

## CHAPTER 2 : THE EXTERNAL SECTOR

### *Summary*

- *The global economy grew modestly further in the third quarter. The US economy gathered some momentum, while the euro area held gradual economic improvement. The Mainland economy also maintained steady growth. With the acute risks associated with Brexit and some other troubling concerns waning somewhat, global stock markets generally bounced back during the quarter after a brief setback. The ensuing modest recovery in global final demand rendered support to Asia's trading and manufacturing activities.*
- *Hong Kong's merchandise exports sustained modest year-on-year growth in real terms<sup>(1)</sup> in the third quarter. Exports to the US improved and reverted to marginal growth, while those to Asia as a whole picked up somewhat in growth, providing the key impetus to goods export growth in the quarter.*
- *Exports of services also improved visibly in the third quarter, with a strong seasonally adjusted quarter-to-quarter bounce-back after five consecutive quarters of decline, and the year-on-year decline accordingly tapered visibly. Apart from exports of travel services, which remained weak amid continued falls in visitor arrivals, other services exports registered more discernible improvements. Exports of transportation services resumed increase while those of trade-related services attained further modest growth, both benefitting from the relative stabilisation in regional trade and cargo flows. Thanks to a revival in fund-raising activities during the quarter, the decline in exports of financial and other business services narrowed distinctly.*
- *The 19th Plenary of the Hong Kong/Guangdong Co-operation Joint Conference was held in September, setting out directions of co-operation between the two places in such areas as the Belt and Road Initiative, finance, innovation and technology and professional services. In addition, Hong Kong and Japan signed Mutual Recognition Arrangement in August, which should help facilitate and secure trade flows between the two economies.*

## Goods trade

### *Total exports of goods*

2.1 The global economy remained on a modest expansion path in the third quarter of 2016, rendering some support to Asia's trade flows and production activity. Hong Kong's *merchandise exports* (comprising re-exports and domestic exports) improved further, reverting to year-on-year growth in August and September after a relapse in July, thus yielding a 1.8% growth for the third quarter as a whole in real terms over a year earlier, after the 1.4% growth in the preceding quarter. On a seasonally adjusted quarter-to-quarter basis, merchandise exports also grew further by 1.5% in the third quarter, after a brisk rebound of 6.8% in the second quarter.

2.2 The relative improvement in Hong Kong's export performance over the period mainly reflected the further stabilisation in the global trading environment, as earlier concerns over acute risks waned somewhat. In particular, the US economy picked up in growth momentum in the third quarter, while the economies of the euro area and the UK also continued to grow modestly. The contagion risks of Brexit had so far been largely contained, and despite lingering uncertainties, economic sentiment in the euro area showed no marked deterioration. International stock markets also rebounded swiftly as economic sentiment stabilised. In Asia, economic growth in the Mainland held steady, while India's economic activity expanded notably. The rebounds in international energy and commodity prices so far this year also rendered some support to commodity-dependent emerging markets economies. In sum, the more benign global economic trend in the recent period had provided some relief to regional trading and manufacturing activities in Asia after experiencing severe downward pressures seen at the turbulent start of the year.

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

	<u>Total exports of goods</u>			<u>Re-exports</u>			<u>Domestic exports</u>		
	<u>In value terms</u>	<u>In real terms<sup>(a)</sup></u>	<u>Change in prices</u>	<u>In value terms</u>	<u>In real terms<sup>(a)</sup></u>	<u>Change in prices</u>	<u>In value terms</u>	<u>In real terms<sup>(a)</sup></u>	<u>Change in prices</u>
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
Q3	-0.2	1.8 (1.5)	-1.6	-0.2	1.8 (1.4)	-1.6	-2.0	-0.1 (11.4)	-1.1

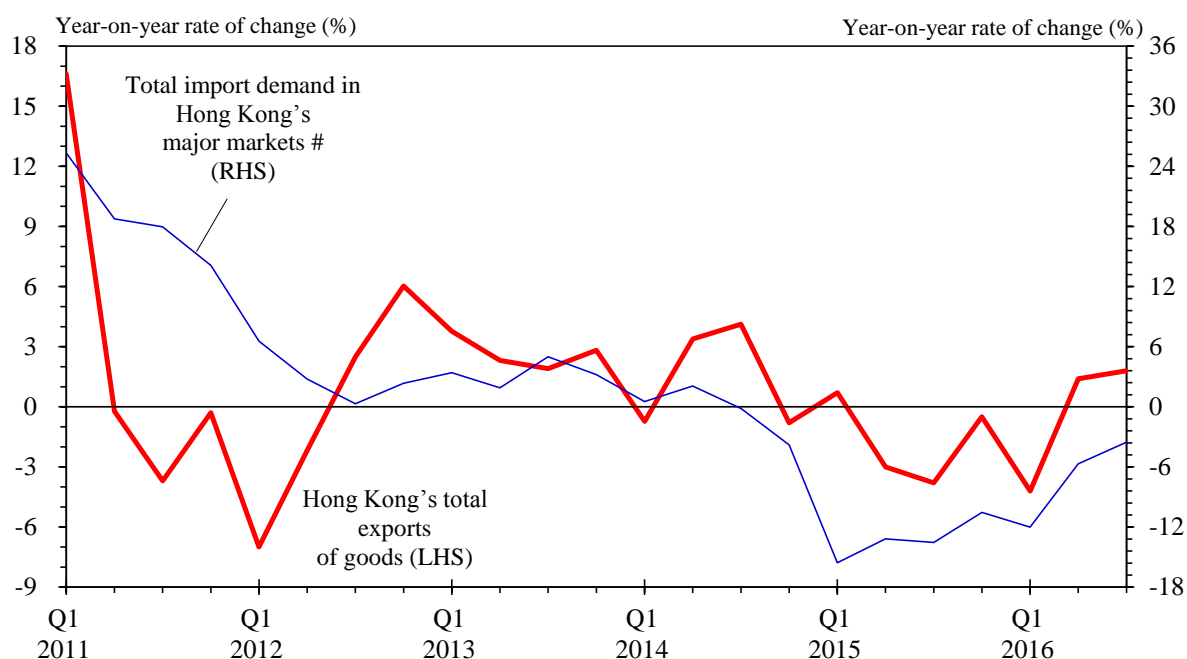
Notes : ( ) Seasonally adjusted quarter-to-quarter rate of change.

(\*) Change within  $\pm 0.05\%$ .

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

2.3 *Re-exports*<sup>(2)</sup>, the mainstay of overall merchandise exports and accounting for 98.8% of total exports by value, recorded further growth at 1.8% year-on-year in real terms in the third quarter, compared with 1.6% in the preceding quarter. *Domestic exports*, constituting the remaining 1.2% of total exports, turned visibly better and edged down only by 0.1% year-on-year in the third quarter, after the 14.7% decline in the preceding quarter.

