

Press Release

(embargoed until 4:15 p.m. on 22 August 2006)

Economic Situation in the Second Quarter of 2006 and Latest GDP and Price Forecasts for 2006

The Government released today (Tuesday) the Half-yearly Economic Report 2006, together with the preliminary figures on Gross Domestic Product for the second quarter of 2006.

The Government Economist, Mr K C Kwok, described the economic situation in the second quarter of 2006 and provided the latest GDP and price forecasts for the year.

MAIN POINTS

- * The Hong Kong economy, after an exceptionally strong growth of 8.0% in the first quarter, grew by 5.2% in the second quarter of 2006 (former figure revised from the earlier estimate of 8.2%). This marked the eleventh consecutive quarter that GDP growth exceeded the average trend growth of 3.9% in the past ten years.
- * Yet when compared with the first quarter, external trade was less sanguine. Merchandise exports, having attained continuous strong growth over the past three years, grew more moderately in the second quarter, by 6.4% in real terms over a year earlier. The slackening in export momentum was most apparent in the US market, upon the somewhat weaker consumer demand there. Exports to most other markets also showed different extents of moderation, partly due to the feed-through of a stronger US dollar in the earlier period. Yet the vibrant Mainland economy has helped to cushion the impact of weaker performance in other markets. Also, exports of services still maintained notable growth momentum, up 8.6% in real terms in the second quarter, bolstered by continued distinct growth in offshore trade and still vibrant inbound tourism.
- * Against a weaker export performance, however, domestic demand continued to hold up well, thereby providing the key driver of economic growth in the second quarter. Private consumption expenditure picked up further to a 5.0% growth in real terms in the second quarter, alongside improving employment conditions. This improvement occurred even amidst the large volatilities in the stock market in May and June caused by an uncertain interest rate outlook.
- * Overall investment expenditure grew by 4.3% in real terms in the second quarter, with the continued surge in expenditure on machinery and equipment, at 12.8%, more than offsetting the decline at 6.4% in building and construction expenditure. The former was a clear reflection of strong investor confidence on the back of expanding business activity.
- * The above-trend economic growth led to a further improvement in the labour market, with the seasonally adjusted unemployment rate edging down to 5.0% in

the second quarter and further to 4.9% in May-July 2006, the lowest in nearly 5 years. Compared with the trough in 2003, some 263 000 additional jobs have been created; and the number of long-term unemployed has also come down markedly by nearly half. The unemployment rate for lower-skilled workers saw further improvement, while that for professional and managerial employees has fallen back to around 2%. Wages and earnings remained on the rise, and job vacancies continued to surge, reaching its highest since September 1997.

- * The outlook for the rest of the year depends on how the various downside risks from the external front, including most notably, weaker US growth and high oil price, would play out to affect Hong Kong's external trade. Yet at this present juncture, it is believed that the external environment would remain largely positive in the second half of the year. Although the US market has shown some signs of moderation lately, the recent pause in the US interest rate up-cycle, the sustained brisk expansion of the Mainland economy, and the current upturn in Europe and Japan are all positive factors which would help to underpin Hong Kong's export performance going forward. The further weakening of the US dollar lately is another supportive factor. On balance, total exports are still poised for further growth in the second half of the year, albeit possibly not as fast as previously.
- * Domestic demand can be expected to remain resilient and play an even more prominent role in driving economic growth in the rest of the year. Consumer spending looks set to grow solidly further in the near term, on the back of rising household incomes and better job prospects, aided further by the positive wealth effect from the recent stock market boom. The pause in the US interest rate up-cycle will add further support to households' willingness to spend. Investment in machinery and equipment also seems likely to increase briskly further, in tandem with rising corporate earnings and the expanding business. But the sluggishness in construction might continue to hold back the pace of upturn in overall investment.
- * With the resilience in domestic demand and with the expected further growth in trade, the economic outlook for the rest of the year is for a further expansion closer to the past trend growth rate. That the economy would progressively move from a high growth track back to a growth pace more in line with its past trend during this year actually accords well with earlier expectations. Given the outturn so far and with the expected further solid expansion in the second half, for 2006 as a whole, the Hong Kong economy should easily attain the forecast growth range of 4-5% as put out earlier. On the whole, the May round forecast of a 4-5% GDP growth for 2006 is still applicable. Indeed, barring any abrupt adverse changes in the external environment, GDP growth for the year as a whole is likely to be close to 5%, the upper end of the range forecast.

