CHAPTER 1 : OVERVIEW OF ECONOMIC PERFORMANCE IN 2014

Summary

- *The Hong Kong economy grew only modestly in 2014 by 2.3%, down from 2.9% in 2013, as the slow global economic recovery weighed on exports of goods, tourist spending slackened, and domestic demand also weakened. Year-on-year economic growth stayed modest through the four quarters.*

- *Total exports of goods grew slightly in 2014, confined by subdued global demand conditions, particularly those in Europe and Japan. The performance was rather unsteady during the year, with momentum faltering again in the fourth quarter, and the performance diverged across markets.*

- *Exports of services eased visibly to grow only marginally in 2014, marking the slowest growth since 2009. The main drag stemmed from a fall-off in visitor spending on big-ticket items, though a high base of comparison was also partly to blame. Meanwhile, other services exports remained generally lacklustre, also affected by subdued global demand.*

- *The domestic sector also softened in growth momentum in 2014. Private consumption expenditure saw only moderate growth. Investment expenditure slackened to a slight decline, mainly due to sluggish machinery and equipment acquisition, which more than offset the rebound in building and construction activity.*

- *The labour market remained in a state of full employment. Total employment growth continued to outpace that of labour force, with the seasonally adjusted unemployment rate still staying low at 3.3% in the fourth quarter. Wages and earnings attained further moderate growth.*

- *The stock markets worldwide were rather volatile during 2014. The local stock market started the year soft, but rallied successively since mid-March. After hitting a six-year high in early September, the stock market fell back amid increasing concern about the global economic outlook and the spill-over from the oil price slump, though still finished the year slightly higher. The local property market staged a revival since the second quarter, with both trading volume and flat prices picking up.*

- *Underlying inflation followed an easing trend in 2014, thanks primarily to mild global inflation and also receding domestic cost pressures. For 2014 as a whole, underlying inflation averaged 3.5%, down further from 4.0% in 2013.*

Overall situation

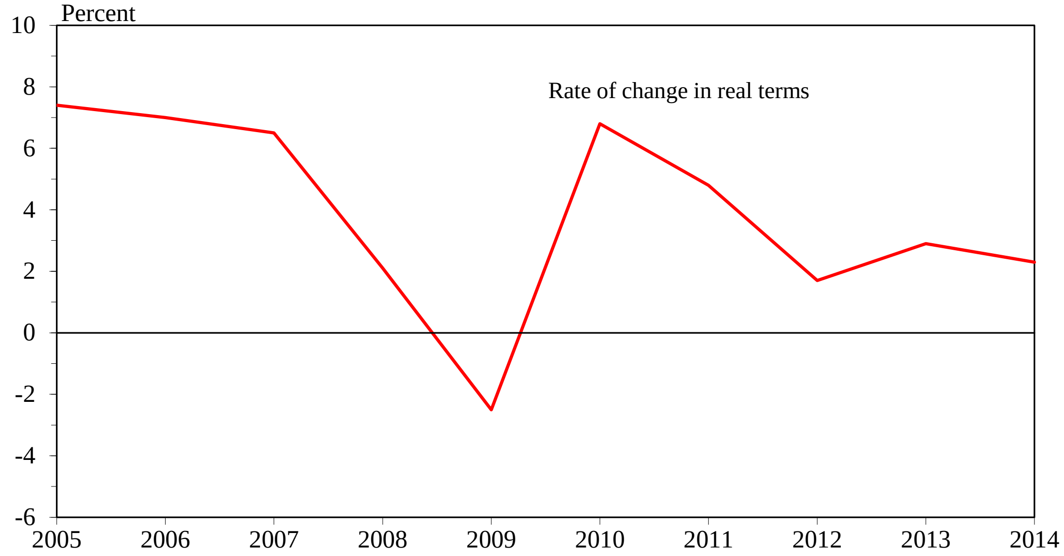
1.1 The Hong Kong economy remained on a modest expansion path in 2014, with real GDP growth staying below the past ten-year trend for the third consecutive year. Six years after the outbreak of the global financial crisis, slow global economic recovery still reigned, and the pace remained highly uneven. The US economy gained more traction, prompting the Federal Reserve (Fed) to end its asset purchases in October. In stark contrast, the central banks in the eurozone and Japan pursued further easing to fend off deflation risks and jump-start their ailing economies. Major emerging market economies also saw growth slowdown, with divergence in performance, featured by a steady Mainland economy and general resilience in the rest of emerging Asia, as opposed to the notable deceleration in Russia and Brazil. Meanwhile, heightened geopolitical tensions in Eastern Europe and the Middle East, coupled with diverging monetary policies among major central banks, agitated the global financial markets, placing further constraints on the expansion of international economic activity. As such, Hong Kong's goods exports only achieved a meagre growth in 2014. Moreover, exports of services eased visibly, reflecting mainly weaker visitor spending, while the domestic sector concurrently slowed in growth momentum. However, the labour market held largely stable and employment attained further moderate growth. Thanks to mild imported inflation and receding local cost pressures, underlying inflation trended lower in 2014, marking the third consecutive year of easing.

1.2 For 2014 as a whole, *Gross Domestic Product* (GDP)(1) expanded by 2.3% in real terms, slower than the 2.9% growth in 2013 and the annual average growth of 3.9% in the past decade. In terms of the quarterly profile, the year-on-year growth rate of real GDP slowed to 2.6% and 1.8% respectively in the first and second quarters, followed by a rebound to 2.7% in the third quarter, before moderating to 2.2% in the fourth quarter. On a seasonally adjusted quarter-to-quarter comparison(2), the performance was rather unsteady. Having risen by 0.5% in the first quarter, real GDP edged down by 0.2% in the second quarter, and then rebounded visibly by 1.4% in the third quarter, before seeing growth easing back to 0.4% in the fourth quarter.

