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Hong Kong Economic Outlook in 2019

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1. Maintaining relatively fast growth in 2018

After recording the fastest growth rate since 2011 last year, the growth momentum has slowed since the beginning of 2018. Numerous positive factors, such as moderate global economic recovery, stabilizing tourism sector, relatively low interest rate environment, full employment and government's somewhat expansionary fiscal policy, etc. supported the economic growth, but the momentum has been slowing recently. Hong Kong GDP growth reached 3.7% and 2.9% year-on-year in real terms in the first three quarters and Q3 respectively. Together with the moderate inflationary pressure, nominal GDP growth reached 7.7% and 6.7% year-on-year in the first three quarters and Q3 respectively.

External performance has yet meaningfully affected by rising protectionism. Riding on the solid global economic momentum, regional trade flows, manufacturing and investment activities remained solid during the year. The negative impacts from the rising protectionism and elevated emerging markets volatilities have yet affected the external performance meaningfully. Front-loading activities might even boost the external performance in the near term, with the overall exports of goods increased by 4.9% and 5.0% year-on-year in real terms in the first three quarters and Q3 respectively, roughly the same as 4.9% growth in 1H. In addition, the monthly merchandise trade statistics showed that exports to the Mainland, the US, the Netherlands, Vietnam and Thailand recorded solid growth of 17.8%, 10.3%, 13.7%, 13.6% and 11.4% year-on-year in October respectively, indicating success of the diversification of Hong Kong trade activities.

Exports of services maintained relatively fast growth. On one hand, Hong Kong tourism sector further recovered this year, driven by steady economic growth both globally and in the Mainland. Together with the opening of the Hong Kong Section of the Express Rail Link and the Hong Kong-Zhuhai-Macau Bridge, the number of visitor and overnight visitor arrivals recorded solid growth of 9.7% and 4.5% year-on-year in the first 10 months of 2018. The value of retail sales also increased by 10.6%, driving exports of tourism services to grow by 9.7% year-on-year in the first three quarters of 2018. On the other hand, even though the global financial markets have become more volatile and the Hang Seng Index declined over 25% from its peak in February, the average daily turnover and fundraising activities remained rather active, stimulating demand for cross-border financial activities. Exports of financial services recorded 7.1% growth in real terms in the first three quarters. Moreover, exports of transportation services improved further amid steady regional trade and cargo flows in Asia. All these factors have supported the overall exports of services to increase by 5.6% and 3.1% in real terms in the first three quarters and Q3 respectively, slowing somewhat from 6.9% in 1H.

Domestic demand remained strong. Firstly, the property market continued to perform well in the first seven months of 2018, driven by low interest rate and limited supply. The property market then entered into a moderate consolidation phase since August amid elevated external uncertainties, Hong Kong dollar interest rate normalization, and huge financial market volatilities, though the wealth effect still supported the consumption performance in the first three quarters. Secondly, the labor market has reached full employment, with unemployment rate declined to the 20 years low of 2.8% between August and October 2018. As such, private consumption expenditure increased by 6.6% and 5.2% year-on-year in real terms in the first three quarters and Q3 respectively, moderating slightly from 7.4% in 1H. Government consumption expenditure remained largely steady and provided support to the economy, with 3.8% and 3.3% year-on-year growth in real terms in the first three quarters and Q3 respectively, moderating somewhat from 4.1% in 1H. In addition, gross domestic fixed capital formation recorded 4.5% and 8.2% year-on-year growth in real terms in the first three quarters and Q3 respectively, much better than 2.6% in 1H, as machinery and equipment acquisition surged and building and construction activity registered a narrower decline.

