CHAPTER 2 : THE EXTERNAL SECTOR

Summary

- *Global economic growth was still lacklustre in the second quarter, though improved slightly from the preceding quarter. The US economy, after a disappointing start of the year, gathered some steam in the second quarter, while the moderate expansion in the euro area economy continued. The surprise outcome of the UK referendum heightened the volatility in the global financial markets in late June, but its fallout on the real economy remains to be seen. Economic growth in the Mainland held largely steady, mainly supported by the sustained domestic demand expansion. Against this background, the downward pressures on trading and production activities in Asia eased somewhat.*
- *Hong Kong's merchandise exports fared better in the second quarter, growing modestly year-on-year in real terms[(1)], having declined in the preceding four quarters. Exports to the Mainland and some major Asian markets reverted to positive growth, and those to the advanced markets also showed some relative improvement.*
- *Exports of services were still weak, though showed a slightly narrower year-on-year decline in the second quarter. The fall in exports of travel services tapered somewhat, helped by a smaller decline in visitor arrivals. Exports of trade-related and transportation services improved slightly, mirroring the relative improvement in trade and cargo flows in the region. However, exports of financial and other business services saw a visibly larger year-on-year decline, due in part to a high base of comparison, while the uncertain global economic outlook was also not conducive to cross-border financial and commercial activities.*
- *The inaugural Belt and Road Summit, jointly organised by the Government and Hong Kong Trade Development Council, was held in May to explore co-operation opportunities and the unique role that Hong Kong could play in the Belt and Road Initiative. In the same month, a memorandum of understanding between Hong Kong and Indonesia was signed, pledging mutual co-operation on investment promotion exchanges and best practices. Separately, Hong Kong's foreign direct investment inflows ranked the second largest among the world economies in 2015, signifying the important status of Hong Kong as a business hub for foreign and Mainland companies.*

Goods trade

Total exports of goods

2.1 Compared to the rocky start of the year, the external trading environment stabilised somewhat in the second quarter of 2016, putting less downward pressures on Asia's trading and production activities. Hong Kong's *merchandise exports* (comprising re-exports and domestic exports) reverted to a modest growth of 1.4% in real terms in the second quarter over a year earlier, compared with the 4.2% decline in the first quarter. On a seasonally adjusted quarter-to-quarter basis, merchandise exports rebounded distinctly by 6.8% in the second quarter, after falling by 5.9% in the preceding quarter.

2.2 The global economy, though still rather weak, improved slightly in the second quarter. After a soft start early this year, the US economy regained some momentum in the second quarter, driven mainly by the pick-up in consumer spending and exports. Economic activity in the euro area continued to expand moderately, partly supported by the exceptional level of monetary policy accommodation. In contrast, Japan's economy remained lacklustre, in part due to the disruptions from the severe earthquakes in Kyushu. Consumer spending in Japan also stayed weak, prompting its government to postpone the planned consumption tax hike further. Elsewhere in Asia, the Mainland economy was still on track for attaining the official growth target this year in the face of the external headwinds, although the growth pace was slightly lower than in the previous year. Amid the relative stabilisation of the global trading environment, many Asian economies saw narrower year-on-year rates of declines in goods exports in US dollar terms in the second quarter.

2.3 However, export prospects in the near term remain uncertain. The UK voted in favour of leaving the EU (Brexit) in the referendum in late June (see ***Box 2.1*** for details). Global stock markets, after facing large sell-off immediately after the referendum result, stabilised shortly afterwards. However, its repercussions on the real economy are yet to be seen. As the negotiations between the UK and the EU on their future economic relationship would take time to complete, the associated uncertainties would inevitably cast a shadow over the global economic outlook. In July, the International Monetary Fund lowered its baseline global economic growth forecast for 2016 to 3.1%, the same as that in 2015, mainly in light of the uncertainties related to Brexit.

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
	Q2	-1.2	1.4	(6.8)	-2.2	-0.9	1.6	(7.0)	-2.2	-16.8	-14.7	(-4.2)	-2.1

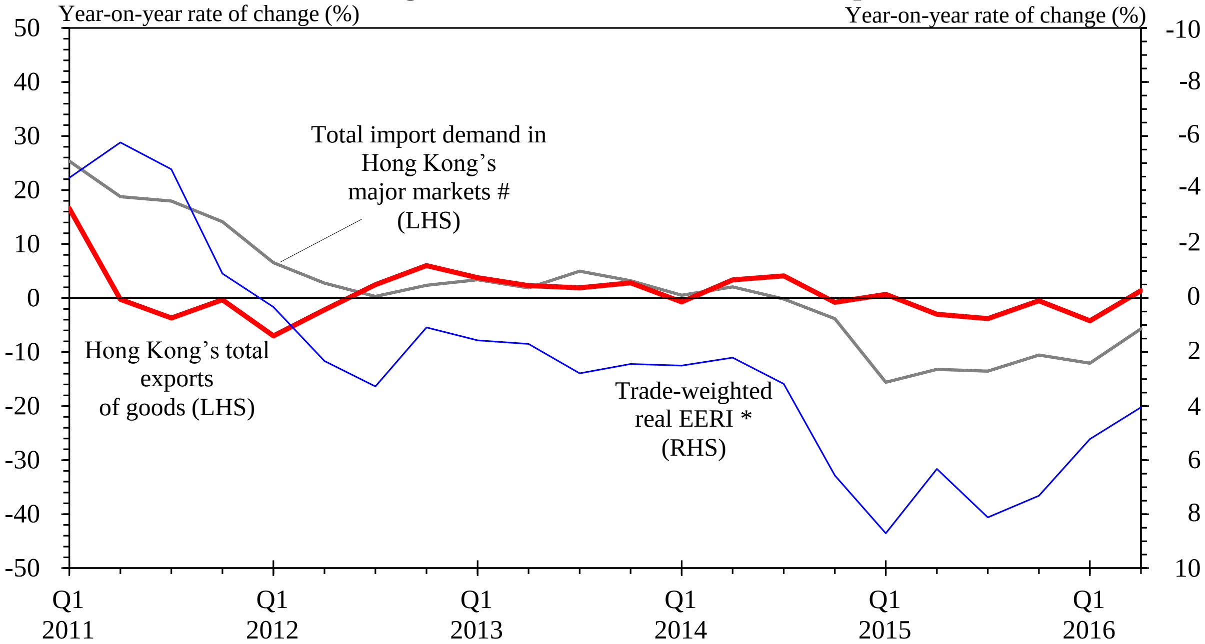
Notes : ( ) Seasonally adjusted quarter-to-quarter rate of change.

(*) 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, reverted to a slight year-on-year growth of 1.6% in real terms in the second quarter, after a fall of 4.0% in the preceding quarter. *Domestic exports*, constituting the remaining 1.2% of total exports, continued to fall notably by 14.7% year-on-year during the quarter, a widened fall compared with that of 12.1% in the preceding quarter.

Diagram 2.1 : Merchandise exports fared better and reverted to modest growth in real terms in the second quarter



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 second quarter of 2016 is based on statistics for April and May 2016.

Diagram 2.2 : Hong Kong's exports staged a relative improvement in the second quarter, in tandem with other high-income economies in Asia

