CHAPTER 2 : ECONOMIC OUTLOOK FOR 2015 AND THE MEDIUM TERM

Summary

- *Global economic growth is likely to remain moderate in 2015, with uneven performance across regions. Among the advanced economies, the US is expected to gather further traction, while the eurozone and Japan will still need to overcome structural impediments in order to gain momentum. Among the major emerging market economies, the growth outlook for Russia and Brazil is lacklustre. In contrast, the Mainland economy, though also affected by the unsteady external environment, should continue with a growth pace that is envy to many major economies. India and some other Asian economies with stronger fundamentals should also be relatively resilient.*

- *The global outlook is, however, still subject to considerable uncertainties, with risks tilted towards the downside. Of particular note are the different and varying monetary policy stances of major central banks on the back of the uneven recovery in the advanced economies. Global financial volatility is bound to increase as interest rate expectations change, with potential significant implications for capital flows, exchange rates, asset prices and liquidity conditions. The global economic growth may also be dragged by the eurozone and Japan, which are facing increasing deflation risks and still struggling to spur and sustain recovery. While the recent plunge in oil prices should help economies which are net oil importers, it could have notable repercussions for some oil-exporting economies. Furthermore, the elevated geopolitical tensions in Eastern Europe and the Middle East remain a cause of concern.*

- *Hong Kong's exports of goods will still be rather weak, constrained by the unsteady and rather feeble external environment in 2015. The strength of the US dollar against other major currencies may also weigh on our export growth. Yet, there is some upside potential if domestic demand in Asia, in particular the Mainland, strengthens to support regional trade flows, or if the US economy picks up faster than expected. Meanwhile, Hong Kong's exports of services should see a somewhat better outlook, supported by further expansions of inbound tourism and cross-border financial and commercial activities.*

- *Locally, private consumption expenditure should show further growth, on the back of a resilient labour market and rising incomes, more so if the asset markets were to remain supportive. The outlook for investment is a bit more uncertain, being prone to possible shifts in business sentiment amid a still-highly unsteady global economic environment. For 2015, there is also an additional source of uncertainty surrounding the local political disputes.*

- *The Hong Kong economy is projected to grow by 1-3% in 2015, compared to the 2.3% growth in 2014 and the average annual growth of 3.9% in the past ten years. A two-percentage-point range is adopted for the GDP growth forecast, mainly reflecting the various uncertainties surrounding the global growth prospects.*

- *On inflation outlook, consumer price pressures should remain tame this year. With global inflation easing and the soft international commodity prices, imported inflation is expected to remain benign. Local cost pressures look set to moderate, given the expected slow economic growth and the moderated commercial rental cost increases. Overall, underlying Composite CPI is forecast to increase by an average of 3% in 2015, lower than that of 3.5% in 2014, signifying the fourth consecutive year of easing.*

- *The medium-term outlook for the Hong Kong economy will still be affected by the "new normal" in the global economy, which would likely see growth slower than that before the global financial crisis of 2008. The demographic challenges will also feature more visibly towards the end of the medium term. Against these, however, the Mainland will remain our main source of growth opportunities, manifesting through the trade, investment and financial channels. The Government's continued investment in education and training as well as in infrastructure will help to uplift Hong Kong's competitiveness. The trend GDP growth rate in real terms is forecast at 3.5% per annum from 2016 to 2019. The trend rate of underlying consumer price inflation is forecast at 3% per annum.*

Major external developments

2.1 The near-term outlook for the Hong Kong economy in 2015 will depend much on the external environment, which is challenging and fraught with uncertainties. Several key external developments will affect our trade performance, GDP growth and inflation. *First*, global economic growth is likely to stay mediocre. While the US economy is seeing signs of strengthening, many other advanced economies, as well as some emerging market economies, are still struggling to gain momentum. *Second*, the global monetary conditions would become more volatile in 2015. The different policy directions among the major central banks could have significant repercussions for capital flows, exchange rates and asset prices. The timing and pace of interest rate hikes in the US remain a major source of uncertainty, which could induce wild fluctuations in global financial markets from time to time, thereby affecting consumption and investment sentiments. *Third*, the sharp decline in oil prices since mid-2014 and the softening of other commodity prices should help to lower world inflation. The oil price plunge would benefit the net oil-importing economies, while hurting the net oil-exporting economies, including those already weakened by geopolitical tensions. Other commodity-exporting economies are also likely to see dimmer prospects. *Fourth*, wilder fluctuations in exchange rate movements are to be expected, given an unsteady external environment. The strength of the US dollar against other major currencies, if continued, may also affect the price competitiveness of our exports in 2015. The following provides a more detailed analysis of the major external developments.

Global economic outlook

2.2 The US economy is the bright spot among advanced economies. Real GDP grew by 2.4% in 2014, slightly improved from 2.2% in 2013. Growth gained traction after the second quarter of last year, supported by stronger private sector activity and milder fiscal adjustment. The improving labour market conditions also led the US Federal Reserve (Fed) to end asset purchases in October last year. The outlook for the US in 2015 is widely expected to improve further, as evidenced by the relatively optimistic GDP growth forecasts put out by analysts and international organisations. However, uncertainties still abound. Despite a general fall in the jobless rate to 5.7% in January 2015 and the sustained solid pace of job creation, a continued improvement in earnings growth has yet to be seen. With the core inflation rate still staying low amid a benign global inflation outlook, the timing of the first interest rate hike is still highly uncertain and remains data driven. The more fragile economic situation elsewhere, coupled with a stronger US dollar, may also restrain its export growth. The risks of political disputes over fiscal issues may also resurface given the expiration of the debt ceiling suspension in March 2015.

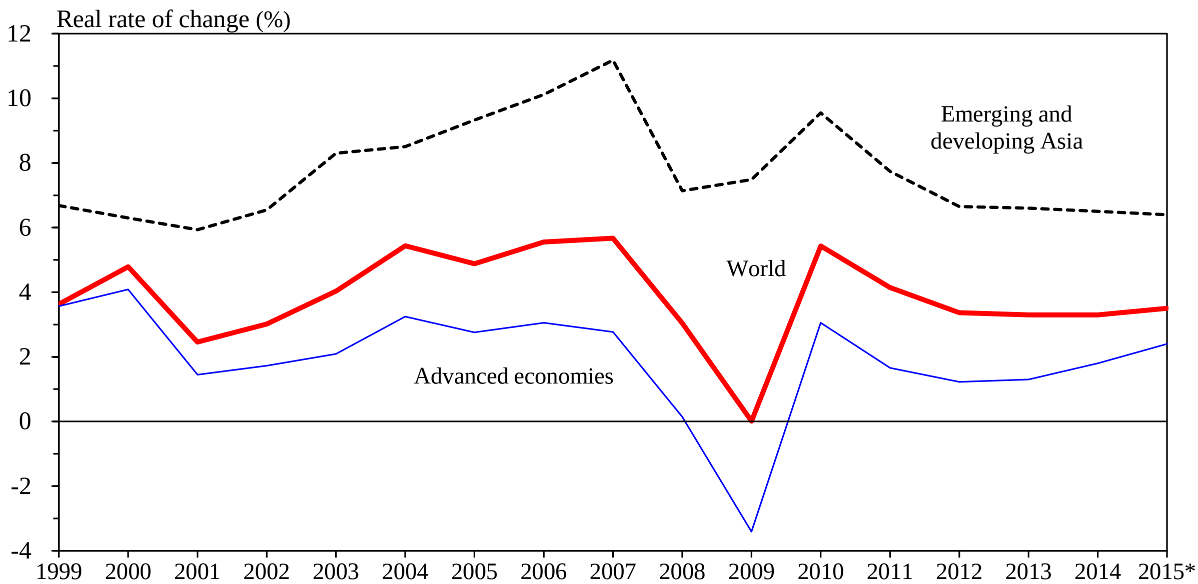
2.3 The growth prospects in Europe have been, and will continue to be, a key concern. The European Central Bank (ECB) cut its policy interest rates to historic lows and introduced further monetary easing in 2014, underscoring sluggish growth, elevated unemployment, and rising deflation risks in the eurozone. The region's growth will likely be constrained for an extended period if the structural problems facing the weaker eurozone members, including high debt levels, fragile fiscal positions and market rigidities, are not properly addressed. The enlarged quantitative easing by the ECB, while helping to fend off deflation risks, may not lend much support to growth if it is not accompanied by structural reforms in the eurozone. The surprise move by Switzerland in January 2015 to slash the cap on its currency against the euro, the sustained political tensions in Eastern Europe, and the recent political struggle over conditions of Greece's bailout programme are clear indications of the fragility and fluid situation in Europe, with clear risks to global financial stability, as well as to the global economic prospects.

2.4 The outlook of Japanese economy does not look promising too. The economy fell back into recession in the third quarter of 2014 after the sales tax hike in April battered consumption spending, prompting the Bank of Japan to expand its asset purchase programme further. Whether the monetary easing measures, the additional fiscal stimulus and the weakness of the yen would help revive Japan's growth remains to be seen. Going forward, Japan would still be confronted with the challenge of bolstering growth while maintaining fiscal sustainability. Moreover, Japan has yet to push through structural reforms, the third pillar of "Abenomics", to tackle the problems of an ageing population and certain market rigidities in order to unleash growth potential.

2.5 In a nutshell, the uneven economic performance among the advanced economies is expected to remain in 2015. Growth of the advanced economies as a whole would likely be led by the US. In January 2015, the International Monetary Fund (IMF) projected that GDP growth of the advanced economies would pick up from 1.8% in 2014 to 2.4% in 2015. This relatively benign scenario is predicated on the assumptions that the Fed's interest rate normalisation would not hamper the US economic recovery, that the central banks' varying monetary policies would not derail the global recovery, and that Europe and Japan would not stay stagnant due to their structural impediments.

2.6 Major emerging economies showed varying degrees of slowdown in growth last year. Russia's economy was hit by the oil price slump and geopolitical tensions, while Brazil's economy faced fiscal issues and structural bottlenecks. In contrast, emerging market economies in Asia remained relatively resilient. Going into 2015, lacklustre growth in some major advanced economies could continue to depress global and regional trade flows, the impact of which would be particularly pronounced for export-dependent Asian economies. Major central banks' policy actions may also threaten the macroeconomic and financial stability of some emerging economies as volatility of capital flows, currencies and asset prices would heighten. Yet, the Asian emerging market economies are expected to perform better than their counterparts in the rest of the world, thanks to their sounder fundamentals and continuing efforts to reorient their economies towards more domestically-driven growth.

