CHAPTER 2 : ECONOMIC OUTLOOK FOR 2014 AND THE MEDIUM TERM

Summary

- *Global economic prospects have improved over the recent past, as the eurozone economy emerged from recession and as signs of the US economy gaining traction are gradually accumulating. While the policy risks in the US still need to be watched over, the budget sequestration in 2014 will be much less of a drag than it was in 2013. Moreover, the Mainland economy with its resilient domestic demand, and helped by the momentum released from further economic reforms, should also remain a key pillar to regional economic growth to the benefit of Hong Kong.*

- *If the latest improvements in the global economy continue and the Federal Reserve's tapering proceeds in a measured pace, Hong Kong's export prospects for 2014 should turn more positive, even though the extent of pick-up may still be limited by the weak fundamentals of the advanced economies. Hong Kong's exports of services, which used to be relatively resilient, should also extend further gains.*

- *Domestic demand should be able to hold up in 2014, even though the momentum may not be as strong as in the past few years. In particular, consumption demand would be underpinned by favourable employment conditions amid a tight labour market. The prevailing positive business confidence should also help sustain investment momentum.*

- *The key sources of uncertainties for the 2014 outlook come from the US Federal Reserve's asset purchase tapering and the consequential impact on the emerging markets in terms of capital flow reversals, exchange rate fluctuations, and asset market gyrations. As such, the risk of setback in exports as well as consumer and investment sentiments in response to any surprise in future US monetary policy still could not be ruled out.*

- *The Hong Kong economy is projected to expand by 3-4% in 2014, compared to the 2.9% growth in 2013 and the average annual growth of 4.5% in the past ten years. This growth forecast adopts a one-percentage-point range, instead of a two-percentage-point range as in the previous year, in face of reduced acute risks arising from the euro debt crisis and the US fiscal cliff over the past year.*

- *Inflationary pressures are likely to be contained in 2014 as imported inflation is expected to stay subdued, while local rental cost pressures will*

also likely recede. Nevertheless, the risks arising from possible swings in global food and commodity prices spurred by ample global liquidity linger. Overall, underlying Composite CPI is forecast to increase by 3.7% for 2014 as a whole, slightly lower than the average of 4.0% in 2013.

- *Over the medium term, the external environment of Hong Kong will likely continue to be restrained by the lower growth potential of the advanced economies, slower trend growth in some emerging markets, and the uncertainty arising from the normalisation of US monetary policy. In this setting, the growth spots arising from the sustained solid growth of the Mainland economy and its determination to deepen economic reforms will be of paramount importance, and Hong Kong could grasp these opportunities by strengthening integration between the two places and aligning itself to the nation's development strategy while continuing efforts to bolster its competitiveness. Given the constraints posed by the external environment as well as the budding demographic challenges, the trend GDP growth rate in real terms is forecast at 3.5% per annum from 2015 to 2018. The trend rate of underlying consumer price inflation is forecast at 3.5% per annum.*

Major external factors

2.1 The challenging external environment has taken its toll on Hong Kong's trade performance in recent years. The pressure should be lessened in 2014 if the progress made by major advanced economies over the course of 2013 sustains and the US Federal Reserve (Fed)'s plan to taper its asset purchases continues at its currently measured pace. However, the uncertain path of future US monetary policy remains a key source of uncertainty to the global economy. Should financial strains re-emerge in various parts of the world due to concerns about US monetary policy shift, the real global economy could be undermined.

2.2 The economic performance of Hong Kong's major trading partners is an important determinant to our export outlook in 2014. The US economic expansion has shown signs of taking hold of late. The eurozone finally emerged from recession, although the pace of expansion was still anaemic amid structural issues. The Japanese economy has grown further in 2013 on the back of the boost from monetary and fiscal stimulus, but it has to meet the challenge from the sales tax hike scheduled for April 2014. On the whole, there has been improvement in the advanced economies. Apart from this, the Mainland economy, with its resilient domestic demand, should continue to outperform the advanced peers. Many other Asian economies, while showing varying paces of expansion last year, still maintain relatively sound fundamentals. Yet, given their export-oriented nature and the threat from the uncertain US monetary policy, their outlook this year is still contingent on how the global economic conditions evolve. In short, the sustainability and the power of the pick-up in advanced economies in 2014 are crucial to Hong Kong's economic prospects this year.

2.3 The fluid global monetary environment will be the major source of risks this year. The Fed last December decided to trim its asset purchases, but it also signalled that the ultra-low interest rate environment would likely remain in place for an extended period. The central banks in Europe and Japan also pledged to maintain their highly accommodative policy stances. As such, the Fed's tapering decision would not amount to a fundamental change to the global liquidity glut in the short term. However, as the world has been accustomed to ample liquidity and extraordinarily low interest rates, the uncertainties surrounding the future course of Fed's moves will sharpen financial market sensitivity to US economic data, possibly tipping off portfolio reallocation and resulting in a more volatile capital flow environment. In particular for Asian economies that have received substantial capital inflows over the past several years, the risk of capital flow reversal would increase as the Fed reduces the size of the asset purchase program further, and the associated risks of financial strains, currency depreciation, and tighter domestic liquidity conditions cannot be taken lightly.

2.4 Economic and financial factors aside, the geopolitical tensions in some parts of the world may also affect global economic sentiment, especially the unsettling situation in the Middle East given the region's dominance in oil supply and strategic location in global cargo flows. The following provides a more detailed analysis of the major external factors.

Global economic outlook

2.5 The US economy only recovered modestly last year, with real GDP growth decelerating from 2.8% in 2012 to 1.9% in 2013 due mainly to the drag from fiscal entrenchment. Yet, growth momentum accelerated visibly in the second half of 2013 partly on the back of the recovering housing market and stronger private sector activity (***Box 2.1***). The budget deal at the end of last year that should relieve the fiscal restraints in this year and the next further improved the growth prospect. Yet, as the fiscal drag would only subside rather than reverse, US economic growth this year should continue to be powered by the private sector demand. In this regard, uncertainties remain, as there are still hurdles for consumption to gather further strength given the slow job creation and possible continuation of deleveraging in the household sector. Of greater concern is the further tapering by the Fed which could lead to higher long-term interest rates, possibly dealing a blow to the nascent recovery of the housing market or capital investment. In sum, the dynamic interactions between the private sector recovery and the Fed's tapering course will be the defining factor to US economic performance this year. To the extent that the housing market recovery as well as business and consumption sentiment could withstand the headwinds from tapering, the US economy should see faster growth in 2014.

2.6 Across the Atlantic, Europe finally emerged from its prolonged recession last year, with the imposing risks coming from the euro debt problems having receded notably following a string of strong actions taken by the European leaders. However, the European Central Bank (ECB) in November 2013 cut its policy interest rate to the historic low of 0.25%, highlighting the mounting economic challenges facing the region. Indeed, economic performances among the member states have been mixed, with Germany providing most of the recovery fuels. Moreover, the repair of eurozone's economic fundamentals were far from complete, with huge public debt loads, stubbornly high unemployment, and an array of unresolved structural issues relating to further integration of the currency bloc outstanding (***Box 2.2***). These problems will likely restrain the eurozone for an extended period, keeping the economy on a low gear in 2014.

2.7 The Japanese economy, after posting rather strong performance in the first half of 2013, decelerated somewhat in the second half on a quarter-to-quarter basis, reflecting the waning boost from the aggressive monetary and fiscal stimulus measures. Down the road, it might be increasingly difficult for the Japanese economy to keep up its momentum, not only because of diminishing returns of the measures, but also the expected adverse effects on consumer sentiment due to the sales tax hike scheduled for April. The sizeable budget for the fiscal year 2014 aiming at cushioning the negative impacts of the tax hike may help at the margin, but the sustainability of such positive effects remains to be seen. Short-term challenges aside, the Japanese economy also needs to hammer out reforms to tackle the energy issues, the rapidly ageing population and other structural problems. The difficulties of putting these reforms in place should not be understated. There is also the possibility of Japan expanding its monetary stimulus further if it fails to achieve the inflation target, thereby adding uncertainty to the global monetary environment.

Box 2.1

Recent performance of the US housing market

The US housing market has been recovering since 2012 on the back of improving economic conditions and unprecedented monetary stimulus. The recovery, while gradual, has been evident on various fronts. Home prices and sales activities have both embarked on an uptrend. Housing starts have also been picking up amid declining vacancy rates (***Chart 1***).