- * Consumer price inflation, though notching up to 2.0% in the second quarter, remained benign. Looking ahead, overall inflationary pressures are likely to stay rather moderate, being kept down by rising productivity and capacity expansion from hefty business investment. With the actual outturn of consumer price inflation so far broadly in line with the earlier expectations, the forecast rate of increase in the Composite CPI for 2006 as a whole is kept unchanged at 2%. As to the forecast rate of change in the GDP deflator, it is revised slightly downwards to 0% from the earlier forecast of 0.5%, in view of the persistent fall in the terms of trade caused by higher oil prices.

DETAIL

GDP

According to the preliminary figure on the *Gross Domestic Product (GDP)* released today by the Census and Statistics Department, GDP grew by 5.2% in real terms in the second quarter of 2006 over a year earlier, following an exceptionally strong 8.0% growth (revised down from 8.2% in the earlier release) in the first quarter and a 7.3% growth in 2005. This marked the eleventh straight quarter of above-trend growth for the Hong Kong economy. On a seasonally adjusted quarter-to-quarter comparison, GDP showed virtually zero growth in real terms in the second quarter of 2006. This came after a strong 2.2% increase in the first quarter and eleven consecutive quarters of sustained expansion (*Chart*).

2. The latest figures on GDP and its major expenditure components up to the second quarter of 2006 are presented in *Table 1*. Developments in different segments of the economy in the second quarter of 2006 are described below.

External trade

3. External trade was less sanguine in the second quarter compared with the exceptionally strong performance in the first quarter. Merchandise exports to most of the major markets slowed. Exports to the United States fell back in the quarter amidst weaker consumer demand there. Exports to Japan also slowed down considerably, conceivably affected by the notable depreciation of the yen over the past year or so. Exports to the EU, though still growing, were also much less robust than in the preceding quarters, again partly due to the feed-through of the weaker euro in the earlier quarters. Yet with the Mainland economy growing at a brisk pace, exports to the Mainland continued to show double-digit growth, thereby rendering some cushion to the weaker performance in other major overseas markets. Overall, *total exports of goods* grew by 6.4% in real terms in the second quarter of 2006 over a year earlier, following a 14.4% increase in the preceding quarter. On a seasonally adjusted quarter-to-quarter comparison, total exports of goods fell by 1.1% in real terms in the second quarter, after a 2.2% increase in the preceding quarter.

4. *Exports of services*, in contrast, still held up well in the second quarter, up 8.6% in real terms, after an 8.9% growth in the first quarter, as offshore trade and transportation service exports were bolstered by Mainland's vibrant trade flows, and as inbound tourism continued to thrive. On a seasonally adjusted quarter-to-quarter comparison, exports of services rose by 1.8% in the second quarter, faster than the 0.8% increase in the preceding quarter.

Domestic sector

5. The role of domestic demand in driving overall economic growth has become more prominent in the second quarter. On the back of improving employment conditions and job prospects, *private consumption expenditure* picked up further to a 5.0% growth in the second quarter, up from the 4.5% growth in the preceding quarter. This was notwithstanding the local stock market correction in May and June caused by uncertainties about future interest rate movements. On a seasonally adjusted quarter-to-quarter comparison, private consumption expenditure went up by 1.0% in real terms in the second quarter, following a 1.6% increase in the first quarter.

6. Overall investment spending in terms of the *gross domestic fixed capital formation* grew further by 4.3% in real terms in the second quarter over a year earlier. Expenditure on machinery and equipment, which surged by 12.8%, continued to provide the major impetus to overall investment growth. Clearly, the business sector has seen the need to increase productivity and expand productive capacity to cater for the envisaged growth in business opportunities. This was also consistent with the strong business confidence prevailing in the economy as evidenced from the latest round of the Business Tendency Survey. Activity in the construction sector, however, remained subdued, falling by 6.4%.

