3. Domestic economy

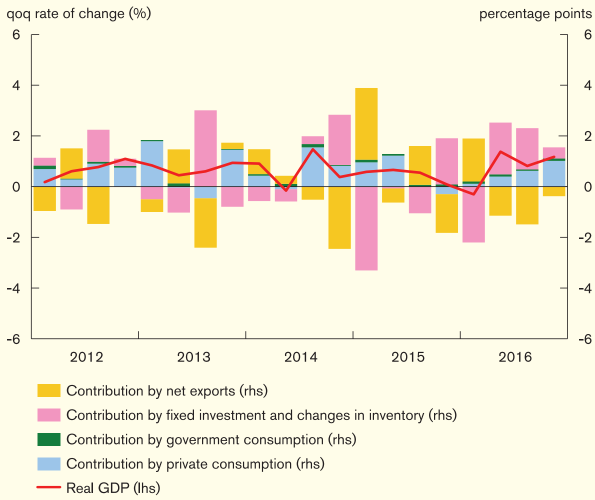
The Hong Kong economy showed a modest pick-up in growth during the second half of 2016, reflecting faster private consumption growth and strong public sector building and construction activities. Economic growth for 2017 is expected to be moderate amid heightened uncertainties in the external environment. Local inflationary pressures are likely to remain contained with benign import prices and moderate domestic growth momentum in the near term.

3.1 Real activities

The Hong Kong economy recorded a modest pick-up in growth during the second half of 2016. On a seasonally adjusted quarter-on-quarter basis, real Gross Domestic Product (GDP) rose by 1.2% in the fourth quarter, slightly faster than the 0.8% growth in the third quarter (Chart 3.1). Private consumption increased at a faster pace and was the main driver behind GDP growth, partly reflecting improved consumer confidence and robust labour market conditions. Building and construction activities also quickened, underpinned by infrastructure projects such as the Hong Kong Airport's third runway. However, the positive contribution of overall investment spending to GDP growth narrowed because of softer business capital expenditure. On the external front, along with rising regional trade flows, both exports and imports of goods grew faster (Chart 3.2).[22] Exports of services increased further driven by trade-related and transportation services, and imports of services rebounded due in part to strong travel interest among residents. On a net basis, overall trade balance continued to detract from the GDP growth.

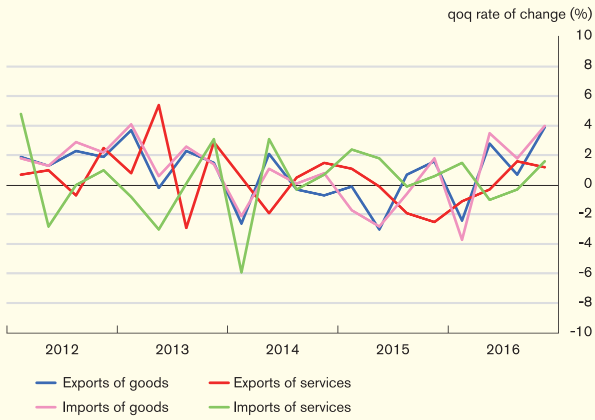
[22] The change of ownership principle was adopted in recording trade in goods and services. More details can be found in *Gross Domestic Product (Quarterly), Fourth Quarter 2016* published by the Census and Statistics Department (C&SD).

Chart 3.1
Real GDP growth and contribution by major expenditure components



Sources: C&SD and HKMA staff estimates.

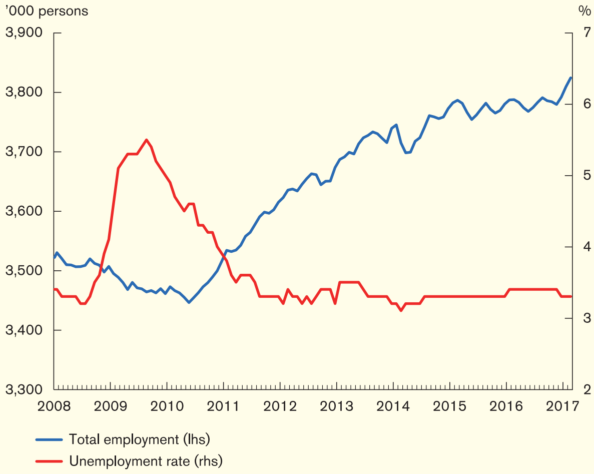
Chart 3.2
Exports and imports in real terms



Source: C&SD.

