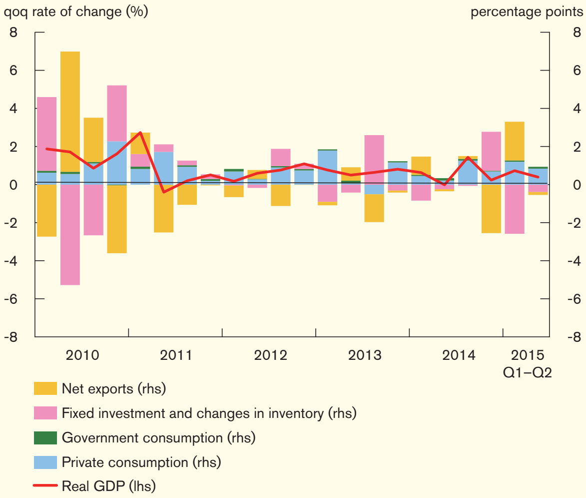
3. Domestic economy

The Hong Kong economy continued to grow at a moderate pace in the first half of 2015, with robust domestic demand offset partly by weak trade performance. Growth momentum in the second half may soften amid increased financial market volatility and risks to global economic and monetary conditions. Local inflationary pressure will likely remain contained on the back of soft import prices and the moderate domestic growth momentum.

3.1 Real activities

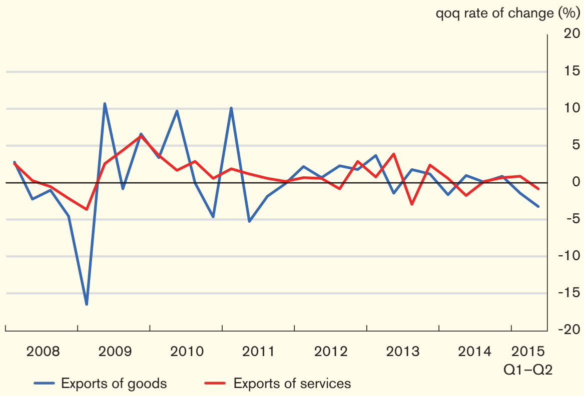
The Hong Kong economy continued to grow moderately in the first half of 2015. On a seasonally adjusted quarter-on-quarter basis, real GDP grew by 0.4% in the second quarter, following a 0.7% growth in the first quarter (Chart 3.1). Private consumption held up on the back of stable labour market conditions and strong spending on financial services amid the stock market rally in the second quarter. While building and construction activities were robust and capital investment improved, inventory destocking has been significant. Overall investment spending thus posed a drag on GDP growth in the first half. Net exports also turned to a drag on growth in the second quarter as both exports of goods and services contracted (Chart 3.2). The latter reflected weaknesses in inbound tourism, offshore trade and logistics, which more than offset the stronger performance in financial services exports. Meanwhile, imports of goods declined along with weak re-export activities, but imports of services increased.

Chart 3.1
Real GDP growth and contribution by major expenditure components



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

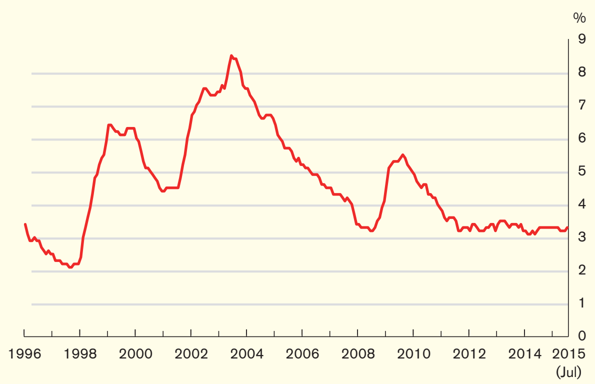
Chart 3.2
Exports of goods and services in real terms



Source: C&SD.