The labour sector

7. The labour market improved further in the second quarter. The *seasonally adjusted unemployment rate* fell to 5.0% in the second quarter and further to 4.9% in May – July, the lowest in nearly five years. Since the trough of 2003, some 263 000 additional jobs were created, leading to improvement in the employment conditions for workers at different skill levels. Meanwhile, the number of long-term unemployed persons continued to decline, and by now it has come down by around half. Also, the total number of job vacancies in the private sector rose markedly further in March 2006 over a year ago, and labour incomes remained on the rise.

Prices

8. Consumer price inflation continued to inch up along with the further economic expansion. The *Composite Consumer Price Index* rose by 2.0% in the second quarter of 2006 over a year earlier, up from the 1.6% increase in the preceding quarter. (In July, the CCPI inflation was 2.3%, giving an average of 1.9%

for the first seven months taken together.) Although the feed-through of rising private housing rentals and soaring oil prices was increasingly felt, in overall terms inflationary pressures were still moderate, being mitigated by rising productivity and generally soft import prices. On a seasonally adjusted quarter-to-quarter comparison, the Composite CPI showed a 0.8% increase in the second quarter, following a 0.4% increase in the first quarter. As to the *GDP deflator*, it continued to decrease marginally by 0.1% in the second quarter over a year earlier, after a similar decline in the preceding quarter. This was entirely dragged by the fall in the terms of trade resulting from the faster increase in import prices, in turn due to higher oil prices.

Latest GDP and price forecasts for 2006

9. After 11 quarters of above-trend growth, the economic outlook for the rest of the year is for a further expansion closer to the past trend growth rate. That the economy would progressively move from a high growth track back to a growth pace more in line with its past trend during the year actually accords well with earlier expectations.

10. Externally, total exports are still poised for further growth in the period ahead, with the support from the vibrant Mainland economy, continued economic upturn in Europe and Japan, and also the renewed weakening of the US dollar lately. But the export growth momentum going forward is unlikely to be as strong as in the past two years when global economic growth was amongst the strongest in 30 years.

11. Although external trade may not grow as fast, domestic demand is likely to stay firm to render the key impetus to overall economic growth in the rest of the year. Consumer spending will continue to be underpinned by rising household incomes and better job prospects, especially with the positive wealth effect from the recent stock market boom and also the pause in the US interest rate up-cycle. Investment in machinery and equipment looks set to surge further, in tandem with rising corporate earnings and the expanding business. But the sluggishness in construction will continue to hold back the pace of upturn in overall investment.

12. Having regard to the strong GDP outturn so far and the expected further expansion at a solid pace in the second half, for 2006 as a whole the Hong Kong economy should easily attain the forecast GDP growth range of 4-5% put out earlier. On the whole, the earlier range forecast of 4-5% GDP growth for 2006 as a whole is still applicable. Indeed, barring any abrupt adverse changes in the external environment, it is likely that, for the year as a whole, GDP growth would be close to 5%, the upper end of the range forecast (*Table 2*). For comparison, the forecasts of Hong Kong's GDP growth by a selection of international organisations and local analysts are summarised in *Table 3*.

