CHAPTER 2 : ECONOMIC OUTLOOK FOR 2013 AND THE MEDIUM TERM

Summary

- *The global economy has stabilised and financial conditions have improved since the latter part of 2012, but the global economic outlook remains challenging. The major advanced economies as a whole, being constrained by structural problems, are likely to stay on a slow-growing path in 2013. While market concerns about the euro debt crisis have abated somewhat, the eurozone has yet to emerge from recession and further strong policy actions will be required to lower the crisis risks. The fragile fiscal position of the US will continue to weigh on its pace of recovery, and political disputes over the fiscal issues may also affect market sentiments. Nevertheless, Asian and emerging economies, especially the Mainland, with their sounder fundamentals and increased efforts to shore up domestic demand, are expected to see faster growth in 2013, though their external sectors would remain susceptible to the vicissitudes of the advanced economies.*

- *With the Mainland economy regaining faster momentum and the imminent risks of a full-blown crisis in the advanced economies somewhat receded, Hong Kong's merchandise trade is poised to see a relative improvement in 2013, though the chance of a sharp rebound still seems rather remote as global economic growth should still be sub-par. Exports of services should likewise see better growth in 2013, thanks to vibrant inbound tourism and the likely recovery in financial and commercial as well as transportation and trade-related service activities.*

- *Locally, private consumption should continue to be underpinned by solid job and income growth, aided further by the positive wealth effect from the bounce-back in the stock market, granting no abrupt relapse in the external environment. As for investment, while machinery and equipment acquisition tends to be volatile, building and construction should continue to benefit from the hectic public infrastructure works and an expected further notable growth in private building activity.*

- *Taking together the relatively sanguine domestic demand and the envisaged improvement on the trade front, and barring any abrupt external shocks, the Hong Kong economy is forecast to grow by 1.5-3.5% in 2013. This, if realised, would represent a pick-up from the 1.4% growth in 2012, though still below the average trend growth of 4.5% over the past ten years.*

- *Inflationary pressures should remain contained in the early part of 2013 amid the still slow economic growth and moderate increases in import prices. However, inflation is subject to upside risks, especially those arising from the possible volatility in global food and commodity prices fuelled by the liquidity glut and the feed-through of higher rentals during 2012. Underlying consumer price inflation is forecast at 4.2% in 2013, as compared to 4.7% in 2012.*

- *The medium term prospects for the Hong Kong economy remain positive. Riding on the economic strength of the region, Hong Kong will continue to deepen its economic integration with the Mainland while striving to maintain and enhance its competitive edge as a knowledge-based, high value-added economy. In addition to consolidating our strength in the traditional pillar industries, new growth areas will be identified and new markets explored, so as to diversify and broaden our economic base. The continued investment in human capital and infrastructure should bolster productivity and ensure sustainable development in the longer run. The trend GDP growth rate in real terms is forecast at 4% per annum from 2014 to 2017, and the trend rate of underlying consumer price inflation at 3.5% per annum.*

Major external factors

2.1 The performance of the Hong Kong economy, being small and open, has been, and will continue to be susceptible to the changing external economic conditions. The downside risks to the global economy, while diminishing, remain significant in 2013. Of particular note is the euro debt crisis. Although the financial strains arising from the crisis have mitigated somewhat since the latter part of last year, further decisive policy actions over the course of 2013 will be required to lower the crisis risks further.

2.2 Equally important to our economic performance in 2013 is the economic health of Hong Kong's trading partners. The eurozone and Japan have yet to emerge from recession, while the debt and fiscal issues would still weigh on the recovery in the US. As such, the fragility of the major advanced economies will continue to put a drag on the global economy. In contrast, the Mainland economy, Hong Kong's largest trading partner, has regained momentum in the latter part of 2012, and will remain the key propeller of global economic growth this year. With sounder fundamentals and increased efforts to support domestic demand, other emerging economies should also see some improvement in 2013.

2.3 The developments on the global monetary front will also have a strong bearing on the Hong Kong economy. Global financial conditions have improved, as evidenced by the lowering of borrowing costs facing the eurozone peripheral economies and the rallies across major stock markets, following the announcement of the Outright Monetary Transactions (OMTs) programme by the European Central Bank (ECB) and the launch of a new round of quantitative easing (QE3) by the US Federal Reserve in September 2012. However, the aggressive quantitative easing measures conducted by the advanced economies would intensify the global liquidity glut and add to financial, currency and commodity market gyrations, which may undermine the macroeconomic stability worldwide. Specifically of direct relevance to Hong Kong and Asian economies will be the increased likelihood of substantial capital inflows, as well as higher inflation and asset market bubble risks.

2.4 Apart from the economic factors, the heightening of geopolitical tensions in many parts of the world as well as the rise of protectionist sentiments may also affect Hong Kong's external environment. The following provides a more detailed analysis of the major external factors.

Eurozone sovereign debt crisis

2.5 The eurozone sovereign debt crisis has entered its fourth year. It started with the fiscal problems of certain peripheral economies, and spilt over to the larger eurozone members to the extent of stressing the banking systems and undermining confidence in the region's fiscal sustainability and even the viability of the euro. The crisis represented the largest downside risk to the global economy and financial market stability in the past year and will remain so in 2013. In mid-2012, political uncertainties in Greece and the heightened risks of contagion to Italy and Spain, the third and fourth largest eurozone economies, had triggered bouts of financial market gyrations worldwide and severely hampered the already-fragile economic confidence in Europe. This, coupled with the vigorous ongoing austerity measures, sent the unemployment rate to successive record highs and tipped the region into recession. Although the ECB promptly announced the Outright Monetary Transactions (OMTs) programme in September 2012, which helped mitigate the financial strains, the fluidity of the crisis continued to overshadow the region's economic prospects.

2.6 Trapped in this difficult condition of unsustainably large sovereign debt, fragile banking sector and moribund economic activities, Europe's policy leaders worked out a series of policy actions with a view to regaining market confidence in the single currency bloc (for details, see ***Box 2.1***). Apart from the second bailout programme and other financial aids for Greece, visible progress was made in narrowing the budget deficits of other debt-ridden peripheral economies and a loan of up to €100 billion was approved to help re-capitalise Spain's banking sector. More importantly, the European Stability Mechanism with an expanded capacity of €700 billion was formally launched, which could re-capitalise eurozone banks directly without putting additional debt burden on the sovereigns once a single eurozone banking supervisory authority is in place, thus helping to break the negative feedback loop between the sovereigns and the banks. In the June 2012 summit the European Council also agreed to mobilise €120 billion to boost the region's growth.

2.7 Although the eurozone sovereign debt crisis had mitigated somewhat in the more recent period, the road to a genuine Economic and Monetary Union (EMU) and a full-fledged economic recovery is bound to be long and bumpy. Despite the recent stabilisation, the crisis remains far from resolved. Strong policy actions will be required from the European authorities. Apart from the imminent task of setting up the single banking supervisor in the eurozone, further efforts need to be geared towards further fiscal and economic integration and restoring growth and competitiveness. Also, a number of issues that could potentially destabilise the situation, particularly in the absence of economic growth, also warrant due attention in 2013. These include the possible social resistance stemming from the deep recessions in Greece and Spain, the progress of fiscal consolidation in highly-indebted members, and the elections in Italy in February and in Germany in September.

2.8 Being the world's largest economic bloc and a major trading partner of Hong Kong, Europe's torpid economic performance had already dealt a visible blow to Hong Kong's external sector last year, both directly and indirectly through its negative impacts on other Asian economies. As the sovereign debt crisis was embedded in deeply-rooted structural problems, it will take time to resolve, likely with some jitteriness along the way. As such, the eurozone economy should stay sluggish in 2013, with the debt crisis continuing to be a key source of risks to global financial stability, thereby adversely affecting Hong Kong through the trade and financial channels. As far as the financial channel is concerned, the direct exposure of Hong Kong's banks to PIIGS debts (including Portugal, Ireland, Italy, Greece, and Spain) is very limited and so gyrations in European sovereign debt markets have not undermined Hong Kong's financial stability in any significant way. Nonetheless, should the crisis escalate further, the possible spillovers to Hong Kong banks warrant due vigilance in face of the highly integrated global banking systems.

