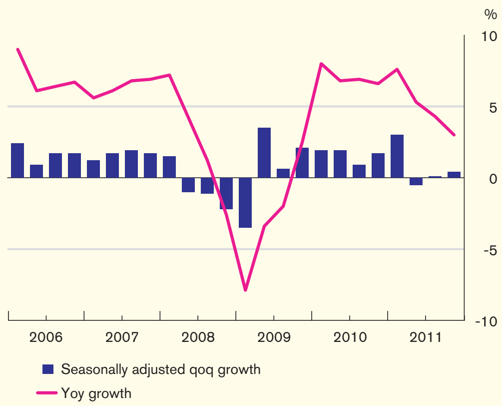
3. Domestic economy

Demand

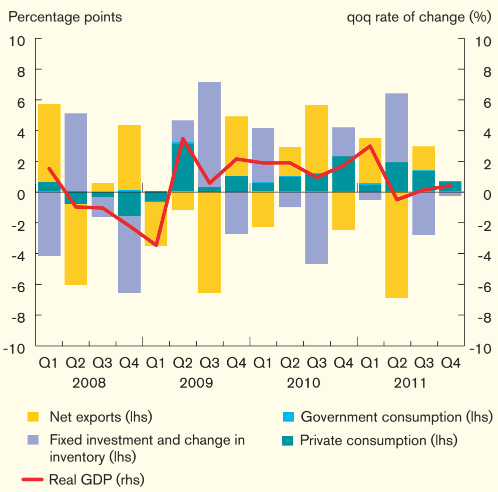
There was little growth momentum in the Hong Kong economy during the second half of 2011. The weakened external environment not only affected Hong Kong's exports, but also appears to have permeated the broader economy. Output growth will likely remain subdued in the immediate future, although recent data flows have been more positive. Nevertheless, the longer term outlook will hinge on developments in global economic and financial conditions, which remain in a state of flux.

Chart 3.1
GDP in chained (2009) dollars



Source: Census and Statistics Department (C&SD).

Chart 3.2
Contributions to quarter-to-quarter percentage change in real GDP



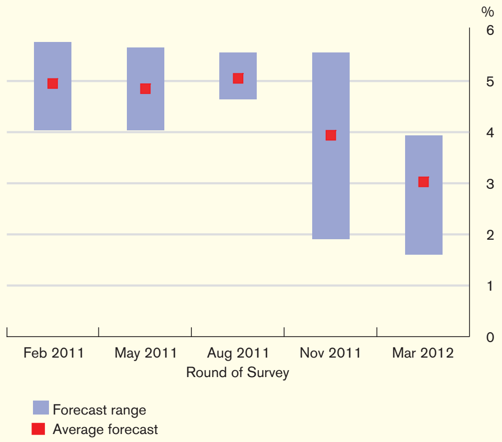
Sources: C&SD and HKMA staff estimates.

3.1 Aggregate demand

The Hong Kong economy failed to regain much momentum in the second half of 2011, with real GDP growing by a frail 0.1% in Q3 and 0.4% in Q4 on a seasonally adjusted quarter-to-quarter comparison (Chart 3.1). On the domestic front, private consumption and gross fixed investment stayed broadly resilient. Inventory investment, however, decelerated and became a drag on real GDP growth. In aggregate, domestic demand subtracted 1.4 percentage points from real GDP growth in Q3, followed by a positive contribution of 0.4 percentage points in Q4 (Chart 3.2). The overall export performance remained weak amid slackened external demand, although it fared better than imports to the extent that net exports made slight contributions to real GDP growth in Q3 and Q4. In tandem with the sluggish sequential momentum, the year-on-year GDP growth rate moderated to 4.3% in Q3 and a subpar 3.0% in Q4.

Growth momentum is expected to remain soft in the immediate future. The headwinds from the external environment – owing to sluggish growth prospects in advanced economies, an unresolved European sovereign debt crisis and the ensuing global market volatilities – are expected to remain a drag on Hong Kong's exports. The frigidity in the external environment will also likely continue weighing on domestic demand. While income conditions and the labour market are expected to remain largely favourable and continue to render some support, the weaker growth in local private consumption seen in 2011 Q4 may persist. Local firms' interests in investment projects may also be affected by the uncertain outlook. On the other hand, fiscal stimulus from the 2012/13 Budget should help support the economy with a robust pipeline of infrastructure projects and some relief measures in place. It is also encouraging to note that recent data have generally improved to the upside. Our composite index of leading economic indicators (LEI) moved notably higher towards the end of 2011, providing an early hint that growth may regain momentum towards mid-2012, although it remains to be seen whether the incipient rebound can be sustained. Box 1 discusses this LEI and the companion composite index of coincident economic indicators (CEI).

Chart 3.3
Consensus forecasts for 2012 real GDP growth



Source: Consensus Economics.

The current economic outlook is subject to an unusually high degree of uncertainty, with prominent binary risks. If the global environment sharply deteriorates, including a worsening in the European debt problems, the Hong Kong economy will be hit hard through both trade and financial channels, which could drag Hong Kong into an outright recession. However, if external conditions normalise, especially in relation to a stabilisation of the European debt problem, the continued two-speed global recovery and the possibility of further monetary easing in advanced economies could lead to renewed capital inflows, resuming upward pressures on asset and consumer prices in Hong Kong. Reflecting the highly uncertain prospects, private sector economists hold widely diverging views on Hong Kong's outlook. While the consensus forecast for 2012 GDP growth centres around 3.0%, the spectrum of forecasts is as wide as 2.3 percentage points (Chart 3.3). The Government also gives a wide-range forecast of 1.0 - 3.0% for 2012.