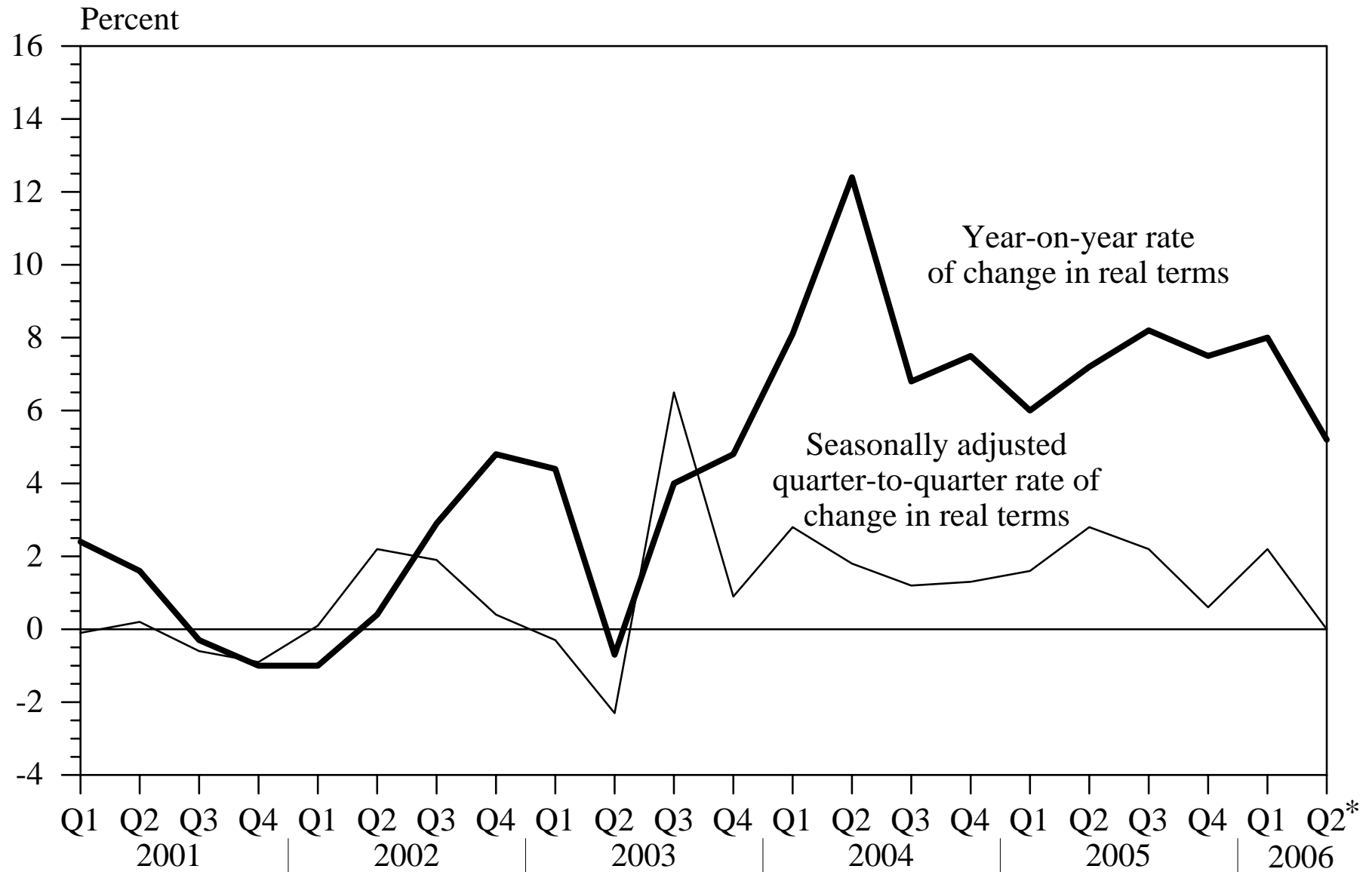
13. As to the outlook for consumer price inflation, it should remain at a rather moderate level through to the end of 2006, though possibly with some further notching up in tandem with the further economic expansion. With the actual outturn of consumer price inflation so far broadly in line with the earlier expectations, the

forecast rate of increase in the *Composite CPI* for 2006 as a whole is kept unchanged at 2%. As to the forecast rate of change in the *GDP deflator* for 2006 as a whole, it is revised slightly downwards to 0% from the earlier forecast of 0.5%, due to the persistent fall in the terms of trade caused by higher oil prices.