Box 2.1

Summary of recent major events pertinent to the euro debt crisis (an update)*

2012

7 Aug	S&P downgraded Greece's outlook from stable to negative, with credit rating unchanged at CCC
31 Aug	Spanish government announced to create an asset management company to help clean up its troubled banking sector, grant its central bank more power to intervene in troubled banks, and toughen rules on complex financial products
3 Sep	Moody's kept the European Union's (EU) provisional AAA rating, but lowered its outlook from stable to negative. In Spain, the Fund for Orderly Bank Restructuring injected €4.5 billion into ailing lender Bankia
6 Sep	The European Central Bank (ECB) decided to launch the Outright Monetary Transactions (OMTs) programme and to implement measures to preserve collateral availability
11 Sep	The troika agreed to relax Portugal's budget deficit targets for 2012, 2013 and 2014 from 4.5%, 3% and 2.3% to 5%, 4.5% and 2.5% respectively
12 Sep	The European Commission (EC) proposed a single euro area banking supervisor for which the ECB will be granted power to monitor eurozone banks. The German Constitutional Court found that injunctions against the European Stability Mechanism (ESM) and fiscal compact were unfounded, but further liability increases will require parliament's approval
25 Sep	The finance ministers of Germany, the Netherlands and Finland said direct bank recapitalisation by the ESM should not apply to legacy assets, such that Ireland and Spain may not be able to shift their current bank bailout costs to the ESM
27 Sep	Spain unveiled a package of regulatory overhauls, tax increases and spending cuts amounting to €13 billion in its 2013 budget, targeted to lower its budget deficit to 6.3% of GDP in 2012, 4.5% in 2013 and 2.8% in 2014. France unveiled an austerity budget saving of €30 billion for 2013, aimed at narrowing the deficit to 3% of GDP from 4.5% in 2012
28 Sep	Spain's banking sector audit showed a less-than-estimated capital shortfall of €53.75 billion, which will be the basis for the €100 billion bailout from the EU. The bank aid will inflate the 2012 budget deficit from 6.3% of GDP to 7.4%
1 Oct	Greece's budget for 2013 projected the general government deficit to decline to 4.2% from 6.6% of GDP in 2012, while GDP will shrink for a sixth year
8 Oct	The ESM was launched with a fresh lending capacity of €500 billion, and Moody's assigned it an Aaa credit rating with a negative outlook
9 Oct	11 eurozone countries agreed to levy taxes on bonds, shares and derivatives trading
10 Oct	S&P cut Spain's credit rating from BBB+ to BBB-, outlook negative. Italy announced a tax cut for low-income earners and a smaller increase in value-added tax
15 Oct	Portugal unveiled a budget proposal for 2013 that includes a spending cut of €1 billion and tax hikes of €4.3 billion
18 Oct	The European Council agreed to adopt a legal framework for a single banking supervisor by 1 January 2013, but it will not be operational until later in 2013
31 Oct	Portugal's government won parliamentary approval for the 2013 budget
1 Nov	Spain extended a short-selling ban on stocks for another three months
6 Nov	The French government announced a tax rebate to improve competitiveness
7 Nov	The Greek parliament approved a €13.5 billion austerity package
11 Nov	The Greek parliament further approved the 2013 budget

Box 2.1 (Cont'd)

12 Nov	Fitch affirmed Portugal's credit rating at BB+, outlook negative
14 Nov	Fitch affirmed Ireland's credit rating at BBB+, and raised its outlook to stable
19 Nov	Moody's downgraded France's credit rating from Aaa to Aa1 and the outlook remained negative, given the weakness of its economy
23 Nov	EU leaders ended a two-day summit without a deal on the Multiannual Financial Framework (MFF) for the period 2014-2020
25 Nov	Four separatist parties in Spain's Catalonia won a majority in regional elections
26 Nov	The Eurogroup agreed to launch procedures for the next aid tranche to Greece, and will take initiatives, including reduction of interest rates, extension of maturities and return of Securities Market Programme profits to Greece, to bring Greece's debt ratio back to a sustainable level
28 Nov	The EC approved restructuring plans of four Spanish banks, clearing the way for them to receive aid from the ESM
30 Nov	Moody's downgraded both the EFSF and ESM's credit rating by one notch to Aa1 and maintained a negative outlook
3 Dec	Spain requested the disbursement of €39.5 billion of European funds to recapitalise its banking sector. Greece launched a €10 billion offer to retire roughly half of the debt the country owes to private creditors, paving the way for the release of the next aid tranche from its European partners
5 Dec	S&P downgraded Greece's credit rating from CCC to selective default
11 Dec	Investors offered to sell back to Greece €31.9 billion of their holdings of sovereign bonds, better than its target to unlock its next tranche of aid
13 Dec	EU finance ministers agreed on a single supervisory mechanism for banks. The ECB is expected to assume the supervisory role on 1 March 2014 at the earliest. The Eurogroup formally approved the disbursement of €49.1 billion in several tranches under the second adjustment programme for Greece
18 Dec	S&P raised Greece's rating from selective default to B- with a stable outlook
19 Dec	The ECB will again accept Greek government bonds as collateral for loans to banks. Spain's Catalonia region agreed to form a new government and hold a referendum on independence in 2014
21 Dec	Italian Prime Minister Monti resigned after the parliament passed 2013 budget
28 Dec	France's Constitutional Council rejected a top 75% income tax rate to be introduced in 2013, but the government could redraft the proposal to address their concerns

<u>2013</u>

1 Jan	Fiscal compact entered into force after ratification by 12 eurozone members
2 Jan	Portugal's government sent the 2013 budget to Constitutional Court for review
6 Jan	The Basel Committee agreed to relax the full implementation of its liquidity rule until 2019
11 Jan	S&P affirmed Ireland's BBB+ credit rating and negative outlook. French unions and employers' organisations reached an agreement to enhance labour market flexibility, pending parliamentary approval
16 Jan	European parliament passed a law that tightens restrictions on credit rating agencies and increases their potential liabilities
18 Jan	An IMF report estimated Greece might face a funding gap of €5.5 to €9.5 billion during 2015 to 2016 and require further assistance from its European partners
22 Jan	The Ecofin adopted a decision authorising 11 member states to proceed with the introduction of financial transaction tax through enhanced cooperation

Box 2.1 (Cont'd)

23 Jan	Portugal successfully sold €2.5 billion five-year bond as a first step to regain access to long-term debt markets
25 Jan	ECB announced that 278 banks will repay €137.2 billion on 30 January, the first opportunity for early repayment of first three-year LTRO, indicating somewhat stabilising conditions in the European financial system
1 Feb	The Netherlands nationalised the fourth largest bank, SNS Reaal at a cost of €3.7 billion
5 Feb	Fitch affirmed its AAA rating of the Netherlands, but changed the outlook from stable to negative
8 Feb	The EU leaders agreed on the next Multiannual Financial Framework (MFF) for 2014 to 2020
11 Feb	The Eurogroup discussed direct recapitalisation of banks by ESM, delayed a decision on a bailout programme for Cyprus and noted the Greek programme was on track

Note : (*) Please see ***Box 2.1*** of the ***Half-yearly Economic Report 2012*** for earlier developments.

At the European Council Summit in June 2012, an integrated framework was set out for four broad building blocks for future eurozone integration: (1) the financial sector, (2) fiscal matters, (3) economic policy, and (4) democratic legitimacy. In the December Summit, progress was made on the timeline for a single banking supervisor, but other aspects such as a single resolution authority, a deposit guarantee scheme and a single rulebook will need to be worked out. Working towards a banking union is only a first step towards the smooth running of the EMU, and the process towards fuller integration is bound to be lengthy. Separately, while the Eurogroup has agreed on initiatives to help Greece bring its debt back to a more sustainable level, further assistance cannot be ruled out to ensure its debt-to-GDP ratio to reach 175% in 2016 and 124% in 2020. At this moment, the euro debt situation is still fluid as EU leaders plough through their differences in rectifying the structural issues, thereby continuing to pose uncertainty to the global economic outlook.

Global economic outlook

2.9 The US, accounting for over one-fifth of the world's output, is still a key player in the global economy. Economic growth was subdued in 2012, as the deleveraging process weighed on household demand and as the government debt and fiscal issues hurt investor confidence. These unfavourable factors may continue to trouble the US economy in 2013. Although the US had partially averted the "fiscal cliff", the higher tax rates reinstated may drag on private consumption demand, which was a major source of growth last year. Furthermore, at the time of writing this report in mid-February, the issue of raising the federal debt ceiling was only temporarily postponed to mid-May while the political gridlock on implementing the automatic spending cuts has yet to be resolved. Satisfactory resolution of these issues would avoid the risks of excessive near-term fiscal consolidation and lay out a credible medium-to-longer-term plan to bring down the debt-to-GDP ratio to a sustainable level, thereby helping boost confidence and remove the uncertainty over the fiscal and economic outlook. Failing that, the downside risks to economic growth would increase significantly. Nevertheless, the gradual recovering of the labour market and housing market since the latter part of last year, if continued, would also help repair the household balance sheets and hence support private demand growth. The latest round of monetary easing by the Federal Reserve, keeping interest rates at super-low levels, should also be conducive to economic growth, though the effects might be rather marginal.