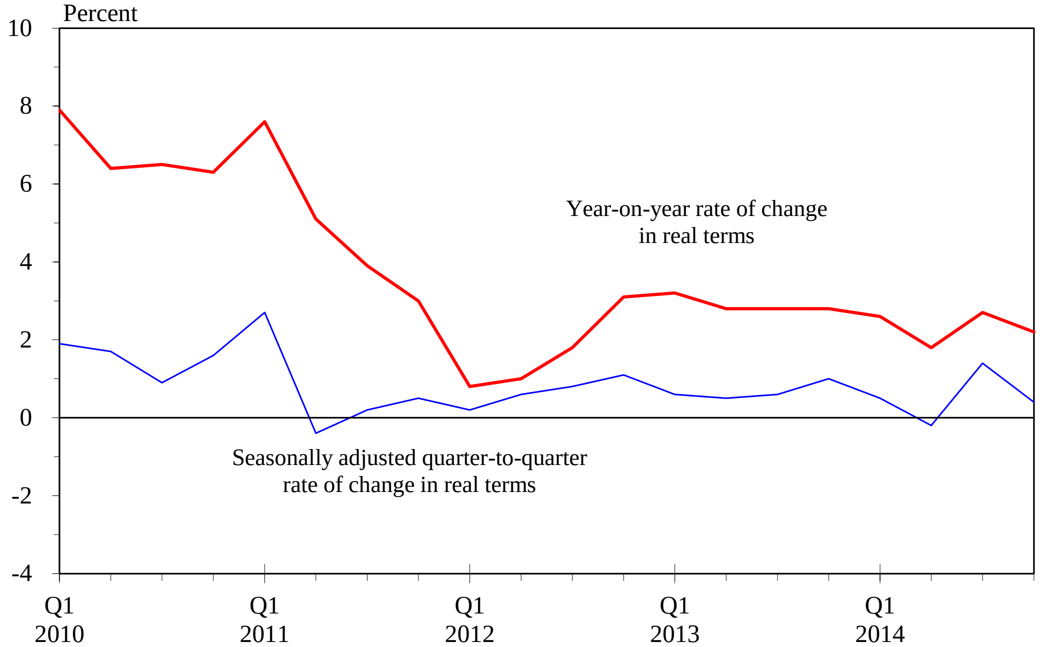
1.3 Economic growth momentum of Hong Kong softened in the fourth quarter of 2014, in part because goods exports decelerated again to barely grow, in tandem with worsening global business sentiment in the manufacturing sector, as deflation risks in Europe and Japan built up and slowdown in some major emerging economies continued. The more volatile financial and currency markets spurred by the monetary policy divergence and oil price slump exacerbated the external headwinds. In the quarter, the local economy also experienced some disruptions to economic activities imparted by the "Occupy Movement", with retail sales and restaurant receipts showing a renewed slackening and the number of non-Mainland visitors reverting to a decline. Yet, the labour market remained remarkably stable and Mainland visitor arrivals continued to grow notably, helping the economy to expand modestly further in the midst of the choppy external environment.

Diagram 1.1 : The Hong Kong economy showed modest growth in 2014

(a) Annual profile



(b) Quarterly profile



The external sector

1.4 *Total exports of goods* compiled under the GDP accounting framework grew by a meagre 1.0% in real terms in 2014, following a rise of 6.5% in 2013. Excluding the distortions by the wild fluctuations in exports of non-monetary gold, export growth of goods stayed modest in 2014, moderating somewhat from the previous year. Exports to the US fared better among advanced markets, logging moderate growth for the year with acceleration in the fourth quarter, as the economy there picked up steam since the second quarter. Exports to Japan fell notably, and those to EU relapsed to a decline in the second half, as their import demand was held down by their subdued economic conditions and the notable depreciation of their currencies against the US dollar. The performance of other markets also diverged, with exports to the Mainland and newly industrialised economies saw modest to moderate growth, but those to India and some ASEAN markets picked up to show notable growth.

1.5 In terms of quarterly profile on a year-on-year basis, merchandise exports after excluding non-monetary gold in real terms reverted from a 0.3% decline in the first quarter to 4.3% and 4.8% growth respectively in the second and third quarters, before relapsing to a 0.4% decline in the final quarter. Similarly, the seasonally adjusted quarter-to-quarter comparison indicated that merchandise exports after excluding non-monetary gold in real terms contracted in the first quarter, resumed growth in the second and third quarters, yet fell back in the fourth quarter.

1.6 *Exports of services* slowed markedly in 2014, rising only by 0.5% in real terms for the whole year, denoting the slowest growth since 2009. The main drag stemmed from the setback in exports of travel services, as a marked decline in visitor spending on big-ticket items took its toll against a high base of comparison, even though the drag lessened in the second half of the year. Exports of financial and other business services also decelerated somewhat, while exports of trade-related services remained lacklustre, both growing only mildly for 2014 as a whole. Exports of transportation services showed some relative improvement, thanks to vibrant growth in cross-boundary passenger flows.

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

	2013#	2014+	2013				2014			
			Q1#	Q2#	Q3#	Q4#	Q1#	Q2#	Q3#	Q4+
Change in real terms of GDP and its main expenditure components (%)										
Private consumption expenditure	4.6	2.7	6.7	5.1	2.9	3.8	1.6	1.3	4.1	3.8
			(2.8)	(0.1)	(-0.8)	(1.7)	(0.4)	(0.2)	(1.9)	(1.1)
Government consumption expenditure	3.0	3.1	2.5	3.8	3.0	2.7	2.7	2.7	3.7	3.3
			(0.7)	(1.4)	(*)	(0.6)	(0.6)	(1.3)	(1.0)	(0.3)
Gross domestic fixed capital formation	2.2	-0.3	-4.0	6.4	1.4	4.3	3.7	-5.2	-3.3	4.0
of which :										
Building and construction	-4.3	6.5	-4.3	-4.5	-0.8	-7.2	11.4	2.0	5.0	7.1
Machinery, equipment and intellectual property products	10.6	-5.2	-4.4	19.6	7.5	17.2	1.9	-9.9	-11.9	1.2
Total exports of goods	6.5	1.0	8.8	6.1	6.1	5.5	0.3	2.0	1.0	0.6
			(2.3)	(-1.3)	(2.8)	(1.4)	(-2.5)	(0.7)	(1.8)	(-0.3)
Imports of goods	7.2	1.0	9.2	7.4	6.5	5.9	1.1	1.1	0.5	1.2
			(3.8)	(-1.3)	(1.3)	(1.7)	(-0.4)	(-1.1)	(0.8)	(0.8)
Exports of services	4.9	0.5	3.9	6.8	4.3	4.5	3.5	-1.9	0.9	-0.7
			(0.8)	(3.9)	(-2.9)	(2.4)	(0.2)	(-1.6)	(0.2)	(0.6)
Imports of services	1.8	1.9	0.2	-0.8	2.2	5.6	-0.5	4.9	2.1	1.3
			(1.1)	(-1.3)	(2.0)	(3.3)	(-4.4)	(4.2)	(-0.7)	(2.3)
Gross Domestic Product	**2.9**	**2.3**	**3.2**	**2.8**	**2.8**	**2.8**	**2.6**	**1.8**	**2.7**	**2.2**
			(0.6)	**(0.5)**	**(0.6)**	**(1.0)**	**(0.5)**	**(-0.2)**	**(1.4)**	**(0.4)**
Change in the main price indicators (%)										
GDP deflator	**1.7**	**3.0**	**1.7**	**0.7**	**2.0**	**2.3**	**2.3**	**4.4**	**2.8**	**2.4**
			(-0.4)	**(-0.5)**	**(2.3)**	**(0.8)**	**(-0.1)**	**(1.4)**	**(0.7)**	**(0.4)**
Composite CPI										
Headline	**4.3**	**4.4**	**3.7**	**4.0**	**5.3**	**4.3**	**4.2**	**3.6**	**4.8**	**5.1**
			(1.0)	**(1.3)**	**(-0.7)**	**(2.7)**	**(0.9)**	**(0.7)**	**(0.5)**	**(2.9)**
Underlying^	**4.0**	**3.5**	**3.8**	**3.9**	**4.3**	**4.0**	**3.8**	**3.5**	**3.3**	**3.3**
			(1.1)	**(1.1)**	**(0.9)**	**(0.9)**	**(0.9)**	**(0.7)**	**(0.7)**	**(0.9)**
Change in **nominal GDP** *(%)*	**4.7**	**5.3**	**4.9**	**3.6**	**4.8**	**5.2**	**5.0**	**6.2**	**5.7**	**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 ±0.05%