(The Half-yearly Economic Report 2006 is now available. Users can download the publication free of charge at <http://www.statisticalbookstore.gov.hk> or <http://www.info.gov.hk/hkecon/report>. Print version of the report can also be purchased on-line, or by calling the Publications Sales Unit of ISD at 2537 1910. The hard copy of the report is available for sale at \$68 per copy (15% discount offered if purchased on-line), yet with a postage charge.)

(The GDP figures up to the second quarter of 2006 are published in the Report of the Gross Domestic Product, Second Quarter 2006. Users can download the publication free of charge at <http://www.statisticalbookstore.gov.hk>. Print version of the report can also be purchased on-line, or by calling the Publications Sales Unit of ISD at 2537 1910. The hard copy of the report is available for sale at \$36 per copy (15% discount offered if purchased on-line), yet with a postage charge.)

Hong Kong's Gross Domestic Product



Note : (*) Preliminary figures.

Table 1

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

	<u>2004</u>	<u>2005</u>	<u>2005</u>				<u>2006</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	7.3	3.4	4.1 (0.4)	2.4 (0.5)	3.6 (1.3)	3.4 (0.9)	4.5 (1.6)	5.0 (1.0)
Government consumption expenditure	0.7	-3.1	-4.6 (-2.6)	-2.3 (-0.7)	-1.6 (0.3)	-3.8 (-1.0)	1.2 (2.6)	-1.3 (-3.0)
Gross domestic fixed capital formation	3.0	4.1	0.4 (N.A.)	4.9 (N.A.)	2.8 (N.A.)	8.4 (N.A.)	7.6 (N.A.)	4.3 (N.A.)
<i>of which :</i>								
Building and construction	-11.7	-6.1	-1.0	-7.5	-5.2	-10.7	-11.1	-6.4
Machinery, equipment and computer software	11.0	10.6	0.8	10.7	7.1	24.0	23.3	12.8
Total exports of goods	15.3	11.2	8.9 (0.1)	11.1 (6.0)	12.8 (3.1)	11.4 (2.2)	14.4 (2.2)	6.4 (-1.1)
Imports of goods	14.1	8.6	3.8 (1.9)	7.0 (5.1)	11.0 (2.2)	12.0 (2.6)	14.0 (3.3)	6.7 (-1.6)
Exports of services	17.9	8.7	8.7 (0.4)	9.1 (2.4)	8.9 (4.3)	8.2 (1.1)	8.9 (0.8)	8.6 (1.8)
Imports of services	14.6	2.9	6.0 (-2.1)	-0.1 (3.7)	3.5 (0.7)	2.3 (-0.3)	4.9 (1.0)	7.9 (6.4)
Gross Domestic Product	8.6	7.3	6.0 (1.6)	7.2 (2.8)	8.2 (2.2)	7.5 (0.6)	8.0 (2.2)	5.2 (*)
<i>Change in the main price indicators (%)</i>								
GDP deflator	-3.6	-0.2	-1.4 (0.1)	-0.6 (0.2)	0.2 (*)	0.7 (0.5)	-0.1 (-0.9)	-0.1 (0.2)
Composite Consumer Price Index	-0.4	1.0	0.4 (0.1)	0.8 (0.3)	1.4 (0.3)	1.3 [@] (0.5) [@]	1.6 [@] (0.4) [@]	2.0 [@] (0.8) [@]
<i>Change in nominal GDP (%)</i>	4.7	7.0	4.6	6.6	8.4	8.2	7.9	5.1

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

(#) Revised figures.

(+) Preliminary figures.

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

N.A. Not applicable, as no clear seasonal pattern is found in gross domestic fixed capital formation, due to the presence of considerable short-term fluctuations.

(@) By reference to the new 2004/05-based CPI series.

(*) Change of less than 0.05%.

