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Low Growth Ahead - Analysis of Hong Kong Economic Trend in 2H 2016

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In 1H 2016, Hong Kong economy was affected by the global economic uncertainties, volatile financial markets, relatively high Hong Kong dollar exchange rate, sluggish merchandise trade and tourism performance, and the correction of residential property prices. Following the 1.9% growth in real terms in Q4 2015, Hong Kong real GDP growth slowed to a mere 0.8% in Q1 2016, lower than the 2.4% growth in 2015 and the 3.4% annual average over the past decade. On a seasonally adjusted quarter-to-quarter comparison, real GDP fell by 0.4% in the first quarter, after the 0.2% growth in the preceding quarter.

Hong Kong economy expanded slowly in 1H 2016

1. Weak external environment adversely affected trade flow. In Q1 2016, the global economic growth remained sluggish. With the slow recovery in the advanced economies, their imports demand continued to be restrained. Together with the volatile financial markets, the downside risks of the global economy intensified. Total exports of goods registered a large year-on-year decline of 3.6% in real terms in Q1, with exports to most major destinations recording contractions. At the same time, the decline of imports of goods deteriorated further to a year-on-year 5.4% in real terms, largely because of the further reduction of import-related re-exports as well as weak retained imports performance.

2. Contraction of tourism dragged on exports of services performance. Exports of travel services recorded a 13.3% year-on-year plunge in real terms in Q1 2016, far worse than the 6.7% decline in Q4 2015. This was largely due to the sharp contraction in visitor arrivals (Overall visitor arrivals, same-day visitor arrivals and overnight visitor arrivals declined 8.8%, 13.0% and 3.4% year-on-year in the first four months respectively) and weakness in tourism spending. Indeed, the implementation of “one trip per week” Individual Visit Endorsements for permanent residents of Shenzhen had profound impact on Hong Kong tourism performance. The number of visitor arrivals holding “multiple-entry” and “one trip per week” Individual Visit Endorsements amounted to 10.97 million over the first one-year period since the implementation of “one trip per week” Individual Visit Endorsements in April 2015, about 4 million less than the number of visitor arrivals holding “multiple-entry” Individual Visit Endorsements in the preceding year. Moreover, given the reduced trade and cargo flows in the region, as well as the heightened volatility in the global financial markets during the quarter, the overall exports of services declined 4.9% year-on-year in real terms in Q1 2016.

3. Momentum of domestic demand was slowing gradually. Domestic demand showed signs of slowdown, amid sluggish merchandise trade and tourism performance, and the asset markets correction (residential property prices declined 4.2% in the first four months of 2016). In Q1 2016, private consumption expenditure only increased a mere 1.1% year-on-year in real terms, notably lower than the 2.7% growth in Q4 2015. In addition, the volatile investment expenditure recorded another quarter of sharp contraction, with a 10.1% year-on-year decline in real terms in Q1 2016 (9.4% drop in Q4 2015), reflecting corporations’ cautiousness in implementing their investment plan amid increasing uncertainty over the global economic outlook. Machinery, equipment and intellectual property products registered a sharp 11.9% year-on-year decline in Q1 2016 (12.9% contraction in Q4 2015), while building and construction recorded a mere

0.8% decline (0.9% drop in Q4 2015), mainly affected by the decline in public sector projects which might be somewhat related to slow funding approval progress by the Legislative Council. Finally, government consumption expenditure remained largely stable at 3.2% growth year-on-year in real terms in Q1 2016 (3.3% growth in Q4 2015).

4. Labour market remained resilient. Since the 2H 2011, the unemployment rate remained largely steady and held at a range near the full employment level of 3.1% and 3.5%. However, because of the weak external and tourism sector performance, as well as the slowing domestic consumption growth over the past few months, unemployment rate edged up one-tenth to 3.4% between March and May 2016 compared to 2H 2015, while wages and income posted further increases, providing some support to the domestic consumption and overall economy.

5. Consumer price pressure remained moderate. Amid the relatively low growth environment, the consumer price pressure was still moderate. Underlying inflation increased from 2.2% year-on-year in Q4 2015 to 2.8% in Q1 2016, largely driven by the increases in the prices of basic foodstuff related to poor weather, and then fell back to 2.2% in May. Excluding the food-related factor, the domestic price pressure remained under control, attributed to the slowdown in domestic demand, consolidating rental level in tandem with the property market performance, still low global commodity prices, and the overall low consumer price pressure globally.

