CHAPTER 2 : ECONOMIC OUTLOOK FOR 2011 AND THE MEDIUM TERM

Summary

- *In 2011, the global economy is expected to expand further in a two-speed manner. The major advanced economies are still grinding through a jobless recovery, and yet, the emerging market economies are likely to show further robust growth. The export prospects for Hong Kong this year are generally positive, though the growth pace would not be as significant as in 2010.*

- *Locally, improving job markets and rising incomes should augur well for consumption spending. Likewise, investment is poised for a further notable growth in tandem with the upbeat business sentiment. Public sector construction works should continue apace, thereby adding a further boost to domestic demand.*

- *After the big gyrations in 2009 and 2010, and with the economy fully recovered by now, the outlook for 2011 is for the Hong Kong economy to return to a more normal growth path, with a solid growth of 4% to 5% this year. Domestic demand, together with inbound tourism and financial services, are likely to take up a more prominent role in driving overall economic growth, thereby compensating for the somewhat slower growth now expected for merchandise exports.*

- *However, there are still considerable uncertainties in the external environment that need to be watched over. These include the sovereign debt problem in the eurozone; the fragile fundamentals in many advanced economies; the ultra-loose global monetary environment; and the increasing risk of rising inflation and asset market bubbles in the region.*

- *Consequential to the robust economic upturn last year and with more visible imported inflation from soaring global food and commodity prices, inflation is likely to go higher in 2011. The underlying consumer price inflation is forecast at 4.5% in 2011. In this regard, the various relief measures announced in the 2011-12 Budget should help to alleviate the impact of inflation on the lower-income group.*

- *On top of these short-term relief measures, the Government will adopt a multi-pronged approach to contain inflation risks, through a counter-cyclical fiscal strategy to contain government expenditure; targeted measures to forestall asset market bubbles; macro-prudential regulation to*

strengthen risk management in the banking system; and issuing inflation-linked bonds to provide people with an additional investment choice.

- *The medium term prospects for the Hong Kong economy are bright. Hong Kong will continue its transformation towards a high value-added, knowledge-based economy, riding on the further integration with the Mainland economy. The economy will strive to capture the new opportunities arising from the implementation of the National 12th Five-Year Plan. The launch of large-scale infrastructure projects, whilst rendering additional impetus to the domestic sector in the coming years, are crucial for capacity expansion and hence sustainable development of the economy in the long run. The trend GDP growth rate in real terms is forecast at 4% per annum from 2012 to 2015, and the trend rate of underlying consumer price inflation at 3.5% per annum.*

Major external factors

2.1 The global economic expansion is expected to continue in 2011, with divergent performance across different regions. The growth momentum of Asia, particularly the Mainland and other emerging economies in the region, should remain robust, supported by their strong domestic demand and sound fundamentals. The major advanced economies, having performed better than expected last year, are likely to recover further in 2011, although their growth pace should be rather moderate, being constrained by the weak fundamentals and the need to pursue fiscal consolidation. On the whole, the Hong Kong economy should continue to benefit from this development in 2011.

2.2 However, the external environment will, as in the previous year, be subject to considerable uncertainties, mainly relating to the vulnerabilities in the major advanced economies. The European sovereign debt problem is still lingering on. Moreover, many advanced economies are facing with challenges from their fragile fiscal positions, high unemployment, household deleveraging, still-tight credit conditions, and depressed housing markets. In short, the conditions for self-sustaining recovery in the advanced economies have yet to be fully in place. Given these threats, the ultra-loose monetary policies in the advanced economies will be extended well into 2011, heightening the risks of volatility in financial and currency markets, and protectionist sentiments in these countries may also rise.

2.3 With abundant global liquidity, the upward pressures on world commodity prices will continue, and emerging market economies will probably experience further capital inflows. As far as Asian economies are concerned, the risks of rising inflation and asset market bubbles will remain significant. Inflation in Asia, including Hong Kong, will go up further in 2011. Moreover, in response to these challenges, many Asian economies are likely to pursue further tightening measures. This could swing financial market sentiments at times and taper somewhat their robust economic growth. Hong Kong will also need to stay alert to these challenges in 2011.

Global economic outlook

2.4 The US economic recovery has been proceeding at a faster-than-expected pace. The weak dollar has helped to foster export growth, while business sentiments experienced some revival of late, with rising spending on equipment and software. Consumption spending also held firm, despite the persistently high unemployment, depressed housing market and the need to reduce household debts. The stimulus measures introduced in December 2010, including tax concessions and extension of unemployment benefits, should provide some support to the economy in 2011, although this may not help to contain the rise of the already high public debt level. As economic growth is still not fast enough to bring down the high unemployment rate, the Federal Reserve is expected to continue with its second round of quantitative easing (i.e. QE2) as announced in November last year (***Box 2.1***).

2.5 In Europe, Germany has been recovering at a robust pace and becoming the major engine of growth in the region, but many peripheral economies remain sluggish. This divergence of growth pattern within Europe due to differences in economic fundamentals among European countries is expected to continue in 2011. The eurozone sovereign debt problem has yet to be fully resolved and will continue to pose a major downside risk to the recovery in Europe and also to the global economy (***Box 2.2***). The large-scale fiscal consolidation under way in the European economies will also put a notable drag on economic growth this year, which will be moderate at best for the region as a whole, and the prevailing high unemployment may also persist.

2.6 Japan saw a notable economic rebound in 2010, benefited from the fiscal stimulus measures and the vibrant trade with the Mainland and other Asian economies. However, private domestic demand has only showed some modest improvement, and the economy is still mired in deflation, posing challenges to the economic prospects in 2011. Despite the introduction of new stimulus measures towards the end of last year, the huge amount of debt (the highest among the major economies in the world) means that the room for further stimulus will be small. Indeed, a credit rating agency downgraded Japan's rating in January 2011. Although the Japanese economy should see some further growth this year alongside the general trend of global recovery, the relatively weak sentiments among consumers and businesses would remain a concern.

2.7 In sum, the major advanced economies are expected to continue their moderate recovery in 2011 with slow employment creation, and it would take time for their fundamentals to show a clear improvement. In January 2011, the International Monetary Fund (IMF) forecast the real GDP growth in the advanced economies in 2011 at 2.5%, compared to a rebound of 3.0% in 2010. In fact, given the sheer scale of the global financial crisis of 2008-2009, the subsequent recovery of the economies at the epicentre of the crisis could be a rather long drawn-out process.

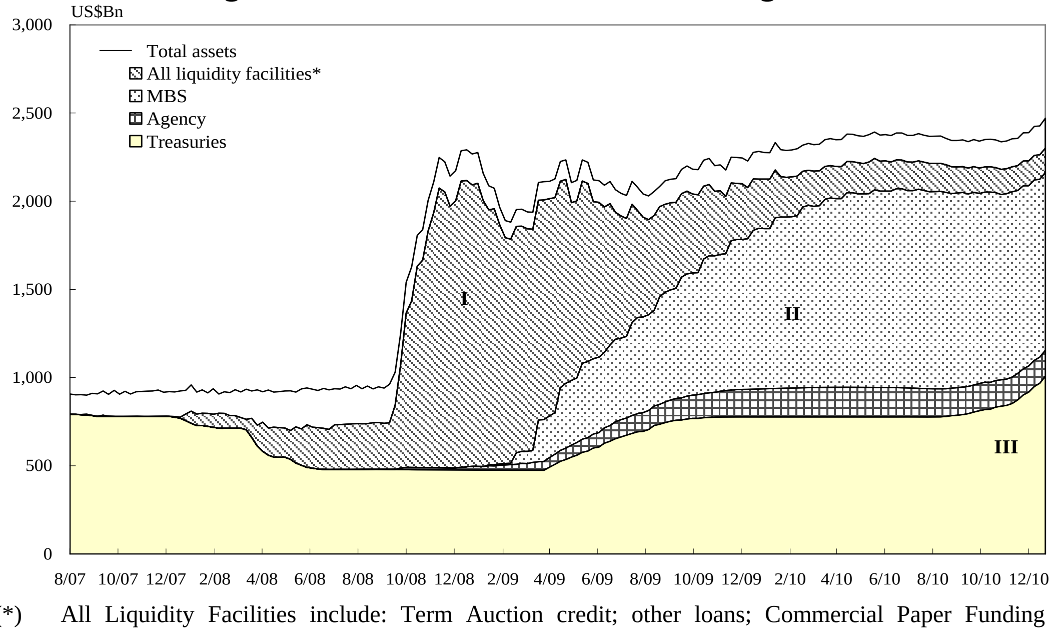
Box 2.1

The Federal Reserve's another round of quantitative easing (QE2)

The US Federal Reserve (the Fed) announced on 3 November 2010[(1)] that it would purchase a further US$600 billion of longer-term Treasury securities by the end of the second quarter of 2011, at a pace of about US$75 billion per month. The fresh round of quantitative easing (commonly termed as "QE2") aroused much discussion, and this article explores some key issues regarding QE2 and its implications for the Hong Kong economy.

The abrupt escalation of the financial crisis in the latter part of 2008 prompted the Fed to step up its pursuit of unconventional monetary policy. From ***Chart 1***, roughly three stages of development in the Fed's balance sheet can be discerned. The first stage of asset purchases aimed at providing liquidity facilities to combat the liquidity and credit crunch faced by financial institutions after the subprime problems and fall of Lehman Brothers. The Fed's balance sheet ballooned to around US$2 trillion by end-2008, from below US$1 trillion prior to the crisis. This QE1 helped to forestall a meltdown of the financial systems. Then from early 2009, the Fed adjusted its balance sheet to target the troubled securitised markets through purchasing mortgage-backed securities (MBS). As market conditions improved and economic recovery gained some traction in the latter part of 2009 and early 2010, there had been talks of an exit strategy. The Fed allowed various liquidity facilities to run their course[(2)], and in February 2010 outlined several tools for exiting policy accommodation (See ***Box 2.1*** of the ***2009 Economic Background and 2010 Prospects*** for a more detailed discussion). As seen from ***Chart 1***, the liquidity facilities portion of the Fed's balance sheet assets had shrunk markedly since the second half of 2009, but was largely offset by the expansion of the MBS portion.

Chart 1 Changes in the Fed's balance sheet since the global financial crisis



Note: (*) All Liquidity Facilities include: Term Auction credit; other loans; Commercial Paper Funding Facility; outstanding principal amount of loans to American International Group, Maiden Lane LLC, Maiden Lane II LLC, Maiden Lane III LLC, and TALF LLC; and central bank liquidity swaps.

