

## CHAPTER 2 : ECONOMIC OUTLOOK FOR 2012 AND THE MEDIUM TERM

### *Summary*

- *The global economy has entered a dangerous phase, with the growth prospects in many advanced economies remaining dim, while only limited progress has been achieved so far towards the resolution of the sovereign debt crisis in the eurozone and fiscal fragility in the US. Also worryingly, there are now signs that funding difficulties faced by some European governments are spreading to the banking sector and the wider economy, which, if escalated further, could lead to potentially damaging repercussions to the global financial markets. Emerging market economies, though having relatively sound fundamentals, can hardly stay unscathed from the slack in the advanced economies.*
- *Given the difficult external trading environment, the outlook for Hong Kong's merchandise trade in 2012 is bleak. Exports of services should nevertheless fare better, underpinned by the expected vibrancy of inbound tourism as well as cross-border financing and commercial activities.*
- *Locally, the notable job and income growth over the past year or so should help underpin a relatively better performance of local consumption spending going forward. However, consumer sentiment will also hinge on labour market conditions and asset market performance down the road in face of the worsening external environment. As for investment, machinery and equipment acquisition will likely suffer more due to its higher sensitivity to the business cycle, while building and construction should continue to be supported by the sustained high level of public sector infrastructure works.*
- *Notwithstanding the cushion rendered by a resilient domestic sector against the expected setback in external trade, the Hong Kong economy is forecast to post a rather muted growth at 1-3% in 2012. This sub-trend growth projection is subject to an unusually wide range of uncertainties, depending on how the eurozone sovereign debt crisis will unfold and whether it will escalate into a full-blown crisis that brings about a global recession.*
- *With the recent easing in global food and commodity prices and the expected economic slowdown, inflation can be expected to come down over the course of 2012. The underlying consumer price inflation is forecast at 4.0% in 2012.*

- *The medium term prospects for the Hong Kong economy should remain bright, although the degree of uncertainty in the external environment would likely stay elevated. Hong Kong will continue to ride on the growing economic prowess of the region and deepen its integration with the Mainland while continuing its stride towards a knowledge-based, high value-added economy. New markets and growth areas will be further explored, and the continued investment in human capital and infrastructure should bolster productivity and ensure sustainable economic growth in the longer run. The trend GDP growth rate in real terms is forecast at 4% per annum from 2013 to 2016, and the trend rate of underlying consumer price inflation at 3.5% per annum.*

## **Major external factors**

2.1 Being a small and highly externally-oriented economy, the Hong Kong economy will inevitably be affected by the vicissitudes on the external front through both the trade and financial channels. The intensification of the eurozone sovereign debt crisis since mid-2011 has not only dealt a severe blow to the already fragile recovery in the advanced economies, but also led to a region-wide deceleration in exports and production activities in Asia which are so closely tied to the final consumption demand in the advanced economies. Against this background, the external environment has turned increasingly difficult and is expected to remain highly uncertain in the period ahead, thereby casting a shadow over Hong Kong's economic outlook in 2012.

2.2 So far, credible plans to stabilise the financial situation in Europe are yet to be in place, fuelling mounting uncertainties to the detriment of business and consumer confidence there and severely undermining Europe's economic prospects. The implementation of austerity measures in the European economies will weigh on their economy in the near term. Meanwhile, the US economy will have to contend with onerous structural problems including the fragile fiscal positions, persistently high unemployment, household deleveraging, and depressed housing market. Given these considerations, the ultra-loose monetary stance in the advanced economies will likely persist throughout 2012, resulting in a continuation of abundant global liquidity that could add to financial and currency market gyrations. Protectionist sentiments in the advanced economies may also rise further given their subdued economic performance.

2.3 In view of the fragility of the advanced economies and the rapidly evolving eurozone sovereign debt crisis, Asian and other emerging economies are deemed for further growth moderation in 2012, although they can be expected to stay relatively resilient given their sound fundamentals. However, the possibility of a sharper-than-expected slowdown in Asia cannot be underestimated, much depending on how the euro debt crisis would unfold and impact on the global economy. At this juncture, risks to the global economic prospects and hence Hong Kong's export outlook are tilted more towards the downside. The uncertain direction of the US dollar movement, with direct implications on Hong Kong's external competitiveness, will also complicate the situation. No doubt 2012 will be a challenging year for the Hong Kong economy.

### *Eurozone sovereign debt crisis*

2.4 The eurozone sovereign debt crisis, which first broke out in early 2010 upon mounting concern over the fiscal sustainability of several peripheral eurozone economies, has re-intensified distinctly since the second quarter of 2011 and emerged as the biggest threat to the global economy and financial market stability. Of particular concern are the heightened risks of contagion beyond the peripheral economies to the other larger European economies, as manifested by the intense pressures faced by government bond markets across the region and a series of negative credit rating actions on various European economies (**Box 2.1**). At the same time, the European banking system has shown signs of increasing strains, stemming from the broad-based economic slowdown in Europe, exposures to the troubled sovereign debts, unease over inter-bank lending, and also the need for many banks to replenish their capital base as agreed at the October 2011 EU Summit. The tighter credit conditions, together with the implementation of austerity measures in many European countries, would likely exacerbate the downswing in their economies.

## Box 2.1

### Summary of major events and credit rating actions pertinent to euro debt crisis\*

#### 2011

- 4 Aug European Central Bank (ECB) re-activated the exceptional 6-month liquidity facility and Securities Markets Programme
- 5 Aug Italy announced a €45.5 billion austerity package
- 7 Aug ECB agreed to buy Spanish and Italian bonds
- 9 Aug Greece introduced a ban in short-selling shares on Athens bourse for two months
- 12 Aug France, Italy and Spain banned short-selling shares of banks and financial companies temporarily while Belgium's ban was for an indefinite period
- 16 Aug The Franco-German summit rejected eurozone bond issuance and expansion of European Financial Stability Facility (EFSF) size
- 18 Aug Spanish government announced new austerity measures worth €5 billion
- 24 Aug French government announced a €12 billion austerity package to meet its pledge to cut deficit
- 7 Sep German Federal Constitutional Court ruled that the eurozone bailout was legal
- 14 Sep Italy passed an enlarged €54 billion austerity package
- 15 Sep ECB decided, in coordination with the Federal Reserve, the Bank of England, the Bank of Japan and the Swiss National Bank, to conduct three US dollar liquidity-providing operations with maturity of three months through year-end
- 19 Sep S&P cut Italy's rating from A+ to A, outlook negative
- 27 Sep Greece approved a new property tax to boost revenue
- 4 Oct Moody's cut Italy's rating from Aa2 to A2, outlook negative
- 6 Oct ECB announced to spend €40 billion on covered bonds starting November and offer banks two unlimited loans of 12 and 13-month durations
- 7 Oct Fitch cut Italy's rating from AA- to A+, outlook negative; Spain's rating from AA+ to AA-, outlook negative; Moody's put Belgium on negative watch
- 13 Oct Portugal announced more austerity measures; S&P cut Spain's rating from AA to AA-, outlook negative
- 14 Oct Expansion of EFSF was ratified by all 17 eurozone member states
- 18 Oct Moody's cut Spain's rating from Aa2 to A1, outlook negative
- 20 Oct Greece passed a bill on additional austerity measures, including pay and staff cuts in the civil service, as well as pension cuts and tax hikes
- 26 Oct European leaders agreed on a rescue plan which included bank recapitalisation, higher voluntary haircut for Greek debt, leveraging the EFSF, etc., but details have yet to be fully worked out
- 31 Oct Greek Prime Minister, Mr. Papandreou, called referendum on the second bailout package and effectively euro membership
- 3 Nov ECB cut its main refinancing rate from 1.5% to 1.25%; Greek government scrapped its plan for a referendum on Greece's euro membership
- 4 Nov G20 failed to agree on the ways to boost International Monetary Fund (IMF) or EFSF resources, but Italy agreed to accept IMF surveillance of its fiscal and structural reforms;
- 6 Nov Greek Prime Minister, Mr. Papandreou, agreed to resign after narrowly won a confidence vote
- 7 Nov France announced €7 billion of new austerity measures to offset the lower GDP growth forecast in order to meet its deficit reduction target
- 8 Nov Italian Prime Minister, Mr. Berlusconi, announced to resign after losing parliamentary majority
- 9 Nov A joint EU/IMF taskforce started monitoring the Italian economy as agreed in the G20 meeting
- 12 Nov Italy passed new austerity measures