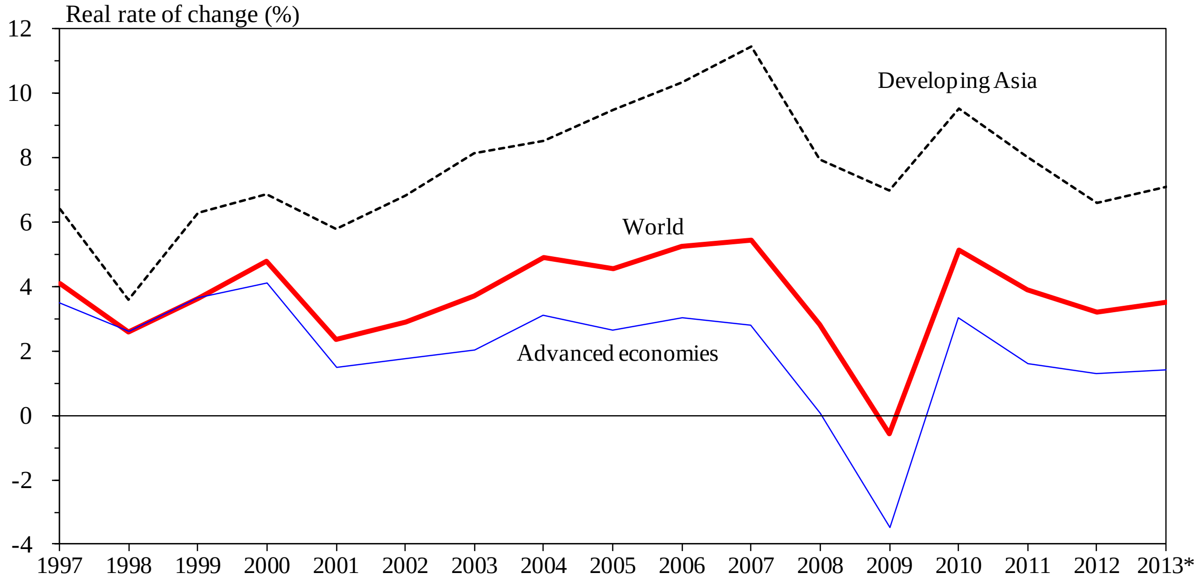
2.10 Economic prospects of Europe are dim. Against the background of the unresolved debt crisis, on-going austerity programmes, damaged banking sector and record high unemployment, the eurozone economy is likely to see stagnation, if not recession, in 2013. In the absence of growth, fiscal and economic reforms, which are needed to boost competitiveness in the peripheral economies and enhance the integration of the eurozone, would meet with greater social resistance and political uncertainty, and therefore would become even more difficult to be carried through. Thus 2013 is another challenging year for the European leaders, who must strike a balance between consolidating fiscal positions to regain market confidence and resuscitating growth to bring down unemployment.

2.11 The Japanese economy slipped into recession in the latter half of 2012 and would face a challenging year in 2013 as the boost from reconstruction works continue to fade. While fiscal austerity would envelop most advanced economies this year, Japan is a clear exception despite its very high debt ratio. The new government unveiled a substantial fiscal package to stimulate growth and the Bank of Japan was pressured to expand further its asset purchase programme. Whether these stimulus measures, together with the substantial depreciation of the yen over the recent past, would help revive the economy or damage market confidence in its fiscal sustainability remains to be seen. But in any case economic growth in Japan should still be constrained by its long-standing structural problems, including an ageing population and the declining competitiveness of its enterprises.

2.12 In 2013, the advanced economies as a whole would likely continue their slow-growing trend. In January, the International Monetary Fund (IMF) projected that the advanced economies would grow by 1.4% in 2013, similar to the sub-par 1.3% pace of expansion in 2012.

2.13 In contrast, with sounder economic fundamentals, the emerging economies, particularly the developing Asian economies, should see some improvement in 2013. The sluggishness in the advanced economies had hampered global trade flows and hence dented the growth of the export-dependent emerging economies in 2012. In response, many Asian and other emerging economies loosened their policy stance to counter the external headwinds. The gradual feed-through of the supportive measures, alongside the stabilisation of the euro debt crisis that created a more stable trading environment, had already translated into some relative improvement in some emerging economies towards the end of last year. If there is no abrupt deterioration in the demand conditions in the advanced economies, pressures weighing on their external sector should recede further over the course of 2013. Together with their relatively resilient domestic demand and ample policy space, emerging economies should see faster growth in 2013. Specifically on Asian developing economies, in January the IMF projected their economic growth at 7.1% this year, up from 6.6% last year.

Diagram 2.1 : The Asian region is likely to see faster growth in 2013, while the advanced economies will grow only slowly



Source : IMF World Economic Outlook Update, January 2013.
Note : (*) Forecasts from the IMF.

2.14 For the Mainland economy in particular, growth momentum looks set to pick up in 2013 as encouraging signs of re-acceleration already emerged towards the end of 2012. Consumption demand in the Mainland held up very well over the past year despite the slower economy, and should be able to maintain a faster growth in the period ahead, particularly with the Central Government's long-term support on re-engineering the economic structure towards domestic demand. The fast-tracked infrastructure works would also render additional boost to growth. However, the domestic asset market developments and the ensuing upside risks to inflation are areas to watch over, and hence targeted cooling measures and a renewed tightening of monetary policy cannot be ruled out. All in all, save for any unforeseen negative shocks from the advanced economies, the Mainland economy should expand at a stronger pace in 2013 and remain the world's growth engine, thereby benefiting Hong Kong and other Asian peers. In January, the IMF projected the Mainland economy to grow by 8.2% in 2013, up from 7.8% in 2012.

2.15 Taking the advanced and emerging economies together, the global economy should strengthen up somewhat in 2013, though again with most of the growth momentum coming from the emerging economies. The IMF in January projected that world GDP would grow by 3.5% in 2013, up slightly from 3.2% in 2012. Nevertheless, this would still be slower than the average annual growth rate of 3.8% over the past ten years.

Table 2.1 : Growth forecasts for major economies in 2013

	2012* (%)	2013 IMF* (%)	2013 Private sector forecast^ (%)
World (PPP## weighted)	3.2	3.5	-
Advanced economies	1.3	1.4	-
US	2.2#	2.0	1.9
Eurozone	-0.5#	-0.2	-0.2
Japan	1.9#	1.2	1.2
Newly Industrialised Asian Economies@	1.8	3.2	-
Emerging market and developing economies	5.1	5.5	-
Developing Asia	6.6	7.1	-
Mainland China	7.8#	8.2	8.2
India	4.5	5.9	6.3
Middle East and North Africa	5.2	3.4	-

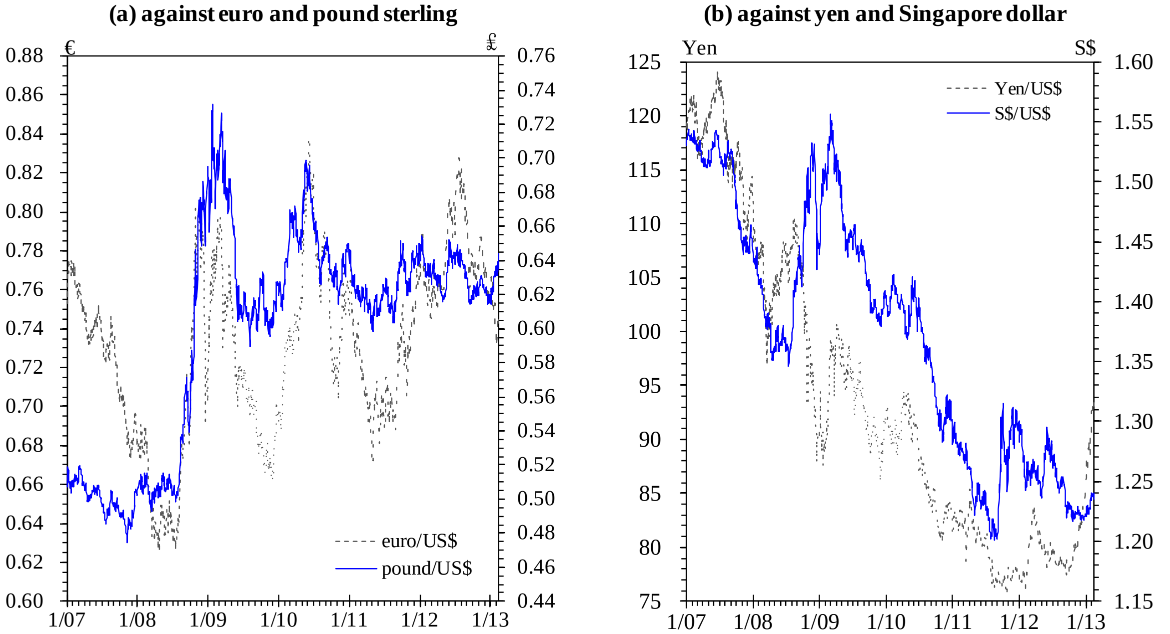
Notes : (*) World Economic Outlook Update, IMF, January 2013.
(^) Average forecast as in February 2013.
(-) Not available.
(#) Actual figures.
(@) Includes Hong Kong, Korea, Taiwan, and Singapore.
(##) PPP refers to purchasing power parity.

