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Hong Kong's Inflation Outlook amid Divergence in Sino-US Inflation

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Affected by the pandemic, China and US have staggered economic performances, and their inflation trends have begun to diverge. Since 2021, US inflation continues to rise, while Chinese CPI generally remains stable. Hong Kong is a small but highly open economy, its inflation is influenced by both US and Mainland China. Hong Kong's staple goods are mainly from Mainland China. The impact of imported inflation on Hong Kong is weaker than those of the other three Asian Tigers, so Hong Kong's inflation remains stable. Looking ahead, the inflation divergence between China and the US will continue for a period of time. Hong Kong's inflation rate this year is expected to increase compared with that in 2021, and the annual inflation tendency may be between 2-3%.

1. Inflation Divergence between China and the US

China and the US have adopted completely different anti-epidemic policies and relief measures under the new crown pandemic. The monetary and fiscal easing policies drive the current round of inflation in the US to continue to rise. While the Chinese economy has better economic performance in the past two years because of the strict anti-epidemic measures, and its inflation is relatively stable.

1) Rising Inflation in the US

US inflation rises continuously since 2021. In March this year, the US CPI rose by 8.5% YoY, the highest since December 1981. The inflation rate has exceeded 6% for six consecutive months, far higher than the average target of 2% set by the Federal Reserve. Excluding food and energy items, the core CPI in March rose by 6.5% YoY, which was also the highest in the past 40 years. The prices of durable goods such as automobiles, home appliances, and furniture rose rapidly, continuously driving the CPI up. From the perspective of PCE data, which the Fed is concerned more, it also exhibits a similar trend. In March this year, the US PCE rose 6.6% YoY, and the core PCE rose 5.2% YoY, forcing US residents to pay higher prices than before for most goods and services.

Analyzed by inflation structure, food, energy, transportation, and housing are the most important components for this round of US inflation. Taking the data of March 2022 as an example, the US energy prices rose 48.3% YoY, food prices rose 8.8%, housing prices rose 5.1%, and transportation prices rose 21.6%, contributing 3.6, 1.2, 1.7, and 1.8 percentage points, respectively. Their sum is 8.2 percentage points, accounting for 96% of the CPI increase in March. The continuous record-high inflation in the US has exacerbated residents' concerns and eroded their consumption confidence. The University of Michigan's consumer confidence index fell to 59.4 in March, the lowest level since 2012. A recent NBC poll also revealed that 62% of Americans said their income could not keep up with the rising living cost, and their lives were significantly affected.

A combination of factors contributed to the rising inflation in the US. Monetary and fiscal easing policies are the fundamental reasons for this round of inflation. From Q1 in 2020 to Q4 in 2021, the average growth rate of M2 in the US is as high as 18%, of which the aggressive fiscal policy accounts for more than a half, resulting in a substantial expansion of domestic demand and higher inflation. Secondly, since the outbreak of the pandemic, the temporary interruption of production and dislocation of supply chains have led to restrictions on the production capacity of international commodities and the rise in the related products prices. At the same time, because of the pandemic, the gap between the supply and demand of labor in the US has widened, and the output has dropped a lot compared with that before the pandemic. The recent Russian-Ukrainian conflict has further pushed up energy and food prices, making US inflation even worse. Finally, the Fed's previous misjudgment of inflation pressures also contributed to the current high inflation. When the US inflation issue first emerged last year, the Federal Reserve repeatedly emphasized that the factors causing this round of inflation were temporary. But subsequent inflation data that beat expectations showed that the Fed had misjudged the inflation, which eventually led to a change in market expectations, triggering even higher inflation.

2) Stable Inflation in China

Inflation in China remained stable. In 2021, under the complex environment of global liquidity flooding, supply chain bottlenecks and commodity supply and demand imbalances, China's overall inflation remained within a reasonable range, and the annual CPI increased by 0.9% YoY, lower than the expected goal of 3%. Entering 2022, the supply of consumer goods and services in China is relatively sufficient. Although the repeated outbreaks of the epidemic have some impacts on inflation, the government has issued various policies to ensure the supply of important commodities. The overall supply and demand are still near the balanced level. In the first quarter of this year, China's CPI rose by 1.1% YoY, which was generally in a moderate range; the core CPI, excluding food and energy items, rose by 1.2% YoY.