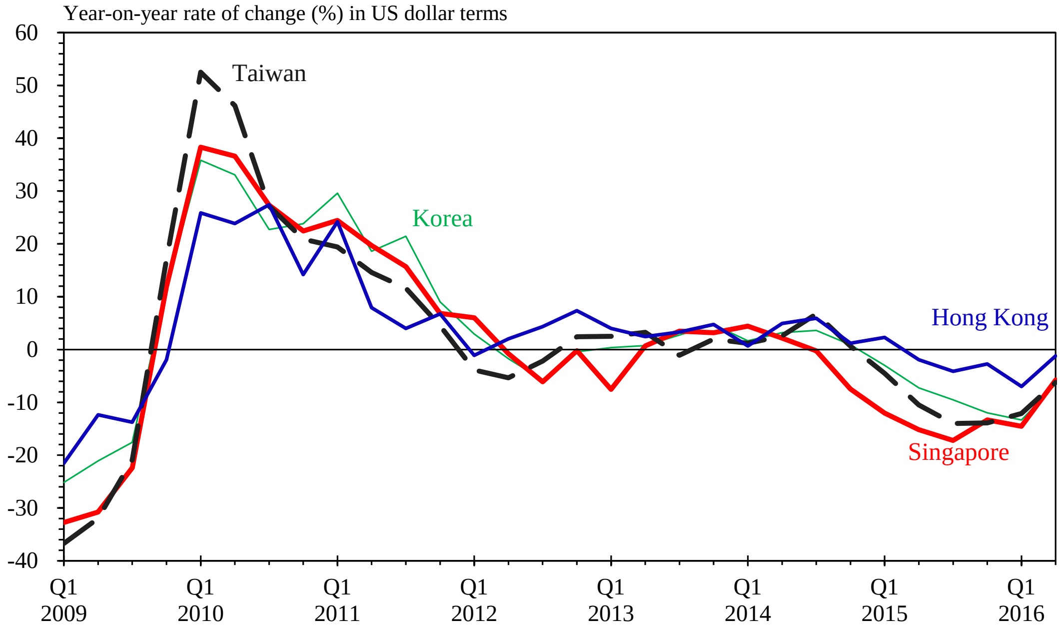
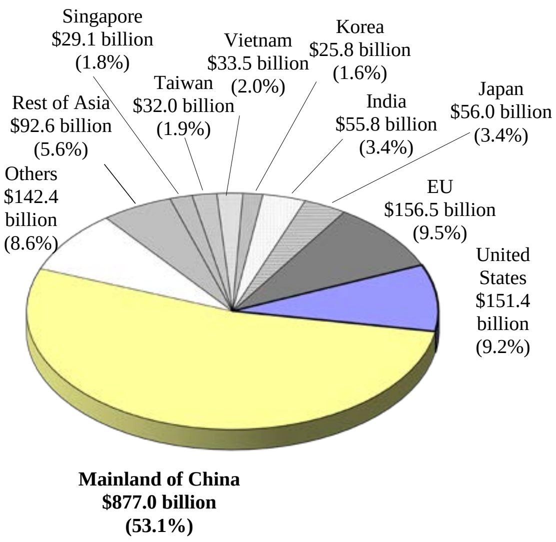


Diagram 2.3 : Exports to the Asian markets also recorded narrower declines in value terms



Total exports of goods in the first half of 2016:
$1,652.1 billion

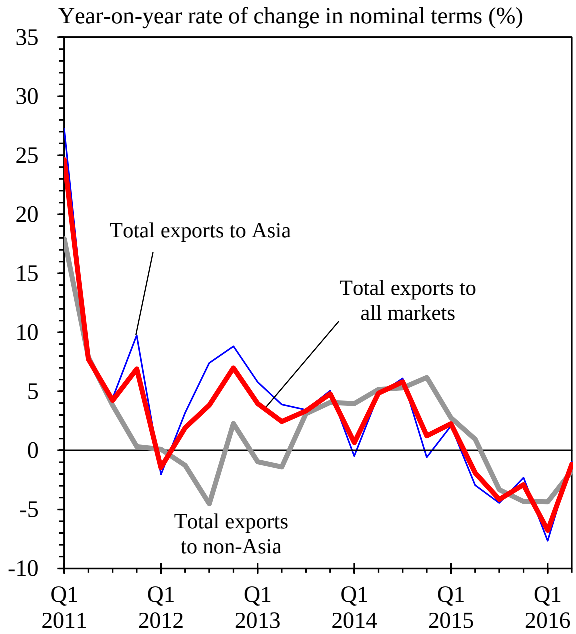


Table 2.2 : Total exports of goods by major market (year-on-year rate of change in real terms (%))

			2015			2016	
	Annual	Q1	Q2	Q3	Q4	Q1	Q2
Mainland of China	-2.0	-0.2	-4.4	-3.5	0.6	-5.6	2.0
United States	1.0	3.3	3.6	-1.4	-0.6	-4.8	-1.4
European Union	-4.1	-3.5	-6.7	-6.0	-0.2	-2.6	3.8
Japan	-3.6	-5.8	-4.0	-1.7	-2.8	-3.3	-6.6
India	7.9	12.4	-3.1	2.3	22.8	15.8	28.0
Vietnam	12.1	14.0	18.0	12.9	5.2	-2.1	-8.0
Taiwan	-15.0	-12.8	-20.3	-23.5	-2.1	-2.9	17.1
Korea	-13.4	-5.7	-13.8	-19.1	-14.2	-14.0	3.2
Singapore	-4.3	0.4	-3.7	-8.7	-4.9	-0.4	-1.6
Overall*	-1.7	0.7	-3.0	-3.8	-0.5	-4.2	1.4

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 on a year-on-year comparison in real terms, exports to the US recorded a narrower decline in the second quarter, in tandem with the improvement in economic activity there. Exports to the EU reverted to show a moderate growth. Exports to Japan showed an enlarged decline, however, reflecting the sluggish economic activity there and the disruptions of the earthquakes in April to the manufacturing sector. The tailwinds from the yen's rebound thus far this year had little help to its import demand.

2.6 Asia's manufacturing and trading activities also saw relative improvement, providing some support to exports of raw materials and semi-manufactures and capital goods to Asia. Exports to Korea improved visibly and reverted to growth, and exports to Taiwan registered a notable growth against a low base of comparison. Exports to the Mainland also showed a modest year-on-year increase. Although the performances of emerging ASEAN markets were mixed, exports to India strengthened to show a remarkable growth.

