CHAPTER 1 : OVERVIEW OF ECONOMIC PERFORMANCE

Summary

- *The Hong Kong economy slowed down further, to a mere 1.8% year-on-year growth in real terms in the second quarter of 2014, marking the slowest growth since the third quarter of 2012. The weak performance was mainly weighed down by a fall-off in tourist spending and moderated growth in domestic demand, though merchandise exports picked up somewhat in growth.*

- *Global trade flows revived somewhat in the second quarter, after a slow start in the year. Yet the recovery of the advanced markets remained weaker than expected, constraining the revival of Asian exports. Total exports of goods staged a modest pick-up in the second quarter, helped mainly by a notable rebound in June. Against this, however, exports of services, dragged by a double-digit plunge in exports of travel services, slackened visibly in the second quarter, posting the first decline since the second quarter of 2009.*

- *Domestic demand also saw some growth slowdown. Private consumption weakened after two quarters of subdued economic growth. Investment expenditure concurrently declined upon a notable fall in machinery and equipment acquisition, the latter partly affected by an exceptionally high base of comparison a year ago.*

- *The labour market held largely stable. The seasonally adjusted unemployment rate edged up from 3.1% in the first quarter to 3.2% in the second quarter. Wages and earnings rose further, and average monthly earnings for grassroots workers still sustained real improvement.*

- *The local stock market recovered ground during the second quarter, as sentiment improved upon signs of a reviving Mainland economy, an improving US economy, and the Federal Reserve reiterating its accommodative monetary stance. The residential property market activity in the second quarter rebounded from the lows, with prices and rentals going somewhat higher.*

- *Inflation continued its easing trend in the second quarter, thanks largely to the still-gentle imported inflation and abating rental cost pressures. The upside risks to inflation remain limited in the near term.*

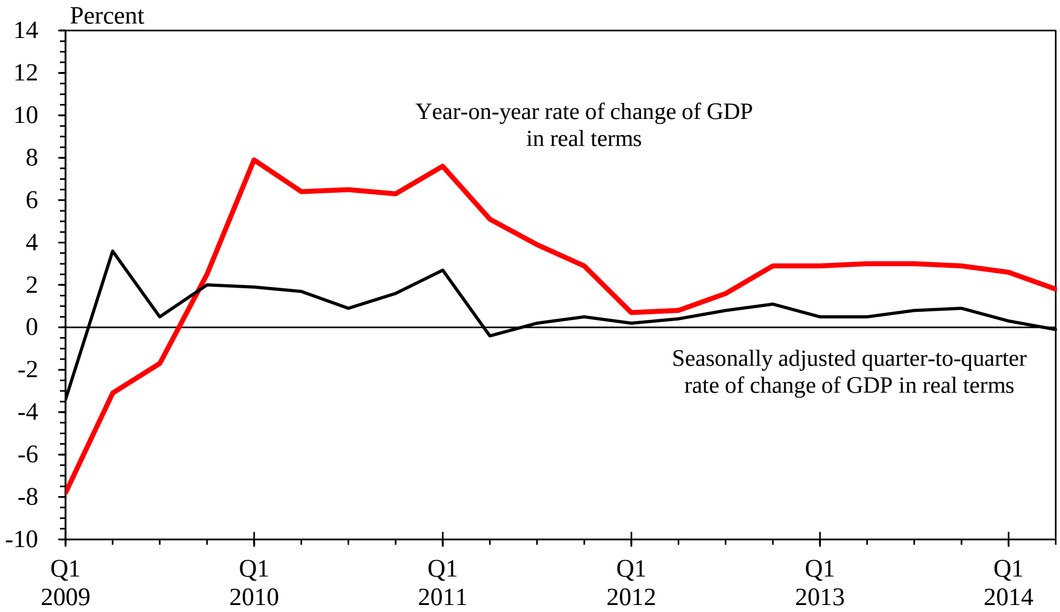
Overall situation

1.1 The Hong Kong economy lost further momentum in the second quarter of 2014, with the moderate improvement in goods exports outweighed by the fall in services exports and slower domestic demand expansion. On the external front, the US economy rebounded visibly in the second quarter after registering a notable contraction in the preceding quarter, but the year-on-year growth remained moderate. The eurozone's economic recovery was painfully slow, plagued by the deep-seated structural issues, and the Japanese economy also weakened after the sales tax hike in April. While the Mainland economy maintained steady growth, the slow progress in the advanced markets had limited somewhat the revival of Asian exports. Moreover, the uncertainties surrounding future US monetary policy normalisation and geopolitical tensions in various parts of the world lingered on.

1.2 Against such an external environment, Hong Kong's goods exports staged only a modest pick-up in the second quarter. At the same time, services exports slackened visibly, dragged by the fall-off in visitor spending on big-ticket items. Locally, domestic demand also saw weaker growth momentum, consequential to the economic slowdown. Yet up till now, the labour market held broadly stable. Underlying consumer price inflation eased further in the second quarter amid benign imported inflation and slower economic growth.

1.3 In the second quarter of 2014, *Gross Domestic Product* (GDP)[(1)] grew by 1.8% in real terms over a year earlier, slower than that of 2.6% in the preceding quarter (revised from the earlier estimate of 2.5%). On a seasonally adjusted quarter-to-quarter comparison[(2)], real GDP dropped marginally by 0.1% in the second quarter, after the 0.3% growth in the preceding quarter (revised from the earlier estimate of 0.2%).