Subitem prices are differentiated. Since 2021, food items are basically in the negative growth range. In Q1 of this year, food prices fell by 3.1% YoY, making the CPI drop by 0.59 percentage points, mainly due to the decline in pork product prices. The price of pork fell by 41.8% YoY in Q1, and has now fallen back to a historical low level, plays as the key factor that keeps China's CPI flat. At the same time, the decline in pork price also led to a 34.4% decline in the price of edible animal oil, and the prices of mutton and chicken fell by 3.5% and 2.3%, respectively. The return of service workers to their posts after the Spring Festival also led to a drop in service prices. Stimulated by the conflict between Russia and Ukraine, crude oil prices rose sharply, driving up China's refined oil prices and becoming the main factor pushing up China's inflation. In Q1, China's energy prices rose by 12.2% YoY, driving the CPI rise by about 0.84 percentage points, accounting for nearly 80% of the total increase in CPI.

It is worth noting that the weight of energy in China's CPI is not large, so the overall impact of crude oil prices on CPI is relatively limited. The direct impact of oil prices on China's CPI is mainly reflected in the components of fuel for transportation and water and electricity for living. Our model shows that the weight of those two in CPI is less than 9%. The indirect impact of oil prices mainly influences other items by affecting production costs. Taking food as an example, the fertilizer required for agricultural production and equipment such as factory machinery need to consume crude oil. In theory, the rise in crude oil prices will push up these costs, prompting the price of final consumer goods to rise, thereby driving the food CPI. However, the impact of rising oil prices on China is mainly reflected in PPI. In the past two years, the transmission of China's production costs to consumer goods prices was generally poor. Therefore, the indirect impact of rising crude oil price on CPI is relatively limited, and its impact on CPI fluctuations is far less than that of food item.

2. Steadily Rising Inflation in Hong Kong

Affected by the pandemic, Hong Kong's economy encountered with many challenges, and inflation is rising steadily. Netting out the effects of all the government's one-off relief measures, the underlying consumer price inflation rate in Hong Kong was 0.6% for the whole of 2021, of which 0% in H1 and 1.2% in H2. In the first three months of this year, Hong Kong's overall consumer prices rose by 1.2%, 1.6% and 1.7% YoY respectively, exhibiting a rising inflation tendency. The main reason was that many cross-border drivers were infected with the new crown virus, and the food supply in Hong Kong was greatly reduced in a short period of time. Meanwhile, affected by the highly contagious Omicron variant virus, Hong Kong citizens panicked and rushed to purchase goods, causing the prices of staple goods such as fresh vegetables to rise, thereby pushing up inflationary pressures. In addition, because of the sharp rise in international crude oil, the prices of energy-related and transportation items also increased considerably.

Inflation in Hong Kong is affected by both Mainland China and the US. However, also as small but highly open economies, Taiwan province, Singapore, and South Korea's inflations were much higher during the same period. In 2021, the CPI in Taiwan, Singapore and South Korea increased by 2.0%, 2.3%, and 2.5% YoY respectively. In Q1 of 2022, the inflation of those three regions increased to 2.8%, 4.6% and 3.8% respectively. The main reason for this is that Hong Kong's economy is more closely related to Mainland China. In years when the inflation trends of Mainland China and the US converge, the inflation trend of Hong Kong is basically the same; while in years when the inflation trends of Mainland China and the US diverge, the inflation trend of Hong Kong is affected by both, and relatively more affected by Mainland China. Taking the data of Q1 this year as an example, inflation in the US rose by nearly 8% YoY, while CPI in Mainland China rose by 1.1% YoY. Inflation in Hong Kong is in between, rising about 1.5% YoY.

Hong Kong's staple goods mainly come from Mainland China. The Mainland is the only or largest provider of most staple goods that Hong Kong consumes every day, from tap water to live poultry and vegetables. Guangdong Dongjiang supplies up to 800 million cubic meters of fresh water to Hong Kong every year, accounting for 70-80% of the total fresh water consumption in Hong Kong. Mainland China is the only provider of live pigs, live cattle, live sheep, and live poultry to Hong Kong. Mainland China is also the main supplier of edible fungi and most fresh vegetables. In addition, in terms of beverages, tea and coffee beans supplied by the Mainland account for the majority. At the same time, Mainland China has already become Hong Kong's largest fuel supplier, providing almost the entire supply of LPG and natural gas in Hong Kong. Therefore, the price of staple goods in Hong Kong depends on the quantity and price of goods supplied from the Mainland, which is also the fundamental reason why Hong Kong inflation is deeply affected by inflation in Mainland China.