The labour market remained tight. After staying at 3.4% in the first three quarters, the seasonally adjusted unemployment rate edged down to 3.3% in the final quarter (Chart 3.3). In fact, many major sectors saw a lower unemployment rate during this period, including the retail, accommodation and food services sector due in part to the stabilisation of the retail downturn. Total employment climbed to a record high of 3.824 million in February 2017, while the labour force participation rate was roughly stable at about 61%.

Chart 3.3
Unemployment rate and total employment



Source: C&SD.

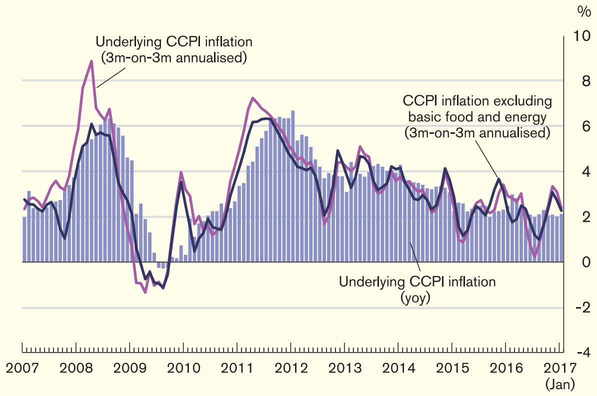
Real economic growth for 2017 is anticipated to remain moderate. Externally, global economic and trade growth may remain moderate amid increased uncertainty in the global macro-financial environment. This, coupled with the appreciation of the Hong Kong dollar real exchange rate due to the strength of the US dollar, will restrain Hong Kong's export performance. Domestically, private consumption is expected to grow moderately, supported by stable employment and earnings conditions, while dragged down by rising interest rates. Building and construction activities should progress steadily on the back of rising housing supply and infrastructure projects in the pipeline, but weak business sentiment and a pick-up in interest rates will weigh on business capital spending. The Government now forecasts 2017 real GDP growth in the range of 2-3%, while private-sector analysts project the economy to expand at an average rate of 2.0% in 2017.

This growth outlook is subject to heightened uncertainties, particularly from the external environment. Policy uncertainties surrounding the new US administration will cloud the global economic outlook, with potential protectionist policies posing headwinds to global trade flows. The Brexit process and national elections in several major European countries may also result in asset market volatilities and affect the directions of Hong Kong dollar fund flows. In addition, the US interest rate normalisation will tighten domestic monetary conditions and pose downward pressure on both the real economy and asset prices.

3.2 *Consumer prices*

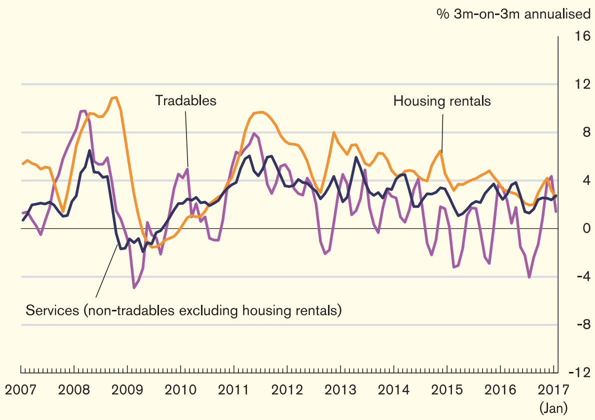
Local inflationary pressures have remained moderate since the second half of 2016, while the sequential momentum has picked up in recent months. On a year-on-year comparison, the underlying composite consumer price index (CCPI) held steady at 2.1% in the second half of 2016 and January 2017 (Chart 3.4). Inflation momentum, as measured by the annualised three-month-on-three-month underlying inflation rate, accelerated from 0.9% in the third quarter to 3.0% in the fourth quarter, before moderating slightly to 2.4% in January. The faster pace of price increases was mainly due to the higher costs of tradables and housing rentals (Chart 3.5). In particular, tradables' price inflation turned positive to 3.0% in the fourth quarter, from its negative territory in the third quarter, mainly driven by the basic food and the clothing and footwear components. Amid the narrowed decline in private residential rentals and the upward adjustment in public housing rentals in September 2016, the housing rental component of CCPI picked up in the third quarter, followed by a slight moderation in January (Chart 3.6).