Chart 1 : Recovery of the US housing market

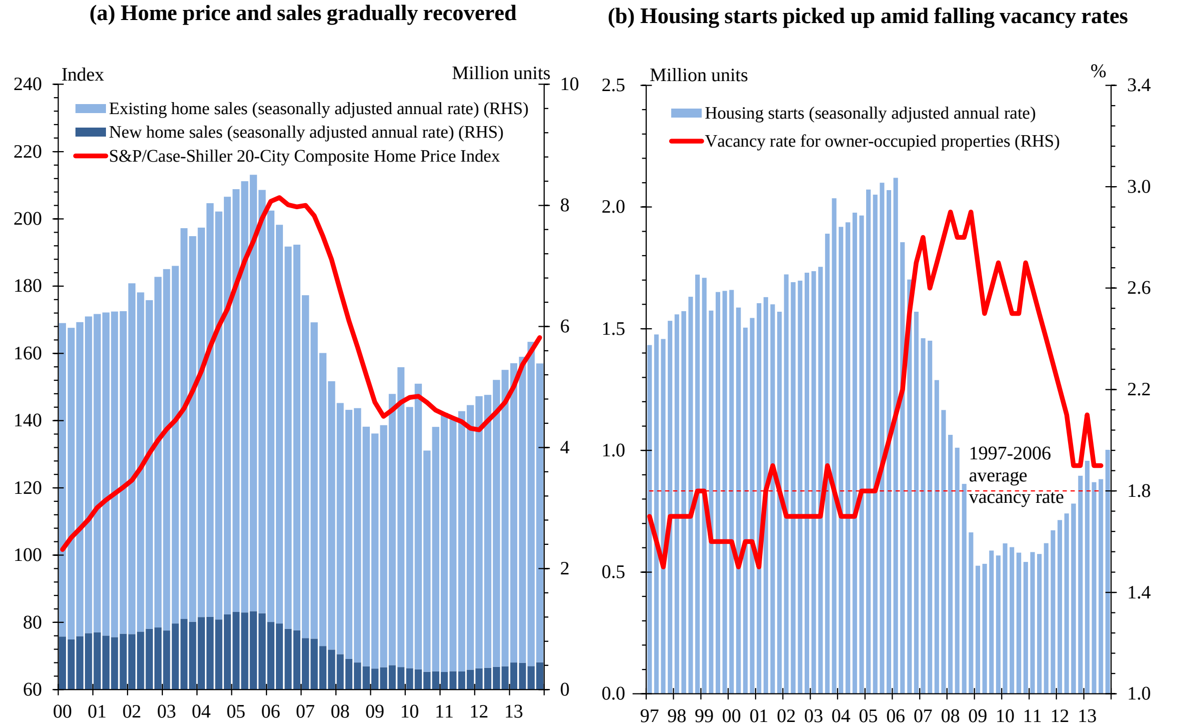
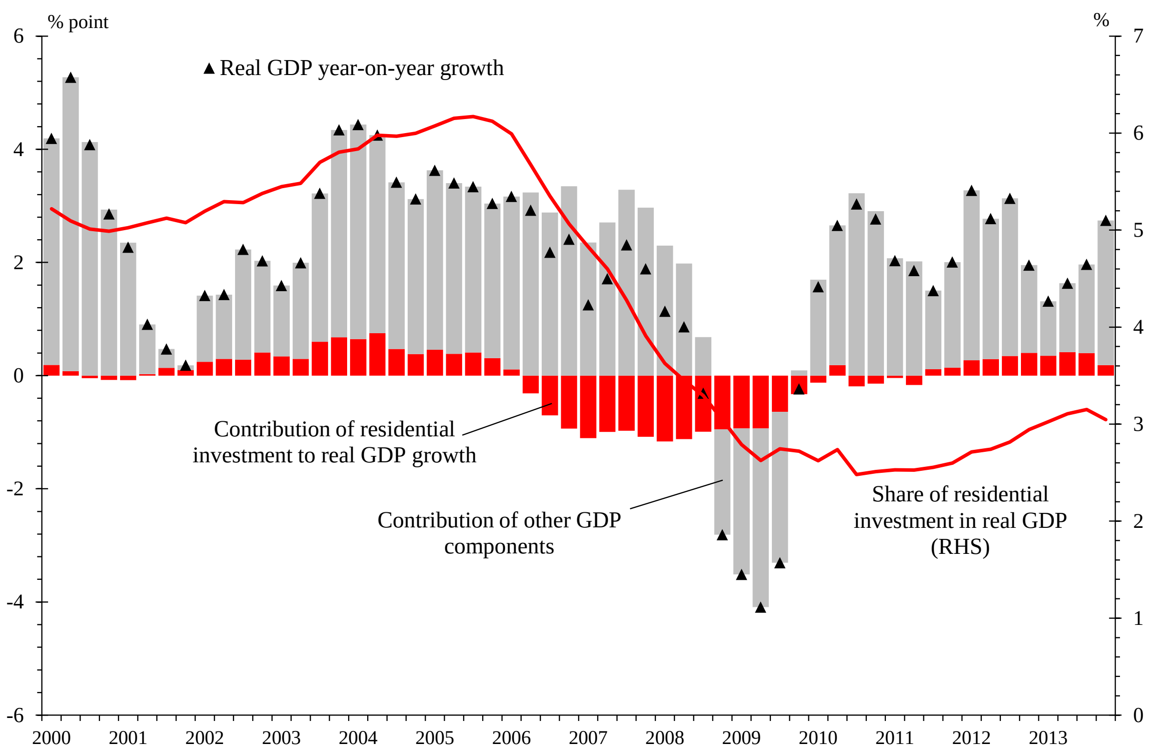


Chart 2 : Contribution of residential investment to real GDP

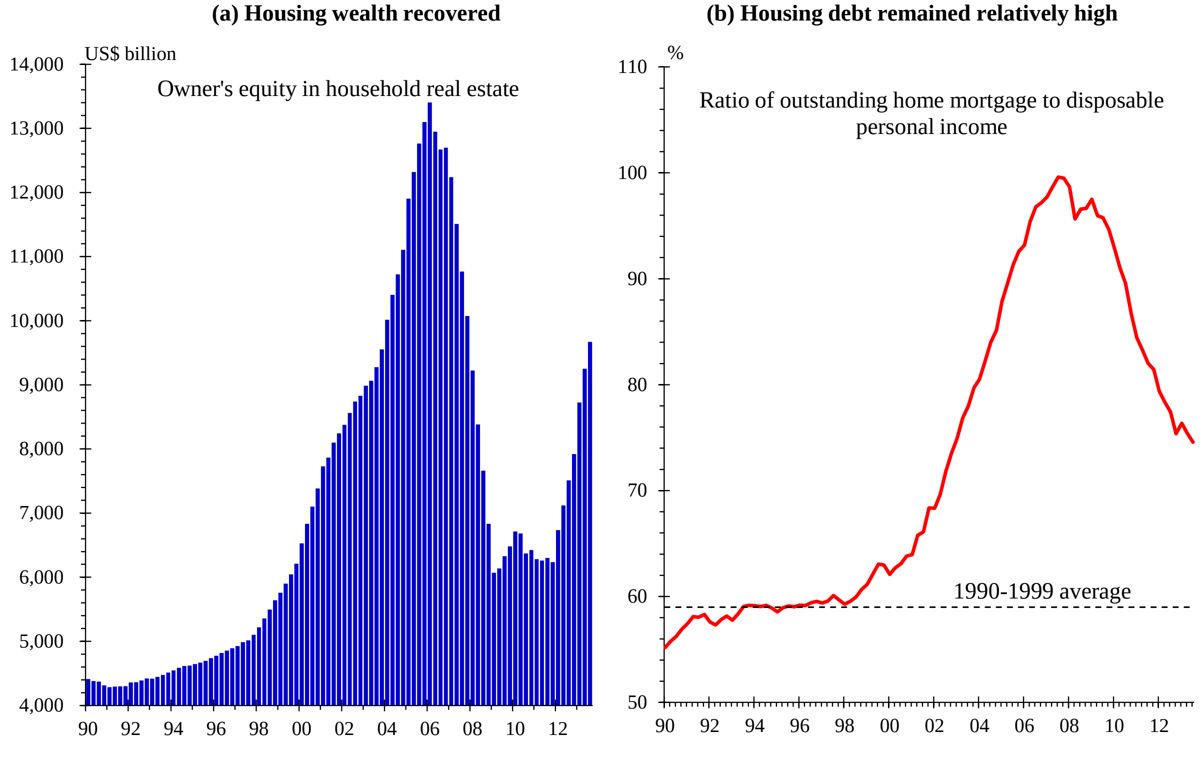


Box 2.1 (Cont'd)

The housing market recovery has contributed to the faster US economic growth in the second half of 2013, both directly and indirectly. The visible pick-up in housing starts since 2012 was directly reflected in the residential investment component of GDP. Its contribution to real GDP growth picked up from 0.01% point in 2011 to 0.32% point in 2012 and 0.33% point in 2013 (***Chart 2***). Correspondingly, the share of residential investment in real GDP rose from a low of 2.5% in the third quarter of 2010 to 3.0% in the fourth quarter of 2013. This compared with the average of 4.4% in the 1990s, before the housing boom in the 2000s.

The housing market recovery should have also helped drive the economy indirectly through wealth effects on consumption. According to the Federal Reserve, owners' equity in household real estate increased notably by 55% from US$6.2 trillion in the fourth quarter of 2011 to US$9.7 trillion in the third quarter of 2013 (***Chart 3***). However, it is unclear whether the household deleveraging process is completed. The ratio of outstanding home mortgages to disposable personal income went down from a high of 100% in the third quarter of 2007 to 75% in the third quarter of 2013. Despite the decline, the ratio remained higher than the average of 59% in the 1990s, when the housing market was in a more normal state (***Chart 3***). Should the deleveraging process continue in 2014, it may still constrain the growth of private consumption, keeping the US economic growth from moving to higher gear.

Chart 3 : Recovering housing wealth amid deleveraging



Also, whether the US housing market recovery could withstand the unwinding of the monetary stimulus is another concern. The Fed's monetary policy direction has proved to be a deciding factor. The indication by the Fed in mid-2013 on the prospect of asset purchase tapering was soon followed by increases in mortgage rates and slowdown in home sales. Now that the Fed has begun reducing the asset purchases, the dynamics between the monetary policy, housing market and overall economic conditions warrant close watch. Given the tapering, it remains to be seen if the US housing market would continue to gather momentum by riding on improving economic fundamentals and in turn contribute to further economic growth.

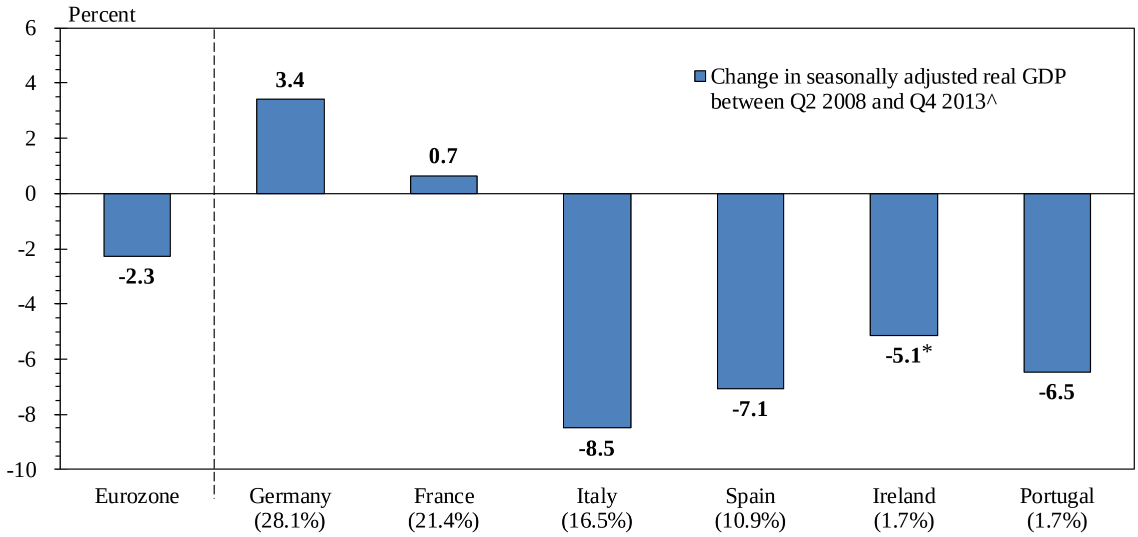
Box 2.2

The eurozone's economic recovery in perspective

Over the past five years or so, the eurozone economy had experienced two recessions – first dented by the acute global financial crisis in 2008-2009 and then a six-quarter recession that began in the fourth quarter of 2011 amid the euro debt crisis. While the eurozone economy has emerged from recession since the second quarter of 2013, its economic fundamentals remain fragile and its recovery severely impeded by structural problems and austerity measures needed to redress the high level of indebtedness. By comparing some of its major macroeconomic indicators before and after the two recessions[(1)], this note attempts to put the eurozone's recent economic recovery in perspective.