Box 1
Taking the pulse of the Hong Kong economy — introducing monthly coincident and leading economic indicators for Hong Kong[4]

GDP is the most comprehensive measure of *overall economic activity*, but does not provide timely information. In Hong Kong, it is available quarterly and with a time lag of six weeks from the close of the reference quarter. On the other hand, some other indicators that capture the key aspects of economic activity, such as retail sales and merchandise exports, are available monthly or an even higher frequency with a shorter reporting delay. The information embedded in these indicators can be systematically extracted to not only tell the strength of the economy in a more timely fashion, but also provide useful insights into the near-term trend of economic activity.

This box describes two in-house indices we have developed for these purposes[5]: the index of coincident economic indicators (CEI) combines four data series to summarise the current state of overall economic activity in one statistic, while the index of leading economic indicators (LEI) is constructed based on 10 data series to provide a broad indication of near-term overall economic conditions.

Index of coincident economic indicators

The CEI is estimated based on a dynamic single-factor model that consists of retail sales volume, equity market turnover, retained import volume and total export volume.[6] These component variables are methodologically selected out of some 300 data series

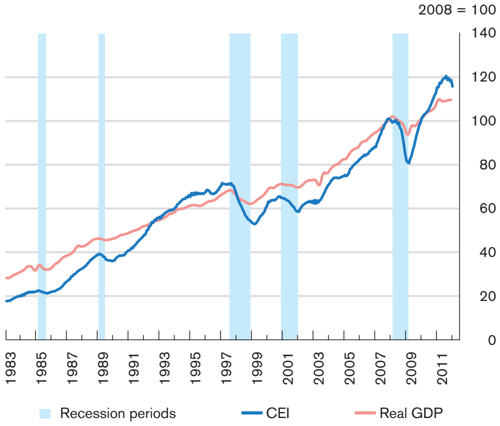
---

[4] We thank Alan Clayton-Matthews of the Northeastern University for providing the DSFM programme for estimating the CEI, Bart Hobijn of the Federal Reserve Bank of San Francisco for sharing his computer codes for the US Tech Pulse Index, and Robert Inklaar of the University of Groningen for providing the programme to perform the Bry-Boschan procedures.

[5] A similar study on the CEI for Hong Kong is Gerlach, S. and M. S. Yiu (2005), "A Dynamic Factor Model for Current-quarter Estimates of Economic Activity in Hong Kong", *Pacific Economic Review* 10(2), pages 279 - 292.

[6] See Stock, J. H. and M. W. Watson (1989), "New Indexes of Coincident and Leading Economic Indicators", *NBER Macroeconomics Annual 1989*, pages 351 - 393.

Chart B1.1
CEI and real GDP (at levels)



Note: Monthly GDP is estimated using the Denton temporal disaggregation technique in the ECOTRIM software package. We identify the recession periods by applying the procedures in Bry, G. and C. Boschan (1971), *Cyclical Analysis of Time Series: Selected Procedures and Computer Programs*, New York, NY: Columbia University Press.

Sources: C&SD and HKMA staff estimates.

Table B1.A
Correlation between the CEI and real GDP (January 2000 - December 2011)

Between CEI and real GDP	
levels	0.980
12-month rates of change	0.867
three-month rates of change	0.654

Source: HKMA staff estimates.

Table B1.B
Chronologies of the CEI and real GDP cycles

Peaks*		
Real GDP	CEI	
Date	Date	Lead (-) / Lag (+) number of quarters
1985 Q1	1985 Q1	+0
n.a.	1989 Q1	n.a.
1997 Q3	1997 Q3	+0
2000 Q4	2000 Q4	+0
2008 Q1	2007 Q4	-1
Average		**-0**

Troughs*		
Real GDP	CEI	
Date	Date	Lead (-) / Lag (+) number of quarters
1985 Q3	1985 Q3	+0
n.a.	1989 Q4	n.a.
1998 Q4	1999 Q1	+1
2001 Q4	2001 Q4	+0
2009 Q1	2009 Q1	+0
Average		**+0**

Note:
* Peaks and troughs are identified by the Bry-Boschan procedures. The Bry-Boschan procedures cannot identify any peak or trough of real GDP during 1989.

Sources: C&SD and HKMA staff estimates.

based on commonly accepted criteria.[7] The cross-correlation of the potential component series with real GDP is examined at different lead and lag lengths. Their cyclical behaviours are also analysed as to whether the turning points come close to, or coincide with, the peaks and troughs of real GDP.[8] Once the suitable component variables are identified, a model involving a system of five equations is built: one equation for each component variable and one equation for a latent factor that is reflected in each of the component variables. The latent factor represents the CEI.

Chart B1.1 traces the CEI against the real GDP of Hong Kong from 1983 onwards. Its trend and curvature provide useful information about the direction and pace of change in the contemporaneous economic conditions of Hong Kong. Several criteria can be used to assess the performance of a CEI. One way is to compare its correlation with the real GDP. We find that the CEI is highly correlated with real GDP and broadly conforms to the cycles of real GDP. The correlation coefficients between the CEI and GDP at levels is as large as 0.980, while their correlation in terms of 12-month and three-month growth is 0.867 and 0.654 respectively (Table B1.A). The CEI also traces the turning points of the real GDP reasonably well (Table B1.B).

