CHAPTER 2 : THE EXTERNAL SECTOR

Summary

- *Strong external headwinds persisted in the first quarter of 2016. The global economy was stuck on a slow track. While US economic growth remained modest, the fragile conditions in other major advanced economies prompted their central banks to roll out more easing measures. The heightened global financial volatility during the quarter also dented economic sentiment. With global demand remaining weak, global trade flows were subdued, continuing to hit Asian production activities and trade flows, and worsening the performance of Hong Kong's external trade.*

- *Merchandise exports saw a larger year-on-year decline of 4.2% in real terms[(1)] in the first quarter. Exports to major advanced markets deteriorated across the board. Exports to the Asian markets were also mostly subdued, except those to India which still recorded notable growth.*

- *Exports of services slackened further, falling by 4.9% year-on-year in real terms in the first quarter. The double-digit decline in exports of travel services amid the fall-off in visitor arrivals was the main drag. The unfavourable external environment dealt a further blow. Exports of trade-related services weakened and exports of transportation services remained subdued amid the reduced trade and cargo flows in the region. Exports of financial and other business services also continued to see a slight decline, as financial market strains during the period dragged on cross-border financial and commercial activities.*

- *The 21st Working Meeting of the Hong Kong/Guangdong Co-operation Joint Conference was held in March, which formulated the 2016 Work Plan covering 92 co-operation items based on consensus reached at the 18th Plenary of the Hong Kong/Guangdong Co-operation Joint Conference held last year. Separately, in anticipation of a challenging economic environment, the 2016-17 Budget unveiled a series of measures to ease SMEs' burden and tide over their liquidity needs, while a pilot programme will be launched to encourage their use of technological services to improve productivity.*

Goods trade

Total exports of goods

2.1 Sluggish global demand continued to weigh on Asian trading and production activities and weakened the performance of Hong Kong's external trade. In the first quarter of 2016, Hong Kong's *merchandise exports* (comprising re-exports and domestic exports) continued to decline, by 4.2% year-on-year in real terms, larger than the 0.5% drop in the fourth quarter of 2015. On a seasonally adjusted quarter-to-quarter basis, merchandise exports relapsed to a notable fall of 5.9% in the first quarter, following a 1.1% growth in the preceding quarter.

2.2 The global economic landscape remained lacklustre in the first quarter. Economic growth in the US was modest in the first quarter, being restrained by weak industrial activity and exports, although there was continued improvement in its labour market. The economic recovery in the eurozone was still slow and faced increasing challenges from persistent structural problems, migrant inflows, geopolitical risks and potential exit of the United Kingdom from the European Union. Japan's economy had been likewise struggling for growth. As deflation risks persisted, both the European Central Bank and the Bank of Japan stepped up monetary stimulus in the quarter (see ***Box 2.1*** for details). Global financial markets saw heightened volatility early this year, in the face of increased global economic uncertainties and monetary policy divergence. All these developments undermined economic sentiment and also generated strong headwinds for emerging market economies. In April, the International Monetary Fund (IMF) lowered its global economic growth forecast for 2016 to 3.2%, indicating that the lacklustre global economic situation would linger on in the near term.

2.3 The sluggish global demand continued to buffet manufacturing and trading activities in Asia. Exports of many Asian economies, measured in US dollar terms, slid notably further from a year earlier in the first quarter. For example, Korea's and Taiwan's exports plummeted by 13% and 12% respectively in the first quarter, and Singapore's non-oil exports also saw an enlarged decline of 10%. The uncertain global economic outlook and accumulated impacts of currency depreciations in many Asian economies dampened import appetite in the region. As a result, there were notable downward pressures on regional trade and cargo flows during the quarter.

Table 2.1 : Total exports of goods, re-exports and domestic exports (year-on-year rate of change (%))

		Total exports of goods				Re-exports				Domestic exports			
		In value terms	In real terms[a]		Change in prices	In value terms	In real terms[a]		Change in prices	In value terms	In real terms[a]		Change in prices
2015	Annual	-1.8	-1.7		0.1	-1.6	-1.6		0.1	-15.2	-12.8		-3.0
	Q1	2.3	0.7	(-0.3)	2.0	2.5	0.8	(-0.3)	2.1	-10.1	-8.7	(-2.3)	-1.5
	Q2	-1.9	-3.0	(-1.2)	1.3	-1.7	-2.8	(-1.2)	1.4	-15.6	-13.8	(-2.8)	-2.7
	Q3	-4.1	-3.8	(-0.1)	-0.4	-3.9	-3.6	(*)	-0.4	-18.3	-15.7	(-6.9)	-4.3
	Q4	-2.9	-0.5	(1.1)	-2.1	-2.7	-0.3	(1.1)	-2.1	-16.4	-12.6	(-0.4)	-3.3
2016	Q1	-6.8	-4.2	(-5.9)	-2.6	-6.7	-4.0	(-6.0)	-2.6	-15.2	-12.1	(-3.9)	-3.2

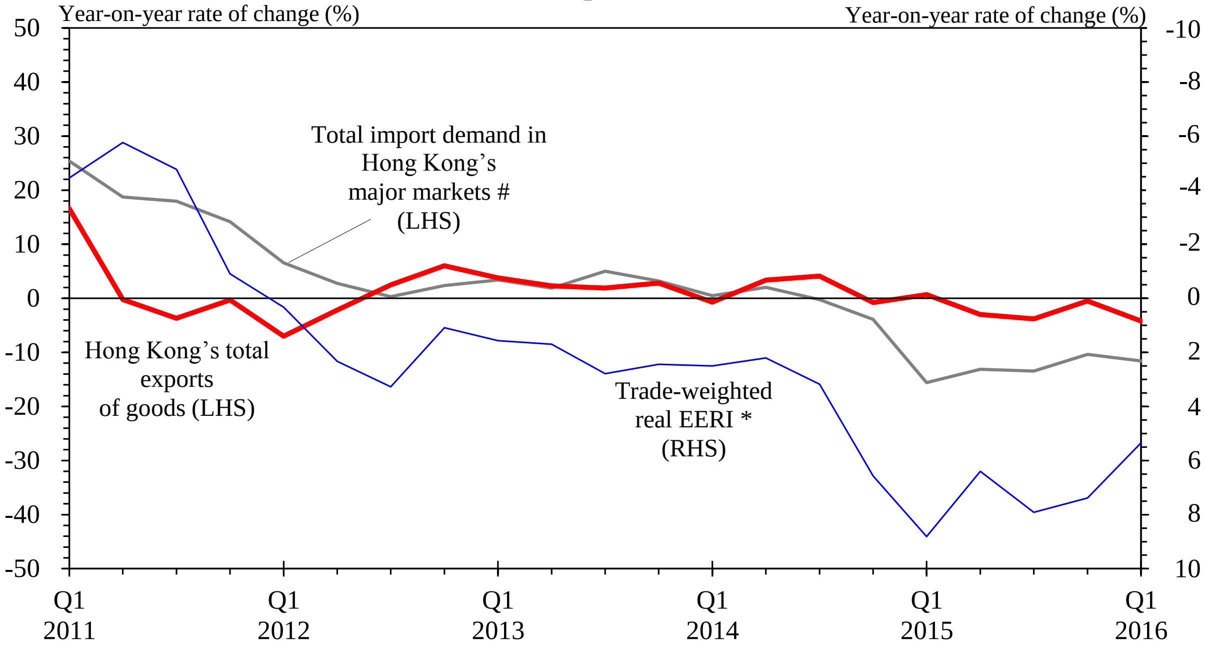
Notes : ( ) Seasonally adjusted quarter-to-quarter rate of change.

