3. Domestic economy

Alongside weakened private consumption, subdued investment spending and poor export performance, the Hong Kong economy contracted in the second half of 2019, entering into a recession for the first time since 2009. The economic performance for 2020 is expected to be very challenging, with significant near-term downside risks associated with the coronavirus outbreak. This outlook is subject to further uncertainties and risks, including those stemming from the slowing global economy, the US-China trade relations, Mainland's economic performance and local social incidents. Unemployment will likely rise further in 2020 due to various economic headwinds, while local inflationary pressures are expected to moderate, although there are potential risks on either side.

3.1 Real activities

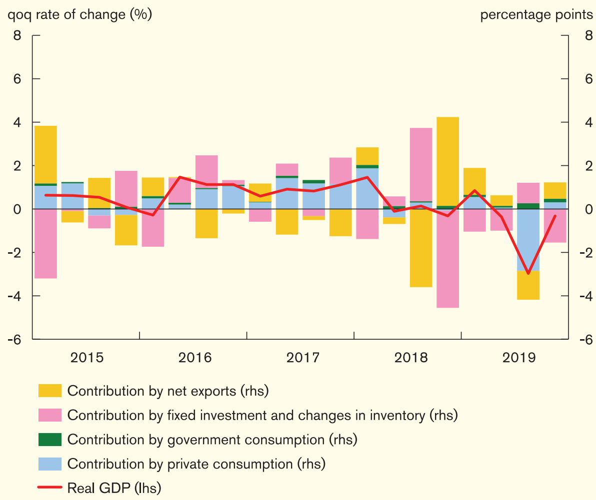
The economy contracted sharply during the second half of 2019. On a year-on-year basis, real Gross Domestic Product (GDP) contracted by 2.8% in the third quarter and 2.9% in the fourth quarter (Table 3.A). The economic contraction in the second half dragged down the full-year growth rate to -1.2%, compared with a 2.9% expansion a year earlier, marking the first annual decline since the 2009 global financial crisis.

Table 3.A
Real GDP growth

	Year-on-year growth rate (%)	
2018	Q1	4.5
	Q2	3.4
	Q3	2.6
	Q4	1.1
2019	Q1	0.7
	Q2	0.4
	Q3	-2.8
	Q4	-2.9
10-year average	(2009 Q1 – 2018 Q4)	2.8

Source: C&SD.

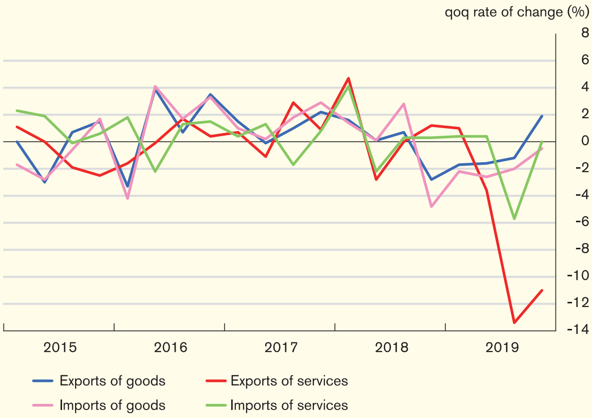
Chart 3.1
Real GDP growth and contribution by major expenditure components



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

On a quarter-on-quarter basis, economic activities slowed visibly in the second half of the year (Chart 3.1). Specifically, real GDP declined successively by 0.4%, 3.0% and 0.3% in the second, third and fourth quarters, indicating that the economy had entered into a recession. Domestically, private consumption constituted the main drag on GDP in the third quarter and has since contracted significantly as local social incidents caused major disruptions to consumption-related activities and the resultant weaker economic outlook lowered consumer confidence.[33] Aggregate investment spending remained weak and pulled down GDP in the fourth quarter due to heightened economic uncertainty and gloomy business sentiments.[34] Externally, Hong Kong's trade performance continued to be subdued amid the escalated US-China trade tensions, weaker global economic growth and plunging tourist arrivals (Chart 3.2).[35] Net trade contributed negatively to GDP in the third quarter driven by a sharp contraction in exports of services, but turned positive in the fourth quarter partly reflecting an improvement in the goods trade balance.