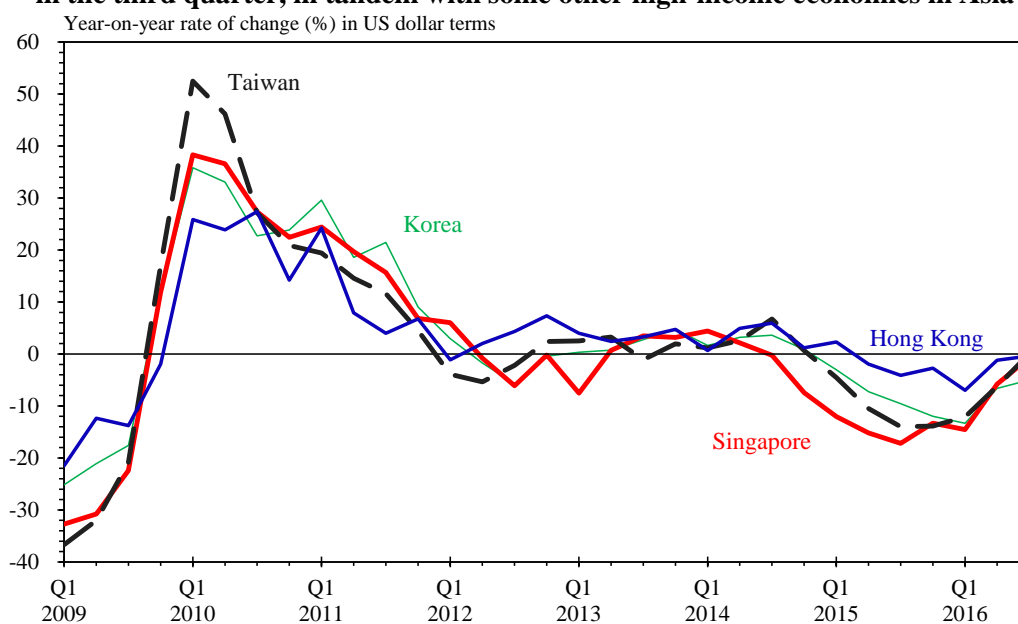
**Diagram 2.1 : Merchandise exports grew modestly further in real terms in the third quarter**



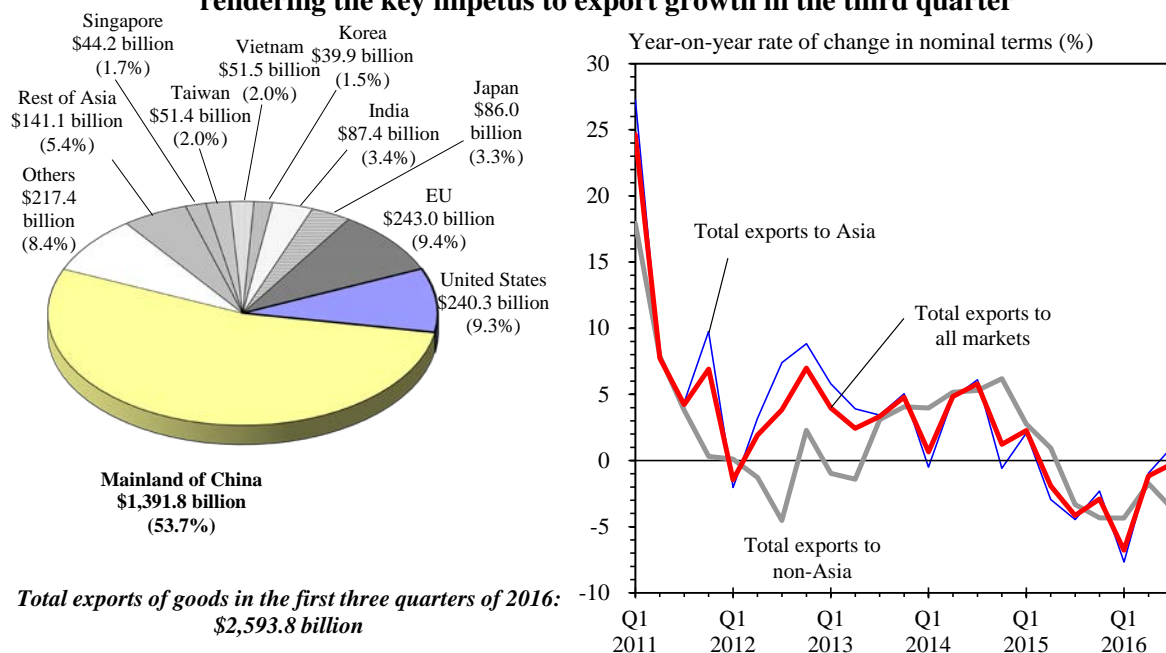
Notes : Total exports of goods as depicted refer to the year-on-year rate of change in real terms, while total import demand in Hong Kong's major markets as depicted refers to the year-on-year rate of change in US dollar terms in the aggregate import demand in Asia, the United States and the European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

(#) Import demand figure for the third quarter of 2016 is based on statistics for July and August 2016.

**Diagram 2.2 : Hong Kong's merchandise exports showed some further improvement in the third quarter, in tandem with some other high-income economies in Asia**



**Diagram 2.3 : Exports to the Asian markets generally improved, rendering the key impetus to export growth in the third quarter**



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

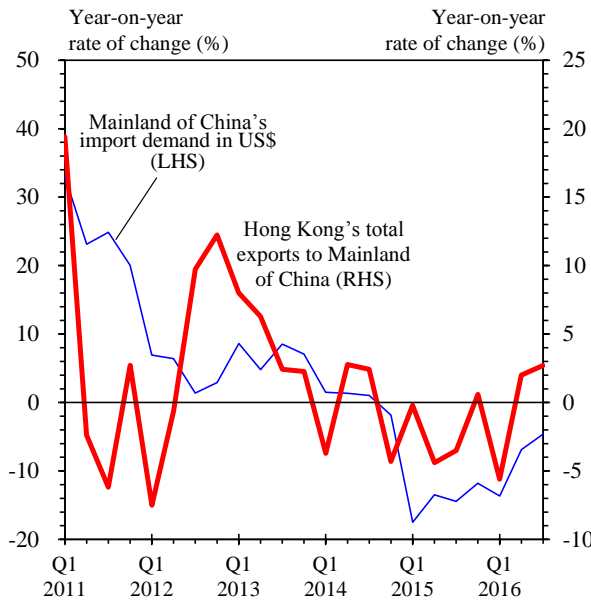
	Annual	2015				2016		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3
Mainland of China	-2.0	-0.2	-4.4	-3.5	0.6	-5.6	2.0	2.7
United States	1.0	3.3	3.6	-1.4	-0.6	-4.8	-1.4	0.2
European Union	-4.1	-3.5	-6.7	-6.0	-0.2	-2.6	3.8	-0.4
Japan	-3.6	-5.8	-4.0	-1.7	-2.8	-3.3	-6.6	-1.1
India	7.9	12.4	-3.1	2.3	22.8	15.8	28.0	15.8
Vietnam	12.1	14.0	18.0	12.9	5.2	-2.1	-8.0	-9.8
Taiwan	-15.0	-12.8	-20.3	-23.5	-2.1	-2.9	17.1	27.5
Korea	-13.4	-5.7	-13.8	-19.1	-14.2	-14.0	3.2	6.7
Singapore	-4.3	0.4	-3.7	-8.7	-4.9	-0.4	-1.6	7.7
Overall*	-1.7	0.7	-3.0	-3.8	-0.5	-4.2	1.4	1.8