(*) Change within ±0.05%.

(a) The growth rates here are not strictly comparable with those in the GDP accounts in Table 1.1, due to differences in coverage.

2.4 *Re-exports*[2], the mainstay of overall merchandise exports and accounting for 98.8% of total exports by value, fell by 4.0% year-on-year in real terms in the first quarter, after a decline of 0.3% in the preceding quarter. *Domestic exports*, constituting the remaining 1.2% of total exports, fell visibly by 12.1% year-on-year during the quarter, following the 12.6% fall in the preceding quarter.

Diagram 2.1 : Merchandise exports recorded a widened decline in the first quarter of 2016



Notes : Total exports of goods as depicted refer to the year-on-year rate of change in real terms, while total import demand in Hong Kong's major markets as depicted refers to the year-on-year rate of change in US dollar terms in the aggregate import demand in Asia, the United States and the European Union taken together.

(*) The real EERI in this graph is inverted in scale for easier comprehension. A positive change denotes real appreciation of the Hong Kong dollar.

(#) Import demand figure for the first quarter of 2016 is based on statistics for January and February 2016.

Diagram 2.2 : Similar to other high-income economies in Asia, Hong Kong also saw a further decline in merchandise exports

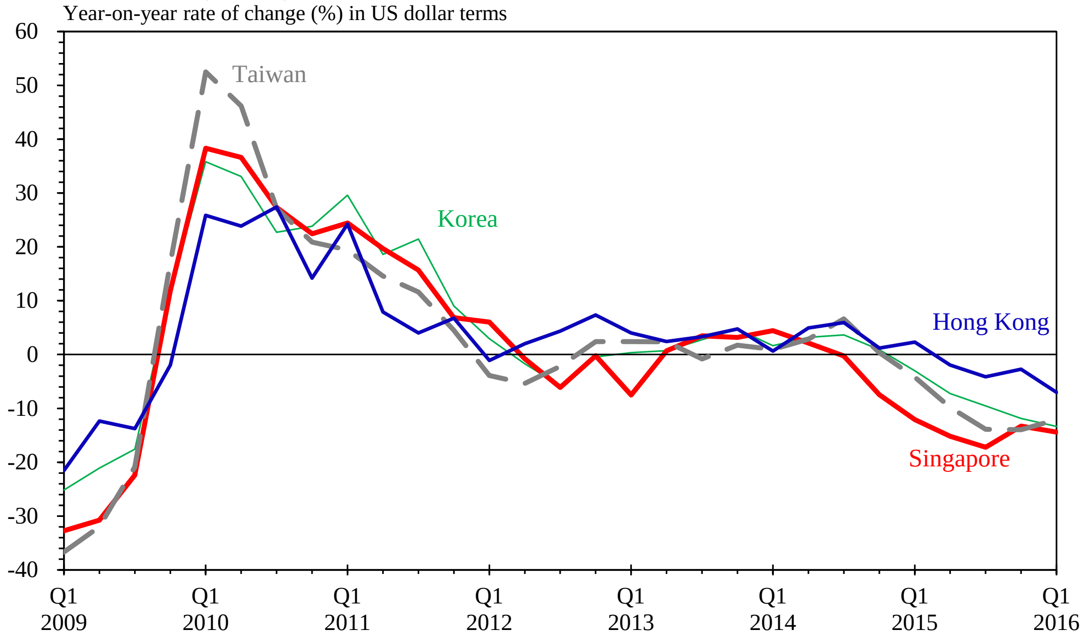
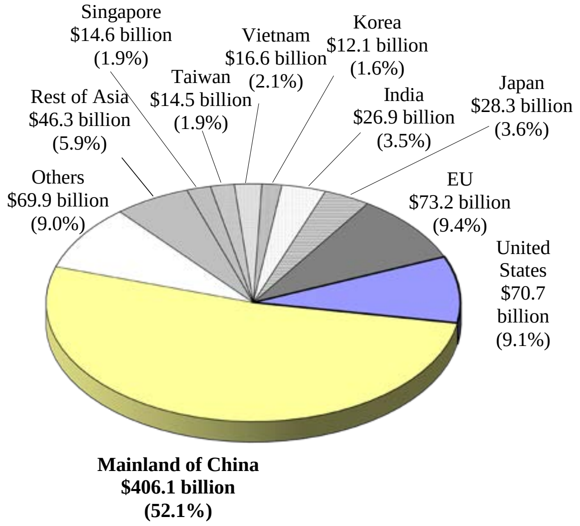


Diagram 2.3 : Exports to the Asian markets fell further amid sluggish global demand



Total exports of goods in the first quarter of 2016: $779.4 billion

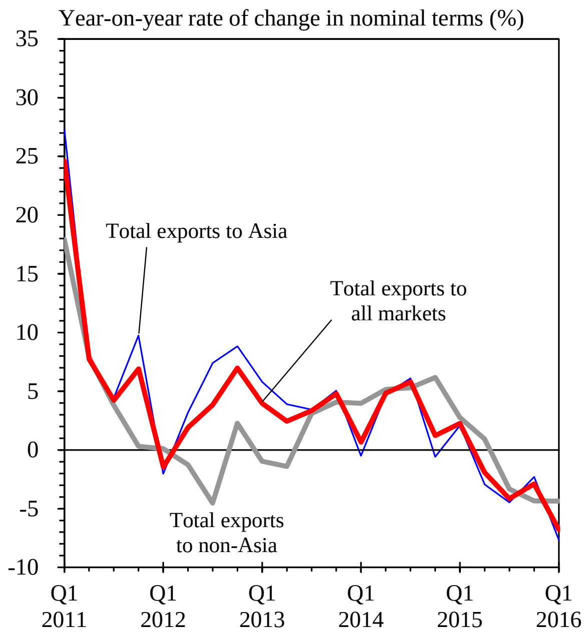


Table 2.2 : Total exports of goods by major market (year-on-year rate of change in real terms (%))

			2015			2016
	Annual	Q1	Q2	Q3	Q4	Q1
Mainland of China	-2.0	-0.2	-4.4	-3.5	0.6	-5.6
United States	1.0	3.3	3.6	-1.4	-0.6	-4.8
European Union	-4.1	-3.5	-6.7	-6.0	-0.2	-2.6
Japan	-3.6	-5.8	-4.0	-1.7	-2.8	-3.3
India	7.9	12.4	-3.1	2.3	22.8	15.8
Vietnam	12.1	14.0	18.0	12.9	5.2	-2.1
Taiwan	-15.0	-12.8	-20.3	-23.5	-2.1	-2.9
Korea	-13.4	-5.7	-13.8	-19.1	-14.2	-14.0
Singapore	-4.3	0.4	-3.7	-8.7	-4.9	-0.4
Overall*	-1.7	0.7	-3.0	-3.8	-0.5	-4.2

Note : (*) The growth rates here are not strictly comparable with those in the GDP accounts in Table 1.1, due to differences in coverage.

