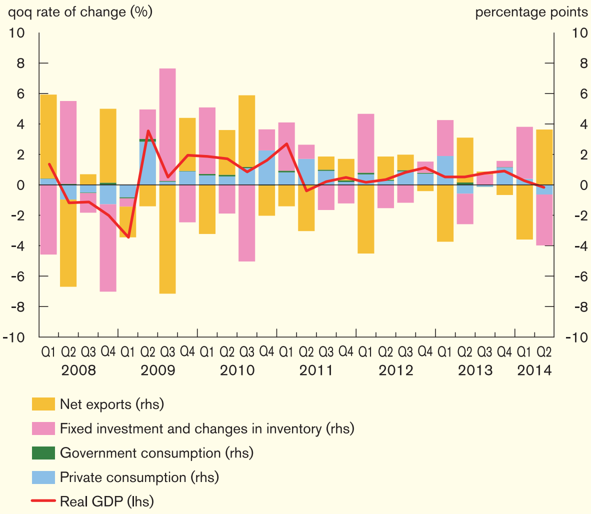
3. Domestic economy

The Hong Kong economy saw little growth in the first half of 2014, with weaker domestic demand and tourist spending offsetting a moderate rise in merchandise exports. While a pick-up in growth momentum is in prospect, as lifted by stronger external demand, downside risks remain amid uncertainties surrounding the global monetary, macroeconomic and financial environment and heightened geopolitical tensions. Domestic inflation will likely remain moderate on the back of mild rental increase and modest business cost pressure.

3.1 Real activities

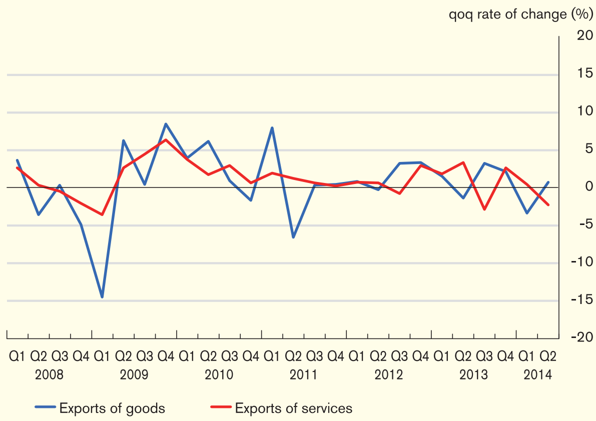
Economic activities in Hong Kong weakened in the first half of 2014, reflecting feeble domestic demand and lower inbound tourism earnings. On a seasonally adjusted quarter-to-quarter basis, real GDP declined marginally by 0.1% in the second quarter, following a 0.3% growth in the first quarter. Contrary to the developments in the first quarter, domestic demand contracted notably and detracted a total of 3.8 percentage points from the second-quarter real GDP growth (Chart 3.1). Investment spending was the primary drag, led by a sharp decrease in machinery and equipment acquisitions. Private consumption also declined, mainly due to weaker growth prospects and receding housing wealth effects. Meanwhile, services exports were weighed down by weaker tourist spending and, to a lesser extent, softer financial market activities (Chart 3.2). A brighter spot was moderate improvement in exports of goods on the back of stronger external demand.

Chart 3.1
Real GDP growth and contribution by major expenditure components



Sources: Census and Statistics Department (C&SD) and HKMA staff estimates.

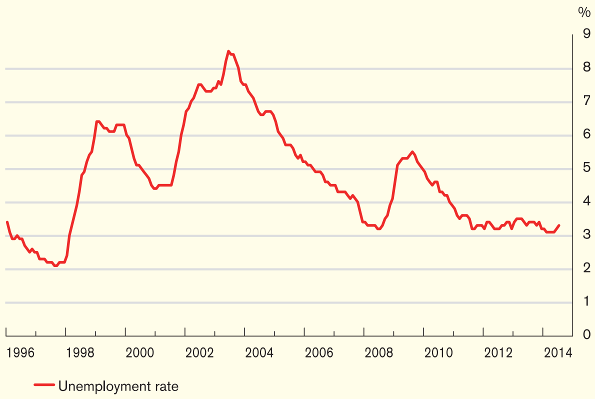
Chart 3.2
Exports of goods and services in real terms



Source: C&SD.