Diagram 2.4 : Exports to the Mainland showed a modest increase

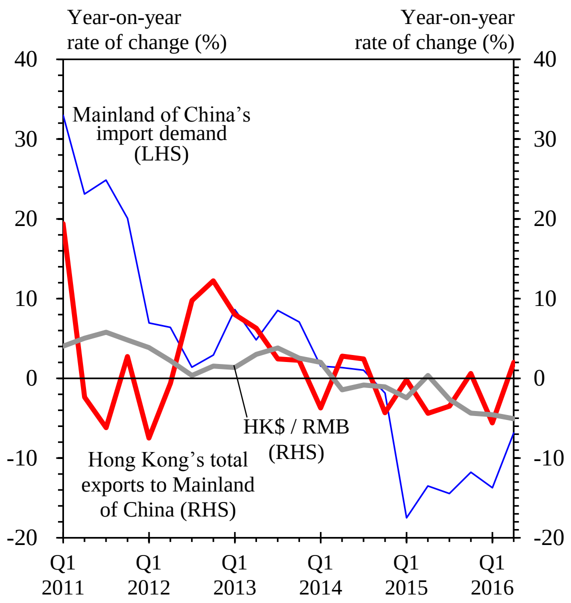


Diagram 2.5 : Exports to the EU reverted to growth

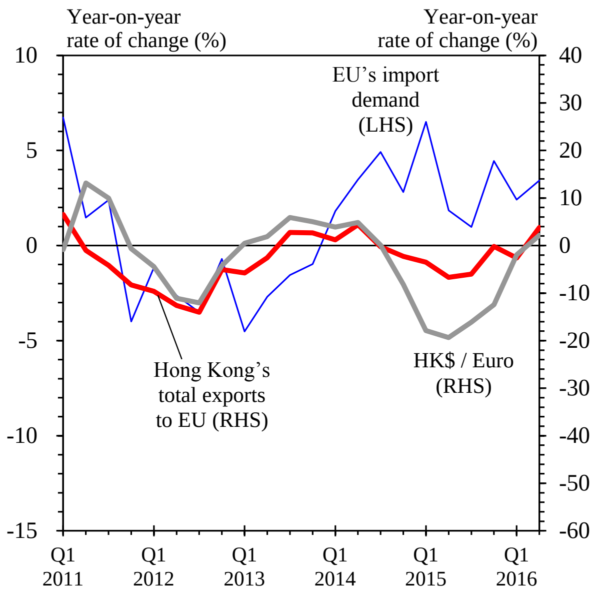


Diagram 2.6 : Exports to the US recorded a narrower decline

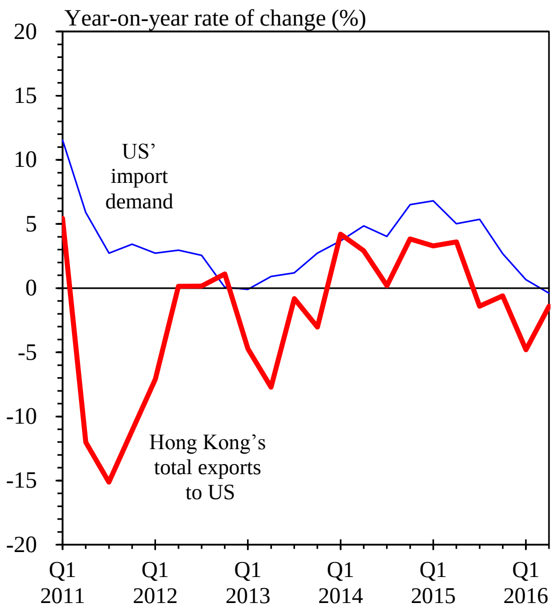


Diagram 2.7 : Exports to Japan deteriorated to show an enlarged fall

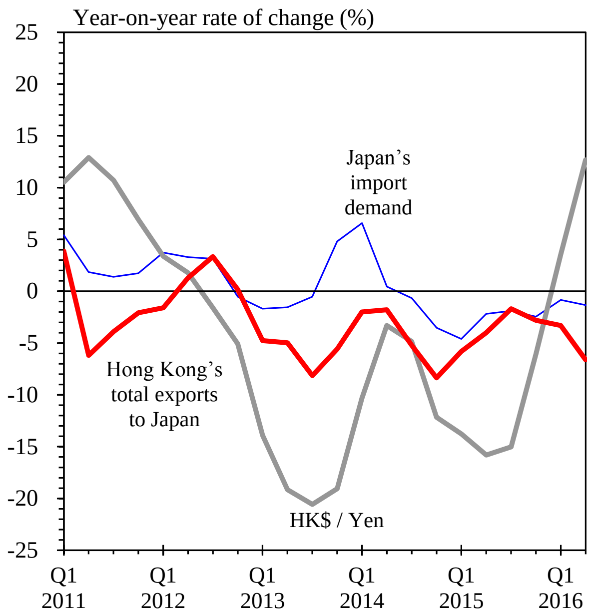


Diagram 2.8 : Exports to India strengthened to show a remarkable growth

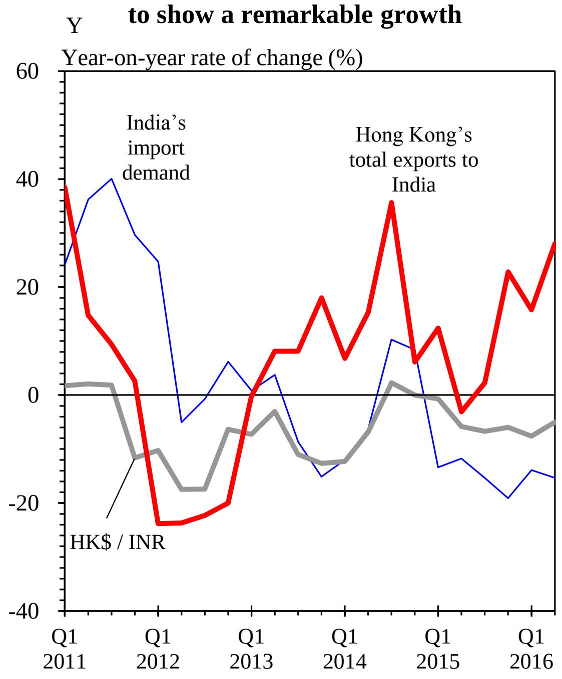


Diagram 2.9 : Exports to Taiwan rebounded in a robust way

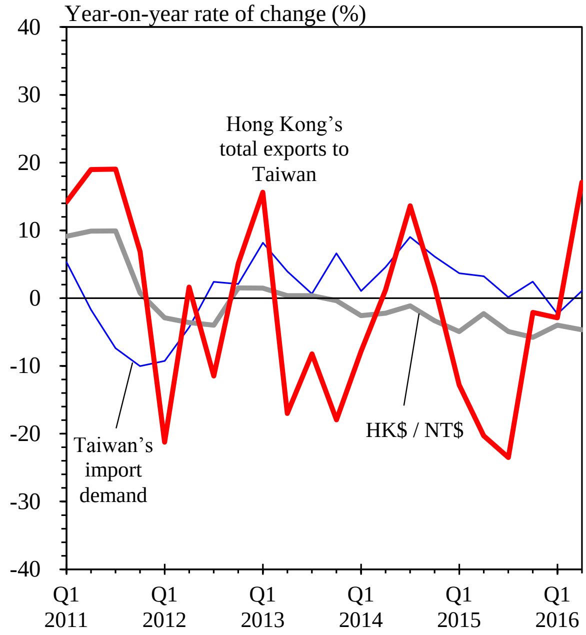


Diagram 2.10 : Exports to Korea improved visibly

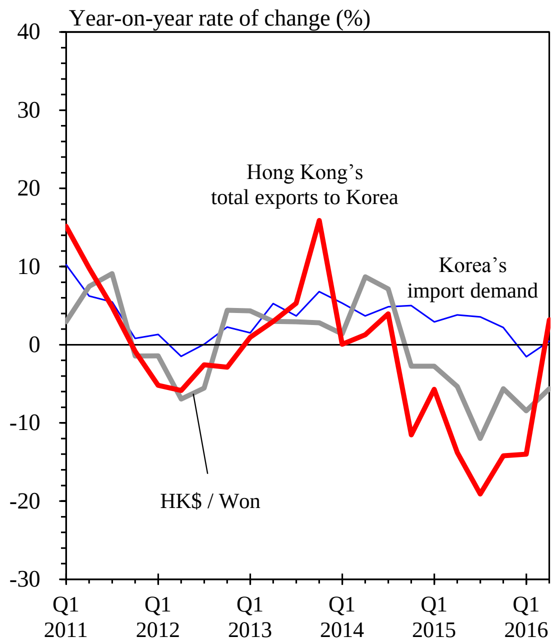
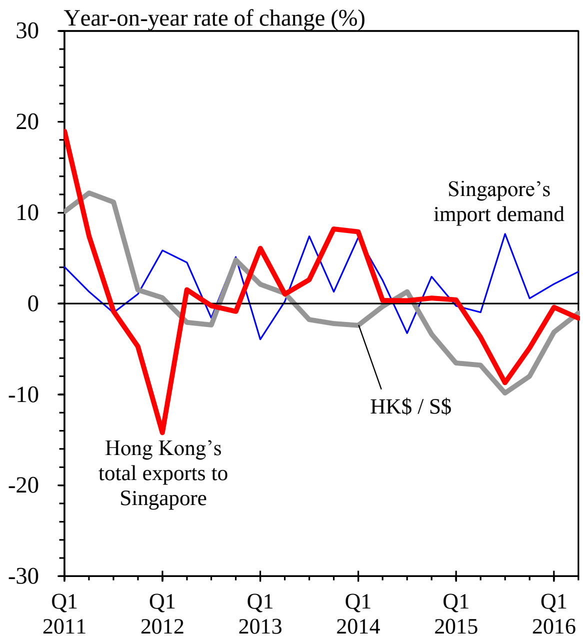


Diagram 2.11 : Exports to Singapore slightly worsened



Box 2.1

Brexit and its possible impacts on the Hong Kong economy

In late June, the United Kingdom (UK) voted in favour of leaving the EU (Brexit). The surprise referendum outcome has far-reaching implications for the UK economy. It could also add hurdles to the fragile recovery of Europe, weakening the global economic outlook. This box article gives an overview of the latest developments of Brexit and the possible impacts on the Hong Kong economy.

The UK joined the European Economic Community in 1973, which later evolved into the EU today. As an EU member, the UK is part of the European Single Market, which upholds free movements of goods, services, capital and people between its member states. For years, the access to the vast European market has provided support to the UK's trade and investment expansion. Its access to the market of financial services in the European Economic Area[(1)] (EEA) has been an important pillar for the UK's position as an international financial hub. Besides, the UK also shares the benefits of better terms of market access when the EU reaches trade agreements with the rest of the world on behalf of its member states. On the other hand, the benefits of EU membership come with obligations and reduction in policy autonomy. For example, the UK is required to comply with the EU regulatory framework and contribute to the EU budget.

Hence, if the UK withdraws its membership from the EU, it would be essential for the UK to negotiate with the EU and other global trading partners on the terms of their economic relationships in future.

At this stage, how Brexit will unfold remains highly uncertain. Firstly, the timing for triggering the UK's exit process is still unclear. While the UK's new prime minister reassured that "Brexit means Brexit", she also pointed out that the exit process should not be invoked until the UK's negotiating strategy is established and a UK-wide approach is agreed. Given the division of local opinions on Brexit and the possibility of Scotland rejecting plans to exit the EU, it seems that it would take a while to build up the necessary consensus in the UK.