2.5 Analysed by major market, merchandise exports to major advanced economies deteriorated across the board and showed widened declines in the first quarter. Exports to the US weakened to show an enlarged fall, as the setback in industrial activity and softer economic activity there suppressed its import demand. Exports to the EU also turned weaker, in tandem with flagging consumer confidence and sluggish economic activity in the eurozone during the period. Likewise, exports to Japan were still in the doldrums, notwithstanding the tailwinds from the yen's recent rebound, given the continued drag from lacklustre consumer spending.

2.6 Exports to most Asian markets were also weak, as protracted demand sluggishness in advanced markets had serious ramifications on activity in Asian supply chains, and precipitated a general setback in Hong Kong's exports of raw materials and semi-manufactures and capital goods to the region in the first quarter. Moreover, headwinds arising from slower economic growth and currency depreciations in many Asia's economies in the past year or so rendered an additional blow to the region's import demand. Exports to the higher-income Asian economies remained in decline, with the plunge of exports to Korea being particularly notable. Exports to the Mainland reverted to a year-on-year decline. Likewise, those to some major ASEAN markets also relapsed to falls. Exports to India remained the outperformer and registered notable growth during the period.

Diagram 2.4 : Exports to the Mainland relapsed to a fall in the first quarter

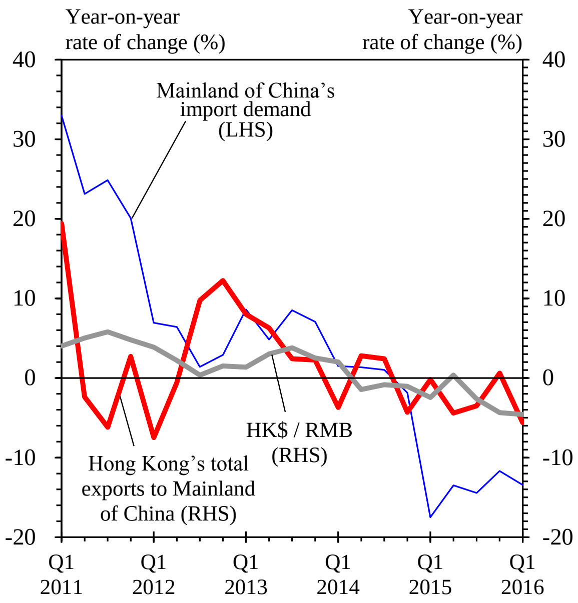


Diagram 2.5 : Exports to the EU showed an enlarged decline

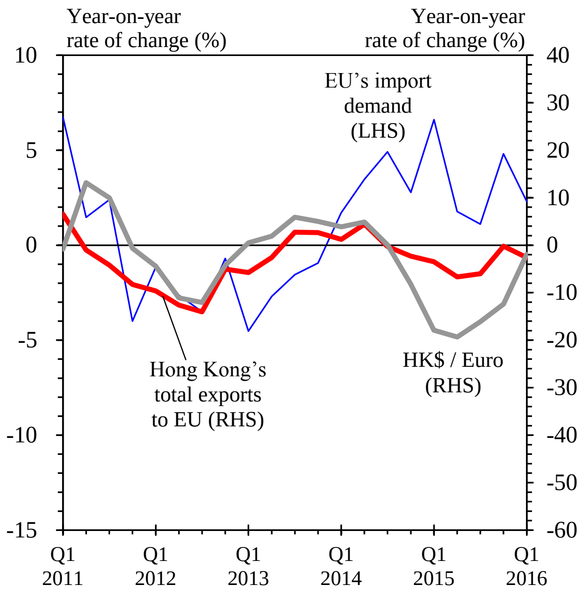


Diagram 2.6 : Exports to the US slackened visibly

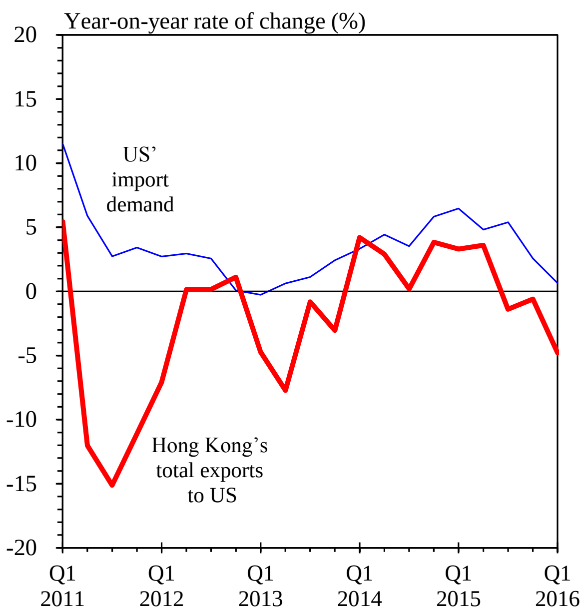


Diagram 2.7 : Exports to Japan were still lacklustre

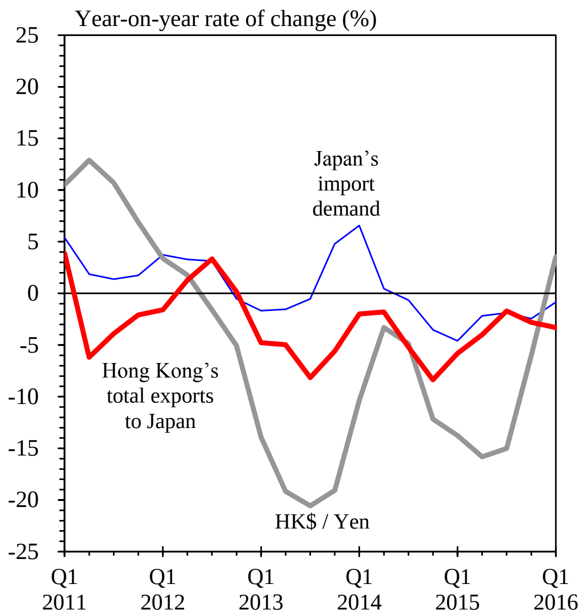


Diagram 2.8 : Exports to India still recorded notable growth

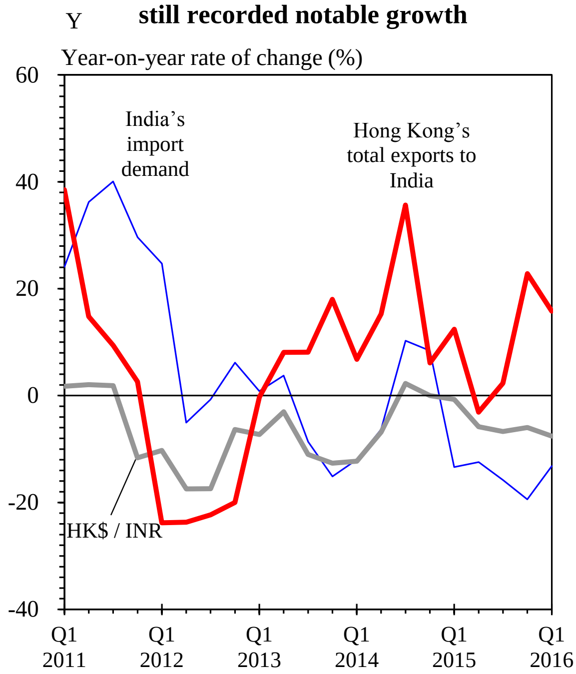


Diagram 2.9 : Exports to Taiwan weakened slightly

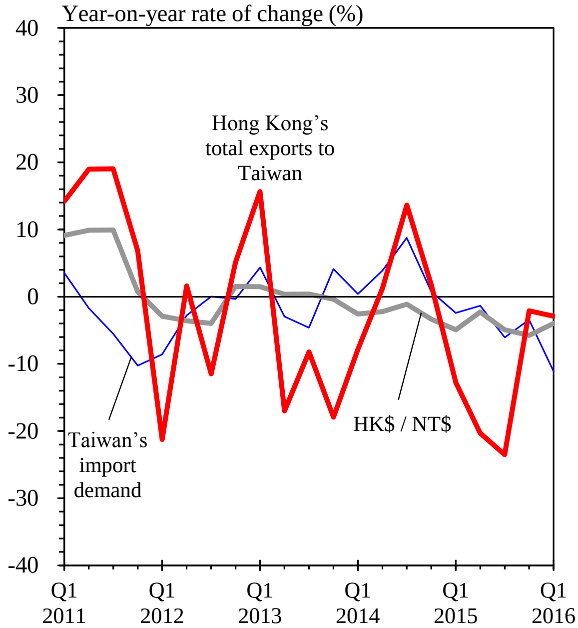


Diagram 2.10 : Exports to Korea plunged further

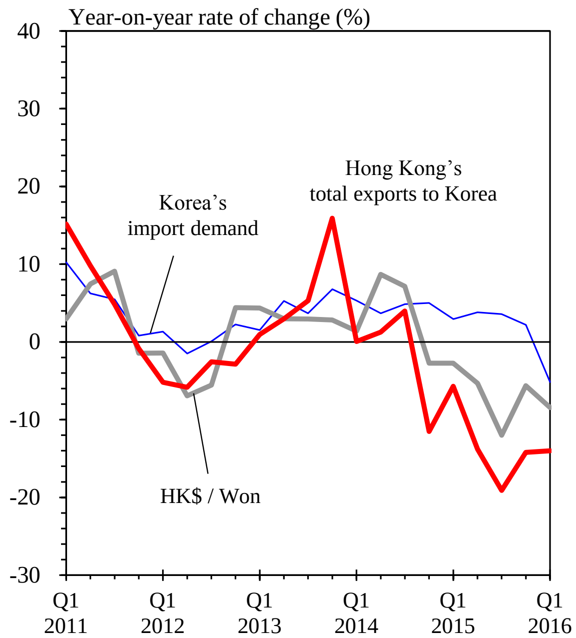
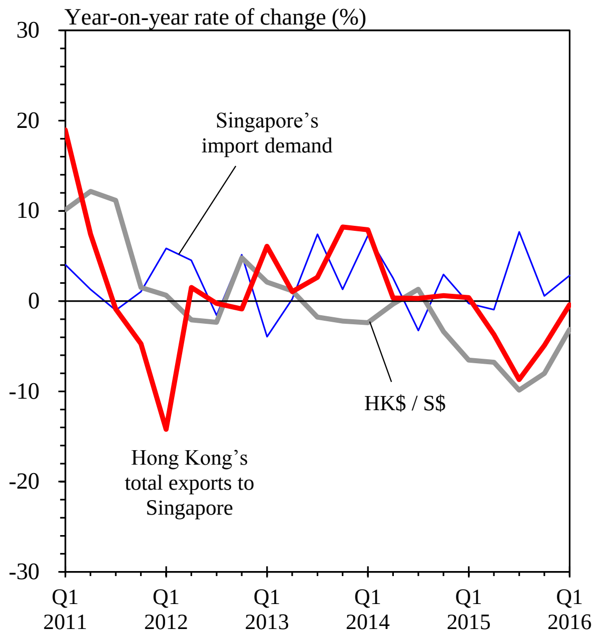


Diagram 2.11 : Exports to Singapore registered a narrower decline



Box 2.1

Negative interest rates in the eurozone and Japan

The global monetary environment has become more complicated against the background of the protracted slow growth of the global economy. Several central banks in Europe, led by the European Central Bank (ECB), have set policy rates at negative levels since mid-2014. In January 2016, the Bank of Japan (BOJ) also followed suit and announced to cut its policy rate below zero (***Table 1***). This note briefly reviews the effectiveness of this unconventional monetary policy tool in the eurozone and Japan, based on the evidence available so far, as well as its possible side-effects.

