



Hong Kong Economy: Low Growth Trend Will Continue Ahead

Senior Economist, Choi Wing Hung

1. In 2016, the Hong Kong economy recorded the slowest pace of growth since the global financial crisis

In 2016, the economic growth of Hong Kong is expected to be around 1.5%, not only lower than the 2.4% growth in 2015, but also lower than the 3.4% average over the past decade. Its characteristics include 1) sluggish external trade performance, against the subdued global economic backdrop; 2) exports of services declined notably, with continuous negative impact from travel services exports and weaker financial market activities; 3) visible slowdown of private consumption activities, amid asset market correction and external weaknesses; 4) weak investment performance, given anemic economic growth and elevated uncertainties; and 5) changes in inventories provided positive contribution to economic growth, etc. Fortunately, the Hong Kong economy has gradually recovered during the year, with the abovementioned factors somewhat alleviating. The economic growth in Hong Kong was gradually stabilizing, from 0.8% in Q1 to 1.7% and 1.9% in Q2 and Q3 respectively.

Amid sluggish global economic growth, both the Mainland and the US economies, Hong Kong's two largest trading partners, decelerated over the past year. The external environment of Hong Kong remained weak, with exports of services also declined notably. Merchandise trade declined 3.6% in real terms in Q1 2016 over the previous year. With the global economy recovered gradually later, merchandise trade of Hong Kong also improved somewhat to a still weak 2% or lower level. However, merchandise imports increased faster than exports, leading to the widening of trade deficit. At the same time, exports of services recorded notable decline. It was attributed to, first, the double-digit decline in exports of travel services in the first three quarters of 2016 because of the continuous declines in the number of visitors and their per capita spending. Second, the worsening in financial market activities as compared with the time of the Mainland's financial market boom

in 2015, together with the negative impact from the US rate hike and the RMB depreciation at the beginning of 2016, the trading and fund raising activities were unavoidably affected, leading to the decline in financial and other business services exports in the first three quarters of 2016 and negatively affecting the overall exports of services performance.

Private consumption recorded meaningful slowdown, while investment performance remained weak. As mentioned above, Hong Kong's financial markets recorded significant volatilities in the beginning of 2016, property market also entered into a correction between Q4 2015 and Q1 2016, together with the sluggish external environment and poor tourism performance, private consumption growth recorded four consecutive quarters of deceleration. Private consumption then recovered slightly to a still low 1.2% growth in Q3 when the overall economy and the asset markets stabilized. Meanwhile, businesses also became more cautious in making new investment amid economic slowdown and elevated uncertainties, resulting in weak investment performance. The gross domestic fixed capital formation recorded four consecutive quarters of decline, with machinery, equipment and intellectual property investment even declined for five consecutive quarters, including four quarters of double-digit decline. In Q3, investment has picked up when the overall economy stabilized during the period.

Changes in inventories were a major driving force for overall economic growth. Based on the component contribution to year-on-year rate of change in real terms of GDP, changes in inventories contributed 1.0, 1.7 and 2.0 percentage points to the overall economic growth for the first three quarters of 2016 respectively. This was mainly because of the low comparison base after massive destocking in 2015. As such, even just a slight increase in inventories was sufficient to bring strong contribution to overall economic growth. However, changes in inventories are not expected to boost the economy meaningfully in Q4.

2. The low growth trend will continue in 2017

1) The subdued economic growth trend will continue globally. According to the latest World Economic Outlook released by the International Monetary Fund (IMF) in October 2016, the global economic growth is only expected to accelerate by 0.3 percentage point to 3.4% in 2017. Thus, the

subdued growth trend will likely remain unchanged amid elevated uncertainties around the globe. The IMF also does not rule out the possibility of further trimming of its growth forecasts, if the uncertainties lead to any negative hit to the economy.

In the US, the economic recovery now enters into its eighth year, though it is still restrained by weak productivity growth and ageing population, etc. However, the US has made good progress in deleveraging, fiscal consolidation, housing market recovery, technology development and destocking over the past few years, and has also benefitted from the support of low oil prices and accommodative monetary policy. Meanwhile, the market has high expectation on Trump's tax cut and higher infrastructure spending policies to stimulate the US economy. It is expected that the US economic growth will improve somewhat in 2017.

The economic recovery in the Eurozone is yet affected by the impact of Brexit. Its moderate and steady growth momentum is likely to be supported by the low interest rate, low euro exchange rate, quantitative easing measures, as well as the less restrained government spending, etc. However, elections will take place in France, Germany and the Netherlands in 2017, which might bring new uncertainties to the region.

In China, the economy expanded 6.7% in the first three quarters of 2016, with the improved growth of industrial value-added and fixed asset investment, new industries like the high-tech and equipment manufacturing sectors continue to grow rapidly, and progress is made in enhancing efficiency in those sectors with overcapacity. Moreover, producer prices also increase again after 54 consecutive months of decline, which could help improve corporates' financial performance, such as revenue, profit and debt sustainability. Going forward, it is expected that, with the support of proactive fiscal policy and prudent monetary policy, the economic growth in China will achieve 6.5% in 2017.

2) Base effect supports merchandise trade performance. Hong Kong economic outlook is still restrained by the subdued global economic environment. The World Trade Organization (WTO) reduced its global trade volume forecast in 2017 from 3.6% to 1.8%-3.1%, together with the uncertainties related to Brexit, and the future trade policy of the US President-elect, Mr. Donald Trump, and the renewed appreciation of US dollar exchange rate, the merchandise trade outlook of

Hong Kong is not optimistic. However, Hong Kong's merchandise trade has undergone its correction phase for more than a year. It is likely to stabilize or even post a slight positive growth ahead, with the support of low comparison base. In addition, given the stabilization of international commodity prices and the recovery of producer prices in the Mainland, Hong Kong's merchandise trade performance is likely to improve in 2017.