Despite the mild growth recorded in recent quarters, the level of real output for the eurozone as a whole in the fourth quarter of 2013 remained 2.3% lower than the pre-crisis level in the second quarter of 2008 (***Chart 1***). Also evident was the distinct growth dispersion among member states of the eurozone. While Germany stood out clearly as the outperformer and provided the key impetus to the region, France's real GDP only marginally surpassed its pre-crises level. Italy and Spain, the third and fourth largest economies in the currency bloc, fared much worse. Member states that requested for bailouts also had considerable slack.

Chart 1 : The eurozone economy has yet to recover to its pre-crisis level



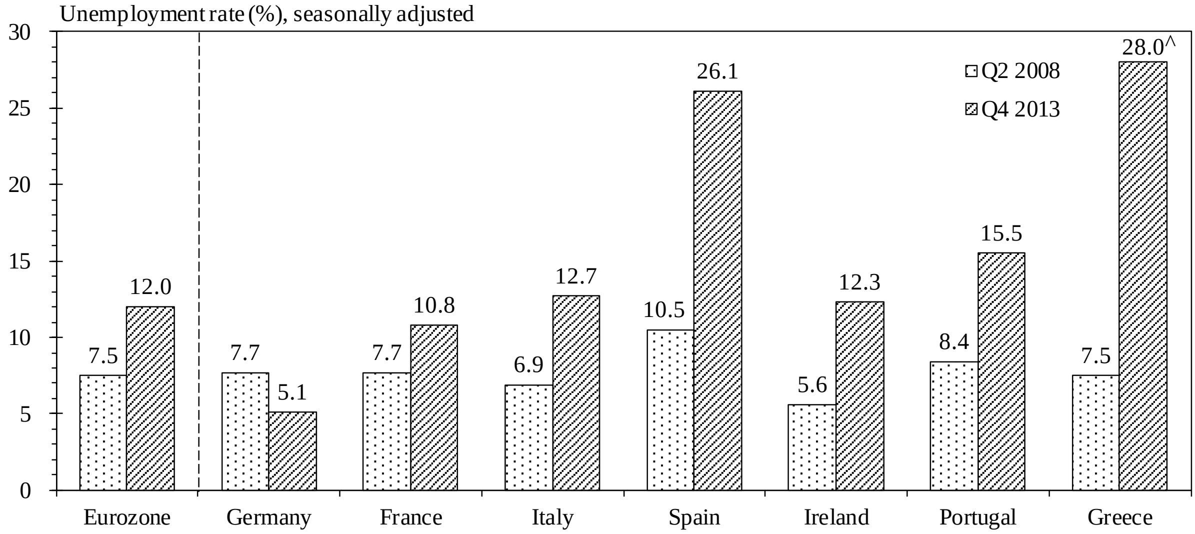
Notes : (^) GDP figures of member states in Q4 2013 were calculated based on the flash growth estimates released on 14 February 2014.
(*) Refers to the GDP change between Q2 2008 and Q3 2013, the latest period with GDP figure available.
Figures in brackets represent the respective member state's % share in eurozone's nominal GDP in 2012.
Greece does not publish seasonally adjusted GDP figures after the first quarter of 2011.

Labour market conditions in the eurozone also remained difficult alongside the widespread economic weakness, with the seasonally adjusted unemployment rate staying elevated at 12.0% in the fourth quarter of 2013, far above the 7.5% recorded in the second quarter of 2008 (***Chart 2***). In fact, except for Germany, the prevailing unemployment rates in most of the major member states were still notably higher than their respective levels in the second quarter of 2008. More worryingly, youth unemployment (i.e. for workers of less than 25 years old) in the eurozone has been even more acute, shooting up from 15.6% to 23.9% over the same period, which could have serious consequences on Europe's longer-term growth potential if the situation persists.

(1) The collapse of Lehman Brothers took place in September 2008. This is widely considered as the event that marked the beginning of the global financial crisis, which also eventually triggered the euro debt crisis. Therefore, in this note the second quarter of 2008 is taken as the reference period for the pre-crisis situation.

Box 2.2 (Cont'd)

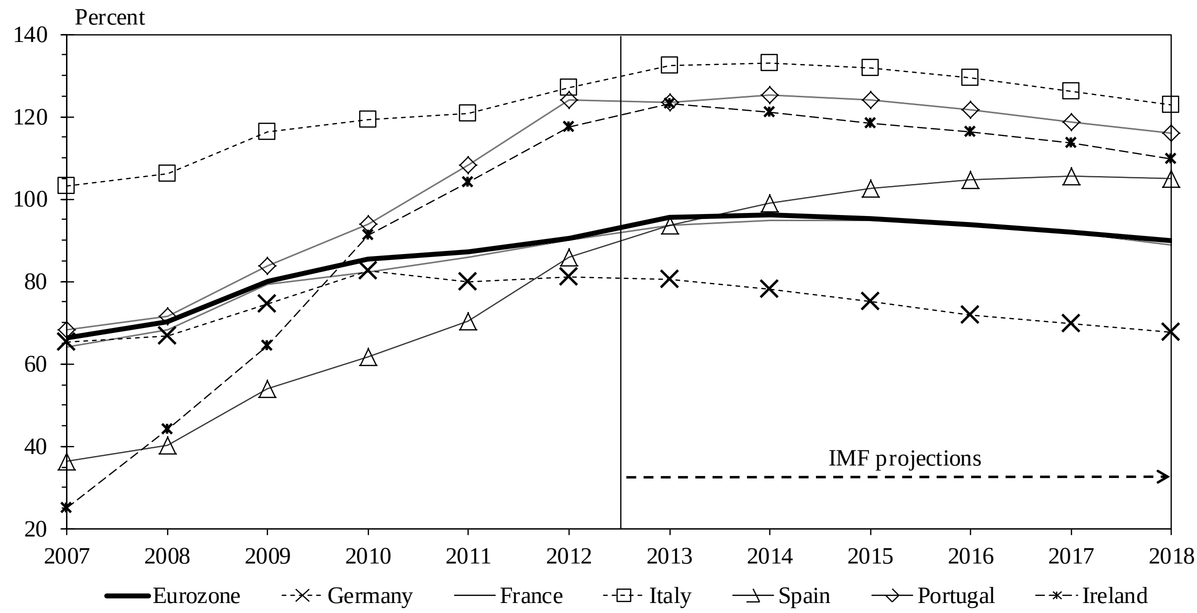
Chart 2 : Unemployment rate has increased significantly in nearly all member states



Note : (^) November 2013 figure.

Furthermore, the debt burden on most of the member states, after rising rapidly over the past few years, will likely remain monumental in the foreseeable future. According to projections by the IMF in October 2013, the gross government debt to GDP ratio for the eurozone was expected to decline only gradually in the coming few years and remain notably higher than the pre-crisis level (***Chart 3***). As such, further sustained efforts will still be needed to repair the region's public finance, thereby continuing to post a drag on growth in the years ahead.

Chart 3 : Government gross debt to GDP ratio

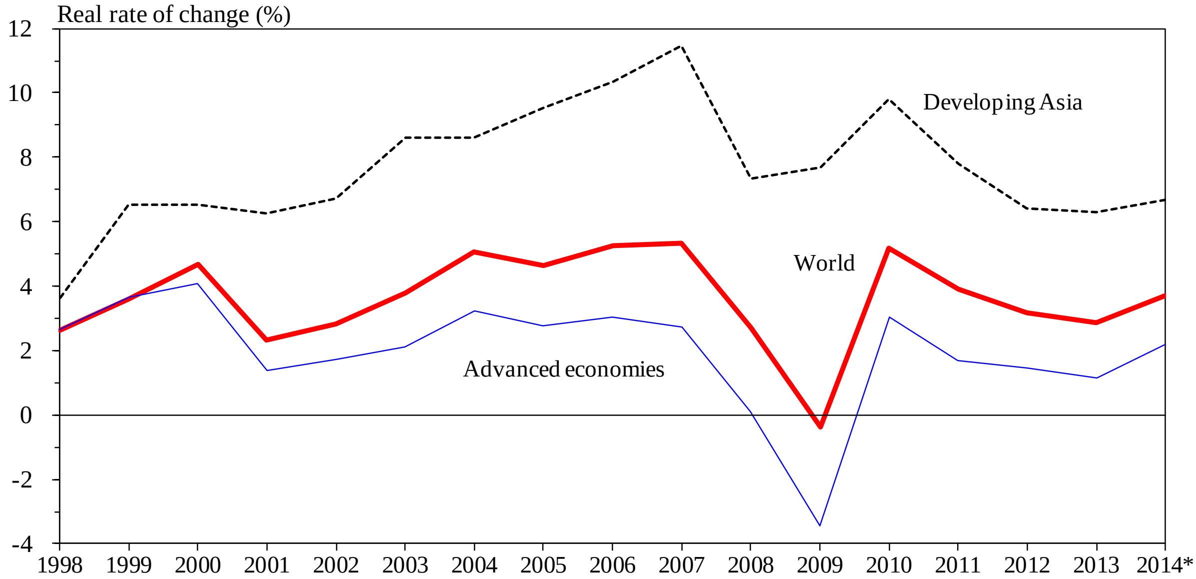


To conclude, while the acute risks of the euro debt crisis have receded notably, the economic outlook for the eurozone remains challenging. The need for fiscal consolidation makes it difficult for the member states to boost growth and bring down unemployment in the near term. While the formation of a banking union has made some progress, the European leaders must also take further strong policy actions to enhance market confidence in the euro by strengthening the various institutions that would make the monetary union sustainable.

2.8 Granting that the Fed were to taper its monetary stimulus gradually without upsetting the US recovery and global financial stability, and that the huge debt loads in Europe and Japan would not derail their economies, the advanced economies as a whole, led by the US, should be able to achieve faster growth in 2014. In January, the International Monetary Fund (IMF) projected that the real GDP growth of the advanced economies would pick up from a meagre 1.3% in 2013 to 2.2% in 2014, which if achieved, would represent the fastest growth since 2010.

2.9 Many emerging economies, including some of those in Asia, moderated in growth last year amid the sluggishness of the advanced economies, more volatile capital flows and domestic supply-side bottlenecks. While there were some signs of stabilisation towards the end of 2013, an important source of concern this year would be the risks of disruptive capital flows and asset price volatility associated with the Fed's future moves. The lesson learnt from last summer is that any dramatic action pointing to possible premature withdrawal of US monetary support could lead to sharp gyrations in emerging market currencies and asset prices, including those in Asia. Again, granting no significant shocks brought about by Fed's policy shifts and that the demand conditions in the advanced economies turn better as expected, the performance of developing Asian economies should hopefully be more stable this year. According to IMF's latest projection, the developing Asian economies would grow by 6.7% in 2014, slightly up from 6.5% last year. Nonetheless, there is no room for complacency, as the capability to cope with more volatile capital flows vary across economies and the contagion from individual emerging markets with weaker fundamentals could spread quickly to others in an increasingly globalised world.

