3. Domestic economy

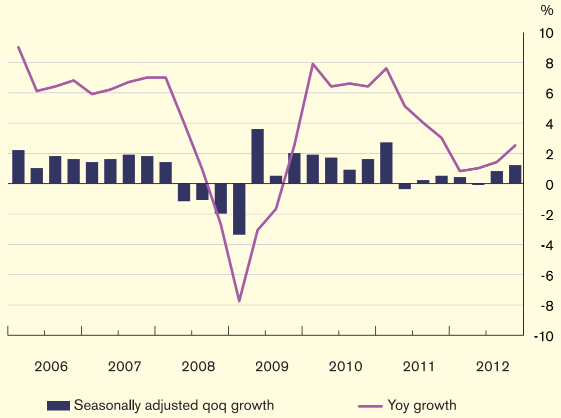
The Hong Kong economy grew faster in the second half of 2012 along with some stabilisation in the merchandise trade performance. The short-term outlook has improved, supported by solid domestic demand and improving exports. Inflationary pressures have only abated slowly and are likely to remain elevated as property rentals continue to rise apace.

The labour market remained tight, with the unemployment rate hovering at a low level. Hiring sentiment stayed strong, and its outlook is likely to be stable barring any major deterioration in the external environment.

3.1 Aggregate demand

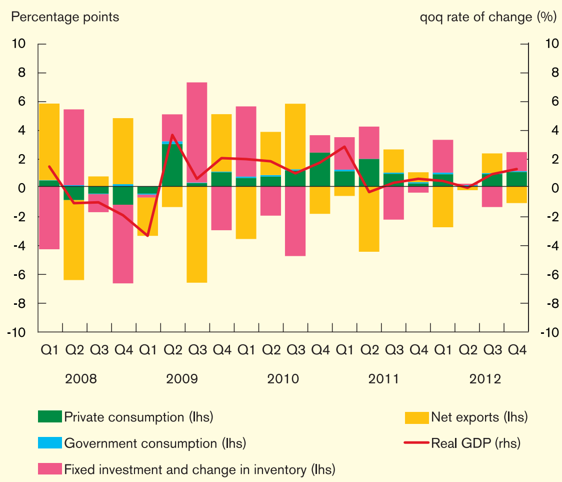
In Hong Kong, growth momentum picked up gradually in the second half of 2012. After contracting by 0.1% in the second quarter, real GDP rebounded by 0.8% in the third quarter and grew a further 1.2% in the fourth quarter (Chart 3.1). The pick-up in growth momentum was underpinned by stronger private consumption, which contributed 0.8 percentage points to real GDP growth in the third quarter and 1.0 percentage point in the fourth quarter (Chart 3.2). A revival in overall investment spending in the fourth quarter also gave extra impetus to real GDP growth. While Hong Kong's export performance improved visibly towards the end of the year, net exports turned into a drag in the fourth quarter as imports of goods and services recorded even stronger performance on the back of resilient domestic demand. In tandem with the sequential growth momentum, the year-on-year growth rate of real GDP ticked up to 2.5% in the fourth quarter from 1.4% in the third quarter. This lifted the annual real GDP growth to 1.4%, yet still sharply slower than the 4.9% growth in 2011.

Chart 3.1
GDP at constant market prices



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.

Looking ahead, the Hong Kong economy is expected to grow faster at a close-to-trend rate in 2013. The drags from external demand should subside gradually, but a full recovery in exports will still take some time as the global economy is struggling to achieve sustained growth. Domestically, consumer spending will continue to be bolstered by the sustained strength in the labour market, higher incomes and increased wealth afforded by the booming asset markets. Large-scale infrastructure works and private building activity are also expected to hold up quite well, although the outlook for capital investment and inventory stocking is less certain as business sentiment remains somewhat cautious. The moderately expansionary fiscal stance in the 2013/14 Budget should provide support to the economy with committed infrastructure projects and a package of relief measures.

Our in-house composite index of leading indicators predicts solid growth in economic activity in the near term, as indicated by the accelerating six-month growth rate (Table 3.A). Overall for 2013, private sector analysts project the economy to grow by 2.5-4.7%, averaging at around 3.5% (Chart 3.3). The Government also sees growth strengthening to the range of 1.5-3.5%.

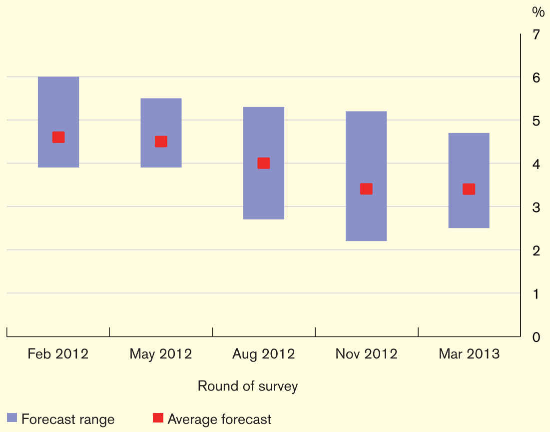
Table 3.A
Recent trends of the coincident economic indicator and the leading economic indicator