The domestic sector

1.7 Domestic demand slowed somewhat in 2014. *Private consumption expenditure* (PCE) grew modestly by 2.7% in real terms in 2014, down from the 4.6% growth in the preceding year, with the moderation concentrated in the first half in tandem with the meagre economic growth. PCE saw some relative improvement in the second half of the year, underpinned by the faster employment growth, while such incidental factors as positive wealth effects and the launch of new smartphone models also provided support. Separately, *government consumption expenditure* grew at a steady pace of 3.1% in real terms in 2014, broadly the same as the 3.0% growth in 2013.

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

		Total consumer spending in the domestic market[(a)]	*Of which :* Food	Durables	Non-durables	Services	Residents' expenditure abroad	Visitor spending	Private consumption expenditure[(b)]
2013	Annual	6.7	4.6	6.8	15.4	3.4	6.5	17.3	4.6
	H1	9.0	4.0	14.2	19.6	4.6	2.6	22.7	5.9
	H2	4.6	5.3	0.4	11.6	2.3	10.3	12.7	3.4
	Q1	8.8	4.2	27.8	12.3	4.4	5.1	17.9	6.7
	Q2	9.2	3.7	-0.3	26.9	4.9	0.2	27.6	5.1
	Q3	4.8	5.2	-0.7	12.8	2.4	6.6	15.0	2.9
	Q4	4.4	5.4	1.3	10.5	2.1	14.2	10.6	3.8
2014	Annual	1.6	1.8	5.3	-2.0	2.5	3.2	-2.5	2.7
	H1	0.9	3.4	0.1	-2.6	2.2	3.2	-0.7	1.4
	H2	2.3	0.3	10.4	-1.4	2.9	3.3	-4.3	4.0
	Q1	3.5	3.1	4.0	6.3	2.2	-1.9	9.8	1.6
	Q2	-1.6	3.6	-5.2	-10.4	2.2	8.4	-10.6	1.3
	Q3	2.4	1.5	4.6	-0.1	3.4	3.4	-4.6	4.1
	Q4	2.3	-0.9	14.9	-2.5	2.5	3.2	-4.1	3.8

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.

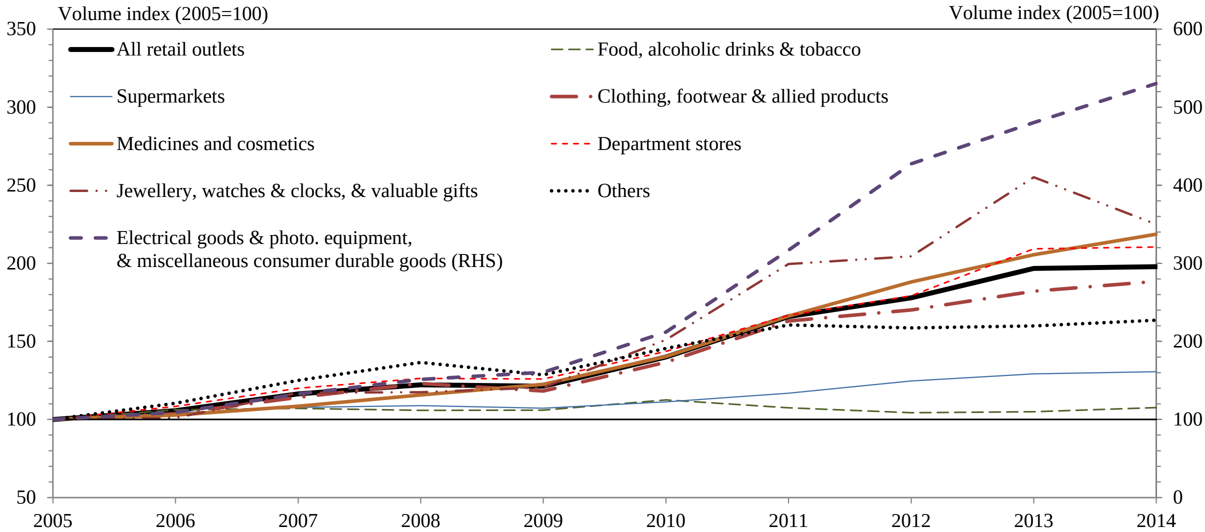
Box 1.1

An update on retail sales trends and performance

The retail sector is important to the Hong Kong economy. The industry directly contributed 4.3% to Hong Kong's GDP in 2013 and some 330 000 jobs, equivalent to 9% of total employment, in the first three quarters of 2014. This box article provides a brief analysis on the recent trends of retail sales with a focus on volume movement by outlet type, as well as an update of ***Box 1.2*** in the ***Half-yearly Economic Report 2014*** which covered the retail sales performance up to the second quarter of 2014.