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

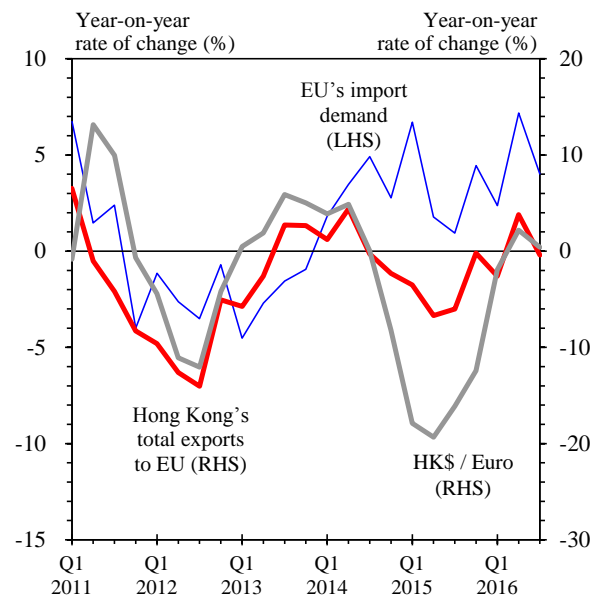
2.4       Analysed by major market on a year-on-year comparison in real terms, many markets showed improvements of varying degrees in the third quarter. Exports to the US improved and reverted to show marginal growth after four quarters of decline, thanks to the pick-up in the pace of economic expansion there. Exports to the EU relapsed to a marginal decline, mainly dragged by the marked fall in exports to the UK amid the visible depreciation of the British pound. Excluding the UK market, exports to other EU member states as a whole actually grew slightly further. Exports to Japan, though still weak, also showed some relative stabilisation after a prolonged period of setback.

2.5       Exports to the Asian markets as a whole improved in the third quarter, propelled mainly by a pick-up in exports of raw materials and semi-manufactures, benefitting from relative stabilisation in global final demand. In particular, exports to the Mainland made another quarter of moderate growth. Amongst exports to the high-income Asian economies, exports to Singapore rebounded after five quarters of decline; those to Korea gathered momentum, while those to Taiwan picked up strongly further. Exports to some ASEAN emerging markets also improved by varying degrees. Exports to India remained brisk, mirroring the solid economic expansion there.

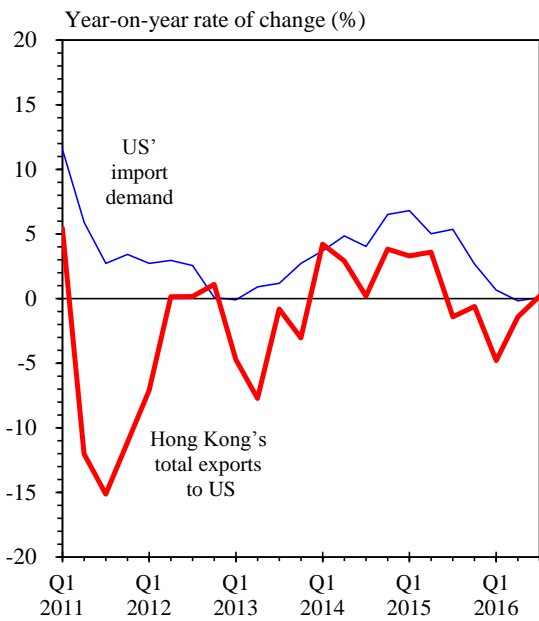
**Diagram 2.4 : Exports to the Mainland sustained moderate growth**



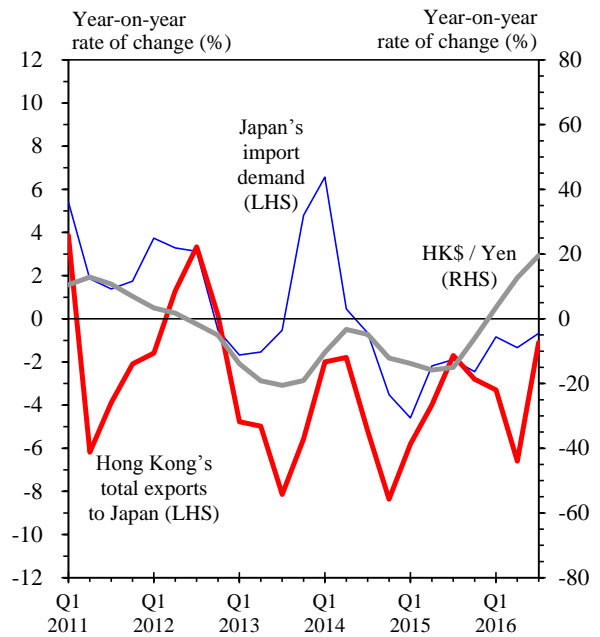
**Diagram 2.5 : Exports to the EU related to a marginal decline**



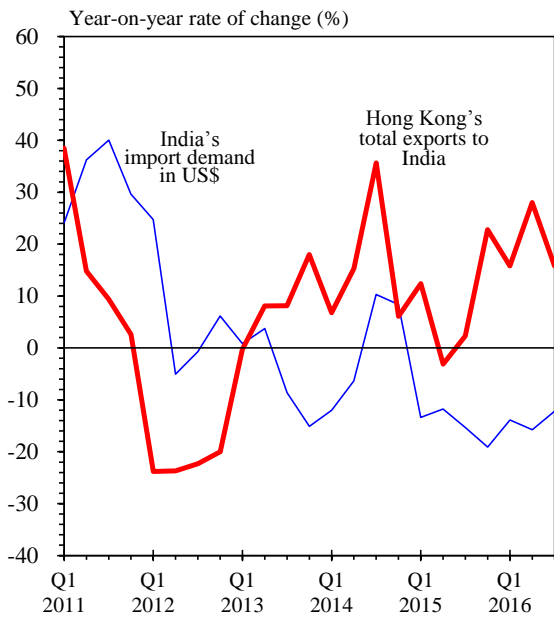
**Diagram 2.6 : Exports to the US improved and reverted to show marginal growth**



