

## 3. Domestic economy

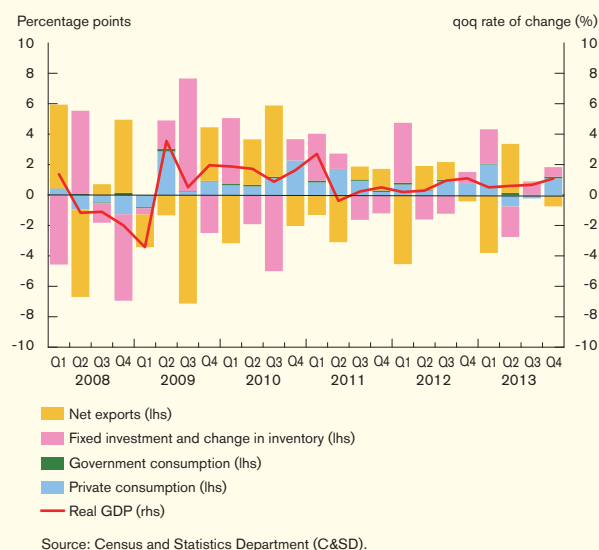
The Hong Kong economy picked up faster in the second half of 2013 with the support of stronger domestic demand and improving export performance. The growth momentum is expected to strengthen further in 2014, but subject to uncertainties mainly stemming from the US monetary policy normalisation process. Meanwhile, domestic inflation will likely remain contained along with slower increase in residential property rentals.

### 3.1 Real activities

Hong Kong's real GDP growth accelerated to a quarter-on-quarter rate of 0.7% in the third quarter and 1.1% in the fourth quarter of 2013 on the back of stronger domestic demand and gradual recovery in external demand (Chart 3.1). Private consumption held up well amid stable employment conditions and broadly improved incomes, while government consumption increased steadily. Overall investment strengthened due to robust machinery and equipment acquisition, which helped offset weaker building and construction activities. Meanwhile, export performance improved with gradual recovery of the advanced economies and continued support from a resilient Mainland China economy (Chart 3.2). However, as retained imports grew much faster than exports, net exports continued to be a drag on real GDP growth.

The year-on-year real GDP growth rate remained steady at 2.8% and 3.0% in the third and fourth quarters respectively. For the whole of 2013, real GDP growth was 2.9%, up from 1.5% a year earlier but still below the annual average of 4.5% in the past 10 years. Labour market conditions however remained broadly stable, with the unemployment rate edging down to 3.2% in the fourth quarter and total employment growing at a robust pace. Box 2 discusses some possible reasons behind the stable labour market conditions in spite of the below-trend GDP growth in recent years.

**Chart 3.1**  
Real GDP growth and contribution by major expenditure components



**Chart 3.2**  
Exports of goods and services



## Domestic economy

The Hong Kong economy is expected to grow at a moderately faster pace in 2014. External demand would lend further support to export performance as recovery in the advanced economies has become more entrenched and the Mainland China economy remains broadly resilient. As for domestic demand, private consumption would grow moderately with the support of still-positive consumer confidence, stable labour market conditions and improving income prospects amid global trade recovery. The housing wealth effect, however, could weaken or even turn to a drag on consumption amid the cooling of the property market. Ongoing infrastructure works, a pick-up in private-sector building and construction activities, as well as sustained increase in machinery and equipment acquisition due to improving business outlook would also contribute to GDP growth. Nevertheless, the fiscal stance has become slightly contractionary due to cutbacks in the size and scope of relief measures.

**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
<b>2013</b>				
Jan	1.1	0.9	7.5	4.0
Feb	0.1	0.3	6.1	4.1
Mar	0.9	0.4	5.5	4.0
Apr	1.3	0.5	5.9	3.6
May	-0.8	0.3	3.8	3.2
Jun	0.0	-0.1	2.6	2.3
Jul	-1.2	0.3	0.2	1.8
Aug	0.0	0.3	0.1	1.8
Sep	0.5	0.5	-0.3	1.9
Oct	0.4	0.3	-1.2	1.6
Nov	2.1	0.8	1.8	2.2
Dec	0.6	0.5	2.4	2.8
<b>2014</b>				
Jan	2.5	0.5	6.2	3.0
Feb	n.a.	0.4	n.a.	3.1

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.

