3. Domestic economy

The Hong Kong economy softened in the second half of 2018, reflecting slower private consumption growth and poor export performance amid the US-China trade dispute. Real Gross Domestic Product growth for 2019 is expected to slow along with weakening global expansion. This growth outlook is subject to a number of uncertainties and risks, including those stemming from trade protectionism, the future direction of US monetary policy and Mainland's economic performance. Local inflationary pressures will likely stay mild in 2019, although there are potential risks on either side.

3.1 Real activities

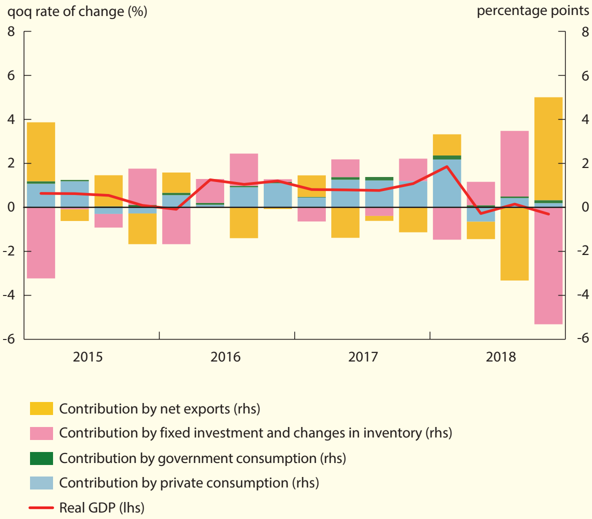
Economic activities in Hong Kong softened in the second half of 2018. Specifically, the economy struggled to sustain its strong momentum recorded in the first half, as the half-yearly growth rate of real Gross Domestic Product (GDP) turned slightly negative (Table 3.A and Chart 3.1). Economic growth also slowed on a year-on-year basis to a below-trend rate of 1.3% in the fourth quarter, dragging down the full-year growth rate to 3.0%, compared with 3.8% a year earlier.

Table 3.A
Real GDP growth

	Half-yearly growth rate (%)*		Year-on-year growth rate (%)	
2017	H1	1.9	Q1	4.4
			Q2	4.0
	H2	1.7	Q3	3.6
			Q4	3.5
2018	H1	2.2	Q1	4.6
			Q2	3.5
	H2	−0.1	Q3	2.8
			Q4	1.3
10-year average	(2008 H1–2017 H2)	1.3	(2008 Q1–2017 Q4)	2.7

* Based on seasonally adjusted volume index of expenditure-based GDP.
Source: C&SD.

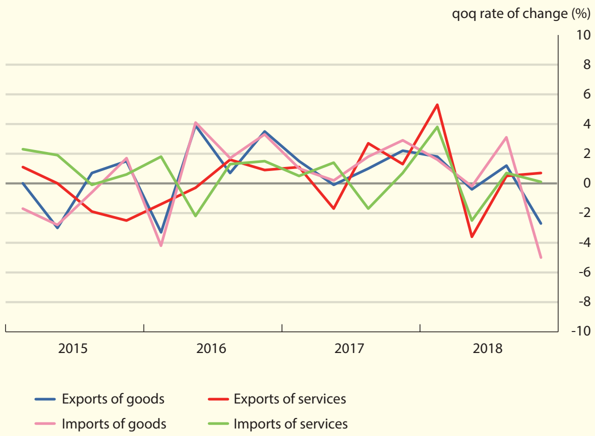
Chart 3.1
Real GDP growth and contribution by major expenditure components



Note: Growth rates are seasonally adjusted.
Sources: C&SD and HKMA staff estimates.

Weakening economic activities occurred as the impact of the US-China trade conflict, either directly or indirectly, weighed on consumption and exports. Private consumption grew at a slower pace (Chart 3.1), likely due to heightened economic uncertainty and some negative wealth effects associated with local asset price corrections. Aggregate investment spending declined significantly amid fragile business confidence. Hong Kong's external merchandise trade performance also worsened, particularly in the fourth quarter following the actual imposition of additional tariffs (Chart 3.2). That said, net trade still contributed positively to GDP growth in the fourth quarter as total imports declined at an even faster pace than total exports. Box 3 takes a closer look at Hong Kong's merchandise trade performance and discusses its near-term outlook and the associated risks.

Chart 3.2
Exports and imports in real terms



Note: Growth rates are seasonally adjusted.
Source: C&SD.

