3. Domestic economy

Significant drags from net exports and a moderation in private consumption resulted in Hong Kong's growth momentum remaining weak in the first half. The near-term economic outlook has tilted slightly to the downside given the lull in external demand and global financial volatility. Risks to the longer term outlook continue to turn on the developments in the euro area crisis and their impact on global macro-financial conditions.

The labour market remained tight despite strong external headwinds, with the unemployment rate hovering between 3.2% and 3.4%. Labour demand stayed buoyant, but the outlook is clouded by the highly uncertain external economic conditions.

Inflationary pressures receded on the back of lowered Mainland inflation, the slower pass-through of market rentals, and lacklustre domestic growth. Inflation is expected to moderate further in the near term, although the recent upward momentum in the property market may pose some risks.

3.1 Aggregate demand

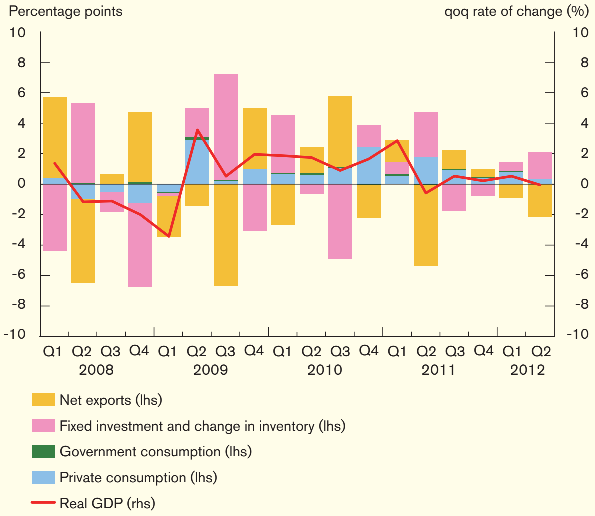
Growth momentum continued to be muted in the first half of this year. On a seasonally adjusted quarter-to-quarter comparison, real GDP grew at a sub-par rate of 0.5% in Q1, and then contracted a little by 0.1% in Q2 (Chart 3.1). The weakness in real activity largely reflected a difficult external environment. Net exports turned into a drag in the first half, detracting 0.9 percentage points from output growth in Q1 and 2.2 percentage points in Q2 (Chart 3.2). Bolstered by a sustained rise in private consumption and a revival in overall investment spending, domestic demand remained solid, although it failed to completely offset the drag from net external trade in Q2. At a longer horizon, real GDP grew by 0.7% year on year in Q1 and 1.2% in Q2, both well below its trend rate over the past decade.

Chart 3.1
GDP at constant market prices

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

The near-term outlook for real activity remains weak, with little signs of a rebound in the growth momentum. Continued external headwinds arising from the weakness in the euro area

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



Sources: C&SD and HKMA staff estimates.

demand and fragile growth in the US and Mainland China are expected to restrain Hong Kong's exports. This in turn could feed through to the broader economy, inhibiting domestic demand partly owing to weaker consumer and business confidence. Local private consumption may go through a soft patch because of decelerating income growth or weaker income prospects. Heightened macroeconomic uncertainty also tends to weigh on private investment. On the other hand, fiscal stimulus from the 2012/13 Budget should help support the economy with a large pipeline of committed infrastructure projects and some relief measures in place. Latest survey results reveal that businesses and households are more cautious about the outlook in the near term. Our composite leading economic indicator also pointed to softer economic activity towards the end of 2012, as evidenced by its muted sequential momentum and a moderating six-month growth rate (Table 3.A). In line with this outlook, the Government's GDP growth forecast for 2012 was revised to 1.0 - 2.0% in August, compared with 1.0 - 3.0% announced earlier this year. Market analysts also pared down their forecasts to an average of 1.8% in September (Chart 3.3).

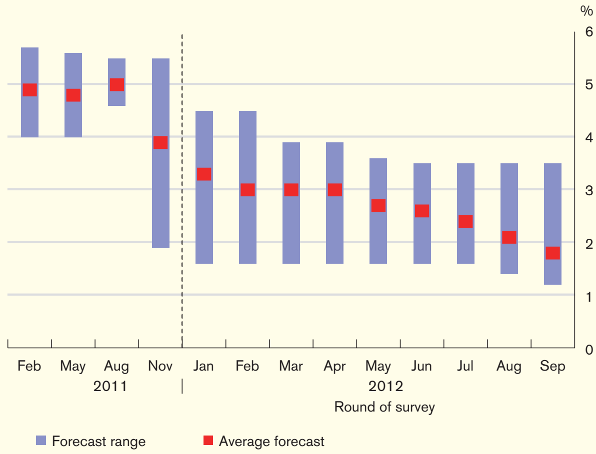
Table 3.A
Recent trends of the coincident economic indicator and the leading economic indicator

	2012						
	Jan	Feb	Mar	Apr	May	Jun	Jul
	(Percentage change over 1 month)						
CEI	-2.6	+3.0	-2.1	+1.1	-1.6	+1.2	-1.9
LEI	+1.1	+1.0	+0.4	+0.7	+0.0	+0.3	-0.1
	(Percentage change over 6 months)						
CEI	-1.3	+0.6	+0.1	-0.3	-0.4	-1.1	-0.5
LEI	+1.1	+2.6	+3.3	+3.6	+3.7	+3.6	+2.4

Note: The six-month rate of change of a leading economic indicator is commonly referred to for detection of any business cycles turning points.

