Outlook for the Hong Kong economy in 2006

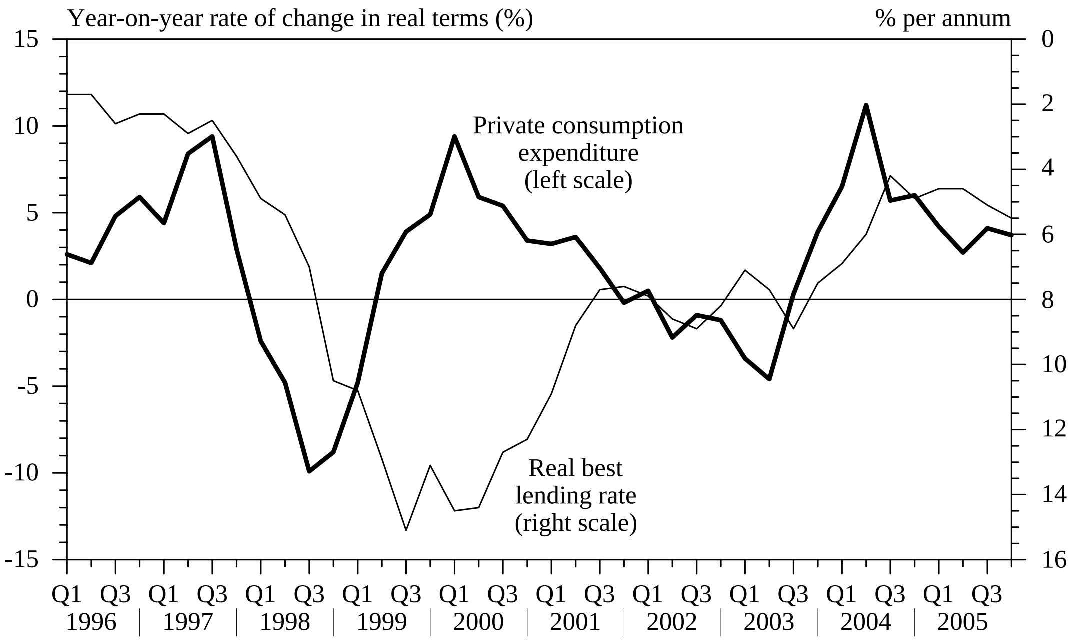
2.12 Against the background of the downside risks stemming from the global economic environment, and after two years of exceptionally strong growth, the outlook for 2006 is for the Hong Kong economy to gradually settle back to a growth pace more commensurate with its past trend growth. The implementation of the three phases of CEPA and strengthening Pan-PRD co-operation, together with the still supportive external environment, should continue to lend support to Hong Kong's economic growth. Hence, while the pace of activity growth in 2006 may ease back somewhat, the scope of expansion will remain relatively broad-based.

2.13 Externally, the outlook for trade in 2006 remains largely sanguine. But the growth pace is likely to be less hectic than last year's, as US economic growth is expected to take a breather after successive interest rate hikes, and as the relative strength of the US dollar should have some negative effect on Hong Kong's exports in the early part of the year. Also, after the exceptionally strong growth in 2005, Mainland's exports, the key source of Hong Kong's re-exports, have shown signs of some tapering in recent months. Against these, however, the relative improvement in economic performance in Europe and Japan should provide useful support.

2.14 Another positive development is the agreements reached by the Mainland with the US and EU last year over Mainland's exports of textiles and clothing items, which has cleared considerable uncertainty in the trading environment, even though these agreements would also tend to limit the export growth to some extent. Against this backdrop, *total exports of goods* are likely to still see solid growth in 2006, though not as robust as the 11.2% growth last year. Within this total, re-exports will remain the major growth driver. Domestic exports seem likely to continue the rapid growth trend that began in the latter half of 2005, as some local manufacturers have already shifted back their clothing production to Hong Kong.

