

CHAPTER 1 : OVERVIEW OF ECONOMIC PERFORMANCE

Summary

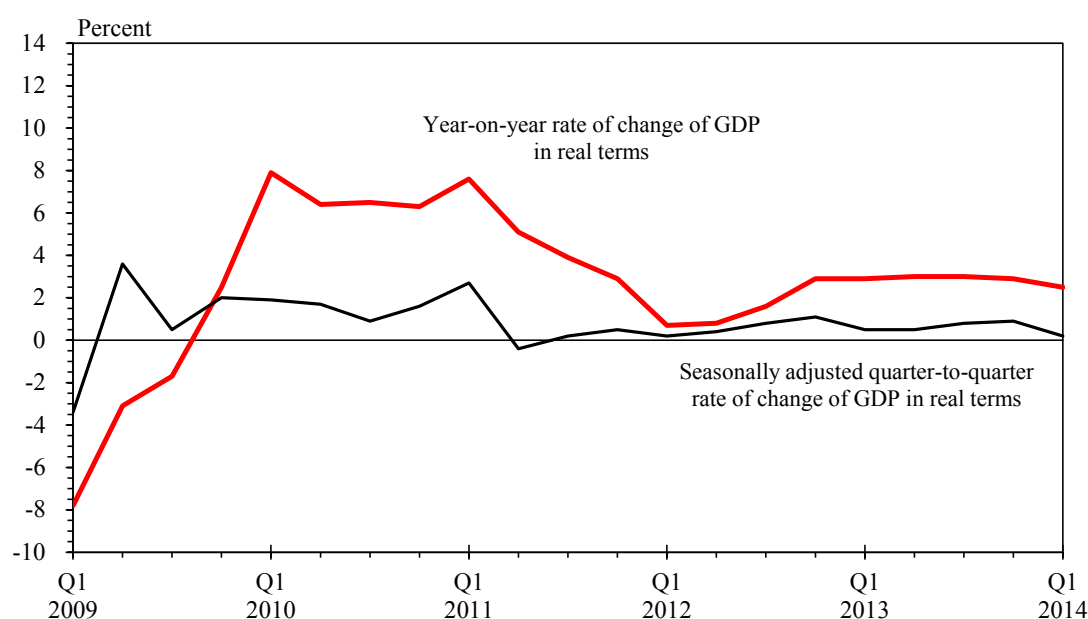
- *Hong Kong's economic growth remained moderate in the first quarter of 2014, at 2.5% year-on-year in real terms. Merchandise exports were sluggish, reflecting the slow improvements in the advanced markets. Nevertheless, services exports and the domestic sector kept expanding, thereby maintaining the labour market in a state of full employment.*
- *The pace of global economic expansion was somewhat disappointing in the first quarter, despite an improved outlook for the year as a whole. Growth in total exports of goods moderated visibly in real terms in the first quarter. Exports to major advanced markets were weak at the start of the quarter, though with a visible pick-up in March. Added to this was the lacklustre performance of major Asian markets during most of the quarter. Exports of services also slowed, dragged by the subdued performance of trade-related and transportation services, though inbound tourism still showed appreciable growth.*
- *On the domestic front, private consumption expenditure grew further. Investment expenditure increased moderately, with the notable growth in overall building and construction expenditure providing the major driving force. Machinery and equipment acquisition grew slightly after several quarters of robust growth. The latest survey showed that business sentiment among large enterprises stayed largely positive.*
- *The labour market stayed tight, as evidenced by the sustained low unemployment and underemployment rates, as well as the high level of private sector vacancies. On the back of the persistently tight manpower resource balance, wages and earnings sustained real improvements for 2013 as a whole. Grassroots workers continued to enjoy solid earnings growth in the first quarter of 2014.*
- *The local stock market underwent some correction in the first quarter, reflecting impacts of various external developments, including the shifting sentiment on emerging markets amid Fed's tapering, concerns over Mainland's growth slowdown and the geopolitical risks surrounding Eastern Europe. The residential property market stayed quiet, with both prices and rentals going lower during the first quarter.*
- *Inflation eased slightly in the first quarter, as external price pressures stayed tame and local rental pressures continued to recede. The upside risks to inflation remain contained in the near term.*

Overall situation

1.1 The Hong Kong economy expanded moderately in the first quarter of 2014 over a year earlier, in the absence of stronger support from the external front. The US economy lost some steam on entering 2014 due to adverse weather conditions, while the recovery in Europe continued at a slow pace. The US Federal Reserve (Fed) began to taper asset purchases in January, adding volatility to the global financial conditions and negatively affecting those emerging market economies with higher inflation and larger external imbalances. Geopolitical risks also increased recently in some parts of the world, though this had not yet affected the global economy in any significant way. Against this background, trading and production activities in Asia were generally lacklustre in the first quarter. The Mainland's export performance was also not immune to these developments, although its overall economy stayed comparatively resilient. As part of a regional phenomenon, the performance of Hong Kong's merchandise exports was rather sluggish in the first quarter. Exports of services also slowed, dragged by the subdued performance of trade-related and transportation services, but still achieving moderate growth overall as inbound tourism maintained notable growth pace. This together with the further moderate growth of domestic demand helped support a full-employment situation in the labour market. Underlying consumer price inflation eased slightly in the first quarter amid subdued imported inflation and fading rental cost pressures.

1.2 In the first quarter of 2014, *Gross Domestic Product* (GDP)⁽¹⁾ grew by 2.5% in real terms over a year earlier, slightly slower than that of 2.9% in the preceding quarter (revised from the earlier estimate of 3.0%). On a seasonally adjusted quarter-to-quarter comparison⁽²⁾, real GDP grew slightly by 0.2% in the first quarter, after the 0.9% growth in the preceding quarter (revised from the earlier estimate of 1.1%).

