
	<u>Business receipts</u>		<u>Employment</u>	
	<u>Jun 2010</u>	<u>Jul 2010</u>	<u>Jun 2010</u>	<u>Jul 2010</u>
<i>Local segments</i>				
Restaurants	47.5	49.1	49.2	49.1
Travel	46.6	53.4	48.3	50.0
Real estate	47.0	56.1	50.0	48.5
Retail trade	43.9	50.0	50.0	49.6
Wholesale trade	47.5	47.4	50.0	50.0
Insurance	45.3	45.0	54.8	50.0
Business services	43.8	50.0	48.4	53.0
<i>External segments</i>				
Import/export trades	50.0	50.0	50.5	50.0
Logistics	52.6	44.7	47.4	47.4
Financing institutions	47.2	44.7	50.0	51.3
All the above sectors*	47.5	49.7	49.9	49.9

Notes: (^) The diffusion index is computed by adding the percentage of SMEs reporting "up" to one half of the percentage of SMEs reporting "same." A diffusion index reading above 50 indicates that the business condition is generally favourable, whereas an index below 50 indicates otherwise. Respondents were requested to exclude seasonal effects in reporting their views.

(*) Weighted average using total number of SMEs in individual sectors as weights.

Box 1.2 (Cont'd)

Chart 1: Access to credit improved further



The labour sector

1.7 The performance of the labour market was somewhat mixed. The *seasonally adjusted unemployment rate* rose back slightly to 4.6% in the second quarter of 2010, after successive declines since mid-2009. While total employment was marginally lower during the quarter, this was mainly due to a fall in the number of self-employed whereas the number of employees actually rose further to an all-time high. The concurrent increase in job vacancies also suggests that the relapse was in large part frictional, caused by workers temporarily breaking from employment whilst seeking jobs with better terms and conditions. Meanwhile, the *underemployment rate* continued its downtrend, reaching 2.0% in the second quarter. Labour wages and earnings picked up further in the first quarter.

The asset markets

1.8 The *local stock market* experienced sharp volatilities and sell-off alongside other major overseas markets in April and May, as concerns deepened over the sovereign debt risks in some part of the euro area. The Hang Seng Index (HSI) plummeted to 18 986 on 25 May, the lowest level since

July 2009. There was some recovery towards the end of the second quarter as the acute strains in the financial markets showed some easing following the massive rescue packages by the European Union and the International Monetary Fund (IMF). HSI closed the month of June at 20 129, down by 5.2% over end-March this year and by 8.0% over end-2009.

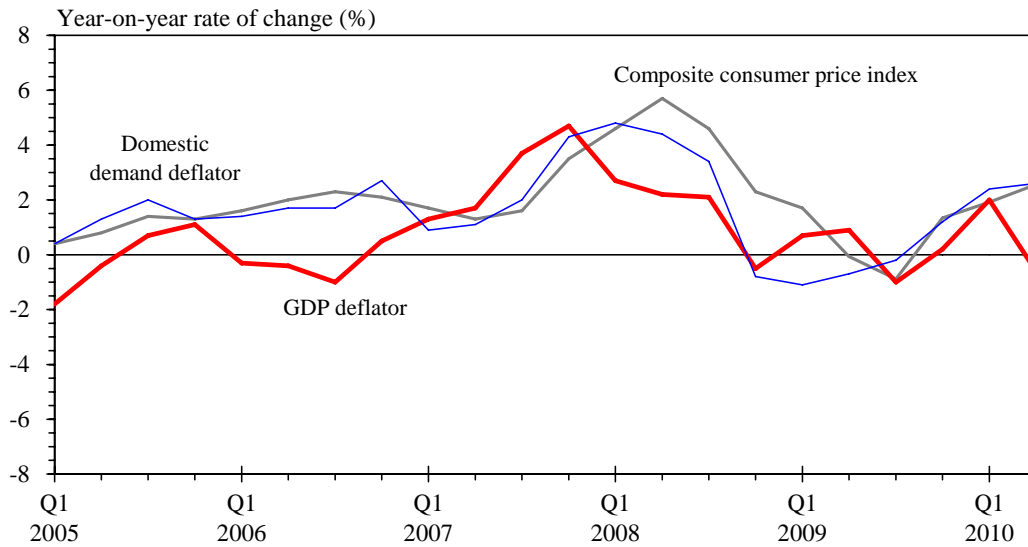
1.9 *Residential property market* consolidated somewhat in May, subsequent to the Government's further measures to ensure a healthy and stable development of the property market. But the upward momentum resumed in June, partly boosted by the favourable land auction results. Overall flat prices rose by a further 1.5% between March 2010 and June 2010, after rising successively by a cumulative 28.5% during 2009 and a further 6.5% during the first quarter of 2010. Nevertheless, transactions in the second quarter fell slightly by 2.6% over the preceding quarter, mainly reflecting the cooling off in May. Thanks to the exceptionally low mortgage interest rates, the home purchase affordability (i.e. the ratio of mortgage payment for a 45-square metre flat to median income of households, excluding those living in public housing) was 41.5% in the second quarter, compared with the long-term average of 52.6% over 1989 to 2008. Meanwhile, flat rentals continued to firm up in tandem with reviving leasing demand. Office and shop rentals also went up further, supported by the resurgence in commercial and retail activities.