	% change over one month		% change over six months	
	CEI	LEI	CEI	LEI
2012				
Jan	-1.4	1.1	-1.2	0.8
Feb	2.0	1.0	0.2	2.3
Mar	-1.0	0.4	1.0	3.1
Apr	0.6	0.8	0.3	3.5
May	-0.7	-0.1	0.9	3.7
Jun	0.8	0.2	0.3	3.5
Jul	-0.2	-0.3	1.5	2.1
Aug	1.3	0.2	0.9	1.2
Sep	1.5	0.5	3.4	1.2
Oct	1.2	1.1	4.1	1.5
Nov	2.0	0.6	6.9	2.2
Dec	1.1	0.4	7.2	2.4
2013				
Jan	1.4	0.5	8.9	3.3
Feb	n.a.	0.3	n.a.	3.4

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 2013 real GDP growth



Source: Consensus Economics.

The improved economic outlook is subject to a number of uncertainties and risks. The unresolved European sovereign debt problems and the uncertain US fiscal outlook will continue to cast a shadow over Hong Kong's growth prospects. Any significant adverse developments could have negative spillover effects on the Hong Kong economy through trade and financial channels. Moreover, aggressive monetary easing in advanced economies will further increase global excess liquidity. There could be further upward pressures on domestic consumer and asset prices. In particular, a continued heat-up of the housing market could further aggravate the misalignments between housing prices and the fundamentals, and increase the risk to Hong Kong's macroeconomic and financial stability.

3.2 Domestic demand

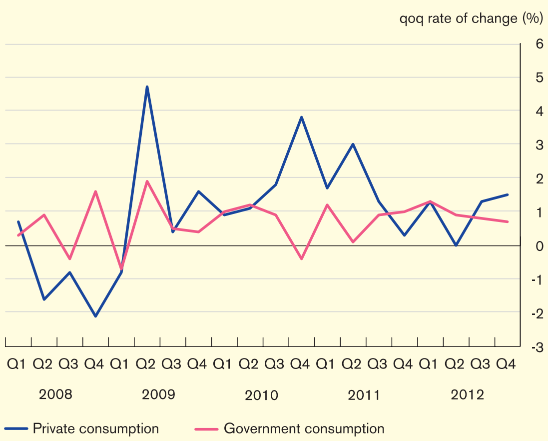
Consumption

Private consumption revived markedly in the second half of 2012 and was a main engine of real GDP growth, thanks to stable job and income conditions, earlier fiscal stimulus and increased wealth from the property and stock markets (Chart 3.4). Its sequential growth picked up to 1.3% in the third quarter and 1.5% in the fourth quarter. Consumption of goods, particularly durable goods, rose at a faster pace. Service consumption also displayed a growth pick-up amid increased financial market activities. Box 2 explains the strength of private consumption in recent years, which was found to have accounted for the deterioration in the current account balance in Hong Kong during the period.

In 2013, private consumption growth is likely to remain strong on the back of sanguine consumer sentiment, labour market resilience and sustained rises in incomes. The relief measures recently introduced in the 2013/14 Budget will also provide additional support. The mean consensus forecast for private consumption growth is now 3.9% for 2013, slightly slower than the 4.0% growth in 2012.

Government consumption continued to hold up reasonably well, expanding by 0.8% in the third quarter and 0.7% in the fourth quarter (Chart 3.4). Its growth rate is expected to pick up somewhat in the future as suggested in the 2013/14 Budget, where the recurrent part of public expenditure is projected to rise by 8.4% in real terms in the coming fiscal year, higher than the 6.8% increase in 2012/13. [11]

Chart 3.4
Private and government consumption



Source: C&SD.

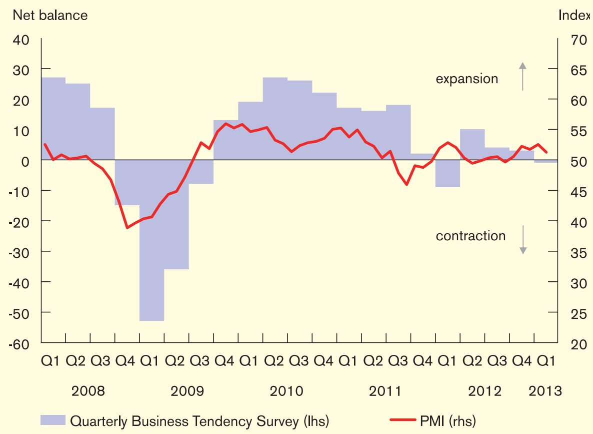
[11] The 6.8% increase in recurrent public expenditure in 2012/13 was based on the 2012/13 Budget projections.

Investment

After being weighed down by inventory destocking in the third quarter, overall investment spending expanded appreciably in the fourth quarter, contributing 1.3 percentage points to real GDP growth. Apart from the volatile inventory investment, gross fixed capital formation remained strong in the second half of the year, attributable to increased public and private construction activity as well as robust capital spending on machinery and equipment. Inventory investment was a significant drag in the third quarter because of active destocking.