Diagram 1.1 : Economic growth slowed further in the second quarter of 2014



The external sector

1.4 *Total exports of goods* compiled under the GDP accounting framework rose by 2.3% year-on-year in real terms in the second quarter, up from 0.5% in the preceding quarter. The improvement over the period was brought about mainly by the visible pick-up in June, though partially offset by the decline in non-monetary gold exports during the quarter. Exports to the EU and the US expanded further in the second quarter, albeit only at a modest to moderate pace, reflecting the slow recovery of the advanced economies. While exports to the Mainland resumed growth in May and June, those to most other Asian markets also turned somewhat better, mirroring the relative improvement in the global economic environment during the quarter.

1.5 Yet, *exports of services* slackened abruptly, registering a 2.3% year-on-year decline in real terms in the second quarter, the first decrease since the second quarter of 2009. On a seasonally adjusted quarter-to-quarter comparison, exports of services fell visibly, also by 2.3%. The setback in exports of travel services was the main drag, with the year-on-year decline magnified further by a distinct high base of comparison a year ago caused by the spike in visitors' purchases of gold-related items. Indeed, the implied fall in per capita visitor spending was rather noticeable, given the nearly double-digit rise in the number of visitor arrivals in the quarter. As to other services exports, exports of trade-related services and transportation services saw some improvement, in tandem with the modest recovery of trade flows. Exports of financial and other business services also registered modest growth alongside further expansion in cross-border financial activities.

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

	2012#	2013#	2013 Q1#	2013 Q2#	2013 Q3#	2013 Q4#	2014 Q1#	2014 Q2+
Change in real terms of GDP and its main expenditure components (%)								
Private consumption expenditure	4.1	4.3	6.3 (2.9)	4.7 (-0.9)	2.7 (-0.2)	3.6 (1.8)	1.5 (0.6)	1.2 (-0.9)
Government consumption expenditure	3.6	2.3	1.9 (*)	3.1 (1.8)	2.3 (*)	2.0 (0.3)	2.6 (0.5)	2.7 (1.9)
Gross domestic fixed capital formation	6.8	3.3	-3.0	7.6	2.7	5.3	3.5	-5.6
of which :								
Building and construction	7.2	-0.9	-1.5	-0.7	3.1	-3.8	10.6	1.3
Machinery, equipment and intellectual property products	10.1	10.8	-4.4	19.8	7.6	17.5	1.9	-10.0
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)	2.3 (0.7)
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)	1.1 (-2.2)
Exports of services	2.2	5.5	4.7 (1.8)	7.7 (3.3)	5.0 (-2.9)	4.7 (2.6)	3.3 (0.4)	-2.3 (-2.3)
Imports of services	1.9	2.0	0.3 (1.1)	-0.7 (-1.1)	2.6 (1.7)	5.5 (3.7)	-0.8 (-5.0)	5.0 (4.8)
Gross Domestic Product	**1.5**	**2.9**	**2.9 (0.5)**	**3.0 (0.5)**	**3.0 (0.8)**	**2.9 (0.9)**	**2.6 (0.3)**	**1.8 (-0.1)**
Change in the main price indicators (%)								
GDP deflator	**3.7**	**1.4**	**1.8 (-0.7)**	**0.6 (*)**	**1.6 (1.7)**	**1.5 (0.5)**	**2.2 (0.1)**	**3.5 (1.4)**
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)**	**3.6 (0.7)**
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)**	**3.5 (0.7)**
Change in **nominal GDP** *(%)*	**5.3**	**4.3**	**4.8**	**3.6**	**4.6**	**4.4**	**4.8**	**5.4**

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.

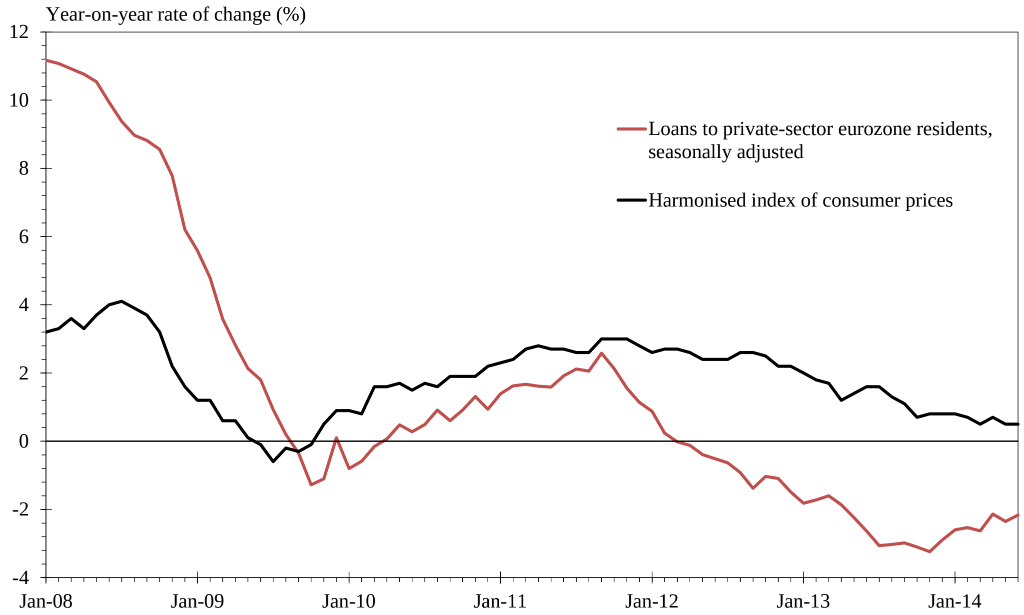
(#) Revised figures.
(+) Preliminary figures.
( ) Seasonally adjusted quarter-to-quarter rate of change.
(^) After netting out the effects of Government's one-off relief measures.
(*) Change within ± 0.05%.