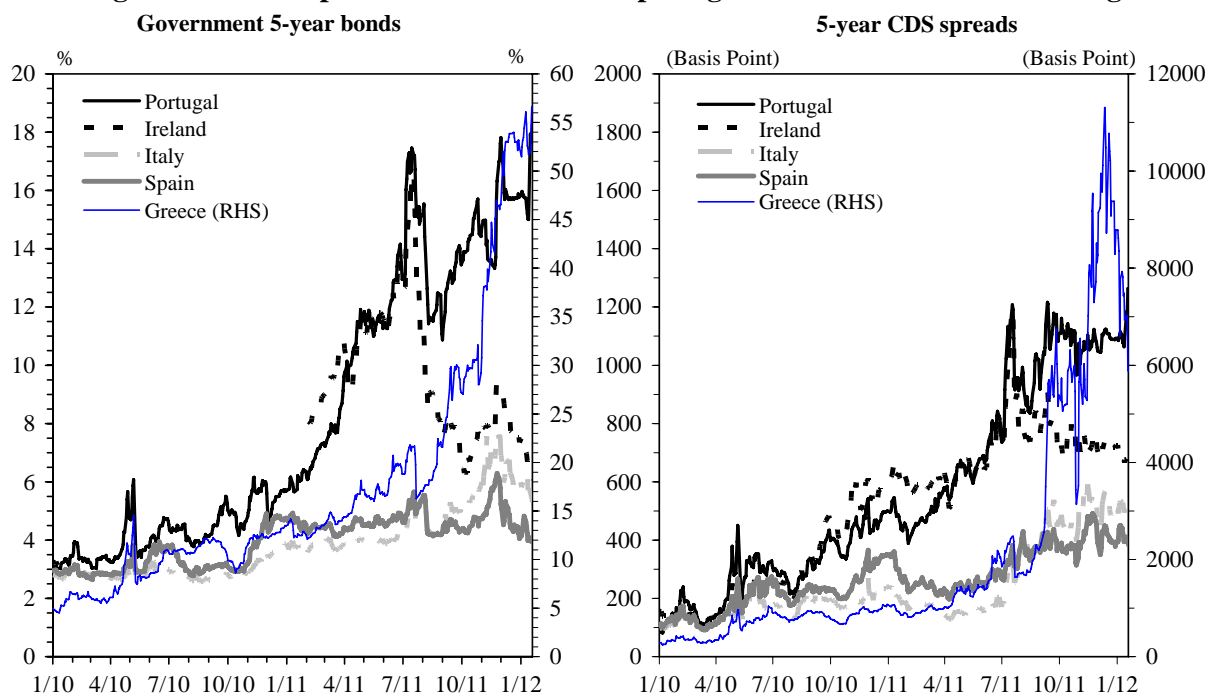
### Box 2.1 (Cont'd)

Mid Nov	The new Greek, Italian and Spanish governments were elected or sworn in
22 Nov	IMF approved reforms to bolster flexibility and scope of its lending toolkit, including a six-month liquidity line to countries at risk from the eurozone crisis
23 Nov	European Commission (EC) proposed tighter controls over eurozone members' budgets, alongside options for a common eurozone bond market
24 Nov	Fitch downgraded Portugal's rating from BBB- to BB+ (junk), outlook negative
25 Nov	S&P cut Belgium's rating from AA+ to AA, outlook negative
28 Nov	Moody's warned that the European debt crisis had rapidly escalated, putting the ratings of all European sovereigns under threat for the first time
29 Nov	Eurozone finance ministers approved enhancements to the EFSF's capacity through leveraging and planned to create certificates that could guarantee up to 30% of new issues from troubled eurozone governments
30 Nov	The Fed and five other major central banks took actions, including the lowering of interest rate charged on dollar liquidity swap lines, to support global financial markets
4 Dec	Italian government announced new budget plan with a net fiscal tightening worth €20 billion
5 Dec	Ireland unveiled new spending cuts of €1 billion to shore up public finances; S&P placed the ratings of 15 eurozone countries on negative watch
6 Dec	Belgium's new government sworn in; S&P placed the AAA rating on EFSF on credit watch negative
8 Dec	ECB cut its main refinancing rate from 1.25% to 1% and unveiled a raft of new measures, such as opening up an unprecedented 3-year refinancing tender, reducing reserve requirements from 2% to 1%, and loosening certain collateral requirements; European Banking Authority released bank recapitalisation plan with an aggregated shortfall of €14.7 billion
9 Dec	EU Summit worked out some steps to support the sovereigns and push for tighter control over national budgets, such as speeding up the establishment of European Stability Mechanism to July 2012, considering the provision of up to €200 billion additional resources for IMF, and imposing automatic sanctions against countries with an annual structural deficit larger than 0.5% of GDP
12 Dec	Major ratings agencies indicated that the proposed actions of the EU summit were not adequate to resolve the sovereign debt problems, and warned to review the region's credit rating
16 Dec	Moody's downgraded Belgium's rating from Aa1 to Aa3, outlook negative; Fitch revised France's outlook to negative and put Belgium, Spain, Slovenia, Italy, Ireland, and Cyprus on negative watch
19 Dec	Eurozone agreed to boost IMF resources by €150 billion to ward off the debt crisis, as compared to its original target of €200 billion
Late Dec	France and Italy passed new budget plans
30 Dec	Spanish government indicated that the public deficit for 2011 would reach 8% of GDP and announced new spending cuts and tax hikes to tackle the shortfall
<u>2012</u>	
13 Jan	S&P cut France's and Austria's ratings from AAA to AA+ and downgraded 7 others, including Spain (A), Italy (BBB+) and Portugal (BB, junk). The rating outlook for all eurozone countries, except Germany and Slovakia, remained negative
16 Jan	S&P downgraded EFSF's long-term rating from AAA to AA+, outlook developing

Note: (\*) Please see **Box 2.1** of the *Half-yearly Economic Report 2011* for earlier developments.

2.5 The European Central Bank (ECB) has taken a series of measures in order to stabilise the financial system, including notably the provision of unprecedented low-cost, long-term funding to financial institutions (known as “Long-Term Refinancing Operations”) and purchases of sovereign debts of eurozone countries through its Securities Markets Programme. The joint central bank actions led by the Federal Reserve in late November 2011 also helped ease the liquidity strain facing the European financial institutions somewhat. In addition, EU leaders have put forth a variety of initiatives to restore fiscal discipline in the eurozone (for details, see *Box 2.1*). Yet, despite all these efforts, there is still no clear-cut solution to the euro debt crisis, which is deeply rooted in structural problems upon years of lax fiscal management and over-spending on cheap credit. Indeed, government bond yields and the associated credit default swap (CDS) spreads for some debt-stricken eurozone countries remain worryingly high, despite some ease-backs in the more recent period, reflecting a high level of fluidity and fragile market confidence over the European debt situation.

**Diagram 2.1 : Risk premiums on some European government debt scaled new highs**



2.6 The consequences of the eurozone sovereign debt crisis can be dire. Even if the crisis can eventually be contained, it will likely linger for some time and significantly dent European consumer and business sentiments. Now that the EU economy is already on the brink of recession, the debt crisis looks set to pose a substantial drag on global economic growth in 2012 and, consequently, Hong Kong’s export prospects. In the worst case scenario where the debt crisis escalates into a full-blown crisis, Europe could be pushed into a deep and protracted recession, resulting in even more severe repercussions to the global

economy. Should this also trigger negative disorderly chain reactions across the global financial and banking systems, the impact on the global economy could be devastating, resembling a replay of the global financial crisis of 2008.

2.7 As an international financial centre, Hong Kong will inevitably be subject to fluctuations in global financial and credit conditions, which could in turn impact on the real sectors of the Hong Kong economy. Although the direct exposure of Hong Kong's banks to PIIGS debts (including Portugal, Ireland, Italy, Greece, and Spain) is very limited, representing less than 1% of the banking sector's total external claims at end-September 2011, the high degree of interconnectedness of the global banking systems means that should the euro debt situation escalate into a full-blown crisis, the possible repercussions through the financial channels around the world cannot be taken lightly.

### *Global economic outlook*

2.8 According to the International Monetary Fund (IMF), the global economy has entered a dangerous phase, as the fragile recovery in the advanced economies has lost steam and yet the room for policy manoeuvre is limited. Interest rates in many advanced economies have already approached the zero bound, while the boosting effects of further monetary tools on real economic activities are questionable. Further fiscal stimulus measures are also not feasible given the already precarious states of public finance in the major advanced economies. Sluggish demand from the advanced economies will in turn dampen the growth momentum of the Asian and other emerging economies.