The HKMA in-house composite index of leading indicators predicts a moderately faster growth path for the Hong Kong economy in the first half of 2014, as shown in the solid six-month growth rate (Table 3.A). Overall for 2014, private-sector

analysts project Hong Kong's real GDP growth to be in the range of 2.8-4.0% and average around 3.5%. The Government also sees growth strengthening to the range of 3.0-4.0%.

The relatively more favourable outlook for the Hong Kong economy is subject to a number of uncertainties and risks. On the downside, the predominant external risk came from the still-uncertain pace and scale of the US Fed's tapering and interest rate normalisation. Any significant adverse developments could aggravate volatilities in the financial market conditions, fund flows and liquidity situations, and overshadow Hong Kong's growth prospects through the trade and financial channels. Elsewhere, a slower-than-expected growth in the Mainland China economy could cause negative spillovers to Hong Kong given the increasingly close economic relations between the two places. Domestically, the property market remains a major concern. The overvalued and thinly-traded market is prone to downward pressures in view of eventual rate hikes and rises in medium-term flat supply. Should the market react unfavourably to the US Fed's monetary actions or there be a significant reversal of fund flows, it could exacerbate downward adjustments in property prices, thereby threatening broader macroeconomic adjustments and asset price corrections.

On the upside, better-than-expected economic performance of the advanced economies and the Mainland China economy could lift global growth and international trade flows, thereby raising Hong Kong's external demand and boosting consumption expenditure perhaps through improved consumer sentiment.

## Box 2

### Revisiting the tight labour market puzzle in Hong Kong

Labour market conditions in Hong Kong have been considered tight in recent years despite the continued moderate growth of the domestic economy. The unemployment rate only moved little around a low of 3.3% in both 2012 and 2013, with robust employment growth offsetting a rise in the labour force participation. The real GDP growth, on the other hand, slowed to 1.5% and 2.9% respectively compared with the long-term average of 4.5% over the past ten years. This situation seems contrary to the general observation that negative output gaps usually coincide with rising unemployment.

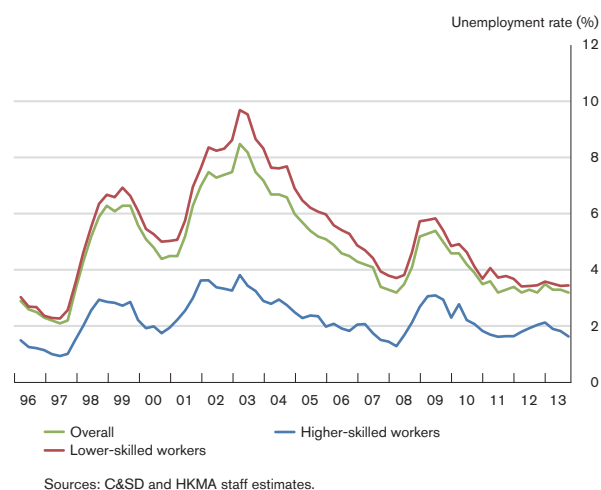
This Box provides some possible reasons for the tight labour market puzzle in recent years. Our analysis suggests that certain structural factors have increased the resilience in the unskilled segment of the labour market. Moreover, we find empirical support for lesser skill mismatch in the labour market and a decline in frictional unemployment. We also find that Hong Kong's potential GDP growth might have decreased somewhat after the global financial crisis (GFC). As such, the actual growth rate, while seeing some slowdown, might not have been too far away from its potential.

#### *Structural factors for increased labour market resilience*

The overall unemployment rate may mask diverse developments in different segments of the labour market. A breakdown by work skill

level shows that the unemployment rate for lower-skilled workers actually edged down and has been resilient against the GDP growth slowdown during this period (Chart B2.1).<sup>10</sup> In fact, there has been a declining trend in the unemployment rate for lower-skilled workers since 2003.