The year-on-year real GDP growth rate slowed to 2.6% and 1.8% respectively in the first and second quarters. The recent pace of growth was the slowest since the second half of 2012 and some way off the average annual growth of 4.5% in the past 10 years. Labour market conditions eased slightly along with the growth slowdown of the domestic economy (Chart 3.3). The seasonally adjusted unemployment rate edged up to 3.2% in the second quarter after hitting a 16-year low of 3.1% in the first quarter, with the retail, hotel and food services sector experiencing a relatively sharper increase. The unemployment rate of the lower-skilled segment picked up in the first half, while that of the higher-skilled segment remained stable.

Chart 3.3
Unemployment rate



Source: C&SD.

In the second half of the year, it is expected that economic activities in Hong Kong will regain sequential traction, albeit at a moderate below-trend rate. Trade in goods is expected to improve gradually with the recovery of the US economy continuing to take shape and the Mainland China economy showing signs of stabilisation following a number of targeted stimulus measures. There will also be some support from exports of trade-related services and financial services, the latter buoyed in part by the soon-to-be-launched Shanghai-Hong Kong Stock Connect pilot scheme. But softer Mainland tourist spending could continue to provide an offset. Box 3 studies the relative importance of Mainland China and the US in driving Hong Kong's economic cycle and trend growth. Regarding domestic spending, private consumption is anticipated to tick along, mainly driven by a relatively stable yet easing labour market. Overall fixed investment will continue to be supported by ongoing infrastructure projects and other building and construction activities, although capital spending tends to fluctuate. The HKMA in-house composite index of leading indicators, which keeps track of the monetary and financial conditions, housing starts, sentiment indicators and global growth prospects, also points to a modest pickup in economic activities in the second half (Table 3.A). Overall, taking into account the weak data in the first half, the Government has revised downward its range forecast of 2014 real GDP growth to 2-3% from 3-4% as announced earlier in May. Private-sector analysts have also adjusted downward their growth forecasts recently to an average of 2.4%.

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
2013				
Jul	-1.3	0.3	0.3	1.6
Aug	0.1	0.3	0.2	1.6
Sep	0.3	0.4	-0.4	1.7
Oct	0.5	0.2	-1.2	1.4
Nov	2.0	0.8	1.7	1.9
Dec	0.6	0.5	2.2	2.5
2014				
Jan	2.5	0.5	6.1	2.7
Feb	-2.7	0.4	3.2	2.7
Mar	-0.3	-0.3	2.6	2.0
Apr	-2.2	0.3	-0.2	2.1
May	0.0	0.6	-2.1	1.9
Jun	-1.1	0.6	-3.8	2.0
Jul	0.9	0.5	-5.3	2.0
Aug	n.a.	0.4	n.a.	2.0

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.

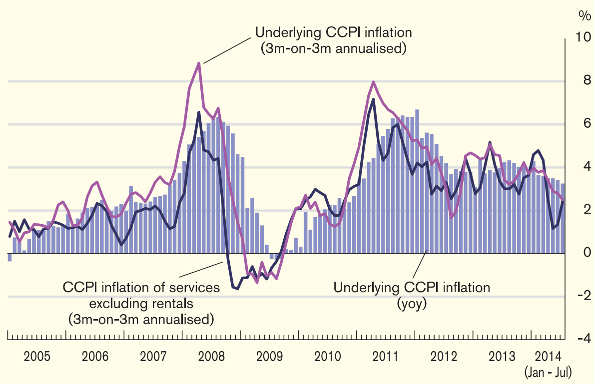
The baseline scenario in which the Hong Kong economy would resume moderate sequential growth is subject to a number of uncertainties and risks. On the downside, external demand could be weaker than expected if the recovery in the US economy slowed down, the euro area economies failed to resume growth, and the macro-financial concerns about the Mainland China economy lingered on. Moreover, worries about the future monetary policy paths of the advanced economies and a potential reversal of recent risk premia and volatility compression could pose important downside risks to the global financial market and induce volatile international capital flows, causing negative spillover effects on the Hong Kong economy. Real economic activities in Hong Kong could also be hurt through trade and financial channels if heightened geopolitical tensions translated into a source of volatility spikes or trade impediments. Domestically, property market imbalance may persist for a time, and this could pose further risks to Hong Kong's macroeconomic and financial stability.

On the upside, if the advanced economies and the Mainland China economy performed better than expected, the resultant boost to world growth and global trade flows could suggest stronger external demand for Hong Kong. This, coupled with an upswing in asset prices, could benefit local private consumption and investments through strengthened consumer and business confidence.