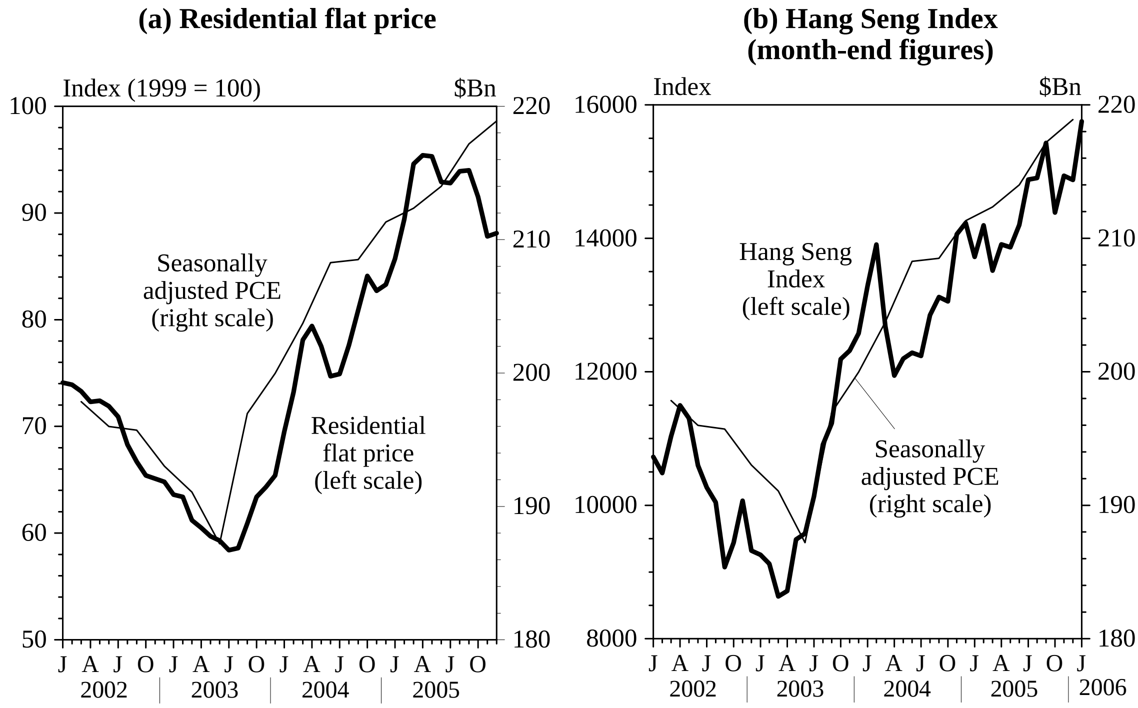
2.15 *Exports of services* would continue to show notable growth in 2006. The further extension of the Individual Visit Scheme to four more Mainland cities in November 2005, the completion of several new tourist attractions, and the full-year effect of the Disneyland theme park would all help raise the number of incoming visitors to a new high in 2006. Thus the further expansion of inbound tourism will continue to support exports of travel-related services. Exports of trade-related services and, to some extent, exports of transportation services should also fare quite well, boosted by still robust performance of the Mainland's external trade and the on-going shift to offshore trade. The implementation of the three phases of CEPA and the strengthening Hong Kong-Mainland economic ties in general will also generate stronger demand for Hong Kong's professional, business and financial services, thereby rendering firm support to exports of finance, business and other services.

Diagram 2.8 : Successive interest rate hikes may slow consumption growth



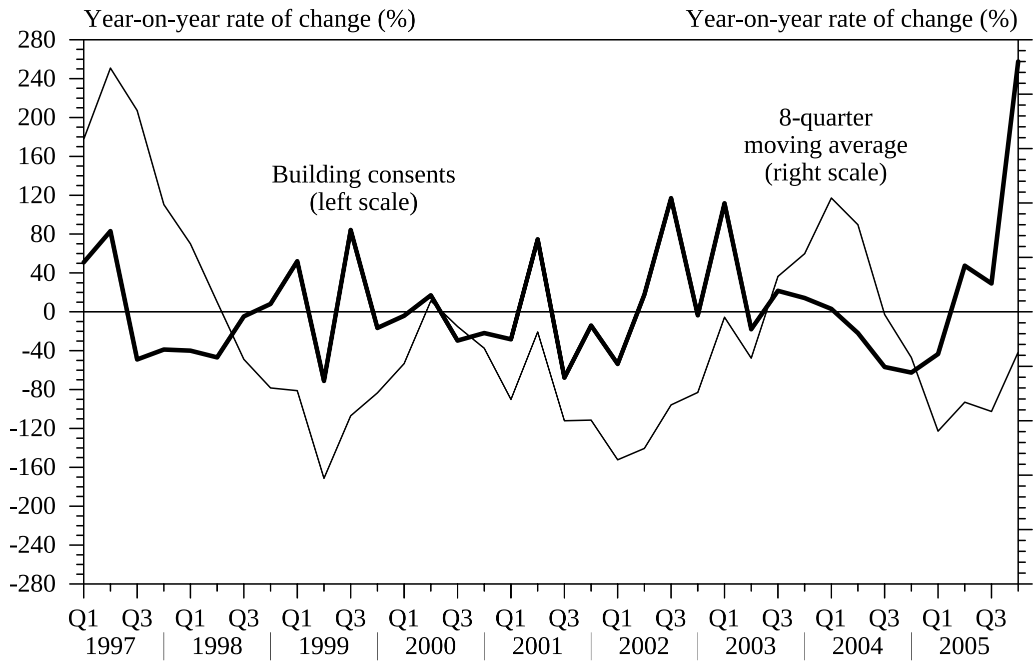
2.16 Locally, with the rise-back in labour income and improving employment conditions, *private consumption expenditure* is likely to attain another year of solid growth in 2006. The past two consecutive years of exceptionally strong economic growth has strengthened consumer confidence considerably, although the feed-through of the interest rate hikes over the past year may rein in somewhat the pace of consumption growth in the near term. Also, developments in the local asset markets should turn more favourable later in the year as the interest rate upcycle hopefully comes to an end, thereby adding further support to consumer spending.