Diagram 2.1 : The Asian region is likely to grow faster than the advanced economies in 2015



Source : IMF World Economic Outlook Update, January 2015.
Note : (*) Forecasts from the IMF.

2.7 For the Mainland economy, growth momentum moderated slightly over the course of last year after a prolonged period of rapid expansion, amid the gradual transition to the "new normal". While export growth was dented by the sluggish performance of the advanced markets, consumption and investment demand continued to expand at a robust pace, consistent with the strategy of shifting the sources of growth towards domestic demand. The unsteady global recovery, if carried forward into 2015, could entail a less supportive external environment for the Mainland's export growth prospect. Yet, given the Mainland's abundant policy room for manoeuvring, this year's economic growth is still expected to outperform other major economies, providing support to the region. The year 2015 marks the final year of the Mainland's 12th Five Year Plan, and the economy should be able to meet the 7% trend growth target set for the period 2011 - 2015. As the Mainland economy is geared towards a more sustainable and balanced growth path, the Central Government will sustain its efforts to render support to the Mainland's domestic demand and to enlarge the role of the services sector in the economy. Institutional reforms, which are conducive to improving the business environment, promoting innovation-driven growth and enhancing growth potential, will continue. In January, the IMF projected the Mainland economy to grow by 6.8% in 2015, after a 7.4% expansion in 2014. For emerging and developing Asia as a whole, the IMF projected an economic growth of 6.4% in 2015, similar to that in 2014.

2.8 Overall, the IMF in January projected that the world economy would grow by 3.5% in 2015, improving only marginally from 3.3% in 2014, hinging mainly on the expected acceleration in US economic growth. The IMF highlighted the downside risks related to shifts in sentiment and volatility in global financial markets, especially in emerging market economies and those oil exporters hit by lower oil prices, as well as to the stagnation and low inflation in the eurozone and Japan.

Table 2.1 : Growth forecasts for major economies in 2015

		2015	
	2014* (%)	**IMF*** **(%)**	**Private sector forecast^** **(%)**
World (PPP## weighted)	3.3	3.5	-
Advanced economies	1.8	2.4	-
US	2.4#	3.6	3.2
Eurozone	0.8	1.2	1.1
Japan	0.1	0.6	1.2
Emerging market and developing economies	4.4	4.3	-
Emerging and developing Asia	6.5	6.4	-
Mainland China	7.4#	6.8	7.0
India	5.8	6.3	6.3
Middle East and North Africa	2.8	3.3	-

Notes : (*) World Economic Outlook Update, IMF, January 2015.
(^) Average forecast as at January 2015.
(-) Not available.
(#) Actual figures.
(##) PPP refers to purchasing power parity.

Monetary conditions

2.9 Given the uneven global growth prospects, especially among the advanced economies, monetary policy actions of major central banks in 2015 could become more diverse or capricious, thereby further complicating the global monetary conditions and macroeconomic situation. While the US Fed is poised to pursue monetary policy normalisation eventually, the central banks in Europe and Japan have enlarged their monetary easing and may roll out further measures over the course of 2015. The timing and pace of these policy actions, including the prospective interest rate hike in the US, are subject to a high degree of uncertainty, contingent on how the economic conditions evolve. Further complicating the situation is the recent plunge in oil prices and the lower inflation outlook worldwide it entails, including that in the US. As such, global financial markets would be increasingly sensitive to incoming data. Increased volatility in financial markets and swings in market sentiment amid an environment of still-abundant liquidity could induce abrupt changes in capital flows and exchange rate movements, increasing the downside risks to economies with weaker fundamentals. The wider-than-usual fluctuations in asset prices could also hurt consumption and investment sentiments.

2.10 In a globalised world where financial markets are interlinked, a crisis elsewhere in the world could potentially have devastative spill-over effects on Asia, including Hong Kong. The currency crisis in Russia in the latter part of last year as a result of the oil price slump was a case in point, though the contagion effects had fortunately been contained as of the present moment. There is thus a strong need to stay vigilant to the fast-changing global monetary conditions and their possible adverse repercussions.

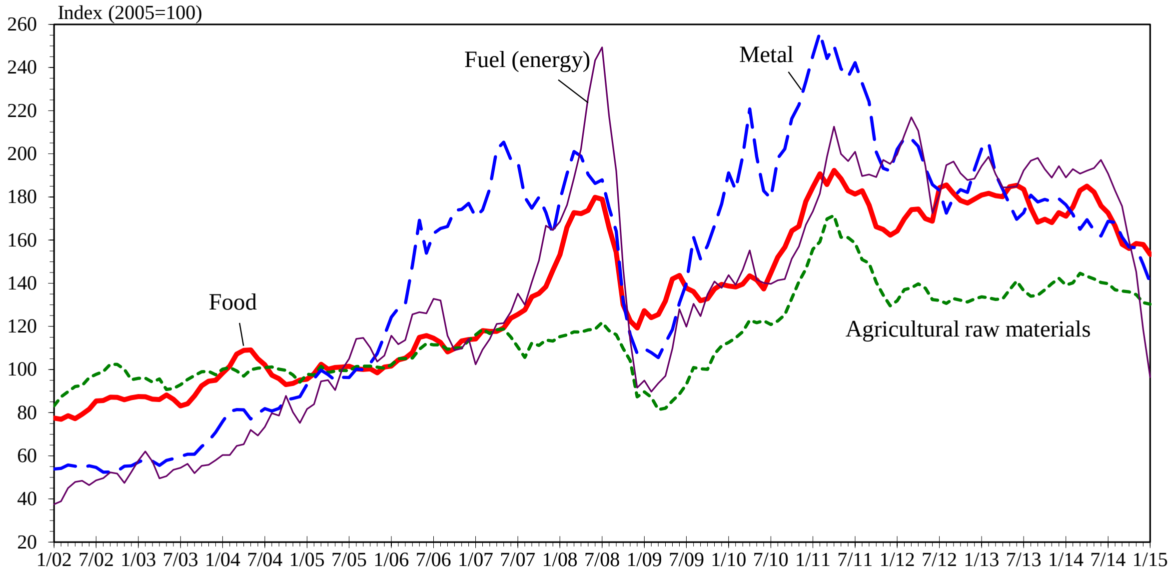
World inflation and global commodity prices

2.11 Inflationary pressures eased across most economies over the past year amid weaker-than-expected global economic growth and falling international commodity and energy prices. As global growth is expected to stay sub-par in 2015, with some economies facing rising deflation risks (see ***Box 2.1*** for details) and international commodity and energy prices tending to soften, global inflation is likely to remain low in the near term.

2.12 The drastic fall in oil prices since mid-2014 is particularly noteworthy, as it could also impact on the real side of the global economy (see ***Box 2.2*** for details). Oil prices plummeted by more than 40% during the second half of 2014 and stayed at rather low levels in entering 2015. While the oil price slump should benefit consumers and lower production costs in the net oil-importing economies, it adds to the deflation risks in such economies as the eurozone and Japan, at least in terms of lower headline inflation. For some oil exporters with weak fundamentals, the oil price plunge would weaken their external positions and exert pressures on their currencies, as what happened to Russia in late 2014. This would remain a potential threat to the stability of the global economy.

2.13 The international prices of other non-petroleum commodities also saw varying degrees of decline in 2014 and are likely to stay soft in 2015. For instance, global food prices fell by 4% in 2014, according to the Food and Agriculture Organization (FAO) of the United Nations. The softening of commodity prices, whilst conducive to lower global inflation, is also an indication of the cautious market sentiment on global economic outlook. Despite the recent developments, the risks of large commodity price fluctuations remain. A sharp escalation of the geopolitical situation in the Middle East could possibly cause disruptions to global oil supplies and feed-through into a notable rebound in oil prices. Likewise, international food prices could also be sensitive to adverse supply shocks arising from unfavourable weather conditions.

Diagram 2.2 : International commodity prices declined over the past year, yet sharp swings cannot be ruled out amid the global liquidity glut



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

Box 2.1

Deflation risks in selected economies

Global inflation followed an easing trend in 2014 amid the disappointing recovery pace of the global economy. Indeed, some economies have seen persistently low inflation or on the brink of deflation. By denting investment sentiment, delaying consumption and increasing real debt burden, deflation can lead an economy into prolonged recession, particularly when central banks are running out of conventional stimulus tools. Furthermore, different inflation trends across regions will result in varying central banks' policy actions, risking increased volatility in the global financial and exchange rate markets. The global inflation situation therefore warrants concern. This note attempts to examine the latest inflation trends in selected economies, including the US, the eurozone, Japan and the rest of Asia.

In the US, the Fed ended its asset purchase programme in October 2014 alongside stronger growth momentum. Yet, the path to normalising interest rates is still contingent on incoming data. While unemployment improved visibly, wage pressures have stayed unusually modest and housing market recovery has also been slow. In December, inflation rates in terms of the core personal consumption expenditures (PCE) deflator and core consumer price index (CPI) were just 1.3% and 1.6% respectively, still below the Fed's 2% target (***Chart 1***). Yet, deflation risk in the US should be less of a concern given the economy's improved outlook.

By comparison, deflation risk is more acute in the eurozone. Consumer price increases have been deviating notably from the European Central Bank (ECB)'s mandate of keeping inflation close to 2%. Excluding food, alcohol and tobacco, and energy prices, the eurozone's flash estimate of core CPI inflation stayed subdued in January, at 0.6%, amid the lack of growth momentum and elevated unemployment rate in the region. The headline rate even dropped to -0.6% due to the plunge in energy prices. Certain weaker eurozone members, including Spain and Greece, have already been experiencing deflation. Germany's inflation also unexpectedly eased in the recent past, despite its relatively resilient economic fundamentals (***Chart 2***).

