CHAPTER 2 : ECONOMIC OUTLOOK FOR 2016 AND THE MEDIUM TERM

Summary

- *The global economy, having experienced the slowest growth since 2009, is still struggling to gather pace in a post-crisis era, some seven years after the Global Financial Crisis. Growth momentum in 2016 is expected to remain slow and uneven with considerable downside risks, giving only a slim chance for a notable turnaround in global trade. Among the advanced economies, whether the widely-expected moderate growth for the US economy would stand the impact of the Federal Reserve (Fed)'s interest rate normalisation has yet to be seen. The recovery in the eurozone and Japan would likely be lacklustre. As for major emerging market economies, the growth outlook for Russia and Brazil remains bleak. While growth in the Mainland economy and other Asian emerging market economies should stay relatively resilient in 2016, their paces of expansion may also slow.*

- *How the complicated global monetary environment will evolve is critical to the global economy in 2016. The biggest source of uncertainty will stem from the Fed's pace of subsequent interest rate hikes, particularly against the backdrop of the more pronounced monetary policy divergence among major central banks and the fragile recovery of many other advanced economies. The renewed volatility in global financial and foreign exchange markets that has triggered notable asset market corrections in early 2016, if protracted, might derail the already weak global economic recovery. Emerging markets with weaker fundamentals could be vulnerable to capital outflows and currency pressures. The plunge in commodity and energy prices, as another manifestation of financial market stress, would unavoidably weigh on the growth outlook and fiscal positions of commodity-exporting economies. Furthermore, heightened geopolitical tensions in various parts of the world remain a cause of concern.*

- *With the strong headwinds in the external environment likely persisting into 2016 and global demand conditions remaining sluggish, the outlook for Hong Kong's exports of goods in 2016 remains bleak. The current strength of the US dollar against many other currencies also would not bode well for our goods exports. After the dismal performance in 2015, Hong Kong's exports of services this year may still come under the pressure of sluggish trade and cargo flows, heightened volatility in global financial markets, and the slack in inbound tourism.*

- *Locally, domestic demand, which was relatively resilient in 2015, may lose some growth momentum this year. While a stable labour market would continue to render some support to private consumption, downside risks to the global economic prospects could rattle global financial conditions and spark fluctuations in global and local asset prices, thereby weighing on consumer sentiment. The outlook for investment is subject to larger uncertainties, with machinery and equipment acquisition being more susceptible to swings in the global environment. Yet, building and construction should hopefully grow further, underpinned by intensive public construction works and ongoing private sector building activity.*

- *The Hong Kong economy is projected to grow by 1-2% in 2016, compared to the 2.4% growth in 2015 and the average annual growth of 3.4% in the past ten years. The less sanguine economic growth forecast mainly reflects the notable and rising downside risks in the external environment. There could be some upside potential if the world's economic growth is stronger than expected, creating a more supportive environment for global trade flows, and if Asian economies hold up better than envisaged.*

- *On inflation, consumer price pressures will likely remain tame this year. Imported inflation is expected to stay muted, amid the rather modest global inflation and the still-low international commodity prices. Local cost pressures look set to lessen further, due partly to the sub-par economic growth and partly to lower rental cost pressures from a quieter property market. Overall, underlying Composite CPI is forecast to increase by an average of 2% in 2016, lower than that of 2.5% in 2015, signifying the fifth consecutive year of easing.*

- *The medium-term outlook for the Hong Kong economy will still be restrained by the below-trend growth of the global economy under the "new normal" after the Global Financial Crisis. Against this backdrop, deepening economic integration with the Mainland will present us with extensive growth opportunities, via the trade, investment and financial channels, particularly in view of the National 13th Five-Year Plan and the "Belt and Road" Initiative. At the same time, the Government's commitment to upgrading infrastructure and raising human capital quality through training and education will uphold Hong Kong's competitiveness. Yet, the demographic challenges, with an expected dwindling workforce after 2018, will become an imminent threat to our medium- to longer-term growth. The trend GDP growth rate in real terms is forecast at 3% per annum from 2017 to 2020. The trend rate of underlying consumer price inflation is forecast at 2.5% per annum.*

Major external developments

2.1 Seven years after the Global Financial Crisis of 2008, the global economy is still struggling to gather pace under the "new normal". Global growth in 2015 was in fact the slowest since 2009. The headwinds in the external environment, characterised by subdued global trade, sluggish growth in many advanced economies, recessions in some key emerging market economies, and highly volatile global financial and commodity markets, led to the disappointing global economic performance in 2015 and have yet to show signs of abatement. The global outlook, which is subject to notable downside risks, remains worrying. Several key external developments will be crucial to Hong Kong's growth and inflation prospects in 2016.

2.2 *First and foremost*, global monetary conditions will likely stay volatile in 2016, amid deep concerns about global growth prospects, uncertain pace of the US Fed's monetary policy tightening, and widening policy divergence among central banks. The financial turmoil at the start of 2016 could only mark the beginning of a more unstable era for economic and financial developments. The wilder exchange rate and asset price fluctuations, further pressures on commodity prices, and possible abrupt changes in capital flows, could disrupt global trade, transmit shocks to emerging market economies with weaker fundamentals, and retard global growth.

2.3 *Second*, the performance of advanced economies as a whole will still be sub-par and uneven, continuing to restrain international trading and manufacturing activities. Whether the US economy, currently the bright spot among the advanced economies, will sustain its moderate growth momentum amid the Fed's monetary policy normalisation remains to be seen. The recovery paces of many other advanced economies are likely to stay slow and fragile. *Third*, amid a volatile monetary environment, it will be an uphill battle for many emerging market economies to maintain or regain growth and to overcome structural problems. The declines in oil and commodity prices, if protracted, will further hamper the growth outlook for commodity-exporting economies. *Fourth*, the intensification of geopolitical tensions in many regions of the world over the recent past has also increased the downside risks to the global economy.

Global economic outlook

2.4 The US economy stood out among the advanced economies in 2015, with GDP growth of 2.4%, supported by consumer spending and its housing market recovery. In view of the solid improvements in the labour market, the Fed in December last year raised interest rates for the first time since 2006. However, the timing and pace of future monetary policy tightening, still data-dependent, have become a key source of uncertainty and downside risk, not just for the US economy but also for the global economy. Any surprising future interest rate actions, or any misjudgements, by the Fed in a still-fragile international economic environment, can easily swing market sentiments and dampen consumption and investment, with destabilising repercussions to be felt around the world. Also, while the US economy is projected by many forecasters to attain further moderate growth in 2016, its industrial sector has already been under pressure and the strength of the US dollar may further hurt its exports and manufacturing activity in the period ahead.

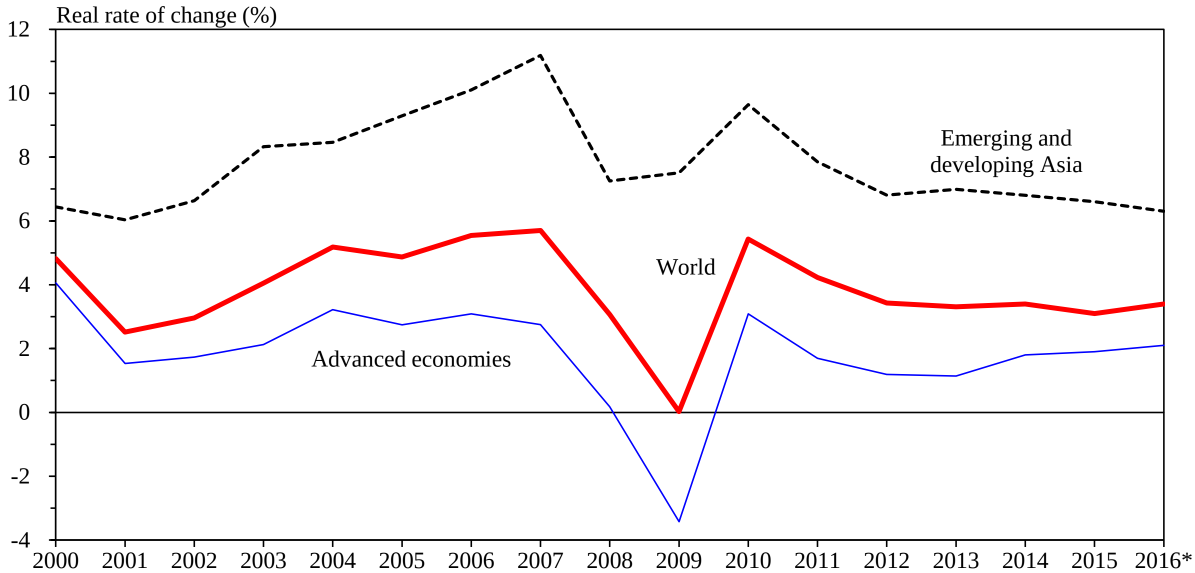
2.5 The eurozone economy improved somewhat in 2015, growing by 1.5%, but its momentum slowed over the course of the year. Its outlook is still wrought with uncertainties. The European Central Bank (ECB) eased monetary policy further in December, underscoring the fluidity and fragility of the region's recovery, which is characterised by persistently low inflation. Deep-seated structural issues of some weaker eurozone members, including elevated debt levels, unsustainable fiscal positions and market rigidities, could curb the region's growth for an extended period (see ***Box 2.1*** for details). While Greece's debt situation has largely subsided, the problem is far from being fully resolved. Intensified geopolitical tensions in Eastern Europe and the Middle East, and the influx of refugees have also clouded the region's outlook.

2.6 Japan's economic performance has been rather unsteady, and went into a quarter-to-quarter contraction again in the fourth quarter of 2015. The Japanese economy has yet to fend off the threat of deflation. Its domestic demand remains weak, and the boost to exports from a weaker yen also seems to be fading. In view of the faltering economy, the Bank of Japan (BOJ) unexpectedly adopted a negative interest rate policy, but it remains uncertain whether this could stimulate growth momentum or whether the central bank needs to introduce further monetary easing measures down the road. Also, the problems of fiscal sustainability, ageing population and market rigidities, if not properly addressed by structural reforms, would continue to limit Japan's growth potential. Economic growth in 2016 will at best be tepid.

2.7 In 2016, the advanced economies as a whole is likely to expand at a modest pace, with the support mainly coming from the US economy, on the benign premise that the Fed's interest rate hikes would be gradual without causing significant disruptive impacts on global financial markets and economic sentiments. In January 2016, the International Monetary Fund (IMF) projected the real GDP growth of the advanced economies at 2.1% in 2016, after a mere 1.9% growth in 2015.

2.8 As for the emerging market economies, the year 2015 saw most of them suffering growth slowdown. Russia and Brazil, the two major emerging market economies, were even mired in recession. Although the Asian emerging market economies stayed relatively resilient in 2015, their growth was also hampered by subdued global trade, which resulted in weaker production and exports, as well as by a volatile global monetary environment, marked by sharp stock market corrections, massive capital outflows and substantial currency depreciations. Some were also hurt by the plunge in commodity prices. Looking ahead, the external headwinds facing emerging market economies are likely to persist in 2016. The Fed's future interest rate moves, and its deepening policy divergence from other central banks, are bound to remain a key threat to the macro-financial stability of these economies going forward, particularly so for those with weaker fundamentals. Nonetheless, on balance, Asian emerging market economies, buttressed by their relatively sound fundamentals and more resilient domestic demand, can still outpace their peers in other regions as well as the advanced economies (see ***Box 2.2*** for details).