The year-on-year real GDP growth remained moderate at 2.4% and 2.8% respectively in the first and the second quarter. In fact, Hong Kong's real GDP growth has slowed to around 2–3% a year since 2012. Box 3 explains this development by examining the productivity performance of the key business sectors and shows that the moderated growth in total factor productivity of the import-export trade sector and the non-bank financial sector after the global financial crisis was the main driver. In the first half of 2015, labour market conditions remained broadly stable. The seasonally adjusted unemployment rate edged down to 3.2% in the second quarter after staying at 3.3% for three consecutive quarters (Chart 3.3). This mainly reflected a small decline in the unemployment rate of the higher-skilled segment. However, the employment situation in the retail and other tourism-related sectors has softened due to weaker inbound tourism.

Chart 3.3
Unemployment rate

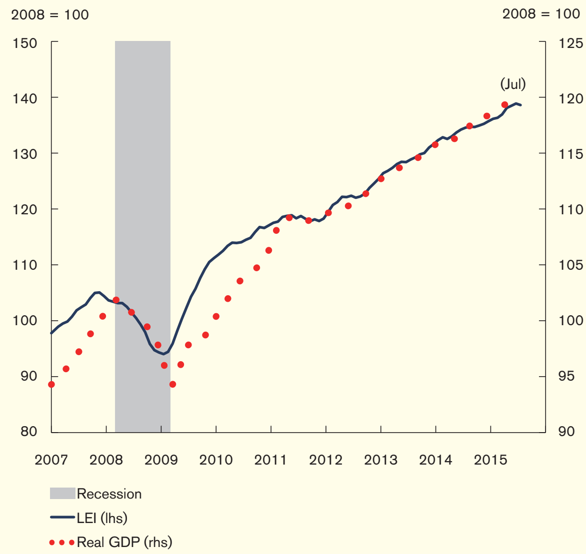


Source: C&SD.

Looking ahead, growth momentum of the Hong Kong economy could see some moderation in the second half of 2015. On the domestic front, while still supported by the broadly stable labour market conditions, private consumption growth is expected to soften amid the negative wealth effect driven by the recent stock market sell-off. Meanwhile, private and public sector building activities are expected to gather pace in the second half, but weaker business sentiment and uncertain prospects amid financial market volatility could weigh on capital investment. External demand is also facing headwinds, with continued weakness in tourist spending and softening in financial services exports due to increased financial market volatility. Exports of goods are expected to remain sluggish amid the weak global growth prospects.

The HKMA in-house composite index of leading indicators points to growth moderation of the Hong Kong economy in the remainder of the year (Chart 3.4). The Government's range forecast of real GDP growth for 2015 has been narrowed to 2–3%, while the Consensus Forecasts project the economy to grow at an average rate of 2.3%.

Chart 3.4
Real GDP and leading economic indicator



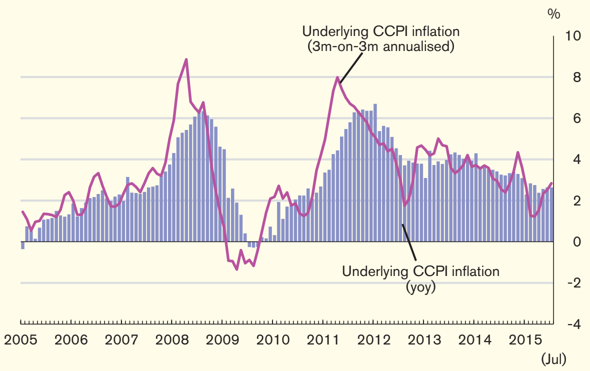
Sources: C&SD and HKMA staff estimates.

This growth outlook is subject to a number of uncertainties and downside risks amid volatility in global financial markets, uncertainty surrounding Mainland's economic growth, US interest rate normalisation and the uptrend of the US dollar. In particular, greater financial stress and a further weakening in market sentiments towards Mainland China and emerging market economies could have considerable spillover effects on Hong Kong by subjecting the domestic asset markets to a re-pricing of risks and putting fund flows under strain. The resulting tightening in monetary conditions and negative wealth effect would adversely affect Hong Kong's economic outlook under such a scenario.