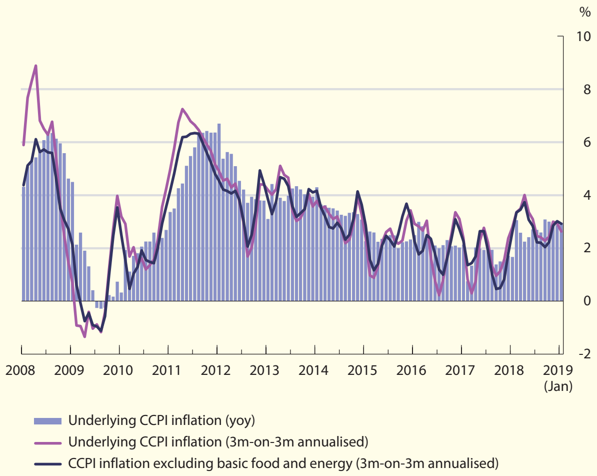
Along with the weaker economic activities, job creation appeared to have slowed in the second half of 2018. Total employment increased by just 0.1%, to around 3,873,000 at the end of 2018, lower than the 0.8% growth in the first half of the year. As output and employment growth was subdued, labour productivity showed little signs of improvement.

Economic growth for 2019 is expected to soften as the world economy slows further. In particular, Hong Kong's export performance is expected to continue to struggle amid a challenging external environment. Domestically, the low unemployment rate and rising household income will continue to support private consumption, but its pace of growth is anticipated to ease partly owing to weaker consumer confidence and negative wealth effects induced by earlier asset price corrections. For fixed capital formation, the outlook may become more uncertain. While building and construction activities should progress steadily on the back of increasing housing supply, firms may become more cautious about making capital investments amid heightened economic uncertainty. Sentiment indicators such as the Purchasing Managers' Index (PMI) for Hong Kong continued to hover in contraction territory, which suggests a further decline in year-on-year GDP growth in the near term, based on the predictive power of the PMI for future growth. The Government forecasts real GDP growth for 2019 in the range of 2–3%, while the growth forecasts by international organisations and private sector analysts range between 1.5–2.7%. This growth outlook is subject to a number of uncertainties and risks as discussed in previous chapters.

3.2 Inflation and unemployment

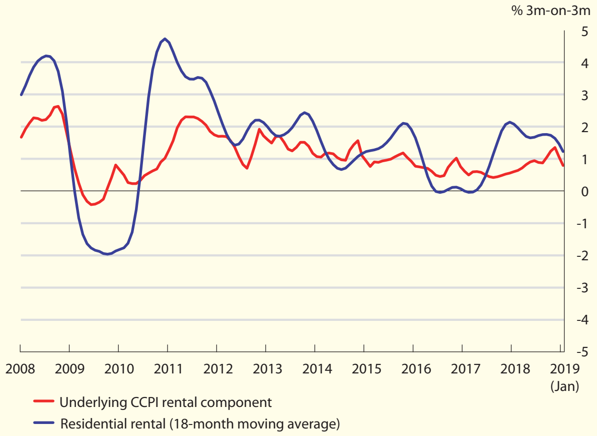
Local inflationary pressures continued to build up, but remained at a moderate level in recent months. On a year-on-year comparison, the underlying Composite Consumer Price Index (CCPI) rose by 2.8% in the third quarter and 2.9% in the fourth quarter, higher than the average rate of 2.4% over the first half of 2018. Inflation momentum, as measured by the annualised three-month-on-three-month underlying inflation rate, also picked up recently, from 2.5% in July 2018 to 2.6% in January 2019 (Chart 3.3). The mild increase in inflation momentum can be attributed to price increases in selected services. The earlier increase in fresh-letting residential rentals and faster rises in the price of meals away from home continued to push up service inflation (Chart 3.4). Labour cost pressures remained subdued in recent quarters (Chart 3.5).