Source: HKMA staff estimates.

Chart 3.3
Consensus forecasts for 2012 real GDP growth



Source: Consensus Economics.

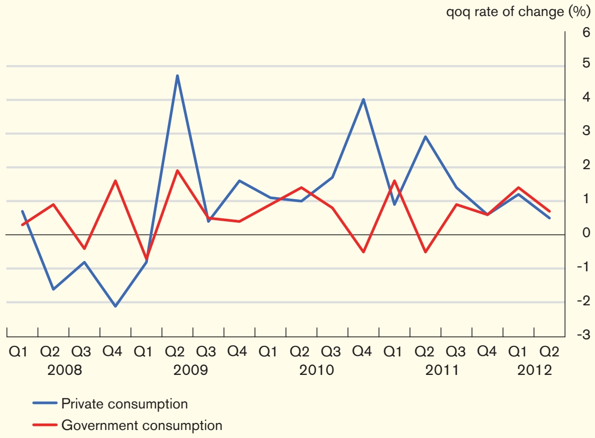
The baseline economic outlook is subject to considerable uncertainty. On the one hand, heightened global uncertainties will subject financial market conditions and fund flows to substantial volatilities and cast a shadow over Hong Kong's growth outlook. In a worst case scenario, an intensification of the euro area crisis or a global synchronised downturn could throw Hong Kong into recession. On the other hand, a stabilisation of external conditions — owing to easing euro area concerns, further monetary easing in the advanced economies or a policy-induced recovery in Mainland economic growth — could allow the economy to return to trend growth at a faster pace and may also lead to some overheating pressures in the local asset markets.

3.2 Domestic demand

Consumption

Underpinned by stable job creation and rising income, private consumption broadly held up in the first half, but its growth profile showed signs of losing steam, with sequential growth moderating from 1.2% in Q1 to 0.5% in Q2 (Chart 3.4). Demand for consumer goods, in particular non-durable goods, increased at a slower pace and service consumption growth moderated, partly because of subdued financial market activities. Indeed, consumer sentiment turned more cautious moving into Q2, due in part to a retreat in stock prices, dimming economic outlook and weaker income prospects. For the remainder of the year, a tepid growth in private consumption is expected, although sustained rises in income and low unemployment will provide some cushion. The mean consensus forecast for private consumption growth is now 3.9% for 2012, more than halving from the 8.2% growth in 2011.

Chart 3.4
Private and government consumption



Source: C&SD.

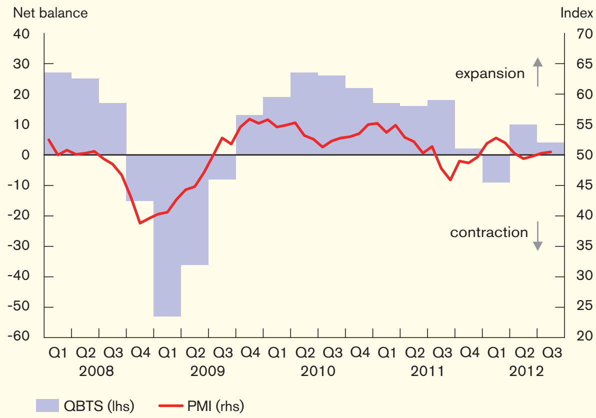
Government consumption rose by 1.4% in Q1 and 0.7% in Q2. However, its growth is expected to pick up in the future as outlined in the 2012/13 Budget, where the recurrent part of public expenditure is projected to increase by 6.8% in real terms in the coming fiscal year, slightly higher than the 6.5% increase in 2011/12.

Investment

After contracting for two quarters, investment spending bounced back in Q1 and Q2, contributing 0.5 and 1.7 percentage points to output growth respectively. In particular, there was a sizable increase in gross fixed investment, powered by a strong rise in private construction works and a revival in business capital spending. Public construction activities were buoyed by works under way on a number of large-scale infrastructure projects. Inventory investment apparently remained stable.