3.2 Consumer prices

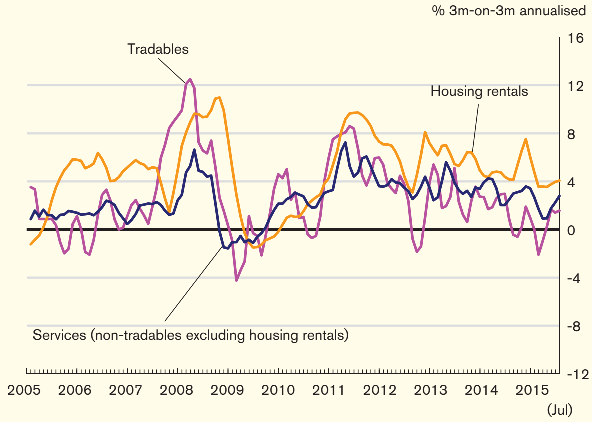
The year-on-year underlying inflation rate eased to 2.6% in July 2015 from 3.1% last December, thanks to abating external and domestic cost pressures. Inflation momentum, as measured by the annualised three-month-on-three-month underlying inflation rate, also moderated to 2.8% from 3.6% over the same period, indicating some softening of price pressures (Chart 3.5). In particular, services inflation came down from 3.4% last December to 2.7% in July 2015, while the housing rental component also retreated visibly from 6.0% to 4.0% over the same period, both of which helped offset the modest pick-up in prices of tradables (Chart 3.6).

Chart 3.5
Different measures of consumer price inflation



Sources: C&SD and HKMA staff estimates.

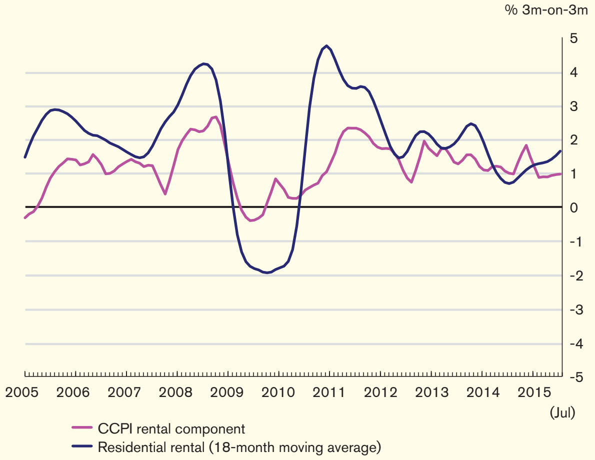
Chart 3.6
Consumer price inflation by broad component



Sources: C&SD and HKMA staff estimates.

Looking ahead, the sequential inflation momentum will likely remain moderate. Import price inflation should remain capped by the strong Hong Kong dollar and subdued global commodity prices. Locally, while the renewed uptrend of fresh-letting residential rentals since the second quarter of 2014 will likely translate into a faster increase in the housing rental component of consumer price inflation going forward, the extent of feed-through is expected to be mild (Chart 3.7). Moreover, easing business cost pressures along with the recent slowdown in retail property rental growth and the modest increases in real labour costs, coupled with the moderate domestic growth momentum in the midst of an expected slightly negative output gap, should help contain the rise in services inflation as well. On the whole, the annual inflation rate for 2015 is likely to be lower than that of 2014, with the latest Government forecast projecting an underlying inflation rate of 2.6%, down from 3.5% in 2014.

Chart 3.7
CCPI rental component and market rentals



Note: The CCPI rental component has excluded the effects of the Government's one-off relief measures.

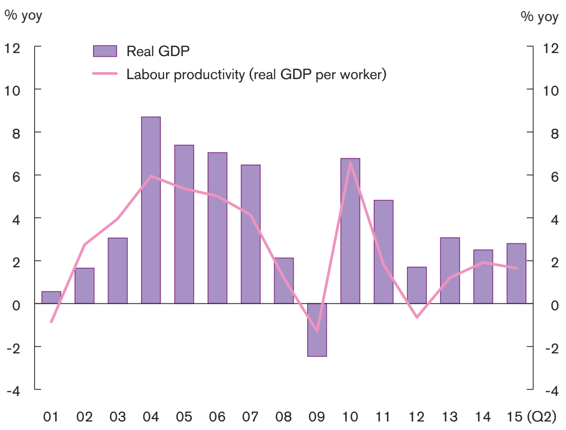
Sources: Rating and Valuation Department, C&SD and HKMA staff estimates.