2.9 In the US, while the economy gathered some strength in the second half of 2011, the conditions of self-sustaining recovery have yet to be in place against the backdrops of persistently high unemployment, depressed housing market and the ongoing process of de-leveraging. On top of this, the US economic outlook is further clouded by the potential spill-over of the European sovereign debt crisis to the US financial markets, the possibility of premature withdrawal of accommodative fiscal policies and a more challenging global trading environment. As economic growth is still not fast enough to bring down the high unemployment rate, the Federal Reserve has pledged to keep the policy interest rate at the current ultra-low level at least through mid-2013, and introduced "operation twist" to lengthen the average maturity of its asset holding with a view to lowering longer-term interest rates. The effectiveness of the Federal Reserve's actions in resuscitating growth, however, remains to be seen.

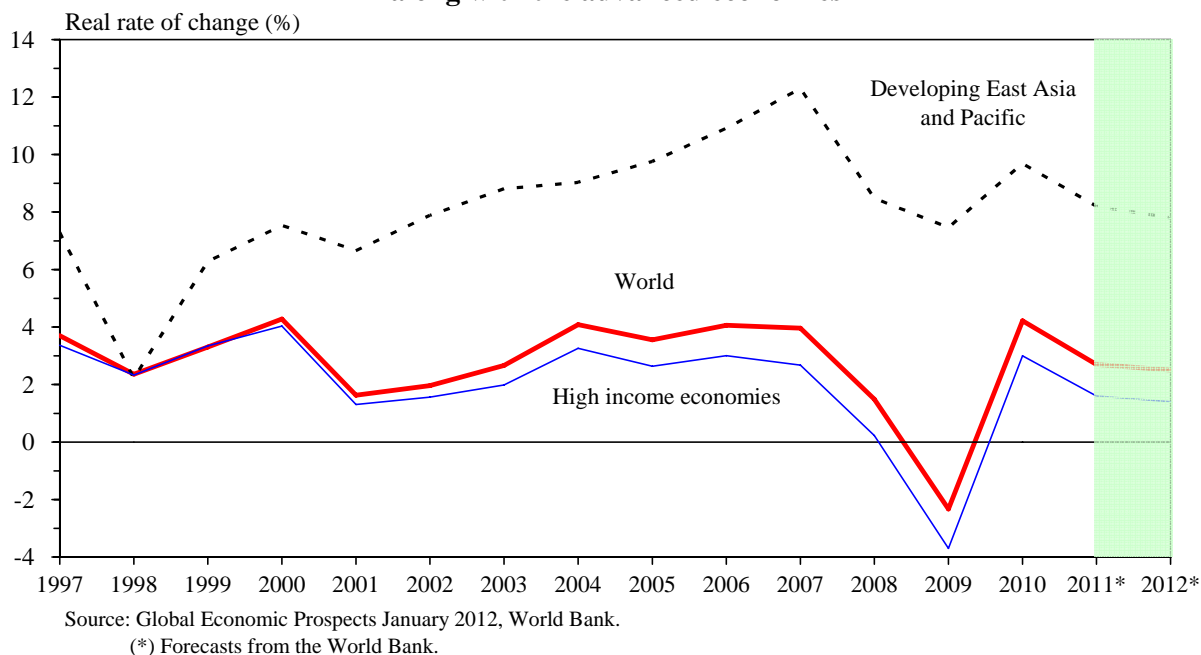
2.10 The European economic outlook is bleak, as detailed in paragraphs 2.4 to 2.6. While the various problems associated with the unsustainably high debt levels in many eurozone countries are yet to be fully addressed, the persistently high unemployment across Europe will also continue to hinder the recovery of domestic demand. The eurozone economy is generally expected to slip into recession in 2012.

2.11 Japan was severely hit by the mega earthquake and tsunami in March 2011. While the economy rebounded in recent quarters as exports recovered alongside the restoration of the supply chain, private domestic demand remained fragile amid the still weak consumer sentiment, and the economy is still mired in deflation. Nonetheless, increased spending on post-disaster reconstruction work should provide some support to economic growth down the road. While the Japanese economy should continue to recover this year, the fluid external environment and the prevailing yen strength are posing significant challenges to Japan's export prospects.

2.12 In sum, given the marked deterioration of the global economic situation in recent months, the advanced economies as a whole will at best see subdued growth in 2012. There will be significant downside risks, depending on how the euro debt crisis would evolve. Indeed, the recovery of the advanced economies will likely be a long drawn-out process, given their fragile fundamentals.

2.13 In contrast, economies in Asia, particularly the Mainland, India and other emerging economies, maintained robust growth in 2011 thanks to their sound fundamentals and relatively robust domestic demand. Going into 2012, however, the Asian economies are expected to decelerate alongside the slowing global trade flows consequential to faltering demand from advanced economies. The Mainland will remain the major growth engine, with economic growth in 2012 forecast at 8.4% on average by private sector analysts. Indeed, if the emerging Asian economies as a whole can exhibit a similar degree of resilience as that during the 2008 global financial crisis, they should be able to cushion part of the negative impacts brought about by the lull in the advanced economies.

**Diagram 2.2 : The Asian region will slow down along with the advanced economies**



2.14 Specifically on the Mainland economy, growth momentum is expected to taper in 2012 amid the increasingly difficult external trading environment and the cooling off of the domestic asset markets. This should nevertheless not be a totally bad development, as some growth moderation to a more sustainable pace is conducive to maintaining the overall macroeconomic and price stability. In addition, the recent retreat of inflationary pressures and the solid fiscal positions of the central government should provide ample room for policy fine-tuning to support growth, should that prove necessary. As such, barring any unforeseen abrupt shocks to the global economy, a sharp deceleration of the Mainland economy does not seem likely. Indeed, the relative resilience of the Mainland economy should not only serve as an important stabilising force for the global economy on the whole, but also render firm support to the Hong Kong economy in the turbulent period ahead.

2.15 That said, reflecting the drags from the advanced economies even in the absence of a sharp intensification of the euro debt crisis, the global economy should conceivably only expand at a modest pace in 2012, thereby posing challenges to world trade and hence Hong Kong's external sector. In recognition of the mounting concern over the eurozone debt crisis and the downside risks it entail, the World Bank, in its latest Global Economic Prospects published in mid-January 2012, has marked down sharply its 2012 global growth forecast, from 4.4% to 3.4%. The IMF has also indicated recently that in face of increasing downside risks, the global economic forecast in its World Economic Outlook Update to be released in late January 2012 would be marked down further.

**Table 2.1 : Growth forecasts for major economies in 2012**

	<b>2012</b>			
	<u><b>2011*</b></u> (%)	<u><b>IMF*</b></u> (%)	<u><b>World Bank<sup>+</sup></b></u> (%)	<b>Private sector forecast<sup>^</sup></b> (%)
World (PPP <sup>##</sup> weights)	4.0	4.0	3.4	-
Advanced economies	1.6	1.9	1.4	-
US	1.5	1.8	2.2	2.2
Euro area	1.6	1.1	-0.3	-0.3
Japan	-0.5	2.3	1.9	1.9
Newly Industrialised Asian Economies <sup>@</sup>	4.7	4.5	-	-
Emerging market and developing economies	6.4	6.1	5.4	-
Developing Asia	8.2	8.0	-	-
Mainland China	9.2 <sup>#</sup>	9.0	8.4	8.4
India	7.8	7.5	6.5	7.3
Middle East and North Africa	4.0	3.6	2.3	-

- Notes : (\*) World Economic Outlook, IMF, September 2011. The IMF will update the forecasts in late January 2012.
- (+) Global Economic Prospects, World Bank, January 2012
- (^) Average forecast as in January 2012.
- (-) Not available.
- (#) Actual figures.
- (@) Includes Hong Kong, Korea, Singapore, and Taiwan.
- (##) PPP refers to purchasing power parity.