Hong Kong's prices are less affected by the imported inflation than the other three Asian tigers. Since Hong Kong's staple goods mainly come from the Mainland, and Mainland China has a good system of ensuring supply and stabilizing prices, it has largely alleviated the impact of international imported inflation. Take the recent surge in international energy and food prices as an example. Russia and Ukraine are important sources of fossil energy and food in the world. Since the outbreak of the conflict, sanctions from Western countries have led to a sharp rise in global energy and food prices, resulting in imported inflationary pressures. However, Hong Kong's energy and food are mainly supplied by Mainland China, which has strong administrative enforcement capabilities in controlling prices. On the one hand, food prices are relatively stable, coal prices are guided by the government, and during the period of a sharp rise in crude oil, its transmission to the midstream and downstream industries will be weakened by administrative means. On the other hand, Mainland China strictly monitors the speculation activities on some key commodities, and the demand will not fluctuate too much. Imported inflation has weakened considerably after being digested by Mainland China, so its impact on Hong Kong is relatively small.

The pandemic has hedged the impact of the Fed's monetary easing on the local property market, and Hong Kong's rental price remains modest. Renting accounts for 40.25% of Hong Kong's CPI, so the stability of Hong Kong's rental price is the biggest guarantee for a flat inflation. As a highly open international finance center, Hong Kong implements a linked exchange rate system with the Hong Kong dollar pegged to the US dollar and dose not have active monetary policies. Therefore, the Federal Reserve's monetary policy has a great impact on Hong Kong's asset prices, including the rental price. Historical data also reveals that there is a positive correlation between Hong Kong's interbank market liquidity and Fed easing. In the past two years, the Federal Reserve adopted quantitative easing policies, which led to the flood of international funds. QE is conducive to promoting the rise of Hong Kong's property prices, and also exerts upward pressure on the rental. However, because of the pandemic, all industries in Hong Kong depressed, the unemployment rate rose sharply, and the economy fell into a deep recession. At the same time, the number of immigrants to Hong Kong dropped sharply, and Hong Kong residents who had left Hong Kong preferred staying outside, superimposing the acceleration of immigration and the aging population, leading to a substantial reduction in the population of Hong Kong. As a result, rentals in Hong Kong did not rise but fall, reducing the risk of high inflation to a large extent.

3. Hong Kong Inflation Outlook

Looking ahead, the inflation divergence between China and the US will continue for a period of time. The current high inflation in the US may not be completely eliminated by normalizing monetary policy alone. It is also necessary to deal with supply-side troubles caused by repeated pandemics and international tensions. The pork supply in Mainland China is still sufficient during the year. Although the pork price may rise moderately in H2, its overall impact on inflation in 2022 is still controllable. We expect inflation in Hong Kong to pick up this year compared to 2021, but remain relatively stable. In particular:

US inflation will remain high during the year. The uncertainty of the Russia and Ukraine conflict is relatively high, and the prices of US energy and agricultural products may still rise in the short term. The US had announced a ban on the import of Russian oil in early March, which may provide support for domestic energy prices. In terms of food, since Russia and Ukraine are important agricultural producers, the protracted conflict will inevitably influence the grain output and exports of these two countries, adding pressures on global food prices. For core commodities in the US, the GSCPI has been falling for several consecutive months, indicating the global supply chain is recovering. Meanwhile, the US is also considering cutting tariffs on China, which may jointly drive down the prices of durable goods. However, the outbreak of epidemic in China and other regions may interrupt the recovery process of the global supply chain. In terms of core services, the labor force participation rate in the US continues to decline, and the widening gap between labor supply and demand has led to a rapid increase in wages, which will improve the paying ability of American residents. Meanwhile, the rental elasticity is relatively low, and the rental items, which account for the largest share of the CPI, are under pressure to rise, resulting in the US CPI staying at a high level. The inflation in the US in 2022 is expected to show a trend of high and then low, and the annual average inflation may exceed 6%.

Inflation in Mainland China is expected to keep flat. Although Western sanctions against Russia may escalate and oil prices still have room to rise, the transmission of PPI to CPI may be difficult to improve in 2022, and the impact of imported inflation on CPI is limited. In terms of food, the pork supply is sufficient in the short term, the market is still oversupplied, and pork prices may remain low. In H2, as the supply of live pigs gradually decreases, pork prices may rise moderately, while the overall impact on inflation during the year is still controllable. Because of the pandemic, the overall development of the service industry has stagnated, which will put pressures on the low-income people, and will largely curb consumption demand. However, once the epidemic is under control, various measures will be loosened gradually. The stimulus of infrastructure and real estate, and the release of M2 will boost inflation. Especially considering the government has proposed an economic growth target of 5.5% this year, it is believed that the credit will also reach a level "basically matching economic growth", which may lead to a moderate increase in the CPI. We expect the overall CPI in Mainland China will be higher in 2022 than last year, but probably not more than 3%, with a trend of low before high.