Chart 1 : US price indicators still below Fed's inflation target

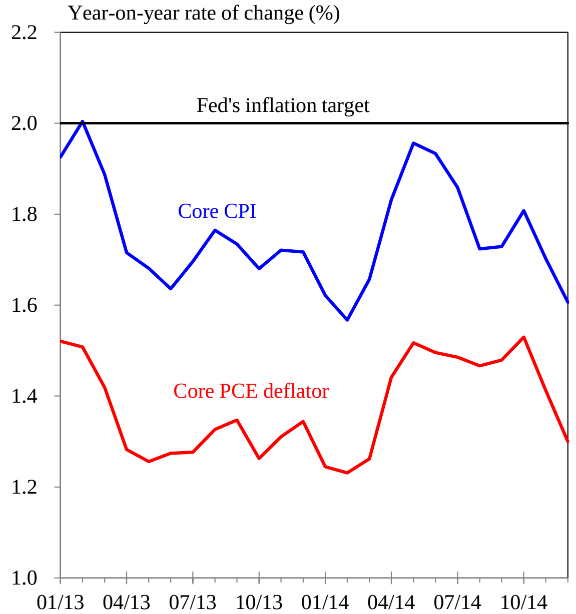
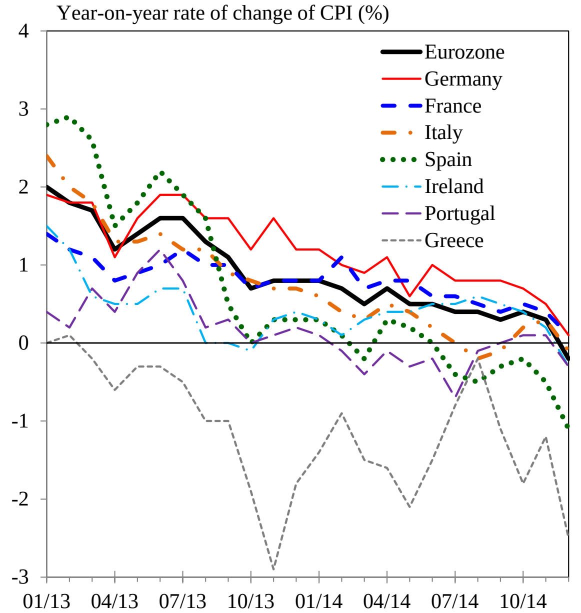


Chart 2 : Deflation risks in the eurozone have risen



Box 2.1 (Cont'd)

To reinvigorate the economy and bring inflation back to the target, the ECB cut its key interest rates to record lows in June and September 2014, and started its covered bond and asset-backed securities purchase programmes since October. However, these measures failed to reverse the course of the region's inflation. On 22 January 2015, the ECB announced further easing measures, and expanded its purchase programmes for asset-backed securities and covered bonds. It remains to be seen whether this can fend off deflation risk.

In Japan, the fight against deflation by means of "Abenomics" has also run into difficulties, with consumer price inflation easing again in recent months. Apart from the recent plunge in oil prices, also accountable were the waning effects of the expansionary macroeconomic policies launched since 2013 as well as the weakened demand following the consumption tax hike in April 2014, which led Japan's economy into recession in the second and third quarters of 2014. The Bank of Japan (BOJ) rolled out further monetary easing measures in late October in an attempt to ward off deflation risk and revive the economy. Japan's inflation was 0.5% in December after excluding the effect of the consumption tax hike, well below the BOJ's target of attaining 2% inflation (***Chart 3***).

As to other Asian economies, inflationary pressures in most of them have also been receding along with the recent declines in commodity prices and the sluggish global economy (***Chart 4***). In the Mainland economy, while producer prices have been falling, consumer price inflation still registered a mild increase, albeit easing further. Also, Singapore's negative headline inflation rates in November and December were due mainly to temporary factors. Compared to the eurozone economies, most Asian economies have relatively sound fundamentals and continue to sustain solid expansion, and therefore the risks of falling into the deflationary trap should not be significant.

Chart 3 : Japan's underlying inflation is still below BOJ's target

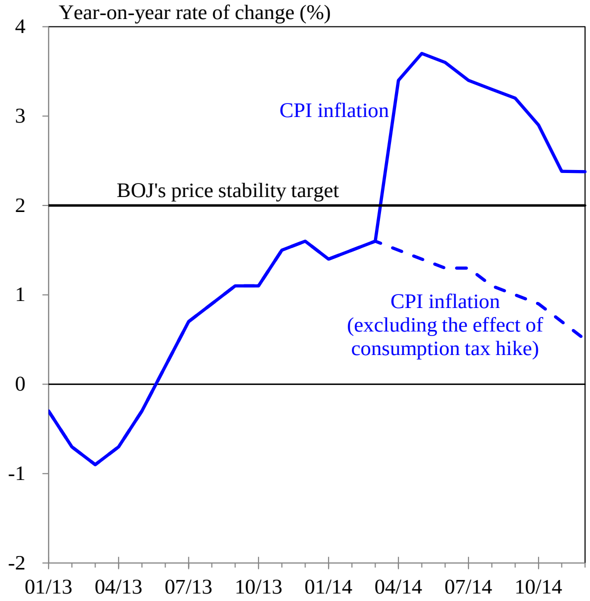
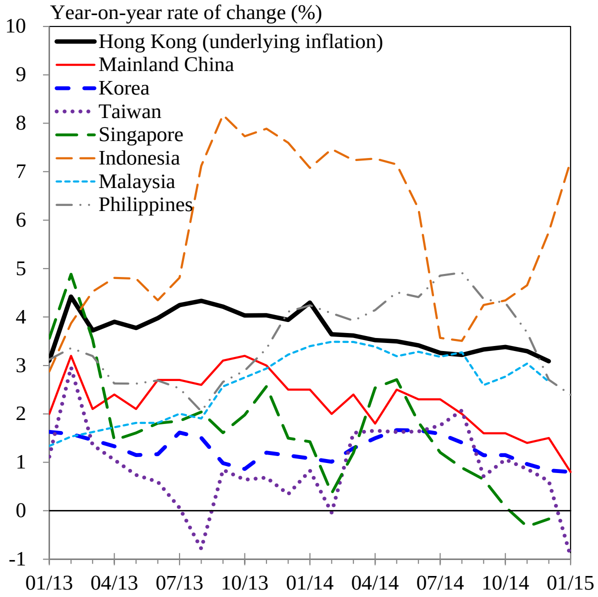


Chart 4 : Inflation in many other Asian economies has also eased in recent periods



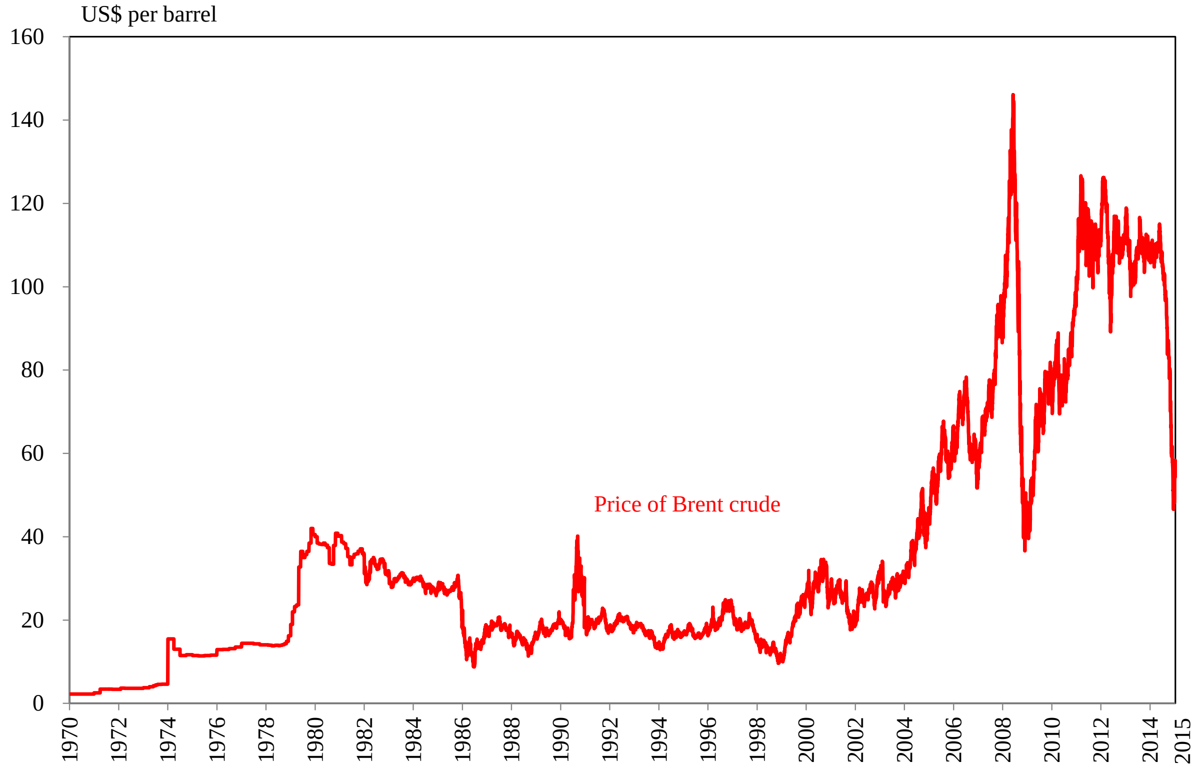
In sum, the deflation risks in economies across the globe are uneven, with the threats to the eurozone and Japan being most severe. The recent oil price slump also complicated the picture. Hong Kong's underlying inflation is currently around 3% and deflation risk is low. However, the unevenness of deflation risks in major economies would reinforce the trend of varying monetary policies among them, with potential destabilising repercussions on global financial and exchange rate markets. We need to closely monitor these developments.

Box 2.2

Oil price fluctuations and its impact on the global economy

International crude oil prices fell drastically since the latter half of 2014. While volatility in oil prices is not uncommon from past experience, such sharp fall in oil prices is still unprecedented and unusual (***Chart 1***). This note attempts to examine the possible reasons behind the latest plunge in oil prices and to highlight its impacts on the global economic situation.