Diagram 2.1 : The Asian region is likely to maintain steady growth in 2014, while the advanced economies should see some relative improvement



Source : IMF World Economic Outlook Update, January 2014.
Note : (*) Forecasts from the IMF.

2.10 The Mainland economy has thus far been on track to beat the 7% trend growth target between 2011 and 2015 enshrined in the 12th Five Year Plan. While the external sector is susceptible to the vicissitudes of the demand conditions in the advanced economies, the Mainland's domestic sector looks set to maintain steady growth on the back of continued urbanisation, further development of the services sector, and the Central Government's long-standing policy objective of economic re-structuring towards domestic demand. The directives given in the Third Plenary Session of the 18th Central Committee of the Communist Party of China, including deepening rural-urban integration as well as pushing forward fiscal and financial reforms, will also help unleash growth potential and present new business opportunities. Save for any unforeseen negative shocks from the advanced economies, the Mainland should continue to play a key stabilising role in the region, with GDP growth of above 7% in 2014, far outpacing the advanced economies. Specifically, the IMF projected the Mainland economy to grow by 7.5% in 2014, after a 7.7% expansion in 2013.

2.11 With the advanced economies led by the US expected to see further improvement and the emerging markets poised to maintain their growth performance, the global economy should be able to attain a somewhat faster growth in 2014. In recognition of the latest progress in the world economy, the IMF in January projected that the world economy would stage an improvement, with growth picking up somewhat from 3.0% in 2013 to 3.7% in 2014, 0.1 percentage point higher than the October round forecast.

Table 2.1 : Growth forecasts for major economies in 2014

	2013* (%)	2014 IMF* (%)	2014 Private sector forecast^ (%)
World (PPP## weighted)	3.0	3.7	-
Advanced economies	1.3	2.2	-
US	1.9#	2.8	2.9
Eurozone	-0.4#	1.0	1.0
Japan	1.6#	1.7	1.6
Emerging market and developing economies	4.7	5.1	-
Developing Asia	6.5	6.7	-
Mainland China	7.7#	7.5	7.5
India	4.4	5.4	5.4
Middle East and North Africa	2.4	3.3	-

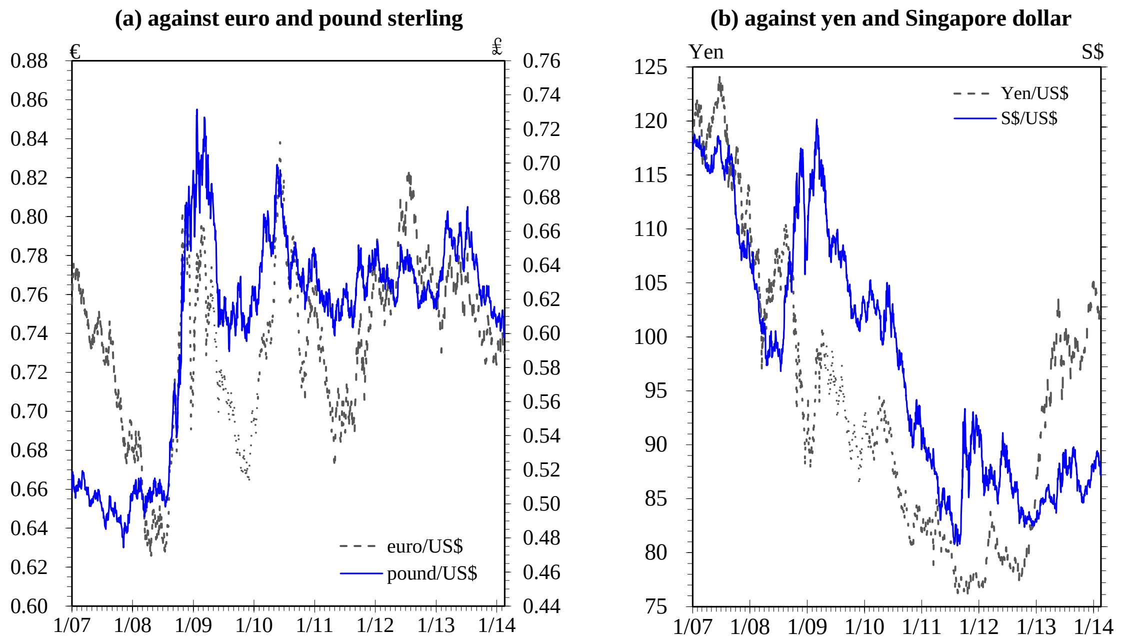
Notes : (*) World Economic Outlook Update, IMF, January 2014.
(^) Average forecast as at February 2014.
(-) Not available.
(#) Actual figures.
(##) PPP refers to purchasing power parity.

Monetary conditions, exchange rates and price competitiveness

2.12 The evolution of future global monetary conditions remains the largest source of uncertainties in 2014. The global monetary conditions would likely remain exceptionally accommodative in the coming year, as the central banks in US, EU, and Japan all pledged to maintain their exceptionally low interest rate for an extended period. However, the start of Fed's tapering of monetary stimulus in January marked an important turning point, and created new uncertainties, especially amid an environment of excessive liquidity that could induce notable volatilities in the global financial markets and abrupt changes in capital flows across economies. As far as the Asian economies, including Hong Kong, are concerned, various renditions of quantitative easing by the advanced economies have resulted in a substantial amount of liquidity parked in the region. Even if the Fed continues to stay its hand on its policy rate target, the policy signal sent by the Fed's further tapering could induce oversized market reactions and capital outflows from Asia, and possibly lead to even more volatile financial conditions, generate strains in foreign exchange markets and pose downward pressure on asset prices in the region.

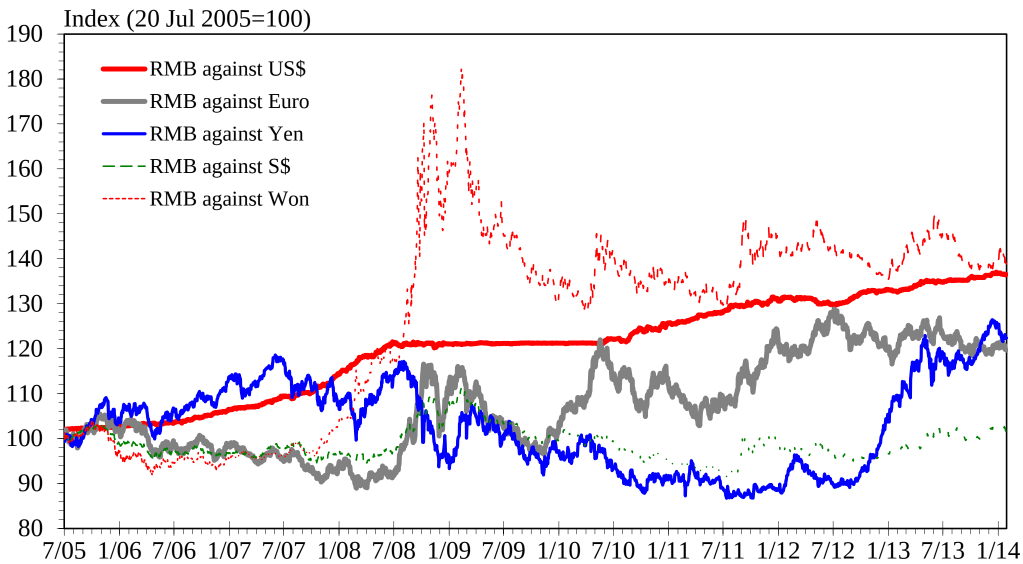
2.13 On the exchange rate front, the Hong Kong dollar appreciated slightly against a basket of major currencies, alongside the US dollar under the linked exchange rate system during 2013. The nominal trade-weighted effective exchange rate index of the Hong Kong dollar strengthened slightly during the first quarter, and then more visibly around mid-2013 against the weakness of the euro, before softening somewhat in the latter part of the year as the global economic environment tended to stabilise. In December 2013, the index rose slightly by 0.7% over a year earlier. The direction of exchange rate movements in 2014 will remain, as it has always been, subject to considerable uncertainty, particularly given the uncertain monetary policy outlook in the major economies and its impacts on the US dollar. Yet as far as Hong Kong is concerned, barring the case of sharp changes in the exchange value of major currencies as with the yen in 2013, the exchange rate is likely to be a less important factor in determining Hong Kong's export growth prospects.

Diagram 2.2 : The foreign exchange market is likely to remain volatile in 2014



2.14 Given Hong Kong's close economic relations with the Mainland, the movement of the renminbi (RMB) is one key factor affecting the performance of Hong Kong's external sector, including both trade in goods and services. A stronger renminbi could weaken the price competitiveness of Hong Kong's re-exports of goods of Mainland origin, but at the same time it could also attract Mainland's demand for Hong Kong's goods and services exports. The renminbi was on a gradual appreciation path against the US dollar throughout 2013, ending the year by about 3% higher. 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 the Mainland in the regional supply chains and the increasing use of renminbi for cross-border trade settlements.

Diagram 2.3 : A relatively stable renminbi will help reduce uncertainty facing Hong Kong's trading companies



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

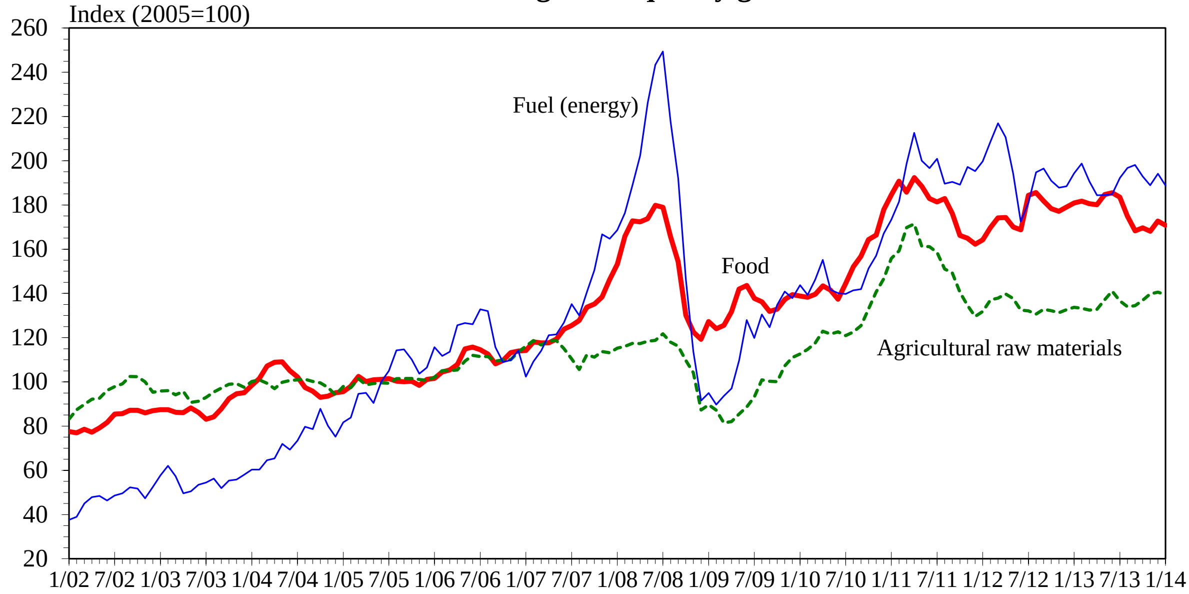
World inflation and global commodity prices

2.15 Inflationary pressures moderated somewhat across most major economies over the past year as global economic growth was subpar and international commodity prices held largely stable. With still-pronounced economic slacks in the advanced economies, global inflation, especially in Europe and the US, will likely remain rather mild in the near term. Focusing on Hong Kong's major import sources in Asia, inflation in the Mainland should be well contained with the People's Bank of China's pursuit of a prudent monetary policy, while the notable weakening of the yen over the past year should also help restrain the price rise in goods imported from Japan. Having said that, some Asian emerging economies with looser control over the monetary conditions, sustained external imbalances and domestic supply constraints may still experience relatively high inflation in 2014.