Economic recoveries in the eurozone and Japan remained fragile after the 2008 Global Financial Crisis, and inflation was persistently below their central banks' targets. Given limited fiscal space and political resistance to expansionary fiscal policy, the burden of bolstering economic growth has increasingly shifted to monetary policy. By early 2014, the eurozone's policy interest rates had already fallen to levels close to zero. In June 2014, the ECB began to cut the interest rate on the deposit facility into the negative territory, and further cuts were made in September 2014, December 2015 and March 2016. In parallel, additional easing measures, including targeted longer-term refinancing operations (TLTROs) and the expanded asset purchase programmes and subsequent enhancements, were introduced to reinforce the accommodative monetary policy stance. In Japan, the BOJ embarked on a new phase of monetary easing in April 2013, aiming to double the monetary base in order to achieve its 2% inflation target in two years' time. A number of monetary easing measures had since been added, with the latest move being the introduction of the negative interest rate in January 2016.

Table 1: Timing of policy rate cuts of central banks in Europe and Japan

Central banks	Policy rate	Timing of announcement	Level
European Central Bank	Interest rate on the deposit facility	June 2014	-0.10%
		September 2014	-0.20%
		December 2015	-0.30%
		March 2016	-0.40%
Central bank in Denmark	Certificates of deposit rate	September 2014	-0.05%
		January - February 2015	-0.20%, -0.35%, -0.50% and -0.75%
		January 2016	-0.65%
Central bank in Switzerland	Interest rate on sight deposit account balances	December 2014	-0.25%
		January 2015	-0.75%
Central bank in Sweden	Repo rate	February 2015	-0.10%
		March 2015	-0.25%
		July 2015	-0.35%
		February 2016	-0.50%
Bank of Japan	Interest rate on balances in current accounts	January 2016	-0.10%
Central bank in Hungary	Overnight deposit rate	March 2016	-0.05%

Theoretically, negative policy rates could help boost activity in the real economy through various channels. *First*, by lowering the relevant policy rate below zero, the central bank would be charging, instead of paying, commercial banks for holding excess reserves. This could discourage commercial banks from holding idle cash, but rather, to look for alternative assets, including making loans, and there could be an easing of credit conditions in the

Box 2.1 (Cont'd)

economy. *Second*, when the policy rate cut is translated into lower lending and deposit rates of commercial banks, this could reduce borrowing costs and returns on savings, helping to boost investment and consumption demand. *Third*, the introduction of the TLTROs in the eurozone aimed at providing liquidity to banks at a low cost, as the interest rate applied could be as low as the prevailing deposit facility rate. Thus, the ECB is incentivising banks to lend to the real economy by subsidising their lending to households and non-financial corporations and strengthening the transmission of monetary policy. *Fourth*, lower interest rate could add depreciation pressure on a country's currency, which could help boost the price competitiveness of exports. The consequential increases in import prices could also help mitigate disinflationary forces, facilitating the return of inflation to the central bank's target.