At the same time, services exports are likely to benefit from the low comparison base. Thanks to the stabilization of regional trade and cargo flows as well as the implementation of Shenzhen-Hong Kong Stock Connect, both trade-related and financial and business services exports are likely to improve gradually. However, while the decline in the number of visitors has been narrowing, the high-spending group continues to decline more notably, even after more than a year of correction. Hong Kong's tourism industry remains challenging ahead. It is likely to take more time for the negative impact of inbound tourism to fade, which will continue to drag on the overall exports of services performance ahead.

3) Under the latest demand management measure, private consumption could be restrained if the property market consolidates again. With the external environment stabilizing and the expectation of US rate hike receding, the equity market first rebounded from their troughs since Q2 2016. The property market also turned more active, with prices going up again. As such, private consumption accelerated somewhat in Q3, following the recovery in both equity and property markets. However, the government announced a fresh round of demand management measure to increase the ad valorem stamp duty rates for residential property transactions to a flat rate of 15% (with exemption for the Hong Kong permanent residents who buy their first homes) in November, together with stronger interest rate hike expectation after Mr. Donald Trump won the US presidential election. It is expected that the property sales transactions will contract notably, which could negatively affect private consumption performance ahead.

4) Investment is likely to improve ahead. Based on the Business Tendency Survey in Q4 2016, the corporates' views on business situation improved from the trough earlier in 2016. Moreover, even though the global economic growth remains subdued, the market's fear over the Mainland's hard-landing, the start of a fresh US rate hike cycle, and the repercussion for the global economy

following the Brexit referendum and Mr. Donald Trump won the US presidency, etc. were all proved to be overblown. Meanwhile, investment recorded four consecutive quarters of decline between 2H 2015 and 1H 2016. It is likely to improve ahead with the support of low comparison base. In respect of building and construction, several large scale infrastructure projects will be completed soon, for example, the MTR Kwun Tong Line extension, MTR South Island Line, and the Hong Kong–Zhuhai–Macao Bridge. Even though capital work expenditure is predicted to increase from HK\$84.5 billion in this fiscal year to HK\$121.9 billion in the fiscal year 2020/21, whether those infrastructure projects could be approved and commenced smoothly are still highly uncertain. However, both public and private sector works are likely to increase amid the government’s drive to increase land supply, with the potential private housing supply to reach 93,000 units in the next three to four years, and the Hong Kong Housing Authority and Housing Society together will supply 95,300 public housing units in the coming five years. Therefore, the increases in building works are likely to offset the negative impact arisen from the time gap between the completion of existing and commencement of new infrastructure projects.

5) Resilient labour market and solid government fiscal position could provide buffers to the overall economy. Over the past year, imports-exports trade, tourism and retail sectors were facing intense downward pressure, with their respective employment segments being pressured. Nevertheless, the overall unemployment rate remains steady at 3.4%, and number of total employment also hits a fresh high of 3.81 million. Many industries, like food and elderly services are even suffering from the problem of labour shortage. Currently, there are over 68,000 private sector vacancies. It is believed that the relatively stable employment market is likely to provide some support to the overall economy ahead.

The government has a very strong fiscal position. According to the Budget announced in February 2016, the government’s fiscal reserve will reach HK\$870.4 billion at the end of March 2017. Together with the accumulated surplus under the Exchange Fund, the overall fiscal reserve could reach HK\$1,468.7 billion. Meanwhile, the Financial Secretary announced HK\$38.8 billion of relief measures in his Budget in February, which is expected to boost growth by 1.1 percentage points in 2016.

6) Financial services, innovation and technology (I&T) industries outperform the overall economic performance. Over the past three years, the value-added of financial services and insurance industry outperformed the overall economy by an average of 3.4 percentage points, even though there were huge financial markets volatilities. This showed that the financial services industry is one of the best performing sectors in Hong Kong. Going forward, with the implementation of the 13th five-year plan and the Belt and Road Initiative, coupled with the further connection of capital markets between the Mainland and Hong Kong, and the further development of offshore RMB businesses, the financial services industry in Hong Kong is likely to maintain a relatively solid performance in 2017.

Similarly, I&T industry also performed well. Both the value-added and employment of I&T industry outperformed that of the overall economy over the past few years. The government announced a number of initiatives in facilitating the development of I&T industry in Hong Kong, for example, it earmarked over HK\$18 billion to roll out a broad range of initiatives to promote the development of I&T, including encouraging universities and private enterprises to conduct research and development, providing support to start-ups, etc. Many of those projects will be launched in 2017, which are likely to support the development of I&T industry, and help diversify the economic structure in Hong Kong.

All in all, the economic outlook of Hong Kong will still be restrained by the subdued global environment, but its resilient labour market and low interest rate environment could provide some support to the private consumption and investment activities ahead. The economic growth is expected to reach 1.5% and 1.8% in 2016 and 2017 respectively, lower than the 2.4% growth in 2015.

On inflation outlook, the global inflationary pressure remains subdued, and the international commodity prices are relatively benign. Thanks to the continued feed-through of softer fresh-letting residential rentals in earlier period and the modest pace of economic expansion, the local cost pressures should remain in check and the inflationary pressure is expected to alleviate further ahead. The underlying composite consumer price index is expected to increase 2.3% and 2.0% in 2016 and 2017 respectively, lower than the 2.5% growth in 2015.