Chart 1 : The recent plunge in oil prices is unprecedented and unusual



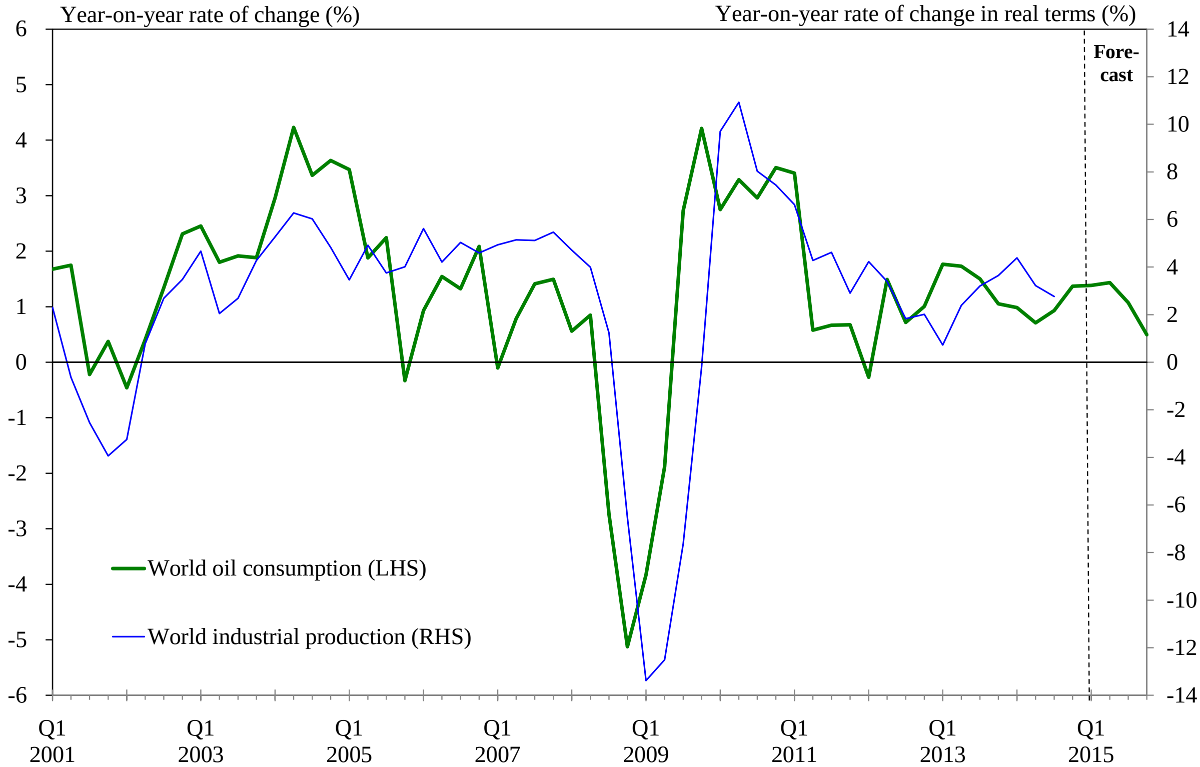
Possible reasons behind the oil price plunge from a supply-demand perspective

Simultaneous changes to factors determining the global demand and supply of oil have possibly contributed to the recent slump in oil prices:

- **Demand-side factors:** Demand growth for oil has been rather subdued. As can be clearly seen from ***Chart 2***, oil consumption is indeed highly related to the global economic sentiment. World industrial production slowed down alongside the below-trend growth of the global economy after the Global Financial Crisis of 2008, thereby reducing the demand for oil. It should also be noted that the strengthening of the US dollar over the course of 2014, to a certain extent, has also put some downward pressure on the dollar prices of commodities including crude oil.

Box 2.2 (Cont'd)

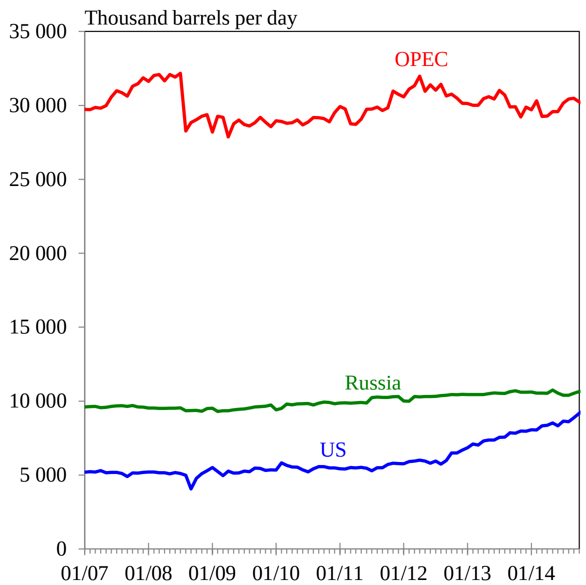
Chart 2 : Lower oil demand amid weaker global industrial activity



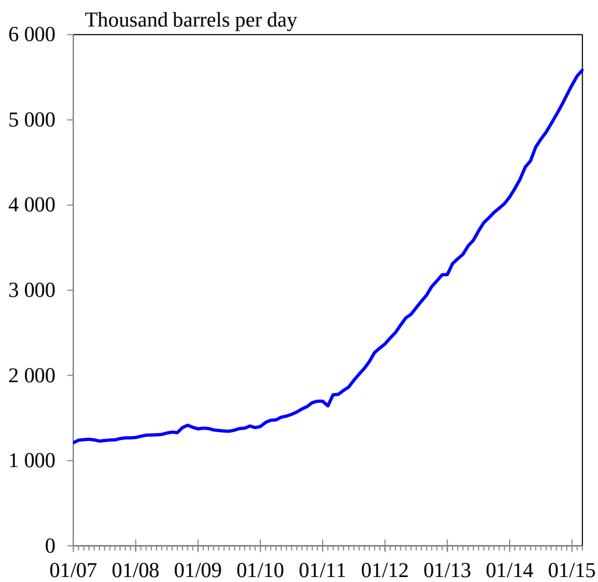
- **Supply-side factors:** The global oil supply has been increasing visibly in recent periods. The production of the Organization of the Petroleum Exporting Countries (OPEC) was rather stable at high levels (***Chart 3(a)***). This, coupled with the announcement of keeping their production ceiling unchanged in end-November 2014, has supported market expectations that oil supply will remain abundant relative to demand in the foreseeable future. Concurrently, Russia's oil production also expanded modestly. Those of the US surged in tandem with the spectacular growth in shale oil production, thanks to massive investments incentivised by high oil prices in recent years and the subsequent technological breakthrough (***Chart 3(b)***).

Chart 3 : Abundant global oil supply given OPEC's unchanged production ceiling and US' increased shale oil production

(a) Crude oil production in selected economies



(b) Shale oil production in the US

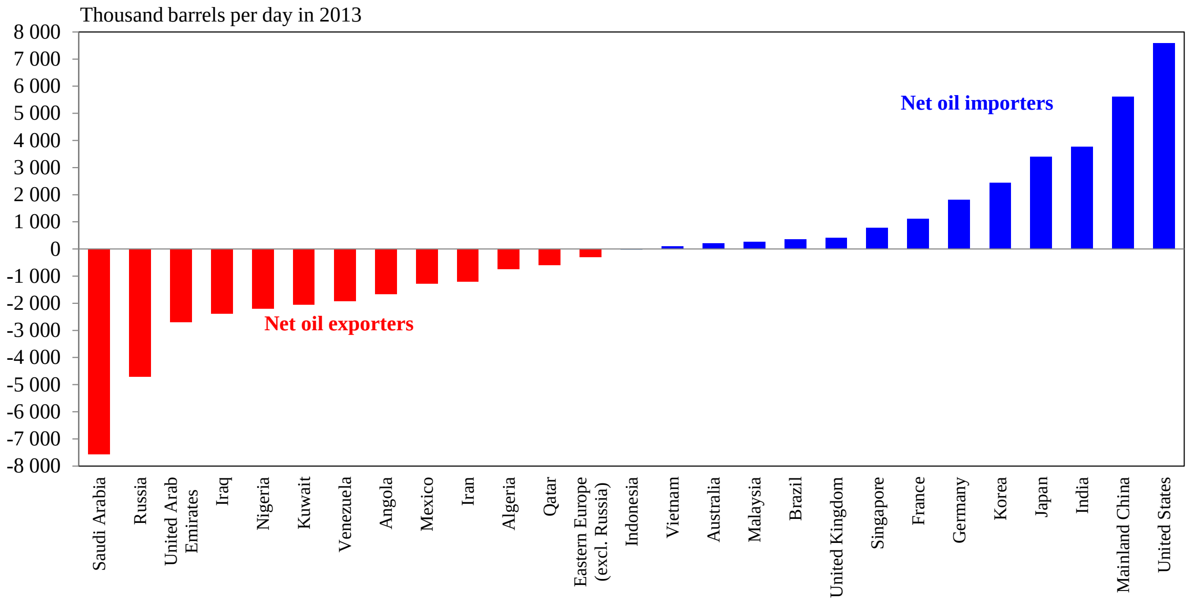


Box 2.2 (Cont'd)

Impact on the global real economy

The recent plunge in international oil prices will not only affect the global inflation outlook (as mentioned in ***Box 2.1***), but will also have potential impacts on the global economy, with likely polarised real impacts among countries. For **net oil-importing countries**, comprising many advanced and Asian economies, lower oil prices could be conducive to bolstering economic growth, as consumers will have more household income to spend, and firms will face lower production costs, and hence better profit prospects. For **net oil-exporting countries**, a sharp decline in oil prices will dampen investment and capital flows on oil-related activity and cut export revenues, which will eventually translate into a reduction in their government revenues. Those with weaker fundamentals, fragile external positions, and dependent on oil revenues to fund their fiscal budgets will be particularly vulnerable, weighing on growth and posing downward pressures on their currencies, as was the case with Russia in late 2014 (***Chart 4***).