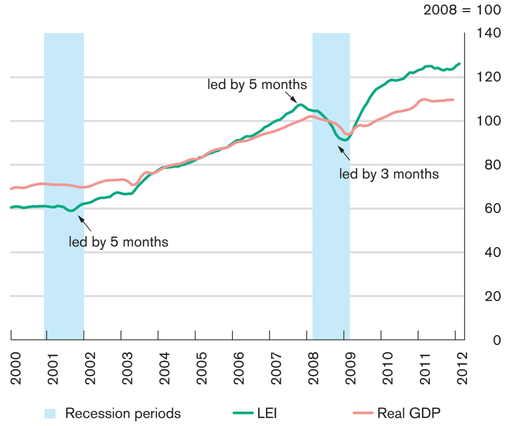
A caveat in interpreting the index is that the cardinal unit of the CEI is different from that of the real GDP, and therefore it is generally not feasible to form a precise numerical mapping between the two.[9] In other words, an increase in the CEI typically indicates a rise in real

[7] Specifically, those criteria are set out by the National Bureau of Economic Research (NBER) so that component series should conform to the cycles of the reference series (Hong Kong's real GDP in this study) including the turning points. In brief, the criteria are (1) economic significance; (2) statistical adequacy; (3) historical conformity to business cycles; (4) cyclical timing record; (5) smoothness; and (6) promptness of publication. For details, see Moore, G. H. and J. Shiskin (1967), *Indicators of Business Expansions and Contractions*, New York, NY: National Bureau of Economic Research.

[8] Synchronisation of cycles is measured in terms of the concordance index in Harding, D. and A. Pagan (2006), "Synchronisation of Cycles," *Journal of Econometrics* 132, pages 59 - 79.

[9] One transformation method is to set the trend of the CEI equal to that of the reference series (real GDP in this study), as applied in the State Coincident Indexes by the Federal Reserve Bank of Philadelphia and the OECD Composite Leading Indicators.

Chart B1.2
LEI and real GDP (at levels)



Note: Monthly GDP is estimated using the Denton temporal disaggregation technique in the ECOTRIM software package. We identify the recession periods by applying the Bry-Boschan procedures to monthly GDP.

Sources: C&SD and HKMA staff estimates.

Table B1.C
Correlation between the LEI and real GDP (January 2000 - December 2011)

Between three-month lagged LEI and real GDP	
levels	0.990
12-month rates of change	0.822
three-month rates of change	0.526

Source: HKMA staff estimates.

Table B1.D
Chronologies of the LEI and real GDP cycles

Peaks*		
Real GDP	LEI	
Date	Date	Lead (-) / Lag (+) number of quarters
2000 Q4	n.a.	n.a.
2008 Q1	2007 Q4	-1
Average		**-1**

Troughs*		
Real GDP	LEI	
Date	Date	Lead (-) / Lag (+) number of quarters
2001 Q4	2001 Q3	-1
2009 Q1	2008 Q4	-1
Average		**-1**

* Peaks and troughs are identified by the Bry-Boschan procedures. The LEI series is only available from 2000 Q1 onwards. Despite the availability of only a few data points, the peak quarter of the LEI is identified as some time before 2000 Q4 by the Bry-Boschan procedures.

Sources: C&SD and HKMA staff estimates.

GDP, and a *faster* increase in the CEI usually suggests acceleration in real GDP expansion. However, an increase in the CEI by 1%, for instance, cannot be interpreted as implying a 1% increase in the real GDP. This caveat against numerical inferences also applies to the LEI discussed below.

Index of leading economic indicators

The LEI is constructed according to the conventional NBER method.[10] It is a weighted sum of 10 component variables: the Hang Seng Index, approvals of building plans, real broad money (M2 deflated by the CCPI), the HSBC Hong Kong Purchasing Managers' Index (PMI), the CUHK Indices of Consumer Sentiment and Employment Confidence, headline results of the Quarterly Business Tendency Survey (QBTS), the HKTDC Export Index, and the OECD Leading Indices for the US and Mainland China.[11 & 12] They are selected according to the NBER criteria to ensure all the components have a leading relationship with real GDP and show a leading cyclical behaviour. Chart B1.2 compares the LEI with the real GDP.

The LEI is capable of providing early signals of economic turning points and it generally leads GDP by three to four months. The three-month lagged LEI is highly correlated with real GDP. The correlation coefficient between the three-month lagged LEI and GDP at levels is as much as 0.990, while their correlation in terms of 12-month and three-month growth is 0.822 and 0.526 respectively (Table B1.C). It also leads the GDP peaks and troughs by about one quarter in the past decade (Table B1.D).[13]

10 See Moore and Shiskin (1967) and The Conference Board (2001), *Business Cycle Indicators Handbook*, New York, NY: The Conference Board.

11 The contribution of each LEI component is weighed by a standardisation factor which is based on the inverse of the standard deviation of the symmetric changes in the data series. See The Conference Board (2001) for details.

12 Some outlook sentiment indicators are available quarterly. The monthly figures are interpolated by the Denton temporal disaggregation technique in the ECOTRIM software package.