Box 1.1

Recent monetary easing in the eurozone

The eurozone, being still troubled by the deep-seated structural economic problems, has been a weak spot in the global economy. The economy expanded slowly at a quarterly rate of 0.2% in the first quarter, and recent economic indicators continued to signal a weak and unsteady recovery in the second quarter. Along with the lack of growth momentum, credit dynamics in the region have been weak and inflation has stayed uncomfortably low (***Chart 1***). Loans to the private sector have been on the decline, reflecting weak demand for credit amid deleveraging and the banking sector's impaired balance sheet. Deflation lingered in such eurozone members as Cyprus, Greece and Portugal. The disinflationary pressures may hurt investor sentiment and increase real debt burden, thereby adding headwinds to the structural adjustment efforts by the public and private sectors. Indeed, the risks of a prolonged period of low inflation were highlighted by the Eurosystem staff macroeconomic projections in June, which forecast that inflation in the eurozone would likely remain at low levels in the near term, before rising only gradually in 2015 and 2016.

Chart 1 : Credit dynamics and inflation in the eurozone remained subdued



Against this background, the European Central Bank (ECB) announced on 5 June a combination of measures to provide additional monetary policy accommodation and to support lending to the real economy. Among them, the policy refinancing rate was reduced by 10 basis points to 0.15%, while the deposit facility rate was lowered to below zero (-0.1%). Starting from September 2014, a series of targeted longer-term refinancing operations (TLTROs) would be successively rolled out, with a view to support lending to households and non-financial corporations by providing banks with low-cost funding[(1)]. In addition, the ECB would intensify preparatory work related to outright purchases in the asset-backed securities (ABS) market, aimed at enhancing the functioning of the monetary policy transmission mechanism further.

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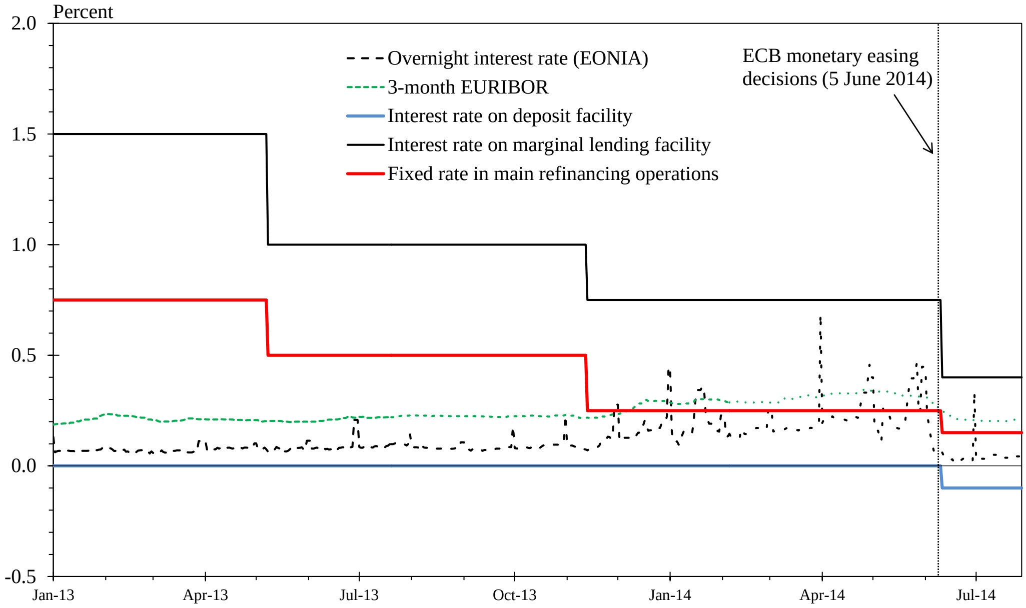
(1) According to the ECB's President, the TLTRO has an initial allowance of about €400 billion, and the overall take-up by banks could reach a maximum of €1 trillion. For details, see the transcript for the press conference held after the ECB meeting on 3 July (http://www.ecb.europa.eu/press/pressconf/2014/html/is140703.en.html).

Box 1.1 (Cont'd)

Following the ECB's latest round of monetary easing, short-term money market interest rates, including the overnight interest rate (Euro Overnight Index Average, or EONIA) and the three-month Euro Interbank Offered Rate (EURIBOR), moved lower (***Chart 2***). Benchmark government bond yields of higher-rated eurozone member states fell, while the euro also weakened somewhat in June and July on a nominal effective exchange rate basis.

Chart 2 : Money market and ECB interest rates



Looking ahead, the weak recovery of the eurozone, along with high unemployment rate and low inflation, will continue to pose a drag to the global economy. Furthermore, the recent default incidence related to the parent company of a major Portuguese bank was also a timely reminder of the weakness in some parts of the financial and monetary systems of the eurozone. In sum, the ECB is likely to adopt a highly accommodative policy stance for an extended period of time.

The ECB's latest monetary easing can potentially create spill-overs to the rest of the world, given the large size of Europe's financial system and its tight integration with the global economy. The provision of low-cost funding via TLTROs, in addition to the outright ABS purchase programme (if implemented), will result in substantial expansion of the ECB's balance sheet and huge liquidity in the European banking system. Coupled with lower eurozone bond yields, capital could be encouraged to flow to emerging markets in search of yield. As a result, and also considering the uncertainties over the US Fed's future pace of monetary policy normalisation, capital flows to emerging market economies may turn increasingly volatile, to the detriment of global financial stability. A possible weakening of the euro exchange rate vis-à-vis the US dollar and Asian currencies may also pose uncertainties to Hong Kong's external trade performance. The Government will closely monitor the latest developments on the external front, and stay alert to the risks arising from the highly accommodative global monetary environment.