Secondly, an exit by a member state from the EU is unprecedented in the EU's history. Hence, the time needed and possible results of the negotiations are full of unknowns. The exit arrangements are set out in Article 50 of Treaty on European Union. Accordingly, upon the UK's formal notification to the EU, the UK will have two years to negotiate its future relationship with the EU, unless it is mutually agreed to extend this period. At the same time, the UK will need to negotiate the trading arrangements with other non-EU countries. Prior to the completion of the negotiations with the EU, the UK remains a member in the EU. However, if no agreements are formed within the time limit, the trading relationships between the UK and other economies will by default revert to the basic form provided by the World Trade Organisation (WTO), which could result in marked increases in trade barriers.

Amid uncertainties, the UK economy would bear the brunt of the shock. Indeed, the UK economy has already entered a likely extended period of uncertainty, which could take a toll on its investment and economic sentiment, dampening its output. Worries about the potential increase in economic barriers with the EU would also affect mutual trade and investment flows.

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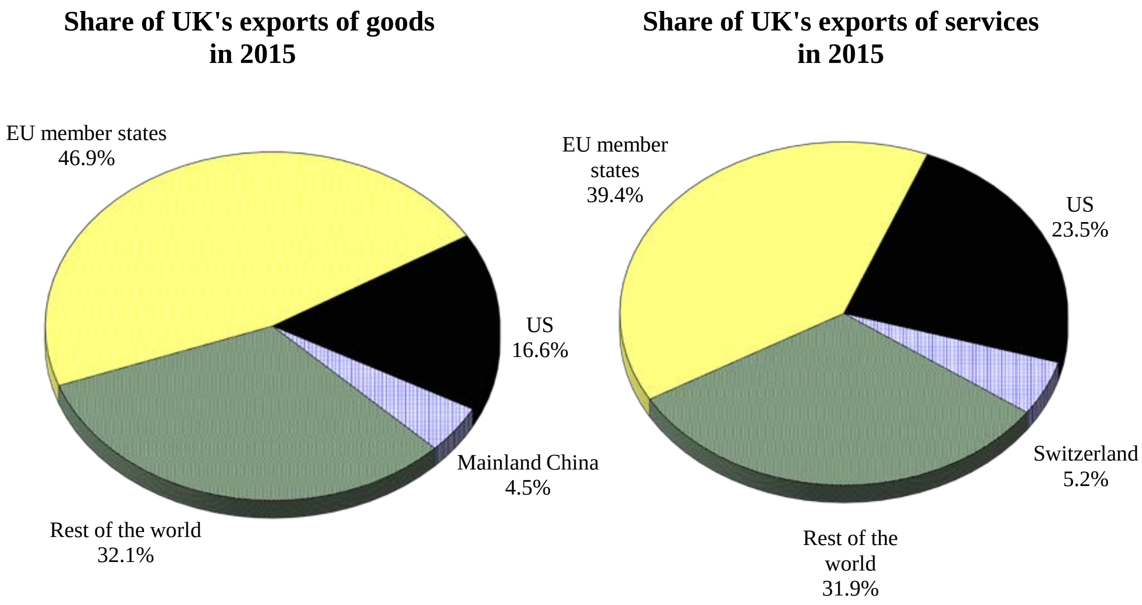
(1) As of July 2016, the European Economic Area includes EU member states plus Norway, Iceland and Liechtenstein.

Box 2.1 (Cont'd)

The EU market features prominently in the UK's trade. In 2015, 47% of the goods exports and 39% of the services exports in the UK went to the EU (***Chart 1***). These exports together accounted for 12% of the UK's GDP[(2)] in 2015.

Chart 1 : The EU is the UK's largest export market for both goods and services



Source: Office for National Statistics, the UK.

Brexit could also have negative effects on some member states of the EU, because of their trade and financial ties with the UK. For instance, the UK took up around 10% of intra-EU goods exports in 2015. Given the slow and fragile recovery of the euro area economy, the uncertainties associated with Brexit may further dim its economic outlook.

The extent of the adverse economic impacts on the UK and the EU would partly hinge on their post-exit trading arrangements. According to the International Monetary Fund (IMF) in June[(3)], the economic impacts on the UK would be milder if it could maintain an EEA-type relationship with the EU, which allows considerable access to the European Single Market after Brexit.

Apart from the above, the extent of the impacts would also depend on policy responses of UK authorities and global policy makers. Immediately after the referendum, the Bank of England (BoE) pledged to provide £250 billion in liquidity. In early July, it eased capital requirements for banks by reducing their countercyclical capital buffer rate to zero, reversing a decision to raise it to 0.5% taken in March, in order to support banks' lending to companies and households. In August, the BoE loosened monetary policy by a package of measures, including cutting Bank Rate to 0.25%, launching a new scheme that will provide funding for banks at close to Bank Rate to reinforce the pass-through of the rate cut, increasing the stock of purchases of UK government bonds by £60 billion to £435 billion and purchasing up to £10 billion of corporate bonds.

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(2) "HM Treasury analysis: the long-term economic impact of EU membership and the alternatives", April 2016.
(3) "United Kingdom : Selected Issues", IMF Country Report No. 16/169, June 2016.

Box 2.1 (Cont'd)

Major central banks also vowed to secure adequate liquidity and guard against systemic risks. The pledges thus far have helped underpin market confidence. The sell-offs in global stock markets, though severe immediately after the referendum, were reversed quickly. Comparatively, the foreign exchange market turned more volatile, with the British pound depreciated by around 10% against the US dollar at end-July from that before the referendum.

As Brexit is still unfolding, its impacts on the real economy have not been fully reflected in the latest economic data yet. The preliminary GDP estimate for the UK and the preliminary flash estimate of the GDP in the euro area showed that the two regions still registered moderate growth in the second quarter. The composite purchasing managers' index (PMI) of the euro area rose slightly and stayed above 50 in July, indicating continued activity expansion. However, in July, the composite PMI in the UK worsened markedly to the lowest level in more than seven years and slid below the boom-bust level of 50, indicating contraction in economic activities. Consumer confidence in the UK also weakened notably.

In light of the possible negative impacts of Brexit, granting that the EU and the UK would settle with a post-Brexit arrangement that would avoid a large increase in economic barrier, and barring major financial market disruptions and severe political fallout, the IMF in July marked down the euro area's growth forecasts for 2016 and 2017 by 0.1 and 0.3 percentage point, to 1.6% and 1.4% respectively. The UK's economic growth forecasts were revised down more visibly, by 0.2 and 0.9 percentage point, to 1.7% and 1.3% respectively in 2016 and 2017. In this relatively benign scenario, the economic impacts outside Europe are relatively muted. Overall, the IMF lowered the global economic growth forecast only by 0.1 percentage point in both 2016 and 2017, to 3.1% and 3.4% respectively.

As a small open economy, Hong Kong will inevitably be affected by the headwinds associated with Brexit through trade and financial channels. Negative spillovers to the European economies, if materialised, would also hurt Asia's trading and tourism sectors, including Hong Kong's. The recent weakening of British pound might dent import demand from the UK and their visitors' spending power in the near term.

In terms of trade, the UK only accounted for 1.5% of our total merchandise exports in 2015 and 6.6% of our total services exports in 2014 (***Table 1***). Thus, the direct impacts from Brexit through the trade channel would likely be not very large. In the second quarter, our goods exports to the UK fell by 7.5% year-on-year in real terms, but our exports to the EU including the UK grew moderately. Hong Kong's total exports also reverted to modest growth in volume terms over the same period. As the data through June have not fully reflected the impacts of Brexit on trade flows, the situation needs to be closely monitored.