Gross fixed investment is likely to progress steadily for the remainder of 2012, in view of robust private and public construction activities ahead and their possible flow-on effects on capital investment. However, business sentiment has weakened, according to the latest Quarterly Business Tendency Survey (QBTS) and the recent PMI readings (Chart 3.5). To some extent, this will weigh on private capital spending in the near term. The latest market consensus now sees a 5.5% increase in gross fixed investment in 2012, down from 7.5% in 2011.

Chart 3.5
Business sentiment

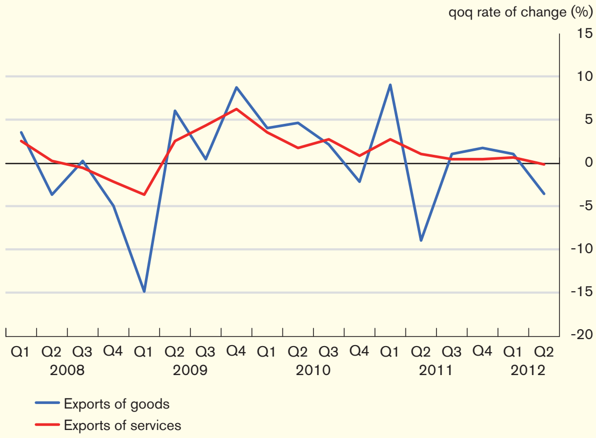


Sources: C&SD and Markit Economics.

3.3 External trade

Hong Kong's export performance was rather weak in the first half of this year. Against the backdrop of sluggish demand in the advanced economies and slackening intra-Asia trade flows, exports of goods contracted by 3.5% in Q2 following a modest 1.1% increase in Q1 (Chart 3.6). Services exports also lost traction, declining by 0.1% in Q2 after rising by 0.7% in Q1. This largely reflected the sluggish external demand for transportation and trade-related services, as well as flagging performance in financial and business services exports. Exports in travel services also showed some signs of moderation in Q2.

Chart 3.6
Exports of goods and services



Source: C&SD.

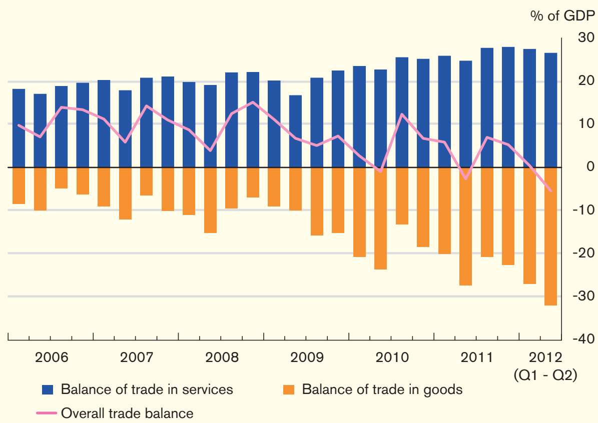
Imports of goods recorded a 1.9% drop in Q2, compared with a 1.5% increase in Q1 (Chart 3.7). Despite a drag from the export-induced demand, domestic consumption and investment continued to provide support for the overall import of goods. Services imports declined by 1.0% in Q2 after a tepid 0.9% increase in Q1, mainly driven by weaker trade-related services imports and sluggish demand for financial services.

Chart 3.7
Imports of goods and services

Sources: C&SD and HKMA staff estimates.

Taken together, the external sector has been a significant laggard in output contribution, with net exports pulling down GDP growth by 0.9 percentage points in Q1 and 2.2 percentage points in Q2. In seasonally unadjusted terms, the overall trade balance recorded a deficit in the first half of 2012, at $23.8 billion, equivalent to 2.5% of GDP (Chart 3.8). In contrast, a surplus of $15.1 billion (or 1.6% of GDP) was recorded in the first half of last year.

Chart 3.8
Trade balance by component (in nominal terms)



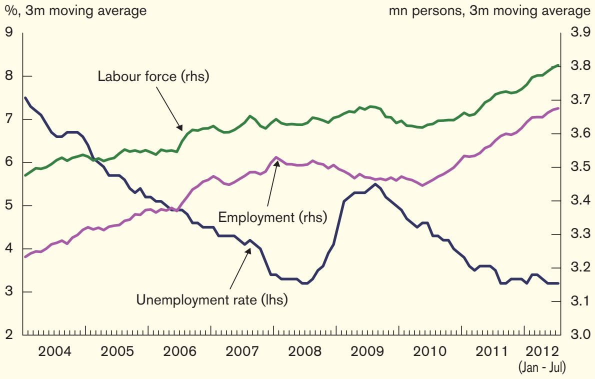
Source: C&SD.