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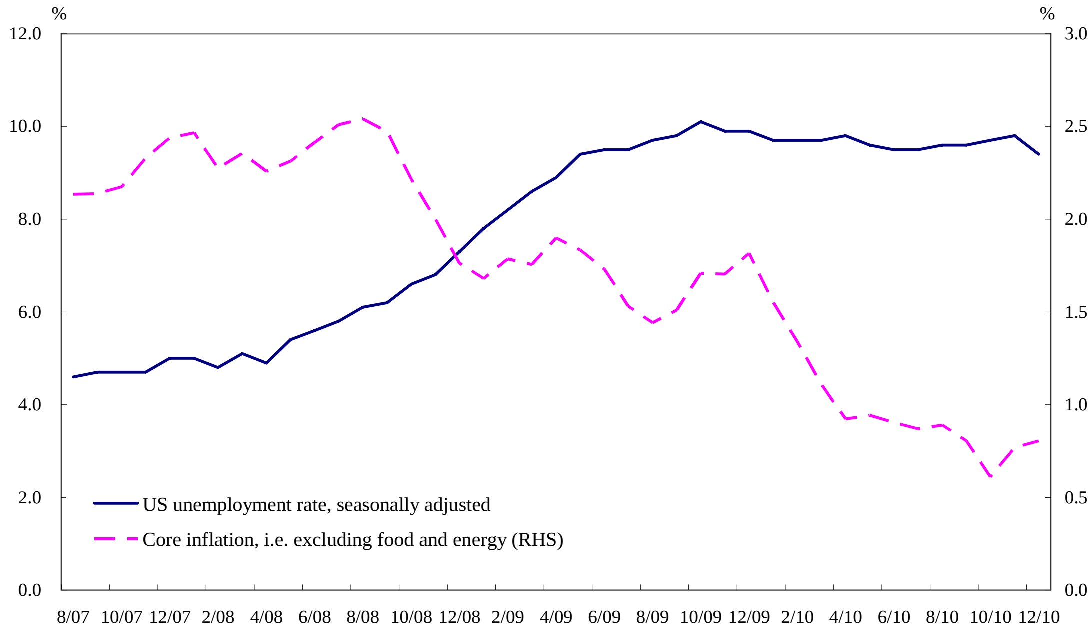
(1) FOMC statement: http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm.

(2) For example, the Money Market Investor Funding Facility (MMIFF) expired on 30 October 2009. The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), Commercial Paper Funding Facility (CPFF), Primary Dealer Credit Facility (PDCF), and Term Securities Lending Facility (TSLF) were closed on 1 February 2010. The Term Asset-Backed Securities Loan Facility (TALF) was extended until 30 June 2010 for loans collateralized by newly issued CMBS and through 31 March 2010 for loans collateralized by all other TALF-eligible securities.

Box 2.1 (Cont'd)

But in spring 2010 the sovereign debt problems in Europe intensified, while economic activity in the US showed signs of losing steam around the mid-year. All these prompted the Fed to reinvest maturing agency debt and mortgage-backed securities into longer-term Treasury securities since August 2010, serving to maintain the size of the Fed's balance sheet without adding to its holdings of securitised securities. Finally in November 2010, the Fed rolled out QE2 to support the economy, in view of the elevated unemployment rate and the downtrend of core inflation (***Chart 2***). This move was consistent with the Fed's dual mandate of supporting maximum employment and maintaining price stability.

Chart 2 : US unemployment still elevated and inflation remained low



Debates and discussions ensued surrounding the effectiveness of QE2 to bolster the real economy. According to the Fed, QE2 would work by lowering the longer-term interest rates, in addition to the already close-to-zero-bound Fed funds rate(3), thereby spurring household and business spending and boosting the pace of recovery. However, some critics noted that in the current environment of deleveraging, the additional liquidity may just be clogged up as banks' excess reserves, or channeled to other overseas economies, rather than trickle down to the US economy. In other words, QE2 does not necessarily induce banks to lend or employers to hire, and hence may fail to spur the economy. Indeed, QE2 had been so anticipated and factored into long-term interest rates that the US long-term interest rates actually went up after the official announcement of QE2 (***Chart 3***). Some critics suggest that the higher rates reflect rising concerns over the US public finance, as the US government has to lay out a more concrete plan to reduce public debt over the medium to longer term. Yet the higher long-term rates may also be an indication that QE2 is working by raising growth and inflation expectations. In fact, recent US economic data have largely been better than expected.

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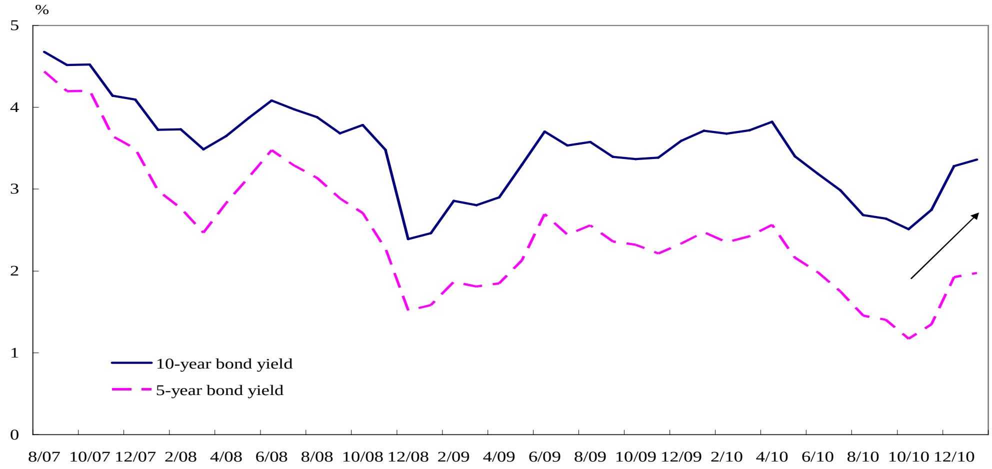
(3) Bernanke's speech on 19 November 2010:
http://www.federalreserve.gov/newsevents/speech/bernanke20101119a.htm.

Box 2.1 (Cont'd)

Chart 3 : US long-term interest rates actually went up after QE2



Whether the QE2 will lead to a sustained solid recovery of the US economy is still subject to uncertainty, but it has aroused some backlash from other economies, especially the emerging market economies. Some critics suspect that QE2's real purpose is to weaken the US dollar and hence boost US exports at the expense of others. This may increase the risks of competitive devaluation and even trade and currency wars. The rise of protectionist sentiment and heightened exchange rate volatility, if happened, are certainly unfavourable to trade and would pose a challenge to the exports of Asia, Hong Kong included.

The Fed had also suggested that QE2 might work through the wealth channel(4). That is, QE2 would push the return on safe assets to such a low level that investors would increase their demand for the riskier assets. The rise in the asset prices could, in principle, render a positive wealth effect on final consumption. Yet it is uncertain to what extent the US economy would benefit from this channel with the housing market still depressed. Again, this line of reasoning has brought severe criticism from emerging market economies, as the resultant ample liquidity in the global banking systems would fuel asset market bubble risks and inflationary pressures in economies in Asia and the rest of the world.

In sum, whether the QE2 will attain the Fed's intended goals remains to be seen but it is already posing some notable side-effects on the rest of the world, especially the emerging market economies. The latest FOMC statement released on 26 January 2011 suggests that the Fed is likely to proceed with the purchase programme under QE2 as planned. Given President Obama's latest US$858 billion tax concession and unemployment benefit package, which is expected to render some further support to the US economy this year, as well as the recent better-than-expected performance of the US economy, the need for a further round of quantitative easing, QE3, appears to be diminishing. Nevertheless, the loose monetary environment on a global scale is still expected to persist for an extended period of time. From Hong Kong's point of view, the advent of QE2 had heightened the risk of asset market bubbles and inflation. To forestall the formation of a housing bubble in Hong Kong, the Government had introduced several rounds of measures over the past year or so to ensure the healthy and stable development of the housing market. The Government will continue to monitor the property market situation as well as the inflation trend closely, in order to safeguard macroeconomic stability and, when necessary, to alleviate the impact of inflation on the lower-income families.

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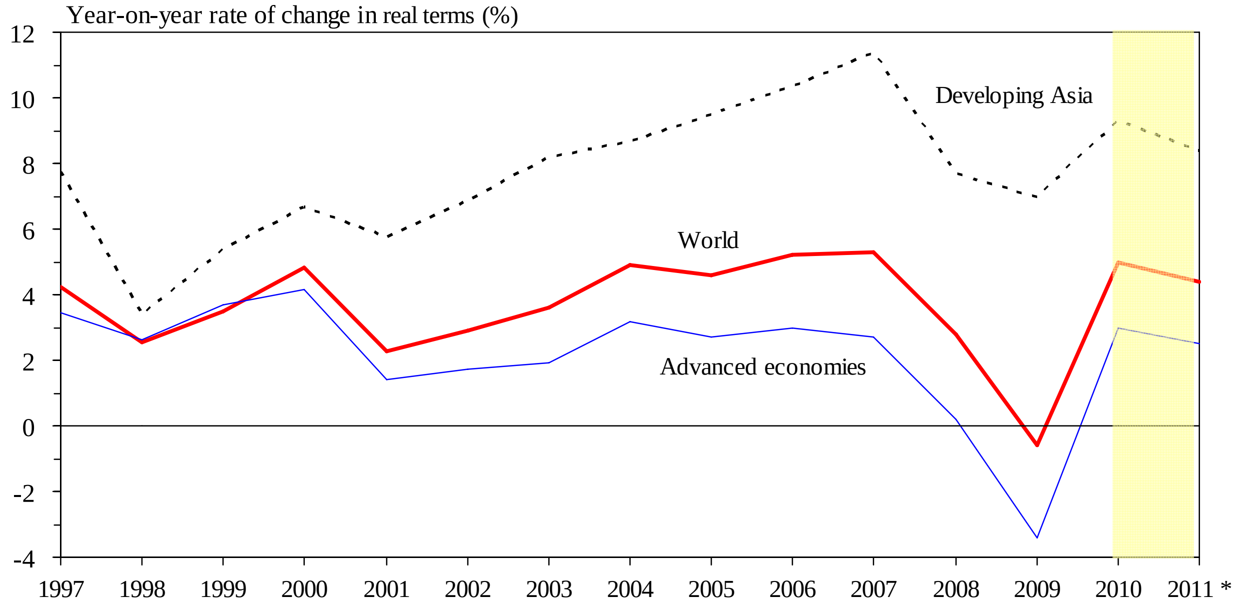
(4) Bernanke's testimony on 7 January 2011: http://www.federalreserve.gov/newsevents/testimony/bernanke20110107a.htm.