Chart 3.4
Different measures of consumer price inflation



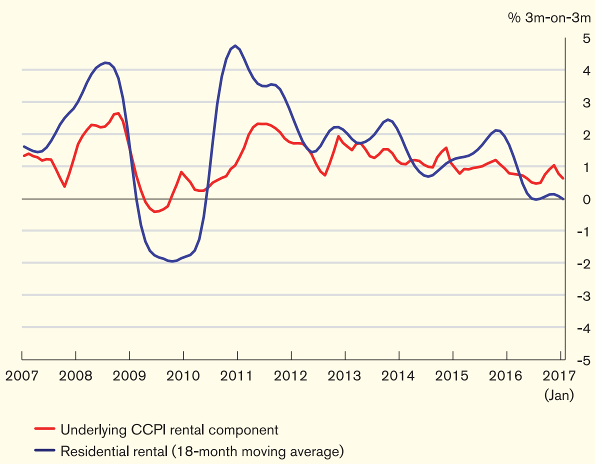
Sources: C&SD and HKMA staff estimates.

Chart 3.5
Consumer price inflation by broad component



Sources: C&SD and HKMA staff estimates.

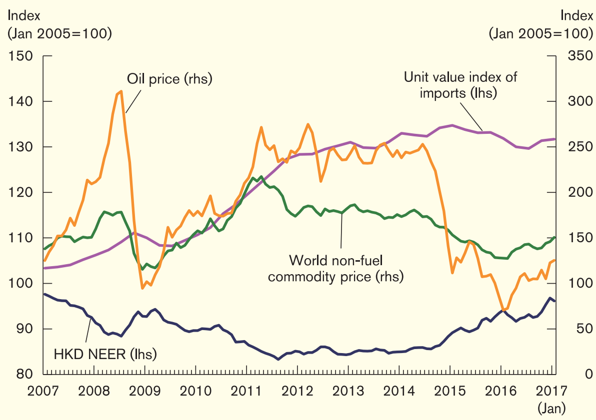
Chart 3.6
CCPI rental component and market rental



Sources: C&SD and R&VD.

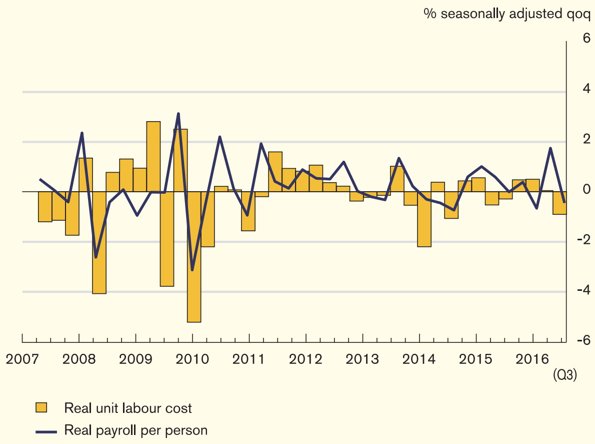
In the near term, inflationary pressures are expected to remain contained amid the soft import prices and modest local cost pressures. Imported inflation should remain muted on the back of the strong Hong Kong dollar, which could offset to some extent the effect of the recovery in global commodity prices (Chart 3.7). Domestically, the output gap is estimated to be close to zero in the fourth quarter of 2016, which should help to restrain business costs and hence the services inflation component. Despite a tight labour market, wage increases have been mild in recent quarters with the real payroll per person falling by 0.4% in the third quarter of 2016 after growing by 1.1% in the first half (Chart 3.8). Growth in the cost of labour is likely to keep steady in the face of cautious business sentiment amid lingering external uncertainties. The growth in retail property rental is anticipated to be moderate with the lacklustre performance of retail sales in recent months. The continued feed-through of the earlier softening in private residential rentals should also help keep inflation pressures in check. On the whole, the annual year-on-year inflation rate in 2017 is expected to ease, with the Government forecasting an annual underlying inflation rate of 2.0%, down from 2.3% in 2016.

Chart 3.7
Commodity and import prices



Sources: C&SD and IMF.

Chart 3.8
Unit labour cost and payroll per person



Sources: C&SD and HKMA staff estimates.

The inflation outlook is subject to risks on both sides. On the downside, a faster-than-expected pace of the US interest rate hikes in response to a higher inflation under the Trump administration, could push up local mortgage rates and add to downward pressure on property prices and housing rentals. At the same time, the strengthening of Hong Kong dollar could further keep import prices soft while dampening inbound tourism. On the upside, a stronger-than-expected expansion in the global economy could support growth in Hong Kong and increase the demand-pull inflation of global commodities, thus exerting upward pressures on local inflation. The increase in Statutory Minimum Wage, effective from 1 May 2017, might drive up inflation further, although the actual impact of this cost-push inflation is likely to depend on the extent of the pass-through from wage cost to consumer prices.