Chart 3.2
Exports and imports in real terms



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

In view of the strong economic headwinds, the Government introduced several rounds of measures between August and December 2019 to alleviate the financial burden of residents, safeguard jobs and support enterprises, particularly small and medium-sized enterprises (SMEs) as well as those in the hard-hit sectors, such as retail, food services, transport and tourism.[36] To allow banks to be more supportive to the domestic economy and help mitigate the economic cycle, the HKMA announced on 14 October a reduction in the Countercyclical Capital Buffer (CCyB) ratio of banks from 2.5% to 2.0%, thereby providing banks with more flexibility to release HK$200–300 billion in bank credit to enterprises including SMEs.

Hong Kong's economic performance in 2020 is expected to be very challenging, with significant near-term downside risks associated with the coronavirus outbreak. Some sectors, including those already suffering from the disruptions caused by the social incidents in 2019, will be doubly hit. However, the countercyclical fiscal measures announced in the 2020/21 Budget, which include a one-off cash handout and a new concessionary low-interest loan under the SME Financing Guarantee Scheme with 100% Government guarantee, are expected to provide some support to households and enterprises (especially SMEs).[37] On 16 March 2020, the HKMA further reduced the CCyB ratio of banks from 2.0% to 1.0%, which will allow banks to be more supportive to the domestic economy, in particular those sectors and individuals that are expected to experience additional short-term stress due to the impact arising from the outbreak. Analysed by GDP components, private consumption and investment will likely remain weak because of fragile consumer and business confidence. While government consumption will contribute to economic growth, public investment expenditure is anticipated to be relatively sluggish following the completion of some major infrastructure projects. On the

33 The Consumer Confidence Index compiled by the City University of Hong Kong fell to 52.8 and 68.7 respectively in the third and fourth quarters of 2019, reaching the lowest levels on record since the fourth quarter of 2008.

34 The Purchasing Managers' Index has remained in the contractionary zone since April 2018 and dropped to 33.1 in February 2020, the lowest level on record.

35 Tourist arrivals plummeted by 39.1% year-on-year in the second half of 2019, especially those from Mainland China (-40.8%), along with tourist spending as indicated by decreases in retail sales.

36 These measures include rent concessions, utility subsidies for domestic and non-domestic households, principal moratorium under the existing SME Financing Guarantee Scheme, a new 90% Loan Guarantee Product, etc.

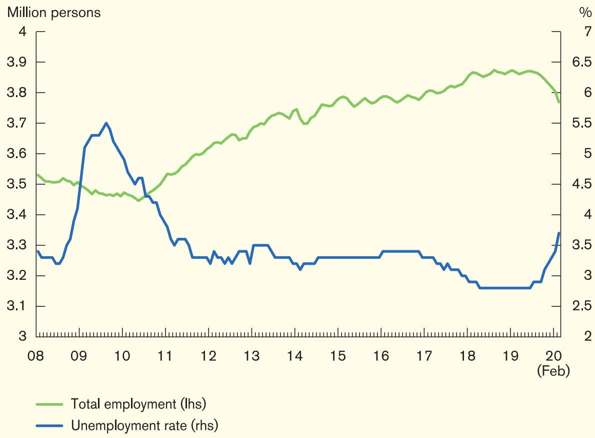
37 Other relief measures include reducing salaries tax and profits tax by 100%, subject to a ceiling, as well as waiving rates of domestic properties and registration fees for businesses. Some banks have also implemented short-term relief measures such as interest-only repayments for mortgage loans and relief loans for SMEs.

external front, the "phase one" trade deal between the US and Mainland China is assessed to be slightly positive for the local economy in the short term.[38] However, Hong Kong's external trade performance will continue to be weighed down by weak global economic growth and trade flows. In particular, the coronavirus outbreak may lead to regional supply chain disruptions and slower cross-border economic activities (e.g. tourism), thereby restraining Hong Kong's exports. The Government forecasts real GDP growth for 2020 in the range between -1.5% and 0.5%, and the growth estimates by international organisations and private sector analysts averaged -1.5%. This subdued economic outlook is subject to a number of uncertainties and risks as discussed in previous chapters.