2.8 In stark contrast, economies in Asia, particularly the Mainland, India and other emerging economies, successfully withstood the global financial crisis and maintained robust growth in 2010. The revival in the region's exports had been particularly strong, despite some signs of moderation towards the end of the year. This reflected in part the impetus from the global economic recovery and in part the strengthening domestic demand in Asia. Going into 2011, the Asian economies are widely expected to continue to outperform the major advanced economies, thanks to their better fundamentals and the rebalancing towards domestic-demand-driven growth. However, the extended period of low interest rate environment and the abundant liquidity conditions have increased inflationary pressures and asset market bubble risks in the region, likely prompting further tightening measures down the road. As such, the regional growth momentum, though still notable, is likely to show some deceleration in 2011. According to the IMF, developing economies in Asia are forecast to expand strongly further by 8.4% in 2011, albeit less rapid than the 9.3% growth in 2010. China and India will remain the two major growth engines with economic growth in 2011 being forecast at 9.6% and 8.4% respectively.

Diagram 2.1 : The Asian region will continue to outperform the advanced economies by a significant extent in 2011



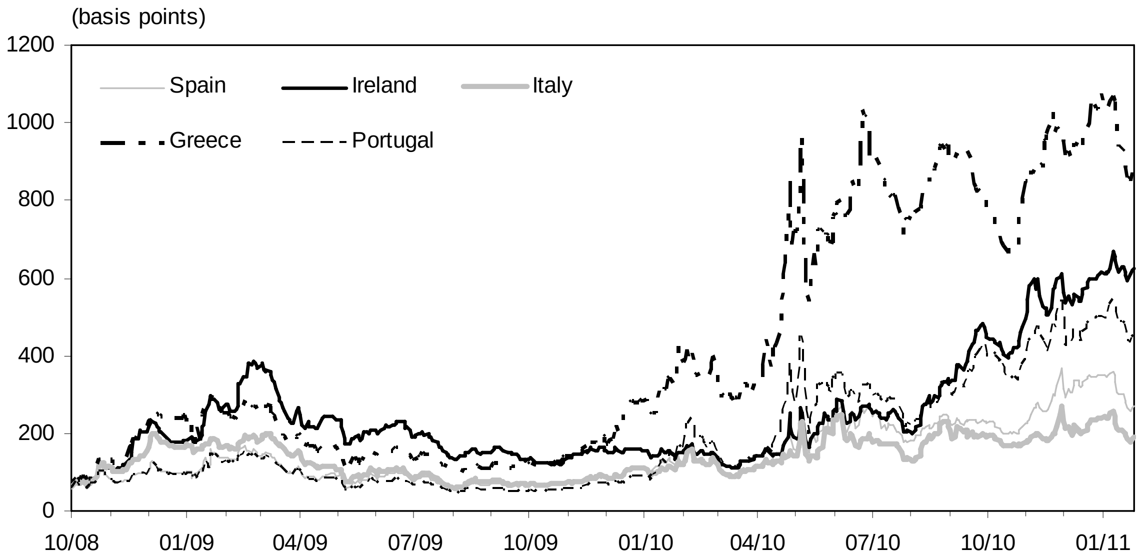
Source: IMF World Economic Outlook Update January 2011.
(*) Forecast from the IMF.

Box 2.2

An update on the European sovereign debt situation

The European sovereign debt problem subsided for a brief period following the €110 billion package of emergency loans jointly provided by the European Union (EU) and International Monetary Fund (IMF) to Greece and the set-up of a €750 billion European Financial Stability Facility (EFSF) backed by the IMF, the EU and the European Central Bank (ECB) in May 2010 (See ***Box 1.1*** of the ***Half-yearly Economic Report 2010*** for earlier developments). However, the problem came into the limelight again in late September 2010, when Ireland's government finance was saddled by its banking sector, and market concerns soon spread to other highly-indebted eurozone economies. In late November, Ireland officially requested international financial aid and subsequently secured a €85 billion rescue package. Yet bond yields widened across Ireland, Italy, Portugal and Spain (collectively known as "PIIGS" together with Greece) (***Chart 1***). This was followed by a fresh spate of credit rating actions in December, when the sovereign ratings of Ireland, Portugal and Hungary were downgraded and Belgium placed on negative watch (***Table 1***).

Chart 1: CDS spreads on PIIGS soared again in late 2010, exceeding the highs in April-June 2010



In response, the ECB decided to extend its remaining nonstandard liquidity measures until at least mid-April 2011, and continued its bond buying to relieve the pressure on indebted countries' funding costs. Between May 2010 and December 2010, the ECB had bought €73.5 billion of European debt. In mid-December, the ECB said it would nearly double its capital base to €10.76 billion, indicating that the ECB was prepared to cushion against potential losses from its bond purchase. In addition, EU leaders agreed to create a permanent European Stability Mechanism (ESM) after the expiry of the current emergency rescue fund in 2013.

Box 2.2 (Cont'd)

Table 1 : Summary of more recent credit rating actions

	Date	Actions by rating agency
Portugal	21 Dec 2010	Moody's changed outlook to negative; rating kept at A1
	30 Nov 2010	Downgraded by S&P to A- from A+, outlook negative
	23 Dec 2010	Downgraded by Fitch to A+ from AA-, outlook negative
Ireland	17 Dec 2010	Downgraded by Moody's to Baa1 from Aa2, outlook negative
	23 Nov 2010	Downgraded by S&P to A from AA-, outlook negative
	2 Feb 2011	Downgraded by S&P to A- from A, outlook negative
	9 Dec 2010	Downgraded by Fitch to BBB+ from A+
Greece	16 Dec 2010	Moody's changed outlook to negative; rating kept at Ba1
	2 Dec 2010	S&P changed outlook to negative; rating kept at BB+
	14 Jan 2011	Downgraded by Fitch to BB+ from BBB-, outlook negative
Spain	15 Dec 2010	Moody's changed outlook to negative; rating kept at Aa1
	1 Feb 2011	S&P reaffirmed AA rating and maintained outlook negative
Hungary	6 Dec 2010	Downgraded by Moody's to Baa3 from Baa1, outlook negative
	23 Dec 2010	Downgraded by Fitch to BBB from BBB+, outlook negative
Belgium	14 Dec 2010	S&P changed outlook to negative; rating kept at AA+

While the rescue measures provide liquidity in times of need, the markets are concerned if they can fundamentally address the issue of solvency. Ultimately, whether a country can remain solvent hinges on its ability to repay or roll over its debt, and this would in turn depend on its growth prospects, debt profile, and cost of funding. Many economies across Europe have put in austerity measures to slash their deficits and reduce debt. Yet their growth outlooks remain uncertain. Although the eurozone saw strong growth in the second quarter of 2010, at a seasonally adjusted quarter-to-quarter rate of 1.0%, growth moderated to 0.3% each in the third and fourth quarters, and much of it was driven by the core members, i.e. Germany and France, while some highly indebted peripherals, including PIIGS, saw meagre growth and even continued contraction. Thus it calls into question whether the peripheral economies can generate sufficient income to cover their debt over the longer term (***Table 2***). Their governments are trying to implement structural reforms to improve competitiveness, but this would take time to bear fruits and is also likely to meet with resistance from the affected social groups and stakeholders. Meanwhile, the costs of borrowing for these countries to service their debts remain high as evidenced by the elevated CDS spreads.

Box 2.2 (Cont'd)

Table 2 : Growth and fiscal liability indicators for the PIIGS economies

	Growth projection for 2011#	Government debt maturing by 2011@	Fiscal balance as % of GDP in 2009*	Government gross debt as % of GDP	
				2009*	2015(*F*)^
		(€bn)	(%)	(%)	(%)
Eurozone 16	1.5	n.a.	-6.3	79.2	n.a.
Portugal	0.0	33.1	-9.3	76.1	97.8
Italy	1.0	359.6	-5.3	116.0	118.8
Ireland	2.3	15.0	-14.4	65.5	113.9
Greece	-2.6	51.6	-15.4	126.8	133.9
Spain	0.6	159.5	-11.1	53.2	82.0
Hungary	2.0	29.6	-4.4	78.4	82.5
Belgium	1.7	83.1	-6.0	96.2	108.2

Notes: (#) Data for eurozone, Italy and Spain sourced from IMF's *World Economic Outlook Update*, January 2011; others from *World Economic Outlook*, October 2010.
(@) Sourced from Bloomberg.
(*) Sourced from Eurostat.
(^) Sourced from IMF's *Fiscal Monitor*, November 2010.
n.a. Not available.

The markets are also closely watching if the eurozone member economies will agree on the details of ESM, establishing viable mechanisms to impose fiscal discipline on member economies and also to deal with fiscal and financial crises within the eurozone in future. Reportedly, there is notable division among the eurozone members. Specifically, the financially stronger core members like Germany are seemingly unwilling to share too much of the financing burden and favour more stringent requirements for the ESM.

The European sovereign debt problem would remain a source of risk to the external environment until it is fully resolved. Apart from its potential destabilising effect on the financial markets, there is also considerable concern about the drag on the economic growth of the eurozone posed by the large-scale budget cuts in the European economies. After all, the advanced economies, including Europe, remain the principal driving forces behind the final demand in global trade. This could have notable implications for exports of Asia, including those of Hong Kong, in the event of a prolonged weakness of the eurozone economy. This is an area that requires close attention.

2.9 Specifically on the Mainland economy, GDP growth should remain robust in 2011. While external trade is likely to expand less rapidly, the strong domestic demand, including both consumption and investment demand, will continue to provide a major impetus to overall growth. Although there has been some deceleration in activity growth towards a more sustainable pace in the second half of last year, this mainly reflects the effect of the macroeconomic adjustment measures that have been introduced to ensure macroeconomic stability. Indeed, the Hong Kong economy should benefit from the sustained relatively fast growth of the Mainland economy, although the news about the tightening measures could shift financial market sentiments at times. Meanwhile, the implementation of the National 12th Five-Year Plan, with 2011 being the first year in the five-year period, will encourage a faster economic integration between Hong Kong and the Mainland, providing additional opportunities for Hong Kong businesses to develop and prosper.

2.10 Taking the advanced and emerging market economies together, the global economy should grow solidly in 2011, supporting further expansion of world trade and hence Hong Kong's external sector. According to the IMF, world GDP would increase by 4.4% in 2011, after a 5.0% growth in 2010.