The domestic sector

1.6 Domestic demand saw some growth slowdown. *Private consumption expenditure* weakened, following two quarters of subdued economic growth, with the year-on-year growth at a meagre 1.2% in real terms in the second quarter of 2014. On a seasonally adjusted basis, private consumption expenditure declined by 0.9% over the preceding quarter. *Government consumption expenditure* maintained steady growth at 2.7% year-on-year in the second quarter.

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

			Of which :						
		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	H1	0.7	3.2	0.1	-2.7	1.9	3.8	-0.9	1.4
	Q1	3.4	3.1	4.0	6.3	2.1	-1.9	10.2	1.5
	Q2	-1.9	3.3	-5.1	-10.6	1.7	9.7	-11.5	1.2

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.

Box 1.2

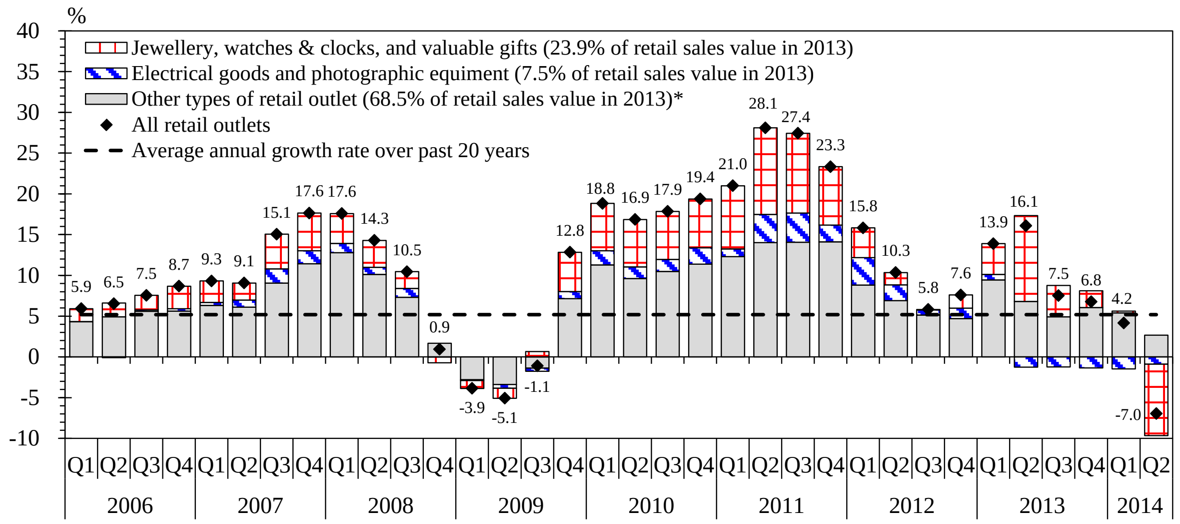
The recent performance of Hong Kong's retail sales

After being dented by the global financial crisis in late 2008 and 2009, Hong Kong's retail sales staged a sharp rebound and then grew briskly further in the ensuing years. However, retail sales decelerated abruptly in early 2014 and registered year-on-year decline for five consecutive months since February 2014, raising concerns about the outlook for the sector. This box article takes a deeper look into the development in retail sales in the past few years and attempts to put the recent disappointing performance into perspective.

First of all, it should be noted that the jumps in retail sales after the global financial crisis had been exceptional. Buttressed by an increasingly tight labour market, improving incomes and thriving inbound tourism, retail sales value surged at an average annual rate of 15.8% during 2010 to 2013, far outpacing the average trend growth of about 5% over the past 20 years (***Chart 1***). While that was favourable for short term economic growth, such a phenomenonal growth pace is difficult to sustain over a longer horizon.

Secondly, the recent deterioration in retail sales was mainly due to weakness in two types of retail outlets – those selling luxury items (namely "jewellery, watches and clocks, and valuable gifts") and, to a lesser extent, those selling electrical goods and photographic equipment (***Chart 1***). Specifically, in the second quarter of 2013, amid a sharp correction in gold prices, the sales value of luxury items rose tremendously by nearly 50% year-on-year and significantly boosted the total retail sales value in that quarter. Against such an exceptionally high base, the sales value of luxury items saw a 31.5% year-on-year dive in the second quarter this year, pulling the overall retail sales into contraction. Another factor denting the retail sales performance was the notable deceleration in the sales of electrical goods and photographic equipment. After taking out the luxury items and electrical goods and photographic equipment, the sales value in other types of retail outlet had actually been expanding rather steadily in the past few years, though also with some moderation in the more recent quarters.

Chart 1 : Contribution to change in retail sales value by selected types of retail outlet



Notes : (*) Other types of retail outlet include "food, alcoholic drinks and tobacco", "supermarkets", "fuels", "clothing, footwear and allied products", "department stores", "other consumer goods" and consumer durable goods other than electrical goods and photographic equipment.
% share in retail sales value may not add up to 100% due to rounding.

Box 1.2 (Cont'd)

One possible reason for the volatile sales in luxury items and electrical goods and photographic equipment is the change in per capita visitor spending. During 2010 to 2013, the sales value of jewellery and valuables leaped by a cumulative 164% and that of electrical goods and photographic equipment by 78%. Such surges in sales could hardly be explained solely by local residents' demand. Detailed breakdowns about visitor shopping expenditure are available only at annual intervals through the surveys conducted by the Hong Kong Tourism Board, and therefore it is hard at present to escertain how the pattern of visitor spending had changed in the first half of 2014. Nevertheless, as evidenced by the movements in exports of travel services (which cover tourists' spending on shopping, food and beverages, accommodation, entertainment, etc), the growth in total visitor spending had slowed sharply in recent quarters, notwithstanding the sustained rise in visitor arrivals.