Chart 4 : Net oil-importing countries would likely benefit from the recent oil price adjustments



Concluding remarks

Whilst lower oil prices could be beneficial to the economic growth of those net oil importers, the future path of oil prices remains highly uncertain. A sharp disruption to oil supply from the elevated geopolitical tensions in the Middle East or a sudden change in the amount of oil production by OPEC could escalate oil prices markedly. Hence, the possibility of a rebound should not be ruled out. The recent price slump has added uncertainties to the already volatile global economic and financial situation. A further downturn in oil prices may lead to growing bankruptcies or defaults of oil producing companies. Possible contagion risks via the financial channels to international financial markets and the global economy need to be watched over.

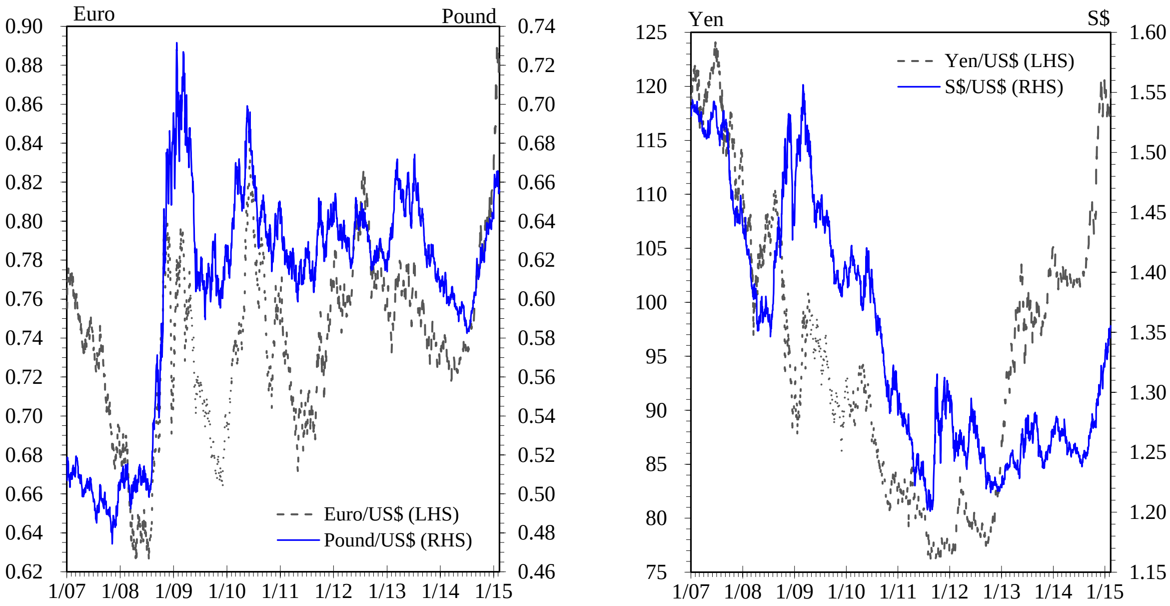
Exchange rates and price competitiveness

2.14 The movements of exchange rates may also affect the outlook of Hong Kong's economic growth and inflation. The US dollar strengthened against other major currencies in 2014 amid US' improved prospects and the Fed's inclination to normalise monetary policy. The appreciations against such currencies as the euro and the Japanese yen were particularly notable given the anaemic economic performance of and the further monetary easing in the eurozone and Japan. The Hong Kong dollar, which mirrors closely the movements of the US dollar, also appreciated against a basket of major currencies. In December 2014, the nominal trade-weighted effective exchange rate index of the Hong Kong dollar rose by 4% over a year earlier. This partly contributed to the modest imported inflation facing Hong Kong.

2.15 In 2015, the direction of exchange rate movements will remain subject to great uncertainty, on the back of the fragile recovery and varying monetary policy directions in the major economies. While the income growth in our major export markets will continue to be the key determinant of Hong Kong's export performance in 2015, the strengthening of the US dollar and therefore the Hong Kong dollar against other major currencies, if persisted, may to some extent weaken the price competitiveness of Hong Kong's exports of goods and services.

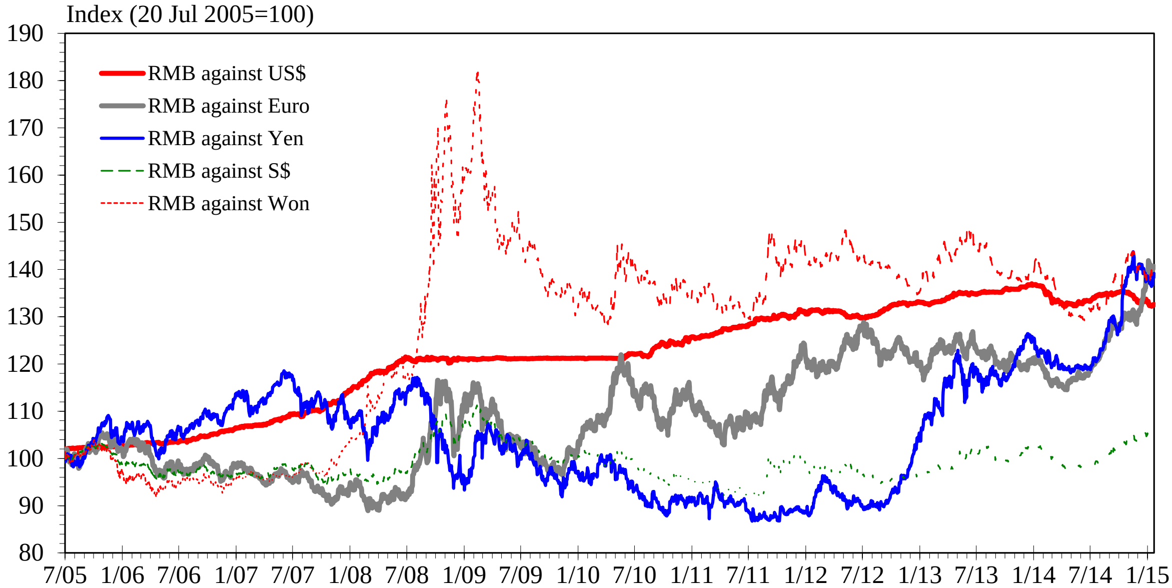
Diagram 2.3 : The foreign exchange market is subject to great uncertainty in 2015

(a) Against euro and pound sterling **(b) Against yen and Singapore dollar**



2.16 Given Hong Kong's close economic relations with the Mainland, the movement of the renminbi (RMB) is an important factor to be watched closely. During 2014, the RMB showed some mild fluctuations against the US dollar. It weakened slightly against the US dollar in the first half of 2014, but strengthened somewhat till end-October, before softening again. In November, the People's Bank of China lowered its policy rates, putting some downward pressure on the RMB. In December, the RMB against the US dollar fell by around 2% over a year earlier. The Mainland authorities are widely expected to proceed with the exchange rate regime reform in a controlled and gradual manner in 2015. A relatively stable RMB can help to reduce the exchange rate uncertainty facing Hong Kong's companies, given the Mainland's important role in the regional supply chains and the increasing use of RMB for settling cross-border trade and investment activities.

Diagram 2.4 : A relatively stable renminbi will help reduce uncertainty facing Hong Kong's trading companies



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

Major sources of uncertainty

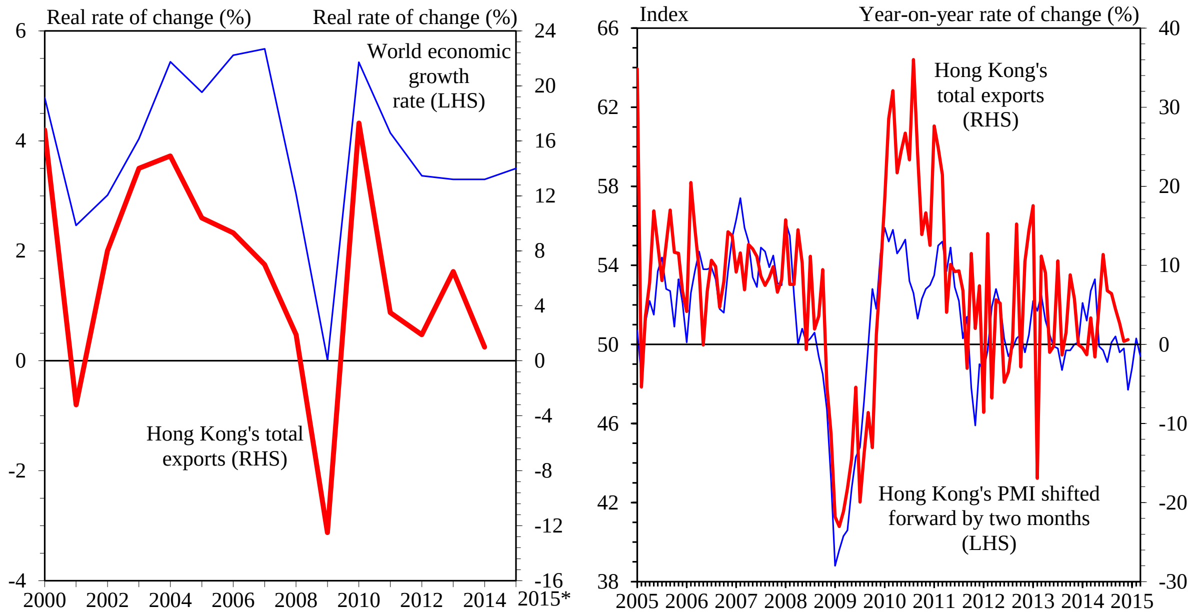
2.17 2015 should be another challenging year, with considerable uncertainties for the global economy as well as the Hong Kong economy. *First and foremost*, the timing and pace of the US Fed's monetary policy normalisation and the possible spill-over effects to the global economy remain the biggest source of uncertainty. This, coupled with the varying monetary policy actions by other central banks, could induce volatility in international financial markets and capital flows. *Second*, swings in market expectations of capital flows and interest rates may also trigger marked corrections in asset markets, including those in Hong Kong, with repercussions on consumer and investment sentiments. *Third*, economic conditions in some major advanced economies remain fragile. The fluid situation in the eurozone, with dim economic prospects and lingering deflation risks, was further complicated by such issues as Greece's debt problem and geopolitical tensions in Eastern Europe. *Fourth*, some major emerging market economies, such as Russia and Brazil, already saw visible growth deceleration of late, and this weak trend is expected to extend well into 2015. More worryingly, emerging market economies with weaker external positions and less robust fundamentals could be destabilised by the more volatile global monetary conditions, with possible spill-over effects on the rest of the world. *Fifth*, the oil price plunge last year was unusual. Its impacts on Russia and other net oil exporters are still evolving. *Sixth*, the geopolitical tensions in various regions linger on and remain a concern.