Monetary conditions, exchange rates and price competitiveness

2.16 The global monetary conditions would likely remain highly accommodative in 2013. The US Federal Reserve expanded its asset purchase to US$85 billion a month at the start of 2013 and pledged to continue its exceptionally low federal funds rate until the unemployment rate falls below 6.5% in the context of price stability. Monetary policies in most other advanced economies are also widely expected to remain ultra-loose in 2013. This would further exacerbate the global liquidity glut, increasing the risks of financial and exchange rate market volatility. While economies with better growth prospects, including Hong Kong, may face stronger capital inflows under the circumstances, possible risk aversion stemming from such causes as the unsettling euro debt crisis and the US bipartisan political gridlock may lead to another round of capital flights to safety assets and hence reversed fund flows, threatening the macroeconomic and financial stability of these economies. Thus there is a need to stay vigilant to these developments.

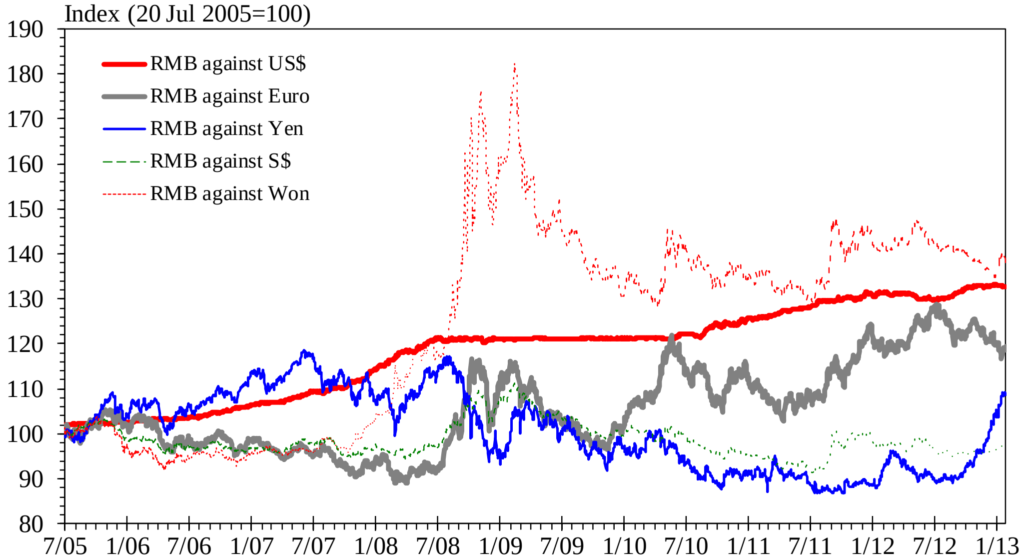
2.17 On the exchange rate front, the movements of the Hong Kong dollar were range-bound during 2012, alongside the US dollar under the linked exchange rate system, against a basket of major currencies. After weakening somewhat at the start of 2012, the Hong Kong dollar strengthened noticeably in tandem with the US dollar in the second quarter amid heightened global risk aversion, and softened again in the remainder of the year as the global economic environment tended to stabilise. The nominal trade-weighted effective exchange rate index of the Hong Kong dollar only fell slightly by 0.9% in December 2012 from a year earlier. The direction of exchange rate movements in 2013, as it has always been, is subject to considerable uncertainty, and especially so in the current environment of aggressive quantitative easing measures by many advanced economies. Yet in any case, as far as Hong Kong is concerned, the exchange rate factor is likely to feature less prominently when compared with the income factor in the major trading partners in determining Hong Kong's export growth prospects under a scenario of relatively weak global trade flows.

Diagram 2.2 : The foreign exchange market is likely to remain highly volatile in 2013



2.18 Given Hong Kong's close economic relations with the Mainland, the movement of the renminbi (RMB) is a key factor affecting the performance of Hong Kong's external sector, including both trade in goods and services. The renminbi depreciated against the US dollar in the first half of 2012, before resuming a strengthening trend in the latter part of the year, and appreciated only mildly against the US dollar by about 1% during 2012. 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 2.3 : 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.

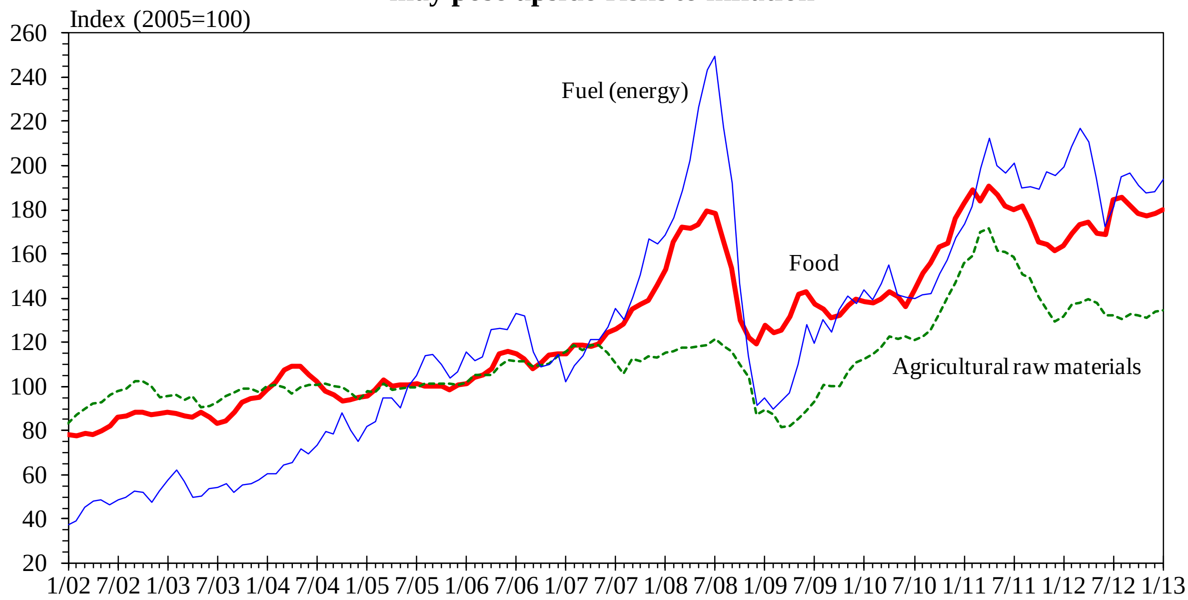
World inflation and global commodity prices

2.19 Inflationary pressures were contained in the advanced economies given their tepid growth, while trending down in many emerging markets since early 2012, alongside the favourable development in global food and commodity prices. However, the early signs of heating up in inflation in Asia towards the end of 2012 warrant due attention. The global liquidity glut may also fuel capital inflows into Asia, given its better economic prospects and solid fundamentals, and in turn add to inflationary pressures and asset market bubble risks in the region. Given the envisaged improvement in growth, Asian economies would gradually give greater emphasis on safeguarding macroeconomic and price stability.

2.20 The movements of international food and commodity prices would add uncertainty to the inflation outlook around the world, particularly in Asia given the relatively large weighting of food in the household consumption baskets. Although the prices of many manufacturing-related commodities, including agricultural raw materials, industrial materials and metals eased back during 2012, food prices only softened modestly for 2012 as a whole after surging visibly in each of the two preceding years, and energy prices held largely flat. According to the Food and Agriculture Organisation (FAO) of the

United Nations, global food prices fell by an average of 7.0% in 2012 after leaping by 18.1% and 22.8% respectively in 2010 and 2011. The potential volatility in food and other commodity prices cannot be taken lightly, particularly in face of the abundant global liquidity. Another key factor would be geopolitical tensions, which had loomed large in many parts of the world over the past year. Of particular note would be the situation in the Middle East, for the possible disruption to global oil supplies and the dampening effect of a surge in oil prices on global economic growth.