From ***chart 2a***, the implied per capita visitor spending, as proxied by the difference between change in exports of travel services and number of visitor arrivals, had grown solidly over the past few years before reverting to a noticeable decline in the first half of 2014, closely resembling the trend seen in the sales of luxury items and electrical goods and photographic equipment. While there were anecdotal evidences suggesting a change in tourists' shopping preferences, the rising share of same-day in-town visitors, with its per capita spending being only around 30% of that of overnight visitors, could also be one of the reasons dampening the growth in per capita visitor spending (***Chart 2b***).

Chart 2a : Exports of travel services and number of visitor arrivals

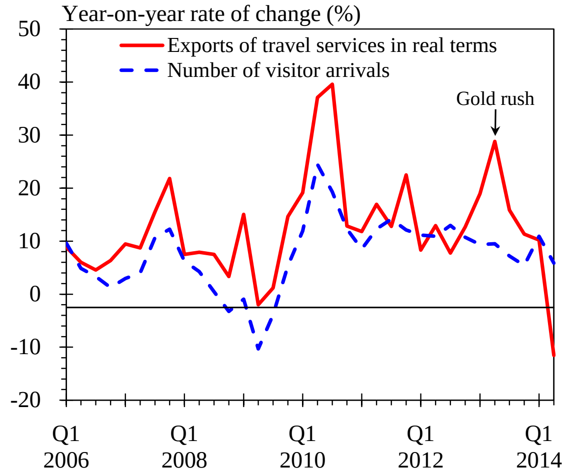
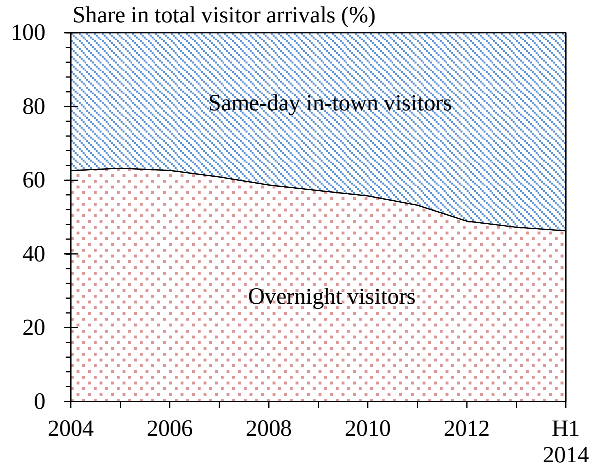


Chart 2b : Compositional shift in visitor arrivals



Considering the retail sales performance by type of retail outlet and the implied per capita visitor spending, it seems plausible that the sharp plunge in retail sales value in the second quarter was the combined result of a distinctly high base of comparison and a shift in tourists' spending away from big-ticket items. In fact, tourists' shopping expenditure accounted for nearly 40% of retail sales value in 2013, and hence its fluctuations could easily distort the retail sales figures and mask the underlying trend in local residents' consumption.

Looking ahead, as the unfavourable base effects gradually fade, Hong Kong's retail sales performance should hopefully turn more stable in the coming months. Nonetheless, given the size of the retail trade industry, which accounted for about 4% of GDP in 2012 and about 9% of total employment in 2013, the Government will closely monitor the repercussions of a slower growth in retail sales on local economic sentiment and labour market conditions.

Diagram 1.2 : Private consumption expenditure weakened along with economic slowdown