Low growth environment will persist globally

1. The low growth environment will persist globally. Currently, the global economy has yet to escape from the low growth environment seven years after the global financial crisis in 2008. The International Monetary Fund (IMF) further trimmed its global economic projections this year and in the next, mainly reflecting the latest weakness in growth momentum globally. In 2015 and 2016, the global economy likely registers the lowest growth rate since the financial crisis. On the one hand, the advanced economies still haven't escaped from the low growth rate, low demand and low interest rate environment since the global financial crisis. On the other hand, the developing economies are still restrained by the global economic uncertainties, US rate hike, US dollar strength, low commodity prices, depreciation of emerging market currencies, capital outflows, global financial market volatilities, etc. Against this background, the global economic outlook is likely to be disappointing this year and has yet to show any notable recovery. With the global economy still subject to the increasing downside risks, the Hong Kong economic performance is likely to be restrained as well.

2. Moderate growth momentum in both the US and euro area. In Q1 2016, the US economy slowed notably to an annualised 0.8% growth. This largely reflected the impact of strong US dollar, weak global economic growth and low commodity prices. Net exports, change in inventories, equipment and petroleum related investments all contributed negatively to growth. However, the latest economic indicators showed that the US economy is still expanding moderately, though its momentum might slow somewhat. The low unemployment rate, solid residential property market and accommodative monetary environment are likely to support moderate economic growth ahead. In the euro area, its economic recovery remains rather resilient, with its quarter-to-quarter and year-on-year growth reaching 0.6% and 1.7% in Q1 2016 respectively. Its manufacturing and non-manufacturing PMIs held rather steadily in April and May. Together with the highly supportive monetary policy, the euro area economy is likely to grow moderately further ahead. However, the issue related to the huge refugee influx has yet to be resolved, while the British referendum of its EU membership might affect consumer and business confidence ahead.

3. Slowing growth in the Mainland, but with some positive development. In Q1 2016, the Mainland

economy continued to be affected by the weak external environment and its own economic rebalancing. The real GDP growth eased further to 6.7% year-on-year in Q1 2016, one-tenth lower than Q4 2015. The growth of fixed asset investment, industrial value-added and retail sales were still hovering at low level in April and May, but there were also some bright spots, such as high-tech and equipment manufacturing, and service sector investment, etc. This indicated that the Mainland economy might be stabilising at the current level. Going ahead, the authorities are likely to make a fine balance between stabilising growth and supply side reforms. On the one hand, the authorities are expected to prevent the economy from slowing too fast, but on the other hand, they will further pursue their goals of deleveraging, reduction of capacity and destocking so as to ensure the economy to grow more healthily in the long term. Furthermore, the government authorities are expected to maintain proactive fiscal policy and prudential monetary policy with slight easing bias. Thus, the Mainland economy is likely to achieve its 6.5% to 7.0% target this year.

Low growth ahead for Hong Kong economy in 2H 2016

As mentioned above, the Hong Kong economy will likely be restrained by the low global growth environment, sluggish merchandise trade and tourism performance, as well as the correction of residential property market in 2H 2016. In spite of these gloomy factors, the resilient labour market, solid fiscal position of the government, and low interest rate environment could provide some buffer to the economy ahead. Low growth for the rest of the year is expected in the following context.

1. No meaningful improvement in merchandise and tourism performance in sight. Hong Kong is a small and open economy which is likely to be restrained by the external environment. Amid the low global growth environment, merchandise exports are not likely to register meaningful improvement ahead, even though the low comparison base could make the year-on-year comparison more favourable in 2H. Meanwhile, exports of services are also unlikely to record notable improvement. Not only the weak trade and cargo flows will continue to restrain the exports of trade-related services, but also the correction of tourism industry has yet to be completed. The number of visitor arrivals continued to fall, in particular those high-spending visitors, as well as increasing competition to attract tourists from different places over the world. As such, more Mainland and overseas tourists are likely to travel elsewhere, which might continue to have a negative impact on Hong Kong's tourism and retail sector ahead, but the low comparison base could somewhat help the 2H figures as well.