The short-term prospects for Hong Kong's exports will remain restrained by the weak external demand conditions, in particular the worsening of the economic situation in Europe and softening momentum in the US and Mainland China. The latest QBTS shows deteriorating business conditions for traders of goods, and the HKTDC Export Index has remained in negative territory since 2011 Q3. Among professional analysts and forecasters, the outlook consensus is for merchandise exports to increase by 2.7% in nominal terms in 2012, down from 10.1% in 2011. This projection is likely to be even lower if cast in real terms. On the services side, growth in inbound tourism is likely to soften with the Mainland economy moderating. This, together with receding demand for trade-related and transportation services, will weigh on services exports. Imports of goods and services are expected to grow at a measured pace amid the slowdown in domestic demand and regional trade flows.

3.4 Labour market conditions

Despite strong external headwinds, labour market conditions remained tight. The seasonally adjusted three-month moving-average unemployment rate remained at a low of 3.2% in July, averaging 3.3% for the first seven months of 2012 (Chart 3.9). Employment edged up further to a record high of 3.68 million by July from 3.63 million in January, with the overall labour force participation rate edging up to 60.9% from 60.4% over the same period. The current state of full-employment is broad-based for both higher-skilled and lower-skilled segments. In particular, employment in retail, accommodation and food services, and finance, insurance, professional and business services stayed at a high level after reaching a multi-quarter high in Q1. Box 2 analyses the reasons behind the tight labour market and assesses its outlook.

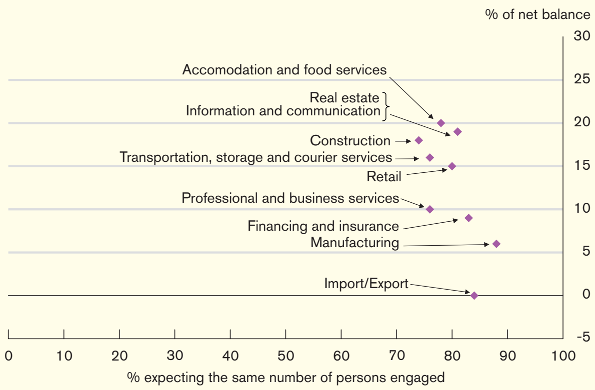
Chart 3.9
Labour market conditions



Source: C&SD.

In the near term, the new batch of school leavers will continue to boost labour supply. Whether the increase can be absorbed by the market will largely depend on the resilience of the domestic economy against the external shocks. The latest QBTS for 2012 Q3 shows that respondents from almost all sectors expect employment to expand in the near term, suggesting that labour demand is likely to stay buoyant (Chart 3.10). Nonetheless, the hiring sentiment is sensitive to business conditions and economic outlook, which are clouded by the mounting uncertainty in the external economic environment.

Chart 3.10
Quarterly business tendency survey for 2012 Q3: 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).

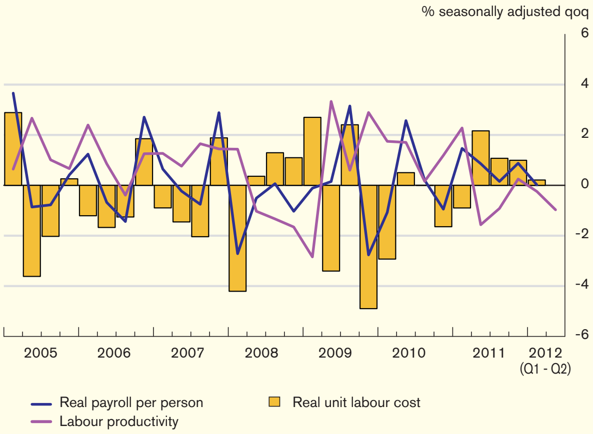
Source: C&SD.

While the potential output continued to expand in the first half due to the increased labour force participation, the deceleration in the growth of actual output amid the weak aggregate demand has significantly closed the output gap and might have turned it from positive to negative in the first half of 2012. Nevertheless, the closing output gap appears to have little impact on the labour market, with the unemployment rate staying at a relatively low level.

Labour cost pressures remained elevated amid the tight market conditions. Real payroll per person in 2012 Q1 and 2011 Q4 registered an increase of 1% over the previous six-month period (Chart 3.11). The faltering momentum in economic growth has weighed on labour productivity. As a result, real unit labour costs were up by 0.2% and 1% quarter on quarter in 2012 Q1 and 2011 Q4 respectively.

In the near term, the domestic economic output is likely to stay below its potential against the background of the fragile global economic conditions. The output gap may decline further, depending on the resilience of the domestic economy to the external shocks. Nevertheless, the weakening demand may help contain rising pressures in labour costs in the tight market conditions.