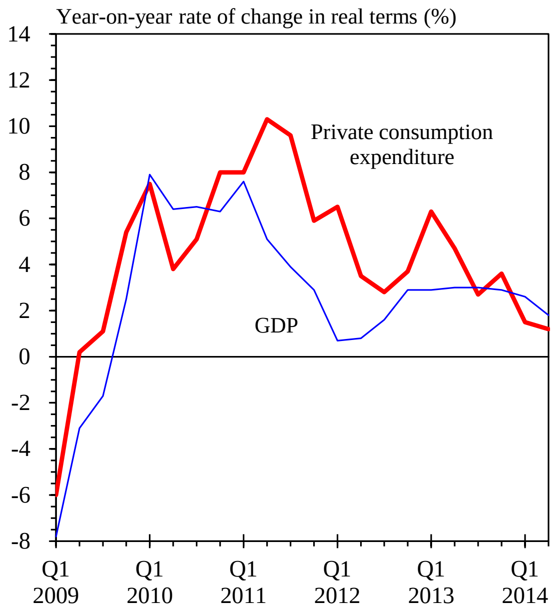


Diagram 1.3 : Investment spending relapsed to a decline

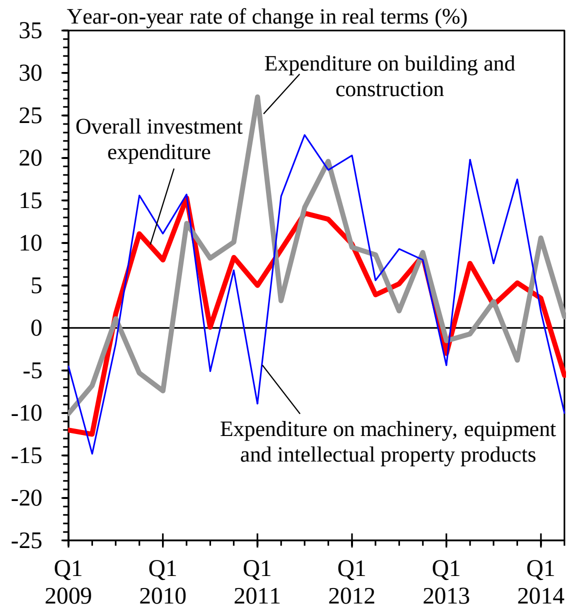
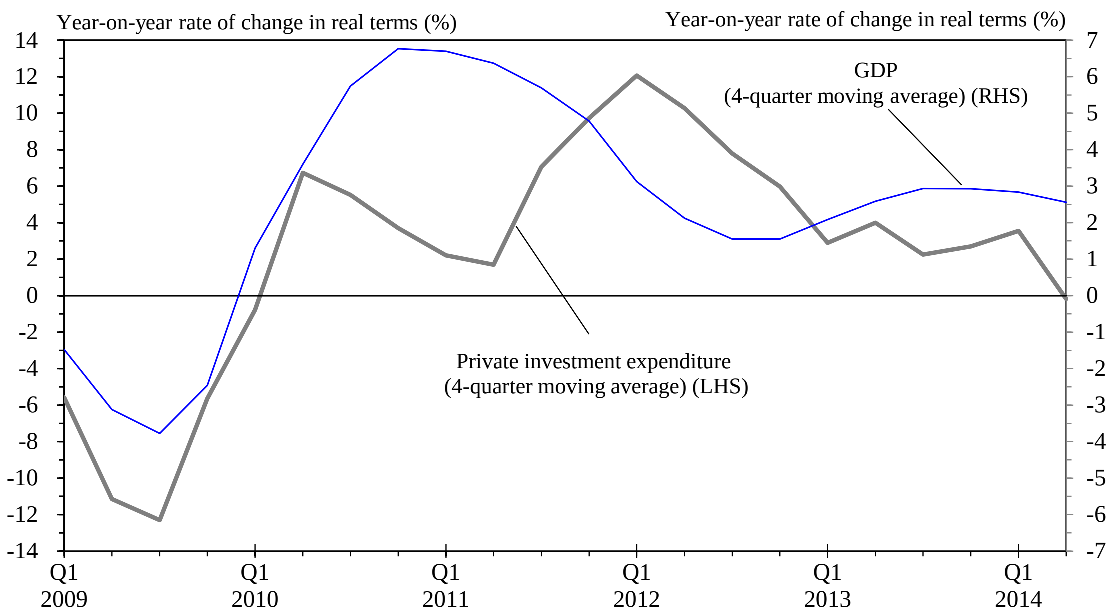


Diagram 1.4 : Private investment spending declined



1.7 Overall investment spending in terms of gross domestic fixed capital formation relapsed to a 5.6% year-on-year decline in real terms in the second quarter, in contrast to the 3.5% growth in the preceding quarter. Within this, the growth in overall building and construction expenditure slowed, as the incremental growth in large-scale infrastructure works tapered after the exceptionally strong growth in preceding quarters, while private sector building and construction activity grew only modestly. At the same time, machinery and equipment acquisition, which was typically volatile, fell notably by 10.0% amid an exceptionally high base of comparison in the same period last year, posing a drag on the overall investment spending performance. The latest Quarterly Business Tendency Survey indicated that large enterprises in the consumption-related sectors turned more cautious, while those in the financing and insurance, information and communications remained sanguine. The sentiment among small and medium-sized enterprises (SMEs) showed a broadly similar picture (see ***Box 1.3*** for details of the consultation on SMEs).

The labour sector

1.8 The labour market held generally stable. The *seasonally adjusted unemployment rate* edged up from 3.1% in the first quarter to 3.2% in the second quarter. Over the same period, the *underemployment rate* rose from 1.3% to 1.5%. Wages and earnings saw further increases in the first quarter. Average employment earnings for full-time employees, especially the grassroots workers, sustained improvement in real terms in the second quarter. Overall speaking, while the recent slowdown in retail sales had not yet affected the employment and income situation in a significant way, the developments going forward would need to be closely monitored.

Box 1.3

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 1.2*** in the ***First Quarter Economic Report 2014.***

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 lacklustre (***Table 1***). In July 2014, the diffusion indices for all selected sectors stayed below the boom-bust threshold of 50. Within this, the readings of the retail trade and wholesale trade sectors fell for three consecutive months, in line with the weak retail sales performance of late. Yet, the diffusion indices for the restaurant and business services sectors moved up moderately from lows. The reading for the real estate sector improved, conceivably reflecting the recent pick-up in property market activity. As regards the external segment, the diffusion index for the logistics sector remained weak, and that for the import/export trades stayed below the 50 mark, indicating the cautious sentiment among SMEs in these sectors had not shifted materially despite the recent improvement in external trade performance. 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 still stood near the boom-bust threshold of 50 in July, possibly indicating the still-uncertain external environment, notwithstanding the visible pick-up in merchandise exports in June.

The proportion of SMEs reporting tight credit access eased to 0.8% in July, reflecting the generally accommodative monetary conditions and the Government's continued efforts to support SMEs through various loan guarantee schemes.

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(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 1.3 (Cont'd)

Table 1 : Diffusion indices^ on business receipts

	2013 Aug	Sep	Oct	Nov	Dec	2014 Jan	Feb	Mar	Apr	May	Jun	Jul
Local segments												
Restaurants	48.2	47.4	47.4	48.2	49.1	48.1	47.2	47.2	46.3	47.2	45.3	47.1
Real estate	35.3	35.3	41.2	36.8	44.1	42.4	42.4	54.5	48.5	48.5	43.9	47.0
Retail trade	50.0	49.0	47.5	48.0	49.0	47.4	49.1	47.4	48.2	47.7	46.9	46.1
Wholesale trade	44.1	47.1	50.0	44.1	47.1	44.7	44.7	50.0	50.0	44.7	39.5	36.8
Business services	43.9	45.5	50.0	48.5	53.0	47.0	51.6	51.6	53.1	50.0	46.9	48.4
External segments												
Import/export trade	47.6	48.5	49.0	49.5	49.0	47.9	48.3	48.7	49.6	48.4	49.2	48.8
Logistics	44.7	44.7	44.7	52.8	50.0	47.2	50.0	50.0	47.2	47.2	47.2	47.2
All the above sectors*	**46.8**	**47.3**	**48.1**	**48.0**	**49.0**	**47.0**	**48.2**	**49.2**	**49.3**	**48.0**	**47.0**	**47.0**