2.16 The movements of international food and commodity prices is a key factor affecting the inflation outlook for Asia. In this regard, many international commodity prices saw little upward pressure in 2013. The prices of agricultural raw materials rose only marginally while those of metals and energy dipped. Global food prices in particular, according to the Food and Agriculture Organisation (FAO) of the United Nations, fell mildly by an average of 1.6% in

2013 after a 7.3% drop in 2012. Meanwhile, it should however be noted that the geopolitical conditions in the Middle East remain rather fluid. An abrupt worsening of the situation could have significant impacts on oil prices given the region's dominance in global oil supply. The international food prices could also be sensitive to adverse supply shocks arising from unfavourable extreme weather conditions.

Diagram 2.4 : Sharp swings in world commodity prices cannot be ruled out amid the global liquidity glut



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

Major sources of uncertainty

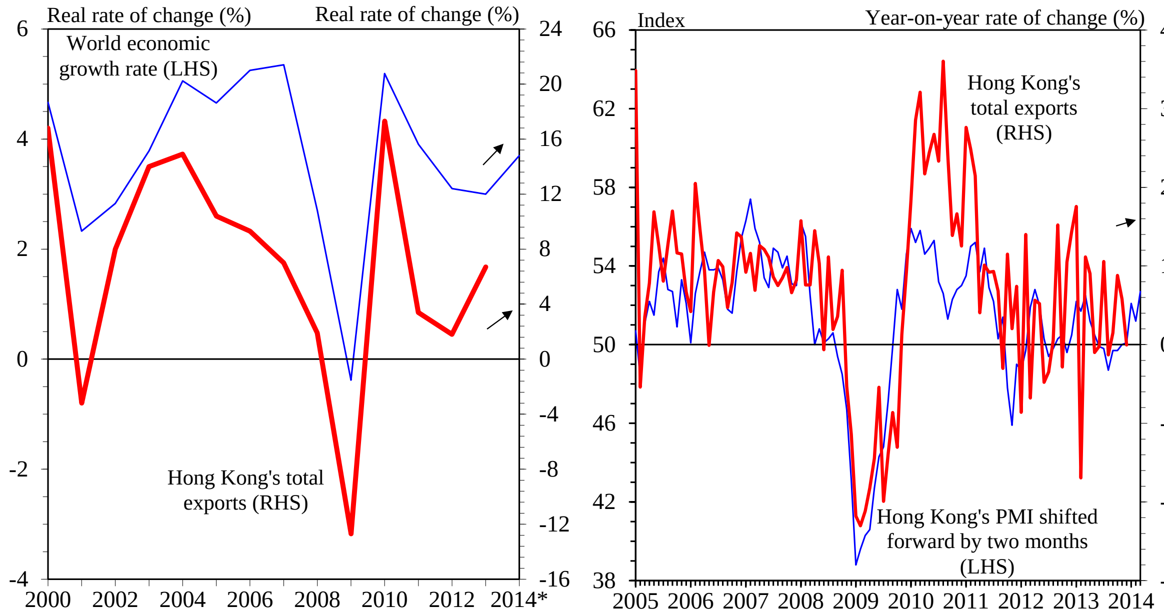
2.17 Global economic conditions have improved towards the end of 2013, but the outlook for 2014 is still subject to uncertainties. *First and foremost*, the uncertain path of US monetary policy and its possible spill-over remain the biggest source of concerns. If the US economic recovery falters, the Fed would refrain from tapering or even augment the asset purchase program, but global growth and trade flows would worsen again in this scenario. However, if the US economic performance broadly matches the Fed's optimistic expectation, the tapering would proceed further throughout 2014, bringing forward the expectation that the Fed would eventually need to return interest rates to more normal levels and inducing volatilities in financial markets worldwide. The emerging and Asian economies that have built up risks of economic imbalance or became increasingly dependent on short-term capital flows in the era of quantitative easing would be particularly vulnerable. *Second*, there is a risk that the EU economy might be trapped in a slow-growing path for a prolonged period given the severe structural issues in many member states. The huge debt loads, especially in conjunction with weak growth and high unemployment rate, will likely persist in some weaker eurozone economies and, as such, the tail risk of the euro debt problem re-intensifying could not be completely ruled out. *Third*, the Bank of Japan may undertake further easing measures should the Japanese economy fail to attain sustainable growth and inflation, adding volatility in the currency markets. *Fourth*, some emerging markets, constrained by the weak demand conditions in the advanced economies and their own supply-side impediments, may find it difficult to regain faster growth momentum. *Fifth*, the still fluid political environment in the Middle East and heightened geopolitical tensions in some parts of the world may pose a threat to oil prices and international trade flows. In sum, there are still downside risks to the global economic outlook for 2014.

2.18 On the positive side, if the Federal Reserve could better communicate its policy intention while the US economy recovering better than expected, the global financial conditions could be more stable during the course of its tapering. This would help minimize the negative impacts on global economic and financial stability. Also, if the US Congress makes use of the time gained by the recently passed budget deal to craft out a credible plan to address long-term fiscal sustainability, another key risk to the global economy would be removed. In a similar vein, if Europe's policy leaders, building on the progress in creating a banking union over the past year or so, continue to take decisive actions to strengthen the institutions of the monetary union, this would boost global confidence in Europe and help stimulate growth there. There could also be some upside potential if the Mainland and other major emerging market economies turn out to perform better than expected, thereby providing a stronger support to the global economy.

Outlook for the Hong Kong economy in 2014

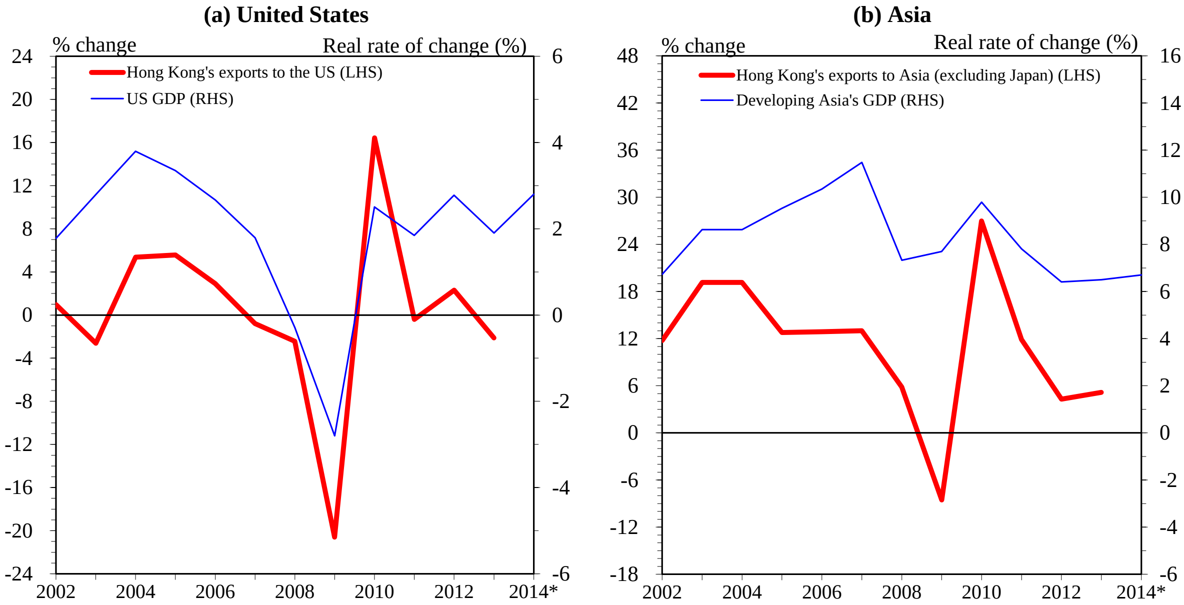
2.19 As a small open economy, Hong Kong's economic performance will hinge crucially on the global economic and financial conditions. If the global economic expansion gains more traction alongside the pick-up in import demand from the advanced economies, and if the Fed steers the tapering at a measured pace with a clear communication strategy, minimising its impact on the emerging market economies, Hong Kong's *total exports of goods* should improve somewhat further in 2014.

Diagram 2.5 : Hong Kong's exports of goods should show modest acceleration in 2014



Source : IMF World Economic Outlook Update January 2014.
(*) Forecast from the IMF.