The outlook for inflation is subject to uncertainties, although the balance of risks has tilted more to the downside in view of a number of considerations. For one, the risks of further growth moderation in Mainland China and subdued growth momentum in the euro area and Japan could dampen Hong Kong's near-term growth and cloud the inflation outlook. Moreover, local mortgage rates may be subject to uncertainties going forward, contingent upon the future paths of US monetary policy. Such uncertainties, coupled with expanding housing supply, could trigger a downswing in the property market and weigh on housing rental growth. Separately, the recent slowdown in inbound tourism, if continued, could spill over to the local labour market and the retail property market, while the recent sell-offs in global equity markets may also have weighed on local consumer sentiment. These developments could exert a dampening effect on services inflation.

Box 3
Productivity growth in Hong Kong: Sectoral patterns and drivers

After staging a strong and swift recovery from the global financial crisis (GFC) in 2009–2011, the Hong Kong economy has been growing moderately for some time, progressing at around 2–3% a year since 2012 (Chart B3.1). This was in sharp contrast with the pre-GFC period when the economy grew at about 5% a year on average. Similarly, real output per worker — a measure of labour productivity — has also increased at a gentler annual pace of 0.8% in recent years, compared with an average of 3.6% before the GFC. This raises the question of whether the recent moderate growth path has become a new normal. This box analyses the factors behind slower trend growth in Hong Kong, and in particular, the total factor productivity (TFP) growth of selected major business sectors in Hong Kong for the period since 2000. This may shed light on the medium-term prospects of the major business sectors and potential growth of the Hong Kong economy.

Chart B3.1
Growth in real GDP and output per worker

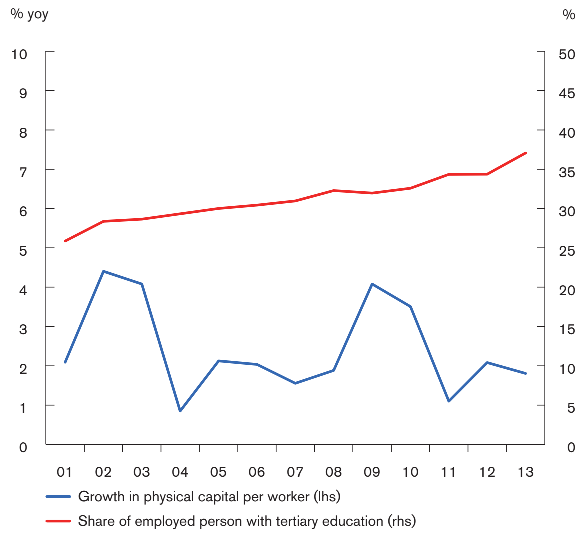


Sources: C&SD and HKMA staff estimates.

Economic growth and total factor productivity

Growth in real output per worker depends on physical and human capital accumulations as well as TFP growth. A cursory look at the data suggests that physical and human capital accumulations in Hong Kong have progressed steadily and they cannot explain the growth slowdown of real output per worker in the post-GFC period. For example, physical capital per worker has continued to increase moderately at an average annual rate of around 2% between 2001 and 2013 (Chart B3.2), while the sharp increase after the dotcom bubble burst and the GFC appeared to be transitory, mainly reflecting firms' tendency to hold back hiring of workers during recessions. Moreover, worker skills seemed to have continued to pick up, as the overall share of higher educated workers (with educational attainment at the tertiary level or above) rose to 37.1% in 2013 from 30.4% in 2006 and 25.9% in 2001.

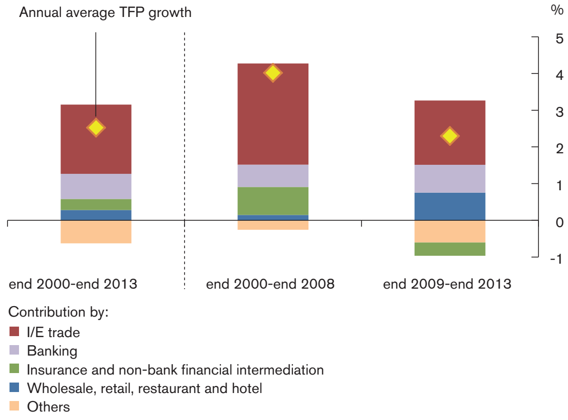
Chart B3.2
Indicators of physical and human capital accumulations



Note: The perpetual inventory method is used to construct capital stock.
Sources: C&SD and HKMA staff estimates.