Chart 3.3
Different measures of consumer price inflation



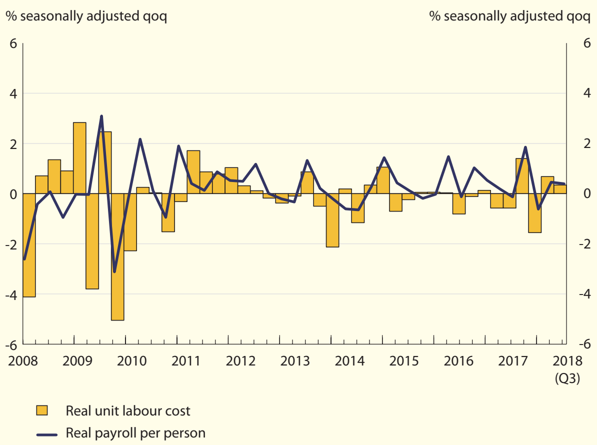
Sources: C&SD and HKMA staff estimates.

Chart 3.4
CCPI rental component and market rental



Sources: C&SD and Rating and Valuation Department.

Chart 3.5
Unit labour cost and payroll per person

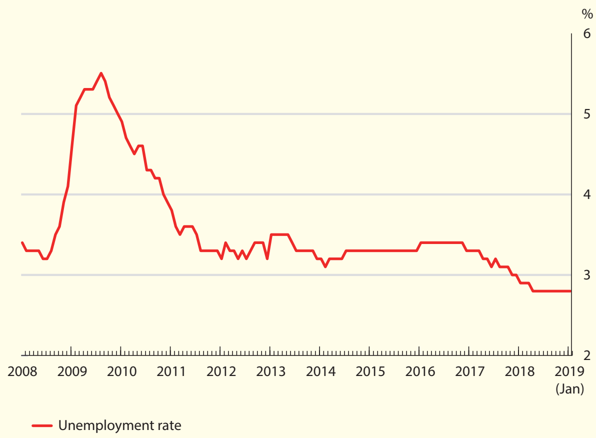


Sources: C&SD and HKMA staff estimates.

Looking ahead, local inflationary pressures will likely stay mild in 2019. This mainly reflects slower domestic growth momentum, although the earlier rising trend in private residential rentals will continue to filter through into consumer price inflation. Market consensus predicts the headline inflation rate at a moderate level of 2.2% for the year and the Government projects the underlying inflation rate to be 2.5%.

This outlook for inflation is subject to risks on both sides. On the downside, the seasonally adjusted unemployment rate has stayed at around 2.8%, the lowest in more than 20 years (Chart 3.6). Should the labour market deteriorate unexpectedly, the current near-zero output gap could turn negative, and additional downward pressure on inflation may emerge. On the other hand, if the local economy performs much better than expected, perhaps due to easing US-China trade tensions, this could boost local inflation.

Chart 3.6
Unemployment rate



Source: C&SD.

Box 3
The impact of the US-China trade dispute on Hong Kong's external merchandise trade: Preliminary evidence and implications

Introduction

The US-China trade conflict began in earnest in the second half of 2018: on 6 July and 23 August, the US imposed additional tariffs of 25% on imports from Mainland China worth US$34 billion and US$16 billion, respectively. Immediately following each of these two dates, Mainland China responded with 25% tariffs on equal amounts of imports from the US. On 24 September, the US levied 10% additional tariffs on a larger list of US$200 billion worth of Mainland imports; Mainland China immediately responded with 5–10% tariffs on US$60 billion worth of US imports. Since then, the two countries have started to engage in negotiations in an attempt to avert further tariffs.

As Hong Kong has long been an entrepôt for trade between the two economies, the additional tariffs are bound to have a direct impact on Hong Kong through the trade channel.[26] As such, the US-China trade dispute has important implications for the macro-financial stability of Hong Kong. This Box reviews Hong Kong's recent merchandise trade performance, and discusses its near-term outlook. In particular, we try to take a closer look at the impact of the additional tariffs by using more granular data — namely, drilling down to traded products that are directly affected by the additional tariffs.

Merchandise trade performance

To analyse the tariff effect, we first extract six sets of Hong Kong's re-exports subject to the three rounds of imposed tariffs described in the previous section. In the first two rounds, the US imposed tariffs mainly on capital and intermediate goods, while Mainland China targeted mostly agricultural products, chemicals, medical equipment and energy equipment. In the third round, the affected product lines grew in scope and involved more consumer goods. For brevity, we name products affected by these three rounds List 1, List 2 and List 3, correspondingly.