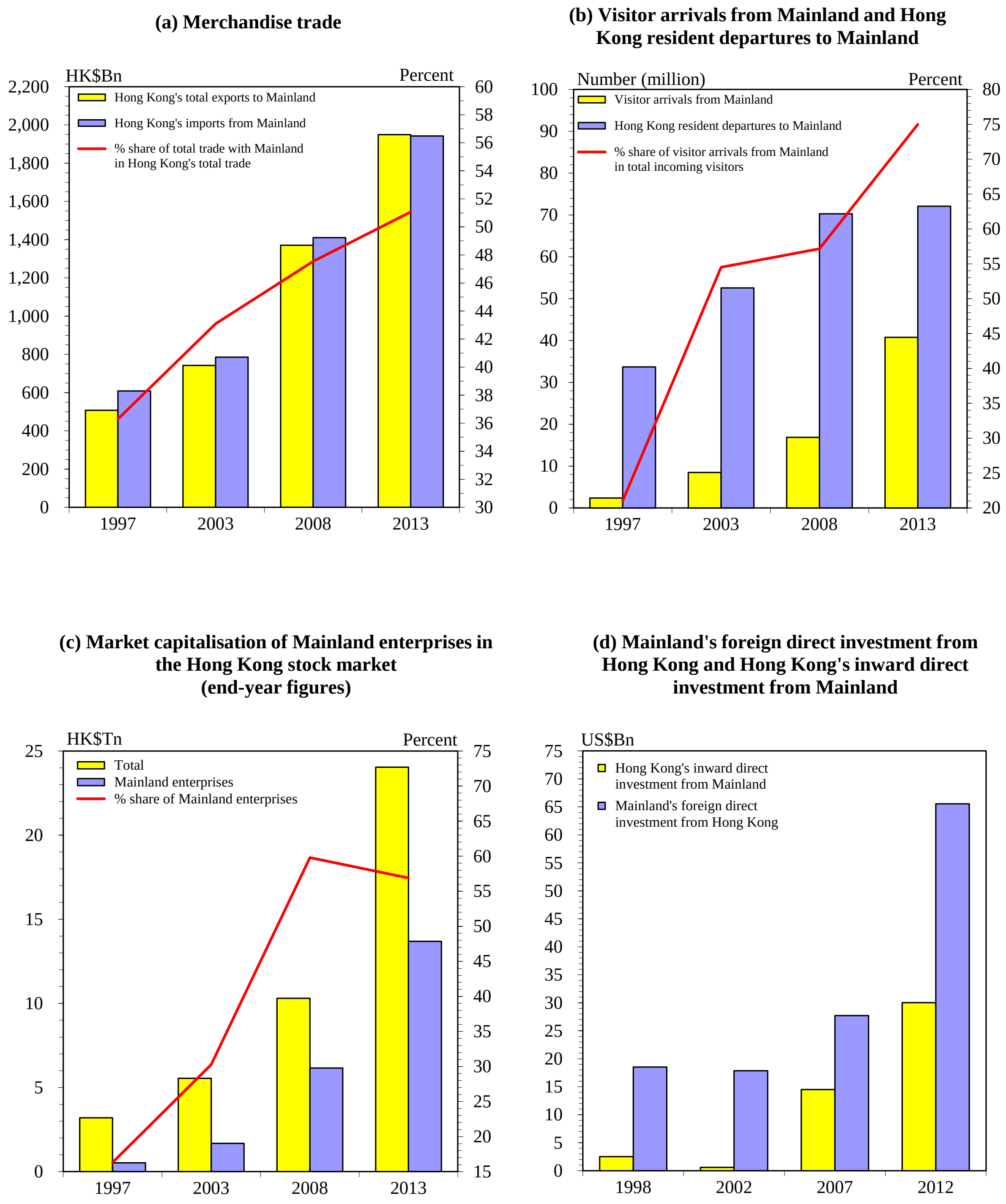
Diagram 2.6 : Regional trade should continue to be supported by the solid growth of the Mainland economy



Note : (*) Forecasts from the IMF World Economic Outlook Update, January 2014.

2.20 *Exports of services* should extend further gains in 2014. In particular, the inbound tourism will likely maintain rather notable growth, driven by the influx of visitors from the Mainland. Exports of financial and business services should benefit from stronger fund-raising and cross-border financial activities and pick up further. Meanwhile, exports of trade-related services, comprising mostly offshore trade, and exports of transportation services, should also stage some relative improvement, the extent of which hinges on the strength of regional and international trade flows.

Diagram 2.7 : The Mainland factor will continue to support the Hong Kong economy



2.21 *Domestic demand*, a resilient growth driver, should be able to hold up in 2014, even though the pace may not be as fast as in the past few years. Specifically, the positive hiring sentiment reported in the latest Quarterly Business Tendency Survey and the stable employment conditions among the small and medium-sized enterprises (SMEs) should bode well for labour market outlook in the near term, thereby lending support to the local consumption market. As for investment, public infrastructure works are expected to stay hectic. Machinery and equipment acquisition is poised to further growth in tandem with the general pick-up in business activity, though they are typically volatile and sensitive to swings in the external environment. Indeed, given the uncertain path of US monetary policy and its potential negative impacts on the global economic and financial conditions, it is important to stay vigilant to the possibility of large financial and asset markets fluctuations, which may dampen consumer and business sentiments.

Diagram 2.8 : Private consumption should be supported by the still favourable labour market conditions

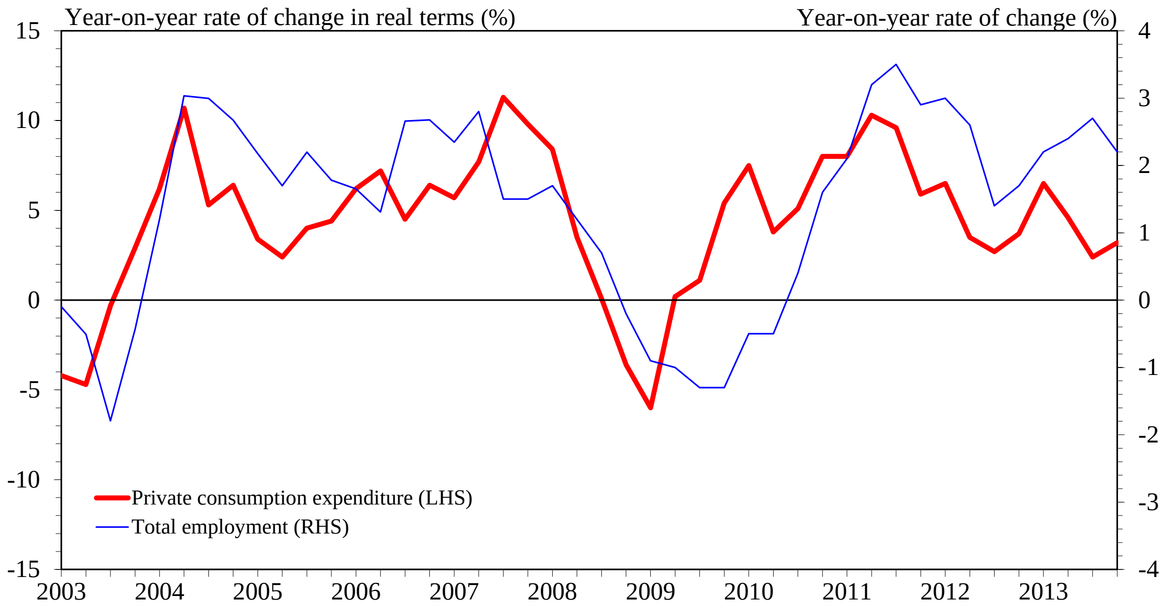


Diagram 2.9 : Consumer sentiment may be affected by asset market performance

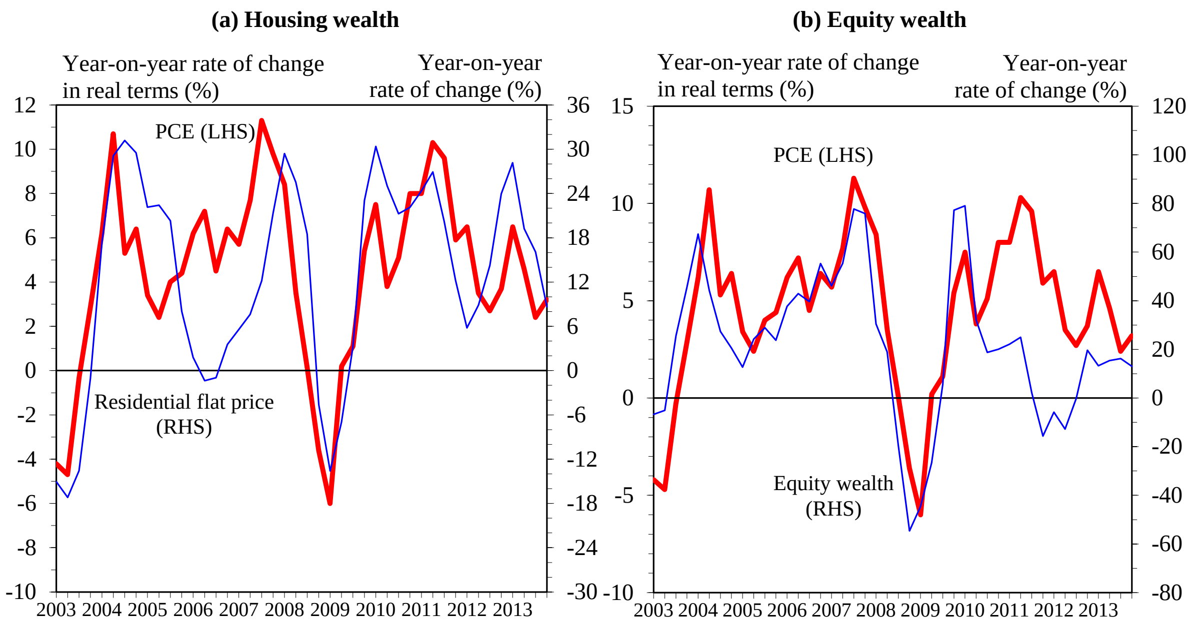
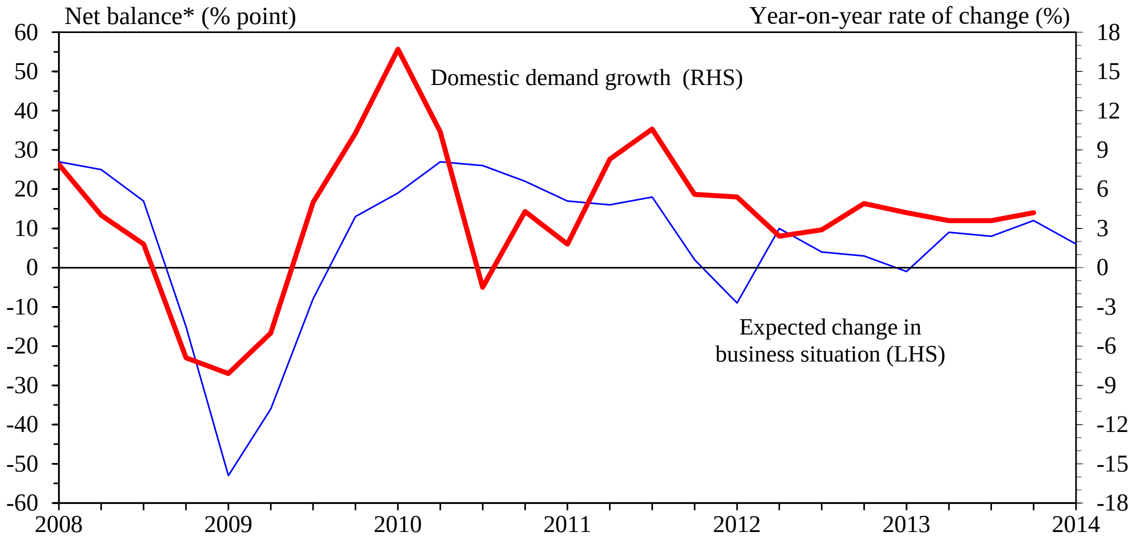
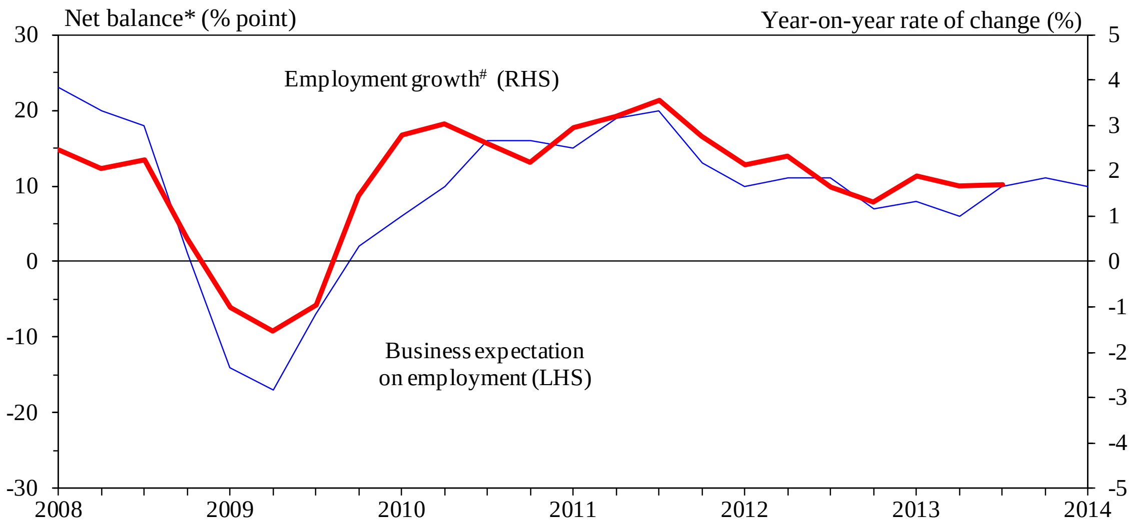