While investments in buildings and construction are expected to power ahead in 2013, supported by continued buoyancy in private construction activity and a robust pipeline of public infrastructure works, the outlook for business capital spending and inventory investment is less certain as business sentiment remains somewhat cautious. This is evident in the latest Quarterly Business Tendency Survey (QBTS) and in the recent PMI readings (Chart 3.5). Market consensus now expects a 5.8% increase in gross fixed capital formation in 2013, compared with the 9.1% increase in 2012.

Chart 3.5
Business sentiment

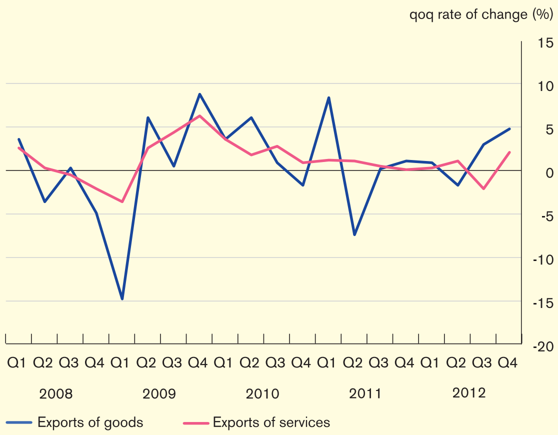


Sources: C&SD and Markit Economics.

3.3 External trade

Hong Kong's overall export performance improved in the second half of 2012 along with the stabilising external conditions. Exports of goods increased briskly by a sequential 3.0% in the third quarter and 4.8% in the fourth quarter (Chart 3.6). This reflected a number of factors including increased external demand from the US, stronger global demand for new electronic products and a growth pick-up of the Mainland economy which helped revive the intra-Asia trade. As for exports of services, a 2.1% contraction was reported in the third quarter, followed by a 2.1% growth in the fourth quarter. The merchanting and other trade-related services components improved alongside increased trade flows, while inbound tourism grew faster.

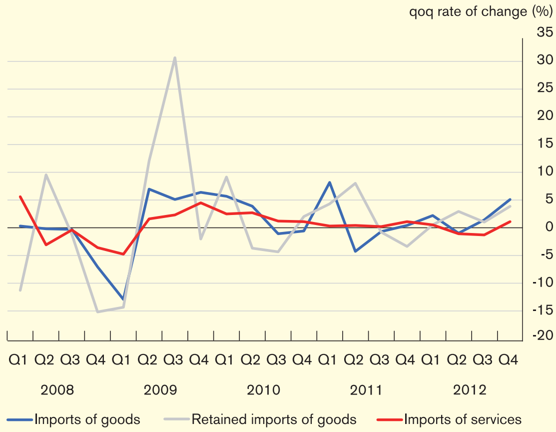
Chart 3.6
Exports of goods and services



Source: C&SD.

Imports of goods revived strongly in the second half of 2012, with sequential growth accelerating to 5.2% in the fourth quarter from 1.5% in the third quarter (Chart 3.7). Robust domestic demand and improving export-induced demand – as reflected in retained imports and re-exports respectively – were the main propellers behind the faster growth in imports of goods. Imports of services declined by 1.2% in the third quarter and then picked up by 1.2% in the fourth quarter. The improving services demand was partly driven by stronger trade-related imports.

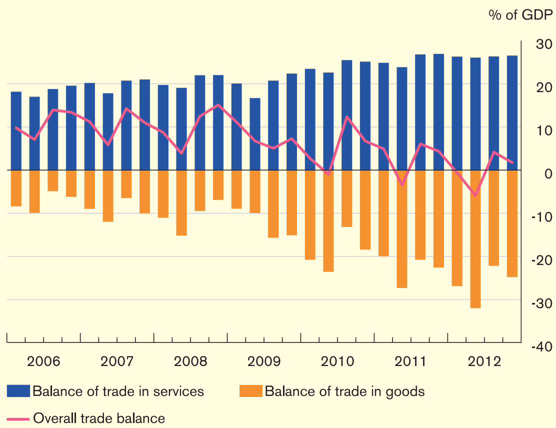
Chart 3.7
Imports of goods and services



Source: C&SD and HKMA staff estimates.

As imports outperformed exports, net exports turned from a contributor to real GDP growth in the third quarter to a sizeable drag in the fourth quarter. In value terms, the seasonally unadjusted overall trade balance recorded a surplus in the second half of 2012, at $31.6 billion (2.9% of GDP), smaller than the surplus of $52.8 billion (5.2% of GDP) recorded in the second half of 2011 (Chart 3.8).

Chart 3.8
Trade balance by component (in nominal terms)



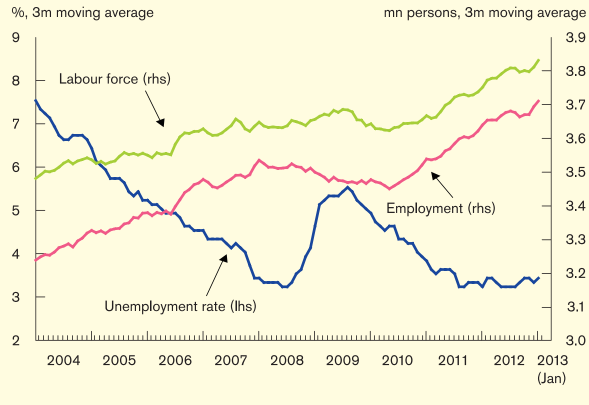
Source: C&SD.