Diagram 2.1 : Asian emerging market economies, while facing notable challenges, are still likely to outperform the advanced economies in 2016



Source : IMF World Economic Outlook Update, January 2016.
Note : (*) Forecasts from the IMF.

2.9 The Mainland's economy, though faced with downward pressures from the external front and the challenges from ongoing rebalancing of its structure, was able to attain a solid growth of 6.9% in 2015, virtually achieving the official target set for the year. The accomplishment was mainly underpinned by the resilience of its domestic demand, especially consumption, which helped offset the setback in external trade amid anaemic global demand. As the global trading environment will remain difficult, domestic demand should continue to be the key driver of the economy in 2016. Meanwhile, 2016 marks the first year of implementing the National 13th Five-Year Plan. The Mainland will continue to rebalance towards a sustainable and medium-to-high growth path under the "new normal". While the trend growth in the coming years is likely to be somewhat slower than before, continuing reforms will help promote innovation-driven growth potential, move the economy up the value chain, make the better use of market forces, and address the issues of population-ageing. All these, together with the "Belt and Road" Initiative, will unleash growth potential and present new business opportunities. Thus, the Mainland's economic growth in 2016 is still expected to outperform other major economies. In January, the IMF projected the Mainland economy to grow by 6.3% in 2016. For emerging and developing Asia as a whole, the IMF projected an economic growth of 6.3% in 2016, somewhat slower than that of 6.6% in 2015.

2.10 Overall, the IMF in January projected that global economic growth would remain modest, at 3.4% in 2016, only a notch higher than that of 3.1% in 2015. Indeed, the IMF highlighted that risks to the global outlook remain tilted to the downside and relate to the ongoing adjustments in the global economy, including a generalised slowdown in emerging market economies, the Mainland's growth rebalancing process, lower commodity prices, and the gradual exit from extraordinarily accommodative monetary conditions in the US. The IMF warned that if these key challenges are not successfully managed, global growth could be derailed.

Table 2.1 : Growth forecasts for major economies in 2016

		2016	
	2015* (%)	**IMF*** **(%)**	**Private sector forecast^** **(%)**
World (PPP## weighted)	3.1	3.4	-
Advanced economies	1.9	2.1	-
US	2.4#	2.6	2.2
Eurozone	1.5#	1.7	1.6
Japan	0.4#	1.0	1.0
Emerging market and developing economies	4.0	4.3	-
Emerging and developing Asia	6.6	6.3	-
Mainland China	6.9#	6.3	6.5
India	7.3#	7.5	7.7
Middle East and North Africa	2.5	3.6	-

Notes : (*) World Economic Outlook Update, IMF, January 2016.
(^) Average forecast as at February 2016.
(-) Not available.
(#) Actual figures.
(##) PPP refers to purchasing power parity.

Box 2.1

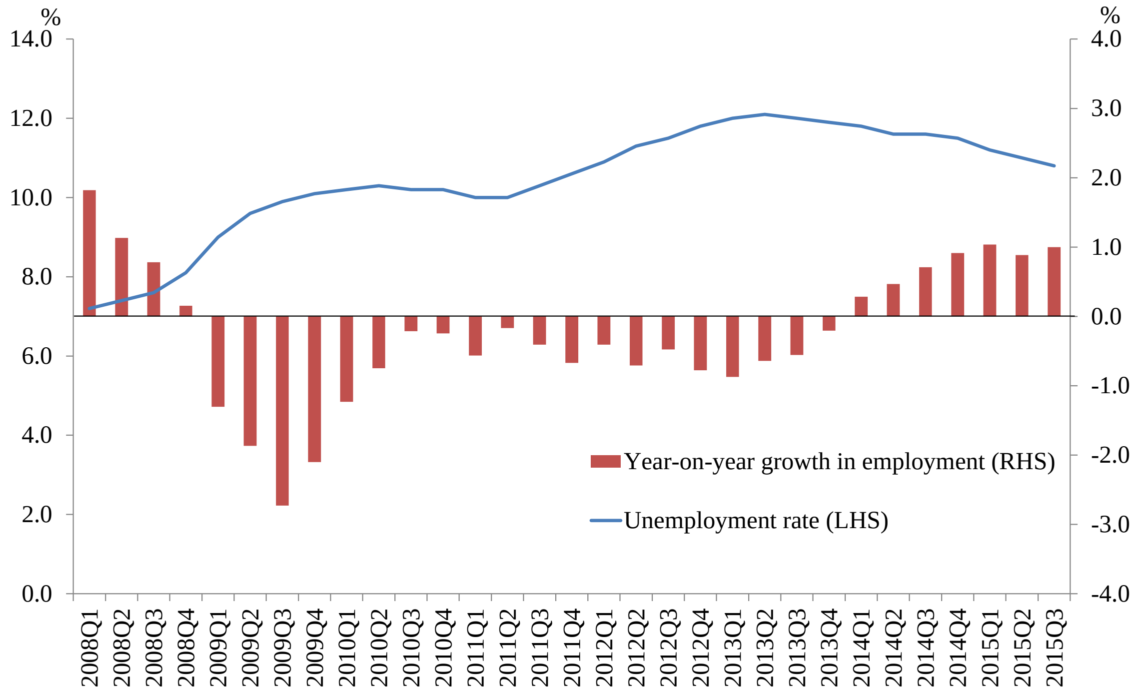
Recent labour market conditions in the eurozone

Unemployment rate in the eurozone as a whole stayed high, despite some slight improvement in the recent past. The situation also varied across member states. This note provides a brief analysis on the recent labour market conditions of the eurozone and implications on the region's economic recovery.

The Global Financial Crisis and the ensuing euro debt crisis severely hit the eurozone's economy, pulling it twice into recession between 2008 and 2013. During this period, the labour market in the region deteriorated significantly. The unemployment rate(1) climbed up from 7.2% in the first quarter of 2008 to an acme of 12.1% in the second quarter of 2013, marking the highest level since eurozone's establishment (***Chart 1***). Some five million jobs were lost during this period.

As the acute risks of the euro debt crisis retreated, the eurozone's economy emerged from recession since the second quarter of 2013, bringing job gains subsequently. The unemployment rate fell since mid-2013. Employment in the region also resumed year-on-year growth since the first quarter of 2014, but the pace was only modest. As such, the unemployment rate still stood at an elevated level of 10.4% in December 2015.

Chart 1: Unemployment rate in the eurozone stayed high, despite some declines in the recent past



The labour market conditions varied across member states. A few have performed fairly well in the recent past, with Germany as a striking example. Unemployment rate there fell to a record low of 4.5% in December 2015, thanks to stronger employment growth than labour supply growth. According to the latest detailed figures available, Malta, Austria, Luxembourg, Estonia and the Netherlands had unemployment rates below 7%. Yet, they are the minority. Unemployment rates in the rest of the region were still high. Eight member states, including France, Italy and Spain, had double-digit unemployment rates. Most member states still had unemployment rates higher than in 2008, with those in Cyprus and Greece more than two times higher (***Chart 2***).

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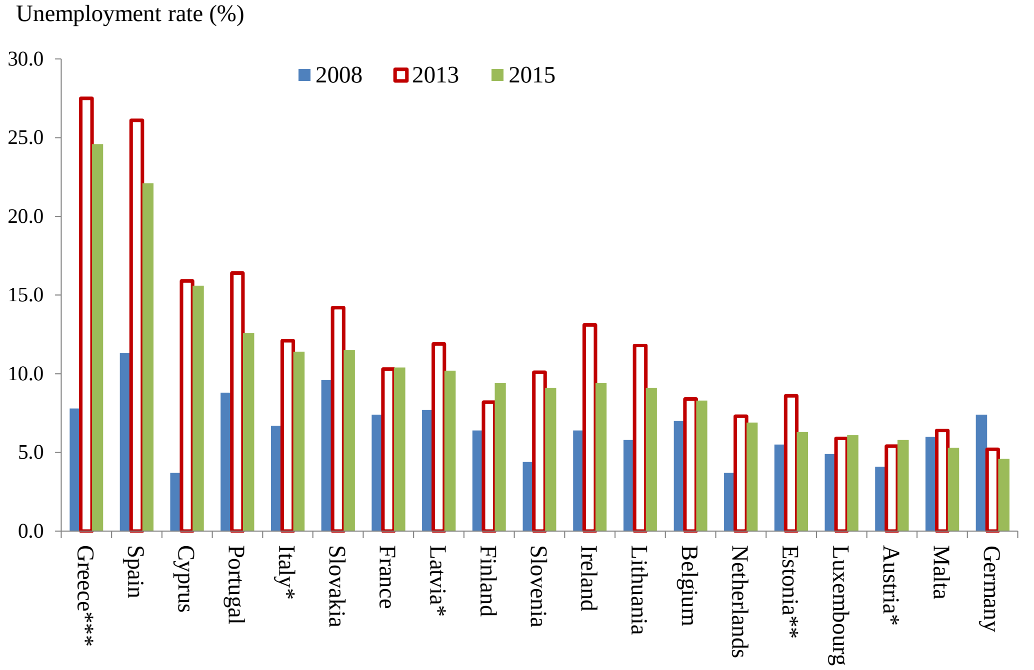
(1) Unemployment rate in this Box refers to the seasonally adjusted unemployment rate.

Box 2.1 (Cont'd)

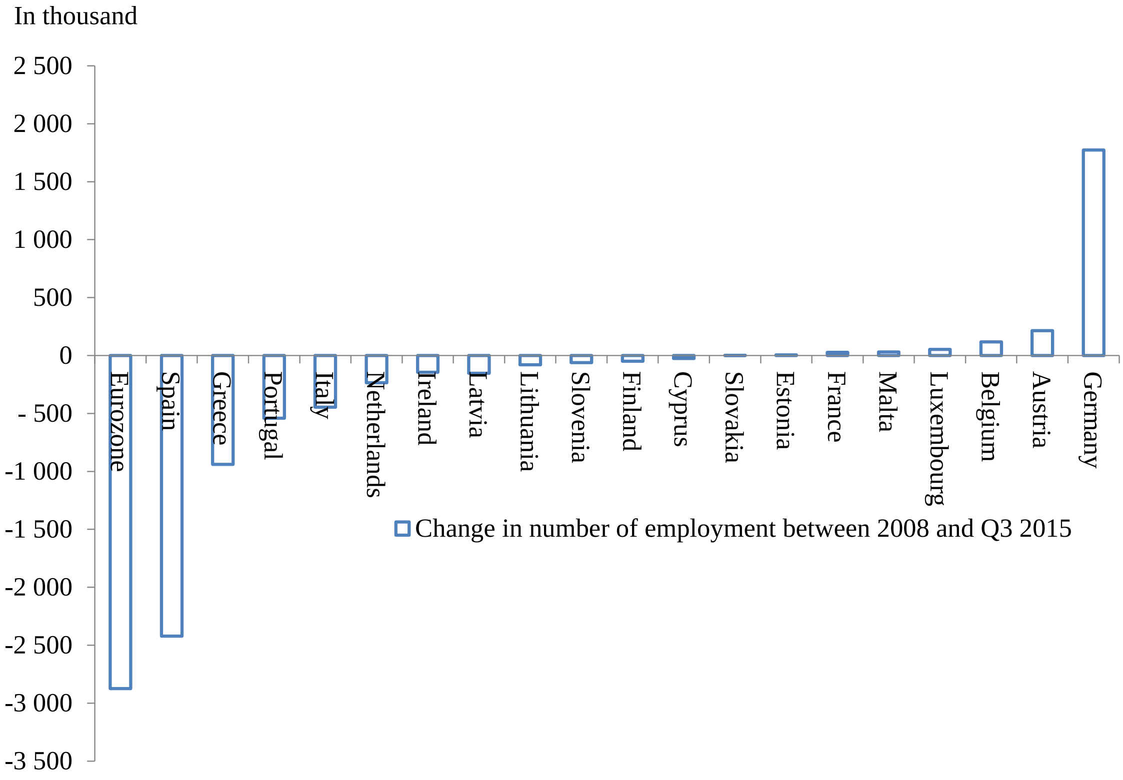
Chart 2: Unemployment situation varied across member states in the eurozone



Notes: (*) Figure for 2015 is not yet available. It refers to December 2015 position.
(**) Figure for 2015 is not yet available. It refers to November 2015 position.
(***) Figure for 2015 is not yet available. It refers to October 2015 position.