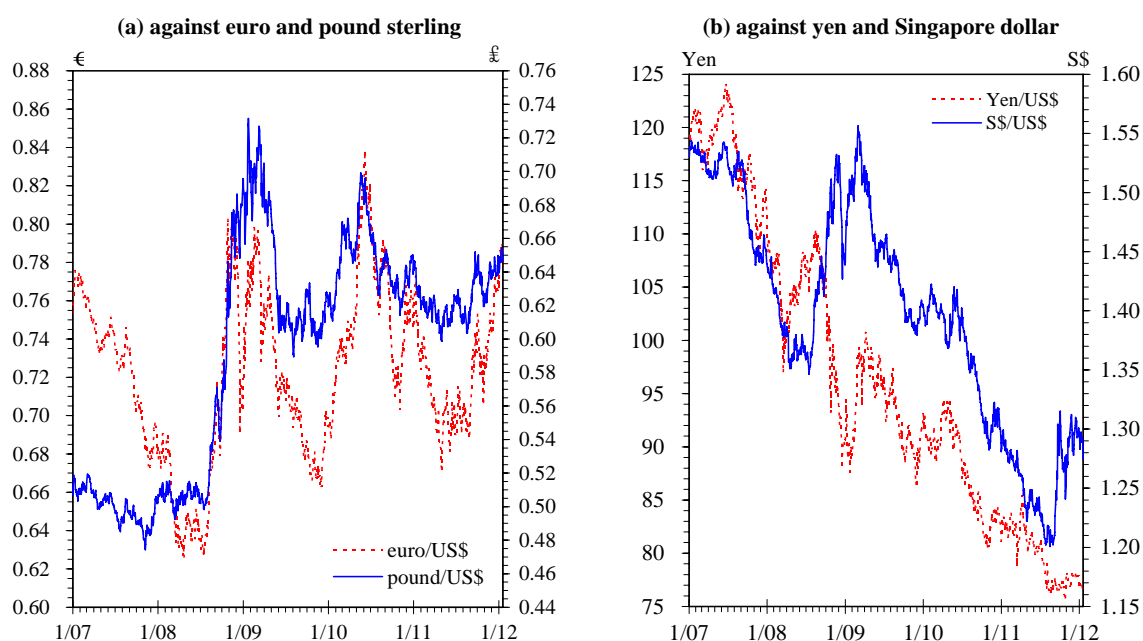
### ***Exchange rates and price competitiveness***

2.16 During most of 2011, the Hong Kong dollar weakened further, alongside the US dollar under the linked exchange rate system, against other major currencies. Notwithstanding some bounce-back in tandem with the US dollar in the latter part of the year, the nominal trade-weighted effective exchange rate index of the Hong Kong dollar still fell by 2.4% in December 2011 from a year earlier. The direction of exchange rate movements in 2012, as usual, is subject to considerable uncertainty.

2.17 In view of the relatively favourable assessment of the US economy by the Federal Reserve of late, some analysts believe that the US dollar should receive some support as the likelihood of the Federal Reserve launching another round of quantitative easing in the near term is not particularly high. Furthermore, risk aversion arising from the rapidly evolving sovereign debt

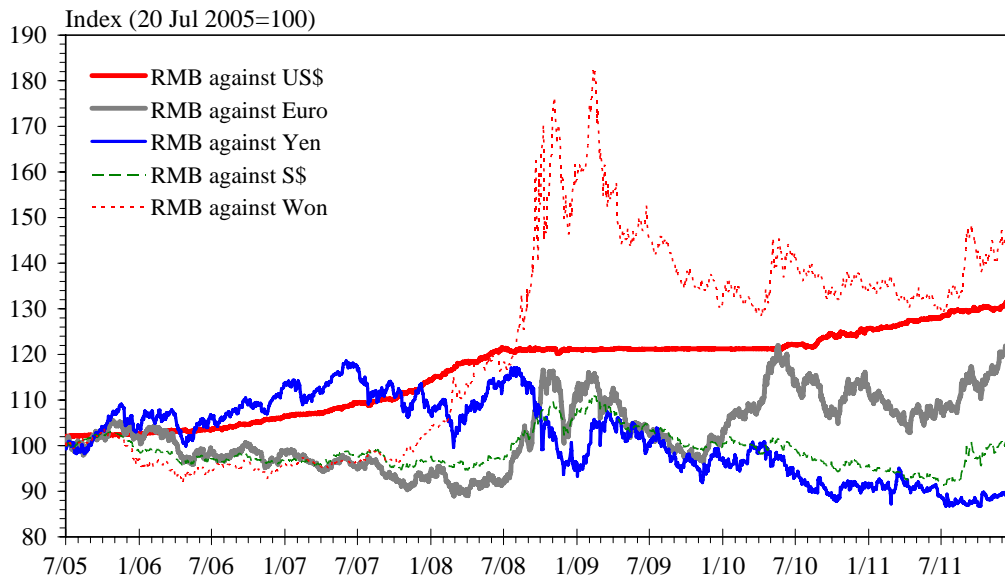
crisis in the eurozone may lead to capital flights to safety assets, including the US Treasury securities, thereby also underpinning the US dollar. On the other hand, the Federal Reserve has committed itself to maintaining the ultra-low federal fund target rates at least through mid-2013. It further indicated the readiness to adopt additional policy tools if the US economy were to deteriorate further, thereby adding uncertainty to the US dollar exchange rate movement. As far as Hong Kong is concerned, the exchange rate factor is likely to feature less prominently compared with the income factor in the major trading partners in determining Hong Kong's export growth prospects under a scenario of sagging global trade flows.

**Diagram 2.3 : The foreign exchange market is likely to remain highly volatile in 2012**



2.18 Given Hong Kong's close economic relationships with the Mainland, the movements of the renminbi is also a key factor affecting the performance of Hong Kong's external sector, including both trade in goods and services. While the renminbi had appreciated modestly against the US dollar since mid-June 2010, by a cumulative 8.5% as at end-December 2011, the market generally expects that the renminbi will not appreciate rapidly versus the US dollar in 2012, against the backdrop of the weak global trading environment. 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 reduce the exchange rate uncertainty facing Hong Kong's companies given the important role played by Mainland operations in the integrated regional supply chains and the increasing use of renminbi for trade settlements.

**Diagram 2.4 : A relatively stable renminbi will help reduce uncertainty facing Hong Kong's traders**



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

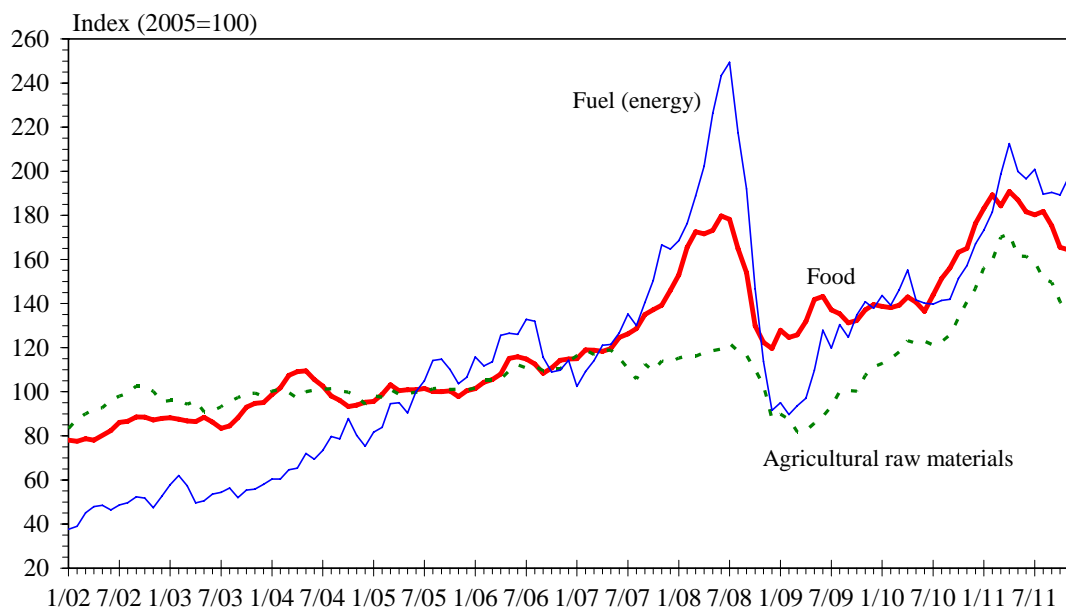
### ***World inflation and global commodity prices***

2.19 Inflation, having risen across emerging markets over the past year or so, showed signs of easing towards end-2011, thanks to a retreat in global food and commodity prices. A slower global growth momentum also contributed to receding upward price pressures in advanced and emerging markets alike. In fact, sustaining economic growth momentum has replaced inflation fighting as the top policy priority in some of the Asian economies. Yet, the extremely loose global monetary conditions will continue to threaten price stability in the period ahead.