Box 2.1 (Cont'd)

Table 1 : Hong Kong's economic relations with the EU and the UK

	EU	Share in total	UK	Share in total
Goods and services trade	($Bn)	(%)	($Bn)	(%)
Merchandise exports (2015)	335.1	9.3	54.8	1.5
Services exports (2014)	119.3	14.9	52.5	6.6
External Direct Investment (DI) (from Hong Kong's perspective)	($Bn)	(%)	($Bn)	(%)
Inward DI position (at end-2014)	1,019.2	8.8	131.9	1.1
Outward DI position (at end-2014)	374.1	3.3	242.0	2.2
Number of offices in Hong Kong (as of June 2015)	(Number)	(%)	(Number)	(%)
Number of regional headquarters (RH)	452	32.3	126	9.0
Number of regional offices (RO)	693	28.9	220	9.2
Number of RH + RO	1 145	30.1	346	9.1
	(Number)	(%)	(Number)	(%)
Visitor arrivals (2015)	1.53 million	2.6	0.53 million	0.9

The UK has a prominent position in international finance. The possible impacts of Brexit on the Hong Kong economy through the financial channel are harder to assess. In early July, several commercial-property funds in the UK suspended redemptions as the investors rushed for withdrawals upon heightened risk aversion towards the UK property market. Fortunately, this had not generated notable ripple effects. While the global financial markets have also stabilised shortly after the Brexit vote, the uncertainties associated with the exit process will still linger on for an extended period and could trigger further shockwaves in future. Moreover, there are also market worries about another referendum on Scotland's independence and the potential rise in anti-EU sentiment in other EU members, which could have implications for market sentiment and expose vulnerabilities in certain weak links in European economies, generating knock-on impacts on the global economy and financial markets. The possibility of these adverse developments happening could not be ruled out at this stage.

Hong Kong is equipped with a sound financial system and resilient fundamentals. It 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. Our regulatory bodies had already reminded financial institutions to guard against the risks in the case of the UK's vote to leave the EU. The healthy position of current account balance, the absence of external debt by the government, and the strong net external financial asset position altogether point to the solid fundamentals of our economy. Yet, there is no room for complacency. In the face of increased uncertainty due to Brexit, exercising prudent risk management is of great importance in safeguarding our financial and macroeconomic stability. The Government will closely monitor the developments and their impacts on the Hong Kong economy.

Box 2.2

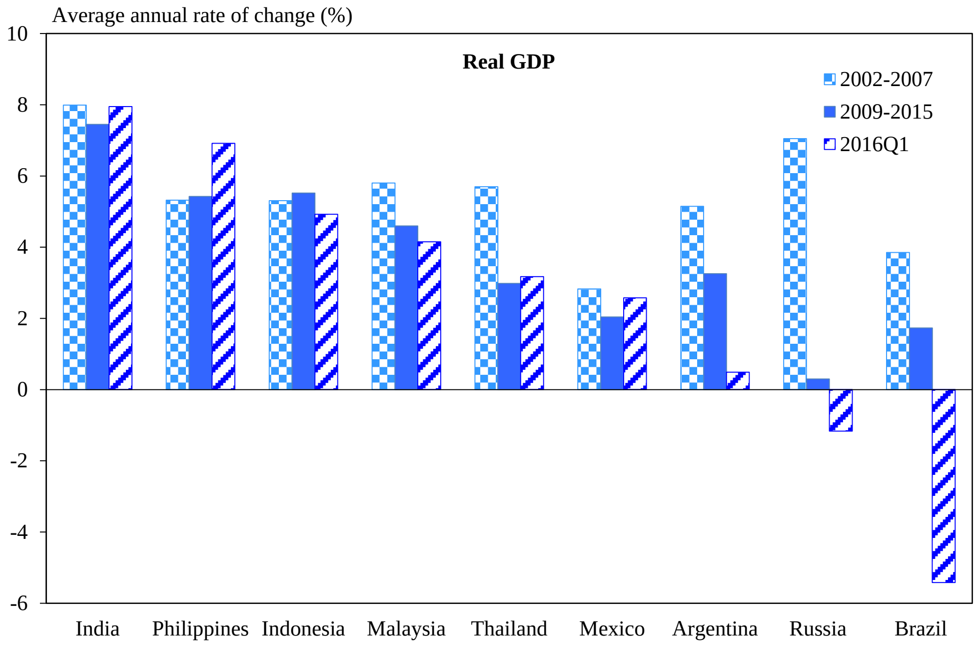
Recent economic performance of emerging market economies

The global economy has been stuck in low gear after the 2008 Global Financial Crisis (GFC), as many advanced economies are still struggling to gain traction. While emerging market economies (EMEs) remain the bright spot, they have also experienced varying degrees of growth slowdown since 2010. This note briefly reviews the recent economic performance of selected EMEs(1). The performance of the Mainland economy is separately discussed in ***Box 2.3***.

For EMEs as a whole, economic growth, while still notable, averaged 5.1% per annum in 2009-2015, and was visibly slower than the expansion pace of 7.2% per annum in the pre-crisis period (2002-2007). A key drag stemmed from the persistently weak external demand, amid the sluggish growth in the advanced economies. This was evident in the notable moderation in the growth of EMEs' merchandise exports to 3.7% per annum in volume terms in 2009-2015, from 10.8% per annum in 2002-2007. Also, EMEs' investment spending expanded at a much softer pace, as compared to the investment boom in the pre-crisis period. As a percentage share of GDP, investment spending in EMEs increased markedly from 24% in 2001 to 30% in 2008, but had barely changed since then, only edging up to 31% in 2015.

Nevertheless, the economic performance of individual EMEs varied greatly. ***Chart 1*** shows that the slowdown in growth after the GFC was not particularly apparent in some EMEs, with some even expanding at faster paces in the first quarter of 2016. These were mainly Asian EMEs, which generally held up well, thanks to their better fundamentals and resilient domestic demand. Their consumption spending growth was particularly impressive, helping to cushion against the lull in external trade. On the other hand, many EMEs in other regions slackened markedly after the GFC, and showed little improvement in the latest period.

Chart 1 : Asian EMEs fared relatively better as compared to their counterparts



(1) EMEs covered in this box article include Argentina, Brazil, India, Indonesia, Malaysia, Mexico, the Philippines, Russia and Thailand.

Box 2.2 (Cont'd)

Among Asian EMEs, India saw exceptional growth, expanding briskly by 7.5% per annum in 2009-2015, and its growth picked up further to 7.9% year-on-year in the first quarter of 2016. Meanwhile, Indonesia and the Philippines also performed well, helped by robust investment spending amid higher infrastructure investments.

In contrast, economic activities in Russia and Brazil have slowed sharply and experienced contraction since 2015, mainly dampened by the sharply lower energy and commodity prices. In the case of Russia, economic sanctions from the West, which have been extended till January 2017, posed an additional downward pressure on its exports. As for Brazil, the increasing political instability and worries about the sustainability of its public finances have eroded consumption and investment confidence. In addition, the currencies of these two economies weakened significantly against the US dollar alongside capital outflows, leading to a surge in imported inflation. Russia's central bank increased policy rates sharply in late 2014, while Brazil's central bank raised interest rates successively since end-October 2014. But monetary tightening dealt a further blow to their economic activities.

Looking ahead, while the sustained growth of EMEs in Asia would continue to help shift the gravity of the global economy towards the East, we still need to be mindful of any sudden increase in risk aversion under the still-challenging external environment, as this could trigger abrupt shifts in capital flows and exert downward pressures on those EMEs with weaker economic fundamentals and less resilient financial systems. Therefore, it is useful to examine the latest state of fiscal and financial health of these economies. ***Charts 2a and b*** present an update to ***Box 1.1 in the Half-yearly Economic Report 2015***.

Chart 2a : Current account and fiscal balances are important indicators of an economy's financial health

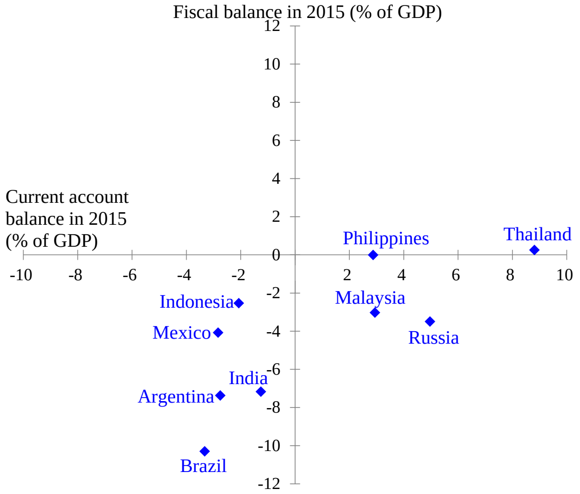
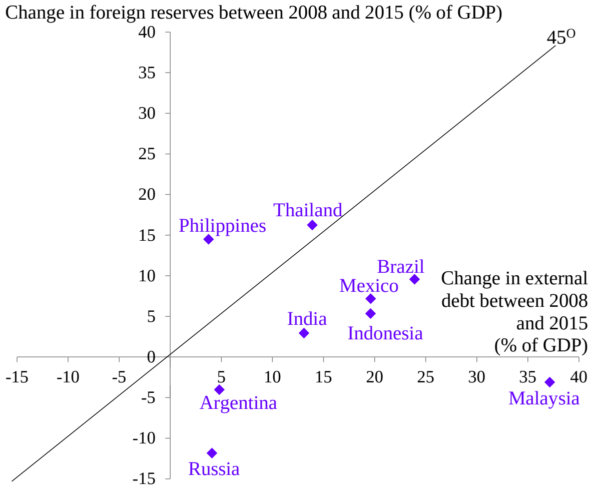


Chart 2b : Sudden shifts in capital flows would exert more pressure on economies with a visible build-up of external debt



It can be seen from the two charts that some of the EMEs are still faced with external and/or internal imbalances, i.e. current account and/or fiscal deficits. Hence, they may be more prone to sudden capital reversals and sharp currency fluctuations, especially if they have also accumulated sizeable external debts, as already experienced during mid-2013 and August 2015. Nonetheless, should these EMEs have an ample amount of foreign reserves, it would hopefully help stabilise their currencies against a sharp rise in capital outflows.