Despite positive developments in recent months, the prospects for a sustained recovery in Hong Kong's exports remain subject to uncertainty. The lingering weakness of the European economies, together with a sluggish recovery in the US, can pose some downside risks to Hong Kong's exports. Reflecting this, the latest QBTS and the HKTDC Export Index still pointed to a negative export outlook. Yet, the strength of the Mainland economy and its flow-on effects on intra-Asia trade are likely to provide some offset. Market consensus expects merchandise exports to increase by 8.2% in nominal terms in 2013, faster than the 5.0% increase in 2012. Overall services exports will benefit from a revival in trade-related and transportation services amid increased trade flows. Inbound tourism and financial services will also be supportive. In anticipation of robust domestic demand and rising export-induced demand, imports of goods and services are expected to progress steadily.

3.4 Labour market conditions

The labour market remained robust in 2012. The seasonally adjusted three-month moving-average unemployment rate hovered between 3.2% and 3.4% in the second half of 2012, staying low at 3.4% in January (Chart 3.9). While the labour force participation rate edged up slightly to 60.8% in January 2013, employment reached a record high of 3.71 million in the same month. Both higher-skilled and lower-skilled segments of the labour market were tight, with the unemployment rate in major sectors, such as manufacturing, import/export trade and wholesale, staying at a low level in the period.

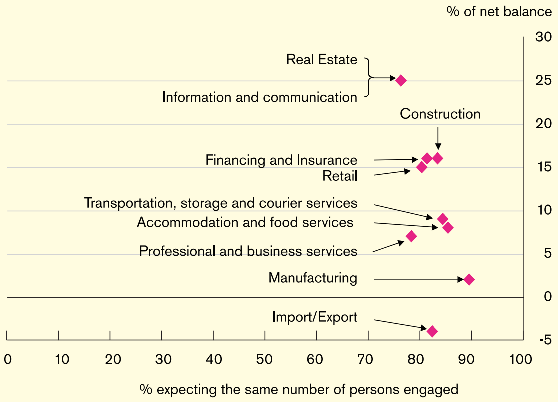
Chart 3.9
Labour market conditions



Source: C&SD.

In the near term, the labour market will continue to be supported by the prevailing strength of domestic demand. The latest QBTS for the first quarter 2013 shows that respondents from all surveyed sectors except the export/import sector expect their employment to increase in the near term, underscoring the strong hiring sentiment (Chart 3.10). The outlook of labour demand is likely to be stable barring any deterioration in the external environment.

Chart 3.10
Quarterly Business Tendency Survey for 2013 Q1: employment



Notes:

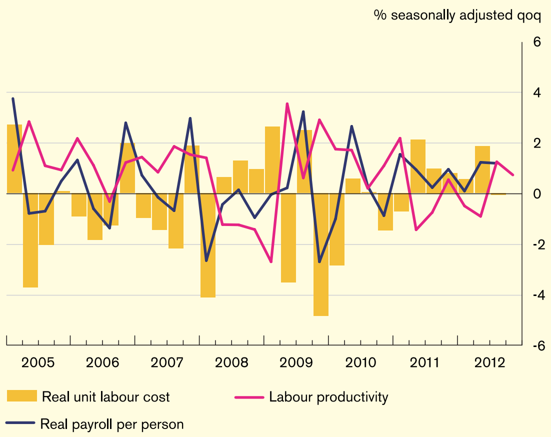
1. Net balance refers to the difference between the percentage points of respondents expecting a rise over those expecting a decline.
2. Sectors are classified according to the new Hong Kong Standard Industrial Classification Version 2.0 (HSIC V2.0).

Source: C&SD.

The domestic economy was operating around its potential during the second half of 2012. After the sluggish performance in the second quarter, the economy appeared to have regained momentum in the third and fourth quarters, with the output gap staying almost closed during the same period. The growth momentum also supported the labour market, with the unemployment rate continuing to stay at a relatively low level.

Labour costs remained on the uptrend in face of the robust labour demand and tight labour market conditions. In particular, the real payroll per person for the second and third quarters of 2012 combined registered a 1.7% increase over the previous two quarters (Chart 3.11). Nevertheless, the reaccelerated output growth in the third quarter of 2012 has supported labour productivity, halting a multiple-quarter uptrend of the real unit labour costs from a 1.8% quarter-on-quarter increase in the second quarter of 2012 to a 0.1% decline in the third quarter.

Chart 3.11
Unit labour cost and labour productivity



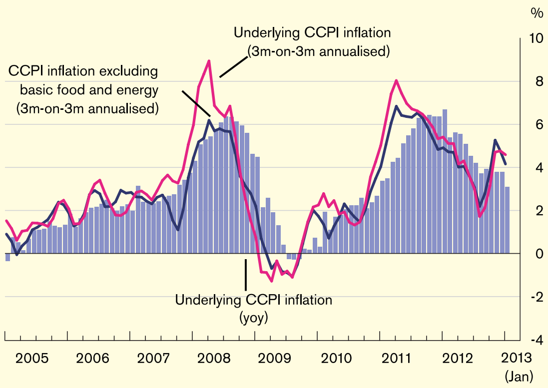
Sources: C&SD and HKMA staff estimates.