13 Owing to the limited availability of some outlook sentiment indicators, the LEI is a relatively short time series, starting from January 2000 onwards.

Table B1.E
Recent trends of the CEI and LEI

	% change over one month		% change over six months*
	CEI	LEI	LEI
2011			
Jan	2.4	0.6	3.7
Feb	-0.1	0.3	3.6
Mar	1.8	0.9	3.3
Apr	-0.2	0.1	2.4
May	1.2	0.0	2.5
Jun	0.7	-0.8	1.1
Jul	0.2	0.3	0.7
Aug	0.7	-0.6	-0.1
Sep	-1.5	-0.4	-1.4
Oct	0.8	0.6	-1.0
Nov	-1.2	-0.3	-1.3
Dec	0.4	0.3	-0.1
2012			
Jan	-2.5	1.1 p	0.8 p
Feb	n.a.	0.8 p	2.1 p

p Provisional.

* The 6-month rate of change of an LEI is commonly referred to for detection of any business cycles turning points.

Source: HKMA staff estimates.

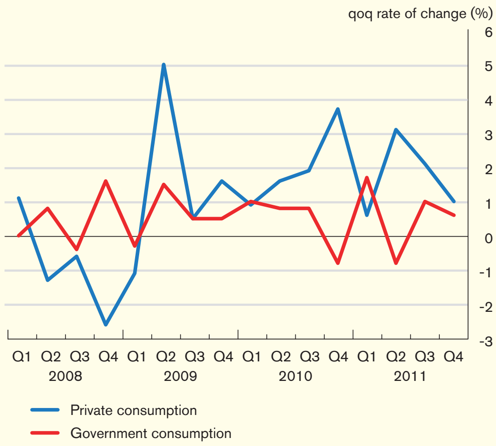
What do the CEI and LEI tell us about the strength of economic activity in the first half of 2012?

The recent readings of the CEI reflect that the Hong Kong economy started the year on a weak note (Table B1.E). The CEI slipped back in January, dampened by a sharp decrease in retail sales and the continually sluggish trade performance. This January figure is however susceptible to seasonal distortions of the Chinese New Year holidays, which fell in January this year but February last year. In order to better gauge the current trends, the first two months may need to be read together. On the other hand, the LEI has moved notably higher for three consecutive months, providing tentative signs of a re-start in momentum for the Hong Kong economy further ahead. Its component data generally arrived with better readings than expected amid improvement in both the domestic and external environments, although drags continued to come from sentiment indicators, such as the QBTS and the HKTDC Export Index.

As with any forecasts, assessments based on the CEI and LEI are highly data-driven. Whether the incipient rebound can be sustained is likely to depend on the evolution of external conditions.

3.2 Domestic demand

Chart 3.4
Private and government consumption



Source: C&SD.

Consumption

Private consumption largely held up in the second half, reflecting robust income growth and labour market resilience. Demand for consumer goods, particularly durable goods, remained strong, and service consumption increased steadily. Looking at the quarterly profile, however, reveals some sequential softening, from a quarter-on-quarter growth rate of 2.1% in Q3 to 1.0% in Q4 (Chart 3.4). While some moderation in private consumption growth had been anticipated following two years of above-trend growth, the slowdown also reflected the negative wealth effect of an under-performing stock market and weaker consumer confidence in late 2011 amid a challenging global environment. In 2012, the notable job and income growth over the past year is expected to cushion private consumption against a subdued output growth. The relief measures recently announced in the 2012/13 Budget will also be supportive. Overall, private consumption growth momentum will likely be tepid in the near term and gather pace again later in the year. The mean consensus forecast for private consumption growth is now 4.1% for 2012, less than half of the 8.6% growth in 2011.

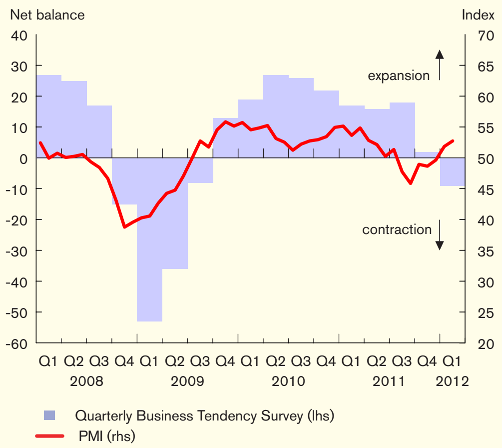
Government consumption increased steadily by 1.0% in Q3 and 0.6% in Q4. However, it is expected to strengthen in the future as outlined in the 2012/13 Budget, where the recurrent part of public expenditure is projected to increase by 6.8% in real terms in the coming fiscal year, slightly higher than the 6.5% increase in 2011/12.[14]

Investment

Overall investment spending weakened in the second half due to a slowdown in inventory investment. However, gross fixed investment remained buoyed by a sharp revival in business capital spending and a sustained increase in public construction works. Private construction activities also improved gradually, although

[14] The 6.5% increase in recurrent public expenditure in 2011/12 is based on the 2011/12 Budget projections.