Retail sales exhibited much resilience during the global financial crisis of 2008-2009 and expanded rapidly in the post-crisis years. Overall sales volume attained a cumulative growth of 63.1% from 2009 to 2014. Analysed by retail outlet, "electrical goods and photographic equipment, and miscellaneous consumer durable goods" saw the fastest increase in business volume, followed by "jewellery, watches and clocks, and valuable gifts", "medicines and cosmetics", and department stores. The strength of sales in these outlet types suggests that, apart from improved local consumer sentiment amid the generally favourable job market conditions and the Government's various measures to support the domestic economy in recent years, sustained vibrancy in inbound tourism also played a key role. However, retail sales growth weakened to a mere 0.6% in volume terms in 2014, substantially slower than the average annual growth of 12.8% in 2010-2013. The notable decline in the sales of luxury items in 2014 was the major contributory factor (***Chart 1***).

Chart 1 : After surging in the post-crisis years, retail sales slowed in 2014

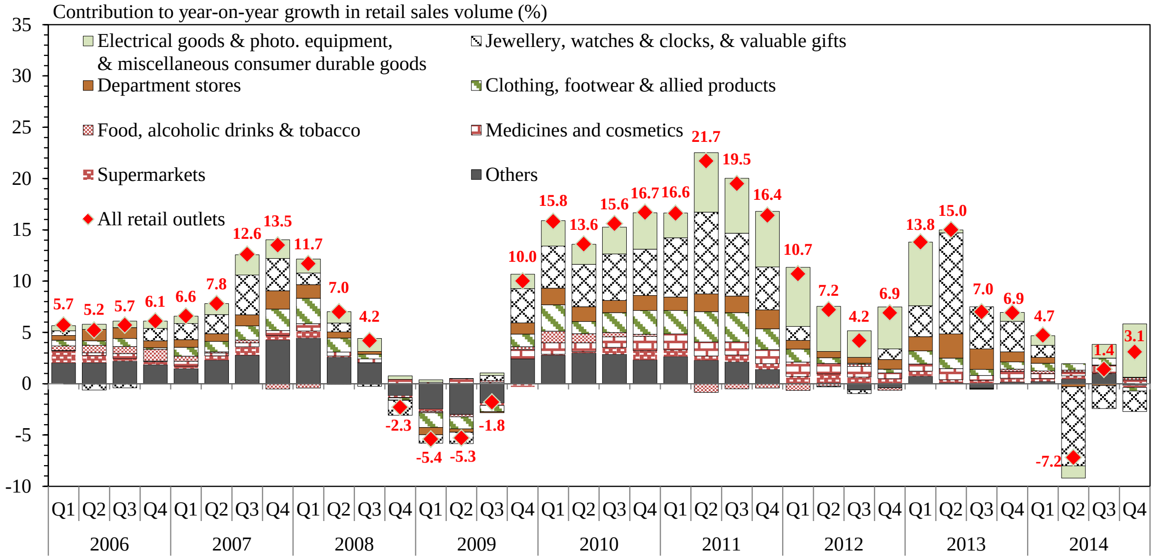


The quarterly profile in ***Chart 2*** revealed that retail sales saw wide fluctuations in 2014. The 4.7% moderate year-on-year growth in the first quarter was followed by a 7.2% plunge in the second quarter. Retail sales then rebounded modestly by 1.4% in the third quarter, and picked up somewhat to a 3.1% growth in the final quarter of 2014.

The plunge in the second quarter of 2014 was related to luxury items, mainly as a result of the high base caused by the spike of gold sales to visitors in 2013 amid the sharp correction in gold prices. Such drag on overall retail sales lessened somewhat in the third and fourth quarters. Moreover, despite the sustained rapid increases in visitor arrivals, sales growth in department stores and medicines and cosmetics also moderated in 2014. All these conceivably reflected some changes in tourists' spending profile. In the latter part of 2014, there was a surge in the sales of electrical and electronic goods, thanks to the launch of new smartphones, supporting retail sales in the fourth quarter.

Box 1.1 (Cont'd)

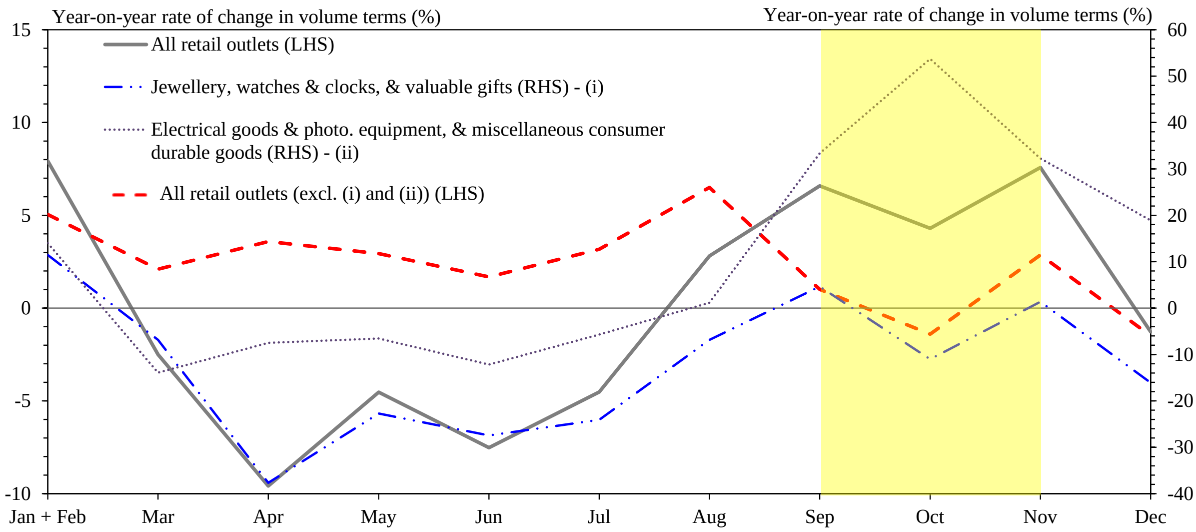
Chart 2 : Retail sales growth was dampened by luxury items in mid-year but was supported by boost to sales in electrical and electronic products in late 2014



Note: Others include: fuels; motor vehicles and parts; furniture and fixtures; books, newspapers, stationery and gifts; chinese drugs and herbs; optical shops; and other consumer goods, not elsewhere classified.

The monthly profile in ***Chart 3*** can help explain the subtlety in retail sales movements in the latter part of 2014, when the "Occupy Movement" was in progress. As mentioned above, the sales performance of the luxury items and electrical and electronic goods accounted for much of the volatility in overall retail sales over the course of 2014. Excluding these volatile components to better reflect the underlying local consumption strength, retail sales, after maintaining some moderate volume growth in the first eight months of 2014, slowed visibly to a modest growth of 1.0% in September and declined by 1.4% in October. Conceivably, such a sharp turn in the underlying growth trend of retail sales partly reflected the weaker consumer sentiment amid the disruptions caused by the "Occupy Movement". Such underlying retail sales reverted to grow by 2.9% in November but declined again by 1.5% in December.