**Chart B2.1**  
Unemployment rate by skill segment



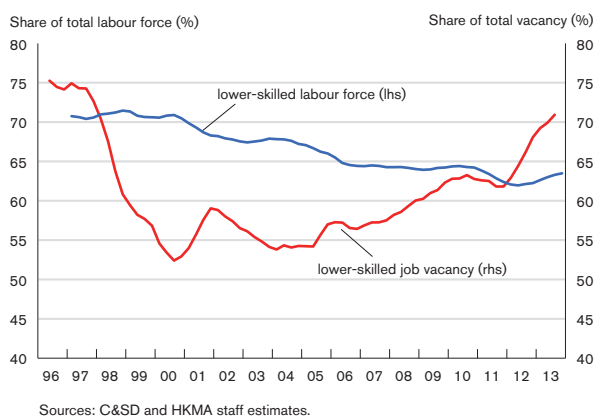
In the September 2012 issue of this report, we pointed out that labour market resilience has increased in the lower-skilled segment due to demographic changes and vibrant growth in inbound tourism following the implementation of the individual travel scheme (IVS).<sup>11</sup> Specifically, with the size of the young cohort population declining and more of them entering into the higher-skilled segment, there has been a decline in the supply of young people in the lower-skilled segment of the labour market. In the meantime, the implementation of the IVS created more jobs in tourism-related sectors,

<sup>10</sup> In this study, skill level is classified by occupation. Lower-skilled workers include clerical support workers, service and sales workers, craft and related workers, plant and machine operators and assemblers, and workers in elementary occupations. Higher-skilled workers include managers and administrators, professionals, and associate professionals.

<sup>11</sup> For details, please refer to the HKMA (2012), "The Tight Labour Market Puzzle: Will It Remain Resilient?" *HKMA Half-Yearly Monetary & Financial Stability Report*, September, pp 30-32.

which are relatively more labour intensive. As a result of restrained supply and strengthened demand (Chart B2.2), labour market tightness in the lower-skilled segment has structurally increased.

**Chart B2.2**  
Labour force and job vacancy in the lower-skilled segment

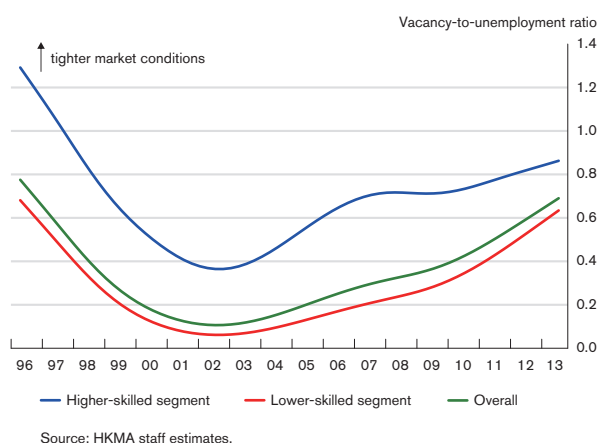


**Increased skill matching**

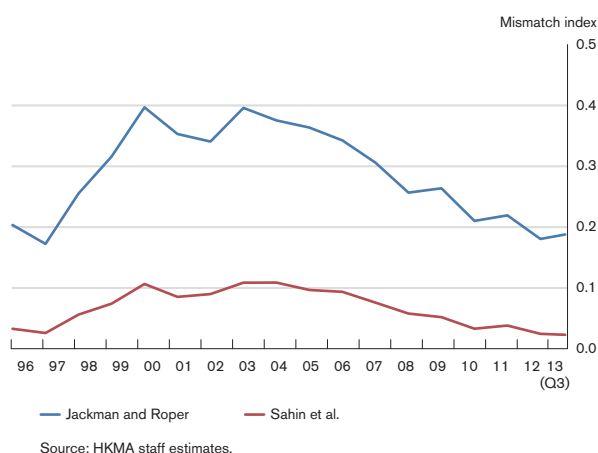
In relation to the increased tightness in the lower-skilled segment of the labour market, it is likely that frictional unemployment has declined in Hong Kong over the past few years. A cursory look at the vacancy-to-unemployment ratios shows that labour market tightness has been converging across skill segments (Chart B2.3), in the sense that the level of ease/ difficulty in finding a job has become increasingly similar for both the higher-skilled and lower-skilled. This can be interpreted as lesser skill mismatch. In this notion, skill mismatch refers to the ability of the labour market to match unemployed workers to jobs in a suitable *skill segment*. However, it should be noted that lesser skill mismatch does not preclude imbalances in manpower demand and supply in certain *sectors*, such as what was reported in the domestic construction industry recently.