Table 2.1 : Growth forecasts for major economies in 2011

		2011	
	2010* (%)	**IMF*** (%)	**Private sector forecast^** (%)
World	5.0	4.4	-
Advanced economies	3.0	2.5	-
US	2.9#	3.0	3.2
Euro area	1.8	1.5	1.5
Japan	3.9#	1.6	1.2
Newly Industrialised Asian Economies@	8.2	4.7	-
Emerging market and developing economies	7.1	6.5	-
Developing Asia	9.3	8.4	-
Mainland China	10.3#	9.6	9.2
India	9.7	8.4	8.3
Middle East and North Africa	3.9	4.6	-

Notes : (*) World Economic Outlook Update, IMF, January 2011.
(^) Average forecast as in January 2011.
(-) Not available.
(#) Actual figures.
(@) Includes Hong Kong, Korea, Singapore, and Taiwan.

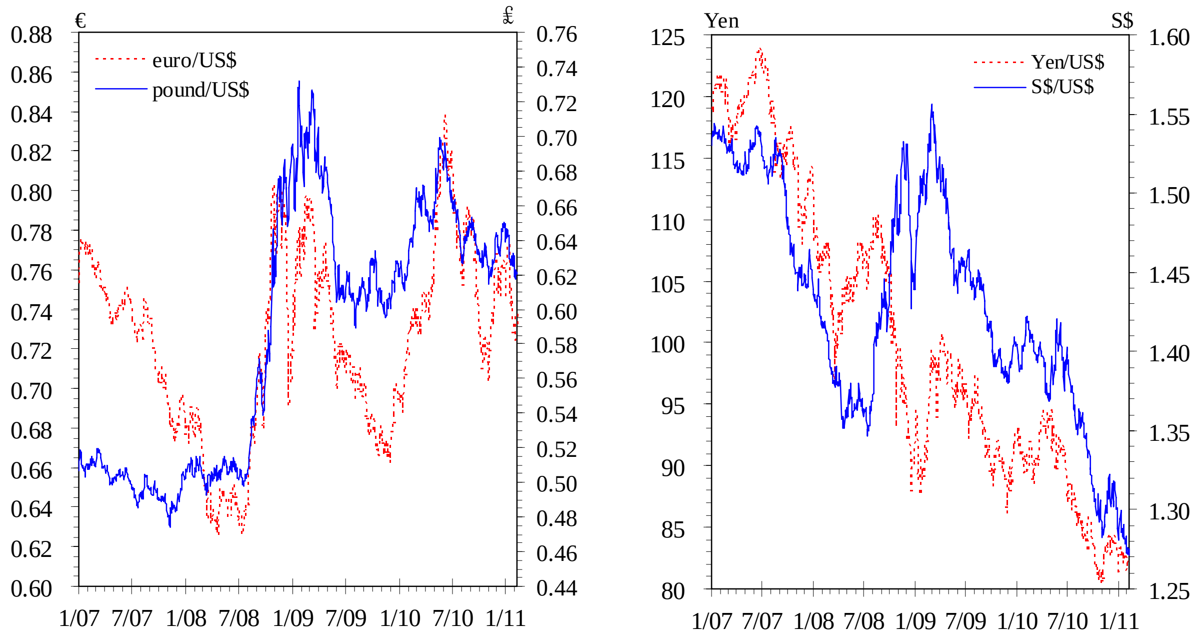
Exchange rates and price competitiveness

2.11 Despite the fluctuations over the course of 2010, the Hong Kong dollar weakened only slightly, along with the US dollar under the linked exchange rate system, against other major currencies for the year as a whole. The nominal trade-weighted effective exchange rate index of the Hong Kong dollar fell by 2.2% in December 2010 from a year earlier. The outlook for exchange rate movements in 2011, as usual, is subject to much uncertainty.

2.12 While some analysts have been envisaging a huge depreciation in the US dollar given the massive scale of quantitative easing in the US, there are also a host of factors working against such a possible development, including the evolving sovereign debt issue in the eurozone, the progress in redressing global trade imbalances, the downgrade of Japan's credit rating, and more recently the political unrests in North Africa and the Middle East. Adding to the uncertainty is the possible divergent pace of implementing exit strategies among the major advanced economies. As far as Hong Kong is concerned, a significant weakening of the US dollar, and hence the Hong Kong dollar, will intensify imported inflation, but may help to increase Hong Kong's export competitiveness.

Diagram 2.2 : The foreign exchange rate market is likely to remain highly volatile in 2011

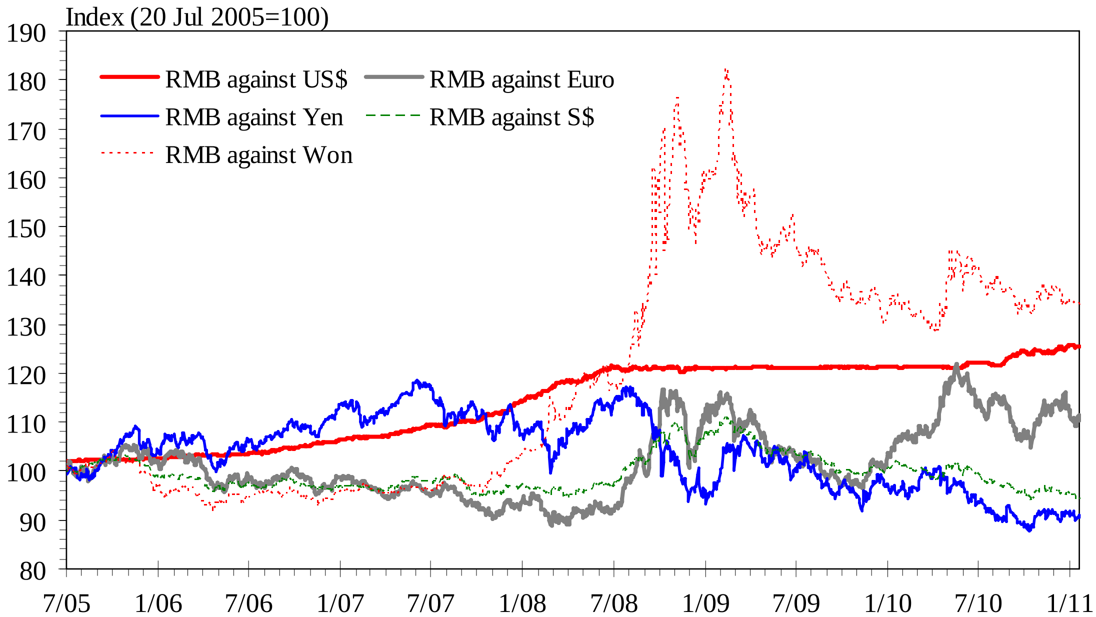
(a) against euro and pound sterling **(b) against yen and Singapore dollar**



2.13 Given Hong Kong's close economic relationships with the Mainland, the value of the renminbi is also a key factor affecting the performance of Hong Kong's external sector, including both trade in goods and services. A stronger renminbi could weaken the price competitiveness of Hong Kong's exports of goods in the overseas markets, but could increase the Mainland's demand for

Hong Kong's exports of services. The renminbi had resumed a gradual trend of appreciation against the US dollar since mid-June 2010, by a cumulative 3.5% as at end-January 2011. Going forward, the Mainland authorities are widely expected to proceed with the exchange rate regime reform in a controlled and gradual manner, avoiding significant fluctuations in the exchange value of the renminbi. A relatively stable renminbi can help to reduce the exchange rate uncertainty facing Hong Kong's companies given the integrated supply chains involving the Mainland.

Diagram 2.3 : A relatively stable renminbi will help to reduce the uncertainty facing Hong Kong's traders



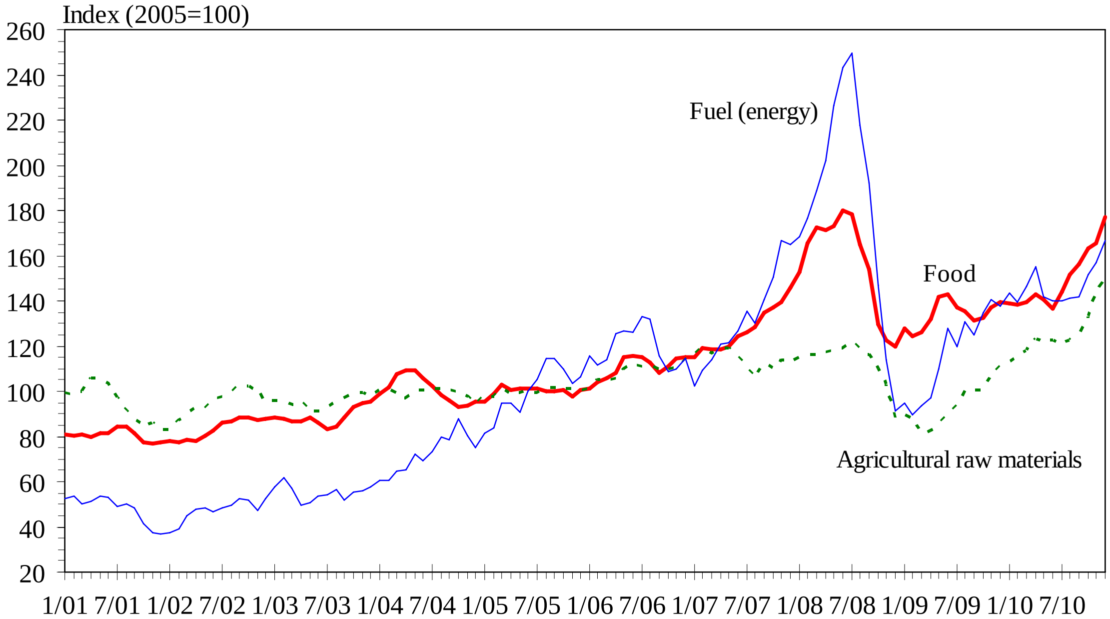
Note : An increase in the index represents an appreciation of renminbi against the currency concerned.

World inflation and global commodity prices

2.14 Mirroring the divergent pace of economic growth across regions, the inflation trends also tend to differ in different regions of the world. Inflationary pressures have been rather modest in the major advanced economies, particularly so in the US and even deflation in Japan. In contrast, the emerging market economies have generally been experiencing a more notable rise in inflation. Given their robust economic performance, they are more susceptible to the influences of abundant global liquidity, continued capital inflows, and rising commodity prices. In fact, fighting inflation has become a top policy priority in some of the Asian economies.

