

3. Domestic economy

The Hong Kong economy grew at a sluggish pace in the first half of 2019, reflecting weaker private consumption growth, contraction in investment spending and poor export performance. The economic performance for the second half is expected to remain subdued and the outlook is subject to heightened uncertainties and risks, including those stemming from the global economic slowdown, the renewed US-China trade tensions and the recent social incidents in Hong Kong. The labour market has been resilient so far, but its outlook is overshadowed by weakened economic prospects. Local inflationary pressures edged up to a still-moderate level though there are potential risks on either side.

3.1 Real activities

Economic growth was sluggish in Hong Kong during the first half of 2019. The year-on-year growth rate of real gross domestic product (GDP) declined to 0.6% in the first quarter and hit a ten-year low of 0.5% in the second quarter (Table 3.A). The growth rate of real GDP was also below-par at 0.8% over the preceding half year.²⁷

Table 3.A
Real GDP growth

	Year-on-year growth rate (%)	
	Q1	Q2
2018	Q1	4.6
	Q2	3.6
	Q3	2.8
	Q4	1.2
2019	Q1	0.6
	Q2	0.5
10-year average	(2009 Q1 – 2018 Q4)	2.8

Source: C&SD.

On a quarter-on-quarter basis, economic activities slowed visibly in the first half of the year (Chart 3.1). Specifically, real GDP declined by 0.4% in the second quarter, following a 1.3% increase in the first quarter. Domestically, private consumption growth weakened and aggregate investment spending continued to drag down GDP. This in part reflected low consumption and investment confidence.²⁸ Externally, Hong Kong's trade performance also worsened significantly amid lingering US-China trade and technology tensions, weaker global economic growth and sluggish tourist spending²⁹ (Chart 3.2). Partly because imports of goods declined more than exports, net trade contributed positively to GDP growth in the first quarter, but its contribution turned negative in the second quarter. Box 3 examines the recent performance of Hong Kong's merchandise exports and their relation to Mainland's exports.

²⁷ Based on seasonally adjusted volume index of expenditure-based GDP.

²⁸ The Consumer Confidence Index compiled by the City University of Hong Kong declined to a five-year low of 77.7 in the second quarter. The Purchasing Managers' Index has remained in the contractionary zone since April last year. Additionally, a slowdown in construction activities caused by completion of some major infrastructure projects also weighed on overall investment spending.

²⁹ Tourist arrivals slowed in the first half of the year and tourist spending also showed signs of moderation as indicated by decreases in retail sales volume of some tourist-related items.

Chart 3.1
Real GDP growth and contribution by major expenditure components

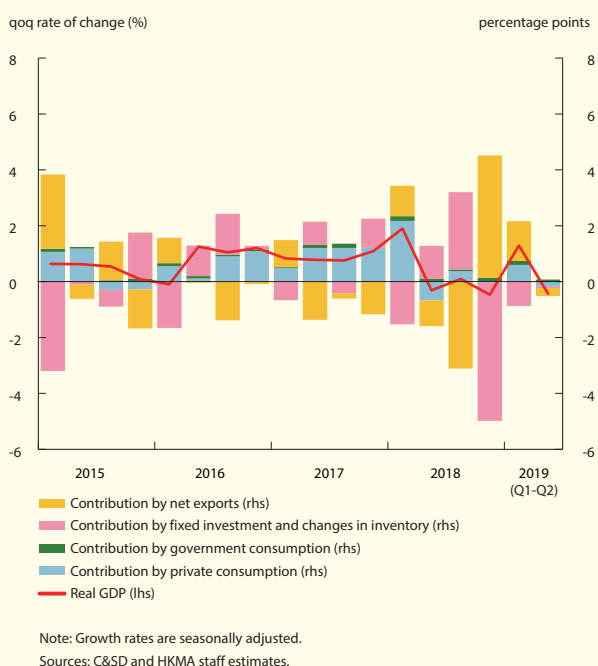
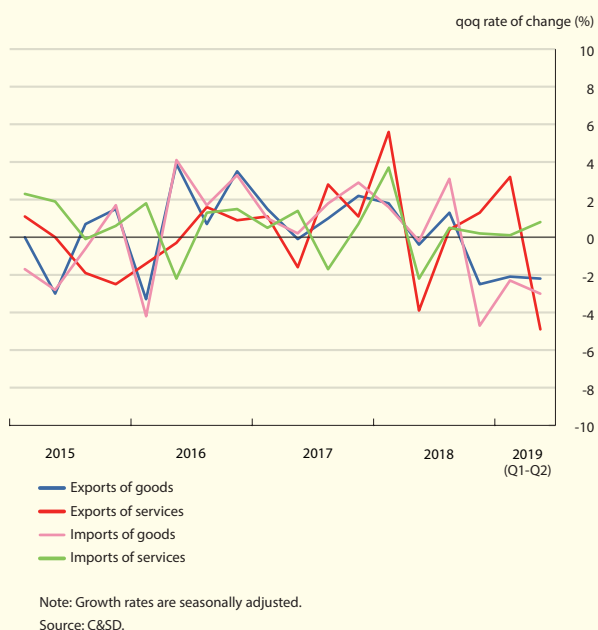