3.2 Labour market conditions

The labour market came under increasing pressures in the second half of 2019 and in early 2020. The seasonally adjusted unemployment rate rose from a multi-year low of 2.8% in June 2019 to 3.3% in December 2019 and further to 3.7% in February 2020 (Chart 3.3). Partly reflecting the impact of the social incidents, the retail, accommodation and food services sectors were hit hard, with the unemployment rate of these sectors rising to 6.1%, the highest in about a decade.[39] Amid the slowing economy, total employment declined by 0.5% year-on-year in the second half of 2019 and dropped further to 3,768,800 persons in February 2020. The decline in employment mostly came from the trade, wholesale, retail, accommodation, food services and construction sectors. Real payroll also showed a year-on-year decline of 0.3% in the third quarter. Looking ahead, the labour market will continue to face more challenges and the unemployment rate will likely rise further given the sluggish economic outlook discussed above. Box 3 discusses in more detail the recent developments in the labour market and its near-term outlook.

Chart 3.3
Labour market conditions



Source: C&SD.

3.3 Inflation

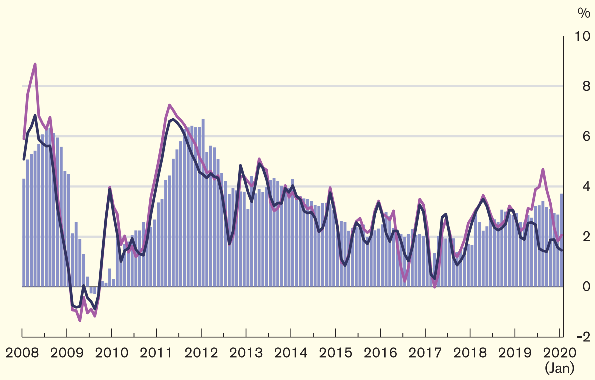
Local inflationary pressures continued to accumulate up to the third quarter of 2019 mainly due to elevated fresh pork prices, but the sequential momentum of inflation gradually eased thereafter along with weakened economic activities. On a year-on-year comparison, the underlying Composite Consumer Price Index (CCPI) increased by 3.3% in the third quarter, before moderating somewhat to 3.0% in the fourth quarter. Inflation momentum, as measured by the annualised three-month-on-three-month underlying inflation rate, also softened from the peak of 4.7% in August 2019 to 2.1% in January 2020. The slower inflation momentum was attributable to the reduced price pressures on a broad range of CCPI components. For tradable items, while inflation of basic food items remained visible due to elevated fresh pork prices, price pressures for consumable goods such as clothing and footwear as well as durable goods remained generally soft. For services, the growth

[38] Our in-house analysis suggests that the trade deal will have a small net positive impact on Hong Kong's nominal GDP in the short term, although the actual outcome will be subject to high uncertainty. The impact is likely to come mainly from a reduction in uncertainty which increases consumption and investment, while the potential impact on trade is estimated to be limited given the offsetting effects from the tariff rollback and possible trade diversion (away from Hong Kong).

[39] In addition, the unemployment rate in the construction sector reached 6.8% in February 2020.

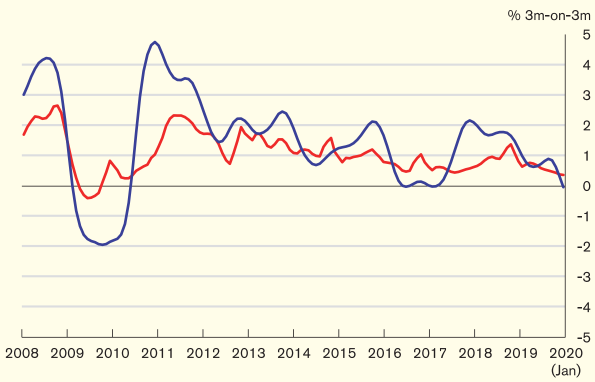
in the rental component of the CCPI has also been on a downtrend in tandem with the earlier consolidation of fresh-letting residential rentals (Chart 3.5). Labour cost pressures edged up slightly, but stayed at modest levels in recent quarters (Chart 3.6).