Following Jackman and Roper (1987), we compile a skill mismatch index and find empirical support for lesser skill mismatch in Hong Kong’s labour market.<sup>12</sup> The index measures the extent of misallocated unemployed workers in the total unemployment under eight broad occupational categories. It ranges between zero and one, equal to zero when all occupations are in perfect alignment and equal to one when in complete misalignment. Chart B2.4 shows that the skill mismatch index has followed a downward trend since 2003 and a similar index following Sahin et al. (2012) gives like results.<sup>13</sup>

**Chart B2.3**  
The vacancy-to-unemployment ratio by skill segment (Hodrick-Prescott filtered)



**Chart B2.4**  
Mismatch indices

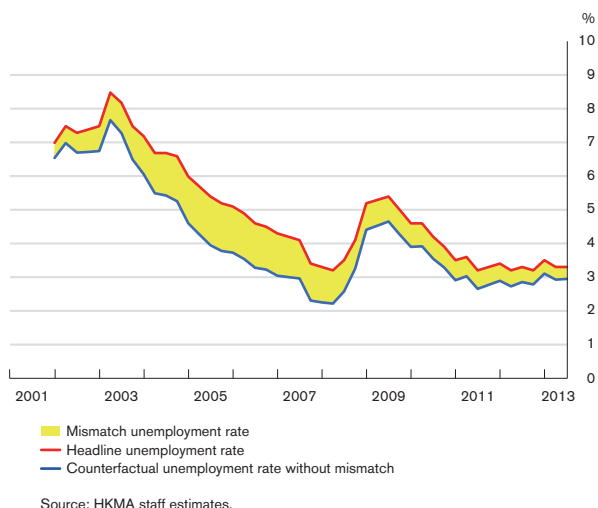


<sup>12</sup> Jackman, R. and S. Roper (1987), “Structural Unemployment”, *Oxford Bulletin of Economics and Statistics*, 49, pp 9-36.

<sup>13</sup> Sahin, A., J. Song, G. Topa, and G.L. Violante (2012), “Mismatch Unemployment”, Federal Reserve Bank of New York Staff Reports, No. 566.

We then derive a measure of mismatch unemployment rate following Sahin et. al., which is defined as the difference between the actual unemployment rate and the counterfactual unemployment rate in the absence of skill mismatch. This measure (the yellow area) has fallen in recent years, from 1.5 percentage points in late 2005 to 0.4 percentage points in the third quarter of 2013 (Chart B2.5). This supports the view that labour market frictions arising from skill mismatch and hence frictional unemployment have declined in Hong Kong.

**Chart B2.5**  
**Mismatch unemployment**



The decrease in skill mismatch can be due to structural improvement in the job finding and hiring technology, particularly with the proliferation of online tools for job search and the rise of recruitment agencies. Nevertheless, the level of skill mismatch may also be subject to cyclical fluctuations. In the US, for example, researchers find that skill mismatch decreases in the later stage of expansions and increase in the

early stages of recoveries.<sup>14</sup> While we do not have enough data points to study this issue, there could be a similar cyclical pattern in Hong Kong.

As frictional unemployment has declined, the level of unemployment rate commensurate with full employment – the natural rate – may have decreased in Hong Kong. As such, the unemployment gap, which is the difference between the actual unemployment rate and the natural rate, may not be as large as otherwise under a higher natural rate. In this sense, the same headline unemployment rate may suggest less tightness in the labour market today than in the period when the natural rate was higher.

Despite all these findings, it should be noted that the overall labour market conditions are still considered relatively tight. In particular, labour earnings and wages have faced more upward pressure in recent years, with the annual growth rates of both nominal wage and nominal payroll picking up to more than 5% in 2011 and 2012, well above the benign growth during most of the 2000s (Chart B2.6).