Diagram 2.4 : Volatile world commodity prices, especially food and energy, may pose upside risks to inflation



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

Major sources of uncertainty

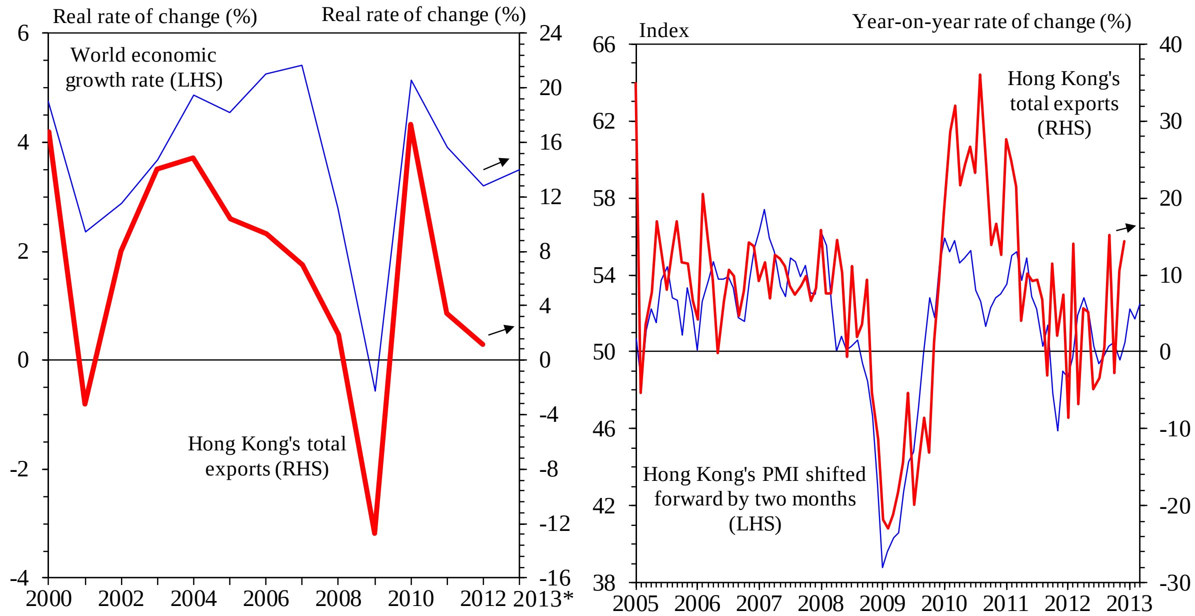
2.21 2013 is expected to be another year full of challenges and uncertainties. *First*, the advanced economies should continue to see low growth, weighed by their debt burdens and structural problems that take time to solve. While this on its own would already pose a drag to global growth and trade flows, any renewed relapse of these economies would undermine economic sentiments to the detriment of the global trading environment. Notwithstanding the relative stabilisation of late, the eurozone sovereign debt crisis remains a notable threat to the global economy, with no clear-cut solution as yet to tackle the root problems of the crisis. Financial market stress arising from the fragility of individual member states may haunt the global financial markets from time to time, and the record high unemployment would also increase political uncertainty. *Second*, lingering uncertainty over the US fiscal situation may also swing market sentiments, and excessive fiscal consolidation in the short run would put a notable drag on economic growth. *Third*, as unemployment in the US and Europe is expected to stay at uncomfortably high levels, this could breed protectionist sentiments and trade conflicts. *Fourth*, the possibility of a "currency war", in the sense of economies engaging in competitive depreciation of their currencies, cannot be ruled out, particularly in view of the aggressive quantitative easing measures among the advanced economies and the recent large depreciation of the yen. *Fifth*, the heightened geopolitical tensions might deter intra-regional trade flows, which would in turn disrupt the highly interconnected regional production chains. *Sixth*, the unstable political environment in the Middle East would pose a threat to oil prices and international cargo flows. At this juncture, downside risks to the global economic outlook for 2013 are still notable. Nevertheless, efforts made by Europe's policy leaders last year had already put some cornerstones in place for stemming the sovereign debt crisis. Should they step up their efforts further and come up with a comprehensive package to address solvency and liquidity concerns as well as to stimulate growth, a key risk to the global economy could be removed. Moreover, if the US Congress can clear the fiscal uncertainties in time and deliver a credible package to restore long-term fiscal sustainability, private demand in the US and also global economic confidence should receive a further boost. There could also be some upside potential if the domestic sector in the Mainland and other Asian economies could strengthen more rapidly than expected, thereby providing stronger growth impetus to the global economy.

Outlook for the Hong Kong economy in 2013

2.22 With the strong headwinds on the external front in mid-2012 by and large subsided towards the latter part of the year, the downside risks should abate somewhat in 2013 when compared with the unusually austere situation in 2012. Indeed, global economic conditions were more sanguine than earlier expected on entering 2013, with improved financial conditions in Europe, sustained revival in the housing market and partial aversion of the fiscal cliff in the US, firmer momentum in the Mainland, and signs of some pick-up in production and export activities in many Asian economies. Hong Kong as a highly externally-oriented economy should benefit from these developments, and barring any abrupt deterioration in the demand conditions of the advanced economies, our *total exports of goods* are poised to see some improvement in 2013.

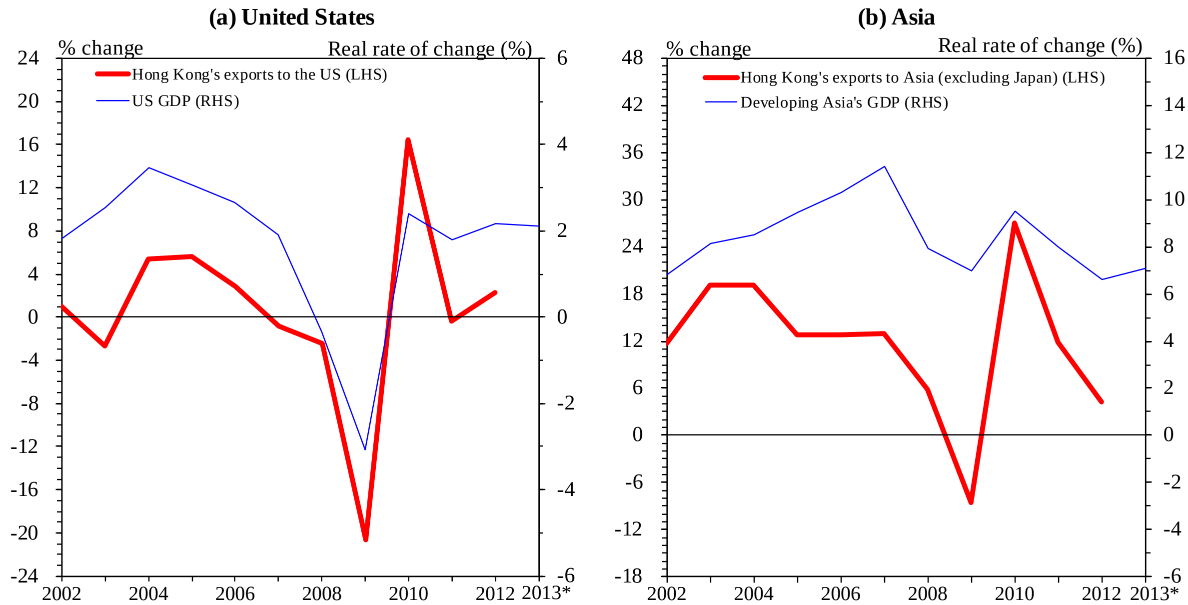
2.23 Nevertheless, the fundamentals of the advanced economies remain weak, with growth still heavily constrained by high unemployment, fiscal uncertainty, and structural problems. On the other hand, the Mainland economy has resumed faster growth and would render a stabilising force to intra-regional trade flows going forward. In sum, the global economy, and hence global trade flows, will likely see another year of modest growth. In view of the still rather fluid external environment, Hong Kong's export performance is not envisaged at this juncture to see a sharp rebound in 2013, and indeed could still see rather uneven performance over the course of the year.

Diagram 2.5 : Hong Kong's exports of goods should see some improvement in 2013



Source : IMF World Economic Outlook Update January 2013.
Note : (*) Forecast from the IMF.

Diagram 2.6 : The Mainland's faster growth momentum should benefit regional trade

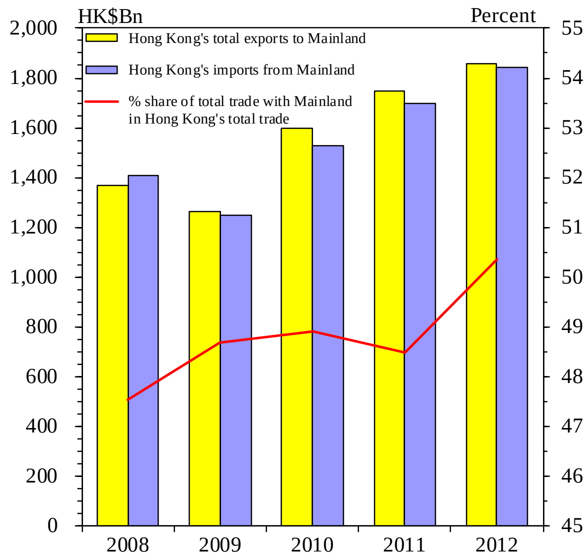


Note : (*) Forecasts from the IMF World Economic Outlook Update, January 2013.