Diagram 2.10 : Sanguine business sentiment should help sustain domestic demand growth



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.

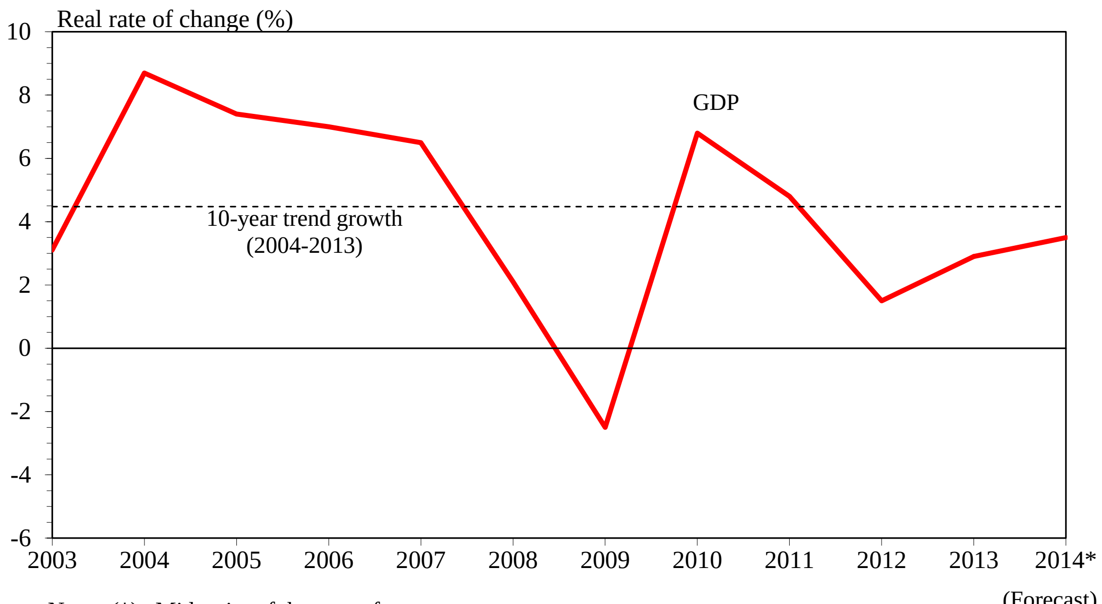
Diagram 2.11 : Hiring sentiment stays positive



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.

2.22 Taking into account the likely improvement in export growth, the Hong Kong economy is projected to expand by 3-4% in 2014, after the 2.9% growth in 2013. This would still be slightly lower than the average growth of 4.5% in the past ten years. Compared with the previous two years, the range of the forecast is reduced back to the normal range of one percentage point, reflecting notably reduced acute risks from the US fiscal and euro debt problems over the past year. The prevailing forecasts by the private sector analysts mostly fall within the range of 3-4%, averaging around 3.6%. The official forecast is built on the assumptions that the US economic recovery could make further progress with smooth tapering by the Fed causing no significant disturbance to global financial stability, while the slow eurozone recovery would continue. The major downside would come from the possible volatile global financial conditions, as financial strains arising from shifts in US monetary policy could re-surface again and develop quickly to hamper global real activity. The possibility for the progress of the advanced economies to stall or even set back, though diminishing, also cannot be ruled out. On the other hand, there could be some upside potential to the forecast, should the global economic recovery pick up better than expected and create a more favourable environment, or Asia's domestic demand provides more powerful support to intra-regional trade to the benefit of Hong Kong.

Diagram 2.12 : Economy expected to grow moderately further

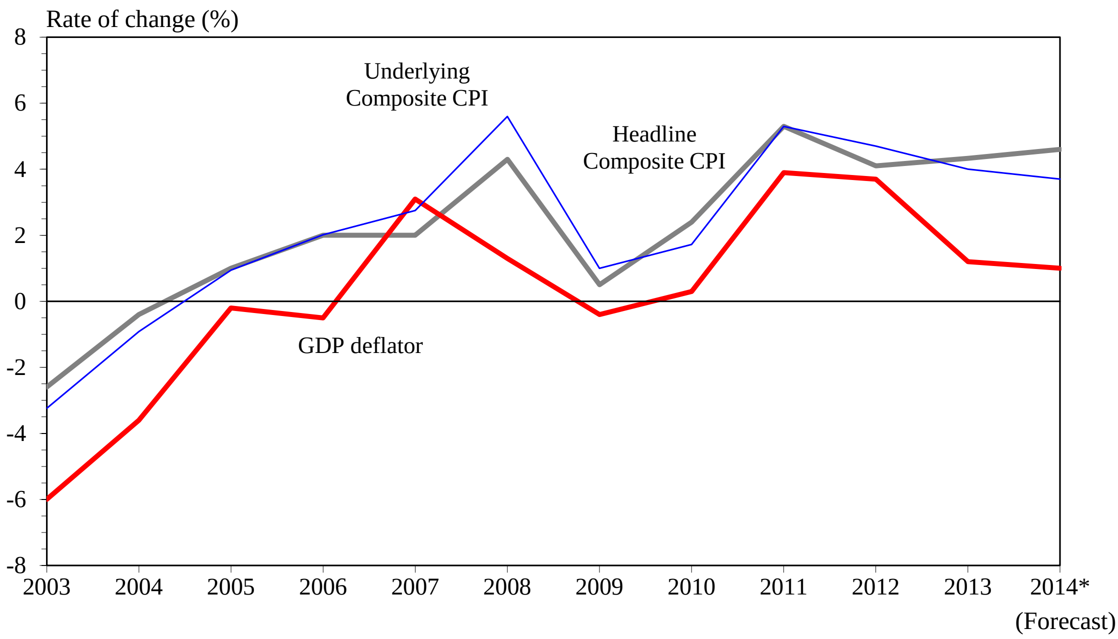


Note : (*) Mid-point of the range forecast.

2.23 Underlying inflation in Hong Kong has declined from 5.3% in 2011 to 4.7% in 2012 and further to 4.0% in 2013. The easing trend will likely continue in 2014. Externally, the still-pronounced excess capacity in the advanced economies and the tame inflation outlook of Hong Kong's major trading partners should help reduce price pressures from imports. The mild increase in global food prices recently is also a favourable development for our food inflation. Domestically, the movements of private housing rentals, a major contributor to inflation in the previous year, should become more favourable as the much moderated rise in fresh-letting flat rentals in the past few quarters successively feeds through. Barring unforeseen spikes in international commodity prices, *underlying Composite CPI* is forecast to increase by 3.7% for 2014 as a whole, slightly lower than the average of 4.0% in 2013. Taking into account the effects of the Government's one-off measures, *headline*

Composite CPI is forecast to increase by 4.6% in 2014, after 4.3% in 2013. The *GDP deflator* is forecast to rise by 1%, largely on account of the expected modest increase in domestic prices and the likely change in the terms of trade.

Diagram 2.13 : Inflation is expected to remain stable in 2014



Forecast rate of change in 2014 (%)

Gross Domestic Product (GDP)

Real GDP	**3 to 4**
Nominal GDP	4 to 5
Per capita GDP, in real terms	2.1 to 3.1
Per capita GDP at current market prices	HK$304,500-307,400 (US$39,000-39,400)

Composite Consumer Price Index

Headline	**4.6**
Underlying	**3.7**

GDP Deflator	**1**

Forecast on Hong Kong's GDP growth in 2014 recently made by other selected parties

	(%)
The University of Hong Kong	3.3 to 4.1
Average forecast by private sector analysts#	3.6

Note : (#) Forecast GDP growth rates by private sector analysts mostly fall between 3% and 4%.

Medium-term outlook for the Hong Kong economy

2.24 Over the medium term, challenges arising from the hangovers of the global financial crisis could stay and continue to evolve (see ***Box 2.3***). Given notable weak fundamentals and continued efforts of fiscal retrenchment, the European and Japanese economies are likely to remain on a slow-growing path with non-negligible risks of setbacks in the coming years. The US economy may perform comparatively better, now that the private sector demand there has been recovering. However, the policy risks arising from the normalisation of the monetary policy and attaining long-term fiscal sustainability will remain, with possible negative spill-over to the rest of the world, especially the emerging markets. Years of underinvestment in infrastructure and persistent high long-term unemployment after the global financial crisis may also have undermined the growth potential of the advanced economies beyond the near term.