Diagram 2.9 : Asset market developments being another crucial factor affecting local demand



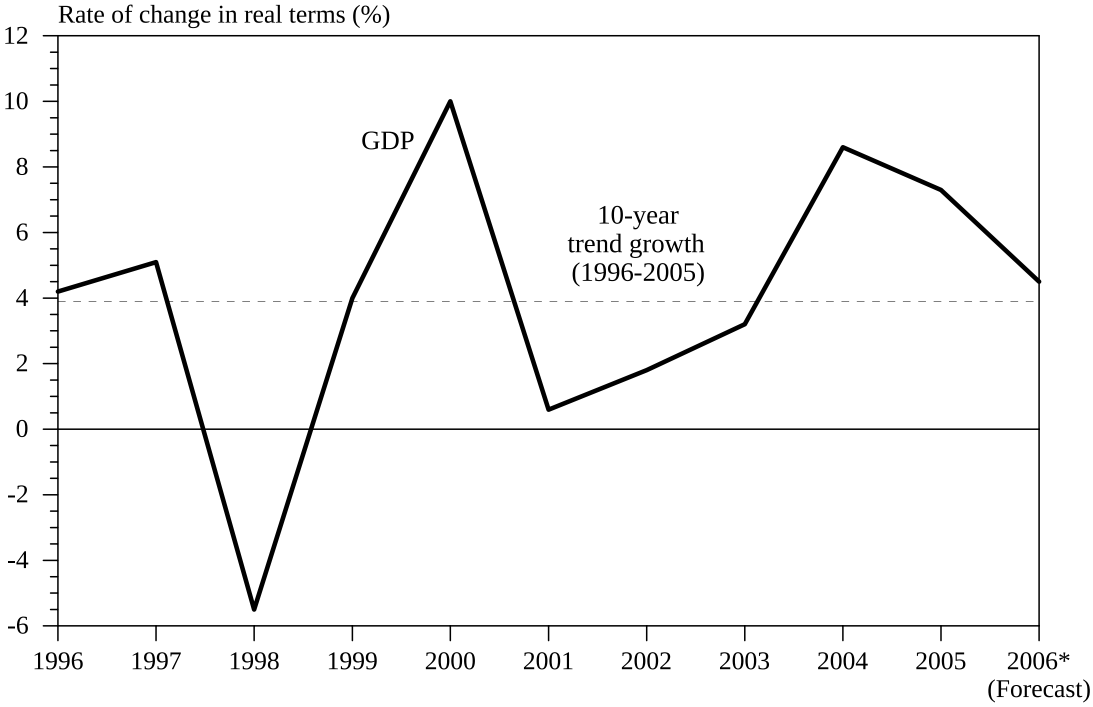
2.17 The main growth impetus to overall *investment spending* in 2006 is expected to come from private sector acquisition of machinery and equipment, continuing the strong trend established in the past two years, on the back of the improved corporate profitability and the drive to raise productivity amidst an increasingly competitive global environment. In contrast, investment in building and construction, having been on a prolonged decline, still shows little signs of turnaround to date. Due to the distinct fall-off in the number of new projects launched in 2004, building consents on an eight-quarter moving average basis was still on a decline in late 2005. As such, the weakness in construction output is expected to extend at least into the early part of 2006. There will also be limited support from the Public Sector Housing Programme following its scaling back in the previous years. Though with the interest rate upcycle probably near its end and with building consents in the more recent quarters showing a significant rebound, the timing and the extent of a turnaround remains subject to great uncertainty.

Diagram 2.10 : Building and construction activity likely to remain slack in near term, thereby continuing to hold back overall investment



2.18 Overall, the *Gross Domestic Product* is expected to attain still solid growth of 4-5% in real terms this year, more commensurate with the trend growth at 3.9% in the past ten years, though coming down from the exceptionally strong growth of 7-8% in the past two years. The forecast is somewhat conservative when compared with the prevailing forecasts by the private sector which are mostly in the range of 4.5 - 5.5%, reflecting the cautiousness stemming from the downside risks and uncertainties in the global economic environment and also the expected feed-through from higher interest rates.