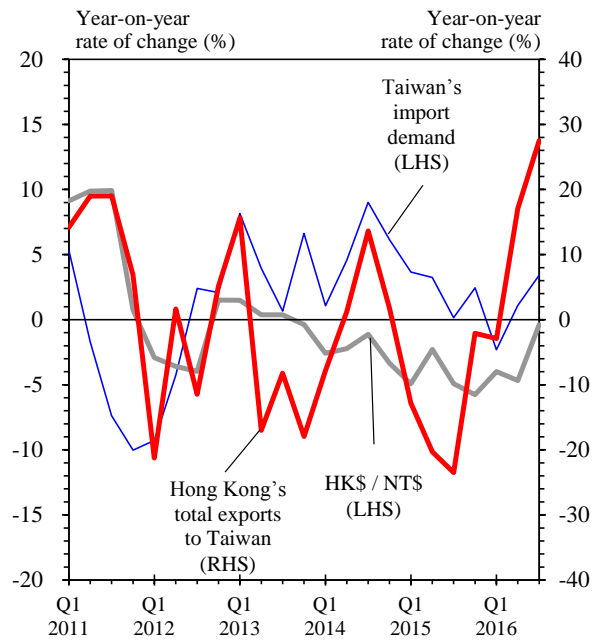
**Diagram 2.7 : Exports to Japan, though still weak, showed relative stabilisation**



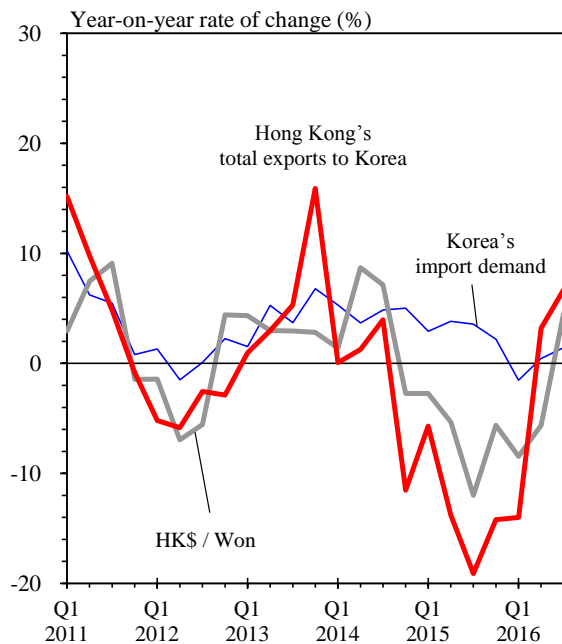
**Diagram 2.8 : Exports to India remained brisk**



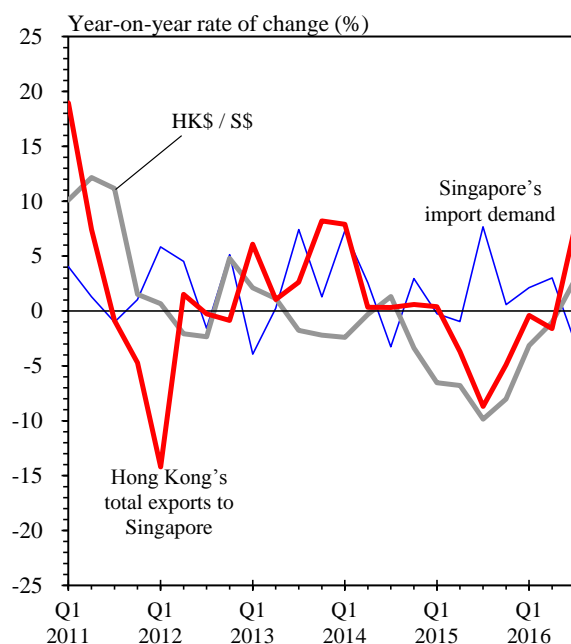
**Diagram 2.9 : Exports to Taiwan picked up strongly further**



**Diagram 2.10 : Exports to Korea gathered momentum**



**Diagram 2.11 : Exports to Singapore rebounded after five quarters of decline**





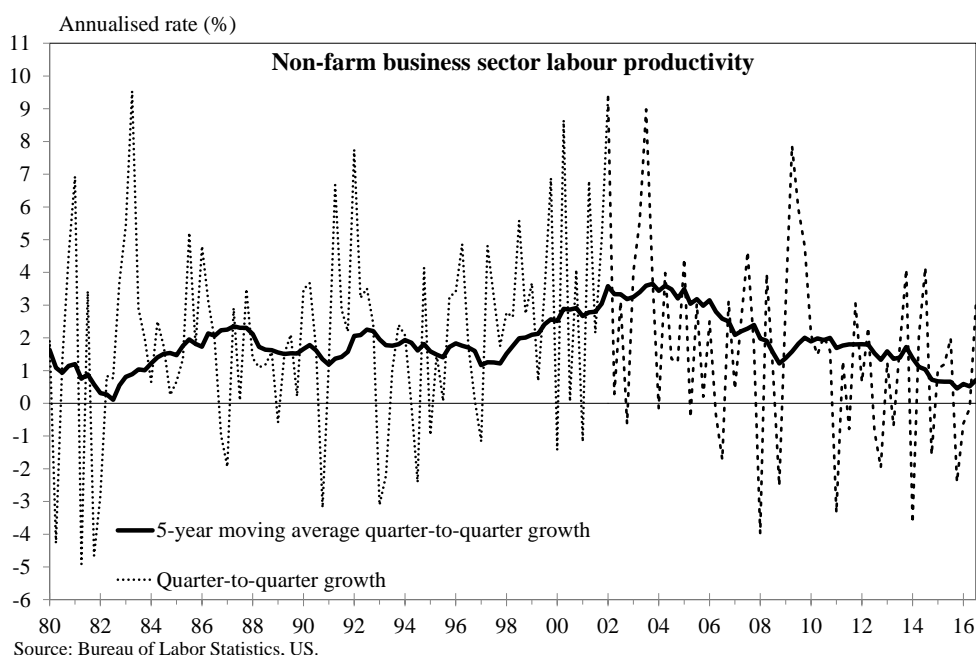
## Box 2.1

### Productivity growth slowdown in the US and its economic implications

The labour productivity growth slowdown in the US has worsened after the Global Financial Crisis (GFC), raising concern about its medium- to long-term economic growth prospects, particularly in light of its prominence in the global economic arena. This note briefly reviews the US labour productivity situation and some plausible explanations for its recent growth slowdown, as well as its implications for the US economic outlook and monetary policy.

Labour productivity here is referred to as output produced per hour worked. Taking a five-year moving average to smooth out the short-term quarterly growth fluctuations, it can be seen that labour productivity growth in the US has moderated in the past decade or so (*Chart*). In fact, on an average annual growth basis, labour productivity slowed from a hefty 3.3% in 1998-2002 to 2.3% in 2003-2007. Yet, the slowdown has become more acute after the GFC, averaging only 0.6% per year in 2011-2015, marking the slowest five-year growth since the recession in the early 1980s.