Chart 3.4
Different measures of consumer price inflation



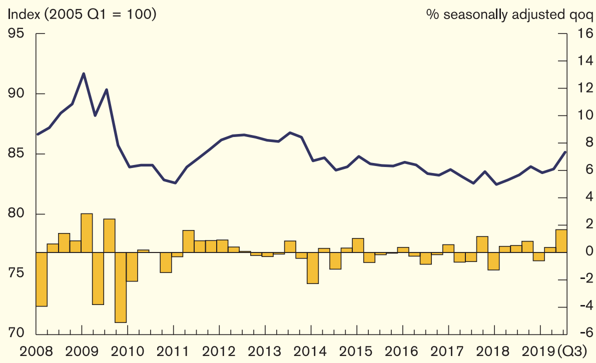
Sources: C&SD and HKMA staff estimates.

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.

In the near term, local inflationary pressures are expected to moderate. Domestically, the sub-par economic conditions, together with a widening negative output gap, will continue to put downward pressures on local inflation. In particular, the rental component of inflation should ease further following the continued feed-through of the consolidation of private residential rentals. Externally, imported inflation will likely remain mild on the back of weak global economic growth and soft energy prices. Market consensus forecasts the headline inflation rate for 2020 to be between 0.6% and 3.7%, and the Government projects the underlying inflation rate to be 2.5% and the headline inflation rate to be 1.7%.

This inflation outlook is subject to offsetting risk factors. On the one hand, if the economy deteriorates more sharply than expected (due to, for example, a prolonged period before the coronavirus outbreak is contained), this could further dampen inflation, given that the estimated output gap has become more negative since the third quarter of 2019. On the other hand, if the disrupted supply of fresh pork re-intensifies, it will exert upward pressures on inflation.

Box 3
An assessment of Hong Kong's labour market: Recent developments and near-term outlook

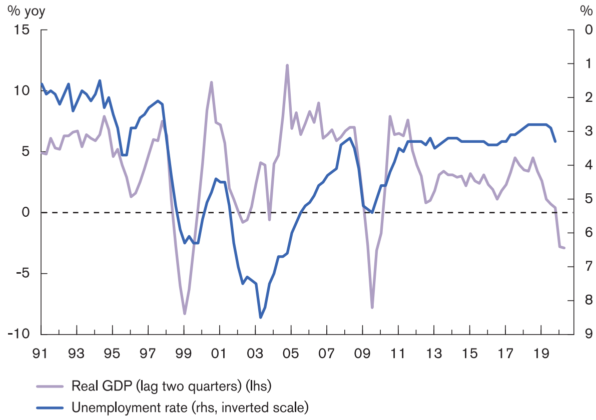
Introduction

Despite a clear economic slowdown, the unemployment rate remained low at 2.8–2.9% in the first nine months of 2019. It climbed more visibly to 3.3% towards the end of the year along with the prolonged social incidents. The labour market faces even stronger headwinds entering into 2020 due to the outbreak of the coronavirus. Against this backdrop, this Box reviews recent developments in the labour market, and discusses its near-term outlook. In particular, we examine why the overall labour market was broadly "resilient" (the unemployment rate barely moved) in the first three quarters of 2019, and how this may shed light on future developments. Our analysis also highlights some risk factors that could lead to a sharp increase in the unemployment rate.

Recent labour market developments

It should be noted that the unemployment rate is a lagging indicator, partly because it is costly to adjust labour demand. Empirically, the unemployment rate tends to lag behind year-on-year real GDP growth by about two to three quarters (Chart B3.1). And this lagged response may explain why the unemployment rate remained stable at about 2.9% in the third quarter despite a sharp deterioration in real economic activities.

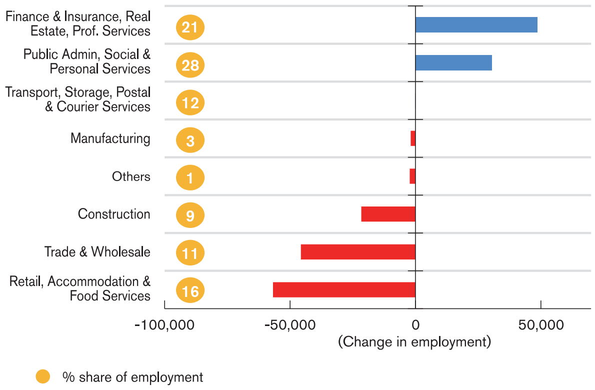
Chart B3.1
Real GDP growth and unemployment rate



Note: Quarterly data.
Source: C&SD.