Chart 3 : Retail sales performance was disrupted in October 2014



Retail sales performance in the period ahead will depend mainly on the future developments in inbound tourism, external environment, and local job conditions. Given the various uncertainties, the Government will continue to closely monitor the situation.

Diagram 1.2 : Private consumption grew modestly in 2014

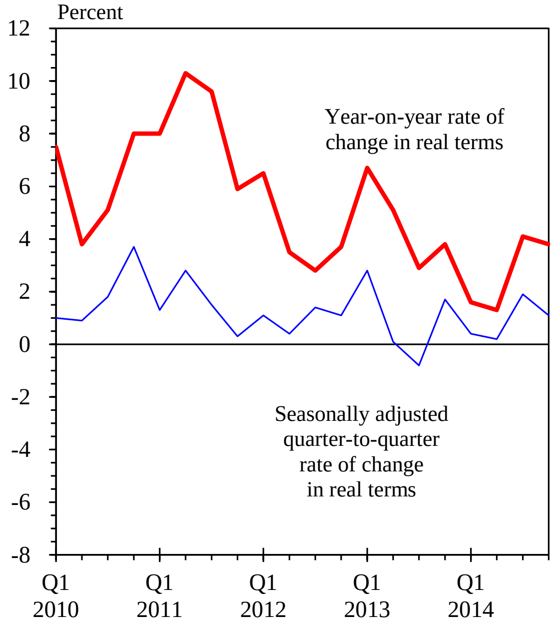
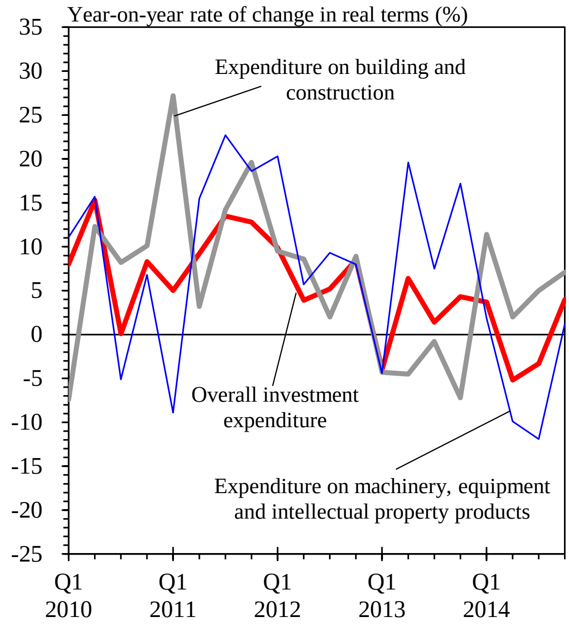


Diagram 1.3 : Investment spending slackened in 2014



1.8 Overall investment spending in terms of *gross domestic fixed capital formation* dipped by 0.3% in real terms in 2014, the first decline since 2009. The decline was due to subdued machinery and equipment acquisition, which fell by 5.2% in real terms. While a high base of comparison after brisk growth in the preceding three years was to blame, its weak performance to a certain extent might have also been associated with the subpar growth of the economy. This was broadly in line with the more cautious business sentiment among large enterprises as indicated by the latest Quarterly Business Tendency Survey, as well as the sluggish business situation suggested by the diffusion indices on small and medium-sized enterprises (SMEs) (see ***Box 1.2*** for details of the consultation on SMEs). Nevertheless, overall building and construction activity staged a solid rebound of 6.5% in real terms in 2014, as public infrastructure works re-accelerated to show notable growth, and private sector building and construction activity also picked up from the lull in the previous year.

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 1.2*** in the ***Third 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.

The overall situation on business receipts of the SMEs consulted, as gauged by the set of diffusion indices, indicated that the views among SMEs remained rather cautious in January 2015, with the overall reading at 48.8, still a notch lower than the boom-bust threshold of 50 (***Table 1***). Nevertheless, the recent indices indeed represented some relative improvement in business sentiment from the trough in October 2014, reflecting that the negative impacts of the "Occupy Movement" gradually waned. Analysed by sector, the diffusion indices showed that both restaurants and wholesale trade, with indices concerned standing at 50.0, fared better among the domestic segments in January 2015, while retail trade and business services were relatively weak. On the external front, the readings for the import/export trade and logistics sectors stabilised somewhat of late, but both only stood at the neutral mark of 50.0 in January 2015, as the external environment had yet to show discernible improvement. As regards the employment situation, the feedback from SMEs suggested a broadly stable development in recent months (***Table 2***).

Specifically for the import/export trade sector, SMEs' 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 rebounded from the low level in October 2014 and then eased back slightly to 50.0 in January 2015, a sign that the external demand conditions would remain rather sluggish.

The proportion of SMEs reporting tight credit access fell back to a low level of 0.8% in January 2015, attributable mainly to 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 1.2 (Cont'd)

Table 1 : Diffusion indices^ on business receipts

	2014 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2015 Jan
Local segments													
Restaurants	48.1	47.2	47.2	46.3	47.2	45.3	47.1	48.1	47.1	38.2	46.1	52.0	50.0
Real estate	42.4	42.4	54.5	48.5	48.5	43.9	47.0	47.0	46.9	40.6	54.7	45.3	48.5
Retail trade	47.4	49.1	47.4	48.2	47.7	46.9	46.1	48.4	48.0	40.3	43.9	48.8	47.5
Wholesale trade	44.7	44.7	50.0	50.0	44.7	39.5	36.8	44.4	41.7	33.3	44.4	44.4	50.0
Business services	47.0	51.6	51.6	53.1	50.0	46.9	48.4	48.4	45.3	45.2	46.8	48.4	45.6
External segments													
Import/export trade	47.9	48.3	48.7	49.6	48.4	49.2	48.8	49.6	49.2	42.6	47.9	50.8	50.0
Logistics	47.2	50.0	50.0	47.2	47.2	47.2	47.2	44.4	47.2	36.1	41.7	41.7	50.0
All the above sectors*	**47.0**	**48.2**	**49.2**	**49.3**	**48.0**	**47.0**	**47.0**	**48.3**	**47.6**	**41.0**	**46.7**	**48.9**	**48.8**