2.18 On the positive side, if the US economy were to show stronger growth momentum in conjunction with the Fed's effective communication about the monetary policy, the negative impacts on global economic and financial stability would likely lessen during the course of its interest rate normalisation. Likewise, if the monetary stimulus measures in Europe and Japan are effective, or if their plans on structural reforms can be implemented in more concrete terms, consumption and investment sentiments will strengthen to support growth in these economies. Also, there could be some upside potential to the global economic outlook if the economic performance of the Mainland and other emerging Asian economies turns out to be better than expected.

Outlook for the Hong Kong economy in 2015

2.19 Hong Kong's economic performance, as always, hinges on global economic and financial conditions. On the external front, the performance of Hong Kong's *exports of goods* has been mostly lacklustre amid the fragile global recovery in the aftermath of the Global Financial Crisis. In 2015, the export outlook remains rather bleak. The subdued growth in the eurozone and Japan will remain the major hindrance to global economic expansion, weighing on global trade flows. The weak demand conditions of some advanced economies will likely cast an adverse impact on production and trading activities in Asian economies, including the Mainland, with some possible spill-overs to Hong Kong. Also, the strength of US dollar will not bode well for our overall export competitiveness, and in particular, the distinct weakness of the euro and yen will directly curtail our exports to Europe and Japan. Yet, better prospects for the US economy and the sounder economic fundamentals in Asia in general should hopefully provide some cushion against the headwinds in other parts of the global economy. There may also be some upside potential if the US economy were to pick up faster than expected, to the benefit of Asia's trade flows.

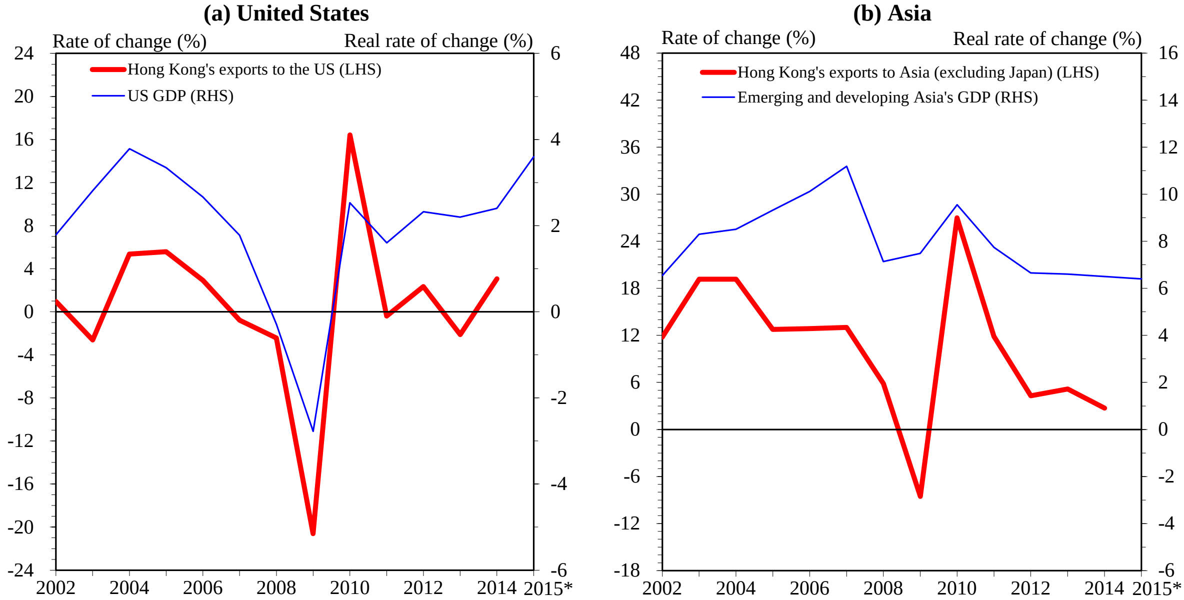
Diagram 2.5 : Hong Kong's exports of goods will continue to hinge on global economic conditions in 2015



Note : (*) Forecasts from the IMF World Economic Outlook Update, January 2015.

Diagram 2.6 : Regional trade is likely to be supported by the steady growth of the Mainland economy

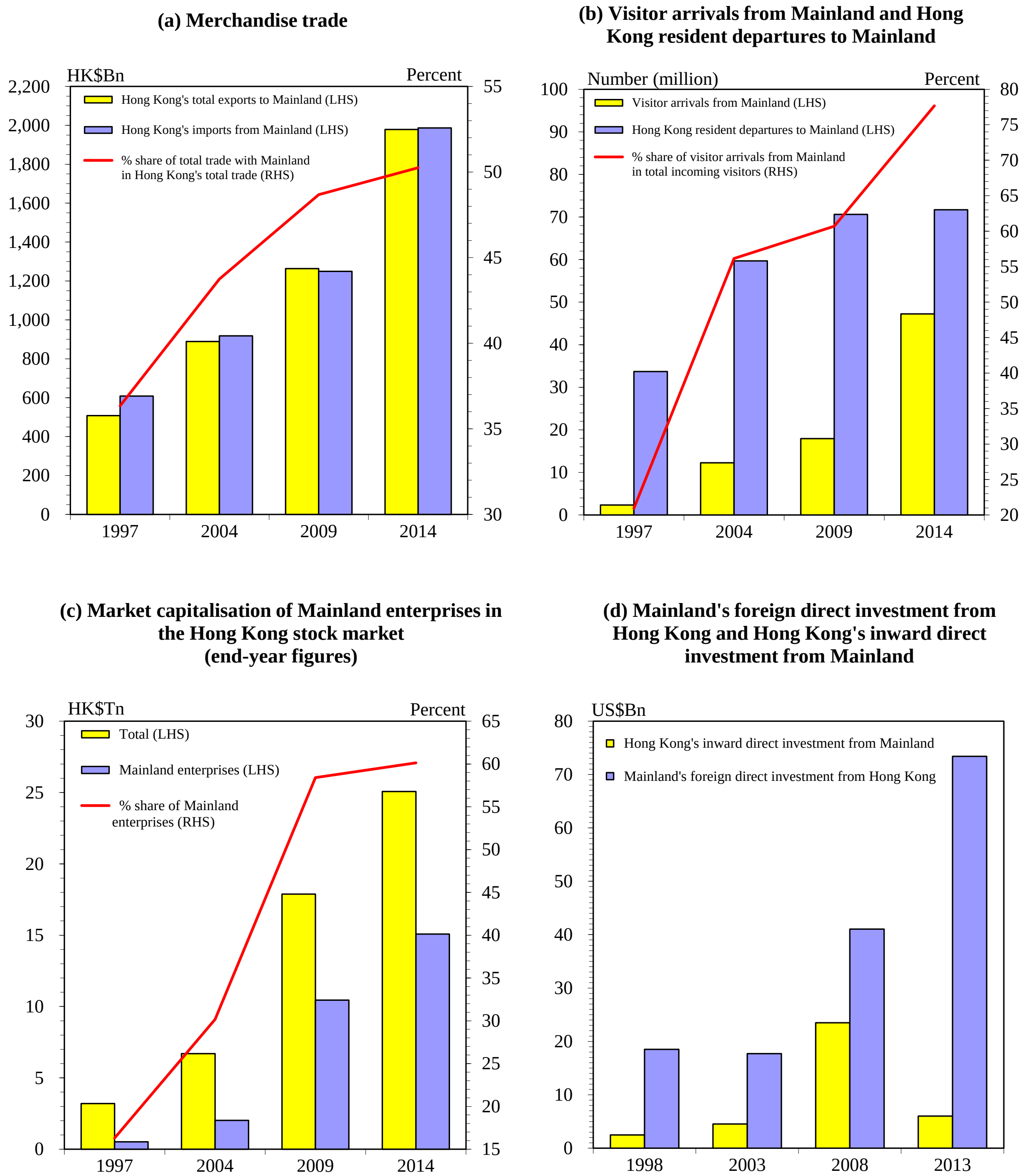
(a) United States **(b) Asia**



Note : (*) Forecasts from the IMF World Economic Outlook Update, January 2015.

2.20 *Exports of services* look relatively more promising and should see better growth outlook in 2015 after a rather weak year in 2014. Exports of travel services are likely to show some improvement as the continued visible increase in visitors from the Mainland should provide solid support to inbound tourism. As to other services exports, exports of financial and business services will continue to benefit from the expansion of fund-raising and cross-border financial activities. On the other hand, in face of the choppy global trading environment, the outlook for exports of trade-related services and transportation services is not as promising, and growth will likely be modest at best. Yet, on balance, overall services exports should still stage a relative improvement this year.

Diagram 2.7 : Economic links with the Mainland are important for Hong Kong



2.21 Given the rather unpromising outlook for the external sector in 2015, this year's growth driver of our economy has to rely on the domestic sector, which has shown much resilience over the past years, helping to cushion the economy against the adverse external shocks. Although *domestic demand* slowed in 2014 following a prolonged period of below-trend GDP growth, private consumption expenditure should be able to hold up and see further growth in 2015, on the back of a resilient labour market and rising incomes, and more so, if asset market conditions were to remain supportive. The outlook for investment expenditure, on the other hand, is a bit more uncertain. In face of a still-highly unsteady global economic environment, investment could continue to see volatility during the year, especially if interest rate outlook remained uncertain, and if local political disputes were to linger on. Indeed, the results of the latest Quarterly Business Tendency Survey on large enterprises and a consultation exercise on small and medium-sized enterprises (SMEs) both indicated that business sentiment about the near-term outlook remained rather cautious, though hiring sentiment stayed robust of late. Public construction works look set for further expansion, and hopefully would be able to provide a more stable growth source for overall investment in 2015.