The domestic economy is expected to regain a firmer footing in the near term. As such, labour demand is likely to be supported, and labour market tightness could well persist.

3.5 Consumer prices

Local inflation momentum picked up along with the improvement in the local economic environment. After bottoming out at 1.6% in August, the annualised three-month-on-three-month underlying inflation rate increased steadily to reach 4.7% in December 2012 (Chart 3.12). Excluding the volatile components of basic food and energy, the core underlying inflation rate also settled on a similar upward trend, suggesting that upward price pressures may persist for a while. Notwithstanding the increase in the sequential momentum, the year-on-year underlying inflation rate remained stable at about 3.8% over the same period, and dropped to 3.1% in January, due to differences in the timing of the Chinese New Year.

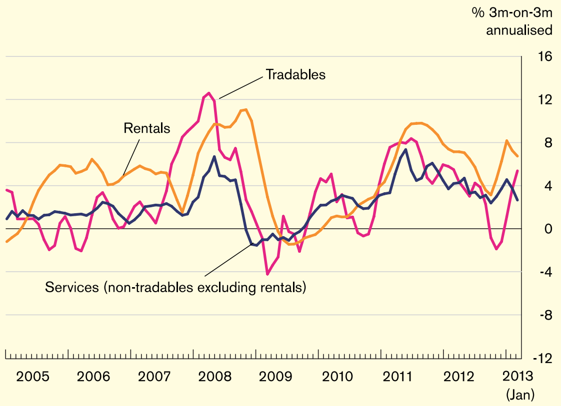
Chart 3.12
Different measures of consumer price inflation



Sources: C&SD and HKMA staff estimates.

The increase in the sequential inflation momentum was broad based. In particular, the rental component inflation rose to 8.0% in November 2012 from 3.0% in August, driven by the increase in public housing rentals in September 2012 (Chart 3.13). The non-tradable component inflation also registered some increases during the same period, reflecting the pass-through of the increases in retail rentals to the CCPI miscellaneous service component. On the other hand, the tradable component inflation picked up during the last two months of 2012, driven by the basic food and the clothing and footwear components.

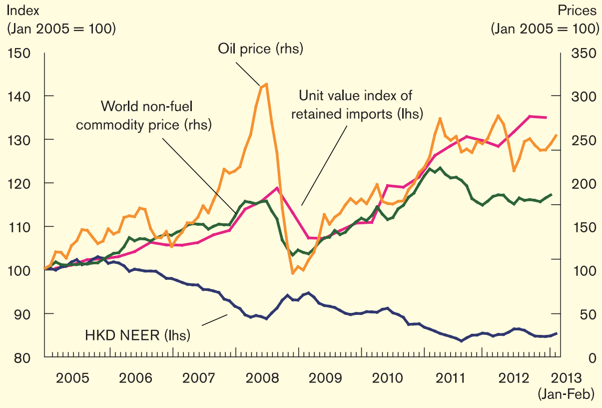
Chart 3.13
Consumer price inflation by broad component



Sources: C&SD and HKMA staff estimates.

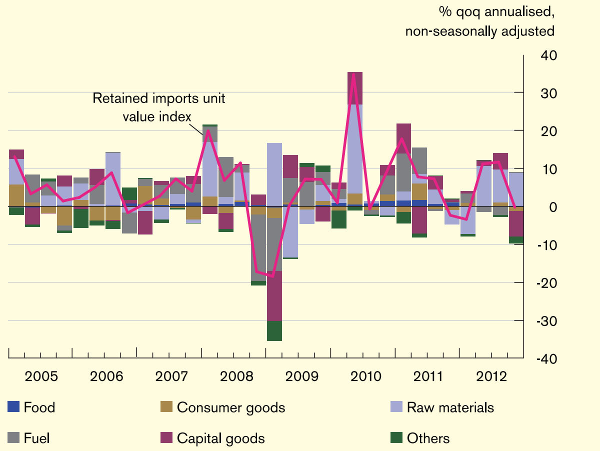
Import price inflation moderated by the end of 2012 amidst softened global commodity prices. The quarter-on-quarter annualised inflation rate dropped to -0.7% in the final quarter of 2013, from 11.2% in the third quarter of 2012 and 10.7% in the second quarter (Chart 3.14). Analysed by end-use category, raw materials continued to be the main driver of import price inflation (Chart 3.15).

Chart 3.14
Commodity and import prices



Sources: C&SD and IMF.

Chart 3.15
Contributions to import price inflation

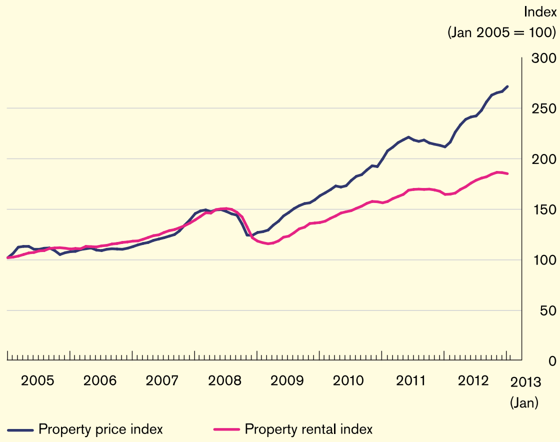


Sources: C&SD and HKMA staff estimates.