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

	2013 Aug	Sep	Oct	Nov	Dec	2014 Jan	Feb	Mar	Apr	May	Jun	Jul
Local segments												
Restaurants	50.0	49.1	49.1	49.1	48.2	49.1	49.1	49.1	49.1	49.1	48.1	49.0
Real estate	45.6	48.5	47.1	47.1	47.1	50.0	50.0	50.0	48.5	47.0	48.5	50.0
Retail trade	50.0	49.5	50.0	50.0	50.0	49.6	50.4	49.1	50.5	49.6	49.6	49.6
Wholesale trade	47.1	50.0	50.0	50.0	47.1	50.0	50.0	50.0	52.6	47.4	47.4	47.4
Business services	51.5	48.5	50.0	51.5	50.0	50.0	50.0	51.6	50.0	48.4	50.0	50.0
External segments												
Import/export trade	49.5	49.5	50.0	51.0	50.0	50.4	50.4	49.6	50.4	48.4	50.4	49.2
Logistics	50.0	47.4	47.4	50.0	50.0	50.0	50.0	50.0	50.0	50.0	52.8	50.0
All the above sectors*	**49.5**	**49.3**	**49.7**	**50.3**	**49.5**	**50.0**	**50.2**	**49.7**	**50.3**	**48.6**	**49.8**	**49.3**

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

Table 3 : Diffusion index on current new export orders

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

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

	2013 Aug	Sep	Oct	Nov	Dec	2014 Jan	Feb	Mar	Apr	May	Jun	Jul
All selected sectors*	0.7	0.7	0.7	0.4	0.6	1.5	1.8	0.9	0.9	1.1	1.1	0.8

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

The asset markets

1.9 The *local stock market* recovered ground in the second quarter, as the US economy revived from the disappointing performance in the preceding quarter, the Mainland economy maintained growth momentum, and the Federal Reserve reiterated its stance to maintain accommodative policy for a considerable time after ending its asset purchase programme later this year. The Hang Seng Index climbed up successively to close the second quarter at 23 191, 4.7% higher than three months earlier and similar to the level at end-2013. Average daily turnover, however, fell back to $57.5 billion in the second quarter, and total equity fund raised declined somewhat compared with the preceding quarter, but still markedly higher than the same period last year.

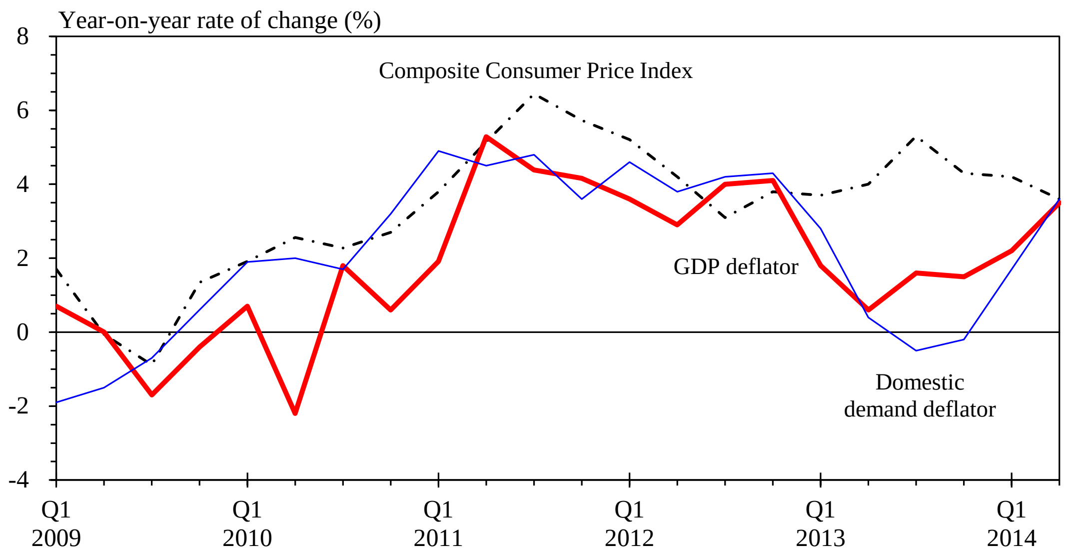
1.10 The *residential property market* showed some revival in the second quarter. Sentiment improved as market concerns over an imminent US interest rate hike lessened. This, coupled with the launch of several large primary projects by developers at a discount to comparable developments in the secondary market, has helped unleash the pent-up demand. Trading volume in the second quarter rebounded distinctly by 48% from the low level in the preceding quarter. Residential property prices rose by 3% during the second quarter, with overall flat prices in June exceeding the 1997 peak by 44%, and the housing affordability ratio staying elevated at around 54% in the second quarter. Separately, flat rentals increased by 1% during the second quarter, while office rentals stayed flat and shop rentals went up by 3%.