Chart 3.11
Unit labour cost and labour productivity

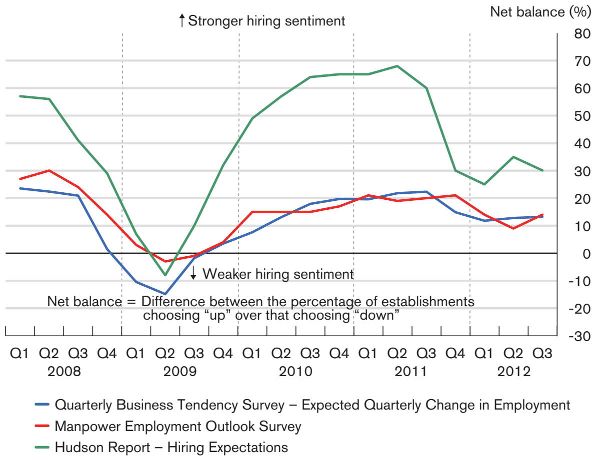


Sources: C&SD and HKMA staff estimates.

Box 2
The tight labour market puzzle: will it remain resilient?

It is puzzling that despite the lacklustre economic performance since 2011 Q2, Hong Kong's unemployment rate has continued to hover at low levels of around 3.2%. While the still-positive hiring sentiment might have cushioned the labour market against the slowdown (Chart B2.1), a closer look at the statistics suggests that some longer term structural factors may also have played a role in increasing the resilience of the market over time. This box sheds some light on these structural factors, and discusses their implications for future labour market performance.

Chart B2.1
Hiring sentiment



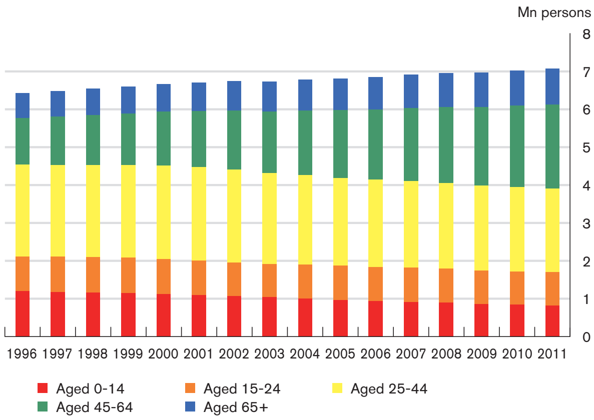
Sources: C&SD, Manpower Services (Hong Kong) Limited and Hudson.

Structural labour supply and demand factors

Both supply and demand factors appear to be at work in increasing labour market resilience, particularly in the lower-skilled segment, which accounts for over 60% of the labour force.[14]

On the supply side, demographic changes have restrained the supply of lower-skilled labour in the economy. With an ageing population and low fertility rate, the size of the young cohort population (aged 15 - 24) has been declining over time (Chart B2.2). In addition, the increased availability of tertiary education has had a further impact on the labour force, as more young people choose to stay in school.[15] With the increased education levels facilitating entry into the higher-skilled segment of the labour market, there has been a corresponding decline in the supply of young people into the lower-skilled segment (Chart B2.3).[16]

Chart B2.2
Age structure of the population



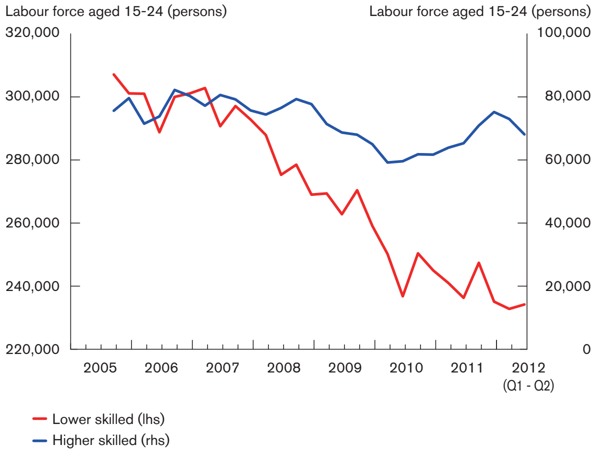
Sources: CEIC and HKMA staff estimates.

14 We classify: (a) managers, administrators, professionals and associate professionals as belonging to the higher-skilled segment; and (b) clerks, service workers, shop sales workers, craft and related workers, plant and machine operators and assemblers, and elementary occupations as belonging to the lower-skilled segment.

15 Education statistics indicate that the number of students enrolled in post-secondary education increased by about 78,000 during 2006 - 2011, closely matching the decrease in the young cohort labour force of about 70,000 registered over the same period.

16 The lower-skilled labour force expanded by only 73,000 people over the period 1996 Q2 - 2012 Q2, far below the addition of 529,000 people in the higher-skilled labour force in the same period.

Chart B2.3
Young cohorts' labour force



Sources: CEIC, C&SD and HKMA staff estimates.