Inflation

1.10 Inflationary pressure, though still moderate, notched up slightly in the second quarter of 2010 alongside the sustained economic recovery. In fact, many Asian economies experienced stronger inflationary pressure in the second quarter given their robust growth momentum. *Underlying consumer price inflation*, which nets out the effect of Government's relief measures to provide a more accurate indicator of the inflation trend, rose moderately to 1.5% in the second quarter from 0.8% in the first quarter. Taking into account the effect of Government's one-off measures, *headline consumer price inflation* went up to 2.6% in the second quarter from the 1.9% in the first quarter. The effect of the electricity charge subsidy, which faded out progressively, largely accounted for the difference between the headline and underlying inflation rates.

1.11 The *GDP deflator* reverted to a modest decline in the second quarter, due to the deterioration in the terms of trade amid the faster increase in import prices as compared to export prices.

Diagram 1.4 : Inflationary pressures climbed up moderately in the second quarter



GDP by major economic sector

1.12 With the economy gaining traction on entering 2010, activity across many major sectors saw a notable turnaround, with the year-on-year comparison in particular favourable considering the low base of comparison in the same period last year. In the first quarter of 2010, the manufacturing sector, which went through a steep decline of 9.2% in 2009, finally reverted to a modest year-on-year growth of 1.0%. The growth in net output of the services sector gathered further steam, accelerating to 8.4% from 3.4% in the fourth quarter of 2009. In tandem with the resurgence in trade flows and business activity, import and export trade saw the sharpest growth, followed by wholesale and retail trades, financing and insurance, and restaurants and hotels. The growth in business services also picked up markedly compared with the previous quarter. However, construction output reverted to a slight decline, and real estate also fell slightly in the first quarter, after the relatively brisk expansion in the preceding two quarters.

**Table 1.3 : GDP by economic activity^(a)
(year-on-year rate of change in real terms (%))**

	<u>2009</u>		<u>2009</u>			<u>2010</u>
		<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>	<u>Q1</u>
Manufacturing	-9.2	-12.3	-10.6	-8.0	-6.2	1.0
Construction	1.6	-3.4	-1.0	7.0	4.7	-0.6
Services ^(b)	-2.0	-6.9	-3.4	-1.4	3.4	8.4
Wholesale, retail and import and export trades, restaurants and hotels	-7.7	-15.4	-11.3	-8.3	2.4	19.8
Wholesale and retail trades	-3.5	-10.4	-7.9	-3.6	6.3	17.2
Import and export trade	-8.9	-18.4	-12.8	-9.5	2.2	22.9
Restaurants and hotels	-4.3	-5.3	-7.6	-4.0	-0.6	7.8
Transport, storage and communications	-4.9	-6.7	-7.5	-6.0	0.6	5.0
Transport and storage	-6.5	-8.4	-9.6	-7.9	-0.2	5.0
Communications	1.2	0.5	-0.2	1.3	3.2	5.0
Financing, insurance, real estate and business services	1.5	-6.4	*	5.2	7.6	6.1
Financing and insurance	1.9	-8.9	0.8	6.3	10.3	8.5
Real estate	1.8	-4.9	1.6	5.2	6.2	-1.5
Business services	-0.1	-0.2	-1.5	0.6	0.5	7.2
Community, social and personal services	1.4	0.7	2.0	1.3	1.5	4.5

Notes : Figures are subject to revision later on as more data become available.

(a) The GDP figures shown in this table are compiled from the production approach, in parallel with those shown in Table 1.1 which are compiled from the expenditure approach. For details, see Note (1) to this chapter.

(b) In the context of value-added contribution to GDP, the service sectors include ownership of premises as well, which is analytically a service activity.

(*) Less than 0.05%.