**Chart : US labour productivity growth slowdown became more acute in recent years**



There are different explanations for the slowdown in US labour productivity growth. Some economists<sup>(1)</sup> argued that the protracted impact on private investment from the deep recession in 2008 and 2009 was the main culprit. In decomposing the US labour productivity growth, they found that weaker capital deepening since 2010 had posed the key drag. They pointed out that cautious business sentiment and subdued demand amid an uncertain economic outlook had reduced the need to expand production capacity, while widespread deleveraging in the wake of the GFC as well as the blow from the oil price plunge to energy-related sectors also exacerbated investment weakness. All these had depressed investment and hence productivity growth. Yet, noting that the deceleration in US labour productivity growth trend has lasted for quite a while, it is natural to hypothesise that some deeper structural influences may also be at work.

(1) Furman, 2015. "Productivity Growth in the Advanced Economies: The Past, the Present, and Lessons for the Future", Speech at the Peterson Institute for International Economics.

European Central Bank, 2016. "The slowdown in U.S. labour productivity growth – stylised facts and economic implications", Economic Bulletin, Issue 2.

## Box 2.1 (Cont'd)

On structural forces, several plausible explanations have been put forward. One of them relates the productivity growth slowdown to the change in the US economic structure. Some economists noted that production in the US was increasingly specialised in upstream processes and the high-tech sector, which are more services-oriented, higher in value added and include discovering and developing new technologies, thereby entailing a slower rate of productivity growth<sup>(2)</sup>. However, productivity in different production stages in general could not be observed directly. Thus, this explanation lacks direct quantitative evidence for verification.

An alternative hypothesis contends that the US economy has been in a state of secular stagnation<sup>(3)</sup>, where a multitude of structural factors have led to a deficiency in aggregate demand, with excessive savings over investment. For example, with a rise in the average age of population, households on balance may increase their propensity to save for retirement. Also, the lack of investment could be due to a reduction in the capital intensity of the US economy, as fewer tangible capital is needed in a service-oriented economy, and the cost of start-ups has fallen visibly amid the rising prominence of technology and internet-driven businesses. Given the possible side effect of nominal interest rates being below zero and low inflation expectations, real interest rates may not be able to adjust sufficiently downward in the negative territory to balance savings and investment. Consequently, the economy may be stuck in a liquidity trap and negative output gap for a prolonged period.

Yet, the argument for the above hypothesis of secular stagnation also has its limitations. Indeed, a reduction in start-up costs could actually encourage more entrepreneurial activity, while the positive effects of population ageing on savings should in theory reverse at some point as more people reach the retirement age. Moreover, a recent study<sup>(4)</sup> showed that the returns on productive capital in the US rebounded quickly after the fall-off during the GFC, with the after-tax returns on business capital already exceeding the pre-crisis levels, way above the negative real rates predicted by the secular stagnation view.

Some economists focused on the supply-side impediments confronting the US economy, pointing out that such structural headwinds as diminishing gains from technological progress, population ageing, plateauing education attainment and overhang of private and public debt have lowered US potential growth<sup>(5)</sup>. A core part of this view is that the boost to labour productivity from the computer and internet revolution have petered out since 2000, while recent technological breakthroughs are not as transformative as those from before.

Nonetheless, since the innovative process is a series of discrete inventions followed by incremental improvements, it is premature to judge at this stage that recent technological innovations, such as robotics, big-data and bio-medical advances are necessarily less transformative and have smaller boosts to productivity growth<sup>(6)</sup>. Moreover, the extent to which an economy could make advances in technology and diffuse the benefits will also depend on policy choices, the regulatory environment and the underlying market dynamism.

---

(2) Sposi and Viridi, 2016. "U.S. Productivity Growth Flowing Downstream", Federal Reserve Bank of Dallas, Economic Letter, Vol. 11, No. 12.

(3) Summers, 2014. "U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound", Business Economics, Vol. 49, No. 2.

(4) Gomme et al., 2015. "Secular Stagnation and Returns on Capital", Federal Reserve Bank of St. Louis, Economic Synopses, No. 19.

(5) Gordon, 2012. "Is U.S. economic growth over? Faltering innovation confronts the six headwinds", Centre for Economic Policy Research, Policy Insight, No. 63.

(6) Mokyr, 2013. "Is technological progress a thing of the past?"  
(<http://voxeu.org/article/technological-progress-thing-past>)

## Box 2.1 (Cont'd)

Besides, there are conjectures that the impact of innovation gains on productivity could have been understated, as statistics may not have fully captured quality improvements and new products over time. Yet, some observers argued that such measurement issues had existed long before the US labour productivity growth slowdown. In addition, there are also doubts about the significance of mis-measurements of innovation gains if any<sup>(7)</sup>.

In sum, it remains unclear whether the slowdown in the US labour productivity growth is structural in nature, or whether it is purely transitory; hence the outlook for labour productivity growth will remain a key uncertainty facing the US economy<sup>(8)</sup>. Slow productivity growth, if protracted, would reduce US potential growth, especially given that labour force is expected to grow more slowly in the future. This would add impediment to the revival of international trade flows and the global economy in the period ahead. A wider issue is whether the slowdown in labour productivity growth may also be happening in other advanced and emerging economies.

As far as the formulation of monetary policy in the US is concerned, slower US labour productivity growth would entail a lower equilibrium real neutral rate of interest in the long run, which is the real interest rate consistent with output at its potential level and stable inflation over time.

**Table : Longer-run real GDP growth and Federal funds rate projections  
by US Fed FOMC participants in various periods**

Projections in	Real GDP growth (%)		Federal funds rate (%)	
	Central tendency	Median	Central tendency	Median
March 2014	2.2 – 2.3	n.a.	n.a.	4.0
June 2014	2.1 – 2.3	n.a.	n.a.	3.8
September 2014	2.0 – 2.3	n.a.	n.a.	3.8
December 2014	2.0 – 2.3	n.a.	n.a.	3.8
March 2015	2.0 – 2.3	n.a.	n.a.	3.8
June 2015	2.0 – 2.3	2.0	3.5 – 3.8	3.8
September 2015	1.8 – 2.2	2.0	3.3 – 3.8	3.5
December 2015	1.8 – 2.2	2.0	3.3 – 3.5	3.5
March 2016	1.8 – 2.1	2.0	3.0 – 3.5	3.3
June 2016	1.8 – 2.0	2.0	3.0 – 3.3	3.0
September 2016	1.7 – 2.0	1.8	2.8 – 3.0	2.9

Such view is gaining traction, as evident by repeated downward adjustments in longer-run US real GDP growth and Federal funds rate forecasts by the US Federal Reserve (Fed) in recent years<sup>(9)</sup> (*Table*). The median projection for longer-run GDP growth has been trimmed to 1.8% in September 2016, slower than the trend growth of 2.4% per annum in 1996-2015, and the median projection for longer-run Federal funds rate has also been scaled back. Moreover, uncertainties associated with the productivity growth slowdown also make the current state of the US economy and its growth prospects more difficult to assess, complicating the Fed's decision on the timing and pace of interest rate hikes.