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

	2014 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2015 Jan
Local segments													
Restaurants	49.1	49.1	49.1	49.1	49.1	48.1	49.0	50.0	48.0	46.1	50.0	49.0	49.2
Real estate	50.0	50.0	50.0	48.5	47.0	48.5	50.0	50.0	50.0	50.0	51.6	50.0	48.5
Retail trade	49.6	50.4	49.1	50.5	49.6	49.6	49.6	50.4	50.0	49.2	50.8	49.6	49.6
Wholesale trade	50.0	50.0	50.0	52.6	47.4	47.4	47.4	52.8	50.0	50.0	50.0	50.0	50.0
Business services	50.0	50.0	51.6	50.0	48.4	50.0	50.0	53.1	50.0	46.8	50.0	50.0	50.0
External segments													
Import/export trade	50.4	50.4	49.6	50.4	48.4	50.4	49.2	50.0	50.0	49.2	50.0	50.0	50.0
Logistics	50.0	50.0	50.0	50.0	50.0	52.8	50.0	50.0	47.2	50.0	47.2	50.0	47.1
All the above sectors*	**50.0**	**50.2**	**49.7**	**50.3**	**48.6**	**49.8**	**49.3**	**50.6**	**49.8**	**48.9**	**50.2**	**49.8**	**49.6**

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

Table 3 : Diffusion index on current new export orders

	2014 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2015 Jan
Import/export trade	49.2	48.3	49.6	50.0	49.6	49.2	49.6	50.4	50.0	44.7	46.7	51.3	50.0

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

	2014 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2015 Jan
All selected sectors*	1.5	1.8	0.9	0.9	1.1	1.1	0.8	0.8	0.8	0.8	0.8	1.0	0.8

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

The labour sector

1.9 The labour market held generally tight in 2014. Total employment on average grew moderately by 0.9% in 2014, bringing the annual average to another all-time high of 3 760 600. On the back of the firm labour demand, the *seasonally adjusted unemployment rate* stayed at relatively low levels throughout the year. After hitting a 16-year low of 3.1% in the first quarter, the seasonal adjusted unemployment rate went up marginally in the following months, to 3.3% in the three-months ending July, and stayed stable at this level through the rest of the year, indicating that the economy was still in a state of full employment. The *underemployment rate* likewise hovered at low levels, at 1.6% in the fourth quarter. Nominal wages and earnings sustained broad-based and moderate growth in 2014.

The asset markets

1.10 The *local stock market* continued to fluctuate during 2014. Dented by the shifting sentiment on emerging markets amid Fed's tapering, concerns over Mainland's economic slowdown and geopolitical tensions surrounding Eastern Europe, the local stock market came under pressure in the first quarter, reaching a low of 21 182 on 20 March 2014. But it gained support subsequently and rallied upon the signs of revival in the US economy, continued steadiness of the Mainland economy, expectations of the Shanghai-Hong Kong Stock Connect, and the continued accommodative stance by the Fed. After hitting a six-year high of 25 318 on 3 September 2014, the Hang Seng Index lost ground again on jitters about global economic outlook and oil price slump, closing the year at 23 605, slightly higher than at end-2013 by 1.3%. In 2014, the average daily turnover rose markedly in the second half of the year, giving an average of $69.5 billion for the whole year. Fund-raising activity also picked up in 2014, with total IPO funds raised amounting to $227.7 billion, rising remarkably from $169.0 billion in 2013. Therefore, Hong Kong ranked as the world's second largest IPO centre in 2014 for the second consecutive year, just after New York.

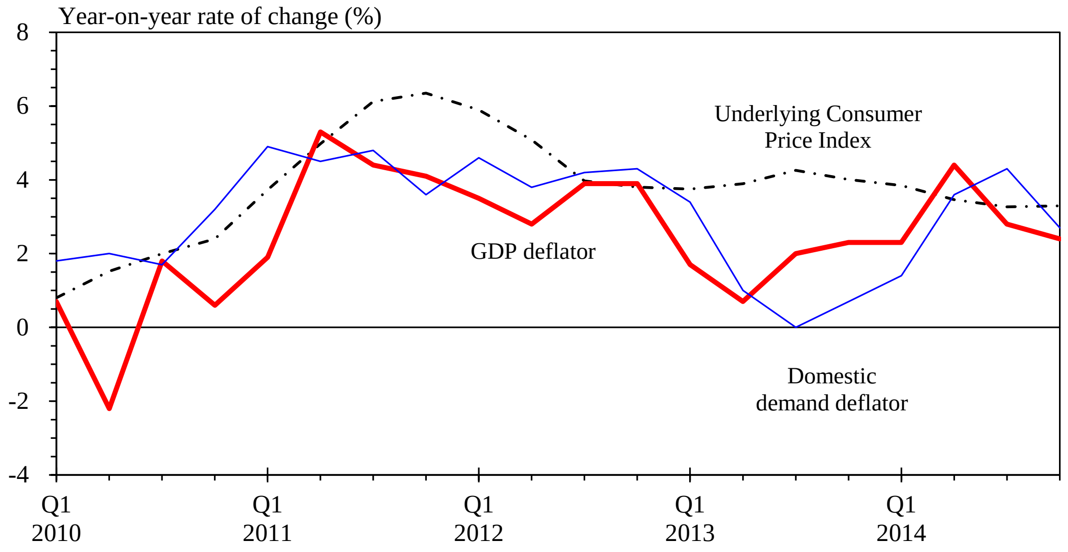
1.11 The *residential property market*, after staying quiet in the first quarter of 2014, staged a revival in the rest of the year, as interest rates stayed low while successive launch of large primary projects by developers at a discount relative to the secondary markets also helped release the pent-up demand. Transaction volume rebounded notably from a low level by 26% in 2014, having declined in the preceding three years. Overall flat prices in December 2014 were 13% higher than a year earlier. The revival of the property market indicates that the bubble risks for the housing market remain prominent. Indeed, overall flat prices in December exceeded the 1997 peak by 61%, with the housing affordability ratio worsening to 58% in the fourth quarter of 2014, well above the long-term average of 47% over 1994-2013. Likewise, flat rentals increased at a slightly faster pace during the second half of the year, leading to a cumulative gain of 6% during 2014, up from that of 3% during 2013. As regards commercial property, increases in shop and office rentals both slowed to 4% during 2014, as against the corresponding increases of 7% and 8% during 2013.