Inflation

1.11 Consumer price inflation continued its easing trend. *Headline consumer price inflation* moved down to 3.6% in the second quarter of 2014, from 4.2% in the preceding quarter. For the first half of 2014 as a whole, headline inflation averaged 3.9%, down from 4.3% in 2013. Netting out the effects of the Government's one-off relief measures to more accurately reflect the underlying inflation trend, *underlying composite consumer price inflation* eased to 3.5% in the second quarter, from that of 3.8% in the preceding quarter. For the first half as a whole, underlying inflation averaged 3.7%, 0.3 percentage point lower than that of 4.0% in 2013. Locally, the residential rental pressures subsided further and continued to manifest itself through narrower year-on-year increases in the private rental component of the consumer price indices. Other domestic costs also saw moderated gains, with year-on-year rises in commercial rentals decelerating further and labour costs keeping its moderate growth pace, both helping to alleviate pressures on business costs. On the external front, the rise in overall import prices stayed largely modest, thanks to the generally stable international food and commodity prices and tame inflation in major import sources, notwithstanding some temporary upward movements in global oil prices spurred by heightened geopolitical tensions in the Middle East and Eastern Europe during the quarter.

1.12 The *GDP deflator* rose by 3.5% in the second quarter of 2014, largely in line with the underlying consumer price inflation rate. Within this, domestic demand deflator recorded a faster increase, while the terms of trade deteriorated marginally.

Diagram 1.5 : Consumer price inflation eased further in the second quarter



GDP by major economic sector

1.13 Net output of the services sector as a whole rose by 2.2% in real terms over a year earlier in the first quarter of 2014, slightly slower than the 2.8% increase in the fourth quarter of 2013 and broadly consistent with the more moderate economic growth during the period. Net output of import and export trade fell modestly amid the sluggish trading environment at the beginning of the year, weighing on the overall services sector performance. Other service sectors expanded further year-on-year by a varying degree. Financing and insurance, as well as professional and business services slowed to show moderate growth in the first quarter amid the uncertain external environment. Growth in retail and wholesale also slackened, reflecting the less rapid expansion in inbound tourism and changes in tourist spending patterns. Information and communications continued to grow steadily, while accommodation and food services and transportation, storage, postal and courier services rose at firmer rates. The net output of real estate, which mainly reflects activity of private sector developers and property agency, edged up in the first quarter from a year earlier after shedding 3.9% in the preceding year, as trading activity stabilised somewhat but was still well below long-term historical average. As for the secondary sector, manufacturing sector showed a mild increase in net output, while the notable pick-up in the expenditure on large-scale public infrastructure works and the moderate revival in private construction activity raised the net output growth of construction sector visibly higher.

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

	2013	2013 Q1	Q2	Q3	Q4	2014 Q1
Manufacturing	0.1	0.5	0.3	-0.9	0.5	2.1
Construction	1.1	-0.8	2.8	8.5	-4.3	12.8
Services[(b)]	2.9	2.8	3.8	2.5	2.8	2.2
Import/export, wholesale and retail trades	3.6	5.4	5.1	1.8	2.8	0.3
Import and export trade	2.3	3.7	3.1	0.8	1.9	-0.7
Wholesale and retail trades	9.2	12.2	12.9	6.4	6.4	4.1
Accommodation[(c)] and food services	3.7	4.3	4.2	3.4	2.9	4.3
Transportation, storage, postal and courier services	2.5	-0.5	2.9	2.4	5.4	7.0
Transportation and storage	2.0	-0.9	2.8	1.2	5.1	6.7
Postal and courier services	12.9	7.7	6.5	27.9	10.2	12.9
Information and communications	4.2	6.5	3.0	4.3	2.9	2.9
Financing and insurance	5.6	3.3	7.5	7.2	4.6	3.3
Real estate, professional and business services	0.1	-0.1	-0.8	-0.7	2.0	1.8
Real estate	-3.9	-2.4	-6.8	-5.2	-1.3	0.2
Professional and business services	4.2	2.3	5.3	3.7	5.3	3.4
Public administration, social and personal services	2.6	2.1	3.8	2.2	2.1	2.7

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

1.14 The Government constantly strives to solidify its competitiveness and collaborates with the industry to study ways to further develop our economy. In this regard, the Financial Services Development Council released a new research report titled “Positioning Hong Kong as an International IPO Centre of Choice” in June, providing concrete recommendations on raising the appeal of Hong Kong’s initial public offering platform to Mainland and overseas companies. The Economic Development Commission also held its meeting in June, endorsing proposals and recommendations on a wide range of areas such as film production, the fashion industry and aerospace financing business.

1.15 To forge closer economic ties with trading partners, in July Hong Kong started to its negotiation for a Free Trade Agreement (FTA) with the Association of Southeast Asian Nations (ASEAN). An FTA with the ASEAN, if materialised, would facilitate and enhance Hong Kong’s trade and investment flows between the two places, which should strengthen Hong Kong’s role as an international trade and commercial hub. Hong Kong has also entered negotiation in July with some World Trade Organisation members on the Environmental Goods Agreement, which would promote our export trade in eco-friendly goods.

1.16 As for other overseas linkages, Hong Kong and Korea signed an agreement for the avoidance of double taxation and prevention of income tax evasion in July. This should reinforce the economic and trade connections between the two places and offer added incentives for companies in Korea to do business and invest in Hong Kong when the agreement coming into force. A Mutual Recognition Arrangement (MRA) on the Authorised Economic Operators between Singapore and Hong Kong Customs was also signed in June, and a similar MRA with the Mainland signed earlier became operational for road cargo in four cross-boundary control points in May. These arrangements provide clearance facilitation, which should help bring more business opportunities to the import, export and logistics industries.

1.17 On addressing the longer-term challenges on public finance in the face of an ageing population, the Working Group on Long-Term Fiscal Planning, following its release of fiscal sustainability appraisal report on Hong Kong’s public finance in March, re-convened in July to examine possible options for the Future Fund savings scheme and explore ways on enhancing the management of Government assets.

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.