(7) Byrne et al., 2016. "Does the United States Have a Productivity Slowdown or a Measurement Problem?", Brookings Papers on Economic Activity, Spring 2016.

Syverson, 2016. "Challenges to Mismeasurement Explanations for the U.S. Productivity Slowdown", The National Bureau of Economic Research, Working Paper 21974.

(8) Yellen, June 2016. "Current Conditions and the Outlook for the U.S. Economy", Speech at The World Affairs Council of Philadelphia (<https://www.federalreserve.gov/newsevents/speech/yellen20160606a.htm>).

(9) Yellen, August 2016. "The Federal Reserve's Monetary Policy Toolkit: Past, Present, and Future", Speech at the Jackson Hole Economic Symposium (<http://www.federalreserve.gov/newsevents/speech/yellen20160826a.htm>).

## *Imports of goods*

2.6 *Imports of goods* reverted to grow by 2.9% year-on-year in real terms in the third quarter, after declining marginally by 0.5% in the second quarter, due to the rebound in retained imports, while imports for subsequent re-exports also grew modestly further. *Retained imports*, referring to the imports for domestic use, which accounted for around one-quarter of total imports, reverted to a 6.3% year-on-year growth in real terms in the third quarter, after falling for five consecutive quarters, going in tandem with the visible pick-up in domestic demand growth in the quarter.

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

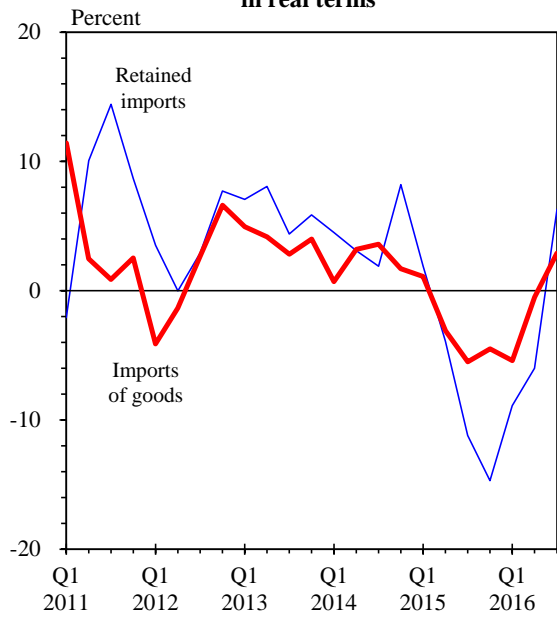
		<u>Imports of goods</u>			<u>Retained imports</u> <sup>(a)</sup>				
		<u>In value terms</u>	<u>In real terms</u>	<u>Change in prices</u>	<u>In value terms</u>	<u>In real terms</u>	<u>Change in prices</u>		
2015	Annual	-4.1	-3.2	-0.4	-10.4	-7.4	-1.8		
	Q1	1.4	1.1	(-1.6)	0.9	-1.2	1.9	(-4.7)	-1.9
	Q2	-3.2	-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
	Q3	1.2	2.9	(2.9)	-1.4	5.8	6.3	(7.2)	-0.5

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.

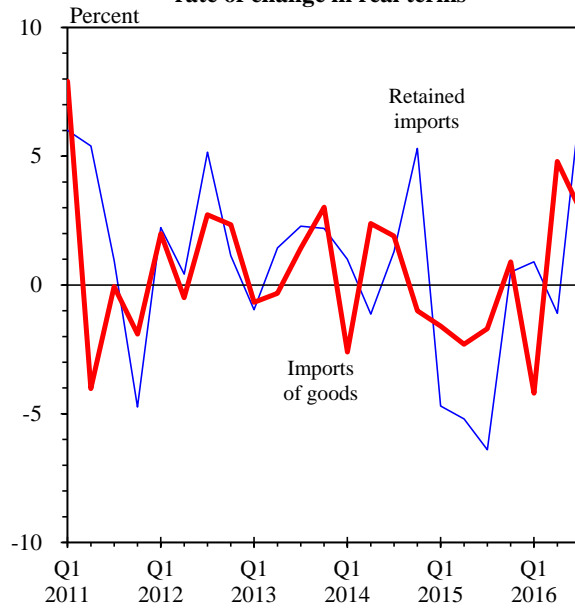
( ) Seasonally adjusted quarter-to-quarter rate of change.

**Diagram 2.12 : Both imports and retained imports reverted to year-on-year growth**

**(a) Year-on-year rate of change in real terms**



**(b) Seasonally adjusted quarter-to-quarter rate of change in real terms**

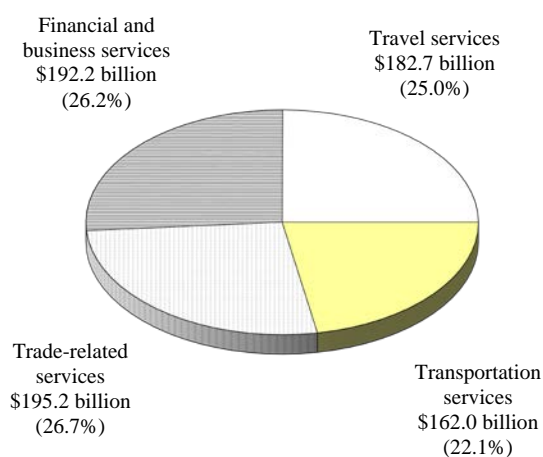


## Services trade

### *Exports of services*

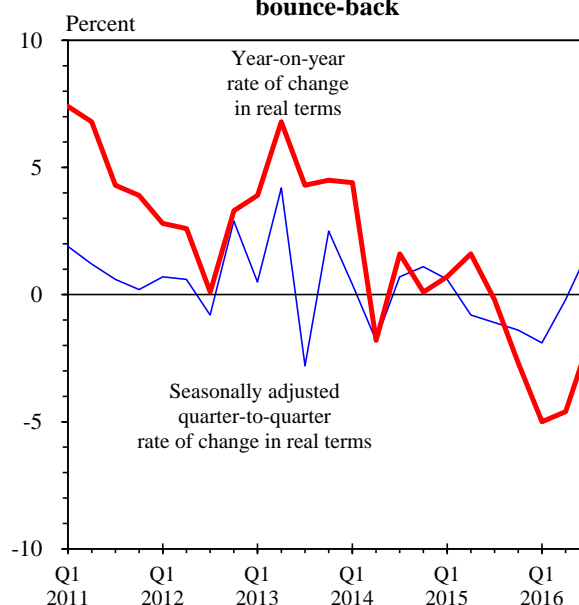
2.7 *Exports of services* also improved visibly in the third quarter, with the year-on-year decline tapering to 1.8% in real terms, markedly smaller than the 4.6% fall in the preceding quarter. The bounce-back on a seasonally adjusted quarter-to-quarter basis was more impressive, at 1.8%, ending five consecutive quarters of decline. The improvement was almost across-the-board. Upon the relative stabilisation in regional trade and cargo flows, exports of trade-related services (comprising mainly offshore trade activities) picked up slightly further in growth and exports of transportation services reverted to show modest growth. Exports of financial and other business services also saw a distinctly narrower decline, as fund-raising activities picked up during the quarter. Exports of travel services remained the weakest link, as visitor arrivals fell further amid a still-strong US dollar during the quarter.