Using these more granular trade data, we examine the year-on-year changes in re-export value, in order to account for seasonality. Care should also be taken when interpreting the September 2018 data, as trading activities were somewhat disrupted by the super typhoon Mangkhut. Overall, the findings in this section should be regarded as preliminary evidence on the impact of the rounds of additional tariffs.[27]

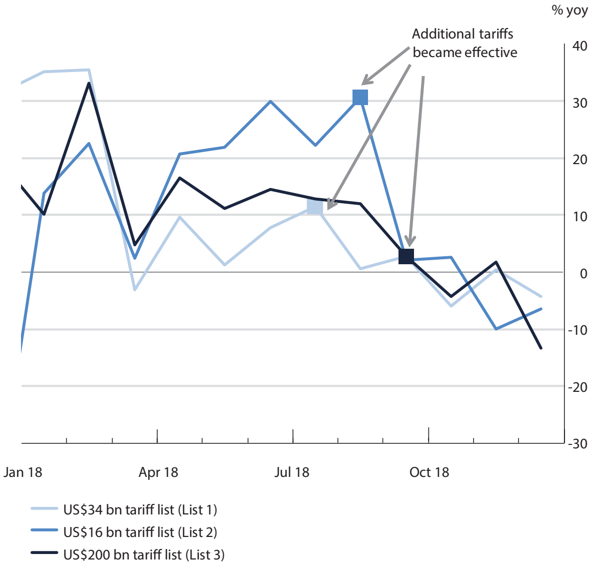
<u>Re-exports of Mainland origin affected by tariffs</u>

For re-exports from Mainland China to the US, the additional tariffs appear to have resulted in a sharp decline or growth slowdown in the corresponding re-exports shortly after the measures took effect (Chart B3.1). For example, the re-exports of List 1 and List 2 grew more slowly in the first month after the imposition of additional tariffs, while those of List 3 registered negative growth. In December, all three re-export lists registered negative growth.

[26] There may also be an impact through indirect channels, including the financial channel (e.g. tightening of financial conditions induced by asset price corrections) and the uncertainty channel. For the latter, see "Box 2: Macroeconomic effects of uncertainty — implications of rising trade tensions for Hong Kong", *HKMA Half-yearly Monetary and Financial Stability Report*, September 2018.

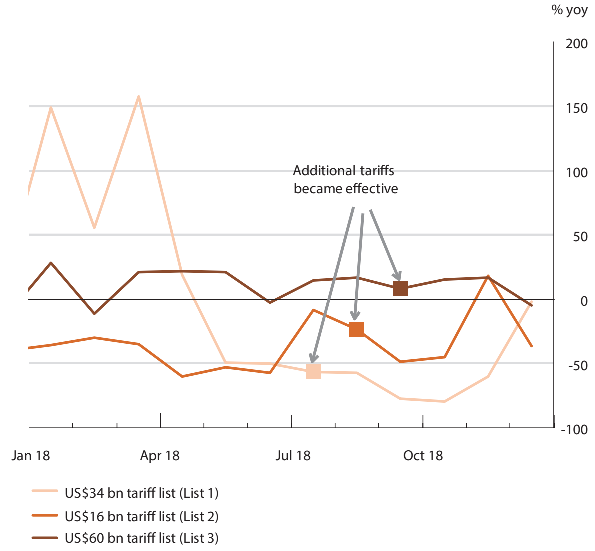
[27] A complete analysis would control for different factors and isolate the impact of tariff increases. However, the data necessary to conduct such an econometric analysis will only be available later.

Chart B3.1
The value of Hong Kong's re-exports of Mainland origin to the US in 2018



Note: Estimated figures. The squares on the lines denote the month in which the tariffs became effective.
Sources: C&SD and HKMA staff estimates.

Chart B3.2
The value of Hong Kong's re-exports of US origin to Mainland China in 2018



Note: Estimated figures. The squares on the lines denote the month in which the tariffs became effective.
Sources: C&SD and HKMA staff estimates.

Re-exports of US origin affected by tariffs

In comparison, re-exports from the US to Mainland China portray a mixed picture (Chart B3.2). The additional tariffs appear to have led to a sharp decline in List 1 re-exports in the first few months following the implementation, but these re-exports picked up somewhat towards the end of the year. The growth in List 2 re-exports was largely negative for the whole year, while the List 3 growth-rate appears roughly stable.

Front-loading activities

Because of the time lag between the announcement and the eventual implementation of the tariffs (or merely a plausible threat of tariffs), an incentive might be for firms to increase their shipments for the goods that would be affected prior to the expected effective date. Indeed, anecdotal evidence and news reports suggest these front-loading activities were fairly prevalent. Some private-sector analysts also partially ascribed the strength in headline trade numbers to these activities prior to the lift in tariffs.