On the demand side, while employment in the trade sector and the retail and tourism-related sector were hard hit by US-China trade tensions and the local social incidents, some large economic sectors remained supportive of the overall labour market. Specifically, the financial, business, public administration, social and personal services sectors still saw employment growth in 2019, partially offsetting the fall in trade and retail employment (Chart B3.2). Indeed, despite the current economic recession, Hong Kong's financial system remained sound and resilient, and financial activities were vibrant in terms of fintech developments and new equity issuance. All these may have helped support employment in the financial and business services sector. In addition, the public administration, social and personal services sector, which includes education, human healthcare and social work activities, appears to be less cyclically-sensitive. Correlation analysis reveals that while employment in many sectors is highly correlated with real GDP, the public administration, social and personal services sector is more cyclically-neutral. In other words, even if the economy slows, the employment in this sector may not be significantly affected cyclically.

Chart B3.2
Sectoral employment changes in 2019



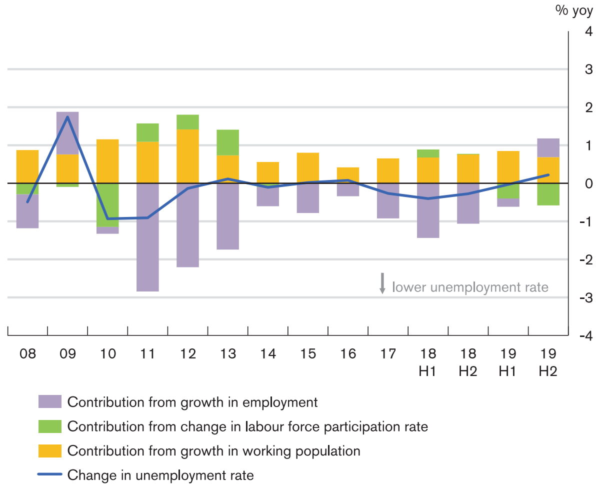
Note: Employment share refers to 2018.
Source: C&SD.

On the supply side, the labour force participation rate (LFPR)[40] declined from 61.2% in 2018 to 60.5% in 2019 and the unemployment rate was cushioned by this recently lower LFPR. Chart B3.3 shows a breakdown of the changes in the unemployment rate (the blue line) into different supply and demand factors. The breakdown reveals that the LFPR exerted downward pressure on the unemployment rate (the green bars) in 2019.[41] On the other hand, rising employment in the first half of 2019 (the purple bar) also helped keep the unemployment rate in check. As the economy contracted markedly in the second half, declining employment put upward pressure on the unemployment rate. Taken together, while employment declined amid the economic recession, the lower LFPR helped mitigate the rise in the unemployment rate in the latter part of 2019.

[40] LFPR refers to the proportion of land-based non-institutional population aged 15 and above participating in the labour market.

[41] Working population grew steadily over the years owing to net migration and, to a lesser extent, natural population growth. As potential labour supply increases, it tends to raise the unemployment rate (the yellow bars in the chart).

Chart B3.3
Factors contributing to changes in the unemployment rate



Note: Period averages. Decomposition not exact. Residuals not shown here.
Sources: C&SD and HKMA staff estimates.

Some changes in the labour market structure are also worth mentioning. In particular, the increased share of voluntary part-time employees may have helped firms to retain workers. In fact, self-employment and underemployment as a share of total employment declined to about 6% and 1% respectively in recent years, but voluntary part-timers increased continually to become the second largest group in total employment (about 7% in 2017).[42] As such, companies can adjust the work hours of part-timers and potentially retain or absorb more labour. Our calculation suggests that average working hours per week generally declined, from a recent peak of 48 hours in 2010 to about 44 hours now, partly reflecting the fact that more part-timers are now in employment.