Some highlights of economic policy

1.13 On 27 May 2010, Supplement VII to the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) was signed. The new supplement provides for 35 market liberalisation and trade and investment facilitation measures in 19 sectors, including the two new sectors of “technical testing, analysis and product testing” and “specialty design”, bringing the number of liberalised service sectors from 42 to 44. The measures will take effect on 1 January 2011. The supplement will expedite the entry of Hong Kong’s service industries into the Mainland market, and foster integration and professional exchanges with the Mainland. Most of the market liberalisation and facilitation measures cover the four pillar industries and the six economic industries where Hong Kong enjoys a competitive edge⁽⁴⁾, and hence will serve to consolidate Hong Kong’s status as an international financial, trade, shipping, logistics and high value-added service centre.

1.14 The Mainland authorities announced on 22 June 2010 that the renminbi (RMB) trade settlement scheme, which was introduced in July 2009, was expanded to cover 20 provinces and cities⁽⁵⁾ on the Mainland. The expansion of the scheme was seen as a welcome opportunity for Hong Kong to further develop the RMB business. The Government is working closely with the Mainland authorities to explore ways to enhance the RMB’s depth and breadth in building Hong Kong into a major RMB offshore centre. In July 2010, the Hong Kong Monetary Authority and People’s Bank of China signed two memoranda of co-operation, one on the exchange, supply and repatriation of RMB cashnotes with Taiwan⁽⁶⁾ and another on the expansion of the RMB trade-settlement scheme⁽⁷⁾, with a view to further promoting Hong Kong’s RMB business platform to new heights.

1.15 The Government stepped up measures to stabilise the property market. Specifically, the nine new proposals to regulate the sales of first-hand private residential properties came into force on 1 June 2010. To further address the housing issue, a five-month public consultation on subsidising home ownership was launched to collect views from the public, and an account of the findings will be given in the Policy Address to be delivered in October this year.

Notes :

- (1) The Gross Domestic Product (GDP) is an overall measure of net output produced within an economy in a specified period, such as a calendar year or a quarter, before deducting the consumption of fixed capital. In accordance with the expenditure approach to its estimation, GDP is compiled as total final expenditures on goods and services (including private consumption expenditure, government consumption expenditure, gross domestic fixed capital formation, changes in inventories, and exports of goods and services), less imports of goods and services.
- (2) The seasonally adjusted quarter-to-quarter GDP series, by removing the variations that occur at about the same time and in about the same magnitude each year, provides another perspective for discerning the trend, particularly in regard to turning points. A detailed examination reveals the presence of seasonality in the overall GDP and in some of its main components, including private consumption expenditure, government consumption expenditure, exports of goods, imports of goods, exports of services, and imports of services. However, due to the presence of considerable short-term fluctuations, no clear seasonal pattern is found in gross domestic fixed capital formation. Therefore, the seasonally adjusted series of GDP is compiled separately at the overall level, rather than summing up from its main components.
- (3) In July 2010, the International Monetary Fund (IMF) revised slightly upward its global GDP growth forecast for 2010 to 4.6% from its April forecast of 4.2%, mainly reflecting the higher economic activity in the first half of the year, while keeping its forecast for 2011 unchanged at 4.3%. Specifically for Asia, the IMF forecast the region to expand by 7.5% in 2010 and 6.8% in 2011, as compared to its corresponding forecasts of 6.9% and 7.0% in April. Yet the IMF also cautioned the increased risks to global economic outlook due to the sovereign debt problems in some euro-zone economies.
- (4) The four traditional pillar industries refer to financial services, tourism, trading and logistics, and producer and professional services. The six industries where Hong Kong enjoys clear advantages refer to medical services, educational services, environmental industries, testing and certification, innovation and technology, and cultural and creative industries.
- (5) The cities and provinces are: Beijing, Tianjin, Inner Mongolia, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangdong, Guangxi, Hainan, Chongqing, Sichuan, Yunnan, Jilin, Heilongjiang, Xizang and Xinjiang.
- (6) Under the arrangement, the Renminbi Clearing Bank in Hong Kong will provide renminbi cashnote exchange and related services to the Hong Kong branches of eligible Taiwan commercial banks as determined by Taiwan. In turn, the Taiwan head offices of such commercial banks will provide renminbi cashnote exchange services to other authorised financial institutions in Taiwan, for the purpose of serving personal customers locally.
- (7) Under the agreement, there will no longer be restrictions on banks in Hong Kong in establishing renminbi accounts for and providing related services to financial institutions; and individuals and corporations will be able to conduct renminbi payments and transfers through the banks. The relaxation is expected to enable more types of financial intermediary activities denominated in the renminbi to be introduced in the market.