There were also visible variations in the recovery of employment within the eurozone. On the one hand, Germany's labour market led the pack again and saw visible cumulative gains in employment between 2008 and the third quarter of 2015. Besides, Austria, Belgium, Luxembourg, Malta and France also registered marginal job gains during this period. Yet, most member states still had employment lower than the pre-crisis level, with Spain and Greece at the end of the spectrum suffering the most severe job losses (***Chart 3***).

Chart 3: Recovery of employment within the eurozone varied



Box 2.1 (Cont'd)

The substantial slacks in the labour market partly reveal the severity of the blows brought by the previous financial crises, particularly to the economies of debt-ridden states. In addition, they also reflect the entrenched structural issues afflicting the region's labour markets. For example, long-term unemployment, defined as those who have been out of work for more than one year, accounted for half of overall unemployment in the third quarter of 2015.

The high proportion of long-term unemployment is worrying, as the longer people are out of work, the more difficult it is for them to be hired again, and their skills would be gradually eroded. Indeed, a fifth of them stop trying to find another job, according to the European Commission.

The high youth unemployment rate in the region, at 22.0% in December 2015, is another thorny issue. In Spain, Italy and Portugal, youth unemployment rates reached as high as 46.0%, 37.9% and 31.0% respectively. This problem is partly cyclical, as young workers with less experience and skills are understandably more affected by the current weak economic situation. The problem is further exacerbated by structural issues in the labour market, such as the mismatch between the demand and supply of skills possessed by the youth and high proportion of workers under temporary employment contracts with weaker job protection in some member states.

To tackle the structural issues, the European Council in 2011 recommended comprehensive labour market reforms, including review of wage setting mechanisms, labour taxations, employment protection legislations and education and training. Many member states in the eurozone, especially those had accepted the bailout programmes from international creditors, have already taken actions. In the long term, the reforms should help increase flexibility of labour markets there. Given the sluggish economic environment, the stress on public finance and possible resistance from the vested interests, however, the implementation of the reform is likely to be a long and bumpy process and requires continuous efforts to bear fruit.

In February 2016, the European Commission forecast that the eurozone's unemployment rate will ease from 11.0% in 2015 to 10.5% in 2016 and still stay at a double-digit level of 10.2% in 2017. In other words, high unemployment rate is expected to stay for a while in the eurozone, which will likely continue to confine the recovery of consumer spending and economic growth in the region in the period ahead.

Box 2.2

Can domestic demand of selected Asian economies provide support to growth?

After the Global Financial Crisis of 2008, many Asian economies faced growth moderations of varying degrees. Demand conditions in the advanced economies have remained sluggish, adding downward pressures to the merchandise trade performance of these Asian economies, most of which are externally-oriented. Over the last few years, these Asian economies have strived to rebalance their growth model by strengthening domestic demand, so as to cushion the adverse impacts arising from the external headwinds. This note briefly examines the latest domestic demand performance of selected Asian economies[(1)], with an attempt to shed some light on the region's growth prospects.

Growth in emerging and developing Asia moderated from an average of 9.5% per annum in 2003-2007 to 7.6% per annum in 2009-2014. In 2015, emerging and developing Asia slowed further to register an estimated 6.6% growth, and their production activities and goods exports slackened sharply to notable year-on-year declines, marking the poorest performance since 2009 (***Chart 1***). But on the other hand, their domestic demand exhibited remarkable resilience, which helped cushion the visible setback from external demand, thereby sustaining a moderate economic performance (***Chart 2***).

Chart 1 : Asia's exports of goods weakened further in 2015, dragged by sluggish demand conditions in advanced economies

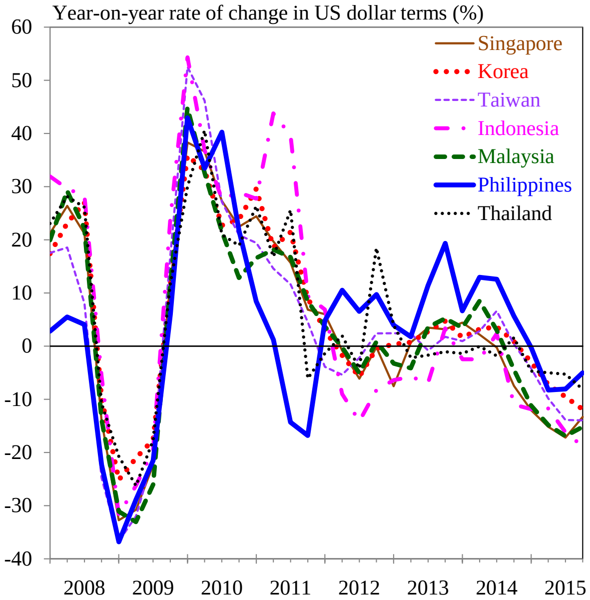
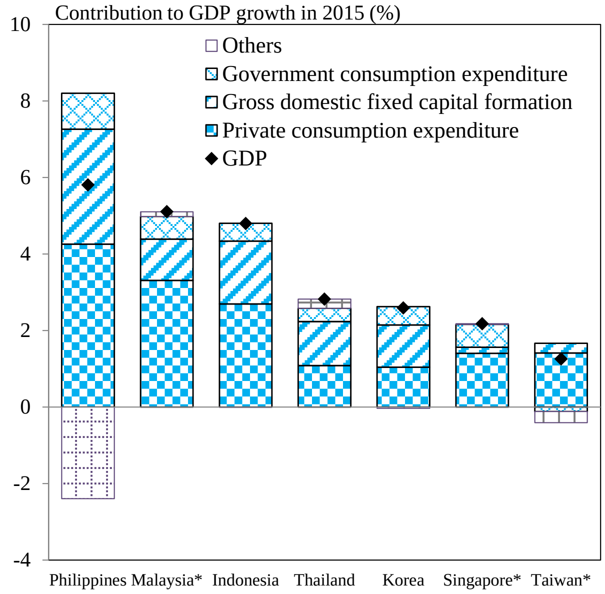


Chart 2 : Resilient domestic demand helped cushion export-dependent Asian economies



Note: (*) Figures refer to 2015Q1-Q3 positions.

Table 1 shows that domestic demand in the selected Asian economies generally expanded steadily or saw pick-ups in growth in 2015, notwithstanding the concomitant GDP growth slowdown. Within the components of domestic demand, private consumption expenditure (PCE) has been a key growth engine. In fact, PCE grew at a faster year-on-year rate than overall economic growth during 2015 in such economies as Singapore, Taiwan, Malaysia, the Philippines and Indonesia. The relatively solid PCE growth reflected the interplay of various favourable factors, including steady labour market conditions with low or falling unemployment rates (***Table 2***); lower borrowing costs under the ultra-low global interest rate environment; and lower oil prices in the past year or so, which were tantamount to terms of trade improvement and an increase in consumer spending power.

(1) The Asian economies covered in this article include Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand.

Box 2.2 (Cont'd)

As for gross domestic fixed capital formation, although this component is typically volatile, investment spending in the Philippines, Indonesia, Thailand and Malaysia still registered visible growth during 2015, conceivably reflecting the support from higher infrastructure investments amid growing urbanisation in these economies. Meanwhile, many economies saw accelerated growth in their government spending, which should have also provided an important buffer against external shocks.

Table 1 : Year-on-year rates of change in domestic demand components (%)

	GDP		Domestic demand(^)		Private consumption expenditure		Gross domestic fixed capital formation		Government consumption expenditure	
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015
Philippines	6.1	5.8	5.3	8.2	5.4	6.2	6.8	14.0	1.7	9.4
Malaysia(*)	6.0	5.1	5.9	5.5	7.0	6.3	4.8	4.1	4.4	4.8
Indonesia	5.0	4.8	4.6	5.0	5.2	5.0	4.6	5.1	1.2	5.4
Thailand	0.8	2.8	#	2.8	0.6	2.1	-2.4	4.7	2.1	2.2
Korea	3.3	2.6	2.4	2.9	1.8	2.1	3.1	3.8	2.8	3.3
Singapore(*)	2.9	2.2	0.5	3.2	2.5	4.1	-1.9	0.7	0.1	6.4
Taiwan(*)	3.9	1.3	3.0	1.7	3.3	2.6	1.8	1.1	3.6	-0.8

Notes: (^) Excluding change in inventories.
(*) As full-year detailed data are not yet available, figures in 2015 refer to Q1-Q3 positions.
(#) Change within ± 0.05%.

Table 2 : Favourable labour market conditions are conducive to consumption spending

	Unemployment rate		
	Average (2003-2007)	Average (2009-2014)	Latest available figure
Philippines	10.0%	7.1%	5.7% (3-month ending October 2015)
Malaysia	3.5%	3.2%	3.3% (November 2015)
Indonesia	10.0%	6.7%	6.2% (August 2015)
Thailand	1.8%	0.9%	0.7% (December 2015)
Korea	3.5%	3.4%	3.4% (December 2015)
Singapore	3.0%	2.2%	1.9% (Q4 2015)
Taiwan	4.3%	4.6%	3.9% (December 2015)

Looking ahead, domestic demand, led by consumption spending, should continue to play a key role in buttressing Asia's economic growth. This is further complemented by the plans and reforms set forth by many Asian economies to bolster growth, on the back of accommodative monetary and fiscal policies. Indeed, the IMF in January projected GDP growth in emerging and developing Asia in 2016 to expand steadily by 6.3%, which if attained would represent a key stabilising force to the global economy, contributing around 60% of the world's GDP growth.

Nonetheless, various external uncertainties would add downside risks to the economic outlook for Asia as a whole. This includes, amongst others, the possible repercussions of the US future interest rate moves on consumption and investment sentiments; businesses' concerns on the still-bleak global economic prospects; as well as the potential strains on households' financial positions from more volatile global financial conditions amid a substantial build-up of household debt in Asian economies over the past years. Needless to say, any sizable negative external shocks to the Asian region would not bode well to the Hong Kong economy, given our close economic ties with neighbouring economies. We will monitor closely Asia's economic situation and stay vigilant to any potential adverse impacts on the Hong Kong economy.

Monetary conditions

2.11 The complicated global monetary environment amid policy divergence among major central banks will pose the most prominent threat to the stability of emerging market economies and to global growth in 2016. The Fed started the interest rate lift-off in December last year, in stark contrast to the further easing of monetary policies by the ECB and the BOJ, reflecting the uneven economic growth in these places. While the Fed may raise interest rates gradually further, the timing and pace of which are data-dependent, hence there are still considerable uncertainties, and the central banks in Europe and Japan may need to step up their stimulus measures to support growth and reduce deflation risks. How global monetary conditions will evolve in 2016, and how they will interact dynamically with the unbalanced global economic scene, are difficult to predict. Downward pressures on world inflation from the continued declines in oil and commodity prices would also complicate the global monetary policy outlook further.