Diagram 2.8 : Private consumption should see further growth as supported by steady employment conditions in the near term

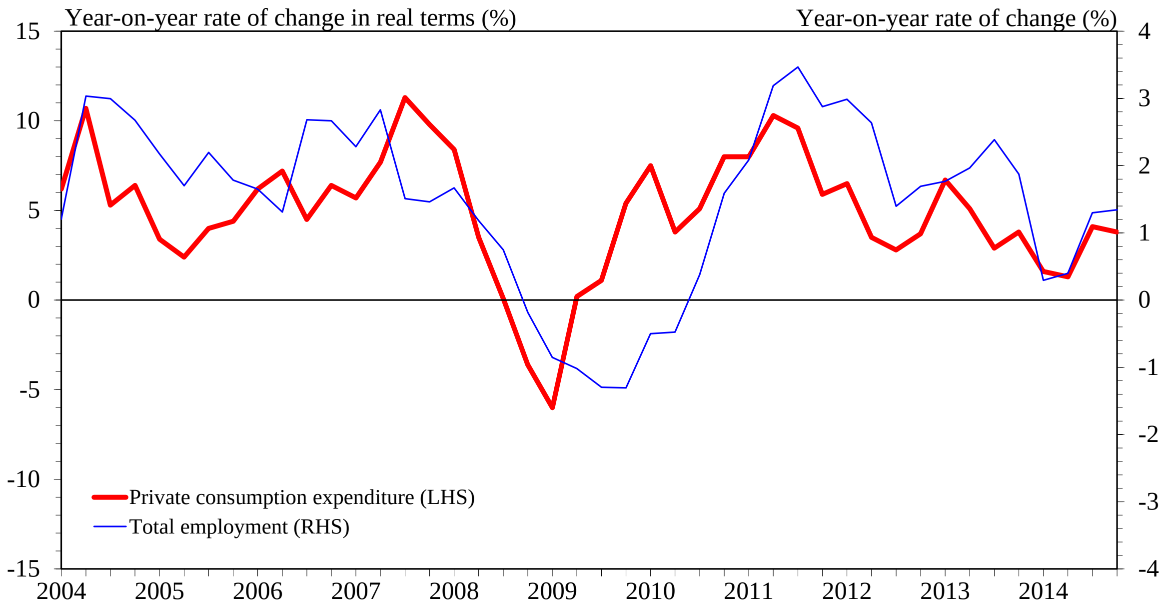


Diagram 2.9 : Consumer sentiment could hold up further if asset market conditions stayed supportive

(a) Housing wealth **(b) Equity wealth**

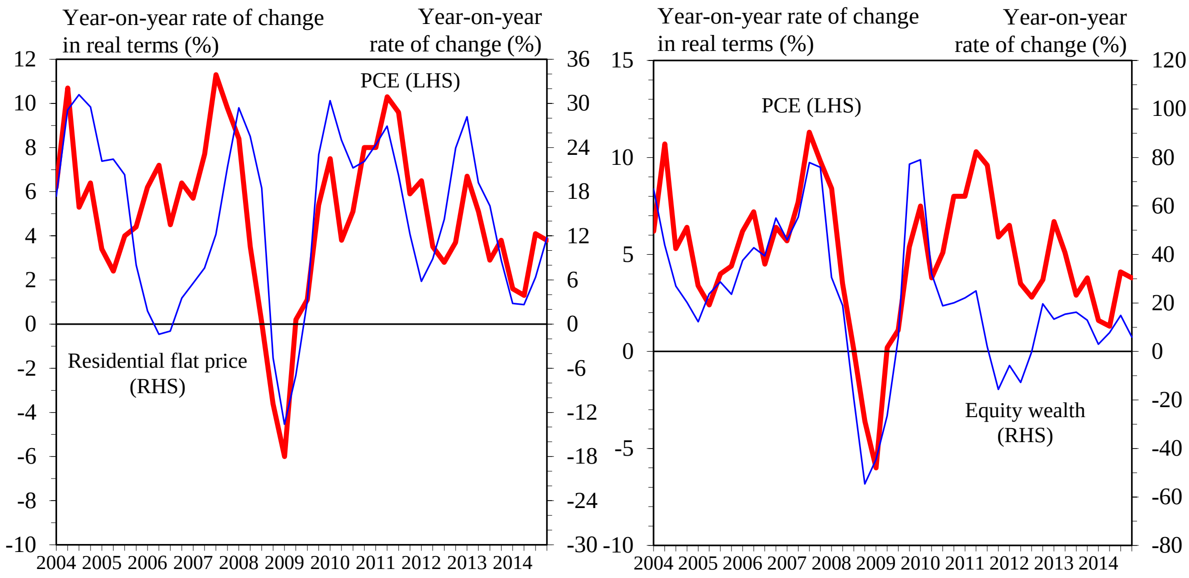
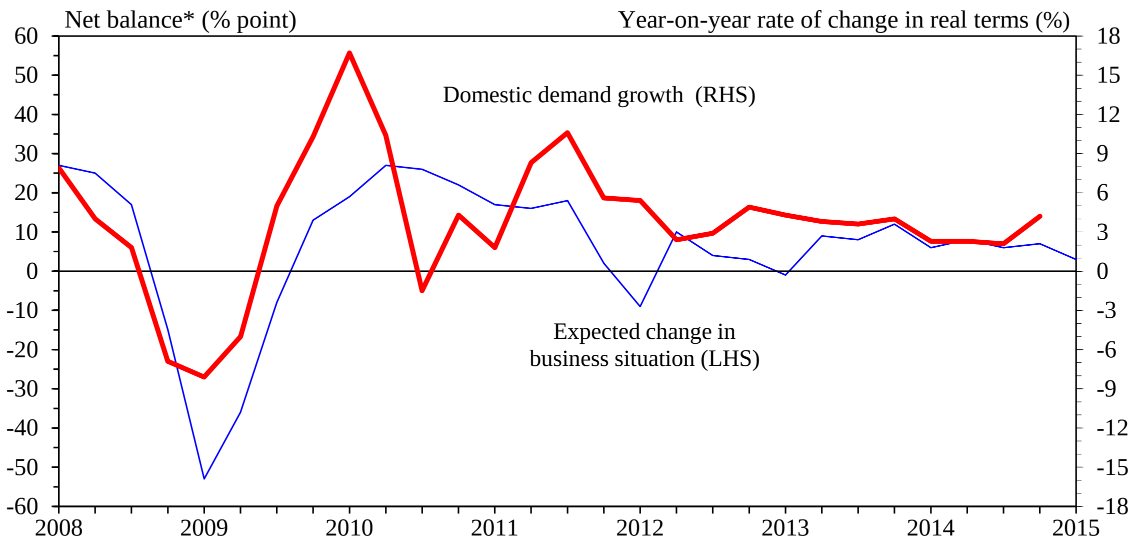
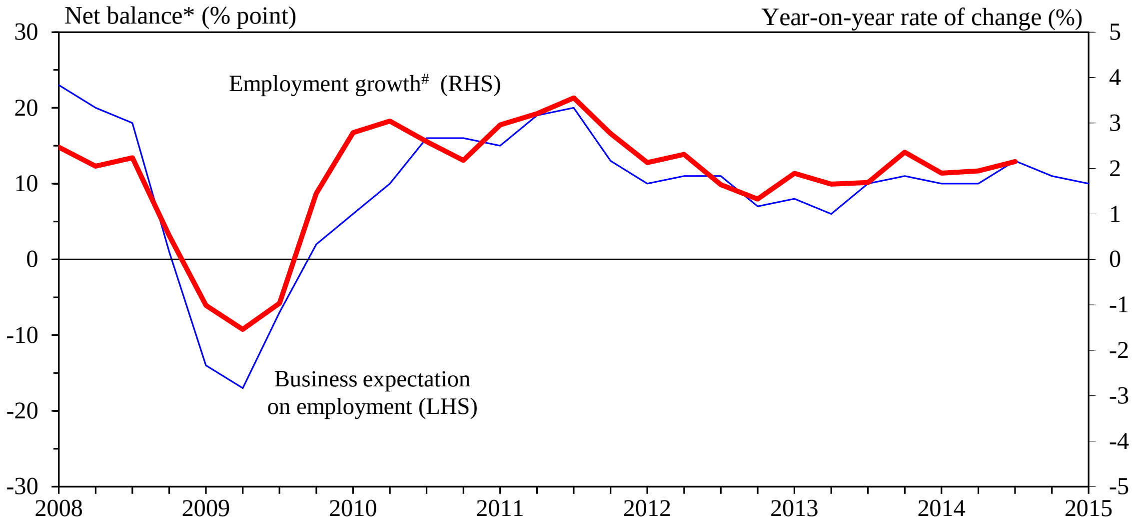


Diagram 2.10 : Business sentiment remained cautious about the near-term outlook



Note : (*) Net balance indicates the direction of expected change in business situation versus preceding quarter. It refers to the difference in percentage points between the proprotion of establishments choosing "better" over that choosing "worse". A positive sign indicates a likely upward trend while a negative sign, a likely downward trend.

Diagram 2.11 : Hiring sentiment stayed positive

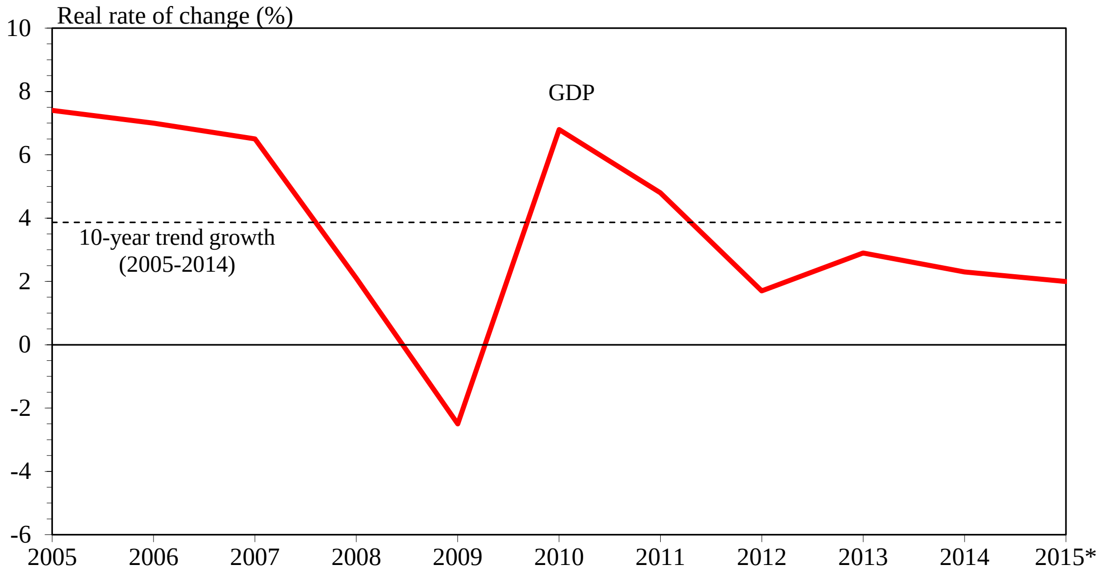


Notes : (*) Net balance indicates the direction of expected change in number of persons engaged versus preceding quarter. It refers to the difference in percentage points between the proportion of establishments choosing "up" over that choosing "down". A positive sign indicates a likely upward trend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

(#) Employment in private sector.

