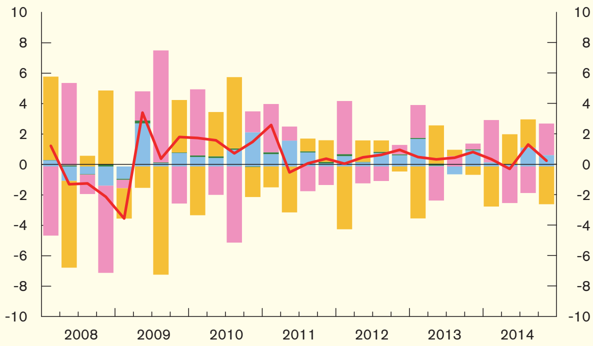
3. Domestic economy

The Hong Kong economy expanded at a moderate pace in the second half of 2014, with continued private consumption growth and slight improvement in overall investment spending offsetting weaker external trade performance. In 2015, economic growth is anticipated to remain moderate, but subject to risks relating to the global growth prospects and monetary conditions. Local inflation momentum is expected to be contained amid the softening in import prices and moderate domestic growth momentum.

3.1 Real activities

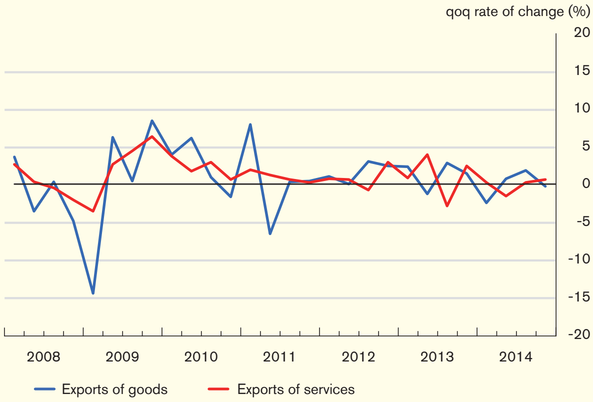
Economic growth in Hong Kong continued at a below-trend rate in the second half of 2014, with the real GDP growth rate easing back to 0.4% on a seasonally adjusted quarter-to-quarter basis in the fourth quarter from 1.4% in the third quarter amid a weaker external trading environment (Chart 3.1). In particular, net exports turned to a notable drag on GDP growth in the fourth quarter as weaker overseas demand weighed on Hong Kong's merchandise exports. In contrast, exports of services recorded modest growth due in part to improvement in inbound tourism (Chart 3.2). Domestic demand strengthened compared with the first half of the year. Overall investment spending improved slightly due to vibrant building and construction activities and inventory stocking, but capital investment stayed weak amid a mixed business outlook. Private consumption growth remained supported by the stable labour market conditions.

Chart 3.1
Real GDP growth and contribution by major expenditure components



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

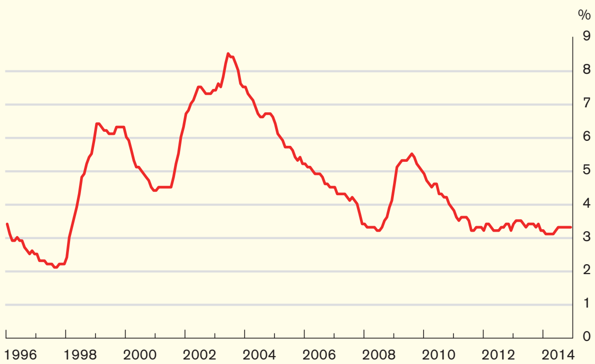
Chart 3.2
Exports of goods and services in real terms



Source: C&SD.

The year-on-year real GDP growth continued to be moderate at 2.7% and 2.2% respectively in the third and fourth quarters. For the whole of 2014, real GDP growth slowed to 2.3%, down from 2.9% a year earlier and still some way off the average annual growth of 3.9% in the past 10 years. This mainly reflected milder growth in domestic demand and sluggish external trade performance. Labour market conditions also eased slightly in the second half, with the unemployment rate edging up to 3.3% from about 3.2% in the first half (Chart 3.3). As a sign of softer labour demand, total employment grew by a modest 0.9% in 2014, the slowest pace in the past four years.