At present, the debate about the effectiveness of negative policy rates on real economic activity is far from conclusive. With negative interest rate policy being carried out in the eurozone for only some 20 months and just implemented in Japan early this year, it is premature to draw a definite conclusion. Moreover, it is difficult to distinguish the standalone influence of the negative interest rate in achieving the central banks' objectives, as it was rolled out alongside other monetary policy measures. Simultaneous developments in the international macroeconomic environment, such as global demand conditions, movements in oil prices and US interest rate normalisation, might also blur the picture.

While the evidence is still tentative at best and the eurozone's overall growth remained slow, it appears that there are some positive developments in the region since mid-2014. By comparing the six quarters after the adoption of negative interest rates (i.e. 2014Q3-2015Q4) with the preceding four quarters (i.e. 2013Q3-2014Q2), seasonally adjusted real GDP growth expanded at a slightly faster quarter-to-quarter pace of 0.4% on average, up from 0.2%, amid some pick-up in the growth of private consumption expenditure, investment spending and exports. The preliminary flash estimate for the eurozone's real GDP growth in the first quarter of 2016 further accelerated to 0.6% quarter-to-quarter. Loans to the private sector reverted to growth since January 2015, and showed a slight year-on-year increase of 1.0% in March 2016 (***Chart 1***). Consumer price inflation, however, remained well below the ECB's 2% target, plagued by further declines in commodity and energy prices, with the latest flash reading at -0.2% in April 2016, as compared to 0.5% in June 2014. Core inflation, excluding food, alcohol and tobacco, and energy, was 0.7% in April 2016, as compared to 0.8% in June 2014 (***Chart 2***).

Chart 1 : Loans to the private sector in the eurozone reverted to growth

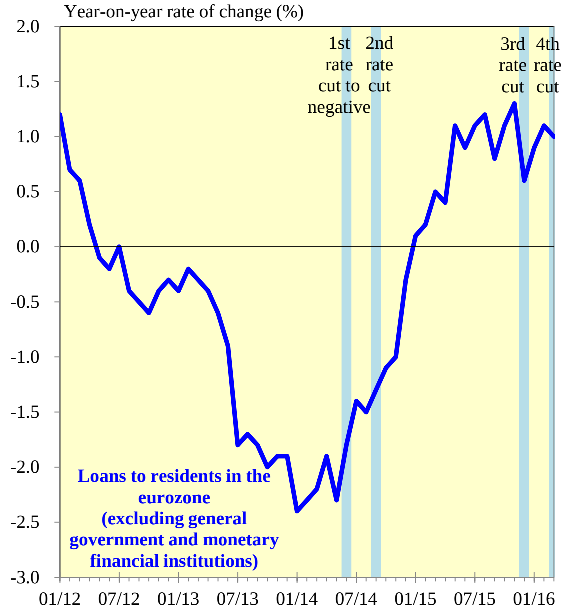
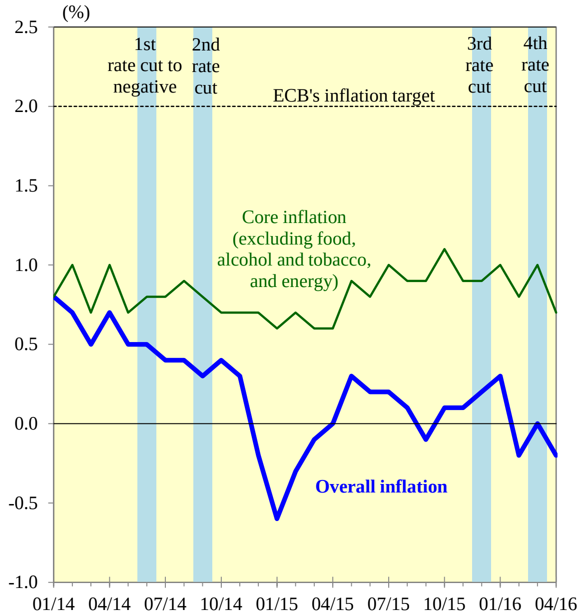


Chart 2 : Inflation in the eurozone remained well below the ECB's target



Box 2.1 (Cont'd)

Nonetheless, there are also widespread concerns about the possible side-effects of negative interest rates. First of all, negative interest rates would squeeze the profitability of banks, as they might not be able to pass these rates to their depositors or augment lending. Banks with weaker capital base could become more vulnerable. Indeed, the recent ECB survey on bank lending in the eurozone(1) indicated that while the negative policy rate so far had a positive impact on banks' lending volume, their interest income and loan margins had been somewhat adversely affected.

Secondly, banks with squeezed margins might undertake excessive risks, if they lend too aggressively to maintain their profit levels. Likewise, some banks may rely more on wholesale funding, the cost of which had fallen alongside lower interest rates. Given the more volatile nature of wholesale funding, this could add risks to the financial system. These potential risks require close monitoring by regulatory bodies.

Also, non-bank financial institutions, such as pension providers and life insurance companies, might find it increasingly difficult to meet their investment return targets, as negative interest rate policy lowers yields on bonds through portfolio rebalancing effects. Besides, if the investment incomes of pensioners' savings are impaired, they may, in turn, cut back consumption.

Apart from the above concerns, the negative interest rate policy may have consequences that are hard to predict. For instance, the movements of the euro and Japanese yen against the US dollar in early 2016 after the recent rate cuts were counter-intuitive. Both the euro and the Japanese yen actually strengthened against the US dollar by around 4% and 7% respectively one month after their recent rate cut announcements in 2016. The surprise movements highlighted the uncertainty associated with exchange rate movements and also cast doubt about the transmission mechanism of this new policy tool in an increasingly complicated global monetary environment.

Thus far, the positive impacts of negative interest rates in the eurozone and Japan on Asia's trade and our exports through the trade channel have been absent amid the still-weak import demand in the two places. The increasing uses of negative interest rate policy have deepened the monetary policy divergence among major central banks, given the US Federal Reserve's normalisation of monetary policy. Under the weak global economic landscape, abrupt changes in investors' risk appetite, interest rate expectations and capital flows could stir up jitters in global financial and foreign exchange markets again, with potential destabilising impacts on the global economy.

Also, with interest rates already at historically low levels in the advanced economies, the International Monetary Fund in April reiterated the need for a more comprehensive strategy to buttress growth. Concerted efforts of structural reforms and stronger fiscal support, subject to the availability of fiscal space, with emphasis on enhancing productive capacity and boosting demand, could complement the highly accommodative monetary policies and help bolster growth.

In the near term, the headwinds arising from a complicated monetary environment will likely persist. Hong Kong, with strong economic fundamentals and a sound and resilient financial system, is capable to sail through sudden changes in financial conditions and handle massive capital inflows and outflows. The Government will stay vigilant and closely monitor the developments on the monetary front and their possible impacts on the Hong Kong economy.

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(1) "The euro area bank lending survey for the first quarter of 2016" published by the ECB in April 2016.