Our granular data reveal some evidence of front-loading for selected tariff lists, but only for re-exports from Mainland China to the US (Chart B3.1). Growth rates for List 1 and List 2 picked up somewhat in the few months before respective tariffs took effect. On the other hand, growth rates of re-exports from the US to Mainland China (Chart B3.2) do not clearly indicate front-loading activities.

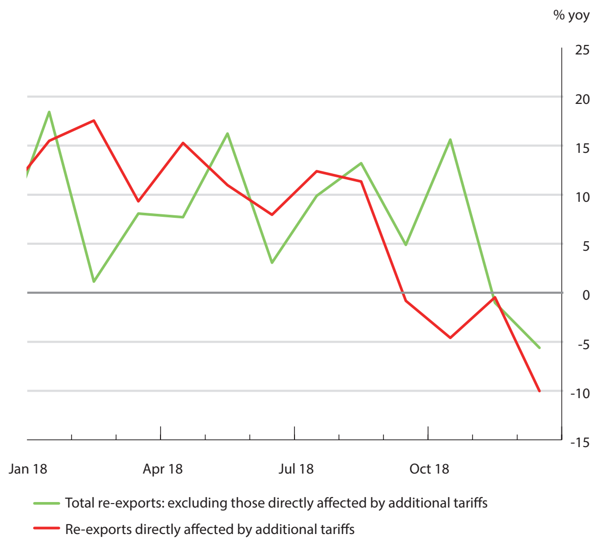
Re-exports not affected by the additional tariffs

It should be noted the re-exports that were directly affected by the additional tariffs accounted for just 4–5% of the total re-exports of Hong Kong. For a more complete picture of Hong Kong's trade performance, it is useful to also look at re-exports that are not covered by the additional tariffs.

Here we find total re-exports not affected by the additional tariffs also recorded negative growth in the last two months of 2018 (Chart B3.3). Since the third quarter, however, the decline in growth in re-exports affected by the tariffs (the red line), was clearly more severe, suggesting the tariffs had notable effects.

The slowdown in the growth of re-exports not affected by the tariffs, in part, reflects a broader weakening in external demand amid increased uncertainties due to lingering trade tensions, tighter global financial conditions and heightened geopolitical risks. In particular, the trade conflict has weighed on global economic sentiment and activities, as evidenced by corrections in major stock markets. This in turn could dampen import demand from other economies, thereby restraining Hong Kong's external trade performance.

Chart B3.3
The value of Hong Kong's re-exports in 2018

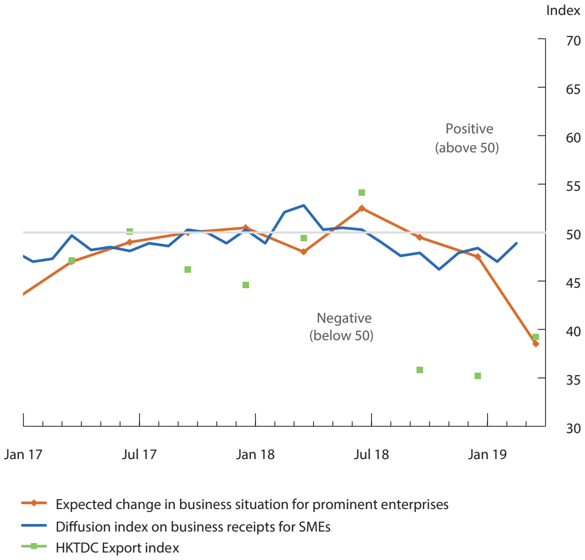


Note: Estimated figures.
Sources: C&SD and HKMA staff estimates.

Implications for Hong Kong

The near-term outlook for Hong Kong's merchandise trade remains challenging, even if the US-China trade tensions were to diminish. The likely slowdown in global expansion this year (see Chapter 2) will further restrain Hong Kong's export performance. Various sentiment indicators continue to point to weaker business prospects for both prominent and small businesses (Chart B3.4), with sentiment especially poor in the trade sector. Other sectors related to trade, such as logistics, could also be affected.