2.20 Of particular note has been the recent ease-back in global commodity prices, against the backdrop of slowing global economic momentum. Many global commodity prices, including those of food, energy, agricultural raw materials, industrial materials and metals, showed some downward corrections in the latter half of 2011, although their average levels in 2011 were still distinctly higher than a year earlier. The slower pace of increase in global food prices is a positive development for consumer price inflation in Asian economies, given the relatively large weighting of food in the household consumption baskets. According to the Food and Agriculture Organisation (FAO) of the United Nations, global food prices surged by an average of 22.8% for 2011 as a whole, yet retreated by 11.3% from the peak in February towards the year-end. Barring unforeseen negative supply shocks, global inflation pressures should recede in 2012, although many of the structural factors in

support of higher commodity prices (e.g. rising population and purchasing power in many emerging market economies) still remain in place and warrant due vigilance.

**Diagram 2.5 : Imported inflation expected to ease in 2012 along with the retreat in world commodity prices**



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

### *Major sources of uncertainty*

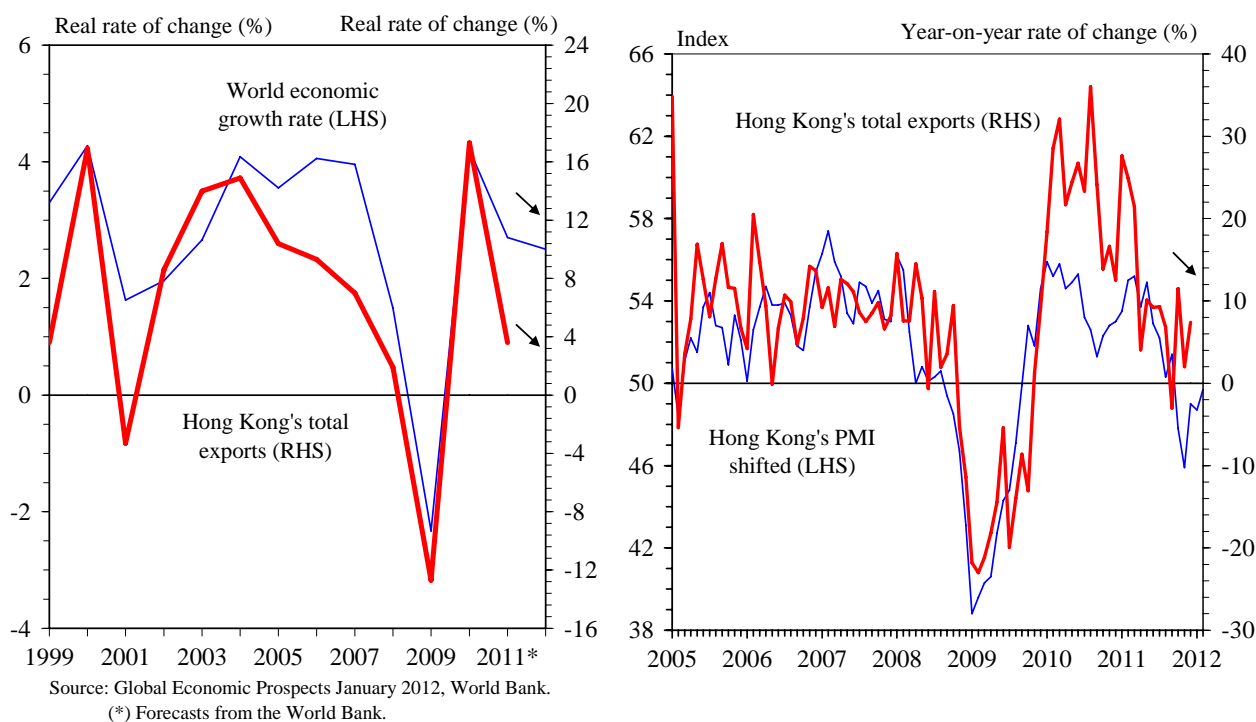
2.21 The level of uncertainty in the external environment is unusually high in 2012. *Firstly*, while pursuing vigorous fiscal consolidation is essential for the advanced economies in clearing the markets' doubts about their longer-term fiscal sustainability, private demand remains fragile and their recovery can be easily derailed by untimely fiscal tightening. Yet, a delay in guiding the public finances of the advanced economies back on a sustainable trajectory would risk undermining market confidence and result in upward pressures on governments' borrowing costs. Financial market volatility may thus remain significant in the period ahead. *Secondly*, it is possible that the evolving eurozone sovereign debt crisis will significantly increase the systemic risks borne by the banking sector, which could potentially lead to a negative feedback loop between credit tightening and deteriorating economic conditions, both within and outside Europe. *Thirdly*, the political disputes in the US over the fiscal issues may re-emerge again in the election year, which could hamper confidence and dim the outlook of the economy further. *Fourthly*, it remains uncertain as to whether emerging markets, those in Asia in particular, have the resilience to tide over a broad-based recession in the advanced economies, given that they are still tightly linked to the business cycles in the advanced economies (**Box 3.1**)

through the trade and financial channels. *Fifthly*, as job creation in the US and Europe is expected to remain slow and sustain unemployment at unacceptably high levels, this can breed protectionist sentiments, casting shadows over the global trading environment. *Sixthly*, whether the geopolitical risks around the Middle East and lately around the Korean peninsula would weigh on regional and global economic developments also needs to be watched over. At this juncture, risks to the global economic outlook for 2012 are decidedly tilted towards the downside. Nevertheless, should Europe's policy leaders step up their efforts further and come up with a comprehensive and credible package to address solvency and liquidity concerns, thereby stemming the sovereign debt crisis, the downbeat global economic sentiment right now should hopefully brighten up somewhat during 2012. There could also be some upside potential if the Mainland and other Asian economies could hold up better than expected in 2012, thereby rendering a more significant driving force to buffer the global economy against the expected lull in the advanced economies.

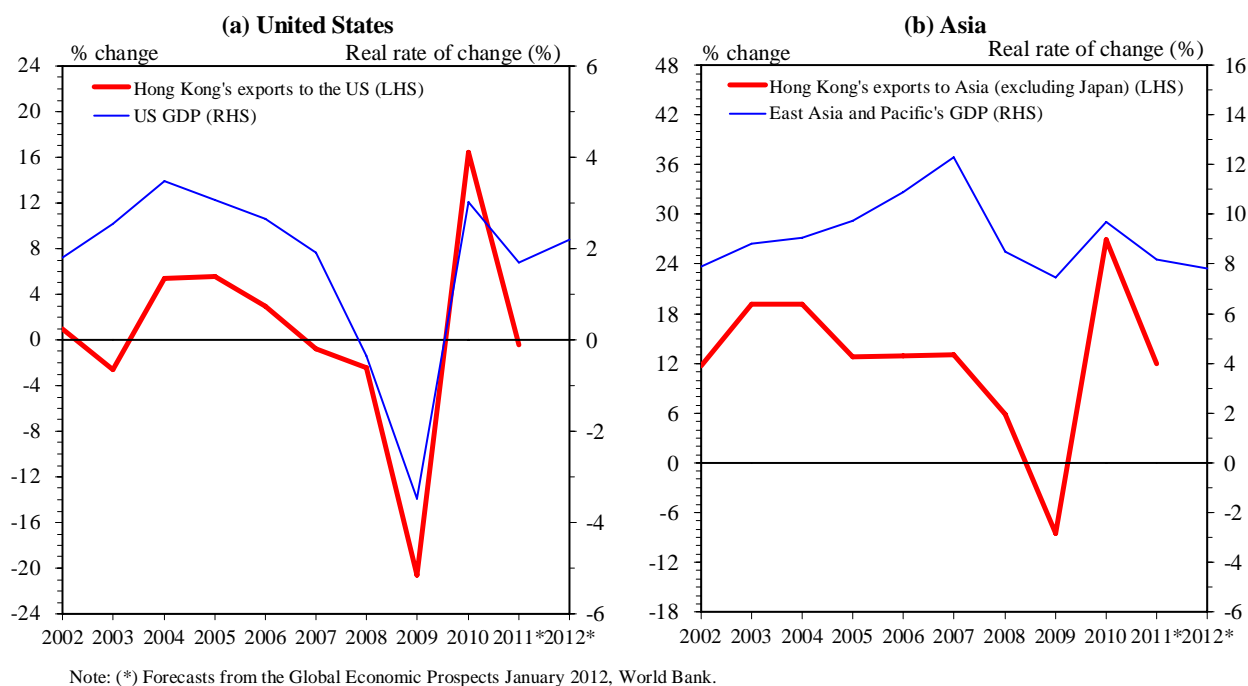
### **Outlook for the Hong Kong economy in 2012**

2.22 Given the highly externally-oriented nature of the Hong Kong economy, its performance is closely tied to the demand conditions of its major economic partners. The external environment has deteriorated visibly over the course of 2011, with the eurozone sovereign debt crisis emerging as an imminent source of threat to the global economy and with the recovery in the US remaining unsteady. In face of increasing headwinds on the external front, the outlook for Hong Kong's *exports of goods* in 2012 is bleak. To what extent merchandise trade will be undermined hinges crucially on how the euro debt crisis will evolve and spill over to other economies, notably the US, for which Europe is a major trading partner. In any case, even if the debt crisis can be contained without unravelling in a disorderly fashion, the austerity measures required in the debt-stricken countries will pose a heavy drag on demand from Europe to the detriment of Asian exports, including Hong Kong's. Yet many Asian economies have relatively more room for policy manoeuvre, and granting that a full-blown euro debt crisis does not materialise, the Asian markets should provide some cushion to Hong Kong's external sector especially in the latter part of 2012.