**Chart B2.6**  
**Nominal payroll and nominal wage**



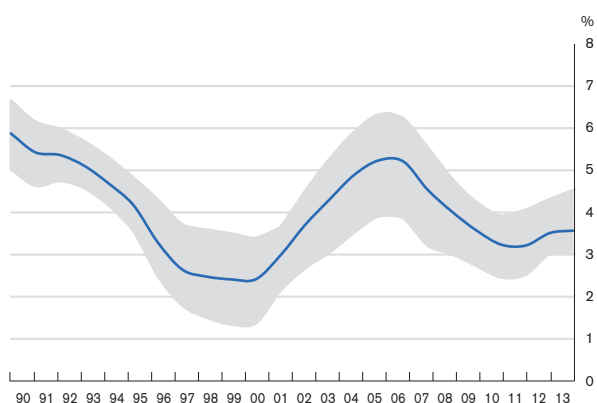
<sup>14</sup> Barnichon, R. and A. Figura (2011), "What Drives Matching Efficiency? A Tale of Composition and Dispersion," Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2011-10.

### *Moderation in potential GDP growth*

If the unemployment gap may not be as large as originally thought, how about the output gap, which is the difference between the actual GDP growth rate and its potential growth rate?

Indeed, our estimates of Hong Kong's potential GDP growth rate point to a declining trend after the GFC (Chart B2.7). This is conceivably due to the negative spillover of slower potential growth in the advanced economies and in Mainland China after the GFC. Therefore, the output gap of Hong Kong may not be as large as otherwise expected if the potential GDP growth rate were higher.

**Chart B2.7**  
Estimates of potential GDP growth<sup>15</sup>



Source: HKMA staff estimates.

Nevertheless, it should be noted that there have been some positive signs in Hong Kong's potential growth developments more recently. While still below the pre-GFC level, our estimates of potential growth rate rose again in mid-2011 (Chart B2.7). Inputs of production have picked up positively in Hong Kong and this should help lift Hong Kong's potential growth in the medium

to longer term. Capital accumulation has increased, with private-sector gross investment in machinery and equipment rising at an annual average rate of 10.2% in real terms between 2010 and 2013. Annual growth in the labour force also accelerated to more than 2% in the past three years compared with the ten-year average of 1.1%, as a result of higher participation rate. Total factor productivity growth has remained steady around its ten-year annual average rate.

### *Concluding remarks*

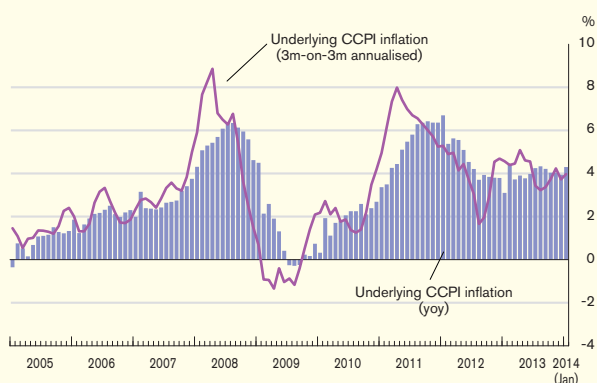
The relation between unemployment and GDP growth is never static but varies over time along with the structural and cyclical developments of an economy. Our analysis shows that certain structural developments have increased the resilience in the lower-skilled segment of the labour market in Hong Kong. But at the same time, we find that labour market efficiency has improved and frictional unemployment has decreased so that the overall labour market may not be as tight as thought in concord with the currently low level of the headline unemployment rate. The labour market might not have been as tight as thought also because Hong Kong's potential growth might have declined after the GFC. However, with GDP growth reaccelerating in recent months, the labour market is likely to have tightened again to pose some upward pressure on wages.

<sup>15</sup> Four estimation methods are used: (1) the production function approach; (2) the Hodrick-Prescott filter; (3) the Kalman filter; and (4) the IMF multivariate filter. The blue line shows the mean of the four methods and the shaded area provides the upper and lower boundaries, all smoothed using the five-year centred moving average. For details, please refer to Cheng, M., L. Chung and I. Yu (2011), "On the Estimation of the Output Gap of Hong Kong", HKMA Occasional Paper 03/2011.

### 3.2 Consumer prices

Local inflation momentum eased in the second half of 2013. Despite a pick-up in the momentum of services inflation excluding rentals, the annualised three-month-on-three-month underlying inflation rate<sup>16</sup> fell to 4.0% in January from an average rate of 4.6% in the first half of 2013 along with slower increase in housing rentals (Chart 3.3). The year-on-year underlying inflation rate remained stable at around 4.1% since mid-2013, but edged up to 4.3% in January, due to difference in the timing of Chinese New Year.