Chart 3.5
Business sentiment



Sources: C&SD and Markit Economics.

at a much slower rate. In 2012, construction activities should continue to be underpinned by a robust pipeline in public sector infrastructure works. And, in association, there will be a positive spill-over effect to public capital investment. However, private fixed investment is likely to weaken. Essentially, the latest results of the Quarterly Business Tendency Survey have painted a pessimistic business outlook for Q1, the most downbeat since 2009 Q3 (Chart 3.5). The PMI also remained soft, only crawling above the expansion-contraction cut-off more recently, after a five-month slump towards the end of last year. In this light, firms will likely be cautious about their capital spending in the near term. Private construction activities are also expected to be restrained, as indicated by a low level of building permits. The latest market consensus now sees growth in gross fixed investment to weaken to 4.2% in 2012, from 7.2% in 2011.

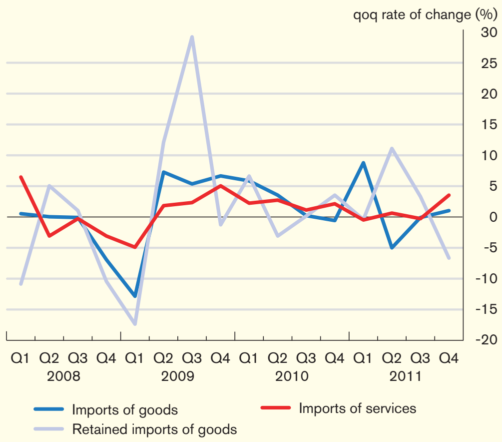
3.3 External trade

Chart 3.6
Exports of goods and services

Source: C&SD.

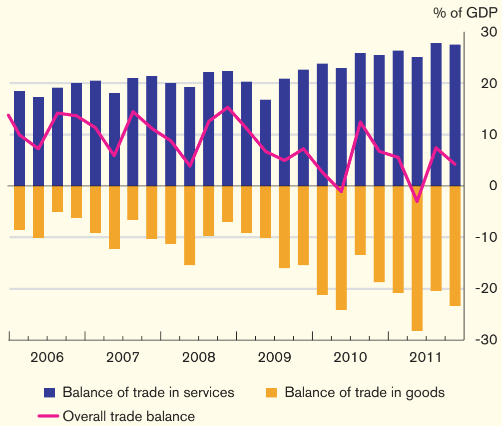
The overall export performance remained weak in the second half of 2011. Exports of goods are yet to recover from the sharp decline in Q2, only edging up 0.7% in Q3 and 1.5% in Q4 (Chart 3.6). Demand from advanced economies continued to falter, while shipments to the Mainland and other Asian markets also slackened due to dwindling processing trade. As for exports of services, a 0.1% increase was reported for Q3, but was then followed by a 0.3% decline in Q4. The trade-related and transportation components exerted a sizable drag throughout the two quarters, while growth in inbound tourism and exports of financial and other business services has been weakening.

Chart 3.7
Imports of goods and services



Sources: C&SD and HKMA staff estimates.

Chart 3.8
Trade balance by component (in nominal terms)



Source: C&SD.

Imports of goods fell by 0.2% in Q3 and then picked up by 0.9% in Q4 (Chart 3.7). Export-induced demand was sluggish, as reflected in re-exports of goods and retained imports of raw materials and semi-manufactures. Imports for domestic use and consumption continued to hold up well. Services imports also displayed a similar divergence. There was a fall in the trade-related and transportation components alongside the slowdown in merchandise trade flows. However, outbound tourism and imports of financial services continued to grow at a fast pace. In aggregate, imports of services dropped by 0.4% in Q3 and then bounced up 3.4% in Q4.

Net exports added 1.5 percentage points to real GDP growth in Q3, but their contribution became negligible in Q4. In value terms, the seasonally unadjusted overall trade balance reverted from a deficit of HK$13.4 billion (equivalent to 3.0% of GDP) in Q2 to a surplus of HK$21.4 billion (4.2% of GDP) in Q4 (Chart 3.8).

It is likely the world economy will remain mired in a slow-growth path and be subjected to substantial downside risks this year. The dampened external demand conditions will, therefore, continue to undermine Hong Kong's export performance, particularly in the first half of the year. Signalling pessimism in the export sector, the HKTDC Export Index has slipped below 50 for three consecutive quarters since 2011 Q3. The market consensus now projects merchandise exports to grow by 5.5% in nominal terms in 2012, down from 10.1% in 2011. The projection would likely be even smaller if cast in real terms. On the services side, inbound tourism and financial services will likely continue to give some support, but with an offset from trade-related and transportation services. In anticipation also of a gradual slowdown in domestic demand, imports of goods and services are expected to soften further.

Labour market conditions

The labour market remained tight in the second half, with the unemployment rate fluctuating between 3.2% and 3.3%. Meanwhile, by late 2011 job creation continued to remain strong despite deteriorating economic environment.

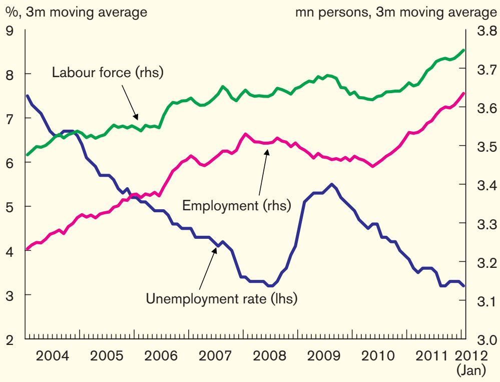
3.4 Labour market conditions

Labour market conditions held up well despite weakening growth momentum in the economy. The seasonally adjusted three-month moving-average unemployment rate remained at a low 3.2% in January 2012 after averaging 3.3% in the second half (Chart 3.9). Employment grew robustly, reaching 3.63 million by January. The current strength of the labour market is broad-based, with the unemployment rate of both the higher-skilled and lower-skilled segments staying at low levels in the second half.