Hong Kong inflation also has upward pressure during the year. The epidemic severely damaged various economic activities in Q1. With the full support from the central government, the supply of staple goods to Hong Kong was sufficient, and the shortage of food and daily necessities was largely alleviated. The daily new confirmed cases in Hong Kong have dropped sharply, and various control measures are loosening gradually. With the stimulus of the consumption voucher scheme, the local consumption has begun to increase. Meanwhile, local property prices and rentals are also expected to rise slowly with the gradual recovery of the economy, which may jointly boost the inflation. Besides, due to the Russian-Ukrainian conflict and related sanctions and counter-sanctions, inflation in many developed economies is expected to remain high in the short term, which may lead to faster price increases of imported items, also adding upward pressure on local inflation.

However, inflation in Hong Kong will remain relatively stable in 2022. Due to the powerful system of ensuring supply and stabilizing prices in Mainland China, Hong Kong will suffer much less from external inflationary shocks. Prices of food, energy, and durable goods will only rise to a limited level during the year. On the other hand, the Federal Reserve will continue to shrink monetary policy. The latest dot plot shows that the US will raise interest rates 7 times this year, pushing the federal funds rate to 1.75%-2% by the end of 2022. This will exacerbate global liquidity contraction, boost capital outflows from emerging markets, and raise financing costs, ultimately suppress the rise in Hong Kong's rental CPI. Taking internal and external factors into consideration, we expect Hong Kong CPI will rise during the year compared with 2021, but it will remain relatively stable, and the annual inflation tendency may be between 2-3%.

主要經濟指標 (Key Economic Indicators)

	2020	2021	2021/Q4	2021/Q1
一 . 本地生產總值 GDP				
總量 (億元) GDP($100 Million)	26,716	28,426	7,692	N/A
升幅 (%) Change(%)	-6.1	6.4	4.7	-4.0
二 . 對外貿易 External Trade			**2022/03**	**2022/01-03**
外貿總值 (億元) Total trade($100 Million)				
總出口 Total exports	39,275	49,607	3,728	11,460
進　口 Total imports	42,698	53,078	4,100	12,087
貿易差額 Trade balance	-3,422	-3,471	-373	-627
年增長率 (%) YOY Growth(%)				
總出口 Total exports	-1.5	26.3	-8.9	3.4
進　口 Imports	-3.3	24.3	-6	2.9
三 . 消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	0.3	1.6	1.7	1.5
四 . 樓宇買賣 Sale & Purchase of Building Units			**2022/04**	**2022/01-04**
合約宗數 (宗) No. of agreements	73,322	96,133	4,852	18,589
年升幅 (%) Change(%)	-2.0	31.1	-47.0	-41.9
五 . 勞動就業 Employment			**2021/12-2022/02**	**2022/01-2022/03**
失業人數 (萬人) Unemployed(ten thousands)	259.1	250.9	16.2	18.9
失業率 (%) Unemployment rate(%)	5.5	5.5	4.5	5.0
就業不足率 (%) Underemployment rate(%)	3.1	2.7	2.3	3.1
六 . 零售市場 Retail Market			**2022/03**	**2022/01-03**
零售額升幅 (%) Change in value of total sales(%)	-24.3	8.1	-13.8	-7.6
零售量升幅 (%) Change in volume of total sales(%)	-25.5	6.5	-16.8	-10.4
七 . 訪港遊客 Visitors				
總人數 (萬人次) arrivals (ten thousands)	356.9	9.1	0.2	1.1
年升幅 (%) Change(%)	-93.6	-97.4	-73.0	-30.5
八 . 金融市場 Financial Market			**2022/02**	**2022/03**
港幣匯價 (US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.2	779.8	780.8	783.1
貨幣供應量升幅 (%) change in Money Supply(%)				
M1	30.1	8.0	2.3	5.4
M2	5.8	4.3	3.6	4.0
M3	5.8	4.3	3.5	4.0
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	5.4	4.6	3.9	4.5
港元存款 In HK$	6.2	1.4	-1.4	0.9
外幣存款 In foreign currency	4.6	7.9	9.5	8.3
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	1.2	3.8	1.6	2.2
當地放款 use in HK	1.7	4.7	1.3	3.0
海外放款 use outside HK	0.1	1.7	2.1	0.4
貿易有關放款 Trade financing	-6.2	14.2	16.0	15.3
最優惠貸款利率 (%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	27,231	23,398	22,713	21,997