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Hong Kong economy strengthens in 2017

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1. Broad-based improvement in 1H 2017

Hong Kong economy gradually improved since 2H 2016. Even though the tourism and retail industries are still suffering from structural adjustment, major economies around the world, including the US, China and Eurozone, all maintained stable growth and the global political uncertainties did not derail the recovery. Moreover, the market has very high expectation on tax cut and infrastructure plans proposed by the US President, which boosted the financial market performance and economic confidence. With the improving global economic outlook, Hong Kong economy grew robustly by 4.3% over the previous year in Q1 2017, accelerating from the 3.2% growth in Q4 2016, the fastest pace since Q2 2011. On a seasonally adjusted quarter-to-quarter basis, real GDP increased by 0.7% in Q1 2017 after 1.2% growth in the preceding quarter.

i) **The external performance improved further.** In Q1 2017, total exports of goods accelerated to 9.2% in real terms over the previous year, compared to 1.8% and 5.1% growth in 2016 and Q4 2016 respectively. It can be attributed to a number of factors including, first, the comparison base was low in Q1 2016, as the economy suffered from intense downward pressure globally, depreciation pressure of RMB and volatilities related to US interest rate hikes, etc. Second, the US and Eurozone economies have been improving since 2H 2016, supporting the recovery of merchandise exports. Third, merchandise exports to a number of Asian economies (including Mainland China) also recorded robust growth. With the strengthening of trading and production activities in the region, their imports demand of commodities, semi-manufacturing products and capital goods also increased notably. Meanwhile, the monthly merchandise trade statistics showed that the value of total exports increased 9.4% year-on-year in the first four months of 2017, indicating continuous improvement of the external performance.

Exports of services recorded moderate expansion, with narrower negative drag from the tourism industry. In the first four months of 2017, the number of visitor arrivals increased 3.2% over the previous year. However, per capita tourism spending was still decreasing and the tourism industry has not yet fully recovered from the structural adjustment. Exports of tourism services declined 12 consecutive quarters, with 1.2% contraction year-on-year in Q1 2017, better than 4.0% decline in Q4 2016, and greatly alleviating its drag on the overall exports of services. Moreover, financial markets improved globally, together with stronger economic outlook, exports of financial services recorded 1.9% year-on-year expansion in Q1 2017, reversing the downtrend since Q2 2016. Furthermore, growth on exports of transportation services remained relatively fast amid stronger regional trade and cargo flows. The overall exports of services increased 2.6% year-on-year in real terms in Q1 2017, stronger than the 3.2% decline in 2016 and 1.2% expansion in Q4 2016.

ii) **Domestic demand also strengthened.** Since 2H 2016, the global and Hong Kong economies have been improving. Together with stronger asset markets performance, in particular the property markets, and the nearly-full employment condition, private consumption recorded solid performance. Following the 3.6% growth in Q4 2016, private consumption expenditure grew further by 3.7% year-on-year in real terms in Q1 2017. Government consumption expenditure also increased 3.7% in Q1 2017, accelerating somewhat from the 3.4% growth in 2016 and Q4 2016. In addition, gross domestic fixed capital formation recorded 6.4% year-on-year growth in Q1 2017, after registering a 5.6% growth in Q4 2016, amid the stabilizing global and Hong Kong economic outlook. The stronger investment performance was largely driven by the expansion of building and construction activities, with the support of the government's effort to increase housing and land supply. However, machinery and equipment spending continued to decline, indicating the corporate confidence towards increasing investment has not yet fully recovered.

iii) **Change in inventories has contributed positively to the economic growth as well.** In 2016 and Q4 2016, change in inventories contributed 1.1 and 1.6 percentage points to the economic growth respectively. It contributed another 1.2 percentage points in Q1 2017, largely due to the low comparison base resulting from destocking in 2015.