Chart 3.2
Exports and imports in real terms



The economic performance for the rest of 2019 is expected to remain subdued. On the external front, the US-China trade disputes and slowing global economic growth will continue to weigh down Hong Kong's external trade performance. Domestically, private consumption may contribute positively to growth, although its expansion will likely be tepid, in part, due to cautious consumer sentiment. As for fixed capital formation, heightened economic uncertainty and fragile business confidence could dampen capital expenditure, as well as building and construction activities. Taking into account the weaker-than-expected GDP outturn, the Government revised its forecast of real GDP growth for 2019 downward from 2–3% earlier to 0–1%.³⁰ The growth forecasts by international organisations and private sector analysts were also adjusted downward to a range between -0.5% and 1% (mean at 0.3%).

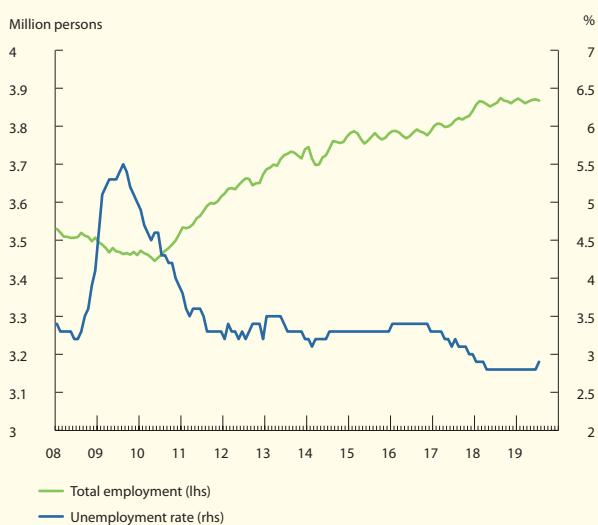
This growth outlook is subject to heightened uncertainties and risks, including those arising from the global economic slowdown, the ongoing US-China trade dispute, the future direction of monetary policy in the US and other economies, the economic performance of Mainland China, the impending Brexit and the recent social incidents in Hong Kong. In particular, downside risks have risen, due in large part to the renewed US-China trade tensions.

³⁰ In his recent blogs, the Financial Secretary said the Government would consider measures to “support enterprises, safeguard jobs” and would not contain public expenditure. The Secretary for Development also said the annual expenditure for the Government’s capital projects was estimated to exceed HK\$100 billion in the next few years, thereby supporting economic growth. On 15 August, the Financial Secretary announced a series of measures to support the economy, including reducing salaries tax and waiving fees and charges for enterprises. On 4 September, two additional measures were announced to strengthen liquidity support to local small and medium-sized enterprises.

3.2 Labour market conditions

The labour market has so far remained resilient, as the seasonally adjusted unemployment rate stayed low at 2.8-2.9% in the first seven months of 2019 (Chart 3.3). With the economy losing steam, total employment declined slightly by 0.05% in the first half of 2019 to end at 3,870,700 persons in June. The decline in employment mostly came from the construction, trade and wholesale sectors. As output grew but employment edged down, labour productivity showed signs of cyclical improvement. Looking ahead, the labour market could continue to face more challenges given the economic outlook discussed above.