Box 2.2 (Cont'd)

In July, the IMF maintained its GDP growth projection for EMEs as a whole at 4.1% in 2016, which if attained, would contribute around three-quarters of the world's economic growth. In particular, EMEs in Asia were projected to grow by 6.4% in 2016, faster than EMEs in other regions. These projections, however, were made under the benign assumption of a gradual reduction in the uncertainties related to the UK vote to leave the EU.

In view of the various downside risks to the global economy, the IMF warned that the scope for short-run demand support may be limited in some EMEs during periods of heightened global risk aversion and policymakers in EMEs should strengthen defences against increased global financial volatility for an extended period of time, while continuing to bolster medium-term growth prospects through structural reforms. Hence, we will need to keep a close watch on the economic situation in EMEs and stay vigilant to any potential adverse impacts on Hong Kong's near-term economic growth and prospects.

Box 2.3

Structural transformation of the Mainland economy

With the Mainland economy entering a state of "new normal", all eyes are on the direction and pace of its restructuring, which is considered as the key driving force for the Mainland's sustainable and steady growth. This note outlines the structural transformation of the Mainland economy since 2004 and its implications for the development of Hong Kong economy.

The composition of aggregate demand in the Mainland economy has been evolving over the past decade or so. During 2004-08, the Mainland economy was growing apace at an average rate of 11.6% per annum, with the external sector developing rapidly to support the overall economy. During the Global Financial Crisis, the demand for the Mainland's exports, however, shrank remarkably as the global economy slackened distinctly. In response, the Central Government launched a massive investment programme to boost domestic demand. As a result, the contribution to economic growth from investment expenditure increased notably in 2009-10, and the overall economy also maintained an average growth of 10.0% per annum over the same period. In the subsequent period from 2011 to 2015, the contribution to growth from investment expenditure declined. Meanwhile, with domestic consumption continuing to fare well, final consumption expenditure remained a solid anchor to the overall economy. Its contribution to economic growth rose progressively from 46% during 2004-08 to 55% during 2011-15. In the first half of 2016, the contribution even surged to 73%, becoming the key driver and stabiliser of economic growth under the "new normal" (***Chart 1***).

Chart 1: Mainland's economic growth gradually led by consumption expenditure

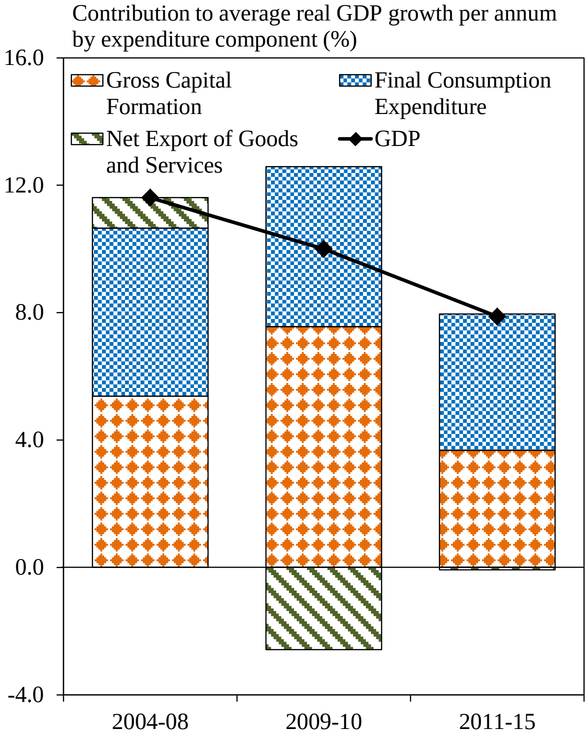
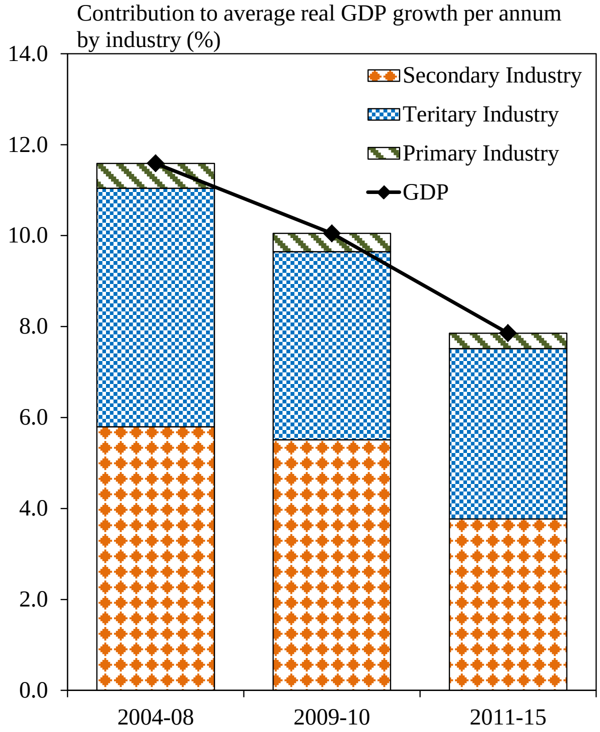


Chart 2: Growing significance of services sector in the contribution to economic growth

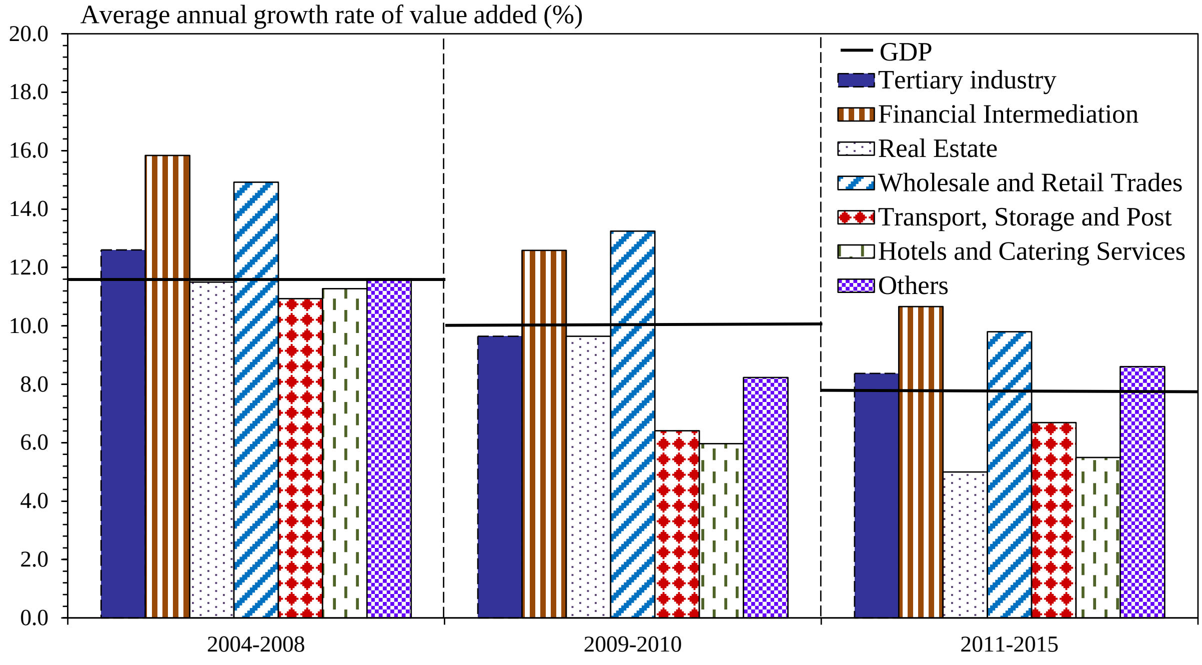


Box 2.3 (Cont'd)