2. Growth outlook better than last year

i) **Global economic growth is expected to be better than 2016, likely supporting Hong Kong external performance ahead.** According to the latest forecasts by the International Monetary Fund (IMF), the global economic growth is expected to accelerate by 0.4 percentage point to 3.5% in 2017, one-tenth higher than its projection in January 2017. In the US, the Trump administration faced some obstacles in implementing the travel bans and reforms on Obamacare, but the market still has very high expectation on his tax cuts, tax reform, deregulation, and infrastructure spending plans, to help boost the US economic growth ahead, leading to strong economic, investment and consumer confidence, as well as record-breaking financial market performance lately. As such, despite the measures proposed by US President Trump might take time to implement, it is expected that the US economy will improve slightly this year.

Economic growth in Eurozone maintained its moderate pace of expansion, with the manufacturing and non-manufacturing PMI, consumer confidence and economic sentiment indices all jumping to multi-year high, while the unemployment rate declined to the lowest level in the current expansion. While inflationary pressure remains subdued, the European Central Bank will continue its quantitative easing program until the end of 2017. Many countries also adopt a somewhat relaxing fiscal policy stance. The Eurozone economy is likely to grow steadily or even accelerate slightly ahead.

The Mainland economy continued its stabilizing trend since 2H 2016, with Q1 GDP growth accelerating another one-tenth to 6.9% over the previous year. However, major economic indicators, like industrial value-added, investment in fixed assets, retail sales of consumer goods, as well as merchandise trade, etc, all pointed towards steady growth momentum in the first five months of 2017.

Meanwhile, the Trump administration announced a deal with China to boost exports. It covers the opening of Chinese markets to American beef, LNG, electronic payment services providers and financial institutions, etc. While the two sides are scheduling to discuss a one-year plan to further solidify actions in promoting economic cooperation, the trade relations between China and the US are expected to improve and the chance of a trade war is much slimmer. This, together with the stronger global economic outlook, should help support Hong Kong external performance. In addition, both merchandise trade and trade in services had recorded a period of contraction over the past couple of years, the low comparison base and improving global economic condition should help support the recovery of Hong Kong external performance. Merchandise trade and trade in services are expected to post stable growth this year.

ii) **The adjustment of tourism-related industry is likely to come to an end soon, which can provide additional boost to services trade performance.** Over the past three years, Hong Kong tourism industry suffered from the decline of the number of high-end visitors, intense competition from other tourist destinations, online sales, retailers establishing footholds directly in the Mainland, and the relatively strong Hong Kong dollar exchange rate, etc. Indeed, the number of visitor arrivals likely bottomed in the first four months of 2017, together with the impact of the above-mentioned negative factors fading, and the low comparison base recorded after 12 consecutive quarters of decline of exports of tourism services. The adjustment of tourism-related industry is likely to come to an end soon, alleviating the negative drag or even providing additional boost to the overall exports of services.

iii) **The financial and business services exports are expected to strengthen ahead.** After the burst of financial markets boom in 2015, and the market worries over US rate hike and RMB depreciation last year, the global and Hong Kong economic outlook becomes more optimistic this year and the financial markets improve gradually. The financial and business services exports also regain some support. Meanwhile, the Mainland economy is now stabilizing, together with the increasing economic size of the Mainland economy and the rising status of RMB as an international currency, further interconnection between the Mainland and Hong Kong capital markets, the implementation of the belt and road initiative and the development of Guangdong-Hong Kong-Macau Bay Area, Hong Kong, as an international financial and business center serving the Mainland, will no doubt benefit from the increasing demand for its financial, professional and business services. The performance of financial and business services exports will likely be supported ahead.

iv) **Persistent low interest rate will continue to support property markets and corporate investment performance.** The Fed has raised rate four times since late 2015, but the banks in Hong Kong have not yet followed its US counterpart in raising rates, given the ample liquidity conditions in Hong Kong. Moreover, even the Fed might raise rate again before the end of the year, it is still uncertain whether the banks in Hong Kong will follow the Fed's move or not. Moreover, the market generally expects the Fed will finish its current round of rate hike when the Federal Funds rate reaches 3%. Therefore, even though Hong Kong might have to follow the Fed to raise rate ahead, the room of rate hike is likely to be contained. Given the low interest rate environment and stabilizing global and Hong Kong economies, the property markets and corporate investment performance will likely be supported.