Rather, the important factor for growth slowdown of real output per worker after the GFC appeared to be slower TFP growth, which is the portion of output increases not directly produced by measured inputs. Chart B3.3 provides an estimate of TFP growth in Hong Kong during 2000–2013 and a breakdown of overall TFP growth in terms of contribution by key business sectors. It is derived based on the estimated TFP of key business sectors using the method of Data Envelopment Analysis.[23] This measure of overall TFP grew by an average 2.7% a year for the whole period of 2000–2013. Using 2009 as a watershed, the average annual TFP growth was remarkably high at 4.0% before 2009. But after 2009, it receded to an average annual growth rate of 2.6%. The major contributor to overall TFP growth moderation was the import/export (I/E) trade sector. After the GFC, contribution by the I/E trade sector has declined notably while that by the wholesale, retail, restaurant and hotel sector increased.[24] In the financial sector, banks' contribution remained fairly stable and resilient throughout 2000–2013, while the non-bank financial corporations' contribution was relatively volatile.

Chart B3.3
Total factor productivity growth and contribution by major economic sectors



Source: HKMA staff estimates.

Drivers of sectoral total factor productivity

But what are the reasons behind the change in the TFP growth pattern in Hong Kong during 2000–2013? Conceptually, TFP hinges on a host of supply-side factors that capture productivity benefits from various sources. These include (1) technology advancement and efficiency gains, (2) product and service innovation, and (3) trade liberalisation and reform measures. The following is an analysis on the possible underlying drivers of TFP developments in the key business sectors.

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[23] Due to data availability, this study only considers some selected key business sectors, which together account for over 90% of GDP in Hong Kong. For details on the estimation method, please refer to Leung, Han and Chow (2009), "Financial services sector as a driver of productivity growth in Hong Kong," HKMA Working Paper 14/2009.

[24] Ideally, the tourism sector should be a focus of the study but no reliable data are available for estimation of TFP growth, so the broader wholesale, retail, restaurant and hotel sector is considered.

Table B3.A
TFP growth of major economic sectors

	TFP growth (%)		
	2000-2008	2009-2013	2000-2013
Overall	**4.0**	**2.6**	**2.7**
of which:			
I/E trade	**9.3**	**6.1**	**6.6**
Financial	**6.3**	**1.3**	**4.2**
Banking	5.1	5.0	5.2
Non-bank financial	11.6	-7.1	3.7
Wholesale, retail, restaurant & hotel	**1.4**	**7.1**	**2.5**
Wholesale & retail	2.8	9.1	4.4
Restaurant & hotel	0.1	2.6	0.1

Note: Compound annual growth rates are used. In this table, the TFP growth rates of the financial sector and the wholesale, retail, restaurant and hotel sector are estimated by first grouping the inputs and outputs in their subsectors. The insurance sector is not shown here as its contribution to overall TFP growth is small.

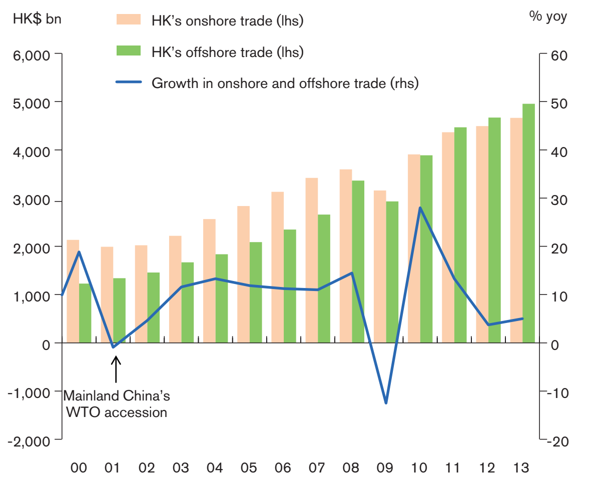
Source: HKMA staff estimates.