3.2 Consumer prices

Local inflationary pressure moderated during the first seven months of 2014, with the year-on-year underlying inflation rate dropping to 3.3% in July from 4.3% in January. The annualised three-month-on-three-month underlying inflation rate also declined to 2.5% in July from 4.0% in January, driven mainly by the easing in services inflation (Chart 3.4). In particular, the rise in labour cost has been subdued, with the real payroll per person growing at a mild pace of 0.1% in the first quarter of 2014 (Chart 3.5). The mild increase in labour cost is due to weak demand in the domestic economy, as the slightly negative output gap widened further in the first half. Meanwhile, the slow retail property rental increase, at below 2% year-on-year in recent months, also contributed to moderating inflation momentum amid the slowdown in retail sales.

Chart 3.4
Different measures of consumer price inflation



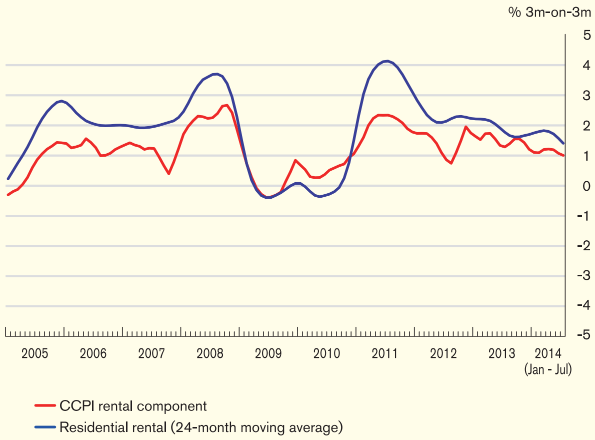
Sources: C&SD and HKMA staff estimates.

Chart 3.5
Labour cost and labour productivity

Sources: C&SD and HKMA staff estimates.

The sequential inflation momentum will likely remain moderate, as the feed-through to consumer price inflation from housing rental increase in recent months is expected to be mild (Chart 3.6). Moreover, the business cost pressure is expected to be contained given the weak labour cost pressures due to the softening in labour demand and weakness in the retail sector, as well as the expected modest increase in commercial property rental. The relief in business cost will help contain the rise in service inflation and thus ease the pressure in consumer price inflation for the rest of the year. On the whole, the annual year-on-year inflation rate for 2014 is likely to decline as compared with 2013, with the latest Government forecast for the underlying inflation rate being revised downward to 3.5% from 3.7%.

Chart 3.6
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 near-term inflation outlook is subject to risks on both sides. On the downside, the risk of sharper-than-expected slowdown in the Mainland economy and any heightening in financial market volatility or tightened monetary and financial conditions resulting from uncertainty in the timing and pace of US monetary policy normalisation could dampen Hong Kong's growth momentum and hence inflation. In particular, more significant decline in Mainland visitors' spending in Hong Kong could spill over to the local labour market and commercial property rental, which could in turn pose downward pressure on services inflation.

On the upside, faster-than-expected growth in the advanced economies could lead to an increase in local demand pressure, while the risk of intensification of geopolitical tensions could increase energy prices, thus putting upward pressures on imported inflation.

Box 3
Hong Kong's growth synchronisation with Mainland China and the US[18]

The continued economic integration between Hong Kong and Mainland China may have led to a higher degree of growth co-movement between the two economies. Headline numbers of trade and financial flows seem to suggest that the influence of Mainland China on the Hong Kong economy has become dominant, especially over the past decade. For example, 51% of Hong Kong's merchandise and services exports destined for the Mainland in 2012, while 21% went to the US, a significantly smaller share than that from a decade ago. Yet, these headline figures have masked the origin of final demand behind the trade flows. Indeed, a significant proportion of goods exported to the Mainland had been re-exported to meet the final demand from advanced economies, particularly the US.

This box studies the relative importance of Mainland China and the US in driving Hong Kong's economic growth. Economic integration can strengthen trade and financial linkages between Hong Kong and the Mainland, which can lead to a higher degree of output co-movement. On the other hand, the US remains an important source of influence for the Hong Kong economy, particularly from the perspective of final demand. The Linked Exchange Rate system (LERS) also reinforces the transmission of economic shocks from the US to Hong Kong. We first provide some stylised facts on Hong Kong's trade and financial flows from a supply and demand perspective. We then analyse formally how Hong Kong's economic cycle and trend are affected by Mainland China and the US, and how such influences evolve over time.