Table B2.B
Labour intensity of different sectors

	Labour intensity (no. of employed persons/mn GDP in 2009 - 2011)	Average output growth rate in 2004 - 2011 (%)
Manufacturing	4.9	-0.8
Construction	4.8	-0.4
Import/export trade	1.5	8.1
Wholesale and retail	4.9	8.5
Accommodation and food services	5.0	6.3
Transport, storage, postal and courier services	3.0	5.3
Information and communications	2.3	3.6
Financing and insurance	0.8	11.1
Real estate	1.7	0.7
Professional and business services	3.3	5.0
Public administration, social and personal services	3.1	1.8

Sources: CEIC, C&SD and HKMA staff estimates.

On the demand side, the implementation of the individual visit scheme since 2003 has strengthened the demand for lower-skilled labour. This can be seen from the observation that most jobs in the tourism-related sectors, such as retail, accommodation and food services, are biased towards the lower-skilled segment (Table B2.A).[17] These tourism-related sectors are also comparatively labour intensive, in the sense that more labour inputs are required to produce each unit of output in terms of value added (Table B2.B). Along with the rapid expansion in these sectors, the demand for lower-skilled labour picked up.

Table B2.A
Labour demand in different sectors

Composition of labour demand	Higher skilled (%)	Lower skilled (%)
Manufacturing	23	77
Construction	0	100
Import/export trade, wholesale	49	51
Retail	9	91
Accommodation and food services	3	97
Transportation, storage, postal and courier services	29	71
Information and communications	85	15
Financing and insurance	77	23
Real estate	46	54
Professional and business services	43	57
Social and personal services	42	58

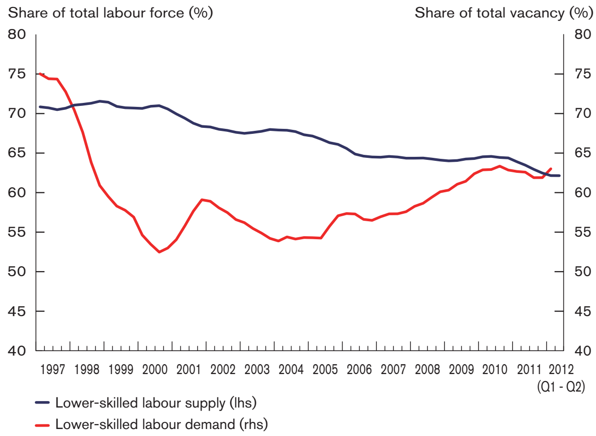
Sources: C&SD and HKMA staff estimates.

17 We approximate the demand for higher-skilled and lower-skilled labour in each sector based on the sector's proportion of higher-skilled and lower-skilled vacancies during the period 2009 Q1 - 2012 Q1.

Implications for overall labour market conditions

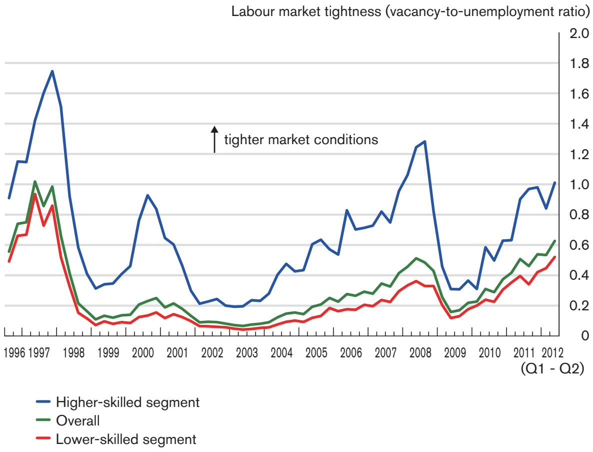
With restrained labour supply and strengthened demand (Chart B2.4), the lower-skilled segment of the labour market has tightened. In particular, the vacancy-to-unemployment ratio, which measures the ease of the unemployed in finding a job, has trended upwards in the lower-skilled segment since 2003, signalling tightening labour market conditions (Chart B2.5).

Chart B2.4
Demand and supply of lower-skilled labour



Sources: CEIC, C&SD and HKMA staff estimates.

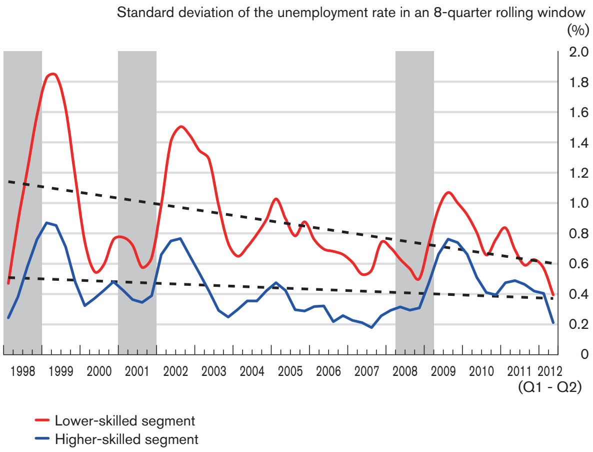
Chart B2.5
Labour market tightness



Sources: CEIC, C&SD and HKMA staff estimates.