Chart 3.3
Labour market conditions



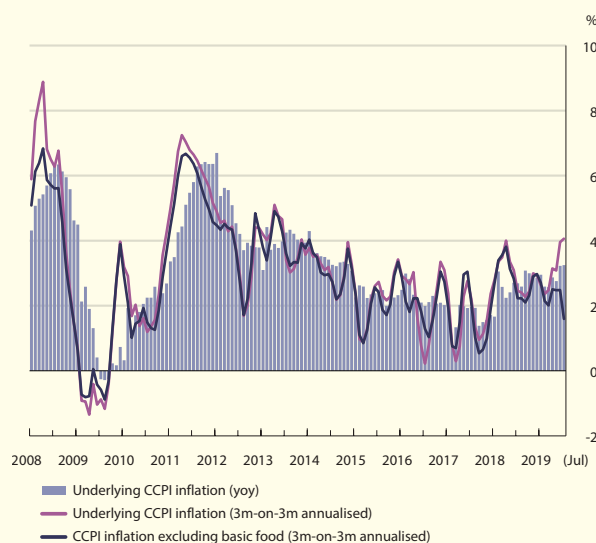
Source: C&SD.

3.3 Inflation

Local inflationary pressures edged up in the first half of 2019 but remained at moderate levels. On a year-on-year comparison, the underlying Composite Consumer Price Index (CCPI) rose by 2.7% in the first quarter and 2.9% in the second quarter, slightly higher than the annual rate of 2.6% in 2018. Inflation momentum, as measured by the annualised three-month-on-three-month underlying inflation rate, also

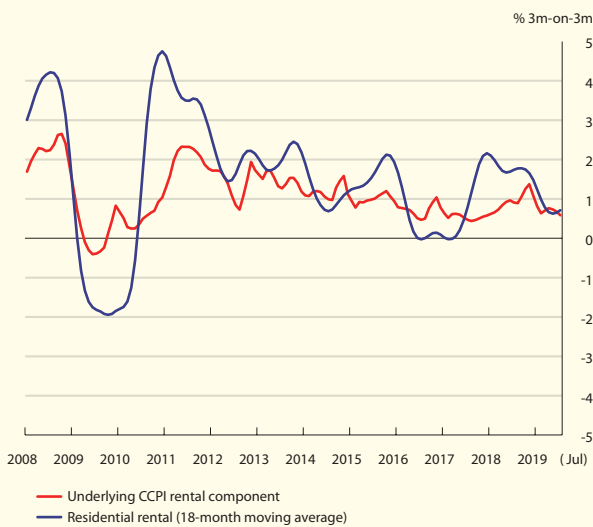
picked up from 2.6% in January to 4.1% in July (Chart 3.4), mainly due to price increases of fresh pork as a result of disrupted supply. Inflation momentum, excluding basic food prices, remained at below 3% throughout the first half of the year. In particular, external price pressures (excluding basic food prices) remained moderate, due in part to weaker global economic momentum and soft international energy prices. Locally, following the earlier consolidation of fresh-letting residential rentals, the rental component of inflation eased slightly (Chart 3.5). As productivity grew in line with payroll, the real unit labour cost was also roughly stable in recent quarters, suggesting that labour cost pressures were largely in check (Chart 3.6).

Chart 3.4
Different measures of consumer price inflation



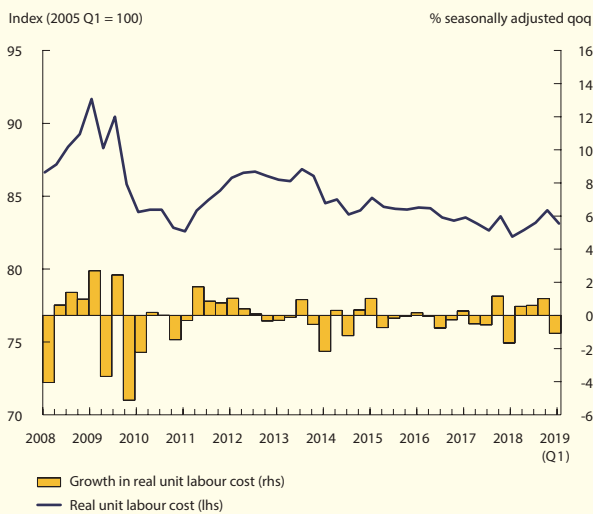
Sources: C&SD and HKMA staff estimates.