Diagram 1.1 : Economic growth remained moderate in the first quarter of 2014



The external sector

1.3 *Total exports of goods* compiled under the GDP accounting framework slowed to a 0.5% year-on-year growth in real terms in the first quarter, after the 5.7% rise in the preceding quarter. This was in part due to the moderation in exports of non-monetary gold after the strong growth in the previous quarters. The decline in exports to the US and the EU at the start of the year was another factor, due to the sluggishness of the advanced economies, especially the US, which was temporarily disrupted by the adverse weather conditions. The weak demand conditions in the advanced economies also weighed on the regional trade flows in Asia, worsening the performance of Hong Kong's exports to major Asian markets. Nevertheless, as the weather-related effects on the US economy abated and the eurozone recovery continued, exports to these two markets picked up visibly in March, resulting in moderate growth for the quarter as a whole.

1.4 *Exports of services* also slowed, growing by 3.1% in real terms over a year earlier, moderated from the 4.7% growth in the preceding quarter. The main drag came from the setback in exports of trade-related services and transportation services amid sluggish trade flows. On the other hand, thanks to the sustained brisk expansion of inbound tourism, exports of travel services grew notably further, staying as the key driving force for overall services exports. Exports of financial and other business services also expanded further, partly driven by fund raising activity.

**Table 1.1 : Gross Domestic Product, its main expenditure components
and the main price indicators
(year-on-year rate of change (%))**

| | <u>2012[#]</u> | <u>2013[#]</u> | <u>2013</u> | | | | <u>2014</u> |
|--|-------------------------|-------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|
| | | | <u>Q1[#]</u> | <u>Q2[#]</u> | <u>Q3[#]</u> | <u>Q4[#]</u> | <u>Q1[±]</u> |
| <i>Change in real terms of GDP and its main expenditure components (%)</i> | | | | | | | |
| Private consumption expenditure | 4.1 | 4.3 | 6.3 (2.9) | 4.7 (-0.9) | 2.7 (-0.2) | 3.6 (1.8) | 2.0 (1.1) |
| Government consumption expenditure | 3.6 | 2.3 | 1.9 (*) | 3.1 (1.8) | 2.3 (*) | 2.0 (0.3) | 2.4 (0.4) |
| Gross domestic fixed capital formation | 6.8 | 3.3 | -3.0 | 7.6 | 2.7 | 5.3 | 3.0 |
| <i>of which :</i> | | | | | | | |
| Building and construction | 7.2 | -0.9 | -1.5 | -0.7 | 3.1 | -3.8 | 10.2 |
| Machinery, equipment and intellectual property products | 10.1 | 10.8 | -4.4 | 19.8 | 7.6 | 17.5 | 1.4 |
| Total exports of goods | 1.8 | 6.6 | 8.8 (1.5) | 6.1 (-1.4) | 6.1 (3.2) | 5.7 (2.1) | 0.5 (-3.4) |
| Imports of goods | 3.0 | 7.4 | 9.5 (3.4) | 7.6 (-1.7) | 6.6 (1.7) | 6.1 (2.3) | 1.2 (-0.6) |
| Exports of services | 2.2 | 5.5 | 4.7 (1.8) | 7.7 (3.3) | 5.0 (-2.9) | 4.7 (2.6) | 3.1 (0.2) |
| Imports of services | 1.9 | 2.0 | 0.3 (1.1) | -0.7 (-1.1) | 2.6 (1.7) | 5.5 (3.7) | -0.2 (-4.4) |
| Gross Domestic Product | 1.5 | 2.9 | 2.9 (0.5) | 3.0 (0.5) | 3.0 (0.8) | 2.9 (0.9) | 2.5 (0.2) |
| <i>Change in the main price indicators (%)</i> | | | | | | | |
| GDP deflator | 3.7 | 1.4 | 1.8 (-0.7) | 0.6 (*) | 1.6 (1.7) | 1.5 (0.5) | 2.0 (-0.1) |
| Composite CPI | | | | | | | |
| Headline | 4.1 | 4.3 | 3.7 (1.1) | 4.0 (1.3) | 5.3 (-0.8) | 4.3 (2.7) | 4.2 (1.0) |
| Underlying[^] | 4.7 | 4.0 | 3.8 (1.1) | 3.9 (1.1) | 4.3 (0.8) | 4.0 (1.0) | 3.8 (0.9) |
| <i>Change in nominal GDP (%)</i> | 5.3 | 4.3 | 4.8 | 3.6 | 4.6 | 4.4 | 4.6 |

Notes : Figures are subject to revision later on as more data become available. Seasonally adjusted quarter-to-quarter rate of change is not applicable to gross domestic fixed capital formation, as no clear seasonal pattern is found for the category due to the presence of considerable short term fluctuations.

(#) Revised figures.

(+) Preliminary figures.

() Seasonally adjusted quarter-to-quarter rate of change.

([^]) After netting out the effects of Government's one-off relief measures.

(*) Change within $\pm 0.05\%$.