**Diagram 2.6 : The outlook for Hong Kong's exports of goods in 2012 is bleak**



**Diagram 2.7 : Exports to the Asian markets should provide some cushion to the expected weakness in the advanced markets**



2.23 The performance of *exports of services* has been more resilient, underscoring the strong competitiveness of Hong Kong's services sector on the back of deepening integration with the Mainland. As such, exports of services should be less vulnerable to weaker external demand in 2012. In particular, inbound tourism is expected to stay vibrant, in view of the prevailing strong influx of visitors from the Mainland. Exports of financial and business services, despite the envisaged continuation of financial market volatilities, should still

be able to benefit from the further development of renminbi business in Hong Kong and cross-border commercial activity. However, offshore trade and exports of transportation services will likely show weaker performance in tandem with the expected slowdown in global and regional trade flows.

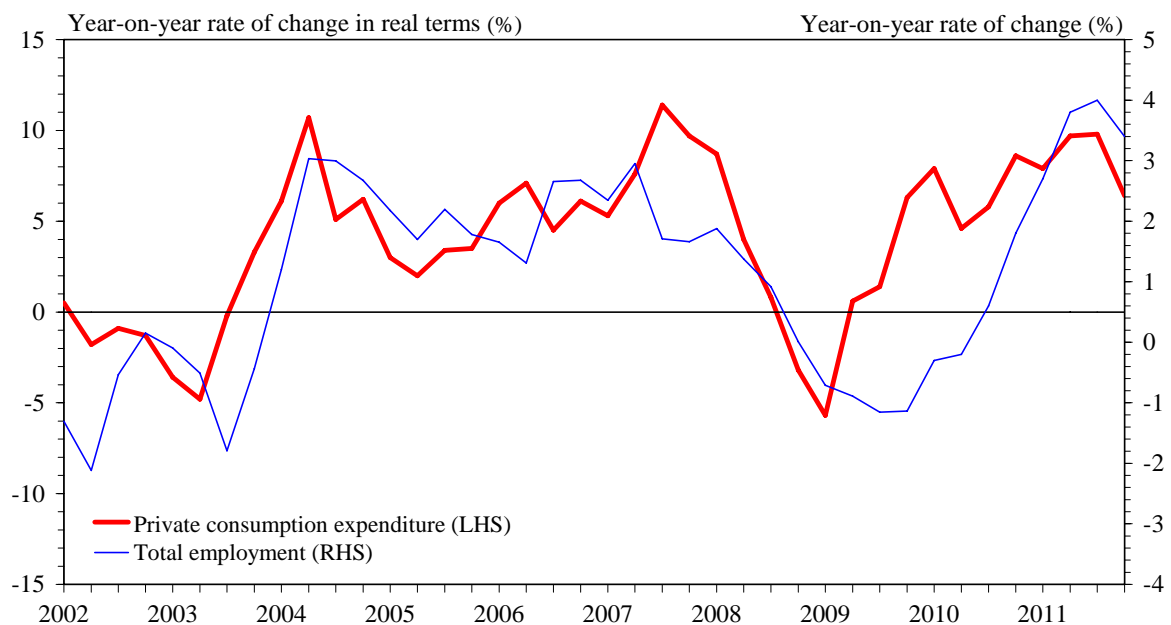
**Diagram 2.8 : The Mainland factor will continue to be a key supportive factor for the Hong Kong economy**



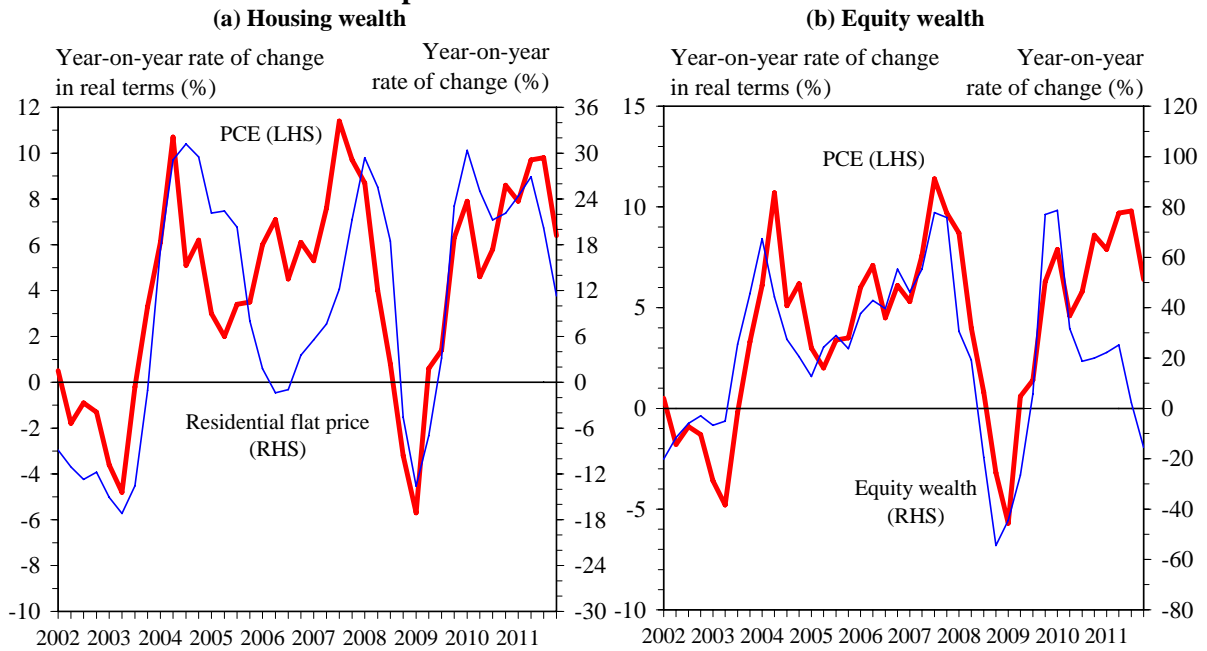
2.24 *Domestic demand* held up remarkably well throughout 2011 and served as a key growth driver. In the light of the notable employment and income growth over the past year or so, local consumption spending will likely hold up relatively better and provide some buffer to the expected weakness in

the external sector. That said, the level of resilience displayed by consumption spending will also hinge on the local labour market situation down the road now that employers' hiring sentiment has turned more cautious of late, and also on the performance of the local asset markets amid the strong headwinds in the external environment. As for investment, machinery and equipment acquisition, being more susceptible to the business cycle, is expected to slacken in the near term. Indeed, the results of the latest Quarterly Business Tendency Survey conducted by the Census and Statistics Department indicated that many of the large companies surveyed have turned more pessimistic about their near-term business outlook. Nevertheless, the building and construction component should continue to be underpinned by the intensive public sector infrastructure works, thereby rendering an additional cushion to the domestic economy.