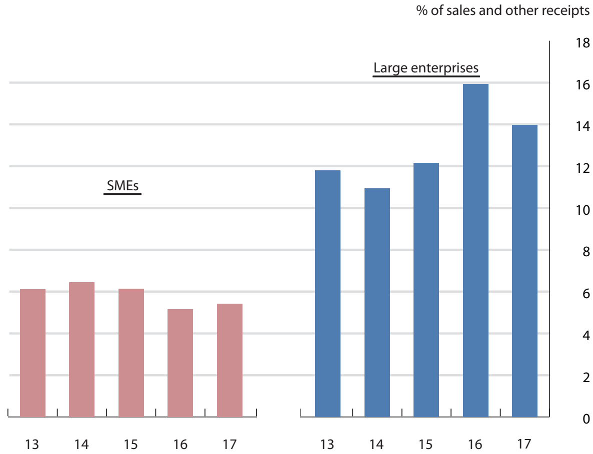
Chart B3.4
Surveys of business prospects for the import and export trade sector of Hong Kong



Note: The index for prominent enterprises also includes the wholesale sector as no breakdown is available.
Sources: C&SD and Hong Kong Trade Development Council (HKTDC).

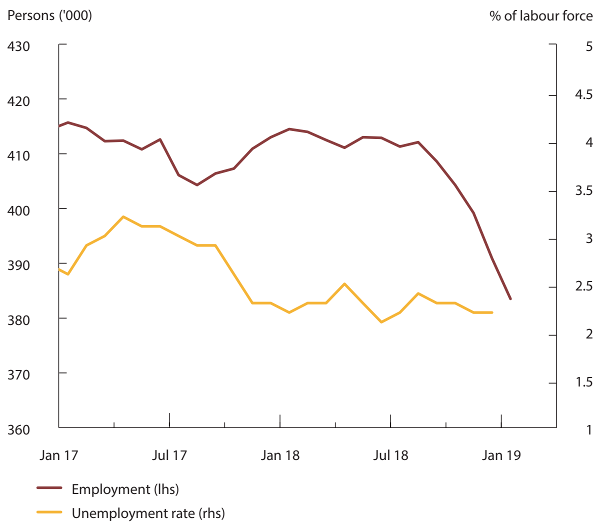
As one of Hong Kong's four key industries, the trading and logistics sector[28] contributes about one-fifth of GDP and employment to the economy. Consequently, the impact of the US-China trade conflict on the overall economy and the labour market should be closely monitored. In particular, given that small and medium enterprises (SMEs) are dominant employers in the import and export trade sector, their thin profit margins[29] (Chart B3.5) make them more vulnerable to trade shocks and may have repercussions on their hiring. In 2017, SMEs accounted for 99% of enterprises and 78% of persons employed in this sector.[30] A further deterioration in the external trade situation could test the resilience of the local labour market. In fact, total employment in this sector has been declining notably since August 2018, although the sectoral unemployment rate has yet to show signs of deterioration (Chart B3.6).

Chart B3.5
The profit ratios of the import and export trade sector over the past five years



Sources: C&SD and HKMA staff estimates.

Chart B3.6
Labour market conditions in the import and export trade sector of Hong Kong



Source: C&SD.

28 Besides import and export trade, the trading sector also includes wholesale businesses. The logistics sector comprises freight transport and storage services and postal and courier services.

29 The before-tax earnings ratio (abbreviated as profit ratio) denotes the ratio of profit before deducting tax, gain/loss on disposal of property, machinery and equipment, bad debts/write-off provisions, etc., to business receipts.

30 According to the conventional definition of non-manufacturing enterprises, SMEs refer to those firms with fewer than 50 employees or persons engaged.

Conclusions

This Box shows that the US-China trade conflict is taking its toll on Hong Kong's external merchandise trade. More granular data point to an immediate adverse impact following the tariff increases, especially for re-exports from Mainland China to the US that are subject to the additional tariffs. There was also some evidence of front-loading activities. In addition, re-exports that were not covered by the additional tariffs also retreated towards the end of 2018, perhaps reflecting a broader weakening in external demand amid increased uncertainties due to the lingering trade tensions, tighter global financial conditions and heightened geopolitical risks.

The near-term outlook for Hong Kong's merchandise trade remains challenging even if the US-China trade tensions were to abate, given the deceleration in global growth. Sector-wise, the import and export trade sector will bear the brunt of the headwinds, possibly with negative spillovers to the broader economy and the labour market. SMEs in this sector may be particularly vulnerable given their relatively thin profit margins.