Box 1.1

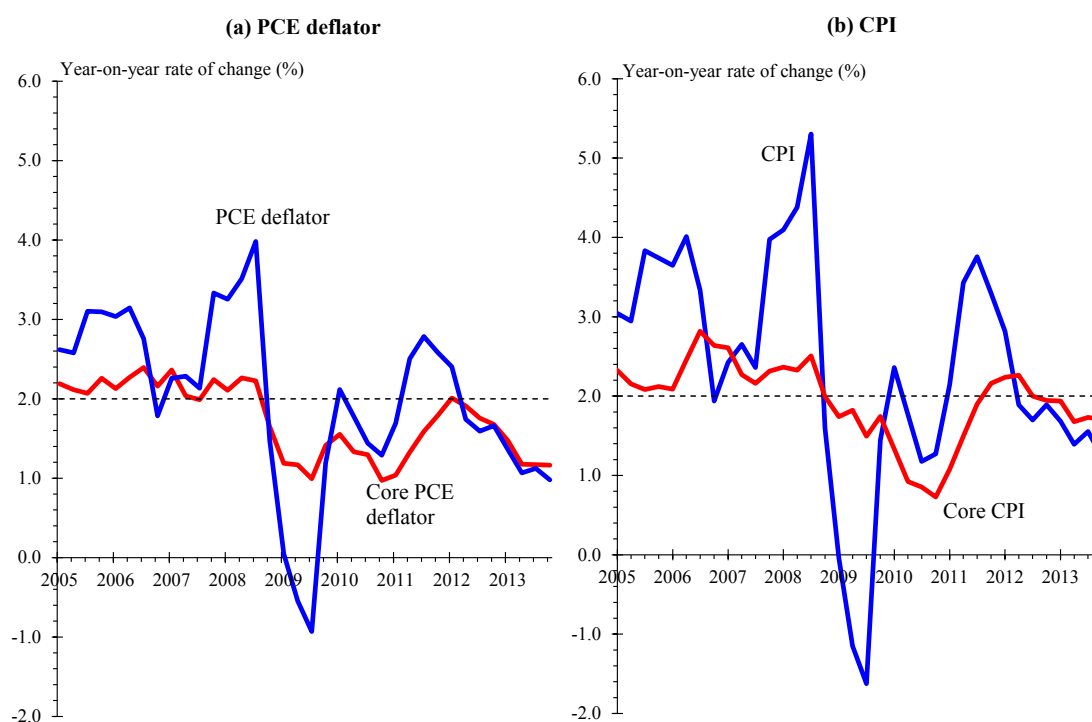
Recent inflation situation in the US

The future path of the US monetary policy is a key source of uncertainty facing the global economy. This note discusses the recent inflation trend in the US, which matters because, together with the range of labour market indicators, it drives the US Federal Reserve (Fed)'s policy, under the dual mandate of the Fed to maximise employment and maintain price stability.

The Fed's recent policy statements reveal its concern on the ongoing low inflation. Indeed, the increase in the personal consumption expenditures (PCE) deflator, the Fed's preferred measure of inflation, has been running below the policy target of 2% since 2012 (**Chart 1a**). Core PCE inflation, which excludes the more volatile food and energy components and hence serves as a better guide for policy decision, has likewise been subdued. The consumer price index (CPI) also showed similar movements (**Chart 1b**). Conceivably, the low inflation stemmed from the great recession of 2008-2009, which slowed income growth and dampened consumption demand. The IMF estimated in April 2014 that the slack in the US economy would remain significant in 2014, with an output gap amounting to 3.3% of the GDP.

Analysed by the aggregate components of the PCE deflator, the price increase for the services component averaged 3.3% per annum during 2005 to 2008, more than offsetting the average annual 1.6% price decline for durable goods, thereby supporting the core PCE inflation at 2.2% per annum before the great recession. However, during 2009 to 2013, the price increase for services averaged 1.9% per annum, while prices of durable goods deflated further, resulting in an average annual rate of only 1.5% for core PCE inflation.

Chart 1 : Inflation as measured by the PCE deflator and CPI

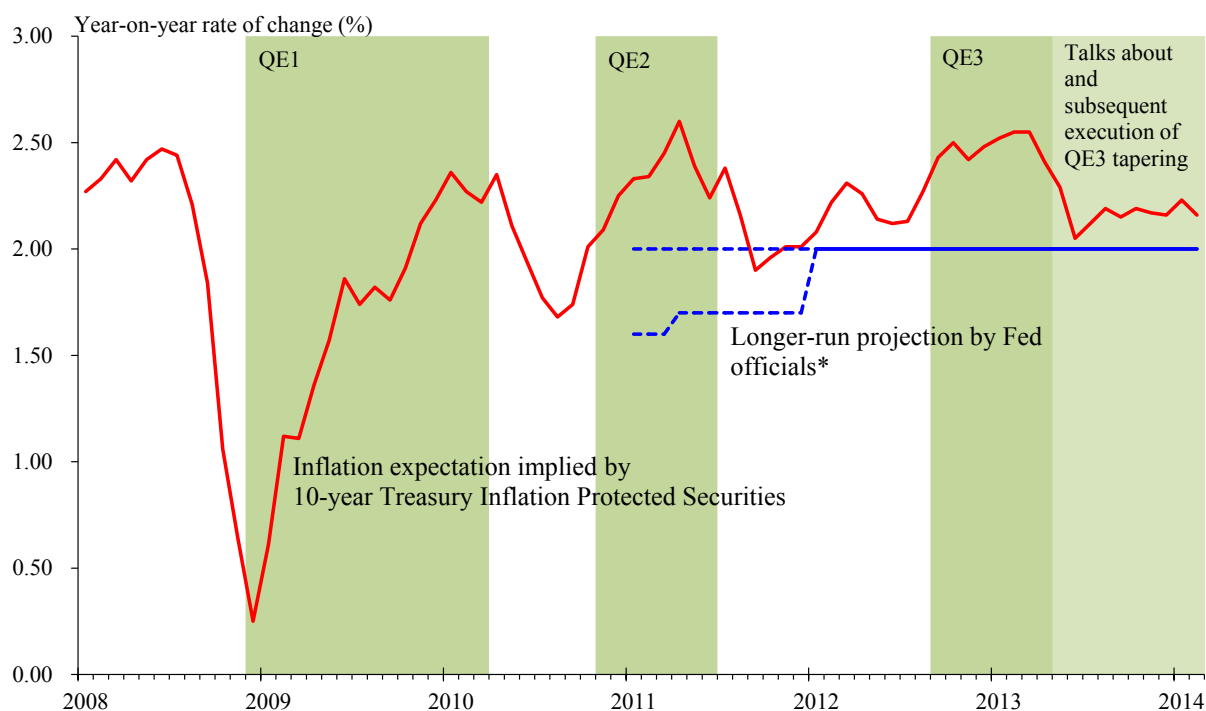


Box 1.1 (Cont'd)

Within the services component, housing, healthcare, and financial services and insurance are the three largest sub-components, accounting for around 60% of total services consumption. They have shown varied price trends recently, with inflation of healthcare and financial services and insurance moving down, and that of housing picking up. In the period ahead, cost-cutting efforts by healthcare providers may continue to rein in healthcare inflation, while housing rents may see slower increase as well given that housing supply has been rising while demand is overcast by the looming monetary tightening.