Imports of goods

2.7 *Imports of goods* likewise fell, by 5.4% year-on-year in real terms in the first quarter, widening somewhat from the 4.5% decline in the preceding quarter. The larger decline was mainly due to a steeper slide in those imports for subsequent re-exporting, while retained imports remained distinctly weak. *Retained imports*, referring to the imports for domestic use, which accounted for around one-quarter of total imports, dropped by 8.9% year-on-year in real terms, after falling by 14.7% in the previous quarter. The notable drop in retained imports mainly reflected slower local economic growth and reduced intake of retained imports related to the plunge in retail sales during the period.

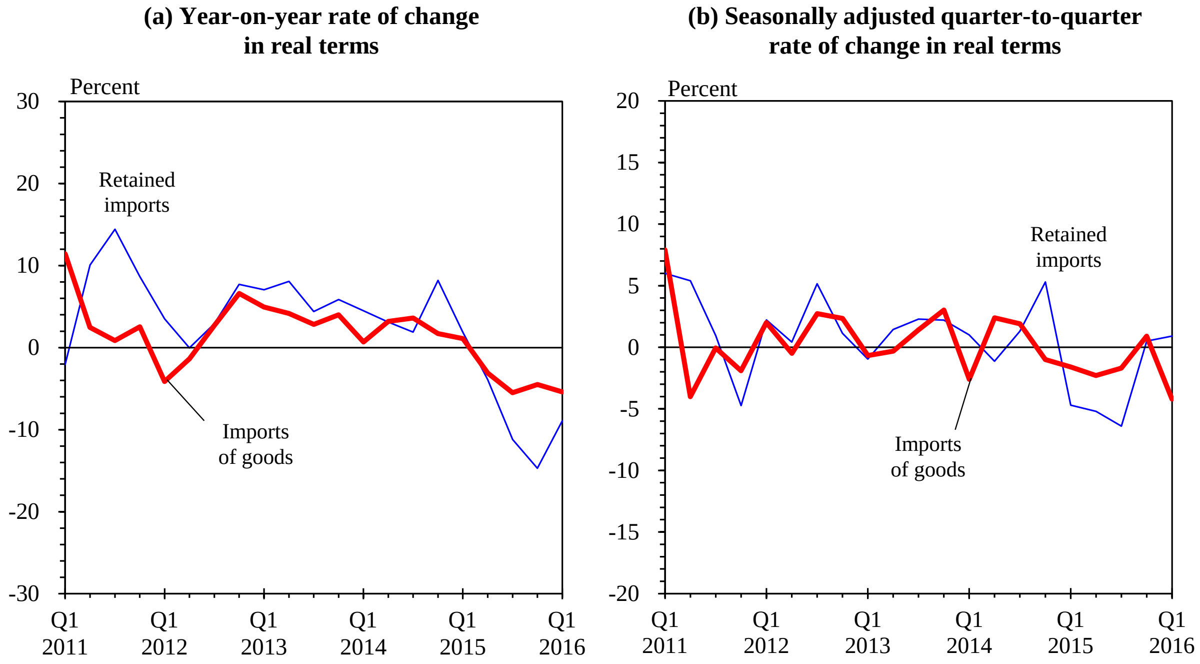
Table 2.3 : Imports of goods and retained imports (year-on-year rate of change (%))

		Imports of goods				Retained imports[a]			
		In value terms	In real terms		Change in prices	In value terms	In real terms		Change in prices
2015	Annual	-4.1	-3.2		-0.4	-10.6	-7.4		-2.0
	Q1	1.4	1.1	(-1.6)	0.9	-1.4	1.9	(-4.7)	-2.1
	Q2	-3.2	-3.1	(-2.3)	0.6	-6.9	-3.9	(-5.2)	-1.5
	Q3	-6.7	-5.5	(-1.7)	-0.7	-14.5	-11.2	(-6.4)	-1.8
	Q4	-7.0	-4.5	(0.9)	-2.1	-17.8	-14.7	(0.5)	-2.6
2016	Q1	-8.2	-5.4	(-4.2)	-2.8	-12.2	-8.9	(0.9)	-3.6

Notes : (a) Based on the results of the Annual Survey of Re-export Trade conducted by the Census and Statistics Department, re-export margins are estimated and adopted for deriving the value of imports retained for use in Hong Kong.

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

Diagram 2.12 : Imports fell further while retained imports remained distinctly weak

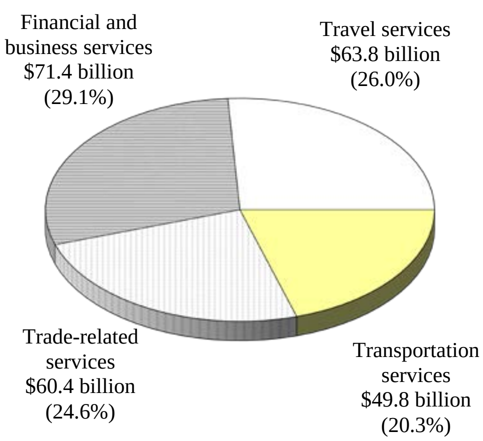


Services trade

Exports of services

2.8 *Exports of services* slackened further, showing an enlarged decline of 4.9% year-on-year in real terms in the first quarter, after the 2.7% fall in the preceding quarter. Exports of travel services suffered a double-digit decline and remained the main drag. The weak performance was due mainly to the plunge in visitor arrivals, while the weakness in tourist spending endured. Also, the notable fall in same-day visitor arrivals was partly due to the implementation of "one trip per week" Individual Visit Endorsement for permanent residents of Shenzhen in April 2015. Moreover, the lagged impacts of depreciations of many currencies against the US dollar had conceivably induced some visitors to shift to other popular travelling destinations, and the subdued global economic environment dampened the demand for travelling. Meanwhile, the difficult external environment also undercut other services exports. Exports of trade-related services (comprising mainly offshore trade activities) turned weaker, and those of transportation services remained subdued, given the reduced trade and cargo flows in the region. Exports of financial and other business services continued to see a slight decline, as the heightened volatility in the global financial markets at the start of the year hindered cross-border financial and commercial activities.

Diagram 2.13 : Major service groups accounted for largely similar shares of Hong Kong's services exports, reflecting a diversified base



Exports of services in the first quarter of 2016: $245.4 billion

Diagram 2.14 : Exports of services slackened further in the first quarter of 2016

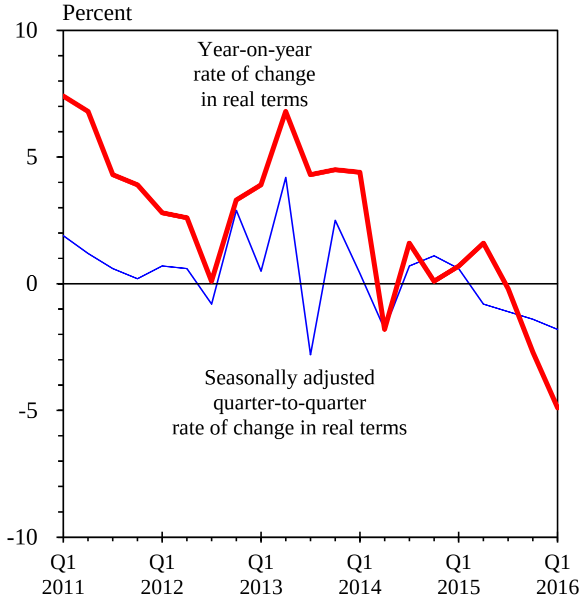


Table 2.4 : Exports of services by major service group (year-on-year rate of change in real terms (%))

		Exports of services		*Of which :* Trade-related services[a]	Transportation services	Travel services[b]	Financial and business services
2015	Annual	-0.2		-1.8	0.2	-3.8	5.6
	Q1	0.7	(0.6)	-1.4	1.8	-3.3	6.2
	Q2	1.6	(-0.8)	-2.3	0.8	-0.8	11.1
	Q3	-0.2	(-1.1)	-3.0	0.8	-3.8	6.5
	Q4	-2.7	(-1.4)	-0.5	-2.7	-6.7	-1.0
2016	Q1	-4.9	(-1.8)	-2.1	-1.4	-13.3	-1.5

Notes : (a) Comprising mainly offshore trade.