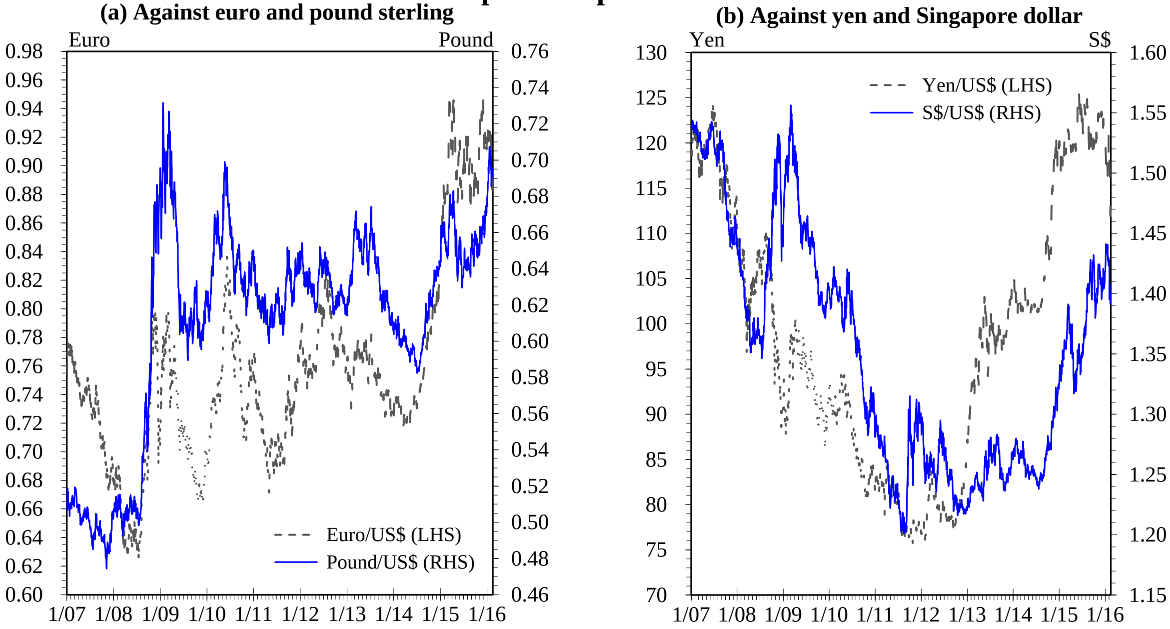
2.12 The renewed volatility in global financial markets and increased capital flight to safe havens, as seen in early 2016, have been rather disruptive and may have already hurt consumption and investment sentiments worldwide. What happened in the recent past could just be the harbinger of an extended period of financial volatility. The impact on emerging market economies, including those in Asia, could be destabilising. Accelerated capital outflows could exert painful strains on those with high levels of dollar-denominated debts, feebler financial structure and shakier fundamentals, as well as those with asset markets facing prominent bubble risks. The consequential tighter credit conditions and asset market downturns could worsen consumption and investment sentiments further. There is a strong need to stay vigilant to the rapidly changing global monetary conditions and the potential negative spill-overs on the global economic landscape.

Exchange rates and price competitiveness

2.13 The US dollar strengthened substantially in 2015, underpinned by the US' economic recovery and the anticipation of the Fed's eventual monetary policy normalisation. The appreciations against such currencies as the euro, the Japanese yen and many emerging market currencies were particularly notable. The Hong Kong dollar, which mirrors closely the movements of the US dollar, also appreciated visibly against many other currencies. In 2015, the nominal trade-weighted effective exchange rate index of the Hong Kong dollar rose by an average of 6% over 2014. This, while helping to lower imported inflation, may hurt the price competitiveness of Hong Kong's exports to a certain extent and deter some tourists from visiting Hong Kong.

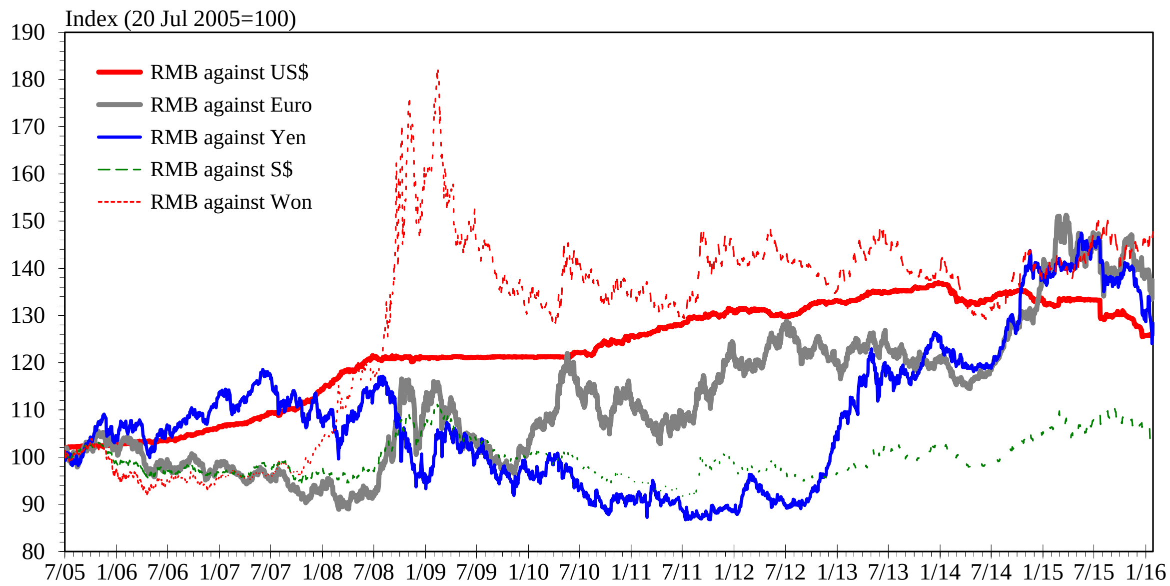
2.14 The direction of exchange rate movements will, as always, be subject to uncertainties in 2016, complicated further by the conflicting monetary policy stances in major economies and the downside risks facing the global economy on both economic and geopolitical fronts. The movements of the US dollar in the period ahead would depend on a number of factors, including any disparity between market expectations and the Fed's actual interest rate moves, as well as global economic and monetary situations. In general, a stronger US dollar and hence the Hong Kong dollar against other major currencies would not bode well for the price competitiveness of Hong Kong's exports of goods and services. Yet, against the backdrop of persistently weak global trade flows, the key factor determining Hong Kong's export performance in 2016 would still be whether the recovery in our major export markets could be translated into stronger import demand.

Diagram 2.2 : US dollar strength, if persisted, will not bode well for Hong Kong's export competitiveness



2.15 Given Hong Kong's close economic relations with the Mainland, the movement of the renminbi (RMB) is also an important factor affecting the performance of Hong Kong's external sector. In contrast to the notable currency depreciations of many Asian and emerging market economies last year, the RMB remained relatively stable against the US dollar and hence the Hong Kong dollar. In 2015, the RMB depreciated by an average of only 2% against the Hong Kong dollar, compared to the more notable depreciations of such currencies as the euro (16%), Japanese yen (13%), Singapore dollar (8%), Korean won (7%), and New Taiwan dollar (5%). After the adoption of a more market-determined exchange rate mechanism in mid-August last year, greater exchange rate flexibility would be conducive to the continued internationalisation of the RMB, in particular after its inclusion into the IMF's Special Drawing Rights, effective from October 2016. Judging from the relatively stable growth of the Mainland economy, the RMB should have no basis to depreciate notably in the long run. The Central Government is widely expected to proceed with the exchange rate regime reform in a controlled and gradual manner in 2016. A relatively stable RMB could help reduce the exchange rate uncertainty facing Hong Kong companies, given the Mainland's important role in the regional supply chains and the increasing use of the RMB for settling cross-border trade and investment activities.

Diagram 2.3 : Greater flexibility of the RMB would be conducive to the steady expansion of the Mainland economy



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

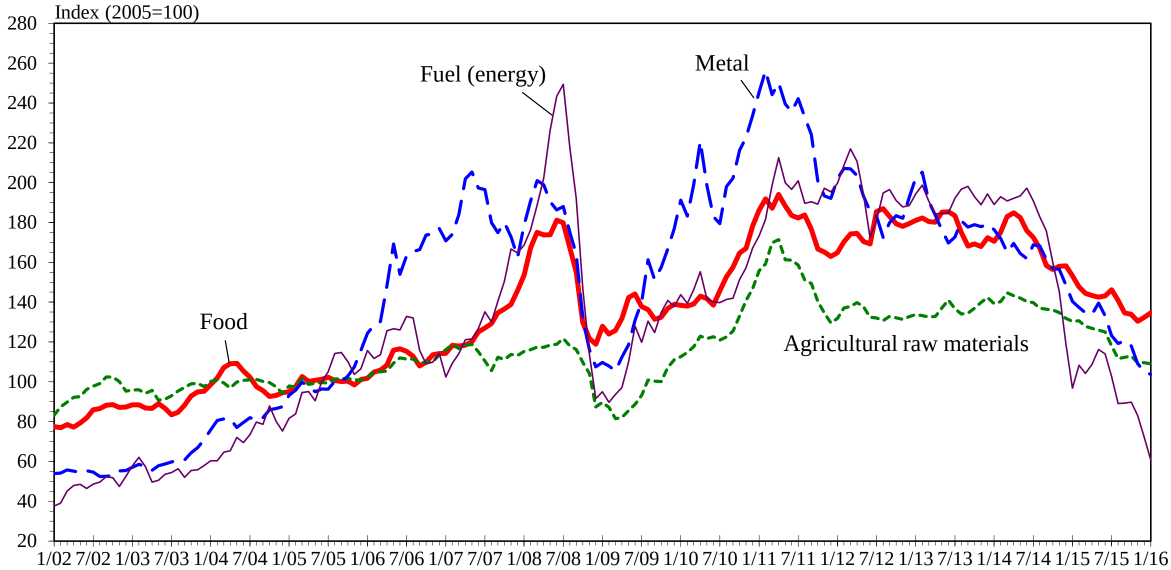
World inflation and global commodity prices

2.16 Inflation stayed low across most economies in the past year, held down by weaker-than-expected global economic growth and double-digit declines in international oil and other commodity prices. This was notwithstanding those emerging market economies that underwent sizeable currency depreciations and thus were concurrently plagued by the by-product of significantly higher imported inflation. Overall speaking, given the slow global economic growth and soft international commodity and energy prices, global inflation is likely to remain low in the near term.

2.17 The movement of international commodity prices is a key factor affecting the global inflation outlook. The plunge in oil prices since mid-2014 remained notable over the course of 2015. Oil prices were still under pressure on entering 2016 amid the global supply glut. The international prices of other non-petroleum commodities also saw visible declines in 2015. Global food prices fell by 19% in 2015, according to the Food and Agriculture Organization (FAO) of the United Nations. The prices of many manufacturing-related commodities, such as agricultural raw materials, industrial materials and metals, scaled back notably during 2015, mirroring the sluggish production and trading activities across the globe. Protracted commodity price declines would put downward pressures on headline inflation in net commodity importers, prolonging the deflation risks in some economies, including the eurozone and Japan. Asian economies such as Singapore, Taiwan and Thailand already experienced negative headline inflation in 2015. The real impact on net commodity exporters also warrants a close watch, as commodity price declines could weaken their external and fiscal positions and hurt their growth momentum, posing a threat to global economic recovery.