2.15 Of particular note have been the continued increases in global commodity prices, against the backdrop of ample liquidity and strong demand from emerging market economies. Many global commodity prices, including those of food, energy, agricultural raw materials, industrial materials and metals, saw marked increases in 2010, especially during the second half of the year. In some cases, their prices in the international markets were close to or have even surpassed the previous peaks in 2008. The rise in global food prices has a more direct impact on consumer price inflation in Asian economies, given the relatively large weighting of food in the household consumption baskets. According to the IMF, global food prices surged by 26.8% in December 2010 over a year earlier. The sustained global recovery will continue to exert pressures on commodity prices in 2011, which in turn will pose upside risks to inflation in Asia. Recently, the political unrests around the Middle East could also add further upward pressures on energy prices. In consequence, Hong Kong is likely to face higher imported inflation in 2011.

Diagram 2.4 : Surge in commodity prices poses upside risks to inflation in 2011



Note : Indices as depicted refer to IMF's commodity price indices.

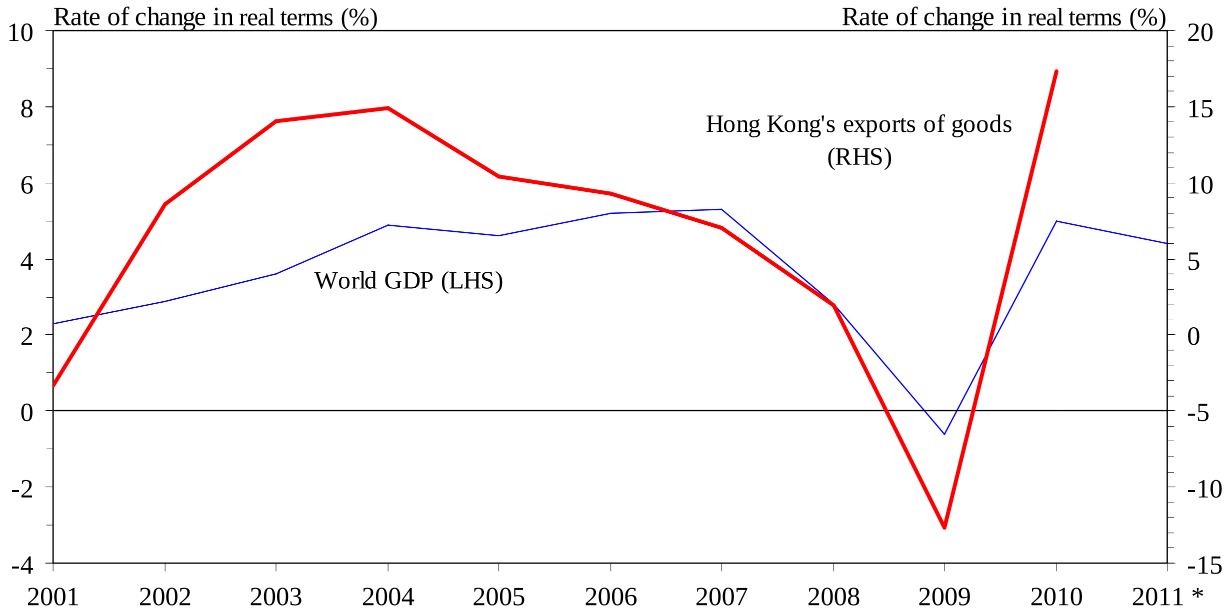
Major sources of uncertainty

2.16 While the global economy should head for further growth in 2011, due recognition should be given to the prevailing high level of uncertainty in the external environment, given the various vulnerabilities in the major advanced economies. *Firstly*, the fiscal positions are fragile in the advanced economies. It will take time for their fiscal consolidation to bear fruits, thereby clearing the markets' doubts about their longer-term fiscal sustainability. In this regard, the sovereign debt issue in Europe will remain a key downside risk to the global economy in 2011. Indeed, the markets are also increasingly concerned about the longer-term fiscal health of the US and Japan. Financial market volatility may thus remain significant in the period ahead. *Secondly*, given the expected moderate recoveries in the major advanced economies, their ultra-loose monetary policies are likely to continue well into 2011. This would increase not only the risk of currency war among countries, but also the inflation and asset bubble risks in the rest of the world, including Asia and Hong Kong, given the abundant global liquidity and low interest rate environment. *Thirdly*, a potential surge in commodity prices can add to inflationary pressure, thereby posing challenge to policy makers around the world in maintaining macroeconomic stability. The abrupt surge in energy prices due to geopolitical tensions, if happened, could also put a drag on global economic growth. *Fourthly*, given their weak fundamentals, the conditions for a full-fledged sustainable recovery in the advanced economies have yet to be put in place, although recent data suggest that the probability of these economies relapsing into recession in 2011 is diminishing. *Fifthly*, as job creation in the US and Europe is expected to remain slow, sustaining unemployment at unacceptably high levels, this can breed protectionist sentiments, casting shadows over the global trading environment.

Outlook for the Hong Kong economy in 2011

2.17 The continuous expansion of the global economy, though still subject to various uncertainties, should remain generally positive to Hong Kong's export sector in 2011. As far as Hong Kong's *exports of goods* are concerned, the Asian markets should continue to outpace the advanced economies, reflecting the two-speed nature of the global economic expansion. However, the growth of merchandise exports should be notably less rapid in 2011 than in 2010, given the much higher base of comparison and the slower growth in some markets overseas.

Diagram 2.5 : Hong Kong's exports of goods should expand further in 2011



Source: (*) Forecast from the IMF World Economic Outlook Update January 2011.

Diagram 2.6 : Hong Kong's exports can be influenced by exchange rate movements

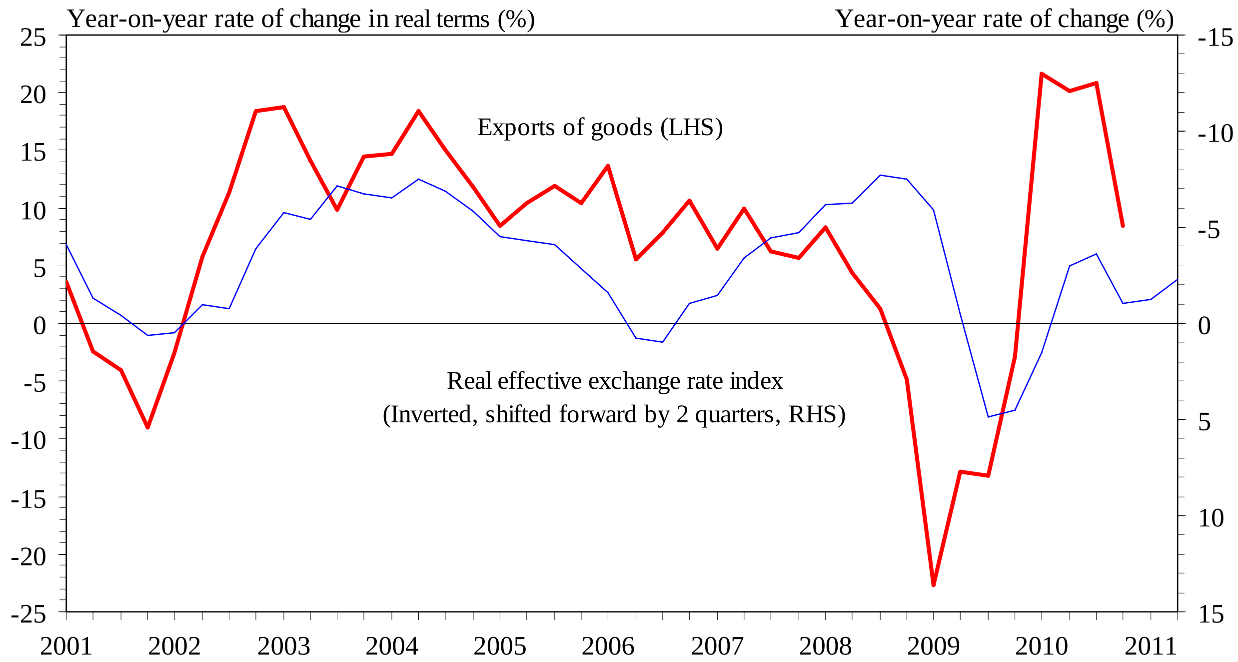
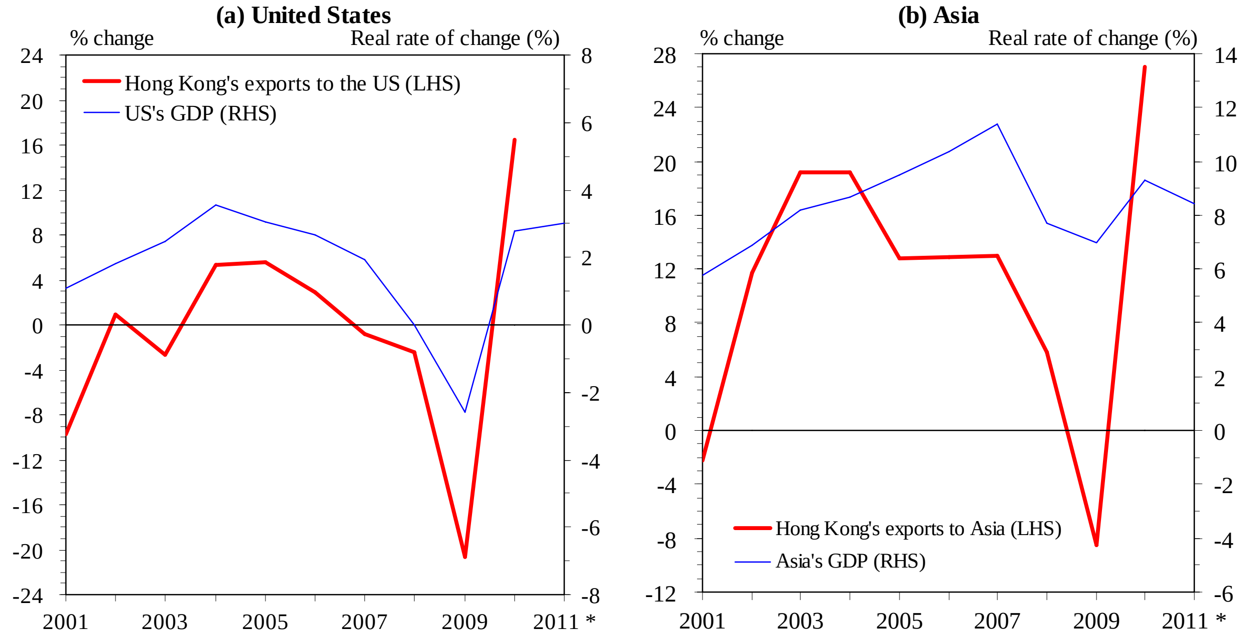