**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 three quarters of 2016: \$732.0 billion*

**Diagram 2.14 : Exports of services improved visibly, showing a strong quarter-to-quarter bounce-back**



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

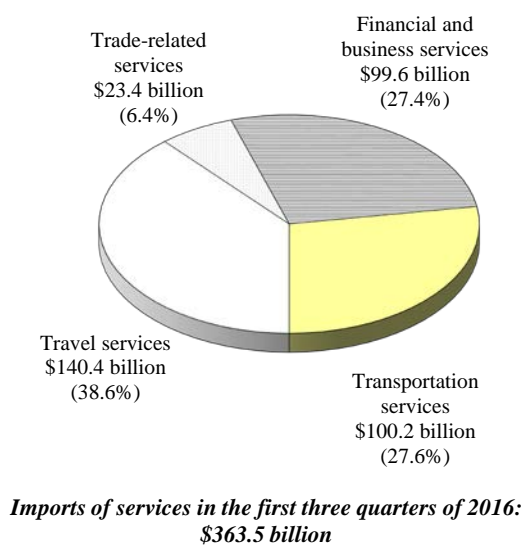
		<i>Of which :</i>					
		<u>Exports of services</u>	<u>Trade-related services<sup>(a)</sup></u>	<u>Transportation services</u>	<u>Travel services<sup>(b)</sup></u>	<u>Financial and business services</u>	
2015	Annual	-0.2	-1.8	0.2	-3.8	5.6	
	Q1	0.7 (0.6)	-1.4	1.8	-3.3	6.2	
	Q2	1.6 (-0.8)	-2.3	0.8	-0.8	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	-1.3	-9.8	-7.6	
	Q3	-1.8 (1.8)	0.6	1.8	-9.0	-0.7	

- Notes : (a) Comprising mainly offshore trade.  
 (b) Comprising mainly inbound tourism receipts.  
 ( ) Seasonally adjusted quarter-to-quarter rate of change.

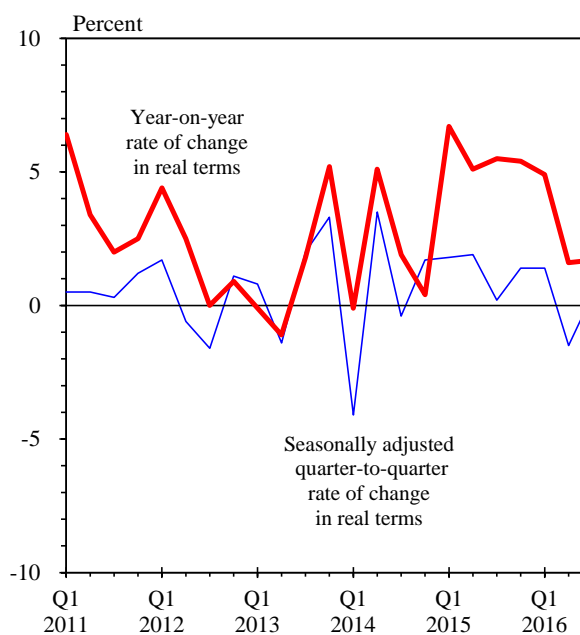
### ***Imports of services***

2.8 *Imports of services* grew slightly further by 1.7% year-on-year in real terms in the third quarter, similar to that of 1.6% in the second quarter. Imports of travel services grew moderately further, as stable job and income conditions continued to underpin local residents' interest to travel overseas. Imports of trade-related services made tepid growth in the third quarter, amid stabilising regional trade and cargo flows. Yet, those of transportation services edged down. Imports of financial and other business services grew modestly further, on the back of the improved sentiment in global financial markets, while cross-border commercial activities sustained growth.

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



**Diagram 2.16 : Imports of services grew slightly further**



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

*Of which :*

		Imports of services				
		Imports of services	Travel services <sup>(+)</sup>	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	1.6 (-1.5)	2.8	-1.0	0.4	2.8
	Q3	1.7 (0.4)	4.0	-1.4	0.6	2.1

Notes : (+) Comprising mainly outbound travel spending.

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



## Goods and services balance

2.9 The goods deficit widened somewhat in the third quarter from a year earlier, as retained imports rebounded amid visible acceleration in domestic demand growth while goods exports grew only modestly further during the quarter. With the services surplus more than offsetting the goods deficit, the combined goods and services account still registered a notable surplus of \$35 billion in the third quarter, equivalent to 2.9% of total import value. The corresponding figures were \$51 billion and 4.2% respectively in the third quarter of 2015.

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

		<u>Total exports</u>		<u>Imports</u>		<u>Trade balance</u>			<u>As % of imports</u>
		<u>Goods</u>	<u>Services</u>	<u>Goods</u>	<u>Services</u>	<u>Goods</u>	<u>Services</u>	<u>Combined</u>	
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	118	-127	109	-18	-1.6
	Q3	989	261	1,089	126	-99	135	35	2.9

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

(\*) Within  $\pm$ \$0.5 billion.

(#) Within  $\pm$ 0.05%.

## **Other developments**

2.10 The Government strives to foster closer trade and investment relations between Hong Kong and its major economic partners, in particular the Mainland. In September, the 19th Plenary of the Hong Kong/Guangdong Co-operation Joint Conference was held, setting out directions for co-operation between the two sides in the coming year in such areas as the Belt and Road Initiative, finance, innovation and technology and professional services. Nine co-operation agreements were signed after the meeting, including, among others, Letter of Intent on Guangdong-Hong Kong Co-operation in Participating in the Belt and Road Initiative, Co-operation Agreement on Guangdong-Hong Kong Co-operation in Taking Forward the Development of China (Guangdong) Pilot Free Trade Zone and Co-operation Agreement between Guangdong and Hong Kong on Tourism.

2.11 Trade facilitation would also help enhance our competitiveness and create new business opportunities. In this regard, Hong Kong Customs signed the Joint Administrative Arrangement on Smart and Secure Trade Lanes (SSTL) Pilot Project Phase 3 in July with the Customs representatives from the Mainland, the European Commission and 15 EU member states. SSTL would enable traders to enjoy more efficient and predictable cargo clearance at both exporting and importing ends, enhancing the network of trade flows between these economies. Separately, in August, the Hong Kong Customs and Japan Customs signed Mutual Recognition Arrangement (MRA) to mutually recognise the Authorised Economic Operator Programmes of both sides, marking the seventh MRA that Hong Kong has concluded with other Customs administrations. The MRA should help facilitate and secure trade flows between the two economies.