Table 2**Economic forecasts for 2006
(year-on-year rate of change (%))**

	Forecasts for 2006 as released <u>on 23.5.2006</u> (%)	Latest forecasts for 2006 <u>on 22.8.2006</u> (%)
Gross Domestic Product (GDP)		
<i>Real GDP</i>	4 to 5	4 to 5
<i>Nominal GDP</i>	4.5 to 5.5	4 to 5
Composite Consumer Price Index	2	2
GDP Deflator	0.5	0

Table 3

2006 GDP and price forecasts for Hong Kong put out by selected international organisations and private sector analysts

	<u>Date of release</u>	<u>GDP</u>	<u>Private consumption expenditure</u> (growth rate	<u>Gross domestic fixed capital Formation</u> in real	<u>Total exports of goods</u> terms (%)	<u>Exports of services</u>	<u>Rate of change in consumer prices</u> (%)	<u>Reference source</u>
International organisations:								
IMF	Jan 2006	5.5	--	--	--	--	1.5	Staff Report for the 2005 Article IV Consultation Discussions, 6 Jan 2006.
	Apr 2006	5.5	--	--	--	--	1.8	World Economic Outlook, Apr 2006.
ADB	Apr 2006	5.5	--	--	--	--	2.5	Asian Development Outlook 2006, Apr 2006.
World Bank	Mar 2006	5.3	--	--	--	--	--	East Asia Update, Mar 2006.
Private sector analysts:								
<i>(a) Major local banks</i>								
HSBC	Feb 2006	5.5	3.2	2.5	4.9	6.4	2.2	Apple Daily, 21 Feb 2006.
	Apr 2006	5.5	3.2	2.5	--	--	2.2	Global Economics, Q2 2006.
	Jun 2006	6.4	3.5	5.8	--	--	2.3	Asian Economics, 22 Jun 2006.
Standard Chartered Bank	Feb 2006	6	--	--	--	--	2.5	On The Ground - Asia, 21 Feb 2006.
	Aug 2006	7	--	--	--	--	2.5	Asia Focus, 16 Aug 2006.
Hang Seng Bank	Dec 2005	5.3	3	2	8.5	6.4	2.3	Hang Seng Economic Monthly, Nov/Dec 2005.
	May 2006	5.3	--	--	--	--	2.2	Hang Seng Bank, 16 May 2006.
	Jun 2006	6.3	3.6	4.4	10.5	6.2	2.3	Hang Seng Economic Monthly, May/June 2006.
Bank of China (HK)	Dec 2005	5	3.3	3	8.5	8	2.5	Economic Review Monthly, Dec 2005.
	May 2006	6.5	4.2	6.8	10.5	8.6	2.2	Economic Review, 26 May 2006.
Bank of East Asia	Jan 2006	5.2	4.5	1	9	6	2.5	Economic Analysis, Jan 2006.
	May 2006	5.8	--	--	--	--	--	Sing Tao Daily, 25 May 2006.
	Aug 2006	5.8	--	--	--	--	2.3	Bank of East Asia, 16 Aug 2006.
ABN Amro Bank	Feb 2006	4.5	--	--	--	--	3	Asia Vision, 10 Feb 2006.
	May 2006	5.5	--	--	--	--	2.5	Asia Vision, 12 May 2006.
	Aug 2006	6	--	--	--	--	2.5	Asia Vision, 11 Aug 2006.

Table 3 (cont'd)