Diagram 2.7 : Exports to Asian markets should fare better, reflecting the two-speed expansion of the global economy

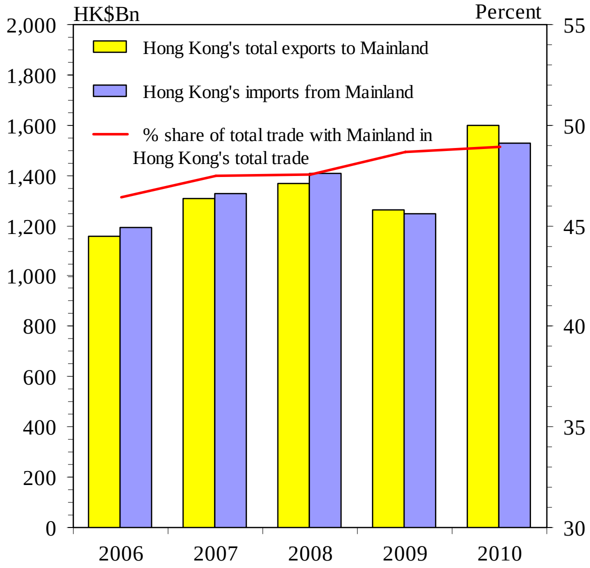


Source: (*) Forecast from the IMF World Economic Outlook Update January 2011.

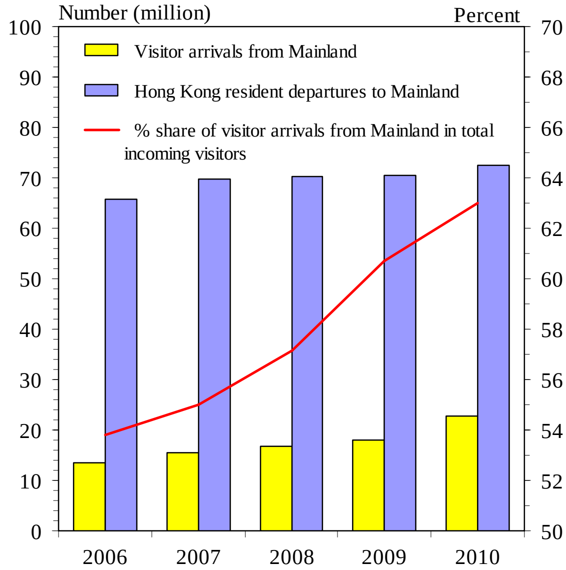
2.18 The performance of *exports of services* has been more resilient than exports of goods over the past decade, underscoring the strong competitiveness of Hong Kong in the provision of tradable services and the considerable benefits from the continued integration with the Mainland economy. Exports of services should continue to fare well in 2011. Exports of financial services, in particular, will ride further on the vibrant IPO activities and the development of Hong Kong into the offshore centre for renminbi business. Inbound tourism, having surged throughout 2010, is expected to stay vibrant in 2011. Offshore trade and other business services should also benefit from further growth in trade flows and expansion of commercial activities.

Diagram 2.8 : The Mainland factor will continue to be the major force driving the Hong Kong economy

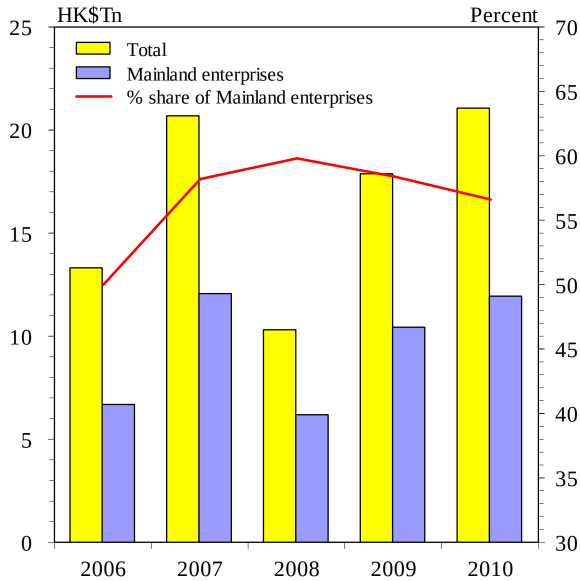
(a) Merchandise trade



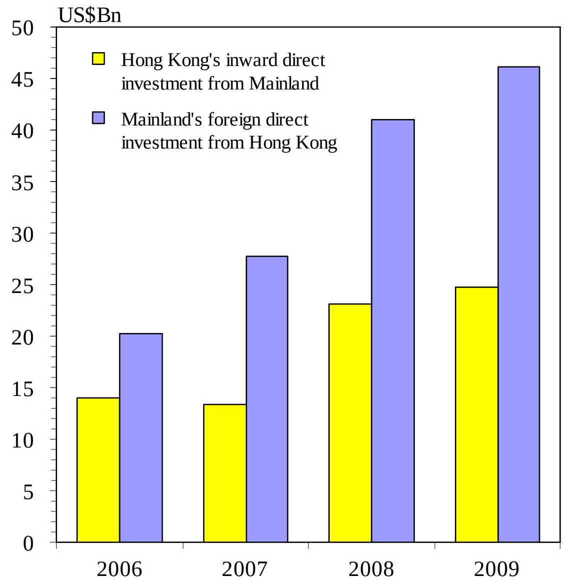
(b) Visitor arrivals from Mainland and Hong Kong resident departures to Mainland



(c) Market capitalisation of Mainland enterprises in the Hong Kong stock market (end-year figures)



(d) Mainland's foreign direct investment from Hong Kong and Hong Kong's inward direct investment from Mainland



2.19 Domestically, improving job markets and rising incomes should augur well for consumption spending. Yet the extent of growth in private consumption in 2011 will also hinge on the performance of the asset markets, including the housing market. Investment is also poised for a further notable growth in tandem with the upbeat business sentiment. Indeed, the results of the latest Business Tendency Survey conducted by the Census and Statistics Department on large business establishments indicated that business sentiments remained optimistic across the board, although the extent of optimism diminished somewhat compared with results of the previous rounds of the survey. These companies are also inclined to expand their workforce further. Meanwhile, the continued surge in public sector construction works, reflecting the intensive progress of several large-scale infrastructure projects, should also render a staunch support to the domestic economy.

Diagram 2.9 : Local consumer sentiment should remain well supported by the improving employment situation

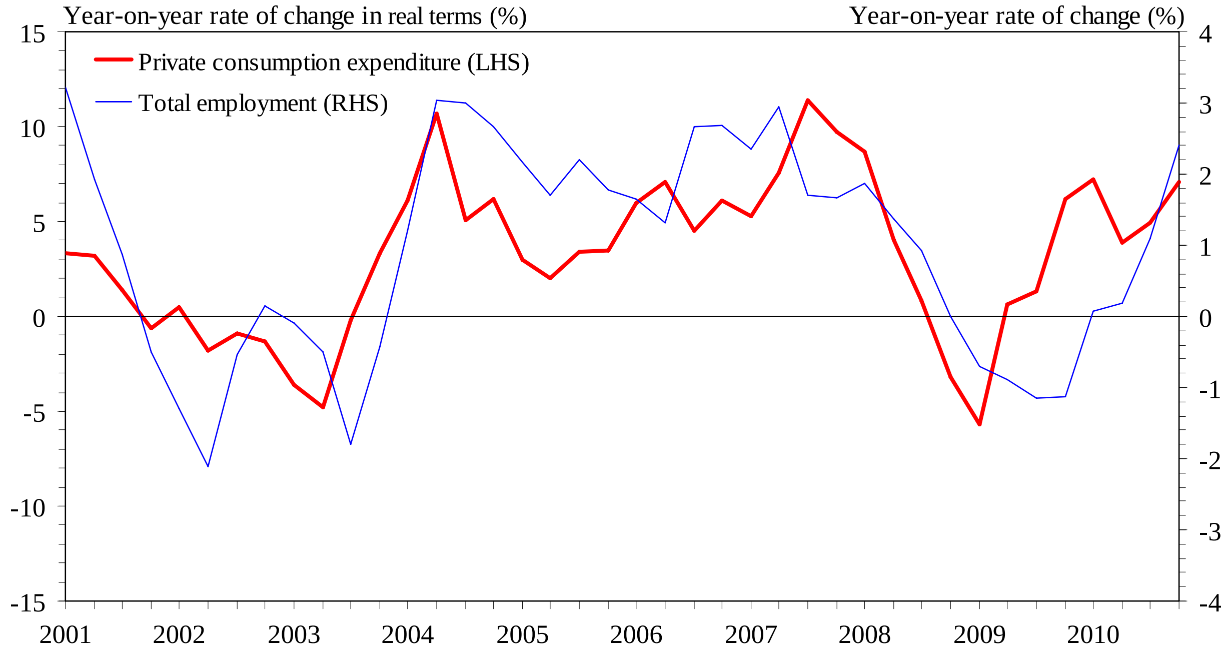
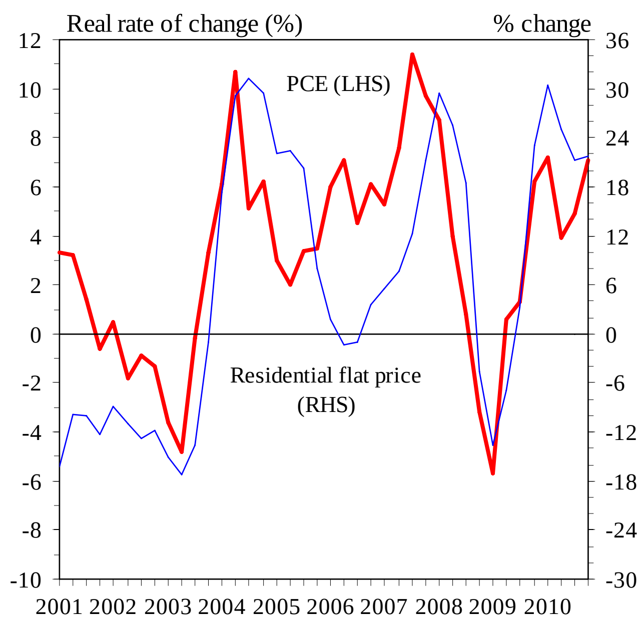