Chart 3.3
Unemployment rate



Unemployment rate

Source: C&SD.

Hong Kong's economic growth is expected to remain moderate in 2015. Slightly stronger global growth, led by the US, should provide moderate support for Hong Kong's export performance. Still, export growth is not likely to see a sharp turnaround as demand from the euro area and Japan remains weak, while growth in Mainland China and other emerging market economies is slowing. On the domestic front, private consumption growth should remain supported by the stable labour market conditions. Large-scale public infrastructure works and private building activities are also expected to hold up quite well, but a mixed business outlook and possible rises in interest rates in the future will likely continue to weigh on business capital investment. The modestly expansionary fiscal stance in the 2015/16 Budget will also support economic activities with a package of one-off relief measures.

The HKMA in-house composite index of leading indicators points to moderate growth momentum in the first half of 2015, as indicated by the soft six-month growth rate (Table 3.A). Overall for 2015, the Consensus Forecasts project the Hong Kong economy to grow at an average rate of 2.6%, while the Government forecasts growth in the range of 1-3%.

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
2014				
Jan	2.4	0.5	6.2	2.7
Feb	-2.8	0.4	3.2	2.8
Mar	-0.2	-0.3	2.5	2.1
Apr	-2.2	0.3	-0.1	2.2
May	0.1	0.6	-2.1	2.0
Jun	-1.1	0.4	-3.8	1.9
Jul	0.9	0.3	-5.2	1.8
Aug	0.8	0.2	-1.7	1.6
Sep	3.1	0.1	1.5	2.0
Oct	0.8	0.4	4.6	2.0
Nov	2.5	0.4	7.1	1.8
Dec	-1.9	0.5	6.2	1.9
2015				
Jan	n.a.	0.6	n.a.	2.2

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

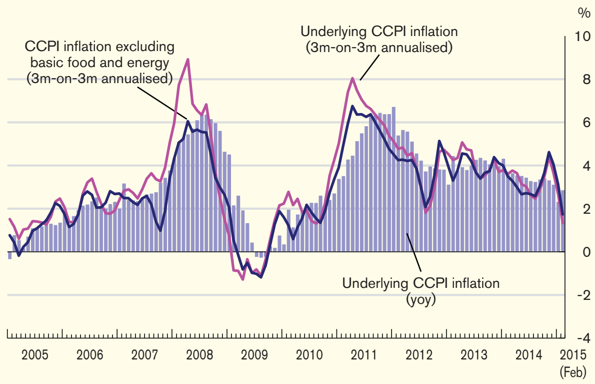
Source: HKMA staff estimates.

The baseline scenario in which the Hong Kong economy would continue to grow at a moderate pace is subject to a number of uncertainties and risks. The divergence of monetary policy paths in the advanced economies could lead to more volatile exchange rates, fund flows and global financial conditions, with potential negative spillovers to the Hong Kong economy through various financial channels. In particular, the timing and pace of US interest rate normalisation remain a major source of uncertainty. When the interest rate up-cycle starts, monetary conditions in Hong Kong would inevitably tighten and this in turn could weigh on real economic activities. Interest rate hikes could also dampen housing demand in Hong Kong and exert pressures on property prices. In case there is a sharp adjustment in the property market, the broader economy would also be affected, with repercussions on consumption and business investment. Moreover, persistent strengthening of the US dollar together with higher US interest rates could increase risks of a sudden re-pricing of risk assets and capital outflow pressures, as well as a rise in the debt-servicing burden of borrowers of US dollar credit. The future path of oil prices also remains highly uncertain. In particular, sharp volatilities in oil prices could put some oil-exporting countries and energy producers under financial and credit stress, with possible contagion risks to global financial markets.