Looking ahead, the sequential inflation momentum may remain steady on the back of the pass-through from the pick-up in market rentals registered in 2012 (Chart 3.16). That said, the annual year-on-year inflation rates in 2013 may still moderate somewhat, with the latest Government forecast for the underlying inflation rate being 4.2%, down from 4.7% in 2012. In particular, the fragile global economic environment is expected to help contain commodity price pressures. In addition, the local output gap is estimated to be close to zero in the second half of 2012, restraining labour cost pressures.

In terms of risks to the baseline outlook, on the upside, unfavourable weather conditions in food producing countries, such as China, may add some volatility to the CCPI food component inflation. Meanwhile, abundant global liquidity, driven by quantitative easing in the advanced economies may pose sharper-than-expected upward pressures to global commodity and asset prices. More-than-expected resilience in the property market may also boost the CCPI rental component inflation to higher-than-expected levels going forward. On the downside, any unexpected sharp deterioration in the external environment, for example, due to a worsening in the European sovereign debt crisis or an increase in the geopolitical risk in North East Asia, may drag on global growth and consequently put demand pressures on local inflation.

Chart 3.16
Residential property price and rental indices

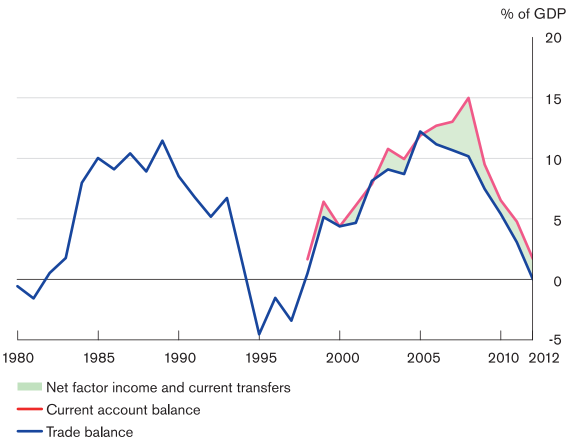


Source: Rating and Valuation Department (R&VD).

Box 2
Recent movements of the current account balance in Hong Kong

Hong Kong's current account balance has declined in recent years, from recording a surplus equivalent to 15% of GDP in 2008 down to 6% of GDP in 2011 and about 2% of GDP in 2012 (Chart B2.1). This article explains the recent decline in Hong Kong's current account balance, based on the trade-balance approach and the savings-investment approach. We find that it was much stronger domestic consumption (hence a decline in domestic savings) that has contributed to such developments. This leads us to examine in further detail the domestic consumption behaviour. Our empirical study shows that rising net housing wealth as a result of the booming property market could have explained more than half of the consumption growth since 2009.

Chart B2.1
Hong Kong's current account balance under the trade balance approach



Source: C&SD.

The concept of current account balance and two analytical approaches

The current account balance reflects the gap between income and spending in an economy, by measuring the net earnings from "here and now" transactions (i.e. those transactions that do not give rise to future claims) with foreigners during a specific period of time. It is usually viewed from the perspective of external balance of an economy as mainly the difference between exports and imports, also known as the trade balance approach. Essentially, the current account balance is the sum of the trade balance, net factor income and net current transfers:

Current account balance
= Trade balance
+ Net factor income + Net current transfers

For most economies including Hong Kong, trade balance itself is the main thrust of the current account balance. A current account surplus therefore usually reflects exports in excess of imports, and vice versa in the case of a current account deficit.

Another way to look at the current account balance is the savings-investment (or internal balance) approach. By the national income accounting identity, the current account balance can be viewed as the gap between national savings and domestic investment:

Gross national product (GNP) [12]
= Consumption + Investment
+ Current account balance

[12] In our discussion, the term GNP refers to the gross national disposable income as defined in the sixth edition of the IMF's *Balance of Payments and International Investment Position Manual*.

Current account balance
= GNP – (Consumption + Investment)
= (GNP – Consumption) – Investment
= National savings – Investment

Unlike the trade balance approach, the savings-investment approach stresses how macroeconomic factors, through domestic consumption and investment decisions, can ultimately determine the current account balance. When an economy runs a current account surplus, gross national savings must, by definition, exceed domestic investment. Alternately, when an economy has a current account deficit, national savings must be less than domestic investment.

What causes the recent decline in Hong Kong's current account balance?

(A) The trade balance approach

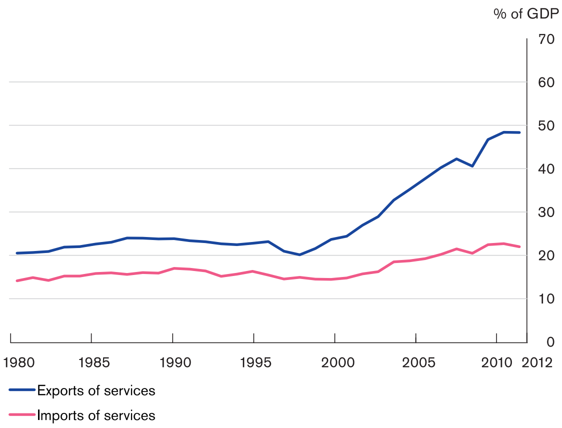
Along with the current account deterioration in recent years, Hong Kong's trade balance also worsened, from a surplus equivalent to 10% of GDP in 2008 to 3% of GDP in 2011 and nil in 2012 (see Chart B2.1 above). A further look at the trade dynamics suggests that much stronger imports, rather than lower exports, have contributed to such developments.