Diagram 2.10 : The extent of growth in private consumption will also hinge on the performance of the asset markets

(a) Housing wealth



(b) Equity wealth

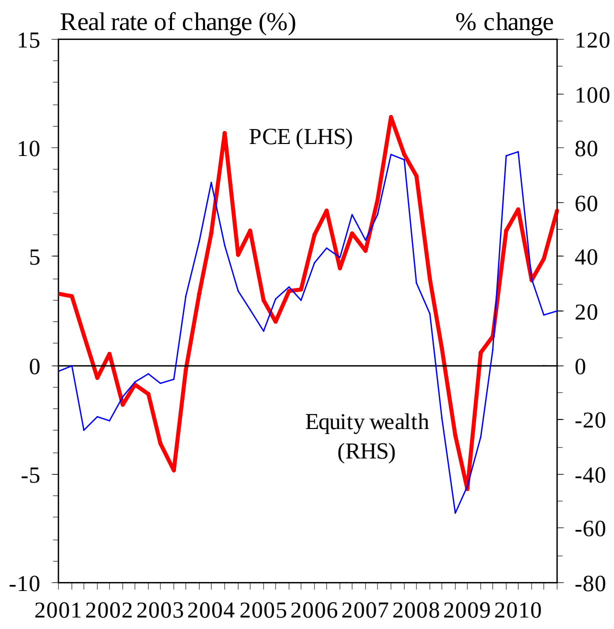
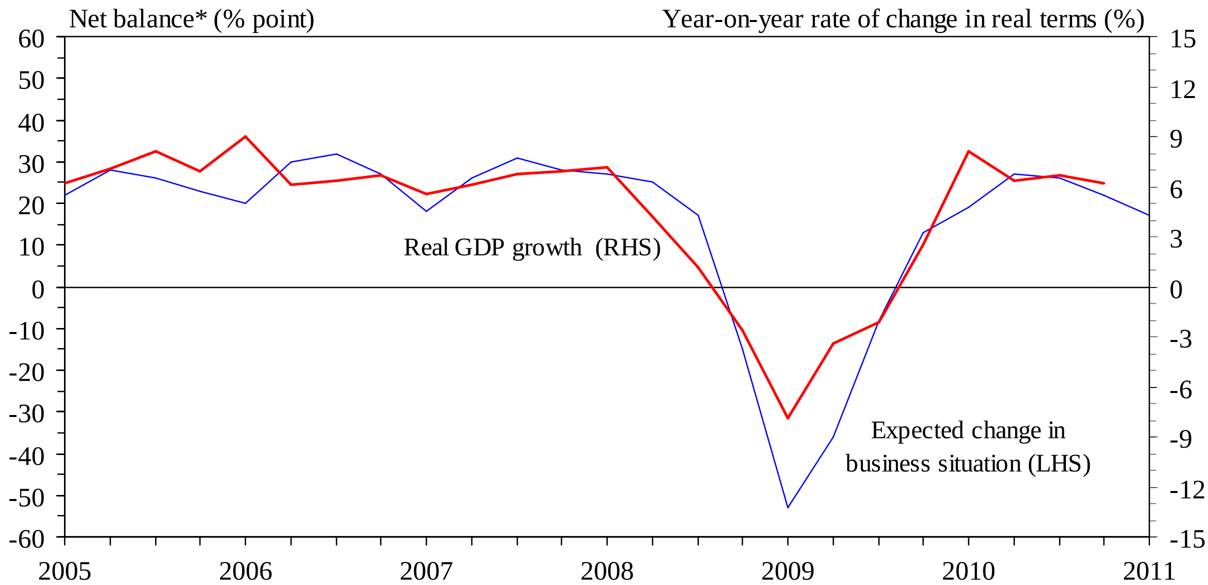
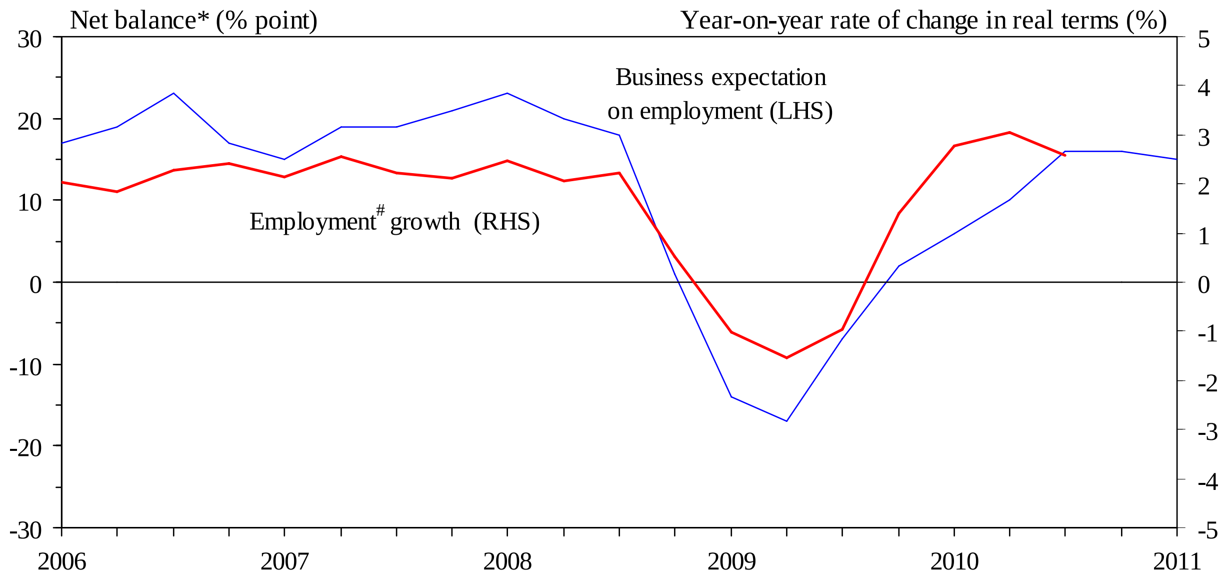


Diagram 2.11 : Business sentiment remains generally optimistic



Note : (*) Net balance indicates the direction of expected change in business situation versus preceding quarter. It refers to the difference in percentage points between the proprotion of establishments choosing "better" over that choosing "worse". A positive sign indicates a likely upward trend while a negative sign, a likely downward trend.

Diagram 2.12 : Businesses are also increasingly positive towards hiring

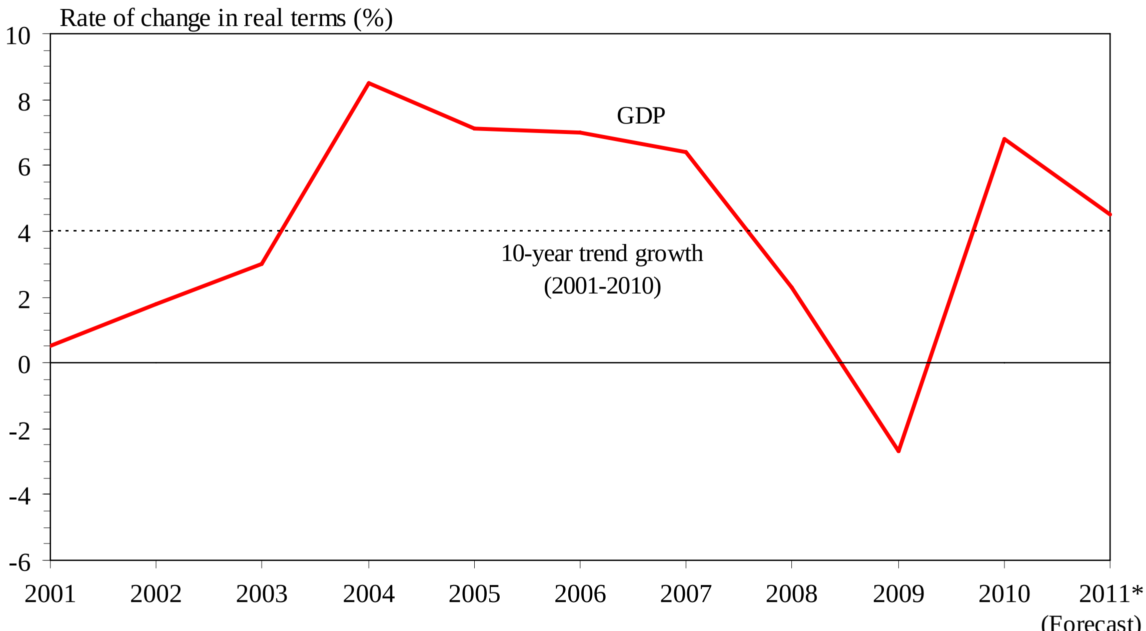


Notes : (*) Net balance indicates the direction of expected change in number of persons engaged versus preceding quarter. It refers to the difference in percentage points between the proportion of establishments choosing "up" over that choosing "down". A positive sign indicates a likely upward trend while a negative sign, a likely downward trend.

(#) Employment in private sector.

2.20 Following the above discussions, the Hong Kong economy is poised for a further solid growth of 4% to 5% in 2011. The sustained expansion of domestic demand, coupled with the vibrant growth of inbound tourism and financial services, is likely to become a more prominent driver of overall economic growth, compensating for the possible slower growth in merchandise exports. This will be largely in line with the 10-year average annual growth rate of 4.7% just before the global financial crisis, and is also broadly in line with the prevailing forecasts by private sector analysts, which mostly fall within the range of 4% to 5.5%. This also signifies that the economy is returning to the normal growth path, having successfully weathered the impact of the global financial crisis of 2008-2009. Yet, the economic outlook for this year is still subject to various uncertainties, mainly emancipating from the weak fundamentals of the advanced economies, as summarised in paragraph 2.16. The Government will stay alert to these risks and challenges, in particular the increasing risks of inflation and asset market bubble in Hong Kong. In this regard, the various relief measures announced in the 2011-12 Budget should help to alleviate the impact of inflation on the lower-income group. On top of these short-term relief measures, the Government will adopt a multi-pronged approach to contain inflation risks, through a counter-cyclical fiscal strategy to contain government expenditure; targeted measures to forestall asset market bubbles; macro-prudential regulation to strengthen risk management in the banking system; and issuing inflation-linked bonds to provide people with an additional investment choice.