On the labour demand side, job creation continued to be strong in late 2011. Employment in some major business sectors such as retail, accommodation and food services, and financing, insurance, real estate, professional and business services reached multi-quarter high in Q4. Labour supply remained strong in the second half, with the overall labour force participation rate staying at around 60.3% in the review period.

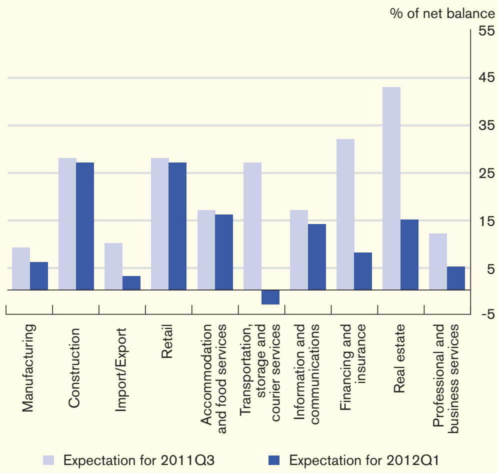
The near-term outlook for the labour market has been clouded by increasing downside risks to the external economic conditions. The latest Quarterly Business Tendency Survey for 2012 Q1 shows that while a majority of respondents expect employment to expand in the near term, the percentage of responses expecting a reduction has increased significantly compared with the survey conducted six months ago (Chart 3.10). The reduction was particularly significant in the sectors of real estate, financing and insurance, and transportation, storage and courier services.

Chart 3.9
Labour market conditions



Source: C&SD.

Chart 3.10
Quarterly business tendency survey for 2012 Q1: employment



Notes:
1. Net balance refers to the difference between the percentage points of respondents expecting a rise over those expecting a decline.
2. Sectors are classified according to the new Hong Kong Standard Industrial Classification Version 2.0 (HSIC V2.0).

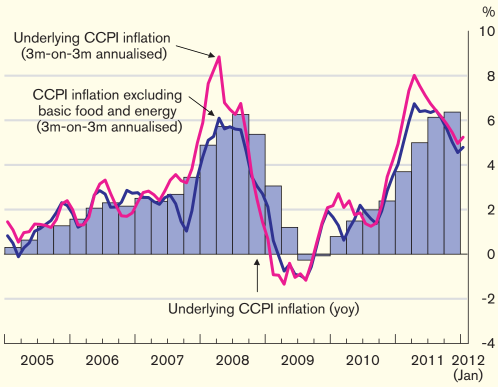
Source: C&SD.

Costs and prices

Inflationary pressures in Hong Kong's economy may have peaked as sequential inflation momentum has decreased, reflecting a slower pass-through of market rentals into consumer prices, lower inflation on the Mainland, and stabilised commodity prices. They are likely to moderate gradually on the back of a further slowing in the pace of the residential rental pass-through and some easing in labour cost pressure.

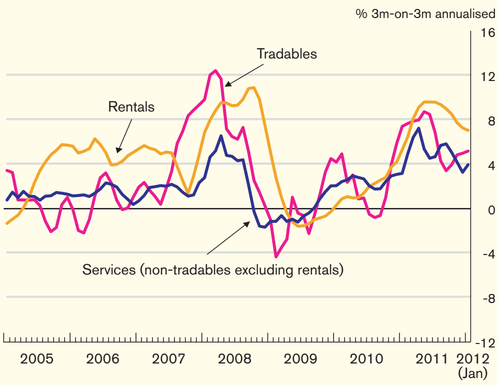
3.5 Consumer prices

Chart 3.11
Different measures of consumer price inflation



Sources: C&SD and HKMA staff estimates.

Chart 3.12
Consumer price inflation by broad component

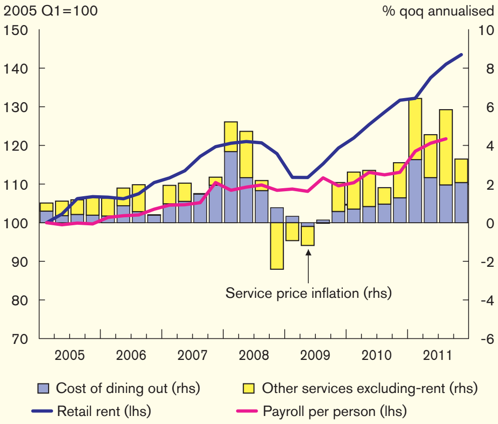


Sources: C&SD and HKMA staff estimates.

Inflationary pressures in the economy might have peaked. On an annualised three-month-on-three-month basis, the underlying inflation rate dropped continuously from 6.8% in July to 5.0% in December 2011 (Chart 3.11). This downward trend in the rate, however, was disturbed in January, as the rate rebounded to 5.3% on the back of the Lunar New Year effect, which is expected to eventually fade out. The core inflation rate (the CCPI inflation excluding the volatile components of basic food and energy from the CCPI basket) also followed a similar pattern, as the decrease in the sequential inflation momentum over the period was mainly driven by a slower pace of increase in the housing component of the CCPI. Along with this, the year-on-year underlying inflation rate also showed signs of stabilising in recent months, staying at 6.4% from September to December 2011.