**Chart 3.3**  
Different measures of consumer price inflation

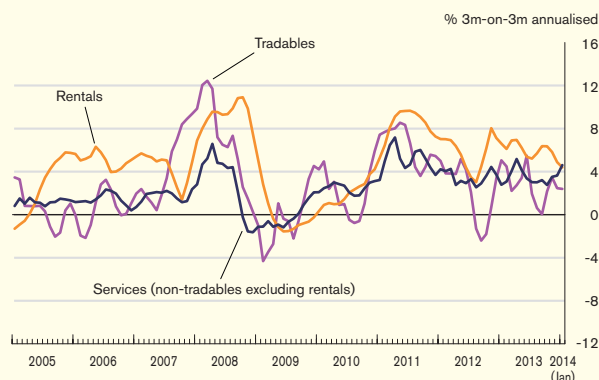


Sources: C&SD and HKMA staff estimates.

The sequential inflation momentum will likely continue to moderate. First, easing commercial rental increase is expected to offset some of the labour cost pressures, leading to a more moderate increase in services inflation. While real payroll per person continued to grow modestly at 0.4% in the third quarter of 2013, the further decline in the seasonally adjusted three-month moving-average unemployment rate to 3.1% in February

from around 3.3% in the second half of 2013 suggests increased tightness in the labour market. Latest survey indicators such as the Quarterly Business Tendency Survey (QBTS) suggest that this situation is likely to hold up and could put some upward pressures on labour costs (Chart 3.4). This is also in line with the possible closing of the output gap in 2014, which could pose some upward demand pressures on the local economy. However, the significant slowdown in the year-on-year growth of retail property rental from double digit in the first half of 2013 to single digit in the second half suggests that the overall commercial property rental could grow more moderately in the near term, thereby provide some relief to rising business costs and hence the services inflation component.

**Chart 3.4**  
Consumer price inflation by broad components



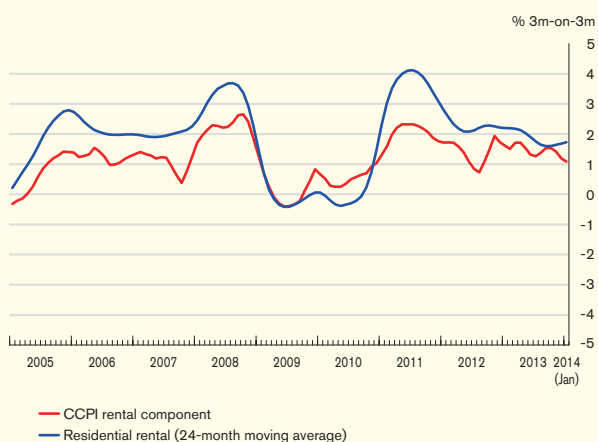
Sources: C&SD and HKMA staff estimates.

Other factors are also expected to keep inflationary pressures contained in the near term. The increase in import prices is expected to be mild as global commodity prices will likely remain broadly stable due to anticipated increase in supply, hence reducing inflation pressure on

<sup>16</sup> The underlying CCPI inflation rate nets out the effects of all Government's one-off relief measures from the headline CCPI inflation rate.

tradables. More importantly, sequential inflation is likely to ease amid a more moderate increase in housing rentals, which accounts for about 30% of total inflation (Chart 3.5). Overall, the annual year-on-year inflation rate for 2014 is likely to decline, with the latest Government forecast projecting an underlying inflation rate of 3.7%, down from 4.0% in 2013.

**Chart 3.5**  
**CCPI rental component and market rentals**



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

The inflation outlook is subject to risks stemming mainly from the strength of external demand and local property market performance. On the upside, faster-than-expected growth in the advanced economies and Mainland China could increase demand pressure and labour market tightness further in Hong Kong, putting more upward pressures on local inflation. On the downside, given the backdrop of the US Fed’s normalisation of monetary policy, global financial market volatility could heighten further amid lingering concerns over emerging markets, which could result in capital outflows and tighter financial conditions in Hong Kong. Any rise in local mortgage rates could pose downward pressures on property prices which would further weigh on rentals and dampen inflationary pressures.