Chart B2.2 shows that there has not been a significant drop in exports of goods (i.e. measured as domestic exports and re-export earnings) in GDP terms since 2009. Market diversification has allowed Hong Kong traders to benefit from the two-speed world, with weaker demand from the advanced economies being offset by stronger demand from the developing economies including Mainland China and other emerging economies in Asia, Latin America and the Middle East. Services exports also held up well. Offshore trade, as part of services exports, continued to expand. More importantly, inbound tourism has provided considerable support to services exports, leading to their dramatic increase in recent years (Chart B2.3).

Chart B2.2
Hong Kong's trade in goods

Source: C&SD.

Chart B2.3
Hong Kong's trade in services



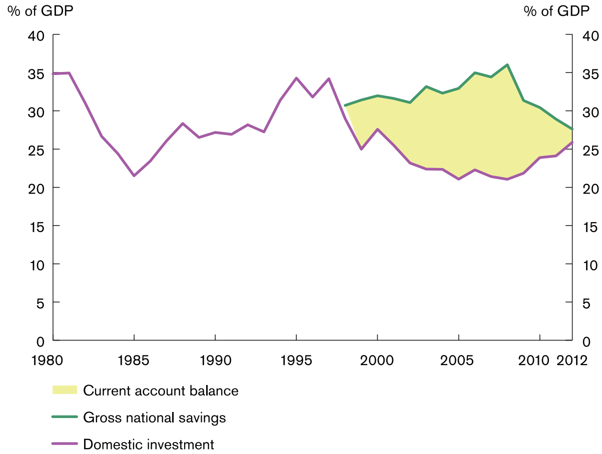
Source: C&SD.

On the other hand, over the past five years, retained imports of goods have increased noticeably to 59% of GDP from 45% of GDP. This reflected stronger domestic demand, as well as surging inbound tourist spending, which also contributed to the rise in services exports in recent years. However, it is difficult to know to what extent it is domestic demand or tourist demand that has contributed to the rise in retained imports. [13] Meanwhile, services imports have grown steadily. If excluding those related to trade and logistics, there would be even stronger increases in services imports due to robust demand for financial and insurance services and outbound travel.

(B) The savings-investment approach

The savings-investment approach provides another perspective of the recent decline in Hong Kong's current account balance. Chart B2.4 shows that it was mainly driven by a decrease in the savings rate to 28% of GDP in 2012 from 36% of GDP in 2008. That also means domestic consumption, as the mirror image of savings, has grown rapidly and much faster than income. [14] On the other hand, there are no signs of excessive investment. The investment rate (i.e. the investment-to-GDP ratio), while increasing gradually amid a robust pipeline of government infrastructure projects, remained below the historical average level.

Chart B2.4
Hong Kong's current account balance under the savings-investment approach



Source: C&SD.

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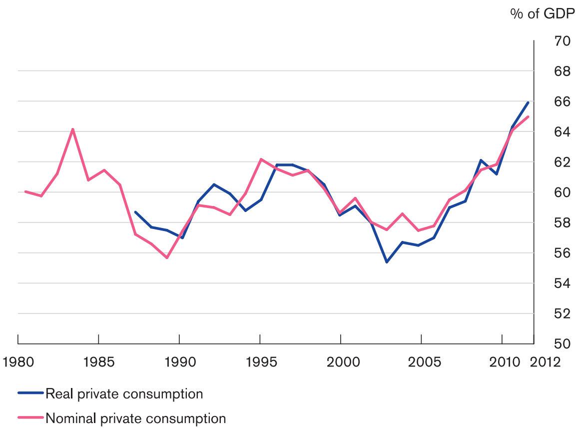
13 Shuttle trade from Hong Kong to Mainland China can potentially understate exports and hence the trade balance and current account balance. While it is difficult to estimate the exact size of shuttle trade due to lack of reliable data, it seems not likely that shuttle trade alone could have explained the decline in Hong Kong's current account balance, which amounted to 13 percentage points of GDP over the past five years. Moreover, given that shuttle trade has existed since well before 2008, the extent of any misestimation on the current account balance would be relatively steady over time, and therefore would not have a significant impact on its changes over time.

14 We also use household expenditure surveys to cross check the savings rate. Household expenditure surveys, however, are conducted every five years, the latest two rounds in 2005 and 2010 respectively. As such, the comparison period does not exactly correspond to the period (from 2008 to present) over which we observed a sharper deterioration in Hong Kong's current account position. With this caveat and limitation, we find that the trend of the household savings rate so derived collates with that using the macro numbers we deployed in this article. The average household savings rate declined by 3.3 percentage points to 11.5% of income between 2005 and 2010. This is consistent with the decrease in the aggregate savings rate (by 2.5 percentage points of GDP) over this same period using the macro numbers.