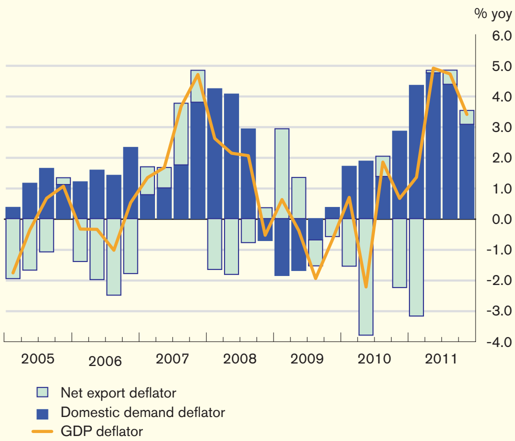
The inflation rate of all three major components of the CCPI, rentals, tradables and non-tradables drifted down (Chart 3.12). In particular, a downward trend is now evident in the three-month-on-three-month inflation rate of the rental component. This means the momentum of the pass-through process of increased market rentals into the inflation rate of the rental component has slowed down after running for some time. The inflation rate of the tradable component also fell from 6.9% in July to 5.2% in January, as the inflation momentum of basic food, durable goods, clothing and footwear components decreased. On the other hand, the inflation rate of the non-tradable component increased from 4.7% in July to 5.9% in September, and then

Chart 3.13
Service price inflation excluding rent



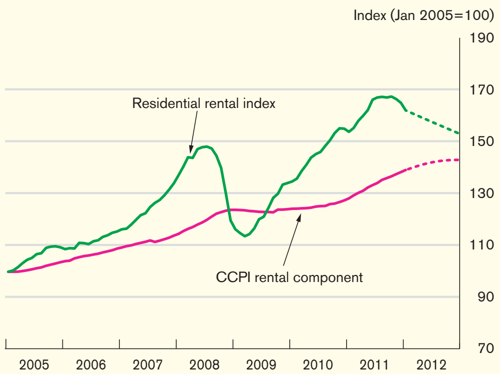
Sources: Rating and Valuation Department, C&SD and HKMA staff estimates.

Chart 3.14
GDP deflator and broad components' inflation



Sources: C&SD and HKMA staff estimates.

Chart 3.15
CCPI rental component and market rentals



Note: CCPI rental component is excluding the effects of one-off special relief measures.

Sources: Rating and Valuation Department, C&SD and HKMA staff estimates.

decreased to 4.0% in January, largely reflecting fluctuations in the inflation rate of the miscellaneous services component, which in turn was subject to the pass-through of increased retail rentals and labour costs (Chart 3.13).

Inflationary pressures, measured from the national account perspective, also eased during the review period. The year-on-year inflation rate of the GDP deflator decreased to 3.4% in 2011 Q4 from 4.7% in Q3, driven by the decline in the inflation rate of the domestic demand component (Chart 3.14). However, the domestic demand component was still the main driver of GDP deflator inflation, despite the pick-up in the inflation rate of the net exports component over the period (i.e. the relative inflation of export to import prices).

Looking ahead, inflationary pressures are likely to moderate. While the outlook for residential property prices and rentals are uncertain in the near term, the pace of the pass-through of the earlier increases in residential rentals into the CCPI rental component are likely to continue to slow down gradually (Chart 3.15). As the rental component plays a key role in shaping inflation, local inflationary pressures are also expected to recede gradually for the rest of the year.

The pace of decline in inflationary pressures, however, will also hinge on how cost pressures evolve in the economy. In particular, while labour cost pressures are expected to be constrained by the increased downside risks to the labour market outlook, retail rental cost pressures are expected to stay firm with the strong retail sector performance. Thus, cost pressures may remain high in the economy, causing inflationary pressures to moderate only gradually in the near term.

However, the expected moderation in inflationary pressures during the year could be hindered by some upside risks, stemming mainly from developments in the external environment. While oil prices could pick up substantially on the back of geopolitical tensions related to Iran, a new round of quantitative easing in the US could fuel further commodity price increases, and the associated weakening in the US dollar and hence the Hong Kong dollar could pose upward pressure on Hong Kong's import prices.

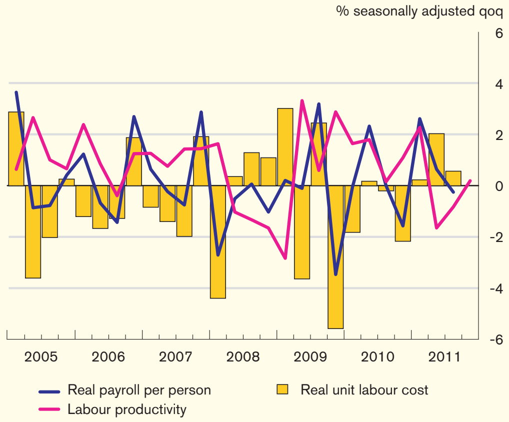
3.6 Output gap and labour costs

The output gap narrowed during the second half of 2011. The potential output was boosted by an elevated labour force participation rate, although the actual output was restrained by the weak aggregate demand. As a result, the actual output expanded at a slightly slower pace than that of the potential output, with the output gap narrowing to slightly above zero, down from above 1% in the first half. Labour market conditions remained tight, with the unemployment rate hovering well below the estimated non-accelerating inflation rate of unemployment (NAIRU) during the review period.