Notwithstanding these trends, the Fed still expects inflation to move towards 2%. Since January 2012 the Fed's projection of longer-run PCE inflation has remained at 2% (**Chart 2**), partly reflecting its judgement that the ongoing monetary stimulus would strengthen the economic recovery and help lift inflation. The implied inflation rate derived from the yields of Treasury Inflation Protected Securities (TIPS), a gauge of expected inflation, has been largely consistent with the Fed's view (**Chart 2**). Indeed, inflation expectation is seemingly affected by the Fed's policy, as evident by pick up in TIPS implied rate in periods with quantitative easing.

Chart 2 : Longer-term inflation expectation



Notes : (*) Projections by the Fed prior to 2011 are not available.

Projections in 2011 consisted of a range whilst later ones consisted of a point only.

In sum, with the TIPS implied rate hovering around 2.2% since mid-2013, the longer-term inflation expectation is still well anchored at around the Fed's inflation target, lending support to the continuation of the Fed's asset purchase tapering. However, should the actual inflation rate stay low in the period ahead and even drive down longer-term expectation, the Fed might need to slow down, or even reverse, its unwinding of monetary stimulus, given its mandate to maintain price stability. With the far-reaching implications of inflation developments in the US, it is worthwhile to monitor the situation closely.

The domestic sector

1.5 Domestic demand held steady. *Private consumption expenditure* grew further by 2.0% year-on-year in real terms in the first quarter of 2014. The somewhat slower growth was partly due to a high base of comparison in the same quarter of 2013 and partly affected by the difference in the timing of Easter holidays in 2013 and 2014. On a seasonally adjusted basis, private consumption expenditure grew solidly further, by 1.1% in the first quarter of 2014 over the preceding quarter. *Government consumption expenditure* also maintained steady growth at 2.4% in the first quarter.

**Table 1.2 : Consumer spending by major component^(a)
(year-on-year rate of change in real terms (%))**

| | | <i>Of which :</i> | | | | | | | |
|------|--------|---|------|----------|------------------|----------|-------------------------------------|---------------------|--|
| | | Total consumer spending in the domestic market ^(a) | Food | Durables | Non- durables | Services | Residents' expenditure abroad | Visitor spending | Private consumption expenditure ^(b) |
| 2013 | Annual | 6.5 | 4.6 | 6.9 | 14.9 | 3.1 | 6.5 | 17.3 | 4.3 |
| | H1 | 8.6 | 4.0 | 14.3 | 18.7 | 4.3 | 2.6 | 22.7 | 5.5 |
| | H2 | 4.4 | 5.3 | 0.4 | 11.4 | 2.0 | 10.3 | 12.7 | 3.2 |
| | Q1 | 8.5 | 4.2 | 27.9 | 11.4 | 4.0 | 5.1 | 17.9 | 6.3 |
| | Q2 | 8.8 | 3.7 | -0.2 | 26.1 | 4.6 | 0.2 | 27.6 | 4.7 |
| | Q3 | 4.7 | 5.2 | -0.7 | 12.6 | 2.3 | 6.6 | 15.0 | 2.7 |
| | Q4 | 4.2 | 5.4 | 1.3 | 10.5 | 1.7 | 14.2 | 10.7 | 3.6 |
| 2014 | Q1 | 3.3 | 3.0 | 4.1 | 6.4 | 1.8 | -0.1 | 7.9 | 2.0 |

Notes : (a) Consumer spending in the domestic market comprises both local consumer and visitor spending, which are not separable from the survey data.

(b) Private consumption expenditure is obtained by deducting visitor spending from the total consumer spending in the domestic market, and adding back residents' expenditure abroad.

Diagram 1.2 : Private consumption expenditure grew moderately further in the first quarter

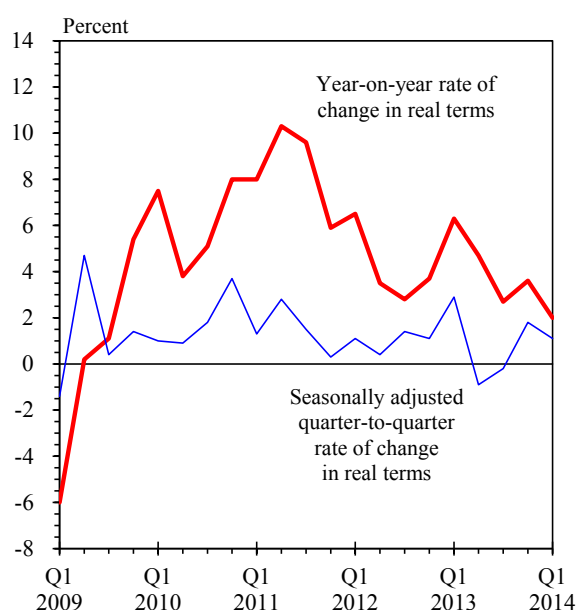
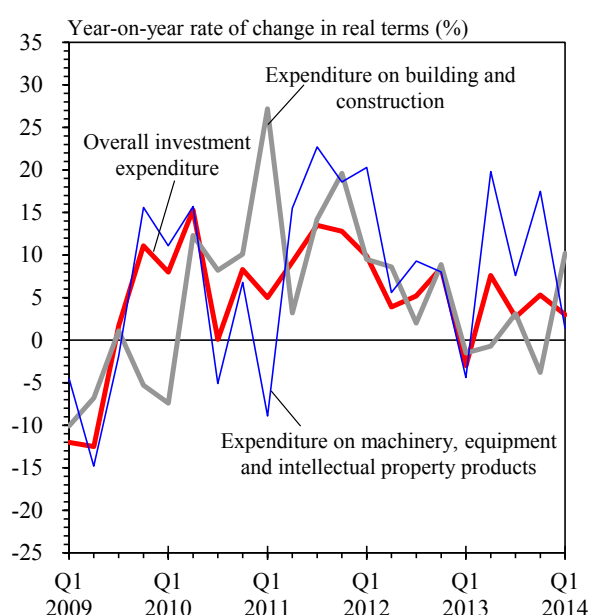