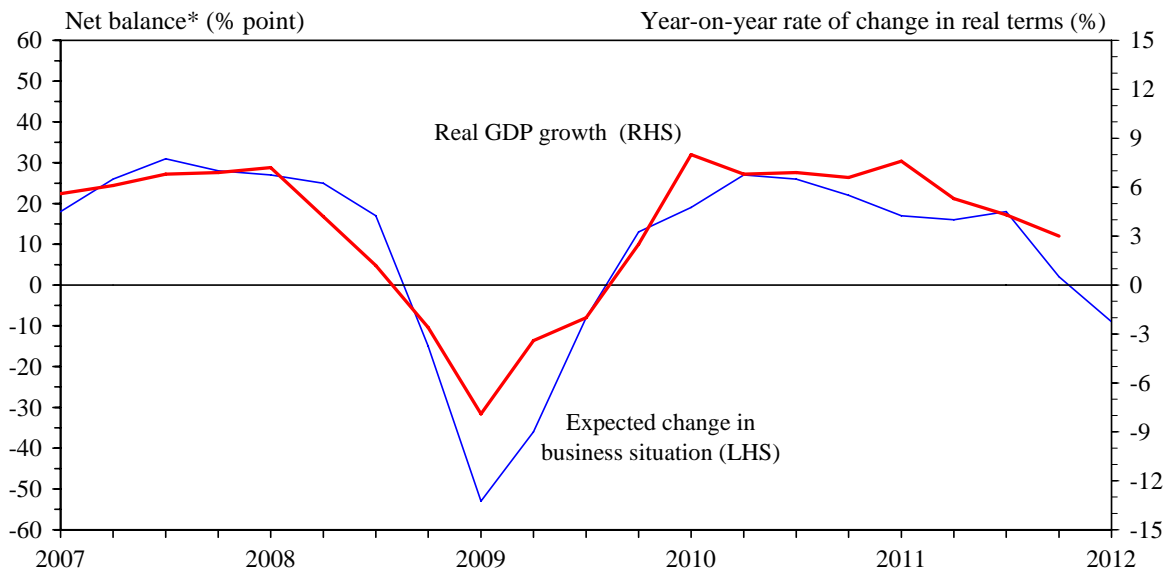
**Diagram 2.9 : Private consumption should hold up relatively better, thanks to the notable employment growth over the past year or so**



**Diagram 2.10 : Yet consumer sentiments will also hinge on the performance of the asset markets**

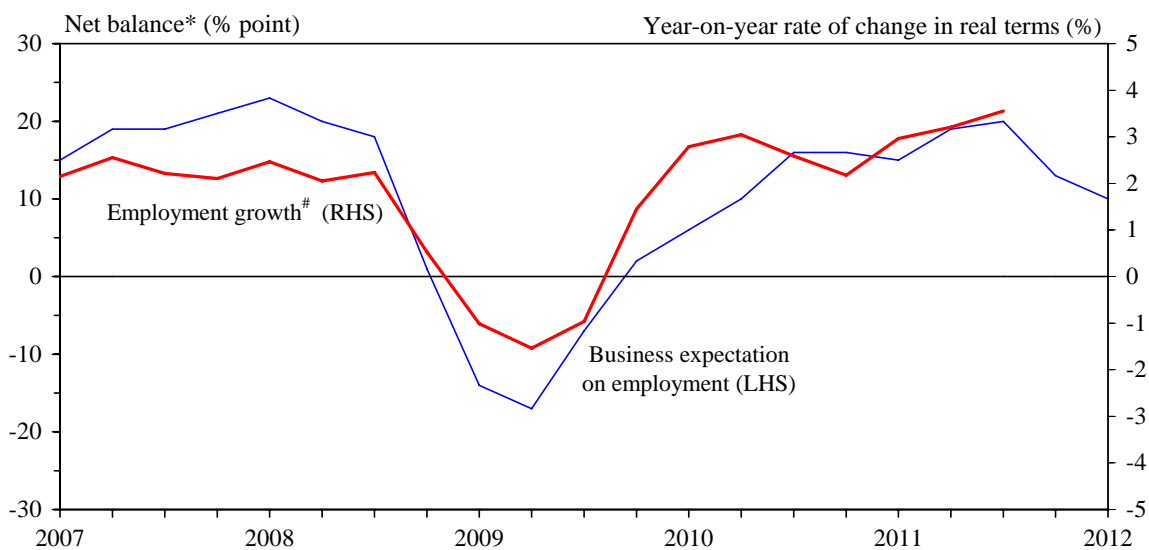


**Diagram 2.11 : Business sentiment has turned more pessimistic of late**



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 proportion of establishments choosing "better" over that choosing "worse". A positive sign indicates a likely upward trend while a negative sign, a likely downward trend.

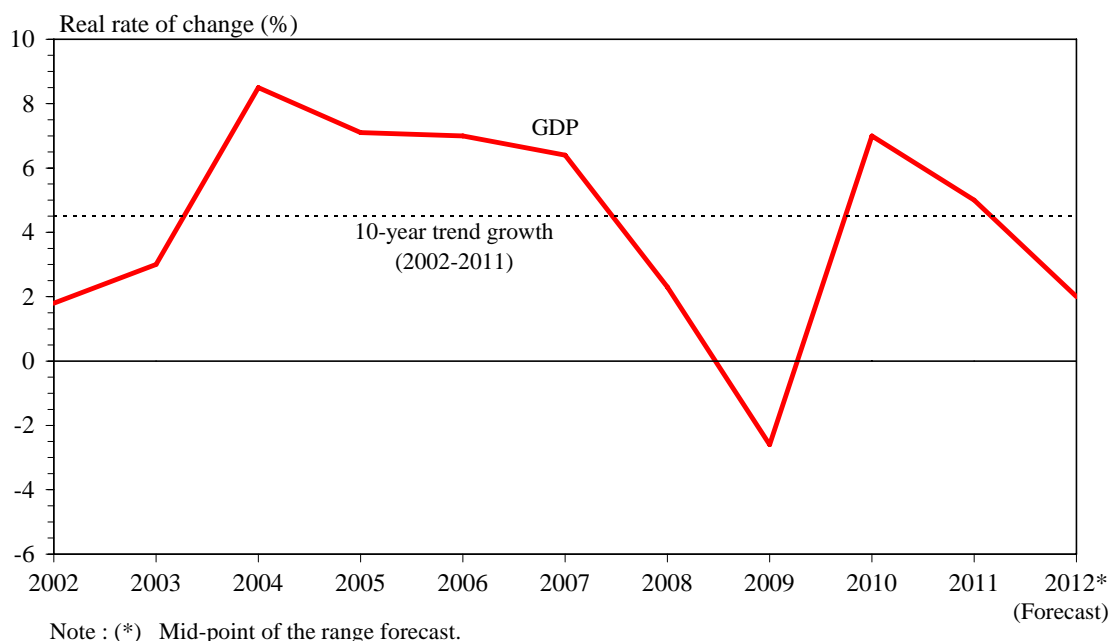
**Diagram 2.12 : Businesses are also more cautious towards hiring**



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.

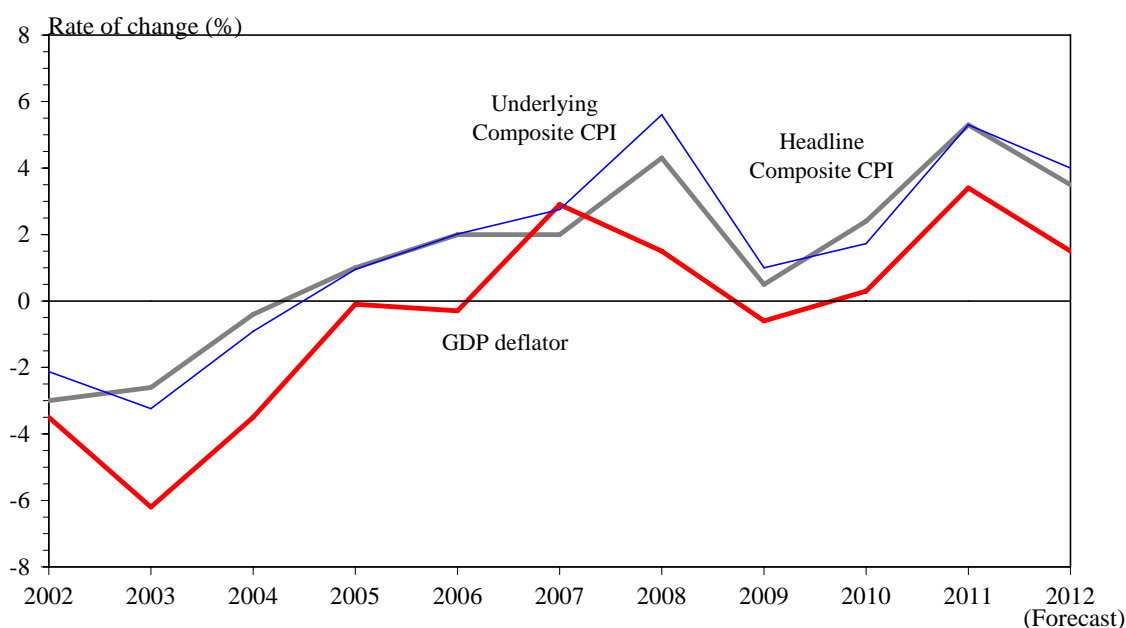
2.25 Taking all these developments together, and barring the adverse development of the euro debt problem into a full-blown crisis, the Hong Kong economy is projected to show a more muted growth of 1-3% in 2012. This will be lower than the average growth of 4.5% in the past ten years and the prevailing forecasts by private sector analysts, which mostly fall within the range of 1.5% to 3.5%. The wider than usual range of growth forecast signifies the unusually high degree of uncertainty facing the economy, mainly stemming from the fluidity of the eurozone debt situation and the ongoing fiscal consolidation in the advanced economies, as detailed in paragraph 2.21. The balance of forces will hinge on how well domestic demand and services exports, as well as the Asian markets, can hold up and to what extent they will offset the severe drag from goods exports due to the dire situations in the advanced economies.