a) The I/E trade sector

Among all the selected sectors, the I/E trade sector recorded the fastest annual TFP growth of 6.6% during 2000–2013 (Table B3.A). Indeed, this sector's TFP growth was extraordinarily fast before the GFC, at an annual average of 9.3%. This overall fast TFP growth was boosted by trade liberalisation in Mainland China (including its accession to the World Trade Organisation in 2001), which in turn led to relatively brisk growth in Hong Kong's onshore and offshore trade (Chart B3.4). In particular, the fast TFP growth was driven by efficiency gains from the continued expansion of Hong Kong's manufacturing base to Mainland China and other lower cost areas and the rise of offshore trade business, as well as product and service innovation as traders climbed up the global value chain.[25]

After the GFC, the I/E trade sector's TFP growth has moderated to an annual average of 6.1%, but still high compared with other business sectors. The TFP moderation was probably attributable to the longer-term impact of the GFC, which has taken a toll on world output growth and international trade flows. It could be difficult for traders in Hong Kong to reallocate efficiently their productive resources that once geared towards the advanced economies to production for final demand of other higher growth emerging markets. Continued weakness in the advanced economies would put at least some of the productive resources (such as machinery and skilled labour) idle and would not be conducive to the progress and evolution of technological innovation for the production process.

Chart B3.4
Onshore and offshore trade value of Hong Kong



Note: Onshore trade is the sum of merchandise exports and retained imports. For the period before 2002, official offshore trade data are not available, and figures in the chart are imputed based on margins and commissions earned.

Sources: C&SD and HKMA staff estimates.

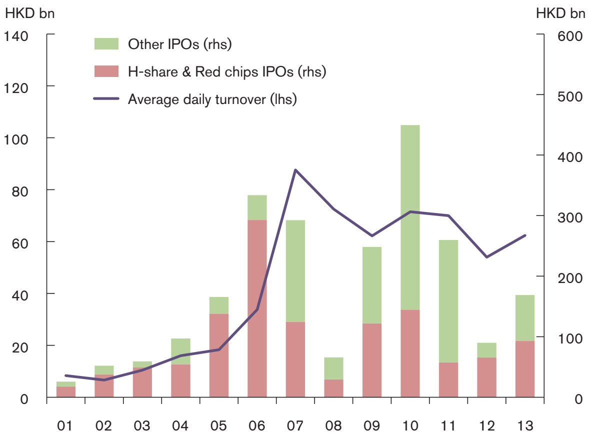
b) The financial sector

The financial sector as a whole was also a key growth spot, recording above-average TFP growth of 4.2% between 2000 and 2013 (Table B3.A). This sector's TFP growth was markedly higher before the GFC but declined afterwards due to volatile TFP performance of the non-bank financial sector, although the TFP growth of the banking sector remained resilient.

[25] The climbing-up of the global value chain included provision of more value-added services such as sourcing, design, production and its management, compliance of quality standards and logistics arrangement, etc. For further details, see Leung, Chow, Szeto and Tam (2008), "Service exports: the next engine of growth for Hong Kong?" HKMA Working Paper 04/2008.

The TFP growth of the non-bank financial sector[26] surged in the pre-GFC period amid booming H-share fund-raising activities and robust equity market trading (Chart B3.5). The underlying TFP growth driver included the Mainland financial market reforms that facilitated the listing of Mainland enterprises in Hong Kong. There was also product innovation with the taking-off of the derivatives and exchange-traded funds (ETFs) markets. However, this sector experienced a period of TFP decline after the GFC, as stock market turnover tapered off from a high level and the H-share fund-raising activities also levelled off. Taking both the financial upcycle and downcycle as a whole during the period of 2000–2013, the non-bank financial sector recorded TFP growth of about 3.7%, still higher than the 2.7% overall TFP growth of the whole economy.

Chart B3.5
IPOs and stock market turnover on Main Board and Growth Enterprise Market



Source: HKEx.