Diagram 1.3 : Investment spending also increased moderately



1.6 Overall investment spending in terms of *gross domestic fixed capital formation* increased moderately by 3.0% year-on-year in real terms in the first quarter, lower than the 5.3% growth in the preceding quarter. Within this, machinery and equipment acquisition, which was typically volatile, grew slightly by 1.4% after notable gains in the preceding three quarters. Business sentiment among large enterprises revealed by the latest Quarterly Business Tendency Survey remained broadly positive, although the sentiment among small and medium-sized enterprises (SMEs) was still more cautious (see **Box 1.2** for details of the consultation on SMEs). On the other hand, overall building and construction expenditure rebounded notably, as expenditure on large-scale infrastructure works rose markedly while private sector construction activity revived somewhat.

Box 1.2

Diffusion indices on small and medium-sized enterprises (an update)

To gain a better understanding of the current situation of business receipts, employment and credit access for small and medium-sized enterprises (SMEs)⁽¹⁾, an ad-hoc consultation exercise has been conducted by the Census and Statistics Department on behalf of the Economic Analysis and Business Facilitation Unit since late November 2008. In the recent past, the exercise has been conducted on a sample panel of around 400 SMEs. This note provides a further update of the results reported in *Box 1.1* in the *2013 Economic Background and 2014 Prospects*.

A set of diffusion indices is compiled to indicate the general directions of change in the respondents' views on business receipts, employment and new export orders versus the preceding month. The percentage of SMEs reporting tight access to credit is also reported. While the findings should be interpreted with considerable caution given the coverage and nature of the consultation exercise, they can serve as a rough indicator to enable high frequency monitoring of SMEs' situation.

Business receipts of the SMEs surveyed, as depicted by the set of diffusion indices, showed that the overall situation remained rather sluggish, but some sectors posted relative improvements in recent months (*Table 1*). In April 2014, the diffusion index for the real estate sector fell below 50 again, after rising above the boom-bust threshold of 50 in March, indicating the still-weak business situation amid the quiet property market. The readings for business services stayed above 50 and indicated some improvement, but those of retail trade and restaurants fluctuated and remained below 50. As regards the external segment, the diffusion index for the logistics sector softened, but that for the import/export trades edged higher to come close to the 50 mark. As to the employment situation, the feedback from SMEs indicated broadly stable development in recent months (*Table 2*).

Specifically for SMEs in the import and export sector, their views on new export orders were sought separately to help gauge the likely export performance in the near term. The diffusion index on new export orders inched higher to 50 in April, pointing to a more steady external demand condition as the major advanced economies seemed to show some pick-up after a slow start at the beginning of the year.

The proportion of SMEs reporting tight credit access, after rising briefly in early 2014, eased back to a low level of 0.9% in April, reflecting the generally accommodative monetary conditions and the Government's continued efforts to support SMEs through various loan guarantee schemes.

(1) Manufacturing enterprises with fewer than 100 employees and non-manufacturing enterprises with fewer than 50 employees are regarded as SMEs in Hong Kong.

Box 1.2 (Cont'd)

Table 1 : Diffusion indices[^] on business receipts

| | <u>2013</u> | | | | | | | | | <u>2014</u> | | | |
|-------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | <u>Apr</u> | <u>May</u> | <u>Jun</u> | <u>Jul</u> | <u>Aug</u> | <u>Sep</u> | <u>Oct</u> | <u>Nov</u> | <u>Dec</u> | <u>Jan</u> | <u>Feb</u> | <u>Mar</u> | <u>Apr</u> |
| <i>Local segments</i> | | | | | | | | | | | | | |
| Restaurants | 45.8 | 46.7 | 45.8 | 48.2 | 48.2 | 47.4 | 47.4 | 48.2 | 49.1 | 48.1 | 47.2 | 47.2 | 46.3 |
| Real estate | 38.2 | 42.6 | 44.1 | 44.1 | 35.3 | 35.3 | 41.2 | 36.8 | 44.1 | 42.4 | 42.4 | 54.5 | 48.5 |
| Retail trade | 47.6 | 47.6 | 47.1 | 49.0 | 50.0 | 49.0 | 47.5 | 48.0 | 49.0 | 47.4 | 49.1 | 47.4 | 48.2 |
| Wholesale trade | 44.4 | 50.0 | 47.1 | 41.2 | 44.1 | 47.1 | 50.0 | 44.1 | 47.1 | 44.7 | 44.7 | 50.0 | 50.0 |
| Business services | 43.9 | 48.5 | 48.5 | 45.5 | 43.9 | 45.5 | 50.0 | 48.5 | 53.0 | 47.0 | 51.6 | 51.6 | 53.1 |
| <i>External segments</i> | | | | | | | | | | | | | |
| Import/export trade | 49.0 | 50.0 | 50.0 | 48.1 | 47.6 | 48.5 | 49.0 | 49.5 | 49.0 | 47.9 | 48.3 | 48.7 | 49.6 |
| Logistics | 47.4 | 44.7 | 50.0 | 47.4 | 44.7 | 44.7 | 44.7 | 52.8 | 50.0 | 47.2 | 50.0 | 50.0 | 47.2 |
| All the above sectors* | 47.0 | 48.4 | 48.3 | 47.3 | 46.8 | 47.3 | 48.1 | 48.0 | 49.0 | 47.0 | 48.2 | 49.2 | 49.3 |

Notes : (^) The diffusion index is computed by adding the percentage of SMEs reporting “up” to one half of the percentage of SMEs reporting “same”. A diffusion index reading above 50 indicates that the business condition is generally favourable, whereas an index below 50 indicates otherwise. Respondents were requested to exclude seasonal effects in reporting their views.

