

ECONOMIC PROSPECTS FOR HONG KONG IN 2018-19

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I. The Current Trends

Real gross domestic product (GDP) in Hong Kong slowed down to 3.5 percent in the second quarter of 2018, after increasing 4.6 percent in the first quarter¹. The second quarter slowdown in real GDP mainly reflected decelerations in private consumption expenditure, gross fixed investment, and total exports of goods and services. Total imports (comprising imports of goods and services), which are a subtraction in the calculation of GDP, also slowed down. Private consumption expenditure decelerated to 6.1 percent in the second quarter from an 8.8 percent increase in the first quarter. The deceleration primarily reflected deceleration in spending for goods and a smaller increase in spending in services. Hong Kong residents' spending abroad showed a downturn of 1.5 percent in the second quarter, after increasing 7.4 percent in the first quarter. Private consumption expenditure contributed 4.3 percentage points to the real GDP growth in the second quarter of 2018. Gross domestic fixed capital formation increased 0.4 percent in the second quarter, contributing 0.1 percentage point to the change in real GDP. The weak performance in gross fixed investment primarily reflected a downturn in total investment in building and construction, and a deceleration in investment in machinery, equipment and intellectual property products. Total exports (of goods and services) slowed down to 4.8 percent in the second quarter, following an increase of 5.6 percent in the preceding quarter. The deceleration in total exports of goods reflected slowdowns in exports of foodstuffs, in raw materials and semi-manufactures, and a downturn in exports of consumer goods. The deceleration in exports of services mainly reflected decelerations in travel services and in transport services. Total

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¹ Rates of change, unless otherwise specified, are year-on-year rates in real terms.

exports of goods and services contributed 9.1 percentage points to the growth of real GDP. Total imports of goods and services decelerated to 5.6 percent in the second quarter from 6.5 percent in the first quarter. They contributed -10.8 percentage points to change in real GDP in the second quarter. Subtracting total imports from total exports, the net exports (of goods and services) contributed -1.7 percentage points to changes in real GDP in the second quarter. Overall, the 3.5 percent GDP growth in the second quarter of 2018 comes from the domestic sector with private spending being the largest contributor, contributing 4.3 percentage points to real GDP growth.

In the external sector, total merchandise exports decelerated to 6.2 percent in the second quarter after a solid growth of 7.3 percent in the preceding quarter. This deceleration primarily reflected decelerations in exports to the Chinese Mainland (the Mainland hereafter), European Union (EU), and Japan, and downturns to India and Taiwan.

Similarly, Hong Kong's services exports (consisting of transport services, travel services, financial services, and other services) grew slower in the second quarter of 2018. They grew at 6.1 percent after having picked up 7.9 percent in the preceding quarter. The smaller increase reflected decelerations in travel services, in transport services and in financial services.

Performance in exports of travel services has been weak since 2014. Exports of travel services showed a severe drop of 8.6 percent in 2016. Upturns in exports of travel services started in the second half of 2017. The expansion in travel services is remarkable in the first half of 2018. Exports of travel services grew at 13.1 percent in the first quarter of 2018, but decelerated to 11.1 percent in the second quarter. Factors contributing to the strong growth

of travel services are a fast pace of recovery in visitor arrivals² from the Mainland, and a notable improvement in per capita spending of overnight visitors³.

Merchandise imports slowed down to 7.6 percent in the second quarter of 2018, compared to a visible 8.2 percent increase in the preceding quarter. This deceleration primarily reflected decelerations in foodstuffs, fuels, and capital goods and a downturn in consumer goods. Within the total merchandise imports, retained imports, which refer to imports for domestic use, increased 11.7 percent in the second quarter after a robust increase of 10.6 percent in the first quarter. This pickup mainly reflected continued expansion of domestic demand in Hong Kong in the second quarter.