In summary, partly reflecting some labour-supportive sectors and lower LFPR, the overall labour market was broadly stable for the better part of 2019, before turning more sluggish towards the end of the year amid the local social incidents. With these observations, what are the prospects for the near-term?

[42] Forms of employment include full-time employees, underemployed employees, voluntary part-time employees, self-employed, employers and unpaid family workers.

The near-term outlook for the labour market

The labour market will face mounting pressure and the unemployment rate will likely rise further in 2020 as the impact from a further decline in labour demand more than offsets the small cushion provided by reduced labour supply. As the economy has slipped into a recession and is combating the coronavirus outbreak, the demand for labour in the logistics, retail and tourism sectors, which have yet to recover from the impact of the social incidents in 2019, will be doubly hit in the near term. Additionally, the SMEs in these sectors will be particularly vulnerable. Other sectors will also be under increasing stress amid the outbreak which hampers various economic and financial activities, both locally and cross-border. As a result, a significant reduction in labour demand will raise the unemployment rate. For labour supply, the labour force participation rate should continue to mitigate the rise in the unemployment rate. However, its impact is likely to be temporary and small. Indeed, private-sector analysts forecast the unemployment rate for 2020 to reach about 3.1–4.7%, up from 3.0% in 2019.

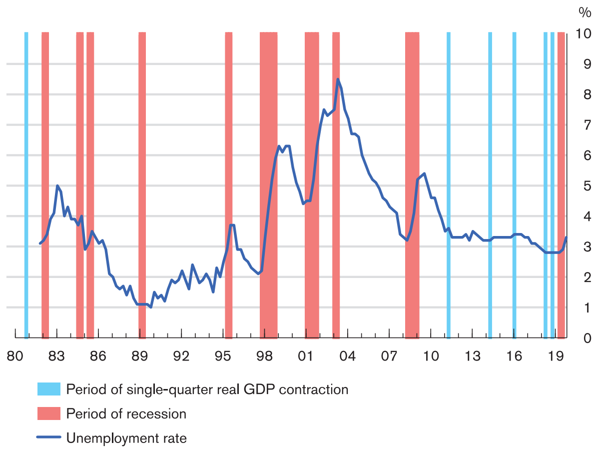
This dimmer labour market outlook is subject to a host of uncertainties and risks. For example, the impact of the increased share of voluntary part-timers on the unemployment rate is somewhat uncertain as there are two offsetting forces. When there is a deeper economic downturn, the unemployment rate may increase if firms find it easier to terminate employment. However, the unemployment rate may not rise much if firms find it easier to adjust manpower or work hours instead of laying off workers outright.

More importantly, the unemployment rate tends to rise much more sharply during a shock than average historical patterns suggest. In other words, we have to be aware of non-linear labour market adjustments. In particular, these rapid adjustments are likely to be associated with an economic recession, an outbreak or rising company bankruptcy and closure. We now take a closer look at these phenomena.

Economic recession

Compared with a single quarter of real GDP contraction, an economic recession can lead to a much sharper increase in the unemployment rate (Chart B3.4). In addition, the deeper the recession, the higher the unemployment rate (Table B3.A). This is particularly relevant to Hong Kong's present situation as the economy has entered into a recession, coupled with the possibility of trade tensions, renewed local social incidents and the coronavirus outbreak, that are likely to drag on in the near term.

Chart B3.4
Economic recession and unemployment rate



Note: Recession denotes two consecutive quarters or more of negative quarter-on-quarter growth in real GDP.
Sources: C&SD and HKMA staff estimates.

Table B3.A
Economic recession and unemployment rate

Major recessions (Time period)	Depth of recession: decline in real GDP	Changes in unemployment rate
Asian financial crisis (1997 Q4 to 1998 Q4)	-9.0% in 5 quarters	+ 3.8 ppts
Global financial crisis (2008 Q2 to 2009 Q1)	-7.5% in 4 quarters	+ 1.9 ppts
Burst of IT bubble (2001 Q1 to 2001 Q4)	-1.1% in 4 quarters	+ 1.9 ppts
Outbreak of SARS (2003 Q1 to 2003 Q2)	-2.5% in 2 quarters	+ 1.1 ppts

Sources: C&SD and HKMA staff estimates.