2.18 The risks of large commodity price fluctuations remain. An abrupt worsening of the geopolitical situation in the Middle East could possibly cause disruptions to global oil supplies, resulting in an oil price rebound. Likewise, international food prices could be sensitive to short-term adverse supply shocks arising from unfavourable extreme weather conditions.

Diagram 2.4 : International commodity prices plunged last year, and further sharp swings in the period ahead cannot be ruled out



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

Major sources of uncertainty

2.19 2016 is likely to be another challenging year fraught with notable downside risks for the global economy. *First and foremost*, the Fed's pace of subsequent interest rate hikes and the potential impacts on global macro-financial stability remain the biggest source of uncertainty (see ***Box 2.3*** for details). Under the adverse scenario that the US' growth momentum is derailed by the rate hikes or unfavourable international developments, the Fed would refrain from further increases in interest rates, but this would also imply a relapse in global growth. On the other hand, if the US' economic expansion continues apace with a more rapid build-up of inflationary pressures, the Fed may normalise rates faster and more aggressively than expected. Both scenarios may induce sharp financial market volatility. *Second*, the ECB and the BOJ may set forth further easing measures, hinging on their growth and inflation developments. Dimmer global growth prospects, coupled with the widening divergence in monetary policy stances of major central banks, could ignite international financial and asset market gyrations and cause abrupt changes to capital flows. *Third*, the fragility and fluidity of economic conditions in some major advanced economies could restrain global economic recovery. *Fourth*, emerging market economies with weak fundamentals could be vulnerable to volatile global financial conditions. Commodity-exporters, faced with the double-blow of subdued demand conditions in the advanced economies and continued declines in commodity and energy prices, may see further setback in growth. They may also run into fiscal and debt crises, with spillover effects on the rest of the world. *Fifth*, elevated geopolitical tensions in various regions remain a notable concern.

2.20 On the positive side, if the Fed could communicate effectively to the markets and give clarity about its policy intentions amid a sustained moderate growth in the US, global economic and financial conditions should hopefully be more stable during the course of its interest rate normalisation. If some breakthrough can be made in implementing structural reforms in Europe and Japan, this would help strengthen economic sentiment and bolster growth in these economies. Also, there could be some upside potential if the economic performance of the Mainland and other emerging Asian economies turns out to be better than expected, benefitting Asia's and Hong Kong's exports.

Box 2.3

What can we learn from the previous US interest rate upcycles?

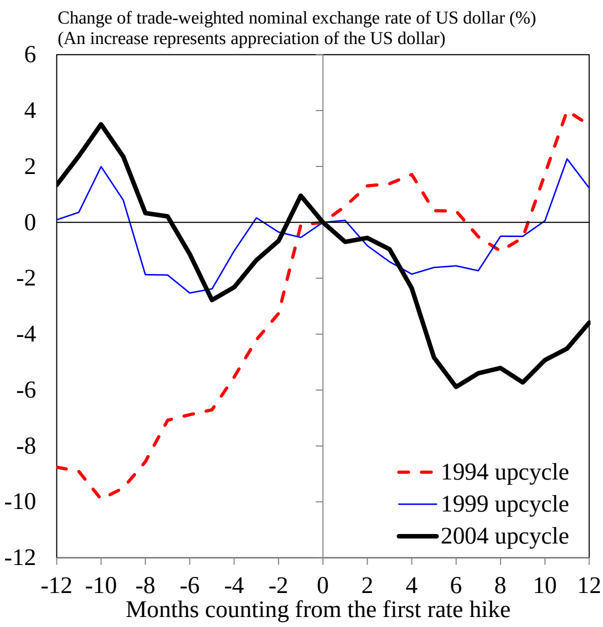
The US Federal Reserve (Fed) raised the range of its target federal funds rate by 25 basis points to 0.25%-0.50% in December 2015, marking a turning point of its super-low interest rate policy. Given the sheer importance of the US economy, the change in its monetary policy direction would not only affect its own economy, but inevitably also have significant implications for Hong Kong and the rest of the world. It would therefore be useful to examine what can be learned from the previous US interest rate upcycles.

This note covers the previous three US interest rate upcycles since 1990s. The first US interest rate upcycle took place between February 1994 and February 1995, when the Fed successively raised interest rates by 3 percentage points to 6%. The second one lasted from June 1999 to May 2000, with the US federal funds rate going up six times by a total of 1.75 percentage points to 6.5%. The most recent one occurred during June 2004 to June 2006, when the Fed increased interest rate 17 times from a low level of 1% to 5.25%.

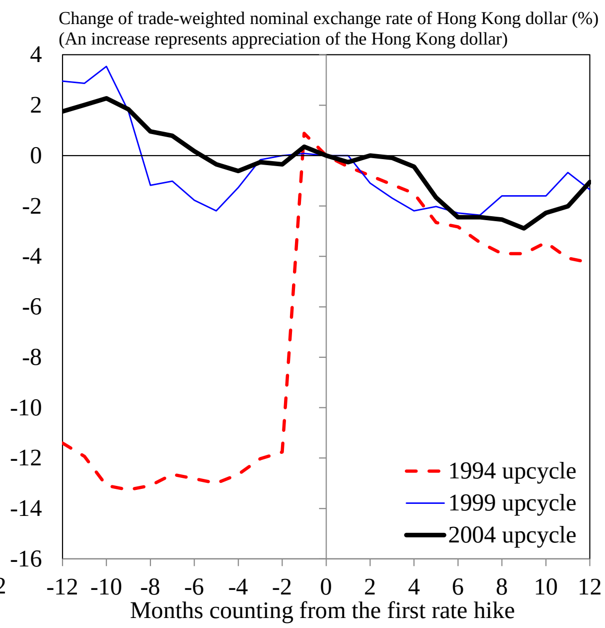
Under the Linked Exchange Rate System, the movements of the Hong Kong dollar against other currencies will follow those of the US dollar. Other things being equal, increases in short-term US interest rates theoretically would lead the US dollar to strengthen. A strong US dollar would potentially reduce the price competitiveness of Hong Kong's exports and hence is a concern for us. However, the actual play-out of the US dollar in the past after US rate hikes varied, as other moving parts also mattered. For example, in anticipation of US interest rate upcycles, the broad trade-weighted US dollar index had already been on an uptrend during the six months before the first rate hike, reflecting that the market had generally priced in the expected effect of the hike (***Chart 1***). In the 2004 upcycle, the US dollar fell visibly after the initial rate hike, due mainly to concerns about widening US current account deficits, while the commodity investment boom and strong global economy generated appreciation pressure on many emerging market currencies.

Chart 1 : The direction of the currency movements one year after the first rate hike varied in the past interest rate upcycles

(a) US dollar trade-weighted index



(b) Hong Kong dollar trade-weighted index*

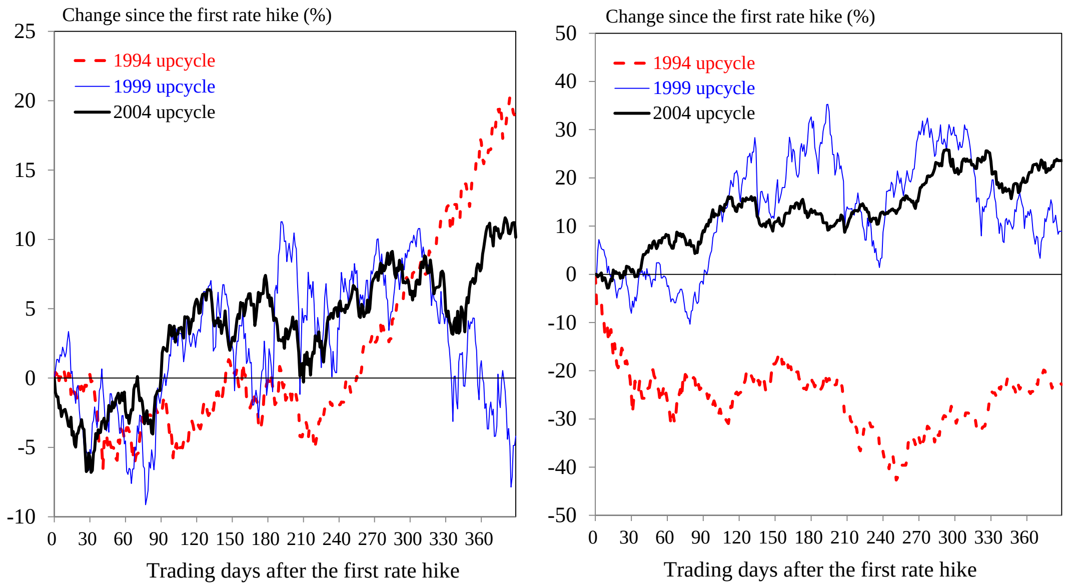


Note: (*) The sharp rise in the Hong Kong dollar's trade-weighted nominal exchange rate before the 1994 interest rate upcycle was due mainly to the one-off adjustment of the Renminbi amid the unification of the official Renminbi exchange rate and swap market exchange rate.

Box 2.3 (Cont'd)

Chart 2 : Stock markets showed diverged movements in the past three episodes

(a) S&P 500 Index in the US **(b) Hang Seng Index in Hong Kong**



As for the stock markets, the US interest rate hikes were rather steep and abrupt during the 1994 upcycle, amounting to 300 basis points in 13 months. Aggressive portfolio rebalancing resulted in visible declines in Hong Kong's stock prices (***Chart 2***), with particular pressure on financial and property stocks. In the other two episodes, the US interest rate lift-offs were more gradual, while the global business cycle generally held up. These favourable factors helped contribute to the resilience of corporate earnings and counter the negative impacts on investment sentiment arising from US monetary tightening during the period.

On economic performance, rising interest rates *per se* in theory have adverse impacts on private domestic demand, which could be a troubling concern. Firstly, higher interest rates weaken household and corporate spending directly by raising borrowing costs. The IMF in a recent study found that a 300-basis-point increase in mortgage rates could reduce household consumption by about 7-8 percent, and a 300-basis-point increase in interest rates could trim corporate investment by 0.5-1 percent(1). Besides, there are also indirect channels imparting negative influences. Corrections in local asset prices in response to higher interest rates could dampen private consumption via negative wealth effects. If the US rate lift-off proceeds abruptly and sends shockwave around the world, the resulting global economic and financial headwinds could further undermine local economic performance.

Comparing the past three US interest upcycles, the headwinds to Hong Kong's economy were most visible in the one that began in February 1994. In this occasion, the steep interest rate rises heightened global financial volatility. Growth of major advanced economies also decelerated visibly towards the end of this upcycle, which added a further drag on Hong Kong's economic performance. Significant fluctuations in local asset prices were also seen after the initial rate hike, with bearings on consumption sentiment via wealth effects.

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(1) IMF Staff Report of Hong Kong Special Administrative Region, People's Republic of China, "Box 2: The Impact of Rising Interest Rates on Domestic Demand in Hong Kong SAR", January 2016.