Chart 3.5
CCPI rental component and market rental



Sources: C&SD and Rating and Valuation Department.

Chart 3.6
Unit labour cost



Sources: C&SD and HKMA staff estimates.

Looking ahead, local inflationary pressures are expected to remain moderate, due to low global inflation, the earlier moderation in fresh-letting residential rentals, and the sluggish domestic growth momentum. However, the supply disruption and the resultant price increases in fresh pork may bolster the inflation momentum in the near term. In August, the Government revised upward its projection of the underlying and headline inflation rates for 2019 to 2.7% and 2.6% respectively, from 2.5% earlier. This inflation outlook is subject to risks on both sides. On the upside, if the disrupted supply of fresh pork lasts longer than expected, then inflation may edge up further. On the downside, if a sharper-than-expected economic slowdown or other market surprises occur, this could dampen inflation, given that the estimated current output gap is slightly below zero.

Box 3 The recent discrepancy in export performance of Hong Kong and the Mainland under the US-China trade conflict

Introduction

Hong Kong's goods export sector has performed poorly in recent months (Chart B3.1), likely in part due to the US-China trade conflict. However, while Mainland's export performance has "gyrated" since late last year, it has not been quite as bad. So, what explains this discrepancy in the export performance of Hong Kong and the Mainland?

Chart B3.1
Growth in total merchandise exports



Sources: China Customs and C&SD.

Using disseminated trade statistics from Hong Kong and the Mainland, we find that Hong Kong's export sector has been hit by a "double-whammy": (i) it faces similar headwinds as the Mainland in exporting to foreign economies; in addition, (ii) Hong Kong confronts a slowdown in goods re-exported to the Mainland, specifically intermediate goods that appear to be inputs in Mainland's production. The contraction in Mainland's imports of these goods has a disproportionately large impact on Hong Kong, considering they account for about half the value of Hong Kong's overall exports.

Export performance by destination and product

Table B3.A shows the share of total exports of the Mainland and Hong Kong by destination in 2017, prior to the US-China trade dispute. First, it is clear that the Mainland and Hong Kong are each other's major export destination. In particular, the Mainland accounted for 54% of Hong Kong's exports. Second, after excluding bilateral exports, the export destinations of the Mainland and Hong Kong are quite similar (the highlighted columns), partly reflecting the fact that merchandise exports of the two economies are generally driven by similar import demand from foreign economies. Thus, we look to Hong Kong's exports to the Mainland and other economies, separately, to understand the recent discrepancy in export performance between the two economies.

Table B3.A
Export share by destinations in 2017

Export destinations	Total exports of the Mainland		Total exports of Hong Kong	
	% share	% share (excluding Hong Kong)	% share	% share (excluding the Mainland)
Mainland China	-	-	54.3	-
Hong Kong	12.3	-	-	-
US	19.0	21.7	8.5	18.7
EU	16.4	18.8	9.0	19.6
- Germany	3.1	3.6	1.9	4.2
Japan	6.0	6.9	3.3	7.3
ASEAN	12.3	14.1	7.3	16.0
- Singapore	2.0	2.3	1.6	3.4
- Vietnam	3.1	3.6	2.1	4.5
S. Korea	4.5	5.2	1.5	3.2
Taiwan	1.9	2.2	2.3	5.0
India	3.0	3.4	4.1	9.0

Sources: China Customs, C&SD and HKMA staff calculation.

(i) Headwinds exporting to foreign economies

In following, we examine selected export destinations among the advanced economies and among Asian economies. These export destinations are chosen because they are major trading partners of both the Mainland and Hong Kong.

As shown in Charts B3.2 and B3.3, export patterns to advanced (blue lines) and Asian (red lines) economies are similar for the Mainland and Hong Kong.³¹ The growth rates of exports to these destinations have generally fallen since the second half of 2018, likely because of the US-China trade tensions.