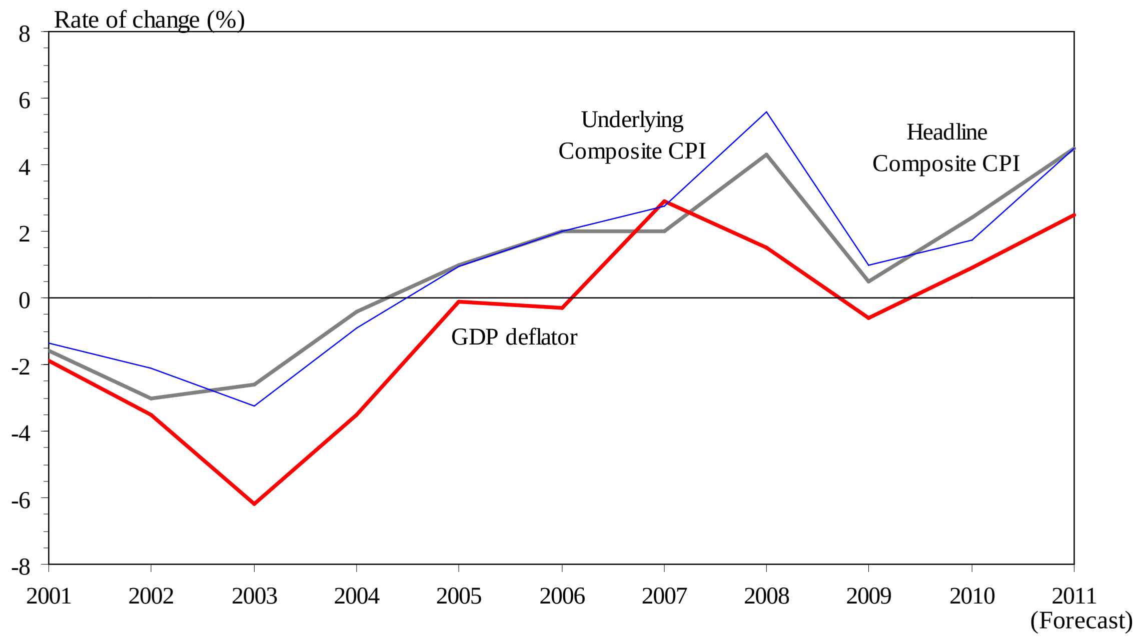
Diagram 2.13 : Economy poised for solid expansion in 2011, broadly in line with the trend performance in the latest decade before the Global Financial Crisis



Note : (*) Mid-point of the range forecast.

2.21 Inflationary pressures in Hong Kong will turn more evident in 2011, having gradually increased alongside the economic upswing. The recent rapid increases in global food and commodity prices, coupled with higher inflation in the supply sources and the weak US dollar, have added to imported inflation. Locally, higher rentals over the course of the past year, particularly private housing rentals, will also progressively pass through to the consumer price indices. The effect on consumer prices from the implementation of the Statutory Minimum Wage in May will also need to be watched over. Against this backdrop, the *underlying Composite CPI* is forecast to increase by 4.5% in 2011 as a whole. Taking into account the Government's one-off measures, the *headline Composite CPI* is also forecast to increase by 4.5%. The *GDP deflator* is forecast to show a 2.5% increase in 2011, reflecting higher inflationary pressures in the economy as well as the expected change in the terms of trade.

Diagram 2.14 : Inflation is expected to go higher in 2011 under the combined influence of both external and domestic factors



Forecast rate of change in 2011 (%)

Gross Domestic Product (GDP)	
Real GDP	**4 to 5**
Nominal GDP	6.5 to 7.5
Per capita GDP, in real terms	3.2 to 4.2
Per capita GDP at current market prices	HK$261,300-263,800 (US$33,500-33,800)
Composite Consumer Price Index	
Headline	**4.5**
Underlying	**4.5**
GDP Deflator	**2.5**

Forecast on Hong Kong's GDP growth in 2011 recently made by other selected parties

	(%)
International Monetary Fund	5 to 5.5
The University of Hong Kong	4 to 5
Average forecast by private sector analysts[#]	4.8

Note: (#) Forecast GDP growth by private sector analysts mostly falls between 4% and 5.5%.

Medium-term outlook for the Hong Kong economy

2.22 The medium-term prospects for the Hong Kong economy are bright. For the global economy as a whole, growth impetus will mainly come from sustained strong growth in emerging Asia, in particular the Mainland, as the economic centre of gravity will continue to shift to the East. Indeed the Mainland has been the largest contributor to global economic growth in the recent past and will likely remain so over the medium term. The major advanced economies should also gradually emerge out of the shadows casted by the global financial crisis.

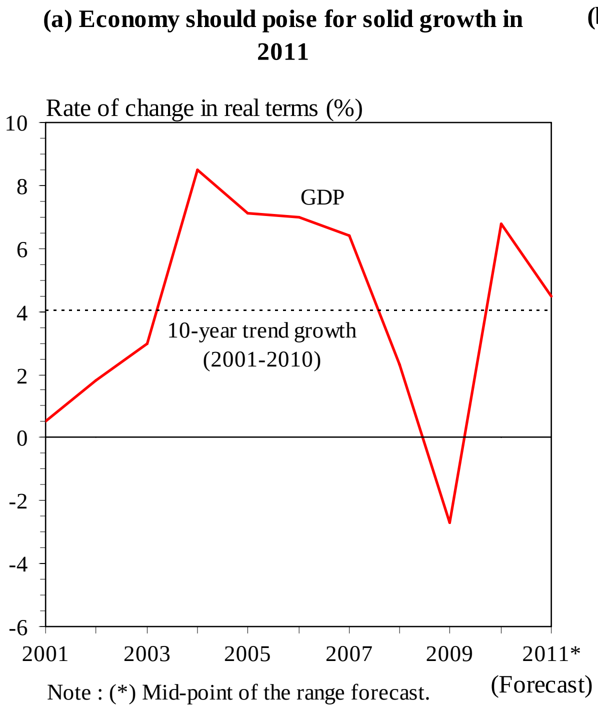
2.23 Hong Kong is in the best position to reap the benefits from the vibrant growth of Asia. The Government will continue to pursue a growth strategy focusing on the Mainland, promoting regional co-operations and the development of new markets and growth areas.

2.24 Hong Kong will enhance further its integration with the Mainland economy, particularly by leveraging its unique advantages and functions during the National 12th Five-Year Plan period. Hong Kong and Guangdong as well as other parts of the Mainland will also push ahead with co-operation in many areas. Of particular note will be financial services. Hong Kong will establish itself as a renminbi offshore centre and an asset management centre for the Mainland. The Government will also continue to help Hong Kong's service sectors, notably the six new industries and other professional services, to expand their presence in the Mainland markets. The various major cross-boundary infrastructure projects, when completed, will enhance the efficient flow of people and goods between Hong Kong and the Mainland. In the coming years the construction of these major infrastructure projects will also help to boost domestic demand.

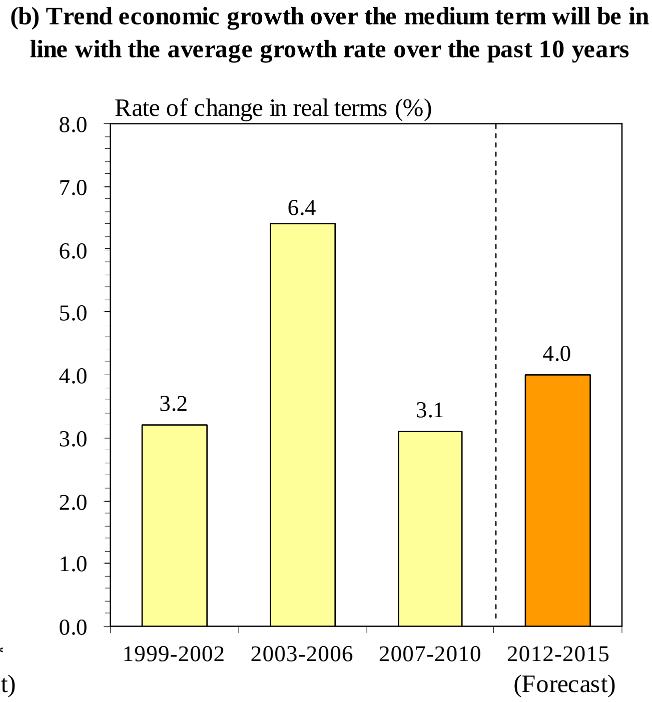
2.25 The Government will also continue to facilitate Hong Kong's transformation into a knowledge-based, high value-added economy. Being a relatively mature economy, Hong Kong has to compete in the global and regional arenas in terms of quality. Hong Kong will continue to uphold its status as an international financial centre and a regional business hub.

2.26 Against this background, the trend GDP growth rate in real terms is forecast at 4% per annum from 2012 to 2015, in line with its trend rate over the past decade. Inflationary pressures are likely to persist beyond 2011, partly because the withdrawal of the massive liquidity in the global banking systems could be a gradual process. The trend rate of change in the underlying Composite CPI in Hong Kong over the medium term is forecast at 3.5% per annum.

Diagram 2.15 : Economic prospects are bright over the medium term



Note : (*) Mid-point of the range forecast.



2.27 The Government is also mindful of the various challenges facing the global and local economy over the medium term. Globally, it becomes increasingly obvious that the global adjustment process in the aftermath of the global financial crisis could go beyond 2011, resulting in weaker global demand and higher inflation and asset bubble risks in Asia, Hong Kong included. European sovereign debt problems will continue to cast uncertainty as the issue of fiscal sustainability in the highly-indebted euro-zone economies is yet to be solved. The high national debt to GDP ratios in other major advanced economies, including the US and Japan, are also worrisome. Also, the persistence of global imbalances can lead to heightened tensions on trade and exchange rate fronts. This can be complicated by the political implications of persistently high unemployment in the US and Europe. Last but not the least, the period of high inflation could return if global liquidity remains abundant for too long and world commodity prices continue to surge. Domestically, the structural shift of the Hong Kong economy to high value-added and knowledge-based activities would lead to greater variability in income and wealth distribution. The training and re-training needs of Hong Kong's workforce are bound to increase over time if it is to reduce the extent of mismatch between jobs and skills. Stronger efforts on environmental protection and other areas will be needed to improve the quality of life in Hong Kong. The ageing population will also have profound implications on Hong Kong's health care and social welfare systems, as well as on the sustainability of public finance, over the medium and longer run. Prudent fiscal policy is needed in view of these medium-term issues and long-term development needs.