Box 2.3 (Cont'd)

On the other hand, the negative impacts in the other two episodes were more muted, being diluted by other positive developments. In the interest rate upcycle that began in June 2004, Hong Kong's real GDP growth managed to stay robust after the rate hike, as the solid global economic growth as well as strong local cyclical economic upturns after a prolonged period of setback prevailed. In the upcycle that began in June 1999, Hong Kong's economic growth actually picked up notably in the year after the rate hike, though this was merely due to the waning of the recessionary pressures from the Asian Financial Crisis. In fact, local mortgage rates actually fell back visibly right before this US interest rate upcycle as the risk premium receded. Moreover, many regional economies also recovered vigorously during 1999 from deep recession. These tailwinds powered Hong Kong's economy to shake off the recession in 1998 and rebound strongly in 1999.

In sum, the past experiences suggest that the impact of US interest rate hikes is not only contingent on the pace and magnitude of the hikes, it also critically hinges on other macroeconomic factors and their dynamic interactions. At this juncture, the pace of US interest rate normalisation is still subject to uncertainties and data-dependent. In late January, the Federal Open Market Committee indicated their concerns about the heightened global financial market volatility, while US economic growth in the fourth quarter of 2015 slowed visibly, greatly reducing expectation for a March rate hike. The uncertain growth momentum of the US, increasing monetary policy divergence among major central banks, and the recent fluctuations in global financial markets would continue to complicate the US interest rate outlook. Any unexpected policy action by the Fed could bring about further ramifications to the global economy via the complex financial channels.

Moreover, the US interest rate lift-off this time began under exceptional global economic circumstances. In particular, the global economy seems to have entered a protracted period of slow growth in the post-crisis period. The US interest rates had hit nearly zero for seven years. Unconventional monetary policies in major advanced economies flooded global financial markets with liquidity glut, buoying asset valuations in different parts of the world. Vulnerabilities in those emerging markets with weaker fundamentals have built up. Besides, the divergence of monetary policies among major central banks is fairly pronounced and the degree of global integration of financial markets is at a historic high.

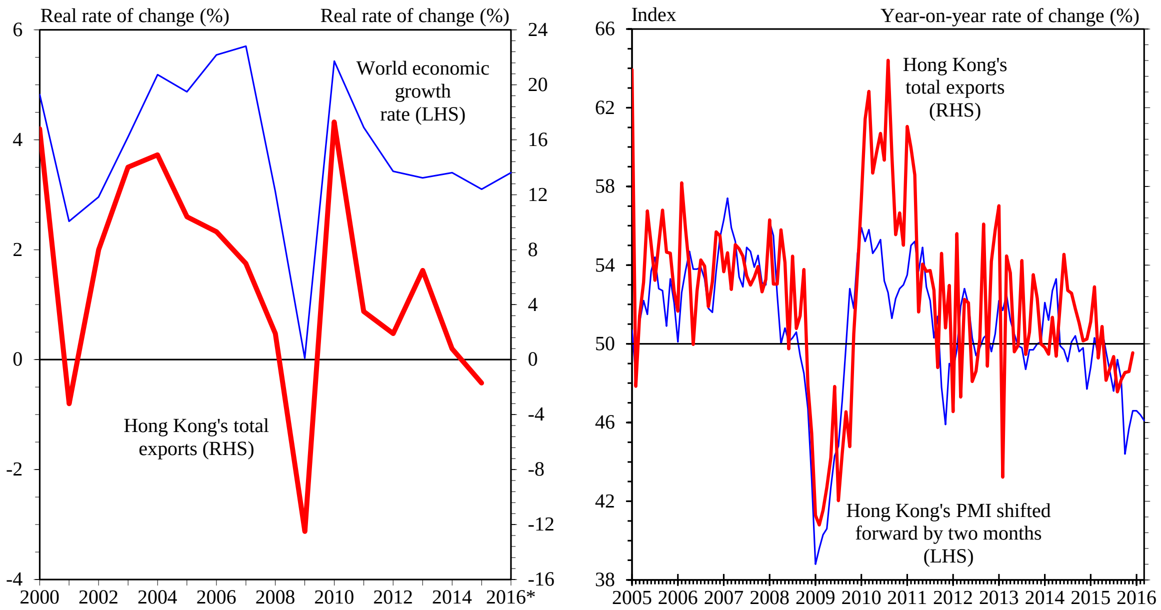
Since mid-2015, the local stock market has followed the global trend and undergone significant corrections. Local housing market has also consolidated of late. Fluctuations in local asset prices, if continued, will likely have dampening effects on consumption demand through negative wealth effects. Besides, the strengthening of the US dollar seen in the past year, if continued, may induce additional downward pressures on Hong Kong's exports and inbound tourism. Yet our main concern stemming from the US interest rate normalisation is that it may interact with the exceptional global circumstances this time in such a vicious way that leads to an acute economic slowdown and financial dislocations around the world, with consequential impacts on Hong Kong's economic performance.

Hong Kong, with a sound financial system and strong fundamentals, is more than capable to handle the abrupt changes in financial conditions and capital flows and navigate through the ups and downs of the global economy. The macro-prudential measures taken in the past few years in preparation of the eventual normalisation of interest rates have also strengthened the resilience of the financial system. The healthy position of current account balance, the absence of external debt by the government, and the strong net external financial asset position would also distinguish Hong Kong from economies with weaker fundamentals in other parts of the world. Yet, given the wide fluctuations of the financial markets since the beginning of this year, an important lesson from the past is to exercise risk management with a view to containing the impacts from any unanticipated adverse developments.

Outlook for the Hong Kong economy in 2016

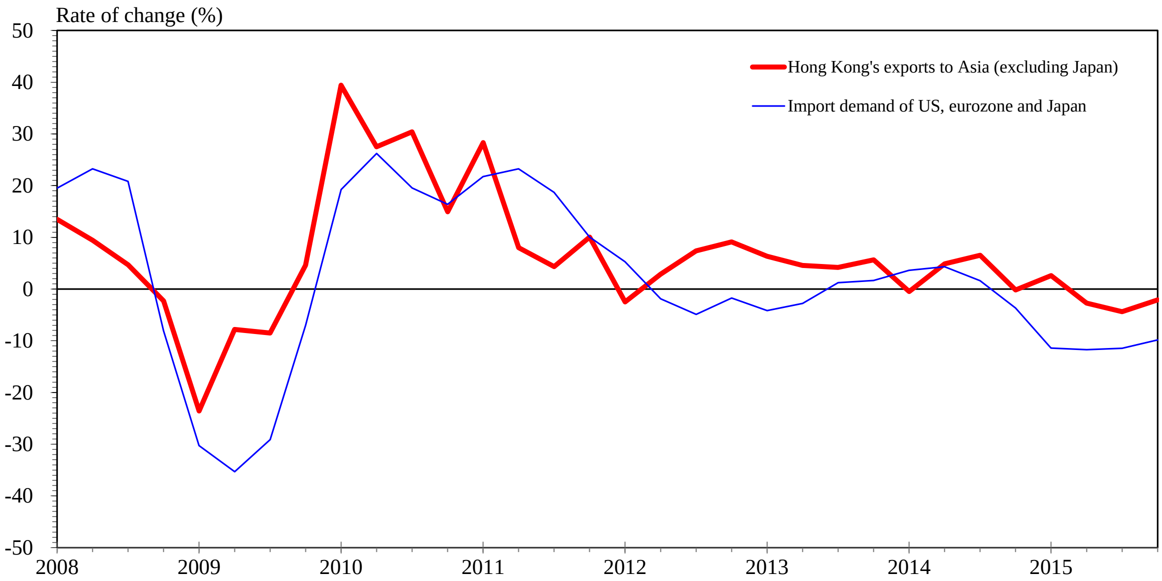
2.21 As a small and open economy, Hong Kong's economic outlook for 2016 will continue to hinge crucially on the vicissitudes of the external environment. The strong external headwinds, which dampened Hong Kong's export performance in 2015, are likely to persist in 2016. The weak global demand may continue to weigh on production and trading activities in Asia, especially if economic growth in advanced economies is to stay slow. Volatile global financial and commodity markets, growth slowdown of many emerging markets, and intensified geopolitical tensions will curtail global trade flows. Also, a strong US dollar will not be favourable to our price competitiveness. As such, Hong Kong's *exports of goods* will likely remain subdued in the near term and the chance of a visible turnaround in 2016 looks slim. Yet, there may be some relative improvement towards the latter part of the year, if the demand conditions in advanced economies pick up and downside risks to the global economy recede.

Diagram 2.5 : The outlook for Hong Kong's goods exports will hinge crucially on global economic and financial conditions in 2016



Note : (*) Forecasts from the IMF World Economic Outlook Update, January 2016.

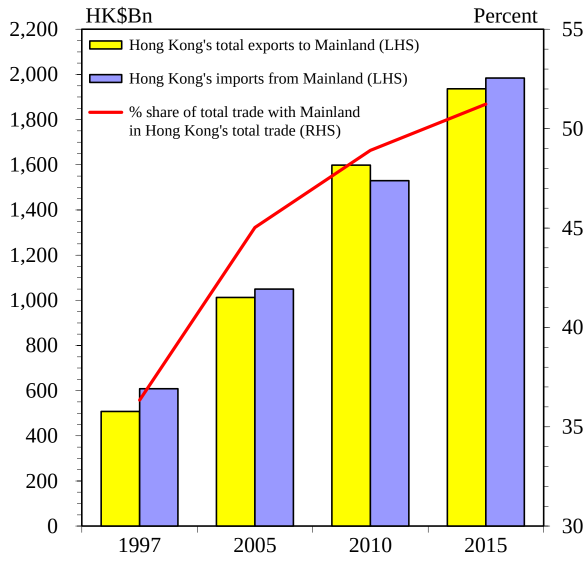
Diagram 2.6 : Regional trade is closely related to import demand in advanced economies



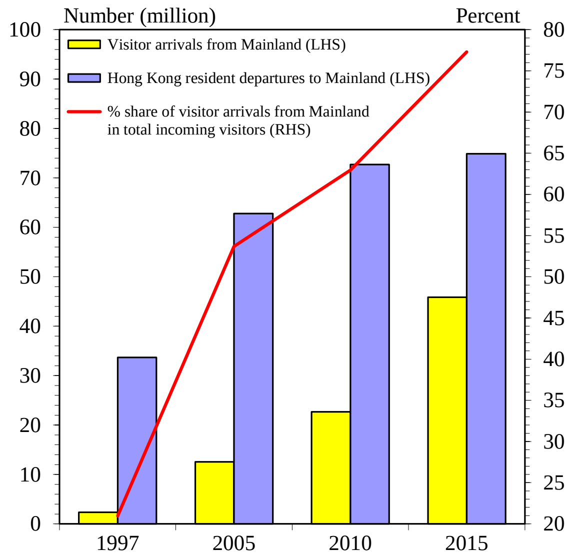
2.22 *Exports of services* deteriorated during 2015 and registered its first annual decline since 1998, battered by a further weakening in inbound tourism and sluggish trade and cargo flows. Looking ahead, the situation is not promising either, as the sluggish trade and cargo flows under the austere external environment may continue to hold back the performance of exports of trade-related services and transportation services. Also, a persistently volatile international financial environment may hamper cross-border financing and fund-raising activities, and dent exports of financial and business services. As for exports of travel services, downward pressures may remain as the consolidation in inbound tourism may still continue for a while, given a further decline in visitor arrivals on entering 2016.