(*) Weighted average using total number of SMEs in individual sectors as weights.

Table 2 : Diffusion indices on employment situation

| | <u>2013</u> | | | | | | | | | <u>2014</u> | | | |
|-------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | <u>Apr</u> | <u>May</u> | <u>Jun</u> | <u>Jul</u> | <u>Aug</u> | <u>Sep</u> | <u>Oct</u> | <u>Nov</u> | <u>Dec</u> | <u>Jan</u> | <u>Feb</u> | <u>Mar</u> | <u>Apr</u> |
| <i>Local segments</i> | | | | | | | | | | | | | |
| Restaurants | 49.2 | 50.0 | 48.3 | 50.0 | 50.0 | 49.1 | 49.1 | 49.1 | 48.2 | 49.1 | 49.1 | 49.1 | 49.1 |
| Real estate | 50.0 | 50.0 | 48.5 | 50.0 | 45.6 | 48.5 | 47.1 | 47.1 | 47.1 | 50.0 | 50.0 | 50.0 | 48.5 |
| Retail trade | 50.0 | 50.0 | 50.0 | 50.0 | 50.0 | 49.5 | 50.0 | 50.0 | 50.0 | 49.6 | 50.4 | 49.1 | 50.5 |
| Wholesale trade | 50.0 | 50.0 | 50.0 | 50.0 | 47.1 | 50.0 | 50.0 | 50.0 | 47.1 | 50.0 | 50.0 | 50.0 | 52.6 |
| Business services | 51.5 | 50.0 | 50.0 | 48.5 | 51.5 | 48.5 | 50.0 | 51.5 | 50.0 | 50.0 | 50.0 | 51.6 | 50.0 |
| <i>External segments</i> | | | | | | | | | | | | | |
| Import/export trade | 50.0 | 50.5 | 51.0 | 49.0 | 49.5 | 49.5 | 50.0 | 51.0 | 50.0 | 50.4 | 50.4 | 49.6 | 50.4 |
| Logistics | 50.0 | 50.0 | 47.4 | 47.4 | 50.0 | 47.4 | 47.4 | 50.0 | 50.0 | 50.0 | 50.0 | 50.0 | 50.0 |
| All the above sectors* | 50.1 | 50.2 | 50.1 | 49.3 | 49.5 | 49.3 | 49.7 | 50.3 | 49.5 | 50.0 | 50.2 | 49.7 | 50.3 |

Note : (*) Weighted average using total number of SMEs in individual sectors as weights.

Table 3 : Diffusion index on current new export orders

| | <u>2013</u> | | | | | | | | | <u>2014</u> | | | |
|---------------------|-------------|------------|------------|------------|------------|------------|------------|------------|------------|-------------|------------|------------|------------|
| | <u>Apr</u> | <u>May</u> | <u>Jun</u> | <u>Jul</u> | <u>Aug</u> | <u>Sep</u> | <u>Oct</u> | <u>Nov</u> | <u>Dec</u> | <u>Jan</u> | <u>Feb</u> | <u>Mar</u> | <u>Apr</u> |
| Import/export trade | 49.0 | 49.5 | 49.5 | 48.5 | 48.5 | 48.1 | 49.5 | 50.5 | 49.5 | 49.2 | 48.3 | 49.6 | 50.0 |

Table 4 : Percentage of SMEs reporting tight current access to credit

| | <u>2013</u> | | | | | | | | | <u>2014</u> | | | |
|-----------------------|-------------|------------|------------|------------|------------|------------|------------|------------|------------|-------------|------------|------------|------------|
| | <u>Apr</u> | <u>May</u> | <u>Jun</u> | <u>Jul</u> | <u>Aug</u> | <u>Sep</u> | <u>Oct</u> | <u>Nov</u> | <u>Dec</u> | <u>Jan</u> | <u>Feb</u> | <u>Mar</u> | <u>Apr</u> |
| All selected sectors* | 0.9 | 0.6 | 0.6 | 0.6 | 0.7 | 0.7 | 0.7 | 0.4 | 0.6 | 1.5 | 1.8 | 0.9 | 0.9 |

Note : (*) Weighted average using total number of SMEs in individual sectors as weights.

The labour sector

1.7 The labour market tightened up further in the first quarter of 2014 as labour supply edged down while total employment stayed near record high. Job vacancies in the private sector also attained further appreciable increases over a year earlier in the fourth quarter of 2013. As a result, the *seasonally adjusted unemployment rate* edged down to a 16-year low of 3.1% in the first quarter, while the *underemployment rate* likewise fell to 1.2%, the lowest since September-November 1997. Amid a state of full employment, wages and earnings saw further growth. Amid the tight manpower resource situation in the low-skilled segment and an additional boost from the upward adjustment of the Statutory Minimum Wage rate since May 2013, the average monthly employment earnings for full-time employees in the lowest decile group rose further by 4.6% in nominal terms or 0.3% in real terms in the first quarter of 2014 over a year earlier.