2. The negative impact on private consumption is surfacing gradually. In addition to the weaknesses of merchandise trade and tourism sector, the negative impact of property market correction on private consumption is also surfacing gradually. Property market entered into a correction phase in September last year, with the residential property prices declined roughly 10.8% from its peak in September 2015 to April 2016 according to the Rating and Valuation Department's statistics. Based on the current economic, interest rate, housing supply conditions, and government policies, no sharp correction in Hong Kong residential property market is expected. However, the performance of residential properties and private consumption expenditure is highly correlated. A further correction of the residential property prices will inevitably affect domestic demand and the overall economy ahead.

3. Resilient labour market, solid government fiscal position and low interest rate environment could provide buffers to the overall economy. In no doubt, Hong Kong economy is now facing downward pressure from the imports-exports trade, tourism and retail sectors, with their respective employment segments also being pressured. Nevertheless, Hong Kong's labour market is in a nearly full employment condition over the past five years. It was also recorded that over 70,000 private sector vacancies were available in Q1 2016. Unless the economic environment deteriorates notably, Hong Kong is not likely to face any large scale job cut or massive layoff. The relatively stable employment market is likely to provide some support to the overall economy.

The Financial Secretary announced $38.8 billion of relief measures in his Budget in February, which is expected to boost this year's growth by 1.1 percentage points. Together with the solid fiscal position, the government could provide further support to the economy if necessary. In addition, the forecasted expenditure of Capital Works Reserve Fund will continue to increase from HK$ 84.5 billion in this fiscal year to HK$ 121.9 billion in the fiscal year 2020/21. Therefore, infrastructure, public housing and private housing projects are likely to increase on the back of government support. The overall economy will likely benefit from stronger infrastructure investment which could help pave the way for more healthy growth ahead.

Since the first rate hike by the US Federal Reserve (Fed) in December last year, the global economy is subject to increasing downside risk. Even though the Fed officials pointed out that it is possible to raise rate in 2H, their median projection of the number of rate hikes this year was reduced from four times to twice only and the interest rate futures implied that the Fed would at most only raise rates once in 2H 2016 . Meanwhile, ECB and BoJ continue to relax their monetary policies. The environment of low interest rate and liquidity glut is likely to be sustained globally. Furthermore, there are around US$130 billion of capital flows into Hong Kong since the implementation of quantitative easing by the US Fed. Therefore, Hong Kong dollar interest rates could stay low for a relatively long period of time and the impact of rate hike on the economy will likely be limited.

4. The development of financial services, innovation and technology industries could drive the economy towards higher value-added direction. In respects of financial services industry, even though its short-term support to the economy will be moderating, largely because of the daily transaction of Hong Kong equity market has returned to normal after a period of buoyant activities in Q2 last year, the prospect is bright in the longer term. Hong Kong will continue to play its unique role as the major springboard for Mainland companies to go global and foreign companies to come to the Mainland, given the advantage of "One Country, Two Systems". Furthermore, Hong Kong will continue to benefit from the opportunities arising from the further opening up of Mainland's financial markets, the financial markets connect between Mainland and Hong Kong, RMB internationalisation, the Belt and Road Initiative and the 13th five-year plan, etc. If there are more financial market liberalisation measures such as the launch of Shenzhen-Hong Kong Stock Connect, etc., it is likely to attract more Mainland and foreign investment in Hong Kong and bring new opportunities to the Hong Kong financial services industry ahead.

In addition, the development of innovative and technology industry is the future trend and focus for Hong Kong. If it succeeds, it could help diversify the economic structure, support higher value-added development, enhance competitiveness and the citizens' standard of living. In an attempt to kick-start, various measures were announced in the 2016-17 Budget to nurture innovation and support technology industries. For example, the Hong Kong Science and Technology Parks Corporation (HKSTPC) is planning two pilot high-efficiency multi-storey building projects in the Tseung Kwan O Industrial Estate. Also, the government has, among others, injected $2 billion into the Innovation and Technology Fund to launch a Midstream Research Programme for Universities. Moreover, the HKSTPC is also planning to expand the Hong Kong Science Park in phases to provide additional floor area for start-ups and other technology companies etc.

All in all, the Hong Kong economic outlook is not likely to improve notably for 2H 2016 and this year's growth is expected to be around 1.3%, far lower than the 2.4% growth last year. On the inflation side, given the moderate global inflationary pressure, low global commodity prices, limited domestic price pressure, especially the correction of residential property market and its rental level, the inflationary pressure is likely to alleviate ahead. The underlying composite consumer price inflation will likely increase 2.2% next year, lower than the 2.5% this year.