Chart B3.2
Mainland exports to major destinations

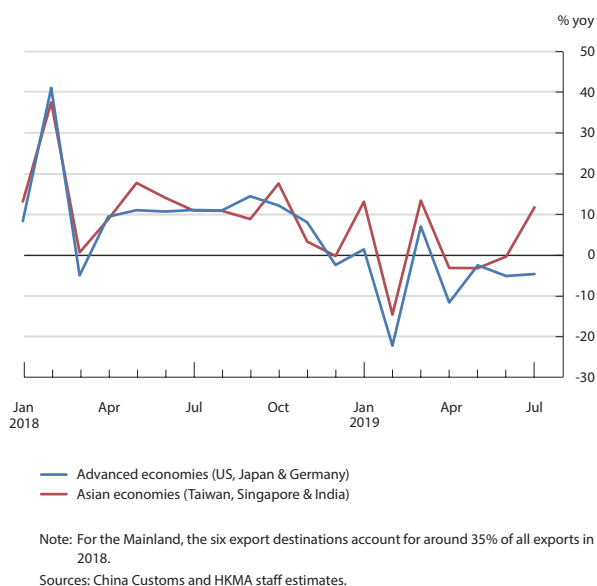
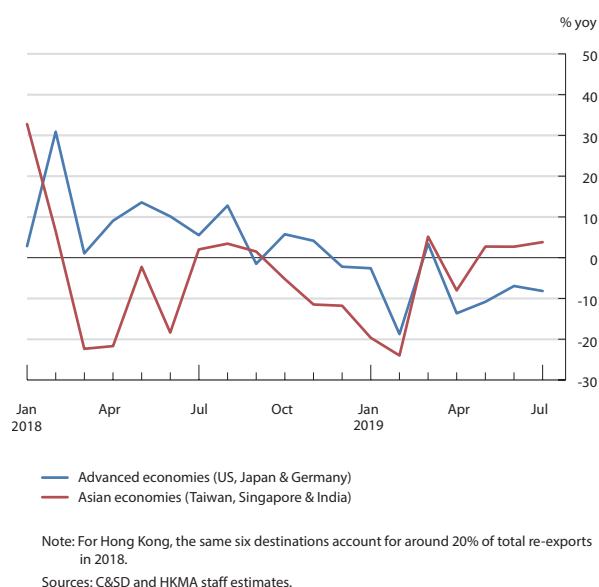


Chart B3.3
Hong Kong re-exports to major destinations

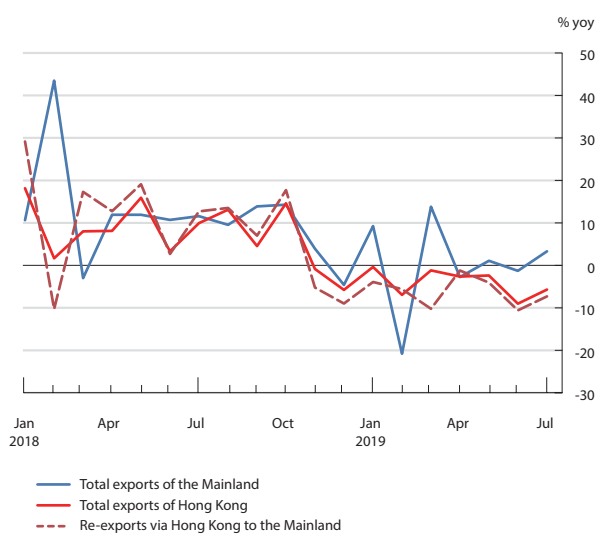


(ii) Headwinds exporting to the Mainland

In light of the US-China trade conflict, Mainland consumers and businesses may have reduced their demand for imports from Hong Kong. Indeed, Chart B3.4 shows that re-exports via Hong Kong to the Mainland (around 55% of total Hong Kong re-exports in 2018) saw a continual decline since the fourth quarter of 2018. This appears to be the key driver of the discrepancy in export growth rates between the two economies in recent months, when comparing the blue and red lines.

³¹ For Hong Kong, merchandise exports comprise domestic exports and re-exports, but the latter makes up about 99% of Hong Kong's export. As a result, export patterns are mainly driven by re-exports.