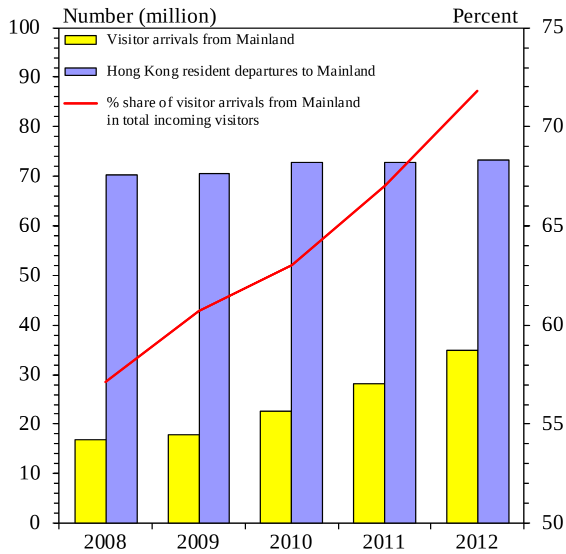
2.24 *Exports of services* experienced a visible slowdown during 2012. Looking ahead, service exports should likewise see some pick-up in growth in 2013. In particular, exports of trade-related services and transportation services should fare better in tandem with the somewhat improved trade and cargo flows. Exports of financial and business services should also regain some momentum thanks to the further development of RMB business, the expected revival of fund-raising activities, as well as the better growth prospects of the Mainland economy, thereby spurring investment flows and cross-border financing activities. In addition, exports of travel services should continue to see solid growth, along with the sustained vibrancy of inbound tourism.

Diagram 2.7 : The Mainland factor will remain supportive to the Hong Kong economy

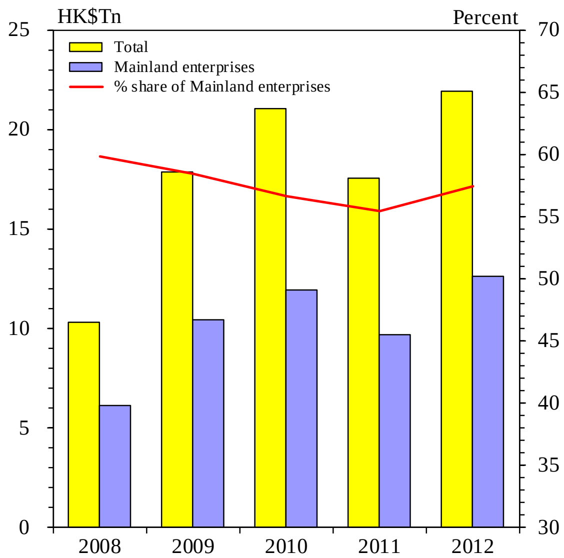
(a) Merchandise trade



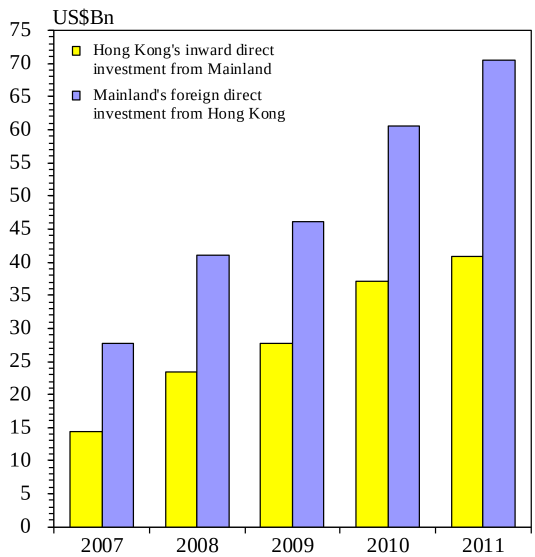
(b) Visitor arrivals from Mainland and Hong Kong resident departures to Mainland



(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



2.25 *Domestic demand* stayed resilient in 2012 and remained the key driver of overall economic growth. In 2013, local consumer sentiment should still be underpinned by the solid employment growth and broad-based income improvement, as well as the positive wealth effect from the asset markets fuelled in part by the loose monetary stance in the advanced economies. Indeed, the latest Quarterly Business Tendency Survey and consultation on small and medium-sized enterprises (SMEs) indicated generally positive and stable hiring sentiments among large enterprises and SMEs respectively. This should be favourable to private consumption spending, granting no abrupt deterioration in the external environment to the extent of severely denting local sentiment and willingness to spend. As for investment, while machinery and equipment acquisition tends to be volatile, the building and construction component should be well sustained by the high level of public infrastructure works under way, as well as the expected notable pick-up in private building activity. All in all, the domestic sector is expected to hold up generally well in 2013.

Diagram 2.8 : Private consumption should be well underpinned by job and income growth

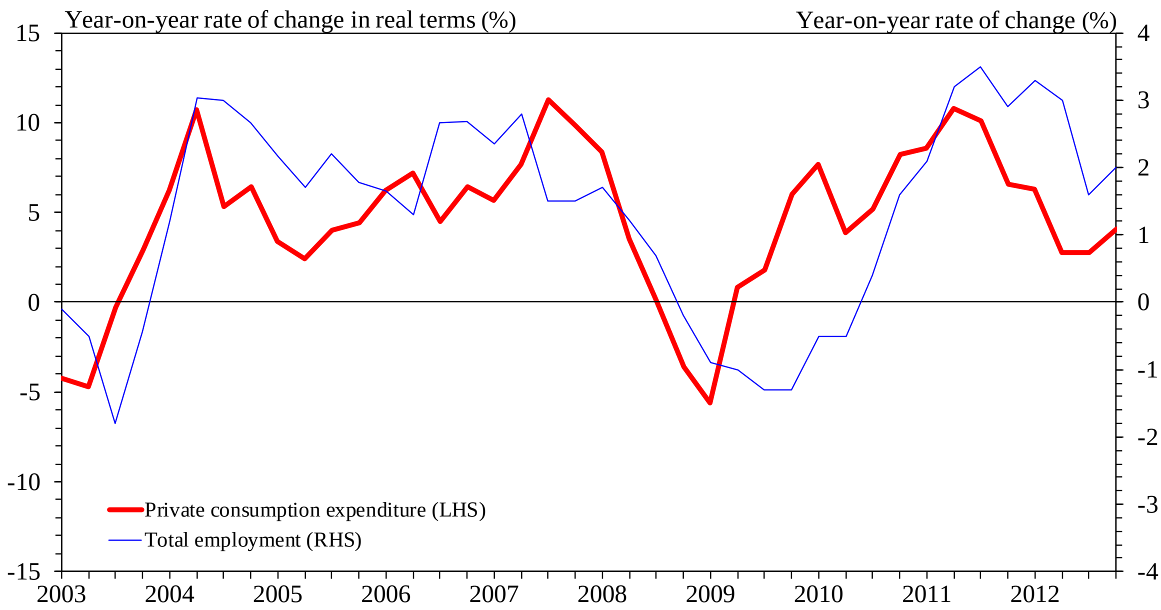


Diagram 2.9 : Consumer sentiment may also be affected by asset market performance