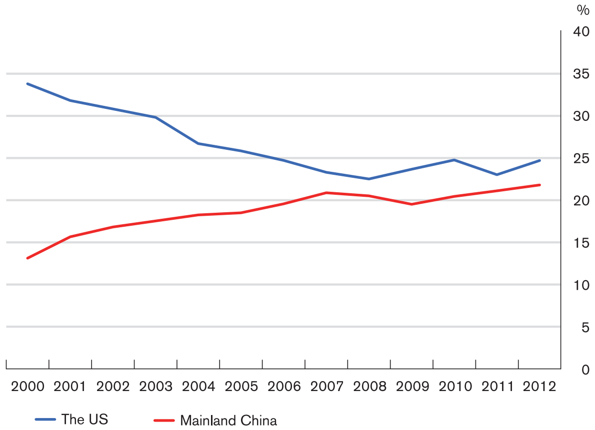
[18] This box is adapted from "Hong Kong's growth synchronisation with China and the U.S.: a trend and cycle analysis" by D. He, W. Liao and T. Wu (2014), Hong Kong Institute for Monetary Research Working Paper No. 15/2014.

Some stylised facts on Hong Kong's economic integration with the Mainland and US

In principle, the cyclical and trend components of Hong Kong's output growth may be driven by different external forces. From a supply side perspective, Hong Kong has been expanding its service-based economy to capture the opportunities arising from the rise of Mainland China in the past two decades. In particular, Hong Kong's financial sector has become more productive in expanding the supply of financial products, including initial public offering (IPO), as well as offshore renminbi bond issuance in recent years as Hong Kong has evolved into a major offshore renminbi centre.

From a demand perspective, Hong Kong has primarily served as a gateway for trade and financial flows between the Mainland and the rest of the world, targeting at demand from overseas. In this regard, Hong Kong's cyclical conditions are very much tied to fluctuations in the flows of goods, services and capital between the Mainland and its major trading partners. To better illustrate Hong Kong's merchandise exports from a final demand perspective, we construct estimates of value-added merchandise exports by excluding import content and applying adjustments to processing trade data. Based on our own estimates, the share of merchandise exports to the Mainland in value-added terms was about 22% in 2012 (Chart B3.1). The US share, though having declined from a decade ago, was still around 25% in 2012. The US share would be even larger if we take into account its influence on other export markets of Hong Kong, such as the euro area. These observations suggest that US final demand could remain the dominating factor behind the fluctuations in the external demand for goods in Hong Kong.

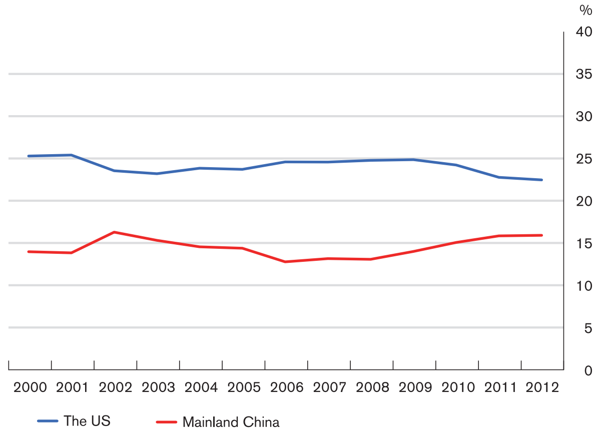
Chart B3.1
Shares in Hong Kong merchandise exports (value-added)



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

While Mainland tourist spending plays a dominant role in Hong Kong's tourism services export, the final demand for Hong Kong's exports of non-tourism services from the US remained larger than that from Mainland China (Chart B3.2).[19] In particular, US demand accounted for 33% of Hong Kong's financial services export in 2012, whereas the Mainland's share was 4%. This reflects demand from overseas investors who are trying to gain exposure to Mainland-related financial assets. In other words, overseas investors have been driving the demand for Mainland-related financial products supplied through Hong Kong's platform, in contrast to the general conception that the demand for financial services in Hong Kong is largely originated from the Mainland.

Chart B3.2
Shares in Hong Kong services exports excluding tourism (value-added)



Sources: C&SD and HKMA staff estimates.

Co-movement of business cycles and trends

To formally study the relative importance of Mainland China and the US in driving Hong Kong's economic cycle and trend, we decompose real GDP into a cyclical (transitory income) and trend (permanent income) component for Hong Kong, Mainland China and the US, and make use of hierarchical, structural vector autoregression (SVAR) models to analyse how shocks originating from Mainland China and the US affect the cyclical output and trend of the Hong Kong economy.[20, 21] Specifically, the SVAR model for studying business cycle co-movement includes cyclical output and inflation rates of the three economies, as well as the 3-month US Treasury bill rates. The variables follow a specific hierarchy so that shocks from Mainland China and the US can affect each other and Hong Kong, while shocks from Hong Kong can only affect itself since Hong Kong is a small open economy. We cover the two sample periods from 1985Q1 to 1997Q2 and from 2003Q4 to 2013Q2. We skipped the period between Asian financial crisis and the SARS outbreak when the Hong Kong economy went through a prolonged period of deflation.