The Mainland's sectoral structure also shows notable changes. Despite the prominence of the secondary industry in the Mainland economy all along, the Mainland's industrial sector slackened in the more recent years, dragged by overcapacity in certain sectors, weak export demand and rising labour costs, etc. Hence, the contribution to economic growth from secondary industry moderated from 55% in 2009-10 to 48% during 2011-15. On the other hand, the general increase in income of Mainland residents pushed up the demand for consumption services, whereas the industrial upgrading and restructuring drove the development of high-end services sector. Therefore, the tertiary industry remained relatively resilient, with its contribution to economic growth rising from 41% in 2009-10 to 48% during 2011-15 (***Chart 2***). As the Mainland's sectoral restructuring continued, the share of tertiary industry's value added in GDP had exceeded that of the secondary industry since 2013, and went beyond half of the overall GDP at 50.2% last year. This development trend was even more notable in the first half of 2016, with the contribution of tertiary industry to economic growth soaring further to 60% and the share of its value added in GDP reaching 54%.

As illustrated in ***Chart 3***, the tertiary industry posted appreciable growth. Except for certain brief periods, the services sector expanded steadily over the past decade or so, at a rate faster than the overall economic growth. Financial intermediation and wholesale and retail trades industries were the key drivers of growth. The rapid growth of financial intermediation industry was conceivably related to the Mainland's ongoing financial reform as well as its opening up, while the wholesale and retail trades industry was mainly underpinned by the solid growth in domestic consumption.

Chart 3: Solid growth was seen in the tertiary industry, particularly in financial intermediation and the wholesale and retail trades industries



Box 2.3 (Cont'd)

The compositional changes in the Mainland's economic growth since 2004 have shed light on the rebalancing of the Mainland economy towards a more consumption-driven and service-oriented growth model. This helps achieve a more balanced and sustainable development of the Mainland economy and cushion the impacts from the volatile external sector, boding well for the long-term economic development of Hong Kong as well as the world. Meanwhile, the structural transformation of the Mainland economy has also offered numerous development opportunities to Hong Kong. Indeed, after years of strengthening in economic and trade co-operation between the Mainland and Hong Kong under the framework of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), the basic liberalisation of trade in services was in effect starting from June this year, allowing Hong Kong services providers to leverage their own experience and strengths to expand their presence in the Mainland market while assisting sectoral upgrading in the Mainland. This will create more development and employment opportunities, bringing about mutual benefits to both places.

Looking ahead, the Mainland is bound to continue with the structural transformation on its way to become a high-income economy. Given the continuous income growth of Mainland residents, coupled with various policies to encourage consumption, domestic consumption looks set to sustain its growth momentum. On the production front, services sector has become the mainstay of the Mainland economy, and its development will be further aided by various initiatives under the National 13th Five-year Plan, such as the promotion of industrial upgrading as well as innovation and entrepreneurship. The sustained expansion of the Mainland's services sector and its domestic consumption market will surely create more development opportunities for various sectors of Hong Kong.

Imports of goods

2.7 *Imports of goods* declined at a moderated year-on-year rate of 0.5% in real terms in the second quarter, compared with the fall of 5.4% in the first quarter. The smaller decline was mainly due to the rebound in imports for subsequent re-exports. *Retained imports,* referring to the imports for domestic use, which accounted for around one-quarter of total imports, declined by 6.0% year-on-year in real terms in the second quarter, after a drop of 8.9% in the first quarter. The continued decline in retained imports, albeit at a narrower pace, reflected the weaknesses in local investment spending and retail sales, which reduced the related intake of imports.

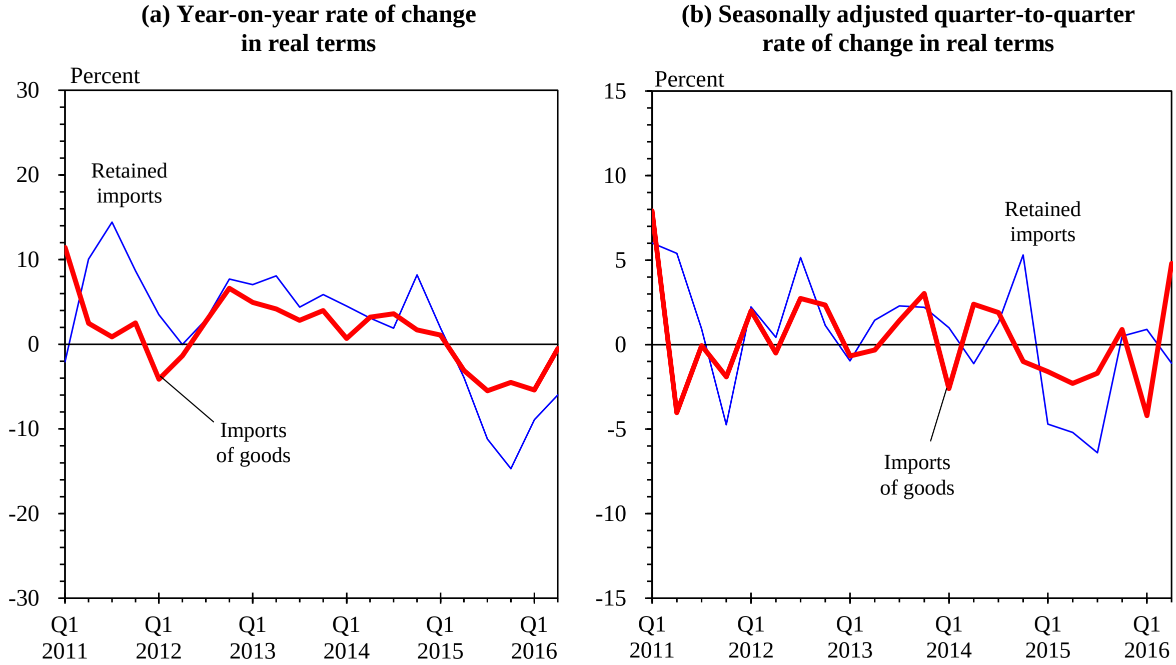
Table 2.3 : Imports of goods and retained imports (year-on-year rate of change (%))

		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	-10.4	-7.4		-1.8
	Q1	1.4	1.1	(-1.6)	0.9	-1.2	1.9	(-4.7)	-1.9
	Q2	-3.2	-3.1	(-2.3)	0.6	-6.8	-3.9	(-5.2)	-1.3
	Q3	-6.7	-5.5	(-1.7)	-0.7	-14.3	-11.2	(-6.4)	-1.6
	Q4	-7.0	-4.5	(0.9)	-2.1	-17.6	-14.7	(0.5)	-2.4
2016	Q1	-8.2	-5.4	(-4.2)	-2.8	-12.2	-8.9	(0.9)	-3.6
	Q2	-3.2	-0.5	(4.8)	-2.6	-9.2	-6.0	(-1.1)	-3.7

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 : The year-on-year declines in imports and retained imports narrowed

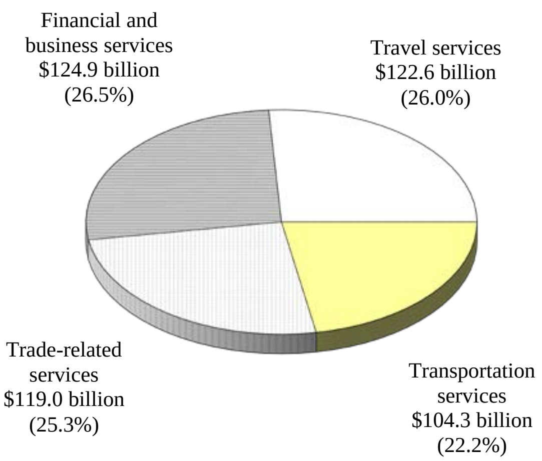


Services trade

Exports of services

2.8 *Exports of services* showed a slightly narrower decline in the second quarter, falling by 4.6% in real terms from a year earlier, compared with the 5.0% fall in the first quarter. The decline in exports of travel services tapered somewhat, as the fall in visitor arrivals eased in the second quarter and partly offset the weakness in per capita spending of visitors. Meanwhile, exports of trade-related services (comprising mainly offshore trade activities) reverted to slight growth and those of transportation services fell only marginally, thanks to the relative improvement in trade and cargo flows in the region during the quarter. However, exports of financial and other business services saw a visibly larger year-on-year fall and reduced the extent of overall services exports improvement. This was partly due to a high base of comparison in the same period last year when fund-raising and cross-border financial activities were rather buoyant, while the uncertain global economic outlook was also not conducive to 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 half of 2016: $470.8 billion