Outbreak

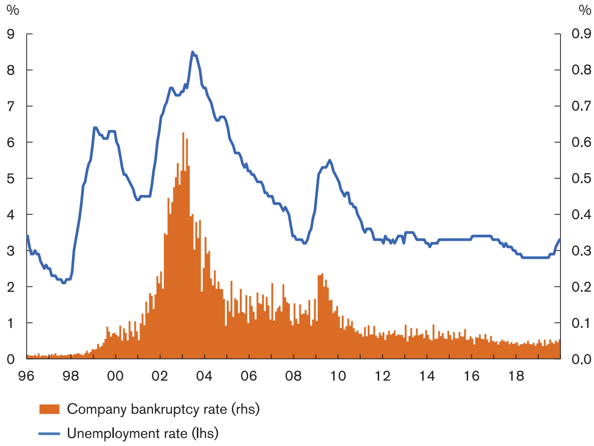
Experience during the Severe Acute Respiratory Syndrome (SARS) period in 2003 suggests that the unemployment and underemployment rates can increase sharply because of an abrupt fall-off in economic activity. At that time, the unemployment rate increased from 7.4% in December 2002 to a high of 8.5% in June 2003 (see also Table B3.A). The underemployment rate also rose from 3.1% to 4.3% as some employees were temporarily suspended from work or asked to take no-pay leave.

Compared with SARS, the impact of the coronavirus outbreak may be larger, so the unemployment rate could rise even faster for two reasons. First, the share of total employment in the tourism sector has increased, up from 4.4% in 2002–2003 to 6.6% in 2018. While the share of total employment in the retail sector has remained roughly steady over the years at about 8–9%, it has become more dependent on tourist spending. As such, the deterioration in inbound tourism due to the current outbreak may have a larger impact on employment compared with SARS. Second, inbound tourism and tourism-related sectors bounced back swiftly in the second half of 2003, partly boosted by the launch of the Individual Visit Scheme in late July that year. A repeat of the favourable effect from such an initiative appears to be less likely now. Of course, the ultimate impact will also depend on the persistence and spread of the outbreak.

Bankruptcy and closure

Company bankruptcies and closures can deepen job losses, thus causing a further spike in the unemployment rate (Chart B3.5). This risk appears imminent as news reports suggest that some retail shops or small businesses are closing down, or considering closing this year or after the expiry of their tenancies.

Chart B3.5
Company bankruptcy rate and unemployment rate



Sources: Official Receiver's Office and C&SD.

That said, the relief measures and liquidity support announced by the authorities, including rent cuts, the principal moratorium under the existing SME Financing Guarantee Scheme, new Loan Guarantee Products (i.e. 90% Loan Guarantee Product and Special 100% Loan Guarantee Product) and the reduction in banks' CCyB ratio, should provide some support to enterprises, especially the SMEs and, hence, the labour market.

Concluding remarks

Partly reflecting some labour-supportive sectors and the lower LFPR, the overall labour market was broadly stable for the better part of 2019, before turning more sluggish towards the end of the year amid the local social incidents. In the near term, the unemployment rate is likely to increase further as a result of the coronavirus outbreak and the more broad-based downturn in the economy, which need to be monitored closely, as these events can be associated with a sharp increase in the unemployment rate.

However, there are some caveats to this assessment. The unemployment rate may understate the labour market slack. For example, as voluntary part-time employee numbers have increased, and are reported as employed, the economic downturn could lead to a further shift to this type of employment, for example, working fewer hours instead of being laid off. And, while this may curb an increase in the unemployment rate, labour hours and earnings may see faster and sharper downward adjustments. In addition, businesses may respond to lower aggregate demand by shortening business hours, or asking employees to reduce work hours or take no-pay leave, which will not be reflected in the unemployment rate (though in the underemployment rate).

Therefore, looking at the unemployment rate alone as an indicator of labour market slack may not be sufficient. To monitor labour market conditions, we should adopt a holistic approach and also look at the underemployment rate, labour movements across different types of employment, average working hours, wage and earnings, as well as other more timely indicators, such as the employment sentiment.