2.22 Taking into account the likely subdued performance of external demand and the relative resilient domestic demand, the Hong Kong economy is projected to expand by 1-3% in 2015, after the 2.3% growth in 2014 and compared to the average annual growth of 3.9% in the past ten years. The official forecast adopts a two-percentage-point range in view of the prevailing uncertainties surrounding the already-modest prospects for the global economy and the expected heightened volatility in global monetary conditions. Needless to say, downside risks still abound from the external front. Abrupt changes to the global economic and financial conditions stemming from the different monetary policy stances of major central banks could trigger corrections in asset markets, in turn adversely denting consumption and investment sentiments. Moreover, the austere global economic environment could impact severely on some emerging market economies with weak fundamentals and thereby derail the global recovery. Nonetheless, there may be some upside potential to the forecast if global growth turns out to be stronger than expected, particularly if Asian economies are more resilient than envisaged despite the sluggishness in the advanced economies. For comparison, the prevailing forecasts by the private sector analysts for Hong Kong’s economic growth in 2015 mostly fall within the range of 2.1-3.3%, averaging around 2.7%.

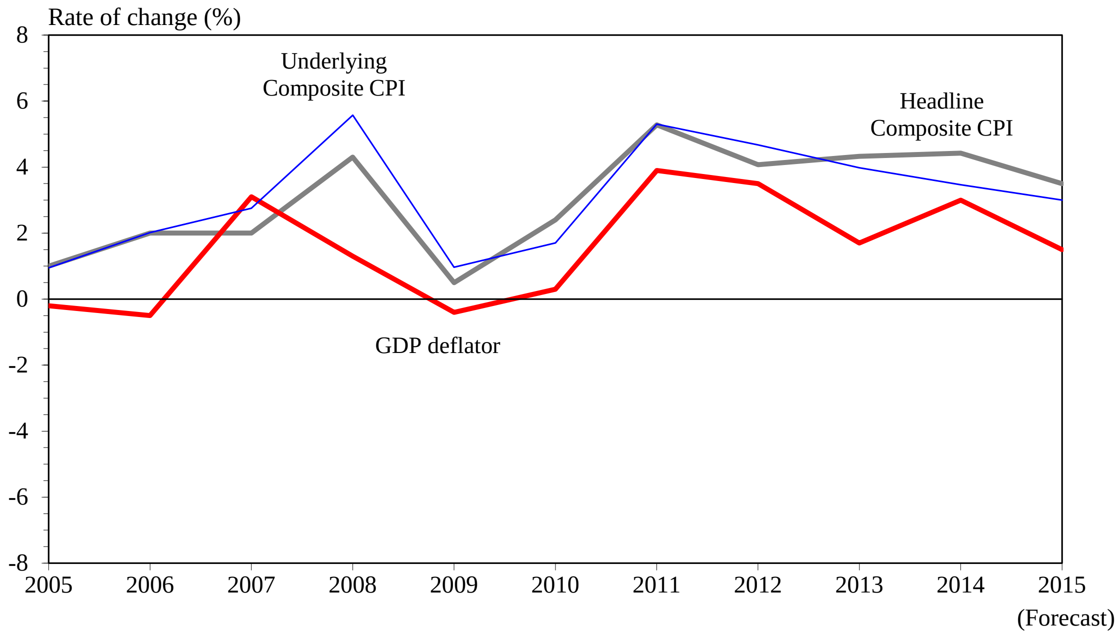
Diagram 2.12 : Economy expected to grow moderately further, but uncertainties still abound



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

2.23 Underlying inflation in Hong Kong fell further from 4.0% in 2013 to 3.5% in 2014. Price pressures will likely remain modest in 2015 amid the sub-par local economic growth and soft imported inflation. Externally, imported inflation looks set to remain tame, thanks to lower global inflation and soft international commodity prices. Locally, the moderate increases in commercial rentals during most of 2014, as well as the steady wage cost pressures, are both conducive to lower inflation pressures in 2015. Granting no unpleasant upside surprises in international commodity prices, *underlying Composite CPI* is forecast to increase by 3% for 2015 as a whole, down further from the 3.5% increase in 2014. Taking into account the effects of the Government's one-off measures, *headline Composite CPI* is forecast to increase by 3.5% in 2015, after 4.4% in 2014. The *GDP deflator* is forecast to rise by 1.5%, taking into account the expected slower increases in prices from both the local and external fronts.

Diagram 2.13 : Inflation is expected to ease further in 2015



Forecast rate of change in 2015 (%)

Gross Domestic Product (GDP)

Real GDP	**1 to 3**
Nominal GDP	2.5 to 4.5
Per capita GDP in real terms	0.2 to 2.1
Per capita GDP at current market prices	HK$315,200-321,400 (US$40,400-41,200)

Composite Consumer Price Index

Headline	**3.5**
Underlying	**3**

GDP Deflator	**1.5**

Forecast on Hong Kong's GDP growth in 2015 recently made by other selected parties

	(%)
The University of Hong Kong	2.3 to 3.3
Average forecast by private sector analysts#	2.7

Note : (#) Forecast GDP growth rates by private sector analysts mostly fall between 2.1% and 3.3%.

Medium-term outlook for the Hong Kong economy

2.24 The Hong Kong economy will continue to face a challenging external environment over the medium term, as the monetary policy normalisation in the advanced economies will be a long drawn-out process and as most advanced economies are expected to stay at low gear under the "new normal". Considerable scope remains for structural reforms in the eurozone and Japan to improve labour market conditions, enhance growth and boost competitiveness. Furthermore, the prevailing sovereign debt and fiscal sustainability issues as well as problems of population ageing will continue to trouble many advanced economies beyond the near term.

2.25 As to emerging market economies, their performance will be constrained by the developments in the advanced economies. Those relying on export-led growth will be affected more. Moreover, those economies with high degrees of external vulnerabilities and less resilient financial systems may find themselves more prone to sharp fluctuations of asset prices and capital flows amid the varying monetary policy stances among major central banks. Nevertheless, emerging market economies in Asia should continue to outperform their counterparts in the rest of the world, given their stronger fundamentals.

2.26 The possibility of a prolonged period of slow growth in the advanced economies underscores the importance of deepening our economic integration with the Mainland as part of our growth strategy. With the Mainland economy shifting towards a more sustainable growth path, it will still outpace other major economies, presenting Hong Kong with extensive growth opportunities. Specifically, Hong Kong is well-positioned to leverage on the opportunities brought about by the Mainland's national strategy of rebalancing growth towards domestic demand and the services sector. In the coming years, further opening-up of the Mainland economy and the enactment of institutional reforms will likely increase demand for high-end services, particularly in the area of financial and professional services which Hong Kong possesses competitive edge. In this regard, the Government will constantly strive to strengthen economic ties with the Mainland through the CEPA and other regional co-operation platforms. Besides, further progress will be made to enhance Hong Kong's status as the leading offshore RMB business centre and premier asset management hub amid the internationalisation of the RMB. Separately, in face of the highly uncertain external environment, the Government will continue to proactively forge economic ties with new and emerging markets.

2.27 Locally, the Government is committed to maintaining Hong Kong's competitiveness and sustaining longer-term economic development. As Hong Kong is moving towards a high value-added, knowledge-based economy, the Government will strive to consolidate our competitive edge in pillar industries and provide support to new growth areas. The Government will continue to upgrade human capital and infrastructure to increase Hong Kong's productivity and competitiveness. Large-scale ongoing infrastructure works will also lend support to domestic demand. In sum, taking into account the challenges in the external and domestic fronts, the economy is expected to attain a trend growth of 3.5% per annum from 2016 to 2019.

2.28 It is worth noting that population ageing remains an imminent challenge to our medium to longer-term economic growth, as labour force growth may stagnate after 2018. Such demographic changes will also have significant implications on our public expenses, especially on healthcare and social welfare. While the 2015 Policy Address has announced a more proactive population policy with a view to boosting labour force at source, it is still important for the Government to exercise fiscal prudence, so as to preserve our ability to meet the upcoming various challenges to our economy. In particular, sufficient public resources must be ensured for infrastructure and human capital investment to drive the economy and also to tackle social issues through various programmes.

2.29 Inflationary pressures are likely to remain moderate over the medium term. Slower global growth under the "new normal" will lower the risks of global inflation. Locally, the productivity gain should help to alleviate some of the local cost pressures. Also important is the Government's incessant efforts to increase land and housing supply, which should bring about a better balance between demand and supply in the property market, helping to ease the upward pressures on rental costs in the coming years. Taking all these developments into account, the trend rate of change in the underlying CCPI in Hong Kong from 2016 to 2019 is forecast at 3% per annum. However, there are still upside risks, including the possibility of sharp fluctuations in food and energy prices arising from adverse supply shocks. Uncertainties about global economic and monetary conditions may also increase the volatility of international commodity prices. Furthermore, if global growth is stronger than expected and major central banks delay their response to the rise in inflation pressures, global inflation may accelerate faster than expected, with repercussions on Hong Kong's inflation.

Diagram 2.14 : Medium term trend growth likely to be moderate