Diagram 2.14 : Exports of services showed a slightly narrower decline in the second quarter

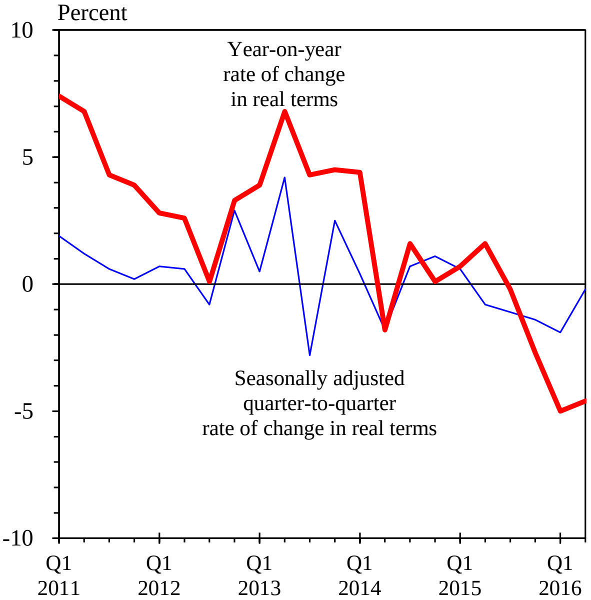


Table 2.4 : Exports of services by major service group (year-on-year rate of change in real terms (%))

		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	-5.0	(-1.9)	-2.2	-1.8	-13.9	-0.6
	Q2	-4.6	(-0.2)	0.4	-0.5	-9.7	-8.7

Notes : (a) Comprising mainly offshore trade.

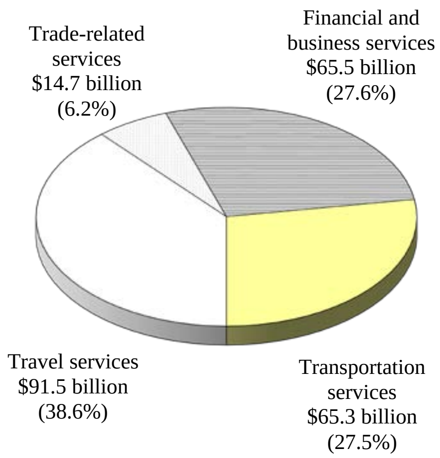
(b) Comprising mainly inbound tourism receipts.

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

Imports of services

2.9 *Imports of services* grew by 1.1% year-on-year in real terms in the second quarter, slower than the 4.9% growth in the first quarter. The year-on-year growth in imports of travel services slowed visibly in the second quarter, after showing notable growth in the previous few quarters. Apart from the distortions from the difference in timing of the Easter holidays, which fell in late March 2016 but in early April 2015, the boost to travel interest of local residents from the earlier depreciations of many major currencies against the US dollar might have also faded. Indeed, the strengthening of the yen over the past year conceivably had some dampening impact on local residents' interest in traveling to Japan. Imports of trade-related services reverted to marginal growth while those of transportation services fell slightly, amid the relative stabilisation in trade and cargo flows in the region. Meanwhile, imports of financial and other business services grew only modestly over a year earlier amid subpar global economic environment.

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



Imports of services in the first half of 2016: $237.1 billion

Diagram 2.16 : Imports of services grew at a slower year-on-year pace

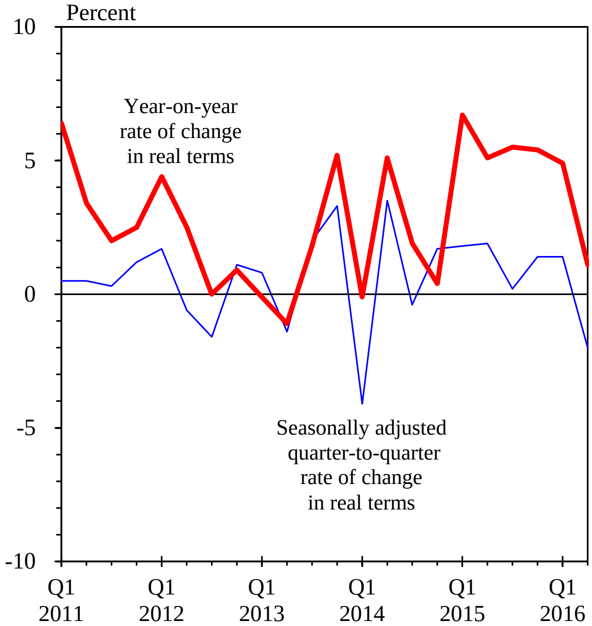


Table 2.5 : Imports of services by major service group (year-on-year rate of change in real terms (%))

		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	4.9	(1.4)	12.8	-0.3	-1.0	1.6
	Q2	1.1	(-2.0)	2.6	-1.1	0.4	1.4

Notes : (+) Comprising mainly outbound travel spending.

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

Goods and services balance

2.10 The goods deficit narrowed in the second quarter from a year earlier, as goods exports showed some improvement while retained imports continued to fall amid subpar economic growth. Adding the services surplus, the combined goods and services account registered a deficit of $18 billion, equivalent to 1.6% of total import value, in the second quarter. This represented an improvement from the same period last year, when the deficit amounted to $24 billion or 2.0% of total import value.

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	120	-114	125	11	1.0
	Q2	912	226	1,039	117	-127	109	-18	-1.6

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

(*) Within ±$0.5 billion.

(#) Within ±0.05%.

Other developments

2.11 Hong Kong strives to forge closer economic relations with its major economic partners and explore new markets. In June, an agreement between Hong Kong and Shanghai was signed, to further co-operation between the two places on various fronts including financial markets, institutions, operation and products, talents, regulation and financial technologies. In light of the Belt and Road Initiative and the vast market potential of the emerging market economies along the route, an inaugural Belt and Road Summit was jointly organised by the Government and Hong Kong Trade Development Council in May, in order to explore co-operation opportunities and the unique role Hong Kong could play.

2.12 Along the Belt and Road, ASEAN is a rapidly growing market, and Indonesia is the largest in terms of size of the economy and the most populous economy within it. In May, a memorandum of understanding (MOU) was signed with Indonesia, pledging mutual co-operation on investment promotion exchanges and best practices. The MOU should help induce more investment flows, exchange of information on potential investment opportunities, as well as investment co-operation between the two economies. Moreover, a new Economic and Trade Office (ETO) was established in Jakarta, Indonesia, with its temporary office commencing operation in June. Together with the existing ETO in Singapore, the two ETOs will strengthen our ties with the ASEAN countries.

2.13 As a responsible member of the international community, Hong Kong has all along been supportive of international efforts to promote tax transparency and combat tax evasion. With this in mind, the Government in June accepted the invitation of the Organisation for Economic Co-operation and Development to join as an Associate in the inclusive framework for implementation of the package of measures against base erosion and profit shifting (BEPS). The BEPS Package seeks to ensure that multinational corporations pay a fair share of taxes in respect of their profits, and to plug the loophole of "double non-taxation" among jurisdictions. Hong Kong will work with other members of the BEPS to implement the BEPS Package and to develop standards. The Government is conducting analysis on the BEPS Package, and will consult the industry on the strategy for implementing the relevant proposals at an appropriate juncture and prepare for taking forward the necessary legislative amendment. The commitment to BEPS Package is instrumental in maintaining our reputation and fulfilling our obligations as an international financial and business centre.

2.14 According to the United Nations Conference on Trade and Development's World Investment Report 2016, Hong Kong's foreign direct investment (FDI) inflows ranked the second largest among the world economies in 2015. Hong Kong has stayed at the second highest position for two years in a row, signifying our important status as an international business hub for foreign and Mainland companies.

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.