v) **Improving corporate confidence supports investment performance.** According to the Report on Quarterly Business Tendency Survey in Q2 2017, the corporate confidence in a number of industries has been improving. This indicated that given the low comparison base in 2H 2015 and 1H 2016, and the stabilizing global economic condition, corporate confidence is gradually improving. In addition, with government's effort to increase land supply, both public and private construction activities will likely increase which can partially offset the negative impact arising from the time gap between the completion of existing and commencement of new infrastructure projects.

vi) **Solid employment and asset markets support private consumption performance.** Since 2H 2011, the unemployment rate in Hong Kong has stayed near full employment level of 3.1% to 3.5%. The unemployment rate stayed low at 3.2% between March and May 2017. The unemployment rates of import-export trade, tourism and retail sectors also improved gradually. Together with the 70,460 private sector vacancies in Q1 2017, the stable employment market will likely support private consumption and the overall economy ahead.

Meanwhile, the property markets hit fresh record high. After a short period of correction between September 2015 and March 2016, property prices recovered and increased further ahead. In April 2017, residential property prices increased for 13 consecutive months, rising 6.5% and 19.8% compared to the end of 2016 and over the previous year respectively. The wealth effect will likely support private consumption and the overall economy ahead.

vii) **Increasing government expenditure also supports economic performance.** According to the Budget announced in February 2017, the Financial Secretary announced HK$35.1 billion of relief measures, which is expected to boost growth by 1.1 percentage points in 2017. Meanwhile, the Capital Works Reserve Fund's expenditure for the construction of infrastructure and public housing will increase continuously from HK$91.7 billion in fiscal year 2017/18 to HK$130.9 billion in 2021/22. By the end of March 2017, the fiscal reserve of Hong Kong reached HK$950 billion. The community has a rising voice requesting the government to use some of its fiscal reserve to solve the social problems and boost economic growth. The economic performance will likely be boosted, if the next administration decides to somewhat increase fiscal expenditure ahead.

viii) **The expenditure in relation to innovation and technology (I&T) industry has already been deployed.** The current administration believes that I&T are the future development trend and focus. I&T can help Hong Kong economy diversify and move towards the high value-added economic structure, as well as facilitate young people to move up the value chain. Over the past two to three years, the government has implemented a number of initiatives to support the development of I&T industry, for example, the establishment of I&T Bureau; investing 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; the Massachusetts Institute of Technology (MIT) also set up an innovation node and Karolinska Institutet's established its overseas branch in Hong Kong; the Hong Kong Science and Technology Parks Corporation develops two pilot high-efficiency buildings in the Tseung Kwan O Industrial Estate. All the above measures are now in the implementation phase, and the government fiscal expenses to I&T industry are likely to provide some positive impact to the economy. The long-term impact on economic competitiveness and diversification still takes time to surface.

Going forward, Hong Kong economic outlook is expected to be better than last year, with slightly faster global economic growth, low interest rate, solid employment and asset markets performance, the GDP growth for this year could hit 2.8%, accelerating from 2.0% last year and reaching the high end of government forecast at 2%-3%. Nevertheless, there are still a number of uncertainties this year, for instance, the successful implementation of Trump's economic stimulus policy, the entering into formal Brexit negotiation between UK and European Union, the rising trade protectionism, the evolving political challenges in the Middle East, and the Fed's future plan to shrink its balance sheet, etc.

On the inflation front, the modest global inflationary pressure, relatively strong Hong Kong dollar exchange rate, steady labor cost, and the slower increases in fresh-letting residential and commercial rentals during 2016 continued to feed through, the inflationary pressure is likely to remain modest in Hong Kong this year. The underlying consumer price index is expected to reach 1.8% in 2017, lower than 2.3% in 2016.