Inflation

1.12 Consumer price inflation followed an easing trend in 2014. Netting out the effects of the Government's one-off relief measures, *underlying consumer price inflation* retreated to 3.5% in 2014, down successively from 5.3% in 2011, 4.7% in 2012 and 4.0% in 2013. Such moderation mainly reflected the milder imported inflation and receding local cost pressures during the year. In particular, increases in the private housing rental component continued to ease as earlier moderation in fresh-letting private residential rentals fed through. Moreover, commercial rentals rose at a low single-digit rate, while the growth in labour costs was rather steady, both helping to contain local cost pressures. *Headline consumer price inflation*, which is under the influence of the Government's one-off relief measures, edged up to 4.4% in 2014 from 4.3% in 2013. Higher headline inflation compared with the underlying figure was mainly caused by the lower base effect created by the Government's payment of public housing rentals in September 2013, the depletion of the Government's one-off electricity charge subsidy by households in the latter half of 2014, as well as the end of rates concession in October.

1.13 The *GDP deflator* increased by 3.0% in 2014, up from the 1.7% increase in 2013. Within this, domestic demand deflator registered a faster increase, as prices for investment spending reversed the decline in the previous year to show a moderate increase, offsetting the slower increase in prices for consumption expenditure. The terms of trade in 2014 showed little change from the previous year.

Diagram 1.4 : Underlying consumer price inflation trended lower in 2014



GDP by major economic sector

1.14 The services sector grew modestly in the first three quarters of 2014, matching the overall economic performance during the period. Net output in real terms grew by 2.3%, 2.0% and 2.9% respectively in the first three quarters of 2014 over a year earlier.

1.15 Among the major sectors, net output of wholesale and retail trades fell in the first three quarters combined, with a marked decline in the second quarter followed by some stabilisation in the third quarter, in line with the retail sales performance during the period. Import and export trade also slowed to show only modest growth amid sluggish export performance. Financing and insurance accelerated in the third quarter after slowdown in growth in the first half of the year, driven by better market sentiment which led to more frequent financial transactions. Professional and business services, information and communications, accommodation and food services expanded moderately in the first three quarters. The net output of real estate activity, which mainly reflects the activity of private sector developers and property agency, saw faster growth in the second and third quarters in tandem with the pick-up in property market activity. Net output of transportation and storage also improved to show solid growth in the first three quarters. As for the other sectors, activity in the manufacturing sector remained subdued, relapsing to a decline in the third quarter after the mild growth in the first half. Yet, construction gathered pace in the first three quarters as a whole, thanks to the hectic infrastructure works and a pick-up in private sector building activity.

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

	2013	2014	2013				2014		
		Q1-Q3	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Manufacturing	0.1	0.8	0.5	0.3	-0.9	0.5	2.1	2.2	-1.7
Construction	4.1	7.7	2.2	6.0	11.8	-1.7	12.5	4.5	5.6
Services[(b)]	2.7	2.4	2.6	3.6	2.3	2.5	2.3	2.0	2.9
Import/export, wholesale and retail trades	3.2	1.0	5.0	4.7	1.5	2.4	0.3	0.5	2.1
Import and export trade	1.9	1.5	3.4	2.7	0.5	1.4	-0.7	2.4	2.6
Wholesale and retail trades	8.7	-0.6	11.4	12.4	6.0	6.0	4.1	-6.1	0.2
Accommodation[(c)] and food services	3.6	3.5	3.5	4.1	3.4	3.4	4.4	2.5	3.6
Transportation, storage, postal and courier services	4.1	6.0	1.2	4.5	4.1	6.8	7.1	7.0	4.1
Transportation and storage	4.1	6.2	1.2	4.8	3.5	7.0	6.8	6.9	5.0
Postal and courier services	4.6	1.5	0.9	-1.8	17.5	2.3	13.6	7.5	-14.1
Information and communications	4.0	4.0	6.4	2.8	4.1	2.8	3.1	5.6	3.6
Financing and insurance	7.6	3.1	5.3	9.8	9.3	6.1	3.3	0.8	5.2
Real estate, professional and business services	-4.0	3.1	-4.0	-5.2	-5.0	-2.1	2.0	3.6	3.6
Real estate	-10.7	2.4	-8.7	-13.8	-12.2	-8.4	0.7	3.0	3.8
Professional and business services	2.7	3.6	1.1	3.5	2.2	4.0	3.2	4.1	3.5
Public administration, social and personal services	2.5	2.4	2.0	3.7	2.1	2.0	3.0	2.5	1.9

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

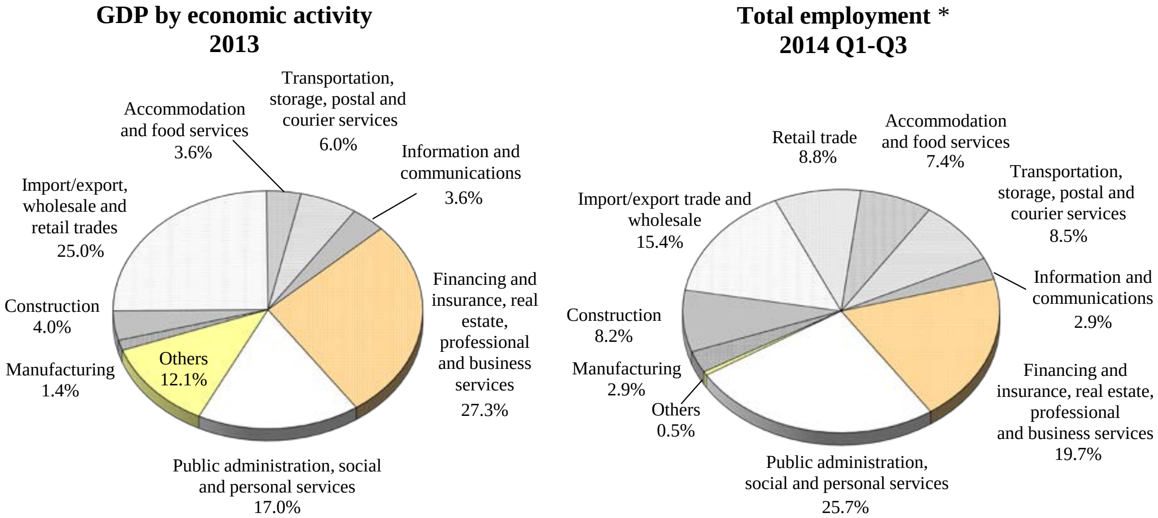
(a) The GDP figures shown in this table are compiled from the production approach, in parallel with those shown in Table 1.1 which are compiled from the expenditure approach. For details, see Note (1) to this chapter.