2. Growth momentum is expected to slow notably in 2019

The pace of global economic recovery remains steady, with downward pressure intensifies. According to the International Monetary Fund's (IMF) forecasts, the global economy is expected to grow by 3.7% in both 2017 and 2018. Similarly, they also expected the global economy to expand by 3.7% in 2019. Even though they have revised their forecasts downward and highlighted the intensifying risk factors, the pace of global economic recovery remains largely steady, with diverging growth momentum among the major economies. In the US, its economy maintained stable growth of 2.2% in the first three quarters of 2018. The positive impacts from the implementation of tax reform and relaxation of federal regulations, etc. will continue to support its economy, while the economic, investment and consumer confidence stays at relatively high levels. Together with the support of full employment, further normalization of Federal Reserve's monetary policy and rising protectionist measures are not expected to meaningfully affect its moderate growth path.

In the Mainland, real GDP growth reached 6.7% in the first three quarters. Against the uncertain external outlook, the Politburo meeting stated that the Mainland will continue to promote high-quality development, implement proactive fiscal policy and prudent monetary policy, and move to stabilize employment, finance, foreign trade, foreign investment, domestic investment and expectations to ensure its economy to maintain steady and higher quality growth ahead. Indeed, its latest economic indicators, such as fixed asset investment and industrial value-added, have already showed some initial signs of stability. Other economies, such as the Eurozone, Japan and emerging markets, also continue their recovery, but their growth momentum diverges gradually, with some emerging markets are more likely to be affected by the rising trade protectionism, the US interest rate hikes, and the strengthening of the US dollar.

The China-US trade frictions could still affect Hong Kong's external trade performance. Even though President Xi and US President Trump concluded a highly successful meeting in early December, and the US agreed not to raise the tariff rate to 25% on US$200 billion worth of Chinese products and not to levy additional tariffs on the remaining Chinese products, they still need to have further negotiations in order to fully resolve the frictions. According to Hong Kong SAR government, about half of the Chinese goods that are re-exported to the US via Hong Kong are likely to be affected by the tariffs levied on US$250 billion worth of Chinese goods. Since the beginning of 2018, Hong Kong's external trade has maintained a relatively stable performance, likely driven by some front-loading activities. However, the negative impact from those protectionist measures is likely to be felt in 2019. Hong Kong is a small and open economy, and both the Mainland and the US are Hong Kong's largest trading partners. With merchandise trade amounted to 320% of Hong Kong's GDP, if the external trade performance is affected by trade frictions, the negative impact might spread to the financial markets and other economic sectors, which will then drag down the overall performance of Hong Kong economy next year.

The normalization of Hong Kong dollar interest rate is now underway. Since late 2015, the Federal Reserve has raised rates for eight times by 200 bps. Banks in Hong Kong also raised the prime lending rate by 0.125% in September 2018, the first rate hike in Hong Kong in 12 years. The interbank rates in Hong Kong also rebounded from its low recently. With the normalization of Hong Kong dollar interest rate is now underway, banks in Hong Kong are likely to follow the Federal Reserve's move to further raise rates ahead. This could help moderate the growth momentum of Hong Kong economy or even increase the downward pressure of the property market.

Asset market corrections will also drag down the growth momentum. Over the past few months, financial markets in the emerging economies recorded huge volatilities amid rising protectionism, higher US interest rate, stronger US dollar, confidence and geopolitical issues in some emerging economies, like Argentina and Turkey, etc. At the same time, the Mainland and Hong Kong economies, as well as the RMB exchange rates were also subject to more intense downward pressures. All these factors affected Hong Kong's financial market performance negatively, with the Hang Seng Index once declined by over 25% from its peak of 33,000 in February to 24,500. With the weak market performance, the turnover, IPO and other fundraising activities, etc. will also be affected, which will then affect the exports of financial and business services in 2019. On the other hand, property market also entered into a moderate consolidation phase, driven by the increasing downward pressure of Hong Kong economy and rising interest rates, etc. With the correction of both financial and property markets, consumer, business and investment confidence will, no doubt, be affected, leading to a more intense downward pressure on the economy ahead.