## Box 2.2

### “Spaghetti bowl effect” of free trade agreements

In any World Trade Organization (WTO) agreement, one of the fundamental principles is that all members must trade among themselves without discrimination. For instance, all members have to offer each other the most-favoured-nation (MFN) treatment, meaning that a lower tariff rate offered by one member to another must be extended to all other members. Noting the increasing difficulty in negotiating trade agreements that are applicable to all WTO members in recent years, economies around the world have instead turned to forging webs of bilateral or regional free trade agreements (FTAs) as an alternative approach to pursue further trade liberalisation<sup>(1)</sup>. While the rapid proliferation of FTAs (some 340 FTAs have notified the WTO since 2000, as compared to only 75 from 1958 to 1999) has understandably created trading opportunities across borders and thereby economic benefits, there have also been discussions among researchers on the consequence of the crisscrossing of multiple FTAs, which is also known as the “spaghetti bowl effect”<sup>(2)</sup>, that could undermine the potential gains of these FTAs.

Multiple and overlapping FTAs increase the transaction costs for international trade mainly because of their differentiated requirements that firms need to fulfill. On one hand, each and every FTA has its unique set of rules of origin (ROOs) to be complied with for the trade to enjoy preferential tariff rates<sup>(3)</sup>. However, the extensive global production chains nowadays mean that the manufacturing process of a merchandise could involve value-added activities in many economies along a trade route that is covered by several FTAs, and the differentiated ROOs of each FTA could render the production unable to take full advantage of all the preferential treatments along the production chains. For example, a study found that the ROOs of FTAs in the Americas alone consisted of a dense tangle of over 38 annexes of rules per product and 24 regulatory chapters operating simultaneously in 2007<sup>(4)</sup>. Such complicated or even restrictive ROOs and technical standards could pose obstacles to firms’ utilisation of these FTAs, as the adoption of intermediate inputs from a FTA signatory by a producer in another signatory might have affected the preferential status of the finished product. The possible hindrance could be showcased with three hypothetical bilateral FTAs between three economies (say, Economies A, B, and C). Assuming there is no provision for cumulation in any of these FTAs<sup>(5)</sup>, it is possible that even if Economy A merely assembles the intermediate inputs originating from the other two and exports the finished goods back to them, the final product from Economy A may still not be able to enjoy the preferential

- (1) The arrangement of FTAs, which allows signatories to grant more favourable treatments to each other than to the other WTO members, is permitted by the WTO as an exception to the MFN treatment principle, so long as such an arrangement observes the conditions stipulated in the relevant provisions of the WTO agreements.
- (2) The term was first used in the paper by Bhagwati, J.N, (1995), “US Trade Policy: The Infatuation with FTAs”, Columbia University Discussion Paper Series 726, New York: Columbia University.
- (3) As defined by the WTO, ROOs are the criteria needed to determine the national source of a product. However, there is wide variation in the practice of governments with regard to the ROOs and there is no single set of harmonised rules governing the determination of the country of origin of goods in international commerce.
- (4) Cornejo, R. and Harris, J.T. (2007), “Convergence in the Rules of Origin Spaghetti Bowl: A Methodological Proposal”, Inter-American Development Bank Working Paper 34.
- (5) The concept of “cumulation” (or “cumulative rules of origin”) allows the use of intermediate inputs that have obtained originating status in one signatory to be further processed or added to products originating in another signatory as if they had originated in that latter economy, without the finished product losing the benefit of preferential customs tariffs.

## Box 2.2 (Cont'd)

treatments if the ROOs are too restrictive<sup>(6)</sup>.

On the other hand, the differentiated FTAs would also incur additional costs to firms. On top of the various administrative burden (such as certification costs and procedures), a large number of FTAs could also expose or exacerbate conflicting technical standards and requirements, thereby increasing the compliance costs and hindering market access that is in contrary to the original intention of the FTAs. Understandably, the more overlapping the FTAs are, the more complex are the rules, and the more likely the benefits of lower tariffs under the FTAs are offset by the higher compliance costs. In the worst case, firms may even choose not to take advantage of the FTA preferential tariffs when exporting their products to other signatories, leading to a decline in the utilisation of the FTAs.

Moreover, the situation is further complicated by the fact that international trade in modern days has gone beyond trade in goods. Very often, trade in goods is complemented by trade in services, and involves such other regulatory aspects as intellectual property rights, investment, competition, government procurement, and labour and environmental standards. While the FTA negotiations in recent years have increasingly addressed these important areas, they remain the areas that are likely to have larger discrepancies across economies because of the relatively short history of international cooperation. Without reconciliation on the terms and standards across FTAs, these would only add more dimensions of differentiated requirements on international trade, exacerbating the “spaghetti bowl effect”.

In 2011, the Asian Development Bank had conducted a survey study on evaluating the benefits and costs of a selected set of FTAs covering the East Asia<sup>(7)</sup>, sampling hundreds of firms in six Asian economies<sup>(8)</sup>. According to the study, while these firms typically reported more benefits than costs from those FTAs, there were 20% of respondents saying that multiple ROOs (i.e. a major aspect of the “spaghetti bowl effect”) did add significantly to their business costs. In particular, a further econometric investigation based the survey data suggested that the larger firms with longer operational history, i.e. those that tend to export to multiple markets and change their business plans in response to FTAs, are more likely to express concerns about business costs of multiple ROOs. Separately, 41% of respondents saw benefits from adopting some harmonised ROOs, particularly among those large firms with presumably more extensive upstream or downstream operations linked up in the region.

---

(6) For example, if the FTAs signed by Economy A with Economies B and C require a certain minimum ratio of value added taken place in economy A (say, 40%) to the total value of the final product in order to be eligible for the preferential tariff under those FTAs, the assembly process alone in Economy A might probably entail a ratio that is too low (say, 10%) to be eligible.

(7) Kawai, M. and Wignaraja, G. (2011), “Asia’s Free Trade Agreements: How is Business Responding?”, Asian Development Bank and Asian Development Bank Institute.

(8) The six economies refer to Japan, the Mainland China, Korea, Singapore, Thailand and the Philippines. There were 841 firms surveyed, yet the number of respondents to each aspect of the survey might vary somewhat.

**Box 2.2 (Cont'd)**

In a nutshell, the cost entailed in one single FTA encompassing a number of economies would be much smaller than that in numerous FTAs covering the same set of economies, and therefore more benefits will be generated. As such, the Government has long been a staunch supporter of multilateral trade agreements. To this end, the Government is actively participating in the development of the Free Trade Area of the Asia-Pacific, which if realised would cover most of the economies around the Pacific Rim. Promoting free trade on a multilateral basis and its continual enhancement are particularly important for Hong Kong, given our highly open economy with trade amounting to more than four times of GDP and our role as an important trading node with extensive trading networks covering a large number of economies. The Government will continue to work on these government-to-government platforms, with a view to enhancing Hong Kong's long-term economic growth and development.

## 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.