**Diagram 2.13 : Economy expected to show only muted growth in 2012**



2.26 Inflation in Hong Kong has largely stabilised towards the end of 2011. Judging from the current trend, underlying inflation should come down over the course of 2012. On the external front, upward pressures on global commodity prices have largely abated given the subdued growth outlook in 2012. Global food prices, in particular, have broadly stabilised recently. Domestically, private housing rentals, after surging notably during 2010 and in the first half of 2011, have shown signs of tapering off of late alongside the consolidation in the local property market, although this favourable development would take time to show up in consumer price inflation. Furthermore, with the local economy poising for sub-par growth, wage cost pressures should also turn less notable. Overall, the *underlying Composite CPI* is forecast to increase by 4.0% for 2012 as a whole. Taking into account the effects of the Government's relevant one-off measures, the *headline Composite CPI* is forecast to increase by 3.5%. The *GDP deflator* is forecast to rise by 1.5%, largely on account of the slower increase of domestic prices as well as the expected change in the terms of trade.

**Diagram 2.14 : Inflation is expected to ease off in 2012,  
with both external and domestic price pressures subsiding**



**Forecast rate of change in 2012 (%)**

**Gross Domestic Product (GDP)**

<i>Real GDP</i>	<b>1 to 3</b>
<i>Nominal GDP</i>	<b>2.5 to 4.5</b>
<i>Per capita GDP, in real terms</i>	<b>0.1 to 2.1</b>
<i>Per capita GDP at current market prices</i>	<b>HK\$270,400-275,700 (US\$34,700-35,300)</b>

**Composite Consumer Price Index**

<i>Headline</i>	<b>3.5</b>
<i>Underlying</i>	<b>4.0</b>

<b>GDP Deflator</b>	<b>1.5</b>
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**Forecast on Hong Kong's GDP growth in 2012  
recently made by other selected parties**

	(%)
The University of Hong Kong	2 to 3
Average forecast by private sector analysts <sup>#</sup>	3.3

Note: (#) Forecast GDP growth by private sector analysts mostly falls between 1.5% and 3.5%.

## **Medium-term outlook for the Hong Kong economy**

2.27 The global economy will likely continue to face a higher degree of uncertainty over the medium term, given that the sovereign debt problem in the eurozone and the fiscal issues in the US are of structural nature, which will take time to be fully resolved. Notwithstanding this, the medium-term prospects for the Hong Kong economy should remain bright and promising. The Asian region, in particular the Mainland, should continue to be the key driver of global economic growth given its sounder fundamentals and huge development potentials. Hong Kong, with its advantageous location at the doorstep of the Mainland and strategic positioning as an international financial centre and regional business, trade and tourist hub, is poised to leverage on the growing economic prowess of the region while continuing to shift towards a knowledge-based, high value-added economy.

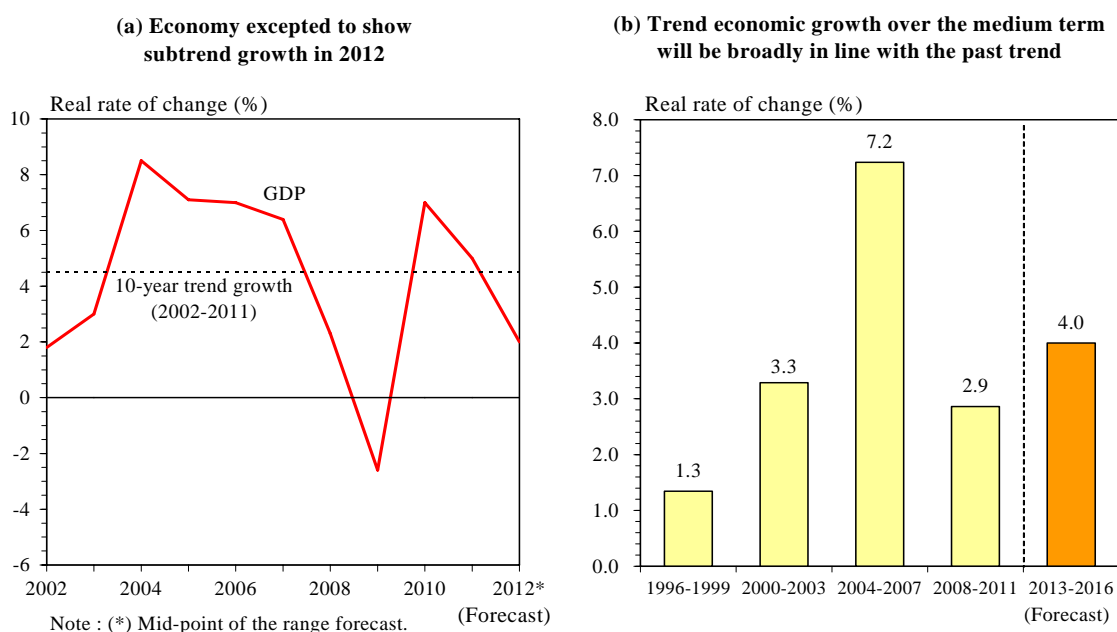
2.28 Specifically, Hong Kong will continue to deepen its integration with the hinterland through the CEPA and Pan-Pearl River Delta region platforms. With its long-established competitive advantage in financial and other services, Hong Kong will contribute to the nation's development in these areas while continuously propelling itself to move up the value chain. This is also a national strategy laid down in the National 12<sup>th</sup> Five-Year Plan. The process will open up vast opportunities for our professional services. In addition, Hong Kong will continue to broaden the local renminbi market and develop the asset management business in its strife to become a premier offshore RMB business centre, where it enjoys a first-mover advantage. Furthermore, the Government will also foster economic ties with new and emerging markets, and explore new growth areas such as the six industries where Hong Kong enjoys clear competitive advantage, in addition to the traditional four pillar industries in driving longer-term sustainable growth.

2.29 On the supply side, the Government will continue to upgrade our human capital and invest heavily on infrastructure to expand the production capacity and enhance efficiency. The productivity growth achieved in the process will help the economy attain a 4% growth per annum from 2013 to 2016, broadly in line with its past trend.

2.30 Inflationary pressures should come down gradually in the near term, but the upside risks to inflation over the medium term should not be underestimated at this juncture. Externally, upward pressures on global commodity prices should ease somewhat amid the expected demand slack in the advanced economies in the coming year or so. However, food and energy

prices may be subject to bouts of supply shocks, and the uncertain direction of the US dollar exchange rate and still-abundant global liquidity may also add further volatility to the global commodity price movements. Domestically, the continued productivity gain should provide some offset to local cost pressures. Taking into account the above factors, 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 remain bright over the medium term**



2.31 The Government is mindful of the various challenges facing the global and local economy over the medium term. Globally, the fragile fundamentals of the advanced economies will continue to overshadow the growth prospects. The fiscal vulnerabilities of the advanced economies are rooted in structural problems that will take years to heal and meanwhile will undermine the real economy and increase financial market volatility. The economic drag and political discontent can also lead to increased protectionist sentiments on the trade and exchange rate fronts. How well the Asia region can withstand the drag with its relatively sound fundamentals will be crucial to the medium-term global economic outlook. Besides, the threat of inflationary pressures may still lurk in the background given the envisaged continuation of ultra-loose monetary stance in the advanced economies for some time. Locally, the structural shift of the Hong Kong economy to high value-added and knowledge-based activities could lead to wider income and wealth gaps, and would call for greater training and re-training needs of Hong Kong's workforce. Also, the ageing population will have profound implications on our public finance management over the medium to longer run, especially on the health care and social welfare fronts. In view of these medium-term issues and long-term development needs, it is therefore important for the Government to exercise prudence in deliberating its fiscal policy.