(a) Housing wealth (b) Equity wealth

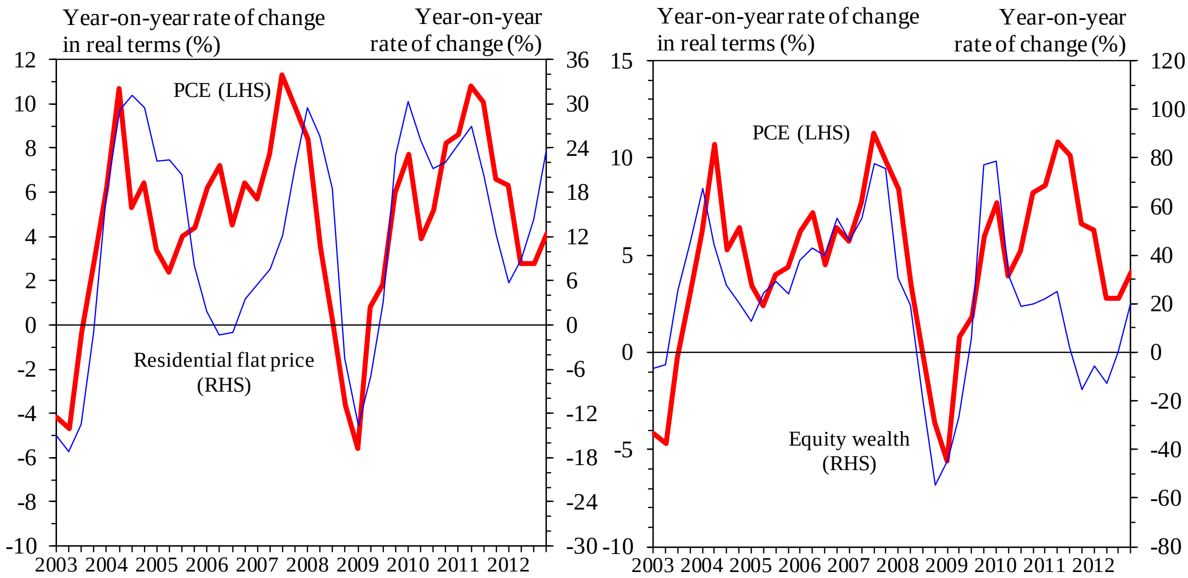
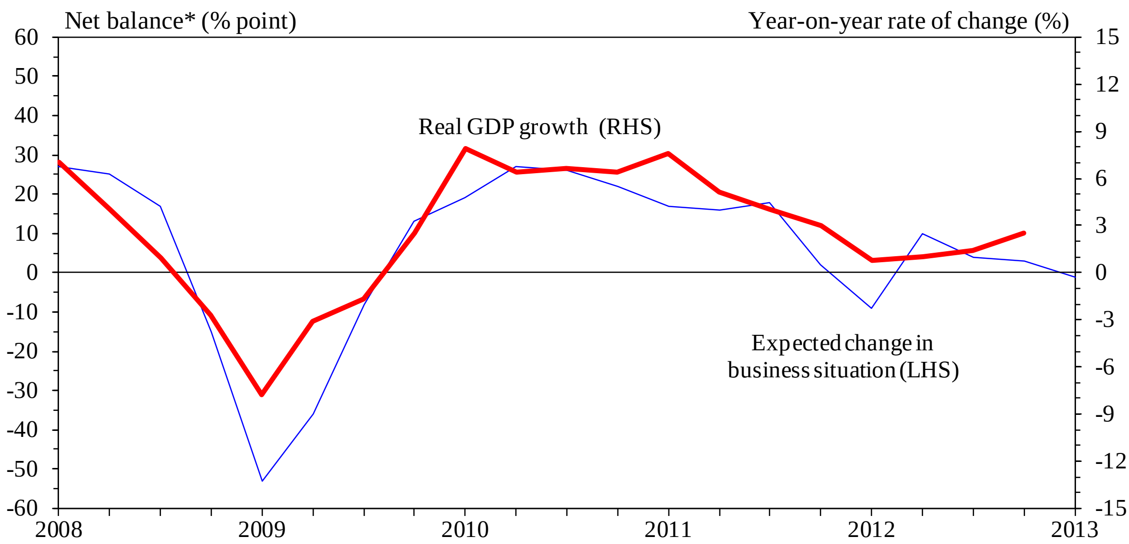
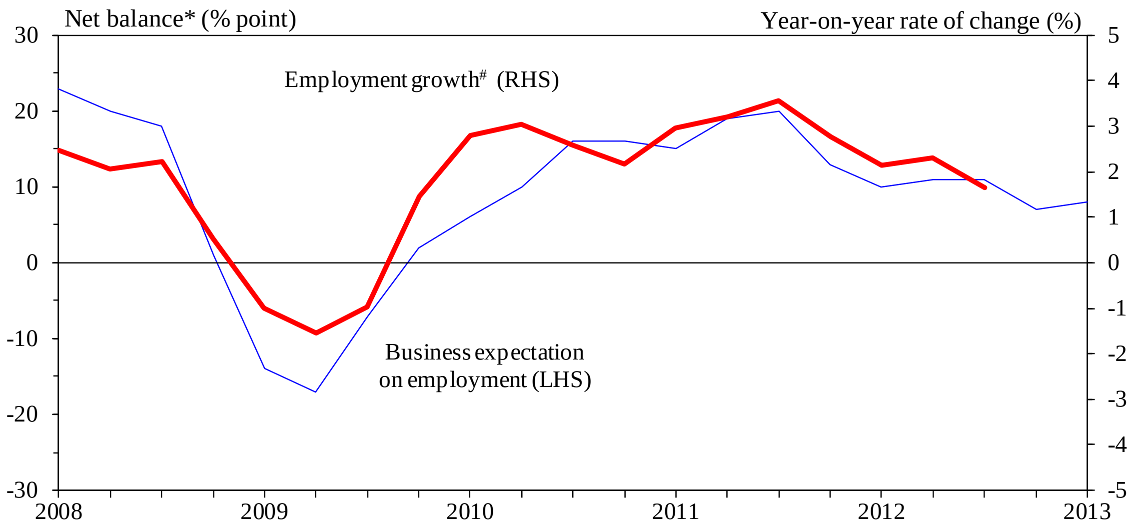


Diagram 2.10 : Business sentiment remains generally cautious



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 2.11 : Yet hiring sentiment is still largely positive

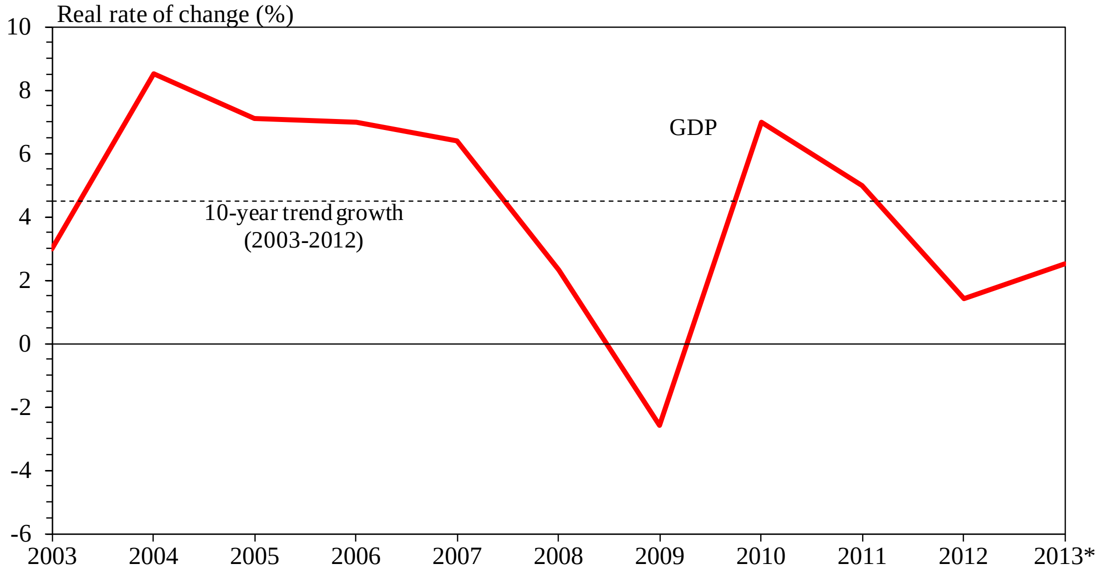


Notes : (*) Net balance indicates the direction of expected change in number of persons engaged versus preceding quarter. It refers to the difference in percentage points between the proportion of establishments choosing "up" over that choosing "down". A positive sign indicates a likely upward trend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

(#) Employment in private sector.

2.26 Taking into account the further steady growth in domestic demand and likely improvement in external trade, the Hong Kong economy is projected to expand modestly by 1.5-3.5% in 2013, somewhat faster than the 1.4% growth in 2012. Yet, this would still be slower than the trend growth of 4.5% in the past ten years, largely due to the continued headwinds from a sub-par, below-trend pace of expansion in the advanced economies. As in the previous year, the range forecast is wider than usual, as the global economic outlook is still subject to a high degree of uncertainty in 2013. The prevailing forecasts by private sector analysts mostly fall within the range of 2.5-4.7%. The official forecast is predicated on the assumption that the euro debt crisis would remain contained with ongoing progress towards reforms at the national and eurozone levels, that the US debt ceiling and fiscal issues would be largely resolved without derailing the ongoing economic recovery, and that the Mainland economy would sustain a faster momentum. Downside risks for 2013, while diminishing, are still prominent, as renewed strains arising from fragilities in the advanced economies cannot be ruled out. On the other hand, there could also be some upside potential to the forecast, should Asian domestic demand prove to be more impervious to the sluggishness in the advanced economies, or should the economic recovery in the US, Japan and EU regain firmer-than-expected footing.