The asset markets

1.8 The *local stock market* underwent some correction in the first quarter amid the swaying sentiment towards emerging markets under Fed's tapering, signs of slower Mainland's growth momentum and the geopolitical risks surrounding Eastern Europe. The Hang Seng Index recovered some lost ground after mid-March amid expectation of further supportive measures by the Central Government to maintain solid economic growth. The Hang Seng Index ended the first quarter at 22 151, still 5% lower than end-2013. Average daily turnover rose to \$68.3 billion in the first quarter while fund-raising activity retreated compared with the preceding quarter.

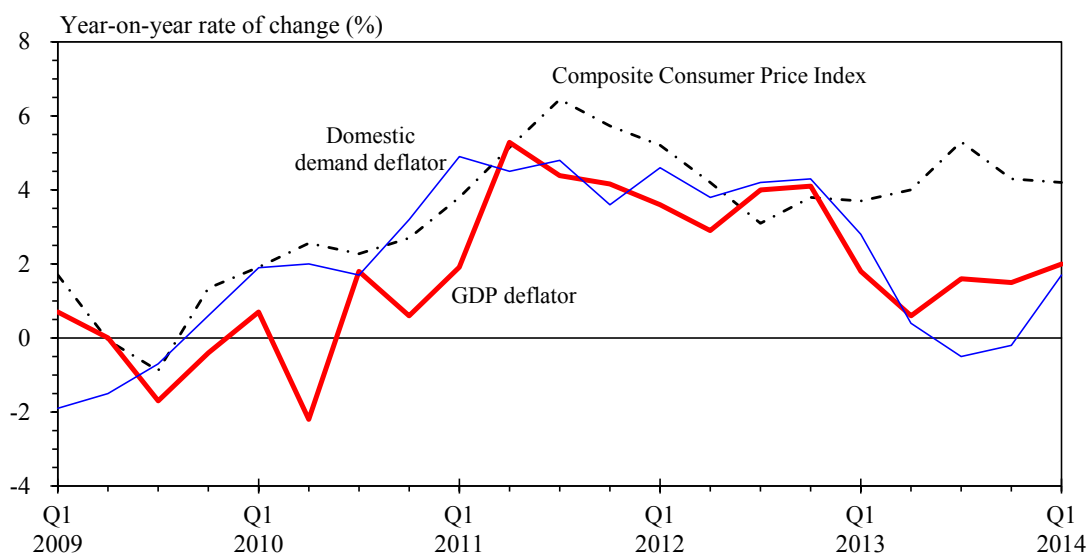
1.9 The *residential property market* stayed quiet in the first quarter amid uncertainty over future US monetary policy and Government's further demand management measures introduced in late February 2013. Trading volume during the first quarter fell further by 34% from a year earlier and by 9% from the preceding quarter. Residential property prices edged lower by 1% during the first quarter. Despite the consolidation in recent months, overall flat prices in March still exceeded the 1997 peak by 41%, with the housing affordability ratio staying elevated at around 56% in the first quarter. Flat rentals retreated by 1% during the first quarter. Meanwhile, office and shop rentals recorded little changes, indicating that the upward pressures in non-residential property market were also contained.

Inflation

1.10 Consumer price inflation eased slightly in the first quarter of 2014. Domestically, the increase in private housing rental component moderated as the milder increases in the fresh-letting rentals continued to feed through. The growth in wage costs also held steady. Externally, international food and commodity prices generally saw little upward pressure, while inflation in Hong Kong's most major import partners remained in check. *Headline consumer price inflation* was 4.2% in the first quarter of 2014, down from 4.3% in the fourth quarter of 2013. Netting out the effects of the Government's one-off relief measures to more accurately reflect the underlying inflation trend, the *underlying composite consumer price inflation* edged down to 3.8% in the first quarter of 2014, from 4.0% in the preceding quarter.

1.11 The *GDP deflator* rose by 2.0% in the first quarter, with a slightly better terms of trade, a moderated decline in prices for gross domestic fixed capital formation and a slower increase in prices for consumption expenditure.

Diagram 1.4 : Consumer price inflation edged down in the first quarter



GDP by major economic sector

1.12 The performance of most service sectors saw improvement in 2013. Net output of the services sector as a whole grew moderately by 2.9% in real terms in 2013, higher than the 1.8% growth in 2012, but the performance varied across individual sectors. Net output of financing and insurance as well as professional and business services picked up to show solid growth in 2013 amid improved investment and business climate. Information and communications likewise grew at a firmer rate. Bolstered by buoyant demand from inbound tourism, retail and wholesale continued to grow notably while accommodation and food services also picked up. Import and export trade and transportation and storage improved from the weak performance of the preceding year, but the pace of expansion remained modest. On the other hand, the net output of real estate, which mainly reflects activity of private sector developers and property agency, contracted amid a quiet property market. As for the secondary sector, manufacturing sector showed little change in net output, while the construction sector expanded only modestly after registering three years of robust growth.