Domestic demand decelerated to 4.9 percent in the second quarter from 6.2 percent of the first quarter. The deceleration primarily reflected decelerations in private consumption expenditure, and total fixed investment. The labor market remained tight in the second quarter, with the seasonally not adjusted unemployment rate staying at 2.8 percent, which is the lowest since 1998. While the GDP growth has fluctuated between 2.2 percent and 3.8 percent during the period of 2013-17, the unemployment rate has fluctuated in a much narrower range between 3.1 percent and 3.4 percent, suggesting Hong Kong's GDP growth can no longer serve as a good predictor for the unemployment rate in recent years. This is due to the fact that the demand for Hong Kong's labor comes from both local demand and more significantly a derived demand from the Mainland.

² Total tourist arrivals increased 10.1 percent in the first half of 2018. Mainland Chinese visitors, which accounted for 76.0 percent of the total in 2017, increased 14.3 percent in the second quarter of 2018 after increasing 12.6 percent in the first quarter.

³ A smaller decrease (2.4%) in the overall per capita spending of overnight visitors was recorded in 2017 after having decreased 8.8% in 2016. During the same period, the per capita spending by visitors from Mainland China decreased 3.6% in 2017 after decreasing 8.2% in 2016.

Analyzed by major economic sector, the construction sector recorded the highest unemployment rate at 4.8 percent and 4.5 percent, in the first and second quarter, respectively, followed by the accommodation and food services sector. The accommodation and food services sector unemployment rate decreased to 4.0 percent in the second quarter from the 4.5 percent in the preceding quarter. This improvement primarily reflected further growth in local consumption spending and in inbound tourism in the second quarter of 2018.

Prices of goods and services purchased by Hong Kong residents, as measured by the GDP price deflator, stayed unchanged at 4.1 percent in the second quarter of 2018. Within the GDP deflator, the price deflator of domestic demand increased 3.7 percent in the second quarter, same as in the first quarter. In the meantime, the trade-related price deflators such as the deflator of total exports of goods, and the deflator of imports of goods increased at moderate rates, while the deflator of exports of services, and that of import of services showed notable increases. The deflator of exports, in particular, increased 5.5 percent in the second quarter following an increase of 5.3 percent in the first quarter.

The headline Composite CPI inflation decelerated from 2.4 percent in the first quarter to 2.1 percent in the second quarter. This inflation rate primarily reflected price increases in food prices, in prices of electricity, gas and water, and in private and public housing rents. The underlying Composite CPI inflation, measured in terms of the change in the underlying Composite Consumer Price Index which nets out the effects of the government's one-off relief measures, was 2.4 percent in the second quarter, unchanged from the first quarter.

II. Forecast Summary for 2018-19

The economic performance of Hong Kong is largely affected by the economic conditions of Hong Kong's trading partners. When making our forecasts, a number of

assumptions on the growth of Hong Kong's major trading partners such as the Mainland, the United States, and the European Union, have been adopted. China's real GDP growth decelerated to 6.7 percent in the second quarter of 2018 from 6.8 percent in the preceding quarter. The deceleration is likely to continue in the second half, as suggested by smaller increases in the volume index of industrial production, in services production, in total sales of consumer goods, and in fixed investment for the month of July. The trade tensions between China and the United States is also likely to be a drag on overall economic growth in the second half, we assumed real GDP of China to increase 6.5 percent for 2018 and 2019.

Real GDP of the United States experienced a sharp rise in the second quarter of 2018. It increased at an annual rate of 4.1 percent in the second quarter, following a 2.2 percent growth in the first quarter. The pace of GDP expansion is likely to continue in the second half of this year. We assumed real GDP of the United States to increase 2.5 percent in 2018 and 2.4 percent in 2019.

Additionally, during the second quarter of 2018, seasonally adjusted GDP released by Eurostat decelerated to 2.2 percent in both the euro area and the EU28, after increasing 2.5 percent and 2.4 percent respectively in the previous quarter. The recovery in the euro area and the European Union should continue to make progress in the near future.