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

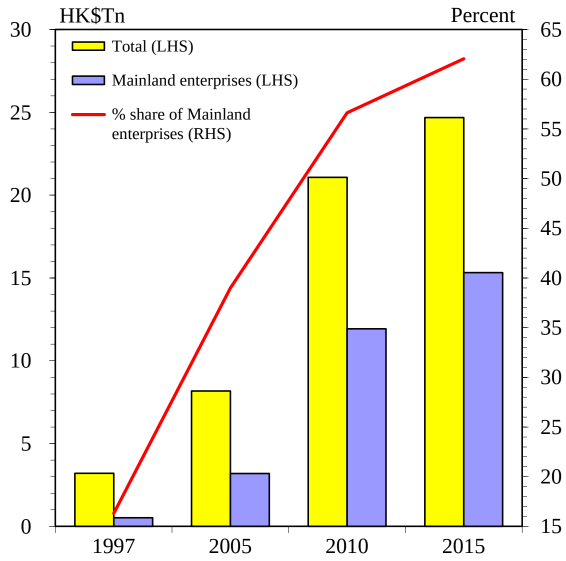
(a) Merchandise trade



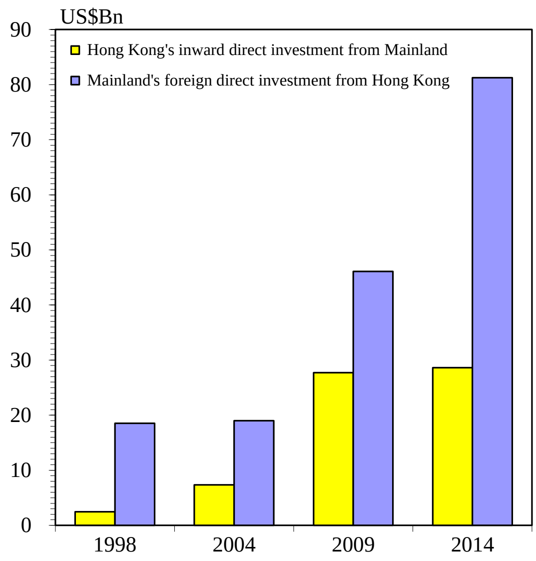
(b) Visitor arrivals from Mainland and Hong Kong resident departures to Mainland



(c) Market capitalisation of Mainland enterprises in the Hong Kong stock market (end-year figures)



(d) Hong Kong's inward direct investment from Mainland and Mainland's foreign direct investment from Hong Kong



2.23 *Domestic demand* was relatively resilient in 2015, cushioning the economy against the setback of the external sector. Going forward, domestic demand should still see some growth in 2016, but may also come under test given a highly uncertain external environment. While a stable labour market should render some support to private consumption, consumer sentiment could be adversely affected by the subdued global economic prospects and the volatile financial conditions. The corrections in asset prices, especially after the kick-off of the interest rate upcycle in the US, may also have an unfavourable wealth effect on consumption. As for investment demand, external developments may weaken investment sentiment. Indeed, business sentiment of large enterprises and small and medium-sized enterprises have turned somewhat negative about the near-term outlook amid the protracted sluggishness in the global economy and the gloomy global growth prospects. Nonetheless, the building and construction component should provide some buffer for overall investment in 2016, sustained by the ongoing public building and construction works and increasing private sector activities.

Diagram 2.8 : Private consumption looks set to moderate in 2016

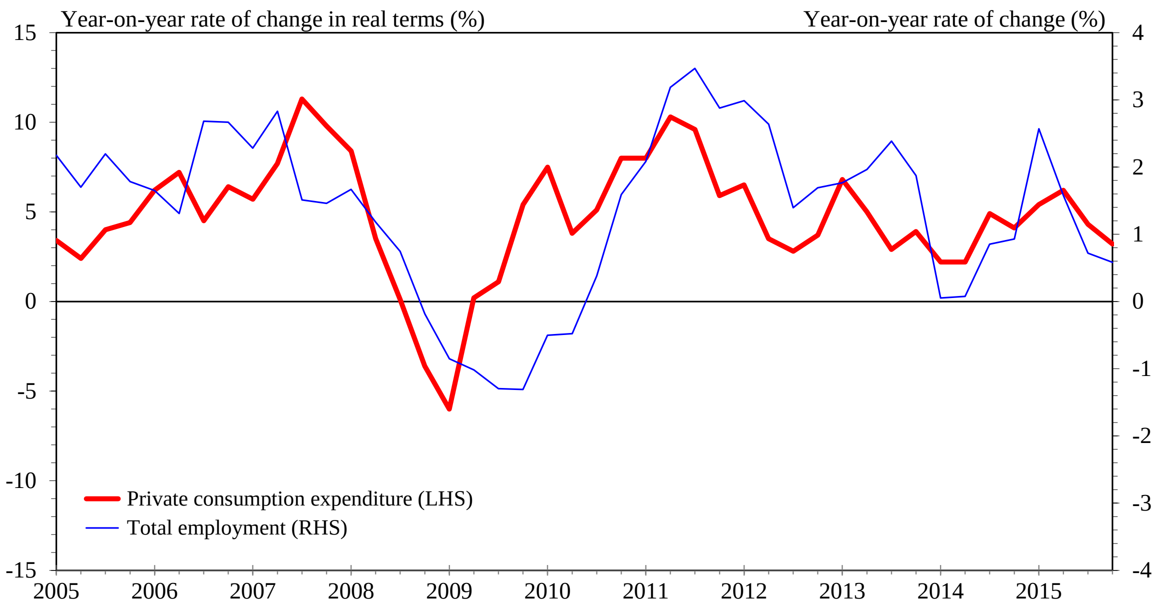
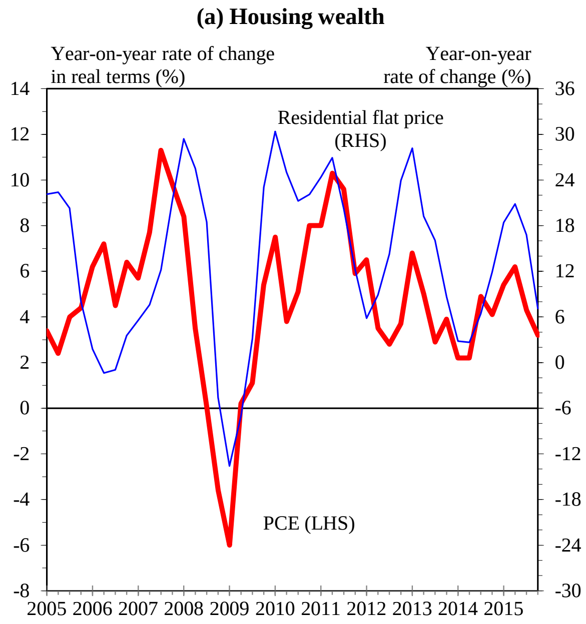


Diagram 2.9 : Consumer sentiment may be affected by asset market performance



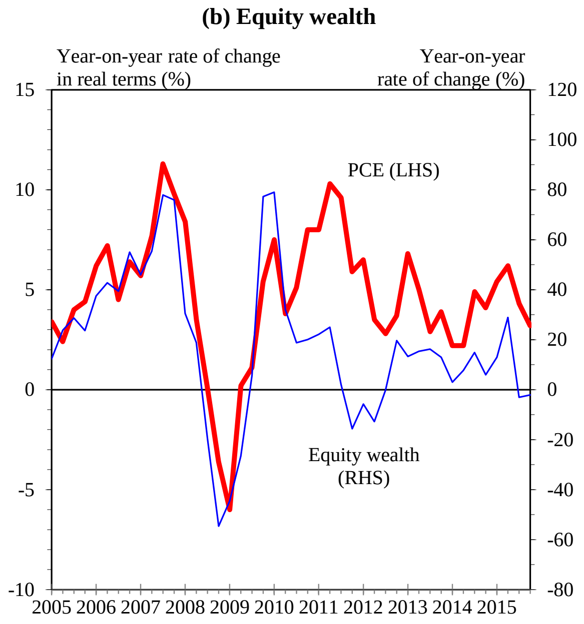
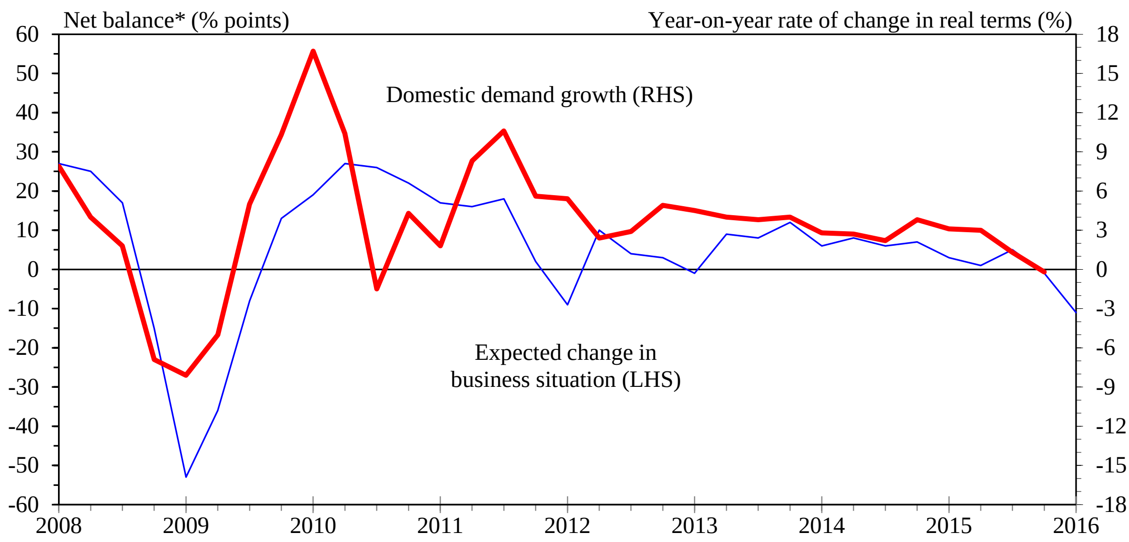


Diagram 2.10 : Large enterprises turned somewhat negative about the near-term business outlook



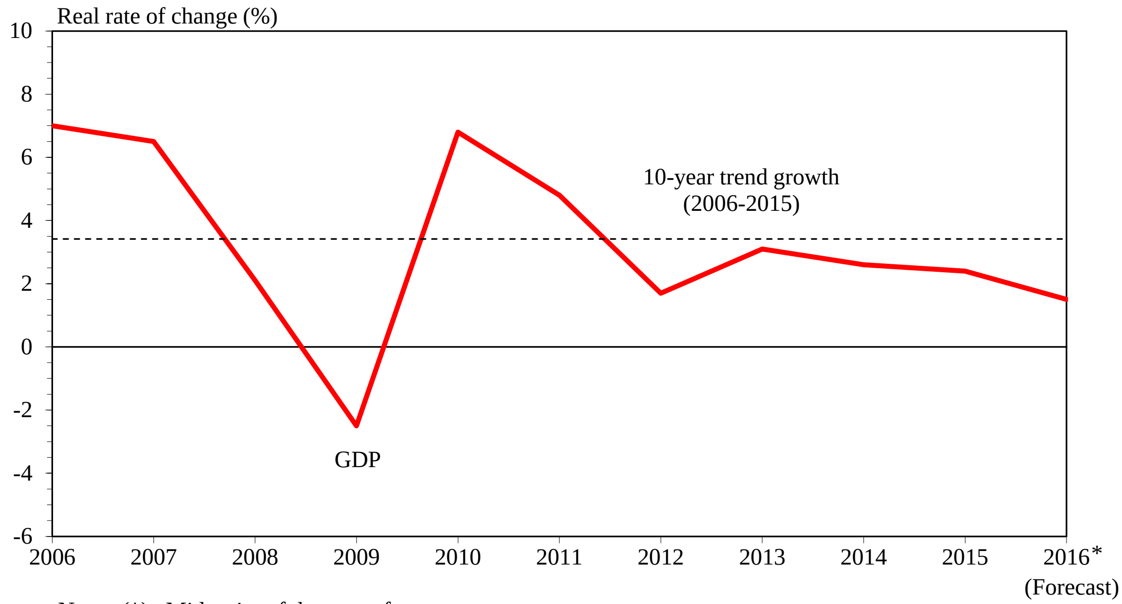
Note : (*) Net balance indicates the direction of expected change in business situation versus preceding quarter. It refers to the difference in percentage points between the proportion of establishments choosing "better" over that choosing "worse". A positive sign indicates a likely upward trend while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

Diagram 2.11 : Hiring sentiment remained broadly stable

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.