With tight labour market conditions, labour cost pressures increased. Notwithstanding a slowdown in the sequential growth momentum, real payroll per person for Q2 and Q3 combined recorded an increase of 1.8% over the previous six-month period (Chart 3.16). At the same time, labour productivity growth was dragged by the sluggish local economic growth in Q2 and Q3, and this pushed real unit labour costs up by 0.6% quarter on quarter in Q3, following an increase of 2.0% in Q2.

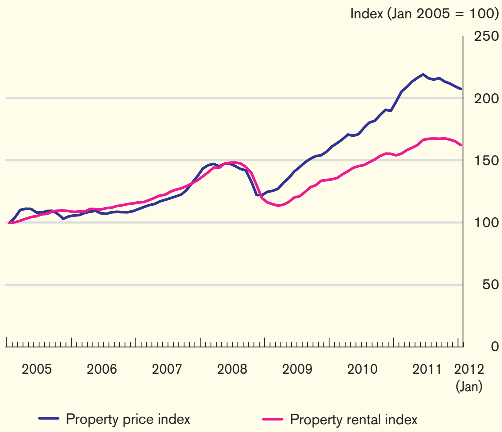
The domestic economy is expected to grow at sluggish rates in 2012 amid the unfavourable external environment. As such, the output gap may narrow further, with the possibility of falling back into negative territory. If this is realised, the unemployment rate will be pushed up, which should help constrain labour cost pressures.

Chart 3.16
Unit labour cost and labour productivity



Sources: C&SD and HKMA staff estimates.

Chart 3.17
Residential property price and rental indices



Source: Rating and Valuation Department.

3.7 Rental costs

Residential property rentals showed signs of stabilising on the back of the decline in residential property prices. After peaking in June, residential property prices settled into a downward trend since then, resulting in a cumulative decline of 5.3% (Chart 3.17). Against this background, the residential property rentals segment also stabilised during the second half, registering its first decline in November 2011, after rising by a cumulative 47.6% from its trough in 2009.

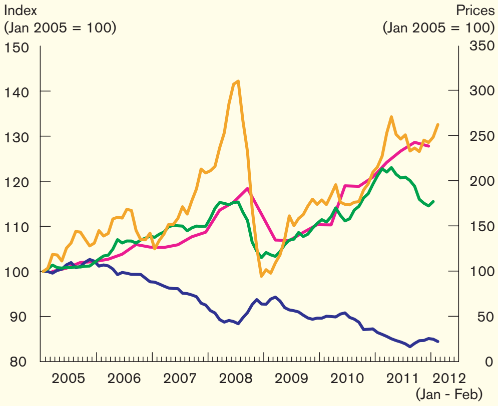
The outlook for the property market is also uncertain. Less favourable global economic prospects and weakened market sentiments will weigh on residential property prices and rentals, while tight supply conditions and the low interest rate environment will support property prices and rentals.

3.8 Commodity and import prices

Import price inflation decreased amid the deepening European debt crisis and unfavourable global economic prospects. The quarter-on-quarter annualised inflation rate of import prices dropped further to -2.6% in Q4, from 6.2% in Q3 and 8.5% in Q2, helped by stabilised commodity prices and moderating inflation on the Mainland (Chart 3.18). A breakdown by end-use category of import prices revealed that the moderation recorded in the second half of 2011 was, to a large extent, driven by softened prices for consumer goods and fuel (Chart 3.19).

The outlook for import price inflation remains unclear. While lowered inflation on the Mainland and weak global prospects are expected to contain commodity prices and thus import price inflation, the negative supply-side developments in the world oil market may trigger sharp spikes in oil prices. In particular, any hope of additional quantitative easing in the US may further support global commodity prices. Despite the safe-haven demand driven by the European debt crisis, any further quantitative easing could weaken the US dollar, with the resulting drag on the Hong Kong dollar, exacerbating potential import price pressures. As such, there is a possibility that import price pressures could increase considerably at some point in the future, and pose upside risks to the inflation outlook.

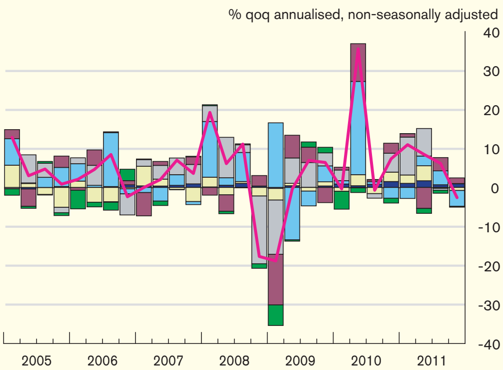
Chart 3.18
Commodity and import prices



Oil price (rhs)
World non-fuel commodity price (rhs)
Unit value index of retained imports (lhs)
HKD NEER (lhs)

Sources: C&SD and IMF.

Chart 3.19
Contributions to import price inflation



Food
Raw materials
Capital goods
Consumer goods
Fuel
Others
Retained imports unit value index

Sources: C&SD and HKMA staff estimates.