2006 GDP and price forecasts for Hong Kong put out by selected international organisations and private sector analysts

	<u>Date of release</u>	<u>GDP</u>	<u>Private consumption expenditure</u> (growth rate	<u>Gross domestic fixed capital formation</u> in real	<u>Total exports of goods</u> terms (%))	<u>Exports of services</u>	<u>Rate of change in consumer prices</u> (%)	<u>Reference source</u>
Citigroup	Feb 2006	5	--	--	--	--	2.8	Hong Kong Economics, 9 Feb 2006.
	May 2006	5.7	3.8	3.8	10.6	8.2	2.6	Hong Kong Economics, 17 May 2006.
	July 2006	5.7	4.3	3.4	--	--	2.2	Asia Economic Outlook and Strategy, 24 Jul 2006.
<i>(b) Investment bank</i>								
JP Morgan Chase	Feb 2006	5.7	--	--	--	--	2	JP Morgan Chase, 16 Feb 2006.
	May 2006	5.8	--	--	--	--	2.2	JP Morgan Chase, 16 May 2006.
	May 2006	6	--	--	--	--	--	Sing Tao Daily, 25 May 2006.
	Aug 2006	6	--	--	--	--	2.2	JP Morgan Chase, 21 Aug 2006.
Goldman Sachs Asia	Jan 2006	5.4	--	--	--	--	2.8	Hong Kong Economic Journal, 3 Jan 2006.
	Feb 2006	5.8	--	--	--	--	2.4	Asia-Pacific Economics Flash, 6 Feb 2006.
	May 2006	6.2	--	--	--	--	--	Sing Tao Daily, 25 May 2006.
	Aug 2006	6.2	4.9	5.8	--	--	2.6	Asia Economics Flash, 10 Aug 2006.
Morgan Stanley Asia	Nov 2005	5	3	3	--	--	2	Hong Kong Economics, 28 Nov 2005.
	May 2006	5	--	--	--	--	2	Morgan Stanley Asia, 16 May 2006.
Merrill Lynch	Jan 2006	6	--	--	--	--	3.9	The Asian Market Economist, 16 Jan 2006.
	Aug 2006	6	--	--	--	--	2.1	The Asian Market Economist, 16 Aug 2006.
Credit Suisse	Jan 2006	4.7	3.6	2.5	--	--	2.6	Asian Daily, 10 Jan 2006.
	Mar 2006	5	4.2	3	--	--	2.3	Global Emerging Markets Outlook, Q2 2006, 24 Mar 2006.
	Jul 2006	5.9	4.6	4	--	--	2.2	Emerging Markets, Q3 2006, 5 Jul 2006.
Lehman Brothers	Feb 2006	5.5	--	--	--	--	3.4	Asia Ex-Japan Weekly Economic Monitor, 10 Feb 2006.
	May 2006	6	--	--	--	--	3	Global Weekly Economic Monitor, 16 May 2006.

Table 3 (cont'd)

2006 GDP and price forecasts for Hong Kong put out by selected international organisations and private sector analysts

	Date of release	GDP	Private consumption expenditure (growth rate)	Gross domestic fixed capital formation in real terms	Total exports of goods (%)	Exports of services (%)	Rate of change in consumer prices (%)	Reference source
<i>(c) Others</i>								
Economist Intelligence Unit	May 2006	5.3	3.8	4	--	--	1.9	Country Forecast, May 2006.
	Jun 2006	6	3.9	4	--	--	1.8	Country Forecast, Jun 2006.
	Jul 2006	6.2	4.4	4	--	--	2.1	Country Forecast, Jul 2006.
	Aug 2006	6.1	5.4	4	--	--	2.1	Country Forecast, Aug 2006.
Hong Kong General Chamber of Commerce	Dec 2005	3.5	--	--	--	--	2.5	Hong Kong Economic Forecast, HKGCC, 2 Dec 2005.
	Feb 2006	4	--	--	--	--	2.5	HKGCC, 14 Feb 2006.
	May 2006	4.5	--	--	--	--	2	HKGCC, 16 May 2006.
	Jun 2006	5.5	--	--	--	--	--	Wen Wei Po, 14 Jun 2006.
	Aug 2006	6.5	--	--	--	--	2.5	HKGCC, 17 Aug 2006.
Hong Kong University	Jan 2006	5	--	--	--	--	2.5	RTHK Online News, 5 Jan 2006.
	Apr 2006	5 - 6	--	--	--	--	2.5 - 3	Sing Tao Daily, 7 Apr 2006.
	Jul 2006	6.5	--	--	--	--	2	RTHK on internet, 7 Jul 2006.
Federation of Hong Kong Industries	Jan 2006	5 - 5.5	--	--	--	--	--	Press release, 11 Jan 2006.
	Jul 2006	6.5 - 7	--	--	10	--	--	Press Release, 27 Jul 2006.

Observation :

Most private sector forecasters have marked up their GDP forecasts for 2006 after the release of the Q1 GDP numbers. Their prevailing forecasts are mostly in the range of 6 to 6.5%, averaging at 6.2%.