2.24 Taking into account the likely lacklustre performance in external trade and possible moderation in domestic demand, the Hong Kong economy is projected to grow by 1-2% in 2016, after the 2.4% growth in 2015 and compared to the average annual growth of 3.4% in the past ten years. For comparison, the prevailing forecasts by private sector analysts for Hong Kong's economic growth in 2016 mostly fall within the range of 1.0-2.5%, averaging at around 1.9%. The slow growth projected for the Hong Kong economy could exert pressures on job creation and the unemployment situation, which warrant close monitoring. The GDP growth forecast for 2016 is subject to an unusually high degree of uncertainty, much depending on how the complicated global financial conditions will evolve and the repercussions on the world economy, especially when some emerging market economies may be susceptible to financial shocks. Significant shifts in risk sentiment and capital flows, if come about, may trigger deeper-than-expected asset market corrections, and the ensuing negative wealth effect would accentuate the downward pressures on our domestic economy. In this regard, the developments in the local property market amid an interest rate upcycle need to be watched over. On the other hand, there could be some upside potential to the forecast if the world's economic growth is stronger than expected, creating a more supportive environment for global trade flows, and if Asian and emerging market economies, with relatively resilient domestic demand, hold up better than envisaged.

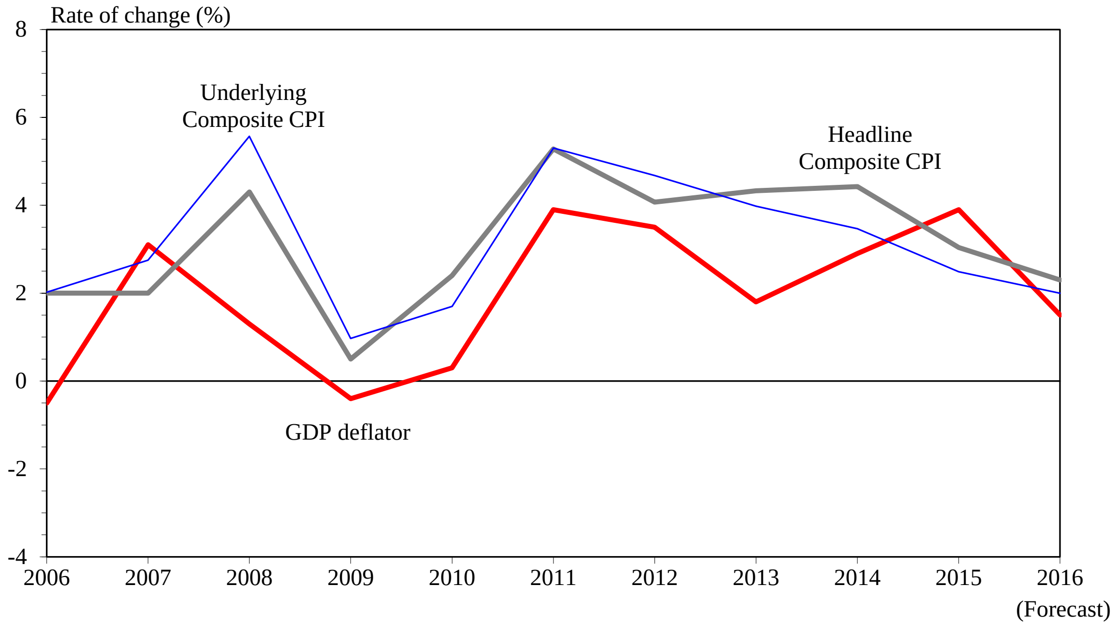
Diagram 2.12 : Hong Kong economy is expected to expand at a slower pace in 2016, under an austere external environment



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

2.25 Underlying inflation in Hong Kong eased further from 3.5% in 2014 to 2.5% in 2015. Externally, declining international commodity prices and tame inflation outlook for Hong Kong's major trading partners should help keep imported inflation low. Thus, barring any unexpected rebound in international commodity prices, external price pressures will likely remain soft in 2016. Local cost pressures also look set to lessen, in tandem with the sub-par economic growth and with the consolidation in the property market that in turn will likely dampen rental costs. Taking all the factors into consideration, the *underlying Composite CPI* is forecast to increase by 2% for 2016 as a whole, easing further for the fifth consecutive year, from the 2.5% increase in 2015. Taking into account the effects of the Government's one-off measures, *headline Composite CPI* is forecast to increase by 2.3% in 2016, compared to 3.0% in 2015. The *GDP deflator* is forecast to rise by 1.5%, on account of the expected slower increases in prices from both the local and external fronts.

Diagram 2.13 : Inflation poised for further easing in 2016



Forecast rate of change in 2016 (%)

Gross Domestic Product (GDP)

Real GDP	**1 to 2**
Nominal GDP	2.5 to 3.5
Per capita GDP in real terms	0.2 to 1.2
Per capita GDP at current market prices	HK$334,500 – 337,800 (US$42,900 – 43,300)

Composite Consumer Price Index

Underlying	**2**
Headline	**2.3**

GDP Deflator	**1.5**

Forecast on Hong Kong's GDP growth in 2016 recently made by other selected parties

	(%)
The University of Hong Kong	Below 2
Average forecast by private sector analysts#	1.9

Note : (#) Forecast GDP growth rates by private sector analysts mostly fall between 1.0% and 2.5%.

Medium-term outlook for the Hong Kong economy

2.26 Over the medium term, the Hong Kong economy will still likely be confronted with a challenging and unsteady external environment. After the Global Financial Crisis of 2008, the world economy has entered an era of underinvestment and high unemployment, which coupled with the challenges of population ageing, have lowered the growth potential of many advanced economies. In the absence of a strong recovery from the demand side, global growth is likely to remain sub-par for an extended period under the "new normal". For instance, growth in the eurozone and Japan would stay slow, with potential risks of setbacks, amid unresolved structural problems such as high debt levels, fiscal sustainability and certain market rigidities. While the economic performance of the US fares relatively better, there remains notable policy risks associated with its interest rate normalisation and the possible adverse repercussions to global economic and financial conditions. Also, the problem of population ageing in advanced economies would intensify over time, pulling a rein on their growth in the longer term.

2.27 While emerging market economies are likely to remain the key drivers of the global economy, they may see growth at a more moderate pace in the coming years. Aside from adjustments to past years of exceptionally brisk expansion, the protracted slow growth in the advanced economies may continue to affect those economies that are export-oriented. In addition, economies with a build-up of domestic and external vulnerabilities over the years and less resilient financial systems may be more susceptible to potential negative shocks from sharp asset price fluctuations and capital flow reversals triggered by the monetary policy normalisation in the US. Nonetheless, Asian economies, generally with stronger economic fundamentals and resilient domestic demand, should continue to be the bright spots in the global economic arena.

2.28 With the shift in the gravity of global economic activities towards the East, deepening economic linkages with the Mainland will continue to be an integral part of our growth strategy. The Mainland is moving towards a lower but more sustainable growth path under the National 13th Five-Year Plan for 2016-2020. In the coming years, the Mainland's increasing emphasis on its services sector and domestic consumption should offer ample opportunities for Hong Kong, as our companies have a competitive edge in providing higher-end services. In addition, the further opening up of the Mainland market, closer integration with the Mainland's financial markets, the internationalisation of the RMB and the "going out" of Mainland enterprises will likely increase the demand for high value-added services, particularly financial and professional services. Against this, the Government will continue to forge closer economic ties with the Mainland through CEPA and other regional co-operation platforms. Further efforts will be made to reinforce Hong Kong's status as the leading offshore RMB business centre and premier asset management hub. Separately, the Government will strive to strengthen economic co-operation with new and emerging markets. In particular, the Mainland's "Belt and Road" Initiative, which encompasses over 60 economies (including many emerging market economies in Southeast and Central Asia, Central and Eastern Europe, as well as Africa), will bring forth extensive business opportunities stemming from infrastructural investments, deepening of financial linkages, trade expansion and people-to-people connectivity. Hong Kong is well-positioned to serve as a fund-raising and financial management platform, a trade and logistics hub, as well as an investment springboard when tapping into these markets with huge growth potential.

2.29 On the domestic front, the Government is committed to uplifting Hong Kong's competitiveness and promoting sustainable and diversified economic development. In order to lay a solid foundation for our longer-term development, the Government constantly strives to enhance our strengths in pillar industries, while exploring and promoting new growth areas. Efforts in upgrading human capital and infrastructure will continue to uphold Hong Kong's productivity and competitiveness. Ongoing large-scale infrastructure works should render support to domestic demand beyond the near term.

2.30 Meanwhile, the Government is mindful of the key challenges that could limit our economic growth potential going forward. Population ageing, a common phenomenon across advanced economies, will pose a key constraint to Hong Kong's medium to longer-term economic growth. The Government is proactively adopting a multi-pronged population policy including unleashing the potential of the local workforce, enhancing the quality of home-grown talent, attracting foreign investors and talent, fostering a family-friendly environment and embracing opportunities in an ageing society. Notwithstanding the Government's efforts in boosting labour force at source, the demographic shift makes it all the more important for the Government to exercise fiscal prudence, in view of the profound impacts on our public expenses from an ageing population, especially on healthcare and social welfare. Also, we need to preserve our ability in meeting the upcoming various challenges to our economy. Sufficient public resources must be ensured for infrastructure and human capital investment to increase growth potential of our economy and also to tackle social issues through various programmes. Taking into account the challenges in the external environment and on the domestic front, the economy is expected to attain a trend growth of 3% per annum from 2017 to 2020.

2.31 Over the medium term, inflationary pressures are expected to remain moderate. Externally, slow global growth under the "new normal" will likely keep global inflation low. Locally, the Government's continuous efforts to increase land and housing supply will be conducive to keeping rental cost pressures contained in the years ahead amid a better demand-supply balance in the property market. Also, productivity gains should help lessen some of the local cost pressures. Taking all these developments into account, the trend rate of change in the underlying Composite CPI in Hong Kong from 2017 to 2020 is forecast at 2.5% per annum. However, there are upside risks to Hong Kong's inflation outlook, if global growth is stronger than expected, and if major central banks delay their monetary policy responses to faster-than-expected increases in inflationary pressures, or if commodity prices rise sharply due to adverse supply shocks.

Diagram 2.14 : Medium-term trend growth likely to be moderate