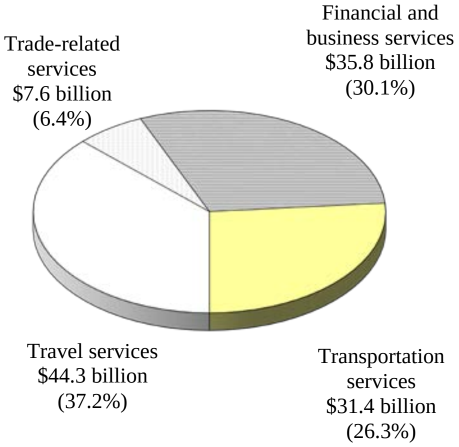
(b) Comprising mainly inbound tourism receipts.

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

Imports of services

2.9 *Imports of services* decelerated slightly and grew moderately by 3.8% year-on-year in real terms in the first quarter, after a 5.4% growth in the preceding quarter. Imports of travel services maintained a notable growth in the first quarter, helped partly by the boosting effect of the earlier arrival of Easter holidays, which fell in late March 2016 but in early April 2015. Meanwhile, imports of financial and other business services relapsed to a marginal decline, amid the heightened volatility in the global financial markets. Imports of transportation services and trade-related services both weakened and relapsed to slight falls, as the austere external economic environment led to subdued regional trade and cargo flows.

Diagram 2.15 : Travel services had the largest share in imports of services



Imports of services in the first quarter of 2016: $119.1 billion

Diagram 2.16 : Imports of services grew moderately

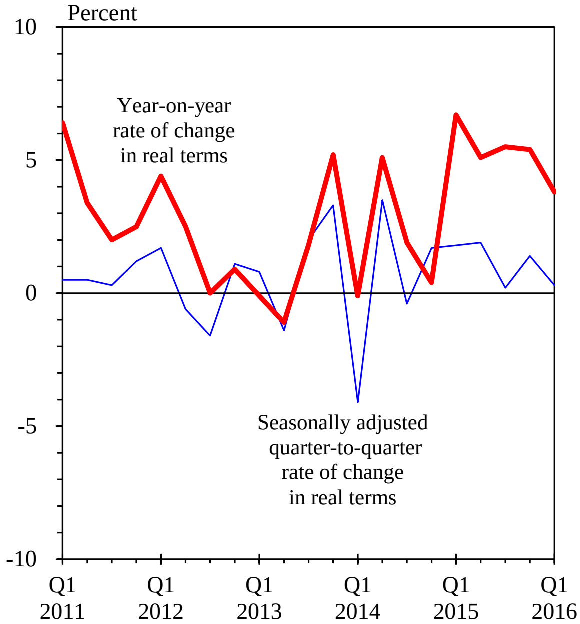


Table 2.5 : Imports of services by major service group (year-on-year rate of change in real terms (%))

		Imports of services		*Of which :* Travel services(+)	Transportation services	Trade-related services	Financial and business services
2015	Annual	5.7		12.4	-0.9	0.6	5.4
	Q1	6.7	(1.8)	13.3	0.5	1.5	6.5
	Q2	5.1	(1.9)	11.2	-2.8	1.5	6.8
	Q3	5.5	(0.2)	13.0	-1.9	-0.5	5.9
	Q4	5.4	(1.4)	12.2	1.1	0.3	2.6
2016	Q1	3.8	(0.3)	11.2	-0.1	-0.9	-0.3

Notes : (+) Comprising mainly outbound travel spending.

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

Goods and services balance

2.10 The goods deficit narrowed somewhat in the first quarter, compared with the same period last year, mainly reflecting the reduced intake of retained imports amid the slowdown in economic growth and to a lesser extent the modest improvement in the terms of trade. With the services surplus more than offsetting the goods deficit, the combined goods and services account registered a surplus of $12 billion in the first quarter, equivalent to 1.1% of total import value, representing an improvement from the same period last year, when such an account was broadly balanced.

Table 2.6 : Goods and services balance
($ billion at current market prices)

		Total exports		Imports		Trade balance			
		Goods	Services	Goods	Services	Goods	Services	Combined	As % of imports
2015	Annual	3,779	1,053	4,290	487	-511	567	56	1.2
	Q1	879	267	1,028	118	-149	149	*	#
	Q2	916	244	1,067	118	-150	126	-24	-2.0
	Q3	982	270	1,078	124	-95	146	51	4.2
	Q4	1,001	272	1,117	127	-116	145	29	2.3
2016	Q1	823	245	938	119	-114	126	12	1.1

Notes : Figures may not add up exactly to the total due to rounding.

(*) Within ±$0.5 billion.

(#) Within ±0.05%.

Other developments

2.11 In anticipation of the challenging macroeconomic environment, the 2016-17 Budget introduced a number of measures to provide support to the small and medium enterprises (SMEs), including those engaging in trading activity. Apart from the relief measures to ease their burden, the application period for the special concessionary measures under the SME Financing Guarantee Scheme will be extended to February 2017 to help them tide over their liquidity needs. In addition, a Pilot Technology Voucher Programme under the Innovation and Technology Fund will be launched to subsidise SMEs' use of technological services, with an aim to improve their productivity and upgrade business processes.

2.12 Strengthening economic relations with our trading partners, in particular the Mainland, is a principal strategy to develop our economy. In January, the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) Forum on Agreement on Trade in Services was held to familiarise the trade with the services liberalisation measures and the implementation arrangements under the Agreement on Trade in Services signed under the framework of CEPA in November last year. In March, the 21st Working Meeting of the Hong Kong/Guangdong Co-operation Joint Conference was held. The two sides formulated the 2016 Work Plan covering 92 co-operation items. This was based on the consensus reached at the 18th Plenary of the Hong Kong/Guangdong Co-operation Joint Conference last year, which agreed that the co-operation this year should include such areas as the Belt & Road Initiative, innovation and technology, liberalisation of trade in services, and financial services. The deepening economic ties between the two places will enhance competitiveness of the whole region and bring new business opportunities (see ***Box 2.2*** for reference).

2.13 In addition to the Mainland, Hong Kong also made progress to strengthen investment relations with other economic partners. In February, an Investment Promotion and Protection Agreement with Canada was signed, which will give additional assurance to investors and help expand investment flows between the two places.