**Table 1.3 : GDP by economic activity^(a)
(year-on-year rate of change in real terms (%))**

| | <u>2012</u> | <u>2013</u> | <u>2012</u> | | | | <u>2013</u> | | | |
|--|-------------|-------------|-------------|-----------|-----------|-----------|-------------|-----------|-----------|-----------|
| | | | <u>Q1</u> | <u>Q2</u> | <u>Q3</u> | <u>Q4</u> | <u>Q1</u> | <u>Q2</u> | <u>Q3</u> | <u>Q4</u> |
| Manufacturing | -0.8 | 0.1 | -1.6 | -2.9 | -0.1 | 1.3 | 0.5 | 0.3 | -0.9 | 0.5 |
| Construction | 8.3 | 1.1 | 10.8 | 7.2 | 1.2 | 13.1 | -0.8 | 2.8 | 8.5 | -4.3 |
| Services ^(b) | 1.8 | 2.9 | 1.4 | 0.9 | 2.0 | 2.7 | 2.8 | 3.8 | 2.5 | 2.8 |
| Import/export, wholesale and retail trades | 1.9 | 3.6 | -0.1 | 0.6 | 2.1 | 4.1 | 5.4 | 5.1 | 1.8 | 2.8 |
| Import and export trade | 0.6 | 2.3 | -2.4 | -0.9 | 1.5 | 3.4 | 3.7 | 3.1 | 0.8 | 1.9 |
| Wholesale and retail trades | 7.3 | 9.2 | 10.2 | 7.2 | 4.5 | 7.6 | 12.2 | 12.9 | 6.4 | 6.4 |
| Accommodation ^(c) and food services | 1.8 | 3.7 | -0.8 | 0.9 | 2.8 | 4.1 | 4.3 | 4.2 | 3.4 | 2.9 |
| Transportation, storage, postal and courier services | 0.9 | 2.5 | 3.0 | -1.7 | 0.4 | 1.8 | -0.5 | 2.9 | 2.4 | 5.4 |
| Transportation and storage | 0.7 | 2.0 | 3.0 | -1.9 | 0.2 | 1.2 | -0.9 | 2.8 | 1.2 | 5.1 |
| Postal and courier services | 6.4 | 12.9 | 3.2 | 1.6 | 7.4 | 12.5 | 7.7 | 6.5 | 27.9 | 10.2 |
| Information and communications | 2.8 | 4.2 | 0.7 | 1.4 | 4.1 | 4.5 | 6.5 | 3.0 | 4.3 | 2.9 |
| Financing and insurance | 0.8 | 5.6 | 2.2 | -0.9 | 1.0 | 1.1 | 3.3 | 7.5 | 7.2 | 4.6 |
| Real estate, professional and business services | 3.1 | 0.1 | 3.4 | 4.5 | 3.2 | 1.7 | -0.1 | -0.8 | -0.7 | 2.0 |
| Real estate | 3.9 | -3.9 | 3.3 | 5.8 | 4.3 | 2.5 | -2.4 | -6.8 | -5.2 | -1.3 |
| Professional and business services | 2.3 | 4.2 | 3.1 | 3.1 | 2.2 | 1.1 | 2.3 | 5.3 | 3.7 | 5.3 |
| Public administration, social and personal services | 2.1 | 2.6 | 2.1 | 2.2 | 2.3 | 1.8 | 2.1 | 3.8 | 2.2 | 2.1 |

Notes : Figures are subject to revision later on as more data become available.

(a) The GDP figures shown in this table are compiled from the production approach, in parallel with those shown in Table 1.1 which are compiled from the expenditure approach. For details, see Note (1) to this chapter.

(b) In the context of value-added contribution to GDP, the service sectors include ownership of premises as well, which is analytically a service activity.

(c) Accommodation services cover hotels, guesthouses, boarding houses and other establishments providing short term accommodation.

Other economic developments

1.13 The 2014-15 Budget laid out strategies to enhance Hong Kong's competitiveness and strengthen its position as an international business hub. A series of measures were unveiled, along with ongoing capital works, aiming at raising the efficiency in the flows of people, goods, capital and information, providing an enabling environment for innovation and technology industries to grow, consolidating the core competence of the four pillar industries, and helping SMEs in coping with various challenges. The Budget also pointed out the constraints of manpower, land supply and an ageing population to Hong Kong's future development and outlined ways and provided measures to overcome these constraints.

1.14 Specifically in preparation for challenges from an aging population, the Report of the Working Group on Long-Term Fiscal Planning was released in March, which assessed the current state of Hong Kong's public finances and made projections of the Government's long-term fiscal positions. Based on its assessment, the Working Group recommended a combination of strategies, including containing expenditure growth, preserving the revenue base and saving for future generations, to cope with the fiscal challenges ahead.

1.15 On the legal infrastructure, the New Companies Ordinance came into operation in March. By enhancing corporate governance, facilitating business, ensuring better regulation and modernising the law along with the dynamic business environment, the new Ordinance should help strengthen Hong Kong's status as an international commercial and financial centre.

1.16 In April, Shanghai-Hong Kong Stock Connect pilot programme was announced under the support of the Central Government, marking a new stage in the cooperation and interaction between the stock markets of the two places. The pilot program will allow Mainland investors who satisfy the eligibility criteria to trade eligible stocks listed on the Stock Exchange of Hong Kong (SEHK) through the Shanghai Stock Exchange (SSE), subject to an aggregate net quota of RMB250 billion and a daily net quota of RMB10.5 billion and some other criteria. At the same time, it will also allow Hong Kong and overseas investors to trade eligible stocks listed on the SSE through the SEHK directly, subject to an aggregate net quota of RMB300 billion and a daily net quota of RMB13 billion. The pilot program will be launched in about six months' time after the preparatory work is finished. Its implementation should help invigorate the circulation of offshore RMB market in Hong Kong market and further reinforce Hong Kong's premier offshore RMB business centre and international financial centre status.

Notes :

- (1) The Gross Domestic Product (GDP) is an overall measure of net output produced within an economy in a specified period, such as a calendar year or a quarter, before deducting the consumption of fixed capital. In accordance with the expenditure approach to its estimation, GDP is compiled as total final expenditures on goods and services (including private consumption expenditure, government consumption expenditure, gross domestic fixed capital formation, changes in inventories, and exports of goods and services), less imports of goods and services.
- (2) The seasonally adjusted quarter-to-quarter GDP series, by removing the variations that occur at about the same time and in about the same magnitude each year, provides another perspective for discerning the trend, particularly in regard to turning points. A detailed examination reveals the presence of seasonality in the overall GDP and in some of its main components, including private consumption expenditure, government consumption expenditure, exports of goods, imports of goods, exports of services, and imports of services. However, due to the presence of considerable short-term fluctuations, no clear seasonal pattern is found in gross domestic fixed capital formation. Therefore, the seasonally adjusted series of GDP is compiled separately at the overall level, rather than summing up from its main components.