Without doubt, Hong Kong economy is facing increasingly downward pressure in 2019, but there are some positive factors supporting it. Firstly, strong labor market will continue to support the economic performance ahead. Over the past few years, the labor market in Hong Kong has reached full employment, with its unemployment rate declined to 2.8% between August and October 2018, the lowest level in 20 years. The total number of employment also reached a new record high of 3.87 million, with a number of sectors, such as catering, elderly services, and construction, etc. facing labor shortage.

Secondly, proactive fiscal policy can support stable growth as well. On one hand, the Hong Kong SAR government has already implemented numerous measures in coping with the rise of trade protectionism. Such initiatives include strengthening various funding schemes for SMEs, and implementing special enhanced measures by the Hong Kong Export Credit Insurance Corporation to strengthen the protection for Hong Kong exporters affected by the US tariff measures. Also, the government enhanced the special concessionary measures under the SME Financing Guarantee Scheme operated by the Hong Kong Mortgage Corporation Insurance Limited and extended the application period to further relieve the financing burden of local enterprises and impact on the overall economy. In addition, the government is actively increasing land and housing supply as well as investing in large-scale infrastructure projects for the long-term benefits of

Hong Kong. For example, the pre-engineering works for the third runway system of Hong Kong International Airport and the expansion of subsidized housing program. The budget for the Capital Works Reserve Fund's expenditure will increase continuously from HK$98.3 billion in the fiscal year 2018/19 to HK$123.9 billion in 2022/23. The increase in investment will likely support the economic performance of Hong Kong ahead.

Thirdly, tourism, financial services, and innovation and technology (I&T) are likely to support economic growth ahead. In respect to the tourism industry, both the Hong Kong Section of the Express Rail Link and the Hong Kong-Zhuhai-Macau Bridge have been completed. The former provides a direct link between Hong Kong and 44 Mainland cities, likely attracting more residents from the Mainland cities within 3-4 hours range to visit Hong Kong more frequently, while the latter is expected to attract more residents from the west Pearl River Delta, in particular during weekends or same-day travels. Both the tourism and retail sectors are likely to be benefitted ahead.

In the financial services sector, even though the financial markets recorded huge volatilities over the past few years, the growth of value-added of finance and insurance sector continued to be one of the strongest in Hong Kong, with its growth rate outpaced that of the overall economy. This is the result of the development of Hong Kong into the international finance and business center in the region. With the implementation of Belt-and-Road Initiative, Guangdong-Hong Kong-Macau Bay Area, RMB internationalization, further interconnection between the capital markets of the Mainland and Hong Kong, as well as the modification of listing rules in Hong Kong, etc., the financial and business services sectors will have plenty opportunities ahead through providing wide range of cross-border financial and business services to the Mainland and the region.

Similarly, the growth of value-added and employment of I&T sector also outpaced that of the overall economy. The government has stepped up its efforts to promote I&T. Further to the HK$50 billion earmarked in this year's Budget, the government has allocated an additional HK$28 billion for university research, re-industrialization, application of technology in public services and fostering of an enabling environment for I&T, etc., so as to maintain Hong Kong's competitiveness in the global arena, enhance Hong Kong's alignment with the development of the Mainland, and become an international I&T hub.

All in all, the moderate global growth momentum is not expected to change much in 2019, even though the downward pressure is intensifying. The unresolved China-US trade frictions, normalization of Hong Kong dollar interest rate, huge financial markets volatilities, and property market correction, etc. are the major risk factors facing Hong Kong economy ahead. However, full employment and proactive fiscal policy could help support the economy to grow steadily, while financial services and I&T sectors could also be developed into new growth drivers. Against this background, the real GDP growth is expected to moderate further to 2.3%, lower than the previous 10 years average of around 2.7%. On the inflation front, even though the global inflationary pressure and local labor cost remain modest, the rises in fresh-letting residential rentals over the past year as well as the impact of tariffs are likely to surface gradually. The underlying consumer price index is expected to reach 2.5% in 2019.