Box 2.2

Impact of a regional trade agreement on Hong Kong as a non-signatory: A case in ECFA

Recognising the enormous challenge in reaching a wholesale agreement on trade liberalisation for the global economy (i.e. the Doha round of the World Trade Organization (WTO)), economies have increasingly focused on regional and sectoral trade agreements in recent years. According to the statistics from the WTO, 75 regional trade arrangements (RTAs), either bilateral or multilateral, notified the WTO from 1958 to 1999, while some 340 additional RTAs were formed since 2000, including the ASEAN - China Free Trade Area, Dominican Republic - Central America - United States Free Trade Agreement and EU - Colombia/Peru Free Trade Agreement, vividly reflecting the enthusiasm for RTAs in recent years across the globe.

Unlike a WTO agreement which would entail trade facilitation measures (e.g. lower tariffs, less non-tariff barriers, etc.) applicable to all of the 162 WTO members, a RTA would only lower the barriers for trade flows between the signatories. As a small, open economy and an international trading centre, it would be meaningful to look at the potential implications for Hong Kong when other economies sign a RTA.

Holistically speaking, the implications of a RTA can be categorised into three effects: (1) the trade creation effect, (2) the trade diversion effect, and (3) the spill-over effect.

The first two are usually referred as static effects. Loosely speaking, trade creation effect refers to the increase in trade flows between the signatories that is made possible by the RTA's realisation of each signatory's comparative advantage through lowering tariffs and non-tariff barriers among themselves. As a result, trade creation effect would be beneficial to all the signatories, but irrelevant to the non-signatories. As for trade diversion effect, it refers to the new trade flows between the signatories that are diverted from those between a signatory and a non-signatory, due to the newly introduced preferential treatment for trade between the signatories. As such, trade diversion effect could be beneficial to the signatories, to the detriment of the non-signatories.

The spill-over effect comes in when the impact of a RTA is viewed dynamically. The relaxation of various trade restrictions among those signatories improves the resources allocation efficiency in these economies, thereby improving their income and production capacity. This in turn would lead to strengthening of import demand in these signatory economies and hence boosting trade flows worldwide.

An example to showcase a RTA's impact on Hong Kong as a non-signatory would be the signing of Economic Cooperation Framework Agreement (ECFA) between the Mainland and Taiwan in 2010, the first and the fourth largest trading partner of Hong Kong at that time. Since the implementation of ECFA, both the Mainland and Taiwan have lowered the import tariffs of more than 800 tariff items. Such reduction of tariffs has inevitably affected Hong Kong's re-exports of these goods due to the stronger price incentive for direct trade between the two economies. Specifically, the value of trade in items under the ECFA's tariff reduction list routing through Hong Kong as a share to the total Cross-Strait trade gradually fell from about 10% in 2010 to around 6% in 2014[(1)].

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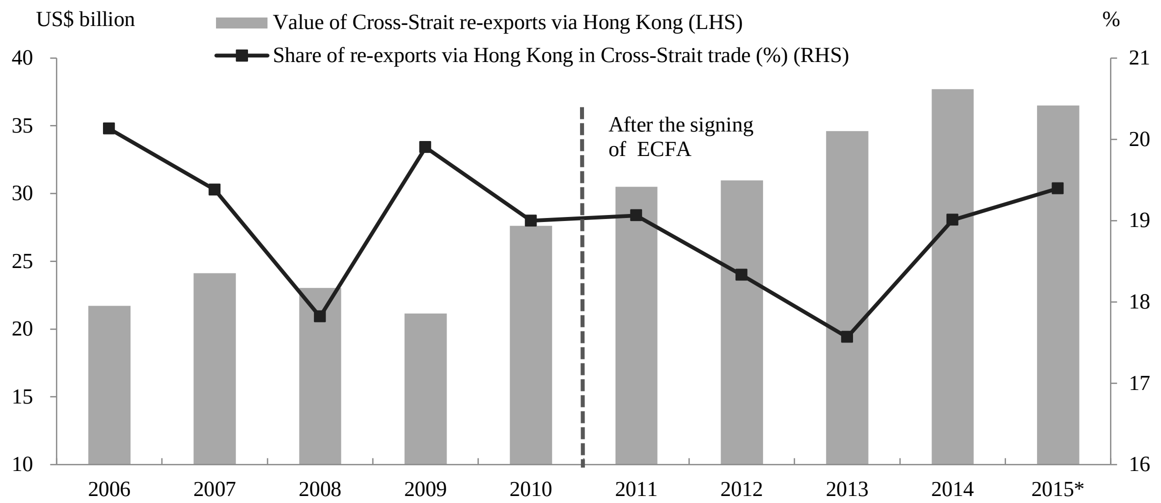
(1) Crude estimates only, based on the product codes on the ECFA's tariff reduction list.
(Source: http://fta.mofcom.gov.cn/cepa/annex/haixiaeran-xyfj01_cn.pdf)

Box 2.2 (Cont'd)

Despite so, since the signing of ECFA, the closer Cross-Strait economic relationship has benefited the Hong Kong's trade in overall terms. With the bilateral trade between the Mainland and Taiwan expanding notably by 29% from US$145.4 billion in 2010 to US$188.2 billion in 2015 (according to the China Customs Statistics), Hong Kong's re-exports between them also grew visibly over the same period, by 32% from US$27.6 billion to US$36.5 billion. Consequently, the share of Hong Kong's re-exports in the total Cross-Strait trade rose slightly from 19.0% to 19.4% over this period, despite a small drop in the early years of ECFA implementation. In fact, the 32% cumulative growth in Hong Kong's re-exports between the Mainland and Taiwan from 2010 to 2015 was even higher than the corresponding 20% growth in Hong Kong's overall re-exports. All these suggest that the positive spill-over effect should be even larger than the negative trade diversion effect, thanks to Hong Kong's close economic relations with the two economies and the competitive strength of Hong Kong as a regional trading hub.

Chart 1: Cross-Strait re-export trade via Hong Kong



Note: (*) Provisional figures.
Sources: China Customs Statistics and the Census and Statistics Department of HKSAR Government

The analysis above shows that, while a RTA would unavoidably divert some trade from a non-signatory, the increase in production capacity and demand thus entailed from the liberalisation measures of a RTA could have positive spill-over effect on a non-signatory, depending on its economic relationships with the signatories and the competitive strengths of its businesses. For Hong Kong in particular, this underlines the importance of continuously sharpening the competitiveness in our various services, and actively participating in co-operation projects in the region and beyond (e.g. the Hong Kong-ASEAN Free Trade Agreement and the WTO Trade Facilitation Agreement).

Notes :

(1) Changes in merchandise exports and imports in real terms are derived by discounting the effect of price changes from changes in the value of the trade aggregates. Estimates of price changes for the trade aggregates are based on changes in unit values, which do not take into account changes in the composition or quality of the goods traded, except for some selected commodities for which specific price indices are available. The real growth figures reported here are based on the external trade quantum index series compiled using the chain linking approach, which were first released in March 2015 to replace the previous trade index numbers compiled using the Laspeyres method with a fixed base year. Under the new approach, the series are comparable with the real trade aggregates under GDP (reported in Chapter 1) which are based on the same measures. However, non-monetary gold is recorded as a separate item in the statistics of merchandise trade and not included in the trade aggregates reported in Chapter 2, but is included in the trade aggregates under GDP in accordance to the international compilation standard.

(2) Re-exports are those goods which have previously been imported into Hong Kong and are subsequently exported without having undergone in Hong Kong any manufacturing processes which change permanently the shape, nature, form or utility of the goods.