The banking sector's TFP growth has remained resilient, at around 5% a year in both the pre- and post-GFC periods. Similar to the non-bank financial sector, financial reforms in Mainland China that bolstered H-share IPOs and equity market trading have helped raise this sector's TFP growth in the pre-GFC period. Banks have diversified their sources of income and secured fast growth in business, as evidenced by the sharp rise in the share of non-interest income from around 36% in 2000 to 57% in 2007. Meanwhile, the launch of RMB banking business in Hong Kong since 2004 and the banking liberalisation measures under the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) have opened up new business opportunities and stimulated development of new financial products and services (including Mainland-related lending, and RMB deposits, loans, trade settlements and dim sum bonds), thereby supporting TFP growth. Throughout the period of 2000–2013, the banking sector also raised their efficiency by outsourcing and/or relocating labour intensive processes (e.g. data processing) to low-cost areas, and promoting electronic and internet banking.

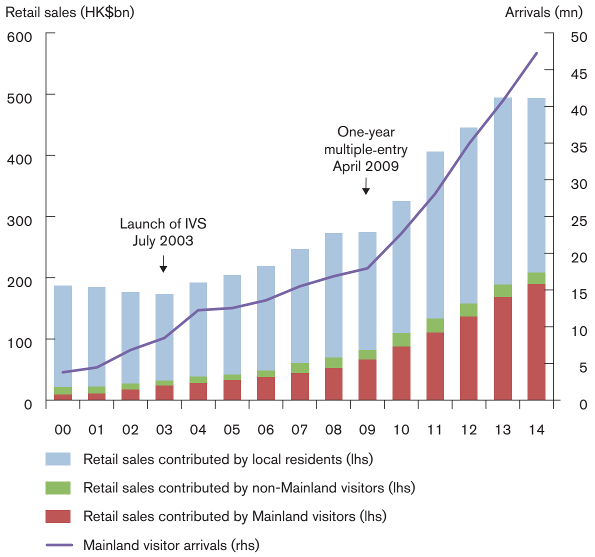
c) The wholesale, retail, restaurant and hotel sector

The TFP growth of the wholesale, retail, restaurant and hotel sector was relatively low in the pre-GFC period particularly before 2003, but it has picked up considerably afterwards (Table B3.A). The main driver behind the acceleration of TFP growth was the launch of the Individual Visit Scheme (IVS) in 2003, its progressive extension in later years, and particularly the introduction of the one-year multiple-entry endorsements in 2009 for eligible Shenzhen residents (until the one-trip-one-week cap took effect from mid-April 2015).[27] The enhanced ease of travel brought by IVS, together with other positive factors such as the increasing affluence of Mainland residents and the RMB appreciation, led to a phenomenal increase in Mainland visitor arrivals and solid business growth of the local wholesale, retail, restaurant and hotel sector (Chart B3.6).

[26] It includes stock brokerage, asset management, finance leasing, and investment and holding companies.

[27] The IVS was first implemented in four Guangdong cities and later expanded several times to cover more cities and municipalities. It allows eligible Mainland residents to visit Hong Kong in their individual capacity, whereas in the past, they could only travel to Hong Kong under business visas or by joining organised group tours.

Chart B3.6
Mainland's visitor arrivals and their share in terms of retail sales value



Note: Retail sales contributed by tourists refer to the shopping expenses of overnight and same-day visitors. Due to data availability, only the shopping expenses of overnight visitors were covered for the period before 2007.

Sources: C&SD, Hong Kong Tourism Board and HKMA staff estimates.

Concluding remarks

Our analysis shows that the I/E trade and financial sectors have provided the major support to Hong Kong's overall TFP growth during 2000–2013, with extra boost from the wholesale, retail, restaurant and hotel sector over the past few years. But the contribution of the I/E trade sector has somewhat weakened after the GFC. On the other hand, banks' TFP growth has remained highly resilient and lent a stable support to overall TFP growth of the economy. Going forward, the financial sector is likely to remain a major driver behind Hong Kong's overall TFP growth. Continued financial reforms in Mainland China (including the Shanghai-Hong Kong Stock Connect and the recent initiatives of mutual recognition of funds) would continue to support TFP growth in the financial sector through efficiency gains and innovation. While the I/E trade sector would likely continue to contribute to overall TFP growth, it could be restrained by the slow-growing international trade flows amid weak global growth and import absorption from the advanced economies. Meanwhile, the tourism-related sector's contribution to TFP growth is expected to weaken after traversing a high-growth stage.