Indeed, private consumption has increased at an average annualised rate of 6.3% since the second quarter of 2009. Moreover, private consumption growth was high in both nominal and real terms, suggesting that inflation or the price effect was not the main underpinning force of increased spending. The synchronised increase in both the nominal and real private consumption-to-GDP ratios also indicates that increased spending was not simply a nominal but also a real phenomenon (Chart B2.5).

Chart B2.5
Private consumption-to-GDP ratio



Source: C&SD.

What could have driven the recent strong consumption growth in Hong Kong?

We have identified stronger domestic consumption (hence a decline in domestic savings) as the main cause of the recent decline in the current account balance. But what could have driven the strong consumption growth? Standard macroeconomic theories suggest consumption depends on such factors as labour income, wealth, and the real interest rate. They respectively account for the income effect, wealth effect and inter-temporal substitution effect. Higher income induces more consumption, while rising asset prices make consumers wealthier or feel wealthier, so they spend more. Rising asset prices also allow households to have more collaterals against which to borrow and spend. Regarding the inter-temporal substitution effect, a lower real interest rate will induce consumers to spend more today because current consumption becomes less costly than future consumption.

Besides these factors, long-term structural factors such as population ageing and financial deepening may also affect consumption. Moreover, households may save more and consume less out of precautionary motive if they face more income uncertainty, which may be measured by unemployment volatility.

To determine the underlying factors behind the strong consumption growth in recent years, we estimate a consumption function for Hong Kong following Lai and Lam (2002) [16], Cutler (2004) [16] and Liu, Pauwels and Tsang (2007a). [17] Determinants considered in the analysis include a) cyclical factors such as labour income, net housing wealth, net financial wealth and real interest rate; b) long-term structural factors such as ageing population and financial deepening and unemployment volatility.

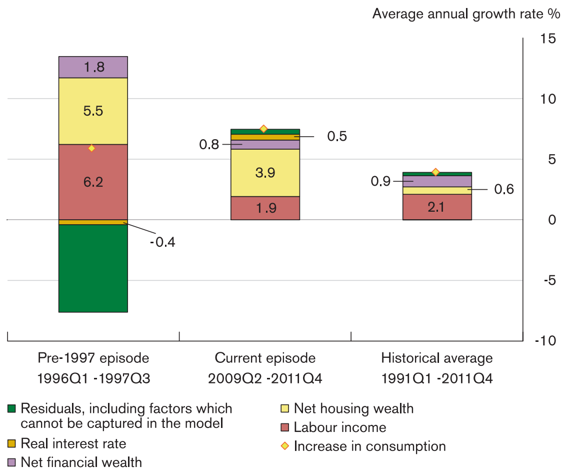
[15] Lai, Kitty and Raphael Lam (2002), "The nexus of consumer credit, household debt service and consumption," HKMA Quarterly Bulletin, November 2002, 35-48.

[16] Cutler, Joanne (2004), "The relationship between consumption, income and wealth in Hong Kong," Hong Kong Institute for Monetary Research Working Paper No.01/2004.

[17] Liu, Li-gang, Laurent L. Pauwels and Andrew Tsang (2007), "Hong Kong's consumption function revisited," HKMA Working Paper No.16/2007.

We find that net housing wealth was the main driver of the strong consumption growth in recent years (Chart B2.6). It contributed more than half of the consumption growth during 2009-2011, by adding, in annualised terms, about 3.9 percentage points to the 7.5% growth rate. This growth contribution was much higher than the historical average during 1991-2011, which was just some 16% of the consumption growth over this period of time. Similarly, net housing wealth also made an outsized contribution during the pre-1997 episode.

Chart B2.6
Drivers of consumption growth in the current episode, the pre-1997 episode and the period from 1991 to 2011



Source: HKMA staff estimates.

The contribution from labour income was still visible in recent years but not as large as that in the pre-1997 episode or over the long term. The historical norm shows that consumption growth has been largely driven by income growth over the past two decades. It is worth pointing out that negative real interest rates, through the inter-temporal substitution effect, also played a role in fuelling consumption growth in recent years. In contrast, in the pre-1997 episode and over the long term, real interest rates only provided negative and nil contributions respectively. The contribution from net financial wealth was relatively small in recent years when compared with previous episodes. [18] Moreover, none of the long-term structural factors are found to be statistically significant.

Conclusion

Our analysis shows that the decline in the current account balance since 2009 was mainly due to stronger domestic consumption (hence a decline in domestic savings). We also find that much of the consumption growth could be accounted for by the housing wealth effect and to a lesser extent by rising labour income. However, housing wealth in Hong Kong can be volatile. Indeed, the strong consumption growth in the pre-1997 episode was also to a large extent driven by housing wealth, but the burst of the property bubble eventually led to a sharp decline in consumption and plunged the economy into recession. This reminds us that property market cycles can pose risks not only to banking and financial stability but also to macroeconomic stability.

[18] This could be due to a faster rise in consumer credit in recent years, which would act as a drag on net financial wealth. Nevertheless, consumer credit may have helped support consumption growth in recent years, as credit card advances and other personal loans have increased by about 15% each year since 2010.