Diagram 2.11 : Economy set for still solid growth in 2006



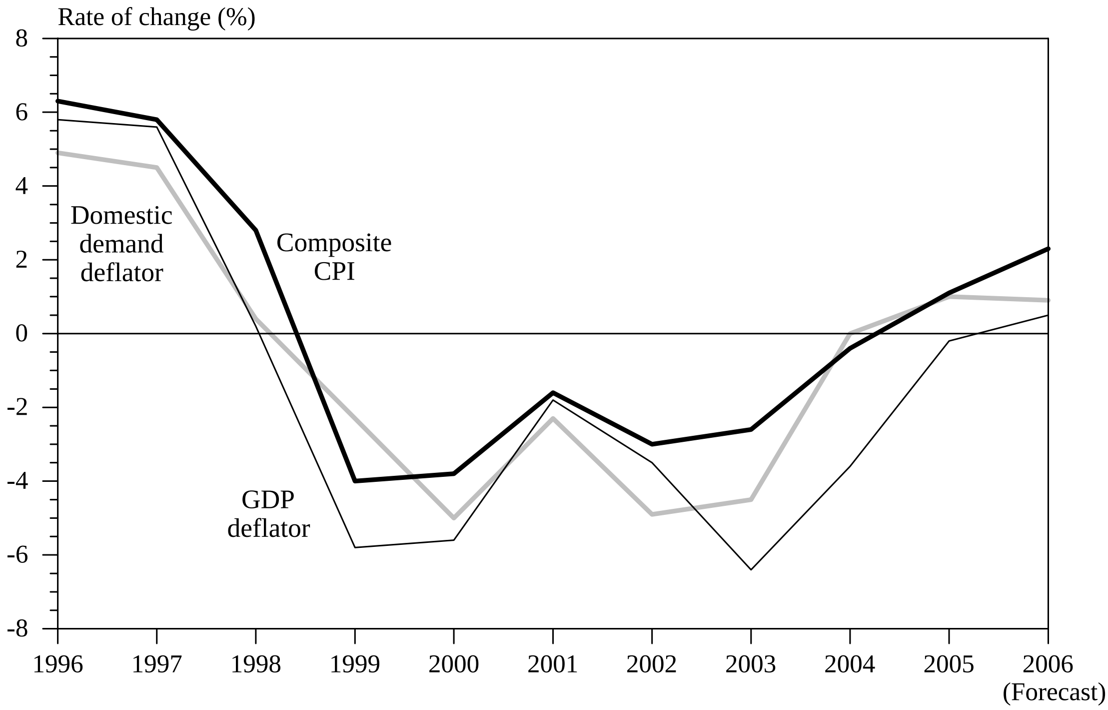
Note : (*) Mid-point of the range forecast.

2.19 The outlook for consumer price inflation is for a further creeping up in 2006. With the economic expansion continuing at a solid growth pace and the broader return of pricing power, any rise in business cost is likely to pass through to the retail price level more readily. In this regard, the rise-back in labour costs over the past year and the continuous increases in office and shopping rentals will add to business cost modestly. Also, the increase in housing rentals, by some 11-12% in 2005, will increasingly show up in the rental components of the consumer price indices. Externally, oil prices and other commodity prices are likely to sustain at high levels in 2006 and may lead to higher import prices, especially if the US dollar were to show some renewed weakening later this year. On the other hand, the envisaged moderation in overall economic growth is likely to keep the CCPI upturn still at a modest pace. Also, continued uplifting in labour productivity along with the on-going shift to higher value-added activities and the hefty investment in machinery and equipment should help expand the productive capacity of the economy, thereby mitigating the overall cost pressures somewhat.

2.20 Overall, consumer price inflation in terms of the year-on-year rate of increase in the *Composite CPI* is likely to climb up over the course of 2006, essentially a continuation of the re-inflation process that began in late 2004.

Yet with economic growth coming down to a level more commensurate with the past trend growth and with continued expansion in production capacity, inflation is expected to average at a still moderate and healthy level of 2.3% for the year as a whole. In tandem with the climb-up in CPI inflation and probably with less of a drag from terms of trade this year, the *GDP deflator* is expected to also revert to an increase at 0.5% in 2006, which if realised would represent the first annual increase since 1999.

Diagram 2.12 : Inflation environment still benign in 2006



Forecast rate of change in 2006 (%)

Gross Domestic Product (GDP)	
Real GDP	4-5
Nominal GDP	4.5-5.5
Per capita GDP, in real terms	3.2-4.2
Per capita GDP at current market prices	HK$206,800-208,700 (US$26,500-26,800)
Composite Consumer Price Index	**2.3**
GDP Deflator	**0.5**