These supply and demand dynamics might have explained the increasing resilience of the low-skilled segment in recent years. Chart B2.6 shows that during previous downturns in the late 1990s and early 2000s, the volatility of unemployment rate in the lower-skilled segment was much higher and contributed much to the rise in the overall unemployment rate. However, its volatility has declined over the past decade. During the recent global financial crisis, the lower-skilled segment was found to have become more resilient, although the fact there was no widespread business bankruptcy might also have helped cushion any impact on the labour market.

Chart B2.6
Volatility of the unemployment rate



Note: Shaded areas correspond to periods of recession.

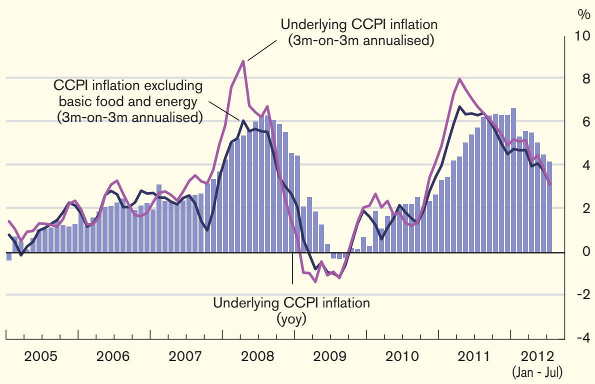
Sources: CEIC, C&SD and HKMA staff estimates.

With the lower-skilled segment representing the major share of the labour market, the increasing resilience of this segment may help reduce the vulnerability of the overall labour market in future. Barring any major shocks that lead to widespread bankruptcy or a sharp reduction in inbound tourism, the unemployment rate is unlikely to increase to levels experienced during the late 1990s and early 2000s.

3.5 Consumer prices

Local inflationary pressures trended downwards during the first seven months of 2012. On an annualised three-month-on-three-month basis, the underlying inflation rate drifted down to 3.1% in July from 5.3% in January (Chart 3.12). Excluding the volatile components of basic food and energy, the core underlying inflation rate also dropped, reflecting that the downward trend in inflationary pressures may persist for a while. Helped by moderation in the sequential momentum, the year-on-year underlying inflation rate also fell to 4.2% in July from its peak of 6.7% in January.

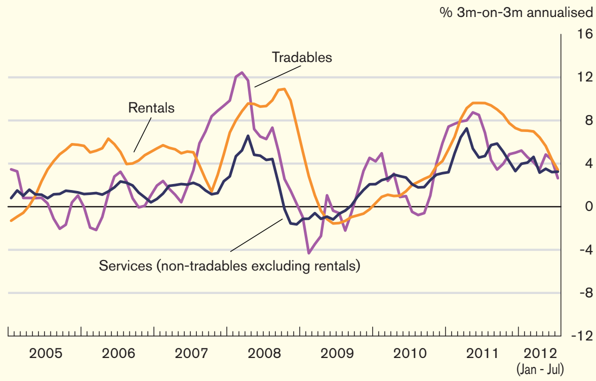
Chart 3.12
Different measures of consumer price inflation



Sources: C&SD and HKMA staff estimates.

The decline in inflation momentum was broad based, with all major CCPI components registering some moderation. In particular, the rental component inflation declined further, as the pace of the pass-through of increased residential rentals continued to slow (Chart 3.13). The inflation rate of the tradable component also slowed from 5.2% in January to 2.6% in July, largely reflecting the volatile nature of the basic food inflation.

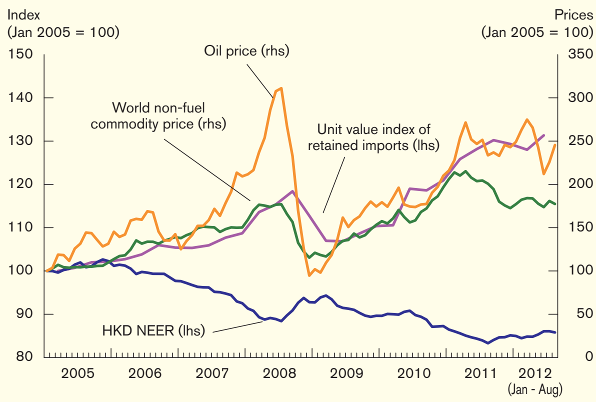
Chart 3.13
Consumer price inflation by broad component



Sources: CEIC and HKMA staff estimates.