2.25 Emerging markets, with their stronger underlying growth potential, should remain the key growth drivers of the world in the coming years. Nonetheless, their growth pace will also likely be more moderate than in the past given the external and domestic constraints. Moreover, those economies with weaker financial systems and larger external imbalances could be more susceptible to the possible shocks brought about by the unwinding of monetary stimulus in the advanced economies.

2.26 Against the lower growth potential of major advanced economies, the Mainland will remain our primary sources of growth opportunities, and the opportunities could be grasped by strengthening economic ties between Hong Kong and the Mainland and by positioning Hong Kong in line with the nation's economic reform agenda. The Government has constantly sought ways to forge deeper economic integration with the Mainland through the CEPA and other Government-to-Government platforms, via which Hong Kong service providers could tap the ever-growing markets amid the nation's rebalancing the economy towards consumption and services. The endeavour of developing Hong Kong into a leading offshore RMB business centre and asset management centre has made visible progress and the efforts will continue, realising the role laid out in the dedicated chapter of National 12th Five Year Plan. Sweeping economic reforms and opening-up in the coming years, as set out by various decisions passed by the Third Plenary Session of the 18th Central Committee of the Communist Party of China, will create new demand for high-end services, which our highly efficient service sectors are well-positioned to take advantage of. In sum, the combination of Mainland factor and the qualities of a worldclass international financial and business hub offered by the "One Country, Two Systems" will remain our biggest competitive edge to develop our economy in the face of possible extended sluggishness of the advanced economies and other external uncertainties.

2.27 Domestically, the Government will continue its efforts in upgrading human capital and physical infrastructure to maintain Hong Kong's competitiveness. Large-scale infrastructure construction will continue to proceed intensively in the coming few years, adding impetus to domestic demand growth. However, the working age population has already been growing at a slower pace amid an ageing population, and the effects of the demographic shift will turn more apparent over time and restrain Hong Kong's medium to longer-term growth. Taking into account the lingering external challenges, the still-bright Mainland's prospect as well as Hong Kong's advantages and demographic challenges, the economy is expected to attain a trend growth of 3.5% per annum from 2015 to 2018.

2.28 Productivity growth in Hong Kong will continue to come from the shift of Hong Kong towards higher value added and knowledge-based economy. Although this structural shift is important in sustaining Hong Kong's competitiveness and hence longer-term development, there are also concerns about the possible implications for income and wealth disparities. While an ageing population will cause the issue of labour shortages to become even more prominent and constrain economic growth, it also has profound implications for our public expenses on healthcare and other social services. In view of all these, it is important to continue to exercise fiscal prudence, so as to preserve our ability and ensure sufficient public resources to invest in infrastructure and human capital to drive the economy and also to tackle the social issues through various programmes.

Box 2.3

Medium and long-term growth outlook of major economies

The recovery in major advanced economies have been slow and unstable in the past five years, reflecting the profound legacies of high unemployment levels, excess capacity and weighty debt burdens left by the financial meltdown of 2008. Despite the improved outlook for 2014, activity in many advanced economies further down the road will likely be constrained if these issues are not addressed by fundamental reforms promptly. Besides, the new challenges arising from US monetary policy shifts and slower trend growth of emerging market economies have also surfaced. Coupled with the global population ageing headwinds in the longer term, there are concerns that the more volatile and less growth-supportive external landscape post-financial-tsunami would become a new norm.

The journey of recovery in the euro area is still fraught with difficulties, as fiscal retrenchment will likely continue for a few years given that the public debt loads of many member states still exceed targets and as the weak credit dynamics could pose further obstacles to the private demand recovery. Consumers in the region may also stay frugal unless the labour market recuperation accelerates. Further ahead, the labour market rigidity and other structural problems could add friction to the recovery, while the much-needed reforms to rebuild fundamentals could confront notable political resistance amid growth sluggishness. Although the policy initiatives taken by the EU leaders to resolve the debt problems in the past few years are steps in the right direction, the eurozone is still not totally out of the woods, and there is still a long way to go to establish a robust monetary union to avoid renewed financial distress in future. Hence, the EU Commission, the IMF and most private analysts forecast the real GDP to grow by around 1.5% per year between 2015 and 2018, which is lower than the average rate in the decade before 2008 (***Chart 1a***).

By comparison, the US economic recovery has stronger support deriving from improving fundamentals in the housing market, quick adjustments of financial institutions' balance sheets, and growing benefits from the shale gas revolution. However, the optimism has to be qualified by the still-slow job recovery featured by fits and starts, the possibility of further deleveraging by households and the absence of a medium-term fiscal consolidation plan. Apart from these problems, the US growth potential in the longer term will likely fall due to slower increases in labour force and productivity amidst population ageing, a common formidable challenge to many economies in the next decade. As such, the IMF, the Congressional Budget Office, the Federal Open Market Committee (FOMC) participants and most private analysts generally forecast a further acceleration of US economic growth in the coming two to three years, followed by a gradual convergence to a lower longer-term potential growth rate (***Chart 1b***).

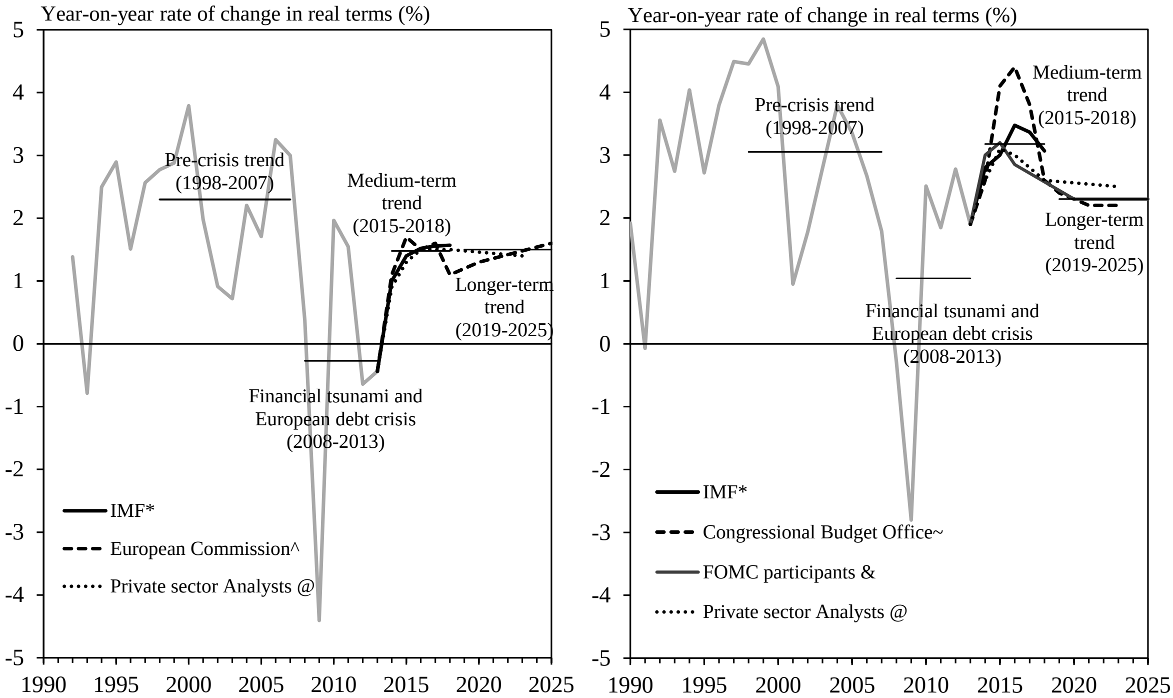
Moreover, the expected acceleration of US economic growth in the near term aforementioned is a mixed blessing, as it would be accompanied by a narrowing output gap and thereby growing risks of monetary stimulus exit and the initiation of the interest rate hikes. At this stage, the Fed seemingly prefers gradualism, but the ultimate exit strategy will actually be contingent on US economic performance as well as price stability. The impacts on global financial conditions and real activity in the coming years over the course of the Fed's monetary policy normalisation are still uncertain, depending on the speed of the Fed's exit and the clarity of its communication, the cyclical positions of other economies, and the capability of the emerging markets in contending with capital flow volatility and rising interest rates.

Box 2.3 (Cont'd)

Chart 1 : Longer-term GDP growth projections for the US and euro area

(a) Euro-area growth on balance is expected to stay below the pre-crisis level

(b) US growth is expected to accelerate first before converging to a lower trend growth



Source: (*) World Economic Outlook October 2013 and January 2014 Update; (^) European Commission 2012 Fiscal Sustainability Report and Autumn 2013 European Economic Forecast; (~) Congressional Budget Office Economic Baseline Projections, February 2013; (@) Consensus Economics October 2013 and February 2014; and (&) FOMC projection materials, December 2013 meeting

As the recipients of massive excess liquidity, emerging market economies are exposed to the risks of capital flow reversals, tighter financial conditions and slowdown in real activity during the Fed's exit to its unconventional monetary easing, with economies having lax financial supervision and large external imbalances being more vulnerable. Apart from global monetary risks, the performance of export-oriented emerging economies, including those in Asia, may still be constrained by the sub-par recovery of many advanced markets. With a more volatile capital flow environment, a less buoyant external demand, compounded by supply-side bottlenecks in individual countries, the trend growth of emerging markets as a group is likely to moderate in the coming years, according to the IMF, to around 5.4% per year between 2015 and 2018, which should still outpace their developed peers and remain the world's growth pillar.

The Mainland should continue to be an important anchor for the world economy. Economic reforms in a wide range of areas will be deepened, aiming at rebalancing the economy towards an intensive growth model propelled by productivity gains. Decisive reform results in important fields are expected to be achieved by 2020, through which the nation's long-term growth sustainability would be enhanced. Given the strong underlying fundamentals, and the anticipation of new potential unleashed by reforms, the IMF envisaged that the Mainland will grow by around 7 percent per year between 2015 and 2018. Such a solid and robust growth, though lower than the double-digit pace in the past decade, would still be among the highest in the global league, making it a vital stabilising force to the global economy in the medium to longer term.

2.29 Over the medium term, the upside risks to inflation still should not be taken lightly in view of the global liquidity glut and substantial uncertainties surrounding global monetary policies and economic performance. Government's efforts in increasing land and housing supply must continue, so as to expand Hong Kong's economic growth capacity and also help contain domestic inflation risks in the years to come. In particular, in the unlikely event that the global economic expansion proceeds faster than expected, any delay by central banks in the advanced economies in draining the excess liquidity could lift international commodity prices and worldwide inflation quickly and pose renewed upside risks to Hong Kong's inflation outlook. Taking these factors together, the trend rate of change in the underlying CCPI in Hong Kong for the four years from 2015 to 2018 is forecast at 3.5% per annum.

Diagram 2.14 : Medium term economic prospects slightly below past trend