However, the trade tensions between the United States and its trading partners which are a threat to the world economy could depress medium-term growth prospects of trade and investment. Our forecast indicates the total exports of goods (under the GDP accounting system) will grow at 5.0 percent in real terms in 2018 and 4.7 percent in 2019. Their contribution to real GDP growth is forecast to be 7.7 percentage points for 2018, and 7.3

percentage points for 2019. Exports of services are forecast to grow by 6.8 percent in 2018, and 7.0 percent in 2019. They should contribute to real GDP growth at 2.0 percentage points in both 2018 and 2019.

In line with the strong growth in private consumption in the first half of 2018, we expect private consumption to increase 7.2 percent in real terms in 2018 as a whole, and to grow at 7.0 percent in 2019. . Private consumption expenditure is forecast to contribute 4.5 and 4.6 percentage points to the real GDP growth in 2018 and 2019, respectively. Total fixed investment spending decelerated to 0.4 percent in the second quarter from an increase of 4.2 percent in the first quarter. This deceleration largely reflected a downturn of 3.0 percent in the building and construction sector, and a deceleration in public sector investment in machinery, equipment and intellectual property products. Total fixed investment is forecast to increase 2.0 percent in 2018 and by the same rate in 2019. Its contribution to real GDP growth is forecast to be 0.4 percentage point in 2018 and in 2019. The government spending is assumed to increase 4.0 in 2018 and 2019, respectively. All the external and internal conditions suggest the real GDP growth is forecast to be 3.8 percent in real terms in 2018, and 3.7 percent in 2019. (See Table 1 attached below for details). The engine of the GDP growth in 2018 and 2019 should come from the domestic sector with private spending as the largest contributor, contributing 4.5 and 4.6 percentage points, respectively, to GDP growth.

In the first six months of 2018, the headline Composite CPI inflation rate stood at 2.3 percent. The increase in the prices of electricity, gas and water, by an average of 6.1 percent in the first half, was one of the main forces lifting inflation rate. Wage inflation and the US inflation were found to contribute to Hong Kong Inflation rate. Inflation rate is forecast to stand at 2.5 percent in 2018 and 2.6 percent in 2019. Similarly, a rising trend in the implicit

price deflator of GDP is expected, and is forecast to increase 4.3 percent in 2018 and 4.4 percent in 2019. The stronger performance in the domestic sector than the external sector will continue to help the performance in the labor market. The unemployment rate is forecast to remain low at around 2.9 percent in 2018 and 3.0 percent in 2019.

III. Concluding Remarks

As in the past years, the engine of the economic growth in Hong Kong for 2018 and 2019 is forecast to come from the domestic sector with private spending serving as the largest contributor. While the global economic growth remained robust so far, external uncertainties have increased markedly since June when the United States escalated trade conflicts with China and other major trading partners. These uncertainties could undermine the global economic sentiment, and trade and investment activities. Additionally, a number of economic indicators released by the State Bureau of Statistics in China in July have suggested the pace of economic growth in the China reached its peak in the first half of 2018. We therefore conclude that our baseline forecast of the Hong Kong economy is increasingly clouded by the ongoing trade tensions and the slowdown in the economic growth of China.

Table 1 Forecast real rate of growth in GDP, GDP deflator and CPI in 2018-19

	Actual 2017	Forecast 2018	Forecast 2019
Real GDP	3.8	3.8	3.7
Private consumption expenditure	5.5	7.2	7.0
Government consumption expenditure	3.4	4.0	4.0
Gross domestic fixed capital formation	3.5	2.0	2.0
Exports of goods and services	5.5	5.3	5.0
Exports of goods	5.9	5.0	4.7
Exports of services	3.2	6.8	7.0
Imports of goods and services	6.3	6.2	5.9
Imports of goods	7.0	6.6	6.3
Imports of services	1.9	2.4	2.4
GDP deflator	2.9	4.2	4.4
Composite CPI	1.5	2.5	2.6