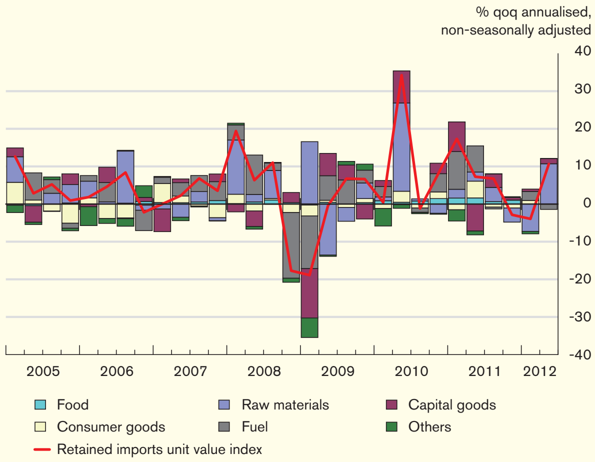
Import price inflation picked up despite moderating inflation on the Mainland and sluggish global growth prospects (Chart 3.14). The quarter-on-quarter annualised inflation rate of import prices rebounded to 10.7% in Q2, after dropping to -3.9% in Q1 from -2.9% in 2011 Q4. Analysed by end-use category, import price inflation was mainly driven by raw material import prices (Chart 3.15).

Chart 3.14
Commodity and import prices



Sources: C&SD and IMF.

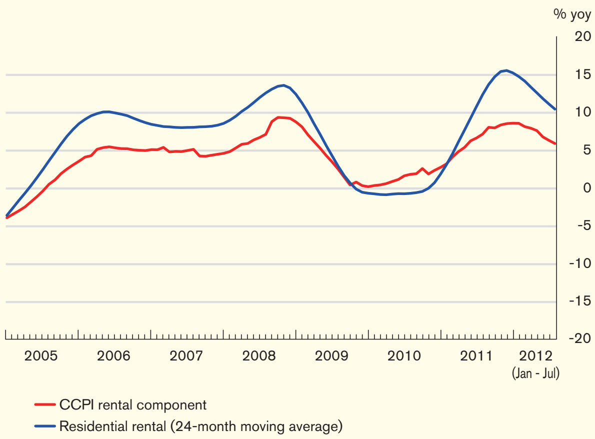
Chart 3.15
Contributions to import price inflation



Sources: C&SD and HKMA staff estimates.

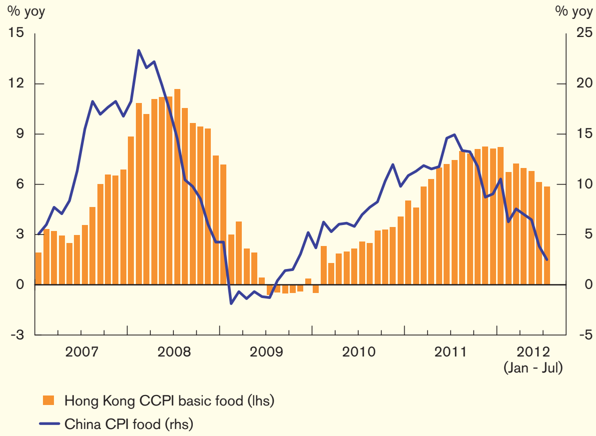
Inflationary pressures are likely to moderate further. The output gap, which is estimated to have turned negative in Q2, is expected to restrain labour cost pressures, while the pace of the pass-through of the earlier increases in residential rentals into the CCPI rental component is expected to continue to slow (Chart 3.16). The moderated food inflation on the Mainland is also likely to help dampen local food inflation in the near term (Chart 3.17). For 2012 as a whole, the Government forecast the headline and underlying inflation rates to be 3.7% and 4.3% respectively, while the latest market consensus for the headline inflation rate is 4.1%.

Chart 3.16
CCPI rental component and market rentals



Note: CCPI rental component excludes the effects of one-off special relief measures.
Sources: Rating and Valuation Department (R&VD), C&SD and HKMA staff estimates.

Chart 3.17
Hong Kong and Mainland China's food inflation



Sources: C&SD, Wind and HKMA staff estimates.

The inflation outlook is subject to some risks. Unstable weather conditions in major food-producing countries, such as the recent drought in the US, may stimulate global food and commodity prices, posing upside risks to the import prices outlook. The monetary easing in advanced economies, particularly an implementation of further quantitative easing in the US, may also add some upward pressures on global commodity and asset prices. In addition, the recent upward momentum in the local property market may continue, which will eventually raise domestic inflationary pressures at some point in the future. On the downside, the European sovereign debt crisis may worsen further, posing negative risks to global economic activity and consequently local inflationary pressures.