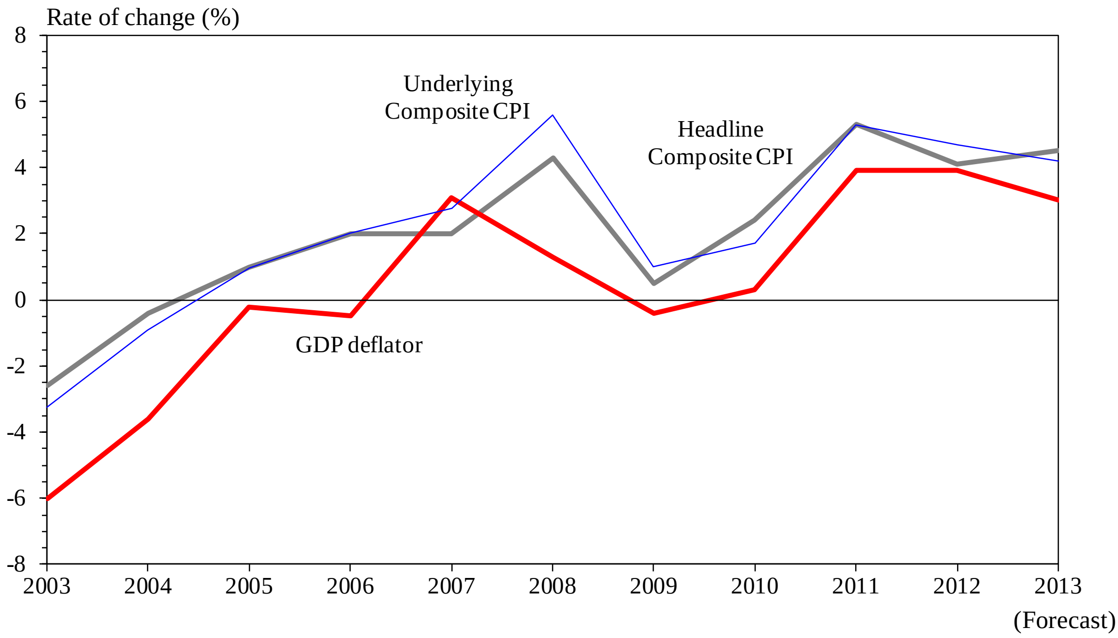
Diagram 2.12 : Economy expected to grow slightly faster, albeit still at a sub-trend rate



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

2.27 Inflation in Hong Kong was largely on an easing trend in 2012, though the pace of tapering slowed towards the year-end. While inflationary pressures will likely remain contained in the near term amid the sub-par local economic growth and moderated imported inflation, the room for further easing will be increasingly limited. Recent developments also suggest that there may be renewed upside risks to inflation further down the road. Externally, global food prices, after peaking in early 2011, have shown signs of bottoming out of late, and the global liquidity glut may induce another round of global commodity price surge, thereby posing upward pressure to imported inflation. Locally, the renewed pick-up in fresh letting flat rentals since early 2012 will feed through to consumer price inflation over the course of 2013. Wage pressure, while moderated of late, may emerge again after the implementation of the new statutory minimum wage rate in May 2013. This, coupled with the rise in commercial rentals over the past year, may entail higher local business costs. That said, given the subdued economic growth, the risk of a sharp resurgence in inflation is not high. Overall, *underlying Composite CPI* is forecast to increase by 4.2% for 2013 as a whole, still lower than the average of 4.7% in 2012. Taking into account the effects of the Government's one-off measures, *headline Composite CPI* is forecast to increase by 4.5% in 2013. The *GDP deflator* is forecast to rise by 3.0%, in line with the expected increase in domestic prices as well as the likely change in the terms of trade.

Diagram 2.13 : Inflation may face some upside risks in 2013



Forecast rate of change in 2013 (%)

Gross Domestic Product (GDP)	
Real GDP	**1.5 to 3.5**
Nominal GDP	4.5 to 6.5
Per capita GDP, in real terms	0.7 to 2.7
Per capita GDP at current market prices	HK$295,600-301,300 (US$37,900-38,600)
Composite Consumer Price Index	
Headline	**4.5**
Underlying	**4.2**
GDP Deflator	**3.0**

Forecast on Hong Kong's GDP growth in 2013 recently made by other selected parties

	(%)
The University of Hong Kong	3.5 to 4.3
Average forecast by private sector analysts#	3.4

Note : (#) Forecast GDP growth by private sector analysts mostly falls between 2.5% and 4.7%.

Medium-term outlook for the Hong Kong economy

2.28 Beyond the short-term volatilities in the external environment, the medium-term outlook for the Hong Kong economy remains positive. Hong Kong is in the best position to leverage on the economic strength of Asia, especially the Mainland, in moving towards a high value-added, knowledge-based economy. The ongoing large-scale infrastructure works will also help support domestic demand over the medium term and improve our economic efficiency and production capacity over the longer run.

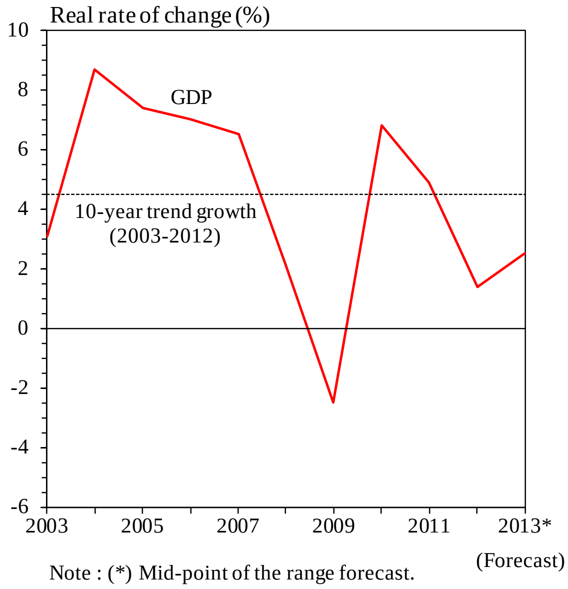
2.29 Deepening our economic integration with the Mainland is an important part of our growth strategy. The nation's development strategy of growth rebalancing and fostering the service industry should offer ample opportunities for our service sectors, through the CEPA platform and other regional cooperation channels. The Government will strive to extend the "early and pilot implementation" arrangement beyond Guangdong to other provinces and municipalities in the Pan-Pearl River Delta region, in addition to exploring new and emerging markets overseas. Further, the development of Hong Kong into a premier offshore RMB business centre and asset management centre as laid out in the National 12th Five-Year Plan has been making good progress. We will continue to strengthen our pillar industries while nurturing new industries with growth potential. The newly established Economic Development Commission and Financial Services Development Council are precisely charged with identifying new engines for Hong Kong's economic growth so as to diversify its economic base while consolidating our competitive edge.

2.30 On the supply side, the Government will continue to upgrade our human capital and build on infrastructure to raise our productivity and competitiveness. The productivity growth achieved in the process will help the economy attain a 4% growth per annum from 2014 to 2017, broadly in line with the average annual growth rate that Hong Kong has achieved over the past decade.

2.31 While inflation pressures should remain moderate in the near term amid the earlier stabilisation of local and external price pressures, we shall stay alert to the upside risks to inflation over the medium term, in view of the super-loose monetary environment and volatile US dollar exchange rate and commodity prices. The continued productivity gain should nonetheless provide some offset to local cost pressures. Taking these factors together, the trend rate of change in the underlying CCPI in Hong Kong for the four years from 2014 to 2017 is forecast at 3.5% per annum.

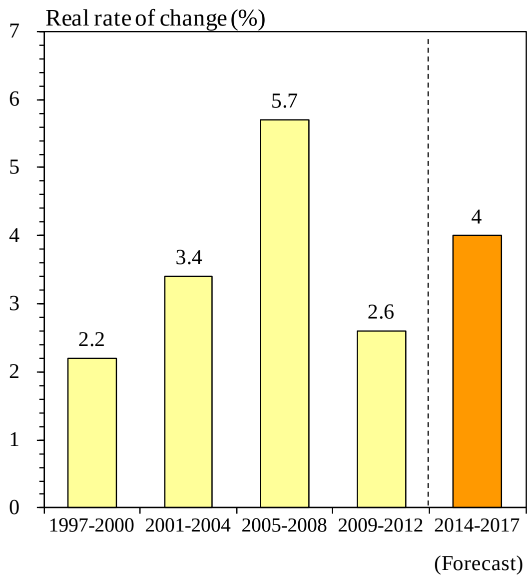
Diagram 2.14 : Economic prospects remain positive over the medium term

(a) Economy expected to show faster but sub-trend growth in 2013



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

(b) Trend economic growth over the medium term will be broadly in line with the past trend



2.32 Over the medium and longer term, there will be challenges on both the external and domestic fronts. Externally, the resolution of the euro debt crisis and fiscal problems in the advanced economies, as well as the withdrawal of the abundant global liquidity, could be long drawn-out processes, posing downside risks to the global economy. Also, the threat from geopolitical tensions in many parts of the world should not be underestimated. Domestically, the structural shift of the Hong Kong economy towards higher value-added and knowledge-based activities, though important to the sustainable development of our economy, has raised concerns in the community over the widening income and wealth disparities. At the same time, the issue of an ageing population and resulting labour shortage has become increasingly imminent, plus its profound ramifications on our healthcare and social welfare systems. In view of these challenges, it is important to exercise fiscal prudence, so as to preserve our ability and ensure sufficient public resources to invest in infrastructure and education to drive the economy and also to tackle the social issues through various programmes.