(b) In the context of value-added contribution to GDP, the services 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.

1.16 The services sector remained the pillar of the Hong Kong economy, accounting for 92.9% of GDP in 2013 and providing 88.4% of total employment in the first three quarters of 2014. Blessed with the unique advantages of "One Country, Two Systems" and a large pool of competent and professional workforce, the services sector is where Hong Kong's competitive advantage lies. With our core competence in high value-added services, Hong Kong is well-positioned to leverage on the nation's comprehensive deepening economic reform as well as its strategy in rebalancing towards consumer-based, service-led economic activities. Hong Kong will continue to enhance its competitiveness as an international financial centre and a regional business hub, by consolidating the strength of the traditional pillar industries, developing new industries with growth potential, increasing land supply, and upgrading its infrastructure and human capital. On the latter, it is worth noting that the proportion of the local workforce with tertiary education attainment increased steadily from 31.7% in 2009 to 36.2% in 2014.

Diagram 1.5 : The services sector remains the key driver of the economy



Note : (*) Figures refer to the Composite Employment Estimates, which are compiled based on results of the General Household Survey and the Quarterly Survey of Employment and Vacancies. Figures for 2014 are averages for the first three quarters of the year.

Other economic developments

1.17 As an international financial centre and business hub, Hong Kong serves as an ideal platform in connecting Asia with the rest of the world, and is well-positioned to tap the opportunities created by the nation's sustained development and economic reforms. To further enhance our competitiveness, the 2014-15 Budget unveiled a series of measures alongside 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.

1.18 The Agreement between the Mainland and Hong Kong on Achieving Basic Liberalisation of Trade in Services in Guangdong (the Agreement) was signed under the framework of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) in December. The Agreement, to be implemented on 1 March 2015, would not only bring new opportunities to our service providers and enhance the competitiveness of the services industries of the two places, but also set a model for basic liberalisation of trade in services in the Mainland by end-2015. Besides, at the Tenth Pan-Pearl River Delta (PPRD) Regional Co-operation and Development Forum and Trade Fair in October, the "Joint Declaration on Deepening PPRD Regional Co-operation (2015-2025)" was signed, which put forward a blueprint for strengthening PPRD regional co-operation in the coming decade.

1.19 Apart from the Mainland, the Government constantly strives to foster trade linkages with other economies, especially emerging markets. In July 2014, Hong Kong entered into formal negotiations with the ASEAN for a Free Trade Agreement (FTA), and with some World Trade Organisation members on the Environmental Goods Agreement. Besides, the FTA with Chile took effect in October, extending our reach to Central and South American markets. Furthermore, a Mutual Recognition Arrangement (MRA) on the Authorised Economic Operators between Singapore and Hong Kong Customs was signed in June. Similar MRAs with the Mainland signed earlier became operational in May for road cargo and in September for air and sea cargo, as did the one for Korea in August. Such customs facilitation should bring business opportunities to the import, export and logistics industries. Separately, Hong Kong signed avoidance of double taxation agreements with Korea, South Africa and United Arab Emirates in 2014, bringing the total number of similar facilitative tax agreements to 32.

1.20 On financial development, the Government works proactively to forge new co-operation and interaction so as to breed new opportunities in international finance. In September, the sukuk under the Government Bond Programme was successfully launched, signifying the world's first USD-denominated sukuk originated by an AAA-rated government. The success of the issue demonstrated the capability of Hong Kong's fund-raising platform for sukuk issuance, which should help advance the development of Islamic finance here. Separately, under the support of the Central Government, the Shanghai-Hong Kong Stock Connect pilot programme was launched in November. The pilot program allows 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 quotas and some other criteria. At the same time, it also allows Hong Kong and overseas investors to trade eligible stocks listed on the SSE through the SEHK directly, subject to quotas and some other criteria. Its implementation helped enhance the two-way flows between offshore Renminbi (RMB) market in Hong Kong and the Mainland, and reinforce Hong Kong's status as a leading offshore RMB business centre and international financial centre.

1.21 To explore ways to make more comprehensive fiscal planning to cope with the ageing population and the Government's other long-term commitments, the Working Group on Long-Term Fiscal Planning released a report in March, with assessments on the current state of Hong Kong's public finances and projections of the Government's long-term fiscal positions. 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.

1.22 The Chief Executive delivered the 2015 Policy Address in January 2015, unveiling measures to develop the economy, increase housing supply and harness the potential of Hong Kong people, alongside other initiatives in poverty alleviation, elderly care, environmental protection, health care, education and youth development.

- Strengthening economic ties with both the Mainland and other trading partners plays an integral role in Hong Kong economic development. The Government will continue efforts to further open up the Mainland market with a view to achieving basic liberalisation of trade in services with the Mainland by end-2015, and actively work with Guangdong to explore new modes of co-operation and maximise development opportunities for Hong Kong people and enterprises in response to the proposed Guangdong Pilot Free Trade Zone covering Nansha, Qianhai and Hengqin. Besides, new

Economic and Trade Offices would also be opened in the Asian region.

- To foster diversity in the industries and enhance the competitiveness of the economy, the Government will, among other things, set aside $500 million to prepare for establishment of the Insurance Authority, and establish a new maritime industry body to promote Hong Kong's maritime services industry. The Government will provide further funding support for private sector research and development projects and the development of the creative industries, and has proposed a new agricultural policy and introduced measures to support the related developments.

- Infrastructure investments are key to raise our long-term economic capacity to grow and improve the connectivity of people and goods with the rest of the world. In this regard, the Government will support the Airport Authority to implement the three-runway system project, take forward development projects of Lantau Island, and press ahead the capital work at the former airport site to complement the hotel development in the adjacent areas.

- On housing, the Government is determined to avert the demand-supply imbalance progressively, by making available more land for housing and commercial development, and achieving the Government's 10-year housing target of 480 000 units.

- To address the challenges brought about by demographic change, a new five-prong strategy was announced, including plans to extend the retirement age, nurture local manpower, attract talent from outside Hong Kong, and help women and the underprivileged to enter the workforce. On poverty alleviation, the Government will introduce the Low-Income Working Family Allowance, and extend the short-term food assistance service. More resources will also be provided to strengthen support for families and children in dire need. On retirement protection, the Government will set aside $50 billion to provide for future needs in offering protection for needy citizens after retirement, and also continue to improve Mandatory Provident Fund arrangements.

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.