3.2 Consumer prices

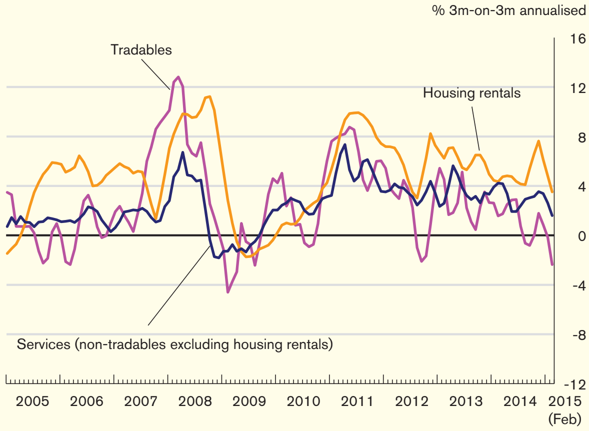
Local inflation momentum picked up somewhat in the second half of 2014 before softening in early 2015. The annualised three-month-on-three-month underlying inflation rate increased to 4.3% in November from 2.4% in August and fell to 1.3% in February on the back of weaker housing rental and service inflation (Chart 3.4). Meanwhile, the underlying inflation rate has declined on a year-on-year basis since the fourth quarter, reaching 2.8% in February.

Chart 3.4
Different measures of consumer price inflation



Sources: C&SD and HKMA staff estimates.

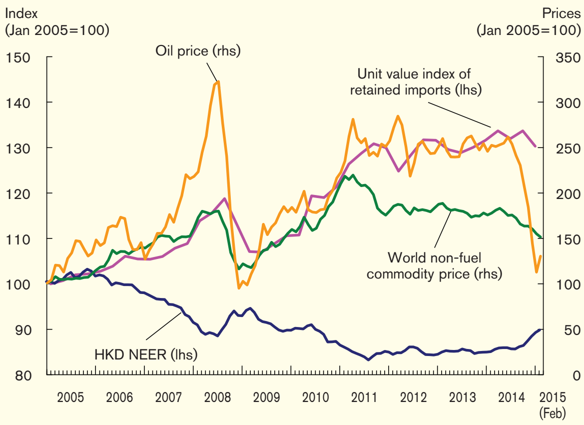
Chart 3.5
Consumer price inflation by broad component



Sources: C&SD and HKMA staff estimates.

The sequential inflation momentum will likely be moderate as the expected softening in import prices and service inflation would help keep inflationary pressure in check. In particular, the expectation of persistently low oil prices, the general softening in global food and commodity prices, a stronger Hong Kong dollar along with the expected appreciation of the US dollar, and the mild inflationary pressure in Mainland China, would limit Hong Kong's import price inflation in the period ahead (Chart 3.6). The moderate domestic growth momentum amid an expected small negative output gap and stable labour market conditions will also help contain inflationary pressure in the service component. On the whole, the annual year-on-year inflation rate for 2015 is likely to decrease, with the latest Government forecast for the underlying inflation rate of 3.0%, down from 3.5% in 2014.

Chart 3.6
Commodity and import prices



Sources: Bloomberg, IMF and C&SD.

The inflation outlook is becoming more uncertain and subject to risks on both sides. On the upside, any delay in the US rate hike cycle as a result of the subdued inflationary pressure, as well as looser-than-expected global monetary conditions due to monetary easing in the euro area and Japan, could add upward pressures on asset prices and more generally on local inflation. In particular, should this fuel greater demand for local properties, it could add upward pressure on property prices and strengthen rental inflation.

On the downside, the risks of further growth deceleration in Mainland China and weaker-than-expected growth in the euro area remain, which could dampen Hong Kong's near-term growth and cloud its inflation outlook. Any further softening in global food and commodity prices resulting from slower-than-expected global growth would also pose downward pressures on import prices. Meanwhile, further increase in capital outflow pressure and shift in market sentiment triggered by a possible surprise in US rate hikes, as well as the uncertain local housing supply conditions, could add to the risk of a downswing in the property market and pose downward pressures on local inflation.