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19 Stripping out import content, Mainland China accounted for 66% of Hong Kong's total tourism services exports in 2012, up from 28% in 2000, whereas the US share dropped to 4% from 11% over the same period.

20 We decompose transitory and permanent income based on the permanent income hypothesis following Aguiar, M. and G. Gopinath (2007), "Emerging market business cycles: the cycle is the trend", Journal of Political Economy, 115, 69-102. Specifically, since consumption only responds to permanent income shocks according to the hypothesis, the common trend between real GDP and consumption can be used to represent the permanent income. The hypothesis has been tested for the cases of Hong Kong and Mainland China, in which the existence of a common stochastic trend between consumption and real GDP data has been confirmed by co-integration tests.

21 We estimate each economy's permanent income based on a simple state-space model using consumption and real GDP data. The difference between real GDP and our estimate of permanent income is the transitory income.

Our results show that shocks originating from Hong Kong contributed the most to its own cyclical output and inflation fluctuations over a short-term horizon during both sample periods. However, US shocks exerted a much larger impact on Hong Kong's business cycle fluctuations in the longer term. For instance, when we look at a 20-quarter horizon, US shocks could explain about 57% of Hong Kong's cyclical fluctuations in the earlier period, and about 48% in the latter period, both of which were larger than the contribution from shocks originating from Mainland China and Hong Kong (Table B3.A). On the other hand, both Mainland and the US shocks had strong long-run influence on Hong Kong's inflation in the latter sample period, while the US influence had dominated in the earlier sample period.

Table B3.A
Contribution to cyclical output fluctuations in Hong Kong

1985Q1-1997Q2	Cyclical output			Inflation		
Horizon (in quarters)	US	Mainland China	Hong Kong	US	Mainland China	Hong Kong
1	13.562	16.346	70.092	33.387	1.737	64.877
4	31.646	17.629	50.725	49.719	7.331	42.950
10	52.055	13.300	34.645	58.304	7.590	34.106
20	57.084	13.680	29.237	59.266	7.795	32.938
2003Q4-2013Q2						
1	16.500	8.574	74.926	36.998	9.709	53.293
4	37.856	18.007	44.137	34.778	36.291	28.931
10	52.416	18.104	29.481	36.855	35.910	27.234
20	47.622	28.657	23.721	37.012	35.992	26.996

Source: HKMA staff estimates.

To study trend co-movement across borders, we estimate a SVAR model which consists of the trend output of Hong Kong, Mainland China and the US, and impose an assumption in which shocks from Hong Kong cannot affect the other two economies due to its limited size. Our results show that the Mainland has become more important than the US in explaining Hong Kong's trend fluctuations. The long-run influence of US permanent shocks on Hong Kong declined from about 36% between 1985Q1 and 1997Q2 to 30% during the 2003Q4-2013Q2 period. On the other hand, the long-run impact of Mainland's shocks on Hong Kong's trend growth increased significantly from about 15% to about 65% in the latter sample period (Table B3.B).

Table B3.B
Contribution to trend fluctuations in Hong Kong

1985Q1-1997Q2	US	Mainland China	Hong Kong
1	2.766	7.558	89.676
4	11.757	14.539	73.704
10	26.385	19.767	53.848
20	35.779	14.702	49.520
2003Q4-2013Q2			
1	4.935	4.735	90.330
4	15.650	42.683	41.667
10	31.818	58.990	9.192
20	29.808	65.270	4.922

Source: HKMA staff estimates.

Conclusion

Our findings suggest that at the business cycle frequency, Hong Kong's growth remains more synchronised with the US economy than with the Mainland economy. Since it is the similarity of cyclical shocks that matters most for the choice of exchange rate regime, the LERS, which links the Hong Kong dollar to the US dollar, continues to be appropriate for the foreseeable future. On the other hand, permanent shocks from Mainland China now have a larger impact than the US on Hong Kong's trend growth. Indeed, Hong Kong has benefited from the rise of Mainland China as a major trading nation and ongoing economic integration by transforming itself from a manufacturing economy to a service economy characterised by higher productivity.