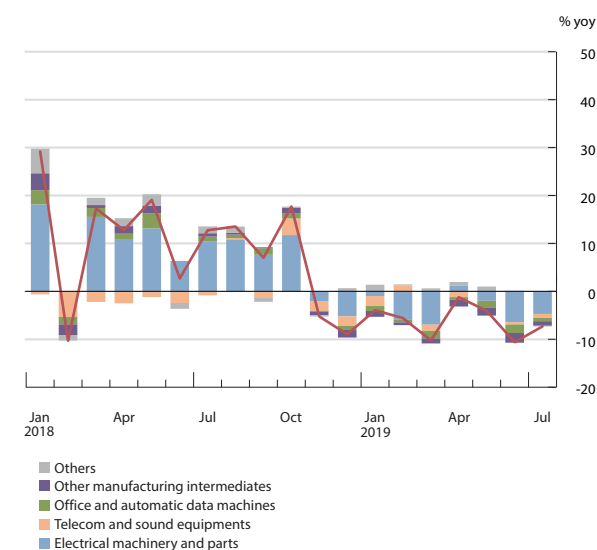
Chart B3.4
Re-exports via Hong Kong to the Mainland



Sources: China Customs, C&SD and HKMA staff estimates.

Taking a closer look at product categories, Chart B3.5 shows most of the declines in re-exports via Hong Kong to the Mainland are in electrical machinery and parts, and manufacturing intermediates (categories that collectively account for 64% of total re-exports to the Mainland by value in 2018). This could be evidence of the purported slowdown in supply chain activities in the Mainland since the trade conflict started in mid-2018.

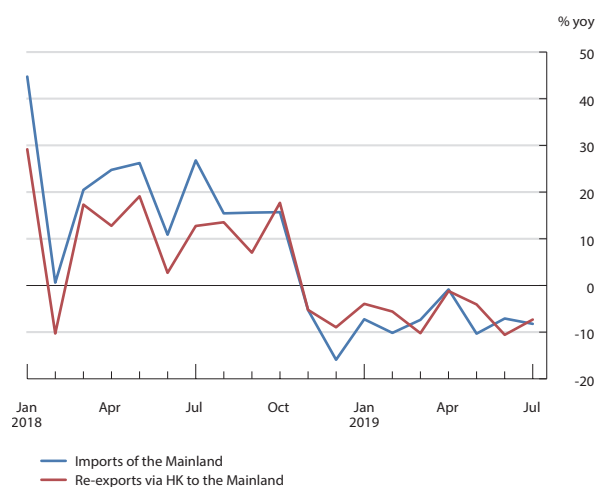
Chart B3.5
Re-exports via Hong Kong to the Mainland by product category



Sources: C&SD and HKMA staff estimates.

To further validate the supply chain slowdown story, we match, by product categories³², re-exports via Hong Kong to the Mainland with the corresponding imports of the Mainland. The results can be seen in Chart B3.6. It is clear that Hong Kong is re-exporting precisely the goods that the Mainland is buying less from around the world.

Chart B3.6
Re-exports via Hong Kong to the Mainland and Mainland's imports (same product categories)



Notes: China Customs does not provide the trade statistics by import origin and product category. Besides, most of the re-exports via Hong Kong to Mainland are not classified as imports from Hong Kong by China Customs.
Sources: China Customs, C&SD and HKMA staff estimates.

Concluding remarks

This Box examines the recent discrepancy in the export performance of Hong Kong and the Mainland. After taking out exports from Hong Kong to the Mainland, which accounts for roughly half of all Hong Kong exports, Mainland's and Hong Kong's export growth have been similar, suggesting that they are facing similar headwinds when exporting to foreign economies. In addition, it appears that Hong Kong is also confronted with reduced import demand from the Mainland, as Hong Kong's exports to the Mainland have registered negative growth so far this year. In particular, declining exports to the Mainland since late last year may reflect a slowdown in its production activities amid weaker growth.

³² That is, the same product categories of electrical machinery and parts, telecom and sound equipment, office and automatic data machines and manufacturing intermediates as shown in Chart B3.5